The COVID-19 pandemic has profoundly impacted our economy, reshaping how many of us go about our daily lives and the ways businesses operate.

In this article, we discuss how the pandemic has affected commercial real estate, or CRE, focusing on sector-level differences and comparing the current trends to the last major episode of CRE distress seen during the 2008 financial crisis.

**Commercial Real Estate During and After the Pandemic**

The developments in CRE during the pandemic have varied substantially by sector, as shown in the figure below.1

Following the onset of the pandemic at the end of 2020's first quarter, the prices of hospitality properties fell particularly sharply (-10% through the first quarter of 2021), reversing the strong upward trend seen in recent years, according to CoStar Group, a leading source of listings and information on CRE.
The office sector had been experiencing weaker conditions than hospitality pre-pandemic, and the onset of the pandemic pushed it into decline as well (-4% through Q1 of 2021).²

On the other hand, although prices for retail properties had been stagnating for an even longer period than for office space, on the whole they have been surprisingly resilient during the pandemic and have remained relatively stable.

However, these aggregate data may mask the fact that some types of retail space, such as grocery spaces, have done quite well, while others, like downtown department stores, have suffered greatly. In stark contrast, industrial real estate, which includes manufacturing facilities and warehouses, has continued to appreciate sharply even during the pandemic.

Consumer spending data can help explain some of these patterns. Data from the U.S. Bureau of Economic Analysis support the observation that large segments of the population simply stopped traveling and doing the type of spending that typically goes with it, which has important consequences for the hospitality sector.

Spending on food services and accommodations was down 22% in the four quarters starting in the second quarter of 2020 compared to the four quarters prior; the analogous numbers for transportation spending (a 36% decline) and entertainment spending (a 35% decline) were even worse.

As the decline in overall consumer spending was a far more modest 4%,³ it is unsurprising that hospitality businesses and thus properties have borne the brunt of the decline in CRE prices, given these shifts in how people are spending their money.
Similarly, retail properties have been affected by shifts in the way consumers shop. Notably, the share of retail spending done online surged from 16% in 2019 to 21% in 2020, an acceleration of an already-important trend. This pattern appears to be reflected in the CRE price data as well, with the price of retail properties stagnating, while industrial properties, which include those used for warehousing inventory of online retail, have been doing quite well.

In the case of office space, the widespread adoption of work-from-home arrangements led to a dramatic decrease in the use of those properties: 2020 saw a reduction in office use of 84 million square feet, a dramatic reversal of recent trends that saw about 50 million square feet added per year.

Even those stark numbers likely understate the shift away from office space, as sublease availability is at a record level, demonstrating that firms are actively seeking to reduce their office footprint. All told, office vacancy is at a record 18.2%. As businesses shifted away from offices, the price of office CRE declined.

CRE prices moving forward will depend critically on how these behavioral patterns evolve once the public health crisis is more firmly under control.

Hospitality properties were doing quite well before the pandemic struck, and it seems likely that once the pandemic recedes, people will return, perhaps even rapidly, to in-person dining, travel and other recreational activities. Consequently, the sharp decline we have seen in the prices of hospitality properties may only be temporary.

On the other hand, the shift away from brick-and-mortar retail had already been occurring for years, and a return to prepandemic levels seems less likely here, boding poorly for the future of retail properties.

The price of office properties is perhaps the hardest to forecast. In particular, many companies, which initially may have adopted a work-from-home arrangement only out of necessity, reportedly are finding the strategy to be unexpectedly successful and popular with their workforces.

The extent to which companies bring workers back to the office is a major unknown and will be critical for determining the prices of office CRE moving forward.

In addition, schemes for so-called hoteling to reduce companies’ office footprints were already being explored prepandemic, but we have little certainty about how successful those and other hybrid work-from-home/in-person ideas will be.

The popularity of working from home has varied by age, gender, income and education, with more educated and higher income workers strongly saying that their jobs can be done from home. If this presages changes in the mix of commercial office workers, that too may affect prices for CRE.

Contrasts With the 2007-2008 Financial Crisis

We can gain further insights into what is on the horizon for CRE by considering the similarities and differences with trends seen during the global financial crisis of 2007-2008 and its aftermath.
The figure above shows that, in contrast to the pandemic, the decline in CRE prices occurred across all sectors during the global financial crisis. Indeed, while the global financial crisis is typically associated with turbulence in the residential sector, the price decline for CRE at that time was actually steeper.

Given the enormity of the economic dislocation caused by the pandemic, with lockdowns shuttering businesses and unemployment surging to 15% — well above its peak during the global financial crisis\textsuperscript{10} — it is striking that the overall effect on CRE prices has been much less pronounced, at least so far.

To understand this, recall that prior to the global financial crisis, there was a frenzy of bullish expectations and expanded credit, and property prices, both commercial and residential, rocketed upward before they came crashing down when the bubble burst.\textsuperscript{11}

There was no analogous boom prior to the pandemic. Although CRE prices grew briskly in 2019, rising 8%, this growth is dwarfed by the run-up to the global financial crisis: 17% in 2004, 16% in 2005 and 11% in 2006. As prices did not inflate nearly as much prior to the pandemic, they had less far to fall.

Additionally, more active support from the government and less aggressive foreclosure activity by lenders have likely contributed to greater price stability for CRE during the pandemic.\textsuperscript{12}

Much of this activity by the Federal Reserve and Congress during the pandemic supported CRE indirectly by helping to soften the blow to consumer spending and the economy more generally. The Paycheck Protection Program, which provided businesses with favorable loans that could be used to pay rent, among other things, was likely of particular importance for CRE.\textsuperscript{13}

Finally, when thinking about the financial instruments that depend on CRE, the global financial crisis had a disparate impact on the performance of mortgage-backed securities backed by residential loans compared to those backed by commercial loans.

Even though the price decline was somewhat larger in the commercial sector, securities backed by commercial loans originated from 2004 to 2008 experienced 5% losses, compared to 16% for those backed by residential loans.\textsuperscript{14}

This better performance was likely due to the absence of a subprime commercial mortgage-backed securities segment, greater resistance to idiosyncratic shocks by commercial mortgages and the fact that initial losses on such securities are borne by a special servicer with a greater ability to resolve distress in the underlying loans.

The resilience of commercial mortgage-backed securities amid the steep CRE price decline during the global financial crisis suggests that they are likely to be resilient again during the fallout from the pandemic.
Conclusion

The COVID-19 pandemic’s impact on CRE has varied greatly by sector. At this point, it seems unlikely that the commercial sector will experience a repeat of the heavy litigation in the residential sector following the global financial crisis.

However, the fallout in the retail and hospitality sectors, and perhaps offices, too, over time may cause an increase in CRE disputes that are resolved by the courts, as loans and leases are disputed and creditors argue over how to manage the problems, an issue that could become complicated due to the widespread granting of forbearance during the pandemic.²

Resolving these matters will require understanding the idiosyncratic underlying factors affecting parties’ decisions in different sectors, and while lessons learned from the previous financial crisis can be valuable, it is important to recognize that this time, conditions and expectations are quite different.

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Endnotes

1 Sources: S&P Case-Shiller National Home Price Index and CoStar U.S. Composite Index.