COVID-19 Infects the Real Estate Cycle

*Featuring: **Bryan Reid,** Executive Director, MSCI Research*

Adam Bass (00:03):

This says MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host Adam Bass and today is September 10th, 2020. This week, what happens when commercial tenants can't pay their rent? What's the effect on landlords and more to our point today, investors. For answers, we caught up with Bryan Reid, Executive Director on MSCI's real estate solutions research team. So Bryan, thank you very much for being on the program.

Bryan Reid (00:37):

No worries. Happy to join. Thanks for having me.

Adam Bass (00:40):

And it is very good to have you here. And I will admit, I do say that to every guest we have on. However, it's particularly meaningful to have you here, because from what I understand, COVID has affected you in a very personal way. And you've had quite a journey these last six, seven months.

Bryan Reid (00:59):

It's certainly been an interesting time up until mid-January I was based in Sydney and we arrived here the start of the year. And my partner had to return to Sydney for what was supposed to be a three week trip in March, but with the outbreak, she ended up getting stuck back in Sydney with no fixed return date.

Adam Bass (01:25):

Well, I'm glad that you're both here now and on behalf of the city of New York, we welcome you. A lot has been written and debated about the effects of the pandemic, obviously some of which you are speaking about, but specifically around the ability of people to do basic things like pay their rent. This has meant loss of income for landlords of course and the cascading effects from that. But today, we're here to discuss your research, which focuses on a similar dynamic with businesses, those that rent their storefront or restaurant or office space. So can you tell us a little bit about what your research has shown with that?

Bryan Reid (02:08):

Sure. So I think the problem that some businesses are facing isn't too dissimilar to what individuals facing in the sense that lockdowns and social distancing have impacted the ability to generate income, and therefore for a number of businesses the ability to pay rent has become more challenging. Commercial landlords are therefore faced with an increasing number of requests for rental relief.

Adam Bass (02:37):

And like many aspects of COVID, has this been the case in all areas of the world, has the effect been the same?

Bryan Reid (02:46):

Well, I think we're dealing with fundamentally a health crisis, which is cutting across global borders. And so what we're seeing is the effect that it's having across borders is very similar.

Adam Bass (02:58):

Real estate has certainly been a cyclical asset class and there've been downturns before. Is that what we're seeing here or is there something different going on this time around?

Bryan Reid (03:10):

To be honest, I think there's a little bit of both elements perhaps. In one sense, we've been through quite a long expansion for global real estate. The MSCI Global Annual Property Index recorded 10 straight years of expansion up to the end of 2019. As that cycle drew on, I think if there was an increasing amount of discussion in investor circles about what a turning point might look like and where the next downturn might come from. Obviously I don't think anyone foresaw COVID as being on the radar, but it's certainly arrived and it's causing asset values to decline. We're seeing impacts on cash flows. So to an extent real estate has reached a turning point, but we're also seeing very different effects depending on what sort of property types you're looking at.

Adam Bass (04:05):

And so you mentioned that as an acceleration of a trend already in process. That's a concept we've heard from a number of guests on the program. Can you talk a little bit more about that and other trends that may have been accelerated?

Bryan Reid (04:27):

To give the most prominent example over the last couple of years, there's been an increasing divergence between retail and industrial property. On the one hand, the increasing amount of online shopping has been sort of providing headwinds to traditional bricks and mortar retail assets. While at the same time, the demand for shipping and logistics has been a tailwind for the industrial sector. There was already a growing gulf between the return performance of those sectors and with the pandemic affecting sectors like retail more than it's affecting logistics assets, that stands to potentially accelerate that divide.

Adam Bass (05:09):

Your research looked at both sides, equally important for real estate equity investors, as well as fixed income. Let's start with equity, how has the drop in rental income and its effect on landlords affected those who invest in these properties?

Bryan Reid (05:26):

So for equity investors, the effect is probably most notable in terms of the income stress that we're seeing. With demands for rental relief, you're seeing declines in rent collections, which is causing income returns to compress. It's fairly unusual in a historical context because one of the features of the asset class is usually the... I would say, stickiness of the rental income. In the sense that you have an existing, in place lease profile, and that provides a certain amount of stability, at least in the near to medium term.

Adam Bass (06:03):

Of course, we can't talk about a crisis involving real estate without talking about real estate debt. What impact are we seeing from the 2008 global financial crisis today and how things are playing out for fixed income investors this time around?

Bryan Reid (06:19):

Experience of the financial crisis I think has quite a long shadow over real estate debt. The consequence of that experience I think is that there's been a lot more caution this cycle around the use of debt. It's been structured a lot more cautiously, it's been used a little bit more prudently. Obviously, there's been regulatory macroprudential reform, which has reshaped the lending market somewhat. The risk factors that we were looking at last crisis had been mitigated, but here, I think we're looking at a different set of circumstances that could pose different challenges, particularly for loan servicing. Now with any loan, there's usually some form of a covenant written into the agreement to protect lenders. In the case of commercial real estate, you're probably looking at something like an interest coverage ratio or a debt service coverage ratio. Those income covenance could be coming under increasing pressure. The amount of buffer in the income profile to absorb and to continue to make repayments has potentially been reduced, particularly for property types that are being more impacted like hotels, leisure, retail, et cetera.

Adam Bass (07:30):

And have we seen any immediate impact of that in terms of the transactions market or is it too soon to tell?

Bryan Reid (07:37):

Yeah, transaction markets have been impacted by the crisis with the increased uncertainty. I think a number of deals that were in the pipeline have been put on hold or potentially canceled, and we've just seen a general drop in the amount of activity taking place in real estate transaction markets.

Adam Bass (07:57):

One fact that struck me when I looked at the data was that in addition to industrial spaces, net operating income for offices actually remained positive through June. Reason it was surprising is because there's been, as you know better than I, so much uncertainty and debate about what the role of offices will be when many people are physically able to go back to work. So I'm curious if you have any thoughts about what may have been behind that positive performance, as well as what kind of questions are you looking at going forward with office space.

Bryan Reid (08:38):

Seeing continued positive net operating income growth, at least in a historical context, isn't that surprising, because the in-place lease structure typically provides some stickiness to rent profiles and it's really only this crisis where we're seeing that changed a little bit. A lot of businesses have been able to successfully migrate their operations and transition staff to remote working conditions. That's enabled them to continue generating income, which in turn means that office tenants so far have been under less pressure when it comes to making rent payments than say a retail tenant whose stores have all been closed and hasn't been able to operate or has had to operate at a reduced capacity.

Adam Bass (09:27):

Looking ahead though, as companies recognize just how well they can work remotely, what's the potential impact on the office sector for real estate?

Bryan Reid (09:37):

Well, this is one of the big question marks that I think investors are facing. The outlook for retail and the risks are fairly well understood at this point. For sectors like industrial, I think again, there's a little bit more confidence. Office sits in this unknown space at the moment because on the one hand, the successful ability to transition so many people to remote working does raise questions about whether there will be a continued long-term demand for office space.

Adam Bass (10:11):

Well, that could certainly take us in a whole other direction, Bryan. Unfortunately we have to cut off the conversation here now, but again, thank you so much for joining us and good luck settling in.

Bryan Reid (10:25):

Thank you very much, Adam. It's been a pleasure and thanks for the time.

Adam Bass (10:29):

That's all for this week. Thanks to Bryan and to all of you for joining us. Be sure to tune in next week when we'll ask, why is the construction of a growth factor index different from all other indexes? Remember, it takes just a moment to subscribe to the podcast, leave a comment, or share with a friend. Until next week, I'm your host Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.