Uncertainty in the time of COVID-19 - by Bill Pastuszek

May 08, 2020 - Appraisal & Consulting

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Uncertainty in the time of COVID-19. Real estate investors – investors of all types – abhor uncertainty, knowing however it is always present. Investment activity is guided by managing risk inherent in an uncertain future. The COVID-19 environment has taken investment uncertainty to new levels. Where a scant two months ago investors worried about the end of the long up-cycle in the economy and in CRE, the new environment has put to rest the notion of when the upcycle ends. It ended.

Investors generally can process specific bad news such as rising interest rates or higher inflation: that kind of news can be quantified. We now have entered an entirely new Era of Uncertainty. Risk is magnified, but not clearly, and is difficult to quantify.

Current inputs making up real estate modeling may need to change. Maybe the models themselves need to be changed. Generally, real estate investors build some factors into their buying decisions to account for uncertainty. What are they under these circumstances and can they be expressed quantitively today?

From my sources, a consensus seems to be emerging about quantifying short-terms effects. Areas of focus being considered include, but are not limited to, rent interruption, changes in expenses, tenants' ability to pay, and loan underwriting standards. Longer term, no consensus has emerged. The concern is that by the time data comes in, it will be outdated.

We can rely on anecdotal information and our own experience, judgment, and opinion. But we all know there are a number of biases at work there. We also know that hard data, its patterns, and the conclusions to be drawn from them take time to emerge. All these surveys (even from thoughtful and authoritative sources), webinars, opinions about opinions, and data crunching make no claims for certainty.

We can look at short-term indicators and to some degree quantify what is happening, but real estate is the ultimate long view investment, which is at least one reason it's so interesting to analyze and try to understand. And under these conditions, specific value impacts will likely end up being case-by-case, property sector by property sector, sub-sector specific, and location dependent.

It's not all bad news. Interest rates are down. Lenders have money to lend. But, do they want to lend now or will they want to three months from now? Some lenders, having gone all in on the recently strong market, may be seriously re-evaluating their portfolios. If there was ever a time to do some stress testing, it is now.

Most investors leverage their investments through financing. Leverage allows them to manage risk and amplify returns. Leverage works the other way, too. Less cash flow in, a tenant forbearance request, or an outright default, may leave a highly leveraged property underwater, with the investor possibly just handing over the keys. Further on, with increased negative activity, will there be opportunities for cash buyers? All this remains to be seen.

What might happen to cap rates? In the short term, maybe very little. Longer term, uncertainty reigns.

A cost of capital model considers both equity and debt. Debt rates may go down, equity rates up. However, lenders may want stricter terms: higher reserves, more down payment, more debt coverage. The proof of concept will be in the sales taking place over the next six months, Anecdotal information and rumors regarding repricing and re-trading of transactions should be taken with a grain salt until they are a fact of the marketplace. Let's revisit in a quarter or so.

Real estate markets tend to be slow moving, much like large oil tankers. (Oil & Energy: Ah, another grave uncertainty influencing real estate.) Both like moving in straight lines, somewhat ponderously. It takes a long time to change headings and by the time it happens, another course correction may be required.

As said earlier, uncertainty goes with investment; we are in a period of very unique uncertainy. As Warren Buffet said about stocks "Uncertainty is the friend of the buyer of long-term values." This could be applied to real estate. Listen carefully, analyze, be sure of the data, then act. Now is not a time to act based on emotion or unsupported assumptions. Time will tell; in the meantime, acting on the best information available is the only reasonable course.

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