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Economics Group

Special Commentary

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Commercial Real Estate Chartbook: Q3

A Recovery Divided

Improvement in the nonresidential space has been hard to come by, but one thing is clear, the recovery that has played out thus far has been unevenly distributed across property types and geographic location. Apartments have been the dominant force in commercial real estate gains in this cycle. This sector has been a beneficiary of changing demographics and has prospered because of, rather than in spite of, symptoms of the Great Recession. Another player is now clearly emerging on the scene: industrial space. While apartment demand remains robust, supply is close on its tail. Industrial demand, however, continues to far outpace supply, which has been a boon to rent growth and vacancy rate declines. Retail and office space have seen much less improvement. Both are struggling from symptoms of the Great Recession as well as technological changes that are dramatically altering business strategies. Geographical location has been another key factor in this recovery. Markets with high concentrations of energy or technology-related businesses have tended to see much stronger growth.

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In the four years following the recession, the apartment sector enjoyed robust growth. Apartments, however, are now beginning to see some moderation in the pace of improvement. The surge in demand has translated into a flurry of new construction, a significant portion of which has yet to come on line. Demographics still look very favorable for this sector, which is a testament to its ongoing sustainability. While household formation is growing well below trend, the number of renters is accelerating. Young adults are more likely to rent due to mobility and financial factors (student loan debt, lack of income, credit history), which has always been the case, but all adults have shown an increasing propensity to rent as well. Individuals hit hard financially by the recession may be forced to rent due to tighter lending standards and poor credit history. The final piece to this sector's recovery is meaningful asking rent growth, which will likely remain subdued in the near term given current sluggish wage and salary growth.

Figure 1

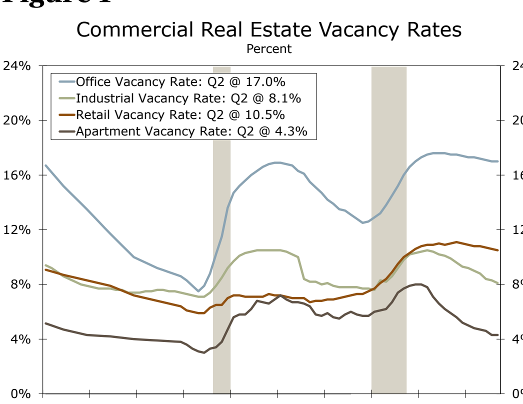

Figure 2

Source: PPR, Reis, Inc. and Wells Fargo Securities, LLC

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Industrial Sector Finds Its Footing

Industrial space appears to be emerging as the new bright spot in the commercial space.

Industrial space appears to be emerging as the new bright spot in the commercial space. Vacancy rates have fallen to 7.9 percent in the third quarter from their peak of 10.5 percent in the second quarter of 2010. Supply and demand are also ramping up. Net absorption marked 33.2 million square feet in the third quarter, the strongest demand for space in five years. Supply increased 13.8 million square feet on net, the most activity since early 2009. The source of this sector's success is likely due in part to the changing business environment, as retailers move away from traditional storefronts and toward a more online marketplace. This move by businesses is a strategy to keep costs contained and to maintain alignment with consumer demand as technology evolves. Customers are becoming increasingly in favor of online shopping and look to brick-and-mortar establishments as more of a showroom than a locale of purchase (if they even step foot in them at all). Growth in e-commerce has led to a surge in demand for industrial/warehouse space, as retailers need a place to store inventory, even if they opt out of a traditional storefront. Shopping online is likely more of a transition and less of a trend, thus we suspect the industrial sector will continue to pick up in the coming years, beginning with a near-term acceleration and longer-term moderation, similar to what we have seen in apartments.

Naturally, with the growth of the virtual marketplace, demand for retail space remains subdued. The retail sector should continue to see gradual improvement in line with the pace of the overall economy, with the exception of space utilized by the high-end retailers that have fared quite well in this recovery, as demand for high-end goods remains relatively strong. Construction of neighborhood centers should also improve as the housing recovery gains momentum.

In contrast, the office sector has lagged, as many tenants have opted to consolidate space during the recovery. While office-using employment peaked in the fourth quarter of 2007, net completions of office space rose more than 10 million square feet per quarter for the following six quarters. Therefore, net absorption declined the following 12 quarters. Although office-using employment is now nearing its prerecession peak, the mix is different in that many tenants are now allocating significantly less space per worker. As a result, office employment will need to improve much further before vacancy rates decline enough to drive significant new office development.

All four major property types must be considered in context of their local markets. A number of strong local markets and submarkets are seeing significantly more strength, even in "lagging sectors," namely office and retail. The strongest geographic markets are generally those that have benefited from the energy and/or technology boom, including San Francisco, Houston, Seattle and Dallas. Slower-growing markets, such as those in the Rust Belt and areas of the Midwest, have seen much less improvement, although vacancy rates in many markets remain relatively low.

Figure 3

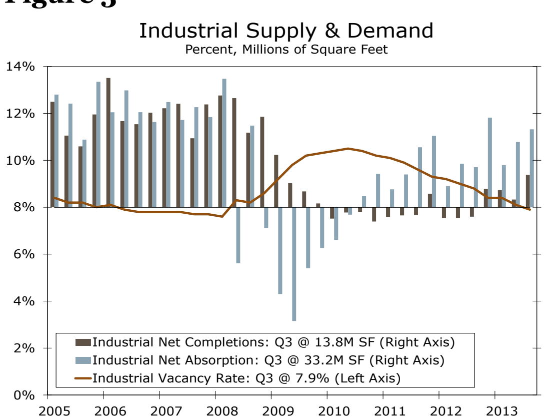
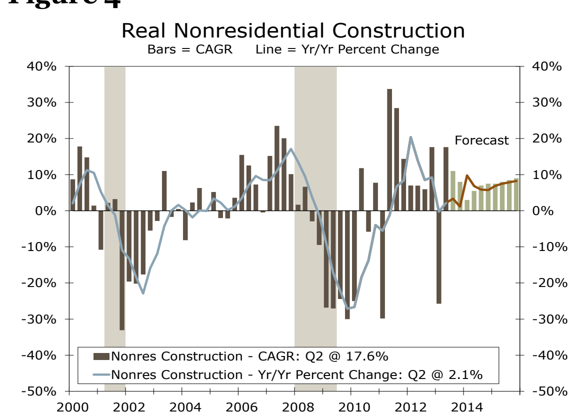


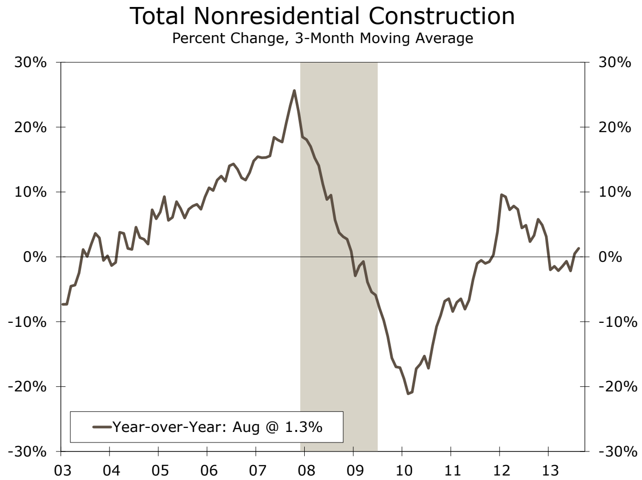
Figure 4

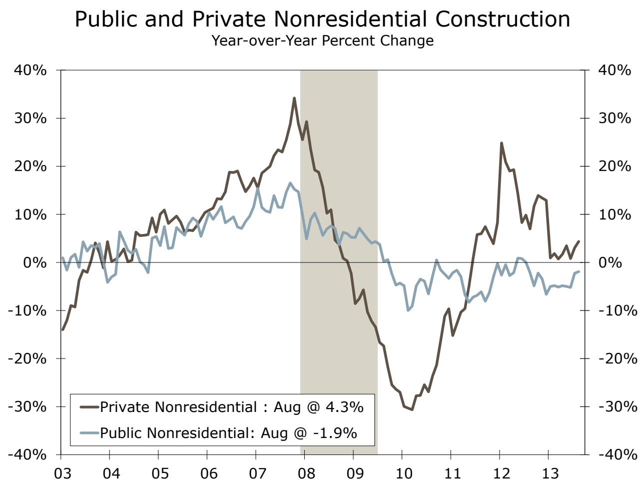


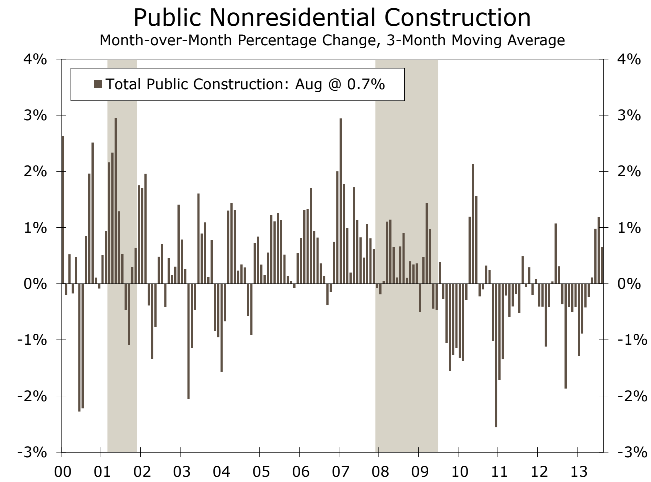
Source: PPR, U.S. Department of Commerce and Wells Fargo Securities, LLC

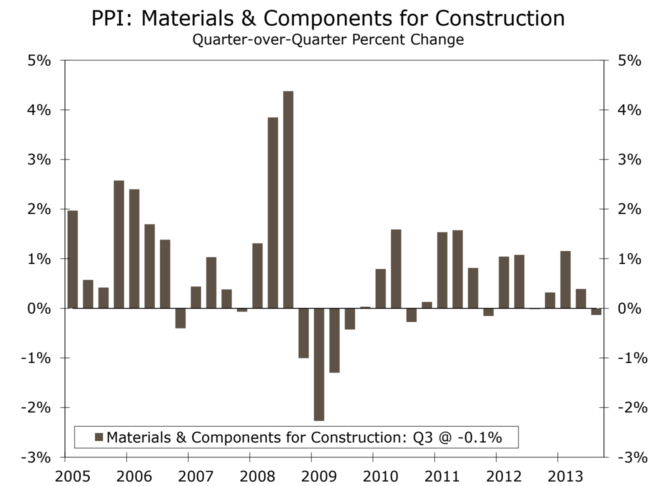
Nonresidential Construction Spending

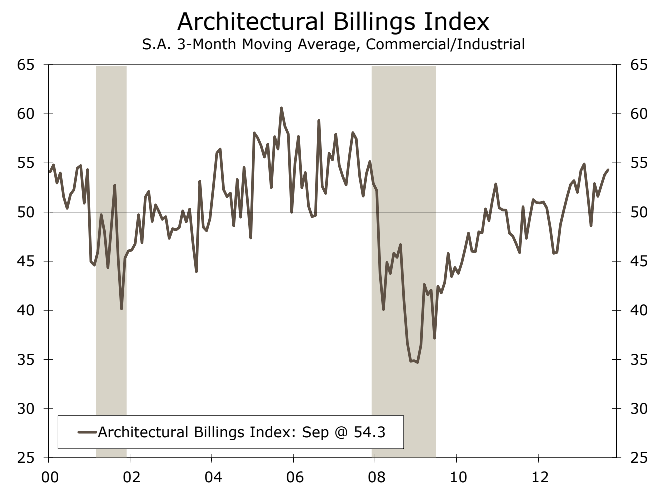
- Nonresidential construction spending is up only 1.3 percent over the past year, constrained by weak public construction activity. Private construction has been more robust, rising 4.3 percent in the past year, driven by strength in power and manufacturing-related projects.
- Earlier concerns over rising material prices have eased as prices appear to have softened in Q3.
- The Architectural Billings Index (ABI), a leading indicator for nonresidential construction, rose to 54.3 in September. Looking at the ABI on a regional basis, the West (60.6) and South (54.1) are the most active markets, while the Northwest (50.7) and Midwest (51.0) are still just barely in expansion territory.







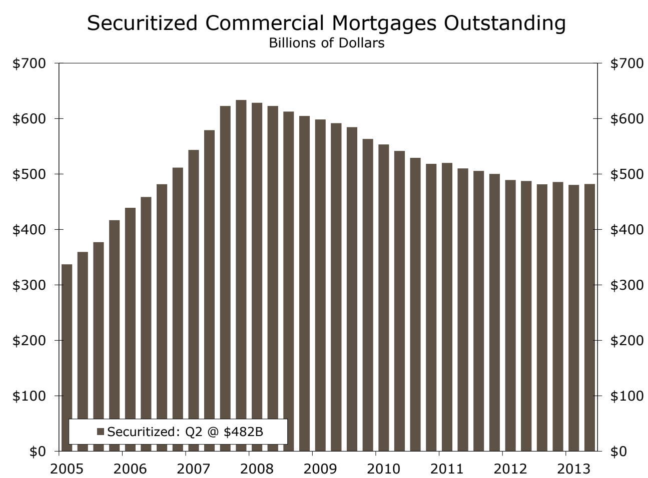


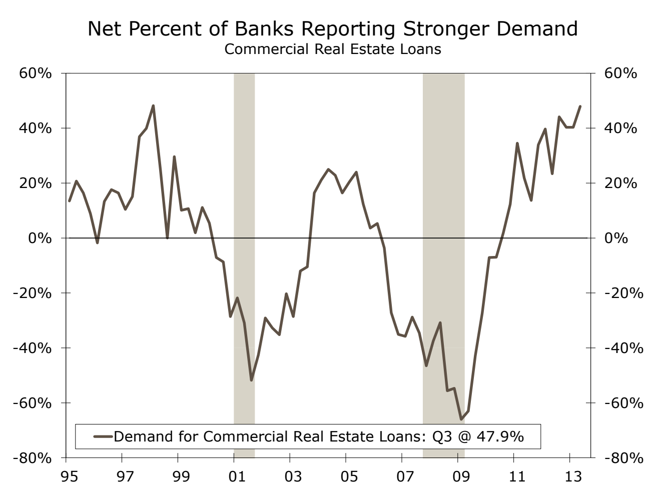


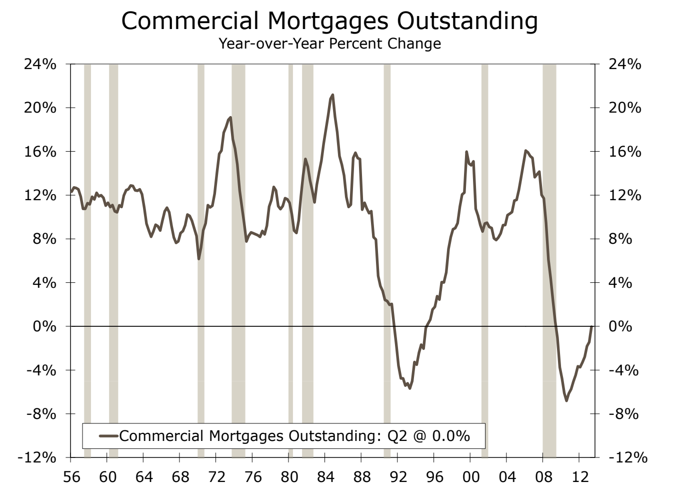
Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, American Institute of Architects and Wells Fargo Securities, LLC

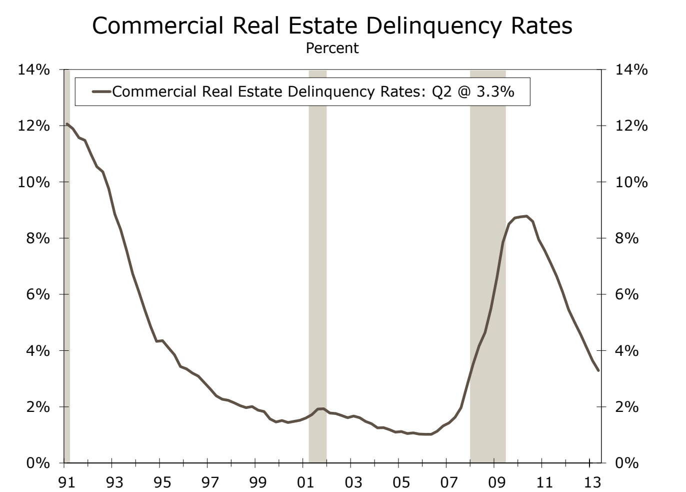
Commercial Mortgages Outstanding

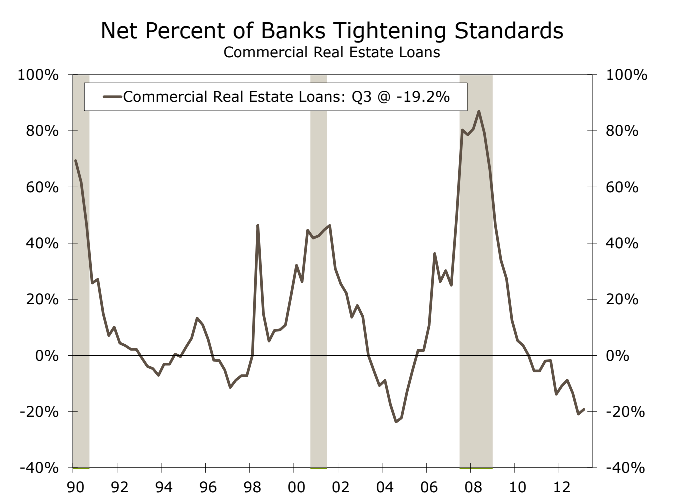
- According to the most recent data from the Senior Loan Officer Opinion Survey, lending conditions on commercial real estate loans remained basically unchanged at most banks, while a small portion reported that standards "eased somewhat." Even as some banks ease lending standards slightly, most banks are not, which is likely holding back some commercial real estate projects. More than one-third of banks reported stronger demand.
- Commercial mortgages outstanding likely rose modestly given the rising demand for loans and slightly easier lending standards; however, we will not receive Q3 data until the Financial Accounts release on Dec. 9.









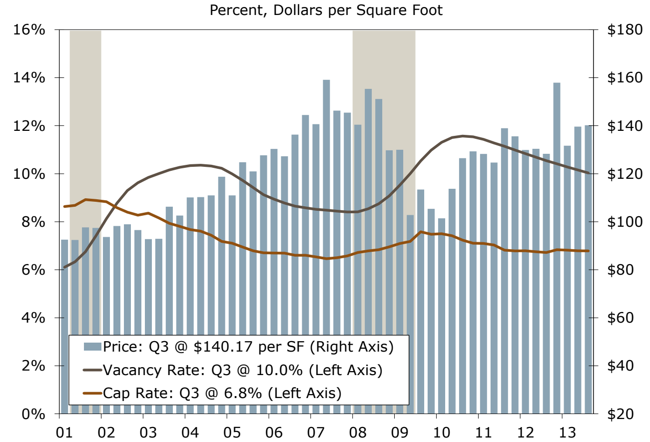


Source: Federal Reserve Board and Wells Fargo Securities, LLC

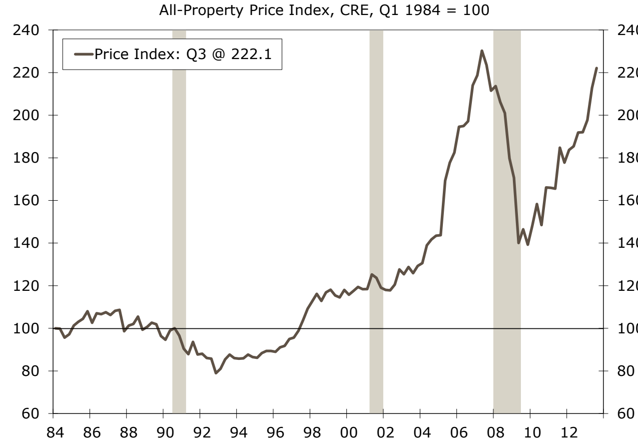
CRE Property Fundamentals

- Property fundamentals improved in Q3, but not remarkably so. Apartments continued to outperform all other sectors; however, activity remained subdued overall. Transaction volume in September came in at a modest $30.2 billion.
- CMBS issuance remains a shadow of its former self, although issuance has begun to pick back up over the past couple of years.
- Property prices appeared to have appreciated considerably over the past year, according to the NCREIF Transactions-Based Index, which is based on properties sold in the quarter. This evidence of price appreciation is an encouraging sign of better times ahead for the nonresidential market.

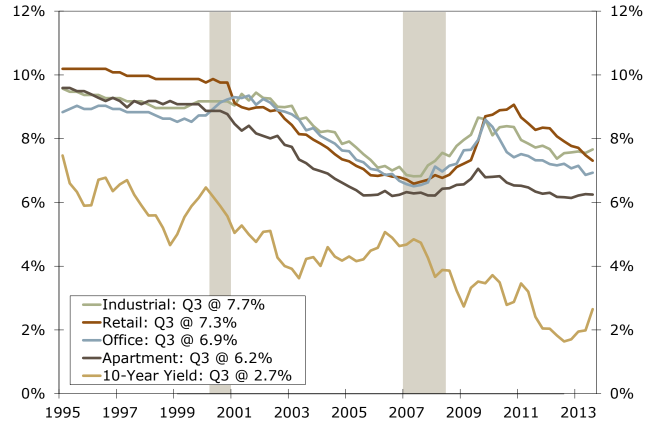
Commercial Real Estate
Percent, Dollars per Square Foot



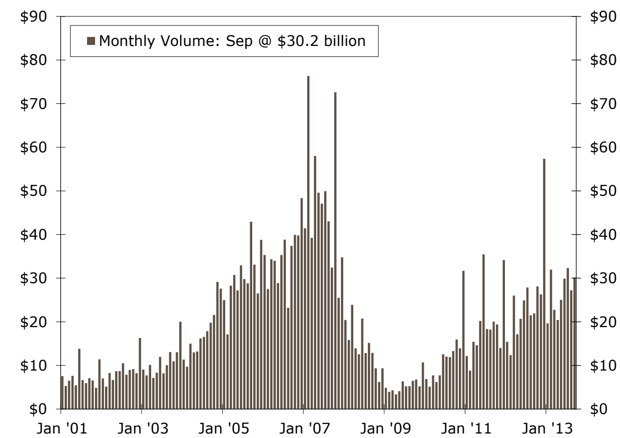
NCREIF Transactions-Based Index
All-Property Price Index, CRE, Q1 1984 = 100



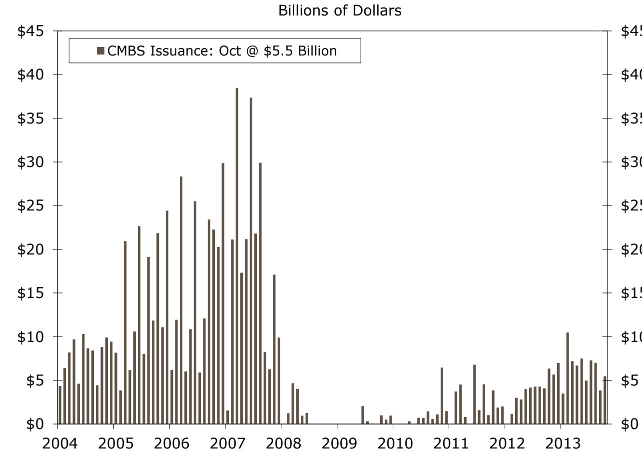
CRE Cap Rates vs. 10-Year Treasury Yields
Percent, Yield



Transaction Volume
Billions of Dollars



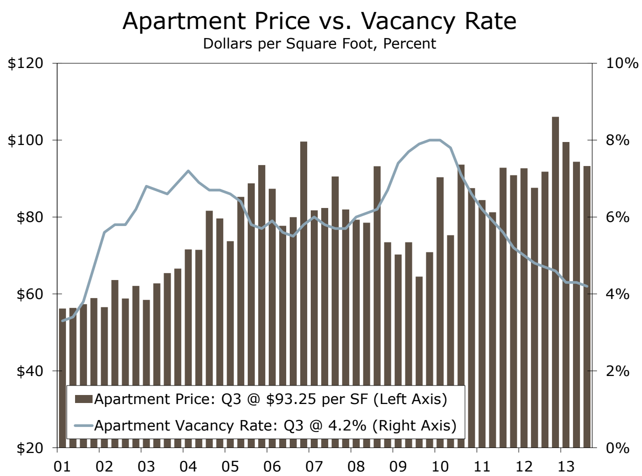
U.S. CMBS Issuance
Billions of Dollars

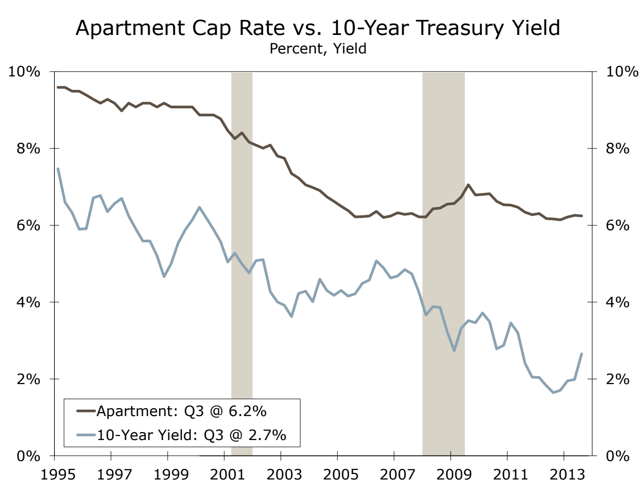


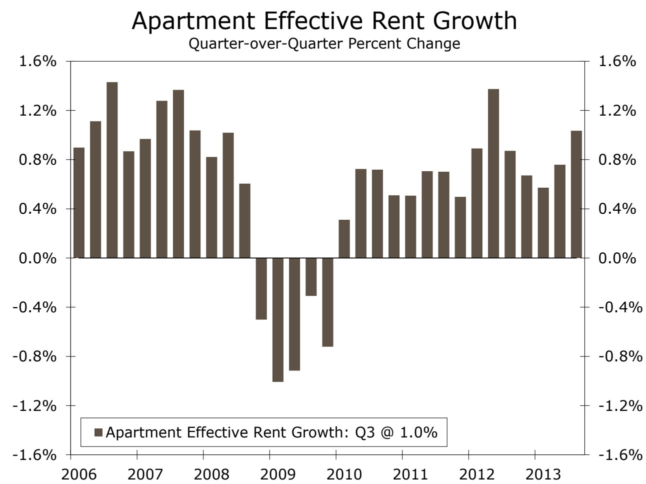
Source: Reis, Inc., PPR,RCA Analytics, NCRIEF, IHS Global Insight, Intex and Wells Fargo Securities, LLC

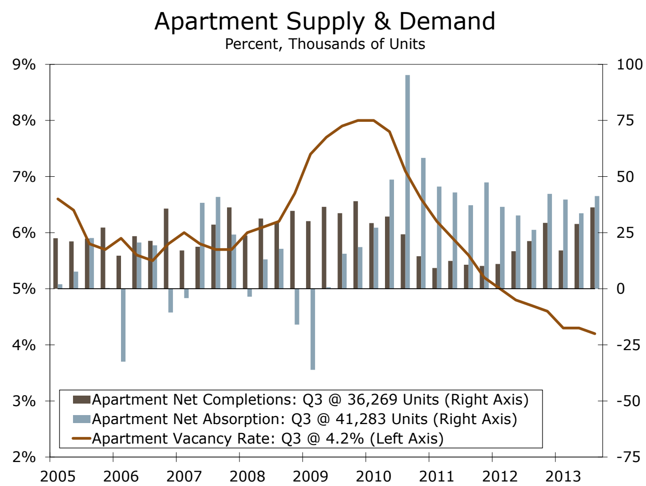
Apartments

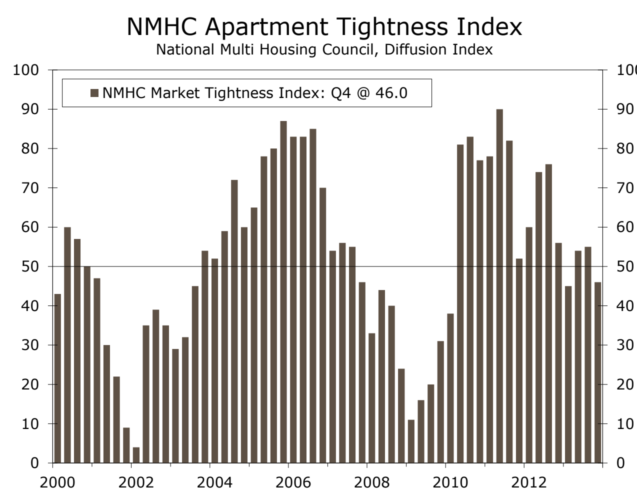
- The apartment market remained firm in Q3, as the vacancy rate declined 10 bps to 4.2 percent due to continued robust demand. Net absorption outpaced net completions for the 14th quarter in a row. Although the gap between supply and demand appears to be narrowing, both continue to increase. Net completions rose to the highest level since Q4 2009.
- Even with such strong demand for apartments, rent growth is not as strong as would be expected given current low vacancy rates. Rent increases are likely being constrained on the demand side by sluggish job and income growth. Unfortunately, we see both remaining sluggish over the next few years.







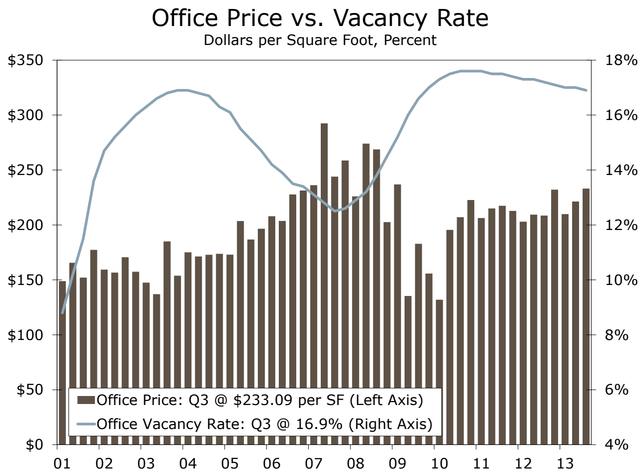


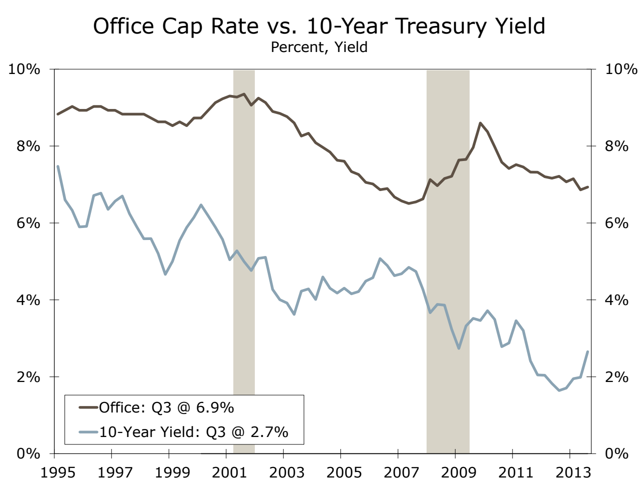


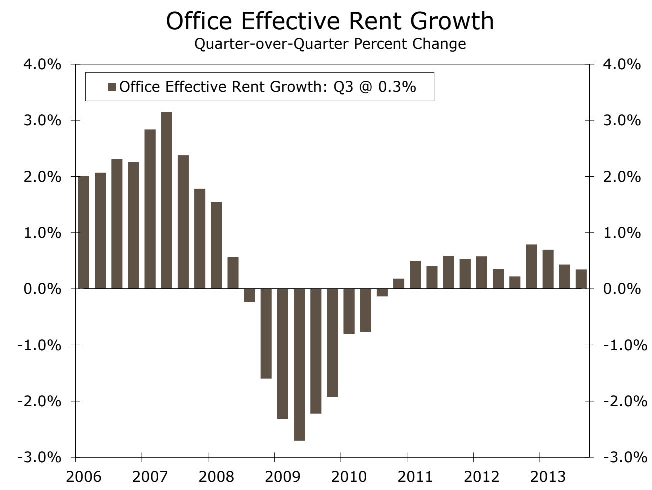
Source: Reis, Inc., RCA Analytics, IHS Global Insight, NMHC and Wells Fargo Securities, LLC

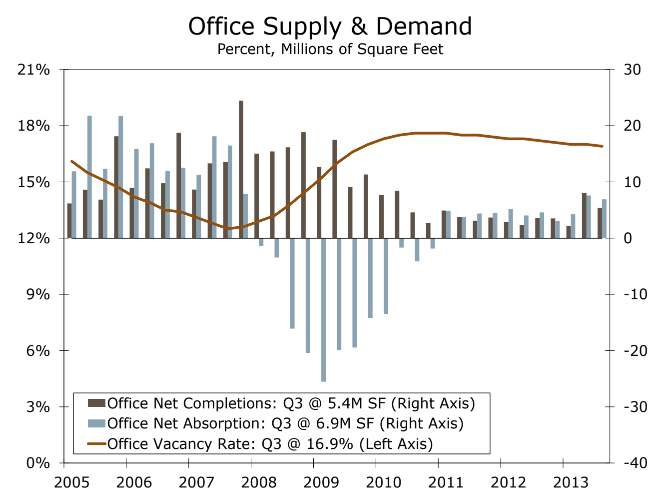
Office

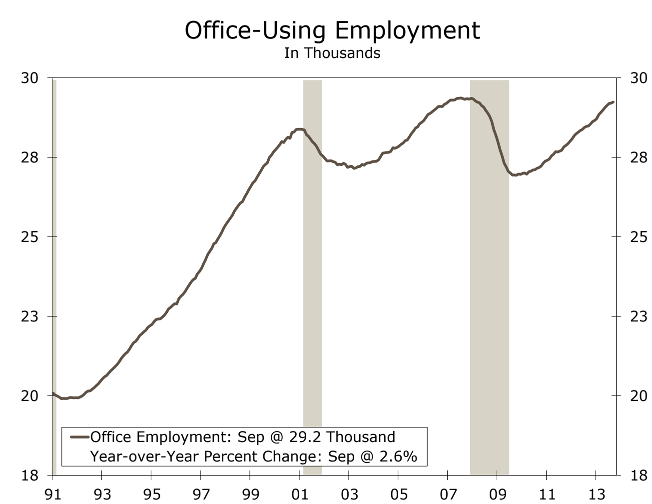
- The office market improved slightly in Q3, with positive rent growth and declining vacancies. The vacancy rate fell 10 bps to 16.9 percent, as net absorptions slightly outpaced completions. Even with this improvement, the office market continues to have far and away the highest vacancy rate of any sector.
- The market for office space will remain weak in the absence of stronger growth in office-using employment, even though it has nearly returned to its pre-recession peak. Office-using employment must increase significantly to work through all the excess space completed as the economy fell into recession. Moreover, many tenants have taken advantage of the soft market to consolidate space needs.







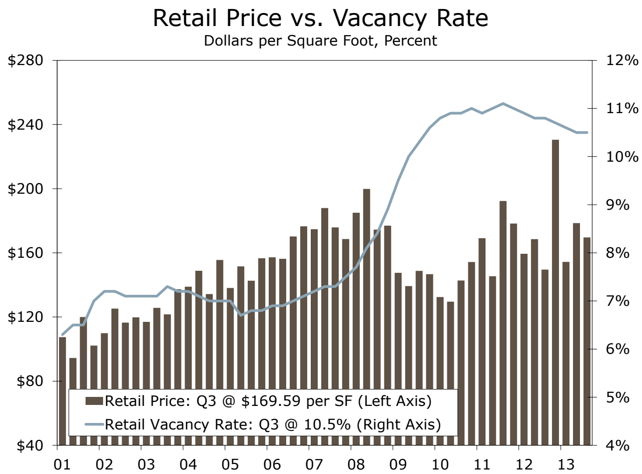


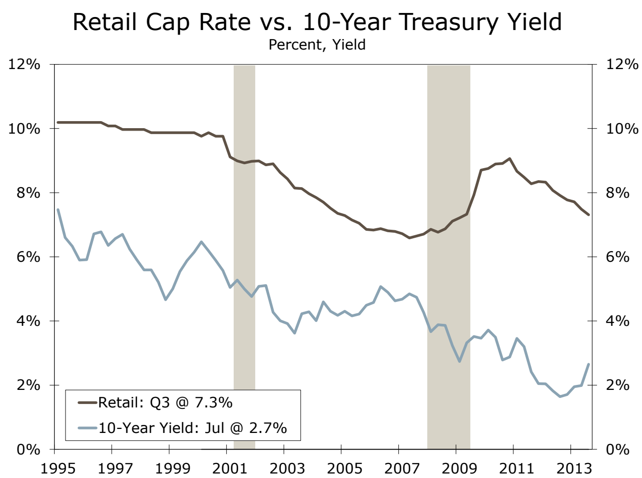


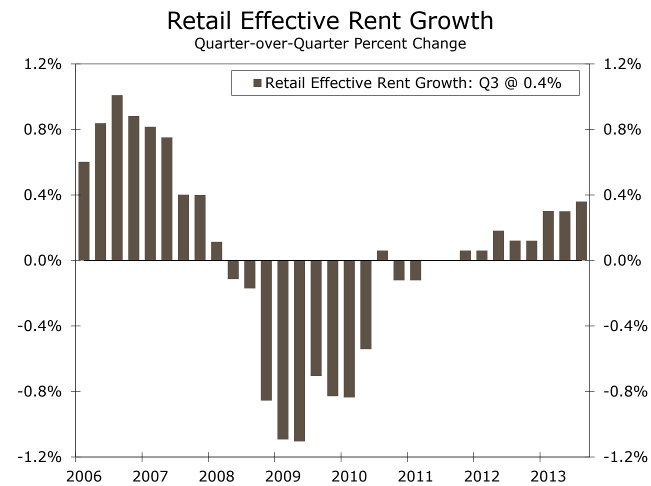
Source: Reis, Inc., RCA Analytics, IHS Global Insight, U.S. Dept. of Labor and Wells Fargo Securities, LLC

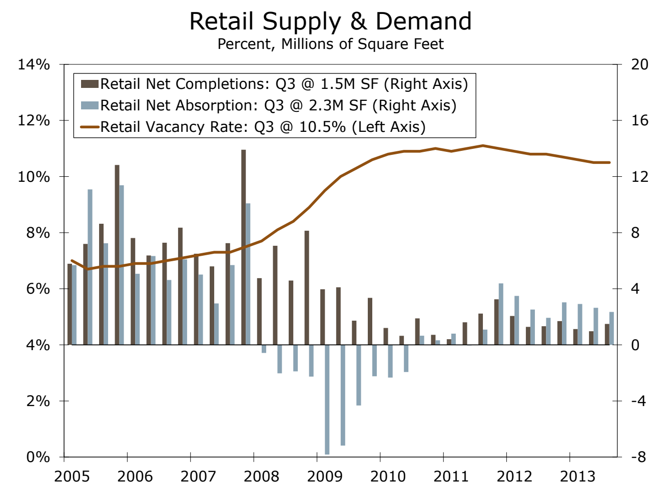
Retail

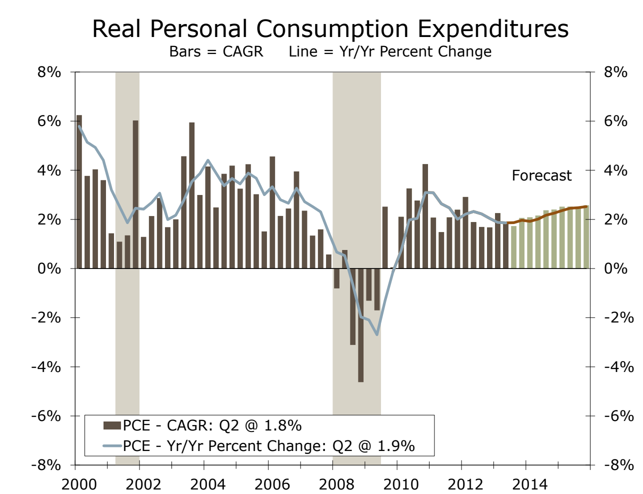
- The market for retail space remains in slow motion. Vacancy rates held at 10.5 percent in Q3, as demand for space remained weak. Over the past few quarters, however, we have seen some pickup in rent growth. Retail sector growth has been uneven due to the increasing divide of the consumer base. High-end retailers and low-end discount stores have been the strongest performers. Retailers focused on middle-income consumers have struggled in the current slow growth environment as this group continues to hold tight to their purse strings.
- Our current forecast for consumer spending remains modest. Thus, we do not see any near-term acceleration in the retail sector, but look for continued gradual improvement.







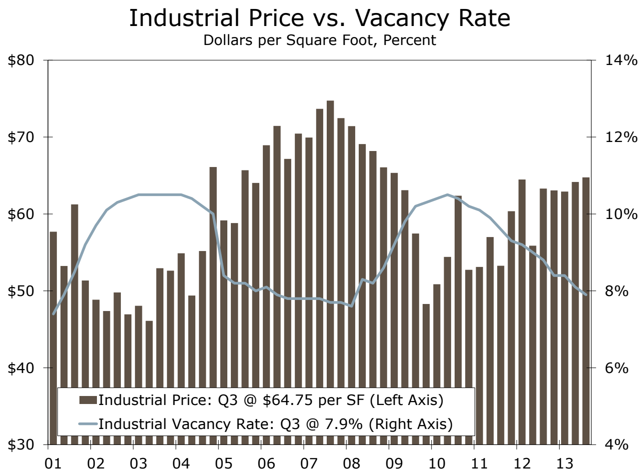


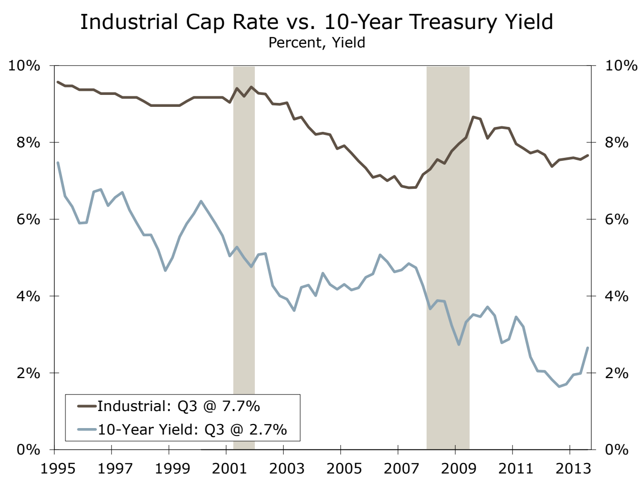


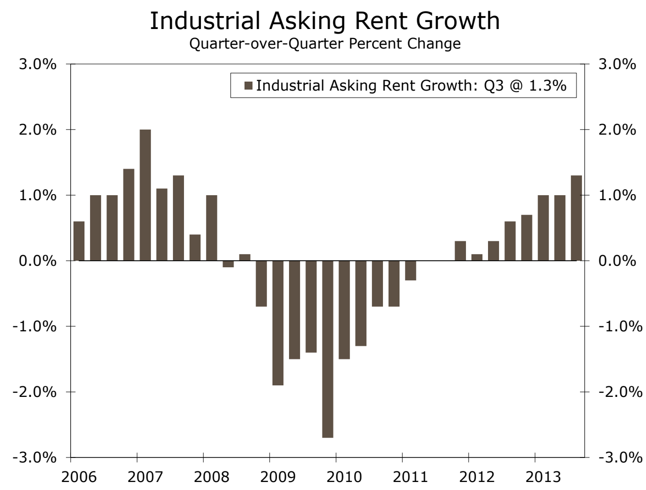
Source: Reis, Inc., RCA Analytics, IHS Global Insight, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

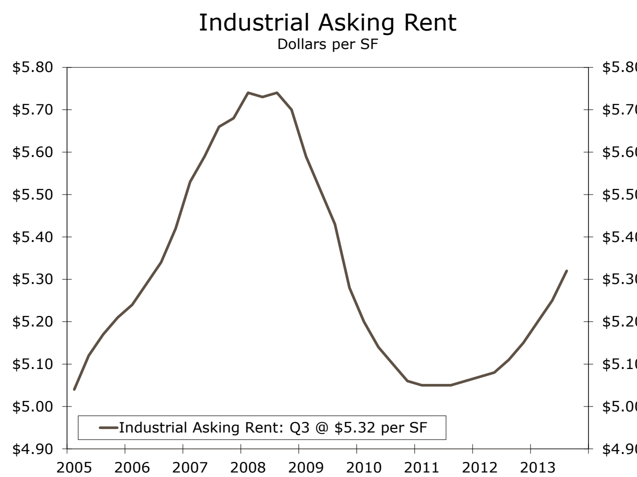
Industrial

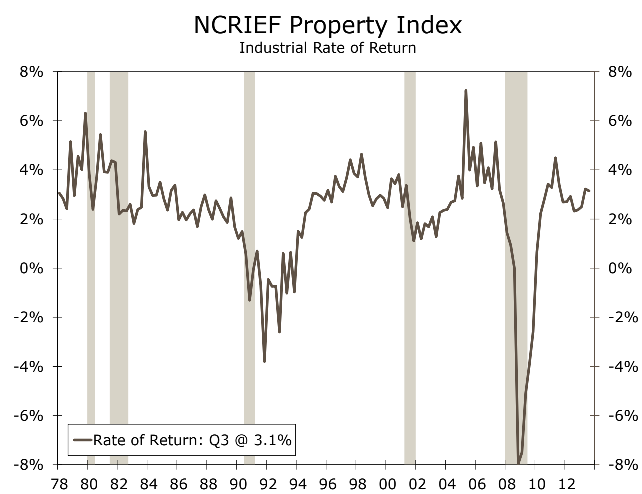
- The industrial sector had another strong showing in Q3. Vacancy rates fell 20 bps to 7.9 percent, bringing the year-over-year decline to 90 bps (the most improvement of any sector). This sector has been a major beneficiary of firms' decisions to scale down brick-and-mortar operations and switch to a virtual marketplace and warehouse business plan. All signs indicate this effort is more than just a short-term trend, which suggests that the industrial sector should see additional gains in the coming years.
- Asking rent grew 1.3 percent in Q3 as landlords likely have more pricing power as inventory is squeezed tighter. Even as supply rose to a post-recession high, net completions were still less than half of net absorption.









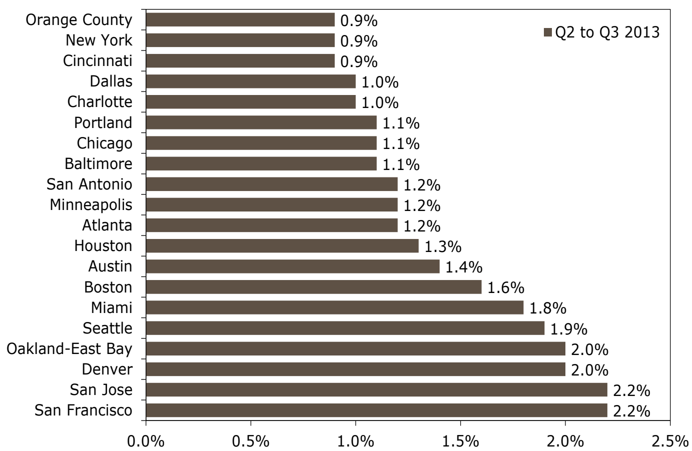


Source: PPR, RCA Analytics, IHS Global Insight and Wells Fargo Securities, LLC

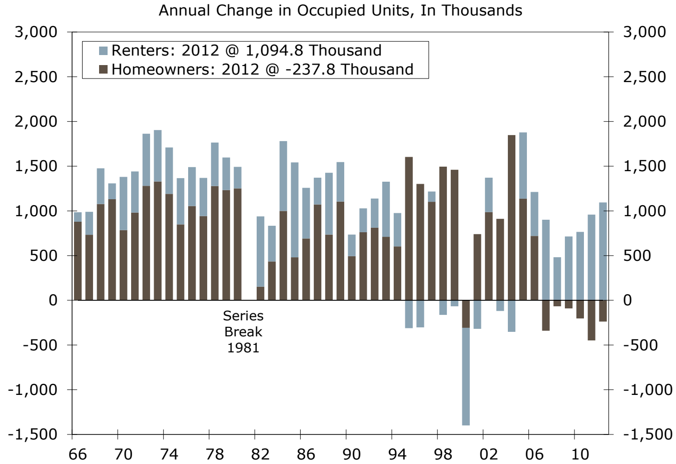
Regional Apartment Market Overview

- Apartment fundamentals continue to outperform all major property types, but much of the strength has been regional. Vacancy rates in markets hard hit by the housing unwind such as Las Vegas, Atlanta, Phoenix, Tampa and Orlando have seen the most improvement over the past year. Moreover, many West Coast markets including Portland, Seattle, San Diego, San Francisco and San Jose are seeing vacancy rates below the national average.
- On the demand side, net absorption has picked up the most over the past year in markets with the greatest job prospects such as Houston, Dallas and San Jose. Much of this activity continues to be driven by large inflows of young workers who will continue to buoy demand.

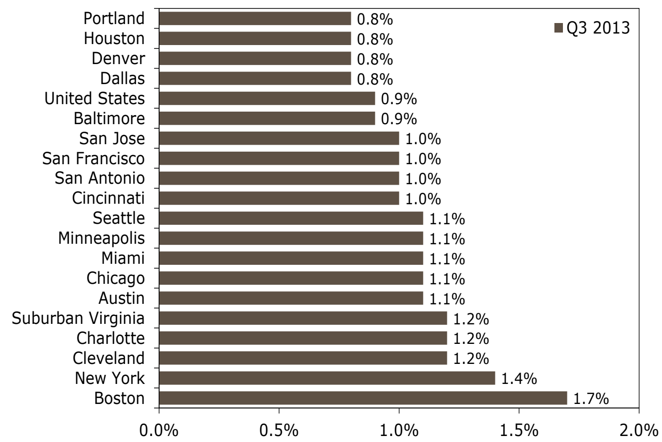
Top 20: Apartment Effective Rent Change
Markets with > 100,000 units, Quarter-over-Quarter



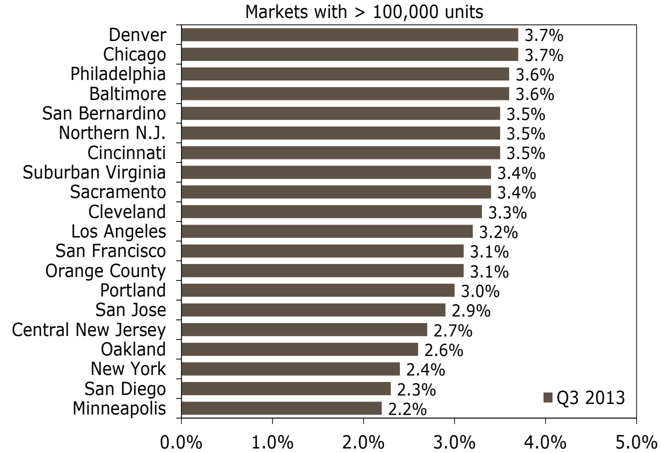
U.S. Homeowners vs. Renters
Annual Change in Occupied Units, In Thousands



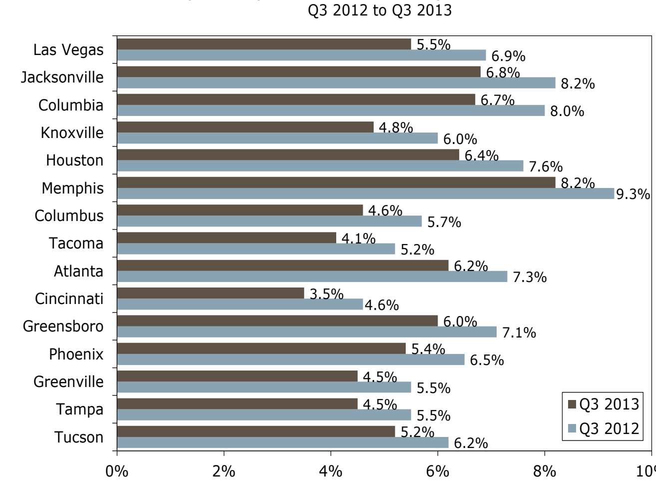
Top 20: Apartment Construction/Absorption Ratio
Markets with > 100,000 units



Top 20: Lowest Apartment Vacancy Rates
Markets with > 100,000 units



Top 15 Apartment Vacancy Rate Declines
Q3 2012 to Q3 2013



Source: Reis, Inc., U.S. Department of Commerce and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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