AVISON YOUNG

AVISON YOUNG BRIEFING NOTE | 03 MARCH 2020

# COVID-19

## Impacts on Real Estate

During the last week, 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. As the situation continues to evolve, businesses and governments are responding to the threat, with increased likelihood of material economic impact reflected in significant capital markets adjustments.

Our base case assessment of the impact on the real estate market assumes that we will see further spread of the virus across and within countries, but that the outbreak will be contained before it causes extreme economic disruption.


### Executive Summary

- COVID-19 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.
- Economic activity is highly globalized in nature – disruptions in business activity will have a ripple effect that will slow economic growth in the short-term, but a degree of bounce back is likely, albeit unevenly distributed.
- Commercial real estate will see secondary impacts from reduced economic activity and temporary "wait-and-see" disruptions as elevated uncertainty and risk will cause some businesses to delay investment or expansion plans.
- Demand for real estate investments remains high, with multiple sources of capital active in the market. The scope of any market impacts will depend on how the disease evolves, but cross-border investment in particular is likely to slow in the short term.
- Longer term, the changes that businesses and individuals will implement during the crisis will accelerate some trends already evident in the market, including deglobalisation of supply chains and a shift towards online retail and flexible working practices in the service sector.

## Economic Implications

Aside from the more important human and social impact on those individuals directly affected by the disease, the likely economic impacts of the virus fall into four main categories:

**FIRST, ECONOMIC IMPACTS DIRECTLY ATTRIBUTED TO SICKNESS OR THE CONTAINMENT MEASURES SUCH AS "SOCIAL DISTANCING" THAT ARE IMPLEMENTED.**

These include loss of production due to quarantining of workers or temporary workplace closures, and reduced business/leisure travel. Analysis of previous epidemics suggests that reduced mobility within the population has a greater economic impact than the illness itself. The hotel, tourism, leisure, hospitality and travel sectors are already being significantly affected, with companies in these sectors seeing less business activity and sharply lower stock market prices.

While restrictions on movement are now being eased in China, their introduction elsewhere in the world will depend on how far and how fast the disease spreads. The very strict measures imposed in China appear to have helped bring the outbreak under control, but such measures may not be practical in the more liberal western economies. Governments will need to balance the need for an effective response with the desire to respect civil liberty. The impossibility of accurately predicting how COVID-19 will spread is therefore compounded by uncertainty over how national and regional governments will react.

A key element of the containment strategies being implemented is to delay the spread of the virus in order to prevent a sharp peak in the number of cases. This prevents healthcare systems being overwhelmed, reduces the total number of infections and allows time for treatment to be improved – and reduces the severity of the immediate economic impact. However this also extends the period during which new cases will be reported, and delays the point at which the number of new cases starts to fall – which will be a crucial indicator for public sentiment. Governments therefore need to focus on managing public confidence and reducing expectations that the outbreak will be quickly "halted".

**SECOND, THERE WILL BE KNOCK-ON IMPACTS ARISING FROM DISRUPTION TO SUPPLY CHAINS AND OTHER BUSINESS ACTIVITY.**

These include inability to source products/components, or cancellation of major conferences, exhibitions and other gatherings. Given the highly globalized nature of economic activity, the disruption experienced in major manufacturing locations such as China, South Korea and northern Italy is quickly transmitted to other parts of the globe. For example, the automotive and electronics sectors are already reporting significant disruption due to closure of suppliers in these countries; there will be a ripple-out effect as the impact spreads through the supply chains of systemically important industries. Evidence is already emerging of a significant global slowdown in manufacturing activity.

The immediate impact will be reduced economic growth during the outbreak, and for a period thereafter as activity takes time to recover. This slowing will be most significant in cities and regions where outbreaks are concentrated, but few areas will remain unaffected. A degree of "bounce back" is likely once the immediate threat posed by the epidemic is removed, with slower growth in the short term followed by a period of faster growth during the recovery. However, not all the lost growth will be recovered, and some regional economies will see more lasting impact.

**THIRD, THERE IS THE POSSIBILITY OF "CONTINGENT" IMPACTS ARISING FROM ECONOMIC DISRUPTION.**

Whatever the cause, slower economic growth will create significant difficulty for any businesses already struggling to maintain profitability. This is particularly true in places where the economic situation is already fragile, such as Japan or many parts of Europe. As was clearly evident during the financial crisis of 2007-08, stress in one part of the economy can easily translate into business failures elsewhere that are not currently visible or easy to predict. Governments are clearly aware of these risks; authorities in China, Hong Kong, Japan, Italy and Germany have already announced stimulus measures designed to support businesses, and others (notably the U.S.) are likely to follow suit.

**FINALLY, THERE WILL BE REDISTRIBUTION IMPACTS ARISING FROM GOVERNMENT, CORPORATE OR INDIVIDUAL RESPONSES TO THE CRISIS AND ITS IMPACTS.**

A heightened level of uncertainty around Covid-19 will compound existing concerns over geopolitics and other risks. A shift towards "risk off" decision-making is already encouraging flight to secure assets, hitting equity markets and driving down government bond yields. Market odds of a U.K. rate cut have risen from 6% a week ago to more than 30% currently; the ECB is also expected to cut rates despite having little scope to do so. In the U.S., the federal reserve has already implemented a 50bps interest rate cut, and markets are indicating an 80% probablility of further cuts this year. While such cuts will help support economic activity, elevated uncertainty and risk will cause some businesses to delay investment or expansion plans, some of which will be deferred indefinitely if the overall economic outlook deteriorates further.

**OVERALL, MCKINSEY'S BASE CASE FORECAST IS A 0.3- TO 0.7-PERCENTAGE-POINT REDUCTION IN GLOBAL GDP GROWTH THIS YEAR, WHILST OXFORD ECONOMICS' (OE) ESTIMATE IS SLIGHTLY HIGHER AT 1.3%.**

This impact will be unevenly distributed. Poorer countries that are less well equipped to deal with the medical aspects of the crisis are likely to be most affected, but OE believe both America and Europe could be at risk of a recession.

## Real Estate Implications

Real estate is often described as "the economy in a box", and thus anything which reduces rates of overall growth will impact the real estate market from both an occupational and an investment perspective. However, there are some clear sectoral differences in the likely impact on the market, and there is also a distinction between the short-term effects expected and some of the potential longer-term implications.

- 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 more temporary "wait-and-see" disruption are not viewed as particularly badly affected**. In the U.K. the FTSE 350 REIT Index fell 11.1% over the week ending 28th February, in line with the decline recorded by the FTSE 350 overall. In the U.S the S&P 500 REIT index fell 12.6% during the week, slightly more than the 11.5% decline in the S&P 500 overall but less than the fall 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 hotels sector is particularly vulnerable to a decrease in tourism and measures to limit public gatherings at conferences and sporting events – many 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 also exacerbate the challenges faced by the retail sector.** In-store comparison goods retailing will suffer in markets where rates of infection increase materially, although ironically some of the most successful areas of the market could be hardest hit. Tourism-related retail, food and beverage outlets, supermarkets, major city centres and dominant malls will all suffer from compulsory or self-imposed travel restrictions, as people avoid locations seen as higher 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.
- **Across most sectors and markets, leasing activity is likely to see a degree of decline in transaction volumes compared with pre-crisis expectations.** If affected at all, transactions currently under consideration are likely to be delayed rather than cancelled, but most such disruption will prove temporary. 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.
- **Disruption to supply chains will impact the industrial and warehouse sectors.** Although U.S. Industrial REIT prices have been hit hardest within the S&P 500 property sector, supply chain reconfiguration and a shift towards regional or local suppliers could ultimately boost demand for warehouse and production space in some markets.
- **It is likely that rates of homeworking will increase, especially in areas most significantly impacted by the outbreak.** This could accelerate the adoption of new technology and flexible working practices, with a proportion of businesses and workers continuing to work more flexibly on a permanent basis, with consequent longer-term impacts on office leasing markets.
- **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, at least during Q1 and potentially into Q2/3 as fewer new transactions are 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.
- **On balance, it seems likely that extending the length of the outbreak to reduce its severity will have at least some impact on investment transaction volumes for 2020.** Given that the aim of containment policies is to slow rather than completely prevent the incidence of new cases, the impact on transaction activity depends on two factors that are extremely difficult to predict. First, how well investors are able to cope with the inevitable disruption. Second, and probably more important, how effectively governments are able to manage public and business confidence that the outbreak is under control.
- **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 current uncertainty is alleviated.** It should also be noted that demand for real estate investments 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.
- **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.
- **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 more modest economic slowdown to morph into a serious recession.
- **The COVID-19 crisis does highlight the fragility of some globalised 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 *elsewhere.*

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.

**Nick Axford**
Global Head of Research
+44 (0)20 7911 2939
nick.axford@avisonyoung.com

**Visit us online**
avisonyoung.co.uk