Commercial Real Estate Outlook: 2018.Q1

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Gross Domestic Product

Economic growth strengthened to 2.3 percent in 2017, from 1.6 percent in 2016. After a slow start in the first quarter, the economy picked up steam in the second quarter and finished strongly in the fourth quarter, with all engines of the economy firing. Private consumption, private investment, exports, and government spending all expanded at a stronger pace compared to the expansion in the third quarter and the same period one year ago.

Private consumption spending—the biggest component of GDP—rose to 3.8 percent in the fourth quarter after a pullback growth in the first quarter. Consumer spending rose 2.7 percent for the year, the same pace as in 2016. Compared to the annual pace of spending in the third quarter, the pace of spending increased for items such as motor vehicles and parts, food and beverage, utilities, gasoline/fuel, and food services and accommodation. The Conference Board’s Consumer Confidence Index indicates a continuing rise in consumer confidence, as the index rose to 125.4 in January 2018, up from the previous month (123.1) and one year ago (111.6).

Private investment spending was the major growth driver in 2017, expanding at 4.0 percent, underpinned by a 4.7 percent expansion in non-residential investment. Residential investment rose at a modest pace of 1.7 percent.
Compared to the third quarter, the annual pace of non-residential investment picked up for non-residential structures (3.6 percent), investment equipment (11.3 percent), transportation equipment (13.8 percent), and other equipment (19.3 percent. Nonresidential investment in structures consists of new construction and improvements to existing structures in commercial and health care buildings, manufacturing buildings, power and communication structures, and other structures, and equipment installed as part of the structure, such as elevators or heating and air-conditioning systems. Investment in structures tends to be marked by large swings.

Private residential investment spending recovered in the fourth quarter and rose by 11.6 percent, after a five percent contraction in the third quarter. The number of building starts, an indicator of the level of residential investment spending, rose to 1.26 million units in the fourth quarter, up from 1.17 million in the third quarter of 2017, although essentially unchanged from the 1.25 million units one year ago. Residential construction has not kept pace with the 1.5 million demand due to net household formation and replacement for demolished units.

Exports expanded at a stronger annual pace of 6.5 percent as oil prices (West Texas Intermediate spot price) continued to recover in the fourth quarter, to $60.46 from $36.94 in the fourth quarter of 2016. Mineral fuels and lubricants, the second largest export item, rose to $41 billion in the fourth quarter, from $26 billion in the same quarter one year ago. Exports of commodity types increased across all items except for crude materials excluding fuels and animal and vegetable oils/fats/waxes.

Imports increased 13.9 percent given the strong rebound in consumption and business investment spending in the fourth quarter.

After contracting in the first half of the year, government spending rose in the second half of 2017, as both federal and state and local spending increased. For the full year, government spending rose at a miniscule rate of 0.1 percent compared to 0.8 percent in 2016.

**Employment**

Payroll employment advanced in the fourth quarter of 2017, with a net gain of 647,000 new jobs compared to 492,000 one year ago.
During 2017, employment expanded in all sectors except in retail trade (-29,000), resulting from department store closings across the country, information services (-33,000), and utilities (-3,000). The sectors with the largest gains were education and health (467,000), professional and business services (452,000), and leisure and hospitality (360,000).

The unemployment rate dropped to 4.1 percent in the fourth quarter of 2017, from the rates in the third quarter (4.3 percent) and one year ago (4.7 percent). Among the unemployed, the average duration of unemployment was 24.9 weeks, down from one year ago (26.1 weeks).

The labor force participation (LFP) rate slightly edged down to 62.7 percent in the fourth quarter from the third quarter’s 62.9 percent, but it was unchanged from one year ago. Part of the decline in the labor force participation rate is due to the retirement of the baby boomer work force.
Commercial space is concentrated in large buildings, yet large buildings are a relatively small number of the overall stock of commercial buildings. Based on Energy Information Administration data approximately 72 percent of commercial buildings are less than 10,000 square feet in size. An additional eight percent of commercial buildings are less than 17,000 square feet in size. In short, the commercial real estate market is bifurcated, with the majority of buildings (81 percent) relatively small (SCRE), but with the bulk of commercial space (71 percent) in larger buildings (LCRE).

Likewise, commercial sales transactions are measured and reported based on deal value. Commercial deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their values. However, these smaller properties comprise the backbone of daily economic activity—e.g. neighborhood shopping centers, warehouses, small offices, supermarkets, etc. Given the importance of these buildings to local communities, and REALTORS®’ active roles in serving these markets, this report focuses on illuminating trends in both large and small markets.

**Large Cap Commercial Real Estate Markets**

The commercial real estate landscape offered an unusual perspective in 2017. The bifurcation in investment trends continued along valuation lines. However, even in LCRE markets, trends proved more nuanced. Investment volume in the large cap space closed the year with $463.9 billion in transactions, a seven percent decline from 2016, according to Real Capital Analytics (RCA). Sales volume declined in each of the four quarters, with the last one posting a 13 percent drop. Typically, the final quarter of the year accounts for about a third of yearly volume, based on analysis done by RCA, with activity picking up speed in the last stretch. The investment trend in 2017 deviated from the historical norm.

Diversion from the trend was also recorded within property types and regions. The steepest declines in sales volume came from hotel and retail transactions, which dropped 24 percent and 18 percent, respectively, from the prior year. Office and apartment sales posted smaller declines, of eight percent and seven percent, respectively. The industrial sector remained on a hot streak, with transaction volume advancing 20 percent year-over-year, the only property type to see gains in 2017, based on RCA data.

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Continuing a trend which has increased in visibility during this cycle, smaller—secondary and tertiary—markets posted a better year in 2017 than their larger counterparts. The six major markets tracked by RCA experienced a 14 percent decline in investment sales over the year. Meanwhile, strengthening economies, employment and higher yields, have brought smaller markets to investors’ attention. Secondary markets’ sales volume slid by a moderate two percent in 2017, while tertiary markets’ investments were flat over the year.

Commercial pricing mirrored the mixed performance of various property sector, as illustrated by other commercial real estate price indices. The Green Street Advisors Commercial Property Price Index—focused on large cap properties—was virtually flat, with a 0.6 percent gain on a yearly basis during the fourth quarter, at a value of 125.8. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased 7.1 percent year-over-year in the same period, to a value of 286.4.

Highlighting the nuanced environment, prices in LCRE markets advanced 7.1 percent year-over-year in 2017, according to RCA. All property types, except hotels, posted higher prices during the year, with the apartment and industrial properties recording higher comparative gains. Analysis from RCA pointed to a growing gap between sellers’ high price expectations and buyers’ willingness to pay those high prices.

Cap rates spent most of the year moving sideways, in a narrow range of 6.7-6.9 percent. The fourth quarter of 2017 average across all property types was 6.9 percent, even with the last quarter of 2016, according to RCA. Retail and hotel transactions witnessed higher cap rates in the last quarter, compared with the prior year. Faced with a likely end to cap rate compression, and facing a rising interest rate environment, investors have shown a much higher discipline of capital, becoming more focused in deal selection and closing.
Small Cap Commercial Real Estate Markets

The small cap space closed the chapter on 2017 on an upbeat note. Commercial real estate in SCRE markets continued to experience advances in investment sales, as the momentum picked up in the final quarter of the year. Following on the second quarter’s 4.4 percent increase and the third quarter’s 3.6 percent gain in sales volume, REALTORS® reported that sales volume advanced a solid 9.1 percent in the fourth quarter.

Mirroring large cap investors’ interest in rising fundamentals and higher yields, small cap markets remained an attractive environment. The shortage of available inventory—a defining market feature during this cycle—remained the number one concern for REALTORS® engaged in commercial investments.

The dearth of inventory pushed prices for SCRE properties up, to the tune of a 6.9 percent yearly advance in the fourth quarter of this year. Echoing the large cap trend, the pricing gap between buyers and sellers proved the second highest ranked concern for commercial practitioners. Anecdotally, REALTORS® indicated that while sellers expected high prices, many buyers were more targeted in their acquisition strategies, and more likely to focus on expected cash flow gains to drive valuations, versus cap rate compression.

Capitalization rates in SCRE markets experienced a modest decline in the last quarter of 2017, posting a 20 basis point compression, to an average of 7.0 percent. However, on a yearly basis, cap rates averaged 7.2 percent in 2017, 10 basis points higher than in 2016, indicating that a likely upward momentum may be building.
International transactions remained a fixture in REALTORS® CRE markets in the final quarter of the year, accounting for 13.0 percent of responses to a survey. The average international sale price was $1.2 million in the fourth quarter of the year. Indicating a likely preference for safety of capital over returns, the average cap rate for SCRE international deals was 6.7 percent.

Longer-dated bond yields moved tentatively for the better part of 2017. The Treasury 10-year note ranged from 2.17 percent in the first quarter to 2.29 percent in the third quarter, and settled at 2.25 percent by the end of December. However, the rate picked up speed during the first part of 2018, riding a precipitous curve and reaching a high of 2.94 percent on February 21 of this year. While the spread between the 10-year note and cap rates remained fairly wide, the expectations are that the spread will compress over the course of the year.
Large Cap Commercial Real Estate Markets

The commercial fundamentals in LCRE markets provided a solid-but-nuanced performance during the last quarter of 2017, in tandem with trends in economic activity. Metrics varied across the core property sectors.

Office demand softened in the fourth quarter of 2017, even as employment in office-using industries expanded. Net absorption of office spaces totaled 6.9 million square feet during the quarter, according to CBRE. Office construction accounted for 11.1 million square feet of new space during the quarter, wrapping up the year with 46.3 million square feet. The annual figure comprised the largest amount of new completions since 2009. Office vacancies increased 1.7 percent in the fourth quarter, to $32.17 per square foot.

The industrial sector moved toward market equilibrium during the fourth quarter of 2017. Industrial net absorption totaled 44.4 million square feet, according to CBRE data. While fourth quarter demand fell below supply, on a yearly basis, demand outpaced new deliveries. Completions in the fourth quarter totaled 51.7 million square feet, with the 2017 total coming in at 195.3 million square feet, up 2.0 percent from 2016. Industrial vacancy declined in the fourth quarter, to 4.5 percent. Industrial asking rents advanced in the fourth quarter by 0.6 percent, to $6.92 per square foot.

With rising wages and employment, consumer optimism was well-reflected in the fourth quarter’s holiday shopping season figures. Demand for retail spaces advanced, with net absorption totaling 3.1 million square feet during the quarter, according to CBRE. Retail construction activity slowed, with completions totaling 9.1 million square feet. The retail availability rate picked up, moving to 6.6 percent in the fourth quarter, as asking retail rents reached $17.12 per square foot.

Household formation firmed up during 2017, moving toward its long-run average. Demand for multifamily properties remained strong across the nation. Net absorption of multifamily units in 2017 totaled 241,200 units, according to CBRE. Construction of multifamily properties maintained momentum, with 265,900 units delivered by the end of December 2017. The national vacancy rate averaged 4.9 percent in the fourth quarter. Apartment rents declined 0.3 percent year-over-year, to an average of $1,628 per month during the quarter.
Small Cap Commercial Real Estate Markets

Commercial fundamentals in REALTORS® markets rebounded in the fourth quarter of this year, from the softer third quarter. Leasing volume advanced by 5.3 percent from the preceding quarter. New construction increased by 4.1 percent from the prior quarter, as developers in SCRE markets faced the close of the year. Leasing rates increased by 3.3 percent, as concessions declined 2.8 percent.

With demand for space advancing, tenants shifted their focus toward larger footprints. In the third quarter, the 5,000 square feet and below segment accounted for 82.0 percent of activity. The fourth quarter recorded a decline in the segment’s share, to 71.0 percent of activity. The 5,000 – 7,499 square feet segment jumped from 7.0 percent of activity in the third quarter to 13.0 percent in the last one. In addition, the 10,000 – 49,999 square feet and 50,000 – 100,000 square feet segments also notched higher interest, accounting for 8.0 percent (6.0 percent in Q3) and 2.0 percent (zero percent in Q3) of total activity, respectively.

Vacancy rates continued on a downward trend in the fourth quarter of 2017 across the property types. Lease terms remained steady, with 36-month and 60-month leases capturing 65.0 percent of the market.

### Exhibit 3.1: REALTORS® Fundamentals

<table>
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<tr>
<th>New Construction</th>
<th>Leasing Volume</th>
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</tbody>
</table>

### Exhibit 3.2: REALTORS® Commercial Vacancy Rates

- Office
- Industrial
- Retail
- Multifamily
- Hotel

% Change, Quarter-over-quarter

Source: National Association of Realtors®
Economy

NAR forecasts economic output to expand at a stronger pace of 3.0 percent in 2018. This forecast factors in the increased investment spending arising from the tax changes under the Tax Cuts and Jobs Act, including the reduction in corporate tax rates from 35 percent to 21 percent. Payroll employment is projected to increase 1.7 percent for the year, which would push the unemployment rate down to 3.9 percent. Inflation is expected to accelerate to 2.8 percent as the economy continues to reach its full capacity and given the uptick in oil prices. With the uptick in inflation, the Federal Operations Market Committee is likely to raise the federal funds rate at least two times in 2018. NAR forecasts the federal funds rate to average 1.8 percent for the year, the 3-month T-bill rate to average 1.8 percent, and the 30-year government bond rate to move up to 3.3 percent for the year.

Exhibit 4.1: U.S. ECONOMIC OUTLOOK — Feb 2018

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<tr>
<td><strong>Annual Growth Rate, %</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP</td>
<td>1.5</td>
<td>2.3</td>
<td>3.0</td>
<td>2.7</td>
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<tr>
<td>Nonfarm Payroll Employment</td>
<td>1.8</td>
<td>1.4</td>
<td>1.7</td>
<td>1.6</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td>1.3</td>
<td>2.1</td>
<td>2.8</td>
<td>2.7</td>
</tr>
<tr>
<td><strong>Level</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Confidence</td>
<td>100</td>
<td>120</td>
<td>127</td>
<td>125.0</td>
</tr>
<tr>
<td><strong>Percent</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment</td>
<td>4.9</td>
<td>4.4</td>
<td>3.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Fed Funds Rate</td>
<td>0.4</td>
<td>1.0</td>
<td>1.8</td>
<td>2.4</td>
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<tr>
<td>3-Month T-bill Rate</td>
<td>0.3</td>
<td>1.0</td>
<td>1.8</td>
<td>2.4</td>
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<tr>
<td>Prime Rate</td>
<td>3.5</td>
<td>4.1</td>
<td>5.0</td>
<td>5.6</td>
</tr>
<tr>
<td>10-Year Gov’t Bond</td>
<td>1.8</td>
<td>2.3</td>
<td>2.8</td>
<td>3.1</td>
</tr>
<tr>
<td>30-Year Gov’t Bond</td>
<td>2.6</td>
<td>2.9</td>
<td>3.3</td>
<td>3.7</td>
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Source: National Association of REALTORS®
Commercial Real Estate

Commercial leasing fundamentals remain poised for expansion this year, boosted by an expanding economy, employment and the tax reform. Vacancy rates are projected to continue their decline, except for multifamily properties, where rising new supply is putting downward pressure on rents.

On the investment side, rising interest rates are expected to add upward pressure on investment yields. The Federal Reserve, under the leadership of newly appointed Chairman Powell, signaled its continued commitment to unwinding its balance sheet and addressing inflationary concerns through multiple rate increases in 2018. Most analysts are expecting at least three, likely four rate hikes this year.

For commercial investments, these moves are likely to result in a slowdown in price gains. The pricing impact is likely to be spread across geography, sectors and property classes. In SCRE markets, price gains are likely in the first half of the year, as inventory shortage is expected to maintain the pricing trajectory’s momentum.

### Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

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<tr>
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<tbody>
<tr>
<td>Office</td>
<td>13.4</td>
<td>13.6</td>
<td>12.7</td>
<td>12.7</td>
<td>12.0</td>
<td>12.5</td>
<td>12.2</td>
<td>12.0</td>
<td>11.9</td>
<td>11.7</td>
<td>11.5</td>
<td>11.2</td>
<td>12.8</td>
<td>12.2</td>
</tr>
<tr>
<td>Industrial</td>
<td>8.7</td>
<td>9.4</td>
<td>9.1</td>
<td>8.9</td>
<td>7.8</td>
<td>8.1</td>
<td>7.8</td>
<td>7.5</td>
<td>7.3</td>
<td>7.3</td>
<td>7.0</td>
<td>6.7</td>
<td>8.8</td>
<td>7.7</td>
</tr>
<tr>
<td>Retail</td>
<td>12.0</td>
<td>13.2</td>
<td>10.4</td>
<td>12.1</td>
<td>11.4</td>
<td>12.2</td>
<td>12.1</td>
<td>12.0</td>
<td>11.9</td>
<td>12.0</td>
<td>11.7</td>
<td>11.7</td>
<td>11.8</td>
<td>12.0</td>
</tr>
<tr>
<td>Multifamily</td>
<td>7.4</td>
<td>5.9</td>
<td>5.8</td>
<td>5.3</td>
<td>5.0</td>
<td>6.1</td>
<td>5.7</td>
<td>5.7</td>
<td>5.6</td>
<td>5.9</td>
<td>5.6</td>
<td>5.4</td>
<td>5.5</td>
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Source: National Association of REALTORS®
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