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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the UCLA Ziman Center for Real Estate and UCLA Anderson Forecast, looks at key disrupters in the retail, industrial, multifamily and office markets.

Commercial Real Estate's Slow-Motion Slowdown:

E-Commerce and Other Disruptors of the 7-Year Boom

By David Shulman, Senior Economist, UCLA Ziman Center for Real Estate and UCLA Anderson Forecast

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We are living in heady times for commercial real estate. Fueled by cheap money, low levels of new construction (except for apartments), and modestly improving demand, commercial real estate values have more than doubled off their financial crisis lows of 2009.

"Over the last five years through April, the e-commerce share of retail growth has increased to 44%."

Nevertheless, prices are leveling off as investors have become concerned that the period of extraordinarily low interest rates may soon be coming to an end. And job growth – the source of much real estate demand – will inevitably slow as the economy approaches full employment. At the same time, supply will pick up as more construction is delivered in 2017 and 2018.

Thus, the overall environment for commercial real estate will become less favorable over the next few years. Further impacting the sector will be technological disruption from e-commerce and reduced square footage per office worker.

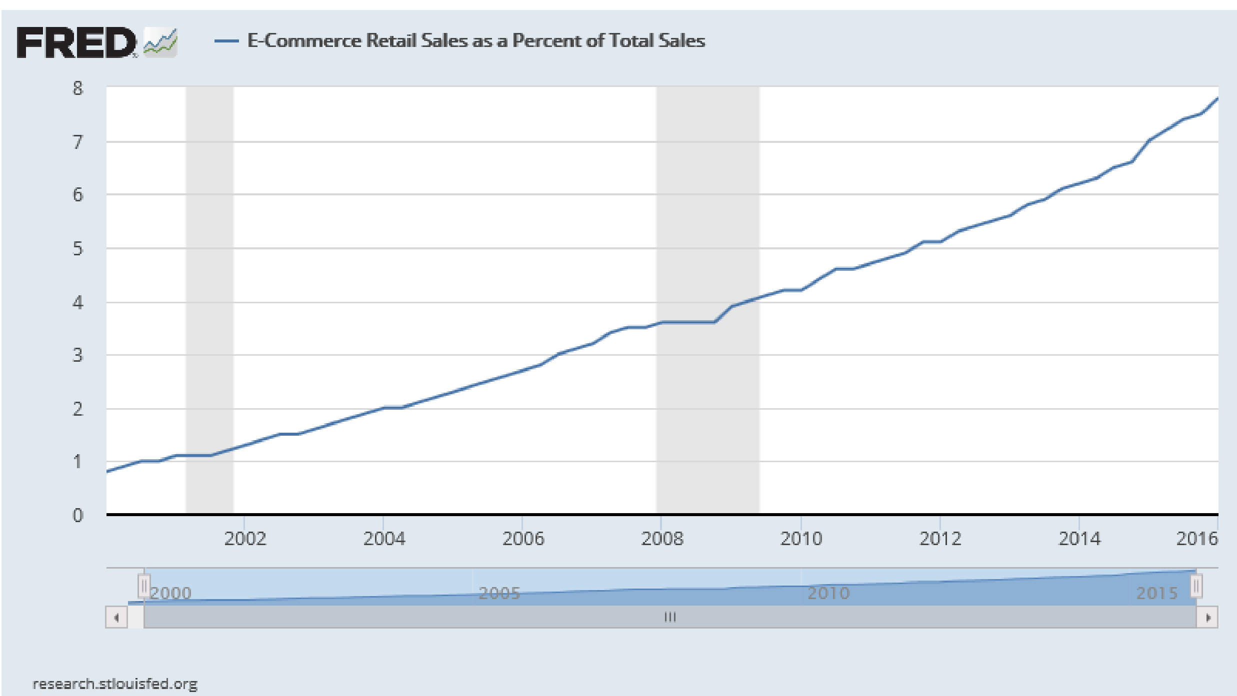
THE CONTINUING SHIFT TOWARD E-COMMERCE

A report by Green Street Advisors shows that roughly 800 department stores – about 20% of all anchor space in U.S. malls – will likely close over the next few years, and many malls will close with them. Moreover, mall problems are not limited to the anchor department stores. In the first quarter, Simon Property Group, the largest owner of regional malls in the U.S., once again reported that same-store sales for in-line shops were down on year-over-year basis.

It is not that overall retail sales have been declining. To the contrary, retail sales have been increasing at a modest pace. But there has been a decided shift toward e-commerce. For example, in April on a year-over-year basis, department store sales declined by 1.7%, clothing store sales advanced by 1.3% and non-store retail (e-commerce) surged by 10.2%. Indeed since 2000 the e-commerce share of retail sales advanced from just under 1% to about 8% in the first quarter. (See Figure 1)

However this data understates the full impact of e-commerce on retail sales, because if you back out those sectors of retail that are not amenable to e-commerce (automobiles, gasoline, food and restaurants) the e-commerce share rises to 14%. Moreover, since 2000 e-commerce has taken about 30% of the growth in retail sales less the categories mentioned above. And over the last five years through April the e-commerce share of the growth has increased to 44%! Indeed we would not be surprised to see significant e-commerce penetration in grocery sector, not currently included in the 44% share, in the coming decade.

Figure 1. E-Commerce Sales as a Percent of Total Retail Sales, 2000Q1 – 2016Q1



Source: U.S. Department of Commerce via FRED

To stay competitive major mall operators have ramped-up capital spending to make their assets more attractive to consumers, adding restaurants and experiential activities not subject to internet competition. Examples of the high level of capital spending include Westfield's Century City with an $800 million program and Taubman's Beverly Center clocking in at $500 million. Both of these assets are in West Los Angeles and compete with each other.

Thus far, grocery-oriented shopping centers have been immune from e-commerce, but with Amazon moving into the private-label grocery business and attempting same-day deliveries, convenience-oriented retail may soon be disrupted as well. Indeed, the still-prized Whole foods anchor is now suffering from increased competition in the organic food space.

Two years ago we noted that the real bright spot in retail real estate was street-level retail in dense urban centers with significant tourist components. That thesis proved true until very recently when a strong dollar and weakness in much of the global economy has diminished international tourism. As a result, asking rents are beginning to drop in Manhattan, for example, which has been a major beneficiary of luxury tourism.

INDUSTRIAL: A BENEFICIARY OF E-COMMERCE

But what has been bad for retail real estate has been good for industrial real estate. E-commerce is warehouse-intensive, and as the need to shorten delivery times has increased, the demand for close-in modern warehouses in major population centers has soared. Overall warehouse rents have been growing at a 5% clip. And in markets such as Los Angeles, East Bay San Francisco and northern New Jersey, rents have increased at a double-digit pace over last year.

OFFICE: IN A LATE-CYCLE RECOVERY

After seven years of economic recovery, albeit slow, the national office vacancy rate has barely come down from about 18% to 16%. To be sure, new construction has been very sluggish until recently, but the demand has been far more muted than in past cycles.

Technological disruption is obviating the need for physical file space and reference rooms, and a shift to open floor plans is reducing the square footage needed per employee. Instead of allowing for 200 square feet per employee, space planners are now allowing for 150 square feet. This trend is far from running its course.

One really bright spot for office demand has been in the technology sector, including computer-systems design and related services. Here we use the year-over-year change in employment and see a surge to 120,000 jobs a year in 2015. However, as the venture-capital tech start-ups wane, employment growth has slowed to 80,000 a year. This decline has raised worries about the sustainability of office demand in tech hubs.

MULTI-FAMILY HOUSING: RUNNING OUT OF HIGH INCOME RENTERS

Multi-family residential housing has been in a sustained boom since 2011. Despite a surge in new supply with starts on track to reach 400,000 units this year, rents continue to rise much faster than the overall prices. According to the official data residential rents were up 3.7% year-over-year in April, but because of quirks in the data the true increase in market rents is in excess of 4% and in more than a few markets, twice that. The rise in rents is supported by a dramatic decline in the apartment vacancy rate, which, of late, has leveled off at a very low 4.5%.

One of most powerful factors affecting rental demand has been the long decline in home ownership. This is partly a preference for a more urban lifestyle and a delay in such life-cycle events as marriage and childbirth. But with the gradual rise in single-family home starts, we believe that the long decline in the homeownership rate has about run its course. Apartment owners may soon discover there might not be enough tenants to support $3,500 a month rent for one-bedroom units. The apartment business now appears to be in transition from great to good.

CONCLUSION

The combination of a less favorable financial environment along with weakening fundamentals arising from increased supply and reduced demand will likely bring to an end the seven year bull market in commercial real estate. To be sure we are in no way forecasting a "crash", but rather an extended period of sideways to down prices. Simply put, financial conditions will transition from being extraordinarily easy to just plain easy making it unlikely for us to witness a repetition of the events of 2007-2009.