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# Economics Group

## Special Commentary

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# Commercial Real Estate Chartbook

***Over a decade into the expansion, commercial real estate fundamentals remain on solid footing, although ascendant property prices present a clear downside risk.***

The U.S. economy passed an important milestone earlier this summer. July marked the 120th month since the recession ended, making the current expansion the longest on record. Ten years in, the economy remains in decent shape, as solid employment growth continues to bolster household income and sustain consumer spending. While household fianances are solid, economic growth is clearly moderating, reflecting the trade war, slower growth abroad and a persistent cloud of policy uncertainty weighing on business investment and manufacturing.

Commercial real estate fundamentals have largely mirrored this trend, with demand softening a bit and new development cooling across most property types. Even with the downshift, property prices remain at or near all-time highs, which is drawing increasing attention from policymakers worried that commercial real estate may be a potential source of contagion that would amplify a slowing in the economy and potentially deepen any subsequent recession. The Fed has cut interest rate 50 bps since July, and we expect an additional 50 bps of cuts, likely in Q4 and Q1-2020. These cuts will likely lift property valuations even further. Over the past 10 years the Commercial Property Price Index has risen more than 87%, and it rose 6.7% over the year through August. Ascendant property prices are understandable given rents are rising across the board and demand remains generally solid. The contrast between the rise in property prices and downshift in economic growth is nevertheless concerning.

***Even with the downshift in demand, property prices remain at or near all-time highs.***

The apartment market serves as a clear example. For much of the expansion, multifamily construction has remained strong and apartment property prices have trended higher, as developers have taken advantage of the seismic shift away from homeownership towards renting. Since 2007, the apartment property price index has risen faster than any other major property type and is 76% above its prior peak. Lofty valuations are arguably justified, given a modern-era low in apartment vacancies. New construction has also been skewed toward higher end urban/lifestyle projects, while suburban apartment development and workforce housing have generally lagged.

**Figure 1**

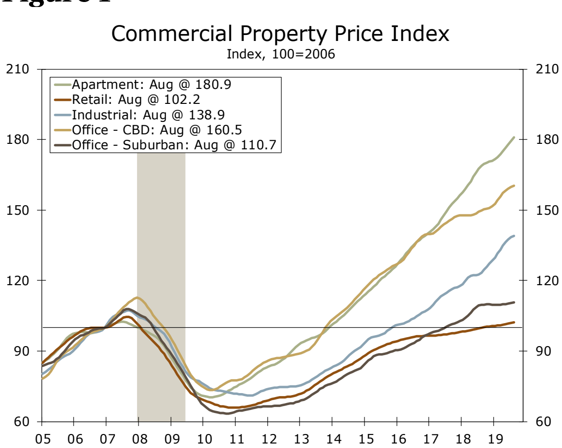
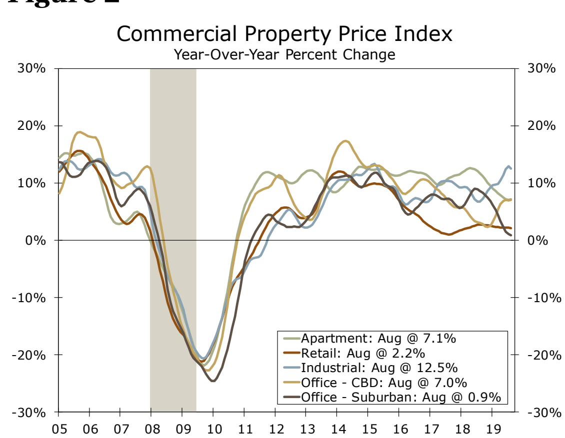



**Figure 2**




**Source: Real Capital Analytics, CoStar, Inc. and Wells Fargo Securities**

***A strong job market has supported apartments, but things are softening.***

Undergirding the demand for apartments has been a strong job market, but hiring has lost momentum in recent months, reflecting growing caution in trade-related industries such as manufacturing and logistics. The slowdown has not been quite as apparent in the creative and knowledge-based industries, such as finance, tech and professional services, which we in part attribute to a still fairly robust pipeline of venture capital. These industries tend to cluster in the large gateway and secondary markets where there is an ample supply of highly educated labor, whose apartment markets have outperformed as a result.

The Bay Area, Boston and Austin have been clear benefactors, with apartment rents continuing to climb alongside a seemingly endless stream of venture capital funding, which supports many of the fastest growing industries in these markets. While employment has held up relatively well, some high profile Initial Public Offerings have run into trouble, which might be a harbinger of tougher times in the venture capital and private funding markets. As venture capital becomes dearer, tech firms are likely to become more cautious, which would slow hiring and leasing.

**Figure 3**

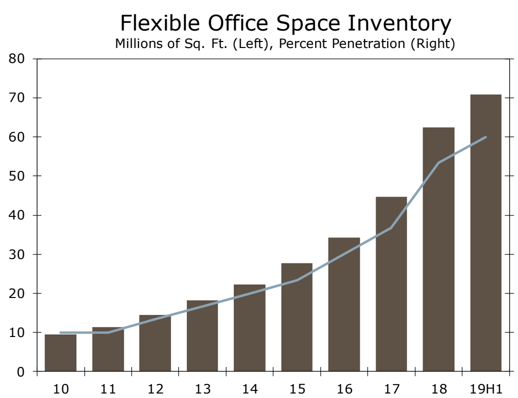
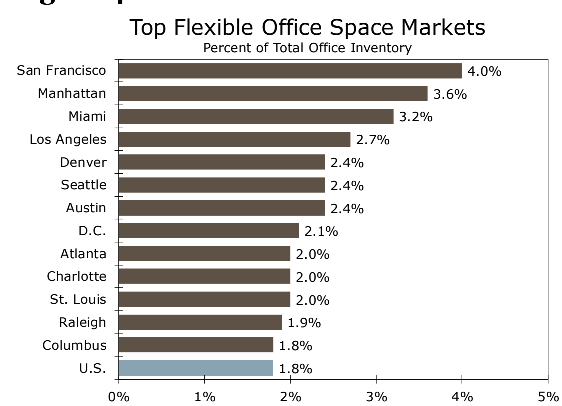



**Figure 4**




**Source: CBRE and Wells Fargo Securities**

The office market is similarly vulnerable, particularly co-working office space, which has benefited from these same trends. Observers have already begun to express concern, most notably Boston Federal Reserve president Eric Rosengren, who recently noted that the rise of co-working space is "creating a new type of potential financial stability risk in commercial real estate." The well-publicized trials and tribulations surrounding a potential public offering for WeWork, the largest co-working company in the United States, has reignited the debate surrounding the long-term durability of the flexible office space model. The risks are pretty straightforward, although we believe they are somewhat overblown. Co-working firms, which typically take on long-term leases with property owners and re-lease the space on a short term basis, would likely be especially vulnerable to falling occupancy and declining rents that typically occur during a downturn. As tenants fail to renew the short-term leases, the loss of lease payments would also likely lead to a higher incidence of loan defaults.

***We doubt the growing share of co-working presents an outsized risk for commercial real estate or the financial system.***

We doubt the growing share of co-working leases presents an outsized risk for commercial real estate or the financial system more broadly. While flexible office space represents roughly one-third of all new office leases over the past 18 months and total square footage has more than doubled since 2015, occupied co-working space is estimated to be just under 2% of overall inventory. Co-working companies have their largest footprints in San Francisco, Manhattan and Los Angeles, but are expanding rapidly in up-and-coming secondary markets such as Austin, Denver, and Raleigh-Durham. But even in the largest and fastest growing flex markets, which tend to have a heavy presence of creative and knowledge-based industries such as tech, media, R&D and professional services, the ratio of co-working space to total inventory remains relatively low. Moreover, not all the firms leasing co-working space are small and thinly capitalized businesses. Many are divisions of large companies or satellite R&D facilities that are looking to quickly ramp up. Co-working space makes this fairly easy. Furthermore, it does not appear that U.S. banks are overly exposed to commercial mortgages, and thus the fallout from a potential downswing would likely be contained to the office market. Today, commercial mortgages amount to nearly 11% of the total financial assets of the U.S. banking system, which is not out of line in a historical context.

Even though there is less exposure than widely thought, the next recession may not be particularly kind to the co-working space model. During the prior two recessions, employment in "office-using" sectors fell relatively further than overall employment, reflecting the deep cutbacks in the tech sector following the long 1990s expansion and massive job losses in financial services following the housing bust (Figure 6). Co-working tenants predominantly include categories of workers which tend to feel the negative impacts of a recession early, such as startups, freelancers and entrepreneurs. A downturn would also halt the vast amount of venture capital flowing into startups, which would evaporate the primary wellspring of funding on which they depend.

***Even if the flex office model bends during the next recession, it likely will not break.***

Still, even if the flex office model bends during the next recession, it likely will not break. While WeWork and Regus rank as two of the largest co-working companies, there are over 200 other small and mid-sized operators such as Impact Hub, Convene and Knotel. Co-working space provides just-in-time office space, which enables both new and established firms to gain efficiencies by acquiring work stations and meeting rooms on an as-needed basis. Additionally, the average space per chair in a flex office is estimated to be 60 sq. ft., considerably smaller than the 194 sq. ft. in the traditional office layout. A more open and collaborative working environment with streamlined technological and business services only adds to the potential productivity gains.

By offering a suite of amenities such as beverage service and access to gyms, restaurants and retail, flex offices also provide creative ways to attract and retain younger workers, a segment growing in importance as more Baby Boomers exit the labor force. Moreover, even large organizations such as Microsoft, KPMG and IBM are beginning to see the benefits of the flex office model, which allows firms to gradually expand into new markets without making long-term commitments. This may serve to limit the downside risks of a downturn. Mitsubishi UFJ Financial Group recently leased enough WeWork space for 300 fintech employees in Charlotte, which allows it to immediately focus on hiring and more quickly ramp up its operations.

***The efficiencies achieved through co-working may have tempered the real estate cycle.***

The efficiencies achieved through co-working may have tempered the real estate cycle. As with apartments, much of the growth in the office market has taken place in the Central Business District or next largest employment center in a handful of rapidly growing metropolitan areas. There have been relatively few spec office towers developed during this cycle, although co-working space is providing much of the flexibility that spec space did in the past. Overall office vacancy rates remain relatively low, particularly relative to the latter period of past business cycles.

**Figure 5**

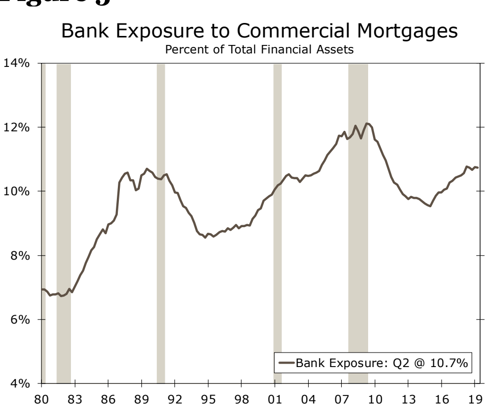
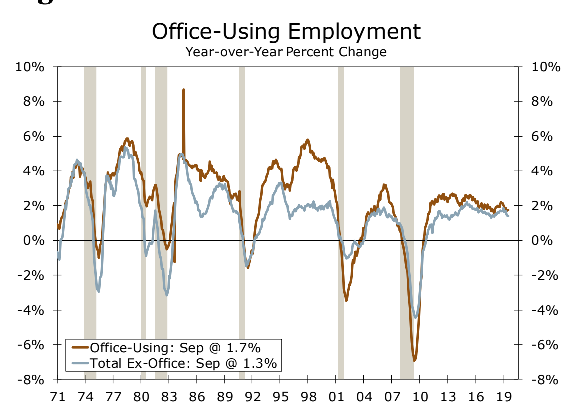



**Figure 6**

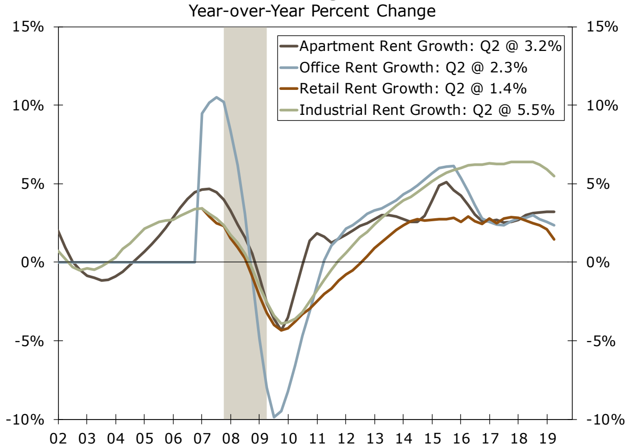



**Source: Federal Reserve Board, U.S. Department of Labor and Wells Fargo Securities**

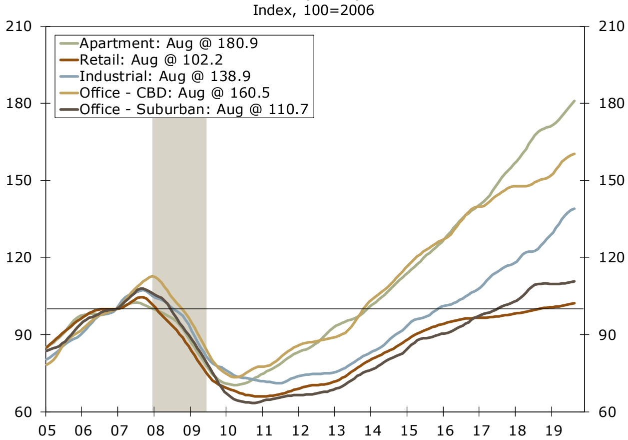
## CRE Property Pricing & Fundamentals

- Commercial real estate valuations continue to climb as prices across all property types rose 6.7% year-over-year in August. The industrial sector continues to lead, with prices rising in excess of 12% for the past three months.
- Prices in the smaller markets (7.0%) continue to rise faster than in the gateway markets (5.5%), with notable strength in Nashville, Tampa, South Florida, Jacksonville and Phoenix.
- Alongside ascendant prices, transaction volumes continue to mostly move sideways. Volumes rose 24% during Q2, giving back some of the sharp 36% decline in Q1. Overseas investors sold more properties than they purchased in Q2 for the first time in seven years.

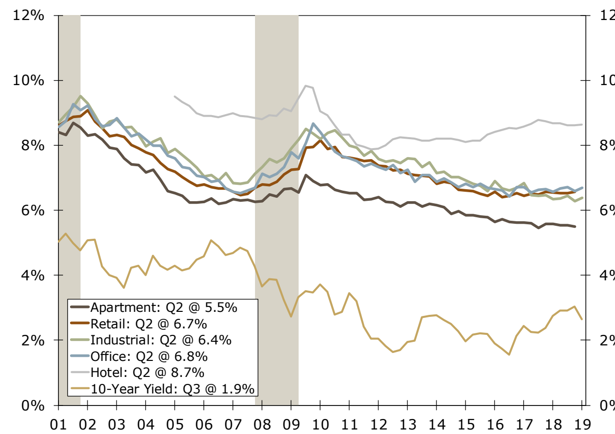
CRE Asking Rents
Year-over-Year Percent Change



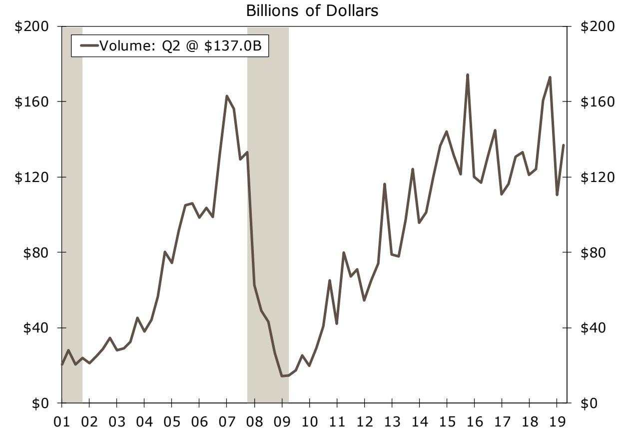

Commercial Property Price Index
Index, 100=2006



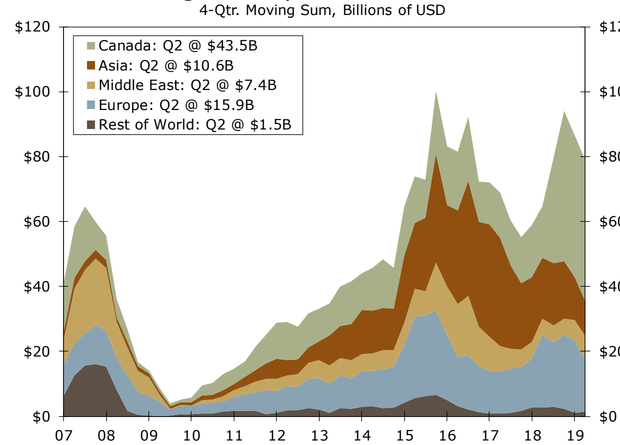

Cap Rates vs. 10-Year Treasury Yield




CRE Transaction Volume
Billions of Dollars



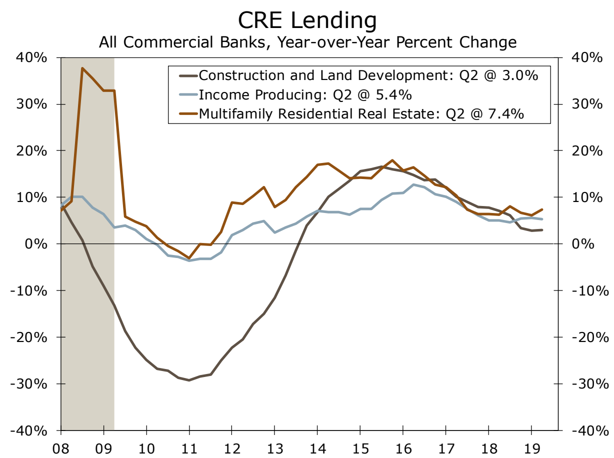

Origin of Capital into U.S. CRE
4-Qtr. Moving Sum, Billions of USD

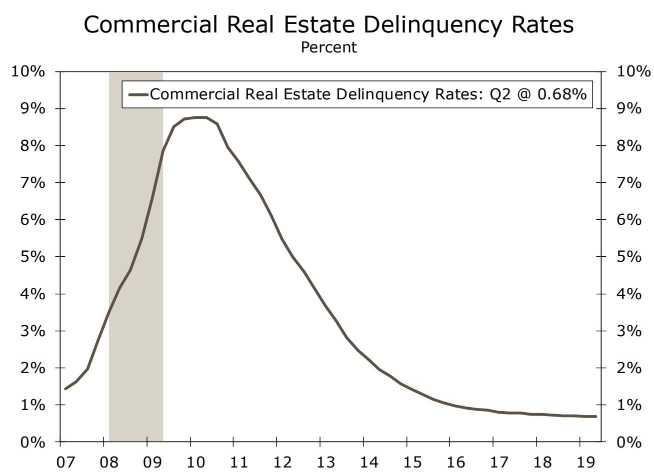


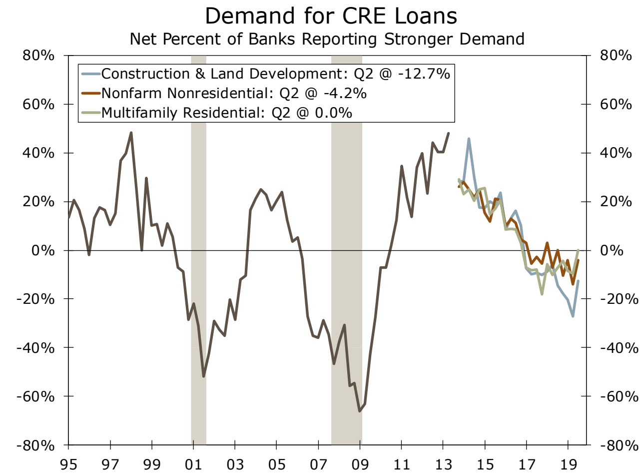

**Source: CoStar, Inc., Real Capital Analytics and Wells Fargo Securities**

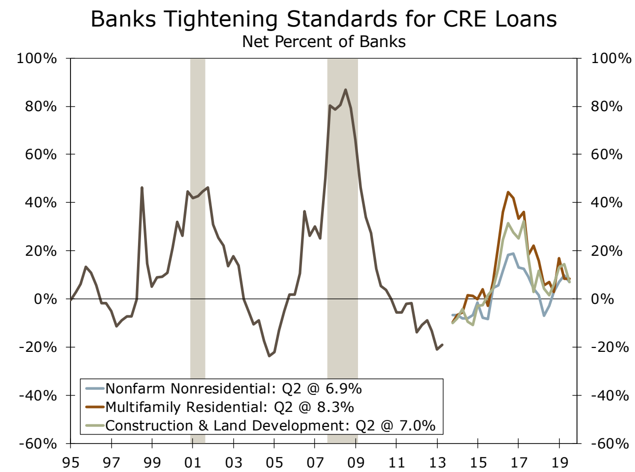
## Credit Availability & Lending

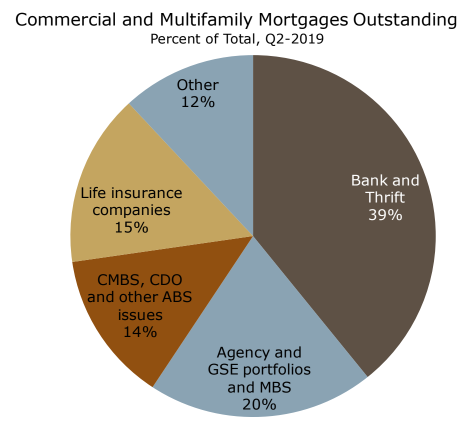
- A lower interest rate environment will likely lead to lower cap rates and continued price appreciation, which may give some lenders pause. Demand for CRE loans has increased since the Fed reversed policy earlier this year and began cutting rates. The proportion of banks tightening standards also fell in Q2, which may reflect banks becoming a bit more optimistic about real estate in a protracted low rate era.
- Commercial and multifamily originations surged in Q2, growing 29% relative to Q1. Over the past year, originations for healthcare properties have been particularly strong, leaping 151%. The yearly upshift was mostly through GSEs (19%) and commercial banks (17%), while life insurance (-4%) and CMBS (-17%) pulled back.



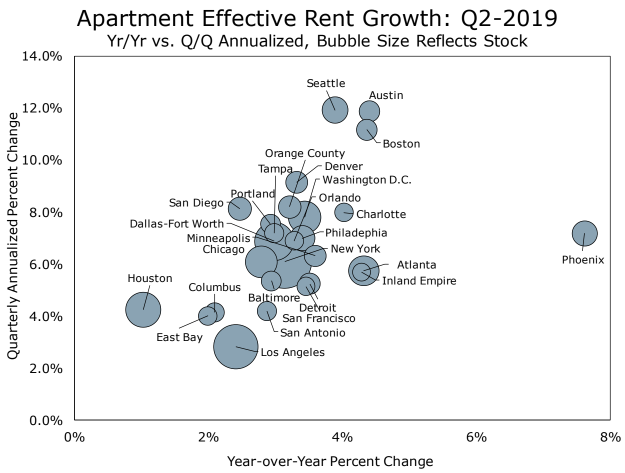



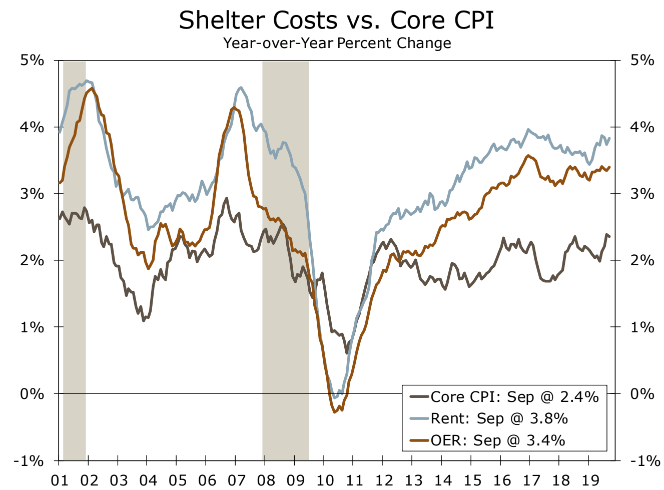



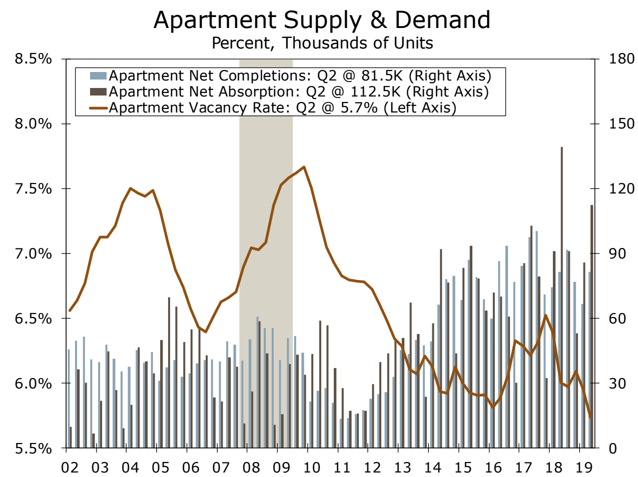

**Source: FDIC, FRB, Mortgage Bankers Association and Wells Fargo Securities**

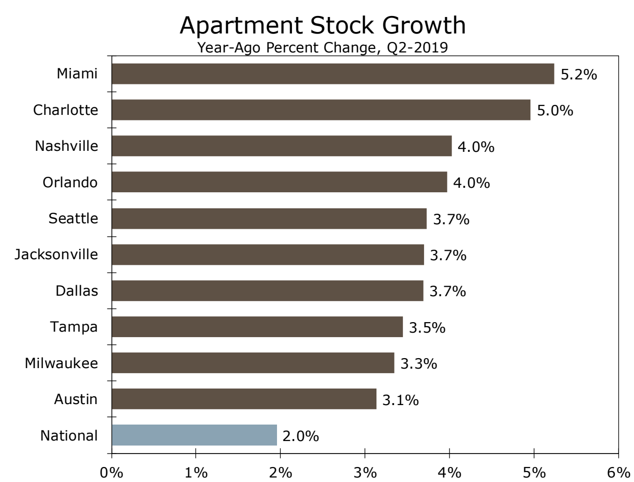
## Apartment

- Demand for apartments continues to surpass expectations. More than 112,000 units were absorbed in Q2, the second strongest quarter since 2000. Leasing tends to pick up in the spring and early summer and cool in the fall and winter, which points to softer demand in the second half of the year. We suspect a more sustained downshift in coming years as sliding mortgage rates, slower home price appreciation and faster income growth persuade more renters to become homeowners.
- New completions were not as strong as demand in Q2, which helped push the vacancy rate to a new cycle low of 5.7%. Still, the multifamily construction pipeline remains robust. On a year-to-date basis, multifamily permits are running slightly ahead of their strong 2018 pace, with the South accounting for virtually all of the growth. Despite the strength there are signs apartment construction is topping out, as the number of new starts has flat-lined compared to last year. Although still elevated, construction in higher priced markets in the Northeast has been slowing for a while. Starts have also cooled in the West, which is particularly exposed to the slowing global economy and hiccups in the IPO market.
- Rents rose 3.4% year-over-year in Q2, marking the fifth straight quarter of growth above 3%. Continued rent increases have spurred policymakers in California to try rent control, joining Oregon and New York in regulating landlords statewide. Those three states have some of the most acute affordability challenges.



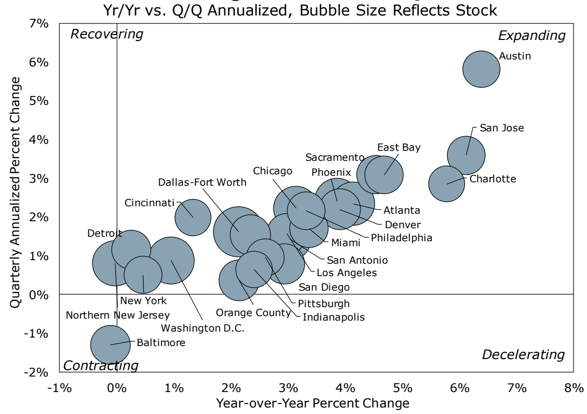




**Source: CoStar, Inc., U.S. Department of Labor and Wells Fargo Securities**

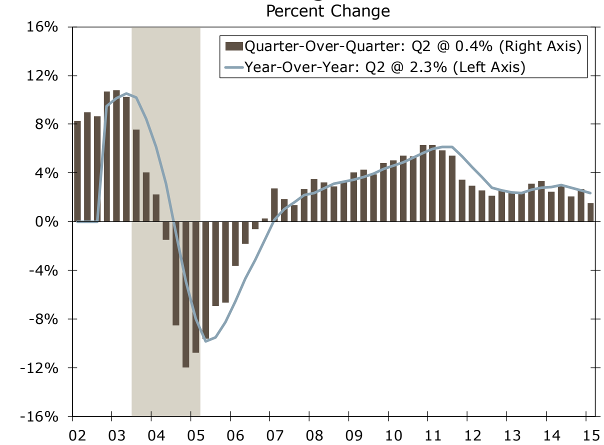
# Office

- Demand for office space continues to moderate alongside slowing employment growth. In Q2, net absorption rebounded to 23.7 million sq. ft. However, this strong performance follows the weakest quarter since 2010. New office development has been restrained, which, alongside sturdy demand, has led to a gradually declining vacancy rate, which hit a cycle low of 9.6% in Q2.
- We expect employment growth to moderate further this year, as slowing global economic growth and tight labor markets restrain a more robust pace of expansion. Growth in office-using employment has generally outperformed other sectors, with the slowdown being mostly confined to the export-exposed manufacturing, trade and logistics industries. Evidence is beginning to emerge, however, that service sectors will soon feel these headwinds, and demand for office space should also moderate.
- Tech continues to drive much of the growth in new construction, particularly in the more affordable Sun Belt markets of Austin, Charlotte, Nashville and Raleigh. Co-working space is expanding very quickly in these areas. Skeptics have recently noted the rise of flex space may pose a threat to CRE and the financial system more broadly. We doubt this is the case, as flex space comprises just 2% of total inventory. Even in the largest co-working markets such as New York and San Francisco, the relative proportion is small.

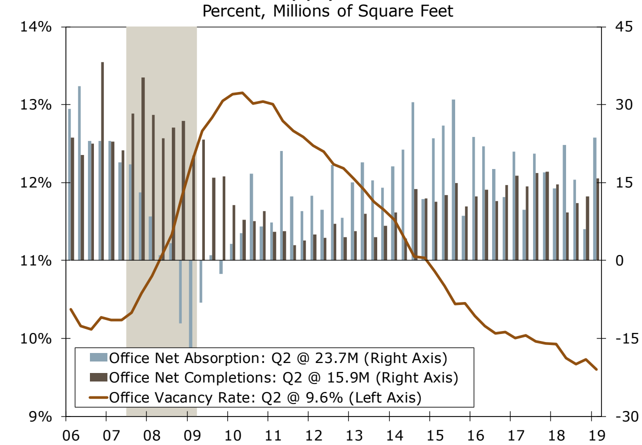
Office Asking Rent Growth: Q2-2019
Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock



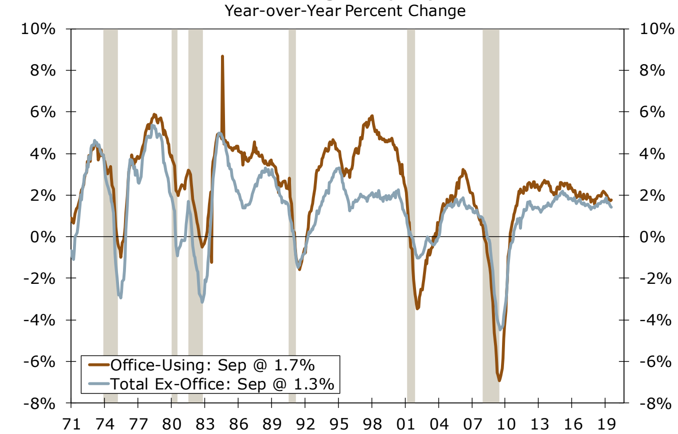

Office Asking Rent Growth
Percent Change




Office Supply & Demand
Percent, Millions of Square Feet




Office-Using Employment
Year-over-Year Percent Change

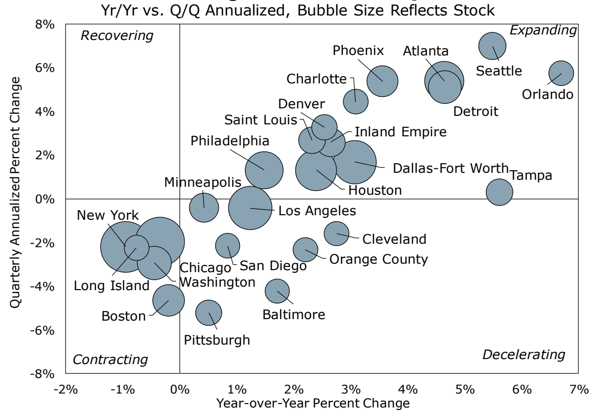



**Source: CoStar, Inc., U.S. Department of Labor and Wells Fargo Securities**

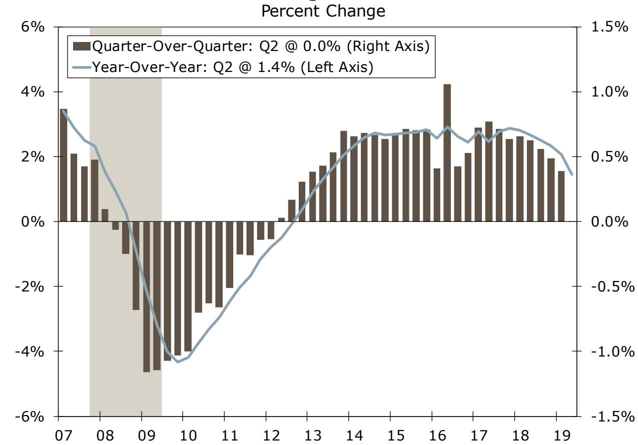
## Retail

- Retail development remains stuck in low gear. Total net absorption followed up a dismal Q1 (5.2 million sq. ft.) with an even softer Q2 (4.8 million sq. ft.), which marks the weakest two consecutive quarters since the recession.
- The slowdown in the cyclical and tradable sectors, such as manufacturing and warehousing & distribution, has not fazed the consumer to this point, which is keeping retail afloat. A historically tight labor market is pushing wage growth higher, and household balance sheets remain healthy. Consumer confidence, as measured by the Conference Board and the University of Michigan, remains near cycle highs but has moderated due to market volatility.
- There are some pockets of strength around the country, typically in markets with strong population, employment and income growth. Florida is a notable standout. Helped by strong growth in visitor spending and tourism, there are massive amounts of new retail properties under construction in Miami, Fort Lauderdale and Jacksonville, while Tampa and Orlando lead all major metros in terms of rent growth, each rising at an above-6% yearly pace. The benefits of tourism can also be clearly seen in Las Vegas and Nashville, with rents up well above average in both markets. The sky-high rents of New York City continue to fall, but that is not enough to impede the roughly 7.7 million sq. ft. of retail space currently under construction.

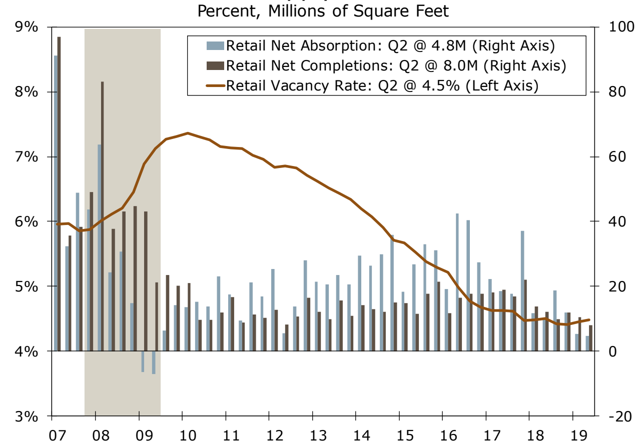
Retail Asking Rent Growth: Q2-2019
Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock



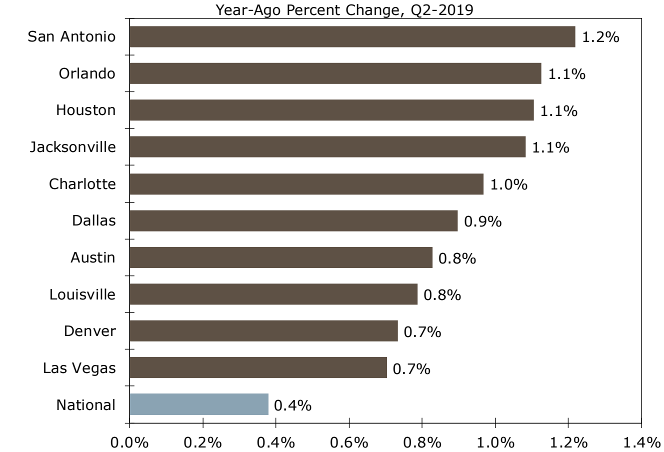

Retail Asking Rent Growth
Percent Change




Retail Supply & Demand
Percent, Millions of Square Feet




Retail Stock Growth
Year-Ago Percent Change, Q2-2019

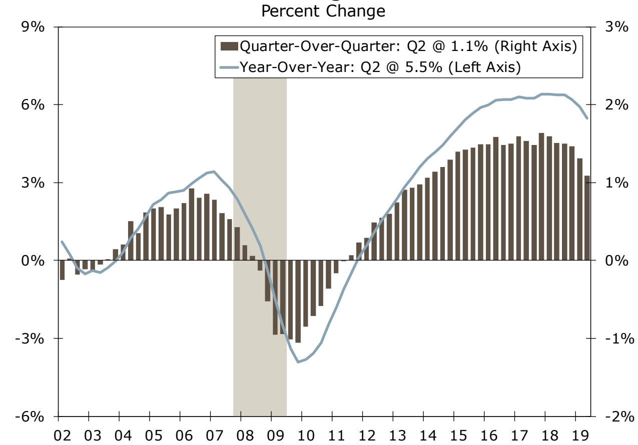



**Source: CoStar, Inc. and Wells Fargo Securities**

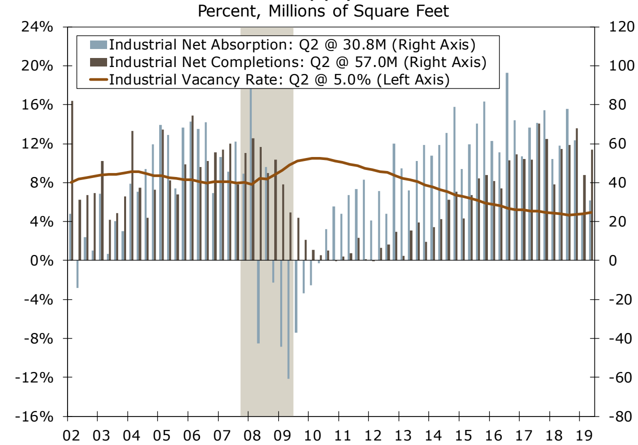
## Industrial

- The industrial market is feeling the heat from ongoing trade uncertainty and slowing global growth. With global export volume falling and the ISM manufacturing index now solidly in contraction territory, demand for industrial properties has cooled. In the first half of 2019, net absorption was just 54.4 million sq. ft., the softest start to the year since 2010.
- That noted, leasing volume has been significantly stronger, which points to the slowdown being only temporary. Amazon continues to expand its footprint and leased a 2.5 million sq. ft., four-story fulfillment center in Tulsa which is expected to employ 1,500. The nation's fastest growing industrial markets continue to see a flurry of activity. Plastic Express will take a 1.1 million sq. ft. warehouse in Savannah, while Ross Stores, TJ Maxx and HomeGoods are expanding their footprint in the Inland Empire.
- The overall industrial vacancy rate ticked up to 5.0% in Q2 but remains well below its long-term norm, reflecting nearly a decade where demand has outpaced supply. The continued shortage of desirable properties may be leading operators to pull back and wait for a new buildings to come online. Net completions moderated as well, although there is still a massive amount of new construction slated to be completed in 2019. The number of completions is expected to double during H2-2019. Rent growth also eased, but prices remain up a solid 5.5% over the past year.

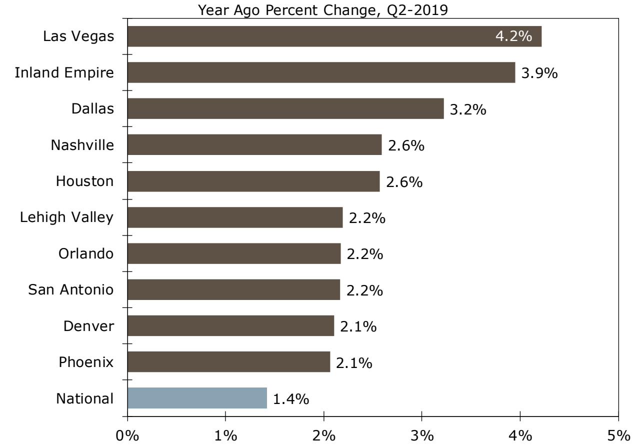
Industrial Asking Rent Growth
Percent Change



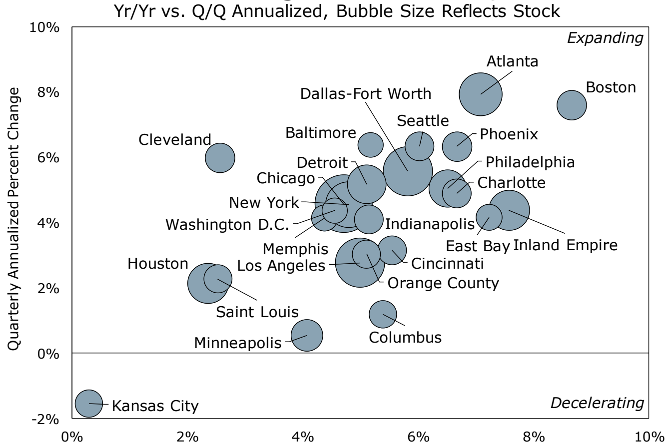

Industrial Supply & Demand
Percent, Millions of Square Feet




Industrial Stock Growth
Year Ago Percent Change, Q2-2019



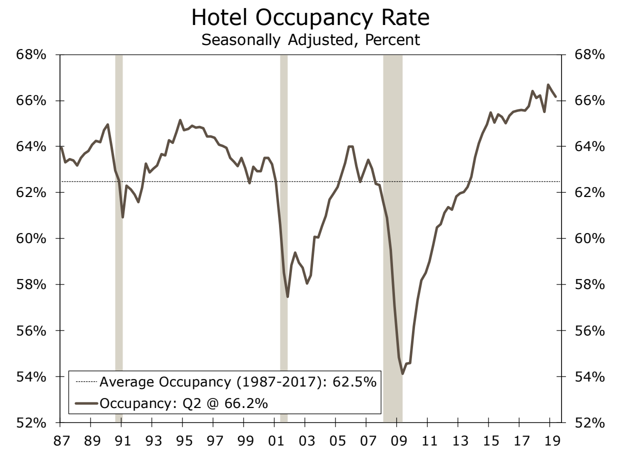

Industrial Asking Rent Growth: Q2-2019
Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock

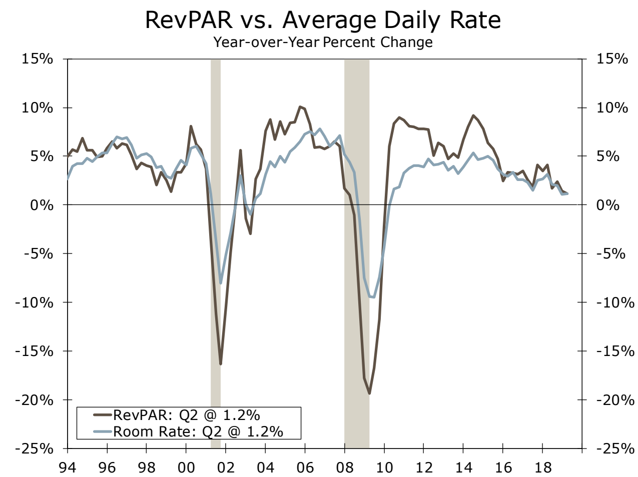


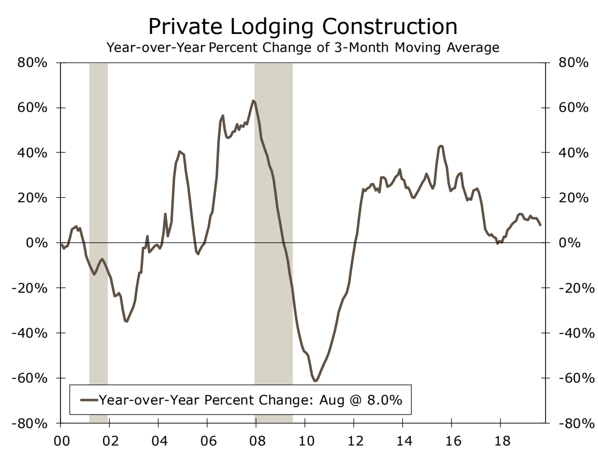

**Source: CoStar, Inc. and Wells Fargo Securities**

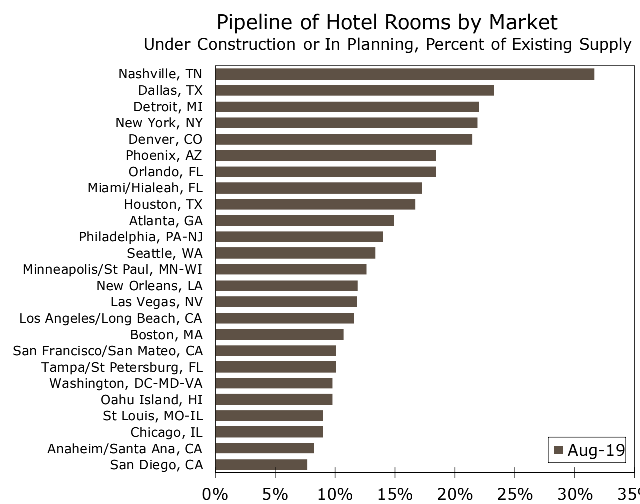
## Hotel

- The hotel industry is holding up well, as overall economic growth moderates. Even with a wave of supply hitting many of the largest hotel markets over the past three years, the industry occupancy rate remains well above its long-term average, falling just slightly to 66.2% in Q2. The new supply, as well as the growing role of online hotel resellers and home rental services, continue to restrain RevPar growth, which moderated to 1.2% in Q2, the slowest pace in over a decade.
- Mediocre RevPar growth may be causing operators to reevaluate their expansion plans as construction has cooled a bit compared to the breakneck pace of recent years. Spending on lodging projects, which includes hotels, motels and resorts, eased to a 3.8% year-over-year pace in August. A shortage of construction workers is a major factor and is delaying projects. Much of the growth in lodging construction spending is the result of large scale renovations to both modernize and "Millennialize" existing properties. Marriot's renovation of the Phoenix Sheraton Downtown and Chicago JW Marriot are well underway, while the Borgata in Atlantic City recently began work on a new lobby bar, VIP check-in and suite redesign.
- The combination of slowing growth overseas and strengthening dollar has taken the wind out of the sails of international tourism. Nonresident arrivals into the U.S. has declined on a year-over-year basis in five of the first six months of the year through June.




**Source: STR, U.S. Department of Commerce and Wells Fargo Securities**

## Wells Fargo Securities Economics Group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