



TRENDS FOR 2021

Real Estate Trends Set to Shape the Next 12 Months

January 2021 | Investment Research

Executive Summary

As a new year gets under way, we turn our attention to the outlook and identify nine major occupier and investment trends we expect will influence market conditions and investment performance in 2021 and beyond.

1. **Uncertain Environment Persists:** Signs are encouraging for economic activity going into 2021, but occupier demand will be held back in the first half of the year because of elevated levels of uncertainty.
2. **Supply Growth Remains Subdued:** Unlike in past cycles, supply growth was contained prior to the downturn and is set to remain subdued in 2021 and beyond.
3. **Increased Remote Working Pushes Vacancy Upward:** Office vacancy is already rising, and the prospect of a shift toward increased remote working is set to weigh on rental growth prospects in the coming years.
4. **Sector Divergence Stays Wide:** Rental growth divergence is set to remain wide, driven by contrasting fortunes across geographies as well as between the logistics and retail sectors.
5. **Transaction Volume Recovers Slowly:** Transaction volume has fallen sharply, and although investors are keen to deploy capital, ongoing restrictions are set to hold back the recovery in deal activity.
6. **Low Interest Rates Continue to Support Pricing:** The sharp drop in long-term interest rate expectations recorded in 2020 is providing support for yields at current levels despite wider uncertainty.
7. **Capital Values and Rents Start to Move Together:** Yields may fluctuate in the near term, but 2021 looks set to be the first year of a new cycle, in which rental growth rather than yield shift determines value movement.
8. **Investor Interest in Debt Is Rising:** The share of debt capital raising continues to increase, supporting a gradual improvement in origination volume from a broader group of lenders in 2021.
9. **Distress Remains Contained, but Financing Opportunities Emerge:** Distress is set to be limited, but value declines in parts of the market and ongoing regulatory constraints on banks imply a growing opportunity for nonbank lenders in 2021.

For Professional Investors only. All investments involve risk, including the possible loss of capital.

INTRODUCTION

The outlook for 2021 remains highly uncertain even though recent months have seen several positive developments, from encouraging progress in vaccination programs to signs that parts of the world, notably in Asia Pacific, are rapidly adapting to the presence of COVID-19 while limiting disruption to normal economic activity.

However, what is perhaps most striking when looking ahead is just how wide the range of plausible outcomes still is. The exogenous nature of the shock means that unlike in past recessions, there are no structural imbalances to address that would limit the speed of the recovery once COVID-19 is under control. It is likely that output will get back to prerecession levels faster than it did during the global financial crisis.

Yet the reality is that in the middle part of 2020, economic output declined by a magnitude unprecedented in peacetime. Even if COVID-19 is swiftly brought under control, the path of recovery back to some kind of normality is far from straightforward.

Occupier markets lag wider economic sentiment, and real estate performance in the opening part of 2021 will continue to feel the effects of the COVID-19 pandemic. Heightened uncertainty limits tenants' desires to expand or lease new space, and the typical features of a recession, such as rising unemployment and corporate failures, are starting to bite.

Undoubtedly there have been some bright spots that should carry over to 2021. Logistics demand has risen faster than was anticipated as supply chains have adapted to sharp increases in online spending during the pandemic. Residential assets continue to deliver steady income, with occupancy supported by job retention programs; and office tenants have generally continued to pay rent despite low space utilization in many parts of the world through 2020.

For investors, 2021 is set to remain highly challenging because several factors are holding back investment activity. The level of uncertainty about the outlook is high; real estate cash flow is set to remain under pressure in the near term; and there are still physical barriers — in the forms of travel restrictions and physical distancing requirements — to doing deals.

At the same time, pricing has barely adjusted outside the retail sector. Central banks have been swift in coordinating their efforts to boost liquidity and hold down long-term interest rates, diverting capital away from fixed income and toward higher-yielding, asset classes. Compared with previous years, investors effectively receive no additional compensation for holding real estate despite the extra risk implied by being in the middle of a pandemic.

On the face of it, there are no shortages of debt and equity capital available in real estate, although investors' and lenders' focus has narrowed. So, even though logistics and residential assets are attracting significant capital flows, struggling sectors, notably retail and hotels, are facing declining transaction volume, disrupted cash flow and limited financing options as lenders pull back to reduce their risk exposure.

The magnitude of the economic shock that is still working through means that further distress is likely in real estate markets, but it is set to remain contained. For stable, income-generating assets — for example, either in a growing sector like logistics or in an office leased to a government-backed tenant — declining long-term interest rate expectations mean that few drivers are pushing yields upward.

At the same time, there is little scope for yields to fall much further on a sustainable basis, given that the yield curve is flat and short-term interest rates have now reached an effective lower bound.

The magnitude of the economic shock that is still working through means that further distress is likely in real estate markets, but it is set to remain contained.

Increasingly, it looks like 2021 will be the first year of a new phase in real estate history, wherein value movements are driven not by yield compression, which lifted capital values through much of the past cycle, but by fundamentals: in other words, the ability of real estate assets to generate, sustain and grow income.

So even though 2021 looks set to portend the beginning of the end of the COVID-19 pandemic, for the real estate sector a transition to a lower returning future is just getting under way.

Trend 1: Uncertain Environment Persists

Signs are encouraging for economic activity going into 2021, but occupier demand will be held back in the first half of the year because of elevated levels of uncertainty.

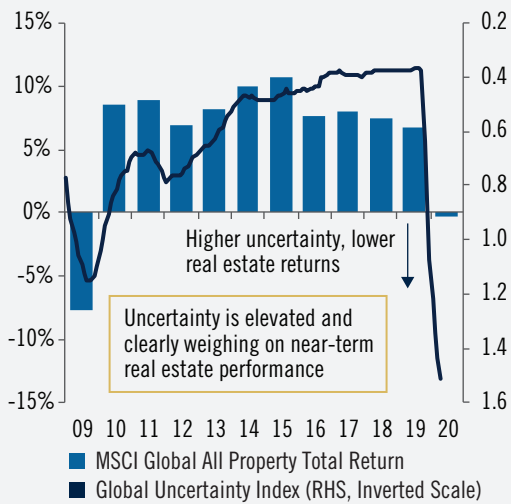
Even though the news has been encouraging about the outlook for 2021, most notably as COVID-19 vaccines start to be rolled out across the world, real estate markets start the year against a backdrop of great uncertainty.

Essentially, a combination of the steep drop in global GDP recorded in 2020, which is likely to be about minus 4.3% – its first decline since a minus 0.1% drop in 2009 during the global financial crisis – and the rapid but volatile shape of the recovery so far means there is a very wide range of potential outcomes.

A simple global uncertainty index, which is estimated using consensus forecasts (exhibit 1), shows an unprecedented divergence of views about growth prospects for next year. COVID-19 is the foremost concern, especially as new faster-spreading variants of the disease have recently emerged. But other risks, too, are set to influence the shape of the recovery, including a disruptive Brexit process, the transition to a new administration and policy focus in the United States, and ongoing tensions around global trade and technology.

Exhibit 1: Uncertainty, Real Estate Returns and Space Absorption

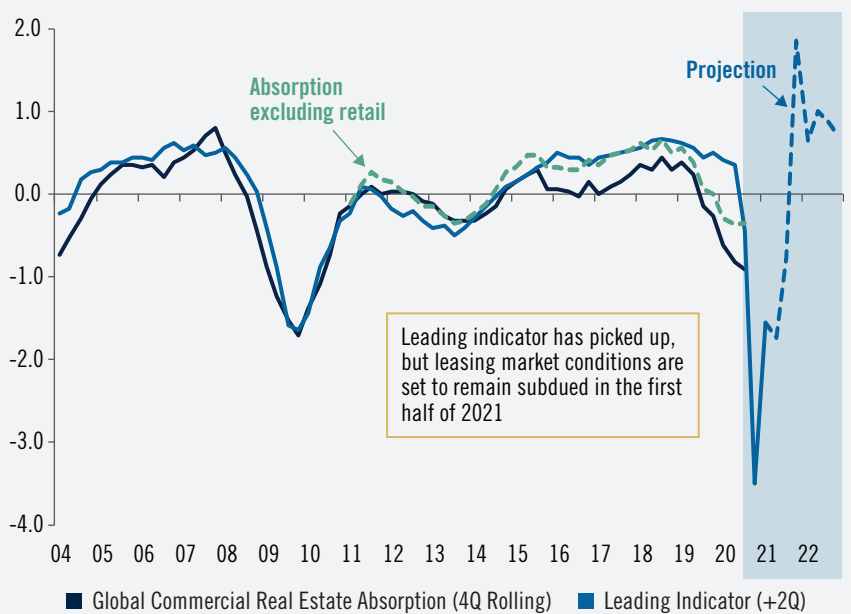
Global Real Estate Returns and Economic Uncertainty Index



Note: Uncertainty Index calculated using the standard deviation of Consensus Economics forecasts for the eurozone, Japan and the United States. MSCI Global Return estimated for 2020

Sources: Consensus Economics, MSCI, Cushman & Wakefield, JLL, RealPage, REIS, Eurostat, Manpower, Oxford Economics, PGIM Real Estate. As of January 2021.

Normalized Global Real Estate Absorption and Leading Indicator



The standard deviation of forecasts is significantly above even the depths of the global financial crisis, reflecting a reasonable chance of any outcome ranging from another year of outright recession all the way to well-above-trend GDP growth.

Uncertainty clearly weighs on real estate markets, whatever the eventual outcome. With investors discouraged from bidding up pricing in an environment in which rents are facing downward pressure, global real estate returns fell to an estimated minus 0.3% in 2020, down from 6.8% in 2019.

In occupier markets, uncertainty dampens demand for final products and weighs on hiring activity. With many firms struggling to keep on trading or at least putting expansion plans on hold, real estate absorption has fallen sharply in response to the drop in sentiment recorded in the first half of 2020.

Sentiment has already started to recover and based on a central scenario forecast, is expected to improve steadily throughout 2021. However, occupier activity lags economic growth and is likely to stay subdued in the first half of the year until there is clearer evidence about the path of the recovery.

The ongoing recovery from the COVID-19 pandemic is set to echo the pattern of the downturn and initial rebound. Experiences across different countries and regions will vary significantly too, determined by a range of factors such as the effectiveness of domestic policy making and COVID-19 containment measures, along with fallout from the severity of the initial decline in output.

The Asia Pacific region, which was the first region to be hit by the pandemic, is already recording an uptick in sentiment and are set to tell a relatively strong growth story in 2021, continuing momentum built up during a swift recovery in the third quarter of 2020. Employment is set to grow again in 2021 in many major Asia Pacific markets, supporting demand prospects in Hong Kong, Shanghai, Singapore and Tokyo.

Apart from some exceptions like Germany, where the impact of the pandemic on the economy has so far been relatively mild, both Europe and the United States face an uncertain start to 2021, with optimism around widespread vaccination programs balanced by restrictions in place to curb resurgences in cases.

Trend 2: Supply Growth Remains Subdued

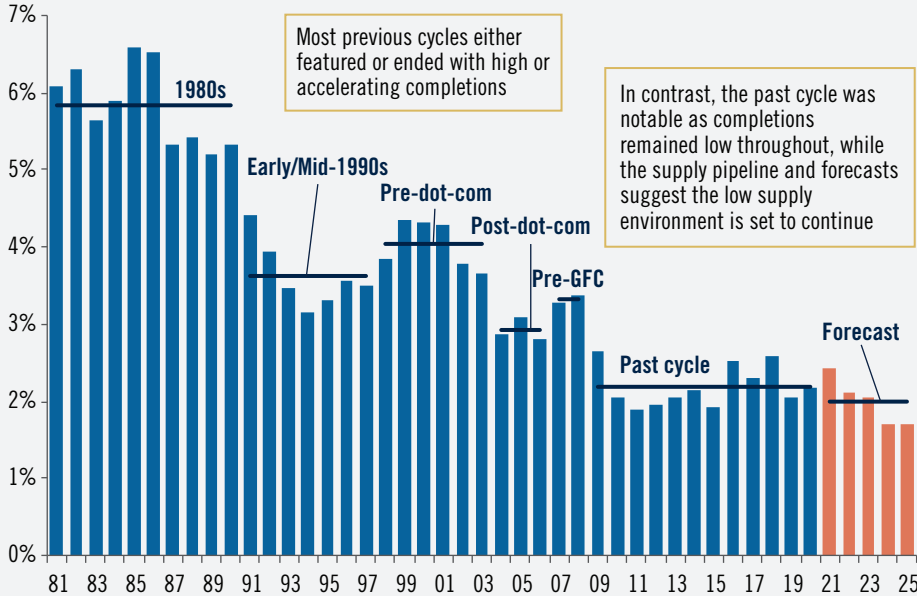
Unlike in past cycles, supply growth was contained prior to the downturn and is set to remain subdued in 2021 and beyond.

The most recent cycle was unusual in that supply growth never really picked up. Unlike in past downturns, when supply growth was either typically elevated or accelerating by the end of the upswing phase, falling demand in 2020 was set against only a very modest uptick in overall space additions (exhibit 2).

Even though the news has been encouraging about the outlook for 2021, real estate markets start the year against a backdrop of great uncertainty.

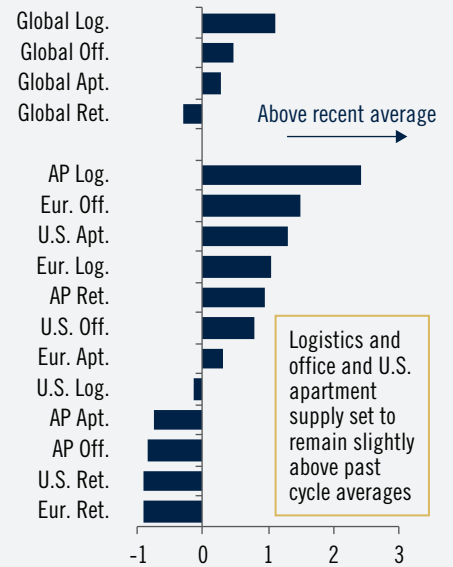
Exhibit 2: Global Supply Growth Summary

Estimated Global All Property Supply Growth (% Existing Stock)



Sources: Cushman & Wakefield, JLL, PMA, RealPage, REIS, PGIM Real Estate. As of January 2021.

Supply Growth Forecast by Sector and Region (2021-25, Normalized vs Past Cycle Avg.)



To an extent, the downward trend of supply growth over time is to be expected. As global property markets have grown significantly in scale over time, adding space to cater to the requirements of an expanding economy and an expanding labor market, new additions look ever smaller as a proportion of existing stock. Declining space requirements per worker or per unit of output further limit the demand generated by expansion of occupier activity.

Even so, there has been little pickup in the pace of supply growth in recent years, and the near-term development pipeline suggests a low-supply environment is set to continue. Postponements, construction delays and cancellations of projects that are not yet under way due to the pandemic point toward downside risks to supply growth forecasts in the near term.

As always, there are differences across sectors, regions and markets. Driven by rising demand among e-commerce occupiers, supply growth in logistics markets is set to remain above its recent average, most notably in Asia Pacific and Europe. In the United States, modest logistics supply forecasts may yet be revised upward and apartment completions remain above average, although the focus is on urban locations rather than suburban submarkets, where demand is rising more rapidly.

In Asia Pacific, the office sector recorded a bump in supply growth to 3.1% in 2020 compared with an average of 1.7% per year in the previous five years. Beijing, Shanghai and Tokyo all recorded faster deliveries in 2020, but even in these markets, the pipeline is set to remain contained during the next few years.

In other sectors and markets around the world, deliveries and the near-term pipeline remain low but have held up better than expected given the severity of the downturn and the physical disruptions to construction that affected 2020. Office starts are down, especially in the United States, and retail supply growth is set to be very limited given challenging trading conditions.

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Trend 3: Increased Remote Working Pushes Vacancy Upward

Office vacancy is already rising, and the prospect of a shift to increased remote working is set to weigh on rental growth prospects in the coming years.

The office sector faces an uncertain period in 2021 and beyond. Owners of office assets are concerned that the remote-working habits developed in recent months might become entrenched. Inevitably, workers and employers are becoming more accustomed to working from home, and disruption has been limited. When the pandemic starts to recede, preferences may shift permanently as a result.

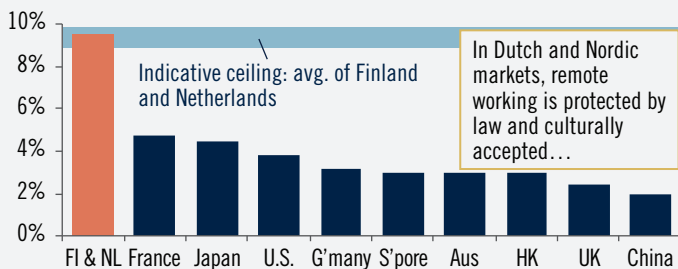
Remote working is set to have a significant impact as office markets start to adjust in 2021, but it is important to not overexaggerate the effect. As a starting point, such countries as Finland, the Netherlands and Sweden are useful guides for other parts of the world because their cultures and regulations had already allowed for a significant degree of remote working.

Levels recorded in those countries represent an effective ceiling or upper limit for other geographies in the longer term (exhibit 3). But even though technology improvements mean the share of remote working is rising gradually over time, there are limits. Estimates suggest that aggregate productivity drops when the share of employees usually working remotely — for, say, three days a week or more — rises above 10%.

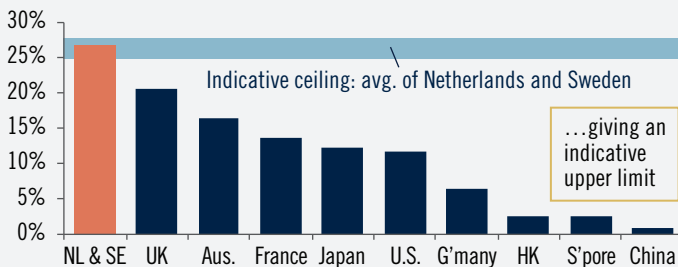
The threat from remote working is real and set to have a significant impact as office markets start to adjust in 2021, but it is important to not overexaggerate the effect.

Exhibit 3: Share of Remote Working and Impact on Office Vacancy

Share of Employees Who Usually Work Remotely (%)

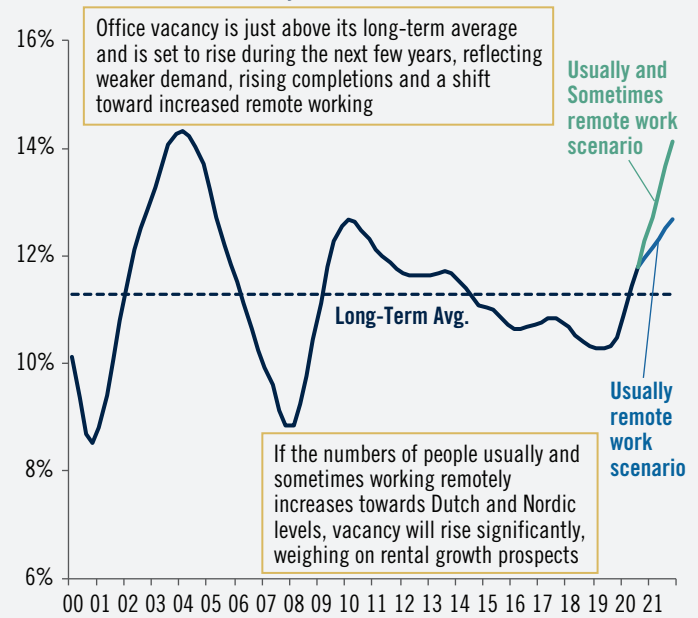


Share of Employees Who Sometimes Work Remotely (%)



Sources: Eurostat, Cushman & Wakefield, JLL, REIS, PGIM Real Estate. As of January 2021.

Global Office Market Vacancy Rate (%)



But even though there is an upper limit to the scope for remote working to increase over time, implying that offices will remain important parts of the economic mix and investment portfolios, there is plenty of room for it to rise from existing low levels in many countries.

The share of workers usually working remotely is relatively low, at 3 to 5% in the United States, Japan and Europe's big three of France, Germany and the UK, compared with 9% in Finland and the Netherlands. Apart from Australia and the UK, most other major countries also have relatively few employees sometimes working remotely, for one or two days a week.

Global office vacancy is already rising, most notably in the United States, where the subleasing of surplus office space is pushing up availability, especially in tech-driven markets. Subleasing has also pushed up the vacancy rate in Sydney, and other major Asia Pacific markets such as Melbourne and Singapore have rising availability as weaker demand has been unable to absorb new supply. In Europe, vacancy remains low in Paris and major German cities such as Berlin and Munich but is rising in London, where worries about Brexit are also weighing on demand, although recent news on a trade deal between the UK and the European Union is encouraging.

The right-hand chart shows in two scenarios the potential impact of increased remote working on vacancy. The first one depicts a situation in which only the volume of workers who usually work remotely increases, thereby reducing office demand and pushing up vacancy. A second, more-extreme scenario, includes the effect of greater numbers of workers sometimes working remotely.

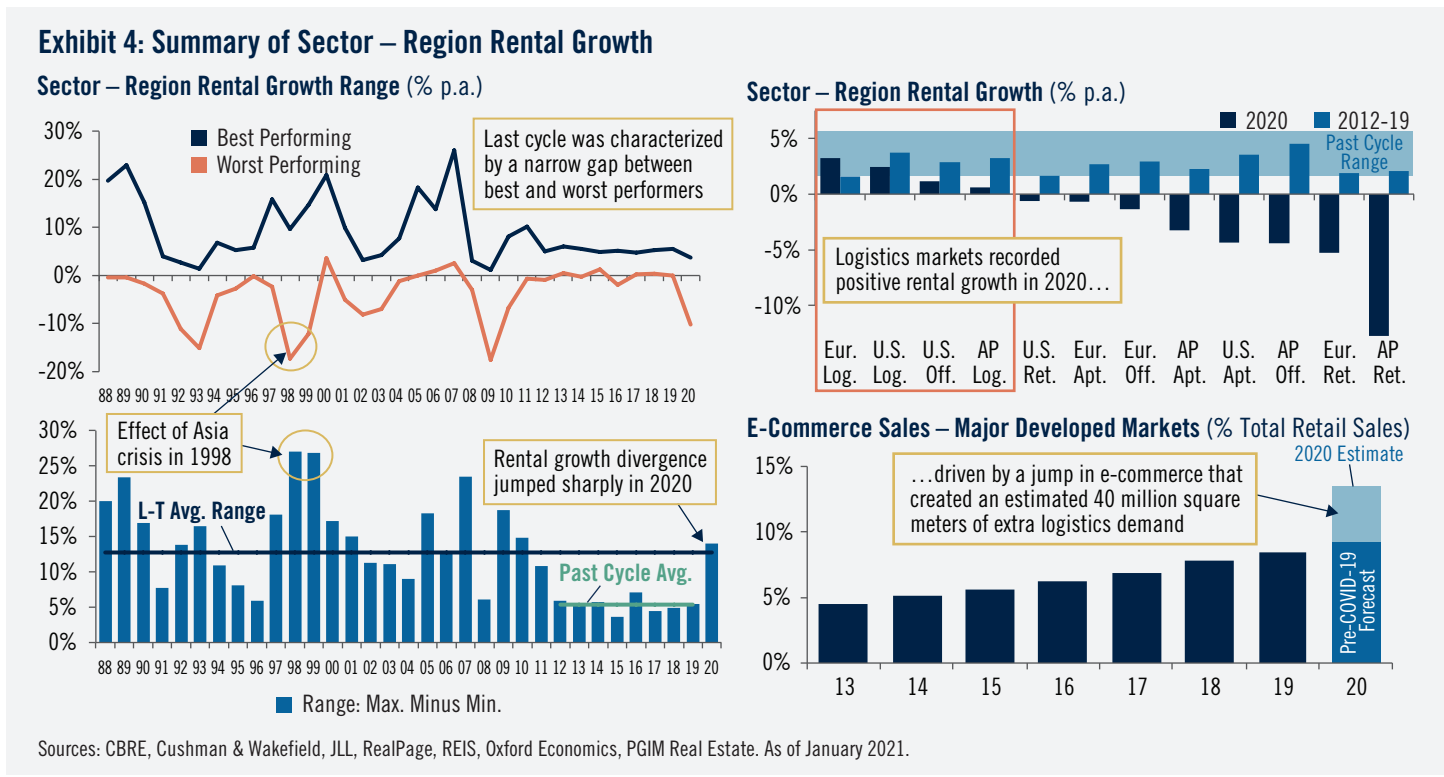
In both cases, global office vacancy rises further above its long-term average to a level at which sustained real rental growth would be unlikely. A low starting point for vacancy helps, but rental growth is set to be subdued throughout 2021 and beyond, even if the wider economic recovery starts to gather momentum.

Trend 4: Sector Divergence Stays Wide

Rental growth divergence is set to remain wide, driven by contrasting fortunes across geographies as well as between the logistics and retail sectors.

The expansion phase of the most recent global occupier market cycle, which lasted broadly from 2012, when the eurozone debt crisis was resolved, until 2019 prior to the COVID-19 pandemic, was notable for being relatively benign and consistent.

With economic growth in most parts of the world steady but not spectacular during that time and with supply broadly under control, rents across different sectors and regions grew at remarkably similar paces (exhibit 4). The average difference between the maximum sector–region rental growth recorded and the minimum in any given year was 5.3% compared with a long-term average of 12.7%.



That changed significantly in 2020. Rental growth in the strongest-performing sectors — logistics in each region — held up, whereas struggling sectors came under pressure. Rents declined sharply in retail markets in Asia Pacific and Europe, in some previously fast-growing U.S. apartment markets and in Asia Pacific office markets, where falling demand failed to keep pace with supply.

Divergence of rental growth performance looks set to remain high for the time being. The impact of the pandemic is set to be idiosyncratic, echoing the Asia crisis in the late 1990s, when occupier markets were struggling in Asia Pacific while enjoying stronger growth in relatively unaffected Europe and the United States.

Parts of the world that are able to contain COVID-19, along with sectors and markets that adapt most rapidly, are set to fare best in 2021. Clear winners and losers are set to emerge.

As happened after the global financial crisis, Asia Pacific looks set to once again lead the recovery, and this time it is clearly the turn of the logistics sector to enjoy structural tailwinds that have, if anything, been strengthened by the pandemic.

Against a backdrop of weak consumer spending, the sharp jump in online spending recorded almost everywhere in 2020 has significantly boosted demand for distribution space. Supply can react relatively quickly, so runaway rental growth is unlikely to last for many years, but logistics is set to continue to be an outperformer in the near term. The rental growth gap between the best-performing, logistics sector and strugglers such as retail is set to be much wider in 2021 than was normal during the most recent cycle.

Trend 5: Transaction Volume Recovers Slowly

Transaction volume has fallen sharply, and although investors are keen to deploy capital, ongoing restrictions are set to hold back the recovery in deal activity.

During 2020, global real estate transaction volume fell by 39%, to its lowest level since 2012. Undoubtedly, to an extent this reflects the traditional features of a recession, including deteriorating occupier market conditions, disruptions to cashflow and increased risk aversion among investors and lenders due to heightened economic uncertainty.

However, physical restrictions arising from measures introduced to curb the spread of COVID-19 are playing a significant role. After a strong start to the year, transaction volume fell sharply compared with recent norms, its decline mirroring the increase in Oxford University's COVID-19 Government Response Tracker. The Global Stringency Index is a measure that gauges various restrictions, including those related to social distancing, workplace openings, physical meetings, public gatherings and international travel (exhibit 5).

Stringent restrictions and measures make a difference for various reasons. Limitations on travel weigh on cross-border volume, and many large investors require conducting in-person due diligence on-site, something that takes much longer — if it's even possible — under the current conditions.

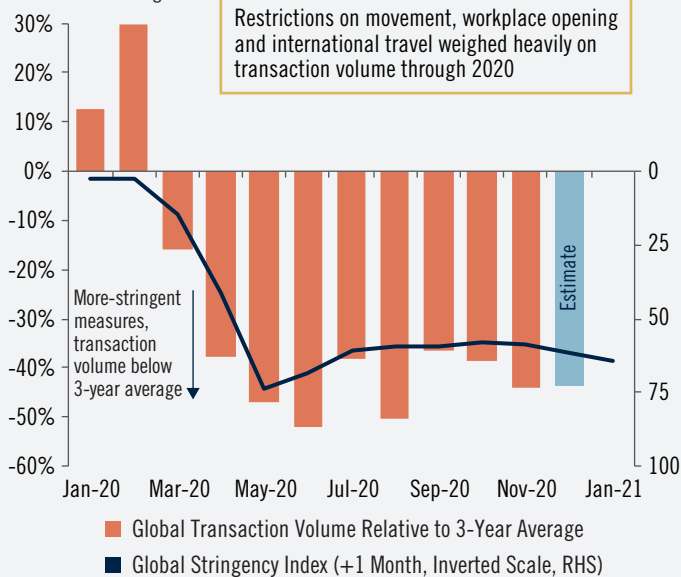
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Restrictions are set to remain in place for some time, weighing on the prospects for a swift recovery in deal activity in the early part of 2021.

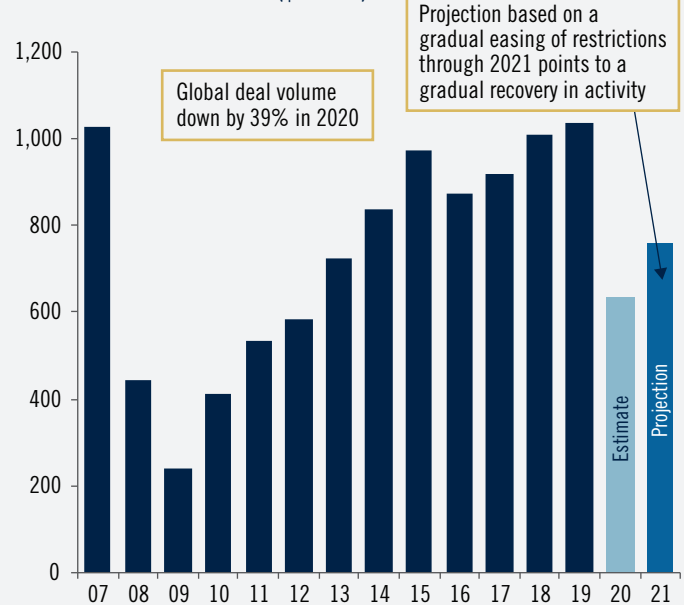
Exhibit 5: Global Real Estate Transaction Volume Analysis

Global Transaction Volume and Lockdown Stringency Index (2020)

% vs. 3-Year Average



Global Transaction Volume (\$ Billion)



Sources: Real Capital Analytics, Blavatnik School of Government/University of Oxford, PGIM Real Estate. As of January 2021.

Relatively buoyant fundraising in 2020 means that investors have fresh capital and a significant sum of dry powder to deploy in global real estate markets. Yet in many parts of the world, restrictions are set to remain in place for some time, weighing on the prospects for a swift recovery in deal activity in the early part of 2021 even if the current sense of caution among investors and lenders recedes quickly.

A projection for deal volume that assumes a gradual unwinding of measures through the year points to a jump in volume of about 19% in 2021, although that leaves overall transaction volume down by 27% compared with 2019. Markets with deeper sources of domestic capital, including Germany, Japan and the United States, are set to be most resilient in the near term.

Trend 6: Low Interest Rates Continue to Support Pricing

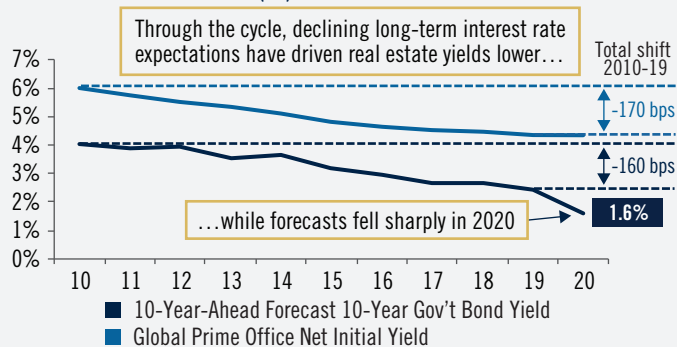
The sharp drop in long-term interest rate expectations recorded in 2020 is providing support for yields at current levels despite wider uncertainty.

During the most recent global real estate capital cycle, which lasted, broadly speaking, from 2010 until the end of 2019 before the pandemic struck in early 2020, a downward shift in long-term interest rate expectations was undoubtedly a key driver in pushing yields lower.

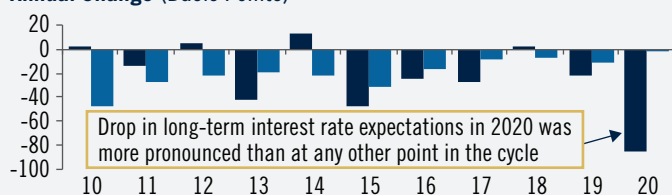
During that time period, global office yields fell by 170 basis points to a historical low, moving by an almost identical magnitude to long-term interest rate expectations, proxied by 10-year-ahead Consensus Economics forecasts for 10-year government bond yields, which declined by 160 basis points (exhibit 6).

Exhibit 6: Impact of Long-Term Interest Rate Expectations on Real Estate Pricing

Long-Term Consensus Economics Global Bond Yield Forecast and Global Prime Office Yield (%)

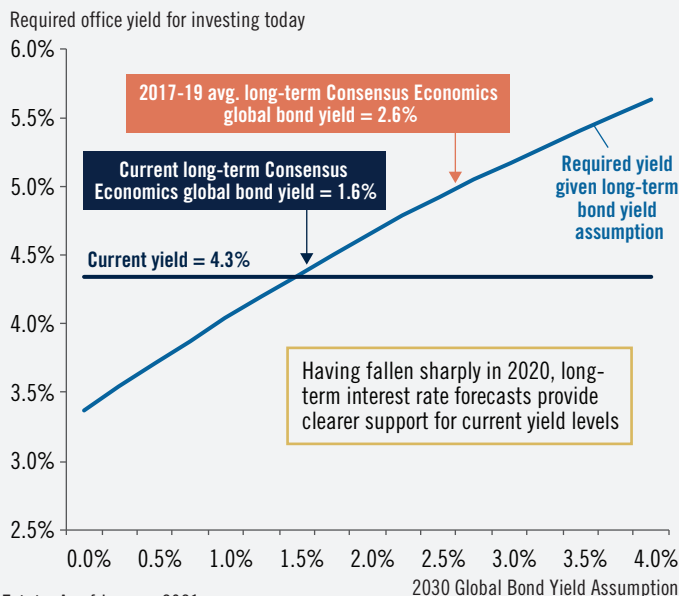


Annual Change (Basis Points)



Sources: Consensus Economics, Cushman & Wakefield, JLL, Real Capital Analytics, PGIM Real Estate. As of January 2021.

Required Global Office Yield at Varying Levels of Long-Term Bond Yield Assumption



Against a highly uncertain backdrop, real estate yields barely changed in 2020, with the exception of the retail and hotel sectors, in which many assets are facing distressed situations. Office yields, for example, are unchanged in most markets despite elevated uncertainty, occupier market weakness and a drop in deal volume — all of them factors that would normally prompt repricing.

In part, this reflects optimism that COVID-19 will pass quickly and normal life will resume, but the situation has also been helped by central bank policy actions totaling \$7 trillion globally since the crisis began, according to the International Monetary Fund, that have driven long-term interest rate expectations down even further.

In an indicative group of major global markets — France, Germany, Japan, the United Kingdom and the United States — for which 10-year government bond yields fell to an average of 0.1% in 2020, long-term interest rate expectations dropped by 85 basis points, a much bigger decline than at any point throughout the most recent cycle.

Two important factors are at play. First, low interest rates today imply a lower discount rate or required return than before, thereby enabling real estate investment to occur at lower yields than would otherwise be the case. A second, indirect, effect is that a drop in long-term interest rate expectations implies lower future real estate yields, essentially enabling investors to factor a more attractive exit position into their underwriting.

With office markets as an example, the average estimated prime yield across major global markets is 4.3%. Running a simple model that factors in expected income growth and estimates of the risk premium, it is clear that the shift in long-term interest rate expectations has taken pricing from looking a little expensive in recent years — required yield above current pricing — to looking broadly fair value today.

The upshot is that even though the market environment remains highly uncertain, there is little pressure on real estate yields to increase from current levels despite being at historical lows. To the extent that central banks remain committed to keeping interest rate expectations anchored until the pandemic is firmly in the past, support for lower real estate yields is unlikely to change anytime soon.

Even though the market environment remains highly uncertain, there is little pressure on real estate yields to increase from current levels.

Trend 7: Capital Values and Rents Start to Move Together

Yields may fluctuate in the near term, but 2021 looks set to be the first year of a new cycle, in which rental growth rather than yield shift determines value movement.

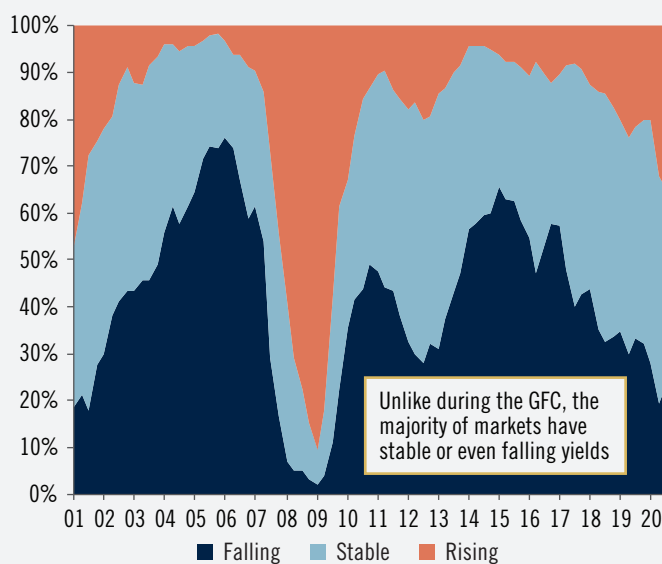
Even though interest rates provide significant support for current pricing, real estate markets are rarely in a steady state for a long time. Clearly, yields could still compress further, especially if, like in many past cycles, they are to overshoot equilibrium levels.

Conversely, there will likely be distress in certain assets, sectors and markets, when near-term levels of uncertainty or disruption get sufficiently high to push the risk premium up far enough to more than offset the supportive effect of lower interest rates.

Pricing movements recorded in 2020 reflect these competing forces. Few markets have recorded yield compression, reflecting lower transaction volume, that implied less of a chase for assets than in previous years. At the same time, far fewer markets have reported rising yields than was the case during the global financial crisis (exhibit 7).

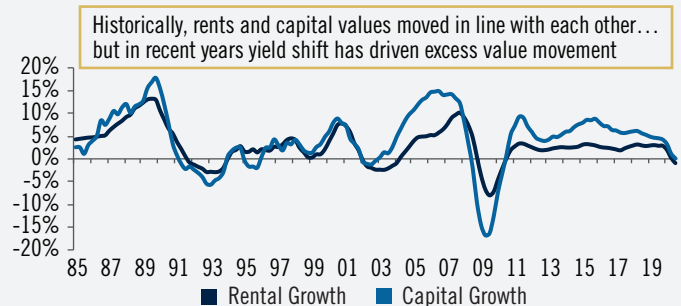
Exhibit 7: Analysis of Global Yields and Capital Value Movements

Share of Global Markets with Falling, Stable and Rising Yields Over a Six-Month Period (%)

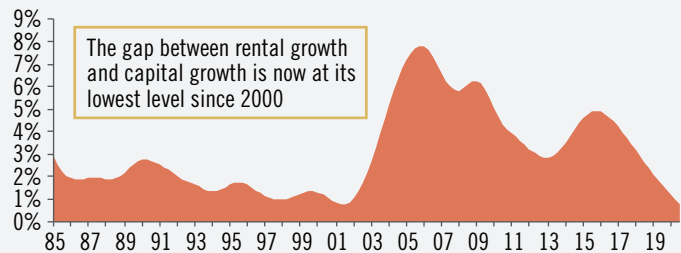


Sources: Cushman & Wakefield, JLL, Real Capital Analytics, REIS, PGIM Real Estate. As of January 2021.

Annual Global All Property Rental and Capital Value Growth



Trend Absolute Gap Between Capital Value and Rental Growth



A lack of price adjustment reflects not only support from lower interest rate expectations but also the effect of other policy measures such as job retention schemes that have helped occupiers navigate weaker conditions and — compared with the global financial crisis — a patient approach from lenders and valuers.

Some markets will undoubtedly fare better than others in 2021, but the bigger picture is that yields, in aggregate, are approaching a sustainable lower bound. The reasons are that interest rates cannot feasibly fall much further and there is little to suggest there will be a sudden boost to the income growth component of returns as the wider environment for economic growth and productivity gains remains subdued.

Unlike in the past couple of cycles — but more like in the decades prior to 2000 before an increase in the influence of global liquidity flows — the gap between rental growth and capital growth has narrowed significantly.

Although yields may fluctuate in the near term, the year 2021 looks set to be the first of a new cycle, in which rental growth rather than yield shift is the key determinant of real estate value movement.

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Trend 8: Investor Interest in Debt Is Rising

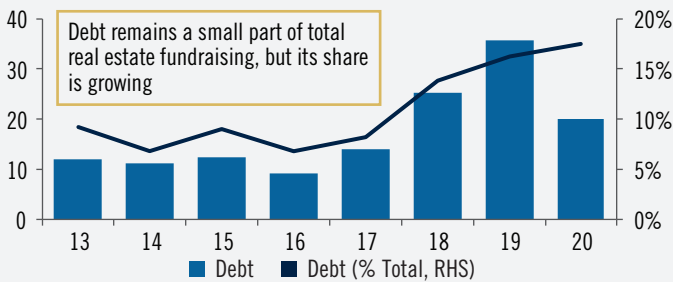
The share of debt capital raising continues to increase, supporting a gradual improvement in origination volume from a broader group of lenders in 2021.

Debt funds remain a relatively small part of the real estate investment landscape, but they have been gaining in prominence in recent years. The share of debt funds in total capital raised by real estate investors has risen significantly in recent years, growing from 7% in 2016 to about 18% in 2020, including a 42% increase in capital raised in 2019 — prior to the pandemic (exhibit 8).

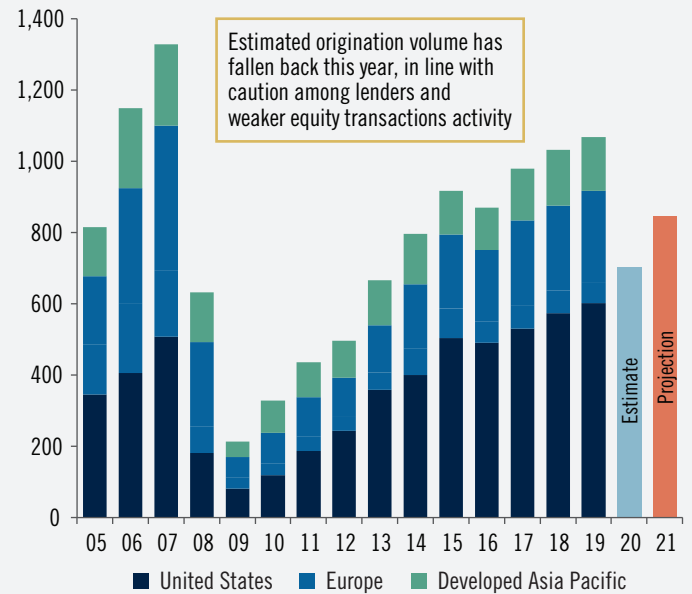
The onset of the pandemic slowed capital raising across the board, but data for the second half of 2020 suggests debt funds continue to enjoy favorable underlying momentum, constituting 30% of all private real estate fundraising, according to Preqin.

Exhibit 8: Real Estate Debt Fund Capital Raising and Origination Volume

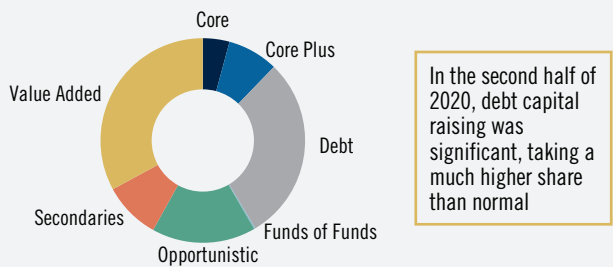
Global Real Estate Closed-End Fundraising (\$ Billion)



Real Estate Debt Origination Volume (\$ Billion)



Share of Capital Raised for Private Real Estate Strategies in 2H20



Sources: Real Capital Analytics, Mortgage Bankers Association, ANREV, INREV, NCREIF, Preqin, PGIM Real Estate. As of January 2021.

Debt funds represent a subset of the broader real estate lending market that includes banks, insurance companies and other private equity vehicles. Investors’ focus on debt funds reflects several factors, including the presence of capital protection and cashflow resilience during periods of market uncertainty.

In addition to benefiting from fundraising from real estate investors, debt vehicles are benefiting from capital inflows from other sources, such as certain fixed-income investors that are searching for yield in a world where investment-grade bonds are generally low yielding or negative yielding.

Investors’ focus on debt funds reflects several factors, including the presence of capital protection and cash flow resilience during periods of market uncertainty.

Origination volume dipped during 2020, reflecting a wider decline in equity transaction volume as well as caution among lenders, especially on the banking side. Origination volume is set to grow again in 2021, as lender sentiment improves with the wider economy, although activity will likely be hampered by ongoing COVID-19 restrictions in the first half of the year.

At the same time, increased debt fundraising is reflective of a broader trend toward a more diversified provision of debt. Nonbank lenders account for around 50% of the overall lending market in the United States and almost 30% in the UK, which remains a large investment market despite Brexit-related uncertainty. Bank lenders continue to dominate in Asia Pacific and Continental Europe, but nonbank lenders are set to gain increasing market share over time.

Trend 9: Distress Remains Contained, but Financing Opportunities Emerge

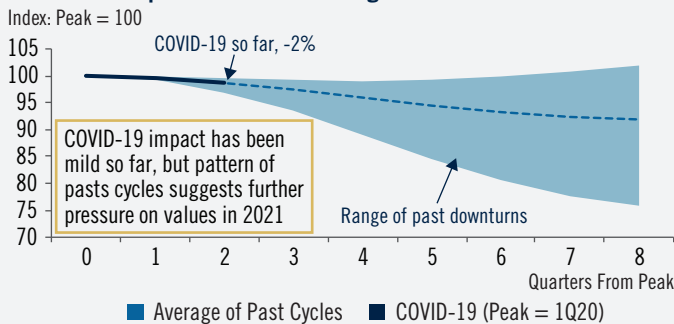
Distress is set to be limited, but value declines in parts of the market and ongoing regulatory constraints on banks imply a growing opportunity for nonbank lenders in 2021.

Downturns all have different causes and effects, so the range of experiences is wide. It can range from mild declines that affect a narrow part of the market — such as the region-specific Asia crisis or dot-com, which affected mainly tech-related office tenants — all the way to full-blown, synchronized global downswing, such as the global financial crisis in 2008.

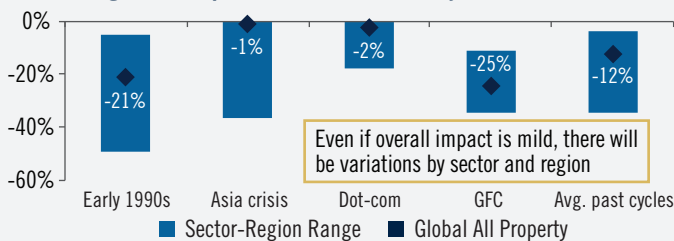
The average peak-to-trough decline of real capital values in a downturn is 12%, but looking broadly at sector–region combinations, it is clear that some parts of the market typically get hit harder than others (exhibit 9). So, the better-performing sectors and regions typically report declines of 5% or less, and in the worst-hit parts of the market, a correction is often more like 30 to 40%.

Exhibit 9: Global Real Estate Value Cycle and Leverage

Global Real Capital Value Index During Downturns

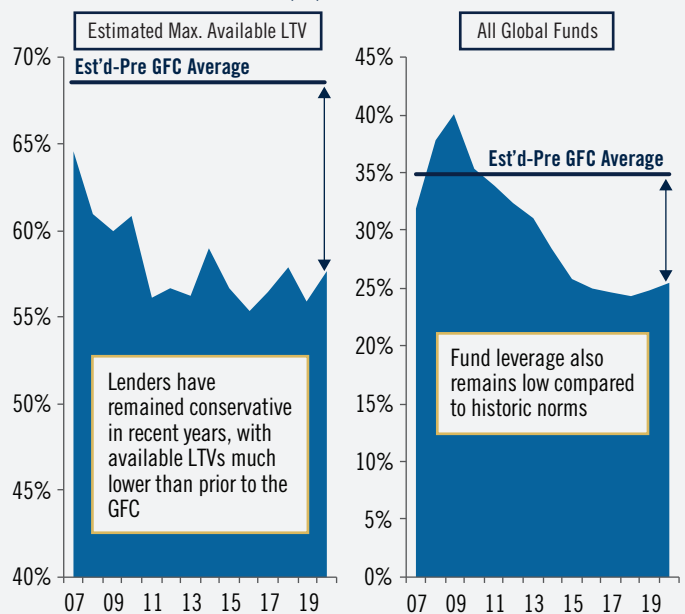


Peak-Trough Real Capital Value Movements By Downturn



Sources: Cushman & Wakefield, JLL, REIS, Real Capital Analytics, ACLI, PMA, ANREV, INREV, NCREIF, PGIM Real Estate. As of January 2021.

Global Loan-to-Value Ratios (%)



Clearly, the downturn caused by the pandemic is still in a relatively early stage as values peaked in the first quarter of 2020. Unlike during the global financial crisis, global policy making has been highly coordinated and sizable, and so far, is having success in avoiding the worst kinds of outcomes.

There is also a notable absence of systemwide excesses of finance, leverage or supply — often the cause of a downturn in the first place — that would require a more substantial correction.

Banks deleveraged heavily in the aftermath of the global financial crisis, especially in major Asia Pacific nations such as Japan and in the United States. As a result, the use of debt in the cycle prior to the advent of the pandemic has been modest. Loan-to-value levels have not been stretched, remaining well below pre-global-financial-crisis norms with regard to both available debt and fund leverage. In addition, coverage ratios have not been squeezed, and overall market exposure to funding risks remains contained.

Nevertheless, history suggests there will be further pressure on values in 2021, as real estate activity lags the wider economy. Shocks recorded in the middle of 2020 are only now starting to affect occupier markets, as tenants release space. Historically, downturns tend to gather pace after the first couple of quarters.

Inevitably, lenders will have to deal with some distress in 2021, even though it is set to be contained as values hold up for assets with defensive characteristics, such as residential buildings, or favorable structural trends, such as logistics, data centers and cold storage. In contrast, there will be pressure on asset values in retail and hospitality and in some office markets too, in which remote working is affecting demand.

Appetite for new lending among banks, which are the largest real estate lenders in Asia Pacific and Europe, remains strong for stabilized core assets and, at the other end of the risk spectrum, developments, albeit more selectively.

For anything that falls in between, such as lending at higher loan-to-value ratios, or providing transitional loans for assets with vacancy, it is set to remain challenging for banks to expand new lending materially. Along with ongoing restrictions related to COVID-19, many banks are facing some combination of increasing regulatory capital charges, a tightening of lending regulations or a mixture of both.

Looking ahead, banks will face limitations on the scope of their lending in 2021, and falling values in parts of the market are set to cause distress situations. Likely requirements for fresh capital imply a growing opportunity for equity investors and nonbank lenders to step in alongside banks and provide liquidity for refinancing to facilitate new transactions and the refinancing of existing assets.

Requirements for fresh capital imply a growing opportunity for equity investors and nonbank lenders to step in alongside banks and provide liquidity.

CONCLUSION

As turned out to be the case in 2020, it very much looks like 2021 will be a year with a great deal of uncertainty. The outlook is undoubtedly brightening, though, as vaccination programs get under way, promising to usher in a gradual return to economic normality. Inevitably, though, it will take some time for vaccines to roll out and take effect and — crucially for sentiment — for their positive outcomes to become clear.

In the meantime, sentiment is weak and volatile, economic growth remains patchy, and restrictions to curb the spread of COVID-19 that have been damaging to occupier and investor demand continue to be imposed.

Real estate downturns tend to worsen after the first couple of quarters, so some bad news is likely to come, yet it looks like the worst kinds of outcomes are being avoided.

At the outset, the global COVID-19 pandemic looked as if it would have characteristics similar to the global financial crisis, being a global shock affecting all markets simultaneously. But it hasn't turned out like that. Policy support has been significant in supporting values and unlike during the global financial crisis but in common with other past downturns, clear winners and losers have emerged.

The Asia Pacific region has controlled the virus and limited economic damage more successfully than either Europe or the United States has, and the logistics sector has recorded rising demand as supply chains rapidly adapt to a large-scale switch to online spending.

So, even though there will be some distress, implying opportunities for equity and debt investors to recapitalize struggling retail and hotel assets, for example, it will likely be contained.

At its outset, 2021 looks set to be defined by the ongoing battle against COVID-19, yet the bigger picture shows that it is set to be the first year of a new era for real estate investing.

With market interest rates now at an effective lower bound, capital values in coming years are set to be determined not by yield movements as they were in the past two cycles but by fundamentals — namely, in maintaining and growing income receipts.

Inevitably, reduced yield compression implies a lower returns environment. Assets that offer structural growth potential, along with equity and debt investments backed by secure income streams, are set to remain prominent and further expand their share of investment activity.

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