MARKETBEAT

U.S. Capital Markets

Q1 2017

CUSHMAN & WAKEFIELD

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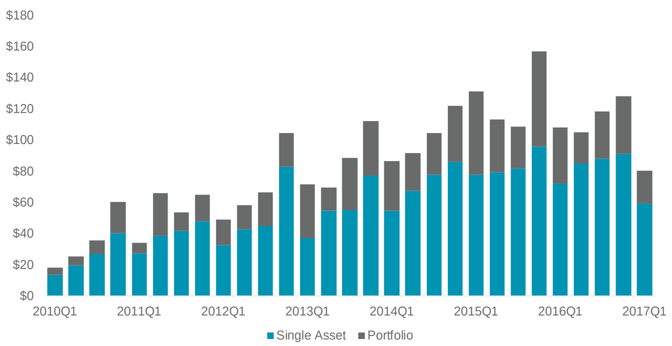
U.S. CAPITAL MARKETS

U.S. Investment Sales Volume (Deals Over $5M)

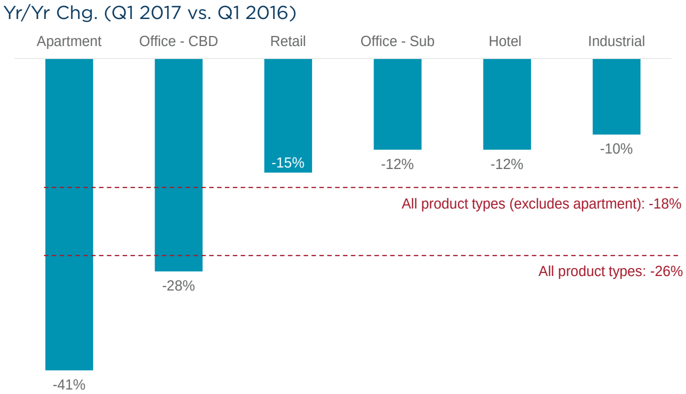
$ Billions



Source: Real Capital Analytics

U.S. Investment Sales Volume by Property Type

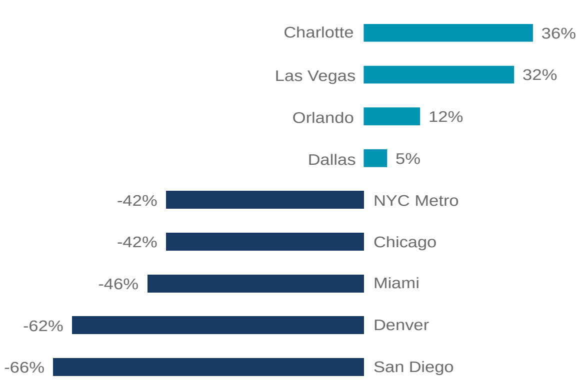
Yr/Yr Chg. (Q1 2017 vs. Q1 2016)



Source: Real Capital Analytics

Investment Sales Volume for Select Markets

Yr/Yr Chg. (Q1 2017 vs. Q1 2016)



Source: Real Capital Analytics

Key Takeaways

- In the first quarter, transaction volume was down 26% from the same period a year ago. Both portfolio and individual asset sales fell. The decline was widespread across market tier and product.
- Appreciation was positive across market tier and product type but uniformly decelerating. This was consistent with a 17 basis points (bps) rise in cap rates for the quarter.
- In contrast to the capital markets data, economic and commercial real estate fundamentals maintained a broadly positive outlook.
- The first quarter was ultimately a pause as buyers and sellers adapt to the new market paradigm. The current environment of low transaction activity, favorable market fundamentals and large amounts of dry powder is not likely to persist.

Challenging Start to 2017

Soft data—such as business and consumer confidence—surged in the final quarter of 2016, particularly in the wake of the U.S. presidential election. The yield on 10-year U.S. Treasuries crept upward from 1.9% on Election Day to 2.5% by the end of 2016. This reaction was widely viewed as positive, reflecting the market's anticipation of a higher growth scenario led by fiscal stimulus, targeted deregulation and higher inflation. But the uncertainty surrounding the policy agenda in Washington was equally as present. Combine that with a persistent uneasiness about the length of the business cycle, and it is not surprising that there was an impact on capital markets for commercial real estate.

Sales activity typically peaks in the fourth quarter of the year, and 2016 was no different. Investment hit $128.0 billion at the end of Q4 2016, 18% below the value in Q4 2015 ($156.9 billion). Fast forward to the end of the first quarter of 2017 (and note the first quarter of any year is typically the weakest in terms of sales), and the trend of declining trade volumes persisted. In Q1 2017, transaction volume fell 26% from the first quarter of 2016 and was down 37% from the fourth quarter of last year.[1] In 2016, declining volumes were almost entirely attributable to a fall-off in portfolio and M&A transactions, but during the first quarter of 2017 there was both a decline in portfolio and M&A activity (-42%) and a decline in single asset transactions (-18%). Indeed, Q1 2017 was the weakest quarter for individual asset sales since Q1 2014.

[1]Deals over $5 million. Based on RCA data as of 4/13/2017

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Outperformance Among the Unexpected

While volumes were down for all product types on a year-over-year basis, those for industrial, suburban office and hotels fell less than other asset classes. Industrial sales activity was down overall in 2016 but that was due to normalization of portfolio asset sales from their pace in 2015. In fact, individual asset sales were up 7% year-over-year in 2016, bucking the broader trend seen across most property types. This suggests that industrial outperformance has continued and reflects the robust demand for the asset class. Similarly, suburban office reflects the larger number of opportunities relative to the supply-constrained CBD on the margin. It is more difficult to assess the reason(s) for hotels' relative strength; it could be a firming after the stark declines of 2016, or it could reflect increased demand in view of the greater inflation protection offered by the asset class.

Apartment volume, on the other hand, was down 41% in Q1 2017 compared to Q1 2016. This is less surprising when one considers that multifamily faced two headwinds not encountered by other product types: 1) apartment volumes peaked in 2016 rather than in 2015, and 2) a large number of deliveries are slated for 2017.

It's All Relative in the Local Market

Sales activity in the major metros, secondary and tertiary markets was down fairly uniformly from the first quarter of 2016. But on a quarter-to-quarter basis, secondary markets showed the greatest deceleration (-44%) and tertiary markets the least (-28%). At the metro market level, however, there was considerable differentiation. Among the six major metros, New York and Chicago tied with the starkest year-over-year drop in transactions (-42%) followed by Boston (-33%). In contrast, Washington, DC (-7%) and San Francisco (-5%) were comparably strong. Within the secondary markets, San Diego (-66%), Denver (-62%), Miami (-46%) and Seattle (-42%) stood out among decliners, while Las Vegas (+32%), Charlotte (+36%) and Dallas (+5%) showed outright strength.

Pricing and Cap Rates

Prices, as measured by the RCA/Moody's Commercial All Property Price Index (CPPI), continued to rise in the first two months of the year, registering a 4.3% annualized rate across all markets and property types. This compares with a 10.3% annualized rate for November-December 2016 and 7.9% for the 2016 calendar year. While it is important not to draw strong inferences from such limited data, the deceleration was broad-based—both by market tier and across different product types—and certain patterns from 2016 seem to be continuing. Towards the end of 2016, suburban office returns began to outpace those of CBDs; so far in 2017, this trend has, if anything, accelerated. Similarly, 2016 was the first year of this cycle in which non-major markets outperformed the six major metros. This too continued, albeit by a slight margin. It should also be noted that while apartment volumes declined dramatically in the first quarter of 2017, prices increased at an 8.5% annual rate, second only to suburban office (14.4%).

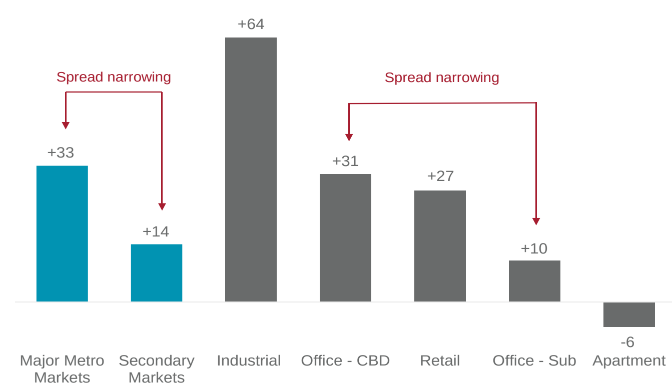
It can be difficult to interpret quarter-to-quarter changes in cap rates since we are extrapolating from a limited sample of the transactions that occurred. Nonetheless, the data seems in-line with the picture suggested by decelerating returns. Cap rates, however gently, are increasing. Cap rates across all product types rose more in the major metros (+33 basis bps) than in the secondary (+14 bps) or tertiary (+3 bps) markets. Similarly, the yield spread between CBD (+31 bps) and suburban office (+10 bps) has compressed. Notably, apartment cap rates continued to decline (-6 bps) while industrial cap rates increased markedly (+64 bps) in a move that seems ripe for reversal.

Fundamentals Still Robust

On its face, the capital markets data are inconsistent with our assessment of the underlying strength of the U.S. economy and commercial real estate fundamentals. Employment growth remains strong, with the unemployment rate declining to 4.5% in March (from

U.S. Cap Rates: Rolling 6-Month Average

Basis Point Chg. (Q4 2016 to Q1 2017)



Source: Real Capital Analytics

4.7% in February) and the labor force participation rate holding steady. It is true that job gains will decelerate going forward, but wage gains should pick up the baton in the relay driving aggregate income growth. A swath of leading indicators point to accelerating growth in coming quarters. At the same time, inflation seems unlikely to force the Fed's hand to raise interest rates at a hazardously fast pace. Indeed, financial conditions indices suggest that the interest rate increases in December and March have not had an onerous effect on the flow of credit in the economy.

As for the commercial real estate sector, construction has been relatively constrained this cycle relative to those cycles in the past. What pockets of overbuilding there may be suggest only transient supply-demand imbalances against strong secular fundamentals (e.g., apartment deliveries in certain prime markets). In addition, underwriting and leverage ratios have been conservative during this cycle, and traditional lenders have recently become even more cautious, creating preferred equity and mezzanine-financing opportunities.

Why such weakness in the investment sales market? Why such an abundance of caution against such a steady backdrop—even against a more favorable outlook than existed a year ago? It seems to be partly due to a general uneasiness about the duration of the cycle. Much of the recent weakness is likely an acute reaction to uncertainty – much of it Trump-branded. But this is curious to the extent that many of the major policy proposals (i.e. corporate tax reform, infrastructure spending, and deregulation) would likely benefit economic growth and commercial real estate. By contrast, the policies and positions most likely to harm the economy, namely protectionist measures, seem to be diluted daily.

Activity to Accelerate in Coming Quarters

All in all, the recent weakness in sales volume is likely transitory. Buyers have amassed a tremendous amount of capital and are ready, but not in a rush, to deploy it. They face the combination of a gap between their valuations and seller expectations and a general dearth of product on the market. Sellers in turn are reticent to capitulate on price and many are withholding product until they see stronger buying activity. The question is who will break the stalemate and when—not if. The cap rate data so far point towards some measure of seller capitulation on pricing expectations. This is consistent with our indications of increasing product coming to market in the coming months. Overall, the stage is set for a robust remainder of 2017.

About Cushman & Wakefield

Cushman & Wakefield is a leading global real estate services firm that helps clients transform the way people work, shop, and live. Our 43,000 employees in more than 60 countries help investors and occupiers optimize the value of their real estate by combining our global perspective and deep local knowledge with an impressive platform of real estate solutions. Cushman & Wakefield is among the largest commercial real estate services firms with revenue of $5 billion across core services of agency leasing, asset services, capital markets, facility services (C&W Services), global occupier services, investment & asset management (DTZ Investors), project & development services, tenant representation, and valuation & advisory.

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