Commercial real estate values, as a crisis unfolds

Discussion paper on property valuation fundamentals in the context of COVID-19

Issued 31 March, 6 days after New Zealand officially enters 'lockdown'

Like many other countries in the world, New Zealand currently finds itself in a government-enforced lockdown in response to the growing threat of COVID-19. While COVID-19 is first and foremost a crisis for people and communities, one of the many economic issues arising is the uncertain impact on commercial real estate values. This discussion paper seeks to set out our observations on the potential impact of COVID-19 on commercial property values and the issues that commercial property valuers will be facing.

We expect that our observations will be of particular interest to:

- Institutional property owners who are compelled to revalue for financial reporting purposes (including shortly as at 31 March and 30 June in many cases) and;
- Commercial property owners generally, and banks with lending exposures in this sector, as a framework for considering the impact of COVID-19 on the value of their assets/security over time.

Setting the scene – what drives commercial real estate values and how might COVID-19 impact these drivers?

In principle, the value of a commercial property is equal to the present value of future cashflows, and this is typically calculated using the following methodologies:

- Discounted cashflow approach (DCF) – discounting (at an appropriate discount rate) explicit nominal future cashflows to inform value and/or;
- Capitalisation approach – capitalising (into perpetuity) normalised net maintainable cashflow at an appropriate capitalisation rate (or yield) to inform value.

Of course, riskier cashflows attract higher discount rates/yields, which drive relatively lower values, and assets that fall into this group might, for example, include investment assets with shorter lease terms and/or poor covenant tenants, 'add-value' and development assets. In contrast, where future cashflows are more certain, such as premium assets with long weighted average lease terms with government or substantial corporate tenants, discount rates/yields are lower and values higher.

Real estate cashflows and investment yields/discount rates tend to be strongly correlated, either positively or negatively. Relatively small shifts in these key metrics in the same direction (for example adversely, with cashflow falling and yields rising) has a magnified impact on asset value.

In the context of the COVID-19 crisis, one thing we can draw comfort from is that the crisis will pass and the market will re-emerge. Nevertheless, this is an unprecedented event in modern times and is creating uncertainty throughout all businesses. At present, the key uncertainties affecting real estate values fall into three buckets:

1. Uncertain net cashflows.
2. Adverse shift in market liquidity.
3. Disruption impacts.

These core elements underpin the principal valuation methodologies that valuers use for commercial investment assets; DCF and capitalised income approaches. We expand on these elements below:

Market observations in the context of COVID-19

Uncertain net cashflows

- The Property Council of New Zealand issued a press release on 27 March 2020 stating that "*We are hearing of a multitude of scenarios regarding rental payments. At one end of the spectrum there are many landlords working constructively with tenants on their particular situations and discussing rent relief such as postponement or other relief measures. However, there are many examples of large tenants sending letters announcing they are refusing to pay rent with no consultation. This move could devastate the commercial, industrial and retail property sectors.*"
- Some tenants' businesses may fail, introducing vacancy and a likely challenging re-leasing environment.
- Landlord recoverable fixed operating expenses (OPEX) may also decline, further impacting net operating income.
- In the medium term, it may be that landlords accept a rent holiday (for a period) but retain the ability to require lessee's to pay for the foregone rent via some form of clawback mechanism.
- The longer-term extent of such impact and the nature and timing of a return to 'normal' is highly uncertain.

Adverse shift in market liquidity

- Governments globally are applying significant monetary and fiscal stimulus to lower the cost of funds and support the economy through the impact of COVID-19. This will help with liquidity, however, in the short term (as a minimum), uncertainty is expected to stall the transaction market and during this period liquidity in the commercial real estate investment market is expected to be severely impacted. There are unlikely to be any suitable transaction reference points in the COVID-19 environment for some time, and transactions that do occur will have to be considered with care as they may involve distressed asset sales.
- Where Listed Property Entities (LPE) are trading at a material discount to net tangible assets (NTA), many institutional investors in particular will struggle to justify buying direct real estate at values higher than the implied value of LPE's (typically prime) assets. The potential flipside for LPEs that are trading at a discount to NTA (noting the circularity here given the challenges with establishing NTA), and where their cost of funds permit, is that asset acquisitions are more likely to be accretive to their shareholders. That is, they may be in a position to buy assets at yields that are higher than the average portfolio yield and, in time, this might stimulate activity.
- The syndicator market has been acquisitive over recent years and the low interest rate environment has underwritten their ability to attract capital. A large proportion of New Zealanders have always been wary of the equity markets (including LPEs) and given recent events and the low interest rate environment, notwithstanding that single tenant risk is typical in this sector and the quality of syndicated product varies from one syndication to another, demand for syndicated product might be expected to continue.
- Sub markets are likely to react differently; tourism assets and student accommodation have borne the initial brunt of the crisis due to international travel restrictions, and the other more traditional retail, office and industrial sectors are now experiencing the consequences of the nationwide lockdown.
- Industrial assets tend to exhibit, over the long term, the least value volatility, so this sector could be expected to be relatively less impacted by COVID-19. Interestingly, as at the date of this paper two of the industrial focused LPEs on the New Zealand NZX are trading close to or at a premium to NTA.
- Expect a flight to quality and assets underpinned by strong cashflow, consistent with what was observed during the Global Financial Crisis (GFC).
- Land and development assets are likely to be difficult to trade at 'intrinsic' value (their 'real' worth) and are likely to exhibit the most significant value volatility. Post the GFC, the value of such assets were dramatically discounted.
- While the sound fundamentals of the aged care sector will continue, many operators carry significant development pipelines which are characterised by relatively long capital requirements (capital for construction and then working capital) before they become cash positive. As discussed above, land and development assets exhibit considerable value volatility. The success of retirement villages is also strongly correlated to the residential market (sale volumes and price), which is an added uncertainty.
- Time will tell whether there is an early number of 'forced sales', noting that if the volume of this type of transaction is significant, such transactions can tend to anchor the market down.

Disruption impacts

Industry-wide issues

- New lease arrangements might be impacted, at least for a period, with occupiers having increased bargaining power and demanding, for example, relatively shorter committed lease terms and more tenant friendly rights of renewal.
- Expect a new range of lease clauses, consistent with what occurred post the Christchurch earthquakes, addressing lessor and lessee rights during COVID-19 style events.
- In New Zealand at least, our central bank has signalled that the all-time low official cash rate will not be increased for 12 months and this might have a long term impact on our already low interest rate environment. This positive impact should assist with a return to transaction liquidity, however, the impact on real estate owners' costs of capital is uncertain as higher risk premiums will likely be required which could (potentially more than) offset the benefits of a lower interest rate environment.
- Additionally, the deep discounting of equities could lead to the refocus on tangible assets (such as real estate), as occurred post the 1987 share market crash, even though interest rates were structurally higher at that time.
- The forced at-home working environment and forced shift to online retailing may also have a longer-term impact on the way we work and the type and amount of real estate businesses need to operate.

The importance of quality

- Customers – The COVID-19 crisis could result in structural changes to how the real estate market risk weights tenants, noting that occupiers providing essential services diversify risk under these circumstances; tenants offering essential services may be considered to offer a robust covenant.
- Diversification – Expect assets with diversified income, across government and essential services tenants, and a broader spread of tenant type to be sought after. It will be interesting to see the longer term impact on food and beverage occupiers who have, until recently, represented a large proportion of many new development projects.

Sub-sectors

- In the industrial market, occupiers involved in key supply chain activity will be more highly sought after, whereas businesses reliant on offshore demand will be less sought after.
- Assets with direct exposure to offshore visitors such as tourism will likely exhibit, at least for the medium term, structural repricing. Student accommodation assets are commonly underwritten by the tertiary sector and will be relatively less impacted.
- The Government has also reintroduced the ability for commercial real estate owners to depreciate the core structure of their assets and this will have an attractive post tax cashflow impact.

Balance sheet and capital structure

- Notwithstanding the conservative gearing across, for example, New Zealand's LPE sector, careful management of leverage and access to equity markets will remain extremely important to be able to weather the potential longer-term impacts of COVID-19, and also execute opportunistic acquisition options in the future.

What, if any, parallels can be drawn from the Global Financial Crisis and other health crises?

The Global Financial Crisis (GFC)

The GFC was of course a very different event from COVID-19. It was a financial shock to the economy and the impact on commercial real estate values was primarily yield driven as a result of acute illiquidity. The impact on property values was material; based on periodic valuation data sets (which are not perfect and typically exhibit valuation 'smoothing'), prime commercial real estate values dropped (from peak to trough) 30%+ in the US, 42% in the UK, 24%+ in Australia and close to 30% in New Zealand. These market adjustments, however, need to be considered with care. For example, many of the assets used to form the data sets were held in listed vehicles that were not solely focused on property and so exhibited equity-style-volatility contagion. Debt levels (loan to value ratios (LVR)) were also generally higher and, in NZ, the concurrent collapse of the 'finance company' sector magnified the adverse impact on property values. Today, LVRs are more conservative and the interest rate environment is materially more conducive to property investment.

Other health crises

The impact of COVID-19 is already significantly deeper than similar public-health crises including SARS (2002 to 2003) and the Bird Flu (2003 to 2007). These were not insignificant events, however, apart from adversely impacting tourism and education sectors, the impact on traditional commercial real estate assets was muted. Conversely, the GFC resulted in commercial real estate values across all sectors being severely negatively re-priced for two years or so before recovering sharply.

The Governments reaction, and other observations

Finance Minister Grant Robertson has suggested (26 March 2020) that the economic impact of COVID-19 is "*going to be significantly worse than the GFC*", and went on to reference projections from economists, commenting that "*those are very difficult projections to assess but we're here to cushion the blow*". As previously noted, the Government's monetary and fiscal response is unprecedented and similar strategies have been employed by many of New Zealand's trading partners and countries that invest in NZ real estate.

Time will tell how effective government responses around the world will be in mitigating the impact of COVID-19 on demand and liquidity generally and, more specifically, on commercial real estate markets.

Research shows that institutional investment sentiment is strongly correlated to liquidity, and we should follow this closely as the impact of COVID-19 becomes clearer. There is considerable market commentary on how the equity markets have reacted to previous crises, and references to a 'V', 'U' or 'L' shaped recovery/response. Direct real estate markets react more slowly than equity markets, or at least the transaction data to confirm a market response is slower to emerge, but they do recover. Interestingly, the equity market recovery from SARS and Bird Flu was a 'V' shaped response and markets were higher one year post the event than just prior to the event.

New Zealand is known as a safe-haven for investment (stable government, environmentally conscious with little corruption, a '*food bowl*', etc) and, in the wake of COVID-19, we would expect the relative interest in commercial assets in New Zealand to increase.

It is worth observing too that the volatility in commercial property markets tends to be 'hidden' because owners (other than distressed owners) tend to 'wait' and so liquidity naturally reduces during recessionary times. In addition, owners of prime assets tend to be better capitalised and able to weather the storm, and so transactions that do occur tend to relate to poorer quality assets and this phenomenon can further skew data availability during and throughout the immediate recovery of a crisis.

How can we expect the property valuation profession to deal with valuations, particularly in the short term?

Valuers are required to comply with International (and local) Valuation Standards, to underpin consistency, transparency and confidence in valuations, which are key to investment decisions, financial reporting and financial market stability. Under both of these standards, market value is defined as:

> "The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion."

In the context of a market that is literally changing day to day as COVID-19 evolves, and noting the earlier commentary in this paper on cashflow uncertainty, market illiquidity and disruption impacts, this definition becomes extremely challenging to comply with:

- **Date of valuation:** Valuers are required to report at a specific date and reflect market conditions at that time. Clearly this challenging at present, and valuers will need to rely on all information available to them when they complete and submit their market value estimates. Valuers can (and should) reflect, for example, historical evidence that suggests how property markets might move under differing economic, monetary and fiscal conditions. Valuers, of course, must inspect the properties they are valuing and this will not be possible during a lockdown period.
- **Willing buyer and willing seller:** Valuers are to assume that the hypothetical parties to a transaction (of the property they are valuing) are not under any compulsion to buy or to sell. During periods of market uncertainty, vendors might become over 'anxious' or conversely unwilling to sell (waiting for a market to recover) while buyers might become opportunistic and seek to take advantage of a period of inevitably reduced liquidity. As previously noted, the volume of prime asset sales tends to be less than secondary assets which can skew transactional data. These nuances are complex and difficult to account for during periods of heightened uncertainty.
- **Proper marketing:** During the short to medium term, it may be that traditional marketing processes, including campaign timing and marketing collateral, will be restricted, resulting in shortened or limited marketing campaigns. The ability to reach the target audience may also be restricted.
- **Each party acting knowledgeably, prudently, and without compulsion:** The ability to undertake proper due diligence will be severely constrained during a lockdown (property inspections will be prohibited) and the ability to procure such advice may take some time to recover once the lockdown is lifted. Normal due diligence material will similarly be difficult to procure. Potential purchasers acting without full knowledge on a property will inevitably risk price and vendors will be reluctant to provide warranties.

As a consequence of the above, expect valuers completing valuations during the COVID-19 crisis to:

- Caveat their advice, referencing some of the issues outlined above.
- Reserve the right to reconsider their advice as events unfold and if these events are likely to have a material impact on value. This might extend to valuers recommending that they review their advice prior to the next financial reporting date and as market evidence occurs. Periodic revaluations occurred in some countries during the GFC, where monthly, bi-monthly or quarterly valuation updates were completed.
- Reference the high valuation uncertainty, and potentially that there is more downside than upside value estimation error.

We note too that valuers will have to estimate the appropriate discount and/or capitalisation rate to apply for their analysis. When markets are stressed, valuers will need to consider issues such as the need for liquidity premiums and whether it is appropriate to consider additional risk premiums to account for the greater degree of uncertainty in estimating cash flows. Care will need to be taken in deciding on the appropriate level of additional risk premia and significant judgement will be required. We would recommend that the reasoning for any additional premia is documented within valuation reports to provide transparency.

The Property Institute of New Zealand (which operates alongside the New Zealand Institute of Valuers, the professional body for Registered Valuers) usefully suggested to its members (on 23 March 2020) that they:

"...should be clearly communicating the unprecedented events that have occurred globally including New Zealand and any impact, or unclear impact (as the case may be) that this event has had on the subject's particular market as at the effective date of valuation."

"...should clearly communicate any elevated valuation uncertainty, should there not be enough market evidence to draw a conclusion on how recent events have impacted the subject of their advice."

Meanwhile, The Royal Institute of Chartered Surveyors (RICS), which provides global guidance to valuers, suggests on their website (as at 29 March 2020) that its members consider advising their clients that they:

"...attach less weight to previous market evidence for comparison purposes, to inform opinions of value. Indeed, the current response to COVID-19 means that we are faced with an unprecedented set of circumstances on which to base a judgement."; and

Report their valuations "on the basis of 'material valuation uncertainty' as per VPS 3 and VPGA 10 of the RICS Red Book Global. Consequently, less certainty – and a higher degree of caution – should be attached to [our] valuation than would normally be the case. Given the unknown future impact that COVID-19 might have on the real estate market, we recommend that you keep the valuation of [this property] under frequent review."

Notwithstanding the above, valuers will need to advance their thinking on how they structure their valuation reports to ensure they communicate their opinions in a way that assists their clients with evaluating the valuation advice and presenting it in a meaningful way to their stakeholders (shareholders, banks, regulators etc).

What does this mean for 31 March financial reporting?

- Management and auditors will need to carefully consider any caveats included in property valuations.
- Depending on the significance of the caveats, in particular if the valuer has indicated there is significant valuation uncertainty, entities should ensure they fully explain the uncertainty in the significant judgements and estimates section of the financial statements.
- Auditors may, depending on materiality, draw attention to the valuation uncertainty in their Key Audit Matter reporting or by inclusion of an emphasis of matter in their unmodified audit report.

Concluding remarks

At present, in the middle of the COVID-19 crisis, the two key drivers of commercial real estate are under pressure; net operating cashflows are being challenged and investment sentiment / market liquidity is stressed. One thing we can draw comfort from is that the crisis will pass and the market will re-emerge; the form and timing of the re-emergence is, however, uncertain.

New Zealand is known as a safe haven for investment and, in the wake of COVID-19, we would expect the relative interest (to equities for example) in commercial assets in New Zealand to remain strong and potentially increase.

From a valuation perspective:

- It is virtually impossible to price commercial real estate at present, at least within the normal bounds of valuation estimation error. We expect that it will take many months before there is more certainty on the status of COVID-19 in New Zealand and globally and before adequate transactional data is available to benchmark value.
- In this context, commercial property valuers are faced with an a difficult task, and they will accordingly need to advise their clients as transparently as possible. In our opinion, that should involve open discussion on the challenges they currently face, and how they have interpreted the market to arrive at their conclusions. Over the short term, when uncertainty is acute, provision of valuation advice expressed as a range and with reference to scenarios, as opposed to a 'pinpoint' estimate, would in our opinion be more appropriate, albeit we accept that this may create challenges for financial year-end reporting. Valuers should be able to report in this manner so long as they clearly set this out in their scope of engagement with their clients.
- The importance of transparent reporting cannot be understated, as it is essential ingredient of functioning capital markets and critically important to banks with lending on commercial property.

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