CRE amid a dimmer outlook

Executive summary

The commercial real estate (CRE) market has continued growing at a moderate pace in the second half of the year, though significant risks remain. Resilience of the U.S. economy in the face of global pressures has provided a steadying hand to domestic property markets. Lower interest rates provide a tailwind for the CRE market in the short term, though they also offer a stark reminder that trade, geopolitical uncertainty and decelerating global growth each pose significant risks to this record-long real estate cycle.

Transaction volume in 2019 has so far fallen short of 2018 levels, and there are some warning signs that volatility may be impacting investor sentiment. Cross-border investment turned negative over the first six months of the year as foreigners became net sellers of U.S. property for the first time since 2012. Foreigners may be reading the late-cycle tea leaves, opting to move up the capital structure and invest in CRE debt rather than equity. Property prices continued their slow moderation, with year-over-year growth at 6.7% through August. While prices in each major sector have increased this year, the industrial sector is the only space that has seen the rate of price growth increase since last year.[1]

Lower interest rates have driven commercial mortgage rates down 100 bps since the beginning of the year, making debt financing even more attractive. The financing spread, or difference between an owner’s yield on a property and the cost of debt, has widened to cycle averages, providing a boost for property returns. Borrowers have started to, and will likely continue to, look to lock in low-cost fixed rate debt. While some may worry that lower rates could lead to increased leverage, it is key to remember that yields have been low for this entire cycle, and debt markets have remained healthy and disciplined. Loan-to-value (LTV) ratios are well below pre-crisis averages, and debt service coverage metrics remain near cycle highs.[1] We see well-functioning debt markets as a key driver of continued price growth in the CRE market.

Price growth in the CRE market continues to be lopsided on a sector basis, as the industrial sector has outpaced the rest of the CRE space with 12.2% year-over-year appreciation. Demand for industrial units continues to be robust, driven especially by last-mile distribution, while supply remains somewhat

1 Real Capital Analytics.

constrained. In the multifamily space, lower interest rates, which have driven down mortgage rates, have not necessarily caused a shift from renting to owning homes. While price growth has declined for the multifamily sector this year, demographics and a strong labor market are supportive for the sector.[1]

Our outlook for the rest of 2019 is for a continuation of the trends we have seen this year. As U.S. economic growth decelerates, property price growth will likely follow suit. Low interest rates should be a tailwind for the space, enabling attractive debt financing while combating any potential upward pressure on cap rates. However, risks linger. U.S.-China trade tensions remain a top concern and have already negatively impacted business investment. Further escalation could impact demand for real estate. Additionally, there is risk that market volatility could deal a blow to sky-high consumer sentiment, pressuring rent levels at a time when they are a critical component of real estate returns.

Macro view: U.S. economy settles into lower normal

KEY TAKEAWAYS

- U.S. economy remains solid; trade a headwind.
- Plummeting yields reflect broad growth uncertainty.
- Construction spending continues to be constrained.

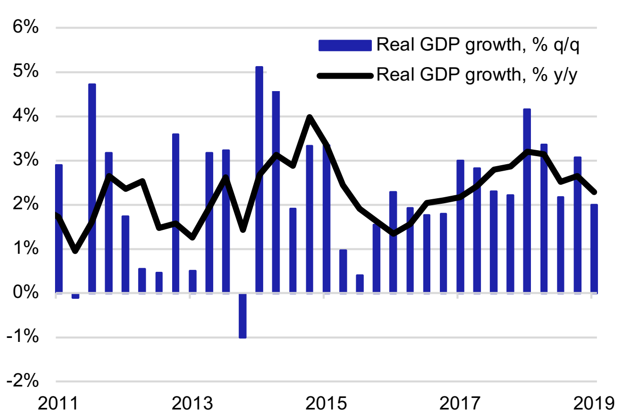
While the condition of the world economy has continued to weaken, the U.S. economy has been more resilient. Despite uncertainty fueled by trade tensions, shifting rate cut expectations and the 2020 elections, economic data has largely been solid. Robust demand for real estate, driven by a strong labor market and buoyant consumer sentiment, continues to keep rent levels steady. There are, however, worrying signs that economic and geopolitical uncertainty are starting to impact the commercial property market, including declining nonresidential construction levels and weakening foreign investor demand.

Q2 GDP data was solid if unspectacular, as quarterly annualized growth declined to 2.0% from 3.1% in Q1. Details as a whole were fairly encouraging, as more transient factors like changes in the trade deficit and inventory levels detracted from the headline number. Growth continues to be lopsided toward consumption, which has consistently driven the vast majority of growth gains. Growth in private investment was negative as a 9.4% decline in nonresidential structures investment drove weakness. Q3 GDP growth is likely to again fall short of 2018 levels.[2]

While the domestic economy appears to be decelerating gradually, sentiment around the globe is deteriorating more rapidly. Europe could be headed for a recession, with GDP growth in Germany and the U.K. declining into negative territory in Q2.[3] Global yields have plummeted, and U.S. rates have finally followed suit. The 10-year Treasury yield fell as low as 1.46% and now sits at 1.66%. Markets are currently pricing in between two and three more Fed rate cuts by the end of 2020.[3] With central banks appearing to be in easing mode, low interest rates should continue to support CRE prices going forward.

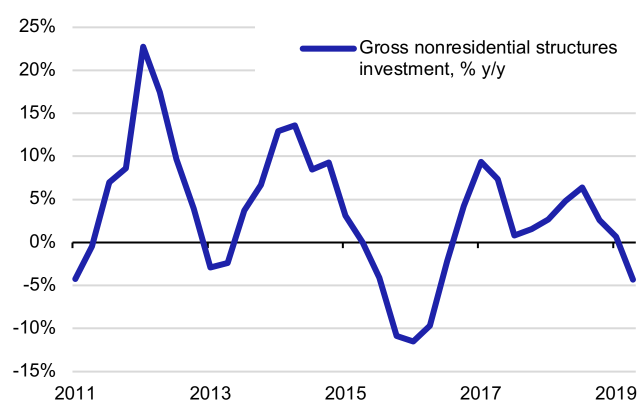
Construction spending continues to be a key weakness in the U.S. economy. Year-over-year growth in nonresidential structures investment went negative in Q2 for the first time since 2016, while the Census Bureau's measure of construction spending has been in the red since November of 2018.[4] Additionally, an increase in the cost of construction inputs has acted to stunt deliveries. While tepid construction spending has certainly helped boost property prices as demand has outstripped new property supply, muted activity could also be a harbinger of an economic slowdown, which would be negative for the CRE market.[2]

U.S. GDP GROWTH DECELERATING



Source: BEA, as of June 30, 2019.

NONRESIDENTIAL INVESTMENT IS SHRINKING



Source: BEA, as of June 30, 2019.

2 Bureau of Economic Analysis.
3 Bloomberg Finance, L.P.
4 U.S. Census Bureau.

CRE equity markets: A late-cycle downshift

KEY TAKEAWAYS
- Prices are still increasing, but at a slower pace.
- Foreigners net sellers in U.S. for first time since 2012.
- Equity returns will be driven mostly by income.

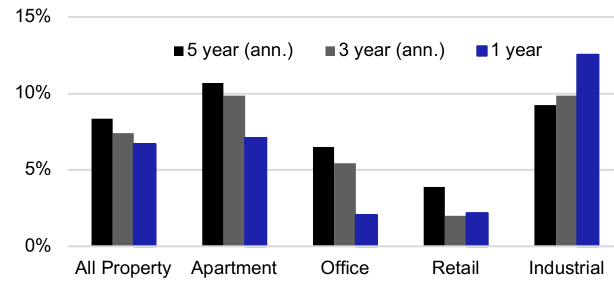
CRE property prices continued their trend of steady but slower growth in Q3. Investors may be showing caution as the economic expansion is showing signs of aging. Price growth has been stable this year, lifted by an industrial sector that has realized 12.2% year-over-year growth as of August, significantly higher than any other subsector.[1]

Cap rates continued to move sideways at 6.6%, even as U.S. interest rates declined significantly. CRE spreads over Treasuries now sit near cycle averages, which could help relieve potential upward pressure on cap rates.[1] However, we do not see cap rate compression contributing substantially to price growth going forward. Economic uncertainty will likely still spur investors to demand a premium for risk assets such as real estate.

Through August, overall volume has declined 11% compared to the same period in 2018. Cross-border investment activity took a turn lower in the first half of the year as foreigners became net sellers of U.S. real estate. Activity is down 14% year over year, a worrisome trend but not yet a huge concern. Cross-border investment is an important source of demand for U.S. real estate, with foreigners accounting for close to 15% of total volume and about 20% of major metro area activity. We will be watching closely whether economic and geopolitical issues continue to impede foreign investment, which could eventually negatively impact pricing.[1]

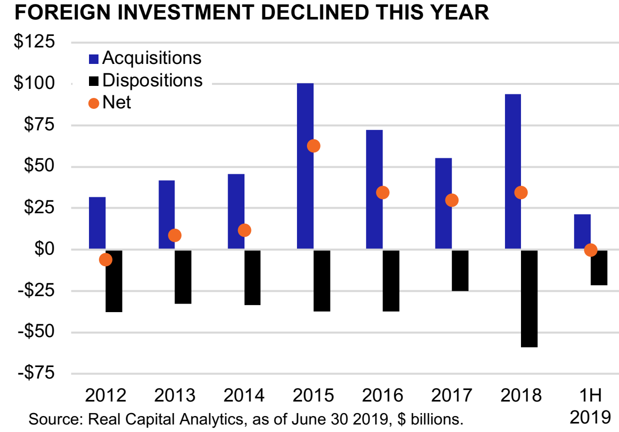
Prices continue to be supported by robust demand and declining construction activity. Private real estate funds currently hold a near-record $338B in dry powder, which should continue holding demand steady.[5] Net absorption continues to be positive across property sectors, while the overall CRE vacancy rate hit a post-2000 low of 5.4% in Q2.[6] The NCREIF NFI-ODCE Index returned 1.0% in Q2, all of which was from income, supporting our view that income will drive the majority of real estate returns going forward.[7] While lower rates are a positive from the standpoint of keeping debt financing attractive to investors, they are also an embodiment of the economic uncertainty that could roil markets.

PRICE GROWTH SLOWING ACROSS MOST OF THE CRE MARKET



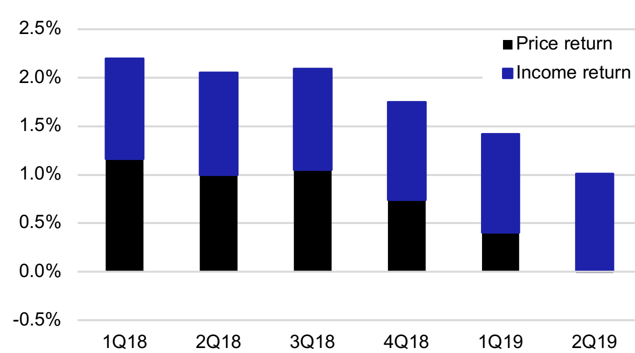
Source: Real Capital Analytics, as of August 31, 2019.

FOREIGN INVESTMENT DECLINED THIS YEAR



Source: Real Capital Analytics, as of June 30 2019, $ billions.

INCOME GROWS AS DRIVER OF CRE RETURNS



Source: NFI-ODCE Index, as of June 30, 2019.

5 Preqin.
6 REIS.

CRE debt markets: Lower rates provide a lift

KEY TAKEAWAYS
- Declining rates increase the attractiveness of debt.
- Borrowers look to capitalize on low rates.
- Market fundamentals remain strong.

CRE debt markets continue to provide attractive financing options for borrowers, especially as interest rates have fallen precipitously over the past nine months. Outstanding commercial mortgages rose to $4.41 trillion, which represents a year-over-year growth rate of 5.2%.[8] Despite lower rates, underwriting continues to be disciplined, as strong leverage metrics indicate lenders are displaying a preference to compete on pricing rather than structure.

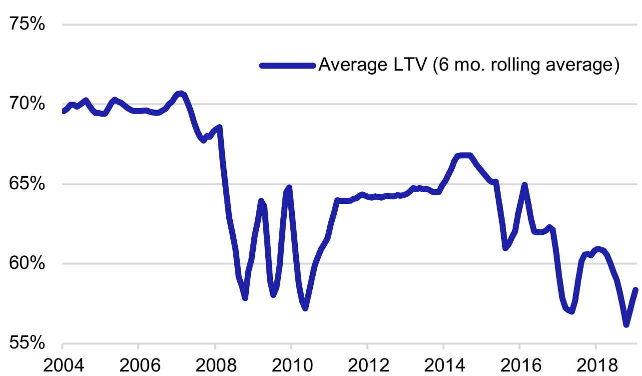
The altered yield landscape has brought down mortgage rates, widening the spread between property yields and cost of debt as cap rates have remained flat. This has made debt financing more attractive, both at a property and structure level. With property borrowers looking to lock in low fixed rates, CMBS issuance has picked up after a slow start to the year. Q3 conduit originations have surpassed those of a comparable period in 2018.[3] Additionally, REITs have taken advantage of lower rates by issuing unsecured corporate bonds. REIT bond issuance during just the first two weeks of September of $12.5 billion represented the highest number ever for a full month.[9]

While the significant rate decline may have caused an uptick in debt originations, it is important to remember that rates have been historically low all cycle, and fundamentals have remained strong. Property LTVs currently sit at 62%, right at the average for this expansion and well below the mean from 2004–2008. Debt service coverage, or the ability to pay off debt through operating income, has risen consistently and is currently close to 2x, a sign that property owners have some cushion in case of a downturn.[1] Echoing that sentiment, CMBS loan delinquencies hit a 10-year low in August, with only 1.73% of mortgages currently considered overdue.[3]

As traditional banks have stepped back somewhat, non-bank lenders such as REITs and debt funds have gained market share in CRE debt. These lenders tend to target higher returns than do banks, so this trend has been especially pronounced in the opportunistic lending space, where debt funds have increased market share from 7% in 2015 to 19% in 2019.[1] While competition in CRE lending is fierce, strong refinancing activity has helped satisfy the growing supply of debt capital.

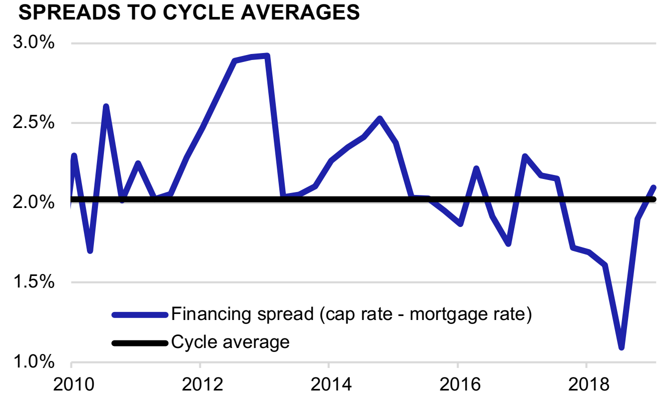
Declining yields have certainly made debt financing more attractive, especially as cap rates have dug in at historic lows. However, we do not see lenders compromising on structural protections to win deals. Rather, we see them competing on pricing, which bodes well for lenders if conditions continue to slow.

PROPERTY LEVERAGE HAS DECLINED DURING THIS CYCLE



Source: Real Capital Analytics, as of June 30, 2019.

LOWER RATES HAVE WIDENED FINANCING SPREADS TO CYCLE AVERAGES



Source: Real Capital Analytics, as of June 30 2019.

8 Federal Reserve, Financial Account of the United States.

9 Commercial Mortgage Alert.

Retail

KEY TAKEAWAYS

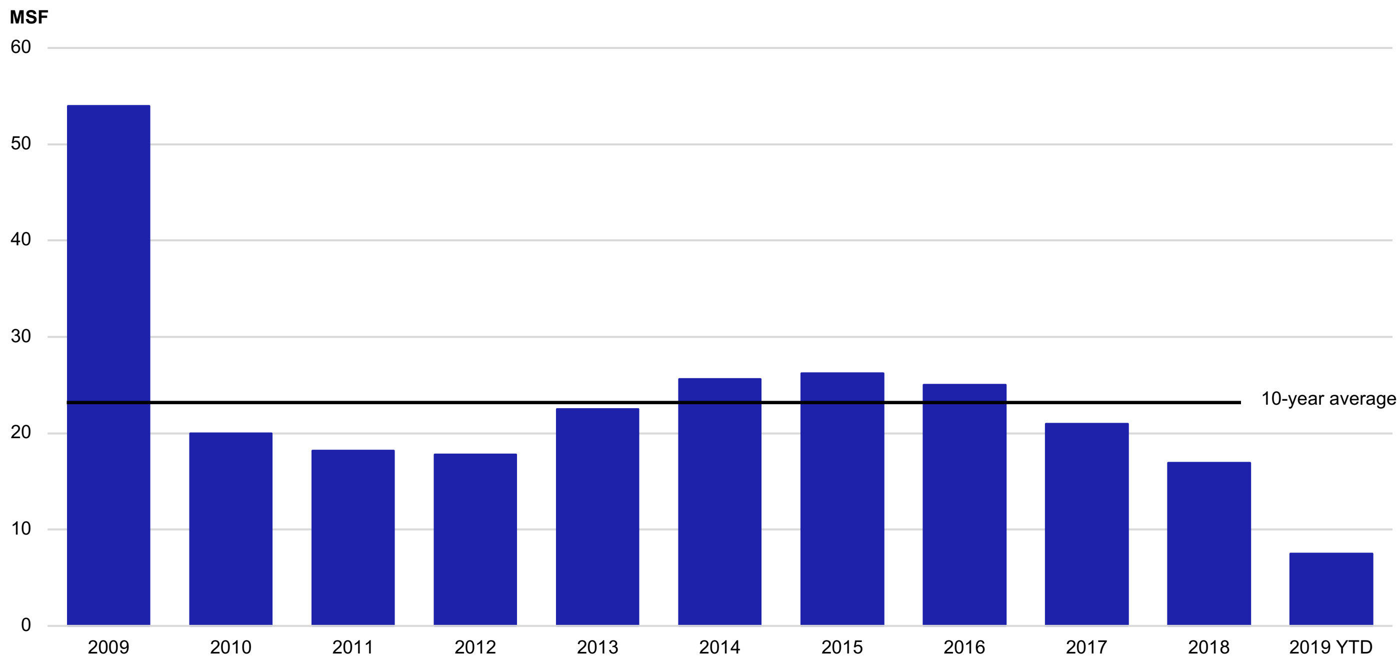
- Pace of price growth in retail trails other sectors.
- Sharp slowdown in new completions supports modest price growth.
- Future growth could come from mixed-use spaces.

U.S. economic growth has decelerated this year. Despite slowing overall growth, consumer spending has held strong and served as a tailwind even as retail continues to evolve. As expected, non-store retailers have benefited most from the strength of the consumer (via online shopping).[10] However, a diverse array of brick-and-mortar retailers such as restaurants and bars, grocery stores and car and automotive parts dealers have still seen healthy sales momentum in 2019.[10]

The pace of retail price growth has lagged other CRE sectors in recent years. However, the dramatic reduction in supply has been a mitigating factor that has helped to keep prices growing modestly. Retail deliveries reached a post-crisis peak of approximately 28M square feet in 2015 but have declined each year since.[11] Deliveries fell sharply in 2018, and that trend has continued into 2019 with deliveries well below the 10-year average.[11] With new supply significantly constrained, retail asking rents have gradually risen since 2014.[11] Vacancy rates also have declined throughout this decade before flattening in the past two years.[11] According to Cushman & Wakefield, the national retail vacancy rate remains approximately 3% below where it was coming out of the global financial crisis in 2010.[11]

As demand for retail space wanes in traditional shopping malls, developers have increasingly turned to mixed-use, experience-rich projects as a source for future growth. More than 345M square feet of major, new mixed-use retail projects are in the works in Northern New Jersey; Miami, FL; Washington, DC; Sacramento, CA; and Norwalk, CT.[12] Included among the amenities at these projects are high-end shopping mall and entertainment facilities, water parks, miniature golf courses, restaurants, and residential, office and hotel spaces.[12]

RETAIL DELIVERIES



Source: Cushman & Wakefield Research.

10 U.S. Census Bureau, www.census.gov/retail/index.html.
11 Cushman & Wakefield, MarketBeat, U.S. Shopping Center, Q2 2019.
12 JLL Research Report, Retail Outlook, Q2 2019.

Industrial

KEY TAKEAWAYS

- The industrial sector continues to power CRE returns.
- Rents rose sharply, driven by a consumer shift to e-commerce.
- Sales volume slowed in Q2 2019.

Growth within the industrial sector continues to fuel returns within the broader CRE market as it remains underpinned by a strong fundamental backdrop. Industrial vacancies hovered near historical lows, highlighting the significant demand for industrial space around the country. The national vacancy rate edged up 10 bps in Q2 from a quarter earlier to 4.9%, but remained 1% below the 5-year average.[13] Savannah, Los Angeles, Orange County and Central New Jersey, all within close proximity to large ports and massive population centers, featured the tightest conditions, with headline vacancies under 2.5%.[13]

Such significant demand for industrial space has helped to keep asking rents rising sharply, as they have been since 2017.[14] According to RCA, the national average rent per square foot rose approximately 17% through July 2019 from a year earlier, from approximately $86 to $101.[14]

Sales volume saw a notable slowdown in Q2. However, the decline was likely the result of a one-time event – namely, due to a delay in closing a historically large transaction – so we do not see the quarterly downturn as indicative of a longer-term concern within the sector.

Looking forward, industrial remains well positioned for continued growth as consumers shift from hard retail to e-commerce. Further, the market shows no signs of overbuilding as indicators such as net absorption and vacancy rates are forecast to remain well in check though the next 18 months.

INDUSTRIAL ASKING RENTS SPIKE IN 2019

Source: Real Capital Analytics, as of July 31, 2019.

13 Cushman & Wakefield, MarketBeat, U.S. Industrial, Q2 2019.

14 Real Capital Analytics, as of July 2019.

Office

KEY TAKEAWAYS

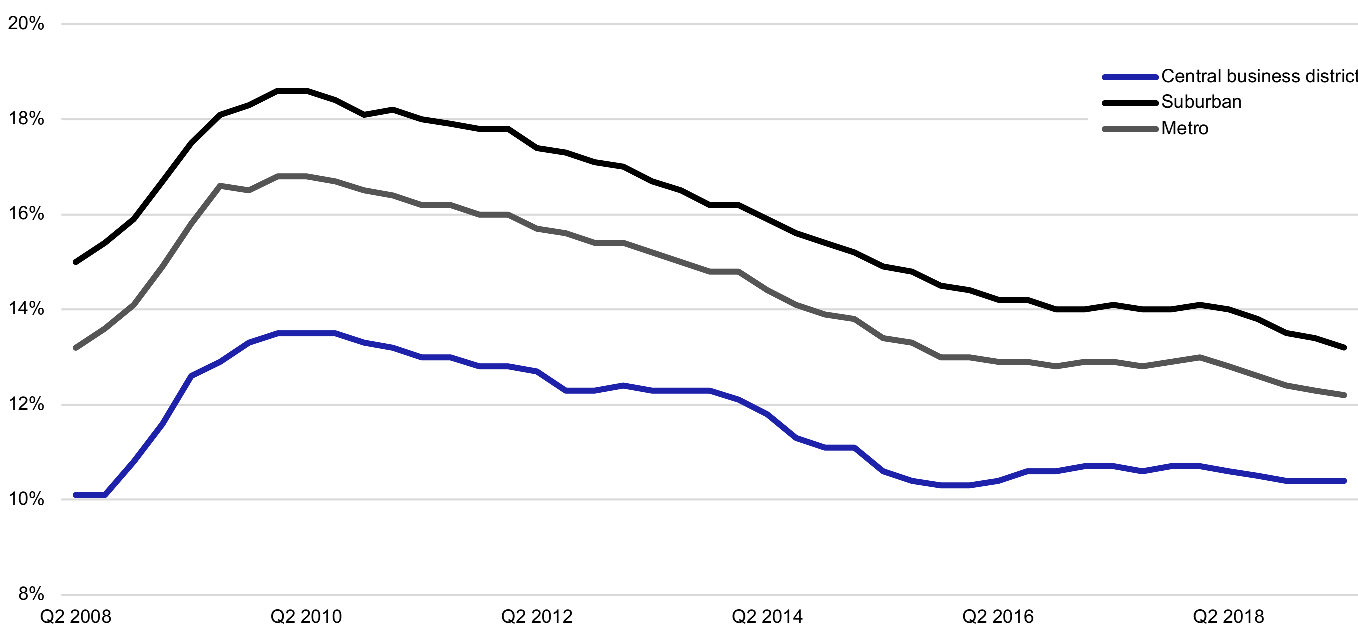
- Year-over-year price growth has halved since December.
- Demand remains high, especially in central business districts.
- Strong employment data supports office properties.

The office segment of the CRE market continues to benefit from a near multidecade low unemployment rate. Even against this constructive backdrop, however, it was subject to the CRE sector's slowdown through 1H 2019. Office price growth, for example, slowed from approximately 6% in December 2018 to 2.6% in July, driven mostly by a decline in suburban office prices.[15] Despite the slowdown, demand for office space remains high. The national office vacancy rate fell 10 bps in Q2 to 12.2%, its lowest level in 18 years.[16] Demand within central business districts has been strong but steady in recent years, with national vacancies hovering near 10.5% since 2015.[16] Increased activity in suburban and metro areas was the primary driver behind the national vacancy rate's decline through the past 12 months.

Despite expectations for considerable new supply to come online in the next three years, Cushman & Wakefield forecasts vacancies to only move up slightly, to approximately 13.4%, well below the sector's long-term average vacancy rate of nearly 15%.[17]

The strong national employment picture should provide an ongoing tailwind to the sector. As has been the case through much of the current cycle, demand has been greatest in regions that feature strong technology presences. These markets will likely continue to lead the sector's growth, yet major market indicators nationally, including properties under construction and asking rents, also point to ongoing health. Forecasts for rising vacancies and slowing rent growth, however, could point to more moderate conditions ahead.

OFFICE VACANCY RATES



Source: National Real Estate Investor, as of Q2 2019.

15 Bloomberg Finance, L.P., as of July 31, 2019 (latest data available). Based on the RCA Commercial Property Price Index and subindexes.

16 CBRE, U.S. Office Figures Q2 2019. Demand based on the rolling four-quarter periods ended Q2 2019 and Q2 2007.

17 Cushman & Wakefield, MarketBeat, U.S. Office, Q2 2019.

Multifamily

KEY TAKEAWAYS

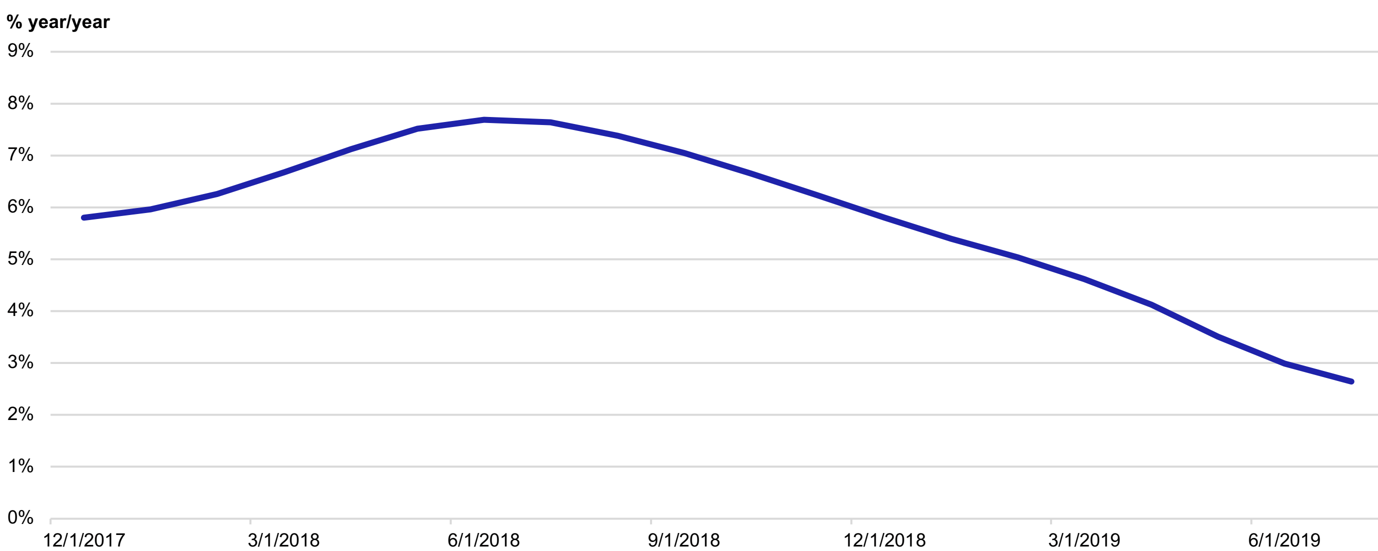
- Price growth in multifamily moderated in Q2.
- Market fundamentals remain supportive.
- Walkability is a leading factor behind demand.

The pace of price growth within the multifamily markets has slowed considerably this year from its recent peak in mid-2018.[18] Despite the slowdown, the macro backdrop remains supportive. Multifamily sales volume through 1H 2019 is on pace for a record year in 2019, and cap rates across the multifamily sector also mostly edged lower in Q2, signs that investor demand remains robust.[18,19]

Walkability and weather (warm weather, that is) were the two overriding themes that continued to drive investor demand throughout Q2 and, in fact, the past several quarters. Several Sun Belt cities, including Dallas, Phoenix, Houston and Atlanta, saw notable pickups in transaction volume during 1H 2019, for example.[20] Walkability continues to be a key differentiator for markets, as the most walkable neighborhoods have generally seen the greatest increase in transaction volume over the past year.[20]

Looking ahead, the multifamily sector has yet to show signs that it might lose momentum to home buyers in the face of rapidly falling mortgage rates. According to a June 2018 report published by Freddie Mac, the cost of housing remained the greatest factor contributing to the decline in homeownership among young adults, ranking well above other factors that included declining marriage and fertility rates, income or employment matters.[21] Additionally, high-income earners have increasingly chosen to rent instead of own a house. According to a RENTCafé study, participants who earned $150,000 per year or more were the fastest growing segment of renters for the 10-year period ended 2017.[22] Demand for senior housing along with steadily increasing populations of empty nesters and millennials choosing to rent should provide further support for the multifamily sector in the years ahead.

MULTIFAMILY PRICE GROWTH



Source: Real Capital Analytics.

18 Bloomberg Finance, L.P., as of July 31, 2019 (latest data available). Based on the RCA Commercial Property Price Index and subindexes.
19 Newmark Knight Frank, 2Q 2019 United States Multifamily Capital Markets Report.
20 Cushman & Wakefield, MarketBeat, U.S. Multifamily Market, Q2 2019.
21 Freddie Mac, Economic and Housing Research Insight, June 2018.
22 Multifamily Executive, based on a RENTCafé study from 2007–2017.