# Commercial Real Estate Market Intelligence Report: First Quarter 2014


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## Summary

*General*

Improvement in the commercial real estate market continues to be supported by the strengthening U.S. economy. Demand for office, industrial and retail space has steadily improved over the past couple of years and, with little new construction, vacancy rates declined across the vast majority of markets and have nearly returned to their historical averages. In addition, distressed property sales volume is now at its lowest level since 2008.

The greatest improvement continues to be in metro areas with exposure to the energy and technology sectors. The proportion of markets experiencing improving conditions has broadened and new construction is ramping up across an increasing number of markets. The relatively low interest rate environment still continues to bolster transaction activity.

The apartment sector has been the dominant force in commercial real estate gains in this cycle, with the hotel and industrial sectors following closely behind. While apartment demand remains robust with supply close on its tail, the demand for industrial space, particularly warehousing, continues to outpace supply. Retail and office space, on the other hand, have experienced much less improvement.

Continued property level performance improvements across all sectors is expected to result in increased transaction levels for the remainder of the year.

*Individual Property Types*

The multifamily sector has experienced the strongest recovery of any major property type, benefiting from both the rebound in employment growth and decline in home ownership. Demand has been strongest in areas where job growth has risen the fastest, which tends to be concentrated in major technology and energy sectors. Notwithstanding, demand has improved much more broadly with a relatively large proportion of new construction located in and around downtown areas. With vacancy rates at cycle lows nationwide, fears about overbuilding, although premature, are beginning to surface. Rent growth has slowed from the very strong growth experienced during the last few years and will likely remain modest in the near term given current sluggish wage and salary growth. The Mortgage Bankers Association projects multifamily loan originations to grow $116 billion in 2014.

Demand for industrial space has been another bright spot, benefitting from the explosive growth in online retailing, growth in international trade, revival in domestic manufacturing activity and the emerging recovery in single-family home building. The sector is experiencing the strongest demand for space in five years, with speculative development growing. Expectations for the sector this year are high.

The retail sector has been slow to gain any meaningful traction in the recovery and has lagged the other property types. The vacancy rate peaked more than two years ago, but has barely budged in recent quarters. Weak consumer fundamentals and competition from online retailers continue to weigh heavily on the sector. Demand should strengthen as the economy gains momentum and home construction improves. The sector remains a segmented market, with growth at the top end which caters to more affluent consumers, and at the bottom end which caters to a broader consumer base that has been more severely impacted by high unemployment and muted income growth. The near-term expectation for the sector this year is for it to continue a slow, steady recovery.

The office sector has also been a laggard, as many tenants have opted to consolidate space during the recovery. Although office fundamentals have slowly but steadily improved over the last three years, recovery in the sector generally has been modest. Office construction more than doubled last year and should post a larger gain this year. While the recovery in office development is still in its early stages, a few trends are emerging. Newer areas of the tech sector, including social media, cloud computing, big data, healthcare management software, payments processing and internet security are especially strong driving forces influencing the growth in office demand.

Despite the relatively slow pace of U.S. economic growth, hotel demand outperformed most major property types over the past three and a half years. Underlying property fundamentals remain strong, with demand up more than 20% since bottoming in 2010. Demand for hotel rooms has remained near a record high for two years. The average occupancy rate is at its highest level in more than seven years. Continued moderate economic growth, coupled with a favorable demand-supply balance, is expected to continue to drive hotel performance improvement. Overbuilding is not anticipated to be a concern this year. An abundance of equity and debt capital is expected to drive approximately a 10% increase in transaction volume in 2014.

*Construction*

The recovery in nonresidential construction overall has been rather sluggish, but is beginning to show improvement. Two commercial real estate construction leading indicators, the Dodge Momentum Index and the Architecture Billings Index, point to increasing construction activity in the next twelve months. The February Dodge Momentum Index, which is a measure of projects first reported in the planning stage, is up 20% year-over-year. Requests for architectural design services, according to the Architecture Billing Index, increased slightly in February, suggesting a slight increase in construction spending twelve months down the road. Rising building and labor costs, however, remain an impediment to a stronger recovery.

*Capital Markets*

While banks have eased lending standards, they continue to be stringent about asset location and quality. Available capital and credit continue to focus on core properties within primary markets, although a move into secondary and even tertiary markets is beginning to make some headway. Fortunately, this year finds the real estate capital markets extremely liquid, with an abundance of capital chasing deals from a wide range of investors. 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, the increases are not expected to be disruptive to the market. The increase in competition and liquidity in the capital markets is expected to bode well for commercial real estate.

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**Lenders**

Commercial property lending continues to gain momentum and could reach a new post-recession high this year. The Mortgage Bankers Association (MBA) projects commercial and multifamily loan originations to grow $300 billion in 2014, a 7% increase from 2013 volumes. Commercial and multifamily lending volume in the fourth quarter of last year was 16% higher than the fourth quarter a year earlier, driven principally by increases in loan originations for healthcare, retail and office properties. The dollar volume of loans originated specifically for commercial bank portfolios increased 54% in the fourth quarter of last year compared to the fourth quarter a year earlier. Among other investor types, there was a 40 percent increase in loans made by life insurance companies in the fourth quarter of last year compared to the fourth quarter a year earlier, a 15 percent increase for CMBS and a 43 percent decrease in the dollar volume of loans originated by Government Sponsored Enterprises (GSEs – Fannie Mae and Freddie Mac). The delinquency rate for commercial and multifamily loans continued to decline in the fourth quarter of last year, according to the MBA. The 90+ day delinquency rate for loans held by FDIC-insured banks decreased to 1.7%. The 60+ day delinquency rate for loans in life insurance company portfolios decreased to 0.05%. For multifamily loans held or insured by Freddie Mac, the delinquency rate increased to 0.09%, compared to a decrease to 0.10% for loans held by Fannie Mae. The 30+ day delinquency rate for loans held in CMBS decreased to 6.97%.

The number of FDIC-insured institutions reporting financial results fell to 6,812 in 4Q13 from 6,891 in 3Q13. In 2007 prior to the last fiscal crisis, there were 8,559 FDIC-insured banks reporting. During the fourth quarter of 2013, two insured banks failed, resulting in a total of twenty-four banks failing 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 4Q13 fell for the eleventh consecutive quarter, after increasing for 19 quarters (since 3Q06). The number of "problem" institutions declined to 467 in 4Q13 from 515 in 3Q13.

Real Capital Analytics (RCA) tracks the distressed asset market and recently reported $137.7 billion in distressed loans associated with 10,644 properties, down from $151.5 billion in distressed loans associated with 10,928 properties reported in the last quarter. The size of the distressed asset market peaked at $191.5 billion in October 2010. The $137.7 billion total consists of $93.2 billion in troubled loans associated with 6,893 properties (down from $103.5 billion associated with 7,113 properties in the last quarter) and $44.5 billion in lender REO associated with 3,751 properties (down from $47.9 billion in lender REO associated with 3,815 properties in the last quarter). According to CoStar, less than 10% of all commercial property sales transactions today are distressed sales, compared to a peak of 35% in October 2010.

The Federal Reserve's January 2014 *Senior Loan Officer Opinion Survey on Bank Lending Practices,* found that almost half (46%) of banks surveyed indicated that they experienced "moderately stronger" demand for commercial (non-residential) real estate loans in 4Q13. The remainder (54%) indicated the demand "stayed about the same as in the previous quarter." The survey also found that lending requirements for approving commercial (non-residential) real estate loans did not change from the previous quarter for 92% of the banks surveyed. However, the requirements were eased somewhat for 8% of the bank respondents.

**CMBS/CDOs**

Commercial mortgage-backed securities (CMBS) 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. A rising rate environment is not expected to impede access this year by commercial real estate issuers who are likely to tap the CMBS market to refinance looming debt maturities while rates remain relatively low. Issuance in 2013 was approximately $86 billion, nearly double the $48 billion in issuance that occurred in 2012. Issuance in 2014 is projected 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. According to Trepp, the delinquency rate in February fell 47 basis points from January to 6.78%, declining below the 7% level for the first time since February of 2010.

**REITs, Life Insurance Companies and Pension Funds**

Capital raising by REITs continues on par with last year's outstanding performance. U.S. equity REITs raised a total of $8.87 billion in capital year-to-date as of March 7, 2014, compared to $9.17 billion raised during the same period in 2013. Retail REITs have raised the most capital so far, followed by healthcare and industrial REITs.

Major life insurance companies have come to prefer real estate investment to bonds and other possible investments. Life companies experienced near-record commercial real estate loan production last year. Of late more firms are even exploring expanding into small-balance commercial real estate lending (loans below $10 million). Life companies had more than $60 billion in loan origination in 2013.

U.S. pension funds remain underweight in real estate allocations, but are exhibiting a desire to increase allocations. They are not only focusing on the prime markets, but also on the secondary markets in search of higher yields. U.S. pension funds currently have 7.2% of their total assets, or an average of $752 million, allocated to commercial real estate. This is below the allocation target goal for the group, which averages 8.2%.

Commercial real estate is attractive to institutional players for three key reasons: attractive yields, diversification and/or a hedge against inflation.

**Foreign Investors**

The U.S remains the top destination for foreign commercial real estate investment, approaching $40 billion in 2013, a 40% increase over 2012. Investment is being made in quality assets located in both primary and select secondary markets (for potentially higher yield), with the gateway markets continuing to be the most popular. Canada represents nearly one-third of all foreign investment activity in the U.S.

**Property Transaction Market**

According to the Mortgage Bankers Association's (MBA) *Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations*, *Q4 2013*, commercial and multifamily mortgage origination volume (dollar basis) in the fourth quarter of last year rose by 16% from a year ago, and 34% between the third and fourth quarters of last year. For the fourth quarter of last year compared to the same quarter a year earlier loans originated by life insurance companies increased by 40%, loans originated by commercial banks increased 54%, and loans originated by conduits for CMBS increased 15%. However, loans originated by GSEs (Fannie Mae and Freddie Mac) decreased 43%.

Year-on-year comparing 2013 with 2012, commercial and multifamily loan origination volume was up 15%. Among investor types, loans for CMBS increased 33%, loans for commercial bank portfolios increased 32%, and originations for life insurance companies increased 25%. However, loans for GSEs (Fannie Mae and Freddie Mac) decreased 18%.