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 rebound in activity is anticipated during the second half of the year but risks remain strongly skewed to the downside.
- Current conditions have driven a significant monetary and fiscal policy response, which should provide some support for the UK economy in the short-term.
- There is potential for outward yield movement due to lower investment activity. However, this is expected to be constrained by 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.
- Short-term rental growth forecasts may need to be revised downwards given expectations for weaker economic growth, which could result in increased tenant failures or 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. Several of these issues were already evident in the most recent PMI numbers. The service sector reading remained strong at 55, but respondents noted the virus hitting transport and tourism with falling activity in both areas. Likewise, manufacturers have noted rising costs, and lengthening lead and delivery times. As a result, they are running down their inventories and shortages of supplies and stock may well occur.

To date, downgrades to UK GDP forecasts have been relatively modest as most commentators assume that the virus will be contained, and that activity will rebound in the second half of the year. The OECD has reduced its UK GDP forecast for this year by 20bps to 0.8%. As we see increasing downside risks, we have lowered our projections for full-year 2020, to now only 0.3% The temporary economic impact on services is expected to be significant, while manufacturing activity should rebound in a v-shaped form later in the year. A major risk is a a longer-term disruption to global supply chains.

Current conditions have prompted an immediate and strong monetary and fiscal policy response. 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 followed the US Fed and announced an emergency cut of 50 bps in interest rates to 0.25%. It has also allowed banks to loosen their capital buffers to allow them to lend an additional £200bn in corporate credit. A significant fiscal policy response has also been unveiled. In the latest

Budget, the Chancellor announced £30bn stimulus package to support the economy through coronavirus and indicated that this could be increased if required.

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 may reduce and yield compression that we anticipated in some segments at the start of the year looks less likely. In contrast, there is potential for yields to increase over the short-term. That said, any outward yield movement is expected to be constrained by the lower interest rate environment. Against a 10-year gilt rate of 0.29% (11 March 2020 – 11.20 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 may need to be 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. 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 - as outlined above. While Brexit, will support this shift, it is also aligned with the growing focus on climate change and reducing the carbon footprint of manufacturing and 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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