Executive Summary

• There is growing interest in investing in commercial real estate because of its diversification benefits. A new paper provides an overview of this major asset class, valued at over $12 trillion in the U.S.
• The research sheds light on how stay-at-home orders and business closures associated with COVID-19 may affect commercial properties.
• Retail and hospitality properties are being hit hardest by COVID-19, but mid-market office space may see some long-term effects as well.

Commercial real estate (CRE) is an extremely important asset class. With an estimated value of $12 trillion in 2016, the only asset classes larger than CRE are residential real estate and common stock.

“Because of its diversification benefits, there’s growing interest in investing in commercial real estate,” says Andra Ghent of UNC Kenan-Flagler Business School. “However, much less is known about commercial real estate because data quality has lagged behind what is available for some other asset classes.”

Ghent recently co-authored a much-needed overview of commercial real estate research in the paper “Commercial Real Estate as an Asset Class.” She and her colleagues document important aspects of commercial real estate that can offer insights into how stay-at-home orders and business closures associated with COVID-19 might affect this asset class.

“One of the unique aspects of commercial real estate is that it is very entangled with the urban landscape in a way that other asset classes are not,” says Ghent. “New buildings or modifications to existing ones influence what other businesses come into an area and who will live in that area.”

Which properties are most affected?

Commercial real estate can be classified into core and non-core property types. Core properties include apartment buildings; freestanding retail, industrial and office buildings; and regional malls and shopping centers. Non-core properties consist of medical buildings, lodging resorts (hospitality), manufactured homes and self-storage facilities.

Although investments in core properties are generally considered less risky than non-core properties, the authors note that data does not support this
perception. The average annual return for core properties is 10-15 percent, while the average annual returns for non-core properties range from 9.4-16.4 percent. Although non-core properties as a category are less sensitive to cyclical periods of economic contraction and expansion than core properties, hospitality properties often get hit particularly hard during recessions.

“Retail and hospitality properties are seeing immediate negative impacts from voluntary social distancing and stay-at-home orders,” says Ghent. “Longer term, there might be some problems with office space as well.” COVID-19 is also likely to accelerate the move away from brick-and-mortar retail toward online retail.

**Will we still need office space?**

As COVID-19 has spread, many workers who previously commuted to the office have been forced to use online tools and adapt to virtual meetings with clients and colleagues. The increase in technology adoption during the pandemic has raised the concern that office space could become obsolete.

However, Ghent says it’s unlikely that increased technology adoption will affect prime office space in core downtown areas in major cities, where location brings important benefits through networking and access to skilled workers.

“Everything we’ve learned in the last 20 or 30 years has suggested that increased use of technology actually raises the value of face-to-face interactions,” says Ghent. “I think people are experiencing this firsthand as they realize that interactions during Zoom calls are not the same as in-person conversations.”

However, she does see potential impacts on suburban and mid-market areas as older people learn to use Zoom and other virtual services to conduct such business as submitting tax documents to their accountant or meeting online with their attorney. “In this case, increased technology adoption could lead to accountants and lawyers not needing their office space as much,” says Ghent. “This might mean that suburban office markets would see more repercussions from the escalated pace of technology adoption that came with COVID-19.”

**Policies that work**

The authors note that commercial real estate is attractive because returns from rental income have been remarkably stable at seven percent annually. However, fluctuations in price also make CRE a risky investment. Because of this, the asset class tends to be more attractive to investors with a long-term investment horizon, such as pension funds. How investors view commercial real estate after COVID-19 depends a great deal on the success of government programs designed to help small businesses.

“Congress passed the CARES Act very quickly, but many small businesses were left out of this first round of loans,” says Ghent. “It’s critical to get that program working again, because tenants can use up to 25 percent of the money to pay rent. States also need to solve their technical issues with processing and issuing unemployment benefits so that tenants can use that money to pay rent. We also need federal assistance for states, since states bear the brunt of the burden of unemployment benefits.”

Ghent notes that the overall effect of COVID-19 on CRE will largely depend on how long restrictions and uncertainties last. “The long-term productive capacity of the American economy has not changed,” she says. “This means that if the economic downturn is short, it won’t affect commercial property prices that much. That said, in the short run, we’re much less productive. Only about 40 percent of workers can truly do their jobs from home, and so, as a society, we have less output, and this has to affect businesses’ ability to pay rents.”

There are still many questions about how quickly things can return to normal. Ghent points out that even if non-essential businesses are allowed to reopen and social distancing restrictions are relaxed, people may choose to not go back to work or return to normal spending habits until more information is available regarding the risk and probability of contracting COVID-19.

“This cannot be solved purely with government interventions,” says Ghent. “It’s key that people feel safe going back to work and that they start consuming again, so that the retail and hospitality sectors can recover.”


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