May 2020

COVID-19

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

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Executive Summary

As parts of the world tentatively ease isolation measures, we are beginning to get a glimpse of a path back to activity, if not yet a return to a previous normality.

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 markets, occupier markets, London offices, UK offices, retail and logistics. As ever, our diverse research team is always on hand to discuss any of these viewpoints in more detail.

William Matthews
Head of Commercial Research

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MACRO BACKGROUND: UNLOCKING THE LOCKDOWNS

What we know

Governments continue to boost fiscal support measures. March saw the initial flurry of additional spending pledges designed to prop up stalling economies around the world, but further programmes continue to be announced. In the US, the Senate has recently passed a $484bn stimulus package, with $300bn used to replenish the Paycheck Protection Programme (PPP), colloquially known as the small business fund. Germany has released an extra €10bn of spending to boost unemployment payments and cut sale tax on restaurants and cafes. The UK Treasury is looking to raise £180bn in the next three months, which is more than quadruple its prior borrowing plans of circa £30bn. In short, government largess has not reached its limits. Meanwhile, furlough payments will now be eased out, rather than abruptly halted, after the initial June 30th end date.

Interest rates: even lower for longer. After a period of volatility, government bond yields have found a floor in many global economies, even if only temporarily. Almost all central bank decisions this year have involved interest rate cuts, or at least maintaining rates at historically low levels. In most major economies there is now little scope to go further using conventional measures, although China was able to reduce key interest rates during April. Many monetary authorities have now resorted to unconventional measures, such as the purchase of public or private securities, or the reduction of counter-cyclical buffers. Against a more normal economic backdrop, these measures would be considered extremely expansionary.

Economic indicators have been predictably dire. Lockdown scenarios around the world were always going mean short-term economic indicators paid a heavy price. A case in point, official statistics from China, one of the first countries to adopt strict containment measures, show a first quarter contraction in GDP of almost 7%. Data remains too historic to matter in many other countries. The latest official UK GDP growth estimates showed a 0.1% expansion in the three months to February, demonstrating that COVID-19 influences were yet to be felt.

There are significant question marks over the quality of certain types of economic data at present, especially those that involve an element of surveying or questionnaires. Consequently, we are also analysing other types of indicators to get a better sense of economic momentum from country to country.

Lockdown scenarios around the world were always going mean short-term economic indicators paid a heavy price.

What we expect

Unlocking the lockdowns: a very gradual process. Parts of Asia are returning to a degree of normality, with employees back at work (but subject to strict testing measures) and elections held recently in South Korea. Some European countries are now easing measures, albeit extremely gradually.

As a flurry of weak first quarter economic growth estimates roll in, pressure will build on governments around the world to go further and faster. Implicitly, an uncomfortable balance between public and economic health must be reached. We expect that while more countries will soon join those that have already begun to lift restrictions, the return to a previous 'normality' will be measured in months and quarters, not weeks.

An intense debate on the shape of recovery. The latest round of economic data will focus minds on the road back to economic growth. At present there is a noticeable divide between banking and financial institutions, which currently predict a sharp rebound, and others forecasting a slower recovery. To be sure, almost all forecasters envisage a deeper decline in global growth for 2020 than the 0.5% contraction seen in 2008 during the GFC.

In the UK, forecasters have re-evaluated growth at lightning speed: during March, the UK Treasury's consensus for GDP growth in 2020 was 0.8%, but by April it had dropped to -4.7%. More positively, the consensus for 2021 is for GDP growth of 4.3%, albeit with unemployment pushing out to 5.3%, from 3.8% at the start of 2020.

On most economic metrics, the range of forecasts is now extremely wide, reflecting the number of elements that remain essentially guesswork: the rate at which lockdown is eased, the time until widespread testing can take place, or the impact of second-round effects. Our sense is that growth in the UK will be slower-paced than the more optimistic proponents of 'V' shaped recoveries hope for, and will be complicated by questions around transition from the EU.

What we question

How long will it take to 'normalise'? 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?

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, make 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. 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.

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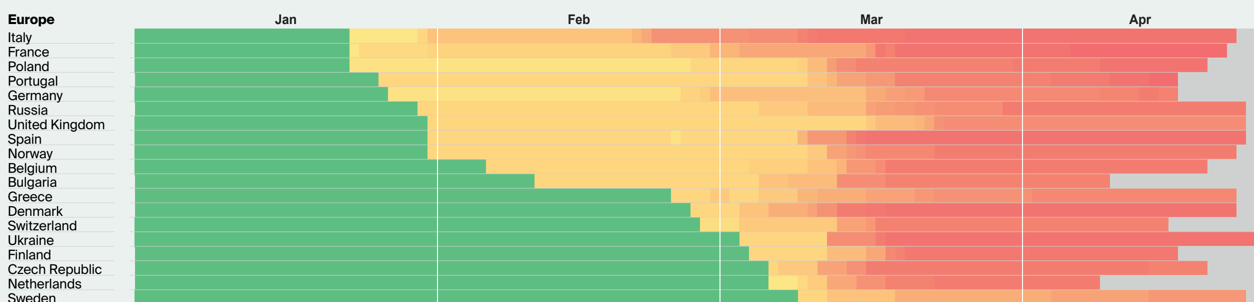
Timeline of Covid-19 containment measures and their stringency

No restrictions — Highest Restrictions / Ban



This chart shows the change in severity of containment measures over time, up to the latest data. Green indicates a score of zero or no restrictions, while the darkest red indicates the highest restrictions or complete bans. Where grey, no new data is available.

CAPITAL MARKETS: SHORT TERM CHALLENGES, LONG TERM DEMAND

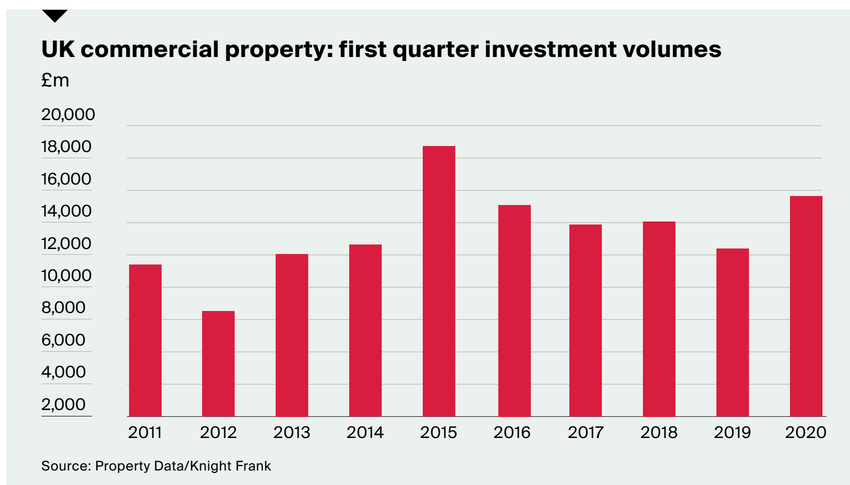
What we know

Q1 real estate investment volumes largely shook off COVID-19 in the UK. Despite some of the UK's Asia-Pacific investors facing lockdown very early in 2020, the UK only embarked on its own lockdown measures towards the end of Q1. As a result UK first quarter investment volumes are nearly one third higher than Q1 2019 and only 12% down on Q4 2019. Office and Alternatives / Mixed use sectors fared particularly well, with volumes 54% and 140% higher than the first quarter 2019 at £4.0bn and £7.5bn, respectively. Industrial volumes were 20% lower than Q1 2019 at £1.5bn. While overall retail volumes were down over Q1 2020, Shopping Centre volumes saw £211m of volume, compared to just £63m one year ago and £180m in Q4 2019.

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 (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, although international investors with local hubs should more easily be able to overcome this, 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 a number of trends. The ability to collect rent has been heavily sector dependent, with the retail-focused companies typically receiving the lowest percentages, although not universally. For 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 lower than in the run up to the GFC.

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. Falls in equity values could mean that some balanced funds need to reweight, potentially selling real estate to do so. However, 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.



At over £15bn, first quarter investment in the UK was the highest since 2015.

What we expect

Government spending to reduce the depth of the economic downswing. However, this is not expansionary capital spending that grows the economy. In future years, interest will need to be serviced and debt repaid, meaning potentially lower future spending and / or increases in taxation, with knock-on implications for real estate investment strategies.

Real estate activities to see a significant contraction in Q2. Commercial real estate markets were already experiencing a tight supply side, including for new development, so the forecast reduction in construction activity should constrain this further, and potentially for the coming few years. Delays in completions also mean risk of covenant breaches for developments reliant on debt, as well as additional costs, potentially reducing the NPVs and / or margins of development companies / construction firms, depending on specific contracts.

Lower density of use of buildings, should there be subsequent social distancing rules similar to places such as China, could also mean squeezed margins and potentially lower profitability. This could also potentially impact capital values of some real estate assets in the future, should this be a longer-term phenomenon.

Challenges to rental and capital growth. Emerging forecasts see rental and capital values falling over this year, both at an asset class and property sector level, albeit with a recovery from 2021 for the main office and logistics sectors. Within all property sectors, the asset specifics will continue to be highly significant, with performance differing between prime, secondary and tertiary assets within the same asset classes.

Demand to persist for income-producing, safe-haven, core assets. Volatility in other financial assets is set to continue. In such an environment, core income-producing assets in safe-haven locations are likely to remain in demand, particularly against a backdrop of low interest rates. We therefore expect an increased likelihood of a bifurcation in performance between assets capable of providing a relatively assured income, and those of a quality or in a sector where income cannot be relied upon. Notwithstanding the continued practical challenges of being able to transact and short term questions over occupier demand and rental levels, London and other UK assets enjoy some of the strongest covenants globally and therefore likely remain in demand.

What we question

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 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.

What will be the long-term impact on real estate debt? Going into the pandemic, loan-to-values are lower than at the time of the GFC but the commercial real estate market is still heavily debt dependent. Banks are better capitalised, but from a real estate investor's perspective, not all debt is with banks.

Due to changes in regulatory capital rules incentivising banks to lend more simply on senior pieces of debt, over the last decade there has been a large rise in real estate debt funds. The loan documentation and the debt funds themselves are as yet largely untested by a significant downswing.

Looking forward, we question how the impact of bank bad debts may impact the availability, loan to value and pricing of bank lending, what the current situation means for existing debt funds and what sort of actions they will take and how future lending by debt funds may change. We also question the degree to which new debt funds / equity players will step in to manage any short falls in debt provision if current lenders retrench. There are also questions related to if, when, and what debt-led asset sales could look like.

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OCCUPATIONAL MARKETS: THE GREAT WORKPLACE EXPERIMENT

What we know

Business confidence is diminishing. With widespread social distancing measures and a third of the world's population in lock-down, the potential economic impacts of COVID-19 are becoming all too apparent. Concerns about the macro-economic outlook are serving to dent corporate confidence, as is evident from recent C-suite sentiment surveys. One such study - Deloitte's European CFO Survey - found that 63% of those surveyed were less optimistic about the financial prospects of their business than they were six months ago; while 40% were planning to reduce their capital expenditure; and slightly more than a third anticipated reducing headcount over the next year.

Occupational markets are in 'pause' mode. Accordingly, the major global office markets have paused. Reducing commitments to capital expenditure has put major fit-out and relocation projects on hold, as corporate attention turns towards building financial resilience to ride out the storm. This pause is evident in our own fortnightly sentiment survey undertaken across 16 global gateway office markets. Active occupier requirements are trending downwards in 12 of the surveyed markets. We regard this as a temporary pause. Occupiers are continuing to strategize, particularly given the clear uncertainties of the post COVID-19 era and the likely continued shortage of quality office supply that characterised global markets as we went into this crisis.

Attention is turning to the challenges of re-occupying space. Current strategizing concerns the re-occupation of offices. As governments begin to consider, and in some cases articulate, timescales for a dilution or removal of lock-down measures, occupiers are facing the new challenge of who to bring back into the formal workplace, and how to ensure that the environment is safe, secure and respectful of social distancing requirements that remain firmly in place. This is particularly challenging given the increased density of occupation that has represented the evolution of the office over the last decade.

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What we expect

A growing challenge to the binary distinction between working from home and working in the office. As re-occupancy starts to become a reality, there will be growing consideration of where work takes place and why. Working from home has become an enforced reality for many. Indeed, 45% of UK's the working population has been doing so during the crisis. This poses two dangers. First, occupiers may conflate an enforced approach to work with an optimal approach to work. Second, the wider real estate industry may continue to adopt a binary, either/or, distinction between working from home and working from the office. The future of work, and hence the workplace, will be multi-locational, more dispersed, more flexible, more individual and much more task specific. Future thinking and action will need to reflect this.

Health and safety will be at the forefront of the post-crisis workplace environment and experience. One undeniable point is that there is going to be a much stronger focus upon health and safety in the workplace as an immediate and direct consequence of this crisis. Employees will demand such, whilst employers will have a moral and regulatory obligation to deliver such outcomes. We, therefore, expect health and safety considerations to sit firmly alongside wider considerations of wellbeing to become central to the future workplace experience. This has already been seen in some Asian markets.

Managed solutions delivered through partnership will address demand for greater flexibility. Social distancing protocols have served to place great pressure on the coworking sector, where occupational densities are typically high. Yet re-occupancy challenges, together with the uncertainty of the post-crisis operating environment, are likely to fuel increased business demand for more flexible real estate solutions. We expect the future to be one where flexibility is in demand but will need to be delivered in partnerships that combine access to product of conventional landlords, with the skills of operators in delivering strong services and experiences to customers. Our recent white paper, Power in Partnership, explores this issue in detail.

What we question

Are sustainable real estate solutions achievable in a low growth, cost-sensitive operating environment? One of the key dynamics that will shape occupier behaviour, and hence market conditions, post COVID-19 is the need to adjust to a cost sensitive, lower growth economic environment at the same time as responding to the critical, time-sensitive requirement to deal with the climate crisis. The portents here are not strong. Following the GFC many corporate occupiers attacked real estate as a cost and, as they did, cut off those considerations of sustainability that had been on the rise prior to the credit crunch. Today the science is unequivocal. We have 30 years to save the planet. We cannot afford for occupiers of real estate – itself responsible for around 40 per cent of global emissions – to ignore the issue in the interests of balance sheet repair. A new approach will needed.

How does the global portfolio reset as globalisation is further questioned? COVID-19 has served to question the resilience of global supply chains and brought growing attention to unintended dependencies and risks within globally organised businesses. Coupled with a political environment that continues to display traits of isolationism and protectionism, global portfolios will need reassessment. Once again in a cost-sensitive, low growth environment it remains to be seen how rapid and radical this portfolio reset can be.

Is this the end of the densification of the office? The legacy of the GFC ensured that the last decade had occupiers typically attempting to shoehorn more people into less space to support what was regarded as greater financial efficiency. Although, there has subsequently been a growing acceptance of the strategic role that real estate plays within business, the perceived financial benefits of increased occupational density have clearly influence behaviour. We question if, in a world shaped by either the reality or psychological legacy of social distancing, such an approach can (or indeed should) be sustained.

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LONDON: ACTIVITY STARTING TO SLOW

What we know

Leasing KPIs point to slowing activity. The depth of market activity sustained throughout 2019 persisted well into Q1 2020, however the unravelling of global growth due to COVID-19 began to erode market sentiment in early March. This, in tandem with restrictions being introduced on building access and a full lock-down eventually inhibiting the ability to view space, led to total office take-up ultimately dipping to around 2m sq ft in Q1, down on Q4 2019 (3.4m sq ft). The long term quarterly take-up average is 3.3m sq ft.

In the six weeks since 16 March, almost 650,000 sq ft has been let. There is also over 1.4m sq ft worth of office space currently under offer, suggesting take-up in Q2 could reach 2.05m sq ft, up on the 2.0m sq ft figure for Q1 2020. There is also 3.7m sq ft worth of office space currently under offer.

Cash flow pressures stemming from slowing economic growth have resulted in a rise in rent holiday requests, a trend picked up by our own sentiment indicators. The COVID-19 pandemic happens at a time of record high rents in all submarkets, so this is perhaps unsurprising. Prime headline rents are however holding steady across the board, underpinned by a chronic shortage of grade A space heading in to the COVID-19 crisis. Lease incentives are starting to move out: 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.

The government's emergency Corona Virus Bill grants a moratorium on forfeiture until 30 June, which offers some temporarily 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 a number of instances of non-payment of rents, circa 20-30% of businesses. Partnerships between landlords and businesses will be critical at this time as they work together to develop new payment plans and timelines. Indeed we have seen landlords responding positively to requests for deferring rental payments, albeit many are also asking to see evidence of financial stress.

Separately, viewings have slowed substantially, but are still being undertaken virtually, particularly on pre-let stock where marketing campaigns are now fully supported by digital fly through presentations, enabling occupiers to progress option review and due diligence elements of searches. Nonetheless, leasing activity is expected to be heavily constrained until social distancing guidelines are eased. Interestingly, with lockdowns being eased to some degree in other cities in Asia and the Middle East, we are increasingly in dialogue with landlords and businesses around safety measures that will be needed once the UK begins to ease its lockdown.

All investment deals are being reviewed. As the COVID-19 crisis bites, investors' default position is to put acquisition efforts on hold until stability returns. Lenders are assessing their portfolios and exposure to struggling businesses with very few in a position to consider new business just yet. Our sentiment indicator continues to show global interest in the London market as many see this as a potential opportunity to secure stock at reduced prices, but few are able to commit now. Meanwhile, there are few signs of any distressed sales at this point.

Data for Q1 shows investment turnover of £2.6bn (LTA: £3.4bn), much of which occurred prior to the lockdown. There has been c.£400m of London office investment transactions exchanged since the lockdown, but transactions are largely limited to those that were marketed prior, as access to new opportunities is very restricted. Q2 turnover will undoubtedly be very limited.

From a positive perspective, investor sentiment about the market fundamentals in the medium term remain broadly positive, and there is a clear build-up of pent-up demand that should be released once some certainty returns. Overseas investors are already becoming more active, at least in terms of enquiries, with those parts of the world that are leading the recovery from COVID-19 lockdowns – principally Asia and parts of Europe – leading the trend.

What we expect

Flexible offices will offer stop gap solution to businesses. There is no doubt that there are some concerns for the flexible office sector. Operators are dependent on daily traffic and will be most impacted by the ongoing situation surrounding COVID-19. There are already many reports in the press showcasing a large list of well-known operators who are asking landlords for rent discounts or holidays. Those with greater exposer to corporate enterprises, i.e., businesses with over 500 staff, are likely to fare better given the longer lease commitments. 40% of WeWork's tenant base is comprised of businesses that fall into this bracket, for instance.

Once businesses begin the transition back to the workplace, flexible offices will likely play a vital role in providing short-term solutions to those occupiers who are caught out by construction and fit-out delays. Our Flexible Office Solutions team has already experienced a rise in such queries.

Furthermore, like some markets in Asia, flexible offices can offer a short-term remedy to businesses looking at their staff density ratios in the wake of COVID-19, as social distancing rules become part of the new normal, not least due to the advantages of securing short leases for plug-and-play space.

Tenant covenant positions are under increased scrutiny. Investors now need to scrutinise from a different perspective to previously, focusing more heavily on the underlying financial health of businesses before making an investment decision. The result? Depending on the depth of any economic contagion from COVID-19, tenants exposed to those business sectors most affected by the virus shutdown will demonstrate softer yields, relative to the rest of the market.

We expect London real estate to ultimately re-emerge as the global safe-haven, as has been the case historically, particularly for investors focussed on wealth preservation and income generation in markets away from their own ailing home economies.

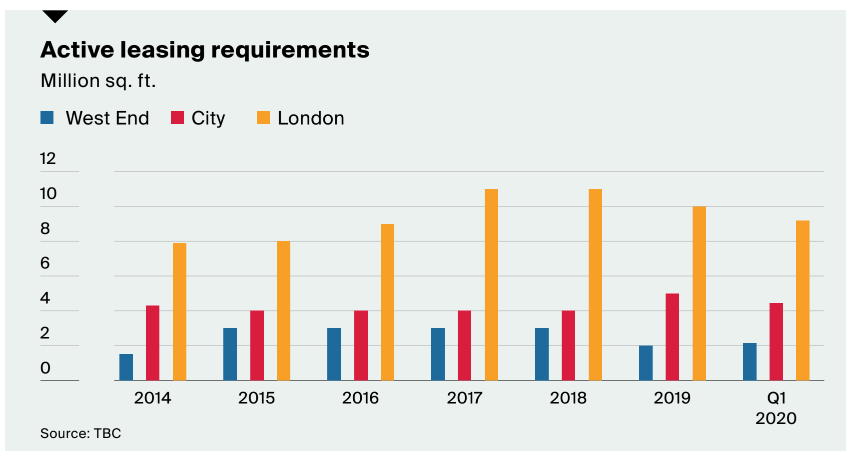
What we question

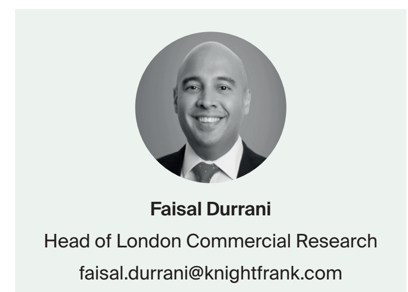
The belief that headline rents will weaken. Prime headline rents were already facing further upward pressure, prior to the COVID-19 crisis, due to the restricted development pipeline and continued pre-leasing dynamic further eroding the future supply of stock. Construction delays will only exacerbate the underlying supply shortage of prime office space across London. Undoubtedly rents will come under pressure as demand is stymied, particularly in Q2 and Q3. We expect to see the lockdown easing in the summer, which will help to reinject both confidence and activity in the market.

Six weeks into the lockdown and after a period of battening down the hatches, some occupiers are re-emerging, undertaking due-diligence and planning for a return to the office. With that in mind, we are of the view that prime rents will likely end the year at more or less the same level at Q1.

Secondary stock however is unlikely to enjoy the same level of stability, with the rental tones in this segment of the market likely to adjust downwards, further widening the gap between prime and secondary space.

> **We expect London real estate to re-emerge as a global safe-haven, particularly for investors focused on wealth preservation and income.**





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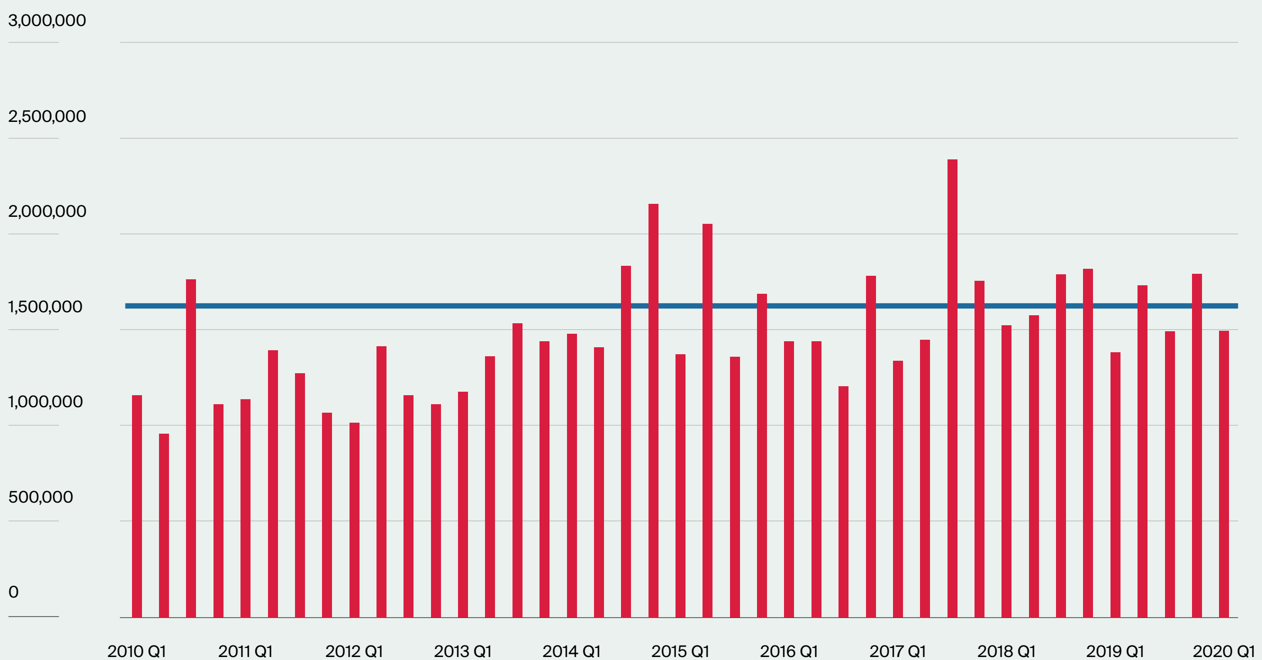
UK OFFICES: ADAPTING TO A NEW NORMAL

What we know

Transactions have slowed. Unsurprisingly, deal flow has slowed in recent weeks as the practicalities of conducting due diligence have proven prohibitive and the appetite of businesses has reduced. Even so, some leasing deals are still taking place, with firms nervous of not being able to secure space in markets of low supply.

What the numbers say. In the major UK cities outside of London, office take-up in the first quarter was 10% below the long term average at 1.5m sq ft. In the South East market, take-up was low at 507,000 sq ft, 37% below the 10 year average. Encouragingly, the amount of space under offer has not dipped markedly. Alterations to lease commencement is being preferred as opposed to complete withdrawal.

Development has reduced but not stopped. With the UK government stopping short of forcing building sites to close, developers across the country have interpreted advice differently. Most have elected to shut down unsure of how to achieve a sensible balance of employee safety and productivity. Those that have continued have largely been operational at reduced capacity.



What we expect

Occupiers: to defer or not defer? – With political unrest seemingly behind us, 2020 was meant to herald a period of relative calm, meaning reassured firms would be able to enact longer term space planning. The material change in the market conditions owing to the global outbreak of novel coronavirus however, will mean that many businesses will simply press the pause button with regard to space acquisitions. This deferral is not without business risk. Vacancy rates outside London at the onset of lockdown were the lowest for more than a decade. With the timing of new and refurbishment schemes disrupted, the prospect of reduced choice post COVID-19 restrictions will bolster some occupier appetite toward advancing space plans.

Development: A slow return to activities. Following largescale closure, construction work will begin to recommence as businesses cautiously become more comfortable that the government's recommendations on social distancing are able to be met. Adhering to this guidance however, will not be the only challenge faced by contractors. Manufacturing units and production facilities of materials required on site have equally been scaled back in response to COVID-19 management measures. This will mean that limitations on ordering and receiving materials could add further delay to construction activity. The expected timings, already under review, may need to factor further slippage.

Financial terms under scrutiny. In the short term, headline rents are unlikely to be subjected to discount in most markets given the tight supply environment. Greater focus therefore will likely reside with securing lease flexibility, extensions to rent free periods and capital expenditure requests. Longer term this picture may begin to shift, with any movement dependant on the scale and quality of space released back to market.

What we question

Will development delivery create an oversupply? A comparison with the GFC, identifies a very different supply picture for UK offices. In the South East for example, vacancy was 7.9% at the onset of the GFC compared to 6.3% today. Between 2009 and 2010, 2.6m sq ft of space was delivered driving vacancy up to above 10%. Completions scheduled for 2020 and 2021 amount to just 1m sq ft of speculative space meaning that although vacancy will rise the influence of completions on market imbalance will be less pronounced.

Where will new demand derive from? Whilst many businesses take stock of the increasingly challenging environment, the demand pool will of course, be greatly reduced. Nonetheless, many markets outside of London now demonstrate a broader array of business groups than even just 10 years ago. Therefore risk, through any downturn in demand, is reduced.

But will any areas of business show growth either through or in the immediate aftermath of the crisis? The obvious candidates for growth are Pharmaceuticals, Life sciences and Technology, all sectors that were having a greater influence on demand before COVID-19. Larger firms within these spheres are likely escalate an ongoing strategy of acquiring complimentary businesses and competitors opportunistically. This in turn will increase the need for more space. Another potential area of growth is 'On Shoring'. Will the repatriation of operations and supply chains gather momentum? Potentially as business resilience is questioned. If major manufacturing operations return, will the supporting office based functions also need to scale up? Almost certainly.

Digitally agile? Improving business agility was an aspiration for firms long before the COVID-19 crisis, but could a consequence of the current crisis be an accentuation of a pre-crisis trend? In part yes, as a major area of scrutiny deriving from the current situation is the management of operational risk. Digital infrastructure has, in short time, been propelled as the principal foundation of business continuity. Will this mean that cities, districts and buildings that have made infrastructure a priority will carry favour and therefore a premium?

Vacancy rates outside London at the onset of lockdown were the lowest for more than a decade.

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RETAIL: THE FALLOUT FROM LOCKDOWN

What we know

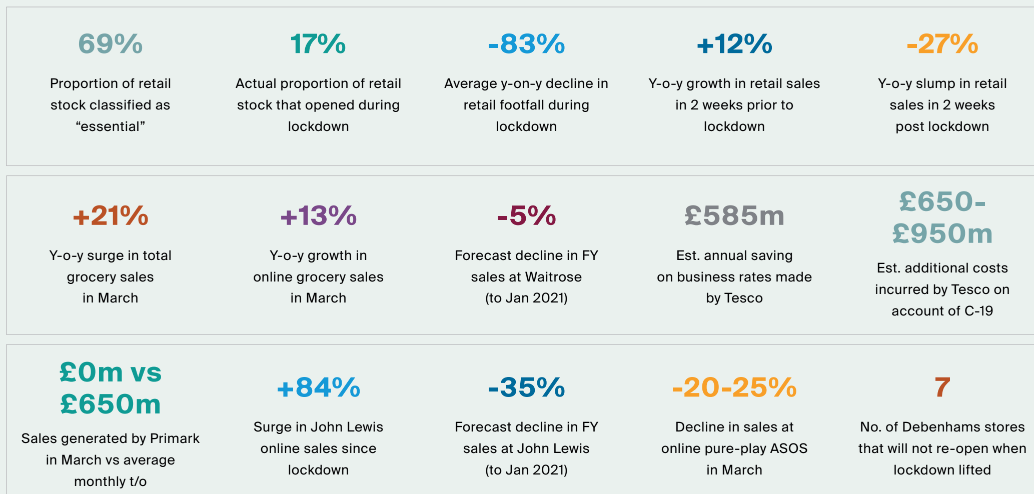
The retail sector has been in lockdown since 24 March. This has forced the closure of "non-essential" stores for an initial three weeks, subsequently extended by a minimum of a further three weeks. 69% of UK retail stock comes under the banner of "non-essential" yet only 17% of stores have stayed open during the lockdown. Those eligible to trade (e.g. DIY operators) are only now slowly opening to the public and adhering to strict social-distancing.

Only around one third of retailers and leisure operators met their Q1 rent obligations in full and on time. Many sought some sort of landlord concession, typically a rent holiday (3 or 6 month or indefinite), a partial payment, or a switch to month payments, or a transition to turnover rents. Many negotiations are ongoing. Most of the foodstore operators complied completely. Conversely, very few leisure and F&B operators paid anything.

Retail sales fell off a cliff post-lockdown. The ONS showed that retail sales values (exc fuel) were down -3.9% in March, the worst monthly performance since records began in 1989. This headline figure masked significant movements over the month. The BRC indicated that retail sales were up +13% in the two weeks prior to lockdown, but slumped -27% in the two weeks post. Consumer demand for clothing has been especially weak, with sales down -35% year-on-year.

Inevitable occupier fall-out. Debenhams has been into a "light touch" administration following its CVA last year and revealed that seven stores will no re-open when the lockdown is lifted. Clothing brands Oasis and Warehouse have likewise entered administration and are currently seeking an 11th hour buyer, Cath Kidston undertook a pre-pack administration that retained only the brand name and online business (but excluded the store estate), while Office and TM Lewin have been put up for sale by their respective private equity owners.

Retail occupier covid-19 dashboard...



Key Market Metrics	69% Proportion of retail stock classified as "essential"	17% Actual proportion of retail stock that opened during lockdown	-83% Average y-on-y decline in retail footfall during lockdown	+12% Y-o-y growth in retail sales in 2 weeks prior to lockdown	-27% Y-o-y slump in retail sales in 2 weeks post lockdown
"Essential Retail"	+21% Y-o-y surge in total grocery sales in March	+13% Y-o-y growth in online grocery sales in March	-5% Forecast decline in FY sales at Waitrose (to Jan 2021)	£585m Est. annual saving on business rates made by Tesco	£650-£950m Est. additional costs incurred by Tesco on account of C-19
"Non-essential Retail"	£0m vs £650m Sales generated by Primark in March vs average monthly t/o	+84% Surge in John Lewis online sales since lockdown	-35% Forecast decline in FY sales at John Lewis (to Jan 2021)	-20-25% Decline in sales at online pure-play ASOS in March	7 No. of Debenhams stores that will not re-open when lockdown lifted

Sources: Local Data Company, Springboard, BRC, ONS, Kantar, Companies, Knight Frank

What we expect

A trickle of occupier fall-out turning to a flood. Retail businesses, by their very nature, are highly cashflow dependent. For many, this cashflow has been vastly reduced or turned off completely, leaving many in a precarious financial situation. Those highest on the "watch list" are operators under private equity ownership (current or historic), those with a track record of past failure and those heavily exposed to the fashion sector (which is vastly over-shopped and subject to very soft consumer demand).

Retail sales will plummet further in April and May. Retail sales will inevitably plumb new depths in April and May as "non-essential" stores remain under enforced closure. After something of a pre-lockdown surge, even "essential" retailers are now seeing sales levels decline as they trade only under deeply-compromised conditions as social-distancing measures remain in force. Online sales will continue to grow in double digits, but will only pick up a relatively small proportion of lost store-based sales.

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 – even those that made their Q1 payments may not necessarily do so in Q2.

Lifting of the lockdown will be highly phased. "Non-essential" retail outlets will only be allowed to re-open in mid-May at the earliest. Certain sub-sectors are likely to be able to open before others. Other European countries (e.g. Germany and Italy) have prioritised small, independent operators, although this flies in the face of the practicalities of enforcing instore social distancing. The UK phasing is likely to be determined more by sector than business ownership. Retail is likely to precede Leisure.

What we question

The extent to which consumer demand will "bounce back" when the lockdown is lifted. Even when stores start to re-open, recovery of trade will be very gradual. On the one hand, stores will still be subject to considerable social-distancing compromises. The experiences of "essential" retailers trading through the lockdown has been of significant sales declines through trading under compromised circumstances (and significantly higher costs). Trading levels will take considerable time to "normalise".

The pace of return to "normality". "The new norm" is likely to become a new buzzword, which has little tangible grounding. Retail sales will remain under pressure for some considerable time. On top of the phased nature of the lockdown lift and compromises to stores, the consumer has most definitely been damaged through the pandemic. Brexit was seen as a test of the wider economy, whereas COVID-19 is seen as far more closely related to consumers themselves. Retail spending patterns are much more closely aligned to the latter than the former.

Will rent holidays ever be recouped? 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 consumer behavioural changes are permanent. Enforced store closures have inevitably resulted in a flight to online. In March, online penetration in non-food increased to 40%+, but in grocery it remains low at just 5.8%. All metrics highlight the fact that online is failing to pick up the slack of lost store-based sales. When stores re-open, online's share in non-food will return to pre-lockdown levels of ca. 20% and resume its historic growth trajectory. Above all else, the pandemic has proved the co-dependencies of online and physical retail, rather than their perceived conflicts.

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INDUSTRIAL WAREHOUSING: A RACE FOR SPACE?

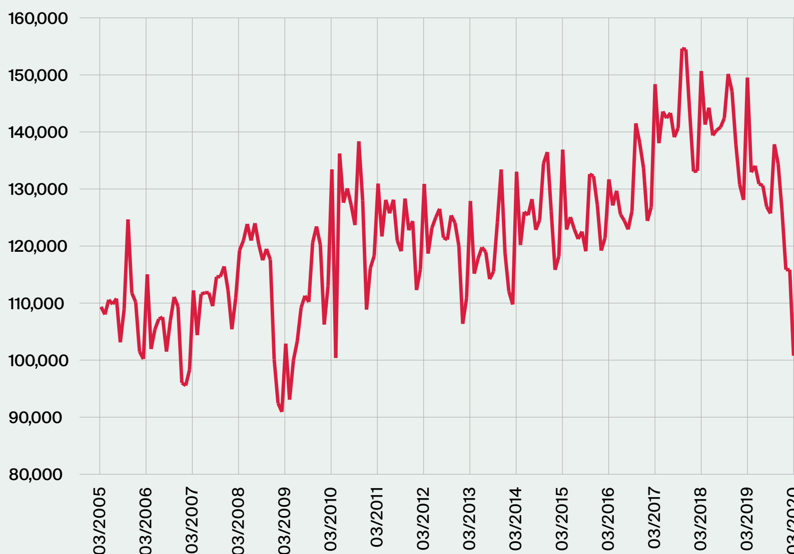
What we know

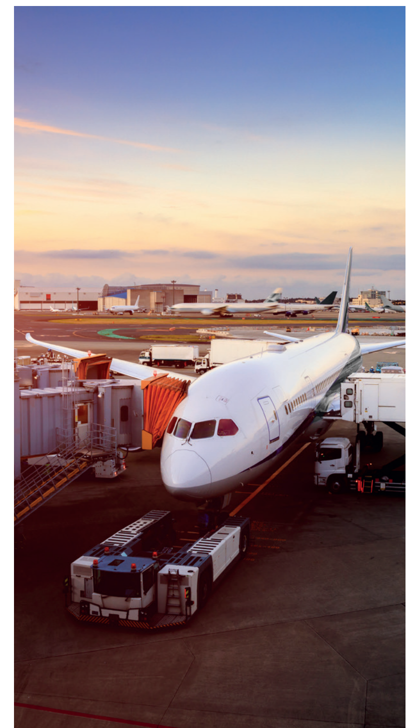
Warehouse capacity under pressure. With many retailers and manufacturers halting operations to counter the spread of COVID-19, a log jam is being generated at UK warehouses. The UK Warehousing Association stated this week that a lack of available warehouse space in the face of COVID-19 restrictions is reaching a critical point. The main problem? Inflows are continuing, with orders placed and dispatched before the lock down reaching destinations. Demand for consumer goods such as clothes and cosmetics however have plummeted, meaning outflows have been severely reduced.

Car manufacturers opening up. As countries begin to relax COVID-19 restrictions, car manufacturers in the UK are gradually restarting operations. Jaguar Land Rover (JLR) announced this week that it will resume vehicle production at its UK manufacturing plant in Solihull from May 18. Nissan are also preparing to resume production at its plant in Sunderland.

Air cargo in decline. Heathrow recorded volumes of just over 100,000 tonnes in March 2020, the lowest monthly total since 2009. A contraction in global manufacturing outputs has resulted in slower in UK imports and air cargo freight.

What the numbers say? In Q1, take-up of units over 50,000 sq ft reached 6.6m sq ft, which compares to around 9.5m sq ft in Q1 2019. Our analysis shows an immediate need of up to 5.5m sq ft nationwide for short-term occupation. This is principally to grow warehousing capacity for food retailers, adhere to distancing requirements at fulfilment centres and to accommodate the disaster management measures deriving from the NHS and local government.





What we expect

Mixed messages regarding Retail. Whilst warehousing demand derived from retail is, on the whole showing sustained growth, some parts of retail are encountering critical challenges amid the COVID-19 crisis. Fashion and other non-essential retailing for example have experienced sharp fall in sales seeing some retailers suspend online shopping services and closing their distribution centres. Raising capital has quickly become a priority for many. Online fashion retailer Asos has raised more than £200m from shareholders as it seeks to mitigate the effects of a coronavirus lockdown that has reduced consumers' appetite for fashion. Similarly, Next have been the latest to explore sale and leaseback opportunities by marketing three distribution warehouses and their HQ building. Further examples of this strategy will surface as the retail sector continues to struggle.

Tenants requesting assistance will rise. Although rent payments in March were largely paid as required, it will be in June when the scale of any cash flow challenges are clearer. Tenant requests regarding rent holidays or altered payment plans such as monthly payments will increase in order to help maintain a manageable balance sheet. Smaller, multi-let units tend to have shorter lease terms and therefore are perhaps more exposed to any occupier distress.

Development timings impacted. In addition to complying with distancing measures, developers are also facing a shortage of building materials due to supply chain disruptions. The proposed timings of many developments will encounter slippage, meaning vacancy rates, already historically low in some markets, could tighten further. In addition, speculative schemes that are yet to commence could now be postponed indefinitely as developers await clarity on the scale of post crisis demand.

What we question

Supply chains re-aligned? The coronavirus pandemic has exposed areas of weakness and the vulnerability in supply chains across industries. As companies take stock and restructure in the wake of the crisis, could an upturn in the reshoring of operations and renationalising supply chains be a preferred method to mitigate future risk?

Will COVID-19 expedite the shift to online? The UK is already the largest online shopping market in Europe. The structural shift has led to upturn in demand for warehousing through the expansion of e-commerce and related services. The need for large scale fulfilment and 'near-urban' warehousing has been the primary driver of take-up in recent years. The COVID-19 crisis has meant a forced acceleration of the shift to everything online. Some are using this method for the first time, with food delivery in particular now the norm for many people who wouldn't bother in the past. Will this leave a permanent legacy?

Will business risk management drive warehouse demand from data centre operators? The current COVID-19 crisis has quickly brought business resilience to the forefront of attention. Integral to this is digital infrastructure and as such, data centre capacity will clearly be an area of scrutiny moving forward. As business across all sectors incorporate new measures to minimise operational risk, data centre capacity is likely to be an area for increase. Although data centre companies represent a small percentage of demand for UK warehousing, operators will clearly need to respond to rising demand for their services. Could data centres therefore play a bigger role in UK warehouse demand post crisis?

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As companies restructure in the wake of the crisis, reshoring may be a preferred method of mitigating future risk.

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