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After the virus; how commercial property might change

Within a few weeks, our understanding of COVID-19's spread seemed to progress from significant but largely contained to full-scale pandemic. Restrictions on work travel and a preference for virtual meetings escalated to panic buying and living in lockdown.

None of us has experienced the realities of an extended 'hibernation' across all aspects of society before. Entire industries have been shuttered and workforces stood down and no one knows how long this will last or what the fallout will be.

What we do know is that, along with almost every other sector of what was once our economy, commercial property has been disrupted by COVID-19 and the use of social distancing to fight it.

Property investors are attracted by the prospect of earning a relatively high risk-adjusted return, supported by tenants who are legally obliged to pay it. That is now in question. With many corporate and private tenants adversely affected by shutdowns and the absence of customers, they're searching for relief wherever they can find it.

In more conventional periods, the rent line of the profit and loss statement wouldn't be the first place to start but these are unconventional times. This means that commercial property will share in the losses from COVID-19, although some segments will share more than others.

Real estate centred around discretionary spending, especially if tethered to high social interaction, has been most affected. Take the leisure and hospitality sector, where pubs - oddly classified as a non-essential service - have been forced to close. Tenants have been confronted by the immediate prospect of zero revenue for an uncertain period.

Despite shopping centres being classified as 'essential services' and remaining open, landlords are dealing with declining foot traffic. Tenants have voluntarily closed stores, while many are in negotiations with landlords for rent relief. Inevitably, the pain will be shared. Both parties will need to agree on a collaborative framework and a long-term built around mutual best interests.

We're confident this will happen but with earnings guidance withdrawn from many AREITs, it will entail some short term pain. As for the long term structural changes the pandemic might induce, we'll get to that shortly.

Beforehand, it's worth noting that some areas of retail are doing well. Shopping centres remain open because they allow access to supermarkets, all trading exceptionally strongly. The non-discretionary retail segment will arguably emerge from this shock as one of the most resilient commercial property types.

Retail convenience and fuel outlets are also experiencing strong underlying tenant performance. Lower volumes in the latter's business model are being offset by higher margins from low crude oil prices.

The performance of commercial office buildings is mixed, determined by the underlying resilience or otherwise of the tenant's business. For example, where tenant rosters include government departments and well-capitalised multinationals with workforces operating from home the impacts are likely to be minimal. Those with tenants whose underlying business model has been disrupted by social distancing, however, are being adversely affected and requesting rent concessions.

The story for industrial and logistics-orientated property will be similar. Social distancing is increasing demand for online retail, which is assisting logistics tenants that fulfil the growing orders. But the sector's leverage to broader economic activity and the movement of physical goods within it will mean many tenants will struggle until things return to normal.

Whilst AREIT investors will shoulder some of the pain with such tenants in the coming months, the long term outlook should be a greater focus for investors' attention.

The aftershock is likely to impact various areas of commercial property differently. Retail malls will likely take some time to return to full patronage as people remain cautious of lingering health risks and hold their wallets and purses tight after a tricky period, especially if unemployment increases.

There may also be an acceleration in the structural change of consumer shopping habits from in-store to online. On balance, though, the competitive advantages of the highest quality fortress malls should continue.

Industrial and logistics properties might also benefit from any acceleration in the structural shift to online retail, along with higher instances of businesses stockpiling physical goods as risk mitigation.

In the commercial office sector, it's possible tenants will re-examine the cost and productivity benefits of having staff work from home. As a concept, a decentralised corporate workforce is nothing new; the ease with which many

companies switched to it suggests as much. We shall have to wait and see whether this prior trend accelerates after the pandemic is over or whether weeks of isolation helps office workers better appreciate the benefits of a centralised location.

Much as we'd like to be more conclusive, this is unchartered territory for society as a whole, just as it is commercial property investors. There isn't much one can say about the future with certainty right now, except that the virus will pass. In the meantime, developing an understanding of the above dynamics and positioning the APN AREIT portfolio accordingly is central to our investment process. Despite everyone working from home, this has been an incredibly busy time.

One thing we can be sure of though - when all this is over, commercial real estate in all its forms will remain central to our economic and social lives. Some things may change, but this greater point almost certainly will not.

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