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REAL ESTATE

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Despite rising pressure, real estate should remain resilient

As coronavirus fears roil the equity and fixed income markets, real estate investors may be wondering how to monitor and assess the asset class. Nuveen Real Estate's experts offer their collective insights on the global, regional and country level along with sector views. Our chief investment officers also discuss the implications for real estate portfolios and what may lie ahead for real estate markets.

INTRODUCTION

ALICE BREHENY, GLOBAL HEAD OF RESEARCH

Making short-term predictions is difficult, and it's impossible to say when the virus will be contained in various locations. But as investors, we have to assess how different sectors, cities and countries are positioned for recovery based on their economic, demographic and social make up. And while the social implications appear to worsen, at least government and central bank actions have been reassuring.

We have some evidence, some of which is anecdotal, about how the virus will impact real estate as some parts of the world are further through the crisis than others.

Along with the day-to-day effects, we're also looking at the structural challenges already facing real estate and whether they will be reinforced or reversed.

While this crisis is very different from previous crises, so is our ability to deal with it. Consider the 2009 financial crisis: if every office employee had to work from home many businesses would have closed down. Fortunately, that's not currently the case and most people seem more resilient and adaptable than ever before.

VIEW FROM EUROPE

STEFAN WUNDRAK, HEAD OF RESEARCH, EUROPE

Among European cities, Milan and Madrid are the worst hit. While other big cities face similar risks, most have been in lockdown for at least a week, so we're hopeful they won't be as hard hit.

The main goal of governments is to try to keep businesses afloat, support households and restart the economy once the lockdown is lifted. We see evidence of this in the stimulus packages that are available even from the most fiscally conservative governments.

In real estate, investors appear to be acting rationally. For example, some investors are postponing rather than cancelling deals and may be waiting for evidence to revisit and possibly renegotiate them. This is different from the great financial crisis (GFC) when everything was called off. We are also seeing fund subscriptions continuing, with investors placing money in anticipation for when the fog has lifted.

The crisis is likely to be a catalyst for change. Online shopping, for example, has accelerated especially in areas that were not previously popular, such as groceries and medicines. We believe some of that business will remain online in the future. In retail, physical consolidation, which was already underway, is likely to happen faster, and we expect that consolidation will occur around the best assets and locations.

Re-shoring is also likely. Manufacturers and suppliers are realising that they cannot rely on one supplier in one region. They are looking for new sources and, in Europe, to shorten supply chains. That could create opportunities in lower-cost locations such as Eastern Europe, Portugal, Turkey, and possibly North Africa.

For offices, one of the biggest changes is the shift to remote work. While that does not mean that offices are out of fashion, it's likely that companies will need less office space but demand higher quality, smarter fit outs, more collaboration spaces and more communications technology.

On the investment side, some of the themes that have been in place for the last few years are likely to accelerate, such as diversification, a focus on business resiliency, as well as responsible and environmental, social and governance (ESG) investing. Society will pressure businesses to play a more positive role in the economy and serve all stakeholders.

VIEW FROM ASIA PACIFIC

HARRY TAN, HEAD OF RESEARCH, ASIA PACIFIC

Asia Pacific is further ahead in terms of the pandemic, having been the first region to be hit by the virus and with previous experience dealing with epidemics due to the SARS outbreak in 2003.

Our near-term base case calls for a contraction in full-year growth across all economies, with Q1 experiencing the most severe downturn. But we're also likely to see relative growth performance in some countries which went into the crisis on a fiscally healthier footing, namely South Korea and Singapore, and also in China and Australia.

It's too early to say how deep the market downturn will be, but valuations are likely to be behind the curve. At the height of uncertainty during the GFC, pricing was scattered and bid-ask spreads widened considerably. Markets dislocated until domestic investors returned, at which point there was more clarity in pricing that encouraged other international investors to come back to the market.

We are seeing the same trends in Asia Pacific that are evident in Europe: With the acceleration of online shopping and further consolidation in physical retail, the limitations of global supply chains are being exposed.

For investors, themes of diversification, consolidation and resilience will be more important. Technology and e-commerce-led sectors offer opportunities. Last-mile logistics also look attractive, especially in areas where supply of modern logistics is tight, such as Seoul. The mass-market multi-family sector in Tokyo is also attractive, where income and occupancy were resilient during the previous downturn.

Many sectors that will benefit from long-term structural trends, such as sustainability and demographics, will continue to do so even though they will experience short-term negative effects.

VIEW FROM THE AMERICAS

MELISSA REAGEN, HEAD OF RESEARCH, AMERICAS

Today's astounding jobless figures of 3.28 million highlight the gravity of the situation, up from 282,000 last week. Fortunately, the Senate passed a $2 trillion fiscal bill, which hopefully will be enacted shortly.

At the same time, the Federal Reserve and U.S. Treasury are now providing liquidity to almost every part of the financial markets. Q2 GDP is expected to be dire, but it should rebound in the second half of the year with such supportive monetary policies and fiscal stimulus.

Recovery really depends on the path of the virus, which no one knows. In the U.S. it's now doubling every three days and the total number of cases is likely to surpass China. Markets will be closely monitoring these developments and are likely only to stabilise when cases decline.

Looking at real estate, every sector will likely get hit by this unprecedented shock to the economy. The worst affected are expected to be places where people gather, such as hotels and shopping malls. We're seeing drastic declines in occupancy, footfall and revenues. Apartments, industrials and offices may fare relatively better but are still likely to take a hit. We need to see the data on rental growth and valuations to get a clearer picture of the impact. Some of that will come through in April and May, but we will have to wait until Q2 figures come out in the summer for greater clarity.

INVESTMENT INSIGHTS FROM EUROPE AND ASIA PACIFIC

MICHAEL NEAL, CHIEF INVESTMENT OFFICER, EUROPE AND ASIA PACIFIC

With assets in China and throughout Asia, we've been dealing with this crisis since the beginning of the year. For our investment teams, we've found that communication is key. We're talking with our investors, tenants, lenders, major stakeholders and comparing notes with our industry peers.

Sectors are affected in different ways. We see this in the European REITs market, which is influenced by equity market volatility, but provides a forward-looking view. Year-to-date stock valuations are down around 30% on average. Average discounts to NAV are also down around 30% but there is wide valuation dispersion. Retail is at a 60% discount on average to NAV, the office sector is discounted around 30%, but industrials are trading close to NAV. It's a similar story in Australia, where REITs are trading at a 40% discount to net assets, weighed down by retail but logistics are holding up. There will likely be an acceleration of structural changes, especially from bricks and mortar to online retail. Last-mile logistics will likely be a beneficiary. Necessity-based retail should be a clear winner. Some areas of living and health care should also do well, as should well-located student assets in good university towns with good operating platforms

In terms of investment activity, there is plenty of capital that is disciplined and patient. In living and housing, there is still a market for the right product on the right platform and there's no sign of any pricing adjustments yet. No doubt, there will be greater scrutiny of the operator's financial strength.

Logistics remains a much sought-after sector but there will be some fallout from the weaker economic environment. We expect deals will continue, some with pricing adjustment, some not. Within the sector, e-commerce is compelling but risks to watch out for are third-party logistics operators with thin margins.

In retail, short-term winners are supermarkets. Once a solution to the virus has been found, we expect prime experiential assets should bounce back and pricing power return to landlords with the best schemes.

The cost and availability of debt has changed. For example, a well-capitalised U.S. REIT just issued 10-year unsecured debt that was at 415 basis points (bps) over. By contrast, a similar deal a year ago was priced at 120 bps over.

We're seeing fewer lenders for new business. Those that are lending have widened pricing, are focusing on strong credit and giving priority to existing relationships. This means there could be good opportunities for alternative lenders, such as debt funds.

We're watching swap rates and credit spreads closely, as widening increases the cost of borrowing and becomes less accretive to real estate. But we expect assets with resilient cash flows should fare well in a lower-for-longer rate environment.

INVESTMENT INSIGHTS FROM THE AMERICAS

CARLY TRIPP, CHIEF INVESTMENT OFFICER, AMERICAS

Our investment teams very quickly came together as a group, to streamline and centralise our communications process. This means we're funnelling all information from our property management teams, verifying business continuity plans, cleaning protocols and sharing best practices. As a result, we're confident we have good protocols to deal for the current crisis.

Asset management will be critical to creating durable and resilient portfolios that will be able to ride out near-term cycles. We are proactively working with tenants who may be struggling and experiencing financial hardship. Our approach across the private and public sector is to ensure we and our tenants come through this successfully.

Real estate benefits from having long-term contractual leases in place. And from a pricing perspective, it also benefits from its illiquid nature. Investors are generally more disciplined than they were in previous crises and are likely waiting for more transparency from the credit markets to see how risk is being priced before taking any action.

Historically, real estate tends to behave well in a recession, offering a source of diversification especially with publicly traded assets. It also earns an income return from those contractual leases and its illiquid nature reduces volatility.

For more information, please visit us at nuveen.com.

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