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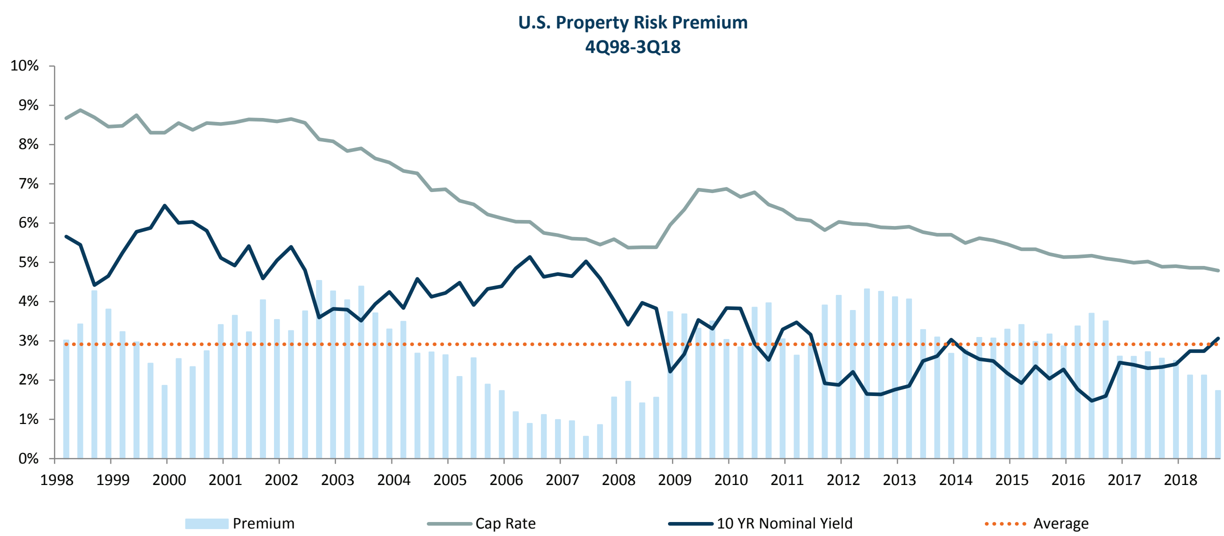
What is Different in this Commercial Real Estate Cycle?

Nearly a decade after the Global Financial Crisis, investors and investment managers remain acutely focused on the cyclical nature of real estate. Given the length of the current economic expansion, there is growing pessimism about its persistence, and the impact of economic uncertainty on pro-cyclical assets. The previous downturn was especially harsh on the commercial real estate market. Real estate experienced a demand driven recession with the halt of the economic expansion, which was exacerbated by the over use of leverage, in combination with risky borrowing practices and extremely compressed risk premia. However, when we review indicators of the aforementioned issues, it appears that in this cycle the market has broadly taken a more tempered approach to investing in real estate.

Real Estate Valuation



Source: NCREIF NPI, Bloomberg

Rising treasury yields have diminished the premium of cap rates over treasuries, but spreads on a relative basis remain reasonable. Last cycle the cap rate spread over 10-year treasuries diminished to 56 bps, while the current spread over 10-year treasuries remains at 173 bps, 117 bps above the previous cycle low. Furthermore, during periods of strong economic growth or high inflation, it is normal for the cap rate premium over treasuries to compress for extended periods of time.

Taking a step back, the U.S. and many developed nations face structural challenges, including lower population and productivity growth. Technological innovation and labor-replacing automation have lowered long-term inflation expectations. In our view, the flattening of the yield curve is a direct result of short-term, pro-growth fiscal policy competing with longer-term structural issues. While fiscal policy has increased short-term growth expectations, the additional debt burden, in theory, increased the risk premia ascribed on the long-end of the curve. However, we expect the structural headwinds to anchor longer-term nominal interest rates, despite the growing deficit.

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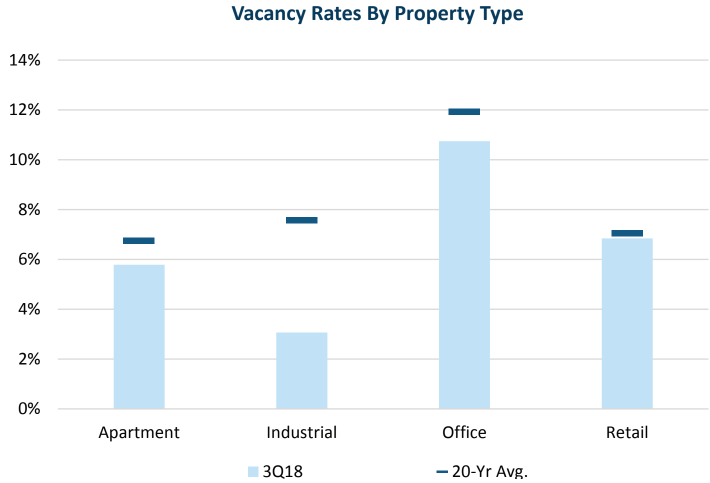
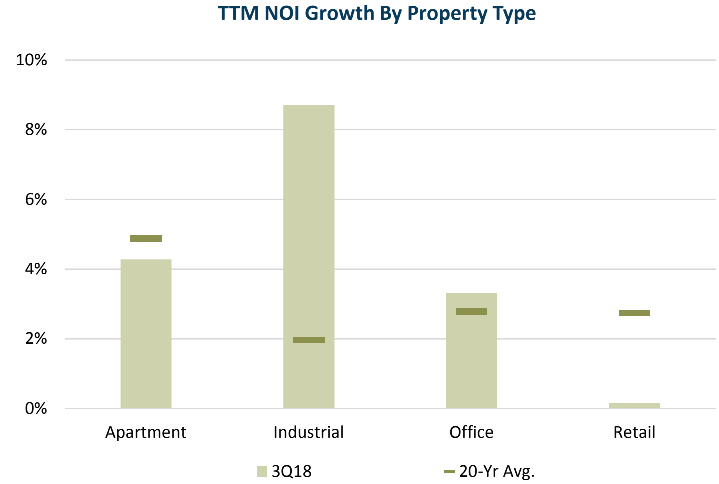
Real Estate Fundamentals





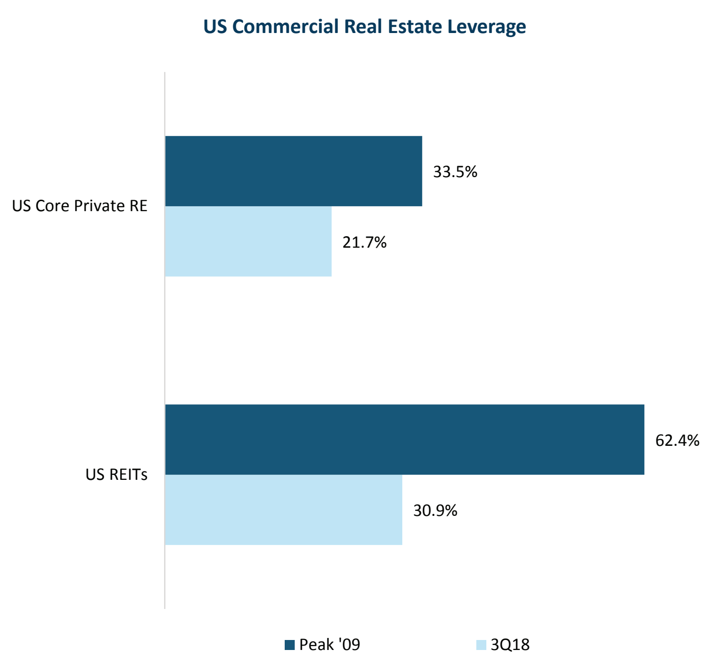
Source: NCREIF NPI

While returns have moderated as cap rate compression has ceased, real estate fundamentals remain healthy. With exception of the retail sector, vacancy rates across property types are well below long-term averages. Similarly, NOI growth remains strong, with positive NOI growth projected across all major sectors going forward. Given initially weak fundamentals and limited liquidity early in the cycle, supply was tepid, however there are now some supply driven concerns in certain markets and property types. As a result, Townsend continues to selectively pursue investment opportunities in cities with favorable supply and demand dynamics.

Regulatory Shifts in Lending Environment

The US Banking system changed as a result of regulation written in reaction to the GFC. The Basel III standard was introduced and continues to be implemented to strengthen the resiliency of the US banking system. Basel III pushed banks to tighten lending standards and stifled construction lending. Further investors and investment managers previously burned by leverage have chosen to pursue a more conservative utilization of leverage (Exhibit B).

This more conservative use of leverage has lowered the risk of default in the commercial real estate market. Core positions are now even more equity, to the extent that a GFC type write-down would not create enough distress to threaten ownership of an asset. In addition, the borrowing practices are more conservative, with most managers either limiting or completely avoiding cross collateralized borrowing.



Source: NCREIF NFI-ODCE, Bloomberg, The Townsend Group

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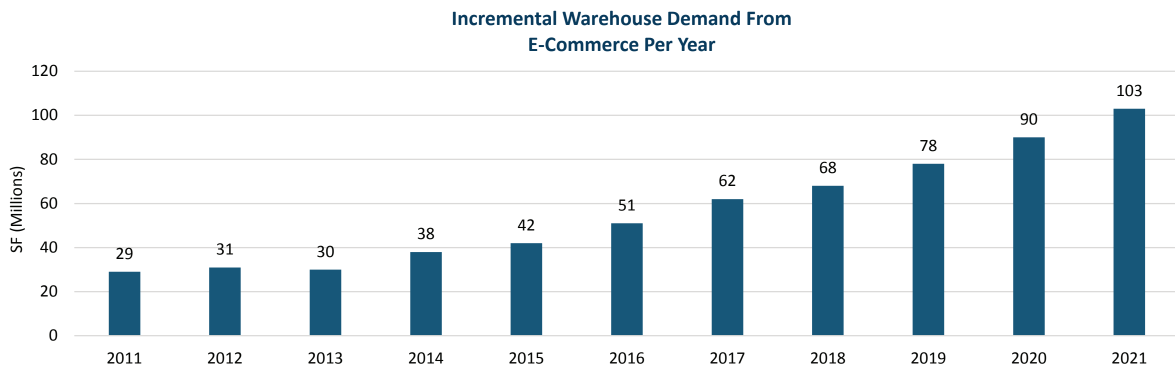
Real Estate Trends for 2019

Outside of the traditional demographic driven investment opportunities, technology and innovation hubs will continue to be the biggest drivers of opportunity in real estate. Technology enabling and expanding the growth of e-commerce will directly translate to greater warehouse use. Innovation hubs will continue to experience outsized employment growth in high quality jobs, which has and will continue to translate to higher than average demand for local real estate.

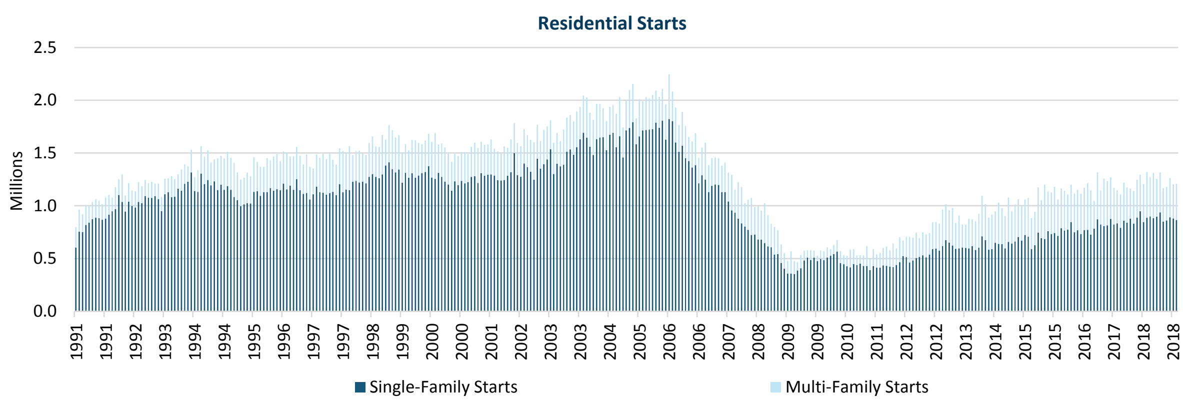
E-commerce Translated to Warehouse Demand:



Source: Duke Realty

Industrial has been the strongest performing core property type of this cycle due to outsized demand from e-commerce players building out of modern logistics networks. An improving economy has also increased demand for industrial space. Looking forward, same-day delivery will create a need for smaller and more agile infill industrial assets. Industrial rent remains a small portion of the overall supply chain, and rents should continue to benefit from historically low vacancy rates.

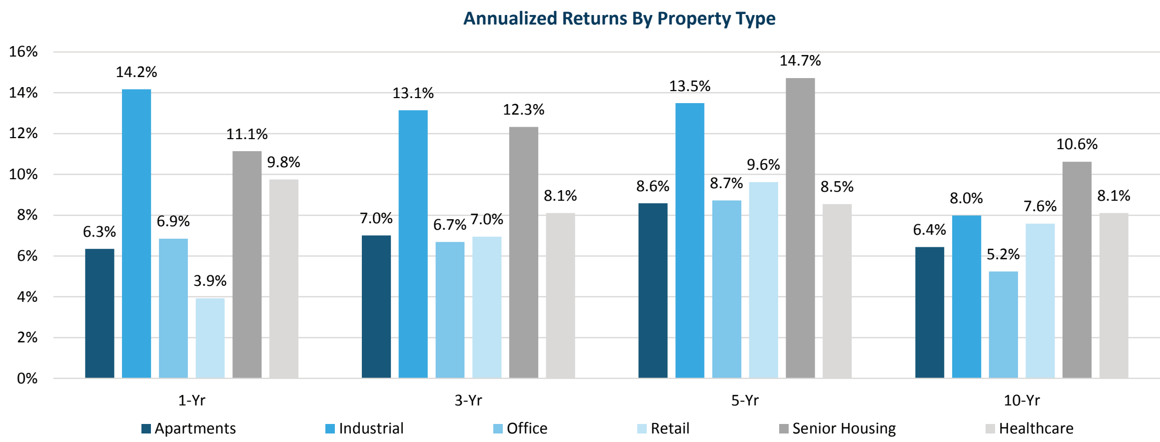
Residential Housing – Suburban Multifamily



Source: Green Street

The residential sector this cycle has seen less overall supply, and demand for multifamily assets is expected to benefit from lack of affordable housing, single family price appreciation, and rising interest rates. Further, mortgage-to-rent ratios remain favorable of renting across most major metros. Urban multifamily has seen a great deal of supply this cycle and trades at a premium to suburban multifamily. In lieu of less affordable single-family housing, we believe suburban multifamily will provide an accessible price point for millennials to transition to suburbs, as life events demand access to school systems and additional living space.

Non-Business Cycle Sensitive Property Types



Source: NCREIF NPI

There has been growth in investable product in non-business cycle sensitive real estate. Senior housing, affordable housing, medical office, and student housing have all seen increased investment activity. These sectors are primarily driven by long-term demographic trends or non-economically related issues. Over the full 10-year cycle, which still incorporates the write-downs of the GFC, senior housing and healthcare related properties outperformed all traditional property types, primarily because the assets performed better during the economic downturn. These other property types can add additional diversification to real estate portfolios.

Conclusion

With more conservative leverage, relative valuation metrics remaining reasonable, and healthy fundamentals, US commercial real estate markets remain on solid footing. Long-term impediments to higher interest rates, such as population growth, give us more comfort with the long-end of the treasury curve, which commonly dictates the direction of cap rates over medium-term periods of time. Structural differences in lending have subdued the use of leverage and initially construction activity, but we're beginning to see supply become a drag in certain markets and submarkets. Given current pricing of commercial real estate, finding investment opportunities has become more challenging and Townsend is being selective in the themes and managers.