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VIEWPOINT
U.S. INVESTMENT

U.S. Investment Performance Outlook

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EXECUTIVE SUMMARY:

- There is a gap between buyers' and owners' price expectations.
- Lending markets, outlook for future growth, and income security are driving buyers' price expectations.
- Intrinsic value is falling, but it won't be realized until owners are compelled to transact.
- We expect the office sector value to fall by 12.5%. This is less than the 21.5% decline during the Great Financial Crisis (GFC). The recovery is expected to be much faster this time.
- Industrial and apartment are expected to weather the crisis better than other sectors.
- Value-add properties will see larger losses than core properties.

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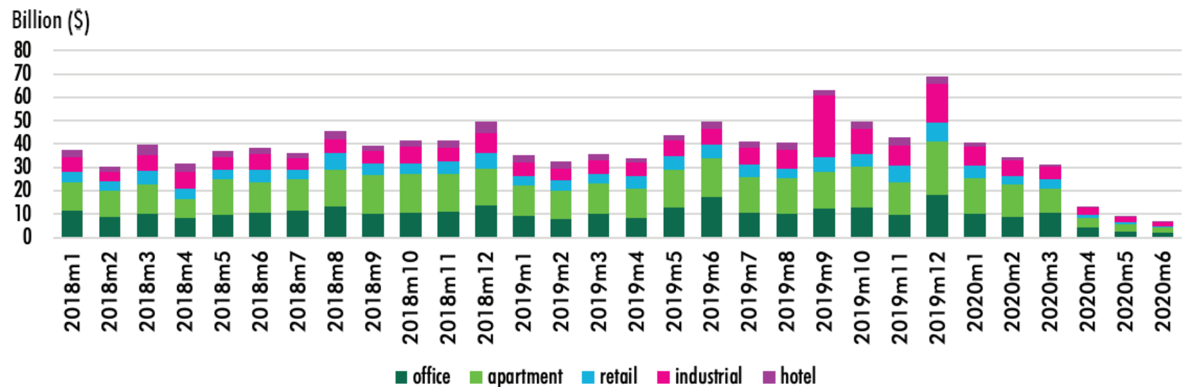
With the pandemic continuing to affect the U.S. economy, investors are wondering what this means for commercial real estate (CRE) performance. Will certain property types be more immune to the economic slowdown? Which factors are driving pricing?

The first measurable impact was on transaction volume in the second quarter, which, according to Real Capital Analytics (RCA), declined 77% relative to last year for the five major property types[1] . The recent stalling of activity is related to renewed spread of COVID-19 and rising uncertainty. Investors are becoming more cautious and lowering their price expectations. However, when it comes to financing the deal, lenders tend to be more conservative, which can lead to rising debt cost and falling leverage. Therefore, the price needs to fall for investors to meet a given target return.

From the owners' perspective, they are not willing to adjust their price expectations unless they are forced to transact. Liquidity, which depends on owners' ability to collect rent and refinance, is expected to be a major determinant of how long the owners can delay the potential loss. Based on CBRE internal data, except for retail, the landlord/ owners are still collecting a large portion of rents. The prerequisite of refinance is a stable source of income, and it is easier for industrial and apartment owners to refinance than office or retail owners.

Figure 1: Transaction Volume



Source: Real Capital Analytics, Q2 2020.

[1]Office, apartment, retail, industrial and hotel.

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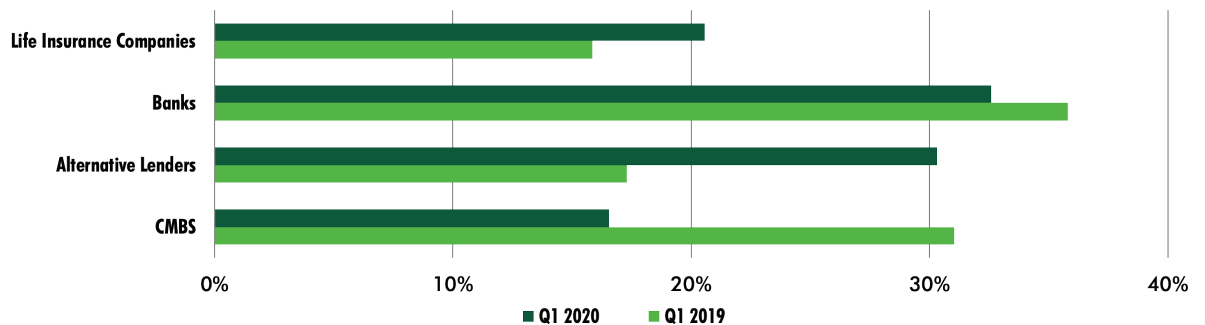
LENDING STABILITY

Banks, alternative lenders, life insurance companies and CMBS were the major lenders pre-COVID. Banks had the largest share of loan value - more than 30%- and are much better capitalized now compared to pre-GFC. We can expect banks to remain a source of liquidity, particularly for core properties. Alternative lenders, which include REITs, finance companies and debt funds, are the second important lender. They scaled back because some private debt funds may struggle with liquidity issues. Life insurance companies will still be active, though conservative, during this time. The CMBS share declined from 31% in Q1 2019 to 16.5% in Q1 2020 because of the rising spread and volatility, but that should be improved as the Fed includes senior CMBS bonds as eligible collateral.

Figure 2: Market Share of Lenders



Source: CBRE Capital Markets and CBRE Research, Q1 2020.
Reflects non-agency commercial/multifamily loans.

In general, lower loan-to-value ratios mean that lending markets are in a much better shape today than during the GFC, which helps to mitigate the negative shock from the pandemic.

RENT SCENARIO

As a result of the big hit to economic activity in Q2 2020 and the gradual return of economic activity and employment to “normal,” the Baseline CBRE EA outlook calls for negative rent growth and rising vacancy rate over the next few years. The hotel and retail sectors are expected to be affected most, with economic rents declining by 39% and 12% respectively over the next year. For retail, this is due to a combination of consumers cutting non-essential spending and accelerated e-commerce penetration. The hotel sector is severely affected by the lockdown and travel restrictions. Rising unemployment is putting stress on both office and apartment, and economic rents are projected to show 9% and 11% declines, respectively, at the lowest point in the forecast.

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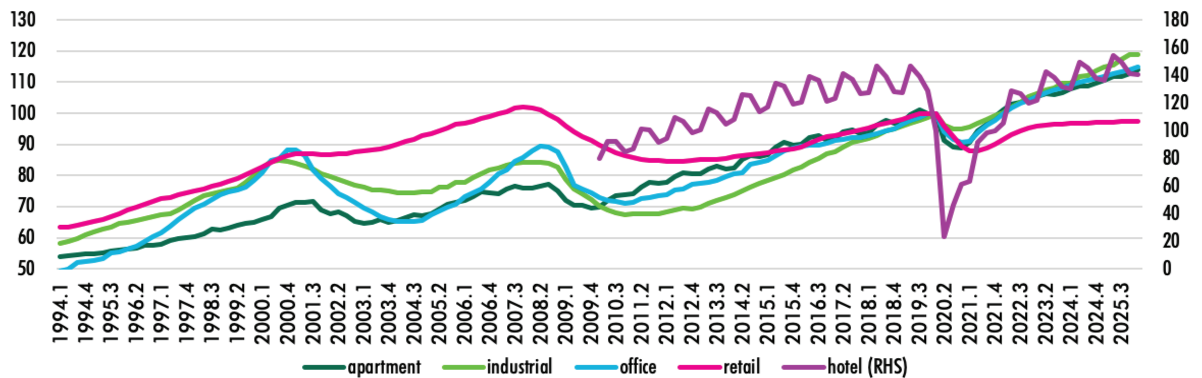
Apartment and office are expected to have a faster recovery as the economy emerges from recession, while retail revenue will stay lower relative to the pre-COVID level in the next five years. We expect demand in the industrial sector to remain stronger than the others, with expected performance (5% decline in economic rent) exceeding other property types in an economic downturn and industrial properties focused on e-commerce possibly experiencing no rental decline at all.

Figure 3: Economic Rent Index (rent*occupancy rate, 2020q1=100)

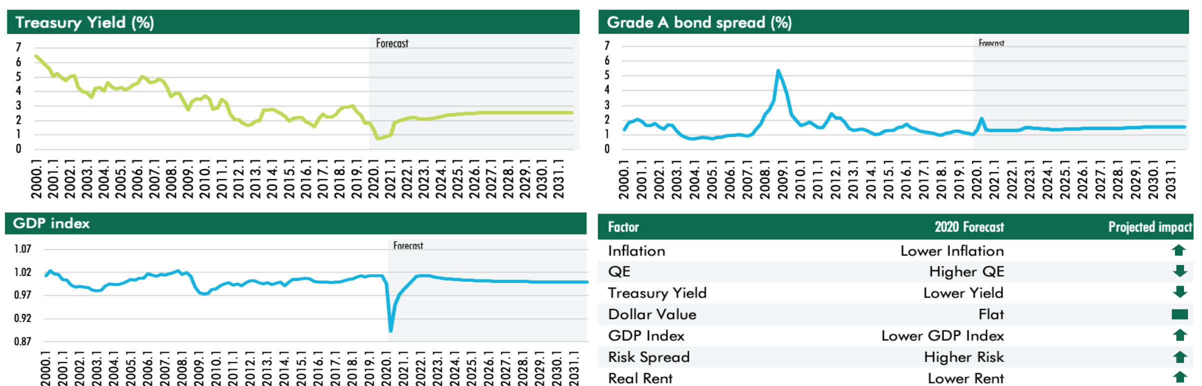


Source: CBRE Econometric Advisors, Q1 2020.

CAP RATE SCENARIO

We expect cap rates to increase in the retail and office sectors. Our previous study found that cap rates are influenced by the yield on medium-term Treasury Bonds, inflation, Federal Reserve quantitative easing (QE), bond spread, dollar value, and GDP relative to trend and local rents. These are included factors in our cap rate forecasting model.

Figure 4: Q1 2020 Assumptions on Macro Variables



Factor	2020 Forecast	Projected impact
Inflation	Lower Inflation	↑
QE	Higher QE	↓
Treasury Yield	Lower Yield	↓
Dollar Value	Flat	■
GDP Index	Lower GDP Index	↑
Risk Spread	Higher Risk	↑
Real Rent	Lower Rent	↑

Source: CBRE Econometric Advisors, Q1 2020.

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Factors included in our model uniquely characterized the economic environment that shapes the direction and degree of cap rate movement at the national and metro levels. For example, in a low interest rate environment, as we experience today, the lower Treasury Bond yield eases upward pressure on cap rates as the risk-free rate declines. The corporate risk premium is used as a proxy for investor uncertainty and liquidity which are key determinants of cap rate movement. Corporate bonds are also a substitute for real estate investment so we would expect a relationship between the two. The bigger the increase in the spread or corporate bond yields over Treasury Bond yields, the more cap rates should rise, as investors demand compensation for higher risk in the form of lower asset values for the same income stream.

In 2020, we expect that the corporate bond risk premium will only show a slight increase (in contrast to the GFC period). Indeed, it peaked in March and has been falling since, so the impact of cap rates will be small. However, the muted movement in the corporate bond yield spread reflects the Fed's intervention in the market, but that need not nullify the relationship between corporate bond and commercial real estate cap rates. The lower inflation indicates a lower rate of nominal income growth, leading to higher cap rates. As we anticipate that inflation will increase as the economy starts to recover in two years, this factor will only mildly contribute to upward pressure on cap rates. Inclusion in the model of GDP relative to trend gives us a dependable indicator of the economic cycle. When the economy is growing, GDP and GDP relative to trend increase and cap rates tend to fall; during economic downturns, we see falling GDP relative to trend and rising cap rates.

In our model, QE is a measure of liquidity. By transferring debt from private to public balance sheets, the Fed is increasing money supply and helping financial markets with liquidity problems. Increased liquidity helps to maintain valuations and hence lower cap rates. This is in addition to any direct impact from QE on Treasury Bond yields. The U.S. dollar exchange rate, which is expected to stay relatively constant in 2020 and decline slightly after, will play a role for cap rates. Dollar decline can, theoretically, push cap rates either way depending on how it affects investors' future expectations of exchange rate movements but empirically we find that a lower dollar is related to a lower cap rate. At the metro level, a lower forecasted real rent would also push cap rates up, as the investors project rent decline into the future and bid down asset values.

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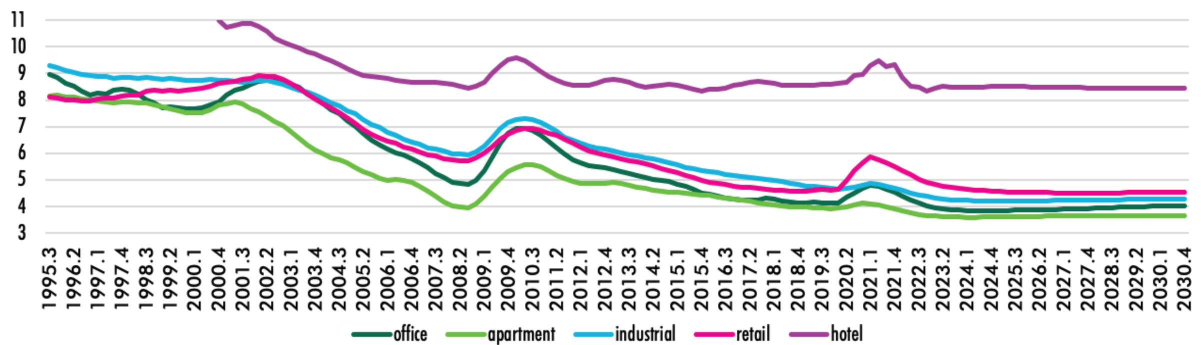
Figure 5: Cap Rate Forecast at National Level



Source: CBRE Econometric Advisors, Q1 2020.

The cap rates in Q1 2020 remained stable relative to Q4 2019 across all property types. However, in our Baseline scenario, with the declining GDP and employment and rising risks, cap rates are expected to increase in 2020. The retail and hotel sectors are projected to be affected the most, with rates rising by 100 bps. This increase reflects both the near-term weakness in the assets' performance and the lending markets. Retail rents are expected to decline 7% and vacancy to rise by 340 bps from pre-COVID to the end of 2020. For hotel, we forecast a 33% decline in ADR and 20% drop in occupancy rate during the same period. On the lending side, lenders are becoming more conservative and are less likely to finance retail and hotel deals until the market stabilizes.

The national office cap rate (averaged across all metros) is forecast to increase 55 bps due to economic impact and worries over the potential implication of remote work policies on future rental growth. However, there is a variation in office property performance depending on the security of income. Stable income is expected from single-tenant properties with good credit, as well as core properties, so these types of buildings will see better valuations than others.

Apartment and industrial are expected to weather the crisis better than other sectors, with cap rates only slightly increasing, 20 bps and 10 bps respectively. Apartment cap rates have historically been tighter than other property types since the early 2000s but have compressed over time, reflecting growing interest from investors. In addition, debt capital from the agencies – Fannie Mae and Freddie Mac – can increase liquidity on the market, preventing cap rates from rising. Industrial cap rates have been higher than other commercial categories since 2004 but have also compressed over time as logistics rather than manufacturing increasingly gained favor with investors. Due to rising e-commerce penetration, industrial is hedged against pandemic-related losses.

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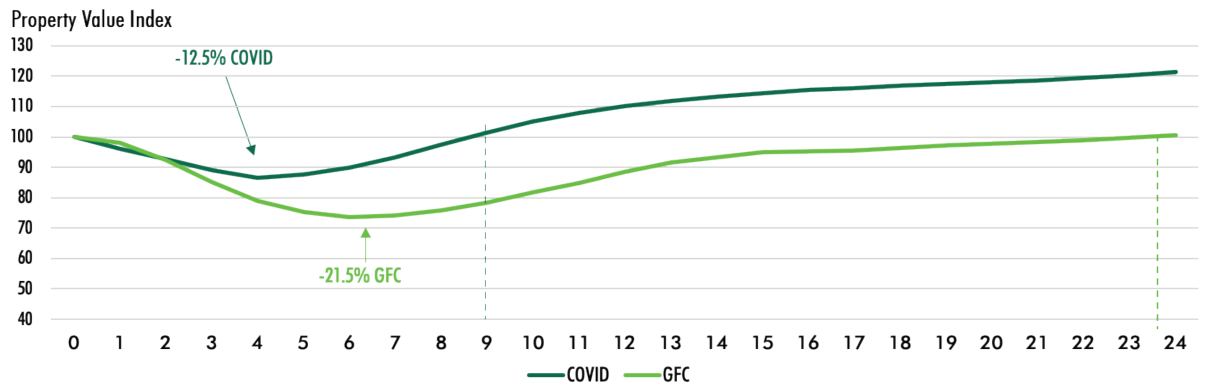
We also expect core properties to perform better than value-add because they have a more stable and predictable income stream.

Given the Baseline forecast of a robust bounce back of the U.S. economy, cap rates are projected to recover to pre-COVID levels in 2-3 years. After recovery, cap rates will be at a lower level compared to pre-COVID, reflecting the impact of low interest rates and injection of liquidity from the Fed.

Figure 6: Office Property value for COVID and GFC



Source: CBRE Econometric Advisors, Q1 2020.

COMPARISON TO HISTORICAL RECESSIONS

How does this compare to the GFC? The property value for the office sector is expected to decline in the next few quarters, and the lowest point would be a 12.5% decline in value in Q2 2021, which is much less than during the GFC's 21.5% lowest decline. We also expect a faster recovery this time. After nine quarters, value will go back to pre-COVID levels, while for the GFC, it took 24 quarters. However, there wasn't an imbalance between the surge of safe asset demand and supply before the crisis this time, nor was there a global imbalance in funding countries' demand for financial assets beyond their ability to produce these assets. Now we also have better liquidity and a functioning lending market, and the economy in general is also expected to recover faster.

Note that the value we are forecasting would be the intrinsic value. One can interpret it as "the value needs to drop 12.5% for the market to clear." But this discount will only be realized if the owners are forced to transact, and they can delay the loss if they have enough liquidity.

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	Relative Liquidity Condition		Outlook For Future Growth		
	Ability to Collect Rent	Lending Market	Rent Decline in 2020	Cap Rate Increase	Long Term
Industrial	High	Medium-High	Small	Small	Solid Fundamentals + Structural Change +
Apartment	Medium-High	High	Medium-Large	Small	Solid Fundamentals +
Office	Medium-High	Medium-Low	Medium-Large	Medium	Work From Home -- Lower Density +
Retail	Low	Low	Large	Large	E-commerce - Structural Change ±
Hotel	Low	Low	Large	Large	Solid Fundamentals + Structural Change +

OUTLOOK BY SECTOR

So far, we reviewed the liquidity condition and outlook for each of the sectors. It's relatively easy for apartment deals to get financing because of the agencies (Fannie Mae and Freddie Mac) and their low-cost provision of debt capital, along with private lenders' perception of the apartment sector's stability. In the short term, due to rising unemployment, there would be some decline in rent. But we believe that's very temporary, due to a quick employment recovery timeline and less uncertainty, as remote working is feasible for many office jobs. Apartment demand will remain remarkably strong, which will lead to declining vacancy and rising rent. As a result, apartment cap rates will also not be affected much.

Office has mixed performance. Currently, landlords can collect most of the rents. But going forward, we are facing some uncertainties in the near term. If people continue to work remotely, that could lead to less demand for office space. But at the same time, safety measures would lead to more space per worker, which would translate to more demand. It's still too early to tell which force will dominate.

Retail is struggling in many ways. In the long term, we expect a structural change in this sector, which can lead to a shrinkage of retail space. But the good news is that after the pandemic, the retail sector will come out in a healthier condition.

For hotel, although a lack of liquidity and revenue declines will characterize the hospitality market for the upcoming year, the overall market will retain its solid footing in the long term.

Industrial is clearly the "winner" in all dimensions.

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CONCLUSION

We believe we are currently in the price discovery phase and there is a gap between buyers' and owners' price expectations. It's only when the markets start to stabilize, and both buyer and owner reach an agreement on price, that we will see the recovery of transaction volumes. On the lending side, we expect the agencies to be the primary source of finance, followed by banks and life insurance companies. The CMBS market is improving, but it may be subject to volatility. In the coming months, we may see some transactions for industrial and apartment, because this type of transaction is easier to get financing from lenders. Perhaps in 3-6 months, investors will circle retail and hotel properties in distress, and lenders will become more willing to finance them as the market stabilizes.

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