Q4 2020 Commercial real estate outlook

Separating the signal from the noise

While the commercial real estate market continues to cope with impacts of the pandemic, we outline performance expectations for key CRE sectors and dig into the dispersion that has been created by this environment.

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The commercial real estate market continues to cope with the impacts of the COVID-19 crisis. With lockdowns broadly being relaxed across the U.S., the economy improved at a quicker pace during Q3 than most expected. However, while the most acute stress has likely passed, significant uncertainty remains around the economic recovery. The pandemic has driven a wedge between fundamentals for different property types and geographies, and although activity in the CRE market has declined, current dynamics differ considerably from what transpired during the Global Financial Crisis (GFC).

Key takeaways

- Economic activity recovered at a quicker pace than expected in Q3, and as a result we've seen the pace of newly stressed properties continue to abate. However, significant uncertainties remain, especially around the labor market, the virus and the November election.
- Transaction activity has slowed materially, as is typical for an economic downturn. Despite this, we continue to see strong refinancing activity, which has helped keep the CRE market afloat.
- The primary theme of the COVID-19 crisis continues to be the massive dispersion among CRE property types. Industrial properties and suburban apartments have seen fundamentals hold steady, and in some cases strengthen, while malls and hotels continue to struggle.

As we enter the final quarter of 2020, it can still be useful to look back to pre-pandemic times to get a sense of how quickly things have changed. Less than nine months ago we published our Q1 CRE outlook, "Mirroring the broader economy," a farcically tame title in retrospect given the events that ensued. With that said, it did capture the sentiment at the time—the commercial real estate market was stable yet moderating, in the same way the economy was downshifting amid rising trade tensions and an expansion that was getting long in the tooth. Importantly, we noted three supporting factors for CRE should we experience a downturn.

First, the lending environment had changed dramatically from the previous decade. Post-GFC, we saw average leverage on properties fall to near 60% compared to around 70% pre-GFC.[1] Second, interest rates had fallen to near-record lows. This enhanced the global hunt for yield, a void that could be filled by investments in CRE, both equity and debt. Finally, nonresidential construction spending had remained subdued throughout most of the expansion, reaching a peak of just 2.4% of GDP in 2016 before declining, compared to peaks of over 2.8% in each of the previous two cycles.[2] Each of these factors would hopefully support the market in the event of a downturn.

Of course, the downturn arrived, much more swiftly and in a different manner than anyone could have imagined. The COVID-19 crisis forced a reshaping of the economy, shifting as much activity as possible away from the physical and toward the digital. This has had a significant impact on commercial real estate, and in particular those property types that relied on the physical presence of labor and consumers. In our view, this is the primary narrative of the COVID crisis—it has, in a sense, demarcated the commercial real estate market in a way we've rarely seen before. In this outlook, we take a look at the different ways in which this crisis has impacted different property types.

1 Real Capital Analytics, as of August 31, 2020.
2 U.S. BEA, as of June 30, 2020.

Within the capital markets, we can observe both how the aforementioned supports have helped CRE stay afloat and how the sharp disparity between property types has manifested. Transaction volume has declined precipitously, as it always does during a downturn as buyers and sellers evaluate property impacts. While we'd expect lower volumes to continue for some time, demand for U.S. CRE remains strong. Private real estate funds hold approximately $373 billion in dry powder that must be put to work, which should aid in building up liquidity and price discovery.[3] Property prices show significant dispersion across sectors, with year-over-year growth ranging from -7.8% for hotels to 7.4% for multifamily and industrial.[1]

In debt markets, lower leverage has led to healthier lenders—a crucial difference compared to the GFC, when a rapid pullback in lending contributed greatly to the severity of the drawdown in property prices. Additionally, an increase in the diversity of lenders has meant the market is less exposed to any one source of funding. While new originations declined alongside transaction volume as the pandemic set in, refinancing activity has remained strong, accounting for half of all CRE capital flow through Q2.[1] As we would expect, delinquencies rose at a rapid pace as businesses were shuttered and cash flow at some properties dropped to near zero.

We would put forth three caveats to the 7.9% headline CMBS delinquency number, which on its face is troubling.[4] First, CMBS information is frequently quoted thanks to its data transparency, but it represents only about 12% of outstanding commercial mortgages today, compared to about 25% pre-GFC.[5] Additionally, CMBS carries the highest percentage of hotel and retail loans (the two sectors disproportionately impacted by the pandemic) of any lender type at 41%; delinquencies on office, industrial and multifamily loans remain low.[1,4] Second, the level of newly delinquent loans has fallen each month, from 4.4% of loans outstanding in May to 1.6% in September.[4] Finally, delinquencies are skewed toward those loans originated around the GFC and shortly thereafter; more recent vintages have so far seen less strain.[6] This is not to say that there is not significant stress in the market; there absolutely is, and it will take time to fully gauge what losses will be. However, it's important to understand the data underlying the headlines.

As we mentioned, stress has not been felt evenly across property types, and we would expect that chasm to widen further before it narrows. Traditionally, the structure of our outlooks has analyzed each major property type on its own; given the fundamental disparity not only between sectors but also within sectors, we changed it up this quarter and structured our analysis by grouping sub-sectors based on their expected performance during this period of dislocation. For the most part, the signals are fairly straightforward—for instance, the industrial sector has benefited greatly from the rapid increase in online sales, while hotels have struggled as travel pulled back. In some sectors, such as retail and multifamily, the outlook may be more nuanced. In all, we believe there are significant opportunities in today's market, but investors must be prudent about how and where they get CRE exposure.

3 Preqin, as of March 31, 2020.
4 J.P. Morgan CMBS Research, as of September 30, 2020.
5 Federal Reserve Flow of Funds, as of June 30, 2020.
6 Bloomberg Finance, L.P., as of September 30, 2020.

Macro view: "Are we there yet?"

Key takeaways
- The U.S. economy has come a long way on the road to recovery.
- Unemployment remains elevated, which is a risk to further gains.
- E-commerce has led a robust recovery in goods spending, a boon for industrial CRE.
- Fiscal stimulus remains key for the recovery.

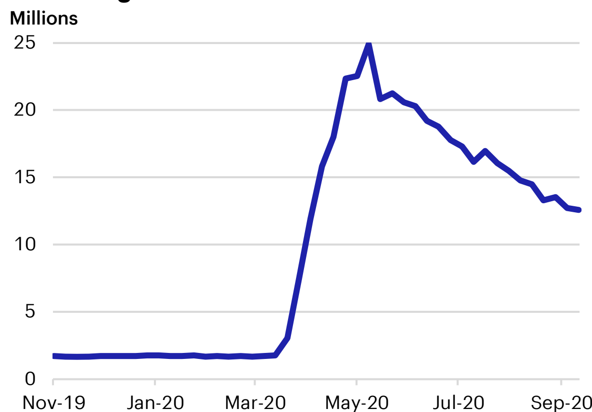
As the U.S. economy continues to recover from a massive economic shock, the pace and trajectory of the recovery remain highly uncertain. Although the unemployment rate remains elevated, the labor market has seen steady improvement since May. While retail sales have recovered rapidly, spending on services, which accounts for 66% of spending, continues to be hamstrung by the pandemic.[2] Ultimately, the economic recovery is at the mercy of the path of the virus, potential treatments and vaccines, and potential further fiscal stimulus. The upcoming election, which will both decide the next president and could also have a huge impact on the makeup of federal, state and local legislatures, adds to economic uncertainty for Q4 and beyond.

The labor market has seen 11.4 million new jobs added since May, a quicker pace of recovery than most expected, though initial claims of just under 1 million per week imply that industries are still working their way through this downturn.[7] The initial impact was felt most acutely by service sector workers in areas such as retail, hospitality and travel. A broader extension of labor market weakness into industries like finance and technology would be a net negative for office demand, though the long-term nature of office lease agreements continues to provide a critical buffer for property owners. Additionally, we've increasingly seen news of finance and tech CEOs recognizing the importance of returning to offices as the crisis has progressed.

The consumer continues to recover from springtime lockdowns, though spending in some categories remains constrained due to mobility restrictions. Retail sales have recovered rapidly to pre-pandemic levels as consumers have quickly adapted to buying goods online, with non-store sales having grown 22.4% year over year, providing a boost to industrial properties.[8] The U.S. economy, however, remains a service-centric one, and the physical nature of services such as health care and recreation have hampered activity. Indeed, Google location data shows that activity at retail and recreation locations still sits about 10% below pre-pandemic levels. Due to weakness in services spending, total U.S. spending is running about 5% below 2019 levels.[2]

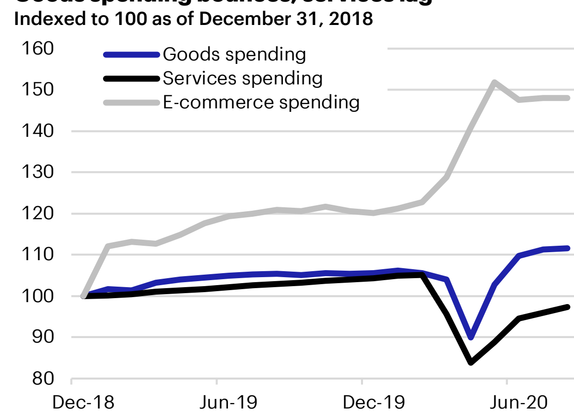
The ebbs and flows of this recovery continue to be impacted by local and national COVID-19 case rates. Absent some panacea such as an effective and widely available therapeutic and/or vaccine, the U.S. economy will likely struggle to return to full capacity organically. The CARES Act, passed in late March, was instrumental in blunting the economic impact in the early days of the crisis, offering support to laid-off workers and shuttered businesses. Further fiscal action is complicated by the election season but will be crucial for CRE fundamentals and the economy at large. The economy has come a long way, but it still has further to go to return to pre-COVID levels.

Continuing claims remain elevated
Millions



Source: Department of Labor, as of September 27, 2020.

Goods spending bounces, services lag
Indexed to 100 as of December 31, 2018



Source: U.S. Census Bureau, U.S. BEA, as of August 31, 2020.

7 U.S. Bureau of Labor Statistics, as of September 30, 2020.

8 U.S. Census Bureau, as of August 31, 2020.

CRE equity: Looking for signs of life

Key takeaways

- Activity is beginning to return, though deal volumes remain deeply depressed.
- Impacts on pricing will be sector-specific.
- The decline in interest rates has widened CRE spreads, which could blunt upward pressure on cap rates.
- Low rates and dry powder should be catalysts for a pickup in activity in the coming quarters.

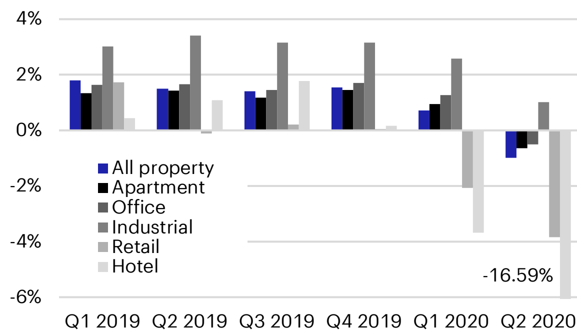
Although activity levels are beginning to pick up, CRE transaction activity remained muted in Q3, and total volume has failed to eclipse $23 billion in a month since March, the longest such stretch since the GFC.[1] The massive uncertainty thrust into markets by the pandemic initially created a chasm between buyer and seller assumptions regarding future cash flows and cap rates, making it difficult for deals to be struck. The current crisis is unique in that it not only calls into question short-term viability of many properties, but may realign the picture for long-term property demand as we see acceleration of certain trends that began before COVID, such as the rise in e-commerce and more flexible work arrangements, as well as new trends driven by COVID, such as de-densification.

Property price levels have begun to tick down, though at a more gradual pace than at the beginning of the GFC.[1] The NCRIEF NFI-ODCE Index, which measures performance of private real estate funds, fell -1.56% in Q2, its first quarterly decline since Q4 2009.[9] After a deep sell-off in the early part of the crisis, public REITs have shown positive momentum, with certain subsectors now even up for the year.[6] Both markets show massive dispersion across property types, as the pandemic and associated mobility restrictions have had a disproportionate impact on retail and hotel properties. The pandemic has also brought about large disparities in outcomes based on geography. In general fundamentals are mixed, and although record-low interest rates and investors searching for yield could help temper upward pressure on cap rates, valuations remain highly uncertain, particularly in the retail and hotel sectors.

Looking ahead, we believe transaction activity will see signs of recovery in the coming quarters. With benchmark interest rates plummeting to record lows, a CRE spread premium above Treasury yields approaching 600 bps should be supportive for deal activity. Additionally, private real estate funds currently hold a record $373 billion in dry powder, equal to about two-thirds of total 2019 U.S. CRE deal activity.[1,3] This has set up a sort of standoff between investors who want to deploy this capital at distressed levels and would-be sellers who don't believe fundamentals in many areas of the market justify such levels. Eventually, this capital will have to be put to work and should serve to support market liquidity and price discovery.

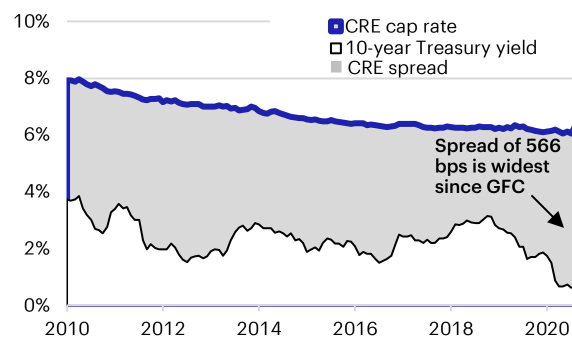
Activity from international investors has declined, though at about the same rate as the overall market. Foreign investors accounted for about 8% of total activity in the first half of 2020, in line with the past few quarters but near a post-GFC low. Interestingly, much of this decline can be attributed to a dearth of entity-level—or M&A—deals. Transactions involving individual properties and portfolios fell only 2.3% year over year, implying still-strong demand for U.S. CRE from abroad.[1]

Quarterly NCRIEF Index returns



Source: NCRIEF, as of June 30, 2020.

Cap rate spreads widen



Source: Real Capital Analytics, as of August 31, 2020.

9 NCRIEF, as of June 30, 2020.

CRE debt: Bending, not broken

Key takeaways

- Driven mostly by hotel and retail properties, delinquencies have risen quickly.
- Demand for yield has driven a thawing in the market, and spreads have tightened.
- It will take time for stress to work its way through the market; losses remain uncertain.

As with most areas of the financial markets, the CRE debt market has taken on stress at an unprecedented pace in 2020. After coming into the year in healthy shape, the pandemic has thrust lenders into the position of dealing with a wave of delinquencies and an uncertain transaction environment. Driven primarily by hotel and retail properties, CMBS loans more than 30 days delinquent quickly rose to 7.9% from just 1.1% six months ago, though new delinquencies have leveled off since June as forbearance requests are granted.[4] In addition to the pressure on pre-COVID CMBS holders, 77% of banks report tightening standards on CRE loans in Q2, implying that lenders have become more cautious on new loans.[10]

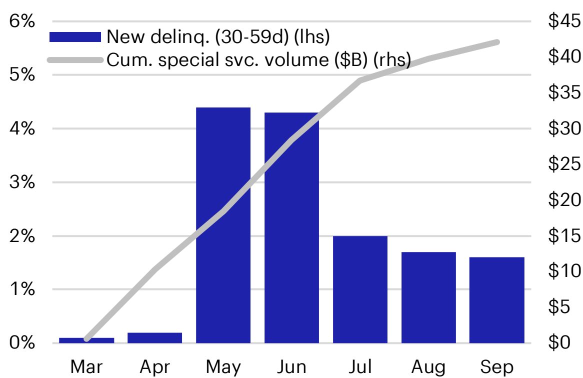
While the overall delinquency rate has risen to 7.9% for conduit CMBS loans, stress is highly skewed toward the hotel and retail sectors. The CMBS market is more exposed to these sectors than other lender types, and although CMBS represents only 16% of CRE lending, it is often focused on in the press due to availability and timeliness of data.[1] Delinquency rates for multifamily, industrial and office loans each remain below 3.5%.[4] One positive to note is that new delinquencies—that is, properties that miss their debt service payment for the first time—have fallen consistently since May.[4] At the same time, special servicing rates have continued to tick up, suggesting that borrowers may be remaining current while working through property-level issues.

Despite this, the demand for yield and the relative security of debt backed by hard assets like CRE has driven a thawing in the market. Though private CMBS volume is down 35% YTD and is expected to remain down for the year compared to 2019, more deals are coming to market and spreads, particularly on higher-rated tranches, are near pre-COVID levels.[4] While a recession generally leads to lower new originations for a time, one key difference so far between the COVID-19 crisis and the GFC is the availability of capital for refinancing. In the first half of 2020, refinancing comprised over half of capital flow into CRE as acquisitions plummeted.[1] The ability of lenders to continue providing refinancing capital is crucial; during the GFC, lenders' neglect of the space was a key factor in the severity of the crisis.

It will take time for stress to pass through the system. Q2 data shows that delinquencies in the CRE bank loan space (representing about 40% of the overall market) rose modestly to 0.60%, still well below levels seen during the GFC.[11] Our analysis shows that at the peak of the GFC, annual loss rates hit a peak of 1.2%. In the current environment, Trepp estimates a total COVID-19 loss rate of 1.8% on CRE bank loans, though this remains variable based on economic recovery assumptions. In the CMBS world, over 7% of outstanding CMBS have been passed to special servicers, who work with properties experiencing stress. It will take time for many of these situations to be worked out, and outcomes will vary widely based on geography and sector.

New delinquencies have declined

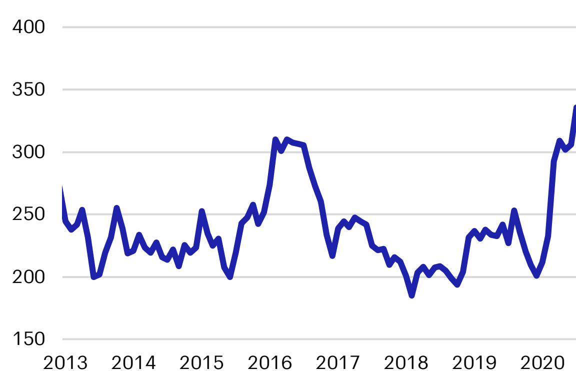
Conduit CMBS market



Source: J.P. Morgan Research, as of September 30, 2020.

CRE debt offers attractive yield

CRE mortgage spread to 10-year Treasury (bps)



Source: Real Capital Analytics, as of July 31, 2020.

10 Federal Reserve, as of July 31, 2020.

11 FDIC, as of June 30, 2020.

Strong signals

Key takeaways
- Industrial, lower-density multifamily and data centers are sectors that have the strongest demand drivers in the near term—and general market pricing reflects that.
- Investors who are looking to minimize near-term risks may be safest here.

Industrial

Industrial entered the year as the shining star of the CRE asset class and we believe it remains so heading into Q4. The many changes that the pandemic has induced have served to strengthen the sector's outlook as consumers have increased demand for e-commerce.

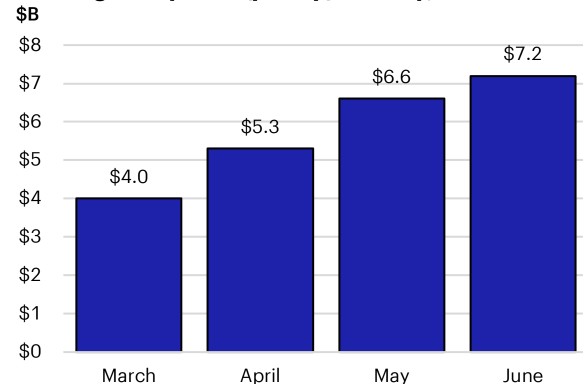
Amid the massive economic contraction in the first half of 2020, industrial fundamentals remained strong. At nearly 90 million square feet, net absorption through Q2 2020 slowed considerably from that of the past three years but remained well into positive territory and held up better than other major property types.[12] At the same time, industrial asking rents nationally have risen modestly, up approximately 2% in Q2 2020 from a year ago, with forecasts moving higher into next year thanks to firm demand.[12]

In fact, more than a third of the 80 markets Cushman & Wakefield tracks nationally recorded new leasing activity through Q2 2020. The new activity was driven by a diverse mix of traditional and online retailers as well as third-party logistics providers that occupy warehouse/distribution space, providing for a constructive outlook across the industrial space. Much of the more recent warehouse leasing activity is the result of a pickup among smaller warehouse spaces in or close to urban centers as shipping in two days or less increasingly becomes the norm. That many former retail sites, often big box stores located in population centers, have also begun converting themselves into smaller industrial spaces speaks to current level of demand for industrial space. According to a CBRE Research survey, there are nearly 60 retail-conversion projects underway accounting for nearly 14 million square feet of retail space.

12 Cushman & Wakefield.

Online grocery sales, which nearly doubled in Q2 from a quarter earlier, provide a further layer of support for the industrial sector in the year ahead.[13] As the chart below highlights, monthly sales growth slowed somewhat during the quarter as foot traffic across all types of stores picked up. But assuming some of this new activity continues to be sticky, the sector should see a prolonged increase in demand for cold storage centers. Other e-commerce categories (health, baby and cleaning products, in particular) also seem poised to continue to benefit from longer-term growth well after the pandemic has passed.

Online grocery sales (pickup/delivery)



Source: Digital Commerce 360, as of June 30, 2020.

Multifamily: Garden and low-density

Multifamily has been the subject of negative headlines since the pandemic began due to concerns over the ability of tenants to pay rent given the massive labor market dislocation. While some areas of the sector may face challenges in the coming quarters, to date it has been one of the lesser-exposed property types given that shelter is a necessity and people tend to prioritize rent over other payments. In previous quarters, multifamily has also likely been the beneficiary of unprecedented levels of support from the federal government, including direct payments to households and enhanced unemployment benefits which expired on July 31. The Federal Reserve's support for the multifamily CMBS market has also stabilized mortgage lending in the sector.

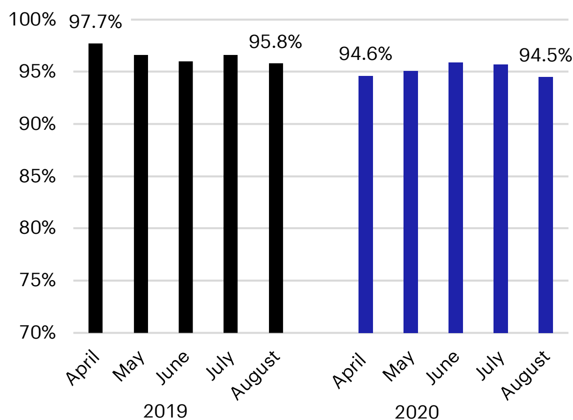
Against this backdrop, fundamentals across multifamily nationally remain relatively constructive. According to the National Multifamily Housing

13 Digital Commerce 360.

Council's (NMHC) Rent Payment Tracker, 94.5% of apartment households paid all or part of their August 2020 rent payment, a decline of just -1.3% from the share who had paid a year earlier.[14] The liquid commercial mortgage market tells a similarly optimistic story. According to Trepp, the overall delinquency rate (the percentage of loans 30+ days past due) on multifamily CMBS was 3.03% in August 2020, up from 1.79% in February but by no means pointing to massive distress across multifamily properties.[15]

The greatest multifamily opportunities appear to be in garden-style or other low-density apartments. These properties tend to be better suited to today's environment, in our view, as they best support tenants' social distancing desires. Buildings with limited elevator needs and direct exterior access to outdoor common areas should see more demand. Further, housing demand in the suburbs has generally held up better than in cities in 2020, a trend we see remaining in place even in a post-COVID world. We also look for higher-end, Class A properties to remain best positioned within the current environment as tenants of these buildings are more likely to have jobs allowing them to work from home and continue to pay monthly rent. The NMHC Rent Payment Tracker tracks approximately 11 million professionally managed properties that often skew toward higher-end, Class A apartments. It points to the relatively minor effects COVID has had on rent collections YTD within these properties.

NMHC Rent Payment Tracker
% of tenants paying on time



Source: National Multifamily Housing Council, as of August 31, 2020.

Specialty: Data centers

The outbreak of COVID-19 has turned the data storage center sector's already-sunny future even brighter. The massive portion of the population working from home this year, combined with a surge in e-commerce activity, has helped create a commensurate spike in data and cloud-computing storage needs. Even after the pandemic, we expect that the changes the health crisis ushered in will at least partially remain in place. Cisco estimated that cloud data centers will process nearly all corporate America's workload—as much as 94% by as soon as 2021.[16]

The changes in the manner and physical location in which we work represents tremendous potential growth opportunities in both cloud computing and, for CRE investors, the properties that house America's massive computing infrastructure needs. While we expect the majority of office workers to eventually return to offices, we also expect work to be more flexible and dynamic in the future, supporting the need for data in the years ahead. According to the International Data Corporation, cloud spending is expected to double to $500 billion between 2019 and 2023. Similar to the changes we've seen across the industrial landscape in recent quarters, new data centers will largely be built closer to urban centers and feature smaller footprints, between 50,000–100,000 square feet. Also like industrial, data centers are among the few property types expected to see little to no damage to their net operating income or property values over the next five years as a result of the health crisis.[17]

14 National Multifamily Housing Council.
15 Trepp, as of August 2020.

16 Cisco, https://bit.ly/2EBGlow.
17 Green Street Advisors.

Some static

Key takeaways
- Office, grocery-based retail and downtown multifamily have a more mixed outlook based on changing demand drivers.
- Investors will need to be more selective in these sectors.

Office: Suburban

The fate of the office has been a prominent side theme throughout 2020 as many American office workers quickly transitioned to working from home and did so with relative success. Office workers and investors have taken part in a collective debate this year about whether offices are inflexible and dated in today's environment or whether they are an important part of building corporate culture, enhancing teamwork and facilitating innovation. Like most polarizing debates, the truth is likely somewhere in the middle.

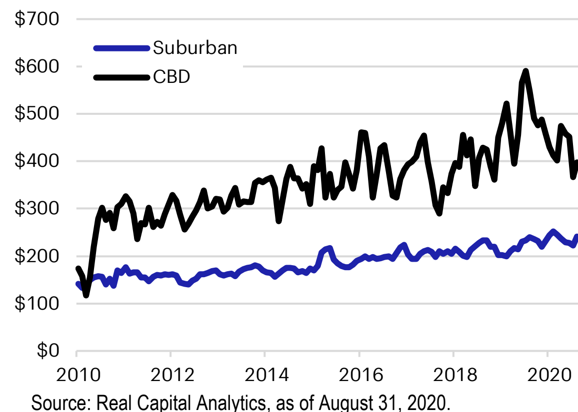
As many CEOs have recently acknowledged publicly, offices play a critical role in helping companies foster culture and a collaborative work environment among employees that can be difficult or impossible to reenact entirely in a virtual setting. Further, the office sector does not face a secular demand degradation analogous to the effect of e-commerce on the retail sector. That said, the office may look different in the coming quarters and, eventually, in a post-COVID world. We are aware of the risks office CRE may carry for shorter-term investors, but we also believe these investments can still be profitable, particularly if made selectively. Over a longer time frame, office continues to offer many attractive investment opportunities despite the disruptions it is managing through today.

Year to date, figures point to the challenges of investing in office CRE as corporations have moved toward a work-from-home model en masse. Effective rent (the average monthly rent a landlord collects) has fallen this year as the national office vacancy rate, relatively stable prior to 2020, has risen 2.5% from 2019 levels and is forecast to remain around current levels through the coming years.[18] Sentiment surrounding the need for an office has weakened considerably since the pandemic began.

Amid the negative sentiment, however, the pain has not been uniform. Office space in the suburbs has held up relatively better than buildings in central business districts (CBDs), a trend we believe will continue in the coming year. Although CBDs will remain an essential part of work and home life in the years ahead, they face significantly more near-term challenges than suburban offices. Suburban office space came into 2020 backed by a relatively better fundamental picture than CBD office, and the pandemic could exaggerate this difference. Similar to our view on low-density multifamily properties, low-density suburban offices will remain attractive to companies given the extra space and flexibility they can afford employees in the coming quarters and even in a post-pandemic world.

Nationally, the average price per square foot of suburban office space is just under 50% of that for CBD offices.[1] The prospect of cheaper leases could be an additional tailwind supporting new suburban office development and leasing activity. This may particularly be true as companies seek to enact cost-cutting measures while looking to support employees' social distancing needs.

Office space, average price/sqft



Source: Real Capital Analytics, as of August 31, 2020.

Retail: Grocery-anchored/community

Headline figures across the retail landscape continue to paint the picture of a deeply troubled sector. Net absorption figures, which trended lower in recent years, have plummeted in 2020 while the delinquency rate on retail CMBS has spiked. Such challenging headline figures, however, may hide the fact that certain areas of retail have performed well this year.

18 Moody's Analytics.

Grocery and grocery-anchored community retail centers, for example, have benefited from increased foot traffic since the start of the pandemic. Grocery stores' performance is not a minor detail given that the top 160 grocery store chains account for nearly 10% of all retail space nationally.[12] Retail town centers, typically open and walkable mixed-use projects, have also fared relatively better. These spaces are more easily adaptable to social distancing and are a potential bright spot within retail even in a post-pandemic world.

The changes 2020 has produced have forced retailers into adjusting their business models significantly quicker than they may have planned. Traditional e-commerce companies have begun opening brick-and-mortar locations in highly trafficked areas. These locations allow customers to test new products and help firms deepen their relationships with customers. Traditional retailers have also found success in blending their long-held sales models with e-commerce, allowing customers to buy online and pick up in the store, a practice commonly referred to as BOPIS. Retailers' adoption of BOPIS as a business model is expected to ramp up considerably in the coming years, with approximately 90% adoption forecast by 2024, as it also often leads to additional in-store sales.[19] Both areas are weighed down by the broader retail landscape, of course, but selective opportunities in the sector are available.

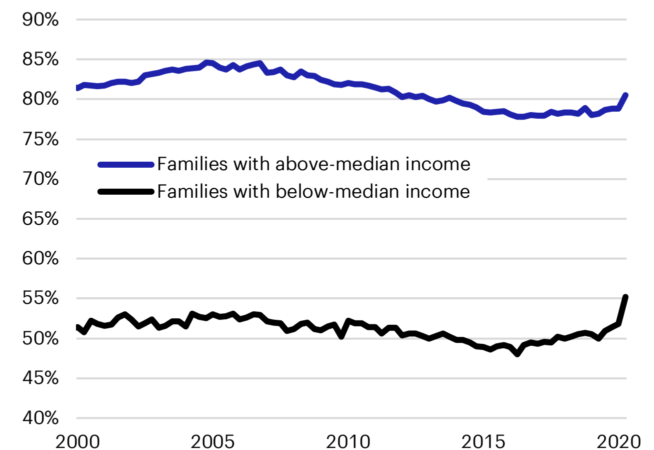
Multifamily: CBD/high rise

Multifamily properties have held up well in 2020 despite several headwinds that have emerged amid the pandemic. Unemployment has moderated in recent months but remains just below the GFC high. Additionally, with mortgage rates at or near all-time lows and work-from-home generally affording employees more flexibility than ever to live where they prefer, homeownership rates have spiked this year. Despite these challenges, attractive investment opportunities are likely to continue presenting themselves across the multifamily landscape. In today's environment, however, investing in mid- and high-rise multifamily properties, primarily located in urban centers or other higher-density areas, may call for considerably more caution and selectivity than investing in garden-style or other low-density properties. The divided case between lower- and higher-density properties today is not unlike that between suburban and CBD offices.

Year-over-year rent growth in downtown areas has plummeted this year, from approximately +3% to -5%, as many renters have shown themselves no longer willing in today's health and economic environments to pay a premium for access to all that city life offers.[8] With this in mind, densely packed buildings, which often feature indoor communal spaces, including elevators, will likely continue to see a notable reduction in demand throughout the coming months and potentially even post-COVID.

Despite the challenges ahead, over the long term city centers will likely remain desirable places to live, particularly for younger renters, who are drawn to them for their diversity, walkability and proximity to cultural events and nightlife, as well as their status as home to millions of employers across the country.

Homeownership rises across the board



Source: U.S. Census Bureau, as of June 30, 2020.

19 Washington Prime Group.

Transmission fading

Key takeaways

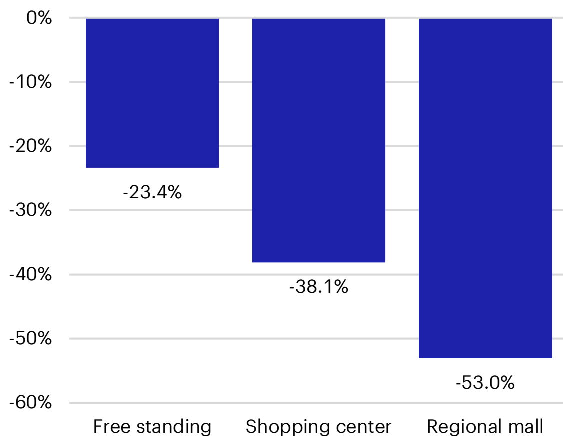
- Malls, downtown offices and hospitality are areas likely to experience more distress in the near term.
- These sectors may face secular challenges or demand headwinds without clear opportunities to balance out these risks.
- Of course, sectors with the most challenges may present the best opportunities for investors who are equipped to handle more complex situations.

Retail: Malls

Retail's deep pain has not been felt uniformly, as grocery stores and stores that sell other "essential" items clearly illustrate. Malls, however, lie at the opposite end of the retail spectrum as they are responsible for much of the distress across the property type. Malls, particularly Class B and lower-end malls, which bring in less revenue per square foot than higher-end Class A malls, faced significant challenges heading into 2020 as they have attempted to keep up with evolving consumer preferences.

The massive store closures COVID-19 has wrought this year, however, have accelerated malls' already-difficult path forward. One analyst estimated that approximately one-third of the 1,000 malls currently operating in the U.S. could close their doors by the end of 2021.[20] The most impacted malls are likely to be Class B- and below, which have less financial cushion their higher-end Class A peers.

Trepp retail pricing estimates
Base case for retail price declines



Source: Trepp, as of July 31, 2020.

In a recent report, Trepp predicted that regional malls will face a peak-to-trough price decline of -53%, steeper than any other property type. Trepp's analysis ranged from price declines of -26% in a best-case scenario to -62% should economic conditions slow meaningfully again.

Office: CBD

Many of the same factors that form the basis of our more optimistic outlook for suburban office—lower costs per square foot, the potential for more space per employee and, for many companies, the ability to be closer to their workers—pose longer-term challenges to demand in central business districts. The density that is inherent to CBD offices is the major hindrance for them amid COVID. Especially in primary markets—New York and San Francisco, among others—workers face significant obstacles to "returning to normal" in a downtown office.

Most occupants of those buildings need to use mass transit systems to get to the office and, once there, potential crowding in elevators also presents difficulties. If working from home becomes the norm for some employers, younger professionals could decamp to more affordable locations rather than paying extra to live and work in large urban population centers. More experienced workers might reconsider moving to larger suburban spaces. Either scenario, we believe, should place pressures on demand for office space in CBDs.

We remain constructive on urban offices in the long term. We continue to believe physical space offers positives that cannot be gained via remote work and continue to question the viability of consistently onboarding new employees remotely. While the subsector will likely remain under pressure in the coming quarters as the virus continues to dictate our daily lives, the long-term nature of office leases lends support to existing properties.

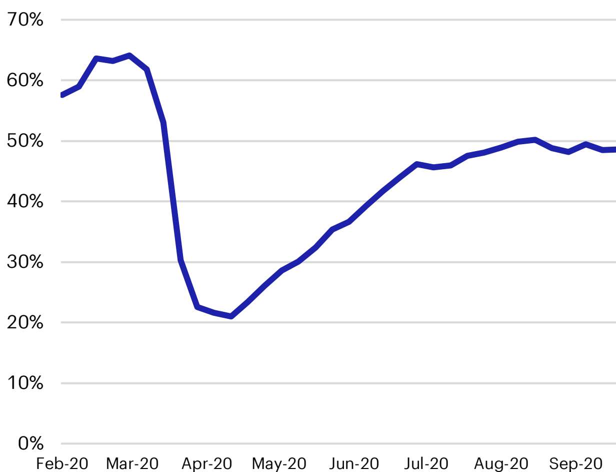
20 CNBC, https://cnb.cx/2RQ5peA.

Hospitality

Many of the lockdowns and travels bans that went into effect in early Q2 either ended or were pared back through the summer months. Yet high frequency indicators show that Americans remain far less mobile than they were at the same time last year. Air travel has recovered somewhat from its April lows, but remains just 25%–30% of its level from a year ago.[21] Gasoline usage is off a more moderate 10% from last year's level as travelers are more willing to drive than fly.[22] Hotel occupancy recovered initially, but the improvement has leveled off somewhat and occupancy remains well below 2019 levels.

Hotel fundamentals were under pressure prior to the pandemic primarily due to increased competition from market disruptors like Airbnb and Vrbo, combined with a supply glut in certain cities. Hotel property prices declined 4.4% y/y in July, steepening their pace of decline from earlier in the year, while transaction volume has plummeted in recent months, down as much as 93% in May.[1] Distressed sales represented nearly 8% of all hotel sales in Q2, up from 2% in 2019 and more than double that of office, the property type with the second largest percentage of distressed sales volume.[16] In the CMBS space, the hotel loan delinquency rate was 22% in August, down from 34% two months earlier but still well above that of other major property types. Retail, for example, saw the second largest delinquency rate, at nearly 15%.[15]

U.S. hotel occupancy gains have leveled off



Source: STR, as of September 26, 2020

Ultimately, the return of travel will dictate the recovery for the hotel sector. As high frequency data indicates, however, there remains significant room for recovery to pre-COVID levels. Occupancy and RevPAR (revenue per available room) rates have both continued to trend upward in recent months but remain approximately 32% and 52% below their respective rates from a year earlier.[23] Full-service hotels that primarily cater to convention and business travelers, along with hotels in locales that rely on flights to bring consumers, such as Hawaii, have lagged considerably further behind those in more driver-friendly locations and those that cater to families and tourists. There is clearly pent-up demand for consumers to take vacations but also still very significant uncertainty about their ability and willingness to do so. As with most other sectors, much relies on how the path of the pandemic progresses over the coming quarters.

21 U.S. Transportation Security Administration.
22 U.S. Department of Energy.
23 STR, as of September 26, 2020.