COVID-19

Australian real estate market summary

27 March 2020

The purpose of this report is to update stakeholders on the impacts of the evolving situation relating to COVID-19 on real estate markets in Australia.

Investment climate

The COVID-19 crisis is both a health and economic issue. As in other countries around the world, efforts to control the spread of COVID-19 in Australia are expected to cause a sharp slowing in economic growth in Q2 2020.

The downside risk to activity stems from Government measures to restrict international travel and large gatherings as well as limit and/or shut down many non-essential activities.

Most forecasters are modelling a contraction followed by a rebound in the second half of 2020 assuming the virus is controlled and restrictions lifted. We note however that the unprecedented nature of this event makes it hard to accurately predict the depth of downturn and recovery timing.

Eventual recovery will be helped by sizable stimulus packages amounting to 4.0% of GDP, announced by both Federal and State Governments designed to help businesses and workers. In addition, Governments around the world have announced very large fiscal stimulus measures.

A reduction in the official cash rate to a record low of 0.25% by the Reserve Bank of Australia and an easing in the Australian dollar will provide further stimulus. Australia’s strong population growth and ongoing infrastructure pipeline should also assist with the recovery.

Office

Leasing markets have softened over the past few weeks. New enquiry levels have fallen and the inspection rate has slowed. Large companies are still pursuing briefs in the market; however, small company enquiry has fallen the most. State and Federal Governments are active for immediate space requirements to provide social service delivery.

A number of office and office-related retail customers are seeking rental relief via rent abatement – ranging from large public companies to small enterprises.

The Sydney and Melbourne office markets were well-positioned heading into this period of uncertainty with vacancy rates below historical averages. White-collar industries like professional services, IT, health and engineering (knowledge-based industries) were growing quite strongly prior to this disruption suggests they may have the ability to recover quickly.

The outlook for office demand will depend on the duration of the economic slowdown. We expect leasing enquiry will remain soft until there is positive news on the public health front.

Retail

The retail sector is at the forefront of measures taken to control COVID-19 in Australia with social isolation, restrictions on non-essential retailing and reduced tourist flows impacting trade.

Essential services retailers like supermarkets, fresh food, medical services, pharmacies and liquor are all experiencing strong sales growth as people advance-buy. However, sales growth for discretionary categories has weakened sharply over the past month.

City based retail shops and food courts are experiencing a reduction in foot traffic as workers and tourists exit and avoid CBD areas.

Foot traffic has declined following government trading restrictions. These restrictions include closure or limitation of enterprises deemed non-essential such as pubs, entertainment venues, cinemas, cafes, food courts, beauty salons, massage parlours etc.

A growing number of retailers are electing to close temporarily or adjust their trading hours to minimise operating costs. A number of retailers are requesting rental assistance, particularly in discretionary categories like apparel, jewellery, cafes, restaurants, and non-essential services. Dexus is working with these retailers to enable them to continue their operations beyond this period of disruption.

Longer term it is likely that the current situation will increase the adoption of online retail, particularly for groceries. We note that majority of online sales are by retailers who also have a physical presence.

On a positive note the retail sector in Australia has relatively low levels of new construction. Australia has stronger population growth and a lower level of floor space per capita than many other countries.

Industrial

Enquiry has slowed, with a divergence in demand depending on the extent to which individual companies' product lines have been boosted or constrained by virus control measures.

Some categories remain relatively active such as food, pharmaceuticals and online goods. Supermarket operators are looking for overflow distribution centres on short term leases to keep up with demand. Enquiry has been positive for food grade facilities in Sydney and Melbourne including from traditional and online food companies. Another sector still expanding is business continuity products such as work-from-home technology and office supplies.

Overall, there have been delays to decision making with a few cases of withdrawal from lease negotiations. There have been some requests for rental assistance particularly from groups that rely on imported goods and logistics contracts supporting discretionary retail.

We expect enquiry will remain soft and patchy in the short term. Market vacancy is relatively low and the risk of over-supply will be mitigated by supply responding to more moderate levels of demand.

The longer term growth drivers for the Australian industrial market remain intact, and include the continued expansion in ecommerce and a steady flow of non-discretionary goods for a growing population.

Healthcare

The healthcare sector is at the front line of virus treatment efforts in an operational sense so there is some uncertainty about how the next few weeks and months will play out.

Medical centres and public hospitals are likely to experience increased activity as infected patient numbers increase and people present for initial testing. For the most part, infected patients are likely to be cared for in public hospitals first, due to their larger capacity and resources.

Non-urgent elective surgeries in Australia's public and private hospitals have been suspended in a bid to preserve the healthcare system's capacity to respond to the COVID-19 pandemic. This will likely mean that the volume of total surgeries in private hospitals will fall in the short term unless offset by an increase in COVID-19 patients. In Australia, hospital operators are typically on long term leases which helps to smooth income to owners.

Rents and values

It is still too early to predict what the effects of these uncertain conditions will have on rents and values across the real estate sector, as much depends on the duration of this disruption. Typically, sustained periods of weaker occupier demand do lead to downside risks for rent growth. However, in relation to rents, the generally low vacancy rates prevailing in the large office and industrial markets of Sydney and Melbourne will provide a useful buffer.

In relation to valuations there may be some impact from softer leasing and downtime assumptions, particularly in the retail sector. There is evidence of a slowing in the transaction market as buyers and sellers alike adopt a more conservative stance and are physically constrained from completing deals.

In times of uncertainty, high quality assets can be expected to hold their value better than lower quality due to their appeal to occupants and relative scarcity. For example, premium office buildings rarely trade. Only time will tell if, on balance, investors will adopt higher risk premiums, or are willing to look through this disruption and take a longer term view.

There are reasons to believe that impacts on real estate valuations may be less than those that occurred during the GFC of 2008. This time, Australian real estate yields have maintained a wider spread (premium) over interest rate yields, and many market participants have deleveraged and are operating with much lower target gearing bands and the pool of committed foreign capital is also much deeper. While credit spreads have increased, credit markets remain open and banks continue to support existing clients and new lending.