Commercial Real Estate Analysis

CRE Going Strong, at Least for the Time Being

Filip Blazheski

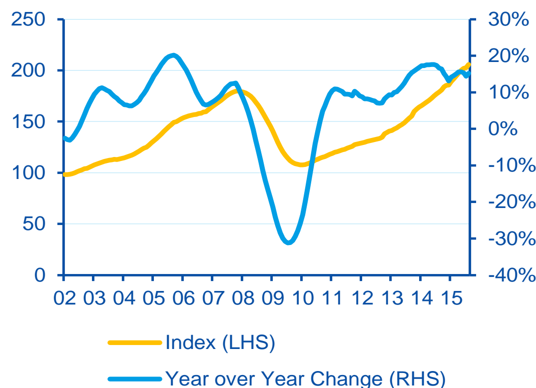
- **Demand for apartment, CBD office, industrial and hotel real estate to continue growing in the coming years, but not in all regions, and somewhat more moderately**
- **Construction spending is solid and growing in most areas, which together with increasing interest rates should contain increases in valuations**
- **Retail is not as hot as other CRE categories and is likely to stay that way**

Commercial real estate (CRE) has enjoyed a good run in the last five years. Looking at the NCREIF[1] National Property Total Return Index, the sector is performing close to some of the best years before the recession (Chart 1). The national all-property Moody's/RCA Commercial Property Price Index (CPPI), which measures price (valuation) changes, reached a peak in July 2015 (Chart 2). This brief analyzes the developments in all sub-components of the sector since 2008, and presents an outlook for the short- and mid-term, based on the fundamentals of each of the CRE classes, and BBVA Research's baseline forecasts for moderate growth of the US economy.

Chart 1
NCREIF National Property Total Return Index, Percent

Source: NCREIF, Bloomberg and BBVA Research

Chart 2
Moody's/RCA Commercial Property Price Index, National All-Property, Level and YoY % change



Source: Moody's/RCA, Bloomberg and BBVA Research

We believe that the fundamentals for CRE remain generally solid. Although the low interest rate environment has driven valuations up, we have not seen large speculative investment as before the crisis. Our baseline macroeconomic forecast projects moderate growth in the next four years, implying moderation in CRE trends. Risk premiums in capitalization (cap) rates[2] are likely to be compressed after interest rates rise, but should recover in the long-term as long as the fundamentals remain solid.

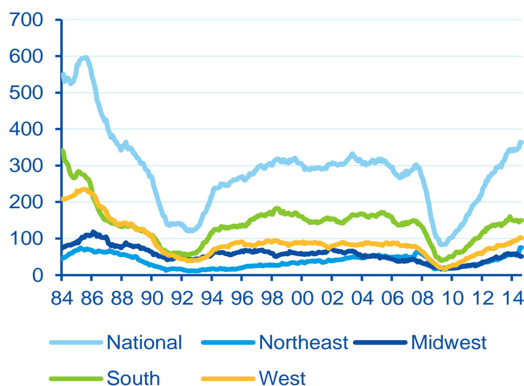
[1] National Council of Real Estate Investment Fiduciaries
[2] Cap rate is defined as a ratio of annual net operating income from real estate property and its market value

Apartments

The demand for apartments has been particularly strong after the recession. Young people delayed purchasing single family homes due to reasons such as uncertain job prospects, increasing student debt balances, stricter mortgage lending criteria, and higher down payment requirements, while at the same time the demand from older Americans increased[3]. The strong demand for apartments has prompted a rebound in multi-family construction in all regions (Chart 3). Housing starts for five or more unit structures now surpass numbers from before the recession, but are still below what was seen in the early 70s and mid-80s. Given the increase in population, albeit slower than in the past, and the trend of seniors moving into apartments, construction is expected to continue growing.

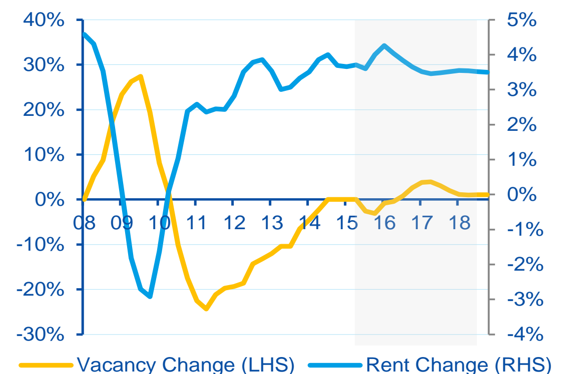
Apartment rents have been growing between 3% and 4% annually over the last three years (Chart 4). Metro areas that have done best in the first half of this year in terms of rent increases are Austin, Dallas, Denver, Oakland, Seattle, and San Francisco. All of these areas are experiencing strong economic growth and attracting new young residents, a prime renter demographic group, many working in high-tech industries. Rent increases have started to slow down in Boston because of increasing vacancies due to increased supply. In Detroit, despite low and further decreasing vacancy rates, rents have been slow to increase until the first half of the 2015, probably because of the slower increases in wages and salaries compared to other parts of the U.S; however, rents have started growing more quickly in the second half of the year. With the new inventory coming on the market, we expect rents to continue growing, but somewhat more slowly, especially in places with less vibrant local economies or higher vacancy rates.

Chart 3
Housing Starts: 5 or More Units, Thousands of Units, 12-month Moving Average



Source: Census, Haver and BBVA Research

Chart 4
Apartments Effective Rent and Vacancy, Year-over-Year Change, Percent



Source: REIS, Bloomberg and BBVA Research

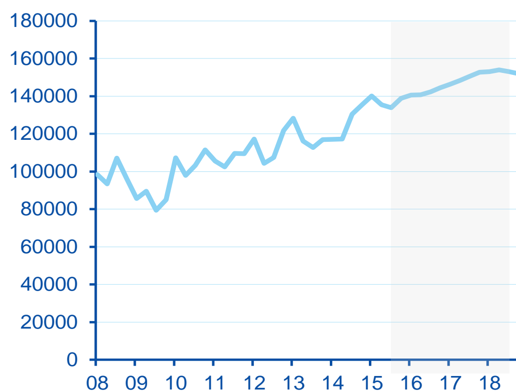
Apartment prices per unit (Chart 5) have been increasing consistently over the past years, but have started stagnating or coming down in some markets recently such as Washington, Houston, Los Angeles, St. Louis, and San Diego – a result either of an increased supply of new inventory, previous fast appreciation, or like in the case of Houston, decreased expectations for the performance of the local economy. At the same time, apartment prices have increased significantly in markets such as Boston, Detroit, San Bernardino/Riverside,

[3] Jordan Rappaport. Millenials, Baby Boomers and Rebounding Multifamily Home Construction. https://www.kansascityfed.org/~/media/files/publicat/research/macrobulletins/mb15rappaport0623.pdf?la=en

Manhattan, Miami, Minneapolis, Orlando, Philadelphia, Seattle, San Francisco, and Tampa, reflecting strong expectations for economic performance of these regions, low vacancy rates, and in some cases limited supply of new units. Going forward, apartment prices will continue growing, but at a slower pace, driven by the new inventory and increasing interest rates.

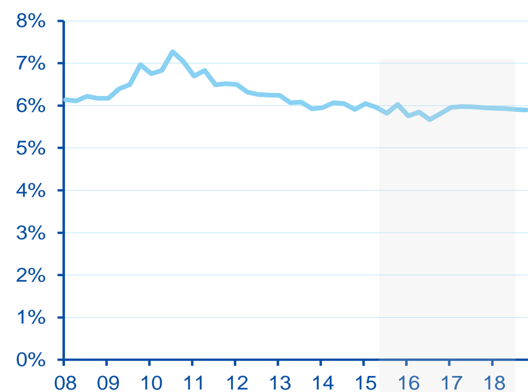
The good performance of the apartments sector after the recession provided a favorable spread between apartment cap rates and U.S. Treasury yields. We expect cap rates not to change much from their current levels in the next two to three years (Chart 6). Nevertheless, higher interest rates will likely compress the risk premiums.

Chart 5
Apartment Prices, Dollars per Unit



Source: RCA, Bloomberg and BBVA Research

Chart 6
Apartment Cap Rate, Percent



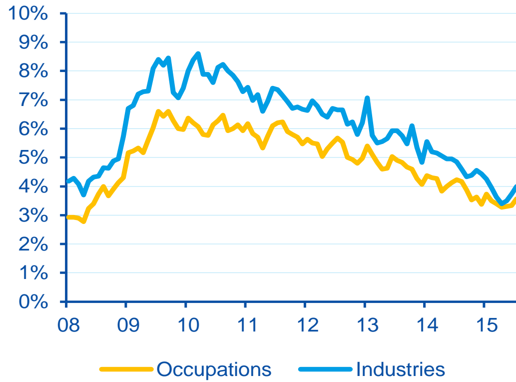
Source: RCA, Bloomberg and BBVA Research

Offices

The offices sector was particularly hit by the Great Recession. Vacancy rates increased dramatically, especially for suburban properties, and peaked in Q3 2010. Since then, office-using employment gradually increased (Chart 7). Also, the limited supply of new inventory, helped stabilize the sector. According to CoStar, “the level of national office construction has risen very slowly since hitting its long-term historical trough of less than 50 million square feet in late 2010, producing quarterly supply growth that was the moral equivalent of zero when factoring in demolitions of obsolete office space and other loss of inventory”[4]. Construction has increased since 2013 (Chart 8). Net absorptions have been roughly in line with office completions for some time, resulting in a slow decrease in overall vacancy (Chart 9). We expect vacancy rates to remain roughly unchanged in the next three years, but rent increases will slow down (Chart 10). However, as is the case of apartments, each market is likely going to follow a different path, with, for example, markets exposed to the oil industry performing worse (at least in the short term) than markets exposed to high-tech employment. Suburban offices will continue to underperform compared to central business district (CBD) offices.

[4] CoStar (2015). U.S. Office Construction Picking Up Momentum. 108 Million Square Feet Under Construction is Highest Total Since 2009.

Chart 7
Unemployment Rate, Office-using Occupations and Office-using Industries, Percent

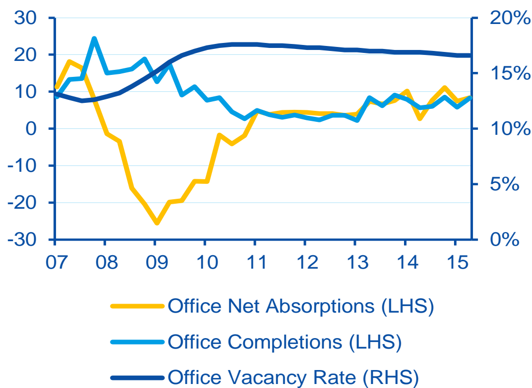


Source: Bloomberg and BBVA Research

Chart 8
Total Construction, Offices, Billion Dollars

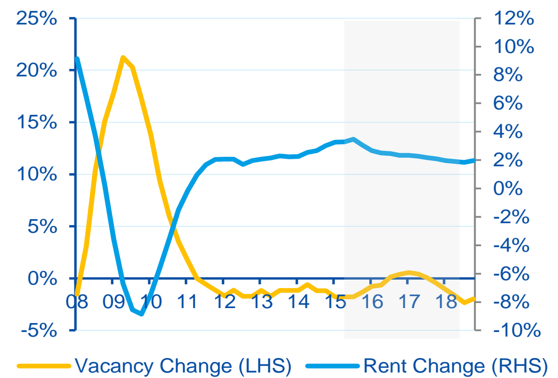
Source: Census, Haver and BBVA Research

Chart 9
Office Absorptions, Completions and Vacancy Rate, Million Square Feet and Percent



Source: REIS, Bloomberg and BBVA Research

Chart 10
Offices Effective Rent and Vacancy, Year-over-Year Change, Percent

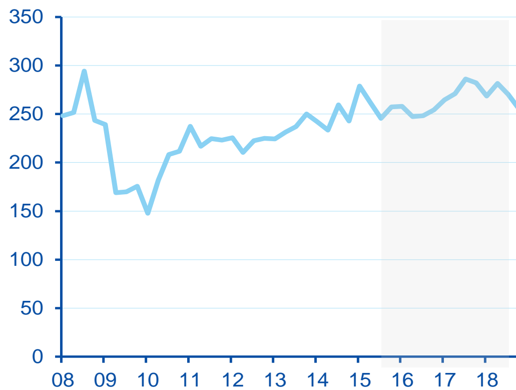


Source: REIS, Bloomberg and BBVA Research

CBD office prices have been increasing faster than in suburban areas since 2009. Year-over-year increases, though, seem to have started slowing down - in February for suburban, and in July for CBDs. As deliveries of new office space increases in the coming years, following increases in total construction investment starting in the middle of 2013, and as opportunities to increase office-using employment approach their limit, the valuations will increase more slowly. Around the middle of 2017, valuations are expected to slow down further as they start being affected by increases in interest rates (Chart 11). In the long term, rents and valuations will also be affected by an increasing trend of telecommuting and hoteling, as well as higher office space density (office space per workstation).

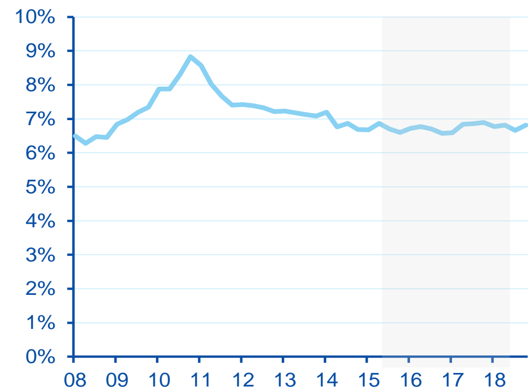
National average cap rates on offices have been providing a favorable risk premium for investors (Chart 12) since the end of the recession. We expect the cap rates not to change much in the next three years, but the risk premium will likely be squeezed as interest rates rise.

Chart 11
Office Prices, Dollars per Square Foot



Source: RCA, Bloomberg and BBVA Research

Chart 12
Offices Cap Rate, Percent



Source: RCA, Bloomberg and BBVA Research

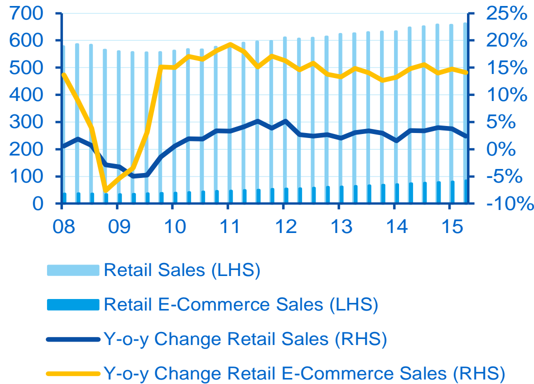
Retail

The Great Recession hit the retail sector strongly, with retail sales more than 10% lower in real terms in 2009 compared to 2007, and taking 5.5 years to recover. Also, there has been a growing reliance of consumers on e-commerce since the 1990s. The growth in nominal retail sales (excluding motor vehicles and parts dealers, gasoline stations, and nonstore retailers) has been around 3% since 2012, while e-commerce retail sales have been growing at close to 15% for some time (Chart 13). All this limited the demand for physical retail space, which resulted in a very sharp drop in construction spending, which is still nowhere close to pre-recession levels (Chart 14). Since 2011, the sector has stabilized somewhat, with net absorptions surpassing retail completions most of the time, and the vacancy rate going down slightly as a result (Chart 15).

Effective rents have been growing very slowly, between 0% and 2.2% in the last three years, with the fastest growth in the first half of this year. Rents in the first half of the year on a year-over-year basis have increased the most in Fort Lauderdale (likely driven by tourism), Los Angeles (driven by low vacancy amid a recovering local economy), and Fort Worth (likely driven by population growth). E-commerce is going to be a threat to the sector in the future, even though it is still small compared to total retail sales, and about half of the e-commerce sales going to retailers with physical stores[5], resulting in stores not necessarily needing as much foot traffic as they used to in the past to succeed. We expect rent growth to be slow in the coming period (Chart 16).

[5] Rigby Darrel. E-Commerce is Not Eating Retail. Harvard Business Review. https://hbr.org/2014/08/e-commerce-is-not-eating-retail/

Chart 13
Retail Sales* and Retail E-Commerce Sales, Billion Dollars and Year-on-Year Change, Percent

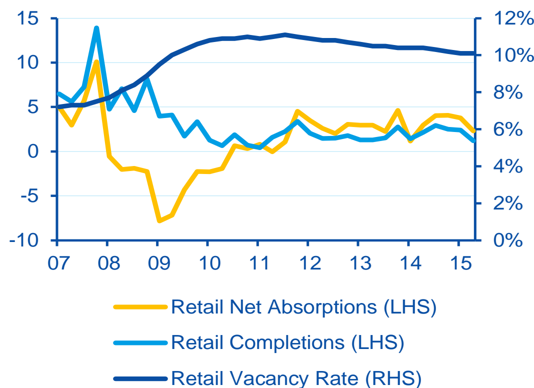


* Excluding Motor Vehicles and Parts Dealers, Gasoline Stations and Nonstore Retailers
Source: BEA, Census, Haver and BBVA Research

Chart 14
Private Construction Spending, Retail*, SAAR, Billion Dollars

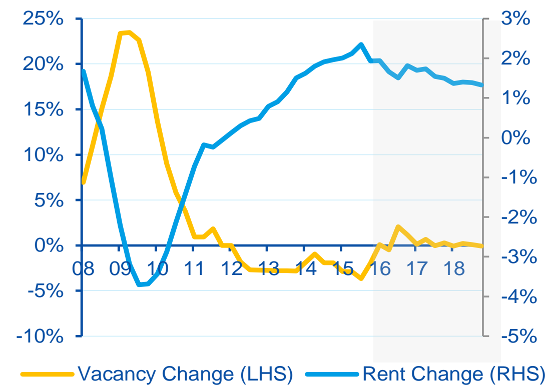
* Commercial Construction Spending, excluding Automotive and Warehouse
Source: Census and BBVA Research

Chart 15
Retail Absorptions, Completions and Vacancy Rate. Million Square Feet and Percent



Source: REIS, Bloomberg and BBVA Research

Chart 16
Retail Effective Rent and Vacancy, Year-over-Year Change, Percent

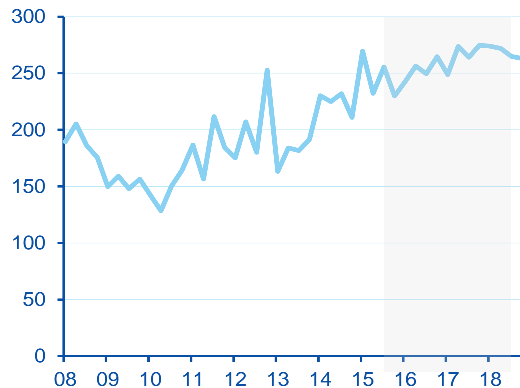


Source: REIS, Bloomberg and BBVA Research

Retail valuations are determined by rents, which are in turn determined by retail sales. As we expect retail sales to continue growing in the coming period, and as new construction has started to stagnate, property prices should continue their increasing trend (Chart 17), with some markets performing better than others. The price increases will slow down further around 2017 as a result of the anticipated increases in interest rates.

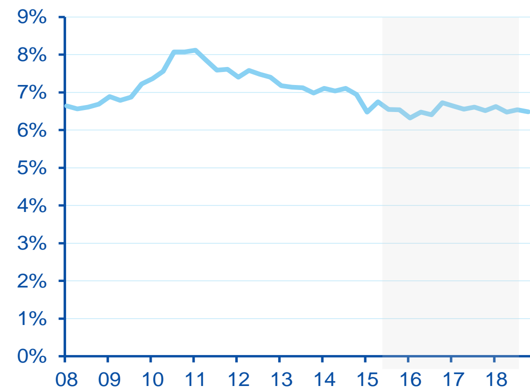
Cap rates for retail have provided a favorable spread over Treasury yields since the end of the recession in 2009, although cap rates have been lower than for offices since 2014. We expect cap rates for retail not to change much from their current level, which should result in a compressed risk premium when interest rates increase (Chart 18).

Chart 17
Retail Prices, Dollars per Square Foot



Source: RCA, Bloomberg and BBVA Research

Chart 18
Retail Cap Rate, Percent



Source: RCA, Bloomberg and BBVA Research

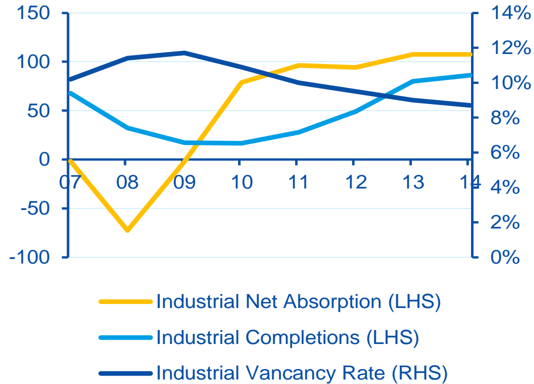
Industrial

Vacancy rates for industrial CRE recovered much faster after the crisis compared to the other types of CRE (Chart 19), because of the strong demand from the growing manufacturing and e-commerce sectors, although with variations from location to location. According to estimates by Cushman and Wakefield, vacancy is very low in the San Francisco peninsula area, Los Angeles and Denver, but is fairly high in Phoenix, Hartford and Boston, reflecting the local supply of industrial space and the performance of the local manufacturing and logistics sectors.

As a result of the low vacancy levels and the strong demand, construction increased dramatically. Private construction in manufacturing is a good proxy for construction spending on industrial CRE (Chart 20), and it shows a huge increase since April 2014. Construction spending on general commercial warehouses not located at manufacturing sites peaked in December 2014 (Chart 21) but still remains high.

Despite the strong demand and limited supply, rents have not been fast to increase, and have grown by 2.1% in 2013 and 2.5% in 2014. In the absence of data for 2015, we can speculate that rents this year will have increased faster than in 2014. The continued growth of the national economy is going to contribute to resilience in industrial CRE, but there are risks from possible declines in demand for US products in the wake of the weaknesses in China and Europe, as well as the relative strength of the U.S. dollar. We predict that the increased supply of industrial space will stabilize the vacancy rates, resulting in a slowdown in rent increases in 2017 and 2018 (Chart 22).

Chart 19
Industrial Absorption, Completions and Vacancy Rate, Million Square Feet and Percent

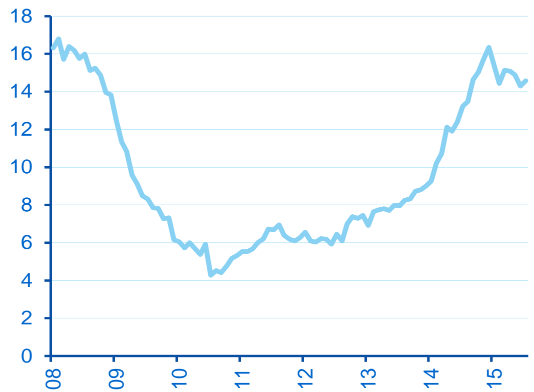


Source: REIS, Bloomberg and BBVA Research

Chart 20
Private Construction Spending, Manufacturing, Billion Dollars

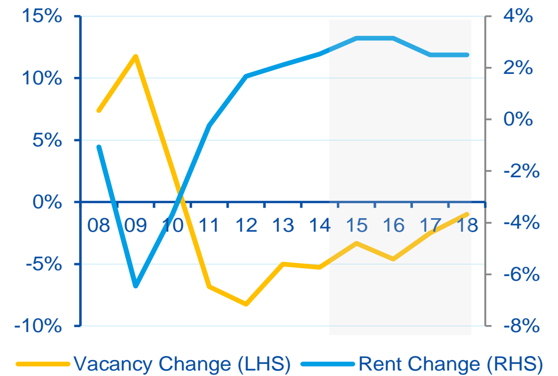
Source: Census, Haver and BBVA Research

Chart 21
Private Construction Spending, General Warehouses, Billion Dollars



Source: Census, Haver and BBVA Research

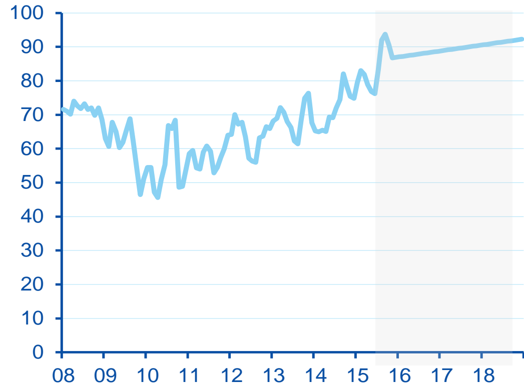
Chart 22
Industrial Effective Rent and Vacancy, Year-over-Year Change, Percent



Source: REIS, Bloomberg and BBVA Research

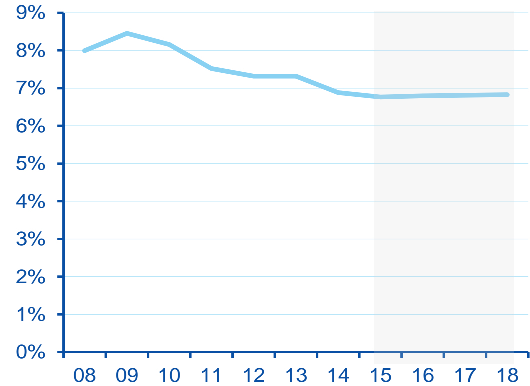
Valuations have increased by 6% CAGR since 2010 and are likely to slow down going forward as a result of the new inventory coming on the market, as well as the anticipated increase in interest rates (Chart 23). In the next three years, we expect the cap rates to remain roughly at the same level as they are today, but the anticipated increase in interest rates is likely going to result in a compressed risk premium (Chart 24).

Chart 23
Industrial Prices, Dollars per Square Foot



Source: RCA, Bloomberg and BBVA Research

Chart 24
Industrial Cap Rate, Percent



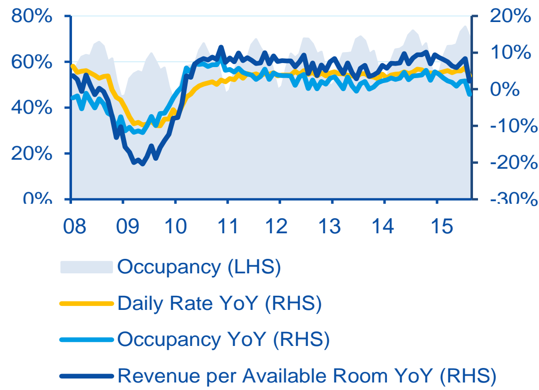
Source: RCA, Bloomberg and BBVA Research

Hotels

The fundamentals for the hotels sector remain solid, especially in terms of occupancy, but the upward trend of gains in occupancy, daily rates and revenue per available room, which has been pretty strong and started in 2013, slowed down in 2015 (Chart 25). The reasons are slowing of business travel from some developed countries, slowdown of domestic business travel in areas highly exposed to the oil and gas industry, and possibly the strength of the U.S. dollar. Furthermore, there has been increased construction spending in the lodging sector in the last few years (Chart 26), which has increased the supply of hotel rooms. The strength of the US dollar and weaknesses in Europe, China and Latin America are risks for the sector to watch in the coming years, together with oil and gas related business travel. Different locations will be affected differently by these risks. Cities like Houston will be more affected by the developments in business travel, while cities like Orlando will be more affected by the strength of the U.S. Dollar and the performance of the European and Latin American economies. In the mid- to long-run, the “sharing economy” and the ascent of platforms such as AirBnB is also a risk that should be monitored.

Construction since 2011 has been expanding, but at a more sustainable level than before the crisis, which contained the increases in valuations. We expect construction to continue, likely at a more moderate level. This, together with the anticipated interest rate increases should moderate the growth in valuations of hotel rooms (Chart 27), which will result in a cap rate that remains stable in the next three years, but with a compressed risk premium (Chart 28).

Chart 25
Occupancy and YoY Changes in Daily Rate, Occupancy and Revenue per Available Room, Percent



Source: Smith R Travel, Bloomberg and BBVA Research

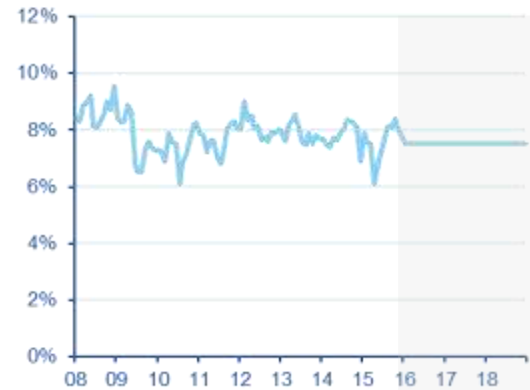
Chart 26
Private Construction, Lodging, Billion Dollars

Source: Census, Haver and BBVA Research

Chart 27
Price Per Room, Thousand Dollars

Source: RCA, Bloomberg and BBVA Research

Chart 28
Hotel Cap Rate, Percent



Source: RCA, Bloomberg and BBVA Research

Bottom Line

In sum, CRE is expected to perform well in the next three years, though not as well as in the last three years. CRE performed well as the economy expanded and the Federal Reserve kept interest rates low, but the downside risks have increased in the meantime due to the anticipated increase in interest rates, lack of more intensive economic growth, and increased supply. We expect rents for apartments to continue increasing because of the interest from retiring boomers, despite the increased supply. CBD offices are likely to outperform suburban offices, but in the long run telecommuting, hoteling and higher office space density will pose a risk. Retail is facing challenges from e-commerce, so rents have risen more slowly, a trend expected to continue. Industrial CRE will continue to perform well, but in an environment that is less predictable due to developments in the global economy, which is the case with hotels as well. Valuations in all segments have so far increased thanks to the low interest rate environment and high demand, but with the anticipated increases in interest rates and new supply coming on the market, valuation increases should start to slow down. Increased construction spending is already starting to contain the quick rise in valuations in some places. Cap rates will likely not change much, resulting in risk premiums that are compressed when interest rates rise.

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