USAA Real Estate Company

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COMMERCIAL REAL ESTATE UPDATE

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U.S. Economy

THE ECONOMIC EXPANSION SLOWED IN THE FIRST QUARTER …

The U.S. economy slowed during the first quarter of 2015 as inclement weather resulted in the coldest winter on record for the Northeast Region of the United States. Economic expansion essentially froze, and Gross Domestic Product (GDP) fell to the lowest level since the first quarter of 2014. This recent GDP downturn, however, is not indicative of the overall health of the economy. Several underlying data points indicate that the economic conditions remain strong, and the first quarter was likely a temporary blip rather than a major cause for concern. RealCo expects the economy to regain momentum in the second quarter as pent-up demand accelerates job growth, consumer spending, and business investments.

- According to an advance estimate from the Bureau of Economic Analysis (BEA), GDP expanded at an annualized rate of 0.2% during the first quarter. This performance was below consensus estimates and trailed the previous quarter by 200 basis points. The economy experienced a similar deceleration during the same period last year but ultimately rebounded to have a strong year in 2014. We expect a similar occurrence this year, as most economists still forecast a 2.7% to 3.3% annualized GDP growth rate in 2015 despite the sluggish start.
- The national employment outlook displayed unexpected weakness during the first quarter. The labor market averaged 197,000 non-farm jobs per month, which trailed the previous quarter's monthly average by more than 90,000 jobs.
- Despite these lackluster figures, the labor market exhibited healthy signs as well. Initial jobless claims were relatively slow, the job openings rate was near a record high, and corporate employment surveys indicated businesses expect to hire more employees going forward.
- These positive indicators were enough to keep the unemployment rate on a downward trend. The unemployment rate declined to 5.5% in March from 5.7% in January. The first quarter weakness was likely due to extreme weather conditions, and RealCo expects labor conditions to improve in the second quarter.
- Retail sales still have room to improve. The monthly average growth figure was negative for the second consecutive quarter. The monthly retail sales average was -0.4% in the first quarter, down 30 basis points from the prior quarter.
- Most economists expected retail spending to surge following the energy price decline in 2014; however, it has not happened yet. Historically it takes six months for retailers to benefit from falling energy prices, as consumers typically wait that long before spending the money saved from lower gas prices. The energy slump began in mid-2014, so it was reasonable to expect an uptick in retails sales during the first quarter.
- However, the historically cold weather throughout the Northeast Region virtually delayed consumer spending by a significant portion of the country. RealCo is optimistic that retail spending will rebound in the first half of 2015 due to pent-up consumer demand, relatively low energy prices, and a resilient labor market.
- The University of Michigan Consumer

Confidence Index indicates that consumers remain in a strong position. After reaching a multiyear high of 93.6 in December 2014, the index soared to 98.1 in January 2015 before settling at 95.9 in March.

- This strong index performance has historically correlated with robust consumption growth, a further indication that the first-quarter GDP weakness was likely a temporary slowdown, and consumer spending should eventually reflect the outlook exhibited in the Consumer Confidence Index.
- The Consumer Price Index (CPI) initially slowed in the first quarter, but the most recent data suggests that underlying inflation is beginning to firm. Initially CPI growth sank to -0.7% in January, before rebounding to 0.2% in February and March.
- CPI increased moderately during the latter two months, which is an indication that the economy is not likely to experience a deflationary spiral due to falling oil prices. On an annual basis, core inflation edged up to 1.8%. This rate still lags the Federal Reserve's target threshold of 2.0%, but inflationary pressures are likely to continue to rise gradually, particularly if oil prices rebound further.
- Federal Reserve officials have expressed a desire to exercise "patience" in raising interest rates. Some analysts expect a short-term rate hike by mid-year 2015. It is unlikely that the Federal Reserve will raise rates so long as the economy has relatively low inflation, weak GDP growth, and a cooling labor market. RealCo would not rule out a moderate rate increase by the end of 2015 should the economy regain momentum.
- The U.S. economy essentially stalled in the first quarter as inclement weather threatened to derail parts of the economy. However, the economic outlook remains optimistic, and any negative impact was likely temporary. Therefore, RealCo expects the economy to rebound in the second quarter driven by pent-up consumer demand and a resilient labor market.

National Commercial Real Estate

TRANSACTION VOLUME AND PROPERTY DEMAND REMAIN ELEVATED…

- Demand remains strong for U.S. properties due to an improving economic outlook, and increased capital flow from both foreign and domestic investors.
- NCREIF's (NPI) total returns for private real estate were strong at 3.57% in the first quarter, which was the strongest period since the second quarter of 2011. Income and property appreciation returns were 1.24% and 2.33% respectively.
- Over the last 12-months, real estate delivered a 12.70% total return (split between 5.3% of income and appreciation of 7.10%).
- Retail led all property sectors with 4.93% returns. Industrial, was the second best performing sector with a total return of 3.47%.
- Office had quarterly returns of 3.30%; apartments had total returns of 2.85%, followed by hotel at 2.52%.
- Over the past four quarters, industrial has been the best performer with a 14.20% total return, followed by retail's 13.80% return. Hotel, office, and apartments had returns of 13.00%, 12.7%, and 11.00% respectively.
- Commercial real estate prices remained strong in the first quarter as sales volume reached $130 billion, an increase of 45% year-over-year, per Real Capital Analytics

- Across the property sectors, cap rates continued to trend lower during the quarter, driven by competition for core assets.
- Commercial Mortgage Backed Securities (CMBS) ended 2014 with $94.1 billion. The first quarter of 2015 resulted in roughly $25 billion, well above the $16 billion in the first quarter of 2014. In 2015, CBMS issuance is likely to eclipse the $100 billion threshold for the first time since the financial crisis began

Multifamily

VACANCY RATES AND MARKET FUNDAMENTALS ARE STRONG…

- The U.S. multifamily sector's occupancy rate remained flat for the second consecutive quarter at 95.8%. The occupancy rate is still 120 basis points above the 20-year average of 94.6%. Occupancy rates have been at or near this level since 2013.
- The first quarter net absorption figure was 37,160 units, which was consistent with the 5-year quarterly average of roughly 40 million units. Demand continued to offset growing supply as 81 of 82 markets surveyed by REIS, Inc. experienced positive net absorption, which is consistent with the recent trend of elevated absorption across most markets.
- Construction pipelines are rising and deliveries are on pace to reach an all-time high in 2015. Developers completed approximately 29,000 units in the first quarter, which was below consensus estimates due to weather-related construction delays.
- The 2015 end-of-year forecast calls for 240,000 units, a 43% increase over the previous year and 100,000 units above the 10-year trailing annual average. The bulk of these deliveries should occur in the second half of 2015.
- Asking rent rates grew by 0.5%, roughly 10 basis points below the previous quarter. On an annual basis, asking rents increased 3.3%, roughly 20 basis points below rates in 2014. Seasonality tends to suppress rent growth during cold months, so the modest rent growth is not surprising given the severe weather in the Northeast Region of the U.S.
- Fast rising supply levels are a concern for this sector, particularly as REIS, Inc. forecast expects occupancy rates to fall 70 to 80 basis points by the end of the year. Even though rent rates should remain relatively strong, revenue growth will likely decline due to falling occupancy rates.
- RealCo expects some softening in this market but demographic trends, such as surging millennial household formations, continue to favor this sector and should prevent occupancy levels from spiraling downward.

Office

THE OFFICE RECOVERY CONTINUES TO IMPROVE …

- The national office occupancy rate increased 10 basis points in the first quarter to 86.1%, up 90 basis points year-over-year. Current occupancy levels are up 83 basis points over the 10-year average, and 11 of the last 12 quarter have shown positive rates improvements. Downtown rates slowed in the quarter by 10 basis points to 88.8%, and suburban rates improved by 20 basis points to 84.6%.
- Demand was solid during the first quarter, and office absorption totaled 9.5 million square feet, below the previous quarter's impressive 16.2 million square feet, but still 600,000 square feet above the 10-year average. This marked the twelfth consecutive quarter of positive absorption for the office market, and 77% of markets tracked by CBRE Research experienced positive net absorption in the first quarter.
- Construction activity is on an upswing. The sector delivered 7.0 million square feet of new supply during the first quarter. This figure is below the 9.5 million square feet in the previous quarter but still up 71% year-over-year. The market place has few large blocks of space available, which has helped spur new office development, particularly as job growth has strengthen in recent years.
- Asking rental rates were up 3.5% year-over-year after delivering a 1.9% increase during the first quarter, substantially higher than the 0.4% increase in the previous quarter. Rents have risen for 15 straight quarters, and average rent rates increase in 65% of the markets tracked by CBRE Research.
- The office sector is highly correlated with the labor market, and the overall employment outlook is optimistic despite slow job growth in the first quarter. During the quarter, the labor market averaged just 197,000 non-farm jobs per month. However, the economy added more than 3.1 million jobs since last year. With office-using employment accounting for roughly 3% of those jobs, demand for office properties should remain robust throughout 2015.

Industrial

INDUSTRIAL SECTOR CONTINUES TO EXPAND…

- The U.S. industrial sector delivered the strongest quarterly occupancy rate performance since the recession. The rate improved by 20 basis points in the first quarter to 89.9%, which marked the highest occupancy level since the fourth quarter of 2007. Furthermore, the sector has experienced 19 consecutive quarters of occupancy growth dating back to 2010. The occupancy improvements were broad based as 81% of markets surveyed by CBRE Research experienced increased occupancy levels during the quarter.
- Net absorption increased for the twentieth consecutive quarter. The industrial market logged 48.7 million square feet, nearly 28.0 million square feet below the previous

quarter, and was down 1.0% year-over-year. However, this performance was still in line with the 5-year average of 40.0 million square feet per quarter.

- The sector added approximately 26.8 million square feet of new supply during the quarter, consistent with recent deliveries and up 5.5% on a year-over-year basis. This recent performance, however, is well below the long run average (since 1990) of 40.0 million square feet. Construction activity has been relatively tepid, but rising rent rates should encourage construction pipelines going forward.
- Rent rates sustained steady growth during the period. Asking rent rates were up 1.8% in the first quarter, and 3.8% year-over-year. Average rents increased in 66% of the markets surveyed by CBRE Research.
- The Industrial sector has benefited from healthy economic conditions and rising consumer consumption. These factors should continue to support this segment in the second quarter of 2015, leading to strong tenant and investor demand.

Retail

RETAIL RECOVERY SHOWS MODEST IMPROVEMENT …

- The U.S. Retail sector has shown steady improvement, but it still has not recovered from the financial crisis. Occupancy rates increased 10 basis points from the previous quarter to 89.9%, resulting in the strongest 12-month performance since the retail recovery began in 2011. Conversely, the national occupancy rate has gained just 100 basis points since the historic lows in 2011, making this cycle the slowest recovery since REIS, Inc.began tracking the sector in 1980.
- New construction pipelines experienced modest growth during the first quarter. There was roughly 2.0 million square feet delivered during the quarter, nearly 200,000 square feet more than in the previous quarter. This is a nominal improvement relative to the several billion square feet of available retail space. Banks are reluctant to finance retail development project without substantial preleasing, but diminishing demand for traditional retail space has limited the number of new construction projects.
- The retail market absorbed 3.5 million square feet, which is nearly 500,000 square feet less than the previous quarter's performance, but still well above the 5-year average of approximately 1.9 million square feet. Demand was positive across most markets, with 76% of the 80 markets surveyed by REIS, Inc. reporting positive absorption, a 10% increase over the previous quarter.
- Asking rent rates improved 0.5%, which is consistent with the rising trend over the last several years. Asking rents expanded 1.9% year-over-year and have increased 14 consecutive quarters dating back to third quarter 2011.
- Grocery-anchored retail continued to perform well. Occupancy rates for grocery-anchored centers were at 94.7% nationally, up 70 basis points year-over-year. Asking rents were up 4.2% over this period, resulting in strong net operating income growth. The asset class has generated significant investor interest because of strong performance during and after the downturn.

- Transaction volume exceeded $13.8 billion in 2014, up 38% over 2013 levels. The $3.4 billion of transaction volume in the first quarter of 2015 represented a 28% increase over the same period in 2014. Meanwhile, asset prices have exceeded the pre-recession peaks. Nationally, the average asset price is now at $162 per square foot, up 3.1% year-over-year for deals transacted.
- Cap rates are at 6.8%, which is near 2006 levels, and should continue to decline due to an influx of capital and growing investor demand.