09 September 2020

RESEARCH NOTE

The Impact of COVID-19 on Commercial Real Estate Capital Markets

TJ Parker, Hartford

The Quick Read:

- The pandemic-induced recession is having a profound impact on commercial real estate (CRE). Unlike the global financial crisis (GFC), when volumes and pricing for all property types plummeted, sectors supported by structural tailwinds have held up relatively well so far.
- Apartments, industrial and office comprised nearly 80% of the total transaction volume for the second quarter, whereas sectors facing secular headwinds, such as hotels and retail, experienced a steep pullback in transaction volumes.
- Looking forward, we expect that structural forces underpinning demand for the major property types will continue to widen the gulf between "winners" and "losers," effectively shaping the CRE of tomorrow.

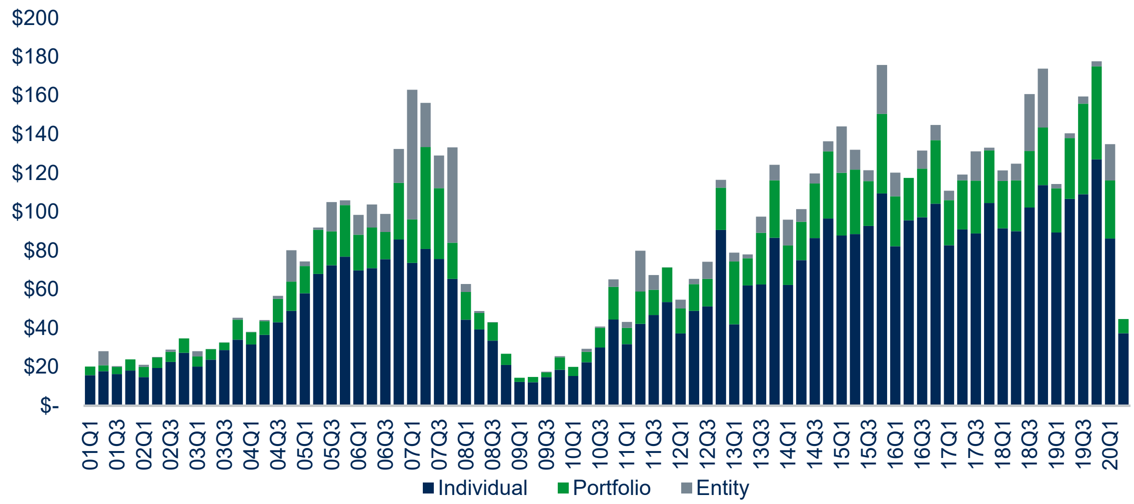
The second quarter contraction in CRE capital markets evokes memories of the significant liquidity and price discovery challenges encountered during the GFC. However, the two crises share little else in common, at least up to this point. While the GFC indiscriminately impacted volumes and pricing across commercial property types as a result of the significant financial market stress, the impact of the pandemic on capital markets thus far has been more selective, widening the gulf between "winner" and "loser" property types. We begin with a brief overview and then dive into a cross-sectional and time-series comparison at the aggregate sector, sub-sector and market level, in a bid to identify trends and understand investor risk sentiment.

Second quarter 2020 volumes, per Real Capital Analytics (RCA), reported the steepest year-over-year (Y/Y) decline in any single quarter since the GFC recovery. Over the last 10 years—the longest economic expansion in U.S. history—annual deal volumes steadily increased and first peaked in 2015, a record year of deal making for large-scale portfolio and entity-level transactions, before reaching an all-time high[1] of $592 billion in 2019. Transaction volume is often a barometer of liquidity in capital markets—and individual, portfolio and entity sales all reported a steep contraction in the second quarter this year. ***But how does liquidity today compare with that observed during the GFC? More importantly, are these trends here to stay?***

Beginning at the sector level, apartments, office and industrial comprised nearly 80% of the total transaction volume for the second quarter, largely driven by individual sales. Portfolio sales were few and far between, with only a handful concluded in the industrial and apartment property types, and no entity sales transacted during the quarter.

[1] Since inception of the RCA transaction volume time series in the first quarter of 2001.

CHART 1: QUARTERLY VOLUME BY TRANSACTION TYPE (IN BILLIONS)



Source: RCA, Barings Real Estate Research. As of June 30, 2020.

Table 1

	2Q 2020	Previous Low	10-Year Average
Office	11.0	10.8	28.6
Office - CBD	3.7	2.0	12.5
Office - Suburban	7.3	6.6	16.1
Industrial	10.3	10.0	15.5
Flex	2.2	2.1	3.8
Warehouse	8.1	7.6	11.7
Hotels	0.6	0.6	7.9
Full-Service Hotels	0.3	0.4	5.3
Limited-Service Hotels	0.4	0.2	2.6
Apartments	13.9	13.6	30.8
Garden Apartments	9.0	8.5	19.9
Mid/High rise Apartments	4.9	4.5	10.8
Retail	4.6	3.9	16.5
Shops	2.9	2.6	5.6
Centers	1.7	1.5	10.9

Source: RCA, Barings Real Estate Research. As of June 30, 2020.

These high-level trends, however, mask sector performance, as shown in Table 1 above, which presents the extent of the contraction in transaction volume within each sector relative to its previous lows and 10-year average volumes. Total transaction volume is at an all-time low for hotels, and near 10-year lows for retail. The depressed volume for both sectors reflects current investor risk aversion resulting from the broader demand contraction in travel and leisure, and retail trade, respectively. However, ***individual and portfolio sales*** for all sectors were at or near their previous lows in the second quarter, with the exception of apartments and industrial, two sectors supported by structural tailwinds.

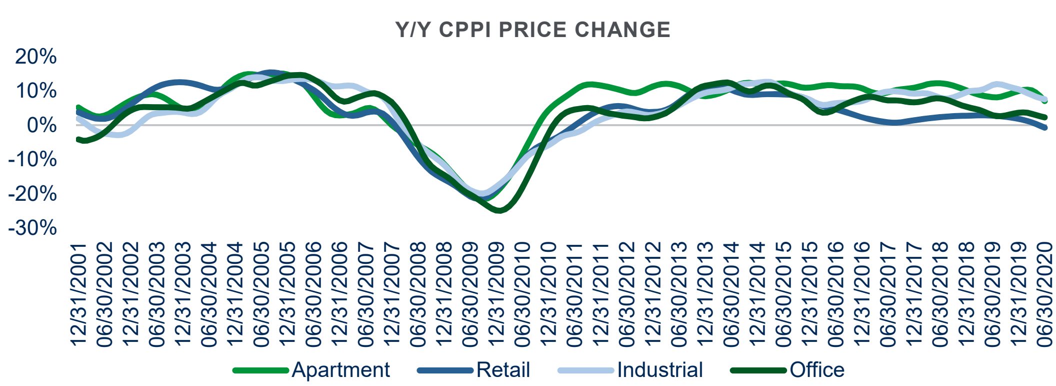
The cross-sectional comparisons above, however, do not inform us on how these sectors fared in comparison to the last major recession: the GFC. To glean this insight, we compare transaction activity between the second quarter of 2020 and the worst quarter during the GFC—which for office, hotels and retail was Q2 2009, and for industrial and apartments was Q1 2009.

At the aggregate level, overall volume transacted during the worst quarter of the GFC was less than a third of the total volume transacted during the second quarter of 2020, indicating better liquidity conditions during the COVID-19 recession; but as mentioned earlier, this liquidity was selective. Apartments and industrial reported five-to-six times the GFC troughs, reflecting investor expectations of long-run sector outperformance, while retail and office traded at two-to-three times the GFC troughs, indicative of a lower risk appetite given structural headwinds facing both of these sectors.

"At the aggregate level, overall volume transacted during the worst quarter of the GFC was less than a third of the total volume transacted during the second quarter of 2020, indicating better liquidity conditions during the COVID-19 recession; but this liquidity was selective."

This stark contrast between the two recessions also reveals the nature of the two shocks. The GFC was triggered by excess leverage in the financial system, which resulted in a liquidity squeeze in CRE capital markets. Investors fled to the relative safety of risk-free, liquid instruments, and price discovery became elusive. The pandemic, on the other hand, is an exogenous shock—a global health crisis that has wreaked havoc in the physical realm, rather than the financial, essentially bringing about behavioral changes that then accelerated existing structural trends in CRE. Employees have worked from home offices, consumers have shopped online, and record unemployment and non-essential business closures have brought forth rent-relief requests across property sectors. Meanwhile, health and safety concerns have dampened occupancy at student housing, and all but halted the travel and tourism industry. As a result, office, retail, student housing and hotels have languished, while industrial has flourished and apartments have held stable.

The above transaction trends also bore out in pricing, as reflected in the RCA CPPI index. The national all-property price index slipped to a 4% Y/Y return in June, a pace of growth last seen in the post-GFC recovery period. Industrial and apartment pricing unsurprisingly surpassed office and retail pricing. While pricing lags volumes, as observed during past recessions, the inter-sector pricing dispersion that materialized in the last cycle should continue into the next one.



Source: RCA CPPI, Barings Real Estate Research. As of June 30, 2020.

From the brief analysis and discussion above, it is clear that the pandemic-induced recession is having a profound impact on CRE. Unlike the GFC, when volumes and pricing for all property types plummeted, sectors supported by structural tailwinds have held up relatively well so far. ***Looking forward, we expect that the structural forces underpinning demand for these property types will continue to widen the gulf between "winners" and "losers," effectively shaping the Commercial Real Estate of tomorrow.***

09 September 2020 | Research Note

Barings is a $346+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients and customers. Through active asset management and direct origination, we provide innovative solutions and access to differentiated opportunities across public and private capital markets. A subsidiary of MassMutual, Barings maintains a strong global presence with business and investment professionals located across North America, Europe and Asia Pacific.*

*As of June 30, 2020

20-1320688