property funds research

COVID-19 market update

March 2020

1. Macro economics

This is an unprecedented and volatile environment with facts changing on a daily basis. It is important to be clear; **nobody knows what the actual impact of COIVID-19 on the global economy will be.** And it is likely that this remains the *status quo* until healthcare experts have provided a way of limiting the spread of the disease. The economic crisis requires the health crisis to be solved first.

In economic terms, the COVID-19 crisis is predominantly a severe demand shock to the economy but with the potential to significantly damage the supply side which would have long-lasting effects on growth. It now appears that the global economy will enter recession at some point in 2020, (some economies may already be there) with a rapid contraction in consumer demand as limits are placed on the movement of populations. Should the impact be limited to a short-term demand shock with limited impact on the supply side then an upside scenario of fiscal and monetary easing and a return in confidence to consumers and business could see a V or U-shaped recovery in GDP. However, if the impact severely reduces capacity in the economy, then the recovery is more likely to be slower and lower with the potential for a prolonged deflationary period. The volatile price swings in global risk assets reflects the fact that there is no consensus view as to the most likely outcome.

Globally, risk assets have fallen 30-40% in value since the peak in early February. There is a clear and understandable risk-off stance that has been adopted by investors with earnings for corporates expected to weaken significantly for at least H1 2020. Markets have not responded positively to the significant easing in monetary policy (reduced policy rates, increasing asset purchases, increasing inter-bank liquidity, etc) and there is concern that there is limited firepower left for central banks. It is likely that a co-ordinated fiscal response is required to restore some calm to investment markets and to protect against lasting economic damage to economies.

Clearly, PFR have no expertise in predicting the path of the virus and as such we are reliant on health experts in obtaining information. For PFR, the key questions are (i) whether the virus has changed the long-term fundamentals for real estate assets? And, (ii) whether the change in market prices are proportional to the fundamentals?

2. Occupier market

At the start of year, occupier market conditions (excluding retail) were generally supportive of further rental growth. Speculative development had been constrained and vacancy rates close to historic lows. The outlook has now changed significantly, at least in the short-term.

<u>Short term impact on sectors</u>
Whilst PFR expect an overall decline in occupier demand across commercial sectors (as is typical for a recessionary period), in relative terms we expect that the impact will likely exacerbate existing structural changes that have been evident in the market over the past 5 years. But to be clear, structural tailwinds will not

provide complete protection against a recessionary period. PFR expect a rise in default rates across sectors but with higher rates in hotels, leisure and non-food retail.

The most impacted sectors are likely to be assets where occupiers service discretionary consumer spending, particularly where consumers are required to travel (e.g. cinemas, restaurants, hotels, shopping centres). Demand for hotels, restaurants, and leisure are likely to suffer a sudden drop that will place operating cash flows under significant pressure.

Retail assets already challenged by the structural shift in consumer habits to online shopping will now experience significant cyclical pressures as consumption is impacted by sharply lower footfall and consumer spending. For European countries where a lockdown on the population has been implemented, non-food (supermarkets) and non-medical retail locations are now closed to the public.

In contrast, retailers that operate a home delivery/online service are likely to experience a rise in the share of sales made through online channels. For instance, Amazon have announced 100,000 new full-time and part-time roles in the US and increased the minimum wage for employees as part of their response to service higher demand. Demand for logistics assets, particularly last mile facilities is expected to be more robust. Storage facilities could also benefit from the disruption to supply chains as business try to reduce disruption by increasing inventories where possible. Logistics/light industrial occupiers linked to the automotive or aerospace supply chains are likely to experience a significant disruption.

For office markets, expect lower net absorption and modest rise in vacancy rates as speculative space takes longer to let with businesses likely to postpone decisions until greater clarity on the impact on the economy is provided. However, the trend towards flexible working and technological advances mean that many businesses will have in place the necessary infrastructure to continue to operate and provide services for customers. This period could see a continued but stronger structural change towards flexible and co-working spaces as business. The risk to offices is more medium term with secondary effects from the reduced operational cashflow from underlying customer base.

In the residential sector, there will be a stark difference in the performance of for rent (social housing, PRS) and for sale assets with the former more resilient as bank financing and demand from owner occupiers reduces.

Across alternative sectors, the impact will be differentiated. In the care home industry, whilst income is often government backed the fragmentation in operators means covenant quality will vary significantly. Some management teams are likely to struggle to cope with growing demands in the level of care required. Facilities aimed at providing social care for younger children may also face difficulties if governments have top close schools. Again, this will place strain on business viability for some operators. Fiscal measures may provide these sectors with more support than other commercial assets. Student accommodation may also see operating revenue squeezed if overseas students are unable to travel to take-up university places at the start of the next academic year (Q3 in the UK).

The short-term outlook for occupier markets may mean that funds have to cut or suspend dividend payments in an effort to preserve cash to meet/reduce liabilities or if managers have to implement rent holidays for tenants.

In regards, to the first question about whether long-term sector fundamentals have changed. The answer is that it is too soon to answer with sufficient conviction to change our expectations. Governments appear willing to "do whatever it takes" to avoid damaging economies in the long term, but it will be some time yet before we know if the measures announced this week (with more expected in the coming months) have been enough. What we can say is that there is now a greater degree of uncertainty around fundamentals and this needs to be factored in when making investment decisions. Or to put it another way, investors should continue to invest with an adequate margin of safety.

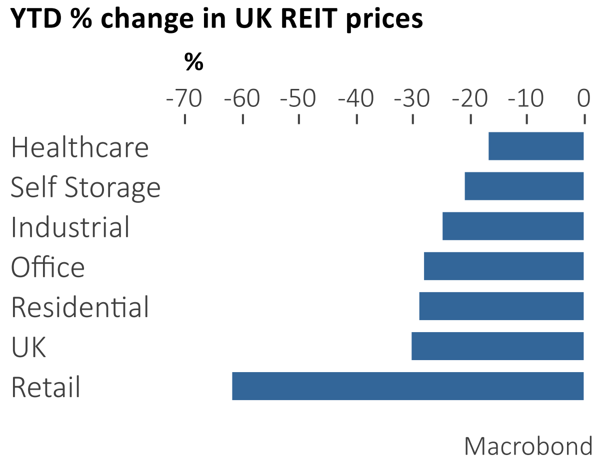
3. Investment market

Our investment approach is based on allocating capital through an absolute value framework. We believe that this enables us to understand the current state of market pricing and sentiment. As written by Howard Marks in 2016 ***"in the real world, things generally fluctuate between 'pretty good' and 'not so hot'. But in the world of investing, perception often swings from 'flawless' to 'hopeless'."*** This brings us to the second question of whether markets have over corrected.

At the time of writing, global public equity markets had fallen 30-40% in value since the peak in early February. There is a clear and understandable shift from a risk-on to a risk-off stance adopted by investors. Given the scale and global nature of the correction this is likely to mean a period of falling real estate prices as risk premiums rise to compensate for a higher risk of tenant default, higher propensity to break, longer void periods and revised rental growth expectations.

Since the start of the year UK REIT prices have fallen by around 30%. After adjusting for leverage of around 30% in UK REITs, this represents around a 25% decline on an unleveraged basis with the retail sector expected to be the hardest hit.

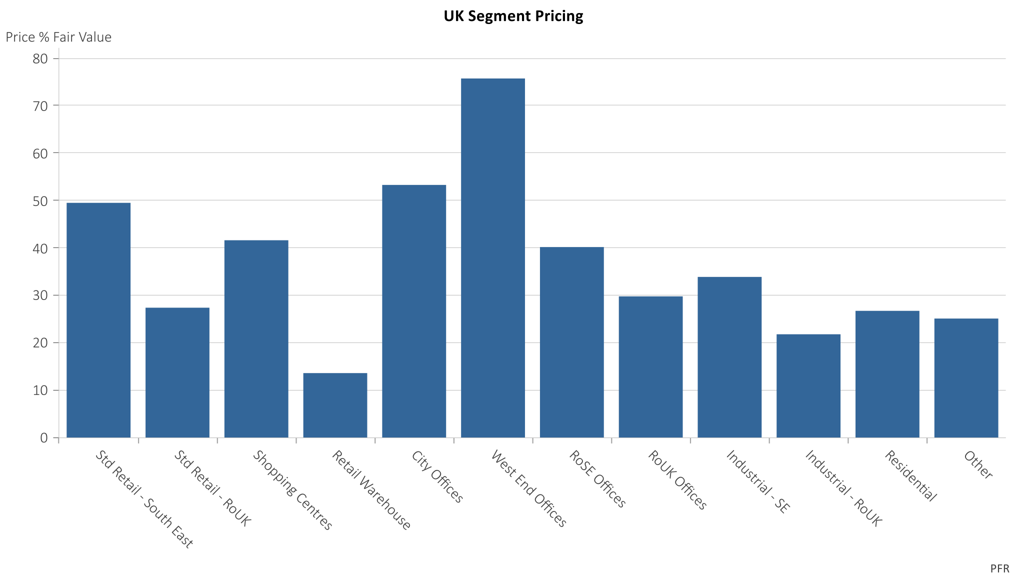
Figure 1: UK REIT prices



Our analysis of UK private equity real estate at the end of Q4, suggested that core asset prices were on average 32% above our estimate of fair value (Figure 2). This suggests an average asset value fall of around 25% would be required for investors to be adequately compensated for the risk of a fully diversified core portfolio. A similar level of overpricing is evident in core continental European markets.

If REITs provide a signal as to a likely magnitude of decline in market prices this would bring the average asset value back to where we think assets should be priced on a risk-adjusted basis. Given that private real estate markets tend to be more inefficient at price discovery an average decline of this magnitude is likely to mean that there will be a significant number of assets priced below fair value.

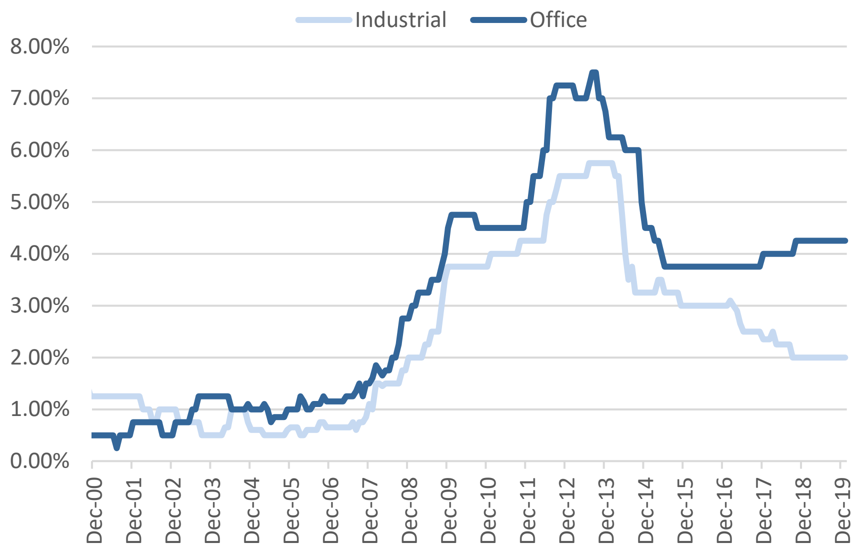
Figure 2: UK Q4 2019 market prices relative to fair value



Given the overpriced signal from our fair value model has been evident over the past 2-3 years, our house view during this time has been to invest in lower leverage, alpha driven strategies rather than to allocate to leveraged beta.

For higher risk assets, the cap rate premium over prime assets was wider at the end of 2019 than at the peak before the global financial crisis (Figure 3). Investors appear to have been more discerning about pricing risk during this cycle and this has provided opportunities for managers with specialist knowledge to generate returns through asset management initiatives. However, concerns over the economy will likely see the spread between perceived lower and higher risk assets widen in the short term.

Figure 3 UK prime vs secondary asset yield spreads



The risk-free rate has declined significantly across the developed world (with the effect of widening the relative yield gap to real estate) and this has often signalled support for real estate prices. However, in this instance pricing is likely to weaken for real estate assets given investor expectations for the economy and corporate profits have materially declined.

Lower sentiment and a risk-off stance from investors will likely create a reduced pool of bidders for real estate assets, particularly for perceived higher risk assets (e.g. shorter leases, higher vacancy, light refurbishment). Retail investor funds are likely to remain under redemption pressures (£1.8 billion of net outflows occurred in 2019) as retail investors (that tend to be pro-cyclical) react initially to concerns over assets prices but could see additional pressures if consumers are required to dispose of assets to fund essential expenses and as employment levels materially weaken. In the UK, daily traded funds have once again suspended redemptions with valuers of fund assets citing material uncertainty in estimating market prices for assets.

Debt financing will likely tighten with speculative development finance particularly difficult to secure in the short term. This also presents immediate refinancing risks for existing borrowers and may force some asset disposals.

Some sectors that may experience support for pricing are supermarkets, medical centres, biomedical research facilities and assets with government backed income streams given the defensive nature of the covenants.

The significant fall in equity prices and rises in bond markets may eventually see a portfolio denominator effect impact on flows into real estate. A significant fall in equity prices means that investors are likely to be under-weight equities and may direct new investment into the sector given cheaper pricing and under-weight positions.

These factors suggest that investors with a long-term view and liquidity may find opportunities to acquire quality assets at attractive prices (by this we mean significantly below fair value).

4. Strategy

Given that uncertainty over the outlook for the global economy is probably as high as it has ever been it would be unwise to suggest that now is the time to fully invest. However, we would recommend continuing to selectively allocate capital to alpha investment strategies whilst maintaining some liquidity to take advantage of any potential further pricing adjustments should the crisis last longer or be more severe than expected.

PFR's preference is for very low leverage and targeting sectors with clear structural tailwinds (logistics, storage, social infrastructure) rather than picking up deep value opportunities in retail sectors given the risk around tenant credit quality.

5. Disclaimer