Global Real Estate Conference: Insights

Covid 19 and its Influence on Real Estate Values

Presenters:
Mark Wynne Smith, Global CEO of Valuation Advisory, JLL

Mark Wynne Smith:

So hi, I'm Marvin Smith. I'm the Global Head of Valuation Advisory for JLL. And I'm going to give you a very high level, a very fast run through how we see the global real estate market today. What I'm first going to do is to have a look at the state of the real estate capital markets. Again, no surprises. Last year saw 28 percent reduction in overall activity. But what was encouraging was seeing performance in the 4th quarter, where the volumes grew by 65 percent from the third quarter.

The other encouraging aspect was that Q4 liquidity equated to about 35 percent of total volumes, and that's the highest that we've seen since 2012. So what was really moving hands quickly? The answer was core offices, and there's no surprises there. There was a flight to quality and a flight to security as well, and those were mostly in the big CVDs of the major global cities.

In terms of some of the key themes behind this recovery, or the early phase of recovery that we think we are in at the moment, and the first one is this real focus on the talent-rich markets. So, you look at the US cities in the Sunbelt, Dallas, Raleigh-Durham. The real beneficiaries of additional invested focus, and those who clearly aren't experiencing the same focus are the larger open markets, like New York and San Francisco.

So as I've mentioned, there was a big focus on core 32 percent of 2020 deal flow was in the core space and that's significantly higher than previous years where we've seen higher yielding strategies getting much more attention. I'm going to touch on logistics living, private capital in a second, and I'm also, as far as debt is concerned, I'm not going to go into too much detail. But clearly we're all aware that crazy amounts of debt appeared, or availability increased through the year. Yields started to compress. All of these factors really helped to drive this much higher level of activity in Q4.

So picking on a couple of those and going into a bit more detail. First of all, private capital, as you can see here, that is the segment of the market that is proposing to increase its exposure to the real estate market the most. Traditionally there's been a focus on the trophies, the trophy office, the hotels, high end retail. But what I'd say is there's been a maturing approach amongst private capital, mostly in domestic markets. Again, it's the highest level of familiarity there.

But what we saw through 2020 was a willingness to get involved in much more complex transactions, be it purchasing debt, platform transactions, and also getting increasingly involved in recapitalizations as well. So private capital is a small element of the overall real estate market. But we think the way it's going to behave over the next 24 months is going to have a much higher influence on the market generally.

Now again, I can show you slides which clearly demonstrate the capital raising through 2020 was down year on year. But I don't think that's the point here. The more important thing is seeing how allocations at the moment are expected to rise through 2021. Everyone's generally shooting, for this 11 percent average allocation, around 59 of the top 100 investors are actually below that. But if it were possible through '21 to see a closing of the gap up to this 11 percent, that would bring close on an additional trillion dollars of capital into the real estate market. And I think in terms of some underpinning future liquidity, this is one of the most important factors to focus on.

Now what's clear is that there will not be an even recovery here. Again, some of these sort of themes in front of you are fairly obvious. But just to pick on a couple of them. I think this shift towards alternatives, and it's something I'll explore in a second, is really deep seated now. It's reflecting demographic trends and the beds, meds, sheds, spreads. These themes are some

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things which are very firmly baked into investors' allocation strategy. And also, this more towards flexibility. Again, the old-style institutional lease … I'll go into it in a second … but I think it is a thing of the past. And landlords occupy this key change of approach. It's going to mean that in terms of going towards the more operational aspects of real estate, I think the market's just going to have to grow much more sophisticated to be able to handle that.

Now I turn to corporate occupiers. And we've clearly got to listen very carefully to what corporate occupiers are saying, because their behavior has changed. And the fundamental thing is that there is a shift towards a worker-centric model. Now it's great news that companies like Google, Goldman Sachs, have said that they're expecting all their employees back in the office at a certain point. But are researchers telling us something slightly different? Which is that clearly employers, occupiers, need to give space where performance is going to flourish. But at the moment our offices aren't set up to do that necessarily. So the need for more creative space, space for learning, development, co-working, all of these aspects have got to be reflected in how the offer evolves over time.

And in terms of what this really means is the going towards this hybrid working environment. Now again, something else is quite hard to define. But the way we are defining it is remoteness that is integrated and optimized. And I think 2021 is going to see many more organizations really evaluating their needs in this space. Why is that? Well the most recent human experience survey that we've done has suggested that the employee desire is now to move to an average of 2.4 days working outside of the office, and that's doubled since the pandemic took place. And you can see for what's in front of you, there's still a spread. And 24 percent wanting to work exclusively in the office and 26 percent keen to work exclusively outside of the office.

So what does this mean for the build space? I think as far as the overall concern is around what densification looks like. And there clearly have been a lot of numbers thrown out there in terms of what occupiers may do. But our latest pulse survey which we do of corporate occupiers is suggesting that around 50 percent of tenants are all actively redesigning their space.

In terms of whether they will shrink space? I think it's too early to say. Some of the modeling that we have done has suggested that there will be a de-densification of somewhere between five and 15 percent. But that's going to vary city by city. And it's also pretty complex to manage the demand as well, because we know traditionally that occupancy on Fridays is 50 percent and Tuesdays 90 percent. But this is what building managers are going to have to get used to, is to be able to accommodate these different use patterns within the different working environments as well.

And last just to finish off on this topic, to look at the leasing volumes. Again, leasing not surprisingly fell … or global leasing volumes fell by something like 42 percent last year, to just over 25 million square feet. Now again, it wasn't even. That trend was significantly higher in the US where obviously the switch to remote working happened very quickly, coupled with greater demographic shifts as well as there was the move towards the Southern Sunbelt states. But again, the sort of converse, if you look at India, South Korea, mainland China, there was very little movement in that respect.

And also, just to touch on absorption rates as well, yes, they got to a new annual low in 2020. The increase in vacancy was something like six million square feet in the world, and also you look at the US, negative absorption rose to close on four million square feet as well. So there's clearly some challenges there. We need to understand. I think it's too early to call it at the moment, but I think the one thing we are very certain about is that tenants are going to remain very cost conscious and they're also going to look for much greater flexibility around their leasing needs.

Now turning to the sectors that have flourished and those that haven't. Again, '20 through '21 it has all been about the alternatives, alternatives have outperformed a number of the more traditional operating classes, and the slide that's up in front of you, that's the Navy(?) data which is showing the growth in stock price. And to pick one, the data centers went up by nine percent, where versus (Inaudible) 47 percent down, over last year. And I think obviously it's an early indicator here.

There has been some recovery in some of the more traditional stocks. But looking at data centers, the demand through additional storage requirements, through cloud, it's pretty obvious why it's there, will continue growing. We're expecting a lot of global M&A in this sector. And we also are adding 5G into the equation as well. So certainly a sector that sees a lot of significant tailwinds for it, and very helpful to investors who want to place additional capital in the space.

Moving to logistics. Again, there's the hot topic the whole way through 2020. Again, the why is fairly obvious, all of the change in behavior that we saw around retail. But e-commerce has been the main driver of this new leasing demand. Again, e-fulfillment accounted for about 16 percent of total leasing in the US and about 22 percent in Europe. And indeed, in the UK now we've reached the point of online retailing accounting for 42 percent of all the space that was transacted in 2020.

We still have more to come. The last mile sector, again particularly in tight vacancy markets like New York, LA. We have vacancy below six percent, demand significantly higher. But I also think that there is a concern that this market is getting potentially over-purchased at the moment and rental income needs to come through to keep delivering returns.

Switching to life sciences. Again, there's two factors that I find fascinating on this stage of this slide. Firstly, the number of diseases which actually have treatments in place today is miniscule in comparison to what is required in the future. And the second thing is, just the demand for laboratory space. Now I know again in terms of there are different ways of getting into this market. Obviously there's the developer and investor.

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There are already established life science REITS there. But I think it is intriguing to see how much of a position Blackstone and others are building in this market.

In terms of what it means for real estate owners, again, this is highly specialized space that these occupiers are seeking. Again, there are very few good developers out there currently. A lot of secondary offices which are not easy to convert at all. But I think we will see much more use swap here, subject to zoning and other limitations.

And finally, just to look at the multi-family market. Again, heavily established as an institutional grouping in the US. But what we've seen through '20 into '21 is the real shift to this being a global trend now, and indeed in 2020 about 25 percent of that global volume that I referred to earlier was in the multi-family sector.

Countries which are seeing the biggest move, mainly Germany, Japan, UK. Again, there is a shortage of space here and the focus is heavily on the buy to rent sector, and institutional investors want to get more exposure to it. And that's evolving as well. And we're now moving into the single-family rental market, and indeed you will have seen a couple of investors take major positions in single-family rental over the last few months.

And let's move on to the topic of ESG and sustainability. Again, we know that we sit in an industry which accounts for about 40 percent of emissions and this industry needs to think very, very carefully about what and how it is going to adapt to a net zero position. At the moment there are push/pull factors. The push is mostly regulatory. Again, Europe may have led the way, but I think it's encouraging to see that the US and other major governments are starting to really wake up and figure out how to necessarily catch up with those countries, but also to take responsibility for driving change.

But the pull increasingly is coming from investors, customers, shareholders. And I think in terms of what it means now is just looking at how many companies have now signed up to target, science-based target, something that we're referring to as the "race to zero" in corporate real estate. So you've now got 95 organizations who've signed up to the net zero carbon buildings commitment. And I think we'll see more to come in the future.

Now where we stand currently of course is there is very little market evidence that this is affecting pricing or indeed demand. But I think we and others have been spending a lot of time trying to figure out what the cost of getting to a net zero position actually means. And insuring that investors are starting to take this into consideration. And there are also the issues of the brand discount, the green premium, stranded buildings. But I think in terms of what we hear a lot about over '21 and '22, this is going to become a major driver of value and something to pay very careful attention to.

So to summarize then, I think the investment case for real estate remains very strong. Again, we've obviously got market volatility in the equities market. That tends to drive more capital into real estate. But we're looking at about 350 billion of dry powder today. Trying to find a home. And again, we haven't spent a lot of time talking about stress or de-stress. I do think that most of that capital will find a place as markets start to recover.

We've talked about the role of commercial real estate and I do think that this flexibility of at-workplace around lease terms, operation, that's something that will be a very, very firm trend within the next 12–18 months. Organization, whilst it's checked potentially in some countries, again you've seen this big move in the US South. We think that whilst again pace may have slowed down, this will pick up again once the effects of the pandemic start to recede.

The sustainability, I've mentioned, and I think again, the way I'd summarize it is that it's the changes around individuals taking responsibility as well as corporate, and I think this impetus coupled with government is what's going to drive us into a much better position.

And finally on the tax side, again, we've all experienced huge acceleration over the last 12 months. But I think we've also got to look forward to a blurring of virtual and physical, which is also going to make occupiers, investors and the constructors of real estate get into a significantly better, more connected and more efficient point.

So hopefully that's given you a quick helicopter view of how we see the market today. Thank you very much.

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