Special Commentary — February 24, 2021

The Economic Outlook: What Could Possibly Go Wrong?

Part X: Significant Declines in Commercial Real Estate Prices

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Summary

In this penultimate installment in our series on economic risks, we look at the effects that the COVID pandemic may have on the commercial real estate (CRE) market in the United States. The need to socially distance has necessitated work-from-home (WFH) for most office workers, which has led to weaker demand for office space. The retail and hotel sectors of the CRE market have also been dealt blows from social distancing protocols and the reluctance to travel for work or pleasure. Will these adversely affected sectors of the CRE market ever recover? Will the U.S. financial system be able to handle a wave of CRE foreclosures, should it occur?

While the shift to WFH will alter the way office workers do their jobs in coming years there will still be demand for office space, given the key role it plays in fostering collaboration, innovation, culture and productivity. Likewise, retailers will continue to need "bricks and mortar" modes of distribution, although the mix could shift in favor of outdoor town-center formats at the expense of indoor shopping malls. Demand for personal travel and the associated need for hotel accommodations likely will recover after the pandemic passes, while business travel will likely take more time to recover.

Despite the marked rise in vacancy rates and the weakening in CRE rents, prices of CRE properties have generally held up relatively well so far. That noted, we readily acknowledge more stress might emerge in the CRE market if a re-acceleration of COVID case growth were to shut down the economy again. In that event, more CRE mortgages could become non-performing. But given the strong capitalization of the American banking system at present, we do not believe that CRE poses a meaningful near-term threat to the viability of the U.S. financial system.

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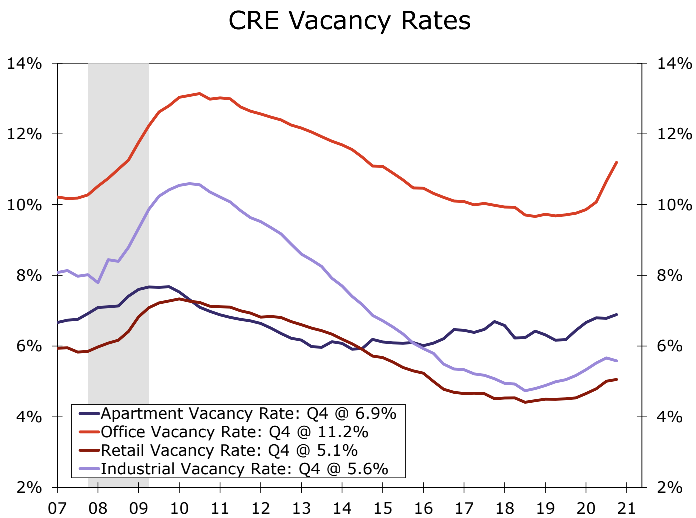
What Effects Will WFH Have on the Demand for Office Space?

Vacancy rates have risen, and rent growth has turned negative in the retail and office markets.

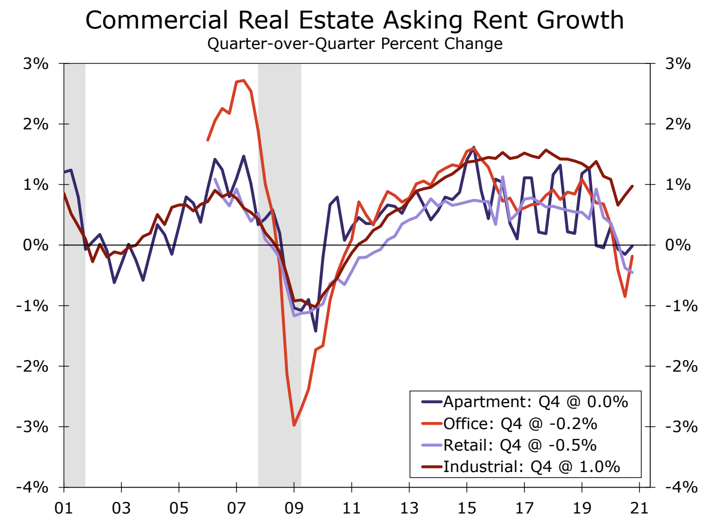
COVID has wreaked havoc on commercial real estate (CRE). Social distancing and other safety precautions have upended demand for office space, retail stores, hotels and other types of commercial real estate where close-contact and engagement is intrinsic to the property's value proposition. Vacancy rates across all major property types ended 2020 above pre-pandemic levels (Figure 1). Rent growth has slowed markedly, and in the case of office and retail buildings, dipped into negative territory (Figure 2). That said, the industrial sector of the CRE market has benefited from soaring e-commerce sales and increased demand for warehouses and distribution facilities, a trend that we expect to continue in the years ahead. For that reason, the focus of our analysis in the remainder of this report will be on properties that have been most adversely impacted by the pandemic, namely the office, retail and hotel markets.

Figure 1



Source: CoStar Inc. and Wells Fargo Securities

Figure 2



Source: CoStar Inc. and Wells Fargo Securities

Occupancy at office buildings remains depressed.

While the pandemic has certainly had a profound impact on CRE, what is less certain is to what extent the short-term, stop-gap measures put in place to contend with the pandemic become long-lasting. The long-run impact of remote work on the office market is perhaps the biggest question. As we have previously written, office space plays a key role in fostering collaboration, innovation, culture and productivity. For that reason, we remain of the belief that the office will continue as the predominant workspace for office-using industries in a post-COVID environment.

Still, the pandemic has not yet abated and occupancy at office buildings remains depressed. According to Kastle Systems, a security firm that monitors access-card swipes in office buildings in major markets across the United States, the average occupancy rate was 23.8% in early February, just a fraction of the 98.4% average level seen in February 2020. Despite the surprising success of WFH initiatives, pandemic-fatigued employers and employees are likely eager for a return to an office setting. Vaccines should eventually help spur an increase in office occupancy, but the full effects of mass inoculations will take time to be realized. The emergence of several new variants add another layer of uncertainty, which has led a number of employers to push out the return to the office from this summer to Labor Day or into 2022. At the current pace of just over one million vaccinations a day, 60% of the U.S. adult population could be vaccinated by the end of August.

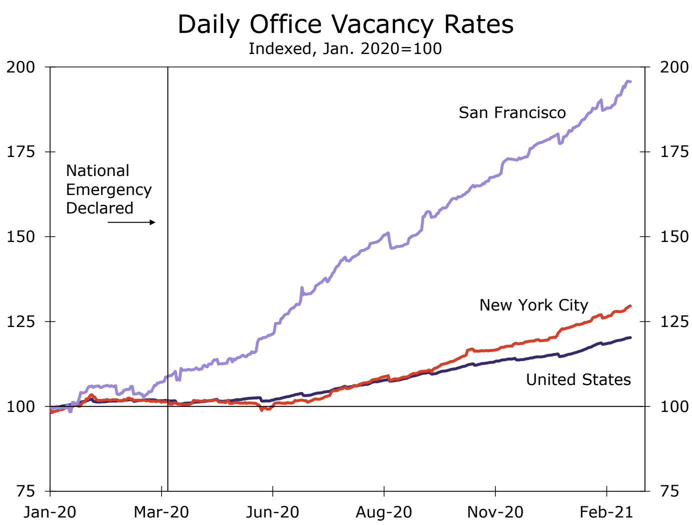
The success of virtual work should continue to cut into demand for office space.

Although we anticipate a return to the office once a larger share of the U.S. population has been vaccinated, there are also questions about how much space businesses will need once the pandemic is fully contained. The experience of the past few months has revealed there are merits to having at least some employees working remotely. Transitioning to a hybrid workforce, where some workers remain remote and still periodically meet in the office, might reduce occupancy costs without a significant drop-off in productivity. According to the McKinsey Global Institute, more than 20% of the workforce could remain productive while working remotely three to five days a week.

Even under a hybrid model, firms may need to maintain their current footprint in order to accommodate social distancing requirements, which are likely to remain in place well after the pandemic has ended. Of course, the pandemic will probably bring other changes to the office environment. Once workers return, there is likely to be a heightened focus on safety for onsite workers and virtual access for those who are still remote. Instead of upgrading older buildings with enhanced air filtration systems, UV lights and smart conference rooms, tenants may prefer to lease space in new buildings, where many of these amenities are already in place. Similarly, there will likely be a shift toward greater flexibility through the use of hoteling stations and agile workspaces. A larger share of the workforce remaining remote and increased focus on occupancy costs may be a boon for flexible, shared office space. According to CBRE, roughly 86% of companies plan to use flexible space as a key part of their real estate strategies in the future.

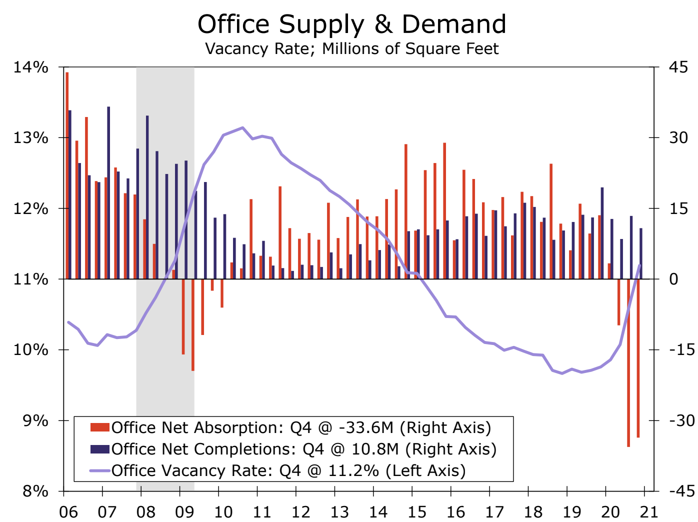
Overall, the surprising success of virtual work should continue to cut into demand for office space. Demand, however, should strengthen next year from its current depressed level as employers bring more of their workforce back and space needs are more certain. Employment in office-using industries remains roughly 3.5% below prior peak levels, but has steadily improved since bottoming in April 2020. Despite all the recent turmoil, many office tenants appear to still be paying rent and holding on to leases, although waves of sublet space have flooded many hard-hit markets such as San Francisco and New York City (Figure 3). Furthermore, office development has been mostly restrained for the past decade, which puts many office markets in a favorable position once a recovery gains steam (Figure 4).

Figure 3



Source: CoStar Inc. and Wells Fargo Securities

Figure 4



Source: CoStar Inc. and Wells Fargo Securities

Rumors of Retail's Demise Have Been Greatly Exaggerated

The retail segment of the CRE market also continues to feel the reverberations of the pandemic. Vacancy rates rose to 5.1% in the final quarter of 2020 (Figure 1) and asking rents fell 0.4% on a year-over-year basis. That noted, it is hard to blame retail's recent hardships entirely on the coronavirus crisis itself. The dire straits into which traditional brick-and-mortar retail had fallen prior to the onset of the pandemic is well-documented, and the decline has only been hastened by an aversion to in-store shopping and accompanying leap toward purchasing items online. Over 12,000 stores closed in 2020 amid a rising tide of bankruptcies and store rationalizations, according to CoStar.

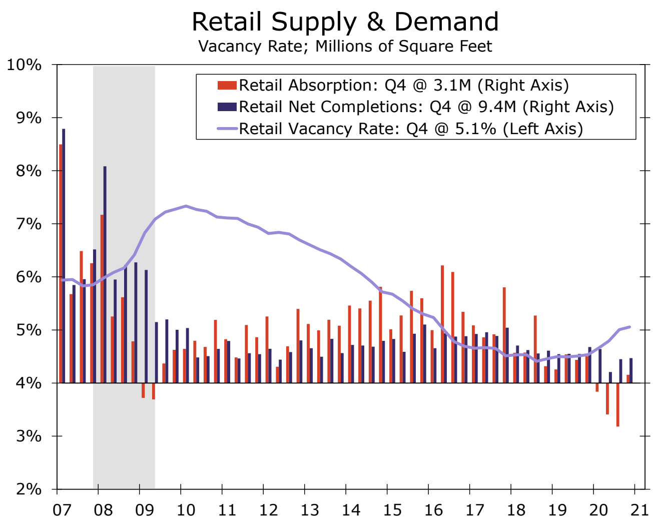
Not every segment of retail is crumbling.

What's more, the high cost of social interactions has encouraged more people to discover the benefits of online shopping more quickly than they otherwise would have, speeding up the timetable for reshaping the retail sector. We continue to emphasize, however, that not every segment of retail is crumbling. Even with a growing share of sales occurring online, retail sales have more than bounced back from the initial losses experienced last spring and total sales were up 7.4% on a year-over-year basis in January. Net absorption (new demand) for retail space was positive during Q4-2020 for the first time since 2019, which provides further evidence that the negative impacts of the COVID crisis have not been universally negative on the retail market (Figure 5).

For example, retailers that offer curbside service and provide products that augment or enhance home living spaces, including furniture, appliance and home electronics, have generally outperformed. Building material stores and big-box stores with robust e-commerce platforms are holding up well and appear poised for stronger growth in the years ahead as more time is spent at home. The same goes for grocery stores and pharmacies, especially those providing online-ordering, delivery, drive-thru and pick-up services. Post-COVID, a greater number of remote workers is also likely to spur more retail development in suburban and exurban areas. Town-center properties, which are mostly outdoor and walkable, also stand to benefit in a world of social distancing and preference for open-air activities. Many of these spaces incorporate residential, office and entertainment, as well as nontraditional options such as playgrounds, gyms, banks, hair salons and medical facilities. Not only do we see town-center formats flourishing, but we also see many traditional enclosed shopping malls transitioning toward this format.

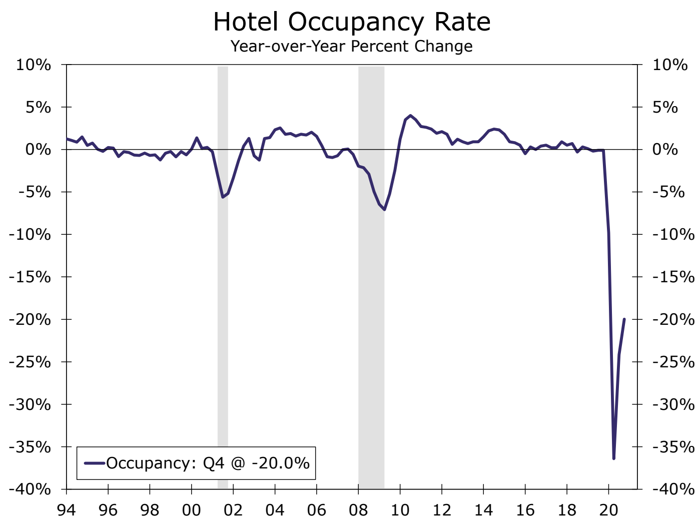
Retailers will also increasingly incorporate a "bricks and clicks" strategy that utilizes the efficiency and time-saving aspects of e-commerce, while having a limited physical store to fulfill the need for consumers to vet products for quality and authenticity in-person. A vaccine will clearly help bring back all forms of in-store shopping, but many of these COVID-related trends will likely prove durable.

Figure 5



Source: CoStar Inc. and Wells Fargo Securities

Figure 6



Source: STR and Wells Fargo Securities

Hotels: Personal Travel Likely Will Recover More Quickly Than Business Travel

Hotel occupancy rates generally remain depressed.

The hotel market has also clearly been swayed by COVID safety precautions and the drop-off in travel of all forms. Recently, hotel occupancy rates have begun to climb higher as COVID case counts have started to descend (Figure 6). During the week ending February 13, the occupancy rate rose to 42.6%, which is the highest since November, but still well below the 62.6% hit during the same week last year. Average daily rates (ADR) and revenue per available room (RevPAR) both remain depressed from relatively weak demand for hotel rooms. In mid-February, ADR and RevPAR were down 25.7% and 49.5%, respectively, compared to a year ago.

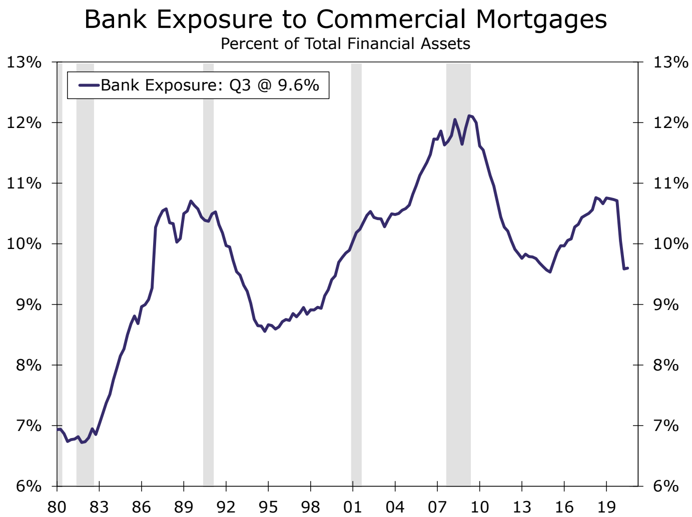
Assuming vaccine deployment is successful, there will likely be a resurgence in bookings, as consumers seek to make up for vacations, weddings and other special events that were canceled in 2020. Although there should be a burst of travel as the population progresses toward herd immunity, business travel will likely not recover as quickly as businesses probably will remain cautious about lifting travel restrictions. Furthermore, international travel, which remains well below prior-year levels, will likely take even longer to recover, as vaccines will take some time to reach developing nations. Even with a rebound in leisure travel, hotels will still face increased competition from online vacation rental services like Airbnb and VRBO, particularly while consumers are concerned about COVID.

Risk to the Financial System from Commercial Mortgages Appears to Be Manageable

Exposure to commercial mortgages accounts for less than 10% of banks' financial assets.

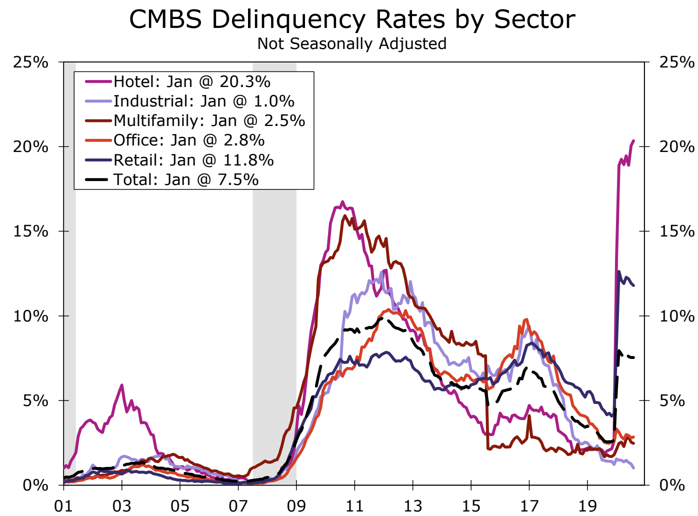
Considering the seismic impact of the COVID crisis on commercial real estate, it is worth pondering the extent to which any negative effects could ripple through the banking system and the U.S. economy more broadly. American banks have a significant amount of absolute exposure to commercial property. The value of commercial mortgages outstanding currently stands just above $3.8 trillion, and 62% of that debt is owned by U.S. depositary institutions. On a relative basis, however, the banking system's exposure to commercial debt generally appears to be manageable. Commercial mortgages accounted for 10.7% of total bank assets on the eve of the pandemic, which was below the high of 12.1% reached in 2009, and that ratio has subsequently receded to 9.6% (Figure 7). The balance sheet of the overall American banking system is widely diversified across commercial mortgages, residential mortgages, commercial & industrial loans (C&I), consumer credit and debt instruments such as U.S. Treasury securities.

Figure 7



Source: Federal Reserve Board and Wells Fargo Securities

Figure 8



Source: Moody's Analytics and Wells Fargo Securities

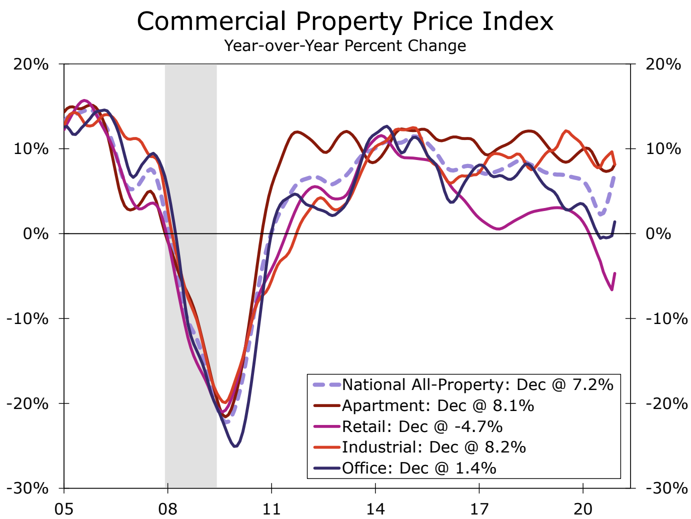
A sharp decline in property prices has yet to materialize.

The ascent in delinquency rates for commercial mortgage-backed securities (CMBS) also appears to be leveling off, at least for most types of properties (Figure 8). Delinquency rates for hotel properties have ticked higher but delinquencies among retail properties, although elevated, have edged lower recently. Delinquency rates among apartment, industrial and office properties are little changed relative to a year ago.

Of course, U.S. banks could still suffer significant losses if the commercial property market were to deteriorate further throughout 2021. As mentioned above, vacancy rates continue to climb and office and retail rents have moved into negative territory. A sharp decline in property prices, however, has yet to materialize. In December, RCA's National All-Property Price Index accelerated to a 7.2% year-over-year pace (Figure 9). One reason why property valuations have held firm is that there has also not yet been a substantial increase in distressed sales outside the hotel and retail sectors. Unlike the 2007-2009 period, financial markets have generally remained liquid, meaning owners have been more easily able to refinance and not been forced to sell their properties.

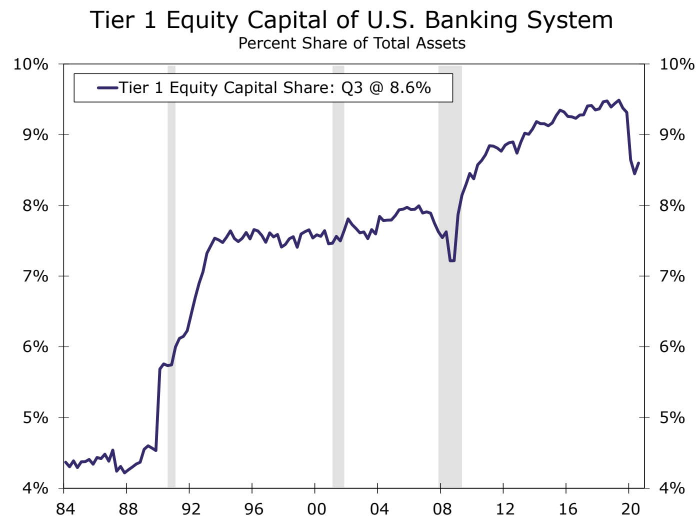
If the economy were to go back into lockdown again due to a significant re-acceleration in COVID case growth, then the pace of distressed transactions could conceivably pick up. In that event, property valuations could come under downward pressure and some commercial mortgages could become non-performing. But the ratio of Tier 1 equity capital to total assets, which measures the loss-absorbing capacity of the U.S. banking system, is at a high level today (Figure 10). In short, the American banking system is very well-capitalized today, which should give it the ability to weather a downturn in the CRE market.

Figure 9



Source: Real Capital Analytics and Wells Fargo Securities

Figure 10



Source: FDIC and Wells Fargo Securities

Conclusions

The pandemic has caused some stress in the CRE market, especially in the office, retail and hotel segments. Vacancy rates have risen since the onset of the pandemic, and rent growth has slipped into negative territory for some classes of properties. Delinquency rates have risen on mortgages that are secured by hotel and retail properties, but other types of CRE loans continue to perform rather well.

The pandemic clearly has had profound short-run effects on segments of the CRE market, but what is less certain is the extent to which these short-term effects will become long-lasting. We are of the belief that although WFH will alter the way that office workers do their jobs in coming years, there likely will still be demand for office space given the key role it plays in fostering collaboration, innovation, culture and productivity. Likewise, retailers likely will continue to need “bricks and mortar” modes of distribution, although the mix could shift in favor of outdoor town-center formats at the expense of indoor shopping malls.

Prices of CRE properties have generally held up rather well so far, but we readily acknowledge that more stress could emerge in the CRE market if a re-acceleration of COVID case growth were to shut down the economy again. In that event, more CRE mortgages could become non-performing. But given the strong capitalization of the American banking system at present, we do not believe that CRE poses a meaningful near-term threat to the viability of the U.S. financial system.

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