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Real Estate Asset Management

The impact of COVID-19 on real estate markets

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In this paper:

- While the economic impact of the coronavirus pandemic could have a more accelerated effect on real estate investors than a typical downturn, maintaining discipline and focusing on long-term objectives is key.
- Cash flow needs and assessing the health of your tenant base should remain top-of-mind.
- Depending on property type, real estate investors could be presented with different short- and long-term challenges and opportunities.
- Access to a professional real estate asset manager to help guide strategies and coordinate resources to handle these complicated matters may be more important than ever.

The outbreak of the coronavirus that causes the COVID-19 disease has resulted in major health and economic upheaval around the world. While economic headlines in the United States have understandably focused on job losses and the stock market, investors should be cognizant of the potential impact to the real estate markets as well.

Investors often look at real estate more closely in times of stock market volatility due to its low correlation to the market, predictable income stream, and generous tax treatment. Typically, real estate is a trailing indicator of changes in the economy, with a six-to-nine month lag being the norm. With the shutdown of all non-essential businesses across the country and “stay-at-home” orders issued in many high population centers, the fallout to the real estate markets may be realized much faster than in prior downturns.

Despite current challenges, real estate remains a key pillar in a well-diversified, long-term investment portfolio. Engaging a qualified real estate asset manager can help maintain investment discipline during volatile and emotional market conditions. One of the chief advantages of a fiduciary advisor in the real estate space is to provide professional perspective and keep the focus on long-term investment objectives. The right advisor will also be able to provide insights and resources to help property owners make sound, short-term tactical decisions to take advantage of potential opportunities while mitigating some of the rash, reactionary decisions that could compromise achieving long-term strategic investment objectives.

Economic impact of COVID-19

The profound impact of COVID-19 on the U.S. and global economies clearly began to manifest itself in the last week of March. Almost every day of the week featured a new data point of historic negative proportions that presaged an economy entering a deep recession in the near term. A complete review of these data points is beyond the scope of this paper, but it is worth noting a few that stand out in an economy dependent upon consumer spending:

- Personal income and spending was solid for February but appears to be set for steep declines in March and beyond.
- On Thursday, March 26, initial weekly jobless claims hit an all-time record of 3.3 million for the week ending March 21. This is more than four times the previous record set in 1982. Moreover, the speed at which the losses occurred is stunning. Non-farm employment during the Great Recession fell top-to-bottom by 8.7 million jobs, but this occurred over a two-year period from January 2008 to February 2010. With stay-at-home orders and shuttering of non-essential businesses, these jobless numbers are set to increase even further in the next several weeks.[1]
- Indications of consumer reaction to the COVID-19 crisis started to appear in tracking numbers when the University of Michigan released its March survey of consumer sentiment. This survey tracks consumers’ moods and is a leading indicator of their willingness to make discretionary purchases. The relative trend from one month to the next suggests either increased, steady, or (in the case of a decline) decreased future spending. Preliminary readings issued two weeks prior to March 27 indicated that the number would come in around 95.9, indicating fairly steady spending. Shockingly, the number came in at 89.1, a downdraft of a magnitude not seen since the Great Recession in October 2008. Preliminary readings for April indicate a further decline in the index to 71.0. If this holds, it will be the largest one-month drop in history of the index, suggesting a dramatic retrenchment in consumer spending.[2]
- Since many commercial real estate tenants are classified as small businesses, ominous warnings of the impending impact of COVID-19 on commercial real estate can also be seen in measures of small business optimism. The March National Federation of Independent Business (NFIB) Small Business Optimism Index, based upon interviews of small business owners conducted in the first half of March before the most stringent stay-at-home provisions went into effect, showed the largest decline in optimism on record. A special update survey conducted on March 30 showed that 92% of respondents were negatively impacted by the coronavirus.

Half of the respondents reported that they could survive for no more than two months under current conditions, with another third reporting that they could survive for no more than three to six months.[3]

Real estate: potential safe haven or the next shoe to drop?

So where could all of this economic carnage leave real estate? Just as the world is in many ways in uncharted waters with the coronavirus pandemic, the shelter-in-place orders and closing of non-essential businesses across much of the country and globe has led many classes of real estate into uncertainty over at least the short term. As an asset class, direct-owned real estate has many desirable features when included in a diversified portfolio—namely as a potential hedge against inflation, potentially stable income, and non-correlated risk-adjusted total returns over market cycles.

On the downside, direct-owned real estate has ongoing cash requirements for operating expenses, debt service, capital improvements, and costs associated with renewing and attracting tenants. This cash need is what we feel could be the greatest risk faced by direct-owned real estate investors and is driven by the health of the tenant base. If the predicted recession is short-lived and ends with a steep and robust recovery, the health of the tenant base may recover to levels prior to the onslaught of COVID-19. Pre-COVID-19, market trends were already impacting real estate asset classes in diverse ways, creating relative winners and losers. The pandemic may accelerate and enhance those trends that we will explore in subsequent paragraphs but in the near term, the stability of cash flow will be on every investor's mind.

Risks and rewards of owning real estate today

The broader impact of COVID-19 will undoubtedly be felt across all property types and in all geographies. Retail and hotel properties are already being hit the hardest, with apartments and certain types of industrial assets faring better. Metropolitan areas with well-diversified economies may expect to fare better than locations that are focused on tourism or the energy sector.

Here is a look at the near-term impact to the main four property types, as well as some potential longer-term effects:

Apartments

Investment in apartments has outperformed all other property types over the long term in part because we all need a place to live. While rent delinquencies will undoubtedly rise due to job losses, apartments should remain well occupied. The Coronavirus Aid, Relief, and Economic Security (CARES) Act includes protections for tenants against eviction and for landlords who have mortgages backed by the federal government to help buoy this part of the real estate market.

Over the long term, we believe apartment investments should remain solid performers. One factor that could influence the future of apartment investments is people's desire to live in high-density areas, which are the hardest hit during this crisis.

Industrial

A subsequent effect of the retail business shutdown will be our nation's continued advance toward e-commerce. This will benefit owners of industrial properties, specifically distribution and logistics centers. Keeping the supply chain of food, medical, and other essential products flowing has been paramount in navigating this crisis. However, tenants that are tied to the retail, restaurant, lodging, or energy space may also be negatively impacted in the near term. The expectation is that certain industrial property owners will emerge from this downturn in fairly good shape.

A secondary, long-term effect on the industrial space may be that U.S. firms consider diversifying their supply chains away from China as a result of this virus and the ongoing U.S.-China trade war.

Office

The short- and long-term impact on the office market has yet to be determined. While office tenants are in a much better place than brick-and-mortar retail tenants due to the ability to work remotely, an extended or partial shutdown will ultimately lead to attrition across many industries and loss of that income for office building owners. As with industrial users, office tenants tied to the retail, restaurant, lodging, or energy space may also be negatively impacted in the near term. The COVID-19 crisis has forced many companies into an involuntary trial run of having employees work from home. While some companies will eagerly get back to the office when this is behind us, others may look at this as an opportunity to reduce or even eliminate office rent as a significant expense line.

Retail

Retail properties have unquestionably been hit the hardest during this crisis. Forced closures of stores, bars, restaurants, and daily needs services are going to be felt for some time to come. Landlords may be faced with further attrition in the big box retail space as well as the loss of some smaller operators who typically fill the neighborhood centers and strip malls. We see a lone bright spot in the brick-and-mortar retail space where essential businesses like grocery stores, pharmacies, and gas stations have seen an uptick in business. While a subsequent effect of this virus may be a stronger push toward e-commerce, consumers will still want to get their haircut, walk through the mall, or go to their favorite pizza place.

A strong focus on preserving asset income and value

With all of the uncertainty in the economy, we believe that one of the primary focuses of real estate owners today should be preserving income and value at the property level. This begins with assessing (and reassessing) the financial stability of a property's tenant base to ensure that income streams remain intact. In cases where tenants are struggling, landlords may need to be flexible and find creative lease modification solutions in order to preserve the long-term value of the property. A successful real estate investment requires an open line of communication between tenants and landlords, and that dynamic is critically important now.

Financial stress on businesses will not only be felt by landlords, but by lenders as well. As income or occupancy levels fall as a result of this crisis, default provisions in mortgages could be triggered. This could lead to loan modifications or, in some instances, foreclosures of properties by lenders. Proactive landlords are already in discussion with business owner tenants on how they can help them continue operating over the coming months and beyond. The unfortunate reality is that some businesses, both large and small, will not survive and landlords need to start formulating contingency plans in order to re-tenant space in their buildings. Private owners of real estate across the country are relying heavily on professional real estate asset managers, who have the resources and insight to handle high volumes of lease activity and, in some cases, strategic repositioning of these properties.

In terms of buying and selling real estate in today's environment, transaction volume has understandably dropped off considerably. While 2019 was a record year for real estate transactions, many institutional and private investors will remain on the sidelines while they assess the length of the shutdown and its long-term impact.

From a buyer's viewpoint, it is extremely difficult to properly analyze the revenue stream of a property in today's environment because we don't know how long businesses will be shut down and what impact there will be on the financial strength of public companies, let alone privately held firms. Many transactions that were in process as the economic shutdown unfolded have either been repriced or canceled altogether. However, uncertainty in the real estate market creates opportunity and, as we move beyond the COVID-19 chapter, there will be real estate opportunities to explore for those investors with the risk tolerance and resources to execute.

There are special risks associated with an investment in real estate, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

[1] "Scope of Crisis Becomes Real for 3.3M People." Wells Fargo Securities, March 26, 2020.

[2] "Lights Out for Consumer Sentiment Amid Reboot of Economy." Wells Fargo Securities, April 9, 2020.

[3] "Small Business Optimism Plunges." Wells Fargo Securities, April 7, 2020.

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