Real estate and Construction industry has a significant exposure to risk due to the knock-on effect of the business downturn in every sector.

Despite the marginal recovery after the Easter Sunday attacks in April 2019, the damage by the COVID-19 pandemic is substantial and it is increasingly evident that demand and best use for the property may be changing for good.

With uncertainty around how many businesses will survive the crisis due to the cash pressures, supply chain and workflow disruptions, and the long-term economic consequences of COVID-19 is unprecedented.

PwC Sri Lanka hosted a webinar on 06 May 2020 with an eminent panel to discuss the current challenges of the industry which included:

- Mega Kuleratna (Director – MAGA Engineering);
- Pravir Samarasinghe (CEO– Overseas Realty PLC);
- Ganatharan Jeyakumar (Co-founder – Millionspaces) and;

This document summarizes the key takeaways of the webinar discussion on the COVID-19 impact and outlook for the Real Estate and Construction sector in Sri Lanka.
Where do we stand?

Real estate and Construction is a key sector in our economy and has supply chains from Small and Medium Enterprises (SMEs) to large manufacturing entities providing building materials.

Whilst appreciating the importance and necessity of having lockdowns and curfews to curb and restrict the spread of the virus, it comes at a greater expense to the economy and further affects mental well-being and social order (especially in vulnerable sectors of our society).

Therefore it is important to have a regulated easing of restrictions to make sure that the economy (and economic development of the country) happens in tandem with balancing the concerns of the healthcare sector and managing the pandemic.

We are facing unprecedented challenges as a result of COVID-19. Without a doubt, there has been severe social and business disruptions and despite varying degrees of success with lockdowns, social distancing and other public health measures, the vaccine is what is likely to control the pandemic in the long run.

Some other questions on the minds of business leaders includes how long will it take for a vaccine to be developed? what does the 'new normal' look like? what will organizations do in the interim in their journey towards the 'new normal'?.

In addition, it was evident during the COVID-19 pandemic some solutions required digital transformation, flexible working and use of robotics. Most importantly, how will this relate to property and its value?
Tenants may be facing cash flow challenges impacting rent payment. What is the potential impact to commercial property owners and what options do they have at their disposal?

Pravir from Overseas Realty (Ceylon) PLC stated, cash flow issues may force the enterprises to move to lower grade buildings or cheaper real estate. For an example, you might see that firms may go from A-Grade buildings in the Business District to the B-Grade buildings or Secondary Business Districts or even to the periphery of Colombo.

He further mentioned that the majority of the commercial office spaces in Colombo were operational throughout the lockdown with many tenants working as well. Under those circumstances, it is unlikely, compared to the Retail sector, that you will see rent reduction for the commercial office space. However, there may be savings in utility costs, service charges or common infrastructure costs being passed on to tenants. Property owners may also offer support in the form of deferment of certain payments.

Property market is a direct barometer of economic growth. If there is economic growth, political stability and investment, prime real estate will always have a demand wherever in the world.”

Pravir Samarasinghe
Chief Executive Officer – Overseas Realty (Ceylon) PLC

In certain countries, there are instances where the government has intervened and provided certain abatements in property rates. In such instances, that could be passed on to the tenants.

The “Working From Home” (WFH) trend grown in popularity over the past 20 years and in certain countries the way of working has changed and will continue to change. Technological and social changes (e.g. millennials) have led to flexible working arrangements creating demand for coworking spaces, hot desks, shared spaces.

As is the case in the retail industry where you will find the digital economy co-existing with traditional brick-and-mortar economy, you will find WFH arrangements to go hand-in-hand with commercial space. It may affect occupancy levels and rental rates of the commercial real estate.
What’s the impact and outlook of COVID-19 for condominium properties?

During the recent past, with the slowing of economic activity, the demand for condominium apartments was severely affected. During the previous year, the Easter Sunday attacks and political uncertainties dampened the market sentiment and demand factors. The supply of condominium apartments is also quite extensive with over 10,000 apartments in the pipeline.

Given the current circumstances, the demand for condominiums is likely to slow down with a probability that they recover over the medium - long term as the economy recovers. The recovery of the residential housing market will be supported by trends in urbanization, increasing land prices, income levels, and a proportion of High Net Worth Individuals and ownership of multiple investment assets impacting the demand for condominium apartments over the medium to long-term.

On the supply side, it is likely that there will be less investment for condominium apartment projects due to the current inventory of apartments in the next few years. Developers are likely be complete their existing developments and wait for demand to increase in the short-medium term.

Affordability is a very important aspect in Sri Lanka and the fact that it is not affordable to most.

Pravir Samarasinghe
Chief Executive Officer – Overseas Realty (Ceylon) PLC

Normally, a household’s capacity to borrow maybe 5 times of the household’s annual income. There can be incentives given by the government especially for the first homeowner by way of concessionary interest rates. The Government can also provide the land at a concessionary rate making apartments more affordable.

“Affordability is a very important aspect in Sri Lanka and the fact that it is not affordable to most”
Mega from MAGA Engineering indicated that 2020 will be a challenging year for the construction industry especially with declining government spending in infrastructure in recent years, competition from foreign contractors especially in residential real estate and inconsistent government policies.

From 2010-2014, the industry recorded a growth of 10-20% per annum but by 2018 and 2019 the growth contracted to 2.5% and 4% respectively.

During the 2010-2012 period, post-war Sri Lanka achieved significant economic boom spearheaded by the construction and real estate industry. This economic growth outpaced global growth at that time.

A point to consider is whether infrastructure spending can be a tool for reviving the economy?”

Mega Kuleratne
Director – MAGA Engineering

He further stated that Sri Lanka could consider recovery in terms of infrastructure development projects such as highways, roads and power and public housing.

However, it is still difficult to assess the impact to the private sector and the amount of capital investment in the next two to three years.
How do you expect the real estate market (i.e. transactions and land value) to be impacted in general?

According to Dilshan from Sunil Fernando & Associates, based on their research, the short term real estate outlook is grim. The impact on value from lockdowns and restricted business activity will vary according to the industry and use of the property.

Transactions have been very few and may include sellers who are under compulsion to sell. The volumes should improve over the next 4-6 months though the market will generally continue to be depressed compared to 'normal' times.

He further stated that during that period, there is likely to be M&As and repurposing of existing properties in severely affected industries. There again, investors will look at the long term prospects of those properties before investing or divesting. Dilshan indicated that in terms of specific markets, low-middle income housing will likely be impacted to a lesser extent.

For commercial properties, the degree of impact will be based on the fundamentals such as location and use. There could be interest in specific types of property where the negative impact from the Pandemic is less likely.

To summarize, property values will be depressed in the short run and continue to be depressed for a while until we reach 'normalcy'. Something to highlight is that the cycle for real estate is generally longer than any other type of traded asset, hence, there could be a delayed reaction in market values.

"Most importantly the drop and recovery of market prices will depend on several factors including the highest and best use of the respective property"

Dilshan Perera
Chief Operating Officer – Sunil Fernando Associates
How are construction companies managing this crisis in terms liquidity, people, safety, supply chain etc.?

Mega from MAGA Engineering stated the key focus for construction and engineering companies would be ensuring the health and safety of the workforce. Due to the nature of the industry, most of the value additions are done on-site. Hence, most companies would be thinking of a phased-out approach to work while taking mitigation measures to stop the spread of COVID-19 pandemic.

The biggest risk seems to be continuation of work and providing accommodation in line with social distancing measures. For an example, in Singapore, majority of the COVID-19 cases are from construction dormitories. So, at first, it will be finding the optimum point of the maximum output an enterprise can gain with the minimum workforce. Infrastructure development project like road and water could be easier to implement compared to building projects.

Construction Industry Development Authority (“CIDA”) and Ministry of Health of Sri Lanka has given guidelines to respond to the crisis.

In the short term, it’s going to be phased out working arrangements while focusing other key areas like improvement of business processes, eliminating non-value adding activities, reducing wastage and driving workforce with KPIs and training and development.

In addition, Mega also mentioned the concern for construction companies is working capital and liquidity. Interventions and support in the form of payments due to the construction firms, debt moratoriums and concessionary working loans given to the SME sector, could potentially be extended. This should help sustain the industry in the short term.

There are existing projects in infrastructure development, health, education and urban development. Fast tracking the approval of these projects could also help.

If highway and road projects could be distributed among small to medium scale contractors the industry will be able to survive for the next 1-2 years.
Will corporates or banks ask for revaluation of assets given the current market dynamics?

Dilshan stated that from a valuation point of view, it is uncertain at this point if firms will opt for an immediate revaluation of assets during this period of uncertainty. When you consider property used as collateral for mortgages for instance, there can be a risk if the market and the forced sale values drop beyond a certain level where the adequacy of the security becomes questionable. So the decision as to whether banks will request clients to revalue will depend amongst other things on the repayment capacity of the borrower.

From the perspective of enterprises, in terms of financial reporting, impairment assessment of assets is going to be necessary. He further stated that although revaluation of these assets may be required in terms of assessing the adequacy of the collateral, it is unclear at this stage what specific criteria Banking and Financial Institutions (BFIs) and Central Bank of Sri Lanka will follow for existing mortgages.
Ganatharan from Millionspaces mentioned that the demand for hot desking had declined steadily even before the COVID-19 crisis. Similarly, hot seating concept has declined in other regional real estate markets such as Singapore. However, the demand for private offices are increasing in Sri Lanka.

He further mentioned that COVID-19 has had a major impact on hot seating working arrangements. For an example, in Singapore, more than 90% of the users have withdrawn their hot seating memberships.

However, co-working and Flexible office spaces as a concept is going to be crucial in the 'new normal' economy after the COVID-19 crisis. We have seen a significant increase in inquiries on serviced and private offices in coworking spaces, both in Singapore and Sri Lanka.

He further mentioned that there could be several reasons; for instance, the impact on a firm's business continuity. For an example, if a firm has 100 employees, 30% are working from home and 70% are working in office. If one of them gets infected, the firm needs to send 70% of the workforce to quarantine for two weeks. Hence, business continuity will be at risk.

“Coworking can help firms distribute their workforce in different locations, where the business continuity risk can be lowered”

Ganatharan Jeyakumar
Co-founder - Millionspaces
Meanwhile, some companies have frozen capital expenditure in this uncertain times which could increase demand for private offices where the workplace is already furnished.

Gantharan also mentioned that other drivers of demand for coworking spaces includes Satellite office space. The companies may be looking at more distributed branches of their operation. Over the last decade, we have seen an increase in demand for office space in Colombo Business District due to the location and address. But with COVID-19, the demand may be skewed towards the Satellite offices in the residential zones, e.g. Moratuwa, Rajagirya.

Companies are looking at redesigning their office spaces due to Ministry of Health (MoH) guidelines (E.g. 6 feet gap). The current office space may not be enough to cater these guidelines. Hence, it will increase demand for coworking arrangement where the workplace is already furnished.

He further mentioned that since firms may lay off employees due to the economic downturn. But if the landlord is not reducing the rent, co-working spaces may be more attractive due to the less space required.

Over the recent past, WeWork was expanding to different regions through joint ventures with the landlords where WeWork provides expertise on management, marketing and operations. Furthermore, due to the depressed real estate market in Sri Lanka, Ganatharan mentioned that it will give more opportunity for landlords to enter into joint ventures with coworking space operators, to convert some of the vacant spaces into coworking spaces. This is quite prominent in regional and global real estate markets.

Co-working space brings the startup culture, community and ecosystem around it to the business space, which increases the value of the property in the long run. In terms of public health protocols, co-working spaces already have incorporated the guidelines into their office spaces such as temperature scans, sanitization etc. In the future, coworking spaces will move towards smart offices where it is driven primarily through technology (e.g. motion sensors, facial recognition, IoT etc.).
How to respond?

It is evident that the outbreak of COVID-19 has brought upon unprecedented challenges, and is expected to have a significant impact on Sri Lanka’s real estate and construction industry in the short term. Based on a PwC and Strategy& analysis, we can highlight a few response strategies for the Real Estate and Construction enterprises, investors and other stakeholders in the short-medium run.

Adapt. Adapt. Adapt.

This crisis is likely to permanently change the use of real estate. Industry stakeholders, that haven’t already, need to reposition themselves as soon as possible to ensure they are prepared for new trends, such as reduced office working, the rise of the digital economy, and a decline in business travel. Health and wellbeing is also likely to become a greater driver of value across all forms of real estate.

Maximizing what can be done

For commercial real estate property owners, assessing a tenant’s financial position and identifying those who are most likely to survive and prosper will be key in selecting where to invest in and create a strategy for moving forward. How investment is shaped (rent deferrals, discounts, lease extensions etc.) will also need close consideration.

However, cash flow analysis needs to be carried out to manage liquidity and plan out financing needs for the short-medium term.

Unlike Commercial Real Estate, Residential real estate owners need to be more understanding on a tenant’s financial position as well as their own (e.g. pay cuts from employers).

Open mind for new sources of financing

Real estate companies should consider old and new funding options to shore up cash in the short term. Existing lenders are a good start. They will also need to consider new sources of capital and debt. For an example, structured private credit (domestic or foreign) can be seen as an attractive solution – prompt, reduced cash burden in the short run, less need of continuous refinancing.

Price is what you pay. Value is what you get.

Rental rates and cash flow, yields and discount rates, occupancy levels and other impacts from the Pandemic will feed in the valuation analysis. Hence, as mentioned earlier, valuation of real estate assets will likely to be affected till we reach normalcy. Furthermore, it is more important than ever, for regular updates of valuations, depending on the use of assets, to understand how the market is responding.

Most importantly, staying focused

Decision-makers must remain rational and strategically minded. The most successful players will be those who can tolerate uncertainty, who can be discerning under pressure and who can make painful short-term decisions for the long-term good.
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