Commercial Real Estate Chartbook

As Many Areas Begin to Re-open, What Does the Future Hold for CRE?

The COVID-19 crisis is having a devastating impact on the U.S. economy. Economic activity came to a virtual standstill in March and April, and a tidal wave of jobless claims (nearly 43 million over the past 11 weeks) followed widespread lockdown orders, business closures and strict social distancing measures. After declining at a 5.0% annual rate in Q1, we expect a much larger contraction in economic output in Q2, easily the largest drop since the Great Depression. On a more positive note, the spread of the coronavirus appears to be losing momentum, and the economic recovery is beginning to take shape. Seeing fewer coronavirus cases, most areas of the country have started to re-open, albeit in phases and at significantly reduced capacity. Economic growth is likely to begin to get back on track in June and bounce back strongly this summer, but questions about a second wave of the virus late this fall and this winter cloud the intermediate-term outlook. One thing seems certain: economic conditions are not likely to regain the levels seen prior to the outbreak for some time to come.

Measures taken to contain the coronavirus have created something of an existential crisis for commercial real estate. How and when will those working-from-home return to the office? Will consumers ever re-engage with traditional retail formats? How and when will business and leisure travel recover? Will the country still be able to hold large sports and cultural events? While all of these things will happen to some extent, the ways that people work, shop and entertain themselves have likely fundamentally changed. The next 12 to 18 months will be challenging for commercial real estate in that there will be short-term pain for many businesses, which will surely lead to higher vacancies and slower rent growth across the board. Until the toolbox of therapies to combat the virus is expanded and a vaccine is successfully developed, there will also be a need to make changes in how commercial real estate formats operate, such as retail occupancy limitations or stricter adherence to social distancing in offices. Longer-term, changes in the way office workers re-engage with the workplace and in the way consumers re-engage with retailers will require changes in the way property is developed.

Figure 1

U.S. Real GDP
Bars = CAGR
Line = Yr/Yr Percent Change
Forecast

GDP - CAGR: Q1 @ 5.0%
GDP - Yr/Yr Percent Change: Q1 @ 0.2%

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

Figure 2

U.S. Mobility
Driving
Transit
Walking

Source: Apple Data

CRE has been threatened immensely.
Short-term Pain for Retail, but Better Days Ahead
The coronavirus crisis is hitting retail particularly hard. In just the past few weeks, large retailers such as J.C. Penney, Neiman Marcus, Pier 1 and J. Crew have filed for bankruptcy, while Nordstrom and Victoria’s Secret have announced store closures. While efforts to suppress the spread of the coronavirus and the resulting collapse in discretionary consumer spending triggered many of these actions, large numbers of brick and mortar retailers were struggling before the outbreak. Department stores, which are often key anchor tenants at malls and shopping centers, have been under tremendous strain for decades, losing market share to discount stores, big box category killers and online competitors. For many struggling retail chains, the abrupt slump in consumer spending this spring was just too much to overcome, and many have thrown in the towel. Even as retailers are permitted to re-open, many will face occupancy limitations which will make it difficult to regain profitability. Headlines declaring the death of retail, however, are overly dramatic. Not every segment of retail is in dire straits. Building material stores, such as Lowe’s and Home Depot, and big box stores with robust e-commerce platforms, such as Walmart, Target, Staples and Best Buy, are holding up relatively well.

Figure 3

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

However, it would also be unfair to blame the pandemic for all the struggles many retailers face. For roughly the past decade, retail has been in a state of flux, and many retailers were teetering on the edge of bankruptcy prior to the pandemic. Recessions tend to accelerate existing trends, such as the long-running decline in market share for full-service department stores and many big box chains. Many enclosed shopping malls and power centers were already struggling to fill their centers with creditworthy tenants. The coronavirus crisis will likely hasten the demise of formats that have been slow to adapt to shifts in consumer behavior and increased competition from online retailers. Even formats that had aggressively shifted their focus toward entertainment, experiences and dining have found themselves in an uncomfortably weak position amid the widespread business shutdowns and possibility of prolonged social distancing requirements.

While retailing is very much at the center of the current economic storm there are also a number of positive shifts. One of the more prominent trends that looks to gain momentum in the post-COVID environment is the rise of town centers. These properties are mostly outdoor and walkable, which gives them a great deal of flexibility to accommodate social distancing. Many also include residential, office and entertainment, and some are adjacent to mass transit. Not only do we see town center formats flourishing, but we also see many traditional enclosed shopping malls transitioning toward this format. Another trend that seems poised to gain momentum is the move by e-commerce companies to open brick-and-mortar locations in highly trafficked areas. These locations, with showrooms that allow customers to test newly introduced products, allow firms to build their brands and deepen customer relationships. Rising homeownership should also be a solid tailwind for operators of neighborhood centers and smaller strip centers that feature restaurants and experience retailers.
Global Recession Will Weigh on Industrial Despite Positive E-commerce Spillovers

The short-term effects of the COVID-19 crisis will be felt unevenly across the industrial property landscape. On one hand, the downturn in global economic growth and international trade will reduce demand for industrial properties tied to exporting and importing goods. We expect global GDP to decline nearly 4% this year, meaning worldwide demand for U.S. goods and services will weaken considerably. Goods exports already fell 25.2% during March, the worst one-month drop on record, and we expect to see more declines in coming months. Similarly, while the recovery is now beginning to take shape, it will be a gradual process. We do not anticipate a full rebound in consumer activity and, by extension, imports, for several quarters. Global factory shutdowns have also revealed the fragility of existing manufacturing supply chains. It’s too early to tell, but many producers may seek to build a more diverse network of suppliers, which would result in more production reshoring, especially for medical supplies and pharmaceuticals. Most shifts, however, will involve relocating production from one country to another.

Social distancing and stay-at-home orders have forced consumers to engage in more online shopping, which is having positive spillover effects for the industrial market. Amazon's success in this environment embodies this trend, and the e-commerce behemoth continues to lease warehouse space and build out a massive network of fulfillment centers across the country. But it’s not just the e-commerce giants that are expanding their industrial footprint. Many grocery stores now offer delivery or curbside pickup, which is generating greater demand for cold storage facilities. Providing fast and cheap delivery services has long been a goal for retailers, and the urgency of the coronavirus crisis is clearly accelerating efforts to, at the very least, bolster e-commerce capacity, in turn boosting demand for warehouses and distribution facilities. Demand for warehouse space will also likely be bolstered by greater preferences for holding precautionary inventories, particularly by manufacturers.

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**Figure 5**

Nominal Retail Sales

**Figure 6**

Global Export Volume

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

**Hotel Occupancy Perking Up, But a Long Way From Normal**

The gradual re-opening of many areas has also led to modest improvement in hotel operating fundamentals. For the week ending May 30, the occupancy rate was 36.6%, better than the lows hit in mid-April but still substantially below the 64.4% registered this time last year. Revenue per available room (RevPar) and average daily rates (ADR) have moved higher as well. While the small gains have been fairly widespread across major hotel markets, many beaches on the West and East Coast have re-opened, which has attracted an influx of visitors, many of which have arrived by car. Typical patterns in occupancy are also beginning to reemerge, where occupancy rates are higher on weekends and lower during the week, a sign leisure travel is starting to pick up.

Overall, the minor improvements in operating fundamentals indicate the bottom has likely been found, but the recovery will be sluggish. Business travelers made up about 20% of all travelers in 2019, and we expect many companies will be cautious in resuming business travel activities, opting
Business and international travel will be slow to return.

For virtual meetings, conferences and events instead. Similarly, we expect restrictions on international travel will remain in place until a vaccine is developed, which will also hold back the recovery. Last year, the United States welcomed 79.2 million visitors from abroad, or about 3.3% of total visitors. Even if leisure travel were to fully recover over the summer as states ease restrictions and virus transmission slows, the combination of lower business and international travel volumes will keep the occupancy rate, ADR and RevPar well below normal levels. Against this backdrop of lower demand, sales activity has dried up. There were just eight recorded hotel transactions in April, which is fewer than during the depths of the Great Recession.

COVID-19 Will Not Bring an End to the Office

The office market will clearly be challenged by the coronavirus. Leasing activity has dried up since mid-March, and many tenants have sought to renegotiate rental agreements. So far, heavy office-using industries such as finance and professional services have avoided the severe payroll losses experienced in hospitality, retailing and healthcare. But heightened uncertainty surrounding the trajectory of the economy has caused many businesses to slow capital investment, indicating demand for office space will likely weaken this summer and fall. Moreover, with many firms successfully implementing work-from-home policies, businesses are re-evaluating their longer-term space needs.

For the most part, construction has been permitted to continue through the shutdowns, meaning new supply will continue to be delivered amid the falloff in demand. We therefore expect rising vacancy rates and a sharp deceleration in rent growth in the second quarter. On the bright side, the office market was generally balanced headed into the crisis from a supply standpoint, with new supply essentially keeping pace with demand. Office development has been mostly restrained this cycle, which puts many office markets in a favorable position once the recovery begins. Still, it will likely take a couple of years for occupancy and rents to fully recover to prior-peak levels.

**Figure 7**

Daily Hotel Occupancy

**Figure 8**

Office-Using Employment

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

Over the long term, physical office space will still dominate.

The coronavirus crisis has raised questions about the necessity of office space, as many firms have successfully implemented work-from-home policies. While the switch to virtual working helps businesses comply with social distancing guidelines in the short term and might significantly reduce operational costs in the longer term, we still see the office environment providing the predominant workspace environment for office-using industries, such as financial and professional services and corporate headquarters facilities.

One of the most important issues employers have to weigh is how they can build and maintain a corporate culture with so many employees working remotely. Without a distinct corporate culture, businesses risk turning their service into a commodity, which would adversely impact revenues and lower the barriers to entry for new, more nimble competitors. Some of the cost savings associated with virtual work would also likely be offset by diminished productivity gains, particularly as workers are away from the office for longer. With workers in separate locations, simple-yet-
necessary tasks such as assigning work and organizing group meetings takes more time and effort, the costs of which add up over time. Furthermore, while virtual work can be a useful stop-gap measure to keep tasks and projects rolling forward, it is less conducive to innovation, which often leads to new products and processes that drive the success of the firm. The value proposition of the office is that it brings employees together and allows for frictionless collaboration between workers, boosting productivity and ultimately driving profits. What’s more, a dynamic, creative or eco-friendly work environment can be a valuable asset to attract the best-and-brightest talent. Another potentially substantial hidden costs of remote work is cybersecurity risk. Remote access to internal resources substantially increases cybersecurity risk, and many companies would need to expand and fortify their existing IT infrastructure.

All of this is not to say the COVID-19 crisis will not reduce demand. For the past two decades, the advent of laptops, cell phones and widely available WiFi has already reduced the square footage of office space per employee. Recent developments will likely accelerate that trend. With widespread availability of a vaccine at least 12 months away, businesses will need to find creative ways to comply with social distancing rules.

While the office will remain the predominant work environment for traditional office-using industries, the model will change. Work spaces will need to be adapted to provide more individual space, and elevators may need to be reworked with more advanced technologies. Common spaces and meeting rooms will need to be reconfigured, and offices will need to incorporate a larger cohort of remote workers. There is also the question of location. Will the move back to the city that personified much of the past decade reverse? A partial reversal was already underway prior to the pandemic, with many suburbs making efforts to increase density and boost walkability. We see these efforts intensifying, but downtown areas and near-in submarkets should still account for a larger share of office work than in prior decades. Collaboration is much more important in an information-based economy, and the best way to boost collaboration is close proximity to other workers.

**Apartment Market Outlook Looking Increasingly Bleak**

The tsunami of layoffs over the past two months will be a massive challenge for apartment owners. Thus far, payroll cuts have disproportionately hit hourly workers in leisure & hospitality industries, and rental markets driven by tourism have suffered the most acute impacts. Energy markets will also be thoroughly tested, as the collapse in oil prices has caused substantial layoffs in the oil & gas industry. The print and digital media industry has also come under pressure from reduced advertising revenues, which will weigh on some of the largest apartment markets such as New York City, Washington, D.C. and Los Angeles. In that same vein, diminished digital ad revenue has bruised the tech sector, which has been the primary driver for the San Francisco Bay area and Seattle, and a big contributor to growth in Boston, Denver, Austin and many other rapidly growing Sun Belt markets.

We expect the dramatic decline in employment coupled with the deluge of new supply set to hit many markets this year and next to push apartment vacancy rates higher and weigh on rents. Even though we expect economic indicators to turn positive this summer, employment will not likely reach its previous highs for 18 months or more. The COVID-19 crisis itself will also leave a mark and lead many homebound renters to consider trading the balcony for the backyard. Stay-at-home orders have cut access to shopping, entertainment and night life as well as proximity to professional and personal networks, all which are benefits of living in an urban environment. Mortgage rates remain extremely low, which will also push some renters towards homeownership. In short, the apartment market now faces substantial short- and long-term headwinds, and the road to recovery will be long and winding.
CRE Property Pricing & Fundamentals

- Real estate was the victim, rather than the villain, of this recession. COVID-19 sent customers and tenants fleeing from retail and office properties, while industrial and apartment properties—although less affected in the short-term—will soon feel the reverberations of shutdowns throughout the economy.

- The immediate threat to CRE is missed rent payments, but valuations will also come under pressure as investors digest the extent of the pullback in demand. Property price indices often lag ‘true’ mark-to-market values, particularly in times of heightened uncertainty. The direction of prices is clear, even though it is too soon to gauge the magnitude of price drops.

### CRE Cap Rates by Property Type

<table>
<thead>
<tr>
<th>Property Type</th>
<th>Q1 Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apartment</td>
<td>5.5%</td>
</tr>
<tr>
<td>Retail</td>
<td>6.7%</td>
</tr>
<tr>
<td>Industrial</td>
<td>6.5%</td>
</tr>
<tr>
<td>Office</td>
<td>6.5%</td>
</tr>
<tr>
<td>Hotel</td>
<td>8.7%</td>
</tr>
</tbody>
</table>

### CRE Transaction Volume

Volume: Q1 @ $131.2B

### CRE Property Price Index

Year-over-Year Percent Change

- National All-Property: Apr @ 6.5%
- Apartment: Apr @ 10.8%
- Retail: Apr @ 3.1%
- Industrial: Apr @ 8.3%
- Office: Apr @ 4.0%

### Origin of Capital Into the United States

- Canada: Q1 @ $15.4B
- Asia: Q1 @ $11.2B
- Middle East: Q1 @ $7.0B
- Europe: Q1 @ $15.4B
- Rest of World: Q1 @ $2.7B

Source: Real Capital Analytics and Wells Fargo Securities
Credit Availability & Lending

- The sudden shutdown of large parts of the economy and spike in uncertainty surrounding how the virus and public policy response will play out has caused credit officers to tighten lending standards.
- On March 23, the FOMC announced it would include agency commercial mortgage-backed securities (CMBS) in its massive new asset purchase program. The promise of a Fed liquidity backstop caused CMBS spreads, which had previously blown out, to tighten a bit.
- While banks entered the crisis well-capitalized, the sharp pullback in economic activity will heighten risk aversion. On the non-bank side, a number of distressed funds have launched.
COVID-19 has disproportionately affected younger, low-wage workers, who are more likely to rent than own a home. Apartment communities that cater to hospitality workers would appear most at risk. Higher-end apartment, which cater to young, professional services workers, have fared better and have had relatively few delinquencies.

The apartment market is also threatened by the deluge of supply coming on-line in the next 18 months, when demand will be soft. There were 669,000 units under construction in April, double the number of completions. Construction is ongoing, but absorption is likely to slow.

Much of the growth in apartment stock this cycle has been in the urban core or close-in submarkets. A large proportion of recent construction has been higher-end, lifestyle units.

There is no clear way to forecast sudden major shifts in housing preferences. We suspect that the demand for urban living, while dented in the short term, will remain relatively strong going forward. Millennials and Generation Z are more racially and culturally diverse than prior generations, and a large proportion will continue to seek urban living.

Rents have already begun to soften in many markets that were previously among the hottest in terms of absorption and new development.

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

- COVID-19 sent millions of employees back to their homes to work remotely and forced a reckoning over how much office space firms really need. Nearly all the advantages of office work over teleworking stem from proximity, the very thing that COVID-19 has rendered unsafe.
- According to experts, the risk for COVID transmission is greatest indoors, particularly when there is close verbal contact. Modern HVAC systems and the way they circulate air have also raised concerns. The recent trend towards open office plans is under major pressure due to health concerns.
- Facebook and Alphabet have announced their work-from-home policies will continue the remainder of 2020, while Twitter announced it will become a permanent option for all its employees.
- Office-using employment fell much less sharply in April (-6.8% year-over-year compared to -14.6% for non-office employment), but the irony is that many of those workers in the former category were not using the office. Working from home, however, is not a perfect substitute for working in the office.
- Co-working space has been harshly impacted. Its distinguishing feature are flexible, short-term leases, which are the first things firms cut back on when they suddenly need to cut expenses. Tenants also skew heavily toward start-ups, many of which have uncertain income streams.

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

- Recession tends to accelerate existing trends, and perhaps nowhere is this more true than in retail. The share of sales at non-store retailers has been steadily rising for years, but jumped more than six percentage points in just two months, according to the Department of Commerce. Alternative data from credit card spending suggest the jump was even larger. Sometimes a decade happens all at once.

- Of course, circumstances will change as brick-and-mortar stores re-open, but consumers may remain wary and choose not to patronize physical establishments until the pandemic is in the clear.

- The initial phase of ‘re-opening’ for many retailers has centered around curbside pickup. With curbside pickup limiting interaction, one of the remaining advantages of physical stores has been neutralized, furthering the shift to online shopping.

- We have written extensively about how consumer preferences for experiences rather than goods have meant businesses that can cater to that niche outperformed. Social distancing has challenged that niche, however, particularly restaurants and gyms.

- Retail bankruptcies have already begun, including J. Crew and Neiman Marcus. A wave of consolidation and downsizing is likely. What emerges will be much leaner and one more integrated with online platforms.

Source: MBA, CoStar, Inc., U.S Department of Commerce and Wells Fargo Securities
COVID-19 has crushed demand for certain industrial properties but been a boon for others. Global trade has crated, reducing port traffic and hurting downstream sectors. The abrupt shift towards online shopping, however, has driven demand for fulfillment and distribution centers to a fever pitch. The transition from brick-and-mortar to online continues to redirect customer dollars from traditional retail stores to industrial, with investment dollars following.

Amazon has led the charge, hiring close to 200,000 workers in Q1 alone. The company was initially forced to prioritize shipments of essential goods, and is investing billions to be able to meet the surging demand. The question is how much of this increase will be permanent.

Grocery delivery has also gained significant market share, raising demand for warehouse and refrigerated storage space. Instacart aims to hire nearly 500,000 workers. One out of three households report shopping for groceries online. While online sales will give back some of their recent gains once consumers resume in-person shopping, social distancing has broken significant barriers.

While the recession is centered in the services sector, the domestic manufacturing sector has also been impacted. New orders have been vastly curtailed, while cap-ex plans have been shelved. Even some of the strongest companies have indicated their plans are on pause for now, holding back demand for manufacturing space.

Hotel

- The coronavirus crisis has devastated the hospitality industry. In terms of occupancy, the low point was hit in April, when the nationwide occupancy rate hit 18.9%. That said, occupancy rates appear to have bottomed, with rates hitting 42% in the last week of May. Even so, the trek back will likely be agonizingly slow.

- Air travel remains down close to 90% year-over-year, according to TSA data, but is up from its nadir on April 14, when just 87,524 people passed through security checkpoints. The uptrend should continue over the summer but will remain below year-ago levels through the end of this year.

- Consumer demand will likely rebound before business demand. Numerous large corporations have announced extended travel bans or moratoriums on large events. Corporate travel and event planners have largely shut down events this year. Leisure travel should improve this summer, led by destinations with outdoor activities, such as the beaches, mountains and national parks. Destinations where the bulk of travelers arrive by car should also fare better than those that depend on air travelers.

- Room rates plummeted in April, based on the CPI. Operators are constrained by fixed capacity, meaning RevPar will be weak through year-end. Hotels will focus on boosting efficiency by increasing use of information technology and striving to book more rooms via in-house reservation systems.

Source: STR and Wells Fargo Securities
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