INVESTMENT SPOTLIGHT

Australian direct property: COVID-19 considerations across four key sectors

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The COVID-19 pandemic event is presenting challenges in all investment asset classes and the property investment sector is no exception. Very serious social and economic headwinds are being experienced, a quick glance at the four main property sectors in Australia reveals that not all property is performing equally.

Industrial – a pandemic 'darling'

The industrial sector has been a relative winner in the COVID-19 environment with strong leasing enquiry as a consequence of rising internet sales which have doubled in recent times, now representing over 10% of retail sales in Australia.

The ecommerce surge has seen companies such as Amazon and Catch of the Day looking to house warehousing distribution centres and associated 'last mile' facilities, the smaller distribution centres that funnel goods to buyers. This has driven both investor and leasing demand for industrial property to all-time highs in many locations.

It's a strong story all up for the sector that does not have an oversupply of accommodation, has a limited supply of tightly controlled land, has low vacancies and has solid rental growth. In addition, with typically long-term leases, it's an attractive proposition for domestic and global investors seeking to generate strong, long-term recurring income streams greater than those supplied by most cash, bond and fixed interest products. Consequently, the asset class is seemingly priced to perfection with no great variation between A and C grade properties.

Commercial office – business reconsiders

The new 'working from home' environment has dominated the narrative for the commercial sector with COVID-19 driving business leaders to reassess their accommodation requirements and increase 'area per staff member' with the need for social distancing. As a result, it is fair to assume that some commercial property net rents may moderate over the short to medium-term. Vacancy rates have already increased from 3.5% to over 7% for Sydney and Melbourne office properties and sub lease space availability has risen substantially.

On the positive side, with fewer people inclined to commute to the CBD if they can work closer to home, high-quality metropolitan office locations with good infrastructure could benefit. Metropolitan office rents can be up to 50% less than CBD rents and offer the advantage of parking which is a big benefit as employees shy away from using public transport.

Commercial investments have also been keenly priced in recent times. They have been supported by a lower for longer interest rate environment with little yield spread between high quality and lesser quality assets. In the late and post COVID-19 environment poorly financed owners may be forced to sell, presenting opportunities for astute investors to buy, re-

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position and increase rental income as well as capital value over time. All up, opportunities will be created in this space for well financed investors with moderate gearing levels and established capabilities.

Retail – existing trends amplified by the pandemic

The retail property sector has been facing strong headwinds since as early as 2018 as consumers shifted to ecommerce and an oversupply of accommodation became apparent in many locations and categories. COVID-19 has escalated this trend and has also revealed other weaknesses in the sector.

Many global brands in the discretionary spending space, like fashion, have reduced Australian store footprints in recent years, and newer sales models have evolved with less of a 'bricks and mortar' focus. On the flip side, some areas of less-discretionary retail, food and alcohol, and some leisure sectors, sporting equipment and gambling, have been strong.

State government legislation has been implemented to help small to medium sized retail operators with their rental payment structures and with agreement from landlords, this has supported many tenants. In contrast to the relatively well financed commercial office and industrial sectors, retail has seen a high proportion of rental relief granted with some landlords receiving <70% of pre-COVD-19 rental cash flows in the early stages of the event.

There have already been many sales transactions in the retail property sector which have highlighted the fall in some asset values. In the current environment, retail is a story of a flight to quality with large, well-financed and deeply experienced operators being best placed to maintain cash flow or reposition their assets. Nimble investors are seeing the changes in the landscape as a purchasing opportunity and in recent months numerous sales have occurred in the neighbourhood shopping centre space by counter cyclical investors.

While this sector has been the beneficiary of unprecedented government stimulus initiatives like JobKeeper and access to superannuation , retail businesses may well face increased financial distress when this support is phased out over the coming months.

Residential – significant challenges

This sector has had considerable government support during the pandemic with a range of initiatives including assistance for some new home buyers and renovators. Banking support in the form of loan deferrals to many existing clients has also supported. That said, these arrangements will eventually end, and we consider that many homeowners could be unable to return to full loan repayments and pay of their debts.

The potential oversupply of high-rise apartments in Sydney and Melbourne was apparent as early as 2018 and this trend has only been highlighted further by the COVID-19 environment. Factors such as the fall in the number of international students and reduced migration to Australia have had an adverse impact and rental demand has fallen. In CBDs, rental rates have moderated and vacancies increased as many renters have chosen to reconsider the need to be so close to the congested city centre and the market value of some CBD high rise developments has been weaker as result.

In contrast, the demand for free standing housing has continued to be quite buoyant with many homes holding their value and owners considering renovation and refurbishment options. Sales volumes for residential land is also solid with banks reporting an escalation in owner occupier and new construction finance applications and approvals.

While COVID-19 has generated some significant headwinds we've also seen new opportunities emerge. We consider that property remains an important cornerstone of a well-balanced investment portfolio and will continue to deliver meaningful risk-adjusted returns for your clients.

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