Mid-Year 2012 Commercial Real Estate Investment Outlook

Investor sentiment withstands latest headwinds

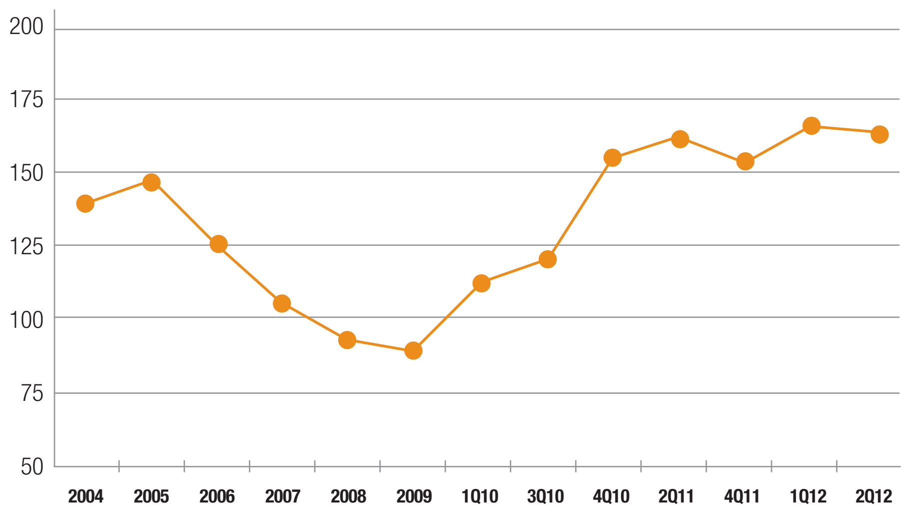
Low job growth, recession in Europe barely dampen buyer appetites.

INVESTOR CONFIDENCE HOLDS STEADY

Investor confidence in the commercial real estate recovery has not been shaken by the latest jolt of economic uncertainty.

Investors' views of commercial real estate barely budged in the second quarter, according to results from the NREI/Marcus & Millichap Investor Sentiment Survey. The Investor Sentiment Index, which measures investor views on key fundamentals such as rising property values and plans to increase holdings, dipped just 2 points from 166 in first quarter to 164 in second quarter **[Figure 1].**

FIGURE 1. COMMERCIAL REAL ESTATE INVESTOR SENTIMENT INDEX



Investor enthusiasm was not thwarted by negative economic headlines that include two months of disappointing job growth numbers in the United States, financial woes in Spain and news that Europe has sunk back into a recession. "Those results confirm the fact that property owners are seeing evidence of another recession emerging here in the United States. The recovery is sustainable but still below trend," says Hessam Nadji, a senior vice president and managing director at Marcus & Millichap in Calabasas, Calif.

The fact that the Investor Sentiment Index held relatively steady confirms that the surge in investor confidence that occurred in the first quarter was no fluke. The index declined to 152 in fourth quarter in the wake of the U.S. credit downgrade and resurgence of the European debt crisis. However, confidence rebounded in the first quarter to 166—the highest level since the survey began in 2004.

Further evidence that confidence remains steadfast is that investors' plans to acquire additional real estate in the coming year did not waver. More than half of respondents (59 percent) plan to increase their commercial real estate investments in the next 12 months—the same result as the first-quarter survey. "Values are near bottom and that is the time to invest in any market," writes one respondent.

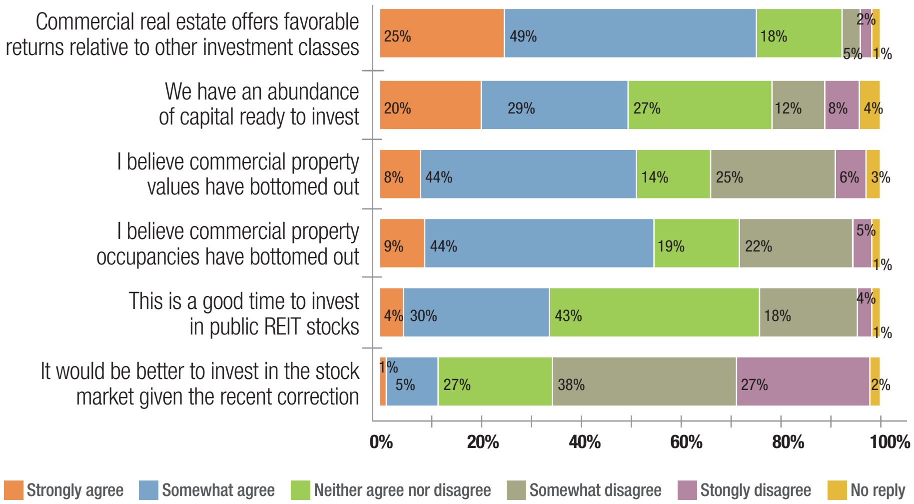
Investors are stepping up their buying. U.S. commercial and multifamily real estate sales reached $58.4 billion in first quarter—a 46 percent increase over the $40 billion in transactions that occurred in first quarter 2011, according to Marcus & Millichap.

Survey Methodology

In the second quarter 2012, National Real Estate Investor's research unit and Marcus & Millichap e-mailed invitations to participate in an 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 and Retail Traffic selected from commercial real estate investor, pension fund, and developer business subscribers who provided their e-mail addresses. The majority of respondents are private investors (36%), developers (14%) and private partnerships (16%) with an average of $42.7 million invested in commercial real estate. REITs and institutional investors represent 6% of all respondents. The survey yielded 526 valid responses.

FIGURE 2. **INDUSTRY VIEWS OF THE COMMERCIAL REAL ESTATE RECOVERY**

To what extent do you agree or disagree with the following statements?



Base: all respondents to the 2Q 2012 (526) survey.

Greater access to capital and historically low interest rates are helping to fuel that activity. Fifty-eight percent of respondents believe that access to more financing sources is somewhat or much more widely available than six months ago. One in four respondents sees no change and only 6 percent believe that capital is less available today. Ten percent of respondents either had not attempted to borrow money in the last six months or had no answer. In addition, nearly half of investors (49 percent) said they have an "abundance" of capital ready to invest.

Respondents have faith in the U.S. commercial real estate recovery. Slightly more than half of the respondents (53 percent) agree that occupancies have bottomed out, while 52 percent believe that values have bottomed out **[Figure 2].** That being said, the outlook for each property type still varies widely depending on the individual sector. "People on the ground are seeing improvement. But, with the exception of apartments, every other sector continues to be in a very gradual recovery," says Nadji.

Is optimism for apartments cooling?

Apartments jumped out early as the clear leader in the commercial real estate recovery, and the sector continues to represent the preferred investment choice. The majority (60 percent) of respondents believe now is the time to buy more apartments **[Figure 3].**

It is no wonder that apartments remain the front runner. Multifamily continues to outperform every other property type in terms of occupancies, absorption and rent growth. However, sentiment regarding the outlook for apartment property values recorded a moderate drop in the second quarter. Among respondents who already own apartments, 68 percent expect apartment values to increase in the coming year. That is down compared to the 72 percent who held the same view in the first quarter. "Multifamily fundamentals remain positive, particularly in core markets. I am worried, however, that prices and rents have become too inflated in some core markets, namely Washington, D.C.," wrote one respondent.

Signs of a potential pullback in sentiment could be a reflection of how quickly the apartment sector has rebounded compounded by fears about slower job growth. "Multifamily fundamentals remain strong and are still improving, particularly in core markets. Vacancies are already back to pre-recession levels and rents are almost back to pre-recession levels," notes Nadji. Marcus & Millichap is forecasting that vacancies will improve to 4.4 percent by year-end and effective rents will rise 4.8 percent this year to $1,027.

Investor sentiment related to retail properties remained stable—despite valid concerns regarding the economy, consumer spending and additional store closings **[See Retail Investment Sidebar].**

Buyers bullish on hotels

Hotels saw an increase in investor confidence in the second quarter. Among respondents who own hotels, 55 percent believe now is the time to buy more. That is more bullish than first-quarter results when 49 percent said that now was the time to buy more hotels. Thirty-nine percent said now is the time to hold and 6 percent think now is the time to sell.

Even though the hotel sector continues to see a number of distressed sales and restructuring of debt on properties, the worst is definitely over for many hotel owners. "In an economy that is growing gradually, we should see fundamentals and RevPar grow gradually," says Nadji. "So, I think the recovery occurring in hotels is sustainable, and that the worst is over."

The U.S. hotel industry is posting year-over-year increases in all three key performance metrics, occupancies, average daily rate (ADR) and revenue per available room (RevPar). During the week of April 29 through May 5, for example, occupancies rose 5.1 percent to 63.2 percent, ADR increased 5.2 percent to $107.18 and RevPar jumped 10.5 percent to $67.70, according to STR Global.

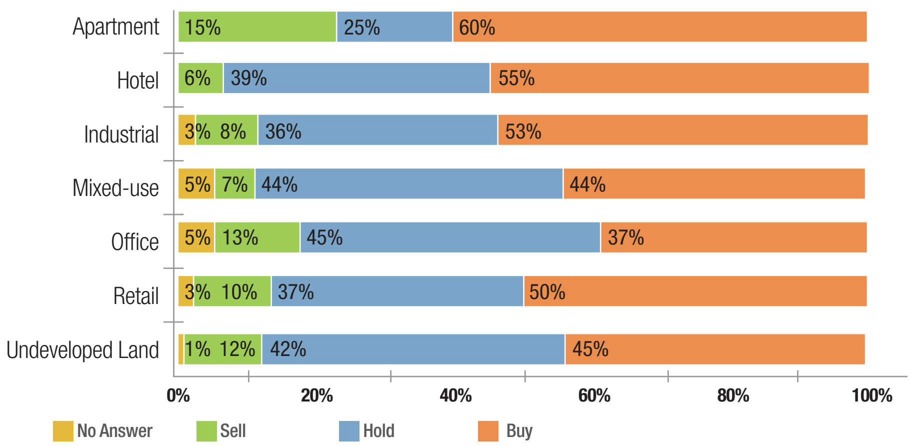
Such industry data explains why respondents are more optimistic that property values will rise in the coming year. Sixty percent of respondents expect values to increase over the next 12 months compared to 51 percent who held that view in the first quarter. Thirty-five percent expect values to remain the same, while only 4 percent anticipate a decline in values. Another 1 percent did not answer. The average increase expected is 5 percent.

Industrial moving with GDP growth

Industrial owners are slightly more positive about the outlook for this sector. More than half (53 percent) said now is the time to buy more, compared to 36 percent who

FIGURE 3. **INVESTOR PERCEPTION OF PROPERTY TYPES**

In your view, is now the time to buy, hold or sell each of the following property types?



Only respondents invested in the property type are included in the column for that property type.

think now is the time to hold and 8 percent believe now is the time to sell. Three percent did not answer. That response is slightly more positive than the 49 percent of first-quarter respondents who thought it was ideal to buy at that time.

Positive GDP growth has helped to boost demand for industrial space, especially among warehouse/distribution facilities. The U.S. economy is expected to post positive growth between 2.0 and 2.5 percent this year. "Those numbers have slowed some, but are still comfortably in the positive territory," says Alan Pontius, senior vice president and managing director at Marcus & Millichap Real Estate Investment Services. Retail sales is another important indicator for the movement of goods, and retail sales have fared well. Although retail sales came in below expectations in April, retail and food services sales for first quarter posted a year-over-year gain in same-store sales of 6.4 percent, according to data from the U.S. Department of Commerce.

That demand for space coupled with minimal new construction is helping vacancies improve. The national industrial vacancy rate of 11.8 percent is expected to drop to 11 percent by year-end, according to Marcus & Millichap. Concessions are continuing to disappear, and effective rents are forecast to grow 2 percent this year to average $4.50 per sq. ft.

Office continues to lag

Office has clearly been the laggard in the commercial real estate recovery, and investors have been consistent in their lackluster views of this sector. Office is trailing on the investor sentiment index with a rating of 123. Although that is an improvement over the 110 mark recorded in fourth quarter, it is well behind apartments at 164, hotels at 156, industrial at 144 and retail at 139.

It is notable that slumping employment numbers did not drag investor confidence lower. After posting job growth of 254,000 per month during December, January and February, job growth dipped to 120,000 in March and 115,000 in April. The sentiment among the 37 percent respondents who already own office properties is that now is the time to buy more, which is a 6 percent drop compared to first-quarter results. Forty-five percent of investors believe it is better to hold, while 13 percent think it is time to sell. Five percent did not answer.

Office vacancy rates have been very slow to improve. The current office vacancy rate is hovering at about 17.2 percent and is expected to drop to about 16.6 percent by year-end, according to Marcus & Millichap. "Uncertainty, impact of excess space and cost cutting among corporate users is showing up in the weak absorption numbers for office," says Pontius. "However, we are very close to a turning point, because much of the excess space has been burned off. Going forward, I think there will be a tighter correlation between job gains and space consumption."

About half of office investors (49 percent) expect no change in values in the coming year, while nearly one-third (36 percent) are optimistic that values will rise and 13 percent expect a further decline in values. Two percent did not answer. The average increase in values expected is 1.6 percent, which is down slightly from the first-quarter survey when respondents thought values would rise 2.1 percent over the next year.

Recovery on track

The second-quarter survey results set another important benchmark that the current recovery is sustainable. Investors remain very confident in real estate as an investment class. Almost three out of four respondents (74 percent) believe that commercial real estate continues to offer favorable returns relative to other investment classes, which is slightly higher than the 70 percent who held a similar view in the first quarter. In fact, only 6 percent of respondents said that it would be better to invest in the stock market given the recent correction.

That being said, buyers remain cautious in their investment strategies due to the many challenges that could impede the recovery. Top concerns have changed little over the last year. The state of the U.S. economy at 85 percent remains the top concern of commercial real estate investors, followed by the potential for higher taxes at 53 percent, high unemployment rate at 51 percent, and political uncertainty and gridlock in Washington at 51percent.

"The economy is anchored by uncertainty and caution because of the macro issues and that is holding back a much stronger organic expansion," says Nadji. GDP growth of 2.5 to 3 percent per year is achievable, and it will be enough to keep the commercial real estate market on a sustainable path toward recovery. "It may not be a robust pace, but it is a good, steady pace all the same." ■

Retail buyers still opt for safety

Risk tolerance to expand in search of yield.

Retail investors are treading cautiously in the midst of a slow recovery that remains laden with pitfalls.

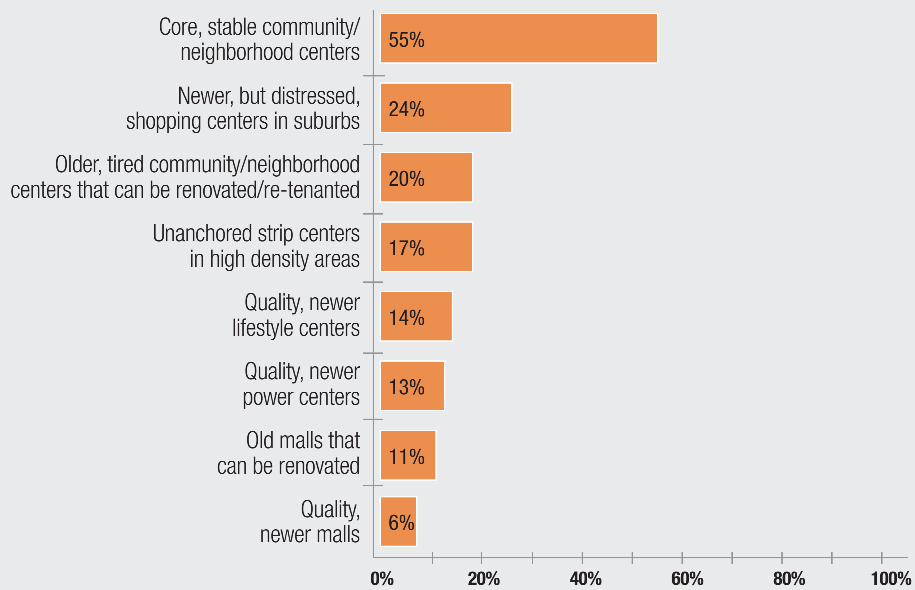
The NREI/Marcus & Millichap Investor Sentiment Survey reveals that worries about the retail recovery remain paramount. Respondents rated another economic shock or recession as their top concern at 47 percent, followed by more store closures at 40 percent. The growing competition from online retailers (37 percent) and negative impact from frugal consumers (36 percent) both rank as formidable concerns for investors.

Part of that pessimism relates to announced closures and further downsizing from major retailers such as Best Buy, Sears and Kmart. Some respondents also cited concerns about additional closings coming from smaller "mom-and-pop" stores. In addition, investors are wary of how the upcoming presidential election will influence the broader economy. At the same time, retail real estate has been recovering sooner than expected with positive net absorption for nine consecutive quarters, according to Marcus & Millichap.

Online retailing is a significant concern that isn't going away even in a stronger economic climate. "The reconfiguration of brick-and-mortar retail in any area that is even remotely competitive with online sales is here to stay," says Bill Rose, national director of Marcus & Millichap's National Retail Group. Best Buy is a great case study. By all arguments, the electronics retailer should have done very well after Circuit City went out of business. Instead, competition from online outlets such as Amazon.com has rained havoc on Best Buy, which is now shuttering stores and downsizing its store footprints.

FIGURE 4. INVESTORS FAVOR CORE, STABLE SHOPPING CENTERS

What are the best sub-sectors of retail to invest in at this time for a five-year hold?



Base: all respondents to the 2Q 2012 (526) survey.

Despite those concerns, investors' views on adding to their retail portfolios changed little in second quarter. Half of retail investors believe now is a good time to buy more. Although that number may seem high given the potential obstacles, buyers have a clear preference for lower-risk investments.

About half of respondents (55 percent) said that core, stable community/neighborhood centers represent the best opportunities for a five-year hold. Although there is some interest, investors do not have a strong appetite for value-add retail right now. Twenty-four percent would consider newer but distressed shopping centers in the suburbs and one in five investors said that they would consider older, tired community/neighborhood centers that can be renovated or re-tenanted and/or would consider newer, but distressed shopping centers in the suburbs. **[Figure 4].**

"The concerns about the economy and store closures feed into the flight to quality investment strategy," says Rose. "But the numbers do reflect a continuation of pretty respectable improvement in retail fundamentals. Retail vacancies are dropping gradually and sales volume jumped 42 percent so far this year. Low interest rates, bottoming prices and improving fundamentals should drive more sales this year," says Rose. ■

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