Full Speed With Caution: Paul Daneshrad on The Evolution In Commercial Real Estate.

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The Industry Is Evolving, Expert Paul Daneshrad Says, And That Means Both Pitfalls and Opportunities.

As a commercial real estate investor, you likely won't forget 2020 for a long time. The COVID-19 pandemic brought a level of uncertainty, hardship and chaos that hasn't been seen in many decades.

But how deep and lasting is the damage within our own industry? Has the real estate investment industry changed forever? What are the immediate and long-term implications for investors?

For answers, we turned to noted commercial real estate expert Paul Daneshrad (https://www.entrepreneur.com/article/358837), CEO of the billion dollar Los Angeles firm, StarPoint Properties. Over the past 25 years, Daneshrad has experienced market conditions of every description, both good and bad.

For newer investors worried about future uncertainties, Daneshrad's message is clear: Relax. We've been through this many times before. The market is evolving, and you can use that to your advantage.

How did he reach this assessment? We decided to find out:

Paul, in your experience, which sector within the commercial real estate market is harmed most by an economic downturn? The least?

Daneshrad: The economic impacts of the coronavirus pandemic continue to unfold. The scope and pace of these impacts on commercial real estate (CRE) markets is unprecedented and evolving as the pandemic continues to wreak havoc on global economies.

Typically, it can take 6-9 months for CRE to experience the negative implications of a downturn as the effects ripple through the broader economy. COVID is unique in the sense that it forced rapid and severe closures of businesses and intensified the adoption of emerging trends, notably e-commerce.

The full extent of the pandemic is still developing but by looking at past economic downturns and considering the uniqueness of the current situation, it's possible to gain insight into the future outlook for CRE. It's worthwhile to consider these examples from two perspectives, external shocks or event orientated downturns and longer-term events like the global financial crisis.

Major downturns or recessions caused by external events have typically resulted in short and sometimes dramatic impacts to CRE markets but have not significantly altered transaction numbers leading to a slow albeit steady recovery.

Most importantly, sectors within the market have not been impacted equally by the pandemic.

While demand for office space and hotels/resorts has been devastated due to work-from-home orders, travel restrictions and regional closures, huge increases in e-commerce activity has led to surging demand for industrial and warehouse space. As you can see below, there were clear losers in the 2020 downturn while other sectors actually improved from pre-pandemic levels.

The clear winners in the second half of 2020 and likely into the first half of 2021 are data centers, infrastructure (such as cold storage) and industrial manufacturing.

Looking below at the YTD total returns and dividends performance, you can see that these sectors have vastly outperformed other CRE sectors as well as the S&P 500 index since the official declaration of a global pandemic. These three sectors have returned a combined average of +12.7% to the -3.1% achieved by the S&P 500.

What sectors within the commercial real estate market bounce back from an economic downturn the strongest? Which will continue to struggle even as the economy gains

traction?

Daneshrad: At the beginning of 2020, all metrics pointed to a continuation of the record growth period that began following the global financial crisis. As coronavirus was declared a global pandemic in March, unemployment soared almost overnight, consumer spending declined, uncertainty increased, and the US economy faced a sharper and more rapid decline than had ever been experienced previously.

Commercial real estate, which normally remains stable in the early periods of a downturn, was immediately impacted as offices closed, travel halted and governments began to impose shelter-at-home orders.

The resulting downturn is unique in many instances. Whereas office, retail and hospitality transactions dropped in only three of the past seven recessions, they have all been severely and perhaps permanently stifled by the current contraction. Trends which were gradually emerging, such as remote-work, food delivery and e-commerce, have been catapulted to the forefront and in many cases are receiving approval from the majority of the population.

Recent opinion polls conducted by REAG show that, among real estate professionals, there is consensus that they expect commercial real estate valuations to fall. While they do agree that a correction is imminent, the polls also shed insight on how different sectors may be affected. It comes as no major shock that retail space, hotels, restaurants and bars are expected to fare the worst. These sectors are built on the need for customers to be physically present and while some of the activities required for these businesses can be taken online, this does not improve the outlook for the corresponding real estate sector.

When respondents were asked which sectors will perform the worst as a result of the current downturn, here's a chart depicting sectors they saw as having the poorest performances:

Alternatively, responses also revealed insight into the sectors which should prove to be the most resilient in the wake of the current crisis. More than a third agreed that logistics facilities, such as cold storage and shipping warehouses will emerge stronger as they benefit from the surge in online shopping and food delivery services. The respondents' answers to which sectors will emerge the strongest are below:

Finally, location will be critical in the short and medium term rebound in the commercial real estate market. The vast majority of industry leaders perceive over-valuation in downtown business districts as workers resist mass transit and companies shift towards suburban offices. Many perceive the oversupply of centrally located offices to be a sign of overvaluation, and these locations could inevitably suffer from decreased demand as a result.

How does an economic slump impact the business office space sector? Does it impact certain class buildings more than others?

Daneshrad: Tenant uncertainty regarding the future viability of centralized offices driven by the economic downturn and the structural shift towards teleworking is driving a major downturn in office space demand.

The coronavirus pandemic has forced many companies to rethink their operating models. The success of employees working at home has the potential to alter the long-term commercial real estate office sector. Companies which remain viable throughout the course of the downturn are noticing the cost-savings associated with having all or part of their workforce telecommute. These cost-savings will be reinforced by the employees themselves, over three quarters of whom want to retain their ability to work from home at least part of the time.

The pre-pandemic trend of densification, increasing employees per square foot, is most certainly over as companies that choose to return to a central office will require additional space for social distancing.

There is some optimism that these companies' additional requirements will bolster the office sector. However, this positive is expected to be completely negated and overtaken by the even greater trend of remote work. A recent real estate advisory teams survey shows a drastic decrease in optimism from 2019 year-end levels which were safely above the flat 100 level. This demonstrates the tremendous uncertainty and genuine fear that the office market may not recover.

Further analysis shows that, even in a relatively baseline scenario without any further setbacks, net absorption levels will quickly surpass levels recessions of recent memory. New projects in various stages of completion will continue to add supply before tapering off at the end of 2022 when, if projections prove to be accurate, vacancy rates will peak at just over 17%.

While the outlook for the office sector is far from optimistic as a whole, there are classes which will fare better than others as well as those which may never recover. Co-working offices which allow for short term office space rental will be one of the most severely impacted and there is some belief they may never recover.

On the other hand, medical office space softened slightly at the end of 2020, setting up an anticipated quick recovery and potential growth phase. There are multiple systemic reasons for this such as an ageing population and backlogged demand as a result of closures early in the pandemic.

There has been a shift towards online medical appointments, but it is widely understood that this is a temporary measure and a return to in-person doctor visits will be adopted. A survey of the same executives who held a negative outlook on the office sector as a whole showed surprising optimism when it came to predicted medical office demand.

As with any economic downturn, there will be winners and losers.

When it comes to the office sector, property managers who are able to adapt will be able to capitalize. There will be a shift towards offices which allow for social distancing and have virus mitigation equipment such as, for example, sanitizing HVAC systems.

There will also be increased demand for technological integration in offices which allows companies to better manage remote workers while some return to the office.

Bottom line for Individual Investors: "Don't Panic. Be Positive. Do Your Homework."

What we're witnessing, according to Daneshrad, is an evolution of the commercial real estate industry not unlike many we've seen before. Cautious optimism is called for, coupled with careful screening of industry performance data.

"Opportunities lie hidden in the numbers," he says. "Our industry is evolving, and the opportunities are still out there. You just have to look for them."