A Special Research Report

Q3 2017 Commercial Real Estate Investment Outlook

Political uncertainty weighs on investor sentiment

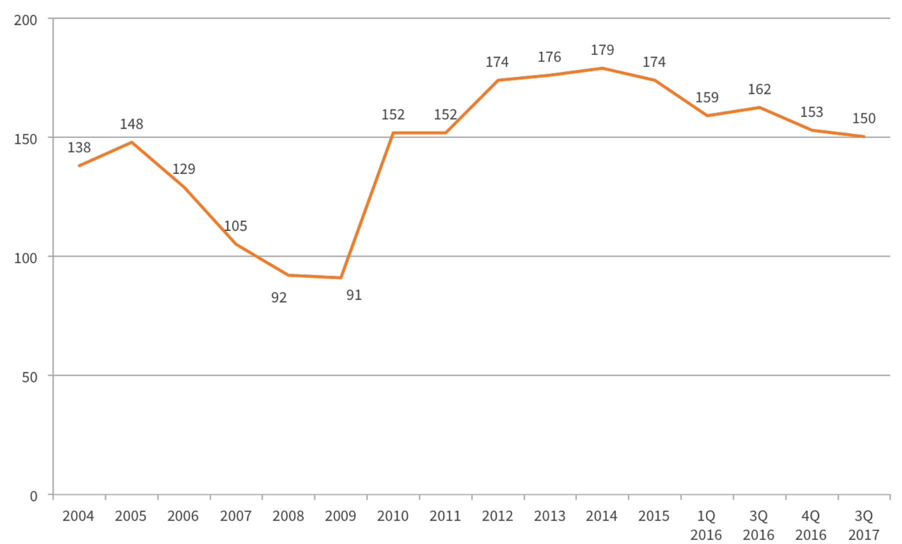
Caution creeping into the commercial real estate market even as property fundamentals remain strong.

By Beth Mattson-Teig

The commercial real estate market may face gradual softening with signs that investors are proceeding more cautiously on new investment.

Exclusive research results from the third quarter NREI / Marcus & Millichap Investor Sentiment Survey show a gradual cooling trend on investor sentiment. The investor sentiment index edged slightly lower to 150 as compared to 153 in fourth quarter. The sentiment index has been tapering since peaking at 179 in 2014 **[Figure 1]**. "It looks like 2014 may have been the peak of sentiment. That doesn't mean that we won't see it push upward again. But right now, we are seeing a modest softening in investor perspective," says John Chang, first vice president of research services at Marcus & Millichap.

FIGURE 1. INVESTOR SENTIMENT INDEX



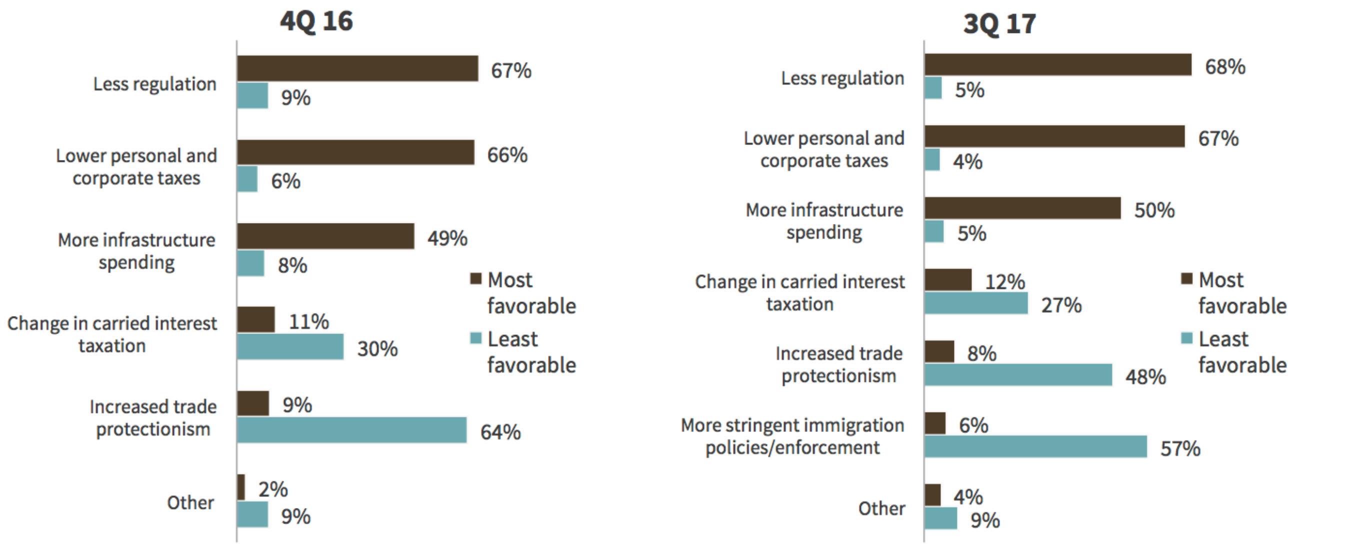
Uncertainty related to the new Trump administration, modest tightening in capital markets, property price increases and the mature market cycle are some of the key reasons behind the decline in sentiment. "There are a lot more questions today about how the Trump administration is going to fuel growth," says Chang. Overall, nearly half of respondents still have confidence in the economy and a positive lift from a Trump administration, but there has been a noticeable pullback in sentiment compared to the fourth quarter survey that was taken immediately following the presidential election. Notable survey results related to the erosion of post-election expectations include:

- Forty-nine percent expect construction levels to rise over the next two years compared to 56 percent in the fourth quarter survey. Nearly one-third (32 percent) do not think construction levels will rise and 19 percent were unsure.
- When asked about the likelihood of a recession over the next two years, 27 percent of respondents said that the odds are greater compared to 18 percent who held that view in fourth quarter.
- The majority of respondents (57 percent) expect the Trump administration's proposed policies to be supportive of real estate values and investment activity, ultimately, prolonging the current cycle. However, sentiment has pulled back from 65 percent who held that view immediately following the election.
- Views on Trump administration policies that would be most favorable to the real estate industry remained relatively unchanged with respondents expecting less regulation and lower personal and corporate taxes policies to be most favorable to the real estate industry at 68 percent and 67 percent respectively.
- Respondents also rated policies that could be least favorable to the industry that included more stringent immigration policies at 57 percent; increased trade protection at 48 percent; and changes to carried interest at 27 percent **[Figure 2]**.

"Again, sentiment is still leaning towards the positive side, but we are seeing some movement reflecting emerging investor caution because they are not sure what will happen with the range of policies on the table," says Chang. Another factor contributing to the decline in sentiment is that a majority of investors (71 percent) believe that commercial real estate values may be approaching a cyclical peak.

FIGURE 2. ELECTION IMPACT

Respondents expect less regulation and lower personal and corporate taxes policies to be most favorable to the real estate industry, while they expect increased trade protectionism and immigration policies to be least favorable to the industry.



Base: All respondents (3Q 17 n varies from 555 to 606).

Fundamentals remain healthy

The survey results also point to a disconnect emerging in investor sentiment with uncertainty on one side and still high confidence related to property fundamentals and performance on the other side. Considering only the property currently in their real estate portfolios, most owners are optimistic that values will continue to increase over the next 12 months. Industrial investors remain confident, with 64 percent believing values will rise, followed by apartments at 58 percent, hotel at 51 percent, office at 41 percent and retail at 30 percent. The average expected appreciation for each property type is industrial at 5.1 percent, hotel at 3.9 percent, apartments at 3.8 percent, office at 1.6 percent and retail at 0.3 percent **[Figure 3]**.

"Fundamentals have been exceptional when you look at vacancies, rent growth and still muted construction for most property types. So, there is a real difference in what is happening at the asset and performance level relative to investor expectations and the potential risks they are anticipating," says Chang.

In addition, confidence remains high on the economic outlook, job growth, access to capital and real estate fundamentals. Nine out of 10 respondents predict that job growth will be the same or better in 2017 compared to 2016, while only one out of 10 expect a decline in job growth. Looking ahead, 81 percent anticipate that job growth will be the same or better in 2018 as compared to 2016 with 18 percent who think that job growth could be worse.

"The greatest impediment to job creation right now is the very low unemployment rate," says Chang. The national unemployment rate has remained in the low to mid 4 percent range and there are nearly 6 million job openings, which is the highest volume on record. "So, we are moving into a situation where we could face labor shortages, which will slow down the pace of job creation," he adds.

The majority of respondents (73 percent) continue to agree that commercial real estate offers favorable returns compared to other investment classes and they are still moving forward with plans to expand portfolios. Fifty-nine percent plan to increase their commercial real estate investment in the next 12 months, while 34 percent expect investments to remain the same and 8 percent think that real estate holdings will decrease over the next year. Among respondents who said their real estate investment is likely to increase, an average 22 percent increase is predicted.

Consistent with the cooling in sentiment, those who do plan to increase holdings is down from 67 percent who held that view in fourth quarter. Most respondents think it is generally a better time to hold assets. Among respondents who already own a particular property type, those who think it is still a good time to buy more include industrial at 47 percent; undeveloped land at 40 percent; and mixed-use at 39 percent. Those property types where it is considered a good time to sell include retail at 40 percent; hotel at 34 percent; and office at 30 percent **[Figure 4]**.

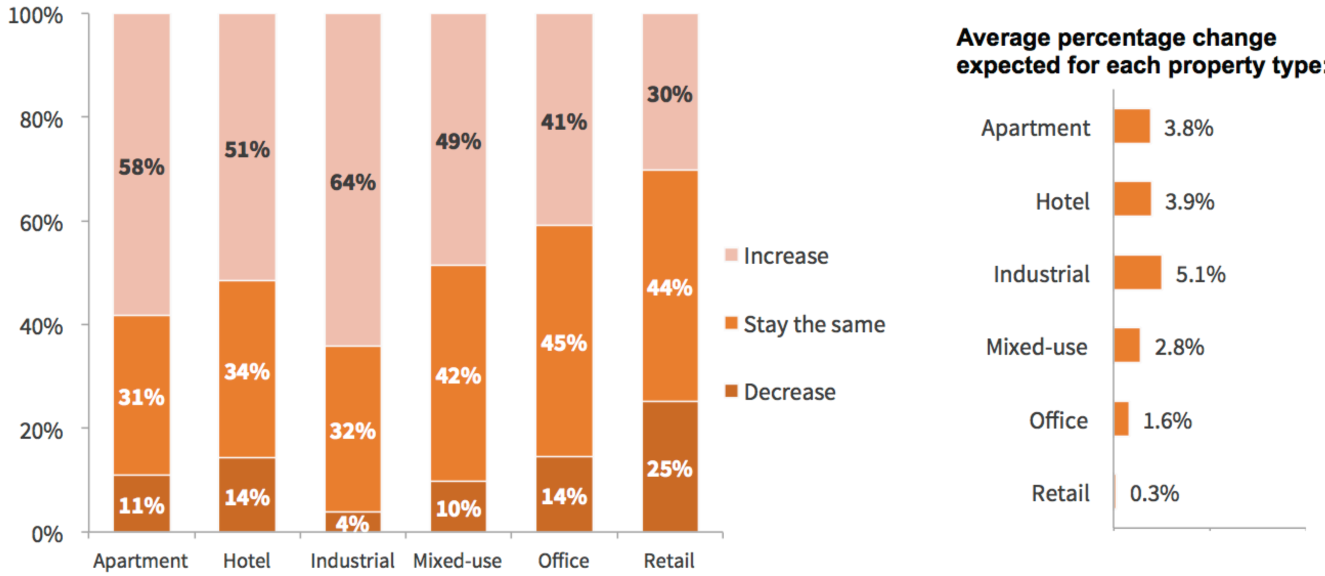
E-commerce invigorates industrial

Respondents remain bullish on the outlook for industrial. Among those investors who already own industrial assets, 47 percent considerate now to be a good time to buy more; 35 percent think it is a better time to hold, and 18 percent want to sell.

E-commerce is an integral element fueling

FIGURE 3. **VIEWS ON PROPERTY VALUES**

A majority of investors in apartments, hotels and industrial properties expect the value of properties in their portfolio to increase 12 months from now. Industrial values are expected to increase the most.



Base: respondents invested in each property type (n varies).

demand for industrial space as it reinvents the supply chain and moves distribution toward "last mile" customer delivery. "As this transformation has taken place, we have seen increased demand for industrial space at the local level. This even includes "adaptation" of non-industrial space," says Alan L. Pontius, senior vice president, national director specialty divisions of Marcus & Millichap.

Nearly two-thirds (64 percent) of industrial owners expect the value of their properties to rise in the coming year compared to 32 percent who predict no change and 4 percent who anticipate a decline. The predicted increase also remains bullish at 5.1 percent, which is 10 basis points higher than the fourth quarter survey. Marcus & Millichap is forecasting that vacancies will improve 30 basis points this year to reach 5.1 percent by year-end, while average asking rents will increase 7.3 percent. "That rent growth is significant, particularly considering how far we are into the cycle. Demand has been running at a pretty steady clip for the last five years and industrial remains a hot commodity," says Pontius.

Office may be late bloomer

Office investors remain consistent in their views on whether it is a good time to buy, hold or sell properties with 46 percent who think it is a better time to hold; 30 percent prefer to sell; and 24 percent who want to buy more. However, optimism on fundamentals ticked slightly higher. Forty one percent predict that values will rise over the next 12 months as compared to 36 percent who held that view in the fourth quarter survey. Views on the expected increase also notched higher from 0.8 percent in fourth quarter to a 1.6 percent prediction in the present survey. Another 45 percent believe values will hold steady and only 14 percent predict a decline.

Office has trailed other segments, notably multi-family and industrial, for investor demand, but it is starting to gain traction due to the long run of employment growth and absorption that has been steadily outpacing construction, notes Pontius. IBM also made a significant announcement in second quarter that it would be moving away from having its workers telecommute. About 5 percent of the total U.S. workforce does work remotely. "So, even a modest change in behavior that favors bringing employees together to collaborate, rather than encouraging remote working, could generate an upturn in the demand for office space beyond what we have seen so far," says Pontius.

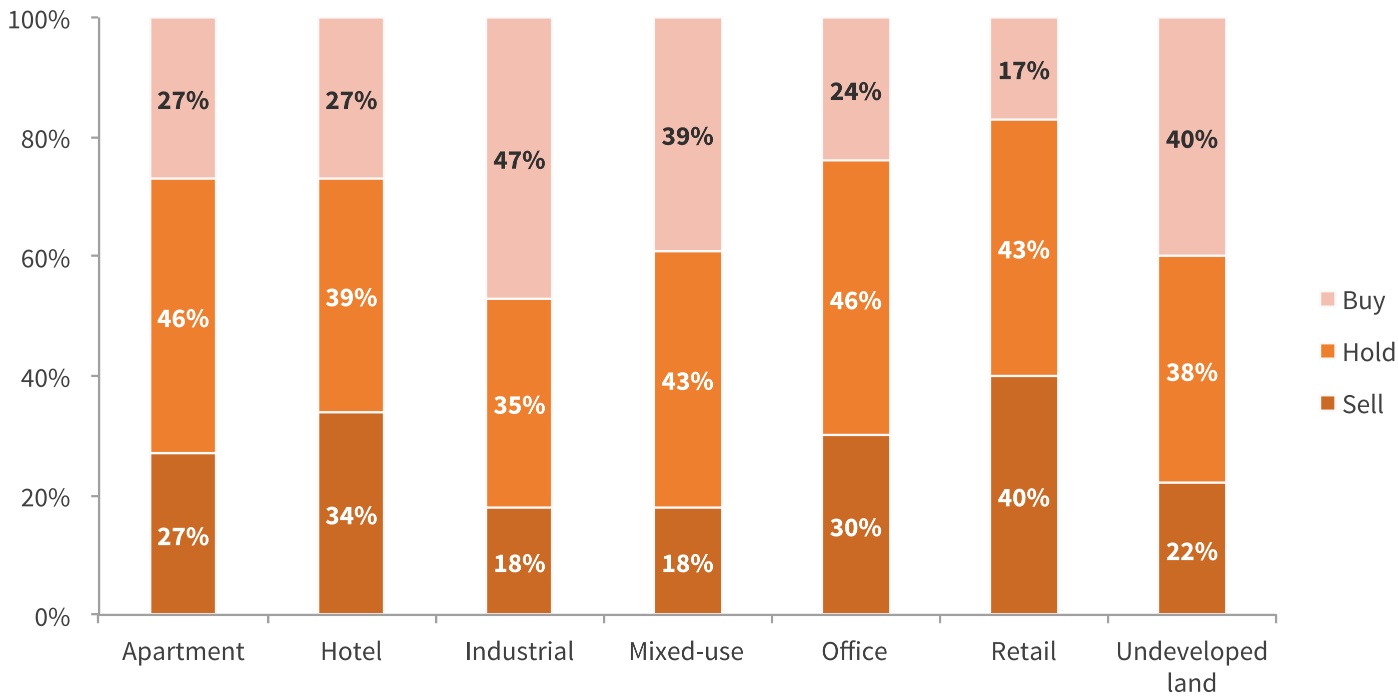
Suburban office also is starting to gain momentum as more and more companies favor the affordability of the suburbs versus higher occupancy costs in the urban core, adds Pontius. Marcus & Millichap is forecasting a 20-basis point improvement in office vacancies this year to 14.1 percent by year-end with annual rent growth of 3.5 percent.

Competition impacts apartments

Despite strong demographics and demand, sentiment on apartments has eased in the past year, most likely due to the high volume of new construction that is occurring. More apartment owners believe it is a better time to hold apartments (46 percent), while 27 percent said it is a better time to buy more and 27 percent think it is time to sell.

FIGURE 4. **BUY-SELL-HOLD**

Respondents invested in industrial, mixed-use and undeveloped land are more likely to consider now the time to buy than sell. Apartment investors are evenly mixed, while hotel, office and retail investors are more likely to consider now the time to sell.



Base: all respondents (varies from 494 to 580).

"Competition for tenants in the Class A space is becoming more and more significant, particularly in the urban core," says John S. Sebree, first vice president, national director of the National Multi Housing Group at Marcus & Millichap. In addition, there are more deliveries on the way with an estimated 371,000 new units that are expected to be completed this year, according to Marcus & Millichap. "That is the most we have seen come online since the 1980s," says Sebree. There also has been a major emphasis on value-add opportunities, which has resulted in more competition to buy Class B properties.

Despite the new supply, fundamentals are still very good. More than half of respondents (58 percent) expect apartment values to increase in the coming year with an average increase of 3.8 percent. Marcus & Millichap is forecasting that apartment vacancies will climb about 40 basis points to reach 4.3 percent by year-end, with annual rent growth that is still ahead of inflation at 3.8 percent. "Construction is still limited in many metros, but in markets with significant development there is lots of competition at the upper echelon of the apartment market," adds Sebree. "At the other end of the spectrum, Class C vacancies are still falling and there is a definite supply shortage for more affordable workforce housing."

Retail fundamentals battle headlines

Retail owners are more pessimistic on whether it is a good time to buy. Forty percent believe it is a better time to sell as compared to 27 percent who held that view in the fourth quarter. Another 43 percent think it is better to hold, and 17 percent believe it is a good time to buy – which marks a drop from 28 percent in fourth quarter. "There is a very significant disconnect between investor perception and asset performance at this point," says Bill Rose, first vice president, national director of the National Retail Group and Net Leased Properties Group of Marcus & Millichap.

Companies that are expanding and opening new locations are being overshadowed by high-profile retailers that are closing stores and shrinking footprints. Amazon's acquisition of Whole Foods also signals an important shift that reiterates that, at least from Amazon's perspective, they do want brick-and-mortar as part of their business model. "That gives validation to the bigger trend towards an integrated online-offline approach," says Rose. Amazon also has eight bookstores open and five more in the pipeline.

Retail investors views on fundamentals held steady with 44 percent predicting no

Survey Methodology

National Real Estate Investor's research unit and Marcus & Millichap emailed invitations to participate in this online survey to public and private investors and developers of commercial real estate. Recipients of the survey included Marcus & Millichap clients as well as subscribers of NREI selected from commercial real estate investor, pension fund, and developer business subscribers who provided their email addresses. The survey was conducted in late June with 616 completed surveys received. Survey respondents represent a broad cross-section of industry respondents that include private investors, developers, advisors, lenders and REITs among others. The largest percentage of respondents are private investors at 47 percent. Respondents are invested in a variety of property types with a majority of 63 percent invested in apartments. On average, respondents have $34.7 million invested in commercial and/or multifamily property.

change; 30 percent anticipating an increase; and 25 percent who think values will drop. However, the net result is relatively flat with an anticipated increase in values of just 0.3 percent over the next 12 months. Marcus & Millichap has a more positive forecast that calls for retail vacancies to improve 40 basis points to 4.9 percent by year-end with annual rent growth of 2.4 percent. "Fundamentally, retail assets are doing well, especially the well-located properties," says Rose. "We are seeing very tight vacancies and we are starting to see rent growth accelerate."

Brighter days ahead for hotels

Hotel sentiment made an interesting shift in the third quarter. Hotel owners hold split opinions on whether it is a better time to hold at 39 percent; sell at 34 percent or buy more at 27 percent. However, sentiment surged forward on the outlook for improving fundaments. Nearly half of hotel investors (51 percent) think values will increase over the next 12 months. That is a noticeable jump compared to the 32 percent who thought values would rise in the fourth quarter survey. In addition, respondents anticipate a bigger increase of 3.9 percent as compared to 1.4 percent six months ago. Another 34 percent believe values will remain the same, while 14 percent predict a drop.

"Hotel investors were very concerned about the wave of construction and the prospect of softening tourism if the economy should weaken, and they are now coming through the construction cycle and finding that demand for hotels remains very strong," says Peter Nichols, vice president, national director of Marcus & Millichap's National Hospitality Group. Investors are more optimistic as they see that performance is better than they expected. "Both the business and the leisure travel demand are doing very well and hotels are maintaining very high occupancy levels," he adds. Marcus & Millichap is forecasting that occupancy rates will decline 40 basis points this year to 65.1 percent, while average daily rates (ADR) will improve by 2.8 percent.

Higher interest rates ahead?

The Fed has introduced three quarter point interest rate increases since December. Given that context, it is not surprising that rising interest rates is the top concern for respondents post-election, followed by unforeseen shocks to the economy at 48 percent and political uncertainty/geopolitical issues at 42 percent. However, it is important to note that the 10-year Treasury has actually declined from 2.45 percent at the start of the year to 2.2 percent in late June. "We have seen lenders tighten lending standards a little bit, but capital is still readily available across asset types and across geographies," says William E. Hughes, senior vice president of Marcus & Millichap Capital Corp.

The majority of investors (92 percent) do think interest rates will move higher over the next 12 months. However, views are split on how much rates will rise. Thirty-nine percent predict an increase of less than 50 basis points; 41 percent expect hikes of 50-99 basis points; 12 percent believed it will be 100+ basis points; and 8 percent said there will be no change or a decrease. Some of the key factors that respondents noted for fueling rate increases include Fed action at 65 percent; expectations of higher inflation at 36 percent; and general growth orientation of the Trump administration at 28 percent.

Despite the uncertainty that has crept into the market, investors remain confident in fundamentals and the economy overall. Even though a majority of respondents are bracing for higher interest rates and believe the market is approaching a peak, there also are a number of dynamics that could prolong the current cycle, notes Chang. For example, baby boomers are poised to start transferring their wealth to the next generation over the next 10 to 20 years, and there also is untapped spending power among millennials that will start families and buy homes. "I think the very good demographics will provide a very strong tailwind for the economy and for commercial real estate for several years," he says. ■

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