



Valbridge Property Advisors – Coronavirus Update

March 18, 2020

We are in rapidly changing times due to the Pandemic virus known as COVID-19. On national and local levels, we are staying informed on real estate market trends, financial markets, and the outlook for 2020.

While it is currently unknown what direct, or indirect, effect this event may have on the national and local economy, our Valbridge Minneapolis-St. Paul office is making continual efforts to measure the impacts on the local commercial real estate market.

At this point the market appears to be pausing, and as such it is too soon to point to actual data points to derive shifts in market pricing, such as specific sale and lease transactions.

Therefore, we have taken the initiative to conduct a series of interviews with market participants from all areas of the industry including brokers, tenant representatives, property managers, developers, even other appraisers. What follows is a brief reporting of the results of our numerous interviews, in an effort to summarize the potential impacts this event will have on our local real estate market and answer many questions that you may have, and that we have already received.

We also want to provide you with an update on our ongoing efforts to continue assisting clients while also protecting the health and safety of our workforce. The Valbridge | Minneapolis-St. Paul office has a robust telework system in place for all of our appraisers and staff. Some of us are in the office, with most others working remotely and we are 100% operational.

Please don't hesitate to contact us if we can be of assistance.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Josh Folland', written in a cursive style.

Josh P. Folland, MAI, CCIM
Senior Managing Director

A handwritten signature in blue ink, appearing to read 'Richard Nordquist', written in a cursive style.

Richard Nordquist, MAI
Managing Director

A handwritten signature in blue ink, appearing to read 'Nathan Hansen', written in a cursive style.

Nathan Hansen, MAI
Managing Director

A handwritten signature in blue ink, appearing to read 'Tony Lesicka', written in a cursive style.

Tony Lesicka, MAI
Managing Director

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COVID-19 Impact on Real Estate

The stock market prices assets daily; the spread of COVID-19 has already driven the market into bear territory, with March 12 suffering a 10% drop -the biggest since the 1987. In real estate, we don't get instant pricing of assets; we appraisers are always looking in the rear-view mirror for data to prove our suppositions. But it isn't too soon to consider the likely impact on various asset classes.

The 10-year Treasury has been pushed to an all-time low. The Fed-funds rate will be 0% to 0.25%. Normally, this would be a big plus for real estate values, but instead we may see a frozen credit market, as we had in 2008, as banks stopped lending to each other across the globe. Fears intensify that the spreading virus will hurt corporate income and ability to repay loans.

Despite the flood of headlines, commercial real estate (CRE) remains in balance, with a positive investment climate. Past shocks such as SARS, swine flu, Gulf War and 9-11 attacks generated short-term volatility that stabilized in less than six months. We expect the same for COVID-19, assuming a tapering of new cases in the next 6 months.

In the short term, many *businesses* will be devastated. For real estate closely tied to the business operation just a few weeks of disruption will turn Mom & Pops upside down. Lodgings that usually run 60-75% occupancy will suddenly drop near zero.

The same for bars and restaurants. On March 16, Minnesota Governor Walz called for all bars and dine-in restaurants to close in the state. While the current shutdown timeline is through March 27, this is subject to change depending on future conditions.

The following commentary is largely focused on *real estate impacts*, as opposed to *business*, stock market or social impacts.

Hospitality, as noted above, will surely see the biggest impact from the novel virus. Both business and tourist demand will surely be greatly impacted. Most impacted will be venues that have a significant conference component.

Favored asset classes will be apartments and self-storage.

Office should show little impact; a large office tenant can't suddenly turn off their plans.

Industrial: the flow of goods from Asia has already tapered. Sales declines will surely follow. For example, Apple issued guidance that iPhone production will be constrained. On the sales side, iPhone sales were down 60% in China in February. Nonetheless, we expect the impact on industrial real estate to be minimal.

Retail demand should remain stable over the medium to long term, but significantly impacted in the short term as shoppers and diners avoid public spaces.

In conclusion, CRE isn't like the stock market or oil market, where assets are repriced daily. And to the extent that some buyers maybe expecting a big price cut but sellers refuse to budge, there will be no sale and thus no data point. Many small tenants will fail before the market returns normalcy. Well-capitalized tenants will carry on as the economy returns to normal by the end of the year.

Treasury Secretary Steven Mnuchin said on March 15, "I think we're in the second of nine innings..."

Market Participant Interviews

For this specific COVID-19 issue, local market participants were interviewed to discuss general market conditions. A brief summary of the discussions is as follows:

1. Broker in the Twin Cities Market:

Date of Interview: March 17, 2020

- The biggest theme is “PAUSE”. Feels like a lot of discussion about what/if/how/when and until that is known a fair amount of watching and waiting.
- There are new construction type projects that require a lot of planning and lead time that seem to still be advancing, but more slowly. There is also the forced activity of renew/relocation regardless of temporary closures, time continues to pass, and lease terms continue to reduce.
- Obviously still very fluid.
- There is also a perspective that this may be a calm before the “good” storm and that the market, RE, etc. will absolutely roar back quickly.

2. Vice President/Broker of Predominant Real Estate Firm in TCMA:

Date of Interview: March 17, 2020

- His firm generally deals with three property types; medical office and built-to-suit medical office, large office buildings, and some retail.
- The food markets (restaurants, cafeteria tenants) are skittish, and a few are already looking for financial assistance, in terms of temporary rent reduction, full rent abatement, or deferment.
- He’s not too worried about large corporate office tenants. He is actually surprised by the amount of commerce still occurring. This may be the brokers still pushing deals forward rather than the actual tenant. Regardless, office lease deals (new, renewals) are still moving forward as of this week.
- If these gathering restrictions end within a month and things look like they are headed back to normal, this might end up being just a blip with only a temporary cash flow issue. If so, market and investment trends could be fully recovered by the end of the year.
- Some construction projects have been put on hold. Upon further investigation, most of these are medical, senior housing, or hospital related. This is probably less a reaction to the market, and more of their desire/need of these markets to focus on immediate care needs and direct cash flow to supplies and staffing.

3. Broker/Property Manager/Banker in TCMA:

Date of Interview: March 17, 2020

- Internal discussions are ongoing and indicated it is too soon to speculate. That said, a recession is expected, but it is projected to be short.
- Will encourage tenants to utilize the resources available including any stimulus provided by the state and federal government and will assist tenants where needed.
- Tenant requests for assistance have not been received but are anticipated.
- They are planning on being flexible and will work with tenants regarding their situations on a case-by-case basis.
- No evictions are being predicted, and actions, such as waiving late fees, are under consideration should current conditions become extended.

4. President/Broker with Real Estate Investment Firm:

Date of Interview: March 17, 2020

- Broker and serves as president of a real estate finance and consulting firm with expertise in childcare, auto repair, and restaurants
- So far, it's business as usual. Transactions that are scheduled to close in the coming days are moving forward.
- Unknown how this will affect the market in medium to long term.
- Believes that daycare and auto service will be resilient. Restaurants will be most hard hit.
- How this impacts the market overall will greatly depend on how long it lasts. If it's a matter of weeks, this could not have a relatively small impact on CRE market moving forward. If economic hit lasts longer than 8 weeks, effects could be more long lasting.

5. Broker and Owner Multifamily Investment Company in TCMA:

Date of Interview: March 17, 2020

- The underlying rental market fundamentals are still strong, and this virus will not change that. If anything, it may cause an increase in the number of renters due to people having less money.
- Interest rates are the main driving force for multifamily properties. Expects cap rates to stay in the 5% - 6.5% range because of the low interest rates
- As shown by the sharp decline in the stock market investors may look for safer investments. Could see the multifamily market as a safer place for investors to put their money

6. Local Property Manager with a Regional Investment/Development Company:

Date of Interview: March 17, 2020

- Internal discussions are ongoing and indicated it is too soon to speculate. That said, a recession is expected, but it is projected to be short.
- Will encourage tenants to utilize the resources available including any stimulus provided state and federal government and will assist tenants where needed.
- Tenant requests for assistance have not been received but are anticipated.
- They are planning on being flexible and will work with tenants regarding their situations on a case-by-case basis.
- No evictions are being predicted, and actions, such as waiving late fees, are under consideration should current conditions become extended.

7. TCMA-Based Industrial Broker with a Regional Firm:

Date of Interview: March 17, 2020

- Everyone is on a 2-month break.
- Two deals that were at Letter of Intent stage, that have been put on hold for a month or so.
- Has felt like the peak for the past 2 years, with high prices by historical measure, so this feels in part like a market correction. Shift from seller's market to buyer's market.
- As far as the impact on prices, instead of getting \$110/SF for a smaller, typical industrial property, perhaps they will get \$90/SF in a couple months.

8. Sales & Leasing Broker in TCMA:

Date of Interview: March 17, 2020

- No clue how this will impact real estate
- Interest rates are low and clients (buyers & sellers) are still wanting to make deals
- Lender interest rates 200 basis points over treasury rates two weeks ago, now 300 basis points over
- Throughout all of the financial markets, real estate has the greatest uncertainty and believes there will be a negative impact because of the uncertainty
- Sellers will want to get deals done ASAP because of uncertainty
- One client who wanted to sell received an unsolicited offer a month ago on a medical office building and is not being advised to hold off until there is more certainty
- More tenants will want to do short term leases
- Seller's won't back out on deal, it's buyers who will have uncertainty
- Tenants seeking flexibility
- Might eventually affect price and raise cap rates due to tenant flexibility needs
- "Self-inflicted recession"
- Good thing is we were at peak unemployment prior
- Will not be quick
- We will take on enormous amount of debt if they take on stimulus package
- Medical office outlook is good – still doing deals
- Working from home will have impact on long term demand for office space, won't be the case, we will have loss of productivity
- Retail will get hit the hardest, then restaurants then office

9. Industrial and Office Broker in TCMA:

Date of Interview: March 17, 2020

- Certain markets such as office and retail, will struggle and we will see a rise in cap rates - in particular, non-credit enhances retail will struggle
- Businesses where people are now working from home may realize they don't need as much office space
- Cap rates will probably stay the same for multi-family and industrial properties "in the case of the better product"
- This will not be a quick fix, and the full effects won't be felt until the end of the year
- There will be foreclosures happening that we haven't seen in seven years
- Issues in the oil industry will have as much of an effect on cap rates as the corona virus
- Investors are pulling back on acquisitions and dispositions with a "wait-and-see" attitude
- Tenant rollovers and changes in credit of tenants will be watched more closely
- There is great fear because of how quickly the virus came on

10. Multifamily Broker with a National Real Estate Investment Firm:

Date of Interview: March 16, 2020

- The COVID-19 pandemic is very new to this market and we don't yet know the impacts it will have on multifamily properties.
- Space market fundamentals are expected to remain strong in the near-term

- Due to decreasing interest rates and the perception of strong fundamentals, properties with primarily local buyers will continue to be highly sought after. These properties include smaller (less than 100 units) Class B & C properties.
- Institutional properties may be impacted the most. Institutional buyers tend to hail from out of state or country and will face difficulties travelling for site due diligence. Listings may see extended marketing times and fewer buyers, which may impact prices. Caution that it is early, and we don't truly know the impacts yet.

Summary Statement

As the outbreak is largely thought to be in the early stages, the various interviews demonstrate that there is little consensus on exactly what the effect may be on the market, which will likely depend greatly on the property type and most probable buyer. The situation is changing daily, and the true impacts on the real estate market will eventually begin to reveal themselves. We at Valbridge will continue constant communication with market participants to provide valuable insights to our clients.



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