Kidder Mathews

APRIL 2020

COVID-19 & BAY AREA COMMERCIAL REAL ESTATE

Early 2020 will mark the end of the country's longest economic expansion. Growth in GDP that began in mid-2009, at the end of the Great Recession, has been halted by COVID-19.

The long-term effects of the pandemic are not yet known, and a variety of forecasts are being made by market participants. This article discusses some of the early impacts being seen in the San Francisco Bay Area's commercial real estate marketplace, through data gathered by Kidder Mathews and statistics published by CoStar.

Financial markets are in turmoil at present. Equity and bond indices are showing significant volatility; the availability of financing is unstable; and the salability of commercial real estate is being strained. The United States' major stock market averages fell 30 percent or more in less than a month during February and March. Certain interest rates have declined during this same timeframe, while those associated with real estate mortgages have risen. As of early April, both the equity and bond markets have recovered somewhat, but still are showing significant instability.

In late March, the country reported its highest level of weekly jobless claims ever – at near 3.3 million. This record was doubled a week later, in early April. Heightened unemployment is expected to continue in the near term as many businesses and properties have been closed due to "shelter in place" orders from local and state governments. In response, the Federal government recently passed the CARES Act, which includes $2 trillion of stimulus in the form of monetary assistance and/or tax relief for government agencies, businesses, and individuals.

Guidance as to what might be expected for the Bay Area's commercial real estate sector can be drawn from trends exhibited during and after the Great Recession, as to the region's vacancy rates, rental rates, and deal volume. The causes of the prior economic decline are clearly different than those of COVID-19, and many forecasters suggest that the current downturn may be much shorter in duration, yet more substantial in its near-term economic impacts. Nonetheless, the ultimate magnitude of the prior slowdown was also indeterminable at its outset, and only took solid form after initial months had passed.

VACANCY RATES

As illustrated on the right, vacancy rates in all property categories throughout the region's nine counties are near decade lows as we enter 2020's second quarter. Nominal increases in both vacancy (currently 5.8%) and availability (8.1%) were most recently reported by CoStar, following a period of relative stability during prior years. If the Great Recession is a guide as to what the Bay Area might expect going forward, vacancy rates could continue increasing and may not peak for another 2 to 2.5 years.

Many market participants expect the impact on vacancy to be more short-term, however. Orders to "shelter in place" have caused broad swaths of commercial commerce to come to a halt, particularly for hospitality, entertainment, and restaurant businesses, and these sectors should be the quickest to bounce back once self-quarantine orders are lifted. Reports of retail, office, and even apartment landlords proactively addressing tenants' concerns with offers of forbearance - including near-term discounts or future rent abatements - are becoming more common. Others facing lease expirations today are extending contracts for short periods so that renewal discussions can take place in more stable and balanced market environments.

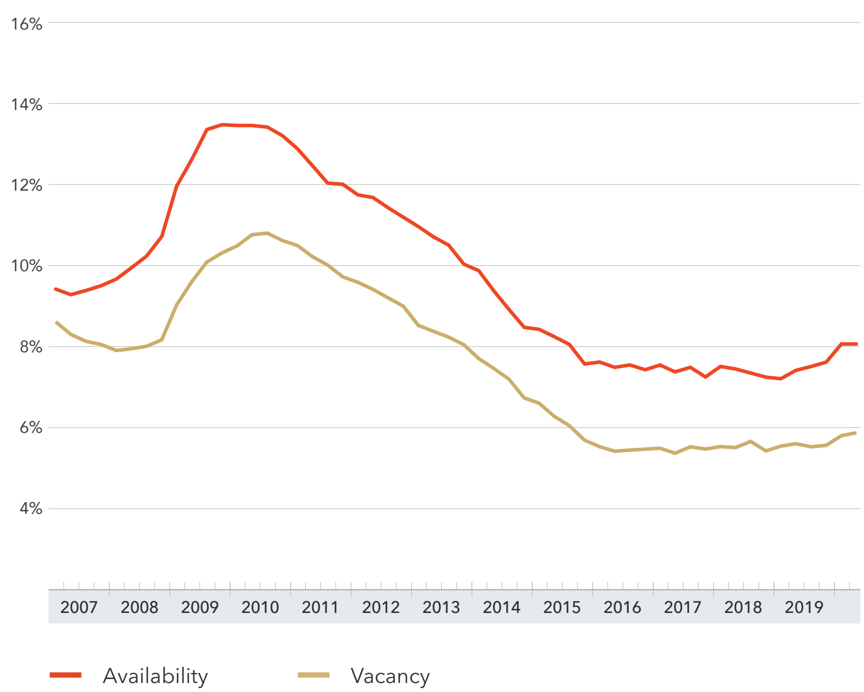
8.1%

CURRENT AVAILABILITY RATE

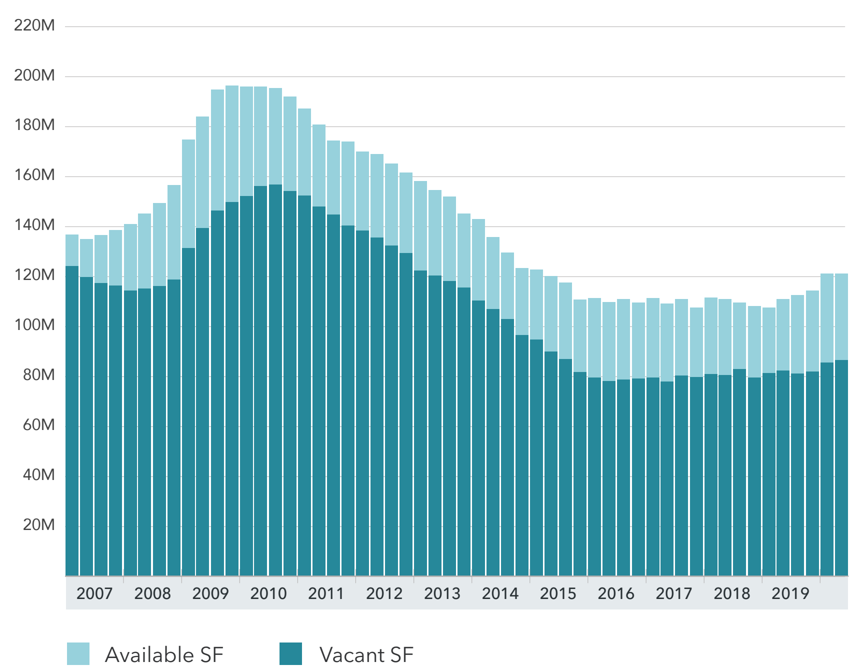
5.8%

CURRENT VACANCY RATE

Availability & Vacancy Rate

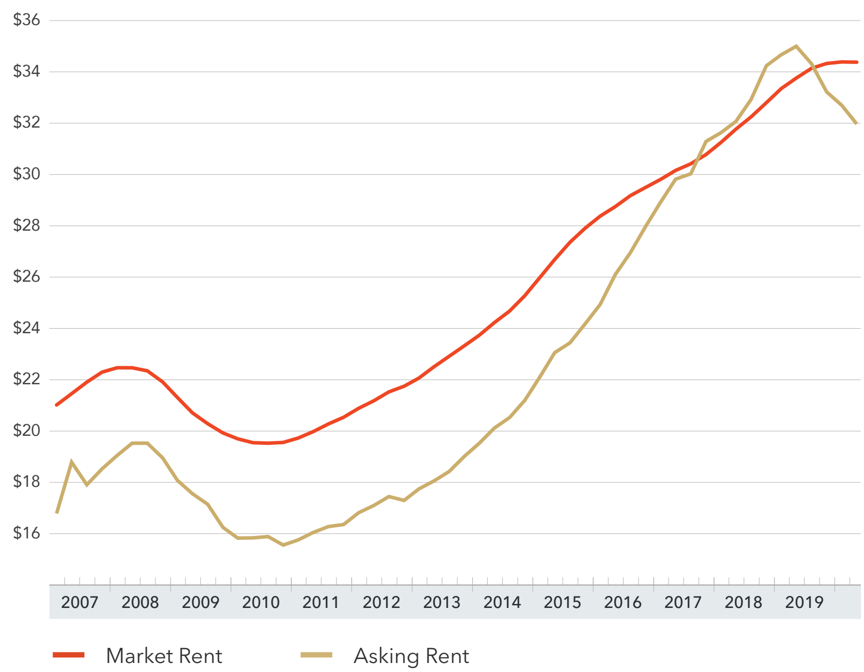


Available & Vacant SF

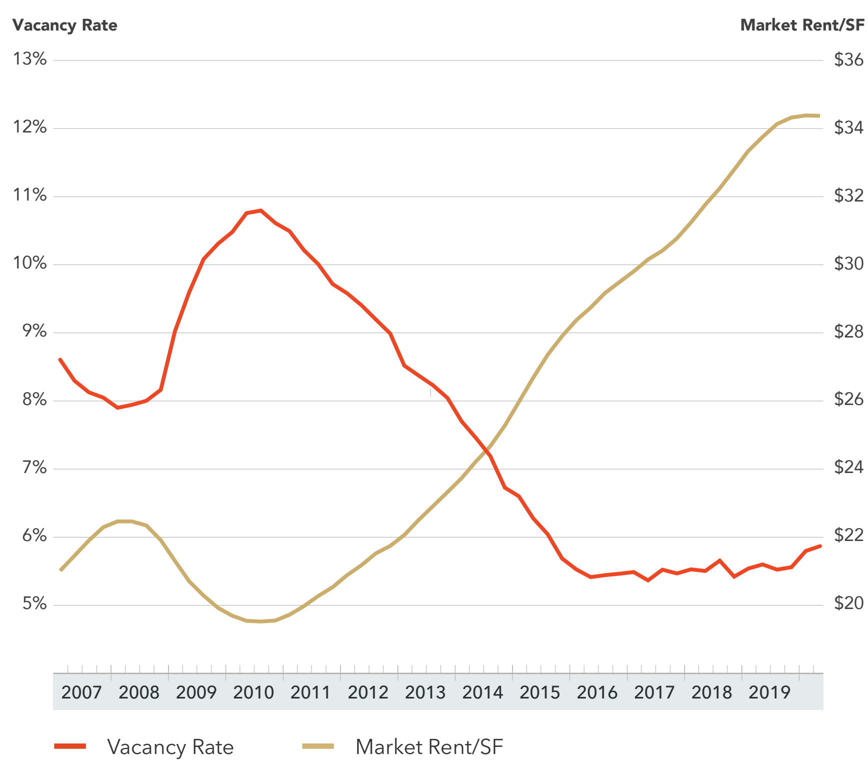


> The average lease rates across all sectors have grown by nearly 75% during the past decade.

Market Rent & Asking Rent Per SF



Vacancy & Market Rent Per SF



RENTAL RATES

Lease rates have a similar history in the Bay Area, although deterioration in this statistic may occur more quickly as economic conditions soften. The past ten years have been a period of substantial rent growth for the region, due to employment and population expansion, combined with limits on new construction. These factors have raised lease rates for office, industrial, retail, and residential properties alike, with the average across all sectors growing by nearly 75% during the past decade. Some submarkets have experienced greater gains than others, but as a whole, real estate rental rates in the region have risen significantly.

This broad trend began to reverse in mid-2019, per CoStar, and has continued its decline into 2020's second quarter. Falling rates may persist as landlords become more competitive in seeking tenants in a market with limited activity. Some property owners are now reducing asking rates to get ahead of where they see the market heading. Many tenants are reported to be more focused on conserving cash and have adopted a "wait and see" strategy with regarding to planning for future space needs.

DEAL VOLUME

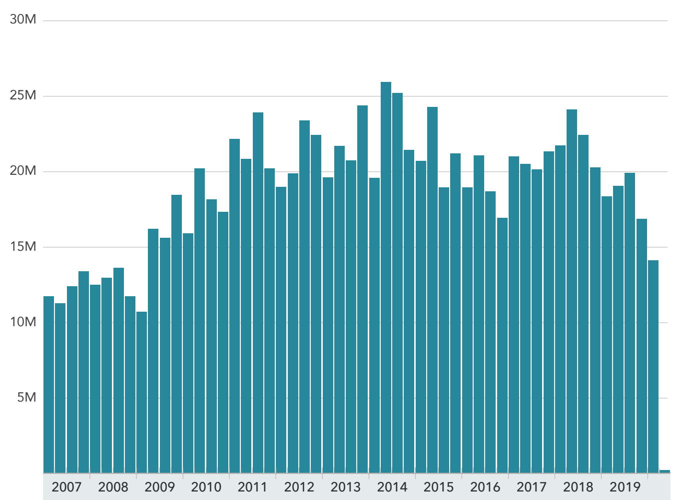
Another impact of COVID-19 on the Bay Area's commercial real estate marketplace is seen in transaction volumes. Both gross leasing and net absorption activity have fallen during the first part of 2020. Whereas the region experienced overall leasing of roughly 75 to 90 million square feet per year during the prior decade, the first quarter of this year saw only 14.2 million square feet leased – representing an annual pace of less than 60 million square feet.

Net absorption, which accounts for simultaneously occurring vacancies, paints an even more compelling picture of a market correction. This statistic was positive each year between 2011 and 2019, at amounts of 4.1 to 19.2 million square feet per annum; it was last negative in 2010 as the region was emerging from the Great Recession. During 2020's first quarter, net absorption again turned negative, posting a total of just under 900,000 square feet of space "lost" from occupancy. This reversal is largely responsible for the recent uptick in vacancy, as previously noted. Early estimates by CoStar for the year's second quarter suggest that another 1.1 million square feet of negative net absorption may take place before mid-year.

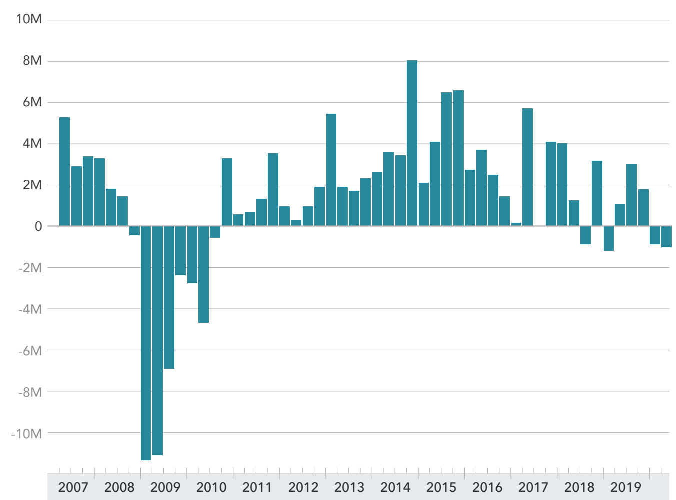
On the sale side, mixed signals are being sent. While there are known to be escrows that have been postponed or altogether cancelled – the most prominent being Blackstone's decision to forfeit a $20 million deposit toward its purchase of the Uptown Station office development in Oakland – others are proceeding. Amazon closed on a $50 million East Bay office building purchase, in mid-March, and Google bought a $41.2 million San Jose R&D building in early April. Many of these are likely the result of deals that were structured in the months prior to the COVID outbreak, and some were noted to have been pressured by 1031 exchange motivations; but all show some degree of continued confidence in the Bay Area's economy.

CoStar's data shows no significant changes in either the number of properties or total square footage being marketed for sale throughout the Bay Area. This appears contrary to reports that some sellers have abandoned plans to sell their properties, not wanting to appear desperate in the currently unstable market environment. If the prior recession is again used as a guide, however, and the period of regional economic weakness is drawn out, there may be many more assets offered in the months ahead.

Leasing Activity

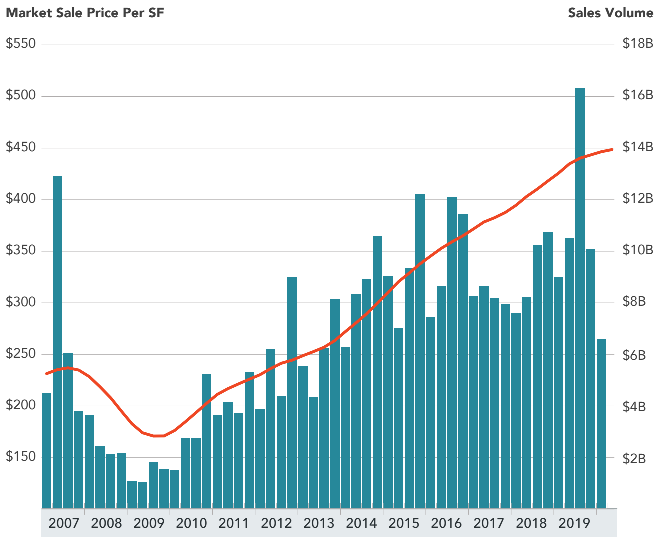


Net Absorption

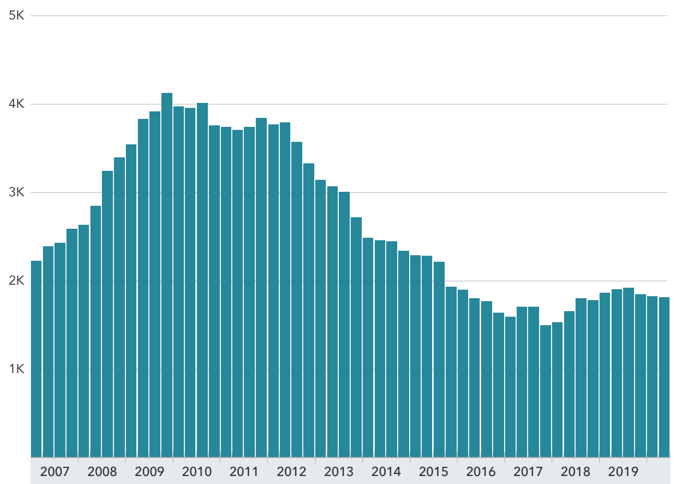


COVID-19 & Bay Area Commercial Real Estate

Sales Volume & Market Sale Price Per SF



Total Sale Listings



CONCLUSION

The San Francisco Bay Area is in the very early stages of an economic downturn caused by COVID-19. Market data shows the region beginning to correct, with an increase in vacancy and a decrease in asking lease rates. Changes in deal volume are more difficult to discern, as some parties are cancelling transactions while others are proceeding. The ultimate resolution of the pandemic, and the length of the downturn it causes, will determine how substantial the corrections are to these and other statistics.

At present, most forecasts expect the initial wave of the disease to relent during 2020's second quarter. If this happens, the recession may be short in duration – but with a substantial near-term impact on economic activity. Many anticipate that the regional recovery will be equally dramatic, although certain unresolved risks could cause longer-term, adverse effects on the Bay Area.

Source: Kidder Mathews Market Research Group and CoStar

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