For professional investors only

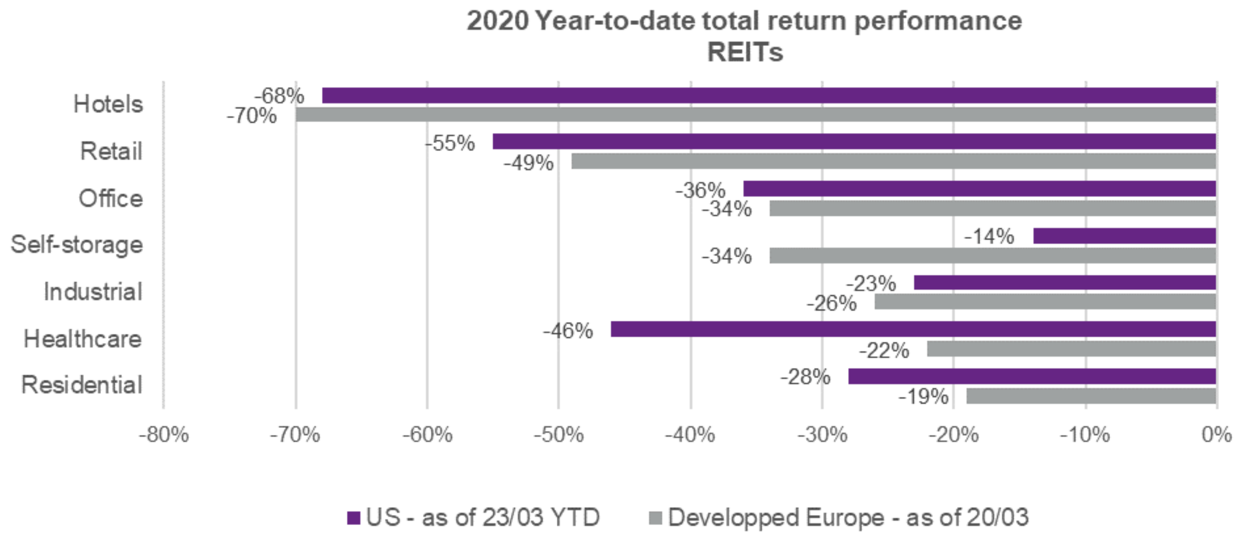
Covid-19:

What is the impact on Commercial Real Estate (CRE) Debt in Europe?

The full spectrum of Real Estate sectors and geographies has been impacted by the Covid-19 crisis; this is felt heaviest by certain sectors such as Hotels & Leisure and Retail, which are on the frontlines.

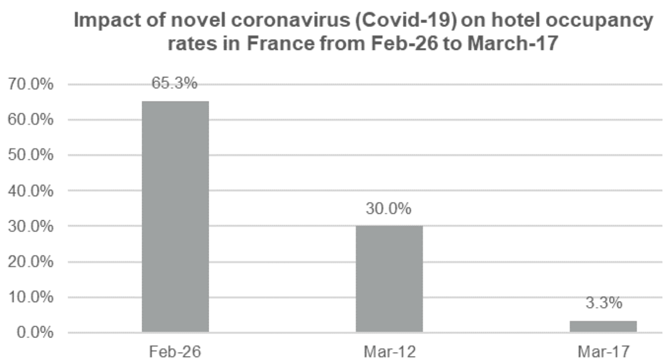
Industry Immediate Impacts

First "immediate" figures of the impact on the CRE Market



Graph 1 -Source: EPRA, NAREIT, Cushman & Wakefield, AEW Research & Strategy, information as of March 2020.
Note: Past performance is no guarantee of future results and may evolve over time.

Hotels and hospitality



Graph 2- Source Statista, STR CoStar, Information as of March 17 2020.

The impact of travel restrictions, event cancellations and apprehension to travel was immediately felt across the hospitality sector. In the short term, occupancy rates will continue to fall. For example, the occupancy rates in French hotels fell from 65.3% on February 26 to 3.3% on March 17.

As containment is expected to last across Europe, occupancy rates will remain close to zero. Post confinement, the recovery will take time, especially in places with a high proportion of international visitors, while locations accessible to a domestic clientele by car or public transport may benefit.

Retail markets

Global retailers must prepare to navigate this period of elevated cash flow risks and increased operational costs, arising from the slump in consumer demand and disruption to supply chains. Protecting cash flow remains crucial for all retailers, particularly for those with thin profit margins. **The hardest hit may seek temporary rent relief from landlords.**

According to a study on the projected impact of Covid-19 on retail sales in Europe, between March 9, 2020 and April 21, 2020, **retailers are expected to face a loss of £3.26 billion** due to disruptions caused by the current outbreak.

Graph 3- Graph 3- Source: Statista, New York Times, Zencargo, information as of April 2020.

Of the three European countries shown here, **Germany is expected to suffer the most** with £728 million lost during this period.

Retailers with robust infrastructure to fulfil online orders could be longer-term beneficiaries, placing a greater emphasis on the shift towards a flexible omnichannel retail model.

Industrial and logistics markets

Disruption to global supply chains is the main effect on the industrial and logistics sector. Reduced activity at major gateway ports and airports is resulting in falling utilisation rates and idle resources. **The outbreak will likely elevate the issue of supply chain resilience and risk mitigation.**

This outbreak may **accelerate the use of automation and robotics in operations** and reduce the sector's reliance on labour.

The move to online shopping, especially for groceries, could also become more permanent and, in turn, **boost demand for logistics** expertise.

Office markets

The outbreak could put **greater pressure on markets which are already in a late stage of their cycle.** This would create the potential for delays in investment activity and softer rental growth than previously forecast. An increase in remote working is likely to reduce office utilisation rates, making landlords exposed to short-term leases the most vulnerable.

Over the longer term, the outbreak will probably fast track the adoption of remote working and investment in collaborative technologies.

Industry Final thoughts

Although it is easy to concentrate on the short-term economic impact of Covid-19, **the longer-term societal and real estate impacts should not be overlooked.** The impact and aftermath will change the way we live and work, potentially leading to new operational models. **Could it prove to be the catalyst for certain secular shifts?**

Office – increased **remote working** and a greater focus on **health, well-being and productivity.**

Retail – the normalisation of **online grocery shopping**, forcing a **change in retailer behaviour**.

Industrial – the **de-globalisation of supply chains** to mitigate risk.

Sustainability – changed **perception of travel** and renewed **emphasis on sustainable** practices.

Technology – increased **integration of technology**, particularly PropTech (property technology) and MedTech (medical technology), impacting all aspects of life and business.

What about previous crisis?

As shown in the table below, the European office market was significantly impacted during the previous economic crises.

- **Capital values of offices have dropped by around 25%** in most markets over 2001-03. The same trend was observed over 2007-09 despite greater discrepancies between countries.
- **Office markets recorded severe reductions in take-up of around 35%** on average, while vacancy rates increased sharply (particularly in Spain).
- However, **prime yields expansion remained limited**, both over 2001-03 and 2007-09, as the decrease in capital values was partly offset by concomitant drops in rental values.

		OFFICE								
		Paris	Germany	Spain	Italy		Paris	Germany	Spain	Italy
Capital value (€/m²)	2001Q1	12879	8836	7284	8036	2007Q3	17255	6763	9953	9982
	2003Q3	9442	6575	5241	8793	2009Q4	10455	6377	5174	9610
	Evolution (%)	-26.7	-25.6	-28.0	9.4	Evolution (%)	-39.4	-5.7	-48.0	-3.7
Take-up (000m²)	2001Q1	624	167	279	120	2007Q3	708	150	351	141
	2003Q3	387	102	201	75	2009Q4	448	94	122	97
	Evolution (%)	-38.0	-38.9	-28.0	-37.5	Evolution (%)	-36.7	-37.3	-65.2	-31.2
Vacancy rate (%)	2001Q1	2.4	3.5	1.7	5.9	2007Q3	4.9	10.8	6.1	8.2
	2003Q3	5.9	10.1	7.7	6.9	2009Q4	6.8	11.6	11.1	10.5
	Evolution (bp)	350	660	600	100	Evolution (bp)	190	80	500	230
Rents (€/sqm)	2001Q1	950	396	428	383	2007Q3	738	345	435	520
	2003Q3	752	330	311	463	2009Q4	630	332	307	495
	Evolution (%)	-20.8	-16.7	-27.3	20.9	Evolution (%)	-14.6	-3.8	-29.4	-4.8
Prime yields (%)	2001Q1	5.6	4.75	5.75	4.73	2007Q3	4.8	4.9	4.25	4.5
	2003Q3	6.25	4.93	5.88	5.4	2009Q4	5	5.3	6.5	5.4
	Evolution (bp)	65	18	13	67	Evolution (bp)	20	40	225	90

Graph 4- Source : Natixis, CBRE, information as of April 2020.

Many **expect a drop of around 25-35% in 2020** with limited impact on vacancy rates or rent prices. Most scenarios are, more or less, based on a strong value correction during the crisis and a **rebound in 2021**.

Such explanations derive from several factors, such as financial support packages announced by European governments, shortfalls in existing capacities ….

On the other hand, **some analysts don't expect such a fast rebound in 2021.** This is due to aspects such as higher vacancy rates or pressure on rents due to the difficult financial situation of tenants, as well as corrections of anticipated yields from investors.

What about Commercial real estate debt: cash flow and value?

"Expect the best, be prepared for the worse"

Current market situation:

The immediate concern is **the cash situation of borrowers**, especially in the Hotel & Leisure, and Retail sectors. To date, a limited number of tenants have asked for non or deferred payments of their rent. Nevertheless**, figures are moving fast** especially when everyone expects longer confinement periods across Europe. One can reasonably expect **some deferred payments to the principal and/or payment of interest for the coming three to six months.**
So far, nobody anticipates a confinement period over six months…

But if worse comes to worse, debtors will have to envisage **two options:**

Option 1: **restructuring the debt to allow longer tenor**, especially for bullet loans maturing in 2020 or beginning 2021.
Option 2**: the use of their security package, pledge on the assets & shares of the borrowers to either reimburse the debt or hold the assets while waiting for better market conditions.**

The positive aspect for lenders is that, if the "expected" value corrections strongly impact the equity part of the financing, the Loan To Value based on those drops should not exceed 100%. This would therefore leave room for lenders to recover their investment.

Potential outcomes and points of attention:

As of today, we anticipate three likely outcomes:

1) **2020 market volume of new transactions will decrease** (some financing packages are already delayed) **compared to 2019 <u>but</u> we expect a shift of deals from 2020 to 2021**, as this was observed during the previous crisis.

2) **Pricing will increase** due to (i) **increase in cost of liquidity** and (ii) update of **risk assessment** on some sectors.

3) **Some downgrades for the transactions or sectors most at risk and potentially some defaults.**

We are closely monitoring the evolution of the following factors:

- **The lock-down situation** around the world, especially in the US but also in developing countries.
- National and international (EU, G7, G20) **economic support plans especially regarding rental payments policies**.
- **The liquidity situation** for corporates and banks.
- **Sovereign bond ratings** and **pricing.**

We are also **paying attention to the financial situation** of the biggest **Real Estate Funds in Equity.**

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