TOP TEN ISSUES
AFFECTING REAL ESTATE®

The Counselors of Real Estate®

The Counselors of Real Estate has identified the current and emerging issues expected to have the most significant impact on real estate for the foreseeable future, with the COVID-19 pandemic being the leading concern of the 1,000-member organization.

1. COVID-19
2. Economic Renewal
3. Capital Market Risk
4. Public & Private Indebtedness
5. Affordable Housing
6. Flow of People
7. Space Utilization
8. Technology & Workflow
9. Infrastructure
10. ESG

1. COVID-19

COVID-19 may be the greatest environmental experiment of our real estate lives. The change wrought by the virus and its aftermath will teach us about priorities, resilience, and demand in ways that we did not dare test before. The 2020-21 Top Ten Issues are an attempt to overlay this new world onto an already changing real estate environment.

In examining real estate markets, we must consider existing fragility, adaptability to new demands, and potential relevance to new markets. Demand will be defined by the extent to which this crisis leads us to abandon old habits and adopt new ones. The duration of the lockdown has been a factor, and so is the confidence with which we emerge. Key questions without answers include: Will we be willing to shop in crowds, sit in theatres, and live close together to the same extent that we did in January?

Two primary factors may drive the effect of this pandemic on real estate markets. One reduces demand. The other may increase it. Will real estate demand be reduced by the virtual office and a preference for home entertainment?

Will we insist on lower density wherever we go? Will social distancing habits persist, and require reduced density in airplanes, airports, stores, restaurants, theaters, offices, banks, and government buildings? This could require larger spaces and higher costs to accommodate the same functions.

Real estate is a lagging indicator. With the economy expected to take a few years to recover from the effects of COVID-19, our industry will show ripples for a few more.

2. Economic Renewal

The U.S. economy was heading toward a tipping point prior to the COVID-19 pandemic, and beyond that we find deep and persistent challenges facing the economy and the real estate industry.

There were a number of statistical signals of deceleration for those willing to see them. Annual job growth in the U.S. had dropped from roughly 3 million in early 2015 to about 2 million in 2019. Industrial production expansion peaked in mid-2018 and had decelerated into negative territory by late 2019. Growth of the labor force had declined from the double-digit pace of the final three decades of the 20th century to less than 8 percent from 2000 to 2019, driven in part by the reduction in the U.S. birth rate.

Significant segments of the economy remain debilitated. Leisure and hospitality, retail, air travel, and construction can expect slow and partial rebounds into 2022. Ironically, the healthcare industry—especially

workers in lower-income jobs—is facing an intense financial squeeze in the wake of the coronavirus. The impact of the economic lockdown on state and local tax revenues could reduce non-federal government employment levels, as occurred in the Global Financial Crisis, and shelve important infrastructure projects. Such risks suggest an unusual "W-shaped" recession, a second contraction following the initial improvement of a partial economic re-opening.

The post-COVID-19 economy will not be settling into long-run GDP, spending, and employment growth rates that bear any similarity to the 2000 – 2019 period. Once the first year of recovery is accomplished—and even this will mean some jobs permanently lost—final demand for U.S. businesses, including real estate, will remain truncated. For the decade of the 2020s, the economy is constrained by long-run potential GDP growth that is a weak 1.5 – 1.6 percent. That is the 'new normal' for which we need to prepare.

3. Capital Market Risk

The last three months have presented not only the real time volatility of the capital markets, but also how quickly debt and equity capital liquidity can stop flowing when risk and returns are difficult to measure.

One thing we have seen since the middle of March is that volatility has spiked which makes pricing debt more challenging. In the face of effectively zero interest rates, the risk premium spreads, valuation metrics and the underwriting assumptions become critical. Percentage of rent being paid in each sector is an important metric as is late debt service payments.

Federal intervention helped to limit a complete seizing of the markets but doesn't necessarily mitigate the longer-term concern about defaults and loses. While pricing stability and liquidity appears to have somewhat returned, late payments and loan defaults have seen a significant increase.

Mortgage REITs took a significant hit early in the pandemic, despite no losses in collateral due to loan defaults. Even with some share price rallies, the commercial mortgage REIT sector is down more than 36% YTD, with several down more than 50%.

While publicly traded shares have come back from early pandemic levels, some sectors continue to feel the effects of market re-pricing. Commercial real estate markets will experience a revaluation driven by lodging, retail, and office.

COVID-19 behavioral changes will steer real estate and ultimately what capital will cost. Non-COVID related risks that deserve our attention are the 2020 presidential election, the switch from LIBOR to SOFR as an index, and reporting regulations that will require investor focus. We will get through this period and come out stronger, but what are the risks ahead and what will they cost?

4. Public & Private Indebtedness

All real estate is local and the value of—and demand for—commercial real estate can be influenced by local indebtedness funded by local taxes.

While fiscal and monetary intervention were necessary in the Great Recession of 2009, and in the current public health crisis, understanding the tentacles of that intervention is a Top Ten real estate issue. Public debt needs to be translated locally to understand the interconnections of air travel, ports, logistics

infrastructure, and public transportation that influence commercial real estate demand, value, and investment activity.

Some noteworthy observations:

- The U.S. national debt has now risen to more than \$26 trillion from \$23 trillion just 6 months ago, or \$210,000 per taxpayer, which is just shy of the median home price in the U.S. This is a drain on savings and investment activity.
- Total state debt is approximately \$1.2 trillion, or \$3,500 per state taxpayer, and local debt is nearly double state indebtedness at \$2.1 trillion and \$6,350 per local taxpayer.
- Student loan debt is now approaching \$1.7 trillion and exceeds total credit card debt of \$1.0 trillion. This burden on what's now the largest demographic group in the workforce—Millennials—will inhibit housing investment and consumption behavior, adversely impacting retail, auto purchases, and leisure spending for travel.
- Total Personal Debt now exceeds \$20.5 trillion and is approaching the U.S. annual GDP. That equates to more than \$62,000 per citizen. This level of debt at the onset of COVID-19—with trillions more ahead in stimulus and fiscal rescue intervention—is not sustainable. It will impact commercial real estate in many ways, from reduced demand for housing to interest rates that will eventually have to rise to attract new capital to fund our debt, to the ability to repair and upgrade our aging infrastructure and fund projects like 5G that will be essential to our future and U.S. competitiveness.

5. Affordable Housing

In this era of political divisiveness, there are two things that most can agree on: 1) there is a tremendous need for affordable housing throughout America, and 2) there is a strong "Not in My Back Yard" or NIMBY agenda.

According to the National Low-Income Housing Coalition, there is a shortage of more than 7.2 million affordable rental homes for extremely low-income renter households—those with incomes at or below the poverty level or 30% of their area median income. Moreover, the lack of affordable for-sale homes drives up rents and increases prices of multifamily investment properties.

According to the Urban Institute, prior to the COVID-19 outbreak, the affordability crisis driven by the lack of housing supply was one of the biggest problems facing the U.S. housing market. Home prices in the bottom 20th percentile increased 126 percent between January 2000 and December 2019. This is a substantially larger increase than the 87 percent increase for homes in the top 20th percentile.

Suggested solutions to the crisis include: (1) expediting the approval process by adding "Inherently Beneficial Use" to municipal land use laws to circumvent "Not in My Back Yard" opposition, (2) expand taxpayer funded one-time front-end subsidy programs for affordable housing and encourage the expansion of existing subsidy programs at the federal, state, and county levels, (3) use the power of zoning to create subsidies necessary for providing more affordable housing and market rate housing at no additional cost to the taxpayers.

6. Flow of People

The flow of people between and within countries has always been a critical driver of real estate and the economy. Today, the world's economies and people face unprecedented challenges to mobility. Immigration has ground to a halt, initially driven by nationalistic policies in the U.S. and countries throughout the world, and more recently by the COVID-19 pandemic.

Reduced migration and COVID-19 behavioral changes will hurt demand for residential, hospitality, and retail real estate, particularly in communities that have historically relied on such demand.

An early May Harris Poll showed that nearly 40% of urbanites are considering fleeing the city as concerns about the virus and economic effects of the pandemic take hold. Given the cost of moving and the disposable income required, such urban flight is primarily viable for wealthier households and those with remote employment options. Potential expansion of suburban and "spoke" employment facilities, as discussed by

Google in May, to reduce mass transit reliance, will also be a key factor in determining how far this dynamic progresses.

The flexibility of people to move to better jobs has driven productivity and the real estate markets. Real estate implications will be determined by how long behavioral changes brought on by the virus last, the quality of innovations in healthcare, living, and working that emerge, and the quality of world leadership.

7. Space Utilization

COVID-19 will have a lasting impact on the design and use of the real estate space, with a level of transformation and rebuilding not seen since the end of WWII. COVID-19 has stressed the use, location, mechanical infrastructure, and interior configuration of commercial buildings. In as much as safety issues were at the forefront after 9-11, a new focus is being placed on the health of building occupants—from building entry and vertical transit to improvement of indoor air quality, including the reduction of transmission threats of airborne particulates.

Density and affordability of housing, job opportunities, social services and health care, and cultural, sports and recreational activities will be even more key in urban planning, with significantly-revised expectations on capacity.

Acceleration of planned, medium-density, mixed-use communities will replace old retail formats, with design

that embraces walkability and integration of uses that enable continued normalcy in case of subsequent lockdown orders. Intentional design will deliver social connectedness with physical distancing that integrates residential, office, retail, and public spaces closely resembling older European cities.

Many classic retail formats and retailers will never recover and will require creative re-use or fundamental redevelopment to replace their former vitality.

8. Technology & Workflow

Amidst the pandemic, there is an urgent call for technology to monitor, manage, and mitigate risks. The combination of migration back to the office, the need for reconfiguration and change in operating methods, and the general desire for working remotely, is accelerating the adoption of technology in the built environment.

Many technologies will go from "nice to have" to "mandatory." These may include: tracking of people in buildings; contactless doors and elevators; air and water quality monitoring; airflow and recirculation control; mandatory remote building services; and health screenings for contractors and facility staff.

Necessity will move us to better and smarter buildings and operations. Forced adoption of web meetings, safety standards, privacy and

collaboration tools, and cyber security has brought the benefits of technology to even the most resistant users. Changes in density, use patterns, meeting frequency, and movement are likely. The result will be spaces that are safer, more efficient, and better prepared for the next big surprise as property owners and managers create confidence for tenants, residents, and shoppers.

9. Infrastructure

Infrastructure has a significant impact on land and the built environment and once again is a principal and critical issue affecting real estate this year. As the world reawakens to its vulnerability to extreme events amidst the current COVID-19 pandemic, we are forced to view infrastructure through a different lens given its crucial function in helping to sustain life and commerce.

Funding remains elusive. The ongoing infrastructure crisis is manifested in an estimated underinvestment of $15 trillion in global infrastructure by 2040. Basic infrastructure needs will go unmet and potentially impact real estate values and development patterns as underserved locations become less livable or even undevelopable. Meanwhile, the American Society

of Civil Engineers rates U.S. infrastructure a dismal D+.

Further complicating the infrastructure crisis are major disruptors including the pandemic, extreme weather, cyber attacks, and terrorism—all of which will require novel, adaptable and strengthened infrastructure across the globe.

10. ESG

Environmental, Social and Governance (ESG) is no longer an emerging trend, but a critical component of real estate investment. While COVID-19 has underscored the importance of ESG issues, this new "norm" is a result of trends already underway, including dramatically changing acceptance of the risks of climate change, innovations in the measurement and tracking of ESG performance, new innovative ESG investment alternatives, the growing influence of millennial investors, and substantial recognition of ESG initiatives from corporations.

Within real estate investing, ESG requires a more conscious focus on stakeholders and different perspectives – from investors and clients, to tenants, residents, building staff and contractors. Issues of equity, sustainability, health and wellness, and diversity all filter into decision-making.

Walkable urban areas, for example, have successfully captured more affluent and younger people attracted to job access, public transit,

entertainment, and restaurants. These urban spaces are accounting for virtually all new office and rental multifamily construction.

The role of resilience and control of operating costs is more important than ever as investors and operators navigate the blow of near-term rental revenue losses, especially for the hospitality, entertainment, and retail sectors. It is the opinion of Counselors of Real Estate that ESG has been established as a prudent risk mitigation strategy that will contribute to long-term value creation that real estate has historically enjoyed.