Commercial Real Estate Market Intelligence Report: Third Quarter 2014

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General

With the U.S. economy continuing to improve and capital more readily available for investment, the commercial real estate market is now well along in its recovery. Steadily higher property prices have benefited from the low interest rate environment, relatively low levels of commercial construction and an influx of foreign direct investment. Operating fundamentals continue to improve across most product types and geographies.

Among income property types, the multifamily sector remains by far the most active. While demand is expected to remain firm, the supply of new units coming on the market is poised to increase even faster over the next couple of years, which should exert modest upward pressure on the vacancy rate and reduce the rate at which rents have been increasing.

Next to the multifamily sector, the industrial sector has posted the strongest recovery. Warehouse fundamentals remain solid with demand continuing to outpace supply. The strengthening in demand, drop in vacancy rates and increase in rents has reached a point where new construction is warranted in many markets and the pipeline of proposed projects and projects under construction is filling up once again.

Fundamentals in the lodging sector continue to remain strong and are reaching new highs. Revenue per available room (RevPAR) continues to rise and demand continues to outpace new supply. Many markets have sizeable construction pipelines and hotel development continues to be healthy.

Construction is also increasing in the office sector, even though vacancy rates have not fallen near as much as they have in other property sectors. Demand has steadily improved, with growth in technology occupations paving the way. Businesses continue to be much more efficient with their space needs, which is one of the reasons vacancy rates have taken so long to come down in a meaningful way.

Retail fundamentals are firming but at a relatively slow pace. Vacancy rates are continuing to decline modestly and rents are continuing to improve slowly. Part of the

lackluster performance is due to languishing mall fundamentals. Sluggish retail sales and stagnant wage and salary growth are largely behind this weakness.

Cap rates for the five major property types (multifamily, office, retail, lodging and industrial) trended lower (compression) in the second quarter giving rise to higher sale prices. Multifamily prices now exceed their pre-financial crisis peak by 14.6%, according to Moody's/RCA Commercial Property Price Indices. The CBD office sector is now about 17% above its pre-crisis peak. CoStar reported that the distress percentage of total sales declined to 10.5% in the first five months of the year, compared to 17% one year ago. A considerable volume of troubled assets have been cleaned up and resolved, significantly reducing market concern.

Commercial real estate transaction volume across all property sectors is expected to remain healthy for the remainder of the year as the market continues its recovery.

Major Property Types

The multifamily sector continues its strong rebound and has recently reached the highest monthly construction pace since the beginning of 2006. Sector fundamentals continue to outperform all major property types, with effective rent growth continuing to surpass expectations. Vacancy rates are at a 13 year low; however, in a few high growth U.S. markets the new supply of units may negatively impact this trend. Sales dollar volume is strong and year-over-year gains are highest among all property types. Multifamily performance could cool somewhat toward the end of the year reflecting normal seasonality and expected new construction completions scheduled at the end of the year.

Fundamentals in the industrial sector continue to show improvement, with declining vacancy rates and increasing rents. The vacancy rate is now below its long-term average, and year-over-year rent increases have now reached a post-recession peak. Landscape in the industrial sector is being redefined by escalating demand from e-commerce, healthy sales from traditional retailers, growth in the manufacturing sector and expansion by third party logistics providers. Rather than solely focusing on ports and intermodal hubs, the emerging trends are creating demand for industrial real estate in a broad range of markets, including secondary and tertiary metros. As economic growth and increasing trade lift demand for industrial space, vacancy rates will continue to tighten. Unlike past recovery cycles, this upswing favors warehouse and distribution centers more than the flex sub-sector. Demand has focused on the limited supply of quality assets, pushing rent growth for warehouses well above the national average in many of the gateway and hub markets. Top-tier assets in late-recovery markets have also benefited, though to a lesser degree, as very tight development pipelines over the last few years limited competition and helped support rent growth. Tightening supply conditions are continuing to drive increased construction activity. Flex space is expected to gain momentum as the year progresses, particularly in technology markets. Sales activity is expected to remain healthy for the remainder of the year and into next year.

In the lodging sector all measures of property performance continue to increase and little appears to stand in the way this year for the sector to attain new highs in occupied rooms and room revenue. Occupancy is increasing and should achieve the highest rate since 1987. Average daily rate (ADR) and revenue per available room (RevPAR) continue to increase. ADR is expected to rise this year at the fastest pace since the recession ended and drive up RevPAR for the fifth consecutive year, despite somewhat higher supply growth. Individual hotel sales are increasing and transaction volume this year could be as high as $25 billion. Acquisition debt financing is expanding, and a greater number of lenders, including CMBS lenders and national, regional and local banks, are competing for deals than at any time since the sector's recovery started four years ago. There is also an abundance of capital offered by off-shore buyers, private equity funds and REITs.

Office sector fundamentals are improving driven by lack of development in most markets and strength in private-sector payrolls. Vacancy rates continue to drift lower and are at the lowest level in five years. Office rents are increasing in most markets due to several years of tightening fundamentals. Values of office buildings are increasing as global capital flows at an accelerating rate into the U.S. office sector, particularly into properties in central business districts.

Wage growth and housing market recovery are paramount to continued improvement in consumer spending and thus overall demand for retail space. Escalating job gains and rising consumer confidence have supported retail spending, but weak income growth still constrains core retail sales. Retail space fundamentals remain on a clear path to recovery, albeit a slow and inconsistent recovery. Asking and effective rents continue a slow but decidedly upward rent growth trend. The market remains bifurcated with strength at the discount and luxury ends of the market spectrum, but weakness in the middle-market. As such, the recovery while moving in a positive direction remains uneven. Rapidly growing e-commerce by retailers has resulted in downsized existing retail footprints but an increase in distribution centers for expedited delivery. While this adaptation may drive retail sales, it has constrained the demand for traditional retail space. Power centers, grocery-anchored centers and upscale outlets are the focus of new construction activity, particularly in markets where availability is tightening. Investment sales to-date this year show considerable momentum, with sales dollar volume increasing more than 50% compared to last year. Average cap rates on retail transactions in primary and secondary markets are now almost at the same level as at the peak of the previous cycle in 2007.

Capital Markets

The capital markets continue to provide considerable liquidity to the commercial property sector. Commercial real estate lending has been on a steep upward trend since its trough in November 2010. While lending standards remain tight, they are beginning to loosen making credit available to an increasing number of borrowers. The Mortgage Bankers Association is forecasting continuing increases in debt financing, with CMBS,

bank and life insurance company financings expected to measurably increase. While long-term interest rates are still expected to tick up a few basis points, the increases are not expected to be disruptive to the commercial real estate market. The availability of multiple sources of capital bodes well for commercial real estate market performance.

Lenders

According to the Mortgage Bankers Association's *2Q2014 Survey of Commercial/Multifamily Mortgage Bankers Originations*, second quarter commercial and multifamily loan originations on a dollar volume basis were 2% lower than during the same period last year, but 34% higher than in the first quarter of 2014. The drop in the second quarter was strongly influenced by a decrease in originations for retail and multifamily properties. The decrease included a 10% decrease in dollar volume of loans for retail properties, a 10% decrease for multifamily properties, a 6% decrease for office properties, a 20% increase for industrial properties, a 45% increase in hotel property loans and a 95% increase in health care property loans. Compared to last year's second quarter, lending (on a dollar volume basis) by banks and lending associated with CMBS increased by 19% and 45%, respectively, while originations for GSEs (Fannie Mae and Freddie Mac) and life insurance companies were each lower by 13%.

The number of FDIC-insured institutions reporting financial results fell to 6,656 in the second quarter, down from 6,730 at the end of the first quarter. In 2007, prior to the last fiscal crisis, there were 8,559 FDIC-insured banks reporting. During the second quarter of the year seven insured banks failed, compared to five in the first quarter. In 2012, there were a total of 51 bank failures. The number of institutions on the FDIC's problem list in 2Q14 continued to fall, declining from 411 to 354 during the quarter. This is the smallest number of "problem" institutions since the end of the first quarter of 2009, and is 60% below the peak level of 888 at the end of the first quarter of 2011.

Real Capital Analytics (RCA) tracks the distressed commercial real estate asset market and reported $109.3 billion in remaining distressed loans associated with 8,729 properties, down from $137.7 billion in distressed loans associated with 10,644 properties reported in the last quarter. The size of the distressed asset market peaked at $191.5 billion in October 2010. The $109.3 billion total consists of $64.6 billion in troubled loans associated with 5,272 properties (down significantly from $93.2 billion associated with 6,893 properties in the last quarter) and $44.7 billion in lender REO associated with 3,457 properties (compared to $47.5 billion in lender REO associated with 3,751 properties in the last quarter). Nearly 70% of the $412 billion in commercial real estate loan defaults since the 2007 market peak have been resolved. Distressed asset sales are fast approaching the end of the cycle.

The Federal Reserve's July 2014 *Senior Loan Officer Opinion Survey on Bank Lending Practices,* found that about a third of the banks surveyed indicated they experienced "moderately stronger" demand for commercial (non-residential) and land development loans in the quarter. Approximately two-thirds of the banks indicated the demand "stayed about the same as in the previous quarter." Only two banks found the

demand weaker. With respect to commercial real estate loans secured by commercial property, about a quarter of the banks surveyed indicated they experienced "moderately stronger" or "substantially stronger" demand in the quarter. Approximately three-quarters of the banks indicated the demand "stayed about the same as in the previous quarter." With respect to multifamily real estate loans secured by multifamily property, slightly less than a quarter of the banks surveyed indicated they experienced "moderately stronger" demand in the quarter. Three quarters of the banks indicated the demand "stayed about the same as in the previous quarter."

Commercial and multifamily mortgage performance continued to strengthen during the second quarter. Delinquency rates for loans held by life insurance companies, Fannie Mae and Freddie Mac all remained low, and delinquency rates for CMBS loans continued to decline.

CMBS/CDOs

Commercial mortgage-backed securities issuance continues to be a cornerstone of commercial real estate financing. The resurgent CMBS market is enjoying its strongest month (September) in seven years with about $15 billion of expected new issuance (associated with 21 separate deals). Through September 22, 2014, there has been $65.1 billion of issuance, almost $5 billion ahead of last year's pace. Should all the deals price as expected in September, issuance volumes through the first three quarters of the year would exceed $67 billion. CMBS issuance through the third quarter would then be up 20% year-over-year. Most industry analysts still believe that total CMBS issuance this year will approach $100 billion (compared to $80 billion last year). The CMBS market has only surpassed the $100 billion annual issuance level three times: in 2005, 2006 and 2007.

Delinquency rates for loans in CMBS continue their improvement trend. The U.S. CMBS 30+ days delinquency rate in September was 6.03%, compared to 8.14% one year ago. Year-to-date delinquencies have fallen 140 basis points from 7.43% as of December 31, 2013.

Life Insurance Companies

New mortgages originated by life insurance companies this year are expected to exceed 2013 levels. More life insurance companies are increasing their allocation to commercial mortgage loans as an alternative to lower yielding bonds. Commercial mortgage loan allocation typically ranges between 8% and 12% for most insurers, although the larger companies have allocations as high as 15%.

Life insurance companies are very active in multifamily lending and competing neck and neck with Fannie Mae and Freddie Mac. While the GSEs have remained dominant, life insurance companies are finding more creative ways to compete with them on Class A, lower leverage deals by offering more flexibility in underwriting. They are able to offer more competitive structures (such as IO (interest-only) loans) and more prepayment flexibility. GSEs often have their hands tied is when it comes to

loan limits and lender restrictions. As balance sheet lenders, life insurance companies have the ability to reassess and negotiate throughout the underwriting process on a case-by-case basis. They do not sell their loans, meaning borrowers have access to the lender if they need to revisit the loan for any reason (from relieving collateral to restructuring payments). Borrowers also find it attractive that life insurance companies have the ability to lock in an interest rate with the application. GSE financing takes much longer, leaving rates open for change.