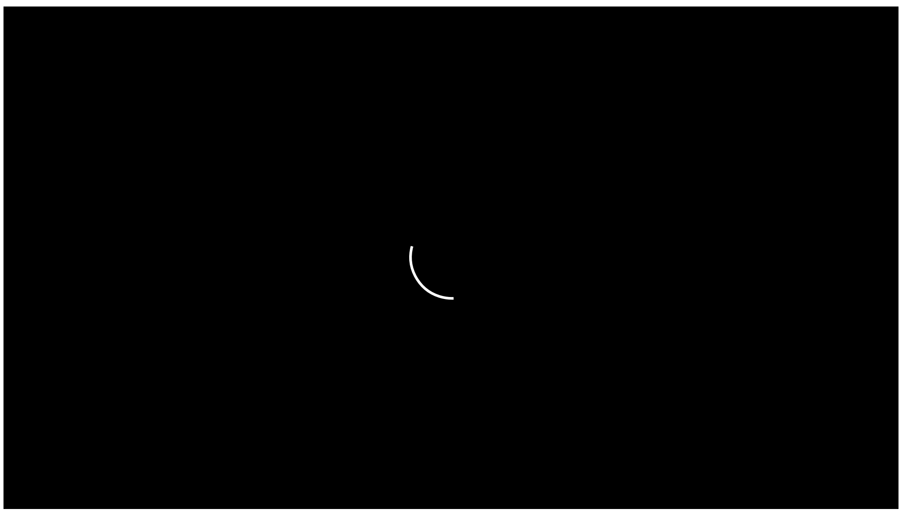
THE STATE OF THE U.S. COMMERCIAL REAL ESTATE MARKET

By **Zain Jaffer** - Mar 2, 2020, 12:32 pm

Zain Jaffer Discusses Highlights from the UBS US Commercial Real Estate Market 2020 Report

As a UBS private wealth client, I had the privilege of being able to discuss the state of the commercial real estate market with the highly-respected real estate analyst, Jonathan Woloshin, who shared with me the latest US Commercial Real Estate (CRE) 2020 Outlook that it provides to its private wealth clients. While the coronavirus is wreaking havoc on the markets, the long-term nature of CRE investment makes it comparatively more resilient than other segments, though we may see a short-term slowdown.



Some trends to follow:

Continued Strength of Commercial Real Estate Market

Market dynamics continue to be favorable for the US commercial real estate market. Commercial real estate has enjoyed over ten years of growth with a favorable interest-rate market that will likely remain at current low levels (or may even get lower), ready access to capital, and an economy that has thrived in recent years. The spread between cap rates and interest rates continues to be at such low levels as to remain attractive to investors. Particularly with all that has happened recently with the coronavirus, there may be an even greater likelihood that the Federal Reserve will lower rates once (or perhaps even twice) more this year.

Cap Rates

The commercial real estate market is expected to continue to be attractive, even though there has been some compression in cap rates. The spread between interest rates and the Baa bond yields has been consistently high, which will continue to be a siren call for investors. While there has been some change in the risk/reward calculus for some submarkets, there are still areas of opportunity. If you are a smaller investor like me, you can be competitive if you are willing to persevere in finding good deals and improving those properties. Properties valued between $2 million and $20 million are typically too small to be considered by industrial investors; however, with the right property and investment in improvements, you may be able to increase the value enough to attract those larger private equity investors upstream.

Rent Control

The UBS CRE 2020 report discussed the role that rent control has played and will continue to play on certain markets. New York, California, and Oregon have all enacted some rent control policies. While I believe that rent control is not effective and makes any city’s affordability crisis much worse, I also believe that you can use rent control restrictions to your advantage. Because of such dynamics in San Francisco, I have shifted my personal CRE investing strategy to focus on short term furnished rentals to corporations, where I am able to realize cap rates in the 5% range with all-cash purchases of properties.

Available Capital

The capital markets have been favorable to commercial real estate investors for over ten years, both for public REITs and for private equity. In fact, the annual aggregate capital raised by the private equity sector hit a twenty-year high in 2019. In addition, UBS estimates that there is $315 billion in unleveraged “dry powder” just sitting and waiting for some sort of change in the market. Fears last year of an impending recession have caused many to stockpile cash so that they are ready to move quickly when market opportunities present themselves. Of course, with the current coronavirus, this may be slowed down somewhat. I am an investor in many funds and am seeing that the smart money is patiently waiting for an opportunity but is being very selective.

Foreign Investments

The report expects that foreign investors may determine that the US is a great market for them in 2020. The recent trend of declining foreign investment in commercial real estate may be changing, given the progress on recent trade agreements (Phase 1 China trade agreements, and the passage of the 'USMCA', or US Mexico Canada Agreement). In addition, the concerns with coronavirus, along with the weakening global economy and otherwise resilient US economy, may make foreign investors more eager than ever to park their capital in the US commercial real estate market. With fast-emerging travel bans and quarantines, we will see certain foreign investments (such as Chinese and Italian) slow until these bans are lifted.

Opportunities in Smaller Real Estate Markets

While real estate values have increased in major metropolitan areas (including New York and California) at a faster rate than the non-major metro areas, migratory dynamics are definitely worth considering. The population growth in smaller states has outpaced those in larger metropolitan areas, due to factors such as age demographics, taxes, jobs, and politics, just to name a few. UBS believes that intra-US population flows are being driven in part by state-level tax, as well as fiscal and regulatory policies in those smaller markets. The report states that Illinois, New Jersey, and New York each lost more than 7% of their domestic population between 2010 and 2018.

Those states growing in population during that same timeframe include Florida, Texas, Arizona, Utah, and Washington. UBS analysts also report that foreign investment in smaller markets has increased. Most recently, Dallas, Atlanta, Houston, Austin, and Phoenix have seen an influx of foreign capital, as have Charlotte, Raleigh/Durham, and Miami. My own experience with both coastal and inland fast-growing markets agrees with the assertion by the UBS report, that "secondary does not mean second-best." Instead, focus on the core fundamentals like population growth and job growth to take advantage of higher cap rates.

Consider that people are migrating away from "brand-name" cities to widen your investment opportunities. Find an experienced local fund if you are looking to be a passive investor, or find local, experienced real estate teams if you are an active investor.

Commercial Real Estate Market: Strongest Segments

The markets in 2020 where you may be able to find and fill that gap in the following areas:

- Multi-family/single-family rentals
- Dry and cold storage warehouses
- Life science and medical office buildings
- Neighborhood shopping centers in markets experiencing population growth
- Wireless towers and data centers

Within those sectors, there could be some huge opportunities, particularly when regional differences are taken into consideration. For example, the migration factors discussed earlier will create increased opportunities for self-storage in those markets and, where regions are growing, there could be big opportunities to invest in much-needed distribution centers as well.

Caveat: As you are investigating opportunities in these sectors, you may want to consider any impact that the recent coronavirus scare may have on them. For example, in regions that do extensive trade with China, such as Tennessee, warehouses and retail properties may see more of a negative impact from a prolonged coronavirus outbreak, as the retail market and its storage needs may be hit hard. This negative environment compounds the retail sector's poor return in recent years due to more challenging operating fundamentals.

Many people are steering clear of retail sectors because of the rise of Internet shopping. In my opinion, it's not that retail in totality is dying; it's just that retail locations need to be creative and reinvent themselves to be more experiential. There will always be a need for personal services (think of dentists, children's activities, or hair salons). When evaluating retail properties, investors need to rethink and reinvent retail spaces by securing more experiential tenants rather than traditional retail establishments. Reimagined uses of commercial real estate could create some great investments, even becoming crown jewels in your portfolio.

While the world watches to determine the long-term impact of the coronavirus, investors need reliable places to put their money. With continued low interest rates and attractively priced capital, commercial real estate will continue to be one of those avenues for smart investing.

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Zain Jaffer is the Founder and CEO of Zain Ventures (https://zain-ventures.com), a global investment firm with over $100 million in assets under management. Zain Ventures invests in start-ups, real estate, stocks, fixed income, hedge funds, and private equity.