COVID-19: next steps for Real Estate Investment Trusts

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Four imperatives stand out for real estate investment trusts as they confront the challenges posed by COVID-19.

How should real estate investment trusts (REITs) respond to the COVID-19 pandemic that has destabilized markets and is disrupting 2020 revenue streams? In any crisis, a three-stage approach of “assess, stabilize and reimagine” is an effective way to approach challenges that, just like the financial crisis of 12 years ago, feel unprecedented.

At the depths of the financial crisis, questions abounded around whether financial structures as we knew them would survive. They did, but with important and long-lasting changes.

A stronger, more resilient REIT industry also emerged, led by management teams that learned and put into practice many valuable lessons, not least around balance sheet strength and structure. Many companies have extended near-term maturities, reduced loan-to-value metrics (US companies under Green Street’s coverage had a market-cap weighted leverage ratio of 32.6% at the end 2019) and taken advantage of accommodating debt and equity markets to raise record amounts of capital last year. And all of this happened as the real estate cycle was looking increasingly long in the tooth. Development discipline has also been a feature of this cycle. Today, the challenge is a health crisis with far-reaching consequences, such as a devastating impact on certain sectors’ revenue that is testing the industry.

The urgency around assessing and stabilizing will be influenced by the sub-sector in which a REIT operates. For lodging, health care and retail REITs, where either occupancy has plummeted (to levels only considered by the most extreme stress tests) or properties have been closed, the threat is immediate and severe. Most management teams have already assessed the current environment and taken measures to stabilize their business. Hotel REITs, for example, have drawn heavily on existing lines of credit.

In sub-sectors like office, social distancing and even isolation measures have temporarily led buildings to sit almost empty as employees adjust to a period of working from home. Here, management teams need to ensure they stabilize their business amid volatile capital markets.

That said, when the time is right, companies should not overlook the importance of using this crisis to reimagine what might be possible and, where appropriate, capitalize on strong balance sheets and the investment discipline seen in recent years.

Just as the financial crisis led to generational opportunities and improved business practices – many of which will be instrumental to REITs’ emergence from today’s challenges, so this crisis will present opportunity. An extreme event such as the COVID-19 pandemic may, for example, accelerate the importance of creating a truly flexible, technology-enabled workforce.

Today, however, as REITs take stock and look to stabilize their business, four imperatives stand out.
People and workforce

After employee safety, issues such as remote working and compliance must be considered.

First, and by far the most important given the nature of this event, is people and workforce. Employee safety is likely to have already been addressed but must continue to be monitored.

Consideration should then move toward remote working, compliance, contingent resources, cybersecurity and behind-the-scenes cost-cutting to avoid layoffs. Many of these considerations will very likely have tax consequences.

From a remote working perspective, keeping people productive and engaged is critical.

Leadership, at all levels, needs to drive connectivity and generate enthusiasm and energy, all while team members are managing children, schooling, elder care or other challenges.

Similarly, consider how companies could provide greater working flexibility (e.g., flexible hours), child-care provision and sick or medical care benefits.

From a cost-cutting perspective, forced vacations, furloughs, mandatory reduced hours, re-evaluating annual merit increases and even adjustments to 401(k) contributions and bonuses are all levers that can be pulled. Cost savings from reduced or eliminated travel and entertainment will directly benefit the bottom line.

Tax-related issues should also be considered, especially if employers are providing technology support, child care or even meal credits. Closely monitor government announcements, as countries, states and municipalities may have different rules. Similarly, some benefits may become tax-free. In the US, for example, the President has declared this a national emergency, which has important implications.
Liquidity and cash flow management are the most important capital allocation considerations right now. Many REITs learned the lessons of the financial crisis and, as a sector, entered 2020 with balance sheets and financial metrics that were in excellent shape. This will provide them with stability to weather the storm. But even so, the extreme disruption to business caused by COVID-19 will stress liquidity and cash flow management.

Companies are broadly split into two groups, and this will influence their response:

1. **Those with a need to maximize liquidity immediately.** Companies will likely draw down on all available liquidity sources such as credit facilities. But what other liquidity-enhancing steps can be taken? One topic that has re-emerged is the potential use of stock dividends by public REITs as a means of both satisfying their tax distribution requirements and preserving cash liquidity. Nareit has already made a submission to the IRS regarding this issue. Employee and vendor-related cost savings will also need to be explored, and capital expenditures may need to be put on hold.

2. **Companies in sub-sectors less directly impacted by closures and restrictions, or with long leases with less-impacted tenants that remain creditworthy.** These will be looking at more proactive capital allocation moves.
Acquisitions or buybacks may enter the conversation depending on the board and management team’s perspective of the implied discounts to NAV at which their shares are currently trading.

Right now, however, the total lack of visibility into underlying private market values, physical challenges of inspecting buildings and uncertainty around the duration of the outbreak – and therefore, underlying capital needs – is prohibitive. Both options are more likely to remain as a management conversation around planning for the reimagine phase, rather than being actioned. There’s no harm in preparing, however.

Debt compliance requirements should be revisited with both near-term and long-term financial and technical conditions discussed with lenders. In the worst-case scenario, even moderate levels of debt restructuring can have important tax implications that need to be considered ahead of any transaction.

As income streams adjust, even temporarily, REITs will need to be aware of taxable income rules. The value of taxable REIT subsidiaries may change relative to the value of the REIT, which has implications for REIT compliance.

Vendor-related conversations are likely worthwhile; how do you ensure you maintain vendor relationships through this period to emerge with a strong and reliable base from which you can prosper?

Other important liquidity and cash management considerations include setting up a cash management office to work alongside your crisis management team. Among other things, this will help keep cash flow options front of mind for management and the board.

Contingency planning given the information we have today (i.e., much more severe downside scenario planning) is worthwhile and should be factored into revised budgets and business plans.

Finally, open and honest communication with all stakeholders is critical. Investor communication has been an area of focus for REITs in recent years, but at this juncture, communication needs to go further still. Direct lines should be maintained to capital providers (both equity and debt) as well as key vendors. Companies need to be consistent, use base-case not best-case scenarios, include worst-case scenarios and get bad news out upfront. Open and honest communication was a differentiating feature of the financial crisis and is likely to be so again.
Lease structures and contracts

Companies may wish to create a framework and establish policies for restructuring leases.

Who pays? Force majeure? Is business interruption insurance valid?

Engaging legal advisors to advise on the above questions is a critical and timely step to at least begin to quantify and scenario plan the likely drop in income. This needs to be layered into the urgent need to make contingency plans around liquidity and cash flow management. Documenting all actions taken is important and could prove invaluable in the future.

At this point, companies may wish to consult with outside counsel on topics such as creating a framework and establish policies for restructuring leases, even temporarily, to accommodate tenants/residents whose cash flow is impacted by these events. Companies may wish to look at creative solutions that defer or delay payment. If strategies include short-term loans or investments in tenants, then companies must consider the implications on REIT qualifications.

Payment terms may need to be revised and internal staff briefed on how companies plan to support tenants/residents, particularly where short-term extensions to expiring leases may be required.

Other questions companies need to consider include:

- Have you created a mechanism for receiving feedback from tenants on their concerns and inquiries?
- Have you scaled up your IT infrastructure to deal with more online/mobile service and sales requests?
- Have you prepared your customer service helpdesks to deal with larger amounts of volume?
- Have you developed relevant enablers to support your account leaders on tenant or resident inquiries?
- Do you have a mechanism in place to constantly monitor performance, updates and alerts on your top-priority tenants?
- Have you developed contingency plans for your priority tenants
Government and regulatory actions

In challenging times, the actions of management teams help develop long-standing credibility.

Staying close to government announcements is important. Most governments have announced extremely robust economic responses. In the US, a second bill delivering around $100b was enacted late last week, and the Senate is working on a further bill that will have far-reaching impacts.

Aside from the headline efforts, other important opportunities should be utilized. For example, in the US, federal income tax returns and payments due April 15 may now be deferred until July 15. More clarity, and the extent to which states will follow suit, is expected to be provided around this in the coming days.

Cash-stock dividends have been mentioned and may gain approval. Interact with key decision makers in the government. The government is very open to hearing ideas at times like these. This is a global event. If you have a global footprint, follow developments in all relevant countries.

There will always be an undercurrent of ensuring individuals and companies do not take unfair advantage, and with many workforces operating remotely, ensuring documentation and approvals are in place is critical and likely more complicated than during “normal” times.

Finally, as we saw in the financial crisis, in challenging times, the actions of management teams and the good decisions they make help develop long-standing credibility with stakeholders, from investors and financiers to employees and vendors. The actions REITs take today will set them up to thrive in the post-COVID-19 environment.

Many parts of Asia are already emerging from the devastating impact of the virus, and Europe and North America will do the same. Companies that can rapidly assess, stabilize and reimagine their business will be best positioned to capitalize on the opportunities that will undoubtedly emerge.
Contacts

Mark Kaspar
Global REIT Leader
mark.kaspar@ey.com

Henry Stratton
EY Global Real Estate, Hospitality & Construction Senior Analyst
henry.stratton@uk.ey.com

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