COVID-19: Potential Impact on Commercial and Residential Real Estate

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The impact of the coronavirus on commercial and residential real estate will be significant. Here are just a few of the changes that are coming and some thoughts on potential actions that might be taken to mitigate risk.

Retail Businesses

In a pandemic, the most vulnerable segment in commercial real estate is retail. While many businesses have an online presence, the vast majority of retail businesses depend on foot traffic. This includes not just stores but also face-to-face service businesses like barbershops, restaurants, and bars, places were 'remote work' for their employees is not a realistic possibility.

If people are afraid or unable to patronize local businesses, retailers have no customers. Additionally, retailers will have increasing problems getting workers, either because of mandatory or voluntary quarantines or because some workers will have to stay home a significant amount of time because they have children whose schools have been closed due to the coronavirus threat. At the same time, retailers have to reassure the potential customers by incurring the extra costs of intense cleaning while publicizing this fact in ways that entice customers in rather than scaring them off.

Depending, of course, on how long this situation lasts, a major slowdown means that retailers, many of whom lack sufficient capital or lines of credit to operate in a downturn, may become unable to pay their rents. While a two- or three-week slowdown may be bearable, if this situation extends into 3, 4, 5, or 6 weeks, leases may go into default.

Because of this, landlords who lease to retail tenants may soon find themselves in a cash crunch leading to mortgage defaults. Additionally, if properties have been valued for loan purposes on the basis of a multiple of earnings, a decline in rental income will lead to a decline in appraisal values, making it difficult to refinance if lenders tighten up their loan-to-value ratios, which can be expected. Further, even if the landlord can make the mortgage payments, a decline in property values may trigger a default due to a financial ratio clause in a number of mortgages.

Residential Property

The same factors that can adversely impact commercial real estate are at play in the residential market. If homeowners do not have paychecks because they are furloughed or cannot get to work, home mortgages may go into default. Additionally, a large percentage of the home lending market is securitized. A local lender does not hold the loan. The borrower has to deal with a loan servicer who may have limited capacity to accommodate a borrower's request. If residential mortgages start defaulting, there can be a resulting slide in home prices.

Selling a home in this environment may become increasingly difficult. Potential buyers, even if they have the funds available for a purchase, may be reluctant to view properties, fearful of coming in contact with an owner or agent who may unknowingly be an infection vector, or even touching surfaces in a home, not knowing who else has touched them. While there are online home purchasing options in some markets, the price received by the homeowner may be less than that available in a traditional sales environment, leading to a further downward spiral of valuations.

Refinancing

Refinancing existing debt may look attractive because of current low interest rates, but lenders appear to be stress-testing their portfolios now. Refinancing may become increasingly difficult, and not just because a decrease in real estate values impacts the amount lenders may agree to loan. Residential borrowers may find that there are increased conditions imposed on refinancing and higher standards required to prove current income and net worth. In commercial loans, refinancing may be less available or more costly because of increased pre-payment penalties and more stringent financial covenants.

Related Impacts on the Automobile Market

While the thrust of this alert deals with real estate, we would be remiss if we did not also note that a downturn in the market for new and used cars can be anticipated. Potential buyers may be reluctant to come to dealerships not only because of uncertainty about their own financial situation but also while calls for social distancing remain. This may also lead to car owners delaying all repairs except those absolutely necessary to keep the vehicle operating, resulting in a further decline in dealership revenue.

If workers are laid off or find their take-home pay diminished because of reduced hours many businesses are instituting, the default rate in automobile loans may be accelerated.

Opportunities

One never wants to see individuals and an economy suffer, but given what we see coming, there may be opportunities for those who can act quickly.

First and foremost, whatever the potential opportunities are, the most important thing is to make sure that you use all possible efforts to protect your family, your employees, and your customers from the effect of the coronavirus.

Second, if it is possible to refinance, extend lines of credit, or renew lines of credit, now is the time to do so before lenders tighten their standards even further.

Third, if one has the capital or lines of credit, there undoubtedly will be buying opportunities in residential and commercial real estate.

These will be trying times for everyone, but the ability to look ahead to spot both risks and opportunities can prove to be invaluable.

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