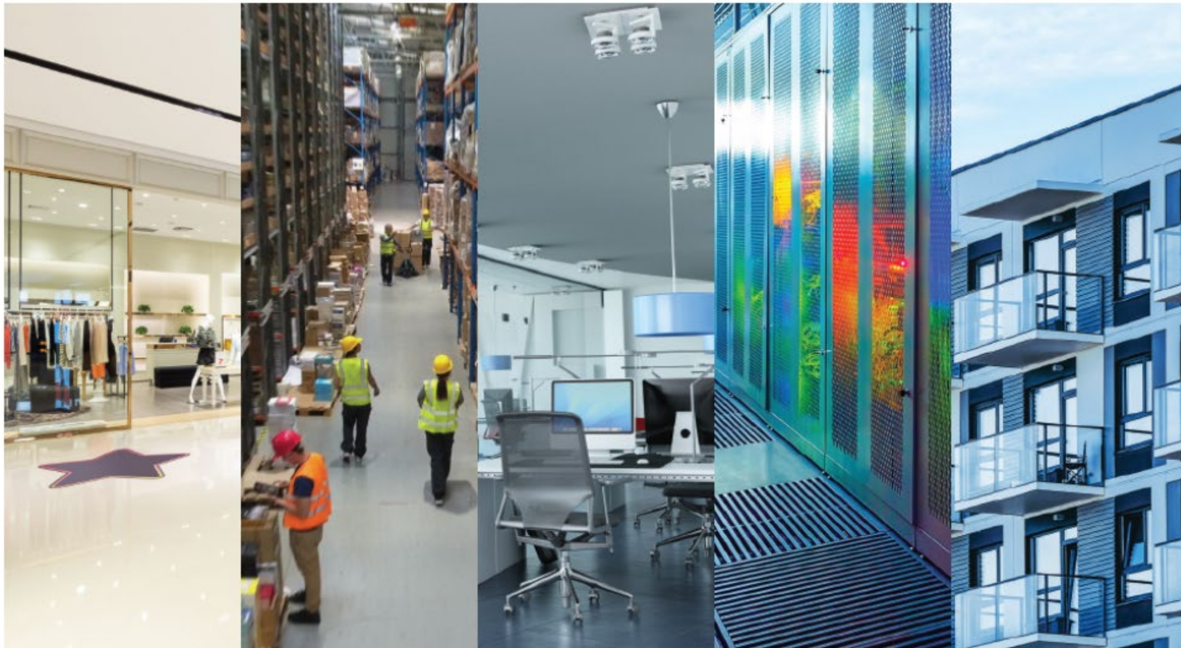

The good, the bad and the ugly: The COVID-19 pandemic will have widely varying effects across property types

BY LORETTA CLODFELTER

Real estate investment in first half 2020 divides into pre- and post-pandemic periods. In the before times, we were a decade into an economic expansion, with the U.S. unemployment rate at 3.5 percent, and real estate appeared to be positioned for another strong year.

But a global pandemic has completely changed everything, with far-reaching economic impacts and a tragic loss of life. And even as movement toward reopening the economy has begun, it remains unclear how long the pandemic will last or what it will take to put the economy back on its feet.

"We think a sharp, 'V-shaped' rebound in the second half of 2020 is unlikely," says Kevin White, co-head of research and strategy, alternatives, at DWS. "Broad-based lockdowns will

probably be relaxed as infection rates stabilize. But history shows that economies exhibit considerable momentum — both on the way up and on the way down — as labor, commercial, financial and global markets are mutually reinforcing."

"We're just at the front end," says Ron Dickerman, president and founder of Madison International Realty. "We were all very naive at the beginning," says Dickerman, "thinking we'll just turn the switch back on."

Among property types, the effects of the pandemic are likely to create winners and losers, as changes in consumer behavior (by government fiat as well as individual choice) will have divergent impacts.

"In our view, sectors that enjoy positive structural drivers and more inelastic demand should outperform in the COVID recession and early stages of recovery. Those that suffer negative structural trends and greater cyclical sensitivity will fare worse," says White.

Dickerman says "residual consumer behavioral patterns" will continue to affect economic performance for a while. These patterns will persist strongly for the next six to 12 months and continue to some extent for the next three to five years.

The end of the mall?

"What this crisis is doing is accelerating and exacerbating existing trends," says Will Robson, executive director and global head of real estate solutions research at MSCI.

One of those existing trends is the so-called "retail apocalypse" — a phrase that has been publicized since at least 2017 and reflects the long-term rise of online shopping and its threat to brick-and-mortar stores. That slow and steady shift in consumer behavior has taken a drastic turn amid the COVID-19 pandemic, as governments moved to close all nonessential businesses through stay-home and shelter-in-place orders.

"The sector was under duress heading into the crisis, and forced store closures have only exacerbated these pressures," says White.

"This is the end of the mall," says Scott Crowe, chief investment strategist of CenterSquare Investment Management. He says it is possible the number of malls could drop from 1,000 to 200.

"Even after the lockdowns end, we think malls will continue to struggle," agrees White. "Initially, consumers may avoid enclosed shopping destinations and pull back from discretionary spending. Longer term, COVID-inspired e-commerce growth might accelerate the demise of department and apparel stores."

But not all retail is created equal. White suggests grocery-anchored centers are likely to fare better, as many of their tenants, such as grocery stores and pharmacies, are open and thriving. "Others, such as hair salons, are closed and not paying rent," adds White. "But

these services should revive after the lockdown eases, even in a sluggish economy, and they are largely insulated from e-commerce.”

And retailers will continue to find ways to survive, just as many dine-in restaurants converted to takeout and delivery.

“We expect retail tenants will be very innovative over the next few months trying new ways to attract customers at a lower density,” says Paul Noland, vice president – acquisitions at L&B Realty Advisors. “Parking fields near spaces will become valuable — curbside pickup — and provide leverage for landlords to collect a higher percentage of rent.”

Job losses within the retail and hospitality sectors have been staggering. April saw an estimated loss of 20.5 million jobs, according to the Bureau of Labor Statistics, including 7.7 million jobs in leisure and hospitality and 2.1 million jobs in retail trade (see “Job losses in April reach levels not seen since Great Depression”).

“The pain point is really going to be the 25 percent of the economy that’s leisure/hospitality and retail,” says Crowe. Crowe forecasts a shift in demand patterns, with one-third of the jobs lost in the leisure, hospitality and retail segments gone forever — roughly 7 percent of employment pre-coronavirus — as the industries increase efficiency and use of technology. Crowe notes it will be difficult for many of the people who lost jobs in those sectors to transition to other employment sectors. “It’s a pretty tough economic picture,” says Crowe.

Crowe predicts real estate markets will see declines in net operating income that are two to three times greater than those following the global financial crisis. “What you’re likely to see is a lot of declines in occupancy,” he adds.

“From our clients, we’re hearing there’s been an immediate effect on short-term cashflow,” says Robson. “Normally, often, you see these economic impacts priced in before they hit cashflows. This time around, all these rent holidays, rent deferrals or tenants just not paying rent is hitting NOIs.”

Warehouse winners

The flipside of the challenges in the retail sector is the way physical distancing and store closures have created a boom in demand for e-commerce fulfillment, benefiting the industrial sector.

“COVID-19 will likely exacerbate several trends that were already in place prior to the pandemic,” says Nancy Lashine, founder and managing partner of Park Madison Partners. She says the industrial sector should continue to see steadily increasing demand as more consumers shop online — a move that is likely to become permanent.

E-commerce penetration is substantially up, but “when shops reopen, we do not expect a drop in e-commerce activity,” says Jonathan Pharris, president of CapRock Partners. Once consumers have experience with online shopping, they are likely to continue doing it.

He describes the continued acceleration of online shopping as “a paradigm shift that is going to benefit industrial.”

“Stay-at-home orders have forced consumers to expand their online buying list, including items such as groceries and furniture,” adds Lashine. “Many of these new shopping habits will likely stay in place following the pandemic. So, that bodes well for industrial and likely presents additional challenges for retail.”

“Industrial, overall, is best positioned to withstand this shock from coronavirus,” says Pharris. He points to the industry’s longer leases and the asset class’s strong position within a consumer economy that has moved almost entirely online in the wake of social distancing and stay-home orders.

But even within the industrial sector, a bifurcation will exist between markets and asset types. Industrial properties leased to retailers, for instance, might give “cause for concern,” says Pharris. The winners include those assets involved in e-commerce fulfillment. And hospitality-dependent markets, such as Las Vegas, will suffer greater impacts than more economically balanced markets, such as Los Angeles (see “Risk geography”).

“Over the past several years, the expansion of e-commerce has been a boon to the industrial sector, as retailers have stored more inventory to facilitate rapid fulfillment,” says White. “The COVID crisis has reinforced this trend: Prominent online merchants have reportedly rationed access to warehouses, prioritizing daily necessities, having run out of capacity.”

The strength of the e-commerce sector through the pandemic will support warehouse leasing. Although not all industrial tenants are in the e-commerce sector, any available space will be taken up by e-commerce tenants, creating a backstop for the leasing market.

Industrial leasing has held relatively well, notes Pharris, though the sales side “definitely has slowed down.” He says: “Lenders are being cautious, as is every buyer.” This has created “a stalemate in the market,” as sellers continue to expect 2019-level pricing, and buyers expect a pandemic-related price cut.

“Our perspective is that there are some headwinds for industrial but a lot more tailwinds,” says Pharris. He predicts speculative development will decline, but as leasing continues to hold up, there could be supply constraints, supporting rents. He also points to two demand factors that could change the way occupiers use industrial space. One thing the global pandemic has shown is the need for resiliency and redundancy in the global supply chain. This could mean some manufacturing gets moved back to the Americas. Second, Pharris predicts companies will increase their inventory as they move away from just-in-time delivery. Pharris references advisory firm RCLCO’s viewpoint that an increase of only 5

percent in corporate inventories would require an additional 500 million to 700 million square feet of warehouse space.

“Even for physical commerce, the crisis has exposed vulnerabilities that may induce businesses to store more inventory as a precaution against future supply-chain disruptions, whether due to epidemics, geopolitical tensions, natural disasters or other unforeseen events,” agrees White.

In addition to the logistics sector, other winning property types are cell towers and data centers, says Crowe, which are necessary to provide “some semblance of a functioning economy.”

“More broadly, the public is relying on technology more than ever. In our view, this will have positive implications for technology-driven markets like San Francisco, Seattle, Boston and Austin,” says White.

“Assets that rely less on physical occupancy, such as cell-phone towers, data centers, and self-storage, have certainly fared better so far, as one might expect,” says Lashine. “Cell-phone towers and data centers, in particular, are demonstrating their economic vitality, given their role in ensuring a functional communications infrastructure.”

“Data-center usage is going to increase exponentially,” says Crowe. He notes only 30 percent of U.S. businesses outsource their data-storage needs, but the pandemic — and the shift toward even short-term telecommuting — means keeping data in a server in a closet is no longer the most practical solution.

Managing through the virus

Among the core property types, if industrial is on top and retail is on bottom, then office and multifamily are holding on in the middle. The pandemic has not meant the same evaporation of rents for office landlords that retail property owners are working through.

“While many office employees are working from home, the tenants are generally paying rent,” says White.

Most office-using businesses have found ways to maintain business continuity through telecommuting. It remains to be seen if the current work-from-home experience will inspire an uptick in telecommuting overall once business-as-usual resumes.

“Some people argue that the recent experiment with homeworking might dampen future demand for office space,” says White. “We don’t buy it: Although remote working is possible, it is not necessarily optimal. Morale and productivity may suffer from isolation and household distractions.”

Cutting against the possibility that telecommuting could cause a reduction in office occupiers' square footage per employee is the fact the rise of a contagious virus may encourage increased physical distancing within the office.

"Long-term leases will mute the short-term effect, but in the medium term, the office experience will not be the same due to social-distancing requirements," says Noland.

"Within the workplace, increased focus on health and wellness might cause some employers to rethink efforts to squeeze more people into tighter spaces," adds White.

And office landlords will face challenges as they manage assets with returning workforces in this era of COVID-19. Dickerman points to changes office landlords may need to institute, such as queuing at elevators to prevent overcrowding, or staggered work hours to have fewer people in proximity.

"Office should remain stable, provided owners embrace protocols that truly mitigate the risk of a 'cluster' infection, but will require cooperation from tenants, as the virus spreads individual to individual in high-density office settings," says Noland.

The very shape of urban high-rise office buildings could fall out of favor, as low-rise suburban office campuses with large parking lots begin to look safer amid a highly contagious disease.

"In a world focused on social distancing, it is clear that for most companies, desirability will shift in favor of lower-density campuses with green space, lower-rise buildings with both stairwell and elevator access to tenant floors, and transportation access focused on individual vehicles rather than mass transit," says David Rubenstein, president and CEO of Rubenstein Partners.

Rubenstein notes a pre-existing development in the office sector over the past few years is the most competitively advantaged assets within suburban markets have outperformed their urban counterparts, reflecting a trend of millennial migration to the suburbs. "We expect the coronavirus to serve as a catalyst to further accelerate this shift, as millennials take advantage of better school systems, more space to raise their families, and closer proximity to their children," says Rubenstein.

"Density is now a problem," says Crowe. He expects density to decrease and a movement toward the suburbs. "Mass transit is going to be the pain point for dense urban environments," he says.

"For many urban-centric companies, this may simply mean the opening of satellite offices in the suburbs, as opposed to full relocations, in order to appease their suburban-dwelling employees and provide risk mitigation in their operations," adds Rubenstein.

Wariness regarding office investment may be warranted, notes White. "History suggests that due to its heavy capex burden, the office sector only does really well in the later stages

of a cycle when rent growth is strong, which we don't expect to see for several more years," says White.

You have to live somewhere

Housing was the epicenter of distress during the global financial crisis of a decade ago, with credit and balance-sheet issues rippling outward. The current crisis is quite different, with problems beginning in net operating incomes from the shutdown of normal business operations and resulting mass layoffs.

That has overturned some of the normal expectations of which multifamily investments will be most resilient. Class A apartments may do better than class C apartments, for example, because the tenant base for the class A segment is more likely to be able to transition to working from home. Despite the current challenges, though, the historical resilience of the apartment market is likely to continue.

Even though COVID-19 job losses have been concentrated among retail, leisure and hospitality, and other lower-wage service workers who have a higher tendency to rent, April rent collections held up well, says White. "No doubt thanks to stimulus checks and enhanced unemployment benefits," adds White.

"We're seeing very strong rent collection for class A apartments," says Sean Burton, CEO of Cityview. "April rent collections were only 1 percent off their usual mark, and so far, May collections are tracking slightly better than April. We have not seen negative impacts at the level we initially anticipated, but that could shift in June." For those tenants facing challenges paying rent, "our goal was and continues to be finding a way to keep them in the building," says Burton.

"From a rental-income perspective, we are not seeing as many rent-relief requests from residents as initially expected," notes Daryl Carter, founder and CEO of Avanath Capital Management, which focuses on the regulated affordable-housing sector. "We planned for a significant number of rent modifications and had assembled a 'triage team' of staff from other areas to potentially process these modifications. To date, we have received fewer than 40 resident requests for rent relief. We believe that one of the reasons for this is that we gave our residents a 10 percent discount on rent for the month of April. We believe this was the right approach, as we saw few rent-relief requests."

The National Multifamily Housing Council reported rent payments in April were at 95 percent of the payment rate of a year ago (89 percent of households made a full or partial payment by April 19, 2020, compared with 93 percent of renters by April 19, 2019). Preliminary data for May also shows a small decline, with 87.7 percent of households making a full or partial payment by May 13, 2020 — down from 89.8 percent by May 13, 2019.

Another property-management challenge for apartment owners is keeping residents safe during the pandemic. Similar to the office sector, multifamily landlords have closed common areas and increased cleaning protocols.

“Multifamily represents a unique cluster risk that needs to be managed closely near term to mitigate reputation risk,” says Noland. “Much better and professional cleaning standards will need to be implemented, as well as the density in enclosed common-area amenities.”

Noland also notes virtual touring will become more popular within the apartment industry.

“Clearly, there has been a technology and digital trend in our business,” agrees Burton, and the COVID-19 outbreak has accelerated that, with online leasing tools and 3D virtual viewings becoming the only way to interact with prospective tenants.

In fact, with a pandemic curtailing mobility, apartment markets may even benefit because there is likely to be less churn in the shorter term.

“People also typically avoid taking on mortgages in periods of economic uncertainty,” notes White. “Longer term, we believe that affordable-housing shortages will continue to support the sector.”

Carter points out the rent-regulated affordable-housing sector has historically performed well in times of economic uncertainty and economic growth. “There is always demand for affordable housing, and even more so in times of economic turmoil. In fact, the demand tends to increase in a downturn,” says Carter.

Despite challenges, the apartment market is likely to prove resilient. “Demand for apartments is relatively resilient during recessions, as people resort to savings and government support to remain in their homes,” says White.

“At the end of the day, people need a place to live,” says Burton. “They may shop differently, work differently, but they need a place to live.”

Headline risk

Niche residential property types, such as senior housing or student housing, are more driven by demographic factors than economic ones, providing a recession-resilient investment thesis. But the COVID-19 pandemic has upturned these expectations, especially the negative press related to outbreaks at some senior facilities.

Because the average stay in a senior housing property is only a couple of years, the asset class requires constant leasing to maintain occupancies. But fears related to the pandemic may make people reluctant to move into such properties — or reluctant to move their parents into such properties. Some expect senior housing occupancy could drop precipitously.

Such challenges have become top of mind for investors, and when evaluating senior housing investments, it is important to factor in partner quality, market and acuity of occupants. “In times like these, a firm’s investment strategy and platform are really tested,” says Christopher Merrill, co-founder, chairman and CEO of Harrison Street.

“Senior housing is painted with a very broad brush, given varying levels of acuity and quality of care,” adds Merrill. Much of the current volatility is focused in the skilled nursing sector and assets with lesser-quality operators, he says.

“We are huge believers in the need for quality private-pay care for those who cannot be cared for in the home,” says Merrill, who focuses on investing in independent living, assisted living and memory care. “The fact is, the U.S. population is growing older and living longer. Accordingly, there is going to be continued demand for high-quality care in well-run facilities. The data is there and supports this thesis. As such, we are continuing to actively invest in what has proven to be a very resilient segment of the senior housing segment.”

Not only that, but retirees are less affected by swings in employment.

“Senior housing is another asset class that is likely to be better positioned in the current environment,” says Carter. Given that seniors are often living off retirement savings and social security, they are less likely to be impacted by the rapid decline in employment and wage reductions. “Seniors, however, have been disproportionately impacted by the virus,” adds Carter.

For student housing, a coronavirus-specific risk is the chance some universities may not reopen for in-person classes in the fall. But Merrill predicts the “tremendous need” for student housing will continue going forward, “even if there is some level of online learning.” He adds, “Online will never replace the college experience.”

One advantage of off-campus, purpose-built student housing is it is more likely to have bed-bath parity. As concerns about the transmission of COVID-19 are likely to continue until a vaccine is developed, the greater privacy and control of one’s own bedroom and bathroom will be more attractive.

Dealing with a new reality

Investors are reacting to the coronavirus outbreak and resulting economic downturn with caution. Initial efforts are focused on processing information, understanding the impacts to their existing portfolios and preparing for future distress. For some investors, jumping back into the market is not the most pressing concern.

“Fundraising generally has slowed down,” acknowledges Burton. “A lot of investors are focused on their existing portfolios.”

“Investors, by and large, are playing defense on existing portfolios,” notes Dickerman. The denominator effect also may dampen enthusiasm for additional investment in real estate.

"There is no doubt fundraising efforts will be affected by this tragedy," says Heather Border, managing partner of Alliance Global Advisors. "However, this also creates an unparalleled opportunity for firms to make tremendous shifts within their organizations."

When investors are ready to come off of the sidelines, opportunities for investment may exist amid the dislocation. Bid-ask spreads remain very wide at the moment, however, and very few deals are taking place.

"Investors, for the most part, seem to recognize the opportunities that could emerge from market dislocations and the low-interest-rate environment," notes Lashine. "So, while fundraising volumes may decline in the short term, we remain confident that institutional investors will continue to steadily increase their allocations to real estate in the years ahead."

"It's difficult to get price discovery right now," says Burton. That, combined with uncertainty regarding rent growth in the year ahead, makes it very difficult to underwrite deals. In addition, the reduced ability to perform physical, onsite due diligence has contributed to the slowdown in real estate investment activity, notes Lashine.

It will likely take time for private markets to fully digest the change in property values sparked by the pandemic and economic dislocation, but looking to REIT markets can be an early indicator for private real estate pricing.

"Valuations [of property] move more slowly than listed markets," says Robson. "If you look to listed markets, you see much greater movements in prices," he adds.

What comes next?

Looking ahead, it is difficult to be certain about what the future will hold.

"Although some property types and strategies will be affected more than others, more importantly, there will be a survival-of-the-fittest situation within our marketplace," says Border. "It is those managers who choose to pivot, to up their game and to provide continuous value to their investors, who will shine during these times."

"Quality of ownership will become very important over the next two years," says Noland. "Tenants will prefer properties where owners are professional, stable and well capitalized, and respond to the pandemic understanding human perception. Institutional owners are well positioned to make the necessary changes the market will expect."

"Those who are up for the challenge and are willing to refine internal and external efforts to create 'best-in-class' shops will ultimately prevail and gain the confidence of investors," adds Border.

“We will recover. We will beat COVID,” says Dickerman. But it could take three to four years, he acknowledges. He predicts we will see a “much more prolonged recovery than we expected a month ago.”

“No one has been through this before. We’re making it up as we go,” adds Dickerman.

Loretta Clodfelter is senior editor of *Institutional Real Estate Americas.*