Research

USAA Real Estate Company

Commercial Real Estate Update

December 2013

U.S. Economy

Economic growth has gathered momentum…

- Incoming data has signaled a pick-up in underlying domestic demand, with consumption growth showing clear signs of acceleration, boosted by stronger employment and income growth
- GDP growth in the third quarter was revised upward to 3.6%, from 2.8%, largely due to a boost from inventory accumulation, and GDP growth is expected to accelerate to around 2.5% in 2014 and 3.0% in 2015
- The employment report for November showed a gain of 203,000 new jobs, bringing the average monthly gain to more than 200,000 over the last 4 months, marking a significant improvement over the 100,000 pace in July
- The national unemployment rate dipped to a five-year low of 7.0% in November, driven by a 818,000 rebound in the household measure of employment, reversing the shutdown-related drop from the month before
- Inflation has likely passed its trough, rising to 1.2% in November from the low of 1.0% in October, and is expected to gradually climb back towards 2.0%
- Households are starting to spend more freely as retail sales experienced a healthy rise of 0.7% month-over-month in November, suggesting that the holiday shopping season started on a strong note—real consumption growth in the fourth quarter is on pace to double the third quarter's gain
- There was a sharp rise in consumer confidence in December's early reading, jumping to a five-month high of 82.5, up from 75.1 previously, and reflecting the strength of the labor market and the upward trend in the stock market
- In an important monetary policy announcement, the Federal Reserve stated that it will start trimming its monthly asset purchases by $10 billion and suggesting that the purchases should be completely halted by late 2014
- The Fed also enhanced its forward guidance on interest rates, stressing that it will be appropriate to keep the fed funds rate at near-zero until well past the time that the unemployment rate declines below 6.5%, especially if inflation runs below the 2% goal

National Commercial Real Estate

Property demand remains strong during the third quarter…

- With growing property income and continued strong liquidity in the market, real estate returns are already exceeding their forecasted performance
- Strong demand for US properties has kept volume up and prices high as both foreign and domestic investors continue to seek real estate for its strong income return relative to other asset classes
- Real estate cap rate spreads remain well above their long-term average relative to 10-year treasuries, which should provide a healthy cushion against future bond yield increases
- Investors in gateway markets are increasingly pursuing higher returns through selective risk taking in the form of development or redevelopment
- The pursuit of higher yields has increased the amount of activity in secondary markets, but has also spurred interest in B-quality properties in primary markets
- Although demand for some property types has lagged, market fundamentals continue to improve in general, driven by the improving economy and low level of new supply
- Transaction volume continues to increase—as of the end of the third quarter, transaction volume exceeded $239 billion, 27% higher than the same period last year
- All sectors enjoyed increased momentum in transaction activity, except for the apartment sector, where acquisitions and property prices appear to have hit a plateau
- The retail and hotel sectors have been the top performers in price appreciation with retail prices up 17% year-to-date and hotel prices following closely with a 16% gain (Moody's/RCA CPPI)
- With the real estate market in a much stronger position and the recovery becoming more broad-based, banks and special services will increasingly offload REO properties and loans, which should provide more opportunities for value-add investors over the next 12 months

Apartments

Market fundamentals experience renewed strengthening in the third quarter …

- The national vacancy rate declined to 4.2% in the third quarter, dropping 10 basis points (bp) from the previous quarter
- The fact that the sector continues to experience vacancy compression is impressive, especially given that current vacancy levels are near historic lows
- Net absorption in the third quarter increased to 41,283 units, significantly outpacing the same period a year ago, and up 22.7% from the second quarter
- New supply is steadily increasing as developers respond to the strong demand, aided by increased availability of financing for multifamily projects
- A total of 36,269 units were delivered in the third quarter, an increase over the 28,891 units in the second quarter
- Rent growth has been disappointing given the overall strength of the sector, but the ability to raise rents has been constrained by the weak labor market and lack of personal income growth
- Going forward, the outlook for the sector continues to be positive. We expect that vacancy rates will establish cyclical lows over the next 12 months, but that pockets of oversupply may start to appear in select markets as a result of aggressive construction activity

Office

The office market only slowly improving, but continues to prove its resiliency…

- The office recovery continues to spread across markets and become more broad-based
- The sector has proved its resiliency to overcome headwinds, the latest example being its ability to withstand the government sequester in the midst of a slow growing economy
- Next hurdle will be the recent federal government shutdown, but we expect it to be a minor impact
- The national office vacancy rate declined by 10 bp to 15.1% in the third quarter, and is 50 bp lower than this time last year
- CBD office vacancy rates increased by 10 bps during the quarter to 12.4% while the suburban office rate fell 20 bp to 16.6%
- Net absorption during the third quarter was a positive 7.5 million square feet, down slightly from the 9.7 million square feet absorbed in the second quarter
- New supply continues to bounce along the bottom as construction deliveries totaled just 3.6 million square feet for the quarter, similar to the pace in the second quarter
- Markets with strong tech and energy components remain the strongest performers
- Aside from the thin demand, net absorption has been impacted by the trend of tenants reducing their office footprints and improving space efficiency
- The current sluggish pace of recovery will likely continue through the end of 2013 and first part of 2014, before accelerating in late 2014
- But the strengthening will likely occur on a market by market basis, making it difficult to pinpoint exactly when the entire office sector is in full recovery mode

Industrial

Industrial sector continues to gain momentum…

- Improvement in the sector was broad-based with the vast majority of markets reporting stronger fundamentals
- The national availability rate fell to 11.7% as of the end of the third quarter, dropping 30 bp from the previous quarter, and maintaining the same impressive pace of decline as the previous two quarters
- Demand strengthened during the quarter, with net absorption rising to 55.4 million square feet, up from the 48.5 million square feet absorbed during the second quarter
- New supply is gradually ramping up—new construction deliveries totaled 20.3 million square feet for the third quarter, up from the 15.3 million square feet delivered in the previous quarter
- The industrial sector has now achieved 13 consecutive quarters of recovery, with the past four quarters notching the largest gains
- Investors are sensing solid growth prospects for this sector and have been aggressively searching the market for opportunities, especially for larger warehouse properties in primary gateway and inland hub markets

Retail

Retail recovery remains challenged by the slow-moving economic recovery…

- The national vacancy rate remained flat at 10.5% in the third quarter, unchanged from the previous quarter

- The vacancy rate is only down 30 bp from one year ago reflecting the stiff headwinds facing the sector
- Demand remains weak as net absorption for the third quarter was 2.3 million square feet, the lowest amount absorbed thus far this year
- New supply inched upward during the quarter with 1.5 million square feet of new construction delivered, although still at historically low levels, but the highest amount thus far for 2013
- The additional construction activity should be of little concern, given the continued necessity of significant pre-leasing in order to secure financing for the development of new centers
- The recovery of the retail sector remains split, with observable growth at the high-end, where top-quality properties cater to more affluent consumers
- This contrasts to the other end of the spectrum, where lower quality properties are struggling with a broader consumer base which has been more adversely impacted by the weak economy
- The outlook for the overall retail sector still calls for continued improvement, but at the same frustratingly slow pace over the near term

Texas Economy

The Texas economy continues to grow at a steady pace…

- Employment growth, sales tax collections, and housing permits all signal that the Texas economy continues to expand at a healthy pace
- Job growth has picked up after the brief slowdown experienced in August, with 18,200 jobs added during October, on top of the 33,700 created in September
- Year to date, 223,000 jobs have been created in Texas, bringing the annualized growth rate up to 2.7% for the year
- The unemployment rate in Texas declined to 6.2% as of October, and is 80 basis lower than the corresponding national unemployment rate of 7.0%
- Texas exports and manufacturing activity both picked up in October, with exports to the European Union jumping by 21.1% in the 3rd quarter after 5 consecutive quarters of decline

Residential housing activity has started to cool off, but remains at elevated levels …

- Texas existing-home sales have decreased, but single-family permits increased in October
- The Case-Shiller House Price index for Dallas is up 9.9% year-to-date
- Sales of existing single-family homes in October decreased to 22,059 units, continuing the downward trend from the peak of 28,924 units in July, but still representing a 9.4% increase over the October 2012 level
- The current inventory of unsold existing homes relative to sales decreased to 3.8 months in October, down from 3.9 months in September, and achieving a new low
- The median sales price for an existing single-family home also continued to decline, dropping to $171,300 in October, down slightly from $172,500 in September, but up 9.5% from October 2012
- The level of single-family construction permits increased slightly in October, rebounding to 7,166 from September's level of 6,471, but are still down from the high-water mark of 8,621 permits in April

The San Antonio Economy

The San Antonio economy continues to slowly expand …

- San Antonio's economy decelerated in early 2013, but has firmed up somewhat since mid-year
- Year over year, payroll employment in San Antonio is up only half as much as the national average and far less than in other major Texas metro areas
- The federal sequester and government shutdown have been responsible for some of San Antonio's employment weakness, due to the large concentration of military personnel, but has been less of an impact than originally feared
- The unemployment rate has fallen to 6.1%, well below the national average, but the labor force has largely been flat for the past year
- House prices and single-family residential construction are both rising, but the pace is slow compared with that in many other areas
- San Antonio continues to offer a much lower cost of doing business than the other metro areas in Texas, making it an attractive option for new companies and encouraging others to expand their current footprint
- Low office rents, cheap labor, and low energy costs also continue to work in San Antonio's favor
- San Antonio's distinction as the largest metro area close to Mexico appeals to many transportation and distribution firms
- However, to attract more well-paying employers, San Antonio will need to further improve the skill level of its workforce
- Some businesses, especially those in value-added industries, have been reluctant to set up shop in San Antonio due to the lack of highly-skilled talent
- San Antonio's housing market should improve in 2014, but the gains will be less than in other major Texas metro areas
- House prices in San Antonio are up only 5.6% from a year earlier, less than half the U.S. increase and the rise in new single-family permits have been modest
- Relatively low per capita incomes and persistently tight lending standards are outweighing household formation growth that is twice the national average
- San Antonio will continue to benefit from its proximity to the Eagle Ford Shale, but the energy-driven employment increases will trend lower going forward
- Overall, San Antonio's economy will continue to expand in 2014, lifted by gains in housing and manufacturing and further development in the Eagle Ford Shale
- Longer term, the concentration of military cyber-security and medical activity, growth in commercial aerospace, low costs of doing business, and above-average population gains should contribute to the area's above average performance

San Antonio Commercial Real Estate

San Antonio Apartment Market

The San Antonio apartment market continues to experience increased activity…

- The vacancy rate for the third quarter remained unchanged from the second quarter, holding at 5.6%, as supply and demand continue to be mostly balanced
- From a historical perspective, the vacancy rate is more than 1.9% lower than the historical average of 7.5% (over the last 10 years)

- Net absorption was a positive 914 units in the third quarter, nearly equivalent to the 891 units absorbed in the previous quarter
- New construction activity delivered 946 units to the market during the quarter, on pace with the 976 units delivered during the second quarter
- Asking rent increased to an average of $780 per month in the third quarter, an impressive increase of 1.3% over the previous quarter, and the fastest rate of increase since the year 2000
- Rent growth has averaged 3.2% over the past four quarters and is expected to continue at a 3.0% pace over the next year
- Between now and year's end, we expect another 1,700 units to be delivered, slightly outpacing absorption, and causing the vacancy rate to drift upward slightly, ending the year at 5.7%

San Antonio Office Market

The San Antonio office market continues to improve, but activity slowed in the third quarter...

- The office vacancy rate moved upward to 18.7% in the third quarter from 17.7% in the second quarter, but is still favorable compared to the 19.7% in the fourth quarter of last year
- Net absorption was a negative 231,000 square feet during the quarter, a significant decline from the pace in the second quarter when 288,000 square feet was absorbed
- Citywide Class A vacancy tightened further to 10.3%, but Class B and Class C properties continue to lag behind with vacancy rates of 23.1% and 24.9%, respectively
- New construction deliveries totaled just 43,500 square feet during the quarter with the completion of Shavano Center IV at Loop 1604 and Paesano's Way
- The average quoted rental rate climbed $0.14 to reach $19.59 per square foot during the quarter, but Class A space experienced a sharp increase of 5.5% during the quarter—top tier Class A space is now commanding rental rates north of $30
- There were no new construction projects started in the third quarter, but two projects are likely to move forward in the next quarter: USAA's WestRidge at La Cantera (128,700 sf) and Stream Realty's 4602 N Loop 1604 (110,600 sf)

San Antonio Industrial Market

The San Antonio industrial market posted another quarter of solid performance…

- The vacancy rate declined 80 bp during the third quarter, tightening to 7.3% from the 8.1% registered in the second quarter
- Net absorption was a positive 316,485 square feet for the quarter, and has now surpassed 1.1 million square feet of space absorbed year-to-date
- If leasing velocity continues at the current pace through next quarter, the year-end absorption figure may surpass the 1.5 million square feet recorded in peak performance years of 2006 and 2007
- However, a lack of available space could be a constraint in the area's ability to attract new companies or retain expanding tenants—only one speculative project has been delivered to the market this year (66,170 square feet) and is the only one expected through year-end
- More than two-thirds of the buildings surveyed currently stand at 100% occupancy; in fact, only one existing building in the city could immediately accommodate a tenant looking to lease 100,000 square feet

- Several significant build-to-suit projects have recently been delivered to the market including the Amazon.com fulfillment center in Schertz (1.2 million square feet) and the Glazer's distribution center (518,000 square feet) on the west side of San Antonio

San Antonio Retail Market

San Antonio retail market improves during the third quarter, but remains sluggish...

- The overall vacancy rate declined to 11.3% during the third quarter, down 20 bp from the second quarter, and the lowest level since Q2 2009
- Net absorption was a positive 223,000 square feet for the quarter, an encouraging trend, given that absorption had only totaled 27,000 square feet during the first two quarters of the year
- With respect to new construction, there is currently 396,941 square feet of space under development, but only 12.1% of that space is not currently pre-leased, as such, the impact of new supply will continue to be minimal
- After advancing earlier in the year, rents have recently weakened—the asking rent during the third quarter declined by 0.2% to an average of $14.93, but is still up 0.2% year-over-year
- Major lease transactions during the quarter include Freedom Fitness leasing two locations: 41,476 square feet at Exchange Plaza Shopping Center and 33,407 square feet at Park Oaks Shopping Center

***Sources**: USAA Real Estate Company Research, Capital Economics, CBRE Econometric Advisors, Moody's Analytics, Price Waterhouse Coopers, Newmark Grubb Knight Frank, Real Capital Analytics, Reis, Inc., & Wall Street Journal*

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