

COVID-19 Virus Infects Real Estate

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Think about skyscrapers. The metaphorical man-made fingers constructed of steel, stone and glass, that bisect the horizons and touch the heavens. These are symbols of human ingenuity and aspirations. Or consider raw land; canvases upon which architects and developers display their creations and visions. In contrast, the presence of sprawling and uninspired utilitarian buildings that populate the landscape are designed for functionality rather than aesthetics. Repurposed buildings marry history with the future. Smart and green technologies strive for efficiencies and endeavor to satisfy environmental concerns.

Brick and mortar, for the better part of recent history, notwithstanding interspersed economic downturns, have been viewed by owners, investors and lenders alike as attractive vehicles for stability and consistent financial returns. Even during recessionary periods, distressed buyers see opportunities.

The COVID-19 pandemic has had a devastating impact on commercial real estate. Short term effects will undoubtedly evolve into more prolonged challenges. Unlike natural disasters where physical structures suffer repairable damage, long term solutions to this pandemic require a combination of medical advancements (i.e., therapies and vaccinations) and the revitalization and stabilization of global economies. There is also a significant psychological component; calming the widespread fears of contagion.

Typically, the value of commercial real estate is intrinsically tied to the generation of revenues and net income. Owner occupied properties present different valuation models. The COVID-19 pandemic with the forced temporary cessation of *non-essential* businesses has dramatically disrupted rental and revenue streams. The intercession of the CARES ACT (including the Payroll Protection Program) has provided short term relief, but it is hardly a panacea. Recent forecasts predict that 30-40% of small businesses will not reopen or will soon fail after the rolling expiration of the governmental closure orders. Keep in mind that approximately 95% of U.S. based businesses are definitionally small businesses. If this proves to be accurate, the domino effect upon commercial real estate will be immediate and profound. We appear to be in the midst a global recession and the prospect of devolving into a depression is not out of the realm.

There are two classes of commercial real estate that are in immediate and serious jeopardy. First, properties that house hospitality and entertainment venues (i.e., lodgings, restaurants, theaters, sporting arenas, health clubs/gyms, casinos, etc.) have been shuttered since mid-March. Their gradual re-openings are tied to the regional entries into Phases 3 and 4, with several of these delayed after Phase 4 began. Even with the staged resumption of their businesses, patrons may be very slow to return due to lingering fears of the virus. The survivability of real estate anchored to these sectors is fraught with peril largely due to cash flow deprivation.

A second endangered species of commercial real estate are retail based properties (malls, strip plazas, big box retailers, standalone store fronts, personal service salons, etc.). It should be noted that brick and mortar retailers were struggling well before the onset of COVID-19, primarily attributed to the proliferation of internet sales. The pandemic undoubtedly exacerbated and perhaps accelerated the widespread demise of retail stores. One need only consider the fate of such prominent retail business as; J.C. Penny, Pier 1, Neiman Marcus and J. Crew to mention but a few. More will soon follow. Depending upon various factors, retailers may resume limited operations as the corresponding geographic regions enter Phase 4.

Office buildings are another class of commercial real property that will struggle with long term issues in the wake of the pandemic. The temporary mandated closure of service-oriented businesses, compelled their employees and staffs to work remotely from home. Invariably, this will prompt many businesses to reconsider their future office space requirements. Some tenants may attempt to renegotiate leases, while others may downsize once leases are up for renewal. Even as office buildings come back on-line, the COVID-19 related health and safety protocols severely restrict access and utilization (i.e., four persons per elevator, social distancing requirements, limited number of personnel, constant environmental services, etc.). Anecdotally, some employers are observing increased productivity levels of employees who are working remotely. These adaptations to the pandemic are harbingers of changing requirements and lowering of occupancy costs. It is noteworthy that while most business offices were permitted to reopen in Phase 3, corporate directives (out of an abundance of caution), have adopted longer periods of restricted access. There are companies that have allowed their employees to work from home for the balance of 2020.

Faring somewhat better are industrial, warehouse and multi-family properties. While industrial manufacturing plants did slow down or temporarily close through the pandemic curve, for the most part these classes resumed operations during Phases 1 and 2. If the businesses were deemed *essential* they remained operational notwithstanding the pandemic. Pre-COVID-19 warehouses and storage facilities were experiencing an uptick. These facilities are an integral part of the internet stream of commerce and the beneficiaries of this transition.

While perhaps experiencing some deterioration of monthly rents and an inability to evict delinquent tenants during governmental imposed moratoriums, in the long run people need affordable and flexible multi-family housing. It is conceivable that the governments will stimulate more affordable housing through subsidization. One caveat, given the uncertainty of the higher education model, student housing (apartments and dorms) may be in overabundance and at risk.

The challenges in the short term are numerous and complex. The upstream and downstream ripple effects are obvious. The disruption of rental and revenue streams resulted in many landlords granting short term concessions (not forgiveness) to assist tenants. Consequently, owners have sought waivers of loan covenants and deferrals of debt service requirements from its lenders. In turn, particularly, if the commercial mortgages are held in securitized portfolios (i.e., Commercial Mortgaged-Back Securities) the continuity of distributions to investors is impaired. The current trend is for short term accommodations, typically 90 days. It seems as though another round of deferrals and waivers is afoot. Moratoriums on evictions and foreclosures are largely still in place for another 90 days or so anyways.

The long-term challenges are numerous and complex:

- How will valuations of commercial realty be adjusted or modified, in the short and long term, to address post-

pandemic factors? Consider how comparable properties in a depressed market may skew valuations or discounted cash flow analyses are affected by disrupted rent and revenue streams coupled with artificially low interest rates.

- Will lender loan covenants, such as loan to value, debt service coverage ratios and net worth calculations require adjustments and new formulations?
- Will mortgagees manifest reluctance to foreclose (or accept deeds-in-lieu) in the current environment and assume the risks of managing and operating distressed commercial properties? Can they do better than ownership?
- What will be the impacts upon CMBS and REIT portfolios?
- Will owners seek refuge under the Bankruptcy Code and seek to cram down and/or restructure mortgage loans?
- Will distressed asset buyers find new opportunities in acquiring distressed loans or the underlying real estate collateral?

Across the board, initial reactions have been short term and measured. Long term outcomes and solutions are elusive and await medical advancements to manage COVID-19 and perhaps its progeny, the restoration of confidence, the abatement of fear and the prospect of normalcy. Patience and ingenuity will be the hallmarks of survivability.