MAYFAIR CAPITAL
Member of Swiss Life Asset Managers

Mayfair Capital Briefing Note: Impact of coronavirus outbreak on UK real estate

Executive summary

- Our UK economic forecasts have been downgraded for this year. A recession is expected during the first half of the year with a gradual return to growth anticipated during H2, but risks remain strongly skewed to the downside.
- Current conditions have driven a significant monetary and fiscal policy response, which aims to support the economy in order to enable a return to growth once the pandemic has passed.
- Material uncertainty clauses have been included in valuations given the unknown future impact that COVID-19 might have on the market. We expect to see outward yield movement over the next three to six months due to lower investment activity, uncertainty and low levels of investor confidence.
- However, under our base case scenario, any outward shift is expected to be constrained due to continued investor demand for income and real estate's pricing relative to gilts in a lower interest rate environment. Pricing of long-let, index-linked assets is expected to remain robust and may harden.
- Rental growth forecasts are being revised downwards given current economic conditions which we anticipate will result in increased tenant failures and delayed decision making by occupiers. Underlying occupational market fundamentals in the office and industrial sectors remain robust and should support a return to rental growth in the medium term.
- Hotel and retail assets are most vulnerable to capital loss.
- Current conditions are expected to accelerate many of the structural changes that inform our thematic investment approach. Assets and sectors that demonstrate strong alignment with our themes are expected to be most resilient.

Economic impact

Economic forecasts for this year have been downgraded following the escalation of the coronavirus outbreak driven by weaker activity in tourism and trade as well as interruptions to supply chains. Given the increasing downside risks, we have significantly lowered our projections for full-year 2020, and now expect the UK economy to contract this year. The temporary economic impact on services is expected to be significant, resulting in a recession over the first half of the year but a gradual return to growth is anticipated during H2. A major risk is a longer-term disruption to global supply chains and the movement of people.

Current conditions have prompted an immediate and strong monetary and fiscal policy response, with the G7 countries pledging to do whatever it takes to support the global economy. Policymakers will be incentivised to take additional significant steps to support employees and the economy over the coming months as voters are likely to be unforgiving if they get it wrong. The Bank of England has held two emergency meetings and cut interest rates to a historic low of 0.1%. It has also allowed banks to loosen their capital buffers to allow them to lend an additional £200bn in corporate credit, announced £200bn of extra quantitative easing and enlarged the Term Funding Scheme with incentives for small and medium-sized businesses. A significant fiscal policy response has also been unveiled. In the Budget on the 11 March, the Chancellor announced a £30bn stimulus package to support the economy through the coronavirus crisis and, less than a week later, a further £350bn of financial support was unveiled. It is highly likely that more measures will be required in the short-term.

Real estate impact – short term

It is still too early to fully assess the impact of coronavirus on the UK real estate market as this will depend on the duration and severity of the current outbreak. However, we can identify some short-term implications related to pricing and rental growth:

1. **Pricing:** Real estate investment volumes are expected to reduce as investors adopt a wait-and-see approach against a backdrop of heightened uncertainty. Volatility in other asset classes will also have impacted portfolio weightings and these may need to be rebalanced. Any slowdown in activity is likely to be compounded in markets that are reliant on overseas capital, due to travel restrictions. Consequently, the competitive pressure seen at the start of the year has reduced and yield compression that we anticipated in some segments at the start of the year looks less likely.

   Pricing assets is increasingly challenging and the impact of COVID-19 on the market is highly uncertain. Consequently, valuers have begun including material uncertainty clauses in their valuations. Yields in the retail and leisure sectors are already coming under pressure and assets with high exposure to co-working operators are also in the spotlight. We expect to see further increases in yields over the next three to six months. However, under our base case scenario we expect any outward yield movement to be constrained in the second half of the year by the lower interest rate environment and looser monetary policy. Against a 10-year gilt rate of 0.49% (25 March 2020 – 11.02 BST), the income characteristics of real estate mean the case for investment based on relative pricing remains compelling. We anticipate that investor demand for long-let, index linked income streams will remain particularly strong and pricing may harden in this segment.

2. **Rental growth:** Short-term rental growth expectations are being revised downwards. Weaker economic growth will have a negative impact on occupier business activity, increasing the risk of greater tenant failures and therefore, loss of income. Faced with the current levels of uncertainty, occupiers are likely to delay real estate decisions, reducing activity in the leasing market. However, the underlying real estate fundamentals remain robust. Good quality supply remains in short supply, particularly in the office and industrial sectors, and should be supportive of a return to rental growth once the virus is contained.

With regards to individual sectors, hotels and retail assets look most vulnerable. Holidays and business trips are being cancelled or postponed, retailer supply chains have been disrupted and people are less likely to visit physical retail due to fear of infection and Government guidance on social distancing. This will worsen if the Government introduces more draconian lock-down measures. In our view, this compounds the challenges facing the retail sector and it is expected that value loss in this sector this year will be sharper than previously anticipated.

The industrial sector may be vulnerable in the short term given the disruption to global supply chains. For many occupiers, this will have a negative financial impact resulting in rent arrears and an increased default rate. However, the latest crisis has highlighted the vulnerability of global supply chains and just-in-time delivery models. Many industrial occupiers may look to reassess their supply chain arrangements in the medium-term. There is potential that this results in more demand for UK storage space or a shift towards the reshoring of some manufacturing. This driver is likely to be exacerbated by Brexit, depending on the final deal agreed.

Potential long-term structural impacts

In our view, the current coronavirus outbreak is likely to accelerate many of the structural changes which inform our thematic investment approach. This includes a shift towards re-shoring or near shoring manufacturing to reduce exposure to global supply chains- as outlined above. This shift was already being driven by concerns around the impact of Brexit on UK borders and tariffs as well as an increasing emphasis on the carbon footprint of supply chains as climate change rises up the corporate agenda. Current events will only increase the urgency surrounding a reassessment of supply chains.

In the office sector, there is likely to be more demand for more flexible arrangements, which would see more people working remotely. This is expected to expose vulnerabilities in some IT infrastructures and may bring forward greater investment into digital connectivity. This will hasten the shift towards flexible working and the related transformation of office floorspace, even once the virus has been contained.

In the retail sector, current events are likely to drive further increases in online retail as people seek to avoid public spaces. Already Ocado has reported a surge in orders and delayed fulfilment times due to demand. This will increase obsolescence in the retail sector and drive increased demand for logistics stock.

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