COVID-19: real estate valuation considerations

June 2020

EY

Building a better working world

COVID-19: real estate valuation considerations

The impacts of COVID-19 on the global and national economy are far-reaching and well-documented — the sudden shutdown of businesses, enormous unemployment claims, years of GDP growth lost in a matter of weeks and record-setting government stimulus packages are in the news daily against a backdrop of continued uncertainty regarding the long-term health and economic effects of the virus. In this environment, the valuation of real estate, a highly subjective endeavor in normal times, is made more arduous by the absence of real-time data — a direct impact of the near shutdown of the real estate leasing and transaction markets for most sectors beginning in March. The data that does exist provides mixed signals — the National Council of Real Estate Investment Fiduciaries (NCREIF) Index, which tracks core property values reported by institutional funds, reported a quarterly increase of 0.71% as of 31 March 2020; however, as of that date, US equity REIT share prices declined by 24.20% since December 2019, implying that stock market investors, at least, believe that the real estate underlying these shares had lost value. These conditions raise some important questions for accounting and finance professionals tasked with providing thoughtful and well-supported valuations to their investors and other stakeholders on a current basis, among them:

- How does the market view the impacts of COVID on real estate values?
- How should cash flow assumptions be changed to reflect the short- and long-term impact of the virus on individual property as well as on the macroeconomy?
- How should property-level discount rates and terminal capitalization rates be impacted? Or should they be changed at all?

In an effort to answer these questions and gain other insights into how real estate market participants are thinking about COVID-19 and real estate valuation, EY professionals conducted a survey of over 200 professionals active in the US real estate markets. The survey was conducted in late April/early May and included representatives from private equity funds and public REITS, as well as brokers, asset managers and lenders. Our survey asked participants 18 questions about their expectations regarding value trends, transaction activity, discount and capitalization rate changes, and other questions about the duration and impact of the COVID-19-induced market turmoil. In this article, we have featured some of the most meaningful findings from our survey, with the objective of helping our clients and friends to think about values in the second quarter and beyond.

Property values

Real estate has lower liquidity and less volatility than equity investments. The stock market is an immediate and real-time representation of market sentiment; real estate market values tend to move more slowly due to the presence of long-term leases, 10-year-plus investment horizons and the higher cost and longer time frame required to ultimately sell an asset. This is why market values do not adjust as quickly as REIT prices, which are down as much as 60% from late February to the middle of May. However, this metric does provide a perspective on investor expectations and cannot be ignored when considering property-level valuations. In contrast, the quarterly NCREIF Property Index increased by 0.71% in the first quarter, though the results varied by sector. The NCREIF index is based on values reported by institutional funds to their investors, which are generally determined by appraisers. Given the scale and economic impact of the pandemic was not fully apparent as of 31 March 2020, it seems likely that the appraisers did not fully reflect its impact in their first quarter values.

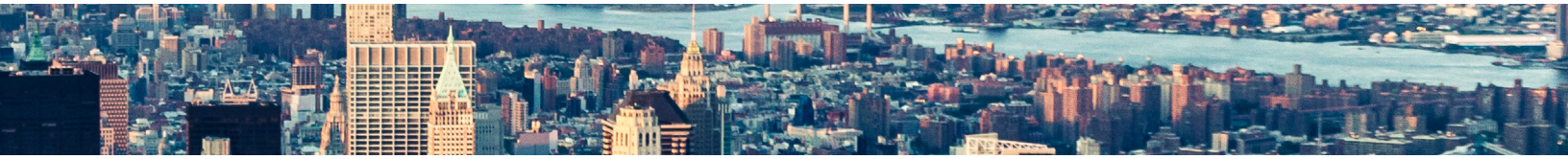
In order to gain some insights into investor expectations regarding property values, we asked our survey participants how they believe property values will be impacted by COVID-19. Not unexpectedly, lodging, tourism and gaming properties, as well as retail properties, are expected to fare the worst. Indeed, over 50% to 90% of respondents indicated that they expect values in these sectors to decline the most as a result of the effects of COVID-19. The industrial sector was expected to be the least impacted, with 55% of respondents expecting no change in values for this sector and 28% expecting higher values.

Property value impact

How do you think property values will be impacted as a result of COVID-19?

	Lodging, tourism and gaming	Retail	Developments in progress	Office
Significant increase	1%	2%	3%	3%
Increase	1%	1%	1%	2%
No change	7%	6%	30%	30%
Decrease	18%	27%	30%	42%
Significant decrease	72%	63%	37%	23%

	Apartments and student housing	Single-family residential	Industrial	Health care
Significant increase	4%	5%	10%	17%
Increase	2%	7%	18%	13%
No change	48%	50%	55%	41%
Decrease	32%	26%	8%	24%
Significant decrease	14%	13%	8%	5%



Transaction activity

We asked our survey participants about their plans for acquisition and disposition activity going forward. Respondents generally expect to curb dispositions of real estate as a result of COVID-19; however, a significantly smaller percentage expect to curtail acquisitions. This suggests a coming disconnect in the market between buyers and sellers that will likely lead to limited transaction activity for the remainder of 2020 in many property sectors. Additionally, while there is a significant amount of "dry powder" equity available for investment that could reignite the transaction market, much of it is seeking distressed opportunities, which may not manifest themselves until late in 2020 or early 2021, once properties have reopened, lender forbearance periods have ended and the extent of the long-term economic damage wrought by COVID-19 is more apparent.

Valuation assumptions

Regarding discounted cash flow valuation assumptions, our survey participants indicated a preference for adjustments to cash flow items as opposed to discount rate and terminal capitalization rates, in order to model the impact of COVID-19 on property values. A majority of participants indicated that they intend to make top-line revenue adjustments, which could include lowering near-term tenant renewal probability, slowing the pace of speculative leasing and modeling rent concessions and deferrals. Only 26% of respondents indicated that they plan to adjust the discount rate applied to their cash flow forecasts and only 22% plan to increase terminal capitalization rates.

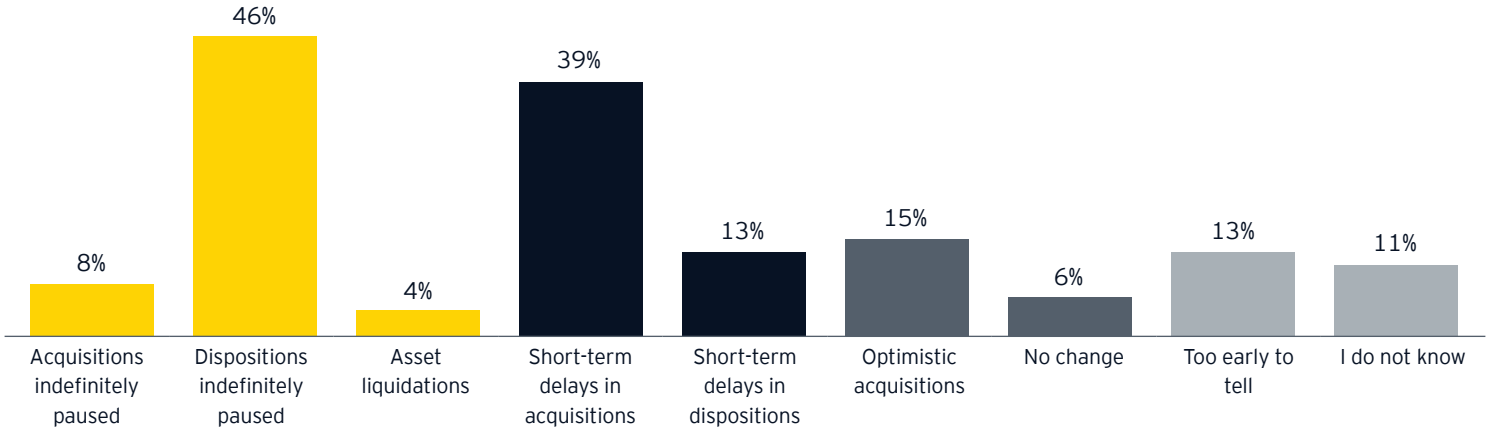
While the near-term impacts of COVID-19 on revenues may already be fairly certain and can be modeled adequately through the adjustment of cash flow assumptions, the probability of tenant bankruptcy and longer-term renewal prospects are difficult to explicitly model in the cash flows. These risks are best incorporated through a change in the discount rate and/or terminal capitalization rates. As the pandemic plays out, more consideration should be given to discount and terminal capitalization rate selection in order to reflect risks that cannot be quantified in the cash flows. We expect the percentage of investors modeling capitalization and discount rate changes to increase as the long-term impacts of COVID become more apparent for individual property sectors.

Property sectors

Of course, there is not a generic, one-size-fits-all valuation adjustment for COVID-19. The pandemic has had radically different impacts on the various property sectors and even within sectors, the effect can vary considerably. As such, the following commentary is presented, based on market observations as of March 31, 2020, by asset class with regard to COVID-19 valuation implications.

Acquisition and disposition

How has COVID-19 impacted your company's acquisition or disposition strategy?



Retail

Within the retail property sector, malls have been the most negatively impacted and expectations are that they will also take the longest to recover. Retail malls have faced an increasingly challenging environment for several years, primarily driven by shifting consumer behavior. Declining foot traffic and rising vacancy put class B/C malls under increased pressure and underwriting scrutiny. COVID-19 has accelerated the changes that were already happening and extended some of the challenges to class A properties as well. Will this change the long-term outlook for malls as well? The COVID-19-related amplification of existing challenges and introduction of new ones is well borne out in the survey results as 90% of retail participants indicated they plan on decreasing their financial forecast in light of the economic uncertainty surrounding COVID-19. More tellingly, 63% noted that there would be a significant decrease. Only 3% responded that they would be increasing their forecast.

While malls are beginning to reopen, it's unlikely that they will see a return to pre-COVID-19 performance in the foreseeable future. Early indications are that outlet and suburban malls are doing better than their urban and tourist-centered counterparts. While not unexpected, a number of major retailers have made bankruptcy announcements in the last few weeks and it's likely more are to come, particularly if efforts to restart the economy result in a resurgence of COVID-19 cases.

Retail strip centers have been impacted as well. Despite the early positive signs, rent collections fell to 50%-60% in April and are expected to be less in May. The dependence of most neighborhood and community strip centers on small businesses and restaurants is certainly a risk factor and makes it difficult to predict their recovery until these properties are open and fully operational. The advantage they have by nature is a flexibility to quickly shift tenants and reinvent themselves to meet changing consumer demand.

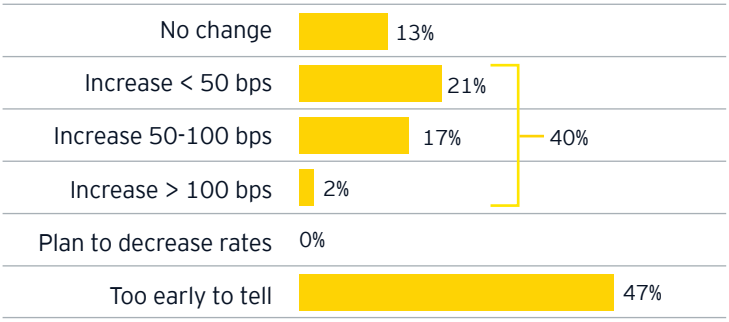
Retail — valuation considerations

Rent growth is projected to be low to negative overall. The probability of renewing existing tenants has decreased, while the risk of tenant bankruptcies and defaults has increased. These factors are difficult to quantify and model through cash flows but should be considered through the discount rate. Nearly half (47%) of survey respondents indicated that it was too early to tell if they would change their discount rate assumptions for retail properties, and an even higher rate (56%) responded that it was too early to tell if they would change their capitalization rate assumptions.

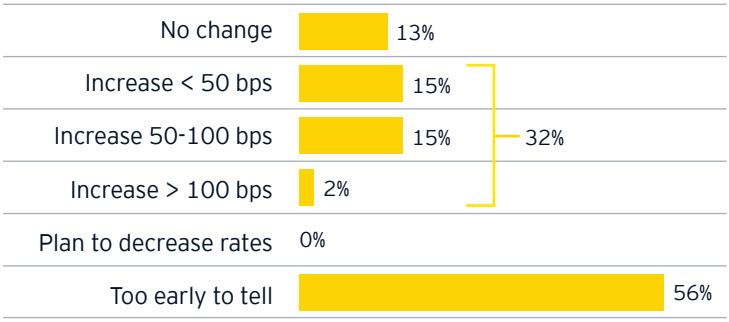
Looking forward, speculative leasing assumptions and optimistic forecasts of deferred rent collection need to be challenged, and operating expense projections should reflect increased costs related to new health and safety requirements.

Retail discount and terminal cap rates

How much do you plan to change your discount rate assumption(s) between December 31, 2019, and June 30, 2020?



How much do you plan to change your terminal capitalization rate assumption(s) between December 31, 2019, and June 30, 2020?



Lodging

Hotels across the nation are focusing on understanding customer preferences and expectations (e.g., daily room cleaning, the impact of social distancing on gyms and restaurants) while changing their operational processes to meet or exceed new cleaning standards, social distancing requirements and workplace protocols. The guest experience, which for most defines the hotel identity, is undergoing radical changes. While in part intentional and part an outcome of the current environment, low occupancy levels are for now causing hotels to revisit and adapt their operating models. Reduced guest and event revenue combined with additional cleaning costs have impacted results. The survey results indicate that 73% of lodging participants plan on significantly decreasing their financial forecast. This is the highest among the property types included in the survey.

Lodging — valuation considerations

In this environment, lodging valuation variables include opening date(s), range of potential occupancies and average daily rates, and impact upon other revenue components (e.g., food and beverage, banquet, parking). Scenarios should be developed with different outcomes for these variables and weighted to estimate overall value.

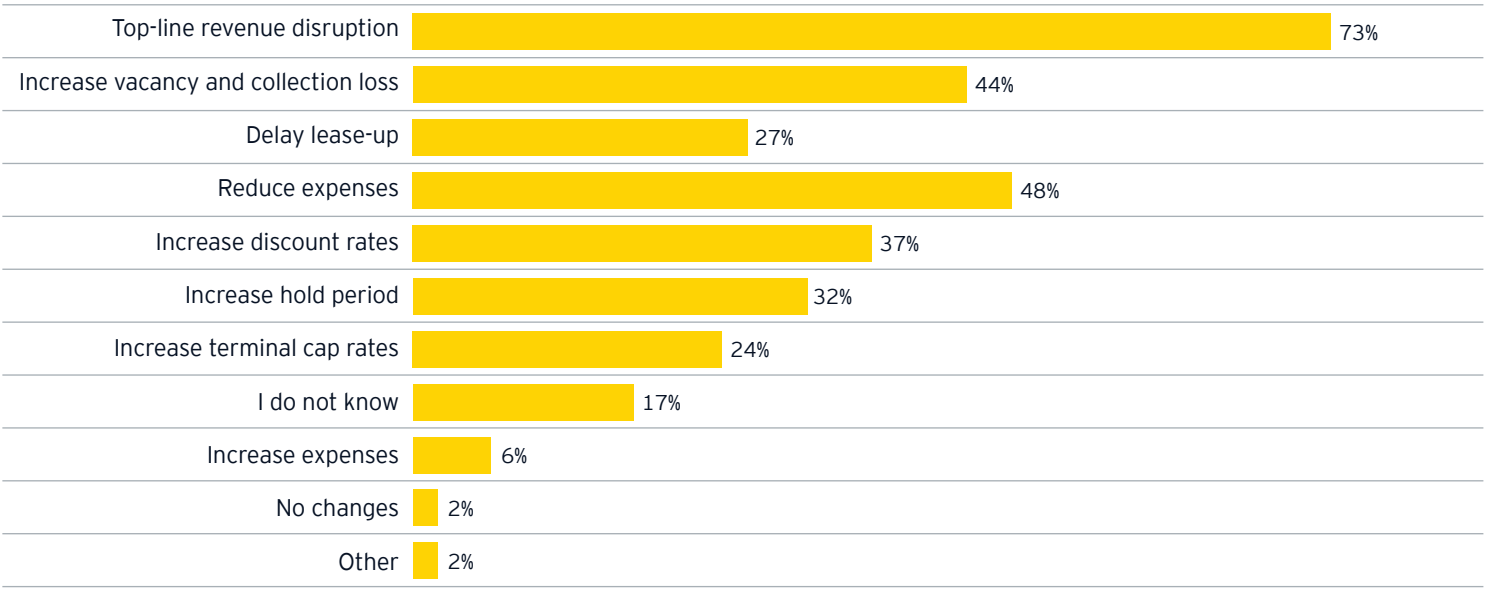
While still signaling a significant level of uncertainty, survey respondents shared expectations of increasing cap and discount rates along with a wider range than in the past, given uncertainty of future performance. The timeline for recovery is seen as being heavily dependent upon market and segment/chain scale.

Industrial

Industrial real estate fundamentals have been exceptionally strong over the past few years, due to the rise of e-commerce. This trend should continue throughout the COVID-19 crisis, as logistics demand is higher than ever with local and national stay-at-home guidelines. The strong outlook was reflected by the survey participants' responses regarding their expectations for future property valuations. Eighty-three percent of the participants indicated that they expect values to either hold strong or to increase or significantly increase going forward for industrial properties.

Lodging financial forecasting

How have you planned or how do you plan to adjust your financial forecasting in light of the economic uncertainty surrounding COVID-19?



Supply chains are under extreme pressure as COVID-19-related disruption led to shortages, production shutdowns and other costly interruptions across numerous industries. Wholesalers, grocers and restaurateurs will require additional dry and cold storage and manufacturers may seek to avoid costly production delays by ensuring supply of critical components. With travel down and gasoline inventories rising, demand has increased for storage of surplus gasoline. As nationalism grows and the global trade environment becomes increasingly complex, re-shoring of critical production and manufacturing may become more prevalent, affecting both warehousing demand as well as location preference.

Industrial — valuation considerations

When considering the COVID-19-related impact on valuation, it appears that the industrial sector will continue to be a favored asset class. Warehouse/distribution space demand is likely to remain strong while the service- and manufacturing-based industrial will be impacted to greater extent, with recovery tied to broader economic metrics. In the near term, increases in general vacancy and bad-debt allowance for properties will be for smaller, manufacturing-oriented tenant bases. Expectations for existing vacancy lease-up time should be extended and the market rents for units leased in the next 12 months may be flat or slightly lower in some markets.

While the overall sentiment and market signs are positive, a significant amount of uncertainty tied to the impact of COVID-19 on industrial assets remains. This is evidenced in the survey results related to changes to discount and terminal capitalization rates for this property type, as the overwhelming response was that it's too early to tell whether rates would increase or decrease as a result of the pandemic.

Office

The COVID -19 impact on the office segment will take longer to play out, as much is dependent upon how office users react to the new experience of having large segments of their workforce working remotely. In general, this experience has gone better than expected. Many companies are planning to keep an increased level of remote work as part of their business model going forward.

The long-term effects are a possible decrease in the demand for office space, particularly large concentrations in urban cores, but it's likely demand for office space won't go away entirely or immediately. The role of the office is being redefined and is unique to each organization. Advances in teleworking will continue to serve as competition for the physical office, and as such, office space will need to accentuate those things that set it apart. Investment emphasis may shift to remote technology and flexible satellite locations in the suburbs that are more easily accessible to employees who primarily work at home.

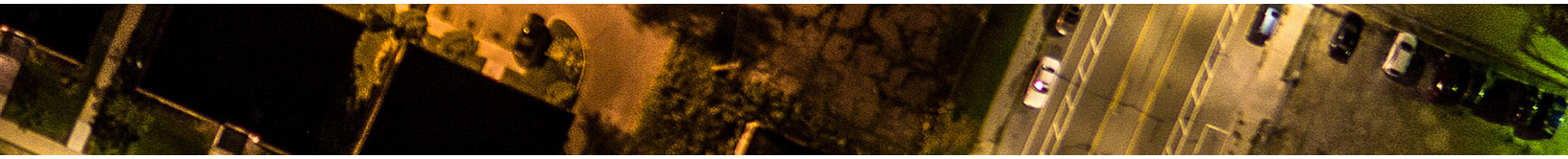
Against this backdrop it is not surprising that 65% of office survey respondents indicated they anticipate a decrease or significant decrease in office valuations going forward.

In the interim, there may be an increased need for short-term space as tenants find it difficult to comply with social distancing guidelines as employees return to the office given the constraints of their current space. Given the numerous uncertainties and the general desire to preserve, cash it is not surprising that renewals are up the last few months as tenants are reluctant to move.

Office — valuation considerations

Office valuation will continue to be impacted by evolving forces such as potential decline in demand, increases in capital and operating costs related to worker health requirements and shifts in the role of the office.

Near-term valuation considerations include pushing out speculative leasing activity — including increased downtimes and leasing concessions. Considerations also include challenging renewal probability for near-term tenant turnover, making sure you are getting real-time updates on the status of renewal discussions from asset managers. Additionally, landlords' ability to increase rents may be diminished so near-term rent growth assumptions should be challenged.



Multi-family

Generally, rent collections have been higher for multi-family than for other property types; approximately 95% or more for April. However, leasing activity is down. Some public REITs have reported traffic down by 50% or more at the end of March. For now, the focus is on renewing tenants with no rent increases. The number of new units coming online in the remaining months of 2020 will decrease significantly due to limitations that have been placed on construction.

Considering the economic crisis and rapid rise in unemployment, class A/B+ assets are likely to outperform class B-/C assets with their weaker tenant profiles and employment bases. Properties with significant concentrations of first-floor retail and parking will be more negatively impacted than those without.

Move-ins and move-outs are largely in a holding pattern so spring and summer lease expirations may continue on a month-to-month basis. "Sight-unseen" leasing activity is likely to rise as a result of enabling technology.

Major long-term lifestyle changes are likely. Remote working could become the new normal for many employees, leading to "reverse urbanization" where tenants move to the suburbs for lower rent and more space. Multigenerational housing could see a resurgence, reducing multi-family demand. Modern multi-family developments with micro-units and an emphasis on common areas now seem less appealing.

Multi-family — valuation considerations

Near-term valuation considerations include lengthened stabilization periods for projects under lease-up that are most susceptible to difficulty in rent mobility.

While the direct capitalization approach is traditionally used to value most stabilized multi-family properties, given the near-term impact of COVID, it may be necessary to convert to a discounted cash flow approach in order to adequately capture the unstabilized nature of the market. Alternatively, this could be handled with several below-the-line adjustments to a direct capitalization value in order to capture near-term income loss. In either case, approximately 33% of our survey respondents indicated that they intend to increase multi-family capitalization and discount rates, with the bulk of the remainder indicating that it is too early to tell what change should be made.

Market rents and near-term rental inflation will likely need to be adjusted. Unemployment and overall wealth loss could result in reduced housing affordability for many tenants. This may be partially offset by lower operating expenses in the form of reduced utility expenses and property taxes or through government assistance programs.

Looking ahead

Based on data published to date and conversations with market participants, we can begin to project some trends for all property types as we move into Q2 valuations (and beyond). While there has been some significant recovery in REIT share prices since the end of March, they are still down significantly in 2020, suggesting that the values of underlying real estate may also be lower. It's clear the impacts of the pandemic may take several quarters to fully manifest themselves in real estate valuations. Indeed, a majority of our survey participants indicated their expectation that it would take one to three years for values to recover from the impacts.

Given this uncertainty, there will likely be fewer sellers, and buyers will become more selective. Although recent employment numbers have been more favorable than expected, the likelihood, of a prolonged recession remains high, which also points toward higher required rates of return. This means that any cash flow analysis will have a much higher risk of not achieving the stated projections. In other words, yield increases are probably coming. While it is challenging to estimate capitalization and discount rates in the absence of transaction data, investors can look to asset class performance in prior recessions as well as changes in borrowing rates, as an indication of how return expectations may change to reflect the increased risk in the current environment.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

US SCORE no. 09722-201US
CSG no. 2006-3520588
ED None

ey.com