Newmark Knight Frank

THE ECONOMIC RECOVERY AND OUTLOOK FOR

U.S. CAPITAL MARKETS

JULY 2020

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KEY FINDINGS

1. The most common description of the projected U.S. economic recovery is a “swoosh” shape, with the sharp downturn of the second quarter of 2020 being followed by a slow recovery with a long tail. This remains the most likely outcome, notwithstanding the surprisingly upbeat May employment report. However, the commercial real estate capital markets are likely to rebound faster than the overall economy due to the substantial liquidity available.

2. Multifamily returns are closely correlated with changes in employment—even more so than are office returns. The economic effects of COVID-19 could dislocate office’s correlation to employment even further—and keep some would-be home buyers in multifamily units. Among all major property types, GDP is *least* correlated with NCREIF’s industrial index, indicating that the industrial market is benefitting from secular growth trends, outside of the typical business cycle. These findings underscore the relatively strong position of the industrial market during the uncertain period ahead.

3. Opportunistic funds have been activated by the decline in operating and property fundamentals. They will be seeking opportunistic monetary bases in property acquisitions, thereby effecting higher risk-adjusted investment returns through a new hold period established in the wake of the pandemic.

4. A tension exists between future office space demand lost to more remote work, and potential growth in demand due to greater social distancing inside the office environment. Between February 2020 and May 2020, the United States lost 5.4 million office-using jobs, or 8.7% of all office-using positions. At May 2020, approximately 128 square feet was occupied per office-using position, meaning the *perceived* long-term need for office space declined by 688 million square feet as a result of those lost positions, equal to roughly 8.5% of the U.S. office inventory. Much of that space will be under lease for months or years to come, and many of the lost positions will be restored over time, but the scope of the present challenge to the office market is significant. However, the sense of isolation and loss of corporate culture in the work-from-home environment may encourage tenants to retain considerably more space.

5. To the extent some companies invite more of their staff to work from home, the COVID-19 crisis may underscore the value of suburban multifamily assets. This asset class features non-cyclical characteristics.

6. Opportunistic investors, particularly in the multifamily space, have circled hotels as a property type ripe for conversions.

THE SHAPE OF THE ECONOMIC RECOVERY WILL DRIVE
U.S. CAPITAL MARKETS ACTIVITY

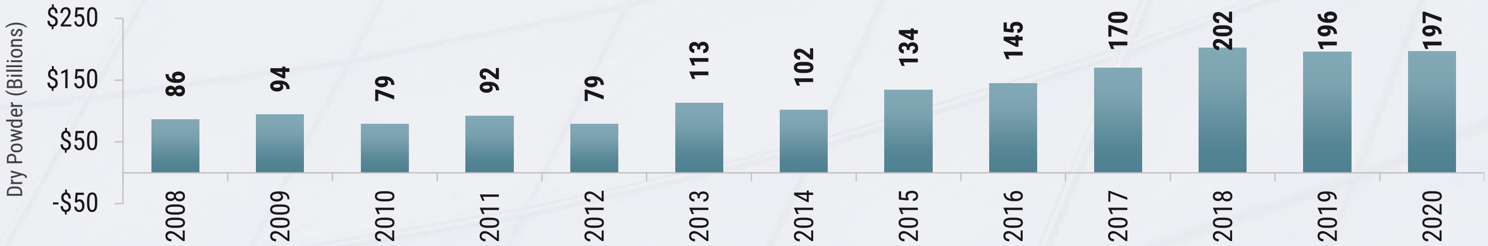
Capital markets activity in the U.S. commercial real estate sector was robust during the 2010-2019 period, with particularly strong performance from 2015-2019. In 2018—nine years into the expansion cycle—total U.S. investment sales volume reached a cyclical peak of $580 billion, and volume in 2019 was just shy of that figure, at $570 billion. However, the COVID-19 pandemic has largely paused sales activity, as buyers and sellers struggle to gauge pricing and evaluate the economic landscape ahead. In April 2020, U.S. transaction volume was down 71% from the April 2019 level. The shape of the economic recovery will help determine the pace of sales volume growth in the years ahead. The investment sales market also is dependent on the debt market; if debt is not available, transaction volume will remain limited. The actions of the Federal Reserve during this crisis have helped stabilize the capital markets.

The most common description of the projected U.S. economic recovery is a "swoosh" shape, with the sharp downturn of the second quarter of 2020 being followed by a slow recovery with a long tail. This is a likely outcome, given the rapid rise in unemployment in April and the likelihood that some employers—from bankrupt retail chains to small businesses—will not survive the recession. While the May employment report reflected a rehiring of some furloughed workers sooner than expected—a welcome development—the recovery is still likely to be an extended one. Limited capacities on indoor spaces and state/local government funding challenges still point toward more of a swoosh than a V-shaped rebound. (A V-shaped recovery would require a symmetrical rebound in the economy relative to the significant declines experienced in March and April. Though the May employment report surprised to the upside, it still suggested a swoosh-shape recovery, which is now the base-case scenario for many investors.) Indeed, the Congressional Budget Office projects that the U.S. economy will not make up all the lost ground—that is, GDP will not catch up to its previously-projected trendline—until 2029. Further, consumer spending is responsible for approximately 70% of GDP, and that spending will not return to normal levels until Americans feel safe in public indoor environments such as stores and restaurants—and their income has sufficiently recovered to make discretionary spending more viable. Continuing unemployment claims of more than 20 million as of early June reflect the ongoing challenge to labor markets and underlying consumer spending; in addition, pay reductions for many of those still employed means a return to peak discretionary spending is a long way off.

However, the commercial real estate capital markets are likely to rebound faster than the overall economy due to the substantial liquidity available, similar to how the stock market responded during April and May. In fact, as of the end of March 2020, dry powder (uninvested capital accumulated by private funds focused on North America) totaled $197 billion—*slightly above* the total at year-end 2019 (see the adjacent graph). The dry powder available today is more than double what was available at year-end 2008, as the market was adjusting to the Great Recession. The composition of today's dry capital is focused on higher-yielding investment strategies.

DRY POWDER REMAINS NEAR PEAK; LIKELY TO FACILITATE CAPITAL MARKETS REBOUND

UNINVESTED CAPITAL IN FUNDS FOCUSED ON NORTH AMERICA | 2008 - 1Q 2020



Note: Excludes debt funds

Source: NKF Research, Preqin; June 2020

I

HOW ARE THE DEBT MARKETS LIKELY TO SHAPE INVESTMENT OPPORTUNITIES?

Early indications of turmoil in the debt markets were apparent as early as February, before COVID-19 became a global pandemic, with the 10-year treasury rate falling by nearly 100 basis points throughout most of February, bottoming at 0.54% on March 9. The subsequent volatility in March impacted price discovery and led to a slowdown in activity as many lenders took a conservative approach, waiting for rates to stabilize and the situation to be more clearly understood. This slowdown had a severe impact on deal activity and overall market liquidity in the early months of the crisis. However, since March and April, there have been more recent signs that the debt markets are opening up. As market participants have had time to better understand the impacts of COVID-19, sentiment has varied across different property types. Additionally, there have been marked differences in lending activity by lender group because of the inherent characteristics of those lenders and the framework that they operate in.

Banks have been focused on utilizing their balance sheets for existing customers or those customers whom they have been pursuing. With a stable and inexpensive source of funding, banks continue to offer very attractive rates for those loans they pursue. Bank loan spreads have increased from the low-to-mid-100 bps early in the year to the mid-200 bps range today; however, that increase has been offset by the decrease in 30-day LIBOR yields over that same period. Thus, bank rates today are comparable to rates offered earlier in the year. However, we have seen banks focusing much more on assets with stable cash flows and funding levels at 55%-60% LTV compared to 65% LTV previously. Banks continue to lend on industrial, multifamily and well-leased office assets, but they are being selective and picking off the best assets and borrowers within their target markets. For the most part banks are shying away from hotel and retail opportunities as they are still working through forbearance requests on those asset types.

Life companies spent the first month or two of the pandemic evaluating the market and investing in alternative assets like corporate bonds. BBB corporate bonds offered tremendous value throughout March and April, providing life companies an attractive alternative to making loans. However, as BBB corporate yields have decreased to levels comparable to the beginning of the year, life companies have become more active in writing new loans. Similar to banks, life companies are focused on quality of asset, market, and sponsor with a strong preference for stable assets with durable cash flows. Industrial and multifamily garner the greatest interest, with office being the third choice. Retail centers anchored by the #1 or #2 grocer in the market will be considered at lower leverage levels, but rent collection is a big focus. With U.S. Treasury yields near historic lows and corporate bond yields back to pre-COVID levels, life company interest rates are in the low-3% range, offering attractive financing—albeit at slightly lower leverage levels of 55%-60% compared to 60%-65% a few months ago.

Fannie Mae and Freddie Mac continue to be very active providing liquidity to the multifamily markets at attractive rates and leverage points. The agencies continue to offer leverage of 75%-80% at rates in the low-to-mid-3% range; however, they are requiring upfront debt service reserves of 6-12 months depending on LTV and DSCR. They have also pulled back on their lease-up programs and are focused on stabilized assets for the time being. Due to the reluctance of many sellers to put their properties on the market while there is economic uncertainty, nearly 80% of the agencies' loan activity in May was for refinancing purposes as opposed to acquisition financing. Fundamentally, the agencies are built to provide liquidity in times of economic uncertainty and represent a sizable government backstop to the multifamily market, covering more than half of the multifamily supply nationally.

THE SHAPE OF THE ECONOMIC RECOVERY WILL DRIVE

U.S. CAPITAL MARKETS ACTIVITY (CONTINUED)

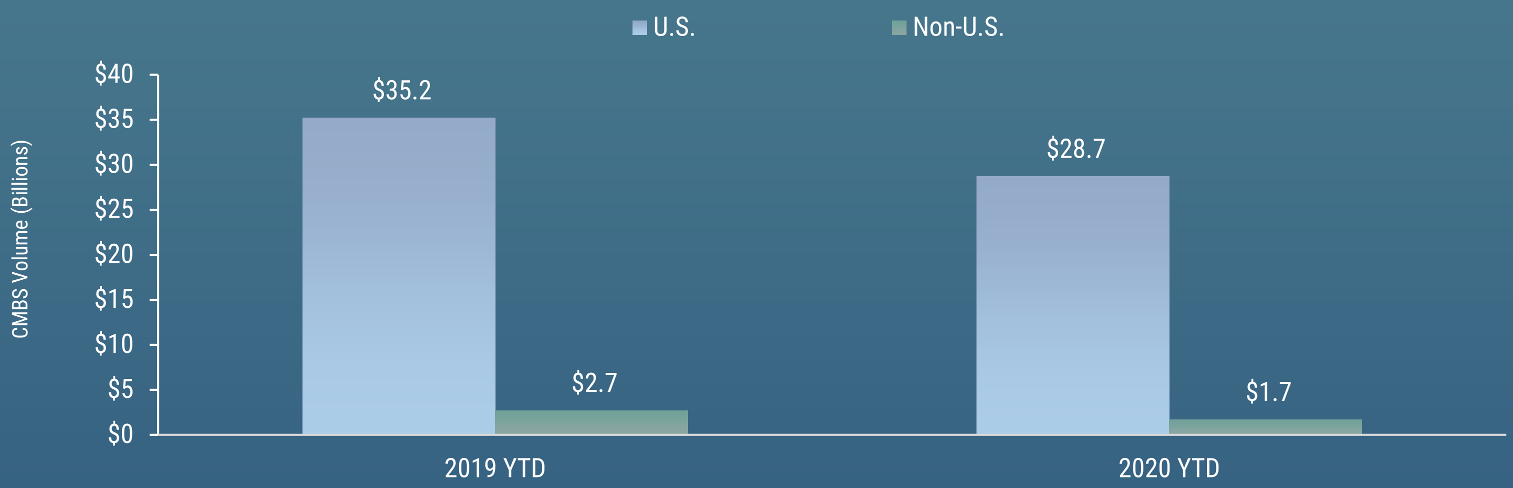
HOW ARE THE DEBT MARKETS LIKELY TO SHAPE INVESTMENT OPPORTUNITIES? (CONT'D)

The **CMBS** market is making a comeback as several securitizations totaling over $4 billion have cleared the market over the past several weeks. Year-to-date CMBS issuance in the U.S. is approximately $30 billion compared to $35 billion in 2019 (see the adjacent graph). AAA spreads have compressed from 145 bps in early June to 115 bps in a late June securitization. While volume has increased, servicers continue to address issues with existing loans. Servicers have allowed borrowers to utilize escrow reserves to keep loans current and avoid being transferred to special servicing. However, in those instances where existing reserves are insufficient, loans are being transferred and borrowers and servicers are working through forbearance. New originations are focused on industrial, multifamily, office, self-storage and NNN leased retail at more modest leverage of 65%-70% LTV compared to 75%+ LTV a few months ago. Rates are in the mid-to-high-3% range as of late June.

CMBS VOLUME

U.S. AND NON-U.S. ISSUANCE

JANUARY THROUGH MID-JUNE OF 2019 VS. 2020



Source: Commercial Mortgage Alert, NKF Research; June 2020

Debt Funds/Mortgage REITs/Finance Companies have been on pause for the most part, as many have been working through their existing portfolios as well as addressing concerns from their line lenders, including potential margin calls. Those lenders with dry powder took advantage early by buying public debt and corporate bonds when yields blew out in March. Now that those yields have compressed they are once again focused on new originations. We have seen some lenders shore up their balance sheets by selling existing loan portfolios and/or bringing in new capital, as evidenced by Starwood's recent $325 million investment in TPG RE Finance. While there has been a limited number of new loans written by this category of lender, the few that have closed have seen a significant increase in loan spread. Pre-COVID pricing was in the mid-to-upper-200 bps range at 75% LTV, but post-COVID pricing has doubled to the 400-500 bps range. As more liquidity comes into this sector we expect to see those loan spreads tighten over the second half of 2020.

I

WHAT IS THE CURRENT STATUS OF REAL ESTATE PROPERTY MARKET FUNDAMENTALS?

Real estate property market fundamentals will guide investor sentiment. Where do the major property types stand nationally, and what is the outlook for each?

- The U.S. office market vacancy rate was 13.0% at 1Q20, as the pandemic's impact was arriving. Asking rent growth averaged 3.4% for the prior 12 months, although effective rents were constrained by elevated concessions. Absorption had been sturdy at more than 30 million square feet in each of 2018 and 2019, but new supply has been accelerating recently, which will slow a post-pandemic recovery in rents.
- Industrial market vacancy at 1Q20, at 5.4%, remained near its cyclical low. Per annum asking rent growth has been greater than 4% since 2017, reflecting the strength of this property type—one that is well positioned for the period ahead due to the projected demand from e-commerce operators.
- Multifamily vacancy was 4.5% at 1Q20—still low but edging higher as new supply arrived. Effective rent growth ranged from 2% to 4% per annum since 2017, exhibiting remarkable consistency. Job losses and pay reductions are likely to keep some potential home buyers out of the single-family market, bolstering demand for apartments.
- Retail market fundamentals have been under pressure for several years as the share of transactions conducted online rose to 11.8% as of 1Q20 compared with 9.9% in 2018. High-quality mixed-use and experiential centers had been outperforming, but centers featuring essential retailers such as groceries and pharmacies now are likely to perform best until a coronavirus vaccine is available.
- Before the pandemic, hotel occupancy rates hovered in the 60-70% range and revenue per available room (RevPAR) was the highest ever recorded at $86.76, although the rate of growth had been decelerating. By early April 2020, hotel occupancy rates were in the single digits in many markets, and numerous properties had closed. Occupancy has been climbing since then, but because of safety concerns regarding air travel and conventions, the recovery of the hotel market is likely to be protracted.

HISTORICAL PATTERNS AS A CUE:

CORRELATING INVESTMENT RETURNS WITH ECONOMIC INDICATORS

Examining the historical correlations between the major property types and macroeconomic variables is important to understanding the future of property type performance and provides clues as to which economic indicators should be watched most closely both during and after COVID-19. For this study, we examined how U.S. gross domestic product (GDP), employment, and e-commerce sales correlate with NCREIF's total returns (see adjacent graph). In each case, we took the data series for returns as far back as possible—in some cases, this was 1978, when NCREIF began its performance tracking. We also examined retail sales and industrial production for this analysis but did not find meaningful correlations with those variables.

GDP

The most universally used economic performance variable, real GDP, encompasses the broadest swath of economic activity. GDP is *most* correlated with NCREIF's hotel index, with a positive correlation coefficient of 95%, indicating a very strong linear relationship—and that economic activity is tightly connected with hotel market performance. Empirically, this correlation is logical—hotels are the most volatile property type (with the highest standard deviation of total returns) and are most impacted by economic declines and changes in consumer discretionary spending. GDP is *least* correlated with NCREIF's industrial index, with a correlation coefficient of 89%. Industrial has been the top performing property type for more than a decade, bolstered by growing demand for warehouse/distribution space from e-commerce users. This growth appears to be less tied to overall economic activity, indicating that it is benefitting from secular growth trends, outside of the typical business cycle. These findings underscore the relatively strong position of the industrial market during the uncertain period ahead.

EMPLOYMENT

Total nonfarm employment is the most macro labor market indicator, and is particularly important for real estate, which is dependent on people with jobs to occupy space, both to work in and live in. Once again, NCREIF's hotel index is the one *most* correlated with employment, with a correlation coefficient of 89%. For similar reasons as for GDP, hotel performance is closely correlated with the labor market, which is directly tied to consumer spending. The second-highest correlation, and perhaps the most significant, is with the multifamily index, which is more correlated with employment than is the office index. The relationship between the multifamily market and employment is well established—some of the highest employment growth markets, in the Sunbelt in particular, have been the top performers for multifamily during the recently concluded expansion cycle. However, the fact that multifamily is more correlated with employment than is office is significant. Fundamentally, people who are employed are not necessarily occupying office space, particularly with the rise of the "gig" economy and contract workers, but they still must live somewhere. The economic effects of COVID-19 will only add pressure to this trend, which could dislocate office's correlation to employment even further—and keep some would-be home buyers in multifamily units instead.

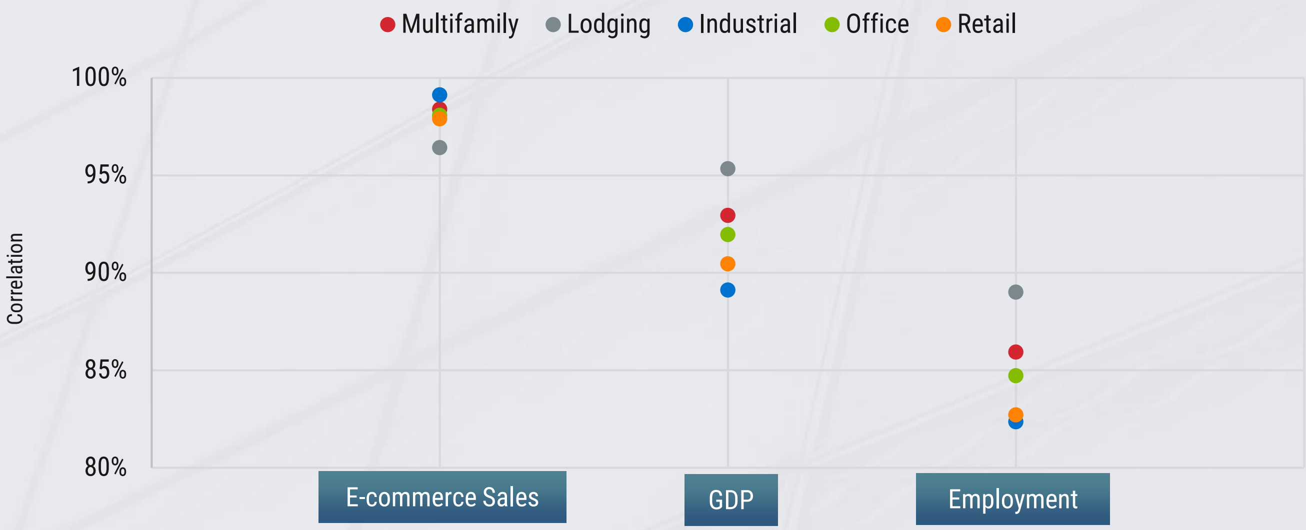
E-COMMERCE

One of the most widely discussed variables in the current cycle, e-commerce increasingly represents an essential driver of American consumption. Unsurprisingly, e-commerce sales have a 99%, or near-perfect, positive correlation with NCREIF's industrial index. Industrial product has been one of the most sought-after property types in commercial real estate, even before COVID-19 disrupted physical retail and in-person shopping. Last-mile distribution product, particularly in the largest metropolitan areas, has tallied record amounts of rental rate growth and NOI growth—and has attracted unprecedented amounts of institutional capital.

Of note, the retail sector more broadly is a very elastic category. The sharp decline in personal consumption will hurt the sector in the short term, but that impact could prove fleeting as employment and discretionary income rebound.

INDEX CORRELATION OF TOTAL RETURNS AND MACROECONOMIC INDICATORS

UNITED STATES | 1978-2020



Note: Returns begin in 1978 or at inception of NCREIF index for each property type. Retail sales and industrial production were examined but did not show meaningful correlations.
Source: NCREIF, NKF Research; June 2020

Although correlation does not imply causation, it represents relationships throughout time and how strongly real estate is connected to top-line macroeconomic indicators. While NCREIF's indices are not representative of all privately-owned commercial real estate, they are an accurate measure of total returns of the institutional-quality (mostly core/core-plus) product that comprises conservatively-managed portfolios.

THE OUTLOOK FOR

U.S. REAL ESTATE CAPITAL MARKETS

The COVID-19 pandemic has shaken the global markets, with the economic fallout affecting all industries uniquely and with varying degrees of severity. While the United States real estate capital markets have been greatly impacted, the downturn has largely intensified trends that were already in place for some time. Not absent of demand, the property types that entered this period in better fiscal health are the ones better positioned to withstand stress and re-emerge on a high trajectory. In summary:

OFFICE

Despite the fact that the COVID-19 crisis has created uncertainty and potential disruption surrounding future office space demand and office-using employment, core office space in gateway markets should remain resilient. A shift—at least temporarily—in favor of less dense environments may lead to an increase in office investment opportunities in suburban markets.

INDUSTRIAL

Stay-at-home orders have bolstered the e-commerce market while conversely suppressing an already declining retail brick-and-mortar landscape. The demand for industrial warehouse space, which was already rising, will accelerate further as consumers order more goods online.

MULTIFAMILY

Multifamily product does not stand to suffer excessively from nation-wide lockdowns, as demand for apartments still outweighs the current supply, and record levels of unemployment will likely force would-be home buyers to continue to rent.

RETAIL

Aside from grocery-anchored and essential big box properties, retail as a whole will lag in recovery compared to other property types as businesses struggle to reopen in dense markets. In fact, even though grocery store and pharmacy retail are more immune from the downturn than general retail, they likely will lag the broader market during the recovery given the likelihood of limited rent increases and already low cap rates.

HOSPITALITY

The hospitality real estate sector will be equally challenged in the interim as both leisure and business travel are slowed indefinitely.

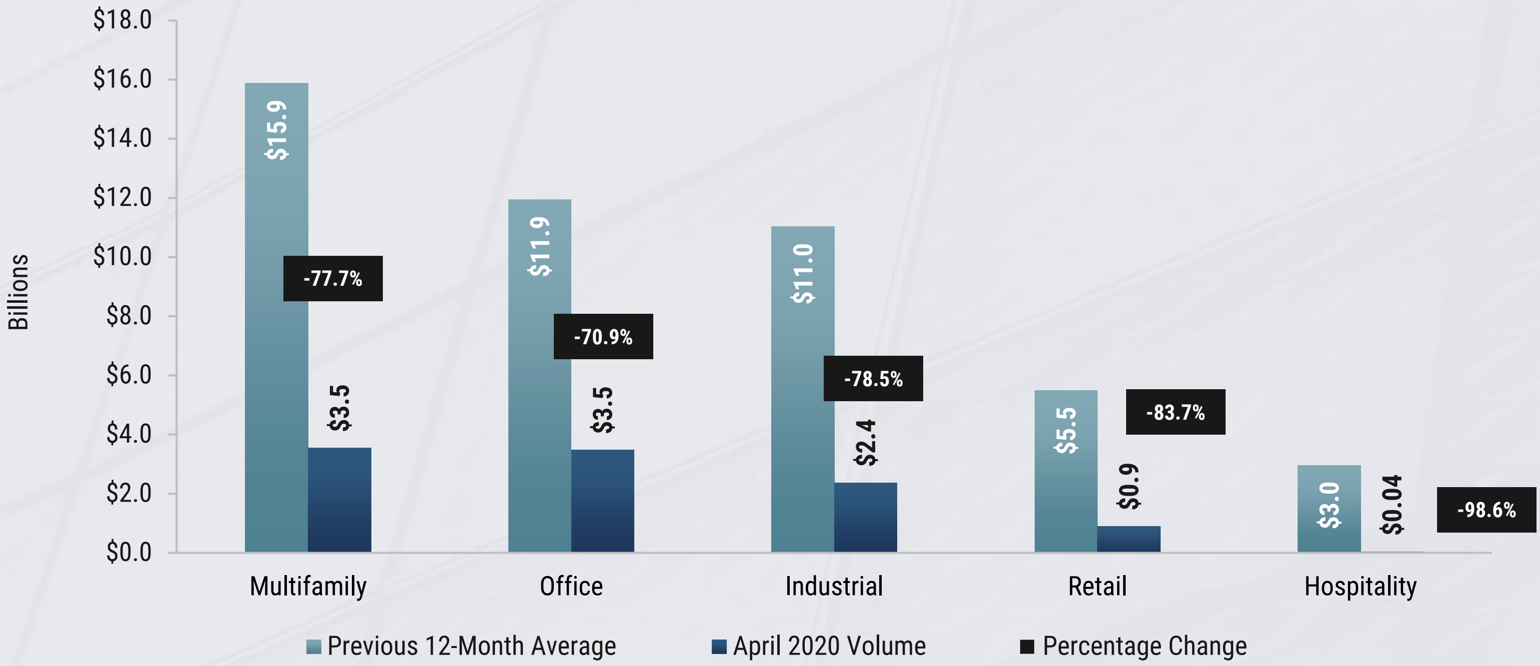
Opportunistic funds have been activated by the decline in operating and property fundamentals. They will be seeking opportunistic monetary bases in property acquisitions, thereby effecting higher risk-adjusted investment returns through a new hold period established in the wake of the pandemic. Assets associated with value-add strategies are less appealing at the moment due to the potential lease-up challenges ahead, while core investments are challenged by the difficulty of underwriting rent growth in the period ahead.

Compared to the monthly average over the past 12 months, April investment volume was down significantly. However, office (-70.9%), multifamily (-77.7%), and industrial (-78.5%) declines in investment sales volume have not compressed as drastically as in the retail (-83.7%) and hospitality (-98.6%) categories (see the adjacent graph).

Certain niche office subtypes such as life sciences and medical office, and industrial warehouse and distribution centers, will attract considerable capital investment in the year ahead, while the retail and hospitality sectors will see historically low levels of volume. In terms of regional recovery, investors are still targeting many of the same markets now as they were pre-COVID-19, although more markets are being red-lined due to their potential for a laborious recovery. Emerging markets in the South and along the West Coast will be the first to bounce back during the recovery period. While the density and transit-oriented nature of the East Coast's gateway markets may slow the recoveries of their investment markets, their highly educated workforces and tech-based economies will accelerate the pace of their economic rebounds. **Broadly, metro areas with innovation economies are best equipped for the recovery, while economies based on brick-and-mortar retail and lower-skilled employment will remain challenged.**

COMMERCIAL REAL ESTATE INVESTMENT SALES VOLUME

UNITED STATES | APRIL 2020 VS. 12-MONTH AVERAGE

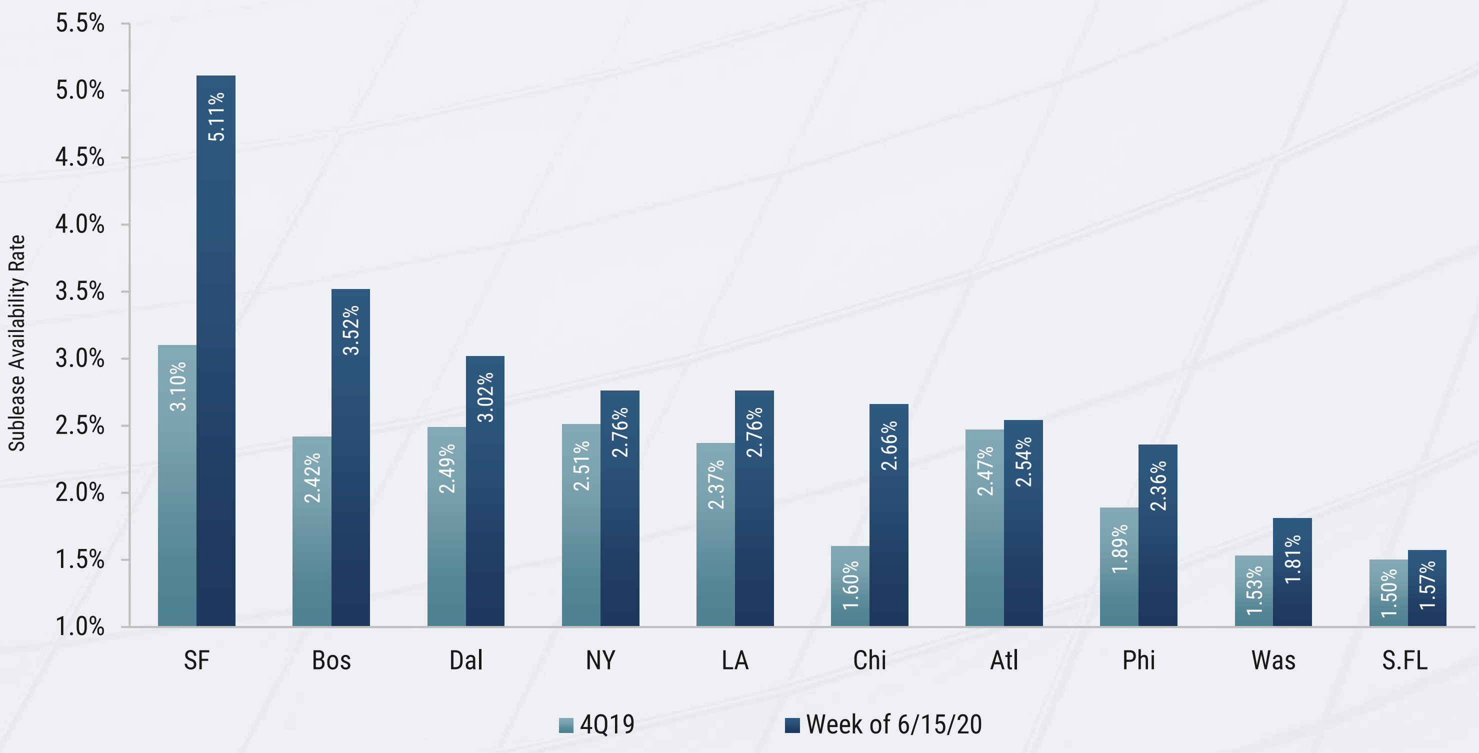


Source: NKF Research, Real Capital Analytics; June 2020

OFFICE

For office investors, understanding future office demand and office-using employment is critical to their investment outlook for the product type, but there has perhaps never been more uncertainty or more potential for disruption to office demand as during the COVID-19 crisis. In particular, there is a heightened awareness that social distancing measures will increase square foot per employee ratios, which if holding other factors constant, would lead to an increased need for office space. However, this effect likely will be outweighed by the fact that certain office functions, especially lower-touch, back office, or technology-centric roles could remain virtual for longer periods of time, reducing the need for as much space. This tension between more space for those in the office, but perhaps fewer people in the office, will determine the scale of office space demand over the next few years and have a material impact on investors' returns. Notably, the increase in sublease availability has been modest thus far in most major metro areas as tenants gauge their future needs in this new environment, although availability is very likely to rise in the months ahead (see adjacent graph).

SUBLEASE AVAILABILITY IN MAJOR METRO AREAS
OFFICE SUBLEASE AVAILABILITY RATE
MAJOR U.S. METRO AREAS | JUNE 2020 COMPARED TO BENCHMARK PRIOR TO COVID-19



Source: NKF Research; June 2020

III

WHAT IS THE POSSIBLE IMPACT ON NET OFFICE ABSORPTION AS A RESULT OF THE TENSION BETWEEN DE-DENSIFICATION AND MORE REMOTE WORK?

Between February 2020 and May 2020, the United States lost 5.4 million office-using jobs, or 8.7% of all office-using positions. At May 2020, approximately 128 square feet was occupied per office-using position, meaning the *perceived* long-term need for office space declined by 688 million square feet as a result of those lost positions, equal to roughly 8.5% of the U.S. office inventory. Much of that space will be under lease for months or years to come, and many of the lost positions will be restored over time, but the scope of the present challenge to the office market is significant. Returning to a period of net positive demand may take a while, even though many workers are eager to escape isolation and return to the office. Employers also are recognizing that it is hard to maintain a strong corporate culture while workers are physically distant.

Importantly, the demand projection cited above is a rough estimate; it is possible that the redesign of office space could result in a *net gain* of demand, especially given the employee pushback against densification that was already occurring before the pandemic began. Further, office-using positions have been the best insulated from furloughs and terminations; while 8.7% of office-using positions have been lost since the pandemic began, that compares favorably with the 12.8% loss for all job categories combined. However, it seems likely that some further attrition in office space demand is ahead as the tension between greater social distancing and more remote work is sorted out.

Investors can capitalize on this situation by buying office assets of the type and location that are most likely to be in favor even if net demand declines, such as those with flexible layouts, or in easily-accessed locations (especially by car), or which are in markets with tech-savvy workforces poised for ongoing growth.

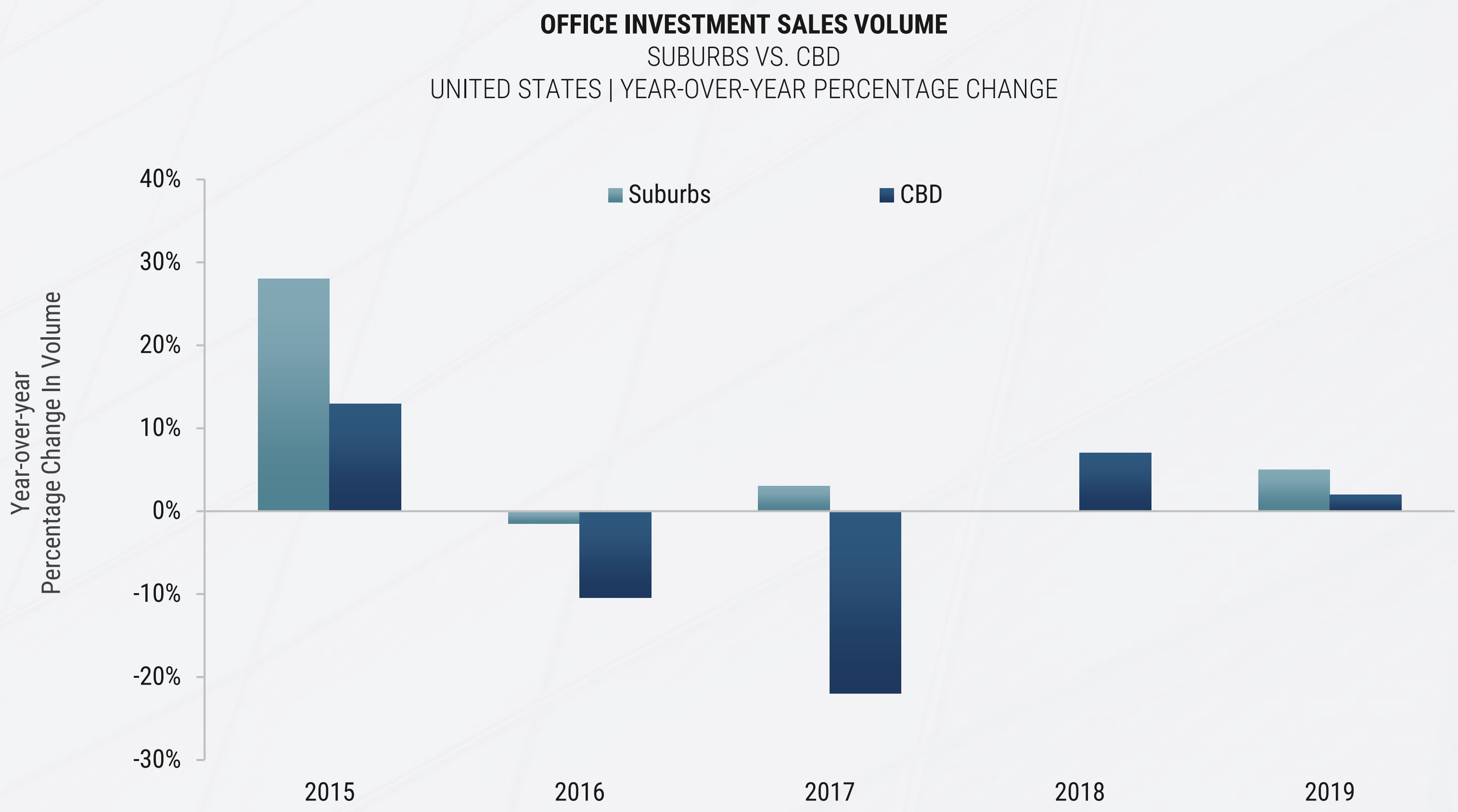
Another potential headwind faced by office asset owners is the expenses incurred by maintaining safe and clean office environments—increased needs for cleaning services, protective equipment for building staff, and upgrades to existing HVAC systems could all reduce net operating income (NOI). As a result of these challenges, the office investment sales market in April 2020 was down 59.7% compared with April 2019, to just over $3.4 billion nationally. Many investors have either chosen a "wait and see approach" or have opted for capital events such as refinancing or recapitalizations instead of bringing properties to market for sale. Despite the slowdown in capital markets activity, initial rent collection data from both public REITs and private funds remain high, at 93% and 87% respectively for April, according to S&P and NCREIF. These strong collection rates suggest that the immediate economic fallout of COVID-19 has not yet materially impacted the revenue accruing to asset owners, although the pace of the broader economic recovery will help determine for how long office rent collections remain high.

Historically, core CBD office product in the largest coastal gateways has remained among the most liquid property types in commercial real estate, and also the most resilient to downturns—consequently, this product has been a critical defensive component of institutional and international groups' real estate portfolios. Markets such as Washington, DC—which are supported by the federal government, medical/healthcare and education services tenants—have been resilient during past economic downturns and appear poised to outperform during the early part of the recovery.

However, COVID-19 has drastically changed the perception of urban areas and public transportation—at least in the short term—especially considering the largest office market in the country, New York City, has been the U.S. epicenter for the virus outbreak. While it is very likely that most corporations will continue to have a presence in the largest metropolitan areas, COVID-19 has put additional pressure on companies to consider opening offices in lower-cost urban markets and suburban markets. For example, some large NYC firms are currently exploring short-term space in nearby suburbs including Northern New Jersey, Westchester, Long Island and Stamford. However, even before COVID-19, large financial institutions were relocating sizable portions of their workforces to Sunbelt markets, such as Nashville and Charlotte. Similarly, institutional groups increasingly allocated capital to these markets, particularly since 2017, chasing higher growth, yields and opportunities. These allocations were driven in part by the lack of available core office product for sale in gateway markets and record cap rate compression in the core space. As shown in the adjacent graph, suburban office sales volume has grown faster year-over-year than CBD volume in four of the past five years.

COVID-19 may accelerate these trends, particularly as corporations consider suburban hub locations that can be accessed easily by car—and as some attempt to manage real estate occupancy costs via an increasingly virtual workforce.

III



Note: The suburban change in 2018 was 0%.
Source: NCREIF, NKF Research; June 2020

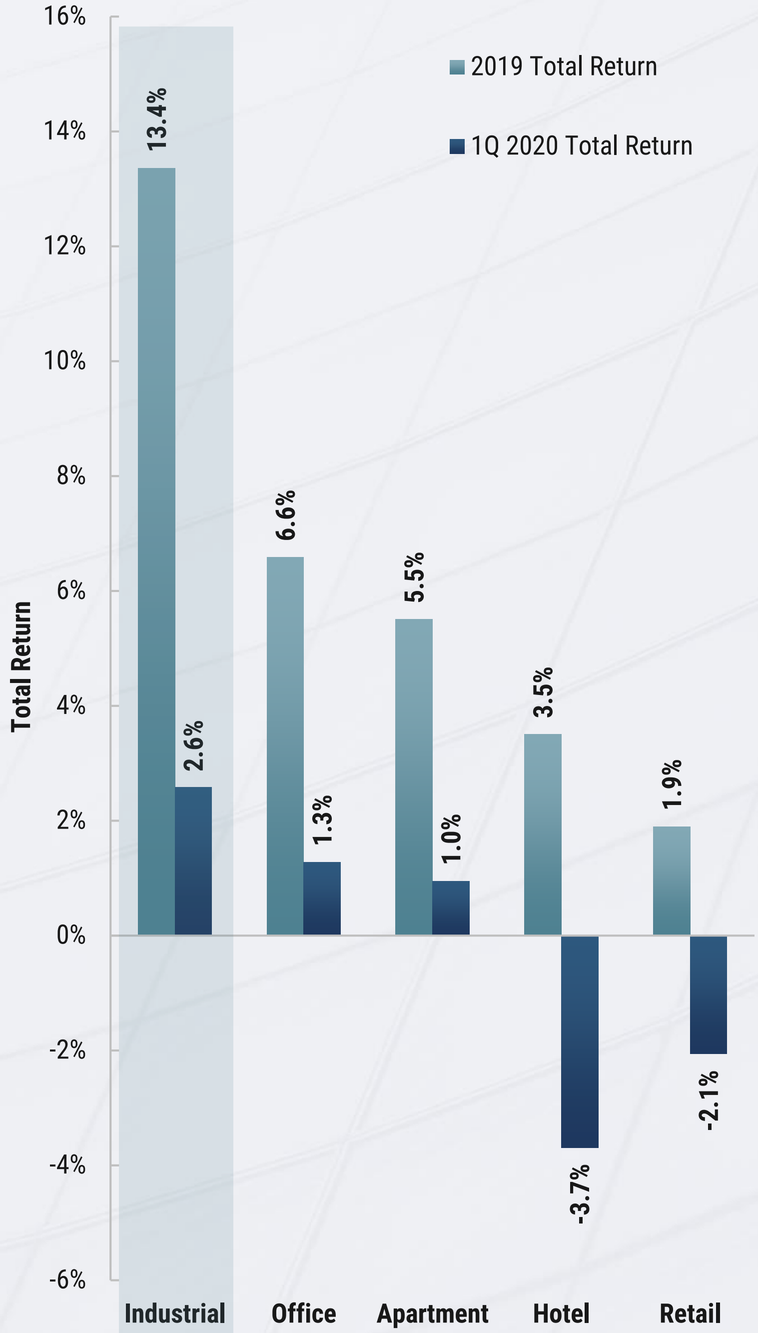
INDUSTRIAL

Industrial volume is likely to accelerate in the wake of COVID-19. From 2016 through 2020, investors devoted 19% of their capital to industrial product, up from 14% during the 2011-2015 period. This preference is expected to continue, as e-commerce sustains its rapid growth. According to the U.S. Department of Commerce, seasonally adjusted e-commerce sales increased by 2.4% quarter-over-quarter in the first quarter of 2020, even as overall retail sales declined by 1.3%. With millions of Americans confined to their homes, e-commerce offers consumers both increased convenience and safety.

This uptick in demand has also resulted in labor challenges. Major e-commerce companies including Amazon and Walmart have hired additional workers during the COVID-19 crisis to keep up with increased demand, although worker illnesses have complicated the sector's growth during the pandemic. The fact that top e-commerce firms, most notably Amazon, have expanded their footprints in recent years—especially for last-mile delivery centers and logistics facilities—has helped to facilitate their response to rising customer demand. **With the recent e-commerce surge, it is likely that there will be strong user retention after the current crisis passes, as well as an increase in new leasing requirements for industrial facilities.** There is 322 million square feet of industrial space under construction across the U.S., meaning near-term expansion needs should be accommodated; net absorption of U.S. industrial space in 2019 totaled 202 million square feet during 2019.

The vacancy rate for national industrial product has been low for several years, closing the first quarter at 5.4%. With demand for space expected to continue to rise, asking rents are likely to follow suit, although rent growth may slow as new product delivers. Rents already increased 4.1%, to $7.54/SF, during the year ending at first-quarter 2020; investors may feel optimistic about the economic prospects of industrial tenants amid the pandemic. That said, industrial values may not accelerate materially since further rental growth will be slowed by the economic fallout from COVID-19.

PERFORMANCE BY PROPERTY TYPE
TOTAL RETURNS | 2019 vs. 1Q 2020



Source: NCREIF, NKF Research; June 2020

One challenge to industrial returns in 2020 and 2021 may be a slowdown in the manufacturing of consumer goods and a related reduction in demand for space by that tenant type, a consequence of the reduction in discretionary spending. **Also, in a recessionary environment, industrial returns may outperform those of other property types, but they likely will fall short of their own recent performance.** Industrial REITs boasted the highest returns of all property types in 2019, at 48.7%; they have suffered the smallest losses during the first quarter of 2020, at just 10.3%. Industrial properties overall boasted the highest annual returns of all property types in 2019, at 13.4% (see the adjacent graph). With e-commerce being just one of a few resilient industries during the pandemic, the industrial sector is well positioned for continued growth and investor interest, especially if some re-shoring of overseas manufacturing operations occurs in the years ahead. However, even industrial investors with a high fraction of their portfolio occupied by e-commerce firms may find it challenging to lease space to other tenant types with softer demand.

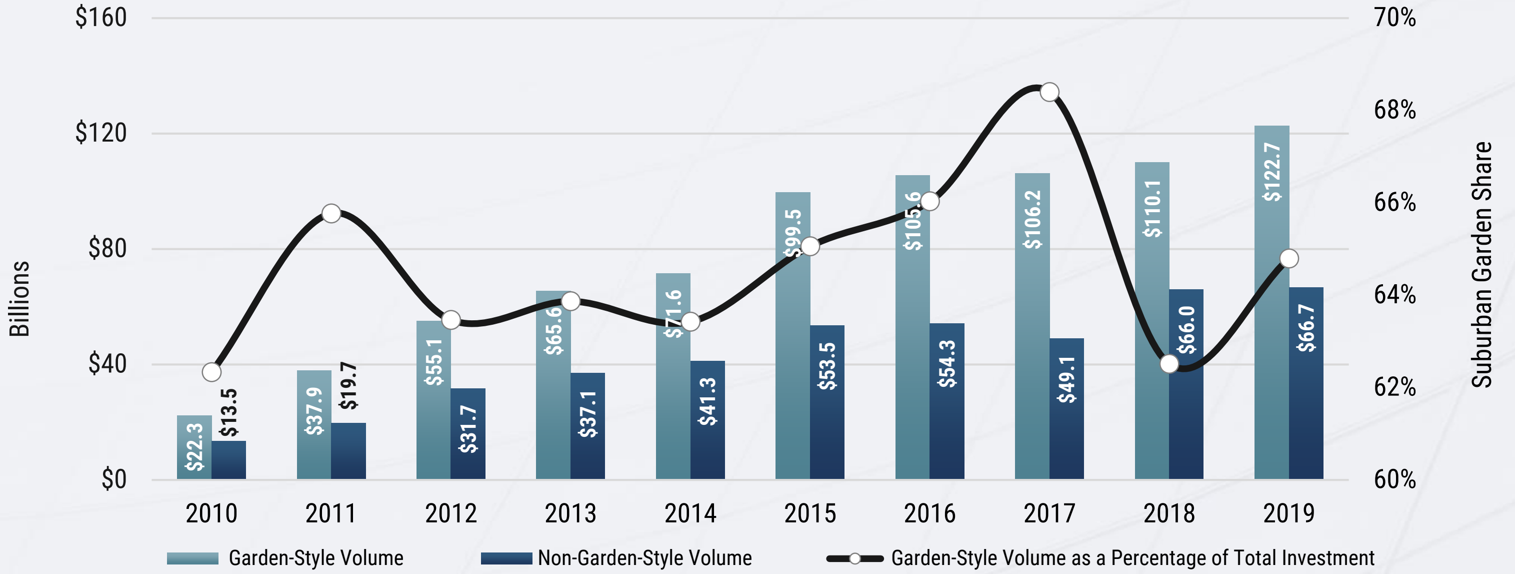
MULTIFAMILY

As investors grapple with new challenges and shifting dynamics following the COVID-19 outbreak, U.S. multifamily assets have emerged as not only one of the most desirable property types among real estate allocators, but also one of the best positioned to attract investment in the years ahead. While the investment sales market has experienced a significant slowdown in activity since mid-March due to the pandemic, as well as the subsequent dislocation in pricing, a silver lining thus far has been durable and resilient rent collections. According to NCREIF's open-end fund rent collections rate analysis, multifamily was the top-performing property type, collecting 91.7% in April and 92.7% in May, in line with similar data collected by the National Multifamily Housing Council (NMHC) and NAREIT.

In addition to strong rent collection data, multifamily is poised to see an influx of investment due to strong demand factors, as well as above-average performance following the previous economic slowdown. Insufficient single-family construction during the previous cycle contributed to a spike in demand for rental housing. Furthermore, with more than 40 million initial unemployment claims in the U.S. since the beginning of the pandemic, many would-be home buyers will have to delay purchasing and instead remain renters. Another reason why multifamily is likely to see increased investment is outperformance in the immediate aftermath of the Global Financial Crisis (GFC). From 2010-2012, multifamily total returns outpaced the broader market. While the catalyst of the current downturn is different and the duration of the recovery may be as well, **investors who are seeking defensive strategies with a track record of strong risk-adjusted returns may increasingly look to multifamily assets.**

Garden-style multifamily, the dominant sub-type in suburban markets, has experienced a surge in investment activity in recent years (see the adjacent graph) as investors gravitated to value-add product, especially in high-growth markets throughout the Sunbelt. The share of multifamily investment volume attributed to Suburban Garden product increased from 62.5% in 2018 to 64.8% in 2019. The stay-at-home orders for much of the U.S. workforce that have been in place since mid-March have put an emphasis on less dense locations and questioned whether remote work may make living in urban areas less valuable. Recently, large corporations such as Facebook, MasterCard and Twitter extended their work-from-home policies longer than what individual state legislatures have, and there is growing sentiment that some jobs could permanently be performed from home. **To the extent some companies invite more of their staff to work from home, the COVID-19 crisis may underscore the value of suburban multifamily assets; broadly, this property type also features non-cyclical characteristics.**

MULTIFAMILY INVESTMENT SALES VOLUME
UNITED STATES
SUBURBAN GARDEN VS. NON-GARDEN | 2010 - 2019



Source: NKF Research, Real Capital Analytics; June 2020

RETAIL

The brick-and-mortar retail environment was under significant pressure from the growing e-commerce sector even before COVID-19 arrived. As noted earlier, it is likely that some of the online shopping habits consumers gained (or honed) during the pandemic will be retained given the convenience they offer. In short, the pandemic has further upended an already-challenged retail market. It is among the hardest hit property types with the heaviest shroud of uncertainty. The sector (including the sub-sectors of Retail, Food Services and Drinking Establishments) has seen the greatest employment loss of any industry, shedding more than four million jobs across the country in April and May combined. Adding to the complexity, retail markets have traditionally been hyper-localized, and that is even more true today with the virus's spread and social distancing regulations impacting various regions differently.

Today, essential businesses such as groceries and pharmacies are the primary retail sub-types in which investors have confidence, although some convenience stores and discount retailers continue to perform well. After essential businesses, the next to open nationally will be purveyors of goods and services that can be put off for a time, but not forever. They include establishments like physical therapy, pet care, and salons. The timing of brick-and-mortar re-openings beyond that is unclear and perhaps dictated as much by market forces as by government regulations; next in line may be luxury goods retailers, or athleisure and casual wear sellers, or outdoor dining establishments. Geographically, retail's recovery likely will begin in places that were less impacted by the spread of the COVID-19. Secondary and tertiary markets are likely to win over gateway cities in the short term, the inverse of the norm. Major markets will rebound, but likely at a slower pace, and perhaps not until herd immunity or a vaccine is achieved.

Malls will follow a similar path. Their valuation can no longer be considered on the basis of Class A versus B and C properties. Rather, the greater the concentration of non-discretionary goods and services, the quicker the mall will rebound. Neighborhood shopping centers with grocery anchors and power centers are currently in the best position with the greatest likelihood of tenants making their rent payments. Next may be open-air centers, which will feel more comfortable to cautious consumers than enclosed malls. In fact, **with the potential for more foot traffic, open-air centers may begin to capture tenants relocating from enclosed malls, making those outdoor centers more appealing to investors.**

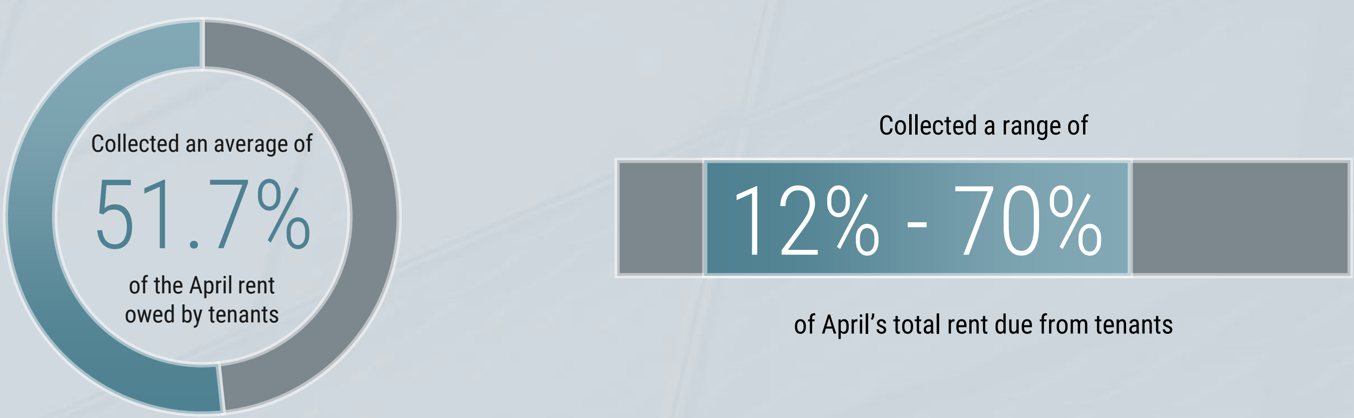
Enclosed malls face some of the greatest hurdles of any property type. Their value is driven mostly by discretionary spending, and their enclosures makes them riskier than open-air malls from an epidemiological perspective. Layering onto those challenges, e-commerce was threatening the traditional department store model prior to the pandemic, and some of those tenants now face bankruptcy. This threat to occupancy may cause a domino effect, potentially triggering lease provisions for viable tenants to pay a reduced rent or get out of lease obligations entirely. (See the adjacent infographic for details on retail REIT rent collection.)

Some malls are currently in default and going into special servicing. What follows will likely be a slow process as special servicers wait for social distancing regulations to be lifted to determine a path forward. Beyond that, some retail market experts caution that mall valuations will drop 25% to 30% and that NOI will be impacted into 2022 or beyond, with second-tier properties offering especially weak returns.

In contrast to malls, urban high streets are likely to follow broader retail sector and capital markets themes. Essential businesses are thriving, while other retailers face uncertain futures. Investors are primarily in a due diligence phase, waiting until social distancing measures are lifted to get a sense of which businesses survive this initial stage of the pandemic. Investors with dry powder and an appetite for retail investments likely will focus on single-tenant credit deals and grocery-anchored centers.

It is important to note that some of these market conditions are temporary. We cannot yet gauge the duration of these phases nor the retail market's long-term prospects, since so much of this sector's performance relies on progress toward immunity from the coronavirus and the efficacy of social and behavioral reactions. That said, the wave of stores closures that was occurring pre-pandemic is now accelerating into bankruptcies.

THE 20 PUBLICLY LISTED RETAIL REITs



Source: NKF Research, S&P Rent Tracker; June 2020

HOSPITALITY

Due to the nature of COVID-19 and the associated travel bans, the hospitality sector has been one of the hardest hit property types by the pandemic and faces a difficult and prolonged recovery. Since the year 2000, the hotel property type has outperformed the broader NCREIF total return index just four times. Performance usually accelerated later in economic expansions, such as during 2006-2007 and in 2018. In 2002, following the dot-com bubble and the September 11th terrorist attacks, hotels also outpaced the market. Increased operational expenses likely will result in diminished returns with new sanitary regulations and procedures in place in response to COVID-19. While it is possible that restlessness in the aftermath of stay-at-home orders causes a surge in travel as states re-open, it is more likely that the travel recovery will be slow, and that job losses will put a damper on discretionary spending.

The cancellation of major conventions and trade shows, which are a significant driver of growth for the hospitality property type, will also hamper the sector—likely until after a vaccine is widely distributed. STR reported that total revenue per available room (RevPAR) declined by 79.9% for the entire U.S. from April 2019 to April 2020, and it was down 84.9% during the same period for just the top 25 U.S. markets. While many hotels have closed during the pandemic, the investment sales market similarly seems to be on hold. According to Real Capital Analytics, April 2020 sales volume totaled just $42 million nationally, representing a 98% decline in activity compared with April 2019. With more stable property types like multifamily and industrial—which have historically outperformed hospitality investment during economic recovery periods—positioned to draw significant capital, the hospitality sector may be recessed for a considerable amount of time. Prior to COVID-19, hotel total returns had still not recovered to their peak 2006 level following the Global Financial Crisis (see the adjacent graph), and recovery to that level will now be pushed out further.

With reduced cash flows, distress is probable for many owners of hospitality assets, especially for union hotels and hotels where the market is saturated (including in many large metro areas). **Given the current situation, opportunistic investors, particularly in the multifamily space, have circled hotels as a property type ripe for conversions.** Given the oversupply of hotels in some major markets, this may have been a burgeoning strategy even in the absence of the pandemic. **Seniors housing will see a renewed focus, as a property type that would be a logical need following COVID-19. Affordable housing is another sector in demand, and hotel conversions could offer value to investors. In addition to increasing demand for these asset types, federal and state tax credits and grants also provide an incentive for owners to re-classify hospitality assets.** With the ambiguous timing of vaccine production and distribution, the recovery of the hospitality investment sales market remains uncertain. For many owner/operators, a swift change in strategy seems like a logical option when compared to the alternative: fighting against an unpredictable recovery timeline.

III

ANNUALIZED TOTAL RETURNS FOR COMMERCIAL REAL ESTATE
UNITED STATES
ALL PROPERTY TYPES VS. HOTELS | 2000 - 2020

**12 months ending March 31, 2020*
Note: Shaded areas indicate time periods covered entirely or in part by recessions
Source: NCREIF, NKF Research; June 2020

OPPORTUNITIES AND
ACTION STEPS FOR INVESTORS

In a time of significant dislocation in the commercial real estate markets, decision-making is challenging and risk is elevated—but opportunities are plentiful. As the markets work through the challenges presented by COVID-19, some possible action steps for investors include:

OFFICE

Employment growth is not supporting office returns the way it once did, as the densification of office space has reduced the square foot per worker ratio and the upside of that growth. However, a reversal of densification due to social distancing requirements may create opportunities. A key decision point involves which types of tenants an investor is targeting—are they tenants who are generally in need of face-to-face interaction, or are they tenants who view remote work as acceptable for the long term? Not all office-using firms will evaluate their space needs similarly.

INDUSTRIAL

The sector is less correlated with GDP performance than investors may think, which presents opportunities during the recession—as long as e-commerce sales remain robust. Supply chain challenges could slow growth prospects, but the need for more warehouse space in the long run is clear.

IV

MULTIFAMILY

Employment is actually better correlated with multifamily returns than with office returns, a reminder that durable multifamily investment opportunities exist at all points of the economic cycle. The inability of would-be home buyers to enter the for-sale market due to the economic repercussions of the pandemic likely will result in a boost to demand for multifamily units.

RETAIL

A focus on centers with essential needs purveyors is a potentially low-yield but productive approach for investors with short- to intermediate-term horizons. Investors with dry powder who are seeking distressed assets may be drawn to the retail market in search of bargains, but the risk is substantial given the uncertainty still present in the sector.

HOSPITALITY

This is a volatile property type historically; while buy-low opportunities may exist for long-term investors, conversions to multifamily and seniors housing may be the highest-and-best-use opportunity. However, volatility goes both ways—when the recovery does begin, there could be a very rapid increase in total returns. Well-capitalized owners who can wait out short-term disruption have a lot of opportunity to achieve long-term outperformance in the future.

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