Real Estate
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BRANCHING OUT, FROM DEEP ROOTS

AFTER 90 YEARS WITH A VERY FOCUSED STRATEGY, THE ROCKEFELLER GROUP IS PUSHING INTO NEW MARKETS—AND NEW DIRECTIONS

From Left: Brandi Hanback, Daniel L. Rashin and Dan Moore

CRE'S CUP: HALF EMPTY OR HALF FULL?

OFFICE GETS BACK ON ITS FEET
FEATURING: TOP OFFICE BROKERS

LUXURY LIVING STILL PENCILS OUT
FEATURING: TOP MF BROKERS

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Midyear Update

IS CRE's GLASS **HALF EMPTY** OR **HALF FULL?**

The industry's best data and its brightest minds gauge the performance of, and expectations for, commercial real estate and capital in the current global, regulatory and economic environment

BY LISA BROWN

The analogies to baseball are beyond overused, but the question on everyone's mind is how much longer performance will remain positive and what will happen at the end of this cycle? We checked in with some of the country's top brokerages and developers, who weighed in on the state of commercial real estate at the midyear point, what's in store for the rest of the year and their expectations in terms of capital and development.

According to Cushman & Wakefield's Atlas Summary, despite political uncertainty, cross-border real estate investment interest remains high and capital continues to flow around the world. However, global activity patterns are shifting in terms of who is investing and where, as new priorities emerge for some investors while others pump the brakes. As a result, the most competitive sources of capital will continue to shift more rapidly than the market may expect, C&W cautions. Overall, Asian capital will spread further into new markets this year, again surpassing North America as the largest source of global investment in 2017, subject to how Chinese outbound investment develops, the report indicates.

A rosier forecast is provided by JLL. The firm reports that a jump-start in the global economy has resulted in renewed energy in several real estate markets. Office rental growth is once again propelled by healthy leasing demand, resulting in 2017 projections being revised upwards, says JLL. Improvements are most evident in Western Europe, which, along with China, has boosted leasing activity. Meanwhile, strong rental increases have been recorded in the warehousing sector in both the US and Europe. The weight of capital pursuing real estate continues to increase, with deal flows similar to the solid ground of 2016.

"The current reversion of total real estate returns toward historic norms in the mid- to high single digits is a sign of a natural normalization of returns. Occupancies remain favorable in most property sectors, markets with multifamily being the exception," observes Austin Maddux, EVP and deputy portfolio manager at American Realty Advisors. "Construction activity in general is not problematic relative to demand, and, lastly, lending standards are still intact."

US investment activity was restrained due to a drop in activity of 7.7% in the second quarter, according to CBRE. When entity-level transactions are excluded, the Q2 decline increases to approximately 10%. The unevenly distributed decline is notable, especially since only the Southeast and Southwest show an increase in investment activity. New York City, Los Angeles and San Francisco continued to attract the most investment, accounting for 32% of all acquisitions in the first half of 2017.

"There is a lot of capital and interest rates are low in the Bay Area and Los Angeles," says Greg Caligari, partner of Cox Castle & Nicholson. "Still, investors are cautious because assets are priced to perfection and highly scrutinized, while construction costs have gone up, so commercial real estate is difficult to find."

Buchanan Street Partners also points to abundant capital on the sidelines, both domestically and internationally. Yet this is more of a market dip than the beginning of a protracted trough because undeployed capital designated for US CRE investments is at an all-time high, says Robert Dougherty, partner of Buchanan Street. If property values adjust downward causing returns to improve, billions of dollars will pour back in, shoring up prices, he says.

CRE investment volume totaled $109.2 billion in Q2, down by 4.8% from a year ago, says CBRE. A decline in retail was the main driver of the volume drop, while other sectors were nearly on par with prior-year totals. Industrial was the only sector to post a year-over-year increase of 10.4%.

Cap rate movement was modest during the first two quarters of 2017, according to CBRE's North America Cap Rate Survey. Only the retail sector posted a change in cap rates of more than 10 basis points.

The National Council of Real Estate Investment Fiduciaries Property Index (NPI) continued to moderate, underperforming the S&P 500 and the US REIT Index in Q2 2017. For the year ending June 30, the index's total return was 6.97%.

Commercial mortgage production increased, as capital availability remained fairly high. CMBS activity in particular picked up, with Q2 volume more than double that of one year ago. Moreover,

Top: Renovating retail sites such as the BLOC in Downtown Los Angeles has resulted in an improvement in surrounding retail, for example the nearby Gastropub Public School 213.

Left: 5613 DTC Pkwy. in Englewood, CO is an example of the type of properties in secondary cities that are appealing to Buchanan Street Partners.

CBRE's lender momentum index rose 27.9% from the same quarter last year.

"The most senior loan officer survey from the Federal Reserve showed fewer banks continuing to tighten standards for all forms of CRE lending amid demand that was still weak," says Heidi Learner, chief economist of Savills Studley. "From an actual asset perspective, Q2 FDIC bank data show a large pick-up in construction/development loans as well as continued growth in multifamily lending."

Fed stats indicated the largest year-over-year change in loans secured by real estate occurred in construction and development at 10.1%. Industrial loans accounted for the lowest year-over-year change at 2.8%.

A report by Newmark Knight Frank indicates that while overall US investment activity declined 6% in the past 12 months, year-over-year growth was achieved in global gateway markets such as Los Angeles, Atlanta and Dallas. Western metros still outpace US averages, with significant multifamily rent growth in Phoenix, Sacramento, Seattle, San Diego and Las Vegas.

Despite a slowdown in overall sales volume, the share of international investment remains well above the long-term average with overseas groups purchasing many trophy assets in primary markets during the past 12 months. CMBS issuance is on pace to eclipse last year's totals, while bank and thrifts continue to be the largest lender type by debt outstanding, NKF says.

While yields remain flat for most property types, industrial cap rates continue to compress further due to sustained investor demand for warehouse and distribution centers tied to e-commerce, according to the NKF report. Limited supply in the industrial pipeline, low vacancy and demand from e-commerce and retail firms is pushing prices of raw land and industrial space outside major metros to record highs.

"Investors continue to pursue both core and value-add strategies. For new fund searches in 2017, investor interest in value-added strategies seems especially robust," says ARA's Maddux. "The strongest performance is in the industrial sector. As of Q2 2017, industrial real estate in the NPI generated a double-digit total return over the past 12 months. Industrial continues to benefit from a number of positive factors, including the buildout of e-commerce-related logistics infrastructure and increasing consumer consumption."

Still, a wave of uncertainty was echoed in the Q3 Marcus & Millichap investor sentiment survey, highlighted by fiscal, tax and political policy weighing on US investor decisions. Despite increased caution, steady apartment and CRE space demand counterbalanced a portion of the uncertainty, containing the decline in sentiment. Though some investors have stepped to the sidelines to await additional policy clarity, many see this as a window of opportunity with less competition for assets–59% of surveyed investors plan to increase CRE investments during the next 12 months.

Most investors surveyed anticipate steady economic growth in 2017 and 2018, but 92% of surveyed investors cited rising interest rates as a concern for the coming year. Respondents believe reduced regulations and lower taxes will benefit CRE, but consider trade protection and more stringent immigration policies to be less favorable for these assets. Given the high demand for e-commerce and logistics facilities, it is no surprise that industrial investors are currently the most optimistic about future asset appreciation, followed by apartment and hotel investors, according to the survey.

"Commercial real estate fundamentals remain healthy and are experiencing a natural moderation in rental rate growth and value appreciation rates from recently elevated rates of growth," says Maddux. "The economic environment continues to provide a supportive tailwind for real estate property fundamentals, which in turn supports continued confidence among capital sources. Reduced regulations and the prospect of further regulatory reductions are viewed favorably by capital sources, further bolstering investor confidence. There has always been foreign capital interest in domestic US commercial real estate. At different points in time, that demand has been from differing parts of the world. For the second half of 2017, there may be some reduced foreign demand from China due to political conditions and upcoming elections, but we expect continued foreign capital interest for the remainder of 2017."

> Fewer banks are continuing to tighten standards for commercial lending amid weak demand."

HEIDI LEARNER
SAVILLS STUDLEY

Indeed, optimism abounds for many, but not all. Broadly, Buchanan Street points to the longstanding but weakening property recovery, now more than seven years old. The cresting point in the market was last year and the post-election bounce that many predicted has yet to materialize. Instead, so far this year, the national property market has been characterized by diminished transaction volume—Q1 2017 marked the lowest level of overall CRE transactions since 2013 and Y-O-Y sales were off 18% versus Q1 2016.

In addition, Green Street Advisors' composite US price index was flat for Q1 2017 after recording only 3.2% appreciation in 2016 compared with an average of 10.3% per year from 2010 through 2015. And, tightening CRE credit standards are evident as banks and other commercial property lenders continue to pull back on the reins. As a result, earlier this year, the first reduction in net demand for US CRE loans since the current recovery began was recorded, Buchanan indicates.

In a related analysis, a recent Ten-X report highlights slowing employment gains across much of the country. Limited job creation—a dynamic arising in a labor market approaching full employment—is likely to suppress the need for companies to add to or expand office space requirements, slowing absorption. The study also notes that vacancies remained flat to start the year and have subsequently hit the mid-year point with no improvement and at 16% flat with a year ago. Vacancies remain at a level far higher than during the prior expansion. Stalled vacancies have resulted in lower rent growth, with rents advancing at the slowest pace since 2012. Ten-X expects vacancies to reach a cyclical trough of 15.3% in 2018, however the firm's downside recessionary model foresees vacancy levels reaching 17.6% by the end of 2020, which would be on par with the recessionary peak in 2010.

Buchanan Street also indicates peaking fundamentals, specifically with regard to office and multifamily net absorption. While still healthy, these property types continue to exhibit a downward trend which began in mid-2015. Though rent growth for both remains positive, the rate of growth has slowed due to significant construction of office buildings and apartment communities nationwide.

"There is a palpable pause. Investment volumes are down," Dougherty says. "We might think it was due to summer doldrums, but this was less prevalent in 2014 and 2015. There is a diminished appetite for new investments; not the robust economic conditions we've seen previously. With prices at the highest levels in many areas, we are circumspect."

Investors seeking value in a cresting market may look to secondary locations, which are attractive for several reasons, says Dougherty. For one, suburban office space is desirable to space users looking to cut costs, as well as to workers who've been priced out of urban housing markets. Investors are also eschewing primary markets because of concerns about overbuilding. Secondary cities like Phoenix, Denver and San Diego have reported less new supply metro wide. and these areas have room to run before substantial new supply is likely to dampen income growth, Dougherty forecasts. Finally, assets in these markets can be acquired well below replacement cost

ARA's Maddux has a different perspective with regard to secondary markets, though. "We expect continued health in real estate fundamentals and sufficient capital markets activity for the balance of the year, supported by continuing economic and employment growth. Our 2017 expectation for core real estate returns remains in line with our outlook at the beginning of the year," he says. "As total returns revert towards historical norms, some investors are seeking to earn returns similar to those generated over the last several years by accepting additional investment risk, including taking on increasing leasing risk. Certain types of investors continue to seek higher current yields by investing in secondary and tertiary markets. While we view select value-add strategies as attractive for the remainder of 2017, for core strategies, we remain committed to primary markets and best-in-class assets that feature creditworthy tenants and longer-term leases with contractual rate escalations as opposed to chasing lower-quality buildings and secondary/tertiary markets where income yield spreads have compressed."

Beyond the nuts and bolts of basic data and prognosticating, the latest trends point to destination retail as one of the hottest development plays. Specifically, Collin Creek Mall in Plano, TX and the BLOC project in Los Angeles are examples of tired malls that are getting new life as mixed-use projects, often with an entertainment/destination component. As a result, surrounding neighborhoods have followed suit.

> For new fund searches in 2017, investor interest in value-added strategies seems especially robust."

AUSTIN MADDUX
AMERICAN REALTY ADVISORS

Even mall properties in less dynamic markets have upside. Vanderbilt Medical Mall in Nashville was a redevelopment of a mall that converted the entire second level into a medical plaza, while densifying the retail on the ground level. And the former Windsor Mall in San Antonio was redeveloped into the corporate headquarters for web-hosting company Rackspace, sparking redevelopment of the surrounding area.

With regard to the outlook into 2018, it is a mixed bag of sentiments, but the general opinion is that real estate is a viable and sustaining investment throughout most property types in many major metros, for now. Only time will tell if prevailing winds will blow it slightly off course into the final innings of the game. ◆