THE GDP FACTOR

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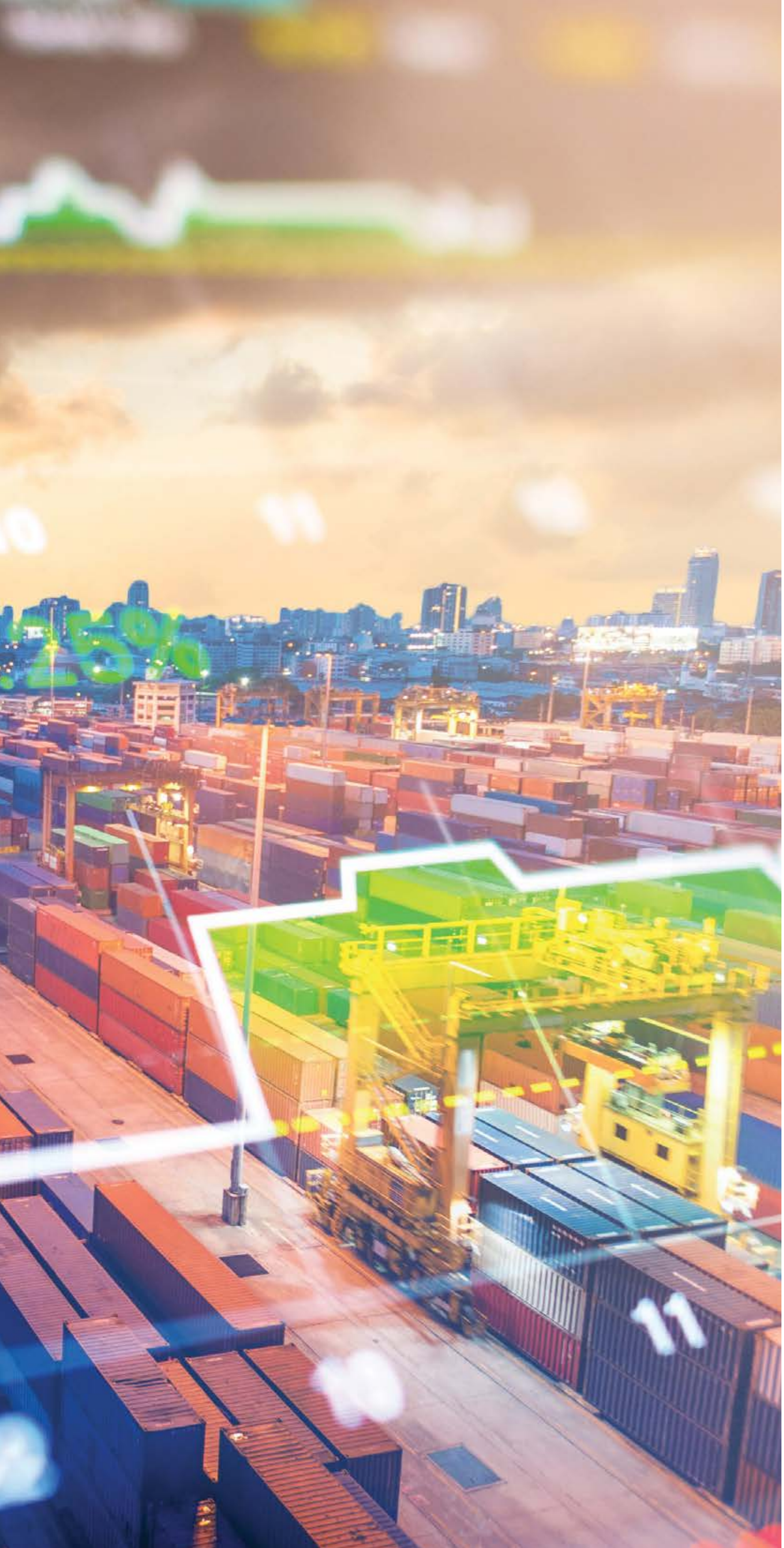

COMMERCIAL REAL ESTATE IS ALL ABOUT **LOCATION, LOCATION, LOCATION.** BUT WHERE YOUR BUSINESS IS HEADED IS MORE ABOUT **GDP, GDP, GDP.**

As a commercial real estate broker, when you are down in the muck and mire of the trenches, scrapping for a new client, nailing down a sale of an industrial building or putting the final dot on a five-year leasing contract, it's hard to envision how the general economy is affecting you in anyway. It's all about your skills, contacts, and local knowledge being put to the test.

Yet, it's very possible you would not be there at that moment, with a client or working a sale, without trends that are evolving in the economy far beyond your trading area. It's for that reason alone that some SIOR members advocate keeping an eye on such national statistics as Gross Domestic Product, better known by its acronym GDP.

Simply put, GDP measures the market value of all the final goods and services produced in a defined period of time. This all affects commercial real estate.

As Gabriel Silverstein, SIOR, national chair of Institutional Capital Markets at SVN | Angelic, in Austin, Texas explains: "GDP's big components are products and services. The latter are people activities that historically need office space. A better GDP means more office space, declining GDP means less office space. On the product side, regardless of what item is physically sold, it invariably requires some level of industrial space for manufacturing, warehousing, or distribution."

GDP growth had been steady for about a decade until the advent of COVID-19, which forced a slight decline (about 5%) in the first quarter 2020, followed by a huge drop in the second quarter. According to the Bureau of Economic Analysis, the GDP decreased at an annual rate of 31.7% in the second quarter. It did make a large comeback at the end of the third quarter, although still lower than pre-COVID levels.

"That meant a substantial change in the need for office and industrial space, but not in the same way," says Silverstein. Declines in the service sector meant less demand for office space, a condition that persists into the third quarter. Shutdown and restrictions of physical retailing decimated retail space, but ongoing retail didn't follow the downward spiral; it only shifted to e-commerce. This meant warehouse and distribution centers were not only busier, but more space was needed.

It's important to take the long-view of the GDP, notes Gary Ralston, SIOR, managing director of SVN | Saunders Ralston Dantzler Real Estate in Lakeland, Fla. "The GDP was in a downturn from 2008 through the third quarter of 2009. In the second quarter of that year, the GDP totaled $14.35 trillion. In the last 10 years, we've had unbelievable expansion, peaking in the fourth quarter 2019 at $21.75 trillion. Even with the huge drop in the second quarter this year, the GDP is still at $19.5 trillion; that's 50% above the peak before the last recession."

The GDP has fallen to about 2017 levels as of mid-quarter, but many predict the economy should improve, especially if there is a vaccine.

"One of the impacts of the COVID-induced recession is that with commercial real estate going forward, we are going to see an increasing amount of discretion-related demand," Ralston predicts. "A rising tide will not float all boats. Across the entire commercial real estate frontier, space that meets the needs of the tenant will continue to grow. That which does not is going to get far worse, which means there will be a wider spread between winners and losers."

He gives the example of office buildings, which have to adjust so as to provide more social distancing, include more touchless operations (elevators), and better air filtration. Those offices that can make those changes will do better than properties that don't.

Many other tangential factors affect the interplay of the GDP and real estate. While the moving value of the latter doesn't affect the GDP, new construction is part of the statistical data, although that would include residential as well.

Ralston maintains there is a high correlation between GDP and the demand for real estate, which has a lot do with the economy.

"Many investors in commercial real estate are investors in the general equity market, so to the extent that the returns in real estate are out of sync with the returns on a risk-adjusted basis in the stock market, that serves to real estate's disadvantage," he says. "As long as the equity market is doing well and is positive, we should expect the real estate market to be good and positive."

Kurt Jensen, member associate of SIOR and industrial broker with Kessinger Hunter in Kansas City, Mo., proffers a note of caution. In the current economy, due to consumers shifting to e-commerce in such a major way, the country could go another six months without a major impact on the one sector doing well through all of this: industrial real estate. However, if the economy limps along for another 12 to 18 months, that will have an impact on consumer spending, which will slow e-commerce growth, which will then ultimately affect industrial space.

The economy would probably have done much worse if not for government assistance programs like the $600/week additional supplement to unemployment and the Federal Reserve activities, which the average person—including commercial real estate professionals—might not understand, despite its importance.

Although on the surface, this seems unrelated to GDP, the Fed's massive injection of dollars into bond-buying has stabilized this financial sector, particularly the debt market. From a commercial real estate point of view, that's exceptionally important since transaction activity almost always includes some combination of debt and equity. To the extent that the market is illiquid and debt can't be used from lack of confidence or liquidity, the entire market freezes.

"What the Fed has done is dramatically stabilize the debt market," says Silverstein. "And one of the greatest illustrations of that is the CMBS market, which largely, if not completely, has returned to where it was in January and February, before COVID, which means borrowers and buyers can gain get debt to buy property, which drives transaction value and is thus helpful to brokers."

There are cautions here. The trouble with the financial support is that it distorts the true economic picture. "Despite that massive cash injection into the economy in order to give people money to spend, our GDP still fell almost 32% in the second quarter," Silverstein says. "Think of how much it would have fallen had the government not done that. Nevertheless, not sending everyone a $1,200 check in PPP loans would have affected confidence levels with both business and private consumers, who not only wouldn't have had any cash in their pockets, but also wouldn't have felt some level of confidence that one way or another we would make it through this"

Temporary measures worked, but a long-term economic decline is worrisome. "If the economy continues to be rough six months from now, that will ultimately have an impact on consumer spending," says Kurt Jensen. "At that point you will see a slowdown in the e-commerce world as consumer spending retracts, something that hasn't happened yet. Right now there is still enough optimism that we are in a short recession and people will get through it, but the optimism won't last if the economy stays weak."

Kurt Jensen's father, Dan Jensen, SIOR, principal with Kessinger Hunter in Kansas City, is much more optimistic about the industrial market. As he notes, for every billion of new e-commerce business that is generated, there needs to be another 1.25 million square feet of warehouse built. Those data points seep down into local markets. For example, Urban Outfitters is building a new 800,000 square foot, 80 foot clear "omni" distribution center in the Kansas City metro.

"Retailers are done trying to get consumers to their stores…now they are trying to bring goods to consumers," Dan Jensen observes.

Plus a new realization has emerged due to the COVID pandemic. "This 'just-in-time' warehousing works wonderfully until you have a blip in the supply chain and you have people sitting around because they don't have raw materials," he added.

Dan Jensen expects, for national safety and security reasons, there will be more warehousing of key goods and raw materials in the United States in the event something like a pandemic happens again. "Near-shoring" will be important, he concludes, "because people realized, 'Wow, we can't even get a box of masks without having to go to China. We need to control some of this on our own shores.'"

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