June 2020

COVID-19

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

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Executive Summary

It is too early to speak of economic recovery. Indeed, time lags mean data released in the coming weeks could paint an even gloomier picture, while an intense debate over the depth, length and shape of the downturn continues to rage. And yet, there are signs of economic life re-emerging in the UK, Europe, and certainly Asia, as the very strictest constraints on activity continue to be lifted.

The medium-term economic path out of the crisis is becoming somewhat clearer, if not universally more positive. In our third short summary, we highlight what we think this means for real estate markets: what understand with relative certainty, some of our current expectations, and some of the questions we feel are most pertinent today.

In this edition, we have chosen to add a focus on real estate debt – a vital part of the story for the asset class during the next phase of the cycle – as well as commentary from our market-leading healthcare and residential research teams.

As always, space constraints mean that we can only scratch the surface of these debates here, but we would be delighted to discuss any of the issues raised with you direct, and in more detail.

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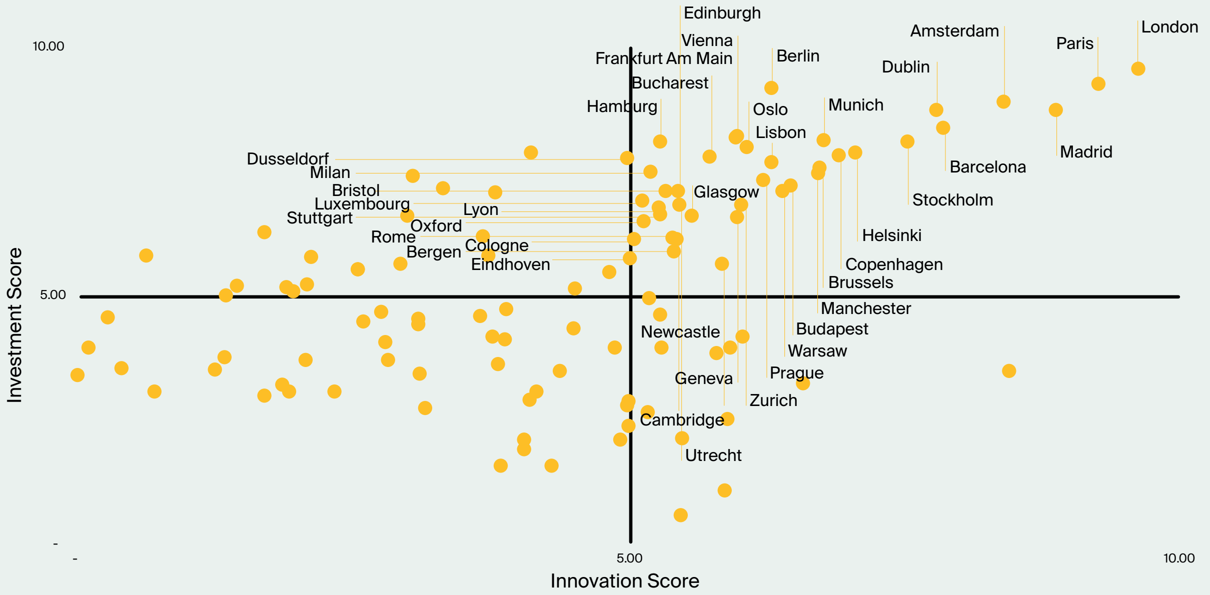
Content

INVESTMENT: CAUTIOUS UN-LOCKING BEGINS

What we know

Some real estate activity is resuming. Residential estate agencies in the UK have been allowed to re-open and across Europe, countries continue to cautiously un-wind their lockdowns and even consider plans for travel. For example, the Baltic states of Estonia, Lithuania and Latvia have already formed a 'Baltic travel bubble', opening their borders to each other, while 11 other European countries have agreed a common approach to reopening their borders. Resuming some level of travel is important for cross-border real estate investment.

Momentum Cities



Source: Knight Frank

What we expect

Innovation to drive future growth. Locations underpinned by innovation should continue to see the necessary wealth and population growth, to drive demand for real estate, both in the occupier and investment markets. Identifying such locations was already important in a lower for longer growth environment. Knowing that innovation often arises out of economic dislocation, identifying these phoenixes becomes ever more important. In the UK, London as well as the university cities of Cambridge, Oxford, Bristol, Edinburgh, Glasgow, Manchester and Newcastle all scored above average for innovation factors, according to our Momentum Cities research.

The ESG agenda to persist. According to Calastone, ESG funds enjoyed record inflows in January 2020 to the tune of £395 million. While March saw outflows of £17 million, £334 million worth of investment flowed back into ESG funds in April. Mitigating the effects of climate change has been legislated for across multiple countries, including the UK. This creates an over-arching backdrop for lower carbon investment into real estate, with potential future regulatory and reputational risks from not doing so. Social investing, particularly workplace wellness should also take on a new focus following the onset of COVID-19.

What we question

What is the longer-term inflationary outlook and what does this mean for real estate? There is considerable divergence of opinion over the medium to longer-term inflationary potential of the unprecedented levels of fiscal and monetary action being undertaken as a result of COVID-19. The outcome in part will depend on the shape of recovery. A strong 'v' shape could mean that rather than the government and central bank actions being just protective of the downside, they translate into actively stimulating economic demand. With a different shaped recovery, the considerable government and central bank actions target the severity of recessionary effects but don't necessarily stimulate the economy enough to generate demand pull inflation. However, cost push inflation could still be possible due to continued trading frictions and social distancing measures. In an inflationary environment real estate can act as an inflation hedge.

How will investor types and nationalities change? Q1 2020 US investment into the UK was the highest quarter on record with £6 billion transacted, we question whether shifting currency hedging benefits and transport frictions will change this US dominance? Will continued low oil prices spur Gulf real estate investors to search for income abroad? How might possible quarantine periods and 'travel bubbles' shape near-term transaction activity?

What will be the impact on pricing? Could we see a bifurcation in pricing between core, income producing assets and others? Will transactions pause rather than pricing shift, as was seen during the Italy-European Union budget row of 2018, when for a time, 10 year-government bond yields were above prime retail yields in Milan? When could we see distressed assets reach the market? Will this be only once government support is unwound?

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There is considerable divergence of opinion over the medium to longer-term inflationary potential of the unprecedented levels of fiscal and monetary action being undertaken.

REAL ESTATE DEBT: STILL OPEN FOR BUSINESS

What we know

The number of lenders open for business has undoubtedly decreased, but the debt market has not closed in its entirety. Whilst it is true that many debt providers have shifted their focus to existing clients and are therefore unable to offer terms for new transactions, there are still a number of active lenders across the UK and Europe who have provided indicative financing terms since the lockdown began. For transactions underpinned by robust business plans, debt finance is still obtainable.

What we expect

The time taken to close debt-backed transactions will increase. Some lenders have introduced additional ‘pre-screening’ credit committees, which will act as a filter for transactions before they reach risk teams for final consideration.

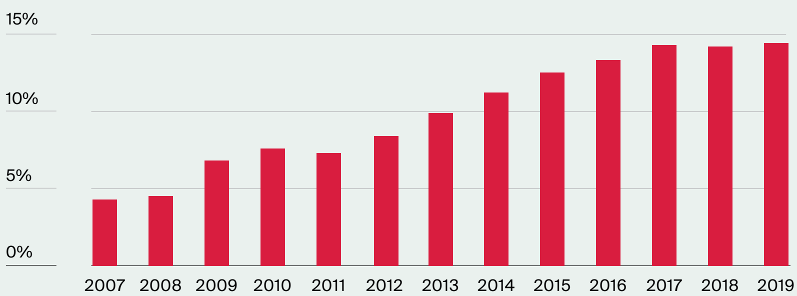
An even greater emphasis on due diligence. As well as taking longer to produce (due to social distancing measures and restrictions), due diligence reports will be placed under additional scrutiny. Some lenders may need to postpone financial close until the material uncertainty clause included within valuations has been removed, whereas others will amend the loan-to-value to cater for any potential ambiguity regarding the asset value.

What we question

Will this lead to a second credit crunch? Following the 2008 Global Financial Crisis, a number of measures were implemented by regulators to ensure that banks’ capital positions would be better protected in times of economic crisis. Since the start of the year, the Prudential Regulation Authority (‘PRA’) has reduced the amount of regulatory capital that banks need to set aside by cancelling the 2020 stress test for eight major UK banks. This will help lenders focus on meeting the needs of borrowers via the provision of credit. In addition, the PRA has removed the 1% countercyclical capital buffer that banks were previously required to set aside. These important measures should support up to £190 billion of bank lending to UK businesses, which is more than 13 times the net amount previously lent to businesses in 2019.

Resilience of major UK Banks (CET1 capital relative to risk-weighted assets)

Reassuringly, major banks' capital positions - known as Common Equity Tier 1 ("CET1") ratios - are almost 3 times stronger than they were before the 2008 Global Financial Crisis relative to their risk-weighted assets.



Source: Property Data/Knight Frank

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RESTRUCTURING AND RECOVERY: BREATHING SPACE FOR BORROWERS, BUT FOR HOW LONG?

What we know

Individuals and corporates with debt secured against all real estate asset classes will be impacted by implications of COVID-19. However, every situation is unique and it would be incorrect to assume that all secured debt will become impaired as a result. Nevertheless, there are significant challenges in the present time to overcome for most borrowers to remain compliant with their debt obligations.

For commercial property, the upcoming June rent collection will be closely observed. Poor rent collection is putting pressure on borrowers' cash flow and ability to service their debt, particularly prevalent in retail, leisure and hotel sectors. Limited rent collection, tenant default and market sentiment are in turn causing LTV issues as the capital values begin to contract.

In general, lenders are providing breathing space for most of their customers. This partly due to the many restrictions; FCA regulations, mortgage payment holidays, risk of negative PR and media coverage, an inability to progress some actions via the courts and the latest reform to UK Insolvency Law. However, customers with existing pre-pandemic issues are under increasing pressure from lenders to perform.

What we expect

Lenders will provide further breathing room to borrowers during the period of restrictions. This is to follow FCA and Government guidance and wait until the courts are able to enable enforcement actions. In addition, lenders will be waiting until transactions start completing in the different sub-markets so they can fully understand their exposure and risk on a customer-by-customer basis.

Where they can, lenders will try to support their customers. Those lenders that have the ability and depth to their loan portfolios will provide customers with more time to resolve their debt issues. However, some smaller lenders such as challenger banks and mezzanine and bridging lenders may not be so accommodating. It is therefore likely that they will be under more pressure to progress with enforcement action much sooner in the cycle.

The sectors most at risk of imminent enforcement action by lenders are those with existing structural challenges predating COVID-19 and, then those most hit because of the virus. We expect to see many retail and leisure assets, leased hotels, buy to let portfolios and development sites (mixed use and pure residential) to be more at risk of enforcement action.

What we question

How long can lenders pause the loan cycle and remain flexible? It would seem that many lenders have stopped taking on new business and are likely to do so for the foreseeable future until more certainty and fluidity to the markets has been restored. They also appear poised for the right time to commence the recovery of their stressed and distress debt positions but wish to do so without drawing criticism from the media and the regulators.

Support and breathing space will not go on forever. Once market and economic confidence does begin to return, we expect lenders to take aggressive steps to re-position their loan portfolios, re-evaluate their risk appetite and to redeploy capital at a rate possibly not seen for over two decades. As a result, will this create an artificially competitive market for debt and capital from Lenders, Private Equity and other sources and will it be a rush to deploy debt and capital in what is anticipated to be a growing and thriving market?

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OCCUPATIONAL MARKETS: THERE IS LIFE IN THE OFFICE, YET

What we know

Markets pause as corporate sentiment weakens. We have tracked sentiment across 16 global office markets since early April. It is clear that COVID-19 has brought an acute slow-down in active requirements from occupiers and a notable upturn in the volume of deals postponed. Weakening corporate sentiment is central to this slow-down, with a recent global survey of CFO's finding that two thirds had already delayed or postponed investment and placed restrictions on capital expenditure. This will take time to unlock, although we have seen an improving level of occupier activity in Hong Kong – the first of our tracked markets exposed to COVID-19 - over the last fortnight. This is grounds for cautious optimism.

Re-occupancy in focus as lock-down measures gradually loosen. As Government's detail routes towards the gradual reopening of their economies, business attention has turned towards the re-occupancy of offices. This is far from a 'normal' return to office life. The necessary requirement to respect social distancing measures – and a 2m distance between individuals – is forcing the reconfiguration of office layouts with a 50-60 per cent reduction in office capacity in most cases.

MARKET	FIRST REPORTED CASE OF COVID-19	ACTIVE OCCUPIER REQUIREMENTS	COMPLETED TRANSACTIONS	POSTPONEMENT OF DEALS	OCCUPIERS SEEKING SUBTENANTS	ASKING RENTS	TOTAL OCCUPANCY COSTS	PREVAILING MARKET CONDITIONS (OCCUPIER, LANDLORD FAVOURABLE OR BALANCED)
HONG KONG	22/01/2020	↑	→	→	→	→	→	TENANT
SINGAPORE	23/01/2020	↓	↓	↑	↑	↓	→	TENANT
PARIS	24/01/2020	↓	↓	↑	→	→	→	LANDLORD
SYDNEY	25/01/2020	→	→	→	→	→	→	TENANT
DUBLIN	29/01/2020	→	↓	↑	→	→	→	BALANCED
FRANKFURT	29/01/2020	↓	→	→	↑	→	→	BALANCED
MANILA	30/01/2020	↓	↓	↑	→	→	→	BALANCED
DUBAI	31/01/2020	↓	↓	↑	↑	→	→	TENANT
LONDON	12/02/2020	→	→	↑	→	→	→	BALANCED
SHANGHAI	20/02/2020	↓	↓	↓	→	↓	↓	TENANT
NEW YORK	01/03/2020	↓	↓	↑	↑	→	→	TENANT
BERLIN	02/03/2020	↑	→	→	→	↓	→	BALANCED
SAN FRANCISCO	05/03/2020	↓	↓	↑	↑	→	→	BALANCED
BANGALORE	09/03/2020	→	→	↑	→	→	→	BALANCED
MUMBAI	11/03/2020	→	→	↑	→	→	→	BALANCED
NAIROBI	12/03/2020	↓	↓	↑	↑	→	↓	TENANT

Source: Knight Frank, May 2020

What we expect

The great global workplace to continue. As re-occupancy becomes a reality for more businesses, we will move rapidly into the second phase of the great global workplace experiment. The capacity constraints within existing office portfolios will force companies to adopt hybrid workstyles with a clear distinction between staff working at home or in the office. This will be a difficult balance for business leaders to strike from both an operational and managerial perspective.

Evolution not revolution. There have been many revolutionary claims about the effects of COVID-19 on office occupancy. We do not buy such claims. Instead, we see an expedited evolution of the office following many of the cues evident in the market prior to the pandemic. A key reason for this is the limited ability for occupiers to enact rapid change at an asset or portfolio level. Economic and operating conditions will serve to apply a brake in the short-term, whilst lease breaks and expiries will typically be required to enact change and these are seldom instantly available.

What we question

A fundamental shift in the pre-crisis supply vs demand dynamics. There has been growing talk of the impacts of COVID-19 on market fundamentals. While a close-eye needs to be kept on sub-letting activity within global markets (with an uptick in four of our 16 tracked markets in the last fortnight) we believe that the limited supply of quality office space in global markets will be sustained, not least because of short-term financial and practical constraints on the delivery of new space. We also believe that demand will be strong post-crisis. While recognising a potentially difficult economic environment, the urgency of business restructuring (particularly in respect of digital transformation) will further the disruption = demand dynamic we have previously highlighted.

The 'death of the office'. The 20-year old death of the office narrative has reappeared with gusto over the last two months. Enforced working from home, and now the emergence of hybrid working styles that blend WFH with working in the office, have led to bold claims about how businesses could benefit from removing their second largest operating cost. This is naïve. The office is central to the creation and maintenance of a corporate culture. It is essential to the innovation and creativity required to stay competitive. It is the place where essential (and often tacit) staff development and education occurs and where social connections transform into important professional collaborations. Businesses are immeasurably weaker without recourse to an identifiable collective hub. That is not to say that the form and function of the office is beyond reconfiguration but, once again, rumours of the death of the office have been greatly exaggerated.

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The office is central to the creation and maintenance of a corporate culture. It is essential to the innovation and creativity required to stay competitive.

LONDON: A QUIETER MARKET

What we know

Leasing decisions being deferred. 10-weeks into the COVID-19 crisis and the market is starting to become quieter. Pre-letting activity that was in train prior to the lockdown is for the most part still completing and new requirements have been slowing for a number of weeks as businesses have been spooked by the very real threat of a prolonged period of economic contagion. We do however appear to be approaching an inflection point, with a small pick-up in new demand. Although it is too early to quantify the exact figure, these new requirements are different. The businesses looking for new offices are typically seeking approximately 75% of the space that they were previously – to accommodate home working.
Since 17 March, there have been 106 lease transactions, totalling just over 700,000 sq ft, with 3.55m sq ft under offer. It is unlikely that all the space under offer will transact before the end of the quarter, suggesting Q2 will see leasing volumes on par with Q1, if not lower.

Rent holiday requests ebb. For now, rent holiday requests, or rent deferment appeals via the government's Corona Virus Bill appear to be subsiding. This could be reflective of the fact that we are now halfway through Q2, with a resurgence likely as we approach the end of June.

Prime headline rents for best-in-class space are still holding steady, with almost no instances of attempts to chip rents for grade A space. Lease incentives, however, have drifted: 21-24 months on some 10-year leases, instead of 18-21 months in the West End and nearer 24 months in the City, which were previously at 21-24 months.

We do appear to be approaching an inflection point, with a small pick-up in new demand.

What we expect

The shortage of grade A office space will persist. As occupational demand begins to recede amongst certain occupier groups who are taking a "wait and see" approach, the extended completion time-frames mean that the supply-demand dynamic which has shaped London's office market since the Global Financial Crisis (GFC) is being prolonged, shielding the market from a potential glut of new stock. In fact, even if take-up levels for new and refurbished space were to fall to levels not seen since the GFC this year, London would still be looking at a development shortfall of new and refurbished space of almost 1m sq ft in 2020.

Private wealth to become a key player in the market. Not hamstrung by the politics of shareholder approvals, we expect to see greater activity from private investors. Indeed, our own sentiment indicators have shown a rise in international buyer inquiries over the past fortnight, especially those from Greater China. That said, despite sterling's weakness as the dreaded B-word (Brexit) returns to haunt UK plc ahead of a potential no-deal scenario by year-end, rapid deployment will be hampered by a number of other critical factors: lack of debt options, a dearth of stock, greater scrutiny of any underlying covenants and perhaps to a lesser extent, global travel restrictions.

What we question

A rapid return to "normal". With the government easing lockdown restrictions, optimism is running high for a rapid return to "normal". However questions remain about the ability of offices to re-accommodate their workforces safely, in our new world of social distancing, which, among other things, requires 135 sq ft per desk based worker, according to our estimates. If this is extrapolated, in theory, the West End emerges as the most generous market, with an almost consistent 160 sq ft apportioned to staff over the last five years. The City, at 126 sq ft per employee, outperforms the Docklands, where the figure stands at 104 sq ft per person, 23% below the minimum threshold to maintain social distancing.

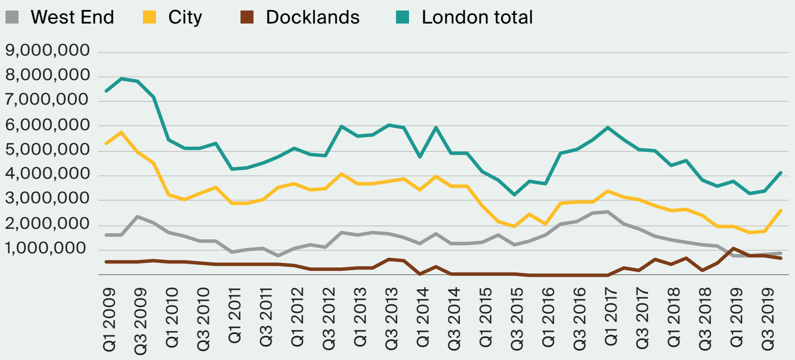
In theory, if we factor for office stock due for delivery this year, which is not already spoken for, this would equate to an immediate requirement of 6.1m sq ft and 4.4m sq ft, respectively. Rather than committing to new space to accommodate their workforces, it is likely that businesses will instead turn to the flexible office market as a stop-gap solution due to the short term nature of commitments. This will likely come in addition to a more permanent adoption of a working-from-home (WFH) dynamic as working practices are reviewed in light of the effectiveness of technology in sustaining productivity across a largely remote workforce.

Notwithstanding mobility challenges stemming from the government's estimate to run our rail networks at 10% capacity to maintain social distancing, the design and layout of offices will need to be revisited as businesses reassess how best to house their staff in safe and secure environments. Indeed with natural materials, such as wood, brass and copper, emerging as unfavourable for the surface transmission of COVID-19, the combined wellness and green agenda that was accelerating before the COVID-19 crisis will likely experience a further surge in interest as the focus shifts to the "S" and "G" in ESG considerations.

In parallel, as businesses work hard to tempt the workforce back into offices, workplace wellbeing, and world-class experiences will become sharper areas of focus. This is especially pertinent in London where 64% of our office stock was completed prior to the year 2000. This creates a tremendous opportunity to upgrade existing facilities to meet the needs of our new post-COVID-19 era.

Availability of new & refurbished space

Sq ft.



Source: Property Data/Knight Frank

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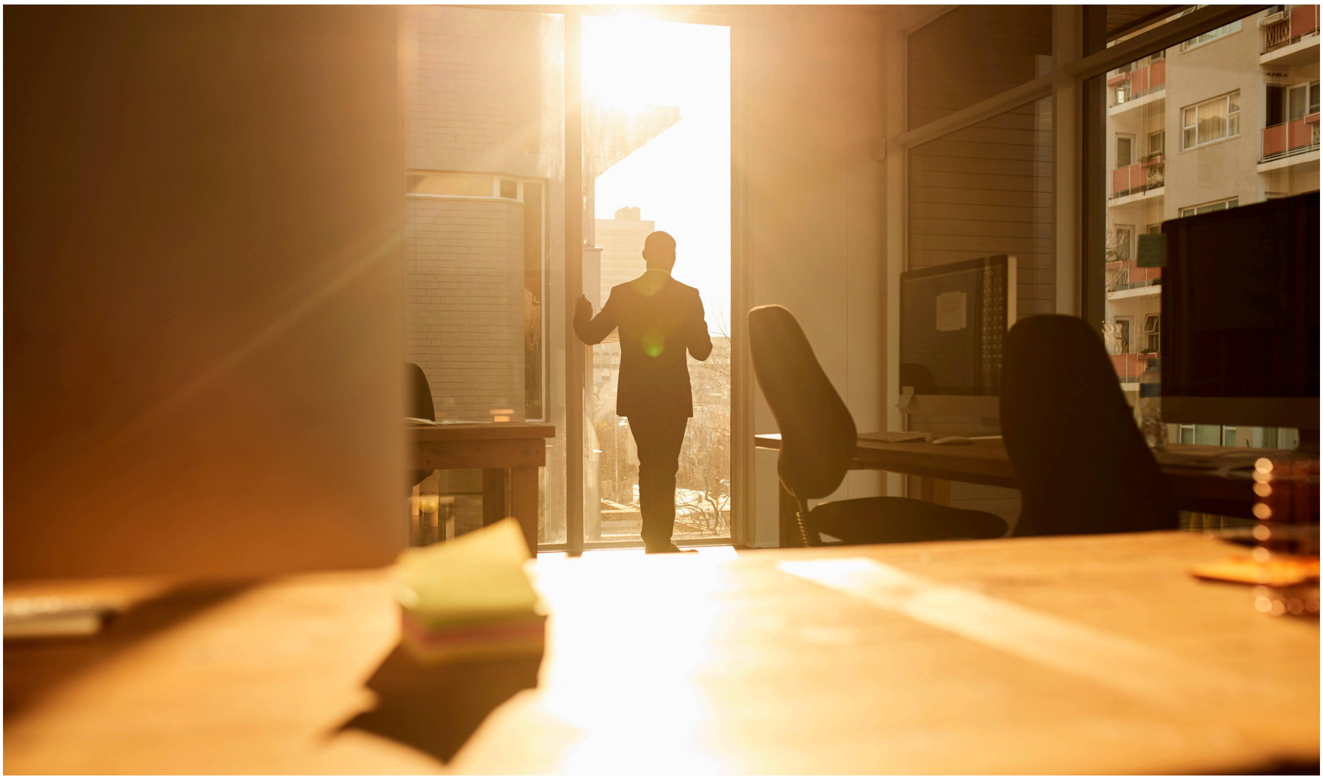
UK OFFICES: A RETURN TO WORK, BUT NOT AS WE KNOW IT

What we know

Space remaining under offer, but new enquiries have decreased. Despite unprecedented market disruption, the amount of space under offer outside of London has not dipped markedly. In the South East for example, close to 590,000 sq ft remains in lawyers' hands. This compares to 567,000 at the same point in 2019. Encouragingly, this demonstrates that there are few examples of withdrawn deals during the pandemic. New enquiries however, have fallen as occupiers take stock of the situation.

Construction sites are restarting. Although the UK government stopped short of forcing building sites to close, many developers elected to stop operations to ensure employee safety. With restrictions now loosening, sites are reopening, albeit materials availability and workforce reduction could affect completion dates. At the time of writing, 8m sq ft is due to complete across the UK cities and South East over the next three years, of which 50% is already let.

The tight supply landscape and a general flight to quality will mean that headline rents hold firm despite the fall in transactional activity.



What we expect

Return to the office will not mean back to normal.
Even after restrictions are relaxed, the return to physical spaces will be slow and gradual. Employees are likely to return to the office in stages and as safety allows. Interaction with spaces will be different, meaning a greater onus on landlord and tenant collaboration. Any strategy for reoccupation will include an assessment of the quantum of space required. Either occupancy will need to be below capacity to allow for distancing or businesses may seek additional short-term space to accommodate this health and safety requirement.

The need for agility will hasten digital transformation. As the forced shift to remote working reveals fissures in business continuity, digital transformation will clearly be a high business priority moving forward. The crisis has evidenced both improved business agility via technological means, and reminded of the important role that technology holds in current and future service delivery. Digital infrastructure, whether at a city or building level, will therefore be a point of differentiation for offices and cities moving forward.

Headline rents to hold firm. The tight supply landscape and a general flight to quality will mean that headline rents hold firm despite the fall in transactional activity. The greatest impact of the crisis will be through a softening in rent-free incentives and lease flexibility.

What We question

Assignment or subletting to rise?
Although all focus for businesses currently will be the safe return to work, firms will also be contemplating the workplace beyond Covid19. The aftermath of previous economic shocks has registered an increase in tenant release space. Will the coming months see a rise in 'grey space' entering the market or will concern over future supply support the retention of current occupational footprints?

Will commuter method aid business recovery? Following the easing of COVID-19 restrictions, businesses across the UK have been hurriedly assessing how to achieve a safe return to office buildings. Whilst practical steps within the workplace in terms of social distancing, sanitisation and staggering work patterns are achievable, the journey method to work remains beyond the control of individual firms. Outside of London, around 60% of journeys to work are by car. With less reliance on public transport as a means of travel for employees, will this preference enable an easier route to back to the office? Will locations with easy car access such as business parks see a demand increase? What alternative steps will balance sustained or additional car use with emission reduction targets?

What will be the consequences for the green agenda? Prior to COVID-19, ESG integration was rising as the topic of urgent action. The environmental component was of particular focus, with real estate considered as holding a key role in achieving sustainability targets. The 'Green Agenda' has not disappeared and is growing in criticality, but fears are that heightened monetary scrutiny in a post pandemic world will derail some environmental management responsibilities as it has done in the past. Moreover, the pandemic may encourage change with regard to commuting choices. Will local authorities rethink plans to reduce car usage in major cities? How suitable are the proposed walking and cycle lane plans to the daily commute? Will any increase in private vehicle use accelerate the shift to electric?

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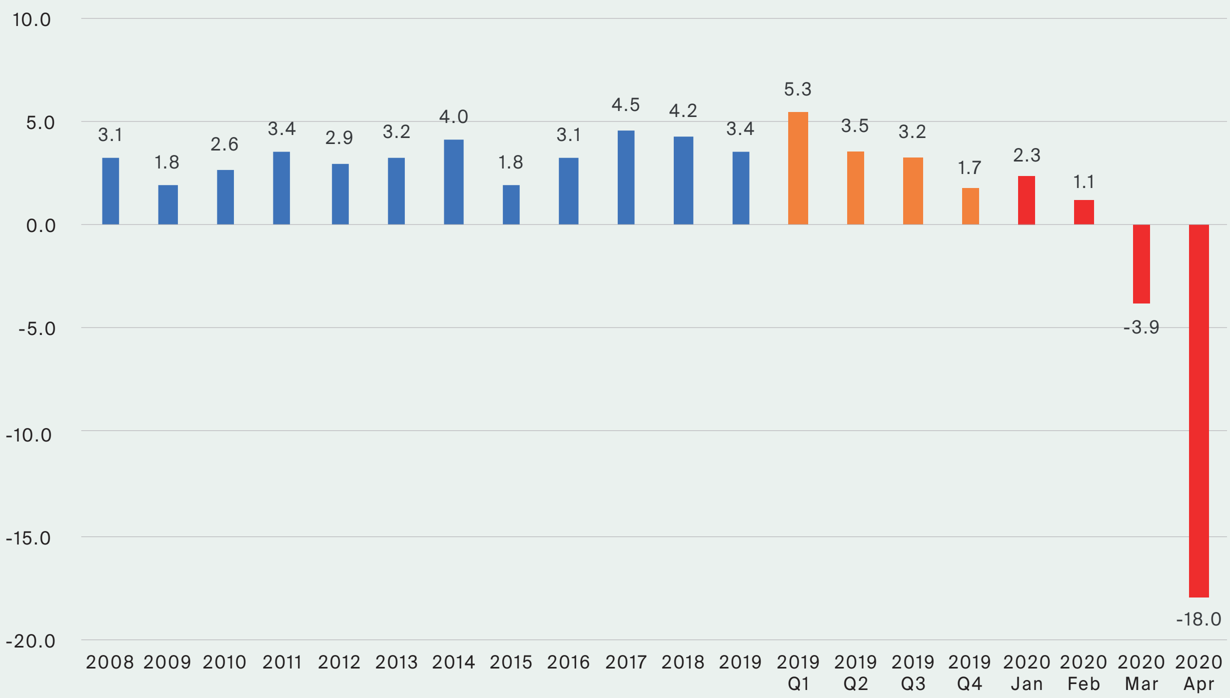
RETAIL: PICKING UP THE PIECES POST LOCKDOWN

What we know

When the high street lockdown will be lifted. "Non-essential" stores come under Step 2 of the UK government's "roadmap out of the lockdown" plan, which becomes operational from 1 June. Leisure (including F&B) falls under Step 3 of the plan, which comes into force a month later (i.e. from 1 July). These dates are provisional and highly conditional on a number of targets being met (although there isn't much transparency as to what these targets actually are).

Footfall and retail sales remain in freefall and many retailers are still operating on a zero or minimal cashflow basis. Footfall was down -84.7% year-on-year in April. Retail sales slumped by -19.1%, unsurprisingly the worst monthly performance since records began in 1995. Although online sales spiked by +57.9% to reach a record high of 69.9% of all non-food sales, the key message from most operators is that online is only picking up a limited proportion of lost store-based sales.

Year-on-Year Retail Sales Growth 2008 - 2020



Source: ONS, Knight Frank

What we expect

Retailers are likely to take a softly-softly approach to re-opening, rather than try to re-commence trading with all guns blazing. There is a sense of relief that that enforced closures may soon be coming to end and cashflows can re-commence, but this is overshadowed by concerns of how to adapt stores to make them compliant to social-distancing and complete uncertainty over potential trading volumes in both the short and medium term.

It is highly unlikely that every shop across the land will re-open on 1 June. Retailers are currently reviewing their portfolios to explore which ones lend themselves best to social-distancing measures and to understand the costs involved (additional door/security staff, inflexible movement of instore personnel, perspex screening, floor taping, additional POS). It follows that stores with larger floorplates are likely to be given priority. In terms of a broad pecking order, this would suggest the following re-opening sequence – retail warehouses, high street and then shopping centres (with Leisure last of all).

June's quarterly rent day will be an even greater pinchpoint than March's. Most retailers are in a far worse cash position now than they were a few months ago. We project that only between 10% and 20% of retailers will meet their Q2 rent obligations in full and on time – most will seek landlord concessions.

What we question

The prospect of a rapid "bounce back" in consumer demand. The "pull" factors (pent-up consumer demand) will be far outweighed by **three key formidable "push" factors,** certainly in the short- to medium-term.

1. Consumer reluctance to return to public spaces (especially retail stores)
2. Stores that are open adhering to social-distancing compromises
3. Genuine economic concerns (especially around job security)

The timeframe on any recovery. Most retailers are already looking to Christmas as the first point of meaningful temperature check. But recognising there are considerable pinchpoints before then (e.g. quarterly rent days in June and September and the prospect of changes to the government furlough scheme etc). Realistically, few retailers are anticipating a return to "normalised" trading levels until this time next year, at the earliest. Even then, Christmas 2021 may be a more realistic barometer.

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Realistically, few retailers are anticipating a return to "normalised" trading levels until this time next year...

INDUSTRIAL WAREHOUSING: PREPARING FOR THE FUTURE

What we know

Short term space requirements rising. Knight Frank has registered over 6m sq ft of short term requirements since lockdown, although only a small proportion have led to deals on vacant space. The majority have been absorbed into existing 3PL networks, but there is now very little "grey space" left unaccounted for. This has meant that 3PLs have re-entered the market with new requirements.

Aviation adversely affected. Jobs losses at Rolls Royce is further evidence of the damage COVID-19 is having on both aviation carriers and suppliers. It is reported the many of the expected cuts will be at the assembly and test site in Derby. To contextualise, Heathrow recorded cargo volumes of just over 50,000 tonnes in April 2020, the lowest monthly total since 2005. Passenger numbers were the lowest since 1997.

What we expect

Social distancing – Here to Stay. The first signs of social distancing on large scale fulfilment operations and wider occupier planning beyond the pandemic are beginning be factored. Businesses are of the view that measures are likely to remain in force for the medium term – years not months – or until a vaccine is developed. As a result, additional space is being sought for immediate use, but longer term warehouse design and a possible move to campus type operations (adjacent units, capable of being run by a single management team) could be the result.

Vacancy to rise, but no oversupply. Whilst tenant distress will inevitably turn to failure for some organisations, a market overweight with warehouse supply is not predicted. It is too early to say how much space may be returned because of downsizing or default, but any increase will be mitigated by development delay. Contractors have now mostly been able to return to sites, although social distancing measures and supply chain disruption will hamper progress for some time to come.

What we question

A shift to online to add further pressure to the supply chain? Whilst supply chains across industries will clearly be an area of scrutiny post pandemic, the acceleration of online retailing could add further pressure. As retailers reopen and adjust to a new marketplace, competition will intensify to achieve speed to customer. Will this encourage a shortening of supply chains as production is brought closer to home markets?

A glimmer of optimism for UK Car Manufacturers? As the UK begins to relax COVID-19 restrictions, car manufacturers are tentatively restarting operations. Even so, with the economic outlook looking increasingly poor, predictions regarding car sales are understandably gloomy. Indications from China, which came out of lockdown ahead of most countries, might offer some positivity however. A sharp rise in individual car use has been recorded as commuters avoid public transport. Could a shift in consumer attitudes to cars protect car makers from the worst of the economic fallout?

Will COVID-19 accelerate automation in warehousing? Risk mitigation is clearly going to be a lasting legacy of the COVID-19 crisis for businesses. This may mean that processes that are labour intensive are assessed as an area of potential vulnerability. As such, an acceleration toward greater reliance on robotics and automation may be the consequence, a shift which will have a marked impact on the design and specification of warehousing. Will the rate of building obsolescence increase as a result? Would any increase in fit out expenditure mean that tenants become more 'sticky'?

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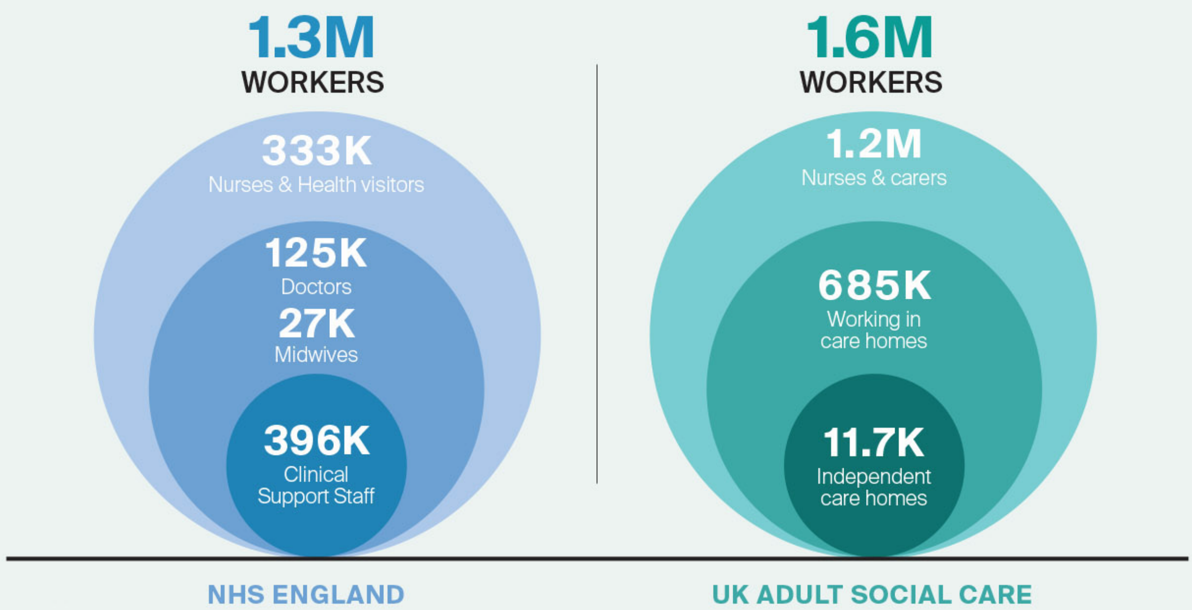
UK HEALTHCARE: THE IMPACT ON THE CARE HOME SECTOR

What we know

Workforce is vital. While we should applaud the NHS professionals working to save lives in hospitals, we cannot forget the role played by 1.6 million people working in the adult social care sector. This includes 685,000 people working in care homes, most of which are highly skilled but low-paid nurses and carers. The lack of PPE and testing kits available to the sector has been in the spotlight, and rightly so. We are now seeing greater availability of such equipment, helping operators to reassure staff and admit new residents without fear of putting existing residents at risk.

Occupancy rates will fall. Initial estimates suggest a mortality rate of 15% for those aged 80 and over, with even greater risks reported for those with acute medical needs – such as care home residents. The rate of mortality will of course vary from care home to care home, but the death toll will have an aggregate effect on the UK market. Occupancy has begun to fall slightly as a result of deaths, but also because of the decline in new admissions. This may change as testing becomes more widespread and admissions return to normal levels.

The NHS and adult social care workforce



Source: NHS Digital, Skills for Care

What we expect

Smaller homes are potentially more at risk. Care operators are well-equipped to deal with seasonal flu, as well as diseases such as dementia and Alzheimer's, but COVID-19 is an unprecedented challenge. While not a blanket rule, outbreaks are likely to have a more pronounced effect on smaller independent care homes, typically with less than 40 beds. Our analysis shows that around half of UK care homes are below this size and those without large group backing or the economy of scale to absorb occupancy loss, are at greater risk.

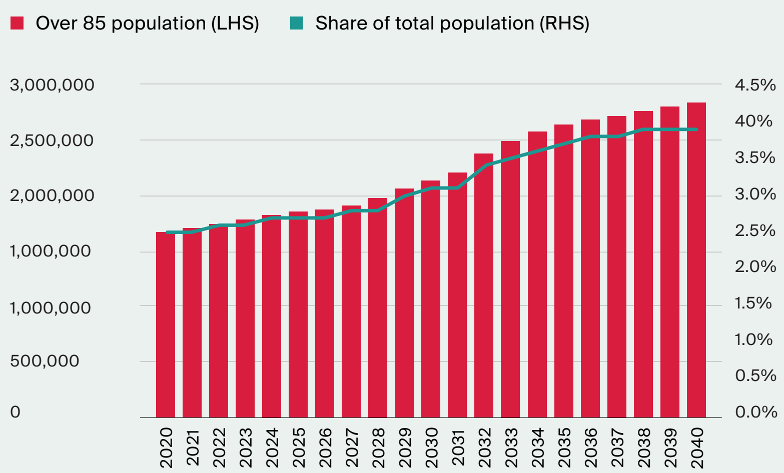
Long-term drivers remain robust. It is going to be a difficult year, but there are some key factors supporting long-term growth in the sector. This is not to underestimate the challenges, but to remind stakeholders that the fundamentals for this property are still strong. A significant decline in bed demand will not be enough to derail the growth in the number of over 85s in the approaching decades. Furthermore, its important keep in mind the UK's strong global reputation, both as a healthcare market and a destination for global capital.

What we question

How prepared was our healthcare system? The NHS and the government did respond quickly to this pandemic, but compared to other advanced countries in Europe, the UK healthcare system looks undersupplied. The total number of hospital beds managed by NHS England has fallen 23% in the last 20 years (Source: NHS Digital), while the population of the country has increased by 15%. Furthermore, critical care bed provision in the UK equates to around 6.5 beds per 100,000 people compared to 29 beds per 100,000 in Germany.

Is there still a development opportunity? Most definitely – While there may be some delays to the construction pipeline, the building of new care homes and other healthcare facilities will remain vital in servicing the demands of our ageing population. COVID-19 is likely to have further implications in terms of design as new builds reshape to deal with future pandemics. Furthermore, the prospect of an economic downturn will enhance the flight to quality among healthcare investors and new developments will provide a means accessing the prime end of the market.

Uk over 85 population growth projection



Source: ONS

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BUILD TO RENT: GOING MAINSTREAM

What we know

Lockdown restrictions have been eased. The government has amended the coronavirus regulations to make clear that people who wish to move home can now do so. The lifting of the full UK lockdown will run in stages through to at least July, but the announcement untangles one of the main sticking points for the rental market with an inability to conduct viewings slowing the lease-up of newly constructed buildings as well as of vacant units. Initial signs are that demand has bounced back strongly, with weekly new prospective tenant registrations 9% above the five year average. Logistical challenges are ongoing, but the liquid nature of the rental market, combined with a release of pent-up demand for good quality rental product should drive a pick-up in new tenancies.

Rent collection has been robust. Rental accommodation has proven resilient in previous downturns and evidence so far suggests that the sector has weathered the initial impacts of COVID-19 remarkably well. Rent collection averaged more than 96% in March and nearly 94% in April, according to the results of our survey of some of the biggest investors in professionally managed PRS in the UK. Figures for the remainder of the year will be tied to the wider economic picture (particularly surrounding unemployment), but initial signs are encouraging.

What we expect

Interest from institutional investors and new entrants to the market could rise. Prior to the outbreak of COVID-19, institutional investment in residential assets, and of diverting capital away from other commercial real estate sectors, was an increasing trend. The current crisis has only served to reinforce the outlook from investors on the defensive characteristics of the sector, as well as the granular nature of income. We expect that a search for core income-producing assets in safe-haven locations (such as the UK) from investors may well act as a catalyst supporting this shift of investment. Our investment team has already experienced a rise in enquiries, particularly for stabilised assets and from new non-domestic investors.

Rental performance will be increasingly asset specific. Near-term expectations among owners and investors are generally for no rental growth, or a slight fall in rental values in 2020. Our view is that BTR rents will be unchanged this year before recovering in 2021 and picking up thereafter. Within this, however, asset specifics will be significant, with performance likely to differ between assets dependant on - but not limited to - their exposure to student, international and corporate tenants, as well as local supply volumes and affordability dynamics.

What we question

What will the long-term impact be on tenant demand? The number of sales transactions is projected to fall nearly 40% in 2020 compared with last year, equating to over half a million 'lost' sales. Logic dictates that some of this demand will be absorbed by the rental sector, but it comes at a time when the shift from owner occupying to renting has slowed. A lot will depend on the speed of recovery within the sales market, but with fewer households looking to buy during times of heightened economic uncertainty (as experienced in the wake of previous recessionary periods), and long-term forecasts pointing to continued growth in new household formation, we believe momentum will pick-up once again.

Whether tenant preferences will be changed. Shared amenity space, such as gyms, lounges, and external terraces and gardens have universally been closed and any re-opening is likely to be gradual and require some form of social-distancing measures. Operators will be keen to understand the practicalities of such an approach, as well as the costs involved. Tenant demand may well be for adaptable multi-use, rather than single-use, spaces. Demand for provision of some form of private outside space is likely to increase and command a premium.

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STUDENT PROPERTY: PROVEN RESILIENCE

What we know

Government has moved to stabilise university admissions. The government announced a package of measures to boost support for students, stabilise the admissions system and ease pressures on universities' finances early in May. More than £100 million of existing research funding for providers in England is being brought forward into this current academic year as is tuition fee payments of students in the 2020/21 academic year, expected to be worth £2.6 billion. Both measures will support cash flow for universities. Controls on student recruitment are also proposed as a temporary measure and will mean providers only being able to recruit full-time, domestic and EU students up to 5% above their forecasts in the next academic year. This is designed to reduce volatility and ensure fair and orderly admissions. The government will also have the discretion to allocate an additional 10,000 places, with 5,000 ring-fenced for nursing, midwifery or allied health courses to support the country's vital public services.

PBSA bookings for the coming cycle are on track. The current evidence of bookings from operators in May is broadly in-line with performance at the same time last year. Operators have targeted UK-domiciled students in greater numbers this year with an expectation that there may be lower international student enrolments. As more universities provide clarity on how they will operate in the forthcoming academic year, both international and UK students will firm up their decisions on where to study.

What we expect

Universities will take a 'blended learning' approach to teaching. UK universities are planning to deliver 'blended teaching' from the beginning of the next academic cycle as a way of maintaining the 'student experience' and in a bid to prevent students from deferring a year. Most institutions are hoping to offer a mix of both face-to-face and online teaching and will implement social distancing measures across campus and in student accommodation. The universities of Manchester, Bolton and Edinburgh and Nottingham Trent have already announced that they intend to deliver a hybrid approach from September.

Demand from UK-domiciled students to increase. Applications data from UCAS for new students showed that a total of 568,330 applicants (as of the 15 January deadline) applied to UK universities this year, up 1.2% on 2019. Overall, a record 39.5% of all UK 18-year olds applied to university, with more than 50% of 18-year olds from London applying. The number of 18-year olds in the UK is projected to increase from 2021 onwards, following years of declines, and this is expected to drive a growth in student numbers. Knight Frank analysis of ONS population projections, along with entry rates from UCAS, points to a 15% increase in full-time undergraduate numbers between now and 2030. This would represent an additional 220,000 domestic students.

What we question

Whether student accommodation preferences will be changed. We have seen a trend over the last few years of greater levels of satisfaction with PBSA against mainstream rented accommodation. This has led to higher levels of retention, within PBSA, of students moving between years. In our 2020 Student Accommodation Survey, undertaken with partners UCAS, a quarter of first year students who were living in private PBSA said that they planned to stay in the same accommodation the following year, rising to 40% among second years. It is likely that the impacts of COVID-19 will see this trend accelerate with further interest by students of all domiciles in PBSA.

The long-term status of UK higher education will be damaged. In its recently announced package of measures the UK government reiterated its commitment to increasing international student numbers. The International Education Strategy, released by the government in 2019, aims to increase international student numbers in the UK by more than 30% to 600,000 by 2030. The government is considering how the International Education Strategy can be updated to respond to the impact of the coronavirus outbreak and will also be launching the new graduate visa route by summer 2021. A stronger offer is likely to boost the UK's appeal and support institutions to attract overseas students. The UK boasts 11 of the world's top 100 universities, and these will continue to act as a draw.

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