The Effect of COVID-19 on CRE Property Sectors

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Executive Summary

With millions of Americans subject to stay at home orders and various other social distancing measures, widespread business closures, and restrictions on social interactions, the economic damage from COVID-19 is expected to be significant. While uncertainty remains, it is generally expected that the U.S. economy will face challenges in the near term.

With millions of Americans filing for unemployment over the past several weeks, many economists believe that the United States economy has already fallen into a recession from the shock of the coronavirus pandemic. JPMorgan updated its estimates on April 9th. JPMorgan expects GDP to decline by 40% in Q2 2020, and they are projecting April's unemployment rate will reach 20%. [(1)] Additionally, Morgan Stanley lowered its Q2 2020 GDP forecast to –38% from –30%. On an annual average basis, Morgan Stanley expects real GDP to contract 5.5% in 2020, which is the largest annual drop in growth since 1946.[(2)]

In March, President Donald Trump signed the CARES Act, the largest expansionary fiscal stimulus package ever enacted by the United States Government. The $2.1 trillion package aims to inject liquidity and provide aid to industries affected by the coronavirus. The act addresses both small and large businesses, as well as individuals and government agencies. Between the CARES Act and stimulus measures enacted by the Federal Reserve, the U.S. Government has the potential to provide $6 billion in funding, which equals nearly 30% of 2019 U.S. GDP. The stimulus measures are intended to potentially mitigate some of the negative economic impact of the coronavirus.[(3)]

Over the short term, various asset classes and industries are expected to feel the economic effects of COVID-19 as consumers stay home and businesses halt operations. More specifically, several property sectors across the commercial real estate industry may face short-term disruptions. The severity and duration of these disruptions will likely vary given each property sector's underlying fundamentals. The actual impacts by property type will not be known in detail until the second or third quarter of 2020 because the commercial real estate industry typically reports data quarterly. This article offers our thoughts on the immediate impact and possible long-term ramifications of the coronavirus pandemic on certain commercial real estate sectors.

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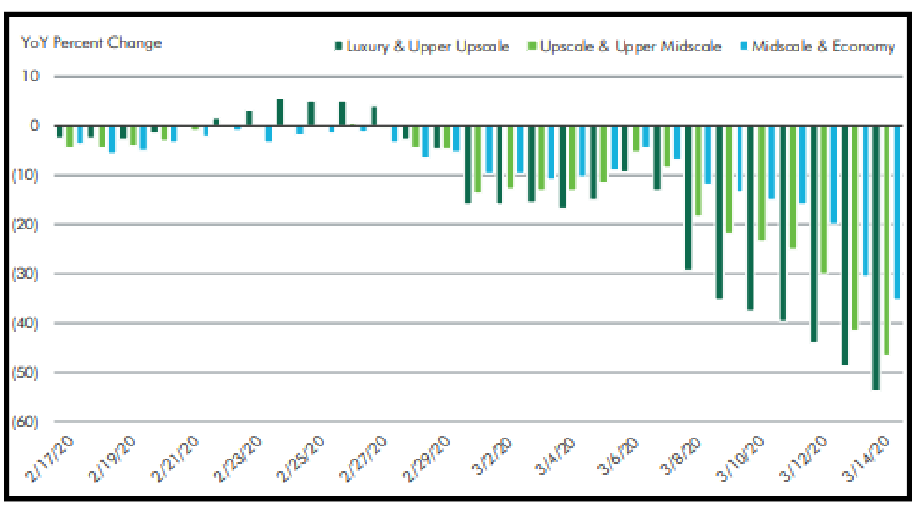
Impact by Asset Type

Hospitality

With travel restrictions and social distancing measures in place across the globe, the hospitality industry is expected to experience the most immediate and severe downtown as consumers avoid air travel, cruises and hotels. According to a report issued by Newmark, U.S. hotels experienced a 24.4% decline in occupancy rate, a 10.7% decline in the average daily rate, and a 32.5% decline in revenue per available room for the week of March 8 to March 14.[4] CBRE expects hotel occupancy to fall nearly 30% by the end of 2020.[5] Hotel landlords and operators will likely expect occupancy rates to continue to drop for the first half of the year as the duration of the pandemic remains uncertain.

The severity and length of disruption to the hospitality industry will likely be fragmented based on differences in market drivers and asset quality. For example, markets that attract international tourists, including New York, Chicago, Las Vegas, and Miami will likely experience the most severe impact as we believe international travelers will likely avoid such trips for the foreseeable future. In addition to a hotel's geographic location, its level of service may also impact its performance over the next several months. According to a report issued by CBRE, hotels with higher average daily rates (ADR) have seen more substantial levels of decline of ADR on a year -over-year basis.[6] Hotels with higher ADRs typically offer higher levels of guest amenities and may see a high number of international travelers. As shown in the diagram below, hotels that offer luxury and upscale rooms have seen much higher declines in ADR compared to hotels with limited and select service offerings.

While many hotels may close permanently, we believe those that survive the current market downturn should recover by 2022. CBRE examined past shocks to hotel demand such as 9/11, the Great Financial Crisis, the Tech Bubble, and SARS, and found that in each case, hotel demand recovered within 14 months.[7] Despite the current contraction in hotel demand, the hotel sector should begin to recover once social distancing measures are lifted.



Source: CBRE Hotels Research, STR, March 21, 2020

Impact by Asset Type

Retail

In the short term, it seems that the coronavirus has had the most significant effect on retail properties. Social distancing mandates have barred citizens from many traditional retail businesses while many state-issued stay at home orders prohibit the operation of any business deemed nonessential. These orders have resulted in the large-scale closures of retail properties. For example, Simon Property Group, the largest retail REIT, announced on March 18th that they would be closing all 209 of their U.S. malls and factory outlets due to the significant decline in foot traffic at its facilities.(8) These mall closures came after many anchor tenants such as Macy's, J.C. Penney, and Nordstrom announced that they would be temporarily postponing operations.

The retail sector was already facing strong headwinds prior to the coronavirus pandemic. For instance, vacancies for retail properties were 10.2% at year-end 2019.(9) These headwinds have been further compounded by the coronavirus pandemic. A study by Moody's predicted that retail vacancies will rise to record-highs, ending 2021 at 14.6%, while effective rents are expected to decline 4.4% in 2020 and another 2.0% in 2021.(10) This shock to brick and mortar retail comes at a time when e-commerce was already gaining market share of overall retail sales. 2019 saw record e-commerce spending with a rise of 14% from the previous year, which accounted for approximately 11% of total retail sales.(11) With many Americans electing to order their groceries online, economists expect that online food and beverage sales, which previously only represented 3.2% of total grocery sales, will see a spike in demand during the pandemic.(12) As the coronavirus forces people to stay home, we believe that e-commerce will likely gain an even greater share of retail sales this year. The growth in e-commerce sales will further change how Americans shop, which may put traditional retail at an even greater disadvantage going forward.

Office

We believe that the office sector is likely to see a mild to medium impact as a result of the coronavirus outbreak in the short-term. Currently, office facilities feature a national vacancy rate of 5.4% with annual rent growth of 4.8%.(13) In the short-term, we believe that vacancy rates may see an uptick as some tenants may be unable to weather the economic downturn and file for bankruptcy.

Despite our expectation for a possible mild softening in fundamentals for the office sector through the end of 2020, we believe that the asset class will likely bounce back over a mid-term horizon due to sound long-term demand drivers. Furthermore, while some tenants may increase their work from home offerings to employees as a result of the current environment, we believe corporations will continue to invest in and occupy modern office facilities that incorporate open floorplans and collaborative environments in order to attract and retain top millennial talent.

Impact by Asset Type

Industrial

Industrial real estate can be broken into the following three primary sub-categories: distribution & logistics space, manufacturing facilities, and warehouses. We believe that each of these sectors may see a temporary decline in transaction volume as well as a moderation in rental growth in the near term because of the impact of the coronavirus pandemic. However, in the long-term, we believe industrial real estate is expected to be a net beneficiary of the current pandemic.

We believe that e-commerce will continue to drive demand for industrial properties. E-commerce has served as a primary demand driver for distribution and logistics space as consumers' preferences for online shopping has increased. As mandated quarantines remain in place and retail stores pause operations, consumers' primary option for basic needs is found online. Thus, consumers' reliance on e-commerce will likely be accelerated. According to Rakuten Intelligence, which tracks electronic receipts as shoppers stay away from stores, U.S. e-commerce sales rose 24% from March 1-17 compared to the same period a year ago.(14) Now that consumers are more accustomed to buying items online, they likely will continue to do so after the pandemic ends, which may continue to drive growth in e-commerce sales. This expected growth should also drive demand growth for distribution and logistics space.

With respect to manufacturing and warehouse facilities, the outbreak of the virus is likely to elevate the issue of supply chain risk mitigation and enhance inventory levels among users. Furthermore, a high level of reshoring will likely take place in the U.S. as companies may move operations to domestic locations to maintain greater control and oversight of their supply chains. As a result, we expect an increase in demand for manufacturing facilities in the U.S. (15)

In addition to adjusting their manufacturing operations, companies may also look to adjust their inventory strategies. Currently, just-in-time (JIT) inventory management is a popular modern supply chain strategy utilized to cut costs by reducing the number of goods and materials a firm holds in stock. Due to COVID-19, modern supply chains that use this method have seen inventory shortages as demand has increasingly outpaced supply. Looking forward, to avoid these inventory short-falls, firms may decide to move towards a "just-in-case" inventory system, whereby producers hold sufficient inventories to have enough product to absorb maximum market demand. This potential increase in inventory levels could increase demand for industrial warehouse facilities in the long-term.

In total, we believe that the industrial real estate sector will likely see a temporary decline in transaction volume as well as a moderation in rental growth as a result of the current environment. However, we believe that the asset class is expected to continue to perform well from both a short and long-term perspective due to its strong underlying supply and demand fundamentals.

Multi-Family

Multi-family assets are residential properties leased to multiple tenants. While we believe the property sector will likely face significant challenges in the near term, federal aid may help soften the near term impact and help position the sector to eventually return to more stable levels over a mid-term horizon. The performance of multi-family assets is generally tied to the health of the U.S. job market. The coronavirus pandemic has caused one of the most significant impacts to the U.S. job market in modern U.S. history. According to the U.S. Labor Department, the number of unemployment claims increased to a total of ~17 million as of April 4.[16] Following the announcement from the Labor Department, the National Multifamily Housing Council released its weekly rent payment tracker, which showed a third of U.S. apartment renters did not pay any of their April rent during the first week of the month.[17] The data found 69% of apartment households had paid their rent by April 5, compared with 81% in the first week of March. As a result of the tenant base, owners of low to moderate-income multifamily properties will likely see this trend continue in the coming months. In response to the impact of the coronavirus pandemic on the residential real estate market, the National Apartment Association (NAA) and the National Multifamily Housing Council (NMHC) formally requested that Congress provides a variety of measures intended to provide relief to renters.

Conclusion

While we believe that COVID-19 is likely to soften commercial real estate fundamentals in the near-term, some asset classes are likely better positioned than others. The retail, hospitality, and multifamily sectors are believed to be experiencing the most severe impact from the current social distancing measures implemented by states and cities. While we believe all three asset classes will recover over the long term, the retail sector may see a slower return to pre-2020 levels due to consumer behavior shifting toward e-commerce.

We believe that the office sector may see a decline in occupancy due to tenants downsizing as a result of layoffs or bankruptcies. However, we believe that due to the lack of new supply and the secular shift of companies using modern office space to attract and retain top millennial talent, the asset class should not experience long-term headwinds once the economy stabilizes.

We believe the industrial sector is most favorably positioned to weather the current market downturn. Logistics space will likely see a spike in demand as companies seek to diversify their supply chains and respond to the growing trend away from brick and mortar retail. Additionally, manufacturing tenants with existing space overseas are likely to explore the opportunity of building plants in the U.S. in response to the current volatility abroad.

Sources

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