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Economics Group

Special Commentary

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Commercial Real Estate Chartbook: Quarter 4

Uncertainty Continues to Hang Over and Shape the Recovery

Economic activity appeared to turn up a notch toward the end of 2011, and data for the early part of 2012 suggest that the new year has gotten off to a solid start. The apparent pickup in economic activity has done relatively little to boost the commercial real estate sector, however. Activity cooled off appreciably following last summer's debt ceiling debacle and S&P's credit rating downgrade, which were, in turn, followed by the intensification of the sovereign debt crisis in Europe. The dust up in the credit markets has whipped up a cloud of uncertainty that held back leasing activity and inhibited deal flow and new construction during the latter part of 2011. While glimmers of stronger economic growth are sporadically breaking through the clouds, the fog is still fairly thick, particularly when it comes to the risks associated with weakening economies in Europe, government spending cuts in the United States and a still-fragile financial system adjusting to colossal changes on the regulatory front.

While glimmers of stronger economic growth are sporadically breaking through the clouds, the fog is still fairly thick.

Heightened uncertainty tends to increase the value of liquidity. Class A apartments are benefitting the most from this trend. Leasing has surged while younger workers shun homeownership, and a larger proportion of workers in general are willing to pay higher rents in order to preserve their mobility. Demand for apartments remains remarkably strong given the still-relatively modest employment gains posted over the past two years, particularly in the South, where the population tends to be younger and where labor markets have generally lagged behind the nation as a whole. Sales of apartment communities remain brisk, and prices are up in a number of markets.

Investors are also paying up for liquidity, driving cap rates lower for prime, well-located properties in large global gateway markets. Prices have also been driven higher in markets with outsized exposure to the energy boom, most notably Houston and Denver, as well as in areas benefitting from the growth in new mobile Internet technologies, such as San Jose and San Francisco—and, to a slightly lesser extent, Los Angeles, Austin and the Research Triangle region.

Figure 1

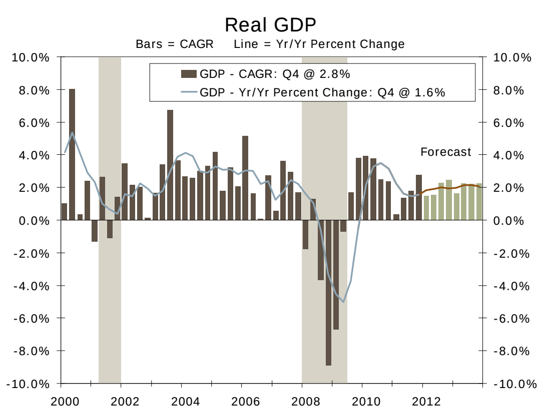
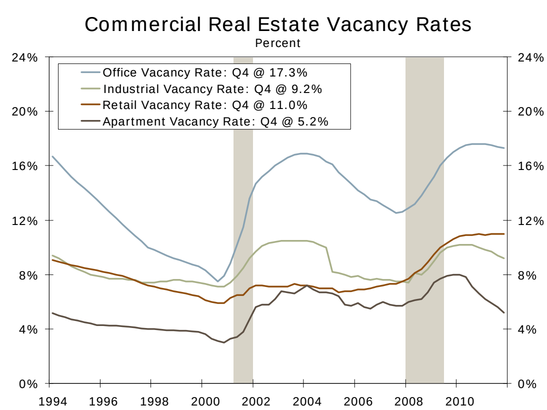


Figure 2



Source: U.S. Department of Commerce, PPR, Reis, Inc. and Wells Fargo Securities, LLC

Still Moving in the Right Direction

Operating fundamentals continue to improve across most property types.

Operating fundamentals continue to improve across most property types. Apartment vacancy rates fell 1.4 percentage points in 2011, as strong demand easily outpaced a modest rebound in new construction. Effective rents rose 2.3 percent and were up much more than that in red hot markets, such as San Jose, San Francisco, Austin, greater New York and Dallas. With the exception of a few extremely tight markets, most of the improvement continues to be confined to Class A developments. Leasing for B and C communities has been hindered by weak job growth and poor credit quality. Investors have also been more cautious, as many B and C properties face more competition from foreclosures and expected large-scale asset sales by the GSEs and banks. The dramatic improvement in operating fundamentals for Class A properties has led to a spike in development that may head off some of the run-up in rents. Many projects have faced difficulty arranging financing, however, and only a small number of units are currently being built.

Demand for industrial space also remains relatively strong throughout much of the country, reflecting the recovery in the nation's factory sector as well as strong gains in international trade. Gains are evident across most major markets, with some of the largest absorption gains taking place in big inland markets, such as Atlanta, Phoenix and Chicago. International trade remains a key driver, lifting demand in Houston, southern California and northern New Jersey. Vacancy rates for industrial space fell 0.8 percentage points over the past year, with the largest drop, a whopping 10.3 percentage points, occurring in Savannah, which is home to the nation's fourth-largest and fastest-growing container port. Despite the improvement, rent increases remain modest, a reflection of the overbuilding that occurred in many markets during the 2000s. As a result, new development remains sparse, with most new construction limited to build-to-suits.

Improvement in the office market has been less dramatic.

Improvement in the office market has been less dramatic, but absorption has remained in positive territory for the past five quarters, and, with new construction limited to just a handful of projects, vacancy rates have fallen slightly. Demand remains strongest in areas benefitting from growth in the technology and energy sectors, but is cooling off considerably in most major financial centers. Businesses tied to software development and entertainment programming for the mobile Internet have emerged as a key growth driver for the office market, fueling gains in the San Francisco Bay area and other tech centers, such as Seattle and Raleigh-Durham. New York City has also benefitted from this trend, with a number of prominent large leases during the second half of 2011 helping to offset the drag from the slowing financial sector. Energy was the other big growth engine, helping to lease large blocks of space in Houston, Dallas and Denver.

Demand for retail space picked up modestly during the second half of last year, but the outlook for the sector remains exceptionally guarded. A number of chains announced store closings after the holiday season, and consumer spending will likely remain constrained by sluggish income growth and higher food and energy prices.

Figure 3

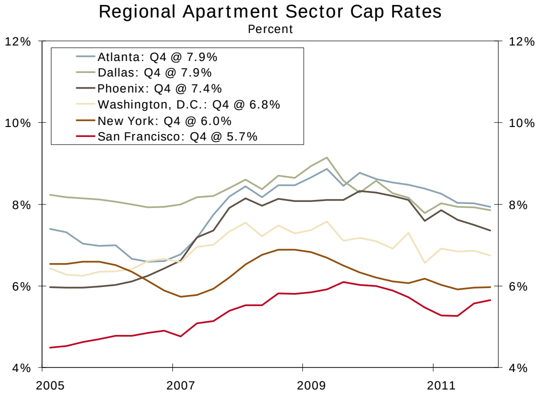
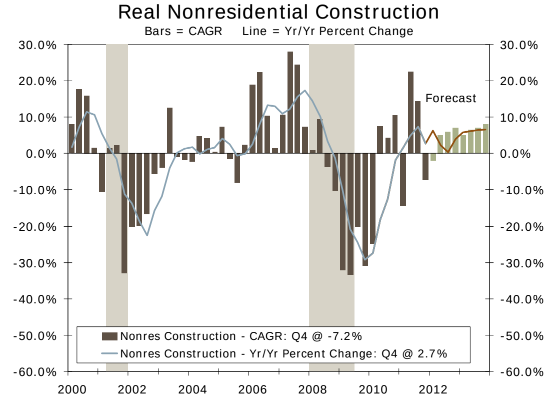


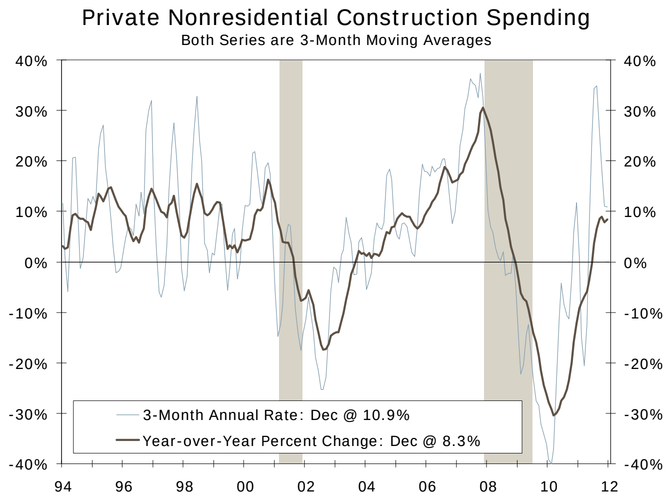
Figure 4

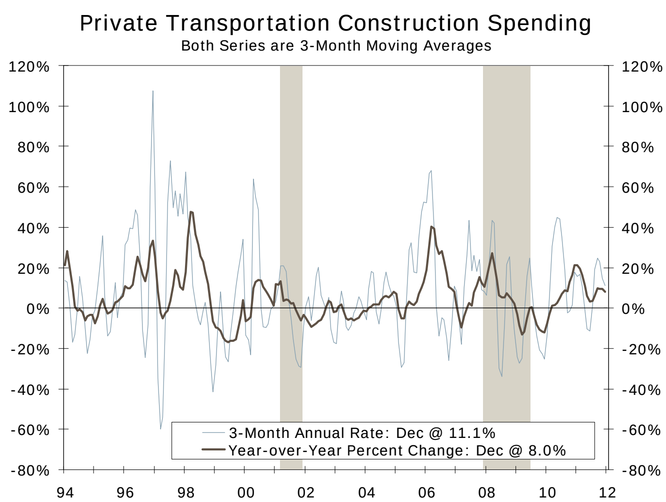


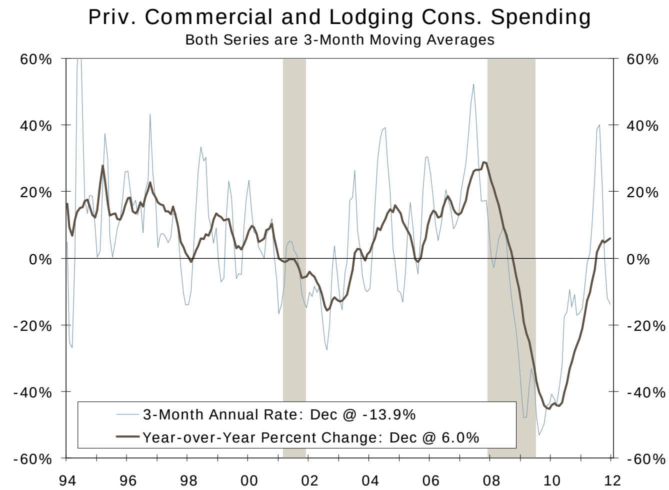
Source: U.S. Department of Commerce, PPR and Wells Fargo Securities, LLC

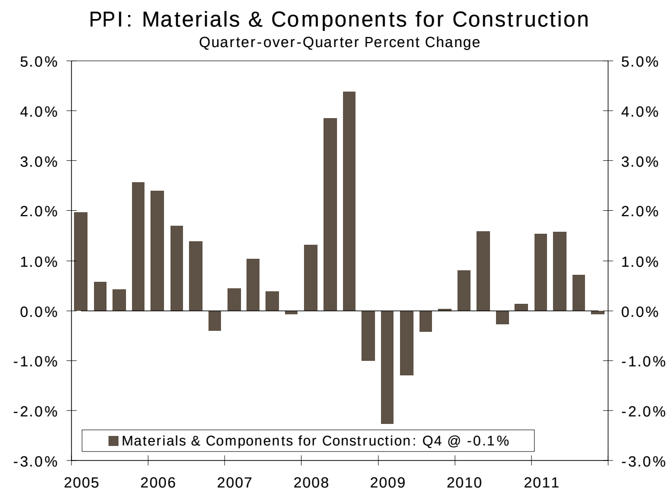
Nonresidential Construction Spending

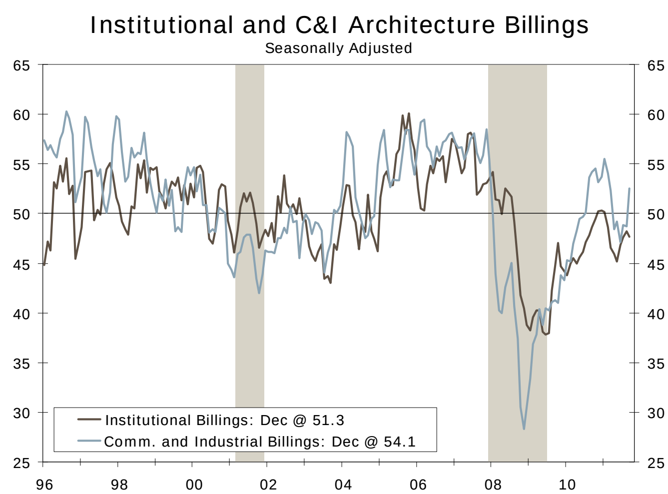
- Private nonresidential construction spending continued to show improvement in the fourth quarter with manufacturing, power, transportation and education leading the way. Power outlays, which include power plants, gas and oil as well as wind and solar, are up 18 percent over the past year.
- Based on BEA's assumptions for the fourth quarter, structures outlays may lead to a slight upward revision to real GDP growth. The value of construction put in place, however, does not account for oil or gas drilling, which according to the American Petroleum Institute, fell in the fourth quarter. Nonresidential architectural billings remained in expansionary territory and generally paint a mixed picture, with commercial billings rising slightly and institutional projects slowing.







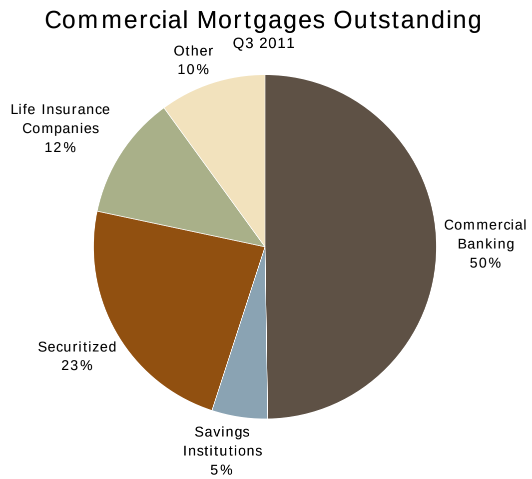


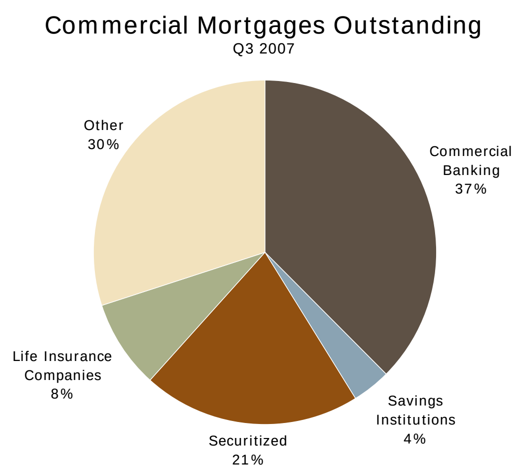


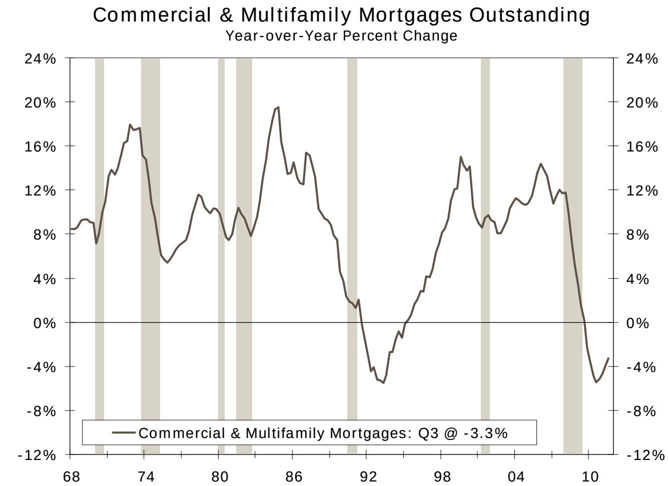
Source: American Institute of Architects, U.S. Dept. of Commerce, U.S. Dept. of Labor and Wells Fargo Securities, LLC

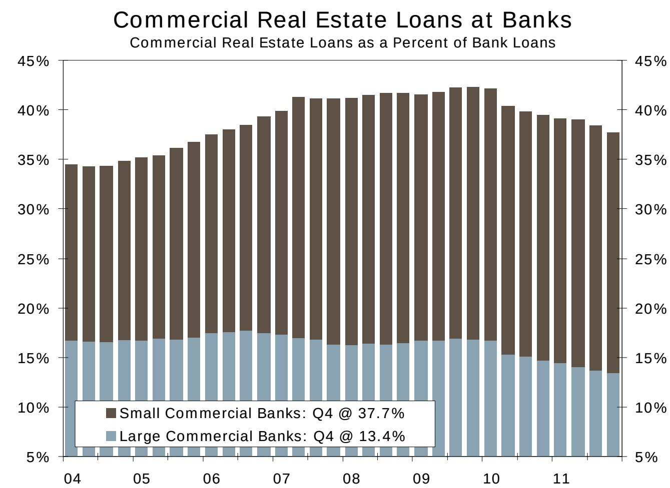
Commercial Mortgages Outstanding

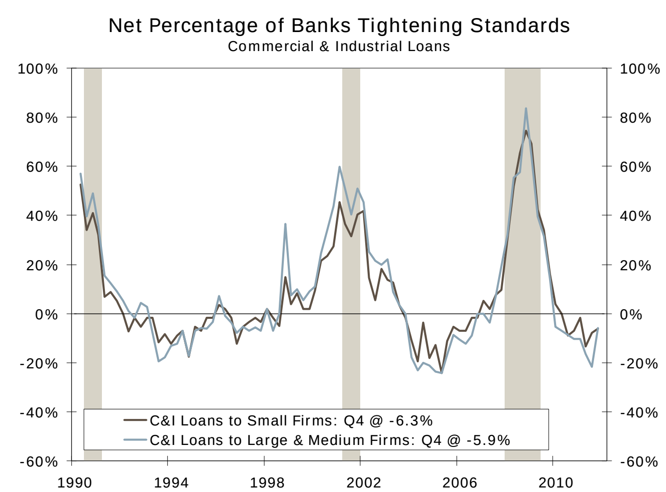
- The total amount of outstanding commercial loans continues to contract, but the pace is moderating.
- The latest Senior Loan Officer Survey included a special question about recent CRE lending policies. The question's results indicate that U.S. banks continue to report a moderate easing in loan terms as well as a modest pickup in the demand for new CRE loans. At the same time, however, a small net fraction of foreign lenders reported having tightened standards for new CRE loans, most likely a result of ongoing financial strains in Europe.
- The amount of commercial mortgages held at private finance companies continues to contract, down nearly 14 percent over the past year. Of all the loan-holder categories, finance companies have shed the most CRE loans over the past year.









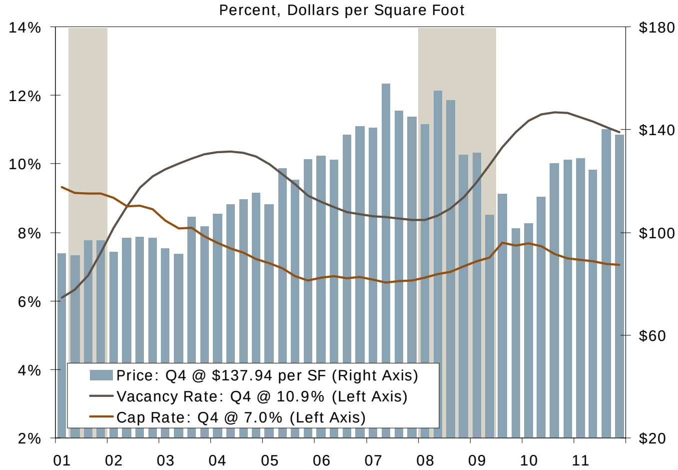


Source: Federal Reserve Board and Wells Fargo Securities, LLC

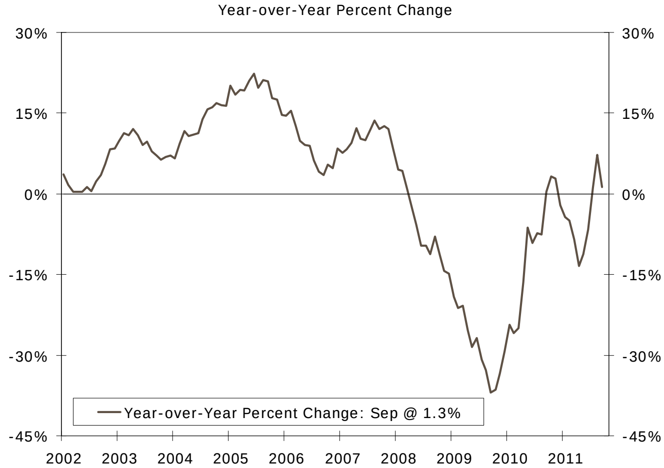
CRE Property Fundamentals

- Operating fundamentals for all property types continued to improve with vacancy rates declining or remaining unchanged in the fourth quarter. The pace, however, has moderated along with below-trend economic growth.
- Cap rates continue to pull off of their third-quarter 2009 peak and have remained relatively stable over the past year. According to RCA, investors continuing to seek yield are moving beyond Class A apartments and central business district office. Cap rates have also declined for leased suburban office and grocery-anchored shopping centers.
- CMBS lending will likely slow in the coming year. Our Structured Products Research Group expects origination to reach only $25 billion in 2012, a 17 percent decline from 2011.

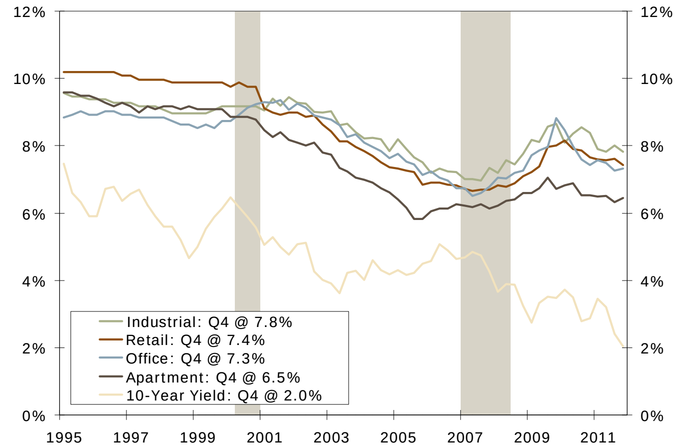
Commercial Real Estate
Percent, Dollars per Square Foot



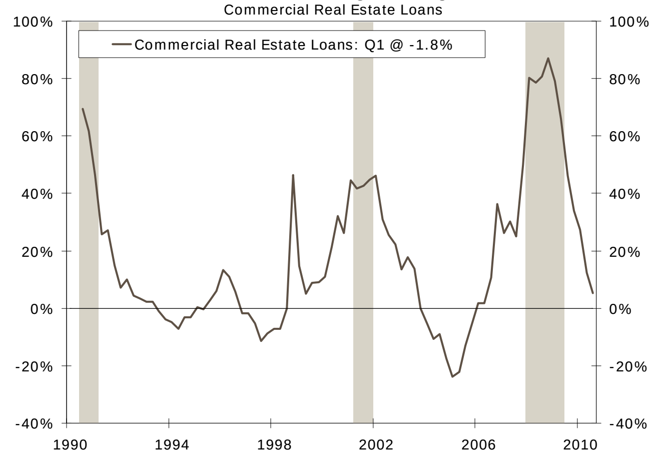
Moody's/REAL Commercial Property Price Index
Year-over-Year Percent Change



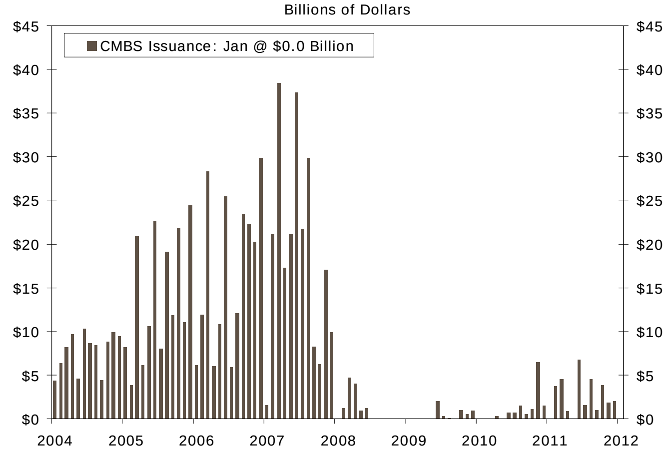
CRE Cap Rates vs. 10-Year Treasury Yields
Percent, Yield



Net Percent of Banks Tightening Standards
Commercial Real Estate Loans



U.S. CMBS Issuance
Billions of Dollars

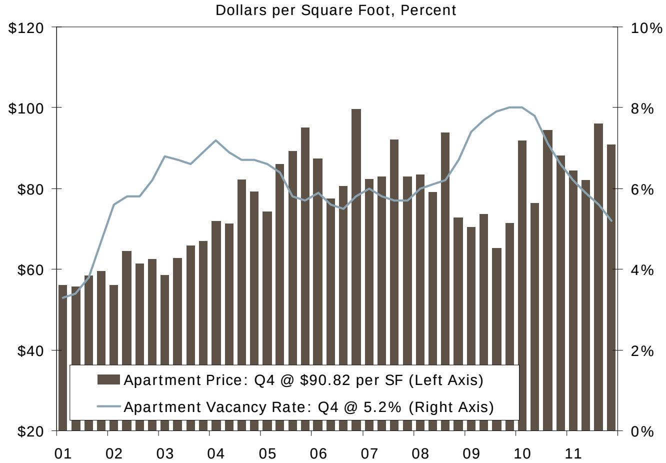


Source: Federal Reserve Board, PPR, RCA, Reis, Inc., Moody's, U.S. Department of Labor and Wells Fargo Securities, LLC

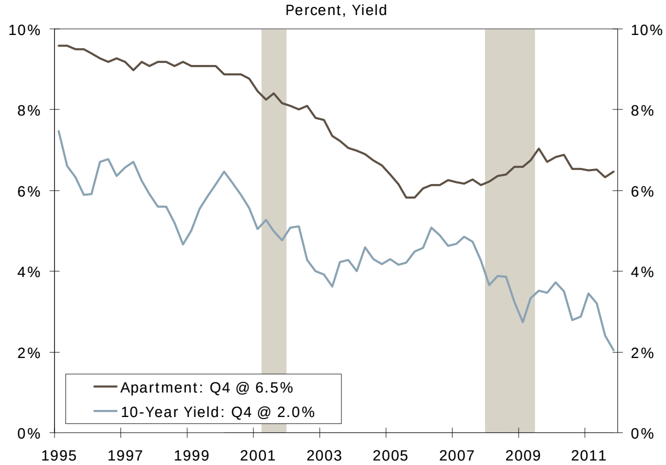
Apartment

- The apartment market's impressive growth continued in the fourth quarter. Vacancy rates fell 0.4 percentage points to 5.2 percent, the lowest level since Q4 2001. Rents continued to rise, and net absorption during the quarter totaled more than 50,000 units.
- The NMHC Quarterly Apartment Survey showed that the apartment market's strength has continued into the new year, with the survey's Tightness Index picking up to 60 in the first quarter. This index has been above its demarcation line of 50 for the past eight quarters.
- The GSE REO-to-rental conversion program the Obama administration is considering may slow rent growth by bringing more supply to the market. The impact should be greatest with B and C properties.

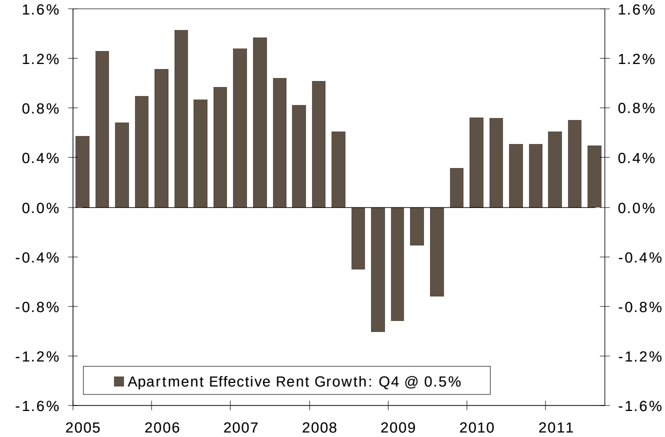
Apartment Price vs. Vacancy Rate
Dollars per Square Foot, Percent



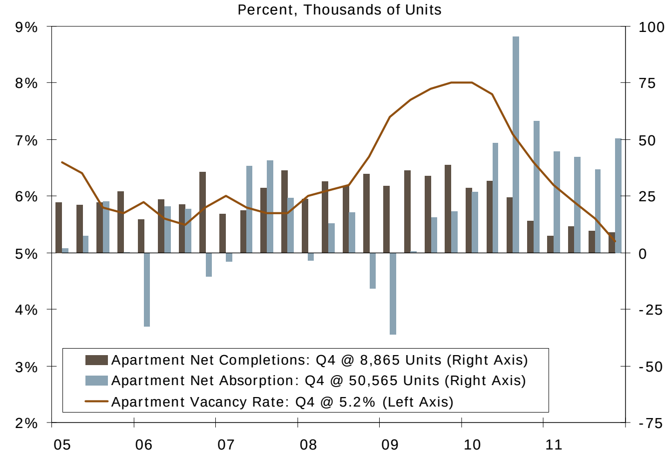
Apartment Cap Rate vs. 10-Year Treasury Yield
Percent, Yield



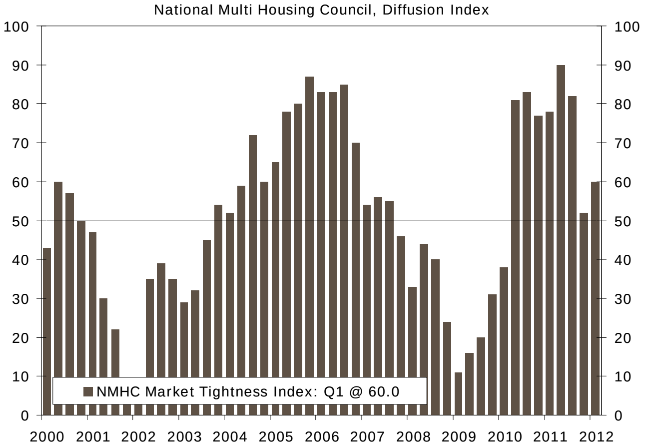
Apartment Effective Rent Growth
Quarter-over-Quarter Percent Change



Apartment Supply & Demand
Percent, Thousands of Units



NMHC Apartment Tightness Index
National Multi Housing Council, Diffusion Index

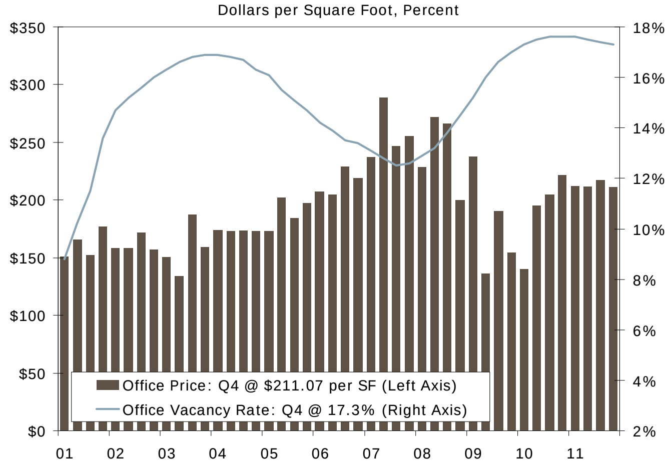


Source: Federal Reserve Board, NMHC, Real Capital Analytics, Reis, Inc. and Wells Fargo Securities, LLC

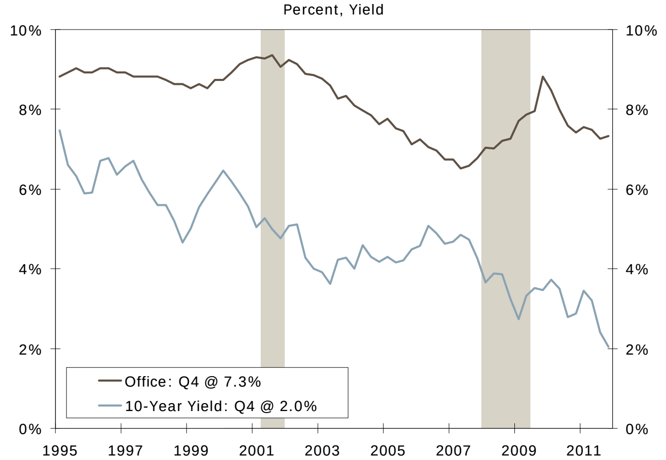
Office

- Office fundamentals continued to improve in the fourth quarter, but the recovery continues to progress at a moderate pace. Office vacancy rates have fallen little over the past year and remain elevated at 17.3 percent in the fourth quarter.
- New construction in the office sector will likely remain constrained due to high vacancies and the sluggish recovery in financial and professional services. With limited office supply and only slight pickup in office-using employment, net absorption will be slow to improve. Despite a pickup in overall hiring, job openings in professional and business services have cooled a bit in recent months.
- Office effective rent growth increased for the fifth consecutive quarter, reflecting increased leasing activity from tenants upgrading to newer space.

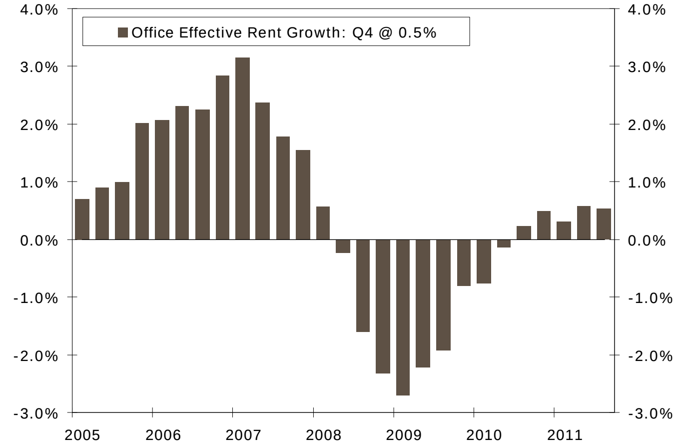
Office Price vs. Vacancy Rate
Dollars per Square Foot, Percent



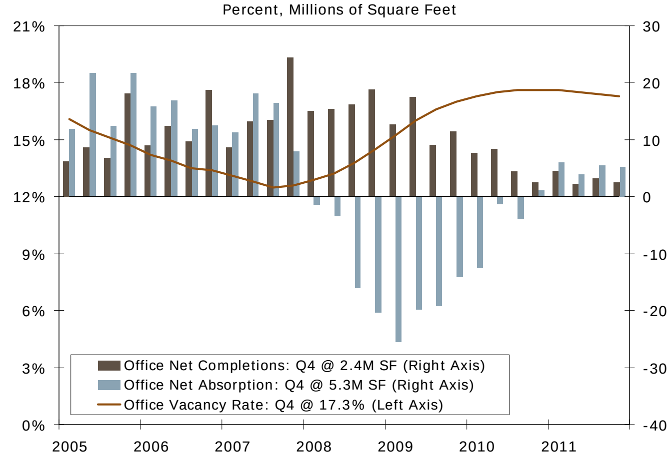
Office Cap Rate vs. 10-Year Treasury Yield
Percent, Yield



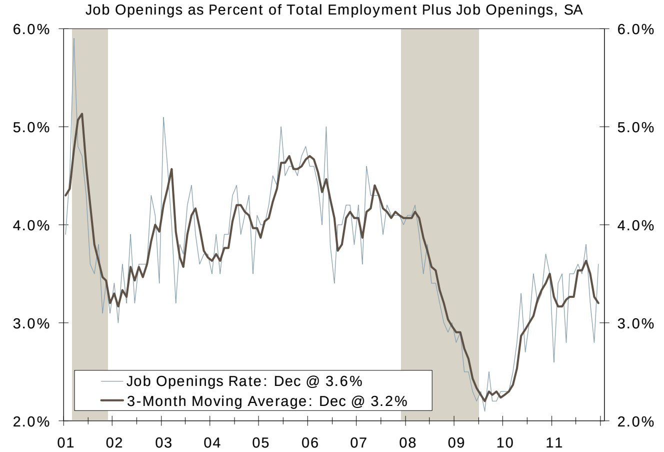
Office Effective Rent Growth
Quarter-over-Quarter Percent Change



Office Supply & Demand
Percent, Millions of Square Feet



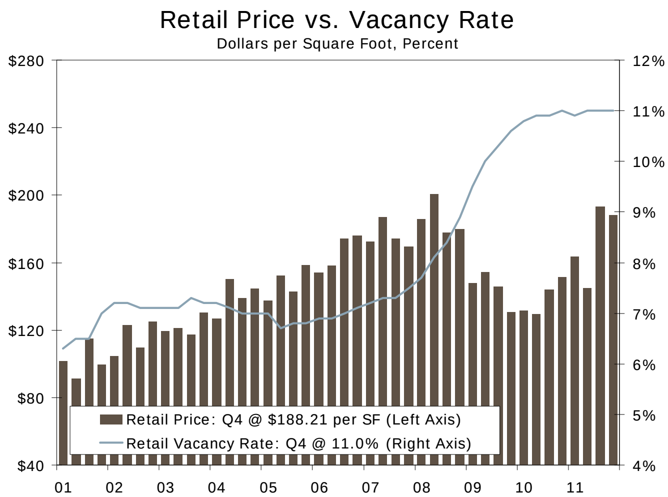
Job Openings Rate - Professional Services
Job Openings as Percent of Total Employment Plus Job Openings, SA

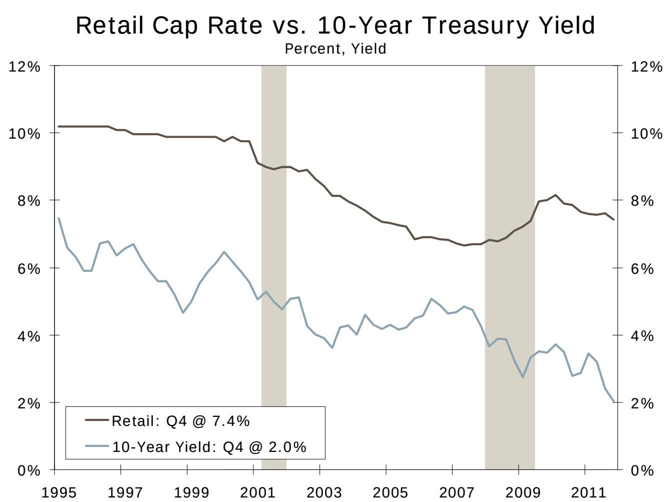


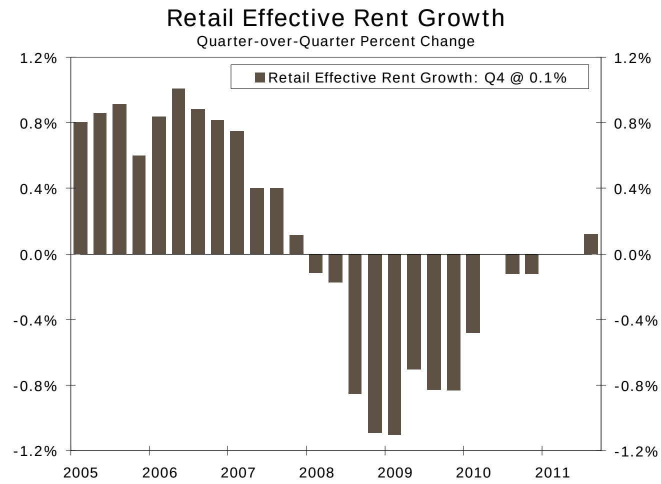
Source: Federal Reserve Board, Real Capital Analytics, Reis, Inc, U.S. Department of Labor and Wells Fargo Securities, LLC

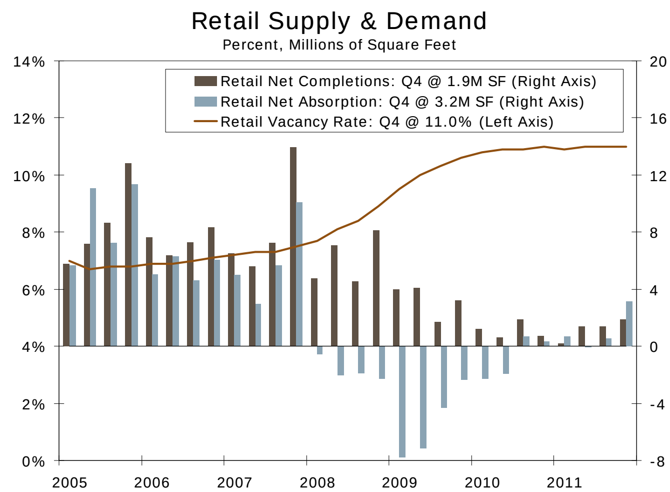
Retail

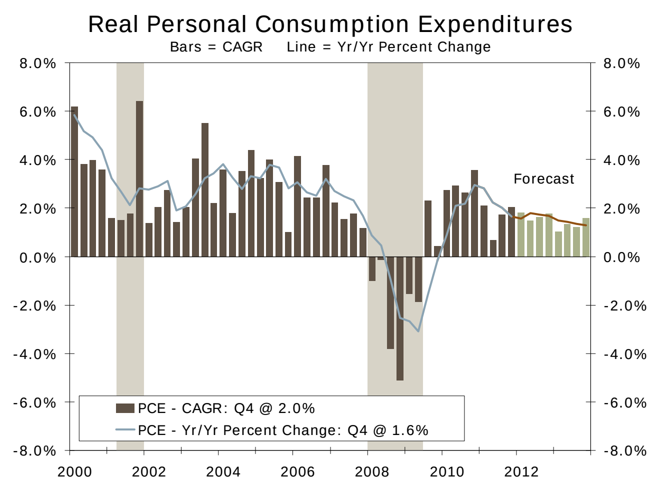
- The retail sector, while still weak, is finally showing some signs of life. Rent growth picked up in the fourth quarter for the first time since Q1 2008, and net absorption came in strong, with the occupied stock rising by 3.18 million units. Vacancy rates, however, remained unchanged at 11 percent.
- We will likely need to see several more quarters of growth in the retail sector before new construction increases in a meaningful way. The Q4 turnaround may simply be a result of seasonal variations. The winter months are typically the strongest for the retail sector. Reis' vacancy and rent data are seasonally adjusted, while the completions and absorption data are not.
- We expect slower consumer spending in the first half of this year to slow retail expansions.







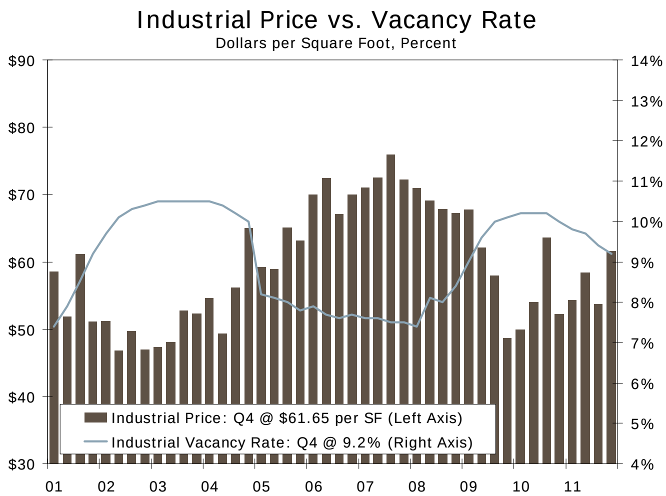


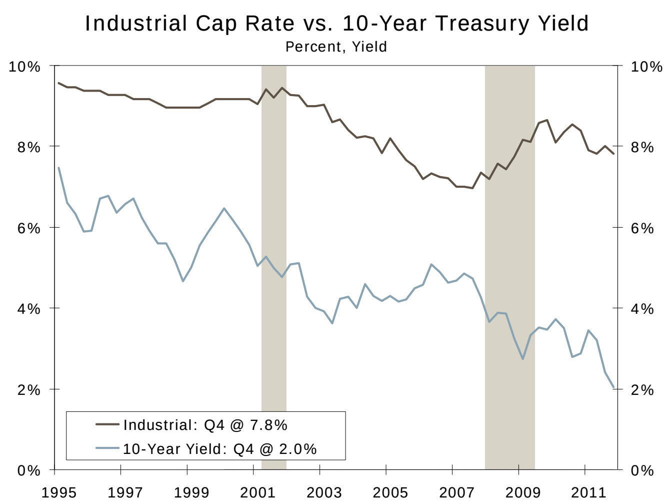


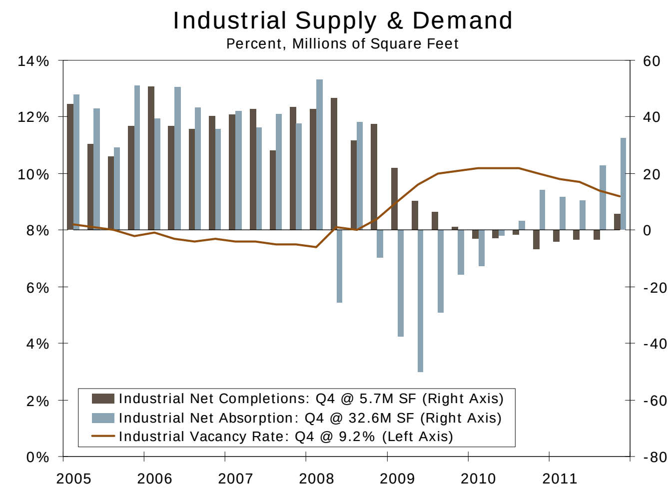
Source: Federal Reserve Board, Real Capital Analytics, Reis, Inc, U.S. Department of Commerce and Wells Fargo Securities, LLC

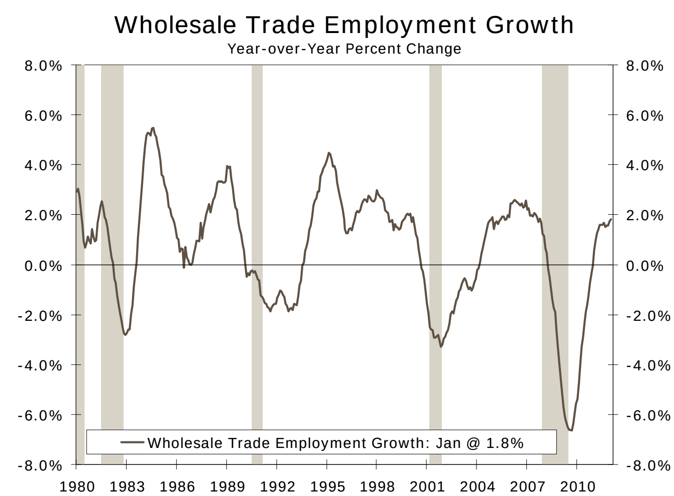
Industrial

- Operating fundamentals for industrial properties continued to improve in the fourth quarter, driven by growth in manufacturing, retail and international trade. Demand far outpaced supply, with only 5.7 million square feet of space delivered. As a result, the vacancy rate dropped 0.2 percentage points to 9.2 percent in the fourth quarter.
- According to PPR, leasing activity generated by retailers and third-party logistics firms, favoring large, modern product, remains strong, but space take-up by manufacturers is seeing the sharpest increase. The growth in industrial and warehouse space is also being fueled by changing retail strategies that place more of the operation in the warehouse and less on the sales floor. The growth in online sales is also driving demand.







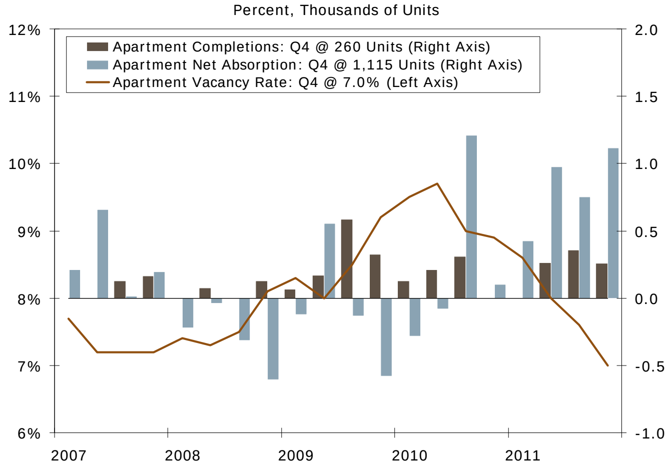


Source: Federal Reserve Board, PPR, RCA, U.S. Department of Labor and Wells Fargo Securities, LLC

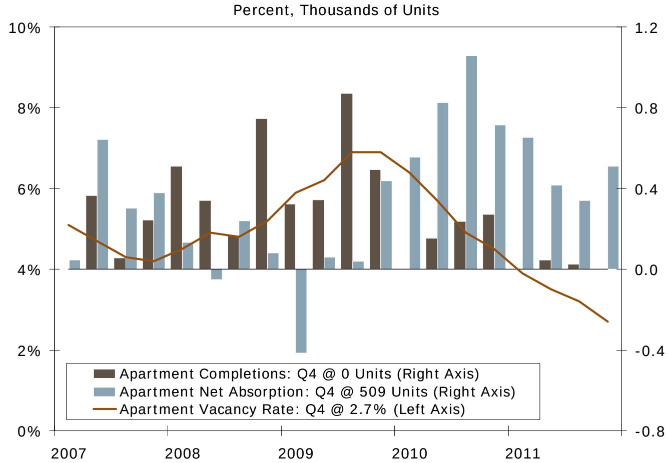
Regional Apartment Market Overview

- The strength of the U.S. apartment market has been a reoccurring theme in recent quarters. That strength, however, is very much a regional story. The most impressive growth in the apartment sector has occurred in many Southern and Sunbelt markets, with vacancy rates falling significantly in Greensboro, Charleston, Phoenix and Houston over the past year.
- Vacancy rates are the lowest in many West Coast markets, such as Portland, San Jose, San Diego and San Francisco. Absorption has picked up the most over the past year in Columbus, Chattanooga, Memphis and Raleigh.
- In general, apartment markets have tended to be strongest in areas that have seen large inflows of young workers, especially recent college graduates.

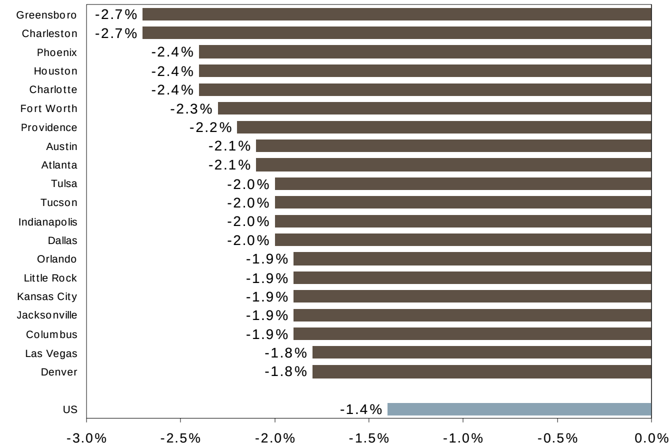
Columbus, OH Apartment Supply & Demand
Percent, Thousands of Units



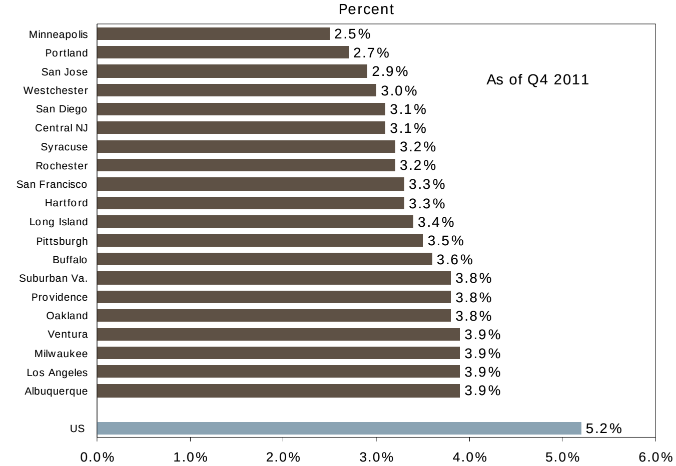
Portland Apartment Supply & Demand
Percent, Thousands of Units



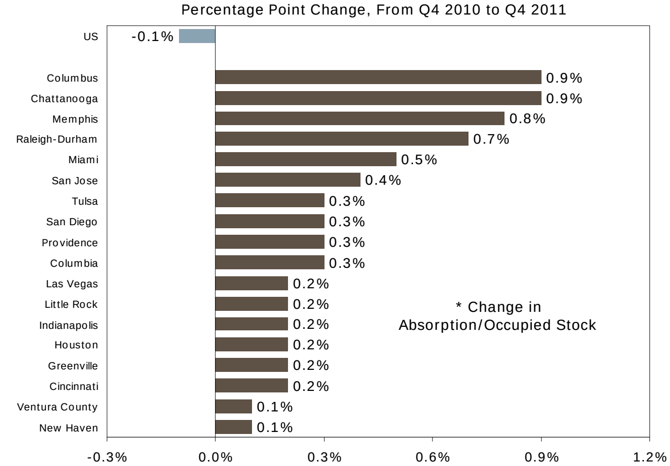
Apartment Vacancy Rate Change by Metro
Percentage Point Change, From Q4 2010 to Q4 2011



Apartment Vacancy Rate by Metro
Percent



Apartment Absorption Rate Change by Metro
Percentage Point Change, From Q4 2010 to Q4 2011



Source: Reis, Inc. and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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