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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the Ziman Center and UCLA Anderson Forecast, offers outlooks on four real-estate sectors: commercial, industrial, retail and apartments.

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

By David Shulman

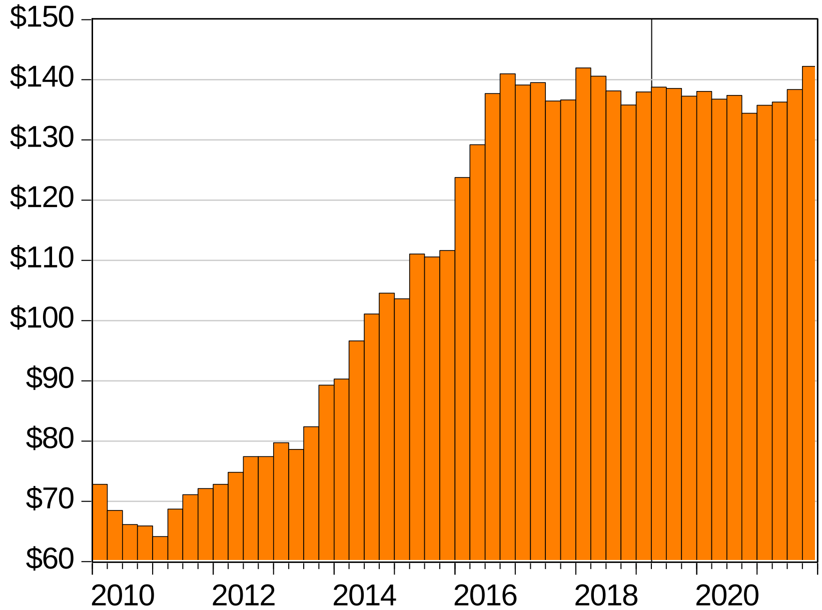
Instead of moving in lock step, the four large categories of commercial real estate – apartments, industrial, office and retail – face different outlooks. And the high-tax/high-regulation coastal markets may soon lose some of their shine as limitations on state and local tax deductions begin to bite, and higher-income households migrate to lower tax climes.

"New building near transit could substantially increase the supply of multi-family housing, thereby reducing the upward pressure on rents."

After achieving a rapid recovery from the 2009 lows, commercial real estate price increases stalled-out, increasing at a 2.1% rate in the three years ending April 2019. Real commercial construction spending more than doubled, but that too is in the process of leveling off. (Figure 1) The sector faces 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). It was rescued by the recent decline in long-term interest rates coupled with falling credit spreads, and these 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%. **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.

Figure 1. Real Commercial Construction Spending 2010Q1 -2021Q4, Quarterly Data, In $Billions, SAAR



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

THE GOOD….FOR NOW: APARTMENTS

The apartment industry still benefits from such macro trends as delayed marriages and child bearing, consumer preferences for urban lifestyles, strong employment growth in major metropolitan areas and land-use regulation that restricts supply in most coastal markets. The decline in the homeownership rate now stands at 64.2%, down from a recent high of 64.8%. As a result, rents as measured by the national consumer prices index have advanced between 3-4% a year since 2014. The rent increases have been supported by a historically low vacancy rate of 4.8%, albeit up modestly from its recent 4% low.

Apartment developers have responded 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: New starts are forecast to be 355,000, 345,000, and 400,000 units in 2019, 2020 and 2021, respectively.

Starts are forecast to remain at these elevated levels despite a significant decline in employment growth and a rise in the home-ownership. Why? **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, with rents rising faster than wages, there is a growing national movement towards rent control in the high-cost metropolitan areas. From Albany to Sacramento, legislation proposes to tighten the rent control already in place. These controls will only worsen the supply shortages. In contrast, legislative moves are afoot especially in California, Massachusetts and Minneapolis to override local control over single-family zoning and substantially increase density in neighborhoods with access to public transit. **Although it is still too early to tell, new building near transit could substantially increase the supply of multi-family housing, thereby reducing the upward pressure on rents**.

INDUSTRIAL

In response to continued rising e-commerce, the industrial sector servicing it has boomed, with new construction and healthy rents. While apartment rents are up 3.5 -4%, and 3-4% since 2014, industrial rents according to CBRE have advanced at twice that rate, between 6-8% a year, since the first quarter of 2017. 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%.

With e-commerce demand for close-in industrial space strong, the U.S. is now witnessing development of multi-story, infill-area warehouses that hitherto had been largely limited to Japan. Industrial rents in high-demand locations are achieving unprecedented rents, in excess of $24 a square foot, and more than double to triple the current average rent of around $9 a square foot. This trend is all about reducing transportation costs. Nevertheless, **as economic growth cools in 2020, much of the euphoria in the industrial market will begin to wane.**

THE BAD: THE CO-WORKING EFFECT

Although the office sector has recovered from the nadir of the Great Recession, the current vacancy rate of 16.6% is only modestly below the highs of previous cycles. This is due in part to much slower growth in the traditional finance and law space-users, only partially offset by growth in computer software and media.

But the real driving factor is the rapid decline in square-footage-per-employee. Offices are densifying from one employee for each 200-250 square feet to about one employee for each 150 square feet. Further, **co-working spaces led by WeWork and Regus have accounted for 1/3 of all of the office leasing in the United States for the 18 month period ending December 2018.** Co-working 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: The unwelcome response to Uber's recent public offering may signal that WeWork venture capitalists might not have a public market takeout, thereby elevating credit risk.**

Co-working providers lease space on a flexible basis from a traditional owner, then releases desks on a very short-term basis to everyone from individual to corporate enterprises, with desk rents ranging from $450-$900 a month depending on city and the location. In most cases, the user is a large corporation such as Amazon or IBM rather than a small business taking up a few desks. The office business has relied for years on long-term credit tenants. But these, too, will become less important, with shorter-term leases becoming the new normal.

And another problem looms for office business: If a 16% vacancy rate is as good as it gets, what will happen when employment growth slows even as 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 restrooms), telecommunications infrastructure and energy use.

THE UGLY: THE MAULING OF RETAIL BY E-COMMERCE

Three words sum it up: "One Day Delivery." With Amazon rolling-out its Prime service, it added yet more pressure to store-based retail. Since late 1999, e-commerce's share of total retail spending has advanced from 0.6% in the fourth quarter 1999 to just under 10% in the fourth quarter 2018. And that dramatic increase only tells part of the story.

When we look closely at e-commerce's share of the "addressable market," the outlook for traditional retailing looks even ominous. We do this by subtracting from total retail sales areas such as gasoline, automobiles and food-service (restaurants and bars), all of which escape e-commerce disruption. In the addressable market, 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.**

Store-based retail is in a world of hurt. This year alone retailers have announced they will be closing 5,994 stores while opening just 2,641, with the prospect of another 75,000 more closings by 2026. Further, the attempt to introduce experiential retailers like Apple, Eataly and Tesla are not drawing meaningful mall traffic. Yes, many e-commerce retailers are opening physical stores, but the square footage is small.

Much of the pain has taken place in lower-quality assets, but even top-tier regional malls and community centers are not immune. Those assets require significant capital investment just to maintain their edge: An A+ property today might not be one in five years.

But wait there's more. We are now seeing **the collapse in the profitability of drug stores**, with both Walgreen-Boots and CVS reporting significant declines. Drug stores have long been mainstays of community shopping centers, and we will soon start to see closures among stores that cannot offer higher levels of medical services along with shopping.

As a result, retail vacancy rates remain stubbornly high. The current **regional-mall and shopping-center vacancy rates are 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? It will not be pretty. This does not mean that retailers will go away. But those who succeed must adapt on consumers' terms.

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