SPECIAL REPORT

Marcus & Millichap

CORONAVIRUS OUTBREAK: IMPLICATIONS FOR REAL ESTATE

MARCH 2020

Interest Rates Hit All-Time Low as Spread of Coronavirus Sparks Flight to Safety; Stability and Yield of Real Estate Reiterated by Stock Market Volatility

Stock market volatility showcases real estate stability and yields. While the stock market was particularly robust last year, with the S&P 500 delivering total returns exceeding 25 percent, equities recorded a major correction that erased a significant portion of the gains. In the ensuing flight to safety, long-term Treasury rates dropped to a record low, offering real estate investors an exceptionally low cost of capital and some of the highest levered returns in 30 years. Strong capital market liquidity and sound underlying real estate space demand remain pillars of support for commercial real estate.

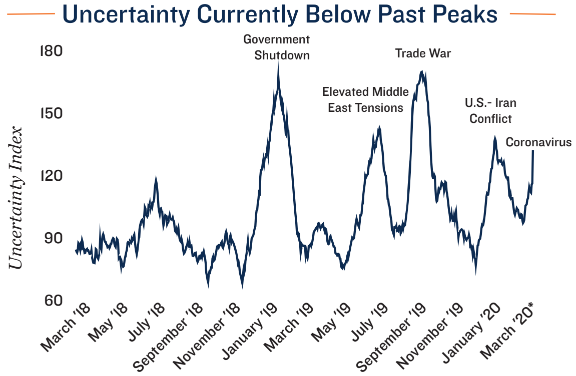
Uncertainty drives interest rates to record low. The spread of the new coronavirus (COVID-19) beyond the borders of China quickly disrupted the financial markets. Investors, focusing on the downside risk potential of the outbreak, drove significant capital to the safety of the bond market, pushing the 10-year Treasury rate to an all-time low while driving the S&P 500 down by 11.5 percent in the last week of February, the largest one-week stock market drop since the financial crisis. Given the nature of this fast-paced correction financial markets will likely remain extremely fluid until confidence is reestablished.

Sturdy economy withstands headwinds. While the coronavirus will weigh on the U.S. economy in the first quarter, a recession is not imminent. Expectations of weaker exports, reduced tourism and supply chain-related shortfalls will moderate the pace of economic growth, but low unemployment and comparatively strong consumption levels should offset the headwinds unless the outbreak amplifies significantly or confidence levels drop dramatically. Empowered by low inflation, the Federal Reserve delivered a surprise rate cut on March 3 in an effort to reinforce the economy. Although Wall Street already expected a 50-basis-point cut at the Fed's March 17 meeting, the Fed adjustment sparked an additional decline in the 10-year Treasury rate.

Executive Summary

- The spread of the coronavirus has sparked fear, causing a flight to safety that has driven interest rates to a record low.
- The U.S. economy is well-positioned to withstand the coronavirus-induced shock with sturdy job creation and growth drivers.
- Historically, pandemic outbreaks such as SARS, the H1N1 "swine flu," and the "avian flu" or "bird flu" generated short-term market instability that moved toward stabilization over the following three to six months.
- The volatility of equity markets reiterates the stability of commercial real estate and the compelling 5-7 percent yields.
- Real estate is a long-term investment offering significantly less volatility than most other investment options. Although there is uncertainty in the market today, real estate investors must keep their eyes on the horizon.

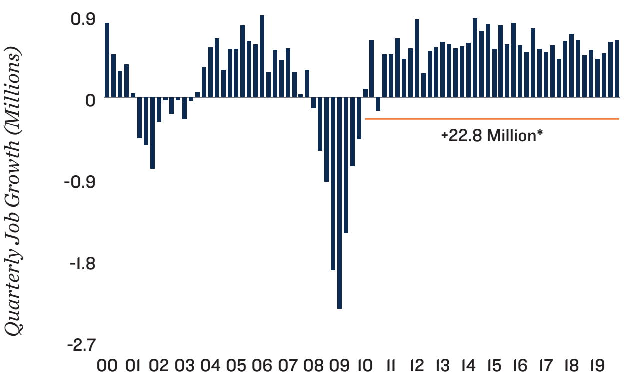
Uncertainty Currently Below Past Peaks



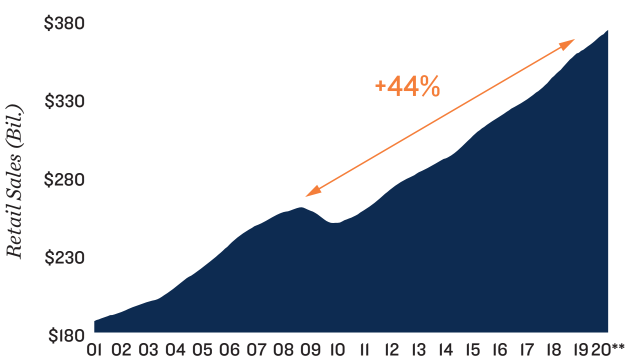
10-Year Treasury at All Time Low

** Economic Policy Uncertainty Index through March 6; 10-Year Treasury through March 9*

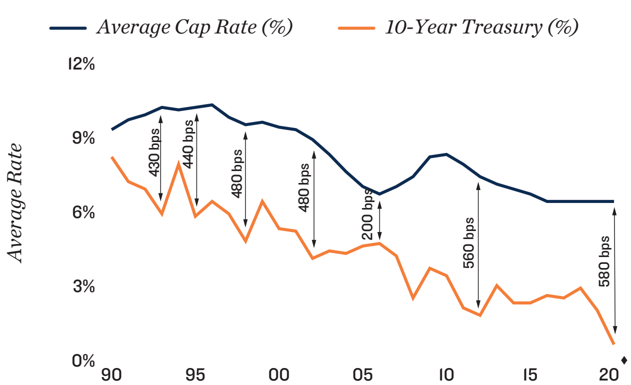
Employment Growth Remains Durable



Core Retail Sales Up Significantly



Yield Spread At Record High



* Employment growth through February ** Core Retail Sales through January
♦ Treasury through March 9

Commercial Real Estate Outlook

Window for investor action could change rapidly. Uncertainty surrounding the expanse and impact of the coronavirus spawned investor uncertainty that sparked the flight to safety. Investor fears, fueled by the limited insights available from leading health organizations as the new virus spread, continue to weigh on the market. As clarity emerges and actions are taken to mitigate the risks from the virus, financial markets will likely begin to stabilize. Past pandemic events such as the swine flu, the bird flu and SARS also generated short-term market volatility that stabilized within 90-180 days on average. While the trajectory of the coronavirus could certainly be different from past pandemics, pharmaceutical firms have engaged in collaborative efforts to move a vaccine to trials as soon as April, offering the prospect of a resolution.

Sound fundamentals support steady performance. Real estate supply and demand generally remain in balance, supporting stable occupancy levels and a steady outlook. Assuming a worst-case pandemic scenario is avoided, the pace of job creation and economic growth will likely taper but remain positive. This will sustain real estate fundamentals over the course of the year, delivering a relatively solid outlook.

Investment Trends

Despite the barrage of headlines focused on the COVID-19 and the impact this has had on financial markets, real estate investment activity remains positive. The steep decline of interest rates to unheard of levels will support refinance and acquisition activity. Though many lenders have widened their spreads over the risk-free rates, investors have been able to lock in debt in the 3 percent range depending on the borrower's credit, asset quality, location, etc. The reduced cost of capital has not translated to higher property valuations or lower cap rates as many sellers hoped because the new coronavirus does create additional uncertainty for many buyers.

Barring a major economic disruption, commercial real estate yields and investment activity should remain stable. Potential coronavirus-related disruptions to the economy and investment market would likely stem from public policies discouraging or restricting travel and public events. In addition, a major sustained drop in business and consumer confidence in reaction to the wave of negative headlines could potentially restrain spending and spark an economic slowdown. The other substantive risk factor stems from financial and stock market volatility, which, if severe enough, could undermine confidence levels. Despite these downside risks, baseline forecasts still point to slower but positive economic growth that will sustain the expansion cycle and the underlying demand for real estate.

Apartments:

The apartment market will continue to deliver favorable performance as housing demand outpaces new supply. The coronavirus will have little direct impact on the demand for housing over the short term. Vacancy rates ended 2019 at 4.2 percent and are expected to rise modestly in 2020 as the market digests the addition of 300,000 new Class A units. Class B and C apartments, with vacancy rates near historic record-low levels, will continue to deliver strong results.

Hospitality:

Hotels will likely face the most direct impact from the new coronavirus outbreak as businesses and tourists reconsider travel plans and restrictions are placed on mobility. Properties with a significant Asian customer base will face softening demand, but venues catering to conferences and major events could also be impacted if businesses and organizations cancel these gatherings. The average 2019 occupancy rate was 66.2 percent, near a record high, so while the virus will likely weigh on performance, the sector should remain above the 30-year average occupancy of 62.5 percent.

Office:

Demand for office space should see little direct impact from the coronavirus outbreak over the short term as sturdy office-using job creation and the tight labor market support demand. The pace of office construction remains nominal in most markets, and absorption is expected to maintain parity with deliveries in 2020, keeping the national vacancy average rate stable at 13.0 percent.

Industrial:

While the flow of goods from China may taper over the short term due to the shutdown of several Chinese factories, this poses little risk to industrial space demand. West Coast port markets' industrial vacancy rates remain exceptionally low and face modest development risk. Distribution hubs like Riverside-San Bernardino may face some softening as a wave of big-box warehouse development enters the market. Some companies may postpone commitments for large space blocks at major warehouse facilities as they cautiously monitor the economic outlook and await additional information on the supply-chain outlook.

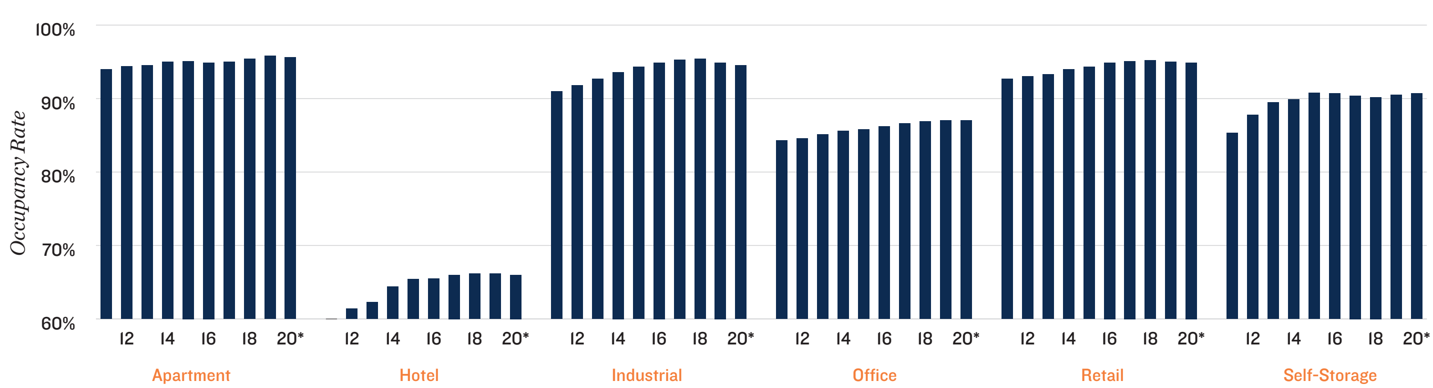
Retail:

In general, retail real estate demand should remain stable, but some coronavirus-centric risks will emerge. Potential product shortages could weigh on retailer performance while an aversion for public spaces could hamper social engagement spaces like restaurants, entertainment venues and fitness facilities. Retail locations in tourist destinations could also face reduced traffic during this uncertainty. As a result, some companies may put expansion plans on hold until activity levels revive, which will weigh on short-term absorption.

Self-Storage:

Space demand for self-storage units will experience little if any impact from the coronavirus. The national average vacancy rate closed 2019 at 9.9 percent, and it is expected to drift up to 10.0 percent in 2020 as the elevated flow of new facilities continues to taper nationwide.

Occupancy Rates Remain Near Peak Levels



* *Forecast*

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Rapid Global Expansion of Coronavirus

December 2019

12/31: *China alerts WHO (World Health Organization/ United Nations) of pneumonia-like cases in Wuhan, China.*

12/31: *10-Year Treasury rate 1.92 percent at close.*

January 2020

1/7: *Virus identified as COVID-19 (Coronavirus).*

1/8: *CDC publishes a health advisory.*

1/11: *First death attributed to COVID-19 in Wuhan, China.*

1/13: *First confirmed case outside of China in Thailand.*

1/17: *CDC implements screening at U.S. airports.*

1/21: *U.S. reports first confirmed case.*

1/27: *50 million people quarantined in 17 China cities, numerous factories closed.*

1/29: *White House announces COVID-19 task force.*

1/30: *First U.S. domestic transmission reported.*

1/31: *President Trump declares a public health emergency.*

1/31: *10-Year Treasury rate 1.52 percent at close.*

February 2020

2/12: *Mobile World Congress canceled in Barcelona.*

2/14: *Facebook and IBM cancel global conferences set to take place in San Francisco.*

2/24: *White House requests $2.5 billion to combat COVID-19.*

2/25: *CDC announces spread of disease is inevitable: "Americans must prepare for disruptions to daily life."*

2/27: *Dow Jones reports largest single-day point drop.*

2/28: *U.S. stock market posts worst week since 2008 financial crisis, Dow Jones drops 12 percent.*

2/29: *10-Year Treasury rate 1.01 percent at close.*

March 2020

3/3: *10-Year Treasury rate falls below one-percent.*

3/5: *$8.3 billion emergency funding to combat coronavirus outbreak authorized by Congress/President.*