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RESEARCH

# Time for A Turnaround?

By Paul Fiorilla, Associate Director of Research, Yardi Matrix

## Market Analysis

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### Contacts

#### Jeff Adler

*Vice President & General  
Manager of Yardi Matrix*  
Jeff.Adler@Yardi.com  
(800) 866-1124 x2403

#### Jack Kern

*Director of Research and Publications*  
Jack.Kern@Yardi.com  
(800) 866-1124 x2444

#### Paul Fiorilla

*Associate Director of Research*  
Paul.Fiorilla@Yardi.com  
(800) 866-1124 x5764

#### Dana Seeley

*Associate Director of Research*  
Dana.Seeley@Yardi.com  
(800) 866-1124 x2035



## Has CRE Reached an Inflection Point?

In 2007, the catastrophic downturn that hit the commercial real estate market came almost like a bolt from out of the blue after several years of euphoric activity. Few saw the bear market coming, and those who expressed concern in advance certainly didn't predict the depth of the downturn.

The real estate market has since seen several years of steady—some might say heady—growth, highlighted by an influx of capital and record property prices. Market players, though, seem eager not to get caught unawares by the next recession, and the discussion in industry forums has turned to whether the bubble is about to burst. One warning sign is that the Moody's/Real Capital Analytics Commercial Property Price Index (CPPI) dropped in February, its first negative month since the recovery began in January 2010. Other market analysts are saying that real estate is in the “ninth inning” of the cycle.

Is it time to head for the exits? Concerns are not unwarranted, as there are many similarities between today's market and that in 2007. Among them:

- The economy has expanded in the seven years since the last recession ended in the second quarter of 2009, one of the longer periods of growth in the post-war period. Signs that investors are nervous about the future include capital markets volatility and widening bond spreads, which also happened in the lead-up to the global financial crisis.
- Property fundamentals and rents have improved for several years, particularly in the multifamily sector, which has seen an increase in rents of 20.3% between 2011 and first quarter 2016, according to Yardi Matrix. Construction activity is back to historical averages in the multifamily and industrial sectors and is growing in other sectors.

■ Property yields, or capitalization rates, have reached record lows and asset values are at record highs, just as they were in 2007. Transaction volume is once again peaking, at \$492.4 billion in 2015, the most since \$573.4 billion in 2007, according to Real Capital Analytics Inc. Sales volumes rose 236% between 2010 and 2015, which is not quite as much as the 440% growth between 2002 and 2007 but aggressive nonetheless.

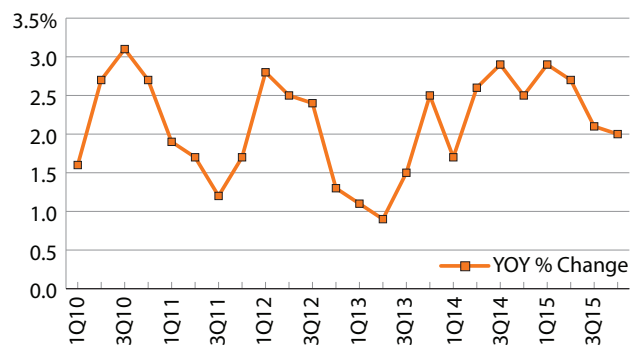
■ Debt is flowing easily, and the total amount of commercial mortgages outstanding is at a record \$2.8 trillion, well above the \$2.5 trillion at the 2007 peak, according to the Mortgage Bankers Association. Plus, loan spreads are rising and lenders have to deal with a spate of frustrating new regulations that adds to the cost of debt.

While each of those factors could be a sign that the next downturn is around the corner, we should also recognize that there are important differences between today's market and 2007 that suggest that the outlook is not quite so dire. Let's take a brief look at each of these factors:

## End to Expansion?

The economy has expanded continuously since the end of the Great Recession, highlighted by the creation of 11.5 million jobs since the beginning of 2011. The national unemployment rate is below 5%, and perhaps more important, the underemployment

## U.S. GDP



Source: Moody's Analytics Inc.

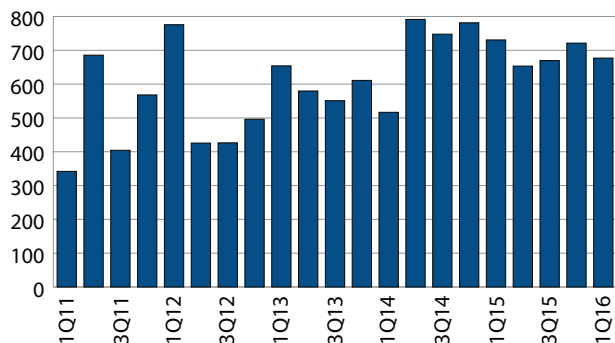
rate has dropped below 10% after topping 17% during the crisis. Post World War II, the U.S. economy has not gone more than eight years without a recession, which is notable but has no bearing on the timing of the next recession. Moody's Analytics Inc., for example, forecasts the next recession for 2019 at the earliest.

The inconsistency in GDP growth in recent years is a concern. On a quarterly basis, growth has bounced around, though year-over-year growth has been steadier, averaging about 2.4% over the last two years. Looking at individual segments of the economy, technology growth appears to be slowing, commodity prices are down, consumer spending hasn't broken out as expected despite the boost from lower energy prices, finance is struggling to find its footing, and exports are weak due to the high cost of the dollar. What's more, slow growth in Europe and Asia continues to roil global markets and is impacting U.S. GDP by a small amount.

Recent months have seen extreme swings in the stock market, oil prices and bond spreads, a sign that investors have wildly divergent views of the future. The race for president also injects a degree of uncertainty, as it may herald a shift in policy depending on the outcome. There are a number of issues that could directly impact the commercial real estate market—including changes in banking regulations, tax issues involving foreign investors and the fate of the GSEs—and will depend on the outcome in November.

*The Wall Street Journal* summed up the economic story nicely with a headline: "Economy Chugs On Despite Fears." Still, none of the

## Job Growth (in thousands)



Source: Bureau of Labor Statistics

issues that are preventing growth from bursting out looks to be cause for an imminent downturn. It's hard to imagine a recession when the economy creates a consistent 200,000-plus jobs per month, with improving workforce participation and wage growth. The likely scenario for the next year or two continues to be ongoing slow growth with low inflation, conditions that have not been unfavorable for commercial real estate.

## Fundamentally Sound?

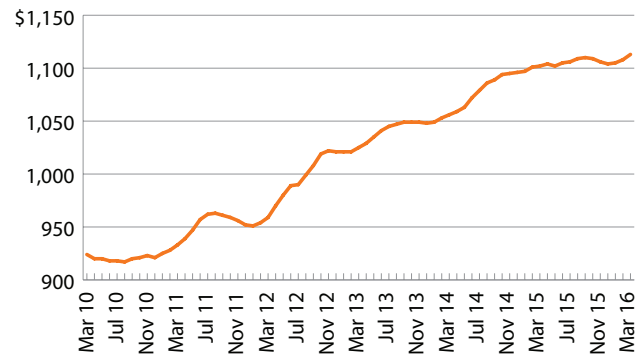
CRE fundamentals have been positive for several years, but other than multifamily and pockets of other property segments—such as CBD office in core markets and industrial in the major hubs—the growth is nowhere near as buoyant as it has been in other cycles.

Multifamily rents have grown 20.3% since 2011, which is unsustainable, given that wage growth is roughly 2% per year. Affordability is a burgeoning crisis, especially in high-cost metros. According to Harvard University's Joint Center for Housing Studies, the percentage of U.S. renter households that pay more than 30% of their income on rent grew to 49% in 2015 from 41% in 2001. At some point, something has to give, and it is a virtual certainty that rent growth has to slow.

Multifamily is also experiencing a wave of supply growth, which is set to top 300,000 new units nationally in 2016. To be sure, there are markets such as Houston and Washington, D.C., where supply seems to be outstripping demand, but by and large, the amount of supply is just about enough to keep up with the demand of a growing population and demographic trends in the era of falling homeownership rates. We published a study in December that found that, based on population and demographic trends, demand for rentals in the U.S. should increase by 400,000 to 600,000 per year over the next decade.

The industrial sector has been strong in recent years. Growth in consumer spending—particularly online purchasing—has led to robust demand for warehouse space with modern technology. This demand is national because occupiers want to locate near population centers. According to Colliers International, more than 200 million square feet of industrial space came online in 2015, while more than 250 million square feet was absorbed and rents

## National Average Multifamily Rents



Source: Yardi Matrix

grew 6.2% year-over-year. While growth is rapid, it is in response to the changing needs of occupiers and does not appear to be indiscriminate overdevelopment.

Office and retail have established pockets of bullish growth. In the office sector, there is a bifurcation between the fortunes of CBD and suburban assets, while in retail the bifurcation is between shopping center types and locations. High-end malls and shopping centers that cater to essentials (such as grocery-anchored centers) are prospering, while centers anchored by dying retail chains and properties in weak locations are struggling. But there is little sense that, other than in a few select markets, rents or new supply have reached untenable levels as they did in 2007.

## Pricing Shock?

If there is one area of commercial real estate that can be considered frothy, it is property values, which are at or near all-time highs in most segments. With low interest rates and steady fundamental drivers, commercial property provided an attractive alternative to stock-and-bond investments in the wake of the recession. The resulting "wall of capital" increased competition for assets and led prices to rise sharply. The CPPI is up 95% since

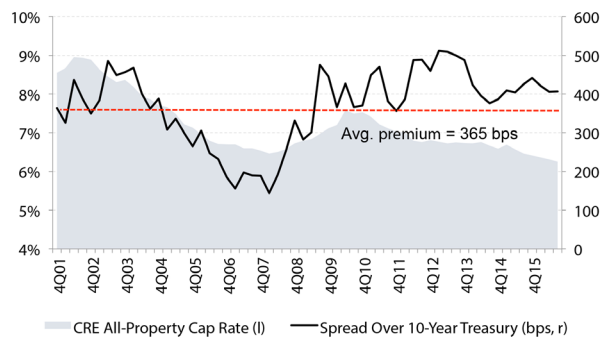
the trough in January 2010 and is 17% higher than the peak in 2007, according to RCA, and cap rates are at all-time lows in most property sectors.

The CPPI had its first negative return in February, falling by 0.3% month-over-month, and many feel that the market is due for a correction. One reason is that some sources of capital may dry up, as foreign investors that rely on oil or commodities—such as sovereign wealth funds from the Middle East or Norway—may not have the cash they did in the recent past. Another concern is that interest rates will inevitably rise and push cap rates higher. Furthermore, debt spreads have widened, which will reduce the amount that buyers can pay.

It is true that foreign capital has been among the sources contributing to the capital influx. According to Cushman & Wakefield Inc., a record \$148 billion in global capital is available to invest in U.S. real estate. Even if the number drops as a result of lower oil or commodity revenues, the amount of capital remaining is substantial. What's more, new sources of capital, such as high-net-worth investors from China who are looking for stability or green cards via the EB-5 program, could increase global investment in U.S. real estate.

Interest rates are sure to rise and push cap rates higher—that's been the refrain for six years, and eventually the odds are that it will happen. However, the Federal Reserve is dovish once again

## Cap Rates vs. The 10-Year Treasury



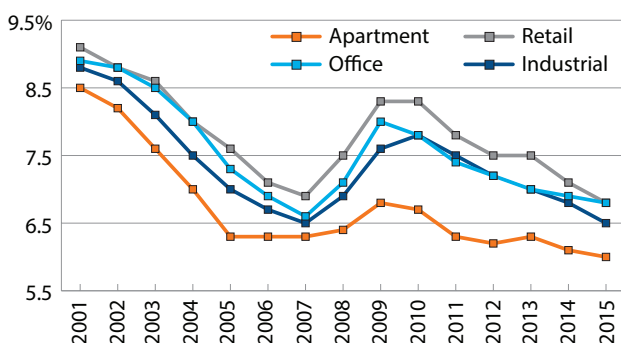
Sources: Federal Reserve, Real Capital Analytics, Yardi Matrix

on rate increases, and most analysts now predict U.S. Treasury rates will stay low for the rest of the year, at least. Even if they do rise, the impact on cap rates is not one-to-one, based on historical data. Cap rates have actually dropped during previous periods of rising interest rates because those periods coincided with strong economic growth.

What's more, even though cap rates in 2016 are comparable to the lows hit in 2007, that doesn't tell the whole story. The average cap rate in the first quarter of 2016 at 6.2% was more than 400 basis points over the 10-year Treasury, above the long-term average of 365 basis points. In 2006 and 2007, the cap rate premium over Treasuries fell to an average of 185 basis points, so there is a good deal of buffer in the event interest rates rise, especially compared to the last bubble.

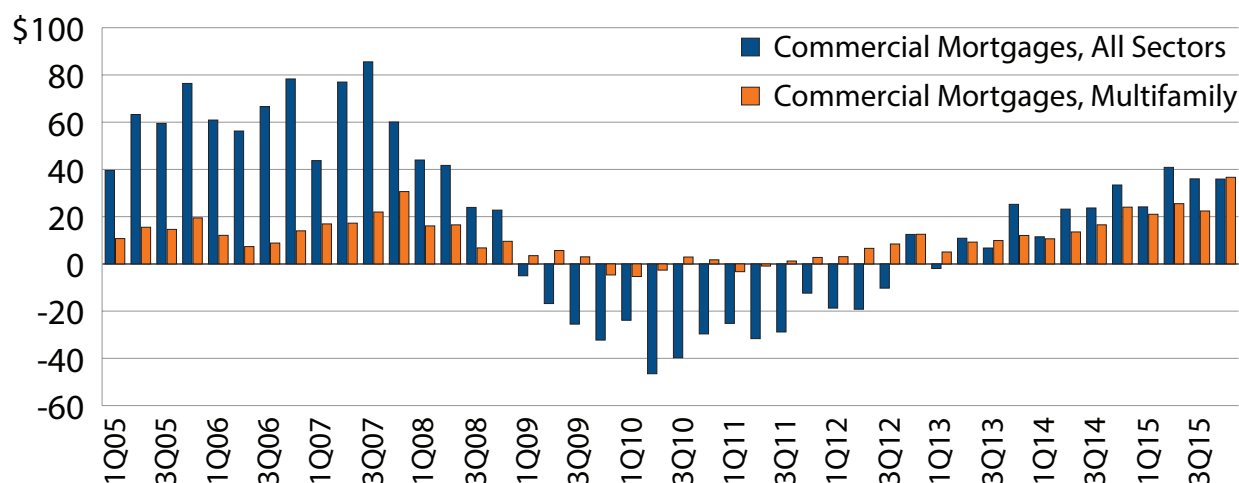
The most significant impact on prices is likely to be the rise in debt spreads caused by the domino effect of increased fixed-income spreads. Spreads of CMBS and bonds issued by government-sponsored enterprises Fannie Mae and Freddie Mac have widened in recent months, leading debt costs to increase by 25 to 50 basis points or more. Buyers have to take the additional costs into account, which is likely to lead to a corresponding increase in property yields.

## Cap Rates



Source: Real Capital Analytics Inc.

## Change in Mortgage Holdings (in millions)



Sources: Federal Reserve, Moody's Analytics

## Doubts About Debt?

One of the trademarks of the 2007 crisis was the growing amount of leverage in the market. The level of commercial debt outstanding hit a record \$2.5 trillion in 2008, before the market collapsed, and shrunk by nearly 10%. Since then, total CRE mortgages outstanding have climbed back to record levels, reaching \$2.8 trillion as of year-end 2015, according to the MBA.

The growth in mortgage debt reflects the rise in property values, but there are important differences from 2007. In the run-up to the last crisis, properties were routinely leveraged at 80 to 90% of value, with multiple layers of mezzanine debt. Underwriting assumed years of steady rent growth. Few loans originated today have the same kind of complicated structure or pro-forma underwriting that was common in 2006-07.

The pricing and availability of debt are growing concerns. The biggest impact is being felt in CMBS, where widening spreads have prompted issuers to stop giving hard quotes and lending

has become sparse. Meanwhile, the GSEs have also raised rates, mostly in response to higher bond spreads but also in part to manage allocations. Banks and life companies don't have the same direct impact from lower bond prices, but they have been able to raise rates in response to the competition. Higher rates will make it more difficult for some borrowers to refinance the roughly \$200 billion in CMBS 1.0-era loans that are maturing over the next two years.

Meanwhile, the regulatory environment is also wreaking havoc on lenders, particularly CMBS and commercial banks. CMBS will be impacted by risk-retention regulations that take effect in 2017, requiring issuers to hold 5% of securitized transactions, and by higher capital charges for bond holdings that will likely reduce trading and liquidity. Already, banks had 50% higher capital charges for construction and redevelopment loans imposed at the start of 2015. That increases the cost of construction debt, but at the same time has the effect of weeding out some construction projects that are speculative or have insufficient equity capital.

## Conclusion: Market Cooling, But Steep Downturn Unlikely

There are a number of similarities to previous downturns that should give pause to the commercial real estate market. The market has seen the run-up in prices, transaction activity and debt volume that precedes most downturns. Meanwhile, the economic engine seems to be cooling down and the industry faces headwinds including widening bond spreads and the growing impact of regulations. Any of these metrics could derail the consistent growth that the CRE market has enjoyed, and combined it could herald the next downturn.

However, there are also some important caveats. Absolute prices may be high, but the premium over the risk-free rate remains consistent with historical norms as opposed to periods of aggressive pricing. Total mortgage volume is at record levels and growing, but leverage on individual properties is not nearly as aggressive as it was at the peak of the last cycle. The level of growth in the economy may be weaker than expected or desired, but there has been little or no irrational exuberance to be corrected. Even though there is volatility in the capital markets, the last crisis was precipitated by unprecedented growth in financial

institution leverage. Whatever one thinks of the impact of regulations, they have had the effect of reducing risk and leverage in the financial system.

So while it appears that the rapid expansion in commercial real estate could be exhausted and the market is likely to see a pause in the run of pricing and deal flow, it's also hard to see what would cause the kind of deep meltdown we experienced in the last cycle. In 2007, transactions were priced with little room for error. Today, leverage is lower throughout the capital stack.

To be sure, the market is dependent on the economy, and that could turn quickly. Recent recessions have been caused by exogenous shocks unrelated to U.S. real estate, and they wouldn't be shocks if the market could see them coming. Any decline in prices would be painful for some corners of the market, particularly those that are paying record prices per pound. That said, given leverage is more moderate and development is largely limited to markets with strong demand, a downturn in the near future is likely to be more shallow than some others in recent memory.

—Paul Fiorilla, Associate Director of Research, Yardi Matrix

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