Covid's Continuing Impact on Real Estate

By Michael Hart

China has fared pretty well, compared to other countries, when it comes to controlling the spread of Covid 19 and lessening the resulting economic impact. That said, the country has still felt some effects and it can be seen in the real estate market. This includes office buildings, hotels and especially shopping malls and retail related projects which first needed to be shut down and now are adapting to a post pandemic world. How will these types of projects be impacted longer term? A recent report by the Urban Land Institute (ULI) and accounting firm PWC focused on the North American market has addressed some of these issues and I think at least some of them are relevant to the China market too.

In their recent report "Emerging Trends in Real Estate – 2021 for United States and Canada" ULI and PWC highlighted ten major trends playing out thanks to Covid in the North American Market. I selected several of these to share that seem to also have relevance to the China market.

These trends are:

-Are We Home Yet?

-Accelerating the Retail Transformation

-Location, Location, Safety

-From Just in Time to Just in Case

Are we Home Yet?

The report noted that the concept of Work From Home (WFH) has been discussed since at least the 1980s, but the adoption of working at home instead of the office, sometimes referred to as telecommuting, never achieved critical mass. There were many reasons for this, some related to the concern of managers that staff would not be productive at home or the reality that sharing some types of information or having group discussions just wasn't easy from afar. The recent combination of the pandemic which forced people to abandon their offices for long periods of time and the improvements in and availability of newer technologies has pushed most companies to try working from home. Now many folks who have experienced working from home or are now allowed to do so by their companies has led to a push to make this change a permanent one. The positive outcome for people is the reduction of time spent commuting and in some cases the ability to help with other duties at home. The positive impact for cities is reduced traffic congesting and related savings of energy and a reduction in car related pollution. For companies they may also be able to save money on occupancy costs if offices no longer to be so large to accommodate all workers every day.

There are challenges of course including that some jobs can't be done from home, but with more knowledge workers in our economies, generally the further up the pay scale, generally correlating with more knowledge work, the more easily these jobs can be done remotely. This trend appears to be here to stay.

Accelerating the Retail Transformation

Traditional retail like shopping malls and department stores have been under siege for some time even before Covid 19. An increase in e-commerce options put pressure on retailers to make the best use of their 'bricks and mortar' stores and had pushed some big box retailers out of business. The recent pandemic which forced the short term closure of many malls has put great pressure on retailers and dozens including J.C. Penny, J. Crew and Brooks Brothers have declared bankruptcy. But expect even more changes to come to the retail sector.

This pandemic is likely to push even more retail online. Shopping from your computer keeps you away from other people, comes with the benefit of home delivery and allows shoppers to find more options than could be carried in one physical store. One immediate impact of this retail transition has been and will continue to be the closure of stores, the failures of retail businesses, especially many small family-owned ones and the resulting elimination of many service sector jobs. This will create many empty retail locations which will eventually mean the closure of some malls and failure of some retail related Real Estate Investment Trusts (REITs.) These properties will eventually be repurposed, but expect to see big pain in the retail sector. The challenges and potential failure of many parts of the retail sector stands in contrast to some of what made it great in the first place, we like to go shopping and we like to gather with friends and family around food. Expect somehow there will still be a role for shops and restaurants, but the retail sector and retail real estate will certainly continue to change.

Location, Location, Safety

This is of course a play on the old saying that the three most important things for success of a business are location, location, location. And since location is at the heart of the real estate industry, when people start to think of a crowded mall or office as a negative instead of a positive, this is likely to turn the property industry on its head. This is obviously linked to the retail sector discussed above. People are now looking for areas that are not as crowded or will prefer to dine outside instead of inside. Property owners are going to have to adapt by reducing maximum occupancy levels. Areas with low density may now even be more preferred, which will also change how tenants think about the pricing of a location. Think of movie theaters which did their best to pack us into a space, elbow to elbow and knee to knee. That isn't going to work anymore.

Although this is initially going to be a major challenge to the property market, this trend appears to be one that may bring many positive innovations to the real estate industry. Already adaptions such as touchless elevators and automatic doors which already existed are getting more prominence. Likewise, the report predicted a whole range of innovations in the field of "prop tech" that is technology around the property business are likely to emerge, think of smart buildings with more health and safety sensors, new automated cleaning systems and much more. Wouldn't we all feel better if technology can help steer us away from crowds or give us assurances that automated filtering technologies are working in the places we work, shop and live?

From Just in Time to Just in Case

Over the past half century, great care has been taken to reduce inventory and its associated costs. This has meant reducing the time a business holds inventory and eliminating the amount of space allocated for storage in factories, stores and businesses. These two savings, the reduced need to own a larger inventory and their reduction of space to store that inventory both resulted in savings. The problem is, this “just in time” delivery works well, until it doesn’t. And with interruptions in production and delivery, factories have had staff standing idle on the factory floor waiting for materials or components to arrive. Likewise stores have run out of stock of some products which means they weren’t able to complete sales. Furthermore, even for e-commerce, the time needed to get products delivered to a customer’s home have gotten longer – when their supply chains have been impacted. Although most supply chains globally are up and working again, there were several examples of big interruptions right when businesses were shut down around initial Covid related lockdown periods. The result is that now, all types of businesses are rethinking their supply chains and are preparing to be a little less, “just in time.” Many have decided it may be better to hold a bit more stock, to have a little more “just in case” and to try and be better prepared for interruptions in their supply chains. There is talk now of supply chain resilience, meaning how prepared is a supply chain to cope with major disruptions. This will result in more warehouse demand and an increase in carrying cost for inventory, but also will mean less shortages in the case of any future pandemics or other major economic shocks. This will also mean that next time stores and factories are designed, they may be a little bigger to make room to hold more stock.

An additional impact of concern about supply chains may be what is called ‘near shoring.’ After outsourcing pushed many factories far away from their customers, like sending factories to China, some north American manufacturers are now looking more seriously at bringing production to Mexico or other relatively cheaper production locations that are closer to their home market. The shorter distance in the supply chain will also hopefully reduce their supply chain risks, but this of course creates a challenge for China, the factory of the world. This will have an impact on prices of land for manufacturing facilities and even longer term for port related facilities.

Conclusion

As highlighted by several of these trends the impact on real estate from the Covid 19 pandemic appears to be wide ranging. The pandemic has pushed Work From Home from a niche concept to a widely accepted alternative to traditional office jobs. Companies who had prospered by keeping their supply chains lean and now looking for options to build in more resilience either by building in more inventory or by reducing the length of supply chains. Retailers who were already being pushed to adapt to e-commerce received a major shock when traditional retail locations were shut down. Many retailers may not survive and those that do may be less profitable and may see their business model shifted. And finally, we’ll start thinking about the health and safety aspects of a property a lot more than we do now.

In all of these cases, when businesses change their models of operation, the related real estate assets will be impacted. Expect to see even more changes in 2021 as many of these trends become more evident.

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