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Impact of Pandemic and Financial Disruptions on Pacific & Global Real Estate Markets

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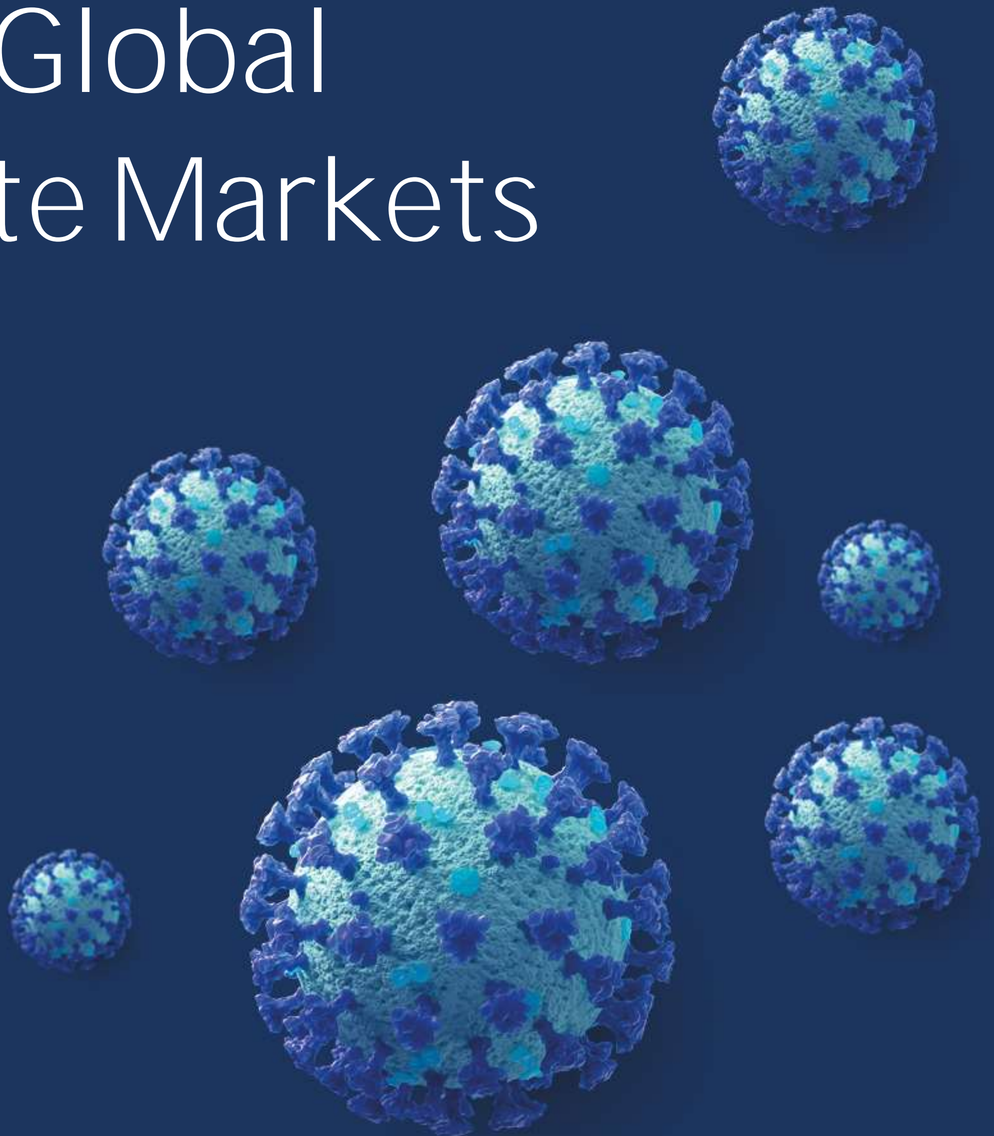

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Impact of Pandemic and Financial Disruptions on Pacific Real Estate Markets

Australia and New Zealand appear to be navigating the pandemic more successfully than most other regions. This is raising the possibility that Government enforced shut-downs will be lifted sooner than in countries experiencing higher infection rates. While some assets will undoubtedly be severely challenged, we expect that real estate's strong income characteristics (at a portfolio level) will remain attractive, particularly when coupled with Australia and New Zealand's strong long-term growth fundamentals.

Prior to the pandemic, Australian and New Zealand real estate markets were broadly well-placed, having consistently enjoyed positive returns since the aftermath of the GFC. Despite record pricing metrics; borrowing and development have been restrained compared to previous cycles. Vacancy across most markets is very low.

Like all asset classes, the full impacts of the pandemic are taking time to emerge. Tenants are generally not in occupation of their premises, with many assets non-operational. Transactional and development activity has all but ground to a halt. Asset owners are responding to a rapidly changing operational environment against a backdrop of legislative intervention and the possibility of disrupted operating income.

Similar to global markets, Mercer believes that the impact of the pandemic in Australia and New Zealand will not be homogenous across property sectors. Grocery anchored, 'essential-service' Retail and Logistics have emerged as beneficiaries given panic buying trends and mass adoption of ecommerce. At the other end of the spectrum, large Shopping Malls, Student Accommodation, Hospitality and Hotels appear to be the most

acutely impacted, suffering the full consequences of the enforced lock-down. Office assets which feature long leases to strong Government and Corporate tenants will continue to deliver strong cashflows.

Across all sectors we expect quality Real Estate assets with strong sustainability characteristics to be the most resilient in an economic downturn. These assets are more attractive to occupiers and vacancy levels tend to be low through the cycle providing robust cash flow. Poorer quality assets were priced firmly in the late stages of the cycle and we expect these assets to suffer the greatest distress. Direct Real Estate is a long term investment and we believe that investors focused on long term thematics will build resilient portfolios with the market downturn presenting opportunities to add quality assets to portfolios.

Impact of Pandemic and Financial Disruptions on the Global Real Estate Market

The disruption across the globe due to the COVID-19 pandemic and the resulting financial distress will have short and long-term consequences for the real estate industry. There are immediate impacts from current financial market volatility and uncertainty around trading values, while consequences related to the occupier-side of real estate will play out in the near to medium term. It will take some time for investors to determine the effects on their portfolios and investment managers to deal with the current market uncertainty.

While one of real estate's defining attributes is a contractual set of cash flows, it is expected that assumptions on cash flow and risk used to determine value will be negatively impacted by recent events. We do know that transactional markets have been disrupted and real estate investors can no longer assume that last week's underwriting assumptions are still valid this week and in to the future. As the pandemic and market disruption unfolds, a greater risk premium will be applied to all risk assets, including real estate.

In the near-term, we expect negative consequences for occupiers across all property types and strategies. The impact of quarantine, social distancing, government shutdowns and the perception of airborne viruses will affect consumer's and landlord's views on shopping and operating retail establishments, using co-working sites, traveling and occupying hotels, etc. Most student housing properties in the US and Europe are closed for the remainder of the school year. Senior housing may be negatively impacted in the short term due to fears of contagion to disease. Hospitality will bear an immediate hit. Tenants will be less likely to sign new leases and may look to reduce space or seek rent relief if their businesses are severely impacted by these events. Industrial and multi-family will not be immune to these events with supply chain disruptions, a rise in unemployment and slower consumer spending.

The degree of these consequences will vary in regions around the globe with government stimulus potentially able to play a role in softening some of the economic impacts. However, the bottom line is that rent growth will be impacted for the foreseeable future, with more severe consequences within property types that have been rapidly impacted by quarantine and social distancing. Properties under development will likely be immediately affected, as these disruptions will cause a pullback or slowdown in tenant leasing and trading activity. Managers of assets that understand and adapt to changes in sentiment and new uses of space will recover more quickly.

We expect to see a divergence in return outlooks for real estate with high quality, well-leased assets utilizing moderate leverage providing the most protection. Assets with weak fundamentals and which are economically sensitive will see the greatest declines. This positioning is consistent with our long-term advice to clients seeking to create resilient and diversified portfolios. We believe the lack of liquidity created by near term negative surprises should lead to longer-term opportunities. Typically, a low interest rate environment is favorable to real estate. Borrowers will now have a lower cost of capital, which is favorable (although lenders who have been inching up on the risk curve could see more defaults). Lower fuel and energy costs are a plus and pent-up demand should be good for commercial tenants. Few markets went into the current crisis with too much vacancy or supply.

There is no question that the global real estate industry will face difficulties in terms of both income and valuation. The severity of the disruption and the activities that occur in each local market will determine the extent of these difficulties. High quality, well-leased assets should be able to ride through these disruptions with less impact to rents and occupancy. Moreover, as always with negative disruptions, opportunities exist. We have begun engaging with investment managers that have navigated these waters successfully in previous downturns to identify compelling opportunities for investors.

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