Property sectors likely to experience most severe pressure from economic recession

By John Loos

8 May 2020

While there are risks to major property sectors over and above direct economic growth pressures, we examine which major property sectors are most at risk due to pressures on GVA (gross value added).

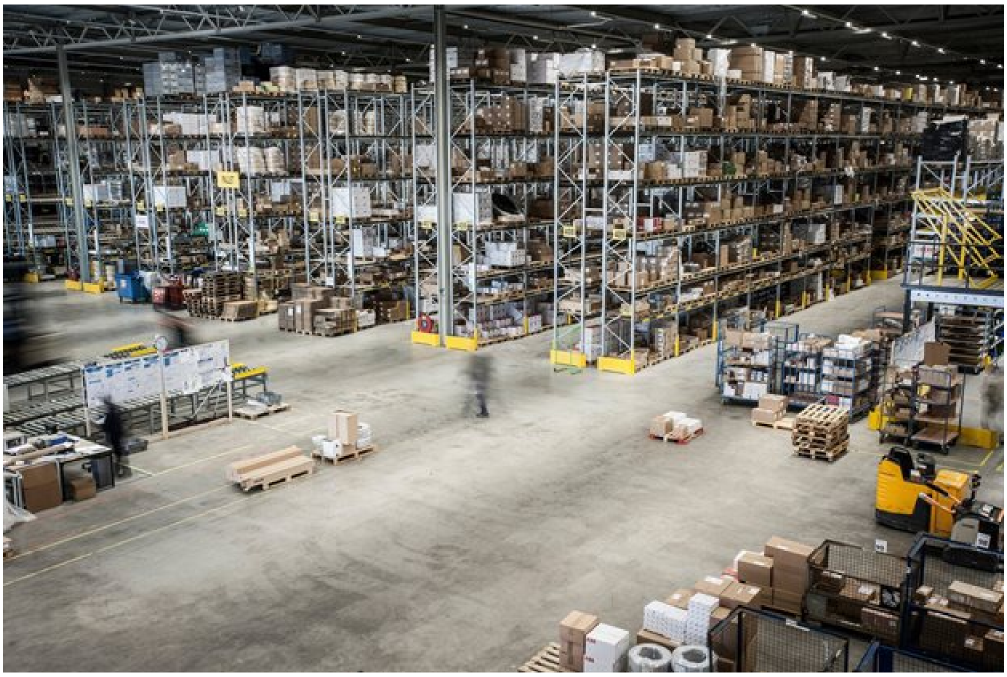

Image source: Gallo/Getty

To the general public, arguably the most visible signs of economic damage caused by the Covid-19-related lockdowns are in the retail sector. In virtually every neighbourhood, many people have regularly been going to their local shopping centres to shop at the very few shops that were allowed to be open during the lockdown, normally the food retailer and one or two others at best.

Less visible, perhaps, have been other major industries that have also been largely locked down, and the manufacturing sector is a key one that springs to mind, an economic sector strongly influencing the industrial property sector.

But while lockdowns have impacted many industries during late-March and April, across much of the economy, we have now headed into the next phase of gradual relaxation in the level of “lockdown”, the rate of Covid-19 “spread” permitting.

Covid-19 may bring about longer term behavior changes, for instance greater remote working, which may pose new risks and opportunities to certain property classes. In addition, certain property sectors have their own home-grown risks, for instance a major affordability deterioration in retail property over the past two decades.

But in this note we merely aim to look at the risks to the major, and certain smaller, property sectors posed directly by "normal" recessionary economic conditions emanating from recessionary pressures on key economic sectors related to these property sectors.

Big standoff between retailers and landlords looms

Kagiso Mahlangu 7 May 2020

Industrial property exposed to most cyclical economic sector(s)

We are of the opinion that, of the major three property sectors, i.e. industrial, office and retail, it is likely to be the industrial property sector that experiences the most direct "GDP pressure" during the current year.

This is based on the historic behavior of the strongly related manufacturing sector during recessions.

Typically, this sector is highly cyclical, and highly exposed to global economic forces too. During the Global Financial Crisis Recession of 2008/9, quarterly manufacturing GVA plummeted by as much as -15.2% in Q2 2009, and was down by an extreme -10.6% for 2009 as a whole.

By comparison, overall GDP declined reached only -1.5% for the entire 2009. Industrial property is thus strongly linked to a highly cyclical industry. And by Q4 2019, the rate of decline in Manufacturing GVA had already reached a significant -2.57% as SA entered into 2020, a leading indicator of both manufacturing production, as well as broader economic direction is the Manufacturing PMI (Purchasing Managers Index) New Sales Orders Sub-Index. Even prior to lockdown, back in February, this sub-index had reached a lowly 31.2 (on a scale of 0 to 100), pointing to a likely worsening manufacturing recession this year, and then came Covid-19 lockdowns, which caused this index to drop to 8.9 in April, the lowest level ever.

JLL Q1 2020 report outlines implications of Covid-19 for real estate

6 May 2020

There's a second key economic driver of industrial property, more linked to the warehousing sub-sector of industrial property, and that is economy-wide inventory trends. Inventory levels can also be highly cyclical, dropping sharply in weaker economic times when an inventory build up is unnecessary and costly.

Indeed, after some years of stagnating economic growth, we did see a decline in the real value of inventories for five consecutive quarters, as from late-2018, on a smoothed four-quarter moving average basis.

The diminishing need for inventories in a stagnating economy may also be seen in a multi-year decline in the economy-wide inventory-to-GDP ratio, which has dropped quite significantly in recent years from 12.1% in Q1 2015 to 9.7% by the final quarter of 2019.

Corona crisis exerts additional pressure on already-correcting property market

John Loos 4 May 2020

Office space demand risks posed by sliding employment numbers

The demand for office space, our second major commercial property category, is believed to be strongly influenced by employment trends in the finance, real estate and business services sector.

This major economic sector itself has for some years had a solid GVA growth rate, and even by the final quarter of 2019 was still at a still positive 1.4% year-on-year. But this sector consistently achieves productivity gains, and its employment rate is key driver of demand for office space rather than its GVA growth. This was estimated to have declined for the second successive year in 2019, to the tune of -1.2% according to IHS-Markit estimates.

The MSCI Average Office Vacancy Rate correlates inversely with finance, real estate and business services sector employment growth reasonably well, and the start of slowing employment growth back in 2015 was soon followed by a rising office vacancy rate rend as from 2016. The declines in this sector's employment during weak economic times are not usually as spectacular as declines in manufacturing GVA, with this employment rate of decline only reaching as low as -2.4% in 2009. The office sector thus arguably feels slightly less direct pressure from the economy during recessions than the industrial sector.

Property Industry Group updates relief guidelines

28 Apr 2020

Real retail GVA growth typically more stable

Perhaps surprisingly to some, the key economic driver of demand for retail space appears typically less cyclical/volatile than those key influential sectors related to industrial property and the office sector.

The major "retail and wholesale trade, catering and accommodation" sector of the economy does indeed undergo contractions during recessions. But its worst quarter during the 2009 recession was a mere -2% (-1.1% for 2009 as a whole), which was far more moderate than the manufacturing sector's contraction in excess of -10% in that year. And indeed, by end-2019, its rate of contraction of -0.26% was more moderate than the manufacturing sector at that stage.

We then dissect this major economic sector using IHS-Markit annual data for its four sub-sectors. Here we see, in addition, that much of the overall "trade" sector's volatility is caused by sub-sectors other than retail.

The retail GVA growth rate in 2019 was estimated at a positive +2.7%. Dragging the broader trade sector down was actually The "motor vehicle sale, repair and sale of fuel" sub-sector, which had declined by -4%, its sixth consecutive year of contraction, along with the "wholesale and commission sales" sub-sector with a -2.4% decline, its third consecutive year of contraction.

Newly formed property council to tackle impact of Covid-19

23 Apr 2020

And then there is one more important sub-sector in this group, which is in part linked to retail property, namely the "hotels and restaurants" (or "catering and accommodation) sub-sector. This sector is largely supplying a non-essential output by nature, and as such requires a strong growth economy to see it flourish. Since the end of the pre-2008 boom years it hasn't had that sustained strong economic growth that drives luxury spend.

As a result, it has appeared under pressure ever since a short sharp post-2009 recession recovery in 2010, a year that was special for the sector in that South Africa hosted the World Cup Soccer. Since then, it has seen its GVA contract in six of the past nine years. It was, thus, under pressure long before Covid-19 lockdowns, and it is now one of the major victims of the lockdowns, not only due to its own lockdown, but also due to the shut down of much of the air and land transport system.

Ripple effects of supervening impossibility on commercial lease agreements
Darryl Furman and Jayde Vaughan 22 Apr 2020

Conclusion

This note is not aimed at assessing the overall risk of the property sector. Rather, it merely looks at direct economy-related pressures which property sectors are likely to face from economic weakness during a deep recession such as the one currently unfolding.

Of the three major commercial property sectors, the direct pressure on the industrial property sector, emanating from a highly cyclical manufacturing sector, along with major economy-wide inventory decline, is expected to be the most severe.

This is expected to be followed by the impact on office space demand from declining employment in the financial, real estate and business services sector.

By comparison, the "mainstream" retail sector of the economy is typically less cyclical than manufacturing, for instance, and was still in positive growth territory last year. This sector is also expected to experience recession, given the major lockdown disruption which it too experienced, but the magnitude of its recession is still expected be less severe than that of manufacturing.

When the Covid clouds clear - future of the commercial property market
Andrew Jefferson 21 Apr 2020

Have we seen the relative performances in the three major property sectors reflect the relative performances of their major influencing economic sectors? Perhaps we have if one views their relative vacancy rate trends as per MSCI Vacancy Rate data.

By 2019, all three property sectors find their vacancy rates elevated off lows achieved three to four years prior.

Each sector has a different "natural" vacancy rate, that of office space almost permanently being far higher than the other two sectors.

However, the more interesting aspect is to examine by how much each sector's vacancy rate has risen from its multi-year low. When viewing it in this manner, we see that the property sector whose vacancy rate has deteriorated the most is that of industrial property, having more than doubled from 2.3% in 2015 to 5% in 2019.

By comparison, the office vacancy rate has risen by just over one third, from 9.2% in 2015 to 13% by 2019.

And in retail property we find what we would expect to find, i.e. the least significant deterioration in its vacancy rate to date, by less than one quarter, from 3.8% to 4.6%.

In short, comparing the magnitude of each property sector's own vacancy rate rise appears to reflect the greater cyclicality in the economic drivers of industrial property demand, followed by those of office and retail property.

In certain of the smaller property-influencing economic subsectors, however, the pressures look set to be very severe. Here we refer to the "luxury item" hotels and restaurants sector (restaurants in part affecting retail centres), vehicle retail and related activities (relating to vehicle dealership properties), and the wholesale and commission sales sub-sector, all three having been well into recession long in advance of Covid-19.

ABOUT THE AUTHOR

John Loos, property sector strategist, FNB Commercial Property Finance