

# UCLA ECONOMIC LETTER

## REAL ESTATE AND THE MACROECONOMY



*A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast sponsored by the Ziman Center's UCLA Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics*

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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and the UCLA Ziman Center for Real Estate. This June 2020 Brief excerpts UCLA Anderson Forecast and Ziman Center Senior Economist David Shulman's report from the [June 2020 Economic Outlook](#), delivered June 24. The excerpt examines key real estate sectors in the post-COVID environment.

## Real Estate in the Post-COVID Economy

### Housing Will Be a Bright Spot, but Density Will Decline

By [David Shulman](#)

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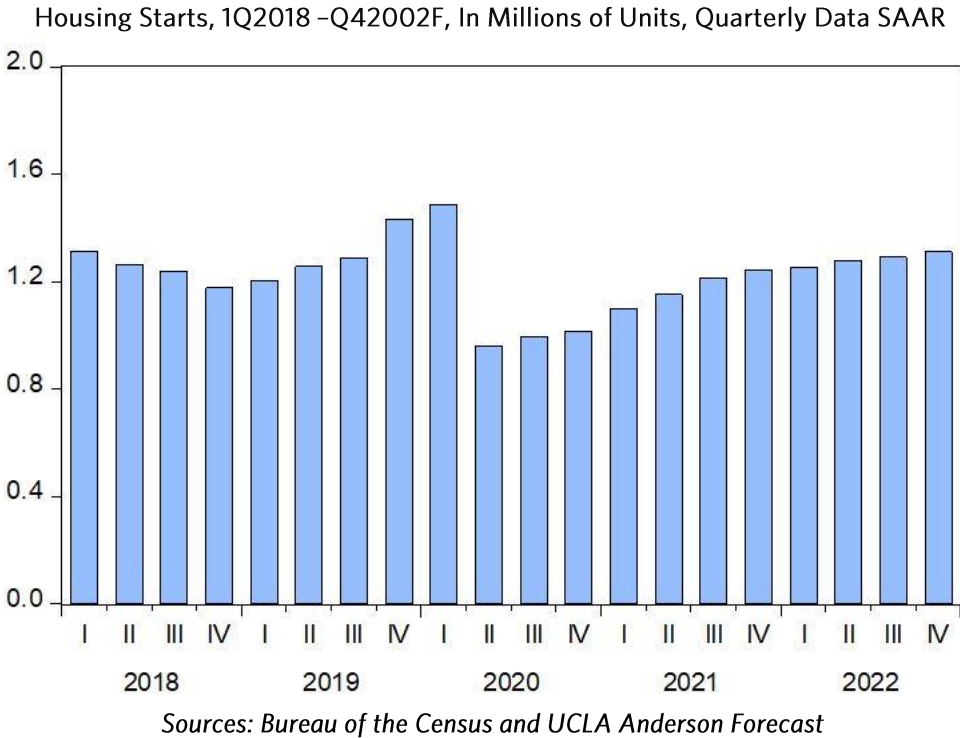
*"There are decades where nothing happens, and there are weeks where decades happen."*  
-Attributed to Vladimir Lenin

To state the obvious, the trends that were in place prior to the outbreak of the pandemic have accelerated. For example, the increased digitization of the economy and cloud computing ramped up to a new higher level. **In April, online shopping, benefiting from social distancing and the closure of brick and mortar stores, accounted for a record 28% of retail sales – less automobiles, gas and restaurants. A year ago it was 21%.** The trend toward de-globalization was in train prior to the pandemic and that too will continue. I will now take in turn the work environment, urban density, the housing market, and the new rental dynamics of retail. I do this fully understanding the admonition of the Nobel Prize winning physicist Niels Bohr who noted, "It is very hard to predict, but especially the future."

“Instead of living in San Francisco, New York or Los Angeles, workers can now choose to live in the relatively less expensive suburbs of Austin, Raleigh, Nashville and Denver. All that is needed are fast Internet connections and a decent airport.”

**HOUSING: A BRIGHT SPOT**

Responding to prolonged under-building earlier this year, housing activity was on a tear. New starts exceeded an annual rate of 1.5 million units in January and February and prices were rising. With the shutting down of the economy, housing starts dropped to 890,000 in April. Nevertheless, despite the spike in unemployment, underlying consumer demand appears to be strong, and the forces in play earlier this year will reassert themselves, especially with the availability of sub-3% mortgage rates. We expect the recent tightening of credit standards will loosen as employment growth begins to pick up. As a result, after housing starts decline to 1.11 million units this year as a whole, we forecast that activity will run at a 1.3 million unit annual rate by the end of 2022.



**THE WORK ENVIRONMENT**

The pandemic has taught us that the economy can work from home (WFH), at least for the 37% of jobs that are amenable to that environment.<sup>1</sup> Firms from Morgan Stanley to Facebook have noted that the WFH experiment has been so successful that they plan to radically reduce their office footprint. Indeed Facebook Founder and CEO Mark Zuckerberg noted, “Over time location will hopefully be less a factor in how many people work ... and we’ll have technology to feel truly present no matter where we are.”<sup>2</sup> He further noted that perhaps half his current workforce of 45,000 could be working from home in five years. **And if you can work from home, it can be practically anywhere.**

<sup>1</sup> See Dingel, Jonathan I. and Brent Neiman, “How Many Jobs can be Done at Home?” NBER, April 16, 2020.  
<sup>2</sup> See Facebook post quoted in *Politico New York Real Estate*, May 26, 2020.

Office purists argue the WFH environment works against corporate culture and the internal and external agglomeration economies associated with dense office environments. They further argue that the Yahoo WFH experiment failed in 2013. **There is merit to those arguments, but given recent advances in telecommunications (e.g. Zoom) it seems to me that agglomeration economies will become less a prisoner of geography than now believed.**

An offsetting factor for the demand for office space will be a partial undoing of the two decade long trend to densify office space. The WeWork model of having 75-100 square feet of office space per employee does not work in a world of social distancing. Office workers will have more space and there will quite a bit of Plexiglass separating workstations.

## URBAN DENSITY

Since the late 1990s we have witnessed a renaissance of many of America's great urban centers, especially on both coasts. Density linked with mass transportation has been the holy grail of real estate developers and owners. Now that whole concept has been called into question as the pandemic thrived in dense urban environments. **Simply put, dense pedestrian-oriented environments and mass transit (both horizontal and vertical as in elevators) do not work in a social-distancing environment.** The arrival of a vaccine will certainly ameliorate the situation, but the shock of the shutdown and the fear that the virus or another virus may return has been seared into the consciousness of the citizenry.

If office work becomes more dispersed, the urban amenities of restaurants, bars and entertainment will be under stress for the lack of customers. That is, of course, assuming that most of the restaurants reopen after the virus shutdown, which seems unlikely. So why be in an expensive city that lacks amenities?

## THE HOUSING MARKET

If WFH becomes prevalent post-crisis there will be less need for people to live in expensive urban environments and it will be hard to justify paying \$3,000-\$5000 a month for small apartments that were never designed to be a home-office. This will cause rents to fall. It will take some time before commuters accept mass transit as a solution. Hence the much-reviled automobile will once again become the commuter's choice. This view is supported by a recent Citi survey of 5,000 urban households which indicated a strong desire to move to the suburbs, especially the higher income ones.<sup>3</sup>

Even as urban rents fall, suburban housing will once again become a choice solution for both millennials and empty nesters who so recently returned to an urban environment. It also means that many workers won't have to live close to their workplace. The recent civil disturbances associated with the largely peaceful protests around the police murder of George Floyd and moves to "defund" the police will give added impetus to the move to the suburbs. Instead of living in San Francisco, New York or Los Angeles, workers can now choose to live in the relatively less expensive suburbs of Austin, Raleigh, Nashville and Denver. All that is needed are fast Internet connections and a decent airport.

For those workers who choose this lifestyle, commuting times will be radically reduced. Indeed with less commuting, carbon emission will be reduced as well.

## THE NEW RENTAL DYNAMICS OF RETAIL

It is no secret that brick and mortar retail has been in a world of hurt for the past several years. As we noted above, the pandemic telescoped all of retail's worst fears in three months. Historically, the rent-paying ability of retail tenants was based on sales per square foot. However under the competitive hammer of online competition, retailer gross margins have been squeezed and rent is actually paid out of gross margin, not sales. Let me present a stylized example. A store in typical Class A regional mall generates around \$700/square foot and the tenant pays a net rent of \$62/square foot with an additional \$25/square foot of common area charges.<sup>4</sup> A few years ago a clothing

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<sup>3</sup> See Bilerman, Michael, "Into the Great Wide Open," *Citi Equity Research*, June 15, 2020

<sup>4</sup> The data are approximations taken from the 2019 Fourth Quarter Supplemental Report of Simon Property Group, the largest mall owner in the U.S.

retailer would generate a 40% gross margin in sales, or about \$280/square foot. However, **prior** to the pandemic that margin was squeezed to around 36%. Thus the new gross margin was running at around \$252/square foot – a \$28/square foot reduction and that is assuming sales remained at \$700/square foot, a heroic assumption. Thus with the gross margin/square foot reduced by \$28/square foot, the \$62/square foot of rent is hardly sustainable and it is likely that when the economy returns to something approximating the pre-COVID normal mall rents will be under intense downward pressure. **I am not saying rents will decline by nearly 50% as indicated by my example, but a decline on the order of 15%-30% seems likely.** We would note that the analysis presented above ignores the raft of department store closings and retail bankruptcies that have occurred in the past three months.

## CONCLUSION

The public health crisis induced by the COVID-19 pandemic has morphed into an economic crisis bringing with it swift depression-like declines in output and employment. **Although the economy apparently has bottomed, it will take time before output and employment levels are restored to the levels achieved in the fourth quarter of 2019.** Both fiscal and monetary policy reacted with great alacrity that thus far has prevented long term decline. However the huge debt buildup in both the public and private sectors will work to dampen output in the future. To be sure, inflation will remain muted over the near term, but the combination of cost increases coming from prioritizing resilience over efficiency, record increases in the Fed's balance sheet and high fiscal deficit regime as far as the eye can see will leave the way open for inflation later in the decade.

The pandemic has telescoped trends that were already in place in the economy towards increased digitization of business functions and online commerce. A major response to the pandemic has been the success of work from home which looks like it will lead to long term changes in work and urban environments as workers avail themselves of more work/life options. **In a nutshell, economic and housing activity will shift from large cites to mid-sized cities and away from the urban centers to the suburbs.**