



Update  
COVID-19  
Impact on  
Real Estate Market  
in Sri Lanka

KPMG in Sri Lanka

May 2020



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## Update on COVID-19

The first COVID-19 patient in Sri Lanka was reported in January 2020. The second patient was detected several weeks later on 10<sup>th</sup> March, and as at first week of May there are 700+ cases. Sri Lanka is presently in stage 3 of the outbreak – Cluster of Cases according to WHO classifications. Several proactive measures are being taken by the Government of Sri Lanka (GoSL) with the aid of the armed forces and health officials of the country to control the outbreak. In order to control the spread of COVID-19, the GoSL enforced a curfew across the island to encourage social distancing. Inter-district travel was curtailed and districts such as Colombo, Gampaha, Kalutara, Puttalam, Kandy and Jaffna identified as “High Risk” areas, were placed under a stricter curfew. The lock-down has caused most economic activities to come to a standstill, with service-oriented industries working remotely, where possible.

The global economy is likely to hit a recession. Fitch estimates the global economy to contract by 1.9% and expects the forecast to return to pre-virus level by late 2021 for the US and Europe. The ADB also anticipates the global GDP to decline by 2.3% to 4.8%, depending on the severity of the demand shock. The Sri Lankan economy will also have a negative impact, with recovery anticipated in 2021.



## Implications on the Real Estate Market of Sri Lanka

The extent of the impact and recovery will depend on the duration and spread of the virus which is still uncertain and the subsequent trajectory of recovery in economic activity. There will be potential delays in investment activity over the next couple of months, owing to the uncertain economic conditions. A slowdown in the construction and engineering sector can be anticipated, as a result of the lock-down and limitations in financing. The industry is evaluating options on how activity can recommence, while ensuring the health and safety of the workforce. The construction sector is also reliant on countries like China and India for imports of construction material. Procurement delays and exchange rate depreciation will drive input costs upward. The impact of the COVID-19 outbreak will be felt across all real estate classes, with the most severe impact being on the Hospitality and Retail segments.



## Leisure related Real Estate Market

The most severe impact of the COVID-19 outbreak will be felt in the Hospitality sector. Sri Lanka's lock-down and closing of its international airports has brought the demand for domestic and international tourism to virtually zero levels. Recovery is dependent on the economic bounce back of Sri Lanka's main tourism source markets and the opening of the international borders. This is a further negative impact on the industry which was severely affected by the Easter Sunday attacks last year, and led to tourist arrivals dropping by 18.0% to 1.9 Mn in 2019.

India was the largest source of tourists in 2019, contributing to 18.6% of the total arrivals. This was followed by UK and China which contributed 10.4% and 8.8% respectively. Impact on arrivals due to the lock-down in China in February, the busiest travel period during the Chinese New Year, was felt across Sri Lanka too, with arrivals from China dropping by 92.6% in the month of February. Overall, tourist arrivals declined by 6.5% and 17.7% YoY respectively during January and February 2020. Tourist arrivals in March dropped by 70.8%, mainly due to restrictions in issuing visas and the closure of all ports of entry for passengers from mid-March, amidst global travel restrictions.

Even though Sri Lanka has managed to contain the spread of COVID-19, the outlook of the industry will largely depend on how fast the key source markets recover. The Chinese economy is gradually restarting, India has recently announced a 21-day lock-down, which will run into early May and countries like the UK and the rest of Europe continue to see new cases, which makes it uncertain to predict recovery dates. Approximately 2.9 Bn people across the world are currently in some form of lock-down. The impact of travel restrictions, event cancellations, reduced personal and business travel will impact short term occupancy levels. Low demand will bring pressure to reduce Average Room Rates, thereby creating a significant impact on profitability.

The recovery of the sector is likely to be well into 2021, assuming the pandemic does not see a resurgence.

Over the past couple of years, Sri Lanka has seen a sharp rise in the supply of leisure related real estate. The supply has outpaced tourism demand, and the informal leisure sector such as home stays and serviced apartments have also been creating pressure on room rates in the formal sector.



## Retail Space Market

Retail stores and malls will suffer, as a result of the drop in tourism and reduction in domestic retail spending on non-essential goods. Domestic buying may be affected as a result of reluctance or inability to visit such retail and mall spaces, due to health concerns. We see this as a temporary effect, unless otherwise local consumers' earning capacity is hard hit with uncertainty in the local economy. Restaurants are also running empty, with limited operations only through delivery. Certain retailers may face higher cash flow risks, due to high operating costs and cash being tied up in the stock build-up for the Sinhala and Tamil New Year season. Supply chain and business operations of certain retailers may be affected due to supply shocks from China, with restrictions imposed on non-essential imports to Sri Lanka (until Mid July) and exchange rate depreciation. Retailers focused on e-commerce platforms and home delivery are beneficiaries at this point of time. Retailers facing tougher business conditions may look for relief on rents. Rental growth will suffer in the short to medium term, with effects also on occupancy rates.



## Office Space Market

The outbreak will put pressure on the office space market and rental growth will suffer in the short and medium term, as a result of low economic activity and negative corporate sector performance. Office occupancy rates are likely to drop. Properties on short term leasing options and expiring leases are the most vulnerable. In order to maintain occupancy during such uncertain time periods, landlords could be well advised to expedite lease negotiations and by offering concessions on lease terms in the short run, will ensure faster deal execution. Even when the lock-down in the country is lifted, many businesses will find it difficult to return to normal circumstances and therefore, we anticipate more corporates will transition to remote working and the use of collaborative technology. The long term implications on the demand for office space will be tested amidst this shift. Co-working spaces and flexible office spaces will have positive implications in the longer run.

Health and safety will be at the forefront of corporate priorities. Businesses will have to create continuity plans for business operations, along with focusing on property management. Increased hygiene measures will have to be adopted and monitored continuously. It will be increasingly important to look into the ventilation, air filtration and general sanitation of buildings, in order to avoid any possibilities of contamination.



## Residential Market

Impact on Residential Real Estate is less compared with the Hospitality and Retail segments. Closing of deals relating to the sale and renting of apartments and houses will be on hold for a period of time, due to the difficulty in arranging sales visits and inspections of properties. Further, despite the actual domestic demand for housing units (with the growing population, reducing household size and housing gap) in the market, the overall economic situation could make home buyers anxious and postpone purchasing decisions. Any transactions during the short term will fetch distressed prices.

Residential apartment sales were seeing renewed interest since January 2020, following a lull in the market in 2019. The residential apartment market has seen a lack of continuous demand, due to both concerns on the economic and political front and also inconsistent policies in the sector during the past few years. More fundamental reforms in policies will have to be devised at national level, to attract foreign investment and expatriate demand in the market.

Common spaces of highly dense vertical buildings and gated housing developments will pose a high risk of virus transmission. Therefore, additional attention must be given on drawing up plans and protocols for present and future scenarios, in order to mitigate such risk.



## Logistics and Warehousing

Global supply chain disruption will restrict activity in the main ports and airports, and the contraction in China's manufacturing sector will cause a drop in the utilization levels in the short run. The relatively long periods of lease contracts will create less pressure on rental rates, though tenants may want discounts and rent holidays. However, in the medium term, in the wake of COVID-19, logistics companies are likely to reassess inventory volumes in line with their business continuity plans, which could translate to greater demand for space. Further, with the growth of e-commerce and the trend of both diversifying manufacturing locations across the globe and near shoring, these may create future demand for Warehousing space.



## Final Remarks and Conclusion

The immediate implications to the real estate sector from the pandemic is straight forward, but the medium to long-term impacts can only be assessed with time. The impact on the main economic sectors, new business strategies by key sectors to weather the crisis and the related implications on labour, will impact on the medium-term outlook of the real estate sector. The aftermath of COVID-19 could also lead to changes in the operating models practiced, such as the greater use of remote working and use of collaborative technology to connect people remotely and the wider use and acceptance of e-commerce by Sri Lankan corporates and the general public. This too will have an impact on the real estate sector.



## How can KPMG Real Estate Advisory help you?

KPMG's Real Estate Advisory is committed to advising corporate institutions and individuals in identifying, evaluating real estate opportunities and enhancing returns on real estate investments. With a broad network built, working with over 1,000 businesses and keeping abreast of changing market dynamics, the Firm advises clients on a range of options and assists in executing a client's real estate strategies with appropriate structures.

### **The Real Estate Advisory Practice provides advise on;**

- Advise on structuring, financing and sale-leaseback services pertaining to real estate transactions
- Analysis and valuation of real estate investments and portfolios
- Market studies and project feasibility studies
- Project management advise to better manage risk and enhance returns from real estate investments

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