Bright Spots in U.S. Commercial Real Estate

June 18, 2020

by Tim Wang, Julia Laumont
of Clarion Partners

Prior to the Coronavirus crisis, commercial real estate (CRE) demand and supply fundamentals were largely healthy in most markets and property sectors. The U.S. labor market and household formation had been very strong, driving robust demand for commercial space. Relatively conservative underwriting and rising construction costs constrained new supply.

In recent months, however, the global pandemic has led to a rapid downturn of the U.S. economy, negatively impacting different industries and real estate dynamics. The fallout is still developing, and the ultimate impact of the outbreak on the economy and the CRE sector remain uncertain.

Nevertheless, we believe that the unprecedented monetary and fiscal stimulus programs – and the transitory, self-induced nature of the shutdown – will facilitate an economic recovery once the outbreak subsides and/or the virus is treatable. Pent-up demand will also encourage a rebound.

Pre-crisis, U.S. CRE had near-cycle low vacancy rates and attractive pricing relative to U.S. Treasuries and investment grade bonds, which may help mitigate some of the negative impact. U.S. financial institutions are not over-leveraged thanks to tighter regulations after the global financial crisis (GFC) of 2008.

Social distancing practices and changing daily routines appear to be accelerating some existing trends in CRE, which will influence sector allocation strategies.

Pre-Coronavirus fundamentals combined with preliminary impacts of the pandemic may lead to:

- Industrial's ongoing rise,
- Retail's continued slide,
- Increased allocations to multifamily,
- Gradual lessening of importance of the office sector, and
- Gradual growth in alternative property sectors.

We expect investors to make strategic adjustments in sector allocations to reflect these shifting investment themes, which may help enhance portfolio performance while reducing potential risks.

Industrial Sector Benefits from E-Commerce Trends

The ongoing e-commerce boom has benefited the industrial warehouse sector. In many ways, industrial has become the new retail. Online sales growth is the primary driver of the sector's significant outperformance and retail's substantial underperformance.

Over the past 20 years, U.S. e-commerce has grown at an 18.2% compound annual growth rate (CAGR), and it continues to gain market share as a percentage of retail sales. E-commerce sales still account for less than 15% of total core retail sales but are forecast to grow to 30% by 2030.

Demand for Class A warehouse and distribution properties has remained very strong, and new warehouse space is expected to grow by about 1.6 billion square feet through 2025. This assumes that every $1 billion increase in e-commerce sales effectively requires an additional 1.25 million square feet of new warehouse space.

According to Adobe Analytics, online sales surged by 49% in April over March as millions of consumers stayed at home and avoided shopping in stores. It's likely that the Coronavirus crisis and social distancing practices will expand e-commerce market share more quickly.

We likely are less than halfway through building the required infrastructure for continued e-commerce expansion, with several years to go. Having recognized this dramatic change, many investors are scaling back on retail and increasing industrial sector exposure.

Investor Interest in Alternative Property Types Grows

There is also likely to be stronger interest in alternative property types. More investors are pursuing investments in life sciences properties, medical office buildings (MOBs), student housing, data centers and self-storage. Some of these property types exhibit core-like investment characteristics, including relatively stable cash flow, high occupancy and good liquidity. We expect that allocations will increase in the years ahead.

The Coronavirus crisis should accelerate several existing themes in CRE, including the continued fall of selected retail – mainly malls and big-box heavy power centers.

Increasingly risk-averse institutional investors are favoring Class A properties in supply-chain logistics, rental housing and health care. Their top priorities are stable cash flows and strong credit tenancy. They look for properties that feature adaptable omni-channel businesses and urbanization outside of big city central business districts that benefit from the outperformance of certain regions and aging demographics.

IMPORTANT INFORMATION