Commercial real estate in 2020: Preserve and adapt

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In the wake of the pandemic-related crisis, the state of the commercial real estate industry is one of both uncertainty and opportunity. On the one hand, by early June public REITs were still down about 10% for the year. But the sector was also quickly able to claw back from the depths of the downturn, rising 35% from the end of March to the end of May.

I recently spoke with three of BMO's commercial real estate experts to get their perspectives on the different aspects of this vital industry:

Ryan Cotton, Director of Private Market Investments, BMO Family Office

John Kim, U.S. Real Estate Analyst, BMO Capital Markets

Kim Liautaud, Head of U.S. Commercial Real Estate, BMO Harris Bank

Webcast Replay: Commercial real estate: Persist and adapt

A summary of our discussion follows.

Capital preservation and cap rates

Prior to COVID-19, 2020 was shaping up to be a promising year for the commercial real estate industry. As Ms. Liautaud point out, there was growth across most asset classes, occupancies were strong and valuations were at peak levels—all supported by active capital markets activity for both debt and equity. All told, as Mr. Cotton said, it was shaping up to be another strong year for investors.

"The expectations were that real estate would continue to be the bastion of stability in an investment portfolio," he said. *"We've certainly seen some deceleration in appreciation in the preceding two or three years as the recovery got a little long in the tooth. But the expectations for low interest rates, sustained economic growth—albeit a little softer than years prior—really continued to position real estate as a pretty rock-solid portion in most private investors' portfolios."*

That all changed, of course, when the pandemic struck. As Mr. Kim noted, companies acted quickly to preserve capital and strengthen their balance sheets. The less drastic tactics included putting a freeze on acquisitions and speculative development. Other firms took action through employee furloughs and cuts to executive pay. Then there were the more drastic measures, such as drawing down on lines of credit and hoarding cash on the balance sheet.

"That put a sign of panic in the market at the time," Mr. Kim said. *"When companies did that, a lot of share prices suffered. Now with the economy opening up again, a lot of companies that took those measures are starting to crawl back."*

Mr. Kim added that after an initial price spike in financing levels, the cost of debt for high-grade public issuers is now attractive again. *"Now some companies are even thinking about restarting developments, and others are thinking about acquisitions once again,"* he said.

Still, Ms. Liautaud noted that for commercial banking clients seeking short-term financing, debt capital availability is still constrained. *"Owners with debt maturity in 2020 should recognize that it is a more constrained debt capital market,"* she said. *"Plan accordingly, think about it early. Our expectation is that it will persist at least for the remainder of 2020."*

There's also the issue of what Mr. Cotton referred to as the million-dollar question going forward: what will happen to cap rates? Cap rates (the ratio between net operating income and property price) have been trending downward for the last several years, resulting in higher valuations—and there wasn't much room for them to fall lower.

"People expect some widening out of cap rates in the coming quarters, it's just a matter of how long that takes," Mr. Cotton said. *"There is some separation that needs to take place in that analysis in terms of what structural and what's cyclical. From our conversations with most of our groups, they expect some short term increase in cap rates, although most of them are somewhat optimistic and look at it as more of an opportunity to gain well-positioned assets at stronger prices. Near term we expect some volatility, it's just a matter of the severity."*

Rent and Expenses

This is one of the more contentious issues to come out of the COVID-19 crisis. Would tenants be able to pay rent? And how would a significant shortfall impact property owners? Mr. Kim noted predictions that one third of multifamily tenants wouldn't pay their rents in April. But as he pointed out, the worst fears haven't been realized. According to the National Multifamily Housing Council's Rent Payment Tracker, 91.7% of apartment households made a full or partial payment in April, while 93.3% made a payment in May.[1]

[1] National Multifamily Housing Council

"Outside of retail, rent collection came in as expected or better," Mr. Kim said. *"Even looking at a sector like office—no one's utilizing their office space and you're hearing a lot of companies saying work from home is going to be more prevalent going forward, but the rent collection in April was 93%."*[2]

But while the news on rent collections is good, Ms. Liautaud said it's crucial to keep an eye on other expenses that will likely emerge because of the pandemic. *"We're spending a lot of time talking about the expense line, because we think that is undergoing some shifts—and not in the right direction for most line items,"* she said. *"People are spending a lot more money on sanitation and security."*

Ms. Liautaud did note, however, that lower interest expenses should help offset some of these cost increases.

The future of office space

We all know the pandemic has forced millions of people to work from home. And that's led to a lot of companies reassessing their office space needs in the long term. Twitter famously announced that it would allow its staffers to work from home permanently, while other big tech firms like Google and Facebook have said employees can work remotely through the end of 2020. That's left the industry wondering if office clients will look to downsize their square footage requirements.

"The question is, how much of this shrinking footprint that we're reportedly going to be seeing over the next couple of years is cyclical versus structural?" Mr. Kim said. *"To be honest, we haven't really seen a lot of evidence that companies are going to be shrinking their footprint structurally over the next five or 10 years. For instance, we met with the landlord of Twitter's headquarters in New York. He said they inquired about expanding their space in the building. Every office owner and broker that we met with over the past month is convinced that Facebook is going to announce an expansion in New York. For a lot of REITs, they understand that market rents will be coming down, but they're going to play the waiting game. They're going to see what happens when companies recalibrate the way they work."*

The post-pandemic future of work has also raised questions about the coworking sector. Although WeWork's spectacular downfall didn't help, the sector in general still held promise heading into 2020. Mr. Kim believes there's still a place for it, but in a different format.

"For a lot of landlords, it was an untapped market," he said. *"They wouldn't have the resources to do shorter-term leases, or be flexible, or to lease to smaller businesses or individuals. But that is a pretty significant market that the coworking operators have addressed. They just grew too fast. But what WeWork proved is that small businesses and individuals still want to network. They will still pay a premium to be in office space to be able to work and socialize and work with other people who may or may not be associated with their own business. I think that will come back again, but it will have to be in a smaller format. The landlords are addressing it. Some are doing it in house, but others will partner directly with the coworking operators."*

Looking ahead

Because of the unique circumstances, it's tough to determine which impacts will last and which ones are temporary. That applies to portfolio performance and new opportunities.

"The expectations we've heard from some of the funds are that over the next couple of quarters we could see declines in the single digit to the high-teen percentages," Mr. Cotton said. *"But they expect that to be a smaller blip on the radar and, ultimately, for fully invested funds to shave only 100 to 200 to maybe 300 basis points off of their overall long-term expected returns".*

"On the private sector side there are a lot of nuances," Mr. Cotton continued. *"You have funds that are fully invested who are obviously going to be more impacted by this. You have those that may be partially invested, so they're playing triage on their current portfolios and current properties. But they also have dry powder to put to work in some of the dislocation and opportunity set that's coming out of that. Then you have those groups that were in a fortunate position to have just closed their funds out prior to the COVID outbreak and are now sitting on a fresh pile of capital. There's a lot of groups out there that will be staring down the rest of 2020 as an opportunity for purchase."*

For now, Mr. Cotton said most funds are taking a wait-and-see approach to making investments. Amid the current opportunities, the bid-ask spread between buyers and sellers is large. *"Performing due diligence on properties is very difficult right now, and the credit markets on the private side are much less liquid than they have been on the Class A, high-grade public side,"* Mr. Cotton said. *"There is an opportunity that will come as that bid-ask spread starts to narrow a bit. What may force that on the sell side of things will be the need for recapitalization. Debt maturities coming due will serve as a catalyst for groups with dry powder to step in."*

Ultimately, new opportunities on the private investment side will be centered around liquidity. That is, having the cash on hand to execute strategies around recapitalization and providing liquidity to current property owners.

"If this ends up being a more drawn-out process and we're looking at years rather than quarters, the [global financial crisis] showed us that there will be an accumulation of nonperforming loans piling up" Mr. Cotton said. *"So the people who have the ability, the resources and the platform to acquire and work assets out and have that distressed mindset, those will be the opportunities we're looking at."*

[2] Nareit

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