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Economics Group

Special Commentary

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Commercial Real Estate Chartbook

Uncertainty Weighing Heavily on CRE

The economy is on the mend, but uncertainty surrounding the trajectory of the coronavirus heading into the fall and winter continues to loom large. Employers added close to 1.4 million jobs during August and the unemployment rate fell to 8.4%. Both of those outcomes were better than expected. The pace of improvement in adding back the jobs lost during the lockdown period, however, appears to be losing a bit of momentum. As the summer has progressed, employment growth has cooled alongside tighter restrictions put in place in order to contend with pandemic's resurgence in many parts of the country. The good news is that these restrictions have largely been successful. The number of new confirmed cases in Sun Belt hotspots have meaningfully declined and hospitalizations, which did not rise nearly as much as new cases, have subsided further.

Even so, the direction of the virus from here on out is still unknown, a fact that will likely stand in the way of further progress. As we head into the colder months, when flu season typically ramps up and outdoor stop-gap measures such as outside dining and curbside pickup are less viable, a withdrawal in economic engagement is more likely. Moreover, many industries are still absorbing the aftershocks of the COVID-19 induced collapse in economic activity, and now some rebalancing may be necessary. While the leisure & hospitality and retail sectors were most directly hit initially, the contagion may spread into white-collar service industries, which have generally been shielded from layoffs thanks to the ability to work remotely. Furthermore, expanded unemployment benefits (prolonged by executive order after expiring in July) are set to run out by the end of September. Absent another round of fiscal stimulus, consumer spending could downshift in coming months.

While slowing, the economy is still firmly on the path to recovery. Unfortunately, commercial real estate is lagging behind in this respect. Across all major property types, vacancy rates have turned higher and rent growth has slowed, or in the case of retail, declined outright. Likewise, property price appreciation has begun to slow, and cap rates have shown signs of pressing higher. This has occurred even as the number of commercial real estate sales have plummeted alongside a growing distance between buyers' and sellers' perception of property values. Once the future path of the economy and demand for commercial real estate is more certain, sales will likely pick up and there will be more clarity on pricing, but valuations are sure to continue in this downward direction.

Across all major property types, vacancy rates have turned higher and rent growth has slowed.

Figure 1

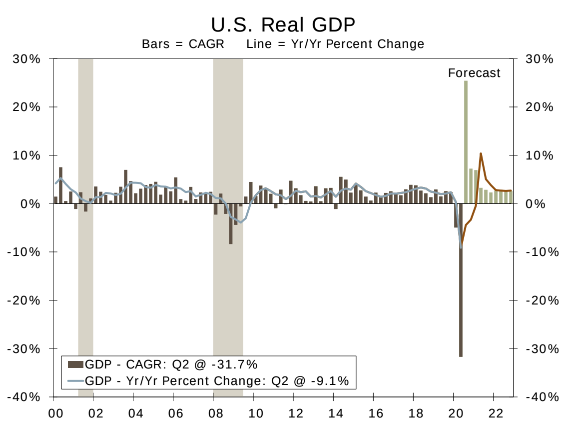
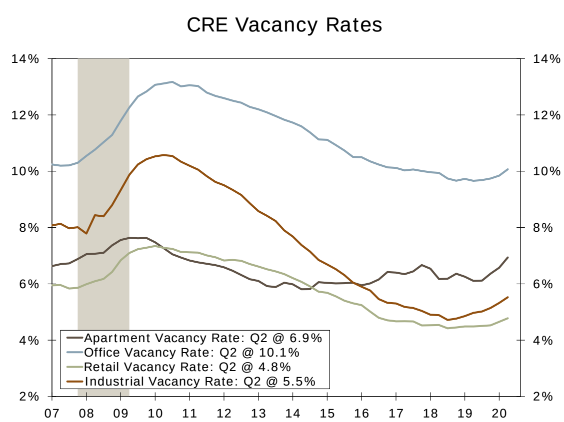


Figure 2



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

Few areas have been unscathed by the crisis, but industrial properties appear to be holding up relatively well.

Few areas of commercial real estate have been unscathed by the coronavirus crisis, but industrial property fundamentals appear to be holding up relatively well. Vacancy rates have risen in recent quarters, but this appears to be mostly a function of new industrial construction finally catching up to demand. Overall, this resiliency is primarily owed to the boom in online sales which has reinforced already strong demand for logistics services, delivery drivers, warehouses and distribution facilities. The leasing activity and hiring plans of Amazon amid a historic economic downturn puts an exclamation point on the trend but most businesses have been investing heavily in their supply chains, logistics networks and online capabilities. Clearly Amazon is currently in a league of their own. The e-commerce behemoth continues to build-out fulfillment networks in proximity to nearly every metropolitan area in the country and recently announced it would lease two million more square feet of office space in Bellevue, WA as well as add 33,000 corporate jobs.

Despite the rapid bounce back in consumer spending on goods, many retail properties continue to be devastated by occupancy limitations and the reticence of consumers to spend a meaningful amount of time shopping inside physical stores. During Q2, demand for retail space fell faster then new completions, pushing the vacancy rate up to 4.8%, the highest since 2016. Still, we continue to emphasize that all retail stores are not under severe distress. Retailers that offer curbside service and satiate soaring demand for products that augment or enhance home living spaces have generally outperformed.

One way to display the wide ranging performance of various retail platforms is shown in Figure 4. Employment at building materials, general merchandise (primarily at discount stores) and grocery stores are actually at higher levels compared to earlier this year, while hiring at clothing and hobby stores continues to be depressed. While some have been successful, most retailers are likely wondering when business can get back to normal. In our view, a safe, effective and widely-available vaccine is the quickest path to more typical business operations. A potential vaccine looks promising, and rapid antigen tests, which are cost-effective and produce results in minutes, may even allow some close-contact retail businesses to resume more normal operations even sooner.

Thirty-nine percent of senior managers and executives plan to bring workers back by Q1-2021.

New testing capabilities and a vaccine would clearly help accelerate a return to the office. Some firms have started to gradually bring back workers in staggered shifts. When businesses more fully bring back their employees and how much space they will ultimately need remains a big question mark. According to a recent Conference Board survey of senior managers and executives, 39% of responding companies plan to bring workers back by the first quarter of 2021. The timing makes sense, given multiple vaccines in development are expected to be cleared for distribution early next year. That said, 35% of responding companies have not yet set a date for reopening, which is a reminder that the path of the virus and viability of a vaccine remains uncertain. Even with a vaccine, some firms may have trouble convincing employees that a return to the office is safe. We expect the return to a more normal business environment to be gradual over the course of next year.

Figure 3

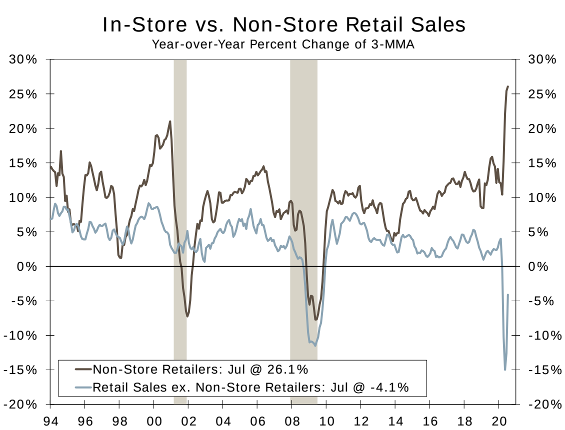
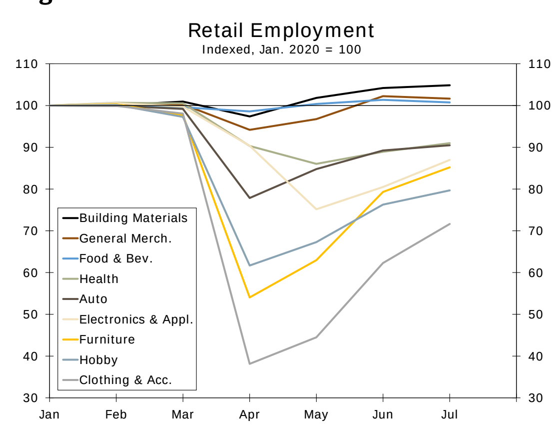


Figure 4



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

As we have previously written, the aftershocks of the COVID-19 crisis will likely continue to ripple through the apartment market for years to come. The severe disruptions brought on by urban lockdowns were apparent in Q2 with vacancy rates ascending amid a pullback in renter demand. On a quarter-to-quarter basis, effective rents slipped 0.5%, the sharpest decline since the Great Recession. Not surprisingly, the cause of the downshift was an exodus of renters seeking relief from the expensive, confined and currently amenity-dry city centers. Record low mortgage rates have also significantly lowered the cost of homeownership and accelerated the upswing in suburban home buying that began before the pandemic. Bearing in mind that mortgage rates are likely to remain low for the next few years, we expect these trends to continue.

But not everyone prefers (let alone can afford) to live in a single-family house. In fact, many former urban-renters appear to be leasing in the suburbs. This divergence between urban and suburban preferences is apparent in recent data from CoStar, which show a skyrocketing apartment availability rate in central business districts (CBD) mirrored by a declining rate for suburban properties. Similarly, suburban apartment rents have been much more buoyant compared to CBD rents. Of course, this shift in preferences presents a massive challenge for the apartment market, as the lion's share of the multifamily investment over the past decade has predominantly occurred in the urban centers which are now experiencing an accelerated outflow of residents. Considering that the suburbs were enjoying a bit of a renaissance prior to the pandemic, we expect this shift to become more durable.

It will still be some time until demand for hotel rooms returns to the levels hit in the years leading up to the coronavirus crisis.

Hotel operating fundamentals, while vastly improved compared to the spring, appear to be plateauing. For the week ending September 5th, the occupancy rate was 49.4%, much better than the lows seen in mid-April but still significantly lower than the 60.9% at the end of summer last year. Revenue per available room (RevPar) and average daily rates (ADR) have also improved. That noted, occupancy has only moved sideways since mid-June when the coronavirus reappeared in many parts of the country. We are hard-pressed to envision occupancy levels returning to pre-COVID-19 levels anytime soon. The same factors holding back workers returning to the office will also hold down business travel, which made up about 20% of all travel last year. Employers will continue to be abundantly cautious in allowing most employees to travel without a vaccine. Restrictions on international travel have been eased somewhat, but we do not foresee a full return until the second half of 2021 at the earliest. Overall, it will still be some time until demand for hotel rooms returns to the exceptionally high levels hit in the years leading into the coronavirus crisis.

Figure 5

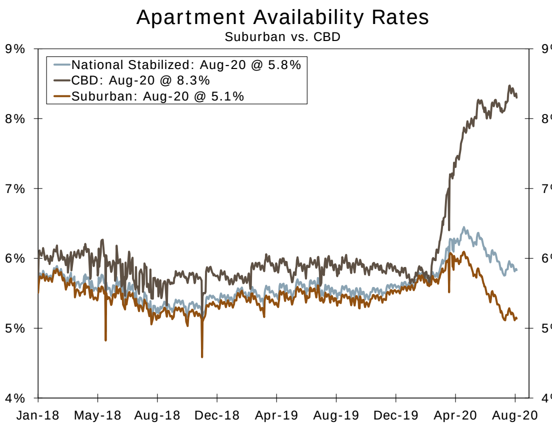
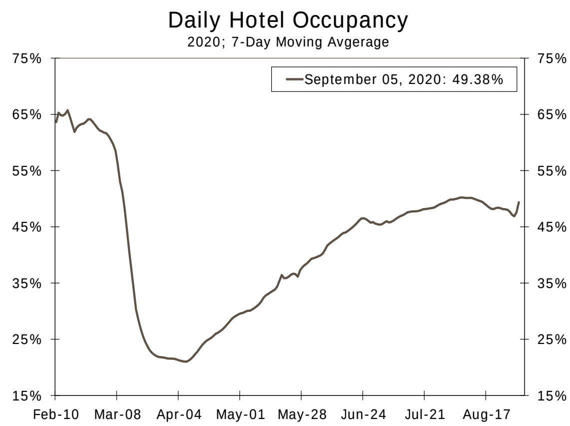


Figure 6

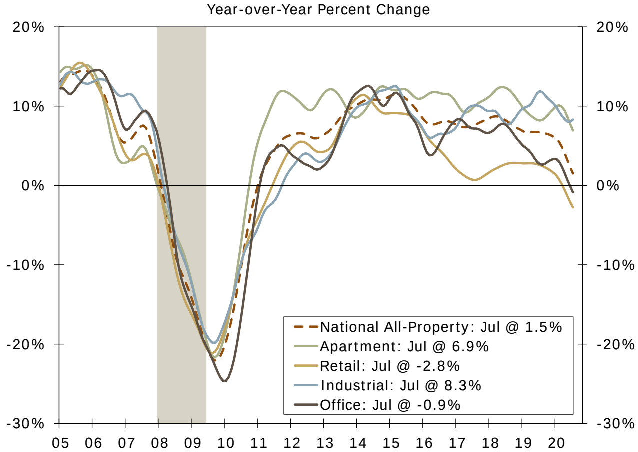


Source: CoStar, Inc., STR and Wells Fargo Securities

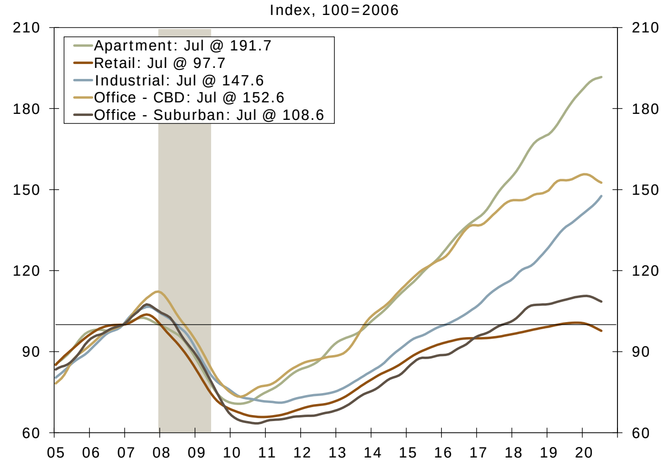
CRE Property Pricing & Fundamentals

- Deal activity remains depressed, down almost 70% over the year in July. The gap between buyer and seller perception of property values remains too wide for many transactions to occur.
- Cross-border deals have downshifted alongside the COVID-19 induced pullback in overall sales activity. That noted, the share of cross-border investment has remained steady at about 8%, evidence that U.S. commercial real estate's status as a global safe haven remains intact despite recent economic turbulence.
- Property prices have begun to decline. Over the past three months, office and retail each fell by 1.7%. Industrial (+2.5%) and apartment (+0.6%) property values have held up much better.

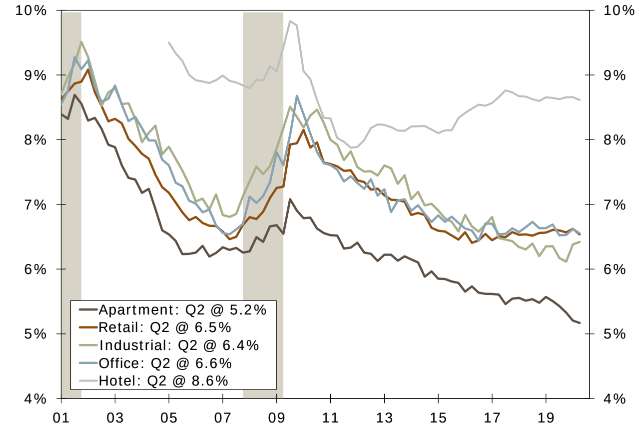
Commercial Property Price Index
Year-over-Year Percent Change



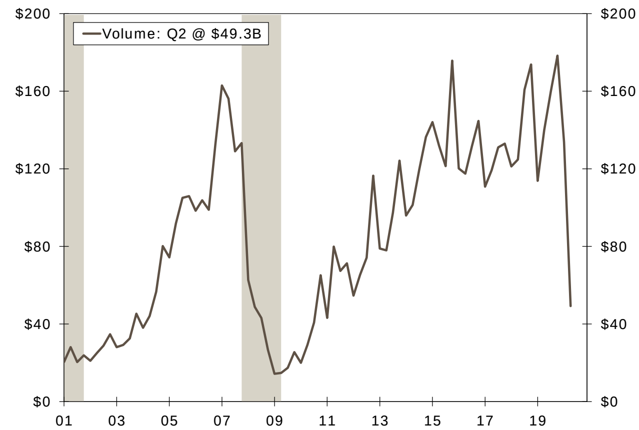
Commercial Property Price Index
Index, 100=2006



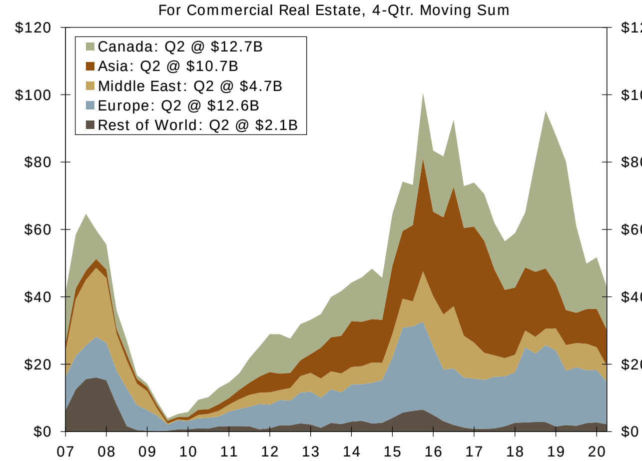
CRE Cap Rates by Propety Type



CRE Transaction Volume



Origin of Capital Into the United States
For Commercial Real Estate, 4-Qtr. Moving Sum

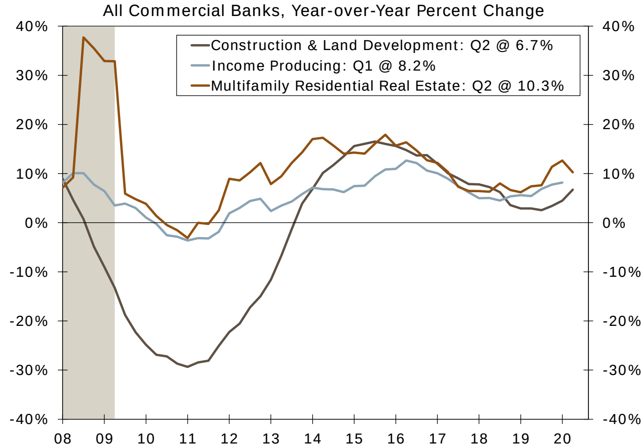


Source: Real Capital Analytics and Wells Fargo Securities

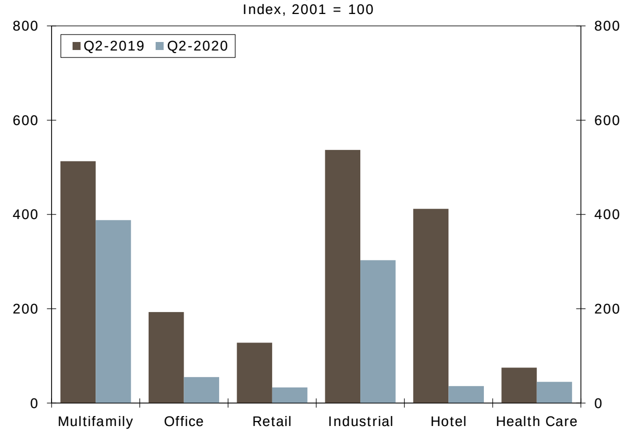
Credit Availability & Lending

- Heightened economic uncertainty has led to much tighter credit standards. The number of banks (on net) tightening standards for CRE loans has surged to a level not hit since the Great Recession. Many firms appear hesitant to seek credit, and more banks are reporting a downshift in demand.
- After widening substantially in the spring, CMBS spreads have since significantly compressed, but have not returned to pre-pandemic norms.
- In the second quarter, commercial and multifamily loan originations plummeted 30% from Q1. Declines were broad-based, but new originations for office (-56%), retail (-53%) and hotel (-82%) loans fell the most.

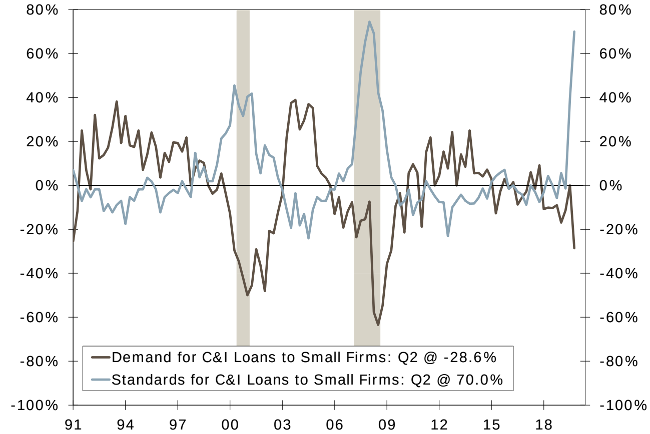
CRE Lending
All Commercial Banks, Year-over-Year Percent Change



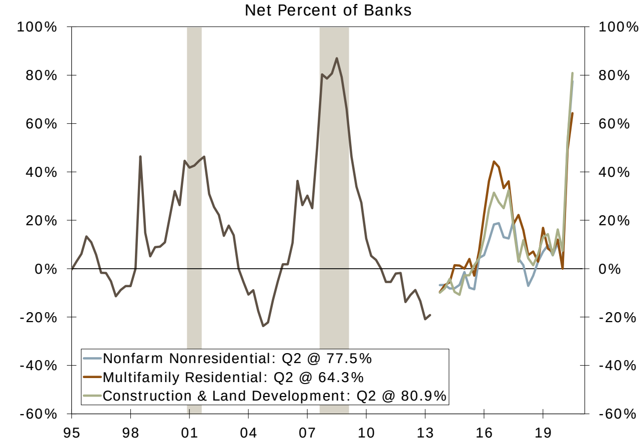
CRE Originations
Index, 2001 = 100



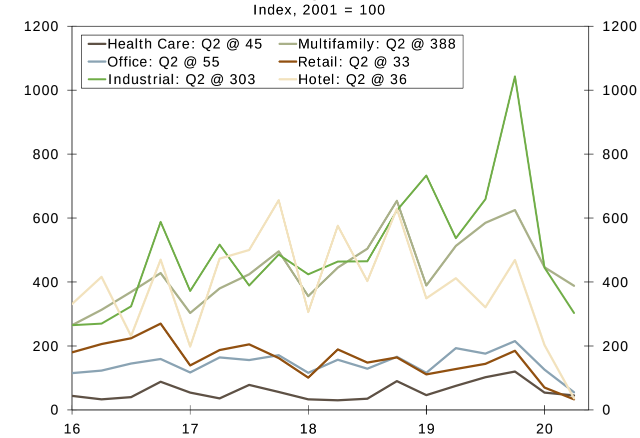
Net Percent of Banks Reporting Stronger Demand vs. Tightening Standards on C&I Loans



Banks Tightening Standards for CRE Loans
Net Percent of Banks



CRE Orginations
Index, 2001 = 100



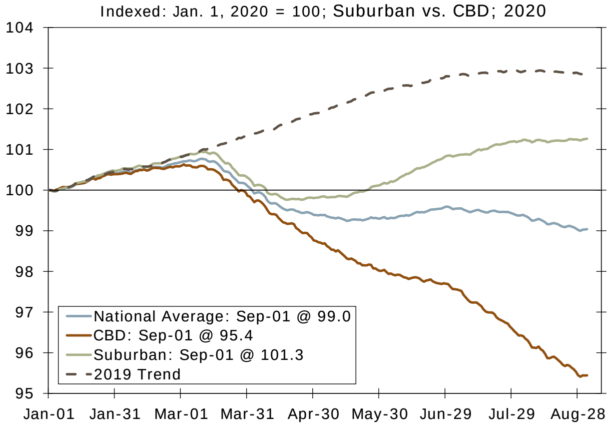
Source: FDIC, FRB, Mortgage Bankers Association (MBA) and Wells Fargo Securities

Apartment

- The vacancy rate jumped to 6.9% in Q2. For context, the vacancy rate peaked at 7.6% during the Great Recession. During Q2, demand for rental units weakened, but remained solidly in positive territory. A surge in home buying spurred by low mortgage rates and a shift in housing preferences away from dense, urban centers are short-term headwinds, but rental demand, especially in the suburbs and smaller secondary markets, will likely hold up better than some headlines are suggesting.
- Supply is more of a concern. Over 94,000 units were delivered in Q2, and, year-to-date, net completions are up 20% compared to last year. Even more supply is on the way, with over 600,000 units currently under construction.
- In an effort to keep tenants, landlords are slashing rents. Rents slipped by 0.5% in Q2. Rents are falling fastest in the dense, coastal gateway markets such as New York City, San Francisco and Los Angeles.
- The ability to pay rent amid historically weak labor market conditions continues to loom large. The expanded $600 per month unemployment benefits expired at the end of July, and the $300 monthly replacement will likely run out by the end of September. More relief is likely necessary given a still-elevated unemployment rate. The CDC (using its quarantine authority) recently declared a moratorium on evictions that will last until the end of 2020.

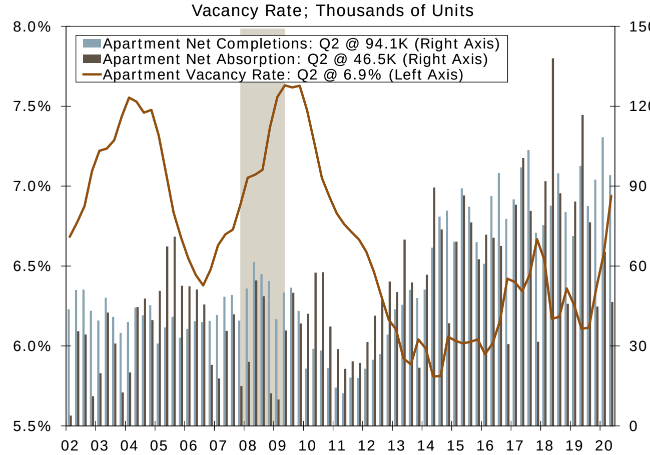
One-Bedroom Rent Trends

Indexed: Jan. 1, 2020 = 100; Suburban vs. CBD; 2020

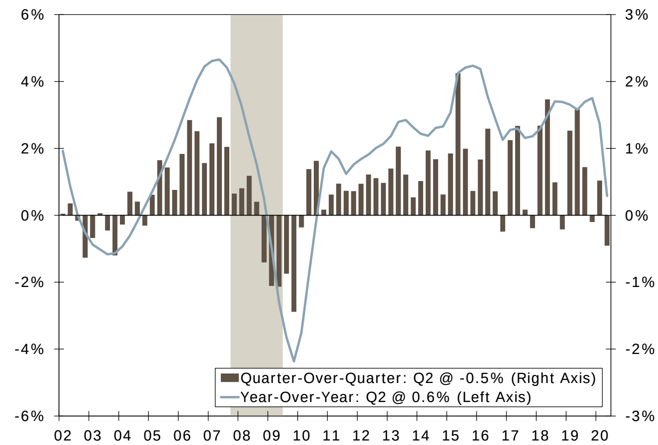


Apartment Supply & Demand

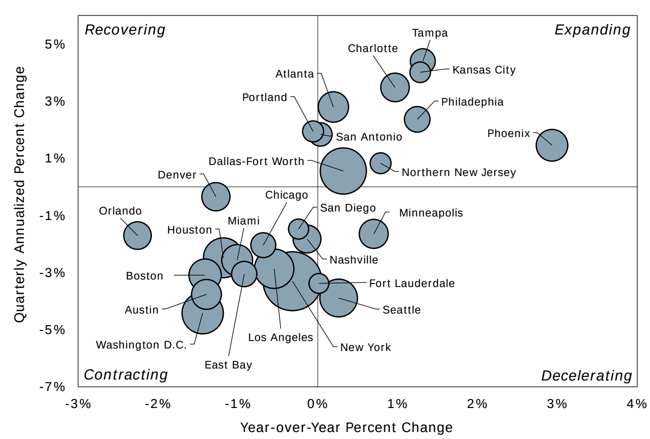
Vacancy Rate; Thousands of Units



Apartment Effective Rent Growth



Apartment Effective Rent Growth: Q2-2020

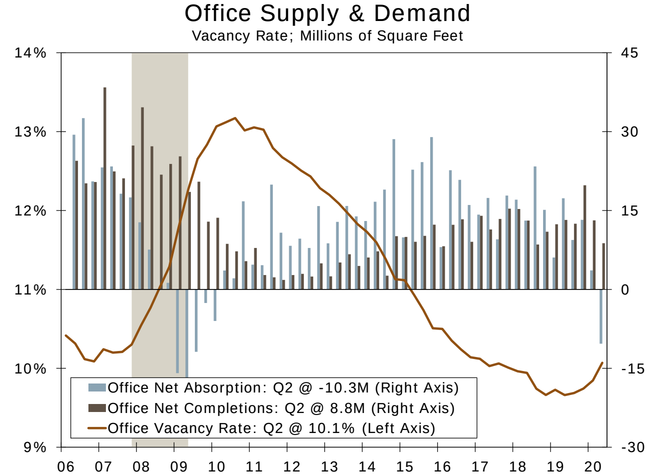


Source: CoStar, Inc., U.S. Department of Commerce and Wells Fargo Securities

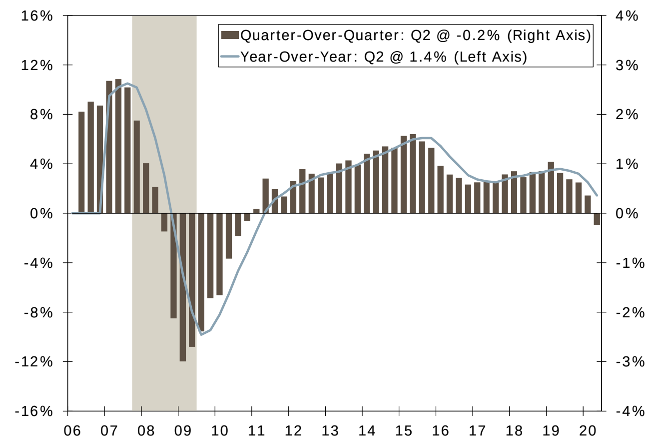
Office

- Demand for office space turned negative for the first time in a decade in the second quarter. As the outlook for returning to the office remains uncertain, leasing activity may continue to be muted in coming months as tenants reconsider their space needs.
- With net absorption contracting, the office vacancy rate ticked just over 10% in Q2. While the rate reached double-digits, it remains well below its peak during the Great Recession.
- Office asking rent growth has decelerated across the country—especially in stronger rent growth markets such as Austin and San Jose. More affordable Sunbelt markets like Charlotte and Dallas, on the other hand, were relatively resilient to downward pressure on rents in Q2 according to recent data from CoStar.
- Initial claims for unemployment insurance averaged just over one million in August, a solid improvement from the shutdown months of March and April. Although initial claims are slowing, over 29 million people are still collecting some type of unemployment benefit.
- While firms like Twitter and Nationwide Insurance implemented permanent work-from-home policies to reduce operational costs, these cost savings might be offset by diminished productivity gains as workers tend to be less efficient and innovative in separate locations. Ultimately, we still see the office environment as the predominant workspace in the long-run.

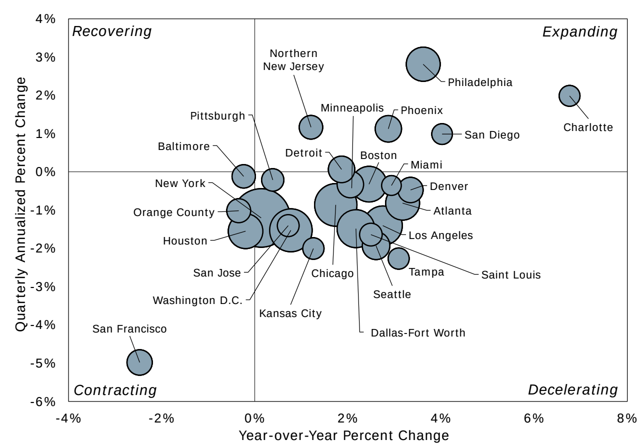
Office Supply & Demand



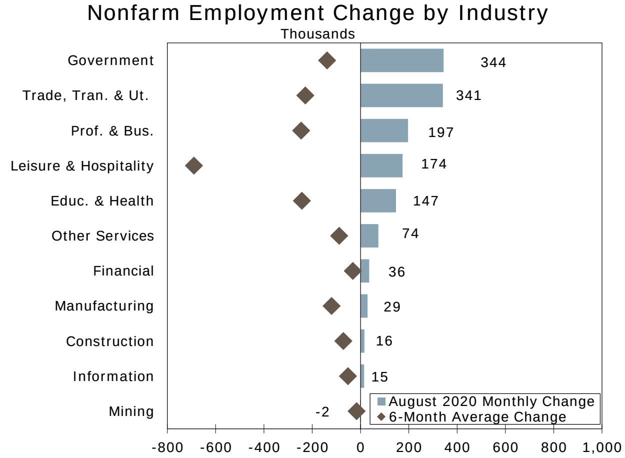
Office Asking Rent Growth



Office Asking Rent Growth: Q2-2020



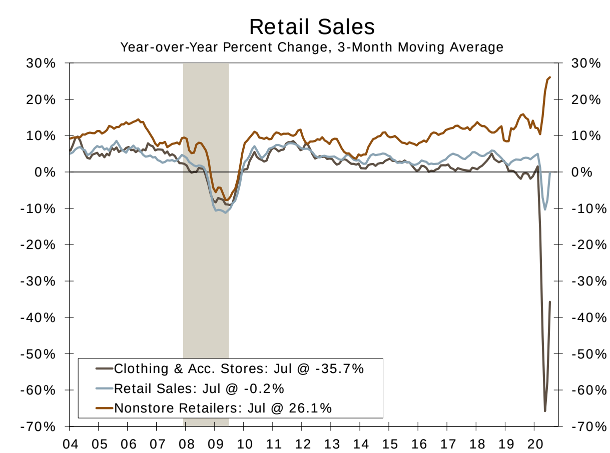
Nonfarm Employment Change by Industry

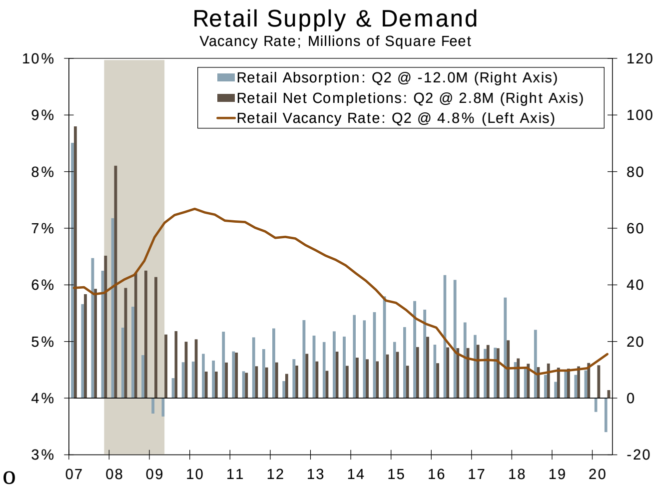


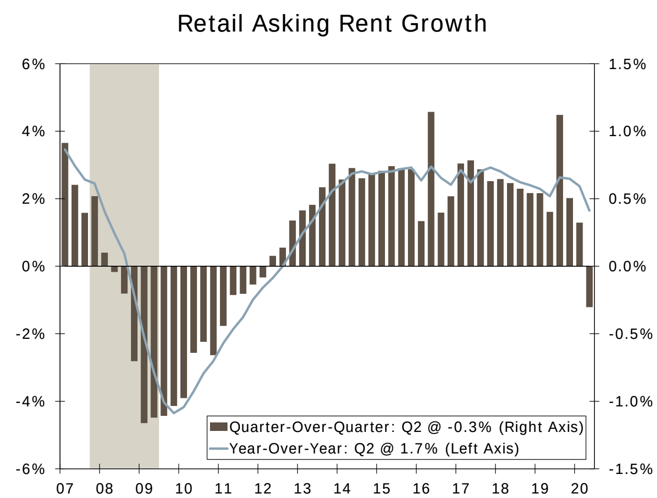
Source: CoStar, Inc., U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

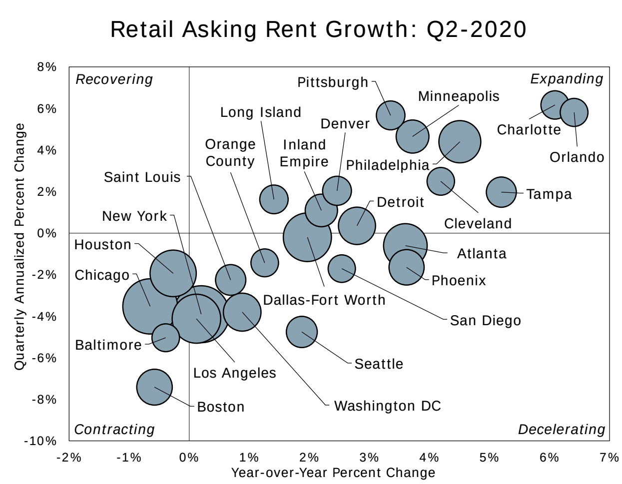
Retail

- Retail entered the downturn already in a vulnerable position and recent data suggest that the pandemic has exasperated previously eroding net absorption and occupancy rates. According to CoStar, investment activity reflected the lowest quarterly volume since 2010.
- Asking rent growth fell 0.3% in Q2, registering the first contraction since 2013 for the retail sector. Unlike the office market, many retailers found it difficult to make on-time rent payments and are seeking deferral or lease modifications.
- Large urban markets like Los Angeles and New York posted year-over-year rent declines while areas with strong demographic growth, such as Orlando and Nashville, continued to register solid rent growth in the second quarter, despite challenging conditions in their local economies.
- The Paycheck Protection Program (PPP), enacted under the CARES Act, incentivized businesses to keep workers on the payroll by providing emergency loans. For retailers that were able to successfully apply prior to the program's expiration in early August, rent and mortgage interest, in addition to payrolls, were both eligible expenses for loan forgiveness.
- Bankruptcies in the retail sector are primarily concentrated in apparel and department stores. As social distancing measures extended well into the summer, an increasing number of fitness centers and personal health brands also declared bankruptcy such as 24 Hour Fitness and GNC.







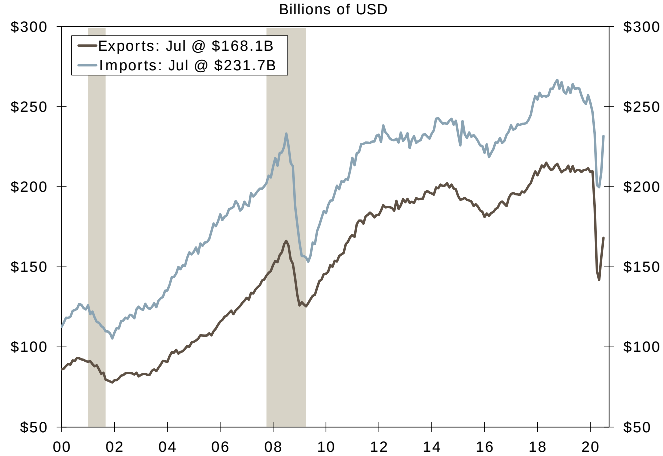


Source: CoStar, Inc., U.S Department of Commerce and Wells Fargo Securities

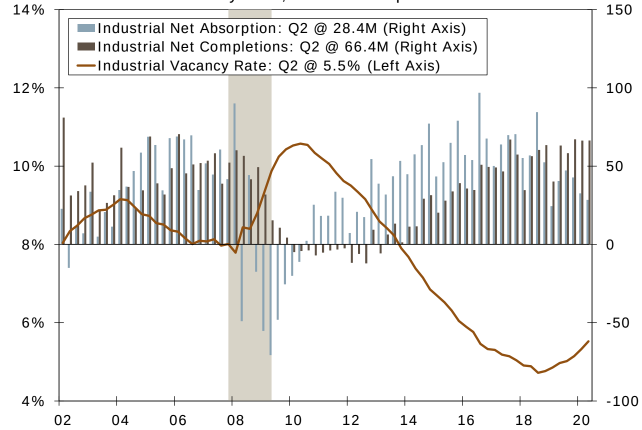
Industrial

- Industrial properties, while swayed by the COVID-19 crisis, have shown a great deal of resiliency. Recent disruptions have curtailed demand, but net absorption remained solid in Q2. The vacancy rate continues to trend higher, but this is mostly a function of new deliveries outpacing absorption. This slight downshift in demand coupled with more supply led to rent growth softening in Q2.
- The boom in e-commerce sales spurred by social distancing and remote work has reinforced already strong demand for warehousing and distribuition facilities from retailers, grocers and third-party logistics firms. Amazon, Target and Walmart led leasing activity in Q2.
- International trade is rebounding—primarily the result of strong demand for consumer goods imports. Exports are further back on the road to recovery, as global economic growth remains held back, especially as some of the U.S.'s major trading partners have seen a resurgence of COVID-19 cases, notably Japan and Europe. Stronger international trade flows should bolster demand for logistics and distribution properties around port markets.
- Leasing activity from healthcare and medical service firms has strengthed as the nation races to expand PPE, testing and vaccine production capacity. Building shorter and more resilient supply chains means some global manufacturing capacity will likely be reshored, which will help support demand longer-term.

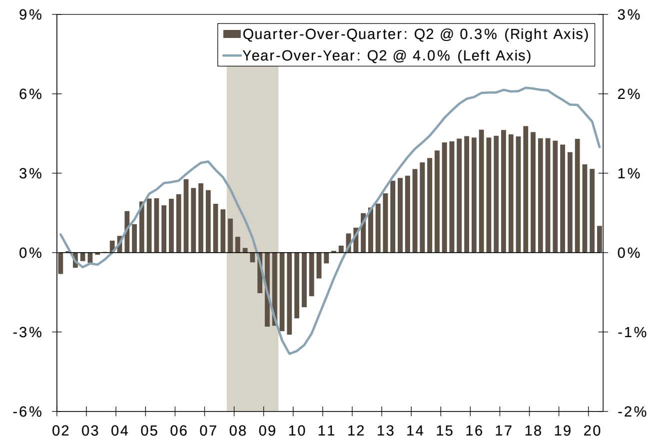
U.S. Exports & Imports
Billions of USD



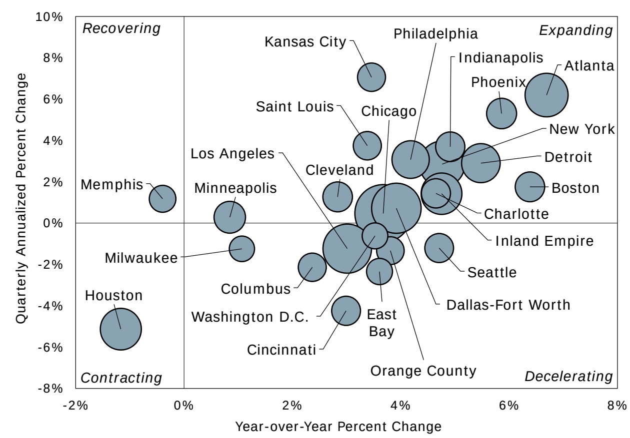
Industrial Supply & Demand
Vacancy Rate; Millions of Square Feet



Industrial Asking Rent Growth



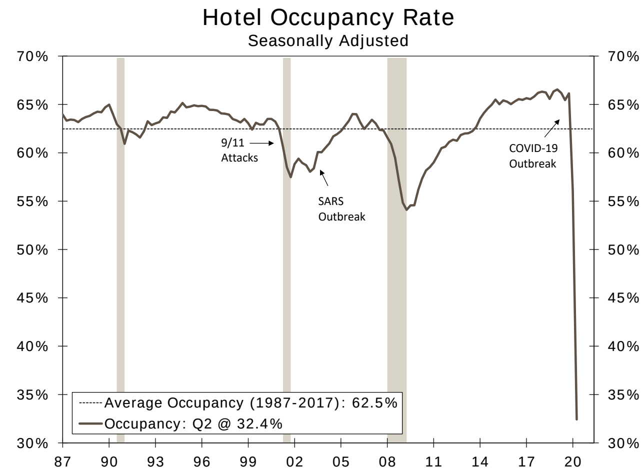
Industrial Asking Rent Growth: Q2-2020

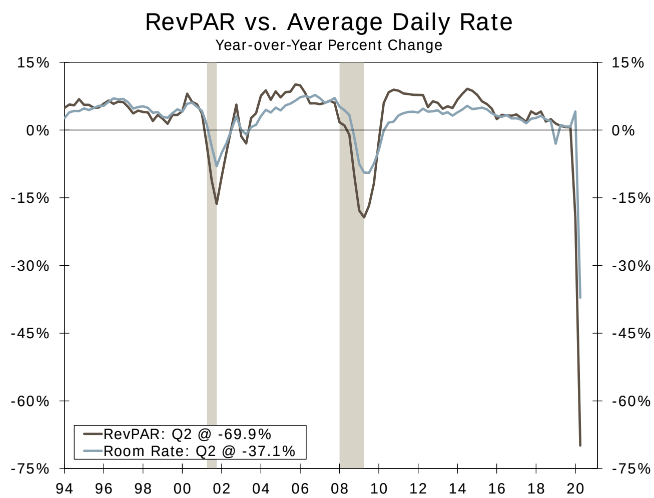


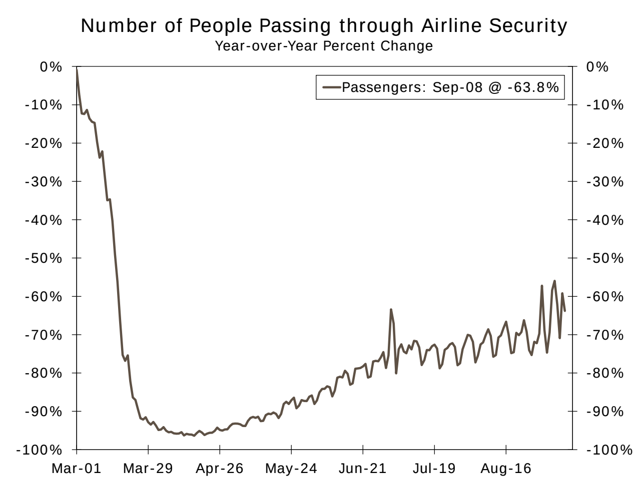
Source: CoStar, Inc., U.S. Department of Commerce and Wells Fargo Securities

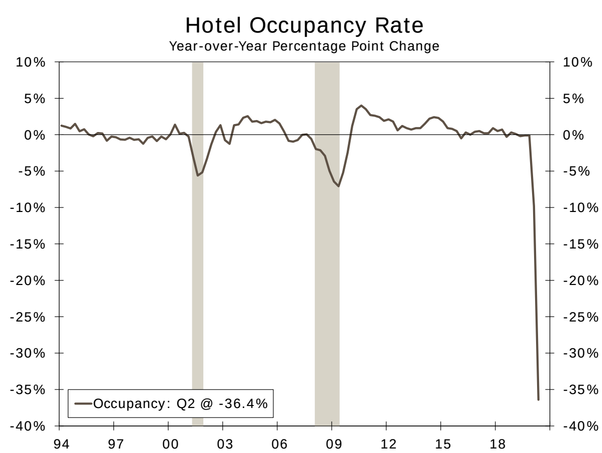
Hotel

- Hotel occupancy, daily rates and RevPar plummeted in Q2. That was to be expected as most forms of travel ground to a halt in order to contain COVID-19. Despite a resurgence of new cases in parts of the South and West in the early summer, most of the restrictions put in place in the spring have been eased and travel has started to pick up. As of the first week of September, the hotel occupancy rate has ascended to 49.4%. For context, occupancy was 60.9% during the same week last year.
- The bulk of the modest improvement was likely owed to the return of leisure travel. Continued progress in the second half on the year is more uncertain. Not only was there pent-up demand from the lockdown months in the spring, but some travel was also likely pulled-forward in anticipation of less favorable public health conditions later this fall and in the winter.
- Unfortunately, the return of business and international travel remains a lingering question. Rapid antigen tests, which are cost-effective and produce results within minutes, could help accelerate the return of these forms of travel. That said, a full recovery is still dependent on an effective and widely distributed vaccine, likely not available until the summer of 2021.
- Employment at hotels, motels and casinos remains well below the February peak. Close to one million of these jobs were lost in COVID-19 containment efforts, and just over 230,000 jobs (about 23%) have been recouped as of July.









Source: STR and Wells Fargo Securities

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