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MARKET IN MINUTES

Savills Research

COVID-19 and the Real Estate Market

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General Overview

Although it is still too soon to predict the real impact of COVID-19 on the Spanish real estate market, we must consider that the agile response after previous critical situations has led to a fast recovery of business activity, in some cases with even greater intensity than expected. In this case, the recovery will very much depend on how far the aid measures designed by the European Union, the European Investment Bank and the various governments go to support the small and medium-sized enterprises.

It is important to note that the current situation differs from all previous scenarios due to the dormant state of the economy, which will remain for an unknown period. This will significantly impact economic growth in 2020.

The government, which has prioritised curbing the infection rate at all times, has left the national economy at a standstill for two weeks, with a temporary halt to the construction sector and most production activity. However, in return, it has steadily taken measures focused on mitigating the impact of the health crisis on the Spanish business sector. These include making ERTEs (record of temporary employment regulations) flexible, a tax debt moratorium for certain companies and self-employed individuals, and a set of guarantees of up to €100,000m, which will be applied for through financial institutions that have an agreement with the ICO (Official Credit Institute).

In this regard, the EU is focusing much of its economic aid on containing unemployment and the destruction of industry, allocating up to €500,000m to maintain jobs and keep businesses active throughout the Eurozone.

In the occupier market, the overall moderation of business activity has been reflected by the postponement of the search for new work spaces in all real estate sectors. The investment market has been equally affected. Both buyers and sellers prefer to defer decision-making to see how the situation develops.

The excess liquidity and the security of the real estate sectors in the most consolidated markets provide an optimistic outlook about the investment market. Moreover, the experience of the Asian market after the last health crisis (Sars, in 2003) shows a rapid recovery, even detected in the quarter following the end of the crisis. That is to say, there was an initial standstill caused by uncertainty, which led to a solid business recovery.

It is also necessary to take into account the extreme volatility in the financial markets as well as the low rates, which are expected to last longer, thus strengthening the position of the real estate sector in the investment market.
The crux of the matter is, on the one hand, the duration of the health crisis, which is estimated at several months, and, on the other hand, the market's ability to recover after the crisis has been overcome. This will depend on the individual circumstances before the current impasse.

Hotel Market

The hotel market is one of the most affected by the situation. The outbreak of the coronavirus across Spain caused massive cancellations, which steadily reduced occupancy levels, until several of the major market chains opted to temporarily close their establishments. The situation worsened with the closure of borders, followed by the order to close all touristic establishments. This prevents a new market peak from being achieved, in terms of the number of travelers in 2020, as has been increasing steadily since 2012.

The temporary nature of the crisis will allow tourism to regain its momentum when the impact of COVID-19 is reduced to a minimum. The indicators coming from Asia are favourable, but in the short term the total resumption of the activity seems rather complicated given the global nature of the business. The reestablishment of trade fairs and conferences will be one of the driving forces behind the recovery of the urban sector. The recovery of the holiday sector is more uncertain, as it will depend not only on the end of the crisis in Spain, but also on other countries that frequently travel there.

The current situation has pushed back plans to develop hotel chains until at least the infection curve has been controlled. Although the recovery period is still uncertain, from the experience of previous disruptive crises, it is safe to say that the market will regain the fundamentals from before the COVID-19 outbreak.

Retail Market

The closure of all establishments and shops that are not considered essential during the state of emergency fully affects the retail market, both on high streets and in shopping centres. According to an international report published by Shoppertrack, in European markets there is a strong inverse relationship between the level of infection of the population and the decrease in footfall.

But the closure of physical stores does not imply the suspension of the retailers' business. Large retailers will be able to balance sales volumes thanks to their online platforms. In fact, e-commerce will definitely benefit from the lockdown of the population.
The challenge for retailers will be whether they can provide the products of virtual shopping, as the dependence on China's industrial production could compromise the stock of certain items in the retail market, as well as parts and other items processed in the manufacturing industry.

In any case, the drop in turnover volume that will occur in the retail sector is already evident. Consumer expenditure will recover in line with the main economic indicators and their confidence in the system. The evolution of the labour market, which could incorporate 4.5 million people in the short and medium term, will also determine society's purchasing power.

Despite the notable position that e-commerce holds in the retail market (currently it is estimated that 5% of retail sales are made through online channel), most of the activity will continue to be developed in physical stores, which provide experiences impossible in the digital world. Meanwhile, the cultural factor will continue to play a large role in the promotion of commercial activity on high streets and in shopping centres. The temporary shutdown of physical activity could favour a resizing of the commercial networks of large retailers, as well as the closure of more local shops, which would increase the vacancy rate both on high streets and in shopping centres. Possibilities could present themselves to investors with a more opportunistic profile.

Logistics Market

The logistics market will be one of the key elements in ensuring the distribution of supplies, both from online sales as well as products dispatched from establishments that continue to operate during the state of emergency. In fact, the massive orders from individuals could be causing delays in deliveries, which until a few weeks ago were made in 24 hours.

The rapid growth of logistics activity in recent years, partly linked to the expansion of e-commerce, will continue as e-commerce strengthens and consumer confidence positively progresses.

The solid fundamentals that the logistics market showed up to Q1 2020 have shifted towards a demand primarily focused on the search for temporary space (from three to nine months) in order to store an overabundance of merchandise brought about by the current market situation. Rents remain stable in most markets. The uncertain circumstances could delay the start of works on some projects, especially in the Madrid market, where several large projects are expected to be incorporated by the end of the year.

The shortage of space for immediate occupancy in some of the country's major logistics hubs (mainly in Barcelona) could favour turnkey as well as pre-letting transactions in the new developments scheduled for the next 12 months. Meanwhile, due to the need to improve the response capacity and speed up the delivery of orders beyond large cities, new logistics hubs are being created in decentralised locations. This is piquing the interest not only of operators but also of investors.

The tenants of warehouses that have been excluded from the urban planning process will continue to look for new spaces adapted to town planning regulations. Interest has also been identified in grouping together the different locations in the same region into a single large warehouse.

The logistics market is expected to continue to grow, and both operators and retailers will closely follow how e-commerce performs. The Q1 2020 figures in online sales will be positive, but it will be necessary to monitor whether the data going forward continues this trend.

The highly resilient nature of the logistics market has reinforced the interest from investors. They remain active both in core and core+ products, as well as in value added, through new developments and refurbishment of assets in disrepair in order to adapt them to town planning regulations, provided that they meet other criteria of height, location, etc.

Office Market

Like the logistics market, the office market indicators show a healthy situation, with certain strain on supply due to low vacancy rates in the most solid sub-markets, which continue to drive rents upwards.

The implementation of new technologies has allowed many companies to develop their activity through working from home, which has been key in limiting human contact as much as possible. Once the health crisis has been overcome, some companies will probably incorporate remote working policies. This experience has taught us, on the one hand, that the commitment to invest in digitalisation has provided in part a competitive advantage in the business network, and, on the other hand, the importance of the relationship with coworkers.

In the short term, these factors will not imply drastic changes in the search criteria for new work spaces. However, the demand for office space will determine the importance that they give to one factor or the other, clearly affecting the allotment of space and work flows within an office. The current trend in space optimisation allocating for individual work could be eased to ensure adequate social distancing between colleagues. Meanwhile, common areas for collective work as well as relaxation and leisure are likely to take on a more prominent role.

The biggest challenge facing the office sector is to attract new demands. Due to the new developments planned not only in the short term (over the next 24 months), but also those programmed in the medium and long term (as a natural growth of the country's main office markets), this demand must be able to take on this office space.

Moreover, the office market could be subject to a reinvention of the business, looking for creative solutions in an agile way that retain and attract new occupiers with the purpose of maintaining low vacancy levels. In addition to direct negotiation between the parties of the contract, the procurement of green seals by owners and occupiers, as well as the implementation of sustainability and wellbeing policies in work spaces, will be one of the key points in the requirements of the investors.

The overall attitude of office buyers is to wait and see, mainly for core+ and value added products. Moreover, core+ investors remain active in analysing opportunities despite the transitional situation during the health crisis.

Residential Market

After several years of double-digit growth (an annual average of 14% since 2015), 2019 ended with the first drop in the number of home purchases (-3%). But the decline in sales transactions in the residential market (in line with the slowdown in mortgage lending, which grew by only 3% in 2019 compared to an average of 12% since 2014) contrasts with the unstoppable growth trend in the rental market. There will continue to be a need for housing once the health crisis has been overcome, primarily in urban populations with higher population growth forecasts.

Access to housing will depend on the population's ability to afford the prices (whether for sale or rent), which up to now have been subject to the law of supply and demand. The evolution of socio-economic data will determine whether there will be any adjustment in the affordability of prices due to the possible increase in unemployment in the coming months, as well as easier access to credit for buyers.

The government also considers extraordinary measures to meet mortgage or rental payments in cases of economic or social vulnerability.

Alternative Assets Market

The so-called alternative markets (student residences, senior homes, hospitals, etc.), which are less influenced by economic cycles, will also regain investor activity in a short period of time. Socio-demographic indicators support the interest of investors who consider them to be a safe product, provided that it is linked to a long-term contract. The main problem in these markets is, on the one hand, the scarcity of available product, and on the other hand, the fragmentation of product among private investors.

The arrival of international funds and operators specialised in the different alternative sectors could favour the increase in supply. This will generate interest as long as it meets the size and quality expectations of buyers, or the possibility of increasing value through capex or management. For example, in the student housing market, entry is achieved through the development of products that adapt to international market standards.

Private health care has recently been on the radar screen because it works as a support to public health care. Many of the real estate assets already form part of fund portfolios, but product disinvestment in portfolio format is a possibility.

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