

Real Estate Outlook

Global overview – Edition 4, 2020



Vaccine trials give hope for 2021



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Rise in virus cases threatens recovery,
while vaccine presents an **exit route**.



A widespread rise in virus cases threatens the economic recovery, though positive news on vaccine trials points to brighter prospects for 2021. Investment activity remains subdued. Real estate capital value movements have varied by sector and showed small falls at the all property level in the third quarter. So far there is limited distress in the market, but we expect some investment opportunities to be generated.

Macroeconomic overview – Renewed lockdowns to weigh on economy in final quarter

COVID-19 continues to have a pervasive global impact. As of 9 November, the World Health Organization reported a total of 50 million cases and 1.25 million deaths worldwide. Following a sharp drop in new cases over the summer in northern hemisphere countries, there was a widespread increase in new cases moving into the autumn. Part of the rise almost certainly reflects increased testing for the virus, but nonetheless it is also due to an underlying increase in the number of cases. In response, some US states and many European countries have implemented new lockdowns, with some at the national level. By contrast, Australia, now entering its spring, has seen a sharp fall in new cases and ended the lockdown it implemented in Melbourne over its winter months.

The virus is impacting the economy in different ways, which can be seen in three broad areas. First, manufacturing, industry and construction, which after the initial shock have been able to implement social distancing protocols into their production processes and been able to continue operating. Second are the knowledge and intangible industries such as technology, software and finance, which have been able to continue to operate effectively outside of their normal office environments. Finally, are those sectors which involve in-person human interaction and continue to be hit hard, with a full recovery unlikely until the virus is gone. These are the retail, hospitality, tourism and leisure sectors.

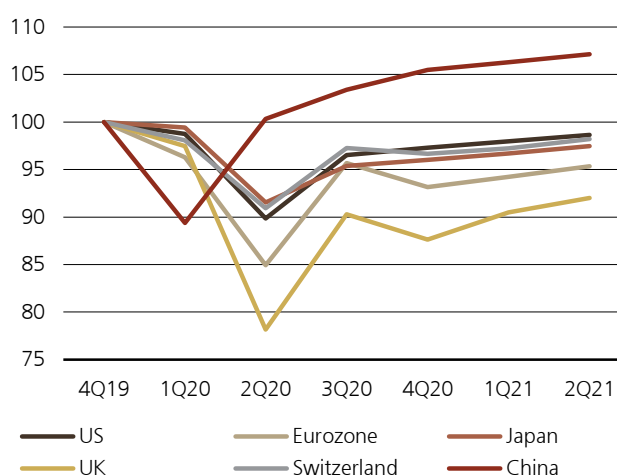
The rise in virus cases and new lockdowns create a clear risk to the economic recovery. Indeed, the latest economic forecasts are for some countries to slip back into negative growth in 4Q20 (see Figure 1). A sustained recovery in 2021 will rely on a vaccine becoming widely available. Trial results released so far have found both the Pfizer-BioNTech and Moderna vaccines to be highly effective. Three conditions must be met for a vaccine to be successful. First, it must be possible to rapidly manufacture and distribute a vaccine at scale. Second, governments and health systems must be able to effectively organize inoculation for the targeted population. Finally, the population must have the confidence in and be willing to take a vaccine which has been developed at record speed.

Central banks were quick to support their economies at the start of the pandemic. They cut interest rates to zero, implemented new QE spending – for the first time in some countries such as Australia and Canada – and introduced new lending programs for businesses in need. As the second wave of the virus hits, the central banks have less ammunition.

However, the European Central Bank is expected to increase the size of its asset purchase program in December while the Bank of England announced an additional GBP 150 billion of QE asset purchases at its November policy meeting. Rather, central banks have been explicitly calling on governments to provide any additional support necessary via fiscal stimulus.

The UK announced an extension of its furlough support scheme until March next year to accompany its new lockdown in November. In the US, an agreement by Congress on a new fiscal programme looks unlikely until after the new president is sworn in, in January. The IMF has changed its guidance on government debt since the Global Financial Crisis (GFC) and is now not recommending a rush to austerity to pay off increased debt once the pandemic has ended. Nominal GDP growth is above nominal interest rates and means that higher debt loads are now thought to be sustainable. This will be a relief for the increasing number of countries where debt is now above 100% of GDP. Ultimately, debt will need to be addressed in one of four ways, or a combination of: higher taxation, reduced spending and austerity, inflation or default. Governments can delay this difficult choice until a later date.

Figure 1: Real GDP forecast (index, 4Q19 = 100)



Source: Oxford Economics, November 2020

Another area of concern is the level of scarring which the economy will suffer following the downturn and how quickly jobs can be re-deployed in the most affected industries. Weak investment spending by firms in 2020 is set to have an enduring impact on the productive capacity of the economy. According to Oxford Economics the expected drop in investment spending (including housing) in 2020 varies by country, from 1.7% in the US, 5.0% in Japan, 9.6% in the Eurozone and 13.4% in the UK, while it is forecast to rise by 5.3% in China. These differences will impact on the growth potential of these economies once the pandemic has eventually passed.

Capital markets – Investment activity remains subdued

Real estate investment activity remained subdued in 3Q20. Despite lockdown restrictions being eased in the summer, international travel remained challenged and continued to impinge on the real estate transaction process, particularly for cross-border investors. According to Real Capital Analytics, global transaction volumes were down 33% in USD terms in the first three quarters of the year compared to 2019. After adjusting for seasonal effects activity slipped 5% in 3Q20, to leave it 52% below the level in the final quarter of 2019.

With new cases of the virus rising and lockdowns being implemented again in many countries, transaction activity looks likely to remain subdued in the final quarter of the year. Traditionally the last quarter has been a time when activity levels have been higher as investors try to complete deals before the end of the year. Despite these impediments, investors continue to target the asset class, with Preqin reporting USD 338 billion of capital targeting real estate globally as of November 2020. We expect activity to pick up in 2021, but this is very much dependent upon the virus easing and vaccination becoming available. If the virus is not brought under control and lockdowns continue, real estate investment activity would also likely remain subdued.

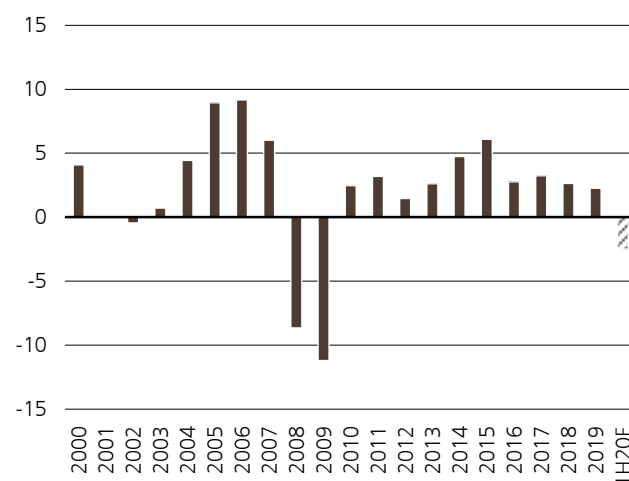
Following the initial uncertainty over the impact the virus would have on the economy and real estate market, some clarity has emerged on property pricing. Real estate capital values have held up well given the scale of the economic downturn. Based on data released so far, we estimate that global real estate capital values fell around 2.5% in the first half of the year (see Figure 2). Moreover, initial data for 3Q20 show that declines eased from 2Q20. In the US capital values were pretty flat, according to NCREIF data, falling just 0.3% QoQ. According to MSCI the pace of decline in the UK slowed to 1.0% QoQ, while in both Canada and Ireland it eased to 1.4% QoQ.

Big differences in sector performances remain, reflecting investor sentiment and the way that the crisis is affecting different property types. Office values continued to show small falls in 3Q20, making for a year-to-date drop in the low single digits of 2-4% for the four countries previously mentioned. Falls in retail capital values have been much more significant, ranging from 9% in the US for the year-to-3Q20 to 15% in Ireland. Industrial values, on the other hand, have been much more resilient and rose in all four countries in 3Q20. This left them down 0.6% so far this year in the UK and up 3.3% in the US.

Overall, these trends suggest that the total return on global real estate for 2020 will be around zero, and possibly slightly positive. Trends in cap rates and yields mirror those seen in capital values. Of the 332 city-sector markets we monitor globally the share reporting a rise in yields fell to 20% in 3Q20 from 30% in 2Q20 and 32% in 1Q20. The increases were by far focused on the retail sector. By contrast office yields were fairly flat, while industrial yields fell in 42% of the markets covered, were unchanged in 52% and increased in just 6% of markets. This reflects strong investor appetite for logistics property and an aversion to retail, where price correction is taking place. For offices, flat yields reflect some uncertainty over the prospects for the sector going forward due to the impact of home working.

Figure 2: Global real estate capital values

(local currency, unleveraged, % change)



Source: MSCI; NCREIF; UBS Asset Management, Real Estate & Private Markets (REPM), November 2020

Following their initial recovery in April and May, REIT markets have remained fairly range-bound. REIT prices for global developed markets were down 24% for the year to the end of October. Apart from industrial, the sector indices were also range-bound after their subsequent rebound following the initial sell-off as the virus struck. Industrial REIT prices on the other hand continued to rise. Having been broadly flat in the first half of the year, prices (in USD terms) rose subsequently to leave them 14% higher by the end of October than they were at the start of the year. The stronger showing for industrial on listed markets mirrors sentiment in private markets. A key question for investors going forward is how much rental value growth logistics property will deliver and what level of valuation it supports.

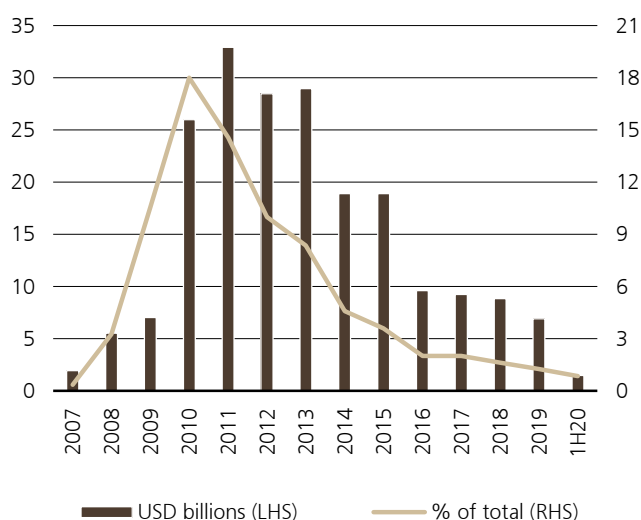
Strategy viewpoint – Limited signs of distress so far

Historically, economic recessions have gone hand-in-hand with downturns in the real estate market, which have forced owners to sell assets for a variety of reasons. For example, they might have breached loan covenants by breaking loan-to-value ratios (LTV) or missed debt and interest payments.

Alternatively, investors may be forced to sell assets to generate liquidity to meet other financial obligations. Similarly, real estate funds may need to sell assets to generate liquidity to meet redemption requests from their investors.

During the GFC, it took time for distress to work its way through the system to final asset sales. For example, according to Real Capital Analytics, distressed asset sales in the US peaked in 2011 at USD 33 billion, 14.6% of that year's total transaction volume (see Figure 3). Distressed sales remained elevated until 2013, after which they began to ease off. So far, we have seen relatively few distressed asset sales in this downturn, though we are still in the early stages of distress working its way through the system. For example, during the first half of the year distressed asset sales in the US were just 0.8% of the total transaction volume.

Figure 3: US distressed asset sales (USD, % total)



Source: Real Capital Analytics, 2Q20

In general, we do not expect to see the same levels of distress in this crisis that we did during the GFC. This is due to several reasons. First and foremost, although the speed and depth of this recession has been much greater than that of the GFC, the economy is expected to recover to pre-crisis levels sooner.

For example, Oxford Economics expects the advanced economies to reach their pre-crisis level of output by 1Q22, while it took a further three quarters to regain that level of output in the GFC. This is clearly very much dependent upon how the pandemic evolves and the ability to make a vaccination widely available. Second, in the run-up to the pandemic lending by banks and non-bank lenders against real estate assets was more restrained and had not reached the levels seen in the credit boom prior to the GFC, when lending standards eased substantially. Loan covenants and LTVs have been stricter this time, giving borrowers more of a cushion should values fall or market distress be experienced.

However, we do expect to see some distress arising due to the pandemic, and we expect it to be focused on those sectors where future income and capital values are suffering the most. Primarily this means the hotel and retail sectors, where we have seen the sharpest falls in capital values so far. The value declines may see loan covenants breached for some assets and result either in investors being forced to sell assets, injecting more equity into properties by paying down debt, or result in properties being re-possessed by lenders and subsequently sold on. Office values have held up well so far, though weaker assets which experience capital value decline and are the most exposed to the impact of home working and structural change on the sector could also be potential areas of distress.






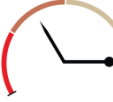







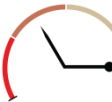





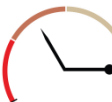






For investors looking to deploy capital, distress in the market can lead to opportunities to buy assets at below market prices and create good investment opportunities. The scope for repositioning retail assets and converting them to other uses is a good example. However, investors must be careful in determining the value of assets for sectors like hotels and retail, where the outlook is most uncertain. They should also have strong business plans in place for how they would manage and potentially reposition any distressed asset purchases.

Hence distressed asset sales, although potentially painful for the original owners and lenders involved, can present investment opportunities at the right price for new investors. Overall, the focus of investors looking for lower risk, core assets at the moment has been the industrial and logistics sector. Residential and multifamily has also been an area of interest and is seen as more resilient.





However, investors are also expressing more interest in alternative sectors, such as medical offices, data centers and laboratory space. Investors will likely continue to focus on these sectors moving into 2021 given uncertainty over the traditional commercial property types. Although for the time being they remain small relative to the overall investment universe, identifying new and growing real estate sectors will be key for investment success moving into 2021 and beyond.

Real estate investment performance outlook

2019 performance and 2020-22 outlook are measured against the country-sector's long-term average total return, with a margin of 100bps around the average described as "in line with long-term average". The long-term average refers to the period 2002-19. The red underperformance quadrant refers to negative absolute total returns, either in 2019 or the 2020-22 outlook.

		LTA	Office	LTA	Retail	LTA	Industrial	LTA	Multifamily
North America	Canada	9.5		10.3		10.1		n/a	
	United States	7.9		9.9		9.9		8.3	
Europe	France	8.0		10.1		9.1		n/a	
	Germany	4.5		5.5		7.3		n/a	
	Switzerland	5.6		6.3		n/a		6.3	
	UK	7.5		5.9		9.5		n/a	
Asia Pacific	Australia	10.3		10.1		10.8		n/a	
	Japan	5.3		5.5		5.9		5.2	

 : Performance 2019
  : Outlook 2020-2022

 : Underperformance (negative absolute returns)
 : Underperformance vs. long-term average
 : In line with long-term average
 : Outperformance vs. long-term average

Source: UBS Asset Management, Real Estate & Private Markets (REPM), November 2020. Note: Abbreviation LTA: long-term average. A performance forecast is not a reliable indicator for future results.

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