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# Can the CRE Tenant Market Navigate the COVID-19 Turbulence?

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Business travelers have historically spent an inordinate amount of their time flying from coast to coast, conference to conference and meeting to meeting. These people have inevitably been on a flight (or multiple flights) that have encountered unforeseen and unavoidable thunderstorms or other inclement weather.

At the first sign of turbulence, the pilot turns on the seat belt sign and calmy asks all passengers to stay seated due to the unexpected turbulence. The pilot(s) have a way of making everyone feel comfortable, at least initially. Then after a few more minutes of bouncing through the sky, they ask the flight attendants to take their seats for the remainder of the flight. It's at this moment the less experienced passengers start to get visibly nervous. The business traveler, on the other hand, likely stays calm. As they key off the flight attendants, the business traveler might settle back into underwriting their latest multifamily or office acquisition on their $8.00 in-flight Wi-Fi session.

Experienced travelers know flight attendants have flown through hundreds of storms and know what regular turbulence feels like. They can be a great barometer for how bad the flight really is. On the flip side, less experienced travelers perceive every bump as chaotic, and unpredictable; the veins popping out of their arms and necks showcase how badly they can't wait to get off that plane!

*So, why the analysis of travel?* Well, real estate investing is very similar. Experienced investors have likely owned, operated, and acquired assets in multiple market cycles. They've experienced the sudden drop in property values caused by the dot.com bust in the early 2000s. They dusted themselves off just in time for the subprime lending crisis to create the **Great Financial Crisis** of 2008-2011. Those that survived those two devastating markets have enjoyed almost 10 years of positive market growth and valuation increases. They have/had been able to enjoy an extremely smooth flight with incredible, almost endless views of continued prosperity along the horizon.

### The Turbulence

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Fast forward to 2020 and the onset of Covid-19, (turbulence). Keep playing until 2021 and you get to experience the never ending **Covid-19 variants**, political strife, and the potential for major upheaval for several commercial real estate sectors, (flight attendants have taken their seats). These sectors include office and retail on the negative side of the equation and industrial as the brightest and fastest rising star, exceeding decades worth of lackluster performance and minimal innovation.

### What Do These Sectors Have In Common?

These property types are generally comprised of multiple tenants leasing space within each building. This multi-tenant structure has long been viewed as a competitive advantage for these operators. It diversifies risk, allows the operator to simultaneously increase rental rates and the value of their assets as their existing tenants move out and new ones move in. It's a tale as old as time.

For some operators who acquired their assets between 2010-2011 and pre-covid 2020, they have always been able to backfill their vacant spaces at rental rates and terms that are more and more favorable to the operator.

Those days are over, at least in the short term, and more than likely, the medium to long term as well. The recent market disruption has caused unprecedented **sublease** space availability which immediately reduces market rental rates in those markets. Tenants with existing leases that are set to expire are not going to renew at their current contract rental rates. They are going to demand the sublease rental rate, or in most cases even less.

### Valuing These Properties

Commercial real estate properties are valued using the income approach to value, which effectively converts the Net Operating Income (NOI) of the property into a property value based on a capitalization rate. This magnifies the impact of each dollar of lost NOI. Trepp has highlighted this concept previously, but for a quick refresher, here is how one dollar of NOI at different capitalization rates impacts the property's overall value.

- For each $1 of NOI loss @ 4% Cap Rate = $25.00 of property value
- For each $1 of NOI loss @ 5% Cap Rate = $20.00 of property value
- For each $1 of NOI loss @ 6% Cap Rate = $16.67 of property value

Those numbers add up quickly, especially for larger tenant-occupied spaces.

### A Case Study Example

An operator has an office tenant that leases 65,000 square feet and their current contract rent is $55.00/SF Gross, which is $3,575,000 in annualized rent. Assuming a 45% expense ratio, the NOI attributed to that tenant would be $1,966,250. If the market supports a 5% cap rate, the value of that lease/tenant is $39,325,000.

Let's assume the new "market rent" caused by the pandemic and **the sublease market** is now $37.00/SF Gross or $2,405,000 in annualized rent. Assuming the same 45% expense ratio, the NOI attributed to that tenant would be $1,322,750. If this softer rental market now only supports a 6% cap rate, the value of that lease/tenant is $22,045,833, or $17,279,167

If this softer rental market now only supports a [illegible] cap rate, the value of that lease/tenant is [illegible], or [illegible] less, almost half of the value is lost.

This double whammy of decreasing rental rates and increased "going in" cap rates accelerate the decline in property value. Cap rates increase in this scenario due to the increased risks associated with an unstable asset. This is usually when the less experienced passengers described earlier start grabbing the little white bag located in the seatback pocket in front of them on the airplane.

### The Impact on the Property

The operator's equity (or perception of equity) evaporates, lenders don't want to refinance the property without increased reserves and the market doesn't want to pay a price that allows the seller to exit the property. It is hard to refinance or sell a property when contract rents are significantly higher than market rents and your property is occupied by multiple tenants with staggered lease expiration dates. This is one reason industrial leases to Amazon are the coveted prize during this market. They pay higher rents, sign long-term leases, and provide a significant hedge against downward rental rate pressures.

### The Future

Let's take a deep breath. There's hope. Pilots don't navigate the storm by flying blindly into the night's sky. Instead, they trust their equipment and data instruments to lead the way. Commercial real estate practitioners should also trust the data to help them guide their clients to smoother air. Having the right data enables you to create a flight plan that minimizes turbulence and maximizes experiences and results.

This is the best time in over a decade for representatives or occupier representatives to negotiate on your client's behalf. However, it doesn't negate the need for accurate, timely, and actionable data. *Can you articulate what the new rental rate is for office space in your local sub-market, your region? What are the typical tenant improvement allowances for office and/or retail space in those same markets? What are the typical lease terms, free rent periods, and other concessions being offered by operators?* For detailed, data-driven answers to these questions, **schedule time to learn more about Trepp tenant coverage.**

The same things can be said of a landlord or operator representative. *How do you fulfill your fiduciary responsibility to your client if you don't have rental rate or tenant improvement allowance data from outside your building?* Making sure your operator maximizes every dollar of rent and ultimately NOI is paramount.

### The Landing

There is a reason pilot's that land their planes safely during inclement weather get a loud and resounding round of applause from their passengers. They successfully leveraged all the information available to them to navigate the plane to safety. CRE professionals can and should do the same. When the markets are disrupted and landlords, tenants, lenders, and everyone else involved in the transaction get nervous, the best way to calm them down is to remain calm yourself. In this context, reliable and accurate data brings the calm and clarity that is desired.

Trepp has a wide range of **tenant-level data** that can be used to navigate this period by identifying market trends as it pertains to rental rates, lease maturities, and other tenant-specific data. Some of the tenant level data currently tracked by Trepp on a large portion of the properties within the database includes top 5 tenants by name in each multi-tenant property type, lease expiration dates, renewal options, upfront reserves, leasing commission amounts, tenant improvement allowances, top 200 tenant profiles across the United States, individual lease rental rates by tenant, lender required Insurance and property tax escrows, weighted-average rental rates by MSA/Zip Code, and more...

***For additional information about Trepp's tenant-level data, from single tenant triple net properties to institutional grade trophy assets, click here to request a demo. Questions or comments? Contact Trepp at** info@trepp.com **or 212-754-1010.***

Learn More about Trepp's Tenant Coverage

*The information provided is based on information generally available to the public from sources believed to be reliable.*