BARINGS

ALTERNATIVES

Global Real Estate: Cyclical & Structural Impacts of COVID-19

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BARINGS INSIGHTS

The global pandemic is dominating the lives of populations around the world—changing the way we all work and live—while also creating heightened levels of uncertainty among investors. Given the breadth of the self-imposed lockdowns in most economies, we almost certainly know that the magnitude of near-term economic contractions will be unprecedented in modern times. We also know that the near-term outlook has significantly weakened for all real estate markets. The impact, however, will not be uniform as some sectors are undoubtedly more exposed than others, and some entered the crisis in a position of strength, while others were already heading down a path of structural decline. Understanding the interplay between near-term cyclical weakness and long-term structural trends will be key for investors as they navigate global real estate markets in the months and years ahead.

An Alphabet Soup of Recovery Scenarios

The duration of the COVID-19 is unknowable at this point, and consequently some property investors will likely choose to hold off on transacting for some time—a decision that, while logical, may result in the high opportunity cost of failing to invest during a period of dislocation. Indeed, the range of potential recovery scenarios is wide—from the familiar "V" and "U" shaped recoveries, to "W" (i.e. multiple waves of infections) and even "L" shaped recoveries in the worst of scenarios. While a "V" shaped recovery could see prices and valuations bounce back quickly—perhaps too quickly for investors to capitalize—a "W" shaped recovery could yield massive opportunities, but at the risk of seeing long-term structural trends derailed.

It is too early to assign likelihoods to such scenarios, given what we know currently. But barring the most dismal of medical outcomes, it is very likely that property values for sectors and strategies that benefit from long-term structural drivers will eclipse their 2020 levels in the years ahead—and as such, investors may want to shift their attention to analyzing the sustainability of these structural trends, and whether or not COVID-19 may put them at risk.

Cyclical and Structural Sector Outlooks

RETAIL

Cyclical: Retailer failures, and thus store closures, were already a rising trend even before the pandemic was on our radar—and are likely to surge in early 2021, if not sooner, from the elevated stress imposed by it. Barring a medical miracle, a rebound is unlikely before Christmas—which itself will prove to be a litmus test for retailers, as it is a critical period for operator profitability.

Structural: The shift to online shopping will undoubtedly continue, likely at an accelerated pace for most items. Online food delivery is no exception, but should grow at a much slower clip due to the fact that food margins are low and mass market affordability will not support universally free (or very cheap) delivery. This is not to say that bricks and mortar will go away entirely across the retail space but physical footprints are likely to morph, where appropriate, toward 'showroom' settings where products can be seen and touched, even if most consumption is happening digitally.

OFFICE

Cyclical: While some co-working operators who have expanded too fast are likely to fail, others focused on larger occupiers with longer-term agreements could conversely benefit from a short-term boost, where corporate leases have expired and the delivery of new development has been delayed during the outbreak. However, total vacancy should steadily rise in the next 12 months, while development will likely be on hold until sometime in 2021. Consequently, the lack of development could build the case for stronger rental growth in 2022 and beyond, particularly for Grade A/best-in-class space.

Structural: It is not yet entirely clear if mass working from home and reliance on communication technology will lead to an increase or decrease in agile workplace practices like "hot-desking"—an office system that involves multiple workers rotationally using a single physical work station or space. We may also see relocations to smaller cities and suburbs, or falling worker-to-floor-space ratios if social distancing becomes an institutionalized practice.

LOGISTICS

Cyclical: This is perhaps the best positioned sector from a cyclical perspective due to the boost in e-commerce. The shift to online consumption has clearly been accelerated by the COVID-19 crisis, resulting in even greater demand for warehouses and supply chains optimized to deliver goods straight to the consumer. That said, heavy GDP contractions, slumping global trade and possible retailer bankruptcies represent near-term risks for investors to monitor.

Structural: Accelerating online penetration and a more robust supply chain to accommodate larger inventories could act as a medium-term positive from a structural perspective. Supply chain and national security concerns could also lead to the gradual on-shoring of some production over the next 10 years. Should some form of social distancing persist, we may also see an accelerated rise in automation for large tenants of industrial properties. And larger logistics properties could grow taller, driving up on-site rents to accommodate the greater intensity of use.

Trends to Watch

EQUITY STRATEGIES

Overall, we think transaction markets will be illiquid in the near term due to a greater reluctance by capital allocators to make new investments, along with logistical challenges presented by the pandemic, including an inability to inspect assets in person. To compensate for this, we expect to see a greater use of technology to enable remote or virtual inspections, and expect that managers with local networks may be at an advantage given travel restrictions.

Core:

- Investors tend to seek "safe haven" assets like core in times of uncertainty, and today is no exception. We expect to see continued investment in core property for this reason. While what investors might typically consider to be a 'core/prime' property asset (i.e. regarding location, physical repair, tenant, lease length, etc.) has loosened somewhat recently, it may revert in short order.
- Location is as important as ever, particularly in areas that benefit from long-term structural trends. Assets in these locations are likely to see lasting value, but investors must carefully monitor data to ensure that structural drivers remain intact.
- Prime versus secondary yield is likely to converge for sites offering "manage to core" opportunities. As such, the "style creep" that we've witnessed over the last 24 months is likely to reverse.
- Highly levered investors face potential covenant breaches, while those with low leverage can stay focused on active management and tenant engagement.

Additionally, we see opportunities to buy stabilized core assets at discounts in the next 6–9 months, in anticipation of a potential 2021/2022 rebound. The best opportunities could present themselves where economic vulnerability to the virus appears highest, and among dense cities with fast growing populations that have dynamic financial/technology hubs or tourism/cultural appeal. Additionally, we may see opportunities arise in cities where cross-border capital flows have been abnormally high and yields could decompress quite a bit. Within REITs, we see value in those trading at discounts to NAV where liquidity can be provided, individual assets can be acquired at a discount, or the REIT itself could potentially be taken private. Finally, companies seeking short-term funding by selling long-term assets via sale and leasebacks will likely present highly favorable terms in 2020. We see particular opportunity in providing solutions for strong corporates facing temporary liquidity weakness (i.e. low cash reserves).

Value Add:

- Secondary prime asset yield spreads are likely to widen in core locations, thereby enhancing "manage-to-core" redevelopments. A lack of development funding and construction slowdown will likely accelerate stock obsolescence/aging.
- We should see greater opportunities present themselves across sectors and markets in the near-term. While non-core, partially cash-producing assets may be temporarily out of favor, we believe owner-occupier sale and leasebacks will present value due to the short-term corporate funding gap. We also think considerable opportunities will lie in the hotel sector.
- Within logistics specifically, we expect to see an increase in Grade A space demand starting in 2021. As such, investors who take advantage of lower competition, lower construction costs and lower availability of financing in the near-term may benefit—and we may see the provision of forward purchasing or forward funding to mitigate development risk where possible. We further expect to see an increase in e-commerce demand, and a significant need for rising inventory levels across corporates in 2021 and 2022.
- In the short- to medium-term, there may be a threat by way of the core definition change, which has narrowed, as well as a shrinking buyer base due to secondary locations and non-core tenant covenants.
- On a longer-term basis, there may be further polarization between prime and secondary space for office and residential properties—and we may see concept shifts in the latter to larger, more suburban assets. Office demand will likely become more focused than ever on Grade A space; retail revenue structures could turn toward more flexible turnover rent; and there will undoubtedly be an even greater focus on ESG going forward.

Long Income Property:

- Although inflation will be subdued as a consequence of the economic demand shock, low interest rates mean falling hurdle returns, which should intensify the appeal of the most bond-like property assets.
- We expect that indexation will continue to be in strong demand from asset/liability matching pension funds and insurance companies, while wealth preservers will likely be in full defense mode in 2020. Further, we believe companies seeking short-term funding via sale and leaseback, ground rents or income strip transactions secured on their operational assets will present highly favorable terms in 2020.
- Given the above, we see opportunities for managers to identify corporate weaknesses (i.e. low cash reserves), research their asset base and secure options/exclusivity in the near-term.

Debt Strategies

Property debt will remain difficult and more expensive to source well into 2021, due to competing demand for bank capital from general corporate lending.

Core:

- We expect to see core continue to act as a lower risk, relatively low return, investment grade equivalent—albeit with a very attractive, risk-adjusted profile—lending to fully stabilized assets only.
- Senior debt pricing will likely be driven by the relative value found in the spread to corporate bonds. We believe managers who focus on parts of the world where 'alternative' lenders have not yet penetrated will benefit.
- Pressure on loan books will likely become focused on income stability, as opposed to capital.
- We believe managers will do well to structure deals that accommodate temporary cash flow disruption, focused on underlying tenant credit rating, especially their cash reserves and loan structural features like cash traps and rent reserves.

Value Add/High Yield:

- We anticipate that positive credit migration and value creation during a loan's life will become the norm, synchronized with capex invested and the execution of business plans.
- Bank lending may become harder to source for non-100% income producing assets, and there may be an increase in lending to equity investors typically engaged in 'manage-to-core' strategies for that reason. We also think the narrowing definition of core places greater importance on location.
- Debt funds may struggle to get debt-on-debt, and therefore may not be able to hit target returns. Instead, we may see them target purely unlevered returns of 4–5% for core plus/ value add deals.

Opportunistic/High Yield:

- We expect bank appetite to lend on developments will be close to zero during the rest of 2020, and therefore expect on-site fund projects to start next year.
- Investment bank securitized and syndicated exits will likely remain closed off—but opportunities may exist to buy loans at attractive prices from banks looking to unload risk.
- REITs trading at big discounts will likely become cash starved and struggle to refinance their capital structures, resulting in potential opportunities to provide refinancing at high single-digit returns.[1]

1. There is no guarantee that this performance will be achieved.

The Takeaway

The global economy and commercial property markets are currently experiencing an unprecedented shock that has disrupted demand and created volatility in financial markets. The longer the economy and property markets remain cyclically weak, the larger and broader the opportunity set will be. Those properties that continue to benefit from demographic and technological long-term structural tailwinds should easily eclipse their 2020 price levels in the future. Investors should thus focus on ensuring that these vital investment trends are not currently being derailed by COVID-19. As always, but especially in the current circumstances, identifying and sourcing the best opportunities requires local teams backed by the depth and breadth of a global platform, with expertise across both equity and debt.

FIGURE 1: Sector Impacts and Trends to Watch

Sector	Cyclical Impacts	Structural Impacts	Trends to Watch
Hotel	• Immediate hit to tourism/travel in major hubs • Significant reduction in Chinese visitor numbers • Near collapse of summer 2020 leisure activities	• Potential long road to recovery for business travel, due to demand shocks • Swift rebound for leisure travel once consumer fears subside	• Increasing hotel occupancy and REVPAR • Decreasing ratio of business versus economy flight price
Retail	• Collapse in footfall (brick and mortar locations) due to social distancing measures • Steep increase in spending on low margin essentials • Sluggish high margin discretionary spending • Considerable supply chain stress, limiting offerings • Closure of leisure for foreseeable future	• Sharp e-commerce boost, even among older shoppers • Accelerated demise of secondary physical retail	• Increased e-commerce penetration rates
Office	• Near-universal working from home due to social distancing measures • Major requirements/projects being put on hold • Testing of co-work/serviced office business model	• Evaluation of agile/flexible working practices • Decentralization due to reliance on technology • Potentially greater working space required due to prolonged/permanent social distancing practices	• Tom Tom City Congestion Index • TfL passenger numbers
Student Accommodation	• Rapid closure of colleges and schools in most economies	• Impaired demand for high paying overseas students • Negative impact on sector due to rise of online distance learning	• Higher education student statistics, particularly in U.K. • Increase in online distance learning offered by elite universities
Senior Living	• Higher mortality rates for those 60+ years old	• Decreased demand from potential residents due to virus fears • Compounded staffing issues due to virus fears	• Increased number of World Health Organization nursing and elderly home beds
Industrial	• Lower throughput of goods due to severe drop in GDP • Significant boost in e-commerce boost	• E-commerce boost from older shoppers • Higher corporate inventories due to supply chain disruption • Shift to on-shoring of production due to fragile global supply chains	• Increased e-commerce penetration rates • World Shipping Council Container Port Volumes
Residential Private Rented	• Heavily insulated rental demand, making moves extremely difficult • Pressure on owner-occupier house prices due to slower transactions	• Increased rent affordability risk in the event that fiscal support eases too soon	• HMRC UK Housing Transactions • Zoopla search numbers

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