Real Estate Outlook

US – Edition 2, 2021

Persistent divergence.

UBS Asset Management

Tiffany Gherlone
Head of Real Estate Research
and Strategy – US

US outlook

Bifurcated recovery.

As summer approaches, we expect the US will make progress in the slow process of reopening. With that renewal, markets are starting to move again as well. By autumn, real estate investors should gain insight from increasing comparable leases and sales.

Real estate fundamentals

Healing.

The US economy is recovering from the depths of distress realized in 2Q20. Political disruptions have not dissolved, even as the incoming administration advances goals and messaging. Additional stimulus and legislation designed to seed expansion have supported stronger economics and inflation.

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 through 2021 as effects from the pandemic and 2020 recession ripple through society and the economy.

The NCREIF-ODCE Fund Index shows income return offsetting capital depreciation in private commercial real estate resulting in a positive total return of 2.1% QoQ for 1Q21, and 2.3% YoY. The hotel and retail sectors continued to be the most directly impacted by lingering effects of the pandemic.

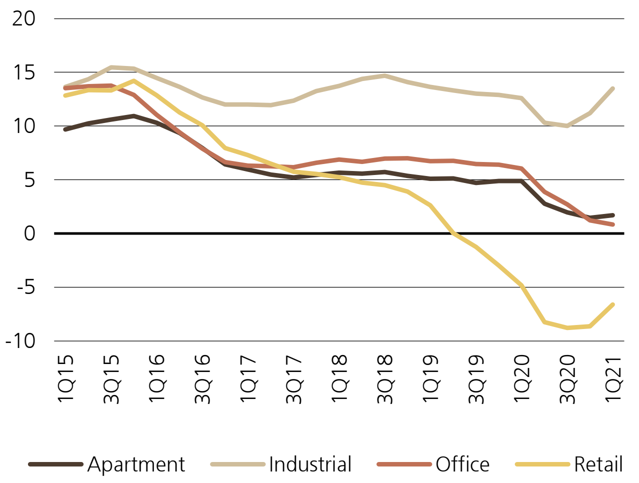
According to the CDC, nearly half of the US adult population was fully vaccinated by mid-May which, combined with spring weather, has led most states to pull back on gathering and travel restrictions.

The most recent legislation, approved in March, provided additional stimulus, extended unemployment benefits, and provided funding support for small businesses. However, direct stimulus is expected to fade by the end of summer.

Divergent sector return performance persists, as industrial returns surge (see Figure 1). Retail continued to post negative returns, albeit at a diminishing pace. Office returns slipped closer to zero. Apartment returns saw a minor increase, leading to optimism for this agile sector. At the market levels, we forecast positive total returns for industrial and apartments, but negative performance for office and retail during 2021.

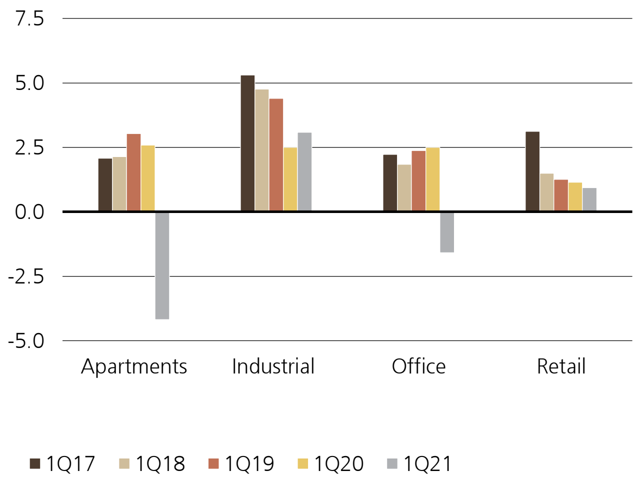
Office performance has been protected by contractual lease agreements, however, the outlook for office demand and future performance is uncertain as occupancy and rents are anticipated to decline into 2022. The short lease cycle and necessity nature of apartments keep the sector poised for recovery and rent declines appear to be ending. A fundamental evolution of the industrial sector has kept performance steady in this increasingly agile sector, consequently occupancy (see Figure 3) and rent (see Figure 2) are both on the rise.

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



Source: Data show unlevered NCREIF Property Index total returns filtered for only ODCE managers, March 2021. Past performance is not indicative of future result.

Figure 2: Property sector rent growth
(year-over-year change, in quarters ended 1Q21, %)



Source: CBRE-Econometric Advisors, 1Q21. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Apartments

Over the past year, apartments vacancy rose 50bps to 4.7% (see Figure 3), according to CBRE-EA. A comparatively modest rise, to a rate in line with the 10-year average. Average asking rents are down 4.2% YoY (see Figure 2); in 2020, landlords sacrificed rent to fill vacancies. However, 1Q21 marked the first increase in the average US rent in a year. The apartment sector's agility comes from short leases with ability to monetize changes in the economy quickly, coupled with low capex burdens, which position the sector for a recovery in 2021.

Poised for summer

Apartment returns continued to hold steady into 1Q21. Buildings actively leasing-up 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. With pandemic restrictions easing in time for the summer holiday season, increasing employment should lead to an uptick in leasing, although competitive concessions are likely to remain. Rental rates hint the beginning of growth.

Industrial

Industrial remains the strongest sector, with rising returns driven by robust fundamentals. With a 1Q21 growth rate in completions of 1.9% YoY, industrial supply remains above average. However, demand has accelerated and 1Q21 availability, at 7.0%, is 30bps below one year ago. Sector rent growth is in line with the 10-year average at 3.1% YoY, as tracked by CBRE-EA.

The more the merrier

Continued e-commerce growth kept sector fundamentals growing, readily supporting increased investor demand and rising income returns. Industrial's low capex requirements supports flexibility. Higher-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 sustainability, technology, in-fill, cold and self-storage.

Office

Office completions have remained in line with the historical average, with over 40 million sqft delivered in the year ending 1Q21. In the same period, net absorption was negative 100 million sqft, causing vacancy to surge to 16.0%. According to CBRE-EA, this supply imbalance is expected to continue through this year; office vacancy could approach 20% by mid-2022. First quarter rents were down by 1.6% YoY, under pressure from lingering effects of the pandemic, and could continue to decline through year-end 2022.

Long road ahead

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 density remain more attractive. As for downtown office, urbanization should return, albeit at a diminished pace as the pandemic eases.

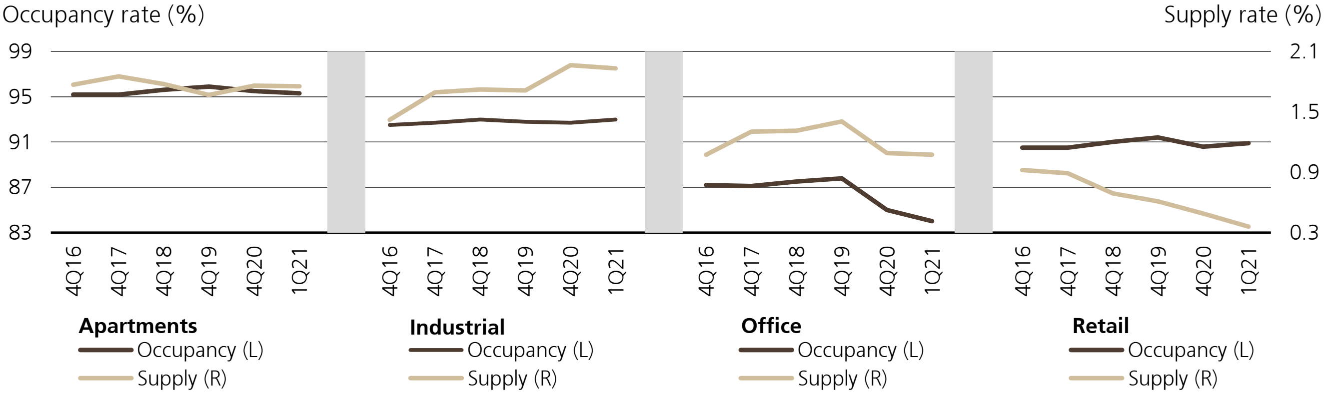
Retail

Neighborhood, community & strip (NCS) retail availability is up 50bps YoY, to 9.1%. The pace of supply has been declining for a decade and inventory grew by just 0.3% YoY. NCS asking rent growth, of 0.9% YoY in 1Q21 (as tracked by CBRE-EA), remains positive. However, a lack of new, comparable leases and offsetting effects of past rent deferrals cast doubt on the observable rental rate data.

Thriving or just surviving?

As recovery begins to take hold, retailers 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. Long-term retail industry transformation will likely come from 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 to reimagine existing sites.

Figure 3: Occupancy and supply trends



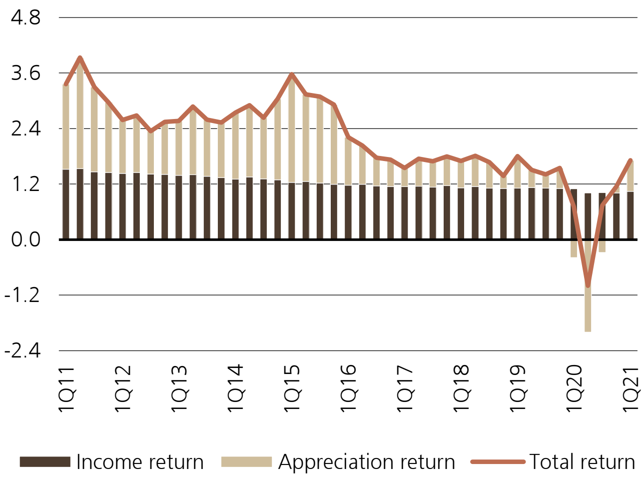
Source: CBRE Econometric Advisors, 1Q21. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community & Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Capital markets

Measured momentum.

Property-level returns improved during each of the last three quarters, with 1Q21 total return approaching recent averages (see Figure 4). Once again the industrial sector carried the bulk of the quarter's improvement, with retail slowly becoming less of an anchor. Although down slightly from a year ago, income returns remain steady.

Figure 4: US property returns (QoQ, %)



Source: NCREIF Property Index, 1Q21. Past performance is not indicative of future result.

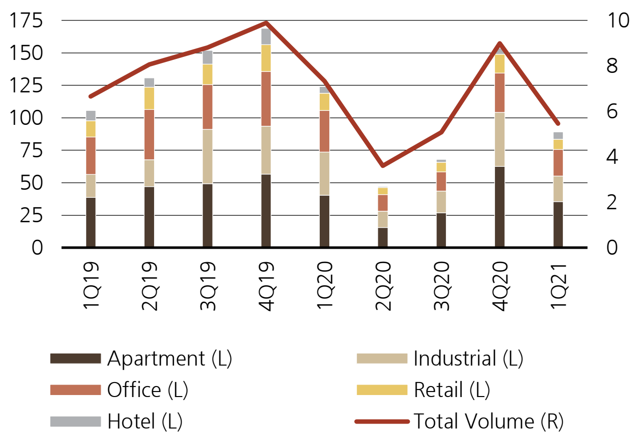
Interest rates are expected to remain low for years. Stimulative measures from the US Federal Reserve moved short-term interest rates to zero in March 2020. On the long-end of the curve, the US 10-year Treasury rate, reported by Moody's Analytics, remains below 2.0%. However, the specter of higher inflation has pushed rates up, which pushed real estate spreads down toward the long-term average (see Figure 6).

While all downturns bring uncertainty to capital markets, the 2020 pandemic-led downturn brought several challenges unique to real assets: travel restrictions, site closures and backlogs in municipal permitting processes. These challenges continue to hinder 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 above long-term averages (see Figure 6). Debt markets are growing more competitive, with lenders favoring high-quality credit, long-term leases, multifamily, industrial and niche-sector properties.

Figure 5: US transactions

(USD, billion) Count of properties (thousands)

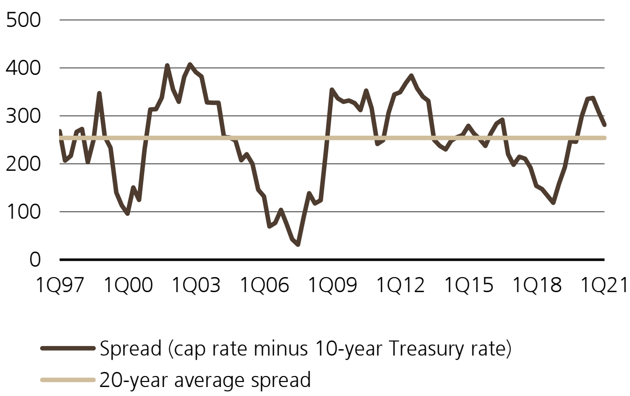


Source: Real Capital Analytics, 1Q21. Includes entity-level transactions.

Fourth quarter 2020 showed a fairly normal surge in transactions (see Figure 5). Early 2021 volume exhibited seasonality but remains well above mid-2020 volume. Apartments and industrial continue to lead the way. Increased transaction volume should give investors more clarity and confidence in values as 2021 progresses. Although transaction volume during the first half of 2021 is trending softer than 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. We expect sales and leasing comps will increase throughout 2021, bringing a new wave price discovery to private real estate.

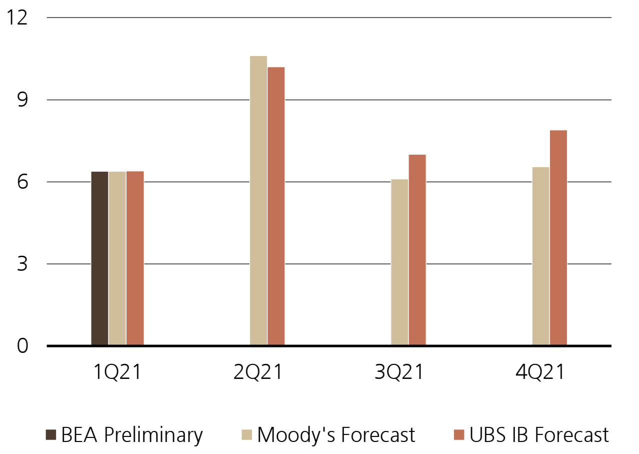
Figure 6: Commercial real estate spread (basis points)



Source: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 1Q21

Despite a year-to-date increase of about 65bps in the 10-year US Treasury rate, interest rates are low and support increasing transactions. Spreads available in private real estate remain near long-term averages (see Figure 6). Borrowers have options as lenders become more competitive, especially for high-quality properties.

Figure 7: US GDP quarterly annualized forecast (%)



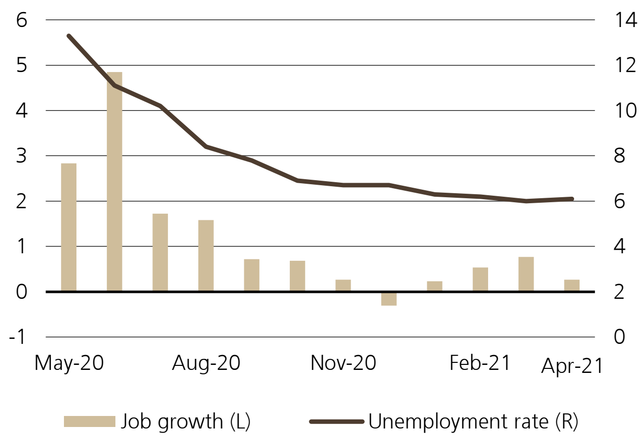
Source: Moody's Analytics forecast, as of 10 May 2021; UBS Investment Bank forecast, as of 7 May 2021

Total 1Q21 GDP has exceeded the 2Q19 level. If the rate of growth remains strong (see Figure 7), US GDP could exceed pre-pandemic levels by this summer. Moody's Analytics expects GDP to reach the 4Q19 level before the end of 2021.

Monthly unemployment has temporarily plateaued near 6% (see Figure 8). Higher virus exposure associated with customer service jobs is keeping candidates away. Additionally, restaurant employees that rely on tips may prefer the steady income from weekly unemployment bonuses, rather than return to an industry restricted to 50% capacity.

Some states are opting out of the federally funded USD 300 weekly unemployment bonus to encourage service employees to return to work. Although most employment sectors are experiencing modest growth, full employment recovery is not anticipated in 2021.

Figure 8: US job growth and unemployment rate
(change in employment, thousands of jobs)



Source: Moody's Analytics, as of March 2021

Strategy viewpoint

Drawing focus.

Progress toward full recovery will remain measured. Current uncertainty is centered on the strength and speed of recovery. Previously shuttered or restricted businesses are reopening and seeking employees. However, many businesses are slow to fill open positions – particularly service jobs. Positive news on vaccine distribution, reopening of schools, and fiscal stimulus should continue to support a meaningful rebound in economic growth and a turnaround in aggregate real estate performance.

Investor confidence remains higher in the industrial and apartments sectors, given the persistent, necessity-driven tenant demand. Confidence is growing in the leisure and travel sector, supporting optimism for hotels. For retail and office investors, 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.

Our research team
Darnesha COLLIER
Matthew DECKER
Kurt EDWARDS
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
Courtney LEE
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

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