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COVID-19 and Commercial Real Estate Considerations

Commercial real estate (CRE) valuations are currently in a state of uncertainty for various property sectors, as the depth and duration of an economic downturn is still unknown.

Landlords, tenants and lenders are hungry for data that reflect COVID-19's immediate effects on levels of rent deferrals and abatements and the longer-term effects on rents, expenses and occupancies, but the script is still being written. All parties are in the middle of multi-faceted negotiations between stakeholders with diverging interests. Many landlords are initially taking "hardball" positions to preserve asset values but ultimately recognize that they need their tenants to successfully navigate the crisis. Yet, landlords risk tripping debt covenants by granting too much forbearance to help ailing tenants, which brings lenders and special servicers into the mix. The following is a collection of observations based on FTI Consulting's review of current economic indicators and interactions with landlords, tenants, and their creditors.

Debt Financing Markets

Owing to this uncertainty, capital markets are in flux, with lenders looking to moderate risk.

- Fewer interest-only loan offerings from CMBS lenders as bond markets recover from credit market turmoil in March.
- Rising spreads leading to higher but still attractive interest rates.
- Tougher underwriting assumptions to protect lenders against collateral risk.
- Rising debt yields coupled with tighter underwriting is reducing available loan proceeds to borrowers.

Clarity on pricing and values will take months to resolve.

- Lenders will have to contend with dramatically increasing defaults.
- Ability and/or willingness to grant forbearance and restructure troubled loans will dictate the flow and resolution of distressed assets.
- V-shaped, U-shaped or L-shaped economic recovery.
- Canceled transactions and sidelined capital in anticipation of growing distress and lower prices.

Below are market developments that will influence valuations in the months ahead.

Sector and Market Developments

Hotel & Lodging

- Hotel closings are widespread during the pandemic, with upscale and luxury brands hardest hit.
- Approximately 70% of hotel employees have been furloughed or laid off, and nearly four million hotel-supported jobs have been lost since the crisis began. (Oxford Economics)
- Key hotel operating metrics, such as occupancy and RevPAR, have been severely impacted.
 - Per STR, nearly 80% of hotel rooms were empty as of April 29th. The 1Q20 occupancy rate of 52% was the lowest since 1Q09 during the global financial crisis and the 16% YoY occupancy decline was the largest on record.
- Steep projected declines (YOY) for RevPAR and occupancy are expected to continue through the end of 2020.

Office

- Declining demand will push down occupancy and effective rents.
- The pandemic is hitting co-working offices the hardest.
- Corporate shutdowns have driven rent relief requests, with no immediate end in sight.
- Successful work-at-home policies may reduce space needs after the pandemic.
- Alternatively, space per employee may increase as current office configurations are redesigned to accommodate social distancing.

Industrial

- Robust online shopping sales continue to spur demand for modern distribution space.
 - Amazon, accounting for nearly 40% of the e-commerce market, hired 175,000 people in March and April.
- Far fewer industrial tenants are requesting rent relief than other users.
- “Last mile” distribution facilities continue to emerge to shorten the supply chain to facilitate the faster delivery of goods.
- Cold storage demand is way up, which may lead to grocery stores incorporating more storage and fulfillment areas.
- As warehouse design transitions to more automation in order to limit labor risks, building costs are expected to increase.

Retail

- In April, total retail sales declined 21.7% (YOY), the largest monthly decline on record.
- On a positive note, grocery sales increased a record 20% in March-April (YOY), which has benefitted grocery-anchored retail. However, much of this increase reflects hoarding and a pull-forward effect, which is not sustainable.
- Between 25% to 50% of retail tenants were estimated to have paid rent in April, with owners typically budgeting for three months of lost rent, as tenant assistance takes on greater significance.
- Retail bankruptcies have accelerated since the pandemic, with liquidations or mass store closings becoming most likely outcomes. Many non-distressed retailers have already announced intentions to upsize store closing plans.
- Cancelled and delayed transactions reflected investor caution.
- Retailers continue to adapt new logistical models for the most efficient delivery of goods in the anticipation of further store closures and retail consolidations/bankruptcies.
- Regional mall owners in the process of transforming their centers to include more food and entertainment concepts have been hard hit by the pandemic.

Apartment/Multi-Family

- The National Multifamily Housing Council reported that 92% of April rents were paid as of April 26th, down from 96% YoY, in its survey of 11.5 million units.
- Fewer potential new renters in markets dependent on trade and tourism hit harder than in economically diverse markets.
- Lower-income residents of Class B and C properties will have difficulty paying deferred rent, leading to reduced income for owners.
- Oversupplied luxury apartment markets will struggle to lease-up vacant units.
- Owners will continue to focus on sustaining cash flows through tenant retention by offering more concessions and rent deferments.

Declining Investor Sentiment

COVID-19 is having a significant impact on sale transactions.

- Through April 17th, CoStar estimated that 17% of deals scheduled for an April closing were cancelled, a record high as compared to 5.6% cancellations in 1Q08 during the global financial crisis.
- Nearly 33% of hotel deals were reportedly cancelled, followed by cancelled deals in multi-family (19.1%), office (13.9%), retail (12.6%) and industrial (8.0%) sectors.
- In March, Real Capital Analytics reported the number of deals in contract that failed to close more than tripled the monthly average between 2016 and 2019, and that a shrinking buyer pool and more cancelled deals reflect a growing disconnect in pricing expectations between owners and buyers.

Cash Flow Projections and Valuations

As sale transactions become more scarce and historical data become less relevant, more emphasis will be placed on cash flow forecasts in an exceedingly difficult time to make such projections. Metrics will naturally vary on a case-by-case basis, based on property type, location, market conditions and tenant profiles. Below are general considerations when projecting cash flows across all sectors.

- Market rent and growth rates will be lower for most markets and property types over the next 12 months and probably longer.
- Rent relief requests will continue through the summer, with more landlords deferring payments and some offering abatements to maintain occupancy.
- Vacancy and credit losses will rise in the short term as more downsizing and bankruptcies occur.
- A higher stabilized vacancy allowance over the projection period may be warranted.
- As the vacancies rise, lease-up of vacant space will slow dramatically as tenants regain their economic stability.
- Expense outlays, such as security and janitorial, will need to be closely analyzed and will likely rise.
- Capital costs to reconfigure space for a post-pandemic environment will need to be considered.
- Capitalization and discount rates will need to reflect lingering uncertainties caused by the pandemic.

Conclusion

It will be many months before the full impact of the pandemic on domestic/global economies and real property markets is understood. In the meantime, real estate owners, investors, appraisers, financial institutions, special servicers and other advisors will need to make difficult projections about an uncertain future in order to make strategic decisions. The level of distress (vacancies, foreclosures, bankruptcies, etc.) over the next year or more will be driven, at least in part, by the level of cooperation and forbearance between owners and tenants, lenders and other creditors, as parties-in-interest seek solutions that preserve value. Otherwise, there is plenty of opportunistic capital waiting to pick up the pieces.

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