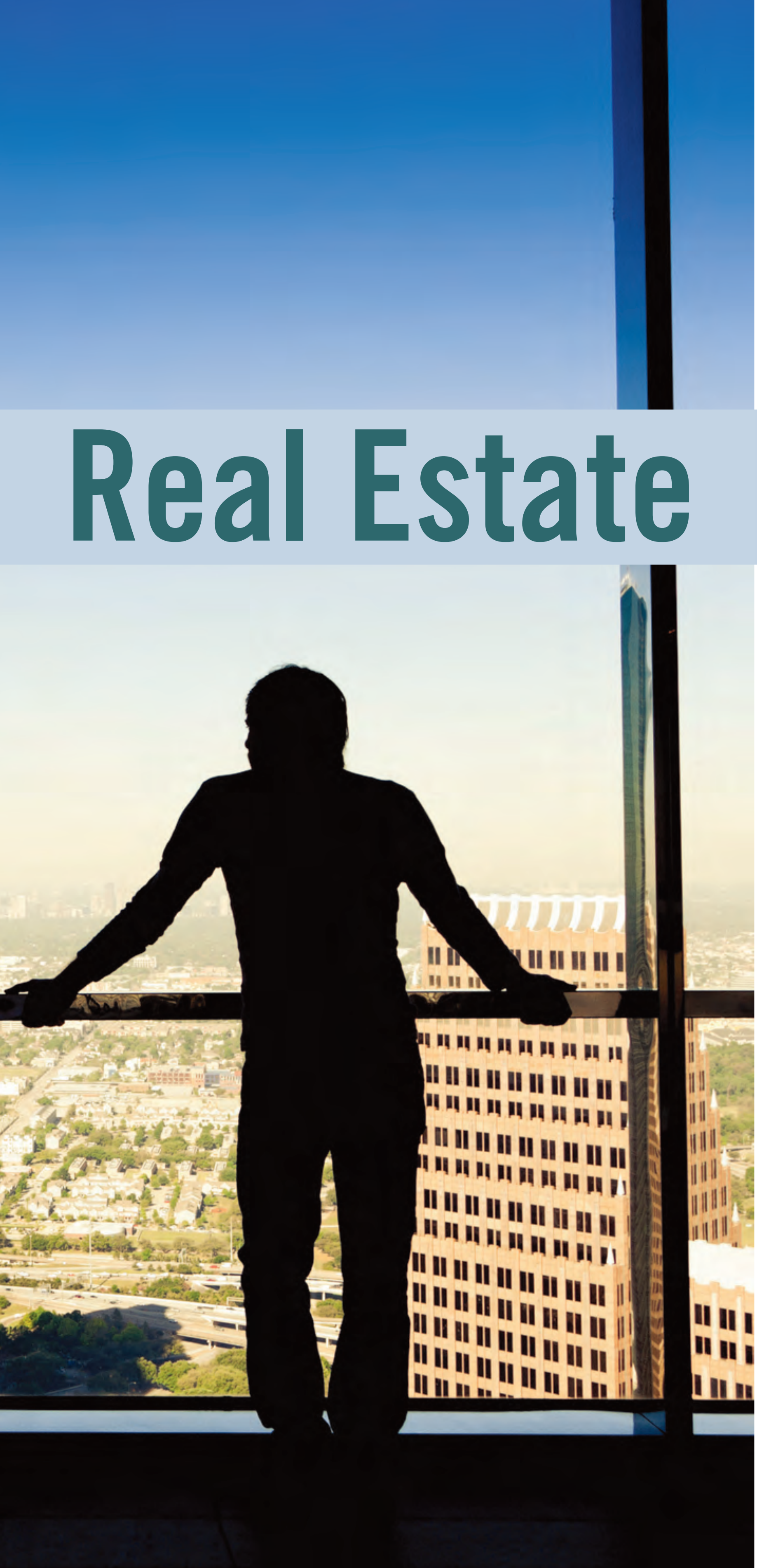
SPECIAL REPORT

Experts Speak: COVID-19's Impact on Commercial



Real Estate

Industry researchers respond to the crisis and take a look at what's on the horizon.

By Ron Derven

The COVID-19 pandemic is having a greater impact on commercial real estate than the global financial crisis of earlier in this century. That was a credit and liquidity crisis. The pandemic directly impacts the demand for space through quarantines, social distancing, shutdowns, supply chain disruptions, employment loss and a shattering of consumer confidence, according to real estate economic and research experts who spoke with Development magazine.

CRE and the overall economy will rebound, according to those interviewed. However, the speed with which the country and the industry emerge from the crisis depends on the ability to ramp up virus testing,

Meet the Industry Experts

John Chang, Senior Vice President and National Director, Marcus & Millichap Research Services

Emil E. Malizia, Research Professor, Department of City & Regional Planning, the University of North Carolina

Spencer Levy, CBRE's Senior Economic Advisor and Chairman of Americas Research

Raymond Wong, Vice President, Data Operations, Data Solutions, Altus Analytics, Altus Group

Maria Sicola, Founding Partner of CityStream Solutions, a consulting firm, and Integrity Data Solutions

development of a vaccine, patience with social distancing, the magnitude of monetary stimulus, and the relative health of the CRE property types, markets and individual projects.

***Development:** How will commercial real estate emerge from this pandemic?*

Maria Sicola: CRE emerges from this pandemic looking different than it did before the emergency. Industries, regions and property types will recover at different speeds. Services such as property management, space design, construction, appraisal and analytics will become increasingly important. Brokerage will take a back seat to consultative advice and strategic planning.

Spencer Levy: The recovery will come in three phases — today, tomorrow and the distant future. Today, we are closely tracking rent collections in the top five asset classes — industrial, office, multifamily, retail and hospitality. The good news is that they are better than we expected in office, industrial and multifamily, which are tracking at about 90% in rent collections. Hospitality and retail are under-performing at around 20% to 40%. Tomorrow, which is likely to last for six to nine months, the assets will be reopened and will likely be reopened in phases, but further outbreaks could prompt local shutdowns. The distant future will find that the office will look a lot like it did in the pre-COVID-19 period, but with enhanced wellness features.

John Chang: The global health crisis poses a set of unique challenges and burdens on both the economy and real estate properties. Each property type faces unique challenges — some very severe, like the hotel sector, and some more mild, such as self-storage properties. All will face hurdles in the recovery process, and some may experience a substantive change, driven by new behaviors adopted during people's stay-at-home/work-from-home time. It's too early to assemble a clear picture on the ultimate outcome.

***Development:** Which asset classes will emerge most quickly from the current crisis, and which will lag?*

Levy: The areas that look to lag at this time are those dependent on airline travel, tourism, and oil and gas. I don't think Houston and New York will have a materially different opening, but Houston will suffer longer than New York because of the oil and gas industry. Retail in secondary cities has been suffering for a long time, but is COVID-19 retail's death knell? I am not prepared to say that. I am prepared to say that trends that have impacted a lot of secondary cities have clearly gotten worse because of the pandemic.

Sicola: Data centers, research and development labs, disaster recovery operations and the industrial sector — particularly warehouse/distribution and last-mile delivery services — will emerge strongly, and office and retail will take longer. Multifamily will hold its own as the need for shelter remains inelastic much the same as the need for food, but we may see decreases in rents initially as renters struggle to make payments. Retail recovery will be mixed, with essential needs such as groceries, gasoline, health and beauty remaining strong, while other such as restaurants will struggle. Some will not survive.

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— *John Chang, Senior Vice President, national director Marcus & Millichap Research Services*

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Chang: The economy will likely reawaken in phases, but the speed of the real estate recovery will largely be dependent on how long the shutdown lasts. Hotel properties will probably be slower to recover because much of their business is driven by conferences, events and tourism — all things that will be slow to revive. Ultimately, a full reopening will require a COVID-19 vaccine.

Raymond Wong: Prior to the pandemic, there was a strong push for just-in-time delivery to minimize space needs. What this emergency has shown us is that we need a little extra space to react to these events, but I don't think that means double or triple industrial space.

Development: *Although COVID-19 will impact all of CRE, do you see any areas of the country being hit harder?*

Chang: As demonstrated by the severe spread of COVID-19 in New York, New Jersey and Louisiana, the impact is less about geography and urban density than it is about population mobility, tourism and public policy. Cities and states that rapidly locked down, like the Bay Area in California, were less severely impacted and therefore will not face as steep of a climb to recover.

Sicola: The urban core markets — New York City, Los Angeles, Chicago, Philadelphia, Detroit, Washington, D.C. — will be hit harder in the short term.

Development: *What happens to office design going forward? What about the coworking industry?*

Sicola: The open-office plan concept, as we know it today, will be a trend of the past. Issues with noise, inability to concentrate and numerous distractions were already creating issues with productivity. Square footage per employee was shrinking to levels that, in some cases, were precariously close to violating codes. The move toward efficiency and lowering costs — while still important to the corporate bottom line — will now give way to flexibility, resilience, employee satisfaction and productivity.

Development: *What about the U.S. supply chain?*

Sicola: Reshoring of manufacturing was already happening in some respects as the cost of labor was increasing outside the U.S. This trend will likely gain momentum with products that can be sourced in the U.S. Consumer products for sanitization will be in high demand, and the need to get the goods to consumers more quickly could impact the supply chain as well. The last mile will become increasingly important and new modes of delivery will emerge, as we are seeing already.

Chang: Many companies were already in the process of restructuring their supply chains because of the trade war with China. However, the pandemic will cause companies to re-evaluate where products are manufactured and how they manage inventory. Just-in-time inventory practices make a lot of sense, but companies may reconsider adding a bit more slack to their highly efficient systems. In addition, some products may be deemed of national importance such as N95 masks, and they may increase domestic production of those products.

Levy: COVID-19 will impact the supply chain, but it brings up a

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much more important issue about globalization. Globalization is not one thing, but rather four: it is the trade of money, information, goods and services. The trade of money and information will continue to accelerate. The trade of goods and services will be called into question. COVID-19 proved that our supply chain is a lot more brittle — using that word as the opposite of resilient — than most people suspected. The word for the next 20 years will be "resilience." Maybe it is efficient and cheapest to have a single supply line from China, but for the future, businesses will expand supply lines to include the U.S., Mexico and Canada. We will also need more resilience at the local level where we saw shortages of cold-storage facilities needed for food deliveries.

Development: *Will working at home become the norm after the crisis, or will people return to offices in large numbers?*

Emil Malizia: There is intense speculation that everyone working at home during the crisis will want to continue to do it. However, the benefits of social interaction far outweigh the benefits of sitting in one's house and working remotely.

Sicola: Office space will need to become more personalized and less communal — we will likely not return to all-private offices and fancy conference rooms. But all space — personal and meeting — will need to be viewed with more breathing room. Enhanced janitorial and sanitization services are also key.

Development: *What happens to cap rates moving forward?*

Levy: Values on buildings are going to come down because of the impairment of rent rolls. The movement of cap rates is asset-dependent. If you have a core asset in a major market, you will see very little movement. If you are in a secondary market with weakness in the rent rolls, you will see a greater diminution in value.

Sicola: Cap rates are likely to rise as operating income declines.

Wong: Cap rates probably will not move up for core assets. Core assets are always in demand. Where we may have problems is with retail assets and with assets in secondary and tertiary markets. I don't think we will see a huge correction to prices.

Chang: Thus far cap rates have seen little movement, but the flow of capital and severity of the downturn could dictate trends. If many property owners face a severe financial impact, they may sell assets, creating a buyers' market that places upward pressure on cap rates. Because most investors have been well capitalized with comparatively low leverage, the probability of a severe distress situation remains low. However, there was considerable volumes of capital pursuing real estate assets prior to the pandemic. If this capital remains active in real estate, cap rates should see little movement in general. It's likely some assets will be sold at an elevated cap rate to clear the market quickly, but it's unlikely to be broad-based.

Development: *When will investors return to the market?*

Malizia: One investor told me that he cannot close on a building because he cannot get an appraiser to go out and look at it. If social distancing — I like to call it physical distancing — remains in place,

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what does that do to occupancy, particularly office buildings? Does that have an impact on tenants' willingness and ability to pay rent?

Levy: Based upon our experience with prior crises, there will be a slowdown in transaction volume for several months until we have a better handle on price discovery and we have the physical ability to visit the asset. The other thing is that potential investors need more transparency into rent rolls.

Chang: Many investors remain active in the market, even during the shutdown period. Investors in a 1031 tax-deferred exchange, even with the extended timelines, continue to pursue assets, and local private investors remain active in many cases. However, logistics such as site visits, appraisals and even the signing of documents have been impaired, and they are slowing the processes. Full market activity will likely not resume until shelter-in-place restrictions are fully removed, air travel is fully operational, and people feel comfortable about traveling and interacting in person. This will likely require widespread vaccine availability.

Sicola: Opportunistic investors are likely already keeping an eye on the market to swoop in on distressed properties. The risk-averse will remain on the sidelines. There will likely be more acquisitions and takeovers if this turns into a prolonged or U-shaped recession rather than a V-shaped recession.

Wong: Real estate investors are continuing to look at projects online. They are doing the best they can to understand what type of asset is in the market. But real estate is a touch-and-feel asset. You have to see it and you have to see the other assets around it. Right now we are in a stall.

Development: *Do you anticipate permanent damage to the industry or to the country due to COVID-19?*

Levy: The economy will be much better in about a year. The bad news is behind us. The good news is in front of us. So things are much better a year from now, and two years from now we will be largely back to normal.

Chang: Generations are shaped by their common experiences, and the pandemic of 2020 will leave an indelible mark for years to come. The millennial generation in particular will carry a new reality with them that will shape future decisions ranging from health to social gatherings to financial matters. The ability to adapt is an inherent strength of people in general. Ultimately these challenges will make people stronger and hopefully better prepare society for the next black swan event, whether it be a health crisis or something else.

Sicola: The industry will be transformed as it has after other black swan events such as the S&L debacle, the tech bust, 9/11 and the Great Recession. There will be winners and losers. The depth and breadth of it depends upon the government's ability to bring public health back to some form of normality and restore confidence, and the length of the economic recession and recovery. Real estate lags the overall economy, so it will need to follow suit and determine how to reinvent itself to aid in the recovery and the growth of the nation. ■

Ron Derven is a contributing editor for Development magazine.