

Outlook special

Potential impact of COVID-19 on global real estate markets

March 2020



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Dear reader

COVID-19 is an evolving scenario with varied economic impacts, depending on country, market, and sector. The severity will, of course, influence real estate demand and will most likely change by the day. It is impossible to say what the exact downgrade to GDP growth – and therefore real estate demand – will be.

However, it is clear that occupier demand will be negatively affected, most significantly in retail, leisure and hotels, as movement is restricted and consumer confidence dented. As a second round effect, this will impact on logistics demand as goods movement slows, although there is a potential short-term benefit to some forms of ecommerce.

Also, businesses tend to defer decision making when there is uncertainty, and this will affect job creation and therefore office demand. In short, there will be an impact on property performance but its severity depends heavily on the duration and spread of the virus, which is very uncertain. SARS, for instance, had a short, sharp impact on growth, which translated to property values, particularly in Hong Kong (most dramatically in the residential sector).

Fergus Hicks
Real Estate Strategist

APAC: What we will learn after this episode is over

Real estate investors in APAC will be able to glean a few insights from this global health epidemic, and we believe developments in the past month have accelerated and corroborated some emerging themes in the real estate space.

Selective on China industrial real estate

The re-routing of supply chains out of China will likely pick up pace, and even become a priority for many industrialists. The world learned the hard way in 2019, as the US-China trade flare up resulted in collateral damage for manufacturers with substantial production linkages within China. With severe disruptions in the availability of intermediate production components and not helped by the long (uncertain) period of factory closures, many producers will see this episode as the validation that is needed to diversify their exposure to China.

Are we implying that investors steer clear of the industrial property sector in China? That is not totally the case, but this virus pandemic does highlight the certainty that low-end manufacturing will start to exit China. And in its place, real estate investors should be looking at logistics catering to the commerce story, and high-end manufacturing and production facilities that continue to be a long-term ambition of China's "Made in China 2025" plan.

Hold your horses on SEA logistics

The second learning point is related to the previous one. The 2019 trade war had investors really excited about the prospects of the industrial real estate markets in Southeast Asia (SEA), particularly Vietnam, Indonesia and Malaysia. We do not think that this has changed with the COVID-19 issue, but we do want to caveat that manufacturing in SEA is highly dependent on China.

The complexity of China's involvement in regional supply chains should not be underestimated. This virus outbreak has already exposed the weakness of many emerging SEA markets struggling with the potential value chain disruptions. Even if the industrial sector in SEA benefits significantly from spillover effects, intermediate production goods in many instances still rely heavily on China's exports. In the near term, there will not be a total hollowing out from China, as the displacement will take years to be effective for many players looking at SEA's industrial sector.

Office tenants review real estate requirements

The notion of mobility and flexible working is being truly tested during this COVID-19 crisis. As countries seek to limit human-to-human contagion, many companies have activated business contingency plans, with home-based working becoming a daily routine for many workers. In other instances, employees are dispatched to alternative work locations where they can perform the same functions with the aid of technology.

Before this epidemic, working from home or mobile working was arguably more a concept that was "good to have" but never really implemented in a big way, at least in most of APAC. When this COVID-19 outbreak is behind us, we believe many office tenants will review their fixed real estate space requirements, especially if this involuntary experiment with mobile working has resulted in comparable levels of efficiency. It does not mean that companies will cut down on their office footprint drastically, but it is likely that there might be a stronger inclination towards shared workspaces, which frees up the long-term lease commitments of many office tenants.

Corporate demand for co-working or flexible working spaces should get a boost, as it becomes increasingly clear that technology can enable the optimization of office occupancy costs without sacrificing productivity. This is not all good news for office landlords but it does suggest that adopting active leasing strategies to capitalize on the workspace of the future may bear fruit for pre-emptive office space owners.

Greater aversion towards hotel and retail sectors

There has already been a general reluctance and aversion towards investing into sectors and markets that rely heavily on tourism and human flow. The GFC and SARS outbreak exposed many hotel and retail investments to huge fluctuations in capital values and income, as the tourist tap seemingly turned off overnight. We can list Japan hospitality as a prime example, where even the recent allure of the tourism story in Japan could not motivate most conservative investors.

Indeed, some sectors are susceptible to even the mildest of disruption in the movement of people across borders, and that could be caused by geopolitical factors, not necessarily a virus outbreak. We expect that investment return requirements in the hotel and selective prime retail segments may be adjusted upwards. However, from a bottom-up perspective, we remain positive on assets that embody strong locational attributes and are more resilient.

Europe: The current situation is volatile and sentiment driven

The impact of Covid-19 on European real estate market varies between countries and depends heavily on how quickly the virus will be contained but also how quickly business and consumer sentiment recovers.

Even if the virus is contained within the next couple of months many European countries are likely to be close to, or in, recession in 2020. Our base scenario at our most recent European real estate market forecasts has already assumed slowing economic growth. In a "contained virus scenario" we anticipate that sector relativities are likely to be unchanged. Retail is likely to underperform as the virus may act as an accelerator of the structural challenges the retail sector is facing anyway. The same is likely to happen in the hotel sector, which is heavily exposed to the global travel industry.

In the office sector, rental growth is likely to become more muted despite a general constraint in office supply and development activity. The same applies for the industrial sector as logistics is a low-margin business. The residential/multi-family sector is most likely to be less affected because demographic mega trends are the major driver. In a more downside scenario with significant rising unemployment rates, rents in the residential sector could also be placed under pressure.

In the short term, pricing could become affected by low liquidity but this assumes that investors are taking a wait and see attitude. As the retail sector is more leveraged than others, and as this sector is more challenged in the short term for the occupier side, we expect more motivated/distressed sales which may accelerate the already happening down valuation. Similarly the hotel sector is more leveraged than other commercial real estate sectors.

Core is likely to be less affected than value strategies as investment underwritings need to be reviewed. The yield spread between core and value-add assets has hardly been existent in many office markets. Despite expected supportive fiscal and monetary policies that should keep interest rates and bond rates even lower for longer, the lower expected rental growth outlook may lead to a slight increase in real estate yields – not only by risk style but also by market.

As rental growth is likely to become more muted (and our capital growth forecasts have been mainly based on rental growth), lower capital growth can be anticipated. We expect that the rankings of our country forecast are likely to be unchanged. In the UK, capital growth might be lower than anticipated but as yields in the UK are above other major European markets the UK is likely to outperform despite the current challenges. Italy, currently the most affected country in Europe, has been on the bottom of our country ranking. In our current forecast we predicted little capital appreciation for the Italian market, and taking the current situation into account, a decline in capital values on the basis of falling rents and income levels is likely.

Offices

Low supply supports real estate market fundamentals

- Uncertainty will dampen new demand in the short term, but unless there is a major downturn occupation levels should remain steady.
- Very low vacancy and a limited pipeline (which may shrink further) will support rents even with weaker demand.
- Serviced office models may be properly tested for first time as their flexibility enables the self-employed and corporates to quickly vacate space they no longer need.
- Over the medium term, forced working from home may break down cultural resistance in some markets and reduce floorspace per worker ratios

Slow investment markets but limited impact on valuation / price movements

- Investment activity is likely to be low in 1H20.
- Investors may re-assess their underwritings, in particular on future rental growth expectations.
- But even lower interest rates may negate weaker rental growth once the market returns.
- Valuation levels depend on how valuers factor in lower liquidity (in the short term).
- We expect a "wait-and-see" approach in the short term but don't expect vendors to offer discounts.

Retail

Falling tenant demand and rents

- Deteriorating consumer sentiment and demand expected which may lead to an increasing number of CVAs (in particular) confronting already weak retailers
- Store expansion plans are likely to be deferred.
- Retailers are expected to cut rents and defer rental payments.
- As investor rental income depends in many cases on store's turnover, falling income returns are likely
- Luxury streets are likely to be particularly impacted in the short term due to dependence on global tourism.
- Less cyclical retailers such as supermarkets likely to be more resilient.

Falling investment volumes and acceleration of re-pricing

- Investment activity is likely to be very low in 1H20
- Additional uncertainty due to COVID-19 may accelerate the re-pricing in the retail sector
- Some distressed situations are possible if income levels fall while assets are relatively highly leveraged

Living / Beds

Hotel sector under pressure but multi family stable

- Slowdown in global travel volumes influences hotel's occupational levels negatively.
- Independent or small hotel chains might be more exposed to a protracted period of low demand than biggest chains.
- Income streams of hotel investments with management/operational contracts are likely to be more effected than hotels with traditional leases.
- Hotel operators on leases may put pressure on rental payments.
- Effects on multi-family likely to be very limited because markets are more driven by demographic mega trend. If unemployment rates rise significantly future rental growth expectations may need to be revised downward.

Effects on the hotel sector significant but multi-family more limited

- Particular low investment volumes in the hotel sector expected which may lead to re-pricing and revised valuations.
- Limited effects on the multi-family sector expected.

Logistics

Less strong market fundamentals in the short term

- Online retail may benefit from COVID-19 but low consumer sentiment may effect online sales as well (short term).
- As logistics is a low-margin business, difficulties in the global supply chain will affect 3PL network expansion plans but could lead to CVAs (short term).
- In the short term supply chains will see disruption as raw materials and intermediate goods trade to/from China (but also within Europe) are disrupted.
- Industrial companies may re-assess their supply chains supporting nearshoring to Europe but this requires significant medium-term capital investment. Rental growth might be muted despite supply shortage.

Slightly lower investment volumes but stable to rising valuations and prices

- Slightly lower investment volumes on the back of overall lower market liquidity.
- Attractiveness of the sector is likely to lead to stable or even rising prices/valuations

US: Base case and downside scenario planning

At the end of every year, our US Strategy Team meets to review a research-led outlook. In 2019, we did not foresee COVID-19 or related disruption on the way, but we were proactive with scenario planning. Research & Strategy led the Portfolio, Transaction and Asset Management teams in a thoughtful discussion around a base case and alternative scenarios where we challenged ourselves to imagine the

investment environment could be better or worse than expected. Table 1 is what our teams reviewed at our discussion in December 2019. Our base case anticipated a slowdown in US economic growth. We noted the fragility of global growth with a downside scenario where we acknowledged that the economy was vulnerable to unforeseen shocks.

Table 1: Performance scenarios from Outlook 2020

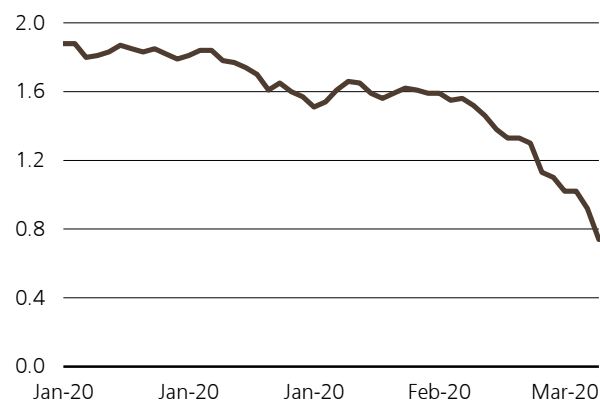
| 2019 | | 2020 | | |
|------------|----------------------------|------------|------------|-------------|
| Estimates* | | Downside | Base Case | Upside |
| 2.2 | GDP (%) | 0.4 | 1.4 | 3.4 |
| 2.0 | Employment (mill. jobs/yr) | -1.0 | 0.8 | 1.0 |
| 1.7 | Inflation (%) | 1.6 | 2.2 | 3.3 |
| 4.1 | Retail sales (%) | 0.4 | 2.5 | 5.5 |
| 4.4 | NOI growth (%) | 2.5 | 3.3 | 5.5 |
| 10 | Cap rate change (bps) | 30 | 10 | 0 |
| 4.5 | Income return (%) | 4.7 | 4.5 | 4.5 |
| 2.1 | Appreciation (%) | -4.0 | 1.3 | 5.5 |
| 6.6 | Total return (%) | 0.7 | 5.8 | 10.0 |

Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy – US based on data from UBS Investment Bank, NCREIF and Moody's Analytics as of September 2019. Economic data are expressed as fourth-quarter over fourth-quarter rates of change except for retail sales where growth is the average annual change. * 2019 Estimates based on actual data as of October 2019. Past performance is not indicative of future results.

Our original base case expecting a slowdown in real GDP growth from 2.2% in 2019 to 1.4% in 2020 still seems to be a possible outcome, with the caveat that the macro response is evolving rapidly. The first half of 2020 may produce very slow or no growth. If the virus is contained within a few months, consumers, businesses and markets will likely ease up on their risk assumptions, allowing growth to improve. By the end of the year, the results of the US election will be known – removing another uncertainty – and growth could be poised to rebound in 2021. Consistent with our expectations for income-driven performance, real estate net operating income (NOI) growth should remain above inflation even though transaction volumes will likely shrink temporarily.

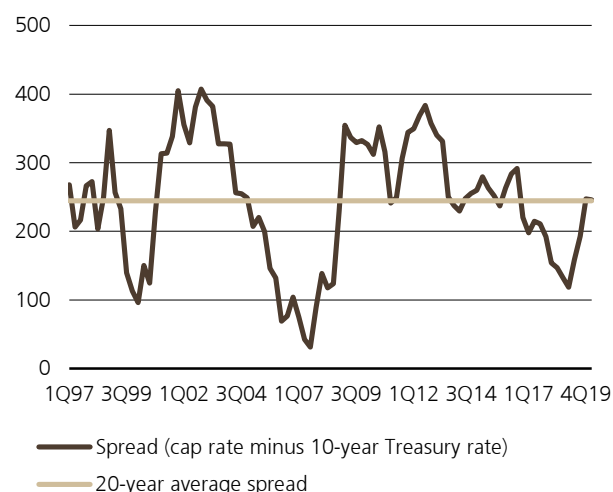
Even though we still expect low, positive economic growth for the full year 2020, there are more immediate macro impacts that real estate investors should consider. Equity markets have experienced large declines, which may lead to a denominator effect as real estate allocations rise simply because equity positions have lost value. As demand grows for lower risk and interest-bearing assets, interest rates have fallen rapidly (see Figure 1). There is no evidence of upward movement in US real estate cap rates, which implies that the spread on real estate investments, shown in Figure 2, will move above average once first quarter data are released. The spread has widened because the risk premium increased. We address this topic in detail in our US Real Estate Outlook 2020. Wider spreads do not imply that capital will flow into real estate. Transaction volume is almost certainly already slowing due to uncertainty, but when the virus peaks and uncertainty fades, we would expect investors to be ready to come back into the market seeking opportunities.

Figure 1: Recent trend in 10-year Treasury rate (%)



Source: Moody's Analytics as of 6 March 2020.

Figure 2: Core cap rate to 10-year Treasury (basis points)



Source: NCREIF Fund Index-Open-end Diversified Core Equity and Moody's Analytics as of December 2019.

The full effect of our downside scenario remains unlikely. Still, if the spread of the COVID-19 is not contained quickly, we would expect economic growth to slow more than our base case, and having a downside scenario helps us stress test assumptions and plan proactively. If the economy slowed more than our base case, NOI growth would still be propelled by existing leases for much of the year. As such, income-driven strategies should prove more resilient than those seeking aggressive growth. Transaction volumes would slow considerably, despite the low cost of debt, as real estate investors price in diminished future income expectations.

However, transactions should rebound when economic conditions improve. There should not be widespread distress. Today's high occupancy rates imply that most assets can continue to service debt payments even during a negative but quick economic event. More uncertainty and slower transaction volume would place upward pressure on cap rates, but steady income offsets the drag from the capital markets, resulting in a positive total return on unlevered real estate even in a downside scenario.

Pressures by property type

Not all property types are facing the same pressures. Travel restrictions and virus containment efforts will likely impact the hotel and retail sectors negatively in the short term. If the virus peaks quickly, consumers and business should resume leisure and shopping activities, resulting in improved conditions later in the year.

Performance of industrial assets should be more nuanced. Lower growth implies a temporary slowdown in the demand for goods, which could be a drag on logistics generally. Supply chains were already under pressure from trade renegotiations and tariffs, and the global nature of containment efforts will likely cause further slowing in fulfilling orders for both inputs and final purchases. On the other hand, less traffic through public spaces, like restaurants and shopping centers, should support ecommerce and home delivery.

COVID-19-related closures and market swings should have a less direct impact on the office and apartments sectors in the short term, assuming the virus is contained quickly and growth rebounds as expected. However, a more pronounced slowdown in the job market would create a more obvious drag on office and apartment demand. If diminished growth persists beyond the spring of 2020, the sluggish economy, pessimistic consumers and risk-wary businesses would likely result in slower lease-up for office space and less apartment rent growth. These lagged effects should begin to reverse after the spread of the virus is contained and growth resumes.

When there is heightened uncertainty in the market, the benefits of diversification become most apparent. Even in the face of capital market uncertainty, private real estate performance should reflect continued ability for assets to generate income and cover debt service.

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