Real Estate Outlook

US – Edition 2, 2020

Uncertainty remains high.

UBS

UBS Asset Management

Tiffany Gherlone
Head of Real Estate Research
and Strategy – US

Short-lived downturn, precedes a long climb to recovery. Private real estate assets are supported by long investment horizons.

No property type is immune to uncertainty and financial impact. A great deal of uncertainty remains around the reopening and recovery of the US economy, a process that is likely to be extended over time rather than a quick rebound to pre-downturn economic levels.

Real estate fundamentals – On the edge of decline

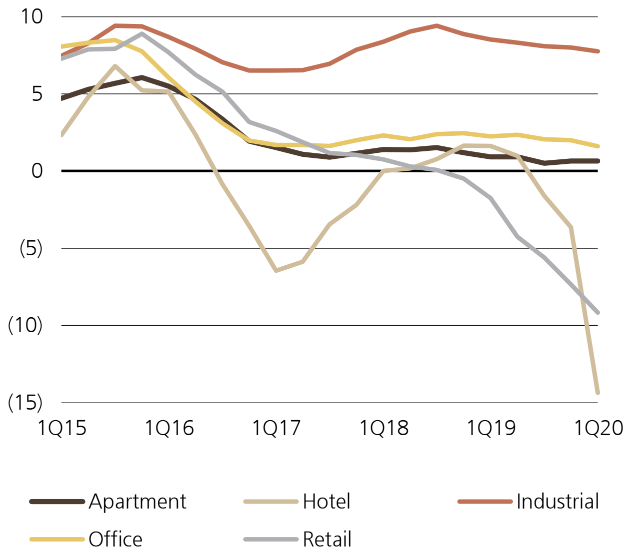
The US is in the midst of an historic downturn. Yet, the NCREIF-ODCE Fund Index shows only the slightest depreciation in private commercial real estate values. It is understandable that early 1Q20 economic and real estate indicators only reflect the beginning of the dip because shutdowns related to COVID-19 began late in the quarter. Economic and revenue declines should intensify as many US businesses remained closed in April and May.

The impact of the current global crisis on private real estate is most immediate in three investment sectors: hotel, retail and development, where properties and sites are closed or limited in operations. Conditions in the office, apartment and industrial sectors have deteriorated in the short term, as would be expected in an economic downturn, but generally these properties remain open with some opportunity to adapt to current conditions.

Cash flows are impacted, even though efforts to smooth short-term losses over long-term horizons – such as rent forbearance, extended lease lengths and deferred interest payments – should have some success. Investors are incentivized to provide workouts to most tenants and borrowers. Uncertainty is high, which means discount rates face upward pressure. Ultimately, we expect opportunities, but not a flood of distressed transactions.

Divergent sector return performance became exaggerated over the quarter. Industries considered non-essential or those which rely on travel or congregation are suffering the most. Office, apartment and industrial have maintained a status quo, while retail and hotel returns have sharpened their decline (see Figure 1).

Figure 1: US real estate capital returns across property types (annual return ,%)

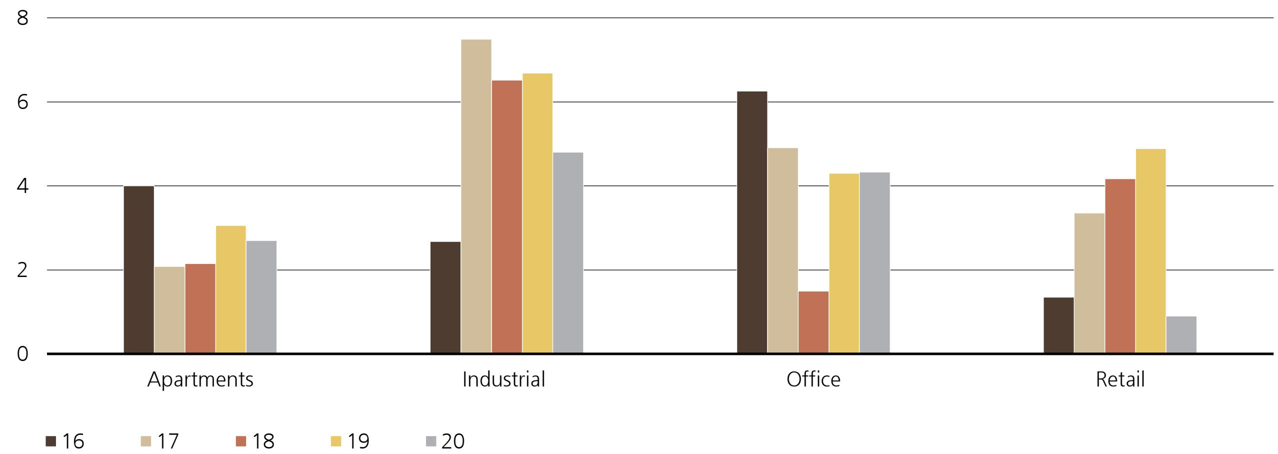


Source: NCREIF as of March 2020. Data show unlevered NCREIF Property Index capital appreciation returns filtered for only ODCE managers. Past performance is not indicative of future result.

First quarter reported data cannot show the whole story, as the first two months were business as usual for much of the nation. Consequently, occupancy (see Figure 3) and rent growth (see Figure 2) reports reflect what seems like typical quarterly fluctuation.

The second quarter is likely to show a more severe contraction. Consumers and investors are expected to remain cautious as lingering social distancing guidelines rein in the velocity of a potential rebound.

Figure 2: Property sector rent growth. (year-over-year change, first quarters, %)



Source: CBRE-Econometric Advisors, 1Q20. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers

Apartments

Many US metros continued functioning normally until the World Health Organization declared COVID-19 a pandemic on 11 March 2020, after the traditional payment date for apartment rent. Consequently, first quarter vacancy at 4.2% and rent growth at 2.7% over the year are in line with previous quarters. Supply pipelines now face delays.

Adaptations

As an essential sector, apartments have the highest average rent collections of any major property type. Landlords are finding innovative ways to attract new tenants while providing a safe living environment, such as moving leasing operations to virtual platforms. Communities seek ways to keep tenants socially active with virtual cocktail parties and game nights.

Industrial

With many stores shuttered, fulfilling online orders and restocking grocers kept the warehouse and logistics industry moving. First quarter 2020 industrial availability is up just 10 bps from the previous quarter to 7.3%, which is 20 bps higher than one year ago. At 4.8%, year-over-year rent growth was slower than recent quarters but showed strength going into the downturn. New supply should slow in 2020.

Holding on

Rent collections are down, but industrial has seen relative stability compared to other commercial sectors. Some manufacturers, warehouses and delivery services are hard-pressed to keep pace with customer demand for essentials from local grocers. The industrial sector could see a short-term occupancy contraction as some companies are unable to adapt to shifting consumer demand.

Office

Occupancy in the office sector benefits from multi-year leases, even if social distancing has turned off the lights. Total office vacancy rose to 12.3% in the first quarter as 10 million square feet came online and new leasing ebbed away. Downtown and suburban office vacancy and rents are up modestly from the previous quarter and one year ago.

Rebalancing

Managers of office properties are working toward solutions to maintain the health and safety of tenants. Office users are considering long-term work from home options that will maintain efficiency without negatively impacting collaboration. Rent collections are down from the first quarter. Capital improvement costs were at all-time highs in 2019. Investors will likely adjust expectations on projects going forward.

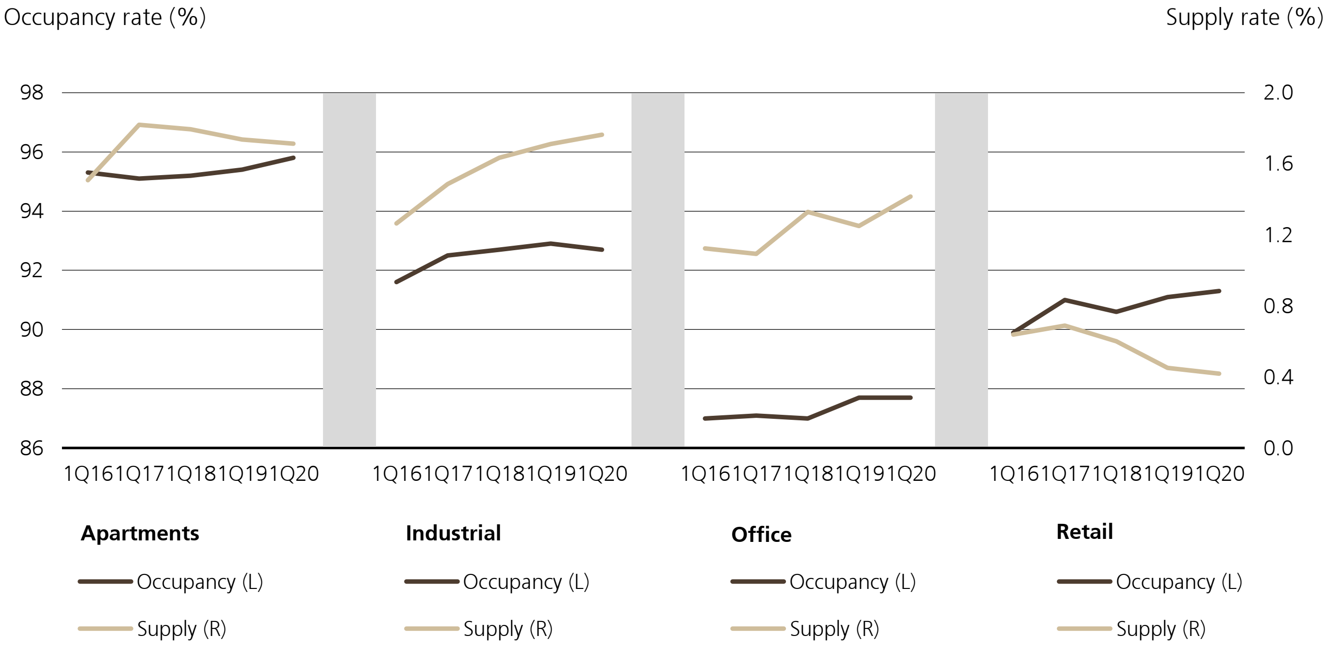
Retail

The retail sector could see the widest divergence in outcomes. Non-essential shops have shuttered and attempt to remain viable, tapping into resources like the Paycheck Protection Act. Grocers, pharmacies and essential services could see record first and second quarter sales. Once stores begin to open, lingering social distancing guidelines and an abundance of caution could restrict traditional brick and mortar retail and food service from achieving a needed recovery pop.

Uncertainties

The Paycheck Protection Act kept some shops and restaurants from shuttering permanently, but that stimulus is not indefinite. As restaurants reopen many are likely to be limited to, at best, 50% capacity; forcing proprietors to weigh the pros of opening against the cost significantly reduced trade.

Figure 3: Occupancy and supply trends



Source: CBRE Econometric Advisors, 1Q20. Note: Supply is shown as a completion rate (ie. completions as a percent of existing inventory).

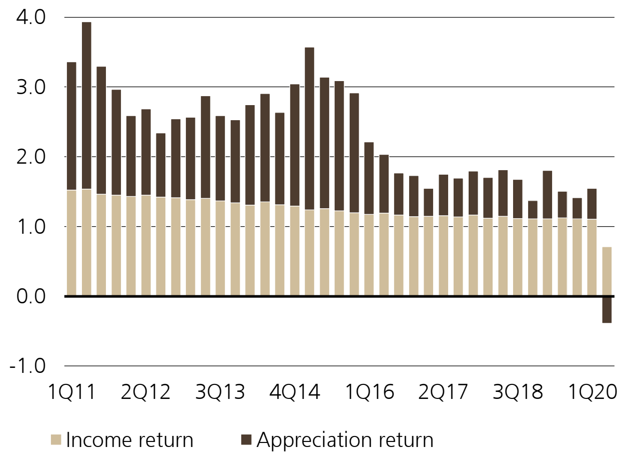
Capital markets – Sales volumes and tenant leasing stalled for now

During 1Q20, the NCREIF Property Index posted capital depreciation for the first time in 10 years (see Figure 4). When taken sector by sector, solid income and modest appreciation have kept apartment, industrial and office returns fairly stable (see Figure 1). Retail returns declined noticeably, pulled down by multiple quarters of capital depreciation, which is impacting the mall sub-sector most negatively.

Transaction volume is stalling out in real time, making it more difficult for investors and appraisers to find comparable sales data. Sales dropped off when the pandemic hit the US in March 2020 (see Figures 5).

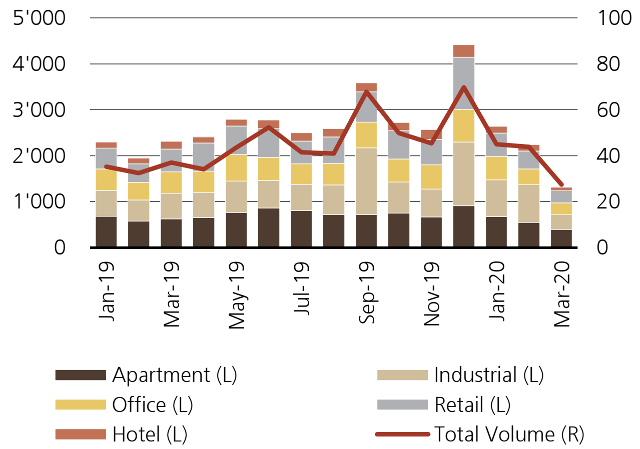
First quarter saw a total USD 99.4 billion in ex-entity transactions, down from USD 102.4 billion in 1Q19. Facing site closures and travel restrictions, transaction volumes are expected to decrease further throughout the second quarter, limited to unique or extenuating circumstances, transfers of interest to partners, and sales under firm contract prior to the shutdown.

Figure 4: US property returns
(%, QoQ)



Source: NCREIF Property Index, 1Q20

Figure 5: US transactions
Count of properties USD billion



Source: Real Capital Analytics, 1Q20. Includes entity-level transactions.

Stimulative measures from the US Federal Reserve moved short-term interest rates to zero in March 2020. On the long-end of the curve, the US 10-year Treasury rate is below 1.0%, pushing real estate spreads well above-average (see Figure 6).

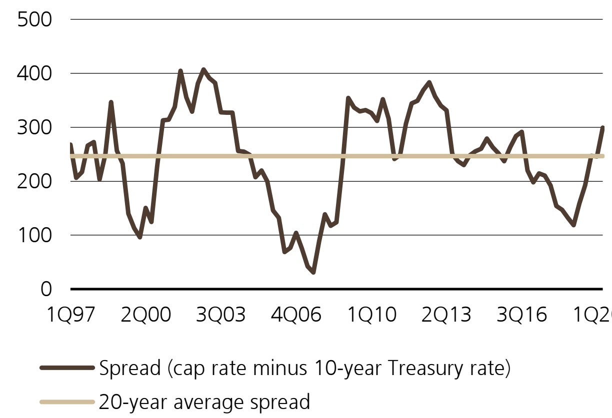
With the beginning of capital depreciation already apparent in property returns, the higher risk premium implied by wide spreads reflects uncertainty around future occupancy rates, leasing velocity and income growth expectations.

While all downturns bring uncertainty to capital markets, the 2020 pandemic-led downturn brings several challenges unique to real assets: travel restrictions, site closures and backlogs in municipal permitting processes. For several months, these challenges will stall investment volumes and tenant leasing. However, these challenges are transparent and temporary. As economies begin to reopen, debt and equity investors should be able to incorporate protective measures and resume due diligence and leasing tours. In the meantime, since these challenges are known, adaptations can be planned and teams should be ready when reopening begins.

With limited sales restricting the availability of current pricing data, the next few months will likely face investor caution.

Although many lenders are open and able to lend, the near-term focus will be on managing portfolio stress and working out terms for existing loans. Early in the recovery, lenders will likely focus on the less-risky, high-quality investments, making few exceptions for deals with low near-term cash flow.

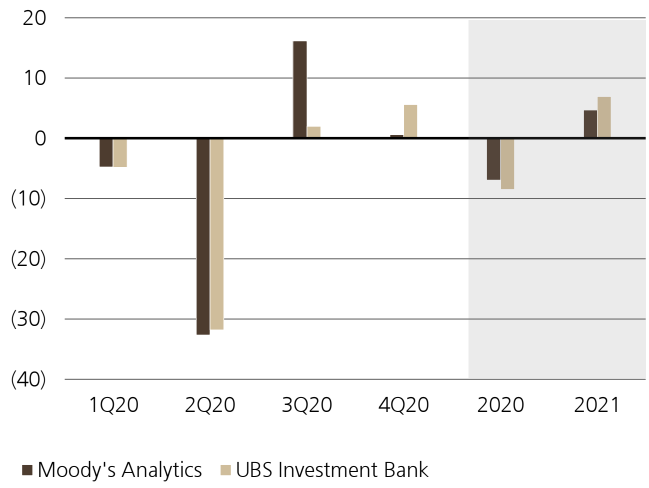
Figure 6: Commercial real estate spread
(basis points)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 1Q20

National GDP fell by an annualized 4.8% during the first quarter (see Figure 7). Economists' forecasts for second quarter 2020 GDP predict an even bigger drop. GDP is forecast to be between negative 7% and negative 9% for calendar year 2020. After an initial lift off a low point, the pace of recovery may slow given fears of virus flair-ups and high debt levels.

Figure 7: US real GDP growth
(%)



Source: Moody's Analytics, 1Q20. Shaded area is forecast data.

The unemployment rate shot to 14.7% in April (see Figure 8). Twenty million jobs were lost in the month of April alone and recovery is expected to be far slower than the drop. Out of a labor force of 164 million people, more than 35 million Americans have filed for unemployment since the start of the crisis in early March. Unemployment is expected to rise above 20% in coming months.

Strategy viewpoint – Uncertainty continues; opportunities vary

Unprecedented stimulus is flowing through the federal government and Federal Reserve to businesses, consumers, states and municipalities. Direct financial support will establish a floor on the severity of short-term decline and help communities, tenants and customers recover when pandemic restrictions begin to ease. As of the end of April, approximately USD 1.15 trillion of the COVID-19 stimulus package has been approved or disbursed.

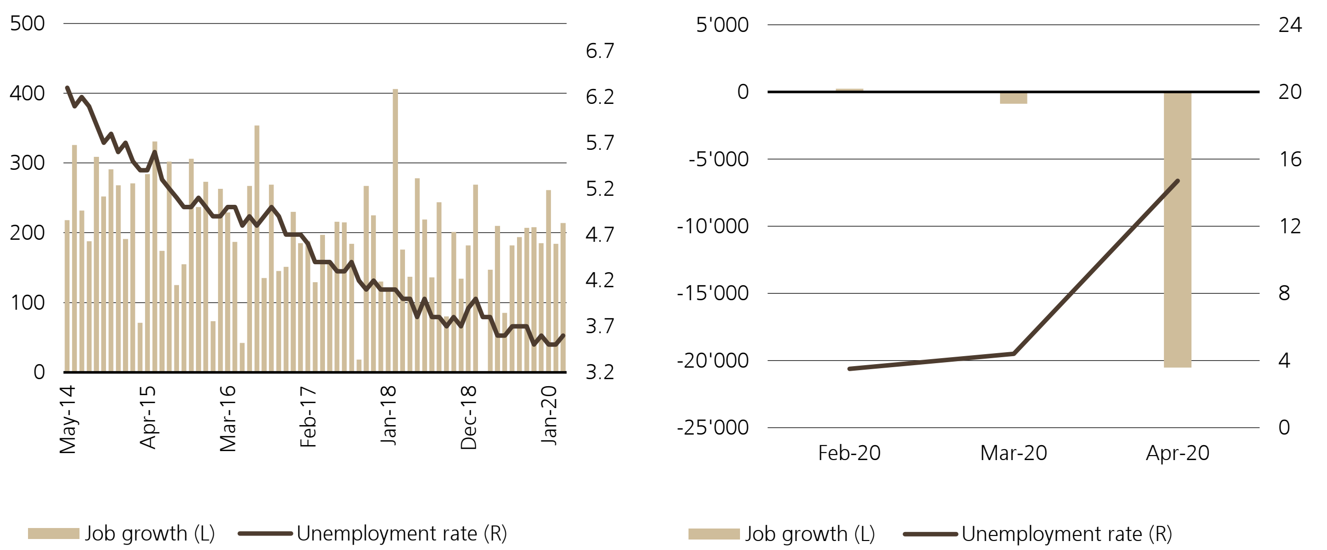
Reduced demand for goods and services is inevitable now that millions of Americans are out of work. Regional differences across dominant industries and local policies should help determine the trajectory for downturns and recoveries. The initiation of future job growth will depend on the lifting of COVID-19 restrictions, discovery of a medical solution that limits a systemic resurgence of the virus, and the confidence employers have in these measures and the potential for growth.

There is a lot of uncertainty around two key inputs to private real estate pricing: future cash flows and current transaction metrics. As data becomes available, there is every reason to expect investors will adjust their underwriting. In the near-term, lower risk investments with stronger cash flows will likely be most attractive to lenders. Capital improvement projects and new construction will likely be delayed by months of closures. More time is needed to understand whether stalled development deals, will deliver back-to-back, which is painful, or trickle into being, which offers opportunities that will vary across markets.

Figure 8: US job growth and unemployment rate

Historic – change in employment (thousands of jobs) %

Recent – change in employment (thousands of jobs) %



Source: Moody's Analytics, April 2020

Our research team

Adeline CHAN
Christopher DEBERRY
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Samantha HARTWELL
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
Sean RYMELL
Shaowei TOH

For more information please contact

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Tiffany Gherlone
+1-860-616 9059
tiffany.gherlone@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research