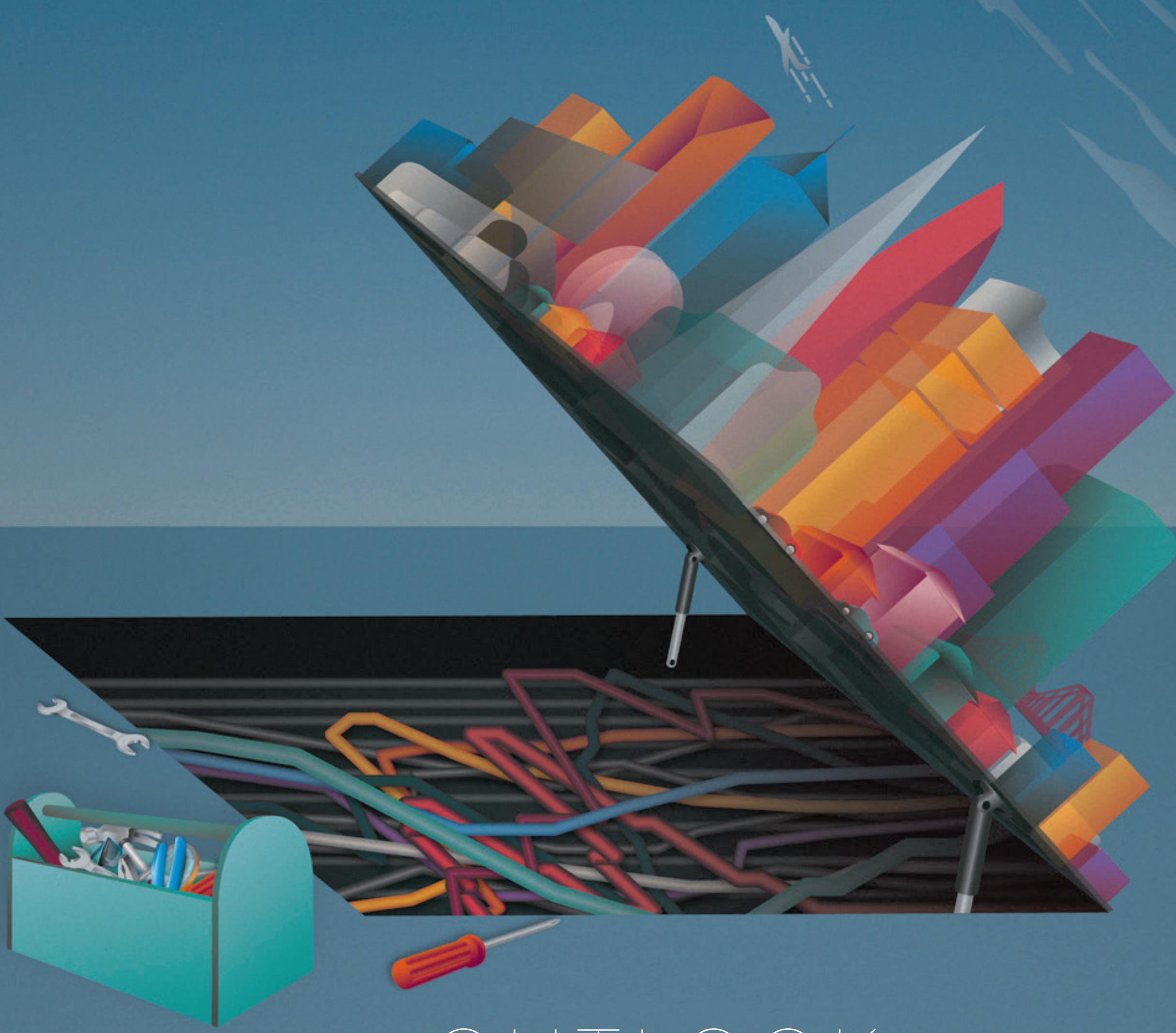
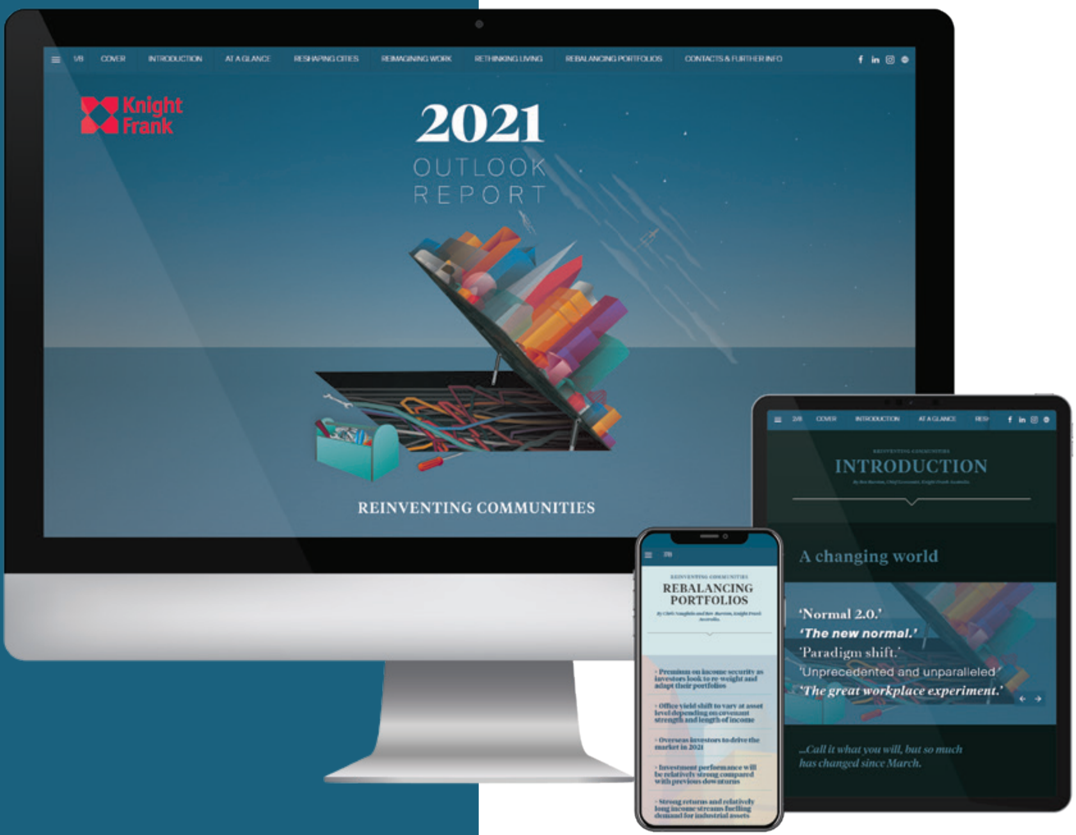
2021



OUTLOOK REPORT

RESEARCH INSIGHT

REINVENTING COMMUNITIES



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CONTENTS

INTRODUCTION

A Changing World

'Normal 2.0.'

'The new normal.'

'Paradigm shift.'

'Unprecedented and unparalleled.'

'The great workplace experiment.'

...Call it what you will, but so much has changed since March.

The year began with a series of by now familiar economic challenges in the form of sluggish growth and trade tensions between the US and China, and also the environmental challenge of widespread bushfires. Despite this framing, the outlook for property markets seemed bright as the market continued to respond positively to low interest rates and the weight of private and institutional capital seeking to be deployed.

But the advent of COVID-19 has upended the proverbial apple cart. Focus on the long-term challenge of weak productivity growth globally and locally has given way to the more pressing and immediate need to minimise the health and economic impact of the pandemic. Similarly, for many in property the focus for 2020 quickly shifted from identifying opportunities for future growth to managing existing assets and risks to income during a tumultuous period.

While the near-term focus is only to be expected, the lived experience of recent months has raised new questions for the future. Out of huge disruption across all aspects of life have come new perspectives, new opportunities and the hope that we can take the lessons of this time to adapt for the better.

Our Outlook Report this year seeks to identify these trends and the way in which they will influence our cities, our workplaces and our lifestyle choices over the coming years. Each dimension has important implications for property and hence the way in which our industry will contribute to change and reinvention right across the Australian community.

By Ben Burston

Chief Economist, Knight Frank Australia.

Reduction in forecast population growth

2019	1.5%
2020	1.0% ↓
2021	0.7% ↓
2022	1.1% ↑
2023	1.4% ↑
2024	1.5% ↑

Source: Oxford Economics

Fall in Australian 10 year bond yields

1990	13.2%
2000	6.3% ↓
2010	5.4% ↓
2020	0.9% ↓

Source: Oxford Economics

Fall in CPI inflation

1990	7.2%
2000	4.5% ↓
2010	2.9% ↓
2020	0.6% ↓

Source: Oxford Economics

Rise in Federal Government net debt

2019-2020	24.8%
2020-2021	36.1% ↑

Source: Budget Paper 1 2020-21

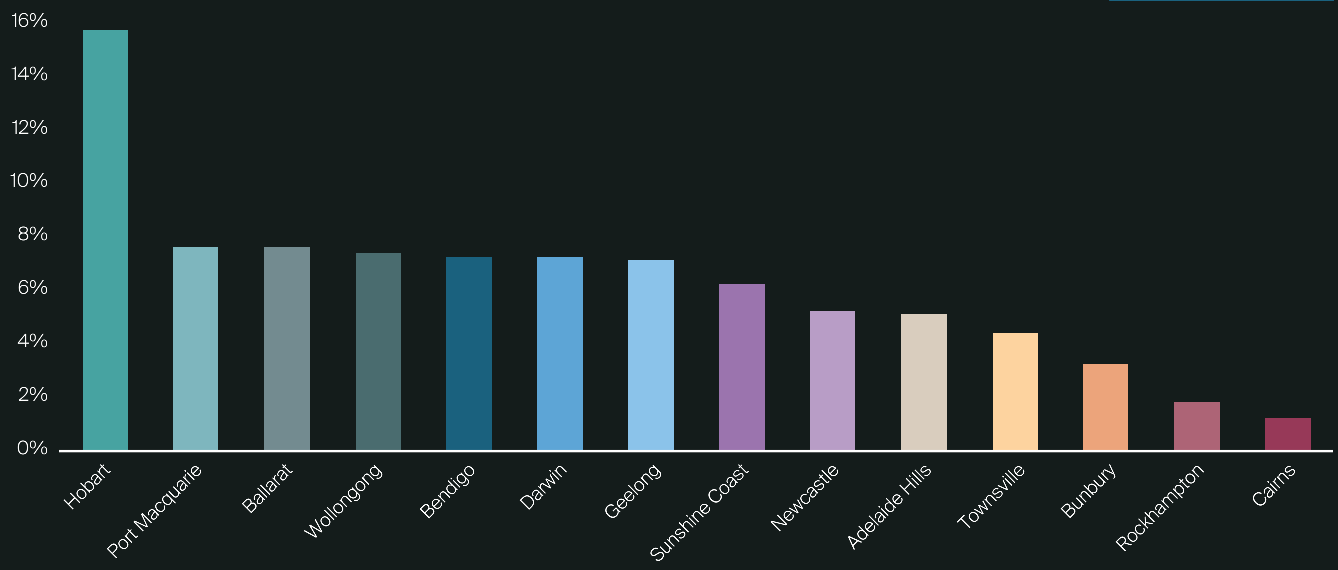
Gold price

↑ 25%

over the past year

Rising house prices in regional cities and lifestyle destinations

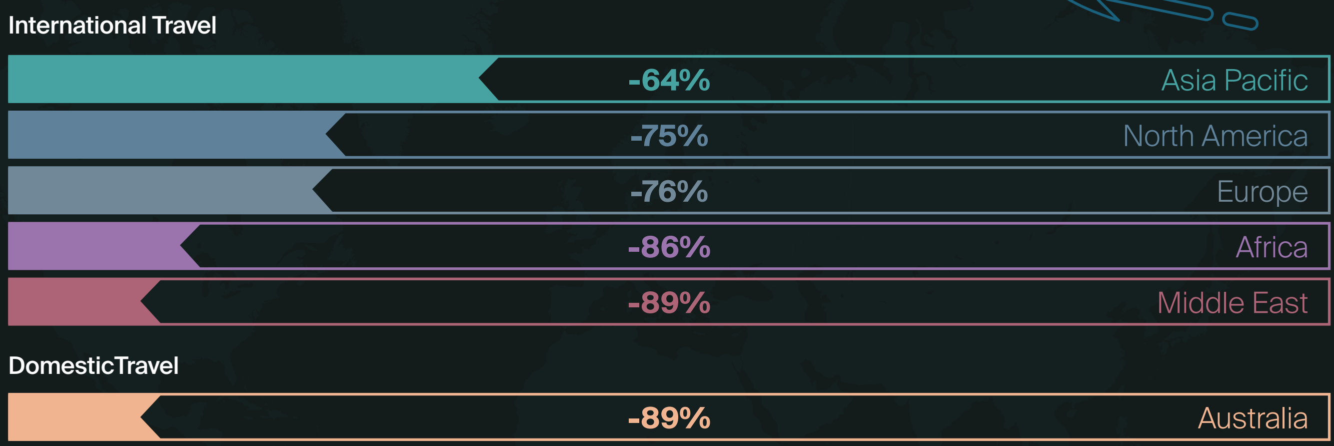
Annual % change in mainstream house prices, as at 30 September 2020



Source: Knight Frank Research, APM

Change in revenue passenger kilometres

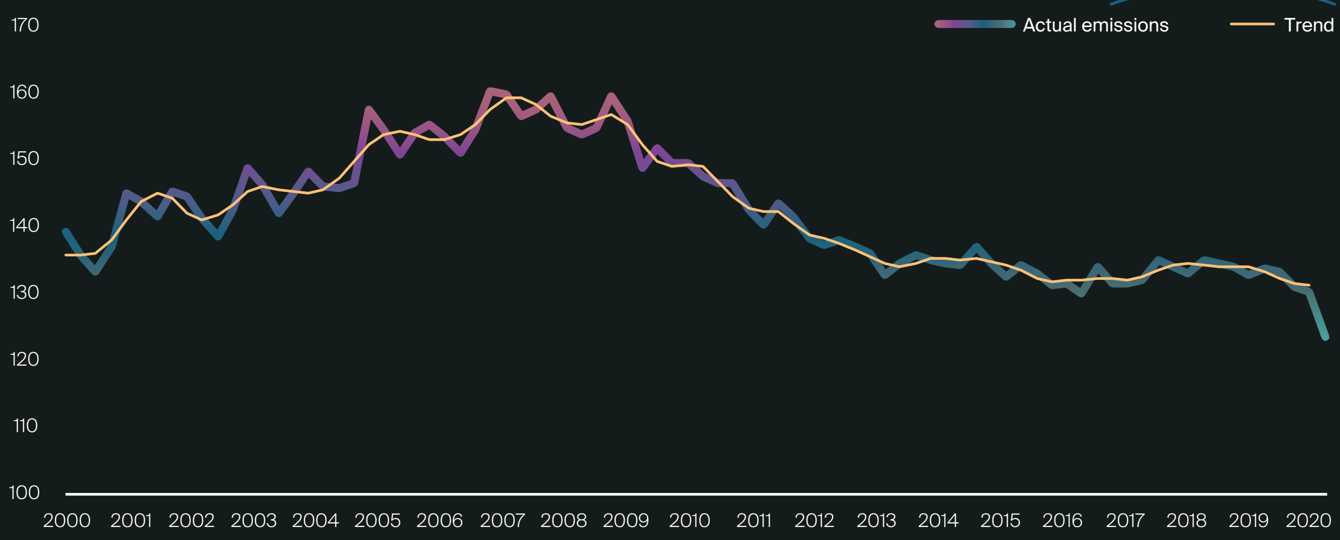
Year-on-year change to September 2020



Source: IATA

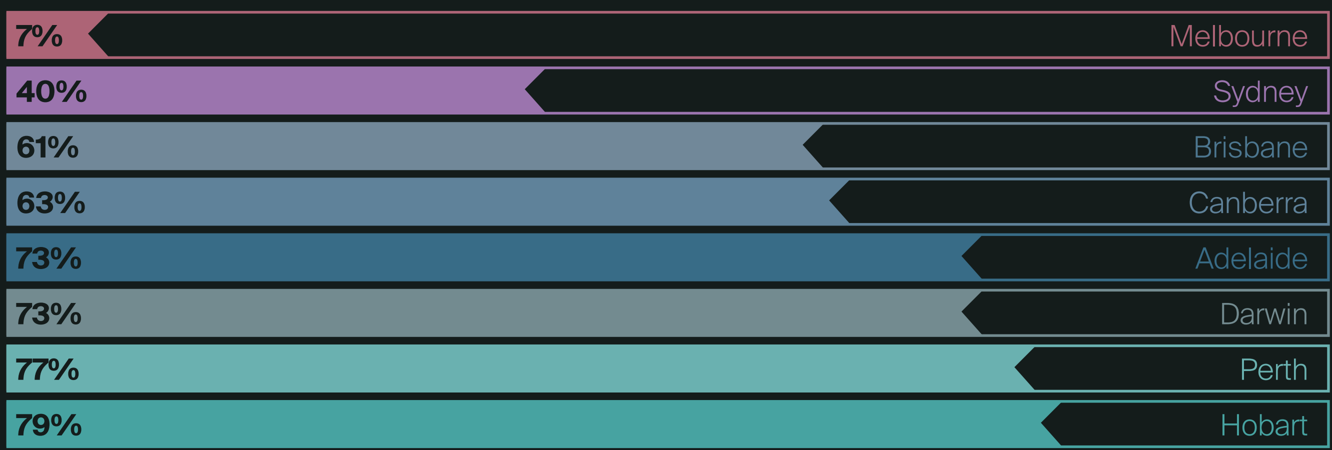
Steep drop in Australian carbon emissions

Emissions per quarter (millions of tonnes of carbon dioxide equivalent)



Source: Department of Industry

Estimated office occupancy compared to pre-COVID – October 2020



Source: PCA

University courses going online

Enrolment in Massive Open Online Courses

↑ 640%

Source: Coursera

International student arrivals

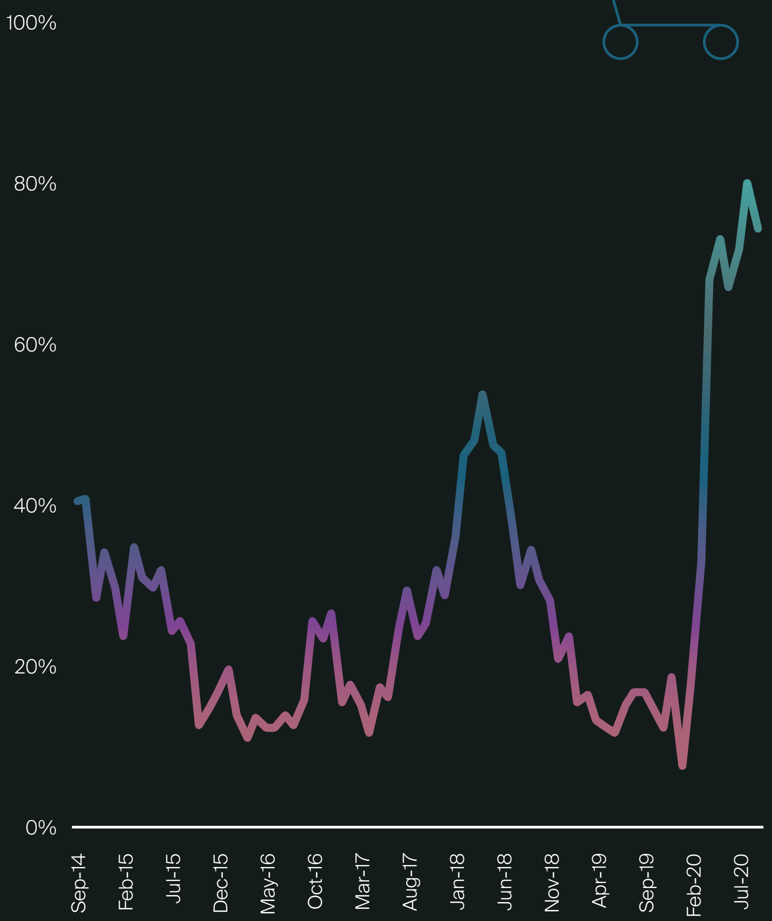
August 2019 ↑ 54,960

August 2020 ↓ 50

Source: ABS

Surge in online sales

Year-on-year change to September 2020



Source: Knight Frank Research, ABS

Divergent retail sales trends

Year-on-year change to September 2020

Household goods	17% ↑
Food	13% ↑
Department stores	-2% ↓
Clothing & footwear	-8% ↓
Cafes & restaurants	-15% ↓

Source: ABS

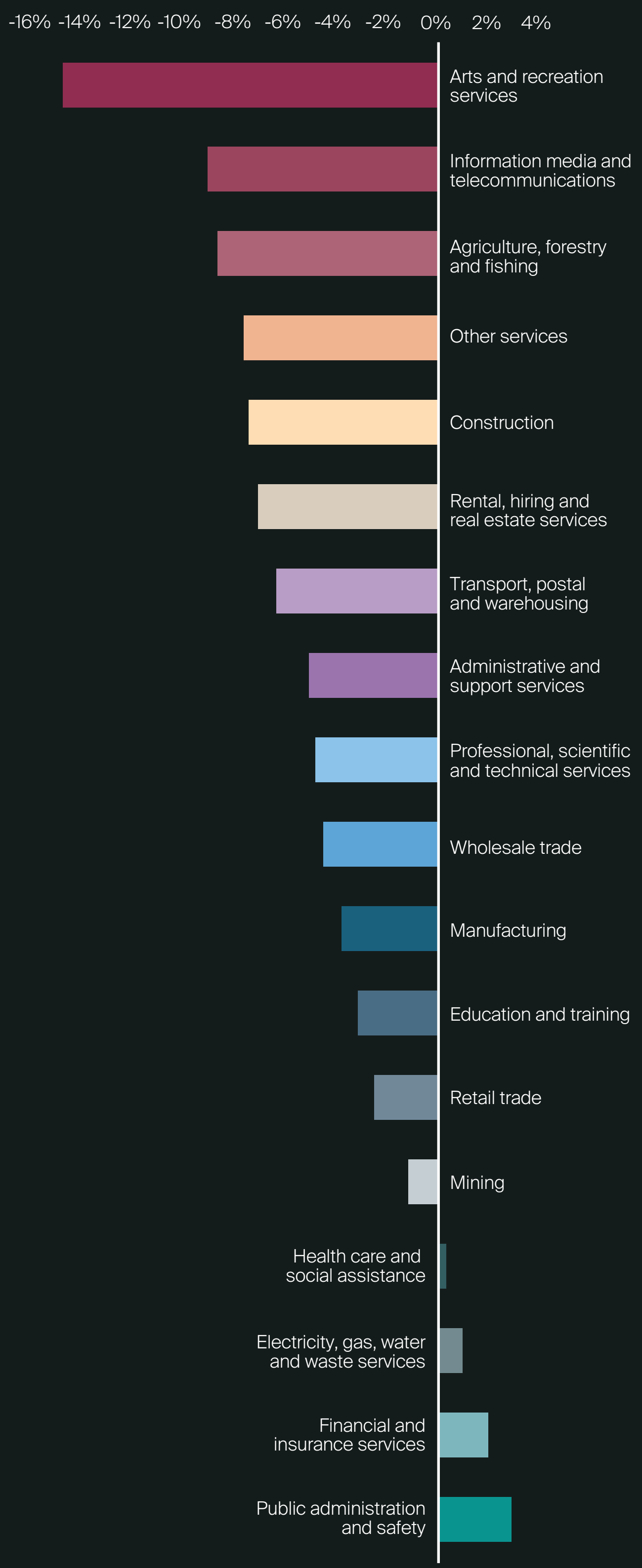
Growth of online retail sales

↑ +75% yoy

↑ **Over 1 million** new households shopped online between March and September

Divergent impact on the labour market

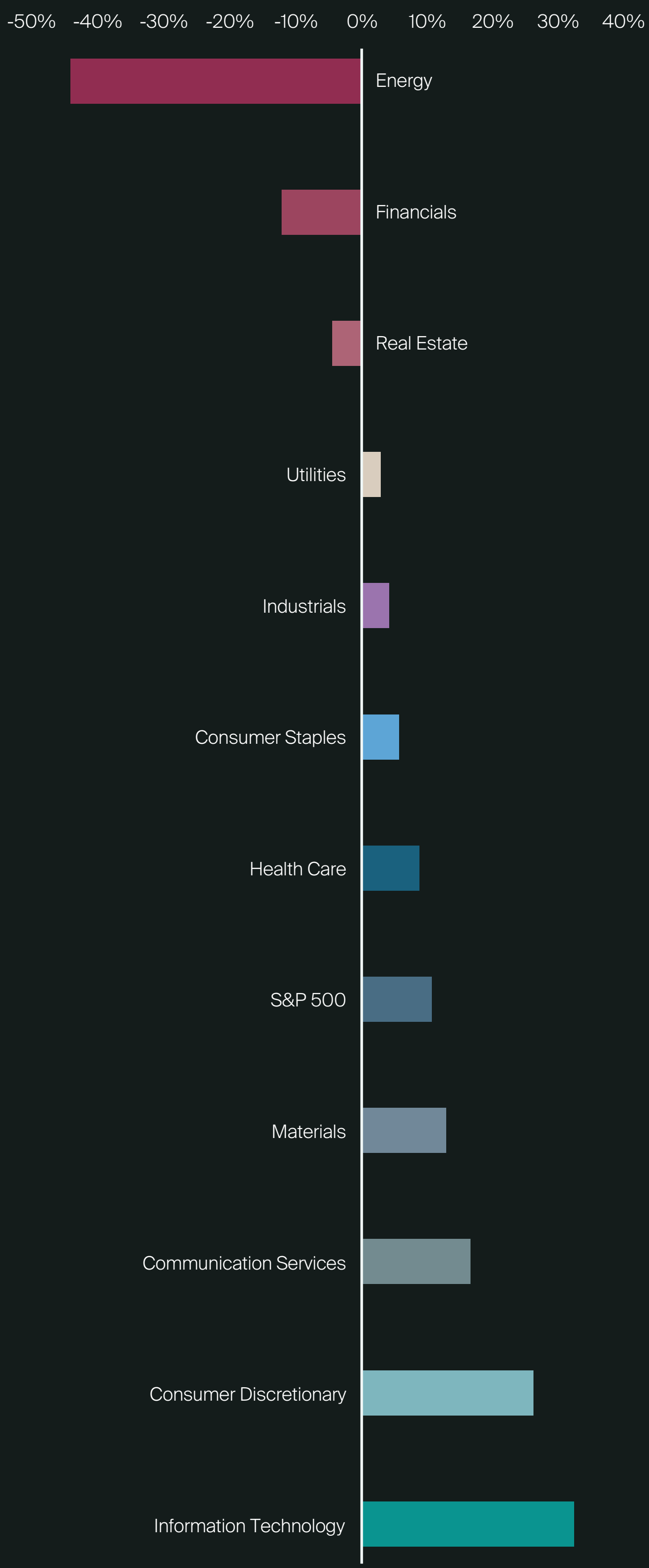
Change in payroll jobs since 14 March 2020



Source: Knight Frank Research, ABS

Divergent performace of different sectors in equity markets

Change in US equity prices by sector in 2020 YTD



Source: Knight Frank Research, Macrobond

AT A GLANCE

Top Predictions for 2021

1 Urbanisation on hold, but cities will re-assert their strength

At one level, COVID-19 seemingly threatens to up-end the status quo of city-centricity, but the weight of evidence on the relative productivity of cities argues strongly that they will remain the engine rooms of the national and global economy. Importantly though, this will no longer be dominated by our major cities. Regional cities like Wollongong, Newcastle, Geelong and the Gold Coast will see accelerated growth. They have sufficient scale and critical mass of service sector jobs to continue to develop rapidly, while also benefitting from a tilt in lifestyle choices due to the pandemic that will see some people opting for a less CBD-centric working life.

2 *'Thinking big'* on next wave of transport and social infrastructure projects

Governments will be seeking to move the needle on economic recovery in 2021 with an ongoing pipeline of new infrastructure projects, enabled by the low interest rate environment. We expect to see renewed debate on projects previously considered to be too expensive or not an immediate priority, such as faster rail connections between Sydney, Newcastle and Wollongong, additional airport capacity for Melbourne and improved access for cyclists in all of our major CBDs. Besides these transport initiatives, we expect more emphasis to be given to social infrastructure projects going forward, encompassing social and affordable housing, renewable energy and aged care facilities.

3 Offices will adapt to remain key to collaboration, training and cultural cohesion

Hybrid work arrangements will result in a shift in emphasis for offices toward their central role as an enabler of collaboration, culture and connection, with less emphasis being placed on facilitating individual, focussed work. Physical offices will be increasingly grounded in the concept of wellness, both mental and physical, meaning greater emphasis on green spaces, exercise and retreat rooms as well as natural light. In an environment of higher vacancy and the greater choice this implies for tenants, lower grade space which cannot meet more stringent requirements will increasingly become redundant.

By Ben Burston
Chief Economist, Knight Frank Australia.

4 The landlord-tenant relationship will need to adjust

Flexibility will be increasingly sought by tenants, and landlords will have to adapt to these changes. Reflecting uncertainty over future space needs, large tenants will seek a mix of core leased space and flex spaces which can be scaled up and down as needed, and also look for an end-to end service where workplace planning, design, fitout, head lease and flex space are managed under the one umbrella. Alongside more frequent break clauses, this will place greater management pressure on assets with long WALE tenancy schedules potentially having a number of break points.

5 Shifting pattern of prime residential demand

The COVID-19 pandemic, subsequent lockdowns and closed state and international borders have given people time to reflect on their lifestyles. Demands on the home are expanding, reflecting changes in the way they live and use their space. As a consequence, more and more people are seeking detached family homes and favouring waterfront and rural homes in particular. Large gardens and outdoor space are now more of a priority, with the lockdown period emphasising the connection between wellbeing and the great outdoors. All of this will drive strong demand for prime property in 2021, with prices in our major cities set to rise, led by Sydney, Perth and the Gold Coast.

6 Short supply of prestige rentals

Whilst the major cities across Australia have experienced minimal uplift in new sales listings, over the past year prime rental properties have also become scarce, in stark contrast to the mainstream residential market. We anticipate strong rental growth in the prestige market during 2021 driven by increased renovation activity, demand for part-time city living to complement rural or country homes and rising expat demand.

7 Investment performance will be relatively strong compared with previous downturns

Given the high level of uncertainty over the economic outlook, forecasting returns is more challenging than normal. But on the basis of a gradual recovery with no further major lockdowns, we expect capital growth in the office sector to average -1% for calendar year 2020 and -2% in 2021, leaving total returns a little over 4% and 3% respectively. The investment return performance of the industrial sector will continue to be relatively strong, with total returns likely remain around or just under 10% in 2020 and 2021. This would mark a much stronger return performance than that experienced during the GFC.

8 Premium on income security as investors look to re-weight and adapt their portfolios toward industrial and specialist sectors

Question marks over the strength of occupier demand in the office and retail sectors are resulting in a reassessment of risk with a greater focus on covenant strength and length of income. This will continue to drive strong demand for industrial and logistics property in 2021, as investors seek to increase their portfolio weightings to the sector. This will drive further yield compression in the industrial market, supported by the adjustment to lower interest rates. In addition, the desire for defensive income returns and diversification will see a further expansion of specialist asset classes such as healthcare, cold storage, data centres and build-to-rent.

9 Overseas investors to drive the office market in 2021

In a more challenging environment, with higher risks to income and less expectation of capital growth, we expect overseas buyers to step up their share of major acquisitions. Major global funds are more accustomed to the shift-down in interest rates and lower capital growth expectations, and overseas family offices will at times be driven more by the desire to diversify and preserve capital over the long term. On the other hand, domestic investors seeking higher returns will be cautious until the risks to the occupier market ease.

10 Lower return environment will drive appetite for debt strategies and boost competition in non-bank lending

The shift to a lower return environment will see a further deepening in the real estate debt market during 2021 with a proliferation in the number of lenders and a widening of their remit to offer greater diversification within the space. Lower expected capital growth will narrow the gap between expected returns on equity and debt strategies, tilting the risk/return dynamic toward debt. The entry of new non-bank lenders into the debt market will widen competition resulting in a broadening of the scope of borrowing available to borrowers, including longer loan tenors and higher LVRs than traditional bank lenders will offer.

RESHAPING CITIES

Urbanisation on hold, but cities will reassert their strength

Urbanisation is one of the defining themes of our age. Cities cover only around 3% of the world land mass, and yet they are home to over 4 billion people, representing over 50% of the global population. This proportion has grown substantially over the past century, having stood at around 30% in 1930.

By Ben Burston and Katy Dean
Knight Frank Australia.

Australia is no exception to the global trend. If anything, we are at the vanguard, with a highly urbanised population focussed on our major centres. Over the past twenty years, population growth in every major Australian city has substantially out-stripped the rest of the state or territory.

Rapid urbanisation has come as a result of an economy increasingly geared around service industries, which naturally cluster and thrive in our largest cities. While the advancement of technology has continually improved the quality and accessibility of remote communication and collaboration, until now it had done nothing to stem the tide of city-led growth.

This has provided a substantial tailwind for developers, driving inexorably increasing demand for space across the traditional sectors, while accompanying demographic and technological changes have given rise to alternative sectors like student accommodation, self-storage and data centres. And for investors it has shifted the strategic focus to cities, and within cities to the micro-locations that offer the best prospects for income security and capital growth.

But COVID-19 threatens to up-end the status quo of city-centricity. Already, population growth projections have been substantially marked down and the steady wave of international migration that has underpinned rapid growth in our largest cities of Sydney and Melbourne has stalled.

The utilisation of remote communications technology has sprung from low levels to near-universal within the space of a few months, facilitating business continuity through the pandemic and raising questions as to the future of urbanisation and city-led growth. If staff can freely communicate online, is there a need for the physical proximity that cities are designed to facilitate?

In the near term, lower population growth means that urbanisation is temporarily on hold. The change in work patterns is also prompting different lifestyle choices with some people opting to leave major cities – themes explored later in this report.

But the evidence on the relative productivity of cities argues strongly that they will remain the engine rooms of the national and global economy because of the superior job matching, training and resulting innovation that they produce.

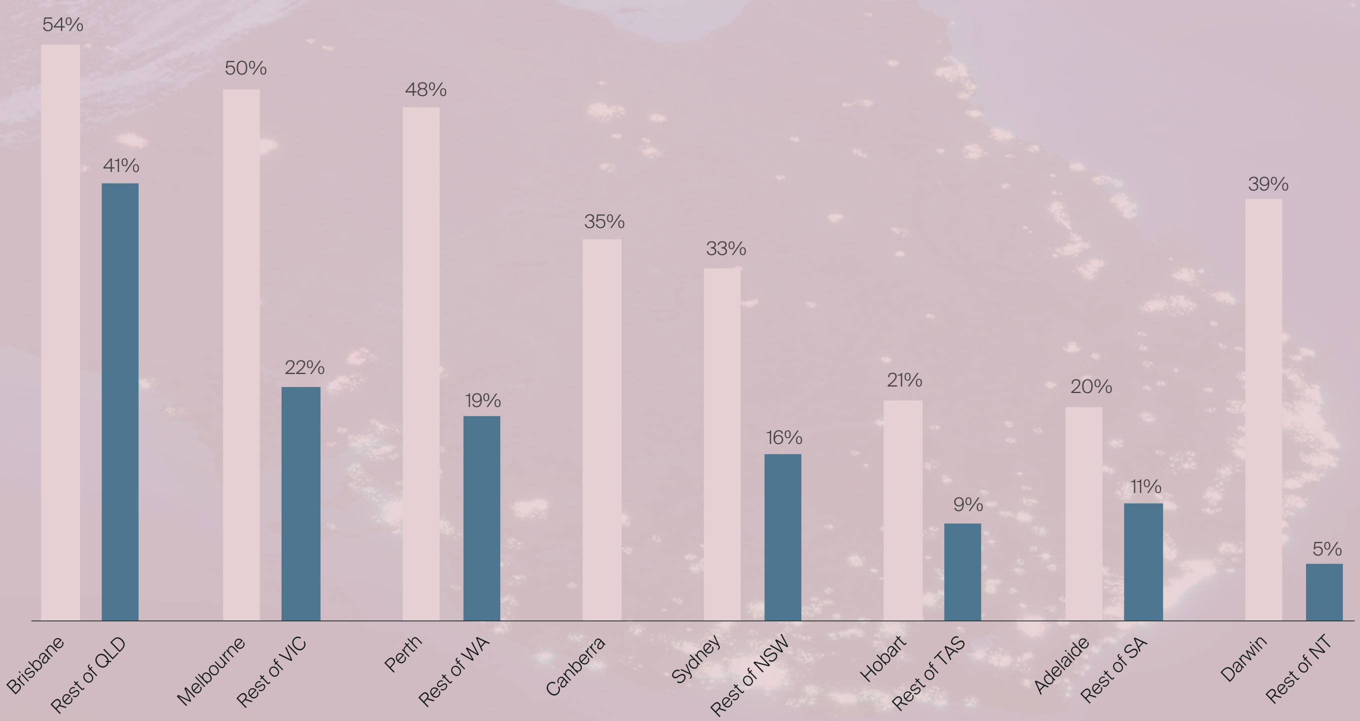
The physical proximity that they provide is inextricably linked to that productivity gain. While widespread adoption of online technologies introduces a new dynamic, it is highly unlikely that these tools can entirely replicate the network effects that physical proximity in cities provide.

In some areas they will be able to do so, and many roles requiring largely independent work may well be done remotely, either in part or completely. But in recruitment, on-boarding, staff training, and roles requiring regular collaboration and innovation, physical interaction plays a key role in improving the quality of communication and engagement, and ultimately end outcomes.

So cities will remain pre-eminent, but they will change shape as they adapt to the contours of a new challenge. The existing web of job matches and corporate knowledge in place locally and globally pre-COVID has enabled business continuity and productivity during 2020, but as we look ahead and this web shifts and is recast to reflect a post-COVID economy, cities will be needed to enable a new web of inter-connections to develop.

Urbanisation in action - population growth in major cities compared to regional areas

Total poplulation growth 2000 - 2020



Source: Knight Frank Research, Oxford Economics

Regional cities and the polycentric model reinforced by the pandemic

The new web of interconnections will increasingly include our major regional cities, especially those proximate to the major hubs. Cities like Wollongong, Newcastle, Geelong and the Gold Coast have sufficient scale and momentum to continue to develop rapidly in their own right as they host a critical mass of service industries that will drive the economy over the next decade. But they are also well positioned to act as satellite cities that will benefit from the tilt in lifestyle choices in the midst of the pandemic that is seeing some people seek a change of lifestyle in anticipation of a less CBD-centric working life.

Within the major cities, polycentric models of city planning are likely to attract closer scrutiny as a consequence of the pandemic. This will partly be motivated by shifting lifestyle choices, with some households seeking the wider spaces of a suburban lifestyle. But city planners will also have in mind the desire to mitigate the risks presented by the pandemic of having key services and employment clusters in one concentrated location, and the challenge of supporting infrastructure and services for a more dispersed community.

Sydney, in particular, has an established vision and plan for a Metropolis of Three Cities, that envisages establishing stronger growth hubs in a Central River City centred around Parramatta and a Western Parkland City reinforced by the development of Western Sydney Airport. This has seen the state government shift parts of its activity to support growth and the experience of the pandemic will serve to reinforce these efforts.

'Thinking big' on next wave of transport and social infrastructure projects

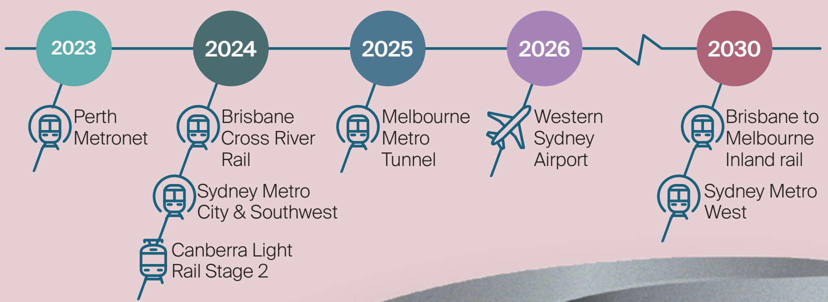
As the emphasis of planning policy shifts firmly to growth mode, further announcements on major infrastructure projects can be expected during 2021.

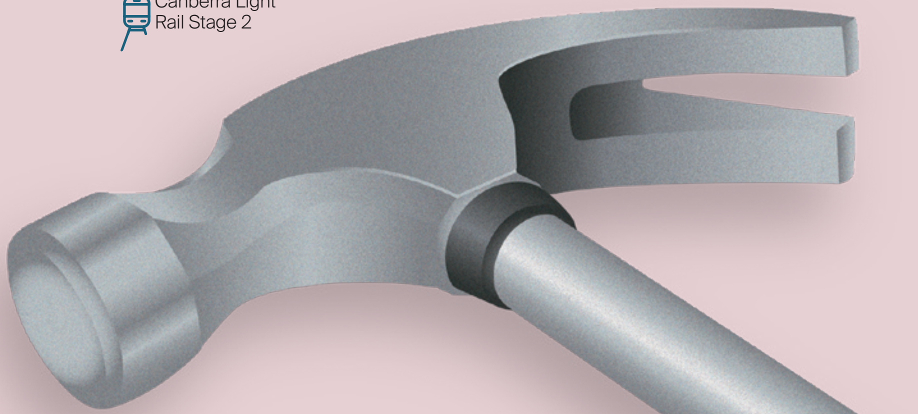
In an environment of recovery and adaptation, both State and Federal Governments will be seeking to move the needle with an ongoing pipeline of new projects. Of course, there is already a strong pipeline of existing projects to be rolled out, but if there was ever a time to cast the net even wider and expand the frontiers with a vision for the future of our cities and the communities within them over the next decade and beyond, the time is now.

A sustained low interest rate environment will help to enable this. The recent Federal Budget confirmed that while net public debt will rise substantially over the next few years, the annual net interest expense associated with this is actually falling because the lowering of bond yields right across the maturity spectrum more than outweighs the impact of higher debt.

While population growth has temporarily stalled, there remains a backlog of demand for new infrastructure to be filled. The current priority list set out by Infrastructure Australia focusses mainly on transport infrastructure to help ease congestion, but the pandemic is shifting the pattern of demand and triggering new needs within the community. As a result, we expect to see more emphasis to be given to social infrastructure projects going forward, encompassing social and affordable housing, renewable energy and aged care facilities.

Selected major projects under construction or committed





Selected priority initiatives that could be brought forward

- Dedicated cycling/walking access to major CBDs
- Boosting Port of Melbourne container terminal capacity
- Brisbane to Gold Coast corridor upgrades to road and rail
- Melbourne Airport third runway
- Perth Airport new runway

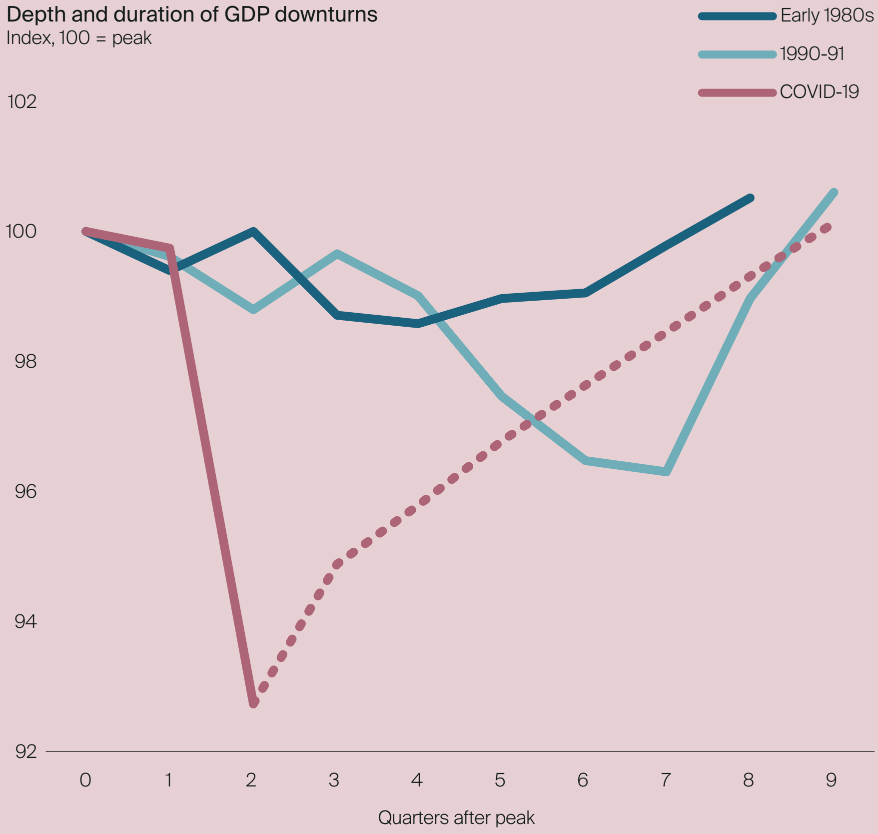
- East Coast High Speed Rail
- Newcastle and Wollongong to Sydney rail line upgrades
- Melbourne Airport to CBD rail connection
- Port of Brisbane freight rail connection
- Expanding Perth rail network capacity

Growth imperative will guide planning policy emphasis and speed up decision making

In Q2, output fell by 7% and even under a rapid recovery scenario the economy will not return to its pre-COVID level of output until 2022. The consequent growth imperative will be front of mind for political, business and community leaders during 2020. Provided that progress can be maintained in curbing the spread of the virus, the economic challenge will gradually shift from income support to reinvigorating growth and recouping the lost output during the recession.

There are a number of dimensions to this, and many policy levers that will be pulled to spur the economy back into gear. Among these, planning policy guiding development in our major cities will be key to driving the pace and shape of recovery. Planning policy approaches are always required to balance the need for growth with other considerations including character preservation, community consultation and transparency. But in the current environment, processes will be refined to speed up determinations and pave the way for economic recovery. New South Wales has led the way here with its fast-tracking of assessment processes. Over the past six months, the NSW Department of Planning, Industry and Environment has determined 101 major projects with an estimated economic value of $25 billion. Other states are likely to adopt similar strategies during 2021.

Depth and duration of GDP downturns
Index, 100 = peak



Source: Knight Frank Research, Oxford Economics

Build-to-rent momentum to grow as tax impediments ease and investor focus shifts to income security

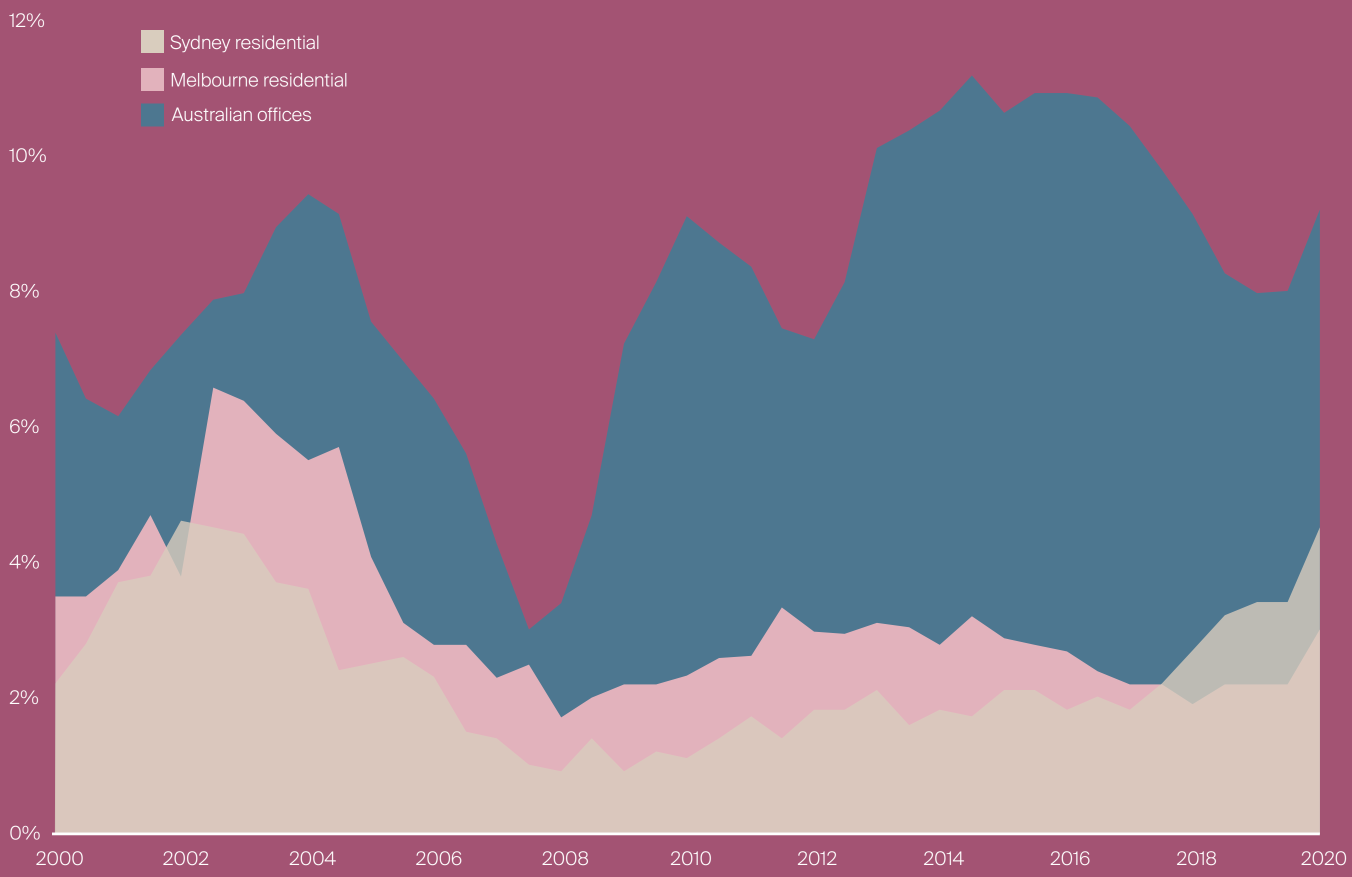
While still largely flying under the radar in terms of broad public awareness, recent months have seen vital steps taken toward the development of an institutional build-to-rent sector. The NSW Government has announced a land tax discount for new build-to-rent projects until 2040 in order to support the development of new housing options that provide greater surety for renters, while bolstering the pipeline of construction during the COVID-19 recovery. This will surely help to speed the development of the sector in Sydney, building on the momentum already established in Melbourne.

Arguably more significant though, are the implications of the economic downturn on perceptions of income security in other sectors and the related further shift down in real and nominal interest rates.

Vacancy rates in the major commercial sectors have risen in recent months, and in some cases will rise further in 2021, so in a challenging climate investors will become more focussed on income security. Build-to-rent is well-placed to offer an alternative source of secure income returns. Both in Australia and overseas, residential has demonstrated lower volatility of rental income through the cycle, off the back of a more stable pattern of occupancy.

In the past, however, secure income has not been enough to motivate the development of build-to-rent stock. Besides the tax issues, the sector has frequently been viewed as offering inadequate risk-adjusted returns compared to other sectors. But the drivers of this assessment are now shifting. Higher risks to income are likely to persist in the traditional sectors in 2021, and retail in particular is at risk of losing its traditional role in providing ballast to property investment portfolios. At the same time the shift to lower interest rates will act to lower targeted returns, and both of these forces are tilting the risk-return trade-off.

Office and residential vacancy rates



Source: Knight Frank Research, REIA, PCA

Universities will reshape property needs to reflect new pattern of demand

R E S H A P I N G   C I T I E S

COVID-19 has highlighted vulnerabilities across several sectors of Australia's economy, and the higher education system has come under particular strain due to restrictions on international travel and hence the flow of international students. Universities that heavily depend on fee income from overseas students are clearly suffering a significant reduction in revenues, with a recent report by the University of Melbourne estimating a total loss in revenue of $3.5 billion during 2020 alone, with this likely to extend into future years depending on the duration of travel restrictions^.

The report observes that 'few if any universities have sufficient operating margins or available cash and investment reserves to withstand a sustained reduction in international fee revenue' and that this will challenge the long-term viability of current operating models.

In addition to cash flow pressures, the pandemic has also required adaptation of teaching formats and accelerated the shift to online learning, and some of this is likely to endure even once the pandemic passes.

In this environment, property portfolios will come under scrutiny. Universities will be re-evaluating the scale and composition of their holdings and adapting them to better suit the shifting pattern of demand. The issues at play are complex, as Australia will remain highly attractive to international students and universities will be sure to maintain capacity.

Like many employees, today's students want to be in close proximity to transport, rich amenities and the business community for placements and internships. The pandemic is providing a catalyst for change, and some existing facilities are likely to be deemed no longer fit for purpose, opening up substantial opportunity for re-invention, adaptation and greater integration with surrounding cities.

^ Modelling Individual Australian Universities Resilience in Managing Overseas Student Revenue Losses from the COVID-19 Pandemic, University of Melbourne, 2020

Hyper-local supply chains emerging through micro-fulfilment centres

Accelerated online spending growth due to the pandemic has seen a shift in logistics trends linked to ecommerce, with retailers targeting the spoke model using automation to develop smaller but efficient distribution channels that will see some retail stores re-purposed and also result in new demand for urban logistics facilities. Grocery retailers have been the first to experiment and bring forward ecommerce development plans giving rise to hyperlocal supply chains on the eastern seaboard.

Over the last few months, the sector has seen a quiet emergence of partnerships with technology startups to make e-commerce fulfilment more efficient using a smaller footprint. While this was in its infancy pre-COVID, the heightened demand for micro fulfilment centres (MFC) is now real. In Australia, Woolworths has been the first to experiment.

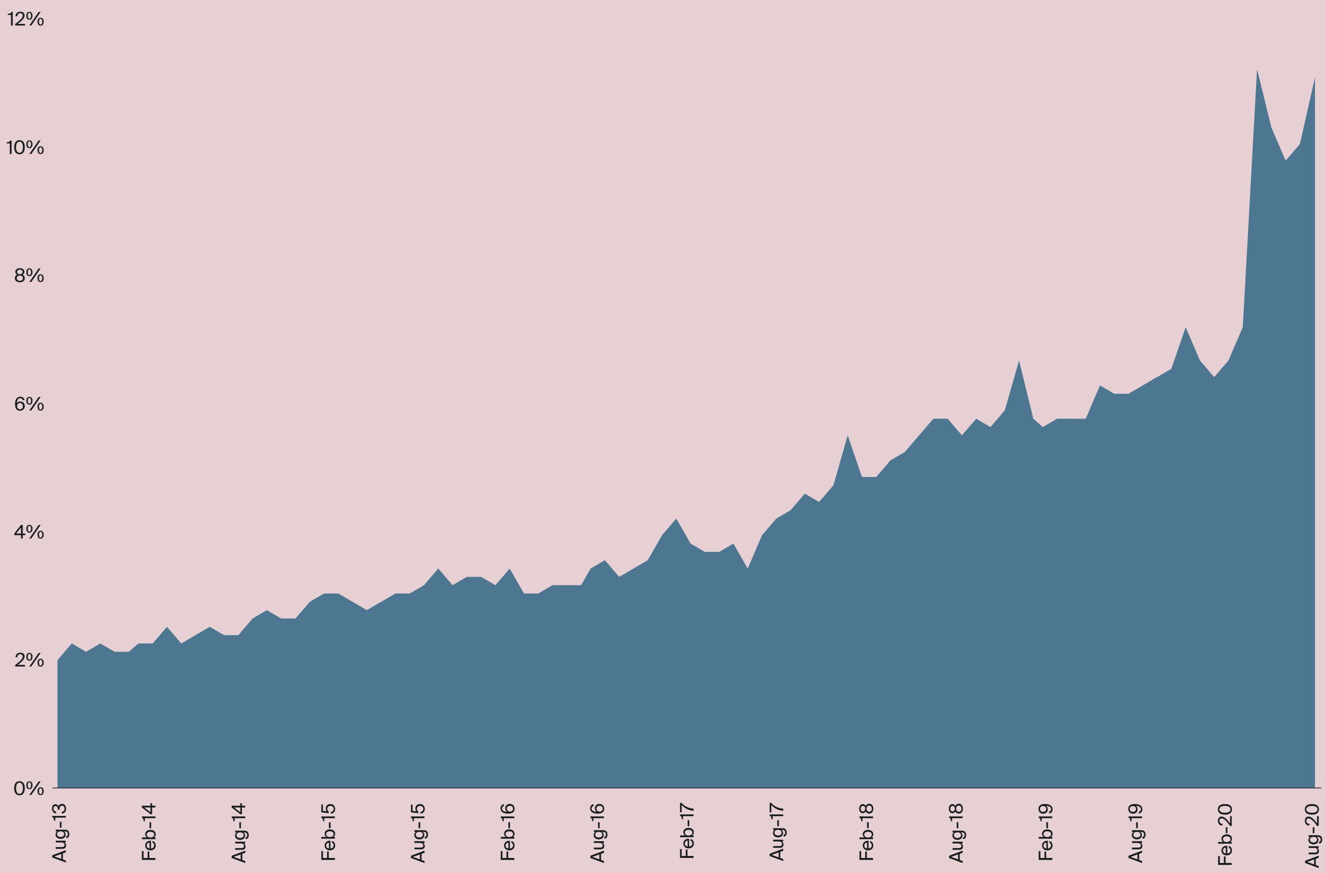
Major retailers already have the existing real estate infrastructure in place and therefore can scale up on land to provide automated MFCs. MFCs are typically housed at the back of existing stores or infill urban locations where space is usually at a premium. The additional advantage of an infill location means fulfilment is in closer proximity to customers, with the potential to provide cost-savings to delivery, as well as speed up delivery times.

For instance, Woolworths recently partnered with Takeoff Technologies, a US-based eGrocery startup, and launched its first MFC in Melbourne, at the back of an existing 4,300 sqm store in Carrum Downs. It incorporates automation, robotic pickers and vertical shelving to move products for packing and distribution to enable same-day delivery and a reduction in dispatch times.

Woolworths plans to build another two MFCs in Australia in 2021, while also building two new automated national distribution centres in Melbourne and Sydney. The group appears to be transitioning towards a hub and spoke supply-chain model with a mix of large-scale fulfillment centres in major regional areas and localised micro-fulfillment centre in infill locations.

The integration of smaller MFCs to help fulfil demand is starting to gain pace and has the potential to revolutionise urban logistics and influence city planning strategies over the long term.

Australian online share of total retail



Source: Knight Frank Research, ABS (Original Estimate)

REIMAGINING WORK

The pandemic has forced a sudden and significant shift in the way people undertake the day to day tasks of work, shopping and play. Dubbed as the greatest working from home experiment, the rapid uptake of entire workforces moving from an office to home based work environment proved in many ways that working in an office is a choice and not a necessity. The steady improvements to video and shared meeting technology, widespread bandwidth increases and secure access to files remotely all facilitated this response.

By Jennelle Wilson
Partner, Research & Consulting, Knight Frank Australia.

While wholesale working from home will be an extreme, as cities open up again some of the lessons learnt during the enforced shutdowns will remain, resulting in lasting change in the way employees engage with their workplace. This will have significant impacts on take-up of office space and the type of space favoured.

Employees need to have a reason to come to a central office

"I'm off to work" once referred to a location, however now it refers to a state of being. The broad success of mass working from home during 2020 has shown technologies are now stable enough to support a dispersed workforce. While many surveys have shown that workers rate themselves just as productive while working from home, a longer period of analysis, and one when there is a degree of normality surrounding public transport and socialising expectations, is required. However, one thing has become clear - once employees have a choice, they will exercise it. Investing time, money and emotional inconvenience into a commute needs to have a productivity payoff and these choices will result in a shift in emphasis away from the office as a place for individual, focussed work and toward its role as an enabler of collaboration, culture and connection.

Offices will remain key to collaboration, training and cohesion of purpose

While working from home was widely supported during a time of uncertainty and need to self-isolate, long term will see central offices retain their place as a necessity in the workplace landscape. Technology allows for formal communications, training and meetings to be undertaken remotely, however, a vast array of vital communication and interaction happen at a human-to-human level.

Person-to-person interaction results in a cocktail of pheromones and chemicals released by the brain which are not replicated in digital interactions. Video conferencing remains a less satisfying interaction, particularly one-on-one, because of the lack of retinal alignment due to the displacement of the camera and screen.

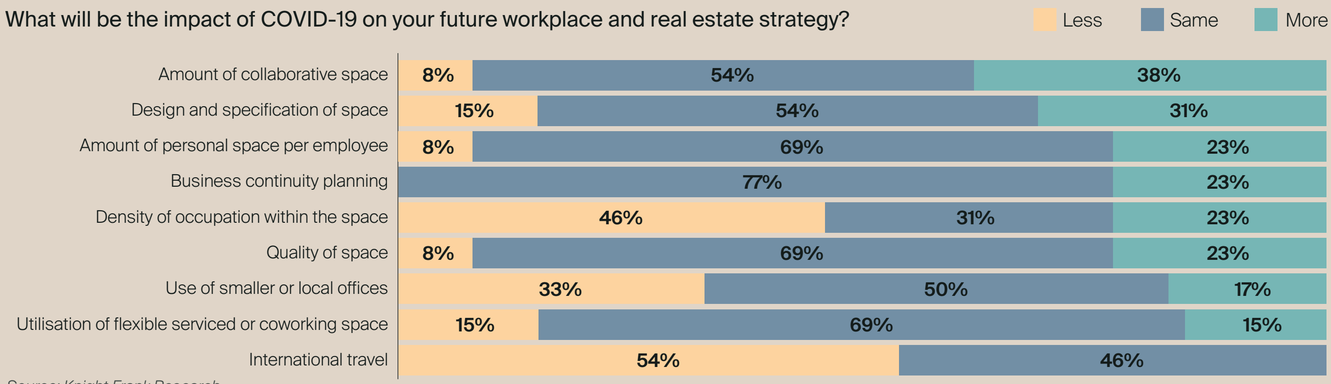
More important than feeding the brain's need for human contact is the informal communication and collaboration that comes from an office environment. This is the 'bump factor', unsolicited conversations in the kitchen, "what happened when….", the 'unsupervised conversations' after a meeting, "what did they mean/how are we going to do…..", the overheard learning and mentoring of younger staff and the informal interaction and alignment of purpose which happens in a busy environment.

As indicated by a Knight Frank survey earlier in the year, the design of workplaces is expected to change with more emphasis put on collaboration while in the office, thus more collab friendly spaces and fewer task work points will be designed. The density of work points in an area is unlikely to see wholesale change in any but the tightest (1:8 sqm or less) of workplaces as in a pandemic public transport is the major limiting factor for employees attending the office or not, rather than distancing while at the office.

What will be the impact of COVID-19 on your future workplace and real estate strategy?

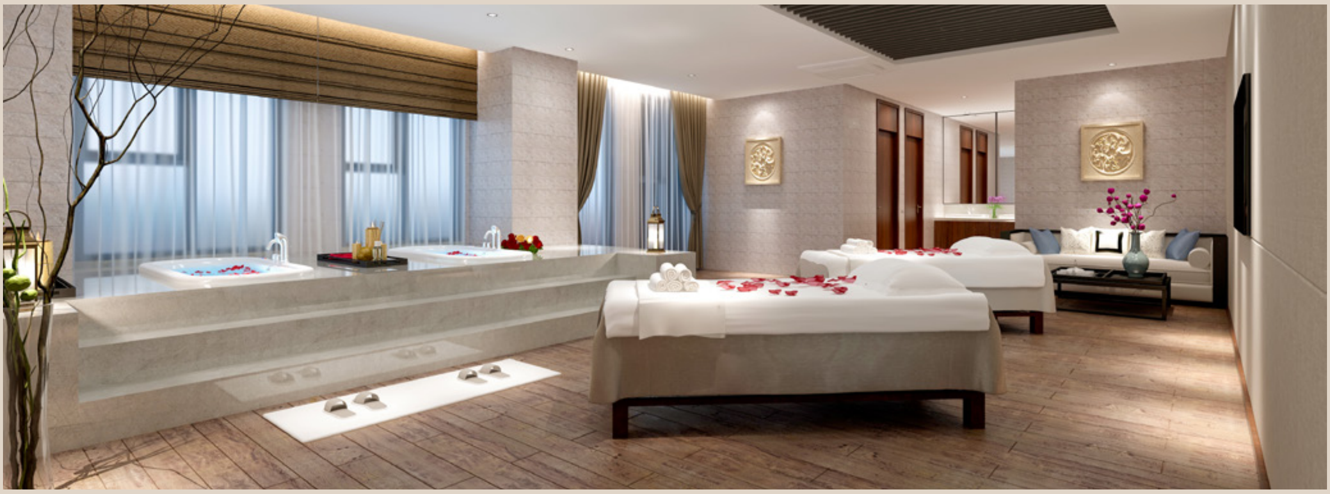
Source: Knight Frank Research

What will be the impact of COVID-19 on your future workplace and real estate strategy?



Source: Knight Frank Research

Wellness, ESG and soft services will be key in the medium term



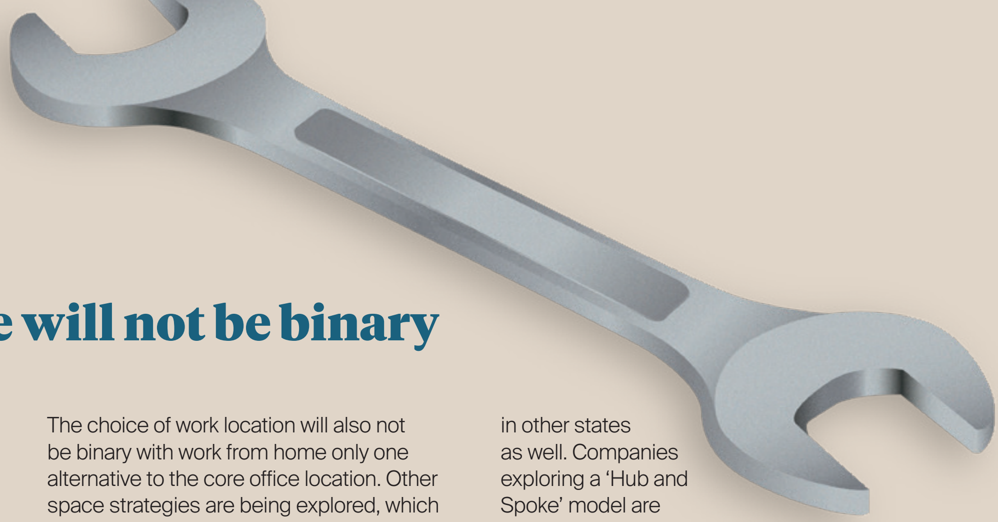
Lasting sentiment changes around office space and features that it should provide will be grounded in the concept of wellness, both mental and physical, and greater social responsibility. Employers are ramping up their mental wellness programmes, recognising the essential role it plays in a healthy happy workforce.

In the building fabric this includes open-air areas, green spaces, exercise and retreat rooms, as well as natural light. Employees will also require a higher standard of physical safety in the workplace with no-touch or low-touch entry and facilities, air quality real-time monitoring, temperature monitoring, the ability to contact trace through booking systems and mitigate against overcrowding in real time.

Innovation has continued in this space during the pandemic with Brookfield recently announcing they will roll out a bipolar ionisation system to improve air quality in their office assets. AMP has also announced it will introduce AI backed HVAC systems into its properties – the system uses a number of factors, including the occupancy in the building to predict the heating/cooling loads required. While both these initiatives improve comfort and air quality for occupants, they also provide energy savings.

Sustainability is expected to remain a key requirement for office building design, management and fitout. While ESG and allied issues can often lose momentum during recessions, the sea-change of sentiment surrounding the correlation between taking better care of the environment and having better quality of life ensures this will remain top of mind.

Lastly, in the quest to keep the office an attractive and prestigious place to be, we expect landlords to continue to broaden their offering of soft services. While end of trip facilities, onsite security and concierges are now ubiquitous there will be an additional layer of services offered within these frameworks. This will include fitness and relaxation classes, enhanced delivery and errand services along with the existing building community-creation programmes.



Workplace choice will not be binary

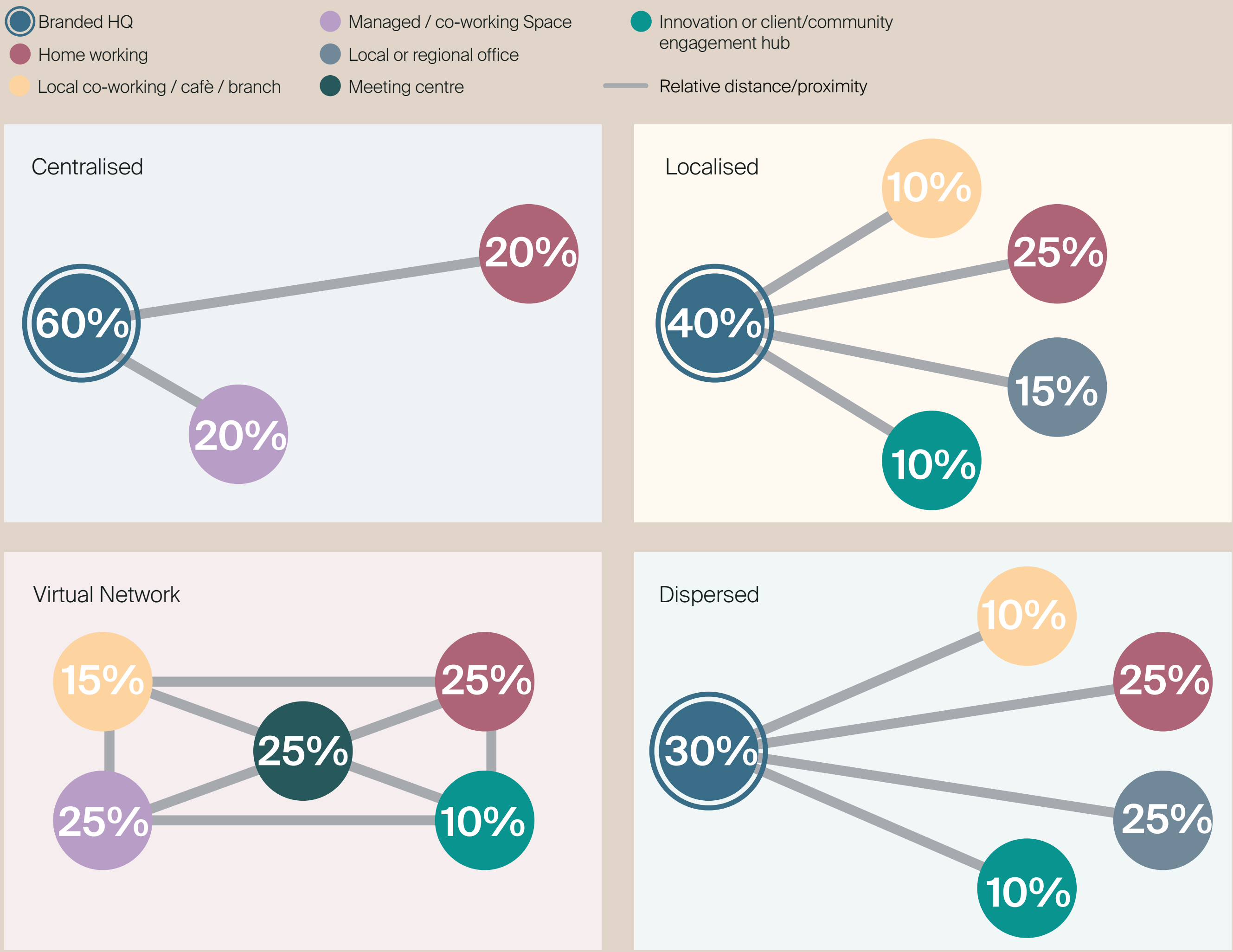
Working from home isn't for everyone with a lack of a dedicated workspace, proximity to partners/ children/flatmates, unstable home lives and potential isolation all barriers. Hybrid arrangements will be most common with mandating either 100% office attendance or 100% WFH likely to meet with resistance. The key will be flexibility with most companies assuming 2-4 days in the office each week, on average, across their employment pool.

The choice of work location will also not be binary with work from home only one alternative to the core office location. Other space strategies are being explored, which will trigger more, smaller, suburban and regional flex office space to cater for those with longer commutes through lifestyle choice or housing affordability.

IWG have recently announced a franchise agreement for the Regus brand to be rolled out in 10 Queensland coast locations including Townsville, Mackay, Cairns, Rockhampton, Gladstone, Bundaberg, Hervey Bay, Airlie Beach and Noosa. This regional offering is expected to be rolled out in other states as well. Companies exploring a 'Hub and Spoke' model are expected to use third-party providers unless there is already a branch office in place, as few corporates will be taking on additional commitments in the current climate.

New portfolio models

Percentage (%) is activity of total staff



Source: Knight Frank Research

The landlord-tenant relationship will need to adjust

Flexibility will be increasingly sought by tenants and landlords will have to adapt to these changes. In the next 12-18 months, this will take the form of short term lease extensions or renewals as decisions continue to be deferred on longer term plans. As companies determine their strategies this is likely to evolve into a mix of core leased space and flex spaces which can be scaled up and down as needed.

While some landlords are actively pursuing management of this flex and third space product themselves, others will outsource to flexible office space providers. Companies will also look for an end-to-end service where workplace planning, design, fitout, head lease and flex space are managed under the one umbrella. The Hub is one flex office provider looking to move further into this consultancy space.

An alternative or adjunct to a core and flex strategy for tenants is to place more frequent break clauses and expand/contract clauses into their leases. This will place greater management burden on assets and greater buyer due diligence required with long WALE tenancy schedules potentially having a number of break points.

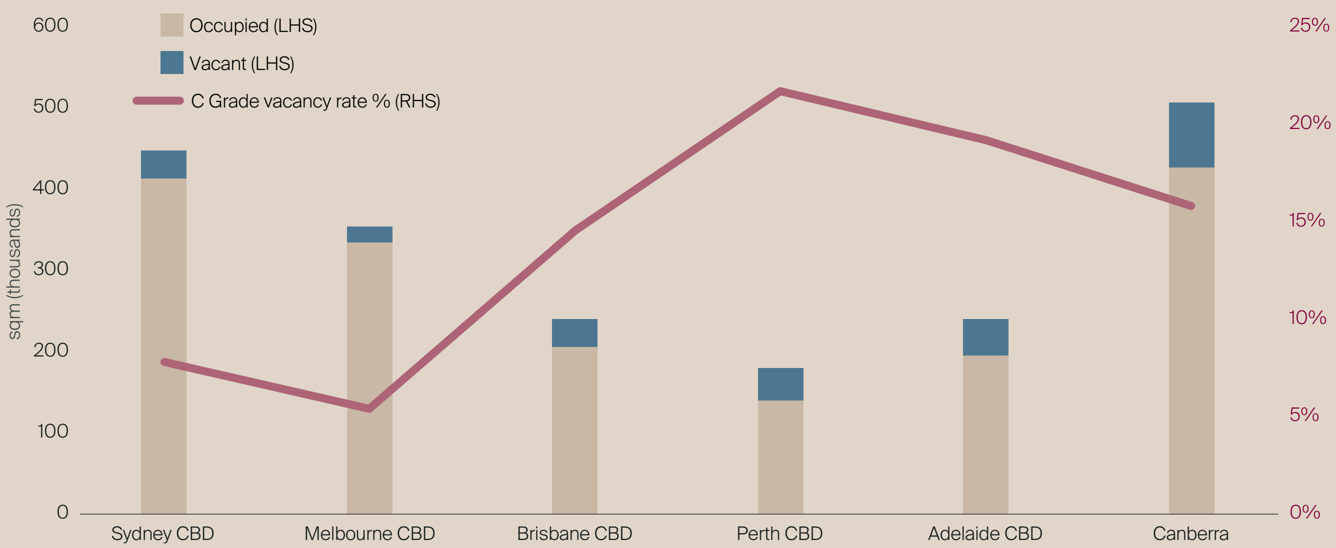
C Grade office space will struggle to remain relevant

Tenant expectations surrounding office space quality and building services, along with soft services will increase as a result of the level of choice available. Space which cannot meet these requirements will increasingly become redundant and the pace of obsolescence is set to increase as vacant space grows further in 2021.

Across Australia's six largest office markets 11.2% is C Grade space, covering just under two million square metres. While some buildings may have heritage features, locational benefits or views making refurbishment or conversion to residential/ hotel worthwhile, there are many older vanilla office assets that would struggle to bring services and amenity up to the required standard for future corporate office occupation, even after refurbishment.

These assets will continue to feed site amalgamation by both institutional and private investors for redevelopment in the medium to longer term and offer low-cost options in the shorter term. Wholesale refurbishment of these assets, aiming for A/B Grade outcomes is unlikely with levels of prime available space high and capital expenditure weighted towards short term outcomes.

C Grade office stock
Top six Australian office markets as as July 2020



Source: Knight Frank Research, PCA

Trends to watch in 2021

1 Corporates still in the review phase

As the office population gradually returns, companies will be focussed on how to maximise output while minimising costs. Decision horizons are expected to remain short with many corporates still testing their responses and not keen to take on new 5-10 year leases until there is a clearer path on both the global economic front and also pandemic trajectory.

In the short term, companies will be focussed on resilience and risk management as the pandemic exposed some shortcomings in disaster planning. Not only having the IT resources on tap to support a fully remote workforce if necessary but also decisions around exposure to single locations, single clients, offshore processing, redundancies around IT systems, data security & storage and human resources risk management to ensure the wellbeing of employees. Business is aware that it needs to be prepared in the event of further disruption.

2 Owners will target CAPEX on getting assets match-fit for sub-lease competition

The significant slowdown in leasing market momentum during 2020 has required landlords to tilt capital expenditure plans to strategies that make it easier for tenants to make decisions and move into space that is ready to occupy. As part of this, landlord-funded speculative fitouts are becoming more common.

Traditionally concentrated in the B Grade market, spec suite development is expected to extend further into prime space over the next 12 months. With spec suites designed to suit a wide range of tenants, most landlords factor in two or more lease terms of use from a fitout, maximising both the financial outlay and sustainability credentials. Spec fitouts are expected to be favoured over full or partial building refurbishments due to the lower initial CAPEX and shorter lead times achievable, and also have the potential upside of reducing the cash component of incentives required to secure a tenant.

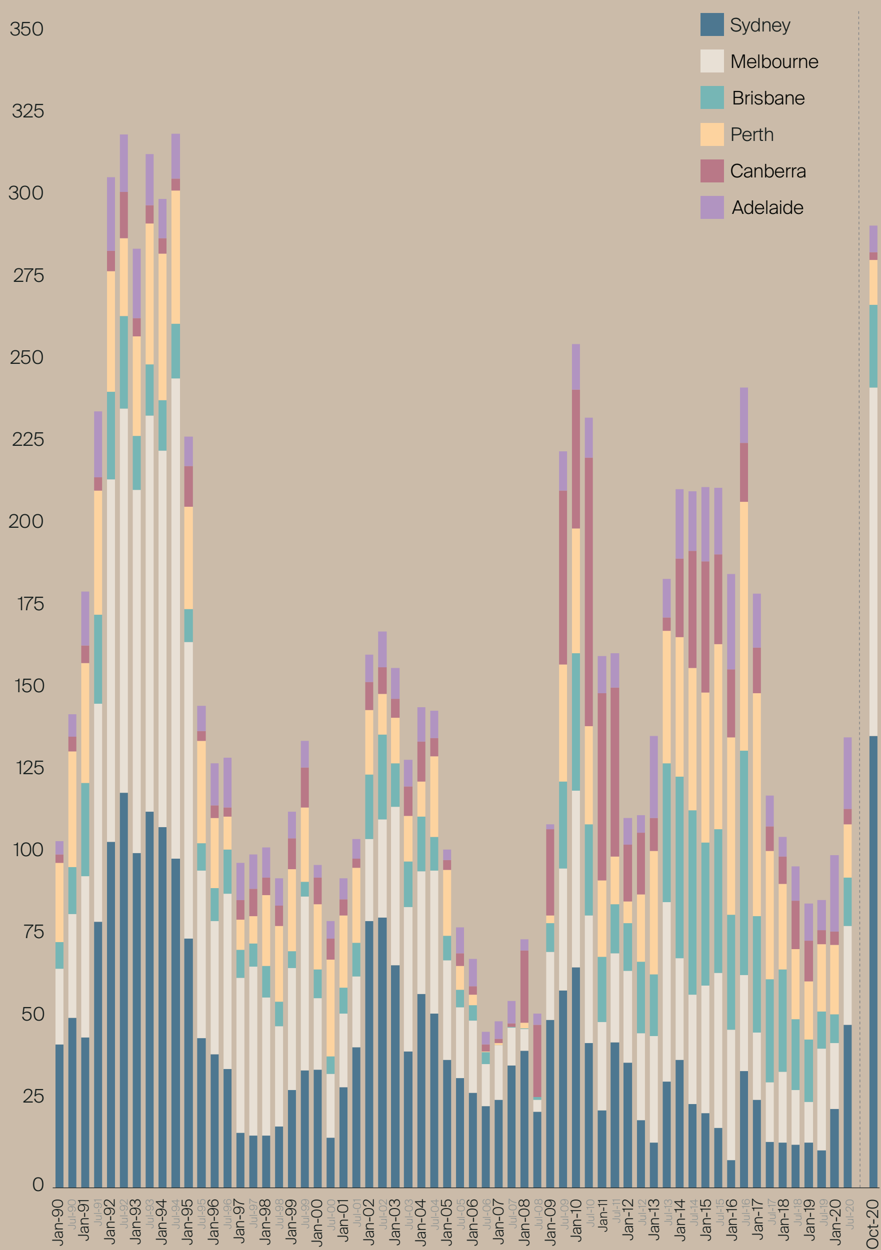
Importantly, it positions the landlord with a product that can compete with both the sub-lease space available and co-working/flex office space that offer fully fitted out options.

3 Downsizing and sub-lease space will dominate the market in 2021 as occupiers seek to do more with less

Although still in the initial stages, many large corporates are grappling with the expectation of sustained low desk utilisation, due to potentially lower headcount and lower daily attendance to the office. This has already resulted in sub-lease space increasing across to record highs across Sydney and Melbourne, with the phenomenon extending into other CBD markets. For smaller companies where the excess space is not of a commercial size, or splitting is too hard, a level of hidden vacancy will return to the market, not manifesting until lease-end.

The concept of doing more with less will increasingly be the first option for office occupiers with minor tweaks to layout to remove unused space, such as commercial kitchens, compactuses and storage space, and repurposing it as usable collaboration space. By optimising layouts a company may be able to sub-lease whole floor or floors and maximise the work points on the number of floors kept.

Historic sublease vacancy in major CBDs
sqm (thousands)



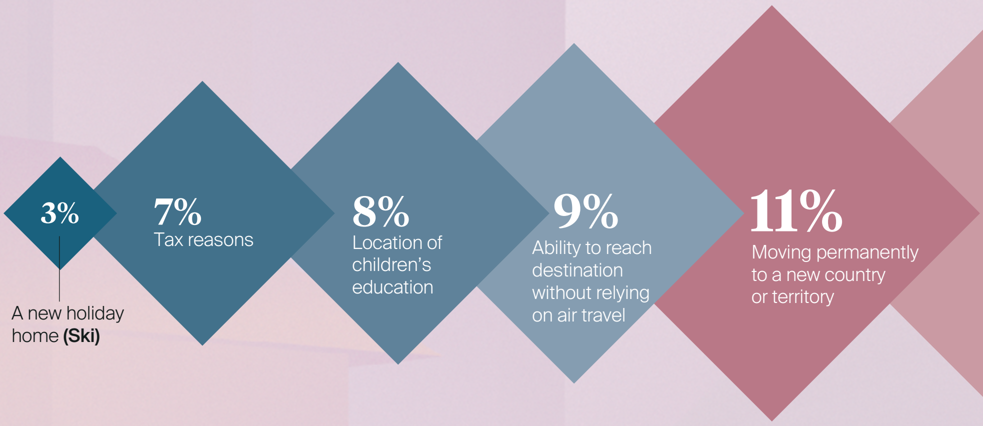
Source: Knight Frank Research, PCA

Shifting patterns of buyer demand

By Michelle Ciesielski
Partner, Head of Residential Research, Knight Frank Australia.

Confidence had returned to the Australian prime residential markets heading into 2020, spurred on by rising wealth, lower interest rates and a limited number of new luxury properties being built. The COVID-19 pandemic, subsequent lockdowns and closed state and international borders have given people time to reflect on their lifestyles with demands on the home expanding the way they live and the use of space. It is inevitable that as we ease out of lockdown and borders re-open, these shifting attitudes will have repercussions on prime property markets around the world.

Please select the top three reasons for purchasing a new property in the future?



Source: Global Buyer Survey 2020 - Knight Frank Research.

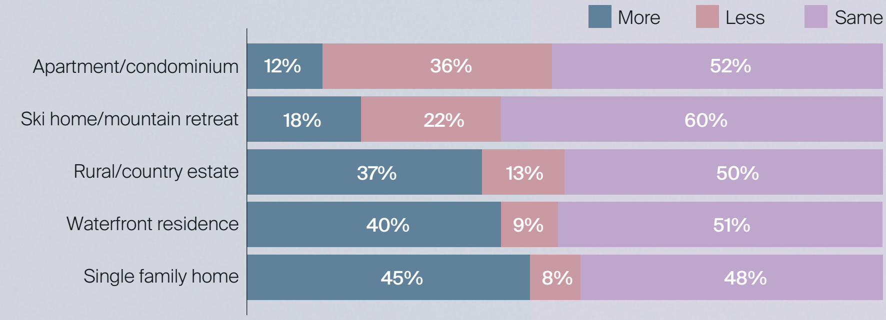
The Knight Frank Global Buyer Survey, undertaken in mid-2020, found one in four survey respondents stated they were more likely to move home in the next 12 months as a result of the pandemic. 40% said they were more likely to move to a different property in the same location. A quarter are seeking a different property elsewhere in the same country, and 34% are considering a purchase abroad. The United Kingdom, Spain, France and Australia topped the list of preferred destinations, followed by Canada, Switzerland and the United States. Such countries offer a good quality of life, a secure currency, world-class education and in normal times, are easily accessible.

Upgrading the family's primary residence was the main reason for the move. Interestingly, improved access to quality healthcare ranked as the second motive and it is perhaps no coincidence this is another common denominator of those countries listed as preferred destinations. Acquiring a holiday home in the sun ranked third and fourth was for business or employment reasons.

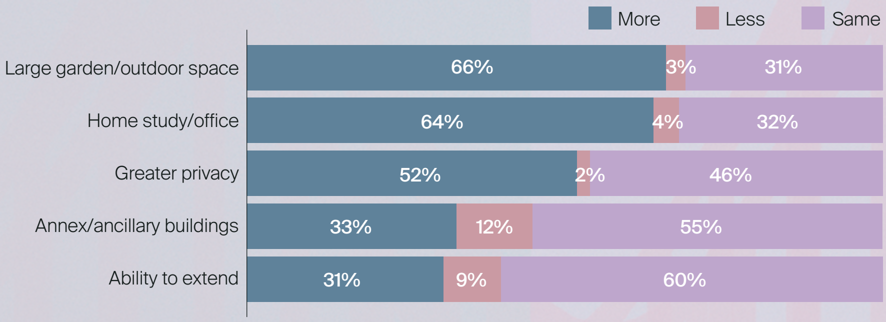
Almost half of the respondents said they are more likely to buy a detached family home than they were prior to the pandemic, favouring waterfront and rural homes. Large gardens and outdoor space were more important noted two-thirds of respondents, with the lockdown period emphasising the connection between wellbeing and the great outdoors. Privacy continues to be highly sought, with a little over half saying this has amplified during the pandemic.

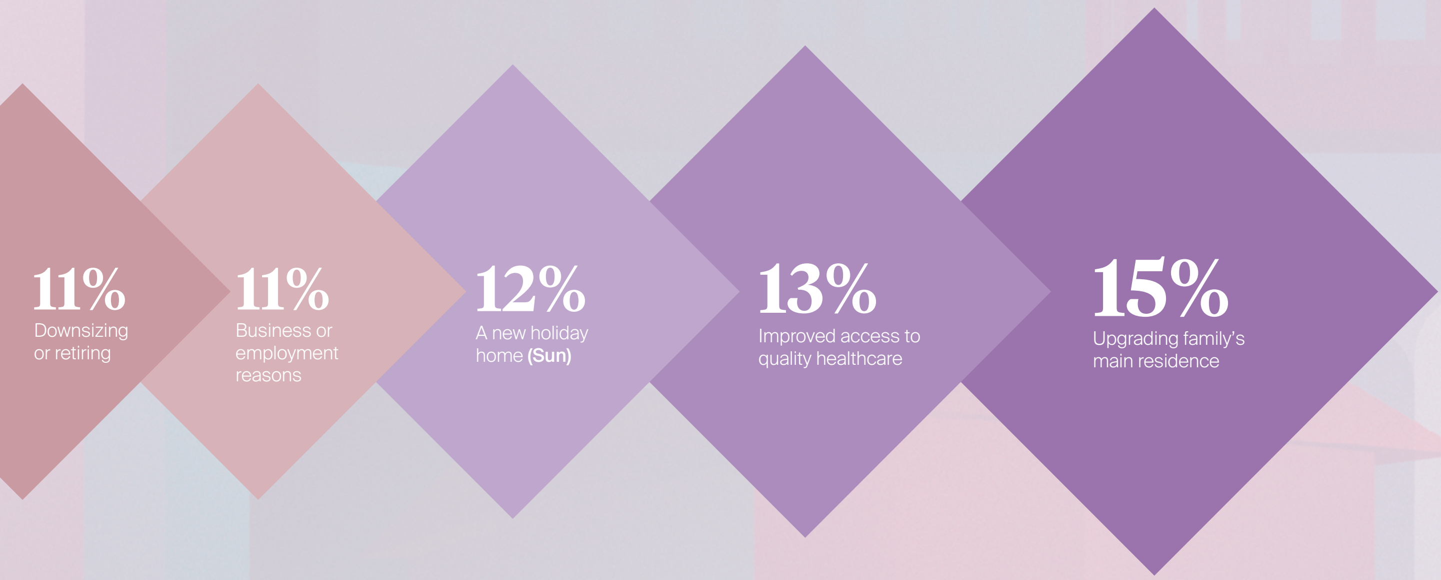
These shifting trends will shape the Australian prime residential outlook over the coming year.

How has the lockdown influenced the type of property you want to live in?



Thinking about any future property purchase (primary residence), how important are following factors when choosing the type of property you might buy post-lockdown?





Volume of prime listings expected to pick up while prices remain firm

Looking back at the prime market in 2020, there were mixed results across the five major Australian cities monitored by Knight Frank Research and this variance is likely to remain in play for the year to come. Buyers will need to act quickly to capitalise on softer prices rounding out 2020, with all five major Australian cities expected to experience stronger price increases next year.

Prime luxury residential property is defined as the most desirable and most expensive property in a given location, generally defined as the top 5% of each market by value.

In Sydney, prime property listings were shallow coming into the pandemic, so when confidence subsided during lockdown it was the volume of sales which took a greater hit than prices with no indication of distress in sales. Although a handful of new prestige projects will come online in 2021, most have already been absorbed via pre-sales, so new listings to the market are likely to climb as more certainty returns to the economy. As a result, the market is likely to recover to a sustainable 3% growth by the end of 2021.

The Melbourne prime market will be playing catch-up to other Australian cities, although capital growth of 1% is forecast by the end of 2021. Not only was Melbourne the last city out of lockdown, it was also the longest and strictest globally at the time, impacting sentiment, population and economic growth. This meant catching the start of the spring selling season was sacrificed, while the market is also working through a solid pipeline of new apartments and townhouses across the prime regions.

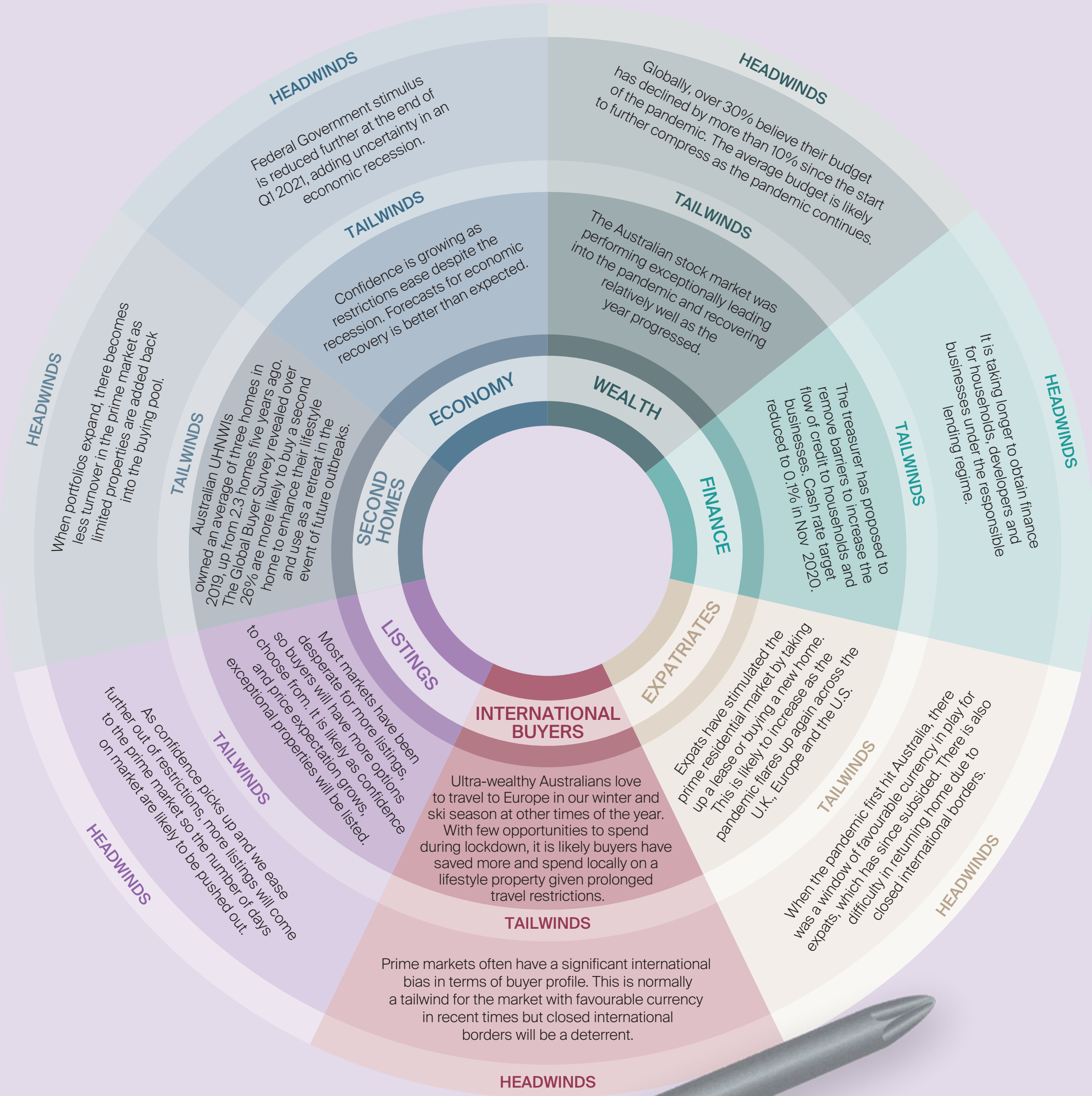
The maturing Brisbane prestige market has significant ongoing appeal for lifestyle and relative value. Despite this, it will not be immune to the economic challenges ahead, but there is some comfort with the significant reduction of new product being built across the Brisbane prime regions in the coming years. This prime market is forecast to grow by 2% in 2021.

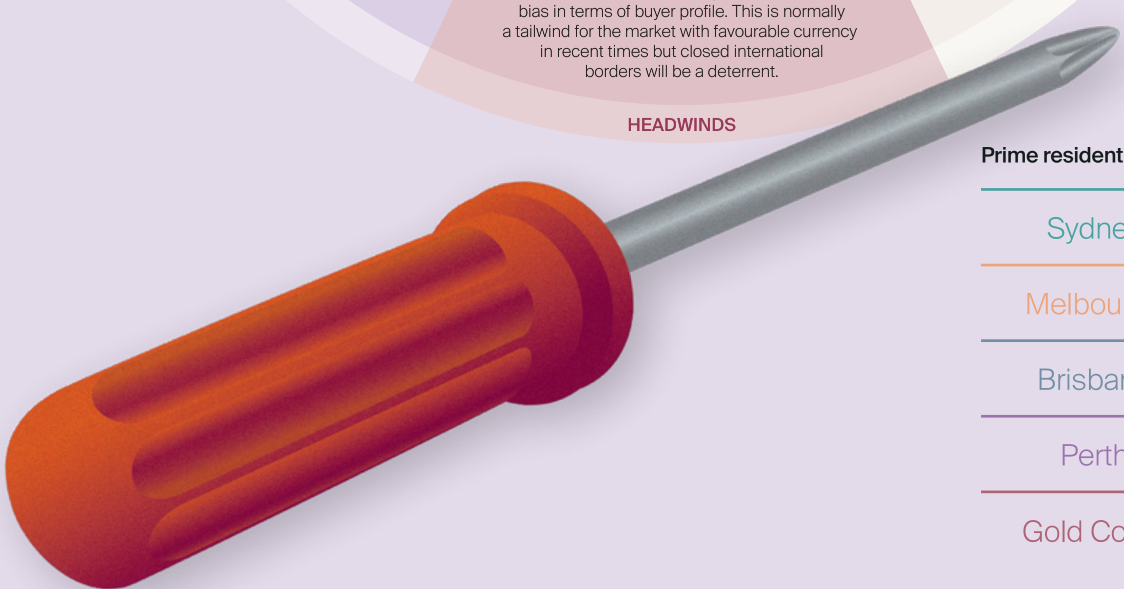
Perth's prime annual price growth in 2020 was the strongest recorded since late-2014 following the uptick in Western Australian mining activity and this is likely to result in a further 3% growth in 2021. Traditionally, the second quarter of the year records an elevated volume of prime sales in Perth and 2020 was no exception. The number of days properties are on the market will continue to be raised, while finance approval is lengthy, despite the new supply pipeline diminishing.

The Gold Coast has seen a steady stream of prime sales transacting in 2020 with capital growth following suit to ramp up in 2021 to record 3% annual growth. Downsizers lead enquiries, followed by families relocating from the southern cities, attracted to the balmy lifestyle and price point.

Crown Residences, One Barangaroo, Sydney.

Prime residential market drivers





Prime residential price forecast for 2021

Sydney	3% ↑
Melbourne	1% ↑
Brisbane	2% ↑
Perth	3% ↑
Gold Coast	3% ↑

Source: Knight Frank Research

Increase in time spent at home driving surge in demand for super-prime property

Transactions at the top end of the prime market were resilient in 2020. After a period of confinement, it is not surprising buyers are seeking more space, and this will be a priority for some time to come – whether it's upsizing to a standalone home with resort-style living and maritime facilities, or rightsizing, the downsizing trend towards luxury apartment living with house-like proportions.

Buyers are currently faced with very little choice of established and new super-prime stock. As a result, in the third quarter of 2020 when the majority of cities had eased lockdown restrictions, the Australian super-prime market recorded 39 sales with a total value of $594 million, the highest tally of third quarter transactions on record. This was incredibly impressive given Melbourne was still in lockdown over this time. The total number of national super-prime sales grew by 4% year-on-year at this time.

The super-prime market is considered to be those property sales transactions above $10 million in Sydney and Melbourne, whilst the remaining cities would need to meet a sales threshold of $7 million to be included.

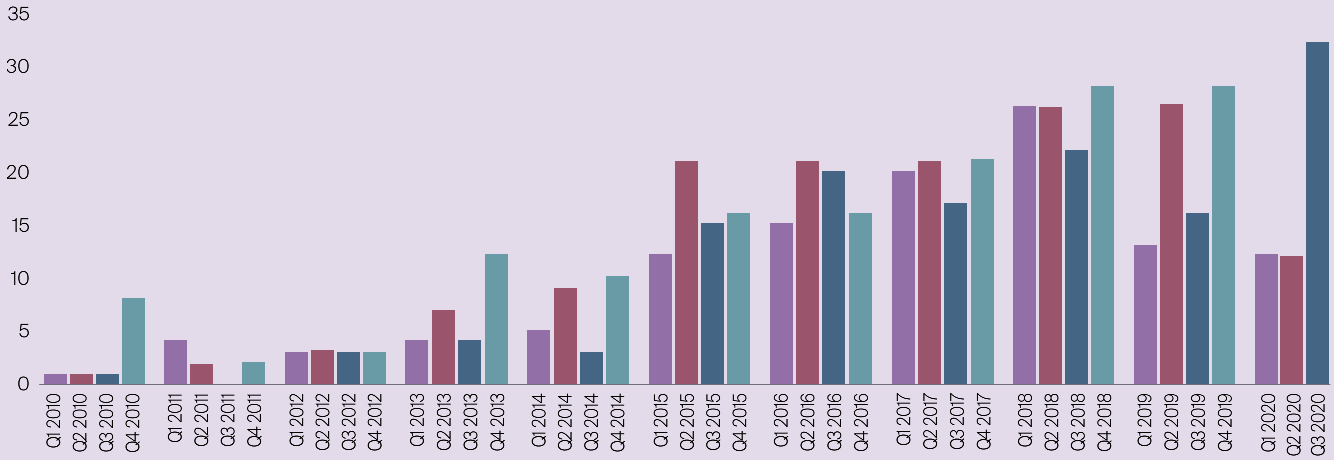
Sydney accommodates the most established super-prime market in Australia. In this pivotal third quarter of 2020, sales totalled $470 million – the second greatest volume recorded for any one quarter – only eclipsed in the fourth quarter of 2018 with $580 million. The number of Sydney's sales transactions in the third quarter of 2020 was 94% higher than the same quarter a year ago.

To further demonstrate the strength of this market in the midst of the pandemic and recession, when confining the number of sales from the second and third quarters, 2020 is the second highest year historically.

Given this sharp recovery, with an ongoing undersupplied super-prime market and while knowing seven of the past ten years have recorded their strongest results in the last quarter of the calendar year, including the past three consecutive years, there is an indication the year may round out better than one anticipated at the start of the pandemic. As many of the Australian ultra-wealthy population is unlikely to travel overseas while the borders remain closed, there is a higher chance more money will be spent locally, so it is likely this flurry of activity will carry throughout 2021.

801/20 Alfred Street, Milsons Point, NSW.

Sydney super-prime residential sales volume
Number of sales each quarter



Source: Knight Frank Research

19 Shellcove Road, Kurraba Point, NSW.

Short supply of prestige rentals

Whilst the major cities across Australia have experienced minimal uplift in new sales listings, over the past year prime rental properties have also become scarce, in stark contrast to the mainstream residential market. Brisbane saw the most significant rise in prime rents in the year ending September 2020, with a staggering 5.7% annual growth. Perth followed, rising by 2.5%, Sydney and the Gold Coast both recorded 2.3% and Melbourne saw 0.9%. There are four common tenants which will push prime rental growth over the coming year.

1 Rightsizers sitting on the sideline

There is an increasing trend of the actively retired group sitting on the sideline, who have recently sold their family home for a significant price and are waiting to buy the perfect new home to reflect their changing lifestyle. This will be by no means downsizing, but rightsizing to luxury apartment living with house-like proportions, space to entertain, concierge provision and the ability to lock-up-and-leave when international travel is back on the agenda.

Apart from being in a low interest rate environment, rightsizers have tended to not be impacted by salary cuts, reduced hours or redundancies. The tipping point for those still to sell their property in preparation to rightsize, appears to follow an unavoidable capital works, in addition to the upkeep costs, which come with maintaining a large property.

Rightsizers have proven they have the patience to hold tight, sign a lease and wait for the right property in their familiar neighbourhood – or experiment living in a rental property walkable to an activity hub with vibrant amenities, where they one day buy. Many are keen to hold out for an apartment offering lateral living, smart living technology, privacy and security which comes with being sky high.

The Horizon Collection, Brisbane Skytower, Qld.

2 Knockdown and rebuilds underway

There are pockets dispersed throughout the prime suburbs of Australia with a hive of unfitting homes being knocked down, sometimes only recently renovated, with a rebuild underway. Many have abandoned searching for the ideal home, instead choosing a well-located site, designing and building to their specifications.

Over the coming years, it's more likely we'll see more of this close to private schools, dotted around the harbour and riverfront locations. In doing so, this will create increased competition for rental properties close to this activity.

3 City pad within walking distance to office

The pandemic has refocused buyers' minds on lifestyle purchases, dividing time between a country or coastal escape, with good access into the city. Over 26% of respondents are more likely to buy a second home according to the Global Buyer Survey, presumably to enhance their lifestyle and to use as a retreat in the event of future outbreaks.

Nearly two-thirds say they are more likely to work from home post lockdown, which explains why 64% said a home office is now more important. But 32% said their working lifestyle will remain the same as before, suggesting the office still has an important role to play as a hub for innovation, collaboration, education and socialisation.

Enquiry for city living is returning and this is likely to ramp up further in 2021 as desk workers return more frequently to the office. Since the pandemic, there is strong appetite for those dabbling in splitting their time regionally, but still need to be connected to the company's office. Some are exploring leasing a city pad until the ideal apartment can be purchased or if this regional commute arrangement can be sustained. Topping the list of location requirements is being within walking distance to the office and business meetings, ideally avoiding all public transport.

4 Expatriates take stock of their priorities

When the global pandemic struck there was an immediate surge in expat flight with a significant uptick in enquiries from Australian, New Zealand and UK expats based in Singapore and Hong Kong looking for a base back home. This has partly been driven by people moving due to employment changes but also families reassessing their lifestyle priorities.

Expats seeking a prime rental property to reside upon returning to Australia outweighed those fortunate to find a suitable prestige home to buy from the shallow number of listings to live in or lease out until they return home. This was despite the significantly favourable currency play in the second quarter of 2020.

Once out of lockdown, there appears to be a growing appreciation globally for the federal and state Government responses to handling and containing the pandemic, given the continued COVID-19 outbreaks in other countries. This is likely to encourage more expats to further reconsider their priorities when international borders reopen.

REBALANCING PORTFOLIOS

Premium on income security as investors look to re-weight and adapt their portfolios

While the economy continues to rebound from the sharp downturn in the June quarter, the recovery will be bumpy and uneven with large divergences in the economic performance between the states and across industries.

By Chris Naughtin and Ben Burston
Knight Frank Australia.

The pandemic raises question marks over the strength of occupier demand in the office and retail sectors, with the shift towards more flexible working and acceleration of growth in online shopping. How long the pandemic lasts and the extent to which these shifts continue in a post-pandemic world are key sources of uncertainty which will in part determine the strength of occupier demand in the coming years.

Given this high degree of uncertainty, investors are reassessing risk with a greater focus on covenant strength and length of income. While liquidity in capital markets has declined significantly in 2020 to date, it is clear there has been a flight to quality over a number of dimensions, with investors placing a premium on prime assets, and assets offering longer and more reliable income streams. Industrial property, in particular logistics assets, has seen strong demand as investors seek to increase their portfolio weightings in the sector. In addition, investors are looking to diversify and position for future growth in new asset classes such as healthcare, childcare, and more niche segments such as data centres.

Freeman Central Richlands, Brisbane, Qld

Office yield shift to vary at asset level depending on covenant strength and length of income

2021 Yield Outlook

↓ Long-let prime assets

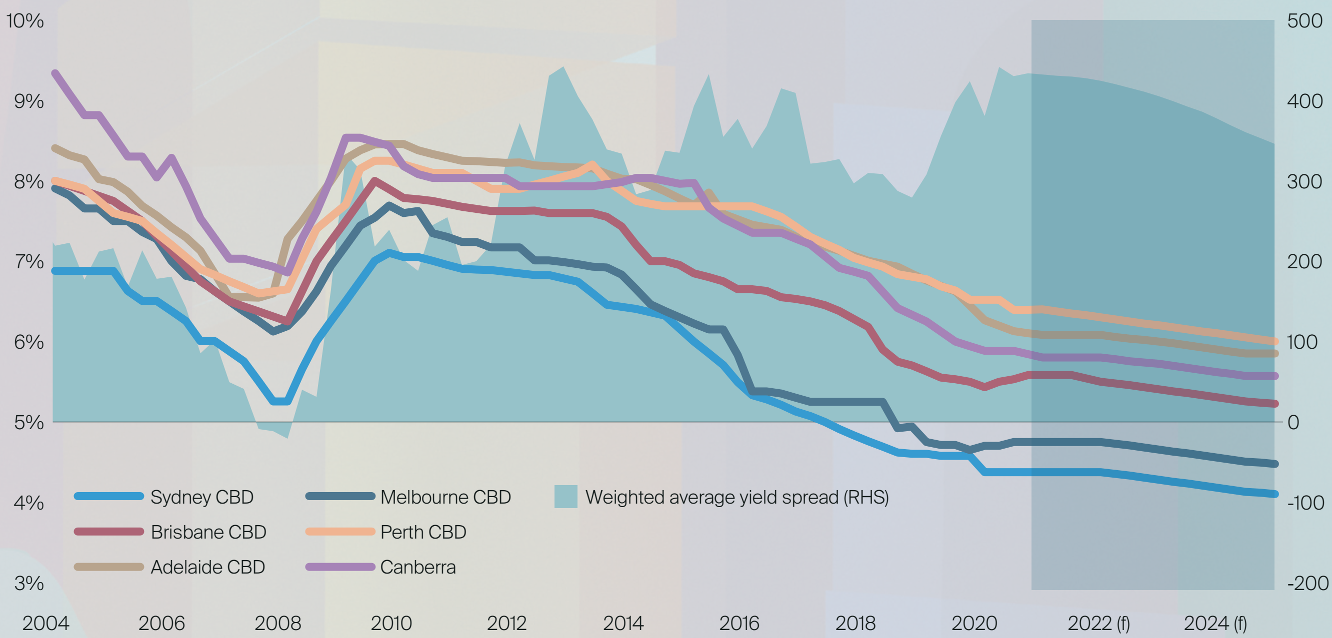
↑ Secondary & shorter WALE assets

Average prime office property yields have remained relatively stable since the onset of the pandemic, with some tightening in the smaller capital city markets such as Perth where yields are relatively high and no overall movement in Sydney and Melbourne. However, there has been more divergence in yields based on income risk in recent months as investors seek longer WALE and higher quality assets.

We expect this trend to continue in the near-term with yields likely widening for secondary and shorter WALE assets where income flows are at risk, but tightening for prime assets with long and secure income streams where lower interest rates are the dominant influence on pricing. These two forces will likely roughly offset each other, leaving average yields broadly stable over the next 12 months or so.

Once the recovery takes hold and risks to income abate, we expect average yields to resume a downward trend underpinned by low interest rates and sustained investor demand. Low interest rates continue to support the relative value of commercial property assets – the average spread between prime CBD office property yields and 10-year government bonds rose to 441 basis points in the March quarter, its highest level since the September quarter 2012.

Australian prime office yields



Source: Knight Frank Research, MSCI

Overseas investors to drive the market in 2021

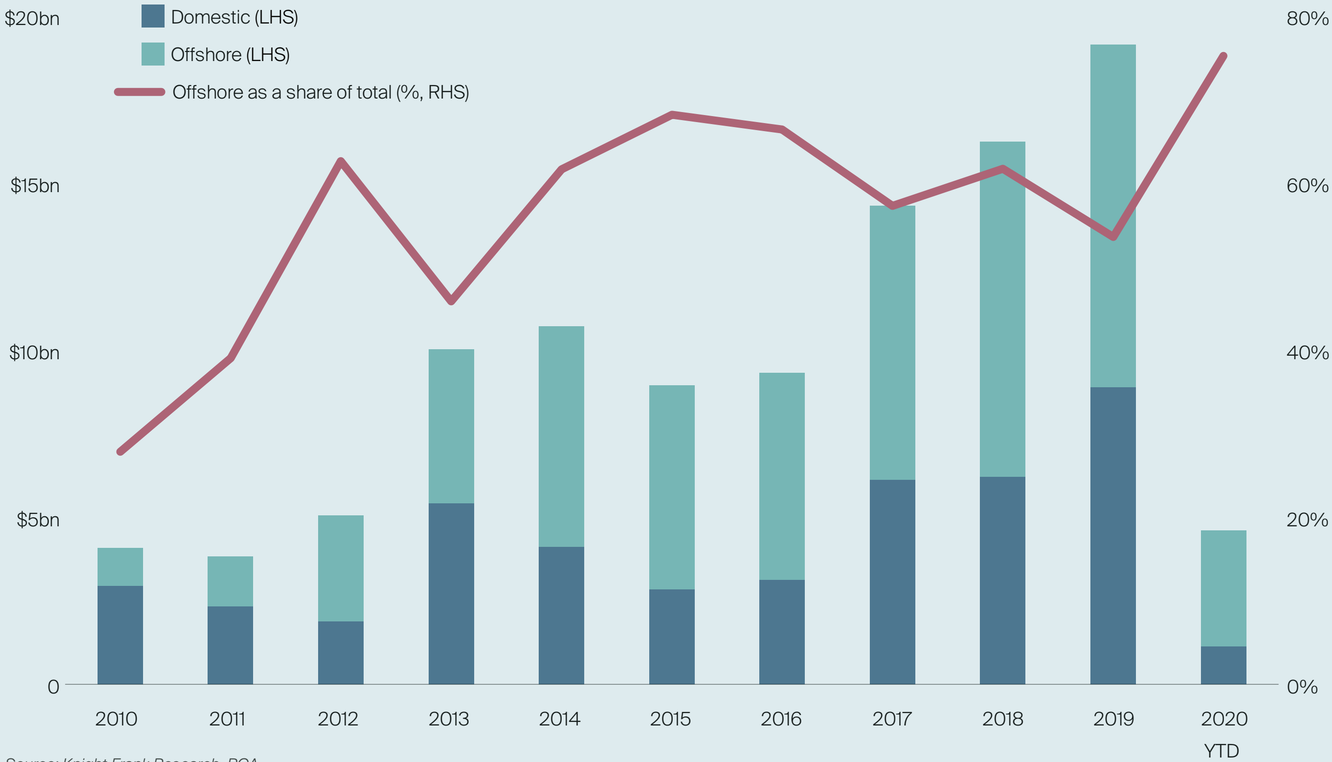
In recent times the share of large office deal activity has broadly reflected a 60:40 split in favour of overseas investors. But in a more challenging environment, with higher risks to income and less expectation of capital growth, overseas buyers are stepping up their share of major acquisitions and this will continue in 2021.

There are several reasons for this. Most fundamentally, they generally have lower required returns. Australia has been slower to see the dramatic reduction in real and nominal interest rates that other major economies saw post-GFC, and so major global funds are more accustomed to the shift-down in IRRs and income returns that it implies. And overseas family offices will at times be driven more by the desire to diversify and preserve capital over the long term than by return expectations.

Australia also looks relatively attractive compared to other global markets facing more difficulty managing COVID-19 and has better prospects of a speedy return to growth. As such, an uncertain outlook for occupier markets is unlikely to change their view of Australia when the outlook is equally or more challenging elsewhere. On the other hand, domestic investors seeking higher returns will be cautious until the risks to the occupier market ease. And the fact that many domestic REITs are trading at a discount to net tangible asset value makes it less likely that they will be taking on major acquisitions in the near term.

This trend is already playing out, with overseas investors underpinning demand for office property over the year to date. Overseas buyers have accounted for 75% of investment volume for office property deals greater than $100 million in value over the year to date, compared with an average of 54% between 2010 and 2019.

Office property investment volume
Deals greater than $100 million



Source: Knight Frank Research, RCA

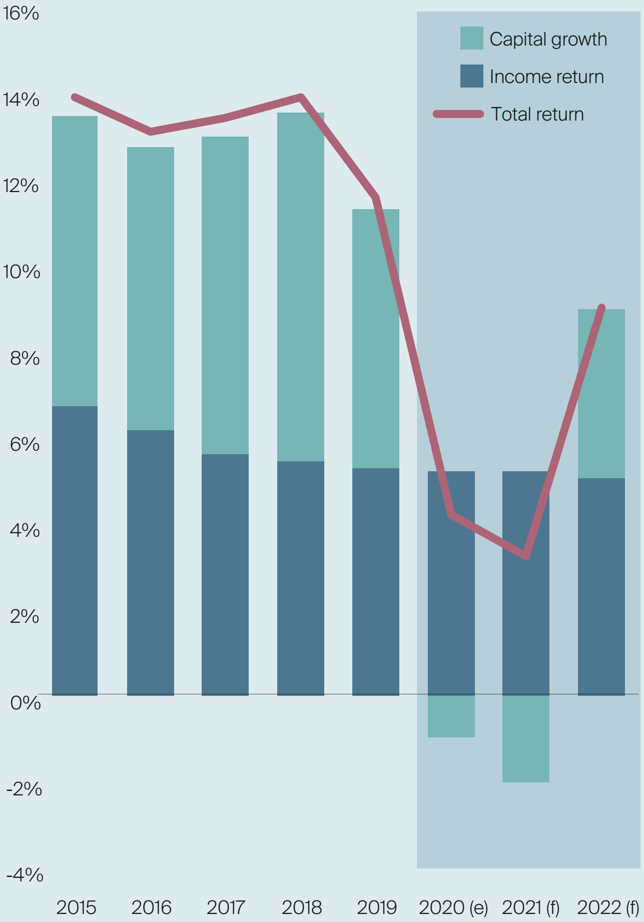
Investment performance will be relatively strong compared with previous downturns

The combination of falling effective rents and broadly stable yields is expected to drive weaker total returns for commercial property assets in the short-term. This is already beginning to play out, with the average value of office property assets falling by 1% since March, having grown by 6% during 2019. Large divergences in performance across sectors is evident, with capital growth for retail assets falling sharply, while the performance of industrial assets has strengthened slightly over the same period.

Given the high level of uncertainty over the economic outlook, forecasting returns is more challenging than normal. But on the basis of a gradual recovery with no further major lockdowns, we expect capital growth in the office sector to average -1% for calendar year 2020 and -2% in 2021, leaving total returns a little over 4% and 3% respectively, compared to 11.5% in 2019. Assuming the economy continues to recover in 2021, asset performance should improve in 2022 as conditions in the commercial property market improve with lag. Capital growth is expected to be around 4% in 2022, with total return rising to 9%.

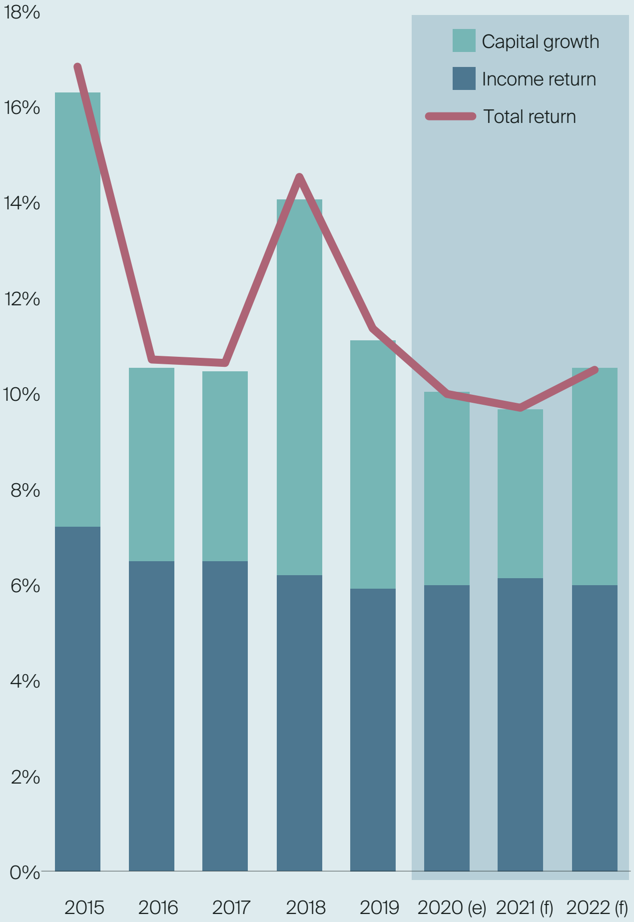
Reflecting rising demand for last mile delivery services and logistics assets, the investment return performance of the industrial sector will continue to be relatively strong. The sector is not perceived to be subject to income risk to the same extent as other sectors and investors continue to target the sector. We expect capital growth to slow to around 4% in 2020 and 3.6% in 2021, down from 5.2% growth in 2019. Total returns will likely remain around or just under 10% in 2020 and 2021. Capital growth is expected to pick up again in 2022 underpinned by the economic recovery and further yield tightening driven by the likely persistence of very low interest rates.

Total return for office property
Percent (%) change year-on-year



Source: Knight Frank Research, MSCI

Total return for industrial property
Percent (%) change year-on-year



Source: Knight Frank Research, MSCI

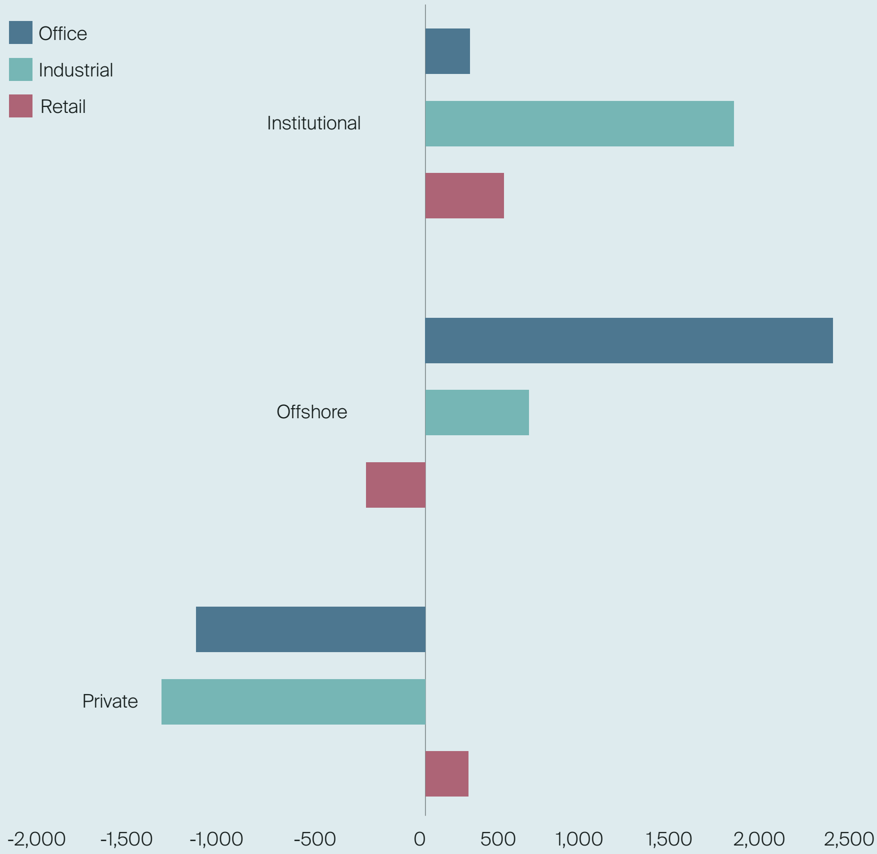
Strong returns and relatively long income streams fuelling demand for industrial assets

An obvious example of the greater premium placed on income security since the onset of the pandemic is the strong level of institutional investor demand for industrial assets, particularly for logistics and warehouse assets with long WALEs in prime locations in close proximity to major infrastructure networks. While commercial property investment volume in 2020 to the end of September is 40% lower than for the same period last year, transaction volume in the industrial sector is up 13% over same period. Investment in the industrial sector has accounted for 36% of total investment volume over the year to date, double the average of 18% between 2010 and 2019.

Institutional investors in particular have been large net acquirers of industrial property in 2020 to date, with notable investments from Charter Hall, Dexus, and Centuria, and overseas investors such as GIC and Mapletree.

Net acquisitions in 2020 YTD by investor type

$ mIllion



Source: Knight Frank Research, RCA

Specialist sectors will benefit from quest to diversify

The sustained strength of industrial market performance means that investors are also aggressively pursuing assets in more niche segments of the industrial asset class such as cold storage facilities and data centres. While neither are new, government-imposed restrictions have forced consumers to change shopping behaviours and made business more dependent on digital infrastructure. That shift is providing investors with more opportunity to gain exposure to these niche segments, which offer diversification with defensive characteristics through their reliable and typically long income streams.

Remote working has forced businesses to review their IT investment initiatives and, for many, accelerated plans to move to the cloud to maintain business continuity and increased demand for colocation services. This shift is driving growth in demand for data centres, with more stock set to emerge as a result.

Similarly, the pandemic has forced changes to consumer shopping preferences and grocery retailers are investing heavily in their supply-chains to keep up with demand and reduce delivery times. As this demand grows, there has been more demand for temperature-controlled space, which is likely to trigger more construction in the cold storage segment and could also see the repurposing of existing grocery retail sites in infill locations.

Lower return environment will drive appetite for debt strategies and boost competition in non-bank lending

The shift to a lower return environment is expected to see a further deepening in the real estate debt market during 2021 with a proliferation in the number of lenders and a widening of their remit to offer greater diversification within the space.

Lower expected capital growth will impact total return expectations during 2021-22 and this will narrow the gap between expected returns on equity and debt strategies, tilting the risk/return dynamic in favour of greater exposure to debt strategies.

Even with strong returns in core sectors, in recent years the number of non-bank lenders has grown as a broad range of global and local pension funds, insurance companies and asset managers have sought diversification and defensive returns in debt markets. And with an outlook for lower returns it is likely that the pool of lenders will grow even further, as indicated by recent examples of family offices and sovereign wealth funds entering the market.

Non-bank lenders are by nature not deposit-taking entities, and as such are not subject to APRA regulations, the fundamental requirement for banks to hold capital against loans. This gives them greater flexibility, faster speed of execution and reduces their relative cost of funding. Their entry into the debt market in greater numbers is widening competition, resulting in a broadening of the scope of borrowing available to borrowers, including longer loan tenors and higher LVR ratios than traditional bank lenders.

However, non-banks are likely to be quicker to enforce terms and seek realisation in the event of covenant breaches, and many borrowers continue to prefer long-term relationships with the major banks.

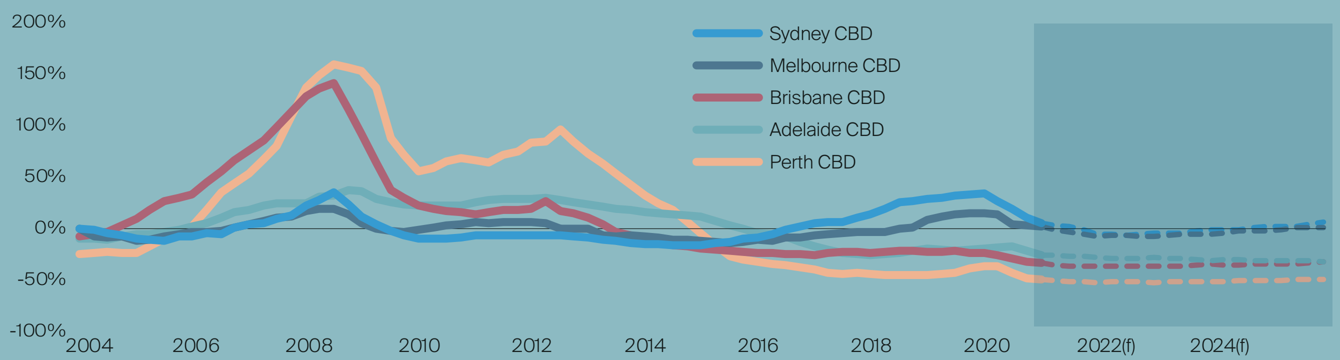
Where are office rents headed?

Although Australia continues to weather the health and economic impact of the pandemic relatively well, demand for office space has softened as businesses assess space requirements. While these impacts are still playing out, face rent levels have largely been resilient and the immediate adjustment has been through higher incentives and falling effective rents. For example, average prime incentives in the Sydney CBD have risen by roughly ten percentage points since January to 29.4% as at October 2020. By contrast, prime face rents have remained relatively stable.

The downturn in effective rents raises the question as to the extent of downside risk in different markets. One way to assess this question is to consider the current level of rents relative to the level implied by their long-term trend. This methodology allows for the fact that there have been different historic rates of growth in different cities, often caused by the relative ease of adding new supply, while still capturing the extent to which different cities are out of line with that trend.

Coming into the pandemic, net effective rents in the Sydney CBD were significantly above their long-term trend level. In Melbourne, effective rents were slightly above trend levels, while rents in Perth and Brisbane were, and remain, well below trend levels. This is a considerable contrast to the lead up to the GFC where effective rents in most major markets were considerably above trend levels and represents a significant difference in the contextual setting at the outset of the two downturns.

Net effective office rents spread to exponential trend



Source: Knight Frank Research

Challenging outlook in the near-term followed by solid rebound

Partly reflecting the respective position of different cities relative to long term trends, Sydney and Melbourne are expected to see a larger decline in effective rents as a result of the pandemic and its impact on demand. This will partly unwind the above trend rental growth seen in recent years.

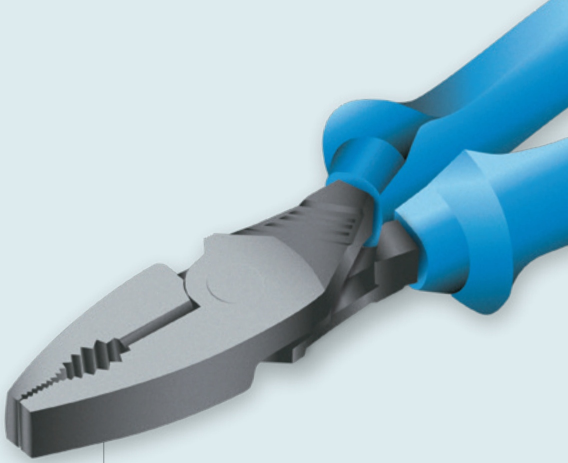
In contrast, Adelaide and Canberra are expected to see relatively stable rental growth, with Canberra in particular benefitting from higher exposure to relatively stable government tenancies and a stronger employment outlook.

While the timing of the recovery remains uncertain, on the basis of a solid economic recovery during 2021 effective rental growth is expected to rebound from 2022 as leasing markets recover with a lag, although face rent performance will be subdued as incentives adjust back down. Sydney, Melbourne, Brisbane, and Perth are all expected to see sizable increases in effective rents between 2022 and 2025, with Perth predicted to see the strongest rise over the period reflecting the relatively favourable economic outlook for Perth and WA.

Forecast prime office net face rental growth 2021 - 2025

Perth	12%
Melbourne	9%
Brisbane	8%
Sydney	7%
Canberra	6%
Adelaide	5%

Source: ABS



Forecast net effective office rental growth

Source: Knight Frank Research

Past Sydney CBD rental cycles point to a subdued face rental growth outlook

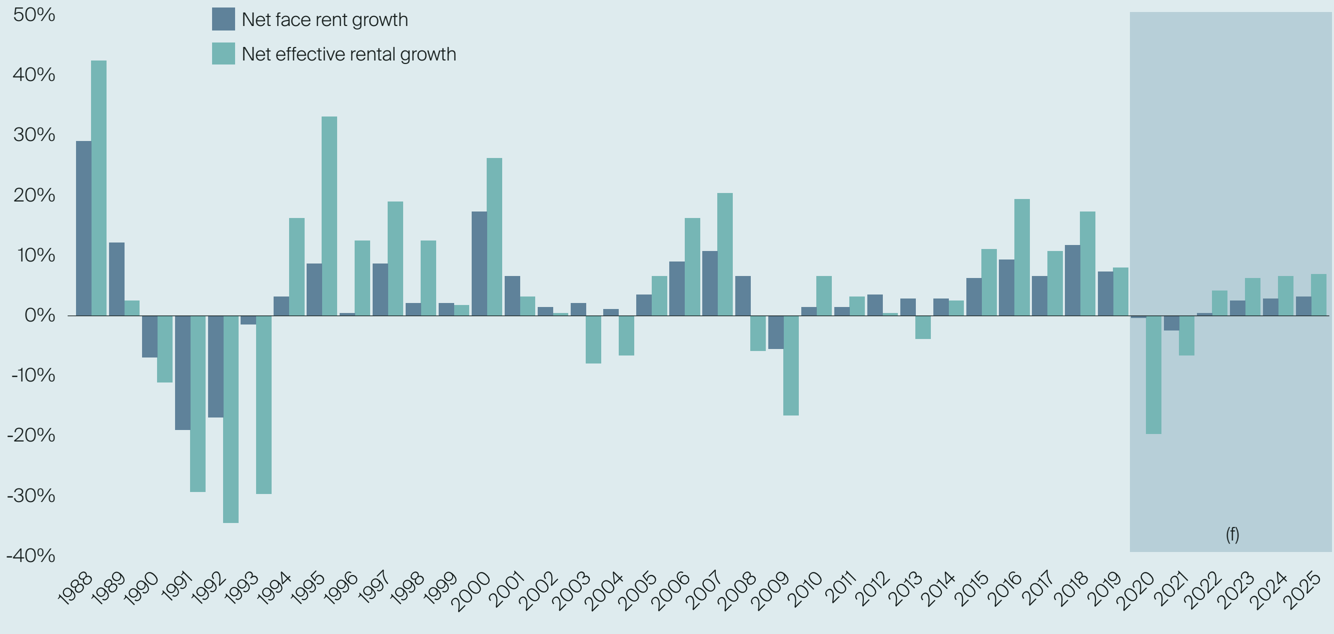
Sydney CBD has demonstrated strong long-term trend growth, but also experienced several aggressive rental cycles, and it has taken some time to recover on each occasion. The early 1990s recession saw a large decline in rents reflecting the aftermath of a property development boom during the late 1980s. Strong face rental growth did not return until 1995, five years after the downturn began.

During the GFC, Sydney CBD saw a 30% peak to trough decline in net effective rents, which did not surpass the July 2008 peak until January 2017, over eight years later. Face rent growth did not exceed 3% until 2015, or seven years after the initial impact.

This is due to the amount of time it takes to return to the low levels of vacancy that are typically required to drive strong rental growth. While we expect a recovery in effective rental growth beginning in 2022, it will be slower progress for face rents because the first response to improving conditions is likely to come through retreating incentives. As such, while face rents will be resilient in the near term, the consequence of this will be the lack of a rapid recovery, consistent with past cycles.

This will not impact Sydney's fringe and suburban markets to the same degree. Rents are significantly lower outside the CBD and have not grown as strongly in recent years in markets like North Sydney. The new Metro will act to improve connections and pave the way for rents in attractive fringe locations to grow at a faster rate than the CBD.

Sydney CBD historic prime office rental growth



Source: Knight Frank Research

A correction like no other

By Michael Schuh Partner, Joint Head of Valuation & Advisory Victoria

Oversupply has an irritating habit of arriving during downturns. Again, it has been preceded by a period of undersupply, buoyant rental growth, and contracting yields that assume that growth will continue infinitely. This is a natural part of the cycle and really no one should be surprised. But for a number of reasons a correction in this office market may be very different. Capital conditions – a number of which are linked – could mean that yields could respond very differently to all other past corrections, and the strength of market performance in the recovery phase could well surprise us.

1 Cash offers no alternative

This is the first time a recession has occurred where cash is not a viable alternative. In every past downturn bond yields have been far higher and even when set against higher rates of inflation still offered a strong real rate of return for investment in risk free government paper. Ten year bond yields were 10% to 12% at the time of the early 1990's recession and ranged between 5-6% from 2007 to 2011. In stark contrast, ten year yields are now just under 1% and real rates are now edging below zero.

Volatility in the office market is normal but the current cash rate is not, and we think the conditions are in place for yields for good assets to hold firm and potentially even contract.

2 No excessive leverage

Past corrections have all commenced with or been caused by major market participants – banks, corporate tenants, trusts and private investors – entering the downturn period over leveraged. The result of overleverage is almost always a cruel combination of a credit squeeze, forced sellers all rushing for the exit at the same time into a capital vacuum and unemployment as large employers cut their headcount.

But this time most of these key players have entered the economic downturn under leveraged. In many ways this is a welcome legacy of the GFC which has led to a more cautious approach to debt in commercial property markets globally. This means no forced sellers, no wholesale corporate failure and a very liquid credit market. In the past we have seen redemptions on non-bank lenders but now we have a growing number of them. And the fact that credit will continue to be widely available means that recovery can occur more quicker than in the past.

3 Influence of global capital

The Australian cost of capital trend mirrors the global trend, except that most of the cash alternatives overseas are even lower yielding. Partly because of these low cash returns, global capital started arriving just before the GFC and now over a decade later these players have a strong understanding of this market that breeds confidence. Australia has some very attractive underlying fundamentals for global capital, with a high level of market transparency coupled with population growth in the long term. We see clear evidence of global investor appetite in recent transactions with a wide range of investors from Germany, Hong Kong, Singapore, Canada and the US all very active and this underlies the liquidity of this market and competitive tension that is keeping yields on track.

4 Outlook for yields

There can be no flight out of property if cash has no return. The gap in yields between property and cash is so wide that property still looks attractive even if returns now soften. This is why yields are holding up, and why the market remains liquid.

The long-term property IRR premium to gilts had been around 3.5% to 4% up until the GFC. Under pre-GFC theory then, current prime IRR's would be around 5%, reflecting the 1% bond rate plus a 4% property risk premium. However, Australian IRR's have maintained a higher premium and generally sit at 6-6.5%.

Whilst the current correction indicates that an additional IRR premium was well founded due to higher risks to growth, the lack of a cash alternative and the presence of confident global capital says prime property IRR's could contract to follow down lower forecast growth rates, which in turn means cap rates should remain stable and may even edge down.

Of course, someone always says 'this time is different', raising eyebrows and groans amongst all old timers. While history doesn't repeat, it has a tendency to rhyme. But this time may indeed be different because these underlying forces have changed so significantly. If inflation spiked and long term rate jumped upwards, the market would react negatively to that but for now that looks a very distant prospect.

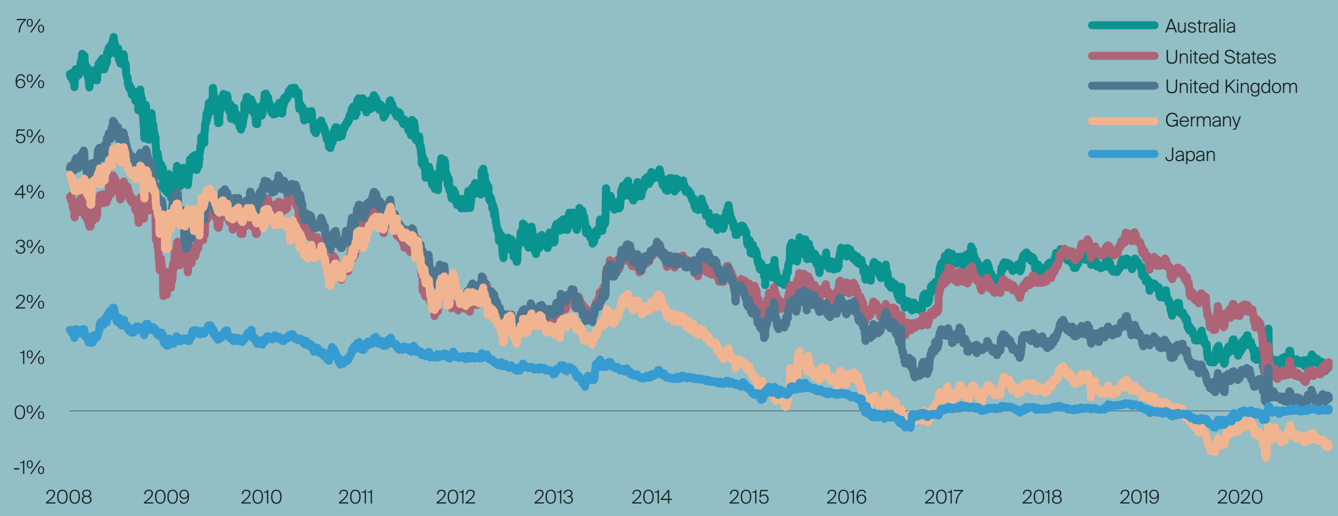
5 All eyes on the occupier market

While these forces are all highly supportive, performance will still differ at asset level as the office market digests the impact of behavioural change and a higher degree of working-from-home.

The full impact is not likely to reveal itself quickly and a meaningful loss in demand for floorspace is possible, but set against this is the need to pull back from tighter density given the health concerns highlighted by COVID-19. The human response to home working will govern its prevalence more than supposed rent savings as it is productivity and efficiency that will ultimately drive business decisions.

Whatever the net outcome, well-located core office property should retain in most major institutional portfolios. But the near-term challenges will be greater for secondary stock, which will face a sterner assessment of income and investment risk.

10-year government bond yields



Source: Knight Frank Research, Macrobond

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