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Stressed Out: Are Commercial Properties Close to Default?

COVID-19 has put enormous stress on commercial real estate. Many office buildings are nearly empty as people work from home, while retail and hospitality are operating at a fraction of pre-pandemic levels. National multifamily data is down only slightly from first-quarter peaks, but urban apartments are losing tenants and government support that has propped up the sector is in doubt.

Misfortune for property owners, however, is a lure for distressed investors, who had little to chew on during the long, profitable 2010s cycle, as default rates of loans originated post-financial crisis were miniscule. Now vulture funds are sharpening pencils in anticipation of increased delinquencies, although so far distress has been concentrated in hospitality and retail. Government support for individuals and laws and policies mandating forbearance have helped keep delinquencies down.

Whatever the short-term pain, however, it pales in importance against long-term property performance. Will tenants be able to pay apartment rents if jobs don't come back and government aid doesn't remain at current levels? Will corporations renew leases on large blocks of space if workers continue to be remote? Future cash flow depends on the answers to these questions. Loss of income could lead to increases in mortgage defaults.

To study potential opportunity for distressed sales, Yardi Matrix examined loan maturities and property performance of office and multifamily properties in the top 50 U.S. markets. We found relatively few properties in those sectors in immediate danger, and most new properties seem to be leasing up well. Potential distress appears to be concentrated in metros in the South and Southeast, such as Dallas, Austin, Atlanta, Houston and Miami, where significant new development and surging COVID-19 cases weigh on property fundamentals.

Opportunity Knocking?

The prospect of distress has spurred opportunistic investors to raise a wave of capital. Entering 2020, commercial properties were expensive: Property values have been at all-time highs, while acquisition yields have hovered at all-time lows for several years. A temporary disruption seems a perfect time to snap up assets at a discount.