Memorandum

Date: March 26, 2020

To: Our valued clients, customers, and investors

From: NAI Affinity

Re: COVID-19 Commercial Real Estate Update

Greetings. While preparing remarks approximately 30 days ago for the then scheduled BizWest Real Estate Summit, we noted that the US Economy was strong, real estate fundamentals were solid, and the biggest risk we all faced was the unpredictable "Black Swan" event…

Enter the Swan. Like you, we are closely watching the impacts of the COVID-19 pandemic, with an eye on how this is impacting the economy and commercial real estate. While this situation continues to evolve, our current outlook as is follows.

"The Curve". By now you are all familiar with the "infection curve" and our country's efforts to reduce the infection rate. Terms such as "flattening the curve", "social distancing", "shelter in place", and "self-quarantine" have become commonplace. We expect that the number of cases of COVID-19 will continue to increase over the next two to three weeks as: (1) the positive impacts of "social distancing" and "self-quarantining" will not yet show up in the numbers; (2) the incubation period takes up to two weeks to result in symptoms; and (3) more tests are only now becoming available, with days of turnaround time for results which, will increase the number of confirmed and reported cases. The next 30 days will provide additional clarity on the length and severity of this challenge to public health and the economy. In the meantime, we encourage all to help reduce the spread of the virus by staying in and practicing social distancing.

Social Distancing. While we are limiting our physical contact, we have not been avoiding communication. Far from it, in fact. We have been and will continue to be in contact with many of you as well as other business, industry, and community leaders.

The Stock Market, Corporate Earnings, and Government Stimulus. While not our area of professional expertise, we anticipate continued volatility in the stock market while our country works to flatten the curve, and thereafter for 60 to 90 days, while corporate earnings reports are announced. 2nd quarter earnings, unemployment reports, and GDP will be bad – no surprise there. With the significant percentage drops across all major indexes, one has to wonder how much of this has already been priced in the market? It is also important to consider that some businesses will actually see an increase in earnings due to new shopping behaviors and stronger demand for their products and services.

It is also important to note that the unprecedented level of government stimulus (the pending Senate package is summarized here by the NY Times) and additional Fed action (interest rate reductions and the multi-trillion dollar return of quantitative easing) will be a helpful life-vest to a number of businesses and a boost to the US Economy.

We are also seeing economic projections from multiple independent economists and reputable sources calling for a resilient second half of 2020, fueled by the strong pre-COVID-19 economic fundamentals, incredible government stimulus, and historically low interest rates. Here is one example, in the form of a LA Times article about a Stanford Noble laureate who is predicting a quick recovery.

Banking and Capital. Unlike the Great Recession, our banking industry remains strong and well capitalized. The government is taking steps to ensure this continues to be the case and we have heard from numerous financial institutions who are pledging their support for our clients and theirs. These actions are already manifesting in loan concessions from banks to impacted businesses. Amongst leading regional banks, we have heard of multiple examples of rate reductions, short-term payment forgiveness, and temporary modifications of debt service payments to interest only payments.

Commercial Real Estate Leases and Contracts. Understandably, we are seeing negative impacts to our clients who are in retailing, restaurants, personal services, hospitality, and oil and gas. Most tenants who fit in these categories are approaching their landlords with concession requests. Less desirably, some tenants are simply notifying landlords that they will discontinue the payment of rent until further notice (we do not advise this and favor a more collaborative approach). We have been and will continue to suggest that landlords approach these requests on a case-by-case basis, with a bias toward offering some assistance. Our opinion is that, if handled properly, this is good business for the landlords too and it is better to work with tenants proactively, as opposed to after some have closed for business and/or filed for bankruptcy.

In considering these requests, landlords would be wise to evaluate the relative strength of the location (or lack thereof), the potential time and expense required to re-tenant the space (which in some cases could be significant), current and pre-COVID-19 sales volumes of the tenant, and the financial strength of the tenant. Most jurisdictions will not enforce evictions or foreclosures for the next 30+ days. Depending on the factors noted above, landlords may wish to forgive a couple of months of rent while employing tactics such as: (1) obtaining documented mutual consent to apply security deposits to current rent (a cash flow neutral solution); and (2) extending the length of leases for a period of time equal to or slightly greater than any free rent periods (the latter months may be subject to future rent escalations, which provides some additional relief to landlords).

To date, we have only seen one cancelled purchase and sale contract company-wide (with a business acutely impacted by current conditions). We are processing several extension requests of buyers, who are currently seeking to delay closings for approximately 30 to 45 days, in order to allow for better visibility on the long-term economic impacts. Many other buyers are proceeding according to plan, including but not limited to, those looking to satisfy 1031 exchange requirements.

Overall, our brokerage pipeline has continued to grow, not decline, over the past two weeks.

Development and Land Transactions. Residential land transactions to single-family home builders and apartment developers remain a bright spot. To date, none of these contracts that we are a party to or have knowledge of, have been canceled. The buyers of these properties realize that the process to entitle and build new homes is long-term and that the underlying fundamentals of low vacancy, low lot supply, and low interest rates are favorable. In fact, our brokers signed up two additional national homebuilders to land purchase contracts last week and we have spoken to multiple builders and brokers who continue to proceed “full speed ahead” with their acquisition and development efforts.

Apartments. Buyers seeking institutional-quality apartment communities remain active. This includes those seeking to satisfy 1031 tax-deferred exchange requirements as well as the typical buyers of these assets. Encouragingly, we have also seen an executed contract this week on a large apartment community; the buyer is a pension fund advisor.

Apartment leasing also continues to be favorable, with clients reporting relatively healthy absorption of 4 to 6 units per week over the last two weeks, in newer class A apartment communities. Most of this leasing is now being done virtually, using proprietary websites, Zoom, FaceTime, and other similar tools. Maintenance continues to be done but, is wisely being limited to critical items. Not a lot of light bulbs are being changed but, utilities, HVAC, and major appliances are being repaired as required.

Many jurisdictions consider the construction of housing to be an “essential business” thus, this work continues, in most cases without meaningful delays. Pricing of new jobs is also becoming more favorable for developers, which may reverse the trend in recent years of construction cost increases outpacing rent growth, a favorable sign for housing attainability.

<u>The Case for Hard Assets.</u> The volatility in the stock market has resulted in a number of our clients and investors expressing an interest in shifting a greater percentage of their portfolio to real estate, more specifically asset types such as class A & B apartments and distribution warehouses. The phrase “everybody needs a place to live” is often uttered. Furthermore, hard assets such as apartments, which offer the ability to reset rents regularly, are a possible hedge against future inflation that could arise due to significant government stimulus.

<u>We are here if you need us</u>. We wish you and yours all the best during this challenging time. We are confident that our country will emerge from this stronger than ever (socially and economically – after all, who wouldn’t like to see more onshoring of industrial production and critical supplies?).

Please know that we are here and stand ready to assist when you need us. We are happy to help formally or informally, as the case may dictate. <u>Tomorrow is one day closer to the next great American comeback</u>.

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