The Next Decade in Real Estate: Predicting the Unpredictable

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Ten years ago, the outlook for the real estate market was grim: After being clobbered by the Great Recession in 2008-09, property values were down about 40% on average.[1] Once the economy struggled back to its feet, one would have expected real estate operations to gradually improve. But for the NFI-ODCE Index to post an 11.4% compound annual return for an entire decade?[2] Unlikely. And yet, contrary to many people's expectations, the last ten years have been a near-perfect decade for real estate.

At one of the recent "pipeline review" meetings held weekly by the Bailard real estate team, one colleague marveled at several things from the past decade:

- The resilience and durability of the economic expansion;
- How high rents have climbed coupled with historically and persistently low vacancy rates;
- How far interest rates have fallen... and how long they've stayed there;
- How low real estate investment capitalization rates[3] have gotten... and, again, how they've been able to stay there.

It's been a steady, mostly unbroken string of outstanding performance as pricing for many properties in most markets hit unprecedented levels four to five years ago... and have continued to climb even since!

Given how unexpected these conditions were ten years ago, one looks ahead to the next decade with a growing sense that anything is possible. If the 2010s taught us anything, it's that everything is rational in retrospect, hence, looking forward, anything is possible. With that in mind, the Bailard team offers the following scenarios that could potentially impact the real estate sector in the 2020s. But perhaps the most prudent suggestion to offer to investors is this: expect the unexpected.

Interest rates continue to decline (or alternatively, skyrocket)

No one anticipated where interest rates and cap rates would go (and stay) over the past decade. Could cap rate compression continue from here? After all, cap rates for core properties are still a comfortable 240 basis points[4] above the 10-year U.S. Treasury yield, which is a normal relationship. It should be noted that the annualized return of the NFI-ODCE Index over last decade would have been 6.7% without the help of cap rate compression; that is, the change in cap rates alone contributed meaningfully to the strong real estate returns over the past ten years. With the relatively-lower cap rates as we head into the 2020s (compared to the start of the 2010s), real estate returns would be expected to be even less over the next ten years and certainly nothing to write home about. And, on the downside view, there is some risk that interest rates and cap rates could work their way higher.

But, could interest rates go (and stay) even lower? Absolutely. And if they trade down to below 1% and cap rates follow and end the next decade at roughly 2.7%, this would boost capital appreciation by another 4.7% per annum. This would be truly eye-popping in the context of U.S. history, though not crazy when one ponders the reality that many stable sectors in the Eurozone currently boast similar metrics.

Is this what Bailard anticipates? No. The Bailard real estate team anticipates a "return to normalcy" over the next ten years. This would mean that interest rates regress to mid-single-digit levels (i.e., 4% to 6%) and cap rates would rise to historically normal levels in the range of 6.5% to 7.5%.

Retail and industrial real estate converge

A massive transformation is already underway in the retail category, as independent stores and big box chains alike fold under pressure from online retailers. Amazon, with a 38% share of the U.S. ecommerce market, has led the transformation.[5] To compete, traditional brick-and-mortar retailers like Walmart and Target are becoming more nimble and focusing on "omni-channel" distribution, i.e., offering customers the option to purchase items online and pick them up in the store—effectively treating many of their retail locations as warehouse space for online shoppers.

Meanwhile, online retailers that ship goods directly to customers need ever-increasing amounts of warehouse space in order to optimize the "last mile" in their distribution chains: the closer a warehouse is to its customers, the faster they will receive their shipments. The same holds true for the food delivery sector, which is booming: Recently, *The Wall Street Journal* reported that in 2019, restaurants were expected to do $46 billion in delivery sales, and that two-thirds of U.S. restaurants now offer delivery service via companies like DoorDash, Uber Eats, and GrubHub.

As the trend toward online ordering and home delivery increases, the demand for warehouse space vs. traditional retail space will continue to shift—and the line separating the retail and industrial real estate categories will continue to blur.

Suburbia gets a makeover to suit changing lifestyle trends

The stereotypical 20th-century suburb is evolving. Now that Millennials are having children, suburban houses located in desirable school districts are looking increasingly attractive to this cohort. However, young

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people who move out of dense urban cores don't want to give up all of the city's perks.

Over the next ten years, the desire for a dynamic, quasi-urban lifestyle will draw these families toward suburban communities that offer vibrant town centers and "walkability" between residential and commercial areas (a concept the *2020 Emerging Trends in Real Estate* report describes as "Hipsturbia"[6]). At the same time, some affluent Baby Boomers whose kids are grown and gone are also looking for a more urban environment in which to enjoy their retirement years. And while many older Americans are choosing to "age in place" and not leave their family homes, those who can afford it are often opting to trade the suburbs for the big city.

The battle over affordability heats up

During the 2010s, median home prices dramatically outpaced median household incomes in the U.S. (driven substantially by the low cost of home mortgages). With affordable housing growing increasingly scarce in the most expensive urban areas, rent control and other mechanisms to increase affordability for low- and middle-income Americans will affect investment returns on multifamily properties. Rent control laws cap potential investment returns, which reduces the profitability of new construction. These government imposed restrictions distort the market and provide incentives for tenants to stay in their existing units rather than move to new apartments or buy homes. As a result, market mechanisms are perverted, which will discourage investment in multifamily properties—particularly high-end assets—making them less attractive to investors.

Moreover, factors like increased tax burdens on the wealthy and growing problems of homelessness and crime related to the affordability crisis may prompt affluent Americans to flee major metropolises like New York, Los Angeles, Seattle, Washington, D.C., Chicago, and San Francisco in favor of smaller cities where these problems are less pronounced, such as Indianapolis, Boise, Reno, Salt Lake City, Charlotte, Raleigh/Durham, and Phoenix.

Technology transforms the way we work (and where we do it)

Demand for office space is slowing and will continue to do so into the next decade. Colliers reports that in the third quarter of 2019, U.S. office absorption fell to 10.4 million square feet, down from 17.9 million square feet in the prior quarter. (Absorption is a measure of tenant space newly occupied vs. vacated over a given time period.) Assuming the economy remains strong, the commercial real estate development association NAIOP forecasts average quarterly absorption of 13.2 million square feet in 2020 and 12.7 million square feet in 2021.

Advances in technology increasingly empower people to work anytime and anywhere, and businesses of all shapes and sizes are reimagining the traditional office to meet their evolving workspace needs. For many organizations, that means leasing desks in a coworking space that offers flexibility to respond to ups and downs in their businesses. According to the *2020 Emerging Trends in Real Estate* report, one in seven employees working for companies of 100 people or more use third-party coworking space.

As more workers elect to do their jobs remotely all or part of the time, existing office space will be repurposed. Exactly how remains to be seen, but one possibility is a reversal of the trend of parking structures and other industrial properties being converted into office space. Businesses may not need as many cubicles or conference rooms, but all those remote workers still need places to park their cars.

A black swan event

This one is a bit of a catch 22: the very definition of a black swan event is that it's an unpredictable occurrence. That said, the possibility of a severe economic reaction to a geopolitical crisis, an unstable excess of corporate debt, or another unforeseen trigger cannot be ignored.

Of course, these humble predictions represent only a fraction of the possible scenarios that could affect the real estate market over the next ten years. Putting aside these and other global—perhaps intimidating—considerations, it feels prudent to play it cautious: buying good quality real estate that is flexible and functional. Investors may have to live with the trend of returns that the broader market allows, but there is no requirement to settle for average. There is always an opportunity to find avenues for a creative, hard-working, and experienced real estate investor to add value.

1 The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index, consisting of all unleveraged or deleveraged properties reported by NCREIF's data reporting members.

2 The NCREIF Fund Index – Open-End Diversified Core Equity (NFI-ODCE) is a fund-level index reporting the returns of various open-end commingled funds pursuing a core private real estate investment strategy and qualifying for inclusion based on certain pre-defined index policy inclusion characteristics.

3 A property's capitalization rate, or cap rate, is a measure of its net operating income relative to its market value.

4 A basis point (bp) is 0.01%.

5 https://www.bloomberg.com/news/articles/2019-06-13/emarketer-cuts-estimate-of-amazon-s-u-s-online-market-share

6 https://www.pwc.com/us/en/asset-management/real-estate/assets/pwc-emerging-trends-in-real-estate-2020.pdf

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