The implications of COVID-19 for the real estate industry

Isle of Man
2020

Consequences of COVID-19 and its related behavioural changes on the real estate industry
This overview provides short and longer term views across the entirety of the industry from two perspectives: 1) The perspective of real estate end-users, in which real estate is supporting to a company’s core business, and 2) The perspective of real estate and construction companies, for which real estate is core business.

Effects of COVID-19 on the macro-economy are impacting the entire Real Estate industry
— Strong correlation between real estate developers’ financial performance and national economies’ wellbeing
— Significant exposure of real estate investment managers to highly affected industries such as hotel & leisure, retail and office investments can hamper future and imminent cash-flows and pension fund returns
— End-users in specific sectors, primarily in retail, highly dependent on real estate for recurring revenue streams
— Loss of jobs in construction industry were unprecedented following the GFC of 2008. The impact of COVID-19 may present similar circumstances
— Retail tenants apply for rent discounts because they want to reduce the standard high fixed costs of real estate due to their loss of income. Property owners are not unwilling to do this, but the demand for customisation complicates implementation
— The question that remains is whether the retail sector, which appears to never have fully recovered from the 2008 crisis, will ever be the same once the blow of the corona crisis is over. This crisis might very well be the end of many outdated business models.
— Share prices of UK real estate and construction industry players have seen unprecedented volatility, with significant declines in value experienced in March & April 2020 to date.

Approach and Mitigations

<table>
<thead>
<tr>
<th>Assess</th>
<th>Adopt</th>
<th>Adapt</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assess Impact on KPIs and map Action plan</strong></td>
<td><strong>Adopt measures immediately to safeguard business as usual operations</strong></td>
<td><strong>Adapt business strategy going forward and refine accordingly</strong></td>
</tr>
<tr>
<td>The increased risk on business as usual operations must be assessed, with specific attention given to risk management:</td>
<td>Identify quick wins in action plan and adopt immediately to mitigate lasting effect of risks. Consider:</td>
<td>Reassess overall business strategy including planned milestones and goals to reflect new economic reality. Consider:</td>
</tr>
<tr>
<td>— Leveraged capital structures and liquidity</td>
<td>— Define a well strategized route to safeguard business, facilitate all stakeholders and keep your longer term ambitions targeted.</td>
<td>— Reassessing planned investments and strategy based on industry developments</td>
</tr>
<tr>
<td>— Solvency of counterparties such as commercial tenants</td>
<td>— Focus strongly on Business Continuity Planning (BCP), in line with long-term ambitions</td>
<td>— Refining (refinancing plan and KPIs based on economic developments</td>
</tr>
<tr>
<td>— Portfolio dependence on at-risk industries (such as retail)</td>
<td>— Rent suspensions helping tenants to survive, but act wisely in mutual interest</td>
<td>— Managing banking agreements and monitor covenants</td>
</tr>
<tr>
<td>— High cost bases and inefficiencies in operating models</td>
<td>— Strong account management orientation to engage tenants</td>
<td>— Continuing or accelerating digital initiatives to further prepare your organisation for the new reality</td>
</tr>
<tr>
<td>— Cash and liquidity management</td>
<td>— Amend cost base where required to reduce operating expenses</td>
<td>— Long-term opportunities for Corporate Real Estate to rationalize portfolio given working from home</td>
</tr>
<tr>
<td>— Tax impact analysis</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Constructions planning impaired due to international labour force: Property developers and construction companies relying on foreign labour may have their plans hampered due to international travel restrictions. Similarly, construction plans are placed on hold and may experience delays. Incurred costs are highly dependent on contractual agreements.

Disruptions to procurement can shake the entire supply-chain: These trying times evidence the interdependence of (construction) supply-chains such that, if one entity is experiencing difficulties, this may reverberate across the chain. The supply-chain and its interdependencies must be managed in its entirety rather than in silos.

Development companies impacted by interruptions in the value chain: Property developers are highly impacted by market uncertainties and consumer confidence resulting in fewer or delayed private sales. Moreover, developers may experience uncertainty due to local government decision-making and supply chain disruptions.

Listed real estate companies’ stock market value and share prices have evaporated in anticipation of deteriorating leasing fundamentals as a result of social distancing and intelligent lock-down.

Players active in at-risk categories must re-strategise post-crisis: Real estate investment managers must reconsider their asset allocation strategies, contractual and financial arrangements and effectiveness of their risk management operations.

Effects and Sector Impact

Working from home experiment may fundamentally change consumer behaviour and the office-space market: Forced working from home restrictions might lead more players to reduce office space renting in the future. However, this presents a potential opportunity to corporates to rationalise portfolios and embrace enabling technologies.

Top-line cash-flows related to unearned (rent) revenue at risk: Real estate investment managers are highly impacted by market uncertainties and consumer confidence resulting in fewer or delayed private sales. Moreover, developers may experience uncertainty due to local government decision-making and supply chain disruptions.

Impairments in tangible assets may lead to deterioration on balance sheet and income statement: For those with real assets on their balance-sheet, loss of income generated through real assets may lead to impairments and devaluations, highly impacting bottom-line and financial performance. Apart from investments and retail, this may also hold for less traditional business models such as flexible office space providers.

Leveraged capital structures are at risk: Property developers and investors financing operations with debt may particularly be at risk of defaulting, exaggerating their credit lines, and struggling to maintain liquidity.

Digital investments seem to pay off: Sector players that invested significantly in digital capabilities seem to be better able to continue activities during crisis.

Key contact

Edward Houghton
Director, Audit
KPMG in the Isle of Man
+44 (0) 1624 681081
ehoughton@kpmg.co.im

Aidan Tucker
Senior Manager,
Restructuring
KPMG in the Isle of Man
+44 (0) 1624 681043
aidantucker@kpmg.co.im

kpmg.co.im