Commercial Real Estate: The Good, the Bad and the Ugly

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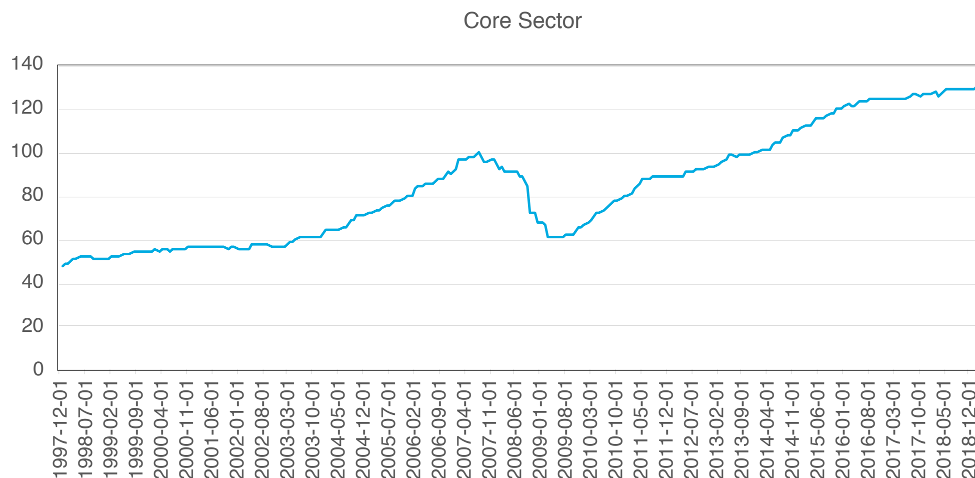
June 2019

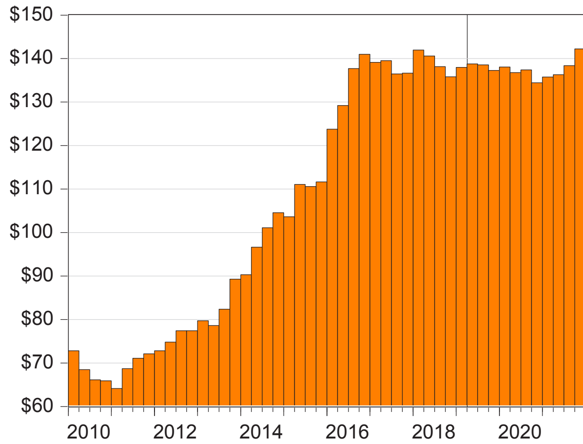
After achieving a rapid recovery from the 2009 lows, commercial real estate price increases have stalled out increasing at a 2.1% rate in the three years ending April 2019. (See Figure 1) In response to the rebound in prices real commercial construction spending more than doubled, but that too is in the process of leveling off. (See Figure 2) In the face of weakening macroeconomic fundamentals (job growth slowing from the recent average of 220,000 a month down to a forecast 50,000 a month in 2020) the sector was rescued by the recent decline in long term interest rates coupled with falling credit spreads have worked to support asset prices. Instead of 10-Year U.S. treasury yields rising to 4% as we once had thought, those yields now sit at around 2.5%. As a result the flood of yield hungry cash continues to buoy the sector as rents and occupancy rates come in somewhat lower than what is now anticipated. **However, instead of moving in lock step, the four large categories of commercial real estate (apartments, industrial, office and retail) face distinctively different outlooks. Further the high tax-high regulation coastal markets may soon lose some of their shine as the limitations on state and local tax deductions begin to bite as higher income households migrate to lower tax climes.**

Figure 1 Green Street Commercial Property Price Index, Dec 97 –Apr 19, Aug07 = 100



Source: Green Street Advisors

Figure 2 Real Commercial Construction Spending
2010Q1 -2021Q4, Quarterly Data, In $Billions, SAAR



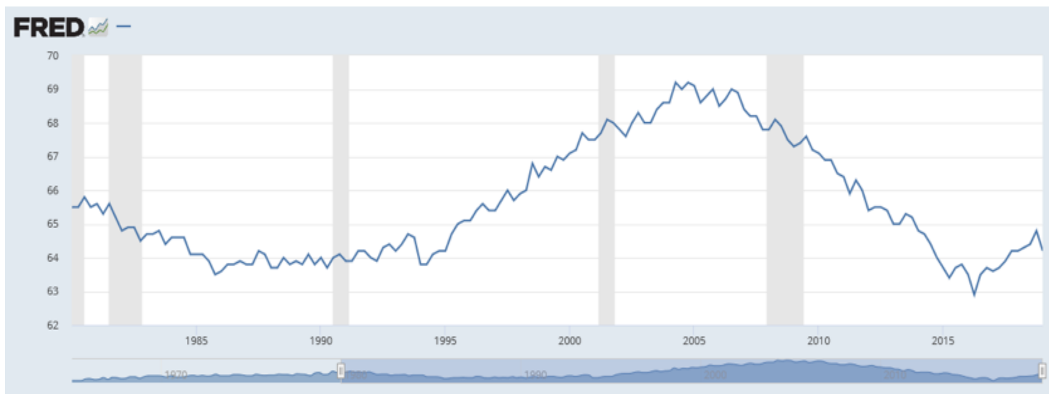
Source: U.S. Department of Commerce and UCLA Anderson Forecast

The Good....for now

Apartments

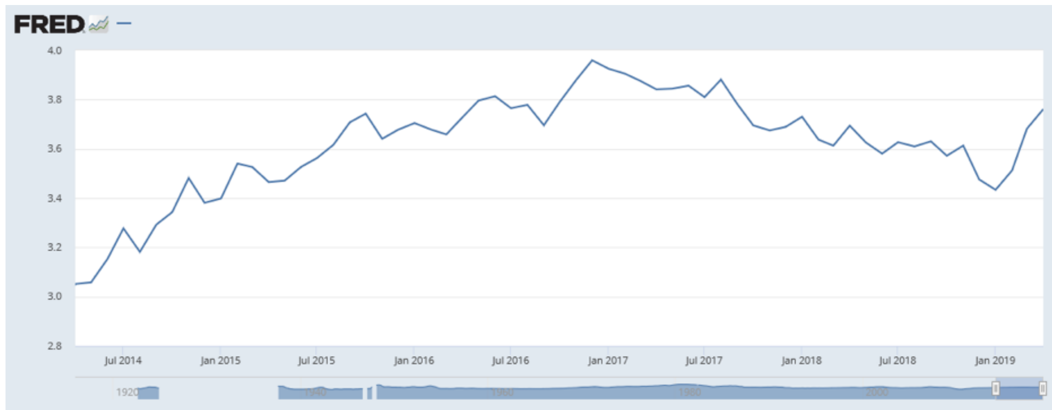
The apartment industry is benefitting from such macro trends as delayed marriages and child bearing, increased consumer preferences for more urban life styles, strong employment growth in major metropolitan areas and strong land use regulation in most coastal markets that work to restrict supply. These trends have led to a decline in the homeownership rate from 68% to 2017 low of 63% and now stands at 64.2% down from a recent high of 64.8%. (See Figure 3) As a result rents as measured by the national consumer prices index have advanced between 3-4% a year since 2014. (See Figure 4) The rent increases have been supported by a historically low vacancy rate of 4.8%, albeit up modestly from its recent 4% low. (See Figure 5)

Figure 3 Homeownership Rate, 1Q1980- 1Q2019. Percent, SAAR



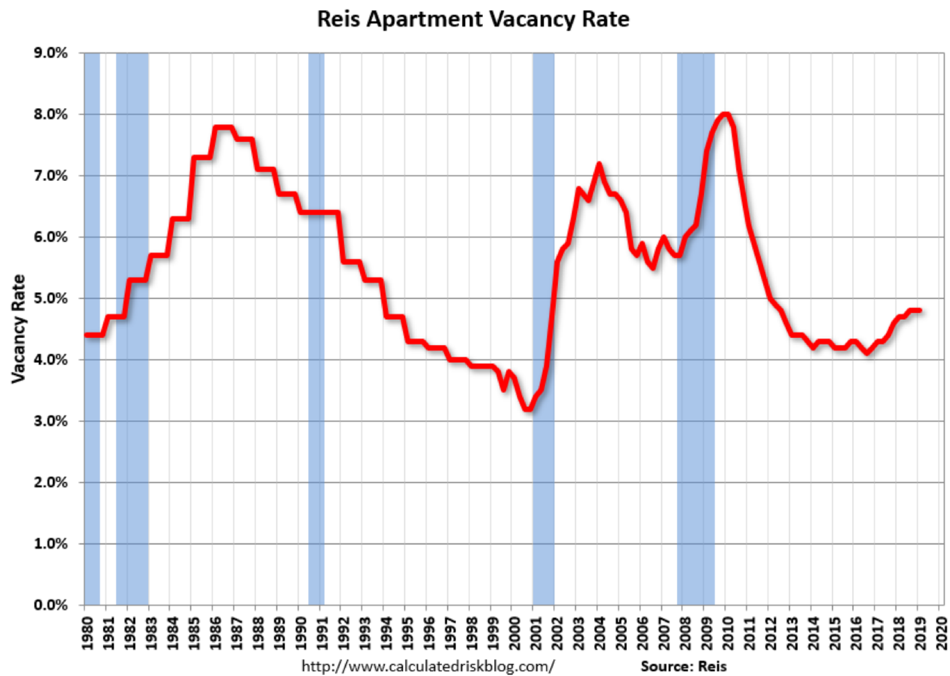
Source: U.S. Bureau of the Census via FRED.

Figure 4 Consumer Price Index, Tenant Paid Rent, Apr 2014 – Apr 2019, Percent Change Year Ago



Source: U.S. Bureau of Labor Statistics via FRED

Figure 5 National Apartment Vacancy Rate, 1980 – Q12019, Percent



Source: REIS Reports via

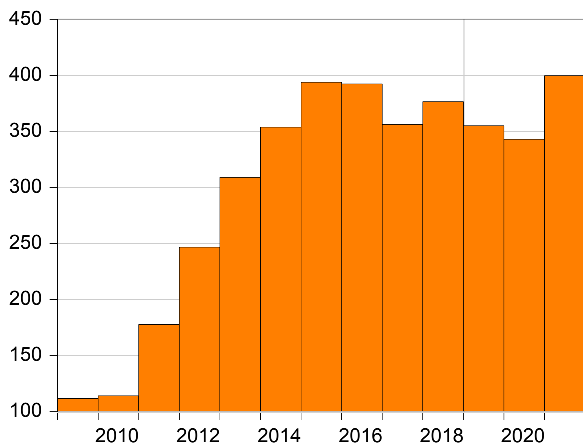
Apartment developers have responded to the increased demand by dramatically stepping up supply. After bottoming at 114,000 units in 2010, new multi-family starts have averaged 380,000 units over the past four years and are expected to continue at an elevated rate. (See Figure 3) For example after starting 375,000 multifamily units in 2018, new starts are forecast to be 355,000, 345,000, and 400,000 units in 2019, 2020 and 2021, respectively. (See Figure 6)

Starts are forecast to remain at these elevated levels despite a significant decline in employment growth and a rise in the home ownership rate. Why? The answer is simple. Even at historically very low 4-5% cap rates, apartment investment remains competitive with low yielding U.S. treasury bonds. With institutions scrambling for yield, apartment developers will have all of the money they need to build. Inevitably vacancy rates will rise and the rate of rental increases will decline rendering pro forma estimates of future returns high.

However as result of rents rising faster than wages a growing national movement towards rent control in the high cost metropolitan areas is coming into being. From Albany in the east to Sacramento in the west, a host of legislative bills have been introduced to significantly tighten (limitations on vacancy decontrol being the most prominent) the rent control regime already in place. Further the state of Oregon has just adopted a loose form of statewide rent control. **It is our guess that this is only the beginning in that much of "blue state" America will drift to various forms of rent control regimes. In the end the controls will only make the supply shortages worse.**

In contrast legislative moves are a foot especially in California, Massachusetts and Minneapolis to over-ride local control over single family zoning and to substantially increase density in neighborhoods with access to public transit facilities. **Although it is still too early to tell, but the potential exists to substantially increase the supply of multi-family housing thereby reducing the upward pressure on rents.**

Figure 6 Multi-Family Housing Starts, 2009 -2021F, Annual Data, In Thousands of Units



Sources: U.S. Bureau of the Census and UCLA Anderson Forecast

Industrial

In response to the rising demand coming from e-commerce, the industrial sector has boomed in terms of new construction and rents. For example while apartment rents have increased 3-4% a year since 2014, industrial rents according to CBRE have advanced at twice that rate, between 6-8% a year, since the first quarter of 2017.[1] In response to the increased demand the availability rate for industrial space has been cut in half since the recession low of 2010 dropping from 14.5% to 7%.[2]

Because the e-commerce generated demand for close-in industrial space has been so strong, the U.S. is now witnessing the construction of multi-story industrial warehouses that hitherto has been largely limited to Japan. As result industrial rents in high demand locations are achieving unprecedented rents in excess of $24 a square foot more than double to triple the current average rent of around $9 a square foot. **Simply put, it is all about reducing transportation costs.** Nevertheless as economic growth cools in 2020 much of the euphoria now being experienced in the industrial market will begin to wane.

1. *"Q1 Industrial and Logistics," CBRE report.*
2. *Ibid.*

The Bad

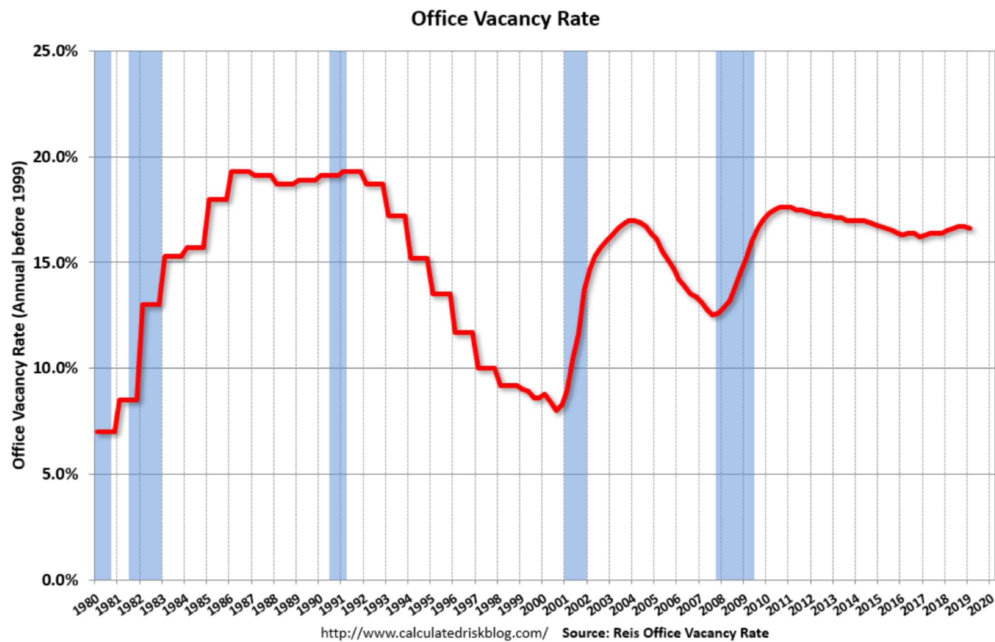
Office

Although the office sector has recovered from the nadir of the Great Recession the current vacancy rate of 16.6% only modestly below the highs reached in previous cycles. (See Figure 7) This is due in part to much slower growth in the traditional office using sectors of finance and law that has only been partially offset by growth in computer software and media.

However the real driving factor has been the rapid decline in square footage per employee as the office environment densifies from one employee for each 200-250 square feet per employee down to around 150 square feet per employee. The densification process has been accelerated by the rapid growth in co-working space tenants led by WeWork and Regus. **According to a recent report co-working tenants have accounted for 1/3 of all of the office leasing in the United States for the 18 month period ending December 2018.**[3] Co-working space now accounts for 3.6% of the overall office market in New York City and San Francisco and 2.6% and 2.0% in Seattle and Westside Los Angeles, respectively. **A word of caution is that WeWork lost nearly $2 billion in 2018 meaning the unwelcome response to Uber's recent public offering may signal that their venture capitalists might not have a public market takeout thereby elevating credit risk.**

Co-working occurs where a provider leases space on a flexible basis from a traditional owner and then releases desks on a very short term basis to individual entrepreneurs or in bulk to corporate enterprises with desk rents ranging from $450-$900 a month depending upon the city and the location. In most cases the user is a large corporation like Amazon or IBM rather than a small business taking up a few desks. What this means that over the longer run the long

Figure 7 National Office Vacancy Rate, 1980 –1Q2019, Percent



Sources: REIS Reports via CalculatedRiskblog.com

3. Bilerman, Michael, et al, Weekly REIT and Lodging Strategy, Citi Research, March 15, 2019.

term credit tenant that the office business has long relied upon will become less important with shorter term leases becoming the new normal.

The problem facing the office business going forward is that if a 16% vacancy rate is as good as it gets, what will happen when employment growth slows and new construction continues and construction will continue because much of the pre-2000 office stock is technologically obsolete with respect to densification (think elevators and rest rooms), telecommunications infrastructure and energy use.

The Ugly

Retail

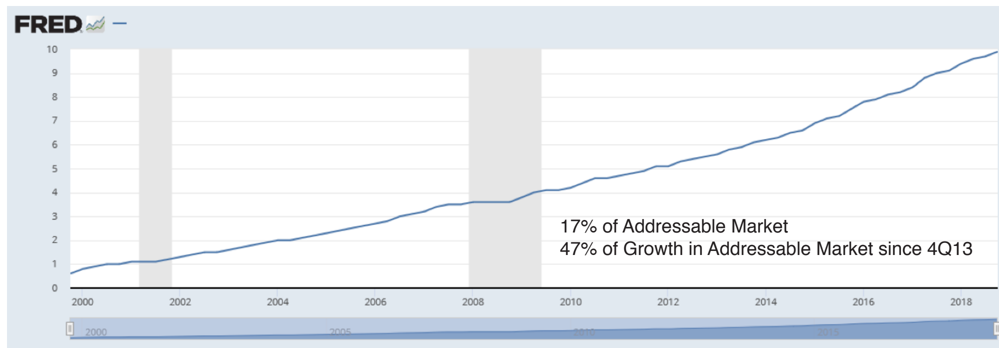
All that has to be said are three words: "One Day Delivery." With Amazon announcing that its Prime service will now offer one day delivery, instead of the prior two day delivery, the pressure on store-based retail has been ratcheted up. Indeed since late 1999 e-commerce's share of total retail spending has advanced from 0.6% in the fourth quarter of 1999 to just under 10% in the fourth quarter of 2018. (See Figure 8). However that dramatic increase only tells part of the story.

Perhaps more important is that when we dig down into the data and look at e-commerce's share of the addressable market, the outlook for traditional retailing looks more ominous. We do this by subtracting from total retail sales, gasoline, automobiles and food service (restaurants and bars) all of which are not subject to e-commerce competition. **Thus in terms of the addressable market the e-commerce has a market share of 17%. Digging further into the data we find that e-commerce accounted for 34% of the growth in the addressable market since 1999 and an astounding 47% of the growth in the five years ending in the fourth quarter of 2018.**

It is no wonder that store based retail is in a world of hurt. This year alone retailers have announced they will be closing 5,994 stores while opening only 2,641 and with the prospect of another 75,000 more closings by 2026.[4] Further there is little evidence that the attempt to introduce experiential retailers like Apple, Eataly and Tesla are not drawing meaningful increase in traffic to the mall as a whole.

To be sure many e-commerce retailers are opening physical stores, but the square footage is small and thus nowhere nears offsetting the triage now going on in retail land. Of course much of the pain has taken place in lower quality assets, but the even the top tier of regional malls and com-

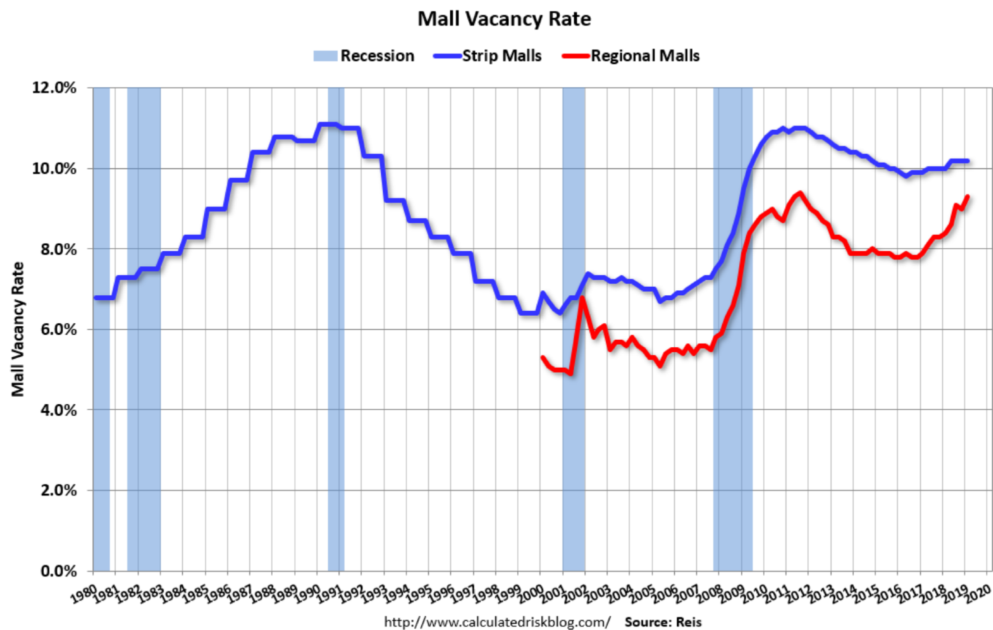
Figure 8 E-Commerce as a Percent of Total Retail Sales, 1Q2000 – 4Q2018



Source: U.S. Department of Commerce via FRED.

4. *See Thomas, Lauren, "Offering shoppers new experiences isn't helping as malls see a tsunami of store closures, falling traffic," CNBC, 15 April 2019 and Bhattarai, Abha, "'Retail apocalypse' now: Analysts say 75,000 more U.S. stores could be doomed," Washington Post, April 10, 2019*

Figure 9 Regional Mall and Shopping Center Vacancy Rates, 1980 –1Q2019, Percent



Source: REIS Reports via CalculatedRiskbolg.com

munity centers are not immune to the challenge brought on by e-commerce. Those quality assets will face significant increases in capital spending just to maintain their edge. And remember what is perceived to be an A+ asset today might not be one in five years.

Further complicating the picture has been a collapse in the profitability of drug stores with both Walgreen-Boots and CVS reporting significant profit declines. Drug stores have long been main stays of community shopping centers and it is our guess that we will soon start to see closures in the stores that do not have the ability to offer higher levels of medical services.

As a result of the dynamics outlined above retail vacancy rates have remained stubbornly high. (See Figure 9) With the current regional mall and shopping center vacancy rates at recession levels standing at 9.3% and 10.2%, respectively when the economy is strong, what will happen when the macro environment turns weaker? Trust me it will not be pretty. This does not mean that retailers will go away, it just means that those retailers who fail to adapt to the new environment will go away. Those that succeed will have to be able to meet the consumer on the consumer's terms.

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Aside from retail, commercial real estate construction levels and asset values are likely to be maintained over the next year. However as the slowdown in employment growth becomes more recognized construction starts will slow and asset values will modestly soften with the multi-family and industrial sectors continuing to outperform and with retail remaining problematic.