NEW YORK LIFE REAL ESTATE INVESTORS

Strategy & Research Group

COVID-19: Short-Term Enemy and Long-Term Change Catalyst

April 22, 2020 **Stewart Rubin**
Head of Strategy and Research, Senior Director

There are decades where nothing happens; and there are weeks where decades happen. One may recognize echoes of Lenin's[1] early 20th century observation in the past few weeks as the U.S. lifestyle, economy, employment, and equity markets experienced unprecedented volatility. While some of those changes will be temporary, others will be with us for the foreseeable future. Despite the near-term volatility and change, which will certainly impact all of us, new opportunities in real estate may evolve for thoughtful and patient investors.

The more short-term effect includes the devastating impact on the U.S. economy. The COVID-19 pandemic is having a negative impact on the U.S. economy and as a corollary it will have an adverse effect on almost all types of commercial real estate. It is still early, but it appears the U.S. is entering a recession that includes some depression-like characteristics such as very high unemployment[2]. The impact on the U.S. economy will depend on the pandemic's duration. The U.S. has passed a $2 trillion legislative aid package and Commercial Real Estate (CRE) will benefit[3]. Nevertheless, more may be required to stabilize the U.S. economy. Small businesses are under pressure and U.S. household balance sheets were already vulnerable before the virus hit. Job losses are mounting quickly, leaving many consumers without paychecks to cover rent and daily needs, much less nondiscretionary goods. There are certain unknowns that will influence the depth and nature of the downturn including its length, scope, and geographic dispersion.

The more long-term changes represent a substantial acceleration of existing trends including e-commerce, work-from-home arrangements, increased factory automation, remote learning, digital banking, data center usage, digital leisure, tele-medicine, virtual tours, and video conferencing. These changes will have an impact on commercial real estate. This includes the impact on retail properties from the acceleration of e-commerce and digital banking, as well as the effect on office buildings from the increased work-from-home trend. Remote learning may lessen demand for student housing. Increased video conferencing will replace some business travel. Data centers and cell towers should benefit from increased demand. Increased factory automation may alter industrial property characteristics. Digital leisure and tele-medicine may reduce demand for their respective venues. Virtual commercial property tours may become de rigueur for all but the final phases of leasing.

With the current turbulence comes opportunity for disciplined investors that can identify distressed opportunities and recognize pricing anomalies. The disruption should cause value declines that become buying opportunities for discerning investors who can differentiate promising prospects from falling knives. The short-term disruption and the long-term transformation will reward those that recognize and understand the altered direction of various property types and subtypes within their respective geographic areas.

---

[1] Vladimir Ilyich Lenin (1870-1924).

[2] The Federal Reserve Bank of St. Louis recently projected total job losses of 47 million, translating to a 32.1% unemployment rate, as efforts to contain the virus exact a mounting toll on the economy. Jeffrey Gundlach, the CIO of DoubleLine, said the current economy looks like a depression, unemployment will rise to 10%, stimulus of $10 trillion will be needed and forecasts of a quick bounce-back are too optimistic.

[3] A $2 trillion legislative aid package – the CARES Act approved by both houses of Congress and signed by President Trump to address the financial fallout from the coronavirus pandemic provides fiscal stimulus, bailout grants and loans amounting to almost 10% of the nation's economy. Some of the initiative is expected to benefit the commercial real estate industry, directly and indirectly, as it braces for an uncertain financial future.

Geographic impact

The hardest and most immediate impact will be in markets with a heavy reliance on leisure and hospitality jobs such as Las Vegas, Orlando, and Miami. Other areas of concern include energy focused markets such as Houston, Oklahoma City, New Orleans, and the Denver CBD. Metros in which non-food manufacturing is concentrated such as areas of Michigan, Ohio, Indiana, and South Carolina may suffer disproportionally from the slowdown. Some sections of Atlanta, Dallas-Fort Worth, and New York may be more exposed to the loss of aviation and transportation jobs. Areas that may prove more resistant include those with a higher than average number of federal jobs such as Washington, DC.

The biggest geographic differentiator may be the incidence and concentration of COVID-19 cases and fatalities in a given locale. As of this writing, New York City, the most densely populated city in the U.S., leads the nation. Gotham's[4] preponderance of apartment dwellers and reliance on public transportation likely contributed to the high numbers. It remains to be seen what the impact will be if over time it becomes apparent that densely populated areas are more susceptible to outbreaks. As the nation rises out of the COVID-19 pandemic, there may be "restricted zones" and "go zones" across the country, with wide differences in daily life and much less travel than usual from one region to another. Less dense suburbs that have facilities that enable residents and employees to avoid public transportation, elevators, and shared entrances in multifamily and office buildings may gain favor.

Multifamily

The National Multifamily Housing Council (NMHC) found a 7 percentage point decrease in the share of apartment households that paid rent through April 12, 2020 in the first review of the effect of the COVID-19 outbreak on rent payments. The NMHC Rent Payment Tracker found 84% of households had paid their rent by April 12, 2020; this compares to 91% that had paid by March 12, 2020, and 90% that had paid by the same time last year[5]. Real estate investment trusts that own apartments performed better, Equity Residential reported 93% collections and Camden Property Trust reported 94% collections. As of April 20, 2020, New York Life Real Estate Investor multifamily investment portfolio collections were 93%.

Many states are looking to enact laws that will impact multifamily owners. For example, Governor Andrew Cuomo of New York has ordered a 90-day moratorium on evictions, a lifeline to people who cannot pay rent and are worried about losing their homes during the crisis. Other states have followed New York State's lead, including California, which introduced a 60-day ban on evictions. Equity Residential, the largest apartment REIT, suspended all evictions and rent hikes for 90 days. While these humanitarian actions may provide some needed relief to the newly unemployed and may lessen the near-term impact of the recession, they will also no doubt stall rent growth.

Some tenants will be temporarily protected from eviction for unpaid rent by a patchwork of federal and local laws. However, unpaid rent could set off a chain of events that first cause commercial mortgage defaults, destroying investments in bonds backed by those mortgages.

The federal government has agreed to let apartment building owners with government-backed mortgages defer their mortgage payments, and the Federal Reserve also said it would buy up bonds tied to certain

[4] Nickname for New York City.
[5] The NMHC Rent Payment Tracker reflects data from 13.4 million units across the country. The NMHC Rent Payment Tracker will be updated on a weekly basis with new data released every Wednesday.

multifamily loans. Those measures, however, don't address loans held by banks without a government guarantee. More than two thirds of U.S. rental units are not federally financed and covered by protections in last month's stimulus package[6].

In general, rents are being sacrificed to maintain occupancy. Rent growth in every quality class will likely go negative. Higher quality rents may prove to be more volatile.

For multifamily there may be some modest offsets. The homeownership rate which recently rebounded from 50-year lows, will likely be constrained in a recessionary environment, creating more demand for multifamily product. Suburban multifamily and single-family rentals, that typically lack shared space such as elevators and common doorways prevalent in urban towers, may gain market share. Apartments large enough to accommodate tenant requests for home offices will be favored.

Multifamily is likely to be relatively stable compared to other property types with better occupancy and less cap rate expansion as it has been in past recessions. Nevertheless, the economic downturn will likely cause leasing demand to slow, rents to decline, and vacancy rates to increase. Identification of the geographic areas that will benefit in a post-COVID environment will be essential to investment success.

Office

Office is likely entering a phase of substantive negative rent change and increased vacancy. Uncertainty has increased and it could result in companies being reluctant to expand space and sign leases. It is likely that the U.S. economy is entering a recession which will result in business failures and curtailment of demand and less demand for office space. The directly impacted sectors, tourism, retail, and energy, are not major office users. Nevertheless, a protracted recession would also weaken heavy office-using sectors. For office property owners, rent growth is correlated to job growth. Should office using job employment levels lag, demand for office space will slow as well. It is also possible that when the recovery begins, companies may replace some laid off workers with artificial intelligence software.

JLL's first quarter U.S. office market report found that office leasing activity dropped more than 20% across the country, mostly owing to the impact of COVID-19. New York City office leasing activity declined 46.9% from the prior 10-year quarterly average and represented the weakest quarterly activity in at least 25 years. Additionally, tenants in the process of looking for space will have difficulty touring properties.

There is also the probability of an acceleration of the growing trend of working-from-home. Employers instructing their employees to work-from-home has resulted in an unexpected forced experiment and many businesses may incorporate this practice, at least partially, as a more permanent measure. This would accelerate a growing trend that enables employers to source talent from all over the U.S., cut office rental costs, and provide a more flexible work environment for employees. An acceleration of this existing trend will negatively impact office demand.

On the positive side, densification may slow or even reverse in the wake of COVID-19. The virus is a particular threat to coworking space with its workers in close proximity to each other and the emphasis on collaborative space. Coworking also includes rotating workspaces which increase the possibility of the spread of infection. Even in non-co-working space – in space leased directly by corporations that have

[6] Urban Institute.

followed a pattern of densification – the need for social distancing and wider spacing of employees will result in the need for more space per employee.

WeWork reportedly recently offered some of its tenants half off their rent to lure them into signing longer–term leases and minimize cancellations during the pandemic. WeWork and other co-working tenants are also purportedly planning on spacing work stations further apart from each other. Coworking will further be challenged by its rent arbitrage leasing model being brutally tested in a recession.

Other changes to office buildings will include higher staffing and cleaning costs. Property managers have been forced by mandated social distancing to develop virtual tour capabilities. They will likely continue conducting them for a more significant share of their tenants in a post-pandemic world.

Suburban office may gain favor in a post-pandemic world as memories of the disproportionate death toll the virus logged in densely populated areas such as New York City remain on employer's minds. Suburban office space is often less expensive and can accommodate more social distancing in the form of more space per employee. In addition, one can drive from their home to their suburban office building and avoid mass transit and may even be able to evade elevator use.

Medical office, a favored subsector with promising demographics, may be challenged by the emerging tele-medicine trend. Heretofore, doctors and insurance companies have been reluctant to back tele-medicine. However, during the pandemic they were left with little choice. In addition, patients may prefer speaking to their physician via zoom for some ailments in order to avoid infection from sicker patients in the doctor's office.

Discerning investors who understand the long-term change taking place within the office sector will recognize opportunities for outsized gains.

Industrial

Warehouse distribution facilities should be in demand as retail sales are diverted from malls to e-commerce platforms. Indeed, the e-commerce absorption trend is expected to accelerate. The above notwithstanding, a recession would depress overall consumer demand. Slower economic activity would substantially impact demand for the asset class. In the short term – "non-essential" industries and non-credit tenants may face supply chain disruptions and slowing demand. In addition, with factories closed, the storing and distributing of manufactured goods will slow. A major slowdown in manufacturing for high-value industries like autos, aviation products, and other manufactured goods will negatively impact demand.

The industrial sector is also challenged by a slowdown of imports across major ports due to manufacturing shut-downs. According to CoStar there is a below average number of properties seeing rents rise. Supply chain disruptions have cut into leasing demand for warehouses. Conversely, delivery delays may mitigate the impact of slowing demand on vacancy.

Since it has become apparent that the U.S. was overly reliant on imports for critical supplies (including but not limited to the medical and pharmaceutical sectors) – it is likely that there will be a certain degree of supply chain reconfiguration away from China and other foreign countries. U.S. supply chains would be further impacted by slowing production in China. Should import demand slow, a warehouse demand decline would be experienced by warehouse facilities in port cities such as Los Angeles/Long Beach and Savannah.

On the positive side, more domestic manufacturing, assembly, and distribution should benefit the industrial sector. Businesses that sell necessities or provide online services are emerging stronger than others.

In summation, warehouse distribution facilities appear poised to benefit from the accelerated shift to e-commerce. Although a recession would have a negative impact on the sector, industrial will likely outperform relative to most other property types.

Retail

The retail and lodging sectors will likely experience the greatest value decline. Most malls and many retail establishments in community and neighborhood shopping centers as well as urban retail strips have closed, either voluntarily or by local mandates to prevent the spread of coronavirus. Overall, most bricks and mortar retail are not open for business and are laying off workers. According to industry intelligence provider GlobalData, nearly 4.8 billion square feet of retail floorspace has closed across the U.S., or 54.8% of the total. Some landlords have reported that only 25% of retail tenants paid April rent. Essential service establishments such as banks, pharmacies and grocery stores remain open and have generally paid their rents.

Retailers, already facing challenges from the growing e-commerce industry, are going to be further strained as more people opt to stay indoors. Depending on the severity and length of the pandemic, tens of thousands of small retailers may fail. That could result in millions of square feet of new vacancies that will lead to negative net absorption in the near future. Even after the malls reopen, people may refrain from going to the mall for fear of infection.

The U.S. may be entering a recession with negative implications for retail. In past recessions, retail properties in dense, affluent locations have seen both average rents and average prices climb back above pre-recession highs at a faster rate than poorly-located properties. Once people return to work and travel resumes, nearby affluence and density should once again become a major determinant of success for retail properties. This should be particularly true after the economic fallout of COVID-19 since it has had a disproportionate negative impact on lower paid workers. Many consumers may cut their spending to necessary goods.

Retail centers located in markets based on leisure and hospitality such as Las Vegas and Orlando should underperform. Retail centers in markets frequently visited by international tourists, such as San Francisco, Los Angeles, Miami, and New York City, may be disproportionally impacted.

Restaurant reservations are down to near zero. Restaurants that can master take out and drive through may fare better – but that is not a long-term sustainable formula. The Texas Restaurant Association, a trade group, expects between 25% and 30% of restaurants to close permanently as result of these virus restrictions affecting about 600,000 industry jobs, according to CoStar's most recent report on the retail sector. While American's shelter in place the online platforms of food establishments, and retailers such as Best Buy and GameStop should outperform.

COVID-19 will have a lasting impact on the retail market. Sales of consumer goods are falling, and a greater share of sales are coming from online platforms. The recently passed stimulus bill will help retailers retain employees and pay rent, but consumers will still spend less on discretionary goods, especially at brick-and-mortar locations. The retail market was already vulnerable. These temporary closures could result in an acceleration of permanent closures. Those that will shine are selling necessity-based consumer goods such as groceries, liquor, pharmaceuticals, and home maintenance products.

Here is some of our thoughts and our outlook and expectations for the various subsectors of retail.

Malls

- Retailers, already facing challenges from the growing e-commerce sector, are going to be further strained by the shutdown of malls and the reticence of post-COVID-19 shoppers to enter malls.
- Experiential retail (i.e. restaurants, gyms, food halls, etc.), a source of demand for malls that could not be replicated online, are sidelined during the pandemic and may be slow in returning to optimum strength post-crisis.
- Sales of consumer goods are falling, and consumers will spend less on discretionary goods, especially at malls.
- A greater share of sales is coming from online platforms. The shift to e-commerce will accelerate.
- Many mall tenants, already vulnerable before the temporary mandated closures, could experience a large amount of permanent closures.
- Once people return to work and travel resumes, retail properties in dense, affluent locations should do better.

Power Centers

- Power Centers are vulnerable to e-commerce and they may be hit hard during this downturn. However, they do have relatively high exposure to discounters like Costco and Sam's Club, and to Walmart and Target, which are holding up relatively well compared to other retailers. Centers anchored by the aforementioned retailers should perform better.
- Nevertheless, retailers such as Target may be taking a profitability hit due to the low margins of grocery and household items which have dominated sales during the pandemic. In addition, the pandemic has necessitated increased staffing and cleaning costs.
- Many Power Centers are anchored by department stores that are not doing well such as Sears and Kmart.
- Many Power Center inline tenants (those that typically pay a higher rent/SF) are closed and many are small businesses which may not survive the pandemic.

Community and Neighborhood Shopping Centers

- Neighborhood and Community Centers have a high share of essential goods and services and offer relative stability.
- Grocery anchored shopping centers should fare better.
- Many Community and Neighborhood Center inline tenants (those that typically pay a higher rent/SF) are closed and many are small businesses which may not survive the pandemic.

The retail sector is undergoing substantial change. Tenant bankruptcy and the greater share of sales being executed online will have a profound impact and result in pricing anomalies and disruption that will create outsized opportunities for gain. Understanding redevelopment opportunities and sources of future demand will be critical in actualizing a positive execution strategy.

Conclusion

Pre-COVID-19, macro-economic and operating fundamentals were very strong. Therefore, the U.S. was in a better position to deal the economic fallout of the virus. The U.S. economy is likely entering a recession which may have a sustained and material impact on the CRE sector. The unemployment rate had been at a historical low point – but is expected to spike up substantially. Hiring freezes and layoffs will take a toll on consumer sentiment and retail sales. The overall decline in U.S. economic activity affects the job market and thereby impacts leasing demand for all types of CRE. Conversely, lower interest rates may militate against some of the damage to CRE values. There is a rough year ahead for many property types. The lodging and retail sectors will likely to feel the most pain.

There are a range of CRE outcomes that may result from COVID-19, and most hinge on the severity, length, and geographic imprint of the pandemic. It is important to note that the pandemic will end at some point as will the economic stress associated with it. It is a possible that any downturn resulting from COVID-19 may be matched by a recovery that ensues once it subsides. CRE is a long-term investment and focus on a lengthy holding period is prudent. CRE should continue to offer good relative value. Nevertheless, long lasting changes going forward may include an acceleration of e-commerce growth, working-from-home, increased factory automation, remote learning, digital banking, data center usage, digital leisure, tele-medicine, and video conferencing. Those that are perceptive in recognizing the future direction of various types of CRE and understand pricing irregularities, will achieve outsized gains in what may turn out to be a once-in-a-generation investment opportunity.

Disclosures

Real Estate Investors is an investment group within NYL Investors LLC. NYL Investors LLC ("NYL Investors") is a direct wholly-owned subsidiary of New York Life Insurance Company.

1853999