

COVID-19:
CROSS-CUTTING TRENDS
TOWARD A NEW REALITY

PART II:
CHARTING THE COURSE:
SECTOR-SPECIFIC IMPACTS

Prepared for: LAI

June 3, 2020



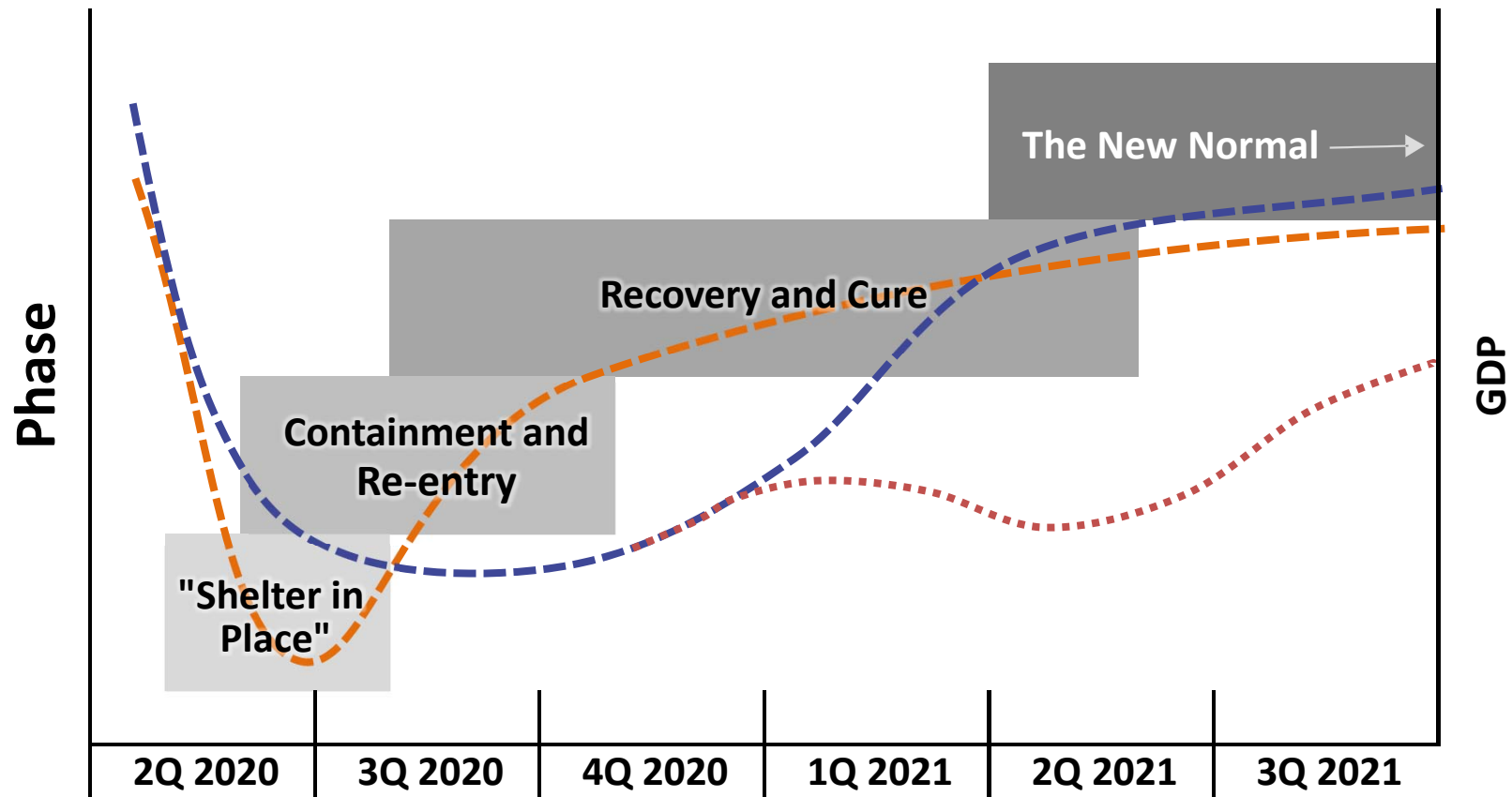
Economic & Planning Systems, Inc.
The Economics of Land Use

400 Capitol Mall, 28th Floor ■ Sacramento, CA 95814
916.649.8010 ■ www.epsys.com

OVERVIEW

- Introduction
- Implications by Real Estate Sector
 - Residential
 - Office/Flex
 - Retail / Hospitality
 - Industrial/Warehouse
- Discussion / Next Steps

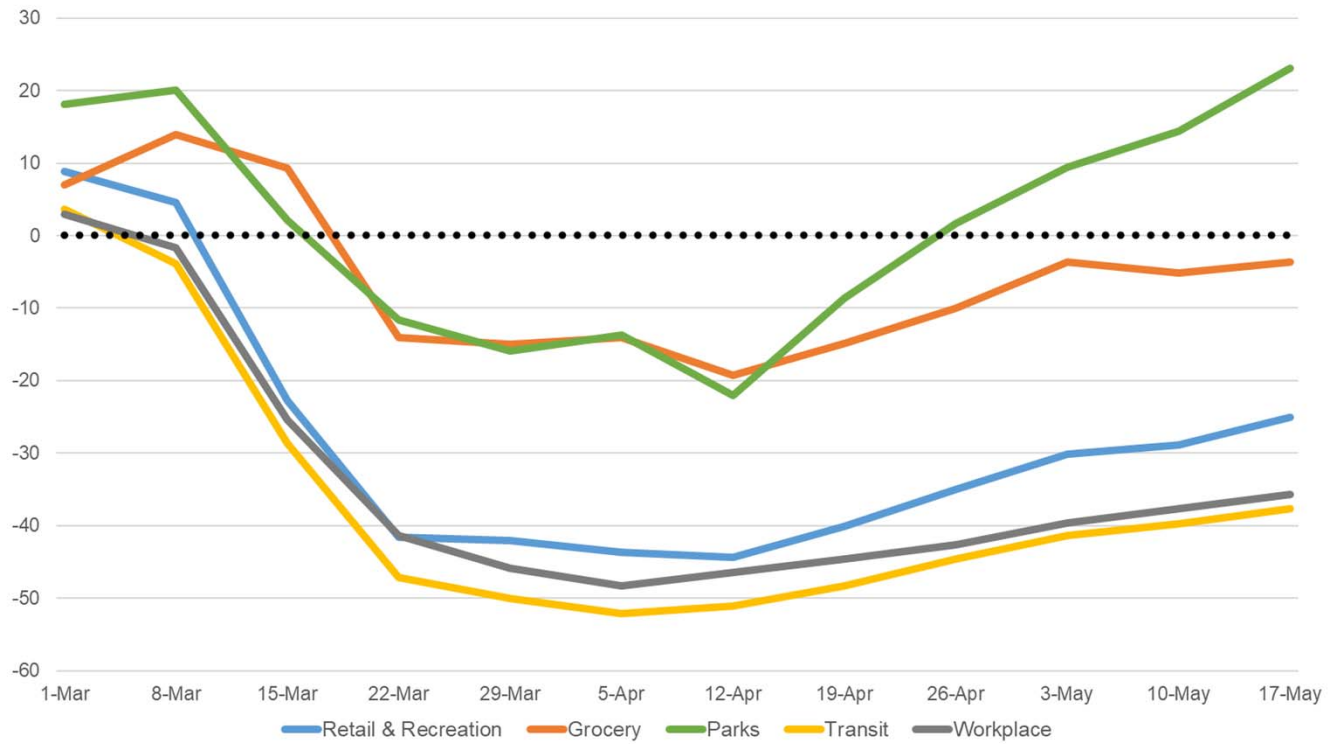
REVISITING THE SHAPE OF THE CURVE -- AGAIN



SOCIAL DISTANCING EFFECTS ON U.S. MOBILITY

Grocery visits nearing baseline and Parks visits gaining popularity

Retail & Recreation, Transit Station, and Workplace visits significantly reduced


















Source: Google; EPS.

THE EVOLUTION OF “PLACE”



PRELIMINARY TAKE-AWAY

Type of Market Impact	Potential Impact by Real Estate Sector						
	Single-Family Residential	Multifamily Residential	Office / R&D Flex	Essential Retail	Discretionary Retail	Warehouse / Industrial	Hospitality
Short-term							
Structural		 					

REAL ESTATE IMPACTS

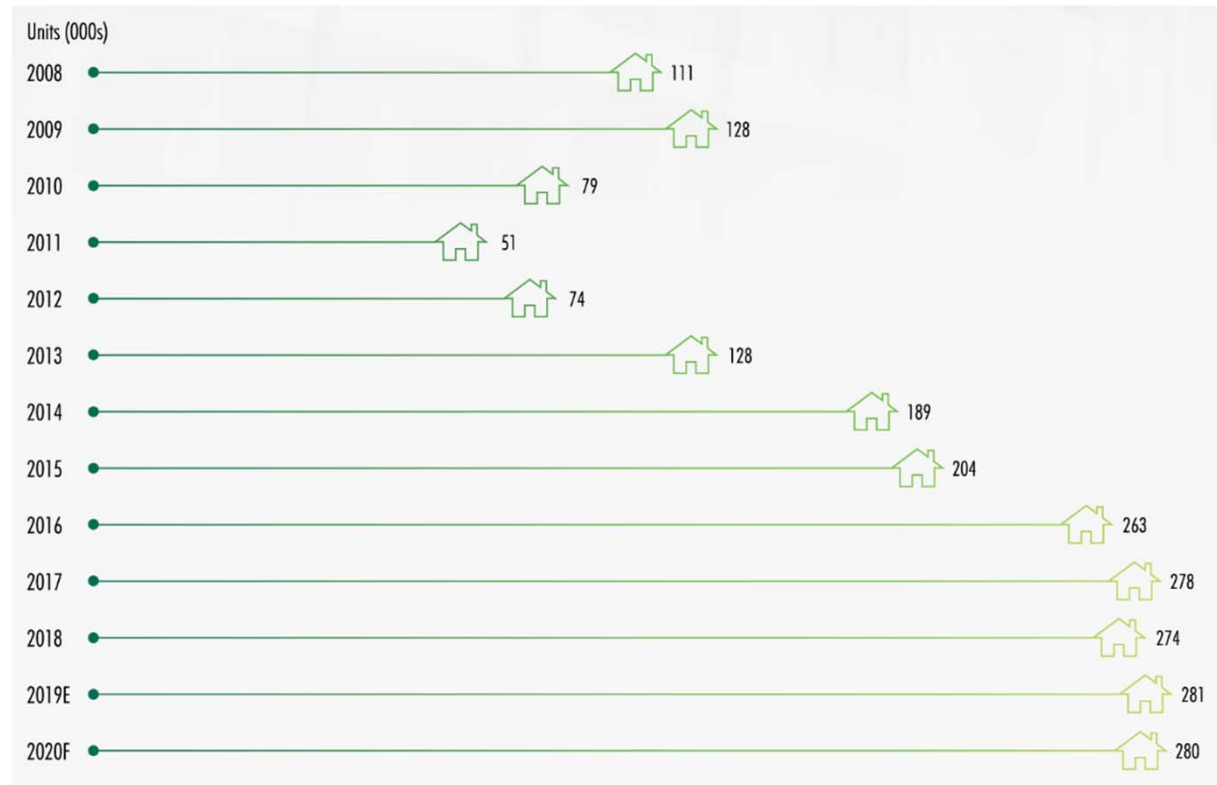
RESIDENTIAL



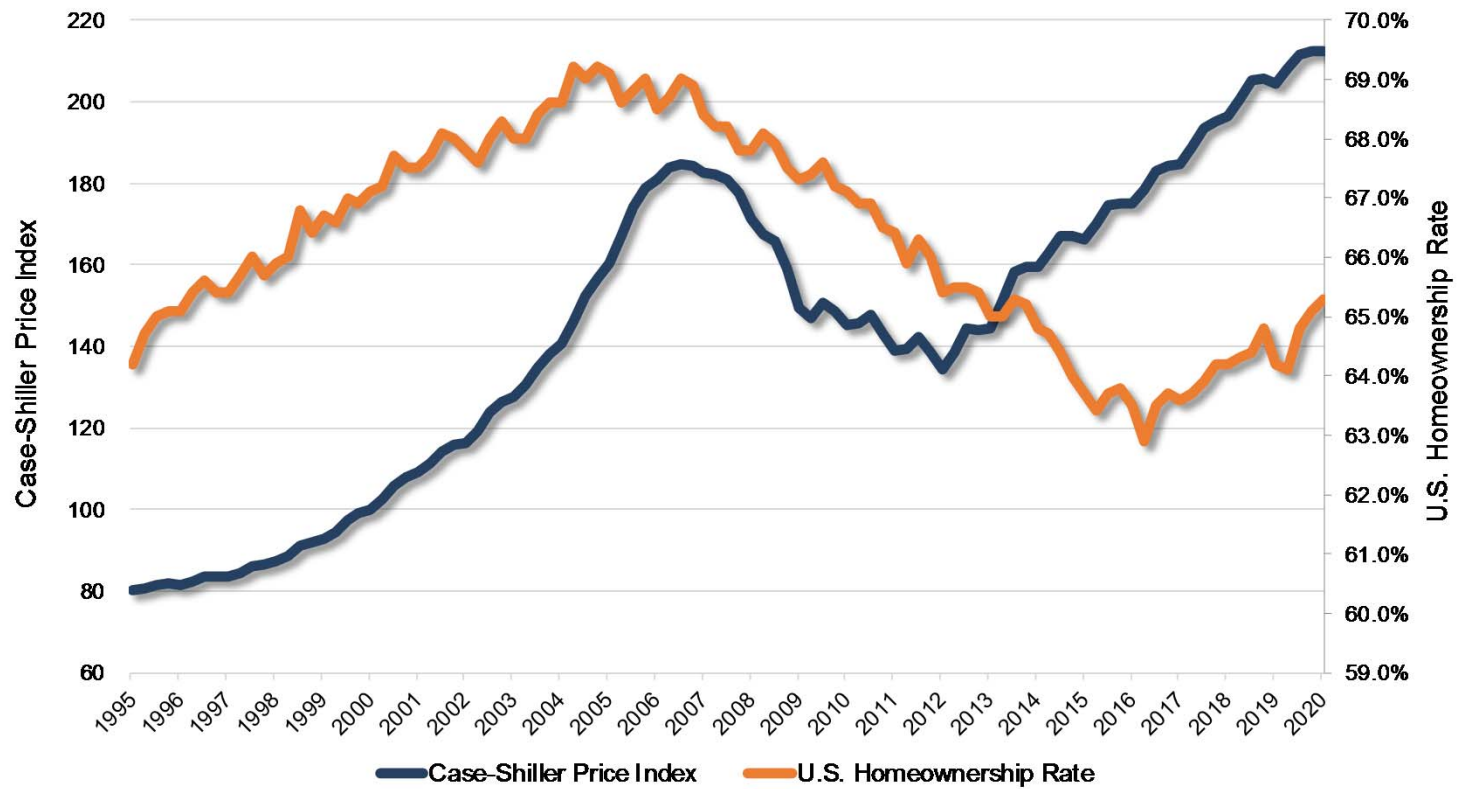
PRE-PANDEMIC: STRENGTH IN MOST MARKETS AND SEGMENTS

- Strong investor and builder activity across US, especially in West and South
- Rent control measures softening high-end markets; increasing momentum in suburbs

US Multifamily Annual Unit Construction



PRE-PANDEMIC: PRICES AND OWNERSHIP INCREASE



Source: S&P Dow Jones Indices LLC; U.S. Census Bureau.

BUT TROUBLE ON THE HORIZON

Occupancy cost exceeding sustainable thresholds:

- **≈ 25% of tenants paying more than half their before-tax income on rent**
- Percentage of tenants not paying full rent – April 25% | May 31%
- Some landlords working with tenants to reduce / forgive payments
- Many tenants are putting rent on credit cards
- *“Landlords and renters will share in the pain, we just don’t know what the sharing balance will look like.” John Pawlowski, Green Street Advisors*

Timing of recovery uncertain but unlikely to be rapid

- Initial stimulus boosted personal income in April by 10.5% (\$1,200 coronavirus relief and \$600 weekly boost to unemployment benefits)
- Various subsidies expire in July and Senate showing little support for second round

TIER I METRO EXODUS?

Expensive Metros Suffer

- Urban living and amenities may become devalued as result of extended stay-at-home orders
- Work-from-home policies increases relevance of affordability and quality
- Rents in Bay Area drop
 - San Francisco: 9% drop in YOY May rents
 - Silicon Valley: 15% drop in YOY May rents
- University-focused metros hit as students stay away from campus
- Impacts of social unrest?

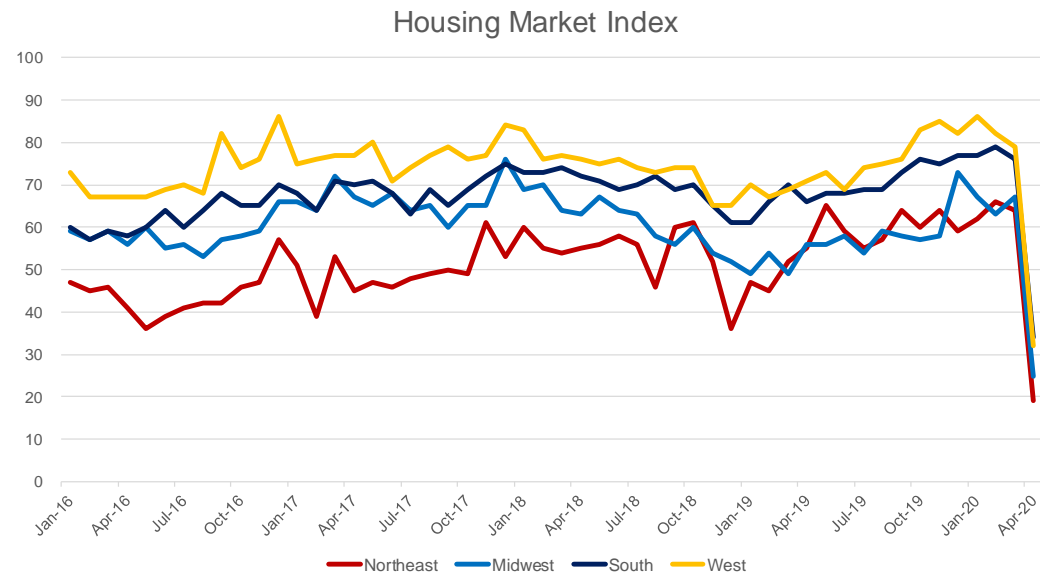


SFR PANDEMIC SHOCKS: NEAR- TO MID-TERM IMPACTS

Reduced mobility and economic concerns will curtail transactions

- Housing Market Index reveals biggest monthly drop 30-year history

Interest rate cuts will help, but many homeownership dreams will be delayed

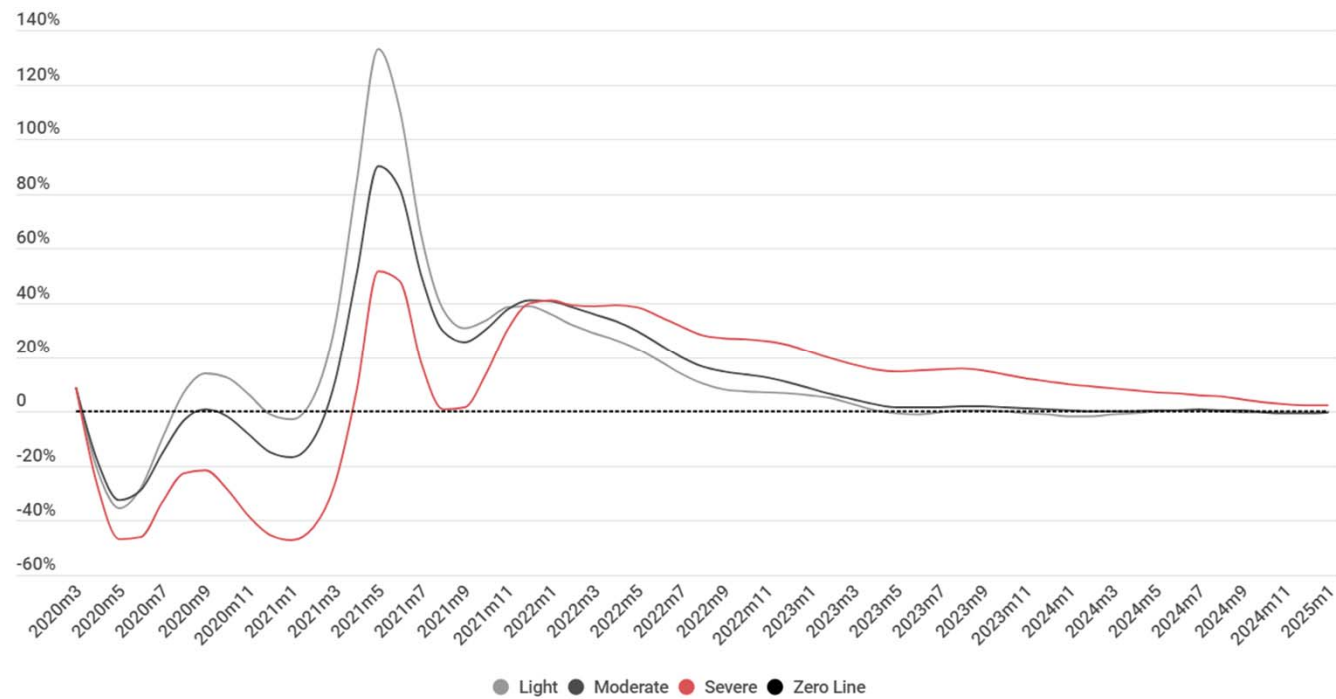


Source: National Association of Homebuilders, Wells Fargo.

Region	March-20	April-20
Northeast	64	19
Midwest	67	25
South	76	34
West	79	32

SFR PANDEMIC SHOCKS: THE BOUNCE BACK?

Single-Family Permits (SAAR) MOM% Forecast, March 2020 - Jan 2025



DEMAND FOR MIDDLE-LEVEL/WORKFORCE HOUSING PREVAILS

- City dwellers may look to more affordable secondary metros and suburban areas
- Increased demand for SFR, coupled with increased economic burdens will delay homeownership dreams for many households
- SFR in High-priced metros still unattainable for most



REAL ESTATE IMPACTS

OFFICE / FLEX



PRE-PANDEMIC FUNDAMENTALS STRONG BUT UNEVEN

Overall Market Fundamentals Strong:

- Prolonged period of growth and absorption
- Declining vacancy and rising lease rates
- Strong LTV ratios and capitalization
- 2018 spec development highest in 13 years

But recovery from GFC was uneven

- Continued bi-furcation between established CBDs and other markets
- Pandemic hits just as many peripheral and emerging markets on cusp
- Excess supply remains in many locations (e.g. LA, DC, NOLA)

Class A Office Vacancies

	Vacancy Rate by Year	
	2019	2005 - 2019 Avg.
United States [1]	11.8%	12.5%
San Francisco	5.2%	9.3%
Los Angeles	13.1%	13.0%
Chicago	12.2%	13.2%
New York City	8.2%	8.1%
Seattle	5.0%	11.4%
Dallas	20.4%	19.8%
Boston	5.7%	8.5%

[1] U.S. vacancy reflects 2007 - 19 average due to data availability

MOST TENANTS / OWNERS WELL POSITIONED TO WEATHER STORM

Most office tenants have:

- Higher educated workforce
- Telecommuting capabilities, technology, and practices (e.g. “digital divide”) to make remote work possible
- Jobs with salary and benefits to better sustain temporary disruption
- Less susceptible to supply chain disruptions or retail shocks

Most office landlords have:

- Strong LTV and occupancies
- Average remaining lease term about 2 years
- Capitalized and sophisticated with access to capital markets

Investor outlook:

- New spec development to hit the pause button
- Reset on some lease terms (e.g. to accommodate necessary TIs)
- Opportunity for well-capitalized, cash rich investors

BUT DIFFERENCES EXIST BY SECTOR AND LOCATION

Most Vulnerable

- Start-ups (funding in 2020 hits second steepest quarterly decline in 10 years)
- Negative ripple effect on professions serving impacted industries (e.g. energy, transportation, staffing resources, hospitality, fitness, retail, development)
- Major CBDs with fast growing COVID case load (e.g. NYC, NOLA, Detroit)

Well Positioned

- Professions with educated and more experienced workers
- Professional and technical services (e.g. legal, consulting)
- Markets concentrated in life sciences and pharmaceuticals, insurance, and tech
- Suburban markets with lower densities and lease rates

MODELS FOR RE-ENTRY AND ADAPTATION WILL VARY

Office modification and protocol (e.g. CDC)



- Reconfigure work stations (6 feet apart / barriers)
- Common area signage and distancing
- Face coverings, temperature checks
- Cleaning protocol and sanitizer

Increased work-from-home flexibility



- Create official policies and guidelines
- Facilitate speedy adaptation of technology

Gravitate to new culture of work



- Central office becomes the brand and cultural hub
- Worker Rotation model
- Continued suburbanization of peripheral functions

LONG-TERM CHANGE IN TYPE / LOCATION OF DEMAND

Work at from home will likely increase:

...But employee density will likely decrease for social distancing

Office environments will likely change but total space demand may not.

Hypothetical Space Demand Scenarios

Category	Before		After	
	High	Low	High	Low
# of Employees	100		100	
Square feet / employee	300	250	360	300
Percent of workforce with a "desk"	95%	85%	80%	70%
Total office demand (sq. ft.)	28,500	21,250	28,800	21,000
<i>Change from Baseline</i>			300	(250)

REAL ESTATE IMPACTS

RETAIL AND HOSPITALITY



PRE-PANDEMIC: GROWTH AND STRUCTURAL CHANGE

Sales at all time high, driven by rising income and consumer confidence

But accompanied by paradigm shift and looming threats

- \approx 10,000 store closures in 2019
- \approx 31,400 jobs loses between 2018 - 2019
- \approx 17% of sales in e-commerce and growing

U.S. remains “over-retailed” (\approx 25 to 45 square feet per person compared to \approx 2.5 in Germany).

Sector	2019 Growth	2020 Y2Y Growth (Through 2/20)
Food	3.0%	5.0%
Drug	3.1%	2.3%
Convenience and Gas	0.5%	8.6%
Mass/Warehouse Clubs	3.2%	8.4%
Dept Stores	-5.5%	-2.8%
Specialty Soft Goods	-0.6%	3.8%
Specialty Hard Goods	0.2%	4.2%
Restaurants	4.4%	8.5%
Non-Store Retailers	<u>13.1%</u>	<u>7.4%</u>
Totals	2.0%	6.2%

DURING THE PANDEMIC: RETAIL IS EYE OF THE STORM

Bankruptcies:

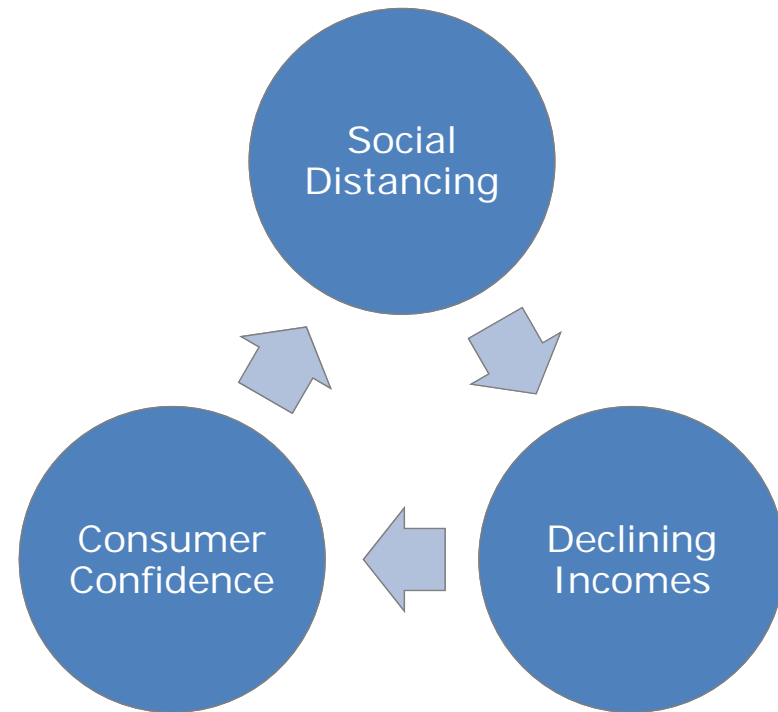
- Neiman Marcus
- J. Crew
- Stage Stores
- JCPenney
- Macy's

4,000 store closures in 3 months

>5 million job losses / furloughs
(≈ 35% of total)

Consumer spending down
≈ 25% since March

Consumer confidence down
≈ 35% since February



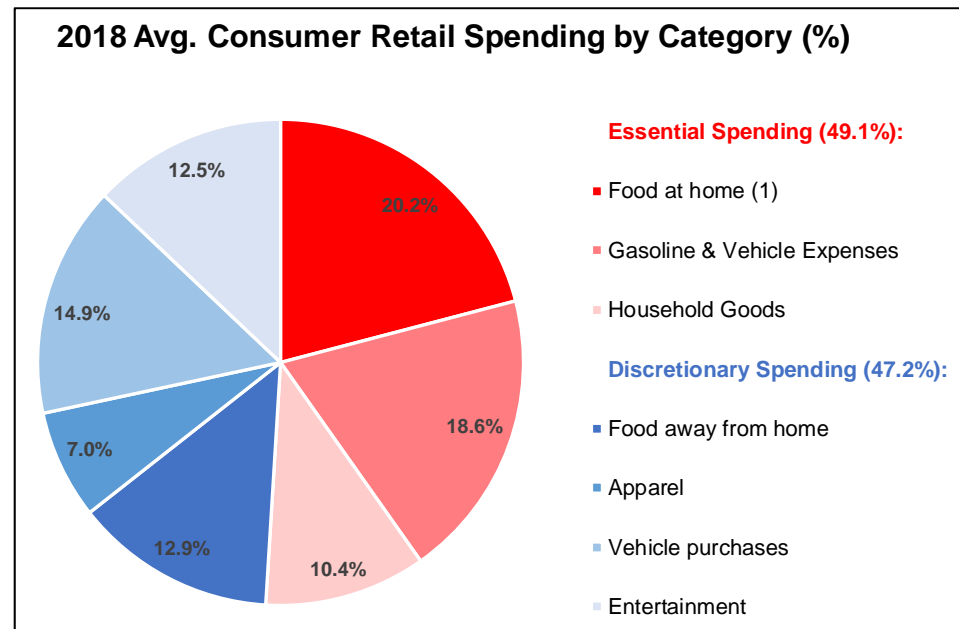
CREATING INSTANT WINNERS AND LOSERS

Temporary (?) reversal of fortunes?

- Nosedive for discretionary or non-essential spending (\approx 50% of total retail) nosedive
- Existential threat to very sectors that sustained “brick & mortar” (i.e. experiential retail)

Temporary (?) boom for e-commerce and non-discretionary items

- E-Commerce grows by about 20% virtually overnight
- Non-discretionary categories see up-tic: But “hoarding” effect likely to subside as shelter in place is lifted

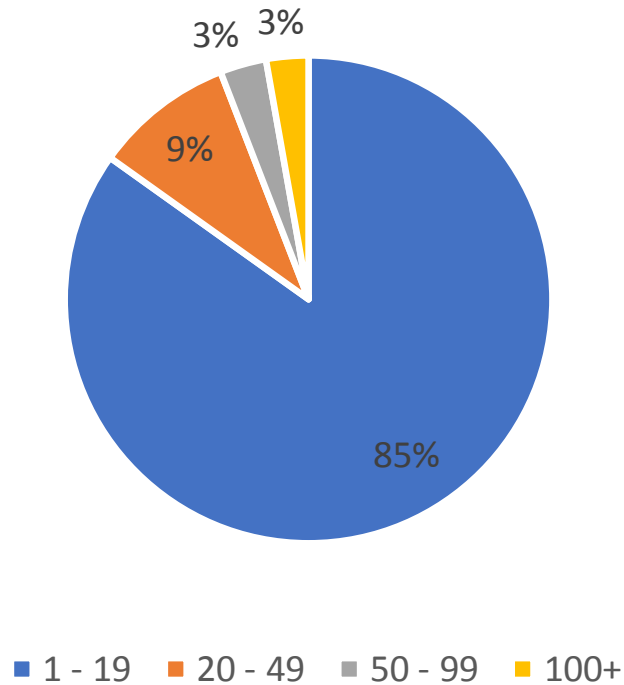


ACCELERATING SHAKE-OUT

Tipping point for marginal retailers and “mom & pops” ?

- Low cash reserves / minimal credit history
- Customer relationships take time to build but quickly disappear
- Transient workforce hard to recover

Retail Establishments by Firm Size (2016)



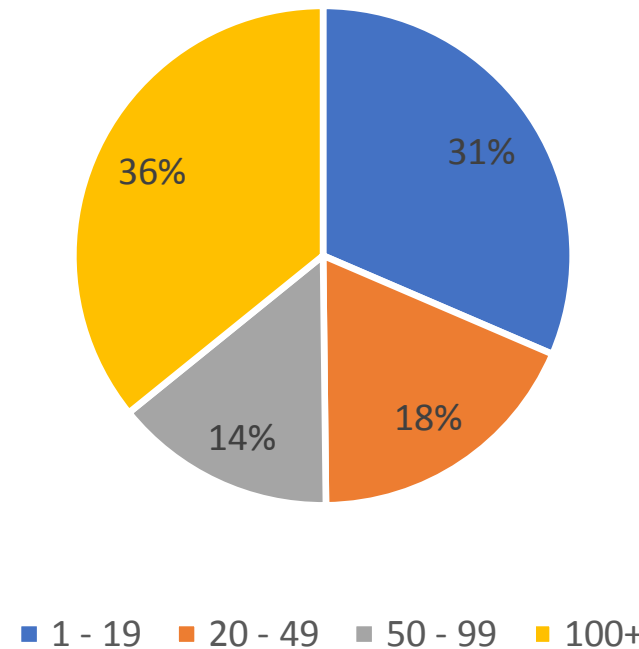
.....AND CONSOLIDATION

Already Widening gap between the most successful and the rest

Industry giants (Amazon, Walmart, Target and Costco):

- Already embrace / leverage e-commerce
- Will likely increase market share

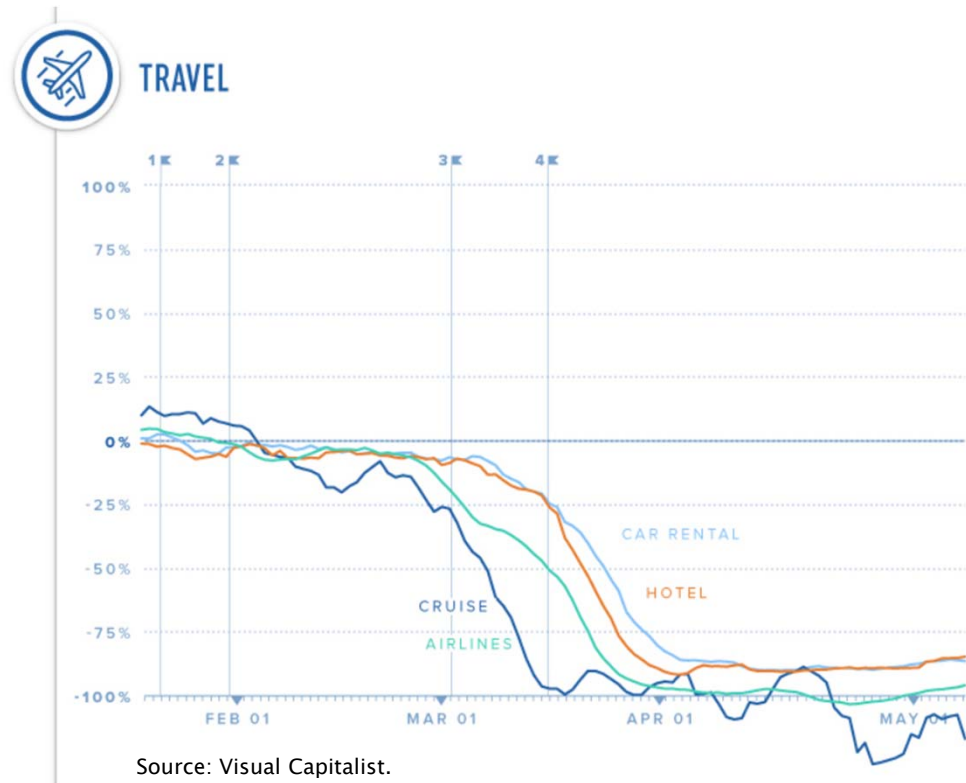
Retail Employees by Firm Size (2016)



HOSPITALITY FACES SIMILAR CIRCUMSTANCES

Pandemic impact has been precipitous

- Cancellation of air travel, conferences, events, and shelter-in-place protocol obliterated occupancy rates
- The damage may take 2 to 3 years to recover, with irreparable damage to some
- Changes in business travel may have long-lasting impacts
- Domestic tourism may soften blow



VARIATIONS BY SECTOR, FORMAT, LOCATION, & TIME

High Risk	<ul style="list-style-type: none"> ● Entertainment ● Hospitality ● Dining ● Apparell 	<ul style="list-style-type: none"> ● Malls ● Hotels ● Strip Centers 	<ul style="list-style-type: none"> ● Tourist Destinations ● Cultural Districts ● CBDs
Medium Risk	<ul style="list-style-type: none"> ● Electronics / Office supplies ● Home Improvement 	<ul style="list-style-type: none"> ● Community Center ● Neighborhood Retail / Convenience 	<ul style="list-style-type: none"> ● Corridors ● Suburbs
Low Risk	<ul style="list-style-type: none"> ● Automotive ● Pharmacies ● Groceries 	<ul style="list-style-type: none"> ● Drive-through ● Big Box / Power Center 	<ul style="list-style-type: none"> ● Small Towns
	Category	Format	Location

POST PANDEMIC: ADAPTATION AND RE-EMERGENCE

E-commerce will continue to disrupt and change the landscape:

- New “customer journeys” have created a cohort of new customers
- But short-term supply performance has been mixed
- And “margin” and delivery issues remain (e.g. delays, costs, theft, returns)

“Brick & mortar” will return with new formats and amenities:

- Will follow rooftops and workers
- Will follow income and pent-up demand
- Will address innate desire for “experience” and socialization
- Will offer diversification of products, delivery, and formats (parking, distancing, hours, more integration with other land uses (“makers”, “pop-ups”))

BUT CONVERSION AND REUSE MAY BE INEVITABLE

Repositioning of obsolete retail and hospitality space may be good

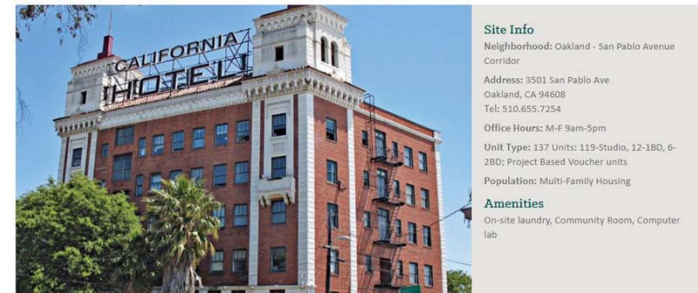
Malls

- Fulfillment centers / distribution hubs
- Mixed-use communities
- Office park / high-tech campus

Hotels

- Residential micro-units
- Office suites
- Affordable / transitional housing

California Hotel



REAL ESTATE IMPACTS

INDUSTRIAL/WAREHOUSE



THE RISE OF FULFILLMENT: THE E-COMMERCE EFFECT

Evolution of retail and rise of e-commerce boosts tremendous industrial and warehousing growth

- The rise of Amazon has transformed the face of retail in America
- Today, industrial properties comprise nearly 2x as much space as the retail sector and 3x the amount of office space in the US
- The high need for distribution functions, especially “last mile” requirements for e-commerce has attracted investments in virtually every US market
- Even as the economy was beginning to decelerate, e-commerce will continue to comprise a greater share of retail sales, increasing the demand for distribution and warehouse space

INDUSTRIAL SHOCKWAVES AND RESPONSE

Current disruption to industrial and logistics markets may lead to greater structural impacts

- In short- to mid-term, the pullback in retail sales will send ripples through the US and global manufacturing base, potentially softening demand for new manufacturing space
- Disruption to global supply chains may influence re-shoring of manufacturing services, increasing demand for industrial space
- Worker absence during stay-at-home orders is causing shockwaves in production and supply chains – may accelerate the use of automation and robots in operations and reduce demands on labor
- Space for manufacturing and fulfillment may require space with substantial clear heights while location siting will be driven by the availability and affordability of significant power loads

INDUSTRIAL FRONTIERS

Advanced manufacturing re-shoring:
major coastal gateways, major freeway
intersects

Secondary and tertiary markets
proximate to tech concentrations
(e.g., CA Central Valley)

Experiential industrial: breweries,
distilleries, baking, roasting, etc.

















Source: Greater Houston Partnership.



Source: Discover Los Angeles.

PRELIMINARY TAKE-AWAYS

Type of Market Impact	Potential Impact by Real Estate Sector						
	Single-Family Residential	Multifamily Residential	Office / R&D Flex	Essential Retail	Discretionary Retail	Warehouse / Industrial	Hospitality
Short-term							
Structural							

IMPACTS LIKELY TO DIFFER BY LOCATION AND FORMAT



Corridors

Creates opportunities to reposition under-performing and antiquated commercial strip formats, mini-centers, etc.



Downtowns & CBDs

How to facilitate bounce back as dining / entertainment hubs with mixed-use office and residential sectors.



Large-Scale Adaptive Reuse

Accelerates reuse of underperforming malls and other large uses for mixed-use residential, fulfillment/distribution, or other campus setting.



Suburban Environments

Potential to capitalize on changing preferences and millennial lifecycle trends.



DISCUSSION / NEXT STEPS
