

Economics Group

Special Commentary

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Commercial Real Estate Chartbook

CRE Fundamentals Will Not Be Immune to the Spread of the Coronavirus

Hopes that the U.S. economy would be spared from the spread of COVID-19 proved to be too optimistic. Initially, the coronavirus was thought to be a threat to China and greater Asia, and the most likely U.S. impact would be from factory closures and slower economic growth abroad, which would ripple through supply chains of U.S.-based businesses and disrupt domestic production. That is still true, but the virus has directly impacted the United States as individuals returned from infected areas in China and Europe and it spread domestically. Efforts to contain the virus have disrupted everyday life for many, especially in global gateway markets such as Seattle, San Francisco and New York City. Containment efforts have led to travel restrictions, event cancellations, quarantines, social distancing at work, stay-at-home orders and an aversion to public spaces, which at the very least will significantly interrupt economic growth in the near term.

COVID-19 is a major challenge to CRE.

We now expect real GDP to contract sharply in Q2 and Q3, before rebounding modestly in Q4 once the outbreak subsides. Financial markets have reacted swiftly, with equities falling more than 20% and Treasury yields hitting record lows. Credit spreads, including commercial mortgage-backed security (CMBS) spreads, widened significantly, potentially undermining lending. The Fed reached deep into its arsenal, lowering the fed funds rate to effectively zero and committing to a massive new quantitative easing program, including open-ended purchases of Treasury and agency mortgage-backed securities, to support the flow of credit.

Such a rapid response from the Fed highlights the growing threat COVID-19 presents to the economy. Commercial real estate fundamentals are likewise not without risk. Normally, lower interest rates tend to reduce commercial mortgage rates and boost demand for income-producing properties. Today, however, uncertainty regarding future tenant cash flows and creditworthiness has brought the CMBS market to a standstill, with hotel and retail properties facing the most immediate challenges. Travel has nearly ground to a halt and, with the exception of groceries and pharmacies, most stores in major metro areas are closed or are operating some type of alternative format. The spike in layoffs also presents challenges to apartment owners.

Figure 1

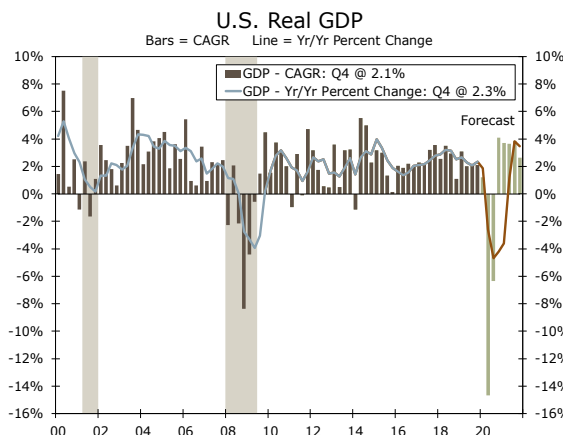
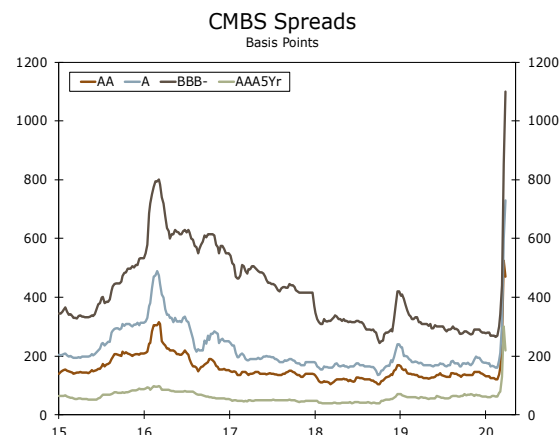


Figure 2



Source: U.S. Department of Commerce, Bloomberg LP and Wells Fargo Securities



Hotels will likely be the most affected property type.

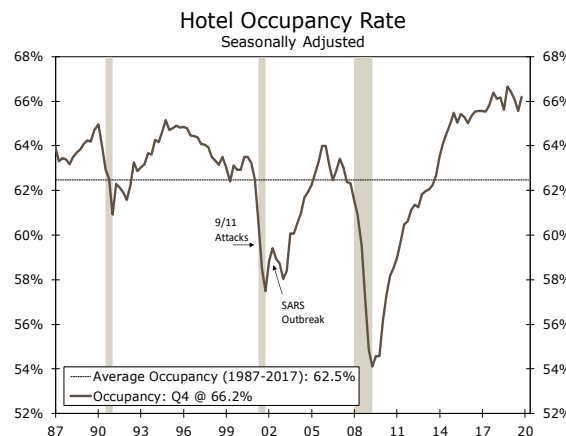
Coronavirus Will Directly Hit Hotel and Retail Fundamentals

The hotel industry is likely to be most directly impacted by COVID-19. In addition to growing fear of travel in general, most major metro areas have implemented either “stay-at-home” or “shelter-in-place” orders and instructed all non-essential businesses to temporarily close. Businesses have likewise implemented their own travel moratoriums, canceled conferences and trade shows and allowed employees to work remotely. International travel has similarly ground to a halt.

With a steep drop-off in travel of all forms, hotel occupancy and RevPar will decline sharply in coming months. Reports suggest occupancy rates have already fallen into the single digits in many large markets, which is prompting some major hotel operators to temporarily close their doors and layoff or furlough employees. Looking ahead, the extent to which occupancy and RevPar will drop nationwide is difficult to predict. During the height of the SARS epidemic in the first half of 2003, the U.S. hotel industry saw a temporary dip in occupancy, average daily rates and RevPar before rebounding in the second half of the year after the WHO lifted travel restrictions (Figure 3). The H1N1 virus likely stifled a stronger rebound in occupancy rates in 2009 when the hotel industry and economy were just beginning to climb out of the recession, although the exact impact is uncertain.

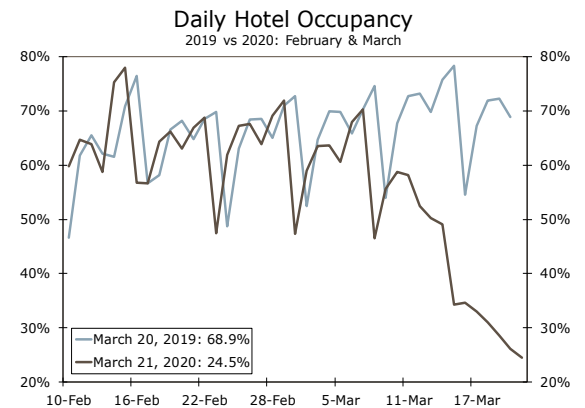
Unfortunately, the SARS and H1N1 outbreaks pale in comparison to COVID-19 in terms of economic impact. The scenario facing the hotel industry is more on par with the fallout from the September 11 terrorist attacks but looks to be even larger and longer lasting. In Q4-2001, the national hotel occupancy rate fell 5.75 percentage points, while RevPar declined 16% on a year-over-year basis. While the situation is still very fluid, the national occupancy rate has already fallen to 24.5%, roughly 44 percentage points below prior year levels (Figure 4).

Figure 3



Source: STR and Wells Fargo Securities

Figure 4



International travel will take even longer to recover.

One of the most confounding facets of the COVID-19 pandemic is that it does not have an expiration date—no one knows how long economies around the world will remain shut down. How much hotel fundamentals deteriorate depends on the success of containment efforts in the short term, both domestically and worldwide. In an optimistic scenario, non-essential businesses in some large markets begin to re-open sometime in May as the spread of the virus slows and testing becomes commonplace. Once travel restrictions are lifted, domestic travel will likely bounce back slowly, at least initially, as businesses will only gradually ease travel restrictions and individuals will need to be convinced that traveling is safe. We expect only a handful of canceled trade shows to be rescheduled this year. International travel should take even longer to recover, as the progression of COVID-19 has been uneven across the globe. Travel warnings and restrictions for many countries are likely to remain in place for some time. Travelers who canceled or postponed vacations abroad may opt for domestic options, but this will do relatively little to offset the overall slide in domestic travel.

In terms of a slowdown in international travel, Las Vegas may be most directly exposed given the market's heavy reliance on tourism and roughly 5.8 million foreign visitors in 2018, about 20% of the total. There is similar risk to the large coastal gateway markets frequently visited by international travelers, however many of those major metro economies are less dependent on tourism. Still, during 2018, international visitors to San Francisco made up 28% of overnight visitation, and more importantly, 61% of all visitor spending. Similarly, international travelers comprise roughly 15% of total visitors to Los Angeles and 21% to New York City. A prolonged drop in international travel would likely have a more pronounced impact of occupancy and RevPar in these markets.

Las Vegas and gateway markets are more exposed to international travel.

Figure 5

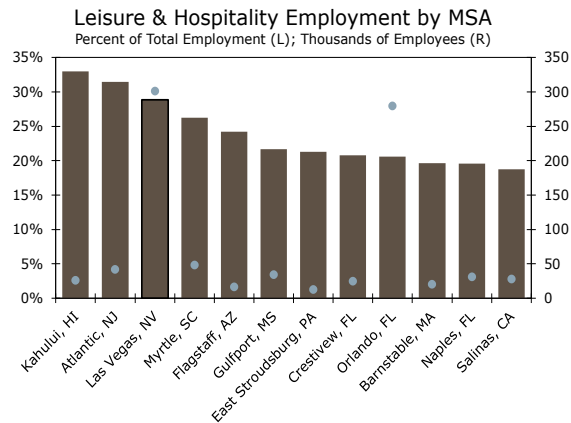
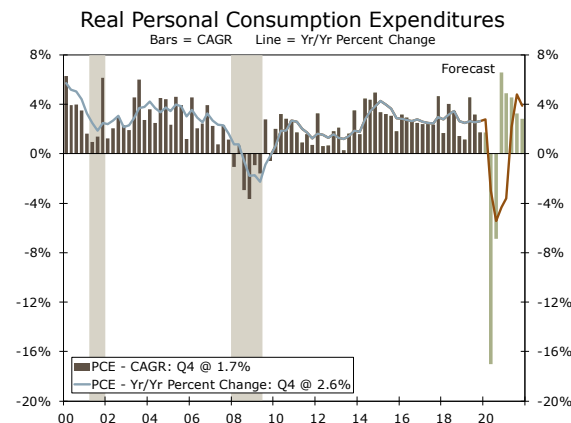


Figure 6



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities

COVID-19 is having similar negative implications for retail markets, especially those which are more dependent on travel and tourism. International travelers account for a disproportionate share of high-end retail purchases in markets which they frequent, while widespread closures of non-essential businesses have hit retail particularly hard. Successful brick-and-mortar retailing is hard to square with social distancing, and most shopping malls have closed. Moreover, shutdowns have impacted businesses that typically ride out recessions fairly well, such as restaurants, movie theaters, yoga studios, gyms and hair salons. There have been a few notable offsets. Sales have surged at grocery stores, pharmacies, major discount stores and warehouse stores, while home improvement centers also appear to be holding their own.

Avoidance of public spaces will weigh on retail properties for the next few months, especially those deriving foot traffic from nearby gyms, restaurants, breweries, movie theaters and other entertainment venues. On the other hand, retailers with ample e-commerce capabilities are better poised to utilize delivery service or handle sales via customer pick-up. Many of these are national chains, however, and smaller merchants have fewer options. Restaurants that had established drive-through windows or delivery models have been able to adapt well but establishments trying to wing it via e-mail and social media are having a tough time covering costs. Longer term, the rise in e-commerce-driven sales may actually hasten the shift to online retailing and might augment demand for warehouses and distribution facilities. Overall, the uncertainty surrounding the coronavirus will further curtail new retail development, as many projects are delayed or sidelined until the virus subsides. Last year was already the weakest year for retail net absorption since 2009.

Retail will struggle.

Coronavirus Could Dent Demand for Industrial, Rental and Office Properties

Industrial markets, especially those proximate to major coastal ports, may be adversely impacted by the slowdown in global trade that will result from the global recession triggered by COVID-19. While it is too early to determine how the coronavirus will impact international trade over the long term, port traffic is certain to see short-term drops. The recent data already show a drop in container volumes at West Coast ports but that is linked to the timing of the Lunar New Year and supply disruptions in China. Reports of a more marked slowdown are beginning to materialize now,

and some ports are expecting the slowdown to last into the spring. For example, the Port of Los Angeles, the nation's busiest port, reportedly saw a 23% dip in cargo traffic in February and has already seen a rash of cancellations for container ships through April.

We expect industrial fundamentals to weaken. The industrial market had already shown signs of cooling alongside a downshift in international trade and slower global growth—net absorption in the fourth quarter was the weakest since 2011. New industrial development remains strong relative to recent history, which should leave the market well supplied. We expect new development to decline significantly until there is more clarity about how hard COVID-19 will impact the economy and how and when the recovery will begin.

The surge in layoffs that followed widespread closures across the country will thoroughly test the apartment market. A disproportionate share of the shutdowns are impacting hourly workers, many of which are apartment renters. Areas with large leisure & hospitality sectors, such as Las Vegas and Orlando, will be significantly impacted. Employment in professional & business services is holding up somewhat better but hiring has slowed, which will cut into absorption. That may lead to some oversupply issues for markets that have a large number of units coming online, including Miami, Austin, Dallas and Nashville. Vacancy rates will increase and asking rents will decline. New multifamily construction, which remains lofty, is bound to slow. We expect multifamily starts to decline 8.2% this year to around 370,000 units, and decline 10.8% further in 2021 to 330,000 units.

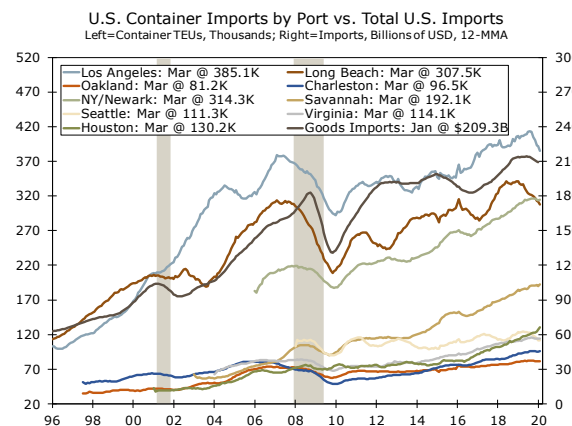
Office properties are expected to be less impacted, as financial and business & professional services employment is expected to hold up relatively well. Co-working space, however, may be a problem area, as the business model is inconsistent with social distancing. Co-working space comprises roughly 2% of overall office inventory, making the potential impact relatively small. Markets with the largest footprints include San Francisco, Manhattan and Los Angeles, and the industry has been expanding in up-and-coming markets such as Austin, Denver, Charlotte and Raleigh-Durham.

Volatile financial markets and growing uncertainty of future tenant cash flows have slowed CRE activity. Hotels and retail space appear to be most affected. A steep drop-off in travel and tourism has slashed hotel occupancy and RevPar. Social distancing and the preponderance of stay-at-home orders has severely cut into consumer spending, particularly at less cyclical outlets that had so far been immune to online competition, such as restaurants, gyms and breweries. The slowdown in global trade will also stymie demand for industrial buildings, in particular those markets linked to major coastal port areas which will see a drop in cargo tonnage. Many commercial projects not already underway will also likely be put on hold. Boston has included construction projects as part of its city-wide shutdown. Most other markets have deemed construction an essential industry and activity is continuing, albeit at a somewhat slower pace.

Industrial properties and apartments will be tested.

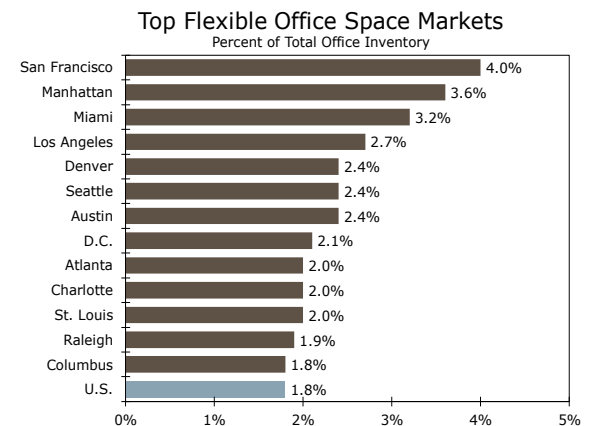
Tenant cash flows are uncertain.

Figure 7



Source: Bloomberg LP, U.S. Department of Commerce, CBRE Research and Wells Fargo Securities

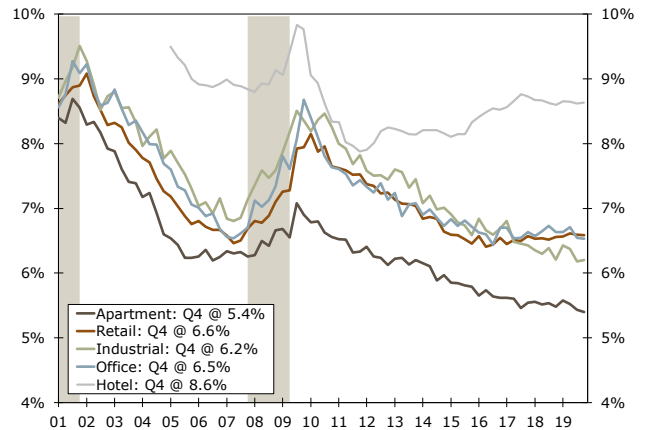
Figure 8



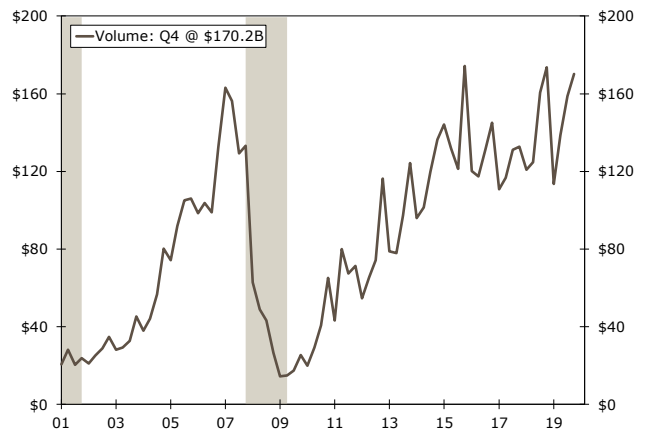
CRE Property Pricing & Fundamentals

- The latest available data show property valuations continued to climb despite weakening fundamentals. Property prices rose a solid 7.0% in January. Annual gains were led by industrial (10.7%), followed by apartments (9.7%), office (5.6%), and retail (2.4%).
- Transaction volumes finished the year down 2% compared to the lofty levels hit in 2018. Declines in retail (-28%) and hotel (-15%) deals weighed on overall activity, while apartment (4%) and office (2%) transactions posted modest improvements. That noted, industrial properties appear to not be losing any luster and were the only major segment to advance sequentially (3%) and on a year-over-year basis (14%) in Q4.

CRE Cap Rates by Property Type

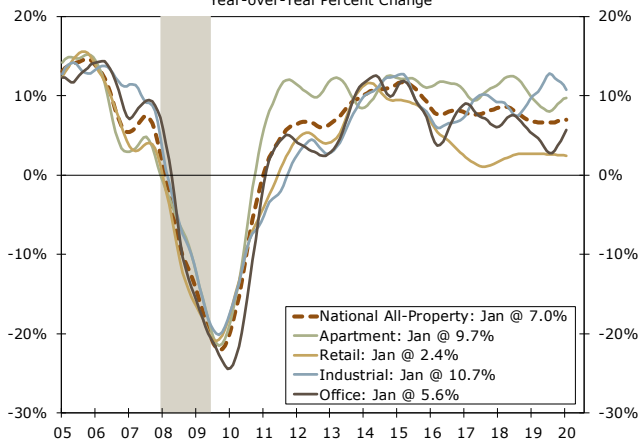


CRE Transaction Volume



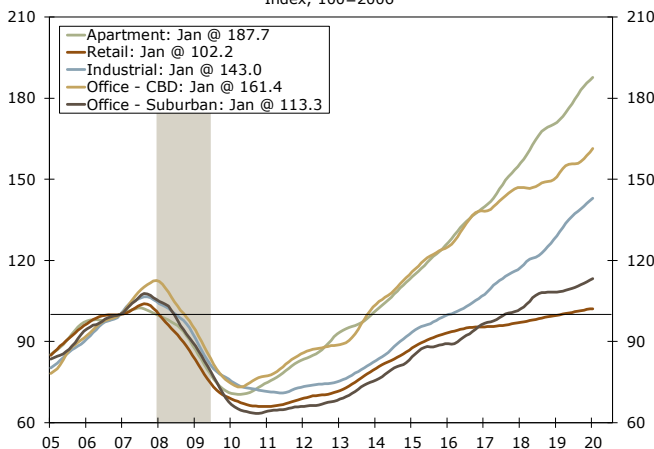
Commercial Property Price Index

Year-over-Year Percent Change



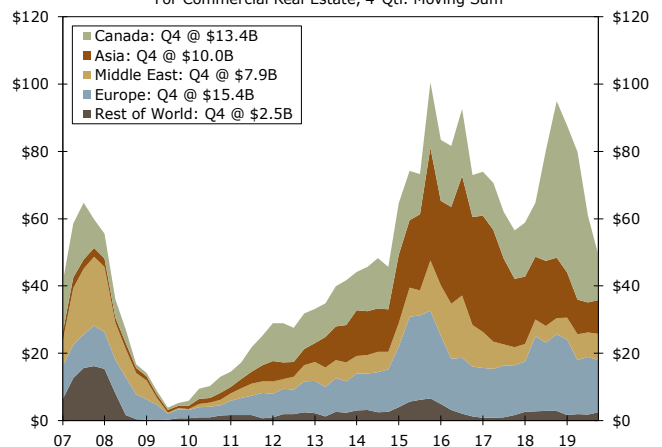
Commercial Property Price Index

Index, 100=2006



Origin of Capital Into the United States

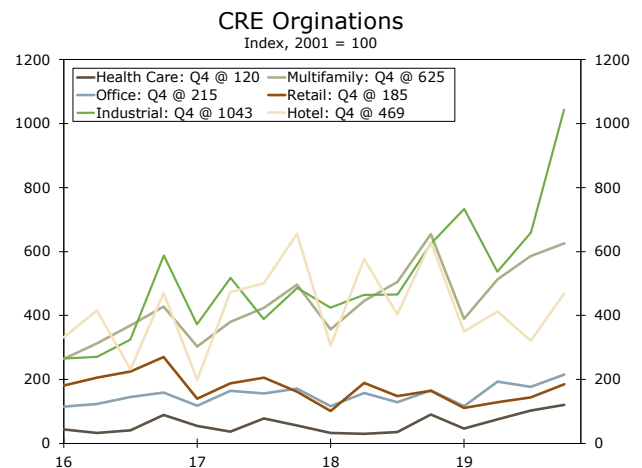
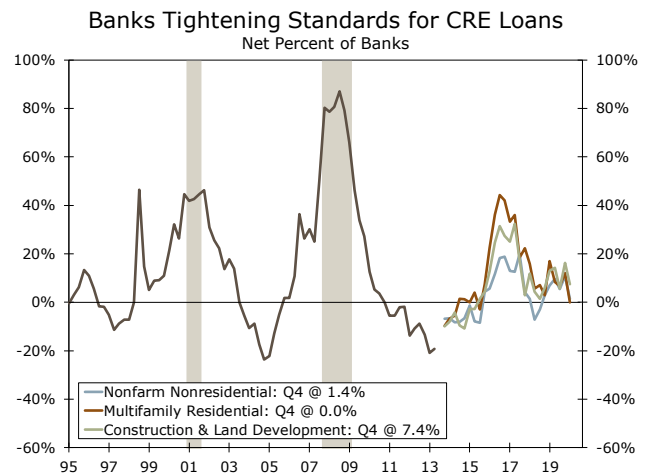
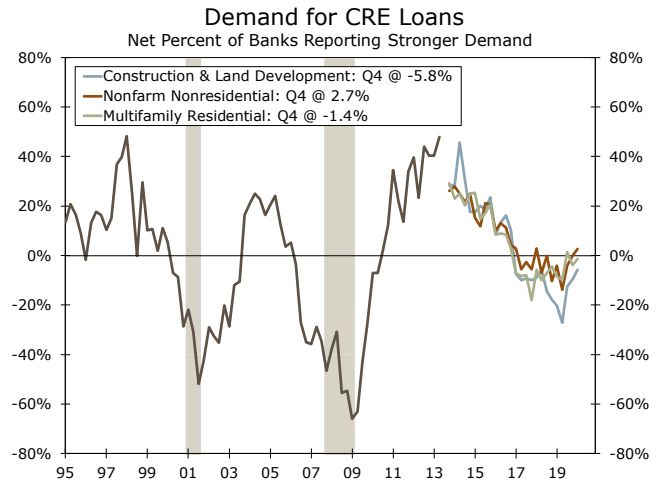
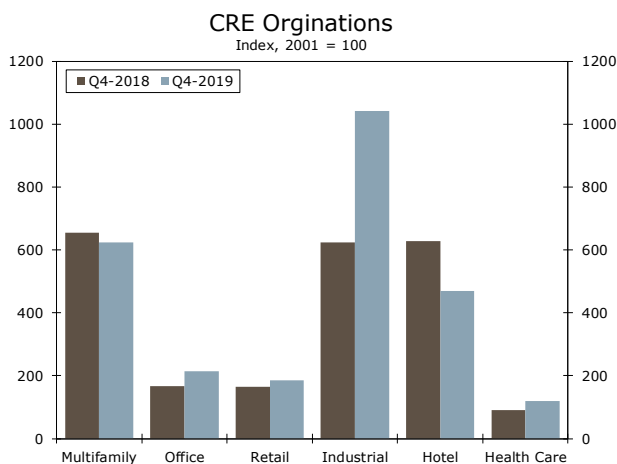
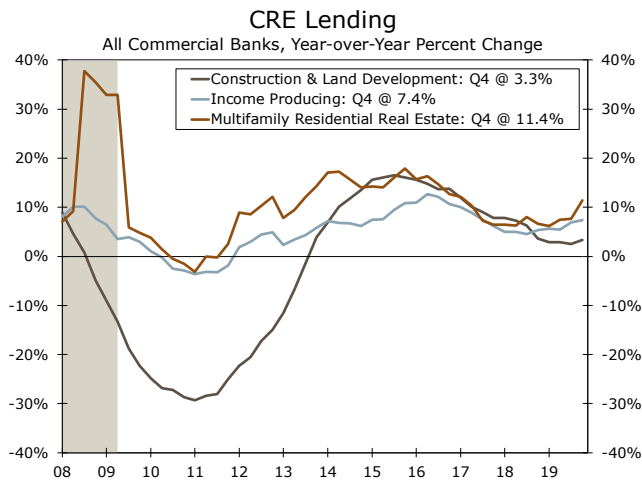
For Commercial Real Estate, 4-Qtr. Moving Sum



Source: CoStar, Inc., Real Capital Analytics and Wells Fargo Securities

Credit Availability & Lending

- The greatest systemic risk to CRE from the coronavirus is likely to be further tightening of financial conditions and widening of credit spreads, which could ultimately led to a pullback in CRE lending. Uncertainty regarding the future tenant cash flows post-COVID-19 has brought the CMBS market to a standstill.
- The Fed's most recent Senior Loan Officer Opinion Survey, which predates the coronavirus outbreak, indicates that lending standards and demand were generally unchanged in Q4. More banks reported tighter standards and modestly weaker demand for construction and development loans.

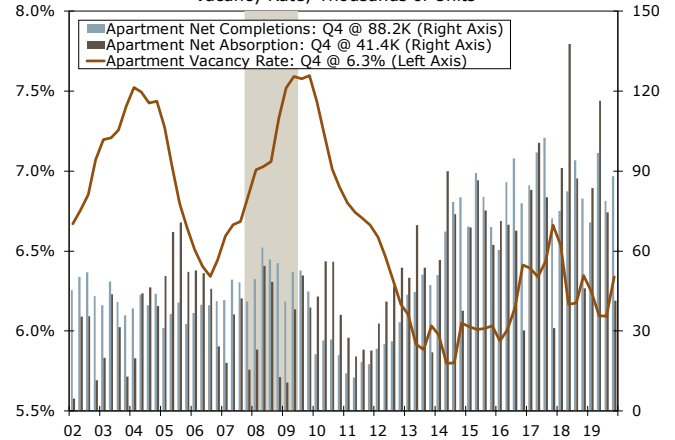


Source: FDIC, FRB, Mortgage Bankers Association and Wells Fargo Securities

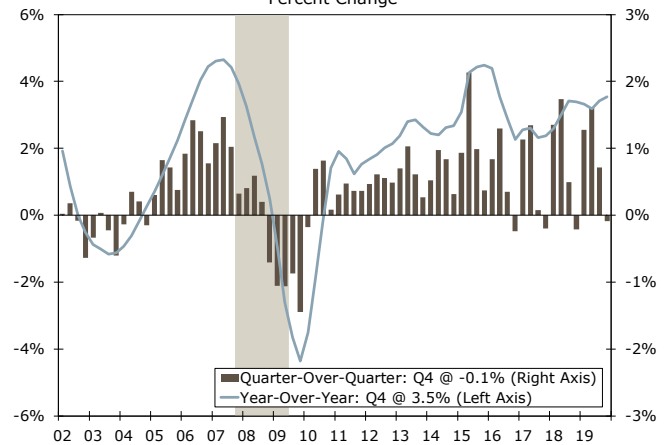
Apartment

- Following years of high-flying growth, the apartment market is headed for challenging times. Massive job losses among hourly workers are likely to lead to a jump in delinquent renters, particularly in markets like Las Vegas, Orlando, Miami and San Francisco, which have a large share of their workforce in the hospitality sector and also have high median rents.
- Delinquencies are likely to be a greater problem with older properties that tend to cater to renters of necessity, rather than higher-end properties that catered to renters by choice. The latter category accounted for the bulk of new apartment development this past decade, and a multitude of units currently under development will come to market at a time when job growth is languishing.
- Multifamily construction started off the year on a high note. After surging 90.5% in January, multifamily starts were up 47.2% year-over-year in February. What's more, the 619K-unit pace hit in January, is a level not seen since the 1980s. Unusually warm weather allowed developers to pull projects forward, and there will likely be some weather-related payback this spring. Even so, permits remain elevated, suggesting there are plenty of projects in the pipeline.
- Apartment development will begin to wind down this year. Projects underway will continue but new projects now face a higher hurdle.

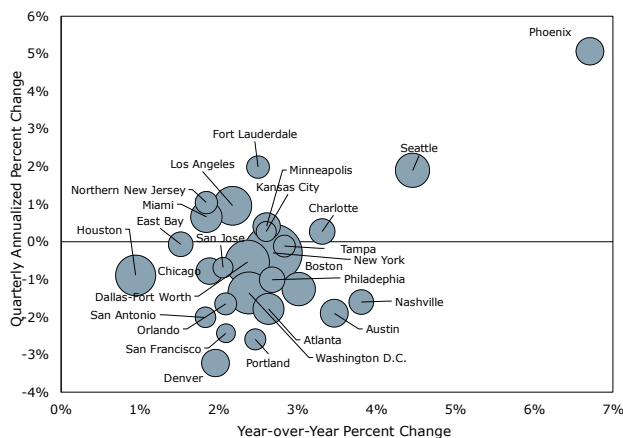
Apartment Supply & Demand
Vacancy Rate; Thousands of Units



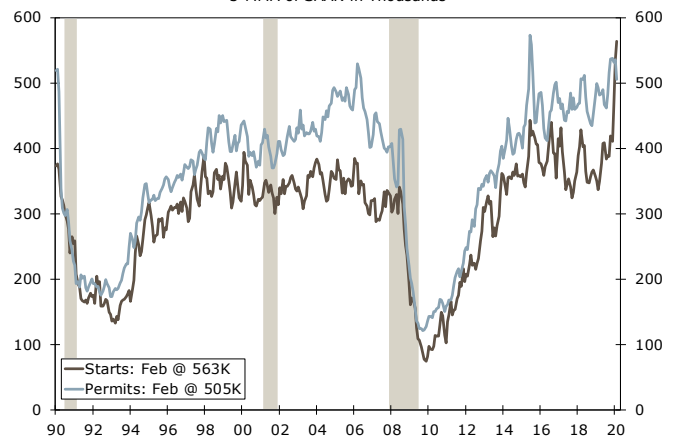
Apartment Effective Rent Growth
Percent Change



Apartment Effective Rent Growth: Q4-2019



Multifamily Housing Starts vs. Building Permits
3-MMA of SAAR in Thousands

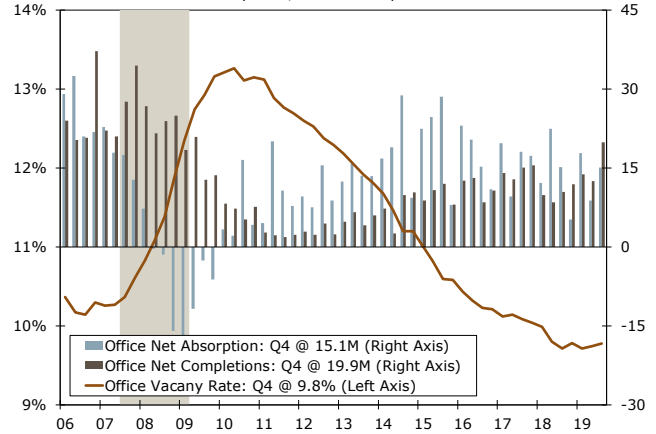


Source: CoStar, Inc., U.S. Department of Commerce and Wells Fargo Securities

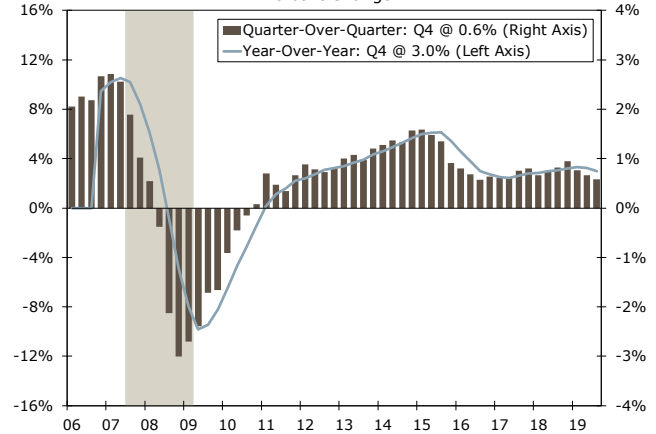
Office

- The COVID-19 outbreak will have less of an impact on the office market, even though many companies are encouraging their workers to work remotely. Efforts to contain the virus may briefly dent co-working fundamentals, as shared spaces are generally inconsistent with social distancing. Co-working space comprises roughly 2% of overall office inventory, making this potential impact relatively small.
- Overall, the office market showed signs of moderating prior to the outbreak, although fundamentals remain generally balanced. Asking rents cooled off slightly in Q4, rising 3.0% over the year. The vacancy rate held steady at 9.8%, as demand was just enough to meet the increase in deliveries in Q4.
- New office development remains elevated. At the end of the year there were over 159 million square feet of space under construction, a cycle high. The 18.7 million square feet of office space delivered in Q4 is the most since 2009.
- North Carolina's major office markets are among the hottest in the entire country. Rents are rising at a nation-leading 7.9% annual pace in Charlotte, while rents are climbing a strong 6.0% in Raleigh. The rapid supply additions this cycle have simply not been enough to keep up with surging population and employment growth. Even more office space is on the way, with nearly nine million square feet under construction in Charlotte, Raleigh and Durham.

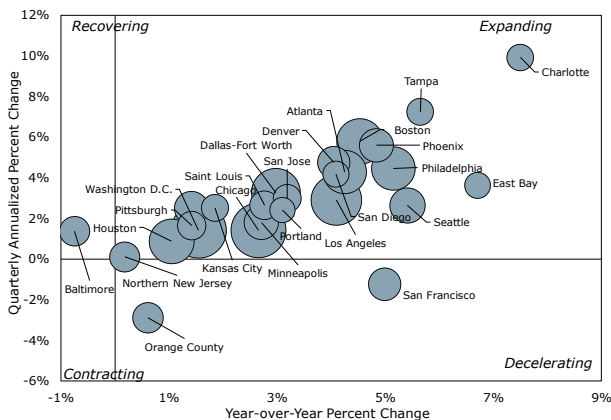
Office Supply & Demand
 Vacancy Rate; Millions of Square Feet



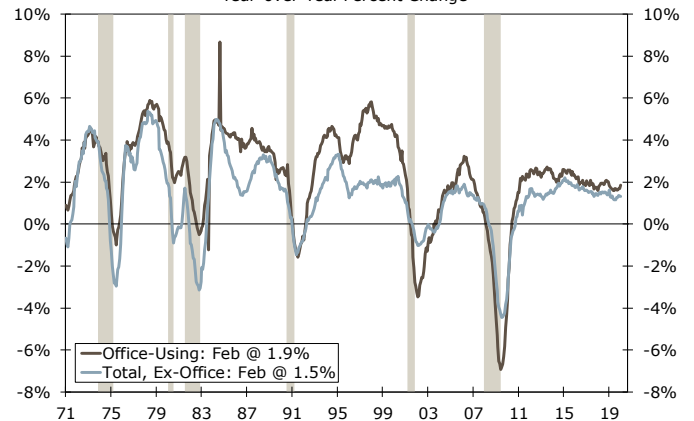
Office Asking Rent Growth
 Percent Change



Office Asking Rent Growth: Q4-2019



Office-Using Employment
 Year-over-Year Percent Change

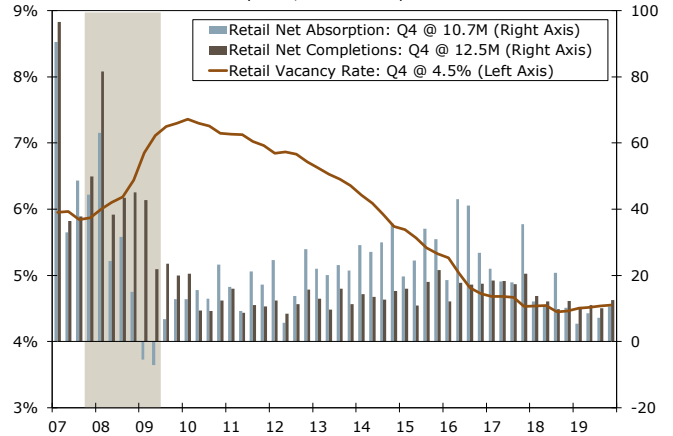


Source: CoStar, Inc., U.S. Department of Labor and Wells Fargo Securities

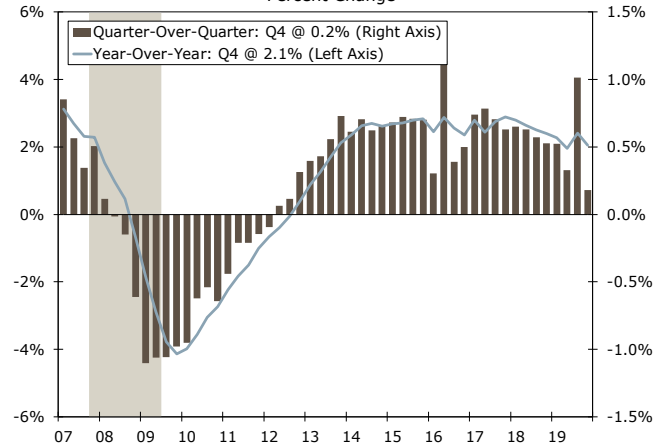
Retail

- Next to the hospitality sector, retail trade has been more harshly impacted than any other. Social distancing and the preponderance of stay-at-home measures have forced many retailers to close their doors. The impact has been heaviest in one of the hottest tenant categories—retailers that market experiences, such as restaurants, breweries, fitness studios and health and beauty salons. The major retail gateway markets which tend to see high volumes of international and domestic travelers are more exposed to the coronavirus slowdown.
- Retailers with ample ecommerce capacity are better poised to handle a drop-off in in-store sales. Several large national chains are implementing order from home and pick-up strategies. Restaurants with established delivery, pick-up and drive-through operations are also doing well.
- The most recent data show retailing was struggling even before the outbreak. In Q4, the retail vacancy rate was essentially unchanged at 4.5%. Net absorption rose to 10.4 million square feet, making Q4 the strongest quarter of 2019. Yet even with the improvement, 2019 was the weakest year for retail demand since 2009. Despite the sector's woes, rent growth remains firmly in positive territory, advancing 2.1% over the year in Q4. Relatively sparse new supply has kept upward pressure on rents over the past few years, and rent growth has exceeded 2% for 25 consecutive quarters.

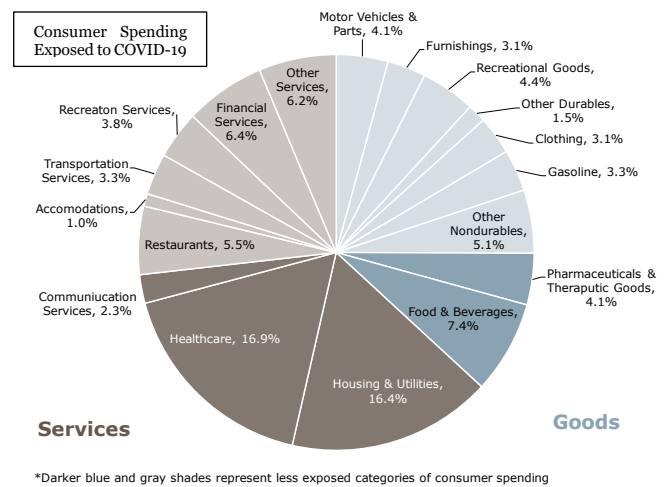
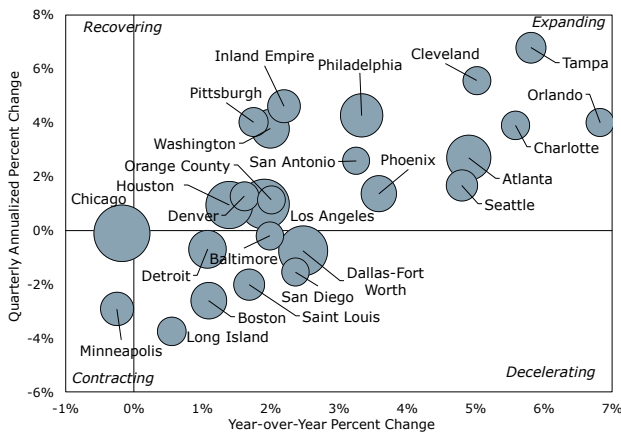
Retail Supply & Demand
Vacancy Rate; Millions of Square Feet



Retail Asking Rent Growth
Percent Change



Retail Asking Rent Growth: Q4-2019

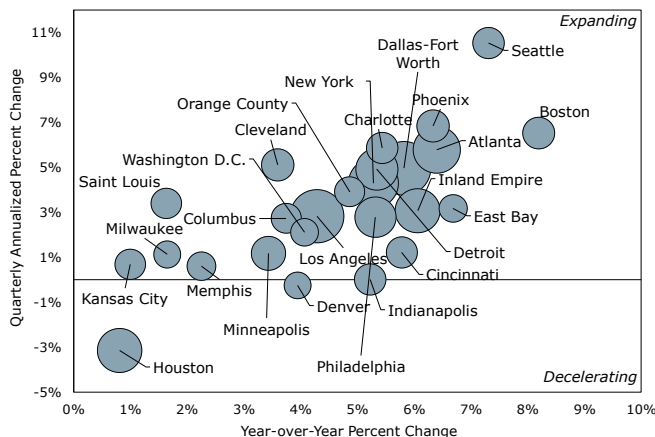


Source: CoStar, Inc., U.S Department of Commerce and Wells Fargo Securities

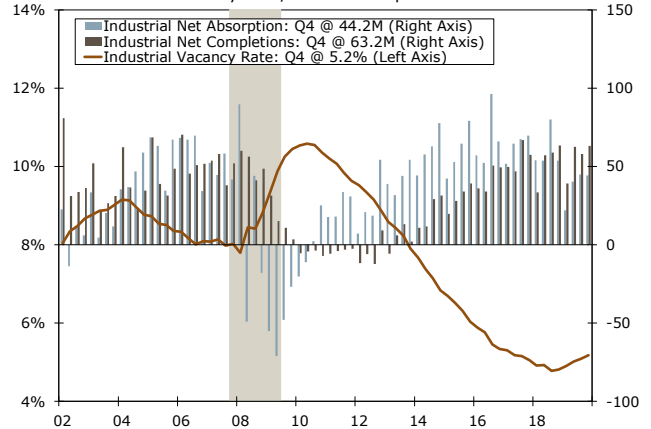
Industrial

- The spread of COVID-19 across the globe is likely to exert some modest near-term pressure on industrial fundamentals, which have already shown signs of cooling alongside a downshift in international trade and slower global economic growth. In Q4, prior to the coronavirus, demand for industrial buildings was already the weakest since 2011. We see further weakness ahead as industrial operators put off expansions until the coronavirus is more contained.
- Markets proximate to major coastal ports may suffer the brunt of the impact from diminished global trade and supply chain disruptions. Furthermore, as the coronavirus crisis tamps down consumer confidence and discretionary spending, demand for warehouses and distribution facilities will likely weaken in the first half of 2020. The accelerated shift toward e-commerce resulting from temporary closures of brick and mortar retailer may hasten the structural shift toward online shopping, which would support demand for warehouses and fulfillment centers longer term.
- There remains an incredible amount of industrial construction underway. The 373 million square feet under construction in Q4 is more than at any other time during the past two decades. The vacancy rate continues to trend higher, ticking up to 5.2% in Q4 as new industrial properties completions surpassed demand. Rent growth cooled off to a 5.4% annual pace, the softest increase since 2015.

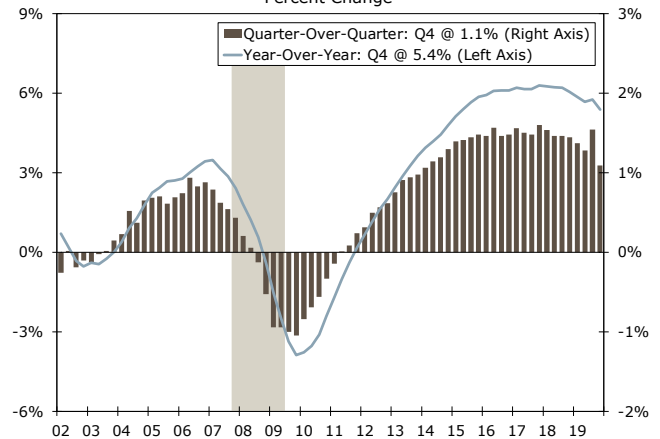
Industrial Asking Rent Growth: Q4-2019



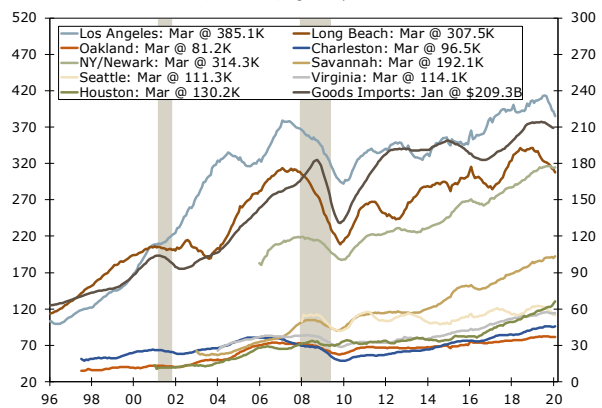
Industrial Supply & Demand
Vacancy Rate; Millions of Square Feet



Industrial Asking Rent Growth
Percent Change



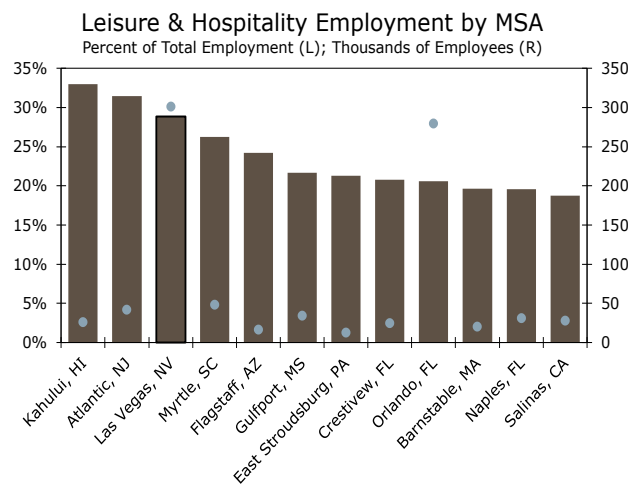
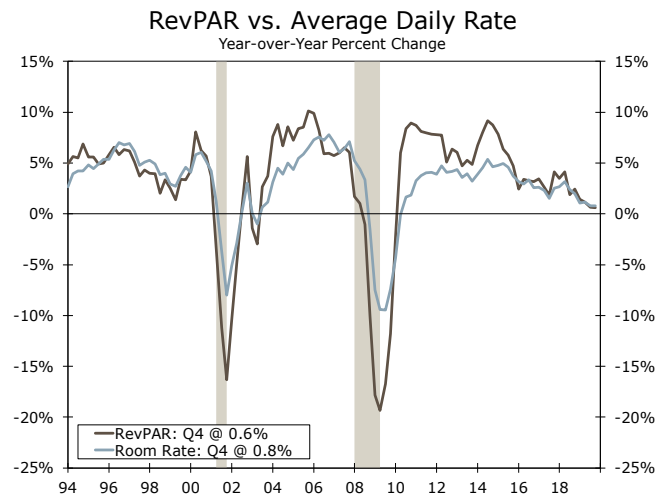
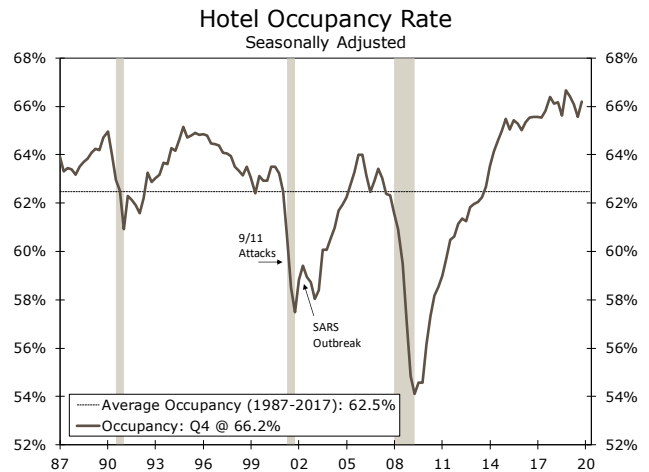
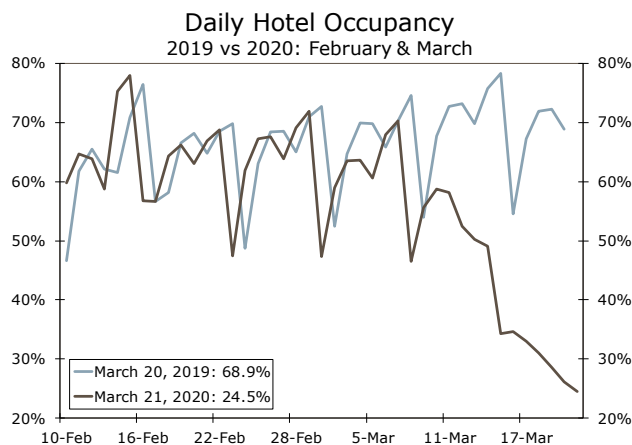
U.S. Container Imports by Port vs. Total U.S. Imports
Left=Container TEUs, Thousands; Right=Imports, Billions of USD, 12-MMA



Source: CoStar, Inc., Bloomberg LP, U.S. Department of Commerce and Wells Fargo Securities

Hotel

- The hotel industry faces its gravest challenge ever, given the rash of travel bans and slew of cancellations of conventions, trade shows, sporting events, concerts and family gatherings. Occupancy rates for hotels still in operation are incredibly low.
- The coronavirus crisis appears to be of a greater magnitude than SARs or H1N1, and more akin to the fallout from the September 11 terrorist attacks/2001 recession. In Q4-2001, the occupancy rate fell 5.8 percentage points year-over-year, while RevPar declined 16%. While the situation is still fluid, we believe the impact to hotel fundamentals will be even greater and expect sharp declines in occupancy and RevPar.
- Markets more dependent on travel and tourism will face particular hardships in coming months, notably Orlando and New Orleans. Yet perhaps no market stands to feel the adverse effects as acutely as Las Vegas. Travel, tourism, conferences, trades shows and professional sporting events have all ground to a halt. All non-essential businesses in Nevada, which includes all 220 Las Vegas casinos, have received an order to close for a 30-day period, and while hotels are not included, most major hotels appear to be following suit. In the year following the September 11 terrorist attacks, visitor volumes fell 2.5% and hotel occupancy dropped almost three percentage points. Each took about three years to return to 2000 levels, even when there were no shutdowns or travel moratoriums in place.



Source: STR, U.S. Department of Labor and Wells Fargo Securities

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