INVESTMENTS®

MIDYEAR 2019 COMMERCIAL REAL ESTATE OUTLOOK

Coasting at the speed limit

Executive summary

The commercial real estate (CRE) market has continued cruising along in 2019, albeit at a slower pace, with U.S. economic outperformance providing a steadying force to the space. Consumers have been driving much of the growth during this expansion, and they continue to feel confident despite financial market volatility at last year's end. However, heightened uncertainty driven by trade tensions, as well as decelerating global growth, could introduce more volatility in the second half of the year.

Transaction volume in 2019 has generally fallen short of 2018 levels, a sign that investors may be starting to feel more uncertain. Price gains have moderated over the past two years, though a 7.1% year-over-year gain is certainly still a solid pace.[1] Cap rates have largely remained flat since the end of 2017, which has left rent growth as the primary contributor to valuation increases. While still comfortably positive, rent growth has fallen across all sectors except industrial since 2015.[2]

During most of this cycle, CRE debt markets have been characterized by strong coverage metrics, which measure the ability of properties to service their debt through net operating income (NOI). This strength stems from a combination of lower interest rates and more-conservative underwriting driven by enhanced post-crisis regulation. The 10-year U.S. Treasury yield has fallen more than 100 bps since October 2018,[3] pushing commercial mortgage rates down and debt coverage up close to a cycle high at 1.85x.[1] The market is now pricing in at least two rate cuts for the rest of 2019, which should continue to hold rates low and keep debt as an attractive source of financing.[3]

The industrial sector continues to outpace the rest of the CRE market, with year-over-year price growth of 11.7%. Vacancy rates have fallen to decade lows as the e-commerce boom has consistently driven absorption that has outpaced new construction. The retail sector, seen as the laggard of the CRE market for much of this cycle, continued to post the lowest price gains. However, a strong and confident consumer should continue to help buoy retail despite less favorable fundamentals.[1]

Our outlook for the rest of 2019 is for a continuation of gradual price growth moderation as economic uncertainty and a tight labor market squeeze returns from both the demand and supply sides. Low rates will likely keep debt financing attractive and cap rates stable. The top risk to the space remains the possibility that the economic growth slowdown starts to impact transaction volume as well as consumer sentiment, which could pressure rent growth at a time when it is an increasingly vital driver of price growth.

INVESTMENT RESEARCH

Robert Hoffman, CFA
Executive Director

Lara Rhame
Chief U.S. Economist

Andrew Korz
Associate

Kara O'Halloran, CFA
Associate

Contact
research@fsinvestments.com

Matthew Malone, CFA
Managing Director, Real Estate

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1 Real Capital Analytics, as of May 31, 2019.

2 Reis, as of March 31, 2019.

3 Bloomberg, as of May 31, 2019.

Macro view: Foundation solid, but potential speed bumps ahead

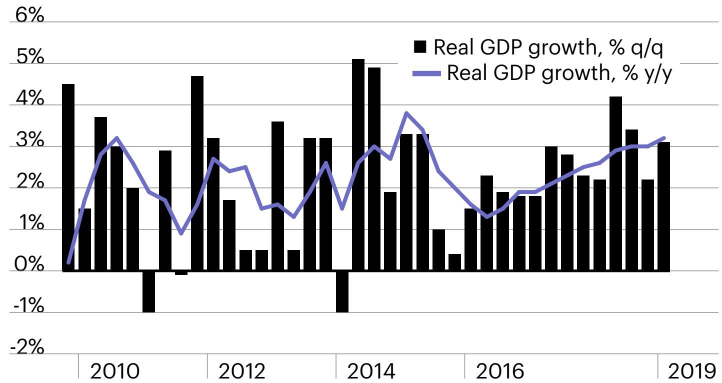
As stated, we expect rent growth to be the primary driver of future price appreciation. The prospects for rent growth rely heavily upon the fundamentals of the U.S. economy, which continues to outperform most of the developed world. Economic conditions impact property supply fundamentals, such as construction levels, as well as factors that drive demand for commercial properties. We look at three areas that will drive rent levels going forward: GDP growth, the labor market and construction activity.

Q1 GDP clocked in at 3.1% annualized, a robust number that beat most estimates. However, under the surface, this number was less encouraging as growth in inventories and a shrinking of the trade deficit, both somewhat transient factors, contributed more than half of total GDP growth. Final sales to domestic purchasers, our preferred gauge of domestic demand, grew just 1.3%, the lowest since 2013.[4] Trade tensions have cast further doubt over global growth.

The labor market continues to look solid, with unemployment at its lowest level in five decades and wage growth finally breaching 3% in 2018 for the first time in this expansion. Payroll data may be moderating somewhat with two sub-100K months during the first half of the year — not unexpected given the extremely tight labor environment.[5] We expect the labor market to continue to support a healthy consumer, which has been the key driver of this expansion and a crucial factor for rent growth.

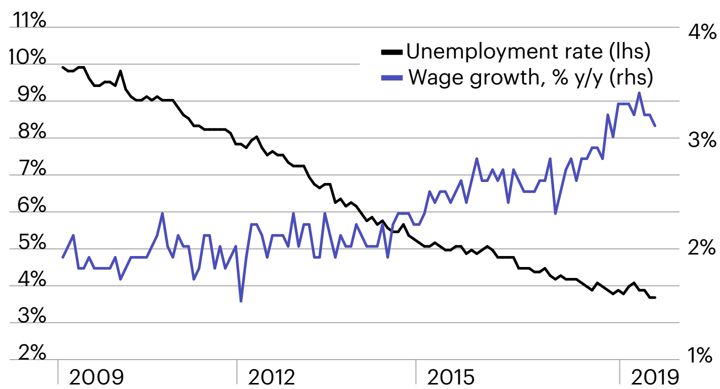
Construction spending has been uneven for much of this cycle, which has helped drive price gains as demand has outstripped new supply. After a mild uptick in 2018, nonresidential structures investment grew just 2% year over year as of Q1 2019 (see figure 3).[4] Input costs will be a top story for the rest of 2019, as a tight labor market has pushed construction worker compensation upward. Meanwhile, materials price growth has moderated but remains above expansion averages.[5] We will be watching whether developers see the market as attractive enough to warrant new investment.

FIGURE 1: GDP GROWTH STILL STRONG, BUT MAY HAVE PEAKED



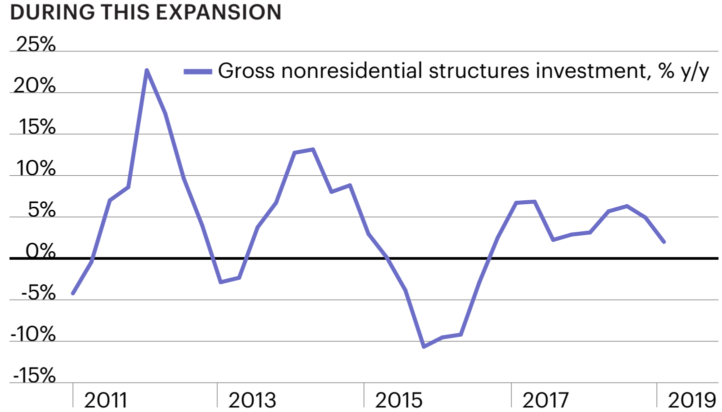
Source: BEA, Macrobond, as of March 31, 2019.

FIGURE 2: LABOR MARKET CONTINUES TO LOOK STRONG



Source: Bloomberg, Bureau of Labor Statistics, as of May 31, 2019.

FIGURE 3: NONRESIDENTIAL CONSTRUCTION HAS BEEN UNEVEN DURING THIS EXPANSION



Source: Bloomberg, BEA, as of March 31, 2019.

4 Bloomberg, BEA, as of March 31, 2019.

5 Bureau of Labor Statistics, as of May 31, 2019.

Equity markets: Pace of price growth slows

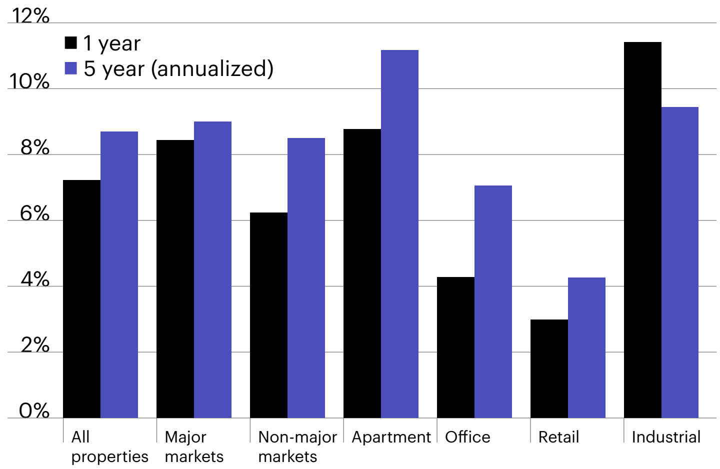
Property prices continue to hit new highs across sectors, though the rate of price growth has slowed noticeably. High valuations and an economic expansion that is now a decade long have started to take their toll on price appreciation (see figure 4). While price growth has picked up modestly over the past few months, current year-over-year growth of 7.14% sits below 3-year and 5-year annualized numbers. A notable exception is the industrial sector, which continues to be the top-performing area of the CRE market as demand has consistently outstripped new supply.[1]

Transaction volume moderated during the first part of 2019 as investors may have gotten skittish following financial market volatility in Q4 2018. April saw the lowest monthly transaction volume since February 2017, and 2019 volume is currently 11% below last year's pace at this time.[1] While we look for continued economic and policy uncertainty to potentially hamper transaction volume going forward, high occupancy rates and solid rent growth should continue to support prices.

Cap rates remain near all-time lows across major sectors, though declines have mostly leveled off over the past few years (see figure 6). Cap rates for each major sector are within 15 bps of their levels from a year ago.[1] The 10-year U.S. Treasury yield has fallen more than 60 bps since the beginning of the year, which has supported cap rate levels but has not yet driven any significant further compression.[3] With heightened economic uncertainty likely for the rest of the year, we see cap rates contributing minimally to price growth.

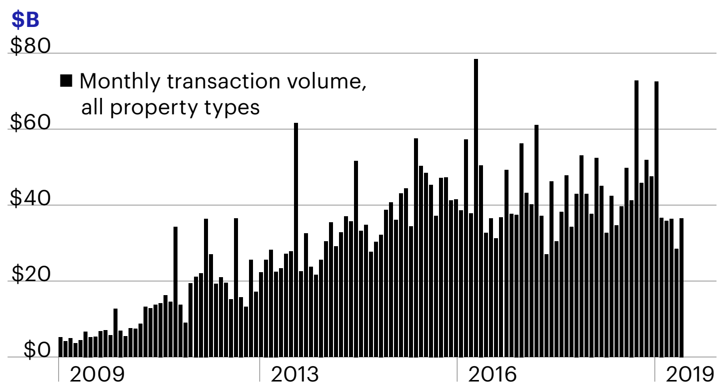
With asking rents having leveled off, volumes declining and cap rates steady, we see a market that is healthy but showing the classic signs of entering a late-cycle phase. Declining interest rates have caused cap rate spreads to the 10-year Treasury to widen somewhat, though spreads for each major sector remain below expansion averages. While lower rates could help drive cheaper debt financing, growing economic uncertainty has started to put a cap on further valuation increases. The rest of 2019 will likely continue this trend, and income will drive an increasingly higher percentage of returns.[1,2]

FIGURE 4: PRICE GROWTH HAS SLOWED ACROSS MOST OF THE CRE MARKET



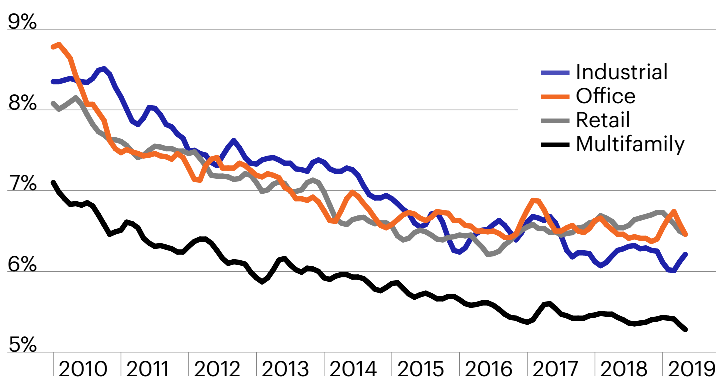
Source: Bloomberg, Real Capital Analytics, as of May 31, 2019.

FIGURE 5: TRANSACTION VOLUME HAS MODERATED SO FAR IN 2019



Source: Bloomberg, Real Capital Analytics, as of May 31, 2019.

FIGURE 6: CAP RATES HAVE LEVELED OFF



Source: Real Capital Analytics, as of May 31, 2019. Rolling 6-month cap rates are shown.

Debt markets: Healthy lending environment provides tailwind

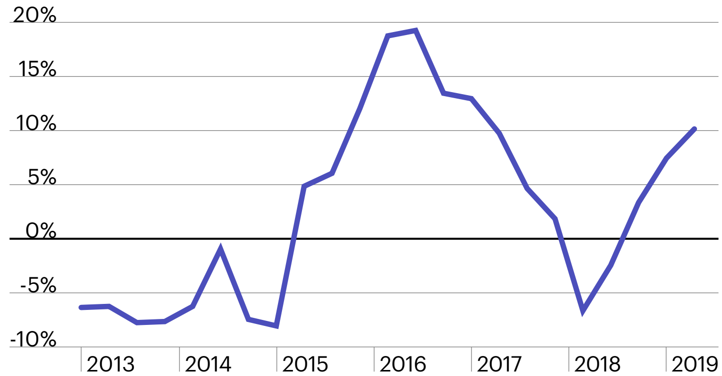
The CRE debt markets remain open and robust but continue to be fairly disciplined. Outstanding commercial and multifamily mortgages rose to $2.9 trillion and $1.4 trillion, respectively, which represent year-over-year increases of 5.1% and 6.6%.[6] Debt growth has been more moderate during this expansion than in past cycles, due in part to more cautious underwriting as well as the uneven recovery in nonresidential structures investment.

Despite solid fundamentals, banks appear to be increasingly cautious in their extension of credit (see figure 7).[7] We view this as a reaction more to the current stage of the cycle rather than the deterioration of credit fundamentals. Alternative lenders, which now make up 26% of the CRE lending market and include entities such as REITs and private debt funds, will likely be the beneficiaries if banks continue to pull back. In Q1, finance companies increased commercial/multifamily debt holdings by 13.5% compared to banks' growth of just 1.1%.[6]

Average property loan-to-value (LTV) ratios have trended downward and currently sit well below levels seen before the last recession, signaling the CRE space has reduced structural leverage (see figure 8). Debt service coverage declined somewhat as the cost of debt briefly increased in 2018, but has recovered to a near-cycle high of 1.85x as commercial mortgage rates have fallen in tandem with benchmark yields. Low vacancy rates and steady rent growth are tailwinds for debt service coverage going forward.[1]

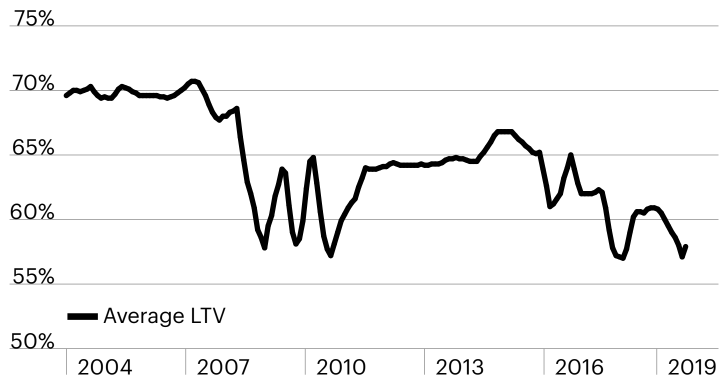
The interest rate landscape has undergone a drastic shift, with the Fed first pivoting to a patient stance and now appearing outright dovish. The market is currently pricing in over two rate cuts by the end of 2019, compared to the beginning of the year when the market gave about equal probability to a rate hike and a cut. Long-term rates have fallen in concert, with the 10-year Treasury yield now hovering around the 2% line (see figure 9).[3] Looking ahead, low yields will likely keep commercial mortgage rates low, which should continue to drive strong demand for debt financing.

FIGURE 7: NET % OF BANKS TIGHTENING STANDARDS FOR CRE LOANS



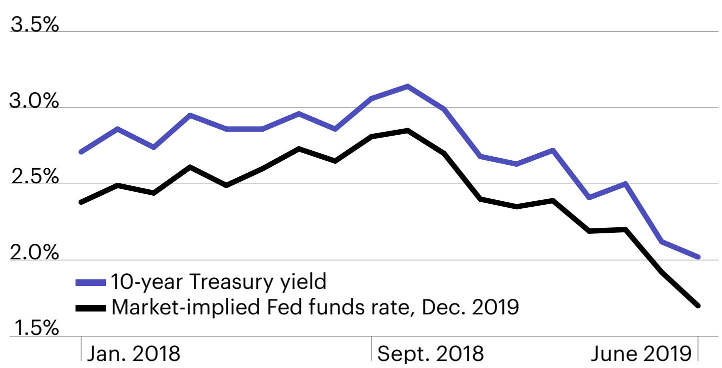
Source: U.S. Federal Reserve, Senior Loan Survey, as of April 30, 2019.

FIGURE 8: PROPERTY LEVERAGE HAS DECREASED SINCE 2014



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

FIGURE 9: THE INTEREST RATE LANDSCAPE HAS CHANGED



Source: Bloomberg, as of June 27, 2019.

6 U.S. Federal Reserve, Flow of Funds, as of March 31, 2019.

7 U.S. Federal Reserve, Senior Loan Survey, as of April 30, 2019.

Retail

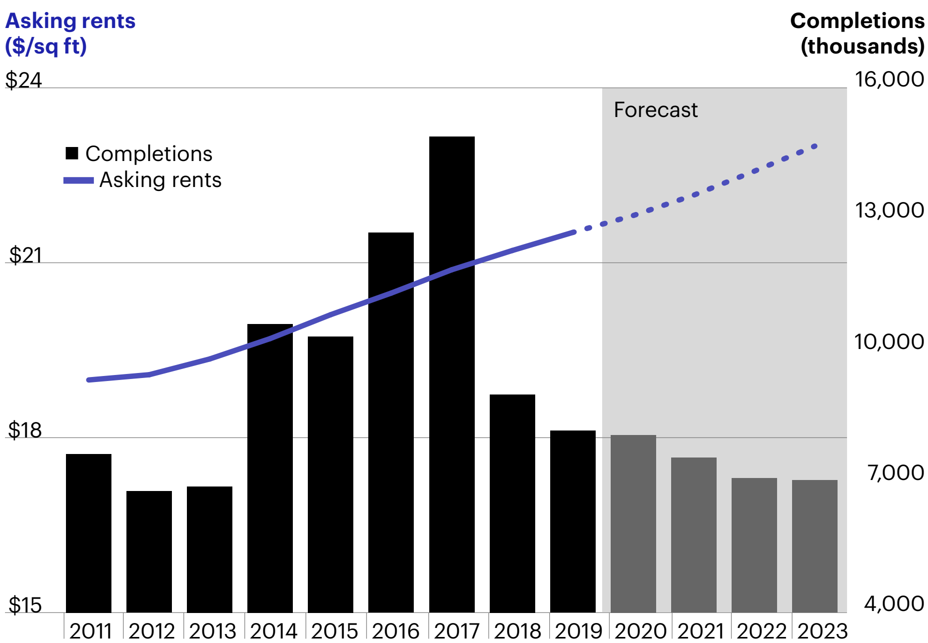
The retail sector has been the focus of a regular stream of dire headlines through the past several years, often citing a "retail apocalypse" allegedly taking place. Certain major retailers indeed face significant challenges, fueled by oversupply as e-commerce has rapidly reshaped the entire CRE space.

Yet, the often-grim headlines surrounding the sector belie the fact that retail is a diverse and generally healthy asset class. In 2017 and 2018, net store openings outpaced store closings by nearly 8,000 nationwide.[8] Restaurants and bars, mass merchants and convenience stores saw the most activity in this two-year span. Malls remain under secular stress, but retail is a diverse sector certainly not on the verge of a collapse.

Against the backdrop of moderating CRE activity, retail completions (finished construction projects) nearly halved from 2017 to 2018. Completions are forecast to remain roughly flat in 2019 and 2020 and decline modestly thereafter. As figure 10 shows, however, asking rents have moved steadily higher following the global financial crisis, from approximately $19 per square foot in 2011 and 2012 to $21.52 this year, with additional growth forecast for the coming years.[2]

Sector-wide, retail's year-over-year price gain of approximately 3.0% trails the other major sectors but marks the best growth for the sector since 2016.[1] Solid consumer spending, spurred on by a still-healthy employment picture and loose monetary conditions, could provide a continued level of support for the retail CRE market going forward.

FIGURE 10: RETAIL COMPLETIONS FALL, BUT RENTS RISE



Source: Reis, as of March 31, 2019.

8 Cushman & Wakefield, "What's Next: U.S. Economic Outlook and Implications for the Property Markets," April 2019.

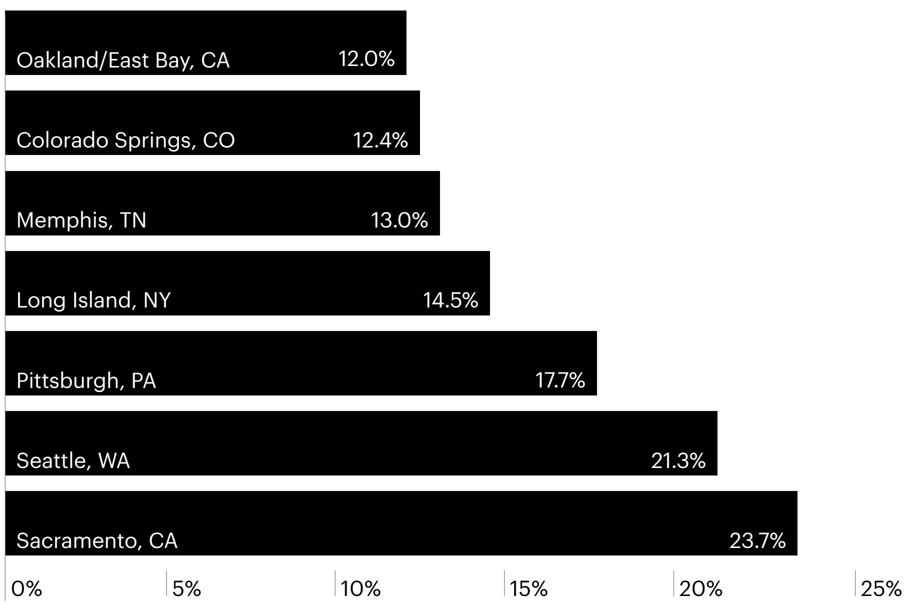
Industrial

Strong total returns in the industrial sector over the past five years have helped fuel returns across the broader CRE market. Driven primarily by extraordinary growth in e-commerce and the related demand for distribution and logistics centers, retail's loss has been industrial's gain. The three-year period from 2016 through 2018 was the sector's strongest period of demand (based on net absorption) since at least 1999.[2]

Over a longer time frame, demand for industrial CRE also has held firm. Since 2010, nearly 1 billion square feet of new industrial space has been built in the U.S., nearly all of which has been absorbed as the vacancy rate for industrial real estate has moved steadily lower.[9] Vacancies have declined from as high as approximately 10% in 2010 to a post-2000 low of 4.8% in Q1 2019.[2] Vacancies are under their prior cycle lows (2002–2007) across nearly all major markets, yet the Los Angeles and Orange County, CA, metro areas stand out, both with vacancy rates below 2%.[1]

Industrial asking rents (price per square foot) have risen approximately 20% since 2015, though they have moderated a bit in recent quarters.[2] Slowing manufacturing activity in the U.S. and globally and rising trade tensions have the potential to slow industrial activity. We see few signs of a notable slowdown as of yet, though declines in the ISM Manufacturing Index, a traditional bellwether of industrial activity, bears monitoring.[3]

FIGURE 11: INDUSTRIAL ASKING RENTS (Y/Y GROWTH %), 2018 VS. 2017



Source: Cushman & Wakefield, as of December 31, 2018.

9 Wells Fargo Securities, Economic Group, Q4 CRE Chartbook: Construction Outlook, March 2019.

Office

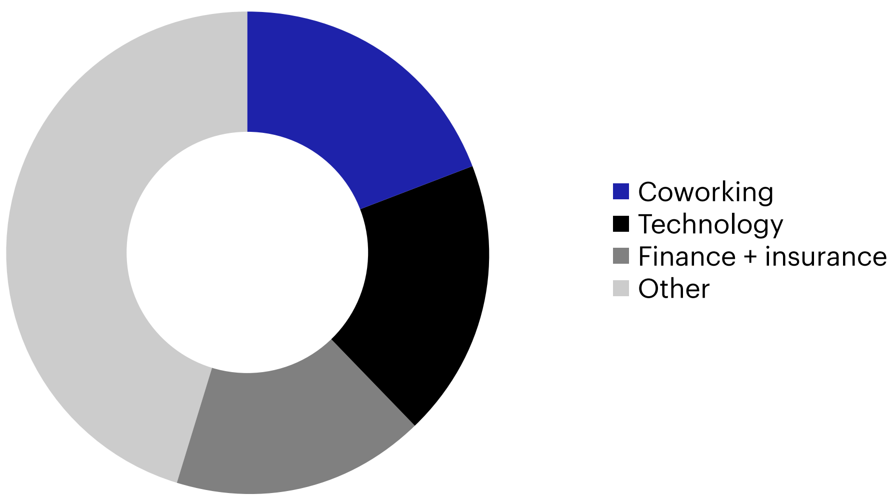
Transaction volume across the CRE market slowed during the first part of 2019, though central business district (CBD) office activity saw one of the sharpest declines of all areas of the CRE market. CBD office volume fell 14% over the first five months of 2019 compared to last year as activity across major markets slowed meaningfully. Suburban office volume declined 6% in the same time period. Unlike in CBDs, though, the decline in suburban markets was mostly due to slowing activity in secondary and tertiary markets.

Moderating quarterly figures mask the supportive trends that remain in place across the national office market. CBD office volume over the past 12 months, for example, rose 10% compared to the prior 12-month period. Suburban office volume declined 2% over 12 months but remained near an all-time high of $84 billion.[1]

Nationally, growth in office rental prices has decelerated from approximately 5% in 2015 to 2.0% in Q1 2019.[2] However, metro areas with entrenched and growing tech sectors, including San Jose, Charlotte and Seattle, continue to see asking rent growth well above the national average.[3] Technology, coworking, finance and insurance accounted for more than half of all office leasing activity in Q1 2019.[10]

Looking ahead, a strong national employment picture combined with a roughly even supply/demand dynamic within the office space could provide an ongoing tailwind to the sector. Office vacancy rates across all subsectors have been slowly declining from approximately 17% in 2010 to 13.3% today, where they are forecast to remain until 2020. The gap between 10.5% vacancies in CBDs and 13.7% in suburban offices, however, remains pronounced.[11]

FIGURE 12: 3 INDUSTRIES DOMINATED OFFICE LEASING ACTIVITY IN Q1 2019



Source: Cushman & Wakefield, U.S. MarketBeat Reports, Capital Markets, Q1 2019.

10 JLL, United States office outlook - Q1 2019, April 13, 2019, https://bit.ly/2HTSaoJ.

11 UBS, U.S. Real Estate Summary, Edition 1, 2019.

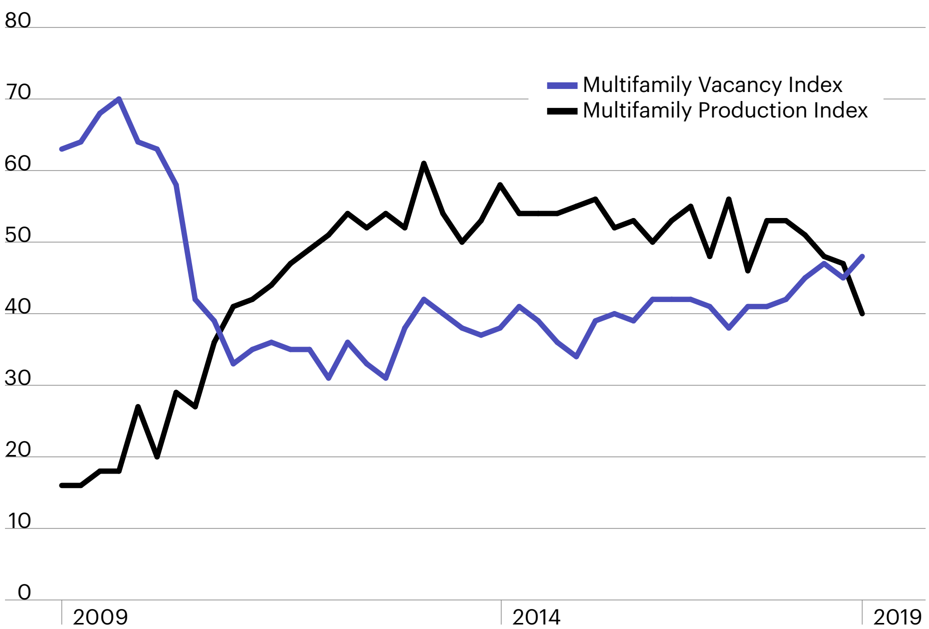
Multifamily

Sentiment within the multifamily sector moved lower in Q1 2019 versus the prior quarter and has been on a gradual downtrend since Q1 2018. The NAHB Multifamily Production Index (MPI), a broad measure of confidence in the multifamily housing market, decreased seven points in Q1 compared to the previous quarter, reaching the index's lowest reading since Q3 2010.[12] The Multifamily Vacancy Index (MVI) moved up three points from the prior quarter and has risen 10 points since Q2 2017.

Consistent with recent softening data, annualized year-over-year apartment price growth has slowed from nearly 13% in mid-2018 to 8.8% as of May 2019.[13] However, fundamentals remain broadly intact. New completions and net absorption are very high in metro areas like Charlotte, Austin, Nashville and other (mostly) Sun Belt cities where job growth and new construction have been strong enough to digest a steady influx of new residents.[8]

The longer-term fundamentals underlying the multifamily market remain relatively positive. Today's apartment vacancy rate of 6.0% is near the low end of its 20-year range while the MPI remains toward the upper end of its 10-year range.[2,12] Broad demographic trends in the U.S. should further support demand through the coming decade. These include exponential growth in demand for senior housing, as the population aged 65 or older in the U.S. is expected to rise from 60 million to 80 million between 2020 and 2040, along with steadily increasing populations of empty nesters and millennials choosing to rent.[14,15]

FIGURE 13: NAHB MULTIFAMILY PRODUCTION AND VACANCY INDEXES



Source: National Association of Home Builders, as of March 31, 2019.

12 National Association of Home Builders, http://bit.ly/2WoHpDK.

13 Real Capital Analytics, https://www.rcanalytics.com/chart-us-cppi-slope.

14 U.S. Census Bureau, https://agingstats.gov.

15 U.S. Census Bureau, American Fact Finder, http://bit.ly/2wEZdLL.

FS Investment Solutions, LLC 201 Rouse Boulevard, Philadelphia, PA 19112 www.fsinvestmentsolutions.com 877-628-8575 Member FINRA/SIPC