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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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CRE Deal Volume Shows Late-Cycle Behavior: Q2 Chartbook

"Prudent, cautious self-control is wisdom's root." Robert Burns (poet)

Following the dismal first quarter real GDP reading, U.S. economic growth advanced at a 2.6 percent pace in Q2 and the unemployment rate, at 4.3 percent, matched the lowest level in more than 15 years. Despite steady economic and labor market conditions, commercial real estate (CRE) transaction volume posted its fifth year-over-year decline in the last six quarters in Q2, according to Real Capital Analytics (RCA), as operating fundamentals cooled. At the same time, pricing climbed 6.5 percent in H1 relative to a year earlier.

Foreign investors are also exhibiting some restraint in acquiring U.S. properties notwithstanding the still-elevated level of cross-border transaction volume. Indeed, the share of cross-border transactions comprised just 14 percent of total market volume in the four quarters through Q1, which is down from a cycle high of 18 percent in late-2015.[1]

Transaction volume gives some perspective on investor's perception, appetite, and market dynamics. With activity down more than 35 percent from the cycle peak, investors are exhibiting cautious behavior; however, the picture is more nuanced than total figures portray. Indeed, the hotel sector registered the largest decline in transaction volume among the key classes from its cycle high, dropping more than 50 percent in Q2 from its 2015 high, but activity stabilized in H1.

On the other hand, suburban office and warehouse were the only sectors to post positive year-over-year deal volume, which is consistent with fundamentals where vacancy rates climbed in retail and apartment in Q2 but have mostly declined in industrial since 2010. The office vacancy rate was unchanged during the quarter but edged a tick higher relative to Q4.

In RCA's The Big Picture report for Q2, the firm noted a disconnect between pricing and deal volume and believes that volume is falling mostly due to dissimilar expectations around pricing. We agree with the assessment and also acknowledge that the persistent weakness in year-over-year deal volume is consistent with late-cycle behavior including moderating asking rent and loan growth, and tighter lending standards. Hence, sectors that registered robust growth earlier in the cycle like hotels and apartments are registering softer performance. However, some secondary and tertiary markets are posting gains in deal volume across more than four property types where cap rates are still high relative to major markets.

Persistent weakness in year-over-year deal volume is consistent with late-cycle behavior.

While the first half of the year was marked by investor caution, and a healthy dose of uncertainty as investors awaited tax reform guidelines e.g. 1031 tax-free exchange, H2 should continue to see investor appetite shift to secondary and tertiary markets and robust growth in the industrial sector. Markets with strong employment and population growth should remain active, while major markets continue to lose steam across property types. We also expect submarkets to begin to tell a better story of pockets of risk and opportunities in the coming quarters.

[1] Real Capital Analytics, "US Cross-Border Investment Compendium," Q1'17

The Road Less Traveled: Secondary and Tertiary Markets Gain

With rent increases slowing and lending standards tightening, investors are traversing into secondary and tertiary markets, especially where employment and population are growing above the national average. Although overall transaction volume was softer in H1 (Figure 1), activity in Orlando, Atlanta, Jacksonville, Charlotte, Dallas and Houston posted positive growth relative to the same period a year earlier in four or more sectors.

Orlando, which is benefiting from a strong leisure and hospitality sector, posted gains in transaction volume across all five categories, with the strongest growth in industrial. Jacksonville also saw acquisitions increase across five segments as volume in the office component surged in H1. Even the once beleaguered Houston market registered positive deal volume in the first half of the year, with hotel, office and industrial up in H1 relative to a year earlier. On a sector basis, overall transaction volume posted gains in limited service hotels, grocery, single-tenant retail, suburban office, warehouse and flex industrial space.

Many domestic investors looking for more yield are opting for secondary and tertiary markets with higher average cap rates.

Another factor that has come into play for investors is historically low cap rates, especially in major markets preferred by foreign investors. Many domestic investors looking for a bit more yield are opting for secondary and tertiary markets with higher average cap rates. For example, the average cap rate in Manhattan, which has recorded the largest cross-border transaction volume in the nation for some years, registered an average cap rate of 3.7 percent in Q2 in the apartment market, matching the lowest level on record. Deal volume fell more than 50 percent in H1 and was down an almost similar figure on a year-ago basis. In contrast, the average apartment cap rate in the Southwest, which includes Austin, Dallas, San Antonio and Houston, was more than 6 percent and transaction volume in H1 relative to a year earlier grew 5.6 percent. Acquisitions in tertiary markets in the West, Southeast, and Southwest were up in Q2.

Elevated pricing (Figure 2) has also been a concern for investors, and we suspect the disconnect in pricing and transaction volume is also due to still-elevated levels of cross-border transactions. Indeed, the low global rate environment and reach for yield, and in some cases, safe-haven plays made U.S. CRE a preferred asset class in many markets by foreign investors. With global economic conditions stabilizing, the risk of global deflation less of a concern, and hence, some major central banks expected to begin tightening monetary policy next year; investors are bracing for higher cap rates in the U.S. and abroad, and in turn, lower valuations. That said, the short- and long-end of the curve are largely driven by different determinants. Moreover, cap rates don't necessarily move in lock-step with the 10-year U.S. Treasury yield. On a global scale, the average cap rate in the U.S. in Q2 was the highest among the 11 countries tracked by RCA (e.g. France, Australia, etc.), with the risk premium still favorable at more than 400 basis points.[2]

Figure 1

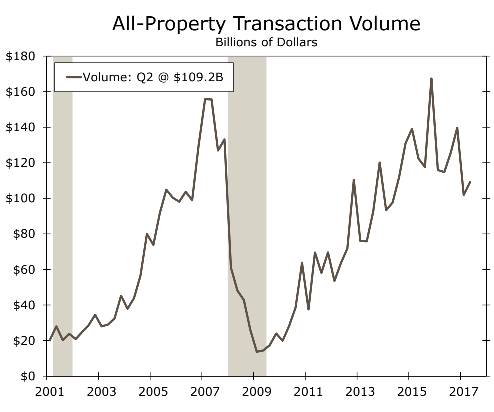
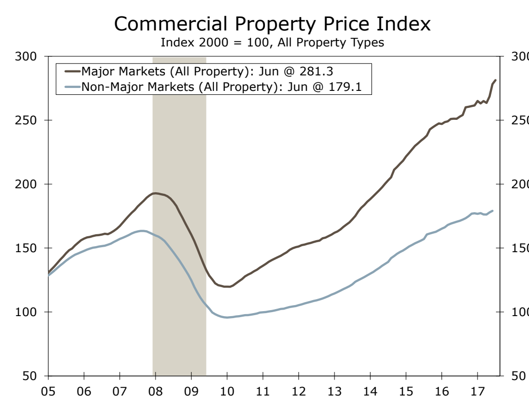


Figure 2



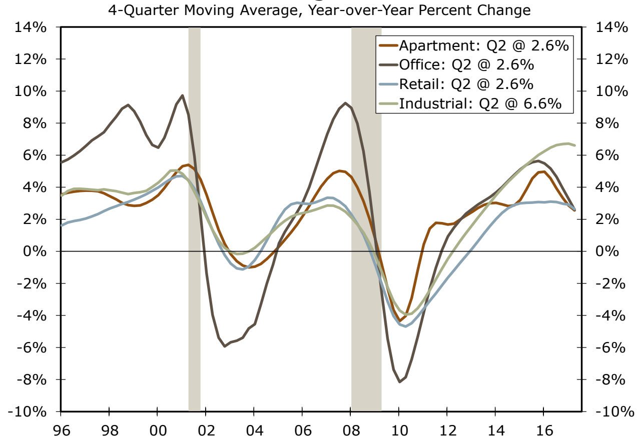
Source: RCA Inc. and Wells Fargo Securities

[2] Includes office, industrial, and retail

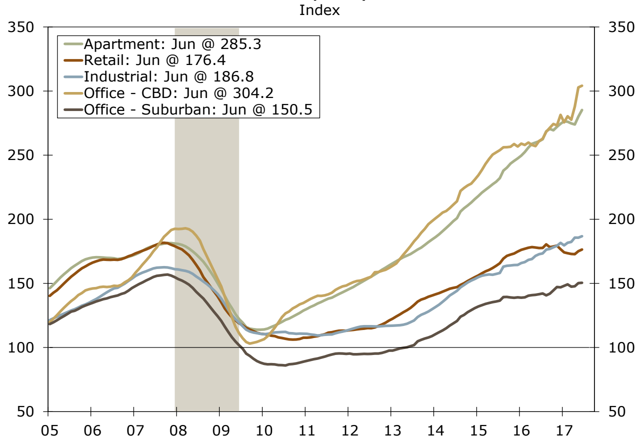
CRE Property Pricing & Fundamentals

- Operating fundamentals improved in Q1, albeit at a much slower pace. Year-over-year asking rent growth for office, apartment and retail fell below 3.0 percent in Q2, while industrial registered another quarter of solid growth. Industrial was the only sector to post an increase in occupancy in Q2.
- Cap rate results were mixed in Q2, with the all-property level easing on the month on the back of compression in the apartment and industrial sector relative to the same quarter a year ago. Average office cap rates were relatively unchanged, while retail was up on the year.
- The Moody's/RCA Commercial Property Price Index (CPPI) grew in H1 with office CBD registering the strongest yearly pace of growth, while retail was the only sector that fell.

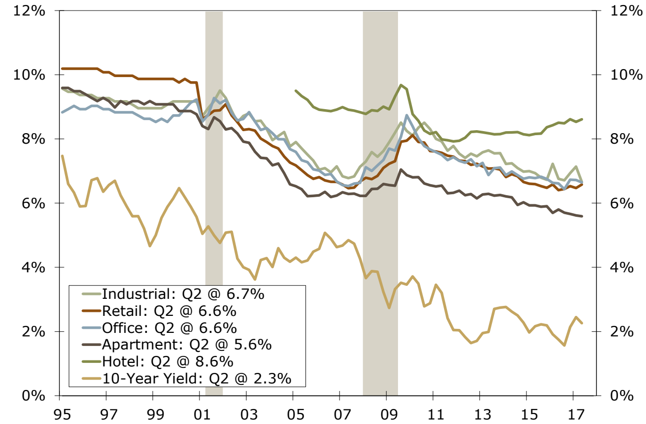
Asking Rent
4-Quarter Moving Average, Year-over-Year Percent Change



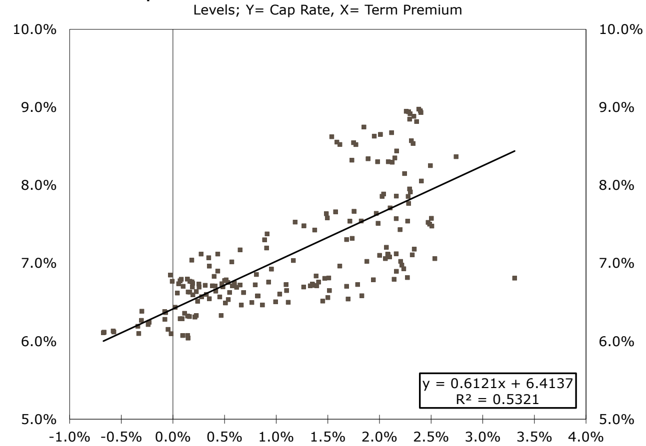
Commercial Property Price Index
Index



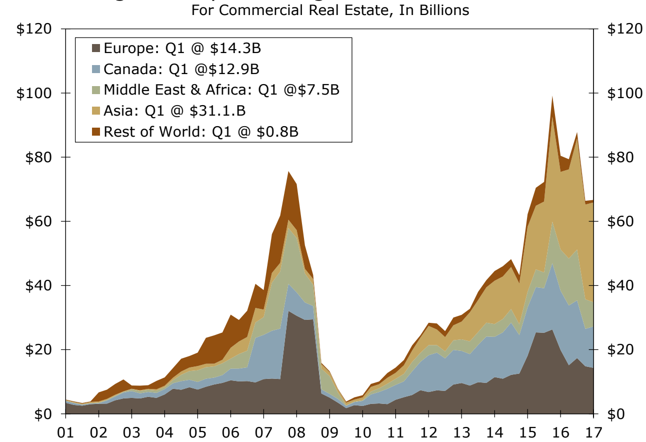
CRE Cap Rates vs. 10-Year Treasury Yields
Percent, Yield



Cap Rate vs. 10-Year Term Premium
Levels; Y= Cap Rate, X= Term Premium



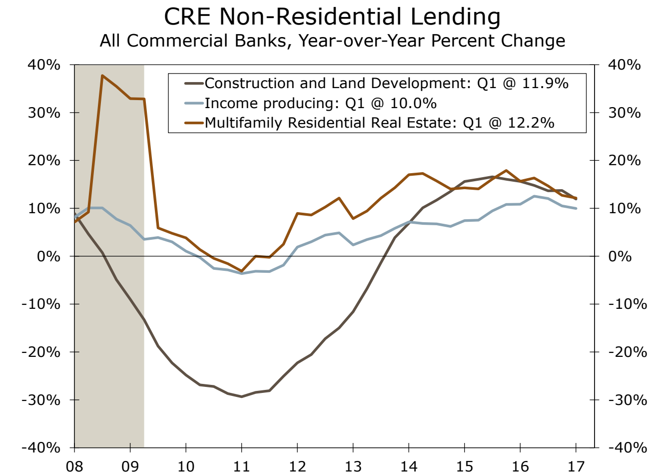
Origin of Capital Going Into the United States
For Commercial Real Estate, In Billions

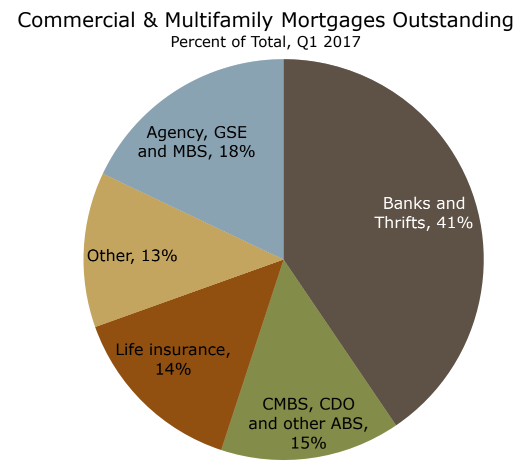


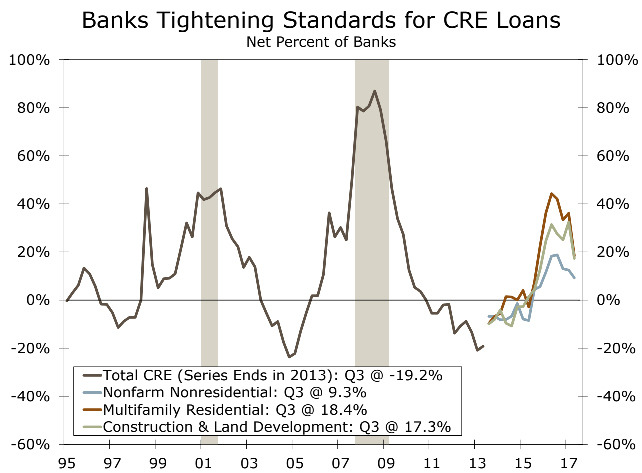
Source: FDIC, Mortgage Bankers Association and Wells Fargo Securities

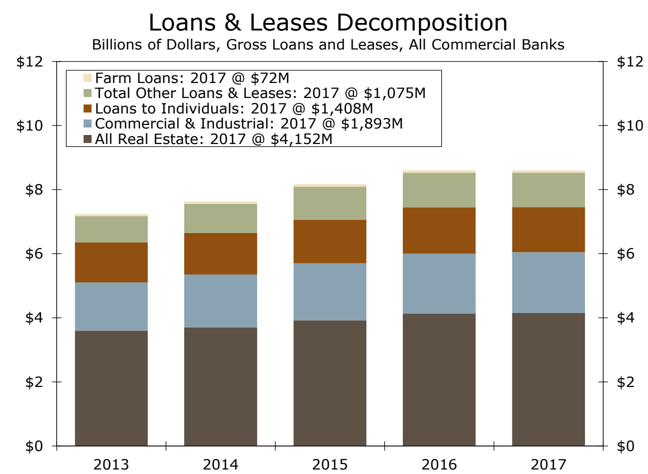
Credit Availability & Lending

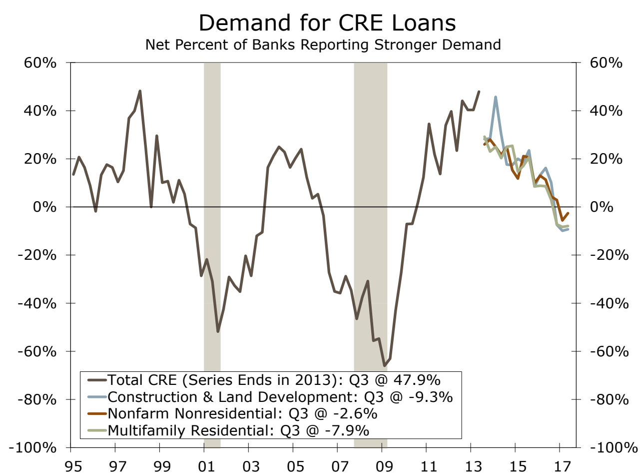
- Senior loan officers reported that CRE lending standards tightened across the three categories while demand cooled during Q2. A net share of around 17 percent of banks, which is classified as "moderate," reported tightening standards for construction and land development loans and multifamily.
- According to the Mortgage Bankers Association (MBA), total commercial/multifamily debt outstanding broke the $3 trillion mark in Q1. At 41 percent, commercial banks and thrifts still comprise the largest share of debt outstanding.
- Consistent with lending standards, loan growth in multifamily and construction and land development has slowed from its cycle high. Growth in income properties is also moderating.







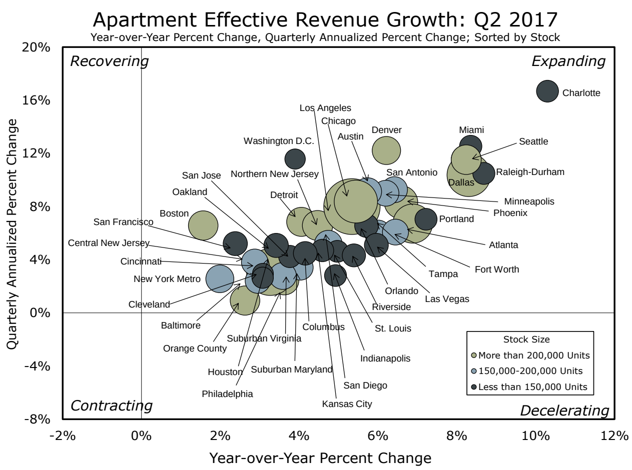


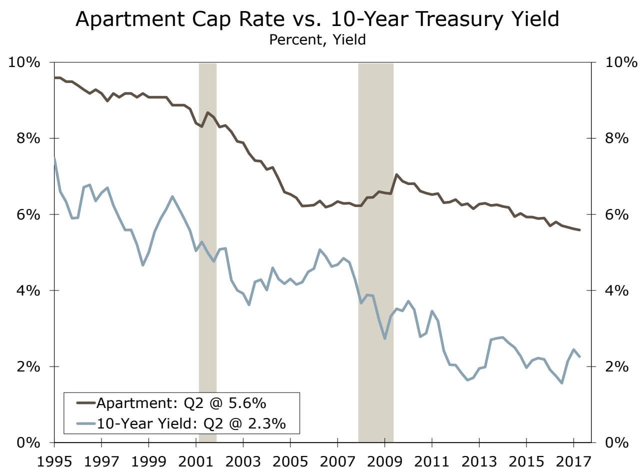


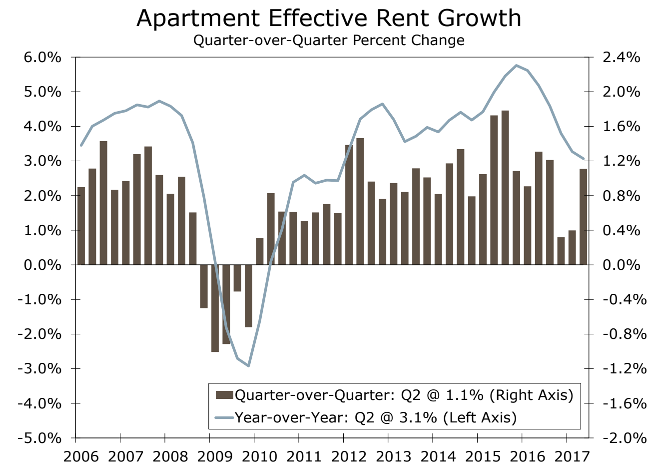
Source: FDIC, FRB, Mortgage Bankers Association and Wells Fargo Securities

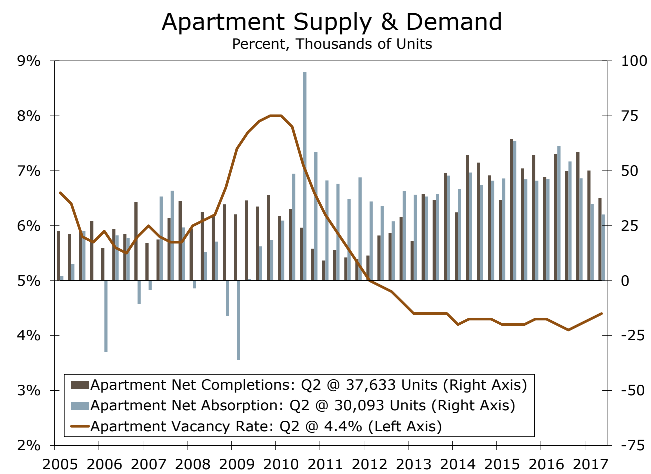
Apartments

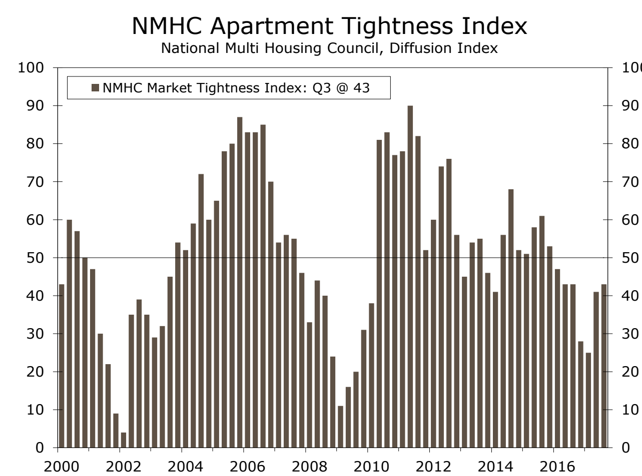
- Apartment fundamentals weakened in Q2 with the national vacancy rate rising to 4.4 percent, its highest level since Q4 2013. While net completions dropped in Q2, demand fell further, with net absorptions at a five-year low.
- Effective rent growth decelerated, slipping to its lowest year-over-year level since Q4 2011, with major markets like Boston, New York and San Francisco weighing on the national average. Year-over-year rent growth in these metros has declined for six quarters. Meanwhile, southern metros led the nation.
- The NMHC Apartment Tightness Index stayed below 50, indicating softening in the market compared to Q1. However, the level rose from last month, reflecting a slower pace of change.







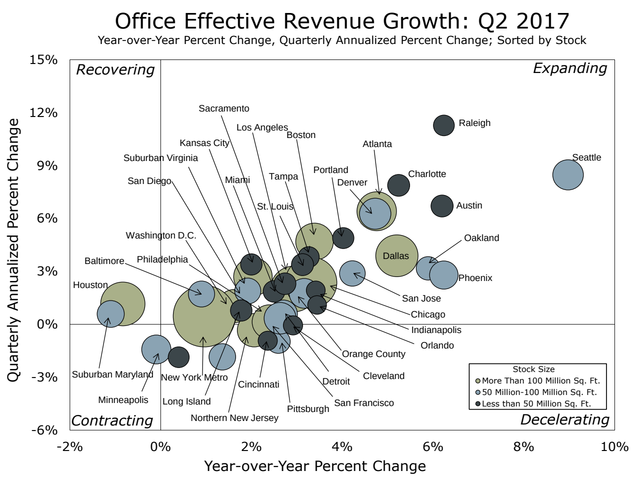


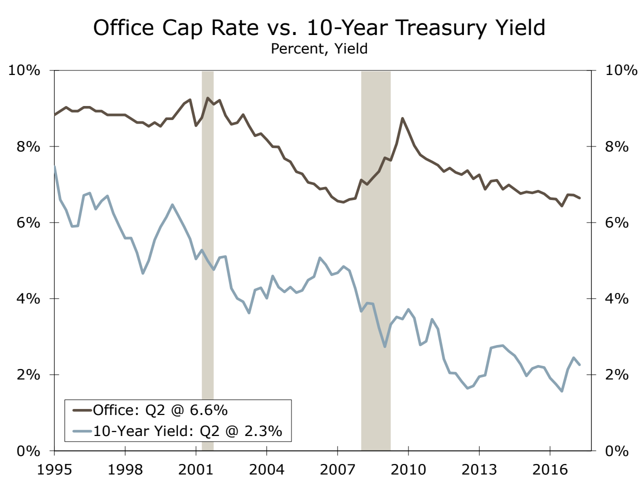


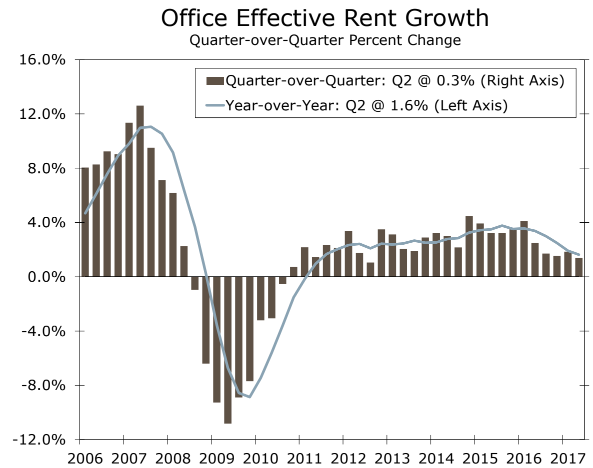
Source: Reis, Inc., RCA Inc., NMHC, FRB and Wells Fargo Securities

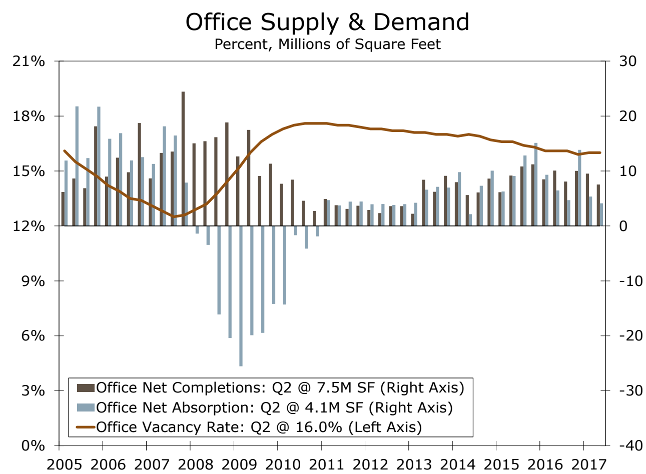
Office

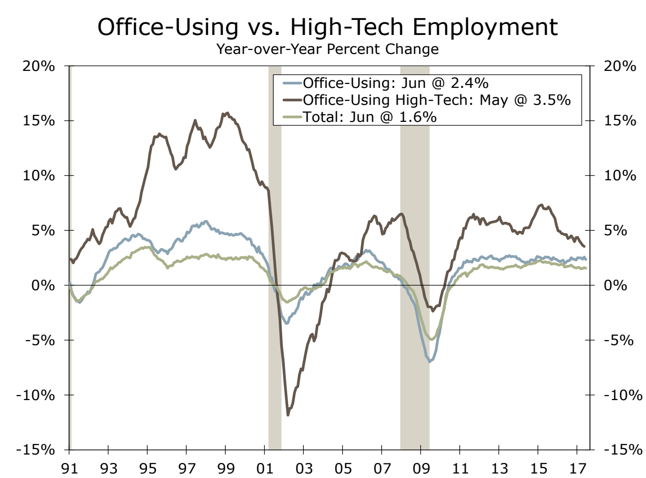
- The surge in office supply delivered since early-2015 continues to put downward pressure on effective rent growth, which slowed to just 1.6 percent year-over-year in Q2, marking the slowest pace in six years. Although rent growth moderated in Q2, most metros posted gains above the national average.
- Vacancies remained unchanged at 16.0 percent in Q2, and completions registered the lowest level in more than two years. On the other hand, occupancy rates in secondary markets like Birmingham, Charlotte, and Chattanooga fell in Q2. With the sector contending with longer-run issues like the decline in average square feet per office worker and increase in telecommuting, changes in the occupancy rate will be modest.











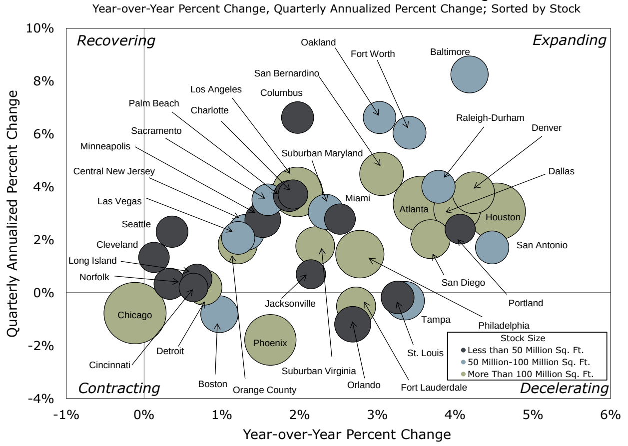
Source: Reis, Inc., RCA Inc., U.S. Dept. of Labor, FRB and Wells Fargo Securities

Retail

- The retail sector continued its slow start to the year, matching a quiet Q1. Net absorptions fell in Q2 to their lowest level since 2011, though net completions ticked up some. Rent growth stayed flat at 1.8 percent over the year.
- Mall rents are rising faster than retail rents as a whole, despite worries over competition from e-commerce, as experiential tenants help support demand for mall space. Within commercial retail, power and neighborhood centers are also seeing stronger growth.
- The retail sector in the Midwestern metros of Chicago, Kansas City and Cleveland is suffering, as these areas grapple with economic and population headwinds. Strength in retail revenue growth is concentrated in the South.

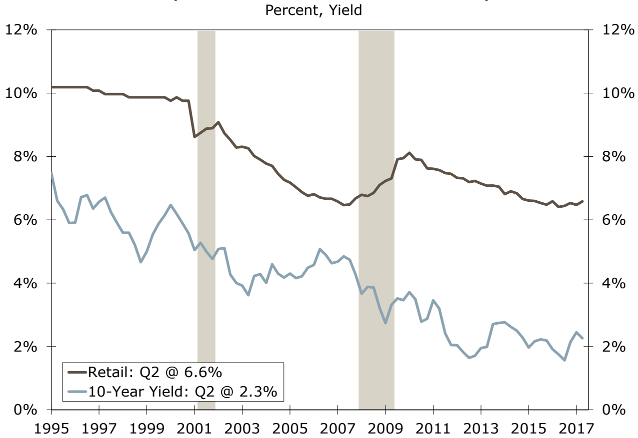
Retail Effective Revenue Growth: Q2 2017

Year-over-Year Percent Change, Quarterly Annualized Percent Change; Sorted by Stock



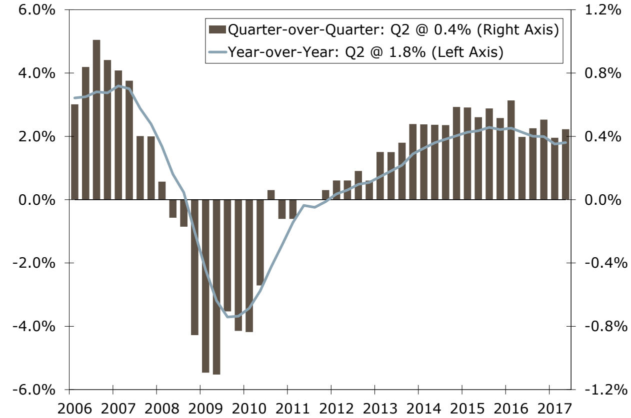
Retail Cap Rate vs. 10-Year Treasury Yield

Percent, Yield



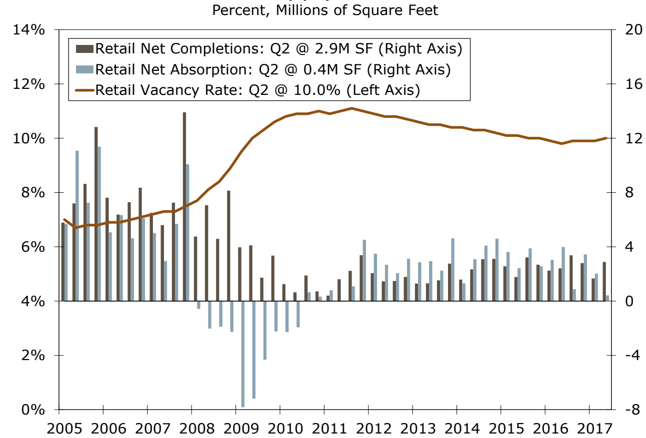
Retail Effective Rent Growth

Quarter-over-Quarter Percent Change



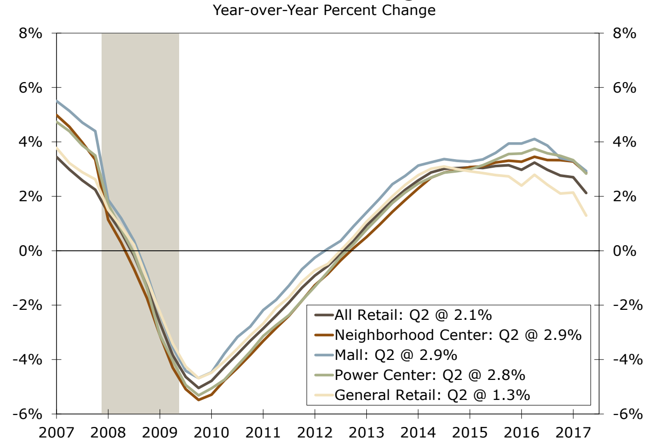
Retail Supply & Demand

Percent, Millions of Square Feet



Commercial Real Estate Asking Rent Growth

Year-over-Year Percent Change

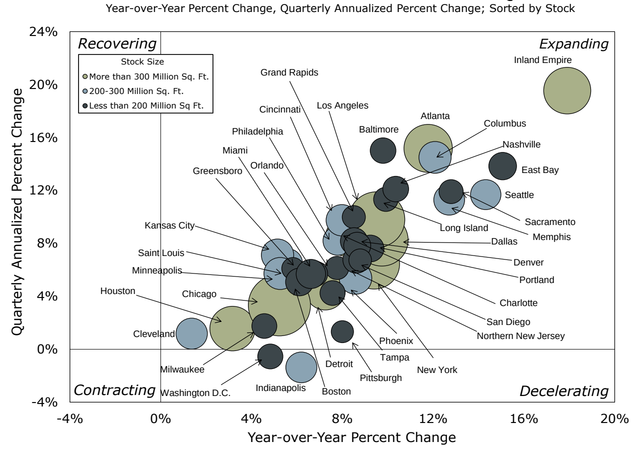


Source: Reis, Inc., RCA, Inc., U.S. Dept. of Commerce, FRB and Wells Fargo Securities

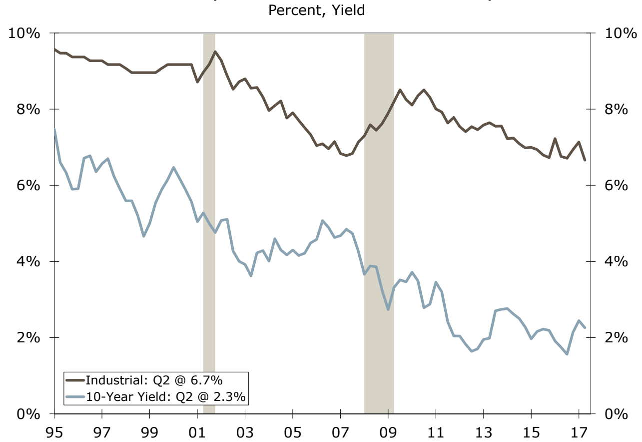
Industrial

- Industrial remained the bright spot in Q2, with asking rent growing near its eight-quarter year-over-year average at 6.3 percent. The increase in e-commerce is evident in the stronger pace of logistics absorption relative to light industrial, with large distribution driving the total. Asking rent growth in logistics advanced 7.0 percent in Q2 year-over-year.
- Overall transaction volume grew in H1 relative to a year earlier but fell on a year-ago basis. Some of the most active markets were Los Angeles, Dallas, Chicago, Northern New Jersey and Atlanta. However, among these markets activity was strongest in Dallas and Northern New Jersey, but fell in Chicago.

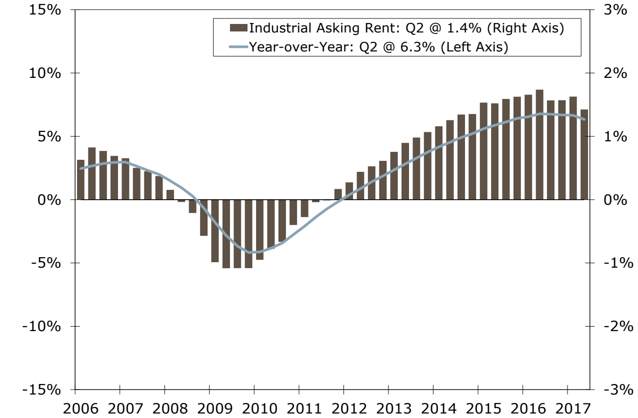
Industrial Effective Revenue Growth: Q2 2017
Year-over-Year Percent Change, Quarterly Annualized Percent Change; Sorted by Stock



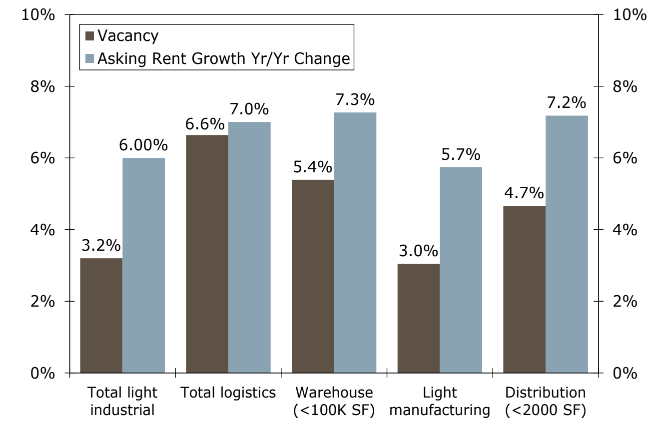
Industrial Cap Rate vs. 10-Year Treasury Yield
Percent, Yield



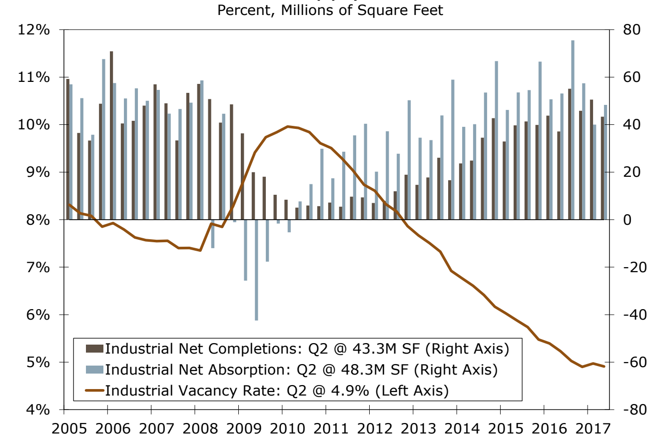
Industrial Asking Rent Growth
Quarter-over-Quarter Percent Change



Q2 2017 Vacancy Rates & Asking Rent Growth
By Type, Sorted by Stock Size, Percent



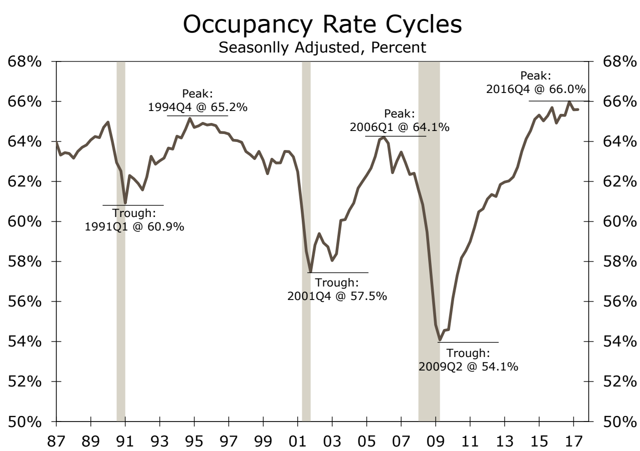
Industrial Supply & Demand
Percent, Millions of Square Feet

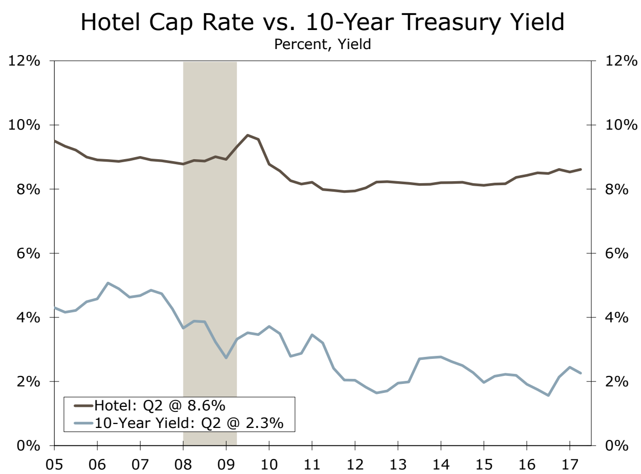


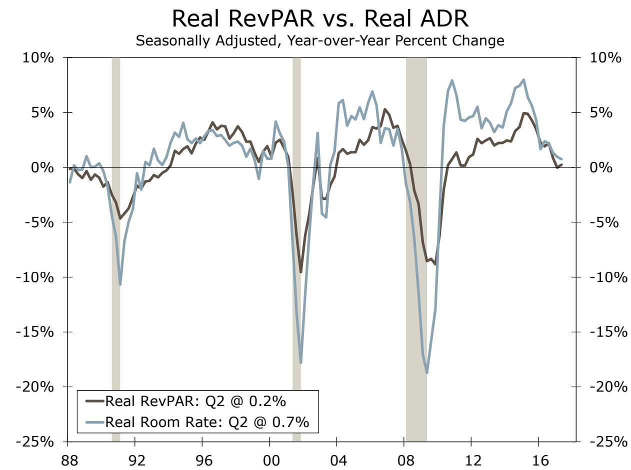
Source: CoStar Realty Information, Inc., RCA, Inc., FRB, Bloomberg LP and Wells Fargo Securities

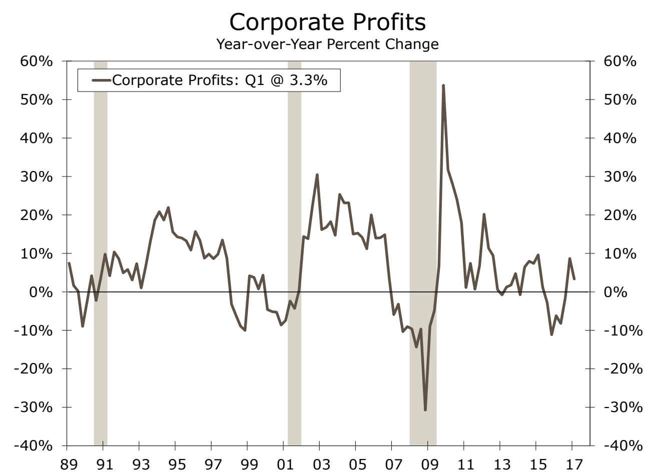
Hotel

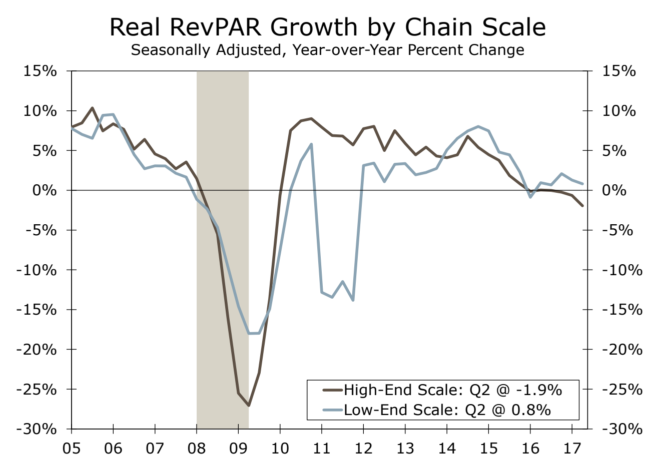
- Still reflecting the previous headwind of weak corporate profits and a stronger dollar, the seasonally adjusted real revenue per available room (RevPAR), which is the product of occupancy and the real average daily rate (ADR), fell to just 0.2 percent in Q2, year-over-year. That said, corporate profits were up more than 3 percent in Q1, and the dollar is softer suggesting there are some upside risks.
- Real RevPAR for higher-end hotels (luxury, upper upscale and upscale) posted its fifth straight year-over-year negative reading in six quarters in Q2, while the pace for lower-end hotels (mid- and economy-scale), has slowed significantly from its cycle peak of 8.0 percent in late-2014 to just 0.8 percent.











Source: STR, U.S. Department of Labor, FRB and Wells Fargo Securities

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