September 2020

# COMMERCIAL PROPERTY MARKET TRENDS AND INSIGHTS

## TRMC INDUSTRY INSIGHTS – COMMERCIAL PROPERTY MARKET TRENDS

the·real·media·collective

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# 1.0

# REPORT SUMMARY

Commercial and industrial properties are much more vulnerable to market conditions than residential property, so the risk of vacancy can be higher and it can take a long time to find a new tenant. This can provide tenants with an opportunity to revisit current leasing terms.

For members that lease sites (retail, commercial, and or industrial) now is an appropriate time to consider your position and how to best place yourself moving forward into 2021. Understanding your position relating to leasing arrangements is as important a factor as any other as we move forward and seek to rebuild the economy and our industry.

In this report we seek to assist members by putting together a review of the current trends and insights relating to commercial property and from a range of sources. Further, and where relevant we have interleaved TRMC's views and positions on these issues and the work we have undertaken on them.

Government initiatives and schemes that have provided business and landlords with rent, loan and other relief were due to sunset in October 2020, but these initiatives have generally been extended to December 2020 or March 2021.

Members need to be aware of a range of influencing factors that can shape lease renewals, including the conditions faced by landlords such as interest rates which remain low and for the foreseeable future.

Further, we provide some practical steps for members to utilise when next undertaking discussions and negotiations on leasing arrangements. For leaseholders, it is an imperative at this time to establish and maintain good relationships with agents and landlords.

# 2.0

# BACKGROUND

A review of available market research and discussions with property firms provides useful information and understanding when looking to interact with landlords and agents and determining future requirements.

Industrial and commercial properties generally attract investors seeking to make a higher return than on residential properties. However, such investments are susceptible to market forces and particularly during downturns in the economy. Investors in commercial property experience variable loan terms based on valuations and other factors, along with potentially higher interest rates. Generally, commercial properties will attract longer leases which can provide a commercial property owner with a greater degree of security.

In the current market tenants appear strongly focused on reducing gross occupancy costs across their business and adopting strategies to improve productivity. Strategies that businesses are considering and adopting include improved efficiencies in warehouse design including space utilisation, office space consolidation, automating processes and flexibility.

Growth in online retail over the past few months has been focused around food, FMCG's, health and pharmaceutical industries. This has resulted in a strong take up of short-term overflow warehousing and efficiencies through consolidation.

Given the impact of COVID-19, tenants are focussing on supply chain strategies with inherent flexibility to cater for the current market changes. Primarily driven by transportation costs, a well-managed supply chain network will assist tenants in determining the optimal location and number of warehouses. Supply chain optimisation will result in annual savings for tenants and position them to achieve a competitive market advantage.

The impact of COVID-19 may also provide the opportunity for some on-shoring of more critical manufacturing where Australia retains expertise such as in the medical and pharmaceutical industries.

# 3.0

# GOVERNMENT ROLE AND RESPONSE

Given the onset of COVID-19 and its effects on the economy, the aim of much of the government (federal and state) stimulus and support has been to boost consumption, stem unemployment and head off widespread bankruptcy. Monetary and fiscal stimulus measures have, to this point in time, supported proper functioning of both households and financial markets, although businesses have suffered negatively.

Many of the government initiatives have been necessarily aimed at limiting or stemming the spread of COVID-19, however those measures have had negative consequences for the economy generally as a result of restrictions relating to retail activity, cross border trade, travel and tourism, and related capital flow.

### 3.1 CURRENT GOVERNMENT RESPONSE TO COMMERCIAL RENT RELIEF

The Australian federal, state and territory governments agreed to introduce a range of measures to help commercial landlords and tenants during the COVID-19 crisis. It included temporarily halting evictions and a framework to support rental reductions at least proportionate to the tenant's decline in turnover.

The National Cabinet agreed that states and territories would implement a mandatory Code of Conduct, including via legislation or regulation as appropriate, to implement the principles agreed upon. The Code builds on the draft codes submitted by landlord and tenant representative bodies in the commercial property sector.

The Code imposed a set of good faith leasing principles for application to commercial tenancies (including retail, office and industrial) between owners/operators/other landlords and tenants, in circumstances where the tenant is a small-medium sized business (annual turnover of up to $50 million) and is an eligible business for the purpose of the Commonwealth Government's JobKeeper programme.

The National Cabinet agreed there would be a proportionality to rent reductions based on the tenant's decline in turnover to ensure that the burden is shared between landlords and tenants. The Code aimed to provide a proportionate and measured burden share between the two parties while still allowing tenants and landlords to agree to tailored and appropriate temporary arrangements that take account their particular circumstances.

National Cabinet stated its expectations that Australian and foreign banks along with other financial institutions operating in Australia, to support landlords and tenants with appropriate flexibility as they work to implement the mandatory Code.

A copy of the national Code can be accessed here.

A summary of the commercial rent relief schemes available throughout Australia and links to state and territory sites can be accessed on the Australian government website here.

In addition to implementing the Code most states and territories have implemented additional measures such as land tax relief, deferrals, rebates and other related concessions.

# 3.0

# GOVERNMENT ROLE AND RESPONSE

### 3.2 FUTURE OF GOVERNMENT INITIATIVES

From a property market perspective, the governments approach goes some way to explaining why distressed opportunities have been slow to materialise as both occupiers and investors have been shielded from the worst effects of the crisis so far. Moving forward a lot will depend on the resolve of government and the RBA and the approaches taken by them. Nonetheless, it is hoped the implemented stimulus initiatives will also encourage businesses to resume normal operations after the health crisis diminishes further.

Most state and territory governments have announced extensions to the Code of conduct and related legislation for those tenants and landlords who continue to experience financial hardships as a result of COVID-19.

### 3.3 TRMC INDUSTRY INSIGHT

- TRMC has and will continue to call on federal, state and territory governments to continue current commercial rent relief programmes and schemes for the industry and Australian businesses.
- TRMC continue to provide government at all levels with an understanding and insights into the specific issues facing our industry as the economic effects of COVID-19 continue.
- It is unacceptable if property owners or agents are unwilling to take a pluralist approach towards members at this time.
- TRMC view that it is unacceptable if landlords fail to pass on to tenants any benefits received from government schemes or who fail to negotiate in good faith with their tenants.

# 4.0

# INTEREST RATES AND BANKING CONDITIONS

The Reserve Bank of Australia has kept rates at an all-time low and has confirmed its commitment to maintain cash rates at the current rates through into 2021 and at least until labour market improvements are realised and inflation rises. The RBA have held that the short-term outlook remains uncertain which can affect consumer and investor decisions now and going into 2021. The Deputy Governor of the RBA has said "the Reserve Bank will maintain the current policies to keep borrowing costs low and credit available, and stands ready to do more as the circumstances warrant".

The Reserve Banks stated position has been adopted by various economic research bodies:

- Focus Economics view the cash rate ending 2020 at .25% and 2021 at .30%.
- Westpac economists view that the .25% cash rate is like to continue for the next three years.
- BIS Oxford Economics view that the current state of the economy precludes any movement for the next few years.

## 4.1 LOAN DEFERRALS

When the effects of COVID-19 hit in March and April, lending institutions were quick to implement six-month loan deferrals and other assistance to both household and commercial loan holders. That being said, deferred principal and interest payments continue to accrue.

Given the end of September deadline for those deferrals, ASIC have issued guidelines outlining their expectations of how banks and lenders will conduct themselves when dealing with clients who move back to normal lending terms. That being said, some lenders have already granted additional deferrals until January 2021 on a case by case basis.

## 4.2 TRMC INDUSTRY INSIGHT

- Based on all available reporting TRMC support the view that monetary policy will continue to hold interest rates at an all-time low until at least the end of next year although they will likely hold for longer.
- Economic forecasts for 2021 are mixed and likely to be inexact, however TRMC continue to view general economic improvements for the second half of 2021.
- Given the forecast of ongoing record low interest rates and loan deferrals, TRMC calls on landlords who receive those benefits to pass them on to members under leasing arrangements.
- TRMC remains unimpressed by the variable lending conditions applied by institutional banks on the SME loan scheme guaranteed by the Reserve Bank. We continue to call upon lending institutions to take a more uniform approach to what are effectively government guaranteed loans for SME's.
- TRMC calls on the Australian banking and lending sector to continue to support Australian business to recover.

# 5.0

# COMMERCIAL PROPERTY MARKET INSIGHTS

### 5.1 BEFORE COVID-19

According to global management consultants, McKinsey & Company, real estate investments have generated steady cash flow and returns significantly above traditional sources of yield with only slightly more risk.

Coming to the end of the first quarter 2020, commercial and industrial property in Australia experienced strong capital value growth and yield compression with continued demand from both domestic private and institutional groups and foreign investors. The last 12 months saw over AUD$6.5 billion of industrial sales (above AUD$5 million) across 273 transactions, many of which consisted of portfolio sales as institutional investors acquired prime industrial facilities into their portfolios. Institutional funds were the most active purchasers over the 12 months to March 2020, accounting for over 50% of transaction volumes.

### 5.2 SINCE COVID-19

According to McKinsey, since the outbreak of COVID-19 the reality of the commercial and industrial real estate marketplace has changed. From an international perspective, many developers can't obtain permits and they face construction delays, stoppages, and potentially shrinking rates of return. Meanwhile, some property owners and operators face drastically reduced operating income, and almost all are nervous about how many tenants will struggle to make their lease payments.

From an Australian perspective, the effects of COVID-19 on the Australian industrial and logistics sector have been modest, particularly when compared to other real estate sectors. The largest impacts have stemmed from supply chain disruptions and the inability of some leaseholders to pay rent. However, this has been concentrated at the smaller end of the market, often in the retail market, and from an overall portfolio perspective they have accounted for only a minor share of tenants.

Prior to the recent economic uncertainty, commercial leasing incentives particularly within the industrial sector were at their lowest level in five years as robust leasing activity meant there were limited leasing options available to prospective occupiers in most submarkets. Heading into COVID-19, it was not uncommon to see sub 5% incentives in NSW being offered for selected assets while more broadly they averaged 12.5% in the prime market and 20% in the secondary market at a national level. Over the past six months, there has been an upward shift in incentive levels as landlords become more aggressive in their approach to secure tenants and to preserve value via holding rents steady.

Growth in online retail over the past few months has been focused around food, FMCG's, health and pharmaceutical industries resulting in a strong take up of short-term overflow warehousing.
This may provide an opportunity for some members if you have additional warehousing space and if your lease permits subletting or you can obtain the consent from the landlord to sublease some of that additional space.

# 5.0

# COMMERCIAL PROPERTY MARKET INSIGHTS

The impact of COVID-19 may also provide the opportunity for some on-shoring of more critical manufacturing where Australia retains expertise such as in the medical and pharmaceutical industries. This may also provide new or additional work for members in the coming months and years.

Looking ahead, it is anticipated vacancy rates in the retail space will increase over the next 12 months, underpinned by a rise in sublease vacancy as some occupiers are unable to trade through the current period.

### 5.3 CBRE - STATE BY STATE

Leading international property and investment firm CBRE have provided TRMC with permission to reproduce the contents of their research report 'Marketview Australia Industrial and Logistics, Q2 2020' which provide some useful insights, forecasts, and statistics.

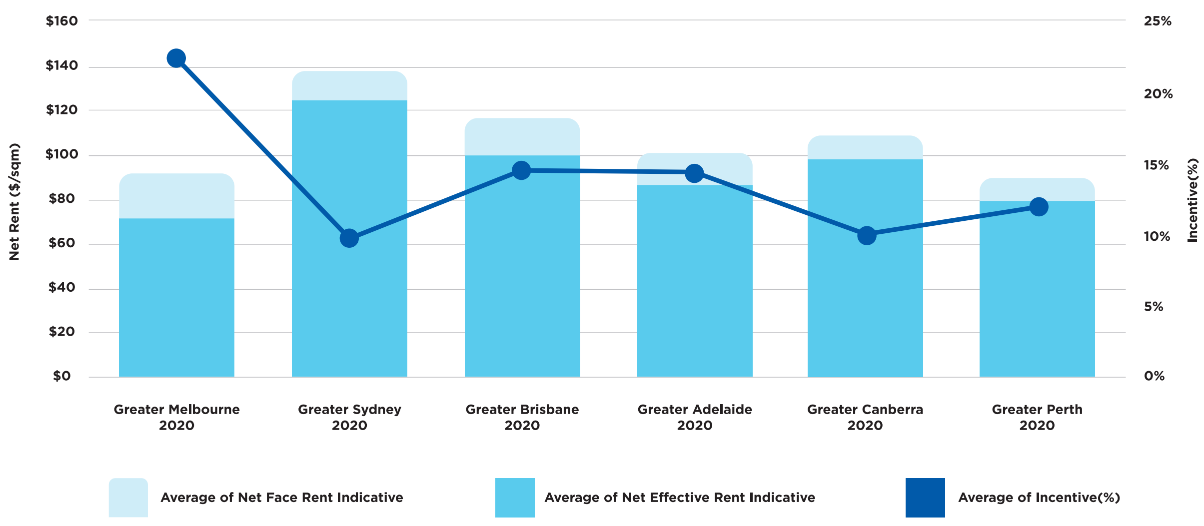


Chart 1: Industrial and Logistics Results Rents by Region (CBRE, Q2, 2020)

Despite turbulent retail trade volumes, consumer spending held up relatively well. Nonetheless, some occupiers have had their supply chain put under pressure and international trade was made difficult with airport closures. Holding more stock domestically will help better prepare for any interruptions to supply in the future. To accommodate higher inventory levels, some occupiers will need more space.

Effectively, CBRE research views that net face rents are expected to remain relatively flat over the remainder of 2020, with some declines in effective rents in line with a forecast increase in incentives.

# NEW SOUTH WALES

Commercial property buyers are currently sitting on their wallets and vendors are waiting for the dust to settle before potentially taking their assets to market. Overall, the NSW Industrial Sector appears well positioned for changes in the economy, however rental growth is turning to decline and occupancy stability is a key incentive for landlords.

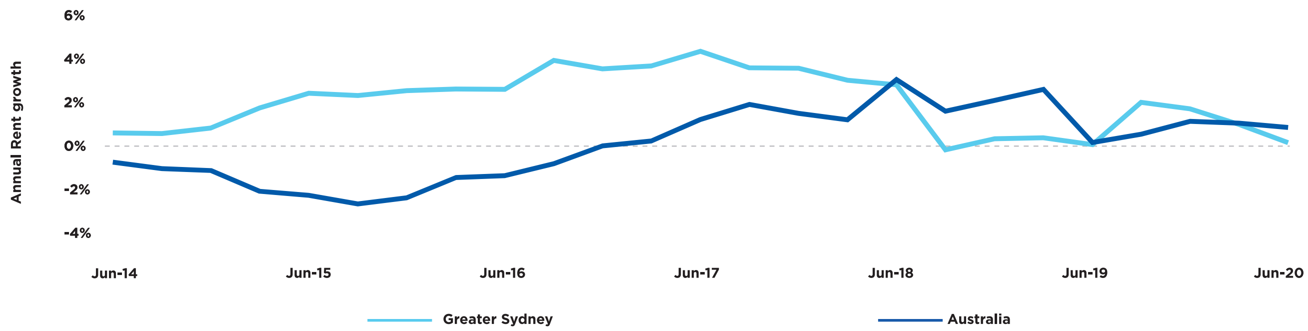


Chart 2: Sydney versus Australia Super Prime Net Face Rent Growth (CBRE, Q2, 2020)

# VICTORIA

Uncertain conditions have seen a decline in sales activity in the Victorian commercial property market and a slight decline in face rent values per sqm. Occupancy security is on the radar as second wave restrictions indicate significant impact.

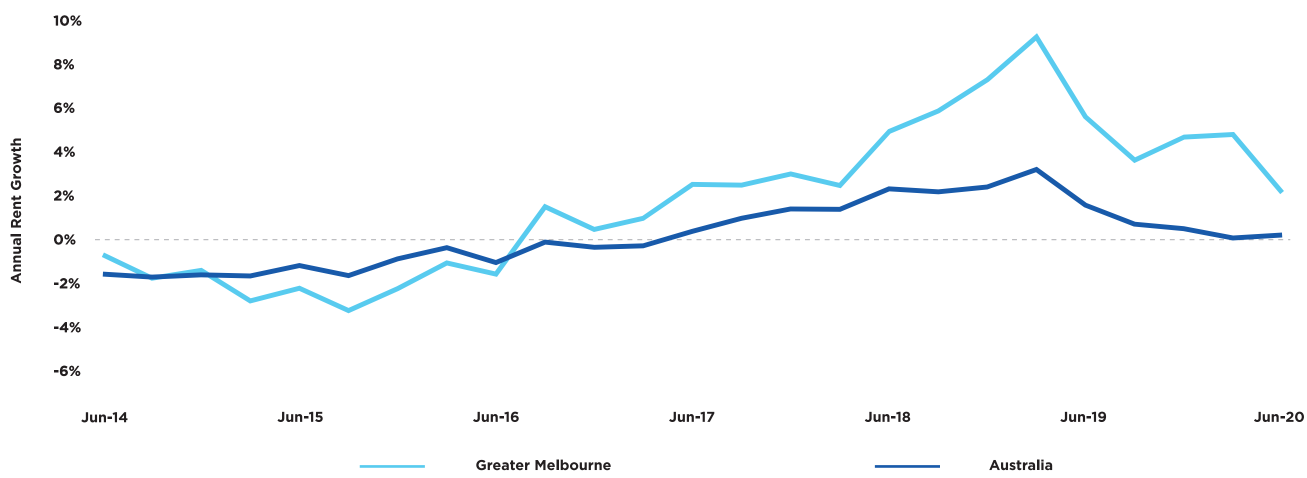


Chart 3: Melbourne v Australia Net Face Rent Growth (CBRE, Q2, 2020)

# QUEENSLAND

Sales of industrial property were already slow leading into 2020, but have been the most resilient in the QLD marketplace. Industrial rents in Brisbane have been relatively stable. Transport and logistics companies appear to be the main source of demand for industrial sites.

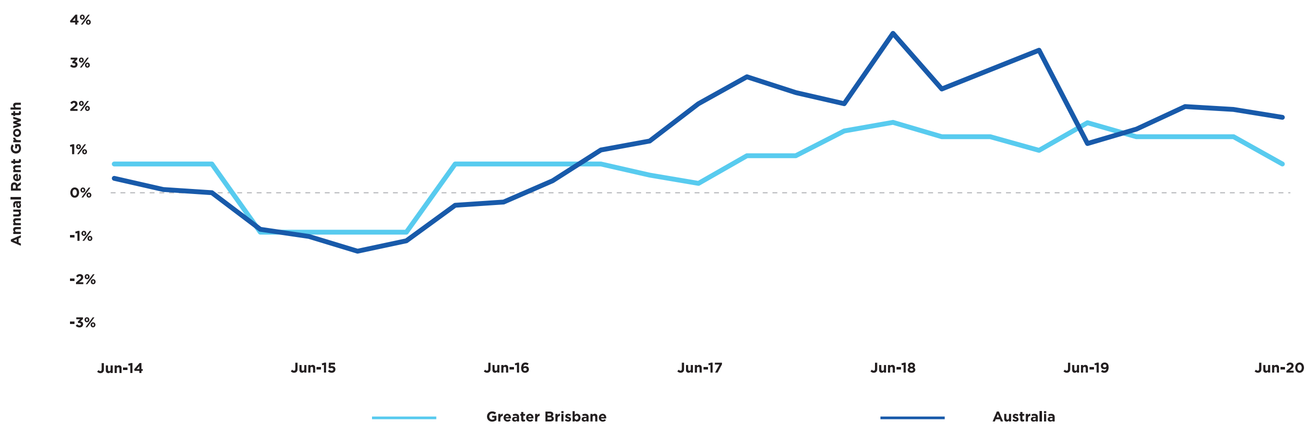


Chart 4: Brisbane v Australia Net Face Rent Growth (CBRE, Q2, 2020)

# WESTERN AUSTRALIA

Focus is on the economy as WA appears to have controlled COVID-19 within the state which has led to the loosening of restrictions. Industrial property is proving resilient in WA as are employment and output in comparison to the rest of the economy.

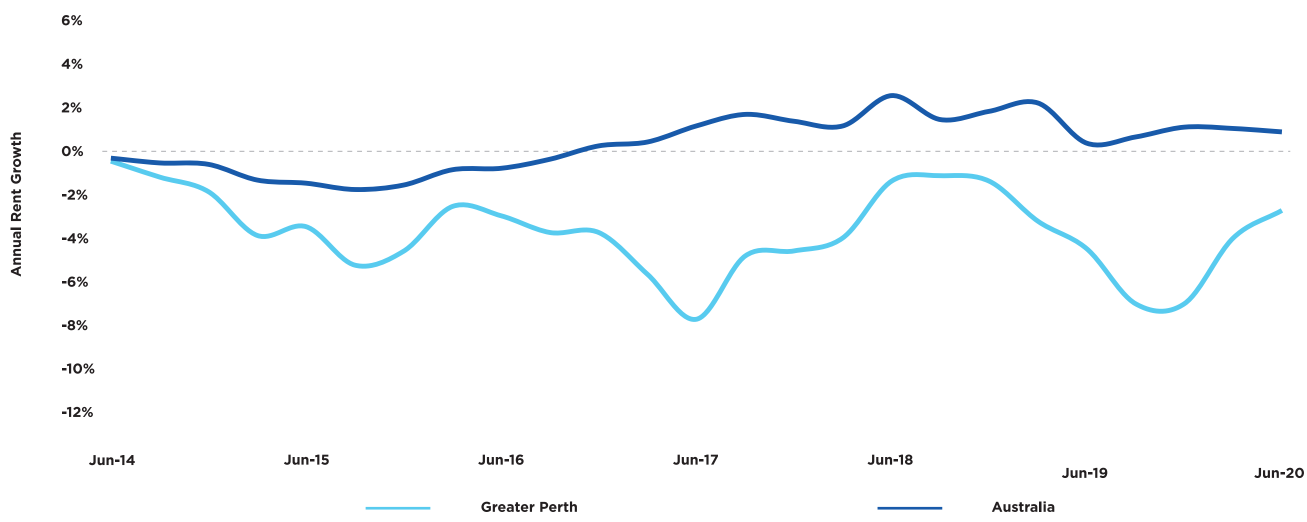


Chart 5: Perth v Australia Net Face Rent Growth (CBRE, Q2, 2020)

# SOUTH AUSTRALIA

Effective net rents in the industrial property marketplace have remained steady, although this stability is underpinned by demand from defence and larger private companies within the buoyant SA mining industry. The North West and West precincts in Adelaide attract most enquiries due to their proximity to the Port and the North-South Freeway. This may be the result of the recent federal government go ahead to expand the Olympic Dam copper mine.

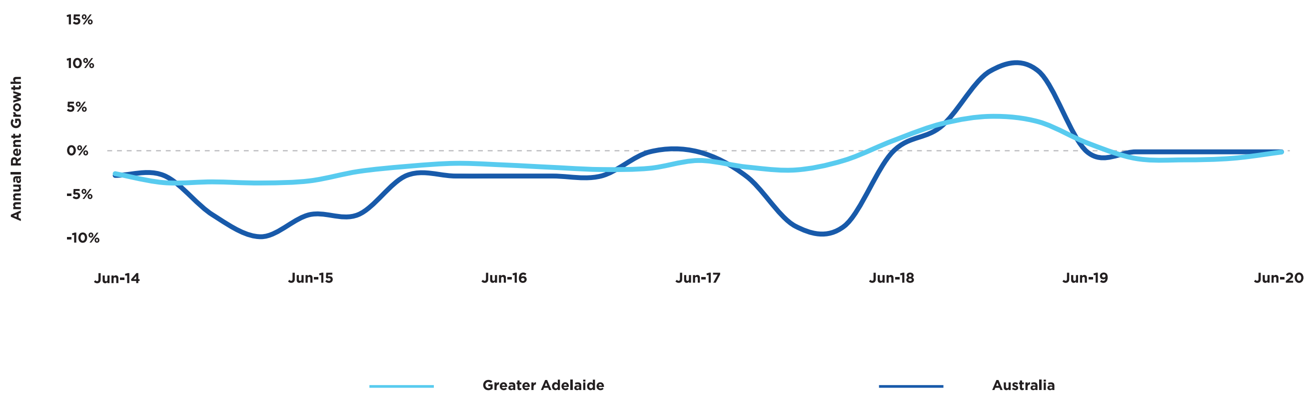


Chart 6: Adelaide v Australia Net Face Rent Growth (CBRE, Q2, 2020)

A link to a full copy of CBRE's report here.

# 5.0

# COMMERCIAL PROPERTY MARKET INSIGHTS

### 5.4 TRMC INDUSTRY INSIGHT

- From reviewing available data and research on the commercial real estate market, TRMC holds the current forecast as presenting leaseholders with the opportunity to secure longer term leases at favourable terms prior to the medium to long term economic impacts of COVID-19 are better understood.
- Any renegotiation of leasing arrangements should encompass and revisit both rents and possible incentives available to the property occupier.
- Given the current warehousing overflow requirements as a result of increases in e-commerce trading, leaseholders with additional warehousing capacity may consider their subletting rights to potentially generate additional income.
- Although we are reviewing the commercial property market in this report, members may realise additional work opportunities resulting from any onshoring of manufacturing and increased e-commerce activity.

# 6.0

# NEGOTIATION STRATEGIES

If members are entering into discussions or negotiations over leasing arrangements, consider the following points as part of your preparation and discussions when looking to negotiate improved or altered terms.

### 1. CREATE A PLAN TO GET THE MOST VALUE

Negotiations of any kind are an information game. Do not enter the renewal negotiation process unprepared. A researched and considered approach positions you with the best opportunity for successful negotiation. Pre-determine what value you are seeking from any negotiations, and what value the landlord might receive by negotiating.

Pre-empting possible responses from an agent or landlord, legitimate or not, will also assist you to respond effectively. Additionally, realising and raising last minute demands late in the negotiation process generally results in irritation and can frustrated a successful outcome.

### 2. TIMING

A proactive approach to negotiating a renewal is always best. Review your lease on an ongoing basis and approach your landlord or agent in the months before the expiration date of the lease.

### 3. UNDERSTAND THE LANDLORD

When a tenant leaves, the landlord suffers a loss in rental income and incurs additional expenses to update or renovate the property and market the vacant site.

Understanding the landlord's current financial situation and the impact and value your lease has within the property market is valuable. It is important to know the dollar amount associated with keeping you on as a tenant, and leverage that information.

### 4. TALK WITH THE AGENT

Although agents are generally seen to represent the interest of landlords, it is in their interests to have the property remain occupied. Start talking with them early and push them to address issues with the landlord.

### 5. POKER FACE

Do not give the impression you intend to stay in your current site. If the landlord or agent believe renewal of your lease is guaranteed, this may be used against you in the negotiation process or limit the scope for negotiations for a better outcome.

# 6.0

# NEGOTIATION STRATEGIES

### 6. ASSESS YOUR CURRENT NEEDS

Some items to consider include optimising office configuration and updated infrastructure. Once you have identified these needs, include them as discussion points in the lease renewal negotiation. In some cases, your landlord may be willing to incur some of the update costs, if it means keeping you on as a tenant.

### 7. CONSIDER ALTERNATIVES

Even if you intend to stay in your current site, take the initiative to review other properties in the market. Are other landlords offering better terms such as a lower price for a longer term? You may uncover an alternative solution that is competitive and worth exploring, or you may be able to request those same terms from your current landlord. Another alternative may be to have an

independent valuer determine rent valuations; however, we advise caution as the outcome of such a valuation my not necessarily go your way.

### 8. DON'T IMMEDIATELY TAKE ANY REFUSAL AS FINAL

If the agent or landlord keep rejecting your offers, respond with 'why not?' and seek to understand their perspective. There may still be scope for a deal to be made if their explanation allows for it and they are behaving rationally. Any discussions need to remain focussed on reaching an agreement that is in line with market rates and the needs of both parties. Additionally, you need to determine when you will walk away from the table.

There is never harm in asking to talk and see if options are available that suit your needs and a landlord. Ultimately, a landlord wants their property occupied by a good tenant and the certainty and security that brings with it for them.

## IMPORTANT NOTICE



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