Real Estate Outlook

US – Edition 1, 2021

Resilience and transformation.

UBS

UBS Asset Management

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US outlook

Real estate careful recovery.

Increased transaction activity late last year reflects pent-up investor demand for real estate assets, with a clear preference for industrial and apartments as 2021 begins. We expect retail and office to continue to face headwinds even as the economy improves.

Real estate fundamentals

Fortitude required.

The US economy is recovering from the depths of distress realized in 2Q20, even as political disputes and surging COVID-19 infections impede progress. We expect vaccine distribution and economic recovery to accelerate by mid-2021. QE supports persistent wide spreads, which positions real estate well relative to other asset classes.

Downturns are rare in private commercial real estate, but when they happen, the disruption brings new and unique opportunities for investors. Some weakness should persist into 2021 as effects from the pandemic and 2020 recession ripple through society and the economy.

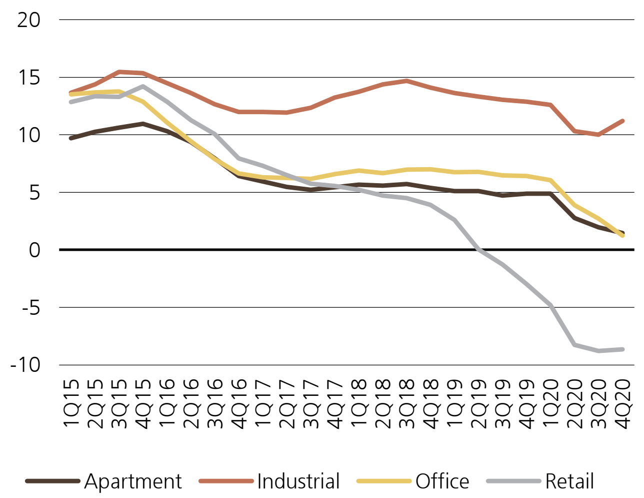
The NCREIF-ODCE Fund Index, shown in Figure 4, illustrates how income return offset depreciation in private commercial real estate resulting in a positive total return of 1.3% QoQ in 4Q20 and 1.2% for the full year of 2020. The hotel and retail sectors continued to be the most directly impacted by lingering effects of the pandemic.

Office performance has been protected by contractual lease agreements, however, the outlook for office demand and future performance is uncertain. The short lease cycle and necessity of apartments keep the sector poised for steady recovery. Fundamental evolution of the industrial sector has kept performance steady in this increasingly agile sector.

Divergent sector return performance remained exaggerated over the quarter. Retail posted a negative total return after nearly three years of negative returns. Apartments and office returns slowed in 2020 (see Figure 1). Industrial returns held in the double-digits. In 2021, we forecast positive returns for industrial and apartments but negative performance in office and retail.

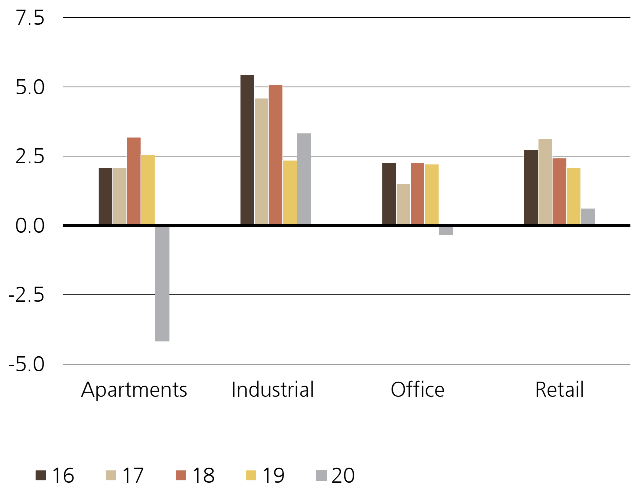
As the year progresses, positive news on vaccine distribution, competitive lending markets, and fiscal stimulus should support a meaningful rebound in economic growth and a turnaround in aggregate real estate performance. In this low interest rate environment, real estate should continue to be viewed as a good portfolio diversifier and a pathway to sustainable and impact investing.

Figure 1: US real estate total returns by property type
(rolling four-quarter total return, %)



Source: Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers. Past performance is not indicative of future result, December 2020.

Figure 2: Property sector rent growth
(YoY change, in quarters ended 4Q20, %)



Source: CBRE-Econometric Advisors, 4Q20. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments

Apartments vacancy is up 30bps from one year ago (see Figure 3), a modest increase under the circumstances, according to CBRE-EA. Average asking rents are down 4.2% YoY (Figure 2); indicating that landlords are allowing rent to slip in favor of filling vacancies. The apartment sector's ability to monetize changes in the economy quickly, coupled with low capex burdens, position the sector well in 2021.

Find opportunity

Apartment returns held up overall in 2020, but it was a year of mixed results. Housing is a necessity, and consumers prioritized paying rent. Buildings actively leasing-up typically faced elevated concessions. Metros with large downtown clusters or high construction levels suffered most. Inner-ring suburbs with proximity to employment, transit connections and moderate rents appear attractive, abrupt employment recovery could drive short lived demand surges. Disruption to transactions, permitting, and construction could lead to reduced supply in some markets over the coming years.

Industrial

The 2020 holiday season was dominated by online shopping and consumer direct shipping. Maintaining a position as the least volatile sector, 4Q20 industrial availability was just 10bps higher than one year ago. 2020 YoY rent growth remained healthy at 3.3%, as tracked by CBRE-EA.

Challenge old trends

Supply chain disruptions and logistics challenges were no match for sustained customer demand in 2020. Growing investor appetite should reinforce good performance while tenant demand is supported by accelerating online ordering and increasing inventory build-up. Industrial's low capex requirements supports flexibility. High-tech firms may begin to require a changing skill set with more expertise in automation and digitalization. Warehouse and distribution still dominate, but opportunities are growing to seek further diversification within modern industrial portfolios through emerging concepts in ESG, technology, in-fill, cold and self-storage.

Office

Total office vacancy surged 280bps over the year to 15.0% in the fourth quarter. According to CBRE-EA, 2020 saw nearly 40 million sqft of new supply delivered into a market with rising availability. Downtown vacancy has risen to 13.8%, 350bps; while suburban vacancy, at 15.6%, is 240bps above last year. Asking rent declines are expected to continue through mid-2022, with downtown declines more dramatic than suburban.

What isn't priced in?

A drop-off in office rents is not priced in right now, but there is downward pressure. Values will likely adjust downward when more leases are signed and allow comparisons to current assumptions. Firms will still need office space, even if the rise of flexible ways of working lowers demand potential somewhat over the long-term. We are more optimistic about the urban edge than the traditional urban core. Despite the need for space and fresh air, locations closer to more densely populated areas remain more attractive. As for Downtown office, as the pandemic eases, urbanization should return, albeit at a diminished pace.

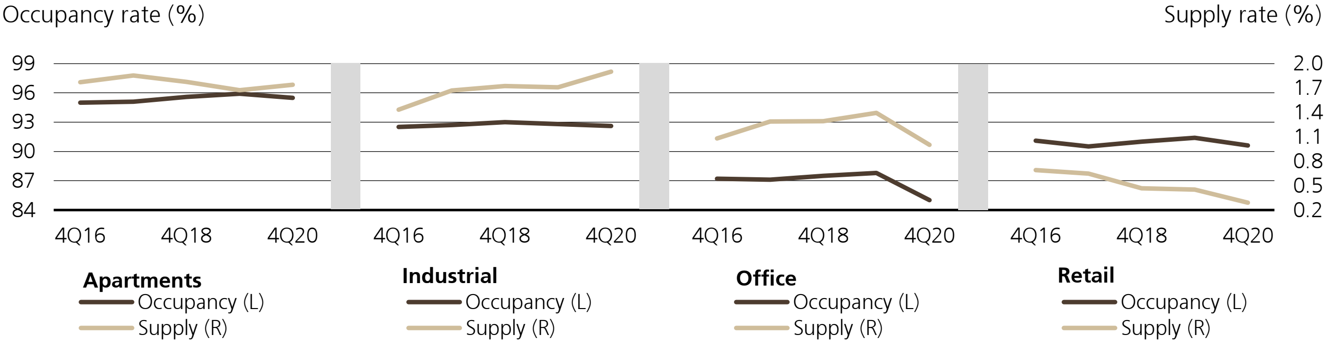
Retail

Reactivation of pandemic restrictions have hurt independent brick and mortar stores and restaurants, particularly businesses unable to adapt to flexible and online strategies. Malls continue to bear the brunt; NCRIEIF indicates 4Q20 annualized mall returns were -12.6% while non-mall returns were -5.5%. Research indicates an average of two years to fill vacated mall anchor space.

Nothing lasts forever

The situation looks dire, but don't count retail out forever. As recovery begins to take hold, retail should benefit from pent-up consumer demand for goods, entertainment and food. Smaller shopping centers should offer less risk than malls with a faster payoff. Retail industry transformation will likely come from increased mergers and acquisitions, tech-oriented innovations and integration of more advanced logistics capabilities. Traditional thinking needs to change, and change quickly including deeper partnerships with operators and tenants as well as cooperation with municipalities.

Figure 3: Occupancy and supply trends



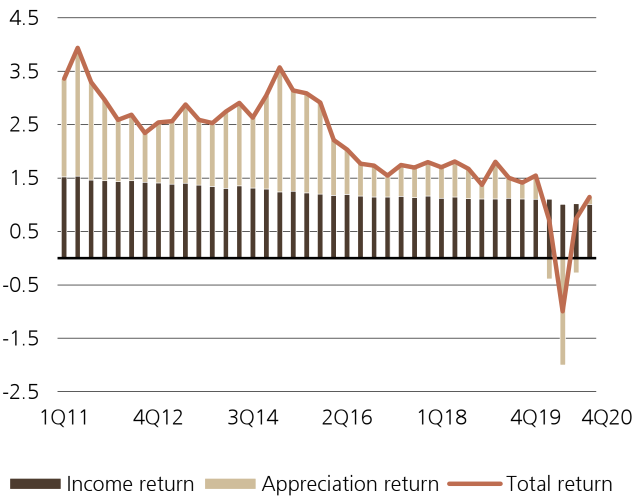
Source: CBRE Econometric Advisors, 4Q20. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community & Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Capital markets

Recovery bottleneck.

Property-level returns improved during the fourth quarter. Only the industrial sector produced positive appreciation, but it was enough to balance the other sector declines and close the quarter with a net value increase (see Figure 4). Although down slightly from a year ago, income returns remain steady.

Figure 4: US property returns (QoQ, %)



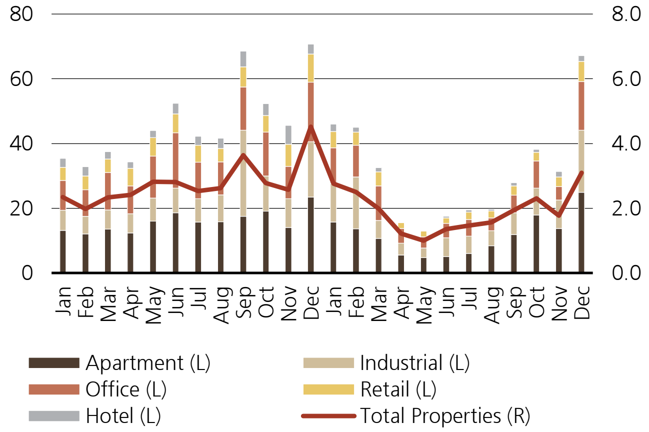
Source: NCREIF Property Index, 4Q20. Past performance is not a guarantee for future results.

Interest rates are expected to remain low for years. 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, reported by Moody's Analytics, is below 1.0%, maintaining real estate spreads above-average (see Figure 6). 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. These challenges continue to stall investment volumes and tenant leasing as returns are repeatedly reassessed. Investors and appraisers are waiting for more comparable lease and sales transactions to support or refute the magnitude of adjustment.
Low interest rates support increasing transactions. Spreads available in private real estate remain well-above long-term averages (see Figure 6). Debt markets are loosening with lenders favoring high-quality credit, long-term leases, multifamily and industrial properties.

Figure 5: US transactions

Number of properties (count) (USD bn)

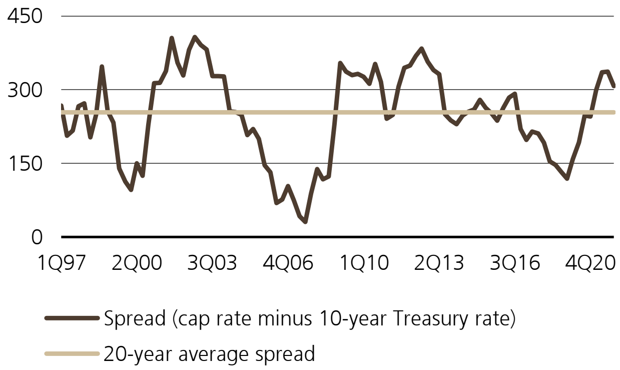


Source: Real Capital Analytics, 4Q20. Includes entity-level transactions.

December 2020 showed a fairly normal surge in transactions, as tracked by Real Capital analytics (see Figure 5). However, total volume during the second half of 2020 was 37% below the second half of 2019. Apartments and industrial trades continue to lead the way. Increased transaction volume should give investors more clarity and confidence in values for these properties during 2021. Although transaction volume during the first half of 2021 is likely to soften from the December spike, optimism in the transaction market and cross-border investment should improve throughout the year.

With limited sales restricting the availability of current pricing data, investors remain cautious. 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, while extending new debt to the highest-quality deals.

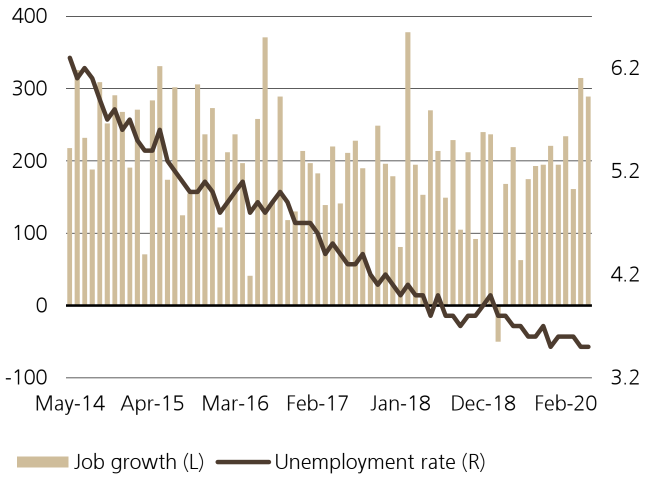
Figure 6: Commercial real estate spread (basis points)



Source: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 4Q20

The unemployment rate, tracked by Moody's Analytics, shot to 14.7% in April (see Figure 7) and almost immediately began to decline as Payroll Protection Program loans were approved. The US unemployment rate was 6.7% by December, which translates to 10 million Americans out of work (see Figure 9), depressing consumer demand, particularly for services. Regional differences should play an important role in determining the trajectory for metro level downturns and recoveries.

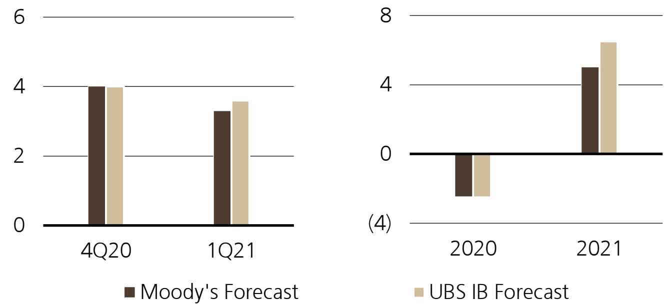
Figure 7: US job growth and unemployment rate
Historic – Change in employment (thousands of jobs)



Source: Moody's Analytics, as of December 2020

Direct financial support helped establish a floor on the severity of short-term decline and help communities, tenants and customers. Additional stimulus, approved and distributed in the last week of December 2020, came too late to have much impact on the fourth quarter but could be supportive of early 1Q21 recovery.

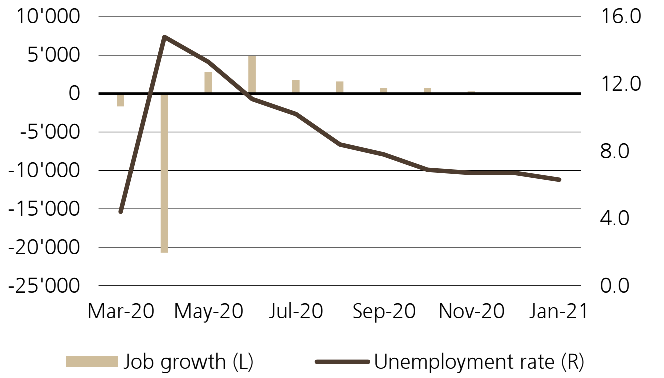
Figure 8: US GDP quarterly annualized forecast (%) **US GDP calendar year forecast** (%)



Source: Moody's Analytics forecast as of 12 January 2021; UBS Investment Bank forecast, as of 29 January 2021

While the third quarter GDP recovery of 33.4% annualized growth erased the bulk of 2020's economic decline (see Figure 8), in the fourth quarter the economy remained 2.5% smaller than a year earlier. Progress toward full recovery will remain measured, given virus flair-ups, challenging vaccine distribution logistics, and stalled stimulus negotiations. Moody's Analytics expects GDP to reach the 4Q19 level by the end of 2021. Recovery will be slow given virus flair-ups and stalled stimulus negotiations.

Figure 9: US job growth and unemployment rate
Recent – Change in employment (thousands of jobs)



Source: Moody's Analytics as of December 2020.

Strategy viewpoint

Near-term dichotomy.

The momentum of future job growth is dependent on vaccine distribution – which has not proceeded as efficiently as anticipated – and the confidence business and consumers have in the security provided by vaccination. State and metro variations in public health procedures may have widened the gaps around near-term economic potential.

Investor confidence is higher in the industrial and apartments sectors given the persistent, necessity-driven tenant demand. In retail, office and hotels, limited transactions and higher capital expenditure (capex) burdens make it difficult to assess whether current risk premiums compensate adequately for the risk. We expect industrial and apartments to continue to diverge and outperform retail and office in 2021.

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