The Australian Real Asset Economy

Quarter ended
30 June 2022

Foreword

Nigel Virgo
National Sector Lead
Property Construction
& Logistics
T: +61 2 9335 7156
E: nvirgo@kpmg.com.au

Sarah Hunter
Senior Economist
& Partner
KPMG Economics
T: +61 2 9245 4754
E: sarahhunter@kpmg.com.au

We're proud to introduce this inaugural quarterly KPMG Australia report: *The Australian Real Asset Economy.* We developed this report in response to the growing demand for regular analysis and insights into how economic activity impacts real estate.

We believe that collaborating with the industry and sharing our insights and experience will help build resilience, protect asset value and inform strategic decisions in this disruptive environment. We hope the outlook in this quarterly report will provide real estate professionals with context and insight to help their business planning and approach.

This concise report articulates the key real estate themes for the quarter and our expectations for the future as we look ahead.

Real estate, along with almost every industry in Australia, faces a challenging economic climate due to significant geopolitical conditions. These include increasing inflation and interest rates, heightened risks, supply chain challenges and the collapse of construction companies.

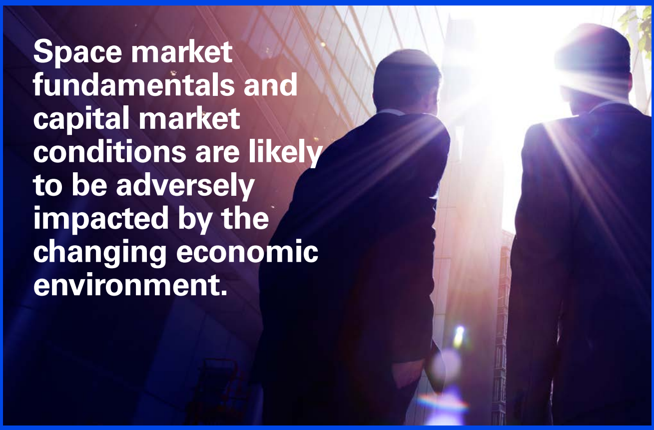
This is happening as the global economy continues to recover from the COVID-19 pandemic, which created uncertainty and accelerated several emerging trends: the digitisation of work; the transformation of physical retail; and the need to refocus on supply chain management. The shift towards environmental, social and governance (ESG) considerations are also now paramount to decision making. These trends are expected to have a critical influence on how real estate markets will fare over the coming years.

This report provides insights from our Real Estate and Economics experts, in conjunction with Real Investment Analytics (RIA), on the current economic environment and each of the real asset classes. It also addresses the fundamental question of whether real estate is an inflation hedge.

THIS QUARTER, WE'VE SEEN:

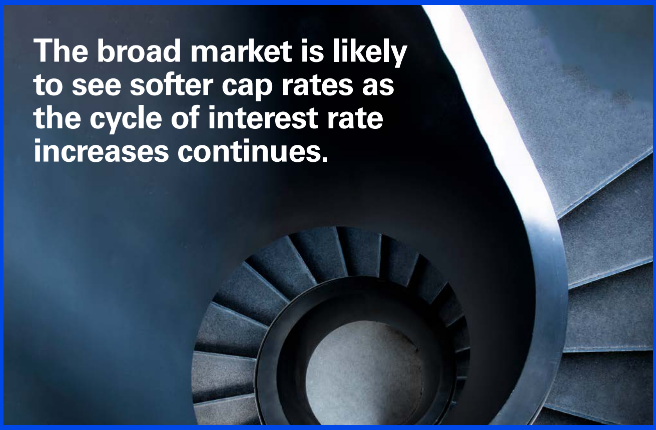
- Challenging conditions for space markets and capital markets. We expect this to continue over the short term, as central banks take aggressive action to manage inflation and increase interest rates. Looking forward, we expect all property sectors will likely see weaker demand for space, higher vacancies and downward pressure on effective rents. Furthermore, we're likely to see an end to the cap rate compression cycle.
- A limit to the capacity of commercial real estate (office, retail and industrial) to act as an inflation hedge. Most leases are fixed, and escalation factors are below the current and expected CPI inflation over the next 18 months. Asset values are likely to retreat somewhat as rising interest rates drive softer cap rates.

Key takeaways



Space market fundamentals and capital market conditions are likely to be adversely impacted by the changing economic environment.

Overall demand for space will be softer, which will see vacancies edge higher and place downward pressure on effective rents.



The broad market is likely to see softer cap rates as the cycle of interest rate increases continues.

Historical performance suggests commercial real estate did provide an inflation hedge. However, with the current economic climate, the resulting rise in interest rates is more likely to adversely impact asset prices and rental growth…

OFFICE SECTOR

Corporate tenants and investors place greater focus on high-quality environmentally friendly buildings.

RETAIL SECTOR

Greater distinction between discretionary and non- discretionary shopping centres in evaluating risk and pricing.

INDUSTRIAL SECTOR

Continued advancements in e-commerce will see new industrial supply to accommodate growing demand.

Executive summary

THE AUSTRALIAN REAL ASSET ECONOMY

The rapidly evolving economic climate is likely to adversely impact space market conditions. While solid economic growth and the tight labour market are the basis for occupational demand, the unfolding economic backdrop will likely translate into softer demand for space.

Current asset pricing remains mixed across sectors. The industrial property sector continues to see some firming in cap rates, but cap rates for the retail and office sectors are now stabilising. However, we're yet to see the flow-on impact of increasing interest rates and bond yields on transactional activity. Property cap rates are broadly set to experience some softening in the second half of 2022 and the extent of this will depend on the level of capital flows into the real estate sector.

Commercial real estate's capacity to act as an inflation hedge depends on having flexible leases that accommodate inflationary pressures to protect income streams and robust tenant demand to maintain asset valuations while interest rates continue to rise. Based on the structure of market leases and economic conditions, we believe neither of these dependencies will occur. Most leases are fixed with escalation factors below the current and expected CPI inflation over the next 18 months. Asset values are likely to retreat with rising interest rates driving softer cap rates.

Continuing advances in e-commerce will see new industrial supply to accommodate growing demand.

OFFICE

- This sector will continue to see soft space market conditions as post-COVID work practice adjustments linger.
- Despite a strong employment market, a significant share of the CBD workforce continues to work part of the working week from home. This was a temporary measure during COVID lockdowns, but is now a structural shift with a permanent proportion of the workforce continues to work part of the working week from home.
- Office markets experienced a mild firming in capitalisation rates through 2021-22, but are now stabilising.
- Capital flows remain relatively strong and investors are focussed on high-quality office spaces, including those with environmental credentials and income strength.
- Tenants are seeking workspace solutions which deliver both flexibility and connectivity.

RETAIL

- Space market conditions improved through 2021 when lockdown restrictions ended, but that's now likely to soften.
- The retail sector has two key segments - prime shopping centres are oriented towards discretionary goods and services while convenience retail and large format are focused on non-discretionary consumer items.
- These segments reflect investors' changing risk appetites and this is reflected in asset pricing.
- The demand profile is changing with the continued shift in consumer demand from physical to online shopping. Household consumption is shifting towards lifestyle items.
- The demographic is ageing and has a longer lifespan, which is influencing the demand for goods and services.

INDUSTRIAL

- There are favourable space market fundamentals with demand out-pacing available space in this sector.
- The surge in e-commerce and disruptions to retail sales and delivery platforms has boosted demand. Industrial space is replacing retail outlet space to support this change.
- Overall, sector repricing now reflects historically tight cap rates below retail and office sectors.
- The convergence in pricing across industrial product offerings highlights the lack of spread to reflect the different risk profiles across product types.
- There are strong capital flows into the sector as investors seek to meet target allocations.

ALTERNATES

- Social infrastructure may be an emerging sector for property investment.
- Performance has some protection from market cycles as the underlying drivers for this sector are linked to long-term demographic and technological changes.
- There is an opportunity to deliver enhanced risk-adjusted returns due to the defensive attributes of this sector.
- Asset management needs to be tailored and requires a bespoke understanding of each business operation.

Economic update

KEY ECONOMIC EVENTS FROM THE LAST QUARTER

The Australian economy is in recovery phase as its growth profile reverts towards its long- term average. This moderation in growth is in line with other developed economies after experiencing a strong upsurge in demand when COVID-19 lockdowns were eased. The labour market remains relatively tight with a low unemployment rate at 3.5 percent. Employment growth remains solid at 3.3 percent, above its long-run average of 1.9 percent, despite it moderating over the quarter. While consumer demand has been strong over recent quarters, it is now dropping as moving annual turnover (MAT) growth at 5.1 percent slows towards its long-term average. The surge in consumer inflation in the March quarter and 6.1 percent in the June quarter has also triggered the Reserve Bank of Australia (RBA) to tighten monetary policy. The cash rate increased from 0.10 percent to 1.85 percent, and there are strong signals of further increases this calendar year.

WHAT THIS MEANS FOR REAL ASSETS

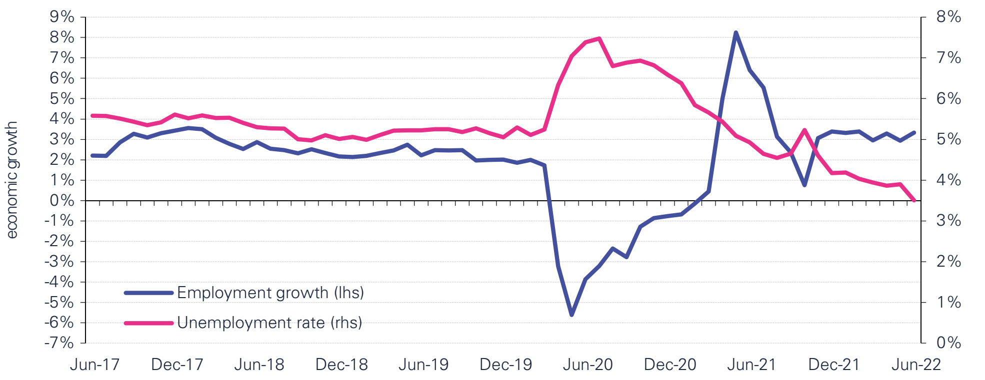
The changing economic environment is likely to adversely impact space market conditions. Solid economic growth and the tight labour market are supporting occupational demand, but the uncertain environment will weigh on lease activity and the demand for space. Rising interest rates are likely to adversely affect capital market conditions for real estate investment. Future asset revaluations are likely to move down, reflected in cap rate softening.

3.5%

UNEMPLOYMENT

Unemployment rate sits at 3.5 percent, down from its peak of 5.2 percent in Oct 2021. Annual employment growth sits at 3.3 percent pa versus long-term average growth of 1.9 percent pa.

Employment growth and unemployment rate
monthly periods ending Jun 2022

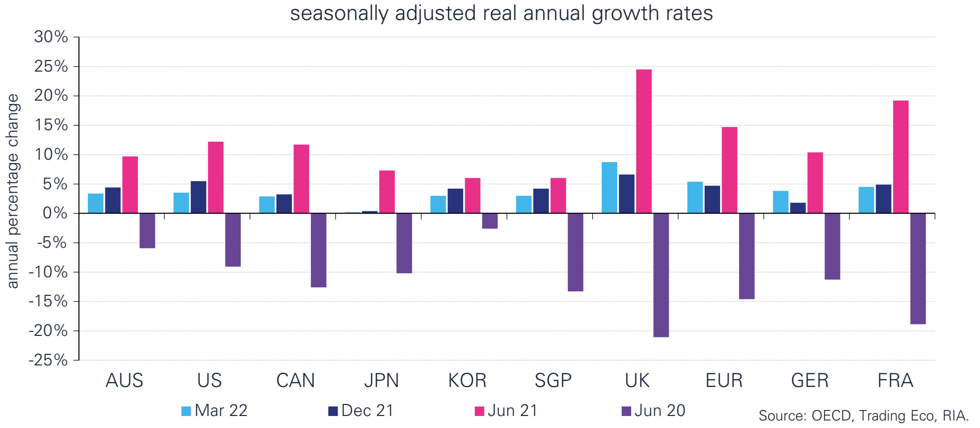


Source: ABS RIA.

GLOBAL ECONOMIC GROWTH

Global economic growth across developed economies remains positive but is moderating. Annualised growth rates were softer in Mar 2022 compared with Dec 2021 and likely to soften further in Jun 2022.

GDP growth across selected developed economies
seasonally adjusted real annual growth rates



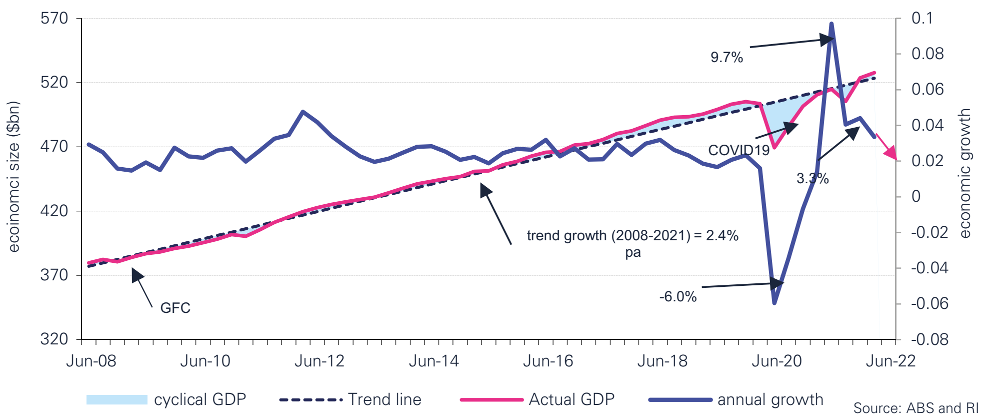
Source: OECD, Trading Eco, RIA.

3.3%

ANNUAL GROWTH

Annual growth to Mar 2022 stood at 3.3 percent lower than the 4.4 percent recorded Dec 2021. But still well above trend growth of 2.4 percent.

Australian macroeconomic size and activity
actual versus trend in real GDP



Source: ABS and RI

DOMESTIC RISK

- The government have flagged they are focusing on managing spending to manage any additional stimulus to the economy.
- Entrenched consumer price inflation. This is likely to occur if wage rises are linked to CPI and supply-side factors continue
- Rising market interest rates. Central banks are taking an aggressive approach to tightening monetary policy to control inflationary expectations

GLOBAL RISK

- Geopolitical risks. These include issues such as territorial claims in South China sea, the AUKUS Alliance and strengthening of NATO
- Ukraine-Russia conflict. This is causing disruptions to food security and elevated resource prices
- Global recession. Caused by slower global trade and overly aggressive monetary tightening policies in multiple national economies
- Supply constraints. Caused by supply bottlenecks as economies exit lockdowns

PANDEMIC RISK

- Robustness of COVID-19. The world faces sporadic outbreaks of virulent mutations (new Omicron sub-variant detected and more recently, monkeypox)
- Persistent COVID-19 outbreaks in China

SHORT-TERM OUTLOOK (12 MONTHS)

- Economic growth to slow in the coming quarters
- The labour market will remain strong but show some softening: employment growth is slowing and unemployment is expected to edge upwards
- Consumer demand will slow with curbs on discretionary spending.
- Housing market softens and prices retreat
- CPI inflation will remain high
- Higher cash rate and other market interest rates

MEDIUM-TERM OUTLOOK (3 YEARS)

- Economic growth will revert to trend
- Strong recovery in tourism, entertainment and education sectors
- The labour market will strengthen, with employment growing and unemployment rate returning towards equilibrium.
- Solid consumer demand but moderating MAT growth
- Housing and construction sector will enter a recovery phase
- CPI inflation to hover around the upper range of RBA target
- Higher but steady market

Real assets: key themes

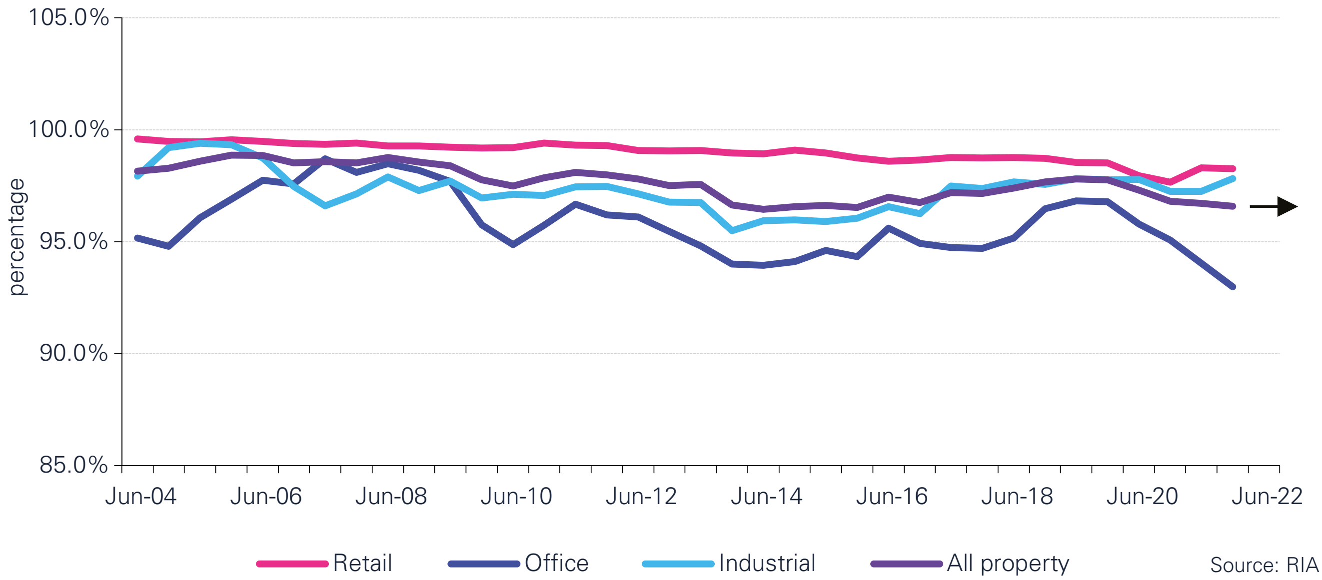
SPACE MARKET CONDITIONS:

Space market conditions generally improved as Australia emerged from lockdown restrictions in late 2021. The sharp tightening in the labour market and pent-up demand in the consumer retail market supported occupational demand, but this varies markedly across sectors and sub-sectors. Overall demand for space is likely to soften as rising interest rates curb aggregate demand.

The industrial sector continues to experience relatively strong demand for space, supported by e-commerce. In contrast, retail shopping centres are reconfiguring to ensure they are fit for purpose to retain and attract new tenants. The office sector will explore adaptions in workspace formations that are more productive, given the shift towards work from home practices.

Space market conditions are mixed across key sector markets. Occupancy rates are relatively tight for industrial, improving for retail yet relatively sluggish for office.

Trends in occupancy rates across sector
bi-annual periods ending June 2022



Source: RIA

TIGHT
INDUSTIAL RATES

IMPROVING
RETAIL RATES

SLUGGISH
OFFICE RATES

ASSET PRICING DYNAMICS:

Property cap rates have displayed steep firming since 2016, with the average cap rate across traditional property sectors now residing at a historically low 4.9 percent. This is due largely to the strong capital weighting towards commercial real estate. However, the cap rate compression cycle is expected to end with rising market interest rates and a narrowing of the cap rate-bond rate spread.

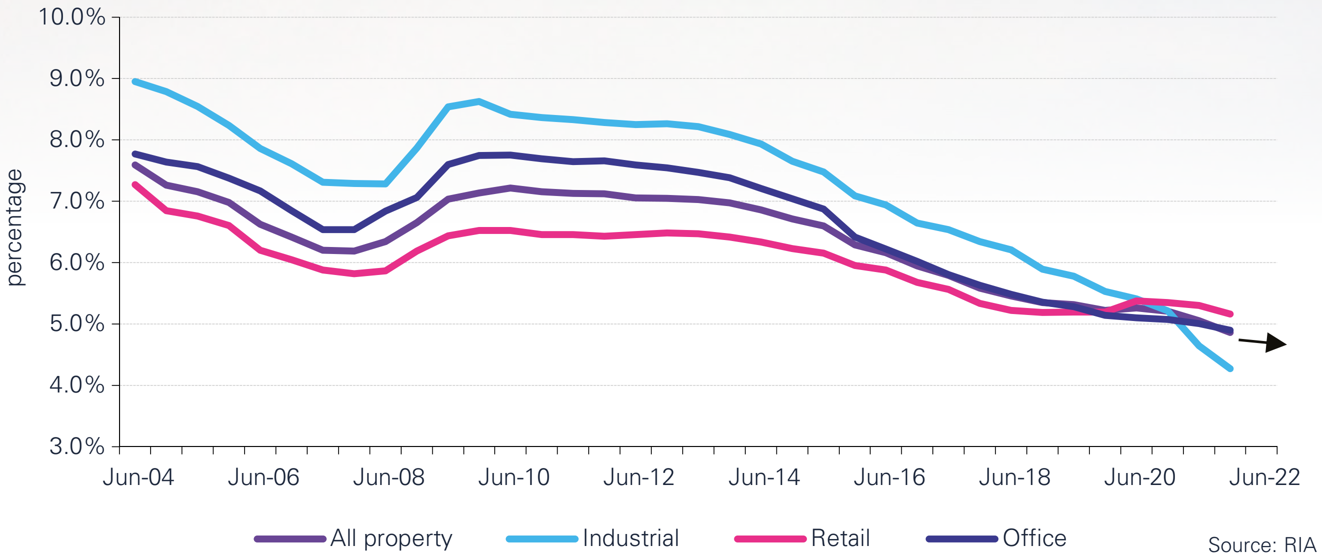
Investor appetite remains strongest for the industrial sector because of the perception it has a relatively higher risk-adjusted return.

Commercial real estate's inflation hedge features will now be tested in a rising interest rate environment.

TECHNOLOGICAL CHANGES:

Continued advancements in e-commerce will see new industrial supply to accommodate growing demand.

Trends in cap rates across sector
bi-annual periods ending June 2022



Source: RIA

Office property sector – performance drivers and outlook

Performance drivers

There has been weakened demand for office space. Vacancy rates for the Sydney and Melbourne CBD will rise by the end of 2022.

As at June 2022, vacancy rates for all sectors rose towards 12.9 percent, which is above the long-term average of 10 percent. However, vacancies vary markedly across CBD markets and grades.

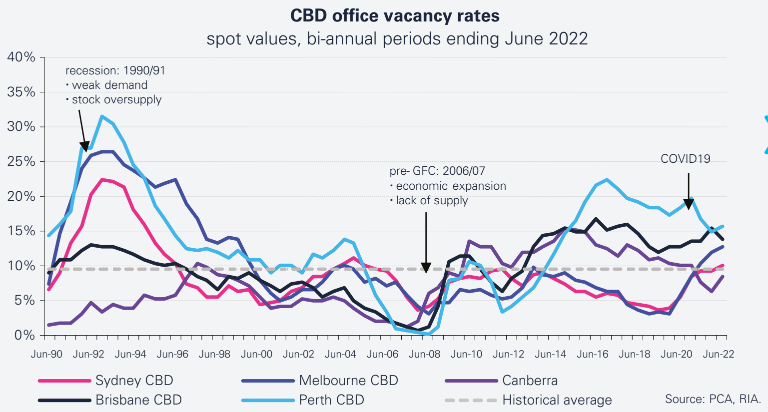
As a result, incentives remain elevated, around 30 percent, and real effective rental growth remains negative.

Demand growth is also experiencing a structural softening, with many corporates continue to give staff the option to work from home for some or all the working week.

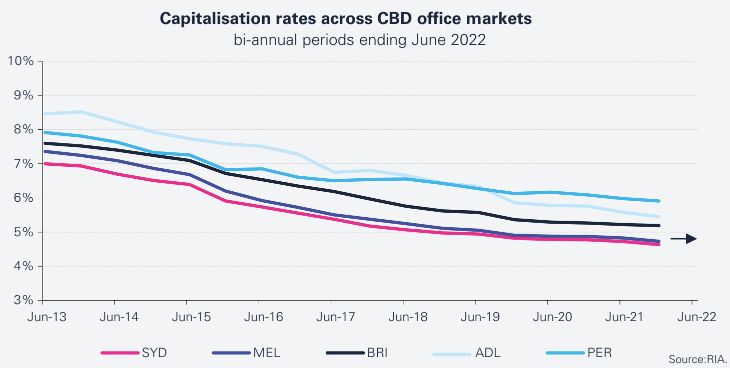
This has caused a recalibration of work-space ratios, as well as a pivot in office fit-out. Tenants are seeking workspace solutions that deliver both flexibility and connectivity.

The office sector generally saw a mild firming in cap rates over the year to March 2022 to 4.9 percent. There is a significant spread (averaging c60bps) between the Sydney & Melbourne markets and other CBD markets.

Space market conditions remain sluggish with vacancy rates at cyclical peak across major CBD markets



Office sector continues to experience mild firming in capitalisation rates across the Sydney and Melbourne CBD markets



SHORT-TERM OUTLOOK

(12 MONTHS)

- Space market fundamental imbalance to persist, mainly due to weaker demand for space. The weaker demand is partly underpinned by 'work-from-home' practices for CBD workforce and an expected weakening in the labour market.
- On-going demand for high-end quality 'green' buildings by corporate tenants.
- Higher vacancies will generally translate into higher incentive levels and lower effective rents.
- Investment property returns are likely to soften with capital growth turning negative.
- Investor demand for office buildings to remain robust, although capitalisaiton rates likely to edge upwards as interest rates move sharply higher.

Retail property sector – performance drivers and outlook

Performance drivers

In gauging retail demand, we typically review the growth in moving annual turnover or MAT. After experiencing sluggish growth in 2020, the retail sector saw a surge in demand as the wider economy moved out of lockdown in 2021.

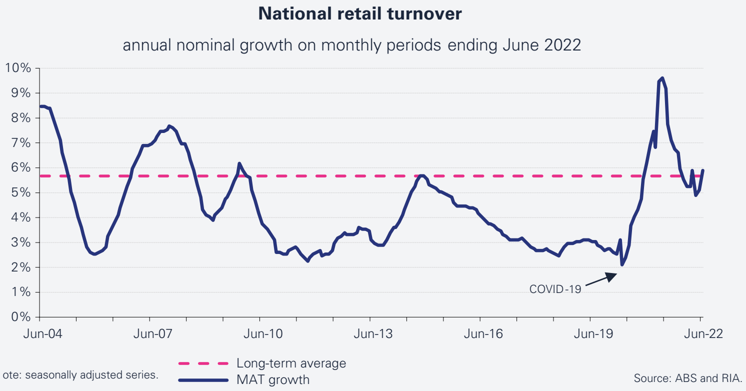
Over this same period, vacancy rates rose mildly in 2020 and then improved slightly throughout 2021 and to March 2022.

The retail sector faces structural challenges in consumer demand, including: shift towards online retailing; shift towards lifestyle goods & services; and changing demographics towards an aging population.

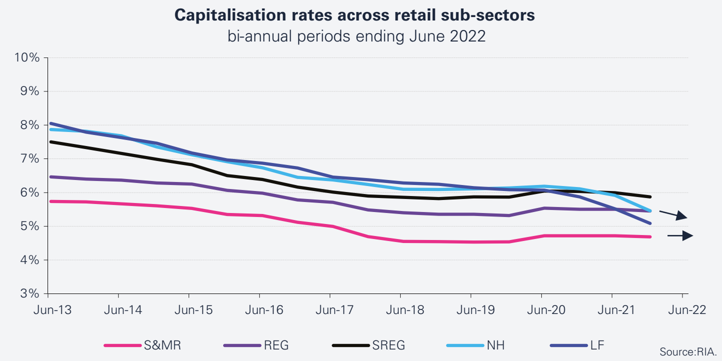
As at March 2022 the sector's cap rate held steady at 5.2 percent and preliminary evidence indicates that this will hold steady for June 2022.

The retail sector saw a softening in cap rates in 2020, mainly concentrated in prime shopping centres (discretionary) which saw an average softening of 25bps. In contrast, convenience retail and large format (non-discretionary) saw cap rates firm by an average 30 bps.

Space market conditions were improving with strengthening retail demand but now moderating towards long-term average



Market cap rates starting to firm once again across sub-sector but strong firming experienced for large format sub-sector



SHORT-TERM OUTLOOK

(12 MONTHS)

- Generally softer space market fundamentals due to slower momentum in consumer retail demand, with household budgets becoming squeezed by cost of living increases and rising mortgage rates.
- Sector vacancies stabilise but rental growth remains sluggish.
- Relatively softer cap rates for prime-grade shopping centres. Neighbourhoods and large format are likely to see relatively firmer asset pricing.
- With cap rates likely to edge upwards, investor demand will focus on non-discretionary focused shopping retail centres and down-weight allocations to discretionary retail shopping centres
- Opportunities with de-risking of retail investments via repositioning SCs in terms of tenancy mix and format.

Industrial property sector – performance drivers and outlook

Performance drivers

The industrial sector continues to experience favourable space market conditions with growth in demand out-pacing available space. The strong demand for space is due to a combination of cyclical and structural factors.

Cyclical demand has been supported by low interest rates, relatively solid economic activity and the growth in e-commerce.

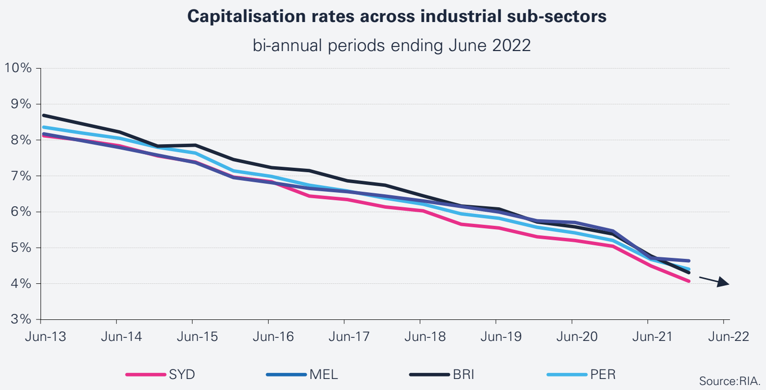
Factors underpinning structural demand for space have included the growth of e-commerce as well as technology disruptions to retail sales/delivery platform, reflected in the shift in demand from on-floor to on-line. This has effectively seen a substitution of merchandise retail outlet space with industrial space.

The relatively tight space market conditions has seen land values rise steeply and strong positive rental growth.

The combination of favourable space market and capital market conditions is reflected in historically tight cap rates, which have firmed by c90bps over the year to 4.3 percent at March 2022.

Industrial demand assisted by advancements in e-commerce and technology disruptions to retail delivery platform

Industrial sector experiences cap rate firming trend across key markets since 2013 but has seen stronger firming since 2020



SHORT-TERM OUTLOOK

(12 MONTHS)

- The industrial property sector is set to experience cyclical weakness in space market conditions in line with a slowing in economic activity. However, we believe it will outperform other sectors due to strong structural demand for storage /logistics & warehouse space, with the shift towards on-line retailing helping vacancy rates to stabilise.
- Investor appetite for industrial to remain relatively strong as they continue reweight capital allocations due to the sector's higher risk-adjusted returns.
- Asset pricing is likely to be relatively favourable for industrial against office and retail property sectors. However, interest rate rises are likely to result in a slower pace of cap rate compression as well as a widening spread across product types.

Alternative sectors – performance drivers and outlook

PERFORMANCE DRIVERS

Institutional investments in alternative sectors are currently worth around $50 billion. Investment in this sector has greatly increased over the last decade, which has seen its market share rise from 3 percent to 13 percent in 2022.

Investing in alternatives expands the opportunities for property investment. Many of these sub-sectors, such as aged care and retirement, childcare and healthcare, are social infrastructure which represents half of all alternative sectors.

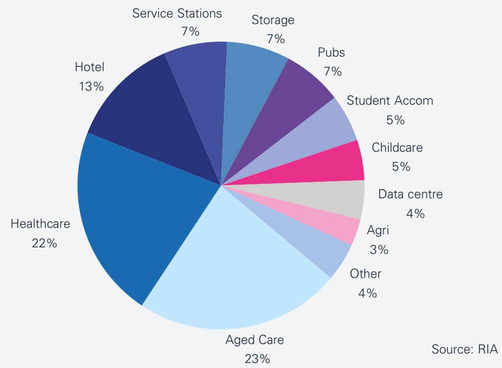
The performance of this sector is somewhat insulated from market cycles as the underlying drivers to many sub-sectors are linked to long-term demographic and technical changes.

A key challenge is the institutionalisation of many sub-sectors due to an inability to scale, especially for early emerging sectors.

A key performance risk is the role of regulation, especially for those sectors that have government support schemes.

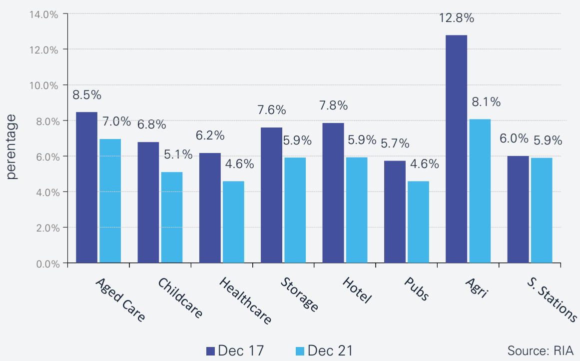
A key attraction of investing in alternatives is the potential to deliver enhanced risk-adjusted returns due to their defensive attributes. Consequently, strong capital flows have resulted in a firming in cap rates over the last 5 years.

Value of alternatives by property sub-sector
as at Dec 2021



Source: RIA

Cap rates aross selected alternative sub-sectors



Source: RIA

SECTOR VIEWS

- **Aged care / retirement:** growing long-term demand but short-term asset management issues. Risk of government regulation.
- **Child care / early learning:** strong demand with favourable capital market conditions (firm cap rates). Risks include regulation and govt subsidies.
- **Data centres:** Strong demand due to technological advancements. Risks include regulatory (data confidentiality & security) & technology.
- **Healthcare / medical:** strong space-market fundamentals and favourable capital market conditions. Pricing has firmed markedly over recent years with strong investor appetite.
- **Hotels**: recovery phase with increased domestic & international travel.
- **Resi build- to–rent (BTR):** in early stages but anticipated strong market demand.
- **Self storage:** Demand due to population density. Risk of being exposed to business cycle.
- **Student accommodation:** recovery phase with opening-up of travel & education.

Commercial real estate and inflation hedging: the historical review

As inflation starts to climb and interest rates increase in an attempt to manage it, the enduring question of whether commercial real estate is an inflation hedge is once again dominating the conversation amongst real estate investors. Does the anticipated rental growth in leases and the overall capital return provide a positive total return against increasing inflation?

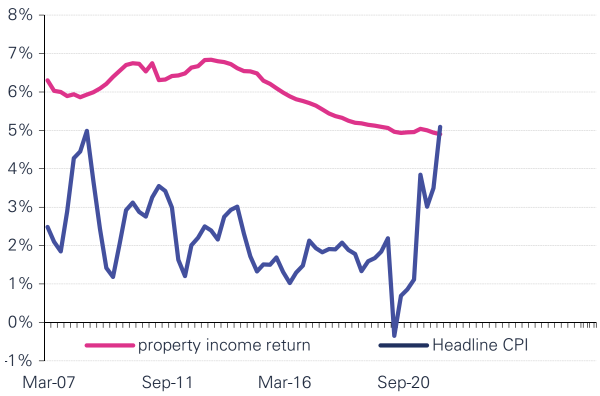
A review of data from the mid-1980s to the mid-1990s shows that direct property performed well, with nominal total returns averaging 10 percent. Over the same period, consumer inflation, measured by CPI, averaged around 3 percent.

This overall period was characterised by above trend economic growth and improving space market fundamentals, which saw vacancy rates trending down and effective rents moving. There was a brief period in the early 1990s when the economy was in recession. At the time, the commercial real estate market experienced a downturn with increases in vacancies, decreases in effective rentals and negative returns.

Looking at income return, real estate has delivered a premium income spread with an average annualised real income return of 3.8 percent over the last 15 years. This reflects fixed rental escalation factors above CPI inflation rates. Real estate has historically delivered this hedge against inflation, but the spread is now narrowing with current inflation at above average levels. If inflation persists at the current rate, there will be an erosion in net income and rental growth may fall short of inflation. Commercial lease structures vary across sectors, but those leases where escalation factors are linked to CPI, turnover (mainly for major retail tenants) or costs (such as triple net leases) are likely to deliver more robust income streams in this inflationary environment. Alternatively, leases with fixed escalation factors below CPI and long lease expiries are likely to experience greater erosion in incomes.

CPI inflation versus commercial property income return

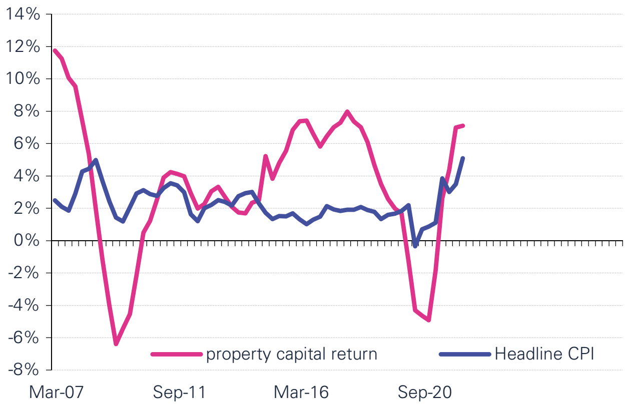
quarterly periods ending March 2022



Source: RBA and RIA.

CPI inflation versus commercial property capital return

quarterly periods ending March 2022



Source: RBA and RIA.

Commercial real estate and inflation hedging: the current view

The performance of real estate as an inflation hedge is now being tested. Inflation rose sharply in the March 2022 quarter, to 5.1 percent, and is set to reach 7 percent by the end of the calendar year. This is being driven by rapidly rising energy and food prices, demand for building commodities, the ongoing impact of supply chain disruptions and an acceleration in wage growth.

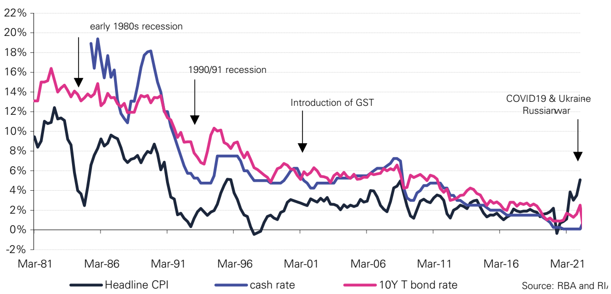
The hastening in inflation prompted a swift response from the RBA which lifted the official cash rate from 0.10 percent in April to 1.35 percent in July and lifted to 1.85 percent in August.

Long-term rates have also edged upwards with the 10-year Treasury bond rate now hovering at around 3.50 percent. The bond rate is deemed to be a key factor in asset pricing for commercial real estate, given its close link with the capitalisation rate for commercial real estate. The capitalisation rate has delivered a favourable spread to the bond rate since the global financial crisis. There will be variation across sub-sectors, and this suggests that increases in the bond rate will translate to a higher capitalisation rate.

The spread between the real estate cap rate and bond rate has been tapering sharply over the last quarter, sitting at around 240bps. Across key real estate sectors, the bond-cap rate spread is tightest for the industrial sector at 180bps with a cap rate of 4.3 percent in March 2022. These spreads are expected to continue reducing with further interest increases.

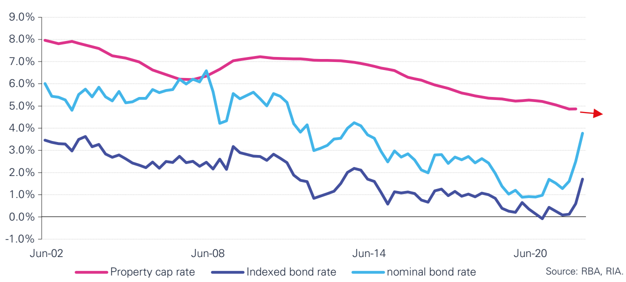
CPI inflation versus interest rates

periods ending June 2022



Commercial property cap rate versus 10Y T bond rates

quarterly periods ending June 2022



Commercial real estate and inflation hedging: the outlook

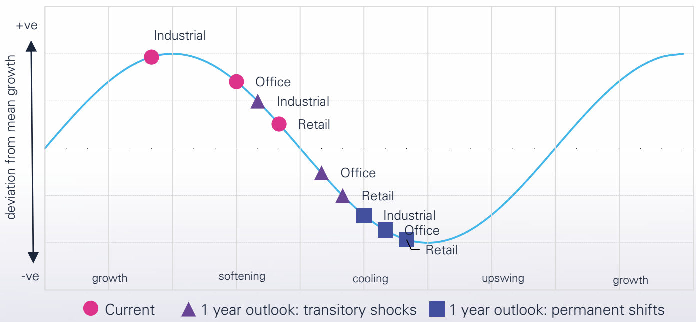
In evaluating the potential future performance of commercial real estate investments, we consider two plausible market scenarios: permanent shifts and transitory shocks. These scenarios consider various risk factors, including the nature of inflationary pressures, domestic market conditions, inclusive of monetary policy, and global factors.

In the **transitory shocks scenario**, inflationary pressures ease to a lower underlying rate such that it's within the RBA's 2 to 3 percent target zone by mid-2023. This means the external headwinds currently buffeting the world economy fade with little damage to the level of economic activity. As such, we would see a moderate but steep cycle of tightening monetary policy, with an increase in the cash rate of 100 to 200bps. Accordingly, the economy would recover with economic growth reverting to trend in the medium- to long-term. The labour market would experience a significant softening in the short term, with slowing employment growth and a mild rise in unemployment. Commercial real estate would likely experience a mild rise in space vacancies, some falls in effective rents and a slight softening in capitalisation rates. The chart shows all three key real estate sectors moving towards the trough of the real estate market cycle. In this scenario, industrial is likely to outperform other asset classes given the strength in demand for its product types. In contrast, office and retail are positioned in the early cooling phase of the cycle due to sluggish demand conditions.

In the **permanent shifts scenario**, inflationary pressures ease but remain elevated relative to the pre-conflict period. We would see inflation as partly transitory, but the shocks to global supply would be permanent and the world would need to recalibrate to a point where commodity prices are permanently higher and the gains from globalisation are permanently lower. As such, we would see a steeper cycle of tightening rates, of around 200 to 350bps. Consequently, economic growth would be structurally weaker, with aggregate demand impaired by the negative shock to real incomes. In the short term, there would be a significant risk that multiple developed economies experience recession.

Property space market cycle

sector market positions on the stylised property cycle



Despite the slowdown in activity, the current strength in the labour market means it would experience a soft landing, with employment growth below trend and a mild to moderate rise in unemployment. The consumer market would remain sluggish as households curb spending on discretionary items. Commercial real estate is likely to see increases in vacancies and falls in effective rents in the near term due to weakness in the space markets. Asset prices would also retreat with softening cap rates. This is shown in the chart with all three key real estate sectors moving within the cooling phase of real estate market cycle.

Historically, it seems that commercial real estate shows inflationary hedge features in:

- an elevated inflationary environment, supported by above-trend economic growth and favourable space market conditions
- a benign inflationary environment with moderate economic growth.

In contrast, the period relating to the recession of the early 1990s saw commercial real estate returns turn negative and below inflation, even though inflation was falling.

Elevated inflation and softer economic growth will shape the short-term outlook. We note that commercial real estate's capacity to deliver inflation hedged investment performance will depend on having flexible leases that accommodate inflationary pressures to protect income streams and robust tenant demand to support and maintain asset valuations in a rising interest rate climate.

Contact us

Nigel Virgo
National Sector Lead – Property, Construction & Logistics
T: +61 2 9335 7156
E: nvirgo@kpmg.com.au

Sarah Hunter
Partner, Economics
T: +61 2 9245 4754
E: sarahhunter@kpmg.com.au

Peter Zabaks
Partner, External Audit
T: +61 2 9455 9214
E: pzabaks@kpmg.com.au

Nicola Woodward
Partner, Property & Environmental Services
T: +61 7 3237 5501
E: nicwoodward@kpmg.com.au

Ryan Eagle
Partner, Restructuring services
T: +61 2 9458 1559
E: ryaneagle@kpmg.com.au

Hoda Nahlous
Partner, Legal
T +61 2 9455 9315
E: hnahlous@kpmg.com.au

Mark Spicer
Partner, Sustainability
T: +61 2 9335 8020
E: markspicer@kpmg.com.au

Scott Farrell
Partner, Tax
T: +61 2 9335 7366
E: spfarrell@kpmg.com.au

Tony Moussa
Partner, Real Estate Capital
Tel: +61 2 9455 9842
E: tonymoussa@kpmg.com.au

Marcella Ugaz
Partner, Enterprise
T: +61 2 9335 8893
E: mugaz@kpmg.com.au

Jeff O'Sullivan
Partner, Risk Assurance
Tel: +61 2 9335 8336
E: josullivan@kpmg.com.au

Jayne Parish
Partner, Operational Transformation
T: +61 2 9455 9439
E: jparish@kpmg.com.au

Mike McCloskey
Partner, Project Controls
T: +61 2 9295 3840
E: mccloskeym@kpmg.com.au

Paul Morris
Partner, Real Estate Advisory
T: +61 7 3233 9420
E: pmorris2@kpmg.com.au

Tom Eade
Partner, Transaction Services
T: +61 2 9455 9344
E: thomaseade@kpmg.com.au

Brett McAuliffe
Partner, Valuation
T: +61 7 3233 9462
E: bmcauliffe@kpmg.com.au

KPMG.com.au

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