AVISON YOUNG

BRIEFING NOTE

# COVID-19

UPDATE
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## Impacts on Real Estate

**Since late February, the COVID-19 disease caused by the SARS-COV-2 coronavirus has emerged as a humanitarian issue of global significance, with hundreds of thousands of people and their communities affected. The World Health Organisation (WHO) now regards the outbreak as a global pandemic and the situation continues to evolve rapidly, as businesses and governments accelerate their responses to the crisis.**

Equity and bond markets have reacted sharply and remain highly volatile, reflecting a paucity of hard evidence about the impact on economic activity. A global recession now appears highly likely, albeit that the unprecedented nature of the crisis makes forecasting the severity, duration and nature of the downturn, and the trajectory of the subsequent recovery, extremely problematic – especially at this early stage.

Our base case assessment of the impact on the real estate market now assumes that we will see significant further spread of the virus across and within most countries.

### Executive Summary

- The COVID-19 pandemic is resulting in very real human, social and economic impacts. Historically, reduced population mobility during epidemics has had a greater economic impact than the illness itself.
- Governments are responding in different ways, but restrictions on population movement, public gatherings and social/leisure activities are now widespread. This will help slow the spread of the virus, but is resulting in a significant shock to business activity.
- Economic activity is highly globalized in nature – disruptions in one country or region are having ripple effects across multiple markets and sectors. It now appears likely that the global economy, and probably many countries, will experience a recession but it is unclear how deep and prolonged any downturn will be.
- Commercial real estate will see secondary impacts from reduced economic activity and "wait-and-see" disruptions as elevated uncertainty and risk will cause occupiers to delay business investment or expansion plans.
- Transaction activity of all kinds is likely to slow sharply for the duration of the crisis, reflecting practical constraints on deal completion as well as uncertainty about the longer-term outlook for the market. However, underlying demand for real estate investments remains generally high, with multiple sources of capital active in the market. We expect a bounce-back in both investment and leasing activity once the immediate crisis dissipates.
- Longer term, the changes that businesses and individuals will implement during the crisis will accelerate some trends already evident in the market, including deglobalization of supply chains and a shift towards online retail and flexible working practices in the service sector.

## Key economic implications of COVID-19

**The COVID-19 pandemic is resulting in very real human and social impacts. The likely economic impacts of the outbreak fall into four main categories:**

- **Direct impact from COVID-19 and associated containment measures**
- **Knock-on impacts from disruption to supply chains and business linkages**
- **Contingent impacts stemming from financial market stress**
- **Redistribution effects from changes in government, business or individual behaviour**

- Containment strategies are being widely implemented to delay the spread of the virus. Analysis of previous epidemics suggests that reduced mobility within the population has a greater economic impact than the illness itself – and this is becoming apparent in the current COVID-19 outbreak.
- The direct impact of travel restrictions, quarantining workers or temporary workplace closures is increasing sharply. The leisure, tourism and travel sectors have been immediately impacted, while manufacturing industries are being affected by supply chain disruption. Many retailers already facing difficult trading conditions have seen a sharp reduction in customers.
- All sectors of the economy, and every country, will be affected to some degree. Businesses that were already struggling will now face a battle for survival, with company failures in one area having a knock-on effect in other sectors and regions.
- The emergency rate cuts and other measures announced by central banks across the globe are primarily designed to flood the market with liquidity to avoid any contagion through the financial sector. The aim is to prevent the inevitable downturn spiralling into a significant global recession or even a financial crisis – although the latter is not currently considered likely.
- Governments across the globe are also introducing personal and corporate fiscal policies on a scale not seen since the Financial Crisis of 2007/8, to help businesses and individuals survive the coming months of disruption. At this stage it is impossible to know how economically effective these will be, although they are beneficial in helping support consumer and business sentiment.
- A shift towards "risk off" decision-making is already encouraging flight to secure assets, hitting equity markets and driving down government bond yields – although the markets remain highly volatile. Overall, we now anticipate that the global economy will experience a recession, or very close to it, in 2020. Activity will slow in North America and Europe during Q2 and potentially into Q3. Elevated uncertainty and risk, or inability to access funding, will cause many businesses to delay investment or expansion plans, some of which will be deferred indefinitely if the overall economic outlook deteriorates further. A degree of "bounce back" is likely once the immediate crisis moderates, but any lasting damage to the demand side of the economy will delay the pace and timing of the recovery.

To dive deeper into the economic implications of COVID-19, please visit avisonyoung.com

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## Key real estate implications of COVID-19

**Real estate is often described as "the economy in a box," -- anything which affects the overall rate of economic growth will impact the real estate market from occupational and investment perspectives. The likely market impact varies distinctly across some sectors, and there is a distinction between the expected short-term effects and potential longer-term implications.**

It currently remains impossible to quantify the likely impact on the property market with any reliability. Comparisons with the Financial Crisis of 2007-8 are not necessarily appropriate, not least because central banks are working hard to avoid a repeat of the credit crunch that characterized the last downturn. Nevertheless, the speed with which the market adjusted to events a decade ago may represent a "downside scenario" against which to assess potential property market outcomes.

- Overall, stock market movements give an early indication of expected levels and relativities of impact. Thus far, **sectors such as real estate, which will see secondary impacts from reduced economic activity or are mainly impacted by "wait-and-see" disruption, are not viewed as particularly badly affected.** As of 13 March, in the U.K. the FTSE 350 REIT Index had fallen 24% since the start of the crisis, compared with the 29% decline recorded by the FTSE 350 overall. In the U.S., the S&P 500 overall was down 26% during the same period – marginally more than the 25% decline in the Office REIT index (although Retail and Industrial REIT indices saw declines of around 30%). In general, real estate stocks fared better than those in the hotel/leisure and financial sectors.
- **The travel, hospitality and leisure sectors are being hit first and hardest, due to the immediate impact on demand and business activity.** The hotel sector is particularly vulnerable to a decrease in tourism, which has largely collapsed and measures to limit public gatherings at conferences and sporting events – virtually all of which are now being cancelled or postponed. Real estate transaction activity in these sectors (both leasing and investment) is likely to decline significantly, at least for the duration of the current crisis and potentially for a period beyond.
- **COVID-19 will exacerbate the challenges faced by the retail sector.** The consumer sector is likely to be more immediately affected. In developed markets consumer spending typically accounts for around one-third of all economic activity, up to half of which is "discretionary." Consumers are likely to delay or forego a material proportion of this expenditure due to illness, self-isolation or uncertainty.
- **In-store comparison goods retailing will suffer,** and some of the most successful areas of the market will be hardest hit. Tourism-related retail, restaurants, bars, entertainment venues, large supermarkets, major city centres and dominant malls will suffer from compulsory or self-imposed restrictions on movement, as people avoid locations seen as posing a high risk of transmission. In contrast, online retailers and local high streets could benefit in relative or absolute terms. Some of the increase in online shopping will become permanent, accelerating the impact of internet retail on the physical market. In many countries, households stocking up (or panic buying) will boost Q1 sales data in the food sector.
- **Occupiers will be intensely focused on cashflow,** particularly those that will see material loss of income due to social distancing and travel restrictions. Landlords will receive some requests for rent deferrals or reductions, and challenges around service charge levels in buildings that need to be kept secure and operational, but which tenants may be unable to occupy. How landlords respond will in part depend on the wording of the lease concerned, but in most cases will be a matter of judgment as much as legality.
- **Across most sectors and markets, leasing activity will decline in volume compared with pre-crisis expectations.** While some transactions will be unaffected, many deals currently under consideration are likely to be delayed (though not yet cancelled) as occupiers adopt a "wait-and-see" attitude. This disruption should prove temporary and we would expect a bounce-back in deferred activity during late 2020 and into early 2021. However, a heightened sense of uncertainty over the economic and business outlook will cause some deals to be withdrawn. Fewer new transactions will be initiated, and some expansion plans will be put on hold. Clearly the extent of this slowdown will be highly variable across markets and will depend on how the economic impacts of the disease play out.
- **The impact on rents is impossible to quantify until we have a clearer view of the underlying economic impact of the current crisis.** Given that we expect the disruption to be severe but temporary – with activity returning to 'normal' more quickly than in previous 'conventional' recessions, we would expect any impact on rents to be similarly short-lived unless the recession has done structural damage to particular areas of demand.
- **Disruption to supply chains will impact the industrial and warehouse sectors.** U.S. Industrial REIT prices have been hit hardest within the S&P 500 property sector, and demand prospects are generally lower in most markets and segments. However, supply chain reconfiguration and a shift towards regional or local suppliers could ultimately boost demand for warehouse and production space in some markets.
- **In the office sector, rates of homeworking have already increased sharply.** The business services sector, which accounts for 10-12% of the economy in the U.K. and U.S., is set to embark on an unprecedented global experiment in flexible working. It remains to be seen what impact this will have on productivity and output, but it will accelerate the adoption of new technology and flexible working practices. In the immediate future, social distancing could provide a stress test for many co-working and flex office operators, with short license customers opting to work at home for a period of weeks or even months.
- **Some capital markets transactions will be delayed or jeopardized** due to practical constraints on completion (such as travel restrictions impacting on-site due diligence) or concerns over the outlook for the economy and occupier demand. Transaction volumes are likely to fall, probably quite sharply; while Q1 totals may be less affected, Q2 will be impacted by delays in completion and Q3 will be hit because few new transactions are currently being initiated. "Long income" deals that are less sensitive to the short-term outlook are in high demand and will be less affected than those higher-risk transactions requiring more active management and asset repositioning to drive IRRs.
- **It seems likely that the extent of containment policies being implemented will have a material impact on investment transaction volumes for 2020.** The scale of impact depends on three factors that are extremely difficult to predict. First, how well investors who wish to transact are able to cope with the current disruption. Second, how effectively governments manage public and business confidence in order to minimize the impact on market sentiment. Third, how well governments and central banks can limit damage to the economy and prevent contagion into the financial system, which would materially affect pricing and investor demand for real estate.

- **It is difficult to assess the likely scale of impact on real estate transactions.** Following the collapse of Lehman Brothers in late 2008, global investment volumes were typically 60%-70% lower during the following four quarters than had been seen a year earlier. On this occasion we do not expect the impact to be as severe or as prolonged, but a fall in transactions of 25%-50% for one or two quarters in those markets most severely affected cannot be ruled out.
- **As in the wider economy, any "wait-and-see" hesitation in completing existing transactions or initiating new ones will be partially offset by a "bounce back" effect once uncertainty is alleviated.** It should be noted that demand for real estate investments generally remains at a high level with multiple sources of capital active in the market. Any reduction in interest rates and bond yields will also encourage further flows of capital into the real estate sector. We would therefore expect a significant pick-up in activity towards the end of 2020 and into 2021.
- **If real estate values fall less sharply than equity prices, this will lead to an effective re-weighting of multi-asset portfolios.** Until equity prices recover or investors adjust their target weightings, this "denominator effect" will tend to reduce some institutional demand for real estate.
- **Residential markets are likely to see sharply slower transaction activity.** Potential buyers will find it hard to arrange viewings even if they want to, sellers will be reluctant to put product into a difficult market, and practical aspects of arranging completion will prove highly problematic. The market will therefore slow sharply at least in the short-term – how quickly it recovers will depend entirely on how severe and prolonged the economic downturn turns out to be.
- **In the debt markets,** lower interest rates will stimulate real estate borrowing but there could be some redistribution of activity. Asian lenders have been very active in the market but could be expected to pull back somewhat in the current environment.
- **In the development market, it remains to be seen whether higher commodity prices will impact construction activity.** Construction costs are already elevated in the U.S., and in the U.K. where Brexit-related labour shortages are a further threat, such that development margins are reduced. Disruption to Chinese raw materials could delay or defer construction orders, particularly if local-sourced alternatives prove more expensive.
- **From a valuation perspective,** we expect any impacts to be relatively short-lived but – as with so many other aspects of the current crisis – this is based on our assumption that we will see a global recession, but not on the scale seen in late 2008. For comparison, office values in London fell 50%-70% during the course of the Financial Crisis, and by 15%-20% in the single quarter following the collapse of Lehman Brothers. While such falls are well in excess of what we expect to see this year, they do highlight the potential scale of short-term impact that is possible when confidence in a highly priced market collapses. Even so, we would note that after a short period of intense decline values of good quality properties recovered rapidly in 2009, as investors quickly re-entered the market once the immediate sense of crisis had passed.
- **More material, long-term impact would only occur if the crisis escalates beyond what is currently envisaged,** most likely as a result of "healthy" businesses being jeopardized by business failures elsewhere in the economy, which could cause a slowdown to morph into a more serious recession or even another financial crisis.
- **The COVID-19 crisis does highlight the fragility of some globalized supply chains,** which will encourage an acceleration of the de-globalization trends we already see emerging in some areas of business and which Avison Young has commented on in our *2020 Forecast.*

**The spread of COVID-19 and the containment policies being introduced are changing rapidly, and some of the views expressed in this briefing may not reflect the latest opinion of Avison Young. The following sources provide regularly updated information on the COVID-19 outbreak:**

**World Health Organization**
*https://www.who.int/emergencies/diseases/novel-coronavirus-2019*

**Government of Canada**
*https://www.canada.ca/en/public-health/services/diseases/2019-novel-coronavirus-infection.html*

**US Centers for Disease Control and Prevention**
*https://www.cdc.gov/coronavirus/2019-ncov/index.html*

**European Centre for Disease Control and Prevention**
*https://www.ecdc.europa.eu/en/novel-coronavirus-china*

**UK Government**
*https://www.gov.uk/guidance/coronavirus-covid-19-information-for-the-public*

**Johns Hopkins University COVID-19 Case Tracker**
*https://gisanddata.maps.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6*

## Should you wish to discuss any details within this report please get in touch.

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