THE ADVISORY

IMPACT OF THE CORONAVIRUS (COVID-19) OUTBREAK ON U.S. REAL ESTATE MARKETS

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by Gregg Logan, Managing Director, and Taylor Mammen, Senior Managing Director | March 2, 2020

In this issue of the Advisory we look at the likely impacts of the COVID-19 outbreak on U.S. real estate markets overall and by sector. The Centers for Disease Control and Prevention (CDC) expects the outbreak to continue spreading in the U.S. and says it's likely to become a pandemic. While we're optimistic that the U.S. economy and real estate markets will weather this crisis as they have many others, we also believe it's important to be prepared for all possibilities.

While it's very difficult to predict economic impacts with any certainty, real estate trends in China and the U.S. to date provide indications of what we may expect. The outbreak is already having severe impacts on the Chinese economy and its real estate markets. China is the second largest economy in the world and accounts for 20% of global manufacturing output, with a hand in much of the world's supply chain. The size of the role that China plays in the world economy is greater than it was during past similar outbreaks, such as the SARS virus in 2002-2003. At that time China represented 4.3% of the world's GDP; today it represents 16%. Its recent decline in economic activity is expected to have a substantial effect on worldwide manufacturing output. U.S. manufacturers are anticipating inventory shortages as their supplies purchased before the outbreak are steadily shrinking.

With many U.S. companies relying on China's factories for parts, materials, and assembly, its decline in activity is expected to negatively influence U.S. economic performance in the tech sector, automobiles, and other industries. This could affect U.S. domestic GDP growth through the first half of 2020, and in anticipation of the China ripple effect, the Dow Jones Industrial Average (DJIA), S&P 500 (SPX) and Nasdaq Composite (COMP) last week experienced their worst weekly declines since the 2008 financial crisis. The reaction of financial markets to stock and bond prices suggests the outbreak could potentially push the economy into recession, though it's too early to tell. Though a recession would affect real estate demand across the board, a general lack of overbuilding during this cycle should blunt the worst potential impacts. As of midday, stocks rebounded today based on expectations that governments and central banks are ready to act to stabilize the economy if it comes to that. Nonetheless, preparing for a period of somewhat lower demand, and moderating pricing growth, is prudent.

Retail was one of the first real estate sectors to be affected in China as authorities asked residents to stay indoors, causing many retailers to temporarily close their stores. Restaurants have been similarly affected, the residential real estate market has taken a hit, and the decline in foreign and domestic tourism is impacting the hotel sector. If the outbreak becomes more significant in the U.S. as the CDC has suggested is possible, retail stores, restaurants, movie theaters, and other places that people congregate could be substantially affected if consumers decide to stay home rather than go out and risk infection, whether or not mandated restrictions on movement like those imposed by the Chinese government are implemented here. This could obviously have substantial impacts on the retail real estate sector, which is already facing competition from online shopping. Meanwhile, in the nearer term big box retailers such as Walmart and Target that are heavily dependent on imports may have trouble keeping store shelves stocked.

The Wall Street Journal reported in mid-February that the Chinese residential real estate market has been hit hard by the outbreak, with home-price growth slowing to an 18-month low, causing developers to slow production and cut prices (China's Real-Estate Market Is Coronavirus Latest Victim, WSJ February 18, 2020). The outbreak has reduced new home construction as government policies prevented construction workers from accessing construction sites. How the outbreak will impact U.S. housing markets is uncertain, and the outlook is at best mixed. Mortgage rates are low, potentially creating an incentive for consumers to purchase. But many consumers postpone making big decisions in uncertain times, and coronavirus fears could negatively affect consumer confidence. Slower economic growth resulting in part from impacts of the outbreak on the global economy could slow demand. Meanwhile, the U.S. depends on China for construction materials. Disruptions in the building material supply chain could impact a housing market where inventories are already low, particularly for more attainably priced housing product.

The first real estate property types to feel the impacts in the U.S. have been hotel and industrial. U.S. hotel fundamentals were already cooling off thanks to heavy deliveries over the past few years. There has obviously been less demand from Chinese tourists in major gateway cities such as Los Angeles, New York, San Francisco, and Seattle. During the SARS outbreak, the decline in Chinese tourism was substantial, and the Chinese have been among the largest foreign consumers of U.S. travel services. The number of cancelled or postponed investor meetings, industry conferences, and personal trips we anecdotally observe suggest that hotels and other travel-related markets and real estate will likely feel the negative impacts of the virus for at least the first half of this year. Additional outbreaks in new locations could push out recovery of the sector even further.

Demand and pricing for U.S. industrial property may soften in some markets with the decline in imports, and with delays in deliveries of manufacturing components and parts to U.S. companies. The decline in imports from China is already impacting the Ports of Los Angeles, Oakland, Seattle/Tacoma, and Portland, as factories in China have slowed production, and some inventory still sits in Chinese ports. Southern California in particular has a huge volume of industrial space dedicated to inbound international trade. This comes at a time when new industrial space supply has been outpacing absorption, although overall performance in this sector remains strong, especially in supply-constrained markets.

Other real estate sectors, such as office and multifamily, are less directly impacted, except to the degree that this “black swan” event pushes the economy into recession and lowers overall demand. Office space fundamentals have been lukewarm overall as new deliveries have exceeded absorption, although conditions vary substantially by geographic market area. For multifamily, despite high levels of new inventory, demand has continued to exceed supply. Since the recovery in 2010 the ratio of jobs to multifamily permits has averaged 6.8 jobs/permit; for the last five years the ratio has been about 6.2, dropping to 4.5 in 2019. In the last recession, professionally managed apartments reported rent declines in the range of -4% to -4.5%, and occupancies also fell from over 96% to just over 92% occupancy. No one expects a repeat of 2008-2009.

Based on what we know today, RCLCO believes the impacts on real estate broadly will likely be moderate overall, though there may be some distress in markets or submarkets with high reliance on tourism, trade, or energy. Given the rarity of an event like this in modern times, no one can be certain how this will work out. How severe the effects are depends in part on the impacts on the economy overall. There is no question that in the short term, the world economy will be hit by the decline in output from China and other countries that have been hit by early outbreaks. The potential exists for these conditions to lead to a global recession, the severity of which will likely depend on the spread and severity of the COVID-19 outbreak in the U.S. and elsewhere, which is currently unknown.

Meanwhile, capital has been stockpiled (through dry powder in funds and growing real asset allocations) for some time to take advantage of just such a moment, so real estate capital markets should remain liquid—at least to the extent that buyers and sellers can travel. With interest rates dropping to yet new historic lows, real estate pricing should be bolstered, as well. Though a recession would affect real estate demand across the board, a general lack of overbuilding during this cycle should blunt the worst potential impacts of a recession. RCLCO believes it will be possible for owners/operators/developers who are disciplined to work through the next recessionary period and remain profitable. Disciplined players should consider some or all of the following strategies, depending on their particular assets:

» Prune portfolios, including land, where appropriate to decrease risk

» Build modest cash reserves

» Limit or decrease leverage levels on assets where market/submarket conditions present higher risk of overbuilding, potentially shifting leverage to more stable assets

» Create future borrowing capacity (lines of credit) at the entity level

» Be particularly diligent in underwriting value add programs, or honest about CapEx that may be defensive rather than driving higher NOI

» Focus on stabilizing and enhancing tactical property management or property management relationships

» Manage overhead by outsourcing non-core functions, or operational areas where you do not have a competitive advantage

If this event does push the world and U.S. economies into recession, the impact of the recession on real estate is likely to be moderate due to generally healthy fundamentals as compared with previous cycles. Nonetheless, it’s important to understand the potential influences and to plan for the possibility of a period of slower pricing growth and possibly lower demand between now and 2021.

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-- Jimmie Jenkins, Vice President, Toll Brothers, Inc.

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