COVID-19 Adelaide CBD Office Market Implications

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Winter 2020

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Overview

Whilst restrictions in South Australia continue to ease, the full impact of COVID-19 is still unknown. To date there is limited transactional evidence to assess the impact on office markets, however we are able to review the impact of COVID-19 on many elements of the cash flows of assets. The responses of Federal, State and Local governments and Corporate Australia has been swift, however, the road to recovery will be challenging as businesses try to adapt to a new 'normal'. We provide below a snapshot of market implications we are seeing and expect to see, as well as how we are treating these matters from a valuation perspective.

• Whilst the Adelaide CBD experienced improved **tenant demand** over 2019, it is now at a relative stand still, (albeit government requirements remaining) and is expected to continue a downward trend over the short term as a result of COVID-19. Given the continued economic uncertainty locally, nationally, and globally, relocation and or expansion decisions are expected to largely remain on hold, coupled with tenants continuing to experience significant financial hardship, potentially leading to an overall reduction in the tenant pool, particularly post JobKeeper. We expect both direct and sublease vacancy levels to increase in the Adelaide CBD due to potential tenant contractions, relocations and or not surviving the financial impact of COVID-19. Adelaide, however, has been more insulated than other states regarding the pandemic, as the government is a large occupier of space.

• **Net Absorption** has likely been negatively impacted in the Adelaide CBD. We expect a substantial fall back from the long-term average of circa 13,500m², particularly over 2020 and 2021 due to the likely increase in vacancy from COVID-19 and Kyren Group's new speculative office tower at 108 Wakefield Street (circa 15,600m²) due for completion towards the end of 2020. Beyond this, whilst we expect green shoots to emerge in tenant demand, Cbus Property's approved 30,000m² office development at 83 Pirie Street is likely to keep the Adelaide CBD office market in a state of oversupply, if it proceeds. Whilst the recent pre-commitment by the Department of Planning, Transport and Infrastructure (DPTI) for circa 17,500m² at 83 Pirie Street is providing a degree of confidence in the market, DPTI's relocation will result in back-fill space across multiple CBD locations. The Commonwealth Department of Human Services also has a large requirement of 29,000m² for occupancy in 2023 and has reportedly shortlisted a number of potential new developments. The relocation, if it proceeds, will create 10,500m² of backfill space at 55 Currie Street.

• **Incentives** are expected to increase due to COVID-19 and the increasing level of oversupply and tenant options available. We are forecasting an increase of prime net incentives from an average of 32.5% to 35% over the next 12 to 18 months as the market absorbs the excess stock.

• **Investor Pricing Shift** – COVID-19 presents significant economic uncertainty, and as a result we expect purchasers continue to have a greater focus on pricing risk, income security and strength of tenant covenants. Resultantly we expect to see a divergence between prime and secondary yields as risk continues to be priced in.

• **Sales Activity** is expected to remain low for the balance of 2020 due to the deteriorating economic environment, resulting in increased uncertainty and indecision by both vendors and potential purchasers. COVID-19 has resulted in a significant decline in equity markets globally. As a result the cost of equity capital (i.e. expected equity return) for commercial real estate has increased, to account for the increased risk in the market-place, especially for secondary assets, limiting the buying power of both local and foreign investors.

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Outlook

Factor	Comment	Shorterm Outlook
Supply	Supply additions from new developments and refurbished stock being reinstated is expected to total 26,550m² in 2020, with circa 11,000m² expected to complete over the first half of the year. There is the possibility that supply chain issues relating to COVID-19 shutdowns could result in a delay of projects currently under construction. Furthermore, changing work arrangements may result in a structural change to the market, reducing net supply requirements over the longer-term.	▲
Demand	Leasing demand is expected to continue a downwards trajectory over the short-term as a result of COVID-19. Given the increasing economic uncertainty globally, leasing decisions for tenants are expected to continue to be placed on hold, coupled with inevitable business closures, is likely to result in an overall reduction in the tenant pool. There are potential mid-to long-term demand implications relating to the widespread application of flexible working practices, which may reduce the need for more office space when business returns to post COVID-19 normality.	▼
Vacancy	We expect the vacancy rate to increase over the next 12 to 18 months as a result of COVID-19, coupled with refurbished space re-entering the market and the completion of Kyren Group's speculative development in 2020. Whilst the Commercial Code of Conduct is helping eligible tenants protect numerous businesses during COVID-19, it is expected that the likely financial impact on some businesses will result in tenant contractions, leading to an increase in both direct and sublease vacancy, particularly post JobKeeper.	▲
Rents	With vacancy expected to increase, there will continue to be a reasonably large number of options available in the CBD, with tenants expected to maintain a relatively strong negotiation position with landlords. As a result, prime and secondary net face rents are forecast to remain unchanged over the short-to medium-term, however, effective rents are expected to decline due to forecast increases in incentives.	◀▶
Incentive Levels	Incentives are forecast to elevate back to levels witnessed prior to June 2019, to range between 30% and 40% for the Adelaide CBD prime office and remain at that level for the next 12 to 18 months, with owners largely trying to maintain face rental levels in negotiations.	▲
Yields	Given the continued economic uncertainty resulting from COVID-19, we expect purchasers to have a greater focus on pricing risk, and resultantly expect a divergence between prime and secondary yields, with a key focus on income security, tenant covenant and length of tenure.	▲

Our Services

Commercial Valuation

The national commercial team advises clients and prepares valuations of office assets in all capital city CBDs and metropolitan markets across the country.

Recognised as the leading independent consultant in the office sector, the team services the institutional and funds management sector (both local and off shore), financiers, corporations, private investors and government.

- Valuations for acquisition, asset reporting and mortgage security purposes
- Development feasibility advisory
- Rental assessments and determinations
- Advisory in respect of matters influencing property values
- Portfolio valuations

If you need any assistance please contact the Adelaide Commercial team.

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