Assessing the operational impact of COVID-19 on the real estate sector

Richard Anthony, Head of Real Assets – Jersey, considers the operational impact caused by the COVID-19 pandemic and social distancing

As a society, we're all still coming to terms with COVID-19, not only in the ways it is changing how we live and work, but also with what it means for our future. At a time when people have been told to stay at home, it's no surprise that the real estate sector faces a great number of questions. While it is still too early to fully assess the impact of coronavirus on the real estate sector, at the Aztec Group, we've been closely monitoring the developments. As a fund administrator and service provider, we interact closely with the full spectrum of real estate investors, investment managers, development managers, banks and advisers. This means we're uniquely positioned to consider the operational impact that has resulted from the COVID-19 pandemic, and to share some of the observations we've gathered from working with our clients in recent weeks.

Assessing the impact for investors

For most retail investors, the first impact of COVID-19 was felt in mid-March, when daily traded open-ended real estate funds suspended their trading. This decision was not one borne out of panic or liquidity issues, but from the requirement for real estate fund managers to 'gate' their funds, since all Royal Institution of Chartered Surveyors (RICS) underlying valuations included a statement highlighting 'material valuation uncertainty' from valuers. Under Financial Conduct Authority (FCA) rules, should 20% of the portfolio be classified with material valuation uncertainty, investment managers must suspend trading to protect investors. So, in this respect, when it had become increasingly difficult to state a fair market value for assets, suspending trading of these funds ensured redeeming investors would not be paid out at an inflated price – thus diluting those investors that remain in the fund – and equally new subscribers would not pay an inflated price, thus benefitting existing investors. Similar actions have been taken for other open-ended funds with monthly or quarterly redemption windows. We agree that this is the most protective action to ensure the concept of ‘equitable treatment’ is upheld by both fund managers and fiduciaries alike.

Institutional investors need to be wary of unintended consequences

In the UK, half of the £500 billion commercial real estate market is owned by UK and offshore real estate funds, as well as property companies whose shareholders are largely institutional investors (pension funds, insurance firms and sovereign wealth funds). As conservative investors, with long-term liability profiles and good liquidity levels, most institutions appear well-placed to withstand the current volatility without becoming forced sellers. However, it’s worth considering the potential consequences of the ‘denominator effect’, particularly within multi-asset institutional portfolios. The value of publicly listed assets (such as equities and fixed income) have to date fallen sharply compared to private market assets (such as real estate and private equity), leading to artificially skewed allocations. In other words, once the public portion of the portfolio falls in value, not only does this mean the portfolio is out of alignment, but it could also mean falling foul of its own technical boundaries.

Therefore, Limited Partners (LPs) who find themselves at risk of breaching asset allocation limits could be forced to take remedial rebalancing action, such as freezing new commitments or selling closed-ended fund interests in the secondary market, or even applying a write-down to entire portfolios of real estate and other private market assets. There have already been some early examples of this in the Australian superannuation space.

Capital calls could leave other investors exposed

Other investors, such as family offices or high net worth individuals, could find themselves with liquidity problems due to concentrated exposure to certain market sectors that are in distress depending on their own risk exposures. Should more funds exercise their rights to make capital calls, we may experience an increase in the number of LPs defaulting on their capital commitments.

So far, we’ve seen a small number of capital call defaults recorded in the European private fund sector, although we expect that number to rise. Therefore, it is advisable for General Partners (GPs) and investment managers to have contingency plans and other sources of liquidity in place.

Operational planning and governance issues

So far, social distancing rules introduced to limit the spread of COVID-19 have had no significant impact on the management and oversight of the various legal entities including fund, holding and property companies that invest in real estate assets. The UK and other key jurisdictions already conduct most processes electronically – whether this involves duties performed by administrators, corporate service providers or legal counsel.

Of course, compliance and Know Your Customer (KYC) requirements mean the time it takes legal entities to set up bank accounts can vary depending on the jurisdiction. We have not seen any major impact to the set-up of new bank accounts. However, with most of the financial industry now switching to working from home, expect potential delays to opening new bank accounts as financial institutions embed their own operational risk processes. As always, we recommend adequate planning dependent on clients' pipeline and needs.

Lastly in terms of governance, I'm pleased to say that the potential for significant disruption has been minimised. For onshore entities with onshore directors (of unregulated funds and property companies) the impact to existing processes is limited, as many board meetings can continue as conference calls, with no tax implications for doing so. In other jurisdictions where there are significant tax substance implications (Jersey and Luxembourg for example), the authorities have waived the need to conduct physical board meetings for the foreseeable future.

The impact on real estate development

Clearly, the introduction of social distancing measures has brought development activities to a standstill. The full effect of such measures on supply chains and building materials for construction is unclear, and much will depend on how long the crisis persists, and whether such distancing measures can be relaxed in future to allow some development to continue. We're closely monitoring events, but naturally, the standstill will have an impact on clients' underwriting assumptions and the planning for development assets.

The impact on commercial and residential sectors

It's no surprise that both retail and office assets have been severely negatively impacted. Before the crisis, retail assets were already finding life difficult, thanks to the continued growth of online shopping and the drop in customer footfall across many high streets and retail outlets. Adding COVID-19 to the mix will likely lead to a wave of restructuring and/or insolvencies of both tenants and landlords.

Through the end of the first quarter reporting cycle, we are seeing significantly lower rent receipts. Tenants are naturally requesting rent holidays, rent reductions and changing payment schedules. Some are unwilling or unable to pay rent or are refusing to pay for certain service charge items. Again, the length and severity of this is hard to estimate at present.

That said, there are some positives to be found amid more resilient commercial sectors, such as logistics and on the residential side – healthcare, care homes and the private rented sector. We are continuing to see positive performance from these segments, with a number of clients making acquisitions. It's encouraging to see areas where activity hasn't ground to a complete halt.

The impact for lenders

When considering the impact for lenders, it's worth noting the distinction between traditional bank lenders, and the proliferation of 'non-traditional' lenders (private debt capital, non-bank lenders and shadow banking institutions) that emerged after the financial crisis of 2008. The good news is that, on the whole, bank balance sheets are far more robust than 12 years ago, thanks largely to deleveraging, reducing their Level 2 and 3 asset exposures, and increasing capital ratios. However, with interest rates at near zero, and net interest margins down significantly, we still expect this to be a stormy time for banks. In addition, banking regulators and central banks are already applying pressure on banks to behave and assist in implementing government policy. In the UK, the Prudential Regulation Authority (PRA) made a direct request to the CEOs of all UK banks urging them to be accommodating during this period, and we would expect compliance given the experience of the financial crisis of 2008.

With respect to non-traditional lenders, which operate without the same level of regulatory scrutiny or sources of capital, there is far greater concern whether they will be able to work with borrowers through this crisis given the limited nature of their mandates, resources and experience. Most will be regulated by the FCA and, similar to the PRA, the FCA will be monitoring the behaviour of non-bank lenders.

Compliance and covenant reporting

One of the roles we perform for our clients is to provide compliance and covenant reporting independently to our clients' lenders. As you would expect, we have carried out a significant amount of work for the 31 March reporting period. Early signs indicate significant breaches, particularly for retail but also office expected for various covenants particularly interest coverage ratios due to the sharp fall in rental income. We are working with a number of clients to perform scenario analysis to assist clients with proactive discussions they need to have with their lenders.

At this stage in the crisis, we have seen bank lenders co-operate and provide flexibility, but we will need to monitor this situation over the coming months.

Derivatives

Many clients may have taken out loans with embedded swaps and derivatives and this is also a good opportunity to review your hedging requirements. CFOs and their advisors may want to review their current derivative exposure and cost of closing or restructuring elements including interest rate caps and reviewing floors as the possibility of negative rates may occur in the UK in the future.

Financial reporting and auditing observations

Similar to the daily traded real estate funds, suspensions and sharp declines were felt across the REIT and listed property market. Institutional monthly and quarterly funds have also been affected due to equitable treatment discussed earlier. The institutional closed ended funds market is less clear at the moment. Clearly the normal price discovery mechanism and the secondary market has dried up so it's very difficult to establish fair market price. We've been seeing across our clients' portfolios generally no material valuation adjustment to underlying assets for the 31 March reporting cycle. Instead, many investment managers and GPs have taken the approach of providing disclosures to the balance sheet rather than writing down assets at this point in the crisis. We will likely see more impact in the 30 June and 30 September reporting cycles.

Finally, we are in the midst of audit season for many funds and companies. A number of jurisdictions have passed extensions to provide enough time for filing statutory accounts where required. On the actual audits, some funds may require additional going concern analysis to ensure the fund can meet its obligations of servicing its debt over the next 12 months. Appropriate disclosures are included for COVID-19 as a non-adjusting post balance sheet event. While there have been delays in the issuance of opinions and completion of audits, we are seeing a good working partnership between investment managers, fund administrators, audit firms and advisors.

Staying vigilant while at home

One last observation that cannot be ignored is that cybercrime and fraud is on the rise. This development is particularly significant as businesses transition to working from home. We have already seen some examples of this – particularly in the capital call and distribution process as well as cash transfers – and recommend investment managers ensure both internal processes and those outsourced to fund administrators are robust, with additional verification as standard.

Summary: crisis creates change

It’s worth reflecting on what will happen after this particular crisis is behind us. It’s conceivable that the very nature of real estate investing will change. For example, with working from home now the norm, will businesses use office space differently? Has social distancing changed the way we shop for good? And what does this mean for traditional retail assets? Will this crisis make us more aware of the shortage of hospitals, care homes and other healthcare assets, in the developed world and beyond?

Right now, there are more questions than answers, but throughout this crisis, society has been forced to embrace change and function in a profoundly different way. We should expect the real estate sector to do the same.