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IMPACT OF THE COVID-19 PANDEMIC ON THE SPANISH COMMERCIAL REAL ESTATE MARKET

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ABSTRACT

The COVID-19 pandemic has had a major impact on the recent performance of the Spanish commercial real estate market. In particular, the crisis has led to a sharp decrease in non-residential investment and has triggered a correction in sale prices, transaction numbers and new financing operations. It has also affected Spanish real estate investment trusts specialising in this market, both in terms of the number of vehicles created and of their stock prices and the value of their real estate assets. By contrast, to date there has been no significant deterioration in credit quality linked to the commercial real estate market.

Keywords: commercial real estate market, COVID-19, real estate investment, commercial real estate assets, mortgage lending conditions, real estate investment trusts in Spain (SOCIMIs), real estate investment trusts (REITs).

JEL classification: E22, G23, R3, R31.

IMPACT OF THE COVID-19 PANDEMIC ON THE SPANISH COMMERCIAL REAL ESTATE MARKET

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Introduction

This article analyses the impact the COVID-19 pandemic has had on the recent performance of the Spanish commercial real estate market. Commercial real estate assets are any kind of establishment in which firms physically pursue their activity, including, for instance, offices, industrial premises, logistics hubs and shops.

Analysing how the commercial real estate market evolves is important, especially in times of crisis such as now, because of its potential implications for the real economy and for financial stability. Investment in commercial real estate is part of investment in construction, so any deterioration in conditions in this market can affect economic growth. Moreover, a crisis in the commercial real estate market can have an adverse impact on banks' capital, as a result of the potential growth in defaults on real estate loans and in losses on the associated collateral.[1]

The COVID-19 crisis has triggered a sharp correction in activity, prices and new financing operations (commercial mortgages) in the sector. This contrasts with the case of the housing market which has performed comparatively better to date.[2] There are at least two reasons for this different performance. First, the commercial real estate sector is per se more sensitive to the economic situation than the housing market. Therefore, while demand for retail premises fundamentally obeys the outlook for the economic cycle, housing is a staple which, together with other – such as demographic – factors, makes residential real estate market demand more stable. Second, owing to the nature of the present health crisis, at some points there have been restrictions on mobility and on the activity of small local retailers. These have exacerbated the negative dynamics of the indicators in certain branches of the sector (for instance, in hotels and other tourism establishments, and in retail outlets in general).

The article first describes the recent developments in non-residential real estate investment, drawing on data on building permits provided by the Ministry of

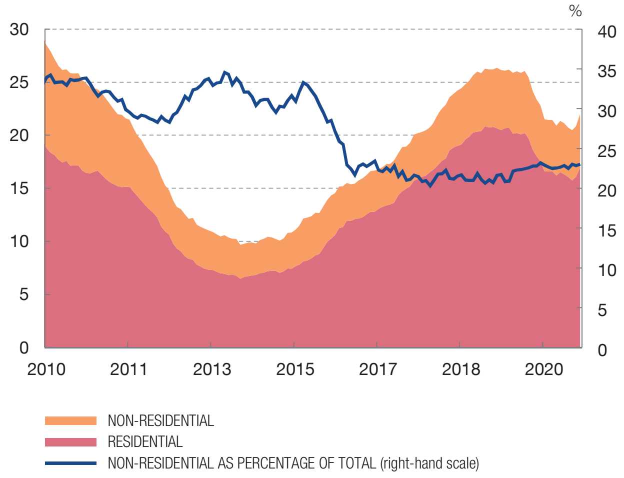
1 See, for example, European Systemic Risk Board (2015).

2 For more details on the recent performance of the housing market, see Álvarez, Blanco and García-Posada (2020).

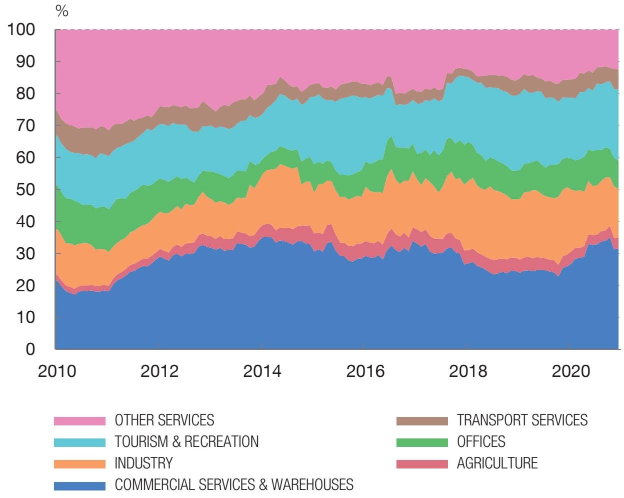
Chart 1
THE SUPPLY-SIDE IMPACT OF THE CRISIS HAS BEEN SIMILAR IN THE RESIDENTIAL AND NON-RESIDENTIAL MARKETS

Permits for new non-residential construction fell by 18% in 2020 overall; this was identical to the decline in the residential segment. But the non-residential segments have performed very differently, with sharp falls for industrial premises and offices, while commercial services and warehouses (linked to the logistics sector) have shown great resilience.

1 PERMITS FOR NEW CONSTRUCTION. FLOOR AREA (MILLION M²). 12-MONTH CUMULATIVE TOTAL



2 PERMITS FOR NEW NON-RESIDENTIAL CONSTRUCTION. FLOOR AREA (MILLION M²). 12-MONTH CUMULATIVE TOTAL



SOURCES: Ministerio de Transportes, Movilidad y Agenda Urbana and Centro de Información Estadística del Notariado, Colegio de Registradores.

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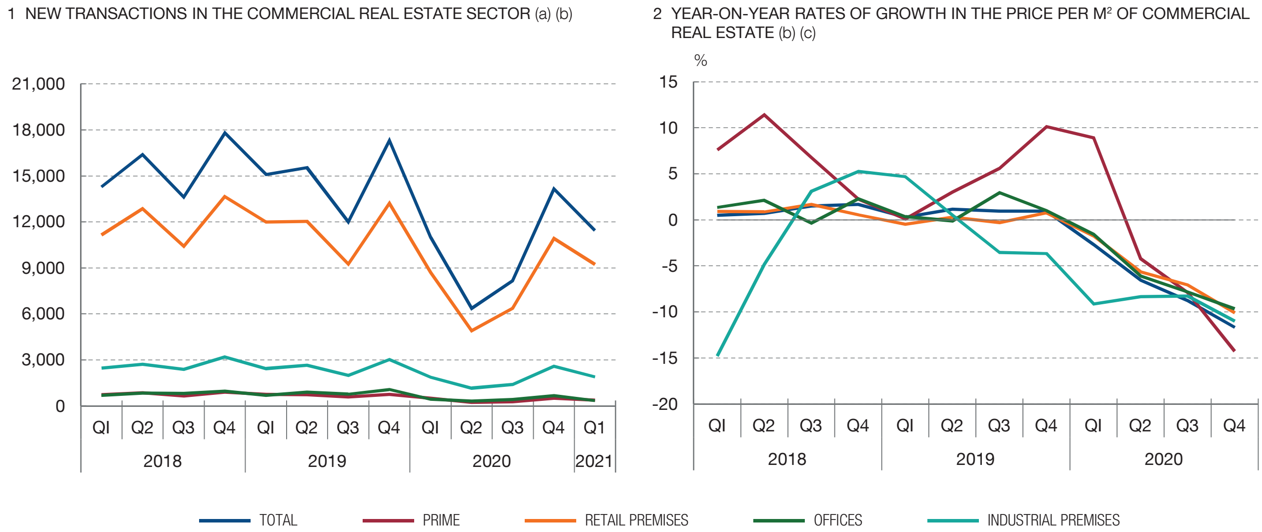
Transport, Mobility and the Urban Agenda. It then goes on to examine the effects the crisis has had on activity in the sector, analysing how commercial real estate transaction numbers and prices have evolved, drawing on information from the Association of Property Registrars. This is followed by a review of Spanish banks' credit exposure to the sector and of the changes in commercial mortgage volumes and credit standards, in this case drawing on supervisory data and information from the Association of Property Registrars. Lastly, the article analyses the impact of the pandemic on the activity and stock prices of the Spanish real estate investment trusts (SOCIMIs, by their Spanish acronym) specialising in the commercial real estate market.

Commercial real estate market investment

According to data from the Ministry of Transport, Mobility and the Urban Agenda, building permits for new non-residential construction fell by 18% in 2020 overall; this was identical to the decline in the residential segment (see Chart 1.1). Accordingly, the proportion of permits for non-residential construction has remained relatively stable, at slightly over 20%, which has been its approximate level in recent years. However, the non-residential segments have performed very differently recently, with industrial premises and offices down 39% and 20%, respectively, and

Chart 2
THE COVID-19 CRISIS HAS TRIGGERED A FALL IN TRANSACTION NUMBERS AND SALE PRICES IN THE COMMERCIAL REAL ESTATE SECTOR

Sales of commercial real estate assets fell sharply in 2020, especially in the first half of the year. In 2020 overall, transaction numbers were down 38.2% on 2019. Prices dropped across the board from March 2020, although less so than transaction numbers.



SOURCE: Centro de Información Estadística del Notariado, Colegio de Registradores.

a The number of transactions recorded each quarter in each segment.
b The prime segment refers to retail premises in the main retail districts of Madrid, Barcelona, Bilbao, Palma, Valencia and Malaga.
c The commercial real estate price indices are calculated drawing on the four-period moving average of the median transaction prices for commercial premises in each quarter.

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commercial services and warehouses (linked to the logistics sector) up 1%. This uneven performance may be related to how firms have responded to the crisis in the face of the growth of e-commerce and the increased importance of flexibility to adapt to demand conditions. On project cost estimation data, the non-residential segments are down 17%, with the most pronounced declines for industry and offices (37% and 16%, respectively), once again in contrast with the good performance of commercial services and warehouses (8%). Indeed, warehouses and tourism are the two segments with the highest proportion of building permits for non-residential construction (31% and 22%, respectively) (see Chart 1.2).

Transaction numbers and prices

As Chart 2.1 shows, during 2020 commercial real estate sales fell sharply, especially in H1 when transaction numbers were down 60% on 2019 H1. Data from 2020 Q3 and Q4 show some recovery, but not sufficient to offset the earlier sharp declines. Moreover, the provisional data for 2021 Q1 point to a further loss of momentum in commercial real estate transactions. These data suggest, therefore, that the lack of dynamism in these transactions is explained not only by the problems associated with the restrictions on mobility, but possibly also by the fact that demand for these assets has been hit by worsening business expectations. In 2020 overall, commercial real estate sales fell by 33.8%.

Sales of commercial real estate were especially poor in areas that normally generate the most retail activity. Thus, sales in prime areas, located essentially in large city centres, fell by 47.9% in the year as a whole, with a particularly significant decline in Q2 (68.5%). However, it has to be borne in mind that sales in prime areas were already suffering before the onset of the pandemic. By asset type, the crisis has had most impact on office transactions, which fell by 47% year-on-year in 2020 overall, while in the case of industrial premises sales saw a slightly smaller correction in that period, down 30.6%, similar to sales of retail premises which fell by 33.6%.

Sales of offices have performed less well than sales of other kinds of commercial real estate, such as industrial premises. This could reflect the impact of certain pre-existing trends, which have been heightened by the pandemic. For instance, the growth of e-commerce, which requires well-situated logistics hubs, could have cushioned the impact of the crisis on this type of property. Likewise, the fall in the number of transactions in the prime segment could reflect the market response to new consumer patterns linked to the surge in online shopping, which took hold swiftly in 2020 as a result of the social distancing measures. All the above could have detracted from the appeal of commercial real estate purchases in what were traditionally prime areas. Similarly, the increase in remote working as a measure to prevent the spread of the pandemic could have reduced the demand for office space; this would explain the larger relative decline in the number of transactions in this segment.

Prices in the commercial real estate segment have fallen across the board since March 2020, but less so than transaction numbers. Specifically, in four-quarter moving average terms, the average year-on-year rate of change in commercial real estate prices fell from 0.9% at end-2019 to -8.8% in 2020 Q4 (see Chart 2.2). By segment, and unlike transaction numbers, prices in prime areas performed somewhat more favourably than in others, increasing in 2020 H1, although they too turned negative in H2 (-7.9% year-on-year in Q4). The worst performance was in offices, where prices fell back in year-on-year terms in 2020 Q1 (-3.6%), and far more than in the other segments in the following quarters (-8.3% in Q4). The provisional data for 2021 Q1 indicate that these price corrections continue.

Financing of purchases and banks' exposure to the commercial real estate sector

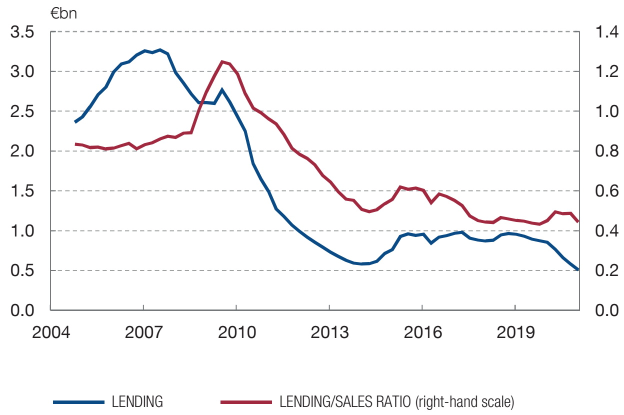
Consistent with the changes observed in sales of commercial real estate, new lending to the commercial real estate market has decreased significantly since the

Chart 3

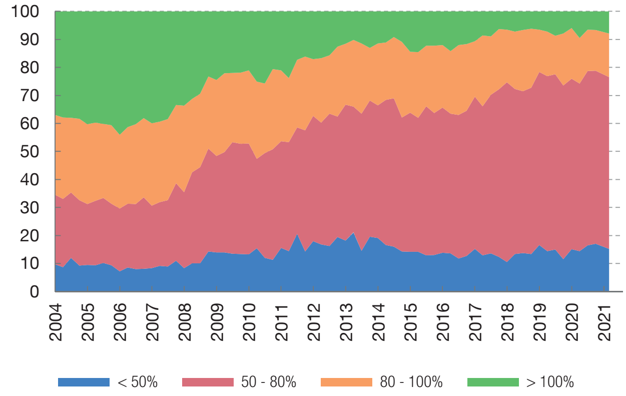
FINANCING CONDITIONS HAVE DETERIORATED SIGNIFICANTLY IN THE PAST YEAR IN THE COMMERCIAL REAL ESTATE MARKET

New lending has decreased significantly in the past year, but not as sharply as transaction numbers (the ratio of new lending to sales has increased slightly). Based on the changes in the loan-to-price ratio, credit standards have become somewhat more prudent since the onset of the pandemic. Despite the crisis, the indicators available do not signal a significant worsening of the quality of these loans.

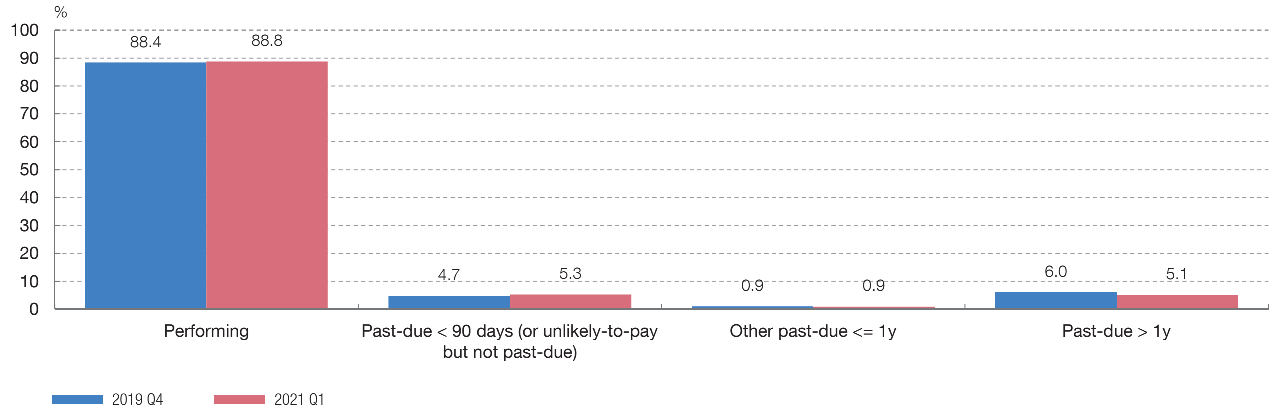
1 NEW LENDING COLLATERALISED BY COMMERCIAL REAL ESTATE (a)



2 LOAN-TO-PRICE RATIO FOR COMMERCIAL REAL ESTATE LOANS (b)



3 BREAKDOWN OF EXPOSURES TO COMMERCIAL REAL ESTATE LOANS (b) (c)



SOURCES: Banco de España and Colegio de Registradores.

a Four-quarter moving averages. Only lending secured by commercial property is included.
b Ratio of the principal amount of the mortgage to the property's registered price. Based on a sample of transactions.
c Exposures on an individual basis. Only loans valued at amortised cost (which includes the great majority) are considered, since for 2019 no more information is available for other portfolios.

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start of the pandemic (see Chart 3.1). Specifically, in 2020 new commercial real estate mortgage volume was down 36% on 2019, close to the minimum of the last 15 years.

Chart 3.1 also shows that the ratio of new lending to sales rose slightly in 2020, reflecting a sharper fall in transaction numbers than in new lending. This pattern, which was also observed at the start of the financial crisis in 2008, albeit much more intensely, could indicate growth in new refinancing operations destined to ease borrowers' liquidity needs which increase in recessions.[3] In any event, the levels of credit granted and sales made in 2008-2009 were more than double the current levels.

Regarding credit standards, the tightening of credit conditions for commercial mortgages observed before the onset of the pandemic has continued in recent months. Specifically, Chart 3.2 shows that the proportion of new mortgages with a loan-to-price (LTP) ratio below 80% has increased. This is consistent with banks being more cautious when granting commercial mortgage loans.

At end-2021 Q1, the outstanding balance of mortgages secured by commercial properties amounted to €84 billion,[4] accounting for 15% of the entire mortgage portfolio of credit institutions in Spain at that date.[5] Even so, the volume of commercial mortgages is significant if measured in relation to banks' own funds. At end-2020 these portfolios accounted for 40% of the Tier 1 ratio, so a substantial impairment in the ability to pay by debtors in this segment could have a negative impact on the banking system's solvency.

Chart 3.3 provides a breakdown of credit institutions' exposures based on information on performing, past-due and unlikely-to-pay loans at end-2019 and 2021 Q1. For exposures classified as non-performing, those that may default in the short-term or in early arrears are distinguished from those in arrears for longer. In general, to date the impact of the crisis on the credit quality of these portfolios appears to be limited. Although the share of short-term troubled exposures (i.e. those defaulting in the short term or classified as unlikely-to-pay) increased slightly between end-2019 and 2021 Q1, the proportion of past-due and unlikely-to-pay mortgages has not changed significantly. The volume of loans without credit impairment but with a significant increase in credit risk (Stage 2 loans) accounted for hardly 0.7% of all exposures at end 2021 Q1.

The scant effect of the crisis on the quality of this type of credit to date is in contrast to the strong deterioration in economic conditions. This could be explained, in part, by the effect of certain support measures, such as the guarantee and moratoria schemes (in 2021 Q1, the moratoria granted in this segment amounted to €9 billion, according to consolidated reporting).[6] Expiration of these measures could therefore be accompanied by a rebound in the volume of non-performing loans. It should also be noted that in commercial mortgages the debtor is often a legal person with limited liability and, accordingly, the risk of these exposures could be higher than that associated with residential mortgages, where in the event of default the bank has

3 There are no data available on loan purpose.

4 Exposures on an individual basis (excluding exposures to the commercial real estate sector outside Spain).

5 Total mortgage exposures include residential mortgages and those secured by commercial properties (e.g. offices).

6 Under the loan moratorium schemes, the payment commitments of debtors in a situation of vulnerability are deferred. On end-2020 supervisory data, 45% of the amount subject to moratoria in commercial mortgage loans had already expired; the remainder will expire over the course of 2021.

recourse not only to the loan collateral (the home) but also to the borrower's equity.[7] In addition, the fall in real estate value reduces the recovery value of these loans in the event of default.[8]

SOCIMIs specialising in the commercial real estate market

The impact of the COVID-19 pandemic on the commercial real estate market has also been reflected in the SOCIMIs[9] specialising in this segment, both in terms of the number of vehicles created and of the changes in their stock prices and in the value of their real estate assets.

Although SOCIMIs continued to be created in 2020, the number of new vehicles entering the market was considerably lower than that observed in prior years (see Chart 4.1). Thus, 13 SOCIMIs were floated in 2020,[10] mostly specialising in the non-residential real estate market,[11] compared with an annual average of 21 vehicles admitted to trading since 2016. Also, five SOCIMIs abandoned the market in 2020, three of which were engaged in commercial real estate rentals.[12] As a result, at end-2020 there were a total of 95 listed Spanish vehicles, 74% of which operated in the commercial real estate market. Of these SOCIMIs, 17 specialised in office rentals, 12 in retail premises, ten in shopping centres, a further ten in hotels and four in logistics, while the remaining 17 had diversified assets in several segments.

As shown in Chart 4.2, SOCIMI listings have been particularly affected by the health crisis. From the global spread of the pandemic in February 2020 up to the cut-off date of this article (05/07/2021), the FTSE EPRA NAREIT REIT SPAIN index, which weights the stock prices of the largest and most liquid SOCIMIs by free-float market capitalisation, has accumulated losses of 30%,[13] compared with a 10% fall in the IBEX 35, the Spanish selective index. Stock prices of vehicles investing in the

7 In 2020 half of all purchases of commercial premises were made by legal persons.

8 The LTP ratio, which measures mortgage leverage at origination (the ratio of the principal amount of the loan to the price of the property purchased) is lower in commercial mortgages than in residential mortgages. However, this does not mean that the percentage of recovery in the case of default is higher in commercial mortgages, since this segment is in a price correction phase (lower present value of the collateral). In addition, lower recovery rates are to be expected in unsecured loans, which are not analysed in this article.

9 For a detailed analysis of the characteristics of this sector in Spain, see García-Vaquero and Roibás (2020).

10 In contrast with prior years, when most SOCIMIs launched on the Spanish alternative market BME Growth, in 2020 more than half launched on the alternative market EURONEXT, which has much more flexible free-float and turnover requirements.

11 Of these 13 new SOCIMIs, four specialised in hotels, two in retail premises, two in offices and three in residential real estate, while the other two had a mixed real estate asset portfolio.

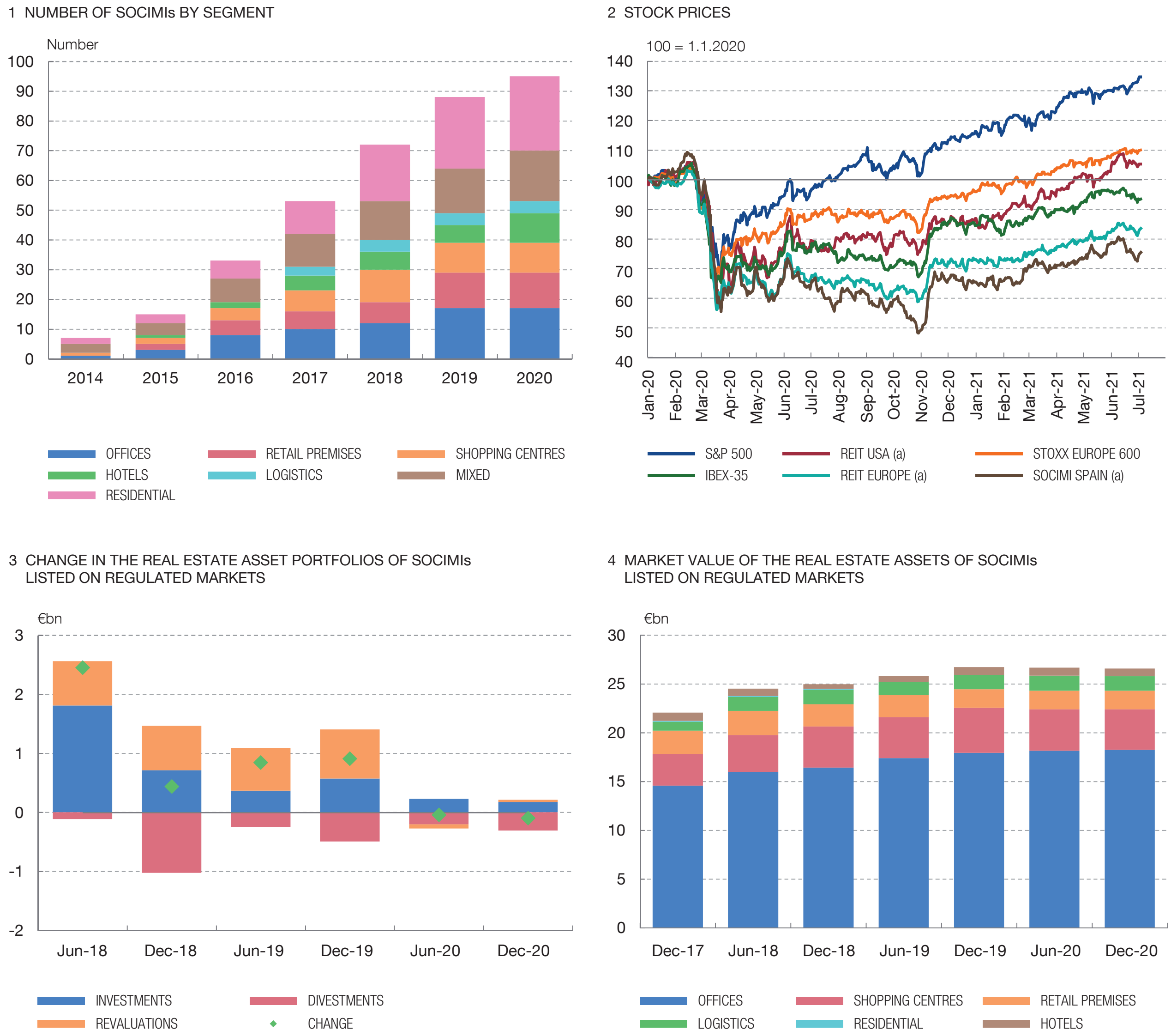
12 Two in retail premises and one in offices.

13 To be included in the FTSE EPRA NAAREIT REIT indices, SOCIMIs or REITs must meet certain minimum free-float, liquidity and size requirements. In the case of Spain, this means that three of the four SOCIMIs that are listed on regulated markets are included. The prices of most of the remaining ones, which are listed on alternative markets, have remained practically unchanged during the entire period, as a result of the minimum turnover owing to their low free-float. Except for three medium-sized SOCIMIs that are listed on alternative markets, the remainder account for a very small part of the total capital of the sector as a whole.

Chart 4

THE COVID-19 CRISIS HAS ALSO IMPACTED SOCIMIs SPECIALISING IN THE COMMERCIAL REAL ESTATE MARKET

The number of new vehicles entering the market in 2020 was considerably lower than that observed in prior years. Since the start of the pandemic SOCIMIs' stock prices have declined more than the IBEX-35 index and the market value of their real estate assets at end-2020 has decreased compared to 2019. This fall was concentrated in shopping centres, hotels and retail premises at street level.



SOURCE: BME, Refinitiv Datastream, corporate quarterly reports and annual accounts.

a The FTSE EPRA NAREIT REIT indices use the free-float stock market capitalisation to weight the stock prices of SOCIMIs or REITs that meet certain minimum free-float, liquidity and size requirements. In the case of Spain, this means that three of the four SOCIMIs that are listed on regulated markets are included. The prices of SOCIMIs which are listed on alternative markets have remained practically unchanged during the entire period, as a result of the minimum turnover owing to their low free-float.

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commercial real estate sector have declined across the board internationally, although comparatively more acutely in Spain. Thus, in the United States and Europe, while the S&P 500 and the STOXX EUROPE 600 indices have recovered their pre-pandemic levels, REITs' stock prices have declined by 1% and 17%, respectively, over the same period.

As regards real estate assets, at end-2020 the market value of the portfolios of the SOCIMIs listed on regulated markets,[14] solely comprising commercial assets, was down €139 billion (0.5%) on the previous year. This was due to divestments exceeding investments and to negative valuation effects (see Chart 4.3). The fall in the prices of these properties was concentrated in H1, coinciding with the first state of alert in Spain and the total suspension of non-essential activity. Although these prices recovered in H2, the increase did not offset the losses incurred during the first months of the pandemic. Also, both divestments – concentrated in non-strategic assets – and, in particular, investments were lower than in the previous year. The moderate decrease in the market value of the portfolios of these SOCIMIs in 2020 is in contrast to the collapse in their stock prices over the same period. Thus, their stock price discount to net asset value (i.e. market value net of debt) rose to 41% at end-2020, compared with 12% recorded a year earlier. These developments could be influenced by the lower liquidity of the commercial real estate market compared with that of the stock markets on which these SOCIMIs are listed.

By asset type, the largest fall in the market value of the portfolios of SOCIMIs listed on regulated markets, on data as at December 2020, was in shopping centres (down 9.7% on 2019), mainly owing to the decline in the prices of these assets. The market value of the hotels portfolio also declined (by 2.4%), as a result of divestments, as did that of retail premises at street level (down 0.9%), because divestments and valuation losses exceeded investments. By contrast, the market value of the logistics and office portfolios increased (by 2.8% and 1.7%, respectively), owing to the good performance of prices in these segments and to the investments made (see Chart 4.4). The improved performance of the SOCIMIs' office portfolio prices is in contrast to the worse performance of other indicators in the sector, such as the transaction numbers and sale prices analysed above. This might suggest that SOCIMIs' office portfolios are of higher quality[15] or that their tenants belong to sectors less affected by the crisis.

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14 SOCIMIs listed on alternative markets do not usually provide market value data on their real estate assets. They are mainly classified as small and medium-sized enterprises and, although they are much more numerous than those listed on regulated markets, they account for approximately half of the sector's real estate assets. At end-2019, around 71% of their real estate portfolio was non-residential.

15 Most of the offices included in the SOCIMIs' portfolios are in prime city centre locations in Madrid, Barcelona and Paris.

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