SPECIAL PUBLICATION:

Real Estate Outlook 2020:
In view of COVID-19

By: Alan Cheong, Executive Director, Research, Savills Singapore                         April 2020
Executive Summary

COVID-19 will no doubt leave a trail of destruction to the business landscape. For real estate, it will not go unscathed as it is a derived demand industry. The impact of COVID-19 for the five major sectors of the Singapore property market can be summed up as:

01 Private Residential market
If information release on infection and death rates is handled well, there will only be a stretching of market sentiments. This may result in a moderate softening of prices. If developers do not budge from their pre-COVID-19 prices, sales volumes will be anaemic. However, if the pandemic gets much worse globally and breaks sentiments here, sales will plummet. Under such conditions, it is pointless for developers to launch projects because no matter how they adjust prices down, demand will be negligible. But whatever it is, be it a stretching or a break in sentiments, the slate cooling measures should be aggressively rolled back. Conditions have changed and these measures can actually pile on the on risk rather than de-risk the market.

02 Office market
Once the dust settles, decision makers in multinational corporations will regroup to decide on the future of their regional and global operation structure. This may result in a fragmentation of office demand between CBD and regional centres or it may merely lead to a reduction of CBD space usage as staff take turns to alternate between working in the office and from home. The possibility of Chinese companies coming to Singapore in a big way to diversify country lock-down risks cannot be discounted. If they come either in a big way or partially, there will be a massive undersupply of office space. We do not know now because COVID-19 has political ramifications that may stumble intuitive conclusions.

03 Retail market
COVID-19 should present the opportunity for landlords to radically change their mode of rental collection from one that charges based on a high base rent or gross turnover (GTO), whichever is higher, to a no or low base rent and higher GTO model. Landlords will therefore have to beef up their asset management teams as they become more proactive in selecting and assisting tenants to do well in their malls. The change to change now. If not, when tenants’ business recovers, even to pre-COVID-19 levels, which wasn’t exactly fantastic, the old ways return, and the war of attrition continues with not even a pyrrhic victory in sight.

04 Coronavirus and the private residential market
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05 COVID-19 - An accelerator of disruption, a new disruptor and possibly a disruptor of disruptors for the office market
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06 Coronavirus and the retail sector – No easy way out
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07 COVID-19's global disruption could create a Phoenix rising out of Singapore’s industrial property market
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09 What if the worst-case scenario develops? A discussion
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Covid-19 And The Private Residential Market

There is a great temptation to look back to the SARS period for guidance as to how much prices may fall due to the Covid-19 outbreak. However, we believe that, for Singapore, that wouldn’t be recommended because the contextual background for SARS is very different from that today.

In 2003, China’s GDP contributed just 4% to the global GDP, but by 2018 was closing in on 16%. That is not the only difference.

Two other key differences are:

- Global supply chains to and from China dominate global trade.
- Chinese capital and human flow to the region have multiplied many times over. Therefore, while SARS was an "unknown unknown" then, for the real estate (and some other economic sectors) market today, the viral outbreak can also be said to be an "unknown unknown" event (but a "known unknown" to healthcare workers and the government).

In our Q1/2019 briefing, we mentioned that the URA PPI had the greatest probability, historically speaking, of stringing together six consecutive quarters of growth in the up-phase of the cycle and if it turns before that, it is likely to be triggered by something different from historical factors that affected the index. For this current upturn, the URA PPI has already risen for three consecutive quarters, beginning Q2/2019. If the past was not disconnected or stretched, then the index should carry on rising until at least end of Q3/2020. So, all eyes will be on Q3/2020 price data and if it comes down sharply, it will be one of two possible cases. The first is serious in that the break is analogous to a hole having formed in the market structure (topology). This hole has punctured or disconnected the market topology and no reasonable number of scenarios being formulated (under various factor changes, e.g. GDP, interest rates, immigration rates, government interventions etc.), prior to the outbreak can give a satisfactory outlook under current conditions. Until that hole is plugged, the various market scenarios will not pan out. In other words, it is an exercise in futility to try to crystal ball what the market will be doing during this viral outbreak period. (See Figure 2)

For the super high-end market in the CCR, the market topology is still intact. It is just warped. Therefore, if rationality continues to hold, then the pre-existing great value can be won, the queue is likely to be much smaller.)

So has that hole formed? For that, let us look at human behaviour. Unlike SARS where fatalities were occurring in frequency, the current outbreak in Singapore has so far not yielded any fatalities or if there are any, there will be few (but, this is dependent on factors within the domain of the healthcare system). As a result, the public is presently not able to assign a probability on death happening to them. This foggy outcome means that rationality still holds in the market. (To put it another way, if you knew that winnings in the coming lottery draw have swollen to $128 million, even if the chances of winning were very small, the queues to buy the tickets would be very long. But if an experiment is done whereby the public is not told the size of the winnings, but only that something of great value can be won, the queue is likely to be much smaller.)

Therefore, if rationality continues to hold, then the pre-existing market topology is still intact. It is just warped.

The trillion-dollar question then is: will there sooner or later be a puncture in the private residential market topology or will it continue to be warped? Our view is that until mid-February 2020, the market topology had only been stretched, though stretched thinly. For the OCR and RCR, it has not torn, at least for now, but as of the date of this writing, the stretching is continuing. For the super high-end market in the CCR, we believe that, for the moment, there could be a puncture because Chinese buyers are now not easily able to move freely (until the outbreak is over).

Figure 2: Multiple market scenarios punctured with the Covid-19 outbreak

Source: Smith & Balfour Consultancy

REAL ESTATE OUTLOOK 2020: IN VIEW OF COVID-19
Our definition of a market puncture or disconnect will be one where the tell-tale sign is even with sharp price discounting, and demand remains anaemic and unresponsive. At the time of this writing, the OCR, RCR and CCR (those priced <S$3,000 psf) new launch markets could just be stretched.

Partial evidence of this stretching is obtained from two recent launches, The M condo and Luxus Hills. The 70% sales achieved for The M condo over the first weekend of launch and the 64% first week sale numbers for Luxus Hills (Contemporary Collection) were what outsiders to the residential property industry did not expect. To them, it was counterintuitive and astounding. Although the sale numbers were good and, making a judgement call, we believe that if there had been no Covid-19 outbreak, either the percentage sold would be significantly higher or the prices could be greater. If we accept this judgement call, then we can say that the market landscape in terms of prices and demand has merely been stretched. Why do we say that the pricing topology has been stretched? Our simple hedonic model appears to impart that inference. (See Figure 3 for the concept of the market topology being stretched.

As virology and containment measures are not topics within our expertise, we will not hazard any guess as to whether it will get worse from here. If it does, the likelihood of a puncture in the market topology cannot be discounted. But for now, given that the topology for OCR, RCR and non-super luxury CCR new launches does not appear to have become disconnected, and arising from the high land cost for most of this year’s launches, developers will have to sell their developments at prices above comparables in the surrounding areas. We will still hold to our pre-Covid-19 view that prices would rise 3% to 5% in general for the year. But for Q2/2020 and even Q3/2020, price indices may turn soft due to marketing strategies adopted to whip up initial sales. Also, the dearth of transactions and the withholding of new launches would mean the indices are being influenced more by resale transactions. Under duress, resale prices may yield to pressure.

To get a better handle of the market structure post-Covid-19 outbreak, we will have to stand aside until the market distortion is over and, in a worst-case scenario, should be become disconnected, then only after which, can we begin reconstructing a new forecast.

Figure 3: Distortions to the market structure

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Looking to buy a residential property during this unprecedented time?

In this uncertain and volatile climate, buying a new home or upgrading to a bigger home could be a rather daunting thought. At Savills, our team of well-seasoned agents anticipate the market price changes brought on by the pandemic and provide you with the best advice to help you make the most informed and cost-effective decision. Our agents bring together parties of interest with integrity, commitment and pride, ensuring smooth processes and transactions via virtual tours, comprehensive buyer guides and trusted digital platforms.
Navigating the private residential market during an uncertain time

Purchasing a property during a pandemic period can be daunting, but our team of experienced agents can help anticipate the changes in the market and provide you with the best advice to make an informed and confident decision. Our Singapore Residential Services department is the only corporate team to offer a full suite of relocation, tenancy and landlord management solutions in Singapore, giving us the winning edge over local market players. We are also the market leaders in our niche and bespoke services, portfolio leasing and individual sales of residential properties in Singapore.

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COVID-19 – An accelerator of disruption for the office market

Views on how markets will react to the virus outbreak are much sought after, so is the case whenever an “extreme” event occurs. Before we attempt to analyse the impact of this viral outbreak on the real estate market, we must take a look at what this event is all about.

Firstly, we do not believe that we can assign any probability to this outbreak nor to when it will end. Why is that the case? There is no domain knowledge on this subject matter. Even healthcare professionals and virologists are still to grasp this extremely fluid situation.

Secondly, is this an extreme event much like a Black Swan? Yes and no. Yes, if we treat this outbreak in terms of how it has cost the economy versus the many previous outbreaks of common flu. No, if we consider how it has impacted the demand for real estate. Why “no”? Because this viral outbreak is the second of its kind, after SARS, that has an effect on real estate. We cannot construct a distribution of probabilities based on just two events or even if a third outbreak has occurred. Thirdly, should we go back to the period when SARS broke out to form the baseline scenario? We wouldn’t recommend it.

The reasons are twofold:

- SARS occurred at a time when the Chinese economy constituted just 4.2% of total global GDP. By 2019, it was over 15%. China’s economic enormity is not in its GDP per se, but the central role it plays as a manufacturing engine of the world. From handphones to lawn mowers, global supply chain lines all lead to and from China. During 2003, Chinese companies and individuals were particularly domestic oriented. Chinese capital was not flowing out anywhere near the levels they achieved in 2019. Chinese outbound FDIs around the SARS period was less than US$20 billion. In 2017, it was approximately US$70 billion. Simply put, the impact of SARS was unchartered territory, an “unknown unknown”, because nothing like that had ever occurred in Singapore.
- SARS was unchartered territory, an “unknown unknown”, because nothing like that had ever occurred in Singapore. The current COVID-19 outbreak is thus prima facie perceived to be a “known unknown”, in that there is a precedent, the SARS outbreak. However, we cannot predict the outcome of this virus strain. The way SARS panned out previously is likely to have reduced the current fear and stress levels, but the unknown outcome is still a cause for concern. We cannot assign a probability to this. But, as mentioned in part (i), the global economic nexus is different today compared to the SARS period. Thus, we may say that our experience of SARS is of little help today, except to extend comfort to the population at large (i.e. “We’ve been through SARS and we know what it was like”). The COVID-19 outbreak is therefore as good as an “unknown unknown” event to real estate market analysts. (Nonetheless, the SARS experience is helpful to those in the healthcare industry. This is because it provides lessons on how resources will be drained and how to communicate effectively with the public. However, for the real estate and other industries, it offers hardly any guidance.)

Ultimately, we should refrain from creating “what-if” scenarios as to how the market structure for the various real estate sectors may evolve after this event. The Johari window is an illustration of the futility of drawing up “what-if” scenarios when the outcome is still unknown to both the healthcare and non-healthcare groups. Some may still be tempted to carry on with the construction of various scenarios. The downside to that is that, if we create scenarios for each variable and, when the time dimension is added in (that is as the market moves on from now), we will encounter branch points where the market will make decisions as to which route it will take. Not only do we not know how many branch points there will be, we also do not know which path the market will take at each branch point. This expands the number of outcomes to the point of mind-boggling impracticality, and the choices we are then forced to adopt are simply guesswork. That is as good as useless. Fourthly, the impact of the COVID-19 outbreak varies from sector to sector. Looking at this event from another perspective, the real estate market structure (topology encompassing the behavioural aspects of demand and supply, which influences price and rent) for the office, retail, residential, industrial and hospitality sectors existing up to pre-Chinese New Year 2020 has either been punctured (disconnected) or has been stretched thinly. Until there is better clarity or reduction in market anxiety towards the viral outbreak, the structural landscape remains disconnected. That means all the previously constructed descriptive equations tend towards uselessness.

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Conquer Your Blind Spots – Johari Window Model

REAL ESTATE OUTLOOK 2020: IN VIEW OF COVID-19
Office Market Vs Covid-19

For today's blog, we broach on how the office market interfaces with the viral outbreak. Unlike its impact on the COVID-19 outbreak is unlikely to affect the office market up to the medium term (e.g. 12 months). CBD Grade A office tenants are often multinationalis who hold a long-term view of the market, not only that of Singapore, but of the region as well. As such, the viral outbreak would not disrupt our views of the sector in 2020. This outbreak has in our view, not path broken the market structure, but it has stretched it. Although the market structure is intact, we believe that it is still not helpful to conduct scenario analysis or attempt a revisit of the SARS period in order to predict how the market will react. This is because this event may have accelerated the evolution of office space usage. Thus “what-if” analyses made now, even if they turn our correct in a few months’ time, may unfold as a result of delayed reaction by companies reorganising their operations to counter future events like this. Therefore, only when this event passes, or is close to passing, can one conduct a better analysis. The long-term impact of the COVID-19 outbreak may alter the landscape of how corporates are structured in the region and this may or may not have an impact on the office market here, and in the region. But we believe it very likely will. Amongst its other effects, this pandemic is akin to a disruptor of disruptors. It has created new branch points for the office market. For example, the recent evacuation of 300 employees from a Grade A office building in the CBD due to a company’s two infected employees may spur companies to rethink the trade-off between working from home and from traditional offices. If so, this will likely affect office demand which then affects landlords and/or co-working operators. Technology will be the catalyst that quickens this new evolution, if it happens. With that come greater business opportunities for tech companies, and more new co-working companies setting up here, and/or existing ones for additional headcount. However, as of the time of this article, it is still too hasty to see what form this new evolution will morph office space demand into. Nevertheless, there are some areas where we may be able to make some assumptions and we will be spending more time looking at them in future. Though tentative in nature, we believe that we may be able to present some hypotheses on how they will begin to move on from here.

• Home office as a viable alternative to taking more office space
• Existing regional centres and business parks may see increasing take-up by companies setting up satellite offices (to be close to workers’ homes). This is a move to de-risk from over concentration by location or building
• Co-working and serviced offices may/may not expand to the regional centres to cater to flexible spatial demand by companies. On this, as well as the previous point, we believe the future for co-working and service offices can go either way. Businesses may wish to engage co-working and service office providers, but whether that benefit may also be more than offset by an issue such as the possibility of contagion brought onto their staff by other companies’ personnel on shared premises remains to be seen. This is a branch point
• Multinational companies upgrading their corporate ecosystem in the regional countries to minimise the risk of relying too much on regional head office staff travelling for work. From these nascent leads, we also may believe that this COVID-19 outbreak has already seeded new directional vectors for the next epoch of office space demand. From these nascent leads, we also may believe that this COVID-19 outbreak is an accelerator for disruption, a disruptor itself, and potentially also a disruptor of disruptors. For the moment, given that the market structure is merely stretched, we have not changed our 2020 forecast for CBD Grade A office rents. Rents are expected to range from -2% to 0%. But beyond that, there is the possibility of a break in the current market nexus. In the course of the following weeks, I will be adding my thoughts to the future for co-working and service offices can go either way. Businesses may wish to engage co-working and service office providers, but whether that benefit may also be more than offset by an issue such as the possibility of contagion brought onto their staff by other companies’ personnel on shared premises remains to be seen. This is a branch point
• Technology companies may, because of decentralisation, get a boost for their services, resulting in more tech companies setting up operations here.
• The possibility that Chinese companies may set up business continuity centres in Singapore to counter any lock down back home. If this takes off, or even if some do decide to come, Singapore could move from a equilibrium market position to an extremely tight one. Rents and capital values will skyrocket. However, this scenario is not necessarily a done deal because COVID-19 has spawned political antagonism between major economic powers. Intuitive outcomes may not have the path of least resistance.

By no means exhaustive, this outbreak has already seeded new directional vectors for the next epoch of office space demand. From these nascent leads, we also may believe that this COVID-19 outbreak is an accelerator for disruption, a disruptor itself, and potentially also a disruptor of disruptors. For the moment, given that the market structure is merely stretched, we have not changed our 2020 forecast for CBD Grade A office rents. Rents are expected to range from -2% to 0%. But beyond that, there is the possibility of a break in the current market nexus. In the course of the following weeks, I will be adding my thoughts to the future for co-working and service offices can go either way. Businesses may wish to engage co-working and service office providers, but whether that benefit may also be more than offset by an issue such as the possibility of contagion brought onto their staff by other companies’ personnel on shared premises remains to be seen. This is a branch point.
Directly, the impact of the COVID-19 outbreak is felt most severely in travel-related industries. This percolates down to the tourism and then the retail sector. The effects of the pandemic then spill over to consumption through potential retrenchments, pay cuts, job insecurity and the avoidance of public places. Therefore, we say that for this year’s Chinese New Year festive period, sales at retail stores and restaurants would likely have come in below expectations as many avoided visiting malls and cancelled dining reservations. Coupled with the benign outlook for tourism sector, overall retail sales growth is expected to remain dismal as the outbreak takes a toll on domestic spending. Nonetheless, there may be a silver lining for food delivery and e-commerce sales, which are likely to see a higher growth potential as more people avoid staying out.

Like the Severe Acute Respiratory Syndrome (SARS) crisis which dampened regional tourism and economy in 2003, the impact of COVID-19 outbreak could likely persist for the next six months, depending on the virus development. However, as we are not virologists, we would caveat this as a best guess estimate. Despite a more broadly held negative sentiment toward the retail sector and the virus outbreak, prime retail space rents (in Orchard or suburban malls) are likely to resist downside pressures much better than the rest, unless there is significant escalation of the ongoing outbreak. The occupancy rate for the prime units is also likely to remain stable alongside a limited supply in the pipeline. We will discuss three main reasons for rents being sticky. One is, even in an environment where businesses have been disrupted by the viral outbreak, tenants are looking beyond the immediacy of the problem. Should they give up the space, under the assumption that the COVID-19 event will not last beyond the short-term, they will be left hanging dry without representation in a prime spot in a mall when business-as-usual returns. The second is that, despite the 25% property tax rebate for shops and Food and Beverage (F&B) given under Section 3.2 (b)(iii) of the Property Tax Rebate for Qualifying Commercial Properties in Budget 2020 (IRAS e-Tax Guide), some landlords are still holding onto their pre-COVID-19 asking rents for available-to-let space.

Thirdly, many prime retail malls in the Downtown Core and suburban areas are owned by REITs and private equity. The ability to adjust rents to match their tenants declining fortunes will be met by strong pushback from unit holders, sponsors and limited partners. Ultimately, how these three points play out for URA’s rental indices not just in Q1/2020, but also the period much further down the road is unclear. But safe to say there is strong downside bias for rents moving forward.

One point that has been overlooked is that COVID-19 may unearath potential minefields. Prior to this outbreak, there could be some large suppliers, retailers and F&B companies who were already struggling but held a poker face. The COVID-19 outbreak may trigger a chain reaction, should some large ones suddenly fold. Though not as dramatic as what transpired in the financial industry 12 years ago, this could still be a Lehman-like event for the retail industry. This possibility aside, the bigger question is how the retail industry may develop when this outbreak blows over. We had mentioned in our Q4/2019 retail brief that for the sector, the COVID-19 outbreak represents a “known unknown” event (unlike that for the office and private residential markets – which is an unknown unknown event). The known part is because we can hark back to the SARS period when the sector was confronted with similar conditions. The SARS experience has relevancy because it imparts to the same variables that drove retail spend and ultimately spatial demand. The unknown part is when the endgame and how the retail industry may restructure thereafter because during 2003, disruptive (online) and catalysts (food delivery) forces were not that strong. In the lingo of econometricians, post-outbreak and resolution, fixed and random effects on tourist/consumer and tenant-to-tenant and landlord behavior is expected. But that may still not be the appropriate way to look at this. Because of the severe impact of this outbreak on retailers, coming on the back of many having fought a protracted war with structural changes to the industry (online sales), the retail landscape, post COVID-19, has a chance of a major structural change.

As such, all one can do is look beyond the immediacy of this knowledge gap and focus on the fundamental and structural issues (e.g. online shopping, budget air travel, high hotel room rates, food delivery entries etc.) impacting the retail market.

However, for some landlords, this pandemic could open the door for them to change their mode of rental collection. Presently, local landlords derive most of their retail space revenue from base rents, with a sliver from gross turnover (GTO) (and the rest from car-park, advertising and other miscellaneous collections). A shift towards GTO will have great repercussions, affecting REITs, private equity and listed real estate development companies who have a significant portfolio of retail assets here.

Admittedly, the initial transition from the current rent collection model to a pure GTO or GTO-biased hybrid construct may result in total revenues collected by landlords declining sharply initially (see Figure 1). The choice is whether one is willing to make a break with the old by going “cold turkey” or slug it out in a long and draining fight with possibly not even a Pyrrhic victory in sight. We acknowledge that it would not be easy for entities such as REITs and invested private equity to transform because the realignment would require Herculean efforts to get any form of buy in. There is also the possibility that the property tax authorities may still revert to comparable base rent to calculate their taxes rather than using the net GTO proceeds. Ultimately, it is the choice for each to make.

The upside arising from landlords having more skin in the game is that the asset management industry will expand as landlords need to take on a more proactive role in the running of their malls. Also, the range of products and services offered in a mall will be wider with different malls in different locations adjusting their tenant mix in accordance to the catchment – instead of what we now have, basically cookie cutters of one another.

For now, because of the structural impediments to change, we will continue to see rents remaining sticky with limited downside, at least for the next quarter or two. Beyond that, the market is likely to adjust to the new reality facing retailers and rents may have to come off significantly before recovering.

For now, we maintain our rental forecast for available-to-let prime retail space in both Orchard Road and suburban malls. This is the best that we can do because we believe that the industry is in the early stages of undergoing structural changes. During this evolution, drastic reduction in rents may happen and GTO rents may not be captured by indices. (So rental indices have to evolve too!)
Navigating the volatile Singapore retail sector

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From 2018 to 2019, the US-China trade war had resulted in falling demand for our industrialists’ products.

The coronavirus outbreak first started in China, and affected many industrialists, suppliers, shipping and logistics players as their supply chain has been severely broken. Next came another spanner in the works when oil prices fell sharply on 8th March after Saudi Arabia invoked a unilateral price cut. It seems that the industrial market never had it worse for many decades. However, we believe that the latest oil price event would not derail the underrun that are sweeping through the industrial and warehousing markets. The key issue is how supply chain may reform post-COVID-19.

By this, we mean whether the COVID-19 event has permanent, long or just short-term effects on their businesses operating out of Singapore. The weaker Small and Medium Enterprises (SME) here would most likely feel this pandemic more than the multinationals. The twin effects of falling end-user demand has put further strain on many firms/financial resources. Although most multinationals may suffer greater declines in revenues than local SMEs, they still have stronger financial muscle and their objective driven presence in Singapore may see them ride through this storm in better shape than smaller local companies.

In our view, what this outbreak has probably done is to quicken the sieving out process in the industrial landscape and accelerated the move to rely less on China, something that manufacturers have already been planning before this. While their supply chains may be immediately impacted by events going on in China, multinational companies nonetheless are likely to weather through this well once they diversify and intensify their hub and spoke networks around the world (for example to Mexico for the automobile industry and Ethiopia for textile, just to name two hubs).

Treating the market share of selected industries by countries and region, we may abstractly view each industry supply chain as a function. There are two sets of functions. One set of functions map from countries that manufacturers intermediate goods or supplies raw materials to China. The other set of functions will be those that map from China to countries that receive intermediate goods for further processing or final goods from China for transhipment. The first set of functions feed from the cluster of countries (domain) to the hub (co-domain). It is like saying that the cluster of countries are the kernels of the supply chain function to China. The same concept applies for the other major hubs e.g. the Mexican group. This is represented by the red arrows in Figure 2.

The second set of functions, those in black in Figure 2, are supply chain functions that lead out of China and gets map to the various countries that either processes the products further before re-exporting them to their final destination, as final goods for transhipment or are end users e.g. Singapore contractors who purchase wall claddings from Chinese manufacturers.

Figure 2: The China supply-chain functions

For those red arrow functions, the post-COVID-19 industrial landscape may see a weakening of magnitude of flow of goods to China. It may not happen overnight but we believe that it should manifest itself within a year or two. The need to reduce single country or regional concentration would bring about reduced flow in the existing supply chain networks. What does this mean to the industries here that are plugged into the “feed-China” supply chain functions? As there are too many industries to contend with, we simplify to get a handle on this and decided to use the analogy of fluid dynamics. In a modified form (using Bernoulli’s equation for fluid flow) and in reference to the supply chain functions feeding from Asia (countries gi) to China:

Figure 1 : What China is to the world by industries

Figure 3 : Singapore merchandise trade with selected countries

For those red arrow functions, the post-COVID-19 industrial landscape may see a weakening of magnitude of flow of goods to China. It may not happen overnight but we believe that it should manifest itself within a year or two. The need to reduce single country or regional concentration would bring about reduced flow in the existing supply chain networks. What does this mean to the industries here that are plugged into the “feed-China” supply chain functions? As there are too many industries to contend with, we simplify to get a handle on this and decided to use the analogy of fluid dynamics. In a modified form (using Bernoulli’s equation for fluid flow) and in reference to the supply chain functions feeding from Asia (countries gi) to China.
Post COVID-19, two things are likely to happen. One is there would be less reliance on China as a manufacturing engine. This means that there is less demand for China made goods as companies diversify to other manufacturing hubs. Secondly, as the supply chain capacity here and in Asia expanded in anticipation of a business as usual China expanding at 6% pa for the foreseeable future, there will be overcapacity. This means a reduction in the rate of flow of intermediate goods and services to and from China (a decline in kinetic energy). On the cost front, the pre and post-COVID-19 status for China should remain the same. Therefore, we can leave out looking at cost advantage. As supply chain functions are akin to those that regulate the rate of flow of trade, post-COVID-19, these functions should see less activity. As a result of a decline in demand and a reduction of trade flows, the energy in the supply chain with China should fall.

If one wants to see an increase in the rate of trade flow (KE), then the only way to do so, is to reduce capacity. That can be done in two ways. One is if manufacturers have production models that can adapt to reduced demand quickly and remain financially viable. Production lines will have to be streamlined. On the spatial front, it is to reduce land supply. This can be done in several ways: reduce new supply of lands for industrial and warehousing, not renewing leases for ageing ones, be open to industrialists handing back their premises before the lease term expires and allowing more flexible uses for industrialists who wish to discontinue operations but have found a replacement use. To illustrate the last point, say a company has an industrial land with just 10 years lease life left in a mature housing estate and wishes to discontinue operations. The company finds a replacement user e.g. say an international school, then flexibility would mean allowing that new use rather than holding fast to legacy plans for the site.

For countries (gi) that China exports semi-finished or finished products to (the black arrows in Figure 2), the effects described in the previous two paragraphs. It is the flow that serves our domestic market that could react differently. For instance, they may have to stockpile more to ensure business continuity. That means greater demand for warehousing. For those that serve their respective domestic markets (black arrow in Figure 2) with goods manufactured in China, be it SMEs or MNCs, they may still have to upgrade their productivity, and for those in Singapore, they will have to contend with the continuing issues on the labour front and structural changes impacting the various domestic sectors.

For example, in the retail sector, online purchases and food delivery will spawn further demand for last mile logistics and central kitchens.

### Industry 4.0 already passed?

Post COVID-19 industries may have different corporate DNA structures from pre-outbreak days. Some of them are already here, some may probably be heading our way. As is with the impact of this outbreak on the other real estate sectors, it is too early to know with clarity what kind of industries will be left in the landscape. Nevertheless, we may still have a vague idea of what the future holds. Industry 4.0 may quickly be upstaged over by Industry 5.0 where there is greater customisation and robotics involved. The need to diversify away from China’s cost advantage may result in companies offering customers the ability to customise their products. This could mask the higher cost issue as alternative manufacturing hubs may not be as cheap in producing compared to China. Industry 5.0 plays into that need.

Under the previous manufacturing construct geared towards Industry 3.5 and 4.0, Singapore was supplanted by China. But post-COVID-19 Singapore’s fortunes as a manufacturing hub for MNCs has the potential to look brighter. That is only if Industry 5.0 takes root here, there being enough supply of buildings spec-ed for this version of the industrial revolution (which we believe that are hardly any available today) and a change in the workforce profile where the tertiary educated are willing to be production workers again.

Also, tied in the need for office space users to find cheap alternative locations for business continuity, industrial estates in the heartlands and central parts of Singapore may be able to need those needs. For this to happen is just a relaxation of use conditions for B1 space but subject to limitations on the amount of space used, or to rezone some B1 areas to Business Parks. All is not lost for the industrial property market and in fact, this could be the dark horse arising from all the global disarray.

### History of Industrial revolution

<table>
<thead>
<tr>
<th>Era</th>
<th>Time Period</th>
<th>Key Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0</td>
<td>1800-1870</td>
<td>Industrial production based on mechanical power and steam</td>
</tr>
<tr>
<td>2.0</td>
<td>1870-1920</td>
<td>Mass production using assembly line</td>
</tr>
<tr>
<td>3.0</td>
<td>1920-1980</td>
<td>Automation using electronics and computers</td>
</tr>
<tr>
<td>3.5</td>
<td>1980-2015</td>
<td>Industry 3.5</td>
</tr>
<tr>
<td>4.0</td>
<td>2015-2035</td>
<td>Industry 4.0</td>
</tr>
<tr>
<td>5.0</td>
<td>2035- onwards</td>
<td>Industry 5.0</td>
</tr>
</tbody>
</table>

### Subscript 1 = pre-COVID-19

### Subscript 2 = post-COVID-19

See references.
Our view: If there is a quick resolution to COVID-19

In our previous quarterly write-up, we had anticipated investment sales to come in between S$30 and S$35 billion in 2020. However, we believe that the range may have to be reduced significantly to S$25 to S$35 billion, not only because of any deterioration in buyer sentiment but rather coming into the new year, there are hardly any large seller's mandates. Owing to the sudden crippl in supply, it is creating a condition where buyers, as the year progresses, face greater pressure to invest, and may end up stretching their offers. This may result in generally higher prices in some asset classes, especially the office, retail and hospitality sectors.

Since H1/2019, the China region has been experiencing a brew of issues. Beginning with the HK protests, the entire Chinese continent has, at the time of writing, sunk into a quagmire of uncertainties. Graph 1 shows the output of the RICS investor and sentiment index survey for Q4/2019. We believe that, come Q1/2020, not only will both indices fall further but also that Hong Kong and China will fall relatively greater compared to other Asian cities.

However, in the backdrop, liquidity is piling up and those with an Asian mandate will but to find relative safety in a sea of uncertainty stemming from the outbreak of COVID-19. Using Q4/2019’s indices as a guide, within the China, Hong Kong and Southeast Asian region, both investors and occupiers’ sentiments towards Singapore had been relatively strong and had placed the country above previously popular markets in China and Hong Kong. We believe that 2020 may turn out to be a year where the channel of investment flow bifurcates sharply with a pool heading towards North Asia ex-China (Japan and South Korea), and another moving down to Singapore and Vietnam. All this is due to the relative risk of being affected by the direct and indirect fallout from the COVID-19 outbreak and the need to find an abode for both institutional and family capital.

Whilst there is still a lack of visibility with regards to large sell side mandates in Singapore, the weight of money looking for relative safety may force bring about off-market transactions at record prices. Nevertheless, even if record prices are set, it is creating a condition where buyers, as the year progresses, face greater pressure to invest, and may end up stretching their offers. This may result in generally higher prices in some asset classes, especially the office, retail and hospitality sectors.

Our view: If COVID-19 infections prolong, the virus finally becomes the new norm

Our approach to looking at the future of our investment sales market is based on the various scenarios that may take place. There are four general ways as to how investment confidence may behave ahead. This is predicated on governments and society accept the presence of COVID-19 in our daily lives as the new norm, or if hope is rekindled with the discovery of an effective vaccine. The fifth direction of investment confidence is severe and may be discussed in a subsequent blog. These are conceptually shown in Graph 3.

If we believe that the infection numbers follow the stylised curves in Graph 4, we really don't need to get to the peak in order to find out when things will start to get better. All we need is to get to the point when the infection numbers begin to slow, and the informed will be able to build a new forecast. When the infection point is and when the whole episode may end. Unfortunately, at the time of this writing, for Singapore and the world, that is difficult to ascertain because we are seeing an acceleration of infection rates in some countries, different approaches taken by countries to test for infections and some countries incredulously reporting almost negligible infection numbers. Also, because of confounding factors, the shape of the infection curve may be distorted. If there are no surprises then, the infection numbers begin to lower, we may be able to have an idea of when the worst will be over.

Scenario 1
One of the ways for this scenario to play out is when there is visibility on how the COVID-19 issue is expected to turn out. For example, using Graph 4 as a reference, when the rate of infections begins to lower (the light blue boxes), even before reaching peak levels, the virus may begin to fade away. By way of forward looking, will pounce on the opportunity, generally once travel restrictions are lifted (for decision makers to fly). Thus, even if the infection numbers continue to rise, there will be a sudden rush to acquire assets (both private or public equity) regardless of whether yields are compressed or if real assets (opposed to equity) are attractively priced.

Scenario 2
Once there is either some clarity on certain fronts (e.g. the ability to travel relatively openly without restrictions), companies can begin to return to a business-as-usual mode. Investors will be able to travel to carry out due diligence work on Singapore real estate assets. Under this scenario, infection numbers are still rising but the rate of increase appears constant rather than accelerating. (The light green boxes in Graph 4.) Scenario 1 and 2 need not be absolute in terms of the degree of climdown in the severity of COVID-19 affecting our lives. It can be relative. For example, if a complete lockdown is implemented in Singapore and then relaxed sequentially, the effect is the same to feeling relieved. (Similar to the feeling that if one is subjected to tough punishment and then brought back to basic, nonetheless tough commando training, the psyche improves.) If infection curves are smooth, like those in Graph 4, the first two scenarios can begin to have possibilities that can lead to an improvement in investment sentiments can be:
- The global village begins to accept that COVID-19 is here to stay.
- COVID-19 mutates to a less virulent strain.
- Society runs into fatigue from prolonged anxiety.

Scenario 3
If there is continual flux in the way governments react to COVID-19, it may not give investors and society alike the ability to get a clearer picture of where markets may be headed. For instance, if some governments take draconian actions to limit social movement while others do not, the possibility of mixed curves cannot be ruled out. Extending and expanding travel bans or sporadically turning them on and off would also be categorised under this scenario. The possibility of infection numbers after a period of decline may also keep investment sentiments within this category. Investment activity would, therefore, continue to face a protracted period of dead calm but the desire to invest would remain latent positive.

Scenario 4
Any further moderate decline in investment confidence may come about should governments, who after months of trying to battle infection numbers, suddenly implement policies that adversely affect the financial and real estate economy, for example, forcing airlines companies and markets to shut for weeks. Investment activity will be similar to that in the previous scenario, namely non-existent, and the interest of wanting to invest will begin to wane. If confidence levels quieter, then scenarios 3 and 4 may be the case.

Scenario 5
This is an extreme case where the outbreak takes a turn for the worse and societal behaviour gets twisted out of norm. We shall not discuss too much about this scenario, but some general possibilities that lead to this are:
- The virus mutates to a more virulent strain
- The breakdown of economies and when social and economic systems function beyond tolerable norms
- Force Majeure clauses get invoked, leading to a chain of defaults
- Hostilities breakout amongst major economic powers
- Prices of basic commodities reverse change drastically (up or down)
- Interaction effects arising from global warming

Outlook
Under the above mentioned scenarios, we have constructed a matrix of vectors relating to several investment variables. This constitutes what we believe is the market place (i.e. our prior beliefs- see Table 1.)

Excluding the Scenario “Present vs late-2019”, we have 14 directional outcomes and, of this, 11 are pointed up, 3 sideways
and 11 down. Therefore, on balance, the ups outnumber the downs. This forms our a priori belief (hypothetical deduction).

Now we combine that with what we are picking up on the ground from potential investors:

- The interest to invest/relocate to Singapore is strong and becoming stronger. We arrived at this view after having gone through numerous meetings and teleconferencing sessions with entities presently based in Hong Kong, for example, or elsewhere in Asia.
- The weight of money has not diminished. Although the amount of dry powder within private equity to invest in Asian real estate has decreased in 2019, it is still high and, for the period until March 2020, has increased to US37 billion (probably due to the inability to conclude deals during the intensification of cracking down on the spread of COVID-19) (See Graph 5).
- COVID-19 has spurred manufacturers (both F&B and goods) and stockists to think about the need to set up facilities in Singapore to mitigate risks of import disruptions. In this regard, the Singapore government is very likely to be looking at future incentives or ways to lower disruptions due to extreme risk events.
- If economic systems do not break down, then an even lower interest rate environment may get investments, which in 2019 were deemed too rich, across the line.

Prior to the outbreak of COVID-19, we were positive about prospects within the Singapore real estate investment market. Now, if scenario 5 does not materialise, we have turned even more positive for the abovementioned reasons. The impact of COVID-19 has shut down the investment sales market because of travel restrictions. The need by private equity to invest once the ability to do so is like that of a spring that has been compressed right down to the shut load. (Please see Figure 1.) The potential energy for a rebound is now high. In fact, for those who are able to pull the trigger and do a deal, the time is now, rather than wait until everyone flock back to work.

**Figure 1: Analysis of the pent-up investment energy arising from the COVID-19 travel restrictions**

Navigating the investment and capital markets during an uncertain time

The Savills Investment Sales & Capital Markets team offers a full suite of capital markets, investment advisory and transactional services:

- Marketing and sale of Office, Retail, Hotel, Industrial, Shophouses, Strata title properties
- Collective sales and land sales
- Investment advisory and consultancy services
- Joint venture partnerships, funding and consortium transactions

Capital transactions services:
- Advising on property equity and debt investment
- Investment acquisitions and dispositions
- Marketing and pricing strategy, and investor targeting
- Real-time market intelligence
- Identifying changing market trends and insights
- Facilitating due diligence

Consult with our agents

**Table 1: Checklist of investment variables under various market sentiment scenarios**

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Real Estate Core</th>
<th>Real Estate Core</th>
<th>Real Estate Core</th>
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<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

**Graph 5: Amount of dry powder amongst Asian focused Real Estate Private Equity**

Source: Savills Research & Consultancy

**Consult with our agents**

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What if the worst-case scenario develops? A discussion

Background
This last blog on the COVID-19’s impact on Singapore real estate will seem very dark. I hope what has been written here does not come to fruition. However, I do feel compelled to opine that we need to spend time to seriously look into the situation when the socio-economic constructs begin to unravel. This piece looks at one aspect of Scenario 5 in the blog on the investment sales market. Scenario 5 can be triggered by a host of other factors and cross-factors. Here, we will approach it from a financial calculation angle.

How things can unravel
Much has been written about the impact of COVID-19 on societies and businesses and how it may change the landscape when it blows over. There is however a problem, a big one in fact, about all analysis that assumes that it blows over without any damage done to the underlying structure of the economy. What if it is to stay and it supposes economic activity for a long period – e.g. for years – and policy inaction or dis-coordination starts to unravel the traditional economic constructs taught in economics/finance? Also, what if certain financial and economic fixed points move? Should these happen, investors could start turning negative and investment variables take on extreme values or behave in unexpected fashion.

For instance, on the private equity front, what if Limited Partners (LPs) stick to just their committed capital and resist future investments or, worse, end up in disaster by future fund-raising exercises? On the corporate front, what if companies find that their current business models are out of sync with a COVID-19 world, resulting in their burning cash and needing a heavy dose of reinvestment to change course? On the private front, what if individuals find that risk taking is not preferred and instead turns to embracing risk free investments?

All this means governments, institutions, corporates and high net worth private individuals will shift from risk taking ventures to protecting their dry powder. There will be major withdrawals on many investment fronts. The result: asset price deflation. If this is where we end up, the combined actions of governments, companies and individuals may lead to a severe contraction in the price levels of many investment goods. There are many paths that can be forecast here. One such an arena when governments need to refuel their economies to keep their society from breaking down. That may happen when investors (government, corporates and individuals) realize that the outbreak has no clear end in sight. In graph 1, the “cut-off” point from investors’ need to invest a cessating of investment is represented by two vertical lines. The red line is applied on the top of the red curve where there is wholesale infection on the yellow line when there is expected a long-drawn battle of containment. For both cases, investors would probably be in the dark and to where rates of infection begin to decline (and so they have little knowledge of when it will get better). At the small interval ranges where the vertical lines are drawn, the final shape of the curve cannot be parameterized with confidence. This leaves markets with no handrails for guidance and markets hate uncertainties.

There is a possible third line (x) and that is when mixed curves begin to form for different countries. This can arise from uncoordinated attempts by various authorities to approach the problem of infection or some earlier infected countries deciding to return to a travel as usual policy. This third line can be anywhere and is particularly dangerous because the parameters are even harder to determine. One cannot calculate its shape and thus also not being able to estimate when the infection rates will start declining. This is conceptually shown in the graph as the light blue coloured box that ranges across much of the graph. The vertical line (x) can therefore appear almost everywhere in this stylized diagram. We also don’t know when the vertical line would emerge, as it depends on the start of the breakdown of order and even less so on what shape mixed curves may take. When the breakdown occurs, its effects are similar to the dynamics in a Great Depression.

We are facing a very serious issue that can reverse the flow of capital to investments. We shall look at how investments can go wonky by approaching it from the mechanics of the discounted cash flow process to valuing real estate (I am focusing only on the net worth private individuals will shift from risk taking ventures to protecting their dry powder. There will be major withdrawals on many investment fronts. The result: asset price deflation. If this is where we end up, the combined actions of governments, companies and individuals may lead to a severe contraction in the price levels of many investment goods. There are many paths that can be forecast here. One such an arena when governments need to refuel their economies to keep their society from breaking down. That may happen when investors (government, corporates and individuals) realize that the outbreak has no clear end in sight. In graph 1, the “cut-off” point from investors’ need to invest a cessating of investment is represented by two vertical lines. The red line is applied on the top of the red curve where there is wholesale infection on the yellow line when there is expected a long-drawn battle of containment. For both cases, investors would probably be in the dark and to where rates of infection begin to decline (and so they have little knowledge of when it will get better). At the small interval ranges where the vertical lines are drawn, the final shape of the curve cannot be parameterized with confidence. This leaves markets with no handrails for guidance and markets hate uncertainties.

The mechanics of this is illustrated using this basic relation between the cost of equity in local currency terms and its various contributing components found in the right-hand side of the equation. This relationship is only well defined if the free rate is 0 and the market return is higher than the risk-free rate.

Graph 3: Return on equity for main industries in Singapore

Cost of Equity = Risk Free Rate + β * (Market Return - Risk Free Rate)

Let us consider just two outlier possibilities.

- If the risk-free rate is zero and the market return is negative, then: Cost of Equity = β * (-Market Return)
- If the risk-free rate is negative and the market return is negative, then: Cost of Equity = Risk Free Rate + β * (-Market Return - Risk Free Rate)

Strange output values.

However, I feel that there are fundamental differences in the socio-economic structure between the US and the rest of the world e.g. the US runs huge budget and trade deficits whilst some in Asia run large surpluses, the US has been a technological leader and exporter while many in the rest of the world are adopters of their inventions, different pension funds systems, varied housing policies etc. If the risk premium is obtained from the equity markets, I prefer to calculate this from the performance of China linked companies listed here. (One can test this claim with a program that gathers and then cluster what market chatter had driven each market at the end of the day, week or month and then conduct a pair test.)

Graph 4: STI’s time series profile differs from the S&P 500 and NASDAQ

2. Interest rates may resist falling, much as the issue of bonds contributing components found in the right-hand side of the equation. This relationship is only well defined if the free rate is 0 and the market return is higher than the risk-free rate. (the total to be raised is S$8 billion) is just the start of many such fund raising exercises across the globe.

3. Financial institutions, moving from a profit seeking objective to defending their credit ratings, focus on mitigating risks, lower their loan-to-value ratios and adopt a selective lending policy.

Combining points 1, 2 and 3 will mean that the cost of equity and cost of debt will rise substantially and on top of that the equity content will have to increase if banks lower their LTVs. This leads to an increase in the Weighted Average Cost of Capital (WACC).

This result will be Net Present Values (NPV) coming off. The relation is found in the following equation.

$ WACC = \frac{E}{V} + \frac{D}{V} \times (1+\text{cost of debt}) + \frac{NPV}{V}$
If we accept that the market risk premium is expected to decline, the cost of equity declines accordingly. But if government bond yields remain sticky, there exists the possibility that the market risk premium turns negative and that can also lead to a negative cost of equity. But how can that be when in risk adverse times, the required return from equity investments should be even higher?

5. Deflation. This D is a “dirty” word that creates mischief in the discounting mechanism. In a deflationary environment, consumption is deferred until absolutely necessary and cash flow is expected to decline over time (when the top line falls faster than expenses). The rate of return from investments will have to be higher at the start to compensate for lower capital or investment income in the future. The effect of deflation can wreak havoc on terminal cap rates.

\[
\text{T\text{erminal cap rate} = \text{Discount rate (r)} - \text{Long-term annual income growth rate (g)}
\]

If long-term annual income growth is expected to be negative, the terminal cap rate will be higher than if growth had been positive since:

\[
\text{Terminal cap rate} = \text{r}^* - (-\text{g}) = \text{r}^* + \text{g}
\]

\* r can be the valuer’s choice of discount rate adopted during the term of the cash flow analysis or it can be the derived WACC used by business valuers.

A higher terminal cap rate, in conjunction with higher r’s used during the term of the discounted cash flows (because the cost of equity has increased and LTVs collapsing), would result in a lowering of asset values. In turn, collateral quality would deteriorate, leading to further credit tightening. This is the evil of deflation.

How deflation can take root is manifold. One path could be this: companies whose business models have been disrupted by COVID-19 may experience stepped down demand for their goods and services when this pandemic either blows over or becomes the norm in daily life. In other words, returns from historically committed investments decline. If the return falls faster than borrowing costs, or if the latter rise even a little, the spread falls. Trouble will begin to trickle down to housing demand, as employment will ultimately be affected. If risk aversion spreads, funding for start-ups and the Gig economy will be even harder to come by. The long and short of it is that there will be price deflation and devaluation of real estate prices across most market segments (private housing, office, retail, hospitality and industrial).

The 2 D words will be very difficult to counter for central bankers when they are intertwined with interacting issues that are expected to appear over time. The interference can limit the degrees of freedom where governments can counter them. For instance, if the push towards reducing CO2 emission takes on greater urgency and if weather changes causes a constant stream of uncertain events, conditions could emerge which could crimp the ability to implement or, even if applied, the effectiveness of policy actions.

Conclusion

The six points discussed are extremely disruptive to the real estate market. Combating its ill effects will need a global effort because in an intertwined investment world, unilateral efforts to fight it will result in arbitrage, annuling any well-intendedness. Policy makers will be grappling with inputs from many fronts but if we pay attention to the variables used in the discounted cash flow process, it filters off a lot of the noise and directs our focus of attention to action plans that seek to prevent the following:

- Adverse risk aversion from developing
- Difficulty in obtaining credit or reduction in LTVs. Rather, LTVs should increase
- Negative interest rates
- Deflation
- Sharp rise in the cost of equity
- Oversupply of land for massive conceptual and visionary plays
- The continuation of the slate of cooling measures in its current form

Yes, the fight requires bold action plans.

It is natural for some to ask what the $855 billion budget boosters, one announced on 18th February and the other on the 26th of March, will do to the real estate market. The various assistance packages pronounced are generally consumption driven in nature and so the short answer is, not much, once the spend works through the money multiplier. Using the DCF method to illustrate its long-term influence on consumption, it is just an injection of cash and subtraction of expenses into one period of a multi-year cash flow model. Cash flow in the subsequent and the terminal years have not changed. The points that I raised pertain to the investment pillar of the economy, in which real estate is part of. The issues discussed are structural in nature and cannot be tackled by budgets or from the consumption side. Therefore, after tackling the immediate need to help the “human factor” in this pandemic, governments (as I mentioned, no single government can do this alone), must get their act together to ward off the evils of deflation.

Owing to the constraints of space, I will not use this platform to look at the options to fight deflation.