BLOG

COVID-19 impact on the US real estate market

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COVID-19 became a humanitarian crisis in late February 2020, affecting more than 3.8m and their communities. The World Health Organization (WHO) has declared it a pandemic, and the different nations are responding differently to slow its spread, for example, by restricting movement, public gatherings and social/leisure activities. However, it has also resulted in a significant shock to business activity.

This has caused ripple effects across multiple markets and sectors. The equity and bond markets are also experiencing high volatility, reflecting the significant impact on economic activity. It is widely expected that the global economy will enter a recession, but it is not clear how deep or how prolonged the downturn will be. US GDP is expected to decline by approximately 18% in 2Q 2020 and to record -1.9% growth for the full year. However, the US economy is expected to bounce back in 3Q 2020 and continue doing so into 2021 (with growth forecast at more than 5%). The reasons for optimism for a short recession and a quick rebound are many:

- The US government has announced plans to provide approximately USD 4trillion in stimulus (approximately 20% of total GDP), including the Coronavirus Aid, Relief and Economic Security (CARES) relief package. The USD 4trillion will be used for recovering from the substantial economic loss suffered in 1Q and 2Q 2020.
- China is beginning to bounce back after the lockdown it announced in January 2020. 80% of its shopping centres have re-opened, including 85% of all Starbucks stores. 81% of its manufacturing companies that export have resumed business. E-commerce (shipping) – after weeks of almost complete shutdown – has made an almost 100% recovery.

Debt capital markets

Due to the global pandemic, credit markets have become volatile and deteriorated. The relatively minor liquidity challenge has become a major liquidity and credit issue.

- The 10-year Treasury rate was 1.88% at the beginning of 2020 and 0.74% as of 7 April. One-month LIBOR fell from 1.25% to 1.05% over the same period. The Federal Reserve made two 50bps rate cuts to the Fed funds rate; the target rate is now 0-0.25%.

- Debt financing costs have risen (although they are coming off record lows). Credit spreads have widened sharply for all product types and forms of lenders. Interest rate floors are higher. Mortgage rates are higher, causing stress to prospective borrowers as loan proceeds are reduced.
- Securitised lenders, i.e., commercial mortgage-backed securities (CMBS) and debt funds, are both very disrupted at the moment and largely out of the market. Some debt funds have closed their operations, while other well-capitalised debt funds not dependent on collateralised loan obligation (CLO) execution and leverage are looking at new business.

Real estate sector:

According to CBRE Research, the hospitality and food service sectors will be impacted the most, due to the immediate effect of the pandemic on demand and business activity, followed by the retail and wholesale trade, arts, entertainment and recreation, transportation and warehousing, construction, educational services and manufacturing sectors, among others. Anything that affects the overall rate of economic growth will impact the real estate market from an occupational and investment perspective. The likely market impact varies from sector to sector, with a distinction between the expected short-term effects and potential longer-term implications.

Commercial real estate:

This sector will likely experience the secondary effects of reduced economic activity and “wait-and-see” disruptions as elevated uncertainty and risk cause clients to delay business investment and expansion plans.

- **Travel, hospitality and leisure:** This sub-sector was the first and hardest hit, due to the immediate impact on demand and business activity. The hotel sub-sector is particularly vulnerable, mainly due to the drop-in tourism and business travel. Real estate transaction activity in this sub-sector (both in terms of leasing and investment) is likely to decline significantly, based on the current scenario.
- **Industrial:** Short-term leasing activity is likely to decline as clients take a “wait-and-see” approach and require site inspections before engaging in capital markets activity. In the longer term, however, this sub-sector is likely to benefit from
    - More secure supply chains with more inventory, increasing demand for industrial space
    - More e-commerce, as buying from home increases
- **Retail:** Shopping malls and shopping centres are closed to avoid social gathering, affecting business. Grocery and pharmaceutical stores will likely benefit the most in this sub-sector. Retailers with strong balance sheets and omni-channel strategies should outperform.
- **Office:** The business services sub-sector, which accounts for 10-12% of the US economy, has provided employees with the option of flexible working (working from home). The method has yet to show an impact on productivity and output, but it may accelerate the adoption of new technology and the work-from-home model. Office leasing is expected to slow in the short term and vacancies are expected to rise, but in the long term, the outlook should improve as offices reopen.

Multifamily real estate:

The current economic and capital markets environment is full of uncertainty and volatility, creating challenges in pricing and debt options. However, the capital markets have not shut down, and sales and debt financing deals are being concluded, albeit at a significantly reduced level.

REITs' real-time data provides a look at the multifamily market. From the market's peak in February to March, apartment REIT stocks fell 40% (on par with all REITs, with multifamily in the middle of the sub-sector). The implied cap rate rose to approximately 7% at the end of March 2020 from 4.8% in February 2020. The implied value per unit fell to USD275,000 from USD390,000 over the period.

Since mid-February to end-March, senior housing and student housing REITs were down 55%, compared to a negative 40% for conventional multifamily. The uncertainty surrounding the performance of student housing is due to a lack of confidence that colleges will be back to normal operations in the fall. Senior housing depends more on demand.

Agencies' focus:

- Both Fannie Mae and Freddie Mac are focused on liquidity and stability
- Agency spreads have widened significantly, leading to higher mortgage rates – around 4.5% in March 2020 compared to 3.50% in February 2020. The wider spreads are due to the recent disruption in credit spreads (much wider DUS and related bonds)
- The agencies will mostly focus on deals with certainty in terms of rent and asset performance over the near term
- Rate-lock policies have evolved due to increased uncertainty on timelines for inspections and deal closing. Deals are now being rate-locked much closer to closing dates

Mortgage forbearance:

- Fannie Mae's and Freddie Mac's regulator (the Federal Housing Finance Agency, or FHFA) announced guidance on 23 March for allowing multifamily asset mortgage forbearance. The guidance mainly shows concern for the hardship many families in rented housing are facing.
- As per the guidance, multifamily property owners with Fannie Mae and Freddie Mac loans may qualify for three-month forbearance on mortgage payments. Borrowers would need to show that their properties' revenue streams have been severely impacted by COVID-19.
- The missed mortgage payments would then have to be paid over 12 months after the end of the forbearance period. Forbearance will not be held against the borrower.
- Owners receiving agency forbearance must suspend for the forbearance period the eviction of any resident financially impacted by the pandemic. Owners also need to work with residents to develop 12-month repayment plans.
- The Federal Deposit Insurance Corporation (FDIC) has also given banks the leeway to exercise short-term mortgage forbearance, and many banks have stepped up, with programmes in place.

Outlook

We expect both the commercial and residential markets to be affected in the short run but believe that due to the substantial fiscal and monetary stimulus, the US market will bounce back from 3Q 2020. As the economy has not been hit by a banking/financial crisis, we think the effect will not be as severe as that during the global financial crisis in 2008. The way China has bounced back is a positive sign that this market will also recover.

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