Real Estate in Uncertain Times: Q&A with Heartland LLC

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Real estate has been a bright spot in the US economy for the last 10 years, but look below the surface in today's context and you see some segments sizzling while others are fizzling. For insights and analysis during this volatile period, we sat down with two of the four principals of real estate advisory firm Heartland LLC: Deva Hasson and Matt Anderson. For more than 35 years, Heartland has advised developers, investors, family offices, corporations and nonprofits on a wide variety of real estate strategies and transactions in the Seattle area and across the US. In 2019, Heartland merged with our sister company Laird Norton Properties, bringing their expertise in-house.

Deva and Matt, as longtime real estate advisors across all major sectors, what has surprised you about 2020?

DEVA: The level at which Covid-19 has accelerated existing trends in real estate is noteworthy. Pre-Covid trends – such as declining brick-and-mortar retail, the evolving nature of office space, and increasing demand for well-located industrial properties – have all been amplified with the pandemic.

An example is industrial properties close-in to major urban areas. These were in demand before Covid-19, but that has ramped up due to online commerce and increasing need for space across the entire supply chain – warehousing, distribution centers, transport, etc. A parcel of land just south of downtown Seattle that was going for $45 a square foot in 2017 could today sell for $100/square foot due to high growth in industrial rents and massive shifts in demand.

What should real estate owners and investors be doing now?

DEVA: Many high-net-worth families and other investors/owners are involved in real estate in multiple ways. And now is the time to assess all of those holdings to see if they are working as intended: residences, investment properties, business-owned or leased real estate, and even the real estate of the nonprofits you might be supporting. To do that, it's important to assess trends and ask the right questions, which is what we help our clients do.

MATT: A key question is which of the recent shifts in real estate supply/demand are permanent and which are not. As the health crisis gets better contained and employment continues to improve, where is there an ongoing, fundamental shift? And what does that mean for what, how and where real estate is impacted?

What indicators are you looking at to gauge the health of real estate market overall?

MATT: Three fundamental things we track are US employment, consumer spending, and the availability of funding/lending. All three have rebounded some since this spring. But we're not out of the woods yet.

The level of new unemployment claims continues to be high, and consumer spending has shifted in some fundamental ways that are affecting real estate. In lending, there was a sharp decline in the issuance of Commercial Mortgage-Backed Securities (CMBS) in the first half of 2020. During this time, lending from alternative sources [private equity/debt, etc.], which are more opportunistic, spiked.

There is currently a lot of debt and equity funding available, but it's become more expensive and the terms more stringent. Both equity investors and lenders are looking hard at credit, even questioning firms not shown to be "pandemic proof." This flight to quality may start to drive up values for top-tier assets more consistently once transactions start flowing again. Other assets will attract capital but at a higher cost, in the construction phase in particular; more developers may be scrambling to figure out how to keep the wheels on the project.

SECTOR TRENDS

What specific metrics are you looking at for each of the major real estate sectors, and what are those metrics indicating?

MATT: Some of the key things we are looking at are rent collections, mortgage delinquencies, vacancy rates, and the forecasted peak in vacancy rates [see chart next page]. Certain segments such as retail and hospitality/lodging have been hit quite hard. Office and multi-family have held steady for now, and industrial is doing quite well.

We expect to see decreasing performance in office, with leases coming up for renewal amid increasing business downsizing and failures. We also expect to see decreasing performance in certain segments of the multi-family market as consumer subsidies subside and also in higher-rent assets in markets with oversupply (both pre-Covid and because of post-Covid trends). Single-family is trending very positively and we expect that to hold in certain submarkets.

Why has industrial space held up so well and is that likely to continue?

DEVA: There is definitely an ongoing trend toward warehousing/distribution space driven by online commerce. This is not likely to go away. There is also the prospect that manufacturing within the US will increase after Covid-19, which pointed out global supply chain weaknesses. Keep in mind that a revival in US manufacturing has been talked about for a long time now with no major results. And there are risks in this space. For one, industrial buildings that cannot be repurposed successfully could lose value. Also, depending on shifts in supply chain geographies, there will be shifts in priority ports.

INDUSTRIAL – KEY QUESTIONS

- Who are the winners from supply chain disruption?
- Will US manufacturing meaningfully increase space demand?
- Which ports will be winners?
- Will facility size requirements and location criteria change significantly?

KEY US REAL ESTATE METRICS (3rd Quarter 2020)

	Office	Industrial	Multi-Family	Retail	Hospitality/ Lodging
Rent Collection*	96.4%	99.4%	96.0%	Free-standing: 90.5%; Shopping center: 80.1%	N/A
Mortgage Delinquencies CMBS**	2.3%	1.2%	3.0%	14.8%	23.0%
US Vacancy Rate***	10.7%	5.7%	6.9%	10.2%	Hotel Occupancy: 47% (July)
Forecasted Peak in Vacancies****	12.7% in 2023	6.9% in 2021	8.7% in 2022	14.6% in 2021	Revenue per available room (RevPAR) recovery to pre-crisis levels expected in 2023*****

Data sources: *NAREIT August 2020, **TREPP (CMBS = Commercial Mortgage-Backed Securities)
***Costar, ****Costar & Oxford Economics, *****CBRE Hotel Forecast.

Much has been written about the demise of the office as we know it. What does this mean for commercial office space?

MATT: Within the US office sector, we're not seeing a big increase in mortgage delinquencies, but we are still seeing requests for rent relief and lease modifications. Here in the Seattle area, the office vacancy rate is actually quite low, around 5% or less, for most spaces. Part of that is because there are delays in seeing the impact until leases are up for renewal. However, we are starting to see the sublease market expanding, which portends higher vacancy in the topline market.

And there are likely to be shifts. Design firms are hard at work rethinking the spaces that support collaboration and mandatory in-office activities and interactions. Even if you have the headwinds of more people working from home, the space per person is likely to expand. So the net impact on office space demand may be neutral. Still, the expectation is that office rents will flatten due to the uncertainty/volatility and shorter leases may become more common upon renewal as more sublease space comes on the market. And building owners will need to make sure their properties stay competitive and relevant.

DEVA: Many tech firms are announcing employees can work from home forever. Even so, for some, their intent is to eventually reoccupy the office, but possibly in a different format, as they want their very expensive human capital interacting. Some firms will reduce their footprints, some will disperse their footprints and some may hold steady. We are seeing different approaches based on factors such as location, the nature of business models, available resources and company culture. The crystal ball is still pretty cloudy as many firms have been on pause and taking a bit of a wait-and-see attitude as they re-think business practices and monitor external factors. While we don't yet know if there will be a massive fundamental shift at this point, we can say that not all impact will be equal across markets, industry and building types. Stay tuned...

OFFICE – KEY QUESTIONS

- What impact will working-from-home have on office demand?
- Will demand for co-working spaces pickup after Covid-19 or fall away?
- Will specific trends in business practices impact particular segments differently, e.g. the rise of telemedicine reducing demand for medical offices?

What are the biggest risks for the owners of apartment buildings or other multi-family structures?

MATT: Surprisingly, rent collections have been holding up well overall. But not all assets are created equal. Rentals in urban cores with well-paid tech workers are very different from older, suburban apartment complexes with lots of workers affected by the economic downturn. That divergence is taking a while to manifest because of federal aid for struggling business owners and the unemployed. So we are watching to see which segments within multi-family will be hit harder. In some sub-markets, there was significant supply coming on prior to Covid-19, and now this is being met with a drop in demand, so you'll see an outsized impact to valuation.

DEVA: Multi-family can continue being a steady, bond-like investment in many markets. But in the near term we will see downward pressure on rents, more concessions, evolving eviction policy and increased pressure on building owners to do more to keep their properties relevant. There was already a shift toward healthy buildings prior to Covid, everything from better ventilation to higher cleaning standards. And there are lot of buildings around metro areas that are slowly devaluing because of deferred maintenance.

As one of our architecture partners highlighted, historically the response to disasters has often had a long-term influence on the built environment: Tuberculosis caused a fundamental shift in how light and ventilation were considered; the Chicago fires in the late 1800s helped accelerate the development of the modern skyscraper and elevators. What will Covid mean for how and where buildings are designed and built?

MULTI-FAMILY – KEY QUESTIONS

- What part of the spectrum will see the biggest rent declines?
- What will happen to vacancies and rents as federal stimulus winds down?
- Where will demand land in the urban vs suburban question?

What about the stay on evictions and the prospect for localized rent control?

DEVA: These are additional risks and volatility points, as the pendulum has swung toward addressing emergency situations. It is important for owners to stay on top of the regulatory environment at all

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times, but even more so when so much is evolving so quickly. If we start to see meaningful rent control in Seattle, for example, landlords may be less inclined to invest in their assets.

MATT: When it comes to rent control, keep in mind that the devil's in the details. In a region, you have different jurisdictions, and rent control could apply to just one jurisdiction. Also, the caps under rent control can be quite high—giving a fair amount of latitude for landlords to increase rents every year. Oregon, for example, passed a rent control law in early 2019 for apartments 15 years or older, capping increases at 7% annually plus inflation (CPI). Landlords would love to achieve that cap, with many submarkets not even close to pushing up against that cap. So even with rent control, rents are still driven by supply and demand.

What would you say to investors in hard-hit real estate sectors like retail, hotels, restaurants?

DEVA: All these sectors have inherently higher risks that have been magnified by Covid-19. So each situation has to be carefully assessed. Retail was facing headwinds prior to Covid, and this year rent collection has dropped dramatically, with vacancy rates continuing to accelerate as retailers fail or restructure under bankruptcy. The big questions are which properties can survive as is because they are offering something that is non-commoditized, and which will be redeveloped and repositioned in the near term for a higher and better use.

MATT: Lodging/hospitality is highly sensitive to the economic cycle. Currently, mortgage delinquency rates in this sector are extraordinary, over 20%, and this is not showing much improvement. It is not at all clear that independent hotels without access to financing will be able to survive; on the other hand, those smaller independent hotels, in the right sub-markets (e.g. not downtown, convention dependent) that are offering unique experiences, may weather the storm if they can bridge this period. Depending on the location, opportunities could be in converting hotels into apartments/condos or repositioning them as extended stay properties.

RETAIL – KEY QUESTIONS

- Which retail categories will survive?
- Which types of retail properties are poised for successful redevelopment in the near term?

HOSPITALITY/LODGING – KEY QUESTIONS

- Will delinquent debt trigger a broader financial crisis?
- How many independent hotels will not make it through the downturn?

SECTOR ASSESSMENT

	Office	Industrial	Multi-Family	Retail	Hospitality/ Lodging
Cash Flow Risk	Medium/High	Medium	Low	Medium	High
Management Intensity	Medium/High	Low	Medium	Medium	High
Price Appreciation*	Medium	High	High	Medium	Low

*Based on NAREIT Price Appreciation Index 1994 – 2020. Source: Costar, NAREIT.

It's been a strong seller's market for single-family homes this year. Is this likely to continue?

MATT: Even before Covid-19, the demand/supply equation favored sellers in many areas, and this too has been amplified, due to fewer houses on the market, even lower mortgage rates, and people's ability to work-from-home and live further out in the suburbs or exurbs. While much has been written about a long-term exodus from cities, that is not all that clear. We will not see data on this for some time and the long-term impact on single-family prices.

Big questions also remain about particular sub-markets dominated by large local employers, who may be facing difficult times, on top of the impact of Covid-19. Renton and Everett, WA are two such examples, given Boeing's ongoing challenges.

SINGLE-FAMILY – KEY QUESTIONS

- Will working-from-home increase demand for suburban homes?
- Will slower construction and low mortgage rates lead to substantially higher prices?
- Where will demand land in the urban vs suburban question?

STRATEGIES

Can you give us some example of how you work with clients to maximize value?

DEVA: In one case, the value of an inherited income property was in the land, but redevelopment of their parcel alone would not be cost-effective. The solution was to work with the adjacent property owners to assemble multiple parcels and sell for major redevelopment, at a much higher price than the value of the individual properties.

PERSONAL REAL ESTATE (Residences, direct investments, LPs) – KEY QUESTIONS

- What is the primary purpose of this asset? Residence Balance Sheet Cash Flow Growth
- Is it achieving that purpose? Why/Why not?
- Does this asset match your risk profile?
- With whom are you investing?
- How is the asset being managed? Actively Passively
- Is your capital structure aligned with the purpose and type of this asset?

In another case, the real estate was underlying a successful, multi-generational family business whose owners wanted to unlock the value but keep their brand alive. The solution was to sell the real estate separately from the business to two different buyers. This maximized the proceeds from the real estate for the family. Just as important, the business they worked hard to build over the decades continued under the new owner, which ended up leasing the underlying real estate.

BUSINESS REAL ESTATE – KEY QUESTIONS

- How is the real estate contributing to your business?
- How does the health of your business impact the underlying value?
- Should you be an owner or a tenant?
- In the near term, do you need to access that real estate value?
- What is the real estate ownership or tenancy structure?

MATT: Real estate owned by nonprofits is another example. Boards of hospitals, schools, and many other types of nonprofits are trying to carry out their mission and underlying that is real estate. We help them think through what that real estate should be doing for them from a performance perspective, especially during times of uncertainty and declining funding streams.

When two healthcare-related nonprofits merged, their mission shifted and expanded. We helped them use the value of their existing real estate to fund a brand new facility that will serve their mission for the long term.

What is your overall advice for real estate investors?

MATT: Keep looking for opportunities; they are there even in very challenging environments. By example, one hard-hit sub-sector has been Park and Fly lots at airports. Pre-Covid, they were losing revenue as more people took Uber and Lyft to the airport. And now scheduled flights are down some 70% from 2019 levels. But there is quite a bit of value in spaces right next to airports. What could be their next use?

DEVA: Another example is senior housing, which has been lumped in with hard-hit long-term care facilities during Covid. But the demographics driving demand are not going to go away. And so this is a segment that will be important in the long term, but may require rethinking and new investment and very likely a flight to quality as families underwrite safety and health even more.

Generally, think about commoditized real estate versus real estate that is a vessel for experiential and unique interaction. In most cases, value can be found over the long term in the latter.

MORE INFO ONLINE

Commercial Real Estate (CRE) Market Overview
- CBRE Quarterly Reports (downloadable)
- NAREIT Fall 2020 Economic Outlook for CRE
- CMBS Lending Data (downloadable)

Single-Family Market Data
- Zillow Research

ABOUT THE INTERVIEWEES

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ABOUT HEARTLAND LLC - heartlandllc.com

Heartland LLC is a Seattle-based real estate advisory and investment firm with over 35 years of experience creating value for clients, including families and family-owned businesses, nonprofit organizations, corporations, as well as real estate development, investment and operating companies. Heartland combines strategy development and analytical rigor with execution capabilities in real estate brokerage, asset management, capital markets, and development services to positively impact the communities, organizations and families with whom it works. In 2019, Heartland merged with Laird Norton Properties (LNP) to create a unique, multi-faceted and fully integrated business and real estate enterprise.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With more than $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest’s premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

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