Coronavirus

Impact on Real Estate

We know already that the COVID-19 virus will cause significant economic disruption. While a serious illness, fortunately its mortality rate is far lower than resulted from the SARS outbreak in 2002. Given the uncertainties about what is still a poorly understood illness, it is difficult to make any reliable forecasts about the pandemic's growth and duration. However, we believe the most likely scenario based on what we know to date is that most countries will be affected to some degree and governments will initiate both public health and financial policies to deal with containing its spread and smoothing out the impact on their respective economies.

From the property market's perspective, some industry sectors are clearly already suffering a negative impact. For other sectors, activity may well slow in the short term but most activity will be deferred to drive a strong recovery later. We also see the rationale for investment in some sectors to be strengthened from the experience of the outbreak of COVID-19.

Impact on Occupational Demand

- Negative: Retailing, restaurants, leisure and hotels will suffer from discretionary spending declines and restrictions on travel. Manufacturing tenants and those in labour intensive industries may suffer supply chain and staffing disruptions
- Neutral: Offices, particularly where staff can work remotely from home
- Positive: Logistics may benefit from a growth of reliance on online sales

Impact on Investment Volumes

- Transaction volumes are expected to decline during the period of disruption, particularly for cross border investment
- Volatility in capital markets may increase demand for core property assets
- Unlikely to have a lasting impact on volumes once the pandemic has passed

Impact on Total Returns

- Short-term, no impact unless tenants fail
- If the pandemic lasts longer than 3-6 months, then we expect valuations to decline and a reduction in tenant demand to feed through into rental levels

What we know and what we don't know about the COVID-19 virus…

We know the COVID-19 virus has a lower mortality rate relative to SARS which was a similar coronavirus. However, coronaviruses are generally poorly understood by the scientific community and so that raises a large degree of uncertainty about how the pandemic will develop and eventually tail off. The two key questions, which are clearly linked, are:

1. How widely will the pandemic spread?

Given the spread of the virus that we have seen so far, it seems unlikely that the outbreak will be contained in a few locations despite containment efforts. The virus appears to be easily transmitted and infected people do not show symptoms through the incubation period. Several countries have discovered that they already have community spread of the virus as opposed to cases only in travellers from affected areas or people who were in direct contact with them

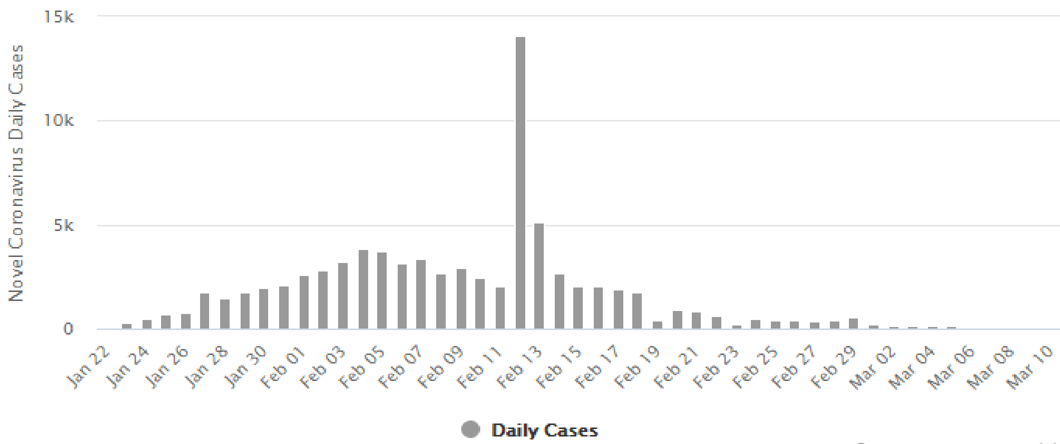
2. How long will it last?

It is not clear yet whether those that have recovered from the virus to date develop a long-term immunity. Accordingly, we cannot be sure whether the virus will stop transmitting and be eliminated through immunity in one cycle or it will continue to circulate and establish itself as a common respiratory virus. Looking at the progression of the initial outbreak in China, the slowdown in new reported cases suggests that the epidemic in China appears to have peaked following the adoption of strict containment measures. It is also noticeable that the waves of outbreaks in subsequently affected countries have become progressively less widespread, although it is quite possible this trend could be reversed if countries less able to coordinate an effective response are affected.

Assuming an accelerated development programme, a vaccine is likely to take 18-24 months before it is widely available. It is unknown if the virus could mutate, as influenza does, to result in the vaccine being ineffective by the time it is available. However, the experience with the similar SARS virus was that it had a relatively low mutation rate in contrast to the high rate that is seen in the influenza viruses.

The takeaway is that we need to prepare for significant short-term disruption due to the uncertainties. Given the low mortality rate, experience with SARS and significant public health policies being enacted globally, the most likely scenario is that we will see one cycle which will potentially run for up to 24 months in a pessimistic scenario that it can only be brought under control with a vaccine. We expect that the most likely scenario is that the pandemic will peak globally in Q2 2020.

Daily New Cases in China



Source: www.worldometers.info

What will be the impact on economies and real estate markets?

We are already seeing the economic impact being reflected in investment market pricing, even if it is not yet coming through in economic data.

We are certain to see further action from central banks and governments to offset the impact of the pandemic on economic activity. For the UK, the Bank of England has implemented an interest rate cut, following similar action in the US last week. The UK government has announced a package of measures valued at c.£12bn specifically to deal with the impact on the virus on healthcare and business disruption.

Given the Eurozone's already low interest rate, the scope to cut rates further is limited. Accordingly, we expect that a small cut will be combined with further monetary stimulus. It is also likely that the EU will look to member states to take targeted action which may require a temporary relaxation of the Union's rules on government finances.

The clearest consequence of the pandemic on consumer activity is the reduction in both tourism and business travel, as well as a reluctance for consumers to visit densely occupied locations. This will have an immediate impact on retailers, hotels, restaurants and leisure businesses in tourist locations. While we expect the change of consumer behaviour directly linked to the pandemic to be short lived, it may well change long term behaviour to some extent.

For office-based businesses, firms will be keen on staff working remotely where feasible during the pandemic, but unless we reach a point where significant numbers of people are absent from work due to illness, then the impact on staffing is going to be limited. However, on the flip side, restrictions on meetings and travel will at least defer business activity which will have a negative short-term impact.

Impact on Occupational Demand

We see physical retailing, restaurants, leisure and hotels as being the key casualties of this short-term trend. Give the pressures already facing retailing, a further drop off in trade could well lead to the failure of further businesses despite the potential for government assistance to ride the crisis out. Decisions on new lettings by businesses in affected sectors are likely to be delayed.

The demand for online shopping is likely to rise in locations where this is a suitably developed alternative. This will be positive for logistics/warehousing. Should the pandemic be prolonged, the demand for short-term storage space will likely increase.

For the manufacturing sector, supply chain issues, particularly those businesses reliant on supplies from areas severely disrupted, and those parts of the industry that are labour intensive are likely to see a fall in activity. Again, we can see new letting activity being deferred.

For offices, we can see a more balanced picture. We do expect that occupier confidence will decline due to the uncertainty, but as a substantial share of business activity is more likely to be deferred as opposed to lost then we expect that the impact will be less significant than for sectors relying on travel and discretionary spending.

Impact on Investment Volumes

The recent fall in government bond yields has certainly had an impact on the relative attractiveness of property, and we are seeing evidence of yields falling on core assets in prime gateway city locations despite economic concerns and the uncertain outlook. However, given businesses imposing restrictions on travel, it is highly likely that investment activity will decline during the pandemic - in particular, for cross border activity which makes up c.50% of transactions in London. This fall in investor demand together with weakening occupier demand suggests that yields may soften for certain sectors. At the other end of the spectrum, core asset yields may benefit as a defensive hedge against equity markets' volatility.

There remains a large volume of uninvested capital still allocated to real estate. Unless, the fall in equity prices leads to investment being redirected away from real estate, this capital will still need to be deployed once the pandemic has tailed off. We expect that sellers with the ability to do so will delay marketing until market conditions revert to pre-pandemic levels. Of course, there may be distressed situations emerging in the meantime.

Impact on Total Returns

For real estate investors, tenants will still be contracted to pay rent under leases, so unless investors receive an element of rent related to tenant turnover or suffer tenant failures then the short-term impact will be limited. Again though, the question remains whether the short-term impact leads to a change in the behaviour of occupiers in anticipation of a longer-term pandemic or recurrences of similar situations.

If the pandemic passes in 3-6 months, then we do not expect capital values to move significantly in the meantime. However, should the disruption last longer, then valuers will start marking down property valuations if transactional evidence suggests that prices have fallen. This will affect investors whose assets are periodically revalued for performance measurement or loan purposes.

Should values decline, then we do expect a sharp "V" recovery if the pandemic peaks in Q2 2020 and tails off after. If the disruption becomes more long-term then there may be a change in investor sentiment more generally towards real estate with a greater focus on core assets in liquid markets.

Conclusions

With the uncertainty over the extent and duration of the pandemic, it is inevitable and understandable that upfront policy measures will not meet the specific requirements of the actual outcomes. The economic impact of the virus looks likely to be huge although relatively short lived.

The impact will be the most disruptive in areas where a "lockdown" approach is taken to containment. We expect that displaced economic activity combined with monetary/fiscal policies will lead to a significant bounceback in activity in H2 2020 or in 2021 depending on how long the pandemic lasts. We expect financial markets to experience this bounceback too, with an expectation that they will overshoot. Accordingly, we expect a higher degree of volatility in markets while the direct impact and measures taken to mitigate the impact of the virus work themselves through the global economy. This evolving situation has almost certainly ensured that the benign interest rate regime has been prolonged and any steps by central banks to wean off economies from accommodative monetary and fiscal policies have been postponed. It is fair to say that investors will factor this aspect into making investment decisions.

What can we learn from the COVID-19 pandemic?

We do not know yet whether the virus will disappear after one cycle or it will linger on infecting people over and over, perhaps in a mutated form, and become a common and accepted illness much like influenza. We do know that similar pandemics are almost inevitable in the future given the growth in urbanisation and travel, and we can learn from the impact of this pandemic. In some respects, it may have been beneficial for the virus to emerge in a country as organised as China to contain the spread, and the emergence of future pandemics elsewhere may result in a much greater growth at the early, critical stages of an outbreak.

The tourism, travel and hospitality industries are extremely exposed to the change in consumer behaviour when faced with a pandemic. Having experienced the impact of COVID-19, occupiers may become more cautious so a longer-term impact could be a reduction in rent achievable on property associated with these industries to reflect to the increased volatility, with an associated adjustment in investment pricing.

Real estate associated with ecommerce is already a strongly growing sector, and the impact of a pandemic appears to enhance its appeal further by dispensing with personal contact and the need to visit crowded areas. The clear beneficiary of this trend is logistics, particularly in urban locations, with traditional retailing declining as a result.

For the office sector, occupiers may well look for more flexible space, conscious of the fact that workers may need to work remotely for extended periods should future pandemics occur. The nature of co-working space removes some element of control over the working environment from employers, so while it is flexible, the model itself presents some flaws in a situation where some degree of isolation is preferred.

For more information on this topic please contact:

Richard Cooper
Head of Investment Strategy
Tel: +44 (0) 20 3349 0226
Email: richard.cooper@dtzinvestors.com

About DTZ Investors

DTZ Investors is a full service, vertically integrated, real estate investment and asset manager. Features of our core service include investment strategy advice, deal sourcing and underwriting, financial structuring, ongoing asset management and property management, regular portfolio review to assess risk, and client reporting. DTZ Investment Management is authorised and regulated by the Financial Conduct Authority. Registered in England no. 4633215. Registered Office: Capital House, 85 King William Street, London EC4N 7BL

Important Notice

Opinions included in this material constitute the judgment of DTZ Investors at the time specified and may be subject to change without notice. DTZ Investors is not obliged to update or alter the information or opinions contained within this material.