Market Report

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International Realty Valuation, Inc.

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In this Report:

A historically deep recession is now coming. Even if it is short, it is likely to be painful, and risks have grown that it could create a financial crisis.

For institutional investors willing and able to put capital to work during these unprecedented times, market volatility is an opportunity, not a threat.

- **Green Street Advisors – March 2020**

Investment Barometer

In January 2020, the investment outlook was rosy. Investors were repositioning their existing portfolios and anticipating a continued strong cycle – at least through the November election. Then COVID-19 hit. The dreaded realization the recession was a daydream turned to a nightmare as the recession billowed smoke and real estate burned.

There are many economists that show a V recovery, a U recovery, a W recovery and even an L (no recovery). But the one I like came from Norm G. Miller, PhD, Ernest W. Hahn Chair of Real Estate at USD, that the recovery will be a "Nike Swoosh" with a steep decline and a long slow recovery.

We are in new territory and the past benchmarks or expectations no longer apply. The real unemployment rate is just over 14.7% with 22 million lost jobs. That will impact all sectors of real estate (See by the Numbers).

I have discussed the risk of Corporate Debt which is nearly $10 trillion and is about 50% higher than it was during the 2008 Great Recession. With employment down and corporate profits tanking– the collateral damage to real estate will be debilitating.

Reality: 1) Real Estate is overleveraged 2) Occupancy is decreasing with lost tenants and lost business, and 3) Historical buying at sub 4% overall rates assuming rent increases was unsustainable.

Real Estate needs AA – *Appreciation Anonymous*. The addiction that real estate always increases is a diseased assumption that is perpetrated by the ignorant, or Pollyanna soothsayers.

By the Numbers

The only benchmark we have of what might occur due to COVID-19 is the Great Recession (2008 and 2009).

As reference, here are the peak overall rates in 2009 when compared to 2019.

According to **Real Capital Analytics and Costar**

<u>Office – Cap Rates</u>

08/09 - National: 7.5%

2019 - National: 6.6%

Expected Loss = 12.00%

<u>Retail – Cap Rates</u>

08/09 - National: 9.00%

2019 - National: 7.10%

Expected Loss = 21.11%

<u>Industrial – Cap Rates</u>

08/09 - National: 7.1%

2019 - National: 6.7%

Expected Loss = 5.63%

<u>Apartment – Cap Rates</u>

08/09 - National: 6.00%

2019 - National: 5.80%

Expected Loss = 3.33%

These expected decreases in value are the only the result of higher risk resulting in a higher cap rates and does not reflect changes in lost rent or vacancy which we realize is unrealistic in the short-term. Consider each category a minimum impact on values. The worst-case scenario is the following:

Office – loss of 25% to 30%

Retail – loss of 30% to 40%

Industrial – loss of 10% to 15%

Apartment – loss of 10% to 15%.

Hotels – loss of 35% to 45%.

Real E-Space

> “We are currently in the initial phase associated with any major real estate market disruption – illiquidity. During this phase, a lack of liquidity caused by increasing fear grinds capital markets to a halt.
>
> Buyers and sellers are less likely to transact, and real estate lenders – both bank and non-bank – are equally hindered by the lack of market transparency.
>
> ***—PGIM Real Estate – April 2020***

Lance W. Doré, FRICS, MAI

The new paradigm in Real Estate will be REAL E (xtra)-SPACE. All real estate must create safe space, quality space, and environmentally sound space. The penchant in the past to squeeze profit by shrinking, squeezing, and loading square footage, and people into the smallest defined corners to reduce risk is over. No longer acceptable will be assembly lines, queues, co-working, or high density – or any semblance of compaction.

Each real estate segment will have to adjust.

Office - workers will demand and will receive options to work at home. Tethered offices will be the new norm. This is an employee market in 2020/21.

Accommodations will be made to provide quality workspace both at the office and home with a great deal of worktime flexibility. Lessors and owners will realize that they still need 150 square feet per employee, but their permanent in-office workforce will be reduced from 10% to 20%. The need for office space will be reduced. Vacancies will increase and rents will slide to attract permanent tenants. Exposed markets include New York, San Francisco, Washington D.C., Boston, Chicago, Baltimore, and Los Angeles.

Retail – fear of crowds, unnecessary travel and Want Retail industry v. Need Retail industry will be the new norm in this sector. This bifurcated tenancy will implode the Retail Sector.

The surviving retail categories will be Need Retail space – such as grocery stores, pharmacies, sundry, comfort restaurants, dry-cleaners, salons and other personal services. Also known as B & B retail (Bread and Butter). Want Retail space will slowly expire such as jewelry, sunglasses, electronics, branded boutiques (Gucci, Vuitton, Chanel, etc.) and luggage. Single source stores are Want Retail. Also known as Showcase Retail. Exposed markets include New York, Las Vegas, New Orleans, Hawaii, and Los Angeles.

Industrial - may be the one industry that is largely insulated from the impacts of the recession. Industrial has proven to be flexible by adopting space into office, warehouse, distribution, manufacturing and R &D, or all of the above. The location of most industrial is near transportation corridors and creates its own employment base. However, industrial will be required to upgrade old inefficiencies in workspace and create greater support for its employees to maintain safe protocols. Favored markets include San Jose (tech), Memphis (shipping and trucking), Boston (medical), Chicago (stock and packing), and Philadelphia (trucking and medical). Exposed markets include Detroit and Houston.

Multi-Family – will likely see the biggest shift in demand requirements, but not necessarily the biggest shift in value. Residential must create Home and Hearth Housing. With more people willing and able to work at home the demand for warm and safe environments will increase exponentially.

This means more space – micro units and high density is passé. Housing must accommodate for home offices and not just a conversion of an extra bedroom or dining room. Independent spaces that allow for technology to be permanently in place will be required and in the highest demand. Occupants (tenants and owners) will look farther out to find more space that is safer and higher quality. The suburbs are back. The backcountry is nouveau. Favored markets include Austin, Denver, Portland, Sacramento, Raleigh, Seattle, and Phoenix. Exposed markets include Detroit, New Orleans, Hawaii and New York.

There are opportunities in the next 3 to 18 months in all sectors. Keep cash or have prequal letters ready.

Regardless of the sector the key features to look for are:

- Technology advancement
- Quality of space and flexibility
- Environmental sensitivity
- Green

Real E-Space is Extra Space which is Safe Space which is Quality Space which creates Demand and Higher Values.

International Realty Valuation, Inc.

Headquarters

1010 University Ave,
Suite C207
San Diego, CA 92103
USA

PHONE:
(619) 933-5040 ext. 101

MOBILE:
(619) 933-9450

E-MAIL:
info@irvaluation.com

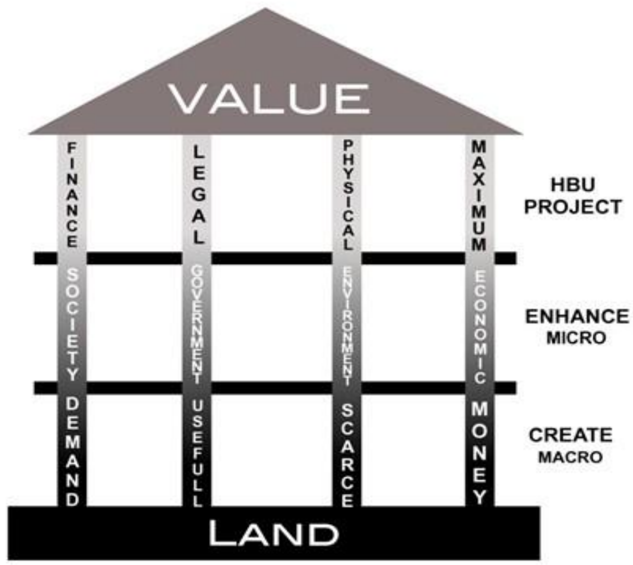
We are on the Web!

See us at:

www.irvaluation.com

Investment Pyramid

Going into 2020/2021 it is important to understand on how to mitigate risk and maximize value. The Investment Pyramid shows you how to 1) Create Value by analyzing macro demand, usefulness, scarcity and money, 2) Enhance value through understanding micro elements of society, government, environment and economic influences and 3) Maximize your project.



The Secret of Real Estate Revealed – Lance W. **Doré,** FRICS, MAI

About the Author

Lance W. Doré, FRICS, MAI
Founding Partner / President
International Realty Valuation, Inc.
ldore@irvaluation.com

As a Founding Partner and President of International Realty Valuation, Inc., Lance values a wide variety of conventional and complex properties, serves as litigation support to public and private clients, and provides expert advisory services. His geographical expertise is focused in the western U.S., and his professional expertise is focused in energy facilities, investment property, lands and special purpose.

About IRV, Inc.

International Realty Valuation, Inc. (IRV) is a global network of independent and highly competent professionals committed to providing expert financial reporting, forensics, consultation, and valuation services for both tangible and intangible assets to the most discerning of public and private clients. With a number of affiliate firms in several countries, our team has cumulative cutting-edge knowledge of global and regional markets, as well as international standards and requirements. This enables us to complete a wide variety of assignment, including valuation of large portfolios with multiple locations, in a thorough, objective, timely, and cost-effective manner. We serve major national, regional and international banks, lenders, developers, investors, governmental agencies, public and private companies.