Special Research

CAPITAL MARKETS REPORT

Marcus & Millichap

Fall 2014

Rising Liquidity Lifts Buyer Competition for Assets

Yields Tighten For All Major Property Types

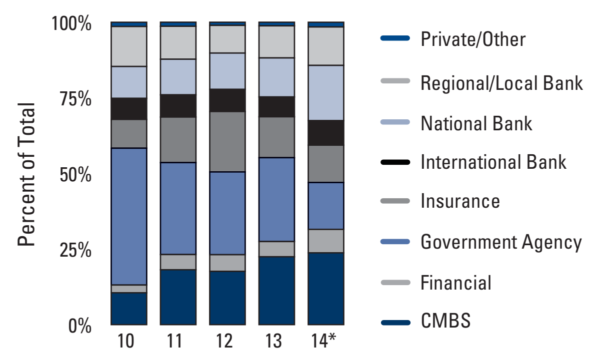
Strong capital flows, from both equity and debt sources, are boosting the liquidity of the commercial real estate market and driving transaction activity. Equity capital of all stripes — from local investors and 1031 exchanges to institutions that include REITs, private equity and sovereign wealth funds — have accelerated acquisitions and portfolio repositioning to capitalize on the low cost of capital, consistent revenue streams, and rising prospect for appreciation. At the same time, lenders are back in full force just a few years after the banking crisis. The volume of commercial mortgages, after dropping about 10 percent during the credit crisis, reached a new high at midyear, rising by $140 billion over the past 12 months. Commercial banks have picked up activity in both fixed- and floating-rate loans, CMBS volume is strong a second year in a row, insurance companies and government-sponsored agency lenders remain competitive, and mezzanine funds abound.

The wave of liquidity has pushed property prices to record or near-record levels in core markets and is in the process of working its way to secondary and tertiary markets. Property sales are increasing in nearly every metro, but investors are increasingly targeting assets in non-core markets as they pursue yields and opportunities with less fervent bidding activity.

The increased liquidity reflects the generally positive outlook for commercial real estate, but the strengthening economy has also supported momentum. GDP has risen steadily over the last several years aside from temporary setbacks such as the polar vortex of the first quarter, and the outlook remains positive through the second half of 2014. In addition, steady hiring has finally surpassed the 8.7 million jobs lost during the recession, and by year end, the U.S. economy should employ 1.7 million more people than the pre-recession peak. Though many remain underemployed or left the labor force, the hiring trends continue to point in the right direction. This steady growth has allowed the economy to spur demand for commercial real estate while minimizing inflationary pressure.

Job gains have supported limited income growth, but the surging stock market has helped household wealth significantly. As of the end of the second quarter, U.S. household wealth was up 20 percent from its 2007 peak and more than 40 percent from the trough in 2009. That has supported rising consumer confidence and substantive gains in retail sales. These steady positive factors will support rising demand for commercial real estate space on a broad basis.

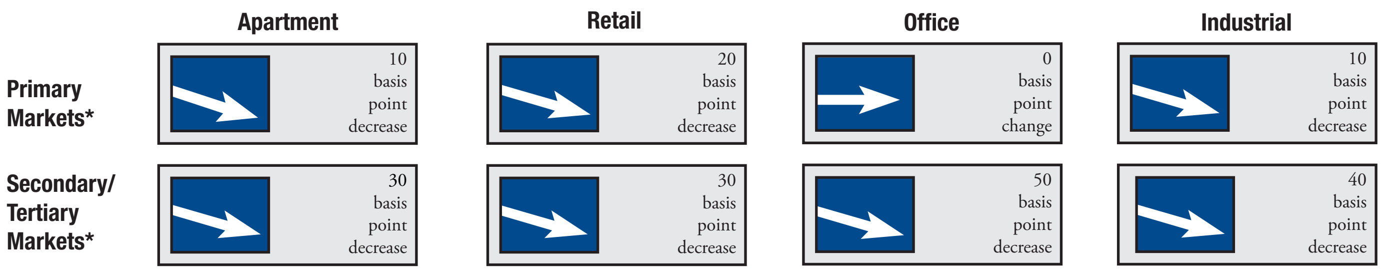
Capital Sources



*Through 2Q
Sources: Marcus & Millichap Research Services, Real Capital Analytics

In a real sense, the moderate pace of the economic recovery has been good for commercial real estate performance. Usually new construction comes roaring back during the recovery cycle following recessions, but incremental growth and the fresh memory of the severe recession has kept development largely in check. Construction is creeping back, particularly for apartments, but it is predominantly centered in core areas of the strongest metros. Supply factors will be slower to emerge and less problematic this cycle than in past recoveries.

Cap Rate Trends



*Year-over-year change through 2Q 2014

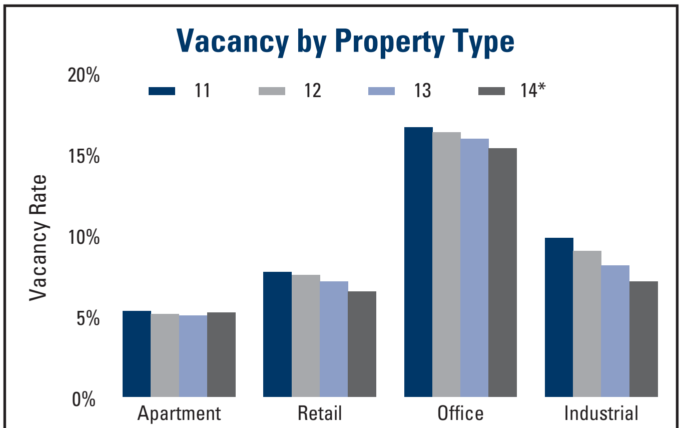
Apartment

Multifamily asset performance has surpassed expectations, boosted by favorable demographics, job growth and emerging household formations. The growing echo-boomer generation, set to expand by 2.1 million through the rest of the decade, could support demand for an additional 1.4 million apartments over the next five years. The recession also left 3.3 million echo boomers living with family, but as job creation accelerates, many of these young adults will move into apartments.

Strong demand lowered apartment vacancy rates to 4.4 percent in the second quarter, the lowest level since 2001. Rents have risen at a robust pace over the last four years and now stand 18 percent higher than their trough in 2010. This momentum has drawn increased developer activity, and 238,000 new units will be completed in 2014, the highest level recorded. Despite the construction surge, vacancy rates will remain stable on a national basis. Some markets such as Washington, D.C., and Austin, however, will likely face increased short-term vacancy volatility as the influx of new units is absorbed.

Apartments have been a favored asset class for investors since the downturn. Not only did performance remain more stable during the recession, but acquisition financing was available from government-sponsored agencies when other lenders tightened access. Fannie Mae and Freddie Mac reined their lending on multifamily assets back to a 47 percent share in 2013, down from 87 percent in 2009, but it appears they are increasing their allocations in the second half of the year. In addition, banks, insurance companies, institutions and CMBS programs have stepped up their lending, producing a highly competitive lending environment. Loan coupons are mostly in the 4 percent range but can go as low as the mid-3 percent range depending on the term, leverage and borrower credentials.

With pricing of premium assets in core markets selling with cap rates in the 3 to 4 percent range, investors are increasingly moving to secondary and tertiary markets in search of yield. But even those markets are appreciating, with average cap rates for high-quality apartments reaching below 7 percent.



*Through 2Q
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., MPF Research

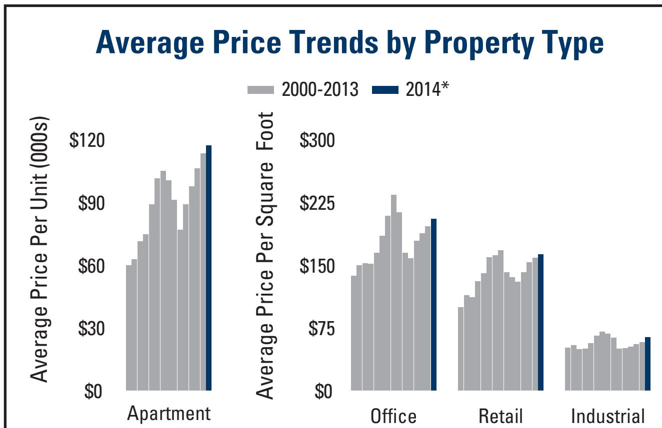
Retail

Retail assets continued their recovery from the recession with needs-based anchored centers and locations favoring national retailers outperforming, while properties that cater to local retailers still face hurdles. The steady emergence of e-commerce as a competitive sector has encouraged numerous retailers to rethink their business models. For some companies that means shrinking floor space, but others have begun to consider how to leverage their local presence into a competitive advantage to expedite shipping and enhance customer service.

By the same token, all retail formats are benefiting from rising consumer spending. Since the recession, retail sales have averaged 4.3 percent annual growth — right in line with the long-term average. As hiring gathers momentum over the next year, and as additional pressure helps support rising wages, consumption should escalate. So far, the momentum has favored market-leading retail centers with strong anchors. Meanwhile, smaller strip centers that rely on mom-and-pop tenants have yet to demonstrate significant momentum. These centers are beginning to sign leases with non-traditional tenants, however, including healthcare and fitness centers and these new prospects will help the sector reinvent itself.

Nationally, vacancy rates of retail properties have tightened, as modest absorption topped the very limited construction pipeline. In the year ending in the second quarter of 2014, only 37.4 million square feet of space, or 0.5 percent of total space, came online. This gradual tightening of vacancies has recently sparked rising asking rents, but they still remain about 11 percent below their pre-recession peak.

Despite the still-soft performance climate for many retail assets, investor demand is strong. The transaction volume between $1 million and $10 million reached a record $10 billion in the first half, while price per square foot and cap rates also reached new heights. The availability of debt continues to improve, though lenders remain focused on stabilized properties. Local/regional banks are increasing market share, while CMBS is dominant in secondary and tertiary markets.



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Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Real Capital Analytics

Office

Increased hiring has begun to translate into solid demand for office locations, particularly in the urban core of major metros. Nearly 2 million office-using jobs will be created in 2014 and 2015, combined. Much of the "shadow" space vacated through corporate layoffs during the recession has been refilled, even though companies are using tighter square footage per employee standards. Only 56 million square feet of space will come online this year, far below historical levels, so supply-side pressure is virtually non-existent.

The national office vacancy rate was 15.6 percent as of the end of the second quarter and should drop by an additional 30 basis points by the end of the year. Demand and rent growth, though, will be strongest in urban centers where the modern live/work/play ethos has gained traction with young professionals. Cities with concentrations of technology, energy and healthcare jobs are thriving, led by San Francisco, San Jose, Seattle and New York, but tenants are likely to move into suburban/secondary markets once space in CBDs becomes scarce and those centers become prohibitively expensive.

Investor demand in core markets remains intense. In the first half of 2014, 40 percent of the $50 billion of office sales came from six core markets where Class A properties trade at cap rates in the 4 percent range. However, investors pursuing stronger yields and a less-competitive bidding process are increasingly looking to alternatve options including secondary markets. With suburban offices in many metros offering investors a 150-basis point yield premium relative to CBD office assets, investors have begun to search beyond core locations.

Readily accessible debt capital has also fueled activity as loan spreads have tightened by 25 basis points from last year. Coupons range between 4.4 and 5.25 percent for 10-year loans with moderate leverage. All lender types have become increasingly active, but national banks have increased their share of lending to 26 percent. CMBS will also be a positive factor, increasing its lending sector by $6.1 billion from last year.

Industrial

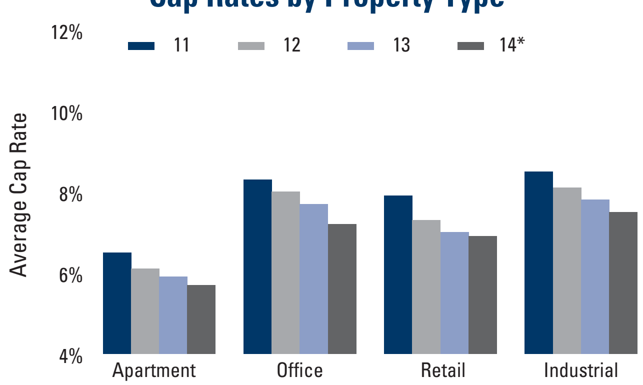
E-commerce has an obvious impact on retail, but it has also spawned change in the solidly performing industrial sector. Demand for industrial space is strong – roughly 380 million square feet will be absorbed in 2013 and 2014, pushing the national vacancy rate down 190 basis points to 7.1 percent. Demand drivers include the housing recovery and increasing auto sales and international trade, all of which produces growth in manufacturing, port volume and movement of consumer goods.

Possibly the biggest driver, though, is e-commerce. Much of the absorption and an even greater proportion of new development encompasses warehouses near population centers across the country. Retailers are attempting to create infrastructure that enables them to quickly deliver products to customers. Not only Internet-based retailers such as Amazon, but many traditional retailers have embraced the concept. Retailers with a bricks-and-mortar presence that are also among the top online sellers include Apple, Wal-Mart, Sears and Macy's.

Investors seeking relative stability and diversity to augment existing portfolios have increased demand for industrial assets. In addition, institutional investors have targeted portfolio assets to build a critical mass of assets in a given locality. Cap rates are tightening for all industrial segments, with warehouses making the biggest gains. Warehouse cap rates averaged 7.2 percent nationally in the first half of 2014, and top properties in major markets traded at yields under 6 percent. Flex properties averaged 7.8 percent cap rates nationally in the first half.

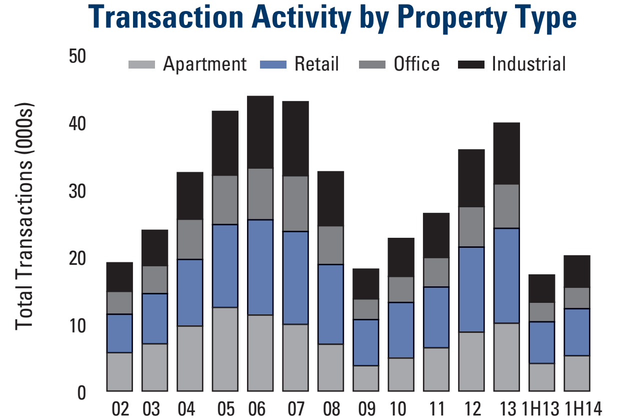
Lenders are actively lending on industrial properties, although underwriting remains relatively conservative. National, international and regional banks increased their share of industrial loans to 62 percent in 2013, up from 48 percent the prior year. Lenders have largely targeted debt yields of 8.5 to 9 percent, producing leverage of 70 percent, while offering longer term rates of 4.6 to 5.5 percent.

Cap Rates by Property Type



*Through 2Q
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Real Capital Analytics

Transaction Activity by Property Type



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Interest Rates

Several years of low interest rates have helped the real estate market recover from its downturn with a lot less pain than would have been imagined in the wake of the 2008 credit crisis. The rapid recovery in asset values and rebound in lending have reduced the severity of what many thought would be a second thrift liquidation-style event. Rising economic strength in recent months has lifted the prospects that the Federal Reserve will begin raising its short term rates early next year, posing limited risk to the real estate market.

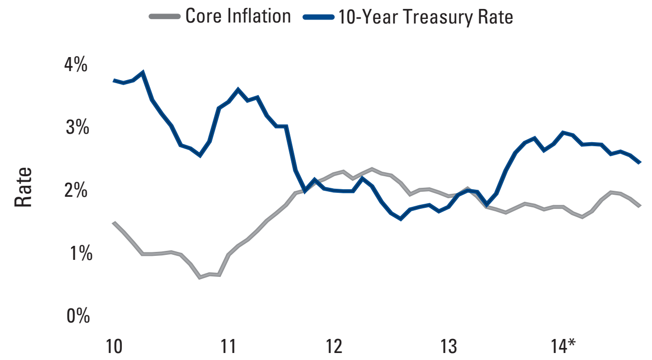
However, interest rates are unlikely to rise quickly enough to slow the economic momentum because demand for U.S. Treasurys remains robust. International investors in particular have sought out the security of U.S. Treasurys as a range of uncertainties plague parts of the world. While China has cut back its purchases, investors from Japan, Europe and the Middle East have picked up the slack. Risks of escalating aggression in Ukraine and the Middle East cement the perception of the U.S. as a beacon of stability.

What's more, the Fed is under little pressure to increase rates. The U.S. economy is improving, but inflation has remained in check and the Fed remains focused on the large number of workers who have dropped out of the workforce or are underemployed. The November elections are another wildcard that could reignite gridlock in Washington and stall the nascent growth cycle. Consequently, the Fed is unlikely to raise the Fed Funds Rate until the signs that the economy is heating up really accelerate. Presently, most anticipate that this will not happen before the middle of next year, but there is a chance that the Fed will surprise and begin tightening liquidity sooner.

Once rates do begin to rise, the impact on commercial real estate may be nominal. Historically, cap rates have not moved in lock step with interest rates, with tightening spreads being the norm during most growth cycles. As a result, should rates begin to rise later this year or early in 2015, it remains unlikely that cap rates will escalate in pace.

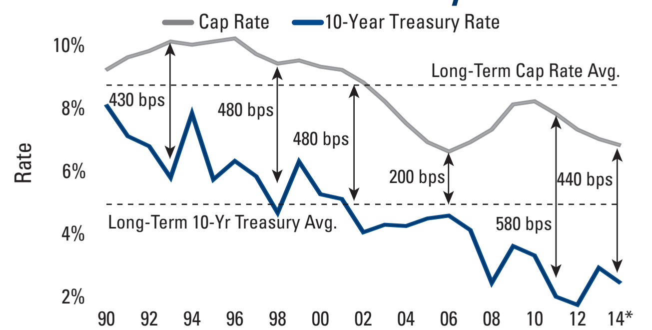
Although cap rates are near historical lows today, the risk premium — the spread between 10-year Treasury yields and cap rates — persists near historical highs. If Treasury yields rise because of positive factors, such as strong economic growth, investors will have a more optimistic outlook about property performance and be willing to absorb some of the rate increase in the form of lower risk premiums. The bottom line is that, aside from a major exogenous shock, interest rates and monetary policy are not likely to have a watershed impact on the economy or commercial real estate in the near term.

Core Inflation vs. Treasury



*Through August
Sources: Marcus & Millichap Research Services, Federal Reserve Board, BLS

Commercial Real Estate Cap Rate vs. 10-Year Treasury



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Marcus & Millichap

Prepared and edited by
William Hughes
Senior Vice President
Tel: (949) 419-3200
william.hughes@marcusmillichap.com

For information on additional research materials, contact
John Chang
First Vice President, Research Services
Tel: (602) 687-6700
john.chang@marcusmillichap.com