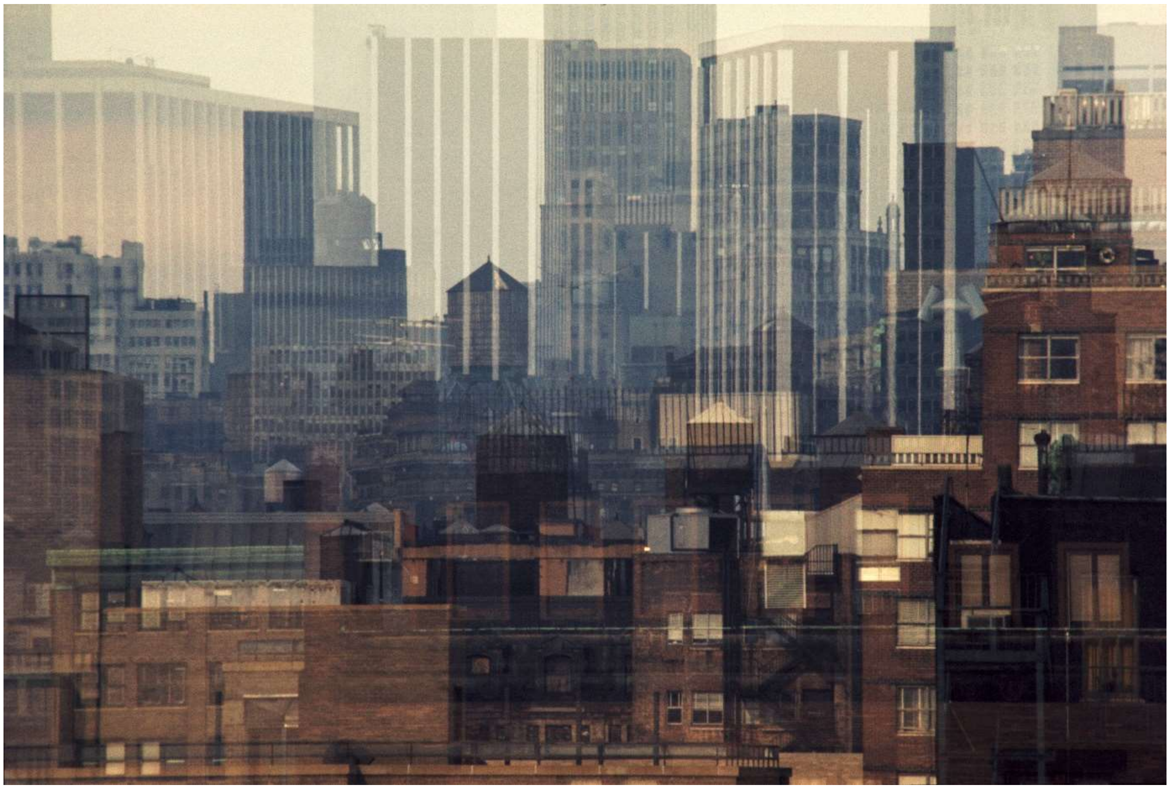
COVID-19: WHAT IS THE LONG-TERM FUTURE OF THE REAL ESTATE MARKET ?

30 September 2020



Florent Brones – Chief Investment Officer

Maxime Jouret – Global Head of Real Estate

IN A WORD:

The current pandemic and its economic and social consequences will undoubtedly impact the real estate asset class. However, this correction cycle in real estate is likely to be short, owing to various stimulus policies and low long-term interest rates. Another factor is that there were no excesses in the sector before the beginning of the crisis, for example in terms of debt or housing starts. Structural changes, including teleworking and e-commerce, which have accelerated due to the health crisis, will also transform some real estate segments, such as offices and retail. Others (e.g. logistics and residential) will certainly benefit from this.

The real estate sector is facing a global recession

The Covid-19 pandemic and the ensuing widespread lockdown measures resulted in an exceptional global recession. It was extremely abrupt in that economies came to a sudden halt, practically overnight. The scale of the stoppage was massive, because some service sectors, such as hotels, restaurants and travel, which during previous recessions had played a shock absorber role, this time, amplified the contraction in activity by coming to a full standstill.

Looking ahead, our scenario is a U-shaped recovery (see table below). We saw this recovery materialize as soon as lockdown measures were lifted, and we expect it to amplify in the second half of 2020. So the date varies according to the country, with Asia being in an advanced stage of the health crisis, lockdown and recovery. We expect the recovery to continue in 2021, thanks to the exceptional stimulus measures taken by central banks and governments. Never have economic policy tools been used so massively in peace times by every country in the world.

TABLE OF ECONOMIC GROWTH FOR 2020 AND 2021

	BNP Paribas Forecasts			Revised Forecasts (%)	
GDP growth	**2019**	**2020**	**2021**	**2020**	**2021**
Global					
USA	2.2	-4.2	4.2	0.7	-0.6
Japan	0.7	-5.4	1.2	-0.6	-0.9
United Kingdom	1.5	-9.7	6.9	-0.6	1.6
Eurozone	1.3	-8	5.2	1	-0.6
Germany	0.6	-5.6	4.7	0	-0.6
France	1.5	-9.8	6.8	1.3	0.9
Italy	0.3	-10	5.3	2.1	-0.8
Emerging markets					
China	6.1	2.5	7.5	0	-0.6
India	4.2	-11.4	9.6	-6.7	0.1
Brazil	1.1	-5	3	2	-1
Russia	1.3	-5	3.1	1.5	-0.4

Source: BNP Paribas (September 2020)
* Fiscal year beginning April

Our assumptions for the development of the pandemic are moderate. We do not foresee a massive second wave because we believe that health authorities now know how to manage local infection clusters, without imposing another widespread lockdown. Neither do we foresee a fully effective vaccine or drug before 2021/2022. In other words, we will have to continue to live with Covid-19.

The real estate sector will not be immune from this situation. Moreover, previous recessions have always had an impact on the real estate asset class. A rise in both unemployment and company default rates will have a large impact on the amount of rents in residential and commercial real estate. As a result, rental yields are likely to fall mechanically. The impact on the valuation of real estate assets should be negative, but it is difficult to assess with certainty as it is dependent on other factors.

A short real estate cycle

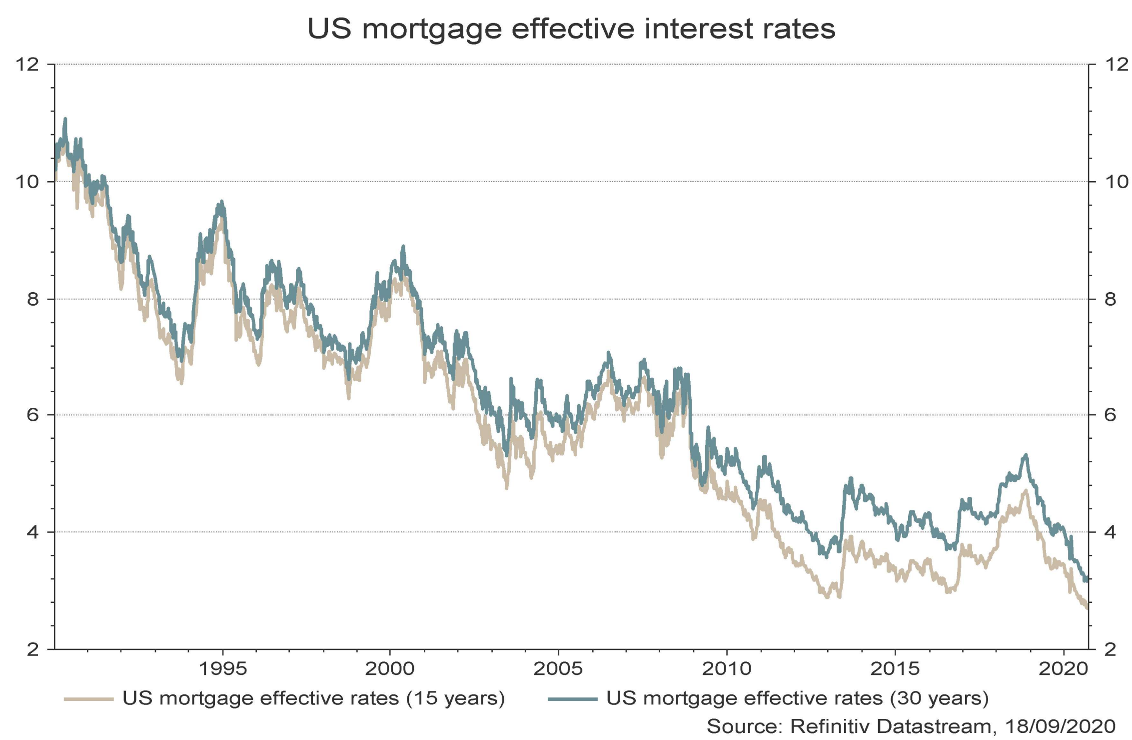
Globally, over the past 40 years, real estate has seen 4 bear cycles:

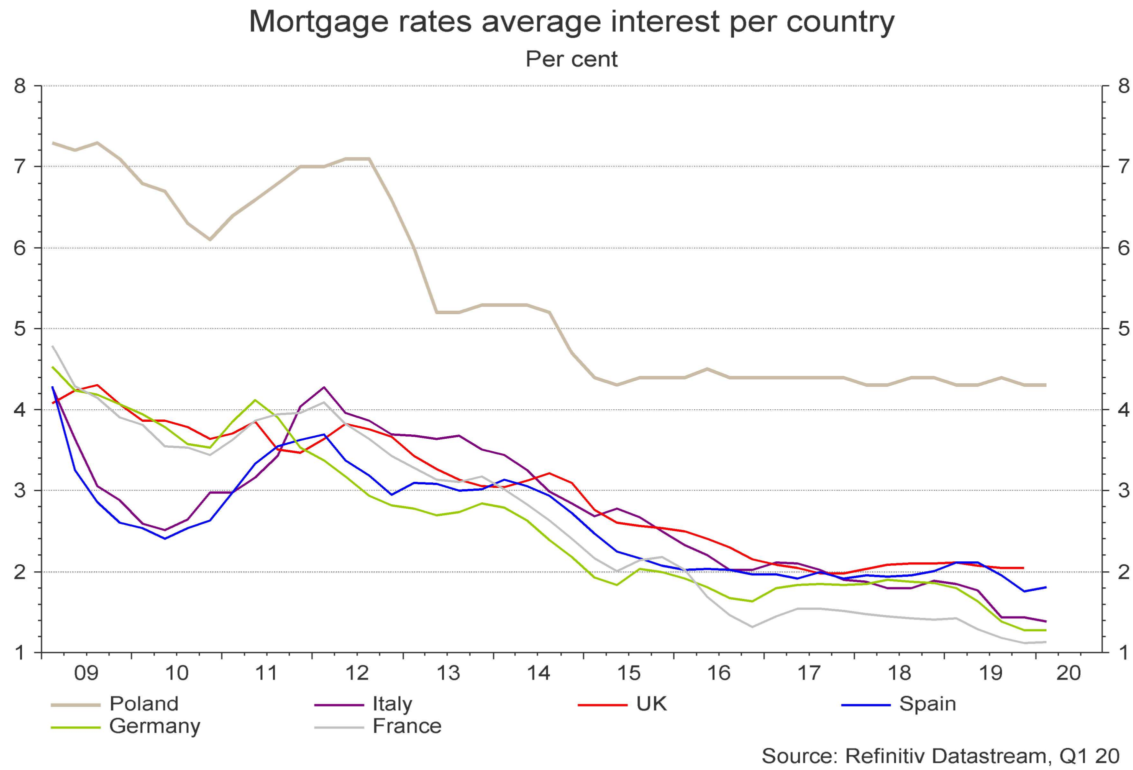
- Two long multi-year cycles (the first in the early 90s and the second in the wake of the Great Financial Crisis of 2008-2009).
- Two short cycles (Asian crisis of 1998 and the bursting of the tech bubble in 2001).

The seriousness of the present crisis should augur for a harsh recession in real estate. We will need to monitor the rise in unemployment and the extent of the rise in default rates, two factors that reflationary economic policies are seeking to limit as far as possible.

Nevertheless, we believe that **this real estate cycle will be short for two main reasons:**

- First, **interest rates are (and will remain) very low**. Central bank intervention - via bond purchases in the markets - coupled with current deflationary pressure suggest that the cost of capital will remain low. Real rates are negative, even for long maturities (see graphs below). Real estate financing rates, at 25 or 30 years depending on the country, are at all-time lows. This is obviously a very strong supporting factor for the real estate asset class.





- Second, **long cycles are usually preceded by excesses specific to real estate markets. In recent years, however, there were no excesses.** Indeed, the new supply of real estate assets has not been dynamic and authorities have curbed growth (e.g. in 2019 France cut the number of building permits). In addition, prior to the Covid-19 crisis, vacancy rates were generally low, particularly in the offices segment. Finally, leverage rates are now close to historical averages. As a reminder, leverage levels were very high in the early 1990s and in 2007 before the Great Financial Crisis. They were one of the main causes of the severity of the real estate cycle in both cases.

The Covid-19 crisis will amplify structural changes already underway

Beyond the short-term negative impact of this recession, some ongoing changes are set to be sustainable and have a significant impact on different segments of the real estate market. However, these trends will not be evenly distributed. The market has recently become much more granular than it used to be. Housing, retail, logistics, hospitality and offices have performed differently in recent months. This phenomenon is older than Covid-19, but the pandemic has greatly increased this de-correlation.

First of all, the residential segment has proved remarkably resilient in the current context. In the long run, this sub-asset class will undoubtedly benefit from favourable structural factors, in view of the demographic trends we are seeing today. A kind of safe-haven, in a way.

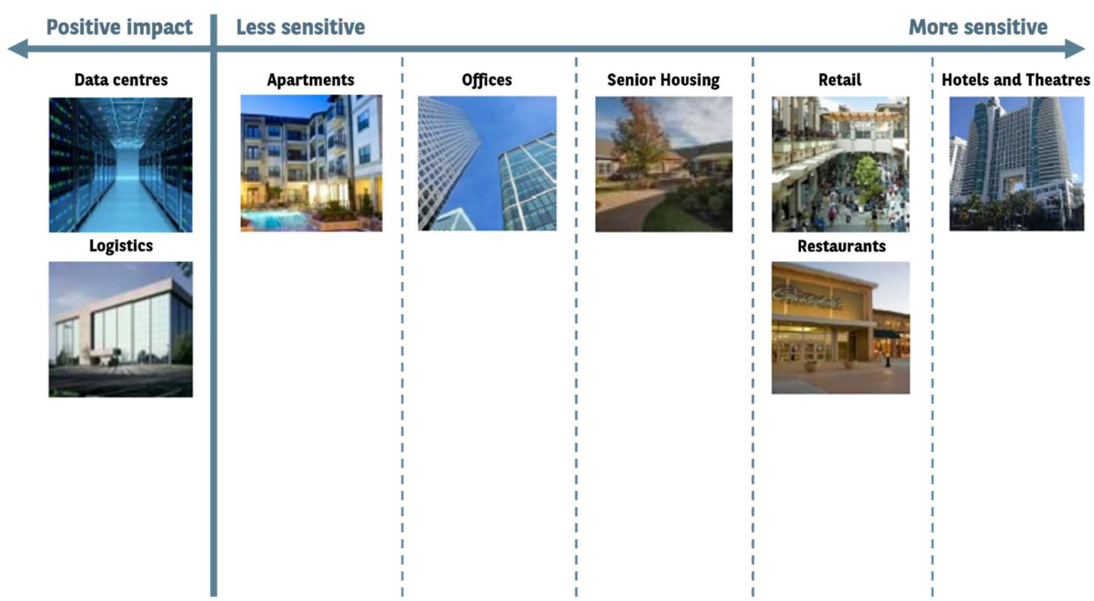
In retail, the situation is much more challenging in the short term, of course, but also in the long term. Lockdown and social distancing measures have unsurprisingly led to deserted stores and shopping centres. The transition in the retail world is just beginning. This is probably the only real estate segment on which we are very cautious.

In the world of logistics, this segment has been (and is still being) driven by a boom in e-commerce in all regions of the world. In the future, logistics should therefore be one of the most buoyant segments in real estate.

The hospitality segment has been one of the hardest hit by the Coronavirus, along with retail. Nevertheless, we remain confident and positive about the long-term trends driving this segment and the leisure activity. However, it will take time to return to what we consider to be a 'normal' situation, probably not before 2022 or even 2023.

As far as offices are concerned, the situation is not easy to analyse. While increasing home-working will obviously translate into a reduction of required office space, on the other hand, more high-quality space will be needed, with smarter fit-outs and enhanced communication technology. In other words, many offices will need to be transformed, renovated or even restructured. These challenges will bring opportunities.

ANALYSIS OF THE IMPACT OF COVID-19 ON REAL ESTATE SEGMENTS



Source: BNP Paribas WM, September 2020

Finally, another major trend across all types of real estate will be the efforts by authorities, landlords and tenants to meet the necessary environmental standards of buildings to be built or renovated. This will imply more insulation and more technology in future constructions.

What position should investors adopt?

We stick to our conviction on real estate. While we have reason to recommend caution in the short term, we believe that in the long term, real estate will benefit from stimulus measures and solid fundamentals that will undeniably create value for investors.

Due to the expected dispersion of returns across real estate segments, we believe it is vital to adopt a diversified investment strategy with a long-term approach. It is particularly important to partner with the most seasoned real estate managers to draw on their expertise and gain the best possible exposure to this asset class, through investment funds.

Real estate is central to the asset allocation of private clients, and will remain so. The challenge in today's context is therefore to help our clients position themselves, in an agile way, in buoyant sectors that will create value for investors over the coming years.

THE INVESTMENT STRATEGY TEAM

France

Florent BRONES
Chief Investment Officer

Asia

Prashant BHAYANI
Chief Investment Officer, Asia

Grace TAM
Chief Investment Advisor, Asia

Belgium

Philippe GIJSELS
Chief Investment Advisor

Xavier TIMMERMANS
Senior Investment Strategy, PRB

Alain GERARD
Senior Investment Advisor, Equities

Pol TANSENS
Head of Real Estate Strategy

Luxembourg

Guy ERTZ
Chief Investment Advisor

Edouard DESBONNETS
Investment Advisor, Fixed Income

Switzerland

Roger KELLER
Chief Investment Officer