6

INVESTMENT REAL ESTATE VALUATION IN THE COVID ECONOMY

Investment valuation uncertainty was a significant issue across all real estate investment classes after the COVID-19 pandemic was announced in March 2020. Real estate transactions virtually ground to a halt as the pandemic set in and we went into various state and territory lockdowns around the country.

The Commercial Leasing Code was announced by the Commonwealth Government in April and progressively adopted by the States in the months that followed, although very differently in each jurisdiction.

With JobKeeper 1 having drawn to a close on 27 September 2020, Greg Preston, from property valuers and advisers Preston Rowe Paterson, reflects on market evolution since the onset of the pandemic.

A CRISIS OF INCOME OR CAPITAL?

Most States adopted the end of JobKeeper 1, or a date soon after, as the period for the Commercial Leasing Code to apply. Understandably, given the significant lockdown in Victoria, the Victorian Government has extended the period to 26 April 2021. Similarly, Western Australia has mooted extending the emergency period to 20 March next year.

The *Australian Financial Review's* Rob Harley got it right in a recent article when he referred to this real estate market as 'a crisis of income' rather than capital (debt and equity), which was certainly the case throughout the GFC.

Capital markets (debt and equity) may however shift in line with rental income risk based on tenants' ability to pay their lease rents in certain properties and sectors. As the big four banks monitor and enforce debt covenants, there may be a further opportunistic flight to the ever-emerging non-bank lending sector as an alternative debt provider to fund managers.

As the COVID economy has played out, the crisis of income has proven to be far from broad based. It is very much dependent on the nature of tenant businesses and the extent to which they have been impacted by the COVID economy.

For example, food and beverage-based tenancies, hotels, and offices have been more significantly affected than warehousing and industrial properties. Some residential sectors have shown resilience and Government-occupied properties have found new appeal and potentially improved on the risk spectrum because of the COVID economy.

On the other hand, business activity for those most affected uses continues to be subdued, even where there has been an ability to resume an element of trading on a socially responsible and distanced basis.

OFFICE MARKET DEBATE

Office markets have been the subject of much debate as to whether occupants will return to their accommodation where employees have become used to working from home.

However, a groundswell of opinion is building that tenants will return to their offices where possible to enjoy the benefits of face-to-face collaboration in many facets of day-to-day business, including training emerging talent. Supportive articles by John McBain from Centuria, Michael Cook from Investa, and Darren Steinberg from Dexus in recent weeks have highlighted the benefits of collaborative face-to-face in office staff and client business interactions and the difficulties associated with running a business via a computer screen. It is difficult to disagree!

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In the COVID crisis cash flow economy, valuers are considering tenant rental cash flows far more closely to establish actual cash flows relative to lease covenant cash flows.

Put simply, they may differ for some asset classes.

Dealing with Leasing Code 'waivers' and 'deferrals' in the continuing uncertain 'pandemic period' and 'reasonable recovery period' continue to be valuation challenges for some asset classes.

Clearly, the workload for investment property managers has increased dramatically in triaging tenant relief requests.

TENANT RELIEF

There has been an ugly side to tenant relief applications where, on the one hand, some tenants have been trying waiver and deferral applications where they perhaps are not entitled to this Government ordained landlord-funded economic relief.

On the other hand, there have been circumstances where genuine hardship cases for small and large tenants have been met with stern and legal responses from investors. Clearly, the workload for investment property managers has increased dramatically in triaging tenant relief requests. Cool heads also need to prevail. Whilst it was not said by any of our Commonwealth and State Governments at the time, the objective of the landlord-funded relief should have been clearly expressed as keeping tenants connected with their building and landlord in the same way JobKeeper is intended to keep employees in touch with their employers.

SOME TRANSACTIONS

Following a few months of inactivity, toward the end of June and through August and September we have seen several transactions occur for multi-tenant investment grade assets. Examples include—

- Deka office acquisition of 452 Flinders Street Melbourne at $454.5 million (100 percent) in September
- GIC office acquisition of 222 exhibition Street Melbourne at $411.35 million (50 percent) in June
- Dexus/GIC acquisition of Rialto, 525 Collins Street Melbourne at $1.288 billion (50 percent) in April
- Haben acquisition of the Pines Shopping Centre in Victoria in July at $160 million
- Haben acquisition of the Caloundra Shopping Centre in July at $97 million.

The Haben acquisitions included vendor rental guarantees. This could be an emerging trend by sellers in the marketplace to guarantee rentals during the pandemic period and reasonable recovery period which most probably will be to cover negotiated waivers and deferrals, not to mention the relet-up risk of vacant tenancies.

SEEKING CERTAINTY

In closing, the initial valuation uncertainty has evolved to be more specifically focused on classes of tenants and affected uses. When considered from a risk perspective, right pricing (valuing) all asset classes will continue to be challenging until some certainty can be found as to the end of the pandemic period and the recovery period. Economic resilience beyond the COVID economy for certain tenant classes continues to be a major issue.

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