CRE fundamentals appear to be losing momentum but remain generally solid. Meanwhile, urban constraints are pushing more investment back to the suburbs.

As 2019 comes to a close, commercial real estate (CRE) fundamentals appear to be losing a bit of steam. Broadly speaking, demand for commercial properties has downshifted and new development looks lethargic relative to recent history. That noted, even with the light dimming a bit, by no means do we think CRE will soon be in the dark. Vacancy rates across every property type remain low, and while rent increases have cooled off a bit, growth remains positive.

The moderation across the CRE landscape follows a broader economic slowdown, which many feared was a clear sign that the 10-year long expansion was coming to an end. But even as growth shifts to a lower gear, the economy appears to be moving forward at a fairly solid pace. This resiliency is perhaps best reflected in the labor market, which continues to defy expectations and generate sturdy payroll growth, record low unemployment and steadily improving wages—all factors which should bolster demand for CRE in 2020.

Lower interest rates will also reinforce these tailwinds. To counter the slowing effects of weakening global growth and widespread uncertainty stemming from the trade war, the Federal Reserve lowered the federal funds rate a cumulative 75 bps this year. We think the Fed is done adjusting rates for the time being, as the effects of more dovish monetary policy should become more noticeable in coming quarters. A lower cost of capital provides the impetus for increased real estate investment, and property prices may already be reflecting some newfound investor optimism. After cooling for most of the year, property prices are once again on the upswing, rising 7.5% over the year through October. With the exception of retail, property prices for every property segment have regained momentum. The reacceleration in property valuations and lower interest rate environment should further assuage fears of a dramatic upturn in cap rates, which currently remain low at 6%. Absent a spike in interest rates or a surge in new supply, cap rates should remain low.

Figure 1

CRE Vacancy Rates

Figure 2

CRE Cap Rates by Geography

Source: CoStar, Inc., Real Capital Analytics and Wells Fargo Securities
Rockin’ the Suburbs

While generally remaining low, cap rates for properties in central business districts (CBDs) have risen slightly in recent quarters. Over the past year, CBD cap rates have risen roughly 0.3 percentage points and now sit at 5.2%. The recent increase suggests that investor interest in the suburbs is increasing. This should come as little surprise. Generally speaking, CRE investment tends to flow to areas that are seeing strong growth in employment and population, and many suburban areas are now outperforming their CBD counterparts along those lines.

Suburbs are now outperforming CBDs.

According to Brookings, large city population growth slowed to a sub-1% pace in each of the past two years (Figure 3), which indicates a clear moderation in CBD population growth compared to years past. Furthermore, analysis of Bureau of Labor Statistics QCEW data also points to job growth slowing within center cities, while picking up slightly in suburban areas (Figure 4). Admittedly, the parts of a metropolitan area which constitute a suburb are somewhat ambiguous. Household density is typically used to demarcate the boundaries between cities and suburbs, and measuring households is notoriously imprecise. Nevertheless, the areas outside the CBD do appear to be seeing an upshift in growth.

Figure 3

![Large City Population Growth Among Cities Larger than 250,000](chart)

Source: Brookings Institution, Indeed, U.S. Department of Labor and Wells Fargo Securities

Urban construction costs are higher.

This suburban swell is likely a consequence of rising urban rents, which is itself a byproduct of subdued new residential and commercial development. Fundamentally, new urban development tends to be constrained by traffic congestion, higher trade union membership, strict zoning ordinances and cumbersome building codes, which together can make building costs considerably higher than in suburb or exurbs. For example, it’s no surprise to find construction costs in the dense San Francisco and New York City markets are considerably higher than in Atlanta, Houston and Indianapolis, which have more of a suburban orientation.

What’s more, the new energy surrounding suburban CRE in many ways represents a return to a previous norm. One of the central themes of the current economic expansion has been the movement of jobs and people back into the city center, as the lion’s share of job creation has occurred in creative industries, which tend to cluster in downtown areas or close-in suburbs. One of the consequences of the rising popularity of the urban core, however, has been that downtown real estate costs have become increasingly prohibitive.

That’s not to say that the urban areas are seeing a mass exodus of businesses and residents. Both, in our estimation, likely still prefer to be centrally located downtown. To some extent, those who can manage the higher costs still choose this option. But, with the steady flow of residents and businesses into the city center, it was only a matter of time until these higher rents outweighed the economic benefits, and population and employment growth began spilling back over to the suburbs. The recent setbacks in the private equity market might reinforce this trend, as tech companies strive to become more efficient.

Figure 4

![Employment Growth Year-over-Year Percent Change, Q3-2019](chart)
The Soaring Sun Belt Suburbs

Suburban outperformance in employment and population growth nationwide may also be influenced by the economic resurgence of many Sun Belt metropolitan areas, which tend to be less dense and have smaller urban cores. Atlanta, which has long been the posterchild of suburban development, embodies this trend. The Atlanta area has seen jobs and population expand at a pace exceeding the national rate, and much of that growth is happening in the northern suburb of Sandy Springs. This area saw its population increase 2.1% in 2018, significantly stronger than 1.3% in the city of Atlanta and, not surprisingly, demand for apartments, retail and office space has also surged. Furthermore, a highly educated labor pool and accessible public transit, which includes subway service to downtown Atlanta and the airport, have been a beacon for businesses, such as Cox Communications, Mercedes-Benz and State Farm, looking to relocate to the area or expand their existing footprint. A similar situation is playing out in nearby Cumberland, where Comcast and HD Supply have each recently leased over 200,000 square feet of office space and Thyssenkrupp is building its new headquarters.

Developers also appear to be bringing certain elements of city life to the suburbs to adapt to the ‘live-work-play’ preferences of the Millennial and Gen Z generations. The success of multi-use town center properties, which look and feel urban and are mostly outdoor, walkable and transit-friendly, is clear evidence that this trend is no flash in the pan. These properties impart a distinctly cosmopolitan feel by not only featuring a diverse array of retail, restaurants and recreation, but also apartments, office space and hotels. With the building of the massive Domain development, Austin offers a compelling case study in how urbanizing the suburbs can be a useful tool in managing the inherent constraints of the city center. Over the past two decades, and through three different phases of construction, the expansive multi-use Domain property has become a budding tech enclave and de facto second downtown. In addition to the nearly four million square feet of Class A office and retail space, the development consists of 3,500 residential units, hotels, its own entertainment district and a new MLS soccer stadium which just broke ground in September.

The significantly more affordable office and apartment rents compared to downtown Austin have been key to attracting new residents and businesses such as HomeAway, IBM, Indeed and Facebook. In 2018, the city of Austin’s population expanded a fairly robust 1.3%. However, the northern suburbs grew even faster, notably in Leander, which saw its population leap 12.5%, quicker than any other area in the country. On top of that, Round Rock saw a 4.3% increase and Cedar Park grew 1.8%. Growth is expanding even further north to Georgetown, which saw a 5.2% change in population during 2018 and was the ninth fastest growing area in the entire country. While historically not considered a bedroom community of Austin, Georgetown’s suburban layout and historic Main Street offer a compelling “urbanized” alternative to downtown Austin.

Source: U.S. Department of Commerce, CoStar, Inc. and Wells Fargo Securities
CRE Property Pricing & Fundamentals

- Commercial property prices are beginning to pick back up. Overall valuations have risen 7.5% over the year through October, the strongest pace since August 2018. Nearly every property type saw prices rise more briskly, but industrial properties once again posted the strongest gain.
- A surge in industrial sales during Q3 boosted overall transaction volumes to nearly $154 billion. Deal volume for every other major property type dipped over the year.
- Investors remain enamored by the tech-driven Boston and San Francisco markets, with property prices rising over 10% year-over-year. Sun Belt markets such as Tampa, Nashville and Atlanta also rank highest for price gains.

![Commercial Property Price Index](chart)

![CRE Cap Rates by Property Type](chart)

![CRE Transaction Volume](chart)

![Origin of Capital Into the United States](chart)

Source: CoStar, Inc., Real Capital Analytics and Wells Fargo Securities
Credit Availability & Lending

- Banks have not been immune to cooling domestic growth and the uncertainty surrounding heated trade negotiations. According to the Fed’s Senior Loan Officer Opinion Survey (SLOOS), lenders reportedly tightened standards on CRE loans during Q3. Demand for CRE loans was generally unchanged during that same period, although demand for construction & land development loans reportedly weakened.

- That noted, loan originations appear to be turning up. The MBA Commercial/Multifamily Mortgage Origination Index is up 15% year-to-date in Q3, led by healthcare (146%), industrial (43%), office (21%) and multifamily (14%). Retail (-13%) and hotel (-16%) pulled back.

![Graph showing CRE Lending](image)

**CRE Lending**
All Commercial Banks, Year-over-Year Percent Change
- Construction and Land Development: Q3 @ 2.5%
- Income Producing: Q3 @ 6.9%
- Multifamily Residential Real Estate: Q3 @ 7.6%

![Graph showing CRE Originations](image)

**CRE Originations**
Index, 2001 = 100
- Multifamily: Q3 @ 659
- Office: Q3 @ 176
- Industrial: Q3 @ 659
- Hotel: Q3 @ 321
- Health Care: Q3 @ 102

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

- Despite losing some momentum, the apartment market remains on solid ground. After a strong first half of the year, demand for rentals softened in Q3. Alongside slower job growth, net absorption has slowed compared to the robust levels of years past. Net completions also moderated in Q3 to their slowest pace since 2016, reflecting earlier concerns that demand had peaked amidst an expected onslaught of supply.

- Even with some fundamentals cooling, the apartment market is by no means about to fall off a cliff. In Q3, the vacancy rate fell to 5.8%, matching a cycle low. What’s more, landlords appear to have no trouble raising rents, which climbed 3.6% over the past year nationwide, the fastest increase since 2016.

- We expect multifamily construction to rise modestly in 2020, as strong demand encourages developers to move forward on projects both downtown and in the suburbs. Year-to-date starts are running roughly even with last year’s pace, while permits are up 10.1%, with the gap likely reflecting concerns over rising construction costs and labor scarcity.

- Salt Lake City tops the list of most new construction relative to stock, mostly owed to robust demand from strong tech-driven job growth. Boston, San Jose, Seattle and Austin also fit this bill. The Southeast stands out as well, as Miami, Charlotte and Orlando each currently have over 10,000 new units under construction.

Apartment Effective Rent Growth: Q3-2019

Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock

Apartment Supply & Demand

Vacancy Rate; Thousands of Units

Apartment Effective Rent Growth

Percent Change

Quarter-Over-Quarter: Q3 @ 0.5% (Right Axis)
Year-Over-Year: Q3 @ 3.6% (Left Axis)

Apartment Units Under Construction

Percent of Existing Stock; Number of Units

Q3-2019

Salt Lake City 7,500
Miami 16,349
Boston 20,356
Charleston 3,990
Kansas City 10,149
Fort Lauderdale 8,083
Charlotte 11,416
Nashville 7,987
Seattle 21,142
Jacksonville 5,588
Orlando 10,280
San Jose 9,061
Austin 13,525

Source: CoStar, Inc., U.S. Department of Labor and Wells Fargo Securities
Office

- The office market also appears to have lost some steam as a more temperate pace of job growth has led to softer demand for office space this year. Asking rent growth cooled off somewhat in Q3. Rents rose just 2.4%, the slowest pace since 2012. Still, the office market appears to be on solid footing with the vacancy rate falling to a cycle low of 9.7% in Q3.

- Investors appear to be looking more favorably on suburban office properties, which reflects the job and population shift towards more affordable areas. After slowing to 2.1% in July, suburban prices rose 4.1% year-over-year in October.

- New office construction remains sturdy, with nearly 150 million square feet of space under construction, about 15% of which is in New York City. The next phases of the massive Hudson Yards project in Manhattan are underway and several other large scale projects are slated to break ground soon. Nashville, Austin and San Jose also have robust pipelines of new activity.

- Perhaps no other office market has felt the boom and busts of the energy industry as acutely as Houston. The vacancy rate skyrocketed mid-decade as the combination of a building boom and 2015’s collapse in oil prices left a sea of unoccupied office space. After finally beginning to drift lower as demand began to recover in 2018, the more recent pullback in capital spending from oil and gas operators nationwide has led to vacancies rising back up to a cycle high 16.8% in Q3, the highest in the country.
Retail

- Even amid retail’s well-documented struggles, the vacancy rate has trended lower for much of the current cycle. Understandably, new retail development has been extremely subdued, and older properties are frequently converted to higher value alternatives such as gyms, banks and medical offices. However, the vacancy rate has finally started to drift upward, reaching 4.5% in Q3. With occupancy declining, rents rose just 1.3% year-over-year in Q3, the slowest pace since early 2013 when the sector was still recovering from the recession.

- Experiential multi-use properties which offer a diverse mix of tenants continue to have more success than their suburban mall and power center counterparts. Aside from an assorted mix of retail, these properties often include office space, apartments, hotel, entertainment and green space. This convergence of property types is a potent example of how retail can further evolve to conform to changing consumer spending patterns.

- Seattle provides a compelling case for the potential synergies between e-commerce and brick & mortar retail. Despite being home to Amazon’s headquarters and a testing ground for the latest e-commerce innovations, rents in Seattle are rising at a robust 5.6% annual rate. Seattle also has one of the lowest retail vacancy rates (2.9%) of any market. While new development has lagged in recent years, surging job growth has ignited demand for retail space.

Source: CoStar, Inc. and Wells Fargo Securities
Industrial

- The industrial market remains resilient, even as the manufacturing, logistics and warehouse sectors have come under increasing pressure from weakening growth abroad and the ongoing trade dispute. That’s not to say the sector isn’t feeling some aches and pains. So far this year there have been just 95.4 million square feet of industrial space absorbed through Q3, which represents a 50% decline from the same period last year.

- Softer demand combined with a mountain of new development finally coming online has led to the higher vacancy rates, which hit 5.1% in Q3. Rent growth has also lost some steam recently, rising a more modest 5.1% over the past 12 months, marking the slowest gain since 2015. Still, investors do not appear to be dissuaded by slower rent growth. The industrial property price index rose 12.4% over the year in October.

- Weakening growth abroad and the ongoing trade dispute have taken a toll on Jacksonville’s industrial market. Home to one of the fastest growing container ports in the country, the industrial vacancy rate in Jacksonville has long topped the lists of lowest vacancy and fastest growing rent. More recently, the transportation and logistics industry has been on the frontlines of the trade war, which helps explain why payrolls in the transportation & utilities industry are down 4.0% over the year through October. Net absorption has pulled back and the vacancy rate rose to 3.9% in Q3, the highest since 2017.

Industrial Asking Rent Growth: Q3-2019

Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock

- Expanding
- Decelerating

Industrial Asking Rent Growth Percent Change

Year-over-Year: Q3 @ 5.1% (Left Axis)
Quarter-Over-Quarter: Q3 @ 0.9% (Right Axis)

- National
- Las Vegas
- Inland Empire
- San Antonio
- Denver
- Dallas
- Salt Lake City
- Phoenix
- Nashville
- Louisville
- Lehigh Valley
- Milwaukee
- Houston
- Columbus

Source: CoStar, Inc. and Wells Fargo Securities
Hotel

- The hotel industry is certainly not immune to cooling economic growth. In Q3, the seasonally adjusted occupancy rate fell to 65.6%, still high by historical standards but slightly lower than the cycle peak of 66.7% reached at the end of 2018. With global growth weakening and trade uncertainty lingering, businesses have become more cautious and pulled back on corporate travel. Even with more moderate economic growth, demand for hotel rooms remains intact and supported by sturdy job growth and elevated consumer sentiment.

- Occupancy rates have moved lower in Florida’s tourist centers—Miami and Orlando each posted declines over the past year, mostly due to the recent wave of new hotels and resorts. Miami will likely see a spike in occupancy and room rates early next year, as the city will host Super Bowl LIV in February.

- Not every market has seen occupancy rates fall. Denver, where occupancy rates are already elevated, saw them rise to 84.7% (not seasonally adjusted) in Q3. With payrolls in the metro continuing to climb at an above-average pace, it’s not surprising to see a slew of new hotels currently under construction in the downtown area and surrounding the convention center. Hotels in Hawaii also saw occupancy rise over the year alongside a welcome pick-up in tourism. After a substantial slowdown, hiring in the state’s leisure & hospitality industry is now expanding at a solid 2.1% yearly pace.