NAI Affinity

Memorandum

Date: April 7, 2020

To: Our valued clients, customers, and investors

From: NAI Affinity

Re: COVID-19 Commercial Real Estate Update

Greetings. Since our March 26th update, there continue to be primarily two things on our mind: (1) the health and safety of those we care about (including all of you); and (2) how long will this last?

Duration. Our NAI Affinity team has been participating in a great number of conference calls and Zoom meetings over the past few weeks. These discussions are with leaders in the fields of commercial real estate, housing, general business, medicine, and government. We will continue to do this in order to stay informed, while operating our businesses effectively and providing timely advice to our clients. Across industries and disciplines, the biggest public health and economic wild card is "duration." How quickly the economy will recover depends greatly on the duration of this acute economic disruption. Current estimates from government and healthcare leaders range from May to August.

The Peak. The next 30 days will be very helpful in determining how long this could last. We will all be challenged by the events of the next few weeks. Hopefully, this is the peak that we have been anticipating. While much of this is out of our control, not everything is out of our control. We can choose to control our behavior and thoughts.

Behaviorally, the best things we can all do to limit the spread of this virus, and its devastating impacts on public health and the economy, are to continue to stay at home and practice "social distancing." We can also choose to practice gratitude, kindness, and an unwavering commitment to improvise, adapt, and overcome the obstacles before us.

The Economy, 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.

It is also important to note that the unprecedented level of government stimulus from the CARES Act and additional Fed action will be a helpful life-vest to a number of businesses and a boost to the US Economy.

The U.S. Senate's Committee on Small Business and Entrepreneurship has published a guide to the CARES Act, which is available at this link. We are finding that many businesses are applying for the Payroll Protection Program ("PP Program") and Economic Injury Grants. The PP Program is offering loans at 1.0% interest that may be forgivable if a business meets certain qualifications related to staffing. Demand for these loans is high and we encourage our clients to explore these resources by contacting their bankers. Please be patient with your bankers as they are doing yeoman's work to implement these programs.

Banking and Capital. Unlike the Great Recession, our banking industry remains 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 seen very few cancelled purchase and sale contracts. More prevalently, we are processing 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.

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 multiple homebuilders to land purchase contracts over the past few weeks. We have also spoken to multiple builders and brokers who continue to proceed with their acquisition and development efforts. The pace at which this continues, and the percentage of these deals that make it to closing, will be determined by the duration of this economic disruption.

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.

Apartment renewals are strong for existing apartments. Leasing, which had been favorable throughout most of March is starting to slow as renters hunker down. 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.

It is a bit early to tell about delinquent rents in April. Thus far, class A apartments in secondary markets appear to be holding up well, with delinquencies of approximately 5%. When larger portfolios are considered (including those in primary markets and with B & C apartments), that number pushes closer to 20%.

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.

The Case for Hard Assets. 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.

We are here if you need us. 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.

Tomorrow is one day closer to the next great American comeback. Be well!

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