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Rent Shock: The Problem of Landlord, Tenant, and Lender

by Paul Osborne

The Greek myth of Icarus is often remembered in times of crisis.

To escape from prison, Icarus fashioned his wings with wax joints and flew away.

Ignoring his father's advice not to fly too close to the sun, the wax in Icarus's wings melted and he fell from the sky into the sea, where he met his end.

Today many people and firms, like Icarus, have been flying too close to the sun. Unlike Icarus, many were not warned. The magnitude of the COVID-19 crisis brings the sun much closer for all parties — and very few have built contingency plans to deal with such an improbable event.

COVID-19 is a crisis on many levels. It's a health crisis as well as an economic crisis, which is also a health crisis. Tragically, lives will be lost through the economic impacts of the shutdown alone. While the equity market has experienced extreme volatility, the slow-moving property market is only starting to be tested. At a financial level, this looming crisis looks to be a crisis of rents, particularly within the commercial property sector. This paper has a narrow focus: to examine the impact of COVID-19 on commercial property. However, as detailed below, a shock in the commercial property market will have wide-reaching impacts on the rest of the economy.

The government stimulus has been well publicised. It's a broad and aggressive strategy: a blunt instrument used to get the majority of Australians over the hump of the next six months. Overall, the response has been positive from both employers and employees. What remains unresolved, are the uncertainties around both residential and commercial tenancies.

The JobKeeper and JobSeeker programs will do a lot to assist the residential sector by allowing struggling tenants to meet their rental obligations. Commercial tenancies remain stranded. The recently released National Cabinet Mandatory Code Of Conduct for commercial tenancies, aims to share the burden between tenant and landlord. The objective of the code is to help partially relieve a business of their rental commitments based on their drop in turnover. A combination of rent abatement and rent deferral are built into a formula.

Bourke Street Mall after Victoria's social distancing restrictions were implemented
Source: Rachel Cary (sbs.com.au)

The code also prohibits landlords from evicting a tenant for the non-payment of rent, during the period of COVID-19 and subsequent recovery period; or draw upon the tenant's security to make up missed rental payments, as well as a number of other measures. While the major banks have offered to defer interest repayments for caught-out landlords as long as they retain existing tenancies. Still, a key directive is to "sort it out" — that is for all parties to discuss how both the business, land owner, and bank can survive the downturn. The government, at present, has had great difficulty in resolving this situation; as time goes on, it may have no choice but to further intervene.

A dependent chain exists between landlord, tenant, and lender (often a major bank).

Landlords borrow from a lender and need to pay principal and interest costs on a monthly basis; the landlord hopes to be able to pay down debt from the rent money received by the tenant. The tenant requires the premises from the landlord to operate the business and also requires the landlord to remain solvent, since a number of leases can be disclaimed should the landlord be forced into liquidation. The lenders often have borrowed funds themselves to help the landlord finance in the first place and have their own shareholders and creditors to worry about. This dependent chain is under much strain throughout the economy and is unlikely to be bailed out with public funds; each link in the chain is squeezed and a solution may not be possible for many within it. Veteran landlords who carry little or no debt should be able to get through — but even a vacant building costs money: rates, taxes, utility charges, as well as repairs and improvements. Many landlords will take a hit.

What makes this crisis remarkable is that almost all sectors are hit at the same time. Downturns in certain sectors are common: book stores or the homeware industry might fold at certain points; often new tenancies are granted to businesses that find a stronger product fit, or are simply better-run.

Now everything has taken a hit at the same time and, except for supermarkets or medical services and other select businesses, the broad downturn will mean no ability for the tenant to operate and no alternative for the landlord to establish a new tenancy in their building — to generate cashflow. Commercial rents form a significant cost for businesses; they are generally long term commitments made by tenants and are fixed costs. They cannot be easily stood down like employees, or discounted like merchandise. As such the goal of most businesses is to survive this period of "hibernation" — rents, particularly in sectors where the percentage of such costs take up a significant amount of the business overheads, are perhaps the difference between survival or receivership.

A pandemic brings into play social practices which are antithetical to how most commercial properties function. While people will spend more time at home, thereby making residential security invaluable; rules on social distancing, shopping for essentials only, and the mandatory closure of many businesses will make much commercial property redundant, even as underlying commitments and obligations remain. With health professionals tipping at least 18 months before a vaccine arrives on the scene (if at all), we are likely to be living in a period of intermittent opening and closing for an extended time. This is likely to have profound impacts for commercial tenancies moving forward.

— ECOSYSTEMS WILL BE BROKEN, BIG AND SMALL

Most properties are not siloed off from one another; to mix metaphors, properties' relations to other properties looks more like the interdependence of a coral reef. Various businesses form clusters and are much more reliant on neighbouring businesses and the surrounding supply chain than many might think. The in-vogue bakery helps form a cluster of other businesses around it such as the greengrocer and fishmonger, all rising and falling depending on the health of these various operations. Industrial property is clustered with interdependent firms who manufacture commodities requiring closeness to ports, trucking companies, and air-freight. Offices are highly clustered too, technology businesses are a prime example; an area like Cremorne is dense with tech companies, which makes it dependent on other nearby technology businesses. The value of the leases from both tenant and landlord is highly dependent on the surrounding combination of properties, services, and other businesses, as is the individual shop or office at hand.

In a normal down-cycle you may find that a few companies go out of business and close down. Often these are replaced by newer firms and the ecosystem, while still affected, is refreshed and can continue to function.

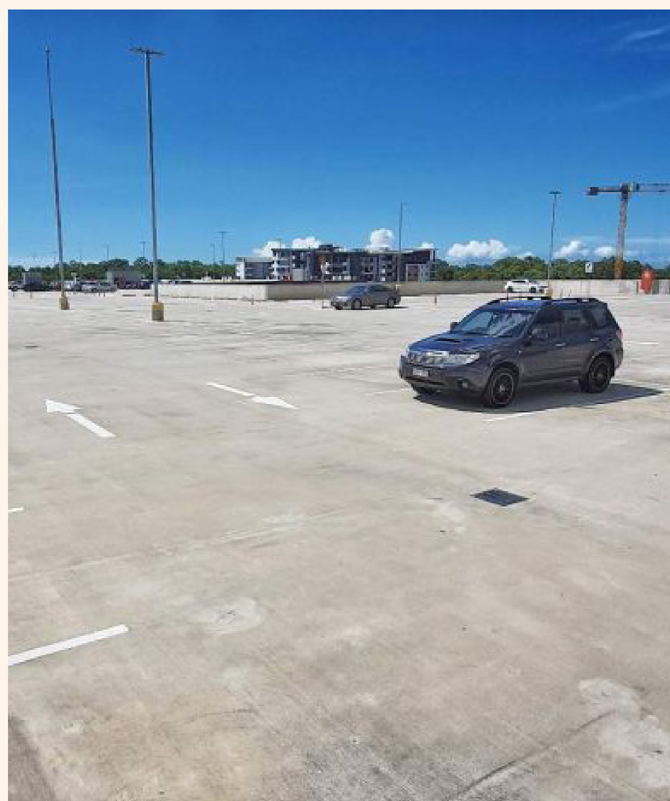
Due to the nature of the COVID-19 impact across pretty much all sectors, entire ecosystems are under threat and many will all go out of business simultaneously. This is challenging for any recovery.

There will be a silver lining; consumers may start valuing their own local supply chain a little more.

The local butcher and greengrocer has been on the nose for some time, as many flocked to large discount stores to source their produce and other goods. Times such as this reinforce the need for good relations with your local food supplier, and provide an example of perhaps the type of business that may emerge better off, after all is said and done. A resurgence in Australian manufacturing to escape our reliance on international markets will be encouraged and likely a boom will come — it's just a question of when.

On the other hand, highly clustered retail areas, many of which were already on the brink, may see this moment as the final nail in the coffin.

These ecosystems will be highly disrupted. Something new will need to emerge to take their place. The hibernation strategy may be the correct policy for the health of all citizens. However businesses are like sharks: their survival depends on a continual movement forwards.



An empty car park at Chermside shopping centre in Brisbane's north.
Source: ABC News, Chris Gillette

— SETTING THE VALUE OF COMMERCIAL PROPERTY; A LOOMING CRUNCH IN VALUATIONS FOR LANDLORDS

Price discovery is extremely difficult for real estate: it's seldom traded and no two buildings are exactly alike. The literature on price falls to commercial property after a pandemic is sparse; we know that in Hong Kong, only small drops in end values occurred after SARS. Rents were hit hard in the short term, but building owners could hold on and wait for the virus to dissipate. As the current crisis is much bigger in its present and projected impact, the consequences will be much more acute.

For many commercial properties the valuation is derived from rent total collected, which is often expressed as a passing yield. To put it in rather simplistic terms: a future investor may compare any potential property investment with the risk-free rate. The risk-free rate is generally accepted as a rate of interest, that can be expected for a mostly risk free investment, such as a government bond. A safe government bond is expected to be rather problem free and secure — although this proposition doesn't look as safe as it has in the past. Say a government bond of the investor's preferred time duration is returning 2%. An investor will seek a premium on this rate, should he or she pursue an investment that carries some risk, such as a property investment.

Over the past few years, many investors have seen a 3% net yield as attractive, especially when the following applies:

1. The tenant is deemed safe — such as a bank.
2. The lease is long.
3. The lease has inbuilt provisions such as annual rent increases that help push the total return higher, as the years accumulate.

Clearly, in the current environment, the gaps between risk-free investments and those that have traditionally been viewed as more risky, such as property investment, have become much too close for comfort.

Therein lies the problem. High levels of leverage have been employed, for small improvements in the expected return, over risk-free investments. With almost no contingency built in for vacancy — and certainly not for a crisis on this scale — valuations are at risk of a sharp contraction.

Consider this example, on how the amount of rent collected can impact the value of the building from the standpoint of an investor:

Pre-crisis:

— Net Income $180,000 as of 2018/2019
— 2 year lease remaining plus further options for tenant / 4% annual increases
— Investor confident that the tenant will stay further terms
— A-grade tenant based in the retail sector
— Investor willing to accept a 3% net yield

= Investor willing to pay $6m

Post-crisis:

— Tenant folds and new lease struck at a reduced rate of $126,000 a reduction of 30%
— 5 year lease commitment plus further terms for tenant / CPI increase
— Investor now seeking a 5% net yield to be well clear of the risk-free rate and for contingency

= Investor willing to pay $2.52m for the same building

This example is a simplistic model and there are always other costs and factors at play. You can see that you don't need to tweak many of the variables for a building's value to distort wildly.

Even leases that haven't been disrupted by the crisis will still have future investors worried as to what "market rent" will look like once current lease terms begin to expire. Will a future investor see a lease with a present stable business (supermarket, etc,.) as safe, or will they be concerned about rental alternatives for these stable businesses if the rent isn't dropped at the end of the existing term?

Clearly there are landlords who have been sailing in calmer waters and are in a much better position to weather the current storm. The issue for banks is the late cohort of investors who have taken skinny returns and are highly leveraged. Owner-occupiers who have bought premises

for their own businesses are highly impacted too, however they are still able to operate in the premises. It will be more about the strength of their business and whether they rely on surrounding businesses to flourish.

— A PROBLEM FOR BANKS; BUT ALSO FOR MANY PRIVATES AND FUND MANAGERS TOO

The major banks have increased their commercial lending business over the last few years. Commercial property exposure (for banks) is highest in the office and retail sectors of the commercial property market. Industrial, land development, and other sectors make up a much smaller part of the overall composition of lending. The impairment rate is low at just 0.2% (APRA) — this figure is expected to rise sharply. It will put increased pressure on the banks in the near future. As the impaired assets under each lender begins to rise, personal guarantees and security for both tenants and landlords could also see the residential market come under pressure too. It is well documented that the largest exposure for banks is in the residential sector. It would not be an exaggeration to say that a problem in the residential housing market would be catastrophic for the entire economy as a whole. Many commercial properties are funded by privates and fund managers too; pressure will likely mount on such outfits as commercial tenants struggle to get back to business as usual.

— ON THE OTHER SIDE

Any bounce back will have vastly different outcomes for the various eco-systems and different geographies. The CBD has experienced a huge run up in prices in recent times and will likely be hit hard, but commercial centres have been hit by plagues and natural disasters for millennia. CBD areas are likely to experience a sharp contraction but also a sharp rebound.

During the SARS epidemic, Hong Kong Class A office rents experienced a remarkable 23.66% drop in a 12-month period before rebounding sharply (Chesterton Petty, 2004). This would be a good outcome in today's environment, considering that all super cities are impacted simultaneously; these global hubs are unlikely to get back to easy trading as their international counterparts are hard hit too. Considering the current shock, a sharp contraction in rents is likely.

It's unlikely that the current virtual world of Zoom meetings and the best of digital apps will make the office redundant. Face to face interaction is still the trusted method of doing business and it's been that way for many millennia. It is direct and has no external broker; companies like Zoom still extract rent for usage; data is still a required payment made by all participants.

In fact, after the virus recedes, the importance of face-to-face contact may accelerate as people tire of video conferencing and realise its limitations.

Transmission is somehow lost despite all the ways technology tries to bridge the gap. In Silicon Valley and the Bay Area in San Francisco, the most advanced tech centres, people still sit in offices next door to each other and they still meet over coffee.

New property projects, which increase supply, will most likely be shelved for the foreseeable future. Eventually, this means that at some point on the horizon, rents will increase as the lag creates a shortage of supply. Whether this will be a few years or a decade away, nobody knows for sure.

Suburban shopping strips may take a lot longer to recover as they were already struggling to begin with. Hotels, restaurants and cafés, as well as properties which have directed themselves to short stays and relied on platforms such as Airbnb are likely to be most savaged by the virus hangover.

The CBDs of both Melbourne and Sydney could be very hard hit — but they're also more robust to bouncing back. The concern will be the suburban strips, which have already been in structural decline. This could be much more of an L-shaped recovery with a protracted downturn and little improvement for a long time to come. Rents in the hospitality space are likely to fall back sharply; as are hotel and accomodation offerings, as travel looks to be off the cards for a number of years.

— A RETURN TO BUILDING IN CONTINGENCY; A MARGIN OF SAFETY

The aversion to "flying too close to the sun" by both landlord and tenant are likely to loom large after the crisis has passed. Memory takes some time to dissolve itself and caution will be the likely order of the day.

For landlords this means selecting strongly capitalised tenants with solid business plans, restricting many tenants from the best locations. There will also perhaps be less emphasis on extracting rents, since a robust tenant beats a poor-paying one any day. For tenants, this means budgeting for a potential downturn and loss of trade and careful building of provisions within their leases, for when unexpected shocks occur. Future investors will look to factor in contingency on their investment

calculations, which might mean reduced sale-prices for many commercial asset holders.

> **Landlords face a very uncertain future when it comes to estimating potential incomes from their buildings. There will be opportunity though: new tenancies are likely to emerge, at perhaps fairer rents and with much more robust business models.**

It is worth mentioning the role of central banks and the dilemma they have created through their policies of ultra-low rates. It's pushed investors out to make riskier and riskier investment decisions in the search for income; little margin for error and pushing for extreme rents have been the side effects.

What started out as an acute health problem has become so much more. A crisis in rents has emerged within the commercial property market. Not since World War 2 have Australian businesses been so swiftly impacted. The future is largely unpredictable and we have no idea how things will play out. What we should be concerned about is the state of commercial leases at present and the current impasse.

— CONCLUSION

This country has done a great job so far to"flatten the curve" when compared to other nations. The public discourse has started to shift from that of severe doom, to when we might be able to loosen restrictions, and allow many to restart their businesses. However countries like Singapore, who have been held up as the model for dealing with COVID-19, have started to see a resurgence of the virus. COVID-19 will loom as a threat hard to eradicate completely and we are likely to be living with the virus for a while longer.

How this impacts businesses remains to be seen, yet further disruption is inevitable. For commercial property, the pain is likely to be deep for all parties involved – with no easy solutions. Whether this rent shock troubles the wider economy or not, only time will tell. The damage could be profound if it does.

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