Research

USAA Real Estate Company

Commercial Real Estate Update

January 2014

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 strong employment and income growth.
- GDP growth in the third quarter was revised upward to 4.1%, from 2.8% in the initial estimate, largely due to a boost from inventory accumulation. GDP growth is expected to accelerate to around 2.6% in 2014 and 3.1% in 2015.
- The employment report for December showed a gain of 74,000 new jobs, bringing the average monthly gain to 182,000 in 2013, just below the average of 183,000 in 2012.
- The national unemployment rate dipped to a five-year low of 6.7% in December, driven by a 490,000 decline in the number of unemployed persons to 10.4 million, and a decline in the labor force participation rate from 63.0% in November to 62.8% in December.
- Inflation has likely passed its trough, rising to 1.5% in December 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 holiday season. For the fourth quarter, real consumption expanded at the fastest pace in three years. Total sales from 2013 were up 4.2% from 2012.
- There was a slight decrease in consumer confidence in January's early reading, declining to 80.4, down from 82.5 in December (Thomson Reuters/UM Preliminary Index of Sentiment). The current reading remains near peak post-recession levels, reflecting the strength of the labor market and the upward trend in the stock market.
- In an important monetary policy announcement on December 18th, the Federal Reserve stated that it will start trimming its monthly asset purchases by $10 billion and suggesting that the purchases could be completely halted by late 2014. With the major economic indicators remaining strong, may believe an announcement of further tapering could occur coming out of the next meeting.

- The Fed has maintained 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 fourth quarter…

- With growing property income and continued strong liquidity in the market, real estate returns are expected to show continued strength in 2014.
- 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 above their long-term average relative to 10-year treasuries, despite compression in 2013 due to the rise in the 10-year Treasury. This should provide some 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. Development transaction activity nationally was up 19% in 2013.
- 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—in 2013, transaction volume exceeded $355 billion, 19% higher than 2012 levels.
- All sectors enjoyed increased momentum in transaction activity in 2013, with national growth between 8% (retail) and 27% (hotel) across the property sectors.
- The retail and hotel sectors have been the top performers in price appreciation with retail prices up 21% in 2013 (November year-to-date) and hotel prices following closely with a 15% 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 servicers 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 continued strengthening in the fourth quarter …

- The national vacancy rate declined to 4.1% in the fourth 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 fourth quarter increased to 50,627 units, significantly outpacing the same period a year ago, and up 22.6% from the third quarter. The fourth quarter had the largest absorption since the fourth quarter of 2010.
- New supply is steadily increasing as developers respond to the strong demand, aided by increased availability of financing for multifamily projects.
- A total of 41,651 units were delivered in the fourth quarter, an increase over the 36,629 units delivered in the third quarter and the highest quarterly total in ten years.
- 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. However, pockets of oversupply may start to appear in select markets as a result of aggressive construction activity.

Office

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

- The office recovery continues to spread across markets and become more broad-based.
- The national office vacancy rate declined by 30 bp to 14.8% in the fourth quarter, and is 60 bp lower than this time last year, the best annual performance since the end of the recession.
- CBD office vacancy rates decreased by 10 bps during the quarter to 12.3% while the suburban office rate fell 20 bp to 16.3%.
- 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 third 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 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 11.3% as of the end of the fourth quarter, dropping 40 bp from the previous quarter, and maintaining the same impressive pace of decline as the previous three quarters.
- Demand strengthened during the third 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 14 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 declined by 10 bp to 10.4% in the fourth quarter, a slight improvement from the previous quarter where it was unchanged.
- The vacancy rate is only down 30 bp from one year ago, and 70 bp from the historical peak vacancy, reflecting the stiff headwinds facing the sector.

- Demand improved as net absorption for the fourth quarter was 4.5 million square feet, the highest quarterly amount absorbed since the fourth quarter of 2007.
- New supply inched upward during the fourth quarter with 2.1 million square feet of new construction delivered. Construction remains at historically low levels, though the fourth quarter was the highest amount deliveries 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.
- Fourth quarter job growth averaged 21,300 jobs per month, in line with the overall 2013 average of 22,200 jobs per month.
- Job growth remained strong in 2013, with 267,000 jobs gained, an annual growth rate of 2.8%.
- The unemployment rate in Texas declined to 6.0% as of December, and is 70 basis points lower than the corresponding national unemployment rate of 6.7%.
- Sales tax collections for fiscal 2013 were up substantially, increasing 7.2% versus fiscal 2012.
- Oil and natural gas production tax collections started fiscal 2014 strong, up 35% for the first four months versus the same period in 2013.

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

- Texas existing-home sales have decreased, but single-family permits continue to show strong annual growth.
- The Case-Shiller House Price index for Dallas is up 9.9% year-to-date through October 2013.
- Sales of existing single-family homes in October decreased to 18,195 units, continuing the downward trend from the peak of 28,924 units in July, and representing a 0.5% decrease over the November 2012 level.
- The median sales price for an existing single-family home also continued to decline, dropping to 158,700, down from $171,300 in October, and down 0.1% from November 2012.
- The level of single-family construction permits in November was 6,090, down slightly versus 7,166 in October and September’s level of 6,471. For the twelve months ending in November 2013, permits were up 15% on a year-over-year basis.

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. Growth picked up from August to November, with a 2% annualized growth rate over this period, up from just 0.7% in the previous eight months.
- 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 5.9%, 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 has 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 fourth quarter was down 10 bp from the second quarter, at 5.5%, as supply and demand continue to be mostly balanced.

- From a historical perspective, the vacancy rate is more than 2% 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 third quarter, on pace with the 976 units delivered during the second quarter.
- Asking rent increased to an average of $789 per month in the fourth quarter, an impressive increase of 1.1% over the previous quarter, following the third quarter increase of 1.3% which was the fastest rate of increase since the year 2000.
- Rent growth is up 3.5% 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 second half of 2013...

- The office vacancy rate remained flat at 18.7% in the fourth quarter, down 100 bp compared to the 19.7% in the fourth quarter of last year.
- Net absorption was a negative 231,000 square feet during the third quarter, a significant decline from the pace in the second quarter when 288,000 square feet were absorbed.
- Citywide Class A vacancy was at 10.3% in the third quarter, 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 third 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 third 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 third quarter, and has now surpassed 1.1 million square feet of space absorbed year-to-date.
- If leasing velocity continued at the year-to-date pace through the fourth quarter, the year-end absorption figure was expected to 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 was delivered to the market through the first three quarters of 2013 (66,170 square feet).

- 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 second half of 2013, but remains sluggish...

- The overall vacancy rate declined to 11.1% during the fourth quarter, down 20 bp from the third quarter and the lowest level since the second quarter of 2009.
- Net absorption was a positive 223,000 square feet for the third 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.
- The asking rent during the fourth quarter increased by 0.9% to an average of $15.06, and is up 0.3% year-over-year.
- Major lease transactions during the third quarter include US Foods re-tenanting a 54,318 square-foot portion of the Concourse Shopping Center along US 281. Power centers continue to dominate the market with the lowest vacancy and highest rents.

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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