

Real Estate Outlook

US – Edition 4, 2020



Seeking equilibrium



Tiffany Gherlone
Head of Real Estate Research
and Strategy – US

Economic recovery begins even as the pandemic intensifies. **Real estate continues to adapt.**



Transaction volume is beginning to improve from the mid-year stall even as investors await clarity on comparative lease rates and required risk premiums. The next six months should bring measurable improvement compared to the last six months.

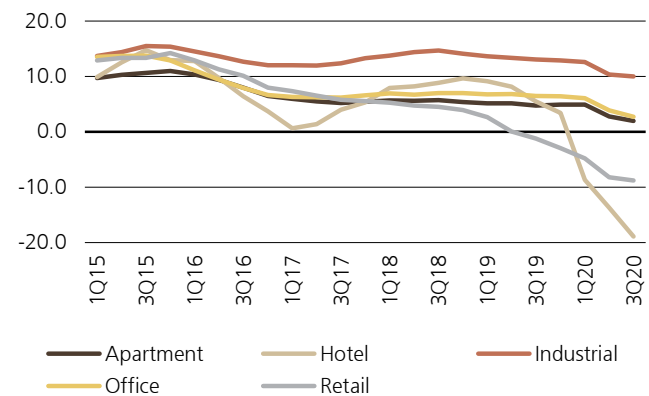
Real estate fundamentals – Looking forward

The US is showing the first signs of recovery from a historic downturn. The NCREIF-ODCE Fund Index shows income return offset depreciation in private commercial real estate supporting positive total return, with wide dispersion among property types (see Figure 1). A complete return to steady economic growth is still at risk as US metros struggle to flatten infection rates. However, rent collection statistics show that the majority of tenants are current on their payments. Quantitative easing supports persistent wide spreads. As an income-driven investment with opportunity for long-term appreciation, real estate is posited well relative to other asset classes.

The hotel and retail sectors continue to be the most impacted by the lingering effects of the pandemic. Most development sites have resumed work. More time is needed to understand whether delayed development deals will deliver back-to-back, or gradually over time. The office, apartment and industrial sectors have deteriorated in the short-term, as would be expected in an economic downturn. But generally, these properties remain open, with some opportunity to adapt to current conditions.

Cash flows are being impacted, even though efforts to smooth over short-term losses for long-term recovery should have some success. Investors are incentivized to provide workouts to most tenants and borrowers. Uncertainty is high, which means discount rates face upward pressure. Ultimately, we expect opportunities, but not a flood of distressed transactions.

Figure 1: US real estate returns across property types
(rolling four-quarter total return, %)

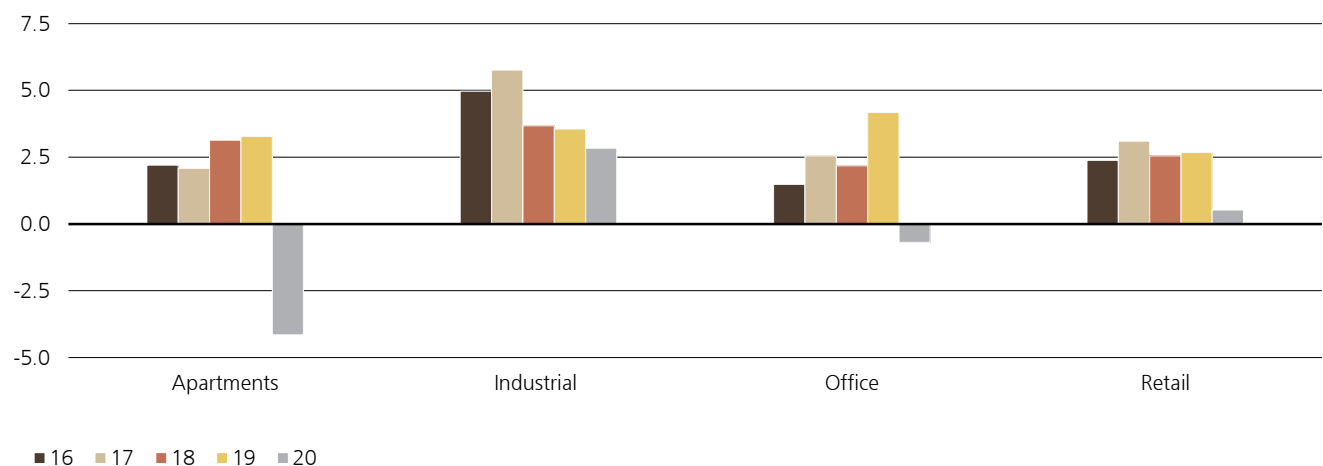


Source: Data shows unlevered NCREIF Property Index returns filtered for only ODCE managers. Past performance is not indicative of future result, September 2020.

Divergent sector return performance remained exaggerated over the quarter (see Figure 1). Hotel returns sharpened their decline as travel remains restricted. Apartment and office returns remain in negative territory on a rolling four-quarter basis. Retail returns continued to decline but at a noticeably reduced pace from 2Q20, exaggerating the still healthy industrial performance.

Consumers and investors are expected to remain cautious as lingering health and safety precautions restrain recovery growth. The US does not yet have universal control over the current health crisis; management and containment vary broadly by state and region. However, national year-to-date sector fundamentals did not contract as much as initially anticipated (see Figure 2), illustrating the resiliency of real estate investment.

Figure 2: Property sector rent growth (year-over-year change, in quarters ended 3Q20, %)



Source: CBRE-Econometric Advisors, 3Q20. Note: retail rent growth only reflects Neighborhood, Community and Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers

Apartment

Apartment sector vacancy has risen slower than initially anticipated even as supply remains elevated (see Figure 3). 3Q20 vacancy is up 80bps from one-year ago; partially a result of job loss but also impacted by an uptick in homeownership. Average asking rents are down 4.1% YoY; indicating that landlords are letting rent slip as they work to sign tenants. The speed of near-term apartment sector growth will likely be determined by the pace of employment recovery.

Necessity, not immunity

The essential nature of housing keeps the apartment sector functioning. Some stimulus, unemployment benefits and eviction moratoriums are expiring without clear replacements. The labor market is improving but results are uneven. Properties with tenants in heavily-impacted industries remain at highest risk. Most downtowns are under pressure, and this is likely to continue with downtown office vacancy rising faster than the suburbs.

Industrial

Despite the delivery of 74 million square feet during the quarter, 3Q20 industrial availability was unchanged from 2Q20 at 7.6%, 50bps higher than one year ago. Sector rent growth slowed to 2.8% YoY (see Figure 2), not far from the sector 10 year average growth rate of 3.1%.

Plenty of gas left in the tank

As public gathering remains restricted, the 2020 holiday shopping season is likely to be dominated by online shopping and consumer direct shipping, allowing industrial to maintain a position as the least volatile sector. The bones of industrial could be reshaped as tenant needs are adapting, including more automation and cold storage options.

Office

Total office vacancy rose to 14.0% in the third quarter as seven million square feet of new supply delivered into a market with rising availability. Preliminary 3Q20 data shows total office rent fell by 0.7% from one year ago. Downtown vacancy has risen to 12.6%, 240bps above one-year ago; while suburban vacancy, at 14.8%, is up by 170bps, narrowing the gap between the subsectors.

Persistent uncertainty

Office tenants are weighing the option of either reducing space as they move to a remote work platform or increasing their required square footage to create a more socially-distant workplace. The net effect will likely be lower demand, and supply will adjust lower over the coming years to seek new equilibrium. New capital improvement projects are difficult to justify until these decisions are sorted. Stress in downtown leasing is likely to persist into 2021.

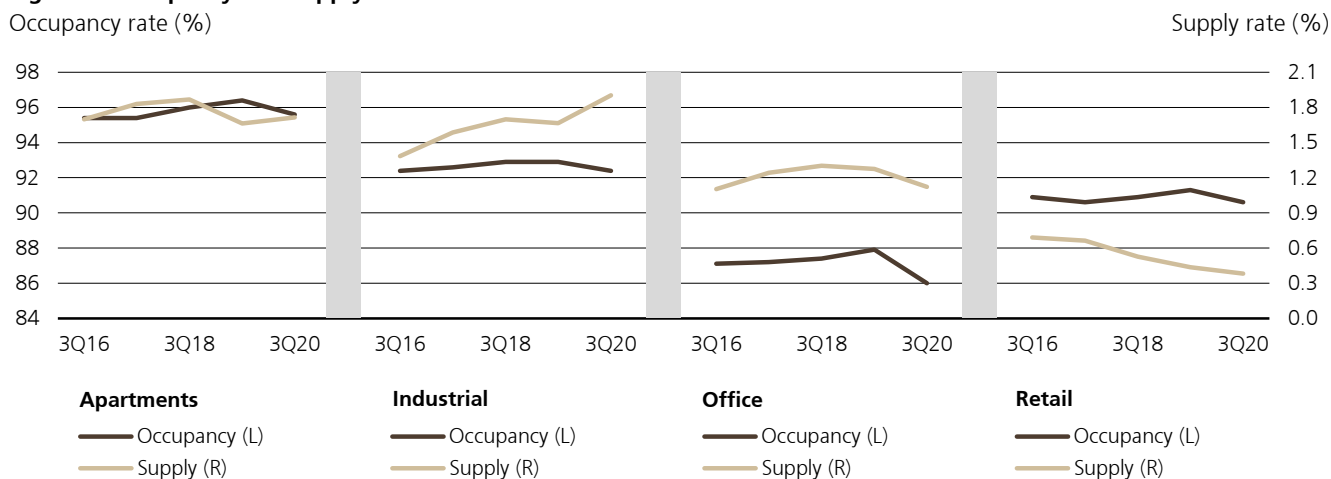
Retail

Neighborhood, community and strip center retail completions are low, but online retail competition is heating up. 3Q20 saw the availability rate rise to 9.4%. Asking rent data is based on space listed with brokers, and because only high-quality space is listed as available the rent data will begin to skew higher. The data shows a 0.5% YoY asking rent increase as the most troubled retail space is converted to new uses, disappearing from the sector entirely.

Agility required

Online retailers are expected to dominate the 2020 holiday shopping season with some initiating Black Friday sales in late October and early November in an effort to snare market share. Reactivation of pandemic restrictions will hurt independent brick and mortar stores and restaurants, particularly businesses unable to adapt to flexible and online strategies.

Figure 3: Occupancy and supply trends



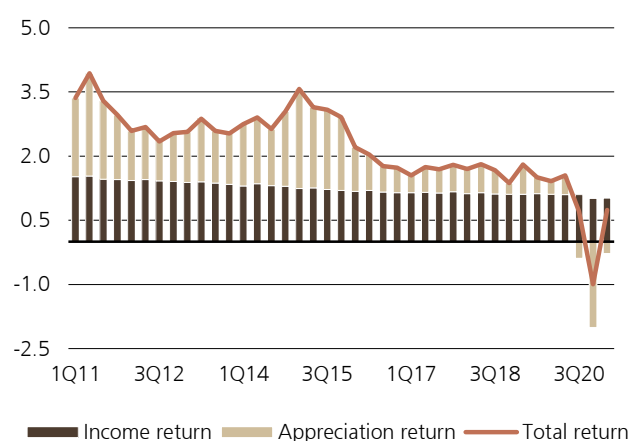
Source: CBRE Econometric Advisors, 3Q20. Note: Supply is shown as a completion rate (i.e. completions as a percent of existing inventory). Note: retail occupancy and supply rates only reflect Neighborhood, Community & Strip Shopping Centers, thus excluding Malls, Lifestyle and Power Centers.

Capital markets – Beginning to awaken

Property-level returns improved during the third quarter as a smaller decline in value was more than offset by income. Only the industrial sector produced positive appreciation. Even though total return remains slightly positive year-to-date, values have declined in aggregate during every quarter of 2020 so far (see Figure 4).

Figure 4: US property returns

(QoQ, %)



Source: NCREIF Property Index, 3Q20.

Note: Past performance is no guarantee for future results.

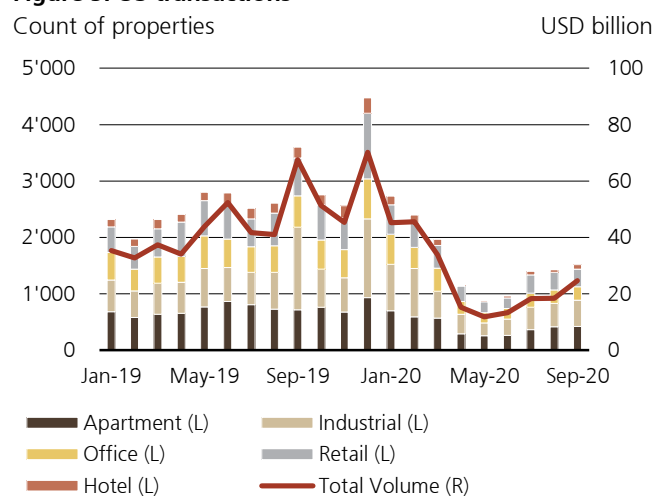
Interest rates are expected to remain low for years to come. Stimulative measures from the US Federal Reserve moved short-term interest rates to zero in March 2020. On the long-end of the curve, the US 10-year Treasury rate is below 1.0%, pushing real estate spreads well above-average (see Figure 6). The higher risk premium implied by wide spreads reflects uncertainty around future occupancy rates, leasing velocity and income growth expectations.

While all downturns bring uncertainty to capital markets, the 2020 pandemic-led downturn has brought several challenges unique to real assets: travel restrictions, site closures and backlogs in municipal permitting processes. These challenges continue to stall investment volumes and tenant leasing. However, as economies begin to adapt, investors should be able to institute protective measures and resume due diligence and leasing tours.

Interest rates are low. Spreads available in private real estate are well-above the long-term average, which should encourage greater transaction volume in coming quarters. Debt markets are loosening and lenders are favoring high-quality credit, long-term leases, multifamily and industrial properties.

September 2020 transaction volume is double the low point seen in May but just a third of what it was in September 2019. Figure 5 shows the sharp decline and tentative rise in total commercial and multifamily sales in the US during 2020. With persistently wide spreads, increased rent collection and cautiously competitive lenders, the US is likely to experience increased transaction activity as firms seek to complete trades by year-end. Optimism in the transaction market and cross-border investment should improve during 2021.

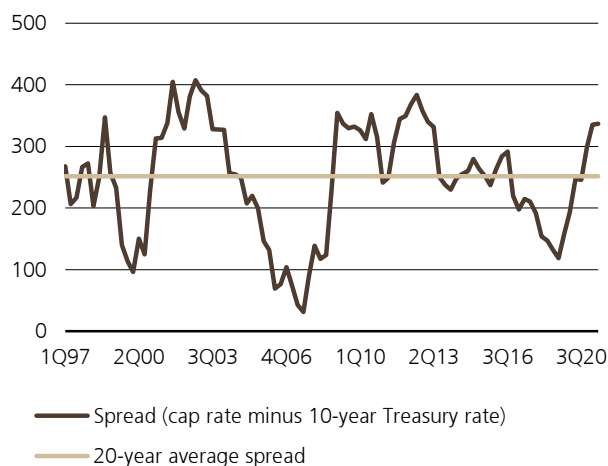
Figure 5: US transactions



Source: Real Capital Analytics, 3Q20. Includes entity-level transactions.

With limited sales restricting the availability of current pricing data, investors remain cautious. Although many lenders are open and able to lend, the near-term focus will be on managing portfolio stress and working out terms for existing loans, while extending new debt to the highest-quality deals.

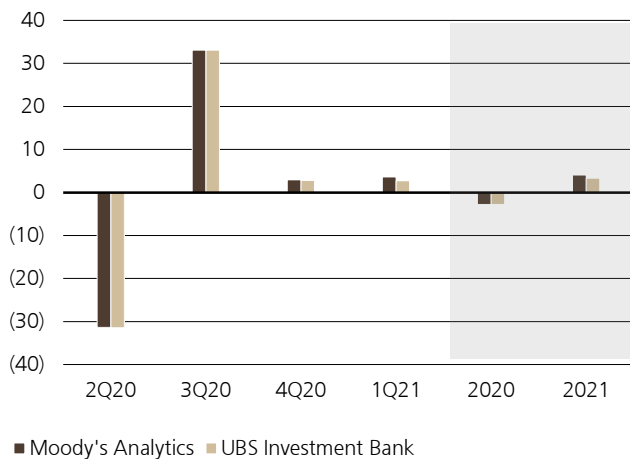
Figure 6: Commercial real estate spread (basis points)



Sources: NCREIF Fund Index – Open-end Diversified Core Equity; Moody's Analytics, 3Q20.

Preliminary third quarter GDP data shows an annualized growth of 33.1% (see Figure 7). Optimism for modest, positive, economic growth during the fourth quarter leads to a GDP forecast of about negative 3.5% for calendar year 2020 – an improvement from previous forecasts. Recovery will be slow given virus flair-ups and stalled stimulus negotiations.

Figure 7: US real GDP growth (% annualized)



Source: Moody's Analytics as of 9 November 2020 and UBS Investment Bank as of 6 November 2020.

Unprecedented stimulus flowed through the federal government and Federal Reserve to businesses, consumers, states and municipalities during the second quarter. Direct financial support helped establish a floor on the severity of short-term decline and helped communities, tenants and customers. However, near-term growth faces headwinds as pandemic restrictions outlasted the initial fiscal stimulus. Negotiations on further stimulus remain stalled.

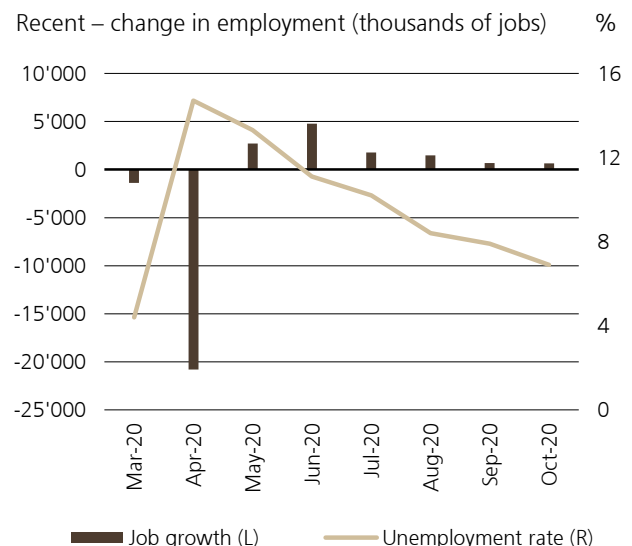
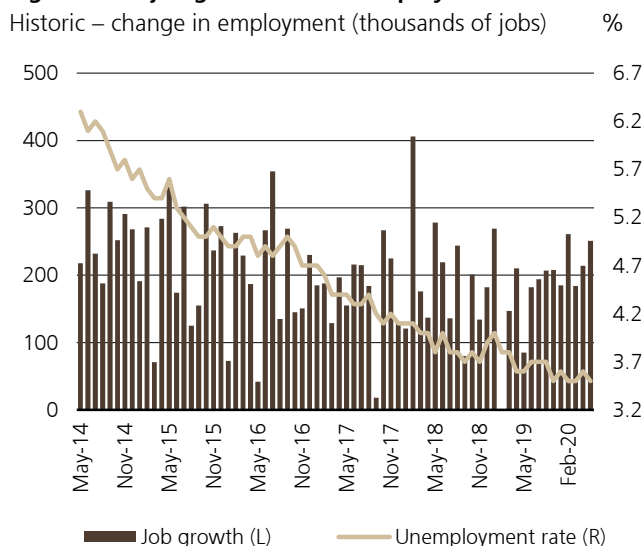
The unemployment rate shot up to 14.7% in April and almost immediately began to decline as Payroll Protection Program loans were approved (see Figure 8). The US unemployment rate was 7.9% for the month of September, which means 11 million Americans remain out of work, depressing consumer demand, particularly for services. Regional differences should play an important role in determining the trajectory for metro level downturns and recoveries.

Strategy viewpoint – Dexterity required

State and metro variations in public health procedures may have widened the gaps around near-term economic potential. The momentum of future job growth will depend on finding a medical solution that limits a systemic resurgence of the virus and supports confidence in the potential for growth. The positive test results for the Pfizer-BioNTech and Moderna vaccines are steps towards that outcome. Downtown locations should show renewed potential in 2021, but the trajectory of growth is muted in the near-term compared to sites that are less dense and less dependent on mass transit.

Uncertainty continues around two key inputs to private real estate pricing: future cash flows and current transaction metrics. As data becomes available, there is every reason to expect that investors will adjust their underwriting. Necessity-driven, low-capex industrial and apartment assets remain in favor by investors in the near-term. Investments with lower risk tenant profiles and stronger cash flows will likely be most attractive to lenders.

Figure 8: US job growth and unemployment rate



Source: Moody's Analytics, September 2020

Our research team

Darnesha COLLIER
Kurt EDWARDS
Nicola FRANCESCHINI
Zachary GAUGE
Tiffany GHERLONE
Gunnar HERM
Fergus HICKS
Brice HOFFER
Amy HOLMES
Courtney LEE
Sean RYMELL
Shaowei TOH

For more information, please contact:

UBS Asset Management

Real Estate & Private Markets (REPM)
Research & Strategy

Tiffany Gherlone
+1-860-616 9059
tiffany.gherlone@ubs.com



Follow us on LinkedIn

To visit our research platform, [scan me!](#)



www.ubs.com/repm-research

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investment in real estate/infrastructure/private equity (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of November 2020 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at November 2020 unless stated otherwise. Published November 2020. **Approved for global use.**

© UBS 2020 The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.

