FEBRUARY 2021
www.bdo.com

INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

REAL ESTATE AWAITS A RETURN TO NORMALCY, FOCUSES ON TENANTS, NOT VALUATIONS

By Brian Bader, Steven Kurtz

If the real estate industry has learned anything from the economic cycles of the past three decades and from crises like the savings and loan collapse, it's patience.

On the surface, the global pandemic seems to have had a uniform impact on the global economy—the tendency is to look at the big picture impact on national economies, job losses and stock markets. While there is no arguing that the effects of this singular event in modern history will be felt—and studied—for years to come, the devil is in the details.

Those who own real estate assets across sectors and around the country see varying realities: Some industries, like restaurants, are harder hit than others. Yet within the restaurants industry itself there is variation: Many quick-serve and fast-food concepts are thriving, while others, like fine dining, are struggling.

For the real estate industry, lessons learned from past cycles and crises are translating into wait-and-see mode. Sellers are not willing to meet buyers' expectations. On the commercial side, 61% of buyers expected a discount from pre-pandemic prices while only 9% of sellers were willing to offer them, according to CBRE's Q3 2020 cap rate report. While some institutional investors may expect to see more distressed deals, unlike the Great Recession of

2008, there is significantly more capital sitting on the sidelines, enabling would-be sellers to wait out the current disruption.

With the vaccine rollout underway, the questions for those with real estate holdings are: When will the return to normal occur, will we be dealing with a new normal, what can be done in the meantime, and how can we position ourselves for the upside?

WHILE LENDING HAS TIGHTENED, BANKS ARE STILL WILLING TO BE FLEXIBLE

Since the Great Recession, when banks ended up owning and taking losses on real estate assets that borrowers could no longer make payments on, banks have been hesitant to foreclose on properties in default. Today, they are looking closely at de-risking their loan portfolios, and in some cases are selling debt to private credit funds to reduce losses. The private credit funds look at this as a way to become owners of real property at a lower price point.

Many banks and real estate owners are waiting for a recovery, as they know from history that the economy eventually comes around. In the meantime, banks have also allowed late or delayed payments or let borrowers tap into loan reserves to meet payment deadlines.

OFFICE + RETAIL REAL ESTATE

More than any other sector in the industry, offices will look very different post-pandemic. The new reality that employees can—and want to—work remotely, at least part of the time, has forced conversations about contingency plans for how office space and layouts should look going forward, what the new demand for square footage may be, the extent to which companies will move to a hub-and-spoke or hybrid model, and the comeback of coworking. Office landlords will need to sell more of an experience as opposed to just a space. That experience could center around additional concierge type services to suit evolving office tenant needs.

Cap rates for offices vary based on location and occupancy. For a fully occupied prime office location, particularly in central business districts like New York City, Los Angeles and Chicago, deals have closed at around 6%, down to 4% for trophy assets. Underscoring the theme of variation within segments, cap rates for niche office segments like life sciences remain lower than non-life sciences properties, as demand for these types of defensive properties rises. In terms of new office leases in 2020, the tech sector accounted for 18% of the top 100 leases, according to CBRE. National cap rates for the office sector in the third quarter of 2020 were **7.12%**, closely in line with the five-year rolling average of 7.16%, according to CBRE.

If they aren't already, office buildings with vacant ground floor retail or restaurant space should be considering leasing to life sciences or medical businesses, which are and will continue to be in high demand. Meanwhile, the conversion of second- and higher-floor office space, as well as shuttered hotels, for residential use is expected to continue to increase.

Retail and restaurants/hospitality have seen the greatest disruption; retail brick-and-mortar closures are expected to range from 20,000 to 25,000 in 2021, on top of the **more than 10,000** stores closures that have already occurred in 2020.

Retail cap rates have increased for freestanding net lease real estate, while for retailers seen as defensive, such as Dollar General, cap rates have declined 50 basis points at most. On the flip side, for typically well-occupied properties seeing vacancies, cap rates have increased 50 to 75 basis points. Cap rates for assets of troubled retailers are, of course, much higher.

Mom-and-pop or "quirky" retail tenants, such as shoemakers or instrument repair shops, who were priced out of central business districts or high-rent downtown areas may see an opportunity to return to cities. Landlords who heretofore were willing to go for years advertising vacant retail space may be more willing to consider working with such prospects on affordable lease terms.

Lease terms should be top of mind, of course. Tenants with less than a year left on their leases are likely surveying the market for alternatives, depending on their evolving workplace needs. Landlords should be willing to work with them to accommodate these needs and to renegotiate leases.

INDUSTRIAL REAL ESTATE

Industrial real estate has been the most resilient sector of real estate throughout the pandemic, in large part due to the increase in demand for e-commerce as the U.S. population largely sheltered in place. As such, the largest distribution tenants—Amazon and Walmart, for example—have been fueling the sector's success. The average cap rate is 6.2% for industrial sales, falling by 119 basis points over the course of 2020, according to CoStar data. However, for Class A properties, cap rates are lower—4.3%, which represents a decline of 171 basis points from the fourth quarter of 2019, according to CoStar.

Industrial tenants' new needs (e.g., on-demand warehousing) have altered business as usual for landlords. E-commerce sales are estimated to hit $1.5T by 2025, creating demand for 1 billion square feet of industrial space, according to JLL.

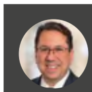
SUBURBAN MIGRATION'S IMPACT

The great migration to the suburbs is driving single-family home values up; multifamily home values remain steady and cap rates have compressed. In central business districts, the story is a little different. Multifamily class B and C properties are seeing vacancies rise and the cap rate increase about 50 basis points.

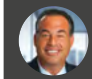
Suburban landlords and developers should be aware that urban migrants will take with them their desire for urban amenities. Ultimately, urban tastes may help support suburban businesses like restaurants, which will also see support from a surge in demand for in-person dining as more of the U.S. population gets vaccinated.

Many industries, as we approach a return to normalcy, may be quite altered from how they looked pre-pandemic. Brick-and-mortar retailers will continue to give way to e-commerce, offices will need to be overhauled and locations across sectors will migrate from cities to more suburban locations. At the same time, those who previously could not afford urban real estate may seek to move to central business districts if the lease terms are right.

Real estate owners are not panicking. As the vaccine rollout continues and the light at the end of the pandemic tunnel eventually appears, deal making will pick up. With $300 billion of global available capital for real estate investment—much of which is aimed at North America, according to CBRE—willingness to sell at discounted prices will remain elusive.



Steven Kurtz is a Managing Director in BDO's Real Estate-Valuations & Business Analytics practice. He can be reached at skurtz@bdo.com.



Brian Bader is a Managing Partner and Co-National Industry Practice Leader in BDO's Real Estate and Construction Services practice. He can be reached at bbader@bdo.com.

People who know Real Estate, know BDO.

www.bdo.com/**real-estate**

CONTACT

BRIAN BADER
Managing Partner, Co-National Industry Practice Leader –
Real Estate and Construction Services
212-885-8203 / bbader@bdo.com

STEVEN J. KURTZ
Managing Director, Real Estate – Valuation & Business Analytics
212-885-7357 / skurtz@bdo.com

KRISTI GIBSON
Real Estate and Construction Practice Co-Leader
214-665-0656 / kgibson@bdo.com

IAN SHAPIRO
Real Estate and Construction Practice Co-Leader
305-420-8052 / ishapiro@bdo.com

BDO REAL ESTATE & CONSTRUCTION PRACTICE

BDO's Real Estate and Construction practice consists of multi-disciplined professionals who are well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.