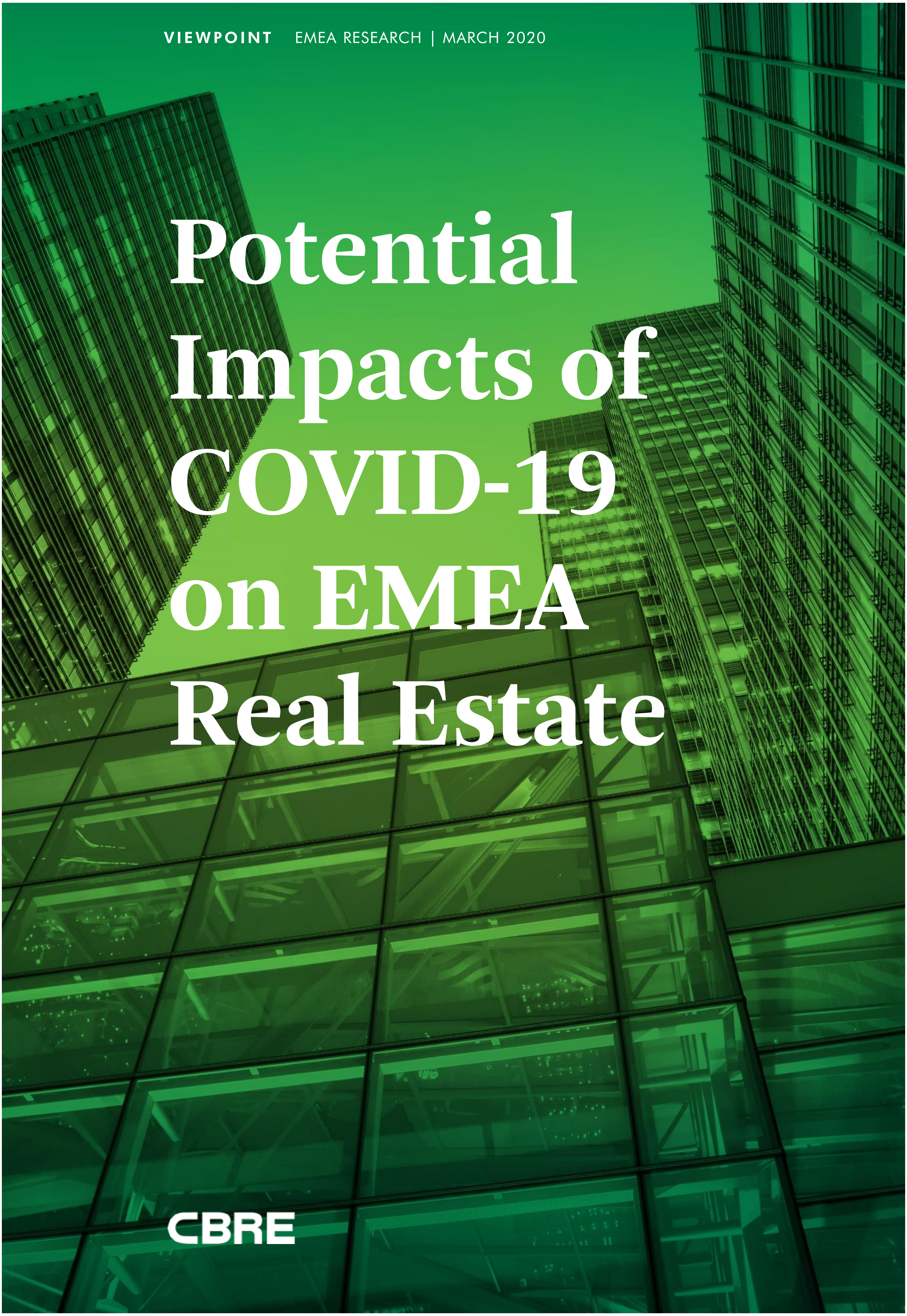


Potential Impacts of COVID-19 on EMEA Real Estate

CBRE

EXECUTIVE SUMMARY

- The consensus is that COVID-19 has yet to peak and will continue to spread. Multiple cases have been confirmed across Europe in recent weeks.
- The net drag on European GDP growth should be limited, conditional on a temporary disruption to global supply chains. However, recent developments, such as the cancelation of major trade shows as well as travel restrictions, present an increased short-term downside risk.
- The most exposed countries to supply chain disruption are Germany, France, Italy and Spain. Highly exposed sectors are those linked to motor vehicles, machinery and chemicals.
- Travel restrictions and fear of exposure to COVID-19 will primarily impact the hotel and retail sectors.
- While real estate yields may be marginally impacted in the near term, the long term outlook remains positive. Investment volume likely to be negatively affected, albeit they are traditionally low in the first quarter. Growing calls for additional interest rate cuts could further support the low yield environment.

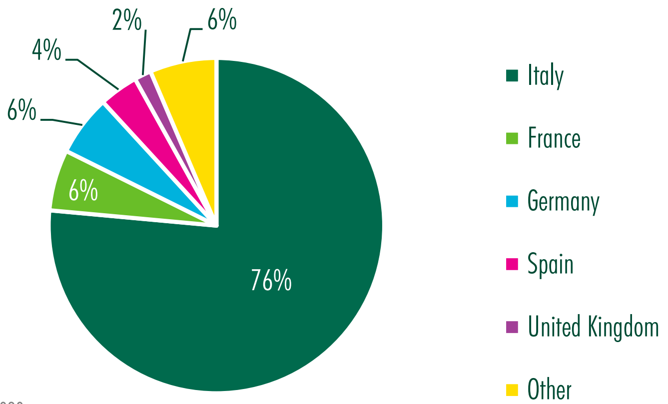
IT IS SERIOUS

COVID-19, also referred to as the coronavirus, has cast a shadow over the global economy. Although the majority of cases are still concentrated in China's Hubei province, in particular Wuhan city, the outbreak has yet to peak and is expected to spread across all European countries. Forecasting the COVID-19's impact on long term economic growth is challenging as the situation is fluid and new headlines break daily. However, rising stock market volatility and the strong influence Chinese manufacturing and investment exert on the global economy suggest a potential negative effect in the short-term.

As of March 2, 2020, Italy had reported 1,689 cases, the highest in Europe, with the majority concentrated in Milan. This is followed by France, Germany, Spain, and the UK, which account for 6%, 6%, 4% and 2%, respectively, of the 2,210 cases reported in Europe. Repatriation and quarantine efforts by European countries, most notably the UK, which recently had as many as 30,000 citizens living and working in China, poses a significant challenge for authorities.

Figure 1: Percentage of total confirmed cases in Europe by country

Total European cases 2,210



Source: European Centre for Disease Prevention and Control, March 2020

SHORT-TERM ECONOMIC IMPACT

The rapid spread of COVID-19 is likely to significantly impact China's GDP growth in Q1 2020, with negative consequences for the rest of the world. China's importance to the world economy has grown significantly since 2003. In 2018, China accounted for 16% of global GDP, 10% of total imports and 13% of exports of intermediate goods[1]. This is in stark comparison to the SARS epidemic of 2003, when China accounted for only 4% of global GDP and a similar level of total imports.

This suggests that the virus has the capacity to have a much higher adverse impact on the global supply chain than during the SARS epidemic and therefore a much more significant spillover effect on the rest of the world.

The global impacts are likely to be felt across four main channels: reduced demand for imports, fewer Chinese tourists, supply chain disruptions due to shortages of Chinese exports of intermediate goods, and negative sentiment in financial markets spilling in to real estate.

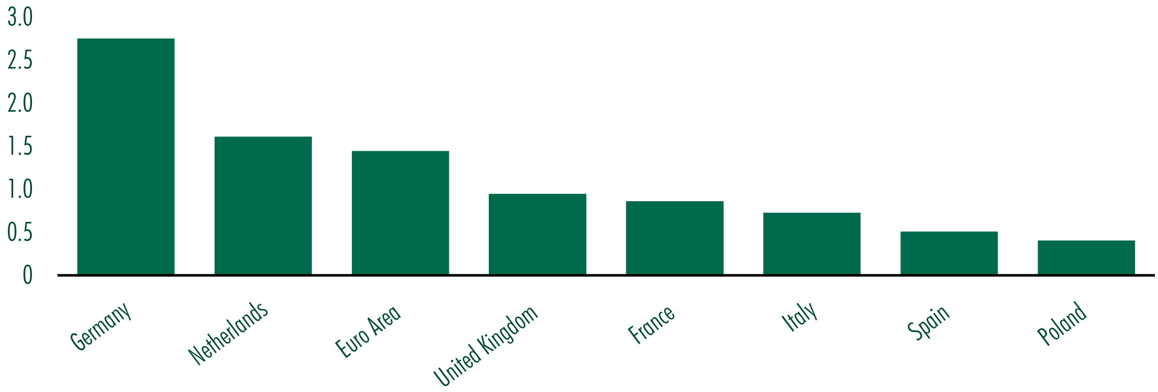
WHAT DOES THIS MEAN FOR EUROPE?

China and external demand – Chinese demand for European exports

As China is the second largest partner for EU exported goods and the largest partner for EU imported goods, there are two immediate risks to the Euro area (EA) outlook. The first is the EA's heavy reliance on China as a source of final demand. By looking at each EA country's exports to China as a percentage of GDP, we can gain some idea of those countries more exposed to fluctuations in Chinese demand. Figure 2 shows that both Germany and the Netherlands rely more heavily on China and any significant downturn is likely to be felt more acutely in those countries.

[1] Eurostat, March 2020

Figure 2: Exports to China % of GDP



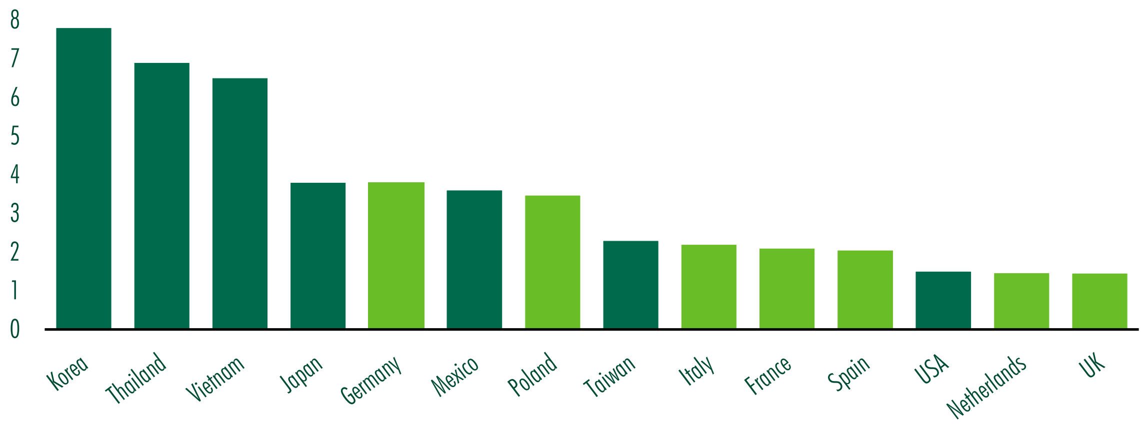
Source: Eurostat, Macrobond, March 2020

China's role in the supply chain

The second and less obvious issue is the EA's reliance on China as a producer of intermediate goods that are vital in EA exports worldwide. Figure 3 displays data on the share of Chinese value-added embedded in a country's exports and highlights the European countries highly exposed to supply chain disruptions caused by a prolonged shutdown of Chinese factories.

For those countries, the risk is the length of the disruption. Restricted movement of migrant workers in China means factories continue to operate at far less than full capacity. While existing inventory levels may act as a buffer in the short-term, any prolonged disruption to production in China will cause production in Europe to slow or stop altogether. This is especially true in markets where China's value-add is substantial, such as motor vehicles, chemicals and textiles[2] and sectors where suitable substitutes are out of the question. Should this happen, it would likely have a disproportionately large impact on GDP growth in the EA.

Figure 3: Chinas VA in total VA exported by country (2015) %

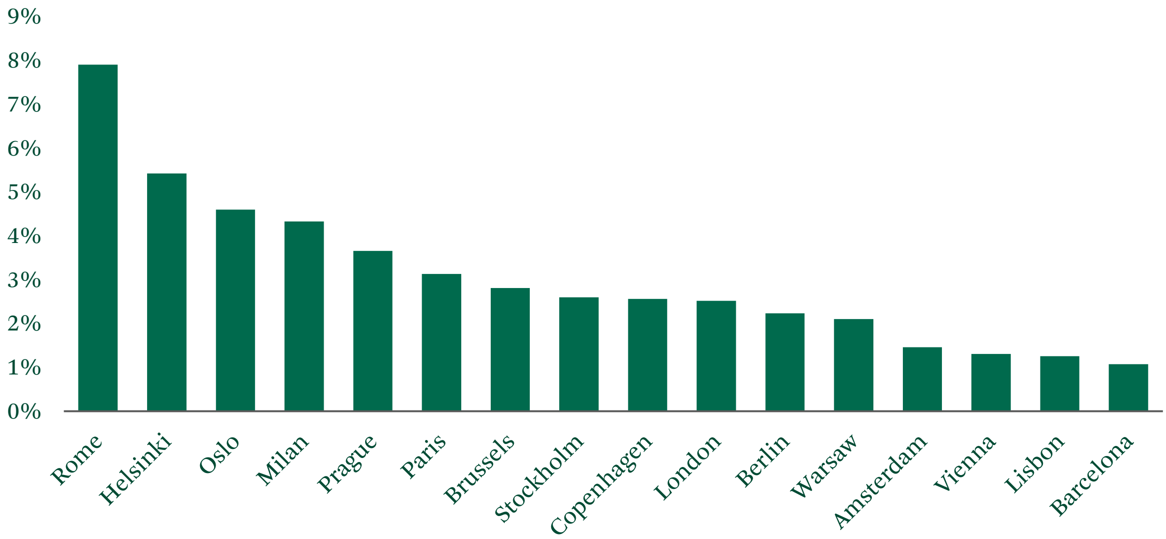


Source: OECD TiVA, TS Lombard

[2] OECD TiVA, 2020

There is also potential for additional negative economic consequences. Measures to contain COVID-19 in China are likely to have the greatest impact on travel and tourism within Asia Pacific. Whilst the importance of China as a global outbound travel market has grown significantly over the last decade and is predicted to increase in magnitude, the country only accounted for circa 2% of overall European international arrivals in 2019[3]. European hotel markets with relatively high exposure to Chinese travel demand include Rome and Helsinki (Figure 4). Whilst a slowdown in Chinese arrivals could be considered a short-term threat, CBRE still sees a medium- to long-term opportunity for markets that appeal to Chinese travellers.

Figure 4: Chinese travelers as % of international nights spent (2019)



Source: Global Data, 2019

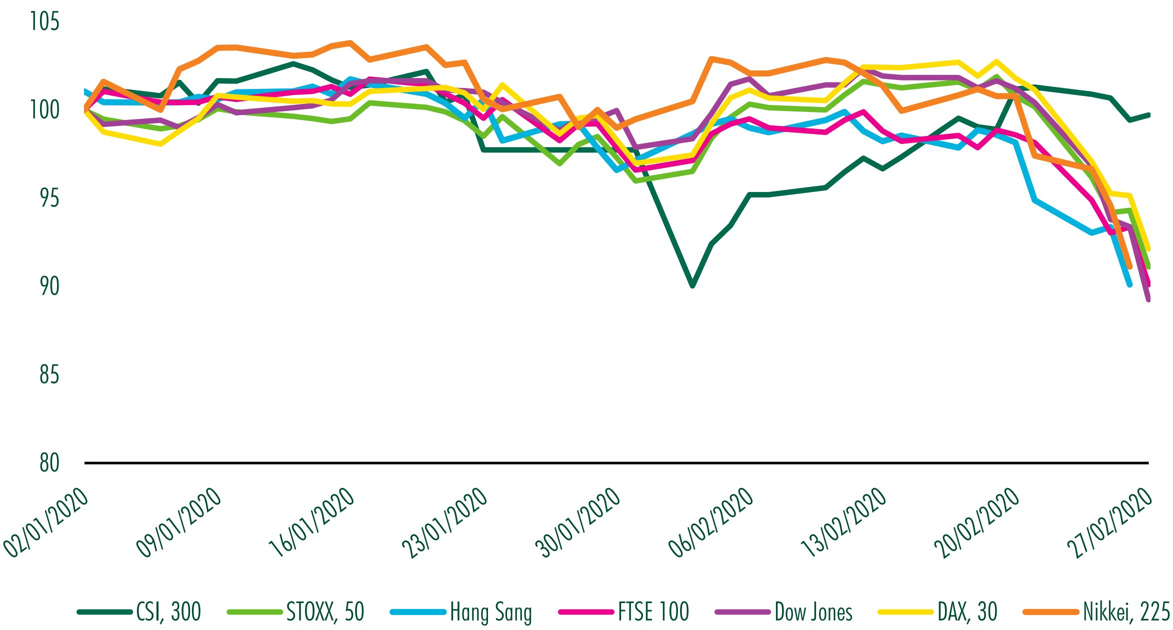
Financial markets

Financial markets were initially slow to react to the COVID-19 outbreak, but recent developments suggest that earnings expectations are now being downgraded (Figure 5). As of March 2, 2020, the average fall in equity markets had been ~8% since the start of the year, and this volatility is likely to continue in the short-term.

While volatility in financial markets affects sentiment in property markets, it may also present an opportunity. A rally in bond markets has seen bond yields fall back to historic lows, this has helped reduce the cost of borrowing and in some instances increased the attractiveness of property as the spread on the risk-free rate continues to widen.

[3] Global Data, 2019

Figure 5: Financial Markets



Source: Macrobond, 2020

Recent developments

While disruptions in China pose an immediate risk to the EA outlook, recent developments pertaining to the number of confirmed cases of COVID-19 in Europe have significantly increased the downside risks to the EA outlook. Intra-EU trade is vital to economic growth and any disruption to trade between countries now poses an immediate threat to the outlook. Announcements of factory disruptions in Northern Italy and postponements of property conferences such as MIPIM suggest that the impact is already being felt in Europe. It is now hugely important that EA governments respond swiftly to contain the spread of the virus, while considering all appropriate policy measures to restore sentiment in the region.

CBRE's base case is that China's stimulus and efforts to contain the virus over the next coming months will successfully act to mitigate the downside risks to the supply chain. CBRE expects China to experience a V-shaped recovery, with a dip in GDP growth in H1 2020, followed by a recovery in H2 2020. The EA outlook is now conditional on both containment in China and in Europe itself. Our view at this stage is that effects on full year EA economic growth is still relatively small but downside risks remain.

POTENTIAL COMMERCIAL REAL ESTATE (CRE) IMPACTS

CBRE expects the COVID-19 outbreak to have a negative short-term impact on certain sectors of the commercial real estate market. However, the further transmission and evolution of the virus remains difficult to predict. If COVID-19 spreads aggressively across the EMEA region, it will conceivably have a significant impact on economic growth and therefore CRE investment volumes. In addition, restrictions on travel and the movement of goods between the EMEA region and China will predominantly affect sectors relying on supply chains and tourism. In regards to the investment market, pressure on the European Central Bank (ECB) for a continued accommodative approach to monetary policy suggests a continued low-yield environment. Nevertheless, if the impact of COVID-19 resembles that of the SARS outbreak in 2003, a strong rebound in investment could occur during the second half of the year (albeit we recognise we are much longer in this economic cycle).

Sector by sector analysis

INVESTMENT

Travel restrictions are already resulting in the cancellation of face-to-face meetings, site visits and trade shows in EMEA. This could impact the real estate investment market, with a reduction of inflows from Asia Pacific-based investors possible. As the first quarter is typically a slow period for the investment market, the impact on full year volumes may be somewhat limited. To put this into context, over the last 14 years, the first quarter accounted for 20% of total annual investment per year, compared to the fourth quarter's 30% (with the risk of stifled economic growth, central banks are likely to keep rates low in this environment. This may help liquidity create new investment opportunities). Moreover, given that the investment market moves slowly in terms of transactions, any effect on investment may not be observable immediately.

OFFICE

The impact on the office market has been limited thus far. However, supply chain and logistics issues arising from a disruption in manufacturing and transport could hamper the construction pipeline and affect renovation projects. Recent stock market corrections may trigger companies to adopt a more cautious approach to expansion in the short-term.

RETAIL

High street retail in major European cities is heavily reliant upon tourism. Therefore, a reduction of travel and fewer tourists could weigh on the sale of luxury goods and consumer staples in cities such as Milan. If COVID-19 spreads across Europe more aggressively than initially expected, local residents' fear of exposure in public places could also disrupt domestic retail consumption. This disruption would further accentuate the already existing pressure on brick-and-mortar retail caused by the rapid growth of e-commerce.

HOTELS

In the short-term, CBRE expects a decline in Chinese arrivals to Europe resulting from measures to contain COVID-19. However, the overall impact of this will be limited, given that China currently only accounts for 2% of total European international arrivals.[4]

Regarding intra-regional European travel, in the short-term we expect corporate and MICE (meetings, incentives, conference and events) demand to be most vulnerable to the COVID-19 outbreak as organisations adopt a cautious stance on non-essential business-related travel.

CBRE also expects leisure travel demand to generally remain stable in the immediate term, ensuring domestic travel markets stay relatively robust. However, this will depend on individuals' perception of risk, government measures and the ability of consumers to recover any possible losses from travel insurance providers.

INDUSTRIAL & LOGISTICS

Transportation restrictions pose a significant challenge for the supply chain and logistics industries. Any obstruction in the transfer of raw materials and intermediate goods may affect import and export dependent markets, notably German manufacturing. Given that these operations require extensive capital to function, the displacement or closure of factories could have long term implications. On the other hand, the market destabilisation may incentivise regional investment in the sector as a means of risk aversion. In addition, while e-retailers may benefit from increased demand in the short-term, these platforms may face some pressure from a disrupted supply chain.

[4] Global Data, 2019

OPERATIONAL REAL ESTATE

The short-term economic perspectives in operational real estate sectors remain favourable. Although trends indicate more international investment in alternatives such as student housing and data centres, the majority of capital remains domestic. International travel restrictions will have a negligible influence on demand as European citizens comprise almost the entirety of targeted consumers. However, a change in market dynamics stemming from the global economic impact of COVID-19 may still ripple through these industries. Quarantine regulations – both self- and government-imposed – could affect certain sectors, particularly healthcare.

CONCLUSION

The impacts of a dip in China's Q1 2020 GDP growth will be felt most acutely in European countries that rely on China as a source of final demand (Germany and Netherlands) and markets where China is highly integrated in the supply chain (Germany, Poland, France, Italy and Spain).

CBRE's base case is that China's stimulus and efforts to contain the virus over the next coming months will successfully act to mitigate the downside risks to the supply chain. While the EA outlook is now conditional on both containment in China and in Europe itself, CBRE's view at this stage is that effects on full year EA economic growth are minimal, despite increased short-term downside risks.

European property market fundamentals remain strong. While the COVID-19 outbreak will have a negative short-term impact on certain sectors, CBRE expects the impact on European commercial real estate to be minimal in the long-term.

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