keyway

What types of CRE are resilient in a downturn?

With the prospect of an uncertain economy, commercial real estate investors should evaluate their portfolio to manage risk during a potential downturn. To build a portfolio with steady returns, it's helpful to understand which types of real estate best withstand economic downturns. Keyway, the leader in technology-powered, small-scale real estate investing, analyzed which commercial real estate sub-sectors performed best during the Great Recession of 2008 to inform investors which sub-sectors may perform well in the current economic environment.

For months, commercial real estate transactions have slowed as a result of higher borrowing costs and wide bid-ask spreads. According to Real Capital Analytics, in 4Q 2022, transactions declined 61% year-over-year. This decline in transition volume has left many institutional investors and family offices on the sidelines until either borrowing costs subside or the bid-ask spread narrows.

Despite these macro headwinds, shrewd investors can deploy capital into real estate sub-sectors that are most resilient in an economic downturn.

To find which companies meet this criteria, we analyzed the Census Business Dynamics Statistics. Specifically, we examined exit rates – how often a company leaves a location, thereby forcing the landlord to find a new tenant – of various companies during and after the Great Recession (2007-2012). Using data from Yardi, we also analyzed occupancy rates and asking rents in the Dallas-Ft. Worth region from 2011-2012.

Multifamily — Class B and Class C

In the Great Recession, nearly 10 million people lost their homes to foreclosure, creating a glut of renters. In this housing downturn, there are a glut of renters – not necessarily due to home foreclosures – but due to persistently unaffordable home prices and limited supply.

Given this market dynamic, there is strong demand and growth for Class B and Class C multifamily properties. When we look at "months of negative estimated revenue growth" for multifamily properties in a downturn, we have observed certain types of properties rise to the top as stable investments. For example, Class B properties showed only eight months of negative growth from 2011-2022 — compared with 30+ for other property types.

Why? When a downturn happens and tenants experience financial pressure, tenants often "move down a rung" on the property ladder. That means those who lived in a Class A building might move to a Class B property. Similarly, Class B tenants relocate to a Class C building. As a result, Class A buildings have higher vacancies and lower asking rents. We've observed this trend over time in the Dallas-Ft. Worth region, where Class B and Class C buildings have shown the best net absorption rates over time.

At Keyway, we like to focus on Class B properties that not only show historic stability, but also serve an important role in communities by keeping affordable housing in desirable neighborhoods.

CLASS	MONTHS OF NEGATIVE ESTIMATED REVENUE GROWTH 2011-2022	ESTIMATED REVENUE CAGR 2011-2022
Class A to B+	33	4.92%
Class B	8	6.01%
Class C	14	5.88%

keyway

Nursing care, assisted living & residential care facilities

Nursing care, assisted living and residential care facilities — especially skilled nursing facilities and residential facilities for intellectual and developmental disabilities — showed a much healthier exit rate through the last downturn. Given 70% of people age 65 and older will need some type of long-term care during their lifetime, we expect even more stability in this subsector in the future.

What drives this stability? In addition to increased demand, these properties have relatively low exit rates, making them attractive long-term investments.

Doctors' and dentists' offices

At Keyway, we spend significant time analyzing physicians' and dentists' offices, both of which have a better overall exit rate than our control group.

With both physicians' and dentists' offices, the size of the practice is correlated with exit rates. For example, smaller practices of one to four employees have the highest exit rate (8-12%). Given the low headcount, the departure of one or more employees due to attrition or retirement could cause the practice to move locations.

We also observed higher exit rates among larger companies of 100+ employees. Why? These larger organizations make strategic decisions about individual practice locations based on profitability or staffing, which can lead to moving locations more regularly.

The sweet spot for both physicians' and dentists' offices is the mid-sized, regional practices that have 5-100 employees. These practices generally remain in their locations, creating long-term stability for their landlords. For example, dentists' offices with 5-99 employees have an exit rate of only 0.7%.

Interestingly, dental practices are more stable than physicians' practices, with lower exit rates.

Warehouses

While warehouses did slightly better than our control group of retail trade and professional services, warehouses can perform better in a downturn relative to other industrial properties.

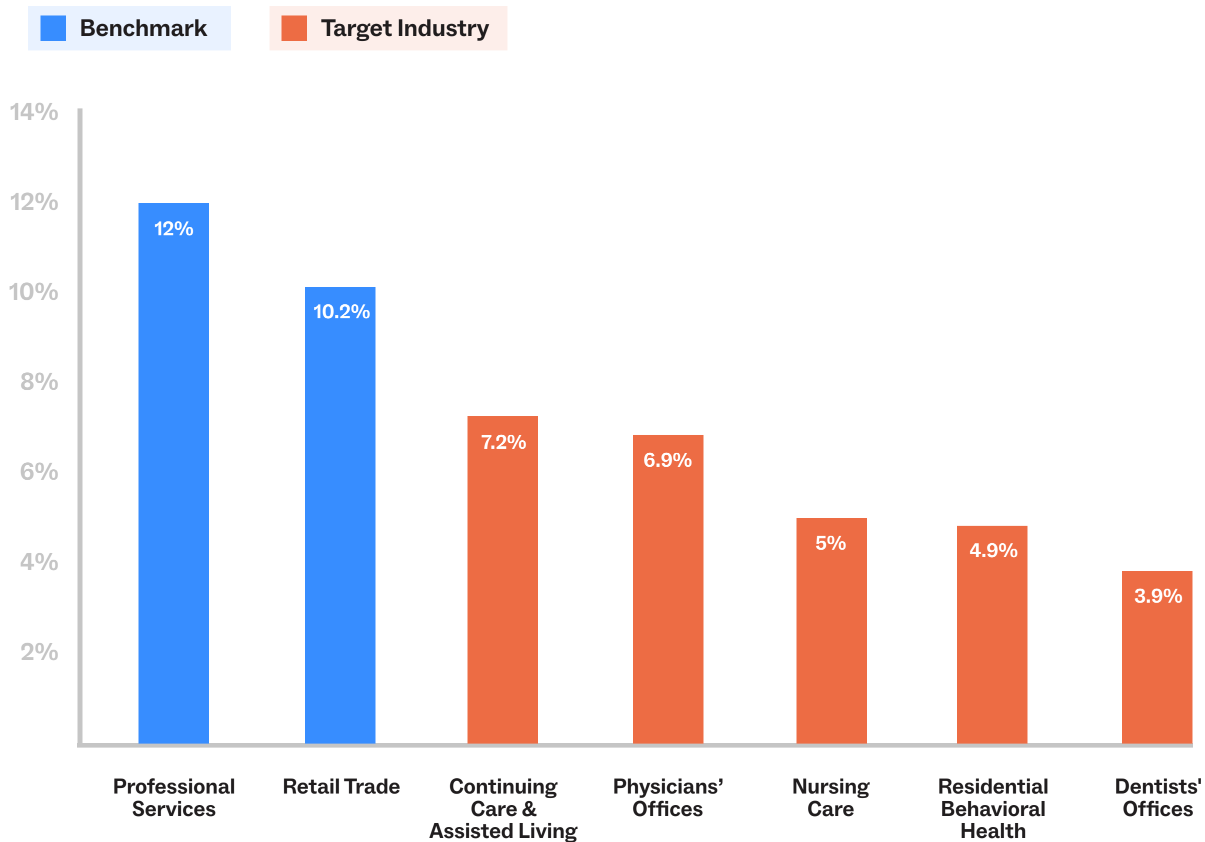
For example, in the Great Recession, **warehousing businesses experienced a 42.4% five-year survival rate, which is higher than its industrial peers.**

Like with doctors' and dentists' offices, we observed similar trends for warehouses based on the size of a company. Small companies have much higher exit rates, while the mid-sized and large-sized companies show more stability.

keyway

Overall Exit Rate:

2008-2012



Exit Rate based on # of employees in company:

2008-2012