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US private real estate

Implications and opportunities amid COVID-19

July 2020

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Executive Summary

The outbreak of COVID-19 has rapidly spiraled into a severe blow to the US economy that will have negative short-term consequences and could lead to long-term structural changes for real estate markets. Although parallels can be drawn to past recessions, this was different for several reasons — some positive, some negative. First, the swiftness of the COVID-19 downturn was unprecedented. Within days, cash flow for certain property types (such as hotels) ground to a virtual halt, and most property sectors are still experiencing various levels of decreased rent collection compared to historical figures. In contrast to previous recessions, real estate entered the COVID-19 downturn with solid fundamentals — relatively controlled supply, low vacancy, healthy transaction volumes and responsible use of leverage. The depth and length of the recession are currently unknown. But based on the strong position in which real estate entered the downturn, we remain optimistic that over the medium term, real estate will regain its solid foundation despite the bumpy road ahead.

However, dislocation creates opportunities, which will likely be the case with the COVID-19 downturn. While most sectors will experience some distress, the disparity between property types will be pronounced. To capitalize on the distress, investors will have to maintain a contrarian mindset and conviction to target property types such as hotel and retail. A low-interest-rate environment is likely to persist in the years that follow the pandemic, favoring property types with lower correlation to GDP and those that rely less on economic growth. These sectors will become more attractive, and investors should focus on diversifying their private real estate portfolios by property type, geography and cash flows that have correlations to various economic drivers.

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COVID-19 trends and policy impact on the real estate sector

The shape of the COVID-19 real estate recovery and its impact on specific property types will depend on multiple factors. Below are some of the most critical.

- **Government policy:** The $2 trillion+ Coronavirus Aid, Relief and Economic Security (CARES) Act[1] is a massive fiscal and monetary response that may have set a floor underneath the economic disruption, providing many forms of protection for properties. Policy response has been unprecedented, but more may be needed as programs expire. We expect the government to extend some of the programs relevant to real estate :
  - $350 billion has been allocated for the Small Business Administration to provide loans up to $10 million per business. Any portion of a loan used to maintain payroll, keep workers on the books or pay for rent, mortgage and existing debt could be forgiven. From a real estate perspective, this aid is crucial to enable such businesses to pay employees and meet other obligations, including rent. These loans are also available to franchisees who own multiple or individual hotels. The Paycheck Protection Program (PPP) that preserved employment for many during the pandemic will potentially expire in late summer, which could negatively affect the ability of individuals to purchase goods and pay rent and mortgages. The negative consequences could have a ripple effect throughout the economy and real estate market if the program is not extended.
  - Individuals received cash payments totaling $300 billion. Most individuals earning less than $75,000 (with a higher limit for married couples) received a one-time cash payment of $1,200. Married couples each received $1,200, and families received $500 per child. This stimulus helped Americans meet financial obligations and contributed to stabilizing the economy, benefiting all property types, as it facilitated mortgage payments, apartment rent payments and spending at retail establishments.
  - The CARES Act increased unemployment benefits, broadened the range of qualification and added 13 weeks to eligibility. While states will continue to pay unemployment benefits to people who qualify, CARES provides an additional $600 per week from the federal government. The expanded unemployment benefits have helped stabilize the economy and provide cash flow to individuals,

[1] U.S. Department of the Treasury. "The CARES Act Works for All Americans," https://home.treasury.gov/policy-issues/cares.

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further benefiting most property types. Note that many components of the stimulus that are helping the economy will expire later this summer.

- **Behavior:** How individuals and businesses behave will have both short- and long-term implications for the real estate sector. Retail, hospitality and senior living have seen the most significant impact from social distancing requirements across the US. These measures and the economic slowdown have contributed to the significant downturn in the real estate transaction market. Air travel is also difficult under the current social distancing guidelines, making it challenging to visit properties physically and accurately underwrite prospective investments.
- **Future of the virus:** Future results also depend on whether the virus can be contained quickly (through treatments or vaccines) or its continued spread requires reinstatement of quarantines and other limiting measures. The course of the virus will have a direct impact on all property types.

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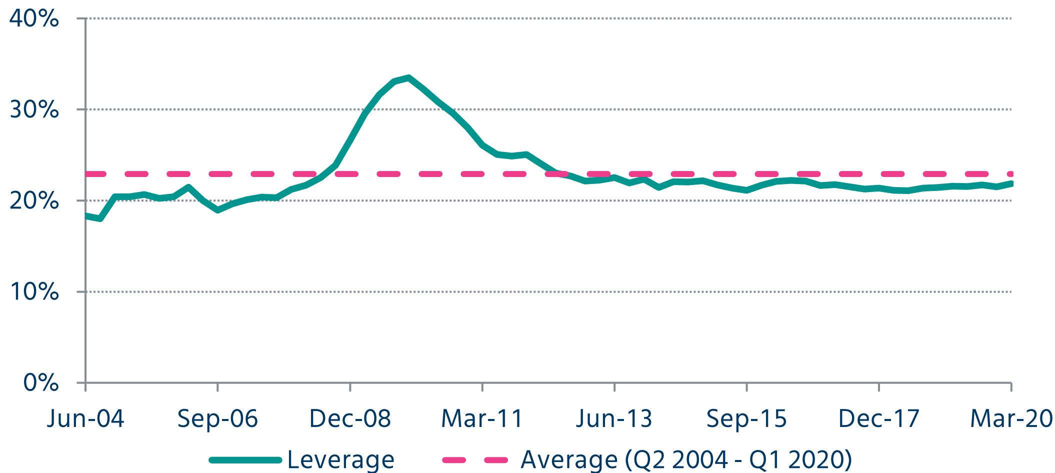
Real estate fundamentals entering the pandemic

Before this recession, real estate fundamentals were on a solid foundation. Although most property types will suffer short-term consequences from the severe and rapid downturn, the measured approach most investors and lenders implemented after the global financial crisis (GFC) is likely to temper the effects.

Leverage — loan-to-value

Throughout the most recent cycle (2009 to 2020), leverage has been much more reasonable than in previous cycles (Figure 1). Following the GFC, government regulations and more conservative lending practices from traditional lenders forced investors to reduce their use of leverage. This more cautious lending environment resulted in capital structures with larger capital cushions than those experienced during the GFC.

Figure 1. NCREIF National Property Index leverage ratio



Source: NCREIF NPI, Mercer calculations.

Vacancy and supply (construction)

Supply growth is much more contained than it was before the GFC, even in the highest-growth markets. This also contributed to a strong start to 2020, signaling that occupier fundamentals were supportive of rent

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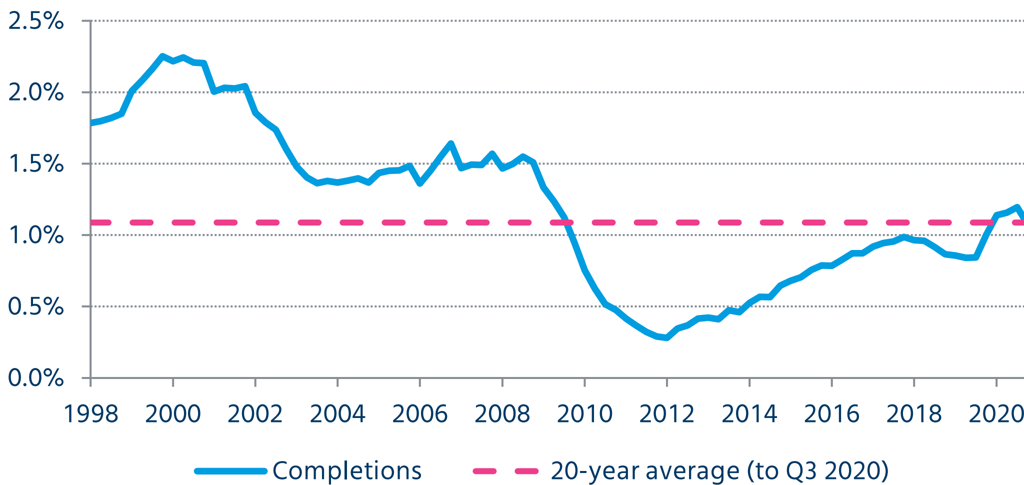
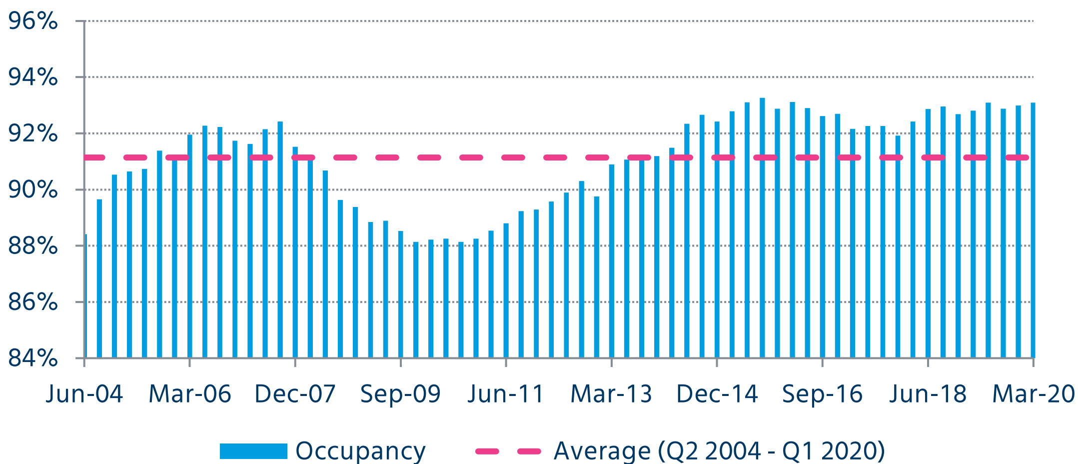
growth across most property types (excluding retail). Heading into the GFC, supply was approaching 2% of total inventory, compared to an average of less than 1% during the 10 years leading up to COVID-19 (Figure 2). The positive supply and demand fundamentals also led to near-record-high occupancies (Figure 3). However, in the near term, record-setting unemployment will put downward pressure on occupancy — but without the added pressure of an onslaught of new supply that accompanied previous recessions.

Figure 2. Completions as a percentage of total inventory – US primary property sectors



Source: CoStar, Axiometrics, Heitman Research. Note Q3 2020 data is forecasted.

Figure 3. NCREIF occupancy



Source: CoStar, Axiometrics, Heitman Research, Mercer calculations.

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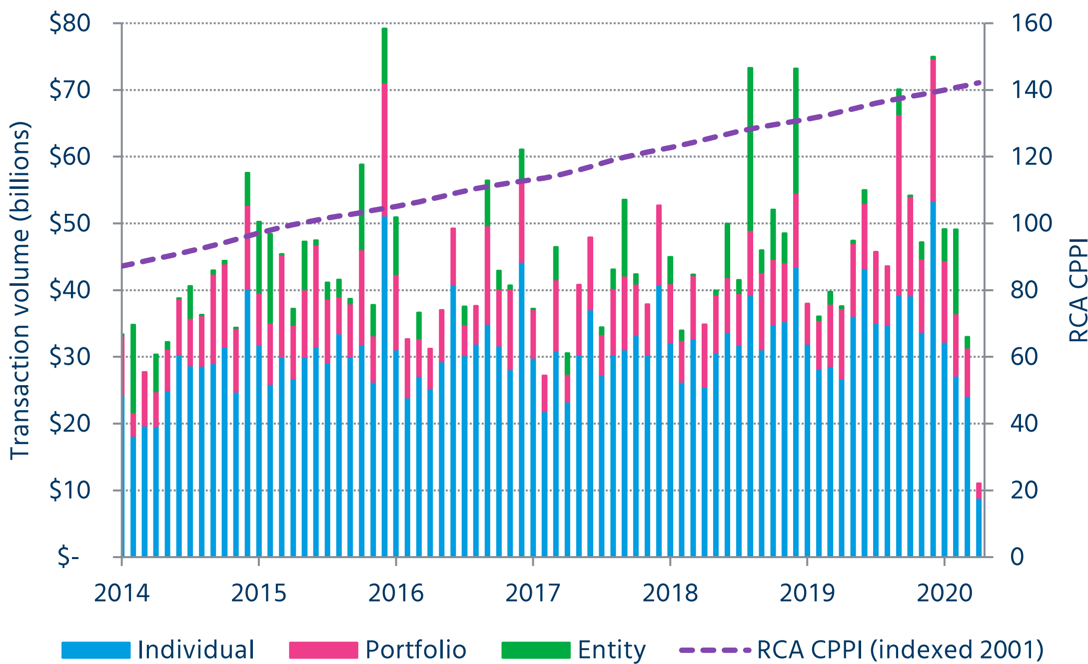
Capital markets

Like most real estate fundamentals, capital flows were reasonably healthy heading into 2020. But no property type has escaped the effects of COVID-19. The lack of visibility into underwriting assumptions, inability to predict cash flows reliably and uncertainty surrounding a vaccine caused transaction volumes in April to plummet by 71% year-over-year to $11.0 billion (Figure 4). This volume is the lowest on record since April 2010.[2] Preliminary data indicates that May volumes did not fare much better. As mentioned above, the reduced buyer pool is partly due to the inability of investment managers to conduct physical property inspections (an important aspect of the property acquisition process). Once travel and social distancing restrictions are lifted, some level of transaction activity will rebound.

Figure 4. Monthly real estate transaction volumes and pricing



Source: RCA transaction volume (Monthly data January 2014 - April 2020).

The COVID-19 downturn came on suddenly compared to the pre-GFC housing market collapse, for which warning bells had been ringing for years. The speed at which the activity of buyers has disintegrated could lead to a faster race to the bottom for market prices.

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[2] Real Capital Analytics. *US Capital Trends — The Big Picture*, April 2020.

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US real estate during and beyond COVID-19

As we've mentioned, most real estate markets entered the crisis with relatively sound fundamentals. Many real estate investments will therefore ride out the downturn with limited adverse effects. Other investments and investors, however, will experience severe impacts that will present opportunities for buyers once the price discovery period passes and buyers and sellers begin to transact. Market fluctuations and distress could provide attractive buying opportunities in some sectors and from some poorly leveraged owners, but the window of opportunity will be narrow, likely closing by 2021.

The pandemic is accelerating structural forces already visible in real estate before the onset of this recession. These forces have provided tailwinds for the industrial sector and created challenges for brick-and-mortar retail as well as office properties.

- **Industrial/warehouses:** The COVID-19 response has accelerated adoption of e-commerce, which was already a major catalyst for change in the industrial sector. According to retail intelligence group Acosta, 33% of online grocery shoppers made their first-ever online grocery order in March or April due to social distancing and shelter-in-place rules.[3] The pandemic has further acclimated consumers to purchasing products online, which will likely accelerate the increase in online sales as a percentage of total retail sales.
- **Brick-and-mortar retail:** Sheltering in place has resulted in the closure of most shopping malls, at least temporarily. The lost revenue disrupted many retailers and has caused a spike in store closings and bankruptcies, continuing a growing trend of the past few years. COVID-19 arrived at an already challenging time for regional malls and some lifestyle centers. These subsectors of brick-and-mortar retail were already facing tenant closures and an oversupply of retail space. The COVID-19 downturn will exacerbate the issue for many shopping centers and retail tenants, further driving down the market value of these assets.
- **Offices:** The drastic adoption of remote working in response to COVID-19 has demonstrated that workspace is flexible. Within weeks of the pandemic's onset, up to half of the American workforce was working from home, more than double the fraction of remote workers in 2017 and 2018.[4] Thus, as with e-

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[3] Acosta. *Grocery Shopping During the COVID-19 Pandemic*, 3rd Edition, April 2020, https://www.acosta.com/news/acosta-analyzes-new-wave-of-changes-to-us-consumer-behavior-amid-covid-19.

[4] Guyot K, Sawhill IV. "Telecommuting Will Likely Continue Long After the Pandemic," Brookings, https://www.brookings.edu/blog/up-front/2020/04/06/telecommuting-will-likely-continue-long-after-the-pandemic/.

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commerce, the pandemic may have accelerated this trend. After COVID-19, there will almost certainly be a reversion to historical telecommuting practices. However, the pandemic has forced businesses to invest in the technology and culture needed to implement a flexible workforce, which will likely lead to reducing office space and leasing expenses.

Another issue exposed by COVID-19 telecommuting expansion is the awareness of flexible office space, such as WeWork, that allows companies to lease space as needed. Small business employers now recognize that they can give up expensive long-term leases, go virtual and use flexible office space for meetings or when otherwise required.

Real estate investors will need to remain disciplined and focused on implementing their long-term portfolio strategies. Real estate portfolios should include strategies that are less reliant on macroeconomic factors and driven more by thematic factors, such as demographics. Although few property types are immune to the impact of COVID-19, thematic-driven sectors (excluding senior housing) have generally been resilient and should offer attractive investment opportunities in the near term. Below are some examples.

- **Affordable apartments:** According to the National Multifamily Housing Council (NMHC), 94.6% of rent payments were made during April 2020, a 3.1% point decrease from April 2019. May 2020 rent payments were 95.1%, which is only a 1.5% point decrease from May 2019.[5] PPP and unemployment have significantly bolstered rent payments. There are some uncertainties about collecting rent when the stimulus runs out later in 2020, but extensions to the CARES Act would strengthen this sector. Apartments generally perform well during recessions, as renters will rely on savings and family support to remain in their apartments. People also tend to avoid large financial commitments, such as mortgages, during recessions. We believe the apartment sector will continue to be an attractive investment, with affordable housing bolstered by government stimulus and a push to eradicate the divide in suitable housing across income levels. Most apartment investments will remain favorable due to the overall housing shortage in the US, household formation by millennials, affordability concerns and stringent requirements for attaining a mortgage.

- **Senior housing:** Although COVID-19 has severely affected short-term senior housing demand (particularly for facilities offering the most advanced care) and net operating income (NOI), we believe this sector will continue to be in demand. The risk of COVID-19 to senior populations has affected occupancy and increased operating costs to keep facilities clean and staff and residents protected. However, our view on senior housing beyond the immediate crisis remains positive given the aging population in the US. The current crisis has been most acute in advanced-stage-of-care facilities, but investments in senior living range from independent living to advanced care. Given the baby boomer contingency, facilities specifically for seniors will likely continue to be in high demand.

[5] NMHC Rent Payment Tracker, https://www.nmhc.org/research-insight/nmhc-rent-payment-tracker/.

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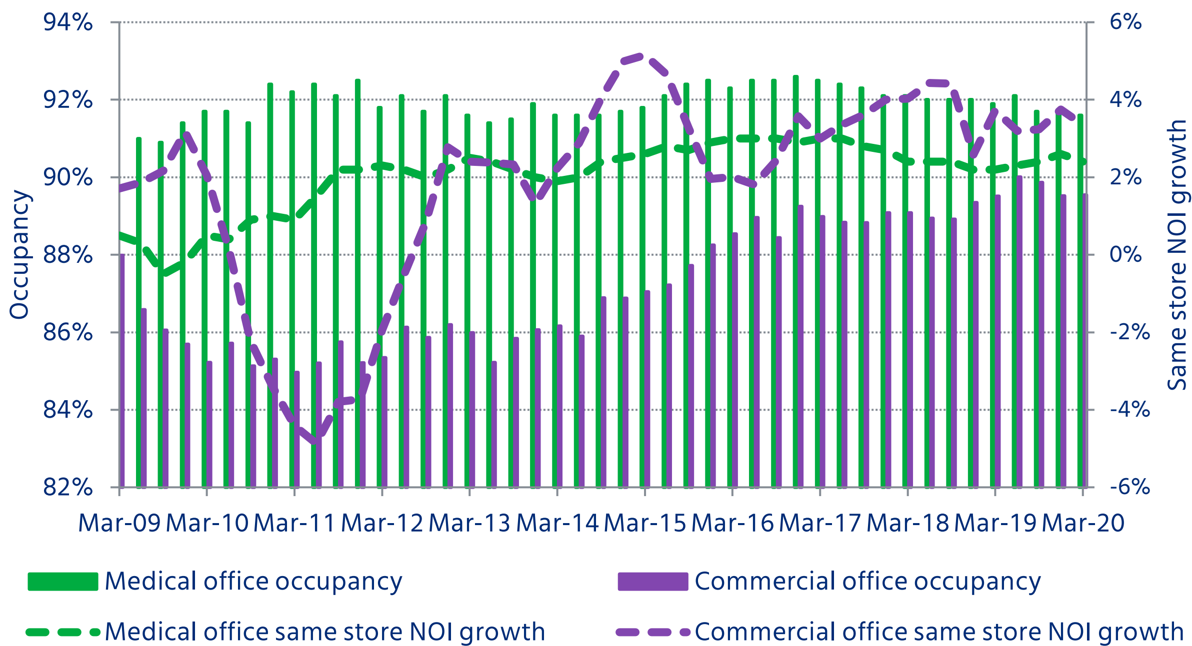
- **Medical office:** This property type proved resilient during the aftermath of the GFC when NOI declined modestly for only two quarters (Q2 and Q3 2009) (Figure 5). Compared to traditional office buildings, medical offices are not as closely correlated to GDP or the job market. As with senior living, the primary macro drivers are demographic trends tied to the aging US population and the increasing cost of healthcare. The number of US residents over 65 is expected to double between 2010 and 2040, which will increase the need for medical facilities. Additionally, shifts in reimbursement policies are driving patients to lower-cost outpatient facilities for services previously only offered in a hospital. Over the past few years, due to increased supply and development, medical offices have experienced slight headwinds. However, we expect the sector to recover quickly from the impacts of the pandemic and absorb the recent supply given the strong thematic forces behind the property type.

Figure 5. Occupancy and same-store NOI growth, medical office versus commercial office US (Q1 2009 to Q1 2020)



Source: Heitman, Revista, NCREIF NPI.

- **Life science/lab space:** Before COVID-19, this sector was well-positioned for several reasons. Strong funding continues to aid the sector. For example, life science venture capital grew from $4 billion in 2004 to $16 billion in 2018, and biotech employment has grown five times faster than total US employment. COVID-19 is providing additional tailwinds from increased R&D funding and significant demand generated from COVID-19 R&D. At the onset of the pandemic, there was heavy development of diagnostics to identify COVID-19. Over the medium term, life science properties will be used for

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identifying and testing treatments and vaccines. Over the long term, the pandemic has created more urgency to develop novel therapies and mass-produce vaccines. There is now more awareness of the need to research infectious diseases in general as other dangerous viruses exist that could trigger the next pandemic. Finally, a government-led initiative to shift the pharmaceutical supply chain to the US and improve the national stockpile will further bolster the attractiveness of this sector.

- **Data centers:** This property type has seen little impact from COVID-19. If anything, demand for data centers has increased during the pandemic due to the rise in e-commerce and flexible working. During the short term, companies have realized the need to decentralize and enhance work-from-home technology, which has increased their reliance on the cloud. Long term, the fundamentals for datacenters remain attractive. Forecasters predict data usage and storage will grow exponentially over the next five years, primarily driven by technology such as artificial intelligence and online gaming.[6] Furthermore, top cloud providers, such as Amazon, Google, Microsoft and Facebook, continue to increase data center capital expenditures annually, further signaling the need for additional data storage assets.

- **High-yield real estate debt:** This sector continues to see significantly lower transaction volumes as lenders wait for more reliable operating income projections. And many borrowers who don't require debt capital for acquisitions aren't currently initiating new loans. Government-sponsored lenders have remained open for business, and large insurance companies and banks have selectively resumed lending, albeit with lower loan-to-value (LTV) ratios, higher spreads and stricter covenants. These traditional direct lenders are retrenching and focusing on stabilized, high-quality assets with strong sponsors, primarily in multifamily, office and industrial property types.

  Attractive risk-adjusted opportunities exist across the value-add risk spectrum and in development sectors where many B-note, mezzanine and preferred equity lenders have pulled back or left the market due to liquidity issues. The dislocation in the structured credit markets has also significantly impacted structured product warehouse lenders, resulting in ample hung loans originally intended for securitization. These market dynamics have created opportunities in bridge and rescue financing, construction lending and secondary-market note sales. As forbearance periods run their course and bank warehouse lenders start making additional margin calls, we expect secondary note sales to increase. Overall, high-yield market dynamics have shifted significantly toward the lenders, especially those with ample available capital and robust origination networks willing to take on asset-level risk. Although lending volume will remain reduced, investors can expect better compensation for taking on risk, creating a favorable investing option in high-yield real estate debt.

- **Hotels:** One final relevant property type we shouldn't overlook is lodging. COVID-19's impact on this sector was so rapid that the magnitude of its decline was unprecedented. Distinct from industrial, retail

[6] CBRE North America Data Center Trends Report, H2 2018

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and office properties, hotels had no existing positive or negative thematic changes accelerated by the pandemic. Liquidity in the hotel market has all but evaporated. Investment sales of hotels were halted by the economic shutdown and travel bans, which resulted in only eight hotels sold in April. This is the lowest number of hotel transactions recorded in any month in the history of Real Capital Analytics coverage.[7]

Hotel occupancy has also dropped to unprecedented levels. These events have culminated in the temporary closure of many hotels. The typical one- to two-night average lease duration makes the sector highly sensitive to GDP. Revenue for hotels falls when individuals and businesses reduce travel, typically during economic downturns. Travel restrictions and the elimination of group meetings have reduced travel so significantly that some hotels have closed and will not reopen until restrictions are lifted and leisure and business travel begins to materialize.

Regardless of the reopening time period, it is uncertain when travel levels will return to historical averages. However, we believe that well-located, newer hotels with high standards for cleanliness and above-average property management practices will rebound to pre-COVID-19 levels more quickly. Lodging sector returns will be divided between newer, well–maintained select-service hotels with reduced overhead and full-service conference-driven hotels that rely on additional revenue from food and beverage, conferences and other ancillary forms of income.

[7] Real Capital Analytics. *UA Capital Trends — Big Picture*, April 2020.

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Figure 6. Summary of property views pre- and post-COVID-19 as of July 2020

		COVID-19 impacts	
	Pre-COVID-19 health	Near term	Longer term
Industrial/warehouses	Green	Green	Green
Retail — malls/lifestyle centers	Maroon	Maroon	Maroon
Retail — grocery-anchored/power centers	Yellow	Yellow	Yellow
Offices	Yellow	Yellow	Yellow
Apartments — high-end	Yellow	Yellow	Yellow
Apartments — affordable	Green	Yellow	Green
Senior housing	Yellow	Maroon	Green
Medical offices	Yellow	Maroon	Green
Life science	Green	Green	Green
Datacenters	Yellow	Green	Green
High-yield real estate debt	Green	Yellow	Green
Select-service hotels	Yellow	Maroon	Yellow
Full-service hotels	Maroon	Maroon	Yellow

Pre-COVID-19 health: Good (green) – (yellow) – Bad (maroon)

COVID-19 impacts: Narrow impact (green), Moderate impact (yellow), Severe impact (maroon)

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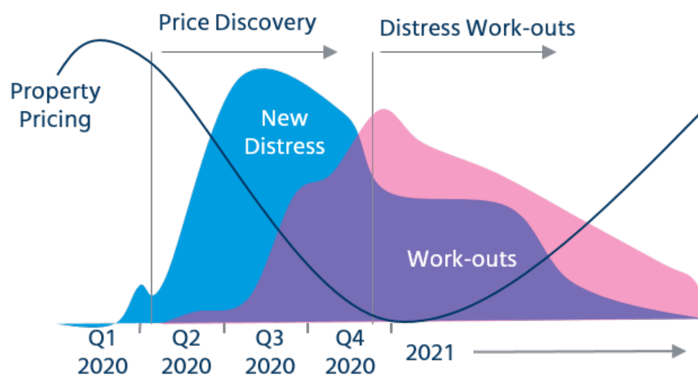
Upcoming real estate opportunities

Dislocation and distressed opportunities

Real estate investors seeking to take advantage of the impending dislocation will have to be patient. The current stimulus and willingness of lenders to work with borrowers will enable distressed owners to "kick the can down the road," and it will take time to distinguish the attractive dislocation opportunities from the assets with long-term issues.

We estimate that parts of the CARES Act will allow businesses to pay their employees and rent until sometime in the fourth quarter of 2020. Many balance sheet lenders have provided 90+ days of forbearance, which will also run out before the end of the year. At some point, lenders will require borrowers to meet LTVs and other covenants. Therefore, distressed property owners, particularly in hotels and retail, will have to find another lifeline, most likely in the form of rescue capital, much of which will be provided by private equity and debt real estate investment managers. We expect that rescue capital will take the form of bridge loans and preferred equity. Our best estimate is that price discovery will take place for most of 2020. However, distressed opportunities will peak in 2021 (Figure 7).

Figure 7. Expected stages of COVID-19 real estate cycle



Source: Mercer, for illustrative purposes only.

Non-GDP-linked sectors

Favorable demographic and structural trends, such as advancements in technology and population growth, continue to support non-traditional property types, such as senior living, life science/lab space, medical offices, data centers and self-storage. These properties are more needs-based and tend to have higher

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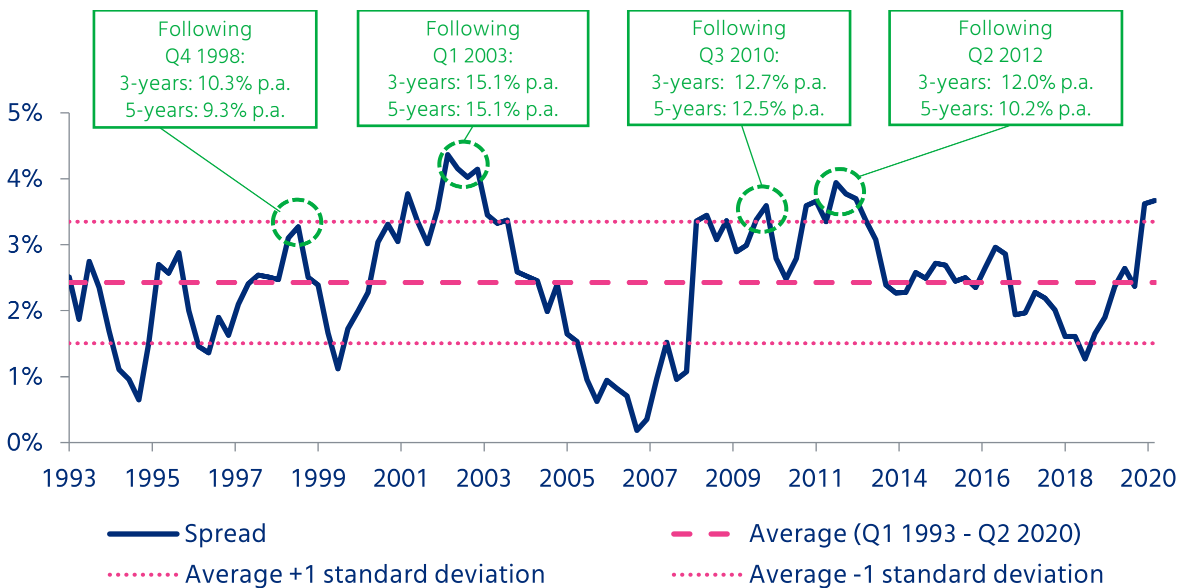
income and less correlation to GDP. We believe these demographic-driven strategies provide increased diversification, stability and resilience throughout a cycle, especially during a downturn such as the COVID-19 pandemic. Since the GFC, non-GDP-linked sectors have become a growing portion of many real estate portfolios, and (as discussed above in Section 4) we expect COVID-19 to accelerate the structural changes that make these properties attractive.

Core

Core real estate is defined as high-quality, well-located leased assets with stable tenant and cash flow characteristics. Market values for core assets are typically adjusted quarterly and anticipated to decline or record flat appreciation for the remainder of 2020. It is difficult to determine the exact time in which valuations will bottom out, but core real estate will emerge strongly from this crisis for several reasons.

Entering the crisis, this style of investing exhibited high occupancy and strong cash flows. And as Figure 8 below illustrates, a reasonable time to invest in core funds is when the cap rate spread to treasuries exceeds the long-term average by one standard deviation. It is worth mentioning that historical cap rate spreads comparable to current core levels (1+ standard deviation) have produced returns well into double digits over the subsequent three to five years. The spread will likely widen since we expect cap rates to increase and interest rates to remain relatively stable. History has shown that the most opportune time to enter the core market is after a market downturn. Therefore, we believe that H1 2021 will be an opportune time to add core-style assets to portfolios.

Figure 8. NCREIF cap rate spread of 10-year treasury yields



Source: NCEREIF NPI, Mercer calculations

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What should investors do?

We are optimistic that real estate will rebound relatively quickly since the asset class was on solid fundamentals before the COVID-19 pandemic hit the US. Although the pandemic came on more rapidly than any downturn in recent history, we believe the swift government policy response should provide a floor to the depth of the downturn. As parts of the US economy continue to reopen, the biggest questions that remain are as follows:

- **Government policy:** Will there be a need for additional government intervention once the existing stimulus expires? We believe most property types will suffer for a longer period unless the government extends some aspects of the policy response.
- **Behavior:** To what extent will individuals and businesses return to normal? Although only time will tell, we believe COVID-19 has led to more efficient and less costly use of e-commerce and the cloud. The impact on real estate will be uneven, with some property types winning and some losing.
- **Future of the virus:** How long will it take to produce a treatment or vaccine? The future of the virus and its impact on real estate ultimately depends on the development of these resources. A major spike in the number of COVID-19 cases during late 2020 and into 2021 would have a significant effect on most economic predictions.
- **Other events:** Will other domestic events (for example, uncertainty over trade and the presidential election) and global events (for example, Hong Kong/China) exacerbate the current recession?

We continue to believe in resilient investment strategies driven by long-term structural trends, which many private real estate investments exhibit. As mentioned above, one of these trends is the ongoing structural shift to e-commerce, which has fundamentally changed the nature of the industrial and retail sectors. We expect the substantial increase in consumer adoption during social distancing and quarantine periods to accelerate this trend. We also see compelling demographic-driven investment trends that could extend beyond the new decade and into the next.

Distressed opportunities across most property types, particularly within hotel and retail properties, will emerge from the COVID-19 dislocation. However, investors will need to maintain firm conviction and a contrarian mindset when pursuing these opportunities. We also believe private core real estate will provide attractive opportunities on a risk-adjusted basis.

Looking beyond COVID-19, we note that demographic-driven investment trends have significant runway. These trends are driven by the two largest generational cohorts in American history, with the baby boomers

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(1946 to 1965) creating a rise in demand for healthcare-related strategies, such as medical offices and senior housing, and the millennials (1980 to 1995) driving demand for affordable apartments and e-commerce-related sectors.

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