YIELD OF DREAMS:

WHERE TO INVEST FOR TOP REAL ESTATE EQUITY RETURNS IN 2024 AND BEYOND

KEY TAKEOUTS:

Higher for longer is here to stay: investors need to look for higher, risk adjusted income returns *of at least 6%+ on equity, in the current cycle.*

Sectors best placed to deliver these returns include hospitality, industrial, residential build to sell and counter cyclical office investments *over the next 12-24 months.*

Longer term, portfolios with a balanced mix of private credit and equity strategies will maximise income performance, *whilst minimizing downside risk.*

INTRODUCTION

AS THE OLD ADAGE GOES, A BIRD IN THE HAND TODAY, IS WORTH MORE THAN TWO IN THE BUSH TOMORROW. ACHIEVING STRONG RISK ADJUSTED REAL ESTATE INCOME RETURNS ON EQUITY INVESTMENTS, THE "CASH ON CASH" YIELD IN A VOLATILE ECONOMIC AND INVESTMENT ENVIRONMENT IS BECOMING HARDER TO FIND.

From 2010 to 2021, nearly all commercial real estate asset classes moved in positive synchronisation as the zero rates environment pushed values higher, and the post GFC tech and financial services boom created record levels of occupier demand.

However, as inflation re-emerged in 2022, and central banks responded with sharp interest rate hikes, investors relying a forever low rate environment Had to broaden their view to achieve appropriate risk adjusted returns.

Set against a backdrop of the prevailing "higher for longer" economic environment, and increasing geopolitical instability, allocating capital into various real estate sectors is proving complicated, given the wide variety of investment strategies on offer.

Not all sectors perform consistently through cycles, and in the current valuation environment, where the spread between market and book prices are widening, the 'mark to market' is more challenging that usual as the performance of sectors is significantly dislocated.

Crafting an "all-weather" real estate investment portfolio in this investment environment, where you can generate returns comfortably above those offered in the more liquid fixed income markets, requires a more active approach to due diligence.

Investors will need to take a deeper look at the underlying sectors and the sources of their cashflows, as well as the structural drivers of pricing growth.

Forecasting income returns in the current, volatile economic environment is becoming far more challenging and creating greater uncertainty around real estate distribution yields. For investors, this means they are now shifting their focus to the cash yield, over the terminal yield, choosing the certainty of the assets cashflow in the near term, over long dated market risk.

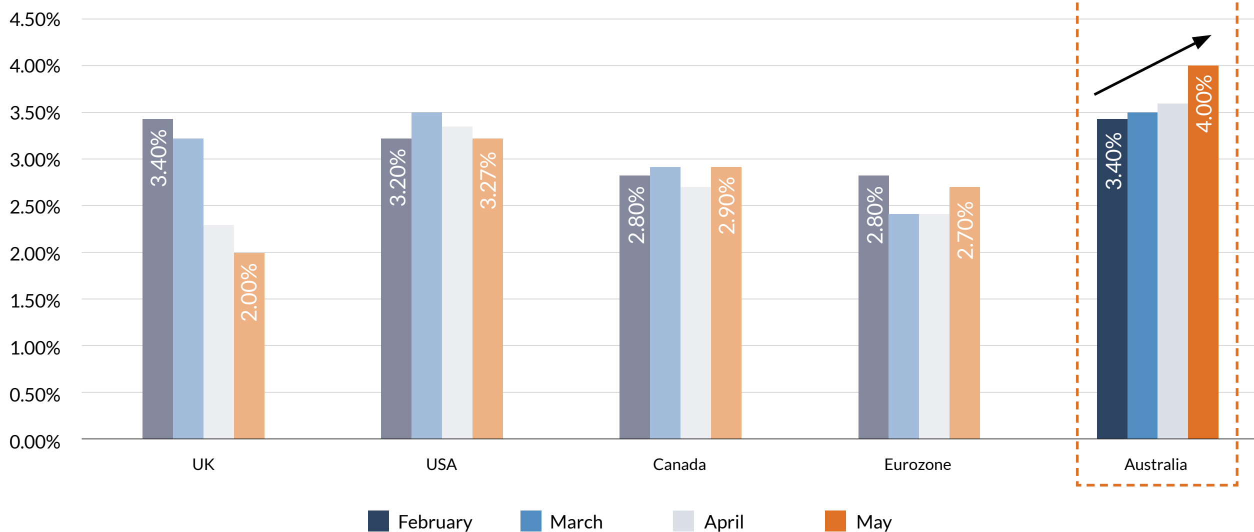
In this paper we outline the structural challenges facing the real estate market, and how they are influencing the performance of each sector, and our playbook on how to allocate capital in order to maximise income yields on your equity investments. Determining the right equity strategy is critical, and comes down to your risk appetite as either a "wave maker", who engineers returns through more opportunistic investments. Or a "wave rider", who invests in thematics linked to long term growth tailwinds.

THE INFLATION TREND IS NOT OUR FRIEND... BUT THERE ARE OPPORTUNITIES

AT THE TIME OF WRITING, THE HEADLINE INFLATION RATE IN AUSTRALIA IS EDGING UPWARDS, IN STARK CONTRAST TO OUR BENCHMARK ECONOMIES SUCH AS THE UK, US, EUROZONE AND CANADA.

Unlike these developed economies, where inflation has been tamed, and cash rates have been cut, Australia's inflation remains stubbornly sticky, linked to core components of the household wallet.

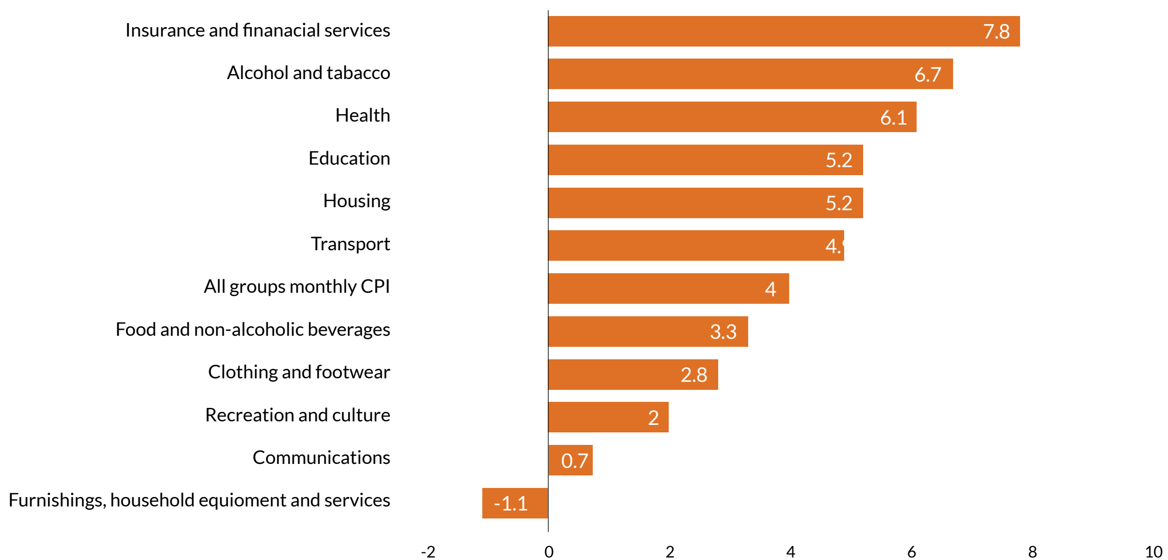
WHEN THE TREND IS NOT YOUR FRIEND:
AUSTRALIAN INFLATION GOES UP AS THE DEVELOPED MARKETS FALL



Source: Bloomberg

AS AT MAY, HEADLINE INFLATION IN AUSTRALIA ROSE FROM 3.6% TO 4.0%, THE THIRD MONTHLY RISE SINCE MARCH. THE BREAKDOWN BY CATEGORIES SHOWED THAT RENTS, PETROL, INSURANCE, UTILITIES AND TOBACCO WERE AMONGST THE HARDEST HIT.

INFLATION DRIVERS BY CATERGORY



Source: ABS

So long as inflation remains above the Reserve Bank's target band of 2% to 3% through the cycle, then rates are unlikely to unlikely to be cut anytime soon, ushering in a higher for longer rates era. The good news for real estate investors is that property income is typically inflation adjusted, providing a natural hedge against inflationary shocks through cycles. This is why the income fundamentals of the underlying assets are so important when making investment decisions. But more on that later…

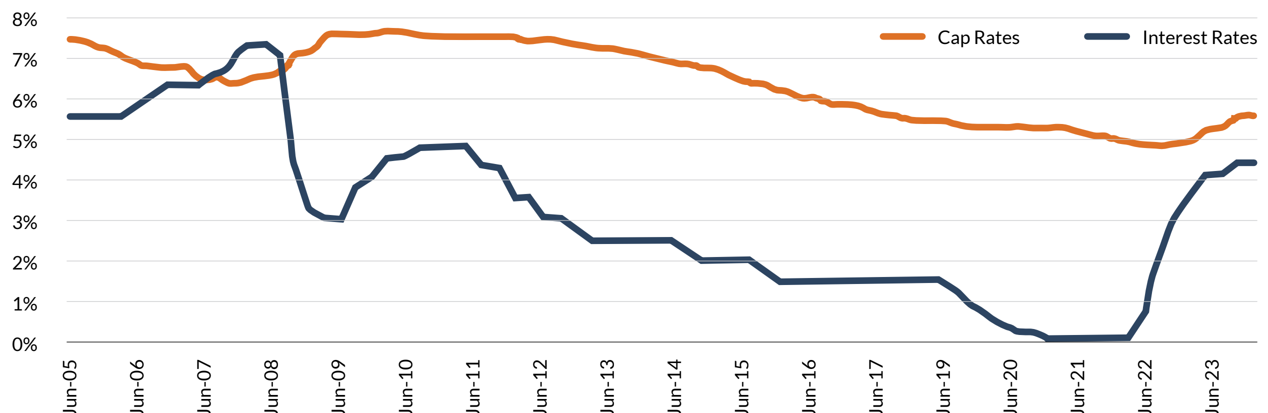
WISHING, HOPING, PRAYING...

The harsh reality of real estate investing now, is that cashflows are less certain, and more beholden to macro events than in previous cycles. Macro conditions are more volatile, business and consumer sentiment is weak, making it more complex to pick winners than in the zero rate cycle of last decade.

THE HOPE OF EVER RETURNING TO A ZERO-RATE ENVIRONMENT IS AKIN TO HOPING FOR THE RETURN OF ELVIS PRESLEY. IT AIN'T COMING BACK.

The zero-rate environment was in reality an aberration, designed to achieve a short term macro outcome post GFC and during the early days of the COVID-19 pandemic, to preserve employment and promote growth. Since 1994, the average cash rate in Australia has been 412 basis points, only 23 basis points off today's rate. If rate cuts were to occur in the near term, even in the midst of a mild recession, the best that could be hoped for is a short cutting sprint, before settling at between 300 to 350 basis points longer term. Resulting in a similar cooling of Treasury bonds, with yields likely to settle at between 300 to 350 basis points.

THE RELATIONSHIP BETWEEN INTEREST RATES AND CAP RATES



Source: CBRE Research, RW Capital Research

This discussion around rates is important one in the context of real estate investment, and are a large contributor to why we have seen such significant pricing discounts being applied to unlisted and listed real estate funds, typically backed by institutional investors such as pension funds and insurance groups.

A major driving of this discounting has been that as rates and bond yields have lifted, the valuations on core real estate assets, still being priced at pre-Covid peak book values, are insufficiently pricing the risk and offering lower income returns compared to their risk free counterparts

According to our analysis of commercial real estate returns, investment grade commercial real estate in Australia offers investors an average net income return of 5.0% as of March 2024. Closer to home, I could walk across the street to a bank and get a term deposit for 5.25% or even 5.5% in some cases, with no risk and a free underwrite from Albo.

The point here is that until income returns on real estate assets are truly reflective of their risk, price declines will continue. By our tally there is approximately $3 billion worth of office product coming to market or currently being closed in Australia, with an average discount of 15% off current book value, the peak to trough valuation spread could be as high as 30% in some cases.

Taking a counter cyclical mindset, as commercial real estate pricing resets it will present new opportunities to re-enter the market, at fairer values. This is already occurring to some extent in the office market, shifting the balance of power away from institutional capital to private capital. The first sign of a nascent recovery in most cycles.

THE GOOD NEWS IS THAT THERE ARE STILL OPPORTUNITIES IN SOME REAL ESTATE SECTORS FOR SOLID, RISK ADJUSTED RETURNS, ENABLING INVESTORS TO RIDE OUT THE WORST ASPECTS OF THE DOWNTURN.

THE NEW RETURN PARADIGM

With inflation up, and staying up for the foreseeable future, investors need to adjust their real estate equity return expectations from what would have prevailed in the previous cycle. As a standardized benchmark for risk, return and fair value, a 200 to 300 basis point positive spread on real estate yields to the ten year government bond yield (currently 445 basis points) would mean that you need to be achieving a net distribution of 645 to 745 basis points in net income to justify the risk.

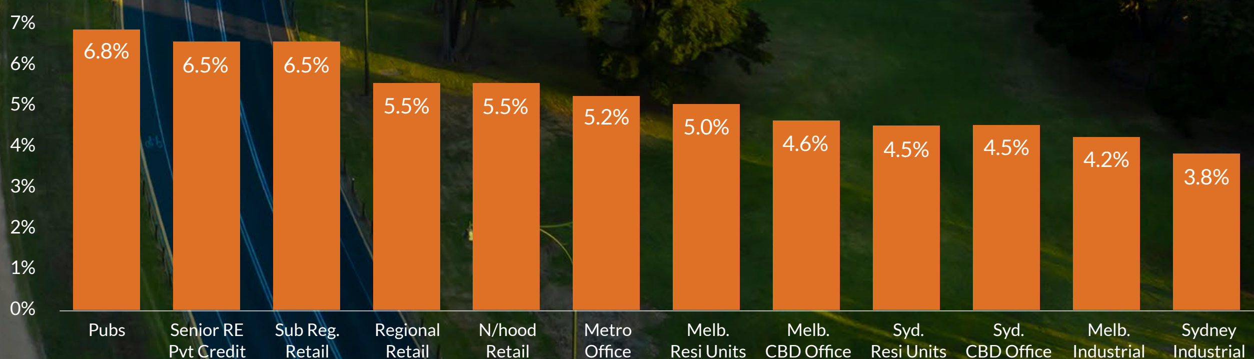
BASED ON THIS NEW BENCHMARK, 'CORE' SECTORS SUCH AS PREMIUM CBD OFFICES, SUPER REGIONAL RETAIL CENTERS AND SOME LARGE FORMAT INDUSTRIAL PRODUCT, LOOK MATERIALLY UNATTRACTIVE FROM AN INCOME PERFORMANCE PERSPECTIVE.

Defensive cashflow assets, with attractive yields are harder to find in a higher rates environment, however there are still good investment opportunities available, that can deliver the stable, risk adjusted property yields.

Investors are now focused on genuine growth in the income, not the terminal yield which is a reflection of CPI and fixed rent reviews, which do not account for cyclical risk and expose investors to potential long term downside.

Returns data we analysed from recent transactions suggests that pubs, sub regional retail, and senior private credit offer the best risk adjusted income distributions at the moment. Other sectors such as CBD office and prime industrial are being re-rated as more assets come to market and the pricing gap between book values and market values narrows. Once the full repricing has occurred, we anticipate that longer term yields on these asset classes will look materially more attractive.

THE HUNT FOR YIELD
WHAT SECTORS ARE DELIVERING THE BEST INCOME RETURNS



Source: RW Capital Analysis, Bloomberg

NOW FOR THE GOOD NEWS...

AUSTRALIA'S REAL ESTATE SECTOR IS RESILIENT AND HAS PROVEN ITSELF TIME AND TIME AGAIN AS A SOLID DELIVERER OF YIELD TO INVESTORS.

At a macro level, the rules of investment however remain the same, sector and geographical selection are the most important drivers of success in generating return. The unknowns are also more known, we know rates are in an elevated cycle, and we know that the broader sector is resetting pricing and risk. So with this in mind, it becomes easier to craft a strategy more suitable to prevailing market conditions.

Investors face two choices when selecting investments for their portfolios. They can move up the risk curve into more opportunistic investments, that prioritise hands on asset management, gearing, capital improvements and leasing risks. Or you can adopt a longer term approach, more suited to riding out multiple cycles with lower volatility, recession resistant cashflows.

Both strategies have their merits, and risks, however core to both of them is picking the right sectors at the right point in the cycle.

RISING INTEREST RATES AND BOND YIELDS MEAN THAT THE SPREADS BETWEEN REAL ESTATE RENTAL INCOME AND RISK FREE PRODUCT HAVE NARROWED SHARPLY, WHICH MAY RESULT IN CONTINUING FALLS IN COMMERCIAL REAL ESTATE PRICES.

ARE YOU A WAVE MAKER? OR A WAVE RIDER? HOW TO FILTER INVESTMENT OPPORTUNITIES IN THE CURRENT CYCLE

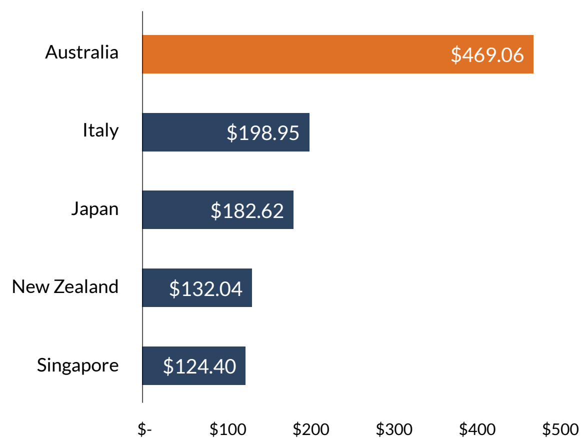
INVESTORS CAN EITHER SHAPE THEIR RETURNS THROUGH ACTIVE MANAGEMENT, AND MOVING UP THE RISK CURVE (WAVE MAKERS) OR PLAY THE LONG GAME AND BET ON LONG TERM THEMATICS THAT SUPPORT STABLE, PASSIVE RETURNS (WAVE RIDERS).

Where you sit on that spectrum will depend on your risk appetite and investment goals, however there are some key strategies you should consider before embarking on either approach.

The four key filters *informing our investment allocation strategies over the next twelve to eighteen months are built around achieving outsized returns, whilst managing downside risk through supportive macro and local factors.*

1. Cash on cash yield: Strong underlying cashflows – *According to our analysis of recent valuations, commercial real estate has achieved an average of 4.7% income returns in the last five years. Over the last four decades, very few commercial real estate sectors have been able to withstand economic shocks. However, the pub sector bucked this trend, particularly in New South Wales which has been a standout for its resilience through cycles. The drivers of this resilience are three-fold. Firstly, gaming revenue as a percentage of pub revenue is approximately 35%, typically through poker machines. Gaming in general has proven resilient in all economic cycles, the most recent gaming data from the New South Wales hotels shows that in the year to June 2024, average daily net gaming revenue in hotels grew by an estimated 1.90%, despite softer economic conditions and elevated interest rates. NSW Government gross gaming revenue data from 2018-2023 further reinforces this trend, with growth in gaming revenue trending upwards by 6% in the year to December 2023. From a yield and resilience perspective, hotels and pubs have the right income ingredients to offer favorable, risk adjusted returns.*

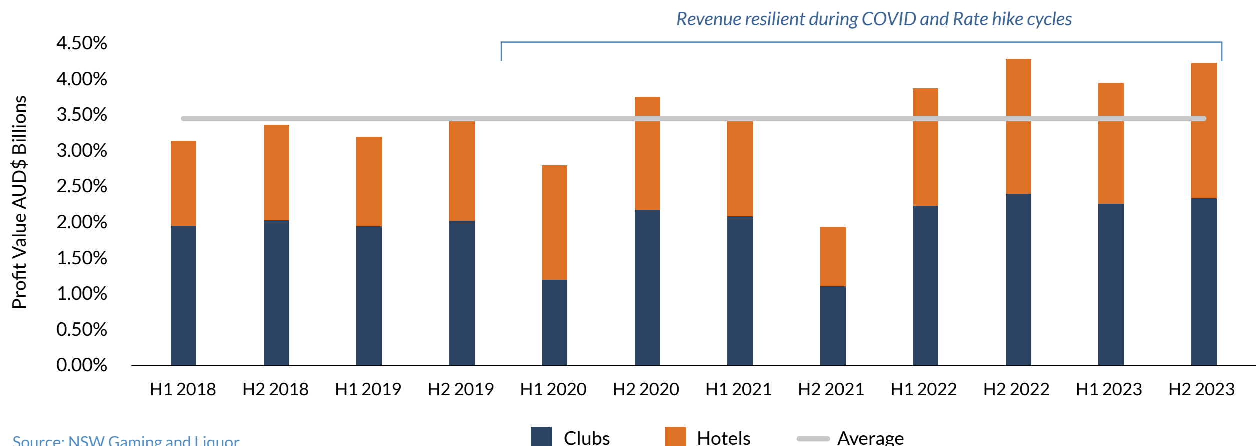
GAMING MACHINE SPENDING PER ADULT 2023 (US$)



Source: H2 Gambling Capital

The pre-covid obsession with long WALE and fixed rental increases has shifted towards a focus on real income growth, marked to market and linked to sustainable, long term fundamentals.

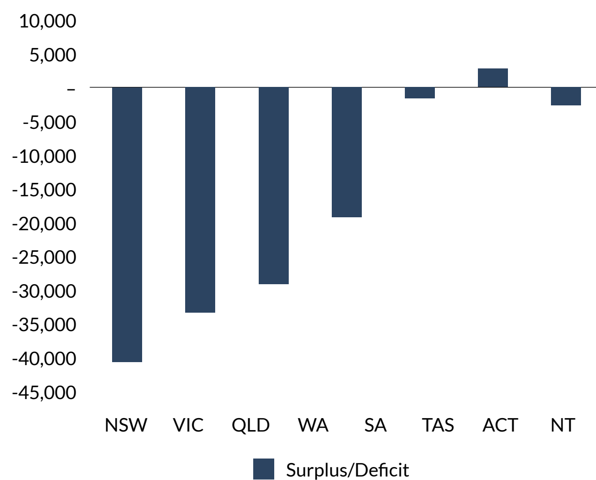
PUBS AND CLUBS GAMING PROFITS



Source: NSW Gaming and Liquor

2. Supply/Demand Imbalances – *Australia's housing crisis is in large part a product of poor planning decisions and skyrocketing construction costs which in spite of rising mortgage rates, are driving continued housing price growth. Population growth is also playing its part, with politicians now in a bidding war to outdo one another on reducing migrant intakes. Between September 2022 and 2023, there was a shortfall of 123,000 dwellings based on net migration and housing delivered. Whilst supply levels in the housing market remain muted, and population growth remains at elevated levels prices will continue to grow.*

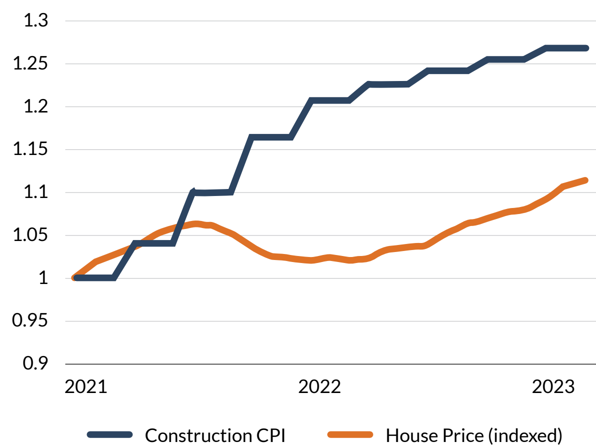
POPULATION GROWTH VS HOUSING DELIVERED BY STATE
SEP 22 TO SEP 23



Source: ABS

Additionally, housing price inflation is growing at a slower rate than the cost of building them, a structural trend driven by labour scarcity and delays on projects push up the cost of building across most markets, with no easy solution to this issue in sight.

CONSTRUCTION PRICE GROWTH VS DWELLING PRICE GROWTH

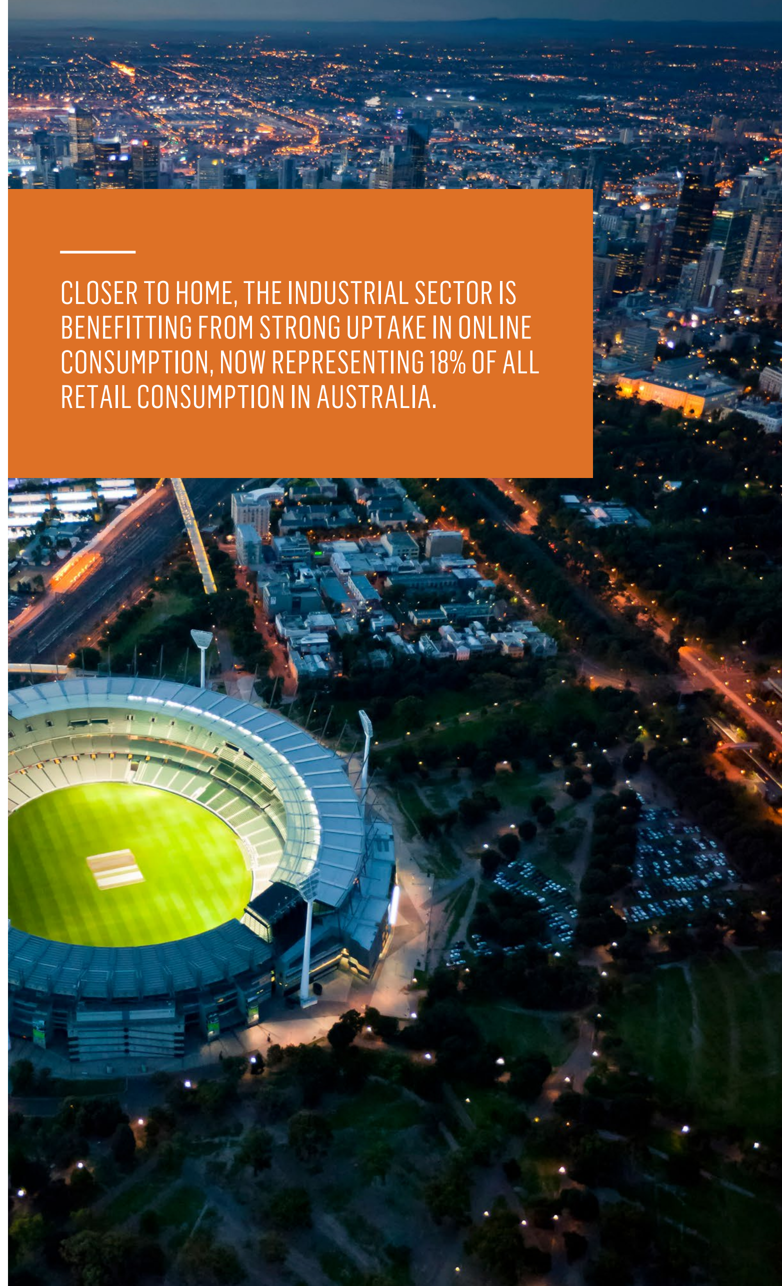


Source: Neoval, ABS

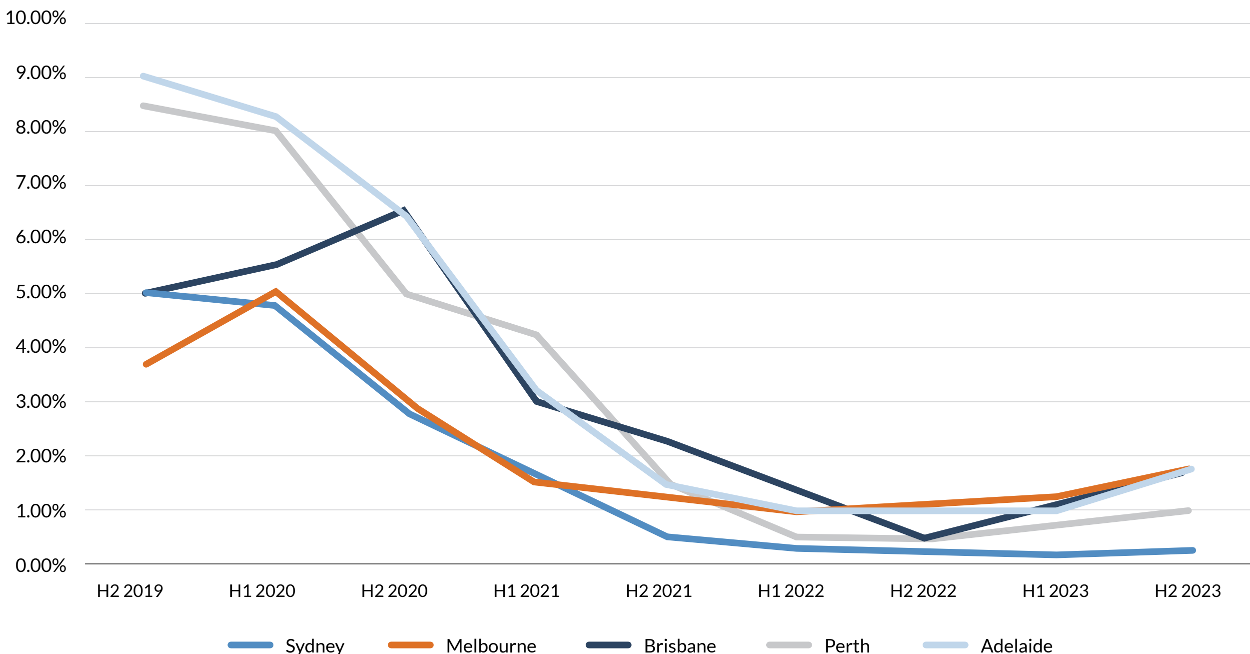
3. Cyclical Pricing dislocation – *Real estate is a cyclical asset class, as the more passive end of investment spectrum, primarily core CBD office and super regional retail enters a repricing period, history tells us that what goes down will eventually go up. High office vacancy rates, weak ongoing demand and steep discounting by office sellers may create medium to long term upside for investors willing to take on leasing risk, and hope for the eventual reversal in interest rates and bond yields, will make equity investments materially more attractive again.*

4. Play the long game: Long term demand thematics – *sectors such as housing, industrial and emerging sectors such as data centers and retirement living are benefitting from long run, demand thematics linked to global structural shifts in demographics and economics. Closer to home, the industrial sector is benefitting from strong uptake in online consumption, now representing 18% of all retail consumption in Australia. This in turn is driving the demand for warehouse and logistics facilities, pushing industrial vacancy rates below 2% in all major Australian markets according to CBRE's vacancy counts.*

Similarly in the residential market, Australia's continuing strong population growth, historical pent up demand and weak supply response points to sustained pricing growth over the long term. According to our analysis of over 40 years of transactions, investors in commercial real estate would have achieved an average 9.7% annual return since 1985. Taking a long term view of 10 years plus, by investing in markets and sectors with consistent, strong underlying growth drivers is always a recipe for investment success.



INDUSTRIAL VACANCY RATES
H2 2019 – H2 2023



Source: CBRE Research

STANDOUT SECTORS FOR THE CURRENT CYCLE & PLAYBOOK

BASED ON OUR INVESTMENT FILTERS WE'VE SELECTED SIX SECTORS WE BELIEVE WILL DELIVER THE RETURNS INVESTORS REQUIRE IN THE CURRENT HIGHER FOR LONGER INVESTMENT ENVIRONMENT.

Sectors	Investment Thematic	Outlook & Strategy
Pubs	▪ *Resilient, recession proof cash flows that typically feel little impact from cost-of-living pressures* ▪ *Income streams linked to affordable entertainment, dining and socializing activities in a tough economic climate* ▪ *Gaming revenue in NSW continues to grow, despite weakening economy. NSW Hotel gaming profit was up 1.9% in the year to June 2024* ▪ *Favourable consumer sentiment, and demographics, a core part of the local community infrastructure* ▪ *Diversified income streams linked to food, liquor, gaming and entertainment* ▪ *Liquid assets with values typically <$50 million makes them highly tradable* ▪ *Strong cash yields, typically ranging from 7-9% per annum* ▪ *Total Return target – 10% to 15%*	▪ *Slowing economy, rising interest rates and rising unemployment having little impact on cashflows at present* ▪ *The sector is trading well, with over 124 assets traded in the 12 months to June 2024* ▪ *We anticipate further acquisition activity in this space, particularly for freehold sites with mixed use potential such as residential development and capital improvement of the existing premises* ▪ Strategy: Mixed use developments, or target sites requiring upgrades with gaming revenue
Industrial	▪ *Strong long-term demand thematic driven by the increase in online consumption, and growth in small business activity post COVID* ▪ *Low vacancy rates, and pent up demand for stock at all ends of the size spectrum, with average vacancy rates across all major metropolitan markets now sub 2%* ▪ *Above average rental growth, driven by the supply demand imbalance in most major cities, currently trending at 4% q-o-q and 16% annually according to CBRE Research* ▪ *Infill inner metropolitan markets are showing more pricing resilience, as their underlying land values are rising strongly providing a 65% to 80% underlying valuation buffer and are in strong demand from industrial and residential developers* ▪ *Return target 9% to 15%*	▪ *Still on track to deliver double digit total returns in 2024-25* ▪ *Supply demand imbalance likely to sustain, but skewed more to the sub 5,000sqm market focused on the SME sector* ▪ *Rental growth decelerating, and cap rates are decompressing rapidly, which will lift overall returns in the next twelve to eighteen months* ▪ *Supply in Sydney and Brisbane being hampered by a lack of developable land, which will keep vacancy levels low in the medium term* ▪ Strategy: Infill, inner metropolitan markets, focused on delivered sub 10,000sqm product targeting logistics, tech and specialized uses like refrigeration
Residential - Build to Sell	▪ *Long term demand thematic with a significant supply demand imbalance driven by rapidly escalating land and construction costs, versus home value increases, rising population growth is outpacing demand by over 100,000 homes per year* ▪ *Ongoing construction delays, and cost blow outs, the likelihood of rate cuts in 2025 further fueling buyer demand, and limited access to supply will continue to drive the imbalance between demand and supply over the medium to longer term* ▪ Return target on equity 20%+, senior debt 12% to 15%	▪ *Demand supply thematics are a long term structural trend influenced by macro and local factors, that will continue to make it difficult to deliver supply* ▪ *The Federal Government has targeted the construction of 1.2 million new homes over the next 5 years, which will be difficult to accomplish given prevailing market conditions* ▪ Strategy: Debt focus on bridge to complete or last mile financing, with no to little construction risk. Equity, partner with builders who can reduce costs or achieve more efficiencies than traditional developers
Counter cyclical Metro & CBD Office	▪ *Significant pricing dislocation as high vacancy rates, low demand and a net sell down by long term core fund investors drives office pricing to its lowest levels since the GFC* ▪ *Sector repricing underway as more than $3 billion of stock comes to market which will cause a pricing reset similar to what we saw in retail between 2018-21* ▪ *Peak to trough valuation pricing falls likely to peak at 30-35%* ▪ *Near term returns low single digits <5%, longer term rebound in pricing and income yields should see returns pick up in 2027-28 at 12%+*	▪ *Office is nearing the bottom of the discounting cycle, with a large amount of institutionally owned stock coming to market which will re-rate pricing further* ▪ *Vacancy and demand remain at record levels, however supply in markets such as Sydney and Brisbane is muted, which will gradually lower vacancy over the next 3 to 5 years* ▪ Strategy: Equity investment in shorter WALE A grade office product in Sydney, Brisbane, Canberra with a focus on re-leasing over the hold period, and selling a fully let asset in 2027-28 when cap rates are likely to start compressing again

Sectors	Investment Thematic	Outlook & Strategy
Manufactured Housing/ Land Lease Communities	▪ *Manufactured housing estates or land lease communities have grown significantly from their origins as caravan and cabin parks in the 1990s* ▪ *Today the sector is sophisticated, and institutionalized delivering significant development profits and income returns to investors* ▪ *Beyond its current scope, targeted towards over 55s, manufactured housing can serve as a quick, ready made solution to housing affordability* ▪ *The average sale price for an MHE unit is between $200,000 to $1,000,000 and typically with 2-3 bedrooms. Which would be suitable to a more affordable entry point for first home buyers and social housing*	▪ *Housing supply levels are still well below the requisite demand to have a meaningful impact on rising prices. Driven by rising construction costs and planning constraints* ▪ *MHE units can avoid many of these issues, in larger format locations with over 500 units, which are pre-fabricated and delivered to site and put together. Reducing delivery times and costs on construction* ▪ Strategy: Develop affordability focused MHEs for the under 55s, with a rent to own financial model where residents can build up equity through their rental payments
Pet Resorts	▪ *The demand for pet accommodation services is forecast to double in the next decade, as spending on pet services in Australia grew from $11bn in 2016 to $22bn in 2022* ▪ *Petcare the new child care: There are now 11 million pets in Australia, an average of 1.7 per household, versus only 1.6 children* ▪ *Australians currently spend $10.2bn on child care services annually, versus $800 million in pet boarding and day care* ▪ *The pet services industry has seen significant consolidation by private equity investors, across multiple verticals*	▪ *With households returning to pre-COVID levels of travel, the demand for pet boarding facilities is likely to rise, we are forecasting this to from $800 million today to $1.6bn by 2030* ▪ *Currently 98% of the industry is privately owned and managed, with only three at scale owner operators* ▪ Strategy: Develop a large scale portfolio of pet resorts, introducing efficiencies to the cost base and improving management and facility quality

HOTEL OPERATOR INCOME ENHANCEMENT
CASE STUDY

RW Capital has a long track record of investment and lending to the hotels and gaming sector, via its historical affiliation with Ray White's HTL business. One of the reasons we like the hotel and gaming sector is the strong, recession proof cashflows, which can be managed effectively to enhance the yield and overall return.

In a recent transaction, with a long-standing hotel operator in outer Sydney, we provided a loan to refurbish an existing asset to improve the food and beverage offering. In one asset, the hotel operator's investment in new food and beverage operations lifted the average weekly turnover by more than 50% in under three months. One of the rewasons for such a sharp rise in performance was the positive impact the new food and beverage had on gaming revenue. It also had the added benefit of reducing the volatility of the income profile of the asset, with more consistent dining spend smoothing out the weekly peaks and troughs of gaming income.

In another hotel refurbishment, RW Capital backed another hotel operator that resulted in a boost to average weekly earnings of 140%. We funded capital improvements to expand the food and beverage offering, which diversified the income streams, and boosted foot traffic and flow on income to gaming.

Hotels offer a unique ability to engineer better income returns in categories that are relatively resilient to economic shocks and cost pressures. Unlike restaurants and luxury hotels, the gaming revenue also provides a consistent underlying income flow that supports the operations of the facility, and to fund expansion. In an environment where traditional core real estate sectors are facing lower, and in some cases falling, income returns, the hotels and gaming market has proven to be a solid deliverer of yield to investors.

CONCLUSION:

AUSTRALIA HAS A DEEP, RESILIENT REAL ESTATE SECTOR THAT HAS DELIVERED SOLID RETURNS FOR OVER FORTY YEARS.

However, the current cycle is a volatile one that is hard to predict, that is why having a crystal clear look through to the underlying investment is more important than ever. In the short term, a focus on absolute returns via the cash-on-cash yield is critical to achieve a suitable risk adjusted return on real estate equity investments. Longer term thematics around pricing dislocation, supply/demand imbalances and favorable demographic and macroeconomic themes will also enhance returns.

NOT ALL SECTORS PERFORM CONSISTENTLY THROUGH CYCLES, AND IN THE CURRENT VALUATION ENVIRONMENT, WHERE THE SPREAD BETWEEN MARKET AND BOOK PRICES ARE WIDENING, HAVING A VERSATILE AND DIVERSIFIED DEBT AND EQUITY APPROACH TO PORTFOLIO CONSTRUCTION IS CRITICAL TO ACHIEVING THE BEST RISK ADJUSTED REAL ESTATE RETURNS.

At the end of the day, the fundamentals of a sector matter, especially in a higher for longer investment environment. The easiest way to assess asset fundamentals is through the cash-on-cash yield on offer today, and what your investment will receive as a distribution yield over the next 12 months. Long dated terminal income averaged over five or ten years ignores long term macro and sector risks and could expose your portfolio to heightened risk and underperformance.

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