ACCELERATING TRENDS

IN THE POST–COVID-19 INDUSTRIAL AND RETAIL REAL ESTATE SECTORS

Even before the COVID-19 pandemic struck, a significant change in consumer demand patterns had occurred over the past decade, driven by demographics, technology, and evolving consumer preferences. In the first quarter of 2020, the environment rapidly evolved to accelerate these dynamics, creating investment megatrends that are critical to optimizing a real estate investment strategy.

One of the most notable megatrends is the emergence of e-commerce. For those paying attention to pricing in the REIT market, the shift away from retail toward industrial was apparent years before it played out in the private markets. The COVID-19 crisis is poised to push this trend over the tipping point, impacting both the retail and the industrial sectors in meaningful ways. Additionally, the crisis is creating a more immediate need for the build-out of a sophisticated supply chain of modern logistics facilities and an opportunity for real estate investors. The fallout from this trend is also impacting brick-and-mortar retail—most acutely, malls.

Investors who rotated their private real estate exposure to focus on sectors and properties poised to benefit from these trends in recent years have likely already seen outperformance relative to traditional portfolios. As the market absorbs the impact of COVID-19 and values adjust accordingly, these secular externalities are expected to continue to provide ongoing support for pricing. When assessing additional capital deployment in real estate in 2020, CenterSquare believes that allocating to specific industrial and retail properties positioned to benefit from these dynamics and serve this demand should be a key consideration for institutional investors.

Accelerating the Shift to E-Commerce

The shift of goods consumption from retail storefronts to the internet is well known. Today, e-commerce accounts for about 20% of all retail spending; CenterSquare believes this market share could reach as high as 50% based on analysis of product types that have reached peak penetration, such as books and music, where e-commerce accounts for more than 60% of all sales. Further, e-commerce represents an efficiency gain—it is generally cheaper for retailers to distribute online, and consumers gravitate toward this lower cost and convenience. Given these factors, many other goods, such as general merchandise, fashion, and jewelry, are likely to see significant e-commerce penetration (Exhibit 1).

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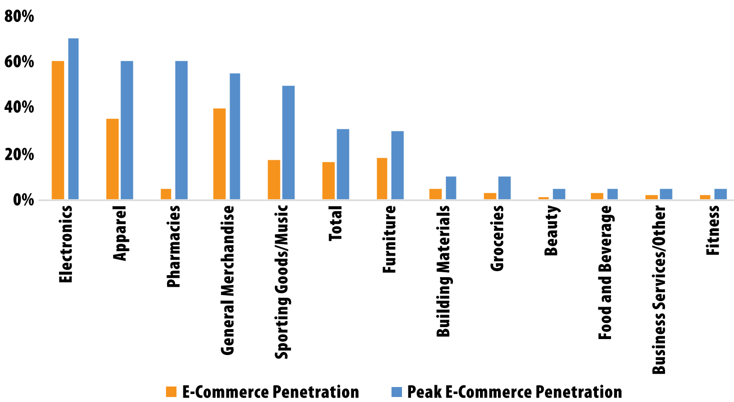
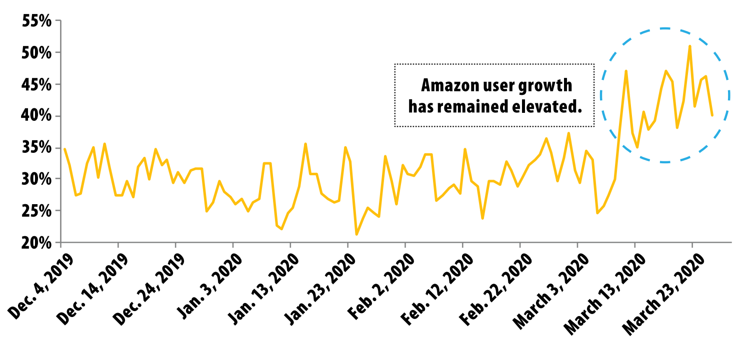
Exhibit 1: E-Commerce Penetration by Product Type



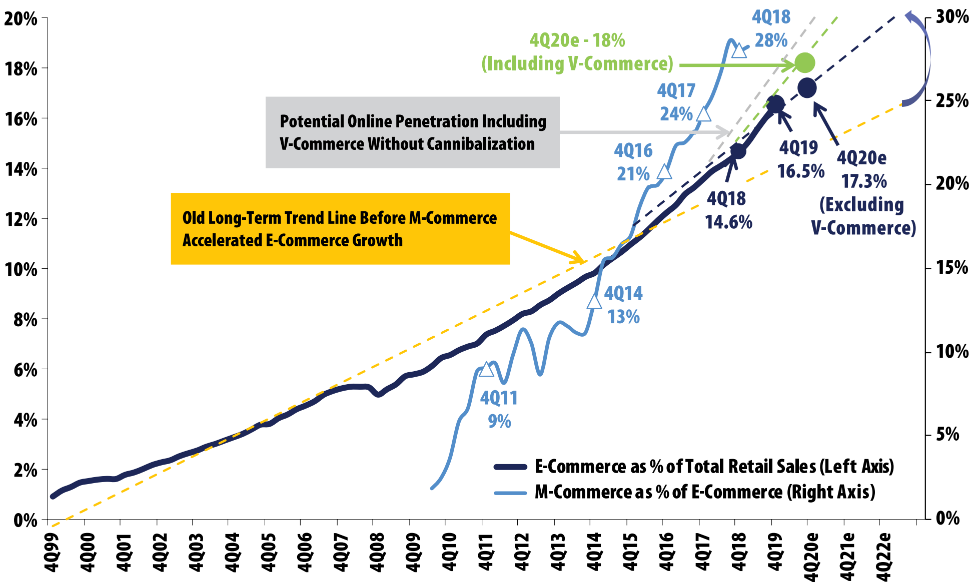
Sources: US Census Bureau, CenterSquare Investment Management; as of January 2020

Exhibit 2: Amazon Daily iOS Active User Growth, Year Over Year



Source: Evercore ISI; Dec. 2019–March 23, 2020

Exhibit 3: E-Commerce and M-Commerce Penetration



Source: Evercore ISI (4Q1999–4Q2022)
Note: The chart includes forward-looking information. Actual results may be materially different from estimates.

Although this megatrend has been in motion for years, the response to the global pandemic—individuals isolating inside their homes and stores closing their doors—has further pushed consumers to purchase goods online. This trend has played out in real time. For example, the number of Amazon users has increased by more than 40%, and the usage remains elevated (Exhibit 2). Though e-commerce has been rising steadily as a percentage of total retail sales, the introduction of e-commerce via mobile (m-commerce) and voice-enabled (v-commerce) platforms is expected to further increase the rate of e-commerce adoption in the US. The exponential growth in e-commerce penetration is clearly getting another leg up (Exhibit 3).

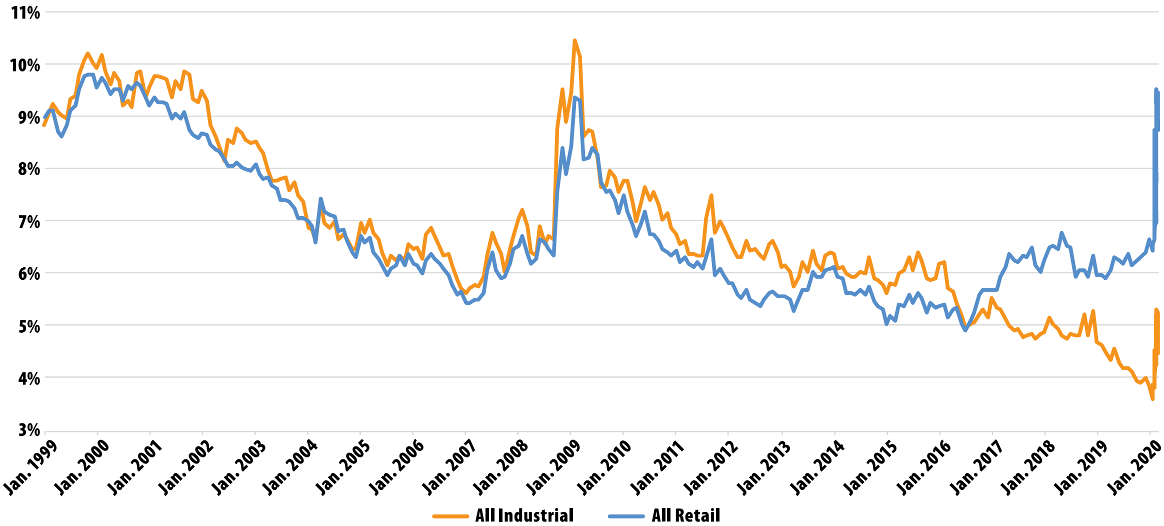
The e-commerce megatrend has been apparent in REIT pricing since 2015, much earlier than in the private market, where it has been slower to approach what CenterSquare believes will be the eventual correct valuation of retail and industrial assets. As demonstrated in Exhibit 4, retail and industrial valuations, which in the past had demonstrated high correlation, saw significant bifurcation within the public markets years ago; and the post–COVID-19 relative valuation spread implies this bifurcation will accelerate. In fact, CenterSquare's initial rough estimates at the time of this writing based on expectations of occupancy and rent are that mall values may decline in excess of 20% in the post–COVID-19 new normal, whereas values for the industrial sector are likely to remain flat to down mid-single digits, with shopping centers likely to fall somewhere in the middle (Exhibit 5).

A Reexamination of Critical Supply Chains

Although some near-term headwinds are likely to impact the industrial sector, such as slower leasing activity as property tours take a pause and companies take a wait-and-see approach, industrial is likely to see benefits in the long term. This potential upside will be driven by two trends that are likely to emerge through the reevaluation of risks in global supply chains.

First will be the heightened focus and urgency to build a retail omnichannel supply chain. Historically, the industrial sector has grown along with the supply chain and is a crucial part of how we consume goods. The coronavirus shutdowns have highlighted the ability for companies with industry-leading supply chain capabilities, such as Amazon, to survive, while many retailers without this supply chain sophistication (such as Macy's) are seeing plummeting sales figures, cutting their workforces, and facing a credit and liquidity crisis. The omnichannel supply chain will be important not only for the product types consumers have grown accustomed to purchasing online (books, electronics) but also for emerging product categories such as groceries and leisure/entertainment, including home fitness products such as Peloton.

Exhibit 4: Historical Industrial Versus Retail REIT Implied Cap Rates



Source: CenterSquare Investment Management; 1Q1999–1Q2020

The second emerging trend is the potential diversification of manufacturing locations to create resiliency in supply chains. The market is already seeing signs of deglobalization, and that means more demand for domestic warehouses and logistics facilities. The US-China trade war first highlighted the need for redundant supply chains when many manufacturers and retailers saw complete disruption as tariffs and restrictions severely hindered the movement of goods to and from China. The COVID-19 shutdown was another reminder. To put this into context, consider the US pharmaceutical supply chain, where 97% of all antibiotics come from China.[1] Over the past decade, China's integration into the supply chain was driven by lower labor costs, but tariffs, technological efficiencies, and consumers' demand for faster delivery effectively bridged that labor-cost gap. In the post–COVID-19 new normal, corporate America may well focus on ensuring these critical aspects of our lives can be satisfied via a domestic supply chain.

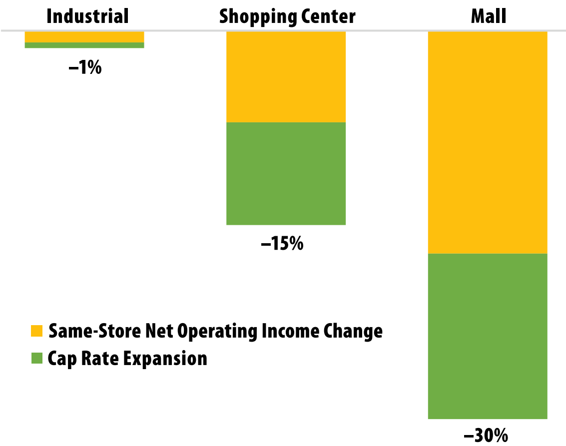
Diverse Recoveries Across Retail

In contrast to the opportunities in the industrial sector, CenterSquare believes certain areas of the retail sector will be permanently impaired by the COVID-19 crisis in the form of lost occupancy and a liquidity crunch. Yet each type of retail property will recover differently.

Within the open-air shopping center space, service-based retail will likely experience the greatest recovery when consumers return to gyms, hair salons, cafés, and breweries once government-mandated shutdowns are lifted; these services cannot be accessed online. Grocery-anchored shopping centers should also recover as grocery-driven foot traffic brings consumers back to the other retailers in the shopping centers. However, grocery could see an acceleration in e-commerce adoption among consumers who shifted to online delivery during the shutdown. Through the pandemic, the online traffic for Walmart's groceries has jumped 55%. With 40 million new online grocery users in the US, this adoption is expected to continue, according to CBRE. On the other side of the shopping center spectrum, the lowest-quality shopping centers likely will not survive this crisis, as this virus rationalizes the oversupply of retailers.

1. Yanzhong Huang, "U.S. Dependence on Pharmaceutical Products from China," Council on Foreign Relations blog, Aug. 14, 2019, https://www.cfr.org/blog/us-dependence-pharmaceutical-products-china.

Exhibit 5: Post–COVID-19 Change in Asset Value



Source: CenterSquare Investment Management
Notes: Data are as of as of April 2020. Sectors are based on the FTSE Nareit Equity Index. The exhibit includes forward-looking information. Actual results may be materially different from estimates.

The future for enclosed malls is more concerning. A meaningful percentage of malls most likely will not make it through this crisis; their tenants were already vulnerable, and they were not positioned to withstand the additional catastrophic disruptions. The emergence of e-commerce has put pressure on retail real estate that was already oversupplied. As more consumers have shifted away from brick-and-mortar locations, retailers have shifted their physical footprints to logistics facilities that could more efficiently cater to their consumers' purchasing habits, leaving many brick-and-mortar storefronts empty, especially in malls.

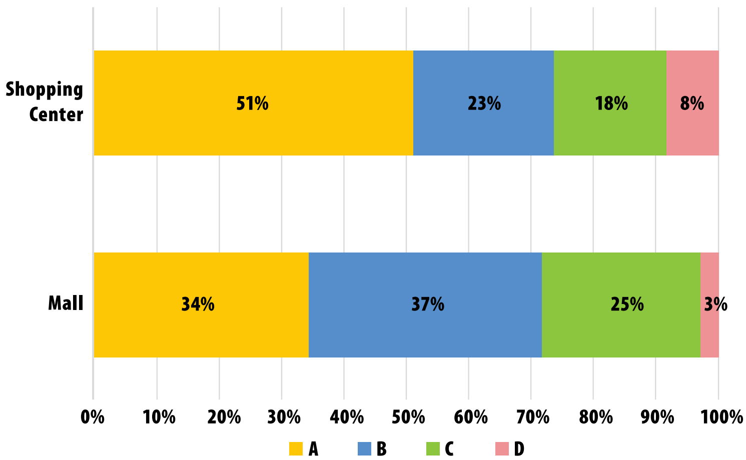
This shifting trend has led to significant bifurcation between high-quality malls—characterized by strong tenants, better locations, and high levels of foot traffic—and effectively everything else. For example, Apple has made significant investments in its physical locations, which are crucial for its business. However, the company has been incredibly discerning, with only approximately 250 physical locations against a backdrop of approximately 1,000 malls in the US. We expect COVID-19 to accelerate this trend among other retailers, not just those in troubled sectors such as fashion but also those tenants inside of malls previously thought to

be more resilient, such as experiential and movie theaters. Even after mandated shutdowns are lifted, consumers will be slow to return to enclosed, high-foot-traffic areas, CenterSquare believes, further dragging out the recovery for many mall tenants.

The silver lining to the COVID-19 crisis, however, is the supply-side rationalization of retail real estate. The US has been over-retailed in comparison to the rest of the world, with 23.5 square feet of retail per capita in 2018, compared to 2–5 square feet per capita in most European countries.

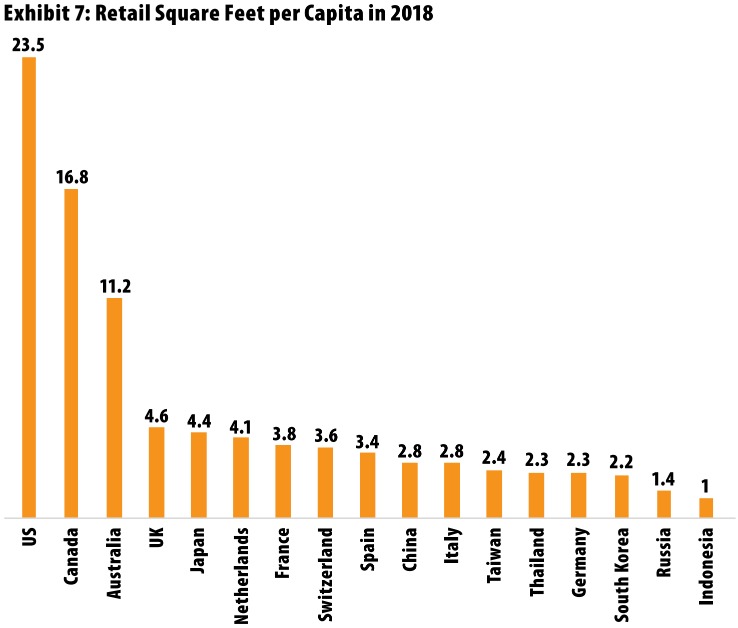
Exhibit 6 stratifies retail gross leasable area (GLA) by CenterSquare's estimates of quality. If C and D retail GLA shutters, 26% of shopping center GLA and 28% of mall GLA would decrease, a notable statistic with respect to supply-side rationalization. With those assets shuttered, the retail square footage per capita in the US would be closer to Canada's retail footprint, which can be argued is more sustainable (Exhibit 7).

Exhibit 6: US Retail Gross Leasable Area by Quality



Sources: Green Street Advisors, CenterSquare Investment Management; as of March 2020

Exhibit 7: Retail Square Feet per Capita in 2018



Sources: Statista 2020

Conclusion

Through the immediate crisis of the COVID-19 pandemic, it is important to understand the long-term implications for diverse real estate property types. Industrial valuations and demand are expected to remain resilient. Though CenterSquare believes vacancies will increase for industrial, in line with a recession, those vacancies will likely be backfilled by the e-commerce megatrend as the economy bolsters its omnichannel consumption and domestic supply chain reconfigurations. Retail will likely experience significant fallout, with the crisis serving as the tipping point for the shuttering of malls. Shopping centers will likely see a return to near normalcy, driven by grocery anchors, with service retail the fastest to bounce back as consumers must continue to access those assets as the interface to purchase services. These trends have been, and will be, manifested in REIT market pricing over the remainder of the year. Private investors should pay heed. ■

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