Box B

COVID-19 and Commercial Property in Australia

The COVID-19 pandemic has resulted in large changes to where people are working and how they are purchasing goods. Most office staff shifted to working from home in early 2020 and the share of employees making use of these arrangements is expected to remain higher over the long term than prior to the pandemic. As a result, demand for office space has declined and is expected to remain lower than it would have been in the absence of the pandemic, although this may be partially offset by increased social distancing requirements and a desire by firms to accommodate larger collaborative work spaces. The pandemic has also accelerated the shift toward online retailing and away from retail outlets in central business districts (CBDs). This has exacerbated the challenges facing the bricks-and-mortar retail sector, but has led to a significant increase in demand for industrial property such as logistics and warehouse space.

Increased remote working has contributed to a sharp decline in demand for office space …

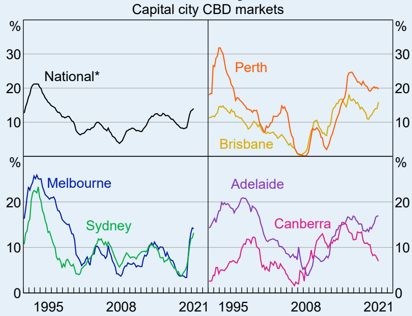
Office vacancy rates have risen sharply in Australia since the onset of the pandemic. This has been most pronounced in Sydney and Melbourne, where recommendations that employees work from home were in place for longer and large volumes of office space have arrived on the market since the pandemic began (Graph B.1). There has been little demand for the office space left vacant by firms moving into newly completed properties.

A distinctive feature of the pandemic has been the increased use of remote working arrangements. The ABS Business Conditions and Sentiments survey, released in April 2021, indicated that the share of businesses with remote working arrangements had increased notably following the onset of the pandemic and had been largely maintained despite activity restrictions being progressively unwound since mid 2020 (Graph B.2). Large businesses, which account for a significant share of CBD office space, were able to accommodate a particularly sizeable increase in remote working in 2020; these firms were already much more likely to have remote working arrangements in place than smaller businesses. Information from the Bank's liaison program – which mostly includes large and medium-sized businesses – suggests that most office staff were working remotely on a full-time basis in the middle of 2020.

Graph B.1

Office Vacancy Rates

Capital city CBD markets



* Excluding Darwin and Hobart

Source: JLL Research

… and is likely to weigh on office demand in the longer term

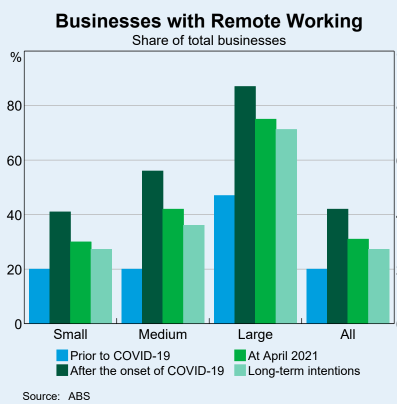
Office occupancy rates have generally increased in line with decreasing social restrictions and transmission risk (Graph B.3). However, occupancy rates have remained 10–30 per cent below pre-pandemic levels even in cities that have had little transmission of COVID-19 since the initial phase of the pandemic, due to the continued higher use of remote working arrangements. Office occupancy in Sydney and Melbourne improved noticeably in the first half of 2021, although recent outbreaks have largely reversed this progress.

Firms are expecting the use of remote working arrangements to remain higher than prior to the pandemic over the long term and this will continue to weigh on demand for office space. Liaison suggests that the majority of firms are adopting a 'hybrid' model for their office staff, where employees have the option of working remotely for part of each week. Around a quarter of surveyed liaison contacts have decided to reduce their floor space by an average of 25 per cent in response to these changes in work patterns (although this may overstate the impact on the office market as a whole given that the sample of liaison firms is biased towards larger firms, which have embraced remote working arrangements the most). While many of these firms have attempted to sublease their underutilised space, few have managed to secure tenants since the beginning of the pandemic.

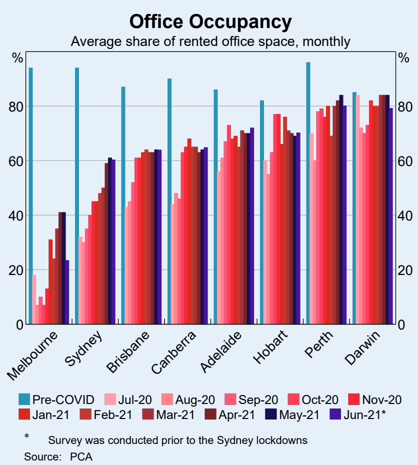
Despite most large firms planning to adopt a hybrid model of work, around half of surveyed liaison contacts have no intention of changing the amount of office space they lease. One reason for this is that the amount of office space required depends on 'peak' usage, rather than average usage across the week. Other reasons noted by firms include the need to accommodate larger collaborative work spaces, social distancing and future growth in headcount.

The remaining quarter of firms surveyed in liaison remain undecided on their long-term work arrangements and office space requirements. The decisions of these firms will have a large bearing on the extent of the negative effect of the pandemic on office demand in the long term. The long length of

Graph B.2



Graph B.3



many existing office leases means that the full impact of these decisions will likely take a number of years to resolve.

Office construction is expected to decline, although the outlook remains very uncertain

Office construction activity over the next few years is likely to be well below 2020 levels. Few large-scale office projects have commenced construction since the beginning of the pandemic, consistent with the heightened uncertainty about the longer-term outlook for demand. Developers and private sector analysts have also noted difficulties in attracting the tenant pre-commitments necessary to obtain debt financing, which has prevented the start of construction on some projects.

However, there are a large number of potential projects in the office construction pipeline, suggesting that developers remain poised to take advantage of a recovery in office demand (Graph B.4). Development approvals typically remain valid for 1–5 years and liaison contacts have suggested that developers may hold off on proceeding with new office construction until vacancy rates begin to fall, rents stabilise, and questions around major tenants' long-term occupancy intentions are resolved – a process that may take several years.

Greater online shopping has supported industrial property demand and construction, while retail property demand has declined

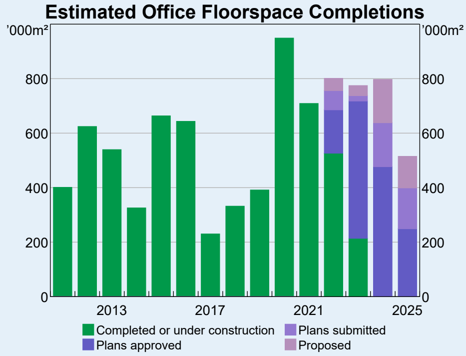
The COVID-19 pandemic has accelerated the shift toward e-commerce as consumers attempted to maximise social distancing and comply with lockdown measures. As a result, tenant take-up of industrial property such as logistics and warehouse space in the year to the March quarter 2021 was around 45 per cent higher than its 10-year average. Liaison contacts have also noted that strong growth in food sales and firms increasing inventory levels in response to pandemic-related supply chain issues have supported demand for industrial property.

Construction timelines for industrial projects are short (typically in the order of 6–9 months) and so construction has been able to respond rapidly to increased demand. One measure of completions over 2020 was close to 50 per cent higher than its 10-year average, and will increase a further 10 per cent over 2021 (Graph B.5). Industrial properties have typically cost less to build than other commercial property types. However, contacts have noted that tenants are demanding facilities with greater technological capacities (i.e. automation and robotics), which is likely to increase the cost of building these properties.

The accelerated shift toward e-commerce has exacerbated the challenges and risks facing the bricks-and-mortar retail sector.[1] This is particularly the case for shopping centres with high exposures to discretionary

Graph B.4

Estimated Office Floorspace Completions



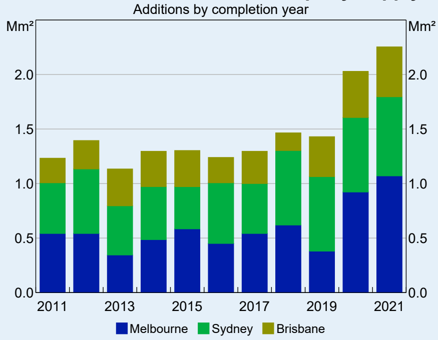
Sources: JLL Research; RBA

retailing such as regional and sub-regional centres.[2] Neighbourhood centres, which derive most of their income from supermarket anchor tenants and have benefitted from office employees continuing to work from home, have been less affected. Construction commencements of retail floor space over the past year were around 70 per cent below the 10-year average and are expected to remain weak for a number of years. In liaison, some contacts have noted intentions by retailers to reformat well-located stores to better facilitate 'click-and-collect' in-store collections of online orders, but this has yet to translate into a pick-up in construction activity.

Graph B.5

Eastern Seaboard Industrial Property Supply*

Additions by completion year



* Forecasts for 2021

Source: Knight Frank

Endnotes

[1] See RBA (2021), 'Box B: Risks in Retail Commercial Property', *Financial Stability Review*, April. Available at <https://www.rba.gov.au/publications/fsr/2021/apr/box-b-risks-in-retail-commercial-property.html>

[2] Regional centres are anchored by department store tenants such as Myer or David Jones, while sub-regional centres are anchored by discount department stores such as K-Mart or Big W.