

Property Funds Association Master Class – 28 April 2021

Valuers Interpretation of the Post (or continuing)
Covid Valuation Scenario



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Introduction

- What a 12 or so months it has been!
- You would have to be a brave valuer (soul) to say you have all the answers
- Right pricing asset values has evolved
- From valuation uncertainty across the board in mid 2020
- To strong active markets for some asset classes (residential and industrial)
- Reasonable markets for well let office and some retail
- And ongoing concerns for markets where rental cash flows have the propensity for ongoing stress
- Initial and rolling impact of lock downs problematic
- The Covid economy and real estate markets continue to play out
- It's a case of watch, wait and react
- But also, to anticipate changes as they unfold as best as we can
- Asset classes being affected differently
- But transactions are occurring albeit at reduced volumes for some asset classes, but 2021 has seen a resurgence of activity

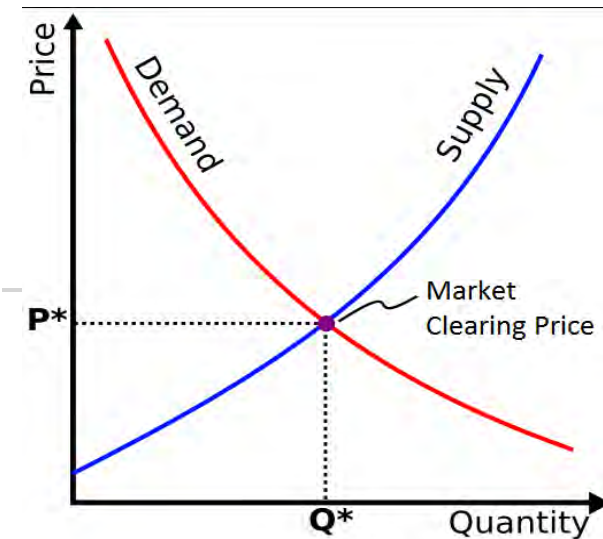


Disruption

Disruption has new multiple meanings in the Covid world (initial and rolling disruption)

Not across the board (Asset Classes)

Impact on demand and supply characteristics in focus (rents and transaction prices)



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Rules and Obligations

- Material Change the trigger for revaluation
- IVSC Paper on valuation uncertainty 2020
- The main Australian accounting standards that relate to investment real property include:
 - AASB 13 - Fair Value Measurement
 - AASB116 - Property, Plant and Equipment
 - AASB 140 - Investment Property
- The valuation standards adopted in Australia by API and RICS are the IVSC's valuation standards (republished effective 31 January 2020)
- Common principles in both the accounting and valuations standards include:
 - Valuation approaches (Market Comparison, Income (DCF and Capitalisation) and Cost)
 - **Need to validate and corroborate inputs** (AASB 13 – Fair Value – Level1, 2 and 3 inputs)
 - Need to apply lease incomes for investment real estate
 - Methods of corroborating and validating discount rates and capitalisation rates
 - More coming from IVSC and RICS



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A close-up photograph of a hand in a blue suit sleeve moving a white chess king piece on a chessboard. The background is blurred, showing other chess pieces and the board's squares. A soft, warm light flare is visible in the bottom right corner of the image.

Crisis of Income not a Crisis of Capital

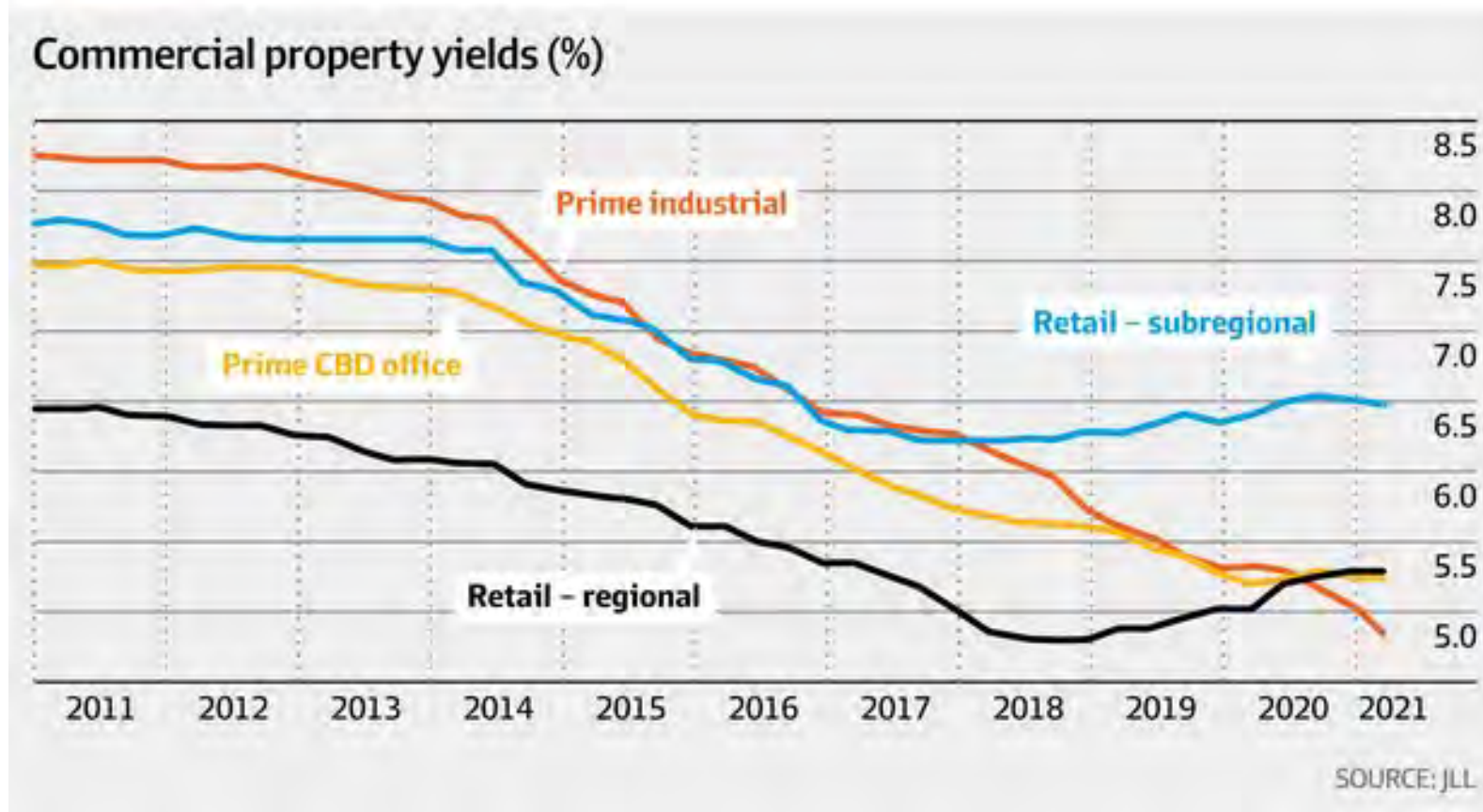
(Rob Harley AFR – Mid 2020) & different to the GFC



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Traditional Market Norms Challenged



Are Valuers backward or forward looking?

- Valuers often accused of being backward looking (historic transactions)
- Yet the main valuation methodology for investment valuation is DCF
- Requires a 10-year forecast of cash flows
- Assessment of terminal value beyond year 10
- Cash Flow NPV and Terminal Value PV relativity in the Covid World – has it changed?
- Cash flow impact – for how long dependent on asset class
- How are tenants traveling – cash flow performance?

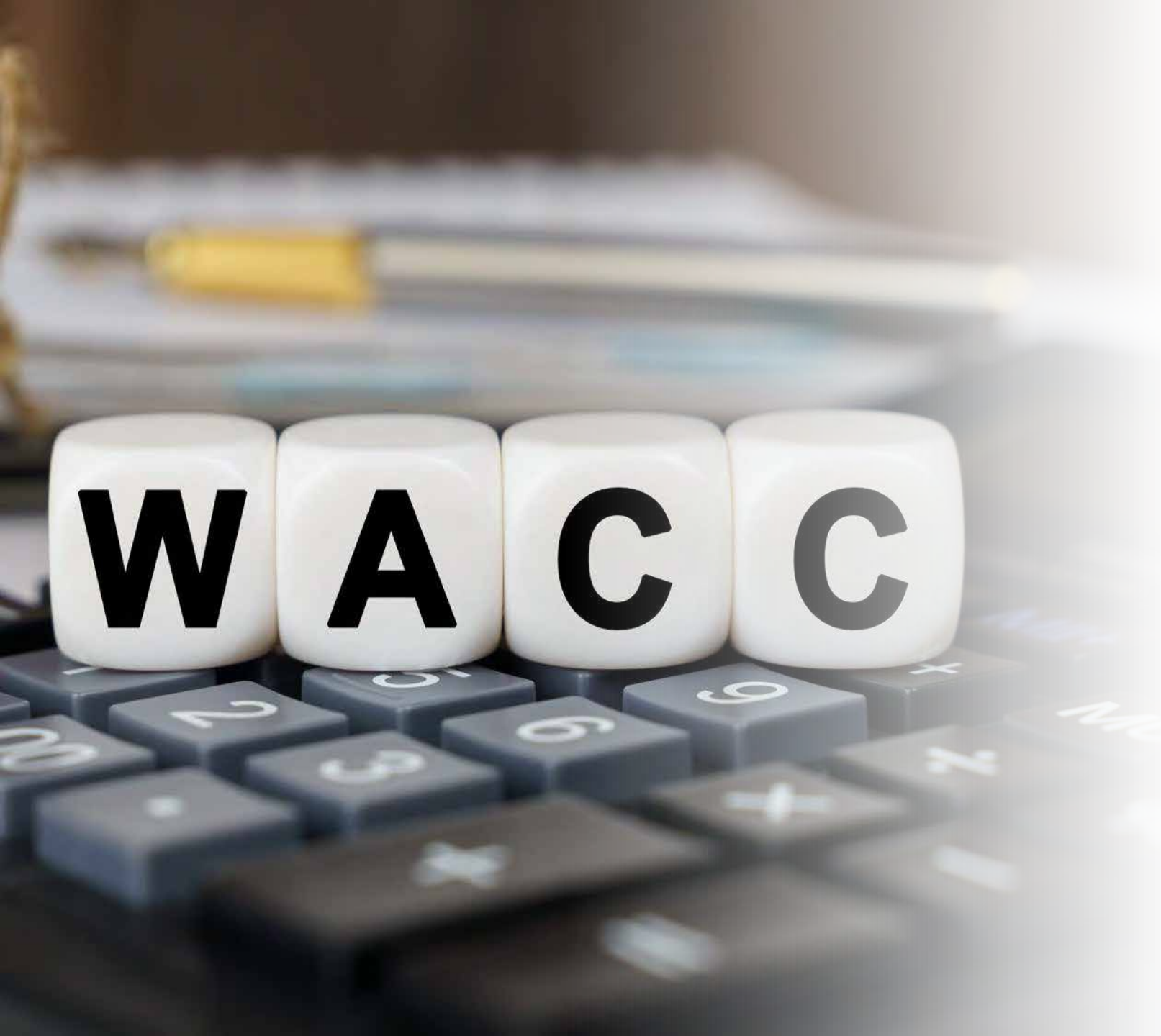


Income Impacts

(Some – not all asset classes – short term & longer term)

- Tenant viability
- Face market rent
- Effective market rent
- Lease Term
- Incentives based on lease term
- Type of incentives (cash/ fitout NB. PropTech), abatements and rent free)
- Future view bases (Mkt, Fixed, CPI, Caps and Collars) and frequency
- Probability of lease renewals
- Tenant Downtime
- Rental growth (asset classes)
- Arrears
- Ongoing impact of the commercial leasing code
- Code waivers
- Code deferral recoupment (priced into valuations?)
- Vacant space letting up allowances
- Short term versus medium terms cash flow affects.....different asset classes
- Ongoing Cap Ex





DCF – Valuation impact of the Covid Economy

- % of value attributable to NPV of cash flows (35-45%)
- % of value attributable to 10 year PV of terminal value (55-65%)
- Short term cash flow impact
- Medium term cash flow impact on certain asset classes (some solutions are on the horizon)
- Terminal Value Impact – Year 10 and beyond



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Interest Rates and Discount Rates

Demand driven cap rate / discount rate compression sought after asset classes (industrial) and stabilised and marginally increasing cap rates and discount rates other asset classes

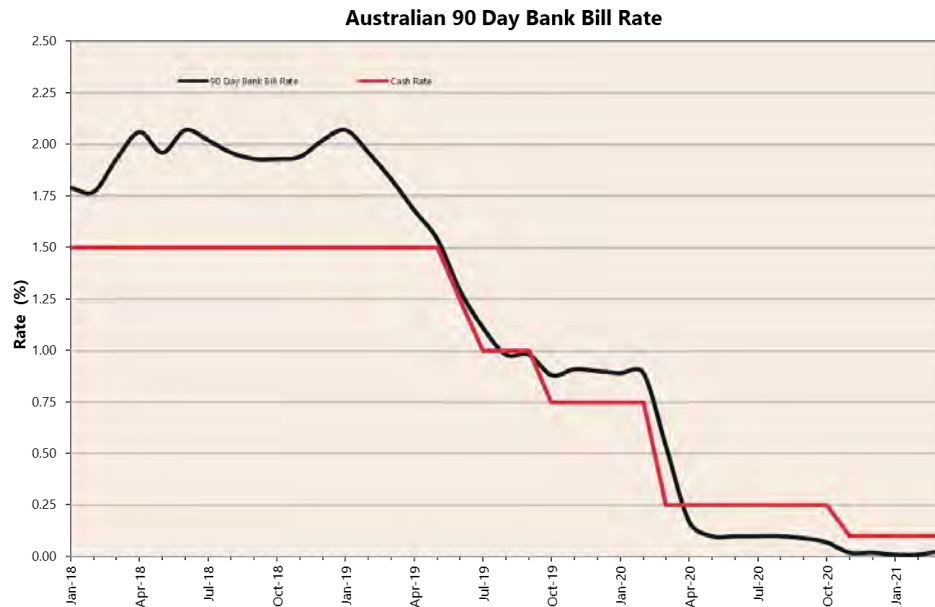


Chart: 90 Day Bank Bill Rate
Source: RBA /Preston Rowe Paterson Research

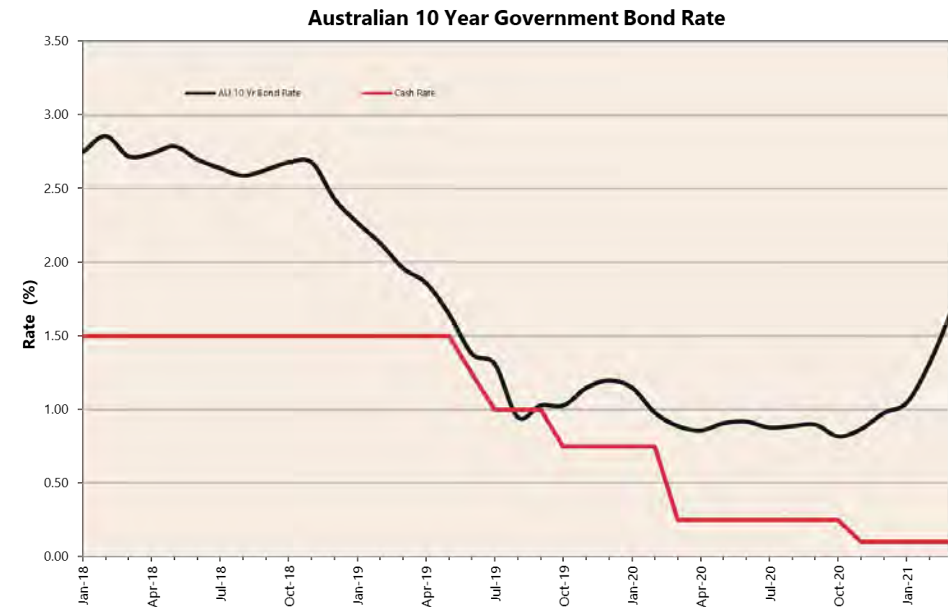
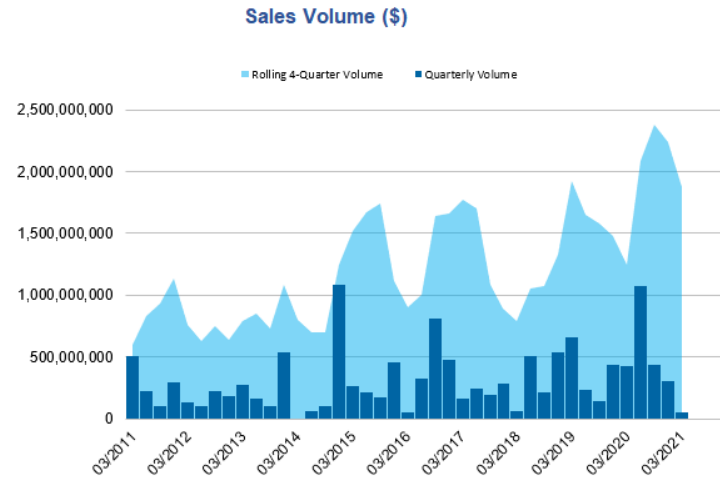


Chart: 10 Year Gov Bond Rate
Source: RBA /Preston Rowe Paterson Research

Sydney Industrial Markets Since March 2020

Sydney, AUS | Industrial, | Deal Price > \$25m

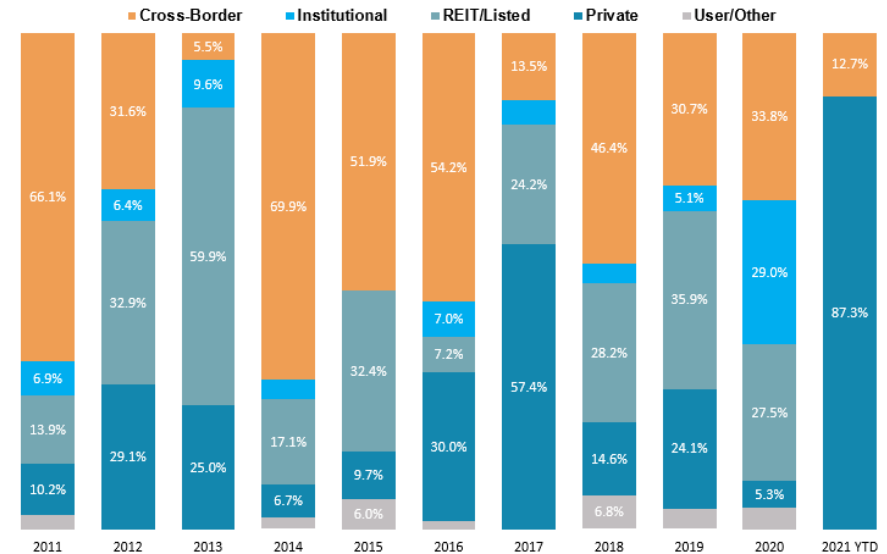
Historical Investment Trends



Sydney, AUS | Industrial, | Deal Price > \$25m

Capital Composition

Buyer Composition



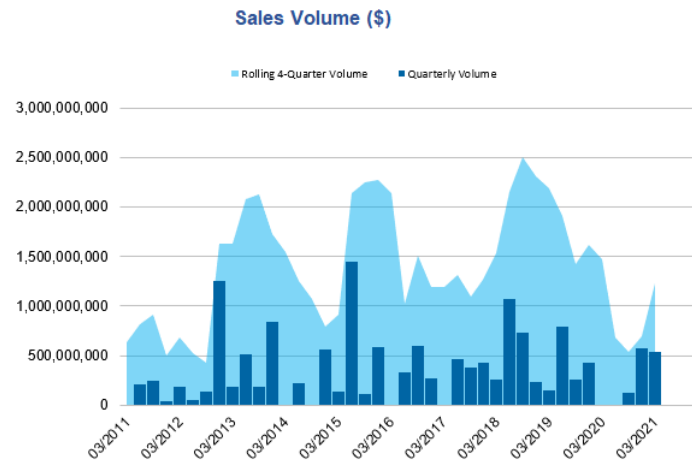
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Sydney Retail Markets Since March 2020

Sydney, AUS | Retail, | Deal Price > \$25m

Historical Investment Trends

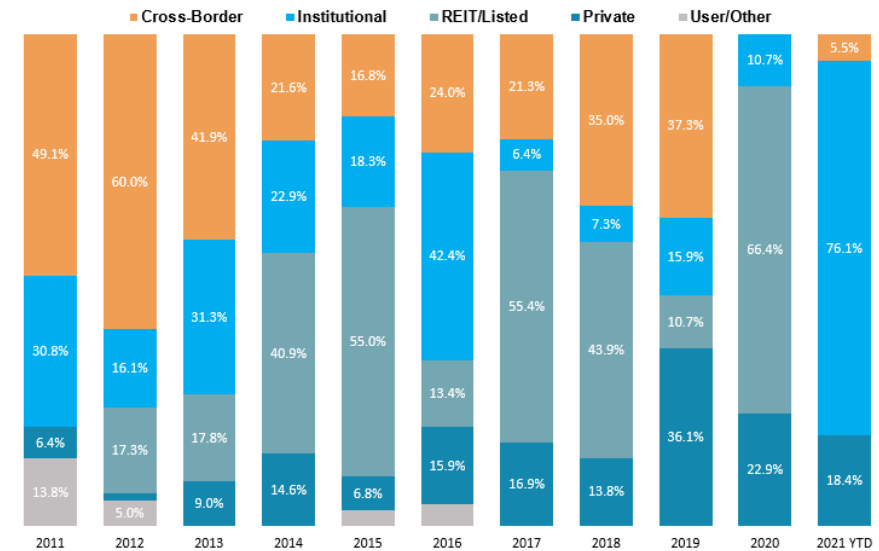


Source: Real Capital Analytics

Sydney, AUS | Retail, | Deal Price > \$25m

Capital Composition

Buyer Composition



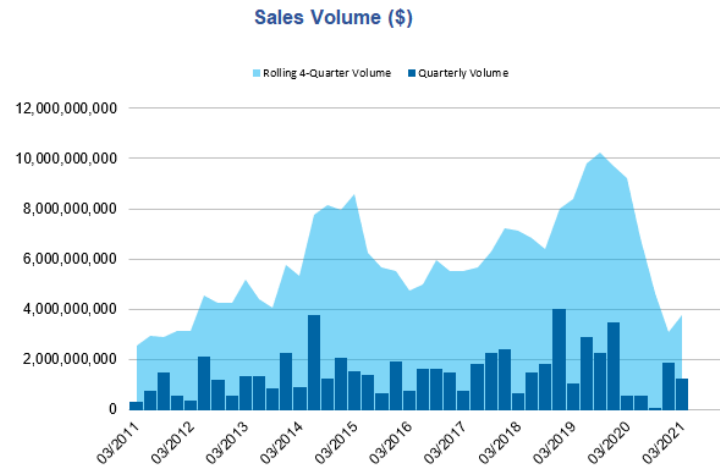
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Sydney Office Markets Since March - 2020

Sydney, AUS | Office, | Deal Price > \$25m

Historical Investment Trends

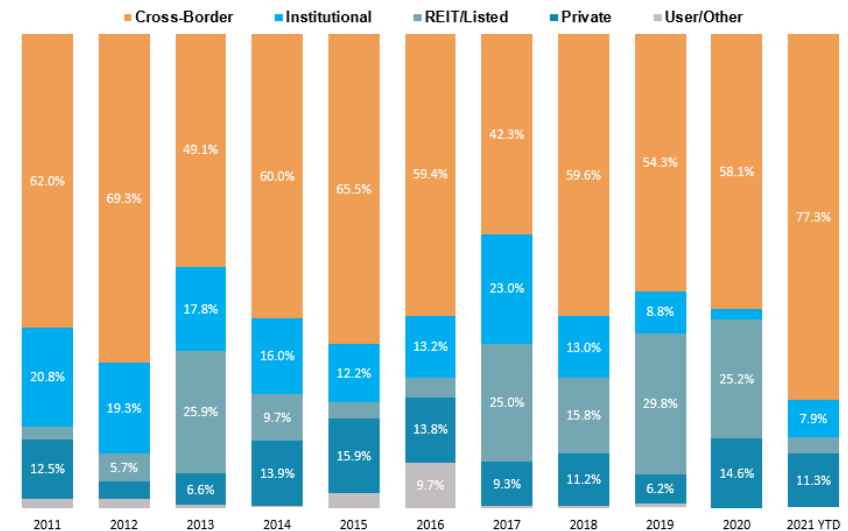


Source: Real Capital Analytics

Sydney, AUS | Office, | Deal Price > \$25m

Capital Composition

Buyer Composition

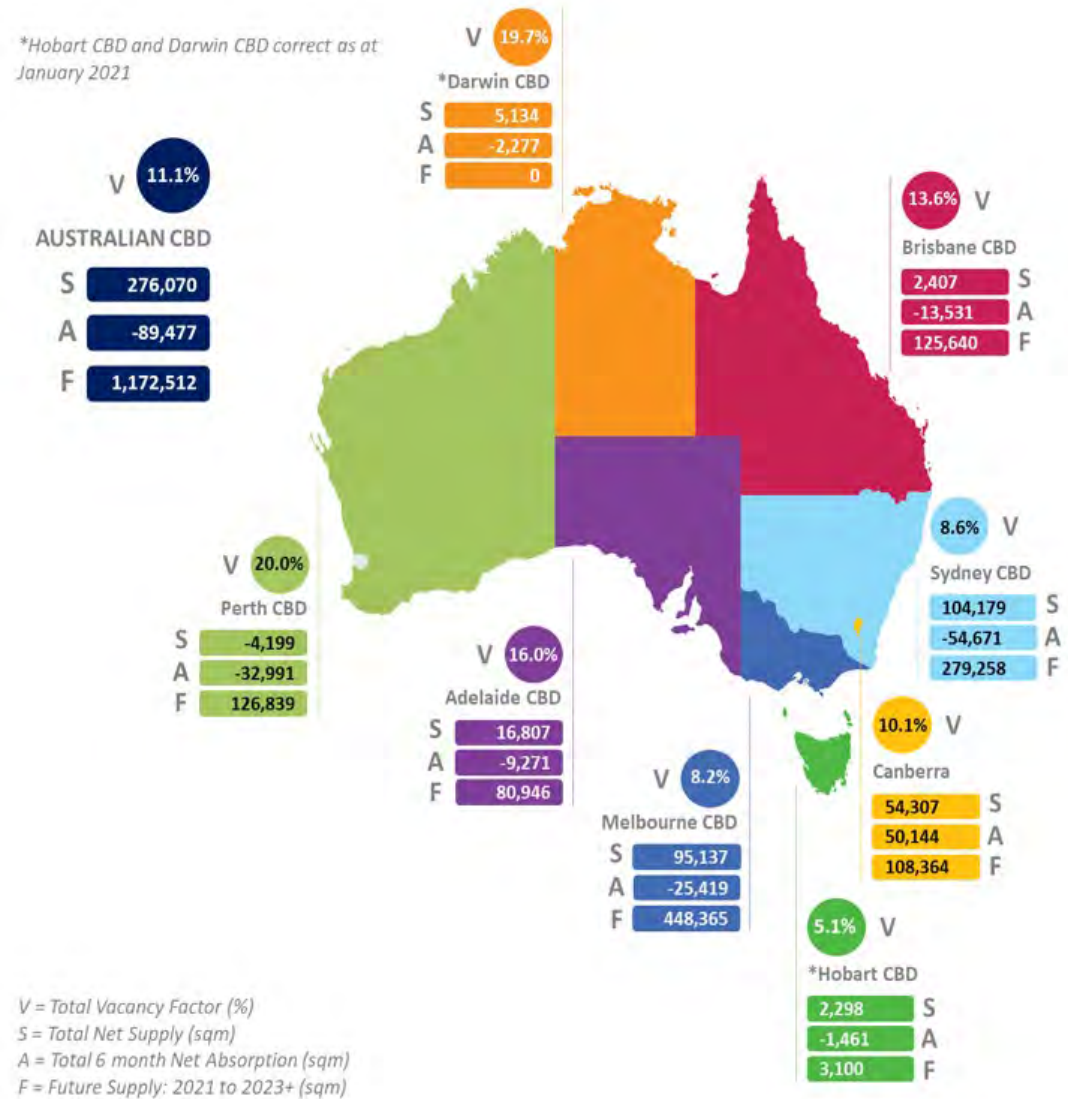


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Office Markets

- Known and mooted supply
- Withdrawals
- Direct Vacancy
- Sub Lease Vacancy
- Total Vacancy
- Net Absorption
- Impact on Incentives, face & effective rents?



Source: Property Council of Australia January 2021



Things on the horizon

- RICS Independent Review on Investment Valuations – Submissions December 2020
- IVSC Consultation – Definition of Long Term Value (Gerry Harvey GFC)
- Effect of FIRB Changes
- Mooted NSW Property Tax Changes
- Inflation - mixed views
- Interest Rates?
- How are abrupt short term lock downs impacting rental cash flows?
- How are transactions being done – vendor income guarantees to cover ongoing waivers and deferral

Due Diligence – Cash Flows and Building Services

- Prior to COVID buoyant markets saw significantly limited DD time in transactions for most asset classes
- Varied now for asset classes in demand (e.g. industrial) versus other asset classes which are more cash flow affected
- Industrial DD could be said to be more vanilla (net rents and limited building services)
- Office and retail can be more involved and is there more time?
- Focus on cash flow DD vis a vis Commercial leasing Code Waivers and Deferrals – NB recoupment of deferrals to be factored into valuations
- Building services may also be more in focus in the future
- Limited time for DD always a concern where demand dictates immediacy or unconditional transactions



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Vibrant cities – need vibrant buildings

- And vibrant buildings need businesses and their people occupying them
- For public buildings and all asset classes
- Lockdowns and WFH acceptance threaten vibrant cities
- Whilst the modern world acknowledges workplace flexibility, in my view progressive and successful businesses need their staff to learn, collaborate and compete to succeed
- Its difficult through a TV or computer screen
- Solutions to get people back into buildings are part of the valuation question and need to be considered



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Healthy buildings - a key to the solution

- Exciting building services Prop Tech aimed at getting people back onto buildings will be factored into valuations
- The PFA/ IACC webinar a few weeks ago unveiled several exciting solutions
- Companies who presented such as **PointGrab**, **Aura Air**, **Juganu**, and **Enverid** have developed lighting and air purification systems as well as personnel monitoring that trace and deal with COVID
- As these technologies gain traction, they present a huge opportunity to protect rental cash flows for COVID impacted assets
- Some of the technologies may incorporate base building services upgrades and some may become part of fit out and be funded through tenant incentives
- It could be the case that a new NABERS or Green Star like rating system is developed for Healthy Buildings – A Healthy Building rating system





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Thank you.

