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U.S. PROPERTY MARKET OUTLOOK
September 2013

The Commercial Real Estate Market Continues to Improve . . .

- The outlook for the U.S. economy remains optimistic as GDP and employment growth continue during the second half of 2013 and into 2014 driven by an improving housing market, business investment growth, a smaller fiscal drag and growing consumer confidence and spending.

- While policy-related uncertainty has declined somewhat, decisions still must be made on budget issues which continue to cause business and consumer concern. However, the improving economy, budget cuts, and tax receipts should help offset those concerns and reduce the fiscal drag.

- With the expected continued improvement in the economy, the outlook for the U.S. commercial real estate market for the remainder of 2013 and into 2014 is favorable. While demand for some property types could be stronger, market fundamentals continue to improve in general, driven by the improving economy and the lack of supply.

- Investors in both the private and public commercial real estate markets continue to be attracted to the income yield, diversification, and potential inflation hedge that real estate can offer. With the recession in Europe and the slowdown in Asia, the U.S. continues to provide a safe harbor and attractive risk-adjusted returns for international investors.

THE ECONOMY

GDP growth is set to accelerate in the second half of 2013 . . .

- The economy grew at a moderate rate during the first half of 2013. Long-term interest rates jumped abruptly in recent months as investors began pricing the announcement by the Fed to start tapering quantitative easing. However, rates still remain near historical lows (Chart 1).

- Second quarter 2013 GDP growth was recently revised upward from 1.7% to 2.5%. We expect third quarter 2013 to grow at a 2.6% rate and the year to end approaching a 3% growth rate (Chart 2). The expansion in GDP growth is expected to be driven in large part by a housing market

recovery, growth in business investment, smaller fiscal drag, increased consumer confidence, and improved overseas demand.

- The economy continues to benefit from new job creation ranging from 162,000 to 199,000 per month over the last several months. Forecasts indicate that 200,000 jobs should be created in August, enough to cover the demand for jobs by new entrants into the labor force and contribute to the gradual reduction in the unemployment rate. We expect the tech, energy, and medical sectors to be important drivers of new job growth going forward.

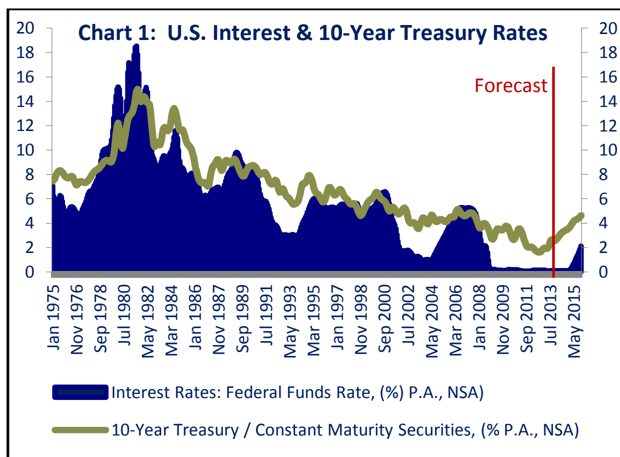
- The unemployment rate currently stands at 7.4% and given the expectations for job growth, is likely to decrease to 6.5% in the second half of 2014, the Fed's target rate that will trigger a short-term interest rate increase. By year-end 2015, we expect unemployment to drop to 6% (Chart 3).

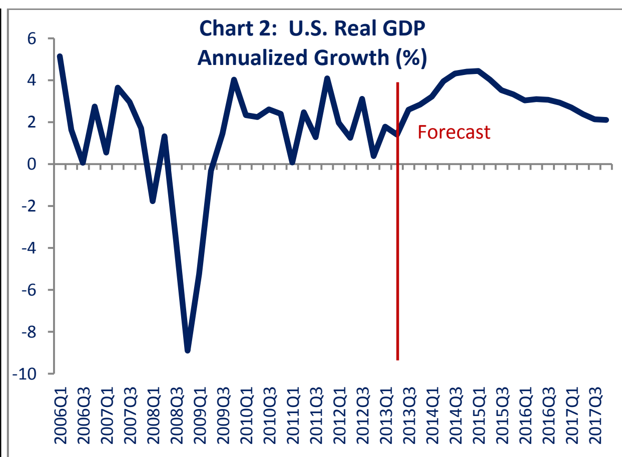
- The residential housing market continues to improve, although recent data suggests that the rate of house price gains may be starting to peak (Capital Economics). Given the 10%+ Y/Y increases in the Case-Shiller index registered in Q1, a slowdown in the rate of price appreciation should not be cause for alarm. Thirty-year fixed-rate mortgages have jumped from 3.6% to 4.7% since April, slowing refinancing activity; however new home purchases remain brisk. Lending criteria has loosened recently and we don't expect the market to run out of steam due to the higher interest rates. As the improving housing market bolsters job growth, rising home prices should improve consumer balance sheets and lead to increased spending activity.

- The improving consumer balance sheet continues to bolster consumer confidence (Chart 4). This increased consumer confidence has translated into improved retail sales. Consumer spending is expected to grow at a 3% to 4% annual rate.

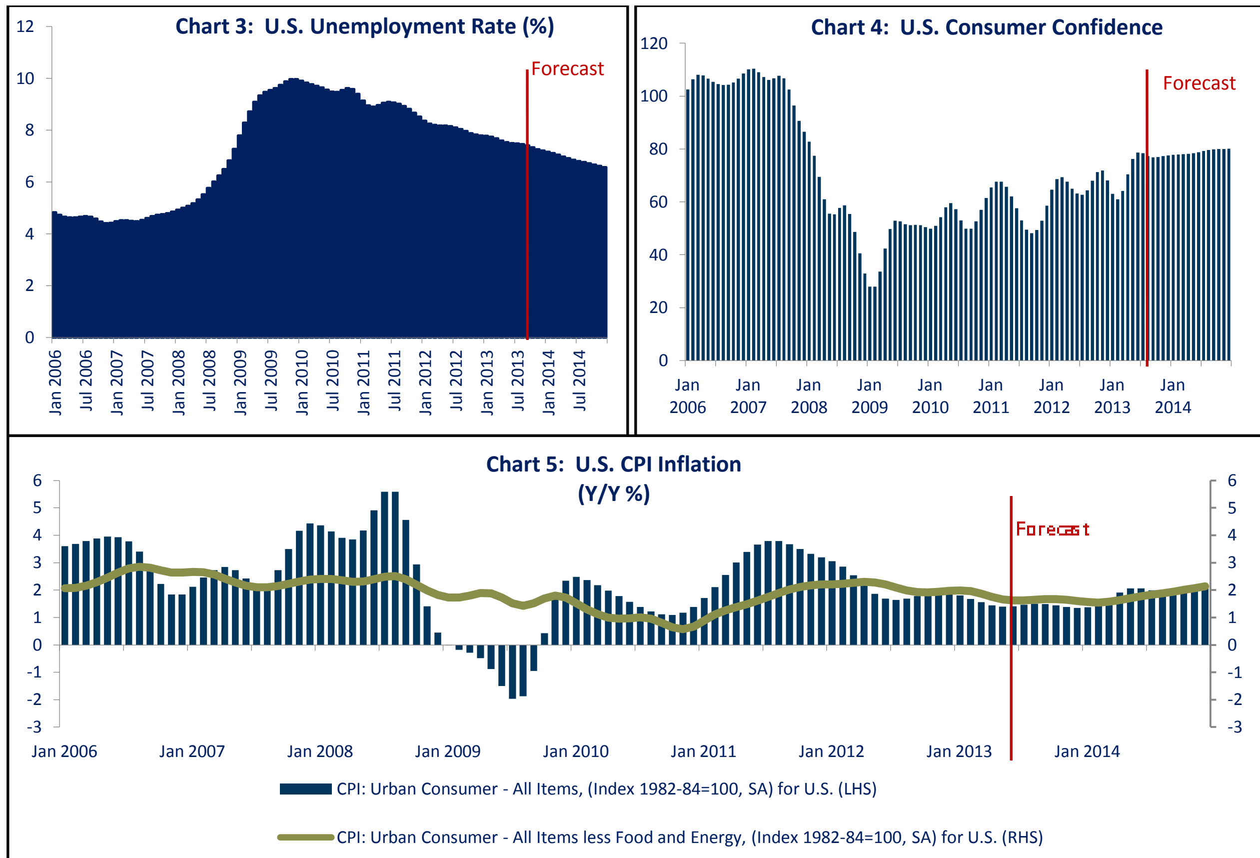
- Corporate profits continue to increase and banks are making credit readily available to businesses. Loan demand is up and corporate investment has increased.

- The downward trend in core inflation has eased as prices have been rising by 0.2% per month for that last several months. However, we still expect that inflation for 2013 will finish at 1.7%. This is well below the Fed's target rate of 2.5% inflation that would trigger a short-term interest rate increase (Chart 5).





Source: USAA Real Estate Company Research. Moody's Analytics.



Source: USAA Real Estate Company Research. Moody's Analytics.

DEBT

Ten-year Treasury rates are inching up but are still at historical lows and should continue to make real estate debt attractive for investors and lenders alike . . .

- Increasing ten-year Treasury rates have been driving up the cost of borrowing. Rates have increased approximately 130 basis points (bps) from their recent low of 1.66% in early May. However, interest rates remain near all-time low levels in the 4% to 5% range depending upon the riskiness of the asset.

- Higher borrowing costs are being cushioned by narrowing spreads, weight of capital, and strengthening NOI. As a result, property sales volume continues to grow.

- Life companies committed to $15.2 billion of commercial loans in the second quarter of 2013 almost double the $8.2 billion in the first quarter and 2% greater than the same time last year (ACLI).

- Year-to-date U.S. CMBS volume totals $55.6 billion, well above the 2012 full-year issuance of $48 billion (Commercial Mortgage Alert, CMA). In addition, non-traditional sources such as mezzanine funds chasing yield have moved into the high-yield debt space. Thus more capital is available for financing and investors have greater access to higher leverage (Chart 6).

- Life companies reported another decline in delinquent loans during the second quarter, continuing the steady downward trend over the last three years. Generally strict underwriting standards with a focus on moderate leverage and healthy debt service coverage ratios have kept delinquencies to manageable levels over the course of the current market cycle (ACLI)(Chart 7).

- Significant increases in intermediate- and long-term Treasury yields hit fixed-income markets hard. Typically, when Treasury rates rise, credit spreads narrow which helps buffer price declines. The second quarter 2013 was an exception for mortgages as the Giliberto-Levy Commercial Mortgage Performance Index (GLCMPI) registered increases in standardized spreads, although it was not universal across all property types. Coupon rates on new loans moved up.

- The average loan-to-value (LTV) on new loans this quarter was 62%. Loans in the 50% - 70% LTV range carried the same spreads over Treasuries, all else equal. Loans in the 35% - 50% LTV range showed spreads 10 to 15 bps lower. Spreads were marginally higher for loans in the 70% - 75% range, with the exception of apartments, which were flat up to 75% LTV.

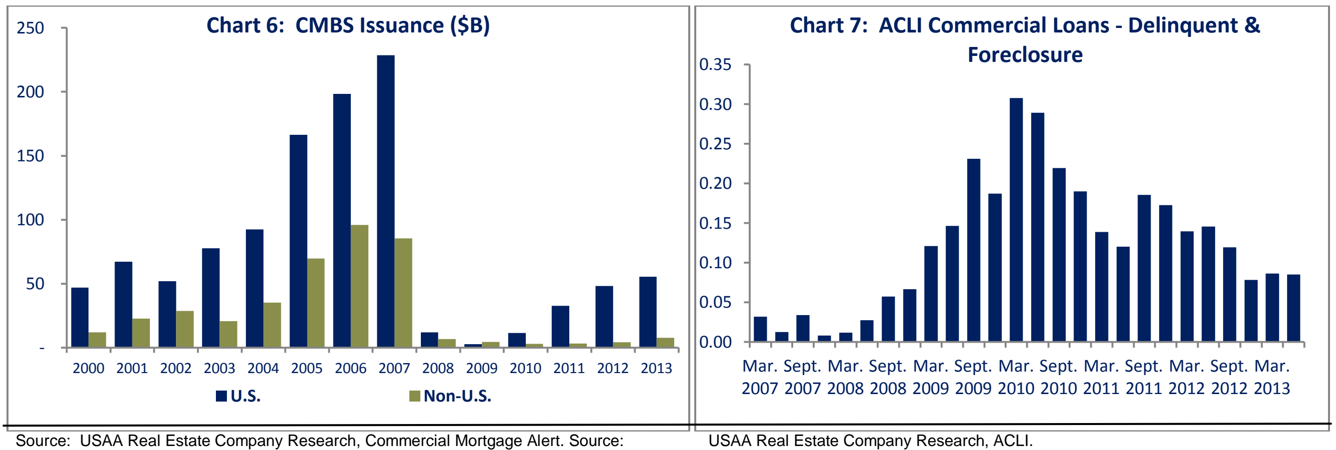
- Loan-size premiums showed up for all property sectors. The dividing point centered at $10 million, and the premium averaged 25 bps, the same as in prior quarters. Loans with full amortization increased significantly during the quarter, representing approximately 19% of total lending.

- We continue to expect good opportunities for balance sheet lenders in 2013 even with increased competition from conduits. The mismatch between the amount of debt maturities and the capacity of the lending community is well known. There will be plenty of demand for financing but parts of the demand will have difficulty in underwriting. Balance sheet lenders appear to be taking on a little more risk in 2013 in the form of higher loan-to-value ratios (LTVs).

- Most life companies have plenty of capital to invest and are focused primarily on the very best properties. Some are actually making construction loans to get a higher yield and some are pricing five- to ten-year fixed-rate financing off corporate debt equivalent returns with spreads at roughly 150 bps but have ranged as low as 30 bps and as high as 250 bps. Even at the current interest rates, mortgage investments are still relatively attractive for these lenders when compared to other fixed income investments.

- CMA reports that CMBS loan asking spreads over treasuries ranged from 156 bps for apartments to 175 bps for office properties for a 10-year loan with 50% to 59% LTV (as of August 15, 2013). CMBS new issue fixed rate spreads (conduit) over swaps ranged from 74 bps for AAA to 332 bps for BBB. Agency CMBS spreads (Freddie K Series) ranged from 45 bps for A1 to 360 bps for C tranches.

- The more active CMBS market should provide additional debt for higher risk properties and markets.



Source: USAA Real Estate Company Research, Commercial Mortgage Alert. Source: USAA Real Estate Company Research, ACLI.

REITS

2013 has been a "tale of two markets" for REITs . . .

- REITs underperformed the broader market year-to-date through the end of August 2013. YTD, the NAREIT Equity Index was up 0.4% on a total return basis, significantly behind the S&P 500 (+16.2%), the Dow (+15.2%), NASDAQ (+19.9%) and Russell 2000 (+21.9%) (Chart 8). After generally following the market higher through late May, the recent focus on "Fed tapering" has caused a sharp selloff in REITs and fixed-income securities over the last three months. REIT real estate acquisition activity earlier in the year has declined with the drop in share prices.

- Hotel performance has led the pack in 2013, with a year-to-date total return of 12.0%, followed by self-storage (+7.2%), retail (+2.2%), office (+0.4%), and industrial (-1.0%). As was the case in 2012, apartments underperformed all sectors with a -6.1% total return year-to-date. Investors have continued to rotate out of the apartment sector due to concerns over new supply and the slowing of net operating income growth (NOI) (Chart 9).

- Real estate mutual fund net flows also reflect the market dynamic of 2013. Through the end of May, real estate mutual funds had recorded inflows of $14.5 billion (compared to $13.5 billion in 2012 and $11.5 billion total for the period of 2007-2011). However, outflows of $3.6 billion during the past three months bring total 2013 net inflows to $10.9 billion (Chart 10).

- REITs continued to raise significant amounts of capital in the first half of 2013, continuing the record pace set in 2012. Debt and equity capital raised in the first half of the year totaled $47.8 billion, however we expect the pace to slow during the latter half of the year due to declining share prices and rising interest rates.

- REIT equity yields stood at 3.91% at the end of August which was very attractive when compared to the 2.14% S&P 500 dividend yield and the 2.76% 10-year Treasury yield. REIT equity yield spreads widened relative to the S&P 500 dividend yield during 2013, currently at 177 bps (a level last seen in late-2011). Relative to 10-year Treasuries, the REIT equity yield spread narrowed to 115 bps largely due to the rapid increase in treasury yields.

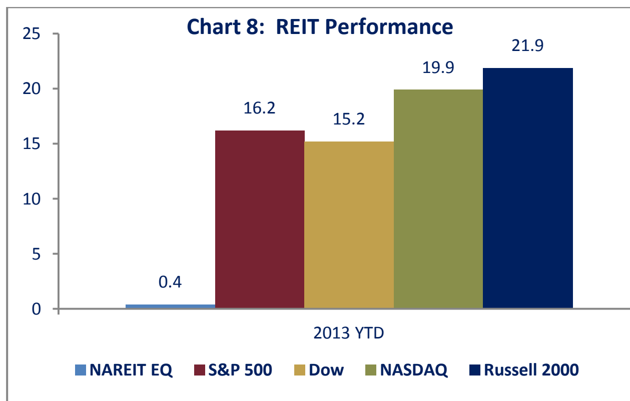
- REIT values currently reflect average funds from operations (FFO) multiples of 16.7x in 2013, the lowest since 2008 and 110% of the S&P 500 price to operating EPS multiple. Of the major property

sectors, industrial currently trades at the highest multiple (19.3x) while office trades at the lowest (15.6x). Apartments and retail fall in between, at 17.0x and 15.8x, respectively (Chart 11).

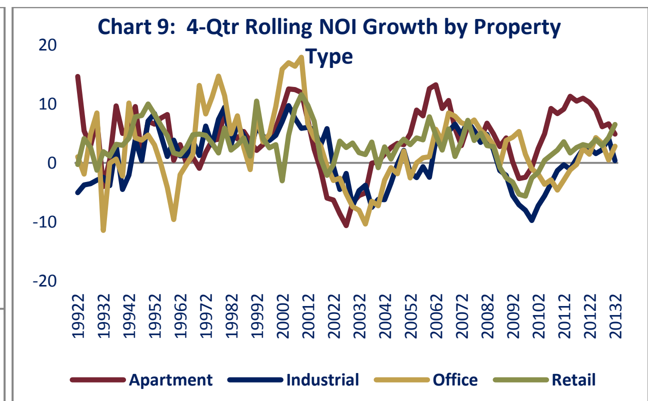
- History has shown that it is worth noting when REIT performance begins to diverge from private real estate. We are currently experiencing a divergence as both the NCREIF NPI and NFI-ODCE indices posted their best quarterly performance since 2011 in Q2, while the FTSE NAREIT Equity Index posted a return of -1.6%, its worst quarterly performance since 2011.

- This divergence in performance between REITs and private real estate points to relative value in the REIT sector. After the recent sell-off, average implied cap rates for REITs in the primary property sectors ranged from 5.9% - 6.4% while the NCREIF NPI market value weighted cap rates ranged from 5.1% - 5.7% at the end of Q2.

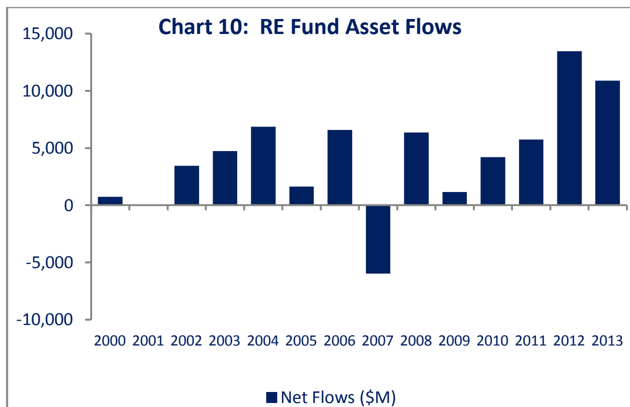
- The decline in REIT share prices typically has not boded well for private markets, which can lag REITs by a year or more. For example, the FTSE NAREIT Equity REIT index peaked in January 2007, while the NCREIF NPI did not register negative appreciation returns until Q2 2008. Conversely, REIT prices bottomed out in February 2009, while the NCREIF NPI did not see positive appreciation returns until Q2 2010. Investors must be careful, however, to not mistake every drop in REIT share prices as an early indicator of a downturn in real estate. In Q3 2011 REIT prices declined by 15% or more, moving in tandem with the S&P 500 amid fiscal concerns and the downgrade of the U.S. credit rating. We view this recent selloff in REITs as a short-term "shock" driven by a rapid rise in interest rates that may create tactical value-driven opportunity in the REIT sector, rather than an early indicator of a downturn in private markets.



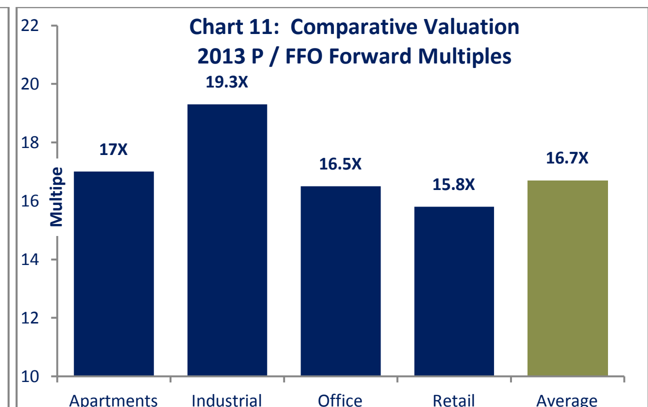
USAA Real Estate Company Research, Barclays US REIT Monitor.



Source: USAA Real Estate Company Research, NCREIF.



Source: USAA Real Estate Company Research, Barclays US REIT Monitor.



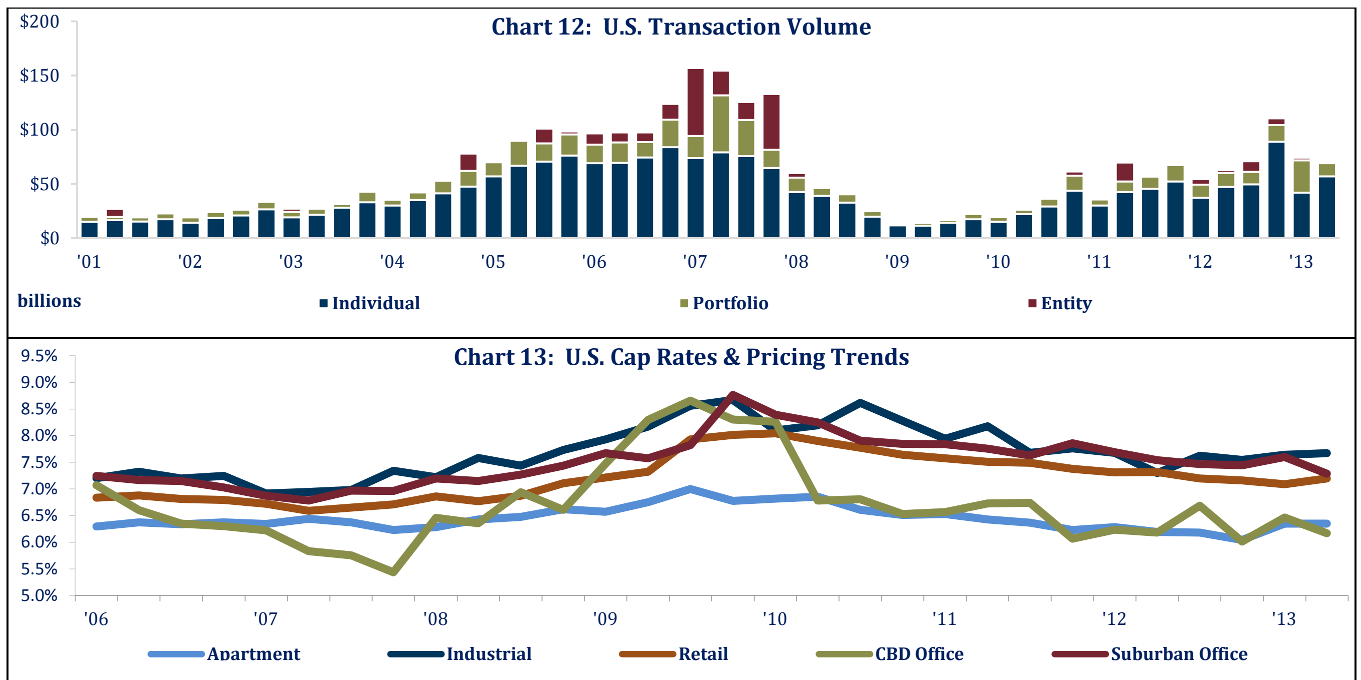
Source: USAA Real Estate Company Research, Barclays US REIT Monitor.

Property

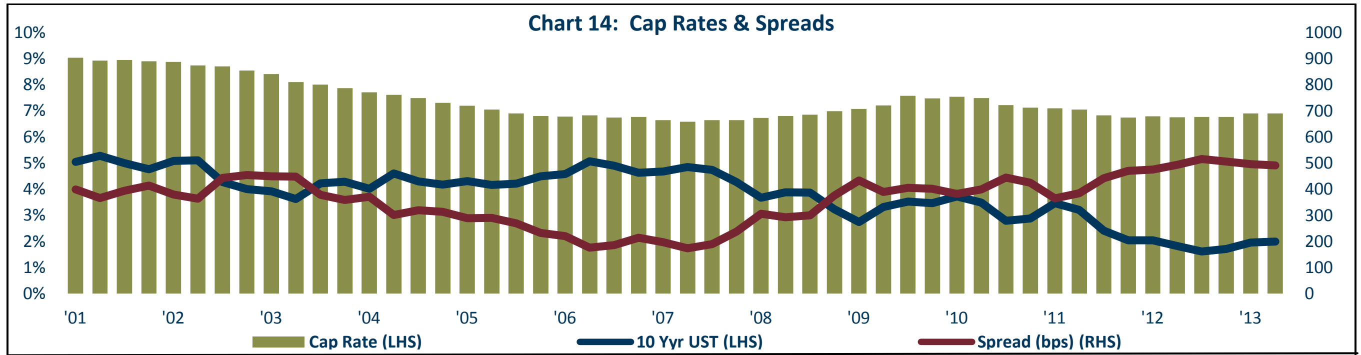
Transactions

U.S. commercial real estate transaction volume has been increasing . . .

- The first half of 2013 experienced transaction volume that exceeded $145 billion, 24% above the first half of last year. All property types grew 20% to 30% in transaction volume (Chart 12) (Real Capital Analytics (RCA)).
- Sales of significant commercial property in the second quarter of this year totaled $71 billion, up 13% year-over-year (RCA). Office and hotel property sales outpaced all other property types.
- While the recent rise in long-term rates has caused some deals to get re-traded or not to be completed, investment activity and prices continue to climb.
- Investors appear to be in more of a “risk on” mode as the level of interest in non-traditional property types and secondary geographic locations has increased.
- Increased demand for commercial real estate continues to drive prices higher and cap rates lower. Even as 10-year Treasury yields increase, cap rates continue to fall in popular markets with strong expected job and population growth (Chart 13).
- Real estate spreads over 10-year Treasuries continue to hover well above their long-term average. However, 10-year Treasury rate increases are starting to reduce the spread (Chart 14). Strong capital flows into real estate and improving net operating income growth are expected to help mitigate the impact of higher Treasury rates.



Source: USAA Real Estate Company Research, Real Capital Analytics.



Source: USAA Real Estate Company Research, Real Capital Analytics.

Apartments

Although the rapid pace of growth has eased, strong market fundamentals continue . . .

- According to REIS, the national vacancy rate in the second quarter remained unchanged from the first quarter at 4.3%, ending the streak of thirteen consecutive quarters of declines in the vacancy rate. As a confirmation to the robust performance of the apartment sector, the current vacancy rate is over 100 bps below the 20-year average of 5.4%. Moreover, this is the lowest national vacancy rate since the year 2000 (Chart 15).

- Net absorption remains strong but leveled off during the second quarter as 31,973 units were absorbed during the quarter. This pace is down slightly from the 39,319 units that were absorbed during the first quarter, but on par with the amount absorbed in first quarter of last year. Overall, the sector has absorbed more units over the first half of this year than were absorbed in the first half of 2012. Demand continues to be strong, driven by a slowly improving economy, the growing number of renter households, increased household formation and a declining homeownership rate.

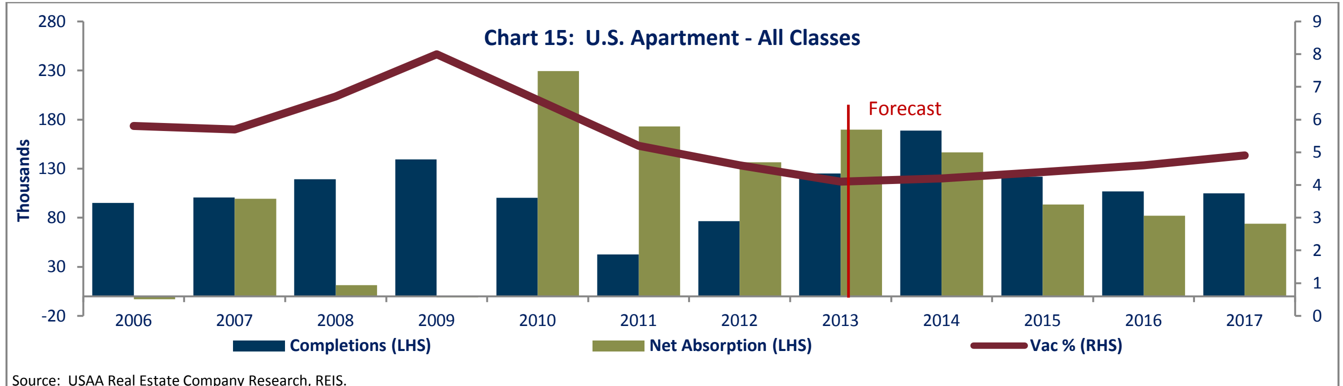
- Supply growth increased during the second quarter as 26,584 units were delivered to the market—an increase from the 16,578 units delivered in the first quarter. In 2013, over 100,000 units are expected to enter the market; however starts and completions still remain below their long-term average (Chart 16), keeping occupancy levels at or near all-time highs. Current trends show that units coming online are at least 85% occupied, indicating that demand for apartments remains strong.

- Asking and effective rents grew by 0.6% and 0.7%, respectively, during the second quarter, resulting in an increase of 10 bps from the previous quarter. Rent growth nationally has slowed over the last few quarters as compared to the growth seen in 2011 and 2012, but still posted a healthy 3.4% Y/Y growth rate in July 2013 (Chart 17). The growth in effective rents coupled with occupancy gains has generated 3.7% revenue growth Y/Y, significantly outpacing inflation. Going forward, market and submarket selection will be a key driver of performance in the apartment sector, as evidenced by the wide spread in Y/Y effective rent growth between the top performing market (Fort Myers, FL + 11.0%) and bottom performing market (Washington, D.C. -0.2%) (Axiometrics).

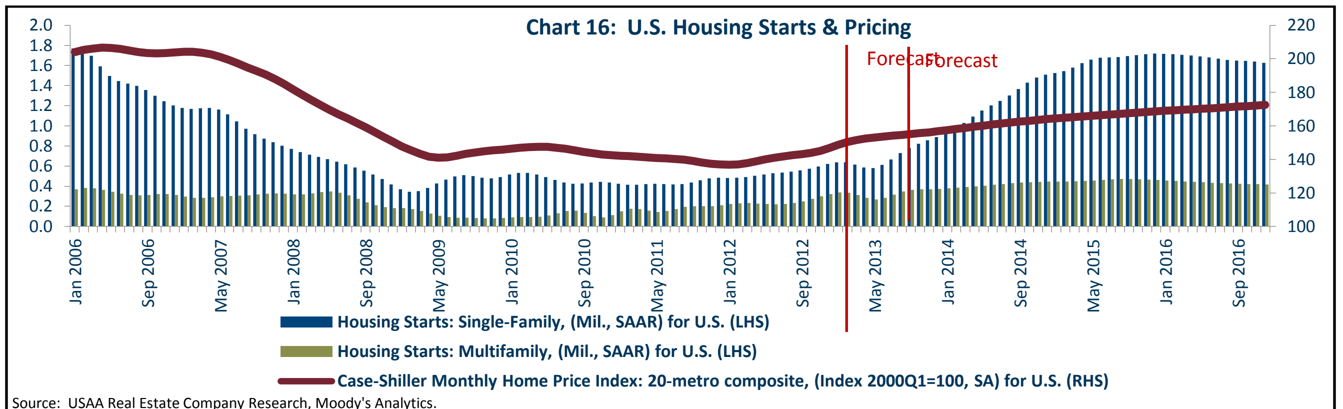
- Mirroring the top performing sectors of the economy, seven out of the top 10 markets for rent growth are in technology or energy-oriented markets. On the flip side, markets at the bottom of

this ranking are a mixed bag of industrial markets, formerly high-flying housing markets, and some already expensive East Coast markets.

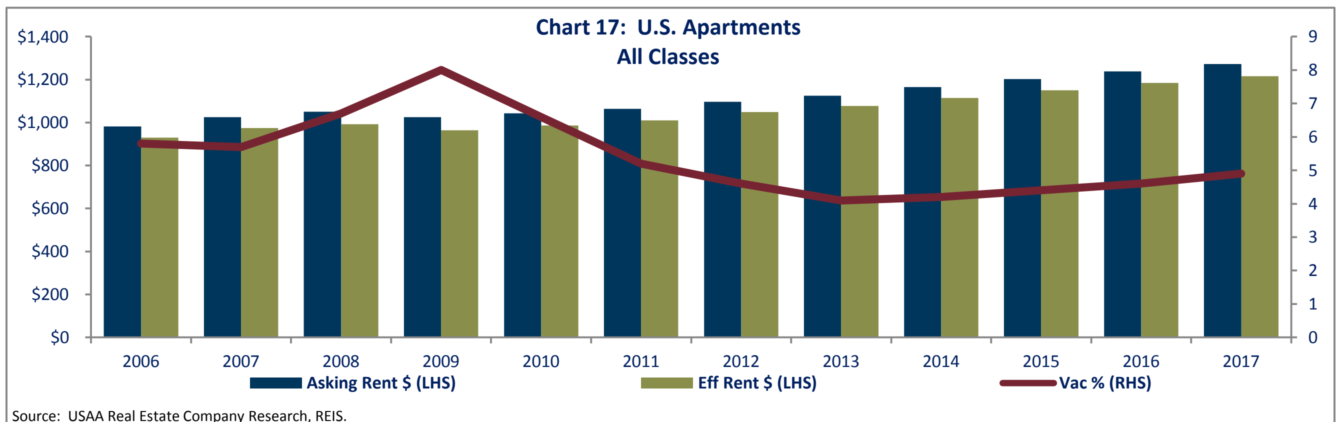
- Looking forward, the outlook for the apartment sector looks healthy for the remainder of 2013. Overall, the sector appears to be transitioning to a point where market fundamentals are stabilizing and a slight slowdown in growth is anticipated. For the rest of the year, vacancy rates should continue to trend lower for most markets, but have likely bottomed-out in the tightest markets.



Source: USAA Real Estate Company Research, REIS.



Source: USAA Real Estate Company Research, Moody's Analytics.



Source: USAA Real Estate Company Research, REIS.

Industrial

Improvement in the industrial sector continued during the second quarter . . .

- According to CBRE-EA, the national availability rate decreased by 30 bps to 12.0% in the second quarter, decelerating slightly from the previous quarter, yet still demonstrating the continued strength of the industrial recovery. Of the 48 markets that showed a decline in their availability rate, half of those markets fell by an impressive 50 bps or more (Chart 18).

- Net absorption was a positive 46.5 million square feet (sf) for the second quarter, a slight decrease from the 63 million sf absorbed in the first quarter. For the year, net absorption was a positive 109.2 million sf, more than double the amount absorbed in first half of 2012.

- As market fundamentals continue to improve, new supply has been trending upward. New construction deliveries increased to 14.5 million sf during the second quarter, up from 10.9 million sf delivered in the first quarter. We expect the gap between supply and demand to continue to narrow over the near term.

- The industrial market has seen 12 consecutive quarters of recovery, with the strongest recovery occurring in the three most recent quarters. Market rent growth continues to remain strongest for larger, modern warehouse properties in major metro areas, especially in the leading coastal markets.

- Rent growth has gained some traction as leasing concessions have continued to shrink. Asking and effective rents were up 0.4% and 0.5%, respectively, during the second quarter. On a year-over-year basis, asking rents have advanced 1.1% and effective rents have increased by 1.7%. As the vacancy rate continues to decline, we expect to see more significant gains in rent growth (Chart 19).

- Drilling down into the details, there is currently a bifurcation between infill core markets and bulk markets with an abundance of available land. The infill core markets are experiencing higher rental rate growth as vacancy rates tighten. Alternatively, in markets where land is more readily available, bulk users are not afraid to locate out of town to take advantage of lower costs. This dynamic is placing a cap on the incremental rent growth of bulk product in those markets, as tenants facing rent increases can seek out build-to-suit opportunities at historically low rent constants.

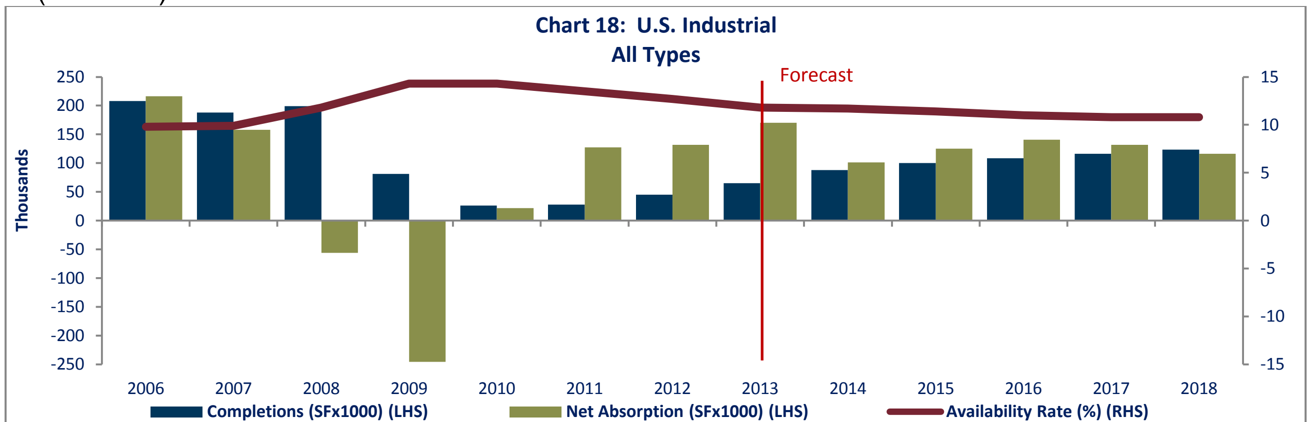
- With respect to tenants, pharmaceutical and home health care industries have weathered the recession very well and continue to be a top choice with landlords.

- We are starting to see dedicated e-commerce space allocated within the larger retail units of stores such as Wal-mart, Home Depot, and Target to act as a flexible fulfillment infrastructure to compete on consumer experience and delivery. At this time, we expect that this new business strategy will have minimal impact on the overall industrial market, as we believe it will be a complementary effect rather than a substitution effect.

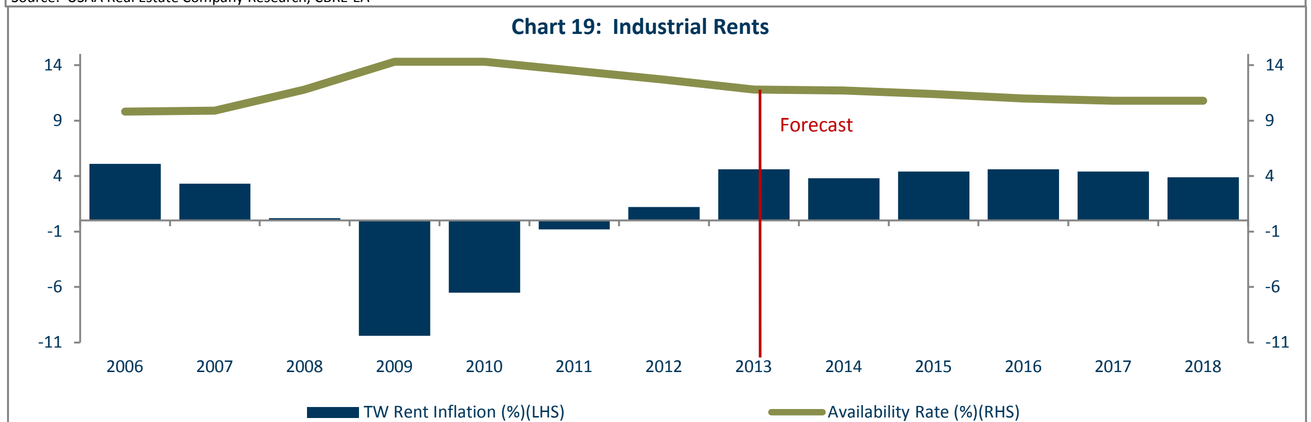
- Transaction activity for industrial properties in the first half of the year was $20.5 billion, an impressive 35% increase year-over-year. Volume gains were recorded for portfolio and individual property transactions as well as for the flex and warehouse sectors.

- For the most part, cap rates have leveled off over the past several months, averaging around 6.5% for warehouse properties and 7.3% for flex properties year-to-date (RCA). Going forward, the best opportunity for cap rate compression is with newer, larger warehouse properties where strong investor demand could promote further pricing appreciation.

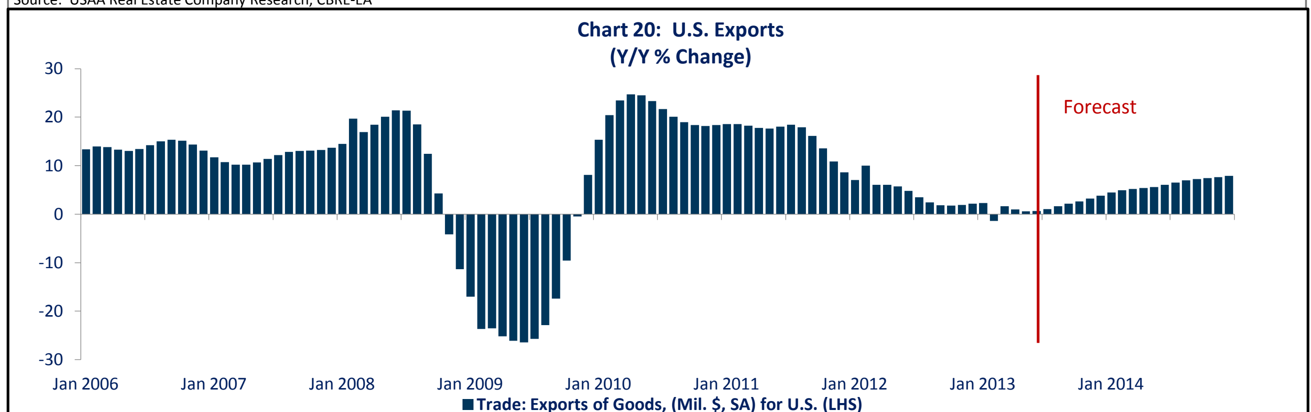
- The industrial outlook continues to be favorable as demand drivers such as exports and manufacturing look promising over the next 12 months and market fundamentals should remain strong. We expect vacancies to trend lower as demand will outpace supply over the near term (Chart 20).



Source: USAA Real Estate Company Research, CBRE-EA



Source: USAA Real Estate Company Research, CBRE-EA



Source: USAA Real Estate Company Research, Moody's Analytics.

Office

The office market is faring well despite uncertainty . . .

- CBRE-EA reports that the national office vacancy rate declined by 20 bps to 15.3% in the second quarter, and is 70 bps lower than 2012's second quarter rate. CBD office vacancy rates declined by 10 bps during the quarter to 12.3% and the suburban office rate fell 20 bps to 16.8% (Charts 21 and 22).

- Net absorption for the second quarter was a positive 9.8 million sf, a sharp increase from the 3.8 million sf absorbed in the first quarter. Year-to-date, net absorption has totaled 13.6 million sf, slightly ahead of the pace in 2012.

- Construction completions picked up in the second quarter as 3.9 million sf was delivered, over double the amount from the previous quarter, but still far below the 9.5 million sf historical average. A large majority of the new supply is focused on pre-leasing in markets such as San Jose and Houston that are well into the expansionary phase of employment growth. But overall, speculative development remains very minimal in the majority of markets.

- New supply growth is likely to remain very low for several years to come. The extended slowdown in new construction will continue to strengthen market fundamentals—the vacancy rate should continue to decline over the next several years, eventually dipping below 13% by early 2017.

- Markets that have growth sectors like energy, technology, medical and education are capturing a higher proportion of the incremental demand. Furthermore, as a sign of the recovery becoming more entrenched, markets that were severely affected by the housing crash have been among the top performers in the first half of 2013.

- There is a continued reduction in square footage per office employee due to technology improvement, flexible working hours, and the ability of employees to partially telecommute. This structural shift will be most detrimental for older office buildings that lack the functionality, flexibility, and divisibility of newer properties.

- Transaction activity totaled $45.2 million for the first half of 2013, a slight dip from the pace earlier in the year, and primarily resulting from fewer portfolio transactions. Individual property sales were down just 5% year-over-year. But the recent increase in interest rates may have spurred some investors into action. In July alone, over $7.0 billion of office properties went under contract, a high number especially given the typical lull in activity during summer.

- Nationally, office prices were up 2.8% in the first half of 2013 with Q2 gains slightly higher than in Q1. Over the past year, the national Moody's/RCA CPPI for office is up 8.1%, bringing prices to 80% of peak levels.

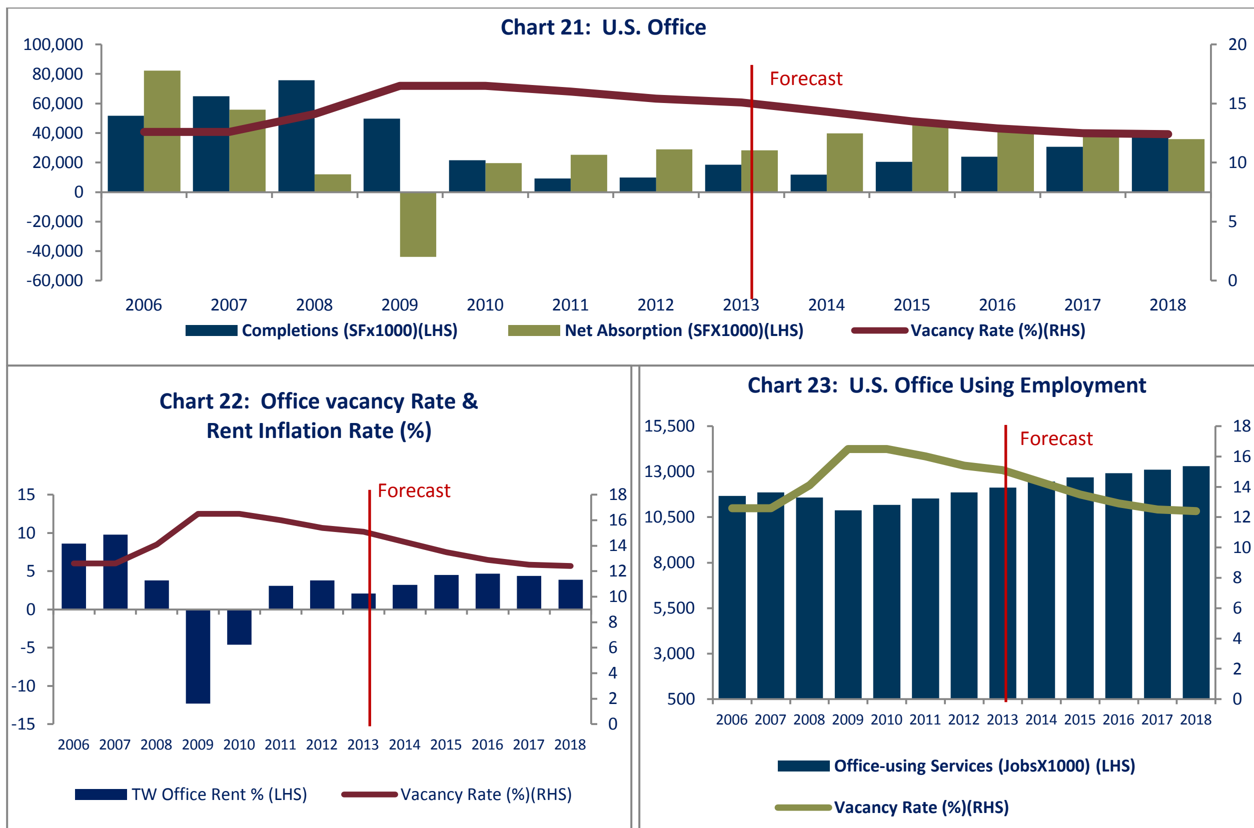
- As investors' appetite for risk grows, they are starting to target well-leased buildings in second-tier markets with strong employment growth. Price gains in the non-major markets posted the strongest gains in Q2, significantly outperforming their peers in the 6 major metro areas. For instance, pricing for non-major market suburban properties is up 8% over the last three months, compared to just a 1% increase for major market suburban properties.

- Cap rates on office acquisitions do not appear to have been negatively impacted by rising interest rates so far. Yields continue to trend lower for deals closed in July as well as for the considerable number of deals reported in contract.

- High-barrier suburban office markets, which are recovering off a deeper bottom than properties in CBDs, are more likely to see cap rates compress and produce returns that are on par with the larger gateway markets.

- With respect to demand, the addition of new jobs in office–using employment thus far this year is further encouragement that employment is poised to surpass pre-recession peaks early next year (Chart 23).

- Overall, the national office market has been remarkably resilient during the first half of the year, especially when faced with the headwinds of sequestration and a moderate employment picture.



Source: USAA Real Estate Company Research, CBRE-EA.

Retail

Retail recovery remains slow . . .

- As a positive sign for the retail sector, retail sales in July increased 0.2% from the previous month, admittedly not too impressive, but the details of the underlying data suggest that households have started to spend more vigorously and that real consumption growth is poised to accelerate in the third quarter (Charts 4, 24, and 25).

- REIS reports that the national vacancy rate declined to 10.5% in the second quarter, down 10 bps from the previous quarter, but the sector is yet to experience any major strengthening in market fundamentals. In fact, this latest decline marks the sixth occurrence in the last seven quarters that vacancy has fallen by only 10 bps or less, reinforcing the notion that the retail sector's recovery has been slow to achieve momentum (Charts 26 and 27).

- Net absorption for the second quarter was 2.5 million sf, a decline from the 2.9 million sf absorbed in the first quarter of the year. New construction added only 930,000 sf during the second quarter, a decrease from the 1,124,000 sf added in the first quarter. Supply is expected to increase slowly over the next several years, but still far below the pre-recession levels.

- Demand for retail space should continue to grow modestly with vacancies slowly declining as new supply remains low. Demand should continue to outpace supply, with net absorption exceeding new supply by at least 3 million sf over the next year. This will systematically drive the vacancy rate lower – it is forecasted to drop below 10% by 2015.

- Asking and effective rents both grew by 0.3% during the quarter, a pace on par with the first quarter growth. High levels of vacant stock and lackluster net absorption have acted to create an environment fostering slower-than-normal rent growth.

- Investor demand is expected to remain focused on dominant centers and markets with high barriers to construction. Marginal properties will continue to struggle.

- Older retail space has become increasingly obsolete as newer, higher quality construction is preferred by tenants. One could argue that retail space is not overbuilt, just under demolished, especially given changing retail formats.

- E-commerce continues to be a wild card that most retailers are struggling to embrace in their business model. But despite the hype, e-commerce only represents about 5.8% of total retail sales, according to the latest data from the Department of Commerce. As such, most brick-and-mortar stores remain critical to the retail industry. The most important take-aways about e-commerce is that it continues to grow at a rate five times faster than overall retail sales and investors should monitor retailer format changes.

- Transaction activity has totaled $26.5 billion for the first half of 2013, representing a 58% increase year over year. Volume gains were recorded for both portfolio and individual property transactions as well as across all the various retail property subtypes (RCA).

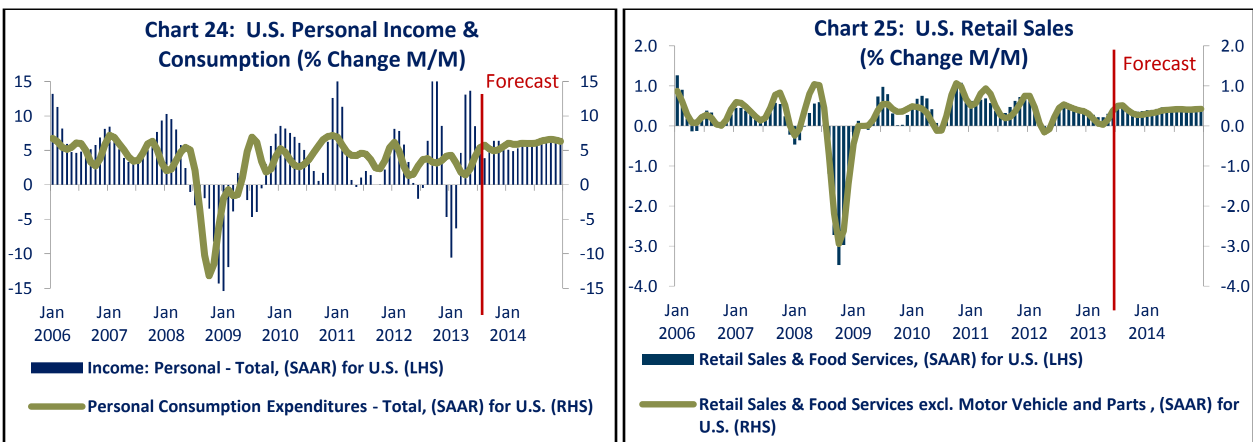
- Nationally, retail prices are up significatnly, rising 8.9% in the first half of 2013, with most of those gains recorded in Q2. Over the past year, the Moody's/RCA CPPI for retail is up 13.1% nationally. The gains in the sector were assisted by the rebounding of segments and markets that had previously been a drag on trends.

- Price appreciation in the retail sector in recent quarters has outperformed all other property types but hotels. The recovery in prices for retail property still trails most other property types and prices have just reached 76% of peak levels. Comparatively, apartment prices have fully recovered to peak levels and prices for CBD office properties could surpass peak levels soon.

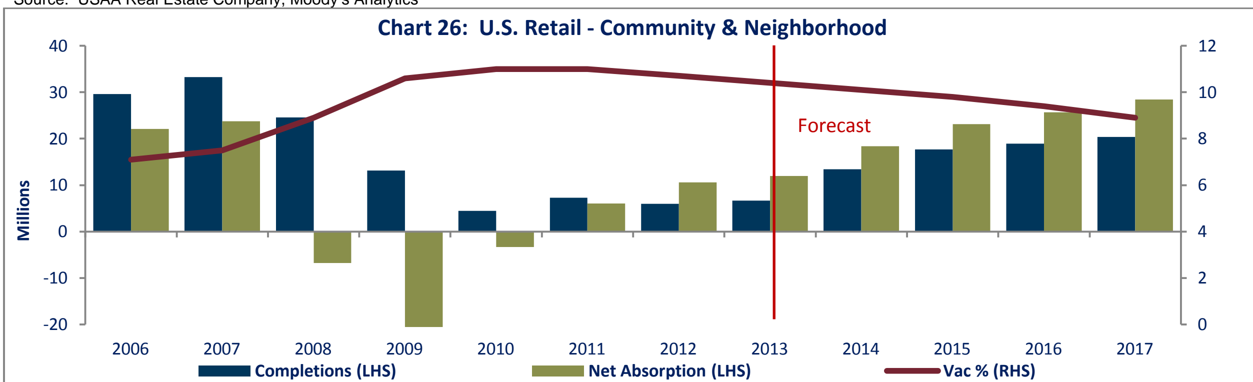
- Average cap rates have been hovering around 7.1%, and have trended slightly lower over the last several months. Pricing appears to be relatively unaffected by the May/June spike in interest rates. Conversely, the national average cap rate for strip centers has trended upward in recent months, but that dynamic is somewhat misleading, as it reflects a greater proportion of transactions of unanchored strip centers and properties located in smaller markets where yields are much higher.

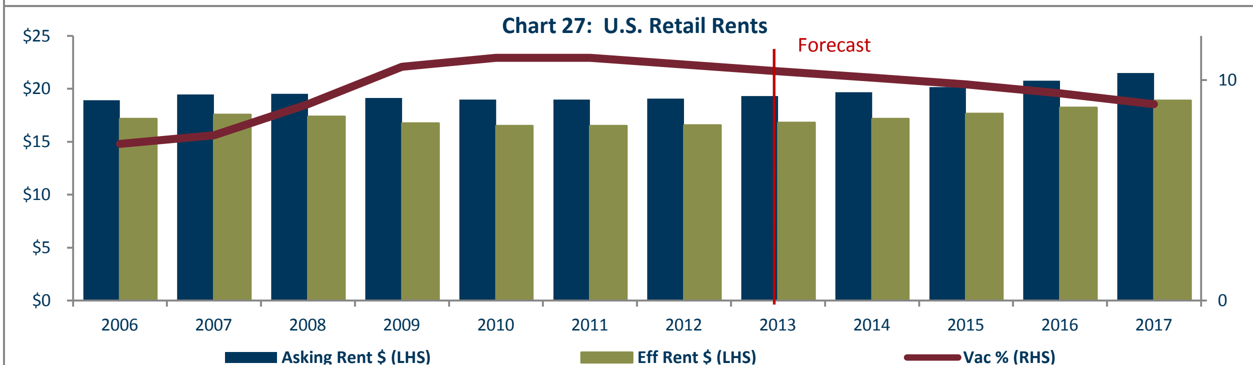
- With little new supply and low vacancies, malls should be in a position to keep raising rents. Pricing power is returning to power centers, while strip centers are lagging.

- Looking forward, the growth of the retail sector remains muted for the rest of 2013, but should continue to trend slowly in the right direction.



Source: USAA Real Estate Company, Moody's Analytics





Source: USAA Real Estate Company Research, REIS.

Hotels

Hotel fundamentals continue to be strong, but there are signs that the rapid pace of growth is leveling off . . . .

- The hotel sector has continued its path of increasingly strong fundamentals, fostering an impressive period of growth. As of the second quarter of 2013, the hotel industry has enjoyed over three consecutive years of exceptional RevPAR gains, considerably exceeding its historical long term average (Charts 28, 29, and 30).

- Not all segments are recovering at the same pace. Hotels in the luxury, upper-upscale, and upscale segments of the industry have surpassed occupancy peaks in 2012, while lower price segments – upper-midscale, midscale, and economy – will not exceed pre-recession occupancy levels until 2015 or beyond.

- According to PKF-HR, national hotel occupancy was 66.3% in the second quarter, a 120 basis point increase over the same quarter last year. Occupancy is forecasted to outperform 2012 levels throughout the remainder of 2013, and is expected to achieve a 62.4% occupancy level for the year, a 100 bps improvement over last year.

- In the second quarter, the national Average Daily Room rate (ADR) increased to an average of $110.79 per room, representing a 4.0% growth rate over the past four quarters. ADR growth is forecast to clip along through the rest of the year and settle at a solid 4.3% annualized rate at the end of 2013. Over the longer term, ADR growth is expected to spike upwards to the 5% to 6% range for the next three years before declining back to 3.5% in 2017.

- Nationally, RevPAR ended the second quarter at $73.50, representing a 6.0% increase from the second quarter of 2012. Going forward, RevPAR is predicted to achieve a 6.1% growth rate for 2013. Consistent with the previous quarter, properties in the higher-end segment are forecast to achieve the greatest gains in RevPAR during 2013. But as upper-tier occupancy levels exceed 70% and room rates begin to skyrocket, RevPAR gains will likely accelerate in the lower-tier and economy segments in the latter part of the year.

- Rising demand from transient business travelers and leisure travelers has been the main driver for the improvement in market fundamentals. Group travel has yet to fully rebound from the recession, and growth in group demand is likely to be tepid into 2014.

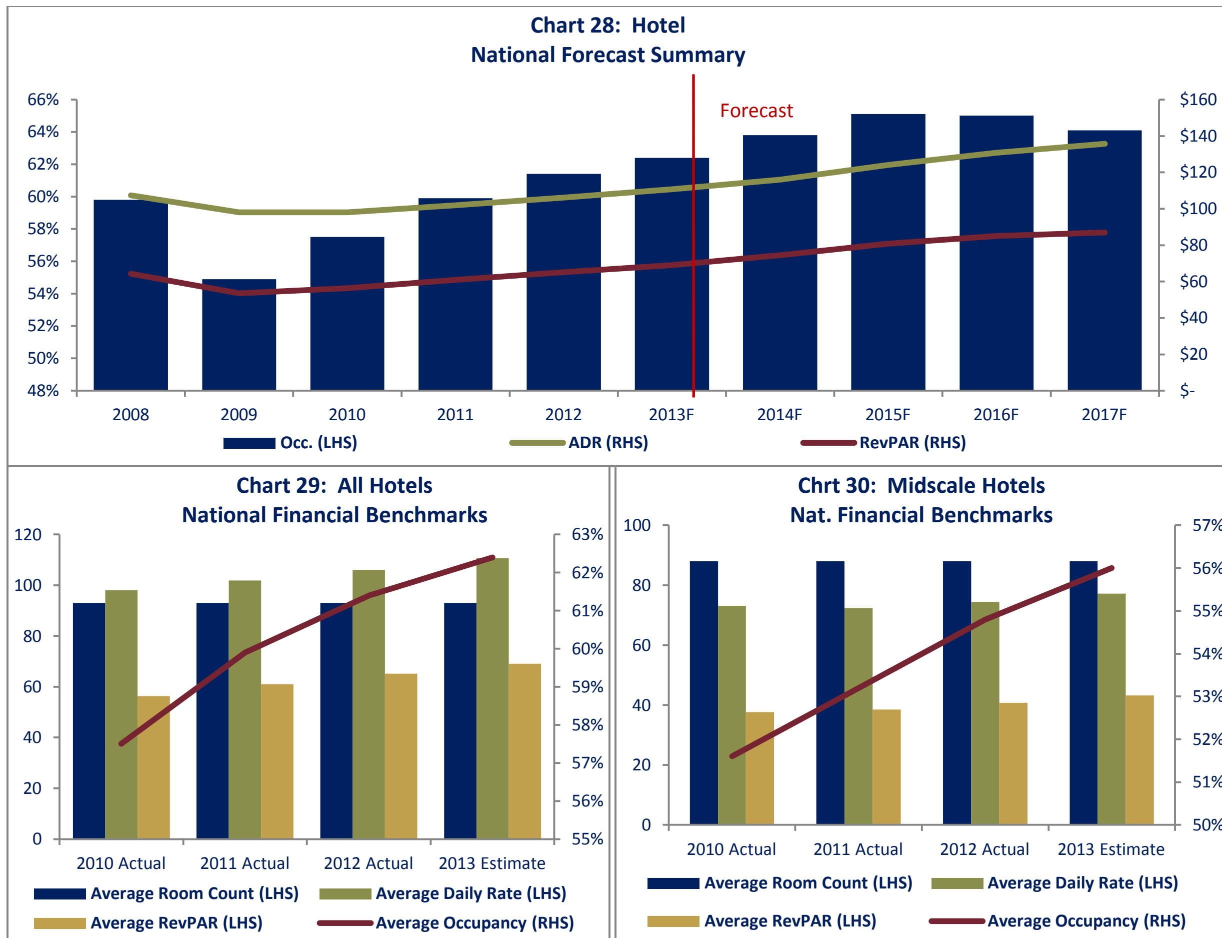
- For 2013, demand is expected to end the year at around a 2.7% growth rate, but still outpace the amount of new supply, which is forecasted to increase by only 0.8% for the year.

- Supply is increasing from trough levels, but is projected to level off at about 2% of stock. Nearly 10% of the national pipeline is in New York City, which has among the highest occupancy rates in the nation and can easily absorb some additional new supply.

- Transaction activity dwindled at the end of the second quarter with July totaling just $1.2B, down 45% year-over-year and the first decline in a year. The greatest drop in sales was for full-service properties.

- Hotel prices are up significantly nationally, rising 12.6% in the first half of 2013, with most of those gains recorded in Q2. Over the past year, the Moody's/RCA CPPI for hotels is up 18.6% nationally, outpacing any of the other property types. The recent gains in hotel prices were largely driven by activity in the largest metro areas.

- For the remainder of 2013, hotel market performance should continue to be very positive, continuing to set the stage for significant growth in 2014. As demand for lodging continues to increase, and supply growth remains in check, favorable market conditions will provide hotel owners the opportunity to place further upward pressure on room rates.



Source: USAA Real Estate Company Research, CBRE-EA, PKF.

USAA Real Estate Company – A Market View

Given current and expected economic and real estate market conditions, numerous attractive investment opportunities exist . . .

- Even at current low cap rates in some markets, core real estate yields still look attractive relative to alternatives, providing stable income with an element of inflation protection. While we believe opportunities remain in the top gateway markets, particularly for recapitalizations and value add investments, these markets are becoming increasingly expensive and investors should consider other markets that have strong demand growth fundamentals and supply constraints. Emphasis

should be placed on markets with heavy employment concentrations in energy, technology, and health care as they should provide significant income growth opportunities.

- Changing demographics in the U.S. are providing opportunities for long-term real estate investors across various sectors and subsectors. The echo baby boom is in its family formation and marriage phase which correlates with the peak in demand for rental apartments and multifamily housing. This should continue through at least 2016 or 2017. While housing affordability may cut into demand somewhat, apartment demand should remain strong until then. Apartments have gotten very pricey in some markets and the volume of proposed new development is increasing, but demand drivers, including reduced homeownership, urbanization, and mobility remain strong. New development will not start impacting the markets for another year. That said, there are a handful of markets where supply concerns should discourage further development activity. There are still attractive opportunities for investors to take advantage of apartment demand by developing infill locations in strong growth markets that can provide attractive development risk-adjusted return premiums. In addition, buying in strong locations in growing secondary markets with supply constraints can provide attractive returns.

- Another changing demographic that is providing attractive real estate investment opportunities is the aging of the population. This demographic is producing demand for senior housing and medical office facilities, as well as incremental demand for traditional apartments as seniors become “renters by choice”. While senior housing can provide attractive returns across the investment spectrum from independent or minimal assistance with activities of daily living to acute care, investment in this area is tantamount to investing in an operating business and as a result we are not actively investing in this sector. While the same can be true for investing in medical office, this varies by the type and location of medical buildings. The demographic trends, among others, provide strong support for investing in this subsector. However, the opportunity should be implemented with a strong operator/partner who can execute transactions with major health care systems.

- Approximately $1.5 trillion in commercial real estate debt will need to be refinanced over the next five years. Opportunity exists to purchase underperforming loans as lenders are in a better position to accept the losses. In addition, new loan opportunities exist that can provide investors with attractive returns relative to other fixed-income investments. An opportunity exists to provide debt in the 65% - 85% segment of the capital stack. This segment can provide very attractive returns with a measure of protection given that the loan is still senior to the equity position. Finally, as this large amount of debt is resolved, there will be significant opportunity to recapitalize the underlying real estate, much of which has been capital starved over the past several years as lenders “kicked the can down the road.” While this produced positive results for the senior lenders, the assets have suffered from deferred maintenance and lack of leasing capital and in many cases occupancy has moved steadily downward.

- As the economy slowly recovers in a constrained supply environment, there are opportunities to take advantage of increasing demand across all property types. Industrial/warehouse assets in select inland and coastal port markets that are along the path of goods movement and near population centers are particularly attractive. Well-located, modern functional warehouse space that is responsive to the needs of e-commerce tenants should provide attractive total returns with a strong income component. Moreover, the rapid expansion of e-commerce tenants has led to build-to-suit opportunities and strong demand combined with diminished supply and has justified speculative development in the healthiest industrial markets such as Central Pennsylvania, the Inland Empire in California, as well as key Mid-Western distribution centers.

- The retail market is very similar to the apartment market as it has to expand to meet the shopping needs of new households. Given the current economic environment, the retail market has become bifurcated in that there is continued demand for necessity shopping and luxury items. Therefore, demand driven investment opportunities exist for necessity-focused neighborhood retail centers, typically grocery anchored, and higher-end regional malls. Investment in grocery anchored centers should focus on locations with steady or growing populations and emphasis should be placed on the quality of the grocer. As Wal-Mart and Target continue to expand their grocery business, investors should focus on major metropolitan areas where multiple strong grocers exist and on smaller markets were a dominant grocer exists. The dominant high-end mall in major markets is also attractive, but investment opportunities are very limited. In general, retail investors must be mindful that internet commerce is slowly causing retailers to consider changing their formats. Caution is warranted for big box retailers that do not adapt to this shift in consumer preferences.

- The demand for office property tends to correlate with the office-using workforce and the strength of the economy. As office employment slowly improves and vacancy rates continue to drop, there are attractive opportunities to invest in office in the gateway markets with cap rates still at attractive spreads over Treasuries. Yields can be enhanced in these markets by accepting leasing or vacancy risk, but this requires a strong understanding of market fundamentals, as well as a careful selection of quality assets that possess competitive leasing advantages. For those looking for even higher yields, strong locations in the major non-gateway markets can provide attractive returns, particularly as greater amounts of institutional capital returns to these markets over the next several years. As a result of the previously mentioned shortage of capital for maintenance and leasing costs, the office sector represents the most appealing area for value-add investment.

- The recent decline in REIT prices due to increases in interest rates has made REITs an attractive relative value, particularly given the strength of the private real estate market. An opportunity may exist to take a public REIT private to capture the value of the real estate assets in the private market.

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