Intelligent Investment

# Steady Investment Activity Shows Commercial Real Estate Resilience

VIEWPOINT

After U.S. commercial real estate transaction volumes declined in 2020, 2021 recorded a remarkable comeback.

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# Key Takeaways

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– After U.S. commercial real estate transaction volumes declined in 2020, 2021 recorded a remarkable comeback.

– With a share of 43% of investment activity in 2021, multifamily remained the preferred sector. This marks the most robust activity since EA's data collection started in 2001, underscoring investors' confidence in the sector.

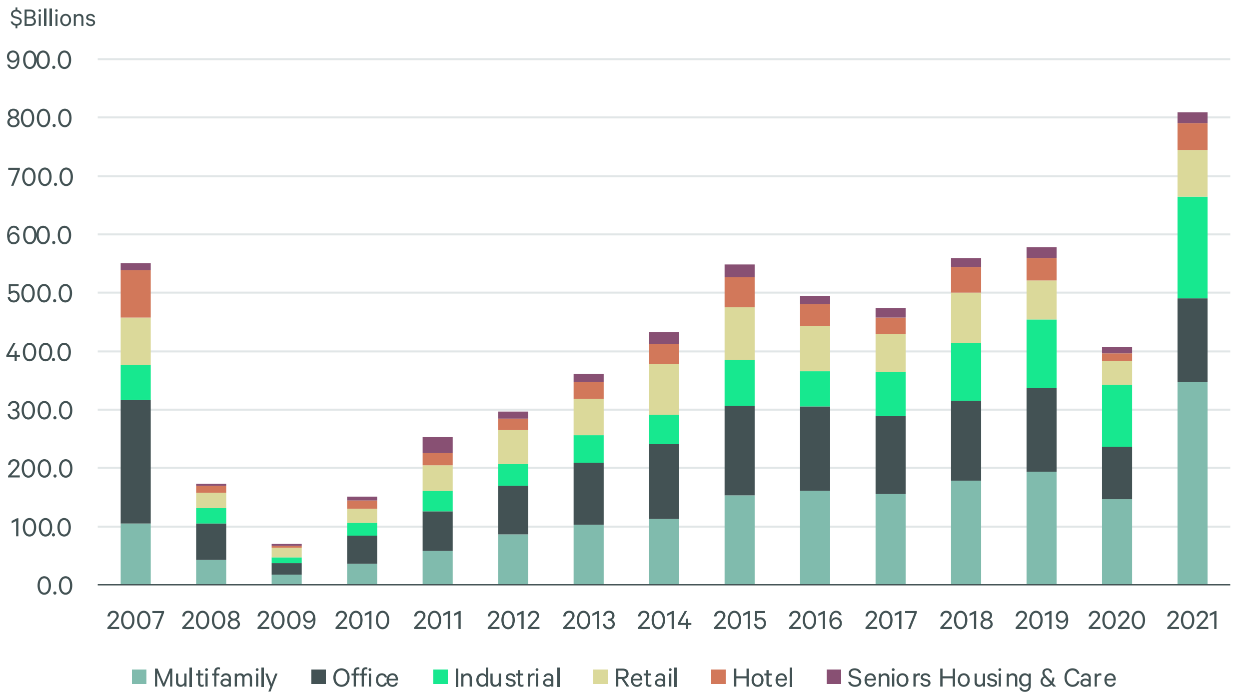
– Except for retail, cap rates are expected to stabilize and stay slightly lower than their pre-COVID-19 levels over the next few years.

– The relatively high cap rates spread can provide some cushion against rising interest rates over the next five years.

After a considerable decline in U.S. commercial real estate (CRE) transaction volumes in 2020, 2021 recorded a remarkable comeback. Overall transaction volumes are nearly double 2020 levels, reaching $809 billion. This is almost 50% above the average annual volume of $530 billion between 2015 and 2019. While historically high transaction volumes in 2021 can be partially attributed to carryover of unfinished transactions during a challenging 2020, investor sentiment also played a major role in the market's sharp turnaround. After reassessing CRE fundamentals and the macroeconomic environment based on new challenges from the pandemic, investors began to regain their confidence and realign portfolios, sometimes expanding into new property types.

**Figure 1:** U.S. CRE Transaction Volume

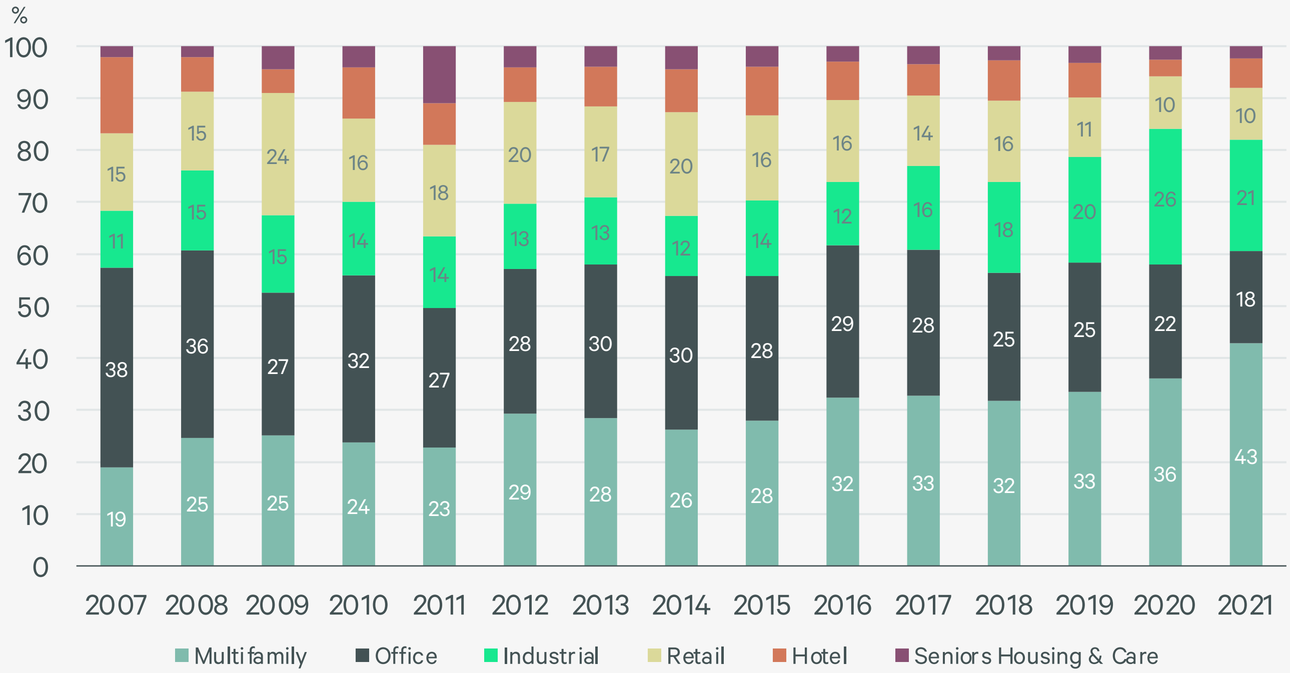



Real Capital Analytics, CBRE EA, Q4 2021.

## Investors shift strategies amid new challenges and opportunities

As employees and consumers adapted to more virtual work and online shopping, CRE investors shifted their strategies in 2021. Some property types experienced increased transaction volume while others declined. Figure 2 shows the transaction volumes by property type illustrating how investors' preferences have changed over the last 15 years.

**Figure 2:** U.S. Transaction Volume Share by Property Type




Source: Real Capital Analytics, CBRE EA Q4 2021.

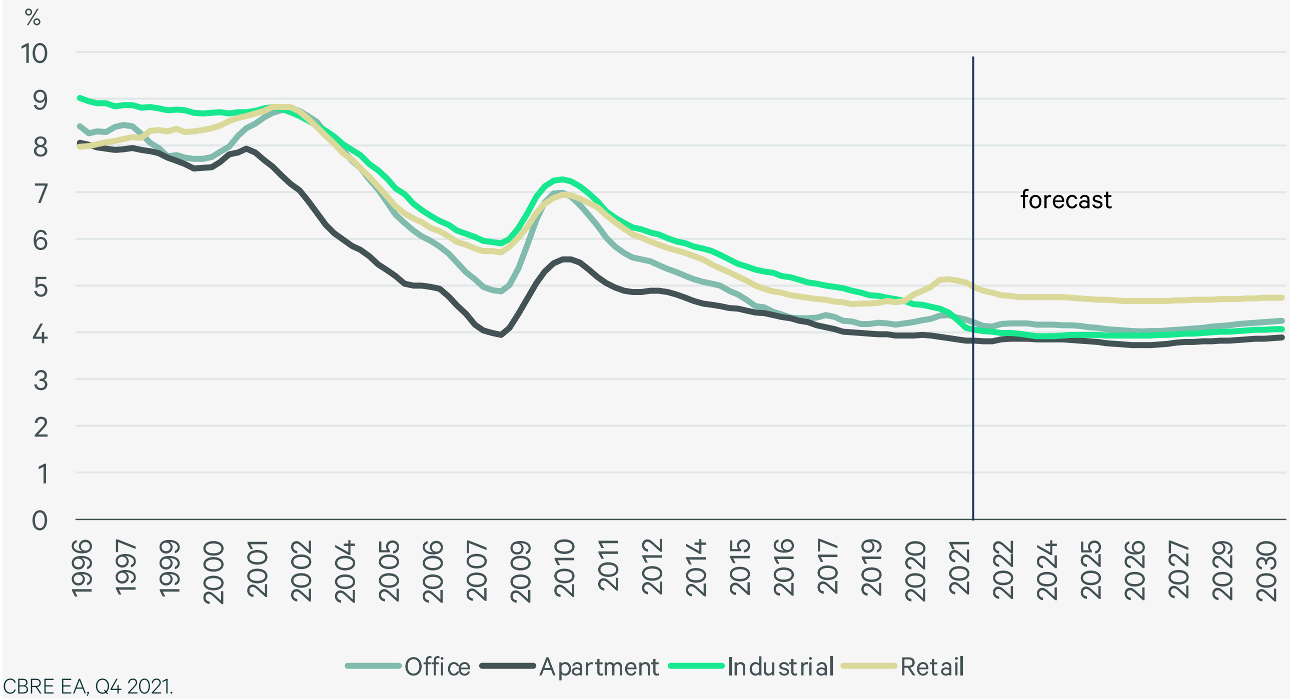
Multifamily's share of total investment has been growing steadily over the past 15 years from approximately a quarter in the late 2000s to one-third by 2016. Between 2016 and 2019 the share stabilized at around 33%, which made it the largest property type by investment volume. During the pandemic, multifamily investment sales were remarkably robust, both by share and volume. Multifamily remained the preferred sector in 2021, with its share reaching 43%, the highest point throughout tracked history, underscoring investors' confidence in the sector. The success is partially because new residential construction has not kept up with the U.S. household formation over the past decade.

Industrial transaction volume also grew significantly over the past decade and continued to increase throughout the 2010s, propelled by e-commerce and expanding warehousing space requirements. Due to lockdown measures in 2020, e-commerce accounted for 22% of total retail sales, pushing industrial transaction volumes to a record 26%. E-commerce volume remained above its pre-pandemic level in 2021. EA expects e-commerce penetration will continue to grow. In the short-term, supply chain disruption could propel U.S. goods production, further increasing demand for warehouse space.

The retail, hotel and office sectors continue to face the most challenges. Retail share of all CRE investment transactions declined to 11% before the pandemic as e-commerce re-ordered the retail landscape. A drop to 10% in 2020 and 2021 showed that investors had already made necessary corrections before the pandemic.

Hotels' share in 2021 bounced back to 6% from 3% of all CRE transactions in 2020, almost reaching its pre-recession level. Office is still under pressure from virtual work adjustments, and office investment share declined to 18% in 2021 from 30% in the mid-2010s. This doesn't mean that the office sector is in permanent decline.

**Figure 3:** Cap Rates Forecast




CBRE EA, Q4 2021.

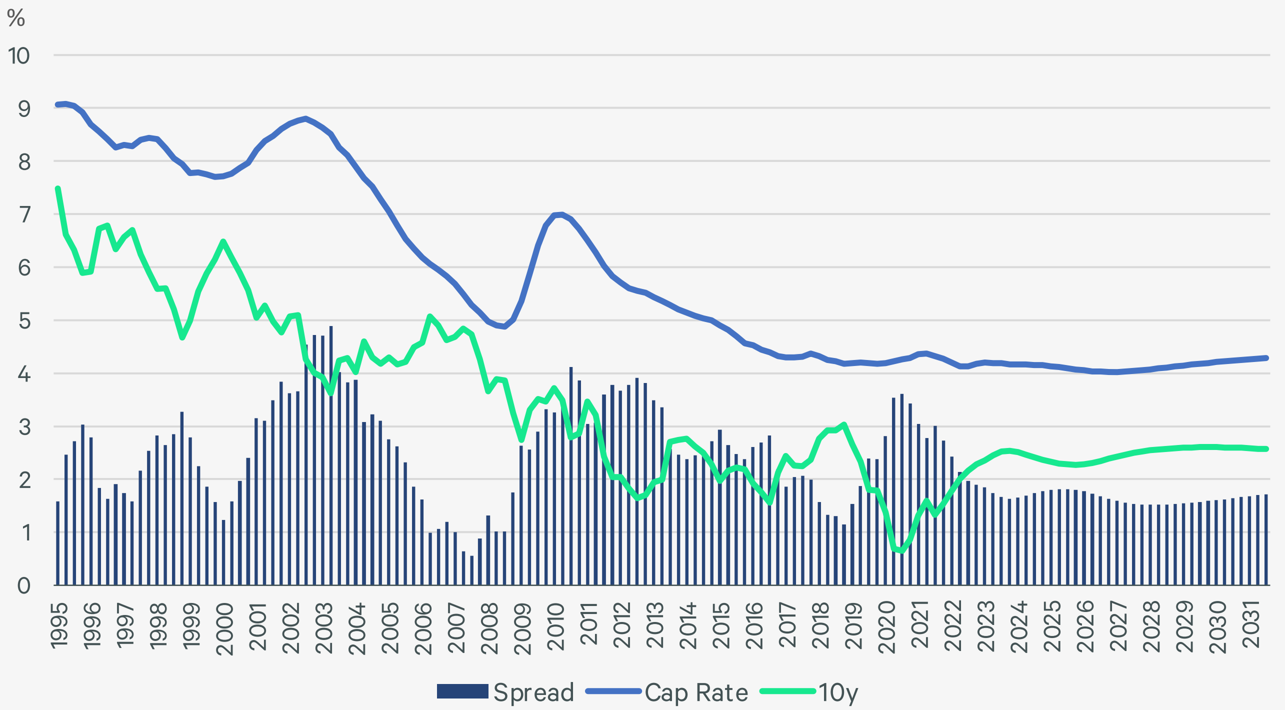
During the pandemic, retail cap rates expanded by 50 basis points (bps). The gap between buyer and seller expectations was the widest for retail property types, according to RCA. As retail fundamentals started to improve in H2 2021, income growth and consumer spending helped cap rates to stabilize and compress slightly. But because the retail sector continues to be adversely affected by higher e-commerce penetration, cap rates are not expected to recover to pre-COVID levels until 2026.

Office cap rates increased by 20 bps from the start of the pandemic into mid-2021. They stabilized and even compressed slightly from the second half of 2021 as vaccines became widely available and employees started to return to the office. There is a variation in cap rate movement across different classes. Higher quality, Class A properties showed more cap rate compression than Class B and C properties.

Multifamily provided relatively high and stable cash flow yields compared with other sectors over the past two decades. Robust government-sponsored agency lending has supported multifamily acquisition volume. Perceived resistance of this sector to ups and downs of the economic cycle make it a good defensive bet during economic downturns.

Industrial rent has been strong and is expected to increase throughout the forecast (10 years). Both multifamily and industrial have weathered the pandemic well, with cap rates expected to compress over the next 5 years. With continued economic growth expected in 2022, CBRE expects commercial real estate to rebound and generate solid income. Except for retail, CBRE expects cap rates to stabilize and stay slightly below their pre-COVID level over the next few years.

**Figure 4:** Office Cap Rates Spread




CBRE EA, Q4 2021.

## There's Still Room for Cap Rate Compression

It's useful to look at the spread between cap rates and risk-free government bond yields. While interest rates impact cap rates, the two variables do not move in lockstep due to shifts in investors' perception of risk.

The spread between office cap rates and the 10-year Treasury yield is high, at 273 bps, which can provide a cushion against rising interest rates. In the CBRE EA forecast, even though interest rates will increase throughout the forecast period, there is still room for some cap rate compression. And the spread in the longer term, after 2026, is expected to shrink to 150 bps, which is still higher than the spread at the end of 2018 (115 bps). In general, the spread tends to rise during times of economic contraction and fall during recoveries, and we expect this pattern to continue in the future.

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