Real Estate Outlook

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Positioning for post-pandemic.

UBS Asset Management

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Global overview

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The only certainty is the real estate landscape has changed, forever.

Economies have seen the sharpest contractions on record while massive central bank and government intervention has supported asset prices. In real estate the crisis has turbo-charged trends we were already seeing prior to the crisis, boosting logistics and hurting retail. We are now in the social-distancing phase, but investors need to think long-term and position themselves for once the pandemic has passed.

Macroeconomic overview – Rise in infections casts doubt on recovery

Compared to one quarter ago the number of people impacted by COVID-19 around the world has increased sharply. As of 12 August 2020 the global death toll stood at 737,417 and the number of confirmed cases was 20.2 million. However, a number of localized outbreaks have occurred recently, such as in Melbourne in Australia, Catalonia in Spain and several US states, including Florida. The uptick in cases is not unexpected and demonstrates the contagiousness of the virus. Opening up the economy entails a tricky balance between limiting economic damage and an increase in cases and mortality.

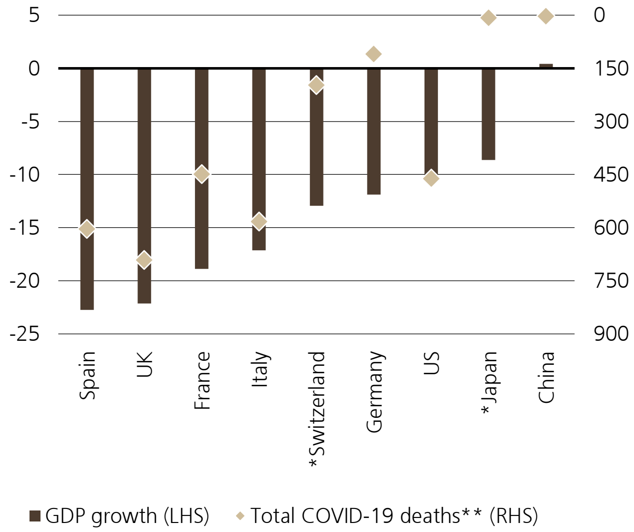
A vaccine would be the most certain way to bring the virus under control. The World Health Organization (WHO) has reported that 165 vaccines are in development globally, with 26 of those having reached clinical trials. Ultimately it seems likely that several vaccines will be produced, coming from several companies, with differing degrees of effectiveness and reliability. Overall, it seems likely that vaccination against COVID-19 will become available in 1H21. A key issue for governments will be the willingness of the population to use a vaccine that has been developed and approved rapidly.

Following much discussion and conjecture, we are finally receiving some factual economic growth figures for 2Q20. In general they were in line with expectations and showed large, double-digit declines in GDP. China fared better and reported a strong bounce-back, with the economy estimated to have grown by 12% QoQ. The overall contraction in economic activity in the first half of the year ranges from an estimated 23% in Spain to 9% in Japan, while China grew 0.4%. The figures wipe off several years of growth for most countries. In general economies which have been hit hardest by COVID-19, in terms of death rates, have seen the biggest economic slumps, though Germany and Switzerland have held up better than their mortality rates alone would suggest (see Figure 1).

A key risk is that schemes to support workers are not extended which results in large scale layoffs and unemployment. For example, enhanced unemployment benefits in the US expired at the end of July as Congress failed to reach a deal to allow for a rollover or replacement scheme. The news in Europe was more positive as the EU confounded expectations and heads of state agreed a EUR 750 billion recovery fund, including EUR 390 billion of grants. This is a sea change for the EU and marks the first time in the bloc's history that the European Commission will borrow on behalf of member states collectively as they pool debt and explicitly share liability.

The monetary policy outlook remains very much accommodative, with central banks holding interest rates near zero, continuing with asset purchase programmes and supplying loans to businesses of all sizes. In reality, even before the pandemic the Fed had returned to easing mode and interest rates now look likely to remain near zero for the foreseeable future. Indeed, central banks are weighing up options for additional measures like yield curve control, further forward rate guidance and altering mandates towards some type of inflation catch-up mechanism via price targeting.

Figure 1: 1H20 GDP growth and COVID-19 deaths
(% and per 1 million of population)



Note: *2Q20 based on forecasts, **as at 2 August 2020
Source: Oxford Economics; BEA; Eurostat; ONS; WHO, August 2020

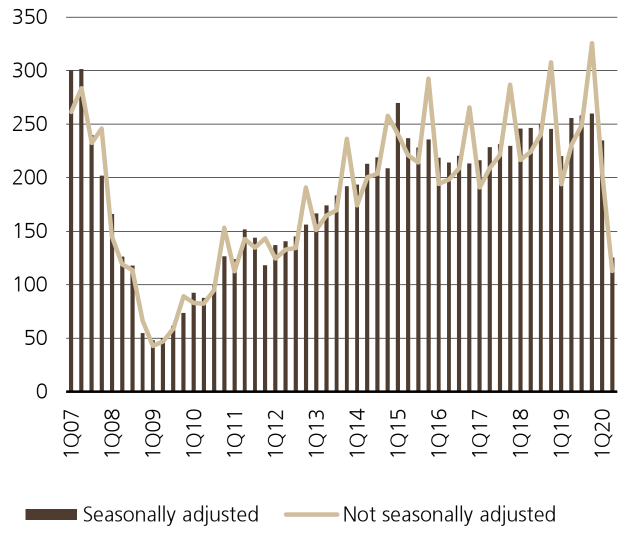
On the political front, things will likely get choppier in 2H20. The US presidential election looms in November and President Trump has suggested that high numbers of postal votes could invalidate the result. The Democratic candidate Joe Biden has shown a double-digit lead in opinion polls and victory would likely see changes in US policy. At the same time, Sino-Western tensions have risen following China's introduction of a security law in Hong Kong, the exclusion of Huawei from the UK's telephone network and disagreements in the tech space.

Following the pick-up in virus numbers the question now is whether the advanced economies will follow China's path of a strong bounce-back or whether further lockdowns will be needed, which in turn will see a renewed down-leg in growth in 2H20. Some choppiness in the economy seems highly likely, but our base case is that growth will recover moving into 2021 as the virus is brought under control and as some form of vaccine becomes available. Any sustained uptick in infections could stall the recovery though and see the economy remain in contraction as it moves into 2021.

Capital markets – Sharp drop in activity and rises in yields

Global real estate investment activity fell sharply in the first half of the year as COVID-19 created both uncertainty over real estate pricing and hindered the physical part of the transaction process as lockdowns and travel restrictions prohibited property inspections. After adjusting for seasonal effects, global investment volumes fell 10% in 1Q20 in USD terms and a further 47% in 2Q20. This left them down 52% in total in the first half of the year (see Figure 2). However, the size of decline has been less than that during the Global Financial Crisis, when volumes showed a peak to trough drop of 84%.

Figure 2: Global real estate investment volumes
(USD billion)



Note: Income producing properties for deals of USD 10 million and above
Source: Real Capital Analytics, August 2020

There were significant differences by region, with Asia Pacific volumes falling 28% in 1H20 in USD terms after adjusting for seasonal effects, EMEA dropping 36% and the Americas 70%. At the global level office volumes fell 56%, retail volumes 62%, industrial volumes 44% and apartment volumes 33%, while hotels showed the sharpest drop, of 80%. Following the easing of lockdowns over the summer and some clarity beginning to emerge on real estate pricing, we expect some recovery in transaction activity in the second half of the year. International travel restrictions remain widespread though technology, such as virtual building tours, is helping to overcome this. A second wave of the virus which necessitated further lockdowns and saw renewed uncertainty would put the brakes on a recovery in transaction activity.

Following an assessment of the shock due to COVID-19, real estate pricing has begun to adjust. Of the 332 markets we monitor globally 30% reported a rise in yields in 2Q20, similar to the 31% which reported a rise in 1Q20. A handful of markets (10%) reported a fall in yields while 60% reported no change. Just 16% of office markets reported an increase in yields, including New York, Paris and Shanghai. There were widespread increases in retail yields, with around half of markets (51%) reporting a rise. The picture was more mixed for industrial and logistics, with the bulk of markets (81%) reporting yields as flat, while 14% reported a fall, outweighing the 4% which reported a rise. For example, industrial yields fell in Dallas, Auckland and Copenhagen, reflecting investor perception and the general belief that industrial is the most resilient sector.

Based on results from the markets which report first, Canada, Ireland, UK and US, valuations fell across office and retail markets in 2Q20, while the picture was mixed for industrial. According to MSCI and NCREIF data falls in office values ranged from 1-2% QoQ, while retail saw larger declines of 5-9% and industrial ranged from a 1% fall to flat values. At the all property level values were down 2% in 1H20 in the US, 5% in the UK, 4% in Canada and 4% in Ireland. We expect further significant declines in retail values, smaller declines for offices while we expect industrial to remain more resilient as capital continues to target the sector.

Mirroring the broader stock market listed real estate values have recovered from their lows in March. However, there has been much more difference between sectors than between countries. For example, by the start of August REIT prices were down 20-25% year-to-date for the main countries. However, globally at the sector level, the worst performer was hotels, down 55% in USD terms and retail down 43%, while offices were down 27% and residential 10%. Industrial, on the other hand, bucked the trend and posted a 13% increase in prices year-to-August. These trends mirror sentiment in private markets.

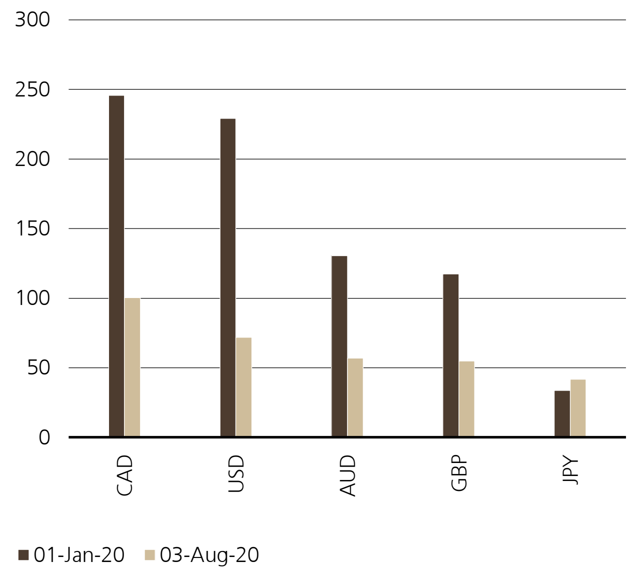
Investor interest in real estate remains strong, aided by healthy spreads between real estate yields and bond yields as near-zero interest rates have presaged falls in bond yields. Preqin reported that as of August USD 337 billion of capital was targeting real estate globally, down from USD 371 billion at the end of 2019. Adding on even modest leverage means there is a significant amount of capital looking to be deployed into real estate. On the supply-side, as of July Preqin reported that there were 903 closed-end funds looking to raise an aggregate of USD 273 billion. Open-end funds provide further opportunities for investors.

Strategy viewpoint – focus on sector allocations

The COVID-19 pandemic has resulted in the sharpest economic contraction on record. However, asset markets have held up surprisingly well and better than might be expected given the size of the downturn. The swift and big intervention by central banks and governments has supported risk assets and put a floor under their prices, including real estate. As such, rather than the 20% decline we saw in global real estate values during the Global Financial Crisis we think they will drop by around 7% this year, and may prove more resilient.

The pandemic has turbo-charged the pre-crisis trends we were already seeing in the real estate market and has been much more about sectors than geographies. At the current juncture we think a broadly neutral allocation between the different regions seems appropriate, particularly given that the move to near-zero interest rates by the world's central banks has flattened hedging costs globally. For example, at the start of the year euro-denominated investors investing into the US faced annualized hedging cost of 230 bps, while by early August they had fallen to just 70 bps (see Figure 3). Moreover, hedging costs do not look set to rise anytime soon given that interest rates are expected to remain on hold.

Figure 3: 3-month hedging costs by currency for euro
(bps, p.a.)



Source: Thomson Datastream, August 2020

With regard to sectors we think investment strategy should broadly mirror our advice before the pandemic broke out. This includes an overweight allocation to the industrial and logistics sector, and a broadly neutral allocation to offices and underweight to retail. There is uncertainty over the office market and the extent to which a permanent rise in homeworking will reduce office footprints once the pandemic has passed. Meanwhile, retail, the sector which was already out of favor with investors, is suffering even more due to the crisis, while industrial is benefiting. We expect further significant declines in retail values, with purchases only viable if at a significant discount to pre-crisis values.

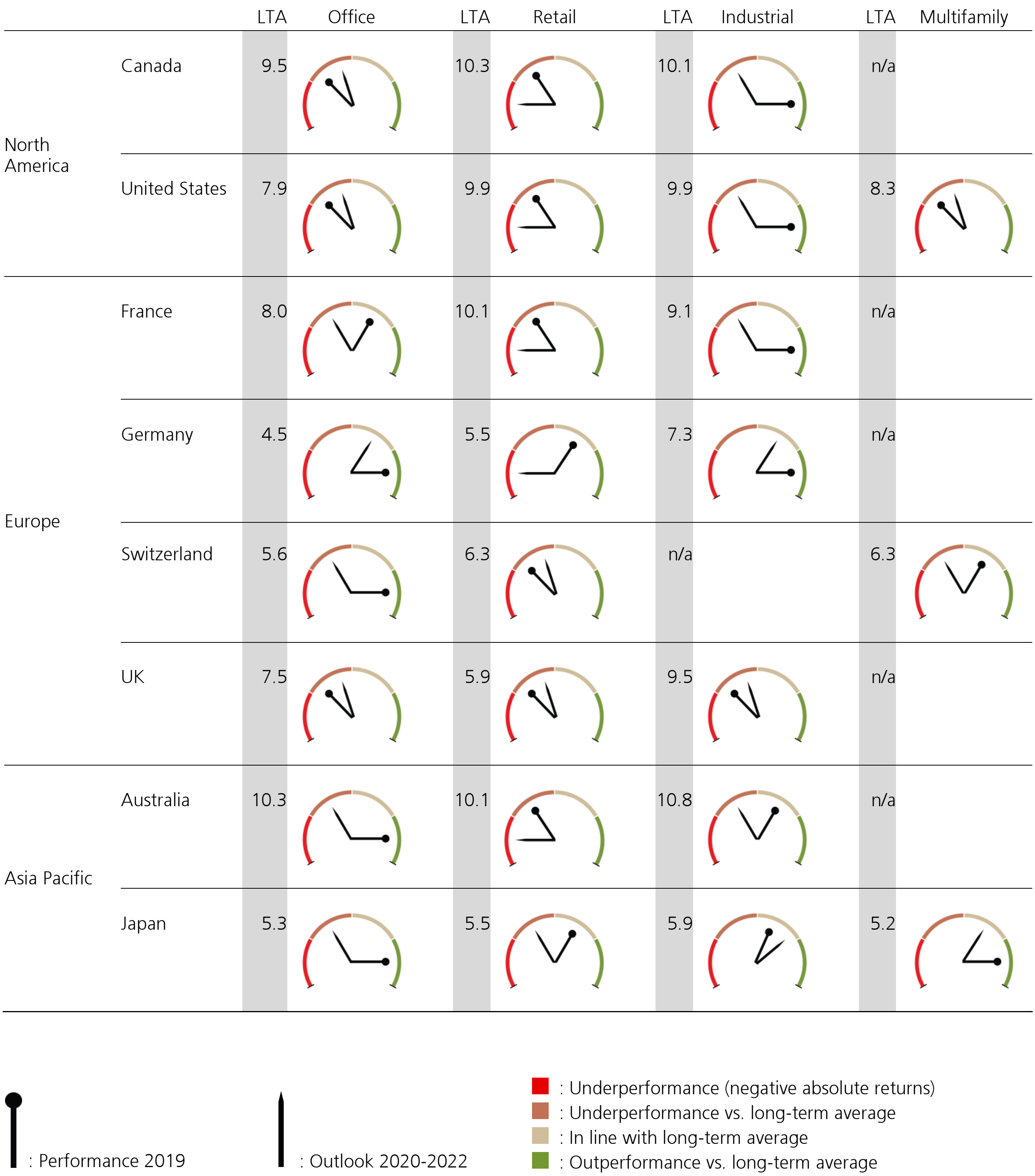
Certain parts of retail will likely prove more resilient, such as convenience retail and grocery retail. However, even grocery retail and supermarkets are being encroached on by the rapid rise in online sales, which accelerated during the lockdown. Online grocery is a challenging area for operators though and has proved less profitable than they would like. Although supermarkets have seen sharp increases in online sales during the pandemic, they have also struggled to meet volume demands and seen sharp increases in costs too.

Since the current crisis is a health crisis rather than stemming from the economy and imbalances within it, we have seen less stress in real estate markets and few forced sales of assets. However, some dislocations will exist and present opportunities for investors who manage to find them. For example, retail assets which have viable alternative uses in the form of residential or logistics space are an option for higher risk investors.

With economies mostly out of full lockdown we are now in the social-distancing phase of the crisis. How long this will last is unclear and will depend upon how quickly the virus can be contained. Businesses will have to continue to operate with social distancing measures in place for some time. For example, the de-densification of offices and continued home working, retail outlets limiting the numbers of people allowed in shops and operating procedures being amended in factories and warehouses. A full return to normal seems unlikely until 2022 at the earliest and could take longer, with permanent changes in consumer attitudes and behavior likely as well.

Ultimately, investors need to position themselves for the long-term and what the world will look like once the pandemic has passed. Two key themes look set to be dominant. The first is an increasing reliance on and pervasiveness of tech and the digital space; the second is an increased value and importance placed on ESG factors by investors, governments and society at large. Property investments which take trends such as these into account will likely perform better than those which do not. Within ESG de-carbonization was already reducing the propensity for air travel prior to the crisis and we may see tourism rotate more towards domestic destinations in the future. This would be a problem for hotels in small economies where tourism is their main industry.

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), August 2020. Note: Abbreviation LTA: long-term average

APAC outlook

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Safeguarding lives and livelihoods key to regional property outlook.

Governments in Asia have largely proven their resolve in protecting lives and livelihoods. The report card for Asia thus far is satisfactory and this bodes well in general for real estate. A slowdown in investment activity was expected and is uneven across markets but pricing stays calm. There is still fact finding being undertaken to gauge the post-pandemic impact on end user demand across sectors.

Real estate fundamentals – On lives and livelihoods

Asia Pacific offers timely lessons in re-opening
As the COVID-19 outbreak continues to spread across the globe, policymakers have to grapple with the dilemma of choosing between lives and livelihoods. It is a delicate balancing act; opening up economies prematurely will lead to more infections, but prolonged shutdowns may inflict economic scarring that could take many years to recover from.

The economist ponders the value of life. Morally speaking, every single life is priceless. However, many governments have frequently adopted a metric to guide cost-benefit trade-offs in policy matters such as traffic control or pollution containment. In 1968, Nobel laureate Thomas Schelling coined the term "value of statistical life" (VSL). In the simplest terms, a VSL is an estimate of how much a person is willing to pay to reduce his/her risk of death. As various sources will point to, the VSL is approximately AUD 4.2 million in Australia, while that same metric is almost USD 10 million in the United States. It is on this basis that some economists start to assess how much countries should theoretically be willing to pay in terms of the associated costs of social distancing and lockdowns vis-a-vis minimizing fatalities due to the coronavirus. Or rather, at which tipping point do we decide that it makes better financial sense in saving livelihoods (opening up) over lives (lockdowns)?

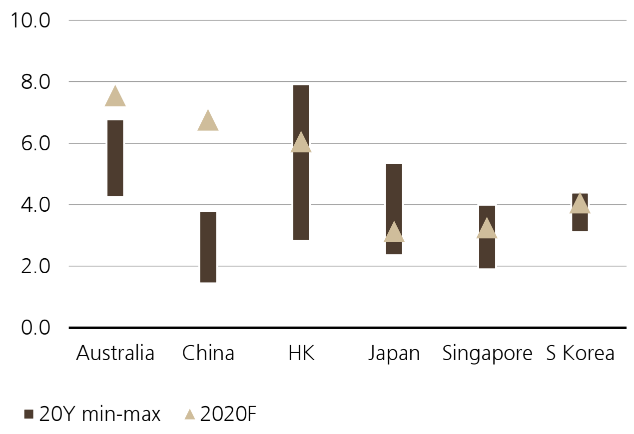
Obviously, this is an overly simplistic and academic endeavor. A life is not just a statistic. One life lost is one too many. Most Asia Pacific governments have adopted a trial and error approach towards the resumption of economic activities, while taking calculated risks in ensuring second or third waves of infections are under control. Instead of a draconian elimination tactic, an aggressive suppression strategy seems to the favored approach in Asia.

As the rest of the world hunkered down and initiated more severe forms of lockdowns, countries such as China, New Zealand, Japan, South Korea, and Australia were amongst the few to relax lockdown measures. The scenes of shoppers trawling the malls and sipping on cappuccinos at cafés offered glimpses of how successful suppression efforts can kick start economic re-opening. At the point of writing, we are seeing a resurgence in new infections in some countries, but that is to be expected.

Saving livelihoods and lives can be managed in tandem, not always perfectly, but arguably on a best effort basis. In our estimation, Japan, Singapore, Australia and Hong Kong are among the economies globally that have pushed out stimulus packages valued in excess of 10% of GDP.

Ensuring that cash handouts and concessions to households and corporates are timely and sufficient goes a long way towards supporting the resumption of economic activities. The downside risk is that subsequent waves of infections can and will occur from time to time. As we have seen in China, Korea and the Victoria state of Australia recently, the reactions by the authorities have been immediate, forceful and confident. This is probably how living in the new normal might look like before the world figures out a medical solution.

Figure 4: Unemployment rate (estimation, %)



Source: Oxford Economics, CEIC, as at 21 July 2020

Despite all that has been done, the truth is, jobs have been lost, workers are furloughed and incomes are affected. These effects are inevitable. However, we see Asia Pacific labor markets doing much better than was originally anticipated (see Figure 4). This is somewhat due to the non-financial nature of this crisis as yet, and also partly due to the balance sheet resilience of Asian corporates. In Australia, there were early estimations of a 10-13% unemployment rate in 2020, which is now being revised down to less than 8% by the Australian central bank. In addition, in Japan, Singapore and South Korea technical recessions are already being recorded, but the labor markets are likely to remain range-bound within the peaks and troughs of the last twenty years.

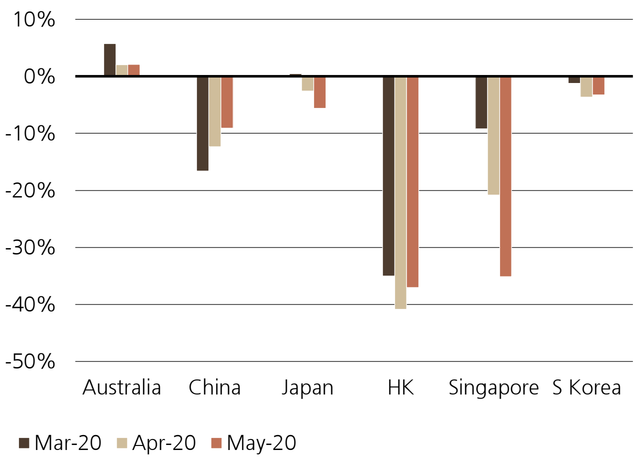
Saving lives now may come at a great expense to livelihoods but they are not mutually exclusive. Governments in Asia have proven their resolve in safeguarding livelihoods, which will reap dividends through the virtuous cycle of creating and supporting more livelihoods during the post-pandemic recovery phase. There will be hiccups along the way, but all in, the report card for Asia thus far can be said to be satisfactory and this bodes well in general for real estate markets in the region.

Retail

The market was expecting greater clarity in terms of the full impact of COVID-19 on the retail sector, following a rather uneven showing observed in the last quarter. Not surprisingly, retail sales performance (see Figure 5) was highly dependent on the extent and timing of the lockdowns.

On a three month moving average basis, Australia's retail sales growth was still in positive territory, boosted by a record surge in retail spending in the month of May alone. China saw improving retail sales performance, although that still pales in comparison with the same period in 2019. The brewing political and social tensions in Hong Kong were an overriding drag on consumer sentiment even as Hong Kong managed to flatten the COVID-19 curve without the need for a total lockdown. Singapore only gradually lifted its mobility restrictions in June, and the stress was clearly felt across the retail segment as retail sales fell by more than 35% in May alone.

Figure 5: Retail sales growth (3mma, %)



Source: CEIC, latest available as at May 2020

The retail sector is precariously standing on one leg, relying solely on domestic consumers as international travel looks to remain curtailed going forward. Domestic consumption can only go so far in supporting prime retail.

In Shanghai and Beijing, according to CBRE data, prime retail rents were flat in 2Q20, an extraordinary show of resilience. While things appear to be looking up for Australia, the dearth of inbound tourists and weak retailer sentiments were barely offset by the timely relaxation in social restrictions, which led to prime high street rents staying flat too. However, Sydney shopping centers saw a 5.1% YoY decline in rents. The same can be said for Singapore, where retail rents fell by 1.5% this quarter. In Tokyo, high street retail rents were unchanged from the same period last year. Hong Kong prime retail rents fell by 36.1% YoY in 2Q20, alongside an almost 54% plunge in values. As most government support measures start to wind down from the third quarter, we can expect a bigger impact on the retail occupier markets at the end of this year.

Industrial

Extending from the last quarter, the dichotomy between sub-segments within the industrial sector is very clear. Even in most of Asia Pacific, where economic and industrial activities are stirring back to life, weak global demand is an overwhelming headwind for manufacturing and trade-reliant countries. The US and Europe are amongst the biggest export markets for Asian industrialists, and until the COVID-19 situation improves in other continents, industrial production and storage is likely to remain soft. This puts a dampener on overall rent growth in the industrial sector even as the e-commerce storyline hogs the limelight. To that end, we saw prime rents in Hong Kong and Singapore fall by approximately 3.0% YoY and 1.3% YoY, respectively, in 2Q20.

Outside of China, Asia Pacific countries have relatively low online penetration rates, and that means the growth headroom for logistics space is high in the region. The demand side of the logistics equation needs no elaboration by now. Prime logistics rents in Greater Tokyo, Shanghai, Beijing, Sydney and Melbourne all saw marginal YoY growth in this quarter. Instead, supply is an issue in some markets such as Singapore, Shanghai and the western parts of Sydney and Melbourne, even as we expect completion schedules to be pushed back. In these markets, we see some pressure on rents and occupancy beyond the second half of 2020. In Beijing and Tokyo, land for development is constrained in the infill areas, which is likely to be supportive of occupier performance, although outer-city supply is high.

Office

We are starting to see vacancies creeping up in the office sectors across most Asia Pacific markets. Despite governments offering concessions and throwing multiple lifelines at the corporate sector, it is certain that no one can swim against the tide. What we observe is not a widespread weakness in occupancy nor sharp rent declines but rather a pullback in leasing activity and increase in space surrenders in some markets.

To be sure, corporates started 2020 on a wary footing, with most companies in Asia having experienced significant volatility in earnings owing to the prolonged trade tensions between China and the US last year. Hence, many service sector and old economy tenants did not overextend themselves in terms of office space requirements, which also means less need to rationalize now. New economy occupiers, such as those in the technology and media sectors, continued to display appetite for office space. In China, the gap between the tier one and lower tier cities is widening, especially as lower tier cities were already grappling with the indigestion of office supply.

This is not to suggest that Shanghai and Beijing are faring much better, with both rent growth profiles deteriorating quickly in the face of significant planned completions. In Shanghai, the office vacancy rate came in at 19.9% in 2Q20, which is flat from the last quarter but almost two percentage points higher than in 2Q19. Beijing was not spared the carnage, with overall office vacancy touching almost 16% in the same period, almost double from the 8.3% in 2Q19. Even though China started opening up and getting back on its feet much earlier than other countries in Asia, the side effects of the trade war and oversupply situation all acted together to hold back the office market performance. Also, China provides a glimpse of what is to come in other markets as the lagged effect of the global slowdown manifests itself in the office sectors in the region.

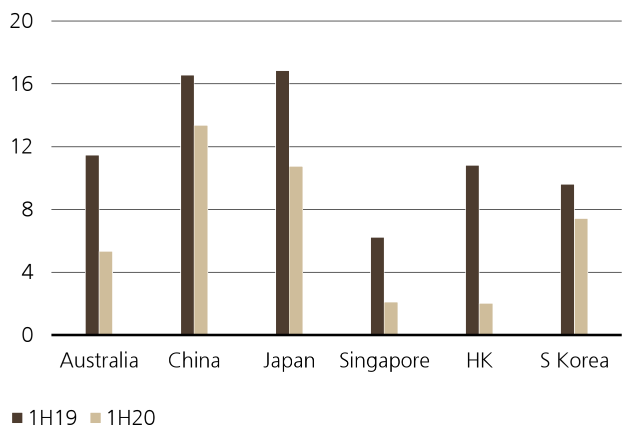
In Tokyo, the weakening economy has affected smaller companies more than the large corporates, with the latter still sitting on cash reserves which are likely to provide a buffer against massive corporate insolvencies and redundancies. The trade dispute and pandemic have effectively interrupted Singapore's two years of office market up-cycle, and we find it increasingly difficult to justify the demand story even though a low level of completions is supportive of market dynamics. The same can be said for Hong Kong, of which the current conundrum is further mired in geopolitical uncertainties.

Capital markets – The calm within the storm

Pricing stays still while activity retreats
According to preliminary data from Real Capital Analytics (RCA), total transaction volumes of APAC commercial property fell by approximately 42% YoY in 1H20. Across the key markets in the region, the slowdown in investment activity was uneven as some markets experienced sharper pullbacks than others (see Figure 6). But consistently, with the exception of Hong Kong, real estate pricing has stayed rather steady.

The slowdown in activity can be generally viewed as the natural consequence of safe distancing measures and global restrictions on overseas travel. Most of the deals inked in 1H20 had already been in discussions since 2019. But that cannot explain the entire situation, because both buyers and sellers are also likely to have delayed investment decisions as they wait to see how capital values are adjusted. The lack of clarity over the extent and longevity of the pandemic is a major consideration these days. As it stands, many Asia Pacific countries are not out of the woods, as second and even third waves of virus outbreaks already threaten to further impede investment momentum and price discovery.

Figure 6: Commercial real estate volumes (USD, billion)



Source: RCA (as at 28 July 2020)

On a relative basis, Hong Kong and Singapore saw the sharpest drop in transaction volumes in the first half of 2020, falling by approximately 81% and 66%, respectively, from the same period last year. The commonality between the two countries lies in their small and open economies, which have been impacted by the shock to global demand for goods and services. That is where the similarities end. In the case of Hong Kong, the economy opened up quite early after the initial taming of the virus outbreak, but socio-political concerns continued to cast a dark shadow over its longer-term prospects. And the recent resurgence in infections is another limiting factor as we saw 2Q20 prime office capital values fall by more than 20.9% from the same quarter in 2019.

Singapore struggled with a three month lockdown that was intended as a circuit breaker to stem the spread of the virus in the community and within its foreign labor pool. While restrictions were gradually relaxed in June, the commercial property market basically came to a standstill this quarter, even though office valuations increased by almost 3.6% YoY. Foreign investors with a working presence in the city-state are still looking at deals, while we also saw a major player in the technology sector finalize the acquisition of an office building. Looking ahead, given the stability of the government and the effectiveness of the virus containment efforts, we are likely to see more overseas investors looking to allocate in Singapore.

Australia recorded a fall in investment volumes by close to 54% YoY in the first half of 2020, while Japan did less worse and came in at a decline of 36% YoY. Logistics continues to be the key sector, although it appears that most investors are looking at developer funding and platform capital infusion rather than the outright acquisition of assets. In Japan, the multifamily sector bolstered its reputation as a resilient asset class, and that has led to greater interest in the segment.

Separately, China saw the smallest fall in investment activity this quarter, and that is partly due to its economy restarting earlier than other countries. As was the case during the GFC, it is likely that domestic investors will take the lead in the transactions market. The recent announcement of a pilot REIT program will open up another avenue for the securitization of income producing assets in the mainland.

There is ample dry powder waiting at the sidelines. A low rate environment globally will further bolster the appeal of real assets, especially for long-term investors. This storm has not brought about a knee-jerk rerating in pricing in most APAC markets, at least not yet. This calm is much welcomed, as buyers retreat temporarily while keeping a close eye on the markets. In some sectors such as retail, valuations will and have been adjusted, but the value proposition has also largely diminished, which explains the capital market performance.

In other sectors, there is ongoing fact finding being undertaken, such as in the office sector where landlords and investors are still trying to get a handle on what the end user demand for office space will resemble. The way we consume real estate will change after COVID-19, but what is the magnitude and impact? For now, these are unanswered questions, and hopefully the calm will continue within the storm as investors sit out the pandemic.

Strategy viewpoint – On living

Rise and shine, make your bed

As investors scan the Asia Pacific region, seeking refuge from the global carnage brought about by COVID-19, it is obvious that the multifamily sector has displayed tremendous grit. To be fair, this sector is not a serendipitous by-product of the COVID-19 crisis. Prior to 2020, the Asia Pacific multifamily thesis was already on the radar of many institutional investors.

In Asia Pacific, the largest and most developed multifamily market is Japan, and Tokyo itself ranks highly amongst global cities with the largest numbers of multifamily renters. Over the last three years, there has been an explosion in institutional interest in this space that is traditionally held closely by domestic operators. Compelling structural drivers underpin the theme, as low home ownership and solid internal migration generate a high propensity to rent.

Also, market forces primarily drive occupier dynamics in Japan and unlike some US and European cities, rent control is not prevalent. The fragmented nature of the Japanese multifamily landscape lent itself to disruption as inbound capital proactively partnered with local operators to gain access to assets and portfolios.

In Japan, multifamily rent collections have been consistent so far and anecdotal indications do not point to a major repricing in the asset class yet. We can all agree that having a roof over your head is a necessity, pandemic or not. The Japanese government has unleashed significant fiscal support in the form of income protection and cash handouts, and these are key in ensuring that tenants do not fall behind in their rent payments. Also, Japan Inc. is flush with cash reserves and while we see some weakness in the jobs market going forward, the impact of which is likely to be smaller than in other economies. The most important factor, which is intangible, is that cultural norms in the society emphasize trust and honor, and these values make the multifamily landlord-tenant relationship very strong, resulting in a limited movement in occupancy.

As we look ahead, investors can start to future-proof their multifamily exposure by ensuring that their strategies move in tandem with overarching changes in work-life patterns after COVID-19. There has been a focus on the acquisition of assets that comprise small unit layouts and are within walking distance to train stations. If we believe that home-based work arrangements will pick up pace, investors should start to look at assets with larger units that are located in suburban areas as renters start to prioritize living space efficiency over commuting time. What this means is that the absolute rent quantum remains the same for tenants as they shift to new working habits. The pre-emptive investor engaged in a greenfield strategy has to start thinking about what the design of Japan multifamily units will look like in the distant future instead of blindly allocating new capital into the sector.

What is next then? As we cast our horizons around Asia, investors with a track record in the multifamily segment should increasingly enlarge their geographical coverage towards other emerging multifamily markets such as in Australia and China. Admittedly, the nuances are not the same in every market but early movers can expect to reap greater dividends in a structural asset class instead of jostling for elbow space in crowded Japan.

European outlook

Gunnar Herm
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& Strategy – Europe

European real estate is struggling right now but the outlook for 2021 is brighter.

The first estimate of GDP data confirmed that Europe has been plunged into a deep recession as a result of the COVID-19 virus. While occupier markets have remained somewhat resilient, investment activity has been impacted, particularly in less sought after sectors. Overall, we expect negative performance in 2020, with a recovery from 2021 onwards, although this is likely to vary by sector and geography.

Real estate fundamentals – The eye of the storm

At the time of writing the 1Q20 outlook there was still some uncertainty about the impact of COVID-19 but the second quarter really saw the storm break over Europe. There are now over 700,000 deaths globally, with European countries UK, Italy and Spain seeing particularly adverse effects. These last three months have seen the most drastic state intervention in the economy since the Second World War, as most European countries initiated near-comprehensive lockdowns to try and contain the spread of the virus. As a result, government spending has increased drastically as most have been required to supplement the income of workers and provide a crutch for businesses.

Nevertheless, the intervention was not enough to prevent Europe from entering a deep recession in the second quarter. The 12% QoQ fall in eurozone GDP was by far its worst quarter since inception and in one fell swoop set GDP levels back to the mid-2000s. By sector, the pain was felt mostly in the industries directly affected by lockdown, namely trade, transport, accommodation and dining, which fell by around 40% QoQ. However, industries which are better positioned to allow homeworking fared better, with financial and insurance output growing 3.4% QoQ1

The recovery going forward depends very much on the success of efforts to contain the virus and the level of certainty that can be provided to consumers. Most countries have come out of quarantine but remain in a cat and mouse game where localized lockdowns are being applied at the discretion of local health officials. This means the expected mechanical snap back in growth may be more intermittent and patchy than many assume, although this should be the nadir of the COVID-19 crisis. However, on balance we are anticipating the core European countries to have a slower recovery when compared with the global outlook (see Figure 7).

Taking Oxford Economics's forecast as our base case, we expect some of the losses to be made up in 2H20. This amounts to an annual GDP decline of around 7.9% for 2020 with growth recovering to 6.1% in 2021, though this varies by country and sector. We are also expecting all property rental decline of -3.7% in 2020, followed by a flat year in 2021. However, like the economy this will vary by sector as the virus has exacerbated pre-existing issues.

Turning to the office sector first, there has been a marked decline in office take-up as occupiers have looked to reappraise deals in light of the market uncertainty (see Figure 8). However, there have not been increased surrenders of active leases, which has resulted in just a marginal uptick in vacancy.

This has meant that for the time being there have been very few centers where we have observed rental declines, with the exception of London, where rents fell in both the West End and City markets as Brexit uncertainty continued to weigh on demand. Paris, on the other hand actually managed to see rental growth of around 2.2% QoQ, possibly related to companies wanting a European rather than a London base.

However, the office sector is facing a further headwind as apart from the cyclical issues of falling occupier demand there is a further secular trend of an acceleration of the switch to home working. This throws into doubt the willingness of even successful companies to expand their footprint after the virus has been and gone. Several high profile companies – most notably Twitter – have announced that they will give their staff the option of working from home full-time going forward.

That being said, we do still expect there to be demand for well-located high quality office space, although offices which are largely functional in nature may see demand dry up. However, high frequency indicators show that employees have been returning to work in locations where the government is perceived to be effectively containing the virus. On the supply side, there has been a slowdown in construction activity in most European centers, which is likely at least to ensure that there will not be a supply shock.

The retail sector was experiencing unprecedented challenges even before the onset of the pandemic, and has since been further hit by the decision to close shops in many European countries. The majority of retailers rely on their stores for the lion's share of trading, despite the growth of online. It is noteworthy that even retailers considered strong performers in their sectors have announced store closures, such as John Lewis in the UK. Going forward, we expect further rental declines across Europe.

Further to this, the high levels of non-rental payment during the pandemic have already prompted several large landlords to offer rents on a turnover basis, such as Hammerson and Legal and General in the UK. This is a trend that was observable pre-COVID-19 and we feel that following the pandemic risk sharing on the part of retail landlords will become much more commonplace. While this makes sense from a fairness perspective, it raises many difficult questions about how retail property should be valued, particularly as it forms an integral part of many managed funds.

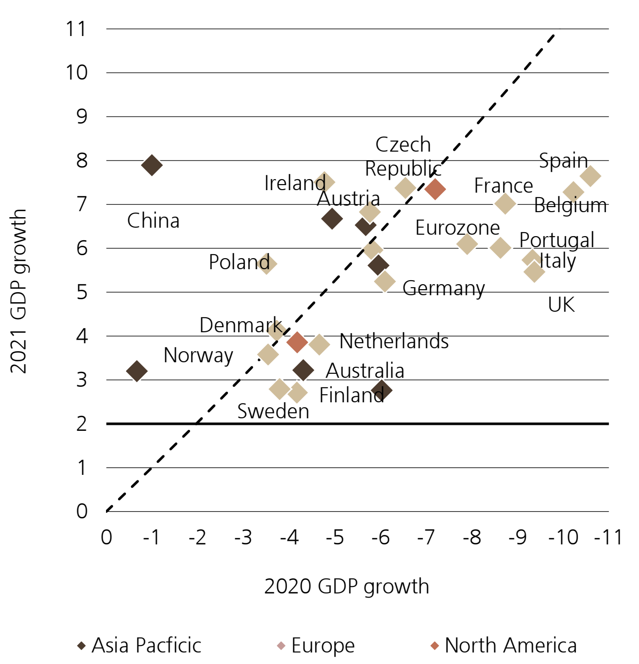
There has been resilient demand from food stores and DIY traders, both of which saw an increase in trading during lockdown as consumers were confined to their homes. However, the next few years will be tough for the vast majority of retailers and their landlords. We are forecasting negative rental growth in 2020 and 2021 of -5% p.a.. The plus side for retail is that supply moving online has reached an all-time low. In fact, landlords in many locations have started to explore conversions to alternative uses.

[1] Oxford Economics, July 2020

The industrial and logistics sector has seen a renewal in demand since the COVID-19 pandemic as consumers have shifted to online shopping, especially in the online grocery space. According to ONS data, a third of UK transactions are now completed online, while food purchases have doubled. It has been a busy first half of the year in terms of existing online retailers looking to boost their capacity, and supermarkets and other retailers ensuring they have sufficient warehouse space to preserve their market share. The fact that Amazon's share price has increased 70% since the start of the year illustrates this point well.

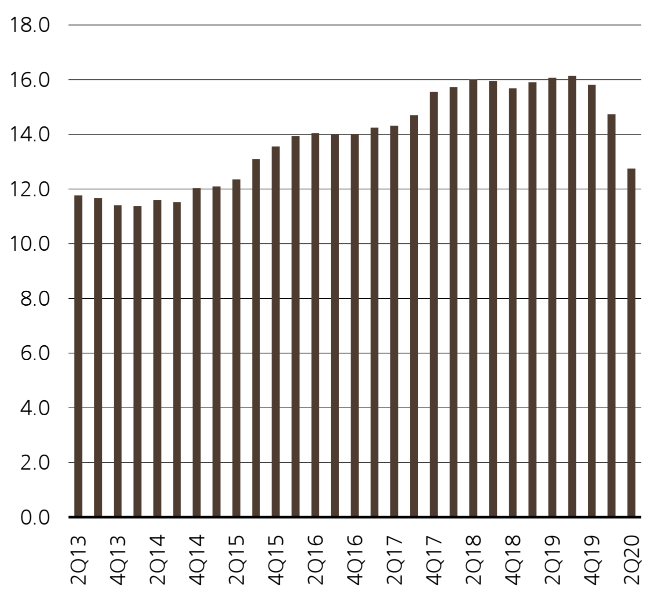
However, the industrial sector is not immune to COVID-19. While it is likely to be one of the 'beneficiaries' of the pandemic, there are certain downside risks investors need to bear in mind. The majority of its tenants are still more traditional operators servicing the 'real' economy, i.e. sectors such as construction, production and aviation. Additionally, many of these operators are small and medium-size enterprises that run on thin margins and tend to have low capital reserves. Such occupiers have struggled during quarantine, with some unable to pay rents on time. As a result, we are anticipating eurozone industrial rents to fall by around -2% in 2020, before returning to growth from 2021 onwards.

Figure 7: GDP growth (%)



Source: Oxford Economics; UBS Investment Bank, 2Q20

Figure 8: Pan-European office take-up
(rolling annual, million sqm)



Source: JLL, 2Q20

Capital markets – European markets in a static phase

The second quarter of 2020 has been a slow one as buyers and sellers have been holding back in the face of uncertainty and the restrictions on travel and social distancing have been preventing the necessary due diligence required to progress deals. Nevertheless, Europe has fared better than the rest of the world, with volumes down around 32% compared with the same time last year (see Figure 9), which contrasts to nearly 50% globally. Indeed, 1H20 was only down by around 9% when compared with the same six-month period the previous year.

However, these headline numbers mask the weakness in the market. The numbers were bolstered by some very large entity deals which do not tend to feature often; entity volumes were up over 200% HoH, driven by IQ's student accommodation portfolio in the UK (EUR 5.3 billion), URW's disposition of a 50% stake in six shopping centers (EUR 1.1 billion) and German residential landlord ADO's acquisition of its rival, Adler Real Estate (EUR 5 billion). This shows the continued popularity of the student accommodation and residential sectors with investors, but when you look at the numbers in terms of deal count the decline was much steeper at around 46%.[2]

There is a greater number of more 'normal' commercial property transactions in the EUR 5-50 million mark, where volumes declined by more than 50% (see Figure 9). The quiet nature of this market segment is of particular concern as it is generally these deals which account for a larger share of transactions and as such provide more sustainable liquidity to the market than one-off 'mega deals'.

However, there were some bright spots. Germany managed to actually see a slight increase in volumes YoY. While some of this is explained by large platform deals, the resilience of domestic investment was important too. Around 85% of deals were done by German institutions in 2Q20, which is highly significant as cross-border capital flows declined substantially. Going forward, we would expect markets which are less dependent on international investors and have a solid investor base to prove more defensive on pricing. This is a concern for more 'peripheral' markets where much of the capital flows from overseas; examples of these more at risk markets are Warsaw, Lisbon and Helsinki, where more than 80% of capital flow comes from overseas sources.[3]

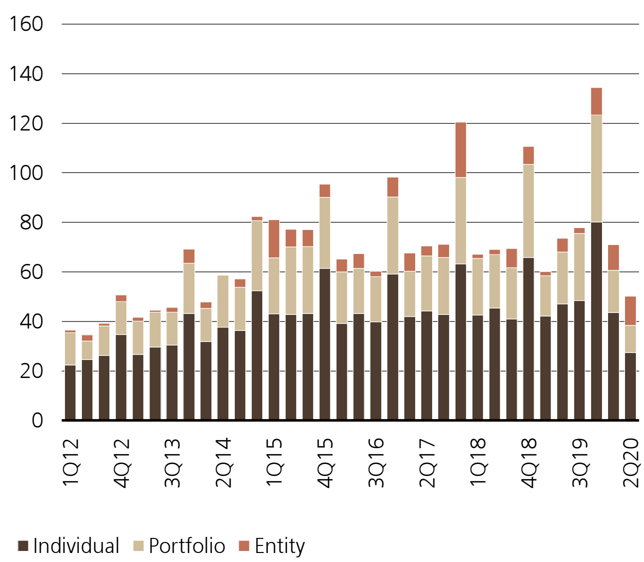
The other bright spot was Denmark, which saw a 110% increase on the same quarter the previous year. Scandinavian countries were generally more defensive, which was no doubt due to their 'light touch' approach to quarantine and operational continuity in the early quarter months.

Overall there is evidence that investors are adopting a 'wait and see' approach to the market. Forward sales have increased significantly over the quarter, many of which involve some kind of development or major value-add component. This indicates investors are taking the view that the COVID-19 disruption should not prove to be long-term and thus taking on projects with J-curve return profiles is proving more attractive.

Disagreements over pricing levels are also playing a role, as many markets and sectors still have situations where valuation houses are evoking a 'material uncertainty' clause. This has meant there is very little basis for negotiations, which has caused a growing disparity between buyer and seller expectations. This reflects the market uncertainty relating to COVID-19 and disagreements over what (if any) discount should be applied. There are signs that yields are starting to move out, however, a good example is Amsterdam where yields moved in 10 basis points YoY, but out 10 basis points QoQ[4].

The direction the market takes in the third quarter will be interesting to observe. A recent PERE survey showed that 70% of raised capital in 2Q20 was opportunistic. There has also been an uptick in distressed debt strategies, as CMBS default rates have been climbing, evoking memories of the global financial crisis. However, with central banks remaining committed to supporting markets with ultra-low interest rates such investors may end up being disappointed.

Figure 9: Investment volumes (EUR, billion)



Source: RCA, 2Q20

[2] RCA, August 2020
[3] Ibid
[4] Ibid

Strategy viewpoint – Office markets and the pandemic

What impact do we see from COVID-19?
We do not envisage a world anytime soon where a significant proportion of office-based work is done fully remotely. Many of the recent statements by CEOs on the future of the office are largely overdone in this regard, although we do acknowledge that COVID-19 is likely to act as an accelerator of some trends.

Changing focus of office space
In general terms, most office-based businesses have been able to achieve a reasonable level of business continuity through home working. What is far more challenging however, is implementing any new initiatives to grow businesses, without being able to meet either colleagues or clients in person. The post-COVID-19 office is going to become increasingly focused towards supporting the latter. In essence, if day-to-day functional desk based work can be done remotely, making a journey into an office needs to add value. So the focus of the space provided will need to shift away from physical workspace, and more towards interactive and collaborative spaces, meeting rooms and company branding.

This will accelerate the polarization to better quality buildings which have value-add attributes. The attraction of leasing bland and functional desk-based office units will have a decreasing relevance going forward. And although we are uncertain on the future direction of the virus, we expect that even if a vaccine or treatment is found, the memory of the pandemic will maintain a focus on wellbeing features.

Central locations will be more defensive
On a similar theme, we expect that office locations which offer very limited value-add will struggle to maintain occupancy. Again it is the issue that functional office locations, typically business parks or weaker secondary city locations, will offer very little to enhance the experience of coming into the office. Without that added value, in terms of both amenities but also proximity to other companies and clients, the value of the workspace element of the office building will diminish.

It is not just proximity to amenities and clients that we think will polarize performance between central and suburban office space. The expected increase in flexible working could actually have more profound impacts on the residential market, particularly in the larger European cities. The length of commute which an employee may be prepared to make if they are only required to be in the office on a few days of the week, rather than five, could increase significantly.

So the radius that employees live away from the city center should increase over time. But the office needs to remain accessible for the days which staff do commute into the office. Essentially this means being located close to the main central public transport hubs to enable the office to be accessible from the widest commutable locations. This gives the company the largest pool of talent to recruit from, and higher rates of retention. The challenge of non-central suburban locations is that whilst they are extremely convenient for staff living in that part of the city, it is the opposite for employees living elsewhere, and limits the capacity for further decentralized living to make the most of less frequent trips into the office.

Could offices become the new retail?
In our view, no. Office buildings have proved to be far more adaptable to changing demand trends in the past than retail. When office markets become structurally oversupplied, conversion to alternative uses is often viable, particularly in undersupplied residential markets, which most major European cities are. Much of the oversupply built during the dot com boom was never fully utilized as office space, but has since been converted into alternative uses.

Even with rents falling, retail floorspace remains by some distance the highest capital value real estate. And this makes conversion of large scale retail parks and shopping centers economically unviable in the vast majority of situations. As e-commerce has eroded the volume of floorspace required, the oversupply has built up and it is going to be much harder for that structural vacancy to come down.

So even if we are too bullish on future office occupancy trends, and the growth in working from home accelerates a decline in net absorption of office space faster than we anticipate, with a city center strategy we remain comfortable as the residual land value of office buildings gives us a strong degree of assurance as we enter an uncertain environment.

US outlook

The downturn was deep in 2Q20, but investors and teams are adapting.

Tiffany Gherlone
Head of Real Estate Research and Strategy – US

No property type is immune to uncertainty and financial impact. A great deal of uncertainty remains around the reopening and recovery of the US economy, a process that is likely to be extended over time rather than a quick rebound to pre-downturn economic levels.

Real estate fundamentals – Divergence intensified

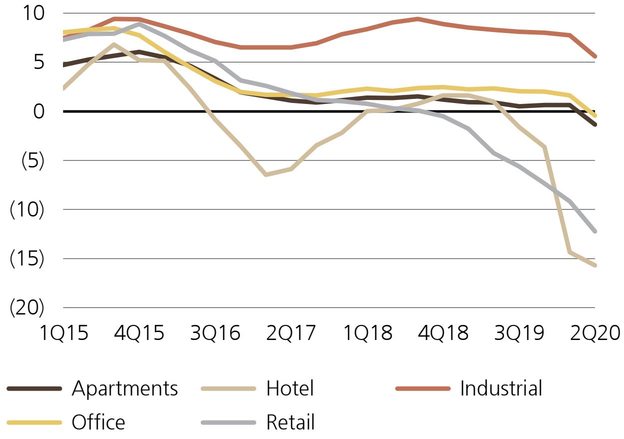
The US is showing the first signs of recovery from a historic downturn. Yet, the NCREIF-ODCE Fund Index has shown only moderate depreciation in private commercial real estate values. Property values are slow to move; softening some of the uncertainty even up-to-date rent collection data cannot dispel. Steady economic growth could be delayed as many US metros have halted or stepped back their phased reopening programs.

No property type is immune to uncertainty and financial impact. The most immediate impact is to the hotel and retail sectors and development sectors, where sites are cautiously resuming work. Conditions in the office, apartment and industrial sectors have deteriorated in the short-term, as would be expected in an economic downturn, but generally these properties remain open, with some opportunity to adapt to current conditions.

Cash flows are impacted, even though efforts to smooth over short-term losses for long-term recovery should have some success. Investors are incentivized to provide workouts to most tenants and borrowers. Uncertainty is high, which means discount rates face upward pressure. Ultimately, we expect opportunities, but not a flood of distressed transactions.

Divergent sector return performance became exaggerated over the quarter. Retail and hotel returns sharpened their declines as travel and in-person interactions remain restricted (see Figure 10). June saw apartment and office appreciation returns slip into negative territory. This exaggerated the relatively healthy, if softening, performance of the industrial sector.

Figure 10: US real estate returns across property types
(rolling four-quarter total return, %)

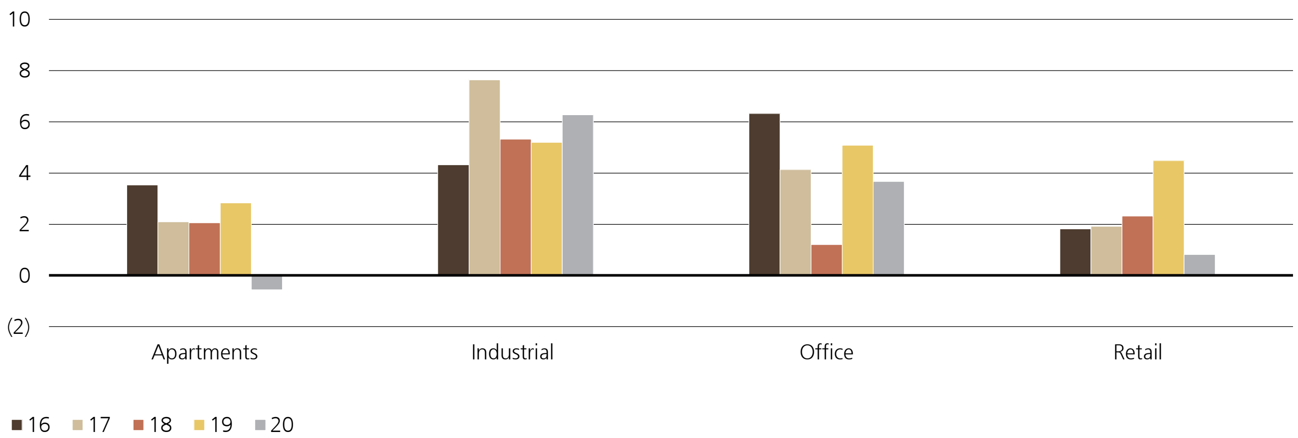


Source: Data show unlevered NCREIF Property Index returns filtered for only ODCE managers. Past performance is not indicative of future result, June 2020.

The first two months of 2020 were business as usual for much of the country. Consequently, first quarter occupancy and rent growth reports reflect what seems like typical quarterly fluctuation. Even as second quarter property sector fundamentals slowed, declines are not as severe as anticipated. Consumers and investors have remained cautious as travel restrictions and social distance guidelines remain in place.

The US does not yet have universal control over the current health crisis; management and containment vary broadly by state and region. However, national second quarter sector fundamentals did not contract as much as initially anticipated; illustrating the resiliency of real estate investment. Consumers and investors are expected to remain cautious as lingering health and safety precautions rein in the velocity of a potential rebound.

Figure 11: Property sector rent growth (year-over-year change, in quarters ended 2Q20, %)



Source: CBRE-Econometric Advisors, 2Q20. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers

Apartments
The pace of completions has not slowed (see Figure 12), with more than 125,000 units delivered year-to-date. At the same time, national home ownership is up by 2.8 percentage points from 4Q19. Apartment vacancy is up 60bps from one year ago, a modest increase under the circumstances. Average asking rents are down 0.6% YoY; indicating that landlords are letting rents slip as they struggle to sign tenants.

Hard choices
The essential nature of housing keeps the apartment sector functioning. Properties with mortgages from Fannie Mae, Freddie Mac and Funding Affordable Homes (FAH) were temporarily prevented from evicting residents unable to pay rent. Additionally, many states had temporary protections in place. As these moratoriums are expiring without clear replacement, landlords must weigh the risks of retaining impacted tenants (however temporary) against months of increased vacancy.

Industrial
2Q20 industrial availability rose to 7.6% – 50bps higher than one year ago – as demand has not kept pace with steady supply increases. Sector rent growth remains healthy (see Figure 11). Asking rent has continued to increase, growing by about 5% YoY.

Shining bright
Industrial has seen the most relative stability compared to the other commercial sectors. With many brick and mortar stores shuttered, fulfilling online orders and restocking grocers keeps the warehouse and transportation industry moving. Industrial properties represent a third of real estate transactions year to date and is the only sector to see rising price per square foot.

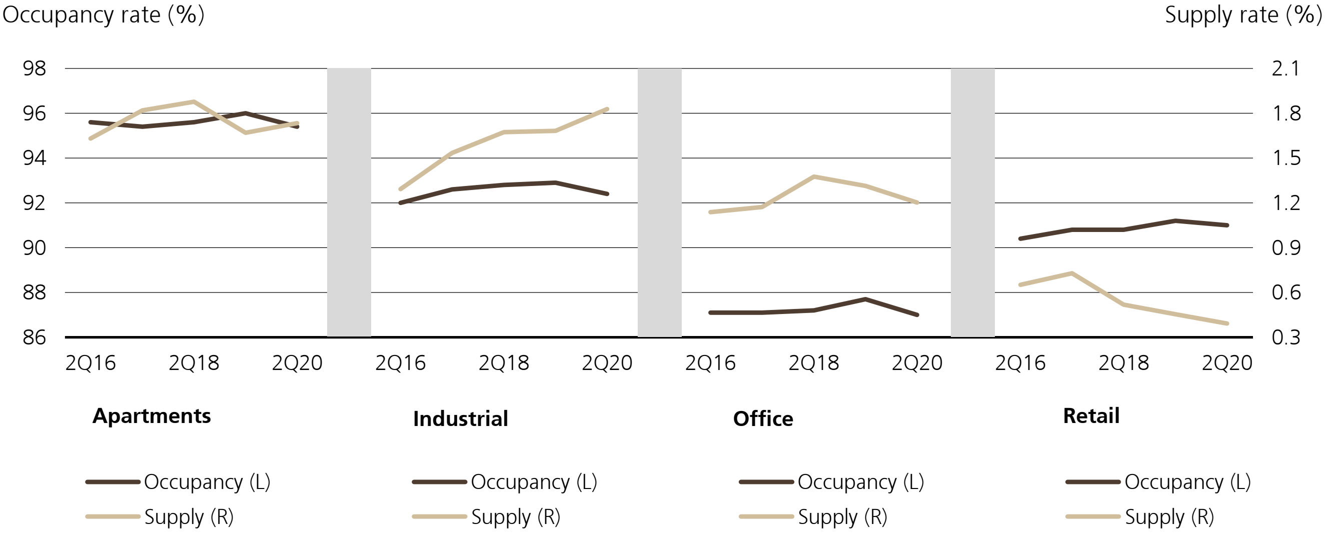
Office
Total office vacancy rose to 13.0% in the second quarter as seven million sqft of new supply delivered into a market with rising availability. Downtown and suburban office rents were up modestly from the previous quarter and one-year ago. Downtown vacancy has risen to 11.4%, 100bps above one-year ago; while suburban vacancy, at 13.8%, is 60bps above last year.

Rebalancing
Occupancy in the office sector benefits from multi-year leases, even if social distancing has turned off the lights. Looking ahead, tenants are weighing the option of either reducing space as they move to a remote work platform or increasing their required square footage to create a more socially-distant workplace. For the most part, capital improvement projects are on hold until these decisions are sorted.

Retail
Neighborhood, Community & Strip center retail completions are well below the recent average. 2Q20 saw available space increase by ten million sqft, bringing the availability rate up to 9%. The data shows a slight YoY asking rent increase. However, asking rent data is based on space listed with brokers, and because only high-quality space is listed as available the rent data will begin to skew higher.

Agility required
Restrictions have remained in place much longer than initially expected, and much of the legislation enacted to sustain small businesses has dried up, with no clear replacement in sight. Today's consumer supply and demand innovations could reshape the face of retail for years to come. Motivated businesses able to shift towards online ordering with home or curbside delivery are more likely to succeed. Agile retailers with low levels of debt are best positioned.

Figure 12: Occupancy and supply trends



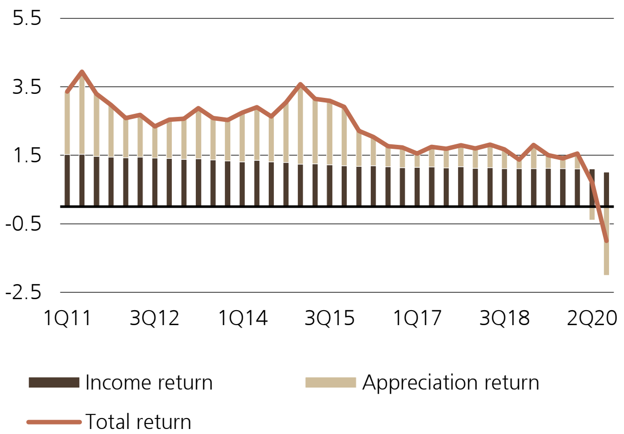
Source: CBRE Econometric Advisors, 2Q20. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers

Capital markets – Unique challenges ahead

During 2Q20, the NCREIF Property Index posted a negative total return for the first time in 10 years (see Figure 13). The apartment and office sectors saw depreciation for the first time in a decade; while retail and hotels each saw accelerating depreciation. The industrial sector remains stable, with appreciation slowing only moderately over the quarter.

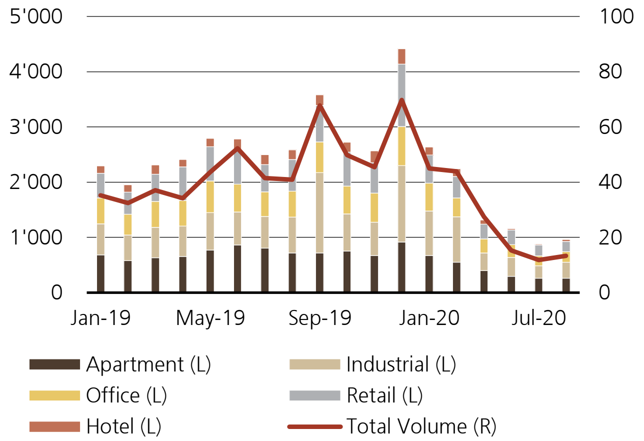
Transaction volume is static, making it more difficult for investors and appraisers to find comparable sales data. Figure 14 shows the sharp decline, while it is possible that the decline in trades has hit bottom as of May, it too early to call it definitive. The slight uptick in transaction volumes during June may reflect a burst of quarter end activity; many of these may have been sales under contract prior to the shutdown. A lack of interstate travel continues to hinder on-site due diligence and inspection.

Figure 13: US property returns
(QoQ, %)



Source: NCREIF Property Index, 2Q20

Figure 14: US transactions
Count of properties Billion USD



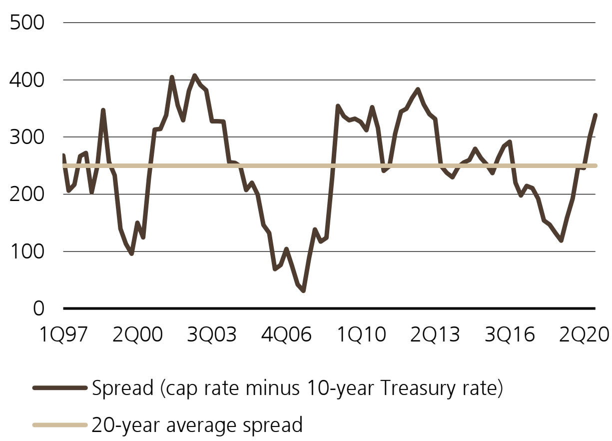
Source: Real Capital Analytics, 2Q20. Includes entity-level transactions.

Stimulative measures from the US Federal Reserve moved short-term interest rates to zero in March 2020. On the long-end of the curve, the US 10-year Treasury rate is below 1.0%, pushing real estate spreads well above-average (see Figure 15). With the beginning of depreciation already apparent in property returns, the higher risk premium implied by wide spreads reflects uncertainty around future occupancy rates, leasing velocity and income growth expectations.

While all downturns bring uncertainty to capital markets, the 2020 pandemic-led downturn brings several challenges unique to real assets: travel restrictions, site closures and backlogs in municipal permitting processes. For several months, these challenges will stall investment volumes and tenant leasing. However, as economies begin to reopen, debt and equity investors should be able to institute protective measures and resume due diligence and leasing tours. In the meantime, since these challenges are known, adaptations can be planned, and teams should be ready when reopening begins.

With limited sales restricting the availability of current pricing data, the next few months will likely face investor caution. Although many lenders are open and able to lend, the near-term focus will be on managing portfolio stress and working out terms for existing loans. Early in the recovery, lenders will likely focus on the less-risky, high-quality investments, making few exceptions for deals with low near-term cash flow.

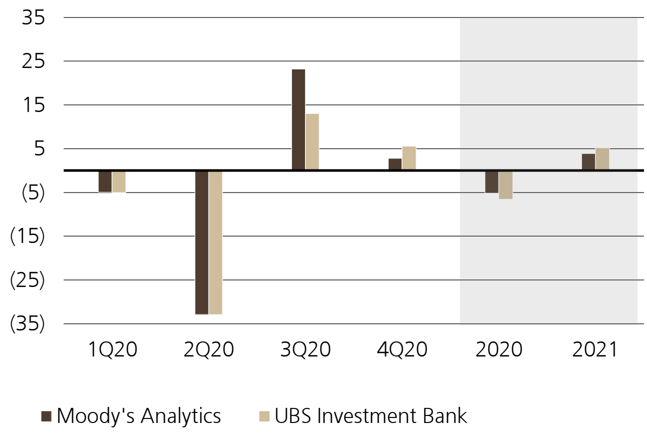
Figure 15: Commercial real estate spread (basis points)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 2Q20.

Preliminary second quarter GDP showed an annualized 32.9% decline (see Figure 16). Optimism for modest, positive, economic growth during the third and fourth quarters leads to a GDP forecast of about negative 5-6% for calendar year 2020. Recovery will be slow given virus flair-ups and high debt levels.

Figure 16: US real GDP growth (%)



Source: Moody's Analytics, 2Q20. Shaded area is forecast data.

Unprecedented stimulus flowed through the federal government and Federal Reserve to businesses, consumers, states and municipalities during the second quarter. Direct financial support will establish a floor on the severity of short-term decline and help communities, tenants and customers recover when pandemic restrictions begin to ease.

The unemployment rate shot up to 14.7% in April and almost immediately began to decline as government loans were approved. The US unemployment rate was 11.1% for the month of June (see Figure 17). Millions of Americans are out of work, continuing to depress demand for goods and services. Regional differences should play an important role in determining the trajectory for downturns and recoveries.

Strategy viewpoint – Agility is crucial

Reduced demand for goods and services is inevitable as millions of Americans remain out of work and the future of extended unemployment benefits is unclear. The momentum of future job growth will depend on finding a medical solution that limits a systemic resurgence of the virus and supports confidence in the potential for growth. State and metro variations in public health procedures may have widened the gaps around near-term economic potential.

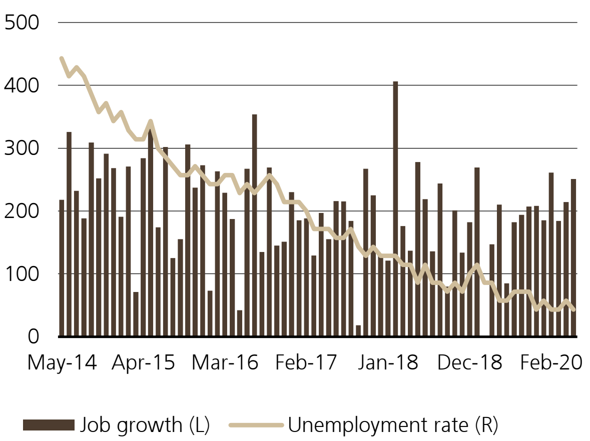
There is a lot of uncertainty around two key inputs to private real estate pricing: future cash flows and current transaction metrics. As data becomes available, there is every reason to expect investors will adjust their underwriting.

In the near-term, lower risk investments with stronger cash flows will likely be most attractive to lenders. Capital improvement projects and new construction will likely be delayed by months of closures. More time is needed to understand whether deferred development deals, across all sectors, will deliver back-to-back – which is painful – or trickle into being – which offers opportunities that will vary across markets.

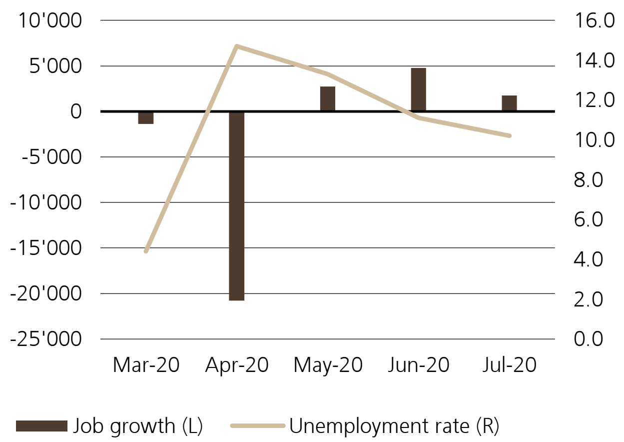
The downturn cut deep in the second quarter, but investors and teams are adapting. We expect more adaptations and some clarity to emerge in the third quarter.

Figure 17: US job growth and unemployment rate

Historic – change in employment (thousands of jobs) %



Recent – change in employment (thousands of jobs) %



Source: Moody's Analytics, July 2020

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