Commercial real estate

Quantifying COVID-19: Impact on U.S. CRE

The coronavirus outbreak that started in China has spread to as many as 50 countries, sparking fears of a global pandemic. Equity markets across the globe have sold off as they appear to be acknowledging the severity of the outbreak, which has already infected roughly 10 times more people than SARS did 17 years ago.[1]

KEY TAKEAWAYS

- Markets have sold off across the globe, reflecting increasing uncertainty related to COVID-19.
- The CRE market is inextricably tied to the real economy, and an economic downturn could have a significant impact.
- In a true downside case, the U.S. CRE market is much better positioned today than it was before the financial crisis, with significantly greater cushion for debt holders.

A global pandemic, of course, would impact every corner of financial markets, though certain sectors are better equipped to handle a global recession than others.

In this note we look at potential impacts of COVID-19 on the CRE market, how much stress properties are equipped to handle, and which property types are most exposed.

The CRE market is inextricably tied to the real economy. As we look at the outbreak, it is first important to acknowledge the many uncertainties that still exist. The Chinese economy has already been severely impacted, and while the number of cases outside China continues to grow, the direct economic impact has so far not been quantifiable.

We will not pretend to have a base case scenario – there is just too much uncertainty – but we will attempt to sift through the ramifications of different potential outcomes. Our upside case is that disruptions continue internationally for a period of months, especially in Asia, but that there is no outbreak in the U.S. The downside case is that there is a widespread outbreak in the U.S., which would have a lasting, material impact on the domestic economy. The reality could, of course, land anywhere in between.

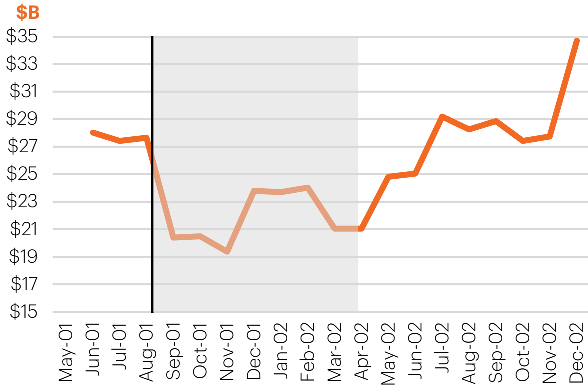
CRE fundamentals

The real estate market is inherently slower moving than public equity and debt markets, as transactions are usually months in the making. The good news is that this means momentary disruptions are unlikely to result in immediate volatility for investors. However, this type of acute uncertainty is likely to result in lower transaction volumes for a period of time as buyers take a "wait-and-see" approach. One historical example of

1 Centers for Disease Control and Prevention.

this is around the September 11 attacks. Volumes fell for a period of months, but recovered soon after, as transactions were pushed to later months.

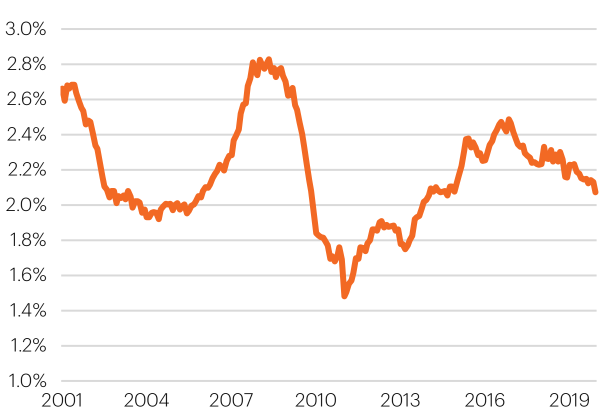
CRE TRANSACTION VOLUMES AROUND SEPTEMBER 11, 2001



Source: Real Capital Analytics.

The U.S. economy is distinctly domestically focused, with total trade equaling just about 13% of GDP.[2] While this is not insignificant, it is much less than in many major foreign economies. The size and wealth of the U.S. give it a unique domestic consumer base. In a similar vein, the CRE market has a strong domestic investor base on which to rely. Foreign investors account for less than 10% of total transaction volume, and investment from Asia represents less than 2% of the total.[3] This is not to say a significant international disruption could not materially impact the CRE market. However, short of a major COVID-19 outbreak in the U.S., the U.S. economy remains well positioned to support demand in the CRE market.

PRIVATE NONRESIDENTIAL CONSTRUCTION SPENDING, % OF GDP



U.S. Bureau of Economic Analysis, as of December 31, 2019.

On the supply side, construction spending has remained moderate over the past 4 years. Private nonresidential construction spending is at its lowest level as a percentage of GDP since early January 2015.[2] As a result, demand has been able to keep up with, and in some cases surpass, new supply. We believe that this gives the market some cushion should demand for property temporarily decline.

CRE capital markets

While fundamentals remain solid, CRE equity holders do hold some risk. Cap rates are largely near all-time lows, and property prices are 34% above the previous cycle peak. If there were to be an extended period of risk-off sentiment, or if rent levels start to decline, cap rates could experience some expansion, hurting property valuations and, by extension, equity values.[3]

Debt markets – effectively the availability of mortgage financing for borrowers – play a key role in CRE markets in much the same way as residential real estate. The ability of property owners to pay their debt service is often a decisive factor in the performance of the CRE market. If our upside case ends up being the outcome, we don't foresee any major impacts on the CRE debt market. However, if an outbreak in the U.S. causes an economic contraction domestically, it is worth looking at how much stress the debt markets can take.

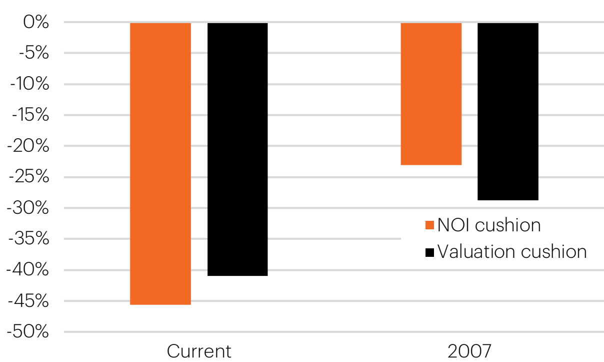
A debt service coverage ratio (DSCR) is a property's net operating income (NOI) divided by its debt service on an annual basis. Currently, the average CRE DSCR stands at 1.84x, meaning the average property generates nearly double the income it needs to pay its regular debt service. This is a meaningful improvement compared to the year before the previous downturn (2007), when DSCR was just 1.30x. Two factors are chiefly responsible for this improvement: lower mortgage rates and more conservative underwriting post-crisis. Additionally, properties carry less leverage than they did pre-crisis – average LTVs currently stand at 59% versus 71% in 2007 – meaning debtholders have more "equity cushion."[3]

2 U.S. Bureau of Economic Analysis, as of December 31, 2019.

3 Real Capital Analytics, as of January 31, 2020.

From these stats we can calculate 1) how much NOI can decline before the average property can no longer pay its debt service, and 2) how much property valuations can fall before debtholders see losses.

CRE DEBT MARKET DOWNSIDE CUSHION



Source: Real Capital Analytics, FS Investments.

Put simply, the average property today could sustain a decline of 46% in operating income before it could not cover its debt service compared to only 23% in 2007. Additionally, the average property could sustain a 41% decline in value before it fell below the value of the debt compared to 29% in 2007. It is critical to note that these are averages, meaning there are properties that will be better insulated and those more prone to stress. However, we believe the overall CRE debt market today is better positioned than it was before the last major downturn.[3]

Impact on property types

The CRE market is a broad and diverse market that is impacted by a wide variety of economic factors. We look at each major property type to see how each could be impacted in both our upside and downside scenarios.

MULTIFAMILY

Upside case: The apartment sector would likely face minimal impact. Second-order economic effects due to weaker demand and employment could occur but would likely be transitory.

Downside case: A widespread outbreak in the U.S. would likely cause an economic contraction, causing significant job losses and hurting demand for shelter.

OFFICE

Upside case: Even if some firms took precautionary measures and told employees to work from home for a month or two, the overall demand for office space would likely see only modest impact.

Downside case: Stress from lower employment and consumer demand would be likely, especially in cities with heavy international economic ties.

INDUSTRIAL

Upside case: Industries with high supply chain exposure to Asia, like chemicals and transportation equipment, could be impacted. However, high inventory levels could provide a buffer for the sector.

Downside case: Slower business activity (manufacturing) and consumption (warehouses) would likely hit this high-flying sector.

RETAIL

Upside case: Certain cities exposed to tourism from China could be impacted; however, a resilient U.S. consumer would likely buffer the effect.

Downside case: Brick-and-mortar sales still account for roughly 80% of non-auto & gas retail sales.[2] An outbreak in the U.S. could materially impact consumption, and thus the retail sector.

HOTEL

Upside case: Demand would likely be dented, although foreign visitors account for just 8% of U.S. hotel demand.[4]

Downside case: People would likely be very wary of traveling, which would put significant pressure on the hospitality industry.

Summary

After roughly 5 weeks of largely shrugging off COVID-19 fears, U.S. equity markets finally succumbed to the uncertainties of the outbreak. Given the range of potential outcomes, it is not possible to predict what impact the virus will have on any market, let alone U.S. CRE, for which data is sparse and lagged. We believe the domestic CRE market is well positioned for all but the most extreme COVID-19 scenarios. In a true downside case, the U.S. CRE market is much better positioned today than it was before the financial crisis, with significantly greater cushion for debt holders.

4 CBRE.

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