WELLS FARGO Asset Management

INVESTMENT PERSPECTIVES

Coronavirus impact on REITs: Our take on losers and winners

We believe the pandemic will cause certain real estate segments to struggle while others will be only minimally pressured or even benefit.

Using our PMV process, we've identified four segments we believe will be negatively affected and four that stand to benefit.

Investment in public REITs and our active allocation strategy provide critical flexibility that's difficult to replicate in private real estate and passive strategies.

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The coronavirus pandemic has been causing a variety of disruptive impacts throughout the U.S. economy, including record unemployment and weakening gross domestic product.

For the most part, public real estate investment trusts (REITs) entered this economic disruption with stronger balance sheets and fewer oversupply issues compared with the global financial crisis. However, we believe certain segments of the real estate space will experience acute pain—driven by traditional cyclical pressures as well as the acceleration of several secular trends—while others likely will be minimally pressured or even benefit.

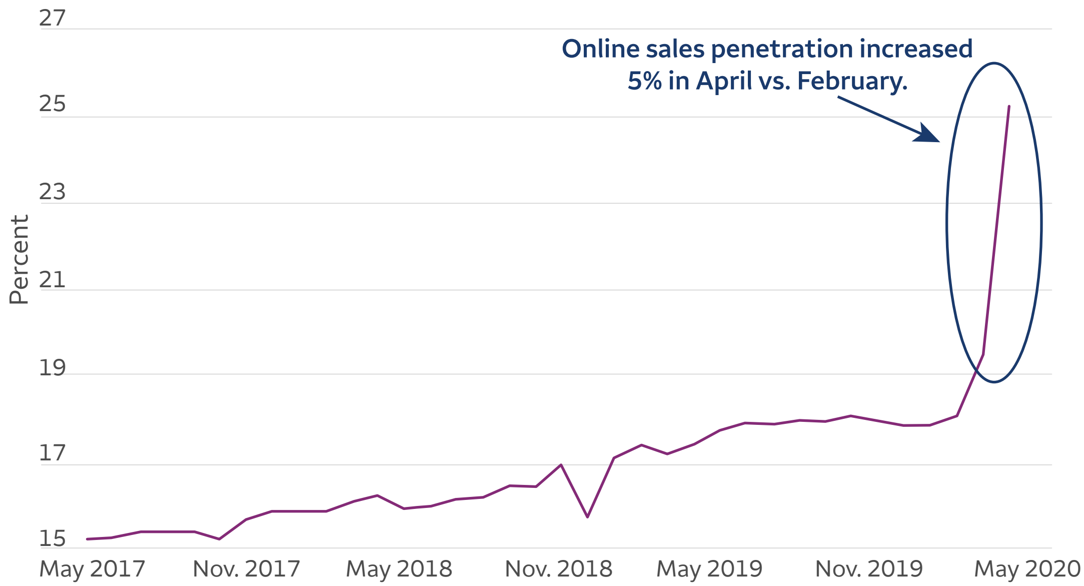
Using our bottom-up private market valuation (PMV) process, we've identified four real estate subgroups that stand out as most negatively exposed to coronavirus-related vacancy and financial stress and four others that in our view should benefit in a post-coronavirus world. In this paper, we discuss each of these groups and explain the advantages that our approach—investment in public REITs and an active sector allocation strategy—provides over investment in private real estate and passively managed strategies in a volatile environment like we're experiencing today.

Real estate losers

Retail

Pre-coronavirus, the retail industry was facing significant secular change and challenges as the demand for brick and mortar commercial real estate was being supplanted by e-commerce. Now, many more physical stores are closed due to state shelter-in-place orders, and by necessity, more shopping has moved online. This has supercharged e-commerce trends.

Online sales as a percentage of total retail sales*



Sources: Wells Fargo Asset Management (WFAM), FactSet, and U.S. Census Bureau
*Total retail sales excludes autos, auto parts, and gasoline sales

It's probably true that many stores will eventually reopen. However, it's also true that:

- Some sales that have migrated online will likely stay there.
- A number of retailers are proactively seeking rent cuts in anticipation of protracted pain.
- Some retailers being pushed into bankruptcy by coronavirus social distancing likely won't be reopening once these rules are lifted.

All of these factors contribute to a low demand/oversupply imbalance that's likely to persist well beyond 2020, punishing retail landlords.

Office

Due to the coronavirus, most office spaces have been empty as workers have been forced to work from home. Post-coronavirus, offices will still be an important tool to maintain workplace culture and collaboration. However, with the forced working-from-home experiment widely successful, we believe workers will be given more flexibility between working in the office and working remotely going forward. If this leads to more employees permanently working remotely, office landlords will have incrementally less demand for their space. This trend should continue driving employers and employees to move from dense, expensive urban areas—where the majority of office landlords own space—into more affordable locations. Also, as the coronavirus wracks the economy, financially struggling companies are more likely to reduce footprints, negotiate lower rents, and/or close entirely. In our view, these factors should weigh on office real estate values for the foreseeable future.

Senior housing

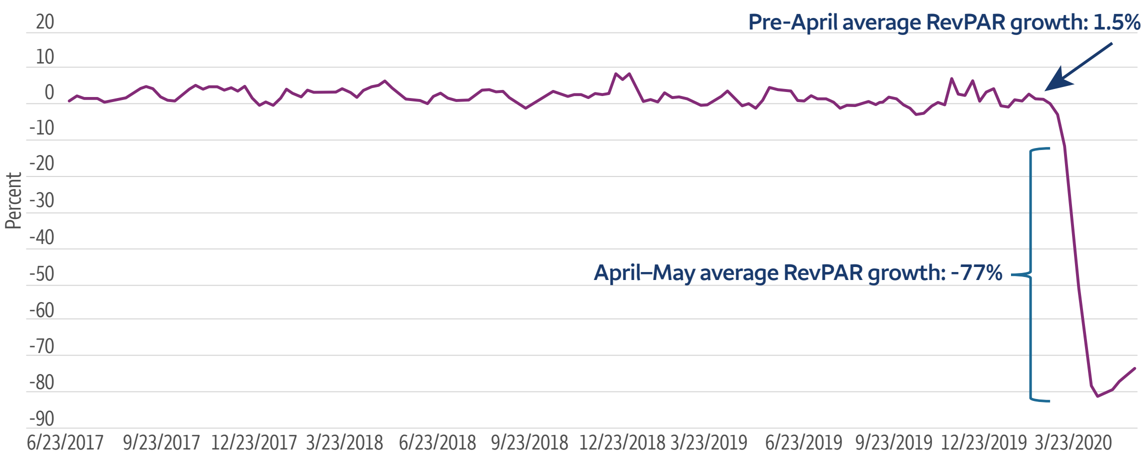
As the largest subsector of health care real estate, senior housing was poised to benefit from growing demand given the demographic aging trends over the next 15 years. In our view, the coronavirus pandemic dampens this expectation given the high rates of coronavirus infections and subsequent deaths in nursing homes. The pandemic's unfortunate impact within nursing homes has boosted vacancies by reducing move-ins and increasing move-outs.

Also, expenses to maintain senior housing facilities have increased as more workers are needed to handle advanced quarantine protocols and as employers have needed to boost pay in order to attract workers to “at risk” jobs. We believe that going forward there’ll be persistent headwinds from the pandemic for senior housing, particularly as children avoid sending their parents to facilities due to concerns about health risks and restricted visitation.

Hotels

The tremendous collapse in travel due to the coronavirus has resulted in historic declines in hotels’ revenue per available room (RevPAR), which is the most-watched performance metric for hotels.

Change in hotel RevPAR(%)
Year over year, 4-week moving average



Sources: WFAM, FactSet, and STR

When hotels reopen, we anticipate some recovery in RevPAR, especially as pent-up spending on leisure travel improves during the summer months. However, we expect this benefit to be outweighed by lingering headwinds for corporate travel. Struggling businesses are likely to reduce their budgets for travel and expenses and incrementally move toward holding more virtual conferences and business meetings. Given that hotels typically depend on corporate travel for the majority of their revenue, we expect hotels’ financial performance to remain pressured for some time.

Real estate winners

Industrial

Pre-coronavirus, the industrial group was the winner—at the expense of retail space—as e-commerce growth spurred warehouse demand. This trend has been supercharged by the surge to online shopping driven by social distancing. As the economy struggles, we do expect some industrial tenant fallout, but this negative is likely to be materially outweighed by continued demand from supply chain investment and the ongoing shift to e-commerce.

Lab space

Lab space demand—a smaller subgroup of the office group—has been growing as an aging population and a fertile funding environment have driven biotech investment. Given the expensive equipment requirements, safety protocols, and collaboration, lab space work is difficult to replicate in a work-from-home environment. In our view, the demand for lab space will continue to accelerate, fueled by the search for coronavirus treatments and vaccine research. Post-coronavirus, we believe a sharper national focus on overall disease treatment and prevention should increase the demand for lab space for the foreseeable future.

Data centers

Pre-coronavirus, data centers benefited from digital traffic growth and the shift to the cloud. Now, consumer digital consumption (video on demand) and remote working solutions will likely increase the rate of overall demand growth. As online traffic grows, data center tenants are likely to continue optimizing their infrastructure footprint for the best user experience, providing a tailwind to retail colocation data center operators with the best hybrid cloud and edge solutions.

Cell towers

Historically one of best real estate subsectors, cell towers have continued their excellent track record with almost no negative impact from the coronavirus pandemic. Increasing digital traffic should continue to act as a tailwind for towers. We believe that post-coronavirus, 5G investment acceleration is likely to keep the case strong for cell tower investment.

The PMV REIT advantage

Public versus private

We closely monitor both the public REITs and the private real estate market. In our view, REITs offer benefits that are difficult to replicate in the private real estate, including these:

- REITs provide exposure to several groups that are generally benefiting from the coronavirus fallout, including the top cell towers, lab space, and data centers.
- REITs have been actively discounting coronavirus issues, while private-market pricing has lagged due to reliance on appraisals and transaction data, both of which are slow to react to changes. As a result, REITs tend to provide cheaper points of entry and less risk of overpaying.

Active versus passive

Active management provides flexibility that's unavailable in passively managed strategies. We've experienced these key benefits:

- Our concentrated active allocation strategy allows us to overweight stronger groups and underweight weaker groups. Passive management, on the other hand, delivers uniform exposure to advantaged and disadvantaged groups alike.
- The ability to weight investments based on conviction creates the potential for active strategies to outperform passive.

In summary

There have been many cross currents affecting real estate use and value, and the coronavirus crisis has accelerated many of these trends. Through diligent application of our PMV process on a bottom-up basis, we've identified opportunities and positioned our clients to take advantage of the changes we see in the real estate market.

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at WFAMInstitutional@wellsfargo.com.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at 1-888-877-9275.
- To reach our U.S.-based retirement professionals, contact Nathaniel Miles, head of Retirement at Wells Fargo Asset Management, at nathaniel.s.miles@wellsfargo.com.
- To discuss sustainable investing solutions, contact Hannah Skeates or Christopher McKnett, co-heads of Sustainable Investing at Wells Fargo Asset Management, at hannah.skeates@wellsfargo.com or christopher.mcknett@wellsfargo.com.

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