

# CBRE FLASH CALL

## COVID-19 IMPACT ON LATIN AMERICAN COMMERCIAL REAL ESTATE

### MARCH 25, 2020 CALL SUMMARY

Thanks to the nearly 1,000 of our clients and colleagues who dialed into the March 25, 2020, Flash Call describing the impact of the Coronavirus on Latin American Commercial Real Estate.

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#### MACROECONOMY

Over the last week the lockdown approach has come to the fore, because of the very rapid escalation in new infections, so we have revised down the economic outlook from the one presented in the Americas Flash Call on Wednesday, March 18.

CBRE's overall view of the economy remains: short-term brutal, medium-term positive. The overall shape of the downturn is the same as in our previous forecast.

- We now believe that the U.S. will decline at -2.8% in 2020 and grow around 5.9% in 2021.
- The big hit will be Q2, with a GDP contraction of -20.5%.
- In Q3 and Q4 we will see the U.S. economy pick up with growth rates of 9.2% and 17.1% as stimulus and pent up demand kick in.

U.S. unemployment will jump to 6.1% with the overall fall in employment of 8 million jobs concentrated in retail, food and beverage, transport and manufacturing. Office employment will experience less impact.

#### What Does this Mean for Latin America?

- Mexico is highly correlated with the U.S., so there will be a significant impact on Mexico. For example, every 1% loss of GDP for the U.S. probably means 1% loss for Mexico, so a tough Q2, but a strong bounce back. Mexico will see an overall negative GDP growth for the year of around 2%.
- Other Latin American countries will suffer a slowdown due to the lock down. Every one week of lockdown means 1% lost consumption spending.
- There is some small upside for Latin America from renewed growth in China, but again that won't help very much in Q2.
- We see Latin American currencies staying low for most of Q2, before picking up a little in H2, with further interest rate cuts likely.

- Mexican assets are now 20% cheaper than they were prior to the crisis in dollar terms, which could tempt investors.
- Longer term, perhaps more speculatively, Mexico stands to gain, perhaps in auto production, but more generally in manufacturing, due to globally shortened supply chains.

## MACRO CAPITAL MARKETS

Despite the fact that the reported cases throughout Latin America are low, there are a few areas of considerable concern that global COVID-19 impacts will affect the region. These potential effects include the impact on consumer demand, especially from the collapse of oil prices, and the drop in demand for other commodities, especially copper in Chile. Secondarily, these macro effects will accelerate the demand fall-off in the auto sector that began a few years ago. Colombia's economy is expected to weather the storm better than the rest of Latin America.

From an industry standpoint, we are seeing the below conditions in the U.S., and much of this has impacted the global CRE markets:

### Hotels

- To no surprise, massive fall off in demand "at any price."
- Prior to the outbreak, we had forecasted U.S. hotels to have a 0.1% decline in RevPAR (revenue per available room); our revised outlook as of last week estimated full year RevPAR decline to -37% for the year. The deepest impact will be in Q2 where RevPAR declines could reach more than -60%.

### Industrial

- Short term leasing activity will decline as occupiers take a wait-and-see approach, and there are challenges with site inspections for capital markets activity.
- But given strong overall demand, rents are likely to remain relatively stable.
- Longer term, Industrial is likely to benefit.
- More secure supply chains with more inventory will increase demand for industrial space.
- More e-commerce as people are buying more at home.
- Continued strength in last mile and cold storage (where we have limited supply).

### Office

- Greatest impact in those markets/asset types impacted by oil & gas and travel & leisure in the short term but most industries are hitting at least a short term "pause" button.

### Retail

- Mixed bag with great weakness where one would expect (enclosed malls, restaurants and gyms), but surprising strength in in-line with grocery and pharmaceutical anchors leading the way.

## Multifamily

- Overall, structural shifts in demand remain favorable for the sector though we are going to see some short-term softness in luxury demand due to delayed moves in class B and C, due to greater stress on incomes for lower income workers.
- Alternatives, notably senior housing, are facing immediate stress and there is some concern of a longer-term demand shift to marginally benefit single-family rental housing.

## GLOBAL STIMULUS

Notwithstanding the fact that stimulus has been sparse in Latin America to date, the massive global and in particular U.S. fiscal stimulus will energize the global economy and first and foremost those within the U.S., Canada, Mexico and Latin America.

Based on our analysis of the trajectory of China that has begun to emerge about eight weeks after the worst of the crisis, and the relatively low mortality rates in Germany and South Korea in particular, CBRE believes that the “curve” of economic recovery will be “V” shaped and may happen sooner than people think, which will further give Latin America hope for a quicker recovery.

## MEXICO MARKET

- COVID-19 and the Oil War have brought economic recession back to our doorstep. Many international and local analysts are placing GDP economic forecasts for 2020 ranging from -2 to -5%.
- We are expecting the Mexican government will keep announcing fiscal and economic incentives. But how meaningful these measures could be remains uncertain. Also, the banking system is programming incentives and protection plans for their clients.
- In this context, the biggest threat we are facing is unemployment that will impact mainly retail, hospitality and service industries. The latter effect could take the unemployment rate from almost 4% last January to 10% in the next six months. Most of the manufacturing and logistics workers could face minimal disruptions, excluding automotive manufacturing, where the disruption from the supply chain has hit first, but we are expecting this could be temporary.
- Our latest reference for this type of economic decline is the 2009-2010 period when the flu epidemics and the international financial crisis hit the global economy. At CBRE Research, we believe the main similarity with that crisis is the sharp decline in economic activity, but the main difference could be a faster rebound. And by “fast” we mean recovery will start at the end of this year or beginning of 2021.

- So, uncertainty reigns in the era of COVID-19. In the last 15 days we have seen how the peso has lost almost 34% of its value versus the dollar, erasing all gains for the last 2 years.
- In the short-term, Mexico's CRE is returning to 2016 (when Donald Trump won the U.S. presidential election): tougher negotiations on caps on the exchange rate lease contracts, Tenant Installation allowances, early exit clauses, concessions, etc. Now we are starting to see office and retail lease renegotiations before due dates, while industrial and logistics are almost business as usual, at least for now.
- In the medium-term, major disruption of supply chains due to COVID-19 will lead to lower economic growth and lower demand for commercial properties. Our estimate is a 44% annual decrease in 2020 CRE absorption, with a 36% annual decrease in office demand in Mexico City (where 90% of Class A transactions are being made), ending at 300K sq.m. gross absorption, half of which represents new demand. We are also expecting rent decreases across all asset types.
- Industrial markets demand will remain at the same levels of 2019 at 3.6 million sq.m., with increasing activity in the northern and central markets mainly from logistics and light manufacturing.
- Retail demand has been decelerating for the last year with almost no expansion plans and delays in shopping center construction activity, but even with that, the vacancy rate in most fashion malls has increased, from 9% at the end of 2018 to 15% at the beginning of 2020.
- In the 2009 crisis, the hospitality industry took 3 years to recover; now we expect it will take half of that, depending on the type of tourist center.
- 2020 will register an 11% decrease in total tourist arrivals to hotels in Mexico, with a 23% annual decrease in international tourists and 7% for nationals. Also, we are expecting RevPAR to reduce at a national level around a 50% average.
- In the medium-term we are expecting USMCA to boost exports but mostly investment flows. We estimate this happening gradually, and we will see full impacts during the next 10 years.

## COLOMBIA MARKET

While COVID-19 is having an impact on our economy, the oil price war is a second factor that will make this time even more challenging for Colombia, devaluating the currency. We will face a year of lower economic growth and much weaker public finances.

### **Capital Markets**

In the short term we expect a slow down on investment decisions. Investors are taking a wait-and-see approach and being more diligent on their analysis. Transactions are expected to be delayed; nevertheless with the devaluation of the Colombian peso, the purchasing power of international investors has increased. There are asset classes that will be more on the radar for these players such as industrial logistic operations, health, technology and pharmaceuticals sectors; transaction volumes are now likely to be lower than in previous years.

### **Occupier**

Occupier activity has not yet shown signs of a slowdown. Companies that generate revenue in U.S. Dollars will lower their operating costs but are still needing to face the threats of business disruption for an undefined period. Oil & gas tenants will experience a challenge to maintain their operations and might start vacating spaces to optimize. Coworking operators, an important player in our market over the last couple of years, will now have to be creative to maintain high occupancy rates.

### **Industrial**

E-commerce seems to be one of the beneficiaries. The short-term impact on the industrial market is expected to be low compared to other asset classes, as it is not likely that tenants will terminate their leases; however, some tenants and deals might be put on hold until there is more certainty about the near future. For now we will experience a temporary downward on demand which we don't expect to last.

### **Hospitality**

The forced shutdown of the borders in Colombia is having severe consequences. Before the crisis the tourism industry was growing rapidly, but given the decision to close down operations and the massive reduction of visitors as a result of the travel restrictions and quarantines, Colombia will experience a huge impact in terms of costs, job losses and occupancy rates. The impact on this industry is immediate; operators are to expect a significant reduction on occupancy rates and therefore RevPAR.

### **Residential and Development**

With the national lockdown, we expect banks to act with arrangements to reduce problems of liquidity for developers. If actions aren't taken immediately, this could result in fire sales from developers to maintain and secure their liquidity. On the other hand, if house buyers feel that this crisis could last longer than expected and that this situation threatens their patrimony, they will most likely withdraw their investments which will increase available inventory.

## PRODUCER INSIGHTS—MEXICO

### **Industrial**

We are experiencing a complex scenario. On one hand, some Chinese companies continue to tour the North part of Mexico looking for space to move some production into Mexico due to the proximity to the U.S. On the other hand, automotive companies are announcing “technical” closing of some facilities adding to the recent slowdown on car consumption. Only medical equipment companies continue their expansion plans.

In the mid-term, we foresee a positive trend of companies moving some part of their supply chains to Mexico, gravitating away from China and moving closer to the U.S.

### **Capital Markets Transaction Volume**

- Our brokerage professionals are not really seeing delays now. We are currently closing four industrial deals and if the Public Registers and some other governmental offices continue to be open, we are on track for closing in the next three to four weeks.
- We have been in communication with investors and since most of them have low LTV ratios, they are mainly focusing in opportunities and strategic dispositions. Some of this opportunity may come from the depreciation of the Mexican peso. Nonetheless, depending on investors’ original currency funding, the devaluation might have a negative rather than positive effect. We will have a better understanding of the impact in coming weeks.
- With the depreciation of most REITS, in the short term we do not expect to have a lot of movement in the capital markets. Hopefully the market bounces back quickly, so REITs and public vehicles regain value and continue to transact.

### **Debt Markets**

There is lots of volatility, but deals are moving forward, and lenders are still comfortable with the assets. LTV ratios are much lower in Mexico in comparison to the U.S. or other developed countries. But there is a flight to quality scenario. Currently, only clients with good financial sponsors and credit tenants could buy assets with dollar denominated contracts. This means only investment grade clients will have access to contracts in dollars.

### **Office**

Before the current economic dislocation, Mexico already had an over-supplied market. Due to the devaluation plus the vacancy, we foresee a faster shift to peso-denominated leases in general with some exceptions. Leasing brokers are struggling with current deals with the exchange rate, and some transactions are being delayed or put on hold until the market reaches some kind of equilibrium.

## PRODUCER INSIGHTS – LATIN AMERICA

### **Debt & Structured Finance and Sales**

We have noted a pause in all capital markets activity in Latin America and all asset classes.

- Investors are spending their time reviewing their own liquidity positions and dealing with a high level of forward-looking earnings uncertainties.
- Investors expect to delay acquisitions when possible by a minimum of 30 to 60 days
- Investors have not indicated any potential repricing of assets and in fact we have noted two common investor approaches to the current situation:
  - Willingness to search out Core opportunities
  - Willingness to search out Opportunistic or Distress return profile types of investments

### **Asset and Country-Specific Overview**

All markets are beginning to see a pause in activity with some markets (most notably Peru, driven by regional capital demand from Chilean investors looking for USD yield) demonstrating more local liquidity prior to the crisis.

- Since travel may negatively impact international investors' ability to return to certain markets, we expect to see activity pick up, driven first by local liquidity.
- We believe that certain markets/countries which are being more proactive in their approach to controlling the virus may in turn see CRE capital markets activity return sooner. We believe that the Andean markets, led by Peru, may be some of the first to demonstrate activity coming out of this crisis due to the extensive mitigation efforts currently underway in their markets.
- The markets of Brazil and Mexico are expected to more closely follow the evolution of the U.S. and European markets due to the more limited domestic mitigation efforts.

### **Impacts in the Local Debt Markets**

- While local interbank lending rates have dropped across the region, the spreads have widened out, minimizing most of the benefits of these lower rates.
- Most lenders have pulled in their lending activity, notably new construction and hospitality-related assets.
- Most of the lenders are currently more focused on corporate company financials over asset valuations and are spending most of their time delaying with existing client lender counterparty risks.
- We have multiple debt deals in various markets in the region. Very similar to both asset and equity level transactions, we have noted that approved deals are moving forward with closings, and deals which were pending any type of credit committee or risk committee approval are being delayed.

## Outlook for Different Asset Classes or Markets

### PUBLIC MARKETS

- International capital and institutional capital to flow back into real estate equities (many trading below their NAVs)
- Expected recovery of many of the Latin America public equities (retail and hospitality focused groups will remain out of favor with investors)

### ASSET SALES

- Well-capitalized local players are taking advantage of opportunity to acquire key Core and Opportunistic types of real estate assets. (local players may be first to acquire due to travel complications)
- Weak local currencies will attract an inflow of USD-based investors.
- Distressed asset sales are expected to be limited due to low local leverage levels.

### DEBT MARKETS

- Lenders will adjust their credit risk analysis and will be less willing to finance new hospitality and/or retail projects in the short-term, as they are expecting a higher level of work outs in these sectors.

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