April 2020

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COVID-19

What we know, what we expect, what we question.

Executive Summary

The COVID-19 pandemic is unlike previous shocks, and its impact on the global economy and real estate markets does not fit neatly into traditional models and research approaches.

This short summary highlights some of what we understand with relative certainty, some of our current expectations, and some of the questions we feel are relevant. Knowledge of the pandemic and its market impact is expanding daily (captured by our Daily Dashboard) and our expectations are evolving. But while it is still too soon to make absolute judgements about the eventual impact on markets, we can usefully pose some of the most pertinent questions.

In the following pages we set out our thoughts on the macro background, investment and occupier markets, London offices, UK offices, retail and logistics. All of our research is available at knightfrank.co.uk/research, and as ever, our research team is always on hand to discuss any of these viewpoints in more detail.

William Matthews
Head of Commercial Research

MACRO BACKGROUND: STILL ALL HANDS TO THE PUMPS

What we know

Recent weeks have seen the announcement of unprecedented stimulus measures, both in the UK and abroad. In the UK, the focus has turned to the refinement and implementation of those initial measures. For example, measures now encompass areas such as the government's wage support programme (now extended to the self-employed) and guidance from the FCA, which suggests a delayed reporting timetable for listed companies, and calls for lender leniency around loan covenant breaches related to COVID-19.

US stimulus measures affect the UK too. The recently passed US CARES act involves a $2.2trn package to support the economy, part of which will see cheques worth up to $1,200 handed to those earning under $75,000 per year. The announcement of these measures coincided with the S&P500 and FTSE250 indices rallying almost 20% from their low points this year, although since then, exceptionally high levels of unemployment registrations has led to some of these gains, particularly in the US, being pared back.

Risk-free rates: now almost return-free, too. The UK 10-year gilt yield remains close to historic lows, reflecting a flight to quality in an uncertain environment. However, there has been some material volatility, which can be an added challenge for investors and lenders alike.

Near term volatility continues to stalk investment markets. Despite the recent recovery in share prices, we expect that markets of all types will remain jittery as new economic data is released. The CBOE VIX (an indication of near-term stock price volatility based on underlying options, and colloquially known as the Investor fear gauge) remains elevated at GFC levels, suggesting more equity turmoil is ahead.

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The pattern of recovery will be hotly debated, with much talk of V, U, W and L shaped outturns.

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	ESTIMATED LEVEL OF DIRECT FISCAL STIMULUS	ESTIMATED PROPORTION OF GDP
AUSTRALIA	A$198 BILLION	9.9%
CANADA	CAD$138 BILLION	6.0%
CHINA	RMB 1.3 TRILLION	1.2%
FRANCE	€45 BILLION	2.0%
GERMANY	€156 BILLION	4.5%
HONG KONG	HK$152 BILLION	5.3%
ITALY	€25 BILLION	1.4%
JAPAN	¥446 BILLION	0.1%
SAUDI ARABIA	SAR 70 BILLION	2.7%
SINGAPORE	S$54.4 BILLION	11.0%
SOUTH KOREA	KRW 16 TRILLION	0.8%
SPAIN	€8.9 BILLION	0.7%
UNITED ARAB EMIRATES	AED26.5 BILLION	1.8%
UNITED KINGDOM	£119 BILLION	5.3%
UNITED STATES	$2.2 TRILLION	10.5%

Source: Knight Frank Research, The International Monetary Fund, National Sources

What we expect

For now, most economic data is too historic to matter. Consequently, the focus is on Q2 estimates, with predictably weak growth figures circulating. In the UK, as in many other countries, the imposition of lockdown measures implies a direct hit to normal levels of economic activity. That much is accepted, but the hope remains for a swift rebound. Expectations differ, however, and the pattern of recovery will be hotly debated, with much talk of V, U, W and L shaped outturns.

This is not the Global Financial Crisis – but it is too early to say what it is. On the one hand, the abrupt halt to significant amounts of economic activity in the UK is more severe and more immediate than during the GFC. However, this time, the Bank of England has acted more quickly to help credit to flow to the SMEs most at risk, and the government has announced swift fiscal measures. We wait to see the extent to which these combined actions will support both the ability of firms to retain workforces, and for those employees (and now self-employed people too) to continue to draw an income.

What we question

How long will it take to 'normalise'? Indeed, will economies and markets ever be the same again? Disruption of this scale naturally raises the question of a return to normality. Will international air travel rebound at scale? Has the shift to contactless payments hastened the decline of cash? Will workforces return to formal workplaces? Will our reliance on online shopping become even greater?

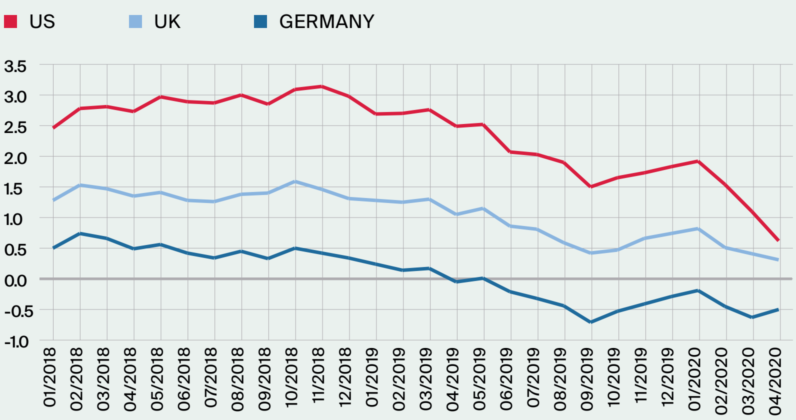
Our sense is that normality does return, albeit with some sensible modifications. Looking to the nearer term, we can point to a degree of 'new' normality already returning to parts of Asia. Although it is very early days, offices and leisure facilities are beginning to reopen in China and South Korea, albeit with understandably cautious measures in place. The UK may broadly follow this path, but the many nuances in the characteristics of different countries, such as their politics or healthcare systems, conspire to make such generalisations impossible. Timings, at the very least, will be different.

Not a typical crisis, not a typical outcome. Traditional crises and their knock-on effects into real estate are normally driven by a mix of i) undercapitalised banks ii) overleverage iii) over supply iv) sentiment. However, this is not a normal economic crisis. The current situation has led to a cessation of parts of the economy and as recent PMI readings show, considerable impact on sentiment. Will unprecedented government and central bank action limit the impact on negative sentiment, supporting a quicker recovery, or will there be a slew of credit events as a result, creating a feedback loop?

There is also a fundamental question over the extent to which behavioural shifts, ranging from how firms operate supply chains to consumer spending patterns, become entrenched, and what longer term impacts these evolutions may bring.

10 Year Government Bond Yields

Percentage



Source: Macrobond/Knight Frank

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INVESTMENT MARKETS: A FLIGHT TO CORE?

What we know

COVID-19 disruption is yet to feed into overall UK volumes. Provisional Q1 2020 commercial volumes marginally exceeded those recorded in Q1 2019, at almost £12bn, albeit over 30% down on Q4 2019. This quarterly fall is not unusual, with the first quarter of the previous two years also being down 27-35% on Q4 the year prior.

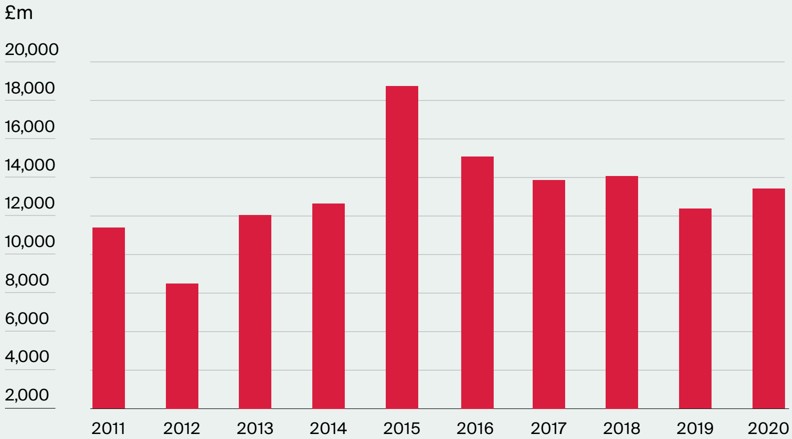
Investment activity has not entirely ground to a halt. Some transactions have progressed despite the difficulties of doing business, and agents continue to report interest (and bids) for the right assets. Inevitably, however, there have also been numerous deals postponed and assets taken off the market.

Finding stock remains a challenge. The availability of stock was already acting as a brake on market activity. The crisis has done little to change this and has presented few forced sellers so far. Some have suggested that the fall in equity values will cause some balanced funds to reweight, potentially selling some real estate to do so, although this is a process that can take many months or even years, and multi-asset portfolios may be reluctant to do so whilst volatility remains in other markets. Meanwhile, with some retail funds gating, the flow of assets from this part of the market is also reduced.

Addressing the practicalities. With one third of the global population now under some form of lock down, there remains a short-term practical challenge for real estate investors. This comes both in the form of income collection (where some landlords have come to agreements with tenants to postpone or waive this quarter's payment), but also the practicality of visiting buildings for inspections. This is particularly relevant given the historically high proportion of overseas investment. International investors with local hubs and a cultural ability for multi-locational decision making may have greater ability to continue to transact once the strictest measures are relaxed, even if borders don't return to normal for some time.

Listed company updates offer an early insight. Recent statements from listed property companies point to several trends. The ability to collect rent has been heavily sector dependent, with the retail-focused companies typically receiving the lowest percentages, although not universally. Like many companies, a focus on cash raising and preservation has been common. Given these two factors, it is unsurprising that some dividend payments are now in question. Positively, LTVs are dramatically lower than in the run up to the GFC.

UK commercial property: first quarter investment volumes



Source: Property Data/Knight Frank

What we expect

Volumes to moderate in the coming quarters. Given that Q1 overall volumes are virtually identical to those seen in the first quarter of 2019 we would expect a moderation of volumes into Q2 2020 and potentially beyond. We do expect some level of frictions to travel to continue. The longer this persists, the more likely we could see technological workarounds to some of the practicalities of transacting.

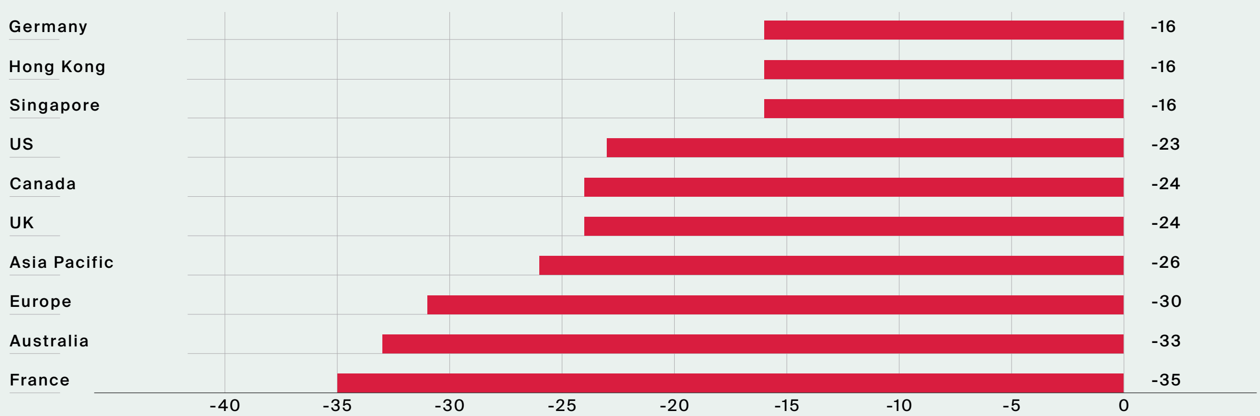
Regardless of these practicalities, finding suitable stock has been a constraint on investment volumes for some time and we expect this to remain a constraint over the coming quarters. In an uncertain, volatile environment, the UK remains a safe haven given relative liquidity, market transparency, property rights and relative ease of transacting and there should be demand for the right stock in the right locations.

Core income to remain in favour. In a volatile environment, core income-producing assets in safe- haven locations are likely to remain in demand. With risk-free rates near historic lows, real estate's comparative yield advantage is even more compelling, and the recent fall in Sterling is significant enough to materially enhance the attraction of UK real estate for overseas purchasers. It is likely there will be some bifurcation in performance between these sorts of core assets capable of providing a relatively assured income, and those of a quality or in a sector where income cannot be relied upon.

Meanwhile, a pause in construction and likely reduction in future construction finance will magnify the overall lack of new stock in the UK for some time. As impacts of the pandemic take hold, we may see an increase in real estate coming to the market, some of which (particularly the core, still-income producing, long income), will likely continue to enjoy a weight of demand. **Local market dynamics will remain key.** Last year in our Momentum Cities research, we identified those cities across the UK and Europe which have strong education sectors which are integrating with the local economy to drive and monetise innovation. In light of the current situation, these cities are likely to gain even more importance over the longer term. As Joe Zidle of Blackstone noted in his recent podcast "history shows that our economy is sometimes the most innovative when faced with the greatest dislocations".

In a volatile environment, core income-producing assets in safe- haven locations are likely to remain in demand.

REIT performance: YTD (%)
Local currencies



Source: Knight Frank, Macrobond

What we question

How will transactions take place? What locations and asset types will be in long term demand? What will happen to transaction volumes? The answers to many of these questions will be largely dependent on the new normal behaviour for businesses and individuals alike. Caveating that there are fundamental differences across countries, a look towards locations in Asia, provides an element of a crystal ball as to potential nearer term futures for the UK. Normality may be returning, in some of these locations but that normality is different to before and also fragile; resurgences of COVID-19 and further lockdown measures are being seen in Singapore and Japan at the time of writing. The question is how will different societal norms play into the experience for the UK?

APAC, the epicentre of COVID-19, saw commercial volumes decline by 50% in the first eight weeks of 2020, compared to the first eight weeks of 2019 (source Real Capital Analytics). European volumes reduced by 18% over the same period. To the extent that the UK's economic pause is coinciding with one third of the global population also being under some form of lockdown across a broad spectrum of countries, there is scope for UK volumes to see even deeper moderation in activity.

What will be the impact on the lending market and how will this impact volumes? The Lending environment is more supportive than during the GFC, but credit risks remain. Banks are better capitalised than in the run up to the GFC and the Prudential Regulation Authority (PRA) has written to UK bank lenders encouraging them to be lenient regarding loan covenant breaches due to general market conditions, rather than specific liquidity or solvency issues in relation to specific businesses. The banks themselves have also had their counter cyclical buffers relating to capital requirements reduced, increasing lending capacity significantly. All of this contributes to a more favourable credit environment than at the time of the GFC – which was ultimately credit led. Nevertheless, there is a question around banks decision making regarding borrowers facing liquidity or solvency issues, which could still see control being transferred to banks through covenant breaches. There are also questions around the magnitude of non-performing loans and whether these could reach levels which create stresses on lenders. This is relevant for bank and non-bank lenders alike, as are the questions around how credit committees could alter their lending criteria, as well as appetite and ability to lend. These questions are particularly key due to the post-GFC growth of non-bank lenders in the real estate sector, which are relatively untested in terms of their resilience, ability to work-out non-performing loans and through-cycle lending appetite.
How will demand for different investor groups and nationalities change? Near term, transaction activity will favour those domestic, equity rich investors, themselves less impacted by the economic impacts of the pandemic. We could also similarly see equity-backed international investors, who are able to draw on local hubs, able to culturally adapt to multi-location decision making or otherwise innovate to overcome travel and other restrictions enter the UK market.

Will reshoring drive a push for greater cross-border investment? In the longer term, commercial real estate could offer a way for investors to diversify globally in a world which is seeing a reshoring and otherwise localisation of other economic activity.

How will the sustainability agenda fare? Prior to the pandemic, there was growing traction and focus on Environmental, Social, Governance investing (ESG), particularly in the UK. Carbon reduction remains legislated for by the government and assessing the impact of different climate change outcomes on assets remains within stability reporting for the Bank of England, so we expect (ESG) to remain important for commercial real estate, potentially with additional weight around wellness and overall building healthiness.

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OCCUPATIONAL MARKETS: THE GREAT WORKPLACE EXPERIMENT

What we know

Lockdown is forcing the adoption of home working. Encouragingly, offices are now re-opening in China and South Korea - albeit with extraordinary levels of testing, but for the majority of office workers in Europe, and now the United States, lockdown is becoming a reality, as is the acronym WFH. As with any change management process, it is important to review the effects of working from home over the longer-term, but there is no doubt that the mobilisation of entire workforces towards remote working has tested business leaders and brought sharp focus to implementing and leveraging the technology platforms so essential to ensure operational resilience.

Occupier sentiment is coming under pressure. Business sentiment indicators are turning downwards as COVID-19 takes hold. The latest IHS purchasing managers index for the UK, which essentially tracks business activity in services and manufacturing– fell to 35.7 compared to 53.2 – the lowest level since the series began in 1990. In a similar vein, the latest data release on UK M&A activity reported a significant drop, although some mega deals were in evidence. Figures for March point to only 131 deals involving a UK-based company, compared with 447 over the same month a year ago. These kinds of indications are likely to lead to occupiers reaching for the pause button, both in the UK and in many global markets.

Corporate focus turns further towards financial resilience. Business leaders, having dealt with short-term operational challenges, are now starting to focus on building financial resilience, and in particular are racing to raise or preserve cash to underpin their businesses over the course of what is an indefinite crisis. Approaches are predictably varied, with some cutting capital expenditure, some selling assets, and others cutting dividend payments.

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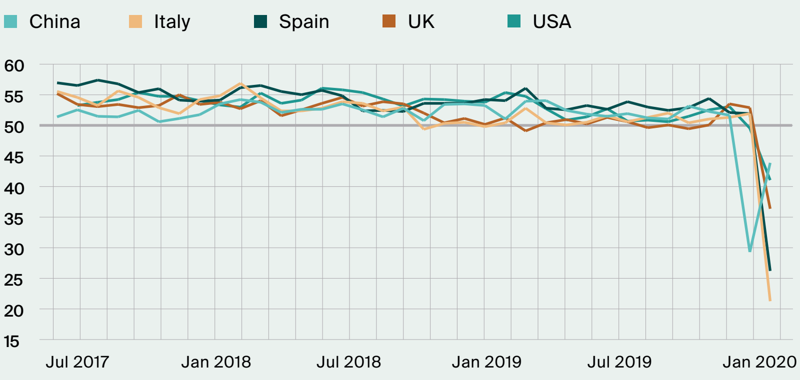
PMI Service indicators around the World

2017 - present



Source: TBC

What we expect

Corporate real estate strategies will have to evolve. The need to preserve cash and hence reduce capital expenditure will inevitably have consequences for corporate real estate strategies. In Asian markets, which were first exposed to the crisis, we have seen those strategic relocation or fit-out projects that require significant capital outlay being placed on hold. However, given the paucity of supply in Asia and beyond, we expect occupiers to pause rather than cancel activities. Such behaviour is likely to ripple around global occupational markets, with occupiers continuing to strategize and plan but taking more time to transact, unless lease structures force activity.

We are also witnessing a growing volume of occupiers seeking rental concessions from landlords, although some of this may be opportunistic rather than forced by underlying business performance.

A nuanced picture will emerge at an industry sector level. The immediate hit to demand has negatively impacted sectors like hospitality but, given the rapid adoption of cloud-based technologies, the tech sector appears more resilient. Another positive example is life sciences, which will benefit from increased government expenditure on R&D. From a real estate perspective, the rise of the life sciences is fuelling activity. Manchester Science Partnerships, for example, have gained consent for the 125,000 sq ft fourth phase of its £150mn Citylabs life science campus and remains “determined to complete” the second phase currently on site and fully-let to an occupier actively involved in COVID-19 testing.

An influence on workplace culture and structure. The current situation represents the greatest global workplace experiment ever conducted. As companies move operations towards remote working, there have been many proclaiming (once more) that this ultimately will lead to the death of the office.

Whilst it is still too early to be certain about the longer-term impacts, we see the demise of the office as an unlikely outcome. Instead, in our view there will be growing recognition that the office is just one of a range of workplace settings.

As people are forced to work remotely and managers adapt to such a situation, remote working will become normalised and the fears that have to date constrained its adoption will be removed. This does not however lead to the death of the office. Instead, it expedites the path we have identified over the last few years namely, the move towards offices that act as social hubs for creativity and innovation rather than as centres for administration and menial tasks on a 9-5 basis. The workplace will become more dispersed, but the office will remain a vital setting. Long-term we see a continued flight towards quality space that provides its occupants service, amenity and a positive and engaging experience.

What we question

Will occupiers look beyond real estate costs? Although recognising the different characteristics of the GFC, a key question must be whether corporate real estate teams become deeply embroiled once again in a heavy corporate cost-saving agenda, as it was in 2008-10 or will real estate be used as a device to drive corporate transformation? Will occupiers learn the lessons of the last ten years and invest in real estate to support a wider or changing purpose, or will they revert to type and attack what is the second largest operational cost?

Can the co-working market ride out the storm? Social distancing may be the last straw for genuine coworking spaces that have multiple organisations on the same floorplate and operating cheek by jowl. Those operators who have taken on leasing risk, often at historically high rental levels, are facing evaporating demand. They are also facing uncertain futures as their investors come under increasing financial pressure. Something will need to give. How will the model change? Will flexible but managed spaces for the exclusive use of a single entity be the answer? Can operators move closer towards their point of difference and become pure-play operators working in partnership with conventional landlords who have the product but not necessarily the expertise in delivering service?

Is this the start of a new partnership between owners and occupiers? There is evidence that landlords are more pro-actively engaging with and listening to their customer during this crisis and then working to create solutions that support them, thus increasing the chances of retaining both the customer and the associated income. But, is this a case of simple crisis management or the long-heralded change to market traditions which have tended to be loaded in favour of the owner and have typically been misaligned to the operational realities and planning horizons of the customer. Will the aftermath of COVID-19 see owners develop a deeper understanding of customer requirements and a willingness to create solutions and services rather than simply physical products? If so, will valuers and lenders similarly adopt a new approach?

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LONDON: BRACING FOR IMPACT

What we know

A quieter start to the year. London's commercial property market has been supported by strong fundamentals since the EU referendum: diverse and robust demand from businesses, led by finance and banking, professional services, tech and flexible office providers; and yields which outstrip most global bond offerings and indeed most major European gateway cities.

Against this backdrop, occupiers have been concerned with the lack of options on the market. This helped to lift pre-let activity with the total proportion of stock available in newly completed schemes across London falling to 28% at the end of 2019; down from 75% in 2009.

Leasing KPIs point to slowing activity. The strength depth of activity persisted well into Q1, however the unravelling of global growth due to COVID-19 began to erode market sentiment in early March, with total take-up ultimately dipping to around 2 million sq ft in Q1, down on Q4 2019 (3.4 million sq ft). The long-term quarterly take-up average is 3.3 million sq ft.

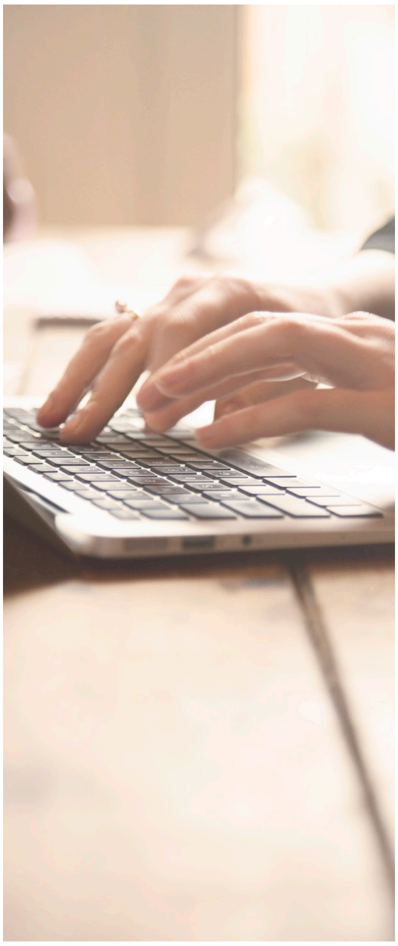
Rent holiday requests on the rise. Cash flow pressures stemming from slowing economic growth have resulted in a rise in rent holiday requests. The COVID-19 pandemic happens at a time of record high rents in all submarkets, so this is perhaps unsurprising. The government's emergency Corona Virus Bill effectively grants a moratorium on forfeiture until 30 June, which offers some temporary relief. The Bill effectively means that tenants are not obliged to pay rent for the next three months. They are however still liable for the missed rental payments in the future.

As a result of this and financial pressures, there have also been several instances of non-payment of rents. Partnerships between landlords and businesses will be critical at this time as they work together to develop new payment plans and timelines.

Investment deals being scrutinised even more closely. As the COVID-19 crisis bites, investors and lenders are moderating their appetite for London assets. Our sentiment indicator is showing that deals are being reviewed, or are stalling as investors reassess the situation, but those committed to London are still transacting and showing interest. Most lenders are still "open for business", but are reluctant to make new commitments, citing the still unknown impact on commercial values, which will almost certainly curb investment activity in Q2.

What the numbers show. Provisional data for Q1 shows investment turnover of close to £2.6bn (LTA: £3.4 billion). The decline has been precipitated by the impact on sentiment as a result of COVID-19, the inability to carry out property inspections and the lack of investible stock. We started the year with just £2.3 billion of assets for sale, 60% down on the LTA, spread across 40 schemes.

With signs of long-term investment strategies remaining in play, London appears to be assuming its position as a trusted global safe haven.



What we expect

Short term challenges for flexible offices. Flexible offices could face a tricky situation in the short term as social distancing rules are enforced, but the medium-to-long term prospects are better: they could offer a stop gap solution to those businesses impacted by fit-out and/or construction delays.

Furthermore, like some markets in Asia, they can offer a stop-gap remedy to businesses looking at their staff density ratios in the wake of COVID-19 as social distancing rules become the new normal.

Whilst COVID-19 will test serviced office business models, it will also reinforce the place of a formal work environment.

London to remain a safe haven. During times of global economic or geopolitical tensions, locations such as London have emerged as an investment safe haven. However, those investors who take a long-term view are likely only to deploy capital once there is clarity on the true economic impact stemming from current conditions.

Opportunistic investors, driven by the hunt for returns may temporarily move into a holding pattern as covenant strengths are reassessed. Indeed, debt funding challenges may also cause an investment hiatus.

Travel curbs will impact inspections. With signs of long-term investment strategies remaining in play, London appears to be assuming its position as a trusted global safe haven. The biggest challenge for investors of course will be the far-reaching travel restrictions that has seen countries close their borders and ground airlines, which clearly will hamper property inspections. This is particularly important for London given that 75% of investment was from overseas in 2019. BA has stopped flights from London Gatwick, London City Airport is closed to commercial flights and Emirates, the world's largest international carrier, has grounded its entire fleet, to name a few examples.

Our Global Capital Tracker, launched at the beginning of February showed £48.4 billion waiting to deploy in London's office market from around the world (up 21% y/y). The volume of capital chasing assets in London may well become further supercharged, depending on the length and depth of COVID-19's impact on the global economy.

What we question

Sentiment towards office usage. Our 2020 London Landlord and Investor Survey revealed three key areas of focus for London's largest landlords and investors: services, amenities and experiences, all of which revolve around the way in which we are using office space. The office has a newly elevated status in the minds of businesses as a tool in the war for talent. Offices are a window into an organisation's culture and an extension of our personal lives. More importantly perhaps is that they are a place for innovation and collaboration.

If the last two weeks have taught us anything, the much touted "death of the office" concept couldn't be further away from the truth. Granted that the daily commute may no longer appeal to all staff and occupational densities may need to be revisited once things normalise, but the need for a central hub and formal work environment has been overwhelmingly reconfirmed by our enforced remote working.

Supply and demand not necessarily the best indicators of market health. One of the factors underpinning rental growth in London over the last 10-years has been a supply-demand mismatch. With construction sites now being closed due to COVID-19, project delays are inevitable. While this may exacerbate the challenge businesses face in finding suitable options, demand will also almost certainly be dampened by current conditions.

The weakening in both requirements and available stock may well cancel each other out, but we are yet to fully understand how this crisis will impact occupational strategies. The supply-demand equation may not be able to paint as black-and-white a picture of the market's health as it has done historically.

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OFFICES - UK CITIES: NOT BUSINESS AS USUAL

What we know

Transactions hindered? In the marketplace, there is still a willingness to continue transacting but because of the challenges with conducting due diligence, the velocity of deal flow will slow down in the months ahead. In Scotland, the closure of Registers of Scotland in March will have further limited the ability of willing parties to transact.

The market is more balanced than pre-GFC. Office vacancy across the UK cities is much lower in 2020 that it was at the onset of the global financial crisis (GFC). The weighted combined city average is closer 9% today compared with 12% in 2008. In fact, many city core areas are below 5%.

The development pipeline is also more constrained that before the GFC. As at March 2020, there was close 7m sq ft scheduled for completion across the UK cities between 2020 and 2022. Much of this has already been let with 4m sq ft speculative. Between 2008 and 2010, development completions were close to 14m sq ft meaning market oversupply post crisis is less of a risk today.

Don't forget the Budget. The March 2020 budget made much of the desire to boost spending beyond London and the South East. It outlined £242m of funding for new City and Growth deals, while eight metro mayors, including the newly announced West Yorkshire mayor, will receive London-style funding worth £4.2bn in total. There is also an expectation of 22,000 civil service roles moving out of London over the next decade.

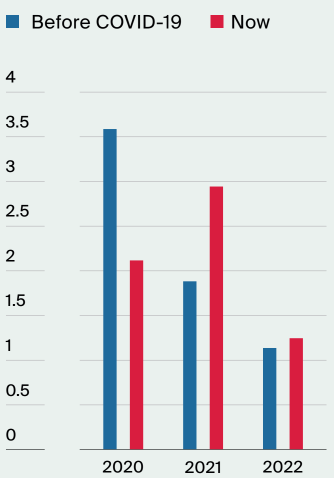
What we expect

Occupier requirements deferred – Whilst businesses take stock of the increasingly challenging business environment, a likely strategy with regard to future real estate needs will be to defer any major decisions until there is greater clarity. Instances of requirements being placed on hold will therefore increase in the coming months albeit so far there are only a few examples of complete withdrawal.

Development: a mixed picture. The reconfirmation of development proposals and the commencement of works is some instances is underlining the positive long-term view on growth in the UK regional cities. In the short-term, although Government measures to counter COVID-19 have so far been only advisory toward construction activity, some contractors have already elected to close sites. Consequently, the timing of projects underway will now shift outward. For the UK regional cities, 2020 was expected to be the peak of the current development cycle. This spike in space delivered will now clearly be smoothed beyond this year.

UK Cities development completions assuming 6 months delay

Million sq. ft.



Source: Knight Frank

Risk aversion will place greater importance on digital connectivity – The social distancing strategy has created an immediate impediment to businesses operations across the spectrum. Digital infrastructure has quickly become an organisations principal foundation of business continuity. Therefore, cities, districts and buildings that have made infrastructure a priority will carry additional favour as firms become more risk averse.

What we question

What will the market balance be post crisis? – Because demand has slowed at the same pace as supply, a supply and demand imbalance may not be as pronounced as recorded after previous economic shocks. Should an early breakthrough materialise on the COVID-19 crisis, a rebound in activity could be swift. What cannot yet be factored in however, is the scale of tenant release space that will derive from business casualties.

What impact will development delay have on the occupational market? Any delay in building work will create particular challenges for occupiers where that space is currently under negotiation, a pre-let has been agreed or a lease taken after works had commenced. Occupiers that fall into these categories will have mostly signed these new contracts having decided to either exercise a break option on an existing lease or pursue a new space move in anticipation of lease expiry. Many pre-completion deals will have conditions to provide some degree of compensation to the occupier, in the event of a delayed completion. However depending on individual circumstances, delay could create a gap between the exit timetable under the existing lease and the commencement of a new occupation. There are three main groups of outcomes: Firstly, for contracts still being finalised, this could mean occupiers simply choose to hold over, extend or negotiate new terms at their existing occupation. Secondly, an occupier may seek to bolster the late delivery compensation clauses in the final version new agreement. Lastly, for those already committed by an agreement for lease, although any delay compensation will reduce exposure to financial disadvantage, in practical terms interim space provision may be needed. This could mean a rise in short term contracts with serviced office operators. Short-term lease extension requests are also likely to rise, albeit landlord compliance may depend on whether or not such leases have security of tenure. Will there be a push in businesses recalling operations from overseas? There is some commentary emerging which suggests a future drive in business creating new jobs in the UK to replace those that were previously moved offshore. Virgin Media are a recent example, with the firm creating 500 new call-centre staff in the UK to mitigate against the impact of coronavirus in countries including India and the Philippines where offshore workers handle customer service calls. Greater scrutiny afforded to operational risk and resilience will be a clear consequence of a post crisis environment. New space requirements will undoubtedly be generated should "onshoring" gather momentum.

Will the shape of office demand change? With IT infrastructure generally passing the unplanned 'work from home' test, could a consequence of the current crisis be the acceleration of more agile and dispersed working? Establishing a more autonomous business culture was already rising on the corporate agenda long before COVID-19 crisis, albeit trust and infrastructure had previously limited some measures being adopted. With these two hurdles now passed, what will the effect be on the shape and scale of occupational demand in the future? Less physical space? In some cases, yes as working remotely is better accepted.

However, most people now forced into the current world of digital only interaction will testify to its shortcomings not least the social, creative and collaborative benefits an office provides. As such an accentuation of a pre-crisis trend is likely, whereby the form and function of the office shifts towards a hub for collaboration, creativity and innovation rather than as a hub for 9 to 5 processing and administration. Onward social distancing might also mean that there is a de-densification of office space with more space per person allocated on the grounds of health and safety. In this sense, requirement sizes may increase. What is clear is that organisations will seek greater dispersal of work. A combination of remote access and creating a centralised flexible workspace will be the preferred strategy to tackle this, with higher budgets afforded to achieving the latter a likely consequence.

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RETAIL: THE FALLOUT FROM LOCKDOWN

What we know

Lockdown closes non-essential stores. The UK officially went into lockdown on 24 March and all "non-essential" retail units faced enforced closure for a minimum of three weeks. "Essential" stores are defined as supermarkets, pharmacies, petrol stations, newsagents, bicycle shops, home and hardware stores, launderettes/dry cleaners, pet shops, post office and banks (with off licences subsequently added to the list). Taking into account "essential" stores that have voluntarily closed, ca. 83% of retail stock is currently not open for business.

Zero cashflow for many retailer occupiers. By their nature, retailers are highly cashflow-dependent. Enforced closure of stores has cut off this lifeline and online is only very partially able to compensate. Already stretched balance sheets have come under even more intense pressure.

Quarterly rent payments are being missed. Quarterly rent day fell a day after the UK went into lockdown. We estimate that only around 33% of retailers met their quarterly rent obligations in full and on time. This was broadly supported by shopping centre REIT INTU, who reported that it had only secured 29% of its quarterly rent roll, compared to 77% this time last year. Hammerson's equivalent figure was 37%.

Landlord concessions very common. The majority of retail and F&B operators pushed for at least some form of concession, typically in the form of rent holidays (3 or 6 month or indefinite). Other issues that came into play were a switch from quarterly to monthly rent payments and in some cases, a transition to turnover rents. With little choice, landlords generally (but not universally) have agreed to these concessions, possibly also re-gearing leases to incorporate an additional term commensurate with the length of the rent holiday.

What we expect

There will be substantial occupier fall-out as a result of COVID-19. Many retail and F&B businesses, including many well-known and long-established high street names, will inevitably fail over the coming weeks and months. Government intervention and concessions from landlords will not be enough to save many operators.

The scale of this fall-out is nigh on impossible to quantify at this stage. The Centre for Retail Research has predicted that more than 20,600 stores may not re-open by the end of the year, with job losses potentially totalling over 235,000 as businesses review how many stores they expect to operate in 2021. By way of comparison, last year 4,547 stores closed. To date (7 April 2020), major retailers to formerly enter administration include Debenhams, Cath Kidston, Laura Ashley and Brighthouse. There have also been casualties on the F&B side, in the shape of Vapiano, Caluccio's and TRG's Chiquitos and Food & Fuel brands. Many more will follow in the coming weeks.

June's quarterly rent day will be an even greater pinchpoint than March's. With stores in lockdown for a significant proportion (possibly all) of Q2, retailers will approach June rent day in a far more challenged cash position than they did in Q1. The call for rent holidays and further concessions will be all the more vociferous.

Polarisation in consumer demand between retail sub-sectors. Retail sales will inevitably show a net decline during the pandemic, but this will mask huge variances between sub-sectors. At the one extreme, grocers are seeing annual growth in excess of 20%. At the other, fashion operators are seeing year-on-year sales fall off a cliff. Online will inevitably see double digit growth, but will not simply absorb the slack from lost sales from physical stores.

The ethics of "non-essential" online retailing increasingly called into question. Several retailers (e.g. Next, River Island, Moss Bros, Net-a-Porter) have already closed their online divisions in a bid to safeguard the health of their warehousing staff. Others suggest they can maintain online operations without compromising their workforce.

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Online will inevitably see double digit growth, but will not simply absorb the slack from lost sales from physical stores.

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What we question

How will rent holidays be recouped? And how the next three months will play out? If the lease is not re-geared, when will the rent holiday be re-paid (if it is not to be written off)? Over the course of 12 – 18 months appears to be a more palatable solution to the landlords, although not necessarily to retailers, who don't want to be committing to a higher rent when they do reopen. Again, negotiations are ongoing and are far from being resolved.

Whether there will be a huge "bounceback" in consumer demand when the pandemic passes. "Revenge spending" will become an increasingly populist term but may not have much substance in reality. This is apparently already a factor in China, but that is a vastly different consumer market than the UK. Yes, there will be pent-up consumer demand in the UK, a stockpile of cash for many people (but not all) and propensity to splash out, but will this not be counterbalanced by employment concerns and the threat of economic recession? A temporary consumer "bounceback" at best.

The pace of return to "normality". This is far more than a blip. Even if the pandemic itself passes within a few months (a big "if" in itself), the damage endured by the retail sector will only heal over a very protracted period of time. When stores finally re-open, retailers will not simply recoup the trade lost in the intervening period and this will have ongoing cost implications – and impact their ability / willingness to pay rent to landlords.

The fight for survival trumps everything. In the face of an existential crisis, many retailers are not looking beyond the immediate future. Are issues such as ESG and CSR really on any retailers' agendas in the current crisis? And do consumers really take into account retailers with questionable CSR ethics and factor this into their shopping preferences?

Whether the crisis will actually prompt permanent changes to the way we shop. Enforced store closures are resulting in an inevitable flight to online. Although many consumers have tested online grocery for the first time, the rate of growth (+13%) is lagging overall market growth (+21%). The shortcomings of an online-only retail market have been laid bare by the pandemic and may actually lead to greater appreciation of the high street.

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LOGISTICS: HOW TO KEEP PACE WITH DEMAND?

What we know

Constraints on distribution are clear. Grocery stores and 3PLs, along with the NHS and councils have been seeking short term warehouse space to cope with increased infrastructure requirements. Amazon have reported they are hiring 100,000 additional workers globally, primarily in fulfilment centres and transportation operations, to meet the increase in demand. While the rise in short term requirements and rising demand for online retail are positives for the logistics sector, much of the business underpinning the sector is dependent on retail.

Manufacturers are seeing demand dry up. Car manufacturers have seen demand slump and Nissan, Ford and Toyota have suspended production. JCB has also halted production as global demand for machinery reduces. COVID-19 is also affecting supply chains.

Air cargo volumes have dipped. Heathrow has recorded volumes of 232,000 tonnes in January and February; down 10.5% on last year. A contraction in global manufacturing outputs has resulted in a slow in UK imports and air cargo freight.

Tenants are requesting assistance. Many tenants are requesting rent holidays or to pay rent monthly rather than quarterly in order to help with cash flow. Smaller, multi-let units tend to have shorter lease terms and weaker covenants and tenants and landlords will likely feel the negative impacts of COVID-19, more acutely than in the single-let market.

What the numbers say. In Q1, early figures indicate approximately 6.6m sq ft of take-up in units over 50,00 sq ft, which compares to around 9.5m sq ft in Q1 2019. Our analysis shows an immediate need of up to 3.2m sq ft nationwide for short-term occupation. This is principally to service online retail, particularly food, and last mile delivery businesses.

For investment, preliminary volumes are approximately 33% below the 10-year average at £966m. The 10-year quarterly average is £1.45bn.

What we expect

Scaling up will be a challenge. Online grocery platforms have been inundated and supermarkets have warned customers they are struggling to cope with demand. Their delivery networks and supply infrastructure do not have the capacity nor flexibility to rapidly scale up their offering and meet demand. The growth in online grocery retail will be limited by the supply-side response.

Expect an increase in demand for flexible space as e-commerce demand rises. However, with some suggestions that social distancing regulations could

...the underlying structural shifts driving greater demands for logistics space have not abated...

continue for as much as 18 months, supermarkets are keen to scale up their supply networks to capture this rise in demand, both in store and online.

Development likely to slow. While some large-scale construction projects have been allowed to continue many firms and contractors have already downed tools and more are expected to follow. Developers are also facing a shortage of building materials due to supply chain disruptions and this is also impacting on their ability to continue works. Several developments currently under construction will need to push completion dates out into next year and planned speculative developments are likely to be put on hold, this will dampen the level of expected development completions this year.

Long term, the rationale for investor interest remains intact. Despite the current spike in demand, logistics operators are certainly not immune to tenant risk, or requests for rent payment holidays. Nevertheless, the underlying structural shifts driving greater demands for logistics space have not abated (indeed, many are arguing they have intensified). We expect well-positioned logistics assets to remain sought after.

What we question

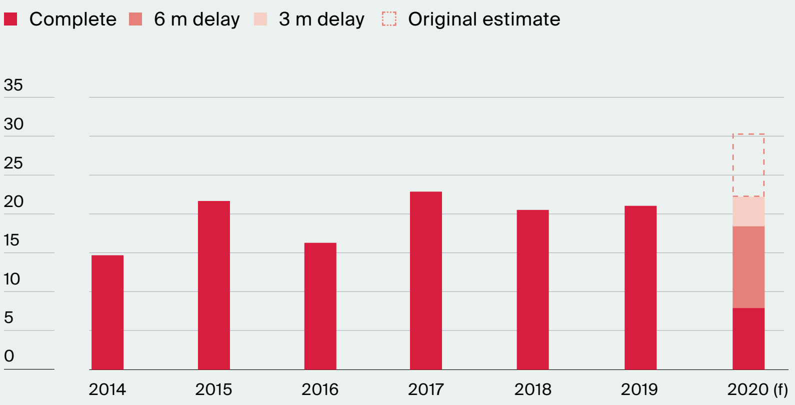
How long will the current restrictions last and what will be the lasting effects on demand and supply? There will undoubtedly be delays to development activity, but the length of these delays is very much an unknown at present. We are currently exploring how different scenarios could impact on the level of new development coming online over the next year or so. The chart below explores the possibilities of 3-month and 6-month delays and how they compare with our original estimates.

How will businesses look to mitigate against future supply chain disruptions? There could be a move towards reshoring operations and renationalising supply chains, potentially further driving up demand for space.

How will retailers improve their agility and ability to respond to future demand-side shocks? How much of a lasting impact will COVID-19 have on online retail demand? And what are the implications for industrial and logistics property?

Development completions (units over 50,000 sq. ft.)

Million sq. ft.



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