ABSTRACT

REIT portfolios in the COVID-19 world

Equity markets around the word have swung wildly in the past weeks. Investors have been struggling to understand the economic damage the fast spreading COVID-19 might cause, as the number of cases continues to rise and governments step up measures to contain them. Policymakers have responded by cutting interest rates to prop up economic growth. Worries about long term economic growth have pushed the yield on 10-year US Treasury notes and German Bund to new lows.

Real estate stocks have not been immune to the sell-off as investors have struggled to assess the potential impact of the COVID-19 outbreak on the sector's demand drivers and net operating income (NOI) outlook. This will be especially true for the REIT subsectors that are more economically sensitive, more directly exposed to demand drivers as travel or events, catering to senior populations, or exposed to China and the inter-connected supply chain. But not all companies and sectors will be equally impacted and no doubt there will be winners.

It is hard to forecast the exact impact the COVID-19 outbreak will have on REITs as statistics are incomplete and constantly changing with new data points. All uncertainty aside, however, we have updated our valuation models with available information.

The different real estate clusters carry different operational gearing and have different exposures to COVID-19. Some clusters experience pressure like Hotels and Senior Housing whereas other benefit like Medical Office Buildings, Laboratory Office space, Datacenters and, to an extent, Logistics.

We have lowered 2020 net operating income (NOI) growth by 5-15% for most real estate companies. We assume a recovery in NOI growth after 2021. Consequently, net asset values (NAVs) are down by approximately 5% to 17%. More operationally geared real estate companies like Hotels, Senior Housing, and Leisure experience the largest fall in values. In general, the shorter the lease terms, the higher the operational gearing. Hotel leases can be cancelled in one day and storage and senior housing several weeks.

Including these NAV write downs, Asian and European real estate markets trade as of 17 March 2020 at approximately 25% discount to KCM NAVs at the moment. North America at approximately 22.5%.

Analyzing the different real estate clusters

Below table summarizes the absolute weight exposure of the Kempen Global Property strategy towards the clusters (x-axis) and regions (y-axis) on a see-through basis. Meaning, we do not look at the real estate company's country of listing, but actually look where the buildings are located in order to create a true understanding of regional location of the properties.

The different real estate clusters carry different operational gearing and hence we highlight several clusters below to assess the impact of the COVID-19 on the real estate fundamentals. Some clusters experience pressure like Hotels and Senior Housing whereas others benefit like Medical Office Buildings, Laboratory Office space, Datacenters and, to an extent, Logistics.

Kempen

What is the look through exposure of the portfolio?

Portfolio: K(NL)GPF

Look Through: Absolute Exposure

	Assets									
Countries	Residential	Office	Retail	Industrial	Health Care	Specialty	Self-Storage	Hotel	Casino	**Grand Total**
USA	12.8%	7.1%	9.4%	6.5%	7.2%	4.4%	4.5%	2.3%	1.4%	55.6%
Japan	2.3%	5.5%	1.4%	0.6%	0.0%	0.1%		0.9%		10.8%
China	2.2%	0.5%	0.7%	0.5%		0.0%	0.0%	0.1%		4.1%
Australia	0.0%	1.8%	0.2%	1.8%	0.0%	0.0%		0.1%		3.9%
Canada	1.2%	1.8%	0.6%	0.0%	0.0%	0.1%		0.0%		3.7%
Hong Kong	0.7%	1.1%	0.9%	0.2%		0.0%		0.3%		3.1%
United Kingdom	1.9%	0.0%	0.1%	1.1%	0.0%	0.0%	0.0%	0.0%		3.1%
Germany	2.5%	0.0%	0.1%	0.4%	0.0%	0.0%	0.0%	0.0%		3.1%
France	0.4%	1.7%	0.3%	0.3%	0.0%	0.1%	0.0%	0.1%		2.9%
Sweden	0.3%	1.5%	0.3%	0.2%		0.1%	0.0%	0.0%	0.0%	2.2%
Singapore	0.1%	0.5%	0.2%	0.7%		0.0%	0.0%	0.1%		1.6%
Switzerland	0.5%	0.4%	0.2%	0.0%	0.0%	0.1%		0.1%		1.3%
Ireland	0.0%	1.0%	0.0%	0.2%	0.0%	0.0%				1.2%
Finland	1.1%	0.0%	0.0%	0.0%				0.0%		1.1%
Eastern Europe	0.0%	0.0%	0.1%	0.6%		0.0%		0.0%		0.7%
Italy	0.0%	0.0%	0.0%	0.4%	0.0%	0.0%		0.0%		0.5%
Austria	0.2%	0.0%	0.1%	0.0%				0.0%		0.3%
South Korea		0.0%	0.0%	0.1%						0.2%
Spain	0.0%	0.0%	0.1%	0.0%	0.0%			0.0%		0.1%
Netherlands	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%		0.1%
Belgium	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		0.0%
Grand Total	26.1%	23.0%	14.9%	13.6%	7.2%	4.9%	4.5%	4.0%	1.4%	99.6%

Notes
- Look through based on square meters of individual underlying properties
- With the assumption that LTV = 0
- Multi-Use assets are spread out equally over the Residential/Office/Retail classes.

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Hotels

Hotels are the one cluster where the COVID-19 impact is felt in real time when travel restrictions are imposed and conferences get cancelled. It is therefore no surprise that hotel REITs have been the worst performers in the past weeks given that the sector will see an unexpected but certain hit to operating income. Performance also appears to be materially worse in major cities, and this is especially bad news for hotel REITs which tend to own properties in key gateway markets which are hit by travel bans.

We have reasonably good data on real-time conditions in the hotel industry that shows revenue per available room (RevPAR) growth dropped significantly (up to 50%) in the first weeks of March for effectively all major global cities and tourist destinations. Using RevPAR as best indicator for current conditions, we have analysed the impact on all hotel properties owned by hotel companies under our coverage. This has helped us assess the short term revenue impact, and led us to decrease the short term NOI growth rate by 5% to 17%. For now, we assume a recovery of RevPAR after 2021. As the RevPAR numbers are in constant flux and can change dramatically, we keep monitoring the market and adjusting our models if necessary.

The cluster Hong Kong gives some indication of economic sensitivity as Chinese tourism collapsed due to measures to reduce travel. Daily visitors dropped by 96% in February from the same time last year. The sectors that suffered the most were hotels, (tourism) retail and primary residential sales. The Coronavirus alone had a negative impact up to 7% on our net asset values for Hong Kong property companies.

The only way to counterbalance the high operational gearing is through very low financial leverage in the form of low loan-to-value (LTV) and debt/NOI. Hotel REITs indeed carry low leverage on an average LTV of 32% for the cluster. This low leverage is a key factor exposure in our real estate investment strategy carrying a 30% weight in our company score.

Industrial

Port statistics illustrate disruptions in global supply chains already in effect, as loaded import container volume declined in February versus last year, mainly due to China's quarantine-driven manufacturing slowdown at the start of the year. Even with manufacturing activity in China ramping up again, full capacity of the entire supply chain is expected to span for much longer.

The Industrial cluster profits from longer leases, making it less operationally geared than for example Hotels. At the same time, Industrial is economically sensitive and exposed to global trade. A recession scenario thus creates potential loss of occupancy in the short term (2020, 2021). NOI tends to recover sharply afterwards as Industrial profits from a secular demand trend on the back of demand from for example ecommerce. The current social isolation strategy implemented by governments actually increases demand for e-delivery. Amazon for example indicated it needs 100,000 more employees to handle current increase in demand at Amazon.com.

Obviously, all markets globally will be impacted, but to give an example of how we quantified the impact on US Industrial REIT valuations we use a bottom-up asset-by-asset analysis for 1,422 markets in the US where industrial REITs own and operate their assets. The combination of low oil prices and reducing global trade volumes will have significant impact on the most cyclical markets. Based on our analysis for the US we believe markets with significant cyclical exposure include Houston, Los Angeles Port, Inland Empire (LA), New Jersey, Phoenix, Seattle, and Miami. Based on this asset-by-asset analysis we assume negative NOI growth for the 8 US Industrial REITs we cover for the period 2020-2022. However, for 2023-2025 we assume a strong recovery in NOI growth. Similar analysis has been done for the other global markets with similar results.

Retail

There are many ways in which COVID-19 is impacting the retail sector. On the one hand, consumers have rushed to stores to stockpile products like disinfectants, rice, canned goods, safety masks and -surprisingly – toilet paper. On the other hand, the virus is having a major impact on mall traffic and tenant sales of discretionary items, with few international tourists and abundant fears expressed by local consumers of going to a public gathering place. As more countries are moving towards an 'Italian'-scenario which includes shutting down bars and non-food stores, short term revenue growth will be affected. A prolonged impact of the virus could further lead to factories getting closed, workers being furloughed, and consumers ceasing to spend. As production has slowed down, or even stalled, supply chains have become interrupted, leaving retailers with less stock in hand or with high margin pressure if shifting production temporarily away from afflicted areas is necessary. Factory closures, particularly those in China, could therefore accelerate bankruptcies from already struggling retailers, leaving both short- and long-term NOI growth under pressure.

Clearly, a difficult environment for retail REITs has just got tougher. We have reviewed our property database in search for asset-level tenant lists. We have divided tenants into "discretionary", "non-discretionary", with the third category being "distressed". In the "discretionary" part, we believe that in the short term percentage rents paid to landlords could decline. As ecommerce growth is likely to further accelerate this year due to store closures, longer-term growth rate might also go down, especially for retailers in the "discretionary" category. In the "non-discretionary" segment, we acknowledged that if non-food stores and groceries will remain open, this might actually be a small boost for operators, provided that their supply chains remain intact. We believe that the virus will speed up bankruptcy filings in the "distressed" tenant category due to disturbed supply chains, further pressure on margins, and reduced demand. In the short term we therefore see a major polarisation in revenue growth rates between discretionary and non-discretionary type of shopping, and we adjust our model accordingly. Mid-to-long term NOI growth rates in our model have been reduced for all retail REITs globally due to increased expected tenant bankruptcy and acceleration in ecommerce penetration.

Yet again, we believe that retail REITs are in for a rough ride, especially ones with higher financial leverage and inadequate dividend coverage (please see our last Alpha REIT on that topic "How to future-proof your shopping centre"). As the balance sheet score is an important metric for us to determine the price we are willing to pay for a REIT stock, retail REITs with a lean balance sheet have a much higher chance of making it to our investment portfolio.

Healthcare

As senior housing and skilled nursing sectors cater to an older population that is particularly vulnerable, a widespread pandemic could have a large impact for these two sub-clusters. A serious COVID-19 outbreak could significantly reduce demand (from people currently over 80 year old) and potential future demand (from people now 60-80 year old) for both senior housing and skilled nursing. On top of that, both sub-clusters have a risky combination of high operating leverage, high financial leverage, and - in the case of triple net leases - very thin rent coverage levels. As it is not difficult to imagine rapid and widespread increases in operator distress, both short term and long term NOI growth rate come under pressure. The senior housing and skilled nursing sectors are particularly large in the US. Other markets where REITs are active in these sectors are much smaller and include Japan, Germany and the UK.

Other sub-clusters within the Healthcare cluster are likely to react differently. Hospitals and medical office buildings benefit from an epidemic given increased demand for medical care. So will the laboratory office space that cater into the life-science industry. Those tenants need more lab space for finding cure and vaccines against the virus. Governments effectively want a vaccine against the virus at whatever cost as soon as possible which will create a surge in demand. In addition, the importance of a good healthcare system is now tested in real time.

We analyzed all types of asset sub-classes owned by companies in the Healthcare clusters, and adjusted the models. We reduced our occupancy and short term NOI growth rates in the senior housing "operating" business. Although REIT management teams say that they have not seen a material impact to senior housing occupancy and the facilities are well prepared to virus outbreak given their procedures and experiences with the flu, we remain cautious. We have also reduced "triple net" senior housing and skilled nursing NOI growth rates for both short a long term. Although these two sub-clusters benefit from long term leases, we worry about health of their operators and a potential need to restructure leases. At the same time, we increased NOI growth rates for medical office and hospital sub-clusters in '2020. We also increased the short term growth rate for the life science business, which we believe is now enjoying a very strong momentum.

Office and Data Centers

As companies across the world are escalating their efforts to protect employees, we are going through the largest "work from home experiment" the world has even seen. Enterprise communication platforms and online collaboration businesses are booming and adapting fast, making remote working increasingly smooth. Although the flex trend has been nothing new with offices, the corona outbreak is likely to work as a catalyst to speed up the trend, and possibly may even structurally change the way we work and use offices. A more "from home" way of working would likely be further supported by national governments, who are pushing their budget and environment agendas, and would love to see less usage of cars and less pressure on public transport.

Although we believe that an office REIT with investment grade tenants in the best office locations in the world is not likely to experience a drop in occupancy or rent receipts, we do wonder about the impact of the ability to work remotely on long-term office demand. The trend of using less office space per employee is likely to continue. At the same time, this experience will also prove to us that human interaction is key to the way we work together which still requires space to come together.

Probably the most clear beneficiary of further digitalization in the way we work, shop and live is data centers. Demand for cloud space, bandwidth, and general data storage is likely to accelerate as a result of flexible working. The data center space is therefore an important and integral part of the Kempen Global Property strategy as well.

Conclusion

The different real estate clusters carry different operational gearing and hence experience different reactions to the COVID-19 outbreak on their real estate fundamentals. Some clusters experience pressure like Hotels and Senior Housing whereas others benefit like Medical Office Buildings, Laboratory Office space, Datacenters and to an extend Logistics.

We have lowered 2020 net operating income (NOI) growth by 5-15% for most real estate companies. We assume a recovery in NOI growth after 2021. Consequently, net asset values (NAVs) are down by approximately 5% to 17%. More operationally geared real estate companies like Hotels, Senior Housing and Leisure experience the largest fall in values. In general, the shorter the lease terms, the higher the operational gearing. Hotel leases can be cancelled in one day and storage and senior housing several weeks.

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The Kempen Global Property Strategy is by definition cluster neutral, meaning we are not over- or underweight any cluster versus the benchmark. This limits risk from a geographical point-of-view. We are, however, monitoring our universe looking for mispricings *within* clusters in these volatile market conditions. Markets tend to sell off indiscriminate driven by (passive) investors facing redemptions. It is fascinating to see how two companies, with one operating on very low leverage, and one operating on very high leverage see similar share prices drops. This creates opportunities for active investors like ourselves who identify such mispricings.

Having low leverage, in the form of low loan-to-value (LTV) and low debt/NOI, is absolutely key under current conditions. Any company that is now forced to reduce debt for example through selling assets or raising equity in the market faces risk. Leverage is an important element of the Kempen investment strategy carrying 30% weight in the company score. The strategy has a current 12% relative overweight to low-leverage (maximum of 35% LTV), and is underweight companies with leverage of >35% compared to the benchmark.

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