WEATHERING THE STORM

PLOTTING A COURSE FOR AVIATION FINANCE, INVESTMENT MANAGEMENT AND REAL ESTATE AFTER COVID-19.
COVID-19 left few parts of the global economy untouched. The disruption has been widespread. As countries across the world went into enforced lockdown earlier this year to slow the spread of the virus, many business sectors had no choice but to go into a kind of suspended animation, while others remained active but at greatly reduced capacity. A fortunate few have thrived.

Now, as economies start to reopen after Government restrictions ease, the scale of the challenges that lie ahead are starting to become clear. In this article, Deloitte Ireland experts look in depth at the implications for three elements of the financial services industry.

First, they examine the impacts for the investment management sector, at a time when liquidity is scarce and the outlook for earnings is soft. Next, we consider aviation finance – one of the most profoundly affected by the crisis. The industry comprises many different players, from airlines to banks and capital markets: How can each of them respond to a crisis of this magnitude? Next, we turn our attention to the real estate sector, which includes retail, industrial, office and residential markets. All four will feel the effects of the pandemic in different ways. Our experts examine where each sector has felt the impacts most deeply, and forecast what changes are likely in the short and long term.

Yet the changed environment also offers potential opportunities for those ready and able to act. Our commentators give guidance on how financial services providers can navigate the tricky passage to safer shores.
The deep and immediate impact of COVID-19 has had a significant bearing on the global economy, with few industries as profoundly impacted as aviation. The effective halt in international air travel has meant a seismic challenge to airline revenues but there has also been an adverse impact on the aviation finance market.

There is a broad spectrum of market participants within aviation finance. Banks have historically been the lifeblood of the industry, providing around 30% of the funding requirements for airlines and aircraft lessors/managers. Capital markets provide roughly a third of the financing requirements in an average year, with cash making up the majority of the remaining balance (along with export credit finance, finance provided by manufacturers and other products).

As airlines are unable to meet debt financing costs, lease rental payments and other obligations, banks and lessors are facing similarly unprecedented challenges in the form of severe liquidity challenges, disruption to operating models and the push from airlines for lease rental/interest payment holidays and deferrals.

There remains uncertainty as to if and when we will see a return to pre-COVID-19 airline passenger numbers but the general consensus is that the industry will face significant headwinds until 2023 at the earliest.
That being said, there will of course be opportunities for some as a result of the global pandemic. There is an expectation of consolidation within the European airline market, akin to what was seen in the US previously. Similarly, within the aircraft lessor industry there may be M&A opportunities for those participants with strong financial support as well as for opportunistic investors with capital available to deploy.

The general consensus is that the aviation industry will face significant headwinds until 2023 at the earliest.

Key considerations for aviation finance market participants:

- Understand where the exposures are in terms of airlines and aircraft type
- Monitor closely the level of government support for airlines
- Undertake recovery scenario planning and modelling to outline liquidity requirements and to understand the options and protections available
- Ensure a robust repossession strategy and capacity is in place
- Consider the level of cyber resilience within the organisation as cyberattacks become a more urgent and pressing concern
- Consider how best to operate in a remote working environment, utilising technology to best effect and the opportunities remote working may bring in terms of attracting top talent
- Ensure open communication with investors and other stakeholders both in terms of the impact of rental/interest deferrals on cash flow as well as airline interaction and remarketing efforts
- Where capital is available to deploy, ensure agility, flexibility and responsiveness to investment opportunities as they arise
- Continue to prepare for an increasing focus on ESG going forward, in particular given a significant number of older generation aircraft are set to be retired on the back of COVID-19. New technology and fuel-efficient aircraft are likely to attract investors.
Global economic activity reduced to a standstill as the world took an aggressive stance to slow the spread of COVID-19 which is having broad implications for the investment management industry. Aggressive fiscal and monetary policy responses combined with critical containment actions around the world have made a major economic impact, yet liquidity remains scarce and the outlook for earnings is soft.
Potential long-term impact on investment managers

Market volatility has redirected the attention of most sellers and buyers as it relates to M&A activity. Buyers may emerge in a stronger position to negotiate transactions while sellers will have to perfect their competitive advantages.

Challenging times can be a catalyst for future innovation and growth. Organisational resiliency plans and overall operating models will be re-examined to advance digital transformation and agility. Work, workforce, and workplace experiences will be forever changed, supported by an ecosystem of virtual resources, technology and behavioural norms that define work as a thing we do, not a place we go. Investor confidence and trust will slowly be restored. The active versus passive debate will rage on as active managers look to advance their brand of investing. The pandemic will increase the attention of investors and boards of directors towards environmental, social, and governance (ESG) considerations.

Key questions executives and boards should be asking:

- What resiliency systems are in place (security, cyber, internal controls, personal trading and outsourced providers)?
- How do resilience and succession plans operate over the long term and across a variety of scenarios?
- How do we retain and incentivise talent?
- What will be the impact on investment capital and where will it focus?
- How can we adapt to being agile with shifting strategic priorities?
- What will be the impact of any new regulatory guidelines?
Challenging times can be a catalyst for future innovation and growth.

**Practical next steps**

- Reassure investors during short-term periods of volatility
- Drive innovation to support the “future of” scenarios
- Enhance ongoing management of investment and non-financial risks
- Ensure motivation and productivity of remote workforce.
The impact of COVID-19 is starting to be felt across the real estate industry. The initial shock has been absorbed and there begins to be some clarity as to which sectors have been impacted the most, and to what extent.

It is very clear the specific sectors such as retail and hospitality have taken the brunt of the impact. Other sectors such as the office and industrial sectors, which at first appeared more insulated from the pandemic, have now started to experience similar effects.
Weathering the storm

The most substantially impacted sector is retail, where COVID-19 is hastening the demise of many retailers that were already struggling. No doubt the values of shopping centres and high street retail will start to suffer beyond the short to medium term, with evidence of longer term value implications.

Retail
Retail and hospitality are no doubt the most challenged of all the sectors. There are a number of options for existing assets here:

- Repurposing is dominating dialogue in the UK market and is starting to be discussed in Ireland. There is a lot of uncertainty about how best to drive a repurposing and what alternative uses might work. Prior to the COVID-19 pandemic, many believed that PRS/residential was the solution, but one size does not fit all.
- Whilst a repositioning of assets is the first initiative that many landlords/owners consider, many are likely to have to implement more drastic repurposing programmes.
  
- This has been a challenge for landlords in the past, and so innovative approaches will be required in order for successful repurposing initiatives to be deemed viable.

Repurposing ultimately depends on being able to identify alternative uses that generate a positive return on the capital and time involved in achieving a transformation.

The medium-term future

- Retail rents are likely to continue to fall as more retailers encounter distress as they compromise rents, close unprofitable stores or fail altogether.
- Downward pressure on rents will be a challenge for valuers to address and there is likely to be a closure on LTV gaps across the board.
- Values of secondary centres anchored by supermarkets will be more stable than those that are predominantly fashion/entertainment/F&B.
Office
The impact of this pandemic is that remote working has become commonplace and an element of this is expected to remain. However, this is not the “death of the office” as has been touted by some. The office is likely to become a “destination” workplace; required for improved efficiencies, client engagement, staff engagement, training of staff, and an overall collaborative place to work.

However, larger corporates will no doubt seek to establish more permanent remote working protocols and structures. This will ultimately reduce headcount in physical floor plates on a daily basis, as more flexible working practices for staff become the norm and companies seek to reduce what is a large operating expenditure, reducing floor space requirements.

The resultant effect is that demand for office space is likely to decrease somewhat, with occupiers looking to consolidate existing offices and reduce commercial footprints.

Delivery and take up
With a substantial percentage of the commercial office stock under construction now pre-let, there will remain a constraint on the supply of new Grade A, modern office space coming to the market. It is therefore anticipated that rents will remain stable, with some yield deflation anticipated in respect of the longer-term reduced demand for commercial office real estate assets.

Whilst generally the professional services and tech sectors have to date remained insulated to some degree, they will likely be impacted by wider economic deflation. Much of the prime office assets in Dublin have already been purchased by long-term core investors meaning competition for such assets that are brought to the market for sale will remain strong.

The medium-term future:
- It is anticipated that there will likely be a mild softening of yields, more likely on an occupier sector-by-sector basis, with rental levels likely to remain relatively stable
- Whilst there will likely be lower levels of activity across the board, the suburbs may see a relative increase in interest/activity in relation to city centre, likely to be driven by reduced affordability and budget constraints of occupiers
- The principal impact will likely be seen through the increase of incentives such as rent free/lease flexibility to occupiers.
Residential
The strong latent demand in the residential sector in Dublin remains. Some of the key factors which will impact the rental accommodation market and sales market (residential housing) are as follows:

Rental/investment market:
- It is anticipated there will be a reduction in short-term demand within the rental market, from both an influx of supply of short-term rental stock due to lack of international travel, along with a reduction in rental demand due to temporary relocation of occupiers from Dublin City until the end of 2020.
- Residential rental rents are likely to remain stable in the medium term. It is anticipated that the short-term decrease in rents will be balanced by a rebound as the economy reopens and stabilises, stock is absorbed and the wider limitations in affordability of the sales market. All of this will likely increase rental demand due to limited new stock coming to market in key locations.
- Landlords may consider a redesign of new stock under construction or in pre-development stage to incorporate a home office/study area, or a “co-working space” in apartment schemes to facilitate remote working.
- Public transport will remain a long-term attraction in residential demand from a locational aspect, despite remote working.

Sales market:
- The affordability issue remains. Economic deflation experience will likely place less certainty on income, with lenders being more cautious and already some examples of limitations and restrictions on lending.
- Short-term sentiment is weak, driven by some hesitation in the market by potential purchasers on the future of remote working (which is driving locational demand), and the availability of quality stock.
- Forward purchase investments are likely to stagnate until there is certainty on construction and completion timeframes, with a delay in commencement of projects currently in planning and a slowdown in the release of phases in schemes currently underway.

Delivery/development land:
The development land sector will experience the effects on a sectoral basis as outlined above. There is an expected reduction and deflation in development land values and AMV over time for residential development, which may also influence other sectors.

Some of the key factors which will impact this sector:
- It is inevitable that there will be an impact on pricing. The pricing of residential development land is influenced by many factors, but mainly variables such as GDV (end values, rents and yields), construction costs, and the funding environment; all of which are shrouded in uncertainty in the current market.
- The role of Local Authorities and Associated Housing Bodies will be crucial going forward,
and the implementation of government policy on both this and the delivery of undeveloped sites will be critical.

- Construction cost inflation remains an issue in the delivery of stock, due to the tight margins for developers in an uncertain market.

There is likely to be a degree of stress on some residential development land sites where excessive prices may have been paid in the acquisition. In particular, fringe and regeneration areas which had experienced substantial increases in pricing over recent months may become challenged or indeed distressed into 2021.

**Conclusion**

As the effects of the COVID-19 restrictions continue to be felt both locally and globally, the real effect on property values as a whole is only starting to emerge. Until such time as a normal transactional market resumes, care will need to be taken when assessing property valuations and the supporting methodologies.