Commercial Property Market Update

December 2025

KPMG.com.au

Contents

Executive summary

All three core asset classes delivered positive returns in the latest data for the September quarter 2025, the first time since the June quarter 2023, and consistent with our expectations set earlier this year. KPMG remains optimistic about the long-term demand for commercial property, underpinned by the sector's long-term stability characteristics.

Office sector

- Investor sentiment towards Australia's office sector remains cautious, with vacancy rates remaining elevated.
- Market conditions continue to reflect volatility typical of a sector in transition. Core markets have shown face rental growth, and total returns have turned positive for the second consecutive quarter after a prolonged period of negative growth since June 2023. Total returns reached 4.4% in the September quarter 2025.
- But progress is uneven and tends to be concentrated in prime-grade assets, while secondary-grade stock continues to face persistent challenges.

Retail sector

- Retail conditions continue to improve reflecting robust fundamentals.
- Total returns are currently at 7.3% in the September quarter 2025, marking six consecutive quarters of increasing returns and representing the highest performance among the three major property sectors.
- Cap rates have remained mostly stable over the half-year, though market feedback suggests early signs of compression as confidence builds, particularly for the neighbourhood subsector.

Industrial sector

- Cap rates have remained stable at around 5.4% with minor fluctuations reflecting sustained investor sentiments. Early signs of moderate cap rate compression are evident in some core precincts.
- Total returns across all industrial markets have remained positive for four consecutive quarters, reaching 6.4% in the September quarter 2025 after a prolonged correction through late 2023 and much of 2024.
- Vacancy rose to 3.7% driven by elevated supply delivery but still well below pre-pandemic levels. Construction costs, which peaked during the pandemic, have eased but remain elevated and are showing signs of renewed upward pressure. As a result, the development pipeline is expected to moderate in 2026 as rising costs weigh on new project commencements.

KPMG Commercial Property Uncertainty Index

- The index improved for the office and industrial sectors between the June quarter 2025 and the September quarter 2025, which provides another positive indicator for the commercial real estate sector. While there was an uptick in uncertainty for the retail sector, it remains at historically low levels.
- Uncertainty across the three sectors is now at low levels compared to their historical levels, reinforcing the view that confidence is returning to the market.

Economic considerations

- Economic growth in 2025 looks to be a notable improvement compared to 2024, despite global trade uncertainty.
- Recent economic performance has been driven primarily by the private sector. However, the improvement is largely attributable to household spending, while business investment – outside of data centres – remains subdued.
- The triple ongoing boosts of strong population, resilient job market and real wages remain key for further recovery. Population growth continues to grow stronger than budget forecasts, due to strong net overseas migration. Unemployment rate remains in the low-4%, while real wages growth has finally caught up to the cost of living.
- While financial stress as indicated by non-performing loans remains low, the persistent upward trend in business insolvencies warrants close monitoring, as it may indicate mounting financial pressures that are not yet evident in non-performing loan data.
- The relative stability of the region, and of commercial real estate, has continued to attract foreign investment.
- Our analysis shows that the spread between cap rates and real bond yields has been declining, reflecting reinforced confidence in the stability and long-term prospects of the commercial property sector.

Economic forecasts	Current	2025 (f)	2026 (f)	2027(f)
Real GDP growth	2.1% (Sep qtr)	2.0%	2.1%	2.2%
Unemployment rate	4.3% (Oct)	4.4%	4.4%	4.4%
Core inflation	3.3% (Oct)	3.3%	2.9%	2.5%
RBA cash rate	3.60% (Nov)	3.60%	3.35%	3.35%
Population growth	1.6% (Mar qtr)	1.3%	1.2%	1.2%

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Executive summary (continued)

Office:

- Vacancy rates are expected to trend down due to the recovery in tenant demand and limited new supply. Secondary stock will continue to face ongoing challenges, while prime-grade assets remain more resilient, supported by stable cash flows and improving leasing conditions.
- Investor sentiment is improving in most subsectors, with capital market activity focused on mid-market deals, involving well-located assets with strong cash flow profiles. Metropolitan markets remain challenging, compared to traditional CBD alternatives.
- Face rental growth remains in most subsectors, however lease incentives will remain elevated for longer.

Retail:

- Vacancy rates look to remain steady. High occupancy, barriers to entry and tight supply conditions will keep vacancy stable, supported by improving consumer confidence and strong household spending.
- Investment sentiment is particularly strong in the middle markets, however current deal flow is not satisfying investor demand. Yield compression is evident in some markets, however cap rate compression is selective within the institutional valuation cycle for the period.

Industrial:

- Increased supply delivery in 2025 will push vacancy marginally higher in the short term but supply has been tempered by elevated construction costs. Sector vacancy remains below historic averages, which will keep pressure on market rents, however the veracity of rental growth has substantially dissipated.
- Income returns have been stable at around 4.6% since the start of the year, below pre-pandemic levels of 5%+. However, there is room for further growth. Looking ahead, steady population growth, the continued expansion of e-commerce, and increased automation are expected to drive demand for industrial space.

		Current	Next 12 months
Office	Vacancy rate	14.4%	Down
	Cap rate	6.1%	Steady
	Returns	4.4%	Up
Retail	Vacancy rate	5.6%	Steady
	Cap rate	5.8%	Steady
	Returns	7.3%	Steady
Industrial	Vacancy rate	3.5%	Slightly up
	Cap rate	5.4%	Steady
	Returns	6.4%	Steady

Key economic events and market conditions

GDP growth slowed to 0.4% over the September quarter

Australia's economy grew by 0.4% in the September quarter, easing from 0.6% in June. On an annual basis, growth edged up to 2.1% from 2.0% previously. Private demand remained the main driver of GDP, supported by both consumption and investment. Notably, private investment made the largest contribution to quarterly growth, led by increased spending on machinery and equipment, reflecting ongoing data centre expansions

While growth in retail turnover has remained steady, there continues to be an acceleration in real household consumption.

The most recent retail turnover data based on bank transactions showed that annual growth in retail turnover has been stable through the year so far, averaging 4.2% in the September quarter, unchanged from the June quarter.

Meanwhile, real household spending volumes (across the entire consumption basket) increased by 2.7% over the year to the September quarter. This is the strongest annual growth since March quarter 2024.

Inflation has rebounded by more than expected and might rule out any further rate cuts by the RBA.

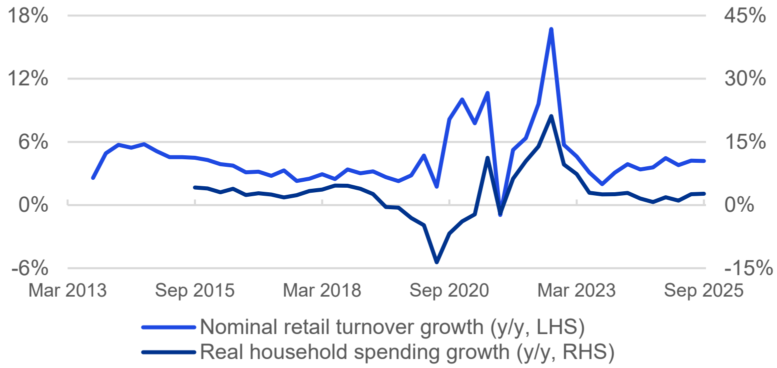
The latest inflation data shows that there continues to be upward momentum in price pressures, casting doubt on further monetary policy easing. Monthly headline inflation accelerated to 3.8% year-on-year in October 2025, from 3.6% in September, and further away from the RBA's target band of 2-3%. This was higher than the consensus expectation of 3.6%. Trimmed mean inflation, which is the RBA's preferred measure, also ticked up to 3.3% year-on-year, from 3.2% in September.

Looking at non-residential construction costs, data for the September quarter shows that growth in output prices accelerated for the first time since the June quarter 2024. Through the year, prices rose by 3.8%, with rising labour costs driven by ongoing skills shortages, alongside enterprise agreement wage rises. Strong demand also drove price increases for concrete trades and electrical services.

Chart 1: GDP growth

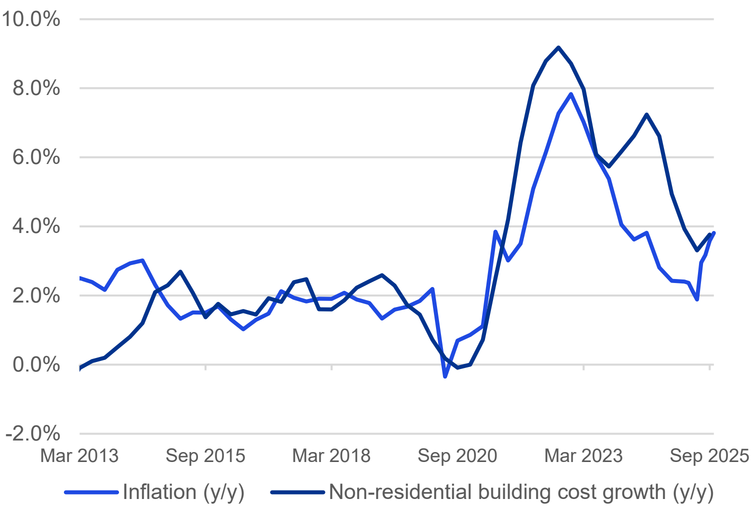
Source: KPMG, ABS, Haver

Chart 2: Retail turnover and household spending



Source: KPMG, ABS, Haver

Chart 3: Inflation and building costs



Note: Inflation reported at a quarterly frequency prior to April 2025.
Source: KPMG, ABS, Haver

The labour market continues to demonstrate remarkable resilience.

The easing of labour market pressures remains gradual, with the seasonally adjusted unemployment rate sitting at 4.3% in October 2025. This was only 0.2ppt higher than the same time last year. Participation also remains strong, at 67.0%, only 0.1ppt lower than a year ago.

Overall, the unemployment rate is expected to rise slightly as public sector employment growth slows while private sector job gains are unlikely to be sufficient to offset this easing.

Meanwhile, in the September quarter, wages grew 3.4% over the year, slightly below the 3.5% increase in minimum wages, which itself was lower than the 3.75% rise a year earlier. Quarterly wage growth was 0.8%, unchanged from the same period in 2024.

Non-residential construction activity appears to be picking up momentum.

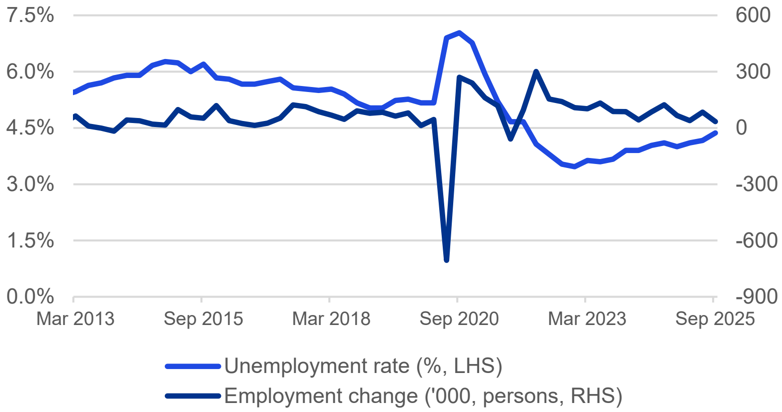
In FY25, non-residential construction starts recorded a notable improvement compared to FY24, reaching $75.9 billion in value and recording a 13% growth. Despite seeing a small contraction (4%) in FY24, work approved has trended upward overall in the past few years, reflecting strong underlying demand for new projects.

Over the past three years, work commenced has also expanded steadily in FY25, increasing to $73.8 billion and by 19%, the fastest over the past four financial years. This indicates that projects are moving more rapidly, potentially reflecting stronger financing support. Importantly, commencements have begun to outpace approvals over the past two years, highlighting momentum in project mobilisation.

However, completions have not been able to keep its upward momentum. Completions eased to $58.2 billion in FY25, a 4% fall compared to FY24 but still reasonably higher than the value completed in FY23. This points to bottlenecks in delivery capacity as the sharp rise in commencements placed additional pressure in delivery. The backlog of work recorded a small increase in FY25 after several years of strong expansion.

Market feedback suggests that developers and investors have been optimistic and are responding to improving demand. However, continued cost pressures could weigh in on sentiment and constrain the supply pipeline further, even as broader market conditions continue to recover.

Chart 4: Labour market

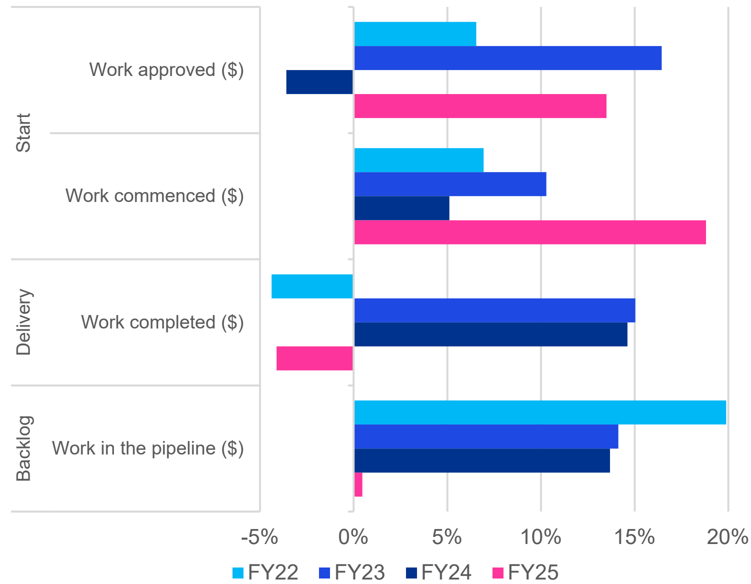


Source: KPMG, ABS, Haver

Chart 5: Wages growth

Source: KPMG, ABS, Haver

Chart 6: Non-residential construction activity by stage (annual growth)



Note: Work in the pipeline is the sum of work yet to be done and work not yet commenced.
Source: KPMG, ABS, Haver

Commercial property exposures as a proportion of lending have continued to grow.

Commercial property lending continues to expand, with growth in commercial property exposures accelerating to 9.4% in the year to the June quarter 2025, according to the latest data. This has seen commercial property exposures increase as a share of total assets to 7.0%.

This was driven by continued strong growth for industrial property, supported by an acceleration in growth for retail. This has been supported by a moderate easing of monetary policy settings, though lending practices have been conservative.

Financial stress ticks upwards but remains at low levels.

The share of non-performing commercial real estate loans increased slightly to 0.8% in the June quarter. However, it is only 0.1ppt higher than a year ago and continues to be far below the levels seen during the GFC, in part, reflecting conservative lending practices among banks operating in Australia.

However, corporate insolvencies continue to rise. Data from the Australian Securities and Investments Commission (ASIC) showed that 14,722 companies entered external administration in FY25, representing a 33% increased compared to FY24.

More recent data for FY26 up to the end of August, showed a further 2% increase compared to the same period of FY25. Furthermore, ASIC reports that the number of companies entering external administration has now started to level out. This persistent upward trend in insolvencies warrants close monitoring, as it may indicate mounting financial pressures that are not yet evident in non-performing loan data.

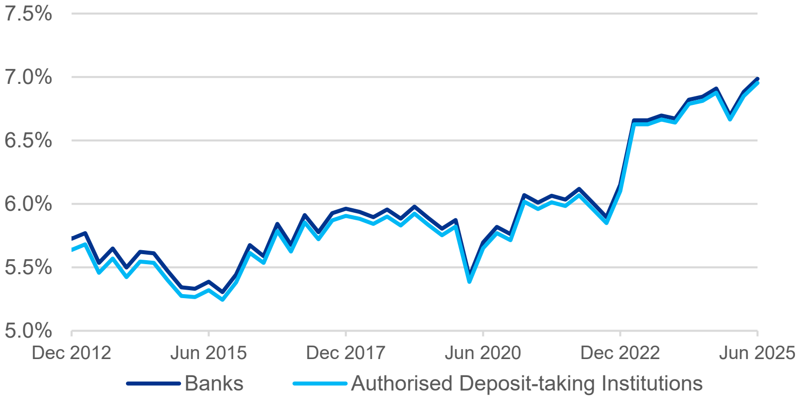
Trends in lender appetites across sectors remain unchanged, per the latest data.

After a sustained expansion, according to APRA data industrial assets as a share of commercial property exposures saw a slight decline in share during the June quarter 2025 to 19.2%. This was the first fall in the industrial sector's share of the total market since the March quarter 2022. Overall, this broader trend still reflects the attractiveness of the sector as an investment class.

Meanwhile, the share of the office and retail sectors also continued to decline. After an uptick in the second half of 2024, the retail sector's share has again slipped back to 24.2% and is 0.1ppt lower than a year ago.

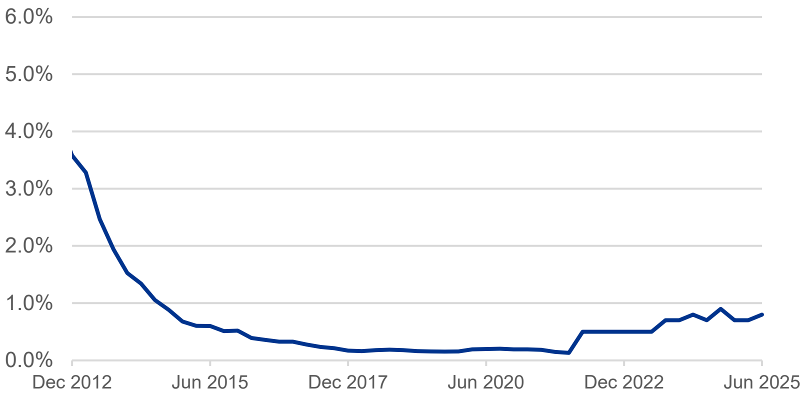
The decline for the sector office has been more substantial, falling by 1.2ppt over the year to reach 26.0% at the end of the June quarter.

Chart 7: Bank loan exposures to commercial property (share of total assets)



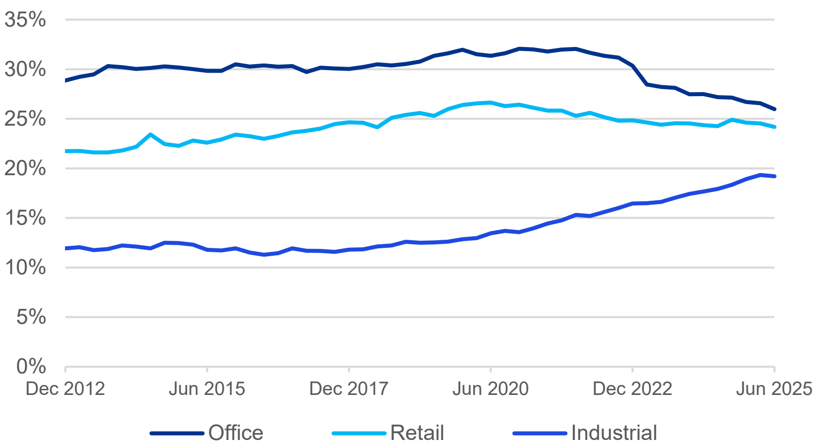
Source: KPMG, APRA, Haver

Chart 8: Non-performing rate* (share of banks' commercial property exposures)



Note: *Data reported as impairment rate prior to 2022.
Source: KPMG, APRA, Haver

Chart 9: Exposures of different commercial property segments (share of total commercial property exposures)



Source: KPMG, APRA, Haver

Foreign demand for commercial investment continues to pick up, particularly for commercial real estate.

Data for the first two quarters of FY25 showed that the value of commercial investment proposals approved, are on track to surpass FY24 levels, with a year-to-date figure of $101.3 billion.

This compared to the full-year result of $187.0 billion in FY24, which itself was an improvement from $173.1 billion in FY23. Nonetheless, commercial investment demand is still far lower than the levels seen in FY22.

There also looks to be some positive momentum, with $54.7 billion of commercial investment approved in the second quarter of FY25, compared to $46.6 billion during the first quarter.

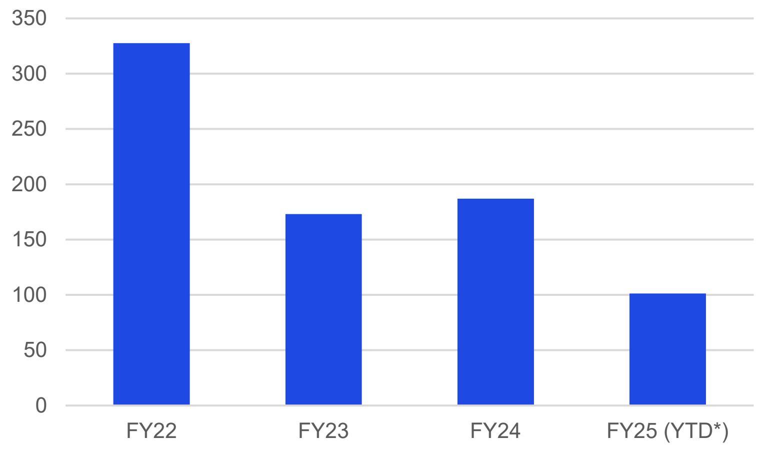
The United States continued to be the most dominant source of foreign commercial investment, with a strong uptick from Saudi Arabia also seen in the first half of FY25.

Notably, investment proposals from Japan, which has been a significant investor base, have so far, been significantly weaker than prior financial years.

Focusing specifically on commercial real estate, FY25 looks to be a much stronger year than FY24. The value of approved foreign investment proposals in commercial real estate was $34.1 billion in the first half of FY25, nearly surpassing the full-year FY24 result of $35.8 billion.

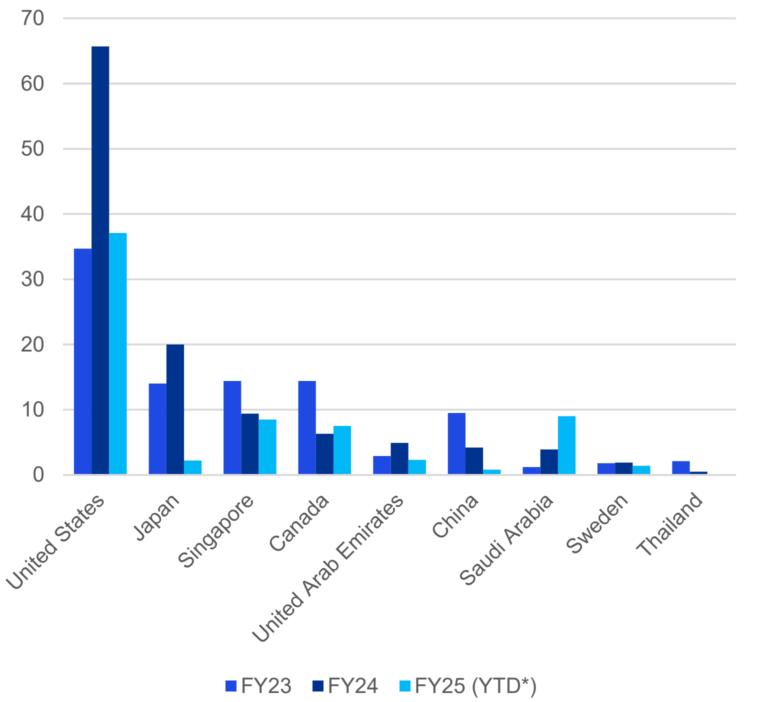
Despite ongoing trade uncertainty and broader economic policy volatility, there appears to be little disruption to the flow of international capital to Australia. The relative stability of the region, and of commercial real estate, has continued to support foreign investment.

Chart 10: Value of foreign commercial investment proposals ($ billion)



Note: *The YTD figure for FY25 only includes data until 31 December 2024.
Source: KPMG, Commonwealth Treasury

Chart 11: Sources of foreign commercial investment proposals ($ billion)



Note: *The YTD figure for FY25 only includes data until 31 December 2024.
Source: KPMG, Commonwealth Treasury

The KPMG Commercial Property Uncertainty Index

Introduction

The KPMG Commercial Property Uncertainty Index provides insights into the unpredictability and potential risks associated with investing in office, industrial and retail property.

An asset that produces consistently fair returns should generate a stable, low uncertainty index. Where an index spikes, it signals investors are expecting, or are reacting to, significant changes in market conditions.

Chart 12 presents the KPMG Commercial Property Uncertainty Index for the industrial, office, and retail sectors between the June quarter 2008 and the September quarter 2025.

Historical performance

During the Global Financial Crisis (2008–2010), all three commercial property sectors in Australia experienced sharp spikes in uncertainty due to volatile economic conditions, tighter and costlier financing, and weakened investor sentiment. As markets stabilised, uncertainty levels remained relatively steady from 2010 to 2020.

A new wave of uncertainty emerged with the onset of the COVID-19 pandemic in 2020, though its impact varied across sectors. The retail sector saw an immediate spike due to lockdowns and a rapid shift to online shopping. Recovery followed as restrictions eased, supported by government stimulus and consumer demand.

The industrial sector, particularly logistics and warehousing, initially benefited from the e-commerce boom. However, ongoing supply chain disruptions and global trade shifts contributed to rising uncertainty in 2021.

In contrast, the office sector experienced a delayed spike. The widespread adoption of remote work led businesses to reassess their need for physical office space, creating long-term uncertainty around future demand.

Recent performance

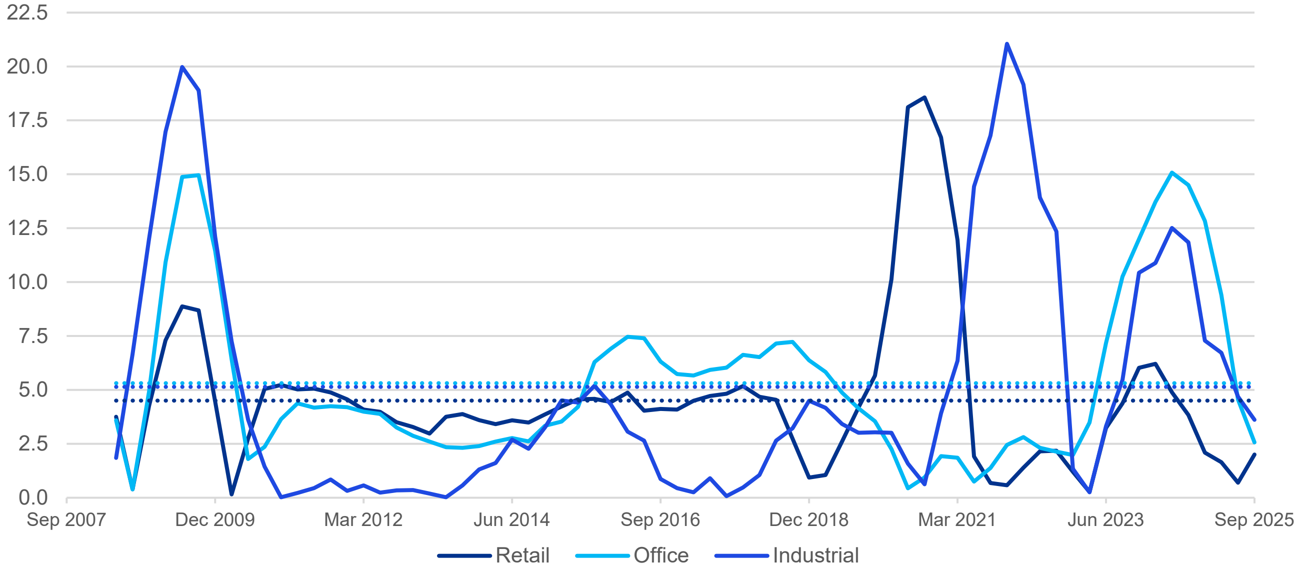
The KPMG Commercial Property Uncertainty Index continues to fall for the office and industrial sectors, although retail saw a slight uptick in the September quarter 2025.

Uncertainty in the office sector has continued to fall sharply, reaching 2.6 index points in the September quarter, its lowest level since the December quarter 2022.

Although uncertainty for industrial properties has also declined further, it is now the highest across the sectors, at 3.6 index points. This comes as the pace of easing in the uncertainty index slowed for the third consecutive quarter.

Meanwhile, uncertainty in retail rebounded, rising for the first time since the March quarter 2024. It now sits at 2.0 index points, although it remains below its long-run average, and is still the lowest across the three commercial property sectors.

Chart 12: KPMG Commercial Property Uncertainty Index



Note: Dotted lines indicate long-run average.
Source: KPMG

Retail property sector

Space conditions

Retail conditions in 2025 have seen a continuing improvement. Consumer spending remains robust across both non-discretionary and discretionary items supported by rising real incomes and the three interest rate cuts. Consumer sentiment has also recorded significant upward momentum. As a result, vacancy rates fell across different subsectors, with prime retail leading, falling by 70 basis points over the past six months.

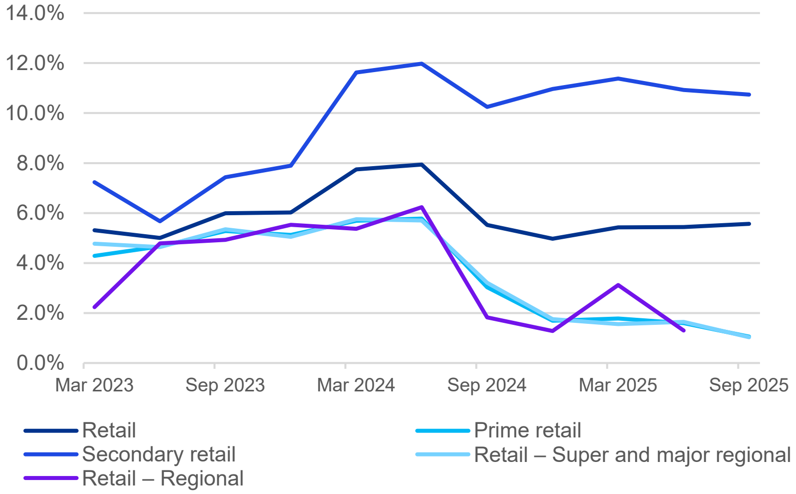
Across the sector as a whole, retail vacancy increased by 17 basis points to 5.6%, though this was largely due to survey timing and asset sales, creating a 'false positive' effect. In reality, underlying fundamentals remain strong, reflecting healthy demand and improving leasing conditions.

Asset pricing

Notwithstanding the recent and expected short-term sentiment of marginal cap rate compression, over the half-year period, capitalisation rates edged up slightly across the sector. In the September quarter 2025, the capitalisation rate for the sector is currently sitting at 5.8%, representing a 12 basis-point increase compared to the March quarter 2025. Prime retail cap rates increased by 6 basis points to 5.8% and secondary retail fell by 5 basis points to 5.9% respectively.

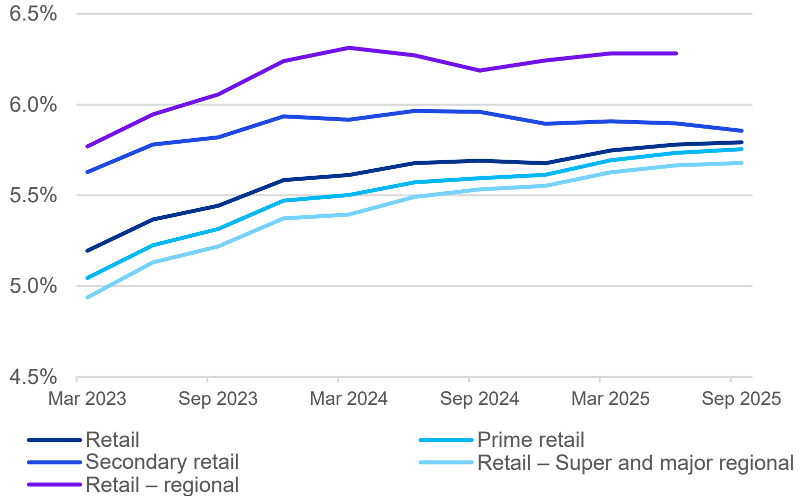
Overall, despite the modest upward movement in most segments, market feedback is currently suggesting strong liquidity, improving sentiment and growing investment volumes. With the current strength in the retail sector, yield compression is expected to materialise as confidence builds and competition for quality assets intensifies.

Chart 13: Vacancy rates across retail property subsectors (%)



Note: The data for Retail – Regional is not reported by MSCI in September 2025.
Source: KPMG, MSCI/PCA

Chart 14: Capitalisation rates across retail property subsectors (%)



Note: The data for Retail – Regional is not reported by MSCI in September 2025.
Source: KPMG, MSCI/PCA

Retail property sector (continued)

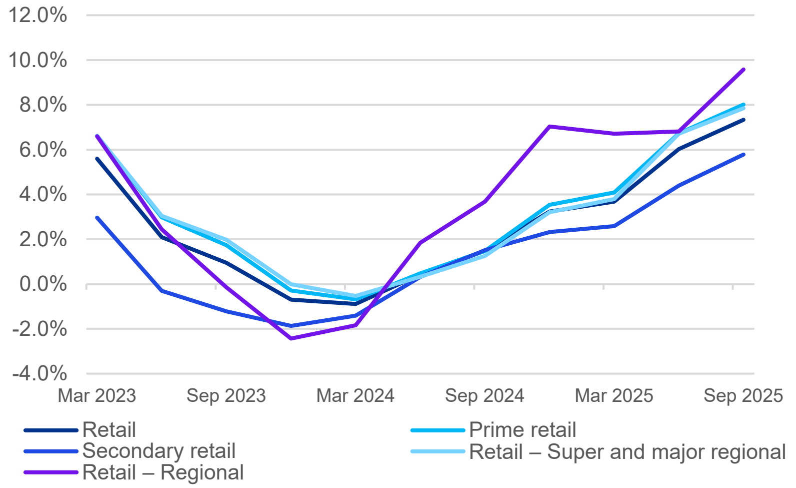
Investment performance

Investment performance has improved in recent quarters. Total returns for the retail sector were at 7.3% in the September quarter 2025, marking the sixth consecutive quarter of positive returns after the sector experienced negative returns in late 2023 and early 2024.

Income returns increased by 100 basis points to 5.9% in the September quarter 2025 compared to earlier this year. The resilience of income returns was supported by strong fundamentals of retail property such as strong population growth and continuing employment growth. Limited new supply for retail property has also played a key role in supporting the recent performance.

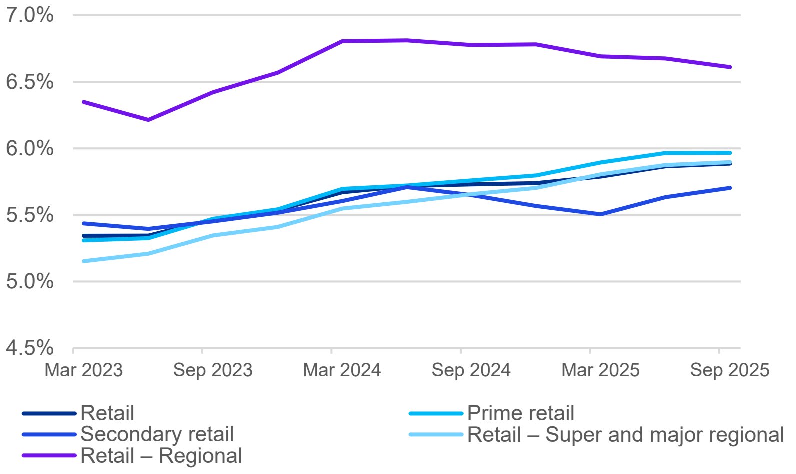
Capital growth has resumed its important role to the strong investment performance. Capital growth was positive for two consecutive quarters, currently at 1.4% and marking a significant improvement from the same time last year, where capital growth was at -4.0%. Capital growth varies across subsectors. Strong capital growth was seen in prime, super and major regional, and regional retail. In contrast, capital values remains relatively subdued for secondary retail.

Chart 15: Total returns across retail property subsectors (%)



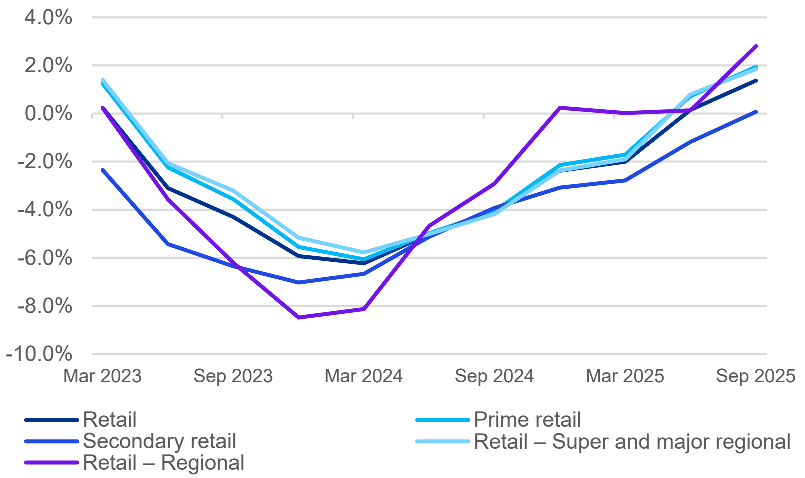
Source: KPMG, MSCI/PCA

Chart 16: Income returns across retail property subsectors (%)



Source: KPMG, MSCI/PCA

Chart 17: Capital returns across retail property subsectors (%)



Source: KPMG, MSCI/PCA

Office property sector

Space conditions

The University of Sydney's Transport Opinion Survey (TOPS) for September 2025 indicated continued stabilisation in remote working time among Australian workers, with the average working from home (WFH) rate edging down to 21% from 22% from the survey result in March 2025.

Office vacancies (as an average of the three sampled CBD markets) appear mostly unchanged from the previous quarter, but still approximately 40 basis points and 100 basis points higher than earlier this year and the same time last year respectively. Across the surveyed locations, Sydney CBD Office experienced the sharpest increase since the last report six months ago, increasing from 13.4% to 14.3%. Melbourne continues to have the highest vacancy rate at 18.4%, while Brisbane saw a slight decline from 10.6% to 10.4%, driven by tenant demand and positive net absorption.

By grade, Premium/Grade A vacancy softened slightly. Demand for secondary-grade assets, particularly older stock, remains subdued, contributing to continued elevated vacancy in this subsector.

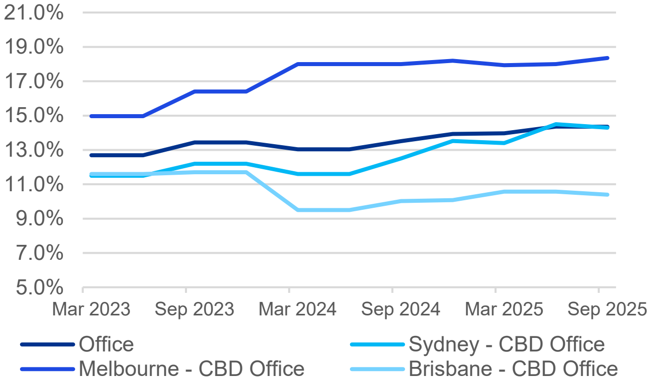
Asset pricing

Capitalisation rates for the office sector edged up slightly over the period, rising by 6 basis points to 6.1%. Nevertheless, this has remained in the low-6% band over the past four quarters. This trend contradicts the earlier market expectation of cap rate compression (for quality assets) and underscores a degree of residual caution for the sector.

Brisbane stands out as the exception, with cap rates tightening to 6.4% from approximately 7% six months ago.

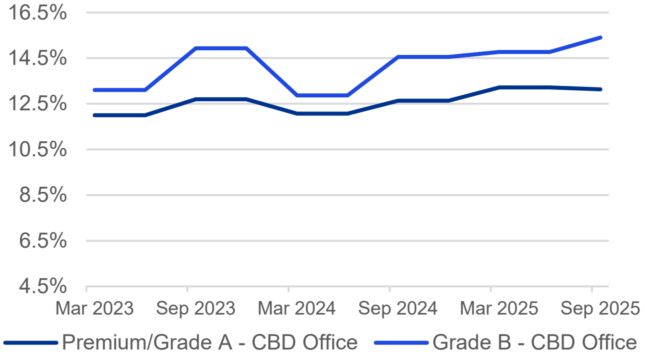
ESG credentials and sustainability opportunities remain a focus for landlords, purchasers, and occupiers, influencing both leasing and investment decisions.

Chart 18: Vacancy rates across office property by location (%)



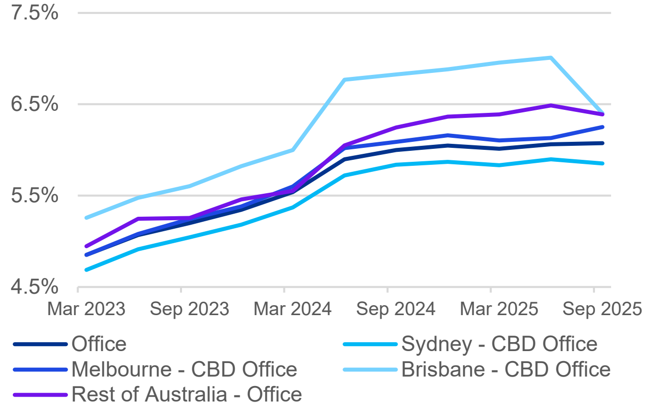
Source: KPMG

Chart 19: Vacancy rates across office property by quality (%)



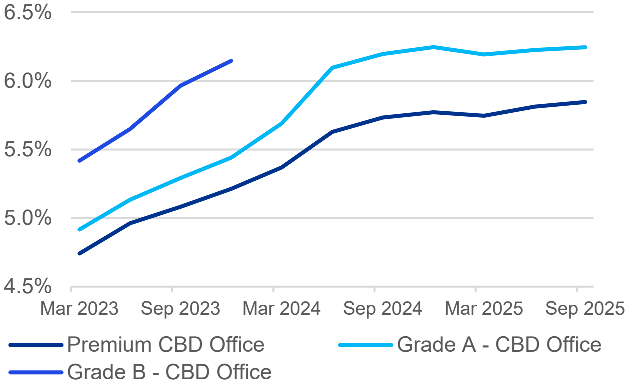
Note: The data represents the average rates collected across Sydney, Melbourne, and Brisbane.
Source: KPMG

Chart 20: Capitalisation rates across office property by location (%)



Source: KPMG, MSCI/PCA

Chart 21: Capitalisation rates across office property by quality (%)



Note: The data for Grade B – CBD Office has not been reported by MSCI since December 2023.
Source: KPMG, MSCI/PCA

Office property sector (continued)

Investment performance

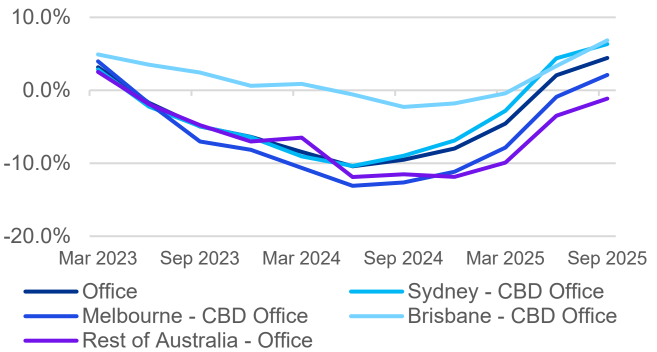
Total returns for office property have been positive since the June quarter 2025, marking a clear break away from the negative growth sustained since June 2023. Total returns reached 4.4% in the September quarter 2025.

Brisbane CBD Office recorded the strongest total returns in the September quarter, at 6.8%. However, since the beginning of the year, Sydney and Melbourne CBD Office have shown the most significant recoveries, with returns improving by 9 percentage points (from -2.8% to 6.3%) and 10 percentage points (from -7.6% to 2.1%) respectively – much stronger than the gains in Brisbane of 7 percentage points (from -0.4% to 6.8%).

As a whole, income returns remain the key driver as capital growth for office remains negative. Income returns have recorded consecutive returns over the past four quarters. Nevertheless, capital growth is expected to turn positive soon, with early signs of improvement in Sydney CBD and Brisbane CBD.

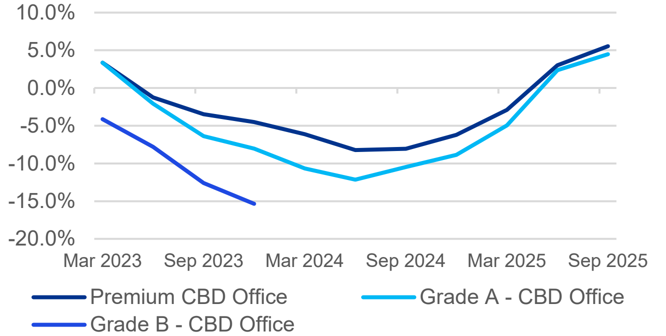
Office quality and ESG credentials remain a key differentiator for asset performance, which include the potential for material capex considerations over the investment horizon.

Chart 22: Total returns across office property by location (%)



Source: KPMG, MSCI/PCA

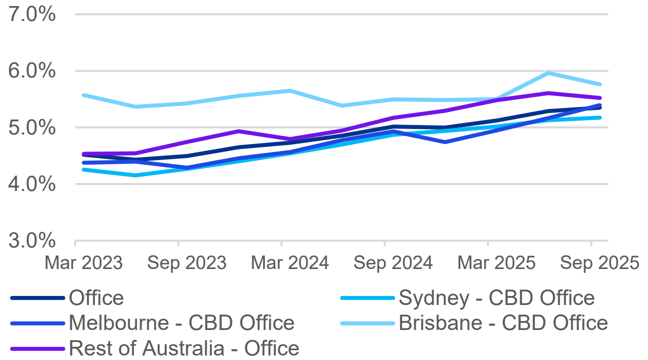
Chart 23: Total returns across office property by quality (%)



Note: The data for Grade B – CBD Office has not been reported by MSCI since December 2023.

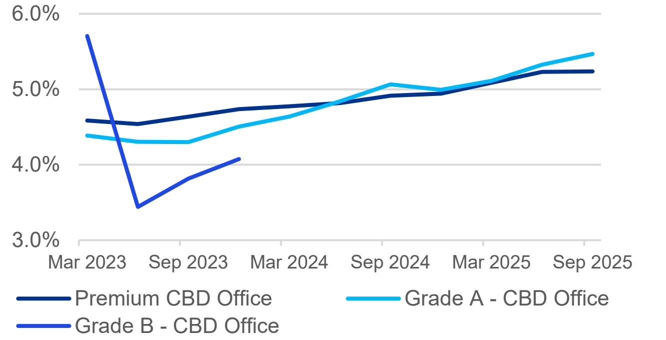
Source: KPMG, MSCI/PCA

Chart 24: Income returns across office property by location (%)



Source: KPMG, MSCI/PCA

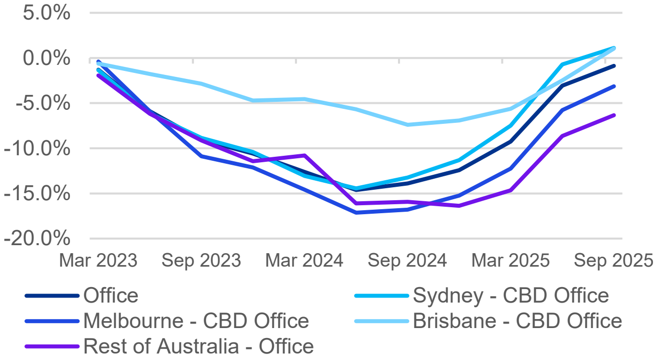
Chart 25: Income returns across office property by quality (%)



Note: The data for Grade B – CBD Office has not been reported by MSCI since December 2023.

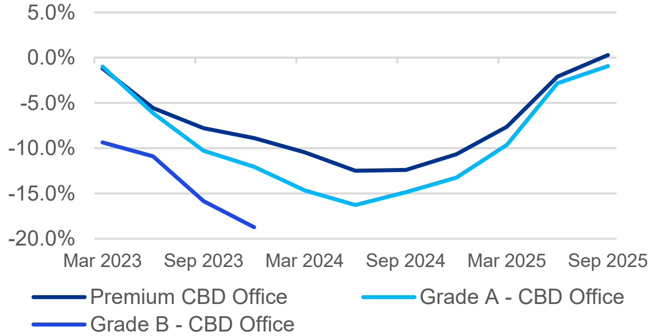
Source: KPMG, MSCI/PCA

Chart 26: Capital returns across office property by location (%)



Source: KPMG, MSCI/PCA

Chart 27: Capital returns across office property by quality (%)



Note: The data for Grade B – CBD Office has not been reported by MSCI since December 2023.

Source: KPMG, MSCI/PCA

Industrial property sector

Space conditions

Vacancy rates have been on a steady upward trajectory over the past two years, though mostly unchanged compared to six months ago, currently standing at 3.5%. This increase reflects elevated supply delivery and the time required for leasing activity to absorb new space. However, vacancy remains well below pre-pandemic levels of 5%+ and global averages, underscoring continued tight market conditions.

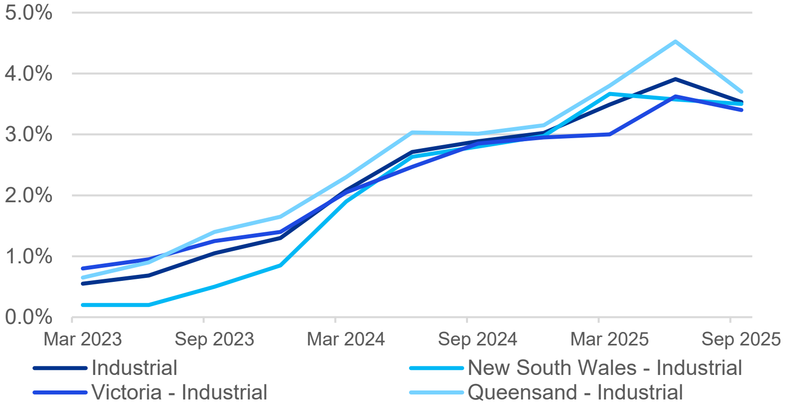
Tight supply in Sydney has prompted some occupiers to relocate strategically to other cities, contributing to a convergence in vacancy rates across the eastern seaboard.

Asset pricing

As a favoured investment class, sentiment remains resilient, supported by three interest rate cuts this year and strong sector fundamentals. Cap rates for industrial property have remained broadly stable around 5.4% over the past 12 months, with minor fluctuations – slight compression in Sydney and a modest uptick in Melbourne – keeping yields near last year's levels.

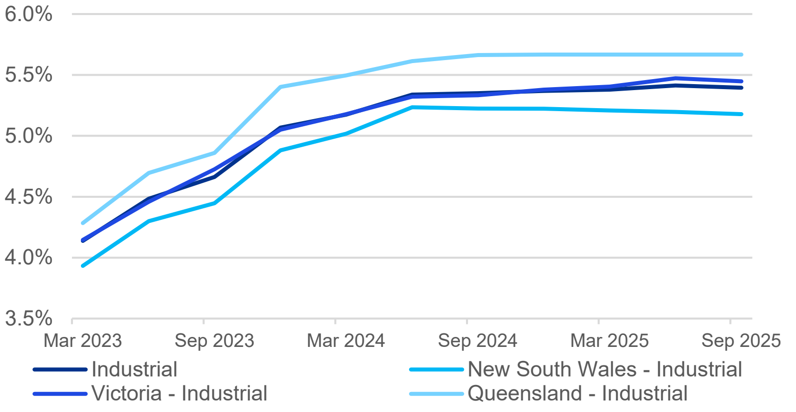
Looking ahead, expectations of yield compression persist, particularly in the middle markets, and markets such as Adelaide and Perth, as investors respond to strong occupier demand. ESG credentials and sustainability considerations continue to influence investment decisions, alongside the potential for rising construction costs to temper future supply.

Chart 28: Vacancy rates across industrial property by location (%)



Source: KPMG

Chart 29: Capitalisation rates across industrial property by location (%)



Note: Queensland data has not been reported by MSCI since March 2025; figures shown are based on KPMG's internal estimates.
Source: KPMG, MSCI/PCA

Industrial property sector (continued)

Investment performance

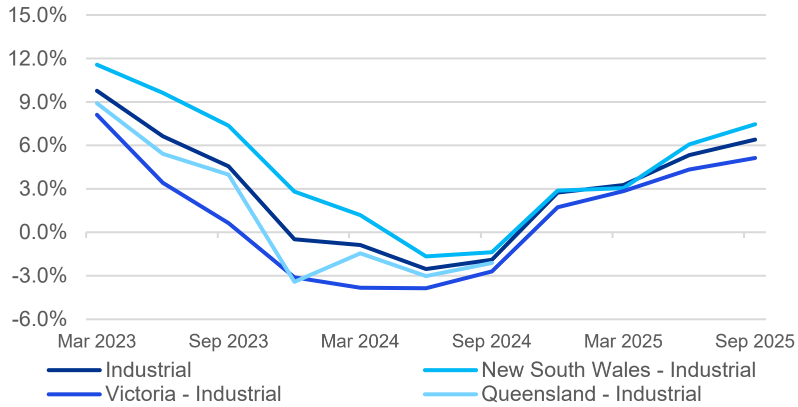
Total returns across all industrial markets have remained positive for four consecutive quarters, reaching 6.4% in the September quarter 2025 after a prolonged correction through late 2023 and much of 2024.

New South Wales recorded the highest total returns among sub-markets, supported by a significant income premium and strong fundamentals. Losses during the correction phase in NSW were less severe than those in Victoria and Queensland, reinforcing its relative resilience.

Capital growth has returned to positive territory, currently at 1.7%, marking two consecutive quarters of gains after six quarters of declines.

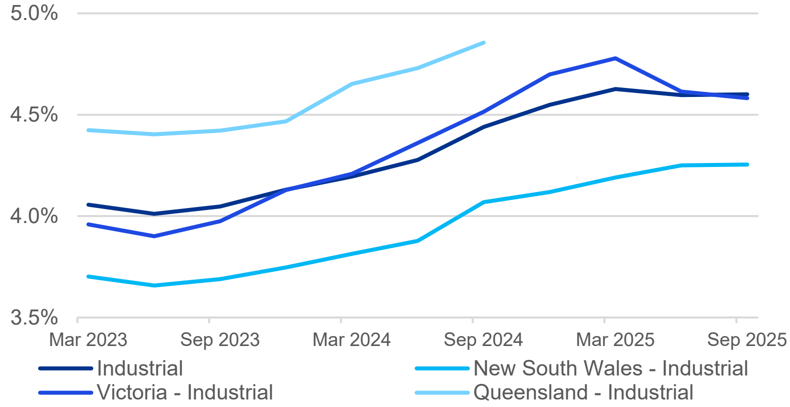
Income returns have been stable at around 4.6% since the start of the year, below pre-pandemic levels of 5%+, but with room for growth. Looking ahead, steady population growth, the continued expansion of e-commerce, and increased automation are expected to drive demand for industrial space. At the same time, supply will be constrained by rising construction costs and limited access to appropriately zoned and serviced land, supporting both rental and capital growth prospects over the medium term.

Chart 30: Total returns across industrial property by location (%)



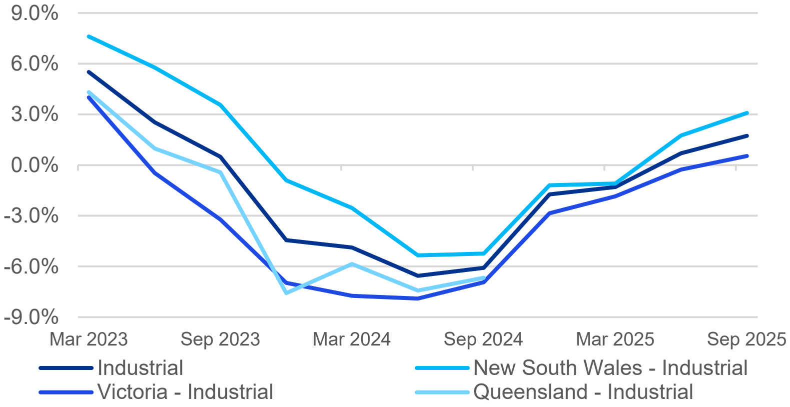
Note: Queensland data has not been reported by MSCI since September 2024.
Source: KPMG, MSCI/PCA

Chart 31: Income returns across industrial property by location (%)



Note: Queensland data has not been reported by MSCI since September 2024.
Source: KPMG, MSCI/PCA

Chart 32: Capital returns across industrial property by location (%)



Note: Queensland data has not been reported by MSCI since September 2024.
Source: KPMG, MSCI/PCA

Real bond yields and capitalisation rates

Capitalisation rates (cap rates) are the cornerstone of real estate analysis, representing the ratio of a property's Net Operating Income (NOI) to its market value. Conceptually, cap rates can be expressed as:

Cap rates = Risk Free Rate + Risk Premium

The theory suggests that movements in real long-term bond yields (inflation-adjusted bond yields), commonly used as proxy for the risk-free rate, should influence cap rates. Bond yields set a benchmark for borrowing costs and investors' expectations and subsequently affecting property values.

The relationship is more complicated than theory implies.

Our analysis of Australian data shows that cap rates and risk-free rates tend to co-move over the long term. Over the long term, the correlation is significant across the three sectors, ranging from 0.5–0.7 as seen as Chart 34. However, there are notable periods of divergence where the 5-year rolling correlation breaks its positive relationship.

In fact, since 2013, the spread between cap rates and real risk-free rates has been on a declining trend as shown in Chart 35. This narrowing spread suggests a structural shift in risk appetite, with investors increasingly accepting lower risk premiums in all core asset classes.

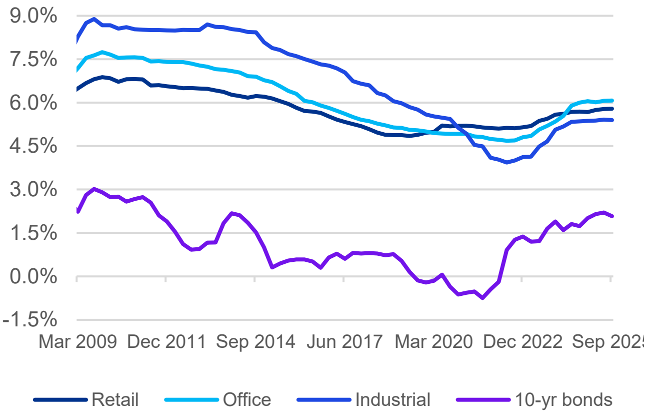
In recent years, real bond yields have rebounded to levels last seen in 2013 (see Chart 33). In 2025, yields stabilised around the low 2% range following three interest rate cuts, reversing some of the earlier upward momentum. Despite these movements, cap rates have not mirrored the increase in bond yields.

The declining spread between cap rates and bond yields reflects changing investor behaviour.

Industrial assets continue to command the lowest risk premium, supported by strong fundamentals and structural tailwinds. Conversely, retail and office sectors have swapped positions, with office now carrying the highest risk premium. This shift is largely attributable to structural changes in workplace dynamics post-pandemic, which have dampened sentiment and placed downward pressure on office values.

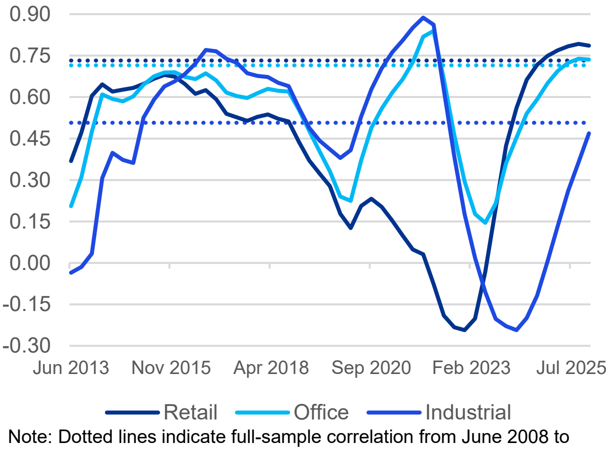
The disconnect between rising bond yields and relatively stable cap rates indicates that property pricing is influenced by more than the risk-free rate movements. While the relationship between bond yields and cap rates remains complex, the resilience of commercial property is evident. The declining risk premium across most sectors reinforces this confidence, signalling that investors continue to value the long-term stability and income characteristics of these assets. KPMG maintains a positive outlook on demand for commercial property, supported by these structural strengths and the recent return to positive performance across all core asset classes.

Chart 33: Capitalisation rates and the real risk-free rate (%)



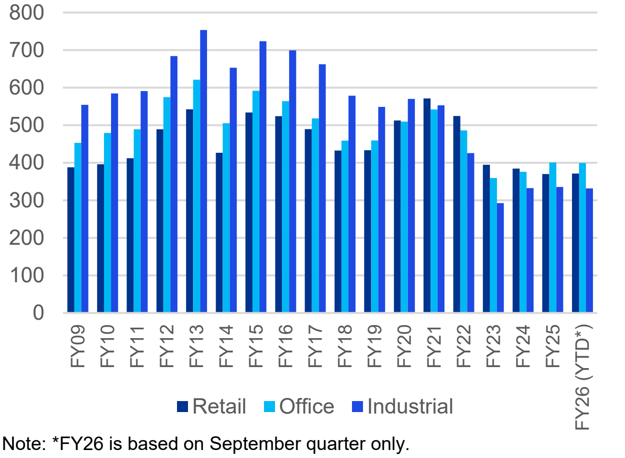
Note: 10-yr bond refers to the yield on 10-year inflation indexed government bonds.
Source: KPMG, MSCI/PCA, RBA, Haver

Chart 34: 5-year rolling correlation between capitalisation rates and the real risk-free rate



Note: Dotted lines indicate full-sample correlation from June 2008 to September 2025.
Source: KPMG, MSCI/PCA, RBA, Haver

Chart 35: Average spread against the real risk-free rate (bps)



Note: *FY26 is based on September quarter only.
Source: KPMG, MSCI/PCA, RBA, Haver

Technical appendix

What is uncertainty?

Uncertainty in a financial asset and from an investment return perspective is defined as the conditional volatility of a disturbance that is unforecastable from the perspective of economic agents, which include investors.

An economic disturbance is an event or action that reduces the predictability of the future net cash flows from income-producing assets, like commercial property.

If an economic disturbance alters the perception an investor has of an asset's ability to earn a predictable return in the future (usually, in some context, to the return it has earned in the past) then the value an investor places on that asset will change; and where that information is not fully transparent across all participants in the market, there is likely to be an increased variance in (investor) valuations.

There can be a wide variety of shocks that alter investor expectations, but where changes occur rapidly (i.e. more volatility) the record of the past necessarily contributes less to predictions about future income. Volatility, which is a well-known indicator for measuring asset price risk, is conventionally measured as the standard deviation of asset returns.

Increases in uncertainty can depress hiring, investment, or consumption if households or investors are subject to fixed costs, are risk averse, and/or if financial constraints tighten in response to higher uncertainty.

What does the KPMG Commercial Property Uncertainty Index measure?

The KPMG Commercial Property Uncertainty Index tracks the variability of total returns from real estate properties. These returns are calculated based on the Morgan Stanley Capital International (MSCI) and Property Council of Australia Property Index (MSCI/PCA Property Index). This MSCI/PCA Index reflects the overall returns from direct real estate investments that are not leveraged, taken from one property valuation to the next, and considers only those properties that are completed and available to rent.

The KPMG uncertainty index does not break down how much of the uncertainty in the market is due to changes in property values (capital returns) versus rental income (income returns). Instead, it provides a measure of the overall level of uncertainty linked with the total returns from property investments.

Properties that yield steady and reasonable returns are typically associated with a lower score on the uncertainty index, indicating a stable market environment. Conversely, a spike in the index suggests that investors are either anticipating, or responding to, significant shifts in the market. An increase in the index value is an indicator of rising uncertainty in the investment environment, while a decrease suggests the opposite.

Technical appendix (continued)

How is the KPMG Commercial Property Uncertainty Index calculated?

The KPMG Commercial Property Uncertainty Index has been constructed using total returns within a stochastic volatility model framework; an approach similar to that applied to measure stock market volatility. The stochastic volatility model treats volatility as a random process that evolves over time as opposed to treating it as constant or deterministic.

The uncertainty index value calculated using a stochastic volatility model tells users whether total returns of commercial property is more volatile in the current period, compared with previous periods (i.e. the index value is higher in period t than in period t-1) or less volatile (i.e. the index value is lower in period t than in period t-1).

A consistently low index number would indicate that the returns from the property market are stable and less variable. This stability could be due to a robust underlying demand for property or economic stability. In such a case, investors might lower their hurdle rates, as the risk associated with investing is perceived to be lower, and hence, they can accept lower returns for the reduced risk.

A moderate or high index number indicates a more volatile investment performance. In a volatile and uncertain investment environment, adopting a 'wait and see' approach can be advantageous. Volatility can lead to rapid and unpredictable changes in investment values. By waiting, investors can avoid making decisions that might result in significant losses due to unforeseen market movements. Uncertainty often implies a lack of information or the presence of conflicting information. Delaying investment decisions allows for the collection and analysis of additional data, leading to more informed decision-making. Alternatively, investors might also want to adjust their hurdle rates higher in such scenarios to compensate for the increased risk.

How is the stochastic volatility formula applied in the KPMG Commercial Property Uncertainty Index?

The key idea behind stochastic volatility models is that the latent volatility cannot be directly observed; instead, it must be inferred from the returns data. To achieve this, we firstly estimate the square of total returns, y_t, using a conditional mean equation:

$$\mathrm{y_t} = \mu + \sigma_t \epsilon_t \quad (1)$$

We then model the evolution of the variance term, σ_t^2, over time using a standard stochastic volatility process (see Harvey et al, 1994):

$$\log(\sigma_t^2) = \alpha + \beta \log(\sigma_t^2) + \omega \eta_t \quad (2)$$

where ϵ_t and η_t are iid $N(0,1)$ random variables.

The stochastic volatility parameters α, β and ω are then estimated by casting (1) and (2) into a state-space form using a Kalman Filter.

We then define the measure of uncertainty as:

$$\mathrm{U_t} = \sqrt{E(\sigma_t^2)}$$

References

Harvey A, Ruiz E, Shepard N. 1994. Multivariate Stochastic Variance Models. *Review of Economic Studies* 61: 247-264

Jurado K, Ludvigson S, Ng S. 2015. Measuring Uncertainty. *American Economic Review* 105: 1177-1216.

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December 2025 | 4330624635E.