The property cycle deepens in Australia

The Australian property market has hit a cyclical inflection point that will see intensifying capital pressures force the hands of many real asset owners and creditors over the next two years.

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The lagged effect on Australian unlisted property markets of material and enduring shifts in monetary policy is well documented. Put simply, Australia is often slower to feel the impact of economic stress than other leading OECD economies. But history tells us that financial shock is more often delayed than avoided. And the most recent opportunities identified by the Dexus opportunity fund, Dexus Real Estate Partnership 1 (DREP1), suggest that a cyclical recalibration of property markets is already in train.

Owners, borrowers and lenders are already re-casting financial models designed to prosper through an era of low interest rates, looser credit, modest inflation and resilient consumer confidence.

Australia is now 18 months into the most rapid increase in interest rates on record. The market has started digesting the size and duration of these interest rate moves. We have seen the listed property market re-price with shares trading at a large discount to net tangible assets. We have seen credit markets re-price too, with borrowers paying wide margins because of the scarcity of capital available for real estate generally and development particularly. And now we are starting to see the unlisted real estate market re-price. This is the point of the cycle where people will be forced to act, where they just will not be able to keep holding on. And that means we are entering a period of opportunity for those with access to capital and management nous.

We have seen this trend overseas. We have all heard about institutional owners handing back the keys to office buildings in the US because debt is higher than the value of the asset. Australian office fundamentals are much better than the US but it's an example of what can happen at points in the cycle.

2024 is possibly a point where the changed monetary environment could generate stresses across multiple layers of the entrepreneurial property market and across multiple classes of the property ecosystem. Some investors will be forced to act.

Our view is that we are already at the point where forced activity is happening and the pressures are accumulating on those who entered this marketplace through the tail end of an investment cycle that has now evolved.

What we are seeing with changing interest rates and inflation is both structural and cyclical repricing.

The opportunity in structural market dislocation

Structural repricing is the response to an expectation that we will have higher rates for longer. In an environment where the cost of capital is high, some real estate is not valued as much as it was at other points of the rate cycle.

As we launch a second opportunity fund, Dexus Real Estate Partnership 2 (DREP2), we are entering the cyclical over-reaction that is caused by illiquidity in some parts of the market.

The DREP1 investment pipeline is dominated by special situation transactions. We have now done 11 deals in this fund and the four latest deals are special situations investments - investment made from forced sellers in need of either capital or fast-paced acquisition. DREP1 is a fund built to target these sorts of special situations, but it is only through the past six months that this potential has opened up.

Through that period we have invested $100 million into the Melbourne apartment market in three deals that have secured financial standing of the targeted developments and delivered high yielding properties at a significant discount to market values. We are now leasing the acquired properties into a market where rental vacancies are running at 1% or less and where rents are rising at double-digit rates annually. And we have an ownership horizon of two to three years with a plan to eventually sell the assets into a market where buyers have recovered confidence, but where there is a structural under-supply of residential apartments.

That, in a nut-shell, is the value that structural change and considered cyclical opportunism can deliver.

Cyclical opportunism: Vintage matters

The recent special situation deals also serve to identify the importance of vintage in property. If you look at the data on global opportunistic real estate returns, what it shows is that the year you invest – the investment vintage - really matters. And the highest performing vintages are those that follow periods of recalibration and disruption.

So if we are at or near peak inflation, we are approaching peak rates, then history would suggest we are entering the period of investment outperformance, a period of really strong investment vintage potential in the opportunistic investment space.

What we are now aiming for with DREP2 is to take advantage of the cyclical over-reaction that is caused by illiquidity. Some investors are down weighting because they are cautious and we are seeing bank lenders constrain capital as they re-weight the risk profile of real estate investments generally and new construction in particular. In the end, that flows through to leverage and pricing. Investors will be forced to make choices: pay more for debt or accept less in selling their assets. We are able to take opportunity in the credit part of the capital stack and the equity part. Whether that comes from strong returns for the risk we are taking in credit, or really attractive buying opportunities in equity, we have the ability to take advantage of it.

Our existing and future opportunity real estate funds have a mandate to invest in situations from distress through to growth and to pursue opportunities right through the capital stack across all of the real estate sub-sectors in Australia. It is a broad mandate. It allows us to go to the sector where the opportunity lies and to the part of any capital structure where the best risk-weighted opportunity lies. So we are not constrained to one sector or one part of the capital stack.

A differentiating advantage over the pure financial players in our markets is the strength of Dexus's fully integrated real estate operating platform that our funds utilise. Leveraging this operating capability when underwriting and managing investments enables us to be agile in identifying opportunities, delivering meaningful solutions and securing the opportunity returns.

What that allows us to do is to target opportunities that require both capital and management capability. This umbilical relationship has proven a pivotal advantage to DREP 1 in sourcing proprietary opportunities and the ability to step directly into management of any underperforming credit situations.

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