GLOBAL REAL ESTATE OUTLOOK

By Neal Lindsay & Andreas Costa

Predictions made this time last year had to be ripped up as commercial real estate markets were left reeling by the impacts of Covid-19. The eruption and rapid spread of the coronavirus was one of the most drastic shocks the world has seen in many generations.

The length of the current downturn remains uncertain. In December economic activity was still contracting in most of the developed world, due to a fresh resurgence of the virus, particularly in Europe. Large Asia-Pacific economies have not yet turned the corner to growth, either. India is facing a severe downturn, and strained relationships between the United States and China are creating significant geopolitical tensions.

Beyond that, the pandemic appears poised to affect almost all aspects of life, including the use of real estate, and for decades to come.

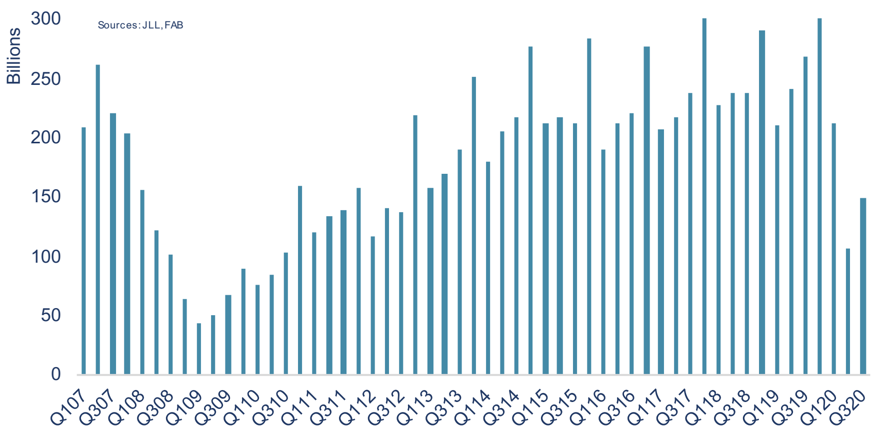
The challenge for the real estate industry now is to start determining the trends that Covid-19 has instigated, and their longevity. During the Global Financial Crisis (GFC) predictions became stale very quickly, and longer-term trends were difficult to ascertain.

Some clear trends have already started to develop, though. There is a dichotomy in performance across sectors: industrial real estate, health care, data centers, and cell towers have been positively disrupted, while offices, hospitality and retail have felt the negative effects. According to Deloitte, global commercial real estate deal volume declined 36% year-over-year to US$306 billion in 2Q20 due to economic stagnation and an uncertain pricing environment.

By the third quarter of last year prices had begun to show early signs of stress across the more negatively-impacted real estate types in the US. In contrast, industrial real estate was still quite buoyant. However, capitalization rates remain lower than at any time during the GFC across all key sectors. However, unlike during the GFC, commercial real estate companies had generally strong financials at the start of the pandemic, and capital markets have remained relatively liquid.

In debt markets, signs of stress are appearing as some banks retrench. Troubled loans are rising; banks, fearing higher delinquencies, are tightening lending standards. In several sectors, rent collections have remained

Total global commercial property transactions (US$)



healthy, but largely because of higher tenant incentives and leasing concessions. Along with the evolving financial landscape, the pandemic has resulted in seismic shifts in the way people live, work, and play, which has put unique pressures on certain real estate sectors. But it has yet to be seen whether all the short-term impacts will represent fundamental, structural changes.

Before the pandemic, many companies were already moving towards flexible working arrangements, while at the same time expanding their office footprints. This dichotomy is likely to narrow. Office space is a significant expense that companies have started looking at optimizing, and often reducing. The majority of commentators believe more companies will choose to allow employees to work remotely at least part of the time. Several major companies have already announced more permanent flexibility regarding the location and nature of the workplace. These new plans range from one or two days a week, to full-time work from home, depending on the function. Experts have forecasts ranging from minimal impact (as a requirement for lower office density offsets work from home intitiatives), to an overall decline in office space demand of 10-15%, according to PwC's Emerging Trends Report.

The bricks and mortar retail environment was already experiencing significant pressures, which have been exacerbated by Covid-19. The UK offers plenty of evidence of the impacts of the second dip, in the form of Debenhams and Bonmarché sliding towards bankruptcy. Neither are new headlines of financial distress, and are proof that some much-needed Darwinism is playing out in retail.

As encouraging as all the vaccine news has been, it does not change the fact that structural changes are underway in the retail sector. While the adage 'stores still matter' is heard loud from the industry, more pain surely lies ahead, though it will not be spread evenly. The pandemic-based recession will force more rent resets and raise vacancies across the board, but the top brands will take advantage of the lower rents to upgrade their locations, while leading shopping malls will leverage any empty space to improve their tenant rosters. Conversely, underperforming locations will need to adapt, converting some space to complementary uses. Clearly obsolete malls will finally need to forget notions of recovery, and reconfigure themselves. Conversions to distribution

centres to service remaining physical and online retailers may make sense; otherwise, conversions to new uses will be the only solution.

On the other side of the equation, however, the industrial sector goes from strength to strength as the structural factors driving growth have accelerated post-Covid. Increased emphasis on risk management and supply-chain resilience is evidenced, with many such strategies transitioning from 'just-in-time', to 'just-in-case'.

In recent years, the relative and absolute return outperformance of logistics real estate has been underpinned by multiple structural drivers. Covid-19 accelerated those forces, including e-commerce, speed-to-consumer supply chain strategies, and logistics users' adoption of high-throughput modern logistics facilities. E-commerce has now become an almost indispensable resource, ultimately driving demand for logistics space, which has bounced back sharply, hitting record or near-record levels in several major global markets during the last quarter.

The hospitality sector continues to navigate uncharted waters, amid heightened economic uncertainty. Travel restrictions for both personal and corporate travel have markedly reduced occupancy rates and income from events and meetings throughout the year. Operating expenses to ensure heightened safety protocols are met will further impact business bottom-lines. While the retail sector issues were intensified, there can be no doubt the hospitality sector has been the hardest hit, with a difficult and prolonged recovery expected.

It is possible that pent-up demand will cause a surge in travel once vaccines are rolled out and restrictions are lifted, however. The UAE hospitality market is well-positioned to be among the first to enjoy a recovery sometime during 2021, driven by supportive stable fundamentals – its centrality of location, surety of weather, and the general feeling that Dubai in particular is open for business. However, in reality it is more likely that travel will be undertaken methodically and with greater consideration than during pre-Covid times. Furthermore, the job losses seen are likely to reduce discretionary expenditure, while corporate travel is likely to remain heavily restricted in the short-to-medium term.

Early indications point to 3Q20 as likely having been an inflection point in real estate capital markets. Following the sharpest drop-off in transaction volumes in recent years, direct transaction volume declines decelerated during the quarter, down 44% from Q319, according to JLL. Markets of scale with access to capital in Asia-Pacific and Western Europe are leading the recovery. Although the US is lagging, it remains the most active market globally, with genuine investor interest. Record low interest rates and substantial government intervention are supporting real estate debt markets globally.

Real estate transaction pipelines are recovering globally, and offer a sense of optimism for the quarters ahead. Investors do remain fairly cautious, though, with many preferring defensive, income-oriented assets. Opportunistic and high net worth investors are poised to capitalize on market fragmentation, while institutions often remain critical of pricing. Markets are firmly in price discovery, and value transparency is expected to rise as activity steadily increases during 2021.

Commercial real estate investors appear to be hoping that premium office buildings in big cities will be a good way to ride-out economic uncertainty during the remainder of the pandemic.

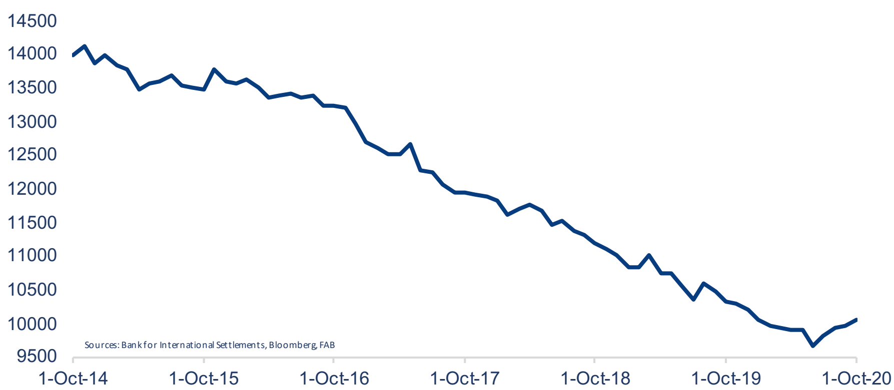
In one of the largest office deals globally during 2020, sovereign wealth fund China Investment Corporation bought an additional 50% stake in the 44-storey Grosvenor Place in Sydney for A$925 million (US$676 million), taking its overall holding in the real estate to 75%.

Global insurance firm Allianz spent €500 million (US$594 million) in September on two Paris office towers within the landmark commercial complex, Citylights. The deal was the group's largest-ever office transaction in Europe. Also in September, private investment firm Tristan Capital Partners acquired seven office buildings, comprising AEW's City Office Germany Fund.

Ultimately, long-term demand for high-quality offices in prime locations should outweigh any short-term increases in vacancies. Demand is also rising for high-quality assets in global industrial and retail sectors.

In addition to the hunt for income security and yield, many investors are pivoting to strategies that focus on domestic and regional markets. Intra-regional activity as a share of total investments made globally during the third quarter of 2020 climbed to 14%, the highest rate in more than a decade, according to JLL.

Abu Dhabi property price index



In Europe, domestic yield compression continues for the very best prime assets in Paris, Germany, and in London, where CBRE indicates there could be close to US$50 billion in dry powder ready to be deployed into that segment. German and French capital accounts for the majority of recent activity, followed by global investment managers from the US and APAC.

Overall, the low-yield interest rate environment makes real estate highly attractive on a relative basis, and there remains a significant amount of capital waiting to be deployed in the industry.

That is particularly true of the UAE.

In the past 10 years, Dubai has risen within the ranks of global cities. Its successful efforts to diversify the economy have contributed to a major increase in capital inflows, facilitated by business reforms and strong national support. The Emirate is emphasizing high-growth, 'knowledge' sectors, and an innovation economy.

In recent years, citizenship, nationality and resident rights for expatriates have been a focal point of UAE Government reforms. Such reforms are fundamental to the city's economic diversification, as they encourage the retention of graduates and highly skilled talent, as well as the emergence of new expatriate-owned businesses. Further potential to add new 'Golden Visa' arrangements and the recent announcement of one-year 'virtual working' visas should lead to further improvements in the UAE's economic competitiveness and status as a global hub.

Abu Dhabi has gradually acquired a strategic position as an inter-continental hub for trade, talent and capital, and now plays a strategic role in promoting the UAE-China-India corridors. Since 2017 more than 15 Chinese companies have established operations in the Khalifa Industrial Zone (KIZAD). The new associations with Israel are likely to further promote inflows into various UAE business sectors, with commercial real estate very likely a beneficiary.

In summary, Covid-19 is expected to have a number of long-term socio-economic implications that may re-shape the way companies and individuals consume, create value, and interact. Both Dubai and Abu Dhabi may be beneficiaries in paradoxical ways as the 'flash recession' resulting from Covid-19 comes to an end. The structural advantages for tourism in Dubai and Abu Dhabi are strengthening, with pent-up demand likely to be satisfied, starting sometime during 2021. At the same time, easing citizenship and business restrictions argue in favour of a recovery in real estate prices in the UAE, despite headline reports of a continuing surplus. The advent of EXPO 2021 later this year is another positive for the country's real estate sector. Meanwhile, as we go to print, the most recent data from the Bank for International Settlements detailing Abu Dhabi residential real estate prices, to the end of October 2020, shows that the index had improved for four consecutive months.