Market Analysis

Winter 2017

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Is Slowing Volume a Sign of Price Decline?

Property owners cheered another strong year in 2016, but beneath the headlines of growing property profits there is notable slowing in acquisition volume. Real estate owners profit both from current rental income as well as presumed price appreciation over the course of the ownership period.

Currently, rental income is growing at a strong pace and commercial property price indexes continue to move higher, in line with broad real estate price indexes such as the Case-Shiller Home Price Index. However, transaction volume and price appreciation have slowed over the past six months, and acquisition yields have risen in some segments of the market.

Could falling transaction volumes be predicting a decline in prices? It is instructive to review what happened to the single-family residential market before the Great Recession. While home prices peaked in 2006, transaction volume actually peaked a full year earlier, in 2005. After the peak in transactions in 2005, late arrivals to the price boom were still willing to pay marginally higher prices, but the more sophisticated owners were already reducing their overall demand for property.

In 2017, owners are enjoying strong rental income growth, but are currently digesting new developments in the political climate, regulatory framework and financing markets. Since real estate underpins the majority of the U.S. banking system, central bankers are unlikely to do anything that lowers property prices. However, the Federal Reserve is trying to unwind

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the massive monetary stimulus it began in 2009, especially in view of current inflationary pressures. If the Fed raises the cost of financing, prices might tread water for a bit.

But beyond a pause in acquisition appetites, property owners are poised to continue increasing rental income and generally experience buoyant operating conditions. The shoe fits Cinderella, and the dance might continue well into the evening.

Specialty REITs Eating More of the Pie

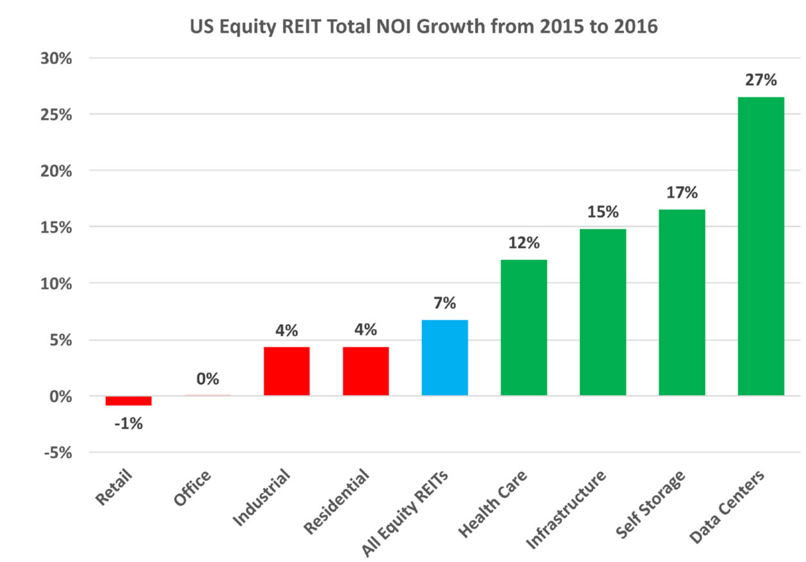
The REIT market has traditionally focused growth on the major commercial property types, which have performed especially well during the long recovery from the Great Recession. However, a new wave of specialty REITs is outpacing the slowing growth of the larger sectors.

While net operating income (NOI) grew by an average of 3% for major property categories and 7% for all equity REITs in 2016, it surged by an average of 16% in specialty sectors, including data centers (+27%), self-storage (+17%), infrastructure (+15%) and health care (+12%), according to the most recent National Association of Real Estate Investment Trusts (NAREIT) Total REIT Industry Tracker Series (T-Tracker®). The four specialty categories represent only 30% of total equity REIT NOI but garnered more than 60% of total NOI growth last year.

The higher growth of specialty REITs comes from a combination of factors. Major property types that have had healthy fundamentals in recent years—including apartments and hotels—are starting to see a moderation in the rate of rent growth. Property types that have longer operating histories and more established sectors have less room for growth.

What's more, while specialty property types require more focused design and management than some of the broader categories, demand for new property classifications continues to grow and is reflected in rising NOI.

An interesting sidebar to the structure of the REIT industry over the last 15 years is the slow disappearance of the diversified REIT, which is a company that owns a variety of property types. Over time, REITs have generally come to focus on a specific property type for strategic and tactical reasons. For example, diversified REITs were accused of investing in sectors that were outside the area of management expertise. But as rent growth slows in the larger sectors, REITs might begin to invest more in both direct ownership of higher-growth specialty property types as well as whole REIT acquisitions by larger property groups.



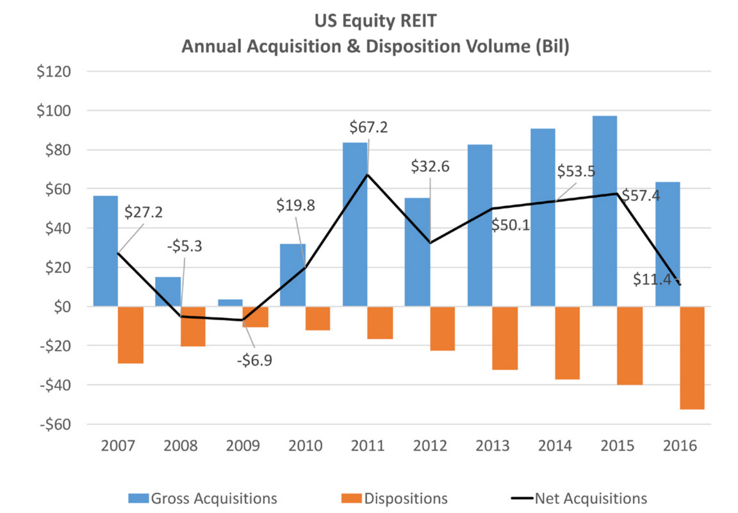
Source: Q4 2016 NAREIT Total REIT Industry Tracker Series

Specialty REITs represent about 20% of the 167 equity REITs tracked by NAREIT, and so there are many interesting combinations to consider. In each major property type, there are a few very large REITs, with another dozen or so mid-capitalization REITs, in addition to several dozen small-cap owners. Strategy teams at major REITs are believed to be identifying smaller REITs to buy or emulate in order to boost NOI growth. That could lead to a new wave of more diversified approaches to REIT portfolio construction to capture emerging opportunities.

REIT Property Acquisitions Fall Back to Earth

REIT acquisitions declined to a trickle while dispositions increased in 2016, and the signs are that the trend of weak net acquisitions may continue in 2017.

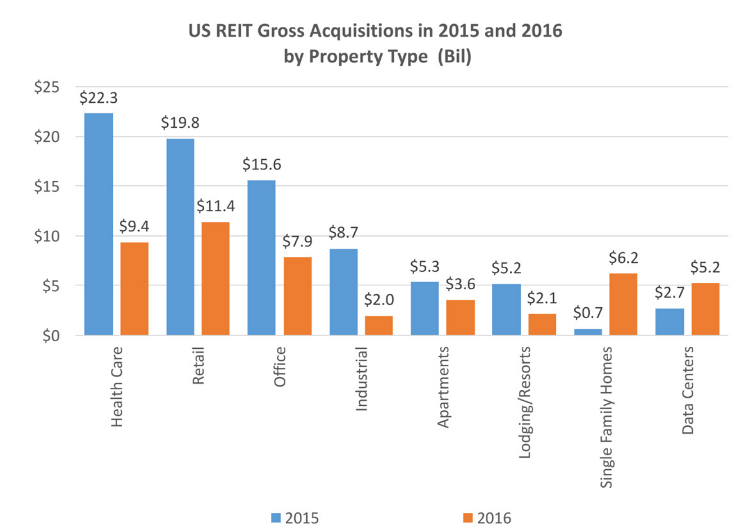
Acquisition activity for equity REITs totaled $63.6 billion in 2016, down 35% year-over-year, and fourth quarter volume of $7.9 billion was the lowest quarterly total since the second quarter of 2010, according to NAREIT's quarterly T-Tracker. Meanwhile, REIT dispositions rose 31% year-over-year in 2016 to $52.2 billion, the highest annual figure in industry history. Disposition activity was led by apartment and office REITs.



Source: Q4 2016 NAREIT Total REIT Industry Tracker Series

Net acquisitions totaled $11.4 billion, the lowest figure since the recovery from the last recession, and early indications are that purchase volumes remain muted in 2017, as the real estate recovery has hit its peak stride. Nearly all property sectors were less acquisitive in 2016, with the exception of single-family homes and data centers, two small specialty categories.

The decline in net acquisitions has a number of causes, from the concern about record-high prices in core markets to rising interest rates and tightening in lending markets. Given that those conditions are not changing, and with so much uncertainty in the near term about tax policies that could affect the industry, REITs are likely to remain cautious about net acquisitions in coming months.



Source: Q4 2016 NAREIT Total REIT Industry Tracker Series

Most larger REITs specialize in major property types in core markets, such as New York, Boston, Los Angeles and San Francisco. Acquisition yields have hit record levels in most of those cities, and REIT managers are becoming more careful about taking on properties at what some feel might be the top of the cycle. In some cases, foreign investors are less concerned about low yields on trophy-type assets, and REITs are reluctant to bid against those types of investors.

At the same time, REIT managers are taking advantage of the high prices to shed non-core assets in primary markets. That enables them to recoup a high return, rebalance portfolios and balance sheets, and wait for more suitable opportunities or even the next market cycle.

Rising interest rates have created some trepidation. Since July 2016, 10-year Treasury interest rates have risen 112 basis points, from 1.37% to 2.49%, and the market expects the

Federal Reserve to raise the discount rate by another 50 to 75 basis points in 2017. Not only are REIT share prices sensitive to rising rates but rising rates could increase acquisition yields. Whether they will or not is unclear, but the prospect of rising rates has led to a growing disconnect between buyers and sellers that is reducing overall property transaction activity in public and private markets.

What's more, the Federal Reserve's Senior Loan Officer Opinion Survey reports that throughout 2016 credit officers raised underwriting standards for commercial real estate loans, both construction and permanent. The Fed survey reveals decreasing demand for commercial real estate loans, as potential buyers move to the sidelines in the wake of higher rates and credit standards. Bank regulators have also pressured many small and regional banks not to overextend in commercial property lending.

Net acquisition levels in 2016 were down 80% from the record $57.4 billion in 2015. Fourth quarter results were slightly positive, but they are now down to levels not seen since 2009, when REITs were net property sellers in the wake of the Great Recession. Health care continues to lead property types, with $7 billion in net acquisitions in 2016, but even that number is down more than 60% compared to 2015's net acquisitions of $20 billion.

The slowdown in acquisitions in 2016 has an approximate corollary in the weakness witnessed in 2012 and 2013. In July 2012, 10-year Treasury rates touched record lows of 1.43% and then began to drift 161 basis points higher by December 2013, when rates crested at 3.04%. In the wake of this back-up in rates, gross acquisitions dropped 34%.

It is worthwhile noting that in 2014 acquisition volume boomed again once interest rates began falling in the wake of additional quantitative easing plans implemented by the European Central Bank and Bank of Japan. However, 2017 begins with a stock market rally and hawkish comments by central bankers, so it seems unlikely that commercial real estate transactions will soon get much of a tailwind from the credit markets.

—**David Dent**, *Real Estate Market Analyst*

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