Q2 2020: Americas Commercial Property Survey

Fallout from Covid-19 leaves a downbeat outlook across the real estate sector

- Weakness visible in both occupier and investment sentiment indicators
- Rents and capital values projected to fall in the year ahead
- Industrial sector seen bucking the negative trend, particularly in the US

The RICS Q2 2020 Americas Commercial Property Monitor results suggest that the economic fallout in response to the spread of the coronavirus is continuing to depress momentum across the real estate sector.

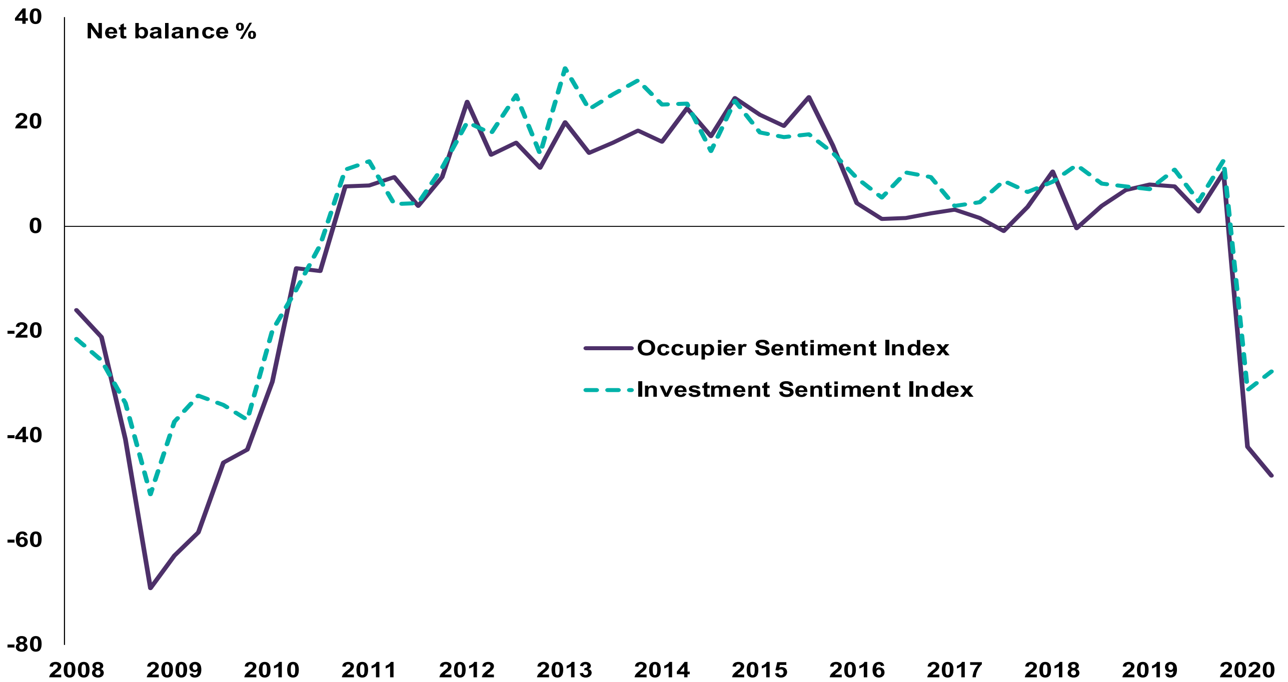
This is perhaps most clearly visible through the lens of the composite Americas Occupier and Investment indices (OSI and ISI). Chart 1 shows that in Q2 of 2020, both the OSI and ISI were firmly negative, coming in at -48 and -28 respectively signalling a fall in momentum across the region. Furthermore, when broken down, the OSI and ISI returned negative readings in all three countries covered in this survey; Brazil, Canada and the US indicative of a broad-based decline in real estate market activity.

Perceptions regarding where the market now stands in the property cycle also strike a downbeat tone with more than two thirds of contributors seeing the market to be in the downturn phase (as shown in Chart 3).

Unsurprisingly, the results highlight that the current macro environment is regarded as a risky one for commercial real estate investment returns. As shown in Chart 2, the largest share of contributors assign the risk at level 4 on a scale from 1 (no risk) to 6 (very high risk).

It appears that a pull-back in demand is a key factor behind the dip in momentum. In the US however, the sector breakdown shows that while enquiries have fallen sharply across office and retail segments of the market, demand for industrial space is still reportedly

Chart 1: OSI and ISI



rising. A net balance of +38% of contributors across the US reported a rise in tenant demand for industrial space in Q2 with this segment of the commercial property market continuing to benefit from the rise of e-commerce.

It is likely that a combination of weak economic conditions and structural changes will continue weighing on the retail and office sectors over the course of the next twelve months across the Americas. Average twelve month expectations for rents and capital values sit in the range of -4% and -10% across the prime retail and office segments and between -7% and -10% for secondary locations. Significantly, the industrial sector is seen bucking the negative trend. For the US in particular, rental and capital value projections for the year ahead are firmly positive for prime industrial assets.

Alongside the mainstream real estate sectors, expectations for rents and capital values suggest that little change is anticipated in data centres and multifamily units over the coming twelve months. Hotels, in contrast, are expected to come under significant pressure.

Survey respondents were asked to what extent they envisaged businesses scaling back their office footprint over the next two years. Across the Americas as whole, over half of the survey's contributors indicated that this reduction could be up to 10% while one-third suggested that it could in fact be greater than this. Only 10% judged that the office space requirements would be left unchanged. Alongside this, more than two-thirds of respondents said they envisaged a shift in office demand from urban to suburban locations. Meanwhile, almost all of the contributors in the Q2 survey (96%) believe that a greater emphasis will be placed on health and well-being in the workplace across the Americas.

Chart 2: How risky is the current macro environment for returns on commercial real estate investment?

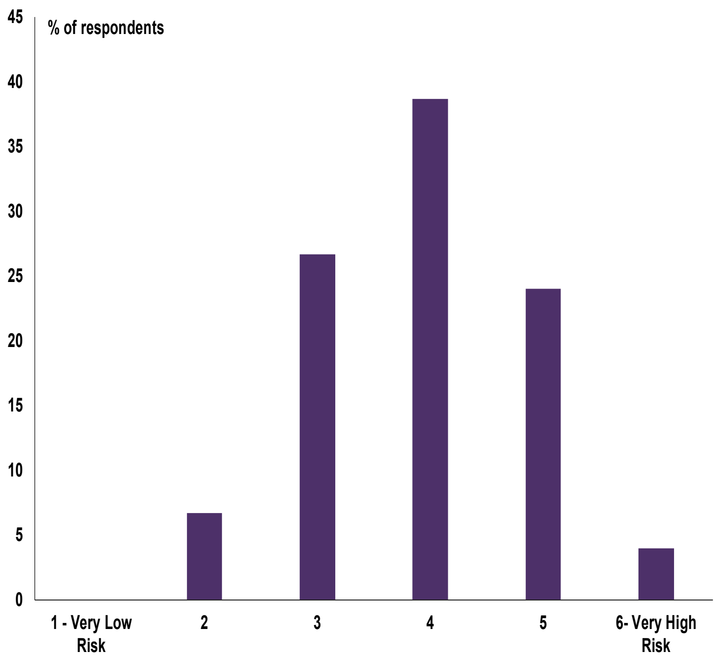
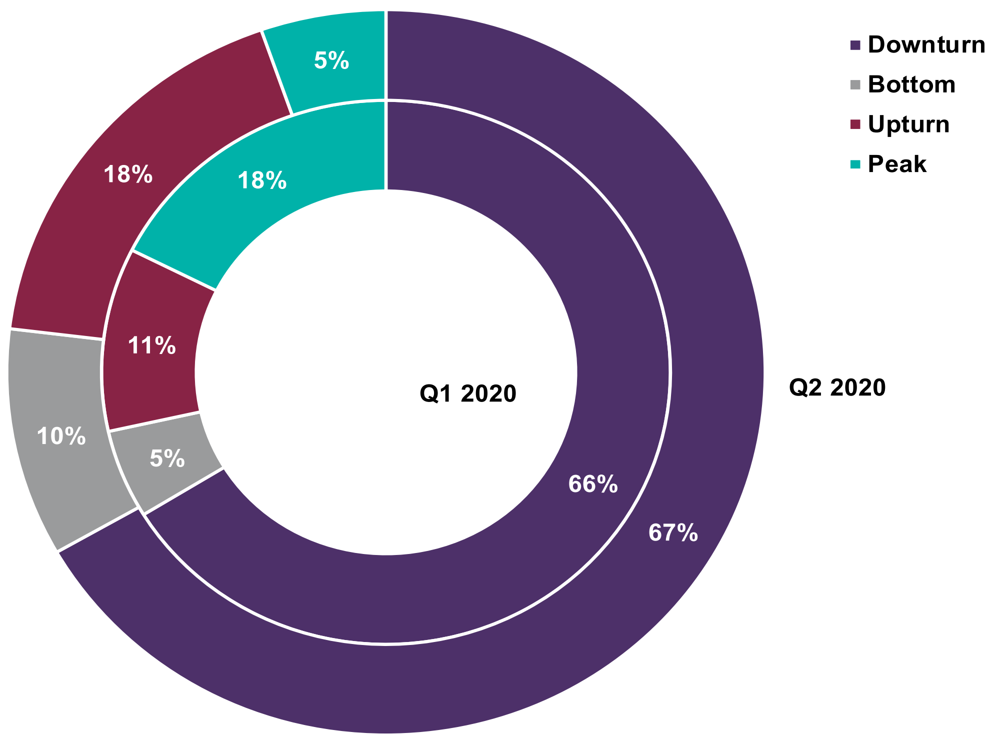


Chart 3: Phase of the Cycle



Key Takeaways

In Canada, rental projections for the coming twelve months have turned negative for the office and retail segments of the market

68% of survey participants across Canada view the commercial real estate market to be in the downturn phase of the property cycle in Q2, this is up from a share of 52% of who were of this opinion in the Q1 results.

Demand for office and retail assets has slipped sharply over the quarter in the US, however participants have reported an increase in enquiries in the industrial portion of the market

Following some improvement last year, contributors on balance have reported that credit conditions have deteriorated in the US in 2020

Both tenant and investor enquires have slipped materially over the quarter in Brazil, with a sizeable fall reported in each segment of the market

The OSI and ISI have slipped sharply into negative territory consistent with a contraction in activity across the real estate market in Brazil, this seems to have reversed the pick-up in momentum reported last year

Brazil

Key indicators to the Q2 2020 RICS Brazil Commercial Property Monitor suggest that the spread of the coronavirus and the subsequent economic downturn has taken a significant toll on the real estate market.

The Occupier and Investment Sentiment Indices, shown in Chart 1, slipped to -41 and -29 respectively in Q2, indicative of momentum slowing sharply over the quarter.

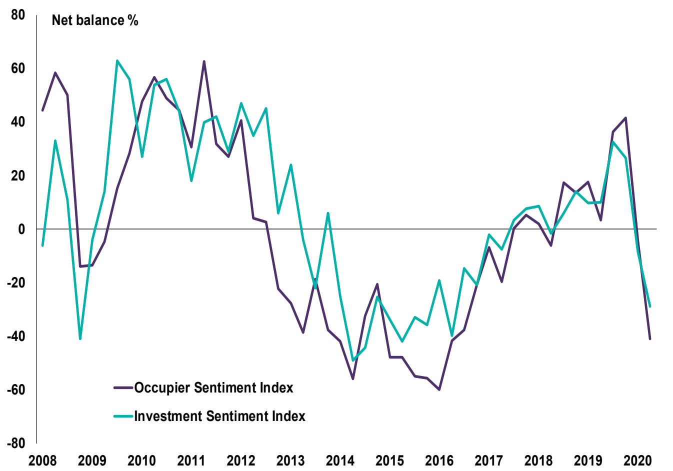
This has been driven by a steep drop in demand. The occupier demand net balance fell to -62% in Q2, down from zero in Q1, with a noticeable decline reported in all mainstream segments of the market (office, industrial and retail). A similar picture was depicted on the investment side of the market, with participants reporting a fall in both domestic and foreign investor enquiries.

As a result of these dynamics, contributors downgraded their rental and capital value projections for the coming twelve months. As shown in Chart 3 and 4, rental and capital values are seen falling across nearly all segments of the market. The only exceptions are the prime office and industrial sectors, where values are envisaged remaining more or less stable.

Alongside this, 55% of the survey respondents believe that the market is in the downturn phase of the property cycle (up from 15% in Q1). That said, more than a quarter of the contributors to the Q2 survey now perceive market conditions to have reached the floor of the current cycle.

More than half of the contributors consider commercial real estate property valuations to be expensive, this is a slightly higher proportion in comparison to the Q1 results.

Chart 1: RICS OSI and ISI



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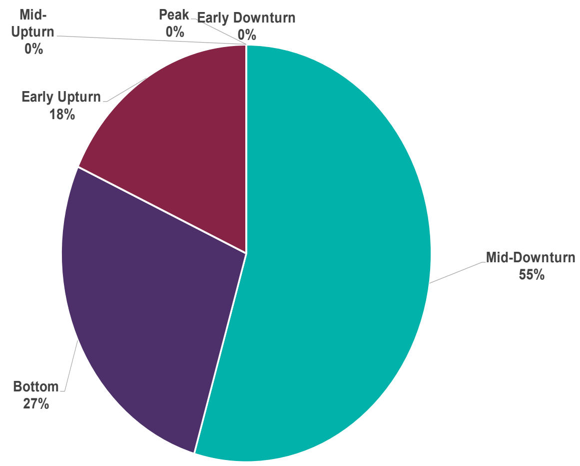


Chart 3: Twelve Month Capital Value Projections

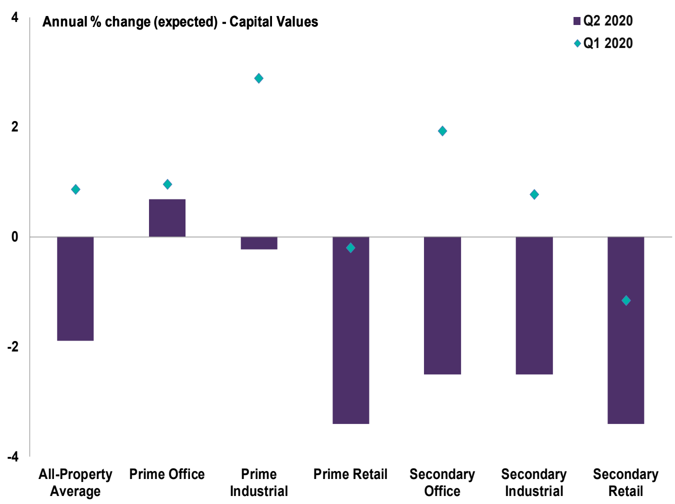
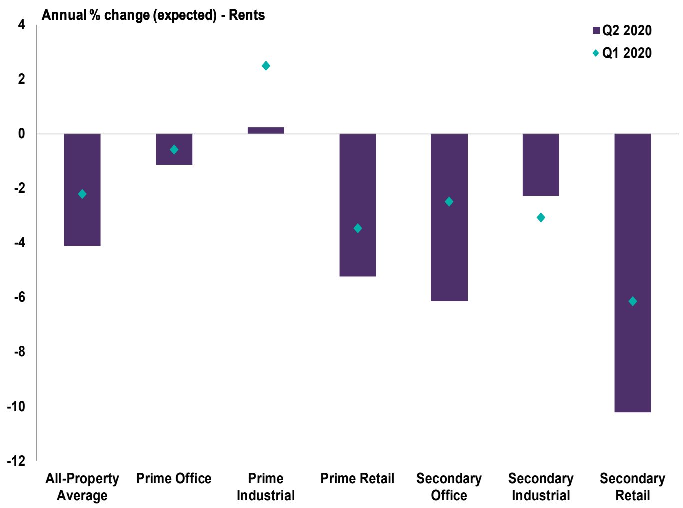


Chart 4: Twelve Month Rental Value Projections



Canada

The Q2 2020 results across Canada show the challenging global economic backdrop is continuing to exert pressure on the real estate sector.

Key metrics capturing sentiment amongst occupiers and investors remain entrenched in negative territory. Indeed, Chart 1 shows that the occupier and investment sentiment indices came in at -51 and -38 respectively, clearly pointing to a steep contraction in activity.

Similar to other countries in the region, this deterioration has been brought about a by sharp drop in demand from both occupiers and investors. It should be noted however that across the occupier market, while demand was seen falling materially across the office and retail segments, the decline was much more modest in the industrial sector.

Rents and capital values are expected to slip over the course of twelve months. The sector breakdown reveals that the retail sector is expected to bear the brunt of the decline (Chart 3). Furthermore, rents and capital values across the offices sector are also envisaged to come under pressure in the year ahead.

With regards to the outlook for alternative asset classes shown in Chart 4, rental values are seen holding more or less stable across data centres. Projections are negative for all other assets classes covered in this survey with a significant fall in rental values projected for hotels.

Chart 2 shows that 68% of survey participants believe that the market is in the downturn phase of the property cycle. This has ticked up from roughly 50% in the last quarter.

Chart 1: RICS OSI and ISI

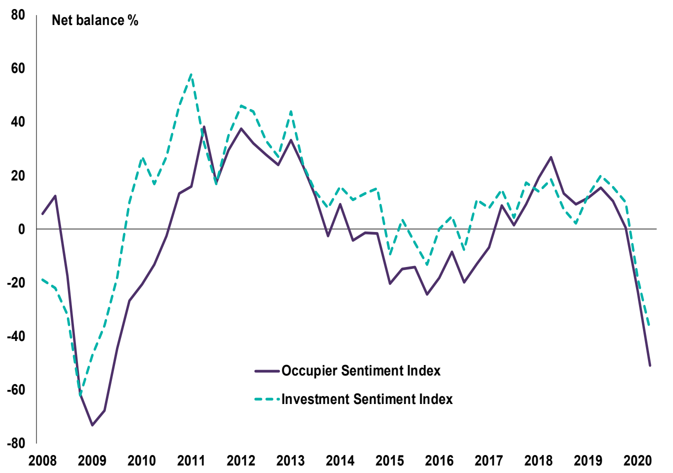


Chart 2: Phase of the Cycle

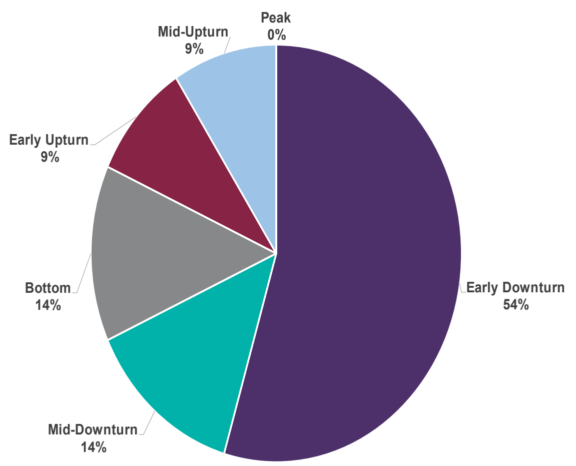


Chart 3: Twelve Month Rental Value Projections - Mainstream markets

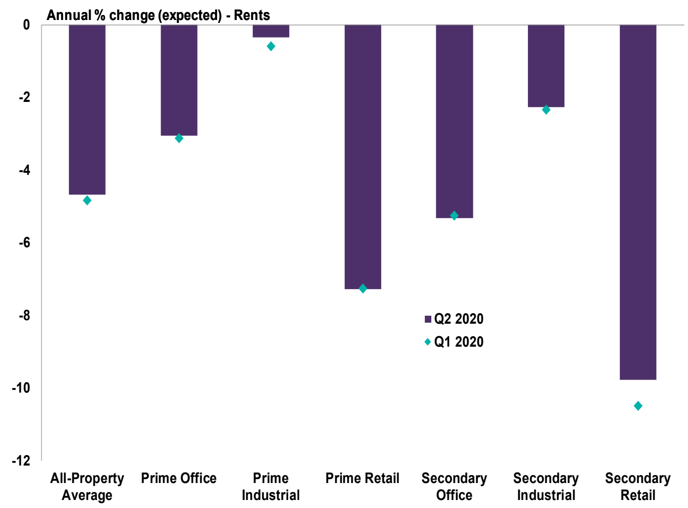
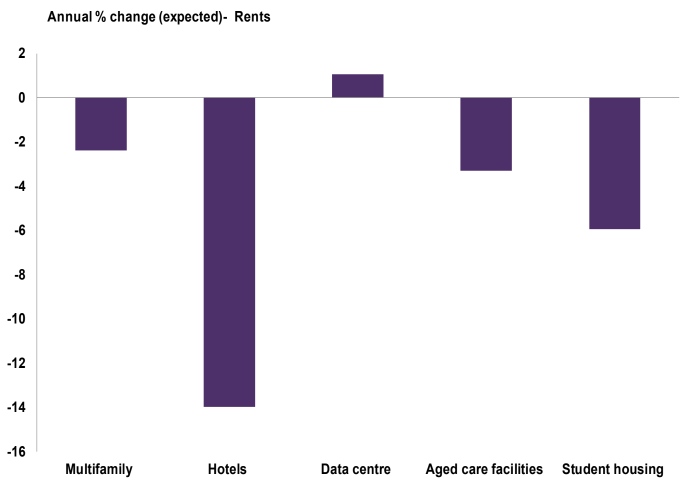


Chart 4: Twelve Month Rental Value Projections- Alternative asset classes



US

As the global economy continues to grapple with the fallout from the pandemic, participants to the RICS US Commercial Property Monitor reported a significant deterioration in conditions across the commercial real estate sector in Q2 2020.

Chart 1 shows the Occupier and Investment Sentiment Indices remain firmly entrenched in negative territory, coming in at -49 and -25 respectively. As such, both readings are indicative of another sharp contraction in activity.

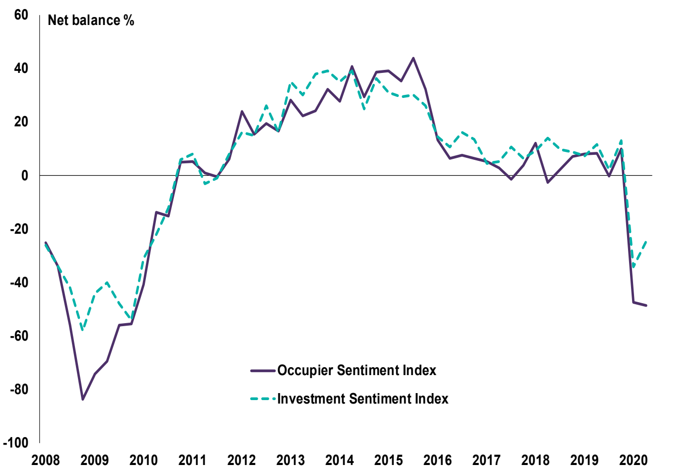
Unsurprisingly, demand from prospective tenants and buyers was seen slipping over the quarter. The sector breakdown however shows that while enquiries fell sharply across the office and retail segments, demand was reported to have risen in the industrial portion of the market.

This trend is also reflected in the results for twelve month expectations. Contributors envisage rents and capital values declining across the office and retail sectors over the course of the next twelve months. In contrast, the outlook for industrial segment is positive, particularly for prime properties (Chart 3).

Chart 4 shows that the outlook for alternative asset classes is also downbeat, with hotels expected to see a significant drop in rental values in the coming year. Data centres stand out as the exception, where rents are expected to remain stable more or less.

A downbeat picture is also seen in perceptions regarding where markets stands in the property cycle with more than two-thirds of contributors taking the view that the market is in the downturn phase. Furthermore, credit conditions have reportedly deteriorated over the last two quarters, offsetting an improvement during 2019 and adding another headwind to an already challenging environment.

Chart 1: RICS OSI and ISI



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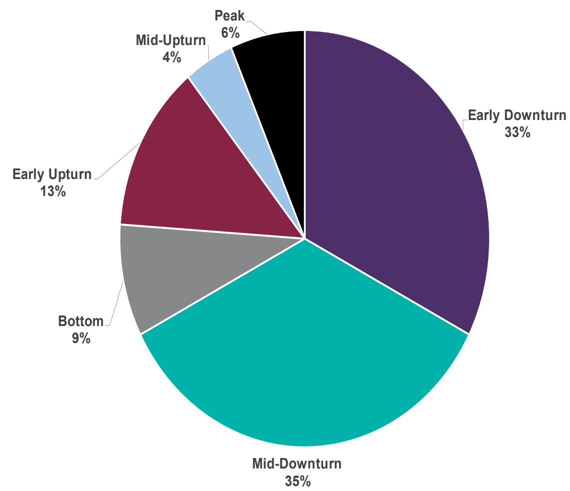

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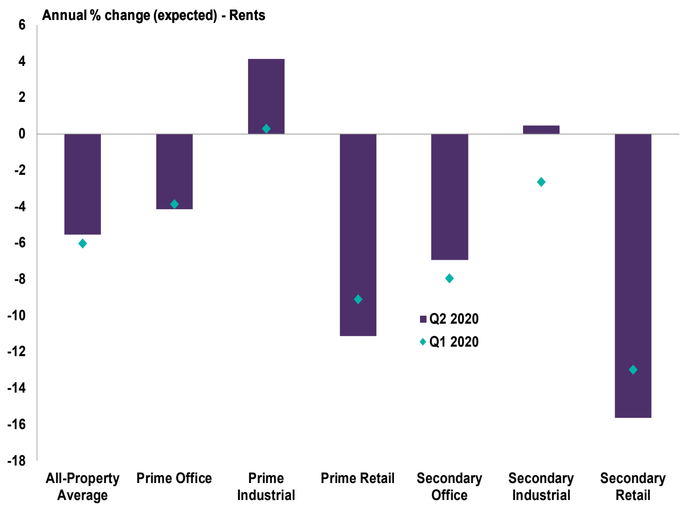

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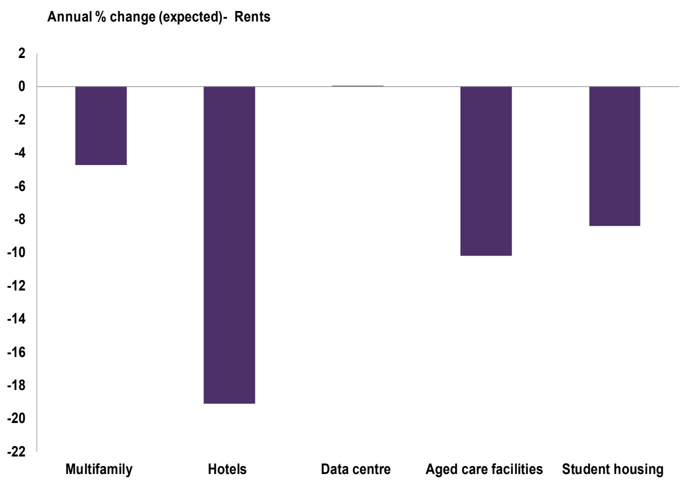

Regional Comments from Survey Participants in the Americas

Canada

"The jury is out but in a 1% vacancy market and significant institutional ownership, a downside scenario is significantly moderated in it's effect in the short term"

Toronto

"Covid19 environment makes any form of future estimates a best guess and difficult to predict how market segments will react"

Sudbury

"Prior to the COVID-19 pandemic small town Alberta was already beginning to struggle as a result of the exceptional oil industry taking a hit. While we have had very few cases here most people are being very cautious and retail businesses are not doing well"

Calgary

"The property market in lower mainland BC has generally been propped up by lots of foreign investment which has the ripple effect of increasing prices, however although Covid-19 has somewhat put a dent in the market, low interest rates and a fairly increasing population has quite caused a crash!"

British Columbia

"The Calgary Alberta market has been impacted by the COVID-19 pandemic, but underlying economic conditions were not favourable previously and will be doubly impacted by the ongoing energy sector volatility, which will impact office tenant demand and the overall stability in the Calgary economy"

Calgary

US

"Capital market shifts take a while to be reflected in general market sentiment. So while there is significant negative sentiment around rents and values, actual rents and sales prices may still be contractually fixed and we won't see COVID-related outcomes until the next half of the year"

Los Angeles

"Retail has experienced the vast majority of the economic fall out of the pandemic and the ripples are broad. The office market is in pause but occupiers are not in panic. The industrial market remains steady and the brief pause has expired."

Washington D.C

"Orlando is rather unique with nearly 100 million visitors annually from around the world that will not be coming back at the same levels for the foreseeable future. This has disrupted the lodging, retail, convention and air travel business significantly, with expectations of a slow recovery on the horizon. Orlando will be one of the last communities in the US to recover"

Orlando

US

"The post COVID recovery is likely to be uneven across markets and property types. Expect a slow growth and low yield environment for a long time to come"

San Antonio

"Office space will need more room to meet social spacing requirements, and will use work at home or hoteling to balance their needs. Hotels will seek alternative uses"

Dallas

"Markets are impacted by performance related issues In certain sectors, capital rates may decline in the near term- impacted by rental relief and collection issues"

New York

Information

Global Commercial Property Monitor

RICS' Global Commercial Property Monitor is a quarterly guide to the trends in the commercial property investment and occupier markets. The report is available from the RICS website www.rics.org/economics along with other surveys covering the housing market, residential lettings, commercial property, construction activity and the rural land market.

Methodology

Survey questionnaires were sent out on 12 June 2020 with responses received until 13 July 2020. Respondents were asked to compare conditions over the latest three months with the previous three months as well as their views as to the outlook. A total of 2083 company responses were received, with 496 from the UK. Responses for Ireland were collated in conjunction with the Society of Chartered Surveyors Ireland. Responses for Spain and Portugal were collated in conjunction with Iberian Property. Responses for Malaysia were collated in conjunction with the Royal Institution of Surveyors Malaysia. Responses in the Americas were collated in conjunction with the Association of Foreign Real Estate Investors.

Responses have been amalgamated across the three real estate sub-sectors (offices, retail and industrial) at a country level, to form a net balance reading for the market as a whole.

Net balance = Proportion of respondents reporting a rise in a variable (e.g. occupier demand) minus those reporting a fall (if 30% reported a rise and 5% reported a fall, the net balance will be 25%). Net balance data can range from -100 to +100.

A positive net balance reading indicates an overall increase while a negative reading indicates an overall decline. The RICS Occupier Sentiment Index (OSI) is constructed by taking an unweighted average of readings for three series relating to the occupier market measured on a net balance basis; occupier demand, the level of inducements and rent expectations. The RICS Investment Sentiment Index (ISI) is constructed by taking an unweighted average of readings for three series relating to the investment market measured on a net balance basis; investment enquiries, capital value expectations and the supply of properties for sale. The Commercial Property Sentimet Index is an unweighted average of the OSI and ISI. Regional indicators are weighted using estimates of the stock of commercial property provided by LaSalle Investment Management, and are adjusted on an annual basis.

Contact details

This publication has been produced by RICS. For all economic enquiries, including participation in the monitor please contact:
economics@rics.org

Disclaimer

Economics Team

Tarrant Parsons

Economist

+44(0)20 7695 1585

tparsons@rics.org

Sean Ellison

Senior Economist

+65 68128179

sellison@rics.org

Simon Rubinsohn

Chief Economist

+44(0)20 7334 3774

srubinsohn@rics.org

Kisa Zehra

Economist

+44(0) 7695 1675

kzehra@rics.org

Janet Guilfoyle

Market Surveys Administrator

+44(0)20 7334 3890

jguilfoyle@rics.org

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About AFIRE

Some responses from this survey were collected from members of AFIRE, the association for international real estate investors focused on commercial property in the United States.

With 200+ member organizations representing approximately $3 trillion USD in assets under management, AFIRE is an essential forum for real estate investment thought leadership. AFIRE members gather to help each other become Better Investors, Better Leaders, and Better Global Citizens through conversations, research, and analysis of real estate capital markets, cross-border issues, policy, economics, technology, and management.

To learn more, visit www.afire.org.

AFIRE
Ronald Reagan Building
1300 Pennsylvania Ave NW, #190-630, Washington, DC 20004
info@afire.org | +1 202 312 1400