

Julian M. Wise | Partner | Real Estate Group | Schulte Roth & Zabel LLP
Erin L. Chizner | Associate | Real Estate Group | Schulte Roth & Zabel LLP



How Natural Disasters Influence CRE Participants' Decisions

Climate change and the increase in natural disasters occurring as a result are increasingly on the minds of those in the commercial real estate industry. Extreme weather events like wildfires, severe storms, flooding, earthquakes, and droughts have the potential to not only damage, but completely destroy real estate assets and in fact, they often do. Certain areas of the United States are more prone to natural disasters; notwithstanding this, many real estate investors and developers continue to remain active in areas with a high risk of exposure to natural disasters.

Climate Change and Natural Disasters

As a result of climate change and shifting weather patterns, storms and other weather events in recent years have caused more damage to real estate than ever. According to the National Centers for Environmental Information, prior to the start of the last fiscal quarter of 2018, there had already been 11 weather-related disaster events in which losses exceeded \$1 billion for each such event. CoreLogic, a provider of financial, property and consumer information and analytics, estimated that more than 23,000 homes were damaged by the November 2018 California wildfires, which amounts to approximately \$8.6 billion in reconstruction cost value. Scientists predict that floods and other natural disasters will continue to occur more frequently; this is particularly alarming for coastal cities and regions susceptible to flooding. Coastal cities make up a significant portion of institutional real estate portfolios due to their popularity – the National Oceanic and Atmospheric Administration reports that “the population density of coastal shoreline counties is over six times greater than the corresponding inland counties,” even though these cities and their real estate markets are especially vulnerable to flooding, rising sea levels and damage from severe storms and hurricanes.

Impact of Climate Change on Commercial Real Estate

It is crucial for commercial real estate investors, lenders and developers to stay informed about changes to the industry as a result of these severe weather events. First and foremost, it is critical to stay up to date on changes made to state and local laws and regulations as a result of climate change, and to changes within the insurance industry occurring as a result thereof. In the wake of some of the recent severe storms, FEMA has rezoned certain coastal areas and it is likely that they will continue to increase the number of designated flood zones throughout the country. Further, Congress may alter rates for FEMA's

insurance program, resulting in increased flood insurance costs. Developers, in particular, need to be aware of changes to building codes as a result of natural disasters. Some state and local governments have reacted to damage caused by natural disasters by strengthening building codes to ensure that buildings can stand up to hurricanes, flooding and other severe weather events.

One of the most valuable tools to mitigate losses for investors in, and owners of, commercial real estate to date has been insurance. Over the last two years, owners of many coastal properties reported losses following the various severe storm systems, but because they had property and business interruption insurance, many were able to recoup a good portion of those losses. In fact, Morningstar Credit Ratings identified \$1.49 billion in securitized commercial mortgages that were at risk due to the damage from Hurricane Florence in 2018. That being said, Morningstar noted that it did not expect a significant increase in loan defaults as a result of such damage, largely due to the fact that most property owners were required to carry business interruption insurance. An analyst for Moody's also cited insurance requirements as one of the reasons that there have not been major losses for CMBS loans as a result of natural disasters. While insurance has consistently been a reliable tool to keep commercial real estate investments profitable, that may not always be the case going forward.

What Can Commercial Real Estate Professionals Expect Going Forward?

If the severity and frequency of natural disasters continue to increase, as scientists predict, the cost of insurance will continue to increase as well. A report from Risky Business (an organization that analyzes the economic risks associated with climate change) indicates that the cost of coastal storms will increase by \$2 billion in the next 15 years due to rising sea levels and climate change. As the cost of damage from natural disasters continues to rise, so too does the cost of insurance. If insurance becomes too costly, commercial real estate investments, especially in those coastal areas that are susceptible to rising sea levels or severe storms, like New York City or southern Florida, may be seen as too risky to investors. Investors and developers must also keep in mind that insurance can only protect against losses suffered as a result of damage to coastal investments, but will not protect against devaluation of properties due to, or following a natural disaster.

Responses to Climate Change and Natural Disasters in the CRE Community

Some institutional lenders and investors are already reconsidering their development strategy in coastal cities as a result of climate change. Some of the more risk-averse investors have stopped investing in high-risk areas like Florida due to hurricanes and flooding, and certain areas of California due to

the increase in wildfires and the possibility of earthquakes (and the downturn in investing in such areas is only going to get worse as a result of the recent wildfires in California). Others are choosing to mitigate risk by focusing on the assets themselves (i.e., requiring the construction of storm surge barriers moving electrical infrastructure to higher floors, retrofitting properties in earthquake-prone areas by adding roof-to-wall anchors to strengthen the foundation and generally making new construction more resilient to natural disasters). Developers and lenders alike have realized that the benefit of putting in time and effort at the initial construction stage to protect an asset against future weather-related damages can yield a high return; this is true not solely with respect to a property withstanding the damaging effects of a natural disaster. In fact, it appears that many tenants are willing to pay higher rent to live in safer buildings. That being said, even the safest building in the world could lose its value if it is located in a city with outdated or insufficient infrastructure that is not equipped to withstand the effects of a natural disaster. If a building is shuttered even temporarily in the weeks following a flood or other natural disaster, the cost to building owners, tenants and investors can be devastating. Investors and developers must familiarize themselves with local regulations and emergency preparedness procedures of the local government as part of their due diligence when investing in these high-risk areas.

A 2017 report entitled “2017 BDO Riskfactor Report for REITs” from BDO, an accounting and consulting firm, indicates that 98 of the 100 largest publicly traded U.S. REITs identified natural disasters and environmental liability among the top risk factors in investing in real estate. Yet, commercial real estate professionals continue to return to disaster-prone areas to develop and invest in commercial real estate. Commercial real estate investments in high-risk coastal areas have proven to be profitable, and thus, the long term benefit of being located in a popular area has been worth the associated risk. While some investors continue to invest in these high-risk areas merely because they are diversifying their portfolios to protect against risk, some are actually strategically capitalizing on the effects of climate change and the increase in natural disasters in order to yield a greater return.

Is There An Upside to Changing Weather Patterns and Natural Disasters?

When looking at property value data following Hurricanes Andrew (1992), Charley (2004) and Katrina (2005), a general trend emerges – after initial damages in the immediate aftermath of the storm there tends to be an increase in both the number of sales of real estate and the sales price ensuing over the years. Destruction following a severe storm or other natural disaster creates a temporary decline in supply across certain types of properties, several of which will simultaneously experience an increase in demand as a result of destruction. Somewhat ironically, this pattern presents an opportunity for investors and developers to strategically enter (or expand in) a market following a major storm or other disaster.

Immediately following a severe storm, there is also generally an increase in housing requirements. Displaced residents looking for shelter often seek out temporary housing in rental apartment buildings. Hotels also benefit from an increase in demand, not only as a result of residents in need of temporary housing, but also due to the arrival of laborers, first responders, FEMA and other governmental agencies.

The decline in property values immediately following a disaster has the potential to create a strategic investment opportunity for investors, but apartment complexes and hotels located in popular coastal areas generally benefit from high occupancy rates irrespective of natural disasters. According to data from U-Haul, despite the recent incidence of severe damage from hurricanes and flooding, Texas and Florida are the top two states for arrivals of new residents.

Instead of looking at the area directly impacted by a weather-related disaster, other strategic investors look to nearby locales. For instance, hotels in neighboring areas that suffered damage from a disaster generally benefit from increased occupancy. Atlanta hotels, for example, experienced considerable short-term revenue growth as a result of Miami evacuees that fled Hurricane Irma in 2017. Some investors also seek out locations near coastal cities that may serve as viable alternatives to residents looking to avoid areas that routinely suffer from natural disasters. After Hurricane Florence inflicted severe damage on coastal cities in North Carolina and South Carolina in 2018, some investors considered investing in popular areas located above sea level (or higher above sea level), in anticipation of populations moving to higher ground to distance themselves from future storms.

Conclusion

Whether it is strategically investing in a certain area in the immediate aftermath of a natural disaster, or a decrease in investments in an area prone to natural disasters, commercial real estate professionals are reacting and paying close attention to climate change and the recent uptick in natural disasters. So long as investors, developers and lenders continue to (1) remain informed about insurance rates and practices, (2) conduct thorough due diligence and (3) diversify their portfolios, they will be able to mitigate a severe effect on commercial real estate finance as a result of climate change. Rather, climate change may provide savvy investors with the opportunity to reevaluate their investments and make strategic choices, which yield greater returns.