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# WILL THE COVID-19 VACCINE RESTORE THE COMMERCIAL REAL ESTATE MARKET?

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# Distress or No Stress?

By Andrew Van Tuyle

Conversations about life after coronavirus lately have focused more on inflation than distress in the marketplace. While some of the issues that have haunted commercial real estate post pandemic are still present, others have yet to show themselves.

The Global Financial Crisis of 2008 affected virtually all asset types at once as vacancies spiked, unemployment increased and banks stopped lending. The Covid-19 pandemic caused nationwide distress. But at the same time, it boosted certain property types, including industrial, life science and even multifamily. The financial impact of the pandemic is different than other recession triggers, and this one is far from over.

It is easy to identify how and why Covid-19 impacted hospitality and retail first.

The general population was required to stay home, nearly instantly halting foot traffic, which forced both small and large businesses to shut down. Some to never return. Home delivery of products—even groceries—changed the way retail operators interacted with customers. They could operate with less retail square footage and more distribution space. Since big box demand has all but vanished, malls are being converted to industrial, multifamily, or whatever use can be justified—and municipalities will allow.

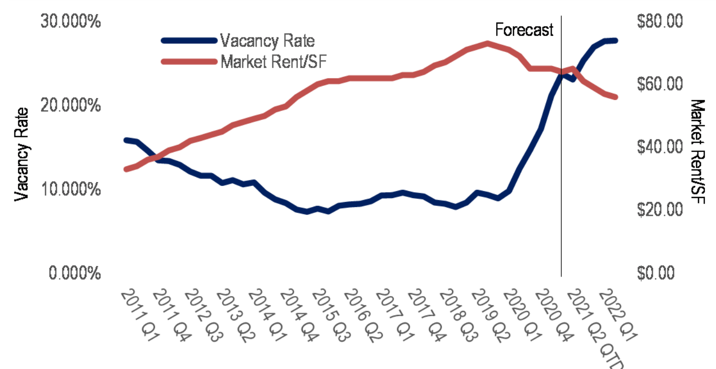
On the other hand, grocery-anchored retail centers have seen a huge spike in demand, causing capitalization rates to compress on the few transactions that are brought to market.

Corporate travel may be slowly starting to return to hotels, but we may not see a return to pre-pandemic levels for years (if ever), and conferences and conventions may be some of the last to recover. These next few years may be a case of the "haves and the have nots."

While retail and hospitality have been getting most of the headlines, distress in the office sector may be lurking in the background.

At the time of this writing, San Francisco has more than 10 million square feet of office space available for sublease. Add that to the 12.6 million sf of direct vacancy and San Francisco's availability rate for office is 32.6 percent. The city had an astounding 6.8 million sf of negative absorption during the last 12 months alone, according to CoStar Group. While San Francisco is merely one example, and maybe the worst, how can that not lead to some level of distress hitting the market?

Many companies still have not decided what their office needs will be in a post-Covid environment. Does 'work from home' mean less office space is needed or will social distancing require even more space than before?  Will companies require greater filtration in their ventilation systems, dedicated amenity packages or direct access to their space? All of these are possible, but they have one thing in common: their spaces will be different. Modifying existing or building out new space used to be costly, but now it could become downright expensive.




*Source: CoStar Group*

Meanwhile, labor and commodity prices are significantly higher around the country than they were a year ago. That will wreak havoc on budgets. Underwriting a property purchase prior to 2020 relied on making general market assumptions for tenant-improvement costs and capital expenditures that today look very different, given the inflationary environment.

At the same time, negative absorption and an increased supply of available space will push rents lower and create a tenants' market. Just to keep an existing tenant could mean a higher tenant-improvement allowance than in the past, plus potentially lower rents.

## Increased Costs + Decreased Revenue = Distress

The news for the office sector may not be all bad, though. Tenants looking to more closely control their environments and decrease exposure to common areas may look to low- to mid-rise office properties, checking the boxes necessary to convince employees to come back to the office.

Companies may look to control an entire building and operate in a single-tenant environment to limit interaction with non-employees. It's also possible that suburban or low-rise buildings might actually see positive absorption and possibly even an increase in rate. That, however, could come at the expense of high-rise or multitenant buildings.

Downtown urban core assets were once the darling of the marketplace, but the shift in what tenants desire or need will test what those locations can provide.

Less occupancy in the marketplace will create a vacuum, and that vacuum, combined with increased costs, will create distress. Retail and hospitality have proven this to be true. With office it is only a matter of time.

Distressed assets are here, and there are more coming. An improving economy can't change the inevitable, but how it presents itself is yet to be seen.

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