Marcus & Millichap

Special Report Emerging Trends

First Quarter 2017

Investors Dial Back Transactions Amid Murky Policy Outlook; Clarity, Healthy Fundamentals Likely to Revive Activity

Investors scale back activity as market recalibrates to higher interest rates and awaits clarity on government policy. The November election sparked a rapid rise in interest rates and introduced a wide range of prospective reform initiatives. Proposed changes to fiscal, tax and regulatory policies raise a host of questions that will influence investor decisions. Over the first two months of 2017, early estimates place commercial real estate transactions down by 20 to 25 percent compared with the same period last year. This comes on the heels of an estimated 15 percent decline in the fourth quarter. Though the pause in activity is significant, it should be noted that sales last year were near record levels. As greater clarity on the range of economic, tax and fiscal policy changes emerges, investor activity will likely recover.

Private investor transactions peaked in 2015, then tapered modestly last year. Sales of commercial real estate properties between $1 million and $10 million hit their highest level on record in 2015 with 44,600 closed transactions, up 26.9 percent from their pre-recession peak set in 2006. Financial market volatility at the beginning of 2016, together with questions arising from the contentious election, reined in sales slightly over the course of last year, but the rapid postelection surge in interest rates sparked a significant 15 percent slowdown in sales in the fourth quarter. The private investor segment remains particularly sensitive to tax and policy changes.

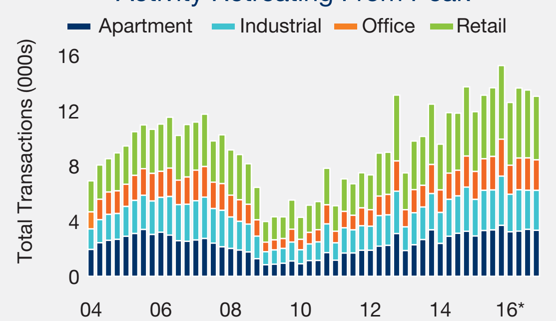
Lull in activity opens window of opportunity. While some investors have stepped back from the market to assess the implications of potential policy changes, many buyers are seeking to capitalize on the reduced competition for assets. The outlook for continued economic momentum, including steady job creation and accelerating wage growth, remains a strong driver of asset performance. At the same time, restrained development in all but apartment properties will help the sector sustain positive fundamentals. Though interest rates have risen since the election, they remain low by historical standards, and many investors are locking in the current rates as the Federal Reserve has signaled steady monetary normalization over the course of the year.

Pricing stable as supply and demand post favorable metrics. Although transactional velocity has eased, pricing and yields have remained remarkably steady. Buyers looking for large discounts are facing sellers who are generally benefiting from elevated occupancies and a lack of distress. The limited development this cycle and balanced debt levels have helped sustain market equilibrium. Another key ingredient has been steady economic momentum that has offered a tailwind to space demand drivers for commercial real estate, pressuring vacancy rates. Apartment, retail and industrial properties achieved their tightest year-end vacancy level in 16 years, while office properties set a seven-year low.

Key Observations

- **Transaction Activity Tapering.** Preliminary estimates of commercial real estate transactions in the first two months of 2017 are down by 20 to 25 percent. The slowdown is broad-based, reflecting investor caution amid uncertain government policies.
- **Pricing Remains Stable.** Although many suspect that a slowdown in transactions would align with falling prices, a particularly strong fundamentals outlook has supported pricing for most assets in most markets.
- **Window of Opportunity.** As some buyers step to the sidelines to await additional clarity on government policies, others are capitalizing on reduced competition for assets. The strong economic outlook and favorable supply/demand dynamics reinforce investment drivers.
- **Limited Inventory Favors Sellers.** The uncertain tax outlook has caused some owners to push back selling decisions; others are locking in pricing that remains near peak levels. The limited quantity of assets on the market remains supportive of active sellers with realistic price expectations.
- **Policy Uncertainty Restrains Decisions.** Many unknowns regarding personal, corporate and real estate taxes, immigration and trade policies, deregulation and a variety of other issues have increased uncertainty, causing some investors to step to the sidelines. Thus far little guidance on the timing of decisions is evident.

Commercial Real Estate Activity Retreating From Peak



* Estimate

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

Range of Factors Slow Transaction Activity; Uncertainty Persists for Investors

The pullback in commercial real estate closings at the beginning of 2017 reflects uncertainty surrounding a variety of economic and prospective governmental policy changes. While transaction trends have moderated since peaking in 2015, investor confidence will likely revive once additional clarity about forthcoming federal government policy emerges.

Fed Rate Increase Delivers Mixed Message

The rapid 75-basis-point postelection surge in the 10-year Treasury rate opened a disconnect between buyers and sellers as they attempted to reconcile higher lending costs. Under-contract transactions where the buyer had yet to lock in financing were affected most, although the rate hike sparked a range of re-trade events. Since the beginning of the year, the 10-Year Treasury rate has largely stabilized in the mid-2 percent range, but most investors anticipate rising inflation will cause the Federal Reserve to further tighten monetary policy this year, leading to a rising interest rate climate. Though some buyers are choosing to postpone acquisition plans based on the belief that rising interest rates will push cap rates higher, little if any elevation in cap rates has thus far emerged. The alignment of cap rate and interest rate movement is far from linear, as demonstrated repeatedly over the last 10 years.

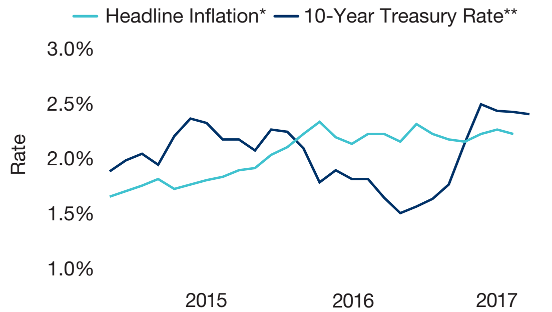
The Federal Reserve's decision to push interest rates more aggressively reflects increased confidence in economic growth. Steady hiring together with tight unemployment rates have pushed average hourly earnings growth to 2.8 percent, its highest level since 2009, and this combination will likely support household formation, increased consumption and inflationary pressure. The common perception that commercial real estate offers an inflation hedge, together with strong fundamentals, will reinforce transaction activity as policy clarity emerges.

Uncertain Tax and Fiscal Policy Sidelines Some Investors

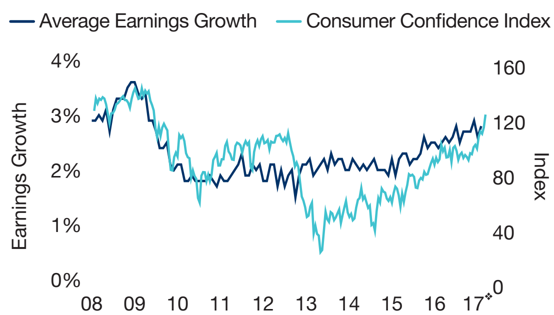
Congress and the White House have stressed a strong desire for comprehensive tax reform. The centerpiece of the policy would be lower corporate and personal tax rates, but the variety of changes in play are significant. The prospect of paying less taxes on a sale has caused some current owners to step back from possible dispositions. Real estate investors must also consider the implications of Speaker Ryan's proposed tax blueprint, which would abolish carried interest, eliminate tax deductions of the interest on mortgage payments and change the rules for depreciation of real estate. At this stage, investors have little insight into which elements of the proposal will come to fruition, and the White House has yet to offer clarity on its tax plans. Once additional insights emerge, investors will begin adapting their investment strategies, boosting transaction velocity.

Aside from prospective changes to the tax code, a variety of new policy initiatives are weighing on investor decisions. Tighter immigration restrictions, looser environmental protection, prospects of increased infrastructure and defense spending, proposed deregulation including the rollback of several Dodd-Frank provisions, and hints of more protectionist trade policies each hold unique implications for commercial real estate. The limited insight investors have regarding which policies will come into play and how they will manifest has increased uncertainty and caused some investors to move to a holding pattern until greater clarity emerges.

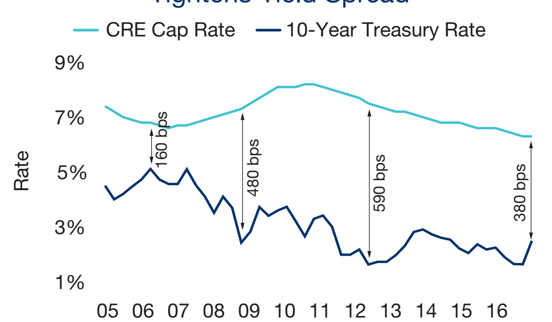
Election Sparks Surge Of 10-Year Treasury



Rising Income Joins Confidence To Boost Economic Growth



Surge of 10-Year Treasury Tightens Yield Spread



* Through February

** 10-Year Treasury through March 27

❖ Earnings Through February; CCI Through March

Elevated Space Demand Reinforces Fundamentals; 2017 Likely to Offer Steady Rent Growth

Against the backdrop of higher long-term interest rates and an evolving economic landscape, U.S. commercial property sectors are performing well. A steady decline in vacancy rates for the major property types has been a hallmark of the current cycle, while overdevelopment has thus far been largely averted. The 2017 economic outlook points to strong support of another positive year for apartment, retail, industrial and office fundamentals, but uncertainty surrounding government policies and global markets has encouraged investors to become increasingly tactical in their decisions.

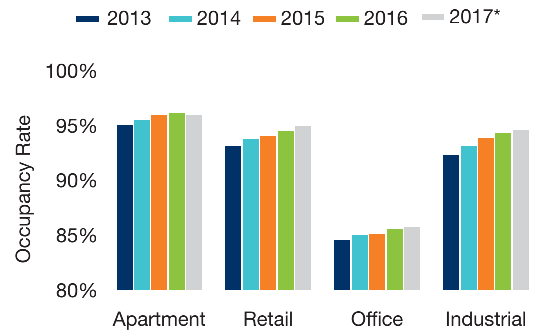
Apartment: The addition of 473,000 jobs in the first two months of 2017 bodes well for the economy, suggesting steady household formation and ensuing apartment demand. Apartment construction will peak this year with the delivery of 370,000 units, but nearly half of that total will be delivered in 10 markets. Traditional workforce housing comprising Class B and C apartments has experienced steady demand, pushing their average national vacancy rates to 4.0 percent and 3.5 percent, respectively. Class A apartment vacancy rates have risen over the last year to 5.2 percent as the influx of new supply has increased competition. The year-end average vacancy rate on a national level reached a 16-year low of 3.9 percent, but the rate should rise modestly to 4.1 percent in 2017 on the heels of increased apartment completions.

Industrial: The expansion and drive of e-commerce retailers toward ever-tightening delivery timelines has pushed industrial space demand significantly. Warehouse and distribution centers, particularly in infill locations that can meet same-day delivery times, have been in steady demand, pushing vacancy rates to a record-low 5.7 percent at year-end 2016. In the coming year, the vacancy rate is expected to tighten further, reaching 5.4 percent. The possibility of protectionist trade policies and a new border tax provision raises some new questions about industrial asset performance, particularly in port of entry markets. However, a potentially strengthening dollar that reduces the cost of imported goods could partially offset these risks.

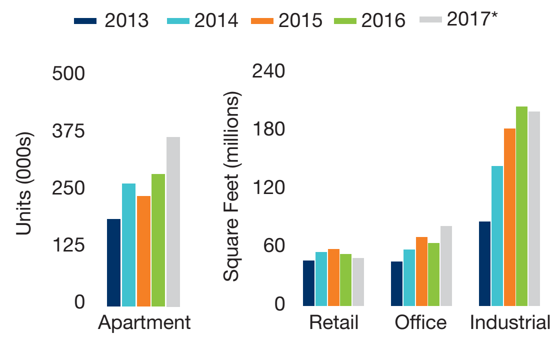
Office: Demand for office space this cycle has been modest by historical standards, but the limited pace of construction has positioned the sector to mark its seventh year of moderate but steady improvement in 2017. Positive supply and demand dynamics are forecast to push the national average vacancy rate to 14.2 percent this year, the lowest level since 2007. While performance gains were led by the urban core during the early part of the expansion cycle, demand for suburban office space has been making steady gains. As of year-end 2016, the vacancy rate in downtowns was 13.2 percent while vacancy rates in the suburbs fell 50 basis points in the last year to 15.1 percent.

Retail: Rising wages will lift discretionary income and, together with elevated consumer confidence, spur spending that will support demand for retail space. Although the sector faces challenging headlines spurred by the downfall of Sears, Kmart, J.C. Penney and other retailers, neighborhood retail centers have performed exceptionally well. Expanding grocery stores, restaurants and service-based businesses that cannot be supplanted by e-commerce have filled retail centers and pushed vacancy rates to their lowest levels since 2000. Tight construction levels will also be a significant factor as just 50 million square feet come online in 2017, about one-third of average pace completions seen in the mid-2000s.

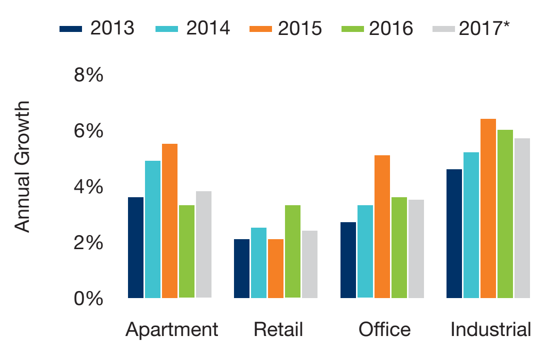
Commercial Real Estate Occupancy



Construction Trends



Commercial Real Estate Rent Growth Trends



* Forecast
Effective rent growth for apartment; asking rent growth for other property types

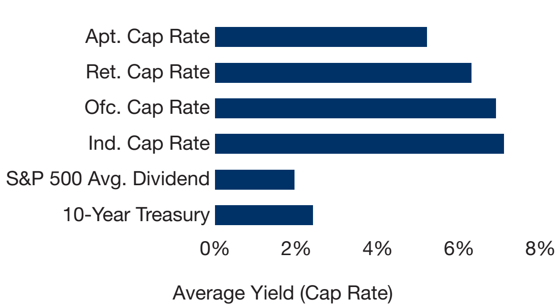
Capital Market Liquidity Elevated but Tightening; Higher Rates a Headwind for Transaction Activity

Capital market liquidity remains elevated despite a slow but steady pace of tightening lending standards over the last year. Construction loans have faced the most significant contraction as the Basel III component of Dodd-Frank has required banks to increase reserves on high-risk loans including construction financing. Still, little of the downturn in sales activity is directly tied to tighter lending standards. A more significant portion of the reduction can by tied to the rapid escalation in lending rates and the recalibration of investment models by both buyers and sellers.

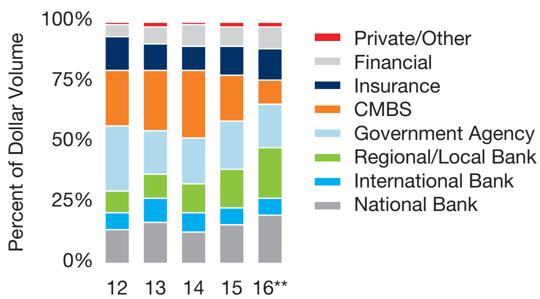
The rapid postelection surge in interest rates stalled or derailed many transactions that were in process at the time of the election. While numerous transactions were delayed by the rapid market shift, the majority moved to closing. The more significant challenge has been the widening of the gap between buyer and seller expectations, a common occurrence during periods of market transition. While buyers have cited a higher cost of capital as a reason for concessions, sellers remain locked-in on peak pricing. The resulting expectation gap has contributed to the slowdown in sales activity.

The Federal Reserve has signaled that in light of its optimistic economic outlook, and to restrain inflation risk it will be more aggressive in tightening its monetary policy this year. Though this action raises short-term interest rates, tighter monetary policy will likely translate into upward pressure on the 10-year Treasury, resulting in a rise in the cost of capital for commercial real estate investors. Many investors have already begun to integrate this trend into their investment models, but it does raise additional short-term hurdles.

Commercial Properties Offer Compelling Yields*



U.S. Commercial Real Estate Lender Composition



* As of March 22, 2017
** Estimate; Includes apartment, retail, office, industrial and hotel properties $2.5 million and greater

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; MPF Research; Real Capital Analytics; Standard & Poor's; U.S. Bureau of Labor Statistics.