Commercial Real Estate Market: Fourth Quarter 2013

Anthony J. Buonicore, P.E.
Principal, Buonicore Partners, Inc.
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Summary

General

The improving U.S. economy continues to strengthen the commercial real estate market, although recovery has been unevenly distributed across property types and geographic locations. Notwithstanding, transaction activity overall continues to improve, driven in large part by the exceptionally low interest rate environment. Vacancy rates across the four major property types have nearly returned to their historical averages and distressed sales volume is now at its lowest level since 2008.

The apartment sector has been the dominant force in commercial real estate gains in this cycle. However, the industrial sector is fast emerging as the new favorite. While apartment demand remains robust with supply close on its tail, the demand for industrial space, particularly warehousing, continues to far outpace supply, which has driven rent growth and vacancy decline. Retail and office space, on the other hand, have experienced much less improvement.

Notwithstanding, the general lack of new construction (supply) during the last four years, combined with pent-up demand caused by economic uncertainty, should cause rents, occupancy and property values to increase for the next several years. This will result in continued property level performance improvements and increased transaction levels in 2014.

Individual Property Types

In the four years following the recession, the apartment sector enjoyed robust growth. The sector, however, is now beginning to experience some moderation in the pace of improvement. The surge in demand translated into considerable new construction, a significant portion of which still has yet to come on-line. The final piece to this sector's recovery is meaningful rent growth, which likely will remain subdued in the near term given current sluggish wage and salary growth.

The industrial sector appears to be fast emerging as the new favorite in the commercial market. The sector has experienced 13 consecutive quarters of improving performance. Vacancy rates have declined to 7.9% in the third quarter from their peak of 10.5% in the second quarter of 2010. The sector is experiencing the strongest demand for space in five years, with speculative development even returning. The sector's attractiveness is likely due to a number of factors, including retailers moving away from traditional storefronts toward a more on-line marketplace. This growth in e-commerce has led to a surge in demand as retailers need a place to store inventory, even if they opt out of a traditional storefront. Expectations for the sector in 2014 are high.

With the growth of the virtual marketplace, demand for retail space remains subdued, with improvement expected to keep in line with improvements in the overall economy. The retail sector remains a segmented market, with growth at the top, catering to more affluent consumers, and at the bottom, catering to a broader consumer base that has been more severely impacted by high unemployment and muted income growth. The near-term outlook for the sector will continue to be challenging, but overall the sector is expected to continue a slow, steady recovery in 2014.

In contrast, the office sector has lagged, as many tenants have opted to consolidate space during the recovery. Although office fundamentals have been improving for more than three years, recovery in the sector generally has been modest. Although office-using employment is now nearing its pre-recession peak, the mix is different in that many tenants are now allocating significantly less space per worker. As a result, office employment will need to improve much further before vacancy rates decline enough to drive significant new office development.

Despite sluggish U.S. economic growth, hotel demand has outperformed most major property types over the past three and a half years. Underlying property fundamentals in the sector remain strong, with positive year-over-year performance. Hotel demand is up more than 20% since bottoming in 2010 and the average occupancy rate is now at its highest level in more than seven years. Hotel occupancy and average daily room rates will continue to grow as demand outpaces supply growth and economic conditions strengthen. Continued moderate economic growth, coupled with a favorable demand-supply balance, is expected to continue to drive hotel performance improvement in 2014.

<u>Construction</u>

With the exception of the multifamily sector, construction remains historically low. However, two commercial real estate leading indicators, the Dodge Momentum Index and the Architecture Billings Index, point to increasing construction activity in the next twelve months. Commercial construction activity has been particularly driven by strength in energy and manufacturing-related projects. Warehouse and distribution construction is also ramping up and construction of data centers remains strong.

<u>Capital Markets</u>

The new year will also find capital markets providing more liquidity to the commercial property sector. The Mortgage Bankers Association is forecasting continued increases in debt financing, with CMBS, banks and life insurance company financings expected to increase the most. While long-term interest rates are expected to tick up a few basis points in the coming year, the increases are not expected to be disruptive. This increase in competition and liquidity in the commercial property debt market is expected to continue in 2014, boding well for the commercial real estate market.

Lenders

The year 2013 is shaping out to be the best year for mortgage originations since the downturn. Commercial and multifamily debt outstanding increased by $25.2 billion in the third quarter, as all four major investor groups (commercial banks, CMBS/CDO/ABS, Agency/GSE and life insurance companies) increased their debt holdings. The third quarter increase represents the largest amount since 2008. The quarter also marked the largest increase in the outstanding balance of loans in CMBS since 2007. This momentum is projected to carry over into 2014 with credit standards expected to loosen further as credit performance continues to improve.

The number of FDIC-insured institutions reporting financial results fell to 6,891 in 3Q13 from 6,940 in 2Q13. In 2007 prior to the last fiscal crisis, there were 8,559 FDIC-insured banks reporting. During the third quarter of the year, six insured banks failed, resulting in a total of twenty-two banks failing thus far in the year. In 2012, there were a total of 51 bank failures. Commercial real estate exposure continues to be the main driver behind problem loans at banks that failed in the quarter.

The number of institutions on the FDIC's problem list in 3Q13 fell for the tenth consecutive quarter, after increasing for 19 quarters (since 3Q06). The number of "problem" institutions declined to 515 in 3Q13 from 553 in 2Q13.

Real Capital Analytics (RCA) tracks the distressed asset market and recently reported $151.5 billion in distressed loans associated with 10,928 properties, down from $152.9 billion in distressed loans associated with 11,275 properties reported in the last quarter. The size of the distressed asset market peaked at $191.5 billion in October 2010. The $151.5 billion total consists of $103.5 billion in troubled loans associated with 7,113 properties (up slightly from $102.4 billion associated with 7,397 properties in the last quarter) and $47.9 billion in lender REO associated with 3,815 properties (down from $50.5 billion in lender REO associated with 3,878 properties in the last quarter). Of the $394 billion of mortgages that became troubled since the 2007 market peak, more than two-thirds have been resolved, and new instances of distress continue to decline.

The Federal Reserve's October 2013 *Senior Loan Officer Opinion Survey on Bank Lending Practices,* found that 22 of 73 banks (30.2%) surveyed indicated that they experienced "moderately stronger" or "substantially stronger" demand for commercial (non-residential) real estate loans in 3Q13. Forty-eight (48) of the 73 banks indicated the demand "stayed about the same as in the previous quarter." Only three (3) banks found the demand weaker. Twenty-four (24) of 71 banks (33.8%) surveyed indicated that they experienced "moderately stronger" or "substantially stronger" demand for construction and land development loans in 3Q13. Forty-three (43) of the 71 banks (60.6%) indicated the demand "stayed about the same as in the previous quarter." Only four (4) banks found the demand weaker. Finally, 26 of 72 banks (36.1%) surveyed indicated that they experienced "moderately stronger" or "substantially stronger" demand for multifamily loans in 3Q13. Forty-one (41) of the 72 banks (56.9%) indicated the demand "stayed about the same as in the previous quarter." Only five (5) banks found the demand weaker.

This same survey found that lending requirements for approving commercial (non-residential) real estate loans did not change from the previous quarter for 88% of the banks surveyed.

However, the requirements were eased for 10% of the bank respondents. Lending requirements for approving construction and land development loans did not change from the previous quarter for 82% of the banks surveyed. However, the requirements were eased for 14% of the bank respondents. Finally, lending requirements for approving multifamily real estate loans did not change from the previous quarter for 68% of the banks surveyed. However, the requirements were eased for 20% of bank respondents.

CMBS/CDOs

Commercial mortgage-backed securities issuance has been a cornerstone of commercial real estate financing. With the significant number of commercial real estate loans coming due in the next three years, industry analysts are predicting dramatic growth in the issuance of CMBS. Issuance in 2013 is expected to approach $90 billion, nearly double the $48 billion in issuance that occurred in 2012, and considerably more than the $70 billion predicted just six months ago. Issuance in 2014 is predicted to grow to more than $100 billion. In 2007, the last year before the financial crisis hit the CMBS market; there was almost $250 billion in issuance.

Delinquency rates for loans in CMBS continue their improvement trend. October marked the fifth consecutive month that the delinquency rate fell, declining below the 8% level for the first time since early 2010.

The dollar volume of loans originated by conduit lenders who pool the loans and sell them to Wall Street as CMBS more than doubled in the third quarter, increasing by more than 105% from last year's third quarter.

REITs, Life Insurance Companies and Pension Funds

Fitch Ratings maintained 2013's "stable" outlook for REITs into 2014, citing continued solid liquidity driven by good access to capital, moderately improving property-level fundamentals and lower-risk strategies. Fitch expects that REITs will continue to have access to low cost debt; both secured and unsecured, and will access equity markets to fund acquisitions and developments.

Commercial real estate lending by life insurance companies remained near last quarter's record pace. Lending is up 19% comparing the first three quarters of 2013 with the first three quarters of 2012. In a rising interest rate environment, life insurance companies have an advantage over many other lenders. Because they raise money from the premium payments of their customers, they are not forced to raise interest rates in lockstep with the rest of the market.

U.S. pension funds are increasing the amount of capital that they are trying to deploy into commercial real estate, both directly and through funds. Pension funds currently have 7.4% of their total assets allocated to commercial real estate against a goal of 8.4%.

Institutional investors are also upping their ante in commercial real estate. They are doing this for three key reasons: attractive yields, diversification and/or a hedge against inflation.

Foreign Investors

Foreign investors continue to spend significant sums on U.S. real estate, $35 billion on 860 properties through mid-December of this year, up from $26.9 billion in all of last year. Canada, Singapore and China top the list of foreign investors, followed by Germany, Switzerland, Austria and Israel.

Norges Bank Investment Management and MetLife recently teamed up on a joint venture to invest in Class A office properties in key U.S. markets. Norges' joint venture with MetLife marks the funds third U.S.-focused real estate investment platform. This joint venture follows on a similar joint venture Norges has with TIAA-CREF.

Property Transaction Market

According to the Mortgage Bankers Association's (MBA) *Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations*, *Q3 2013*, commercial and multifamily mortgage origination volume (dollar basis) in the third quarter of this year rose by 29% from a year ago, although it was essentially flat compared to the second quarter. Compared to the third quarter of last year, loans originated by life insurance companies increased by 72%, loans originated by commercial banks increased 41%, loans originated by GSE (Fannie Mae and Freddie Mac) increased 40%, and loans originated by conduits for CMBS increased 105%.

Total property transaction volume (on a property-count basis) increased more than 21% comparing the first three quarters of 2013 with the first three quarters of 2012. Investors have strong expectations that both occupancies and rents will continue to grow across property types for the remainder of 2013 and into 2014.