Will COVID-19 Result in Write-downs of Your Real Estate Investments?

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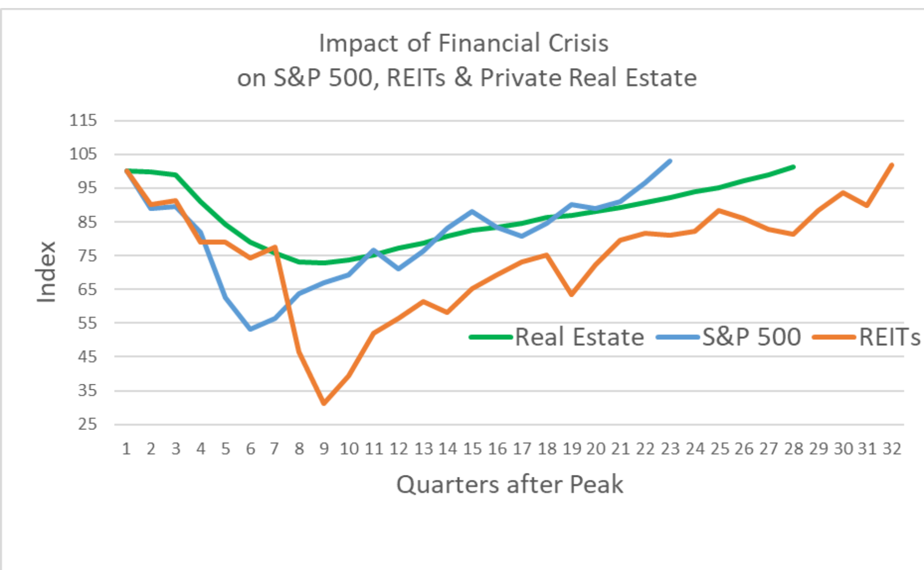
COVID-19 is causing havoc in financial markets as seen by declines in the S&P 500 as well as increased market volatility seen in the VIX. The S&P 500 has lost about 30% of its value since the February peak. Many businesses have shut down at least temporarily, and there is significantly less household spending on goods and services, which could lead to a consumer-driven recession.

There will be many tenants that have the financial wherewithal (or who can access government support) to survive this crisis, but it seems inevitable that some will not. In the longer term, occupancy of many properties is likely to be impacted, which in turn is likely to result in lower rental rates, NOI, and ultimately property values. History suggests that new tenants will eventually take the place of failed tenants, but the timing is unknown. The costs of replacing tenants, including leasing commissions, legal, tenant allowances, and tenant improvements, will be substantial and are typically not in current pro-forma budgets, particularly in situations where lost tenants had significant terms left on their leases.

Will this result in a write-down of your real estate assets? If so, how much of a write-down might be expected? No one knows, but we can look at the history of recessions and see how they impacted CRE, keeping in mind that the cause of each has been different and a pandemic has precipitated none.

A recent note from UBS Financial Services, Inc. looked at the impact of past recessions on stocks.[1] For the most recent financial crisis leading to what has been termed the Great Recession, the calendar year return was as low as negative 33% and there was an intra-year downturn of as much as 48% during 2008. Should we expect a similar decline in the value of commercial real estate? To answer this question, Jeffrey Fisher recently looked at how the past recessions impacted the value of properties in the NCREIF property index, which tracks over a half trillion dollars of institutional real estate (apartment, hotel, industrial, office, and retail).[2] The index starts in 1978 and thus captures several recessions, including the most recent financial crisis.



The exhibit shows the decline in value and number of quarters until private real estate, the S&P 500, and publicly traded REITs recovered to their pre-recession value. We see that private real estate had the least decline in value at about 25% whereas the S&P dropped by about 45% and REITs dropped by slightly over 65%. The recovery of private real estate was about four quarters behind the S&P 500 but about four quarters before REITs.

[1]UBS Talking Points: Market Volatility, 4 March 2020. https://ubswma.bluematrix.com/sellside/DocViewer?encrypt=795aed73-1755-4c47-a1a4-55f5e4b648d9&mime=PDF

[2]Impact of Recessions on CRE Values: Lessons from the NCREIF Index. https://www.ncreif.org/globalassets/public-site/covid19/fisher-impact-of-recessions-on-cre-value-2020-03-24.pdf. REITs added to the above exhibit.

Each of these crises arose from different circumstances. The real questions are the timing and amplitude of the impacts. If recovery is swift and tenants are "back to normal" in a relatively short period, the number of tenants lost is likely to be much smaller than in a prolonged crisis. While we recognize that the short-term cash flow impacts can be challenging to address, particularly in highly leveraged assets, our view is that vacancy and turnover costs are more likely to have a long-term impact on property values. We also have no real sense of how likely government fiscal stimulus in the form of loans and grants to businesses will help to reduce the number of companies that fail during this crisis.

While we can't say that history will necessarily repeat itself, this may give us some clue as to what to expect for commercial real estate based on what happens to the stock market over the next year. The drop we have seen so far has been somewhat like that of the 2007-2008 financial crisis. Whether the impact on real estate is the same remains to be seen.

At this juncture, we would not recommend writing down all assets on a portfolio basis. Instead, we would suggest that entities with property interests make an effort to assess the potential impact that COVID-19 will have on short-term cash flows and long-term occupancy. This should be done on a tenant by tenant basis where possible. The tenant by tenant analysis can be aggregated up to the property level and used to determine if there will be a shortfall in operating income relative to operating expenses, debt service, and taxes. Property owners and debt holders can then make informed judgments about whether or not an individual asset valuation should be adjusted.