Commercial Real Estate Outlook: The Gap Between Winners and Losers Widens

Contributors

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Executive Summary

- Not surprisingly, hotels and retail properties face the most significant challenges in the current economic environment.
- Voya's exposure to hotels is minimal and in retail, our portfolio continues to avoid troubled properties anchored by malls, focusing instead on higher-quality, grocery-anchored properties and functional local retail properties.
- While forecasts calling for the "death of cities" are extreme, there is no doubt that multi-family properties in the densely populated "urban core" will face significant challenges over the next three to five years.
- In the years ahead, we believe the most attractive opportunities in the multi-family space will be in suburban markets, where properties are more isolated from competition and less susceptible to overbuilding.
- While the office segment remains relatively less affected by the pandemic disruption, the full impact of the economic shock may take two to three years to be realized. For the few tenants looking for new office space, there is a shift towards suburban office space.
- Looking ahead in the industrial space, as companies like Amazon are forced to solve the "last mile issue" with local delivery, the industrial segment could benefit as defunct retail properties convert to meet the evolving needs of the industrial space.

Hotels are the Hardest Hit

The commercial real estate market, while late cycle, was healthy coming into this recent pandemic crisis. Although there were pockets of concern around certain asset classes and metropolitan statistical areas (MSAs), there was not a significant mismatch between supply and demand.

Looking ahead, given the limits of monetary policy tools, the uncertainty of further fiscal policy support, and the uneven fundamental outlook across market segments, we see the U.S. economy shifting into a "K-shaped" recovery. The resulting uneven pressures will create winners and losers with broad strokes across the commercial real estate spectrum.

Going forward, being nimble and remaining selective will be critical to identifying attractive new opportunities. From our view, the winners and losers in the post-COVID commercial real estate market world fall into two camps. In the first camp are cyclical properties like hotels that have been disproportionately affected by the response to COVID-19 and resulting shift in consumer behavior.

"Hotels, which represented a very small percentage of our portfolio before COVID-19, is an area of the market we will continue to avoid."

An average hotel occupancy rate is 70%. As the pandemic took hold, hotel occupancies dropped to below 20%. While hotels in drivable vacation destinations have seen a slow rise in demand for rooms, profitability remains far out of reach for most of the market. Convention hotels that rely on business travel have been the hardest hit and are expected to be the last to recover. According to a study by hotel research firm STR and Tourism Economics, a full recovery to pre-COVID levels may be three years away.

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Some Trends are Here to Stay: COVID Accelerates the Death of Malls

Among the major property types, retail continues to be the hardest hit after hotels, with many showing rent collections in the 50% to 70% range; some outliers are much lower. Brands that could not overcome the pandemic include J. Crew and Neiman Marcus, which both filed for Chapter 11 bankruptcy in early May.

"Collections in our retail portfolio have been stable and, generally speaking, Voya's retail properties are holding up well as we have no exposure to malls. As we evaluate new opportunities going forward, the retail space is an area where we will continue to exercise selectivity and caution."

In the second camp of winners and losers are properties affected by trends that were in place prior to COVID and have accelerated because of the world's response to the pandemic. In this camp, the most cited potential "loser" would include commercial retail properties that are anchored by malls. Malls had already seen declining consumer foot traffic that resulted in the exodus of key, brand name retail tenants, a trend that has been exacerbated by the social distancing and store closures put in place to combat the COVID-19 pandemic.

Collections in our retail portfolio have been stable and, generally speaking, Voya's retail properties are holding up well as we have no exposure to malls. Our focus is instead on higher quality grocery anchored properties and functional local retail properties. As we evaluate new opportunities going forward, the retail space is an area where we will continue to exercise selectivity and caution.

Multi-family: The Pandemic Boosts the Appeal of the Suburbs

August rents were a microcosm for the broader shift in renter demand since the pandemic, as urban rents fell another 1% while suburban rents remained steady—in fact October rent collections in the suburbs were at pre-COVID levels. Without the worry of a long commute in the near term, some in-town or Central Business District ("CBD") renters are finding suburban options more attractive as they offer more space at more affordable prices.

"In our portfolios, we have always favored the secondary and suburban markets over the urban core."

From the March pre-COVID peak to August 31 nearly all of the top 20 markets posting the largest rent declines were CBD with San Francisco posting the largest decline at over 16%. For the same time period, nearly all of the top 20 markets posting the largest rent increases were suburban with Los Angeles's suburban "Inland Empire" posting rent growth of over 4% during the pandemic.

"Most of our multi-family portfolio is represented by Class B multi-family or "workforce housing," which should benefit from a wave of new tenants who can no longer afford the Class A segment of the market."

However, while the pandemic has accelerated the exodus from cities, there were signs of trouble in the urban core well before the pandemic took root. In early 2019, we started to see overbuilding in the urban core and other densely populated areas as cities encouraged more development with tax credits. In addition, these Class A properties saw the most significant rent increases over this cycle, making the rents hard to afford in good times and impossible in bad times.

"While forecasts calling for the "death of cities" are extreme, there is no doubt that multi-family properties in urban areas will face significant challenges over the next three to five years."

Heading into the pandemic, most of our multi-family portfolio was represented by Class B multi-family or "workforce housing." While Class B properties will come under strain from mounting unemployment, these properties should also benefit from a wave of new tenants who can no longer afford the Class A segment of the market.

"The opportunities over the next three to five years will be in suburban markets."

Looking ahead, we expect the trend towards the suburbs will continue. In addition to being more affordable, new suburban apartments are larger and tend to have many more two-bedroom and two-bath units. The extra room in suburban apartments can be used as a home office or for a roommate, characteristics that are likely to remain appealing in the years ahead. More generally speaking, one of the key benefits of suburban properties from a lender's perspective is that it is more difficult to develop properties in suburbs than it is in the urban core. Suburbs are regulated by the "not in my backyard" mentality, which makes property development a more expensive and longer process. This dynamic keeps suburban properties more isolated from competition.

While forecasts calling for the "death of cities" are extreme, there is no doubt that multi-family properties in urban areas will face significant challenges over the next three to five years. As people eventually return to the cities and the younger generation begins to rent, floor plans in many urban core multi-family properties may prove to be functionally obsolete. Apartment units in the urban core continued to get smaller, which makes working from home more challenging. Studio and small one-bedroom/one-bath units may be hard to rent in years to come. Unlike an old suburban affordable apartment, which has many options for renovations due to the larger unit size, the urban core assets with small units leave little wiggle room.

Eventually, we expect construction declines in urban markets to allow for some absorption. In the meantime, however, the more attractive multi-family opportunities over the next three to five years will be in suburban markets.

Office: How Will Properties Absorb the Shift towards Working from Home?

While the office segment remains relatively less affected by the pandemic disruption, the full impact of the economic shock may take two to three years to be realized. Indeed, the future of office properties in a post-COVID world continues to be a topic of discussion as tenants recognize their organizations can successfully work remotely, but also want the benefits of face-to-face interaction including the development of culture, training new employees, and cultivating relationships.

"For the few tenants looking for new office space, there is a shift towards suburban office space."

Colliers International recently completed a survey of more than 5,000 respondents across 18 different industries inquiring about future work-from-home plans. The survey found that while there is support for the continuation of some remote work, many industries have a strong desire to return to the office. Nearly 90% of respondents said they believe physical office space remains a necessity for companies to operate successfully. Nearly half of respondents said they would limit remote work to two days per week after the pandemic subsides.

Despite the apparent longer-term shift to some work-from-home flexibility, at this time the overall demand on office space is not expected to be significantly impacted as tenants consider new layouts and more square footage per employee.

Industrial Properties Weather the Storm

The industrial (and the industrial subset self-storage) is seeing little, if any, problems. By no means is this asset class insulated from general economic downturns, but for now, this area of the real estate market is performing well. Rent collections in April and May were in the mid- to high 90% range.

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E-commerce-related leasing demand spiked during the height of the pandemic (to nearly half of all activity) but is beginning to flatten to normalized levels. Discounts to acquisition prices have not materialized, especially in core markets. Looking ahead, as companies like Amazon are forced to solve the "last mile issue" with local delivery, the industrial segment could benefit as defunct retail properties convert to meet the evolving needs of the industrial space.

Production Outlook: Pockets of Opportunity

We continue to find the most compelling opportunities where other lenders have walked away from loans and the borrowers need capital. Typically, these situations are near-term debt maturities where the existing lender has not extended the loan, or a property acquisition that is moving forward with closing in the near term. We are re-underwriting deals with the view of near-term weakness and a more negative long-term view of valuations and cash flow. If these deals meet this hurdle and the wider pricing is acceptable to the borrower given the limited choices, we are willing to sign up a loan.

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