

To assess the impact of COVID-19 on capital markets, Knight Frank Research has reviewed a basket of 60+ active sales processes across the main Eastern Seaboard markets.



A quarter of asset sales are on hold

knightfrank.com/research

Capital Market Insight, April 2020

AUSTRALIAN EASTERN SEABOARD HIGHLIGHTS

33%

FALL IN INVESTMENT ACTIVITY ACROSS AUSTRALIA YTD

26%

OF SALES CAMPAIGNS IN THE BASKET OF KNIGHT FRANK ANALYSED SALES ARE ON HOLD

52%

OF SALES HAVE PROGRESSED OR SEEN NO CHANGE BETWEEN MARCH AND APRIL

DEFENSIVE

PRIME INDUSTRIAL HAS EMERGED THE MOST DEFENSIVE ASSET CLASS IN THE INITIAL MARKET RESPONSE

The physical restrictions on movement and the economic uncertainty arising from COVID-19 has had a material impact on capital markets.

Investors remain engaged, however are on the sidelines to see how the market plays out. In an environment which was generally considered relatively fully priced at the start of 2020, caution dominates.

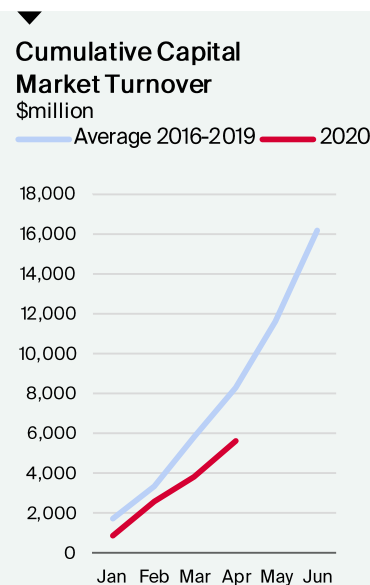
Activity has been impacted

While transactions are still occurring, with c\$5.6 billion in transactions across office, industrial, retail and hotel sectors in Australia through to May, there has been a material slowdown with activity **33% below levels seen in recent years.**

As the economic uncertainty spread from early March many active buyers chose to **wait and see where deal evidence would place pricing.**

While many buyer classes are seen as having **dry powder**, notably private investors and private equity firms, the current expectation is that they will **need to see discounting** before moving into the market in the short term.

With commercial property competing with other asset classes such as the share market, these buyers are opportunistic and are **unlikely to engage at pre-COVID pricing for anything but prime assets with tenants in industries minimally exposed to the short term economy.**



Source: Knight Frank Research, RCA

Sales are progressing but more than a third have price impacts

Analysis of a basket of sales transactions within Knight Frank shows that some sales are still progressing.

Tracking the process from initial submission to the client through to unconditional contract—**52% of assets** within the sale process either **progressed to the next stage** (ie negotiation to contract) or **remained on track with no change to status** (ie DD and still in DD) between March and the time of survey in April. This excludes assets already unconditional as at March.

Of the sales which progressed March to April, more than a third (36%) have seen an actual or expected impact to price or price expectations. Most commonly, between a **5% and 10% reduction in dollar value has been reported**, however there remains a large proportion for which the final price has not been set.

A quarter of asset sales are on hold

Reflective of the quick change in market conditions and the lack of clarity this has engendered in the market, **26% of asset sales in the Knight Frank basket are currently on hold.**

Vendors are seeking a time-out to determine whether to press on with a sale now or wait for the **expected economic green shoots of Spring, accepting potential re-pricing** in the intervening time.

Assets that have active requests from tenants for **rental relief also provide challenges** in a market suddenly risk-averse and guarantees are expected to expand from vacant space only to encompass a set portion of the income.



“With sentiment now firmly risk adverse, rental guarantees are expected to expand from vacant space only to encompass a set portion of the income.”



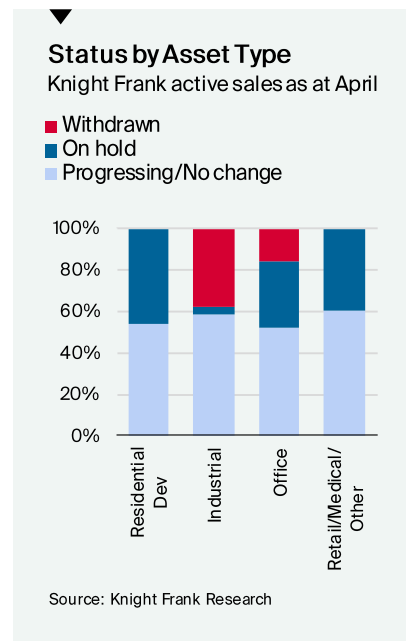
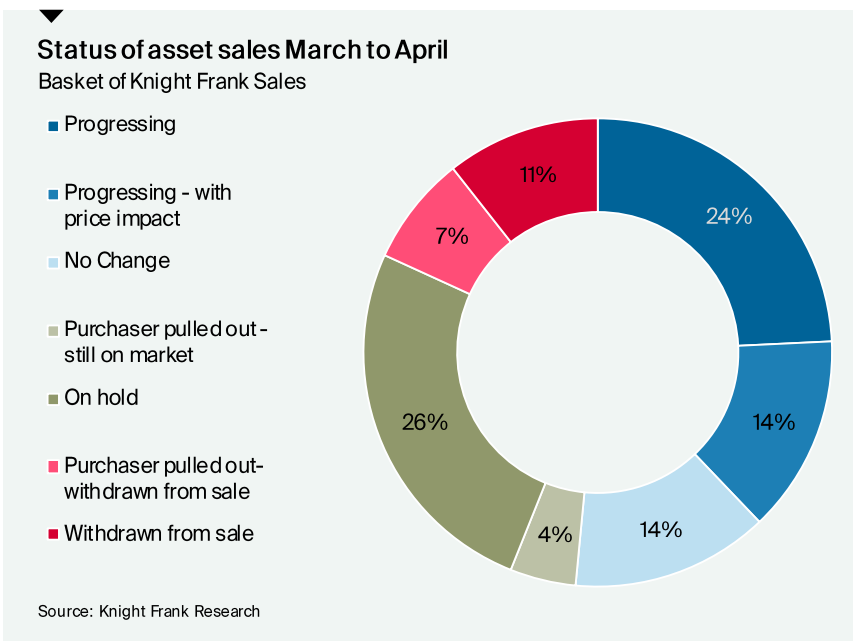
Prime industrial to be the most defensive

Industrial assets, particularly prime distribution centres **leased to non-discretionary retail or 3PL providers**, will fare best with high investor demand and limited tenant risk.

The Sigma portfolio and Aldi distribution centres leaseback campaigns have continued through the COVID period with reported good **buyer engagement and a competitive process.**

However, all industrial assets are not created equal and as shown below, the Knight Frank experience is that activity in the industrial **space is more binary** than other asset classes having both the highest proportion of asset sales progressing and the highest rate of withdrawal from the market.

Secondary assets or those with high exposure to discretionary brick and mortar retail tenants will be less favoured.



Values are initially being impacted by softer let up and rental assumptions

With little to **no sales evidence available to point to any material change in yields**, asset values have been impacted by **alterations to rental and letting-up assumptions by buyers**. This has had the greatest impact on the retail market, with office assets impact dependent on the tenant profile.

Many sales campaigns during 2019 and into the start of 2020 featured competition between buyers and **pricing was undertaken with a relatively risk-off attitude to immediate vacancy**, particularly in the office markets of Sydney and Melbourne where vacancies were more of an opportunity to reset rents.



“Particularly in the office markets of Sydney and Melbourne vacancy had been seen as an opportunity to reset rents, rather than as a risk to be priced.”



The current environment has seen a dramatic **change in sentiment to risk-on** and the key input assumptions for the next few years have softened significantly.

A balancing factor, however, is the expected **extension to lower for longer cost of capital** with negative target cash rates now openly discussed as possibilities in a number of advanced economies. This extended forecast for low interest rates has seen **terminal value yields stay low or even firm slightly**, supporting the overall DCF.



“There is greater diversity in outcomes between prime and secondary assets.

While long leases are favoured, there is greater scrutiny on tenants and their exposure to discretionary spending and the wider economy.”



Debt margins have increased

While the co-ordinated actions of central banks across the globe have kept the **underlying cost of capital low**, there are anecdotal reports of cost of debt increases for property loans due to **increased margins charged** by banks and other lenders.

Banks are reportedly slower to respond to current and potential new clients, with offered terms and LVRs at **generally less favourable terms** seen prior to COVID-19.

Difficulties in refinancing may emerge in the coming months, potentially bringing assets to market.

Additionally, purchasing activity will likely remain slow in the near term as some investors may **struggle to raise debt in a timely fashion**. Equity based investors will have **more flexibility**, however are seeking discounting before they enter the market.

Key Expectations

Activity will remain **sporadic** until there is a **clear path forward** as buyers and vendors will remain cautious until there is greater clarity on how and when **economic activity may begin to accelerate**.

Limited institutional activity until domestic travel restrictions are lifted

REITs are currently hampered by share price falls and will **need to see deal evidence** emerge to re-engage.

Private investors and private equity are **ready to move**, however their offers represent **discounted prices**.

Expect to see more **JVs or mandate buying** between local and offshore groups, both as risk mitigation and also for offshore buyers to **access the market through trusted partners** while they are unable to physically access properties for inspections and DD.

Significant demand for institutional grade assets with strong tenant covenants and long term leases.

Initially vendors are likely to **test the market quietly** with off-market campaigns.

Greater **diversity of outcomes** between prime and secondary assets as the yields for secondary assets or those with **exposure to vulnerable business sectors** or current/near term vacancy are pushed out.

Distressed sales are not yet an influence in the market, however can be expected to grow over the next six months. Banks are notably currently focussing on residential and small business mortgage relief.

DATA DIGEST

The Knight Frank Basket of sales and analysis of deal progression is based on a sample of 66 sales being undertaken by Knight Frank across the East Coast during March and April 2020. Each sale's status was classified as "Submission to client, Off Market Appointment, On Market Appointment, Active Campaign, Offers Being Assessed, Contract, Unconditional, Settled, Campaign Delayed/On Hold or Withdrawn from Sale" in both March and April. If a sale moved forwards in the process (ie submission to off market appointment, or offers being assessed to Contract) then that sale was categorised as "Progressing". If a sale was still at the same stage (ie contract as at March and still under contract as at April), and the associated comments indicated that there were no negative issues emerging then that was "No change".

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

Research



Ben Burston

Chief Economist, Partner
+61 2 9036 6756
Ben.Burston@au.knightfrank.com

Jennelle Wilson

Partner
+61 7 3246 8830
Jennelle.Wilson@au.knightfrank.com

Property Enquiries

Ben Schubert

National Head of Agency, Partner
+61 2 9036 6870
Ben.Schubert@au.knightfrank.com

Paul Roberts

National Head of Capital Markets, Partner
+61 2 9036 6872
Paul.Roberts@au.knightfrank.com

Media Enquiries

Philippa Giles

Associate Director, PR & Communications
+61 2 9036 6627
philippagiles@au.knightfrank.com

Knight Frank Research Reports are available at knightfrank.com/research

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.



Important Notice © Knight Frank Australia Pty Ltd 2020 – This report is published for general information only and not to be relied upon in any way. Although high standards have been used in the preparation of the information, analysis, views and projections presented in this report, no responsibility or liability whatsoever can be accepted by Knight Frank Australia Pty Ltd for any loss or damage resultant from any use of, reliance on or reference to the contents of this document. As a general report, this material does not necessarily represent the view of Knight Frank Australia Pty Ltd in relation to particular properties or projects. Reproduction of this report in whole or in part is not allowed without prior written approval of Knight Frank Australia Pty Ltd to the form and content within which it