THE SUPPLY/DEMAND EQUILIBRIUM
WHY CRE CONCERNS HAVE BEEN GREATLY EXAGGERATED
Why CRE Concerns have been Greatly Exaggerated

From newspaper outlets to on-air pundits, skepticism appears to be brewing as the commercial real estate (CRE) cycle approaches its later stages. A recent Financial Times article warned of a post-crisis construction surge, suggesting developers might already have built too much real estate. Banking regulators have signaled “a caution light,” insisting lenders do more to mitigate their exposure. Even Federal Reserve Chair Yellen has weighed in, indicating prices are “high” in a recent address regarding the U.S. economic outlook. These are certainly all valid issues investors should evaluate in the proper context, but much of this criticism appears to ignore one distinct point: the CRE market is decidedly different today than it was leading up to the Global Financial Crisis (GFC). This is not to say that the current market is without risk, but at the very least, there is more to the story.

SUPPLY FACTS

Today’s real estate market has arguably been undersupplied with respect to new construction, which is in sharp contrast to the period leading up to the previous peak. While supply growth in the office sector has increased substantially in both 2015 and 2016 (60M square feet annually), this was barely half the average annual amount between 2004 and 2008. Retail construction completions have averaged 46M square feet per year since 2010 — down from 160M square feet annually in the decade leading up to 2008 — a decline of more than 70%. A portion of the retail decline is certainly attributable to e-commerce, which has bolstered industrial sector demand. Consequently, industrial completions have been relatively strong; delivering 150M square feet annually over the last 3 years, but this is still 20% less than the same period leading up to the previous peak. The multifamily sector is the only major property type that has consistently outpaced pre-recession supply levels across major MSAs (metropolitan statistical areas), it has been supported by an unprecedented growth in demand (see Exhibit 1).

Therefore, it is misleading to suggest developers have oversupplied the broader real estate market when new construction has occurred primarily in the apartment sector, and the other major property types have trailed pre-recession peaks, as of year-end 2016. By comparison, retail, office, residential condominiums, and industrial (to a lesser degree) were all overbuilt leading up to the GFC. Furthermore, to suggest that multifamily is currently overdeveloped would also imply that construction has significantly outpaced demand, which is simply not the case.

Exhibit 1: Supply & Demand Fundamentals: Four Major Property Types

Sources: CoStar Portfolio Strategy, USAA Real Estate Research
DRIVING DEMAND

Given the recent scrutiny regarding multifamily supply growth, it is worth revisiting the sector’s past demand drivers as well as its current and future growth prospects. It is well documented that the GFC precipitated more than 16 million home foreclosures from 2007 to 2012; many of these affected consumers opted for apartments, sparking the current cycle’s initial surge in multifamily supply. Fast forward to 2017; the economic conditions have improved but the key demand drivers are equally robust. Lenders require higher credit scores for home mortgages, causing would-be purchasers to rent longer. Single-family construction remains depressed with just 560,000 completions delivered annually over the last eight years, well below the 1.4 million annual average in the decade leading up to 2008. Many in the millennial generation (the largest renter cohort) struggle to save for a down payment on a home, partially due to record amounts of student loan debt. Baby boomers have also opted for apartments in retirement, targeting highly “amenitized” locations near walkable and active cultural centers. Looking even further ahead, Generation Z (at its peak) will be the largest cohort ever and should backfill apartment demand as millennials eventually shift to homeownership. The urbanization trend should also continue to increase housing density and apartment growth, particularly near city centers. Ultimately, these demand drivers have become the building blocks for today’s multifamily outlook.

While it is certainly possible to overbuild a sector even with such strong demand drivers, the underlying fundamentals indicate multifamily is in a relatively healthy equilibrium. Vacancy rates have risen slightly in recent quarters but remain near historical lows. Net absorption, which tracks the number of units leased within a market over a given period, has topped new supply in five out of the last seven years. Rent growth rose at a blistering pace of 4.1% in 2015 but fell closer to 2.0% in 2016, still outpacing the headline inflation rate. Following a record high of $163B in 2016, apartment sales volume declined 32% year-over-year as of first quarter 2017, but cap rates have been largely unchanged and remain near record lows. This suggests investors are still willing to pay a premium for high-quality assets despite there being fewer offering packages in the market. Admittedly, there is a bifurcation between the different classes and segments (e.g., urban infill high-rise Class A versus suburban garden-style Class C), in large part, because they mature at various speeds throughout the cycle. In aggregate, however, the multifamily sector remains in a healthy state because developers have generally responded to demand drivers rather than arbitrarily overbuilding, which was a prevalent issue in previous cycles. Even today, as we see vacancy levels begin to rise slightly, the capital markets are responding such that new projects will be more difficult to finance and further growth in supply will be constrained.

UNDERWRITING ASSUMPTIONS

During the period 2006 to 2008, many less disciplined investors assumed aggressive growth in rental rates, low cap rates, and strong absorption would continue indefinitely. In fact, these inputs were often straight-lined over ten-year forecasts. During this cycle, by contrast, investors have relied upon sophisticated data sources to develop more disciplined underwriting assumptions.

Indeed, prudent investors have assumed flattening rental growth, bringing it to near zero at this point in the cycle. Absorption assumptions have been conservative throughout the cycle and recently these assumptions have become even more cautious. Finally, most investors have assumed interest rates and cap rates will rise as we move forward in the cycle. As such, they are also assuming assets will sell for cap rates that are higher than today’s levels, therefore, establishing the need for investments to be justified on the basis of strong cash flow rather than excessive appreciation (resulting from cap rate compression) that has marked the current cycle.

CREDIT STRUCTURE

So, what about the significant increase in loan volume? This is a fair question given lenders originated over $500 billion last year — comparable to the years leading up to the financial crisis. Yet, the current credit environment is distinctly different from the previous
cycle. For starters, construction loans outstanding at U.S. banks topped $630 billion in 2008, but remain less than half that today. Collateral debt obligations (CDOs) and commercial mortgage backed securities (CMBS), which were at the heart of the “debt-on-debt” culture leading up to the previous crash, have fallen significantly from pre-crisis levels. Additionally, there is considerably more equity in the market today given the average life insurance loan in 2016 had a 58% LTV, or loan-to-value ratio, compared to the historical pre-crisis average of more than 70% LTV — resulting in a higher equity requirement per transaction. It is also important to consider the stable economic backdrop in which these loans are occurring. The labor market continues to approach full employment, CRE borrowers are not overleveraged like in the previous cycle, and interest rates (though still near historic lows) are gradually increasing, consistent with an improving economic outlook. At the same time, all four major property types have relatively stable fundamentals. Yes, loan volumes have been comparatively higher in recent years, but the underlying market conditions are indicative of a strengthening lending environment and calls for alarm appear to be premature at best.

DATA DIFFERENTIAL

This paper presents a number of factors that are different today than they were in the last cycle, but we believe one key differentiator has been the proliferation of high-quality data throughout the CRE industry. Investors have unfettered access to an immense trove of information (e.g., sales comparables, demographic trends, tenant history, lease terms, property values, ownership structures, financing activity, and performance returns) for nearly every institutional-quality property in the U.S. This amount of information was simply not available in the last cycle and was unfathomable less than two decades ago. This has led to better research-driven decisions and arguably even more realistic underwriting in today’s market.

For instance, it was common practice even during the early years of the previous cycle to cold call area properties in an effort to gather competitors’ rent data. Today, algorithms can access the same information in real-time, allowing investors to adjust rents as market fundamentals shift in a given area. Consequently, the industry has reacted much quicker to early indicators (i.e., market softening, overbuilding, and pricing issues). Inherently, access to high-quality data also supports the crucial role of market transparency. In fact, JLL’s Global Real Estate Transparency Index 2016 echoed this sentiment: “[there is] …more frequently updated and real-time information than ever before,” which helps solidify CRE as an institutional asset class. In the end, history will likely view the current cycle as a turning point in both the availability and usage of high-quality data by CRE investors.

Conclusion

Admittedly, the current real estate market is not perfect. Pricing of core assets in gateway markets have been priced to perfection. The economic cycle is approaching 10 years, one of the longest on record, and it is impossible to rule out a downturn at some point in the near future. In fact, it is generally our view that values have already declined slightly in many markets and a broader correction in values is likely over the next 24 to 36 months. The difference, however, is that an economic slowdown would likely result in a downturn in property values but not necessarily a sharp decline in real estate fundamentals, as investors have been far more disciplined and cautious than in the previous cycle. In fact, the current market has lacked the exuberance of past recoveries — especially compared to the previous cycle — and this deliberate restraint has been instrumental in the market’s below-trend supply growth, controlled debt levels, and measured approach to underwriting. Indeed, it is difficult to predict market behavior, particularly in the current environment where the potential for an economic shock seems to be ever-present. To suggest that a repeat of 2008 is imminent, however, would be to ignore the distinct differences in the current market as compared to the previous cycle, while greatly exaggerating the risks within the CRE industry today.
