Turning the Corner

MaxCap Group Research – February 2025

Turning the corner

Turn in, apex and exit. Since 2020, real estate markets have seen some interesting times, as supply chain disruptions, cost inflation and higher rates all combined to weigh down asset prices. In 2024, the downturn has run its course, as we look forward to the next upswing.

Eyeing the corner. Heading into 2025, there are more definitive signs of a turning point in local commercial real estate markets, marked by stronger share prices, firmer investor sentiment and a cautious uplift in transactions, even ahead of actual reductions in policy interest rates.

Foot on the accelerator. Already, we are seeing gains in commercial asset values for the first time this cycle. While these initial price gains are modest, they do signal a clear change in sentiment as investors move from fear to greed, from loss aversion to a search for profits.

A model's outlook. We can use simple econometric models to illustrate the potential impacts of firmer market conditions, to better understand the timeframes for a turnaround and the likely extent of the subsequent rebound in prices or recompression in cap rates.

Compression and ignition. With an improving real estate market, we anticipate a broadening recovery to come through as firmer cap rates in 2025. The initial pace of cap rate recompression is likely to be quite modest, as it will take some time for markets to gather momentum.

Strategies for the next lap. As investors look for a timely window for a return to market, it is important to reinforce the perennial importance of sector selection in 2025. The outlook remains strong for living sectors, as out-of-favour sectors make a slower comeback.

MaxCap Research Team:

Bruce Wan
Head of Research
bruce.wan@maxcapgroup.com.au

Nicholas Moorman
Research Analyst
nicholas.moorman@maxcapgroup.com.au

Corner markers

Since 2020, the Australian **economy and real estate markets** have seen some interesting times. A global pandemic drove Australia into its first recession in 29 years and ended the longest expansion in the developed world. The **subsequent impacts** are still lingering to this day in the form of disrupted supply chains, higher inflation and elevated interest rates.

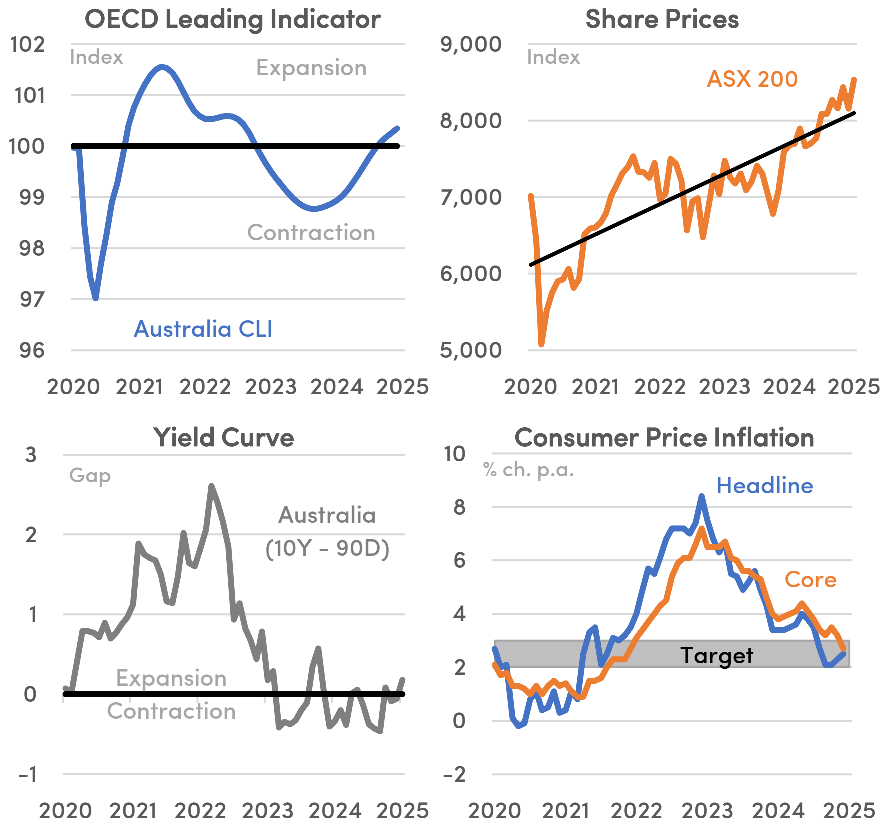
In 2025, there are more definitive signs of **a cyclical turning point** taking hold in the broader economy, increasingly evident across a range of economic and financial market indicators.

- **Price inflation** is slowly coming back under control in Australia, and gradually moving back into the target band. **Interest rates** are coming down in many places, but with Australia lagging the rest of the developed world in this cycle. **Share markets** are surging ahead, partly on the back of lower funding costs abroad.
- The generally firmer tone of these indicators is neatly summarised by the OECD composite **leading indicator**, which for Australia has pushed back into expansion territory in recent months.
- The forward outlook is set to strengthen in 2025, most notably with the expected cuts in **local cash rates**. Specifically, we expect a small step down in interest rates to translate into a bigger step up in market confidence, essentially providing the last piece of reinforcement needed for a more durable cyclical upswing.

Over time, the more upbeat market conditions are progressively feeding into **a firmer outlook** for real estate markets.

- For investors, the key questions are related to the **likely timing and extent** of this forthcoming recovery. What is the likely pace of pricing recovery or cap rate recompression? When should cap rates start tightening? In this context, we apply a range of simple econometric models to illustrate the potential paths of recovery ahead.

Leading signals for the Australian economy and real estate markets are looking relatively firmer, suggesting a more broad-based recovery in asset pricing and transaction volumes in 2025 and beyond.



Source: ABS, Bloomberg, OECD, MaxCap Group (February 2025)

Staying on track

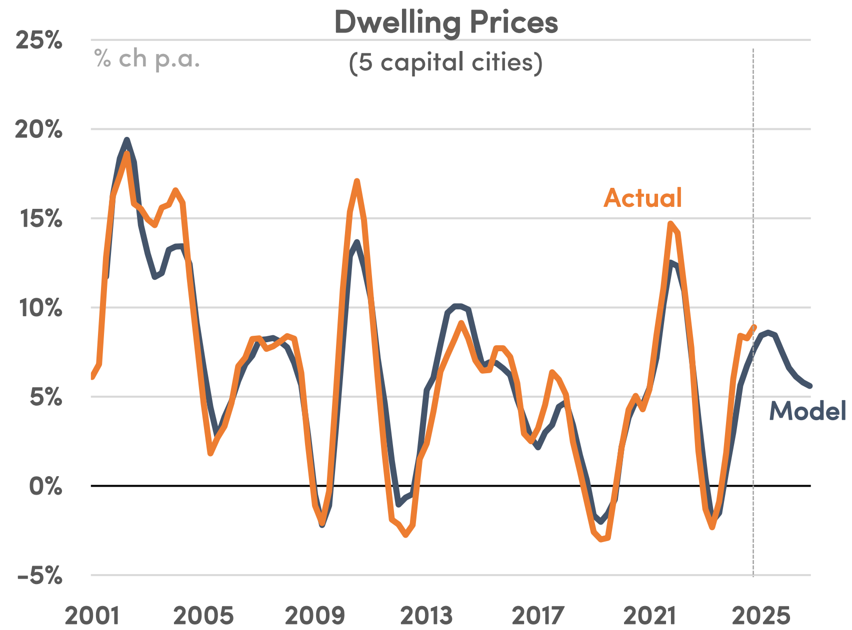
The Australian **residential market** has proven to be remarkably resilient in recent years, with prices holding up despite the aggressive uplift in mortgage rates and its massive drag on mortgage repayment capacity.

- The downturn itself from late 2022 was **modest and short** in duration (-2% over 7 months), before rebounding as the impact of rate hikes diminished. This degree of pricing resilience was highly unusual, being driven by a significant undersupply in housing across the country.
- In late 2024, there were some signs of **fading momentum**, due to overstretched affordability and dashed expectations of early and substantial rate cuts. Indeed, many potential buyers are adopting a wait-and-see position, holding out for those eventual rate cuts.
- At the same time, there is a massive gulf between the **robust price gains** reported in Perth (December 2024: +23% y/y), Adelaide (+18%) and Brisbane (+16%), compared to the **subdued price growth** seen in Sydney (+5%) and Melbourne (+0.5%).

In terms of the **forward outlook**, we are informed by the historical drivers that have worked well in explaining past performances, to better understand the potential paths for the market ahead.

- Indeed, historical price movements can be **well explained by a few drivers**, like household incomes, mortgage interest rates, share prices and building activity. This simple framework readily accounts for prior upswings and downturns, as well as the major cyclical turning points.
- In 2025, the **residential pricing outlook** is set to firm later in the year, perhaps better than commonly expected. Altogether, we have a better alignment of market drivers, including sustained income growth, buoyant wealth creation in equity markets, improving construction activity and lower mortgage rates. The impact of mortgage rates is interesting, as lenders have started to modestly reduce some mortgage rates off the back of lower offshore funding costs, even ahead of actual rate cuts locally.

While housing price gains have slowed slightly near-term with poor affordability, we expect to see a better alignment of pricing drivers in 2H 2025, most notably with the expected reductions in mortgage rates



Drivers	Prices	Income	Rates	Shares	Supply
2023	**-1%**	↑	↓	→	↓
2024	**+8%**	↑	↓	↑	→
2025 (f)	**+8%**	↑	↑	↑	↑

Source: Proptrack, MaxCap Group (February 2025). Past performance is not a guarantee of future performance. Forecasts may not come to pass.

Foot on the accelerator

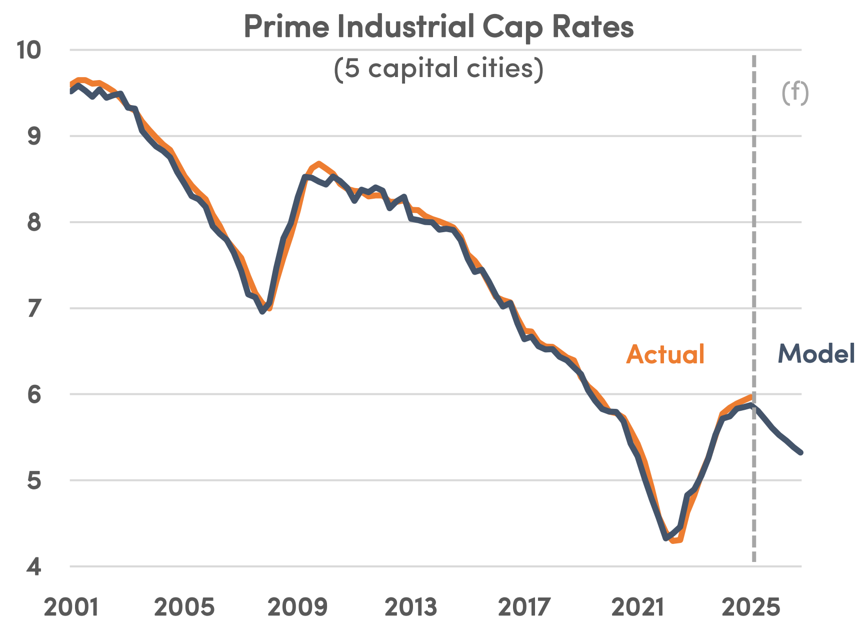
The Australian **commercial market** has gone through some difficult times since 2020.

- Big **structural changes** have markedly weighed on occupier demand. Work-from-home arrangements have diminished occupancy in the Melbourne and Sydney CBD office markets, while online shopping has moved tenants from major shopping malls to distribution warehouses.
- More recently, the sharp increases in **interest rates** since 2022 have markedly lifted cap rates and depressed asset values across all sectors, regardless of their structural headwinds or tailwinds. Altogether, cap rates have softened to varying degrees this cycle, from +50 bps for sub-regional malls, to +250 bps for secondary CBD office.

Ultimately, the economic environment will always be a major driver of commercial **cap rate trends**. Indeed, GDP growth, inflation and interest rates have historically explained most of the movements in cap rates across multiple cycles, including all prior cyclical turning points.

- In this context, there are some **genuine causes for optimism** ahead on market cap rates (and asset prices). The combination of firmer economic growth, moderating inflation and lower interest rates will likely support a broadening turning point in cap rates over the course of 2025, before a subsequent re-compression phase unfold.
- Importantly, the **pace of cap rate re-compression** is likely to be relatively gradual to begin with, as investors slowly regain their appetite before eventually pushing down yields, not just in the popular sectors like living and logistics, but also in the previously out-of-favour sectors like office and retail.
- All told, we are looking at **a more consistent set of drivers** pushing cap rates lower, but it will take several more years (of firmer market conditions) before we revisit the cyclical lows of the last cycle.

Commercial cap rates are approaching a cyclical turning point, with another phase of re-compression expected to start from 2025, on the back of slightly firmer economic growth and lower interest rates.



Drivers	Cap Rates	Growth	Inflation	Rates
2023	↑	↑	↑	↑
2024	↑	↑	→	→
2025 (f)	↓	↓	↓	↓

Source: ABS, Bloomberg, JLL REIS, MaxCap Group (February 2025). Past performance is not a guarantee of future performance. Forecasts may not come to pass.

The next hot lap

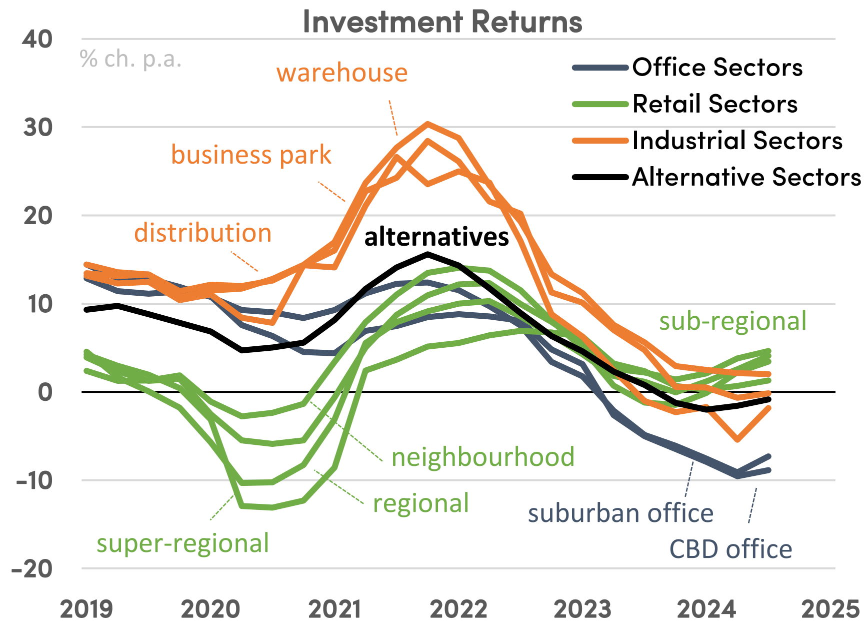
With growing confidence of a turning point in the market, investors have **time to prepare and position** their strategies ahead of the next upswing.

- **Time to get ready.** Unlike public markets, private equity real estate cycles are slower to turn. Investors have a little time to get set in 2025. The key catalyst for a cyclical recovery will likely be lower interest rates, which is expected to come through in the first half of the year.
- **Still in adjustment in 2025.** Several segments – particularly suburban secondary office – still face more pricing adjustments in the year ahead, reflecting the disproportionately harsher impacts of weaker tenancy demand, tighter credit availability and the historical adjustment lags from prime CBD to secondary suburban office markets.
- **Book value versus reality.** Anything can be sold at the right price. However, some landlords have been slow to move from yesteryear's book value and revalue their assets to today's clearing price. Buyers need to get comfort on fair value before transaction flows lift in earnest.

Looking at the year ahead, we continue to expect some clear **leaders and laggards** across different real estate sectors.

- **What is likely to lead.** There is still considerable momentum behind the living and logistics sectors, aided by greater credit availability. Fundamental sectoral tailwinds – housing undersupply, next-day delivery – are still in place, and likely to sustain demand and returns.
- **Somewhere in the middle.** While some retail segments are showing relative value in 2024 – sufficient to lift rents and returns – high mortgage rates continue to hamper underlying sales performance. Lower mortgage rates will be the key driver for a bigger recovery here.
- **What is likely to lag.** The turnaround in office markets is likely to lag other sectors (and other parts of the world), particularly in secondary and suburban markets. There is still good scope to find value from distressed office landlords in 2025.

In a broadening cyclical recovery, returns are improving, but there remains a persistent performance gap across sectors. For investors, good sector selection processes remain a key factor for alpha returns.



Returns	2022	2023	2024 YTD
Top	Warehouses +13	Warehouses +3	Sub-regional Mall +5
Bottom	Suburban Office +3	CBD Office -7	CBD Office -9

Source: MSCI IPD, MaxCap Group (February 2025). Past returns are not a guarantee of future performance.

Additional Information

Senior Lender of the Year, Asia Pacific | MaxCap Group | Private Debt Investor AWARDS 2023

Legal Disclaimer

This report was prepared by MaxCap Group Pty Ltd a Corporate Authorised Representative 1286367 of MaxCap Investment Management Pty Ltd ABN 68 169 902 005 AFSL 462086 (MaxCap).

The information and material contained herein are for informational purposes and do not constitute an offer for any financial product or service or an investment recommendation or advice. Past performance information contained in this report is not an indication of future performance. Use, reliance or reference to any of the information contained in this report will be at the user's own risk.

In preparing this report, MaxCap derived and relied upon, without independent verification, information obtained from third party sources. Although high standards have been used in the preparation of the information, analysis, views and projections, MaxCap or its affiliates and subsidiaries make no representation or warranty about its adequacy, accuracy and completeness.

This presentation is confidential and may not be reproduced or distributed, in whole or in part, to any other person in any form without the prior written consent of MaxCap. The information in this report is current at the date of issue and is subject to change.

Key Contacts

Wayne Lasky
Executive Chairman
wayne.lasky@maxcapgroup.com.au

Rob Hattersley
Group Head of Capital
robert.hattersley@maxcapgroup.com.au

Bruce Wan
Head of Research
bruce.wan@maxcapgroup.com.au

MaxCap Capital Team Contacts

Ben Klein	Head of Private Capital	ben.klein@maxcapgroup.com.au
Haley Devine	Director – Capital	haley.devine@maxcapgroup.com.au
Romy Grace	Director – Capital	romy.grace@maxcapgroup.com.au
Leyla Sacks	Director – Capital	leyla.sacks@maxcapgroup.com.au
Penny Tao	Director – Capital	penny.tao@maxcapgroup.com.au
Hugh Thomson	Director – Capital	hugh.thomson@maxcapgroup.com.au
Domenic Demaria	Associate Director – Capital	domenic.demaria@maxcapgroup.com.au
Ashley Feldman	Associate Director – Capital	ashley.feldman@maxcapgroup.com.au
Ben Woolley	Associate Director – Capital	ben.woolley@maxcapgroup.com.au

MaxCap Group

HEAD OFFICE

Level 34, 376-390 Collins Street
Melbourne, VIC 3000 Australia

maxcapgroup.com.au

MAXCAP LOCATIONS

Melbourne
Sydney
Brisbane
Perth
Auckland

CONNECT WITH US

LinkedIn
YouTube