

COVID-19 Valuation Considerations For Institutional Commercial Real Estate in the U.S.

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The COVID-19 pandemic is causing tremendous turbulence in the global economy. Stock markets around the world have sustained enormous losses and the 10-year U.S. Treasury yield has fallen to less than 1.0%, an all-time low. Cancellations, curbed travel and supply chain disruptions are taking a toll on economic fundamentals, which has caused a pronounced global recession. At present, most buyers, sellers, and lenders are waiting on the sidelines for better clarity about the depth of the crisis. Even the mechanics of completing deals has become an issue as the due diligence process is more challenging to complete given the difficulty in traveling, accessing properties, and having the necessary technical reports completed.

Properties likely to be the most impacted by the crisis include hotels, retail centers, senior housing, and other assets where performance is immediately impacted by lower traffic and demand. With constrained liquidity, underwriting standards are expected to tighten for properties that will require significant capital expenditures or those in geographic areas that are being hardest hit. Supply chain disruptions will also hamper timing and cost for planned developments and assets currently under construction. Properties with bond-like income qualities, like apartments, industrial warehouses and properties leased to credit tenants on a long-term basis, are best poised to weather this extraordinary period of uncertainty.

The COVID-19 outbreak is affecting both supply and demand drivers within the US and around the globe. The situation has caused a sharp near-term decline in economic activity and transaction velocity for commercial real estate assets. Once the crisis subsides, we anticipate economic activity will gradually re-normalize. However, the potential economic fallout and the ultimate impact to property values will be wide ranging, unevenly applied, and require thorough analysis on a case-by-case basis.

Below are some general observations related to different property types:

Multifamily: The *National Multifamily Housing Council* reported that as of April 12th, 84% of April rents were paid, though some only partially. However, the real test will be the payment of May rents as unprecedented unemployment continues to rise in most markets. Markets tied to energy and tourism will experience more severe negative impacts from unemployment due to the lingering effects of economic drivers in these markets. In these more severely impacted markets, near-term real effective market rent growth (i.e. after adjustment for inflation) is expected to be negative. Other more economically diversified markets that are only suffering from temporary stay-at-home orders should recover more quickly. In the near term, owners are focused on maintaining cash flow through managing vacancy and credit losses and offering increased concessions when necessary. With property tours severely limited, operators are getting creative with virtual tours. But the lack of move-in activity is mitigated by the fact that many tenants are choosing to renew existing leases, often at the existing rent, until movement is less restricted. Landlords have also worked with tenants by offering relief from late penalties and “blend and extend” options. In the near term, landlords are more focused on tenant retention than increasing rents. Overall, sale transactions will be limited in the near term due to limited financing options. This situation should lead to pent-up demand resulting in increased transactions in the second half of 2020 and early-2021.

Industrial: By and large, the industrial sector is projected to be one of the leading asset classes through these unprecedented times. However, the current disruption to the national and global economies brings uncertainty and concern to the greater health and performance of the industrial markets. Factors of concern include uncertainty with industrial demand, leading potentially to higher vacancy rates and reduced near-

term manufacturing in certain markets. This may also cause a slowdown in leasing with national and local stay-at-home orders in place, causing delays and increasing absorption periods in the near term. Investors are also concerned with tenants' capacities to stay current with their lease payments and meet other financial obligations. This concern is, for the most part, limited to smaller and multi-tenant buildings occupied by non-credit tenants and/or buildings located in second tier markets. Buildings located in core, coastal markets or along major transportation corridors are not anticipated to see this same risk exposure due to the continued demand for industrial space. In addition, in many markets there is the ability to backfill tenants that vacate with shorter-term rentals as a result of increased demand for additional space with retail storefronts temporarily closed. Positive factors offsetting these concerns include e-commerce continuing to gain significant market share, pushing tenants to carry higher inventory levels resulting in increased demand for space. With the declining brick and motor retail environment, tenant needs for additional space have been witnessed in many markets across the United States to meet home delivery demand from consumers. In summary, many investors view the industrial market for 2020 as being a "hold" year with anticipation of a sharp rebound in late-2020 and in 2021.

Office: Requests for rent relief and restructuring among office tenants are increasing as they cope with the impact of COVID-19. Knowing that many tenants are having financial difficulties and have lost the use of their space, the majority of landlords have begun accommodating these requests either by offering a rent holiday, deferring rent and amortizing it at a future point in time, or pausing rent and negotiating additional lease term. The tenant's ability to pay, legal standing and remaining lease term are the factors that have the largest bearing on the outcome of each restructuring. With rent collections faltering, some highly leveraged landlords have initiated requests for mortgage forbearance. The steep drop in economic activity and a large spike in unemployment since the pandemic took hold have reduced near-term demand for office space. In the short run, weak demand is likely to lead to increased vacancy, downward pressure on rents, increased concessions, and protracted lease-up of vacant space. While pent up demand is likely to emerge in the aftermath of the crisis, overall demand will likely coincide with economic recovery. Another byproduct of this crisis that could negatively impact long-term office demand would be if current work-from-home policies prove effective and continue after the crisis abates.

Retail: With the emergence of COVID-19, the paradigm shift occurring in the retail industry is likely to accelerate further as retailers and landlords struggle to find a profitable way forward. Of all the retail formats, grocery anchored neighborhood centers are the best positioned for the near term due to increased demand for household staples. Even so, roughly 30% of property cash flow at these centers is derived from restaurant and smaller service-based businesses, many of which are shuttered and unable to pay rent. Also, as the online grocery delivery model evolves, the need for grocery anchor space may change significantly over an accelerated timeline as grocers are already designing fully automated grocery warehouses to process online orders. Large community and power centers, segments that were struggling before the crisis, are obviously hobbled by the lack of traffic and big box tenants are scrambling to find new ways to deliver goods to consumers. Of all the retail formats, regional malls are absorbing the largest negative impact of the crisis. While dominant Class A malls and individual malls without competition in large trade areas are likely to survive, the path forward for less viable assets is precarious and many will require eventual redevelopment. Compounding the problem for malls is the fact that many operators have recently added significant restaurant and entertainment components to drive traffic – a strategy that will likely fail in the near-term due to the pandemic. Not surprisingly, soft goods retailers experienced the largest drop in retail sales during 1Q20 (50%), which will place more pressure on an already struggling segment of the industry.

Hotels: The hotel segment remains the hardest-hit among the commercial property types. In the wake of travel restrictions, all hotel demand segments, including corporate, leisure, and group, came to a virtual standstill in 2Q20. Nationally, overall RevPAR (Revenue per Available Room) was down over 80% in the weekly data from March through April 2020. Similar to previous economic downturns, the damage is proportionate to the chain scale and positioning of properties, with economy hotels seeing relatively lower, but still massive, downturns, and luxury properties seeing the largest declines in excess of 90% with many shutting down entirely. This is due to the "buy-down" of the limited travel that is occurring, whereby the small number of current travelers are opting for lower-priced, limited-service options. Further, the upper-scale properties are more dependent on group and convention demand to fill their generally larger room

supply. Earlier hope that the postponed group business from the current shutdown would buoy second half 2020 performance is now waning. According to a special forecast revision from *STR* and *Tourism Economics* released on March 31st, the U.S. hotel industry is now projected to report a 50.6% decline RevPAR in 2020. Overall RevPAR declines include downturns in both occupancy and ADR; and, even as demand eventually returns, the lagging ADR recovery will likely extend overall revenue impact from the pandemic at least into 2021, especially for the larger, upscale properties.

Self-Storage: Market participants are optimistic that the self-storage segment will weather the pandemic better than most other property types. Self-storage assets typically have a limited number of on-site employees, limited day-to-day traffic, and, as such, are easier to operate in the current environment. General performance of self-storage properties is expected to closely track that of the apartment market. Most operators are working with tenants enduring hardships related to COVID-19 and are holding off on auctioning unit contents for non-payment. In the near term, the self-storage market can expect to experience increases in vacancy, credit loss, and concessions as well as flat to declining asking rents. Recovery times for effective rents and economic occupancies are expected to vary significantly depending on the location and its level of impact from COVID-19. Increased uncertainty makes underwriting difficult in the current environment and few self-storage trades are anticipated for the remainder of the year.

Student Housing: Overall, owners and operators are optimistic that student housing will bounce back once colleges and universities re-open. Historically, there has been an inverse relationship between unemployment and college enrollment. Universities are expected to reconsider densities of on-campus housing, which could lead to more relationships and master leases between universities and private operators in the future, ultimately creating more demand for off-campus housing. The largest risk factor is whether universities will resume on-campus classes in the fall or continue with distance learning through the end of the calendar year. Properties have continued to lease up for fall enrollment at similar leasing velocity as seen in previous years. In the near term, underwriting assumptions include significant credit loss deductions of 5% to 25% for the remainder of the 2019/2020 academic year, as well as the elimination of summer related other income categories, such as camps and activities. Pricing and other cash flow assumptions have remained steady. Sale transactions have been suspended and are expected to stall until more clarity on fall classes can be determined.

Given the foregoing discussion, we offer the following underwriting/modeling guidance.

- **Market Rent Growth** – Near-term rent growth will likely be impacted for most markets and property types. The consensus among market participants is that rents will be flat to declining rents over the next 12 to 18 months followed by a rebound as markets normalize.
- **Retail Sales Growth** – Sales for 2020 will likely be down across most properties and tenants, with grocery and big box likely being the exceptions. As such, overage rent projections should be carefully analyzed going-forward for the next 12 to 18 months, at minimum.
- **Rent Relief** – Landlords are being inundated with relief requests. For now, two to three months of deferred rent appears to be the norm (through June 2020) for all but the least affected property types and markets. However, some retailers (restaurant/entertainment/theater) are requesting larger packages recognizing that their businesses will be slower to re-open.
- **Credit Loss** – Tenant aging and delinquency reports will require careful analysis in order to forecast realistic near-term and mid-term credit loss. Prior to COVID-19, many retailers were already struggling, and the pandemic has only compounded this further. Along a similar vein, office co-working concepts should be similarly scrutinized.
- **Vacancy/Absorption** – Near term vacancy is likely to increase for most asset types as tenants adopt a “wait and see” stance about to how the recovery will evolve, how it will impact their particular situations, and where effective rent levels will ultimately settle. In addition, lease up will continue to be negatively impacted in the near term by limitations on property tours. Given the economic slowdown and fallout likely to occur due to rightsizing, downsizing, bankruptcy, etc. absorption and

lease-up of vacant space will likely be extended at most properties/markets. Though one positive of the CARES Act is that tenants will no longer be required to amortize and depreciate the cost of improvements but rather be able to immediately expense them.

Conclusion: The above guidance is in no way meant to be all-inclusive and its application will vary by property type and market. The next 45 to 60 days will be critical in determining the near-term degree and direction of economic activity and its impact on the performance of institutional real estate assets. For the time being, much of the focus in the valuation of these assets is on assimilating rapidly changing property-level and market information into updated cash flow forecasts. Near-term uncertainty and the resulting lack of liquidity or bid/ask spread mean that, in many cases, it is too early to justify across-the-board movement in investment rates. While increased uncertainty typically results in more conservative underwriting, a good argument can be made that commercial real estate as an asset class will ultimately deliver superior risk-adjusted returns versus alternative investments. Given the fluidity of the current market environment, it is likely that valuation parameters will remain highly dynamic through quarter-end requiring frequent re-evaluation.

