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The effect of government stimulus on commercial real estate amid COVID-19

Governments have used a variety of measures to support commercial real estate and their tenants through COVID-19—with mixed results for both parties. What opportunity exists for new approaches?

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The COVID-19 pandemic, the worst humanitarian and health crisis the world has seen in the last 100 years, has had devastating effects on families, livelihoods, and economies. Governments' efforts to enforce work-from-home rules and limit congregation as critical public health measures to control the spread of the virus have had significant impacts on commercial real estate, the businesses that occupy these spaces, and the people who work there. Indeed, physical distancing and stay-at-home mandates have left many office buildings deserted, and many companies have pushed office return dates out to summer 2021—more than a year after the lockdowns started.[1] In Q3 2020 the United States saw a decline in office occupancy of 28.9 million square feet—the largest single-quarter drop on record—and vacancy rose to 16 percent.[2] Meanwhile, retail real estate and shopping malls have been utterly devastated.

Given that real estate is the largest illiquid asset class in the world, estimated at more than $228 trillion in asset value in 2016,[3] as well as how many people are employed directly or indirectly in the industry, governments at the federal, state, provincial, and municipal levels are focusing significant amounts of COVID-19 financial support on the sector. The responses have varied considerably by government, ranging from indirect support, such as simple deferrals of rent and changing of eviction rules, to significant direct financial support of landlords (via payments to tenants).

Clearly, governments recognize that maintaining stability throughout the duration of the pandemic is required for the tenants, landlords, building value, property taxes, safety and security, and quality of life in every community. But, to date, how effective have these stimulus plans been—and what might governments, landlords, and tenants consider doing differently going forward, especially in a post-vaccination economic recovery? In this article, we review the shape of various programs around the world, offer a perspective on their effectiveness and the second-order distortions they're causing in the market, and offer some considerations to facilitate the sector's exit from the COVID-19 pandemic and set it up for success in the years to come.

What do these stimulus programs look like?

To date, government funding has largely come from federal sources, where there is more substantial borrowing capacity compared with hyper-local sources. Federal funds have generally provided direct support that is time-limited and targeted, as opposed to generally available. This support has included, for example, stimulus checks given directly to employers that allows businesses to divert scarce cash to nonemployment costs, as well as checks to the tenants themselves that allow them to keep paying their rent or mortgage.

For example, at the outset of the COVID-19 pandemic, Canada made forgivable loans available to landlords where the loans cover 50 percent of the rent, the tenant pays 25 percent of the rent, and the landlord absorbs 25 percent of the rental loss. The government also extended the period before eviction notices can be served. During the second wave of COVID-19, the Canadian government launched a second rent relief program that covers up to 65 percent of rent or commercial mortgage interest (linked to a sliding scale of revenues impact due to COVID).[4] The UK government has required extensions in notice periods by landlords before eviction, and issued a moratorium on commercial lease evictions.[5] The French government is offering landlords a tax credit equal to 50 percent of the amount of rent waived for commercial tenants that have no more than 250 employees.[6] In Germany, the

[1] Gillian Friedman and Kellen Browning, "July is the new January: More companies delay return to the office," October 13, 2010, nytimes.com.
[2] Scott Homa and Phil Ryan, "United States office outlook—Q3 2020," Jones Lang LaSalle, October 14, 2020, jll.com.
[3] "Global real estate: Trends in the world's largest asset class," Hongkong and Shanghai Banking Corporation, July 2017, hsbc.com.
[4] Jordan Press and Christopher Reynolds, "Anxiety, criticism greet arrival of Liberals' revamped commercial rent relief program," Canadian Broadcasting Corporation, November 23, 2020, cbc.ca.
[5] "COVID-19 government measures in real estate: Europe," Squire Patton Boggs, April 3, 2020, squirepattonboggs.com.
[6] Emilie Renaud and Nassim Vareilles, "French government introduces new tax credit for landlords to waive rent payments," Gowling WLG, November 16, 2020, gowlingwlg.com.

government enabled tenants to defer lease payments from 2020 to 2022.[7]

Beyond such direct financial supports, many governments have also announced green retrofits of buildings as an important part of their economic recovery plans. For example, the Canadian Government has pledged 2 billion Canadian dollars for building retrofits;[8] the French government has pledged €7 billion and the UK government has pledged £3 billion.[9]

Are these programs effective?

To determine if the stimulus programs aimed at the real estate sector had any positive impact, we need to examine two metrics: the percentage of uptake by landlords and tenants, and the impact of these programs in terms of vacancy, rent rolls, and ultimately asset values. It's also helpful to consider the distortions in the sector caused by stimulus efforts.

Uptake by landlords and tenants

The evidence on the uptake of these programs is mixed by country. For example, in Canada, the government set aside more than 900 million Canadian dollars for commercial rental support. Its most recent estimates are that just 163 million Canadian dollars was spent and that 21,000 of 1.2 million small businesses that could have benefitted from the program were funded.[10] We have heard from many real estate executives that the application process is too arduous, and many landlords do not want to put more debt on their balance sheets even though the loan was forgivable in part.

At the other end of the spectrum, there has been significant uptake for COVID-19 support in the United Kingdom through the "Bounce Back Loan Program," which provided £50,000 loans to small businesses that can be paid off over ten years. Demand for these loans, which can be used to pay rent, far exceeded anticipated levels. It was estimated that there would be £18 billion to £26 billion of uptake. But it is currently estimated that uptake ranges from £38 billion to £48 billion.[11]

Impact on market metrics and asset values

While it is still early to understand the full scope of government intervention in the market, it would seem that the majority of efforts to support landlords—from requiring rent deferrals to funding building retrofits—have served to avoid a panic or sell off in the sector. According to research from JLL, sublease markets are suffering as the supply of available space far outstrips the current demand. The overall volume of asset sales has dropped precipitously, even as individual asset pricing has remained stable (except for retail). Asset values are not being remarked quickly by financial institutions. Yet, small business defaults and closures continue to increase. For example, in Canada, where the government has arguably been the most aggressive in terms of rental relief programs, it is estimated that the COVID-19 pandemic could cause the permanent closure of up to 19 percent of small businesses.[12]

As noted above, the impact on occupancy and vacancy has been severe. Delinquency rates have varied by sector, with both lodging and retail spiking significantly starting in May 2020 (exhibit).

While there are several indicators showing that things are worsening in real estate, things likely would have been even worse without these stimulus programs. Rent support has shored up continuity of income and continuity of occupancy, which in turn has stabilized asset values. However, unlike the rebound we have seen in other parts of the economy through the end of 2020 (for example, retail shopping), the real estate market

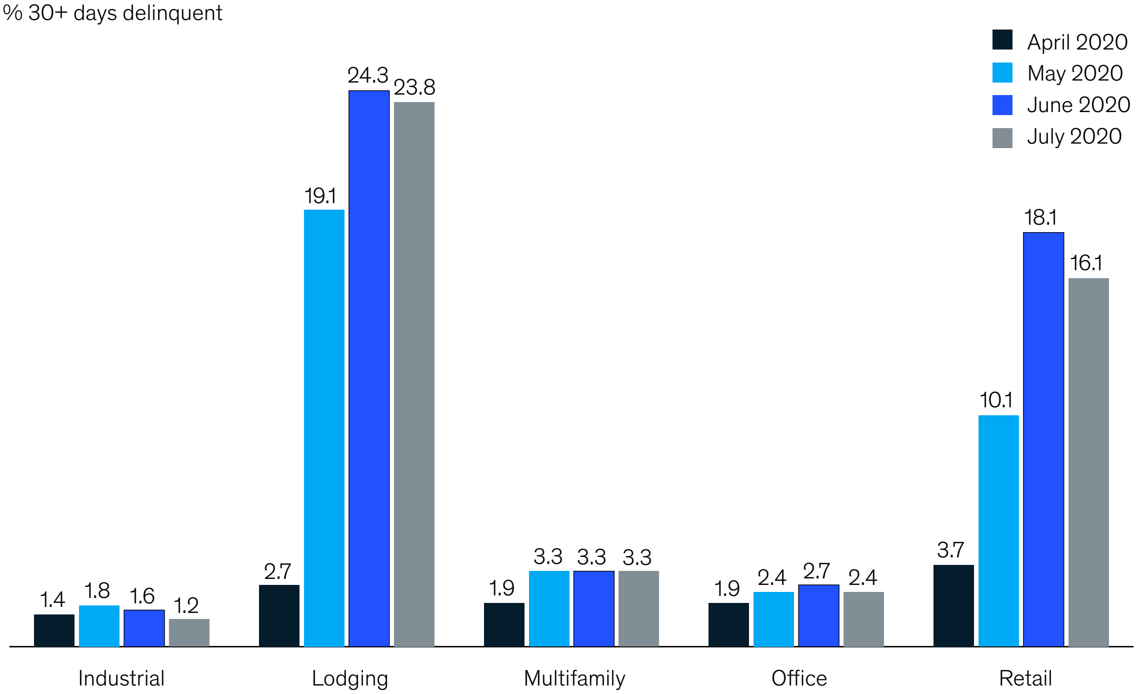
[7] "COVID-19 government measures in real estate: Europe," April 2020.
[8] "Canada Infrastructure Bank's growth plan backgrounder," Canada Infrastructure Bank, October 2020, cib-bic.ca.
[9] Yamide Dagnet and Joel Jaeger, "Not enough climate action in stimulus plans," World Resources Institutes, September 15, 2020, wri.org.
[10] Samantha Edwards, "Commercial rent subsidy program uptake remains low," *NOW Magazine*, July 3, 2020, nowtoronto.com.
[11] "Bounce back loans: Taxpayers may lose £26bn on unpaid loans," *British Broadcasting Corporation*, October 7, 2020, bbc.com.
[12] "Canada could lose an additional 158,000 small businesses to COVID-19," Canadian Federation of Independent Business, July 29, 2020, newswire.ca.

Exhibit

The significant spike in delinquency in lodging has been stabilized.

Delinquency rate by property type

% 30+ days delinquent



Source: Trepp CMBS Research, August 4, 2020

has seen—at best—a modest rebound, and asset values are generally below pre-COVID-19 levels.

Distortions in real estate

In some cases, stimulus efforts have exacerbated the problems created by tight construction markets already struggling to meet demand. Most major projects around the world did not stop construction as a result of COVID-19; many took temporary pauses to learn how to operate a construction site in a socially distanced manner, but work has continued. Green retrofit packages can provide critical support in increasing adoption of these technologies, reducing greenhouse gas emissions from buildings, and helping stimulate the economy—but not without trade offs. They are increasing construction costs in several markets. Without the possibility of rent increases to offset increased construction costs, this is a new, pandemic-induced element of risk in the real estate market.

Because many of the stimulus policies have involved deferring eviction notices, many real estate markets have essentially "frozen" as people wait for these eviction rules to expire. Curiously, despite the use of anti-eviction laws in many jurisdictions, it does not appear that tenants are forgoing rent payments when they can afford to pay. Despite that landlords can still sue tenants for unpaid rent, interestingly, they have not jammed the courts with lawsuits. Rather, landlords have been trying to work matters out privately through alternate payment plans. As such, these interventions seem to have brought some stability to the market (a form of distortion).

Assets are not trading hands and so assigning value to assets is difficult, making mark-to-markets challenging—and the mortgage and loan groups of banks are having difficulty assessing the true riskiness of their portfolios. As a result, relatively few distressed situations have emerged, and transaction volumes are relatively low. In the US, the dollar volume of commercial real estate sales in Q3 2020 was 57 percent lower than the same period in 2019.[13] Moreover, with the possible exception of distressed retail, there has been limited forced selling or distressed loan portfolios traded, as regulators have mostly left banks alone provided that they can pay or reasonably restructure their debt service.

Finally, before COVID-19, real estate investments produced yields above treasuries or bonds and boasted attractive risk-adjusted returns. Now, the risk equation has shifted. Once government support tapers off or disappears altogether, it is unclear how the market will shake out and it is difficult to know what the future holds for government policy and regulation. This uncertainty has stemmed the flow of real estate investment in the short term—and could cause longer-term sputtering.

What other approaches might governments, landlords, and tenants consider going forward?

While existing programs have provided some relief, it is possible that more can be done to assist commercial landlords and tenants. For example, federal governments might study ways to more effectively provide rent relief, which may involve offering tax credits directly to landlords rather than providing rent money to tenants and simplifying access to relief programs, as the French government has done. Governments may also consider some form of property tax relief, as those in South Australia, Western Australia, and New South Wales are doing. And with programs aimed at stimulating new infrastructure investment, such as green retrofits, governments may want to consider how funding these programs today will affect future budgets and spending.

Landlords and tenants will also have to do their part. While all landlords have been restructuring tenant leases, it may be increasingly important for them to consider switching to leases with variable rent components where the landlord receives more rent when the business performs well and less when it does not. Greater rent flexibility may help tenants stay in the building and enable the landlord to benefit from a vaccine-induced economic recovery in a way the landlord would not have in a more traditional fixed-rent approach. Tenants, meanwhile, can be proactive in negotiating with their landlords to work out payment plans or restructure their occupancy—before their debts to the landlord begin to mount. Tenants that have received a loan or grant may see increased flexibility in negotiating rental agreements. They can work with the landlord on a payment plan in exchange for resetting the lease to a more affordable level for a period of time.

Stimulus efforts to date have served to quell panic and keep many doors open, even if workers aren't walking through them at the moment. As governments, landlords, and tenants look to the future, new formulations and approaches to stimulus offerings can help beat projections and accelerate recovery.

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[13] Matthew DiLallo, "Commercial real estate investing statistics 2020," *Millionacres*, November 16, 2020, fool.com.