IPA Institutional Property Advisors
A Division of Marcus & Millichap

Special Report

Presented by John Abuja, Senior Director

Commercial Real Estate Outperforms as Volatility Grips Stock Market

International uncertainty hits Wall Street. Globalization, real time information and interconnected capital markets offer investors a wide array of options, but as recent market turbulence reiterated, sparks of uncertainty can rapidly circumnavigate the globe. China's currency devaluation and collapsing Shanghai Stock Exchange kicked off a surge of volatility that struck U.S. equity markets, driving the S&P 500 down by nearly 10 percent in a week and pushing the S&P Volatility Index (VIX) to its highest level since 2011. The ensuing flight to safety tightened yields on the U.S. 10-year Treasury dramatically, pushing returns to the 2 percent range.

Sound U.S. economy remains a stable foundation. Recent stock market turbulence reflects global uncertainty rather than U.S. economic performance, which remains positive. Indicators including job creation, consumption and the housing market continue to post steady gains, reiterating that core economic trends will reinforce solid growth. Though there is some risk that an international shock-level event could create contagion and cause the economy to stumble, the probability remains minimal. A silver-lining benefit of the recent turbulence is that it restrained the Fed from raising rates until December or even 2016.

Commercial real estate offers compelling options. Underlying demand drivers including job formation, strong demographic trends, and consistent retail sales growth reinforce the outlook for commercial real estate investments. Vacancies have tightened for all major property types as steady demand has outstripped new supply in most markets. Robust rent growth will remain a positive driver as investors consider future yields. As a result, transaction activity has risen and it will likely surpass the record levels of 2006 this year. Tightened U.S. Treasury rates could suppress capital costs, widening yield spreads for investors using leverage.

Drivers Supporting Commercial Real Estate Investments

- The U.S. economy has added nearly 1.5 million jobs this year, maintaining broad demand for commercial real estate
- New construction for most property types remains low given the current stage of the cycle
- Falling gas prices, a tightening unemployment rate and rising wage pressure will boost discretionary income
- Strong corporate performance underpins demand for office space as residual space is burned off
- Favorable demographics and pent-up demand will support the housing sector - both apartment and for-sale housing
- Rising consumption and emergence of Internet retail lift industrial demand at major hubs and in local markets
- Steady gains in both business and leisure travel generating record-setting hospitality performance
- Specialty commercial real estate including self-storage and seniors housing performing well as limited construction amplifies positive demand drivers
- Competitive commercial real estate yields benefit from low interest rate environment
- Influx of domestic and international capital seeking security of hard assets boost commercial real estate liquidity and support increased property values

2015 Second Quarter Vacancy Trends

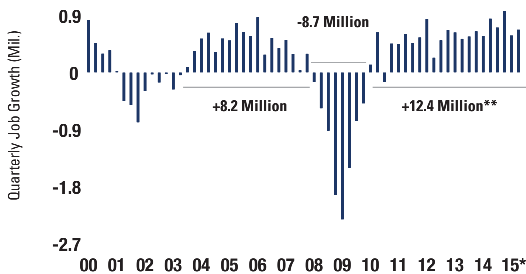
Apartments:
down 40 bps year over year
Vacancy lowered to 4.0 percent as net absorption dramatically outpaced the nearly 100,000 units completed in the first half of 2015.

Industrial:
down 70 bps year over year
The vacancy rate nationwide reached its tightest level since 2000, contracting to 6.9 percent on steady quarterly absorption in excess of 50 million square feet.

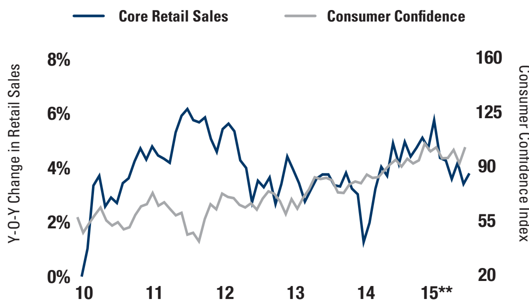
Office:
down 30 bps year over year
With a slow but steady recovery, office vacancy edged lower to 15.3 percent as the sector benefited from still-limited construction.

Retail:
down 50 bps year over year
The national retail vacancy rate improved to 6.4 percent as limited construction supported broad-based tightening. Multi-tenant vacancies have contracted to 7.8 percent.

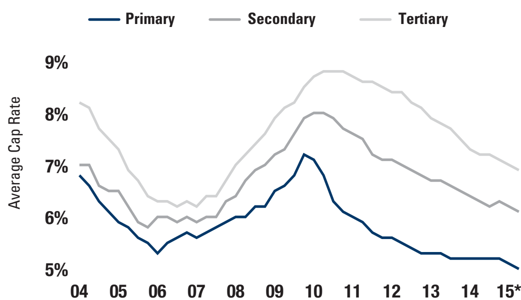
Steady Hiring Underpins Strong Commercial Real Estate Performance



Core Retail Sales Advance As Consumer Confidence Rises



Apartment Cap Rates Compress As Capital Flows Beyond Core



** Through 2Q*
*** Through August*
Sources: BLS; CoStar Group, Inc.; Census Bureau; U.S. The Conference Board; Real Capital Analytics

Economy Maintains Growth Trajectory; Global Uncertainty a Modest Risk

Recent market turbulence largely reflects international uncertainty – not U.S. economic performance. China's currency devaluation and stock market plunge in recent weeks triggered the reaction as investors feared contagion and flattening U.S. growth prospects. Considering that only 7.3 percent of U.S. exports go to China, risks to the economy are modest. The moderate pace of U.S. economic growth is working in favor of long-term prospects, and a wide array of indicators still point to additional momentum.

- Consistent, broad-based hiring has underpinned the growth cycle, and the prolonged momentum has supported the balanced progression of a wide range of economic drivers. The recovery has added 12.4 million positions to the economy, pushing total employment 3.7 million jobs higher than the previous peak. More than a million more jobs are anticipated this year.
- Demographics play an integral role in the economic outlook as millennials come of age. This 80 million strong age cohort exceeds the baby boom generation and is reshaping the economy with purchasing power that will surpass the boomers $3.0 trillion by 2018. Over two-thirds of these young adults live in rental households, a critical dimension boosting apartment performance.
- Retail sales now stand 20 percent higher than their pre-recession peak, and though momentum slipped in the second quarter, July generated a modest bounce. Rising consumer confidence should support retail gains, led by consumption patterns favoring the convenience of Internet retail and dining out at restaurants, the two largest retail growth segments.
- Inflation has remained in check as the modest pace of the growth cycle, reduced oil costs and the strong dollar have prevented overheating. Core inflation, which excludes energy and food costs, has been range-bound near 1.8 percent, below the Fed's 2.0 percent target, giving it considerable latitude in the timing of any rate increases

Apartment Performance Still Improving; Transactions Push Toward Record Levels

Apartment vacancies tightened in almost every major metro in the second quarter as the steady pace of hiring boosted demand nationwide. Following the addition 97,000 new units in the first half of the year, completions will accelerate, bringing total 2015 completions to 250,000 units. Some cities still have a significant development pipeline and will likely face softer performance in the second half of the year, but on a national basis, vacancies will only tick up modestly. Investor activity has edged up from last year, and if the trend holds, transactions will once again set a new peak. Interest has spread well beyond core metros, as pursuit of yield has bolstered transactions in secondary and tertiary markets. As a result, average cap rates have trended lower to the mid-5 percent range largely influenced by tightening yields in secondary and tertiary markets.

- Rent growth surged in most markets, pushing the national average gain up to 5.6 percent on a year-over-year basis through the second quarter.
- Upward pressure on vacancies will be most significant for Class A assets in submarkets with disproportionate construction activity. Class B and C properties will remain in high demand.
- Tightened Treasury rates and the Fed's decision not to lift rates in September will restrain interest rates and support steady investor demand, setting the stage for record transactional velocity.

Industrial Assets Benefit from Three Major Trends; Yields Hitting a Resistance Point

Industrial vacancies have tightened dramatically, reaching 6.9 percent in the second quarter, their lowest level since 2000. Construction has accelerated to meet demand with 145 million square feet anticipated this year, still 30 percent below pre-recession development levels. The sector is benefiting from the convergence of three major trends. Strengthened retail sales now stand 4.4 percent higher than the pre-recession peak on an inflation-adjusted basis. Likewise, international trade has grown by an inflation-adjusted 15.4 percent since 2008. The third significant factor has been the rise of e-commerce and rapid fulfillment services which has placed new demands on local storage and delivery infrastructure. These trends, which show no signs of abatement, will continue to pressure industrial space demand and entice investor interest.

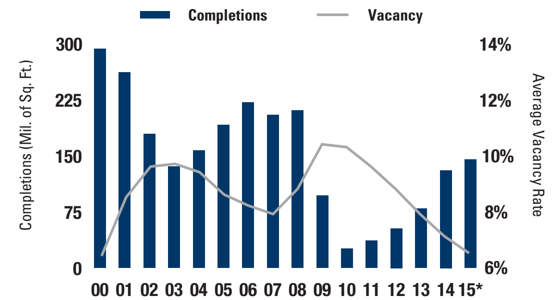
- Industrial investor activity has escalated, pushing past the 2007 transaction high, particularly in the private client segment under $10 million.
- Cap rates for industrial properties tightened modestly, to the mid-7 percent range, but movement has been limited in recent quarters.
- The cap rate spread between primary and tertiary markets has contracted from its 150-basis-point peak in 2012 to about 80 basis points as additional capital targeted smaller markets in the last three years.

Office Sector Maintains Momentum as Sound Performance Bolsters Transaction Activity

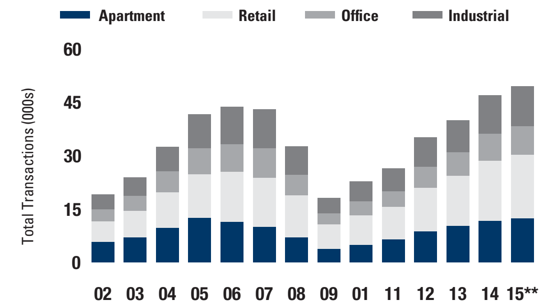
Although total office-using employment has surpassed pre-recession levels, the office sector has faced a slower than expected recovery because many companies reduced their space per employee allocations. Moderate construction levels have been instrumental in the recovery of the sector, with the 67 million square feet of office space expected this year totaling about half the annual deliveries prior to the recession. As of second quarter, vacancy rates stood at 15.3 percent, down 30 basis points from last year. Investors have responded to the positive supply/demand dynamics, boosting transaction activity to levels just shy of their pre-recession peak. Cap rates have trended down, reaching the low-7 percent range as of midyear, led by momentum in secondary and tertiary markets as primary market yields continue to flatten.

- As of the second quarter, national office rents increased 3.8 percent from last year, the strongest growth since 2008. The gains were led by Class B/C properties, which grew 4.5 percent.
- Vacancies have steadily tightened since 2010 with absorption outpacing construction each year. Total occupied space now stands 200 million square feet greater than the prior peak in 2008.
- Although average office cap rates have compressed, the spread to the 10-year Treasury remains greater than 500 basis points, offering investors considerable positive leverage potential.

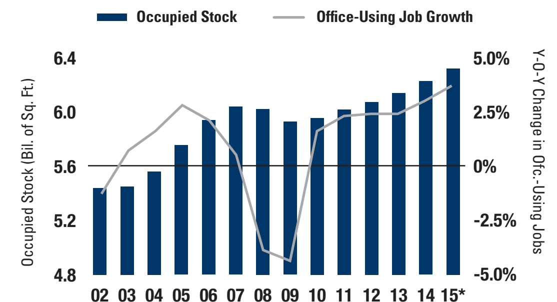
Industrial Vacancies Approach Record Lows Amid Modest Construction



Commercial Real Estate Transactions Push to Record Levels

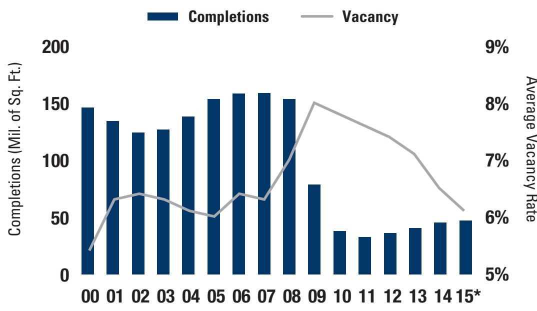


Occupied Office Space 200 Million Sq. Ft. Above Prior Peak

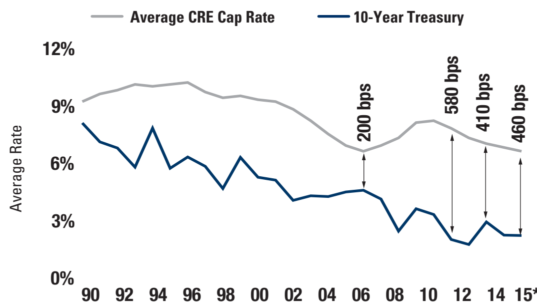


** Forecast*
*** Trailing 12-months through 2Q*
Sources: CoStar Group, Inc.; Real Capital Analytics

Limited Retail Construction Supports Performance Gains



Combined Commercial Real Estate Cap Rate Spread Over Treasury Still Wide



** Forecast*
*** As of August 28*
Sources: CoStar Group, Inc.; Real Capital Analytics; Federal Reserve

Still-Limited Development Pipeline Key to Continued Retail Performance Gains

Retail vacancy rates edged lower in a broad swath of markets across the country during the second quarter, pulling national vacancy lower by 10 basis points to 6.4 percent. The sector continues to benefit from limited new supply, with the 47 million square feet anticipated in 2015 totaling just one-third the volume delivered in years before the recession. Space demand will remain strong through the end of the year as retailers benefit from falling gas prices and rising consumer confidence, reinforcing investor appetite for these assets. Average Cap rates for single tenant properties have tightened to the low-6 percent range, depending on lease term and tenant quality, while average multi-tenant yields have compressed to the low-7 percent range. Investors will continue to pursue these assets as average national rents escalate back toward their 2008 peak levels.

- Single-tenant retail transactions have significantly surpassed their prior peak set in 2006, pushing cap rates to their lowest level on record. The recent stock market volatility will likely boost sales further as the value of stable returns becomes more appealing.
- Multi-tenant retail average per foot prices and transaction activity are both just shy of peak levels. Given the positive supply/demand dynamics and momentum, both measurements may reach new heights this year.
- Lower Treasury rate yields remain a silver lining of the recent volatility as wider spreads to cap rates broaden investor options.

Capital Markets Cautious but Active Amid Volatility; Fed Could Delay Rate Increase

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

An influx of both corporate bond and CMBS issuance over the last couple months stretched investors' appetite for fixed-income investments, setting the stage for additional caution when equity market volatility erupted. Spreads on CMBS offerings widened by 15-30 basis points amid the rising uncertainty, while life companies mitigated risk by establishing rate floors on their lending and by slowing their processes to await a calmer lending environment. Banks had already started to adjust their lending practices before the wave of volatility hit the market by shortening lending terms, favoring five to seven-year loans over longer options. Considering the significant stock market swings, lending proceeded with little interruption and mortgage rates have remained exceptionally low.

The surge of volatility that hit Wall Street sparked a rapid flight to safety into Treasuries. The yield on the 10-year Treasury dropped from about 2.2 percent to below 2.0 percent in four trading days. As the dust settled in the ensuing week, Treasury yields recovered, returning to the 2.2 percent range. The whipsaw performance contributed to the Federal Reserve's decision not to raise rates in September, but this is likely just a temporary delay. As international uncertainty eases, the Fed may reconsider a rate increase, but the strong dollar and flat inflation levels could inspire the Fed to hold Action until 2016.

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