SPECIAL REPORT

Investing in real estate:

The outlook for 2015 and beyond

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Real estate on the rise

What do the property markets have in store for 2015 and beyond?

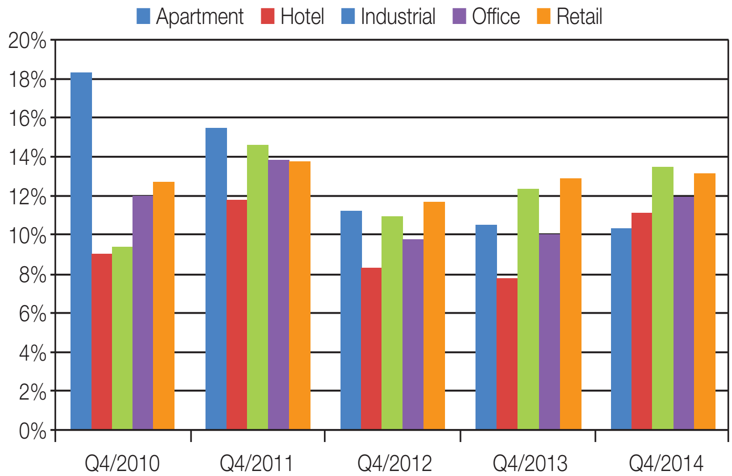
by Matt Hudgins

The commercial property types regrouped on solid ground in 2014 after climbing back from the pit of lost values, deflated pricing and stagnant transaction markets set off by the Great Recession. From multifamily's long-standing growth run to the office market's plodding gains in tenant demand and retail's bifurcated efforts to pursue changing consumer spending habits, the property types had all found sufficient footing by the end of the year to generate meaty investor returns.

"Industrial properties, mainly warehouse, had the highest price appreciation and highest return for 2014 followed by retail, office and then apartment," observes Jeffrey Fisher, professor emeritus at the Indiana University School of Business and a research consultant to the National Council of Real Estate Investment Fiduciaries (NCREIF). "All [property types] had returns over 10 percent for the year on an unleveraged basis."

The NCREIF Property Index pegged total returns for the year at 11.82 percent, including a 5.36 percent income return and a 6.21 percent appreciation return, assuming all-cash property purchases. But with current low interest rates, NCREIF members that used leverage to acquire assets raked in considerably more; the index showed leveraged returns at nearly 18.7 percent for the year, outpacing the S&P 500 Index's 13.7 percent return for the same period.

Property type total returns — annual returns over last five years



Source: NCREIF Property Index

"Private real estate has been very competitive," Fisher says, summarizing the sector's overall appeal to investors. "And real estate offers diversification benefits, and a potential inflation hedge if and when inflation comes back."

Investors seem to agree. Commercial real estate transaction volume swelled to $423.8 billion in 2014, up 17 percent from the previous year and on a par with 2006 levels, according to New York City–based Real Capital Analytics, which tracks property sales valued at $2.5 million or more. That does not eclipse the record volume of $570 billion recorded just before the downturn, but that total reflects a rush of portfolio deals including the $39 billion Equity Office Properties Trust sale, which skewed the numbers in 2007, observes Jim Costello, senior vice president at RCA.

"When we strip that [portfolio volume] away and look at individual asset sales, that's where people are going in and buying buildings by thinking about the revenue stream, and that's what most investors are doing today," Costello says. "We're now at the previous level of transaction volume for individual asset sales."

From recovery to sustainable growth

Transaction volume was not the only milestone the industry passed in 2014. RCA reported that the Moody's/RCA Commercial Property Price Index, which is based on RCA's data, will likely show that aggregate real estate prices at the end of 2014 surpassed their 2007 peak. "Prices grew across the board in the year," Costello says. "Some have moved past previous peak levels, but not everything has."

Indeed, the apartment sector overtook its pre-recession price peak more than a year ago and climbed another 15 percent over the course of 2014, RCA found. Office pricing as a whole has regained its pre-bust level, while suburban office has struggled and remains 17 percent below its previous peak. Retail pricing still lags its previous peak pricing by nearly 15 percent, Costello says. Hotel pricing is 12.7 percent below its previous peak; and industrial pricing is only 6.1 percent below its earlier peak pricing.

Investment activity is settling down, however. Transaction volume grew just 5 percent year-over-year in the fourth quarter, far less than the gains in excess of 20 percent posted in each of the previous three quarters. “The rate of growth is slowing, which makes sense because we’re so close to the previous peak levels,” Costello says. “2011 and 2010 were the years for excessively high volume gains, and it has been steadily moving downward since then as things become priced more competitively. We had all this distress in the market, but that’s been cleaned up.”

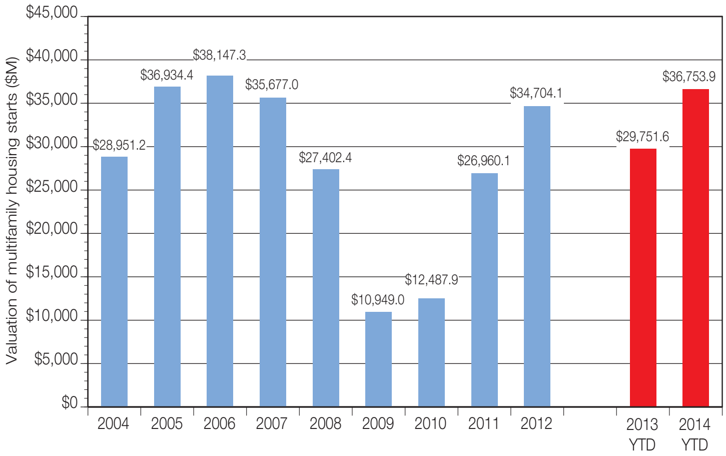
As investors slow down to catch their breath and ease the upward pressure on prices, investor returns over the next several years will more closely reflect net operating income, according to observers including Fisher, the NCREIF adviser. “Long term, I would expect [annual] returns to be more like 10 percent for commercial real estate on an unleveraged basis,” Fisher says. “Apartments may be a little lower since they are more liquid and a little less risky in general than the others. Hotels would tend to be a little riskier since they involve more of a business component and no leases.”

Clearly, investors and their advisers need a firm understanding of the property fundamentals affecting the property types in 2015 and beyond. The following sections encapsulate the current dynamics in the multifamily, retail, industrial, office and hotel subsectors, along with observations from industry experts about what those conditions portend for investor returns during the next two to three years.

Supply-side risk emerging for multifamily

Apartment investors’ unleveraged average return of 10.29 percent in 2014 was the lowest return among the major property types, according to NCREIF, but do not take that as a weakness. Multifamily has already logged several years in the number one spot for returns since the recession, and the other property types are stealing the spotlight as they catch up.

Value of multifamily starts hits $36.7 billion, nearing previous peak



Source: Jones Lang LaSalle

Buyers snapped up more than $110.1 billion of multifamily properties in 2014, an all-time high that surpassed the previous year by 10.6 percent, according to Jones Lang LaSalle, a global commercial real estate services firm. Nearly half of that volume occurred in New York City, Los Angeles, Atlanta, Dallas, Houston and Washington, D.C. — all markets where apartment cap rates have fallen below 5 percent on some deals.

Low unemployment of 3.2 percent for white-collar jobs is beginning to drive up wages, which climbed to 2.2 percent from 2.0 percent recently, says Sean Coghlan, head of multifamily research at JLL. Coupled with a demographic shift away from homeownership, that growing income will help to fuel rental household formation. “Anecdotally, people are increasingly valuing flexibility, and many don’t view the American Dream as owning a home, as we were used to for the last 40 to 50 years,” Coghlan says.

Nationwide, apartment occupancy held at 95.8 percent at the end of 2014, according to New York City–based researcher Reis. Strong renter demand enabled landlords to raise asking rents 3.4 percent in 2014, the fastest annual increase since 2007, and effective rents climbed 3.6 percent, Reis found.

Although the apartment occupancy rate was unchanged from a year earlier, supply pressure is beginning to dampen rent growth in some markets, says Victor Calanog, Reis’ chief economist. “As long as we’re creating between 200,000 and 250,000 jobs per month, I don’t see demand flagging for multifamily rental,” Calanog says. “Where we will see the balance change, with occupancy deteriorating and rent growth slowing relative to the rest of the country, is in those places where supply growth is outstripping demand. Washington, D.C., is a prime example." Landlords in the nation's capital have begun offering shopping gift cards worth $100 to $500 as an incentive to new renters, Calanog says.

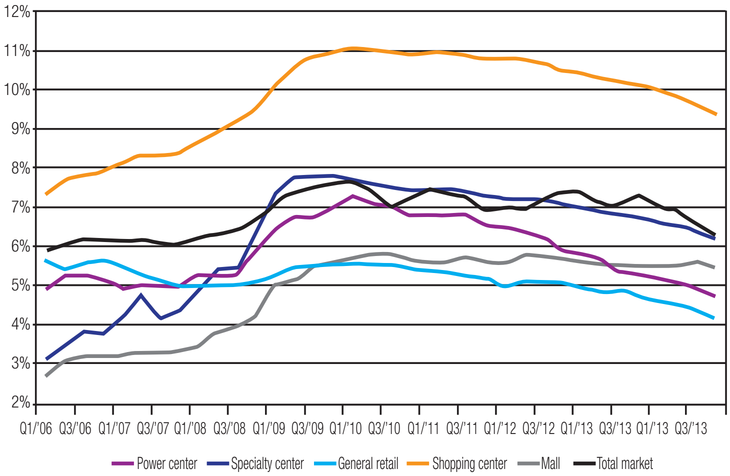
While occupancy has not declined nationally, rapidly expanding supply is a growing risk at the market level. Developers cranked out more than 160,000 apartment units in 2014, and Reis expects construction to add another 230,000 units this year. That will slow the pace of rent growth in most markets, with a few pockets where rents may briefly stagnate or decline while new supply is absorbed. Reis calls for the national apartment occupancy rate to decline slightly this year and to remain between 5.5 percent and 6 percent through 2019, just above the long-term average of 5.4 percent.

"I'm not crying a river for multifamily," Calanog says. "With that caveat said, as a lender or investor, you may have to temper your most optimistic assumptions. Don't underwrite a deal that calls for vacancies to fall over the next five years."

Retail's troubled triumphs

Retail provided investors with a 13.12 percent return in 2014, second only to industrial properties, according to NCREIF. The property type also generated the largest gain in transaction volume, mushrooming 31 percent from the previous year to close out 2014 with $82.6 billion in deals, according to RCA. That volume surpassed the previous peak volume of $81.4 billion, set in 2007.

Retail vacancy rates by building type, 2006–2014



Source: CoStar Property

Some 24 million square feet of net absorption in the fourth quarter pushed vacancies down 20 basis points to 6.3 percent, the lowest rate in more than six years, according to CoStar, a market researcher. Rents grew by 3 percent for the third straight quarter. Yet retail property fundamentals lack some of their pre-recession luster.

Significantly, and despite more than a 5 percent improvement in asset prices from a year ago as measured by the Moody's/RCA index, retail pricing is down nearly 14 percent from the peak price level achieved before the financial crisis in 2007. That makes retail the furthest behind its previous peak, RCA reported.

Several forces are holding back NOI and value appreciation, contends Ryan McCullough, senior real estate economist at CoStar Group. "Vacancies have essentially recovered to pre-recession levels, now 6.3 percent, so on that basis it would seem this market is fine and dandy," McCullough says. "In reality, rents are still significantly below where they were pre-recession."

For one, the replacement of high-dollar retailers that closed their doors during the recession, such as Best Buy, with lower-priced retailers has reduced the income capacity of many shopping centers. That is due in part because retail tenants often pay percentage rent, in which the retailer shares a portion of its sales revenue as part of its rental obligation to the landlord. A store with higher sales volume will pay more rent than a store with lower sales volume.

The leasing of a former Best Buy space to a Dick's Sporting Goods or Petco, for example, illustrates the effect of the changing tenant base on rent at a typical shopping center, observes Ryan Severino, a senior economist at New York research firm Reis. "I can't imagine a pet store or sporting goods store generating sales like Best Buy did back in the day," Severino says. "Some pieces of sporting equipment might be expensive, but it's not like buying a TV or home theater."

Severino has noticed reduced demand for neighborhood and community shopping centers since the recession, and attributes the decline to the 15-year growth of lifestyle centers, town centers, power centers and outlet centers. "That's undoubtedly siphoning sales away," Severino says.

Investors considering a bargain-priced retail acquisition must determine whether the high cap rate is due to cyclical — and therefore temporary — reasons or because of more permanent conditions, such as falling out of step with consumers. To help retail investors avoid acquiring an obsolete property, McCullough advises them to ensure the trade area offers good density, with job growth and a concentration of affluent shoppers. Additionally, they should avoid an overreliance on baby boomers in the consumer base because that group is moving toward retirement and a fixed income.

And retail investors should pay extra attention to tenant selection. "It's a Darwinian process we see happening today, in large part driven by the rise of the Internet," McCullough says. "We don't see the Internet as wholly a threat to bricks-and-mortar retail; what it is changing is the way retailers operate. The ones that are able to effectively omnichannel, or have in-store and online channels complement each other, are going to survive and will become stronger."

Investors grow endeared to industrial

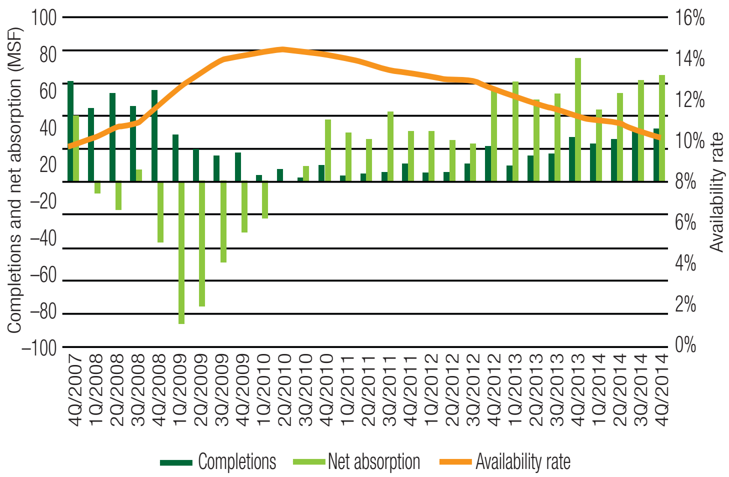
Industrial real estate generated an annual return of 13.42 percent in 2014, making it the returns leader among the property types, according to NCREIF. Industrial also exhibited the sharpest decline in cap rates, which fell an average of 40 basis points for the year. Prices have climbed to within 5 percent of the pre-recession peak as measured by the Moody's/RCA index. Transaction volume was $54.2 billion in 2014, up 13 percent from a year earlier, states RCA.

The investor fervor for industrial space reflects the property type's improving fundamentals, characterized by 19 consecutive quarters of positive net absorption and a vacancy rate that fell to 10.3 percent at the close of 2014, down 90 basis points from a year earlier, according to CBRE, a global commercial real estate services firm. Rents grew a hefty 4.7 percent over the course of the year to $6.01 per square foot, CBRE found, with the strongest rent growth in Oakland, Calif.; San Antonio; suburban Maryland; and the San Francisco Peninsula.

"Overall, the appreciation in the value of the U.S. dollar will benefit industrial demand because imports are a better indicator of industrial demand than exports," says Spencer Levy, Americas head of research at CBRE. "The industrial story from a currency standpoint is a very strong one."

The most popular distribution properties, among both developers and tenants such

U.S. industrial supply and demand



Source: CBRE Research

as Target and Walmart, are massive distribution centers measuring 1 million square feet or more. The most likely users for these largest of the large distribution centers have been online retailers such as Amazon.com. Now, however, brick-and-mortar retailers are taking mega-box industrial space to establish their own fulfillment centers for online sales, Severino observes.

"Retailers don't want to get caught flat-footed, and they know the Internet is going to be a part of their sales going forward," Severino says. "Big-box distribution centers are becoming the malls of the future to some extent; all of those goods that would once have been on store shelves are sitting in a warehouse, waiting for [an online or omnichannel retailer] to send it to you within 24 hours."

CBRE's Levy believes the biggest rent gain in 2015 will be for light industrial buildings measuring 250,000 square feet or less. Though too small for a giant fulfillment center, these smaller buildings enable Internet retailers to locate their distribution closer to dense urban centers, shortening delivery times to the consumer and moving closer to the holy grail of online sales: same-day delivery. "Internet retailers are popping up in industrial sites more and more frequently," Levy says.

Since the recession, warehouse/distribution buildings have enjoyed the greatest demand among industrial subtypes, observes Calanog, at Reis. Demand for flex and research and development space, which can be finished out for industrial or office use, is tied more closely to specific markets, especially technology hubs such as San Francisco.

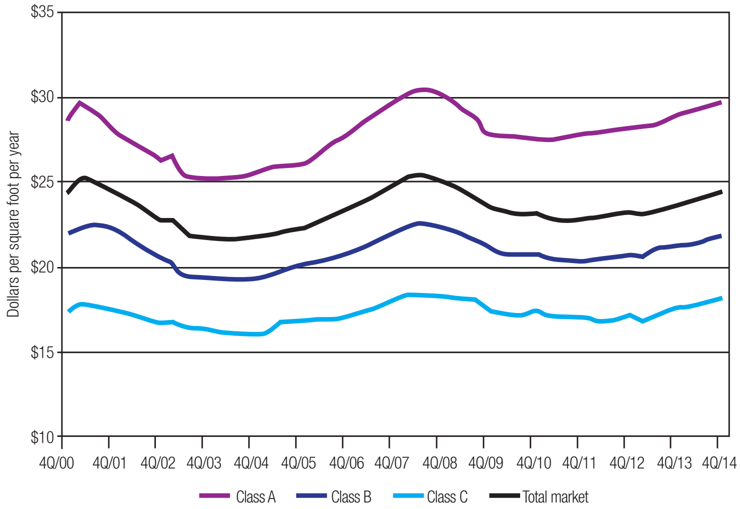
"What's keeping flex/R&D from recovering much are the same factors that are keeping office in the doldrums," Calanog says. "We aren't seeing as much job growth in the office-using segment. While this should pick up with healthier employment growth, it is keeping the recovery for flex/R&D relatively modest."

Headwinds abate for office properties

Office properties generated returns of 11.5 percent in 2014, NCREIF reported. Of that annual return, 6.1 percent reflects value appreciation and the remaining 5.2 percent is from property income.

Office-using job creation topped 3 percent in 2014 and is at long last accelerating the demand for office space, with tenants soaking up available space and even calling on new construction to meet their needs. New signed leases pushed net absorption to 52.5 million square feet in 2014, the strongest annual performance since the Great Recession and above the long-term annual average of about 40 million square feet, according to CBRE.

Historical office rental rates based on full-service equivalent rental rates



Source: CoStar

Absorption helped to bring the national vacancy rate down 100 basis points from a year earlier to end 2014 at 13.9 percent, or 11.1 percent in the nation's central business districts and 15.5 percent in the suburbs. Rents averaged $28.30 per square foot at year's end, and after 15 consecutive quarterly increases, the national average is only 240 basis points below the previous peak set in 2008, noted CBRE.

The recent year's performance aside, absorption has been sluggish in this cycle as office-using companies have backfilled or subleased their own unused space, as well as squeezed in more employees per square foot as part of emerging work practices that favor project rooms and group areas over individual offices and cubicles.

With these twin dampers on demand, a slow development pipeline has been a saving grace to avoid a crippling oversupply of office space; developers added 22.2 million square feet of multi-tenant office space in 2014, which is only half of the long-term average, CBRE reported. "The single best piece of news this cycle, versus other cycles, is limited new development," says CBRE's Levy. "We've seen pockets of development, and we've seen build to suits, but so far we are well below the national average for construction."

Developers and investors have good reason to introduce high-quality projects, observes Walter Page, CoStar's director of U.S. research for the office market. Demand is twice as strong for well-located, high-end offices, and those properties will compete more effectively for tenants and rent gains than lower-quality digs.

"If you're going to take some type of risk, you might as well take it with nice space," Page says. "Fix it up, renew the lobby, put in nicer bathrooms or … re-skin the outside of a building. Those things all bring you increased rents but also make it easier to lease it up."

Construction volume already exceeds historical averages in roughly one-third of major U.S. markets, Page says, and that will increase to half of the country by 2017. "At that point, we will have a tipping point of rising vacancy rates and then slowing rent growth," Page predicts. "The number one market that's going to lead this is going to be Houston."

CoStar tracked rent growth of nearly 4 percent nationwide in 2014 and expects a similar performance in 2015, followed by slower growth of 2 percent to 3 percent in 2016. After that, CoStar calls for rents to rise at about the rate of inflation until the next recession. "We're very close to long-term averages," Page says, "and it's going to be a balanced market for the next two or three years."

Hotels on a hot streak

The U.S. hotel market generated stronger investor returns than any other property type in the fourth quarter of 2014 and appears to be on a multi-year run of above-trend demand and profit generation. For the year, hotel returns were less spectacular at 11.1 percent, NCREIF found, but the income component of that return at 8.2 percent was the strongest among the property types, underscoring the critical role of operations in generating the sector's returns.

And currently that performance is outstanding: The U.S. average daily room rental rate (ADR) has been rising at an accelerated pace to close out the year at an estimated $116.14, up 5.4 percent from a year earlier, according to PKF Hospitality Research, a CBRE company. Researchers attribute the rising trend to increasing demand for hotel rooms that is filling hotel rooms and enabling operators to charge more for those rooms, creating a double boost to revenues.

Daily room rates will climb through 2016 as occupancy moves up to 65 percent, surpassing the previous annual occupancy average of 64.7 percent set in 1995, predict PKF researchers in the company's *Hotel Horizons* report, published in December 2014.

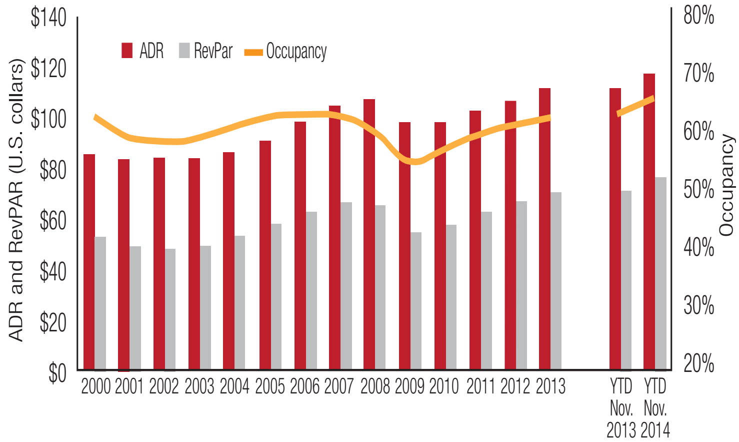
Driven by healthy rents and strong occupancy, average revenue per available room (RevPAR) is poised to increase at two to three times the rate of inflation through 2017, according to PKF. That should translate into double-digit annual growth in unit-level hotel profits for at least the next two years. "This six-year run of double-digit growth in profits is the longest observed by PKF-Hotel Horizons since it began collecting data in 1936," PKF researchers note.

Variables that investors should watch are the strengthening U.S. dollar and falling oil prices. Lower oil prices should boost hotel demand by making travel more affordable, Levy says. But a robust dollar may bite into demand for U.S. hotel rooms by foreign travelers, especially in the major gateway markets that depend more on international travelers. "Overall, the drop in the price of oil and appreciation of the U.S. dollar is good," Levy says. "But travelers from countries whose currency has devalued may find it much more expensive to come here, so luxury hotels may see some drop [in demand]."

Fortunately, U.S. hotels are the most domestic of the large global hotel markets, according to Lauro Ferroni, senior vice president of hotels research at JLL. That is in contrast with countries such as France and Spain, which rely more exclusively on international tourists for hotel demand. "Washington, D.C., is a global or gateway city, but it has less than 5 percent offshore traffic," Ferroni says. "So even if that slows a bit, the domestic engine we're experiencing should increase overall RevPAR."

Hotel values have climbed steadily during the recovery but at the end of 2014 remained 13.1 percent below the previous peak, according to RCA. Prices climbed 14 percent in 2014 alone, the company found.

U.S. historic lodging performance



Source: Smith Travel Research

Offshore capital to U.S. hotels increased 50 percent in 2014, and foreign buyers will increase their stake in the market in the coming years, Ferroni predicts, with investment by Chinese investment firms growing more than any other group.

Cap rates are low across the country, Ferroni says, but investors believe hotel asset values have room to grow and that means cap rates could further compress. Performance will vary from market to market and across classes, but the sector as a whole is on a positive track. "Supply is still lower than historic levels," Ferroni says, "demand fundamentals are strong, and we have a robust outlook in the number of transactions and capital coming into the U.S." ❖

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