Coronavirus Impact: Commercial Real Estate Is a Ticking Time-Bomb

Description

If you cut oxygen to the brain for long enough, it could lead to severe and long-term damage, which is precisely what seems to be happening to the global economy this month.

While China is slowly coming back online, much of the developed world is shutting down its borders and pausing a significant chunk of economic activity. This unprecedented shutdown is likely to have an impact on a critical segment of Canada's economy: commercial real estate.

Unlike residential real estate, commercial properties like factories, retail stores and office units are much more exposed to economic cycles. Commercial property owners and real estate investment trusts (REITs) already pay higher interest rates for borrowed capital.

Meanwhile, commercial tenants are much more exposed to the business cycle, which makes them more likely to default when the economy collapses.

Slate Real Estate

Take **Slate Office REIT** (TSX:SOT.UN), for example. Last year, interest and financing costs represented more than 22% of the company's annual sales. The firm carries $1.77 in long-term debt for every dollar in shareholder equity.

That shareholder equity, of course, could be slashed if the trust's commercial property portfolio loses value this year. If the economic crisis triggers a credit crisis, banks could cut back on commercial lending, which will erode the value of several high-profile commercial markets.

On the income side, it could be argued that companies will continue to pay rent for office units and honor their rental agreements. This is despite the fact that everyone is working from home.

While that's true, the average tenancy term is four to five years. However, the tenants are under financial pressure as well and could be compelled to cut back.

Slate's largest tenant, as of the end of 2019, was **SNC Lavalin**. The controversial engineering company already faced funding challenges and was considering layoffs for years. Now, the company's stock is down 39.4% over the past month. SNC represents 6.8% of Slate's tenant portfolio.

Similarly, small- and medium-sized businesses or energy producers that have leased office space from Slate could be compelled to cut back if economic conditions worsen as expected. Roughly 8.1% of Slate's leases are due for renewal this year.

Retail Real Estate

Slate Retail REIT could also face similar challenges this year. Malls and non-essential retail stores are all but empty right now, which is obviously having an impact on store owners' bottom lines.

A combination of tightening credit, reduced property value and uncertain rental income could crush commercial property owners and their shareholders this year.

Other commercial REITs, like **Plaza Retail REIT** and **Morguard** face similar pressures. The fact that Slate Retail and Slate Office have both lost nearly half their market value over the past month indicates that investors are bearish on this sector.

Bottom line

All shops and offices are shut due to the national health crisis. It should therefore come as no surprise that commercial property is vulnerable.

If the shutdown lasts longer than expected, things could get worse. REITs may have to cut dividends and mark down the value of the real estate assets.

Investors should beware of the risks here. Avoid catching falling knives.

CATEGORY

1. Coronavirus

TICKERS GLOBAL

1. TSX:RPR.UN (Ravelin Properties REIT)
2. TSX:SGR.UN (Slate Retail REIT)

PARTNER-FEEDS

1. Business Insider
2. Msn
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