A Special Research Report

Second Half 2018 Commercial Real Estate Investment Outlook

Déjà vu: Investor Sentiment Resets to Pre-Tax Reform Levels

Investors are confident about property performance outlook, even as they prepare for a rising interest rate climate.

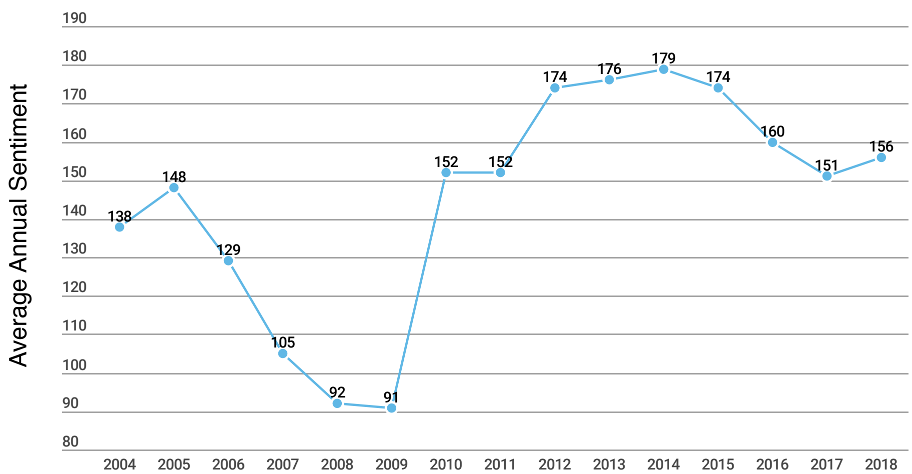
By Beth Mattson-Teig

Commercial real estate investors came into 2018 riding a high following approval of the Tax Cuts & Jobs Act. Yet the latest NREI/Marcus & Millichap Investor Sentiment Survey shows that the bounce in positive sentiment that occurred in the wake of tax reform has now drifted back to levels in alignment with this time last year.

Investor sentiment jumped in the first half of 2018, but gave up the gains in the new second half survey with a move back to 150 – the same index level as the second half 2017 survey **[Figure 1]**. At the start of the year, many people thought that tax savings for both companies and individuals would drive business expansion, job growth and consumer spending – all of which bode well for real estate investors, notes John Chang, senior vice president of research services at Marcus & Millichap. "The current survey shows that a lot of that rise in optimism has scaled back," he says.

FIGURE 1. INVESTOR SENTIMENT INDEX

After a post-tax reform bump in the first quarter of 2018, Investor sentiment eased back in the third quarter.



A majority of respondents are still positive on their views of tax reform, but there has been a clear step back in sentiment as people digest the potential impact of the new tax laws. Fifty-seven percent of respondents think the economy will grow faster as a result of the new taxes compared to 68 percent who held the same view in the first half survey. One-third of respondents expect growth to remain the same and 10 percent predict slower growth ahead. The 60 percent of respondents who said they consider tax reform to be favorable for commercial real estate also reflects a drop compared to the 71 percent who held the same view at the beginning of the year **[Figure 2]**.

"There are a lot of very positive things for real estate investors in the new tax reform, but I think people are still coming to terms with what it means to them," says Chang. In addition, the IRS has been slow to issue guidance on the application of some of the new laws, which is contributing to greater uncertainty. "Investors are still getting their arms around the new tax law, so it's still a little too early to anticipate a lot of change resulting from tax reform," he says.

That being said, more than half of respondents (52 percent) do expect the new tax law to increase the flow of investment capital into real estate and 46 percent believe new tax laws will result in increased property values. When asked how tax reform will influence demand for space across specific property types, more respondents think industrial and apartments will see the greatest benefit at 48 percent and 46 percent respectively.

Sentiment Remains Above Pre-Recession Peak

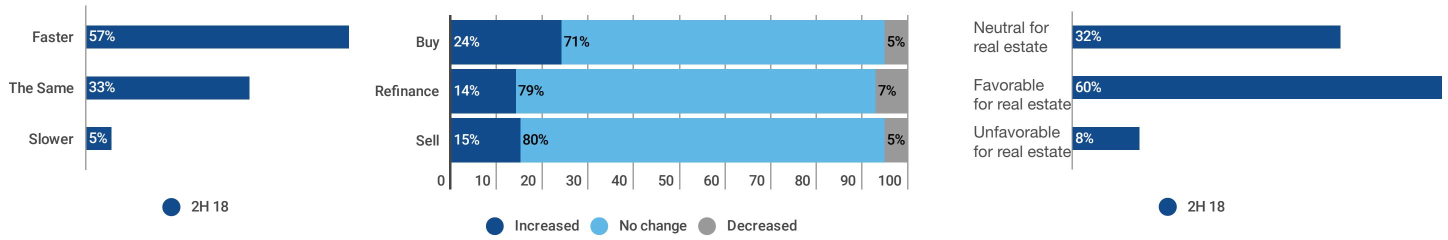
The Investor Sentiment Index has settled back at a strong level, averaging 156 for the year. Although it is below the levels from 2012 to 2015 that reached into the 170s, it remains elevated and even above the pre-recession high of 148 set in 2005. "Not only is confidence still strong, but overall activity is very much ahead of where we were 10 to 15 years ago," says Chang.

FIGURE 2. **IMPLICATIONS OF TAX LAW**

Do you believe the new tax law will cause the economy to grow?

As a result of the new tax law, how have your plans to sell, buy and refinance properties changed?

In general, do you consider the new tax law will affect real estate?



Base: all respondents (n=524 for chart on left and n varies from 506 to 519 for center chart and n= 522 for chart on right).

Investment sales, cap rates and pricing all continue to look very solid in 2018. Transaction volume during the first half of the year reached $240 billion, up 6 percent year-over-year with sale prices that also rose 7.2 percent year-over-year, according to Real Capital Analytics.

More than half of respondents (59 percent) plan to increase their commercial real estate investment in the next 12 months. Although that is a drop compared to the 67 percent who said they intended to increase holdings in the first half survey, sentiment is on par with last year at this time. In the current survey, one-third of respondents expect investments to remain the same in the coming year, while 8 percent are likely to reduce holdings. Respondents who intend to grow real estate portfolios anticipate an average increase of 20 percent.

While many respondents think it is a better time to hold assets rather than buy or sell more, nearly a third (32%) of retail investors believe it is a better time to sell. Notably, 47 percent of industrial owners said it is a better time to buy, while 38 percent of mixed-use, 33 percent of undeveloped land and 25 percent of apartment investors also think it is a better time to buy **[Figure 3]**.

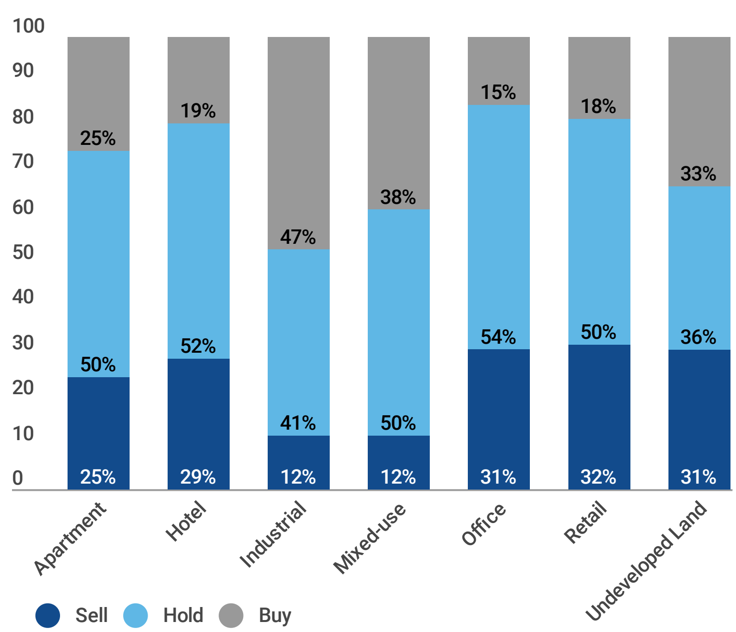
"When you look at the different property types, there is a little softening in sentiment. The outlook remains positive, but the level of optimism has eased back since the beginning of the year," said Al Pontius, senior vice president, national specialty division director. "In some ways, this is reflective of the late cycle and investors being a bit more cautious. After having ridden the growth for several years, they are generally happy with where they are and feel good about the outlook ahead," he says.

Bracing for Higher Interest Rates

Rising interest rates is an issue that has moved to the forefront of investors' minds. Two-thirds of respondents indicated rising interest rates are their top concern followed by unforeseen shocks to the economy at 48 percent; and both political uncertainty/geopolitical issues and rising operating expenses at 44 percent **[Figure 4]**. The Fed's move to pursue tighter monetary policy is pushing up short-term interest rates, while long-term interest rates have just recently begun to rise, with the 10-year Treasury yield marginally above 3 percent.

As a result of the new tax law, **respondents expect the economy to grow faster.** Overall, respondents consider the new tax law **favorable for commercial real estate.**

FIGURE 3. **BUY/HOLD/SELL INVESTORS**

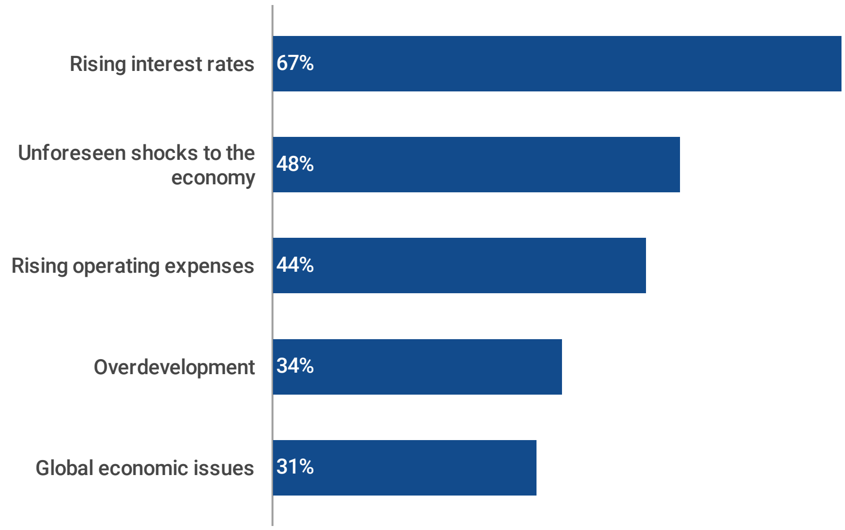


"The Fed has implied that it will likely raise rates again in December, although whether or not they follow through with that remains to be seen," says David Shillington, president of Marcus & Millichap Capital Corp. There could be some risk to the economy if short-term rates were to rise above the long-term rates, which is commonly perceived as a sign of an upcoming recession, he adds.

Sixty-three percent of respondents cited Fed action as the main factor driving interest rates higher, while 47 percent also believe that rates will rise due to expectations of higher inflation. Sentiment regarding rising interest rates is consistent with past surveys. Nearly all respondents believe rates will move higher over the next 12 months, but opinions vary on just how much rates will rise. Twenty-five percent predict an increase of less than 50 basis points; 51 percent expect hikes of 50-99 basis points; 21 percent said 100+ basis points; and 3 percent anticipate either no change or a decrease.

"As long as interest rate movement is controlled, and the pace is gradual, investors should be in good shape, because the market has time to adapt," says Shillington. "What we would prefer not to see is a very rapid movement in interest rates, which causes people to slow things down in order to re-underwrite transactions and potentially reposition their portfolios."

FIGURE 4. TOP 5 INDUSTRY CONCERNS



Base: all respondents (n=506).

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Investors Favor Industrial

A majority of investors anticipate stable or rising property values over the next 12 months. Industrial investors are most confident with 69 percent who anticipate values will move higher, followed by 62 percent of apartment investors and 49 percent of hotel investors who expect values to rise **[Figure 5]**. Industrial investors are predicting the biggest gain at 5.4 percent followed by a 3.5 percent increase for apartments, 2.6 percent for mixed-use and 1.7 percent for hotels.

Nearly half of industrial investors (47 percent) believe it is a good time to buy more; 41 percent think it is better to hold and 12 percent said it is better to sell. "There has been the paradigm shift with e-commerce, making industrial – and particularly fulfillment locations – very attractive," says Pontius. Overall, the fundamentals for industrial still look very good, but the pace of improvement is beginning to ease, which is reflective of additional development in the industrial space, particularly in port markets and intermodal hub markets, he adds.

After delivering 255 million square feet in 2017, developers are expected to increase construction with 260 million square feet of completions, according to Marcus & Millichap. Industrial occupancies remained strong with mid-year levels at 4.9 percent. However, rent growth has been slowing from 7.7 percent 12 months ago to now below 6 percent, according to Marcus & Millichap. "That is still exceptional, but it's not quite as strong as it was," says Pontius.

Office Sector Delivers Mixed Signals

Office investors are weighing a wide range of factors and closely monitoring the market. While fundamentals have slowly improved, the sector has yet to experience the surge in demand that underlying drivers would suggest. More than half of respondents (54 percent) believe it is a better time to hold office asset, while 31 percent think it is a good time to sell and 15 percent see an opportunity to buy. "Record-high business sentiment and a highly competitive recruiting environment point to accelerating office demand, but the sector has yet to break free," says Pontius.

Office demand continues to outpace construction, with just 88 million square feet of new space expected this year nationwide. This has supported a vacancy decline to 13.8 percent at mid-year, while rent growth moderated to 1.9 percent, according to Marcus & Millichap. In alignment with the rent growth trend, 35 percent of investors believe values will rise by 1.3 percent over the coming year, while 45 percent believe values will remain stable. Investors can capitalize on these very conservative opinions by targeting well-located suburban office, which are generating increased traction as companies favor more affordable rents, larger footprints and locations that are closer to qualified staff, adds Pontius.

Investor Appetite for Apartments More Balanced

Investors remain bullish on apartment performance, but the appetite to increase holdings has steadily trickled lower for the past few years. Half of apartment owners believe it is a better time to hold, while the other half are split on whether it is a better time to buy or sell, signaling a balanced market. Views on buying have slowly eased since hitting a high in 2010 when 73 percent of respondents were voraciously targeting the asset type.

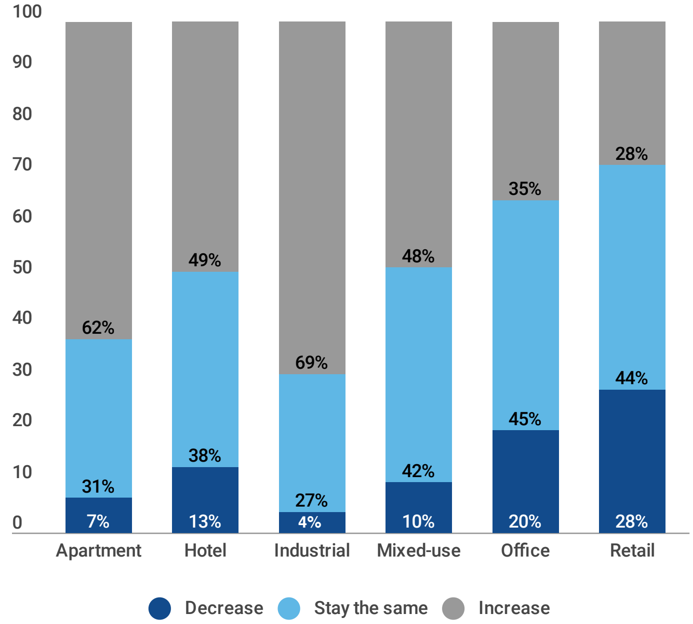
"We have seen a very long, very strong run in apartment performance, and many investors have questions about the volume of construction coming into the marketplace and the risk that represents," says John S. Sebree, first vice president, national director of the National Multi Housing Group at Marcus & Millichap. Developers have been delivering, on average, about 270,000 new units per year for the past five years, according to Marcus & Millichap.

That elevated construction level is raising some concerns among investors that developers are going to overshoot the market. However, absorption has been keeping pace with construction as the strong economy has unlocked significant household formation, notes Sebree. Most of the new households favor renting, which caused vacancies to dip 30 basis points in second quarter to 4.6 percent, while rent growth has been hovering between 3.7 percent and 3.9 percent for the past year, according to Marcus & Millichap. "So, although some investors have concerns about new development, housing demand is forecast to surpass completions on a national level," he says.

The majority of respondents have a very favorable outlook on apartment performance. Consistent with past surveys, 62 percent of respondents expect apartment values to increase. The average increase expected is 3.5 percent, which is down from the 5 percent prediction in first half, but still at very healthy levels compared to other property sectors.

FIGURE 5. PROPERTY VALUES

Considering only the property currently in your real estate portfolio, do you expect the property values to increase, decrease or remain the same twelve months from now?



Base: respondents invested in each property type (n varies).

Retail Continues to Face Headline Headwinds

Retail did benefit from a bump in sentiment in the first half survey, likely due to optimism related to increased consumer spending due to tax cuts. However, sentiment has dropped back to levels more on par with where they stood a year ago. Half of respondents think it is a better time to hold assets, while 32 percent favor selling, and 18 percent said it is a good time to buy.

"Retail still faces the challenge of perception that the sector is being dramatically eroded by e-commerce," says Scott Holmes, senior vice president, national director of the National Retail Group of Marcus & Millichap. "But while some high-profile businesses have closed their doors, that hasn't necessarily been driven by the e-commerce dimension," he says. The most vulnerable retailers failed because they carried a heavy debt burden or failed to innovate.

The fundamentals for retail are strong with mid-year vacancies at 5.0 percent and annual rent growth at 2.9 percent, according to Marcus & Millichap. In addition, the National Retail Federation announced in August that it is raising its expectation for core retail sales for 2018 to 4.5 percent. "That is a very, very significant gain in total retail sales," says Holmes. In addition, numerous online retailers, such as Amazon, Warby Parker and Wayfair have begun expanding in brick-and-mortar retail, signaling the importance of maintaining both an online and physical retail presence.

Forty-four percent of retail investors think retail values will hold firm over the next 12 months, while the other 56 percent are evenly split on whether values are likely to increase or decrease. On average, respondents anticipate a decline of -0.7 percent in retail values.

Record-high business sentiment and a **highly competitive recruiting environment** point to **accelerating office demand,** but the sector has yet to break free.

Survey Methodology

National Real Estate Investor's research unit and Marcus & Millichap emailed invitations to participate in this online survey to public and private investors and developers of commercial real estate. Recipients of the survey included Marcus & Millichap clients as well as subscribers of NREI selected from commercial real estate investor, pension fund, and developer business subscribers who provided their email addresses. The survey was conducted in the third quater, 2018, with 543 completed surveys received. Survey respondents represent a broad cross-section of industry respondents that include private investors, developers, advisors, lenders and REITs among others. The largest percentage of respondents are private investors at 45 percent. Respondents are invested in a variety of property types with a majority of 66 percent invested in apartments. On average, respondents have $35.5 million invested in commercial and/or multifamily property.

Hotels Deliver Record Results

The hotel sector is riding a wave of strong room demand coming from both business and leisure travelers. "We're well into a growth cycle that is driving key metrics for the hotel sector to record levels," says Peter Nichols, vice president, national director of Marcus & Millichap's National Hospitality Group.

Average occupancies on a 12-month trailing basis reached a record 66.3 percent in June. In addition, both ADR and RevPAR are exhibiting strong annual growth for the 12-months trailing June at 3.3 percent for RevPAR and 2.3 percent for ADR, according to Marcus & Millichap. And investors continue to have a very positive outlook on further improvement. Nearly half of respondents (49 percent) expect hotel values to rise further over the next 12 months. However, projections of an average increase of 1.7 percent is down from the 4.1 percent respondents anticipated in the Q1 survey.

Despite strong fundamentals, investors are more cautious in their plans to increase holdings. Nearly half of hotel investors (52 percent) are content to hold existing assets rather than to buy more (19 percent) or sell (29 percent). "Hotel investors remain cautious," says Nichols. They had been concerned about risk of overdevelopment and online competition from Airbnb and other sharing economy ventures, but despite these risks, the sector has outperformed. A healthy caution level is always prevalent among hotel investors but the current outlook remains positive, he adds.

> We know that **business confidence is elevated** and companies are **aggressively hiring all over the country,** but they are having a **hard time filling those positions,** particularly **in higher skill areas.**

Investors Becoming More Selective

Although there are signs of caution creeping into investor sentiment, respondents remain optimistic about the economy and property performance. Ninety-three percent believe that job growth will be similar or better in 2018 compared to 2017. That optimism continues out to 2019 with 79 percent who expect job growth to be the same or better than 2017, while a minority of 20 percent anticipate a decline in job growth as compared to 2017.

"Job growth remains strong, and if there is anything that is going to slow down our pace of employment growth, it is actually a labor force shortage," says Chang. Unemployment is down below 4 percent, and yet the number of job openings has reached a record 6.9 million. "We know that business confidence is elevated and companies are aggressively hiring all over the country, but they are having a hard time filling those positions, particularly in higher skill areas," he says.

Most respondents continue to agree that commercial real estate offers favorable returns compared to other investment classes and it is better to invest in commercial real estate rather than the stock market. Investors also appear to be well capitalized with 56 percent of respondents who said they have abundant capital to invest. "The market liquidity and availability of capital is very strong. While we saw movement in the treasury rates earlier in the year, many of the lenders absorbed a portion of that increase with tighter spreads," says Chang. Investors are more selective at this stage of the cycle, but still active in what continues to be a very stable market, he says.

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