December 2020

WHITE PAPER

How the COVID-19 Pandemic has Impacted the Commercial Real Estate Landscape in the Short and Long Term

This paper, written and published by *Real Estate Fund Intelligence*, contains a combination of insight and intelligence from senior personnel at FTI Consulting, a global consulting firm, and a joint research initiative conducted by both REFI and FTI among 64 U.S.-based commercial real estate investment professionals, including fund and investment managers, REITs, and other institutional investors. The research was conducted over a two-month period in partnership with *REFI's* July 2020 Global Investors Virtual Summit.

All quoted material is exclusively used in this report unless stated and has been checked with all parties. Quotes represent the views of the individuals quoted and do not represent the views of the entire firm.

Introduction

COVID-19 has created challenges for the commercial real estate market in the U.S. that have not been seen since the 2008 global financial crisis. While the 2008 crisis was the direct result of credit and liquidity fiascos, the pandemic has had a direct, powerful impact on the demand for space, put pressures on supply chains, created almost non-existent travel and job losses, and devastated consumer confidence. As a result, 2020's CRE marketplace has been characterized by rising vacancy rates in the office sector, delinquent rents in the retail sector, more distress in hospitality, and falling property prices overall, especially in major cities across the country.

But because the pandemic's impact has varied dramatically across property types in some cases and between urban and suburban markets, there have been some bright spots. For example, industrial, warehouse and suburban multifamily have outperformed expectations as more consumers shopped online and flocked to residential life outside major cities, with an eye toward steering clear of the virus. Now, the promise of a vaccine in late 2020/early 2021 has the commercial real estate markets on standby, and the recovery is likely to look very different than the one that followed the 2008 financial meltdown.

"The financial crisis of 2008 was a very different situation from the COVID-19 crisis. In 2008, there was doom and gloom and little expectation that things would recover quickly. And then, of course, it was followed by one of the longest bull runs in modern history," said **Josh Herrenkohl**, a Senior Managing Director and Leader of Business Transformation Services within the Real Estate Solutions practice at FTI Consulting, based in New York City.

Immediate Reaction

The 2020 pandemic swiftly shut the door on transactions, with most deals stalled or stopped. A few transactions continued, mostly in the industrial and life sciences sectors, and in other sectors where buyers risked losing deposits. There is anecdotal evidence that some transactions that were in negotiations when the COVID shutdown hit were later resurrected at prices 10% or more lower.

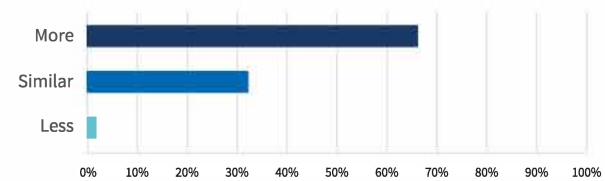
Yet in the ensuing months, the various real estate asset classes have experienced mixed results. According to **Jahn Brodwin**, a Senior Managing Director and Co-Lead of the **Strategic and Transaction Advisory** group within the Real Estate Solutions practice at FTI Consulting in New York:

- Industrial: "This segment of the market hasn't taken a break."
- Retail: "Retail is a different story and much more problematic, as it was facing unprecedented challenges before COVID; with the significant number of large retailers that are filing for bankruptcy, the pain has been amplified and accelerated. When big box retailers file for bankruptcy, they often have the opportunity to cancel leases. This creates a domino effect on other retailers that rely on foot traffic created by the larger box retailers.
- Office: "Most of the real estate is leased on a long-term basis, so office real estate is traditionally a lagging indicator of the marketplace and therefore, is generally easy to predict. However, in the longer term (two-to-three years out) I believe this will be a zero-sum game, as a) more office workers will work remotely and the fewer people occupying office space will demand more square footage per head, and b) select suburban office properties will be winners in the short-to-midterm as they become the "spokes" to the urban office "hubs." On a longer-term basis, though, I predict employees and employers will gravitate back to urban centers; however, it is unclear what rental concessions will be needed to reinvigorate this market."
- Multifamily: "Large cities are going to suffer in the near-to-midterm. Rents will get repriced, less in the form of headline rents, but rather, in free rent and other incentives."

"There's a lot of optimism about industrial, which makes sense given that ecommerce will continue to be a very significant trend, but a lot of pessimism around office. Multifamily was middle of the road, but, in large part, dependent on geography. Metropolitan multifamily will likely experience continued distress in the near term," Herrenkohl said.

The virtual landscape has also impacted how investors and sponsors interacted with each other, no longer relying on in-person meetings and conferences to communicate. Sixty-six percent of survey respondents are speaking with investors more frequently than they did in 2019, with an additional 32% saying they speak a similar amount as last year. The sum of a virtual commercial real estate landscape left some commercial real estate players looking back to the global financial crisis to evaluate how best to respond to the market volatility.

How often are you speaking with your investors (or are your sponsors speaking to you) now versus 2019?

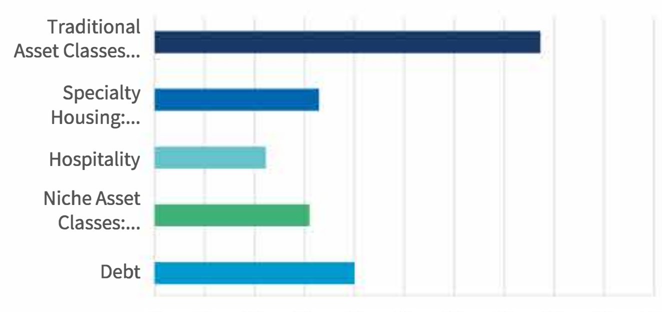


Investment Outlook

In the short term

When assessing short-term investments,77% of respondents are attracted to traditional asset classes compared to investing in debt (36%), specialty housing, niche asset classes and hospitality.

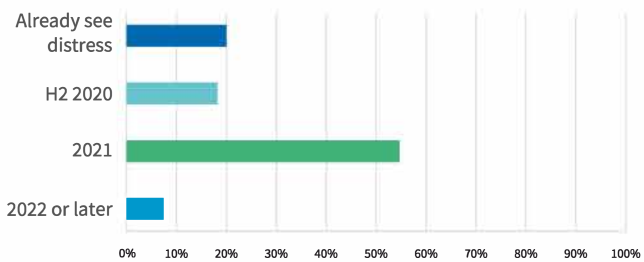
What types of assets are you attracted to invest in the short-term?



“We are already seeing distress. There’s a significant amount of capital available for investment, and many are waiting for someone else to dip a toe in the water and start investing again,” Brodwin said.

Fifty-four percent of respondents believe 2021 will be characterized by a great deal of distress in the real estate market, with 20% of respondents already seeing distress and 18% expecting to see it before the end of 2020. While trying to take advantage of market distress, commercial real estate professionals remain conscious of how the COVID-19 pandemic may impact investments in the asset class.

When do you expect to see distress? (Foreclosures, bankruptcies, etc.)



Outlook by asset class

“The survey results show varied expectations about the recovery across commercial sectors. The areas where we see expectations of a V-shaped recovery—most notably industrial, suburban multifamily, and single home residential—reflect the thinking that when 2021 rolls around, there will be a vaccine and then everything gets back to normal,” Herrenkohl said.

What is your general expectation for the shape of the recovery from pre-Covid 19 to post-Covid-19 for the following types of asset valuation?

- Quick decisive recovery
- Quick recovery followed by another downturn followed by another recovery
- Slow steady recovery
- Further drop and no recovery for an extended timeframe (depression)
- Further fall followed by a quick recovery

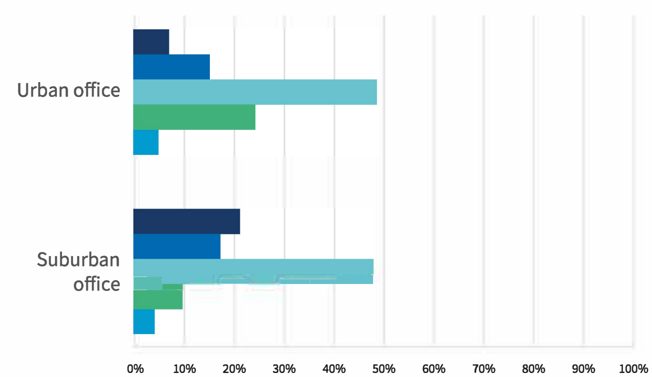
Overall, commercial real estate professionals see the industrial sector—which has remained relatively stable throughout the pandemic—as bouncing back quickest. Seventy-five percent of respondents predict a V-shaped recovery for the asset class. For most asset classes, the majority of respondents believe the recovery will take one of two paths: a slow and steady U-shaped recovery or an L-shaped scenario with further drop and no recovery for an extended period. However, looking deeper into other traditional asset classes:

— There were mixed levels of optimism for short-term investment across multifamily and office, with respondents saying suburban locations may experience a quicker bounce back than urban locations. Across the office sector, a U-shaped recovery was also what the majority of respondents predicted for both the urban and suburban asset classes.

  — Seven percent of respondents expect to see a V-shaped recovery in urban office, far less than the 21% that are expecting to see it in the suburban office market.

What is your general expectation for the shape of the recovery from pre-Covid 19 to post-Covid-19 for the following types of asset valuation?

- Quick decisive recovery
- Quick recovery followed by another downturn followed by another recovery
- Slow steady recovery
- Further drop and no recovery for an extended timeframe (depression)
- Further fall followed by a quick recovery

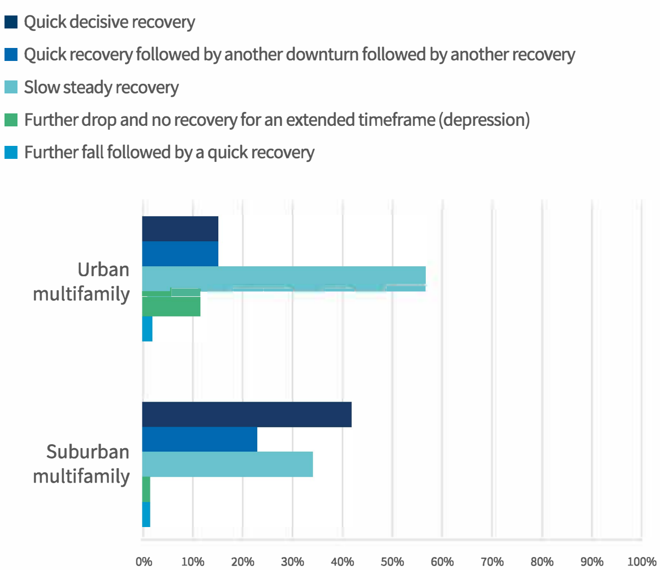


Regarding the office market, Brodwin noted that, “There has been a resurgence of companies that are traditionally in gateway cities renting additional office space in suburban markets to accommodate employees that don’t want to come into a dense city. They don’t want to take public transportation. They don’t want to be in a crowded elevator.

Many refer to this as a hub (city) and spoke (suburb) concept. The bigger question is whether this hub-and-spoke concept is here to stay or will run its course in the next couple of years as employees become more comfortable returning to gateway cities. History has shown over and over again that amnesia will eventually set in. However, the trend for more full- or part-time remote work was already in motion before COVID-19, and perhaps COVID-19 accelerated this movement by many years. On the other hand, the densification trend will likely throttle back as employees will not want to be shoulder-to-shoulder with their coworkers; as I said before – a zero-sum game in a few years."

- When looking at the multifamily sector, there is also a discrepancy between urban and suburban markets among respondents.
  - Fifty-six percent believe there will be a U-shaped recovery in urban multifamily assets, slightly above the 33% in the suburban multifamily.
  - Fifteen percent of respondents see a quick recovery (V-shaped) in urban multifamily, with 41% seeing this in suburban multifamily.

What is your general expectation for the shape of the recovery from pre-Covid 19 to post-Covid-19 for the following types of asset valuation?



There is much less optimism for short-term recovery across various types of in-person retail, with 1% of respondents expecting a quick revival of high street retail and mall shopping.

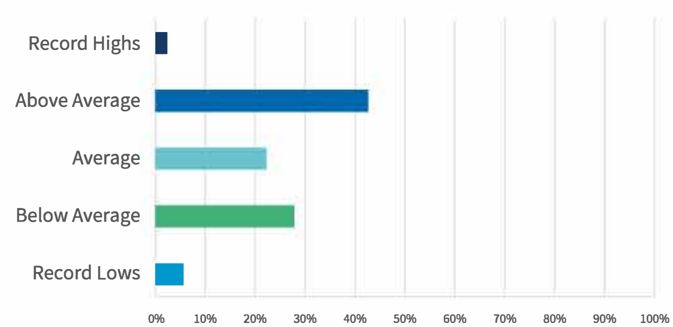
- For shopping malls, 70% predict an L-shaped recovery with a further decline and sustained downturn.
- Respondents were slightly more optimistic about neighborhood shopping, with 16% of respondents expecting a V-shaped recovery in that asset class, and 58% foreseeing a slow, steady U-shaped recovery.

One asset class projected to make a slower rebound is the hospitality sector, given the limits on both domestic and international travel due to the pandemic. Seventy-five percent of respondents predict a U- or L-shaped recovery for hospitality assets. With worldwide acceptance of proptech companies such as Airbnb, there is a strong likelihood that the number of traditional hotel rooms will contract for the foreseeable future. One bright exception might be a new genre of hotel concepts focused on the needs of the digital nomads.

2021 Will Outpace 2020

Outside of how real estate managers will assess investments in different asset classes, transaction volume will be significantly higher in 2021 given the lack of activity for most months in 2020. Forty-two percent of respondents believe 2021 transaction volume will be above average if there is a cure or vaccination by the end of 2020 or early in 2021.

Where do you expect to see 2021 transaction volume assuming we have a cure/vaccination by the end of 2020?



"We're starting to see transactions, distressed and otherwise. This is definitely going to continue. The fourth quarter of 2020 might surprise us in a good way with some level of transaction volume. It's a sure bet that 2021 is going to outpace 2020. Acquisitions directors spend half of their lives trying to look good and half of their lives trying not to look bad. At the moment, everyone is trying not to look bad. We are waiting for one or two credible investors to kick-start transaction activity and show us where the market has bottomed out," Brodwin said.

Institutional investment in real estate is also something that commercial real estate managers are closely monitoring, with 87% of respondents thinking there will be more or similar amounts of institutional investment in 2021 than what took place in 2020.

Long-Term Investment Outlook

Commercial real estate's historic long-term viewpoint must provide some sense of stability for interested investors. With other asset classes being more turbulent due to market volatility, institutional investors may remain keen on making long-term investments.

"Institutional investors have the capital and fortitude to play the long game and weather the storm. This will create significant opportunity, but also widen the divide between the larger and smaller players," Herrenkohl said. "That said, everything gets reframed if there is no cure or vaccine within the next several months, because at the end of the day, if this pandemic goes on for some time, the cracks in the foundation will continue to grow."

Of the office sector, Brodwin noted that, "Looking out five or so years many office workers are going to realize they don't need to be in the office every single day. There are many companies that are going to allow their employees to work two or three days a week in the office and the balance of the week offsite. I also believe that it's going to be a long time before we can go back to having people sitting three feet apart. So, some companies are going to need more space and others are going to need less space. We will find that new equilibrium," Brodwin said.

For the entire commercial real estate market, the long-term view remains positive knowing that distress creates opportunities for both buyer and seller. With no crystal ball that can predict the short-, medium- or long-term horizon, market leaders continue to compare how the market jumped back post-global financial crisis.

"I think there will end up being a lot more turnover, a lot more consolidation. I think there will be many more ups and downs with a W-shaped recovery before there's really an elongated up," Herrenkohl said.

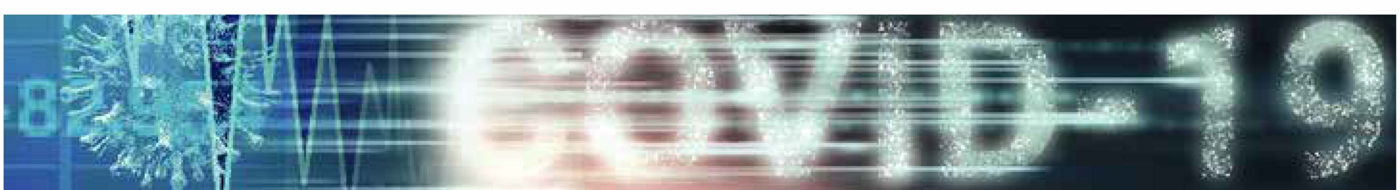
"At the end of the day, real estate is more stable than equities, which tend to experience much bigger peaks and valleys than real estate. So, it's a good hedge for many investors looking to manage risk. Real estate is not going to dissolve," he added.

JAHN BRODWIN
Senior Managing Director
+1.646.632.3826
jahn.brodwin@fticonsulting.com

JOSH HERRENKOHL
Senior Managing Director
+1.646.632.3859
josh.herrenkohl@fticonsulting.com

INGRID NOONE
Senior Managing Director
+1.973.852.8131
ingrid.noone@fticonsulting.com

GLENN BRILL
Managing Director
+1.646.632.3820
glenn.brill@fticonsulting.com



Learn more at fticonsulting.com/covid19