Coronavirus: Potential Impact on Real Estate

The COVID-19 strain, more commonly known as the coronavirus, has rattled global markets since the first reports of the disease emerged in Wuhan, China on December 31, 2019. Since then, the virus has spread to more than thirty-eight countries (including the U.S.), with the largest concentrations outside of China occurring in Italy, Iran and South Korea. At the time of this publication, the World Health Organization (WHO) was tracking more than 81,100 confirmed cases of the virus worldwide and attributed 2,718 deaths to the virus.

Notwithstanding the most obvious concerns regarding global public health and safety, nervous investors already on edge due to lofty equity evaluations watching for signs that the coronavirus could represent a significant recession-inducing shock to already-fragile global growth led to a decline of nearly three percent in early trading of the S&P 500 on February 24th and European markets recording their single-worst day since 2016. For those looking for harbingers in the equity markets, they needn't look far.

The potential near-term impact of the virus is likely to be varied by industry, region, and ultimately, the trajectory of the disease's spread over the coming weeks. The following is our quick take on the virus, our view of the potential impacts to global and U.S. growth, and how it might influence domestic real estate markets.

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Coronavirus Context

While the death toll from the coronavirus thankfully remains considerably lower than from influenza (which accounted for 8,200 deaths in the U.S. alone for the 2019-2020 season[1]), the speed at which the virus has spread globally has prompted due concern. Unlike the flu, the onset of the coronavirus has been marked by widespread quarantines essentially shutting down entire cities, exacerbating the impact beyond just those infected. The tragic loss of more than 2,700 lives brings additional gravitas to an already-serious epidemic, one we at ARA are highly sympathetic to.

Statistics are constantly evolving in situations such as these, making a commentary on outlook especially challenging. According to Worldometer, total active cases of the coronavirus peaked in mid-February at 58,747 and have since declined 15%; of those cases that have been marked as closed, 91% have recovered or were discharged.[2] The number of new cases in China has dropped dramatically in recent days, while at the same time there have been sharp upticks in the number of cases in Italy, South Korea and Iran and for the first time since the first identified case of COVID-19, there have been more new cases reported from outside of China than from within. The Center for Disease Control in the U.S. issued a statement that the spread of the disease in the U.S. is "not so much a question of if, but a question of when."

Impacts to Global Growth

The primary economic risk to the U.S. and global economies is the domino effect of companies being unable to source necessary component materials from China amidst multi-week-long factory shutdowns and quarantines coupled with

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[1] World Health Organization
[2] As of February 24th, 2020

a steep drop-off in Chinese spending (which would be worse if the quarantine continues and more companies are forced to shed jobs) slowing demand for goods and services.

How does a factory shutdown in China adversely impact U.S. and global growth? While a bit of an oversimplification, it could hit on several fronts:

1. Businesses, especially high-tech companies such as Apple, are unable to source much-needed component parts to make their products – this ultimately leads to a shortage of inventory on hand and a reduction in sales given the availability of product. This further materializes in public companies' earnings.
2. U.S. consumers are faced with fewer higher-cost items to purchase; retail sales soften and the consumer contribution to GDP growth falters.
3. Fewer travelers may weaken demand for U.S. hotels, airlines and cruise lines.
4. China's total trade in goods accounts for roughly 12% of global trade; a steep slowdown in Chinese consumption could have far-reaching ripple effects on export-oriented countries such as Germany, whose economic base is already weak.

While the severity of these forces will depend in part on how widespread the virus becomes, we believe that under present conditions the impacts are manageable. When production returns, pent-up demand may even provide a boost to sales, in turn bolstering corporate earnings and confidence and negating the short-term impacts. A more severe pandemic scenario would have a greater adverse impact but could also be met with stronger pent-up demand on the back end serving to offset weakness – how? Consumers who had planned to acquire these high-ticket items will not suddenly decide not to buy them; rather, they'll defer these purchases, creating a "slingshot" recoil after the virus has been contained, ultimately keeping full-year growth on or near pre-virus estimates.

This balancing of near-term softness by later-term recovery is not a unique perspective. Economists' expectations for the impact to global and U.S. GDP growth for the year overall suggest only minimal impacts – Moody's Analytics, Oxford Economics and Barclays have noted expectations of the virus to shave between 20-30 bps off global growth, while U.S. predictions range from a 20-bp impact on Q1 growth to as much as 40-45 bps. While the more severe scenario would no doubt sting, we do not believe it would be sufficiently devastating to derail full-year growth – as a point of comparison, China's quarterly GDP at the peak of the SARS outbreak contracted by 240 bps in Q3 2003, and official figures for that year still reflected 10.0% annual growth.

Real Estate Implications

For U.S. commercial real estate, the impacts of a prolonged infection period will vary considerably by sector and market. Markets that are more heavily reliant on Chinese tourism (such as San Francisco and New York hotels) will feel the effects the quickest, as revenue per available room weakens amidst fewer foreign travelers. These markets may also see retail sales weaken, as Chinese travelers tend to be one of the highest-spend foreign visitors to the U.S. – however, given the broader headwinds in the retail industry, this will only serve to reinforce ongoing trends.

The office sector could be impacted to the extent that companies miss their earnings meaningfully as a result of product unavailability and subsequently curb near-term leasing decisions until the uncertainty has passed. While this may impact tech-centric markets first, many companies' goods are produced at least in part with components from China so the longer the impact period, the wider the impact net will be. Again, under current conditions, we believe the delay in decision making will be temporary; companies' decisions to occupy office space are part of longer-term capital expenditure and growth planning and as a result are not often sidelined by near-term noise.

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While manufacturing PMIs have begun to show softness amidst the pullback in Chinese factory output, the institutional industrial real estate sector has very little true manufacturing product in its composition, which is the segment that will feel the greatest and fastest impact of the coronavirus. Broader forces related to e-commerce and supply chain rationalization should continue to buoy demand for warehouse space in spite of manufacturing weakness; while West Coast port-centric markets such as Los Angeles/ Long Beach may see activity pause given the heightened exposure to Asia Pacific imports, most major markets should continue to be relatively isolated. An unintended, though positive, consequence of all this may be an uptick in future net absorption as companies decide they want to shore up their inventory levels so they aren't caught in a similar situation in the future.

The multifamily sector is domestically driven and as such, is the most insulated from a sector perspective.

The world is only starting to deal with the sudden and extensive eruption of the coronavirus and the loss being experienced across the world is having a tragic impact on human life and the global community as a whole. This potential epidemic could have significant ramifications for the global economy and global supply chains, and with the myriad of possible outcomes changing daily as new information flows in, investors face uncertainty. While we at ARA are by no means epidemiologists, we believe there are a few positive signs beginning to emerge, including

- A decline in the number of new infections in China.
- More Chinese factories coming back online.
- Work resumption rate in China is rising.

We believe there are sufficient policy tools yet available to global central banks to leverage in the event the epidemic becomes more widespread and begins to influence growth more heavily, and that there is an upside that near-term softness may create a "V" effect whereby consumption and business earnings rebound more strongly after the trough. In either scenario, we intend to "stay the course", pursuing opportunities that align with our stated core and value-add strategies while continuing to monitor developments.

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