THE OUTLOOK

Marcus & Millichap

MULTIFAMILY; RETAIL; OFFICE; INDUSTRIAL

MIDYEAR 2019

Investors Target Widening Range of Opportunities

Fed takes action to extend economic growth cycle. Sturdy underlying fundamentals continue to support domestic growth, expanding the economy by 2.1 percent in the second quarter, but headwinds are emerging. Growth has moderated over the past several months and some international forces are weighing on momentum, prompting the Fed to cut the overnight rate by 25 basis points at the end of July in an effort to extend the economic runway. This modest cut may have fallen short of what was needed to offset the escalating trade war and financial market turbulence as the 10-year/two-year yield curve briefly inverted recently. This commonly perceived signal of an impending recession has the potential to increase uncertainty and work against the positive economic forces such as steady job creation, low inflation, sound wage growth and elevated consumer confidence. In addition, sustained recruiting demand has resulted in a 20 percent surplus of job openings relative to job seekers, enabling many people with weaker skills and education to find work. Reflective of this, organizations are becoming increasingly competitive in their recruiting efforts, opening additional locations to tap new labor pools and boosting compensation packages to attract new staff members and retain existing workers. This has provided a bump to household and disposable income levels nationwide.

Uncertainty restraining some growth drivers. Though economic optimism remains elevated, consumption and corporate investment have moderated relative to 2018. Unresolved trade talks, slowing international economies and the hangover from elevated interest rates last year continue to pressure domestic markets, prompting some consumers and businesses to act more cautiously until additional clarity emerges. These factors have restrained leasing activity for some property types in several markets during the first half of this year, but a recovery could be sparked by lower interest rates. Still, the recently inverted yield curve and uncertainty surrounding trade will weigh on the outlook.

Millennials Key to Commercial Real Estate Expansion

Suburban real estate may be biggest winner of evolving millennial lifestyles. The millennial cohort will have a transformative impact on real estate markets as this generation approaches a new life stage. Many millennials are beginning to form families after delaying marriage until their late 20s or early 30s. Family formation will boost the appeal of suburban neighborhoods as more moderate housing costs and proximity to quality schools becomes increasingly important. Suburban housing demand will be bolstered in the coming years as a result of this lifestyle shift, putting further pressure on apartment vacancy rates and producing even stronger demand for entry-level single-family homes. Corporations are taking note of this, setting up campuses in suburban employment hubs in many primary metros, bringing jobs to the growing talent pools. Additional suburban retail, particularly in proximity to office properties, will be developed to create live-work-play hubs that support the migration to the suburbs.

EXECUTIVE SUMMARY:

Multi-Housing

- The economy remains on solid footing, supported by sustained employment growth. With job openings vastly outnumbering job seekers, those typically hard-pressed to find work are securing employment, generating additional households as more people are able to move out on their own.
- High pricing and tight yields have many investors rethinking their strategies as the cycle extends. Many buyers are expanding their search parameters to include secondary and tertiary markets, where cap rates are generally stronger and more assets are available.

Retail

- Transitioning to an omnichannel model remains key for retailers as they keep stride with evolving consumer preferences. Improving online capabilities and widening distribution networks allow physical retailers to better compete against their online counterparts.
- The sector's transformative nature makes retail assets a viable value-add opportunity for many investors. These properties can also be suitable portfolio diversification tools as the current cycle extends.

Office

- As millennials form families and begin to transition out of core areas in many primary metros, suburban office demand will rise. Suburban employment hubs are gaining momentum as companies take note of this demographic shift.
- Yield-driven investors are capitalizing on late-cycle dynamics and demographic transitioning, remolding investment strategies. Strong price appreciation in primary and secondary metros is also contributing to this, outperforming other areas of commercial real estate.

Industrial

- Trade talks with China are impacting industrial markets nationally, supporting altered supply chains and modified business models to help companies reduce tariff-induced costs. If negotiations extend closer to the holiday season, additional adjustments may be required.
- Industrial underwriters remain active despite a slowdown in space absorption. Lenders have shown a strong willingness to sponsor well-leased projects, in addition to pinpointing proposals for speculative industrial developments.

Apartment Demand Surges to New Peak; Household Formation Boosting Leasing Activity

Lawmakers focus on housing affordability. The tight job market has accelerated household formation, sparking an extended period of price and rent appreciation and reducing housing affordability in many markets. Legislative measures in several states are being taken to restrain rent growth through regulation. These measures will restrict market forces and investors' ability to create value in rental housing. Rent control will also exacerbate the tight housing market by inhibiting new development. Cash flows may be more stable under rental statutes as tenant turnover can be reduced, but growth potential can be dramatically limited, weighing on valuations and prompting owners to reconsider investment strategies. Oregon led the nation by creating the first statewide rent-control law in February this year, while New York recently implemented the Housing Stability and Tenant Protection Act of 2019. The New York act removes the ability to transfer stabilized units to market rates and puts limits on the amount owners can raise rents to pay for capital improvements. Additionally, California and some other states continue to push toward local and statewide rental regulations to tackle affordability issues.

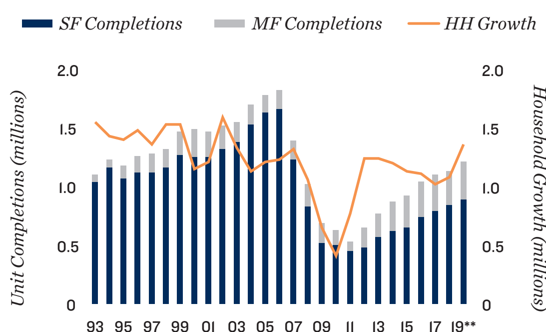
Evolving lifestyles prompt developers to rethink strategies. While the millennial generation remains the key age cohort for apartment renters, older generations are emerging as a quickly growing renter segment. Empty nesters are beginning to downsize from suburban single-family homes into urban lifestyle apartments as wide-ranging amenities and increased walkability serve as primary drivers. Homeownership among the 55-64 and 65-plus age cohorts has decreased by roughly 2 percent each over the past five years — declining faster than younger age groups. Less maintenance and closer proximity to employment and entertainment hubs boost the appeal of urban living. Increased demand for two- and three-bedroom apartments has resulted from this trend as many older renters prefer larger spaces that can accommodate home offices and guest rooms for visiting family members. Vacancy for these apartment types were pushed to the lowest levels in nearly two decades at the end of the second quarter, posting 3.9 percent for two-bedroom units and 4.8 percent for three-bedroom units.

Developers still trying to keep pace with demand. Deliveries will surpass 300,000 for the second time this cycle as builders feverishly bring new units to market. Average annual completions sit about 40 percent higher than last cycle's pace, illustrating a contrasting dynamic relative to other property types during the same periods. New York will lead development efforts, adding 37,000 new apartments this year, while Dallas posts the next highest total at 26,000 units. Though primary markets will comprise the eight most construction-heavy metros, a number of secondary and tertiary cities will witness increased development as economic growth flows inland from large gateway cities. Many smaller metros are experiencing expanded urban renewal efforts as some companies relocate from the suburbs to downtown buildings, seeking to capitalize on urban millennial populations. Detroit and Indianapolis are prime examples, each recording a substantial uptick in construction activity this year.

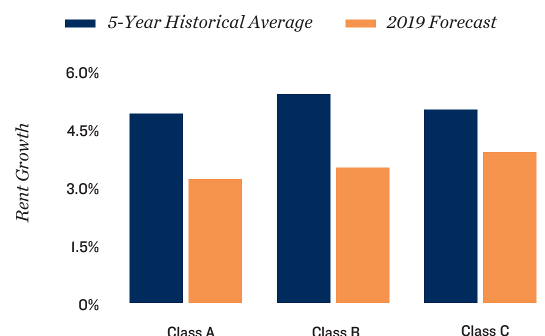
Tight labor market ballooning apartment demand. A record-high 182,000 units were absorbed in the second quarter, pushing the 2019 absorption total to roughly 200,000 and putting the apartment market in position to finish the year strongly. Exceptional leasing activity will keep the national vacancy rate tight, hovering in the low- to mid-4 percent range as widespread demand maintains momentum across all asset classes. Class C units will continue to experience the tightest conditions — with vacancy in the mid-3 percent band — as low unemployment enables those with fewer skills and less education to find work and create new households. Broader demand trends continue to squeeze the Class B market tighter, pushing vacancy down 70 basis points to 4.1 percent since last June, while Class A vacancy dropped 60 basis points to 4.7 percent during the same span.

Rents benefiting from tight unemployment. Rent growth remained strong over the past year, with Class B and C apartments witnessing 5.1 percent and 5.0 percent increases, respectively. Elevated household formation is putting significant pressure on workforce-housing availability, tightening vacancy rates to near 20-year lows. Class A rents also posted strong growth, climbing 4.2 percent during the past year. The Class A national average effective rent sits at $1,827 per month, nearly $500 above Class B and almost $800 higher than Class C apartments. Growth rates in all classes are receiving additional support as developers struggle to keep pace with demand amid the shortage of construction workers, rising construction costs and tightened lending.

Housing Construction Falls Short of Demand



Rental Growth by Class



* Forecast

Investors Redefine Strategies As Cycle Matures

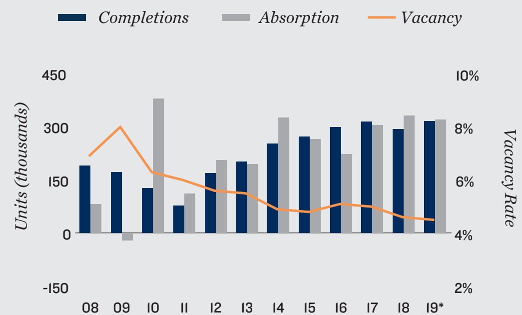
2019 Forecast

U.S. CONSTRUCTION:

315,000 units completed Y-O-Y

- Completions are scheduled to hit the highest mark in more than 25 years, adding to the over 1.4 million units completed in the past five years. Primary markets will dominate construction headlines this year.

Supply and Demand



U.S. RENT

4.1% Y-O-Y increase

- This year's rent growth will come in below 2018's increase of 4.9 percent as the average effective rent rises to $1,402 per month. While Class B and C will likely lead gains, Class A will also post strong growth rates.

U.S. VACANCY

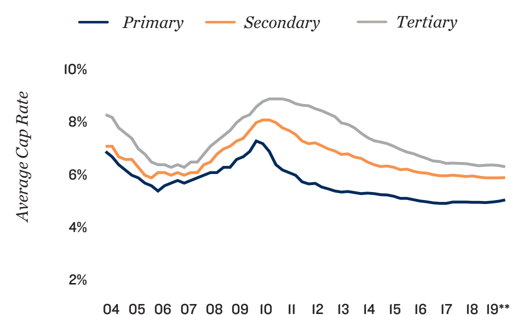
10 basis point Y-O-Y decrease

- Record-setting absorption in the second quarter will support another decrease to the national vacancy measure, nudging it down to 4.5 percent by year end. This will support the ninth vacancy reduction in the past 10 years.

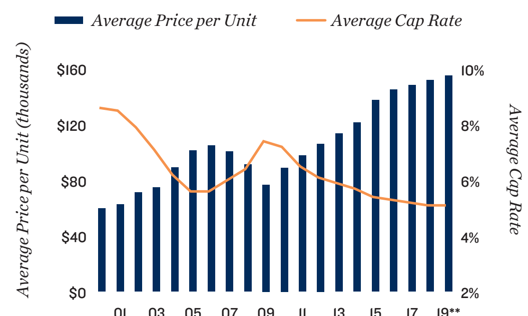
2019 INVESTMENT OUTLOOK

- **Buyers zero in on smaller cities.** Limited available assets and quickly climbing prices in primary markets have many investors diverting their attention to secondary and tertiary metros, where more opportunities may be found. Many Midwest markets are seeing increased trading activity with yields up to 250 basis points above large coastal markets and roughly 150 basis points higher than the national average cap rate of 5.1 percent. Metros including Columbus, Minneapolis and St. Louis have witnessed transaction velocity more than double over the past five years.
- **Suburbs attract new wave of buyers.** New supply risk continues to grow in urban areas, encouraging more investors to expand their search parameters to include suburban neighborhoods. Roughly 28 percent of the nation's apartment completions occur in downtown areas, up 10 percent over the past decade. The share of suburban apartment transactions has been trending up since 2010 from about 74 percent to approximately 83 percent of that total at the end of 2018.
- **Investors closely monitor rent control.** Rent control remains a hot topic as the nation's housing shortage puts additional upward pressure on rental rates. An increasing number of legislative proposals to put a ceiling on rents or regulate rent growth in some cities and states is creating uncertainty for apartment investors, weighing on investment strategies and potentially causing them to look elsewhere for opportunities.

Cap Rate Trends by Market



Price and Cap Rate Trends



* Forecast
** Trailing 12 months through 2Q
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

Increasing Appetite for Experiential Retail Transforms Sector; Investors Adopt Strategies to Capitalize

Retail platforms converging from different angles. Retail has witnessed dramatic change over the past several years, but the transition is still ongoing. Companies are finding ways to mesh brick-and-mortar locations with strengthening online capabilities to produce seamless omnichannel experiences for consumers. Walmart and Target embraced this strategy, taking their prominent physical footprints and adding enhanced digital and logistical systems to better compete with internet retailers. This has resulted in more online sales and faster delivery times. Digitally native companies including Bonobos and Warby Parker came from the other direction, building internet-only platforms and then opening physical stores to heighten brand awareness and customer engagement. The confluence of these factors is reinventing retail, helping companies realize the importance of a combined physical and online presence. The retail sector continues to refine the nuances of the new, broader platform.

Experience-oriented retailers spearhead positive consumption trends. Several retail categories have a positive outlook as the cycle progresses and the retail sector transforms. Bars and restaurants will remain highly sought after tenants as consumers continue to increase spending at these establishments — surpassing consumption at grocery stores, which have exhibited solid growth over the past few years. These places provide experiential settings and drive foot traffic, making them key to healthy tenant blends. Gyms are also expanding quickly, particularly as an increasing number of big-box vacancies can accommodate these types of businesses. Fitness tenant space in shopping centers has almost tripled in the past 10 years, as these retailers tried to keep pace with the nearly 72 million consumers nationwide using health clubs. Entertainment retailers, like esports venues and dine-in movie theaters, are using vacant big-box locations to support growth strategies as well. As some retail concepts falter in the face of sector transformation, many owners are surveying options to fill empty space, giving other retailers opportunities to expand their footprint.

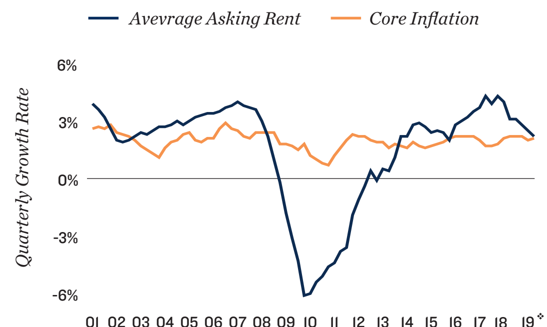
Development highlighted by southern markets. Retail construction will remain limited this year, totaling just 50 million square feet. While stricter lending practices will weigh on the pipeline, development is further restrained by rising labor and materials costs. Nearly half of this year's completions will be confined to 10 major metros, with New York leading the way by adding roughly 5 million square feet of retail space. Quickly growing Sunbelt markets including Houston, Dallas/Fort Worth, San Antonio and Charlotte will also generate increased development as builders are attracted by robust employment growth and household formation. In higher-density areas like Northern New Jersey and Miami-Dade, a rising number of mixed-use projects will fuel supply growth. Conversely, construction will be relatively sparse in the vast majority of Midwestern markets, keeping space supply and demand in balance.

Evolving retail sector benefiting investors. Retail vacancy nudged higher in the second quarter for the first time this cycle as space absorption retracted. Absorption was slowed by two factors: Retailers have become more cautious in their expansion plans as they weigh the risks of rising tariffs, in addition to low vacancy rates in premium locations inhibiting expansion options. The pace of single-tenant absorption has retreated in 2019, with many expanding retailers pausing to evaluate the market. Shopping center absorption has been comparatively stronger but has still posted declines each of the past three quarters. Despite this, increasingly refined retail business models continue to support demand, giving retail investors a range of high-quality tenants to choose from to fill vacancies. Adding internet-resistant concepts will boost the long-term viability of retail properties, elevating foot traffic and asset performance. The repurposing and redevelopment of existing retail assets will also contribute to decreasing vacancy as investors get creative with outdated shopping centers. While this may include redesigning an asset's layout to accommodate desired retail tenants, it could also mean converting the space to another use such as self-storage, last-mile fulfillment or office space.

Income growth outpacing inflation. The nation's average asking rent will rise steadily this year, driving the figure to roughly $1 above its pre-recession peak. The vast majority of major metros will witness growth levels above the current 2 percent core inflation measure, offering retail owners stable revenue growth. Tight coastal cities and Sunbelt markets will headline rental gains this year, producing 5-plus percent growth rates. Muted construction nationwide should continue to bolster asking rents as retailers vie for the limited remaining available space.

2018 Net Store Growth

Rent Growth Remains Above Inflation



* Forecast

Reinvention of Retail Sector Drives New Opportunities

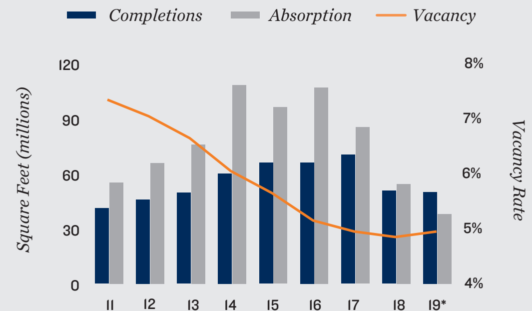
2019 Forecast

U.S. CONSTRUCTION:

50 million square feet completed Y-O-Y

- Development will reach its lowest level since 2013 as retailers rein in expansion plans and lenders maintain conservative underwriting. Sunbelt markets will headline this year's construction trends.

Retail Supply and Demand



U.S. RENT:

3.3% increase in average asking rent Y-O-Y

- The nation's average asking rent edges up to $20.49 per square foot as growth remains stable this year. Shrinking space availability in the multi-tenant segment will play key role in the sector's rental growth moving forward.

U.S. VACANCY:

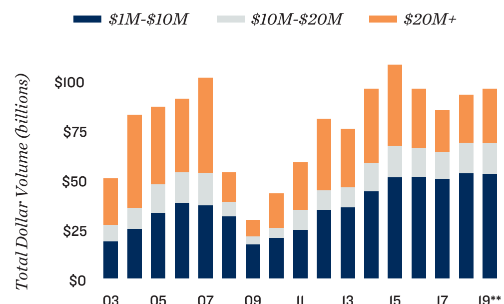
10 basis-point increase Y-O-Y

- With net absorption on track to hit 38 million square feet in 2019, the national vacancy rate is forecast to increase for the first time this cycle, inching up to 4.9 percent. Last year, more than 56 million square feet was absorbed.

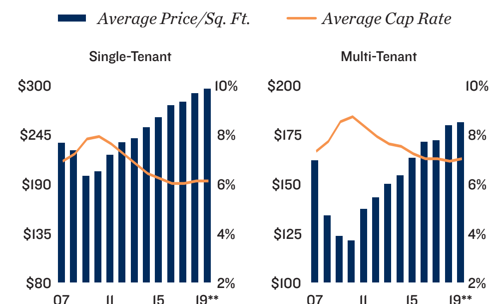
2019 INVESTMENT OUTLOOK

- **Yield-driven investors find opportunities.** Multi-tenant retail continues to serve as a viable value-add option for many investors, providing an avenue for portfolio diversification in a maturing cycle. Midwestern metros have seen increased activity as investors seek returns up to 200 basis points higher for multi-tenant assets than in coastal markets. High-growth Sunbelt cities have also produced strong demand as buyers focus on population expansion, netting yields above the national average cap rate of 7 percent for value-add properties.
- **Investors explore ways to enhance retail assets.** The mixed-use trend is gaining more traction with investors as they adapt to modern consumers. Adding a housing or office component proximate to an existing retail center can deliver significant value, better positioning it for long-term growth.
- **Grocery stores bring additional dimension to owners.** Retail investors continue to target grocery-anchored strip centers, generating competitive bidding environments for these assets and producing cap rates typically between 7 and 8 percent. Grocers' ability to drive foot traffic can provide a jolt to overall property performance, making them highly desired shopping center tenants.
- **STNL sector sustains steady performance**. Over the past year, the national average single-tenant cap rate remained flat at 6.1 percent after rising 10 basis points one year earlier. Investors favor the stability and hand-off nature of single-tenant assets, maintaining strong bidding climates and pushing the average price per square foot up 5 percent year over year.

Retail Sales Volume by Price



Retail Property Sales Trends



* Employment change trailing 12 months through July; Unemployment rate as of July
** Trailing 12 months through 2Q
⁺ Through 2Q
Source: CoStar Group, Inc.

Suburban Office Assets Poised for Rising Demand; Buyer Profile Transforming as Sector Outperforms

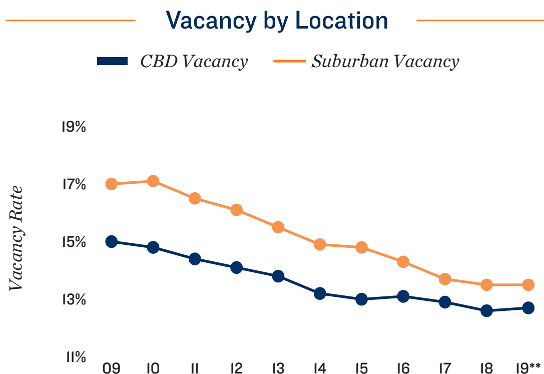
Employers bring innovation to suburbs. Office-using job creation will again outpace overall employment growth this year, fostering the continued evolution of the office market as companies reshape working trends to align with primary talent pools. STEM sectors will be main engines behind this movement, supporting some emerging themes within the office market. Many companies are embracing more innovative workspaces, building amenity-rich offices that work well with relatively small floor plates. While urban submarkets have historically been at the center of these contemporary designs, suburban locations are beginning to gain traction. Corporations are responding to the presumptive shift of millennials from the city to the suburbs over the next several years, establishing operations in these areas with highly amenitized offices to attract talent in walkable locations. Mixed-used developments have also been popular hosts for companies transitioning to the suburbs as live-work-play communities become increasingly appealing for those seeking a variety of nearby amenities.

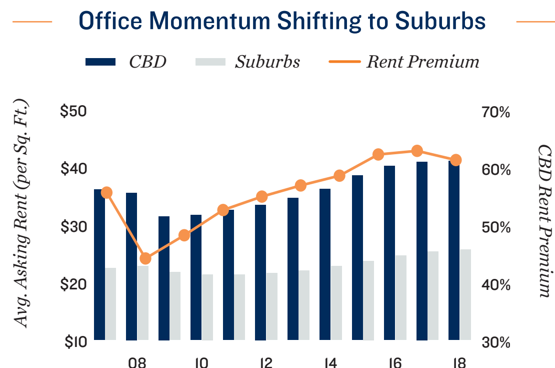
Coworking operators may see two-tone effect as economic outlook moderates. Coworking continues to gain prominence among office markets nationwide as work trends transform. More companies are allowing their employees to work remotely, encouraging operators like WeWork and Regus to capitalize on the growing trend. Many small businesses also occupy these spaces as it can be more affordable and flexible than entering a long-term lease depending on the size and dynamics of the company. Coworking could be a viable option for more small businesses if economic momentum further moderates due to the short-term nature of the leases, allowing companies to quickly opt out if the cost burden becomes too heavy. However, this concept may have an adverse effect on independent contractors who use coworking to enhance their work environment. These people may choose another option such as working from home if budgets tighten, leaving more open desks for coworking entities to fill.

Smaller markets gaining momentum. Steady economic growth continues to fuel the office market, generating sustained job creation and keeping corporate growth strategies active. Office development is on pace to reach 86 million square feet this year, tied for the highest mark this cycle; however, this total is just 80 percent of the last expansion's annual average completions. Though construction volume has been rising, builders have become increasingly conservative amid climbing development costs and the tightened availability of construction capital. A host of primary markets headline the top construction metros this year, with New York, Dallas/Fort Worth, Washington, D.C., and Seattle-Tacoma leading the way. Several secondary and tertiary markets will also witness strong development as the extended cycle has produced increased economic growth, translating to urban renewal efforts in these smaller cities. Charlotte, Nashville, Phoenix and Salt Lake City exemplify this notion, bringing more white-collar jobs into their central business districts and providing a rejuvenated urban feel. While Midwestern markets are seeing similar dynamics, supply growth has yet to follow as many companies are choosing to revitalize existing buildings, breathing new life into outdated properties.

Space demand coming from variety of directions. With more than 37 million square feet leased in the first half of the year, absorption was slightly below previous years but still generally strong. National office vacancy remains on track to drop for the ninth year in row, inching closer to 13 percent. Demand for suburban space continues to drive this trend as the suburban vacancy rate has dropped 180 basis points to 13.4 percent over the past five years, while urban vacancy decreased 80 basis points to 12.6 percent in that span. Coworking operators will put additional pressure on space availability, maintaining strong leasing activity in urban and suburban areas. Tech-heavy metros will highlight this trend, welcoming more flexible space to accommodate the evolving work trends of growing millennial populations.

Current cycle showing more consistency. Sustained modest supply growth will keep rental gains stable this year, driving the average asking rent up 2.5 percent. Tight primary markets like Oakland and San Jose will post growth rates above 6 percent, while high-growth secondary metros including Charlotte and Phoenix are also expected to log strong gains. This cycle's rent trends are showing more regularity than the previous expansion as downtown areas in many of the nation's smaller metros and tech-heavy markets remain key drivers of overall growth.





* Forecast

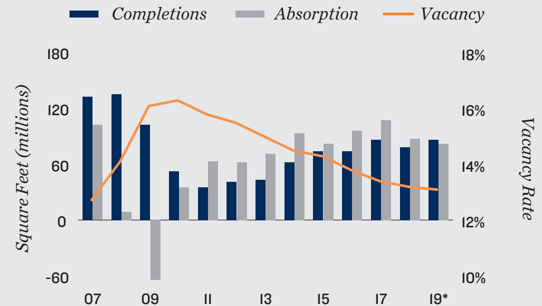
Investors Consider New Strategies as Sector Strengthens

2019 Forecast

U.S. CONSTRUCTION:

86 million square feet completed Y-O-Y

- Completions are on track to match the cyclical high in 2019 as construction volume rises. Primary markets highlight this year's office development, although numerous secondary metros will witness increased deliveries.



U.S. RENT

2.3% Y-O-Y increase

- The average asking rent moves up steadily in 2019, climbing to $31.07 per square foot and eclipsing growth rates of the previous two years. Solid rental gains among Class B/C space will continue to promote overall growth.

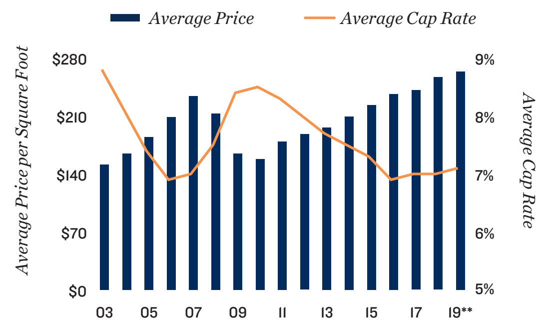
U.S. VACANCY

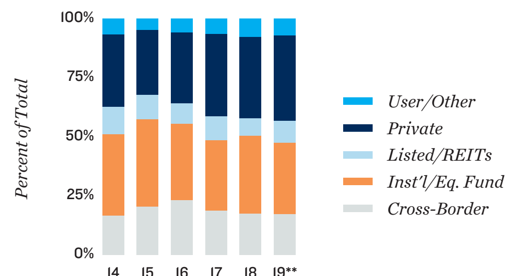
10 basis point Y-O-Y decrease

- National vacancy is scheduled to remain on a decline this year, dipping 10 basis points to 13.2 percent. This reading still sits 100 basis points above the pre-recessionary nadir, suggesting room for more growth.

2019 INVESTMENT OUTLOOK

- **Extended cycle favoring smaller markets.** The national average cap rate rose 10 basis points over the past year to 7.1 percent as investment composition favored smaller metros, where average yields were generally stronger. Transaction velocity climbed roughly 20 percent in both secondary and tertiary metros during the past four quarters, while climbing just 12 percent in primary markets. The extended cycle has evoked increased economic growth in many of the nation's smaller metros, propelling investor demand.
- **Evolving lifestyles reshaping investor demand.** With some talent pools beginning to shift out of urban areas, office investment may begin to pick up in the suburbs. Suburban assets can produce stronger yields than similar properties in CBDs, giving investors more opportunities with high-growth potential. Population growth among young adults in suburban areas is scheduled to rise 0.5 percent each of the next several years, while downtown populations are expected to drop 0.8 percent annually.
- **Investors redirecting focus as sector outperforms.** The nation's average price per square foot jumped 5 percent during the past year — doubling apartment growth and outpacing retail. This was fueled by exceptional price appreciation in primary and secondary markets. Strong growth in these markets has paved the way for more sophisticated capital, refining buyer pools as some investors get priced out. As a result, buyers who historically favored larger metros are diverting their interest to smaller, more affordable cities.





* Forecast
** Trailing 12 months through 2Q
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

Absorption Eases as Companies Temper Growth Strategies; Investors to Target Widening Range of Metros

Digitally driven environment creating new opportunities. The increasingly connected world is fostering accelerated demand for data storage, making data centers a mainstream property type in the industrial sector. E-commerce and tech companies rely on massive amounts of tracked data, prompting companies like Amazon, Facebook, Google and Microsoft to set up data storage operations. Many states offer data center developers significant tax incentives to build facilities, creating new full-time jobs and potentially generating additional employment through technology-related development. In 2009, only seven states provided incentives, but now 30 states offer inducements for large data center projects. Much of this is due to the high development cost relative to other industrial projects as proximity to fiber optic lines and power grids is essential, putting a premium on required land. The rapid expansion of data centers is piquing the interest of investors, offering them additional investment opportunities and providing them a viable portfolio diversification option amid the maturing cycle.

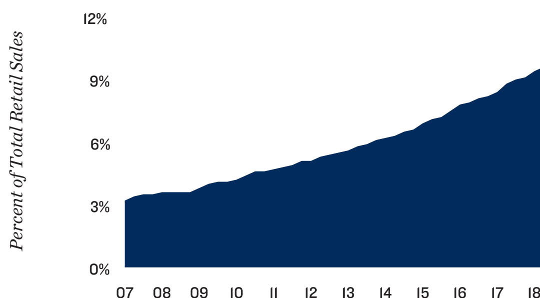
Refrigerated space proliferates as consumers evolve. Demand for cold storage is rising as grocery delivery is embraced by more households. Though online grocery shopping is still in its early stages, its growth potential is high as rapid digitization is shifting consumer shopping patterns. Aging baby boomers have also begun to adopt new digital purchasing habits to support their decreasing mobility. The expanding popularity of prepared meal kits is also driving demand for refrigerated space, keeping these products fresh until they reach consumers. Companies like Blue Apron, Hello Fresh and Sun Basket are spearheading this trend, particularly among younger generations, offering customers personalized meals to cater to varying dietary preferences. Additionally, consumers' growing aversion to food chemical preservatives is spurring the need for more cold-storage facilities as many common food items now require refrigeration.

Tariffs shake up supply chains. The ongoing trade war with China continues to weigh on the industrial sector, causing some businesses to adopt a more cautious stance until negotiations are settled. Some companies are rerouting their supply chains to help mitigate tariff-induced costs, while others are compelled to stick with original arrangements for logistical and economic reasons. Though most consumers have yet to feel the impact of tariffs, the effects could surface over the next few months as rising product costs navigate through supply chains, potentially impacting the pricing of common goods. Trade negotiations remain open-ended, putting pressure on suppliers with the holiday season approaching as many Chinese products are needed to meet consumer demands.

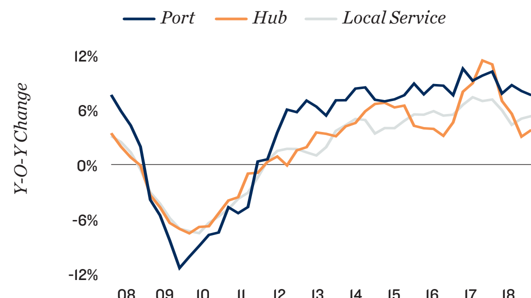
Fulfillment and logistics driving force behind construction. Up to 210 million square feet will be added this year as the proliferation of online shopping and expansion of last-mile delivery strategies continue to support elevated levels of construction. Development is concentrated in logistics hubs, led by Dallas/Fort Worth, which will receive 33 million square feet, while Riverside-San Bernardino and Atlanta each receive about two-thirds of that total. Several other Sunbelt and Midwestern markets round out the top 10. Houston remains a top harbor for foreign waterborne freight and Chicago strengthens its status as a distribution hub. In contrast, many coastal metros will see limited construction as sparse land availability restrains traditional development strategies, making it difficult for companies to expand their footprint. To help sidestep this, some builders are beginning to design multilevel industrial spaces in dense areas; however, some configuration challenges still exist. Dense coastal markets may further adopt this trend moving forward as the concept is refined.

Leasing activity falters amid economic uncertainly. Absorption in 2019 has substantially softened, registering about the half the pace as previous years in the current cycle. This has generated the first vacancy increase since 2010, moving the national rate up 10 basis points to 4.8 percent in the second quarter as some businesses put expansion plans on hold in response to economic uncertainty. Several Midwestern and West Coast metros support this trend over the past year; however, significant supply shortages still exist in many markets. Nearly a dozen of the nation's major metros boast vacancy rates under 4 percent as developers struggle to keep pace with demand. While the confluence of ongoing trade negotiations and more conservative domestic growth will impact absorption moving forward, vacancy is expected to remain flat through the end of the year. Rent growth remains strong in 2019, maintaining an average rate in the mid-7 percent range and putting the average asking rent at $7.29 per square foot at the end of the second quarter. Ultra-tight port markets including Jacksonville, Los Angeles and San Francisco remain primary drivers of nationwide rental gains, posting 10-plus percent boosts over the past year. Though overall space absorption has moderated, demand still remains closely aligned with supply infusions on a national level. Southern California markets will headline rent growth through the remainder of the year as tariffs continue to disrupt supply chains, leaving many warehouses full as companies accelerate imports before additional changes to the geopolitical landscape are made.

E-Commerce Sales Growth



Industrial Rent Growth Healthy Impact of Construction on Hubs Apparent



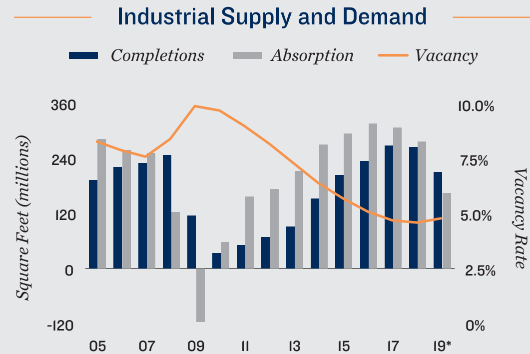
Nuances of Sector Momentum Delivers Range of Options

2019 Forecast

U.S. CONSTRUCTION:

210 million square feet completed Y-O-Y

- The building boom continues in 2019 as development eclipses 200 million square feet for the fifth year in a row. The growing e-commerce industry is prompting more fulfillment centers and last-mile distribution hubs.



U.S. RENT

5.8% Y-O-Y increase

- Rent growth will remain strong this year despite another wave of new supply, moving the average price per square foot up to $7.43. Since 2011, growth has averaged 4.6 percent amid the completion of more than 2 billion square feet.

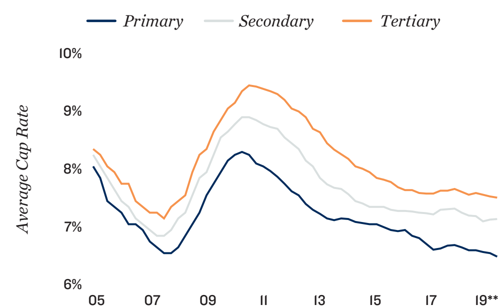
U.S. VACANCY

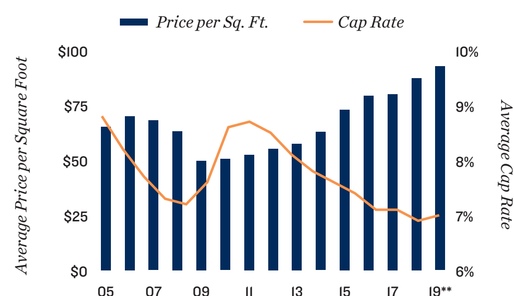
20 basis point Y-O-Y increase

- Year-end vacancy will increase for the first time since this cycle, moving the national vacancy rate to 4.8 percent. Uncertainty surrounding the economy will continue to weigh on space absorption.

2019 INVESTMENT OUTLOOK

- **Investors find opportunities across range of assets.** The nation's average cap rate remained flat over the past year at 7 percent as bidding stayed competitive. While yields are largely dependent on asset and location, secondary and tertiary markets continue to offer considerably stronger returns for turnkey options, producing cap rates in the mid-5 percent range — about 100 basis points above primary metros. Yields on older properties with significant value-add potential in primary markets sit in the mid-8 percent realm, while returns in secondary and tertiary metros are in the low-9 percent range.
- **Urban infill sits atop the list for many buyers.** With last-mile delivery strategies becoming increasingly essential, investors are zeroing in on urban infill projects, redeveloping existing buildings to accommodate distribution needs in dense areas. These assets are highly prized by investors, generating cap rates in the high-3 to low-4 percent band in markets like San Francisco, Los Angeles and New York City.
- **Smaller markets drawing more interest.** Industrial price appreciation significantly outpaced other property types, climbing 11 percent year over year to $92.59 per square foot. Pricing jumps hovering around 20 percent were posted in a number of coastal cities including San Jose, Tampa and Washington, D.C. Several Midwest markets also witnessed solid appreciation as investors focused more heavily on smaller metros. Over the past year, sales volume in tertiary markets rose roughly 22 percent, while sales volume in primary and secondary markets remained relatively stable.

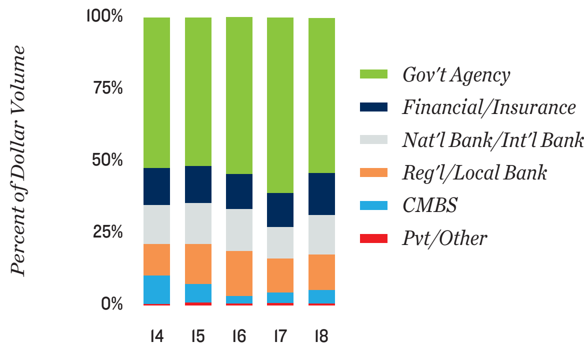




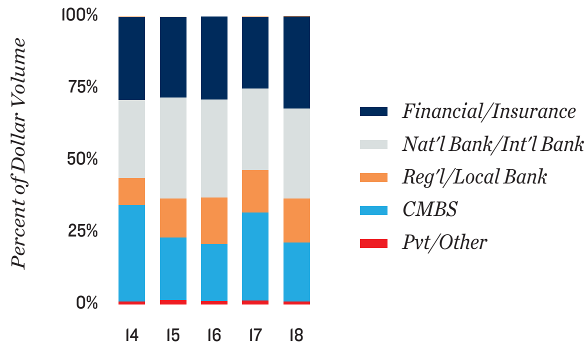
* Forecast
** Trailing 12 months through 2Q
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens

Apartment Mortgage Originations By Lender



Office Mortgage Originations By Lender



** Through Aug. 14*
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

Fed Breathes More Life Into Economy

Fed efforts to extend economic runway facing increased headwinds. The Federal Reserve's decisive action, including the rate drop in July, will support the economic growth cycle but may be outweighed by the escalating trade war. Uncertainty and caution increased following the Aug. 1 announcement that additional tariffs would be levied, sparking a flight to safety and the recent inversion of the 10-year and two-year Treasurys. Though the Fed's 25-basis-point reduction of the overnight rate and early end to quantitative tightening could pose some inflationary risk, the Fed has communicated a willingness to let the economy "run hot" in an effort to spur growth. Should core inflation rise above 2 percent, it will not be seen as an immediate risk. Falling interest rates, a byproduct of the trade war and the Fed's efforts to boost the economy, will bolster leveraged yields for investors. With the yield on the 10-year Treasury now down 70 basis points from the cycle peak last October and at its lowest level since the record low set in 2016, investment options that may not have penciled even 30 days ago have been reinvigorated. This should help moderate the buyer/seller expectation gap that widened earlier in the year.

APARTMENTS: Capital Sources Show More Flexibility as Interest Rates Decline

Abundant liquidity balances conservative underwriting. Debt financing for apartment assets remains strong, supported by myriad lenders. However, Fannie Mae and Freddie Mac, two mainstay apartment capital sources, will moderate activity in the second half of the year as they reach their lending caps on market rate assets for the year. The Government Sponsored Enterprises will remain active lenders for "uncapped business" including environmentally sustainable and affordable housing properties. A wide range of local, regional and national banks, pension funds, insurance companies and CMBS sources will remain very active. All have responded to the falling interest rate climate by reducing mortgage rates, but lender spreads have widened as the 10-year Treasury rate has fallen. Given the downward pressure on interest rates, lender caution has risen, particularly for construction loans. Though lending is still available for these types of projects, investors may need to blend mezzanine debt with other capital sources until they prove out their concepts and substantially fill units. For stabilized existing assets in most major markets, financing remains plentiful.

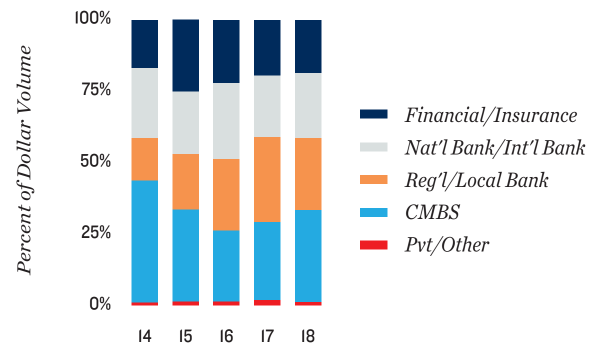
OFFICE: Capital Plentiful for Proven Products

Conservative underwriting balances ample capital sources. While debt financing remains available from a wide range of sources including local, regional and national banks; insurance companies; and private capital funds, lenders remain cautious, typically requiring debt service coverage (DSC) ratios in the 1.3 range. Additionally, loan-to-value (LTV) ratios generally sit in the 65 percent area depending on the borrower, asset and location. This conservative approach has filtered into a focus on proven property results, showing less willingness to lend based on pro forma rents. As a result, investors have turned to short-term mezzanine debt and bridge loans to cover planned capital improvements, while seeking long-term solutions once returns have been validated. Construction origination has also remained softened, prompted by a lender focus on core locations, where there is proven project viability.

RETAIL: Plenty of Capital Available for the Right Deal

Lenders focus on tenant composition. The evolving nature of the retail sector is providing opportunities for investors, giving underwriters more confidence in the long-term outlook of retail. Lending habits remain relatively conservative; however, a wide range of financing is available for strong proposals. Underwriters are beginning to focus more on tenant mixes, heavily emphasizing the inclusion of tenants with sustainable business models before they sponsor a deal. Active lenders include local, regional and national banks, and insurance companies, with a primary lender focus on net-leased assets and premier mixed-use structures being highly desirable. Meanwhile, outlying malls and non-credit tenants will undergo much more scrutiny. This has produced loan-to-value (LTV) ratios in the 60 to 70 percent range and typical debt service coverage (DSC) ratios above 1.3 depending on borrower, asset and location factors. Mezzanine and bridge loan structures have been more frequently used in this environment, with owners undertaking capital improvements at higher leverage ratios on the short-term debt before seeking long-term financing options once their operations have been proved.

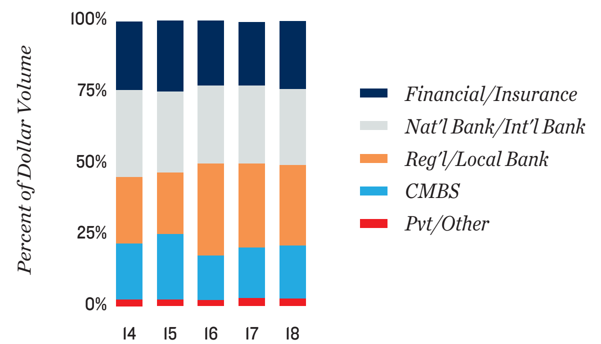
Retail Mortgage Originations By Lender



INDUSTRIAL: Lenders Recognize Space Shortage

Lenders remain eager as investors bet on shifting consumer preferences. Underwriters continue to favor industrial space as the rapidly growing e-commerce sector fosters marked space demand. Well-leased projects receive interest from an array of lenders, especially in tight markets, as capital sources remain more than willing to sponsor deals. Conversely, underwriting for speculative space can be slightly more restrained, with lenders focusing on clear-cut investment proposals amid the prolonged cycle. Lending for speculative development appears to be more moderate than the previous cycle as underwriters have maintained their conservative tone coming out of the last recession. Local, regional and national banks and insurance companies remain actively involved, typically offering loan-to-value (LTV) ratios in the 60 to 75 percent range and preferring debt service coverage (DSC) ratios near 1.3, depending on the borrower, asset, location and pre-leasing arrangements. Non-core locations and use cases can call for more nuanced financing such as mezzanine and bridge loans to undertake capital improvements

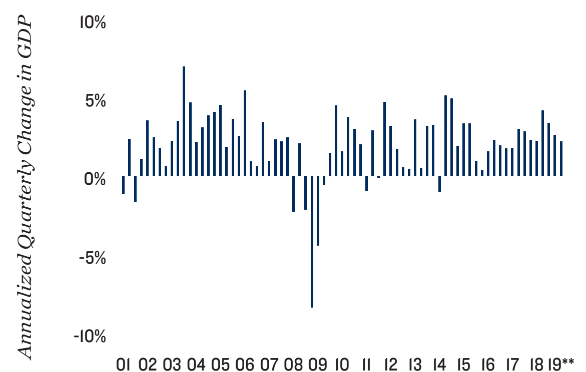
Industrial Mortgage Originations By Lender



Trade Negotiations Bring New Challenges

Tariffs shake up supply chains. The ongoing trade war with China continues to weigh on the industrial sector, causing some businesses to adopt a more cautious stance until negotiations are settled. Some companies are rerouting their supply chains to help mitigate tariff-induced costs, while others are compelled to stick with original arrangements for logistical and economic reasons. Though most consumers have yet to feel the impact of tariffs, the effects could surface over the next few months as rising product costs navigate through supply chains, potentially impacting the pricing of common goods. Trade negotiations remain open-ended, putting pressure on suppliers with the holiday season approaching as many Chinese products are needed to meet consumer demands.

U.S. GDP



*Forecast
Include sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; Moody's Analytics; Real Capital Analytics; TWR/Dodge Pipeline; U.S. Census Bureau

Price: $250

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