

Vector Calibration: 2020 Capital Markets

By CCIM Institute Chief Economist K.C. Conway, MAI, CRE

4Q19/1Q20 *Commercial
Real Estate Insights* Report

Commercial Real Estate Capital Markets Update

The New Year is a time of reflection and reassessment. That holds true in commercial real estate, especially regarding reallocation of capital and realignment of investment strategies. There's no shortage of white papers and research on capital markets by all industry sectors of commercial real estate — ranging from banking and brokerage to debt and equity sources — but today's CRE practitioner is searching for a reconciliation of the plethora of data and conflicting views into a forward-looking outlook that puts events and trends in perspective and paints a clear picture of what lies ahead in 2020.

This *Commercial Real Estate Insights* report certainly checks those boxes and goes one step further by sharing what it means in real-world application for those in the industry. First, let's set the stage for this capital markets' year-end narrative. Chapter 1 begins with the backdrop of \$4.36 trillion of investments on the debt side of the ledger (the highest since pre-Great Recession) from all the CRE lending entities — REITs, pension funds, government-sponsored enterprises (such as Fannie Mae and Freddie Mac), construction lending banks, and permanent debt sources like CMBS, according to Moody's Analytics.ⁱ The U.S. economy is still chugging along in its 11th year of recovery (125 months at year-end 2019) with November 2019 GDP revisions back up to 2 percent. The surprising

December BLS jobs report showed 266,000 jobs created in November; U3 and U6 unemployment levels declined to 3.5 percent and 6.9 percent, respectively; and a 3.1 percent year-over-year wage growth. In addition, banks are well capitalized and producing gross revenues at levels that are the best in a decade. And key credit metrics, like CRE loan delinquency, are stellar. The latest 3Q Mortgage Bankers Association's Commercial/Multifamily Delinquency Report shows CRE delinquency rates of just 3 basis points for life insurance companies; 4 and 6 basis points respectively for Freddie Mac and Fannie Mae; and 45 basis points for banks.ⁱⁱ Plus, all these rates are down over the prior Q2 period and year-over-year. With the nation in a presidential

election year, how could conditions be any better and what could go wrong? Instead of resting on these laurels, Chapter 2 of our narrative lays out the rationale for looking beneath the surface of this

stellar data, and asking what signals could warrant rethinking the direction and magnitude of real estate investment in 2020. This process is what we call a vector calibration of commercial real estate capital conditions. In other words, now that we've popped the cork on the champagne and celebrated the New Year, what adjustments are needed to our real estate investment strategies for all of us to be around a year from now celebrating another great year of CRE performance?



Chapter 2: What's a Vector Calibration?

Vectors are well understood by rocket scientists and engineers as an invaluable mathematical function to determine both the direction and magnitude at which aircraft travel. Surprisingly, vectors also have a worthwhile application in commercial real estate. A vector calibration for the CRE industry, in a modified application, is a process to determine where and how much investment activity to deploy. Think of the “where” — both geography and property type — as the direction aspect of the CRE vector and the “how” — by geography and property type — as the magnitude. Despite the whiplash to commercial real estate investment sentiment as a result of the tariffs implemented more than a year ago and a Federal

Reserve that reverses course almost as quickly as the College Football Playoff selection committee changes its rankings (i.e., four interest rate hikes in 2018 followed by three rate reductions in 2019), the ongoing hunt for yield in a negative-yielding global debt environment of more than \$14 trillion suggests that 2020 could be another year in which capital continues to flow into U.S. commercial real estate due to a compelling risk-reward yield premium. Let's turn the page to Chapter 3 and take a deeper dive into the key influences on the direction and magnitude of capital flows into CRE in 2020. Chapter 3 begins by answering the question, “Where does one go to commence a CRE capital vector assessment?”



Chapter 3: It All Starts With the Economy

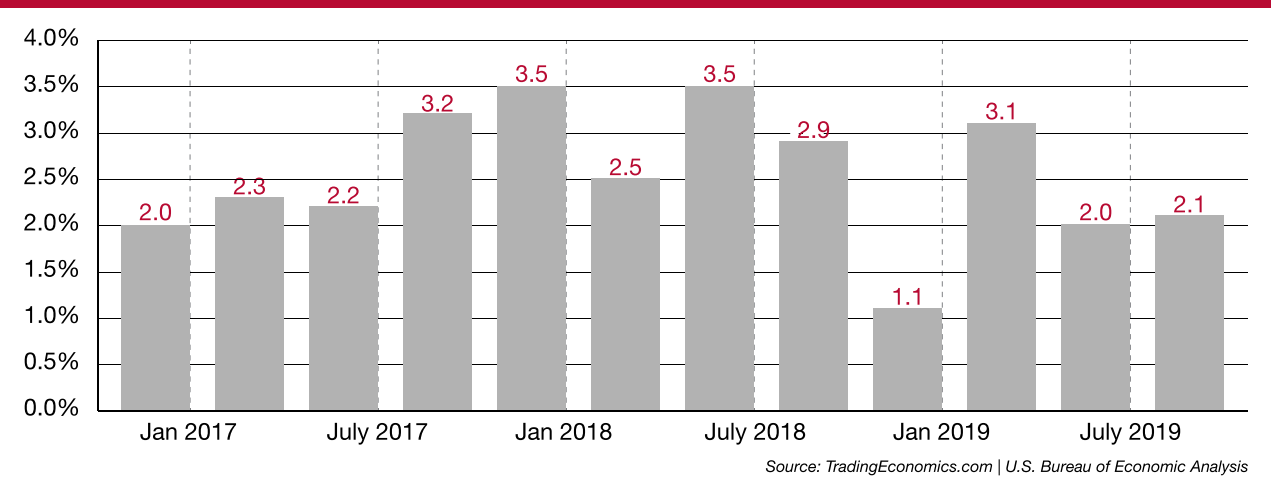
Capital allocations take their cue from economic conditions, which is why an understanding of the underlying economic conditions at year-end 2019 is integral to forecasting the flow of capital into CRE for 2020. CCIM Institute posits that eight primary indicators have proven effective in determining continued economic growth or, conversely, the onset of a market correction. Those metrics — as reported at the time of writing this report — point to a stay-the-course outlook. However, some early caution signs have implications for 2H20 and into 2021. If, for example, CRE debt concentration continues to rise or trade tensions don't abate, you need to have an alternative investment strategy at hand to change course. These eight metrics are GDP; employment; consumer optimism and total retail sales; small business activity and optimism; corporate earnings; FDIC-insured bank lending activity and income growth; CMBS and macro-CRE loan performance and delinquency; and commercial property price indices.

1. GDP: Although U.S. GDP expansion slowed from 2.5 to 3.5 percent in 2018 to 2.0 to 2.5 percent through the first three quarters of 2019, it remains a

story of growth — despite the headwinds from tariffs. Additionally, the three-year trend bears out that GDP is still expanding despite the latest GDPNow forecast from the Atlanta and New York Federal Reserve Board Banks (FRBs). The market is anticipating at least 2 percent GDP growth for 2020 — and maybe more if even a partial or phased China trade deal is reached in early 2020. The subsequent upward revisions to 3Q19 GDP and the December BLS jobs report seem to support the “more” position.

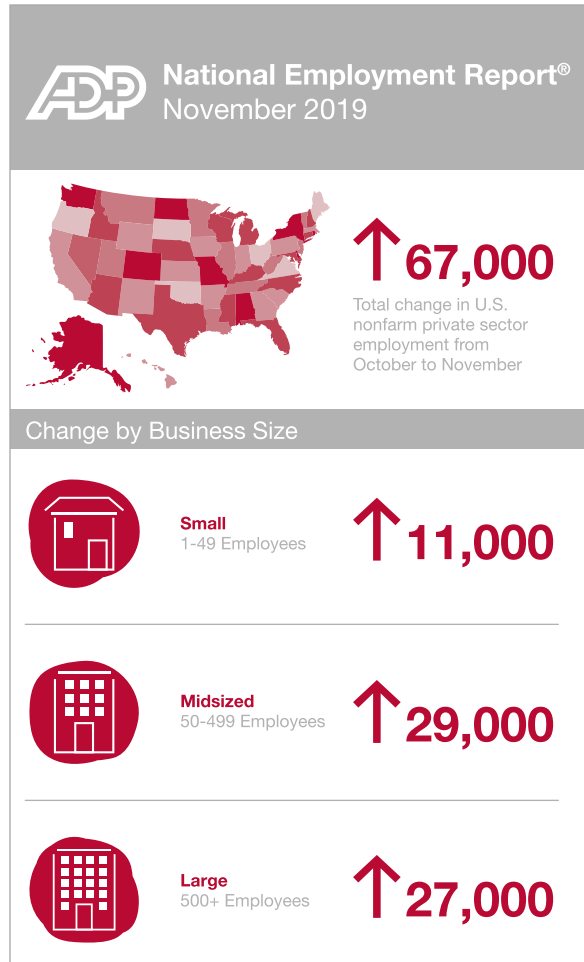
2. Employment: As detailed in the 1Q19 *Commercial Real Estate Insights* report, private and small business measures of employment should be emphasized over government or Bureau of Labor Statistics figures. The three leading private industry measures show private and small businesses adding employment. This includes ADP (largest processor of payrolls for businesses in the U.S.), PayChex (primary entity monitoring small business labor), and LinkedIn's Workforce Reports. ADP's November 2019 report covering October data revealed that companies of all sizes are still adding labor, the most coming from midsized companies with 50 to 500 employees. All

United States GDP Growth Rate

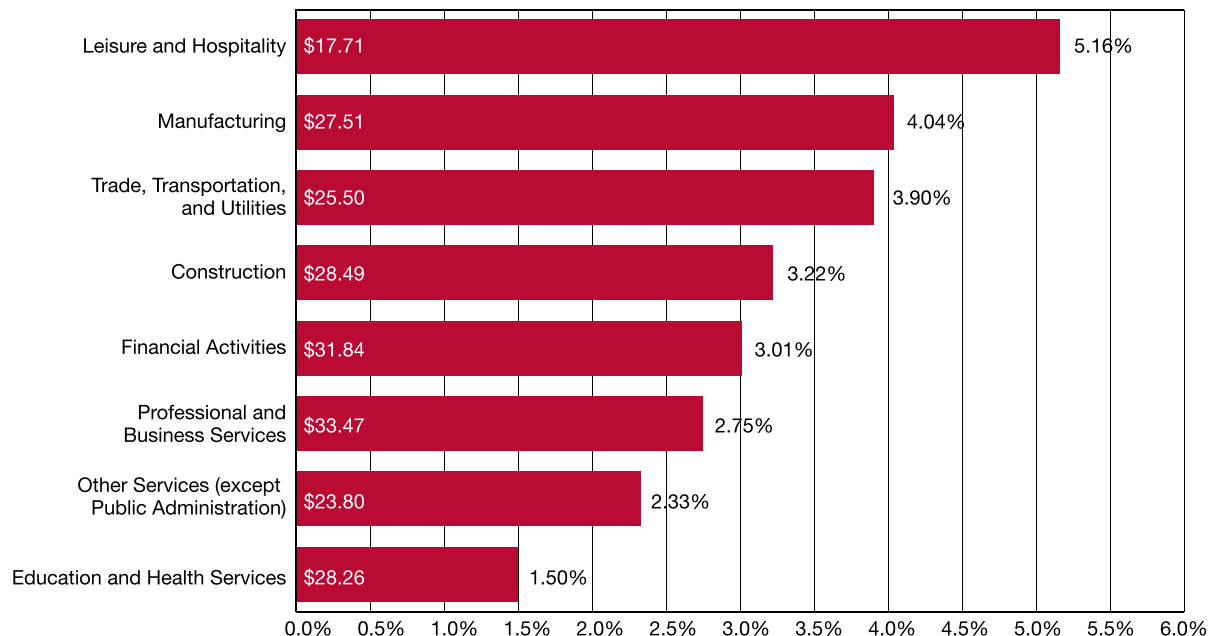


industry sectors, except mining and manufacturing (as a result of the General Motors strike), are adding to payrolls. Finally, a healthy 1.57 million jobs were created through November 2019, an average of 157,000 jobs per month.ⁱⁱⁱ With an unemployment rate under 4 percent and 105,000 new entrants to the workforce each month according to the Atlanta Federal Reserve's December 2019 Job Calculator^{iv}, the monthly job creation average speaks well of growth and continued labor stability. The Job Openings & Labor Turnover (JOLTS) report corroborates this point, showing the U.S. has more job openings than unemployed.

Where the government and BLS are unable to speak to wage growth, PayChex certainly can. The company's industry wage report through October 2019 showed every segment recognizing wage growth, ranging between 1.2 percent (education) and 5 percent (hospitality).^v The December 2019 BLS jobs report also reported year-over-year wage growth at 3.1 percent.^{vi} All these factors — low unemployment, more job openings than unemployed persons, and wage growth in every industry segment — suggest a healthy job market heading into 2020 that will be conducive to CRE growth (e.g., demand for housing and office space) and continued capital investment



Industry Hourly Wage Performance



Source: Paychex | IHS Markit Small Business Employment Watch

3. Consumer Optimism and Total Retail Sales:

Several sources, like the University of Michigan, measure consumer optimism; however, the best gauge of consumer health is retail sales. The Commerce Department's report on October retail sales revealed a healthy rise. Excluding automobiles, gasoline, building materials, and food services, retail sales increased 0.3 percent, resulting in a year-over-year increase of more than 3.1 percent.^{vii} This news is consistent with 3Q19 earnings from larger retailers like Walmart, which posted a 41 percent increase in online sales and 3 percent increase in physical retail stores. With consumer spending driving approximately two-thirds of the U.S. economy, this data indicates that no recession is in sight from the consumer perspective. The record \$7.4 billion^{viii} in sales recorded from Black Friday through Cyber Monday in 2019 further reinforces the view that consumer spending is in good health.

4. Small Business Activity and Optimism:

The National Federation for Independent Businesses maintains the longest running comprehensive monthly survey on small business optimism. Readings above 100 are predictive of small business growth. Like consumers, small businesses are also bullish on the economy with a November 2019 reading of 102.4.^{ix}

5. Corporate Earnings: Corporate earnings often correlate with capex spending, hiring, wage growth, and demand for commercial real estate. Through mid-November 2019, 75 percent of the S&P 500 companies reported earnings and profits that beat

expectations. How are they doing it? Companies are remaking supply chains and finding efficiencies to offset margin erosion from tariffs. A notable example is CSX Transportation, which has increased profits despite less revenue. Of course, a few have missed earnings due to company missteps versus a macro-economic condition, such as Boeing (grounding of its 737 MAX), Under Armour (accounting investigation), and Twitter (glitch in advertising software). What's more, REITs — a harbinger of capital flow into CRE — have performed as well, if not better, than corporate earnings. Strong performance by REITs drove a recent wave of CRE portfolio transactions at year-end 2019, including Nuveen's acquisition of a \$29 million industrial portfolio from Blackstone and ProLogis's acquisition of Liberty Trust REIT at a price that suggests a cap rate of about 4 percent.

The final three indicators relate to CRE lending performance, lending activity, and the Commercial Property Price Index (CPPI) — all of which are healthy and conducive to more CRE capital flow in 2020. In short, metrics like the net income growth of FDIC-insured banks (the highest since the 2007 financial crisis, surpassing \$62.6 billion in 2Q19*), CMBS loan delinquency (declining to a record low of 2.5 percent in October 2019, according to Trepp), and CCPI are all improving with no imminent signs of erosion or reversal. Altogether, the eight economic indicators that serve as the foundation for this capital markets outlook show neither an indication of a recession ahead nor a reason for capital to pull back from CRE debt or equity investing in 2020.



Chapter 4: CRE Direction and Magnitude

Three remaining commercial real estate capital metrics that serve as the canary in the coal mine for CRE investing are:

- **FDIC-Insured Bank Lending Activity and Income Growth;**
- **CMBS and Macro-CRE Loan Performance and Delinquency; and**
- **Commercial Property Price Indices.**

The performance measures for FDIC-insured banks (revenue growth and asset quality), CMBS permanent CRE loans (loan delinquency), and commercial property values all continue to improve and achieve benchmarks not seen since before the Great Recession.

Bank Performance for FDIC-Insured Institutions

The FDIC Quarterly Banking Profile contains an income report for the 5,303 commercial banks and savings institutions insured by the FDIC. The 2Q19 report reveals plenty of wind in the sails regarding profitability and CRE credit quality. Aggregate net income totaled \$62.6 billion, representing an increase of \$2.5 billion (4.1 percent) from a year earlier, and the best post since 2009.^{xi}

The FDIC also reported that approximately 60 percent of all institutions reported a year-over-year increase in net income, with fewer than 4 percent of institutions being unprofitable. The breakdown for community banks was even more promising than the measures for all insured banks. The 4,873 FDIC-insured community banks' net income increased 8.1 percent from 2Q18 and \$522.7 million from a year earlier. These community banks are the backbone of commercial real estate lending in secondary and tertiary markets, as well as smaller investment properties throughout the nation (less than \$10

million in aggregated debt and equity capital). These metrics translate into stability in CRE lending in 2020 with no contraction due to either erosion in credit quality or less profitability. That checks another box for a healthy outlook on CRE capital flow.

CMBS Loan Issuance Activity and Loan Delinquency

Year-to-date CMBS volume in October 2019 surpassed the comparable figure for 2018, according to both Kroll Bond Rating Agency and Trepp. October's activity level of \$12.4 billion brought YTD 2019 issuance to \$70.2 billion, up 7.8 percent YOY.^{xii} The year-end pipeline for November and December was active as well, with potential issuance that will result in 2019 issuance matching or surpassing that for 2018.

A more important measure than CMBS issuance, though, is CMBS delinquency. In Trepp's November CMBS Delinquencies report for January through October 2019, the CMBS delinquency rate fell to another post-Great Recession low of just 2.47 percent. In comparison, the all-time high of 10.34 percent was registered in July 2012.^{xiii} On a property-type level, CMBS delinquency is down from a year ago across all but multifamily (up 0.19 percent from last year). The slight increase in multifamily is relatively small and at a level below the overall delinquency rate of 2.47 percent. Additionally, Trepp's CMBS delinquency data is more broadly supported by the Mortgage Bankers Association's (MBA) latest 3Q19 Quarterly Commercial and Multifamily delinquency report, which shows just 45 basis points of delinquency in the banks and 4 to 6 basis points, respectively, in Freddie Mac and Fannie Mae multifamily loans.^{xiv}

Commercial Property Price Index (CPPI)

The three organizations that provide reliable insights into overall CPPI via proprietary indices, Real Capital Analytics, Moody's Analytics, and Green Street

Delinquency Rate by Property Type (% 30 Days +)

	Oct 19	Sep 19	Aug 19	3 Mos	6 Mos	12 Mos
Industrial	2.46	2.00	1.75	1.70	2.10	2.81
Lodging	1.49	1.47	1.54	1.80	1.55	1.98
Multifamily	2.07	2.43	2.39	2.04	1.99	1.88
Office	2.50	2.61	2.83	2.71	3.11	3.93
Retail	4.20	4.15	4.07	4.35	4.62	5.39

Source: Trepp

Advisors, all show similar trends on commercial property appreciation. Two primary property value trends prevalent in both 2018 and 2019 are likely to persist in 2020:

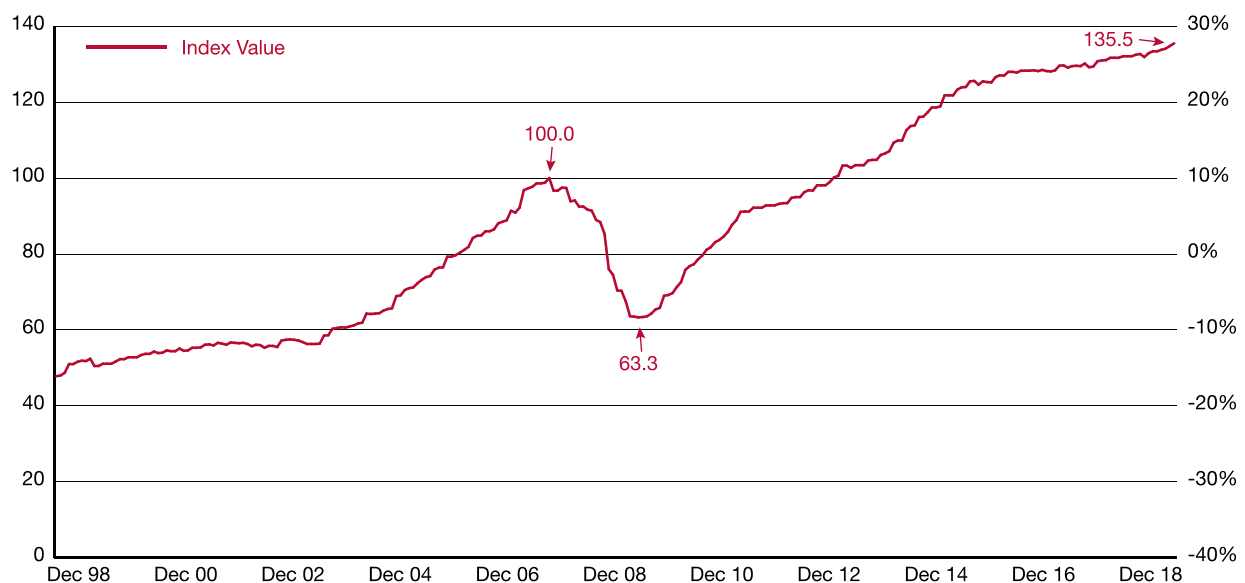
1. The rate of commercial property price appreciation is moderating.
2. The direction that capital is flowing by property type has shifted solidly in favor of industrial warehouses; additionally, it is migrating to non-core property types — such as manufactured housing — and away from sectors like self-storage.

Green Street Advisors' CPPI November 2019 report indicates that the rate of increase (magnitude of the property price appreciation vector) in property values is slowing after nearly a decade of property

performance recovery. This flattening began in 2017 and surprisingly did not spike upward following the 2017 Tax Cuts and Jobs Act or downward with the onset of tariffs. Most capital appears to be making investment decisions that are neither short-term, focused on tax incentives like opportunity zones, nor deterred by tariffs.

Regarding the shift away from the perennial star performers — multifamily and office — to industrial warehouses and non-core property types, this capital rotation has become more pronounced. This trend is likely a reflection of two key factors: the hunt for yield as core markets are fully priced and structural changes in the U.S. economy as it transitions from a “shop-and-take-home economy” to a “order-everything-online-and-deliver-to-me economy.”

Green Street Advisors' Commercial Property Price Index: December 2019



Data as of Dec. 5, 2019

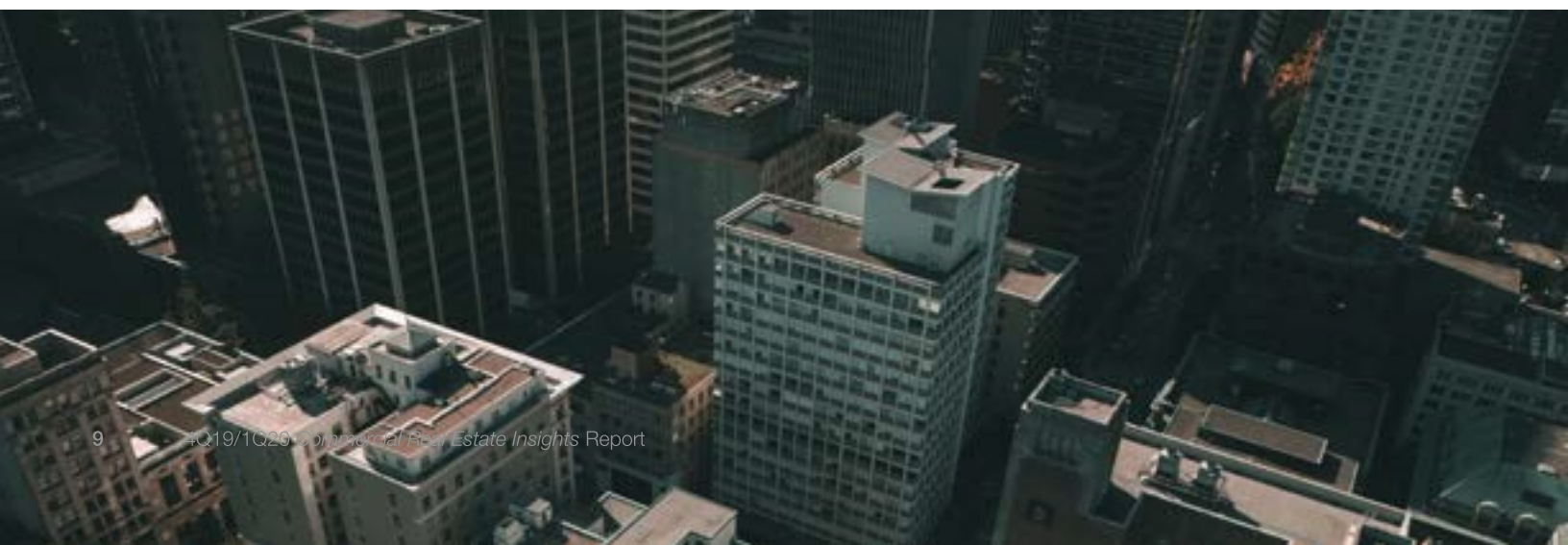
Commercial real estate is undergoing an identity makeover. E-commerce warehouses are today's big-box retail stores, hospitality is the new retail showroom, and office space is used and rented like hotel rooms. Housing is more than a traditional house in the suburbs; it's a tiny home in new tiny home developments in markets like Atlanta or Dallas; an infill subdivision where all the homes are for-rent by entities like American Homes 4-Rent; or a reincarnated manufactured-home community with sidewalks, amenities, and HOA covenants by UMH Properties, Inc., a public equity REIT. The latest Green Street Advisors CPPI report illustrates that capital is following the identity and use makeover occurring among all property types, not just

malls. Among core property types (multifamily, office, hospitality, and industrial), industrial warehouses have experienced the highest price appreciation over the past 12 months, at 12 percent, followed by multifamily at a distant 6 percent. Across all property types, however, manufactured housing maintains its lead for price appreciation for a second consecutive year at 20 percent from November 2018 to October 2019. Self-storage, health care, and student housing have seen property price appreciation slow to rates of 5 percent or less due primarily to overbuilding. Traditional mall and strip center retail are among the worst-performing sectors from a valuation perspective, with -13 percent and +2 percent, respectively.

Green Street CPPI: Sector-Level Indexes

	Index Value	Change in Commercial Property Values		
		Past Month	Past 3 Mos	Past 12 Mos
All Property	135.5	0%	1%	3%
Core Sector	135.1	1%	2%	4%
Apartment	152.2	1%	3%	6%
Industrial	164.7	3%	4%	13%
Mall	106.9	0%	0%	-11%
Office	116.8	0%	0%	3%
Strip Retail	111.7	0%	0%	1%
Health Care	142.7	1%	1%	2%
Lodging	108.9	0%	0%	0%
Manufactured Home Park	233.3	1%	3%	16%
New Lease	99.3	0%	0%	1%
Self-Storage	186.6	0%	4%	4%
Student Housing	154.9	0%	0%	3%

Data as of Dec. 5, 2019



REITs: A View From the Top of the Investment Pyramid

Despite some investment groups' perception of the CRE cycle being in late-stages, REITs continue to outperform most other investment asset types (such as stocks, bonds, gold, other commodities). This is due primarily to growth in yield from both low debt costs and rising rents, as well as property price appreciation in low cap rate and high-demand environments. Looking back over a half-century, this current period could be the sweet spot for REITs over the past five decades. However, just as all property types don't perform equally or in tandem, not all REITs are performing in tandem and outperforming the broader market. Earlier this year, *National Real Estate Investor* published its fourth annual research survey on the state of publicly traded REITs. A deeper analysis and commentary on the key findings in the report include:

- **Good balance between debt and equity use:** REIT balance sheets have remained remarkably stable year after year in the history of the NAREIT survey. For the third consecutive time, 58 percent of respondents said that REIT balance sheets are “balanced.”
- **Multifamily and industrial remain favorite investment property types.** Surprisingly, multifamily has regained the most preferred status, but only by a single percentage point.
- **Multifamily REITs (47 percent) sat atop respondents' “buy” lists in 2019, leapfrogging industrial REITs (46 percent), which was the most favored category in 2018 and 2017.** The number for multifamily REITs jumped considerably from 2018's figure of 36 percent, while industrial's number fell slightly from 49 percent in 2018.

With multifamily and industrial topping the in-demand list, which property types are on the bottom? It's no surprise that retail is the asset most REITs prefer to sell. Based on two previous *Commercial Real Estate Insights* reports, that divestment may be an overlooked opportunity. As detailed in “Retail

e-Volution: Predictions for 2025” and “Adaptive Reuse: Turning Blight into Bright,” these retail assets can still be of considerable value for the savvy investor. Surprisingly, multifamily is the property type ranking second on the “sell” list. This may reflect some harvesting of return and/or asset rotation to acquire more value-add properties in the face of the housing affordability crisis and the rising ratio of cost-burdened renter households across the U.S.

- **Capital is plentiful.** Three in 10 survey respondents said both equity and debt are more widely available than in 2018 and 2017. Respondents continue to have a stable assessment of capital markets for REITs.
- **Debt remains the preferred source of capital with low interest rates.** In terms of raising capital, for the fourth consecutive year, respondents endorsed property-level debt (48 percent in 2019 versus 50 percent in 2018) as the best avenue for REITs given current market conditions and low interest rates in 2019. Another 34 percent endorsed equity issuance (compared with 31 percent in 2018), while only 16 percent said secondary debt issuance was the best avenue (unchanged from 2018).
- **Finally, there is no clarity whether to expand, stand pat, or shrink REIT portfolios.** Thirty-five percent reported REITs would stand pat, with 28 percent indicating REITs would be net buyers and 17 percent on the net sellers side. One-fifth of respondents weren't sure what REITs would do. The stand-pat consensus view is likely a reflection of the convergence of three factors: assets and primary markets where REITs prefer to play are fully priced and have more downside risk at this late stage of the cycle; assets and portfolios are hard to find so the best strategy may be to focus on enhancing or repositioning existing portfolios to increase EBITDA; and a bias toward mostly multifamily and industrial property types versus a broader spectrum of property types.

Chapter 5: Capital Is Coming From All Directions

No warning signs have been indicated either from banks, CMBS debt markets, erosion in credit metrics like loan delinquency, or declining property values. Instead, look to the directional influences necessary to calculate the pace, magnitude, property type, and location variables for commercial real estate capital vectors in 2020. In short, capital is coming from all directions — domestic and foreign, debt and equity. But why?

First, capital is attracted to the growing economy in the U.S. Second, it's a hunt-for-yield story with the U.S. offering more on everything from interest rates on government bonds, to dividends on stocks, to cap rates and IRRs on commercial real estate. Not only does the U.S. offer a 150- to 200-basis point government bond yield premium over the negative-yielding debt in Europe and Japan, but stock dividends, REIT returns, and property valuations (as indicated by cap rates of 4 to 6-plus percent) also offer an additional 200 to 400 basis points of yield over foreign market and asset alternatives. This yield differential is enough to mitigate capital concerns over tariffs and any potential slowing of the U.S. economy. Commercial real estate in the U.S. was simply the place to find an attractive yield in 2019, which is likely to continue this year. This observation is supported by the 2019 AFIRE (Association of Foreign Investment in Real Estate) report prepared by the University of Wisconsin. The Spring 2019 report clearly noted that both foreign and domestic investors:

- remain confident in a strong U.S. economy,
- are optimistic in the continuation of solid real estate market fundamentals, and
- have a strong preference to put capital to work in U.S. real estate.^{xv}

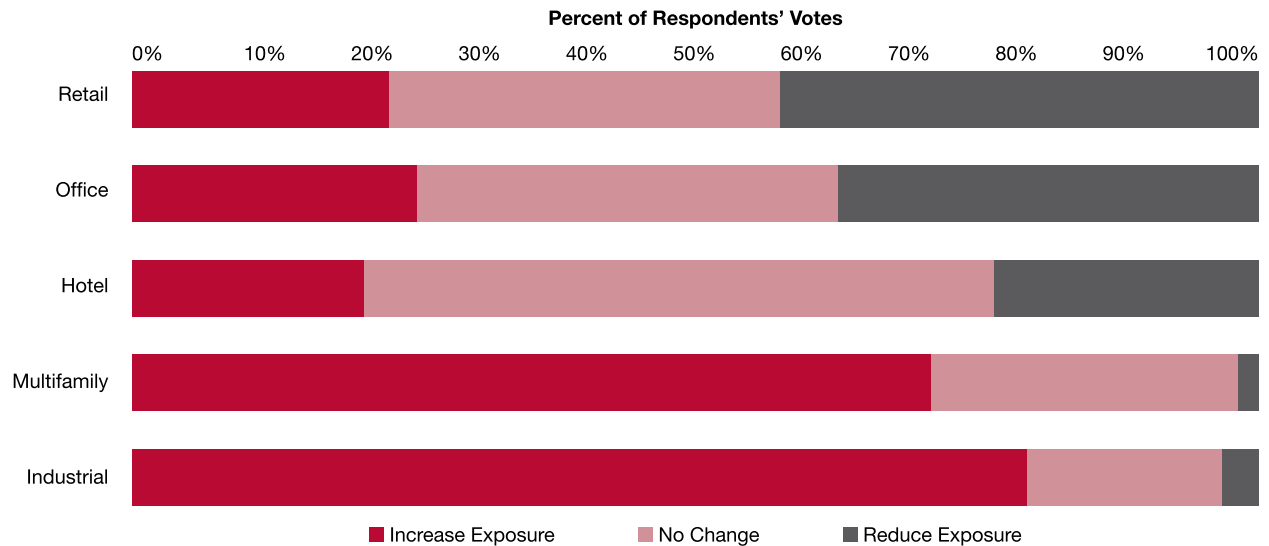
In looking at the direction of capital flow, industrial and multifamily continue to be the property sectors in which foreign investors will increase their exposure. The AFIRE report notes that approximately 80 percent of investors

want to increase industrial exposure and 71 percent want to increase multifamily exposure. As for location, four of the top five global cities offering the most stable and secure real estate investment opportunities where investors want to increase their capital exposure are in the U.S. — New York, Boston, Seattle, and San Francisco. The only city outside the U.S. to make the top five ranking was Berlin, beating out perennial favorites London, Paris, Hong Kong, and Tokyo.

Another noteworthy opportunity in the AFIRE report is that cities that are affordable, offer lower taxes, and can attract workforce were identified as markets where investors want to increase their capital flow. Atlanta and Dallas are prime examples. Conversely, cities with crime, fiscal and/or affordability challenges, such as Chicago, Los Angeles, and Washington, D.C., ranked high on the list of places where capital sources want to decrease their investment exposure.^{xvi} CCIMs interviewed for this outlook have seen this migration trend in action and affirm the capital flow migrating toward the affordable, low-tax, and workforce attractive markets. Several MSAs are benefitting from this trend and are likely to see more capital migration in 2020 — Charlotte and Raleigh, N.C.; Charleston and Greenville/Spartanburg, S.C.; Huntsville, Ala.; Nashville, Tenn.; Orlando and Tampa, Fla.; Phoenix; San Antonio; and Salt Lake City. Port markets like Houston have also garnered foreign capital investment interest and are part of the increased interest in industrial CRE investment.

Look for this trend of capital migrating to other fast-growing port markets to continue in 2020. These markets include Charleston, S.C., and Savannah, Ga., both top 10 North American ports in terms of container activity; Mobile, Ala., and Port Freeport, Texas, both of which are close to Houston and along the Gulf Coast (coupled with new port user additions like Airbus, Walmart and Toyota/Mazda in Alabama); San Juan, Puerto Rico; and Veracruz, Mexico (a top automobile port). In addition, growing congestion problems from

Property Types Where Respondents Would Like to Increase or Decrease Exposure



Source: 2019 AFIRE International Investor Survey

energy and chemical companies at Port of Houston are benefiting Port Freeport, which serves as a relief valve for Port of Houston. Key Florida port markets, including Miami, Port Everglades, and Tampa, are also in the mix. On the West Coast of North America, Canadian ports in Prince Rupert and Vancouver continue to do well, outperforming their American counterparts in Seattle and Tacoma, Wash.

An additional offshoot of this growth in industrial warehouse and port city market investment activity is the growth of burgeoning inland port markets. In 2013, the South Carolina State Port Authority brought this development trend into focus with its effort to better serve port users like BMW with the development of a modern inland port concept. This Greer, S.C., inland port now processes more than 1.2 million containers per year, accounting for more than one-third of the Port of Charleston's activity. The concept has also taken root with the growth of e-commerce retail. Inland ports are a CRE directional growth story expanding along I-95 from South Carolina to New York and into Pennsylvania, as well as throughout central and north Georgia, Texas, and Arizona. It has resulted in millions of square feet of new industrial real estate for the upstate portion of South Carolina and the Greenville-Spartanburg region, adding thousands of jobs.^{xvii} These

inland ports are major commercial real estate demand drivers attracting both foreign and domestic capital.

In addition, it's worth noting the cross-border findings about the direction and magnitude of capital flowing into U.S. real estate from the National Association of REALTORS®. Citing 2019 Real Capital Analytics data, NAR reported in its 2019 Commercial Real Estate International Business Trends report that:

- \$94.9 billion of capital flowed into the U.S. in 2018 for the acquisition of commercial properties and portfolios of \$2.5 million or more.
- That \$94.9 billion accounts for 17 percent of total domestic and cross-border flows of \$571.4 billion.
- Of the \$94.9 billion in cross-border flows, \$48.1 billion came from Canada.
- Compared to 2017, cross-border flows rose 72 percent from the \$55.3 billion level in 2017, with the increase mainly coming from capital from Canada.
- Canada accounted for half of the cross-border capital (\$47.5 billion), followed by Europe (\$23 billion), then Asia (\$17.57 billion), the Middle East (\$4.5 billion), and other countries (\$2.32 billion).

Chapter 6: Where Is the Capital Coming From?

Here's where the old adage, "Follow the money," comes into play. The U.S. commercial mortgage holdings of foreign-owned banks grew to \$238.7 billion as of midyear 2019, up 5.5 percent from a year earlier. The growth accelerated in the first half, according to a Commercial Mortgage Alert analysis of data compiled by Trepp Bank Navigator. In the first six months of 2019, the foreign banks' combined portfolios of U.S. commercial real estate loans increased by \$8.8 billion, or 3.8 percent from year-end 2018. That amount exceeded the 2.7 percent growth rate for all of 2018. In other words, foreign banks are another CRE capital source increasing lending in U.S. CRE. The most likely reasons are: hunt for yield globally, foreign currency exchange volatility, and risk mitigation for fear of events like Brexit.

capital into U.S. commercial real estate at a faster rate than the top 350 U.S. banks — another opportunity for CCIMs and other CRE pros. As the Fed and other bank regulators implement and experiment with new capital requirements for U.S. banks — such as Current Expected Credit Loss and CCyB (refer to sidebar) — CRE debt capital is more at risk of contraction in 2021 to 2023 from new capital rules on banks when the next recession or CRE finance disruption emerges. But don't fret too much about foreign bank lending growth in U.S. commercial real estate. The aggregate amount of foreign bank lending is dwarfed by Wells Fargo bank alone, the largest U.S. bank. Wells Fargo had \$129 billion of U.S. commercial real estate debt on its books at midyear 2019. In fact, the CRE loan portfolios of the top three U.S. banks — Wells Fargo, J.P. Morgan,

Top 5 Foreign Countries in U.S. Commercial Real Estate Loans (in \$ Millions)

Country	Commercial	Multifamily	Construction/ Land	6/30/19 Total	6/30/18 Total	Year-Over-Year % Change
Canada	\$49,842.3	\$9,489.0	\$9,012.7	\$68,344.0	\$64,454.1	6.0%
Spain	\$16,410.9	\$10,754.8	\$4,181.8	\$31,347.4	\$30,173.6	3.9%
Germany	\$20,591.2	\$6,696.7	\$2,951.2	\$30,239.1	\$27,474.9	10.1%
France	\$18,711.8	\$1,946.7	\$2,543.7	\$23,202.2	\$26,026.4	-10.9%
Japan	\$12,615.4	\$6,880.4	\$3,081.1	\$22,576.9	\$19,432.8	16.2%

Source: Trepp

The figures from the top five countries suggest foreign-owned institutions' CRE loan growth have outpaced CRE loan originations by domestic U.S. banks. Trepp data showed the 350 largest U.S. CRE lending banks held \$1.66 trillion of commercial mortgages by mid-2019, up just 1.3 percent from the same time last year. The key takeaway is that CRE investors need to understand that foreign banks are expanding debt

and Bank of America — hold an impressive \$321.8 billion of commercial real estate loans, a multiple for the entire cohort of non-U.S. banks. The significance of U.S. bank debt as a capital source for commercial real estate warrants monitoring bank lending trends and earnings reports for early signs of change in either direction (increasing or pulling back).



Chapter 7: How to Navigate CRE in 2020

Turning the page of our outlook to Chapter 7, it's clear that vectors have an application to commercial real estate capital deployment because they incorporate direction and magnitude into their mathematical formula. As the U.S. surpassed 125 consecutive months of economic recovery at the onset of 2020 (the longest recovery on record), CRE professionals should pause and ask:

1. What direction will capital flow into commercial real estate in 2020 (at both the property type and MSA/geographic levels)?
2. What volume of both debt and equity capital will flow into CRE?

Triangulating the data from the sources cited in this report, the vectors are pointing toward capital sources for commercial real estate focusing their efforts on five areas in 2020:

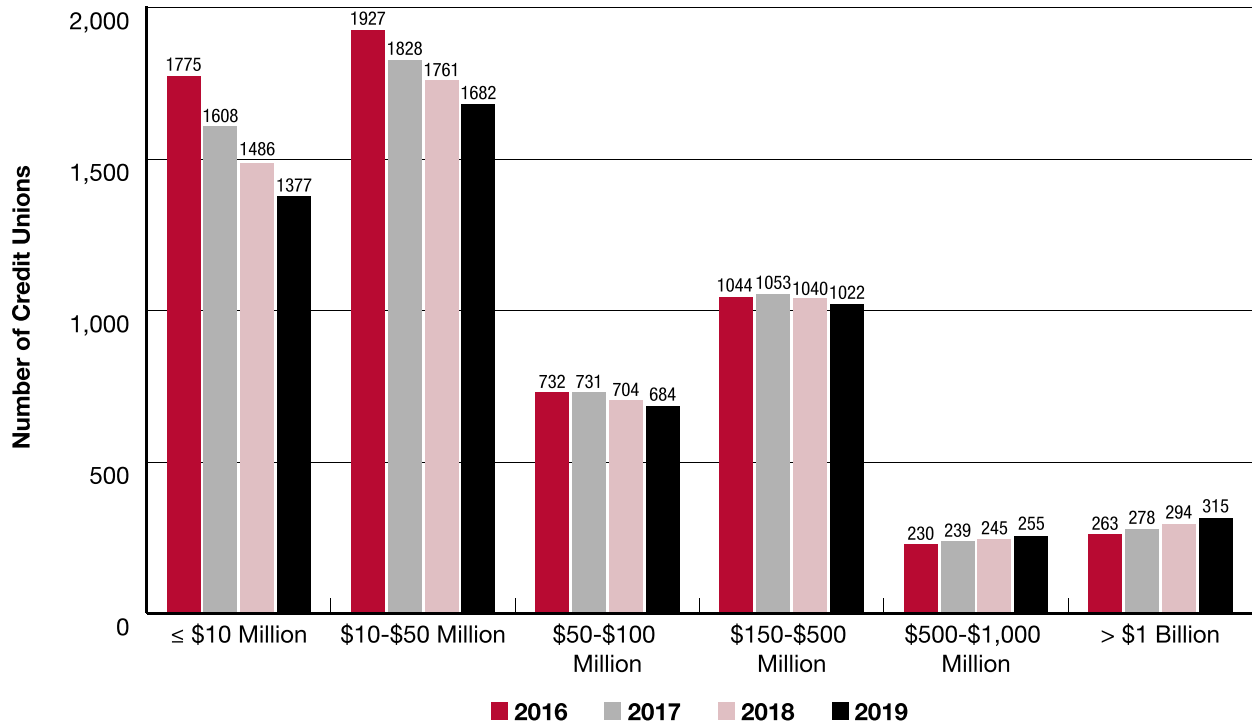
1. **Searching for viable assets given a landscape that has a dearth of properties for sale in 2020.** Competition to find assets and portfolios to list will intensify in 2020. Some relief may come from completion of new construction, but the market is clustered primarily around two property types — multifamily and industrial. Since it's late in the economic cycle, institutional and foreign debt and equity capital sources will not move away from these two property types. Opportunity exists in sourcing multifamily and industrial assets in key port, inland port, and logistics markets for industrial, value-add multifamily in cost-burdened MSAs along the East and West Coasts, and new construction in emerging secondary or tech hub MSAs such as Austin and San Antonio, Texas; Phoenix; Raleigh, N.C.; Nashville, Tenn.; and Tampa, Fla.
2. **Ensuring that assets, while fully priced, are not over-priced.** The New Year will continue to be a sellers' market, with a scarcity of assets for sale,

low interest rates, and a low cap rate environment. Having the investment and comprehensive market analysis skills to maximize net operating income — coupled with the ability to coax institutional investors out of their large-MSA bias that is driven by late-cycle liquidity anxiety — are essential tools for success in 2020. It's time to hone those discounted cash flow analysis skills to identify operating expense savings from areas like property tax appeals or rebidding property insurance, and deep-dive market analysis savvy that can differentiate submarkets, tenant and lease-term trends, and the impact of new construction. This level of sophistication in commercial investment real estate will differentiate those who list and sell CRE assets in 2020 from those missing the mark. Foreign investor composition is also evolving with new players from Vietnam, South Korea, and manufacturing countries not impacted by tariffs. These new or expanding capital sources do not understand the markets or market drivers like traditional investors from Canada, Japan, and Europe. Consider investing time in a new education conference in 2020 to expand your cross-border connections and knowledge of international investor wants, needs, and concerns.

3. **Understanding that while CRE debt capital is healthy today, risks lie ahead.** CRE concentration in domestic banks is elevated back to pre-2009 financial crisis levels. With community banks healthy and able to lend more in commercial real estate loans, now is the time to diversify your debt-lending relationships in case a lender in your stable merges or pulls back due to its regulator's concerns over CRE concentration. Investigate organizations like Trepp, American Banker, and RMA for updated intel on CRE bank lending. Seriously consider the community bank landscape as a diversification strategy from your large bank lenders. Bank mergers can and will happen in

an expanding economy with two notable ones occurring in 2019 — SunTrust-BB&T and Iberia-First Horizon. Bank regulators may think they've tackled “too big to fail,” but they have yet to say,

5. Three letters: E-S-G. Environmental and social governance is permeating all aspects of CRE investing. This topic usurped almost all other discussions at the 2019 PERE America private



Source: Statista

“too big to merge.” Bank consolidation continues. We now have approximately the same number of credit unions as FDIC-insured banks (5,335 vs. 5,362 FDIC-insured banks as of mid-2019).^{xviii}

4. Incorporating housing affordability as a cogent investment driver or deterrent in all markets.

Just as Amazon left the West Coast for the East Coast, Apple migrated to Texas, and Norfolk Southern Railroad announced its headquarters will move to Atlanta, housing affordability is as much a site selection and asset investment consideration as workforce availability and asset price. Investment prospectuses that lack analysis of housing affordability and metrics like the ratio of cost-burdened renter households will miss the mark with CRE investors and capital sources in 2020.

equity real estate conference in New York in October 2019. Knowing how to factor in emerging local ordinances to enhance building efficiency in markets like New York and Washington, D.C., is critical to investment. But it's still unclear if capital will migrate from or toward intense ESG markets where capex is more of a known into less ESG-intense markets like Atlanta, Dallas, or other large non-coastal MSAs less fixated on the rise of sea levels. Will capital, for example, opt to retrofit an office building in New York City or Washington, D.C., in lieu of a new and environmentally efficient building in places like Texas, Tennessee, Georgia, the Carolinas, and, yes, even Central Florida? Trusted local advisers, like CCIMs, are invaluable to properly understand how to assess the market-specific impacts of ESG.



Chapter 8, The Final Chapter: What Could Go Wrong in 2020 and Why CRE Investors Need a Plan B

There's no dearth of items keeping CRE investors awake at night. Some are uncontrollable; some can be mitigated to a certain degree with strategy; and others are avoidable if your vectors are properly calibrated (measured twice and invested right the first time).

The uncontrollable factors that can't be mitigated unless one taps into money on the sidelines include:

- 2020 elections that result in reversing the tax and economic policies from the current presidency;
- The Fed getting monetary policy wrong and the market losing confidence in the central bank; and
- Geopolitical items like Brexit (with more capital leaving Europe for U.S.), and China trade.

Conversely, these items that can be mitigated by altering capital and property mix or tracking construction activity:

- Elevated CRE concentration in the banks. It's time to diversify your lending relationships and capital mix with a higher ratio of equity;

- GSE reform gaining traction after 2020 elections and impact on multifamily. Simply rotate into other property type sectors like industrial, medical office, and student housing;
- Overbuilding risk in self-storage with an emerging concern for industrial. Monitor the ratio of new construction activity as a ratio of total existing inventory and diversify out of those markets where the ratio is above 2.5 to 3.5 percent of existing inventory; and
- Capital migration from high-tax states creating a fiscal crisis for preferred foreign investment markets like New York, San Francisco, and Chicago. Consider heading south to low-tax, low-cost states like Florida, Texas, the Carolinas, Utah, Arizona, and re-emerging parts of the Midwest like Indiana, Ohio, and Michigan.

As with any data, it's not about the numbers as much as the story behind them. The capital markets for commercial real estate in 2020 will remain strong, but it will take an added layer of sophistication on the part of the CRE practitioner to stand out in the crowd and enjoy success in the New Year.



Footnotes

- i Moody's Analytics Report on Federal Reserve Flow of Funds Report
- ii MBA's Q3 2019 Commercial/Multifamily Quarterly Databook: <https://www.mba.org/news-research-and-resources/research-and-economics/commercial/-multifamily-research/commercial/multifamily-quarterly-databook>
- iii ADP National Employment Report: <https://www.adpemploymentreport.com/2019/November/NER/NER-November-2019.aspx>
- iv The Federal Reserve Bank of Atlanta Jobs Calculator: <https://www.frbatlanta.org/chcs/calculator.aspx>
- v Paychex | IHS Markit Small Business Employment Watch: <https://www.paychex.com/employment-watch/#!/news-release/>
- vi U.S. Bureau of Labor Statistics Employment Situation Summary: <https://www.bls.gov/news.release/empsit.nr0.htm>
- vii US Retail Sales Rebound, But Big-Ticket Purchases Drop via *CNBC*: <https://www.cnn.com/2019/11/15/retail-sales-october-2019.html>
- viii Heat Map Shows Billions Spent on Black Friday Weekend Shopping via *Observer*: <https://observer.com/2019/12/heat-map-spent-black-friday-weekend-shopping/>
- ix NFIB Small Business Optimism Index in the U.S.: <https://tradingeconomics.com/united-states/nfib-business-optimism-index>
- x FDIC Quarterly Banking Profile, Second Quarter 2019: <https://www.fdic.gov/bank/analytical/quarterly/2019-vol13-3/fdic-v13n3-2q2019.pdf>
- xi FDIC-Insured Institutions Report Net Income of \$62.6 Billion in Second Quarter 2019 via FDIC: <https://www.fdic.gov/news/news/press/2019/pr19078.html>
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- xiii Trepp CMBS Research, November 2019 CMBS Delinquency Report: <https://www.trepp.com/november-2019-cmbs-delinquency-report>
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- xv AFIRE 2019 International Investor Survey Points to Strong Fundamentals for Commercial Real Estate in the U.S. and Growing Concern About External Risks: <https://www.prnewswire.com/news-releases/afire-2019-international-investor-survey-points-to-strong-fundamentals-for-commercial-real-estate-in-the-us-and-growing-concern-about-external-risks-300822481.html>
- xvi AFIRE 2019 International Investor Survey Charts: <http://www.afire.org/wp-content/uploads/2019/05/AllGraphs-Public.pdf>
- xvii S.C. Ports Anticipate Record Growth, Upgrades at Greer Facility via *Greenville News*: <https://www.greenvilleonline.com/story/money/business/2017/09/26/sc-ports-anticipate-record-growth-expansion-greer-facility/694785001/>
- xviii Number of Credit Unions in the United States From 2016 to 2019, by Assets via Statista: <https://www.statista.com/statistics/470325/number-of-credit-unions-usa-by-assets/>
- xviii FDIC Issues List of Banks Examined for CRA Compliance via FDIC: <https://www.fdic.gov/news/news/press/2019/pr19071.html>

What are your thoughts?

This report is intended to start a dialogue. Share it with clients and colleagues, and send your thoughts to report@ccim.com.

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Author Bio and Acknowledgements



AUTHOR: K.C. CONWAY, MAI, CRE

CCIM Institute Chief Economist Kiernan “K.C.” Conway is the director of research and corporate engagement at the Alabama Center for Real Estate (ACRE) housed within the University of Alabama’s Culverhouse College of Business.

Conway is a frequent speaker for the Federal Reserve, FDIC, FHLB, state bank commissioners, academic groups, professional organizations, and industry associations. He previously served as chief economist for Colliers International – US.

In addition to being a frequent lecturer at international conferences, Conway has consulted with major governmental agencies, most notably briefing former Federal Reserve Chairman Ben Bernanke and the Board of Governors on the burgeoning subprime lending and housing crisis and its impact on the commercial real estate industry.

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