FINANCIAL ADVISORY

What Real Estate Asset Classes are the Winners and Losers from the COVID Crisis?

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

In May of last year, my article discussed the effect the COVID crisis could have on certain real estate asset classes. Now that this strange time may be nearing an end, (or is already over- depending on what state you live in), we may have a clearer picture of who the winners and losers are. Although the "race" isn't yet over, let's take a look at who is in the lead, and who is trailing behind.

WINNERS – NNN LEASED NECESSITY RETAIL

In that May article about Net Leased properties, I wrote about the appeal of "Necessity Retail:" Grocery stores, pharmacies, auto parts stores: places that stayed open for business during the entire downturn. The real estate market saw what stockbrokers would call a "flight to safety" last year that seems to be continuing: money pouring into this asset class sent prices soaring and saw properties selling quickly with very low inventory.

For Necessity Retail assets, I think careful attention needs to be paid to purchase prices. Has this asset class become a victim of its own success? Prices in this group are remarkably high now. Will the high demand driving these high prices stay around permanently? I think we will see demand – and therefore prices – drop over the next few years as the market "normalizes." In racing terms, Necessity Retail properties are way ahead, but I am not sure they saved enough for the last lap.

WINNERS - APARTMENTS

A lot of apartment owners are concerned about the impact of the nationwide eviction moratorium. Is this giving tenants a "free pass" not to pay rent? In my experience, the Covid calamity has stressed cash flows in a minority of the properties that we watch but has not been a potentially fatal blow. People will always need somewhere to live, so apartment buyers in good growing metro areas, with growing pools of potential renters, are giving themselves the best chance at success.

My partial-interest apartment investors tend to buy 200-400 unit properties. I have found that tenants in these larger communities prefer them to smaller options. Although some renters may be tempted to forego paying rent during this moratorium, they do realize that the order does not call for rent forgiveness: Unpaid rent will need to be repaid eventually, or these residents could face eviction. Rather than risk the pitfalls that an eviction record would create, these tenants continue to pay rent as agreed.

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over four hundred 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

The recently updated eviction moratorium states that tenants cannot be evicted if they can not pay rent due to COVID-related issues. (As of my publication deadline, a legal challenge to this order is working its way through the courts) In many areas, this means the tenant must convince a judge that he suffered a loss of income due to COVID. So every delinquent tenant still gets a legal notice and a threatened future court date. Our managers find that many delinquent tenants pay their past due amounts immediately after receipt of such notices – this has successfully flushed out tenants who are trying to "game the system."

During this pandemic, we have seen average monthly rent collections 1 or 2 percentage points lower than seen in "normal times." On most of our properties, this falls within the "normal variability" of financial projections. If a 1 or 2 percent variance in gross rents or in expenses will change your cash flow dramatically, then you are forecasting too aggressively.

WINNERS – INDUSTRIAL DISTRIBUTION CENTERS

The emergence of online shopping certainly received a huge boost in 2020. This "new tech," surprisingly, is leading to higher demand for "1950's tech:" cardboard boxes and other packaging, trucks and vans to deliver, warehouses to store everything in.

Many of my clients have bought interests in Amazon distribution facilities throughout the country. As with other investments, careful attention must be paid to the location of these assets. Since Amazon is pretty much the model of the stereotypical "heartless corporation," we need to buy knowing that they may just decide to move out when their lease expires or threaten to do so in order to squeeze a lease renewal at lower rent from us. A well-located property in an area with high demand for industrial space is good security against this: if Amazon wants to keep their prime space in our property, they will need to pay for it.

LOSERS – THE "BAD" RETAIL

Note that I focus on Single-Tenant, Necessity Retail. I call this asset type "Good Retail." If I have a single-tenant CVS Pharmacy or a Hobby Lobby, my income security is tied to the credit of my tenant. With a Net lease, that tenant pays most or all of my expenses as well. If CVS or Hobby Lobby were to vacate, they can be replaced with another necessity retailer (A grocery store, etc.)

"Bad Retail," on the other hand, has multiple tenants. Large and small shopping centers were having a hard time already before they were shut down during the COVID scare. On one late afternoon last summer, I was at our local shopping center with my kids looking for swimsuits. We decided to check the Sears and discovered that the store was only open from 10AM to 6PM on weekdays. Staying open only when your customers are at work? This just tells me that Sears has given up. Indeed, the large mall operators have plans in place for what to do with their Sears and JC Penny stores when the inevitable happens – and these plans typically don't involve another retail store. (Building hotels or condos are the most common options that I see.)

LOSERS – OFFICE

The maintenance of office space (rent, utilities, insurance, janitorial, etc.) is a significant line item on the income statements of many companies. If companies can avoid these costs by letting their employees work from home – why wouldn't they? San Francisco computing giant Salesforce is the city's largest employee with 9,000 workers occupying 881,762 square feet across 36 floors of the 61-story Salesforce Tower. (Owned by public REIT Boston Properties.) The company announced earlier this year that all their employees will be given the option to work in the office full time, part time, or not at all – 100% from home. Salesforce estimates that 65% of their employees will visit the office "one to three times a week." So this firm's need for office space will reduce by 35% right away. In the future, as this tenant decides that someone who visits the office once a week doesn't need their own office or desk, the space needed is likely to decline even more. Multiply this by thousands of companies across hundreds of cities, and you can see what a huge effect this could have. Lower demand usually leads to lower rents and lower values.

I feel that the key to successful investing is not to buy current issues, but to buy long term trends. We should not, therefore, base our decisions only on what has worked during the pandemic. This pandemic has accelerated some already-in-progress long term trends. These could show us where to find success in the future. If you have any questions, my toll-free office number is (877) 313-1868.