

Czech Republic - March 2020

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CLIENT NOTE
Savills Research

Covid-19 in the Czech Republic



Timeline • Czech government measures & policies • Real estate impacts

Timeline

Here is the timeline of how the coronavirus outbreak evolved in the Czech Republic

March 1st

The first three positive cases of Covid-19 in the Czech Republic.

March 3rd

Flights from northern Italy and South Korea are suspended.

March 10th

Gatherings over 100 people are banned.

March 11th

94 positive cases. All schools are closed.

March 12th

State of Emergency declared.

March 13th

Borders with Germany and Austria are closed.

March 15th

298 positive cases. All restaurants, bars and retail stores are closed (groceries, drug stores, pharmacies and gas station are excluded).

March 17th

Czech National Bank lowered the two-week repo rate by 50 basis points to 1.75%.

March 18th

560 positive cases. It becomes mandatory to wear a face mask or scarf in public.

March 22nd

1,161 positive cases. The first death caused by the virus (male, 95 years old).

March 27th

Czech National Bank lowered the two-week repo rate by further 75 basis points to 1.00%.

Introduction

The pandemic will hit the global economy hard, with all real estate sectors affected to varying degrees. But in the subsequent low interest rate environment, real estate as an asset class should continue to offer superior returns.

The coronavirus has created huge economic and social turmoil all around the world. The full human, economic and real estate impacts of this health crisis remain unclear for the following reasons:

- As a novel virus, Covid-19 is, by definition, not yet fully understood.
- Human health outcomes will depend on country-specific variables such as public health policy and protocols (travel restrictions, social distancing guidelines), social compliance, health service capacity, weather conditions, seasonality, population age structure etc.
- Economic outcomes also depend on country variables: The underlying economic structure (e.g. weighting between manufacturing and services), integration into global supply chains, the fiscal space to intervene and the policy choices that are made.

However, Savills has a large and well-established presence in Asia – one third of group revenues derive from Asia-Pacific and we employ 30,000 persons across 58 offices in the region – and this extensive first-hand experience of Covid-19, as well as previous outbreaks like SARS in 2003, mean they have important information to share. We would like to pool and leverage this learning from our Asian and global teams with our on-the-ground experience in the Czech Republic to provide the broad preliminary observations outlined on the next pages.

Czech Policy Response

To slow the spread of the coronavirus in the Czech Republic and minimize its impact on the economy the government adopted several key measures.

Public Health Policy Response

- As of March 12th a State of Emergency was declared. As of March 24th, there were 1,472 cases of Covid-19, with 3 deaths associated with the virus. ÚZIS Institute of Health Information and Statistics forecasts there will be 15,000 confirmed cases at the end of April.
- The Czech government did not delay in activating a coherent strategy to deal with the Coronavirus in line with guidance from the WHO and European Centre for Prevention and Disease Control (ECDC), including closing borders, schools and restaurants/bars; and forcing people to wear masks outside, engage in social distancing, and self-isolate at home.
- Measures enjoy wide compliance and support, with a survey by Kantar CZ finding that 80% of respondents approve of the steps taken by the government.

Fiscal Response

- The government introduced a set of preliminary measures to mitigate short-term negative effects of the crisis. It will provide CZK 100 billion in direct support and CZK 900 billion indirectly in the form of guarantees. The government will pay out 60% of the average contribution base to employees affected by the quarantine. At the same time the state will support employers who continue, despite their businesses being shuttered, to pay out 100% of the salary to affected employees by covering 80% of salary costs (all this up to CZK 1.2 billion).
- The government also introduced tax delays and interest-free 2-year loans for affected SMEs with a one-year delay in payments. This Covid loan programme was raised from the original CZK 600 million to CZK 10 billion.
- On March 17th, the Czech National Bank (CNB) reduced the two-week repo rate by 50 basis points to 1.75%. On March 27th, the interest rate was lowered again, this time by 75 basis points to 1.00%.
- The government approved the suspension of electronic sales records (EET) during the state of emergency and following 3 months after. It means that taxpayers have no obligations to record their sales during this period.

Real estate impacts

Below, we provide our view on the likely impacts of the coronavirus pandemic on the commercial real estate markets in the Czech Republic.

Manufacturing

- Automotive production is one of the most significant sectors for the Czech economy. The three largest car producers (Škoda Auto, Hyundai and TPCA) have suspended production for a period of two weeks (to be prolonged if need be) and some suppliers are following with similar measures. The sector has been hindered by supply chain issues as components from China were not being delivered as required. This may affect offshoring strategies and the long-term business plans of some production companies, potentially leading to a partial return of production to Europe over the coming years.
- Rent abatements are being requested by tenants, but in many cases landlords are not able to offer such relief due to own loan payments.
- The government is preparing financial support to help production companies retain staff and cover their wages. The “Antivirus employment protection programme” should become effective on April 1st, 2020.
- Lessons learned from this and the SARS-CoV-2 outbreak could accelerate the introduction of automation into the manufacturing sector, further reducing its labour dependence.

Logistics

- The need for short-term storage capacities increased significantly as F&B retailers and producers, pharmaceutical companies and distributors of personal care products try to keep up with unexpected demand levels and longer, or disrupted, supply chains.
- Increased online retail sales are putting further strain on the distribution capacities and last-mile deliveries. We have yet to see any evidence or indications that the increased online sales will endure after the crisis, but if that is the case, then e-commerce providers will be looking to expand their warehousing capacities, enhancing leasing activity on the industrial market.
- Transport of goods is already facing delays caused by temperature checks at border crossings and could soon also be hit by labour shortages brought about by quarantine measures. Both of these factors could be eliminated by the future utilization of self-driving (autonomous) trucks.
- Many of the larger industrial developers have suspended land acquisitions.

Retail

- The short-term closure of most retail stores, food courts and leisure services has caused a major contraction in shopping centre footfall. The grocery sector is the least affected and has actually seen revenues rise due to the closure of restaurants and many people cooking at home, as well as people stocking up on essentials. The largest stores reported almost 19% year-on-year increases in turnover during the last week of February. Leisure and fashion segments are the most impacted.
- Some small retailers may fall into insolvency, the likelihood of this happening increases with each day that the state of emergency is prolonged.
- Rent abatement and relief is being requested by many retailers but will be treated on a case-by-case basis, as landlords have no legal obligation to reduce rents under the current circumstances. Declines in revenue are expected to affect rental payment flows and could result in the inability of some landlords to repay loans (where bank financing is in place). The best outcome would be reached through the active engagement of all parties – government, banks, landlords and tenants. After the crisis, landlords are expected to pay more attention to the financial health of tenants and it is assumed that a higher proportion of landlords will start asking for monthly rental payments to smooth out operational cash flows.

- Enforced online shopping could accelerate the long-term behavioural shift to e-commerce. The coronavirus pandemic has made many consumers reluctant to go out and online grocery shopping has increased rapidly. The major online supermarkets in the Czech Republic (Košík.cz, Rohlík.cz and Tesco Online) reported that consumer demand has been several times higher than during the same period last year. E-retailers are also trying to quickly expand their geographical coverage to deliver to more locations across the country. As a consequence, they are not managing to maintain same-day or next-day deliveries (often delivering within 3-5 days from ordering). They also face issues with suppliers, meaning many products are out of stock.
- There have been cases of increased investment in online retail platforms as some of the brick-and-mortar stores attempt to go online to stay in business.

Offices

- Construction works are expected to be slightly hindered by short-term labour shortages and social distancing measures, causing delays (1-2 months) in the completions of new buildings and refurbishments. Some of the new developments are likely to be postponed or put on hold.
- Short-term paralysis in leasing activity is anticipated. Advanced transactions are still proceeding but, inevitably, some decisions will be put on hold as companies shift their focus towards keeping their businesses afloat. Occupiers are expected to be more cautious in the 6-12 months after the crisis, reconsidering relocation plans and focusing more on lease renewals. Preleasing activity is, therefore, projected to slow down.
- Over the next 12 months, landlords are expected to focus on lease renewals to secure tenants and stabilise cash flows for their buildings. Interesting incentives packages may be offered.
- Rent levels are forecast to remain stable with no anticipated growth in next 6-18 months, but any significant drop is not expected. Incentives for new leases to remain stable or slightly decrease.
- Following the crisis, landlords will start to pay more attention to the financial health of tenants.
- The coworking business model could be affected in the short to medium term after the crisis as people remain cautious about sharing their workspaces with large groups of “strangers”. On the flip side, coworking could offer a short-term back-up solution for companies affected by construction delays.
- Remote working is unlikely to gain more widespread traction after the crisis. The enforced working from home will more likely draw attention to the benefits of an office environment, in terms of collaboration, focus and the immediacy of personal contact. The coronavirus crisis surely induced the largest work-from-home experiment to date, serving as a good test of the ability to form virtual teams and perform within them.

Residential

- The coronavirus froze apartment sales in the Czech Republic. Some transactions are only postponed (and price may be challenged by the buyer), but many acquisitions are being re-evaluated and, in these times of income / job uncertainty, rental living is likely to become more popular. Under the current restrictions, apartment sales are impossible to realize. Online and contact-less models have not proven effective for, in many cases, a lifetime investment such as the acquisition of a residential property.
- After the government measures are released, the share of investment acquisitions is expected to increase while the demand coming from the lower and middle class will fall. Buyers falling into the upper class will continue to invest into the residential sector, which still represents one of the safest investments.
- Banks are expected to tighten the mortgage assessment criteria further, loans with higher LTV (above 80%) will be seen as risky. Mortgages will therefore become even more inaccessible.
- Rent levels in Prague have seen a sharp decline. Due to the sudden departure of foreigners from Prague, many of the short-term rentals became available and this disruptive increase in supply caused fast decline of rents. A fresh wave of demand is projected to come from those who were previously considering the acquisition of an apartment.
- Similar to the office market, completion of some of the new residential developments may be delayed or even put on hold.
- Due to the nature of the product, the residential market is not so volatile and the activity decline is expected to be short-lived and not very dramatic, depending on the duration of the coronavirus crisis.

Hospitality

- In the fight against the coronavirus, the Czech government introduced a travel ban prohibiting foreigners from entering the country. The introduction of social distancing measures caused all events to be cancelled and bars and restaurants closed. The sales of accommodation services were banned, with the daily E15 reporting that all 11,000 apartments in Prague used for short-term rentals via the Airbnb or Booking platforms are empty. All these actions led to a sharp (in some cases total) contraction in revenues. Some restaurants began offering meal deliveries or pick-up options to retain as much of their staff as possible and cut their losses.
- Despite these efforts, it is obvious the hospitality sector will be hardest hit. With considerable losses in revenue and without state support, insolvencies are expected. Many restaurants are likely to fall into cash flow issues after 20-30 days. Hotels are likely to be impacted more severely as the travel restrictions could last several months.
- As people's incomes suffer during and after the crisis, they will demand less luxurious goods. This decrease will be relatively higher than the decline in the demand for necessities and everyday goods. The five-star hotel segment will be most affected.
- Room prices in the 4* and 5* hotels have fallen and occupancy rates dropped significantly as a result of the government-imposed measures.
- CPI Group, one of the largest hotel operators in the country, has offered the government the full capacity of their 14 hotels (5,000 beds and conference space) spread across the country, in case extra space for patients is needed. The company also announced cost reductions and some job losses.

Investment

- There has been a sharp contraction in investor activity. Transactions that are in the final stages are expected to complete successfully, but new acquisitions are being postponed or slowed (across all real estate sectors). Marketing campaigns and opportunities planned for sale are also being postponed.
- Investment activity is expected to pick up in H2 2020, but overall annual investment volumes will certainly be lower than had been predicted before the crisis.
- Going forward, investor views on assets will shift from the prevailing sentiment of '90% leased' or '5Y WALT' to conducting more thorough credit checks.
- A shift to defensive assets is expected. Investment in regional cities to become less attractive in the medium to long term.
- Interest rate cuts will support financing and this should dampen the yield increase to some extent. Yields are, therefore, forecast to increase only moderately.
- In comparison to the equity market, which will suffer from low dividends, and the debt market, which reflects the low interest rates of central banks, real estate as an asset class will continue to offer superior returns.

Summary

Whilst conditional on an appropriate public policy response and social compliance, based on the preliminary evidence from China, the pandemic appears to be controllable within a two-quarter timeframe, but the world of course joins together in hoping that a second wave of the virus does not occur. The Czech government has extended the current restrictions to April 1st, with the first relaxation of the rules possibly coming after Easter in mid-April if the measures taken have proven successful.

In terms of the economy, the Czech economy is relatively robust and can cope with domestic restrictive measures due to sufficient fiscal space (4th lowest total debt/GDP in the EU – around 32% of GDP). Even so, economists' baseline scenarios are now that it will fall into recession because Covid-19 measures will not only affect domestic but also foreign demand significantly. ING believes foreign demand might become a bottleneck for a quick recovery in the second half of 2020, though it is too early to estimate the full effect. Inflation had been forecast to go above 3% this year, but

disinflationary pressures mean headline CPI should decelerate towards 2.0-2.5%* this year.

Construction works are expected to be hindered by short-term labour shortages and social distancing measures, causing delays in the completions of new office and residential buildings and refurbishments. Short-term paralysis in office leasing activity is anticipated, with the coworking business model likely to be hit in the short to medium term.

Retail and hospitality sectors are expected to be the hardest hit segments with many insolvencies expected – the extent will depend on how long the restrictive measures remain in place. The grocery sector is the least affected and has actually seen revenues rise, especially those with online presence. Declines in revenue to affect rental payment flows could result in the inability of some landlords to repay loans although at this stage we see the banking sector being understanding and not enforcing loan covenants and / or allowing principle payments to be rolled.

Enforced online shopping could accelerate the long-term behavioural shift to e-commerce, benefitting the logistics last mile and supply chain real estate segment. E-commerce providers could look to expand warehousing capacities or secure smaller regional depots, which would in turn enhance leasing activity on the industrial market.

Overall annual investment volumes will certainly be lower than had been predicted before the crisis and with liquidity always the one restrictive factor to real estate, the question will be if a return to normality will come in time to allow transactions to happen in 2020. A shift to defensive assets is expected with significant activity in the opportunistic sector when some assets or owners face financial difficulties.

Real estate as an asset class will continue to offer superior returns in a low dividend/low interest rate environment but the focus of investors will heavily shift to understanding covenants and business operations of tenants better, with stress test and cash flow being central to pricing.

STRONGER TOGETHER

In this time of need, people in the Czech Republic have to a broad extent come together as one community and are trying, in many different ways, to help each other in the best way they can.

The most alarming issue in the Czech Republic has been the acute lack of face masks and respirators, which were missing at crucial “first front” places and responders such as hospitals, retirement homes, firefighters and policemen. In response to this, ordinary people, including the large Vietnamese community, have started to make face masks at home, supplying neighbours, retirement homes and even hospitals. In a few days the whole nation, including actors, fashion designers and prison inmates, were producing face masks for those in need.

New websites and apps were created to support restaurants trying to survive the enforced closure by continuing to offer meals for pick-up in the restaurant or home delivery.

Companies and universities have also shown a great deal of initiative.

- Brno-based company Respilon has redesigned and improved their nanofiber face masks, which are now capable of isolating and even killing the new coronavirus.
- Technical University of Liberec, known for its nanofiber research, has developed and already started producing unique filters that are extremely effective in preventing the entry of pathogens and can be placed on home-made face masks.
- Czech Technical University has developed a new type of respirator that can be used for up to a week and is made by a 3D printer. These special respirators will be supplied to hospitals where they are most needed.
- Many more companies are joining in, lately including Hartmann-Rico, Batist Medical or Adler.

Ordinary people continue to help each other by creating various support groups offering psychological help to cope with isolation and helping elderly citizens with grocery shopping so they can avoid crowded supermarkets.

After restaurants were closed, the famous Czech chefs Zdeněk Pohlreich and Jan Punčochář started preparing and delivering meals to key workers such as firefighters, emergency crews and policemen. This is with the support of other companies who offered to take care of the delivery service and donated money for the ingredients.

To help farmers and small producers who cannot sell their goods because of the quarantine, Expira.cz offered the use of their online platform to facilitate online sales and purchases of surplus supplies.

*) These figures represent the current outlook but further downward forecasts are expected.



Savills Czech Republic Research

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