National Association of REALTORS®

COMMERCIAL REAL ESTATE OUTLOOK: 2018.Q3

COMMERCIAL Real Estate

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Commercial Real Estate Outlook: 2018.Q3

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2018.Q3

1 | ECONOMIC OVERVIEW

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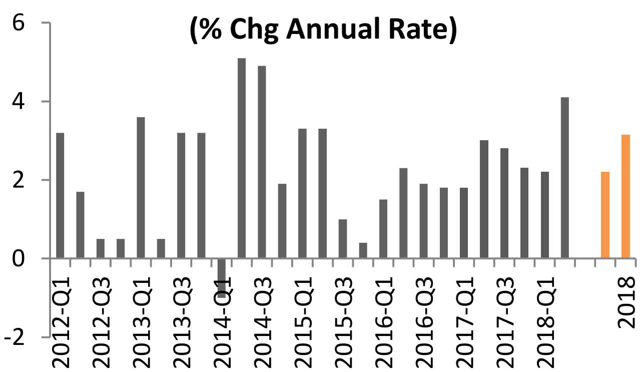
Gross Domestic Product

The economy expanded at a stronger pace of 4.1 percent in 2018 Q2 (first estimate), the strongest expansion since 2014 Q3 (4.9 percent). Growth strengthened due to stronger consumption, exports, and government spending while investment spending rose at a slower pace.

Exhibit 1.1: Real GDP (% Chg Annual Rate)



Source: BEA

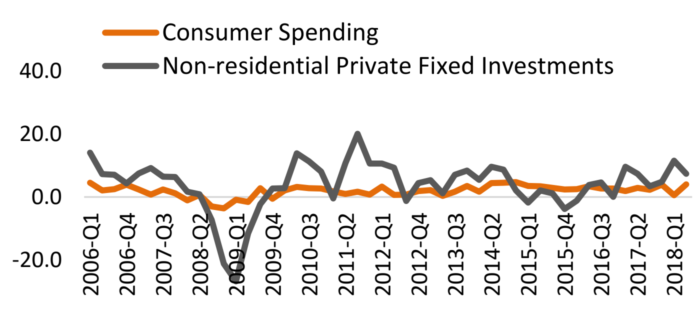
Private consumption spending—which accounts for 69 percent of GDP— expanded at a stronger pace of 4.0 percent in 2018 Q2, the strongest pace since 2015. Compared to the pace of change in the first quarter, spending rose at stronger pace for all types of consumer goods, except for gasoline/fuel/oil/other energy. The Conference Board's Consumer Confidence Index also indicated an improvement in consumer confidence, with the index at 127.4 in July 2018, up from one year ago (120).

On the other hand, private fixed investment spending expanded at a slower pace of 5.4 percent as non-residential investment rose at a slower pace compared to the growth in Q1 and as residential investment spending contracted.

Private non-residential fixed investment spending rose 7.3 percent, a slower pace compared to the first quarter (11.5 percent), as investments in industrial equipment contracted, at -2.2 percent. The strongest expansions were in structures (e.g., buildings), at 8.5 percent, and information processing equipment, at 10.2 percent.

Private residential investment contracted 1.1 percent in 2018 Q2. The number of building starts—another indicator of residential investment — slightly declined to a seasonalized annual rate of 1.168 million units in July 2018, down from 1.185 million units one year ago. Labor, land, financing, and raw material costs are cited by home builders as the main headwinds facing residential construction.

Exhibit 1.2: GDP - Real Consumer Spending & Business Investments (% Chg Annual Rate)



Source: BEA, SAAR, Bil.Chn.2009$

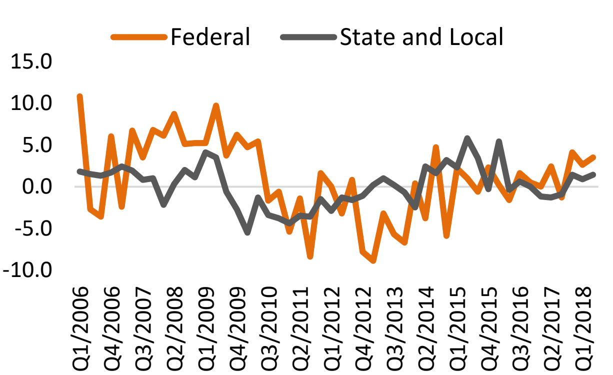
Both exports and imports rose at a stronger pace in 2018 Q2 compared to the pace in Q1. Exports expanded by 9.3 percent, while imports rose at a more modest pace of 0.5 percent, resulting in a smaller deficit in exports of goods and services.

Exhibit 1.3: Real Exports & Imports (% Chg Annual Rate)

Source: BEA, SAAR, Bil.Chn.2009$

Federal and state/local consumption and investment spending rose modestly by 2.1 percent (1.5 percent in Q1). Federal spending rose 3.5 percent while state and local spending increased 1.4 percent. Government spending has been a weak source of growth compared to private consumer and investment spending and exports.

Exhibit 1.4: Real Government Spending (% Chg Annual Rate)

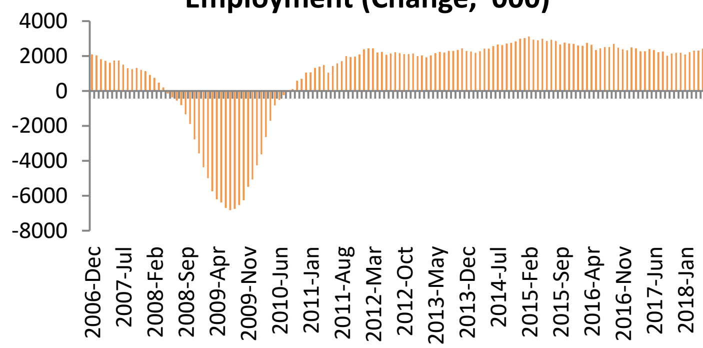


Source: BEA, SAAR, Bil.Chn.2009$

Employment

Employment conditions remain healthy. During the 12-month period of August 2017–July 2018, there were 2.4 million payroll jobs added, more than the 2.2 million jobs that were added in the same 12-month period one year ago. The economy has been steadily adding employment since October 2010.

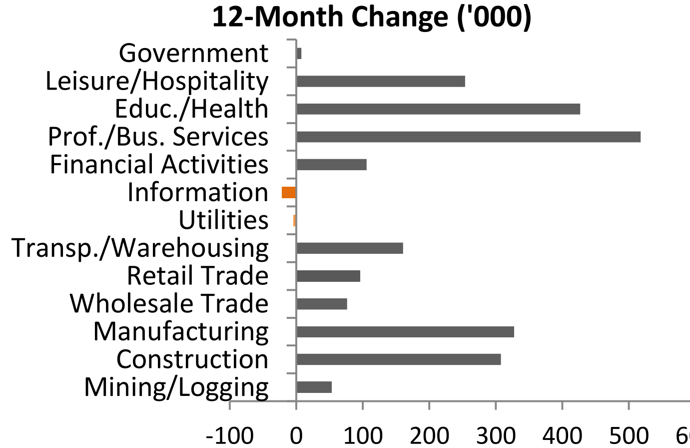
Exhibit 1.5: 12-Month Payroll Employment (Change, '000)



Source: BLS

During the 12-month period of August 2017–July 2018, employment expanded in all sectors, except information services (-21,000) and utilities (-3,000). Retail trade, which has lost jobs in the past, generated 96,000 jobs.

Exhibit 1.6: Payroll Employment: 12-Month Change ('000)

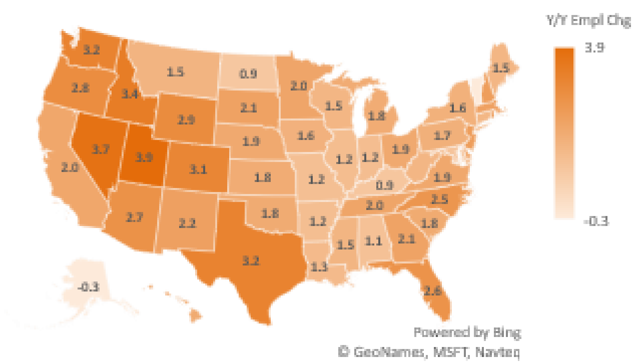


Source: BLS

2018.Q3

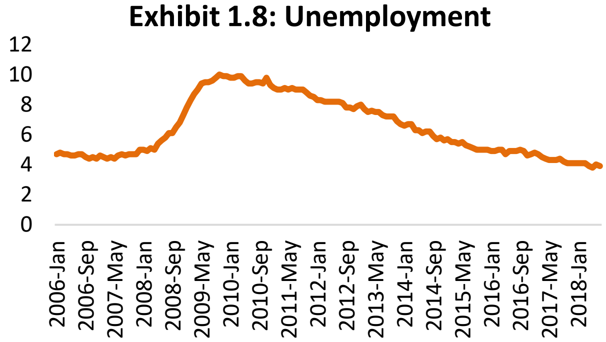
The West and South regions have experienced the strongest gains in non-farm employment. In July 2018, employment increased at the fastest pace from year-ago levels in Utah, Nevada, Idaho, Texas, Washington, and Colorado, with employment growing at above three percent. Employment increased in all states except Alaska. Nationally, non-farm employment rose two percent in July 2018 from the level one year ago level,

Exhibit 1.7 Change in Employment in July 2018 Compared to One Year Ago



The labor market continues to tighten. The unemployment rate dropped below four percent, to 3.9 percent in July 2018. The unemployment rate has hovered at four percent since April 2018.

Exhibit 1.8: Unemployment

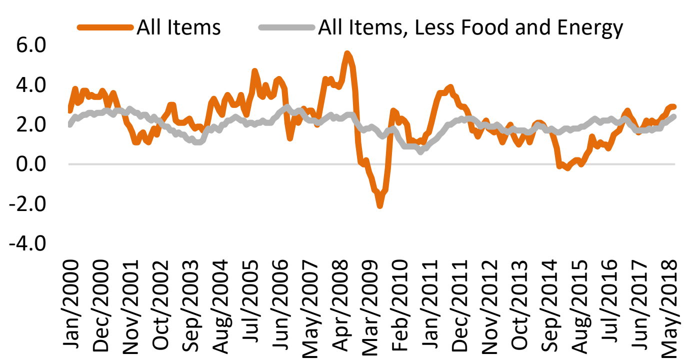


Source: BLS

Inflation and Interest Rates

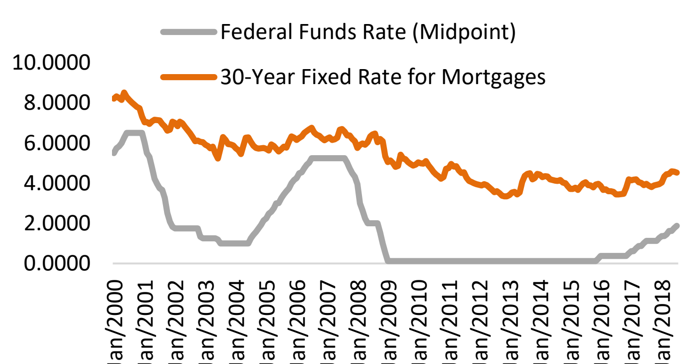
With sustained growth, inflation has trended up. In July 2018, prices for all items (CPI) rose 2.9 percent from the levels one year ago. Core inflation, which measures the change in prices other than food and energy, rose to 2.4 percent. The Federal Open Market Operations Committee (FOMC) seeks to keep inflation at two percent when setting the federal funds rate target. FOMC has raised the federal funds target range twice this year, to a range of 1.75 to two percent in June 2018, an increase of 50 basis points since January 2018. With the higher target, the 30-year fixed rate for mortgages rose to an average of 4.53 percent in July 2018 (3.97 percent in July 2017).

Exhibit 1.9: Inflation



Source: BLS

Exhibit 1.10: Interest Rates



Source: FRB, Freddie Mac

2 | COMMERCIAL REAL ESTATE INVESTMENTS

Commercial space is concentrated in large buildings, yet large buildings are a relatively small number of the overall stock of commercial buildings. Based on Energy Information Administration data approximately 72 percent of commercial buildings are less than 10,000 square feet in size.[1] An additional eight percent of commercial buildings are less than 17,000 square feet in size. In short, the commercial real estate market is bifurcated, with the majority of buildings (81 percent) relatively small (SCRE), but with the bulk of commercial space (71 percent) in larger buildings (LCRE).

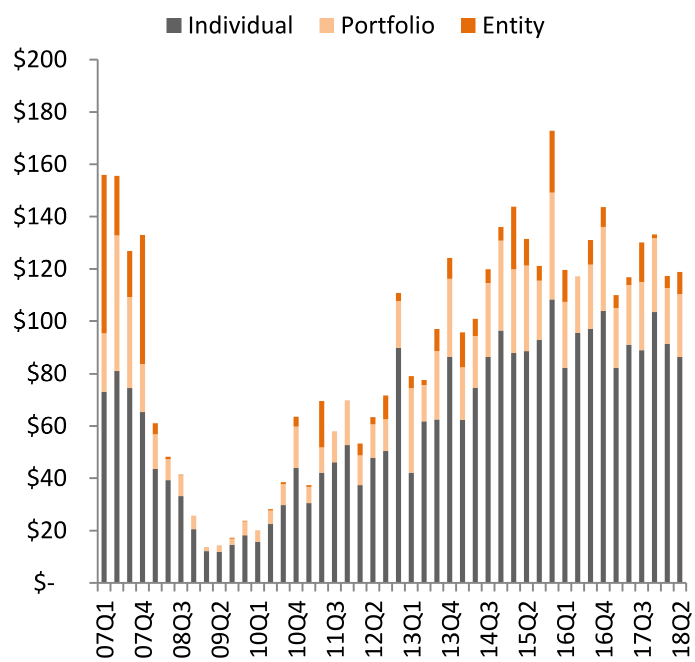
Likewise, commercial sales transactions are measured and reported based on deal value. Commercial deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their values. However, these smaller properties comprise the backbone of daily economic activity—e.g. neighborhood shopping centers, warehouses, small offices, supermarkets, etc. Given the importance of these buildings to local communities, and REALTORS®' active roles in serving these markets, this report focuses on illuminating trends in both large and small markets.

Large Cap Commercial Real Estate Markets

The first half of the year confirmed the maturation of the current real estate cycle. Investors have become more disciplined in the acquisition process, as rising interest rates are squeezing the spread between cap rates and long-term bonds. In addition, faced with declining sales, sellers have been adjusting their price expectations and have started to close the noticeable pricing gap of the past two years.

After the two-year decline in sales volume, investments in LCRE markets posted increases in both the first and second quarters of this year.

Exhibit 2.1: CRE Sales Volume ($2.5M+)



Source: Real Capital Analytics

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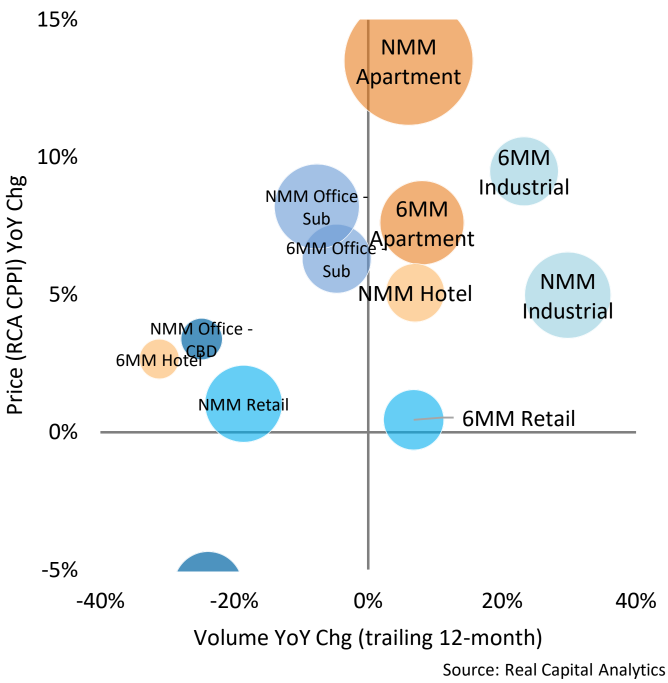
[1] Smith and Ratiu, (2015), "Small Commercial Real Estate Market," National Association of REALTORS®

2 | COMMERCIAL REAL ESTATE INVESTMENTS

Investment volume in the large cap space reached $236.1 billion in transactions by the midpoint of this year, a 4.1 percent advance compared with the same period in 2017, according to Real Capital Analytics (RCA). Deal volume proved mixed across property types, with momentum shifting further toward industrial and apartment properties in both major and secondary markets.

Apartment sales accounted for the largest share of transactions—29 percent—with $34.5 billion in closed transactions, based on RCA data. However, the second quarter of the year saw apartment deal volume post a seven percent decline year-over-year.

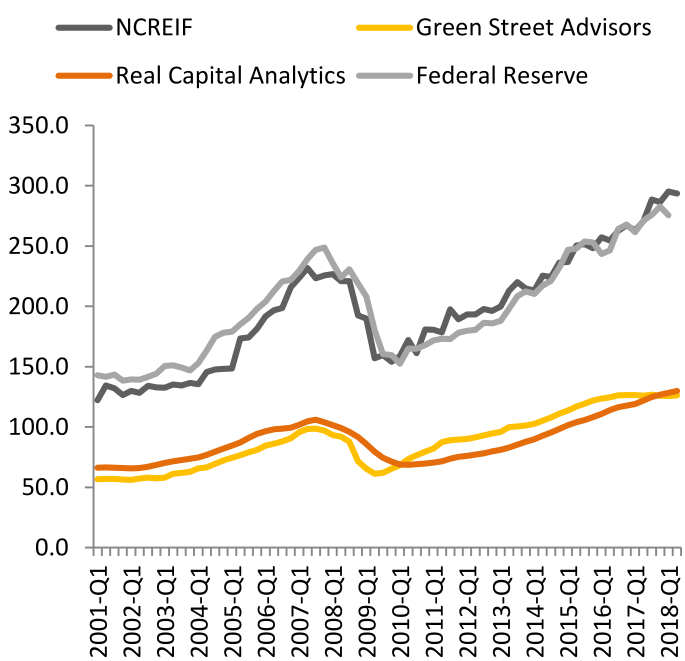
Exhibit 2.2: Sector Momentum - Major vs Non-Major Metros



Office properties accounted for almost one-in-four transactions during the quarter, with $28.8 billion in sales. However, office investment volume faltered, with a 17 percent decline. The sector seemed to be undergoing a rebalancing, with Central Business District properties experiencing waning interest, while suburban office properties regained their attractiveness.

The retail sector closed $20.7 billion in sales during the second quarter, an increase from the same period in 2017. However, the advance was mostly driven by Unibail Rodamco's acquisition of the Westfield portfolio, as single asset sales mirrored investor concern over the general direction of the retail space. Industrial properties remained on a strong upward trend, with sales totaling $18.2 billion in the second quarter, up 17 percent from the prior year.

Exhibit 2.3: Commercial Property Price Indices



Prices in LCRE markets advanced 6.5 percent year-over-year in the second quarter of 2018, according to RCA's Commercial Property Price Index. All property types posted higher prices during the quarter, with the apartment and industrial properties recording higher comparative gains of 11.6 percent and 6.5 percent, respectively.

Exhibit 2.4: NCREIF Property Index Returns—2018.Q2

NATIONAL	1.81%
OFFICE	1.54%
INDUSTRIAL	3.58%
RETAIL	1.32%
APARTMENT	1.54%

Source: National Council of Real Estate Investment Fiduciaries

Other commercial real estate price indices posted mixed trends. The Green Street Advisors Commercial Property Price Index—focused on large cap properties—was virtually flat, with a 0.4 percent gain on a yearly basis during the second quarter, at a value of 126.3. The GSA index has flattened for the past several quarters. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased 8.5 percent on a yearly basis during the second quarter, accelerating from the prior quarter's 7.1 percent gain.

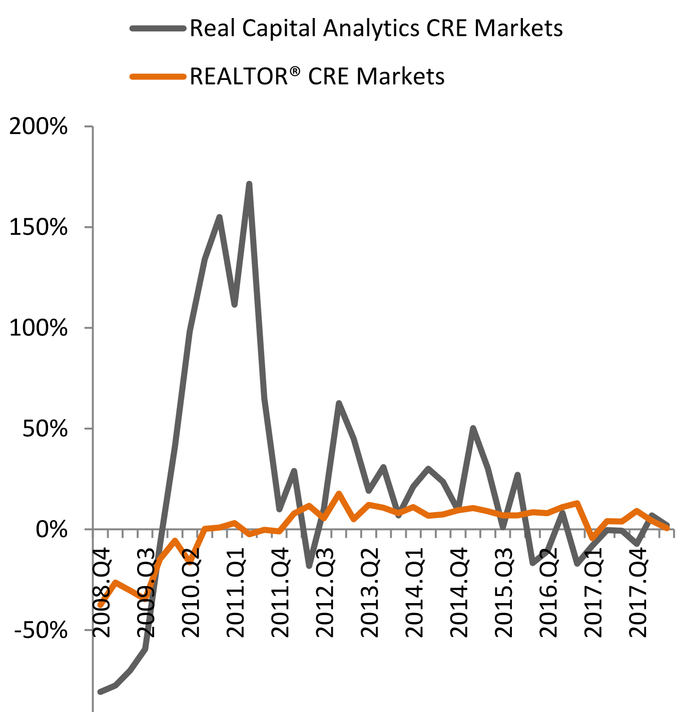
Cap rates spent the first half of the year continuing on a sideways trend, in a narrow range of 6.7-6.8 percent, according to RCA. Apartments continued experiencing slight cap rate compression, with an average of 5.5 percent in the second quarter. Industrial transactions also posted a minor decline in cap rates, at an average of 6.4 percent. Office and hotel sales saw increases in average cap rates, while retail deals retained an average rate of 6.5 percent in the second quarter, on par with last year.

Small Cap Commercial Real Estate Markets

The second quarter of the year marked a slowdown in investment volume gains in the small cap space. Commercial real estate sales in SCRE markets increased by 0.5 percent from the same quarter in 2017. The slight advance stood in contrast to the 4.9 percent average second-quarter increase typical of the previous five years.

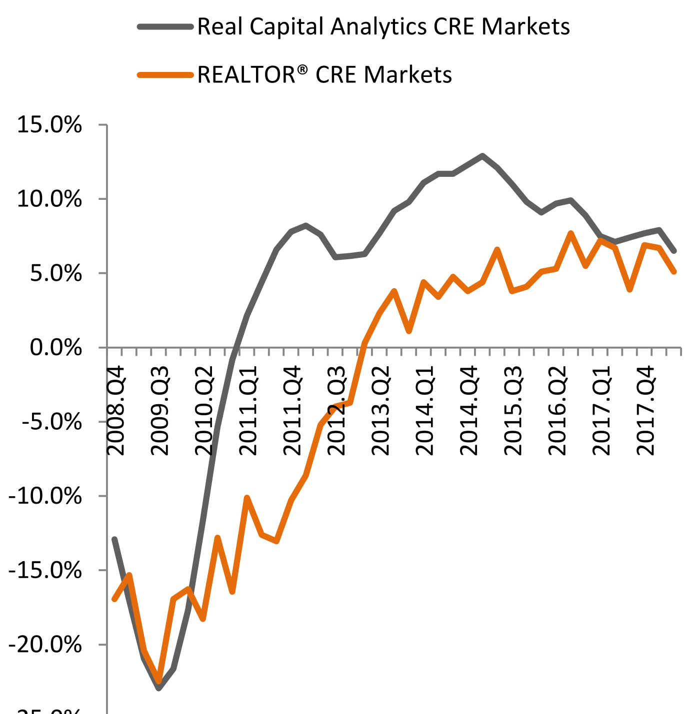
The figure may portend a broader slowdown, mirroring the LCRE markets trend, with a two-year lag. The shortage of available commercial inventory remained ranked as the top concern for REALTORS®, likely impacting deal volume. Almost half of respondents to a market survey ranked tight inventory as the number one issue affecting their markets.

Exhibit 2.5: Sales Volume (YoY % Chg)



Sources: National Association of REALTORS®, Real Capital Analytics

Exhibit 2.6: Sales Prices (YoY % Chg)



Sources: National Association of REALTORS®, Real Capital Analytics

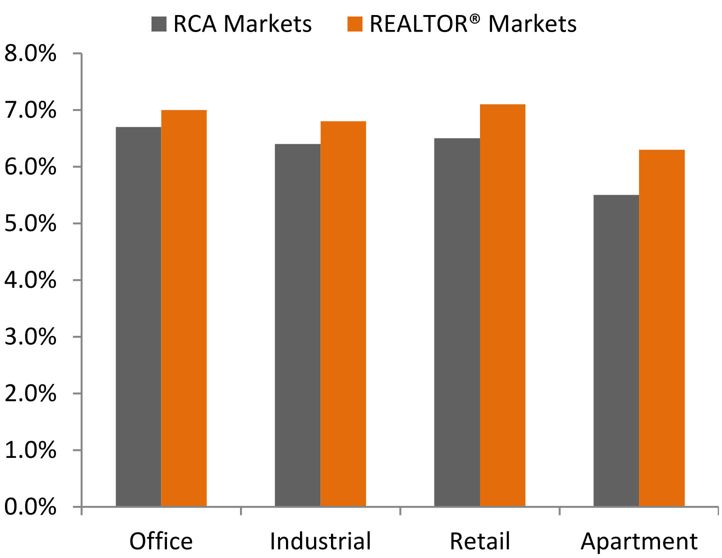
The inventory squeeze continued exerting upward pressure on prices in SCRE markets, to the tune of a 5.1 percent yearly advance in the second quarter of this year. In turn, the pricing gap between buyers and sellers proved the second highest ranked concern for commercial practitioners, reported by about one-in-five members.

Capitalization rates in SCRE markets moved sideways in the second quarter of 2018, at an average of 6.8 percent. Compared with the prior year, cap rates declined 46 basis points.

International transactions remained a fixture in REALTORS®' CRE markets in the final quarter of the year, accounting for 12.0 percent of responses to a survey. The average international sale price was $2.5 million in the second quarter of the year. Indicating a likely preference for safety of capital over returns, the average cap rate for SCRE international deals was 6.7 percent.

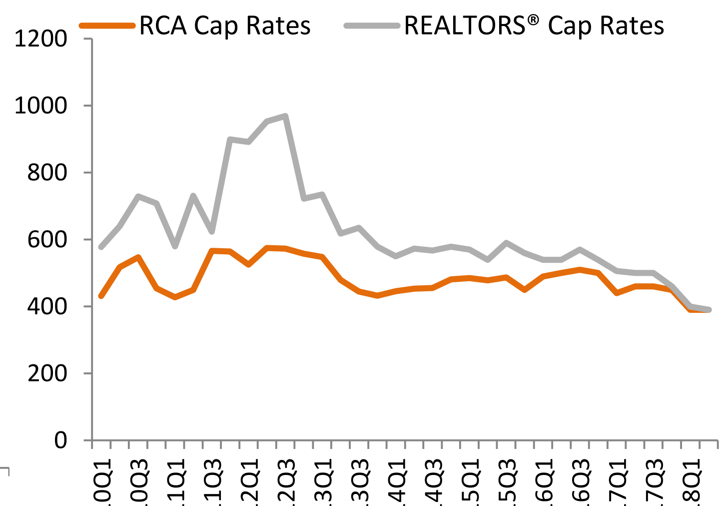
Longer-dated bond yields advanced over the first half of 2018. The Treasury 10-year note started the year at 2.6 percent, and rose to 2.9 percent by August of this year. As the Federal Reserve is expected to continue raising the short-term rate, longer termed bonds should continue feeling upward pressure. The upward trajectory of 10-year Treasuries, coupled with a flat cap rate movement, has begun to narrow the spread between the two. In the second quarter, the spread dropped below 400 basis points, a noticeable decline from the over 570 basis points registered in 2012.

Exhibit 2.7: Cap Rates - 2018.Q2

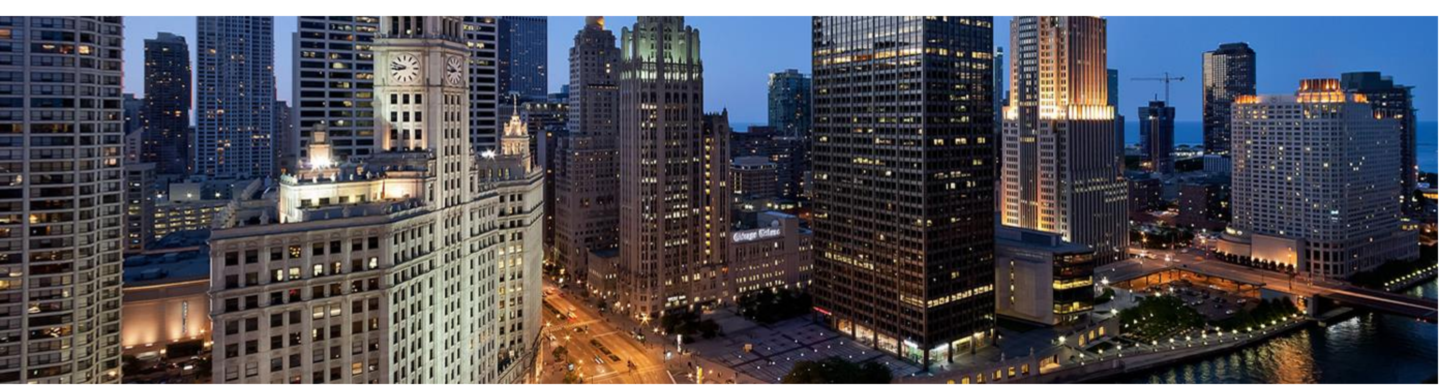


Sources: National Association of REALTORS®, Real Capital Analytics

Exhibit 2.8: CRE Spreads: Cap Rates to 10-Yr. T-Notes (bps)



Sources: National Association of REALTORS®, Real Capital Analytics



3 | COMMERCIAL REAL ESTATE FUNDAMENTALS

Large Cap Commercial Real Estate Markets

The commercial fundamentals in LCRE markets continued to provide solid performance during the second quarter of 2018, benefitting from strong economic tailwinds. While demand maintained course, market metrics were more nuanced across the core property sectors.

The second quarter of 2018 witnessed solid demand for office space, driven by continued employment gains in office-using industries. Net absorption of office spaces totaled 15.5 million square feet during the quarter, according to CBRE. On the supply side, completions remained strong, with over 10 million square feet of new space finished during the quarter. According to CBRE, a majority of newly-finished space was preleased, as tenants continue to seek quality work accommodations. Reflecting the demand-supply balance, the office vacancy rate slid to 13.0 percent. The asking rent for office space nationally averaged $32.58 per square foot, a 1.3 percent increase from a year ago.

Boosted by strong consumer spending and trade, the industrial sector experienced another quarter of gains in fundamentals. Industrial net absorption totaled 58.8 million square feet during the second quarter, according to CBRE data. The solid demand outpaced new deliveries, even as new supply rose 7.5 percent from the second quarter of 2017. Completions totaled 48.9 million square feet, leading to a decline in the vacancy rate, to 4.4 percent. Industrial asking rents advanced in the second quarter to $7.11 per square foot, a 5.5 percent year-over-year increase, and the highest level since 1989.

As the unemployment rate and rising wages have buoyed consumer optimism, retail spending registered a noticeable gain. Some of that spending translated into a net of 4.5 million square feet of retail space absorbed during the second quarter, according to CBRE. The figure was slightly lower than the first quarter, as store closures continued to affect the mall landscape. Retail construction activity declined to the lowest level since the first quarter of 2012, as completions totaled 7.0 million square feet. The retail availability rate moved sideways, at 6.5 percent in the fourth quarter, as asking retail rents reached $17.37 per square foot, a 5.1 percent increase year-over-year.

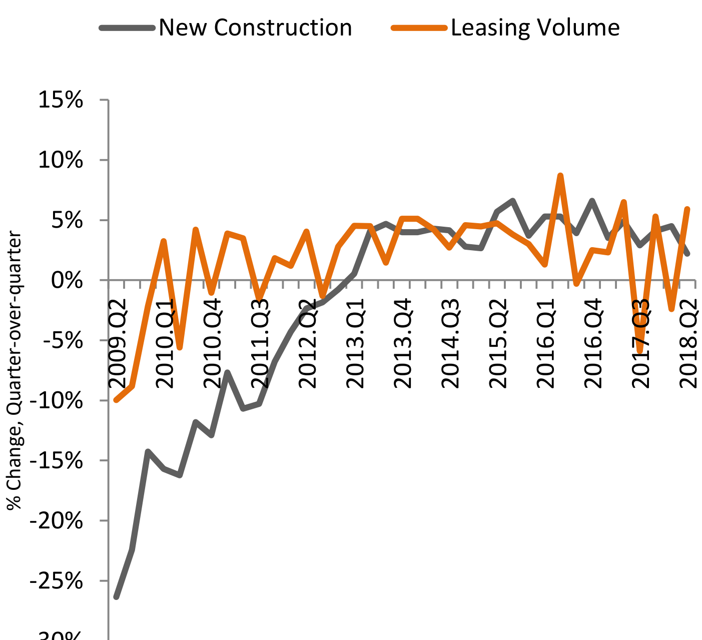
An improving employment environment and growing population continue to favor demand for housing. With residential pricing remaining strong and a market influenced by tight inventory, the apartment sector continued to experience favorable conditions in the second quarter of the year. Net absorption of multifamily space totaled 249,000 units over the 12 months ending in June 2018, according to CBRE. Construction of multifamily properties maintained momentum, with 276,000 units delivered over the same period. The national vacancy rate inched up 10 basis points from a year ago, to an average of 4.7 percent. Apartment effective rents rose 2.0 percent year-over-year, to an average of $1,685 per month during the quarter.

Small Cap Commercial Real Estate Markets

Commercial fundamentals in REALTORS®' markets notched a quarter of gains, following a softer first quarter. Leasing volume advanced by 5.9 percent from the preceding quarter, as demand for space remained solid in small cap markets. New construction rose by 2.2 percent from the prior quarter, as developers in SCRE markets faced rising construction costs. Leasing rates increased by 1.8 percent, as concessions declined 2.8 percent.

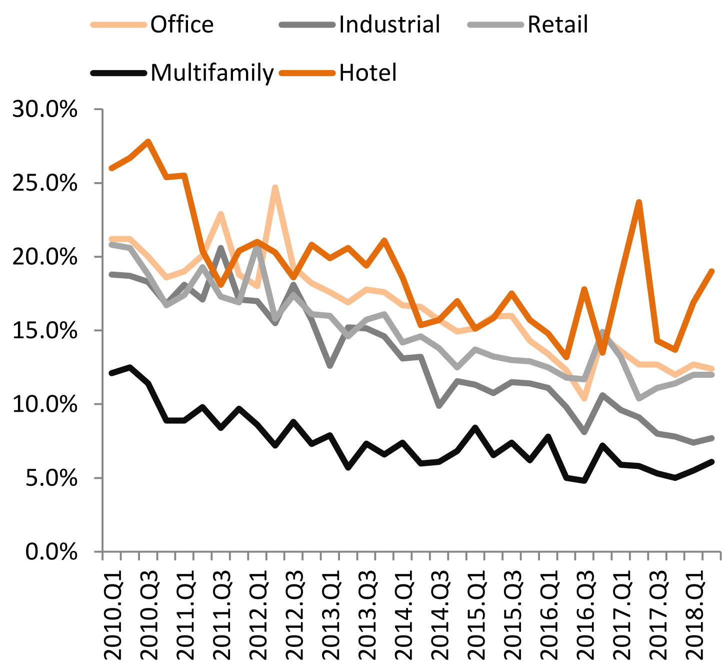
Vacancy rates reflected the mixed conditions of the core property types. The office and industrial vacancy rates declined 30 basis points and 140 basis points, respectively, from a year ago. Retail properties experienced higher vacancies, averaging 12.0 percent in the second quarter. Multifamily spaces contended with rising supply, which pushed vacancy rates up 30 basis points, to 6.1 percent.

Exhibit 3.1: REALTORS® Fundamentals



Source: National Association of Realtors®

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

Tenants in REALTORS®' markets remained focused on smaller footprints. In the second quarter, the '5,000 square feet and below' segment accounted for 75.0 percent of activity. The '5,000 – 7,499 square feet' segment accounted for 5.0 percent of activity during the quarter, similarly to the '10,000 – 49,999 square feet' segment's 6.0 percent. The '50,000 square feet and above' segment comprised 4.0 percent of total activity.

4 | OUTLOOK

Economy

NAR forecasts economic output to expand at a stronger pace of 3.0 percent in 2018. This forecast factors in the increased consumer and investment spending arising from the tax changes under the Tax Cuts and Jobs Act, which includes a reduction in the corporate tax rate from 35 percent to 21 percent. Payroll employment is projected to increase 1.7 percent for the year, which would push the unemployment rate down to 3.9 percent. Inflation is expected to accelerate to 2.9 percent, as the economy continues to reach its full capacity and as oil prices continue to recover. NAR forecasts the prime rate to hit 4.9 percent and the 30-year government bond rate to move up to 3.2 percent for the year. NAR expects monetary policy to continue to tighten in 2019, but at a cautious pace.

	2016	2017	2018	2019
Annual Growth Rate, %				
Real GDP	1.6	2.2	3.0	2.7
Nonfarm Payroll Employment	1.8	1.6	1.7	1.5
Consumer Prices	1.3	2.1	2.9	2.7
Level				
Consumer Confidence	100	121	127	125.0
Percent				
Unemployment	4.9	4.4	3.9	3.9
Fed Funds Rate	0.4	1.0	1.8	2.6
3-Month T-bill Rate	0.3	1.0	1.9	2.5
Prime Rate	3.5	4.1	4.9	5.6
10-Year Gov't Bond	1.8	2.3	3.0	3.5
30-Year Gov't Bond	2.6	2.9	3.2	3.7

Source: National Association of REALTORS®

Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

	2017.Q2	2017.Q3	2017.Q4	2018.Q1	2018.Q2	2018.Q3	2018.Q4	2019.Q1	2019.Q2	2019.Q3	2019.Q4	2020.Q1	2017	2018	2019
Office	12.7	12.7	12.0	12.7	12.4	13.2	13.2	13.1	13.0	12.8	12.8	12.7	12.8	12.9	12.9
Industrial	9.1	8.9	7.8	7.4	7.7	7.5	7.4	7.2	6.9	6.7	6.5	6.7	8.8	7.5	6.8
Retail	10.4	12.1	11.4	12.0	12.0	12.0	12.1	12.1	11.9	12.1	12.3	11.7	11.8	12.0	12.1
Multifamily	5.8	5.3	5.0	5.5	6.1	6.3	6.4	6.3	6.4	6.5	6.6	5.4	5.5	6.1	6.4

Source: National Association of REALTORS®

With economic output and employment trends continuing on an expansionary path, commercial fundamentals are expected to exhibit solid demand and increasing cash flows. Vacancy rates will likely provide mixed results, with multifamily undergoing growing availability from an expanding supply pipeline. Office and retail properties will likely see vacancies move sideways, while industrial spaces will find rent growth advancing at a steady pace.

On the investment side, rising interest rates will continue to add upward pressure on investment yields. The Federal Reserve has indicated that it is committed to unwinding its balance sheet and, as consumer prices rose by close to 3.0 percent in August, will continue with several rate increases in 2018 and 2019. Most analysts are expecting another two rate hikes this year, and three-to-four next year.

For commercial investments, the trends have already shown in pricing. Cap rates seem to have found a floor, and for some property types, have already begun to turn upward. In SCRE markets, price gains will likely continue during the latter half of 2018, mostly due to the inventory shortage. However, the momentum is moderating, and beginning to converge toward that of LCRE markets.

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