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Economics Group

Special Commentary

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Commercial Real Estate Chartbook: Q1

The Economy's Slow Start Did Not Upend the Recovery

Unexpectedly sluggish economic growth during the first quarter has not derailed the commercial real estate recovery. Even though U.S. GDP likely contracted at a modest pace during the first quarter, most of the underlying fundamentals for the commercial real estate market improved during the quarter. Office employment increased during the quarter, which helped pull the office vacancy rate modestly lower and send rents and sales prices a bit higher. Industrial activity also remained strong during the quarter, while retailing posted modest gains. Travel and leisure continue to do well, with strong international business now being supplemented by rebounding domestic travel. The apartment market remains in overdrive, with new construction racing to meet unswervingly strong demand.

Unexpectedly sluggish economic growth during the first quarter has not derailed the commercial real estate recovery.

Increased investment in technology and energy sectors remains the driving force behind the recovery, and markets with outsized exposure to these industries are seeing some of the strongest employment and population gains. Notable hot spots include the greater San Francisco Bay area, Seattle, Austin, Houston and Denver. Other standouts include key international gateways, such as New York City, Miami, and Los Angeles. All are seeing almost boom-like conditions, with tower cranes dotting the skyline and a steady tide of newcomers fueling demand for new homes and apartments.

The boom in technology centers and energy markets now appears to be broadening in two key ways. Most directly, the technology and energy booms have spread to more areas, most notably Atlanta, Boston, Dallas, Charlotte and Nashville. Other industries are also beginning to gain momentum. The U.S. Bureau of Labor Statistics diffusion index, which measures the share of the 264 private industries adding jobs each month, rose to 67 in April, marking one of the broadest increases in employment since the recession ended.

Figure 1

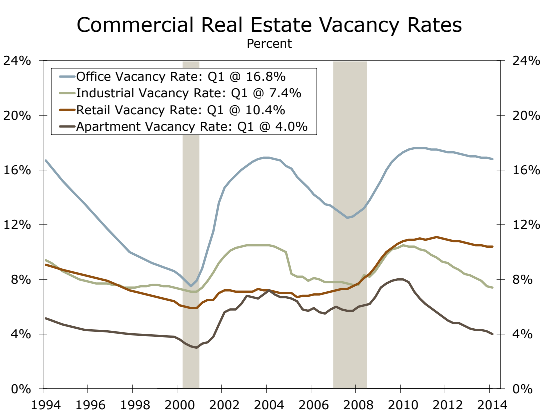

Figure 2

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

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Commercial Real Estate Fundaments Continue to Improve

Stronger office employment growth combined with the dearth of new building activity has helped curb office vacancy rates and pull rents higher.

Office employment growth has risen at a 1.3 percent annual rate over the past three months and has increased 2.4 percent over the past year. With the gain, office employment is now 1.1 percent above its pre-recession peak. Stronger office employment growth combined with the dearth of new building activity has helped curb office vacancy rates and pull rents higher. Silicon Valley and San Francisco continue to lead the recovery, with office vacancy rates in the San Jose area tumbling 1.1 percentage points over the past year and asking rent rising 5.9 percent over the past year. San Francisco saw office vacancy rates fall 70 bps over the past year to 12.8 percent and asking rent rise 4.8 percent. Other tech markets, most notably Seattle and Austin, also continue to see strong gains in absorption and rental rates. Moreover, the tech boom appears to be driving much of the recent improvement in many other markets not typically thought of as tech centers, including Atlanta, Los Angeles and New York City.

While major tech centers have been enjoying a building boom for the past couple of years, office markets have improved enough in other areas that new construction is finally beginning to move forward in a major way. While the bulk of new office deliveries over the next few years will still be heavily dominated by major energy and tech centers, development is beginning to move forward in many other metro areas. Financial services in general have seen an exceptionally slow recovery, which has weighed on New York and Chicago. Two areas that are beginning to make headway, however, are insurance and asset management. State Farm Insurance is developing two large campuses, one in suburban Dallas and another in suburban Atlanta. Downtown development is also getting a boost. Natixis Global Asset Management signed a lease for 150,000 square feet of office space in a new 17-story building set to break ground in Boston this summer and Babson Capital recently announced plans to lease more than one-third of a new 25-story tower that is set to break ground in downtown Charlotte.

Demand for industrial space has primarily been driven by the explosive growth in online retailing.

Demand for industrial space has primarily been driven by the explosive growth in online retailing, which has driven big-box warehouse and distribution center development around key distribution hubs. Changing global trade patterns and the re-shoring of manufacturing operations back into the United States are other major trends driving the industrial markets. Some of the biggest beneficiaries of these trends have been established distributions markets such as Chicago, Atlanta, Dallas, Los Angeles, eastern Pennsylvania and Indianapolis. Several port cities along the East Coast are also seeing improvement, as port facilities are expanded to handle the increased volume of trade expected to take place after the Panama Canal is widened.

Retail development has lagged throughout the recovery, as retailers have battled sluggish job and income growth as well as a number of structural shifts. One of those shifts has been the growing preference for urban living, particularly by younger households. The trend has been a driving force behind recent apartment development and for a limited amount of infill and urban retail development. By contrast, suburban development has languished through much of the recovery, particularly for development in distant suburbs.

Figure 3

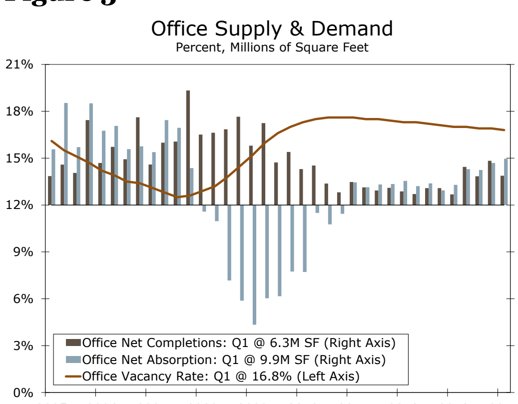
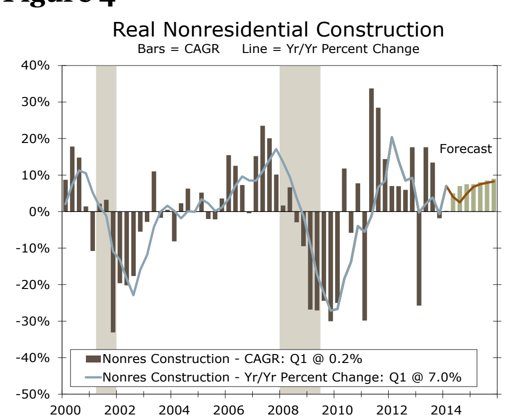


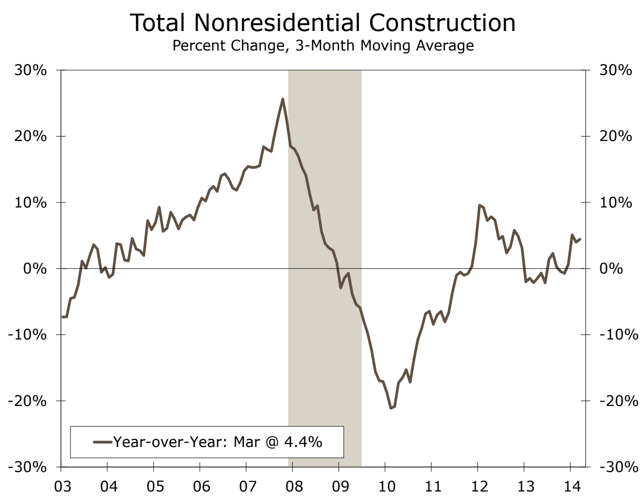
Figure 4

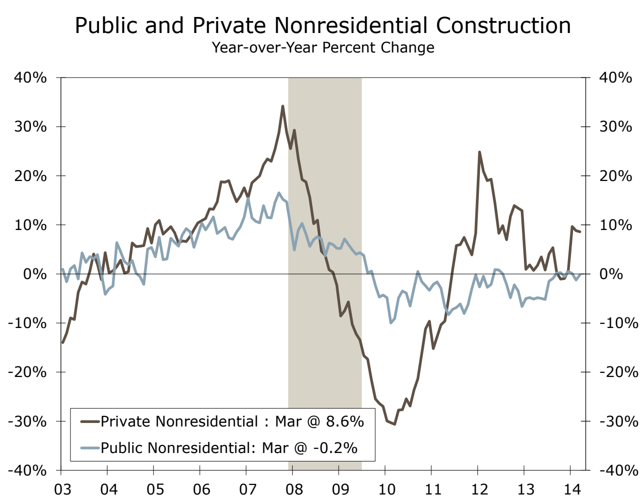


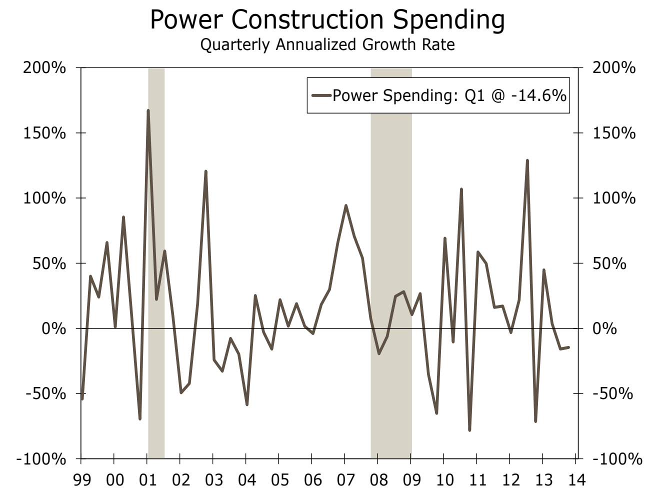
Source: PPR, Reis, Inc., U.S. Department of Commerce and Wells Fargo Securities, LLC

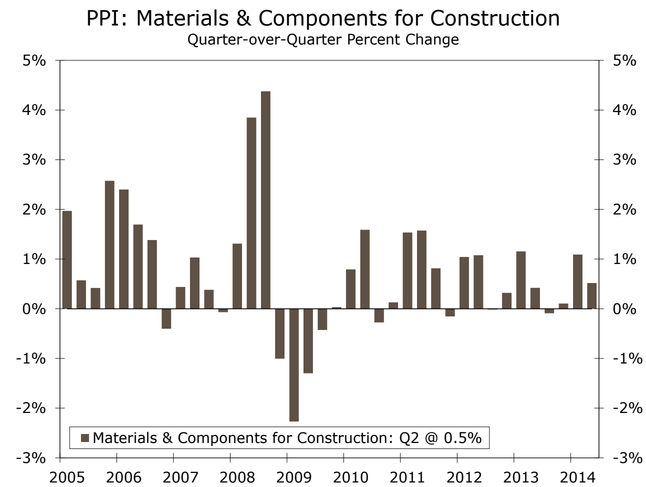
Nonresidential Construction Spending

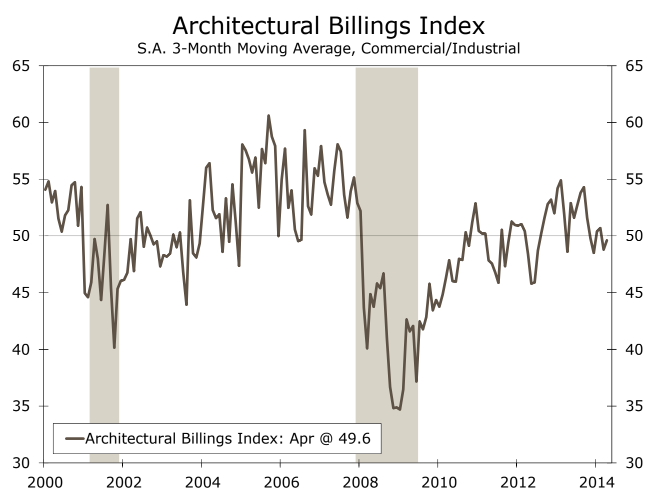
- Private nonresidential construction spending started the year off in the red, posting a negative reading in the first quarter as unusually harsh winter weather conditions slowed improvement.
- Commercial construction has been a notable bright spot over the past year, but also weakened in the first quarter. The largest drop was in power outlays, which shaved off more than one percentage point from headline nonresidential construction growth.
- With the first quarter already in the books, structure investment is expected to detract a bit further from first quarter real GDP growth, but should show an improvement in the coming quarters.







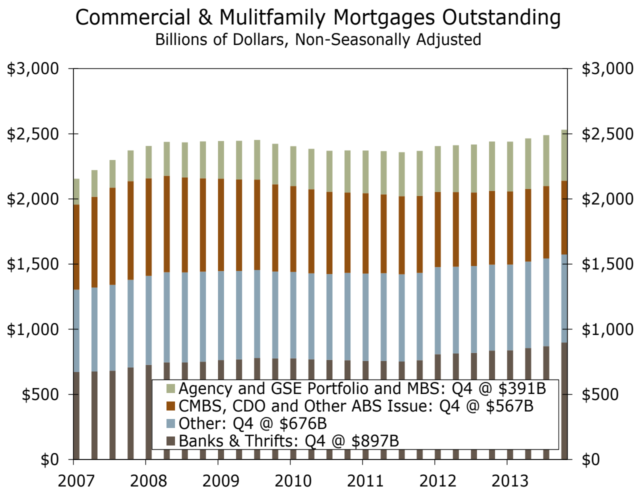


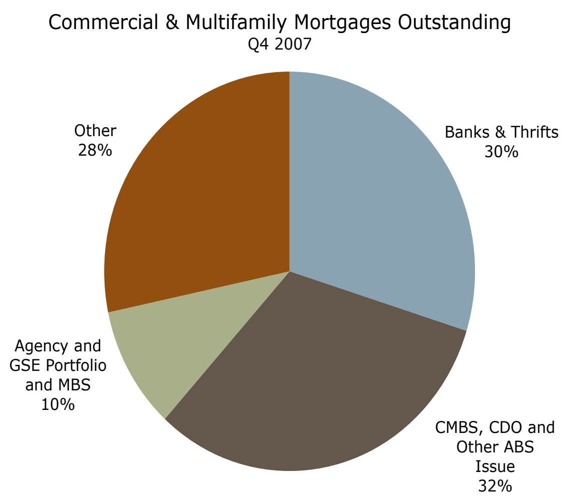


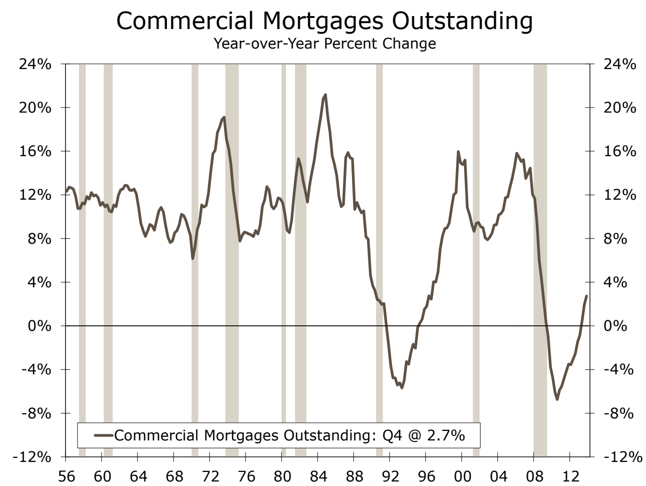
Source: U.S. Dept. of Commerce, U.S. Dept. of Labor, American Institute of Architects and Wells Fargo Securities, LLC

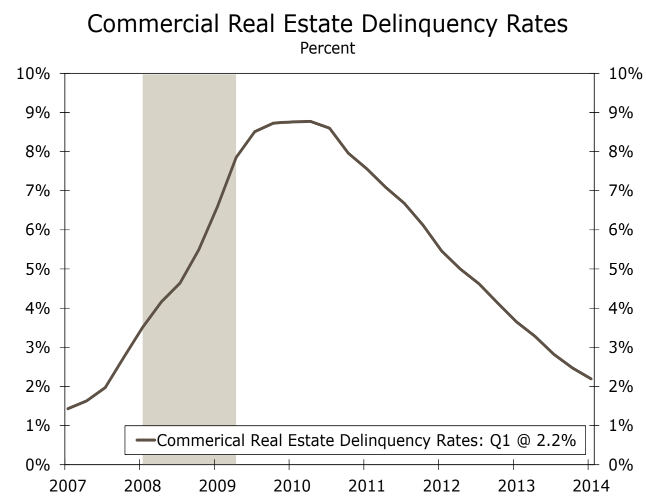
Commercial Mortgages Outstanding

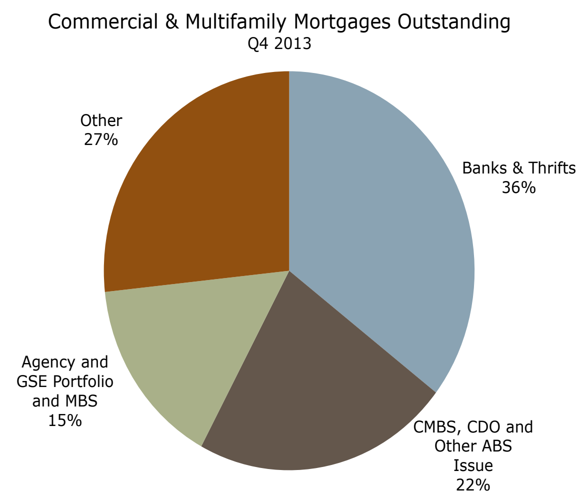
- Commercial/multifamily debt outstanding rose 3.7 percent in 2013, to roughly $2.5 trillion. Banks continued to hold the largest share of mortgages and increased their holdings in 2013. CMBS posted its first positive reading since 2007, but holdings remain well below the pre-recession share of 32 percent, with only 22 percent of total mortgages outstanding.
- Finance companies, private pensions and state and local government reduced their overall share of commercial holdings over the past year.
- According to the latest Senior Loan Officer Opinion Survey, lending conditions for commercial real estate loans continued to ease while demand has strengthened.







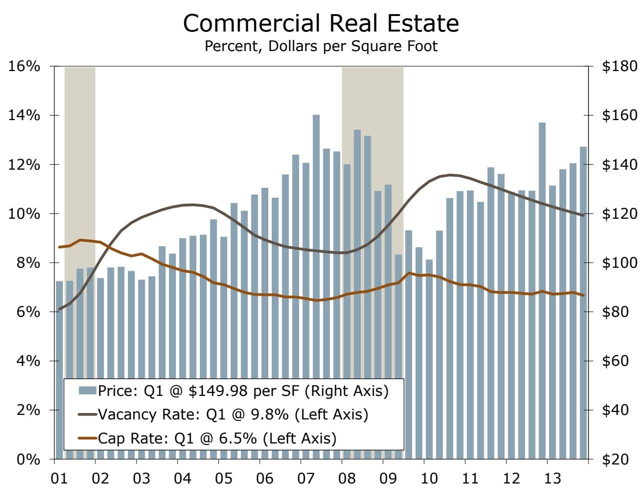


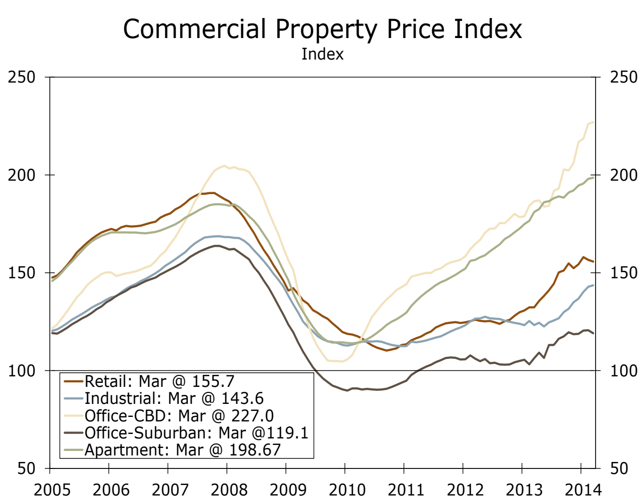


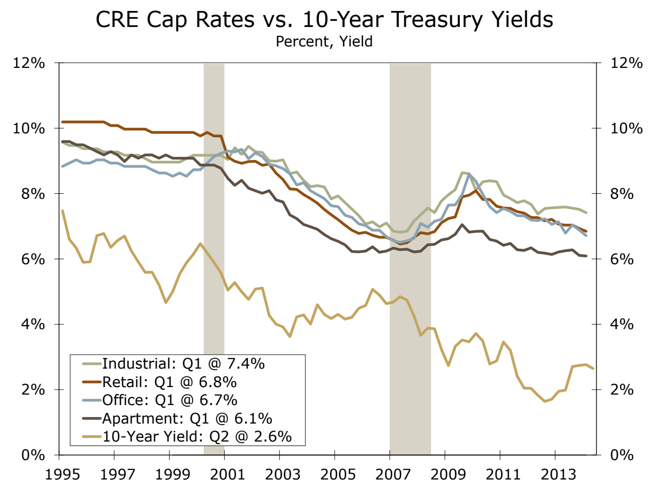
Source: Federal Reserve Board and Wells Fargo Securities, LLC

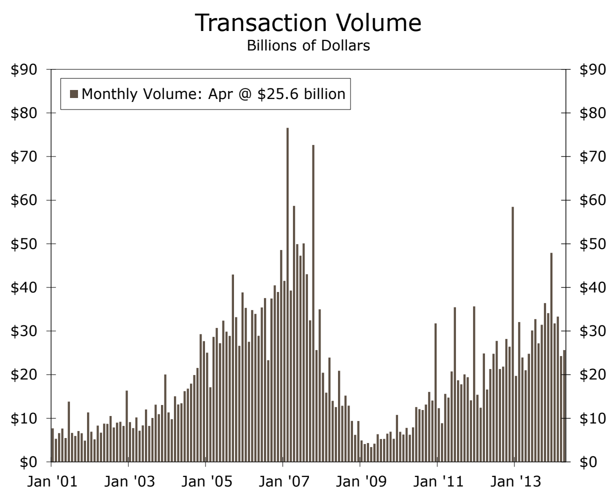
CRE Property Fundamentals

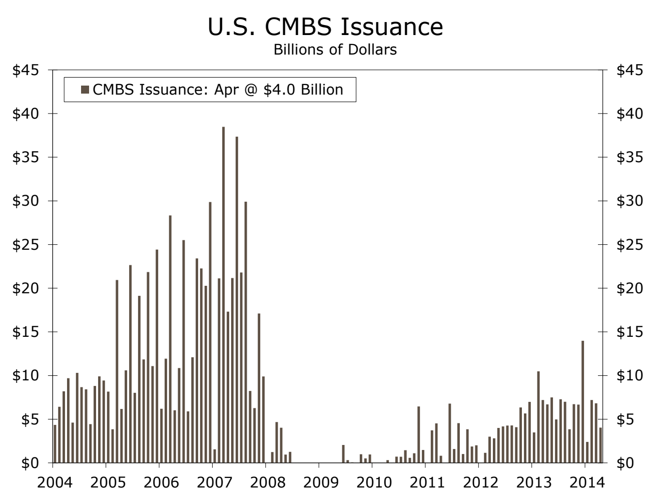
- Operating fundamentals are strengthening along with improving economic and employment growth. Demand for office, industrial and retail space has steadily improved over the past couple of years and with little construction, vacancy rates have continued to fall. However, apartment supply has picked up in recent quarters and is expected to slightly outpace demand this year. Markets such as Austin, Washington, D.C., Raleigh-Durham and Charlotte are expected to see the greatest additions to apartment supply.
- Cap rates for the four major property types trended lower in the first quarter. Much of the compression remains in the apartment sector.







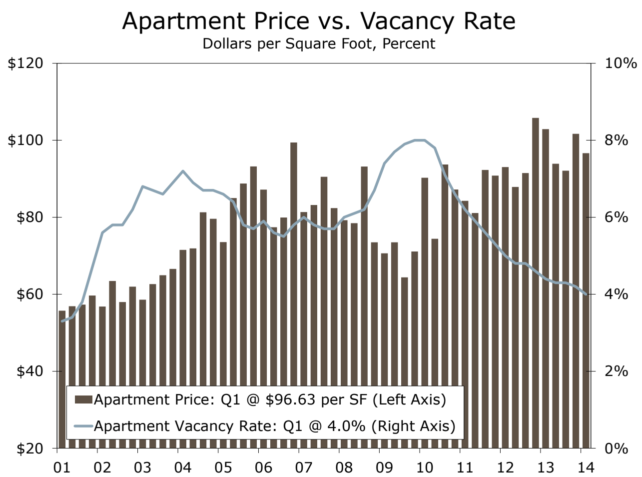


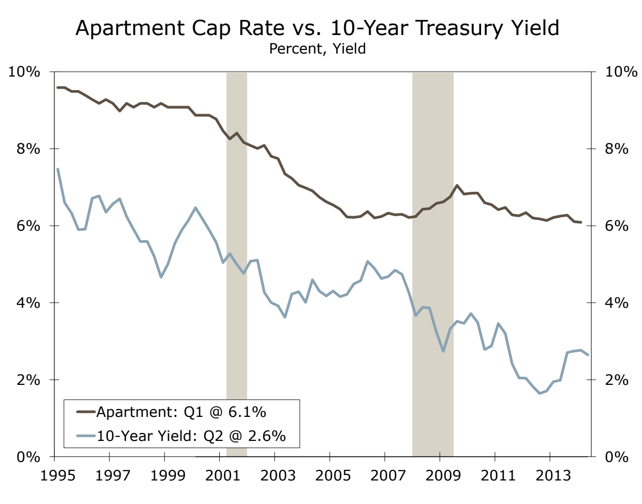


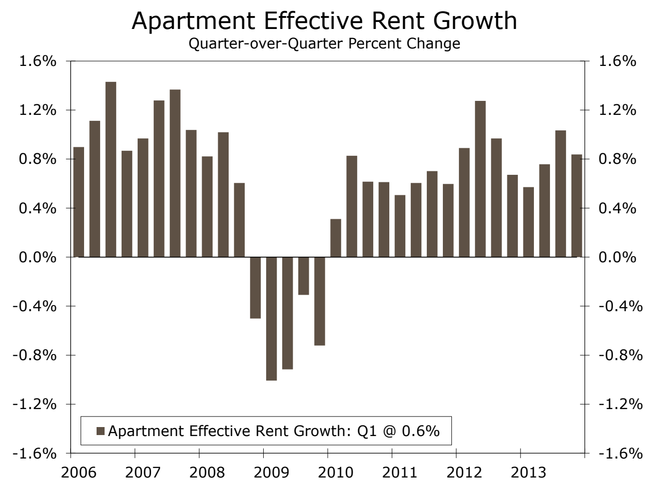
Source: Reis, Inc., PPR, RCA Analytics, NCRIEF, IHS Global Insight, Commercial Mortgage Alert and Wells Fargo Securities, LLC

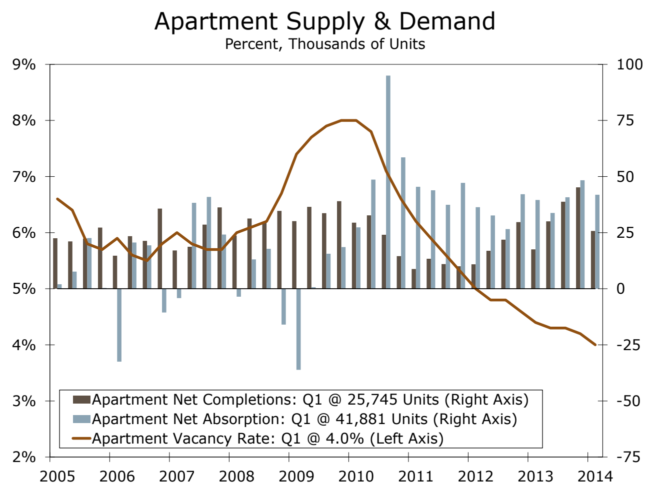
Apartments

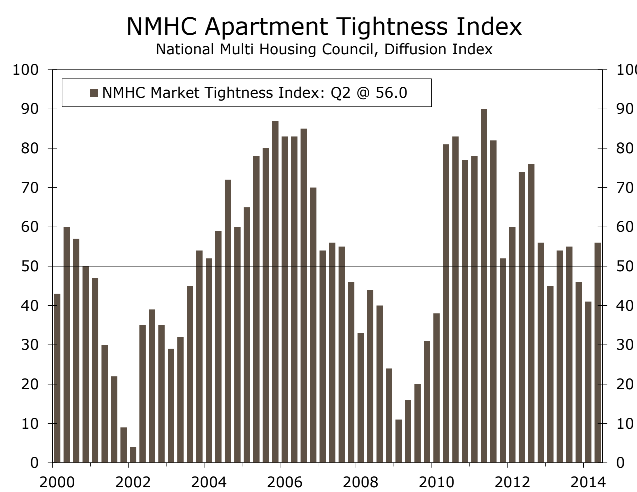
- Apartment fundamentals continue to outperform all major property types, but supply is expected to outpace demand this year. Reis expects 178,653 units to come on line this year, which is well above the long-run average of 125,000 units per year. With demand moderating, the national vacancy rate will likely post a flat reading in 2014. Although demand has moderated from its peak in 2010, improving economic and job growth should keep absorption strong.
- Year-over-year effective rent growth has also been stuck in the 3.0 percent to 3.2 percent range since mid-2013, and is expected to moderate in coming years, as more supply comes on line.







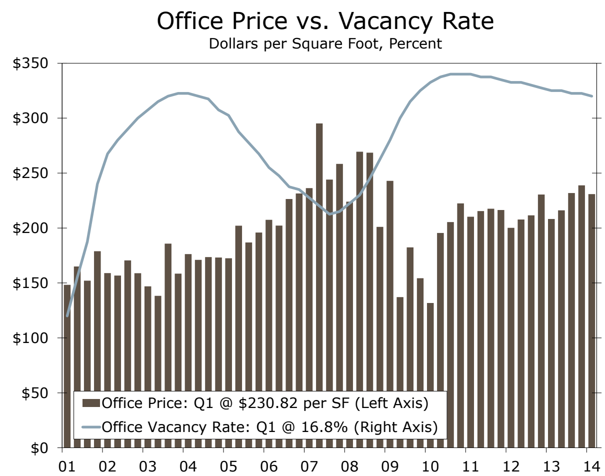


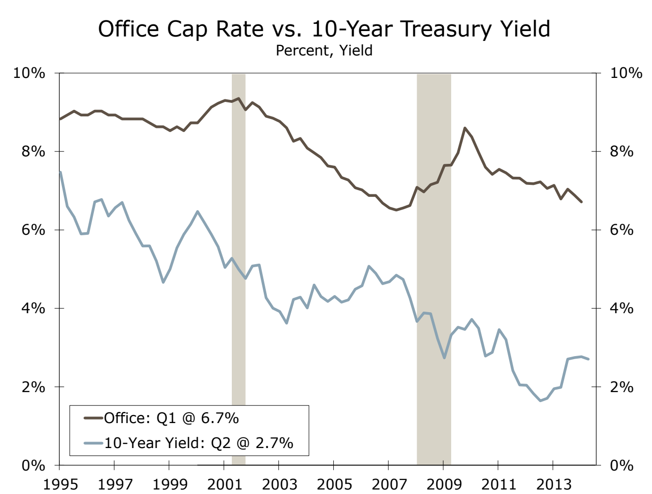


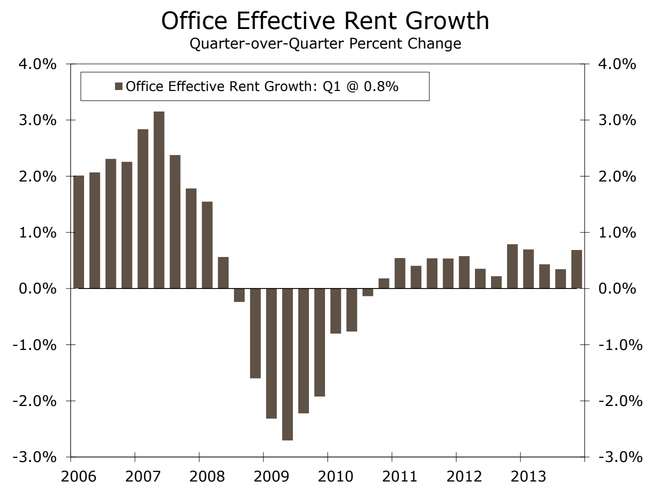
Source: Reis, Inc., RCA Analytics, IHS Global Insight, NMHC and Wells Fargo Securities, LLC

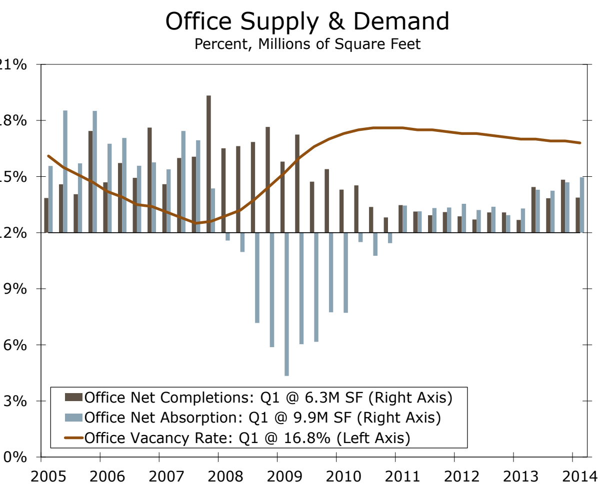
Office

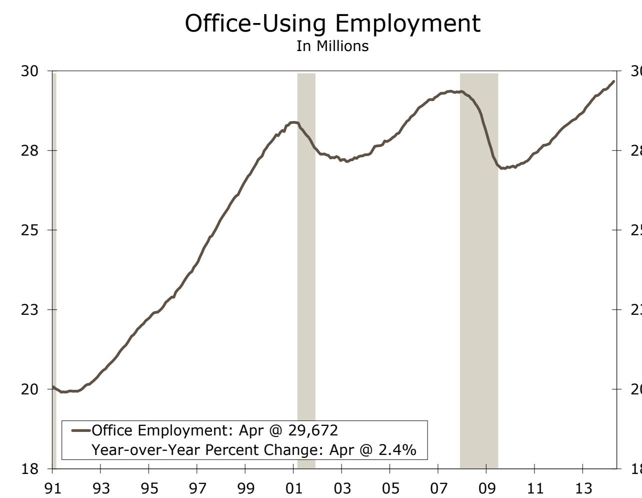
- Office fundamentals continue to improve, but progress has been modest. The office vacancy rate is still more than 400 bps above their pre-recession low and demand is also well below its cycle peak.
- With lackluster demand, new construction has been limited and accounted for only 0.6 percent of total stock in 2013. The low level of supply has helped keep fundamentals in balance, but the elevated vacancy rate suggests rent growth will see only modest improvement.
- Office-using employment, which accounts for about one-fifth of overall jobs, is now at its highest level on record. Space per worker continues to drop, however, and remains a headwind.









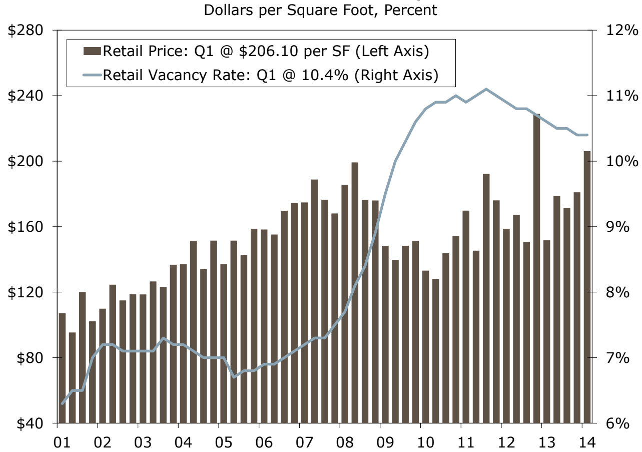


Source: Reis, Inc., RCA Analytics, IHS Global Insight, U.S. Dept. of Labor and Wells Fargo Securities, LLC

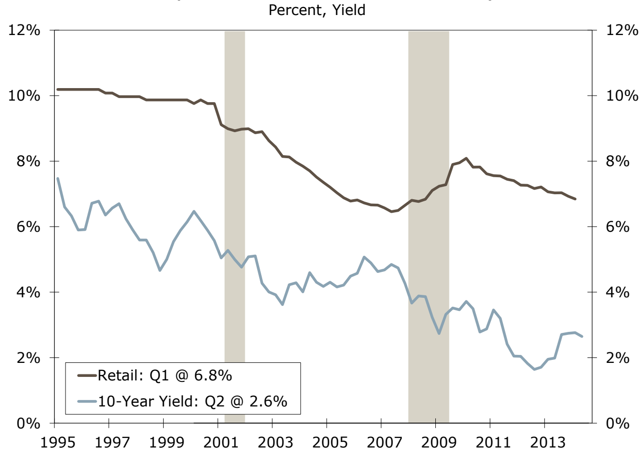
Retail

- Retail commercial real estate has been slow to gain any meaningful traction in this recovery and has lagged the other key property types. The retail vacancy rate peaked more than two years ago at 11.1 percent, but has barely budged in recent quarters and remains elevated at 10.4 percent in the first quarter.
- The shift away from the exclusive brick-and-mortar model has led many big-box stores to downsize floor plans and open fewer stores, which is a trend that will persist for some time. Large anchor retailers remain a concern, particularly as e-commerce takes a greater share of retail sales from physical stores. The slow pace of consumer spending growth also suggests weakness ahead.

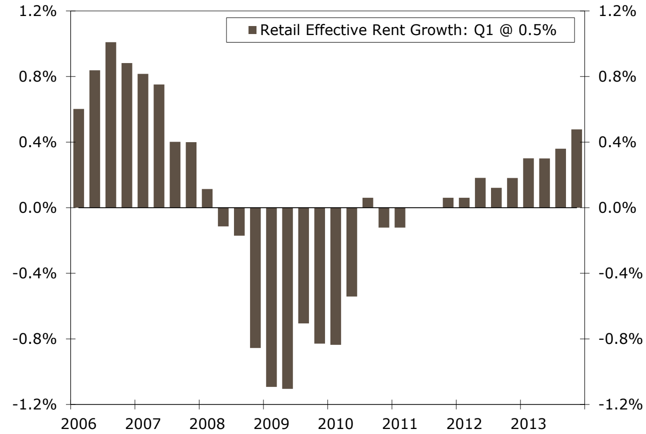
Retail Price vs. Vacancy Rate
Dollars per Square Foot, Percent



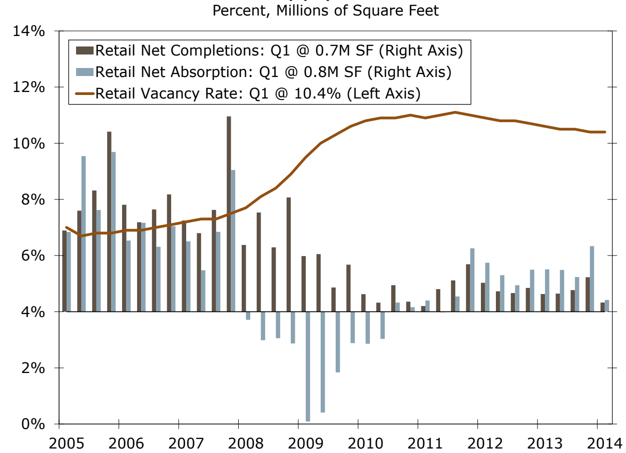
Retail Cap Rate vs. 10-Year Treasury Yield
Percent, Yield



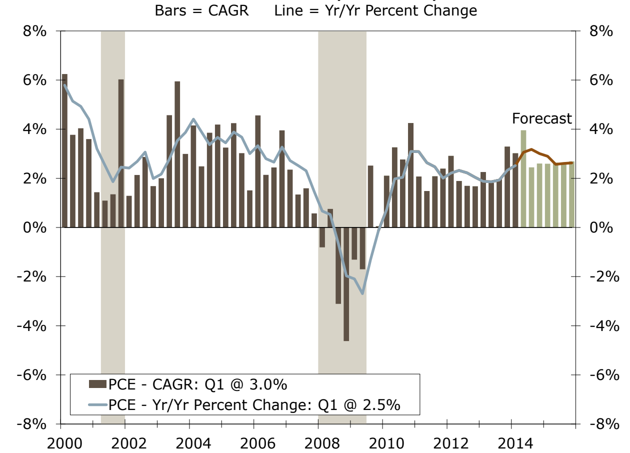
Retail Effective Rent Growth
Quarter-over-Quarter Percent Change



Retail Supply & Demand
Percent, Millions of Square Feet



Real Personal Consumption Expenditures
Bars = CAGR Line = Yr/Yr Percent Change

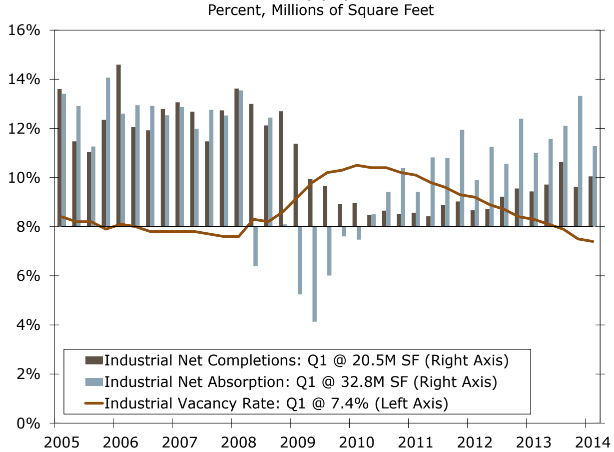


Source: Reis, Inc., RCA Analytics, IHS Global Insight, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

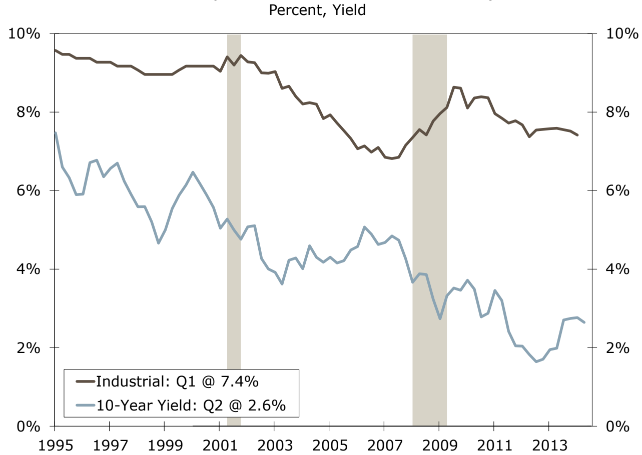
Industrial

- Distribution hubs are sprouting up across the country and online and traditional retailers are expanding their networks to speed up delivery time to the consumer. As a result, fundamentals in industrial continue to show improvement.
- Demand should continue to strengthen, as the housing recovery gains momentum and homebuilders require warehousing for the storage of construction materials.
- Coastal markets, however, are showing less activity. Net absorption in Los Angeles, which is one of the busiest ports in the United States, remained well below its pre-recession peak in 2013 and is not expected to gain much traction in the coming years.

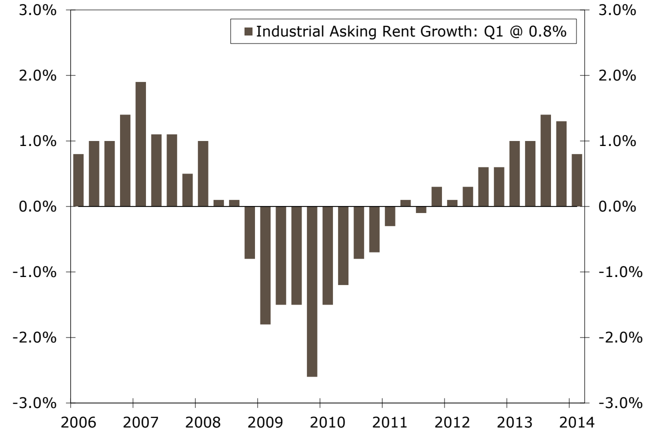
Industrial Supply & Demand
Percent, Millions of Square Feet



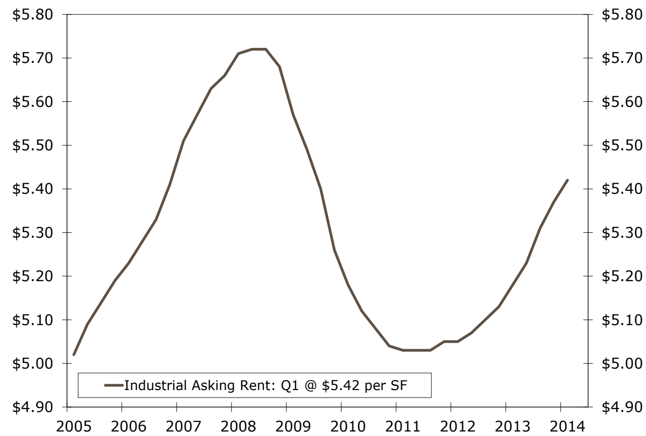
Industrial Cap Rate vs. 10-Year Treasury Yield
Percent, Yield



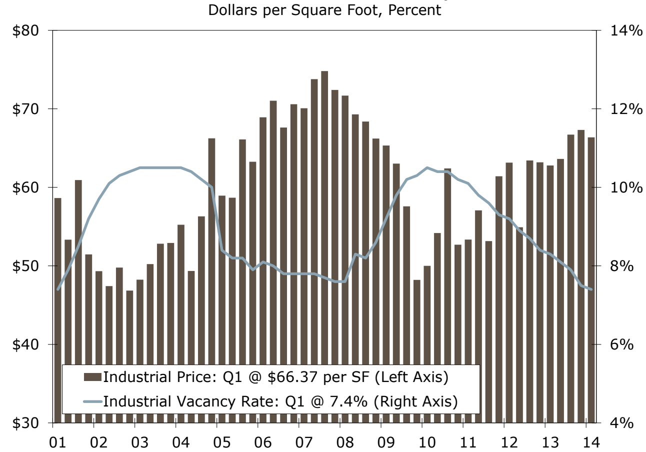
Industrial Asking Rent Growth
Quarter-over-Quarter Percent Change



Industrial Asking Rent
Dollars per Square Foot



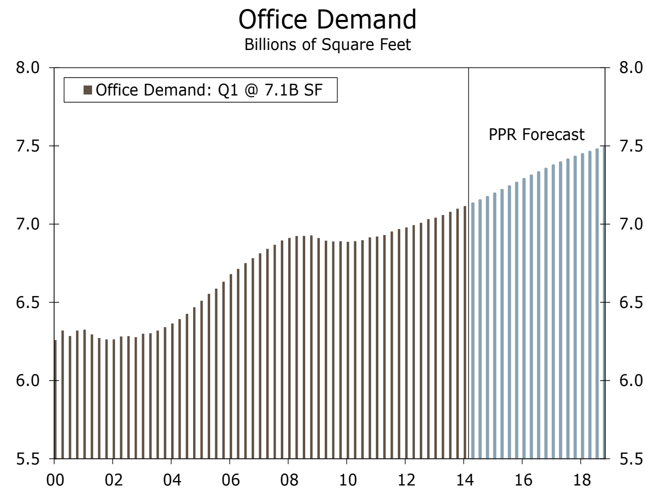
Industrial Price vs. Vacancy Rate
Dollars per Square Foot, Percent

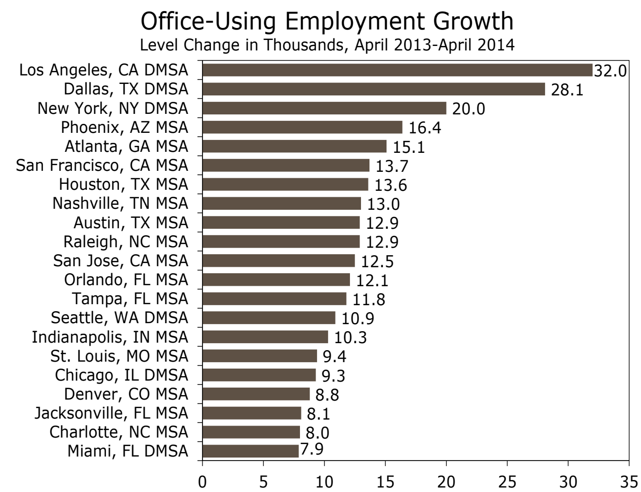


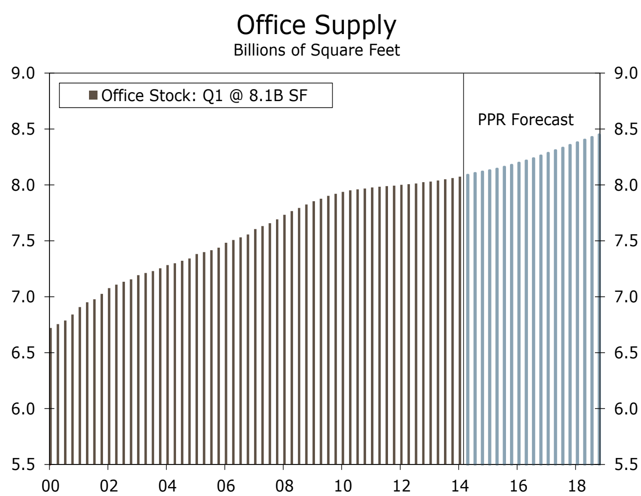
Source: PPR, RCA Analytics, IHS Global Insight and Wells Fargo Securities, LLC

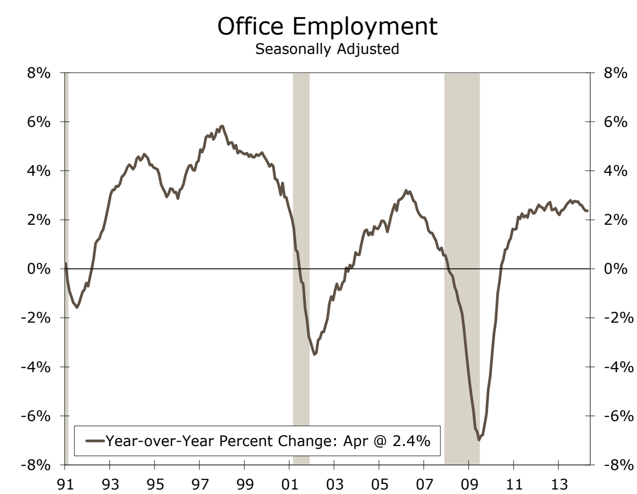
Regional Office Market Overview

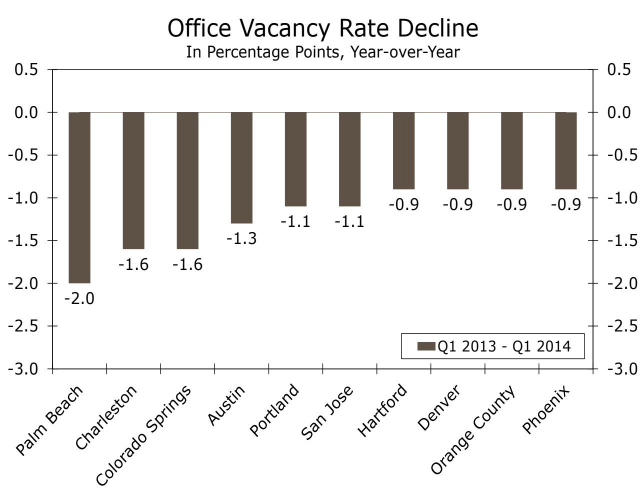
- Office supply growth is expected to improve over the next five years, but fundamentals should remain balanced, as demand also modestly strengthens. According to PPR projections, demand growth is expected to improve about 5.5 percent, while supply increases about 5 percent. Markets with the fastest pace of demand growth through 2018 are Phoenix, Las Vegas, Raleigh, and Austin.
- With demand picking up in these markets, albeit at a sluggish pace, construction activity is also expected to improve. Supply growth in Houston, however, is expected to outpace demand. Other markets that are expected to see the largest imbalance in fundamentals are Pittsburgh, Raleigh and San Jose.











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

Wells Fargo Securities, LLC Economics Group

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