What will the European CRE sector look like when the dust settles?

The question is not whether the European commercial real estate sector will be affected by Covid-19 but how severely and for how long. This report provides an overview of the current state of the market and Scope's outlook by asset type, which highlights trends that might reshape the sector's future. We also offer insights into the liquidity buffers of investment-grade transactions recently analysed by Scope and on the rebound in CRE rents after the global financial crisis.

Executive summary

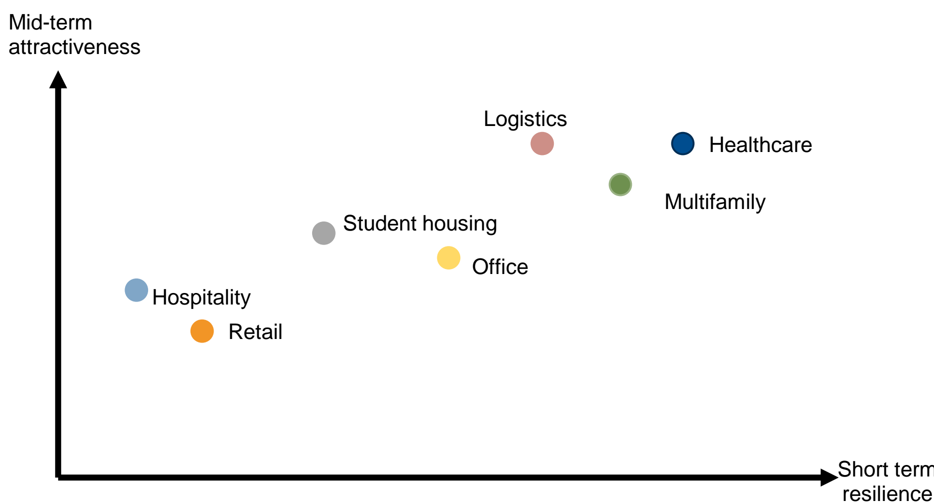
There is no doubt that the Western European commercial real estate sector will be affected by Covid-19, but we do not expect a CRE crash like in the aftermath of the global financial crisis because CRE financing in the past decade has been healthier. Risk reassessments and social impacts will speed up structural changes, and the consequences will likely diverge between locations and asset types.

Differentiation between prime and secondary assets and locations will increase; investors will focus more on assets in prime locations. Investors' flight to quality will result in CRE values and debt being repriced, as already indicated in the CMBS and REIT equity markets.

Differentiation will also occur in the short term between asset types with sectors most exposed to non-essential activities, social distancing impacts, and international customers. Hospitality and retail will suffer the most, while the residential, logistics and healthcare sectors will exhibit most resilience; office in between.

Beyond 2020, structural trends will accelerate the reshaping of the CRE sector. The office sector may be at an inflection point following the successful world's biggest-ever working-from-home experience. The already gloomy retail outlook will worsen, while logistics, residential and healthcare may benefit from capital reallocation. The hospitality sector will need to adapt to the new trends, which will take some years while student housing may also have a more prolonged recovery (Figure 1).

Figure 1: Western European commercial real estate outlook



Source: Scope Ratings

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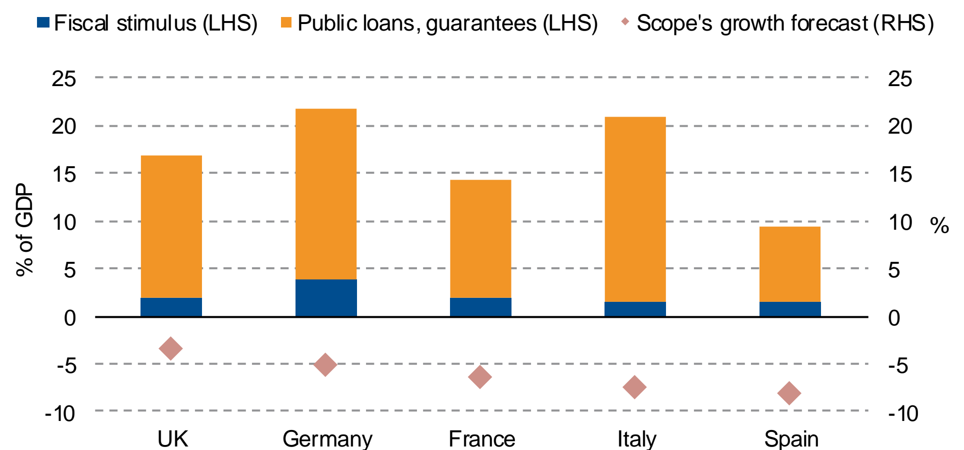
General economic overview

Covid-19 had infected over four million people by 9 May and led to roughly 275,000 deaths, while forcing around three billion people to stay at home in varying degrees of quarantine. Closing of borders, lockdown of non-essential activities and social (physical) distancing has halted the economy, unavoidably resulting in job losses and corporate bankruptcies. Scope expects that the global economy will fall into recession in 2020, experiencing a 0.5% drop in real economic growth, while the decrease could be 6.5% in the euro area[1].

European policymakers quickly realised that immediate measures were needed in both fiscal and monetary policy to moderate the impact (Figure 2). These include tax deferrals and write-offs, easing access to social safety benefits as well as direct financial support. Burdens have been eased by moratoriums on loan and rent payments. To boost lending, governments announced public loan and guarantee schemes. Several national central banks temporarily eased capital adequacy and liquidity coverage ratio criteria. Some central banks cut base rates while several announced large-scale asset purchase programmes.

Figure 2: Volume of public measures and expected growth in major Western European countries



Source: Scope Ratings

Commercial real estate overview

Most non-essential businesses faced a sudden and unprecedent halt in their activities, exposing many to a liquidity crunch. Most exposed or opportunistic tenants have partially or completely stopped paying rent; in some cases advocating a force majeure type of event. Consequently, landlords will not only experience rent deferrals but lost rents if they are not flexible, since if they aren't, it is likely that their losses will be even higher.

Even if, strictly speaking, there is some legal uncertainty, government measures likely will not allow for enforcement in the short term due to missed rents. Indebted landlords immediately started cutting cash outflows by reducing operating costs (including temporary lay-offs), postponing capital expenditures and drawing on their liquidity lines to honour debt payments.

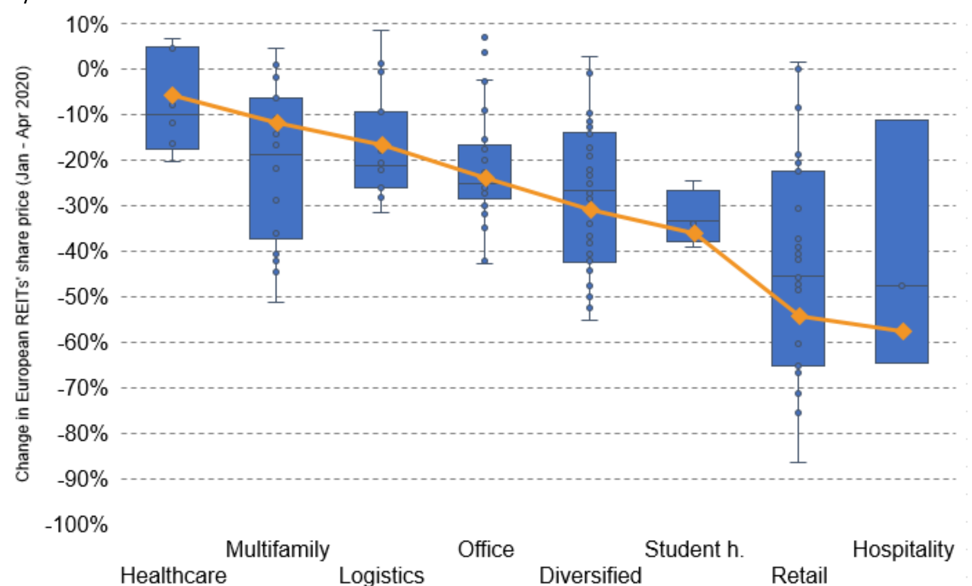
[1] See Q2 2020 Sovereign Update, Scope Ratings

2020 REIT performance: what might come next for the CRE sector

Hospitality and retail the most exposed; residential and logistics exhibiting resilience

Our analysis of the 2020 performance of 148 European listed Real Estate Investment Trusts (REITs) to April shows Covid-19 impacts across sectors and is a good indicator of likely near-term sector preferences in private CRE lending, besides differences in liquidity, leverage and tax considerations. Unsurprisingly, the share prices of hospitality and retail REITs have exhibited the worst performance with, respectively, a 58% and 55% decrease on average[2], followed by 36% of student housing. The office sector showed 24% decrease. Logistics and residential performed relatively well in comparison, with an average 17% and 12% value discount. Healthcare REITs exhibited the highest resilience, with share prices decreasing on average by 6% only (Figure 3).

Figure 3: Change in European REITs' share price between January and April 2020



Source: Bloomberg, Scope Ratings

Financing

Ongoing flight to quality and repricing

Investors' risk aversion has increased, as under severe economic situations, they exhibit flight-to-quality behaviour. This supports efforts by large investment-grade companies to create reserves, including some REITs. European investment-grade corporate bond issuance reached a weekly historical peak in the first week of April with EUR 56bn, while high-yield bond issuance volume was below EUR 1bn. Primary debt issuance by some REITS was oversubscribed – like Unibail-Rodamco-Westfield (EUR 1.4bn) and Vonovia (EUR 1bn). In the meantime, CMBS spreads had widened: at the end of March, European AAA-rated CMBS spreads were 33bp higher at 126bp. BBB-rated CMBS spreads, at 322 bp, were 75bp higher than at the beginning of 2020.

Healthy CRE sector pre-Covid-19 unlike pre-GFC.

CRE lenders are in much better shape than before the global financial crisis (GFC). Financial institutions are facing neither liquidity nor solvency issues, owing to a more than 10-year cycle of healthy underwriting standards and diversified business models. Monetary policy is supportive and previous macroprudential measures have resulted in better capital adequacy. However, lenders have taken a wait-and-see approach to new transactions. Currently only pre-crisis committed deals are being executed. But the stop in lending activity since March should be temporary and not attributable to underlying factors affecting their ability to lend – unlike during the GFC.

[2] Weighted average of REITs in the respective categories (weighted by market capitalisation as of 2 January 2020).

Lending standards will tighten

Lenders are showing some understanding of the situation of borrowers, as demonstrated by loan covenant waivers. They are reviewing their books, reassessing the credit risk of the sector and their portfolios, while appraisals are also on hold. Borrowers with debt maturing soon are therefore exposed to lengthier refinancing processes. There are already signs, through ongoing price discovery, that (re)financing conditions will tighten. According to market feedback, in some cases lenders intend to increase margins by up to 100bp compared to pre-Covid-19 conditions, while some borrowers would be prepared to accept a 25bp premium only. Lenders will also require stricter covenants focusing on more certain cash flows and larger liquidity reserves.

Focus on fundamental analysis and asset and location differentiation

Lenders are focusing on areas that have not been at the centre of attention recently, like liquidity risk, counterparty risk and tenancy industry profiles. Fundamental cashflow-driven analysis will more than ever be the cornerstone of CRE investment in the near future rather than focusing primarily on leverage metrics. We expect that it will result in increased differentiation between prime and secondary assets and locations. This means that after some years of decrease in the gap, asset differentiation will materialise in terms of both yields and refinancing conditions. This will be accelerated with some CRE appraisals likely to tumble when the dust settles.

Covid-19 will reinforce already observed structural changes in the sector

Covid-19 will reshape the real estate sector over the long term. Already observed structural trends will be boosted, namely digitalisation, on-line shopping, and remote working. New potential outcomes may push participants in real estate to rethink their business plans and strategies, including a retreat of globalisation, the re-industrialisation of European countries in strategic sectors like pharmaceuticals, or a greater appetite among citizens for going rural.

Scope Ratings' commercial real estate outlook

Q2: gradual citizen lockdown release, Q3: travel ban; Q1 2021: preventive measures

The unprecedented nature of this crisis and the uncertainty about the outcomes both in terms of the timing and shape of recovery make any outlook highly uncertain. Scope expects something in between a quick V-shaped and an elongated L-shaped economic recovery. The longer the limitations last, the bigger the economic impact will be. This will also create differences between the recovery in each country. We expect a gradual release of the lockdown both for populations and economies in most parts of Europe by the end of Q2, travel bans until the end of Q3 and removal of most preventive measures by Q1 2021 (social distancing, wearing of masks etc). Our baseline scenario focuses on short-term expectations to the end of 2020 and medium-term through 2021.

Office

Increasing demand for an asset: home office

In 2019, the office segment continued to show dynamic performance, with healthy lease-up driven by declining unemployment. This led to low vacancies, positive rent growth, spread compression for both prime and secondary assets and a tightening gap between them. Overall European office vacancies at end of 2019 stood between 5%-6%, with some cities experiencing lower vacancies, led by Berlin, where vacancies were just above 1%. However, with the outbreak of the pandemic, offices became unpopulated, and the world's biggest-ever working-from-home experience started.

Temporary setback in 2020

We expect a slight decrease in rental income and/or some tenant-friendly solutions (i.e. providing longer rent-free periods) in 2020. Some increase in vacancies will be unavoidable. Over the next few months, new investments will be frozen as lenders focus on reviewing their portfolios. Regarding tenants' ability to pay rents, large differences exist by type of assets and tenants industries. Prime assets with long-dated leases, rented by top-tier tenants operating in sectors where working from home is a sustainable option will face fewer difficulties. Tenancy sectors most exposed to the pandemic – like non-essential retail – in secondary locations will try to re-negotiate their leases.

2021: inflection point?

We expect employers' behaviour to change, as the biggest-ever remote-working experiment will prove mostly successful. Companies may adjust downwards their real-estate needs in the medium-term. We expect a smooth inflection in demand for office space rather than a drastic decrease, since companies will still need prestigious and high-quality buildings to promote their image and retain workers.

Hot-desk policies will gain space in a push for cost-reduction and compliance with the ESG trend in business sectors like finance or legal (i.e. reducing real estate carbon footprint and pursuing increased social responsibility).

Retail

A segment facing challenges even before Covid-19

Retailers have been facing structural challenges for years due to a significant change in consumer patterns [3] even before the Covid-19. More and more customers prefer online shopping and many bricks-and-mortar retailers have struggled. This is well illustrated in the UK, the European country with the largest share of online sales: 20% more retailers went into administration in 2018-19 than in the preceding two years (see our report on UK retail : Maroon CRE loan: autopsy of a default for further details).

Differentiation at sub-segment levels

This segment will be the most severely hit, crystallising already well identified weaknesses. Many retailers will suffer irrecoverable losses in turnover and face growing liability charges. Even some of the largest players have already stopped paying rent following their significant loss in turnover due to the lockdowns[4] . However, non-cyclical retailers focused on essential goods like grocery and pharmaceutical products have proven to be more resilient.

The old days won't come back

We expect that after the sudden substantial drop in retail sales, there will be no return to pre-Covid turnover levels under its known form, even after 2021. E-commerce growth will significantly push back bricks-and-mortar-only players. The crisis will catalyse already ongoing structural changes within the sector. Bricks-and-mortar non-essential goods retailers will need to strengthen their online channels or establish them if they do not yet exist. Moreover, Covid-19 might have prolonged negative consequences potentially affecting revenues beyond 2020, with a low non-essential consumption due to increased consumer consciousness, and some ongoing limitations negatively affecting footfall.

Logistics

A segment on top before the pandemic

The logistics segment is moving in the opposite direction to retail. At an extremely simplified level, what has been bad for retail has been good for logistics in recent years. Logistics real estate has been characterised by a strong supply-demand imbalance across Europe: undersupply of warehouses of necessary size and quality coupled with strong demand. The segment has experienced historically low vacancy rates of around 5% overall, increasing the path of rents and declining yields.

Likely to be resilient even in the short-term

We expect this asset type to be more resilient than others in the short term and it may be seen as a safe haven compared to peers, alongside residential property. We expect pressure to be sustained from the demand side, boosted by increased online purchases following the outbreak of the pandemic. Building numerous new assets is unlikely in the short term. The shortage of supply is exaggerated by some companies increasing their stock to be able to fulfil customers' needs while stocks of unsold non-essential goods absorb warehousing capacities. We expect resilient occupancy rates and limited rental shortfalls thanks to continuing activity and the above-average length of logistics leases.

[3] See for example: Adapt or Disappear: E-commerce Transforms European Retail, February 2017, Scope Ratings
[4] See Europe commercial real estate: retail-exposed firms can weather Covid-19 crisis in the short-term , April 2020, Scope Ratings

Logistics might be a big winner among CRE sectors post-Covid

After 2020, we continue to expect a bright future for the logistics sector supported by

i) A potential investment shift into CRE and particularly into this segment,

ii) continuous e-commerce growth, which requires around three times more logistics floor space than traditional retail;

iii) crystallisation of details of the Brexit-related trade agreement between the EU and UK, allowing for strategic decisions regarding new logistic locations.

The pace of e-commerce development might even accelerate owing to two factors arising from the current situation: senior citizens will discover how convenient e-commerce can be; and prepared food and beverage delivery (see European logistics CRE: outdated assets won't ride growth momentum for further details).

This will result in higher demand for logistics real estate, thereby building new capacities and potential rent and value appreciation. In online sales, last-mile urban warehouses will become more crucial as same-day delivery will be a field for competition between retailers. This will put increasing pressure on new urban developments and land values. Performance differentiation may continue between business assets fit for e-retailers and outdated assets not suitable for refurbishment.

Multifamily

The European multifamily CRE sector has performed well in recent years fueled by the low interest-rate environment and continuously decreasing unemployment. Demand, even with a considerable amount of construction, has not been completely fulfilled, also supported by the millennial generation's higher needs. This led to low vacancy levels, growing rental value and yield compression.

In the short term, lease-up of units will slow sharply, driven by the wait-and-see approach of customers, while investors may rebalance their focus to this sub-sector where diversification provides natural hedging.

Resilient asset type with location differentiation expected

In the medium term, we expect the sector to remain stable. Once the investment market comes back, investors will likely reallocate capital to the residential sector due to its resilient fundamentals and lower-than-average risk profile. Location and asset selection will be key because of affordability issues that may worsen in some urban areas following an expected spike in job losses and negative GDP growth.

Hospitality

A growing sector immediately hit by the pandemic

The European hospitality sector has grown substantially in recent years a 17% CAGR over a five-year period and is seen as a standard property type rather than an alternative asset class. Growth has been supported by less seasonal market performance driven by more frequent and longer travel, cheaper flights, a shift in traveller preferences to southern Europe rather than North Africa and significant investor appetite for this above-average-yielding asset class. The sector has been hit the worst by Covid-19 due to travel bans and hotel closures demanded by governments, which immediately turned current revenues to zero.

Supply will need to adapt to change in demand

The sector is likely to be the last to rebound. We expect a slow recovery starting in Q3 2020 with the gradual release of restrictions but no full recovery before 2022. Operators will need to rethink their business models, given that people's tendencies are likely to shift towards having holidays domestically even in the absence of travel restrictions, and companies are also likely to reduce the number of business trips based on positive experiences with remote meetings during the lockdowns.

Healthcare

The European healthcare sector reached EUR 7.7bn of investment in 2018, the second most popular alternative investment sector after hospitality. The defensive nature of the sector meant it performed better than traditional asset classes, with 29% like-for-like value appreciation since 2007 sustained by non-cyclical fundamental drivers (see our report on Healthcare: an attractive segment for alternative CRE investors for further details).

Strong fundamentals will continue driving the healthcare sector

The Covid-19 outbreak put the sector under the spotlight and severe criticisms arose due to the unpreparedness of some care homes, the lack of resources of the sector in countries like in the UK or the number of deaths in care homes like in France.

In the short term, we believe the fundamentals to be strong and non-cyclical enough to prevent the sector from being severely hit. Beyond 2020, the sector will likely benefit from the strong financial support from Western European governments as part of their massive and ambitious healthcare reforms.

Student accommodation

Investment in student accommodation peaked at EUR 8.8bn in 2019 with 70% of all investments in the UK. Few opportunities arise in this niche market, but the segment usually provides good opportunities for securing stable cash flows driven by countercyclical drivers. With the lockdown of universities, students and particularly foreign students have returned home which has resulted in rent shortfalls.

No return to pre-crisis level before 2020-21 year

We expect lower demand in the 2020-21 academic year, which will be partly attributable to a decrease in the number of non-European students. The pace of this sector's recovery will highly depend when they return. Historically, the number of students has increased significantly after crises, with fired workers returning to university to increase their chances in the labour market and families investing more in their children's future. We expect this segment to have a more prolonged recovery, returning to earlier levels only after the 2020-21 academic year.

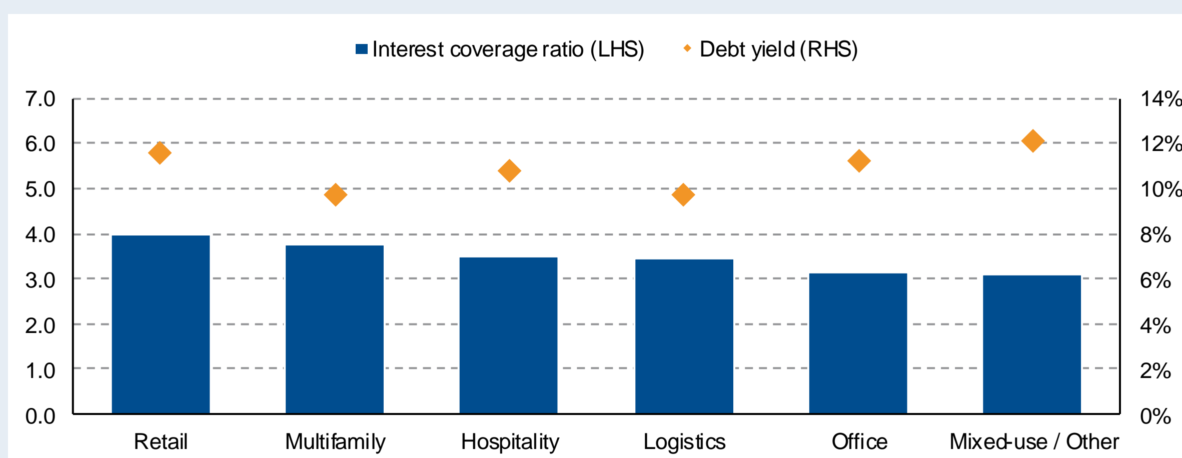
Scope's insights

To assess possible implications of the Covid-19 crisis, we conducted two analyses: a short-term liquidity analysis of a portfolio of outstanding transactions rated by Scope; and a look-back at rent recoveries in Western European capitals after the GFC. Based on this, we found that investment-grade CRE loans rated by Scope are likely to be well protected against possible adverse Covid-19 liquidity impacts, and that this crisis may result in diverging country paths.

CRE debt instruments currently face liquidity risks arising from tenants not paying their rents as detailed above. We examined the senior interest coverage ratio (ICR) of 21 investment-grade transactions recently rated by Scope (see Figure 4). All asset types exhibit senior ICR between 3.0x and 4.0x, which means that borrowers' net operating income could cover their interest payment obligations even if only 25%-33% of the rents are paid over one year, therefore protecting them from a short-term liquidity crunch.

As an illustration: it was reported that an owner of 17 shopping centres in the UK and Spain received around 30% of April's rents. Meanwhile debt yields range between approximately 10% and 12%, which is also protective against more expansive and tightened refinancing conditions. Interestingly, retail and hospitality, the two most exposed sectors to Covid-19, are within the Top 3 highest ICR levels, while debt instruments backed by diversified security types have the lowest ICR levels.

Figure 4: Scope rated senior instruments cash flow metrics



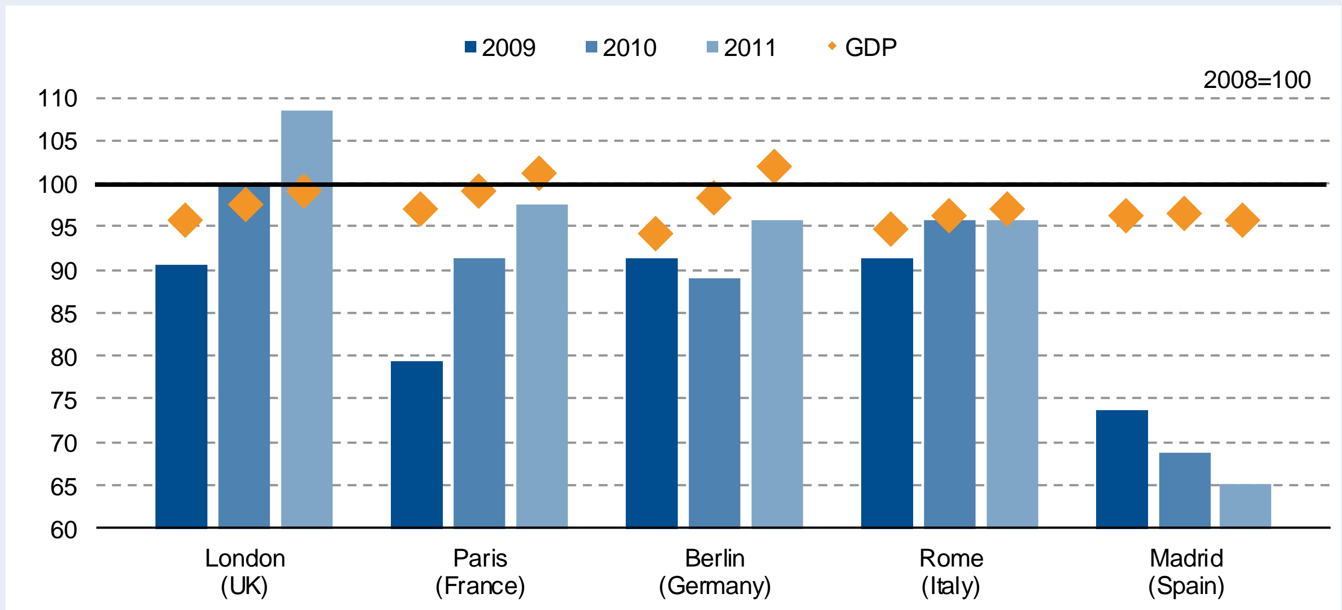
Source: Scope Ratings

A sudden economic shock might bring about long-term structural changes in the CRE sector, notwithstanding it might be caused by a natural disaster type of event rather than underlying unsustainable economic factors like the GFC. Previous experiences might not be repeated, but it is still worth looking at them. As an illustration we investigated the path of prime office rents after 2008 (Figure 5).

After a significant drop in each major capital, London rent levels5 had returned to their pre-GFC levels by 2010, while in Paris, Berlin and Rome rents were still around 5% below their 2008-levels in 2011. In the meantime, Madrid's rents experienced a more meaningful initial drop and did not even return during the following years. Rent growth followed a similar path to GDP growth, which was driven by countries' macroeconomic recoveries. Similar performance dispersions may arise once the dust of the Covid-19 crisis settles.

[5] Unweighted average of London sub-markets

Figure 5: Recovery of GDP and prime office rents after the GFC



Source: Colliers, Eurostat, Scope Ratings

Key risks for commercial real estate analysis

Credit analysis of commercial real estate loans is usually a bottom-up process that focuses on up to four steps: i) sponsor and business plan analysis, ii) tenancy analysis, iii) property analysis, and iv) loan analysis.

The likelihood of default of CRE securities is two-fold:

i) Term default risk: borrower's failure to service its interest and principal obligations during the term of the loan;

ii) Refinancing default risk: borrower's failure to refinance at the maturity of the loan.

The CRE credit risk analysis usually focuses on the cashflow-generating capacity of the assets and the available net operating income to service the debt. The cashflow financial metrics drive default risk (debt service coverage ratio and exit debt yield), while the loan-to-value ratio provides an estimate of the loss severity upon default.

Scope's commercial real estate snapshot

Figure 6: Asset type coverage

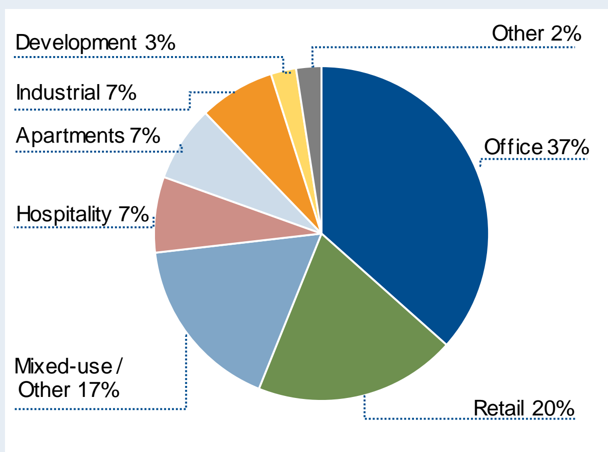


Figure 7: Financing type coverage

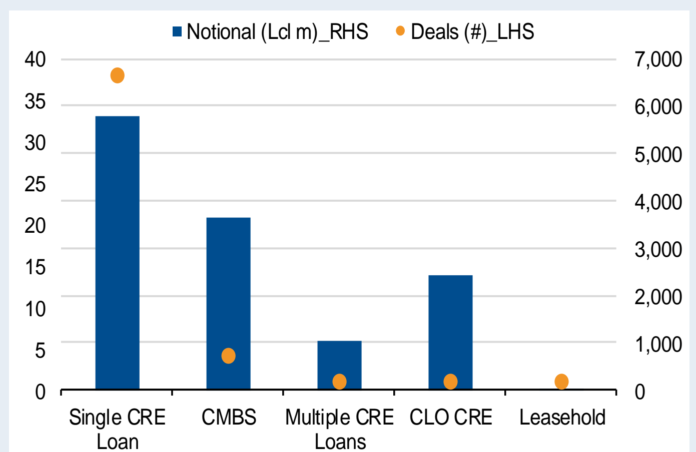


Figure 8: CRE rating evolution

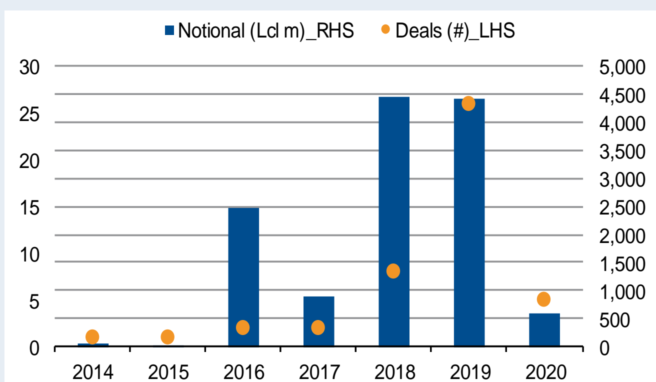
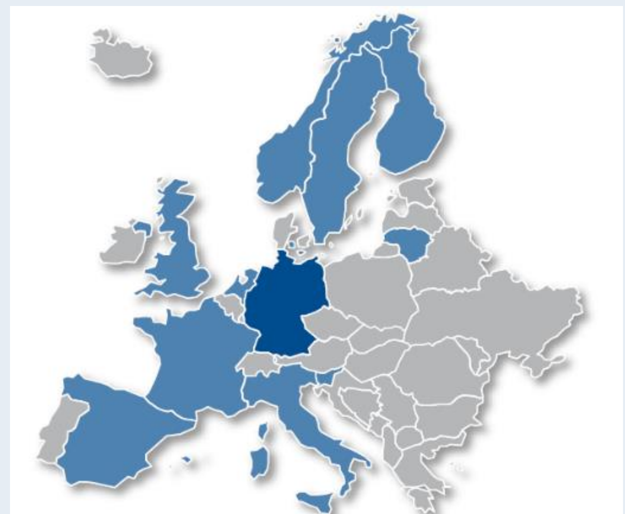


Figure 9: Geographic coverage (USA excl.)



What will the European CRE sector look like when the dust settles?

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