BBVA | RESEARCH

CRE Outlook
United States

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Economic Analysis

Jason Frederick
jason.frederick@bbvacompass.com

Investors Turn up the Heat
Broad Gains Across Property Types and Local Markets

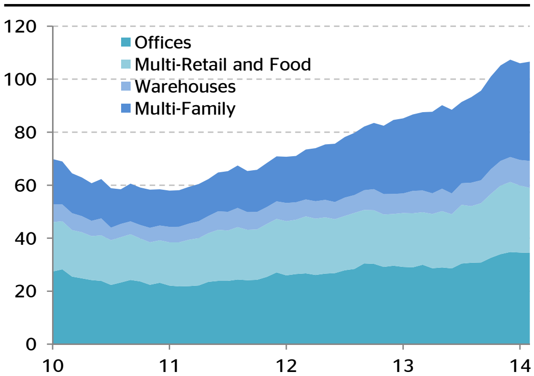
- **Price growth slowing among apartments; office, warehouse and retail prices continue to rise as vacancy rates decline and net income improves.**
- **Top metro areas for CRE in California, Texas, Colorado, Washington, Oregon, Florida, North Carolina, South Carolina, Pennsylvania and Massachusetts.**
- **Overall commercial construction activity is accelerating in 2014.**

The outlook for Commercial Real Estate (CRE) is positive, because strengthening economic activity and job creation will support further price appreciation. Net operating income is rising as net absorption increases and vacancy rates approach and drop below pre-recession lows. Overall, the pace of commercial construction activity will accelerate this year, and national CRE prices will edge higher. Investors will continue to pay premiums for properties in major urban markets, but they will increasingly seek out attractive opportunities in smaller markets with substantial job creation.

Notably, however, high returns will be harder to achieve in the tight apartment market because property prices have surpassed their pre-recession peaks. Office-using job growth needs to pick up to drive vacancy rates down and rents up at office buildings. In cities with high-tech clusters such as Austin and San Jose, robust job creation continues to absorb vacant space among suburban office buildings. Industrial warehouses are seeing the highest rent growth at large buildings that are suitable for efficient distribution throughout major metropolitan areas. Finally, the retail sector still continues to struggle in many markets with weak job growth; however, the amount of vacant competitive space is low and new construction activity spiked in 4Q13. An ever increasing population and a nascent rebound in consumer spending bode well for net absorption and near-term rent growth at retail properties.

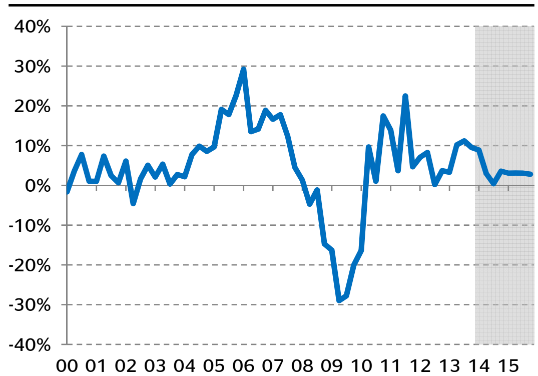
In spite of an expected slowdown in the price appreciation of apartment properties, our baseline forecast points to 4.0% overall CRE price growth in 2014 after a nearly 9% increase in 2013.

Chart 1
New Private Construction, Selected Categories, $ bn. (SAAR)



Source: Census and BBVA Research

Chart 2
CRE Price Index, All Properties, YoY % Change



Source: NCREIF and BBVA Research

Capital Markets

Accommodative monetary policy will bolster CRE investment throughout the country because we expect the Federal Reserve to maintain the federal funds target rate at 0% to 0.25% through at least mid-2015 and rise slowly thereafter. Low risk-free interest rates induce investors to hunt for higher yielding assets; consequently, prices of income-producing CRE properties are being bid up because fundamentals such as vacancy rates and rent growth are improving. Rising CRE prices will thus attract new investment and construction activity during the next several years.

Property price trends alone, however, provide an incomplete picture of the CRE sector, as real estate performance is inherently linked to local economic conditions. Investors and sector analysts rely on transaction-based observations of capitalization rates (cap rates) across markets. A cap rate is simply defined as the ratio of the net operating income of a property to its purchase price. Typically, the highest quality properties in the most attractive markets such as Class A office buildings in New York City sell at the lowest cap rates. Buyers are optimistic that income will grow and they are willing to pay a premium for that income stream.

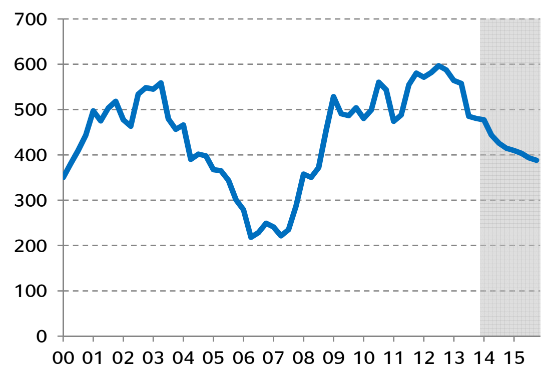
Lower quality properties in smaller markets tend to sell at the highest cap rates (lowest prices) as investors demand additional risk compensation. For example, a property's vacancy rate may be high or it may need substantial renovations to attract new tenants. Market analysts also look to average cap rate spreads with 10-year U.S. Treasury yields across property types as an indicator of risk perception. This spread spiked upward in late 2008 as CRE prices and transaction volumes plummeted, but it has steadily declined even after the 100 basis point jump in the 10-year yield in mid-2013. Our baseline forecast of the national office cap rate spread in Chart 4, for example, projects a decline that reflects lower risk perception among investors as fundamentals improve.

Chart 3
Observed Cap Rates and Spreads from Selected Sources, % and basis points (bp)

Source	Property Type	Cap Rate (%)	4-Qtr Change (bp)	Cap Rate Spread (bp)	4-Qtr Change (bp)
PPR54 HP Median Filter	Apartment	6.1	(22)	338	(126)
	Office	7.2	(34)	446	(138)
	Retail	7.2	(23)	443	(127)
	Industrial (Warehouse)	7.0	(36)	424	(140)
PPR54 Smoothed Cap Rate	Apartment	6.7	(28)	397	(132)
	Office	7.6	(3)	480	(107)
	Retail	8.0	(19)	522	(123)
	Industrial (Warehouse)	7.9	(19)	512	(123)
REIS Rolling Cap Rate	Apartment	6.4	(10)	350	(130)
	Office	7.1	(30)	420	(150)
	Retail	7.8	10	490	(110)
	Industrial (Warehouse)	7.8	(20)	490	(140)

Source: PPR, REIS and BBVA Research

Chart 4
Cap Rate Spread with 10-Year Treasury, Offices, bp

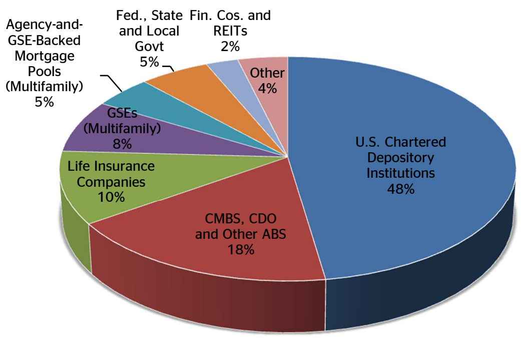


Source: PPR54 and BBVA Research

Lower risk perception in the CRE market helped to drive a $99.0 billion increase in total CRE-related debt between 4Q12 and 4Q13, the first yearly increase since 2008. As of 4Q13, total outstanding CRE-related debt stood at $3.2 trillion according to the Federal Reserve's Flow of Funds report. U.S.-chartered depository institutions hold 48% of that total, and their holdings increased by $72 billion during the past year - the vast bulk of the total increase.

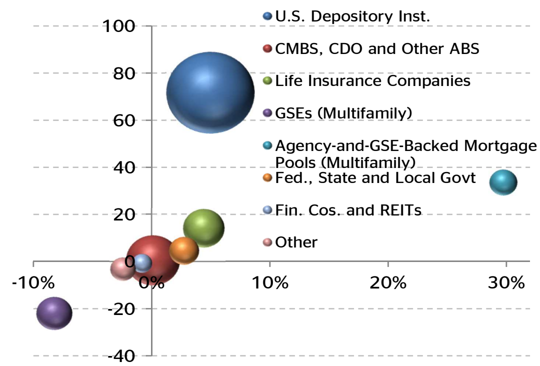
Bank lending has ramped up as the delinquency rate for commercial real estate loans plummeted below 2.5% for the first time since 2007 and the charge-off rate was a minuscule 0.05% in 4Q13, the lowest since 2006. The Mortgage Bankers Association's 4Q13 Data Book notes, "The fourth quarter marked the highest volume of mortgage originations since 2007, as all the major investor groups increased their activity. Initial indications are that 2013's volume was up 15 percent from 2012… originations for commercial bank portfolios increased by 54 percent from last year's fourth quarter." The steady rebound of CRE prices during the past four years is certainly behind improvements in asset quality and lending activity.

Chart 5
Composition of Total Outstanding CRE Debt, as of 4Q13, $3.2 Trillion



Source: Federal Reserve and BBVA Research

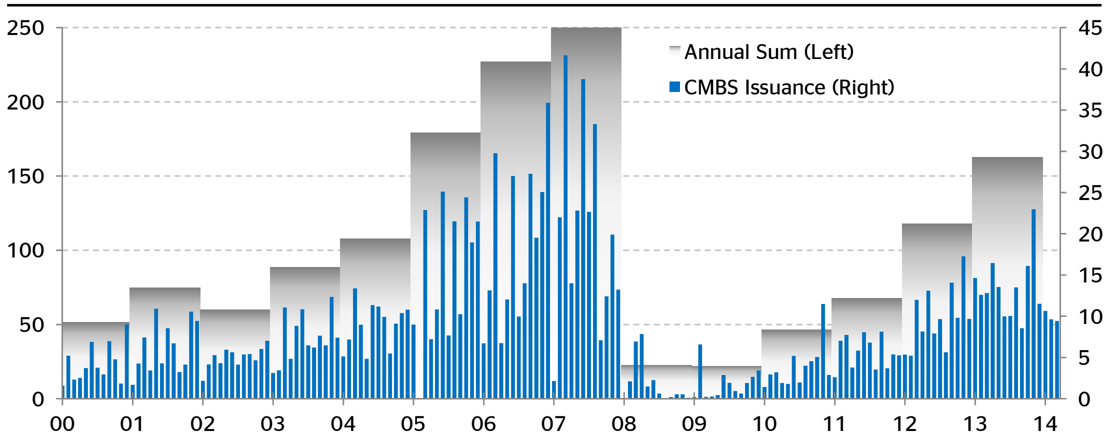
Chart 6
Growth of Credit by Type of Financing, Year-over-Year Level ($ bn.) vs. % Change



Source: Federal Reserve and BBVA Research

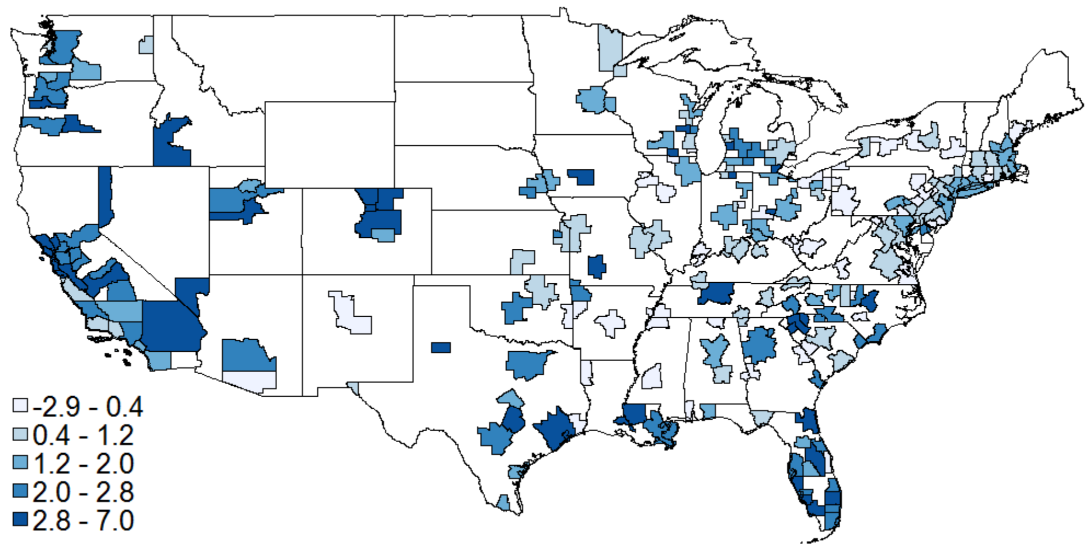
Banks will continue to be the primary source of an increase in total CRE debt this year, as the amount of debt held in Commercial Mortgage Backed Securities (CMBS) will only post a modest increase after it remained essentially unchanged last year. CMBS originations are well below prior years and were lower in 1Q14 versus 1Q13. Banks will seek to expand their lending in both primary and secondary markets where job growth is strengthening. Ultimately, higher job creation directly leads to greater demand for rental apartments, office space and retail shopping centers.

Chart 7
Monthly CMBS Issuance and Annual Total, $ bn.



Source: Bloomberg and BBVA Research

Chart 8
Employment Growth, Year-Over-Year % Change, 4Q13



Source: BLS and BBVA Research

BBVA Research Quarterly CRE Activity Index

BBVA Research has developed a tool to compare CRE activity within the major property types across the 210 metropolitan areas that PPR Global and CoStar track. A high value of the index indicates that fundamentals are improving in that local market.

The BBVA Research CRE Activity Index is a weighted composition of the latest quarterly rent growth, net absorption, vacancy rate and PPR's modeled cap rate. It highlights markets in which the first two variables are higher and the latter two are lower. BBVA Research constructs a separate index for apartments, offices, industrial warehouses and retail shopping centers using data from PPR Global. The index is benchmarked against employment growth and comparable data from REIS, Inc.

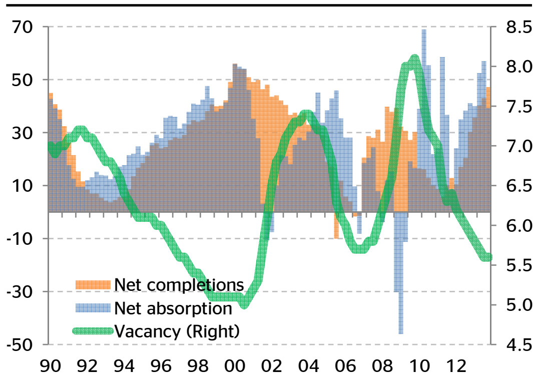
These indexes reflect our current assessment of top metropolitan areas for CRE investment, and they are reported graphically in quintiles. A darker blue color indicates a higher index value for that region and implies a higher level of attractiveness.

Multi-Family Apartment Prices at New High

The apartment sector enjoyed a fast rebound during the recovery, because the number of home foreclosures surged and more than 2 million households transitioned from owners to renters. Consequently, the apartment vacancy rate fell rapidly from a peak of 8.1% in 4Q09 to 5.6% at the end of last year and effective rents increased 16% from 2Q10 to 4Q13 according to PPR Global data. Net operating income rebounded due to these trends and drove valuations above pre-recession highs. Consequently, cap rates are the lowest among the major property types.

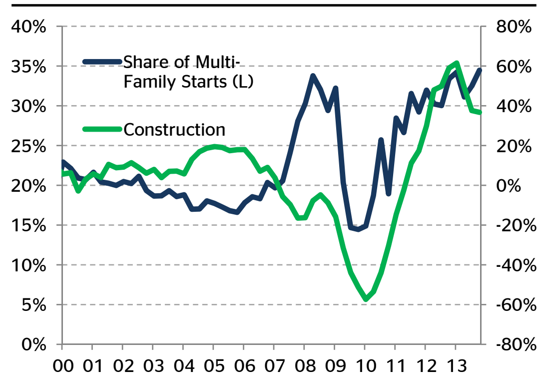
Apartment demand will remain elevated during the next few years as household formation increases with faster economic growth and job creation. By January 2016, we project that the number of households will increase by approximately 2.1 million. Because the homeownership rate is projected to decline further, however, the majority of these new households will enter the rental market. During the next two years, number of renting households will expand by 1.2 million, while the number of owner-occupied homes will rise by approximately 900,000. Demographics are supporting apartment demand, because there is a wave of young people in their early twenties who are entering the labor market. Workers in this age group tend to rent as they begin to form families and save money for a down-payment to purchase a single-family home.

Chart 9
Apartment Absorption and Completion vs. Vacancy, Thousands of Units and %



Source: PPR, CoStar and BBVA Research

Chart 10
Multi-Family Housing Starts and New Construction, % and YoY % Change



Source: Census and BBVA Research

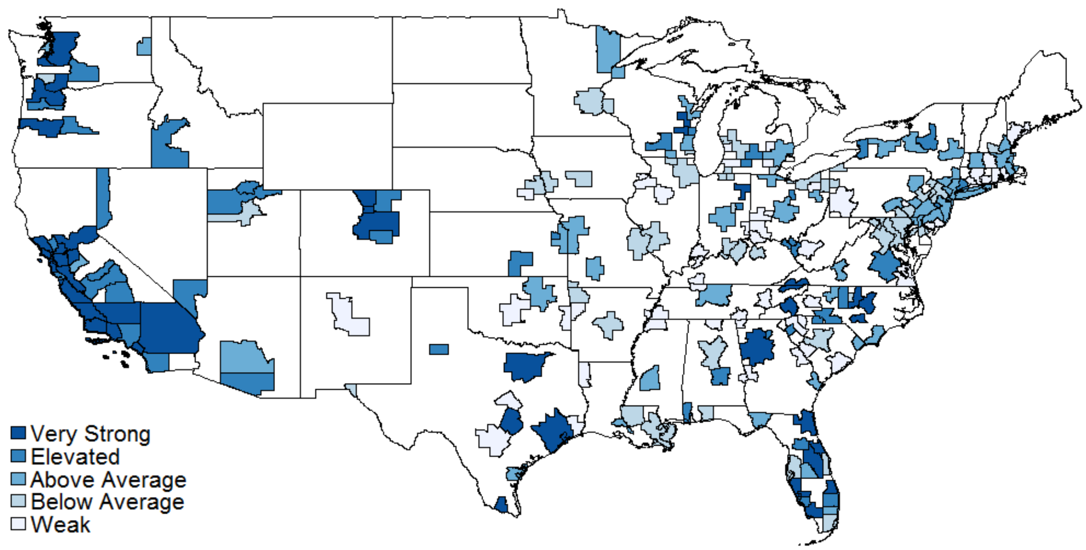
Market fundamentals are changing for the apartment sector, as nationwide vacancy rates are expected to decline only slightly in 2014 and begin to increase in 2015. New multi-family construction has skyrocketed and leads CRE investment: the average pace during 2013 rose nearly 50% from 2012 and is currently up 30% year-over-year. Multi-family housing starts have outpaced those of single-family units and currently comprise 35% of the total - levels not seen since the early 1980s. New apartment buildings have not sat empty, because net absorption (demand) has been trending above net completions. Nevertheless, a wave of supply is beginning to hit the market, as net completions were higher than net absorption in 4Q13, and this trend is expected to continue through 2015.

Apartment rent growth is softening in this environment, in part because household incomes have not kept pace with rents; however, it will remain positive as market conditions are tight. There is not much room for apartment cap rates to fall further: spreads with the 10 Year Treasury are the lowest among the four major CRE sectors and are only about 40 basis points off their 20-year historical average. Given that treasury yields are expected to ascend further as the Federal Reserve tapers its bond purchases and economic growth improves, cap rates will begin to rise. This rise suggests that apartment valuations may have reached their limits in some markets and CRE investment will achieve higher returns in other property types.

The markets with the fastest rent growth have been rapidly creating high-wage jobs in the energy and technology sectors: Reis, Inc. cites the top five metro areas in terms of revenue-per-unit growth during 2013 as Seattle, San Francisco, Houston, San Jose and Oakland.

The BBVA Research CRE Activity Index for Apartments ranks the top twelve markets in 4Q13 as Seattle, Austin, San Jose, Portland, Santa Rosa, Eugene, Denver, Jacksonville, Fort Collins, Orlando, Houston and Port St. Lucie, FL.

Chart 11
BBVA Research CRE Activity Index, Apartments, 4Q13



Source: BBVA Research

Certainly, the most important driver of apartment rents is employment growth, and thus there are still likely to be attractive investment opportunities in particular markets that are experiencing robust job creation but have yet to see comparable price appreciation of apartment buildings. Some of these areas, for example, include Columbus, Austin, Naples and Raleigh.

Office Transactions Rising in Secondary Markets

Although offices have experienced a slower recovery than apartments, properties continue to be snapped up for high prices, particularly in dense urban markets. The national office vacancy rate peaked in mid-2010 and it remains above its pre-crisis low point because office-using job losses were relatively more intense than overall employment.

The 4Q13 estimate of the national office vacancy rate (and improvement from 2010) varies across data providers because each source aggregates a distinct set of properties - PPR/CoStar 54, 11.9% (160bp); CBRE, 14.9% (200bp); REIS, 16.9% (70bp) - but all estimates exhibit a downward trend. Office-using job growth has expanded at a faster pace than overall employment during the past three years, and this difference has been responsible for the decline in vacancy.

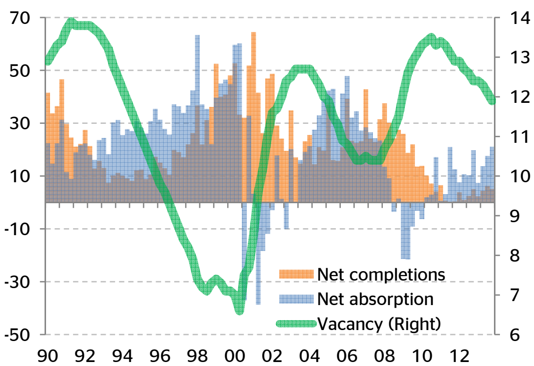
Net absorption will continue to surpass net completions of office space through at least mid-2016 because of strong job creation in professional services, finance, insurance, real-estate and high-tech. Vacancy rates will descend further and support a modest acceleration of rent increases to push net operating income higher.

This outlook for the office market is demanding new construction. Private office construction activity accelerated in 4Q13 is up 19.0% year-over-year as of February and it will maintain a fervent pace as the oversupply of prior years is absorbed.

Thus, we expect cap rates to decline further, because current spreads with the 10-Year Treasury could decline around 50bp to be consistent with a long-term historical average. Consequently, valuations of office properties will continue to rise.

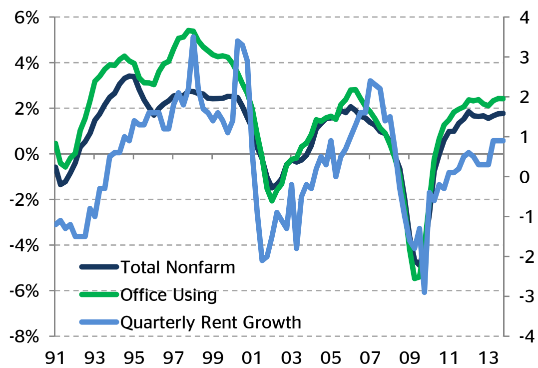
Although central business districts (CBD) properties in major metropolitan areas such as Chicago, New York, Boston, Houston, San Francisco and Washington, DC have recently sold for record high prices, investors are increasingly turning to suburban properties in markets with energy and tech companies, because employers in these sectors are increasingly choosing to locate outside of the CBD. San Jose, California and Austin, Texas, for example, are experiencing a wave of this type of investment.

Chart 12
Office Absorption and Completion vs. Vacancy, Million Sq. Ft. and %



Source: PPR, CoStar and BBVA Research

Chart 13
Office-Using Employment and Quarterly Rent Growth, YoY % Change and %

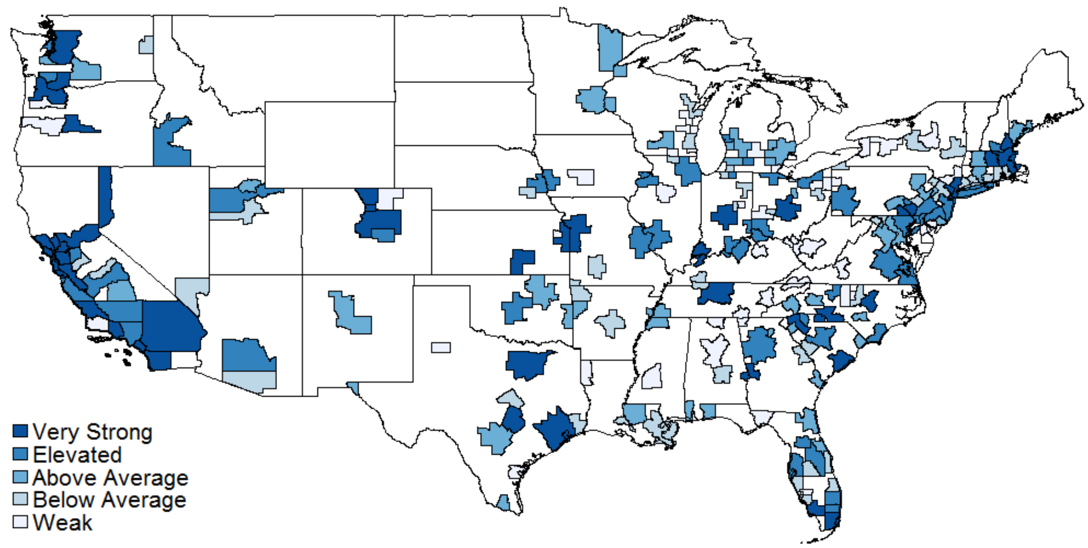


Source: BLS, PPR and BBVA Research

Nevertheless, office transaction volume is still well below average. As investors decide to take additional risks and more transactions take place - particularly of lower quality buildings - cap rates will rise. However, a risk-on environment is unlikely until the national vacancy rate declines another 200+ basis points and rent growth accelerates.

The top-ranked markets according to the 4Q13 BBVA Research CRE Activity Index for Offices are San Jose, San Francisco, Austin, Boulder, Greenville, Houston, Bend, York, Vallejo, Oakland, Boston and Dallas-Fort Worth. These top markets are in California, Texas, Colorado, South Carolina, Oregon, Pennsylvania and Massachusetts. Next in line are markets in Georgia, Tennessee, Indiana and Florida. Clearly, the top markets reflect the strong job creation of the energy and technology sectors.

Chart 14
BBVA Research CRE Activity Index, Offices, 4Q13



Source: BBVA Research

Industrial Warehouse Price Appreciation Will Accelerate

The industrial warehouse sector is looking increasingly attractive, as cap rates have declined and converged with those of retail properties. In contrast with that sector, however, net absorption of warehouse space rose 48% in 2013 and totaled 124 million square feet. Net supply, however, only increased modestly, and PPR/CoStar estimates put the current vacancy rate at 7.6% - equal to its pre-recession low point in 1Q08.

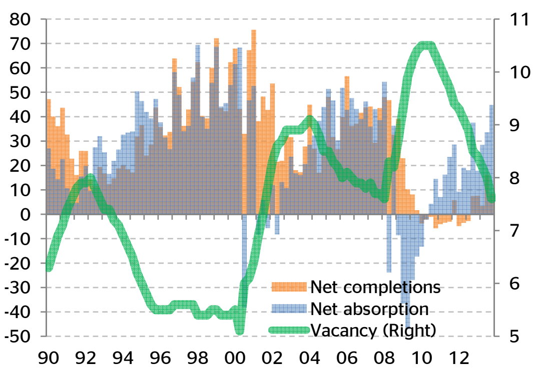
As the vacancy rate plummeted, warehouse rent growth was the strongest among the major CRE property types during 2013. Because net absorption is expected to exceed net completions through the remainder of the year, rent growth will remain elevated and steady. Net operating income will continue to rise, as cap rates decline further.

Thus, warehouse properties will see the highest price growth relative to other property types during the next two years. In response to this attractiveness, construction spending in the warehouse sector is booming - up 21% year-over-year in February - and much of that new supply will hit the market next year.

One trend that will continue to positively impact the warehouse and distribution sector is the sustained growth of electronic commerce sales. Rising e-commerce sales are requiring national retailers to expand their distribution network across the country as they seek to reduce shipping times to customers. Although the share of e-commerce sales as a percentage of general retail sales (excluding food and beverage stores) is only around 6%, when we further exclude sales of autos, gasoline stations, and building materials that are traditionally conducted on site, the share of e-commerce transactions rises to nearly 13%. Furthermore, electronic sales are growing three to four times as fast (16% YoY, 4Q13) as general retail sales.

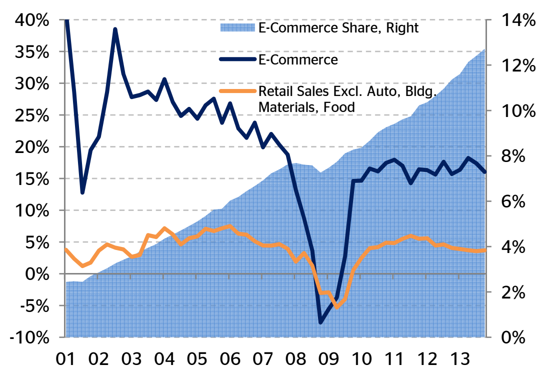
However, all warehouse properties and locations will not benefit equally. In the Winter 2014 edition of *CRE Finance World* Victor Canalog of REIS cautions, "There is a clear dichotomy between the recovery for newer, larger warehouse space versus that of older, smaller properties. At the core of this dichotomy lies the success of e-commerce and the type of space demanded by internet retailers." He explains that e-commerce is shifting the purpose of retailers' warehouses, as they now must stock larger quantities of inventory in fewer places to fulfill orders from many locations. His analysis finds that "seeing as how new, big box space is now in high demand, those metros with large swaths of big box space stand to gain the most from this trend."

Chart 15
Warehouse Absorption and Completion vs. Vacancy, Million Sq. Ft. and %



Source: PPR, CoStar and BBVA Research

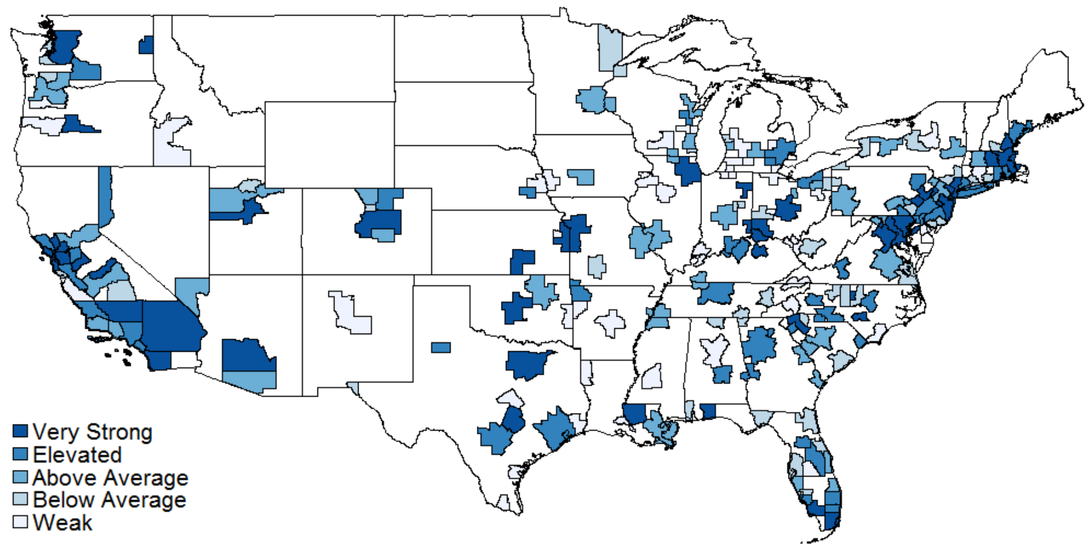
Chart 16
E-Commerce Sales and Share of Retail, YoY % Change and %



Source: Census and BBVA Research

The BBVA Research CRE Activity Index for Industrial Warehouse properties ranks the top 4Q13 markets as Oklahoma, Dallas-Fort Worth, Trenton, Allentown, San Francisco, Seattle, Reading, Fayetteville, Edison, Vallejo, the Inland Empire (Riverside-San Bernardino-Ontario) and Denver. While all of the above markets experienced a decline in vacancy, Fayetteville, Reading and Allentown ranked in the top largely due to a 200+ basis point decline in their 4Q13 vacancy rates as net absorption surged. This increase in demand, however, is unlikely to repeat in these areas. This ranking reflects increasing demand for big-box space, as both Dallas-Fort Worth and the Inland Empire area have relatively more large warehouses.

Chart 17
BBVA Research CRE Activity Index, Industrial Warehouses, 4Q13



Source: BBVA Research

Retail Sector's Recovery Lagging but Luxury Segment is Hot

In spite of soft consumer spending activity, the vacancy rate continues to trend downward among retail properties as net absorption far surpasses net completions. Cap rates have declined along with all other CRE property types, but the rate spread remains the highest among them. Based on a historical average of the spread with the 10-Year Treasury yield, retail cap rates could compress another 30-50 basis points and drive valuations up.

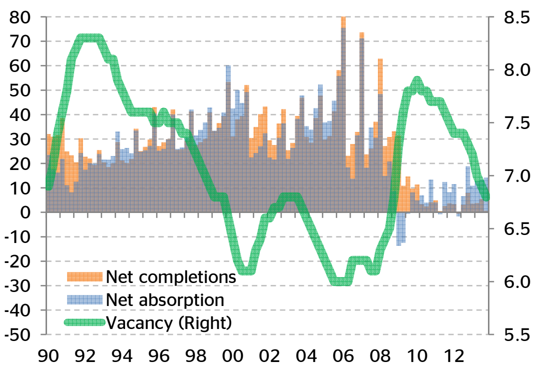
Nationwide, the relatively slow pace of consumption growth and household income hinders broad improvement in the retail sector. A below-trend pace of spending on services underlies the declining pace of retail sales growth during the past two years. Because neighborhood shopping centers are filled with service-related stores, spending on services is vital for the retail CRE market. Recent data offer a hint of optimism, however, now that consumer de-leveraging has come to an end and spending on services accelerated in 4Q13.

The story of improving fundamentals and higher prices, however, is not consistent across all retail properties, and the actual vacancy rate in a particular area may not accurately reflect the vacancy rate of competitive space. Retail properties are acutely impacted by changing demographics and social interactions, because once occupied space in a center decreases below a certain threshold, remaining tenants will vacate and the center essentially dies. Analysts at CoStar, for example, note that the competitive vacancy rate across markets is getting tight - slightly above 3% - and this factor is behind the acceleration in rent growth.

Furthermore, the "urban luxury" market in high-traffic and high-income areas such as the Magnificent Mile in Chicago, Fifth Avenue in New York, and Beverly Hills is very tight and properties in these areas are seeing record prices in transactions. Going forward, rent growth will accelerate through 2015, as new supply will remain limited due to a dearth of construction activity during the past several years. The pace of new private commercial construction of multi-retail centers, however, jumped 35% year-over-year in 4Q13 as new projects are finally beginning to appear across the country.

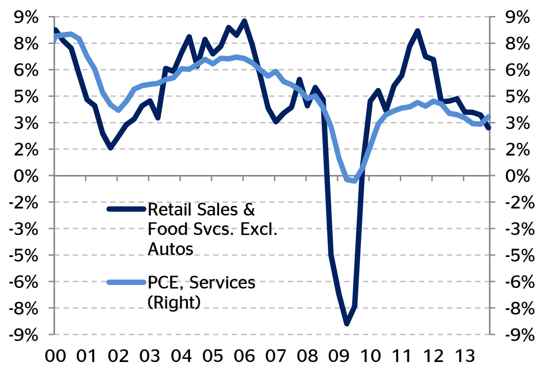
Finally, the rise of e-commerce sales as in Chart 16 does not mean that retail CRE properties are in trouble. Although the rapid growth of e-commerce is projected to boost demand for warehouse space relative to storefront space for certain retailers, investors must pay careful attention to the mix of store types in a successful shopping center.

Chart 18
Retail Absorption and Completion vs. Vacancy, Million Sq. Ft. and %



Source: PPR, CoStar and BBVA Research

Chart 19
Retail & Food Sales, Ex Autos and Services Consumption, YoY % Change



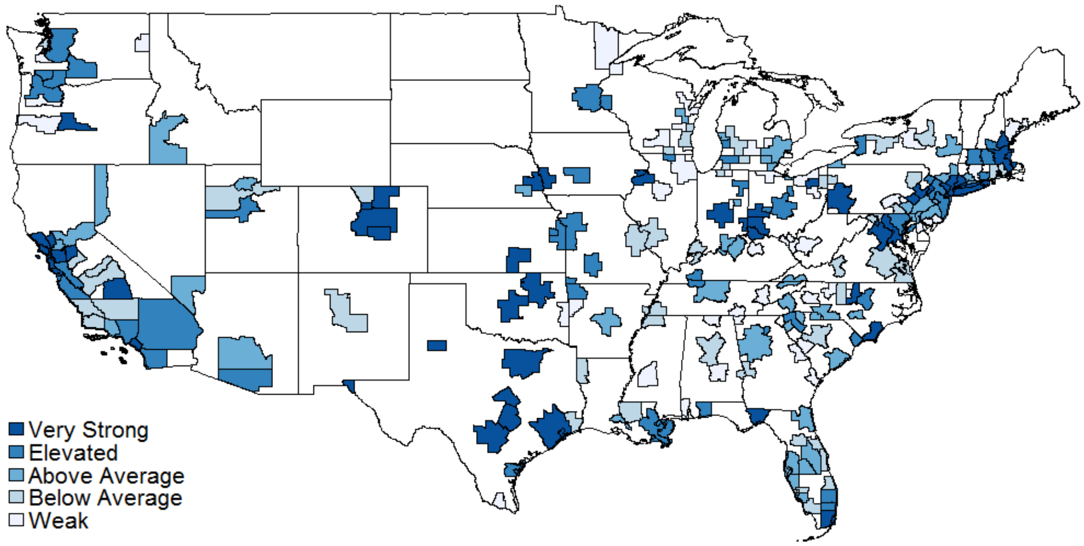
Source: Census, BEA and BBVA Research

Key attractions such as a factory-direct outlet mall, or a grocery store that anchors an array of restaurant and service businesses may attract the most foot traffic. Sales at building material stores are improving as demand for home remodeling and new home construction is rising.

Another emerging trend involves the expansion of the ambulatory health care sector that includes dialysis centers, medical imaging labs and standalone emergency rooms. These "medtail" storefronts are proliferating because they can provide medical services at lower costs compared to other providers such as hospitals, and they are increasingly absorbing vacant retail space because renovation is substantially less expensive than development of a new medical office building. The CoStar Group notes that "Accenture expects the number of retail health clinics to double to more than 2,800 by 2015, handling 10.8 million patient visits and saving $800 million annually."

The most attractive markets according to the 4Q13 BBVA Research CRE Activity Index for Retail properties are San Francisco, Durham, Santa Rosa, Tallahassee, New York, Long Island, Bend, Dallas-Fort Worth, Washington, DC, Omaha, Davenport, IA, San Antonio, Stamford, and Boston. Wichita, Kansas also appeared on the 4Q13 list due to a large increase in net absorption that is unlikely to be repeated. Rent growth remains weak in this market. Several of these areas are experiencing fast-growth and others are high-income areas that attract luxury retailers.

Chart 20
BBVA Research CRE Activity Index, Retail, 4Q13



Source: BBVA Research

Bottom Line

The commercial real estate (CRE) market is poised for broad-based improvement this year, as higher overall GDP growth and job creation will drive vacancy rates lower and boost property income. Cap rates have room to decline further, and thus prices will appreciate. In spite of higher interest rates, cap rate spreads are shrinking as market risk perception falls and purchase demand rises. In contrast with prior years, price appreciation will not be limited to select primary markets because investment activity is increasingly targeting smaller secondary markets. These rising prices will support additional construction activity across all major property types: apartments, offices, warehouses, retail shopping centers and hotels.

Although we expect overall price appreciation, it will not be symmetric across apartment, office, retail and industrial properties, nor will it be as rapid as during 2013. Among these four major property types, prices of apartment buildings have soared to record heights and are now 4.0% above their pre-recession peak. Prices of offices, warehouses and retail shopping centers, however, are still approximately 6%, 15% and 9% below their prior peaks, respectively. Warehouses and offices are on track for the fastest near-term price appreciation, while the retail sector will lag. Apartment building valuations face the highest risk of stalling or declining slightly later this year as new supply comes online.

Our quarterly BBVA Research CRE Activity Index indicates that top performing metropolitan areas across several property types are in California, Colorado, Florida, Oregon, Washington and Texas. Additionally, metropolitan areas in Massachusetts, Pennsylvania, North Carolina, South Carolina, New Jersey and Oklahoma appeared at the top of the list among at least one major property type.

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