NAI Affinity

<u>Memorandum</u>

Date: May 11, 2020

To: Our valued clients, customers, and investors

From: NAI Affinity

Re: COVID-19 Commercial Real Estate Update

Below are a few observations regarding current and potential real estate conditions from a group of self-professed “real estate nerds”.

1. <u>Duration</u>: While much of the business world has shifted its focus to opening up the economy (a positive sign), the significant damage due to the economic shutdown is becoming increasingly apparent.

    - Consumer spending declined nearly 8% in March, the biggest month-over-month drop since the 1980’s.

    - Implied unemployment, when adjusting for furloughs, is now approximately 20% nationally (one in five Americans are out of work). Colorado is in better shape than most (one of the bottom five states at 11% initial jobless claims through April 30).

    - The consensus amongst several prominent economists is that we are looking at a 14 to 20-month recession, which technically began in February. Most are predicting a strong initial rebound in Q3 and Q4 of 2020, with slower growth thereafter.

2. <u>Apartments:</u> Class A apartments in secondary markets appear to be holding up well in Colorado and in other growing suburban markets. This continues to be a favored asset class for many.

    - Class A apartment owners are reporting May delinquencies of approximately 6 - 8%. B & C apartments are being hit much harder.

    - NAI Affinity’s April, 2020 rent survey showed year-over-year asking rent growth of 2% and 3% in Larimer and Weld County, respectively. Occupancies are down slightly at 93% and 95%, respectively.

    - Site acquisition activity remains strong with developers continuing to pursue new opportunities. Few, if any, buyers dropping deals in N. CO.

    - The volume of new listings is down and there appears to be fewer buyers in the market but, this is in comparison to a recent multi-year peak in activity. Overall, strong institutional and 1031 exchange buyers continue to contract for and close on properties.

    - There are a few groups putting together funds to target older B & C properties, which are faced with higher delinquencies and too much debt, for acquisition.

- There is concern in the industry that with municipal revenues being down, local governments will seek to raise fees, which will negatively impact the feasibility and supply of new communities, while further hindering housing attainability.

- Beware of the overnight apartment experts – as other areas of real estate slow, those lacking sufficient expertise in apartments are "the new experts", shifting their focus to apartments. Be cautious about hitching your cart to the wrong horse. Look for proven track records of success in the industry.

3. Homebuilders: Most homebuilders recognize that we have an undersupply of housing. They also have a development time horizon that extends beyond the projected length of the recession. Interesting national stats from Meyers Research (5/6/20) follow below:

   - Many homebuilders are noting that sales are off 30 – 50% from last year. A few outliers are down only 10 – 15%. However, 84% of these builders have kept base prices flat week-over-week (14% actually increased prices). Very few have decreased prices which, is creating an expectation gap with some buyers.

   - The resale market (existing homes) is seeing a lack of new listings, which is helping to maintain, and in some cases increase, market pricing on available properties.

   - 36% of builders are adding to their new land/lot pipelines and 57% are selectively moving forward with land/lot acquisitions. Only 16% have paused acquisitions and less than 1% have cancelled acquisitions.

   - It should be noted that these trends tend to vary by geography but, are reasonably consistent with what we are seeing in N. CO.

4. Hotels: Few, if any, industries have been hit harder by the COVID-19 shutdown than the hotel industry. The runup in supply over the last several years coupled with the sudden and steep decline in demand has created an extremely challenging business environment.

   - We have heard it said recently that "we are not oversupplied with hotels but, we are under demolished." Sadly, this appears true but, the silver-lining is that many of these older hotels are located in desirable locations for a new hotel or alternative uses.

   - However, in the short-term, we expect that there will be an expectation gap between the owners of these properties, who have value expectations based on yesteryear's income and pre-COVID-19 cap rates, and potential redevelopment buyers, who are underwriting at unimproved land values.

   - Over the next five years, we anticipate seeing an increasing trend toward redevelopment of older hotel sites.

   - Post-COVID-19, how existing hotels perform will depend on obvious factors (e.g. location, quality and service) and the not so obvious (customer mix – i.e. business travelers, leisure, convention business, etc.).

   - Regular business travel is anticipated to return first, followed by leisure travel. Convention business is anticipated to be dramatically impacted for a minimum of twelve months, possibly much longer.

5. Data Centers: As we noted in an earlier update, demand for data centers will continue to grow as the way we all do business continues to further digitize.

6. <u>Industrial:</u> Demand for larger format industrial distribution continues to grow in N. CO, led by food and beverage companies, consumer staples, and regional / last-mile distribution.

    - As more supply has crept into the Denver market over the past few years, and began to eclipse demand, several prominent industrial developers have broadened their search for new development sites and are landing in N. CO.

    - It appears probable that over one million square feet of new class A, large-format, distribution space will be built in N. CO by the end of 2022.

7. <u>Medical:</u> Telemedicine is here to stay, at least with respect to certain primary care providers and in certain follow up situations (likely decreasing future demand for bricks and mortar facilities) but, telemedicine is not sufficient for all primary care needs, nor is it for many specialists and surgeons.

    - Most of these specialty practices have begun seeing patients and scheduling procedures. New business procedures and their use of real estate will take into account social distancing, especially with vulnerable patient populations. They may also be operating at a reduced capacity for a time, in order to maintain social distancing.

    - We expect some surgeons will seek to add more surgery center space to avoid future hospital related disruptions that are unrelated to their practice (e.g. another pandemic). A few of these groups are already re-engaging in expansion discussions which commenced pre-COVID-19.

8. <u>Office Space</u>: The COVID-19 related shutdown of business has caused the expanded use of telecommuting and technology, while substantially decreasing the use of bricks and mortar real estate.

    - Businesses will be re-evaluating their use of real estate and employment models, due to new insights gained from the COVID-19 shutdown and as cost savings measures.

    - We anticipate acceleration of the pre-COVID-19 trend of decreasing per capita demand for office space. This will create new supply (vacancy).

9. <u>Restaurants</u>: It is no secret that restaurants are struggling and many will not survive. How they are performing at this time varies, depending largely on the type of restaurant.

    - Casual dining has been hit the hardest, with many of these restaurants closed (temporarily – we hope). Bright spots include those that have developed marketing, systems, and menus around take-out and delivery. Some hardworking local entrepreneurs have successfully adapted on the fly. The “nationals” that had these systems in place previously, have tended to be amongst the top performers (e.g. Chili’s, Olive Garden, etc.)

    - When we talk about retail, we talk about the need to be omni-channel. The same thing is true with restaurants. COVID-19 resistant (not proof) businesses excel at take-out, delivery, and dine-in.

    - Don’t expect fast-food restaurants and coffee shops to give up their drive-throughs anytime soon. In fact, as many are reporting that they are achieving 75% of their pre-COVID-19 sales with drive-through only traffic, we anticipate a trend towards more demand for drive-thru windows going forward.

10. <u>Retail</u>: Buyers during the Great Recession began to place a more pronounced premium on grocery anchored retail centers. Sometimes the market (or in this case a black swan event) makes a smart person look prophetic.

- Prior to COVID-19 (do we have to keep typing that?), 49% of food was consumed at home, now that number is somewhere in the 80% to 90% range.

- Take a drive through your nearest high-volume grocer's parking lot, then drive through the parking lot of your nearest lifestyle center or regional mall; the difference is sobering. Going forward, there will be an equally pronounced difference in the way tenants, investors, and lenders look at these types of properties.

- We anticipate that grocery anchored centers will continue to outperform power centers, lifestyle centers, and regional malls. Some of the latter are seeing between 40-80% rent delinquencies. Expect mall vacancy rates to trend higher and rents to be lower, as a result. Exceptions will include best-in-class lifestyle centers and malls in areas with exceptional demographics and sales performance.

- Sales from curbside pickup and delivery of groceries are up 300%, in comparison to pre-COVID-19 levels… from a baseline of 3% of sales. So, 90% of sales are still occurring at the cash register, in the store. However, before going "all-in" on grocery anchored centers, it will be interesting to see how grocers modify their bricks and mortar footprints in the future, in order to respond to increased demand for delivery and pick up options.

- Gold's Gym, Nieman Marcus, True Religion, Pier 1, and J. Crew have filed for bankruptcy. JC Penny appears amongst those most likely to follow.

- Nordstrom's announced on May 6th that it will permanently close 16 full-line department stores. The culling of the herd of department stores will continue. With recreation and places of assembly not likely candidates to backfill these stores, it will be interesting to see how the shopping center industry responds. Some have speculated that former retail boxes could be used for distribution centers… maybe in some markets with lax zoning. That seems hard to imagine in most of the municipalities where we do business. More likely… similar to the fate of some older hotels/motels, some of these former department stores will be demolished to make way for entirely different uses.

- Lease modifications continue to regularly take place. In addition to commonly seeing forbearance of 60 to 90 days base rent amortized over the next twelve months or added to the end of the lease term, we are seeing some use of percentage rent in retail and restaurant situations. One such example for a prominent asset manager with many best-in-class tenants is as follows… (1) Tenant pays NNNs plus 5% of sales for three months. (2) After three months, the percentage rent paid is compared to the rent previously due. The difference is then amortized over the next 12 months.

- Back to the good news… Grocers are leading the "Food Retail Renaissance." Albertson's sales were up 47% in March. Some local and regional grocers nearly doubled their sales, which they partially attribute to outperforming their larger brethren when it comes to sourcing inventory locally.

- Encouragingly, we heard from a prominent N. CO auto dealer today who said they have sold more cars in the first week of May than they did in all of April.

11. Final Random Thoughts:

- College Towns. Many universities have said that they are planning to hold classes on campus in the fall but, how they do so and the impacts this will have on enrollment and employment are to be determined. State funding to public institutions is virtually certain to be decreased. Locally, the economies of Fort Collins, Greeley, and Boulder have long been buttressed by the multi-billion-dollar annual economic impact that our universities and colleges provide. One interesting wrinkle – if the number of students living in dorms is intentionally reduced, where else might these students live? Will this boost occupancies of local rentals? Could some hotels be repurposed for student housing?

- "Dedensification" was a term we tossed out on a company Zoom meeting a few weeks ago. In our context, dedensification means the migration of people from dense population centers to the suburbs. We anticipate that COVID-19 will give some people pause about living in urban settings, in the heart of major metros (many of which have been hit the hardest by COVID-19), and retreat to less dense communities. One possible early shred of evidence… Meyers Research is seeing signs of greater online buyer traffic in suburban master planned communities.

- Commercial Mortgage Backed Securities ("CMBS"). According to an April 30, 2020 article, CoStar is projecting $148 Billion in CMBS defaults over two years. This is 14% of the CMBS loan count and 11% of current dollar volume. For context, this is up from 2% pre-COVID-19 and the Great Recession saw a CMBS default rate of 32%. We are most concerned about defaults on hotel, retail, and B/C grade apartment properties. We anticipate that servicers will be most inclined to work with borrowers who have significant portfolios. One-off investors and those who were distressed pre-COVID-19 will be challenged to avoid foreclosure.

- Deflation vs. Inflation? Short-term, deflation appears to be a greater risk than excessive inflation. That is why the Fed has been promising to do whatever it takes to avoid such an event. Thus far, the Fed and the US Congress are backing that up by pumping trillions into the US economy. Long-term, this stimulus offers the potential for inflation (we said that during the Great Recession too and it didn't happen). Within the last five minutes, I started a stopwatch and observed that the US National Debt Clock. It went up by $13.6 million dollars… in five minutes… seriously. (this is a sickening exercise we picked from Ali Wolf, Chief Economist at Zonda – see USDebtClock.org). If inflation is the price to pay, investments in hard assets like real estate with shorter-term leases (without tenant renewal options), should be a helpful inflationary hedge.

- Construction Costs. We are hearing and seeing evidence that construction costs are starting to come down. Some builders are also reporting minor supply shortages (e.g. cabinets, one-off replacement faucets, etc.). Assuming that supply shortages do not become excessive and widespread, we anticipate that construction costs, which have far outpaced rent growth in virtually all products types, will continue to moderate until the holes in contractors' pipelines have been backfilled with new work.

If you are looking for additional insights or more formal advice from students of their craft, who focus on proactively working fewer assignments in order to help you maximize results, please give us a call. It is always our policy to treat you like we would like to be treated and give straightforward and honest answers, good or bad.

Be well! – The NAI Affinity Team