USAA Real Estate Company

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COMMERCIAL REAL ESTATE UPDATE

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U.S. Economy

THE U.S. ECONOMY REBOUNDED IN THE SECOND QUARTER…

The U.S. economic outlook remains upbeat following a temporary slowdown during the first quarter. Real GDP growth slowed in the first quarter primarily due to harsh weather in the Northeast region and an arduous port strike on the West Coast. Conversely, strong consumer confidence, a resilient labor market, and pent-up consumer demand spurred an economic rebound in the second quarter. We expect this dynamic to continue as U.S. economic and real estate fundamentals continue to strengthen in the second half of 2015.

- According to an advance estimate from the Bureau of Economic Analysis (BEA), GDP expanded at an annualized rate of 2.3% during the second quarter. This performance was slightly below consensus estimates, but still 170 basis over the revised-up 0.6% expansion during the first quarter.
- Forecasters project 2.10% to 2.40% annual GDP growth in 2015, which is in line with our view that the economy will sustain strong-to-moderate expansion over the next six months.
- The employment market continued to produce jobs at a rapid pace. Despite the first quarter headwinds, monthly employment growth averaged 208,000 jobs during the first half of the year. The unemployment rate fell to 5.3% in June, the lowest measure since April 2008 – a significant milestone given that unemployment peaked at 10.0% less than six years ago.
- The Federal Reserve currently forecasts the unemployment rate to moderate between 5.2% and 5.3% by year's end; however, the job market could surpass this target given the current pace of growth.
- Retail sales experienced modest growth in the second quarter, but some pockets of the economy are seeing a surge in consumer spending. Monthly retail sales averaged .2% growth in the second quarter, up more than 60 basis points from the first quarter contraction. The rise in consumer spending has consolidated in a few areas; for instance, existing home sales were up 12.5% year-over-year in June, the highest level in eight years. In addition, the auto industry sold 8.5 million vehicles in the first half of the year, on pace to surpass the current annual record of 17.4 million units set in 2000.
- RealCo is encouraged to see a notable increase in big-ticket purchases (e.g., houses and cars) because it suggests that more Americans feel secure about their long-term job prospects.
- Consumer confidence has been strong throughout the first half of 2015. The University of Michigan Consumer Confidence Index has remained above 90.0 since December 2014. The index began the quarter at 95.9 in April, dropped to 90.7 in May, but rebounded to 94.6 in June. Despite the small decline in May, the current index measure still indicates that consumers are confident in the economy recovery.
- Consumer confidence should remain elevated in the near term particularly with an improving employment market, an expectation of near-term wage growth, and the potential for lower gasoline prices ahead. The resilience of the broader economy combined with elevated levels of consumer confidence should ensure that this positive economic trend persists.

- The Consumer Price Index (CPI) experienced a slight uptick during the second quarter, but overall inflation has stagnated. The average month-over-month CPI growth was .2% during the quarter, up 30 basis points over the first quarter contraction. The CPI expanded at just 0.1% year-over-year in June.
- In July, global commodity prices (per the Bloomberg Commodities Index) reached their lowest level in 13-years. If downward pressure on commodity prices persists, the global economy could experience a prolonged period of low inflation.
- The first interest rate hike in nearly a decade seems poised to occur in the second half of 2015. According to the June “dot plot,” which shows where Federal Reserve members expect interest rates will be at the end of the year, only two of the 17 Federal Open Market Committee (FOMC) members recommended postponing a rate increase until 2016 – the rest of the contingent suggested at least one rate hike by the end of this year. This overwhelming consensus is somewhat surprising given that inflation (according to the Personal Consumption Expenditure Price Index) undershot the central bank’s 2.0% target in May for the 37th consecutive month.
- Certainly, the central bank believes that inflation will pick up in the second half of the year, but it is difficult to foresee sustainable inflation levels occurring by year’s end. As a result, RealCo is not convinced that economic conditions justify a rate hike by the end of 2015.
- In summary, the U.S. economy is back on track after a temporary slowdown in the first quarter, followed by a healthy rebound in the second quarter. Our outlook remains optimistic; RealCo expects economic fundamentals to continue to strengthen in the second half of 2015 and deliver strong-to-moderate growth supported by resilient consumer confidence and a robust labor market.

National Commercial Real Estate[1]

MARKET FUNDAMENTALS AND PROPERTY DEMAND REMAIN ELEVATED…

- NCREIF’s (NPI) total returns for private real estate were strong at 3.14% in the second quarter, 43 basis points below the robust first quarter return, but stronger than the 2.91% returned the same quarter a year ago. Income and property appreciation returns were 1.26% and 1.89% respectively.
- Over the last 12-months, real estate delivered a 12.98% total return, above the 5-year average of 12.72%.
- For the year ending second quarter 2015, the 12.98%, total return consisted of a 5.20% income return and 7.49% appreciation return.
- Industrial was the leading property type for the second quarter and the trailing year with a total return of 3.78% in the second quarter and annual return of 14.80%.
- Retail was the laggard for the quarter with a 2.96% return, the only return below 3% across all property types. For the year, hotels (13.96%) and retail (13.53%) closely followed industrial returns as the next strongest performers.
- Apartments had the lowest return over the

[1] Data provided by NCREIF and Real Capital Analytics

past year at 11.67%, as the sector's expansion phase is maturing after leading all major property types in performance for several years following the financial crisis.

- US commercial real estate investment volume grew 23% year-over-year in second quarter on volume of $118b. Volume came in at $255 billion in the first half of 2015, up 36% year-over-year. These levels of volume put activity just ahead of the pace seen in 2006.
- Despite this sign of strength, the volume for the year to date was front loaded with year-over-year growth at 49% in the first quarter. Deal volume for both the sale of individual assets as well as that for portfolio and entity level deals was front loaded with a faster pace of growth in the first quarter versus the second quarter.
- A cautionary perspective would view this slowdown in growth with concern that investors are becoming hesitant about future trends in interest rates, what the Federal Reserve Bank will do in the fall, and how it will impact the property markets. A more optimistic view is that the 49% year-over-year growth in volume seen in the first quarter, had it continued, would have likely been the start of frenzied market with the potential for a bubble.
- As it stands, the lower growth in volume has not been matched with increases in cap rates so it is not as if investors are pulling away from commercial real estate. This trend in volume warrants further attention, but is not a major concern at this time.

Multifamily

DEMAND CONTINUES TO KEEP PACE WITH RECORD SUPPLY LEVELS …

- The U.S. multifamily sector's occupancy rate remained flat for the fifth consecutive quarter, despite a record level of new construction.
- The national occupancy level held strong at 95.8%, and is still 40 basis points above the 5-year average of 95.4%. The sector has sustained strong occupancy rates of at least 95% dating back to first quarter 2012.
- Construction deliveries are on pace to reach an all-time high in 2015. Over 46,000 units came online during the quarter, which was the highest amount since REIS began tracking data in 1999. The 2015 end-of-year forecast calls for 230,000 units, a significant increase over the previous year.
- The forecast also calls for 100,000 units to deliver in the second and third quarter collectively, meaning the third quarter could see an even higher number of new units delivered to the market place.
- Furthermore, the total amount of units constructed could grow even larger depending on gas prices; some developers in markets like Houston, Texas have put projects on hold due to low oil prices.
- The second quarter net absorption rate reflects strong demand that has kept pace with increasing supply, as absorption topped 44,000 units during the second quarter.
- The recent quarter's absorption figure is 13.0% above the five-year average of roughly 39,000 units. Demand continued to offset growing supply as all 82 markets surveyed by REIS experienced positive net absorption.
- Asking rent rates grew by 1.1%, roughly 60 basis points above the previous quarter. Asking rents notched one of the strongest quarters since 2012. Seasonality tends to increase rent growth during warm months, so the rise is rents was somewhat expected.

- However, of the 275 metros and over 800 submarkets that REIS tracks, each one was at an all-time high during the second quarter. Rent rates cannot sustain this upward trajectory indefinitely, but for now, demand continues to support the rise in market rents.
- Record supply levels combined with record rent rates are legitimate concerns for this sector. REIS forecast expects occupancy rates to fall 60 basis points by the end of the year, but that modest decline is not sufficient enough to slow construction so long as demand remains strong.
- RealCo expects some softening in this sector over the next couple of years, but in the near-term, the increasing number of household formations by the Millennial (Gen-Y) cohort should continue to support multifamily demand.

Office

THE OFFICE SECTOR IS BENEFITTING FROM STRONG JOB GROWTH …

- The U.S. office sector has benefitted from strong job growth, business expansion, and rising tenant demand. The national office occupancy rate increased 40 basis points to 86.5% in the second quarter, a 1.2% year-over-year increase. The office sector has improved consistently with 13 of the last 14 quarters delivering positive occupancy growth.
- Downtown occupancy rates outperformed the suburban segment with a 60 basis points increase to 89.4% in the second quarter, while suburban office improved just 30 basis point to 84.9% occupancy.
- Demand was solid during the second quarter, and office absorption totaled 21.0 million square feet, 11.5 million square feet above the previous quarter. This period marked the highest total since second quarter 2007 and the 13th consecutive quarter of positive absorption for the office market.
- Nearly 93% of markets traced by CBRE Research experienced positive net absorption in the second quarter.
- Construction activity surged in the second quarter. The sector delivered 7.2 million square feet of new supply, as construction completions increased 80% year-over-year.
- This abundance of construction has occurred in major metros with the strongest growth occurring in tech driven markets such as San Jose, California.
- Asking rental rates improved 1.1% in the second quarter, and 3.6% year-over-year. Rents have risen for 16 consecutive quarters. Furthermore, asking rents eclipsed pre-recession peaks during this period, delivering the highest rental rate since second quarter 2008.
- The office sector has benefitted from robust job growth and the current employment outlook remains optimistic. The labor market produced roughly 1.25 million new jobs in the first half of 2015.
- Many of these positions were in the office-using employment sectors, indicating that office demand will likely increase in the second half of 2015.

Industrial

INDUSTRIAL SECTOR OCCUPANY RATE REACHES PRE-RECESSION LEVELS …

- The U.S. industrial sector delivered the strongest quarterly occupancy rate performance since the recession. The rate improved by 30 basis points in the second quarter to 90.2%, which marked the lowest occupancy level since the fourth quarter of 2007.
- Furthermore, the sector has experienced 19 consecutive quarters of occupancy growth dating back to 2010. The improvements were broad based as 81% of markets surveyed by CBRE Research experienced increased occupancy levels during the quarter.
- Net absorption increased for the 21st consecutive quarter. The industrial sector logged 67.1 million square feet, up 33% over a relatively slow first quarter, and up 20% year-over-year. The recent performance was well above the 5-year average of 44 million square feet per quarter.
- Due to rising demand, net absorption has surpassed 50 million square feet in 10 of the last 11 quarters dating back to fourth quarter 2012.
- The sector added approximately 36.5 million square feet of new supply during the quarter, which was consistent with the 36.0 million square feet average over the last four quarters.
- Furthermore, the second quarter new construction total was up 38% year-over-year, suggesting the sector is continuing to expand at a rapid pace.
- Rent rates sustained modest growth during the period. Asking rent rates were up 0.6% in the second quarter, and up almost 4.0% year-over-year.
- Rent rates have increased in 17 of the last 20 quarters but are 6% below the previous peak, indicating there might be further opportunity for improvement. Average rents rates were at or above the previous quarter in 75% 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 half of 2015, leading to strong tenant and investor demand.

Retail

THE RETAIL SECTOR RECOVERY HAS BEEN MODEST…

- The U.S. retail sector still has room for improvement. Occupancy rates remained flat at 89.9% from the previous quarter, marking the first time since second quarter 2014 that national occupancy levels have not increased.
- While levels have improved 20 basis points over the last 12-months, overall progress has been anemic as the sector's occupancy level is still below 90% following six years of economic recovery.

- New construction was meager during the second quarter. Developers only produced 1.2 million square feet, nearly 800,000 square feet less than the previous quarter.
- Due to softening demand, it is difficult to justify construction in most markets. Currently, most construction projects have occurred in the redevelopment of existing properties and the creation of new outlet, lifestyle, and power centers in select markets.
- The retail market absorbed 2.3 million square feet, which is nearly 200,000 square feet less than the previous quarter's performance. Despite logging the lowest absorption figure since third quarter 2013, the recent measure was within a reasonable range of the 5-year average of approximately 2.7 million square feet.
- Demand was positive across most markets, with 63% of the 80 markets surveyed by REIS reporting positive absorption, but still down 13% from the first quarter.
- Asking rent rates were up 0.5% in the first quarter, which is equivalent to the rent growth experienced in three of the last four quarters. Asking rents expanded 1.9% year-over-year and have increased every period since third quarter 2011.
- Grocery-anchored retail continued to perform well. Occupancy rates for grocery-anchored centers were at 95.1% nationally, up 105 basis points year-over-year. Rental income was up 4.8% over this period, resulting in strong net operating income growth.
- This asset class has generated significant investor interest because of strong performance during and after the downturn. Transaction volume for the four quarters ending in the second quarter 2015 was $14.7 billion, up 28% over the previous year and the highest level since 2007.
- Meanwhile, asset prices have exceeded the pre-recession peaks. Nationally, the average asset price is now at $162 per square foot, up 1.1% year-over-year for deals transacted. Cap rates are at 6.5%, down 30 basis points year-over-year, and should continue to decline due to an influx of capital and growing investor demand.