Real Estate Outlook

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Uncertainty remains high.

UBS Asset Management

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The downturn was deep in 2Q20, but investors and teams are adapting.

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 – Divergence intensified

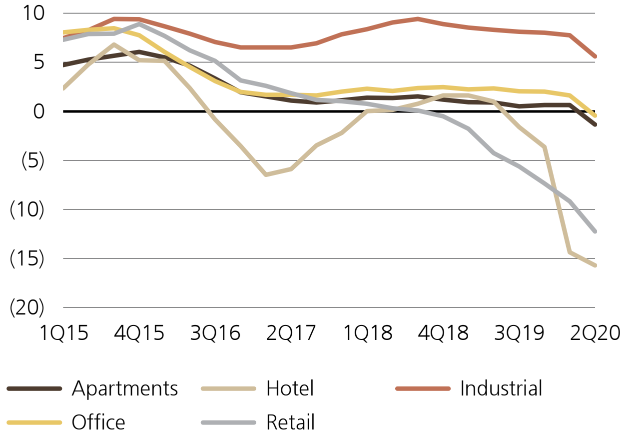
The US is showing the first signs of recovery from a historic downturn. Yet, the NCREIF-ODCE Fund Index has shown only moderate depreciation in private commercial real estate values. Property values are slow to move; softening some of the uncertainty even up-to-date rent collection data cannot dispel. Steady economic growth could be delayed as many US metros have halted or stepped back their phased reopening programs.

No property type is immune to uncertainty and financial impact. The most immediate impact is to the hotel and retail sectors and development sectors, where sites are cautiously resuming work. 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 over short-term losses for long-term recovery 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. Retail and hotel returns sharpened their declines as travel and in-person interactions remain restricted (see Figure 1). June saw apartment and office appreciation returns slip into negative territory. This exaggerated the relatively healthy, if softening, performance of the industrial sector.

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

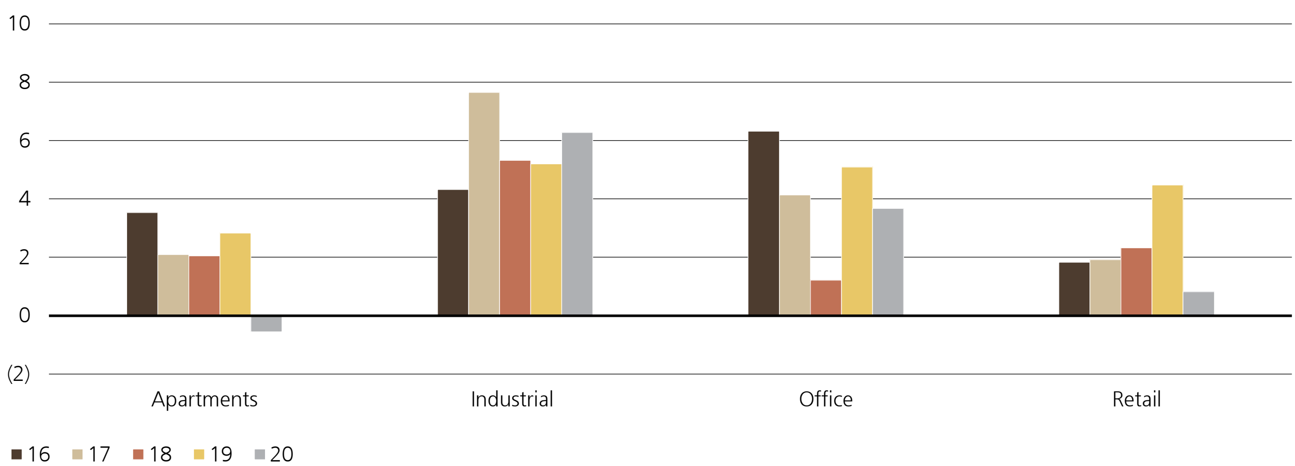


Source: Data show unlevered NCREIF Property Index returns filtered for only ODCE managers. Past performance is not indicative of future result, June 2020.

The first two months of 2020 were business as usual for much of the country. Consequently, first quarter occupancy and rent growth reports reflect what seems like typical quarterly fluctuation. Even as second quarter property sector fundamentals slowed, declines are not as severe as anticipated. Consumers and investors have remained cautious as travel restrictions and social distancing guidelines remain in place.

The US does not yet have universal control over the current health crisis; management and containment vary broadly by state and region. However, national second quarter sector fundamentals did not contract as much as initially anticipated; illustrating the resiliency of real estate investment. Consumers and investors are expected to remain cautious as lingering health and safety precautions rein in the velocity of a potential rebound.

Figure 2: Property sector rent growth (year-over-year change, in quarters ended 2Q20, %)



Source: CBRE-Econometric Advisors, 2Q20. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers

Apartments

The pace of completions has not slowed (see Figure 3), with more than 125,000 units delivered year-to-date. At the same time, national home ownership is up by 2.8 percentage points from 4Q19. Apartment vacancy is up 60bps from one year ago, a modest increase under the circumstances. Average asking rents are down 0.6% YoY; indicating that landlords are letting rents slip as they struggle to sign tenants.

Hard choices

The essential nature of housing keeps the apartment sector functioning. Properties with mortgages from Fannie Mae, Freddie Mac and Funding Affordable Homes (FAH) were temporarily prevented from evicting residents unable to pay rent. Additionally, many states had temporary protections in place. As these moratoriums are expiring without clear replacement, landlords must weigh the risks of retaining impacted tenants (however temporary) against months of increased vacancy.

Industrial

2Q20 industrial availability rose to 7.6% – 50bps higher than one year ago – as demand has not kept pace with steady supply increases. Sector rent growth remains healthy (see Figure 2). Asking rent has continued to increase, growing by about 5% YoY.

Shining bright

Industrial has seen the most relative stability compared to the other commercial sectors. With many brick and mortar stores shuttered, fulfilling online orders and restocking grocers keeps the warehouse and transportation industry moving. Industrial properties represent a third of real estate transactions year to date and is the only sector to see rising price per square foot.

Office

Total office vacancy rose to 13.0% in the second quarter as seven million sqft of new supply delivered into a market with rising availability. Downtown and suburban office rents were up modestly from the previous quarter and one-year ago. Downtown vacancy has risen to 11.4%, 100bps above one-year ago; while suburban vacancy, at 13.8%, is 60bps above last year.

Rebalancing

Occupancy in the office sector benefits from multi-year leases, even if social distancing has turned off the lights. Looking ahead, tenants are weighing the option of either reducing space as they move to a remote work platform or increasing their required square footage to create a more socially-distant workplace. For the most part, capital improvement projects are on hold until these decisions are sorted.

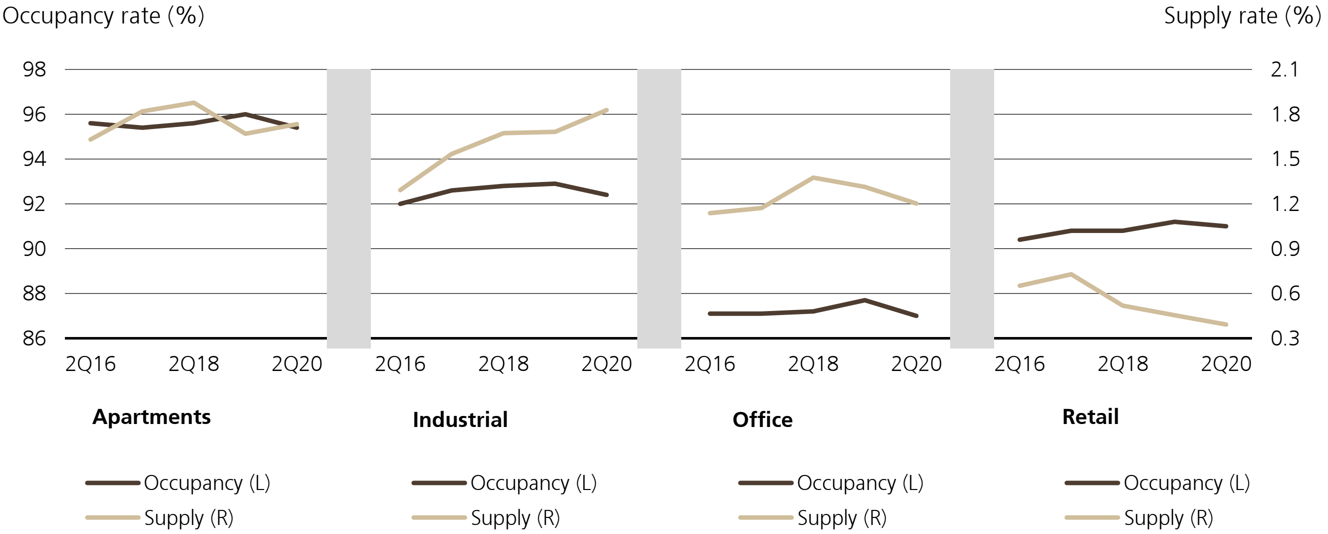
Retail

Neighborhood, Community & Strip center retail completions are well below the recent average. 2Q20 saw available space increase by ten million sqft, bringing the availability rate up to 9%. The data shows a slight YoY asking rent increase. However, asking rent data is based on space listed with brokers, and because only high-quality space is listed as available the rent data will begin to skew higher.

Agility required

Restrictions have remained in place much longer than initially expected, and much of the legislation enacted to sustain small businesses has dried up, with no clear replacement in sight. Today's consumer supply and demand innovations could reshape the face of retail for years to come. Motivated businesses able to shift towards online ordering with home or curbside delivery are more likely to succeed. Agile retailers with low levels of debt are best positioned.

Figure 3: Occupancy and supply trends



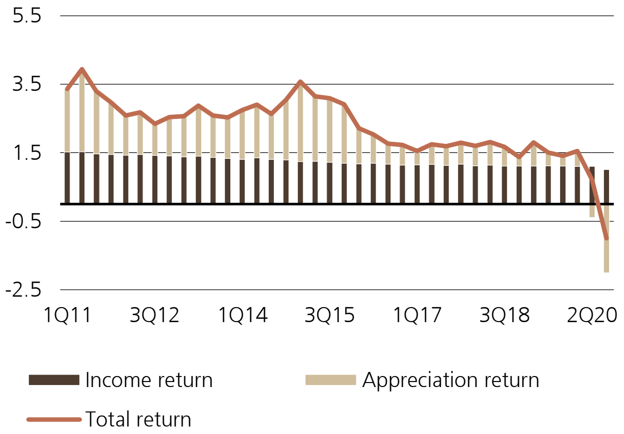
Source: CBRE Econometric Advisors, 2Q20. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community & Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Capital markets – Unique challenges ahead

During 2Q20, the NCREIF Property Index posted a negative total return for the first time in 10 years (see Figure 4). The apartment and office sectors saw depreciation for the first time in a decade; while retail and hotels each saw accelerating depreciation. The industrial sector remains stable, with appreciation slowing only moderately over the quarter.

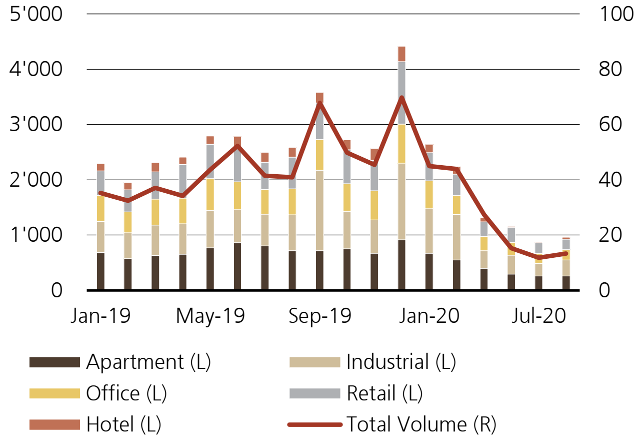
Transaction volume is static, making it more difficult for investors and appraisers to find comparable sales data. Figure 5 shows the sharp decline, while it is possible that the decline in trades has hit bottom as of May, it too early to call it definitive. The slight uptick in transaction volumes during June may reflect a burst of quarter end activity; many of these may have been sales under contract prior to the shutdown. A lack of interstate travel continues to hinder on-site due diligence and inspection.

Figure 4: US property returns
(QoQ, %)



Source: NCREIF Property Index, 2Q20

Figure 5: US transactions
Count of properties
Billion USD



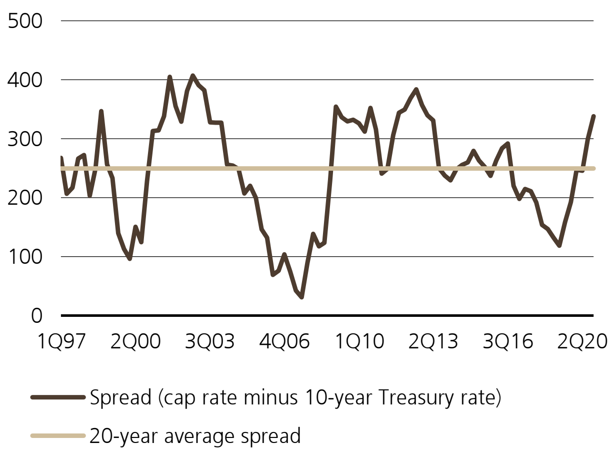
Source: Real Capital Analytics, 2Q20. Includes entity-level transactions.

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 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, as economies begin to reopen, debt and equity investors should be able to institute 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.

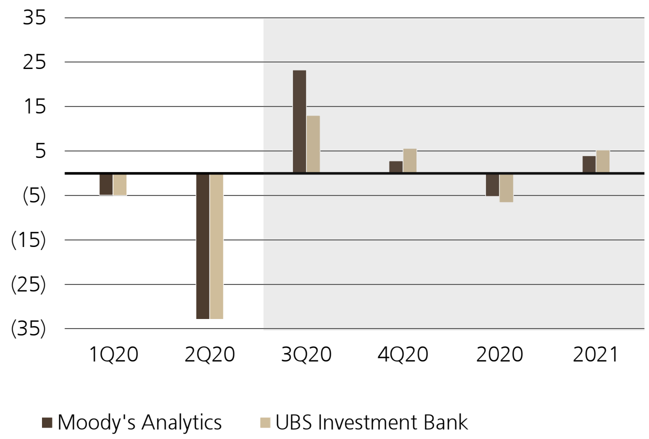
Figure 6: Commercial real estate spread (basis points)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 2Q20

Preliminary second quarter GDP showed an annualized 32.9% decline (see Figure 7). Optimism for modest, positive, economic growth during the third and fourth quarters leads to a GDP forecast of about negative 5-6% for calendar year 2020. Recovery will be slow given virus flair-ups and high debt levels.

Figure 7: US real GDP growth (%)



Source: Moody's Analytics, 2Q20. Shaded area is forecast data.

Unprecedented stimulus flowed through the federal government and Federal Reserve to businesses, consumers, states and municipalities during the second quarter. 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.

The unemployment rate shot up to 14.7% in April and almost immediately began to decline as government loans were approved. The US unemployment rate was 11.1% for the month of June (see Figure 8). Millions of Americans are out of work, continuing to depress demand for goods and services. Regional differences should play an important role in determining the trajectory for downturns and recoveries.

Strategy viewpoint – Agility is crucial

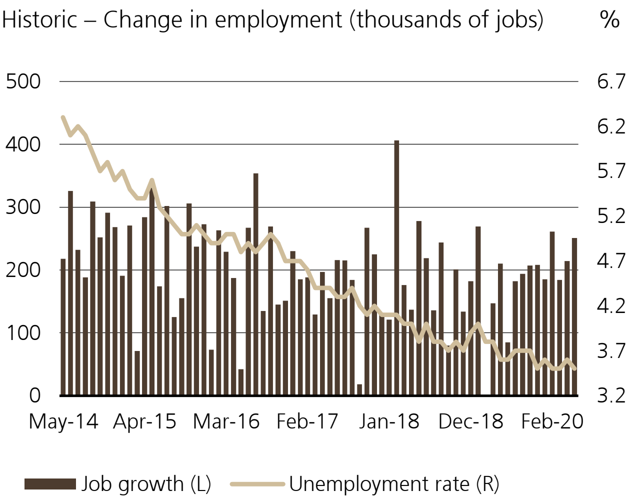
Reduced demand for goods and services is inevitable as millions of Americans remain out of work and the future of extended unemployment benefits is unclear. The momentum of future job growth will depend on finding a medical solution that limits a systemic resurgence of the virus and supports confidence in the potential for growth. State and metro variations in public health procedures may have widened the gaps around near-term economic potential.

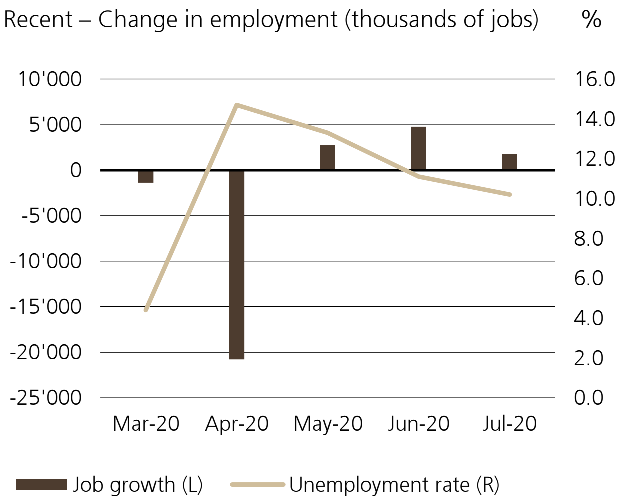
There is a lot of uncertainty around two key inputs to private real estate pricing: future cash flows and current transaction metrics. As data becomes available, there is every reason to expect investors will adjust their underwriting.

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 deferred development deals, across all sectors, will deliver back-to-back – which is painful – or trickle into being – which offers opportunities that will vary across markets.

The downturn cut deep in the second quarter, but investors and teams are adapting. We expect more adaptations and some clarity to emerge in the third quarter.

Figure 8: US job growth and unemployment rate





Source: Moody's Analytics, July 2020

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