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UNDERSTANDING COMMERCIAL PROPERTY

The COVID-19 crisis has had significant impacts on the commercial property sector as stay-at-home orders dented demand for office space and the retail sector. Yet, other sectors shone through as a result of this. The Adviser explores these trends in greater detail, and how brokers can service clients interested in investing in this type of property

BY MALAVIKA SANTHEBENNUR

When COVID-19 first hit Australian shores, the social movement restrictions meant that commercial properties were suddenly left vacant as everyone pivoted to working remotely.

As the restrictions eased and we settled into a new way of life, the commercial property scene looked drastically different.

What has changed

There are ongoing concerns that huge office towers being built in the central business districts may be left empty or unfinished, as Australian businesses continue to embrace hybrid working arrangements and rely less on commuting into the city centres.

Indeed, there are fewer office buildings being bought, as evident in the figures provided by real estate services provider JLL, which recorded $10.89 billion worth of office transaction volumes across Australia and New Zealand in 2020, the lowest volume since 2012.

Australia took a particular beating in this regard, with office transaction volumes falling by 57 per cent in 2020, compared with a 15 per cent decline in New Zealand, JLL reported.

Vacancy rates continued to climb across most CBD office markets in the December quarter 2020, too, with the Reserve Bank of Australia (RBA) noting that they were at their highest levels for nearly two decades in Sydney and Melbourne.

While vacancy rate increases have been similar across property grades to date, generally, secondary-grade office buildings are more vulnerable when demand drops, because tenants capitalise on incentives to

$10.9 BILLION

Worth of office transaction volumes across Australia and New Zealand recorded by JLL in 2020, the lowest volume since 2012

57 PER CENT

The fall in Australia for office transaction volumes in 2020, compared with a 15 per cent decline in New Zealand

$9.4 BILLION

The value of commercial loans settled by mortgage brokers for the six months to September 2020, up around 4.22 per cent year-on-year, based on MFAA data

23.7 PER CENT

Increase in the number of mortgage brokers writing commercial loans in the six months to September 2020

“BORROWERS ARE SEEKING PROPERTIES THAT ALLOW FOR SELF-EMPLOYED BUSINESS OPERATIONS AND A RESIDENTIAL COMPONENT TO LIVE IN, LIKE THE OLD RETAIL SHOP ON THE GROUND FLOOR AND RESIDENCE ABOVE”

– *Peter Vala, Thinktank*

move to higher-quality properties, according to the RBA. While the RBA predicted that office supply would expand this year, as new office buildings are completed, it added that it would be less than in 2020, because most new office space has pre-committed tenants.

Retail commercial property also took a hit. According to the RBA, this sector was already facing a challenging environment prior to the pandemic (especially bricks-and-mortar retailers), due to retailer margins being compressed by stiff competition from both large international and online retailers.

The transition to online retailing, which accelerated during the COVID-19 crisis, not only reduced retailers’ ability to pay high rents, but also reduced the demand for retail commercial property premises, which in turn dented rents and prices in this segment.

“With Australia having a relatively low share of online retailing relative to other advanced economies, it is likely this shift will continue to depress demand for retail properties,” the RBA said.

The new trends in commercial property

While the COVID-19 crisis may have created a “cloud of uncertainty” around office occupancy and valuation implications, investors have continued to exhibit confidence towards prime-grade assets.

JLL has predicted a K-shaped recovery in the office market in 2021 and 2022 (mirroring a K-shaped recovery in the economy) with professional services (including technology), healthcare and public administration the most robust industries.

According to non-bank lender Thinktank, which specialises in commercial mortgages, the retail sector may require longer-term strategy changes to be revitalised. Explaining the current trends further, Thinktank general manager, partnerships and distribution, Peter Vala said that the lender has observed more borrowers seeking mixed-use properties to accommodate their business operations as an outcome of COVID-19-induced change.

“Borrowers are seeking properties that allow for self-employed business operations and a residential component to live in, like the old retail shop on the ground floor and residence above,” he said.

“This refocus also can help insulate self-employed clients from hostile landlords that may be seeking to terminate expired lease arrangements.”

In contrast to the retail and office markets, a bright spot in commercial property has been industrial property. While the shift towards online retailing may have dented the retail sector, this has tilted the demand towards logistics and warehousing facilities, according to the RBA. The central bank noted that sales transactions in this segment managed to avoid declines in 2020, unlike in other sectors.

Keeping track of the changes

This difference in performance across segments during the COVID-19 crisis not only demonstrates the complexities of commercial property, but also the need for brokers to gain specialist knowledge of the markets they are serving.

Scott O’Neill, founder and director of buyer’s agent Rethink Investing and brokerage Rethink Financing, has therefore emphasised the need for brokers to understand the supply and demand trends in each commercial property class.

Speaking to The Adviser’s In Focus podcast, Mr O’Neill explained: “Do not blanket commercial as one market. There are hundreds of different markets. There are three or four main subsectors like office, industrial, residential or specialty (including childcare and service stations).

“But within them is B-grade or C-grade spaces and regional [properties]. Understanding the right asset class to go into is probably a very important first step.”

Speaking as a buyer’s agent, Mr O’Neill revealed that he would typically now purchase only those properties that he perceives as easy to re-let, because the prospect of vacancy is the greatest fear factor among commercial property investors when it comes to returns.

He similarly advised that brokers should rigorously research the sector and understand the business and property value trends before

TOP TIPS ON WRITING COMMERCIAL

Non-bank lender Thinktank spoke to The Adviser about the commercial property space, including the nature of the demand from clients, which lenders to target in this space, and what brokers should bear in mind when servicing clients interested in this sector.

“There appears to be an increased level of interest in commercial property in most states, with concerns of declining commercial values abating. One notable area of demand has been for owner-occupied commercial lending using SMSF LRBA structures. Industrial and warehouse property assets are generally performing very well in all states, with some states seeing strong growth in certain regional corridors such as Queensland’s Sunshine Coast and Gold Coast. As expected, retail strip shops and CBD office spaces are among the weakest performers in Sydney and Melbourne, but are actually holding up better than expected following on from last year.”

Adam Hutcheson – regional sales executive, Qld/WA/NT

“Look for a lender that will support you through the whole process of a loan application from origination to settlement, and where you have someone to speak to who has ownership of the loan all the way through to settlement. As commercial transactions can sometimes take a little longer than residential loans (given the in-depth nature of the full commercial valuation), make sure the customer is aware of the time frames. Regarding this, although commercial transactions are usually approved subject to valuation due to the cost of the valuation, an upfront valuation is always an option if you need the transaction to move along more quickly.”

Heather Noonan
regional sales executive, Vic/Tas/SA

“Commercial property does provide a different risk profile to residential. Yields (returns) may be higher depending upon the unique characteristics of the property. Generally, the higher yields help offset higher-risk profiles such as specialised security properties, specialised tenancy, risk of vacancy, location, required capital works or ability to re-lease.”

Cath Ryan
regional sales executive, NSW/ACT

servicing clients interested in purchasing commercial property, given the changing environments and their changing appetites.

He continued: “Once you go through it, you realise it’s not that different from residential. It’s more complicated. You’ve got to understand the business trends more, and you’ve got to know the due diligence process of a commercial property purchase.

“Just get into it, start learning, and eventually you’ll feel comfortable enough to take the plunge.”

As well as keeping track of key trends in the commercial property space, brokers can also stay across what is happening in the area by speaking to business development managers from lenders specialising in the commercial space, such as Thinktank.

More brokers looking to commercial

Commercial mortgage (and business lending more generally) is already an area that more brokers are looking at as they seek to diversify their offerings.

Recent data from the Mortgage & Finance Association of Australia (MFAA) shows that, in the six months to September 2020, the number of mortgage brokers writing commercial loans increased by 23.7 per cent to a new high of 4,539, exceeding the previous record high of 4,486 brokers (set between the October 2019 and March 2020 period).

For the six months to September 2020, the value of commercial loans settled by mortgage brokers reached its second highest ever value at $9.37 billion, up around 4.22 per cent year-on-year.

The total book value of commercial lending for mortgage brokers also grew, reaching a record high of $48.91 billion.

The MFAA commented in its *Industry Intelligence Service* report: “The continuing uplift in broker numbers writing commercial lending suggests that in a challenging home loan market, more and more brokers are diversifying into this sector, expanding their portfolio beyond just residential home loans into other growth sectors in response to uncertainty, fluctuations and instability in the market due to the impact of COVID-19.”

With more competition to service commercial finance opportunities, and with business confidence surging forward, now is an opportune time for brokers to help businesses access commercial property through finance. ■