Economic Analysis

Commercial real estate in the wake of the Covid-19 crisis

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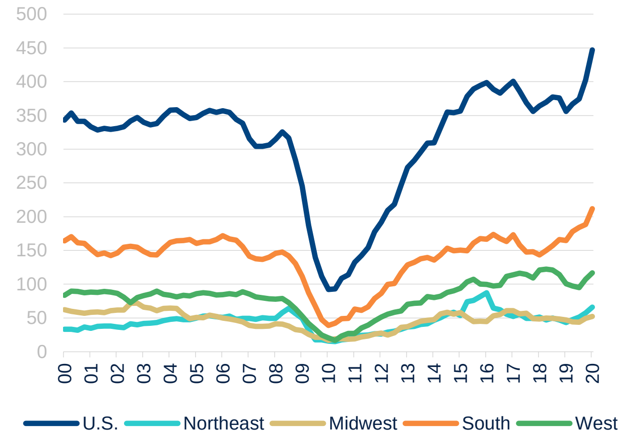
The commercial real estate (CRE) sector is experiencing a significant disruption in the wake of the Covid-19 crisis that could have significant long-term consequences. Before the current downturn, the industry enjoyed an extended period of favorable vacancy rates, rising prices and increasing inventories. However, the unprecedented increase in unemployment, the large-scale transition to work from home, and the decline in activity in many face-to-face service industries are leading to demand destruction, higher vacancy rates and rent declines. Even after the acute stage of the crisis is behind us when a vaccine or a therapeutic becomes widely available, questions will remain about the future of the office and brick-and-mortar retail. This brief presents our outlook for CRE conditions over the coming two-and-a-half years, conditional on our baseline macroeconomic scenario, which contains a strong shock to economic activity in 2Q20, a strong but incomplete pick-up in 2H20 and a moderate recovery thereafter.

Apartments

Since the last downturn, the apartment segment benefited from strong demand for housing as millennials started forming households while renting for an extended time. This mostly benefited the most attractive large metropolitan areas which tend to be denser and therefore more conducive to apartment living. The strong demand led to a solid level of new multi-family construction, particularly in 2Q14-1Q17 and in 2Q19-1Q20 (Figure 1). The second wave of strong apartment building in 2019 was supported by attractive financial conditions, but it came to an abrupt end in the second half of March of this year. Multifamily housing starts in April stood at 260 thousand SAAR, the lowest since 2013, but still significantly above the lows reached during the Great Recession.

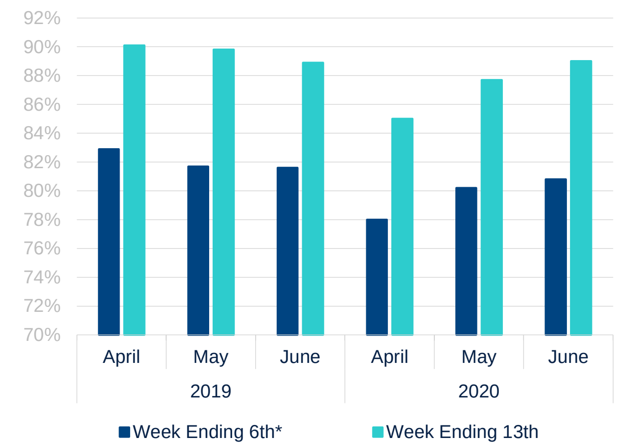
With the unemployment rate increasing to close to 15% in April, some landlords experienced late or incomplete rent payments. However, according to data from the National Multifamily Housing Council (NMHC) this has been limited, at least when it comes to professionally managed apartment units. Moreover, the pace at which rent payments are made has recovered completely in June (Figure 2), with 89% of apartment households making a full or partial rent payment by June 13 – a 0.1 percentage point increase compared to the period through June 13, 2019. This positive development has undoubtedly been undergirded by the recovery in job creation, enhanced unemployment benefits (set to expire at the end of July unless Congress decides to extend them), and the Economic Impact Payments that have been sent to 159 million individuals, totaling almost $267bn. That said, landlords other than professional apartment renting companies are likely facing mode difficult conditions, especially if they rent to lower-income individuals, which have been disproportionately adversely affected by the decline in employment.

Figure 1. **Housing starts of multifamily units (Thousands, SAAR, 4-quarter moving average)**



Source: BBVA Research and Census Bureau

Figure 2. **Apartment rent payments made**

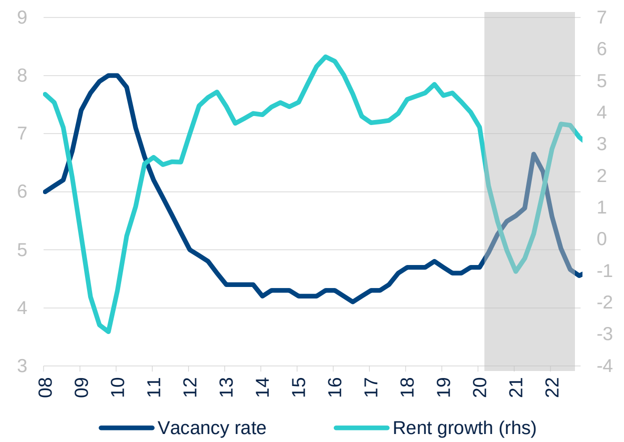


* Initial results that might be impacted by seasonal factors
Source: BBVA Research and NMHC

Vacancy rates will experience upward pressures from the increase in unemployment and economic uncertainty. The completion of a number of projects that will deliver a nontrivial number of new units in 2020 and 2021 will also be a significant factor. In other words, the market imbalance in 2020 and 2021 will be due to both a retrenchment in demand and an increase in supply. However, due to generous unemployment benefits as well as an economic recovery that will gain steam in 3Q20, we expect the national apartment vacancy rate to remain below Great Recession highs. The increase in vacancies will go hand in hand with a modest to moderate decline in rents (Figure 3), depending on location. Over the mid-term, higher vacancy rates will suppress somewhat new multifamily housing starts, which in turn will help rebalance the market.

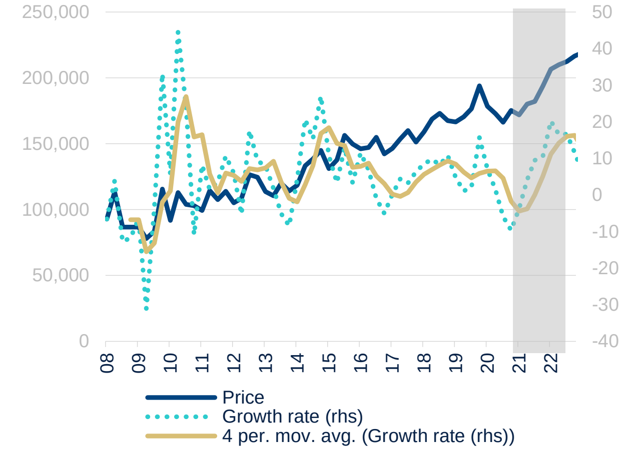
Apartment prices per unit at the national level have been increasing at a solid rate over the last decade, but this trend will be temporarily interrupted by a modest decline in prices over the 2Q20-1Q21 period (Figure 4). The decline in prices will be limited to some extent by the tight overall supply of housing after an extended period of suboptimal new construction of single-family units over the last decade, which indirectly benefits the multifamily market. Additionally, the recovery of the economy, low interest rates, and an active monetary policy that supports asset prices will limit the downside risk to some extent.

Figure 3. **Apartment vacancy and effective rent (% and % YoY)**



Source: BBVA Research and REIS

Figure 4. **Apartment prices ($ per unit and % YoY)**



Source: BBVA Research and RCA

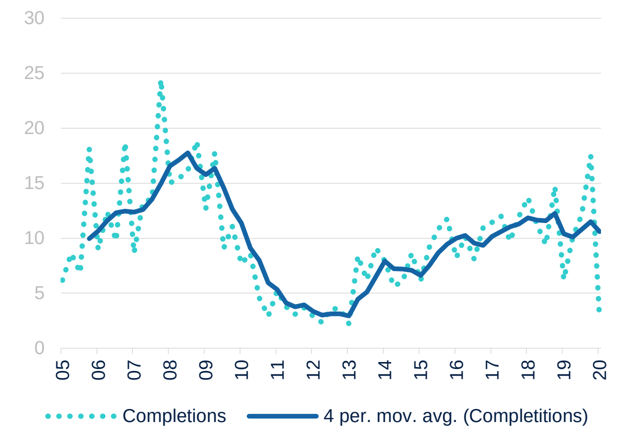
Apartment capitalization (cap) rates have been declining since 2010. While we expect the risk premiums to increase in the short-term, the low risk-free interest rates will offset some of this uptick, resulting in relatively stable cap rates, especially after the economy regains its footing, vacancies start to decline and rents begin to increase.

Beyond the current downturn, the apartment segment will benefit from younger cohorts renting for extended periods, and Baby Boomers downsizing in larger numbers. While central business district apartments have been relatively more attractive than suburban locations over the last decade, the tide could turn as teleworking becomes more widespread and commute times become less of a concern, particularly in suburban locations that provide amenities comparable to some central locations like cultural and shopping experiences in addition to recreation facilities, parks, and nature preserves. That said, the elevated uncertainty around how individuals balance the risks and benefits of health issues and living in denser areas remains.

Offices

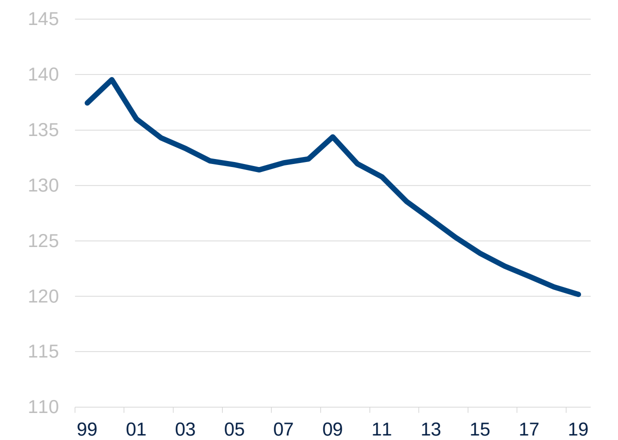
Office construction over the last cycle remained below the levels reached over the preceding one (Figure 5) despite solid gains in office employment. Employers were able to allocate progressively less square feet per employee (Figure 6), leveraging trends such as flexible workspaces, hoteling, and open space layouts. With the onset of the current recession, the office segment is facing both cyclical and structural shifts. The cyclical drivers in the form of lower office employment and cost-cutting measures by businesses are easily identifiable. The structural changes are less clear at this point but will likely include a combination of lower density and increased telework. Likewise, the ongoing shift toward a service-oriented, high-tech economy, as well as the efforts from policymakers to bring back jobs to the country and contain offshoring, will also impact the future of this segment.

Figure 5. **Office completions** (Million sq. ft.)



Source: BBVA Research and REIS

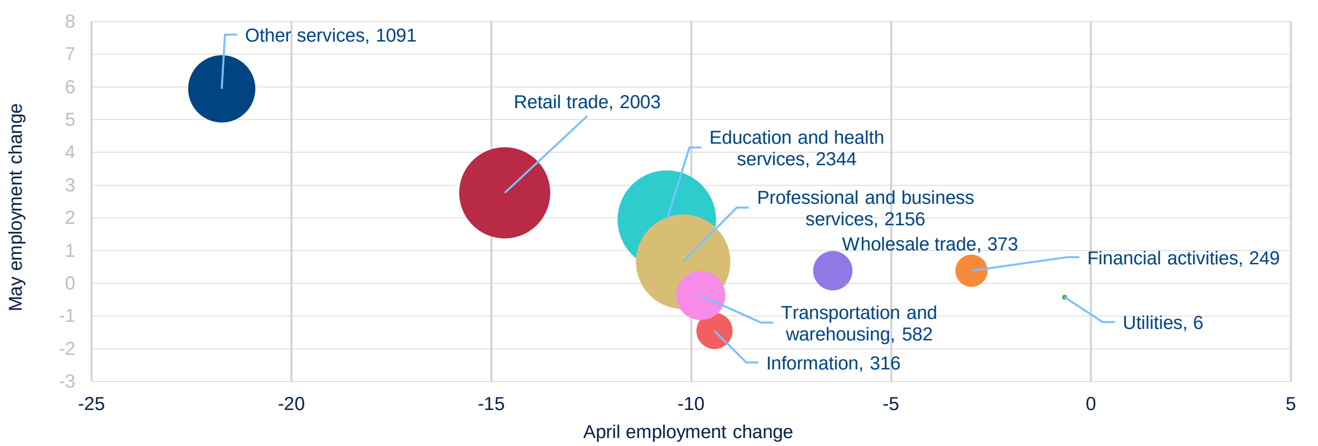
Figure 6. **Offices** (Average sq. ft. per office employee)



Source: BBVA Research calculations using REIS data

While the largest share of losses in employment between February and March has occurred in leisure and hospitality (40% of the total decline in payrolls), large office-using sectors also posted significant declines that will weigh down on the demand for office space going forward. Employment in professional and business services, financial activities, and information – three sectors that account for the overwhelming majority of office employment – was lower by 8.2% in May compared to February, despite some of the losses being pared down in May relative to April (Figure 7). Moreover, risks to employment in these industries are further tilted to the downside because of the likely increase in bankruptcies and debt defaults of companies in the second half of the year, despite the rebound of economic activity from the Covid-19-induced shutdown.

Figure 7. **Payroll employment change and employment deficit since February 2020. Services excluding Leisure and Hospitality** (% MoM and thousands, represented by bubble size, value shown in labels)



Source: BBVA Research and BLS

Over the mid-term, the outlook for the industry depends on the balance between greater workspace per employee, which will be required to maintain social distancing in the post-coronavirus world, and the ability of a large share of the office workforce to telecommute (Figure 8). The density consideration will be critical over the next two years, assuming a vaccine is developed. After that, the push for lower density will likely subside, but the expanded practice of telecommuting will remain, representing a downside risk for office space demand.

Figure 8. **Office demand sensitivity analysis to density, change in office employment and telecommuting**

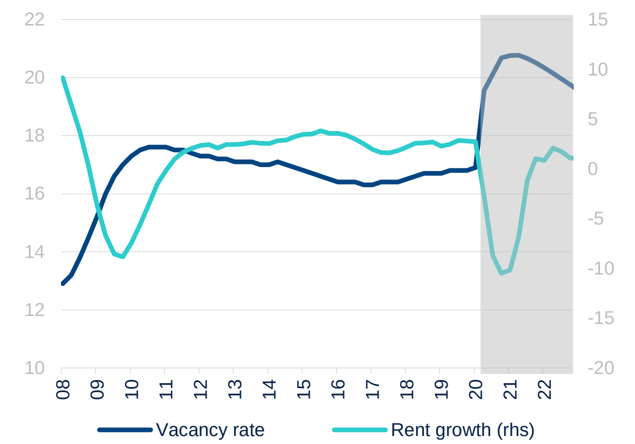
		Sq.ft. per employee				
Change in office employment	Increase in telecommuting	180	225	300	450	600
0%	0	0%	25%	67%	150%	233%
0%	20%	-20%	0%	33%	100%	167%
0%	40%	-40%	-25%	0%	50%	100%
0%	60%	-60%	-50%	-33%	0%	33%
-2%	20%	-22%	-2%	31%	96%	161%
-2%	40%	-41%	-27%	-2%	47%	96%
-2%	60%	-61%	-51%	-35%	-2%	31%
-4%	20%	-23%	-4%	28%	92%	156%
-4%	40%	-42%	-28%	-4%	44%	92%
-4%	60%	-62%	-52%	-36%	-4%	28%
-6%	20%	-25%	-6%	25%	88%	151%
-6%	40%	-44%	-30%	-6%	41%	88%
-6%	60%	-62%	-53%	-37%	-6%	25%
-8%	20%	-26%	-8%	23%	84%	145%
-8%	40%	-45%	-31%	-8%	38%	84%
-8%	60%	-63%	-54%	-39%	-8%	23%

Source: BBVA Research

As a result of the confluence of these factors, the adverse effect of the Covid-19 crisis will be more pronounced in the office segment relative to the multifamily one. Increased unemployment, financial distress experienced by many businesses, telework gaining greater traction, and increased caution on behalf of employees will contribute to higher vacancy rates and lower rents, which will not start to recover before mid-2021 (Figure 9). Prices will also experience a significant correction over the next year (Figure 10), but the downside will be limited by low construction.

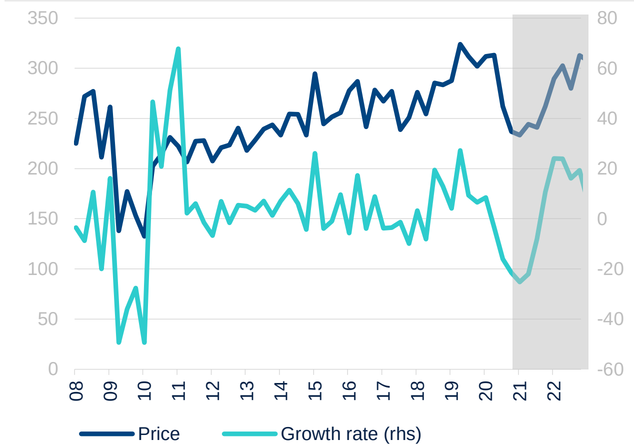
On a positive note, while the office segment is facing a challenging period over the next year and the traditional office will have to undergo some changes, it will remain a necessity for the foreseeable future. The reasons for this are the continued attractiveness of large cities due to network and agglomeration effects, which remain catalysts for innovation, as well as the necessity to maintain social and organizational capital within organizations, which arises when people work in close proximity and could be partially diluted through extended telework. In this sense, cities that understand the new paradigms and adapt better to remain safe and attractive will have the upper hand.

Figure 9. **Office vacancy and effective rent (% and % YoY)**



Source: BBVA Research and REIS

Figure 10. **Office CRE prices ($ per sq. ft. and % YoY)**



Source: BBVA Research and RCA

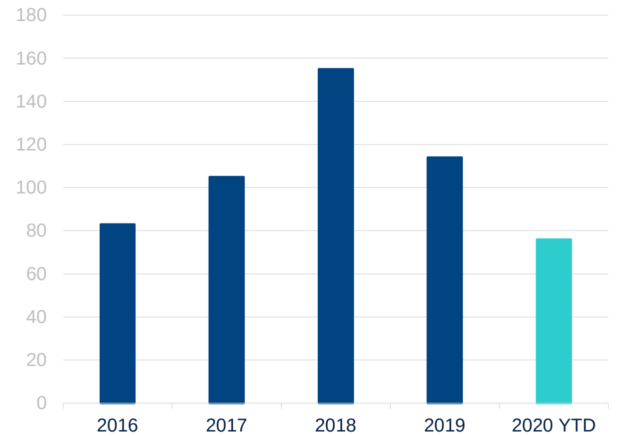
Retail

The retail segment is arguably the most at-risk CRE asset class. Cyclically, the Covid-19 induced downturn is placing significant pressures on all retail, especially service-oriented small businesses. Structurally, the greater reliance on e-commerce, exacerbated by the onset of the current crisis, results in ongoing secular headwinds. As a result of the stay-at-home orders, many retail outlets have had to remain closed for extended periods, and many real estate owners have been unable to collect rent, especially from tenants located in malls. In this sense, the impact is more direct and deleterious relative to offices and multifamily properties.

Since April 1, there has been a dramatic increase in bankruptcies of retail chains, some iconic such as J. Crew, Gold's Gym, Neiman Marcus, JC Penney, and Pier1 Imports. While the bankruptcy proceedings do not mean that all of these retailers will cease to exist, they will undoubtedly have to decrease their footprint and transform their business model, which will contribute greatly to higher vacancy rates. Over the first five months of this year, 76 million square feet of retail space has been announced for closure (Figure 11). According to data from S&P, the retail industry is currently one of the most financially distressed ones, and conditions are likely to deteriorate further by the end of the year. While smaller businesses have benefited, to some extent, from the government's Paycheck Protection Program (PPP) loans, if economic activity does not pick up as strongly as expected or if there is a large second wave of Covid-19 infections, many of these establishments might end up insolvent and will be forced to close.

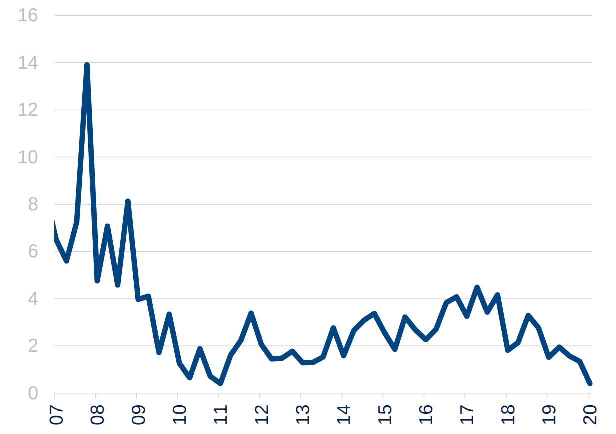
On a positive note, since the segment has not experienced a large inflow of new inventory in the run-up of the current crisis (Figure 12), there will not be additional pressures on vacancies from new completions. Therefore, we expect vacancy rates to increase and rents to decline similarly as during the Great Recession (Figure 13). Prices will decline and remain below pre-crisis levels for some time (Figure 14). The cap rate will increase more than in the case of apartments and offices to compensate owners for assuming higher risk. Over the mid- to long-term, very modest new construction and intensified repurposing of some of the existing inventory will moderate the adverse shock.

Figure 11. **Retail space announced for closure** (Million sq.ft.)



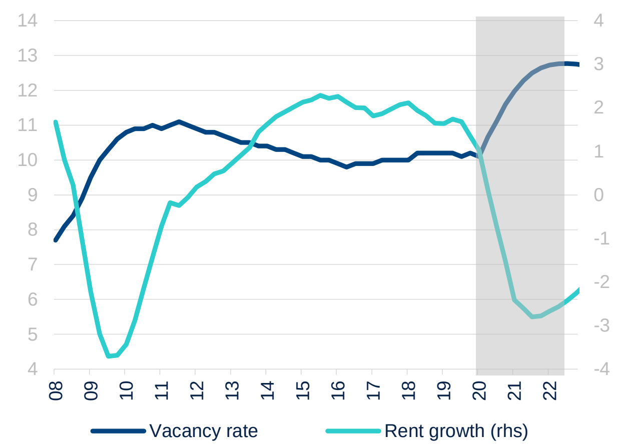
Source: BBVA Research and CoStar

Figure 12. **Retail completions, quarterly rate** (Million sq. ft.)



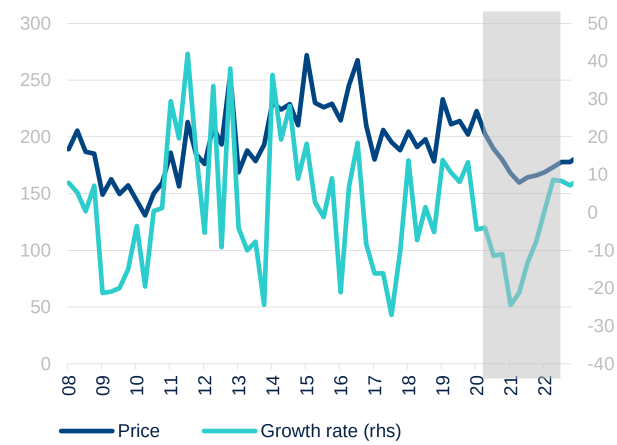
Source: BBVA Research and REIS

Figure 13. **Retail vacancy and effective rent** (% and % YoY)



Source: BBVA Research and REIS

Figure 14. **Retail CRE prices** ($ per sq. ft. and % YoY)



Source: BBVA Research and RCA

Industrial

Industrial CRE has benefited from some of the same structural forces that have presented headwinds to retail, such as the rise of e-commerce, which has driven up the demand for distribution centers. That said, over the short-run, the recession will dampen the demand for industrial properties, especially in regions exposed to industries that will take longer to fully recover such as lodging, air transportation, and amusement and recreation. Likewise, the global recession and de-globalization trends will disproportionately affect activity dependent on international trade. Industrial CRE exposed to trends in areas such as education, healthcare, and utilities is likely to perform better due to lower immediate disruption and supportive demographic trends despite population growth slowdown.

Since industrial vacancies were relatively low going into the current downturn, any decline in rents in 2020-2021 is going to be limited. While the crisis in this segment will be more moderate and short-lived, conditions will vary significantly from location to location, as some metropolitan areas have been experiencing stronger speculative buildout relative to others. Over the longer term, this segment could also benefit from re-shoring in some industries, increasing demand for new and sustainable technologies, as well as a potential infrastructure spending package that could be passed by Congress after the November elections.

Bottom line

The Covid-19 recession is severely disrupting CRE. Recent data suggests that the largest damage has been in the retail segment while offices have seen mixed results. Meanwhile, apartments have experienced a more moderate impact. For industrial CRE, the effects have been more heterogeneous, with some hard-hit parts but also with some that have benefited from the crisis. Nonetheless, vacancies are expected to increase across the board, leading to a temporary decline in rents and prices. Over the short-term, apartment vacancies depend on the progress in lowering the level of unemployment and the extension of enhanced unemployment benefits beyond this summer. Over the longer term, apartment demand will be supported by demographics that will help rebalance the market. Corporate debt distress and telecommuting will limit the demand for office space, but lower office density due to public health concerns will mitigate some of these pressures. The health of small service-based businesses will be critical for the retail segment, while e-commerce remains a substantial challenge over the long-term. We expect a pickup in repurposing of some of the retail properties that face particularly low demand in their current form. Overall, industrial CRE will hit a soft spot but will recover relatively quickly due to low vacancy rates going into the recession and supportive structural trends.

The difficulties that CRE operators are facing and the temporary declines in property values will result in deterioration of CRE credit quality. This will be mitigated to some extent by massive fiscal support, monetary policy actions, and favorable financial conditions, allowing for a refinancing and restructuring of some of the outstanding CRE liabilities. That said, the risk to our baseline forecasts remains tilted to the downside due to potential additional waves of infection and policy mistakes. Given the unprecedented environment, the level of uncertainty about the recovery is high and our point estimates for multiple CRE variables are subject to a wider-than-usual margin of error.