December 14, 2020

Economics Group

WELLS FARGO SECURITIES

Special Commentary

Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 410-3277
Charlie Dougherty, Economist
charles.dougherty@wellsfargo.com • (704) 410-6542
Nicole Cervi, Economic Analyst
nicole.cervi@wellsfargo.com • (704) 410-3059

Commercial Real Estate Chartbook

CRE Fundamentals Still Struggling to Find Secure Footing

The economy continues to gradually improve. After plummeting in the second quarter, real GDP jumped at a 33.1% annualized rate in Q3. While this record-setting pace comes as welcome news, it still leaves the level of GDP well short of the peak hit at the end of 2019. The recent resurgence in COVID infections tempers this positive development. The arrival of cooler weather has coincided with the onset of pandemic-fatigue. COVID case counts have sky rocketed ahead of the cold and flu season, stressing hospital capacity and bringing about more lockdowns and restrictions.

With COVID cases again climbing, economic growth in the fourth quarter will likely downshift substantially. Renewed pressure on many hospital systems has led to a patchwork of restrictions on businesses and social gatherings in many large cities, including Los Angeles and New York. Most of California now faces some sort of operating restrictions. Despite these setbacks, the economy appears to have enough momentum behind it to remain solidly in positive territory. While high-contact activities remain challenged, consumers have shifted spending toward goods. Stronger demand for things such as cars, home furnishings and electronics has given a boost to manufacturing. Similarly, the need for more space to make room for virtual activities, as well as low mortgage rates, has led to soaring home sales and single-family construction. Overall, we expect real GDP growth to moderate to a 5.3% annualized pace in Q4.

Longer term, the picture looks much brighter. The first vaccine is now being rolled out and two or three others are likely to follow in short order. Widespread distribution, however may take several months. Still, effective vaccines should help bring the return of many of the in-person and indoor activities by late spring or early summer. Of course, vaccine deployment stands to benefit commercial real estate immensely. Retail stores should start to see larger volumes of foot traffic, hollowed-out office buildings will begin to fill back up with workers, and hotels will likely see a rebound of vacation-starved travelers. Business travel, however, will take longer to return.

Vaccine deployment stands to benefit commercial real estate immensely.

Figure 1

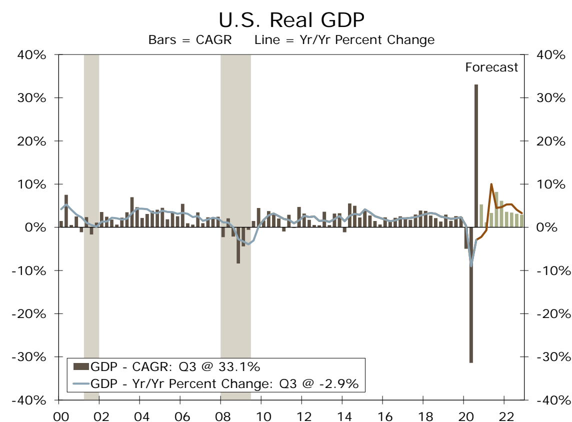
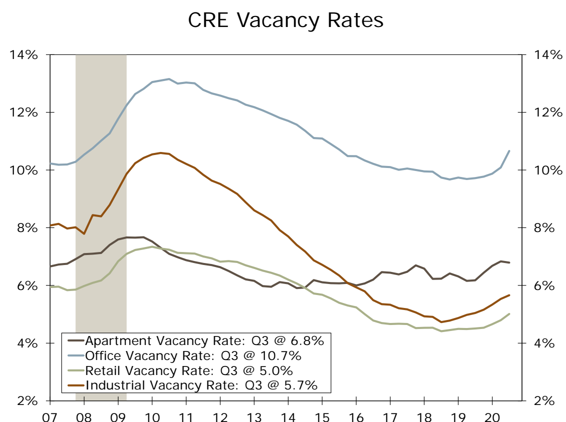


Figure 2



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

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

Retail and office property vacancy rates increased sharply during the third quarter.

Still, the full effects of vaccines will likely not be realized until the calendar moves deep into 2021. Until then, there is still an uphill climb ahead for commercial real estate. Retail and office property vacancy rates increased sharply during the third quarter (Figure 2). Preliminary estimates for October and November point to vacancies rising even further in Q4. Similarly, after markedly improving alongside the pickup in summer travel, hotel occupancy rates now appear to be moving in the opposite direction. Industrial vacancy rates also ticked up in Q3, as new deliveries slightly outpaced an upturn in demand. Apartment vacancy rates fell slightly as some of the pent-up rental demand from the spring lockdowns was unleashed.

Not surprisingly, rising vacancies are putting downward pressure on rents. On a quarter-over-quarter basis in Q3, apartment, retail and office rents all declined (Figure 3). This is the first time these property types have seen rent growth in negative territory since the Great Recession. Rents in the beleaguered retail sector fell furthest and registered a 0.6% decline. By contrast, industrial rents actually picked up 0.7% over the quarter, reflecting stronger leasing activity as e-commerce businesses, retailers and logistics firms rush to secure warehouses and distribution facilities to accommodate the massive ongoing shift to online shopping.

Figure 3

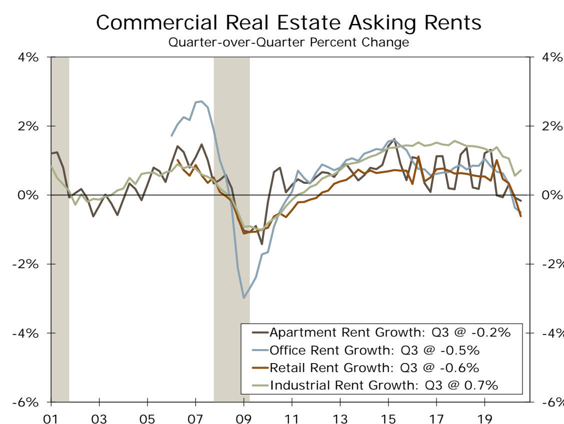
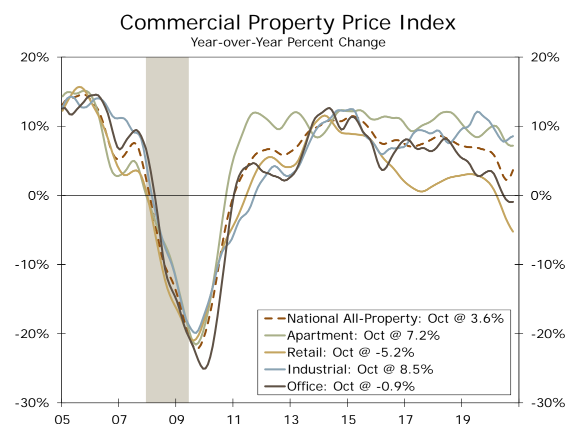


Figure 4



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

The divergence between retail and industrial rents is also evident in property valuations. In October, industrial prices again outperformed all other property types (up 8.5% year-over-year), while retail prices fell more than any other category (-5.2%). Office valuations are down 0.9% over the year, driven by falling suburban office property prices. Central business district (CBD) office prices have held up much better, improving 3.5% on a year-over-year basis. The resiliency of CBD office prices lends credence to our view that the office will remain the predominant location for office-using industries, even if some workers continue to work remotely post-COVID.

Fast-growing apartment markets are outperforming the dense, global gateway markets.

Apartment valuations have also been more buoyant than expected. While apartment property price appreciation has moderated since February, valuations are still 7.2% above prior year levels. However, there appears to be quite a bit of regional disparity. Fast-growing apartment markets which have seen robust job and population growth over the past decade are generally outperforming the dense and less affordable global gateway markets. For example, apartment prices in Tampa, Phoenix and Nashville are up over 10% over the year, while New York and Chicago apartment valuations have slumped.

The overall resiliency of property prices should allay fears that plunging valuations could potentially ripple through the entire commercial real estate industry and leave property owners, investors and lenders all worse for the wear. One caveat, however, is that current pricing is still clouded by the substantial drop-off in sales. The future income potential of many CRE properties is still in question, which is contributing to the widening gap between sellers' and buyers' perceptions of property values. Overall sales activity did pick up in Q3, with transaction volumes

growing to $73.4 billion. Still, this low volume of transactions is roughly on par with the pace registered in 2012.

A mounting overhang of troubled loans might also give rise to even more distressed asset sales and put additional downward pressure on prices. CMBS delinquency rates have inched lower in recent months, but remain highly elevated. As displayed in Figure 5, the number of borrowers who are behind or late in payments is concentrated in hotel and retail properties. Apartment, industrial and office delinquency rates have also risen, but to a much lesser extent.

The number of borrowers who are behind or late in payments is concentrated in hotel and retail properties.

Delinquency rates might be even higher were it not for federal fiscal relief programs, forbearance agreements and debt relief granted by servicers. According to Fitch Ratings, approximately 665 loans ($20.2 billion), or 4.2% of all Fitch-rated U.S. CMBS loans, have received some form of relief since the start of the COVID crisis through November. Even with relief efforts on multiple fronts, the number of distressed sales has risen. There were 57 distressed sales (totaling $739 million) in Q3, up from 48 ($683 million) in Q2, according to RCA. These figures only represent about 1% of all transaction volumes, yet distressed sales for hotel, retail and apartment properties all appear to be headed higher. There is a mountain of cash waiting to pounce on any bargains that find their way to the market. So far, bargains have been few and far between.

Overall, challenging times for commercial real estate are likely to extend into 2021. That noted, there is a light at the end of the tunnel. A host of effective vaccines are set to roll out in coming months, which should be the antidote to what ails the hotel and retail sectors. Both will take some time to mend, however. And while many office, apartment and industrial markets have certainly been swayed by the pandemic, operating fundamentals in those properties appear to be holding up much better than initially feared. Much of the rhetoric about the future of work appears to be over the top. Will more workers work remotely? Absolutely. The majority of office work, however, will continue to be done in office buildings and the density provided by downtown areas still offers a great value for innovation.

Commercial real estate fundamentals were in a relatively strong position heading into the crisis, which should allow for quicker turnaround once the pandemic is over. Demand for office space was strong in 2019 and office construction lagged demand for much of the past decade. This past decade's robust pace of apartment construction, particularly in downtown areas, is a concern (Figure 6). That noted, the bulk of this construction has taken place in fast-growing markets in the South and Mountain West. Demand for rentals in these areas should be supported by the continued influx of jobs and residents from less affordable coastal areas. Aside from apartments, builders and developers have been restrained for the past decade, meaning vacancy rates and rents will recover more swiftly once the economic recovery gains more steam.

Commercial real estate should be headed for a quicker turnaround once the pandemic is over.

Figure 5

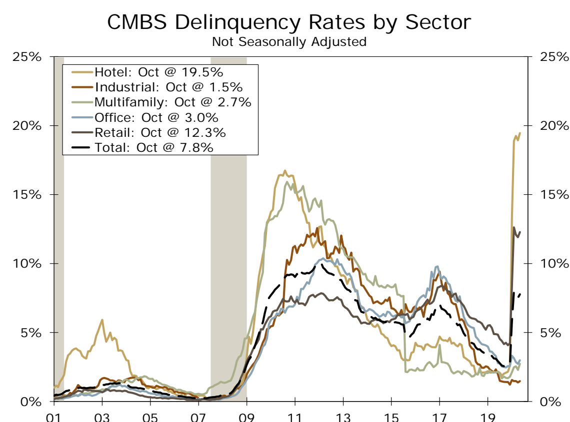
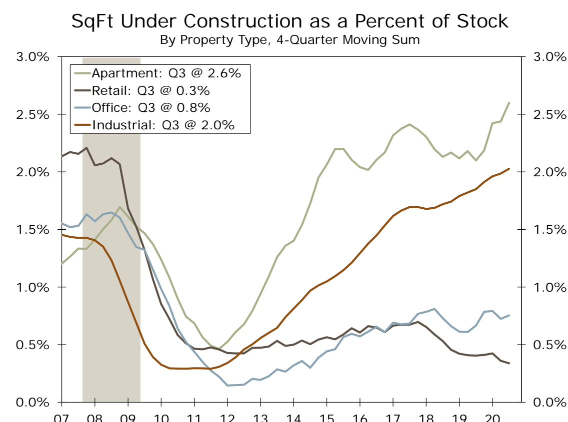


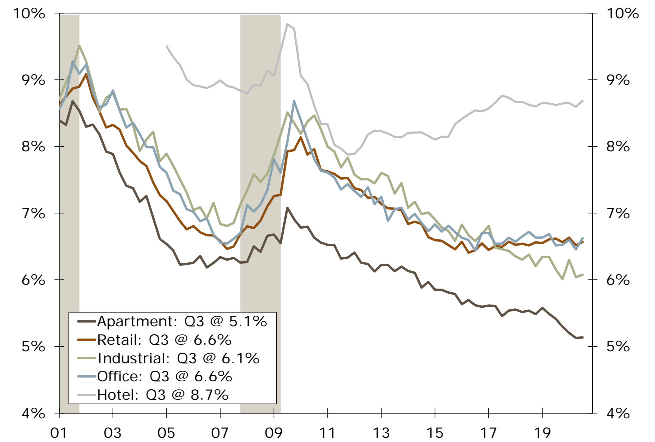
Figure 6

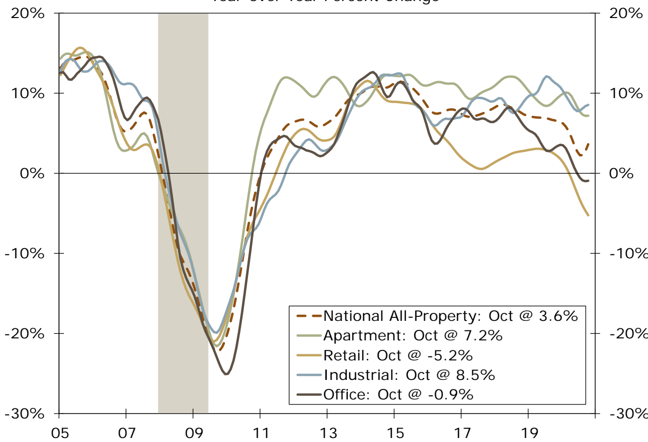


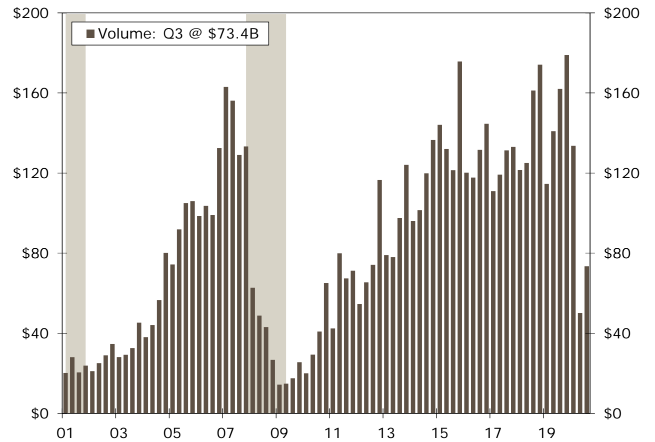
Source: Moody's Analytics, CoStar Inc. and Wells Fargo Securities

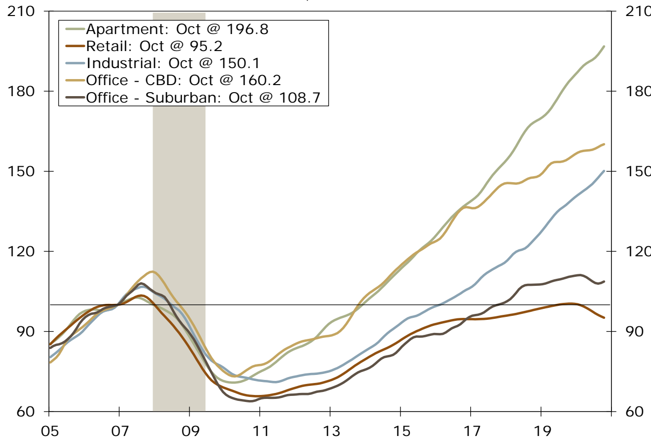
CRE Property Pricing & Fundamentals

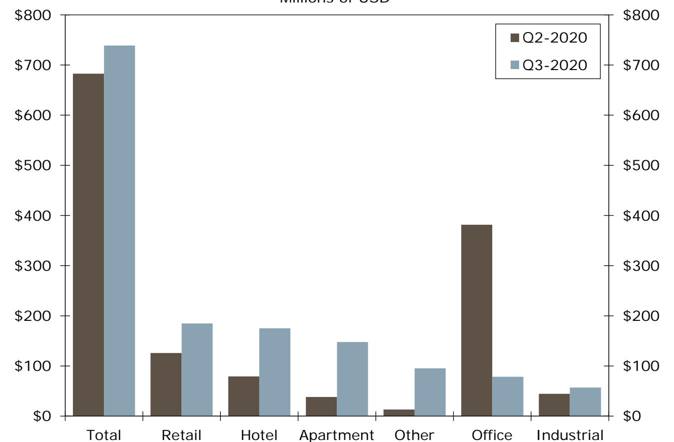
- Deal activity perked up somewhat, rising to $73.4 billion in the third quarter. While slightly improved, transaction volume is down 55% over the year. Mismatched buyer and seller expectations of value continues to limit sales.
- Property price appreciation turned up in October. The national all-property price index rose 3.6% over the year. The reacceleration was led by industrial (8.5%), apartment (7.2%) and CBD office (3.5%) prices. Retail (-5.2%) and suburban office (-1.6%) valuations declined.
- Pricing is still somewhat clouded by the depressed level of transaction volumes, however. Mounting distressed asset sales could potentially weigh on price appreciation.







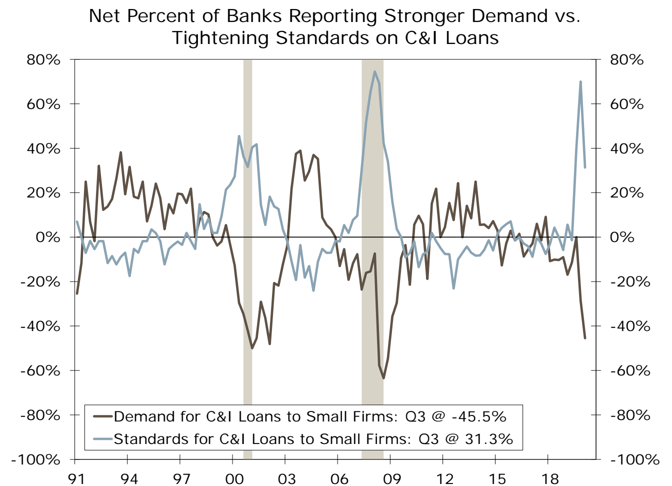


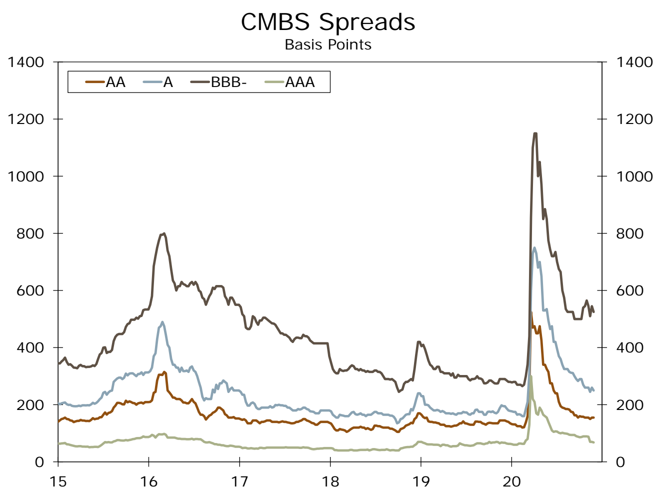


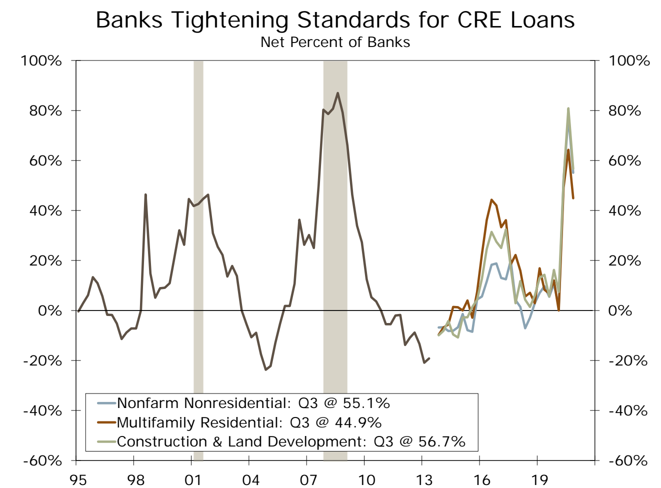
Source: Real Capital Analytics and Wells Fargo Securities

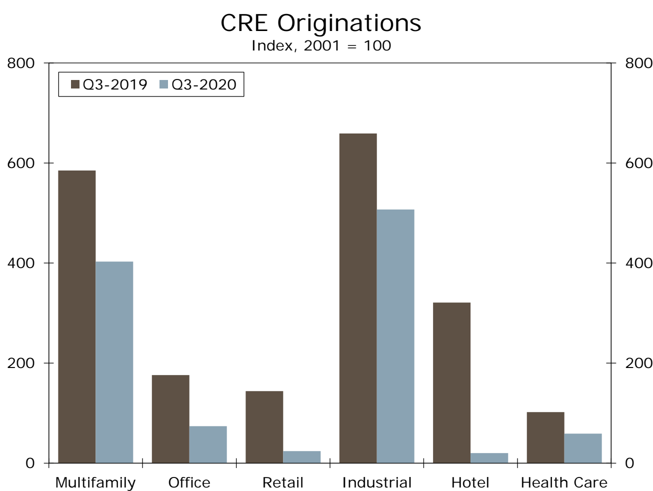
Credit Availability & Lending

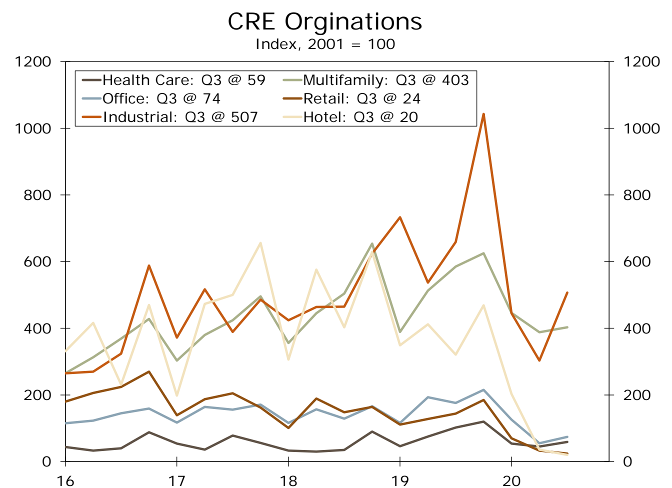
- Credit standards slightly eased in Q3, although the net percent of banks tightening standards remains elevated. Easier credit standards follow what appears to be a continued downdraft in demand for commercial & industrial (C&I) loans.
- Loan originations for industrial buildings jumped 67% in Q3, while office (35%), health care (31%) and multifamily (3.9%) originations also climbed. Retail and hotel lending pulled back 27% and 44%, respectively.
- Commercial mortgage-backed security (CMBS) spreads have significantly compressed since blowing out earlier in the spring. Spreads have generally not returned to pre-COVID levels, but higher-rated tranches have narrowed quicker.







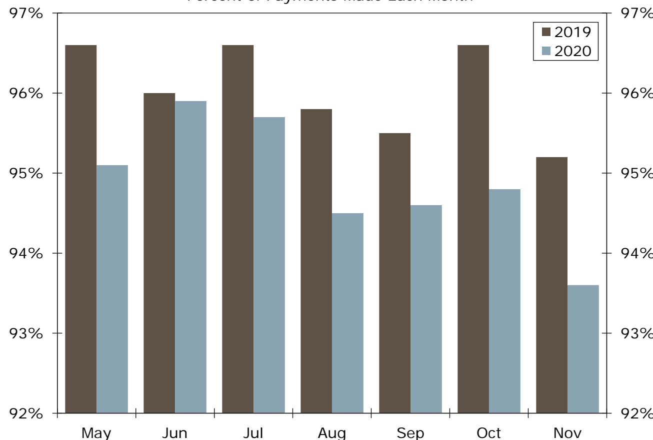


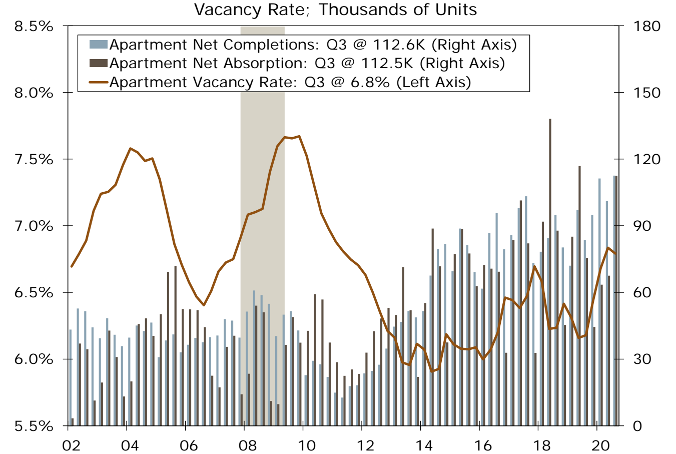


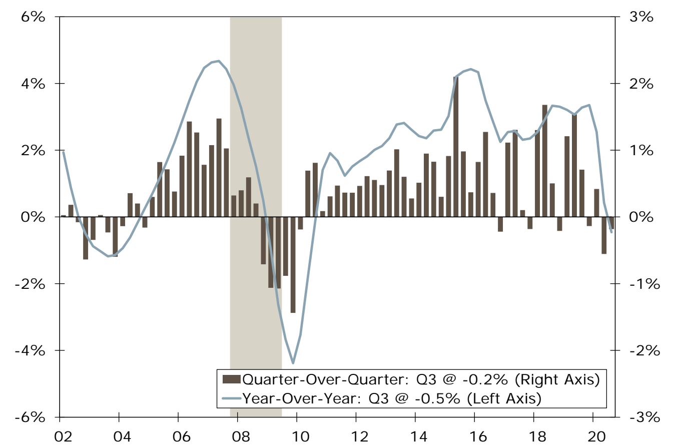
Source: FDIC, FRB, Moody's Analytics, Mortgage Bankers Association (MBA) and Wells Fargo Securities

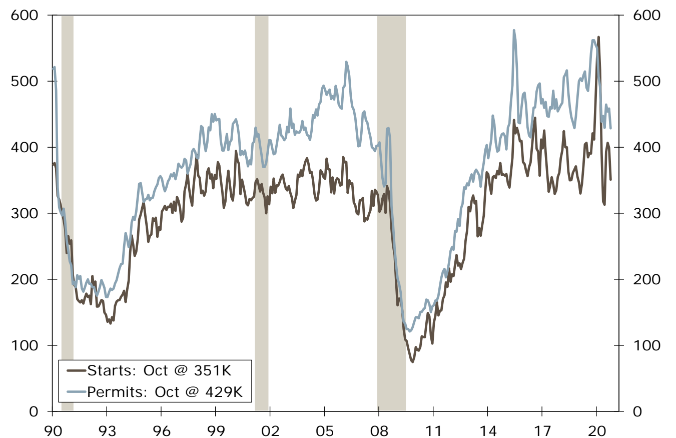
Apartment

- Demand for multifamily units surged in Q3, suggesting that the second quarter's weakness was potentially a result of the lockdowns rather than reduced underlying demand. The vacancy rate remained elevated at 6.8% in Q3.
- The exodus of urban renters to the suburbs and smaller, secondary markets is gaining traction. Leasing in suburban areas primarily drove net absorption in Q3, as downtown areas saw weaker demand. Supported by record low mortgage rates and the desire for more space, single-family home buying has been incredibly strong lately.
- Supply remains a concern. Over 113,000 units were delivered in Q3, with another 570,000 units under construction. Deliveries in denser, urban markets may prove difficult to lease out in 2021.
- Asking rents inched down 0.2% over the third quarter. As renters moved out of the cities, suburban and urban rents have diverged. According to CoStar, suburban rents have recovered, while downtown rents are more than 5% below their pre-pandemic levels. We expect rents to weaken further, especially in urban areas, but also in the suburbs.
- While households generally appear to be making timely rent payments, the NMHC Rent Tracker fell for the first time since August in November. Rising long-term unemployment and the forthcoming expiration of eviction moratoriums at year-end may drive increased delinquencies in 2021.





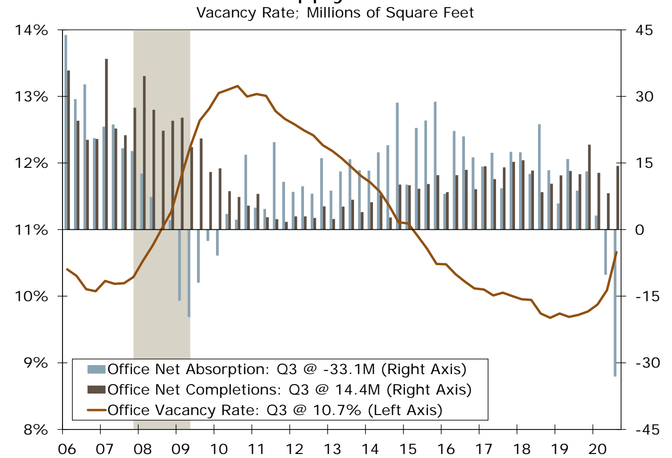


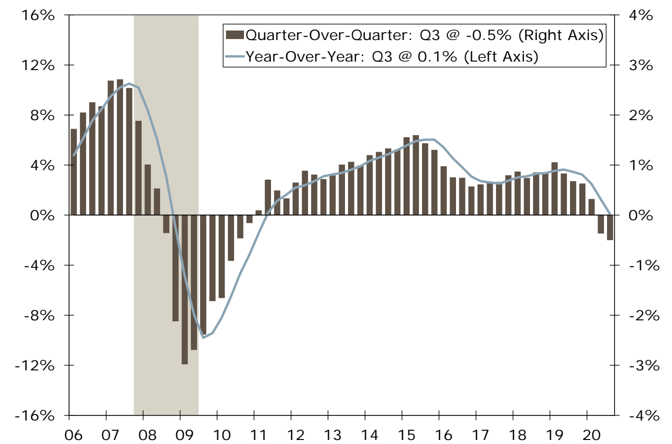


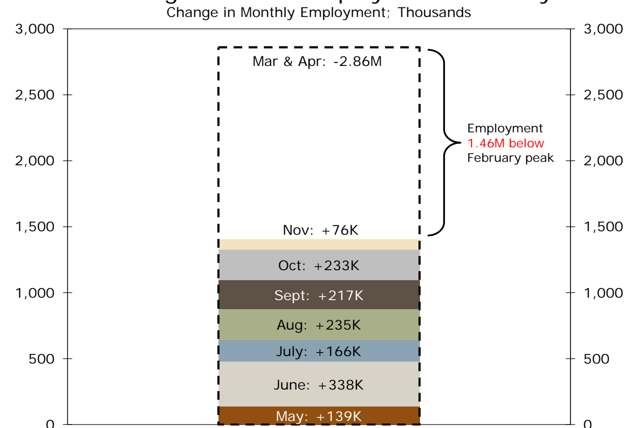
Source: CoStar Inc., U.S. Department of Commerce, National Multifamily Housing Council and Wells Fargo Securities

Office

- Office space demand continued to fall in the third quarter as many companies extended their work-from-home policies well into 2021. Many businesses are reconsidering their long-term space needs. During the quarter, the vacancy rate rose 0.6 percentage points to 10.7%.
- Rent growth was essentially flat in Q3. As many tenants cut down on their space utilization, property managers appear to have flooded the market with discounted sublet space. This may add downward pressure to asking rent growth in the coming quarters.
- Markets with strong demographic growth such as Charlotte, Austin and Atlanta continue to see waves of new deliveries. Elevated supply levels may keep vacancy rates high next year should demand for office space continue to soften.
- Even with the ability to work remotely, the latest pandemic wave is taking a toll on hiring in white-collar industries. Office-using industries added just 76,000 jobs in November, the fewest since March and April when firms shed nearly 2.9 million jobs. Only about half (49%) of those jobs have since been recouped.
- Although we still believe office space plays a key role in fostering collaboration and productivity, there is clearly some merit to a work-from-home employment mix. We expect the integration of remote work to weigh on demand for office space over the long-term but a rise in space allocated per worker will offset some the impact.



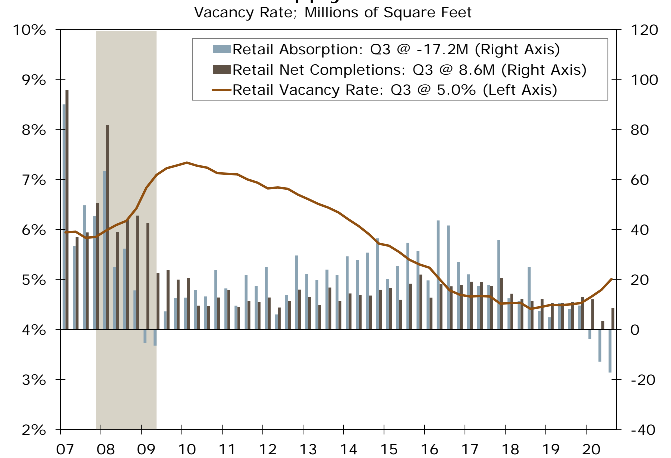


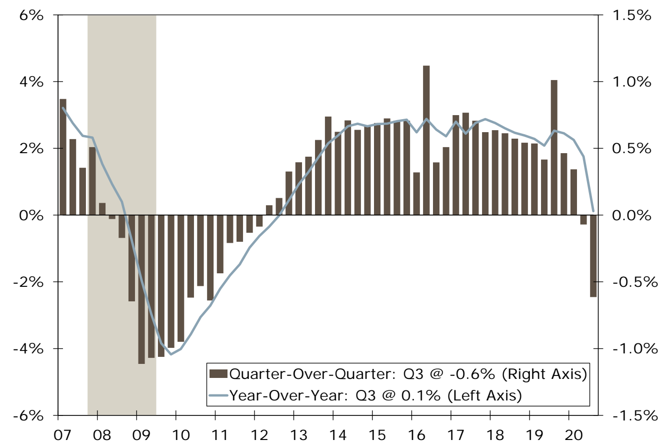


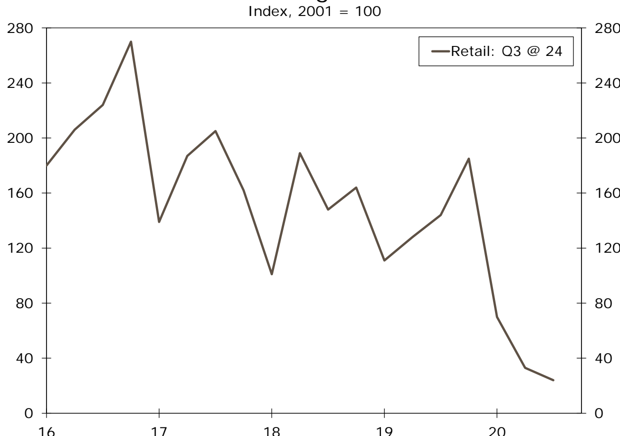
Source: CoStar Inc., U.S. Department of Labor, MBA and Wells Fargo Securities

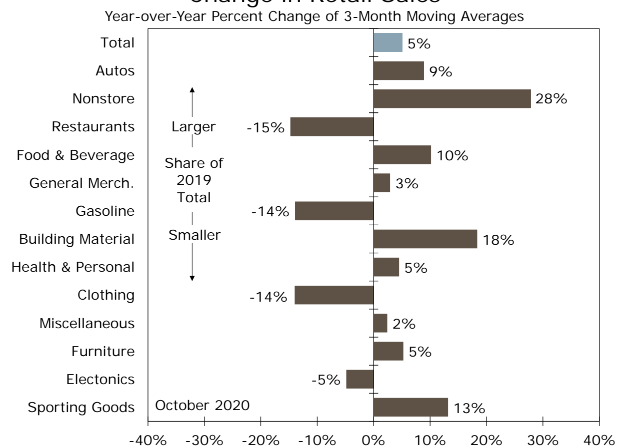
Retail

- The pandemic continues to wreak havoc on the retail sector. Net absorption remained negative for the third consecutive quarter in Q3, amid weakening demand and a growing list of retailers declaring bankruptcy. The vacancy rate rose to 5.0% from 4.8% the prior quarter.
- Asking rent continued to contract in Q3, falling 0.6% over the quarter. Eroding occupancy rates and reduced rent collections have pressured rent growth. Nonessential retailers in particular are seeking rent concessions or deferrals.
- Essential services and durable goods oriented retailers have shown resilience while small retailers with limited e-commerce capabilities have continued to struggle. Big-box stores, general merchandisers and pharmacies were among the most active lessees in Q3.
- A migration toward lower-cost, suburban areas may be supporting retail fundamentals in smaller markets. Large coastal cities such as Boston and Los Angeles saw rents fall in Q3. By contrast, Southeastern markets such as Nashville and Tampa saw a rise in rents.
- Retail sales have moderated over the past few months, as consumers have started to pull back spending again. Lawmakers are again negotiating another round of fiscal relief, although we do not expect the absence of stimulus to lead to a cratering in sales. The savings rate remains elevated, which will support spending even if a new bill does not come to pass.





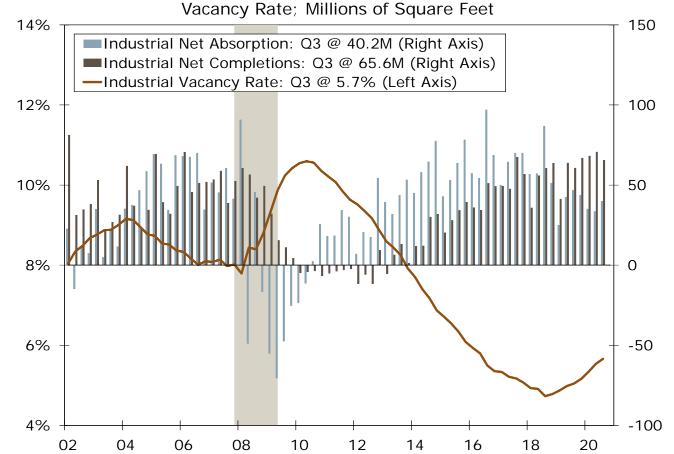


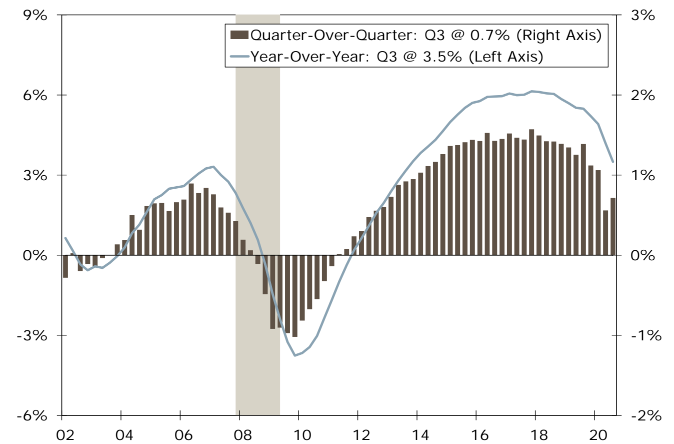


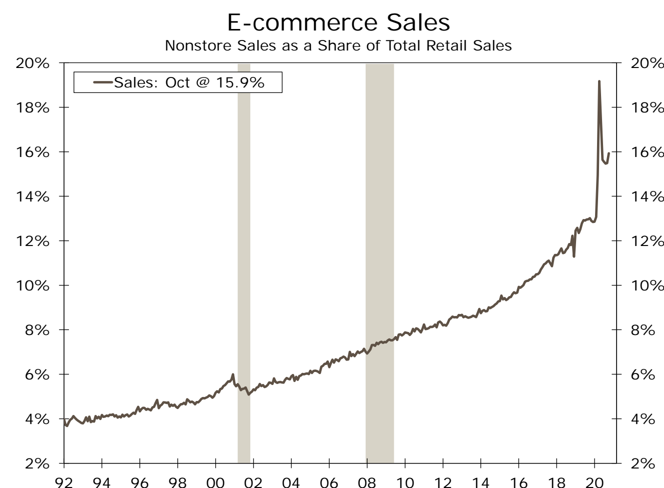
Source: CoStar Inc., U.S Department of Commerce, MBA and Wells Fargo Securities

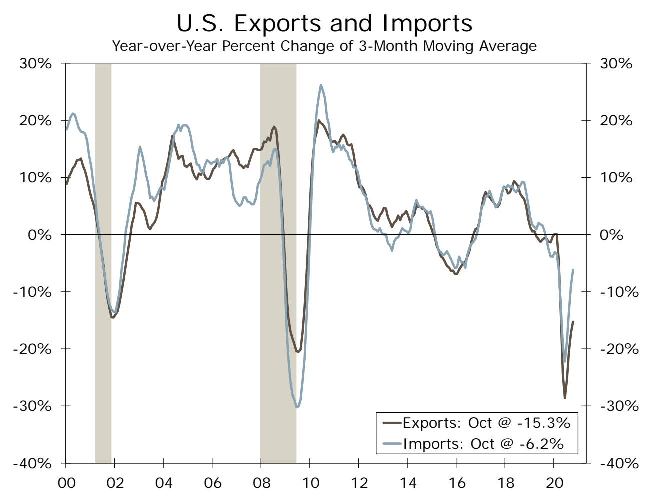
Industrial

- The industrial market has been one of the most resilient sectors of the economy in 2020. Demand for industrial space was robust in Q3, as firms invested in their logistics and industrial functions. Despite strong demand, the vacancy rate ticked up to 5.7%, as completions outpaced net absorption. Asking rent growth continued to ease, but is still up 3.5% year-over-year.
- Social distancing measures have bolstered online shopping and supported already strong demand for warehouses and distribution centers. While Amazon continues to lead leasing activity, third-party logistics operators, home improvement stores and general merchandisers, such as Walmart and Target, were also among the third quarter's most active lessees.
- International trade is rebounding with strength in exports and imports. Imports have outpaced exports, driven by strong domestic demand for consumer goods. Although export activity has more ground to make up, gains have been broad-based, with notable strength in industrial supplies and capital goods. But with COVID cases on the rise and reinstated global restrictions, trade could be disrupted again in the near-term.
- The pandemic has shined a light on vulnerabilities in global supply chains. With this in mind, industrial capacities will likely be reshored, especially those concerned with healthcare or national security.





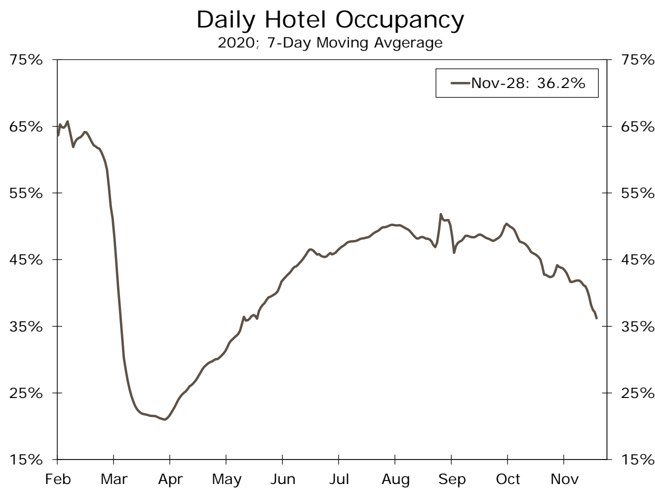


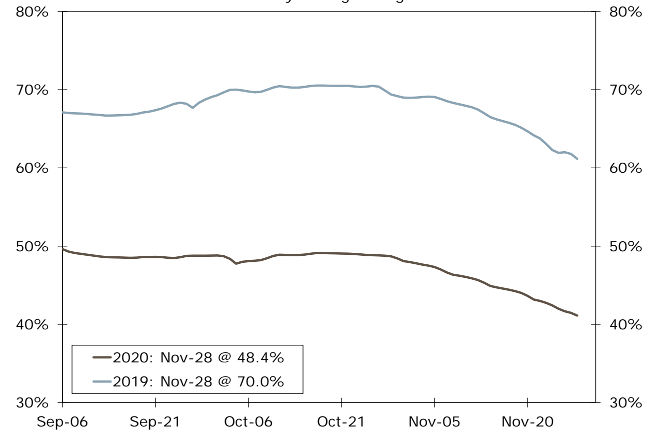


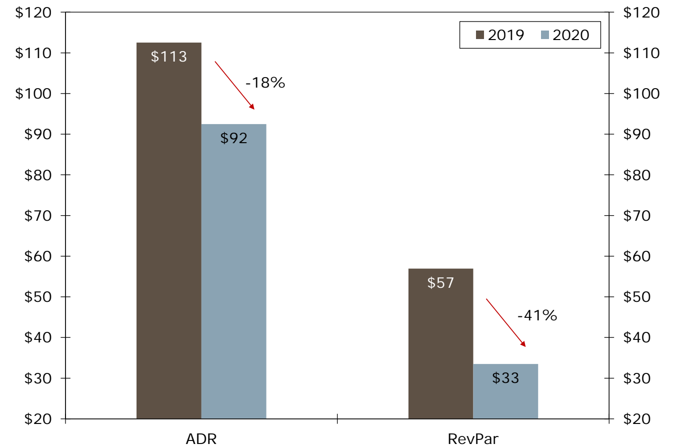
Source: CoStar Inc., U.S. Department of Commerce and Wells Fargo Securities

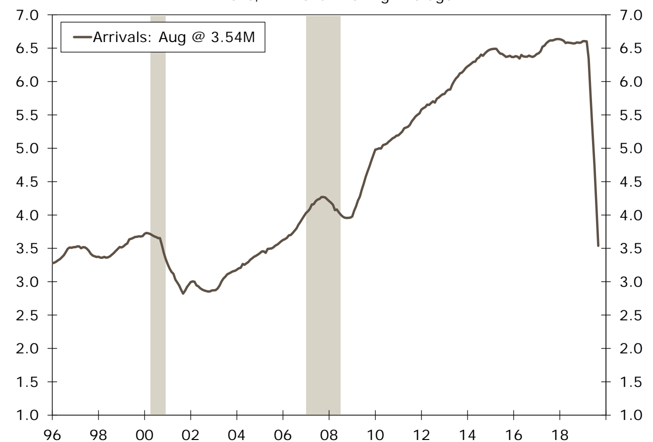
Hotel

- Hotel occupancy rates have started to sag again as COVID cases surge across the country. During the week of November 28, the occupancy rate fell to 36.2%, which is the lowest rate since lockdown restrictions were first eased in late May. Occupancy tends to fall as the temperature drops and the holidays approach. That said, the pandemic is still clearly weighing heavily on travel, with occupancy rates about 22 percentage points below prior-year levels.
- Average daily rates (ADR) and revenue per available room (RevPAR) both remain depressed from relatively weak demand for hotel rooms. In the last week of November, ADRs were 18% smaller over the same period last year. RevPAR has since fallen even further and is down 41%.
- A highly effective vaccine will come as welcome news to the hotel industry. Assuming vaccine deployment is successful, there will likely be a resurgence in bookings, as consumers seek to make up for all of 2020's cancelled trips, vacations, weddings, sports, concerts and other special events.
- But even with a vaccine, a full return to pre-COVID levels will take time. Businesses will likely remain cautious about lifting travel restrictions for their employees. Business travel made up about 20% of overall travel in 2019. International travel, which remains roughly 90% below prior-year levels, will likely take even longer to recover, as vaccines will take some time to reach developing nations.









Source: STR, National Travel and Tourism Office and Wells Fargo Securities

Wells Fargo Securities Economics Group

Name	Title	Phone	Email
Jay H. Bryson, Ph.D.	Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	International Economist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	International Economist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economist	(704) 410-1681	shannon.seery@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Nicole Cervi	Economic Analyst	(704) 410-3059	nicole.cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	(704) 410-1437	sara.cotsakis@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Canada, Ltd., Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC. is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC. and Wells Fargo Bank, N.A. are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2020 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

WELLS FARGO SECURITIES