SPECIAL REPORT

TD Economics

April 9, 2013

U.S. COMMERCIAL REAL ESTATE TO TAKE CUE FROM HOUSING RECOVERY

Highlights

- Commercial real estate (CRE) has mounted an impressive comeback over the last three years. Since reaching a trough in January 2010, prices have rebounded by 30%.
- Rising interest rates will make for a more challenging environment for CRE over the next several years, but aided by a resurgent housing market, the industry is up for it.
- Sequestration will slow demand for office space over the next year, but as the drag lifts, the sector will be supported by accelerated employment growth.
- Among CRE segments, the retail sector has the highest correlation to housing and was hit hard during the recession. As residential construction rises, demand for retail space will also improve.
- The industrial sector will benefit from an expanding manufacturing sector and increased international trade, especially with South and Central America.
- Apartments have been the fastest growing segment of CRE. Demand for apartments will remain robust and support continued investment in the sector over the next several years.

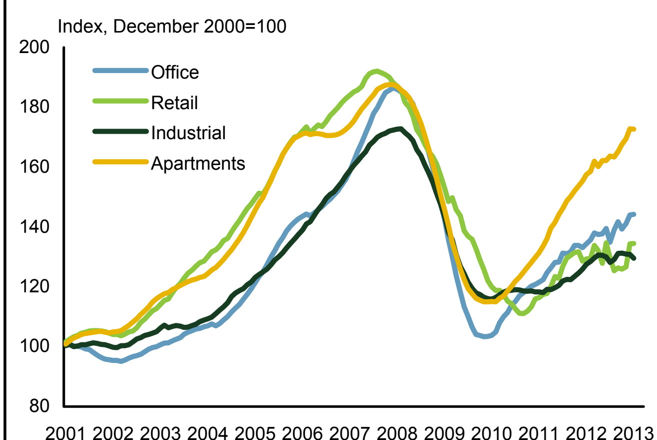
One cannot say much about the American economy without talking about real estate. The rise and fall of residential real estate is central to the story of the Great Recession. Commercial real estate (CRE) – retail, commercial, industrial and apartment properties – has received less attention, but it was also hit hard.

Supported by declining interest rates, the industry has staged a comeback over the past three years. The challenge over the next several years will be maintaining this momentum as interest rates rise. The year ahead will provide obstacles – particularly as the impact of sequestration is felt – but, led by the recovery in the housing market, prospects for commercial real estate are likely to continue to improve.

The U.S. economy is set to grow by 1.9% in 2013, restrained by the dual impact of tax hikes and government spending cuts. As the weight from fiscal consolidation lifts, economic growth will gain speed, reaching a pace of 2.8% in 2014.

Regionally, within TD's footprint, economic growth will be led by the South Atlantic, with New England and Middle Atlantic states seeing a slower economic and job recovery. This differential is likely to result in a faster improvement in vacancy rates and rents in southern markets relative to those in the Northeast. Areas more reliant on government outlays – such as Washington D.C. – will see a slower pace of improvement this year, but prospects

CHART 1. COMMERCIAL REAL ESTATE PRICES



Source: Moody's/RCA Commercial Property Price Index

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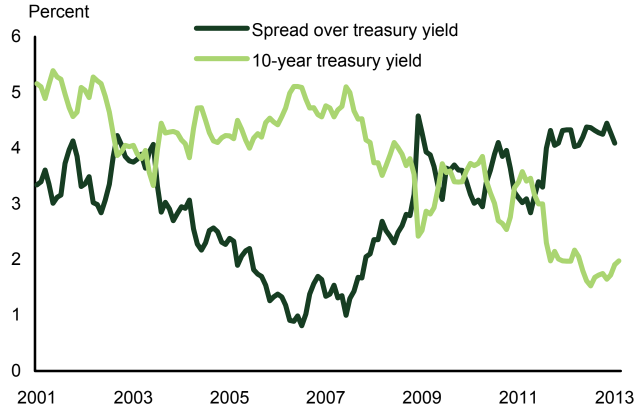
CHART 2. APARTMENT CAP RATE SPREAD OVER 10-YEAR TREASURY



Source: Federal Reserve Board, Bloomberg

should improve as the impact from fiscal consolidation lessens in 2014.

CRE's turnaround: jobs, but not just jobs

Commercial real estate is a highly pro-cyclical market and it was hit by a perfect storm during the recession. Not only was demand for commercial space pummeled as the U.S. economy shed 8.8 million jobs, but heightened risk aversion among investors and creditors led to a near-complete drying up of funding to the sector. The combination of these two factors led to an unprecedented drop in real estate values over the 2007 to 2010 period. Prices for commercial real estate fell by 40%, compared to 30% for residential real estate.

By the same token, the return to positive job growth and improvement in financial conditions explains the 30% recovery in prices that has taken place to-date. Since reaching a trough in 2010, non-farm employment has risen by 5.7 million jobs. The rebound in job creation has increased the demand for commercial space and led net absorption rates to turn positive across all commercial real estate sectors. In combination with limited new supply, this has led to a decline in vacancy rates.

However, job growth is not the only factor behind CRE's rebound. The low interest rate environment has also played a key role in bringing investors back into the market. Between 2007 and 2012, the yield on 10-year Treasuries fell by 285 basis points. As a result, the spread between commercial real estate yields (capitalization rates) and 10-year Treasury yields rose dramatically (see Chart 2), helping to attract investors in search of yield.

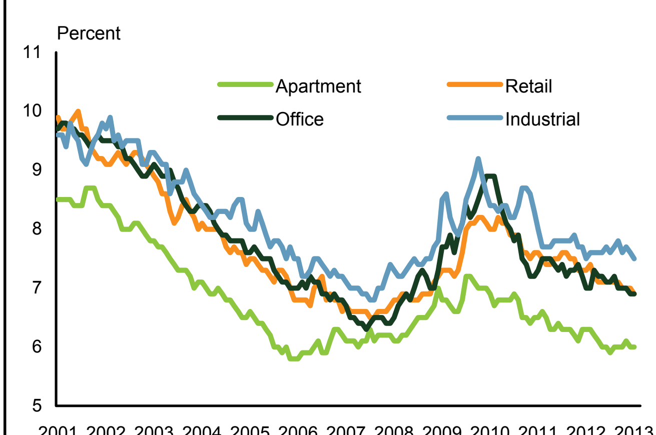
As interest rates rise, this spread will narrow and, eventually, put upward pressure on capitalization rates. Prospects for price growth will then depend on rising rents, which will require further improvement in vacancy rates. Given the outlook for job growth and a resurgent housing market, vacancy rates should move downward over the next two years. As long as the interest rate adjustment is relatively gradual, the ride should be smooth. The main downside risk to the outlook is that if interest rates rise abruptly, it could lead to losses on commercial real estate.

Prices have diverged between major and periphery markets

The improvement in commercial real estate spans across market segments and locations, but the real estate principle of location naturally still applies, with core markets outperforming the periphery by a wide margin. According to Moody's Analytics, commercial real estate prices have rebounded by close to 45% in major markets, but have risen at half that pace in non-major markets. As a result, prices are 9% below their pre-recession peak in major markets, but are still 29% below in non-majors.

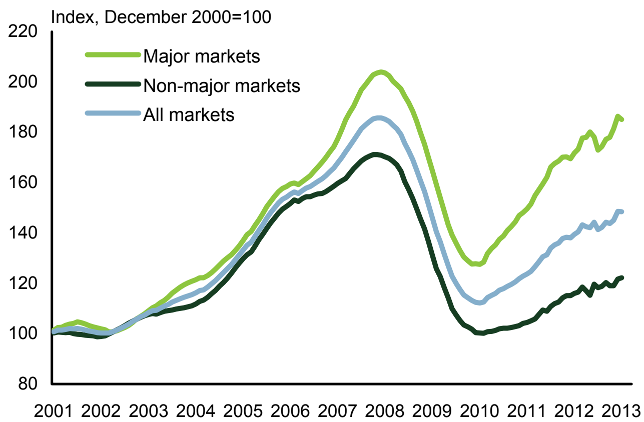
The divergence in prices is also evident between urban and suburban areas. The price of office buildings in core business districts (CBD) has rebounded by 74% from its trough and is down just 8% from the pre-recession peak, while the price of office buildings in suburban areas has risen just 14% and is still 37% below pre-recession levels. Drilling down even further, CBD offices in major markets have surpassed their pre-recession peak by 2.3%, while suburban offices in non-major markets have hardly grown

CHART 3. AVERAGE CAP RATES BY SECTOR



Source: Bloomberg

CHART 4. COMMERCIAL REAL ESTATE PRICES



Source: Moody's/RCA Commercial Property Price Index

at all and are still a whopping 42.8% below their December 2007 peak.

The unequal nature of the recovery is indicative of a market that has been driven by the search for yield, which has flown first to the largest and best understood markets. This should broaden out with time. Going forward, prospects for prices and rent growth will increasingly depend on economic fundamentals. As such, the large gap in prices that has emerged between major and non major markets and core and suburban areas is likely to narrow. The remainder of this report will consider the outlook for each market segment within commercial real estate.

Sequestration will hinder office employment in 2013

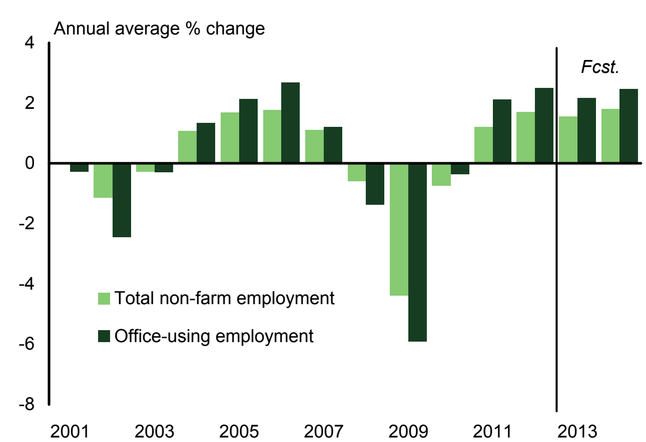
The office market was hit hard by the recession. While total non-farm employment declined by 6.3% during the recession, employment in office-using sectors – professional and business services, information, and financial services – declined by an even greater 8.3%. Unsurprisingly, vacancy rates for office space also rose dramatically, reaching 16.8% from 12.6% in 2007. Fortunately, as is often the case, office employment has recovered faster than non-office employment since the recession's end. As of February 2013, office employment was only 2.0% below its peak, compared to 2.3% for non-office employment.

Office employment is expected to continue to outperform overall employment over the next year, but will grow at about the same rate as it did in 2012. Similar to the outlook for overall job growth, the challenge for office-using employment will be the cuts to government spending, which will have spillover effects to the private sector – especially professional and business services.

Another challenge for the office sector is business efforts to reduce their real estate footprint. Smart-space design has reduced absorption rates even as employment growth has rebounded. This is particularly true of higher cost areas like New York City. Given the near term outlook for economic growth, businesses are likely to remain in consolidation mode over the next year. However, as the economic recovery strengthens and businesses increasingly turn towards expansion, this trend should ease and lead to a further improvement in vacancy rates.

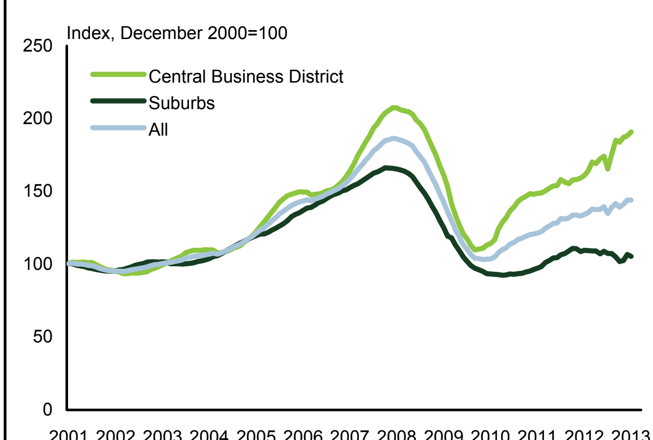
Office employment will continue to perform better in urban areas relative to suburban, but the outperformance of prices in downtown areas relative to suburban areas will

CHART 5. EMPLOYMENT GROWTH BY SECTOR



Source: Bureau of Labor Statistics, Forecast by TD Economics

CHART 6. OFFICE PROPERTY PRICES



Source: Moody's/RCA Commercial Property Price Index begin to diminish. While a price gap existed between offices in central business districts (CBDs) and suburban areas prior to the recession, it has widened considerably in the years since (see Chart 6). The gap that has emerged between prices is not nearly as pronounced for rents, implying a widening spread between office yields in CBD and suburban areas. Over time, this spread is likely to narrow back to more historic norms. Reflecting lower vacancy rates, rent growth in CBDs is likely to outpace that in suburban areas. At the same time, the higher spread is likely to draw investors to suburban areas, further helping to narrow the gap in prices.

Retail sector faces challenges, but should be supported by housing recovery

Of all the sub-sectors within commercial real estate, the one that has faced the most challenges is retail. Much of the difficulty faced by the retail market is a direct consequence of the recession and its concentration in the housing market. And, like the housing market, the greater hangover in the retail sector is the result of overbuilding prior to the recession. Elevated vacancy rates for retail space are due to positive net-completion rates at the same time that net absorption turned negative.

While construction activity has now been reduced, absorption has been slow to pick up. The tepid rise in absorption for retail space is due in large part to the slow nature of the consumer recovery, but also to the growth of online shopping that has increased competition with traditional bricks and mortar retail space. While online competition will continue to be a headwind for the retail sector, the outlook is still positive, given its close correlation with housing. Growth in retail investment tends to follow residential investment with a lag of about a year, and housing is expected to grow by over 15% over the next two years.

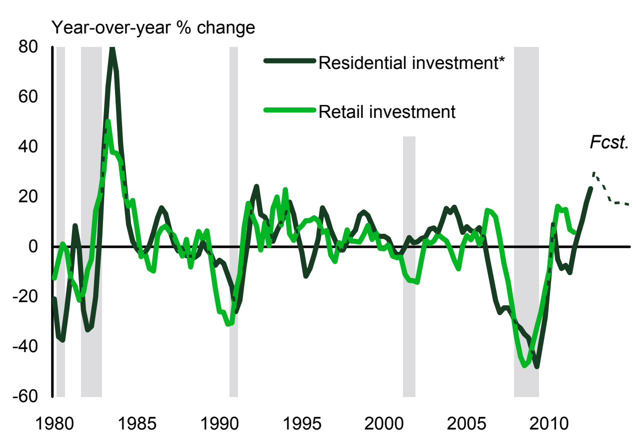
Similar to the outlook for offices, opportunities in retail space are likely to expand outside of the urban core to suburban areas. While the housing recovery to-date has been driven by multi-family construction, several years of under building have left single-family market ripe for recovery, which will also increase demand for retail space in lower density areas.

Manufacturing resurgence will give support to industrial sector

Just looking at vacancy rates, industrial properties have outperformed both retail and office properties. From a high of 14.6% in June 2010, the vacancy rate for industrial space fell to 12.8% in the fourth quarter of 2012. Some of the difficulty faced by retailers has benefited the industrial sector by increasing demand for warehousing space from online retailers. This is a trend that will likely continue in the years ahead.

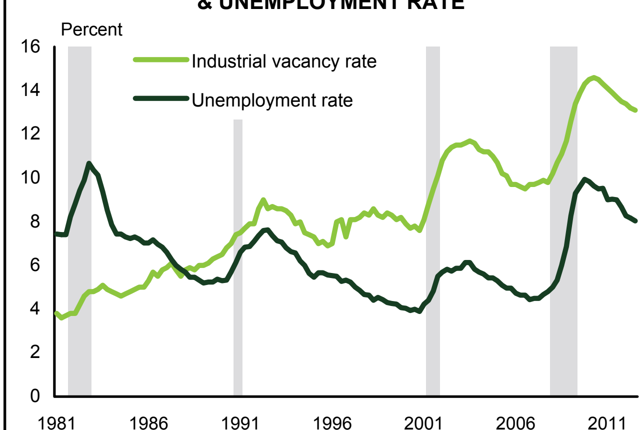
Demand for industrial space should also continue to be supported by growth in U.S. manufacturing. Amidst the cyclical recovery, a secular shift is occurring in manufacturing that is leading the sector to expand capacity and add jobs in a way that it has not done in more than a decade. This manufacturing resurgence is supported by low energy costs due to the shale gas revolution and the manufacturing sector's increasing competitiveness relative to its international peers (see report).

CHART 7. STRUCTURES INVESTMENT



*Ahead one year. Source: Bureau of Economic Analysis

CHART 8. INDUSTRIAL VACANCY RATE & UNEMPLOYMENT RATE



Source: Bureau of Labor Statistics, Bloomberg

Growth in manufacturing will benefit coastal markets that are more exposed to foreign trade. U.S. exports are likely to be one of the fastest components of overall economic growth over the next several years. Moreover, the patterns of trade are more likely to shift to greater trade with North, Central and South America, creating opportunities for regions that are more oriented to north-south trade.

Nonetheless, despite an overall good news story, the industrial sector will not be immune to the relatively slow pace of overall economic growth over the next year. The vacancy rate for industrial properties has a close relationship to the unemployment rate (see Chart 8). The unemployment rate is expected to average 7.7% in 2013, edging up from the 7.6% rate reached in March. The lack of improvement in unemployment is also likely to slow the recovery in industrial vacancy rates. This should prove temporary, and stronger growth in both the U.S. and its global trading partners will lead to greater improvement in 2014.

Apartment sector still has room to grow

While demand for retail, office, and industrial space is largely driven by employment growth, demand for apartments has been influenced by the decline in the homeownership rate, which has led to an increase in renter households – and therefore demand for apartments. The increase in demand relative to new supply has led the rental vacancy rate to fall to 8.7%, the lowest level since 2001.

Going forward, a backdrop of robust demand should continue to drive investment in the sector. The key factor behind future apartment growth is the number of renter households, which is a function of growth in households and the homeownership rate. Over the next several years, 1.4 million new households per year are likely to be formed across the United States. Assuming no further declines in the homeownership rate – which currently sits at 65.4% – this implies an additional 450,000 rental households per year.

While some of these households will end up renting single-family homes, demand for apartments is likely to support continued growth in construction over the next few years. In 2012, 222,000 rental-purpose multi-family units were started – over 50% below the expected growth in renter households.

Southeast outperformance to stretch across all CRE segments

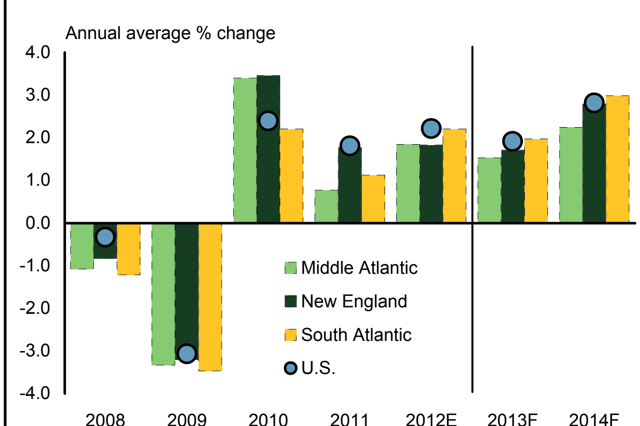
The previous discussion has outlined the main macro trends influencing commercial real estate. Of course, the picture will vary considerably by region. In TD's footprint across the East Coast, a similar pattern is likely to emerge across all segments of CRE: the strongest growth will be visible in the South Atlantic, which is expected to lead the country in terms of economic growth, but was also hit hardest by the collapse in construction.

The best performers in terms of office job growth in 2013 are likely to be in areas that have exposure to housing, energy and technology and less exposure to government. Consistent with faster economic growth, we expect stronger performances in the South Atlantic, especially in North Carolina, South Carolina, and Florida. Within Florida, the steep reduction in office completions in Miami and Orlando over the past several years should lead these markets to see the fastest improvement in vacancy rates.

CHART 9. U.S. HOMEOWNERSHIP RATE

Source: U.S. Census Bureau

CHART 10. REAL GDP GROWTH



Source: Bureau of Economic Analysis,
Forecast by TD Economics at March 2013

A similar story holds for retail and industrial. Given the correlation with housing investment, the best performers regionally are likely to be those in the South Atlantic, especially Florida. Finally, as we outlined in a previous report, faster population growth, in combination with a better supply picture, points to southern outperformance in the apartment space over the next two years.

Bottom Line

After suffering one of its worst declines on record, commercial real estate has staged an impressive comeback over the last few years. While the ongoing recovery is likely to continue, this year will remain challenging. Without a major acceleration in job growth, vacancy rates will not see rapid improvement. Furthermore, without the support from declining interest rates, prices are unlikely to see the pace of appreciation that has characterized the initial rebound.

On the bright side, with economic growth held back by deficit reduction, interest rates are unlikely to rise swiftly, giving some breathing room for fundamentals to take over. As the housing recovery gains steam and economic and job growth accelerates, vacancy rates will show more meaningful improvement, giving support to prices and investment.

This should become more apparent in 2014, as employment momentum and vacancy rates move closer to historic levels. The steep decline in investment during the recession resulted in a reduction in the stock of a broad range of commercial structures from office buildings to shopping centers. Similarly, the rebound in investment activity is likely to be relatively broad based across segments, with apartments leading the way, followed by retail, office and industrial buildings.

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