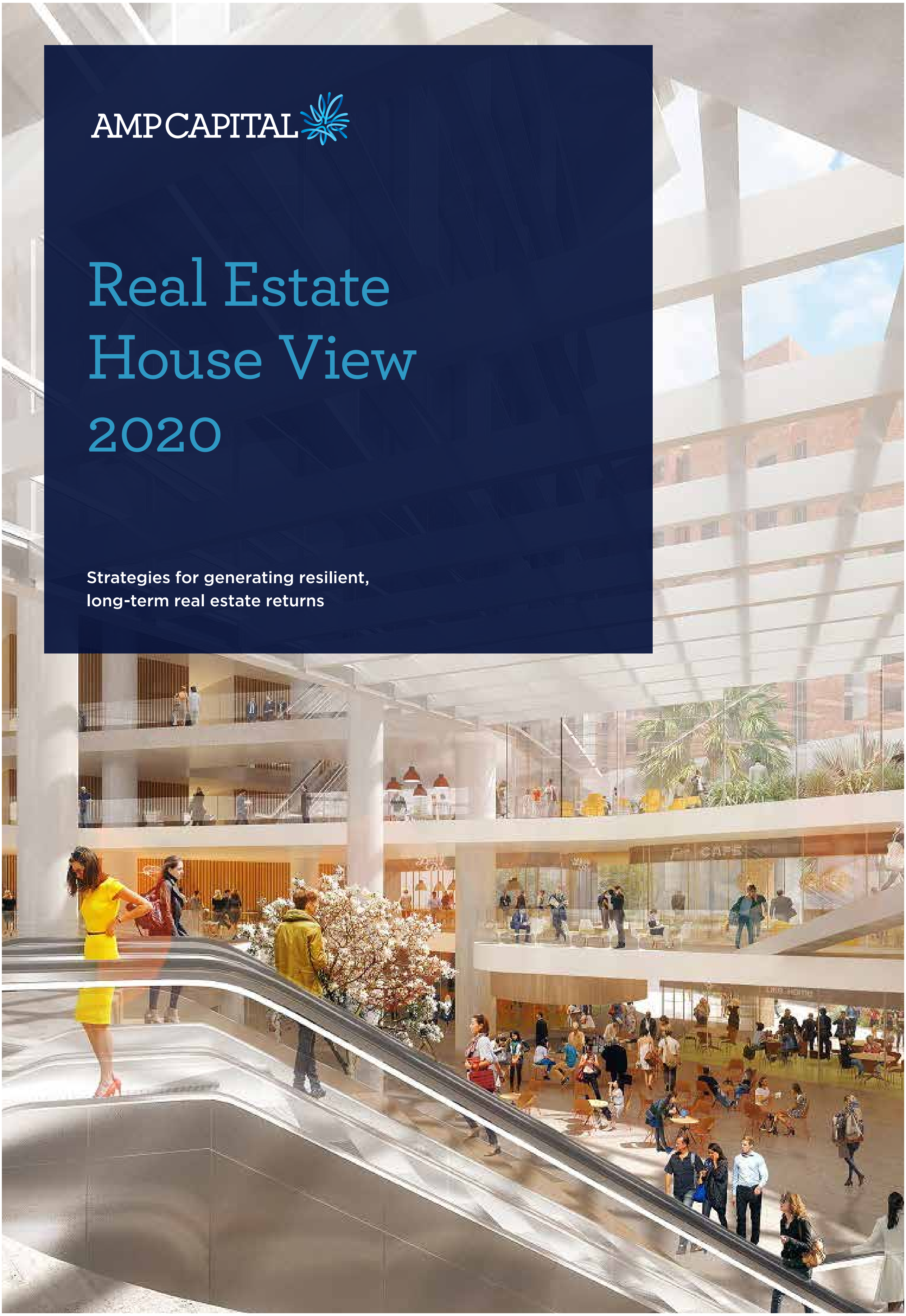
AMP CAPITAL

Real Estate House View 2020

Strategies for generating resilient, long-term real estate returns



Highlights summary:

- COVID-19 will permanently transform the way we shop, work and play.
- Markets that flatten the curve sooner will rebound quicker – Australia and APAC to lead global recovery.
- Sectors aligned to online fulfillment, wellness, household consumption and flexibility are well placed to prosper in the wake of COVID-19.
- Core, long WALE strategies will likely dominate capital flows, as investors turn increasingly defensive.
- Core logistics will grow as the investment market favourite, as investors lift allocations to the sector.
- The office of the future will be spacious, wellness focused and more flexible, to accommodate greater workforce mobility.
- Retail and consumer spending will cool, while e-commerce competition will sharply accelerate.
- Logistics fulfillment and inventory led by online household good demand looks set to drive strong demand story long term.
- Defensive alternatives such as medical office and multifamily will be compelling as "next gen core."

Contents

Image: 700 Bourke St, Melbourne
Cover Image: Quay Quarter Tower, Sydney

The new normal – strategies for generating resilient, long term real estate returns

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Credit: Nathan Dumlao-Unsplash

I don't normally put sugar in my coffee, but I did enjoy the sweetness of being able to sit down in my local coffee shop in Sydney recently, for the first time in months.

While the first signs of cautious optimism emerge as the Australian economy begins to thaw out from its hibernation, the task of returning to 'normal' gathers pace. Investors have been looking for the moment pricing would turn and the cycle would spin out. However, unlike previous downturns which have been precipitated by excesses or signs of economic distress, this current crisis was caused by a true black swan event. So, unlike during the 1991 recession for example, the economy was in comparatively better shape going into this current battle. The commercial real estate sector is no exception, it enters this downturn in a stronger position with low gearing levels, low vacancy and balanced supply levels.[1]

The global impact of COVID-19 and its aftershocks will undoubtedly be felt for some time to come, triggering structural shifts in the way we go to work, shop and play. COVID-19's economic knock-on effects stemming from enforced social distancing, store closures, and record levels of unemployment are already driving a stark divergence in real estate performance at a regional and sector level.

All commercial real estate sectors have felt valuation and liquidity impacts from this crisis, but as we've noted in our research, commercial real estate performance varies from sector to sector creating opportunity gaps. This leave us with the question: which sectors will emerge from this crisis stronger over the long term?

In our view, the answer lies close to home. Due to success in parts of the Asia Pacific region with flattening the COVID-19 curve and minimising infections and fatalities compared to Europe and the US, it is becoming increasingly clear to us that the global recovery will emerge from this region. Despite the disruption to global supply chains, we believe the Asia Pacific region will continue to do the heavy lifting of global economic growth during and beyond this crisis. According to data from the IMF[2], the Asia Pacific region contributed the lion's share of the global economic output (on Purchasing Power Parity basis) at some 46 per cent in 2019, which is forecast to rise to 50 per cent by 2024. As investors wait and see how the implications of COVID-19 play out, many are sitting tight and putting investment decisions on hold. However, in our view, some of the structural trends emerging from the shutdown period will have significant valuation implications that will impact real estate performance in the short and longer term.

Hysteria is common in every downturn, and this crisis is no exception. However, history tells us that markets always recover, no matter how harsh the downturn. The current social and travel restrictions have unleashed significant income downside on retail, office and hospitality sectors in the short term, we don't anticipate this state of affairs, or its economic consequences to be permanent. Recovery will inevitably happen.

In the aftermath of the SARS epidemic in 2003, Asian retail centres recovered in a matter of months[3], as did the Manhattan office market in the year following September 11th and the GFC[4]. Following COVID-19, we believe the acute pain phase for real estate will be felt in the second half of 2020, before a sustained recovery driven by low interest rates and government stimulus packages beyond 2021.

Every real estate cycle is fundamentally different. History may be a good place to start, as we look to anticipate how we may emerge from this one. In past downturns, pricing and rental recovery typically takes two years to normalise back to their long-term averages. Given the real estate sector entered this downturn with strong fundamentals, recovery could surprise on the upside. Logistics, healthcare, and multifamily may be the early winners from the COVID-19 downturn. We believe thematics linked to wellness and omnichannel will generate new growth opportunities over the longer term, benefitting the logistics and healthcare sectors. Investors will inevitably be drawn to opportunistic strategies to exploit current market volatility, but patient capital will be rewarded too, by investing in strategies aligned to long term, structural growth thematics.

1 ASX REIT Results, Bloomberg, Company Results

2 World Economic Outlook, April 20

3 CBRE Research 2004

4 CBRE Research December 2002

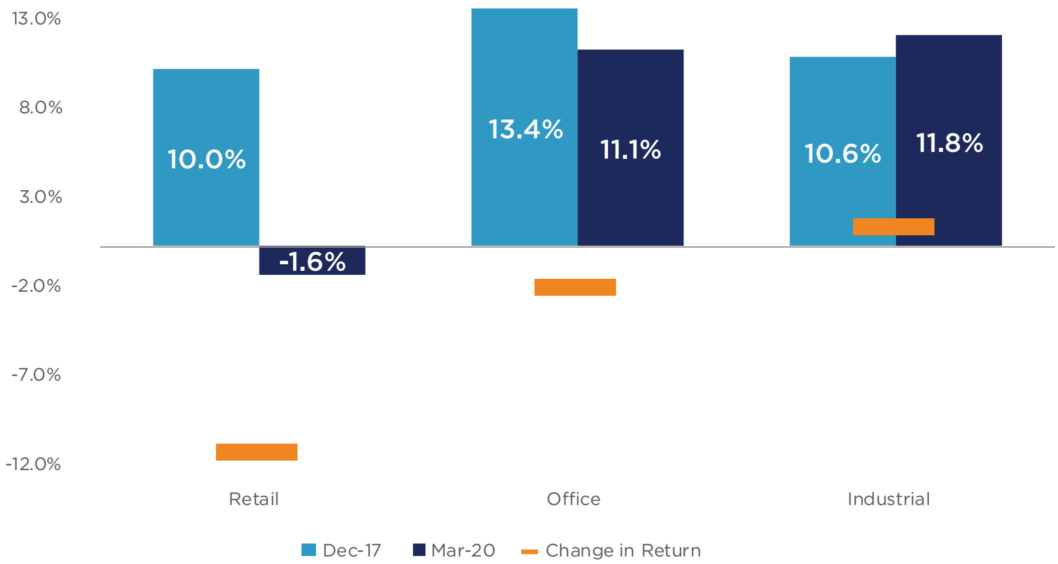
Commercial real estate performance will see sharper divergence post-COVID-19

Prior to the COVID-19 pandemic, the alignment between sector returns had been decoupling. This occurred for two reasons. Firstly, sector performance varies, driven by the different economic fundamentals. Secondly, disruption led by global structural shifts in consumption, working and technology were beginning to influence direct asset performance[5].

As noted in the chart below, for both the listed and unlisted markets, retail was the weakest performer and industrial the strongest performer. Retail returns peaked in Q4 2017 at 10% and have since fallen to -1.6% as at Q1 2020. During the same period, office returns fell from 13.4% to 11.1% whilst industrial improved from 10.6% to 11.8%. The relative underperformance of retail returns has been linked to falls in income, and devaluations reflecting the structural challenges, on multiple fronts, the sector faces[6].

Looking ahead, we are anticipating the spread between the highest and lowest returning asset classes to broaden. Retail and office may see falls in return levels, relative to their exposure to the small-to-medium sized business sectors that underpin their rental rolls feel the pinch of a short, but sharp economic downturn.

Sector bifurcation widening as sector performance varies sharply
Total Returns Q4 2017 vs Q1 2020, Change in Return



Source: MSCI/IPD

5 PwC Emerging Trends in Real Estate Asia Pacific 2020 Report; https://www.pwccn.com/en/industries/real-estate publications/emerging-trends-in-real-estate-asia-pacific-2020.html

6 MSCI/IPD

“Looking ahead, we are anticipating the spread between the highest and lowest returning asset classes to broaden.”

Image: Milton Green, Melbourne

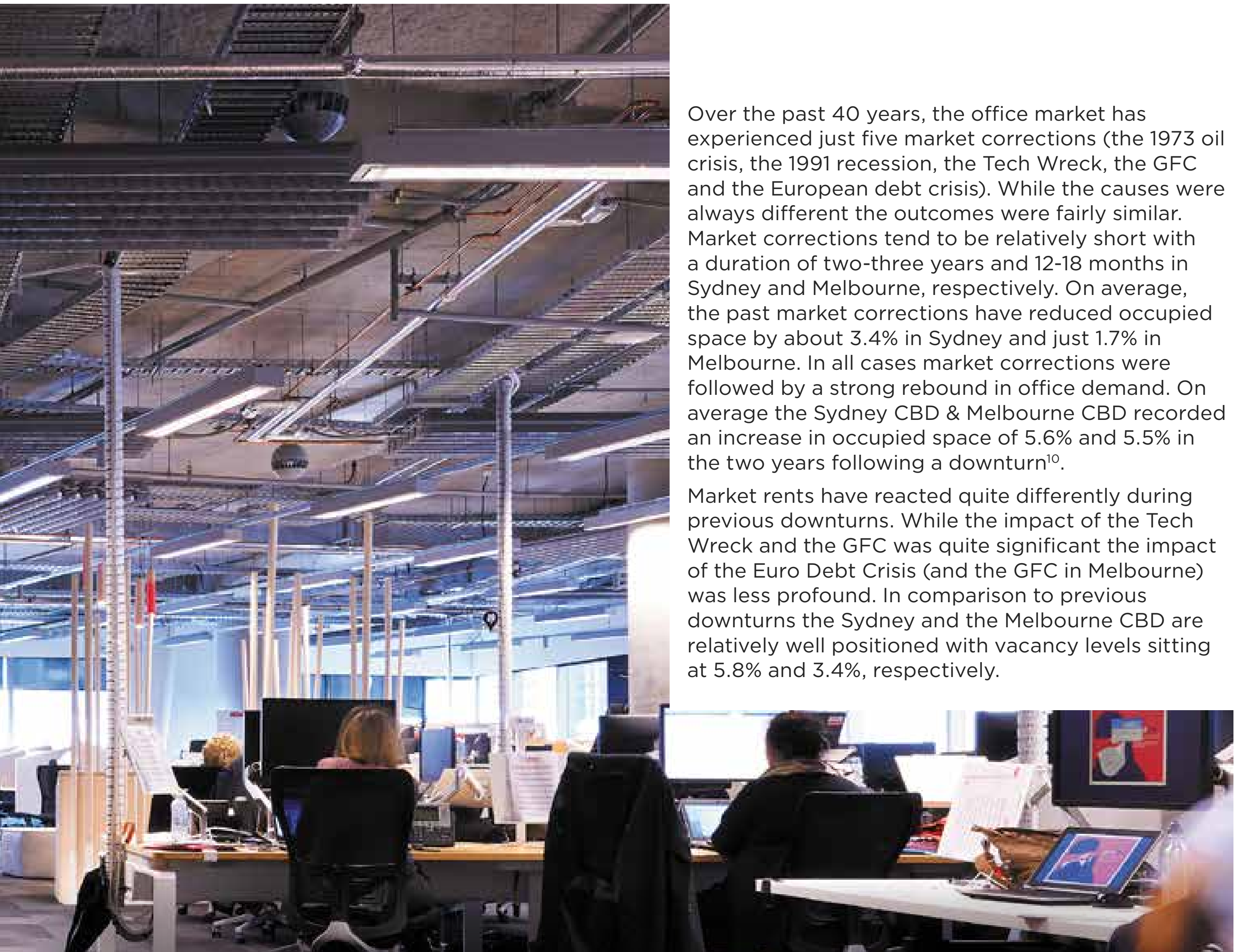
Is it end of the workplace as we know it, or should tenants and landlords feel fine?

Will we still need offices after COVID-19? Everyone it seems has an opinion on this topic, and with so many theories flying around the market, it is easy to lose sight of what the value proposition of an office-based environment is. For us, the true answer is that it is far too soon to answer this question. A period of working from home during a crisis is far from a normalised environment, suitable for determining long-term structural trends. No one knows how soon everybody will return to the office, but when we do, it will be because we value human interaction, collaboration and working together in person. Humans are hard wired through evolution to socialise and COVID-19 won't stop that. We believe it will, however, change some of the ways we do socialise and interact in the workplace in future.

From an economic perspective, there are few industries which will be immune from the effects of the COVID-19 downturn. Based on announcements to date, as well as welfare agency data, economist forecast expectations point to four out of five jobs feeling some negative impact from COVID-19 disruption[7], be it via reduced hours, wage cuts, temporary absences, or permanent staff reductions. Negative employment impacts stemming from a sustained economic downturn may have the strongest impact on the office markets, as is the case with past cycles. Compared to the GFC, which stemmed from the financial services sector, the COVID-19 crisis is primarily focused on the retail, hospitality and food services sectors.

While these job categories don't necessarily represent your typical CBD tenant, it would be unwise to assume that the office markets will be sheltered. The general assumption is that the CBD is generally occupied by large corporate and government tenants. However, smaller tenants (<1,000 sqm) have been the major driver of positive net absorption over the last 10 years, representing over 70% of total demand in Sydney CBD alone[8]. Furthermore, small tenants now form a greater tenant base for prime stock, as the withdrawal of a significant amount of secondary stock over the past five years has pushed smaller tenants into higher grading stock[9]. In our view, one of the biggest impacts of the downturn will be the ability of the small business sector to recover.

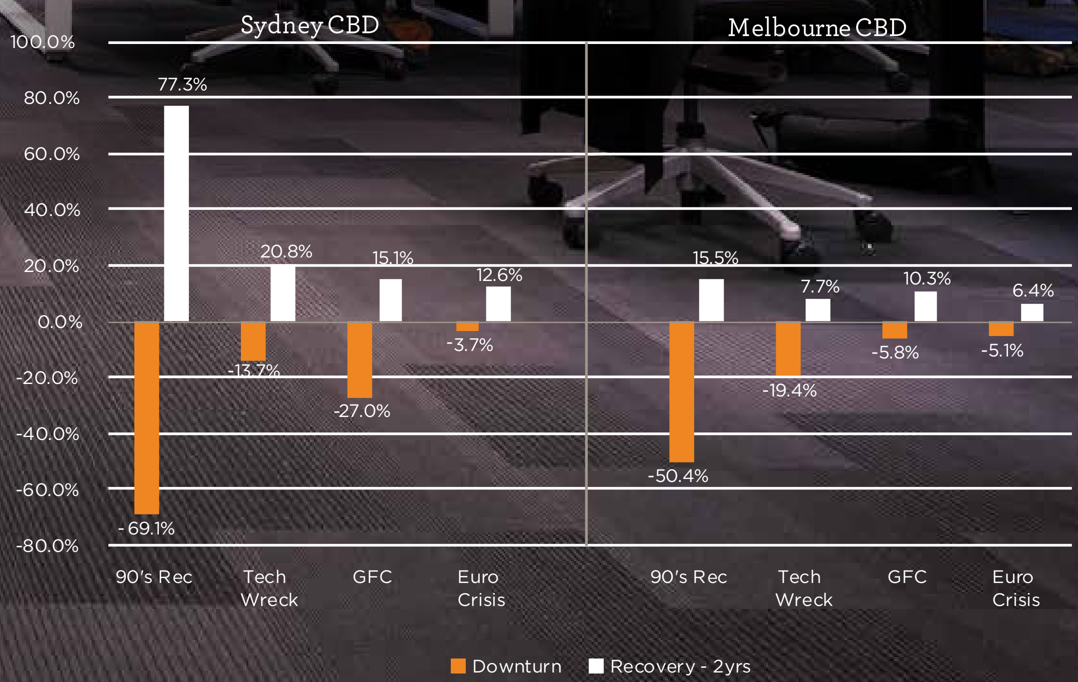
7 Deloitte Access Economics Q1 2020
8 JLL Research, June 2020
9 JLL Research, June 2020



Over the past 40 years, the office market has experienced just five market corrections (the 1973 oil crisis, the 1991 recession, the Tech Wreck, the GFC and the European debt crisis). While the causes were always different the outcomes were fairly similar. Market corrections tend to be relatively short with a duration of two-three years and 12-18 months in Sydney and Melbourne, respectively. On average, the past market corrections have reduced occupied space by about 3.4% in Sydney and just 1.7% in Melbourne. In all cases market corrections were followed by a strong rebound in office demand. On average the Sydney CBD & Melbourne CBD recorded an increase in occupied space of 5.6% and 5.5% in the two years following a downturn[10].

Market rents have reacted quite differently during previous downturns. While the impact of the Tech Wreck and the GFC was quite significant the impact of the Euro Debt Crisis (and the GFC in Melbourne) was less profound. In comparison to previous downturns the Sydney and the Melbourne CBD are relatively well positioned with vacancy levels sitting at 5.8% and 3.4%, respectively.

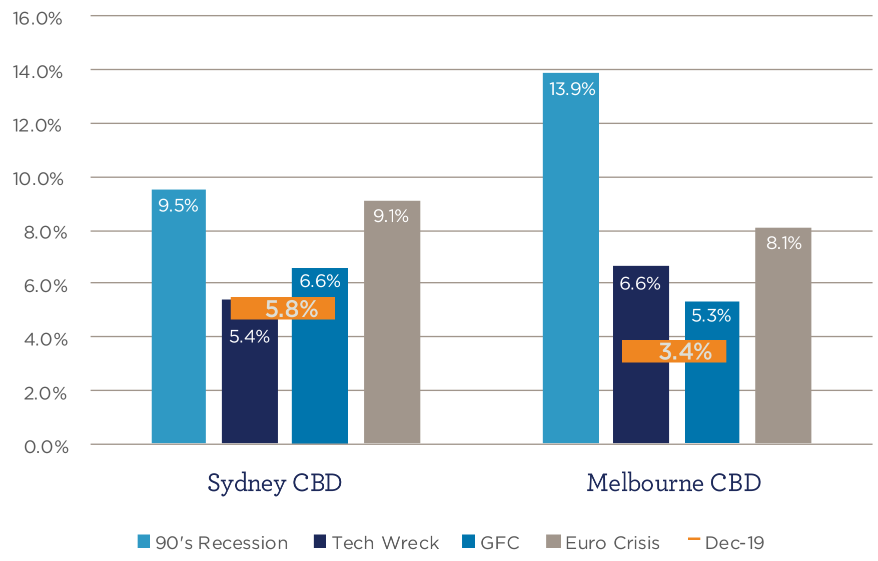
Effective rental growth during & post downturns



Source: JLL Research

10 JLL Research, June 2020

Vacancy levels prior to previous downturns



Source: JLL Research

Image: Quay Quarter, Sydney

While we believe the major office markets are relatively well positioned, historical evidence suggests vacancy levels to move above historical average levels, before recovering from 2022 onwards. Our peak forecast would see Sydney CBD vacancy (all grades) reach approximately 8-10% in 2022, however a milder downturn with a speedier recovery would see vacancy hold below 10%. Secondary office markets with higher exposure to small business tenants are likely to experience the sharpest increases in space handbacks, compared to the Core Prime markets which are anchored by more stable, long-term tenants.

In our view, history is a good place to look if you want to get a sense of how offices reopen after major disasters. Following 9/11, many believed that the New York office market would struggle to recover, however following the attacks, governments instituted stricter flight path policies over cities, increased building security and introduced new policy measures that restored confidence to business workers over time. We think a similar pattern of recovery and adaptation is likely following this pandemic.

Further, while we don't have a cure for this virus now, management options are on the horizon, and it's not unlikely that modern medicine will prevail. For example, a vaccine could eventually emerge inoculating the population. Further, we believe permanent policy shifts in office cleanliness and a greater awareness of workplace wellness will play a part in restoring confidence amongst office workers again.

There are more significant reasons for businesses to want to keep the office. While video conferencing, and soon enough 'VR', is making it easy to collaborate, for many projects there is still no precise substitute for in-person teamwork. If you're working on something that is extremely visual, for instance, being able to share a computer screen can be helpful. Simply being able to sit down in a conference room can be a lot easier than having to deal with getting everyone on Zoom, and for businesses that have a lot of sales activity, the office can be great for meetings, too. A significant body of evidence exists that suggests posting significant parts of your workforce offsite results in reduced productivity and can weakened workplace culture[11,12]. In 2013, global technology giant Yahoo, moved its staff back to the office, with then CEO Marissa Mayer citing the lack of face-to-face communication as weakening collaboration and workplace culture. A copy of the internal memo from Yahoo, was quoted as saying "some of the best decisions and insights come from hallway and cafeteria discussions, meeting new people, and impromptu team meetings. Speed and quality are often sacrificed when we work from home"[13]. In 2017, IBM followed suit, bringing 2,600 people within its marketing teams back to their offices as they turned their focus to increased productivity[14].

While technological achievement has improved the remote work experience, it is not a replacement for human interaction. Humans will still crave interaction, and companies will still look for innovation. We believe landlords will need to focus on creating well-designed, healthier office spaces that foster innovation and human interaction will see better tenant and investment outcomes over the long term. The post-COVID workplace strategy will need to solve for these issues as workers return to the office, and beyond COVID as we assess the permanent impacts it has to the office. Regardless of individual strategies, weaker economic conditions will sharpen the focus on productivity for the business sector, as the recovery starts to take shape. Whilst flexibility will remain important, the beforementioned Yahoo and IBM examples suggests that workplace collaboration to drive more efficient outcomes will be critical.

11 https://www.nytimes.com/2013/02/26/technology/yahoo-orders-home-workers-back-to-the-office.html
12 https://qz.com/924167/ibm-remote-work-pioneer-is-calling-thousands-of-employees-back-to-the-office/
13 https://www.nytimes.com/2013/02/26/technology/yahoo-orders-home-workers-back-to-the-office.html
14 https://qz.com/924167/ibm-remote-work-pioneer-is-calling-thousands-of-employees-back-to-the-office/

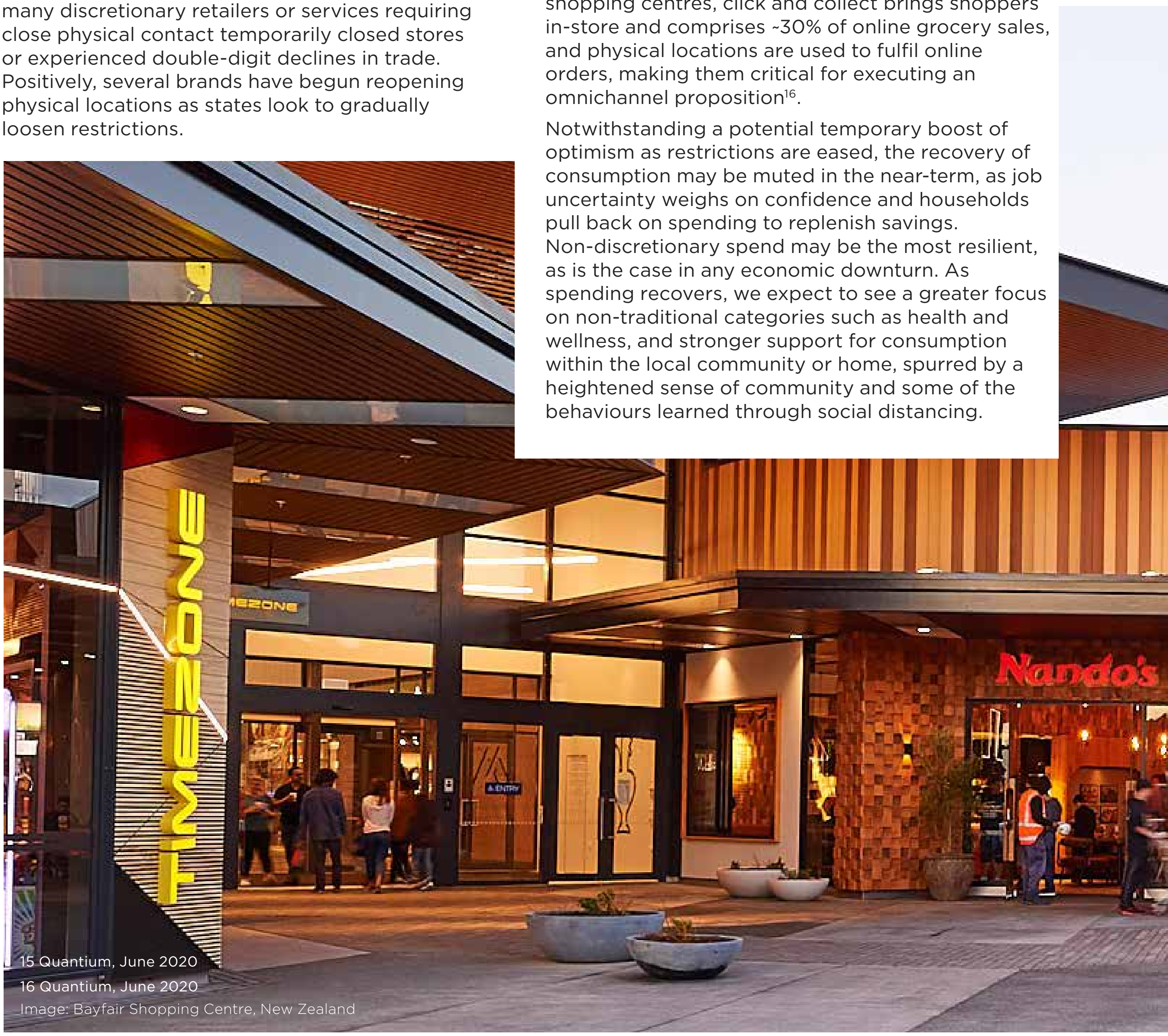
D Day (Disruption Day) is upon us, but there is still time to evolve the model

The retail sector was facing challenges from several fronts prior to the spread of COVID-19, and these trends have been exacerbated and accelerated by the behavioural changes (rightly) forced by governments around the world in a bid to contain infections.

Fear of an extended quarantine saw consumers stockpiling long-life pantry items, household essentials, medical supplies and work-from-home equipment. This was a boon for supermarkets, pharmacies, and home office retailers, which saw sales volumes exceed Christmas levels[15]. Conversely, many discretionary retailers or services requiring close physical contact temporarily closed stores or experienced double-digit declines in trade. Positively, several brands have begun reopening physical locations as states look to gradually loosen restrictions.

Retailers with existing e-commerce capabilities were able to soften the hit to trade by transitioning in-store sales to their online channel. One of the outcomes we expect from this crisis is an acceleration of e-commerce adoption, as some consumers convert the short-term trial to sustained usage, and retailers leverage the digital and supply chain investment they have made through this period. Increased supermarket online penetration (currently ~4%) would be a key driver of headline e-commerce penetration moving higher, given the category's high share of wallet. Positively for shopping centres, click and collect brings shoppers in-store and comprises ~30% of online grocery sales, and physical locations are used to fulfil online orders, making them critical for executing an omnichannel proposition[16].

Notwithstanding a potential temporary boost of optimism as restrictions are eased, the recovery of consumption may be muted in the near-term, as job uncertainty weighs on confidence and households pull back on spending to replenish savings. Non-discretionary spend may be the most resilient, as is the case in any economic downturn. As spending recovers, we expect to see a greater focus on non-traditional categories such as health and wellness, and stronger support for consumption within the local community or home, spurred by a heightened sense of community and some of the behaviours learned through social distancing.



15 Quantium, June 2020

16 Quantium, June 2020

Image: Bayfair Shopping Centre, New Zealand

Leasing/development Implications

As evidenced by network rationalisation announcements from the likes of Flight Centre and Accent Group, retailers continue to 'right-size' their physical footprint to reflect e-commerce's rising share of sales. This may reduce leasing demand, and retailers may be more likely to retain stores in high foot traffic locations managed by adaptive landlords that can support the execution of an omnichannel offer. To protect and grow income, we think landlords will need to undertake their own 'right-sizing' of space, reducing an asset's allocation to traditional retail categories and increasing exposure to non-retail uses that introduce new sources of income, value and footfall, and are aligned to the growth of the consumer wallet. As a result, we believe developments will largely be focused on repurposing existing space or adding non-retail floorspace (e.g. mixed use, health and wellbeing), rather than expanding the traditional mall footprint.

Income implications

In accordance with the principles of the National Cabinet Mandatory Code of Conduct, shopping centre income from small and medium enterprises will be reduced in the near-term proportionate to reduction in revenue caused by COVID-19. Income from other tenant types will also be impacted to some degree, while most landlords work with tenants to plan a path forward. We think assets with a higher weighting to non-discretionary and low touch uses will benefit from a less volatile and more secure income base. For discretionary assets, the ability to backfill space by leveraging relationships across a pool of traditional retail, non-traditional retail, and non-retail uses will be critical to preserving income. Beyond the direct impact to near-term income, market rental growth and releasing spreads will be weaker than previously forecast over the medium term, reflecting the economic environment and lower tenant demand. As landlords compete for new tenants, particularly digital native brands, new income generating opportunities may emerge.

Rising online household consumption to drive sustained long-term pricing growth

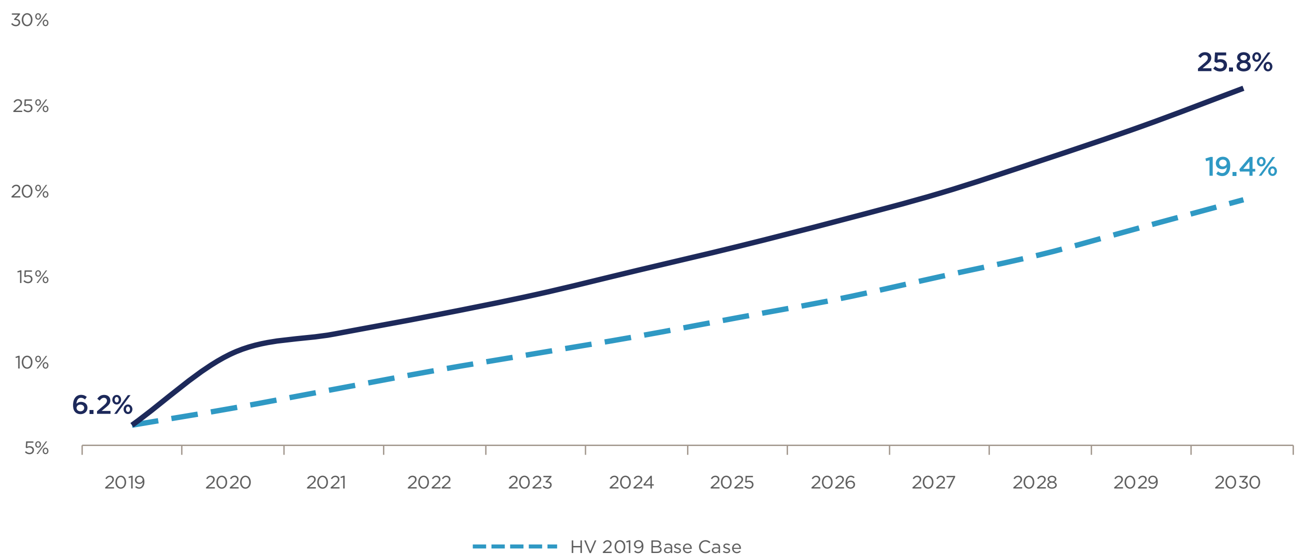
Of the core real estate sectors, we believe industrial will be the most resilient to the impacts of COVID-19. While industrial demand and throughput will be diminished by declining trade volumes, continued focus on stimulatory infrastructure projects may support some tenant types, and the long-term structural tailwinds benefitting the sector are expected to strengthen.

E-commerce is one of the main trends benefitting industrial, as retailers shift their new space requirements from shopping centres to warehousing and logistics. The e-commerce capabilities and supporting supply chains of Australian retailers are relatively immature when compared to other markets such as the US and UK, and significant investment in distribution centres and last-mile facilities was already occurring pre-COVID-19. With adoption of e-commerce now expected to accelerate, industrial assets with proximity to consumers (i.e. metropolitan east coast) are set to benefit from heightened demand, as retailers and third-party logistics providers seek to increase fulfilment capacity to required levels. This need was clearly evidenced by the challenges Australian supermarkets faced through March-April, as online delivery was restricted to at-risk customers due to an inability to meet demand using current infrastructure and resources.

Our base case forecasts point to a take up of 20% of all retail spend by online by 2030, however COVID-19 is driving the rapid adoption of online through the home bound period. According to the ABS, retail sales figures online represented 10.4% of all sales, up 50% year-on year in April 2020[17]. Based on a continued, short-term pick up in online consumption, we anticipate that online sales could reach an elevated level of 25.8% by 2030, assuming a relatively conservative average annual growth rate range of 15-25% p.a. See chart below.

Our analysis indicates supermarkets are set to drive distribution and fulfillment demand growth. Several customer industries are still in the early phases of e-commerce adoption, including food and beverage and construction/home improvement. In recent weeks, supermarkets have announced 50%+ growth in online sales[18]. While all this growth may not be permanent, much could be as new adopters are now familiar with e-commerce and its convenience benefits. Australian supermarkets struggled to fulfil orders during the peak of the COVID-19 lockdown due to constrained supply chain capability, resulting in stock shortages across their store network which often services online orders. We think growth in these categories will reinforce same- and next-day service requirements: if anything, legacy three-to-five day delivery capabilities were a barrier to adoption for these categories, where consumers typically have short planning horizons. These industries have relatively small e-fulfilment operations, and re-tooling supply chains will require substantial real estate investments.

Projected impact of COVID-19 on Australian online retail growth
Forecast annual growth 2019-2030



Source: ABS/AMPCI Real Estate

17 Australian Bureau of Statistics
18 Quantium, June 2020

Importantly, the structural demand story for industrial isn't just about e-commerce. Many industries are pursuing a more efficient supply chain, leveraging robotic process automation and advanced data analytics. This may require higher specification, larger assets that can incorporate automation equipment, or more last-mile nodes nearer to customers – both sources of industrial demand. The rationale for investment in better supply chain is simple – faster movement of goods means higher revenue and the ability to deliver higher service levels (e.g. same-day delivery). As supply chain transforms from a traditionally linear model to a more complex multi-directional ecosystem, businesses are increasingly viewing their supply chain strategically and as a possible source of competitive advantage, particularly in a post-COVID-19 economic environment which will reward those that can deliver more for less.

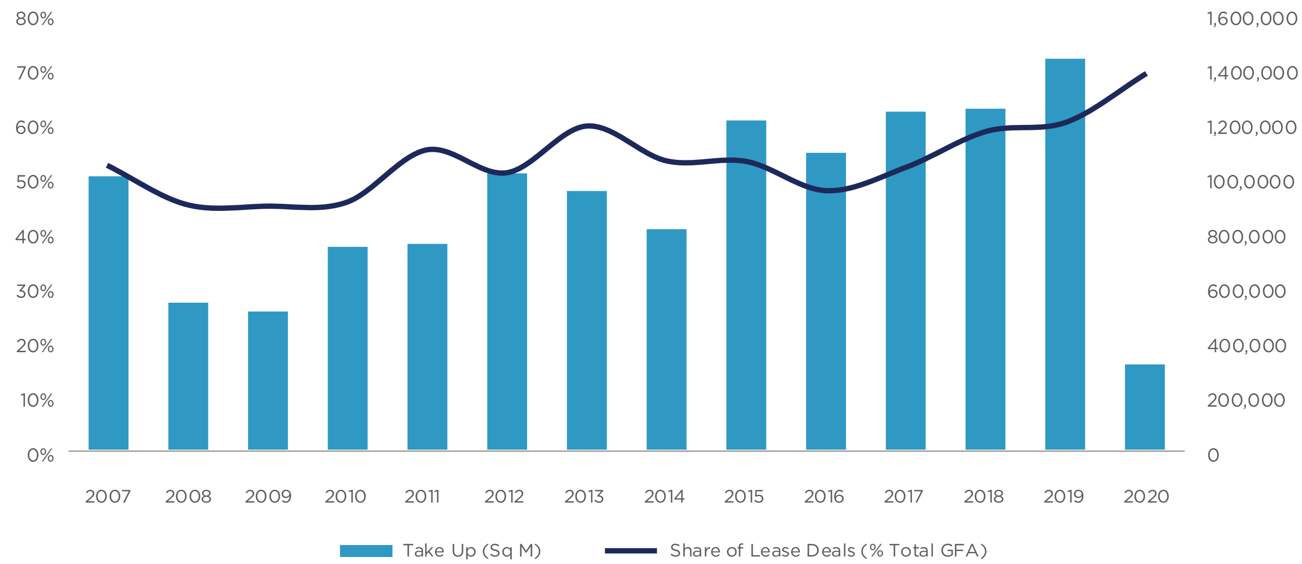
While we do not expect there will not be a significant retraction from globalisation or a proliferation of protectionist policies in the wake of COVID-19, there is scope for some manufacturing to be brought onshore. The Federal Treasurer and Chairman of the National COVID-19 Coordination Commission have highlighted high-tech essentials, such as medical equipment, as something in the national interest that could be produced locally. This could provide a demand tailwind for specific assets and support a domestic manufacturing sector which has been in decline (food manufacturing the exception).

We expect supply is expected to moderate as developers adopt a more cautious approach amidst weaker tenant demand. While this will help limit downside to the sector going forward, we think some speculators that have already committed to over-leveraged developments may fall over, releasing land back to the market. Specific sectors, such as cold storage and food manufacturing, are already undersupplied in Australia and will need further development to meet accelerated demand.

While we consider the income outlook for industrial remains reasonably positive overall, there will still be divergences between sub-sectors. Food manufacturing and cold storage logistics continue to push against capacity constraints and are not an income risk. Traditional manufacturing or discretionary logistics providers are likely to see a slowdown in business due to reduced demand.

Retail services and transport dominate East Coast logistics

Sydney, Melbourne, Brisbane - E-Commerce Category Take Up 2007-2020



Source: JLL REIS

Logistics set to dominate capital markets in medium term

From a sectors perspective, core investors historically adopted weightings of 30-50% office, 30-50% retail and 10-20% industrial/logistics[19]. Given the rapidly changing economic circumstances bought on by COVID-19 and speed of structural change, our view is that core investors remain materially underweight logistics and overweight retail in their weightings.
To maximise performance over the next five years, we believe optimal core portfolio settings should have an APAC bias with higher weightings to logistics, multifamily and office, whilst maintaining a defensive position in core retail. The following is how we are thinking about our sector weightings.

Sector	Pre-COVID-19 Weightings	Post-COVID-19 Weightings
Office	30% - 50%	30% - 50%
Retail	30% - 50%	30% - 40%
Logistics	10% - 20%	20% - 30%
Multifamily	0%	10% - 20%

Source: AMP Capital Real Estate

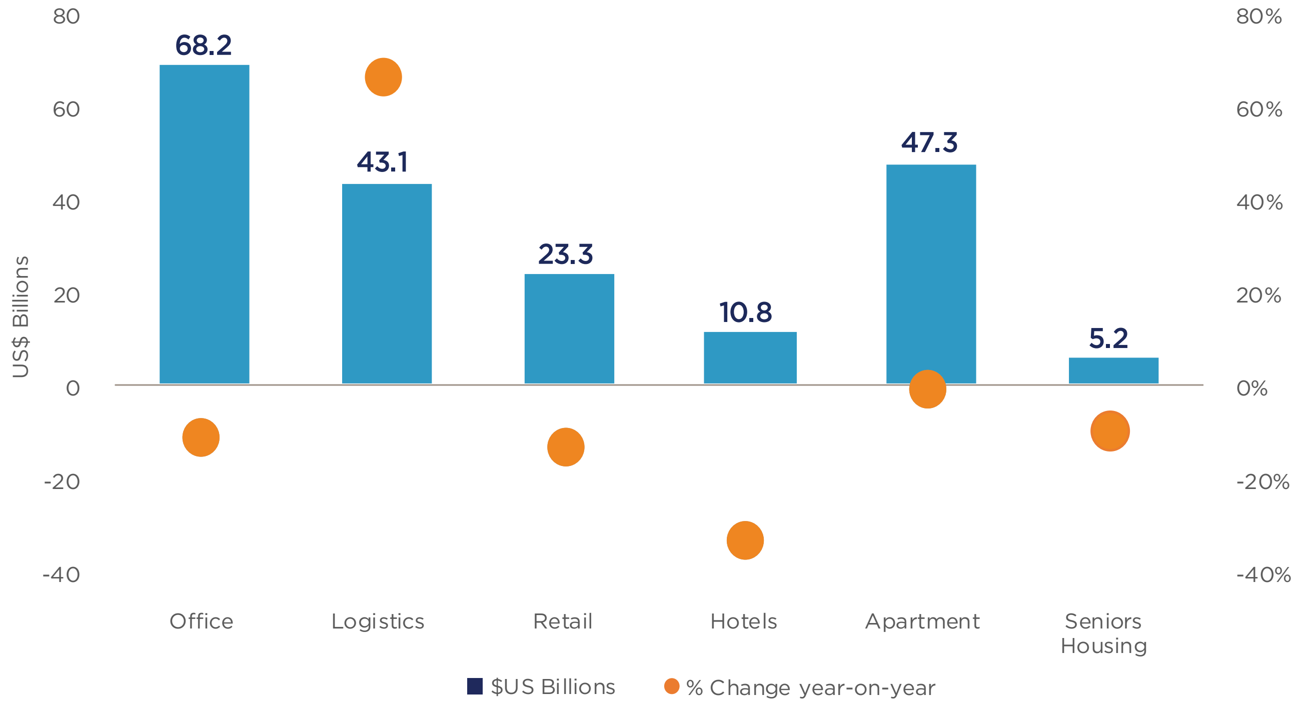
Investors are already starting to realign their portfolios along these lines as the weight of capital shifts strongly towards the core logistics sector, away from office and retail. According to sales data released by Real Capital Analytics in April, logistics was the only sector to see investment levels grow. As at Q1 2020, the logistics sector accounted for $US43 billion in global transactions, up 65% year-on-year. Office remains the dominant asset class for capital allocation, with $US68.2 billion in transactions, down 12% year-on-year and retail $US23.3 billion down 14% year-on-year, respectively.

Accessibility to core, income-producing products may put a break on direct allocations in the near term, driving some capital into the securitised REIT markets where discounts to book value have opened up in the wake of sharp market reactions to the pandemic. We believe as the economic impact of COVID-19 becomes clearer, core strategies linked to solid, long-term income fundamentals will be a popular strategy amongst most investors, however opportunistic strategies arising from price discounting may drive value-add demand from private equity and high net worth markets in the near term.

19 AMP Capital Real Estate


Image: Goodman, Hong Kong.

Global Investment Flows Favour Logistics Strategies
Investment sales volumes & change Q1 2020 year-on-year



Source: Real Capital Analytics

Beyond COVID-19
10 long-term game changers that could transform real estate

01.

Growth in e-commerce

Structural

20% of Australian retail sales are projected to be conducted online by 2030. Led by consumers pursuing convenience and selection benefits, this effectively represents supply competition from a landlord perspective and a requirement of doing business for retailers, with implications for the value of space and supply chains.

02.

Hyper-convenience

Structural

Consumers (particularly younger segments) are willing to pay a premium for technology-enabled convenience (e.g. UberEats), and have higher expectations across all facets of life for when, where and how things should be available. Consumers are looking to make the essentials as convenient to focus their energy on the things that really matter.

03.

Experiences over things

Structural

Younger consumer have grown up in an era dominated by social media and digital interaction, however they actively seek greater personal connectivity. As this group now leads generational spend, shopping centres must transition from passive places ‘to buy stuff’ to engaging places ‘to do stuff’, and provide a meaningful return on time for consumers.

04.

Globalised competition

Structural & Cyclical

International flow of goods and people has created a global marketplace, reduced barriers to entry, and increased domestic competition. Categories resilient to the effects of globalisation are likely to benefit from inflationary tailwinds relative to tangible goods manufactured overseas.

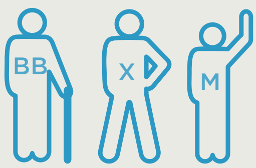
05.

Speed of change

Structural

Speed of change is increasing as the internet facilitates and democratises global access to capital and resources, and saturation/ maturation of trends occurs more quickly due to instant, widespread dissemination of information. This pressures those trying to align to consumer trends.

06.



Generational demography change

Structural

There is a changing of the guard as wealth transitions from Baby Boomers to digital natives, who have grown up in an internet-enabled, globalised world, and have different living and leisure preferences.

07.

Wellness (personal & planet)

Structural

Environmental awareness is driving an increased sense of human sensitivity and responsibility, affecting consumer behaviour and investor preferences. Consumers are prioritising their mental and physical wellbeing, beyond traditional medical services and religious spirituality.

08.

Personalisation

Structural

Social and digital mobility is accelerating the rise of individualism, while also more closely connecting us to our communities. Facilitating a sense of simplified but personal experience and identify is critical to driving relevance and long-term connection.

09.

Rising Asian influence

Structural

Asian influence is rising globally and locally, driven by population scale and economic relevance in a globally-connected supply chain. This is more pronounced in Australia given our geographical proximity and the significant proportion of population growth from Asian migration.

10.

Urbanisation

Structural

Populations continue to concentrate in metropolitan locations, driving a divergence in population growth and changing the density, connectivity and lifestyle of inner-urban communities.

Source: AMP Capital Real Estate
Image: Pacific Fair Shopping Centre, Gold Coast