Global Real Estate Outlook: A Quest for Certainty in Uncertain Times

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COVID-19, a global pandemic, is first and foremost a public health emergency. As a result of the necessary policy responses around the world to slow the spread and mitigate the health impacts, it has also become an economic crisis and triggered financial market turmoil.

Both the emergency itself and the policy response to the emergency have consequences for real estate:

- **Asset management: The public health emergency has demanded swift and decisive measures by real estate asset managers and property managers** in a host of ways including frequent communication, enhancements to hygiene and security, guidance and support to tenants; but also checking the degree to which public policy measures may disrupt or help to cover any near-term disruption of net operating income.
- **Portfolio management: The unfolding economic crisis and policy responses around the world will demand a measured real estate portfolio response** depending on the depth and duration of the period of dislocation, with real estate sectors such as hotels and retail relatively more vulnerable than logistics and multi-family.
- **Capital markets: The turmoil in financial markets may generate transaction opportunities if a level of stress and distress** among some real estate investors leads to the potential to recapitalize otherwise sound real estate; the most immediate impact on real estate has been felt in the debt markets with rising risk premia; those investors with low-leverage, long-duration debt should be relatively less impacted.

Investors crave certainty but these are uncertain times. Events are moving very fast and, by the time this paper is published, will likely have evolved further. So while this represents current thinking at the time of writing, it is perhaps best interpreted as a commentary on how to connect the pandemic to short-term stresses in the capital markets, especially debt and listed real estate, and point to the potential longer-term implications for direct real estate on the other side of the crisis.

Pandemic conditions – The epicenter shifts

COVID-19 has sent shockwaves around the world. This is not the place for an in-depth epidemiological discussion. In time, health authorities may know more about the spread and transmission of the disease and how best to tackle it. The focus here is on the implications for the real estate outlook of what is presently known.

By March 31st, more than 800,000 people worldwide have tested positive. By April 13th, the number of cases had more than doubled to close to two million worldwide. That number is poised to rise. While approaches to recordkeeping and levels of testing vary widely, it is clear nowhere is immune. Initially centered in Wuhan in China, by early March the epicenter shifted to Continental Europe (Figure 1), initially Italy, Spain and France, more recently the United Kingdom. At the end of March, the number of active cases in the US was rising fast. With more than 500,000 active cases in the USA by April 13th, it is clear the epicenter is shifting again.

Does the early Asia Pacific experience hold any lessons for Europe and North America? Perhaps. In both China and South Korea, the initial outbreak appears to have peaked following tenacious containment efforts; the number of active cases is in decline. After 6-8 weeks, a semblance of normal life has begun to return, although warily given the potential for a second wave to flare up, imported from overseas.

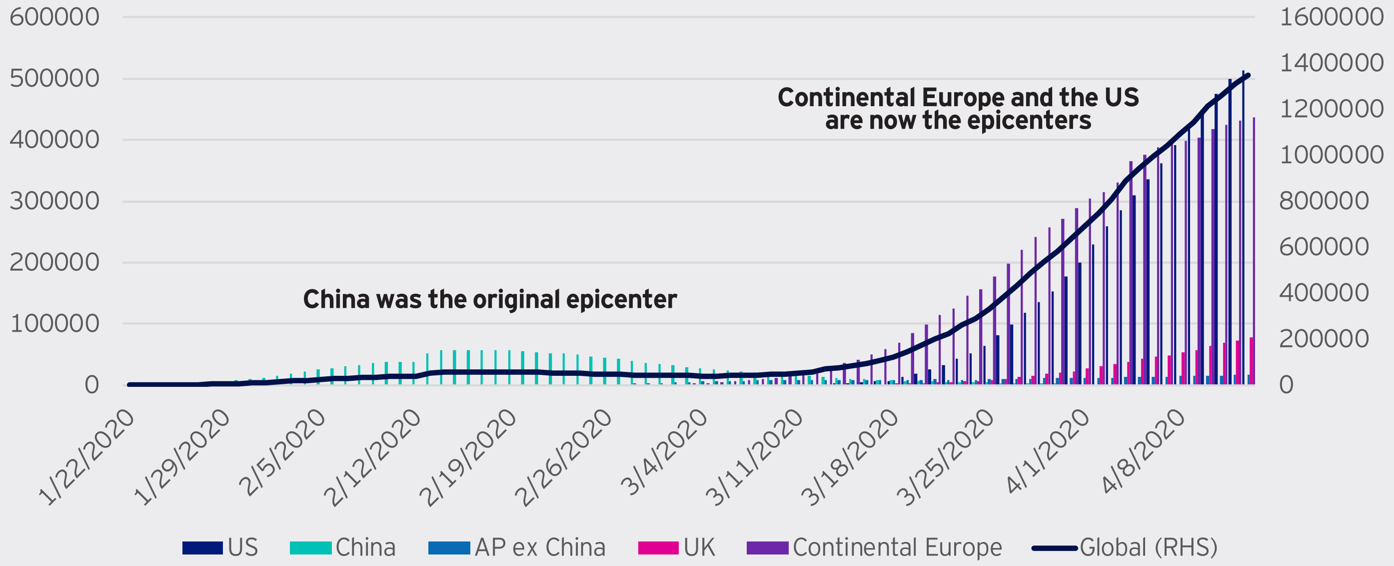
Real estate occupier market conditions – A temporary cessation of economic activity

Under normal conditions one looks to the health of the economy and employment as a guide to real estate demand. That is difficult to do right now. There is considerable uncertainty. Historically, most short recessions, most natural disasters and most epidemics have been followed by a quick and sharp recovery.

At this stage no one knows how long the global pandemic will last. No one knows how effective the policy response is going to be. The global economy is likely to contract sharply in Q2 2020, probably by the most on record, but by exactly how much in different countries, and if that endures in H2 2020, is difficult to judge.

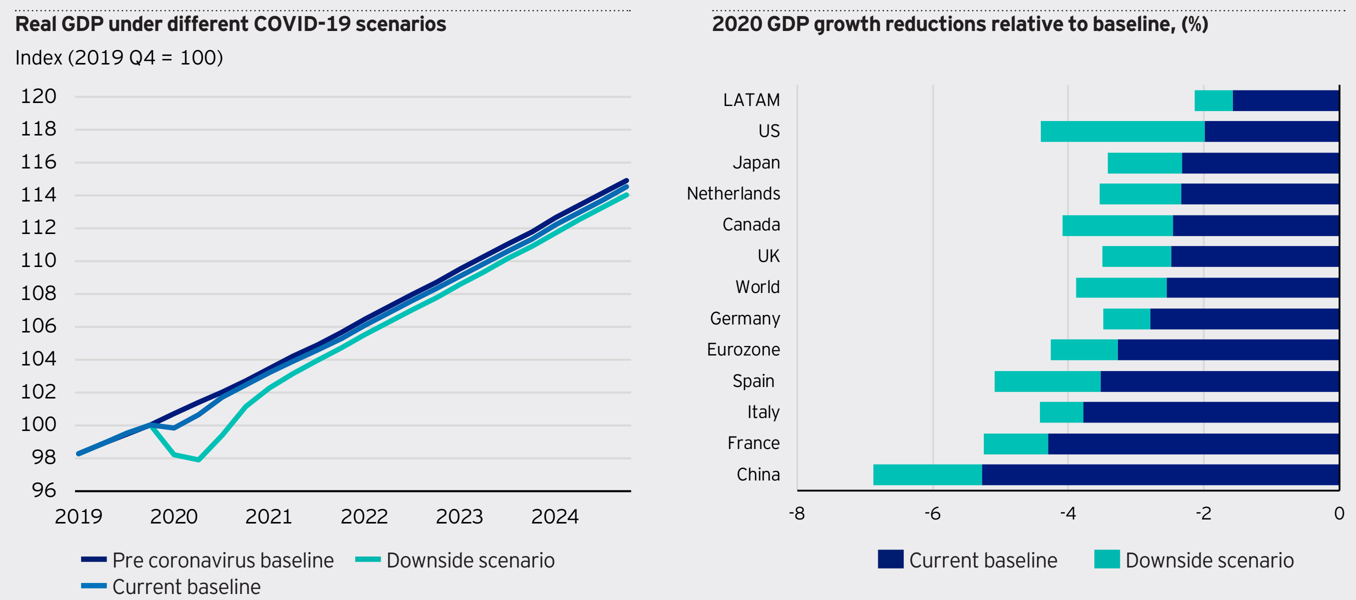
The Oxford Economics data from March 18th are shown in Figure 2. Along with other economic forecasters, Oxford has been updating its forecasts very frequently and is likely to continue to do so. Compared to a pre-coronavirus forecast of 2.6% global economic growth in 2020, by April 8th they had downgraded their central forecast to -2.8%, effectively the downside scenario they had published in mid-March. They anticipate that the global economy will be permanently 1.5% smaller than it would have been on its pre-COVID-19 trajectory. Many forecasters expect major economies to contract by an unprecedented 20-40% in Q2 and Q3 2020.

Figure 1 - Active COVID-19 cases around the world
The epicenter shifted first to Continental Europe and now the US



Source: Invesco Real Estate based on data from Johns Hopkins University as of April 14, 2020.

Figure 2 - Global growth in different COVID-19 scenarios
A sharp downturn; China and the Eurozone are the most affected



Source: Invesco Real Estate based on data from Oxford Economics/Haver Analytics as of March 2020.

In many ways for direct real estate, it is unnecessary to try to estimate or forecast the exact scale of the impact. A global pandemic leading to a lockdown of much of the global economy is an unprecedented black swan event. The consequences for real estate demand are clear. Demand is at the very least "interrupted"; there is a good chance that it will be materially diminished for an extended period. It is doubtful that describing the economic conditions we are in as a "recession" do them justice. They are more properly thought of as simply a "disruption" or "temporary cessation" of economic activity. Whether the outlook afterwards is for a recovery that is "V-shaped, "U-shaped" or "U-shifted" remains to be seen (Figure 3). The longer the pandemic remains virulent, the deeper and more lasting the economic consequences are likely to be.

The starting point helps. Entering this crisis, real estate market fundamentals around the world appeared largely sound. Demand was adequate to absorb the modest supply volumes in most cities and sectors. We had expected rents to increase, mostly at a gently slowing pace in about 80% of the market-sector combinations we monitor worldwide (retail being the notable exception). No longer. With economies locked down and many tenants in crisis mode, market-level rents are now unlikely to stabilize or increase until a period of pandemic and economic stability has re-emerged.

At the end of the first quarter, the focus of real estate asset managers is on rent collection as occupiers, particularly those in the hotel and retail sectors struggle to maintain cashflow and liquidity in the unprecedented locked down economic conditions.

Figure 3 - What might the recovery look like?
The shape and timing hinges on the scale and level of the disruption

Depth of disruption | **Length of disruption** | **Nature of the disruption**

Virus contained in H1 2020:
- Sharp global contraction in Q2
- Offset by fiscal stimulus
- Monetary policy addresses stress
- Resumption drives recovery

Real estate implications:
- Occupier markets recover quickly
- Values largely stable for core assets

Virus disruption persists into H2 2020:
- Global contraction persists in Q3
- Offset by additional stimulus
- Monetary policy addresses stress
- Pent-up demand drives recovery

Real estate implications:
- Occupier markets recover gradually
- Hotel/retail values under pressure

Virus disruption until vaccine effective:
- Lasting global economic damage
- Fiscal stimulus less effective
- Monetary policy mitigates stress
- Stimulus needed to spur recovery

Real estate implications:
- Occupier market weakness endures
- Values under pressure in all sectors

Source: McKinsey and Invesco Real Estate.

Real estate capital market conditions – Debt markets and listed real estate most affected

Perhaps the most immediate impact on real estate capital markets has been through the debt markets. Initially, the Federal Reserve and other central banks emergency cuts in interest rates lowered borrowing costs for real estate. Not for long. A sharp spike in corporate debt yields reflected the uncertainty about the near-term outlook for occupiers (Figure 4). This was rapidly transmitted into less liquidity and higher lending margins when lenders faced their own balance sheet pressures as equity prices plunged. This triggered a wave of margin calls which put extreme liquidity pressure on some borrowers, particularly some mortgage REITs. As a result, total lending costs are now slightly higher than before the crisis. One consequence is likely to be a positive debt mark-to-market at the end of the quarter for those private real estate funds which had locked in long-term, low-cost debt before the coronavirus broke.

Have underlying real estate values fallen? Probably, but there is scant empirical evidence to substantiate by how much so far. Direct real estate cannot be traded on a screen. One consequence of the disruption to normal life has been the curtailment of transaction activity. Due diligence becomes difficult if specialists cannot carry out property inspections.

Initially in Europe and North America, transaction activity continued with many deals that were far advanced closing as planned. More recently, examples of delay, cancellation and re-pricing have emerged. This is likely to accelerate. According to RCA data, by April 10th, North American transaction volume was down just 5% on the same period in 2019, Europe was down 24% (Figure 5). This seems unlikely to last. In Asia Pacific transaction volume is down 60% on 2019 levels. Thus far there is little evidence that transactional activity is getting back to normal in Asia Pacific. The experience in the region seems likely to set the pattern for the other regions in the quarter ahead.

While so far there is limited transaction evidence of the impact on direct real estate pricing, the implied asset pricing in global REIT markets is another matter. Given the extraordinary volatility in financial markets over the last month. It would be unwise to read too much into the precise scale of implied price decline. In previous recessions, such as the Global Financial Crisis, the eventual decline in direct real estate prices was only half that implied by the listed market. One consequence of this, is that when the recovery phase comes, listed real estate is likely to recapture some of the ground it has lost during the price correction over recent weeks.

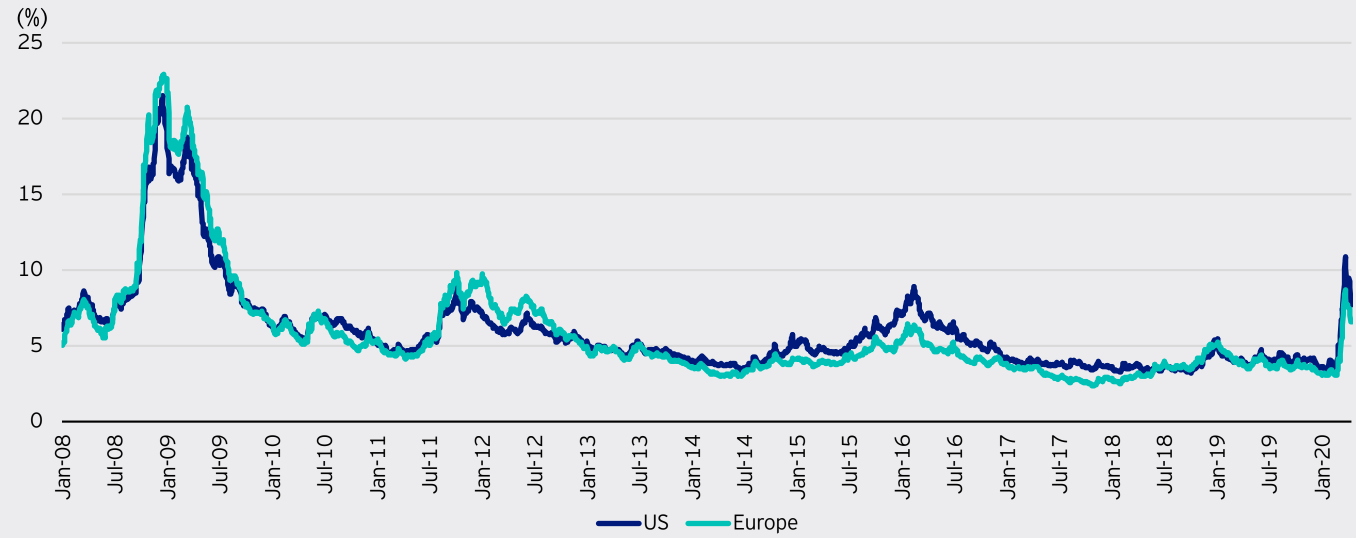
The direction and pattern are clear though. Analysis by McKinsey suggests that the density of human interaction typical in a property sector appears to be more closely correlated to the decline in REIT prices than typical lease length, which has traditionally been a good metric for price vulnerability (Figure 6). REIT prices for lodging, student housing, healthcare and regional malls have all fallen much more significantly than specialty sectors like data centers and cell towers. Industrial, office and apartments are somewhere in between.

Real estate strategy considerations in the current environment – Back to basics

These are extraordinary times. An economic chasm appears to be opening over the coming weeks and months that needs to be bridged by massive fiscal and monetary policy measures on a scale unseen before in order to limit any long-term damage. The initial salvoes in that policy response have been at an unprecedented scale to match the unprecedented nature of the challenge. That is encouraging.

The theme of our H2 2019 House View was "a question of balance". Last year, with real estate prices high, we felt it was important to adopt a defensive posture against near-term cyclical risks, but to continue to try to take advantage of the long-term structural trends that were playing out – largely related to technology and demography. While, we did not envisage a global pandemic as the trigger for a downturn, this strategic positioning provides some comfort as we endure the COVID-19 crisis.

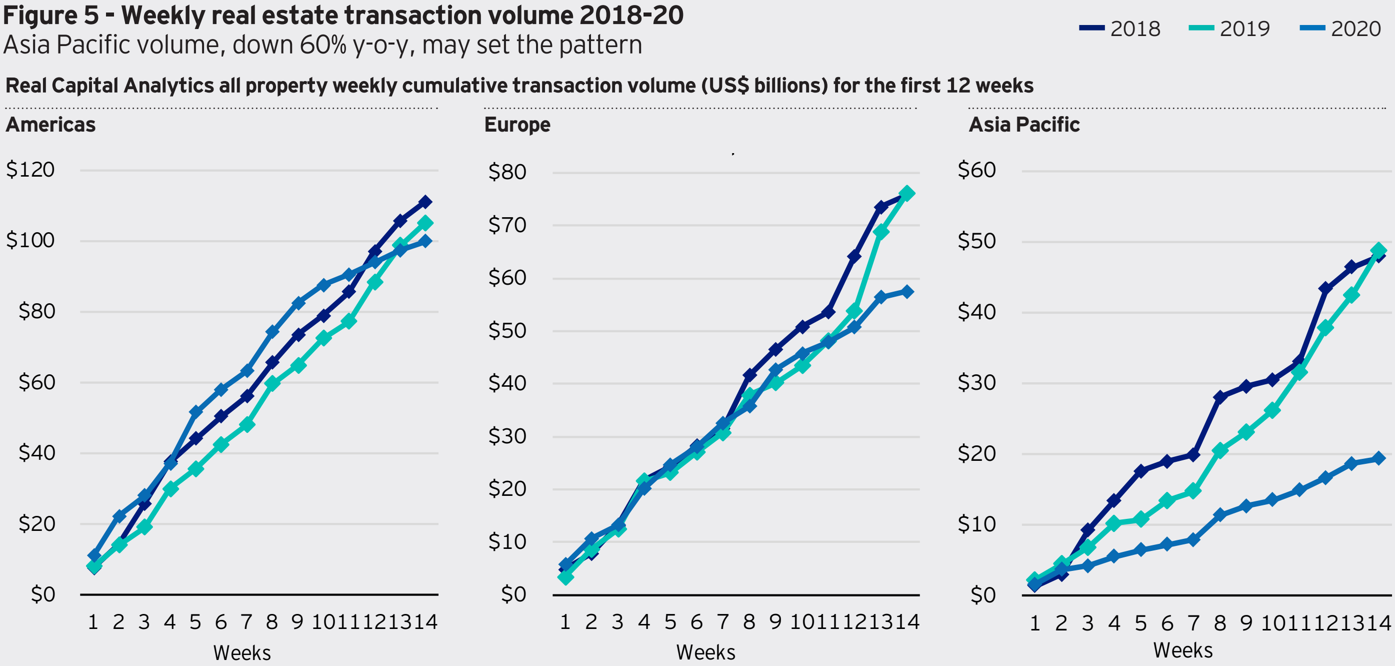
Figure 4 - US and European corporate debt markets 2008-20
High yield debt has spiked to its highest levels since the GFC



Sources: Invesco Real Estate based on data from Bloomberg Index Services Limited as of April 13, 2020.

Figure 5 - Weekly real estate transaction volume 2018-20
Asia Pacific volume, down 60% y-o-y, may set the pattern

Real Capital Analytics all property weekly cumulative transaction volume (US$ billions) for the first 12 weeks



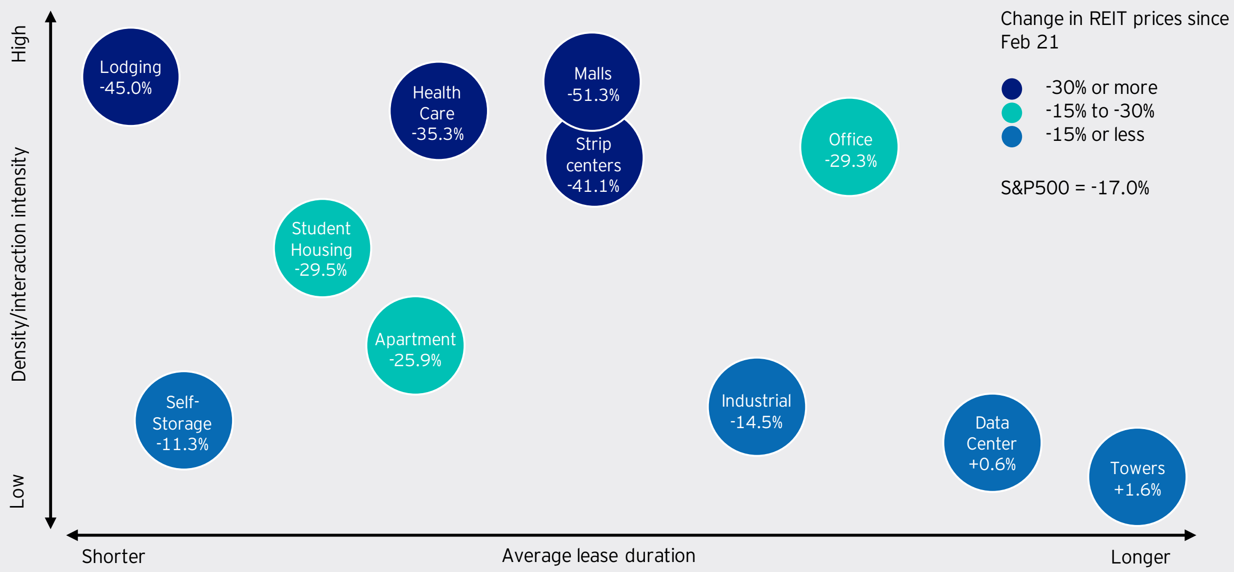
Note: Deals $10m and greater; all major property types excluding development sites.
Sources: Invesco Real Estate based on data from Real Capital Analytics as of April 2020.

If the disruption is relatively short, it is easy to envisage a relatively swift bounce back. If the disruption endures, the consequences would likely be more substantial. Either way the prudent broad investment strategy actions in real estate in the near term are likely to be similar and include three main themes:

- **"Cash is king".** A focus on prudent cashflow management by efficiently collecting rent, nurturing tenants, hoarding cash, maintaining occupancy and minimizing discretionary operating expenses.
- **"Care for capital".** Frequent communication with investors is essential; at both the asset and portfolio level, pay close attention to loan covenants, carry out stress tests, maintain low levels of long-duration leverage.
- **"Pursue opportunities".** If favorably priced opportunities arise in sectors that are good long-term prospects, be prepared to act on any quality assets that may become available especially through dislocation, stress or distress. One of the lessons learned in previous down-cycles has been the importance of being prepared to act before the bottom of the cycle is clear. By the time the bottom is clear, the window of opportunity is likely to have closed.

Figure 6 - Change in REIT prices by sector during COVID-19
Interaction density seems to have mattered more than lease length

Illustrative relationship between density of interaction, lease length and the implied decline in unlevered values



Total return estimates based on data from Green Street for the period Feb 21 to Apr 13, 2020.
Source: Invesco Real Estate using data from McKinsey Real Estate Practice and Green Street as of April 2020.

Looking forward, what can we have conviction about? Long-term trends. Despite the uncertainty, perhaps because of the uncertainty, it seems appropriate to focus on a handful of clear, sub-market/sub-sector combinations that are likely to outperform long term, in which values should hold up better and opportunities would look better if they reprice. There are many real estate themes that flow from secular trends in technology and demography. Three broad sector examples that seem to apply globally are:

- **Logistics** has recently been a strong outperforming sector and is likely to continue to be (demand remains robust, supply chains will be recalibrated, manufacturing may become more local, e-commerce has been reinforced).
- **Offices** in prime CBD locations and innovation/life science hubs have been the winners in this sector (outperformance is a clear pattern, space per employee may increase, work from home may offset this but more in buildings catering to commodity activities than innovation).
- **Multi-family** may face affordability challenges in the near term but longer term is likely to remain robust (it may be more resilient in the slowdown because it is possible to maintain occupancy, tenants are less likely to move, most tenants of quality product are in less vulnerable occupations and income levels but beware regulations that may limit landlord options if tenants stop paying rent).

What else? Had COVID-19 not come along, one of the main themes of our H1 2020 Global House View would have been climate change and resilience. While this topic has taken a back seat over recent weeks, it has not gone away. Building climate change into real estate strategies and asset level execution activities in ever more thoughtful ways will remain a key priority over the next decade. In some ways, a lesson of COVID-19 might be how important it is to plan for resilience to the potential big picture risks associated with climate change.

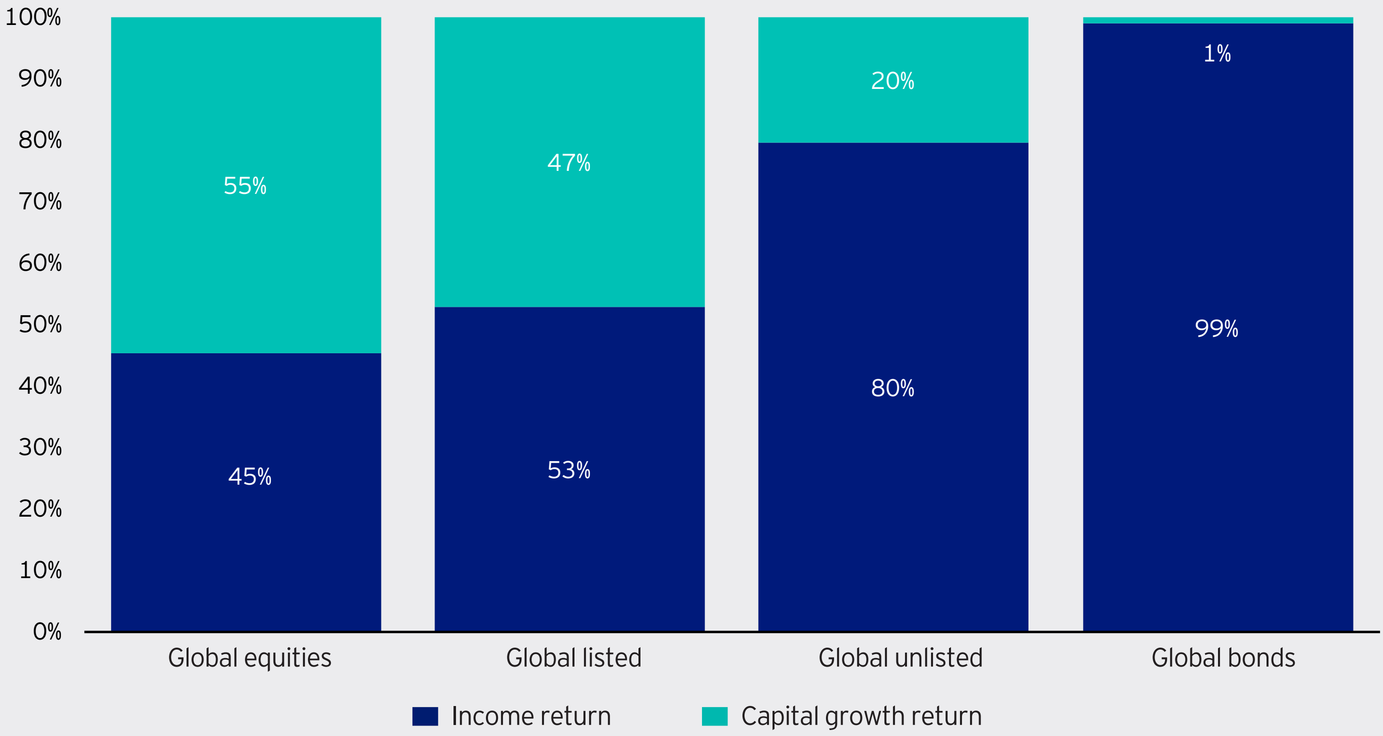
Conclusion

The COVID-19 crisis is unprecedented. The pandemic has led to a major disruption of the global economy, not a typical recession. Until the path forward on the pandemic becomes clearer it is too soon to predict the depth of the slowdown or shape of the recovery.

Underlying the different investment forms, real estate at its heart is a long-term asset class. Historically, globally over the long term, income has provided 53% of the total return from unlisted real estate and 80% of the total return from direct real estate (Figure 7). Post-coronavirus, in an era of enduring low inflation, interest rates and growth rates, the income return from real estate, generally secured on contractual leases, is likely to prove very attractive to investors.

Figure 7 - The income component of total return 2001-18
Real estate derives a significant share of total returns from income

Total return components for different asset classes (%)



Notes: Shares of total returns are approximate values which exclude residual effects. They are based on 18 years (2001-2018) of annual income return and capital growth histories. Global equity performance is calculated based on the MSCI World Index. Global bond performance is calculated based on the Bloomberg Barclays Global Aggregate Index. Global listed real estate performance is calculated based on the FTSE EPRA/NAREIT Global Developed Index. Global unlisted real estate performance is calculated based on the MSCI Global Property Index. Source: Invesco Real Estate based on data from MSCI, Bloomberg Barclays and Macrobond as of May 2019. An investment cannot be made into an index. **Past performance is not a guide to future returns.**

Risk warnings

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