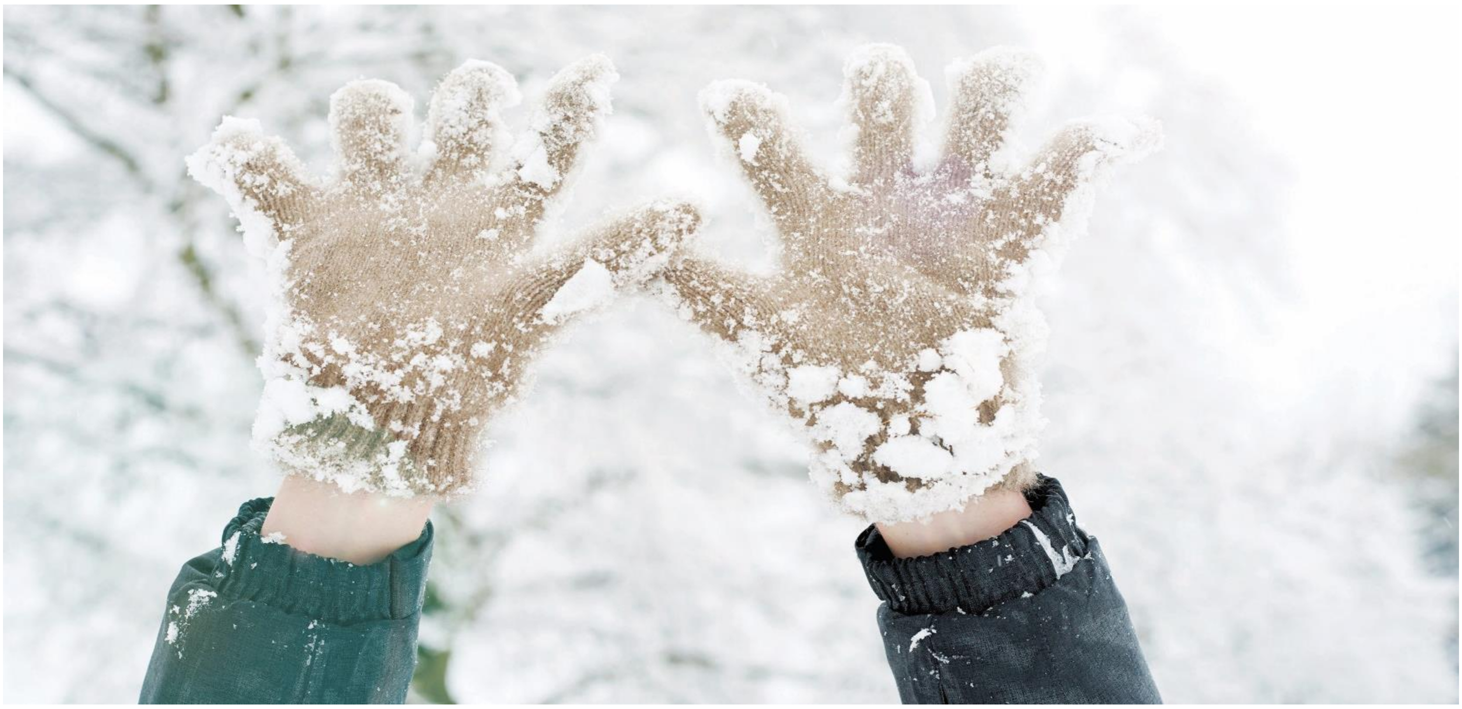
Looking ahead

Top 10 real estate questions for 2021 – December 2020



The first and foremost question on everyone's mind is whether vaccines will rid the world of COVID-19 in 2021, or at least substantially lessen its impact.

For several years now we have looked at the key questions we expected our industry to face during the forthcoming year. When we looked ahead to 2020, back in early December 2019, we have to confess that we did not even mention COVID-19, let alone foresee the massive impact that this new virus would have on the world. However, some of the predictions we made then have proved prescient.

For example, we posited that the floor on property yields could be below 2% and in 2020 we have indeed seen further falls in yields, focused on industrial markets, but also in some office markets too. Although we were not expecting a recession in 2020, in order to be prepared for one we recommended de-risking office strategies to core and ESG-compliant assets, and allocating to alternative sectors which provide more predictable income. In hindsight, we think this was a reasonable strategy. We tentatively suggested that some retail assets might start to find a bottom and industrial performance would ease. However, the pandemic put paid to this by turbo-charging the structural trends affecting these sectors.

Looking to 2021 the world has a huge challenge ahead of it. The first and foremost question on everyone's mind is whether the good news we have heard on vaccines can be translated into a solution which will rid the world of COVID-19, or at least substantially lessen its impact. The answer to this question will be crucial in determining how the real estate market performs in 2021 and beyond. Along with different COVID-19 scenarios, we provide answers to some of the questions we see as being key for the real estate sector.

For example, will retail continue to be a Big 4 sector? Is logistics real estate over-priced? We also look at ESG considerations such as the impact of climate change on insurance costs and how social impact investing is evolving. In addition, we look at the role of real estate in investors' broader portfolios post-COVID-19, an important question to address in the ongoing low interest rate environment.

1

Will the social component of ESG gain in importance in the aftermath of the COVID-19 disruption?

Even though the importance of the Social component of ESG has already increased over the past few years, we think the negative consequences of the COVID-19 pandemic, in terms of economic and social disruption, will further accelerate this trend. Socially responsible real estate strategies are very diverse and continue to expand. We think the importance of providing support services and infrastructure to communities and neighborhoods will grow dramatically (affordable housing, mental health assistance, schools/education, parks and safety). The growing inclusion of social responsibility factors into the real estate industry has triggered increasing demand to quantify and measure the positive contribution of real estate investments to society, specifically how they contribute to the 17 United Nations Sustainable Development Goals, which include: #3 Good Health and Well-being, #4 Quality Education, #8 Decent Work and Economic Growth, #10 Reduced Inequalities, #11 Sustainable Cities and Communities, #13 Climate Action and #17 Partnerships for the Goals. Additionally, we think that how real estate companies incorporate Diversity and Inclusion practices and metrics into their businesses will continue to grow in importance.

2

What is the role of real estate in client portfolios post-COVID-19?

Since real estate is playing an ancillary role in investors' portfolios we think it is useful to analyze how traditional assets, such as equities and bonds, have behaved recently. So far, the pandemic has been a unique recession in terms of its impact on financial investments. Indeed, major stock market indices will likely close 2020 with minor losses or even positive gains over the year, while bond yields have seen further downward compression from unprecedented lows. Assuming that the main central banks will continue to sustain their real economies with low rates for a relatively long period, we think that real estate will continue to be seen as a partial substitute for low risk bonds. Pension funds and insurance companies, in particular, have appreciated the ability of real estate to match their outflows against the income stability provided by rent collection. It's no surprise that such investors are now focusing even more on properties which can assure a high level of income stability in a recessionary environment. On top of this, real estate can provide the opportunity to deploy capital with a positive impact from the social and environmental points of view, which institutional investors are increasingly demanding.

3

What are the different COVID-19 scenarios?

Our base case is that vaccination will be effective, become widely available in 2021 and allow the economy to gradually recover to sustained growth. In turn, this will support real estate occupier demand and investor confidence. Positive trial results were announced for several vaccines in November 2020, which gives us some assurance that this base case will actually become reality. However, we acknowledge that there is a lot of uncertainty. A situation where the vaccine program proves more effective than expected and eradicates the virus more quickly poses an upside risk. In particular, it would likely speed up recovery in the leisure and hotels sector, which has been hit especially hard by travel restrictions. Alternatively, a downside risk stems from vaccines not being quickly and widely administered, due either to delays in manufacturing or distributing and administering them at scale. This could render the economy and real estate markets lackluster in 2021.
A more pernicious downside risk is if the vaccines prove only to be temporarily effective and the virus mutates into new strains which are resistant to vaccination. This could see the pandemic endure and ultimately force society to adapt to live with the virus on a permanent basis, radically altering the way we live.

4

Is logistics real estate overpriced?

With prime yields now below 4% in many key markets, the logistics sector has certainly seen a very rapid increase in pricing globally. Whether it is overpriced is hard to ascertain. On the one hand, the exponential surge in pricing has been a reaction to extreme times. The pandemic has pushed e-commerce penetration to levels many forecast would not be reached until 2025, or even 2030 in some countries. This has led to a surge in occupier demand, reduced availability and sustained rental growth. And the low yields need not be remarkable if they reflect structural shift. With the challenges facing retail and, to a lesser extent offices, who's to say logistics could not become the dominant commercial sector? Conversely, bidding processes have become so competitive that assets currently start at ambitious prices which are bid up further. There is certainly a sense of clamor around these deals, which questions the robustness of some of their underwriting. There is a risk that yields will start to reverse should conditions in other sectors start to normalize, leaving those who bought at record low yields vulnerable to capital declines. However, currently it is hard to see anything that would trigger such a reversal.

5

Will COVID-19 reverse the urbanization mega-trend?

We think that COVID-19 presents a temporary demand shock for urbanization, as ultimately, the main attractions of urban living have been temporarily closed or their operations severely limited. As we hopefully return to some form of normality in 2021 as vaccines become available, these attractions will start to be relevant again. Proximity to a workplace is normally the key attraction of urban living. Although many staff will increase the number of days working from home, most will still need to have at least some access to a centrally located office building. Whilst a select group of people may extend their commute on the basis of less frequent trips, they will need to remain within reasonable proximity to that hub location. And for other (generally younger) cohorts of society, the more social aspects of city living, and the need to have more physical time in their workplace, will remain major draws to urban living. Throughout history, job opportunities have been the number one driver of urbanization. In the post-COVID-19 world, urban centers are expected to remain the primary focus of job and wealth creation. A *pause for breath* is probably a more likely outcome, than a complete reversal of the urbanization trend.

6

What will corporate office occupancy look like at the end of 2021 and what is the future of this sector?

The positive vaccine news means that office workers should be able to return to their place of work by the end of 2021. But the key question remains: will there be a permanent structural shift to agile working? Employee surveys suggest that we will see a marked acceleration in the agile working trend, with the vast majority of office workers indicating they would like to see at least some degree of increased flexibility in their working arrangements. Corporate real estate teams are planning for this, and we expect the general trend of corporates consolidating their office footprints to continue and that headline vacancy rates will remain on an upward trajectory. Where lease events fall after the end of 2021, a significant volume of grey space is likely to form as lower desk utilization takes hold. Offices will be much busier this time next year for sure, but occupancy is likely to remain below the pre-COVID-19 level, particularly on Mondays and Fridays, when home working will be at its most popular. Offices will need to start to adapt to this increased flexibility, providing renewed focus on space for social interaction, which will ultimately be the main attraction in drawing employees back into the office.

7

What is the likely growth trajectory of emerging sectors like medical offices and data centers?

By convention, emerging sectors in real estate have struggled to find a permanent place alongside the traditional segments. Many investors have viewed them as niche and probably too high up the risk curve. Liquidity premiums were also arguably higher for non-mainstream sectors, where the path to a clear exit was often not straightforward. That said, in recent times these emerging sectors have garnered a growing group of admirers. Moreover, these new fans are increasingly open to deploying capital into these new asset classes, which often are compensatory in returns. Importantly, new sectors such as medical offices and data centers, to name but two, are backed by structural changes and macro-trends which are evolving at a pace faster than we ever knew. In the next year, we expect that the ample dry powder in capital will continue to find its way into these assets classes, mainly by way of operator and developer funding or portfolio acquisitions. With a greater critical mass, risk perceptions and investment underwriting will improve as investors gain a deeper understanding of the fundamentals and operating nuances in these emerging sectors. Slowly but surely, emerging asset classes can become mainstream once risk factors become easier to price in.

8

What impact might climate change have on real estate insurance costs?

The pandemic interrupted public discussion on environmental issues in 2020. However, insurance companies are concerned about the physical risks to real estate due to climate change, the effects of which are evident in the world today: warmer average temperatures, rising sea levels, melting ice caps, longer and more frequent heatwaves, erratic rainfall patterns and more weather extremes. According to Swiss Re[1], less than 50% of the total economic losses due to natural events in 2019 were insured. However, insurance companies, and in particular re-insurance companies, are increasing their attention on the effects of climate change, and real estate is a major focus. Currently the industry believes that the risk can still be insured, but has started to categorize areas with regard to risk exposure. Most of the risk categorization is still relatively static and around natural catastrophes like flooding. However, the short-term nature of most property re-insurance businesses allows for continuous adjustment of risk views. As such, insurance companies are developing more dynamic models which incorporate different climate change risk scenarios that can continually embed new understandings into risk assessments. This is likely to have an impact on insurance premiums for real estate assets over time. Ultimately, the question in 10 years might be what impact climate change has on an asset's valuation.

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[1] Swiss Re Institute Sigma report, No 2/2020, Natural catastrophes in times of economic accumulation and climate change, April 2020

9

Is retail still a Big 4 sector?

Yes, we think retail is still a major sector in the private market, but it's clear why investors would wonder. Momentum has been negative for years. Even after recent value declines, retail comprises 19% of the NCREIF US Property Index as of 3Q20 and 23% of the MSCI Global Property Index as of end-2019. The retail allocation of large, diversified core funds is a bit lower, at just 14% of portfolios in the US[2]. Tenant credit risk, repositioning costs or just insufficient risk premiums will likely keep the sector out of favor in 2021. Looking to the future, retail fundamentals should stabilize when economic expansion strengthens. Consumer spending powers the world's largest economies. All shopping will not move online, and indeed the majority still remains offline. Retail sites occupy desirable locations across metro regions and development approvals will likely bring new life to old centers over time via mixed uses. We think that retail will continue to play a part in portfolio construction, though the rise of niche sectors means retail is not likely to regain all of the ground it has lost. Notably, retail comprises only 9%[3] of the US listed market, having dropped five percentage points in 2020 alone. By contrast, niche sectors account for more than half of the US listed market capitalization. On that point, office is just 6% of the US publicly-traded market, yet no one questions whether that sector is too small to be a Big 4.

10

Rates are low while risk is not. What is the current state of the lending markets?

Lending to commercial real estate has been constrained throughout this cycle, due to increased regulation after the financial crisis, as well as heightened risk aversion among bank lenders. This had created space for debt funds to enter the markets, where bank lending fell away most dramatically, particularly the UK, US and Australia. The lower interest rate environment enabled them to secure deals at good risk-adjusted returns and there has been increasing investor interest for debt products as returns on equity have compressed. Following the onset of COVID-19, initially there was a freeze in the market as lenders struggled to underwrite deals. While rates are low, there are concerns about what widespread capital declines mean for loan-to-value (LTV) covenants, particularly in the embattled retail sector and increasingly in the office sector as valuations remain uncertain. For these two sectors, lending margins have increased slightly (~25 bps), while LTVs are believed to have fallen by around 5-10 percentage points. Logistics on the other hand has seen margins fall as lenders engage in a *flight-to-quality*. There may be even more favorable returns for those willing to lend due to decreased supply. However, participants need to be very thorough in their due diligence to ensure valuations provide enough of a cushion.

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[2] Source: NCREIF Open-End Diversified Core Equity index as of September 2020

[3] Source: FTSE NAREIT as of October 2020

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