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COVID-19 and Real Estate: What Can We Anticipate?

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COVID-19 was listed as the #1 issue in the 2020-21 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

If one thing is clear from the flood of COVID-19 news, especially news about the economy, it's that we don't know what to think yet. This is especially true for real estate, which lags the larger economy in its response to change even in normal times. Yet COVID-19 rose to the top of The Counselors of Real Estate's Top Ten list with the speed of a bullet.

To think about its impact, we consider three sets of data: (1) measures and models of the illness and its progress, (2) the real estate supply, and (3) a look at history. This last is essential because extrapolation from recent trends is not particularly relevant.

DATA SET ONE – THE VIRUS

When considering the virus and its path, we can rely on data models that consider likely duration and potential resurgence of the pandemic. These are now available at the level of country, state or province, and in many cases, individual hotspots. A close examination reveals which communities are in trouble, or headed for trouble, and which have sufficient hospital capacity and self-discipline to keep hospital demand below emergency levels. This response has been key to identifying those

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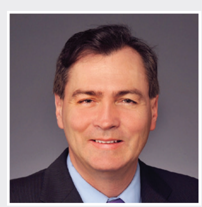

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communities that are first, last, or premature to relax controls and begin a return to the New Normal, and the new question – "Is the New Normal sufficient?" Such review is tempered by the absence of a cure and the slow emergence of treatment, vaccination, and immunity testing. The timeline and adoption of all three of these will define "Normal" because it will define consumer confidence and ability to congregate.

Last, our ever-changing understanding of transmission – will surface transmission and asymptomatic transmission be sufficient to necessitate barriers, systems and controls on a permanent basis? Or, are they a shorter-term concern with an interim response?

DATA SET TWO – THE REAL ESTATE SUPPLY

In examining real estate markets, we must consider existing fragility, adaptability to new demands, and potential relevance to new markets. Demand will be defined by the extent to which this crisis leads us to abandon old habits and adopt new ones. The duration of the lockdown has been a factor, and so is the confidence with which we emerge. Key questions without answers include: Will we be willing to shop in crowds, sit in theatres, and live close together to the same extent that we did in January?

And what new habits are we learning? In this Golden Age of the Late Adopter, have the rest of us become telecommuters, online shoppers, do-it-yourselfers, teachers and cooks? There will definitely be a shift at the margin, but is it wide enough to change demand for the built environment?

Among existing buildings, advantage may go to those that support resilience in the face of this and future crises—sufficient storage space, life-safety and isolation features, ability to reconfigure for surges in demand, isolation without loss of capacity, and ease of cleaning. This could reverse recent trends toward internet-enabled sharing of nearly everything—cars, kitchens, common areas, meeting space, workout space, and elevators. Much depends on the duration of the pandemic and emerging science on transmission.

DATA SET THREE – HISTORY

Though this virus is novel, its impact is not new. We can look to pandemics of 1958 or 1918 for specific instances, or we can address its symptoms individually. A broad approach: after the Great Influenza of 1918, a period of 4-5 years passed before people were comfortable in theatres and restaurants. A symptomatic approach: After the Great Depression, a generation was left with habits of thrift, savings and risk aversion that lasted their lifetimes and was not reset until the emergence of baby boomers. Following the rationing and shortages of WWII, a generation of conspicuous consumers emerged. Whether COVID-19 will define a generation and its behavior depends on its severity, its duration, and the hardships we endure while it passes.

DURATION, TRANSITION, NEW NORMAL

With these three data sets, we can think about what is happening, and what will. How long will the phased re-openings and a stagnant economy last? How will we restart a machine that's been more thoroughly shut down than anything since WWII? Will employees return to their former companies, or will we be retraining a new workforce for a new economy? How will landlords and tenants negotiate forgone and unpaid rent? Will lenders foreclose, forgo or renegotiate? Which businesses and groups of tenants will not return? Will students want to return to Universities that remain virtual?

And to what will we return? The impact on building operations, purchasing habits, and corporate tolerance for risk and interruption will depend on the habits being formed right now, and the losses sustained or glimpsed during this pause.

A BRAVE NEW WORLD

Good science fiction is the art of extrapolation and gives us some useful guides to COVID's impact. Huxley's Brave New World portrays a society based on isolation. Stephenson's Snow Crash describes a world of burbclaves, gates, and delivery of almost everything. Sci-fi writers are able to take chances, and to be wrong. To an extent, we must do the same. A combination of history, data, market understanding and smart extrapolation is what we need now. We may be wrong, but we cannot sit still.

This may be the greatest environmental experiment of our real estate lives. The change wrought by the virus and its aftermath will teach us about priorities, resilience, and demand in ways that we did not dare test before. The 2020-21 Top Ten Issues are an attempt to overlay this new world onto an already changing real estate environment.

SPECULATIONS ON THE POTENTIAL IMPACT IMPACT ON REAL ESTATE SECTORS

With all of this in mind, we turn to the real estate industry, first in general terms and then by sector. We expect there will be a short-term change in the way many people perceive and use the built environment. In the short-term, a "new normal" may comprise new protocols around social distancing, the wearing of PPE and new rules around congregating and crowding. Will these new protocols become long-term standard practices? It is anyone's guess. We expect that for most people, life as we know it may not return to "normal" until the discovery and comprehensive deployment of a vaccine or the perhaps the gradual emergence of "herd immunity" in the majority of the population. Bear in mind, that these are speculations as the scope, severity and extent of the pandemic and economic fallout are fluid.

Demand

Two primary factors may drive the effect of this pandemic on real estate markets. One reduces demand. The second may increase it. First, the reduction: Have we learned to work, entertain, and live at home? Have we discovered that we can cook, that we have too much stuff, and need to configure for more time at home? Second, the increase: Will we insist on lower density wherever we go? Will social distancing habits persist, and require reduced density in airplanes, airports, stores, restaurants, theaters, offices, banks and government buildings? This could require larger spaces and higher costs to accommodate the same functions.

Operations

How will expectations and laws drive the way real estate is run? Nonpayment of rent or rent reductions have become a major issue, with a less-than-simple response. Likewise for mortgages. Cleaning practices are both more stringent and more visible and are done according to safety and sanitation protocols. Traffic patterns in hallways, lobbies and elevators will affect the utility of buildings. Tracking of human contact may affect security systems, meeting scheduling and reporting.

Supply

Buildings do not obsolesce overnight, but instead do so as superior alternatives are built, or as needs change enough to drive new development. It is not clear which will be the case here. Safer circulation, easier cleaning, and ability to isolate components could be the "killer app" of new office buildings. Retail stores could further evolve from delivery warehouses for the masses to experience centers for a smaller crowd. A boost in online everything could force logistics-driven delivery to evolve beyond its already optimized designs.

By sector, specific speculations on potential impacts include:

Office

Open floor plans suddenly appear risky. Dedicated square feet per employee, long declining, may rise again. White-collar work from home just got its stress test. It's going better than expected, and paperless, cloud-based practices are being force-fed to even the most Luddite managers and employees. How many won't want to come back? Co-working is based on very short leases and a lot of shared facilities. Its downturn is happening much faster than conventional office space with its longer-term commitments.

Market effect is driven by industry concentrations—energy, hospitality, entertainment and travel sector concentrations will hit certain markets hard. Conversely, businesses focused on tech and tech adoption, web hosting, bioresearch and business processes may be gainers.

Though 2020 lease expirations approximate 10%, a slower decision process will increase vacancy and non-renewal. New decision drivers may include building safety, connectivity and cleaning standards, and ability to reconfigure.

Experiential Retail and Restaurants

Preliminary data suggests an 8.7% decline in retail and food services (restaurants) and job losses in the millions. While Federal funding and employment tax breaks help these businesses recover costs, many of these companies have very thin margins and may need additional capital to continue operations. Most grocery stores have seen increased sales while clothing and clothing accessories sales have plummeted by over 50%. Many well-known stores such as TJ Maxx and Victoria's Secret have been permanently shuttered. Widespread acceleration of online shopping, combined with anticipated small business failures, will accelerate the decline of the retail sector. Shoppers may become more "germophobic" and want to avoid or minimize their physical retail shopping. A shift to online grocery shopping may impact existing grocery-anchored centers. Commodity and big box stores will suffer most from this trend, but those that can shift to either intimate experiential formats or curbside online hybrids may fare better. Lingering trepidation about human contact may reduce demand for fitness centers, nail and hair salons, and other intimate settings. Strip centers will be adversely affected.

Entertainment, Conferences and Gaming

Anxiety about proximity will likely last until vaccines, immunity, or other advances in treatment are widespread and accepted. As referenced earlier, confidence did not return for 4-5 years after the Great Influenza of 1918. Casinos, theater, cinema, stadiums and conference centers are opening, but at very reduced capacity, and may remain so for years. Operations will require extra-visible sanitation, possible audience dispersion, and challenges not yet anticipated. Changes in movie releases may prove durable and drive a shift to in-home consumption.

Conventions and meetings, having shifted online, may not fully shift all the way back, especially as organizations look to cut costs after a blow from the weaker economy.

Travel

Travel has been dramatically reduced because of concerns around COVID. The decrease in travel affects airlines, hotels, trains, cruise ships, ridesharing and tax/limo services. Cruise ships may see a lasting diminution in bookings.

Public transport feels riskier and may drive demand toward one's own car or bicycle. Until confidence is re-established, the trend toward transit-oriented development may be slowed or even reversed.

Multifamily

Long seen as the battleship sector, strong in rain or shine, multifamily is not without challenges. Massive, historic job loss reduces the tenants' ability to pay. Forbearance has appeared in the form of lengthened leases, rent reductions, or loss of tenants. Mandated non-eviction, rent holidays or other mandated aid might persist through a recovery. Markets hit hard by industry job losses will be hit especially hard in the multifamily sector. However, income losses in the under-40 market may help, in that tenants will be less able to obtain mortgages and will remain renters.

Hotel and Hospitality

During the height of the pandemic, occupancies dropped to 10% or lower, along with precipitous declines in food and beverage revenue. The industry transitioned from strong fundamentals to perhaps the worst performances in history. Will business travel be replaced by online meetings, damping any return to prior levels? In-person conferences and meetings may have to wait until mitigation for the pandemic is in place and accepted.

Data Centers and Cell Towers

Data centers represent a bright spot in any portfolio due to an enormous rise in demand. Cell towers should also do well with increased internet activity and cell communications. Voice calls and data transmission are up more than 100% since the start of the crisis.

Medical Office Buildings

While COVID-driven medical utilization has increased, the rest of medicine has suffered, and a growing backlog of elective or discretionary demand means that growth will outlast the current crisis.

Perceived risk of infection in hospitals will accelerate the trend toward distributed and decentralized services in MOBs and clinics. Future facilities will see larger crisis preparation components such as drive-through testing and enhanced communications pre-visit.

Student Housing

Forced adoption of online learning decreased the affinity between students and their universities. The inability to administer college testing will result in unusual admissions patterns in fall 2020. Generation Z is smaller than the previous millennial generation, but typically higher college enrollment during a recession may offset this. The "forced experiment" of online education may lead to hybrid delivery models going forward. Being proximate to the university may not command the premium it once did if more students are taking their courses or their entire degrees online.

Senior Housing/Skilled Nursing

Senior housing was already suffering from weak fundamentals. Too much supply relative to the demand over the last decade is to blame. Skilled nursing was characterized by low margins and declining reimbursables. Over the last two months, we are seeing that high-density concentrations of the elderly makes for a dangerous setting for the spread of the virus. Across the nation, we have seen numerous senior housing facilities that have high rates of infection and fatalities. This has created a new risk factor and poses new questions. Are senior housing facilities safe? Are they, like cruise ships, highly contagious vectors for the spread of the virus? Will this change our view of senior housing—from a safe haven and solid investment to a dangerous and potentially high-risk sector? Will we see more seniors being taken care of in home environments instead of purpose-built, dedicated buildings? At any rate, the future for senior housing and skilled nursing is far less certain than ever before.

Industrial

The WTO estimates a depression-like decline of 32% in global trade. Supply chains will continue to diversify away from China with more manufacturing shifting to local sources. Markets with significant speculative development will suffer disproportionately. Failures in industries that rely on just-in-time manufacturing will increase the need for warehousing and warehousing management.

E-commerce already led industrial space absorption, and this will accelerate that, but be offset by a slowdown of consumer demand. Business-to-business distribution, especially of food and cleaning supplies, will respond permanently to the demand shift of many people working from home.

THE TRANSITION AND THE RETURN

The recovery of the people and business will not be easy. The modern economy is a relay race, with goods, money and ideas passed from person to person with great speed. In a shutdown we do not know what will come back and in what order, and what has been broken for the long term.

In this relay race, there are now batons on the ground everywhere, and roads that have been washed out or closed. Enormous backlogs of demand, maintenance and production will slow a restart. We are already running out of places to store oil, for example. Major food producers were temporarily shut down by illness, yet pigs continue to grow. Millions are afraid to go to a dentist or a salon, but the demand persists.

Real estate is a lagging indicator. If the economy takes a few years to recover, our industry will show ripples for a few more. •

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