BLOG POST

The Future of Commercial Real Estate

6/22/2020

It's no surprise that the COVID shutdown has posed an enormous challenge for the commercial real estate industry. With people increasingly staying and working from home, it's highly likely that the commercial real estate industry will undergo substantial changes in the not-too-distant future. Furthermore, simply reopening the economy doesn't ensure people will return to previous behavior. This will impact the profitability of the industry over the short- to intermediate-term.

Based on data from the National Association of Real Estate Investment Trusts (NAREIT), some sectors of the real estate market have taken a substantial hit this year. Based on the table below, retail as a group is lower by roughly -41% through April, with regional malls lower by -52% (see table below).

Likewise, lodging and resort properties are lower by roughly -45% as people have avoided travel since the pandemic hit. Other sectors, however, have held up relatively well, such as data centers and infrastructure. These sectors are not as sensitive to the effects of the coronavirus.

The fact that retail REITs are in decline isn't surprising. Investors have been calling for the so-called death of brick and mortar stores and shopping malls for some time, as consumers turn increasingly to making online purchases. However, the current situation with the COVID 19 shutdown has brought into question the future for office space and resort properties in particular.

According to a Gartner survey of 317 CFOs conducted in April, 74% of respondents indicated that they will move at least 5% of their previously on-site workforce to permanently remote positions. Furthermore, 25% of respondents said they would move 20% of their on-site workforce to permanently remote positions.

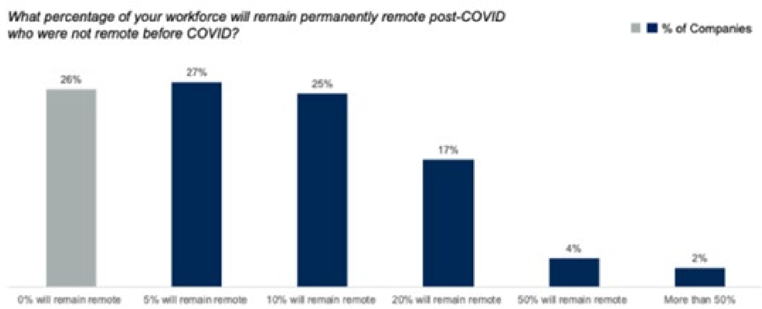
Investment Performance by Property Sector and Subsector

April 30, 2020

Sector	Number of Constituents	Total Return (%) 2019	April	2020: YTD	Dividend Yield (%)	Market Capitalization ($)[1] Equity	Implied
FTSE Nareit All Equity REITs	162	28.66	8.83	-16.68	4.32	1,030,111,822	1,058,115,627
FTSE Nareit Equity REITs	153	26.00	8.30	-21.27	4.87	802,104,527	830,078,935
Industrial	13	48.71	7.98	-3.17	2.82	114,286,444	117,530,601
Office	18	31.42	7.52	-22.63	3.84	79,569,848	84,285,089
Retail	32	10.65	14.78	-41.16	8.51	97,903,513	103,237,198
Shopping Centers	18	25.03	16.61	-41.16	8.25	34,626,191	35,319,936
Regional Malls	6	-9.13	20.03	-52.49	13.06	25,201,959	29,507,278
Free Standing	8	24.76	10.04	-29.94	5.70	38,075,362	38,409,984
Residential	21	30.89	8.60	-18.05	3.43	153,201,342	158,990,770
Apartments	15	26.32	9.15	-19.53	3.90	108,685,807	112,311,186
Manufactured Homes	3	49.09	6.61	-11.80	2.38	23,967,619	24,679,182
Single Family Homes	3	44.30	7.98	-16.59	2.07	20,547,916	22,000,402
Diversified	16	24.10	13.06	-31.15	6.68	42,930,403	45,009,179
Lodging/Resorts	15	15.65	11.29	-45.81	8.26	24,386,694	24,567,329
Health Care	17	21.20	10.03	-30.42	7.05	85,618,086	86,283,516
Self Storage	5	13.70	-6.72	-14.15	4.41	54,416,144	56,409,160
Timber	4	42.00	22.13	-25.82	5.81	22,162,424	22,162,424
Infrastructure	5	41.95	9.58	8.82	2.05	205,844,871	205,874,268
Data Centers	5	44.21	8.14	17.66	2.30	112,936,784	116,173,102
Specialty	11	27.39	6.83	-31.89	9.32	36,855,270	37,592,991
FTSE Nareit Mortgage REITs	37	21.33	19.41	-47.61	15.55	43,170,662	43,454,395
Home Financing	23	17.20	16.84	-49.10	16.52	27,849,146	27,864,230
Commercial Financing	14	32.10	24.97	-44.30	13.61	15,321,516	15,590,165

Source: FTSE™, Nareit®.

Lodging and resort properties will likely see a return to more normal conditions as the virus eventually runs its course. Hotel REITs have struggled considerably, but as people begin to travel again, hotel properties can begin re-pricing rooms. Hopefully, there will not be significant cash flow issues for many commercial REITs. As vacancy rates are likely to go up, and leases are renegotiated, the ability for some REITs to continue to pay a dividend to shareholders could come under pressure. In all likelihood, some REITs might delay or cancel some dividend payments (this has already happened in the hotel sector). As a result, the volatility of the asset class might remain elevated for some time.



Source: Gartner (April 2020)

Overall, office lease transactions have declined considerably so far this year. If work-from-home becomes more common, or permanent, lease demand will weaken at least in the short- to intermediate-term. This shift will likely impact densely populated, urban areas, such as New York City. Businesses will likely trim costs by leasing smaller spaces. Over time, however, the industry will adapt. Only time will tell to what degree workers go back to the office when, working remotely becomes more accepted.