Research

USAA
USAA Real Estate Company

Commercial Real Estate Update

November 2013

U.S. Economy

Economic recovery appears to be strengthening, despite last month's government shutdown…

- Recent economic data suggests that the U.S. economy has largely shrugged off the government shutdown fiasco, and more importantly, that the recovery has started to rebuild momentum
- The initial estimate for GDP growth in the third quarter registered 2.8%, which was higher than anticipated due to an unexpected boost from inventory accumulation, but will likely be revised down to 2.5% in the second estimate due to the overestimate of export activity
- Fourth quarter GDP growth is expected to be a little weaker, between 2.0% and 2.5%, but should accelerate to 2.5% in 2014 and reach 3.0% in 2015
- The employment report for October was stronger than expected with a gain of 204,000 new jobs, combined with a cumulative 60,000 upward revision to the gains in the two preceding months
- Although the strength in job creation was widespread, the national unemployment rate edged up to 7.3% in October from 7.2% in September due to the 720,000 drop in labor force participation
- Inflation dropped to a four-year low of 1.0% in October, falling further from the 1.2% annual rate in September, and primarily driven lower by the continuing decrease in gasoline prices
- Retail sales growth accelerated in October, rising 0.4% month-over-month, and soundly beating most economist's expectations of little to no growth due to the government shutdown
- Unexpectedly, consumer confidence dropped again in November to a two-year low of 72.0—this further drop is hard to explain given that the government reopened, the job market is strengthening, the stock market has touched record highs, and gasoline prices have fallen
- There is growing speculation that the Fed will start reducing the pace of its asset purchases in December or early next year, especially if the incoming economic data remains upbeat

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 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 basis points to 15.1% in the third quarter, and is 50 basis points 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 basis points 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 basis points 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 basis points 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…

- The real estate and energy sectors remain at high levels and continue to be the primary drivers of economic growth
- Job growth decelerated sharply in August, with only 2,400 jobs added during the month, compared to the 33,400 added in July
- Austin has led the other metro areas in job growth since the recession; Austin's performance is followed by Houston and San Antonio, with Dallas bringing up the rear
- The ongoing sequester seems to be partly responsible for the slowdown in San Antonio and the border region, where the share of federal government employment is twice as large as the state average
- The unemployment rate in Texas inched downward to 6.4% in August, and remained 90 basis lower than the corresponding national unemployment rate of 7.3%

Residential housing activity is still booming…

- The low supply of housing relative to demand has put upward pressure on prices
- The Case-Shiller House Price index for Dallas is up 6.2% year-to-date
- Sales of existing single-family homes fell slightly in September to 23,229 units, down from the 28,003 units in August, but still representing a 20.5% increase over the September 2012 level
- The current inventory of unsold existing homes relative to sales decreased to 3.9 months in September, down from 4.1 months in August, and one of the lowest levels in recent history
- The median sales price for an existing single-family home declined to $173,100 in September, down from $177,700 in August, but up 9.2% from September 2012
- The level of single-family construction permits declined slightly in August, dropping to 7,846 from July's mark of 7,885, but are still up 9.0% from the number of permits issued in August 2012

The San Antonio Economy

The San Antonio economy has transitioned from recovery to expansion …

- Payroll employment in San Antonio has grown faster than the national average over the past year, though not as rapidly as Dallas, Houston or Austin
- All major industries have contributed to the gains in payrolls, though manufacturing has been weak at times
- The unemployment rate has fallen to 6.3%, though some of the decline was caused by a drop in the size of the labor force
- Home sales and prices are rising and the amount of available inventory has declined, although more slowly when compared to other Texas metro areas
- Among the major Texas metro areas, San Antonio faces the greatest threat from the automatic federal spending cuts (sequestration); about one-fifth of the state's military jobs are in San Antonio; many associated civilian workers could face furloughs, including the private sector work that is generated by the Air Force
- As a major destination for Mexican tourists, the San Antonio economy should continue to enjoy support from leisure/hospitality which was the fastest growing industry in 2012; San Antonio is the seventh most visited U.S. city by Hispanic travelers and the most visited in Texas
- Air traffic to and from Mexico quadrupled over the past year
- Longer-term above average population growth in the Hispanic demographic segment will contribute to further industry gains
- San Antonio should benefit from expanding solar panel manufacturing
- Despite its long history of military aerospace, the metro area has a surprisingly small pool of aerospace, mechanical and electrical engineers; further the workforce is not as well-educated as other competing metro areas
- San Antonio's economy should grow at an above average rate in 2013, supported by a variety of industries such as tourism, housing, manufacturing, local government, and those associated with the oil and gas production in the Eagle Ford shale
- Domestic federal spending cuts pose a significant downside risk
- Long-term, the concentration of military cyber-security and medical activity, growth in commercial aerospace, and above-average population gains should enable San Antonio to outperform the nation by a significant margin

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 basis points 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 project 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 basis points 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*

USAA Real Estate Company
9830 Colonnade Blvd., Suite 600
San Antonio, TX 78230
USA

Tel: 210.641.8416
Fax: 210.641.8425
Web: www.usrealco.com
E-mail: will.mcintosh@usrealco.com