21 July 2020

Challenges and opportunities in US Commercial Real Estate


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- *Coronavirus is disproportionately affecting different sectors of the US commercial real estate market, and driving major short- and long-term trends that have consequences for investors.*
- *Within major subsectors of US commercial real estate, we are negative on the outlook for retail and senior housing sectors, cautious on office space, and positive on the industrial sector*.

The impact of the Covid-19 pandemic has raised concerns over the durability and health of the commercial real estate (CRE) market. At the start of the pandemic, there were concerns the CRE sector might be acutely more vulnerable to remote working, the surge in unemployment and the recession. Instead, what we found is that the impact is more nuanced across the retail, office, senior housing and industrial subsectors and based on the macro outlook for this sector we expect there will be clear winners and losers.

The Covid-19 pandemic has upended life for millions across the globe and disproportionately disrupted broader demographic, and seemingly well-entrenched demographic consumption trends**. US CRE is likely to feel the effects of these shifts in a number of ways, including risks that are being underestimated in some subsectors and have the potential for far-reaching consequences to the broader financial markets.**

The broader fundamentals of the US economy are supportive, but fragile

- **US economy and jobs.** We expect a U-shaped recovery. After a sharp collapse in Q2, we expect a nice snapback in output in Q3, with the economy contracting 5.5% at the midpoint. Beyond Q3, we expect a more gradual slope in recovery. The trajectory of the rebound will determine the degree of recovery in CRE. Ultimately, discovery of better Covid-19 treatments and eventually a vaccine will be the catalyst to the scope and speed of the recovery, and make it easier to inhabit shared space. The quicker the decline in the unemployment rate, the faster the recovery in CRE, especially in the retail and office sectors.
- **Government stimulus.** The US government has provided aggressive stimulus with a seemingly unlimited capacity. We estimate that a total of $9tn of liquidity has flooded the economy, with monetary ($6tn) and fiscal stimulus ($3tn). Rent collection rates have held up better than expected due to programmes such as the Payroll Protection Program, augmented unemployment benefits, and direct payments that have helped replace lost income. A fourth stimulus package, if well telegraphed to provide another incremental bridge for the economy, will support CRE. Congress is aiming to approve a stimulus package sometime in July or August. However, if fiscal support dissipates, certain sectors in CRE could become increasingly vulnerable, particularly if the lack of government action contributes to a subpar recovery.

Potentially significant underlying pandemic-induced structural trends are churning, including:

Trend reversal:

Urbanisation. The desire for the convenience of city dwelling may be coming into question as social distancing and health measures increase the allure of the safety of single-family detached living.

Nascent trends that have accelerated:

- **E-commerce.** The acceleration of the existing growth of retail e-commerce and the associated emergence and popularity of click-and-collect options.
- **Remote working.** There is a quick and seemingly successful move to large-scale adoption of work-from-home, and increased acceptance of virtual conferences, video-chats, and telemedicine. All of these will have impacts on how and when we use commercial space, and what value we put on the spaces we use.

Outlook for Commercial Real Estate subsectors

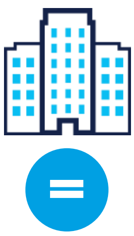
We examine four sectors of the CRE: retail, office, healthcare (specifically senior housing) and industrial. We are negative on retail and senior housing, cautious on office, and positive on the industrial sectors of CRE.

Retail – Negative headwinds accelerating

Covid-19 is accelerating trends in retail CRE that have been in place for the better part of the last decade. **Retailers, already burdened with debt and fighting the e-commerce wave, are shutting stores and filing for bankruptcy protection at an accelerated rate**. Property owners will be forced to spend significant capital to re-tenant, reposition, or redevelop their properties not only to remain competitive, but also remain in business. In recent years landlords have relied on gyms, restaurants, movie theaters and other 'experiential' tenants to backfill declining apparel and department store spaces, but the Covid pandemic has crippled these tenants. Properties that struggle to maintain their pre-Covid rental streams and face an increasing expense burden will see valuations forced lower.

Lower valuations will not mean the end of physical retailing. Well-located properties with stable surrounding demographics will continue to attract both consumers and tenants, and will survive. Properties and property owners who have pivoted with consumer demand to better enable 'click and collect' or an omni-channel shopping experiences are also likely to be winners.

Longer term, the retail environment is challenged. While retail real estate in the past was viewed as stable due to its long lease terms and strong consumer demand, it is poised to become more cyclical. Retailers are more uncertain of the profitability and want more flexibility, demanding shorter terms. Many high-profile retailers are filing for bankruptcy, refusing to pay rent or attempting to negate their contracts. In late June, Italian designer Valentino sued to terminate its lease for its four-story Fifth Avenue boutique. 'Experiential' replacement tenants, such as restaurants and cinemas, are exposed to higher discretionary spending than core retailers of the past, causing the retail income stream to become more cyclically exposed.



Office – Medium-term risks are elevated

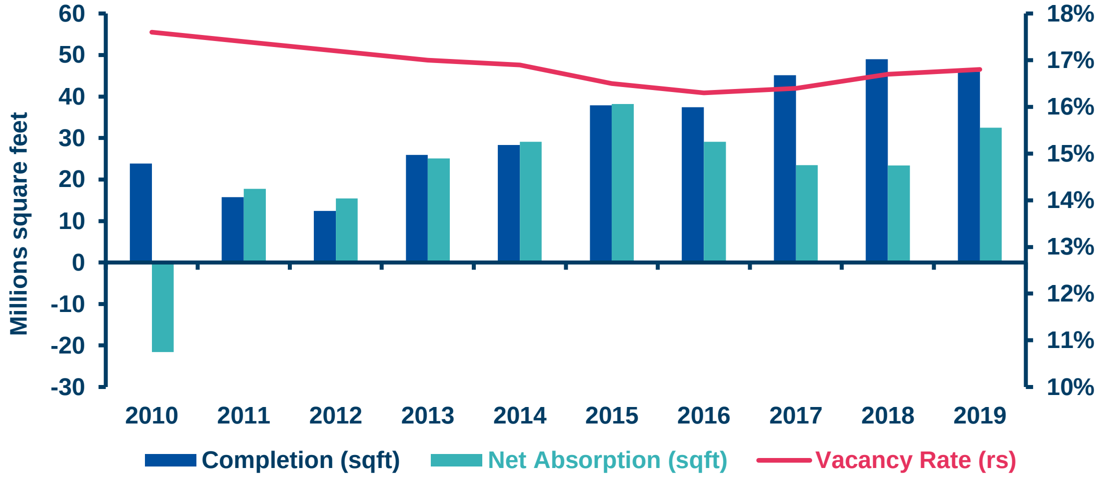
Like most office workers globally, US office workers experienced a rapid shift to remote working as Covid-19 hit. Now, as the United States is reopening, office use in most major metros is less than 25% of pre-Covid capacity. What we have not seen yet is broad-based requests for rental relief from corporate tenants (unlike retail tenants). Despite the immediate drop in utilisation, office rent collection remains 95% or higher.

The impact of Covid-19 on the office sector is likely to play out over an extended period of time, in contrast to the immediate impact to the retail sector. Office leases are longer term in nature, and corporations cannot change their footprint quickly. Office space per employee since the Great Financial Crisis has shrunk by approximately 10%, to less than 200 square feet. The densification has been driven by firms adopting a tech-like model of 'open floor plans' and doing away with the cube farms and individual offices of the past. Ultimately, Covid-19 will change the way corporations utilise their office space. Given the current pressure for the C-suite to reduce costs, we do not expect companies to expand physical footprints to accommodate social distancing. The global 'work-from-home' experiment has proven much more successful than anticipated, and we believe the shift to remote work is poised to have material impact on space demand.

In the United States, office vacancies range from 8% to 15% depending on the metropolitan statistical area. Many major metros have benefitted from co-working companies leasing large amounts of new construction space in recent years. We have seen once high-profile co-working tenants be forced to reduce meaningfully their footprints over the last 6-12mos. The decline of the co-working space model poses an additional setback for the office market.

While renewal rates and tenant retention will be high in the near term, in 12-18 months, **we believe we will see the early stages of space rationalisation among large corporate tenants and decelerating rents as absorption inflects lower.** This is likely to persist over 24-36 months, as more space comes up for renewal, creating a challenging outlook for US office CRE. This is likely to be felt most acutely in high-cost major urban centers. The trend to move employees into lower-cost settings, perhaps in suburban areas, is likely to persist.

US office space snapshot: vacancies are likely to rise



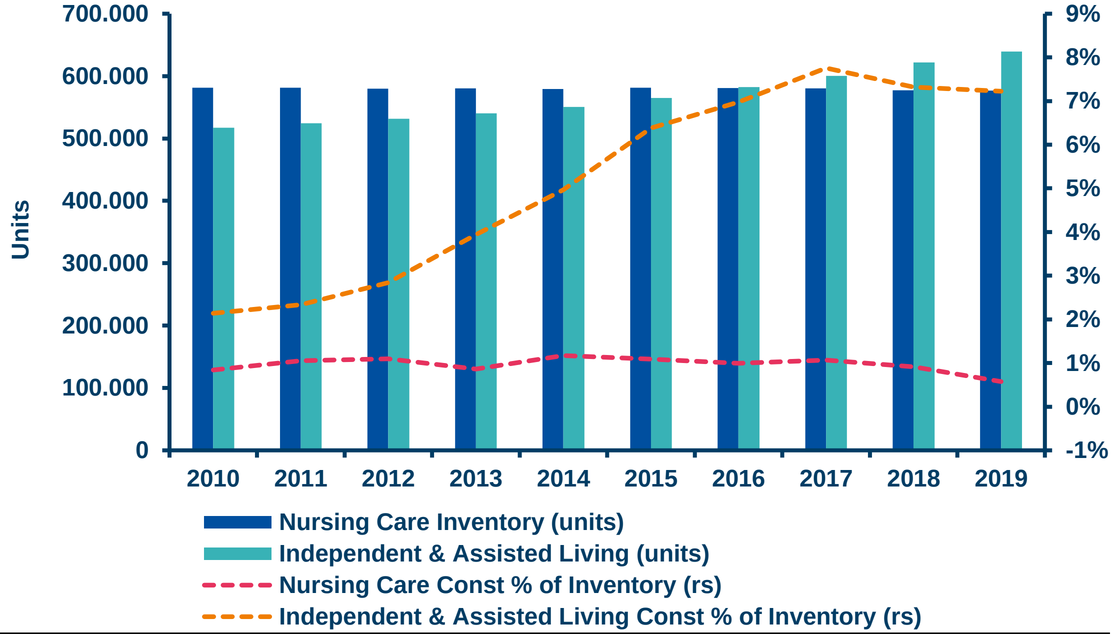
Source: REIS data via Bloomberg as of 31 December 2019.

Healthcare – Senior housing headwinds

The healthcare CRE landscape encompasses many different property types, ranging from hospitals and medical office buildings, to skilled nursing facilities, senior housing, and lab sciences/R&D properties. Among these industries, **Covid-19 has had impacts ranging from positive (increased R&D spending as we work towards a cure) to much more negative in the skilled nursing and senior housing centers,** where the bulk of US Covid deaths have been concentrated. By some accounts, greater than 50,000 US deaths have been in nursing homes and senior housing facilities, evidencing a systemic failure in safety protocol.

While aging US demographics are not in question, a number of factors provide offsetting headwinds for the economics of these facilities. Since 2014, construction of units (beds) of all varieties to serve seniors has been on an upward trend, and this supply glut has kept a lid on occupancy levels more broadly. Additionally, seniors have shown an increasing desire to age in place, and delay or avoid entry into these facilities. An increase in the use and acceptance of telemedicine is likely to exacerbate this trend and keep occupancy well below 90%. The concentration of nursing home deaths from Covid-19 will weigh on sentiment, as well as increase expenses. Wage pressure from staffing increases, increased personal protective equipment, higher insurance costs, and litigation expenses are among the factors that undermine the business model and weigh on valuations. Some weaker operators and owners will be forced out of business.

US senior housing & nursing care snapshot



* Source: NIC MAP data via Bloomberg; data as of 31 December for each year.
** NC: majority of beds skilled nursing, SNH: includes independent and assisted living facilities.

Industrial – A potential bright spot

The well-established e-commerce trends that threaten the retail sector are a tailwind to the US industrial sector. The rise of online market places and strong e-commerce growth among traditional retailers has ignited demand for warehouse and logistics space across the country, especially in close proximity to major population centers.

More recently, rising geo-political tensions between the United States and China, and Covid-related supply chain disruptions, have forced companies to reconsider their entire supply chains. We believe 'Just in Time' inventory management will transition to an increase in raw materials and finished goods on hand throughout the system. In order to avoid supply shortages, companies will need more warehouse and light industrial space.

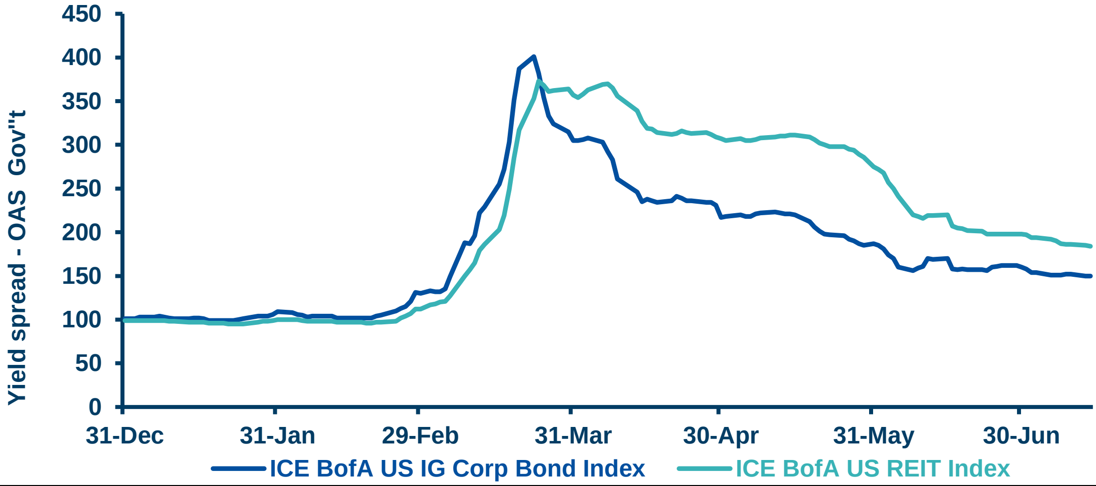
The industrial sector in US CRE is one of the few sectors likely to see an actual benefit from Covid-19, as changes in consumer behaviour and delivery expectations serve to increase demand from commercial tenants in these buildings.

Implications for Fixed Income

US CRE valuations were generally attractive compared to investment grade bonds as of 30 June, with the spread between the ICE BofA US REIT Index trading at 38 wide to the ICE BofA US IG Index. Though wider spreads and higher yields are attractive, **they still warrant conservative positioning and intense focus on individual security selection, as heightened levels of idiosyncratic risk exist**.

Larger companies, who are more geographically dispersed and less reliant on relatively few large assets, should be favoured over 'pure-play' companies with heavy concentrations in Covid-19 impacted sectors. Furthermore, the greatest stability is likely to come from those sectors least affected by shocks from Covid-19, primarily in the industrial, residential, and select healthcare sectors. On the other hand, retail, office and senior housing sectors will likely suffer the longer-term effects of Covid-induced changes in consumer behaviour and space demands. A focus on strong balance sheets, ample liquidity, and well-laddered debt maturities will afford management teams the flexibility required to meet the challenges of a changing landscape.

US Commercial REIT valuations are generally attractive



Source: Bloomberg and Amundi as of 30 June 2020. An option-adjusted spread is the difference between the yield of a security that pays fixed interest payments and US Treasury rates, taking into account options embedded in the security.

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Definitions

- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Office vacancy rate:** Share of unoccupied office space immediately available relative to all existing office space.
- **Option-adjusted spread (OAS):** It is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.
- **REIT:** A real estate investment trust is a company owning and operating real estate which generates income. Most REITs specialise in a specific real estate sector, focusing their time, energy, and funding on that particular segment of the entire real estate horizon.
- **Spread**: The difference between two prices or interest rates.
- **U-shaped recovery:** A U-shaped recovery is a type of economic recession and recovery that resembles a U shape when charted.

Important information

Date of first use: 27 July 2020

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