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COMMERCIAL REAL ESTATE
DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

Real Estate Forecast Breakfast 2019

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January 17, 2019

So, how did I do last year?

Assets fully priced, but not over-priced based on relative risk spreads

- Cap rates remained narrowly unchanged – Got it right!

Equity capital markets are in check, and stepped back in 2017T

- Transaction volumes were up 5.8% YOY 2018Q3 – Got it right!

Debt capital markets are at a sustainable level

- Debt started to grow at unsustainable rates – Got it directionally right.

Space markets are not overbuilt, with the exception of fairly narrow pockets of apartments

- Apartments are being overbuilt – Got it directionally right.

GDP growth looks sustainable through 2018, probably 2019 growing 2.25-2.75%

- GDP grew at 2.90% YOY, underestimated – Got it directionally right.

Wage inflation will push interest rates higher

- 10-year UST up 14 bps from 2.57% to 2.71% -- Got it directionally right.

History shows us that the worst transactions are done at the best of times . . . now is the perfect time to be cautious.

**The
Economist**

OCTOBER 13TH-19TH 2018

Dirty capital: the City of London

The fate of Jamal Khashoggi

Medicare for all

Vegans on the rampage

The next recession

How bad will it be?



WISCONSIN
SCHOOL OF BUSINESS

UNIVERSITY OF WISCONSIN-MADISON

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JAMES A. GRAASKAMP
CENTER *for*
REAL ESTATE

Source: Economist,
October 13-19, 2018

The next recession will not be wicked, it will likely be politically initiated

. . . . maybe China restarts its debt-fueled growth (from 175% of GDP in 2009 to 300% today)

. . . . what could possibly go wrong with Brexit and Italy's weak economy and the EU???

. . . . the U.S. consumer get spooked, SALT limits, import prices/tariffs, market volatility, etc

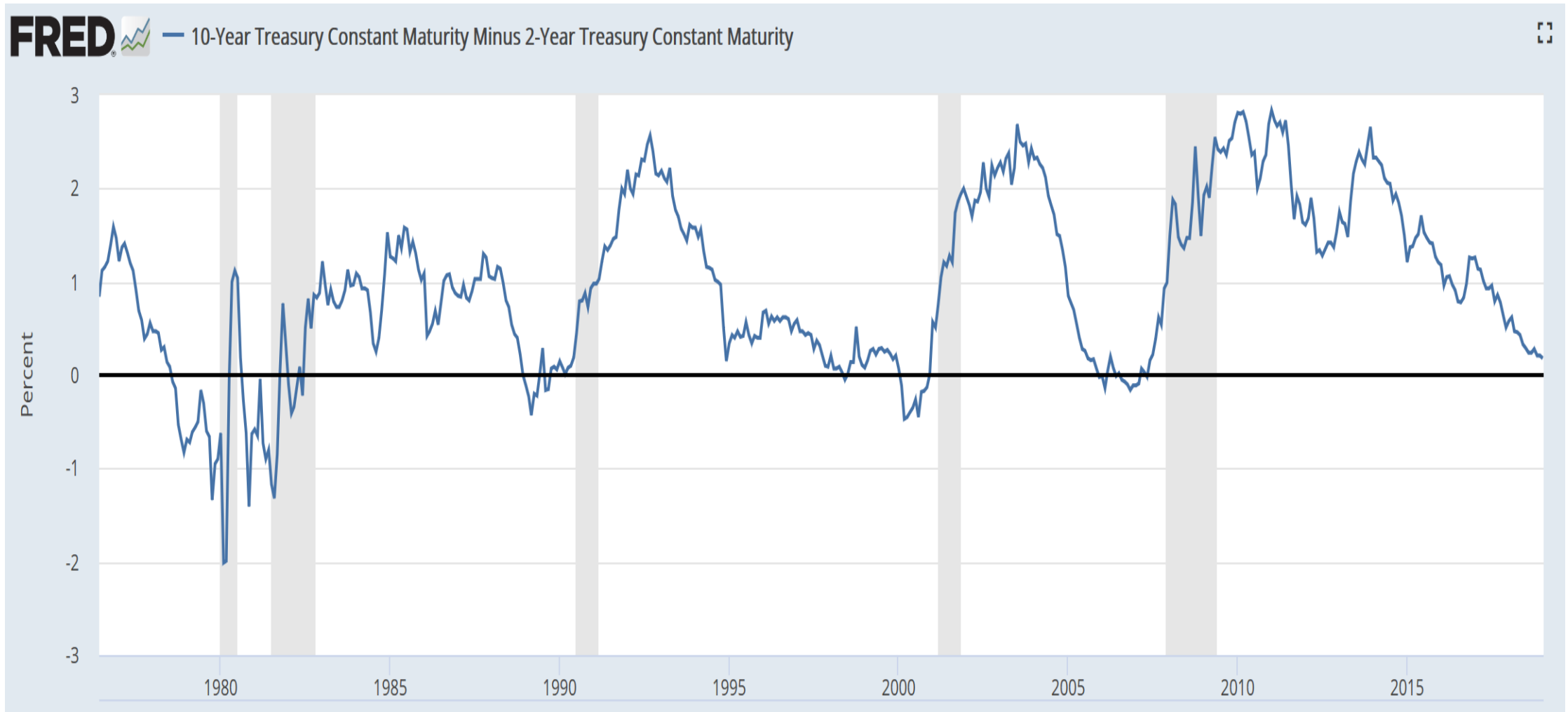
. . . . financial markets tighten (wage inflation, quantitative tightening, Fed rate increases) . . .

Tools to address a downturn are limited:

Federal Reserve – Fed typically cuts rates five points in a recession – has only 2.5 points today
-- Fed has a \$4.06 trillion on balance sheet from Quantitative Easing

Fiscal Stimulus -- Federal deficit was 3.9% of GDP in 2018 and is expected to be 4.6% in 2019

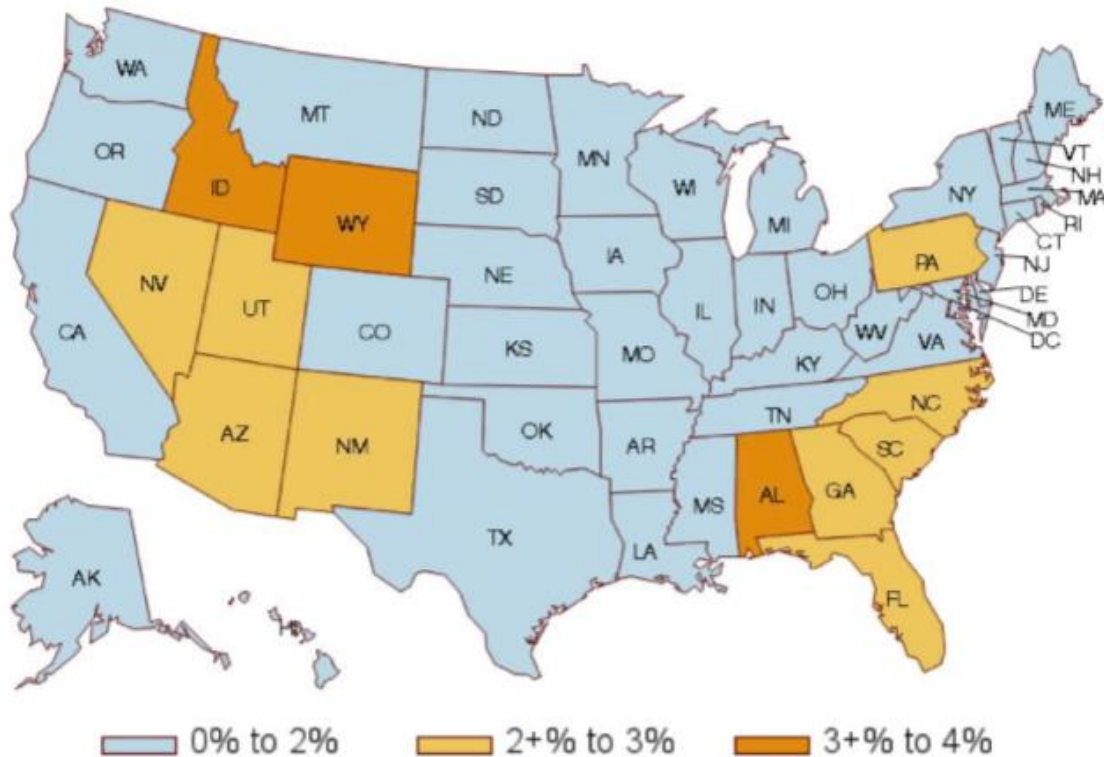
The inverted yield curve (10 yr. v. 2 yr.), a solid a recession predictor



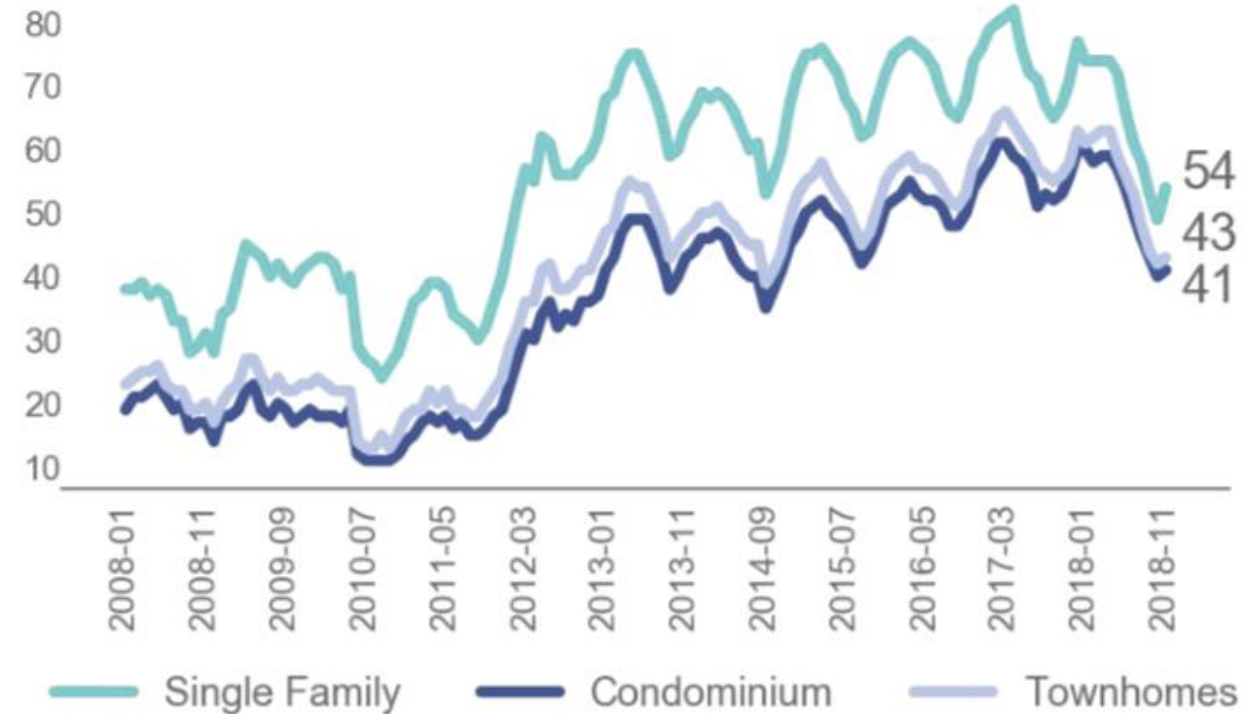
. . . . consumer expectations are dimming, this despite an average 6.1% price appreciation over previous six years

MEDIAN EXPECTED PRICE CHANGE WITHIN THE NEXT 12 MONTHS

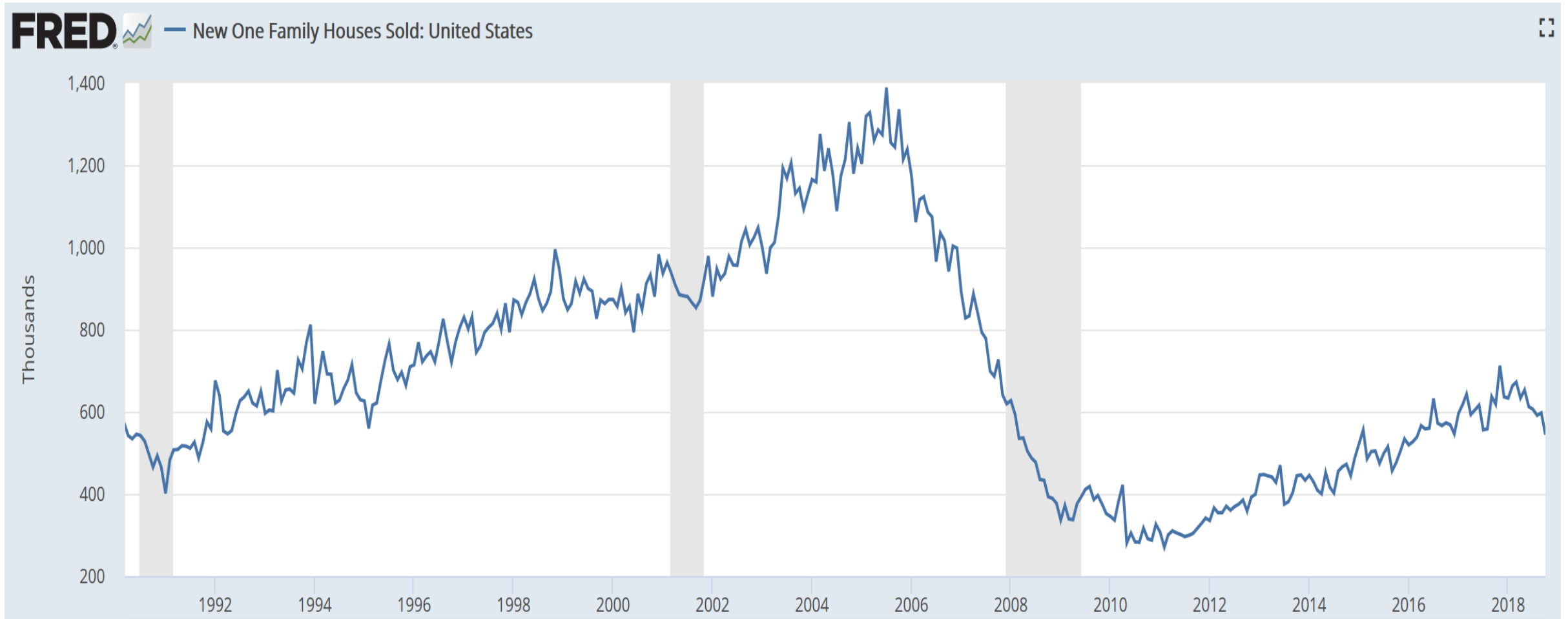
By State, in the Past Three Months



REALTORS® CONFIDENCE INDEX—SIX-MONTH OUTLOOK



. . . . consumer concerns impacting new single-family home sales . . .



. . . . middle/upper income households may be in for tax liability

Tax Differential 2017 to 2018 for Selected Income Levels, with
\$55,000 of Deductions Including \$40,000 of SALT Deductions

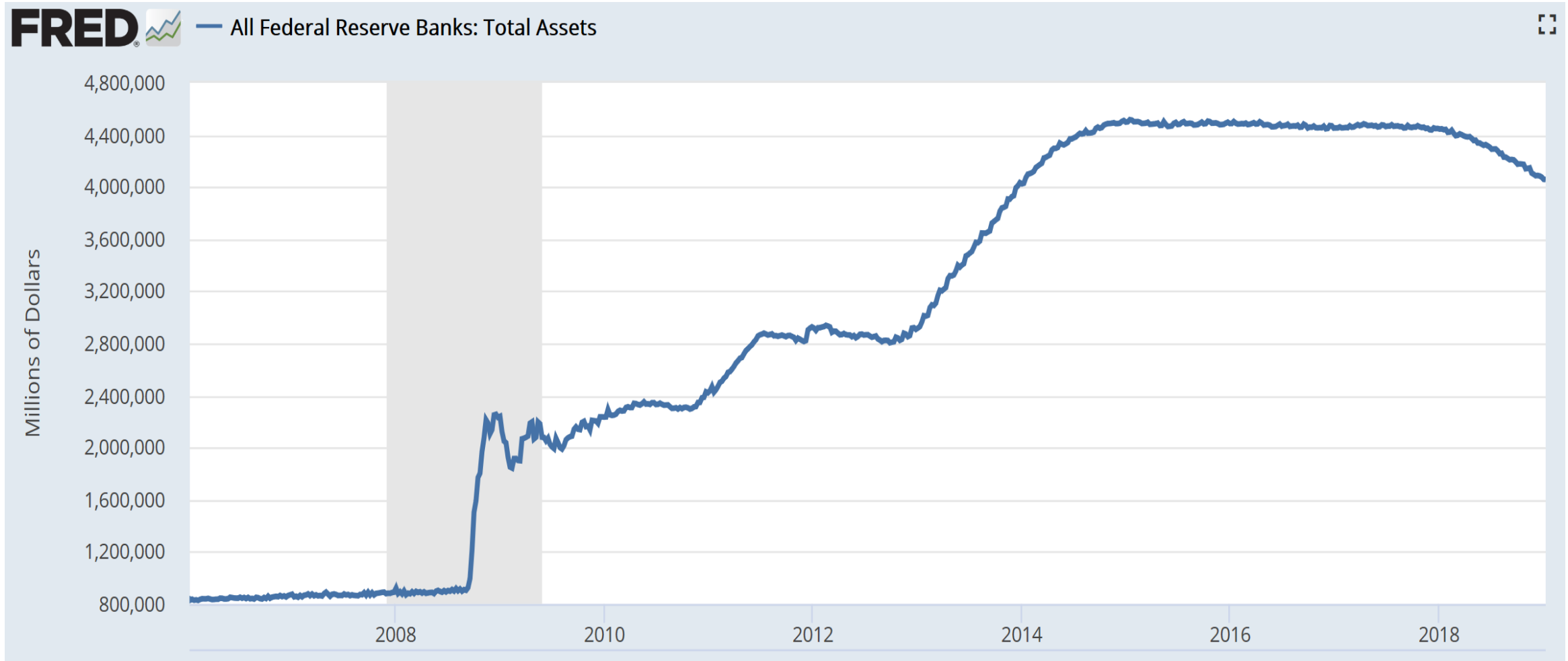
Income Level	Additional Taxes in 2018
200,000	\$3,495
300,000	\$1,663
400,000	\$63
500,000	\$752
600,000	-\$3,571
700,000	-\$8,179

... business optimism is also dimming, with the PMI new factory orders approaching recession levels ...

Purchasing-managers index

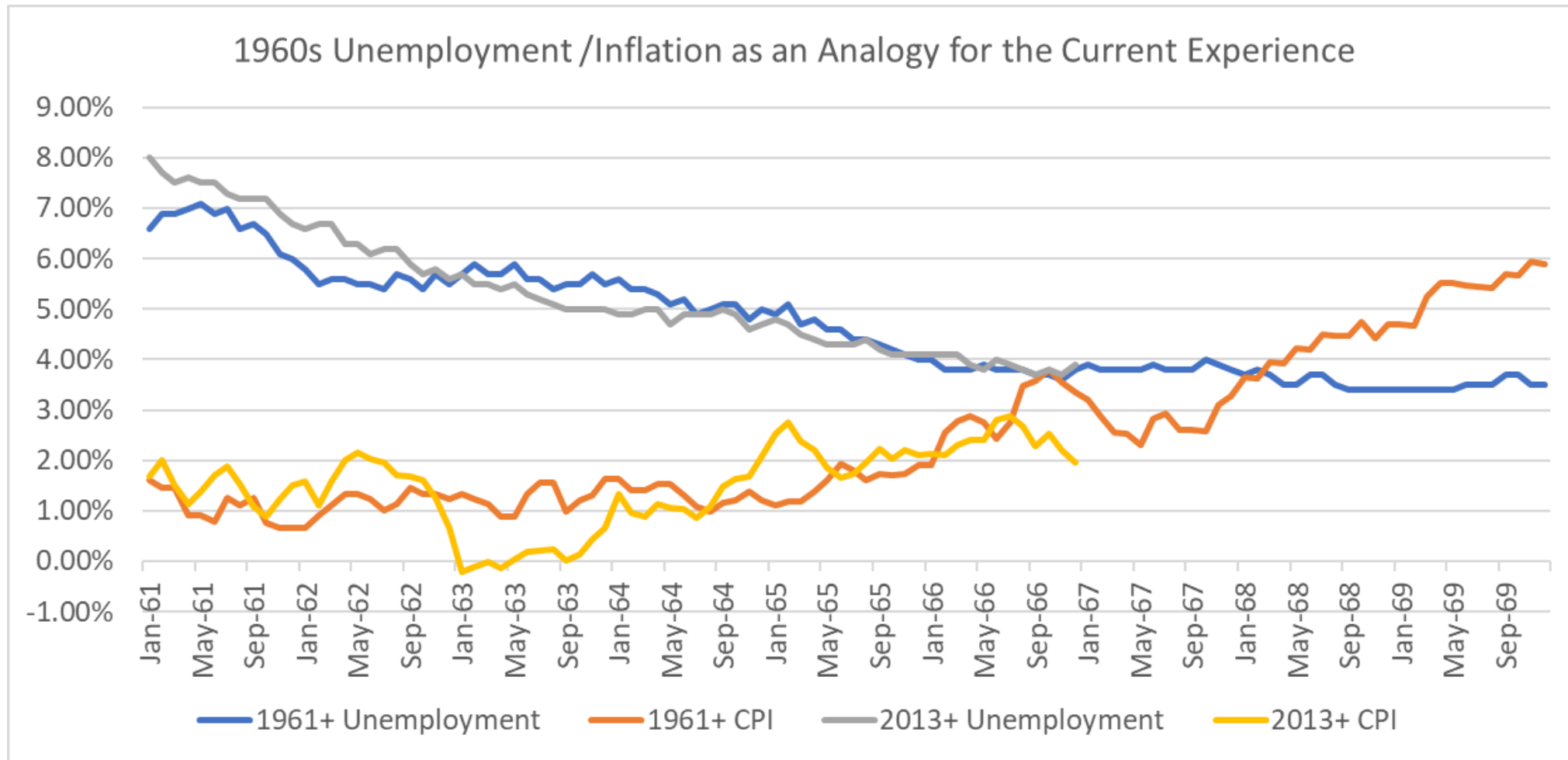


. . . . Quantitative Tightening of up to \$50 billion per month, tightening money supply



. . . . trade tariffs,
we have yet to feel the inflationary impacts

... the 1960s experience presents a challenging path for the Fed ...

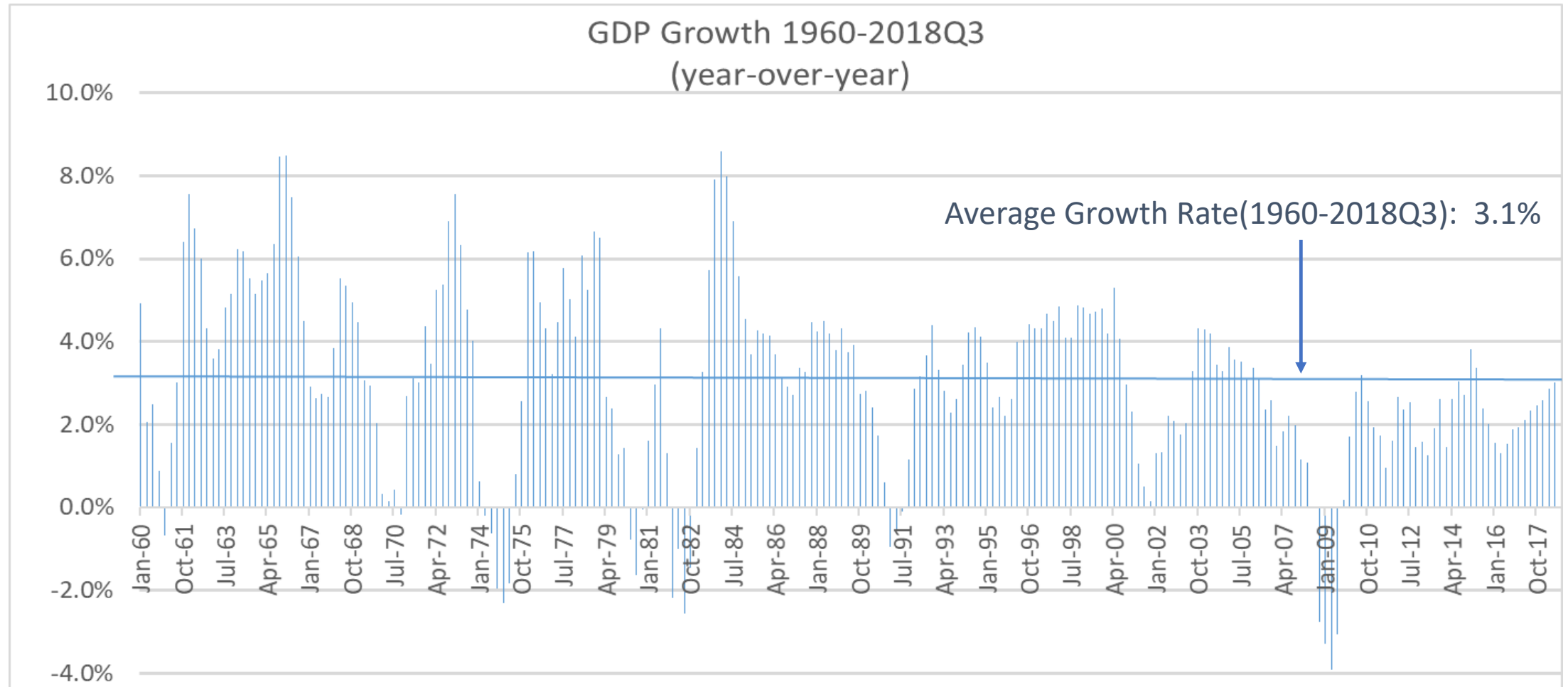


The Rest of the Presentation

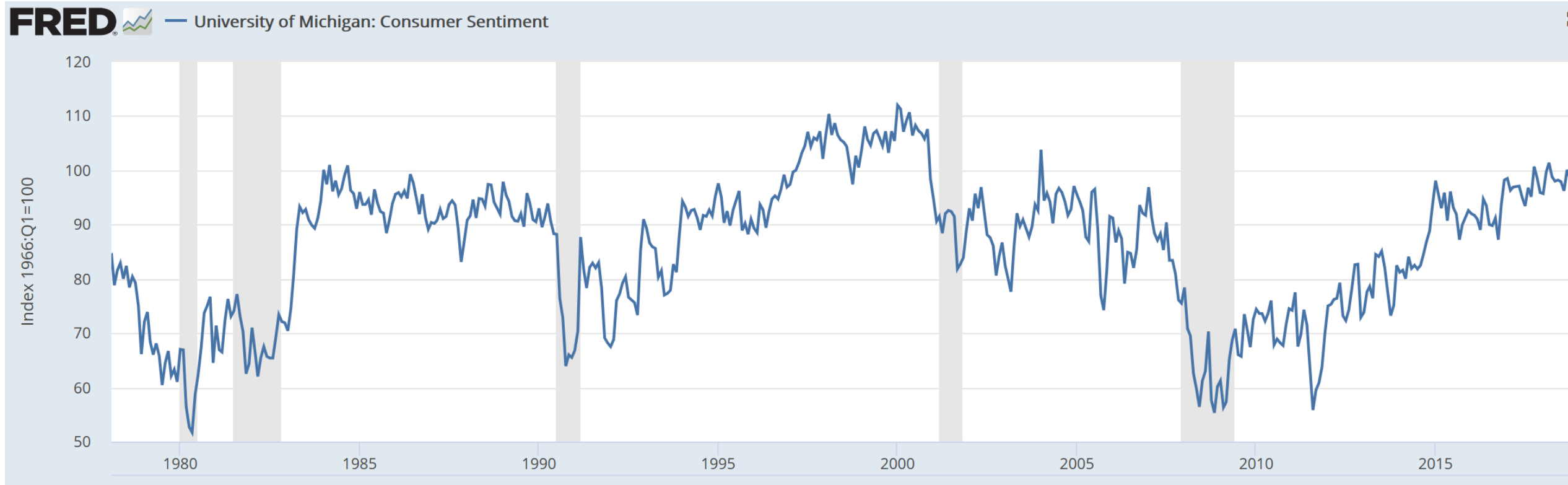
- I. The Economy
 - Economic Growth
 - Employment
- II. Capital Markets
 - Equity
 - Debt
- III. Multifamily

Economic Growth

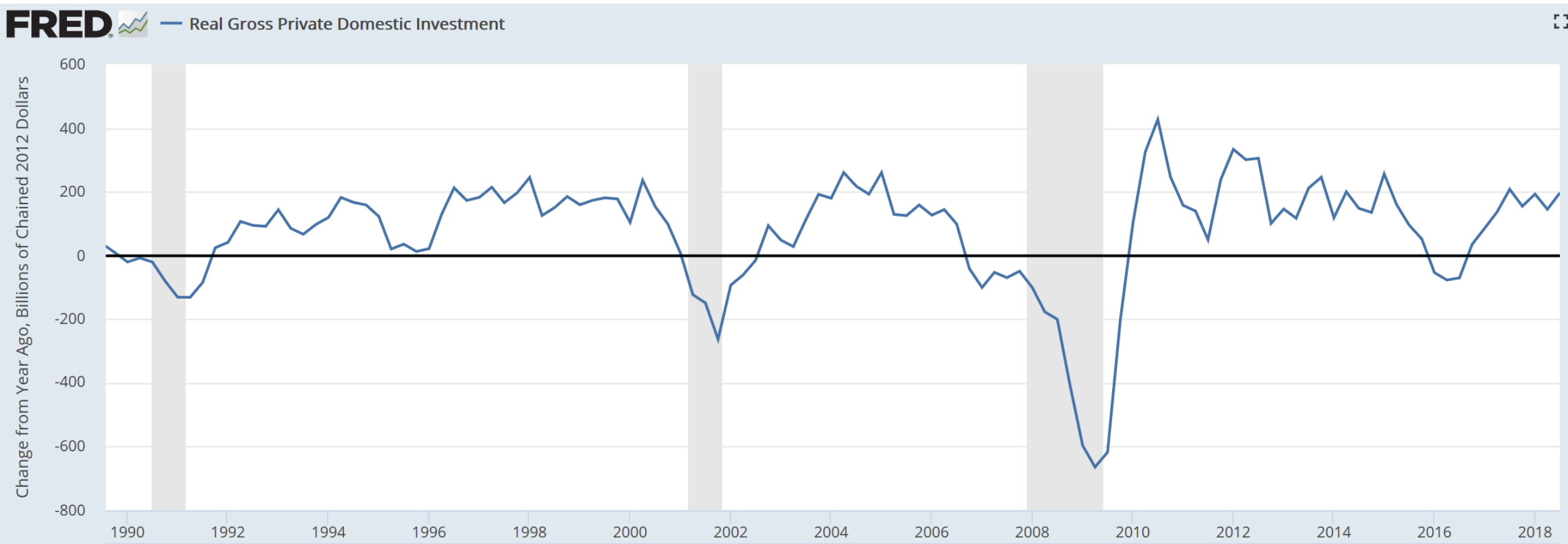
The additional 0.7% growth to a 2.9% GDP growth rate largely comes from increased defense spending (0.21%) and 0.34% in State and Local Government spending



. . . . consumer sentiment remains strong, but changes quickly . . .

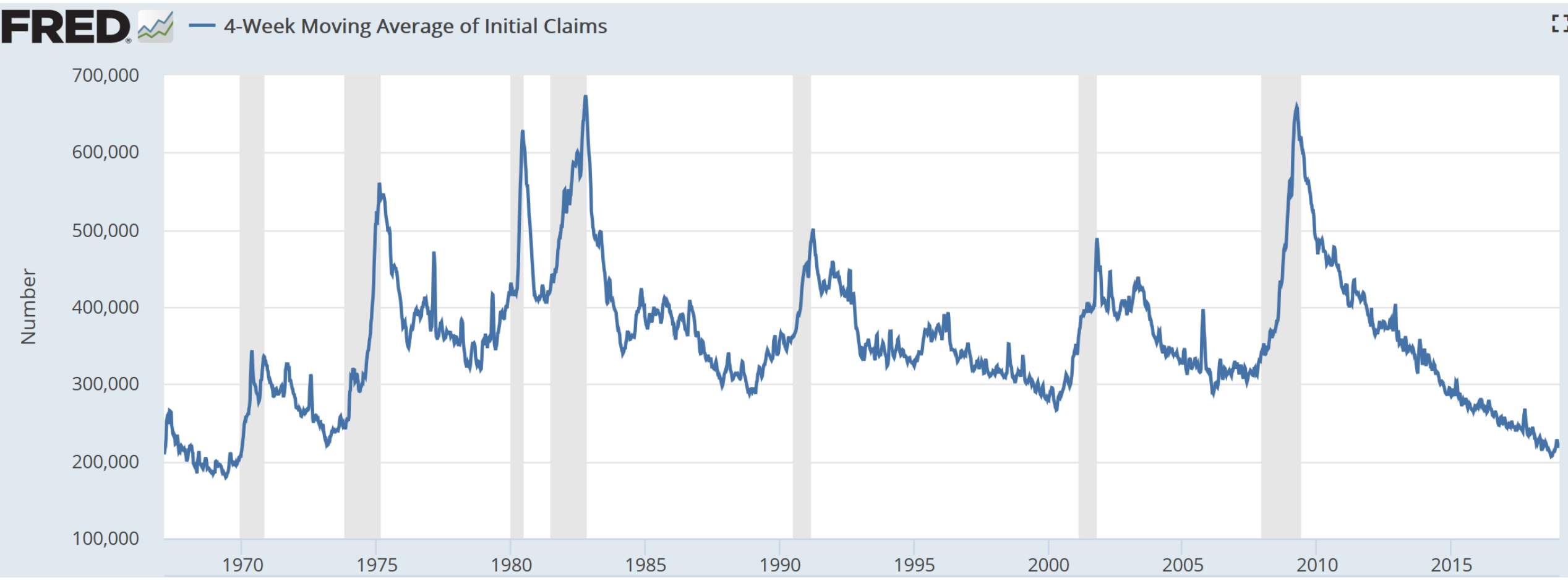


. . . . and business investment is contributing about 1% to GDP growth

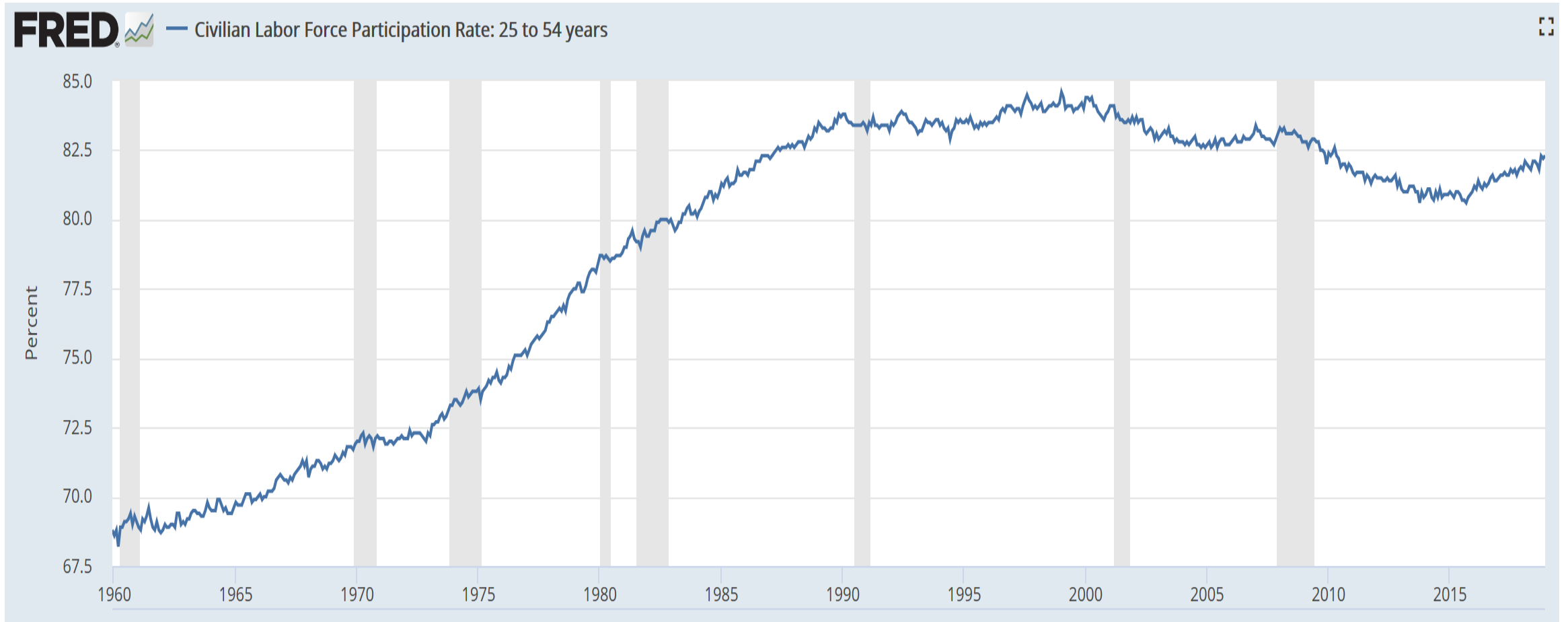


Wages and Employment

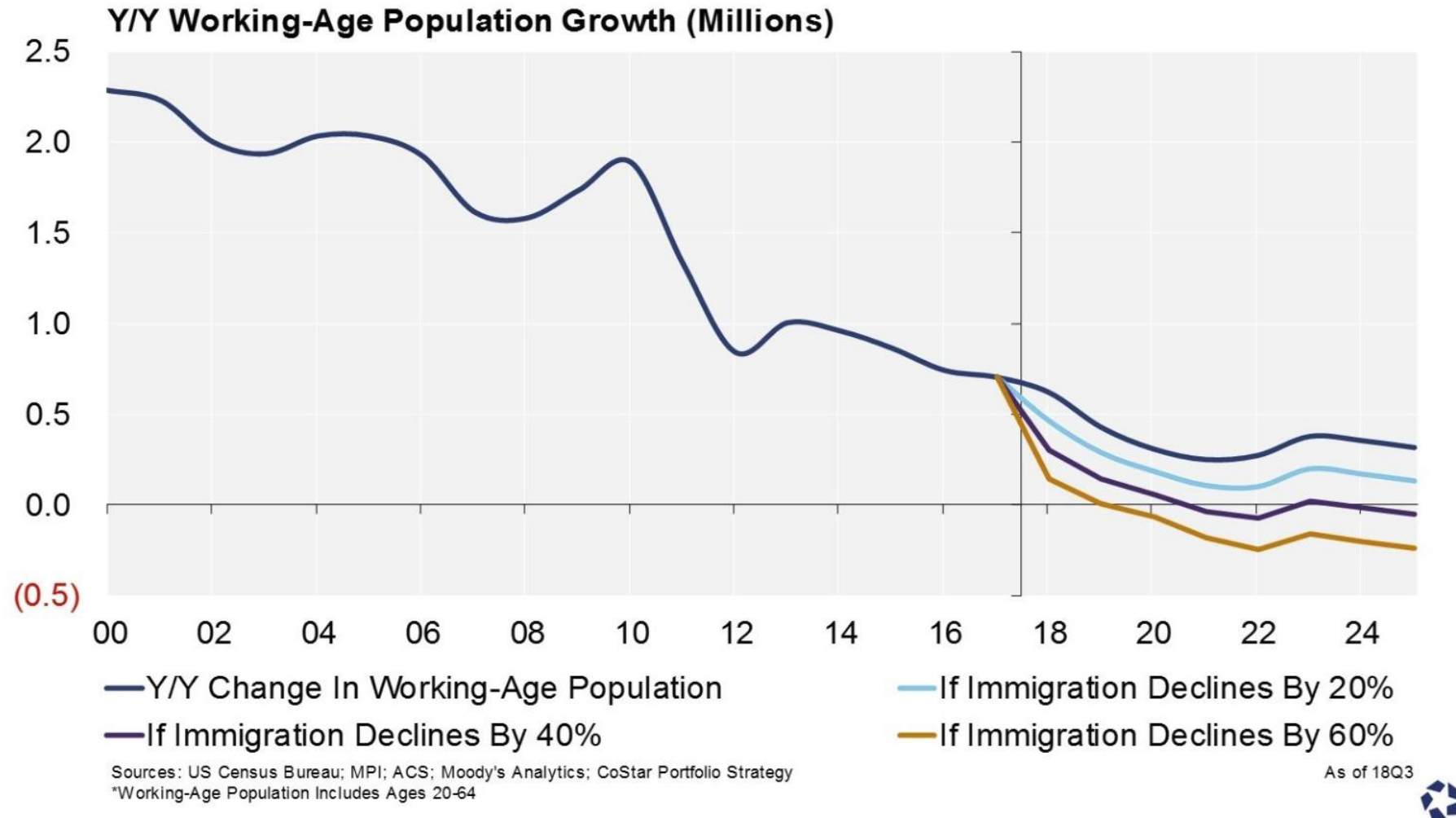
The labor force has doubled since 1970, jobless claims remain near all-time lows. . . .



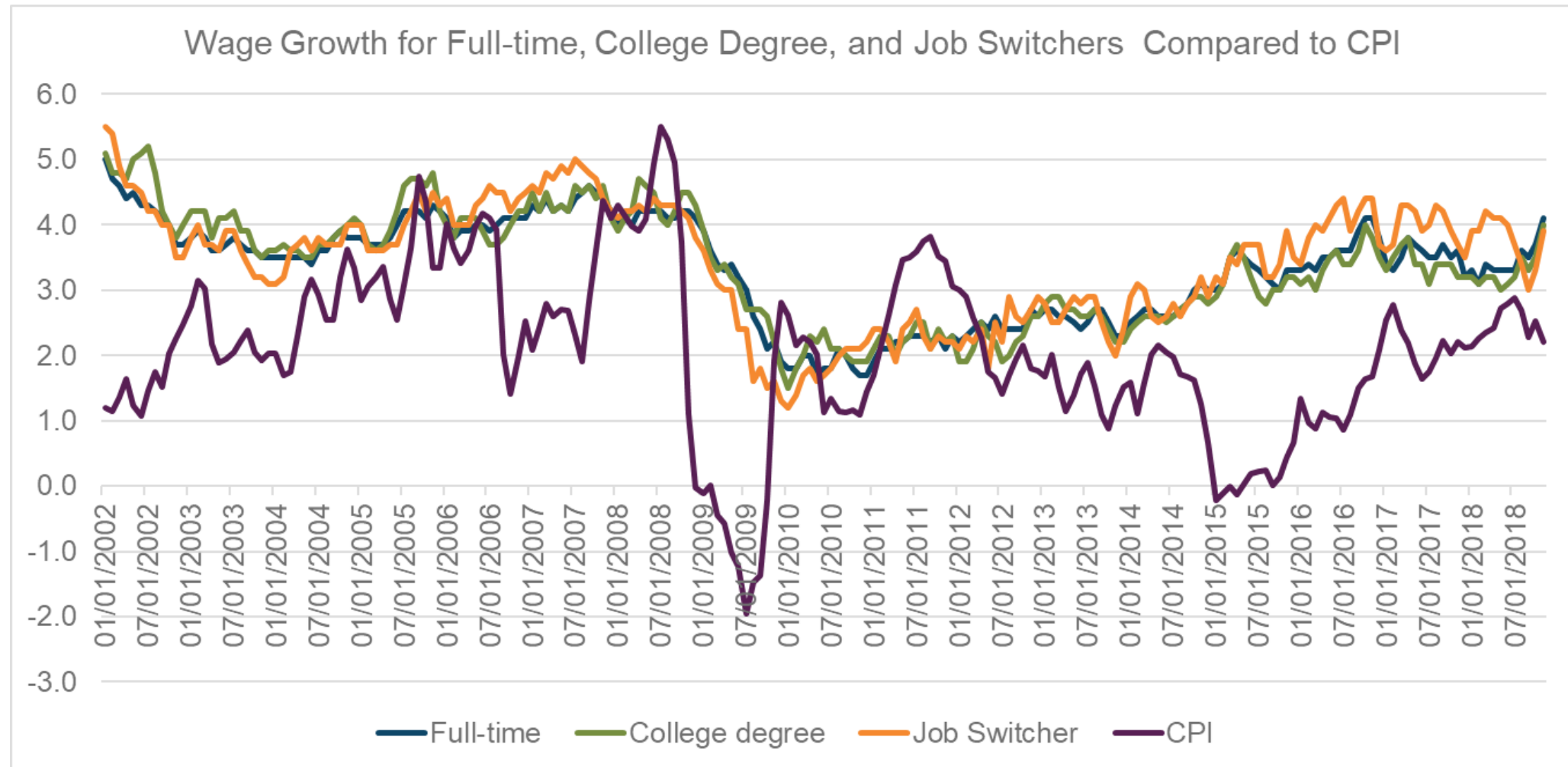
... labor force participation rates are edging up to mid-2000 levels ...



... when participation rates stabilize, the U.S. will need more workers ...



. . . . the Fed is navigating difficult economic waters.

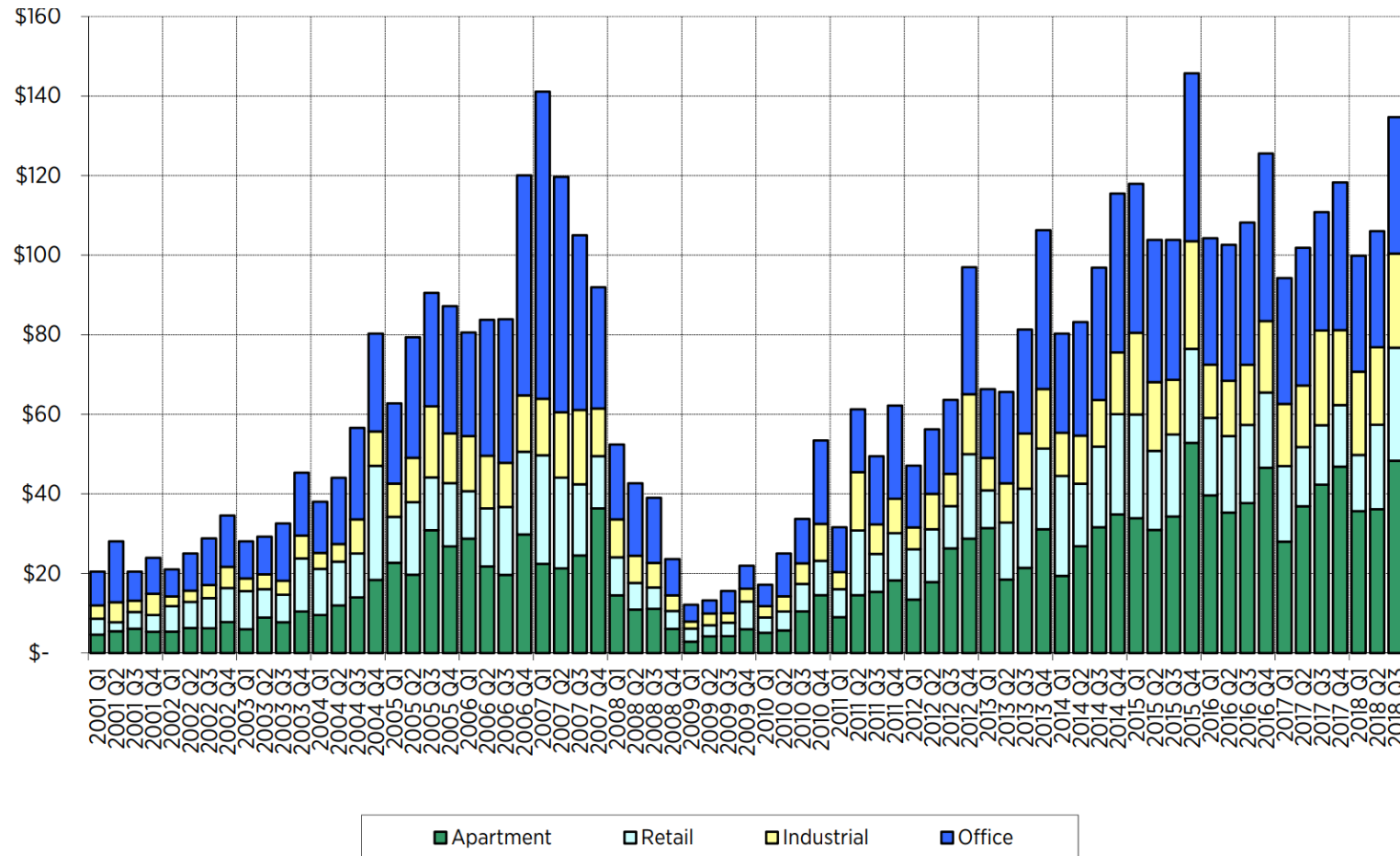


Equity Capital Markets

Commercial real estate transaction volume remains stable/robust

QUARTERLY SALES OF LARGER (\$2.5 MILLION+) COMMERCIAL/MULTIFAMILY PROPERTIES

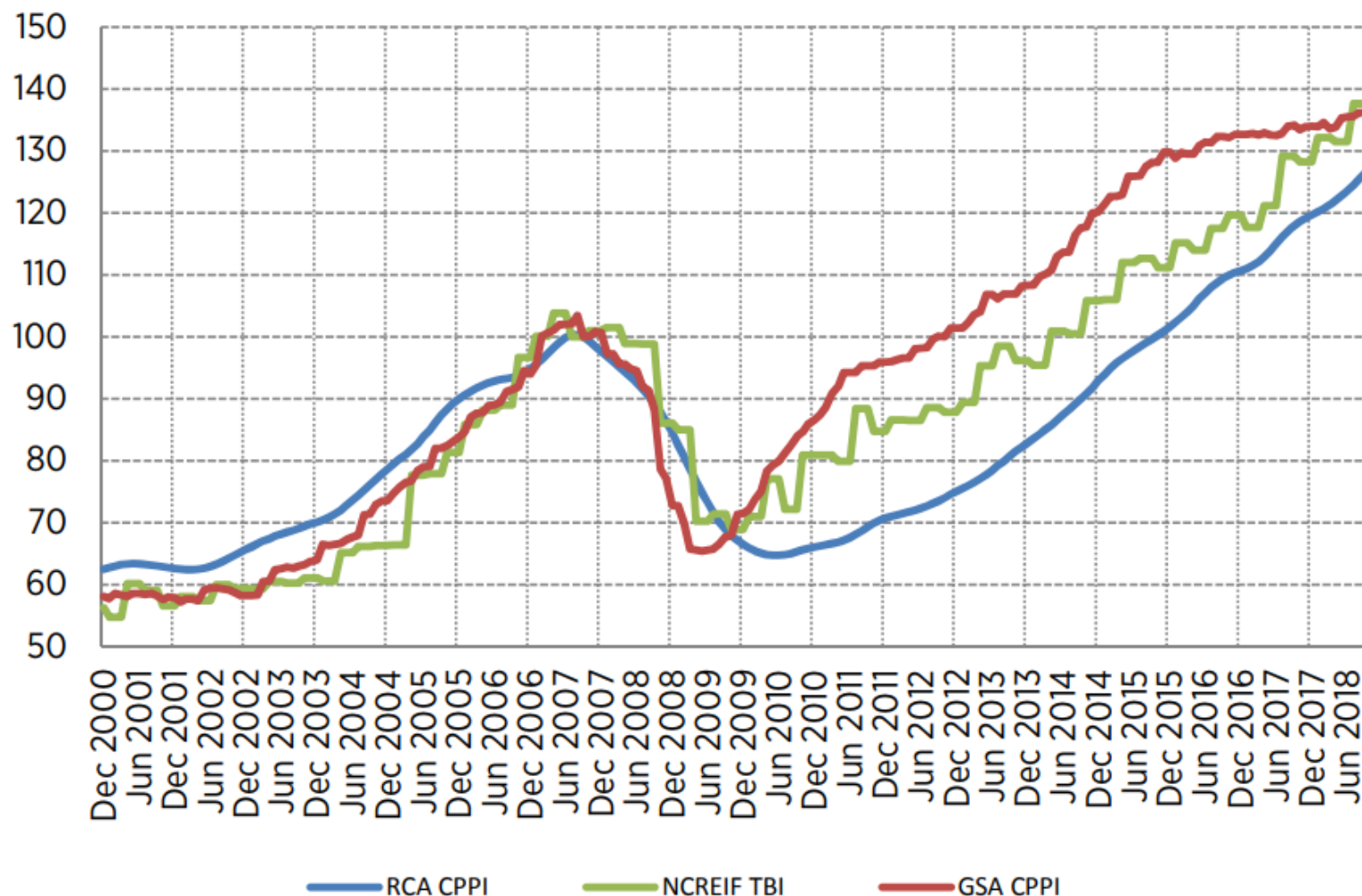
Billions of dollars, Properties and portfolios \$2.5 million and greater



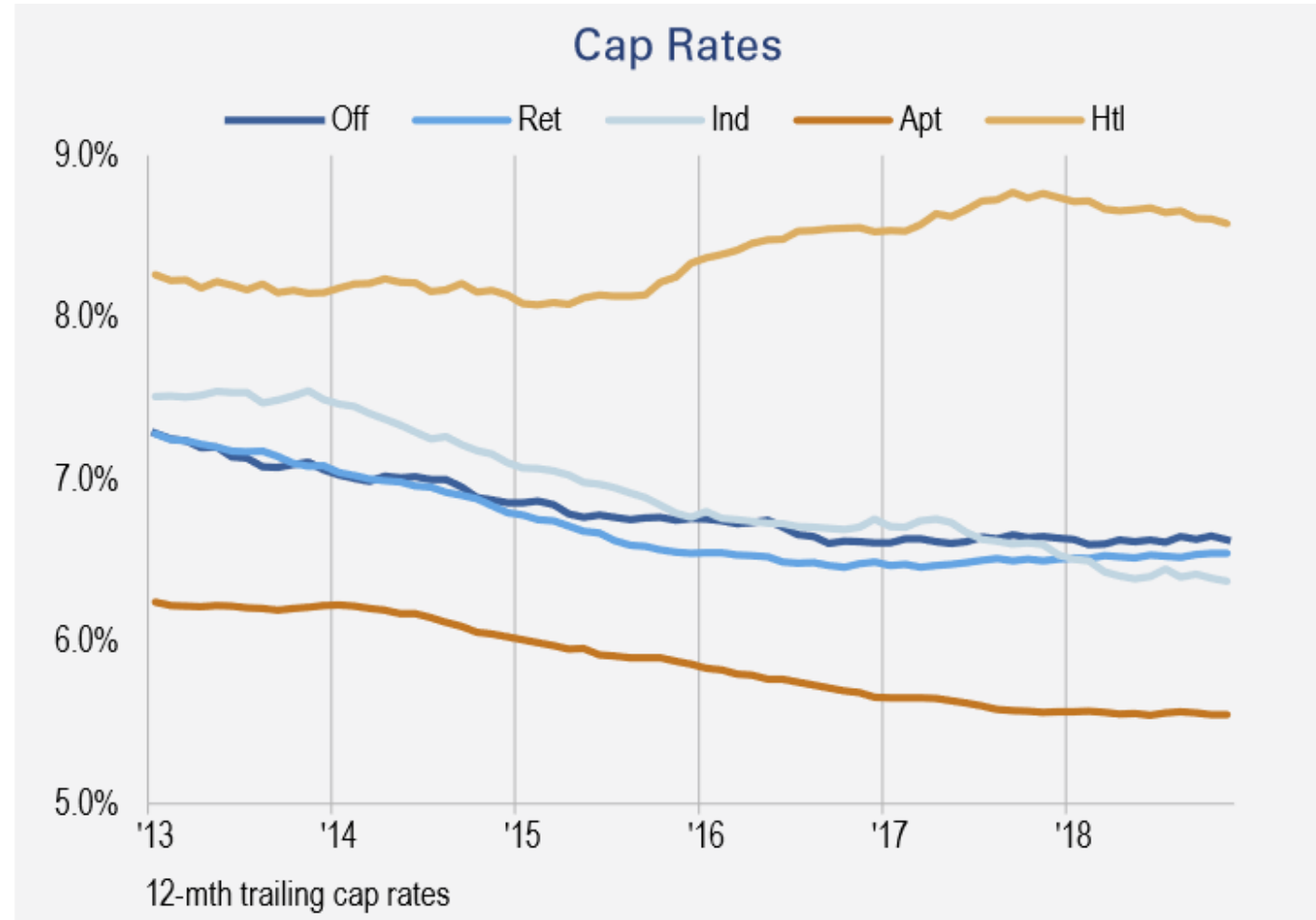
September 2007 = 100

... with property values
stabilizing/growing
depending on
which index you
follow, mid-4%
CAGRs 2000-2018 .

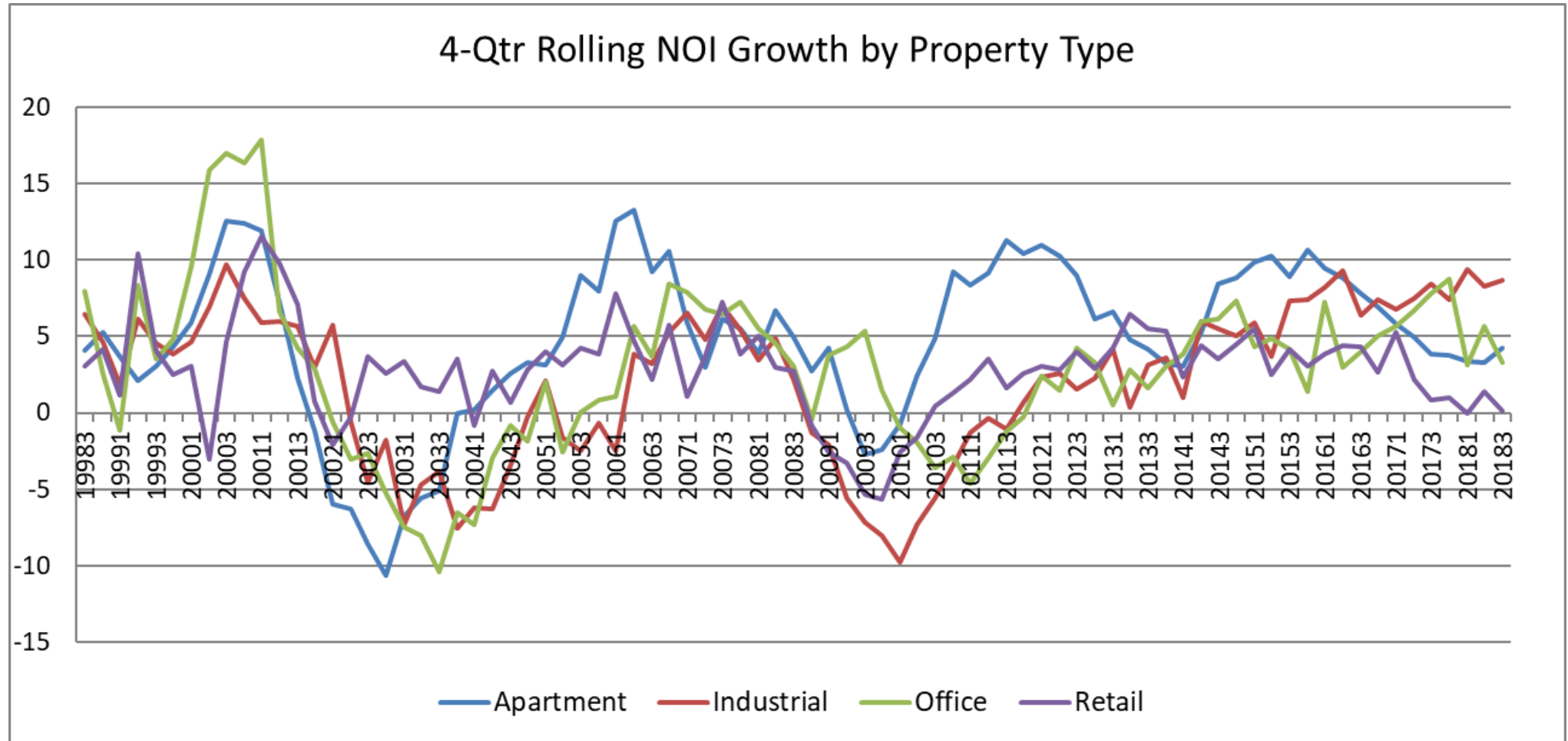
...



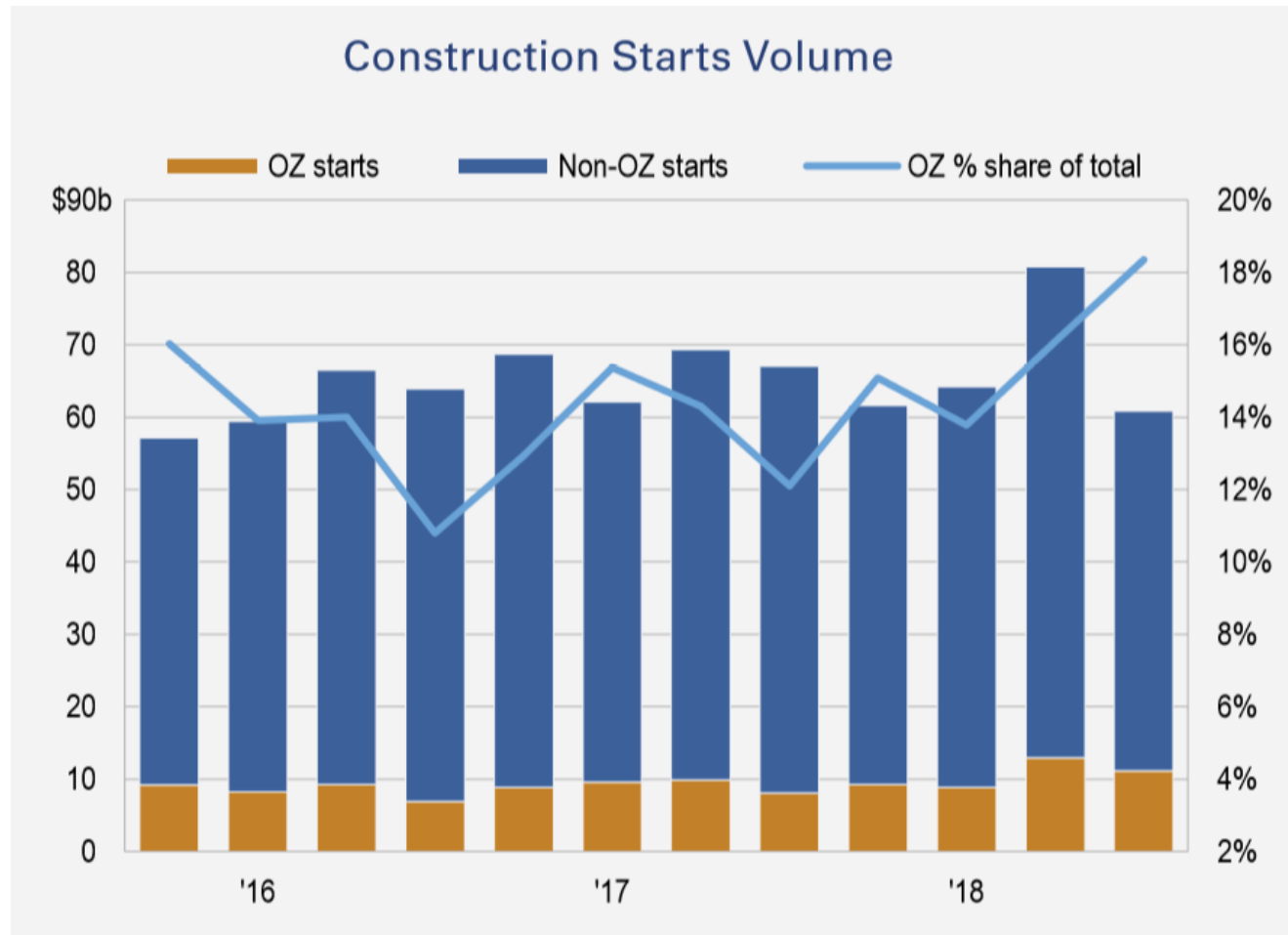
. . . . RCA cap rates are stable across the four main property types



. . . . NCREIF property income growth remains robust, sans retail



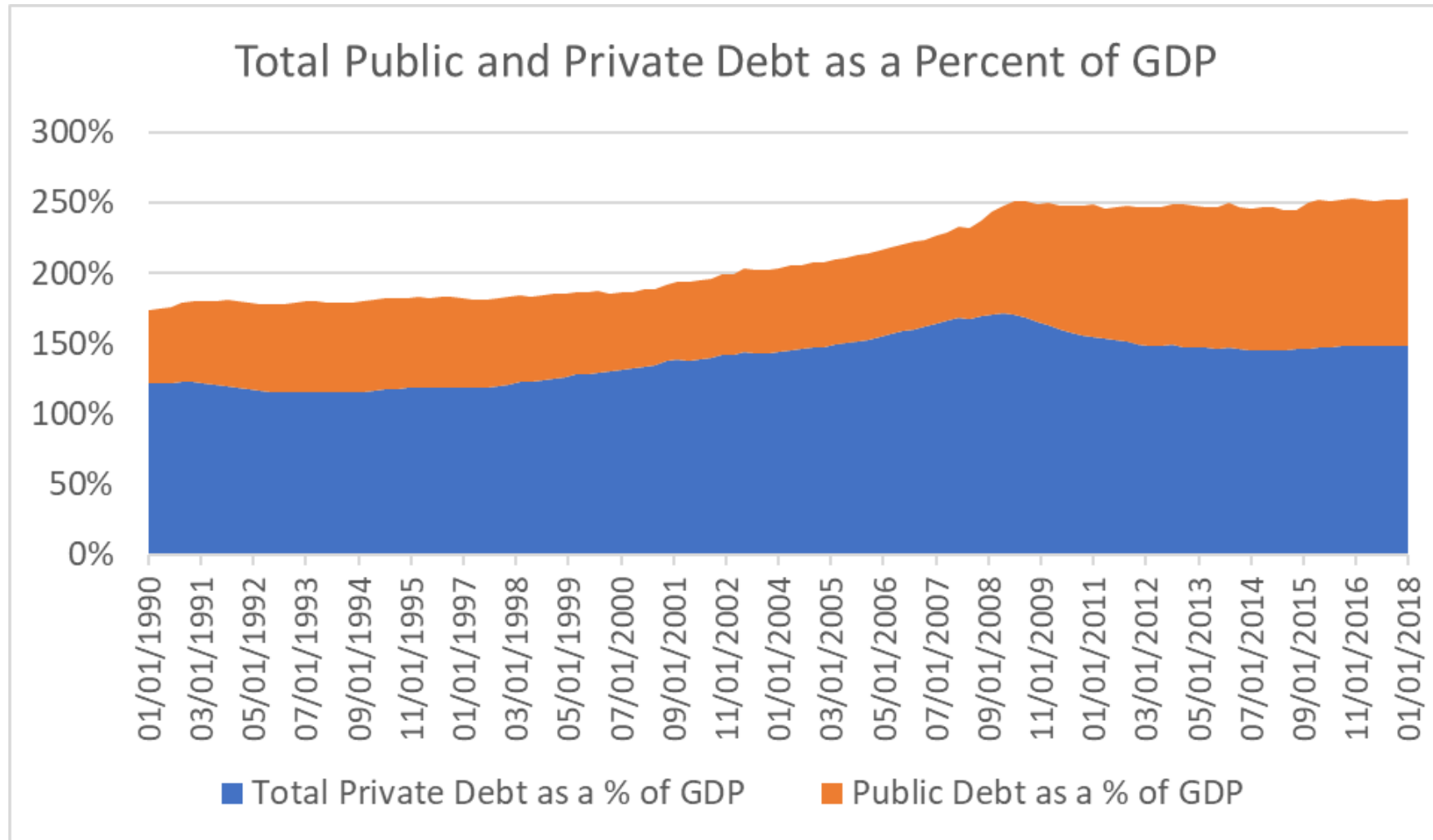
. . . . and construction volumes are stable



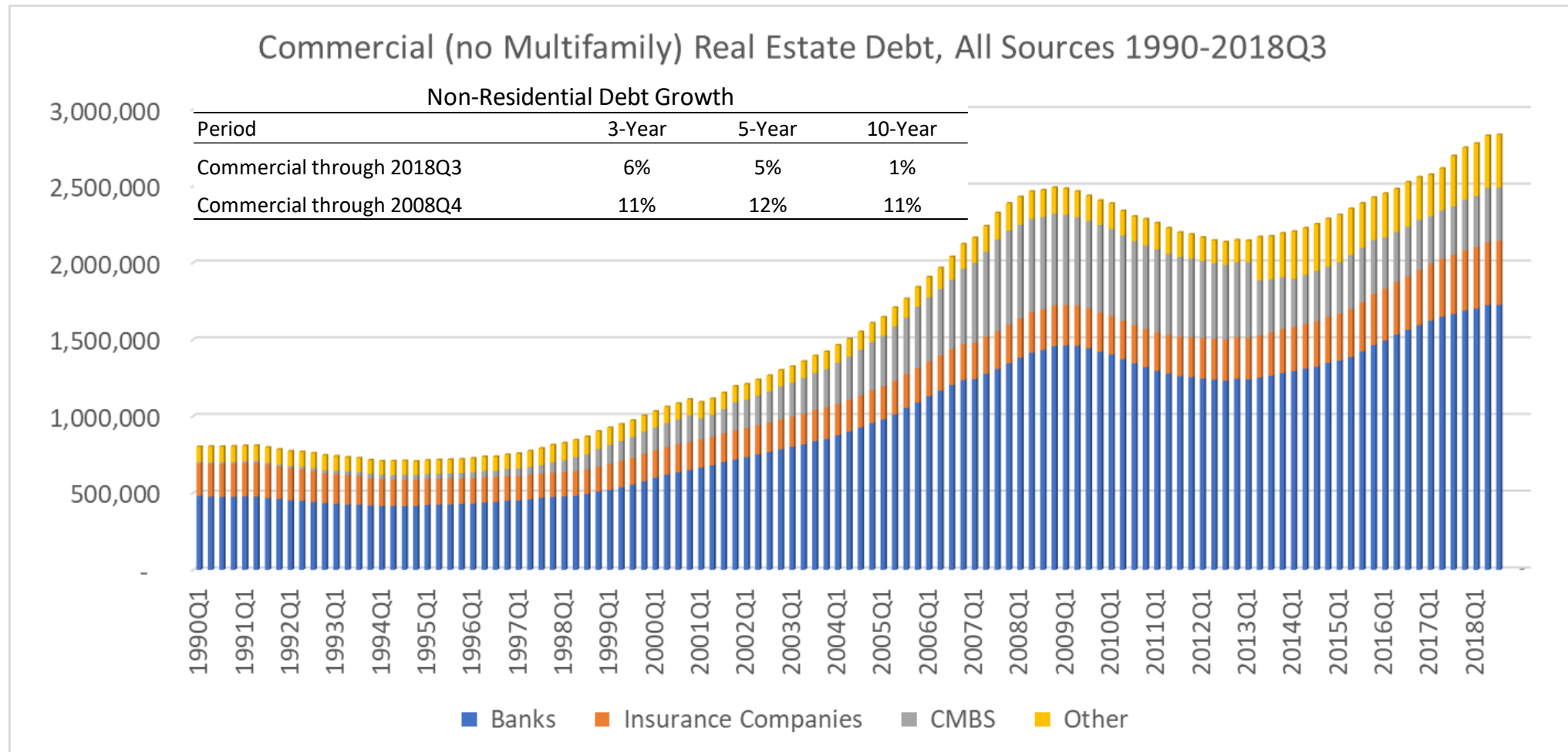
With significant levels of equity on the sidelines

Debt Capital Markets

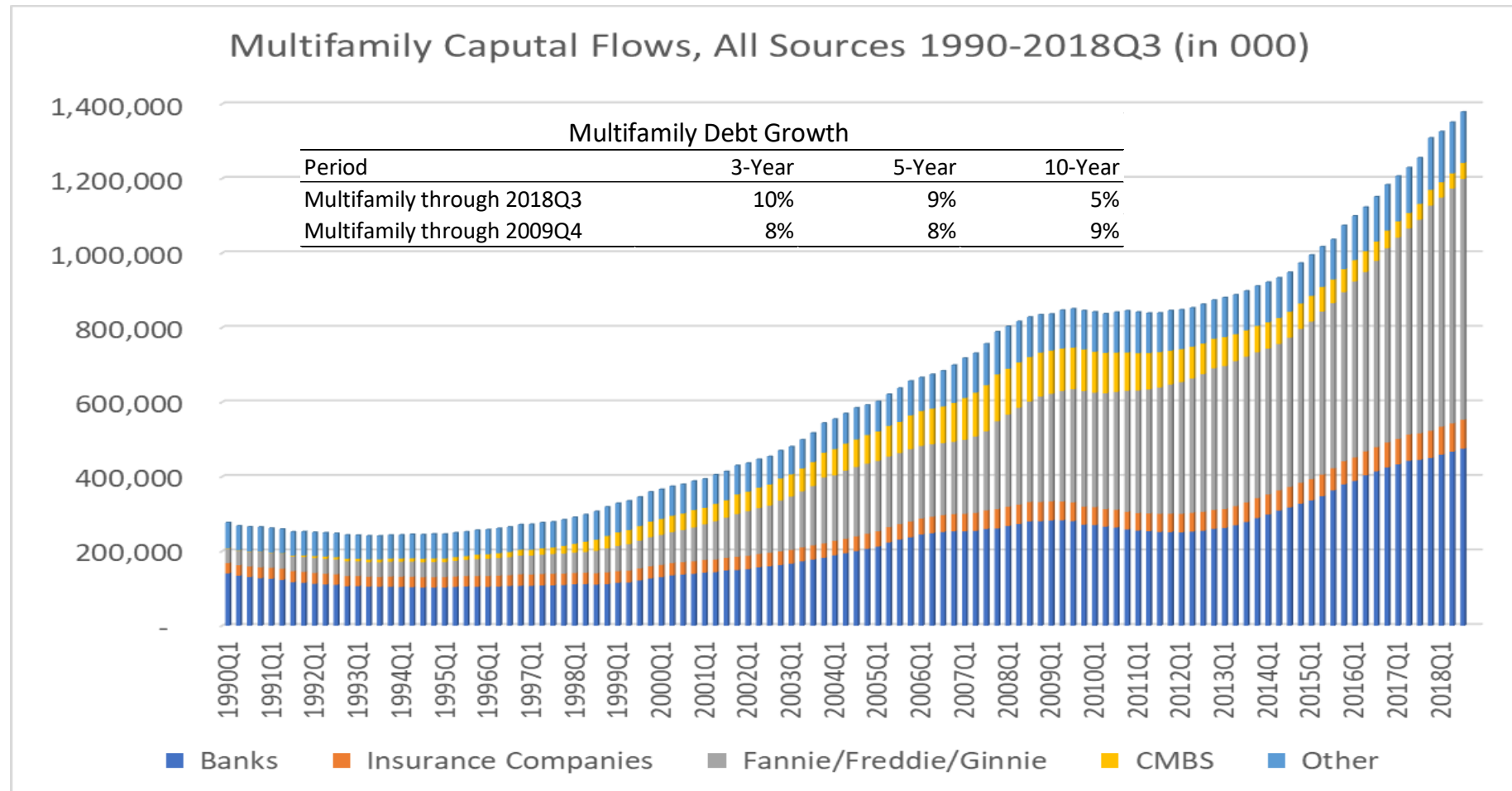
Private debt as a percent of GDP has fallen from 171% in 2009 to 148% today



... commercial real estate debt outstanding has grown over the last several years ...



. . . multifamily debt is growing at an unsustainable pace (maybe)

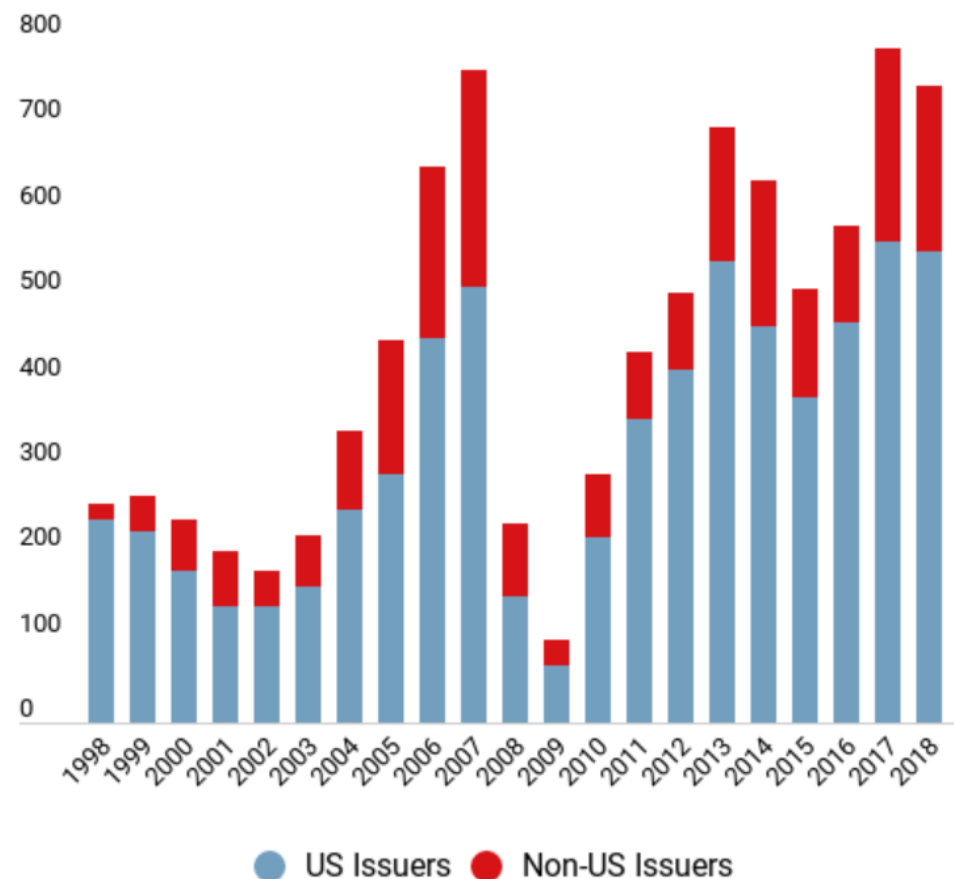


. . . .late-cycle
lending
behavior,
leveraged loans
(for all deal
types) volume is
reaching 2007
levels. . . .

Levering up

Global issuance of leveraged loans has been growing since the global financial crisis.

(in billions of dollars)

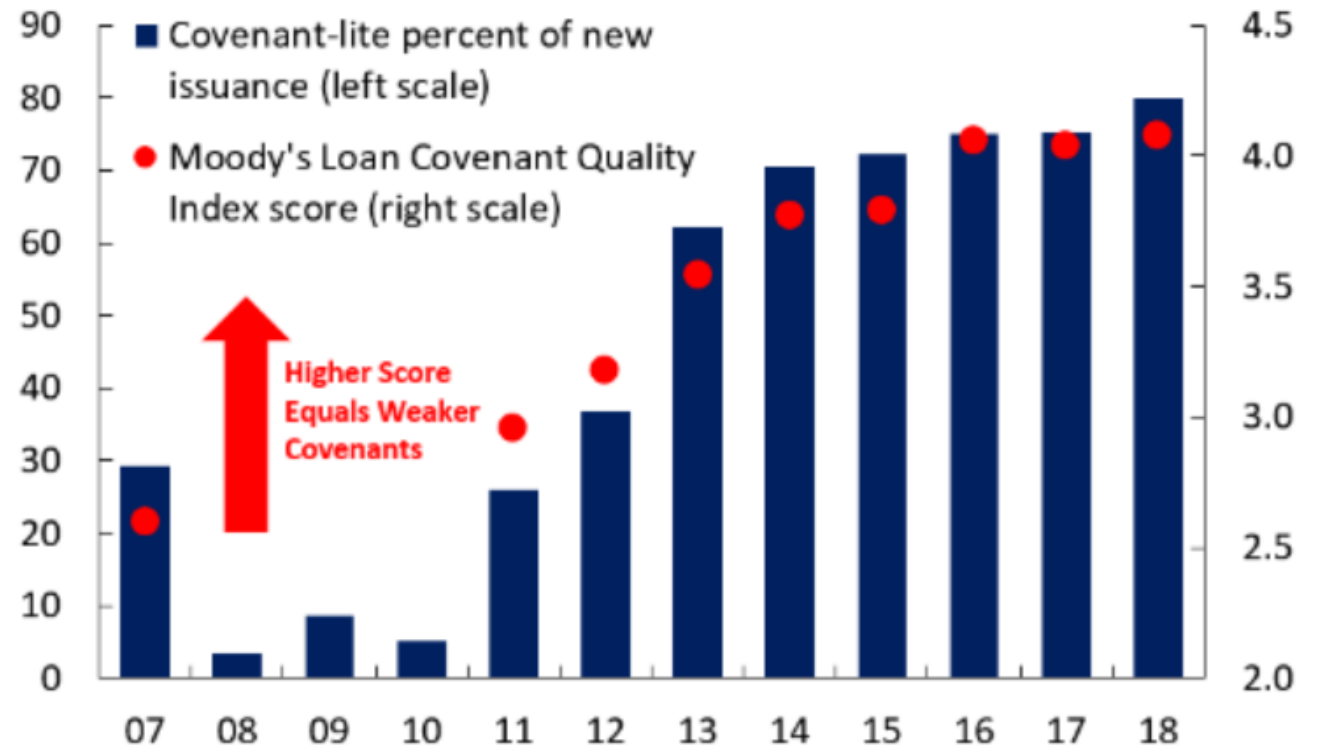


. . . . late cycle
lending
behavior is
showing up in
leveraged loan
underwriting . . .

Less investor protection

The volume of loans with fewer investor protections, known as covenants, has grown in the United States, and quality has weakened.

(percent of issuance)



. . . . what are leveraged loans

What are leveraged loans? Lending by syndicates to non-investment-grade companies.

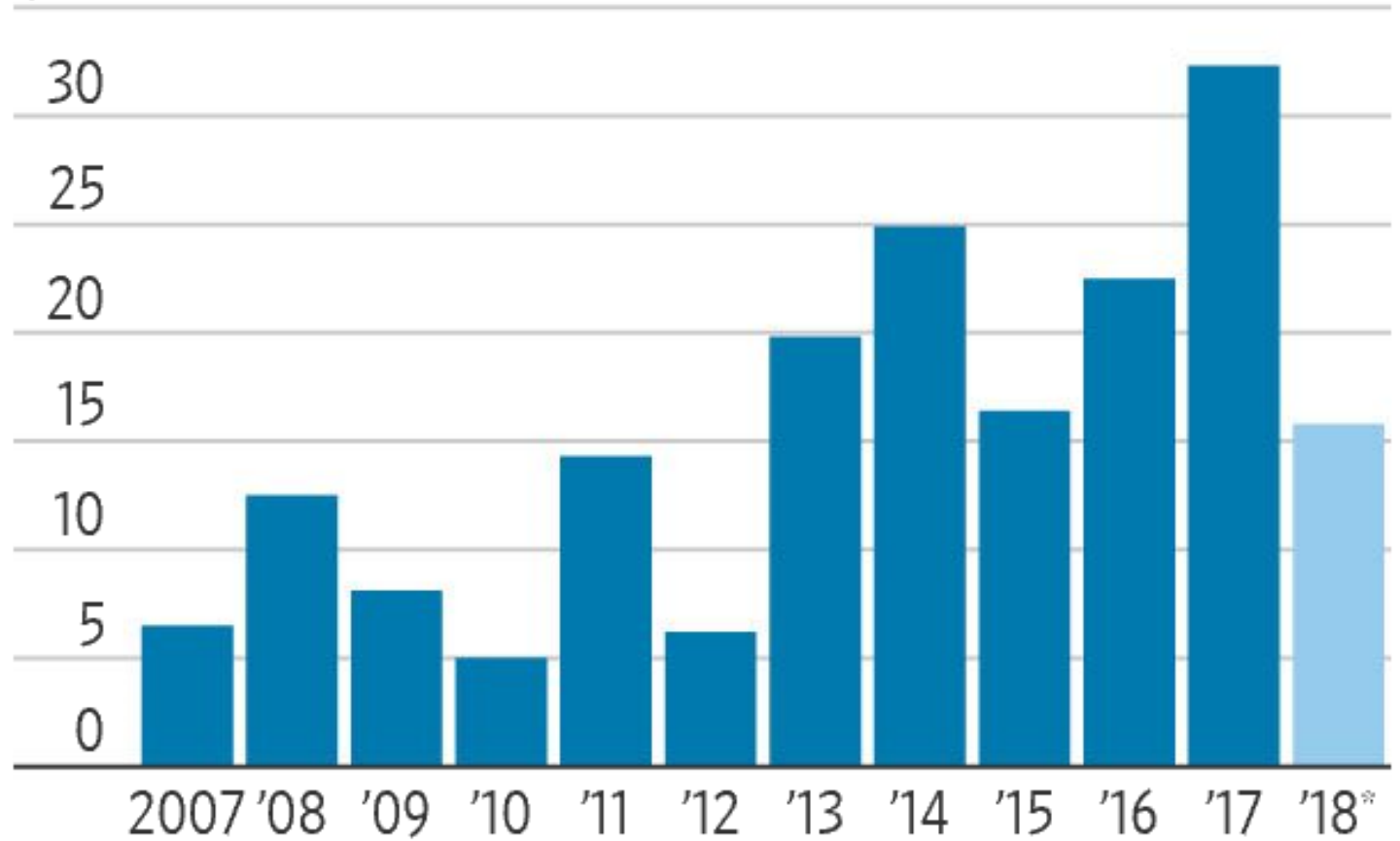
What is the size of the leveraged loan market? \$1.36 trillion in outstanding loans at year-end 2017, slightly bigger than the high-yield bond market.

What is the collateral underwriting? More than 80 percent of new loans are "covenant lite" loans, with no financial maintenance restrictions, that give borrowers flexibility to issue more debt, pay out shareholder dividends and even put collateral out of lenders' reach.

... late cycle real estate behavior, leveraged loan debt is a growing part of real estate debt, with investors in these funds including CALPERS, Blackstone, Oaktree Capital, Goldman Sachs, KKR, and TPG

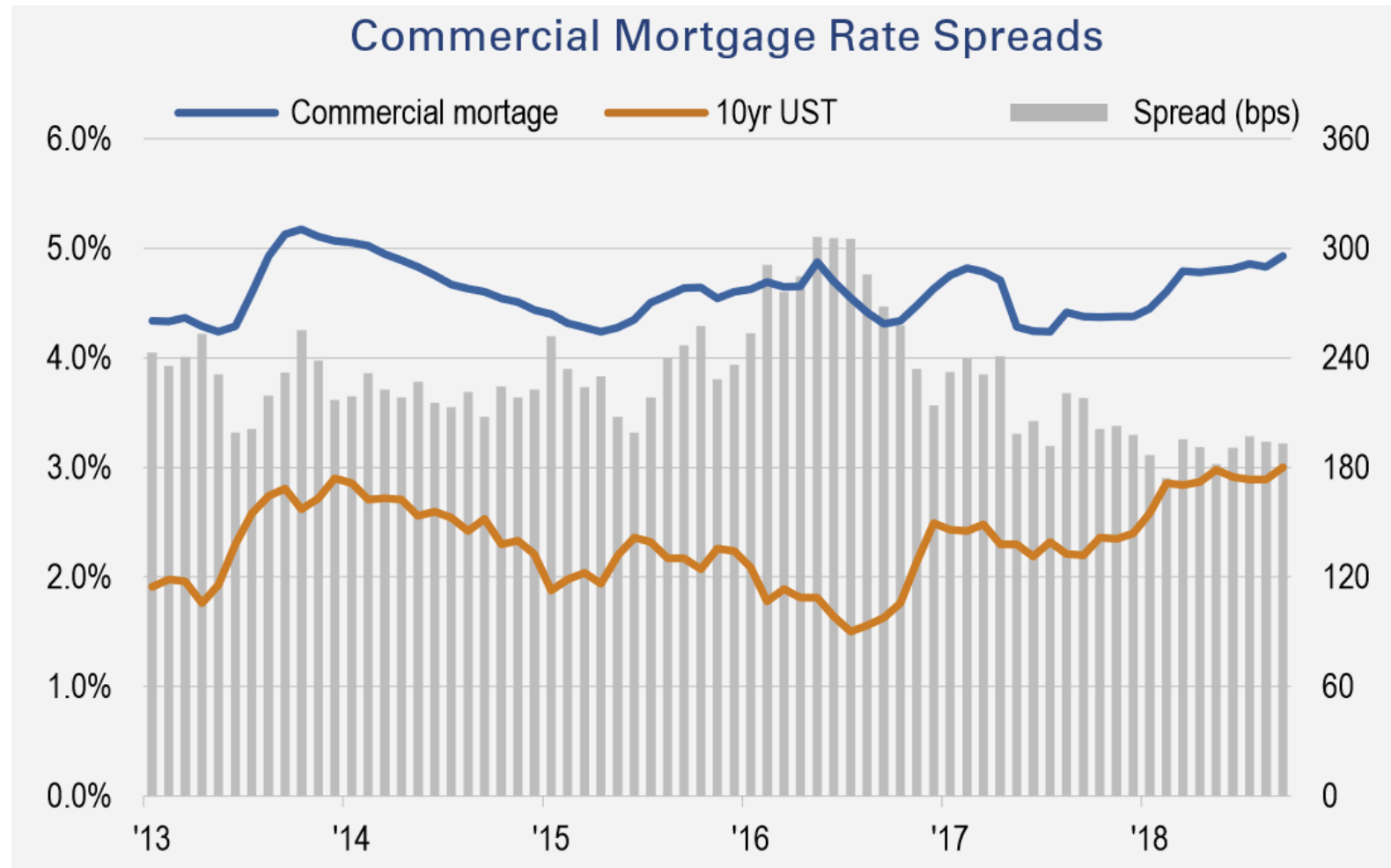
Real-estate debt funds

\$35billion



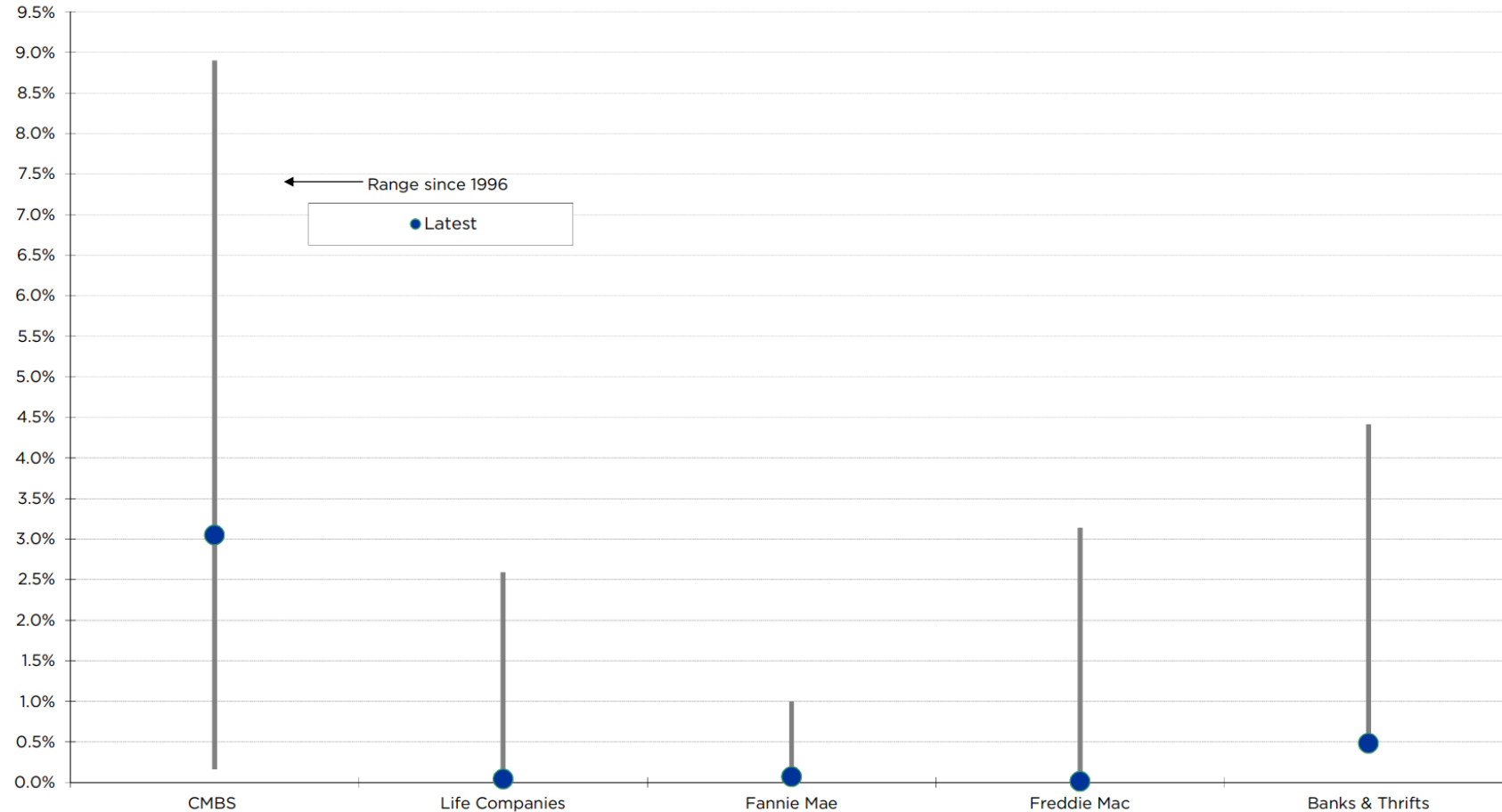
* Through August 2018

... competition for debt has kept commercial mortgage spreads tight ...



. . . . delinquency rates are at or near 20-year lows for all but CMBS

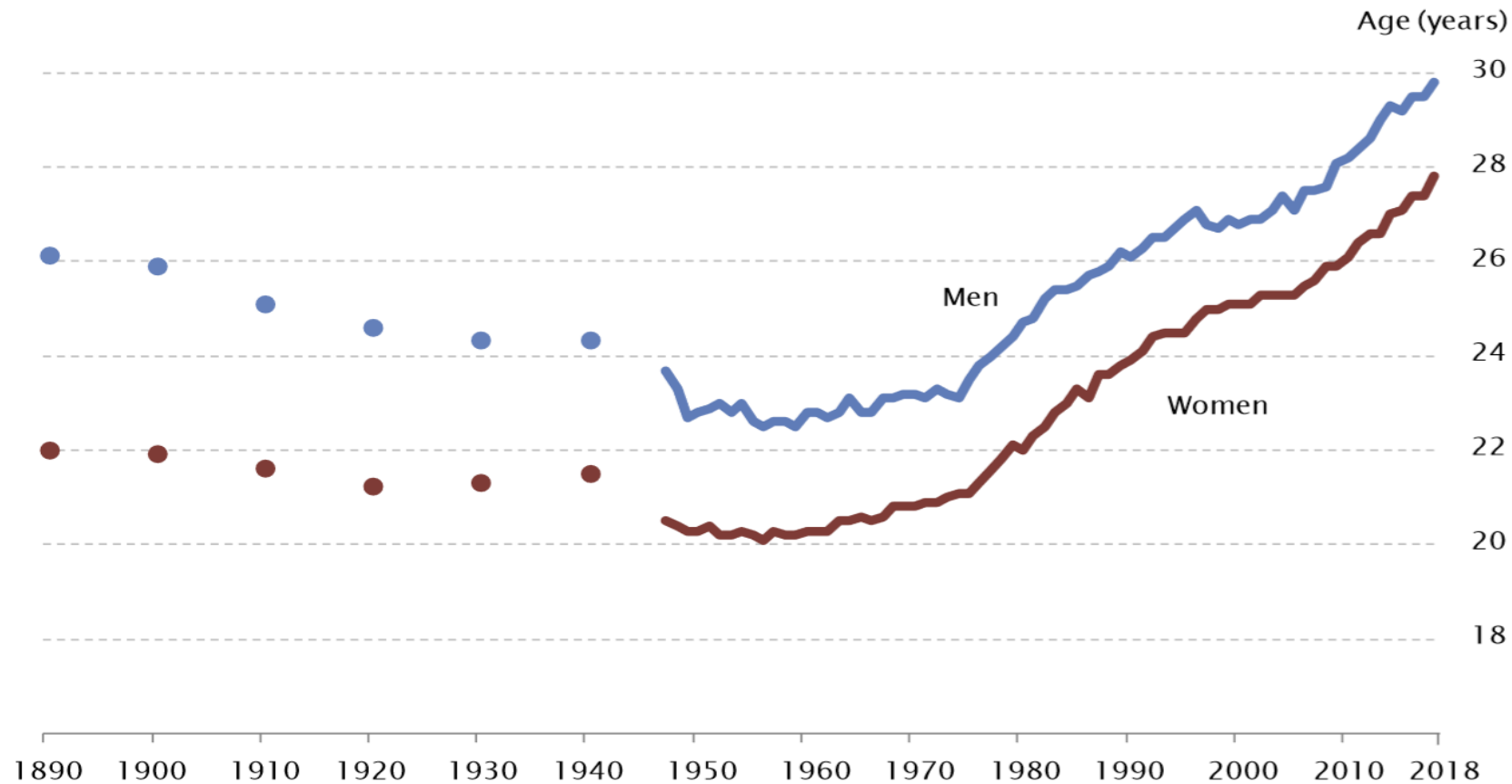
Delinquency Rate Range 1996-2018 for Select Real Estate Lenders



Multifamily

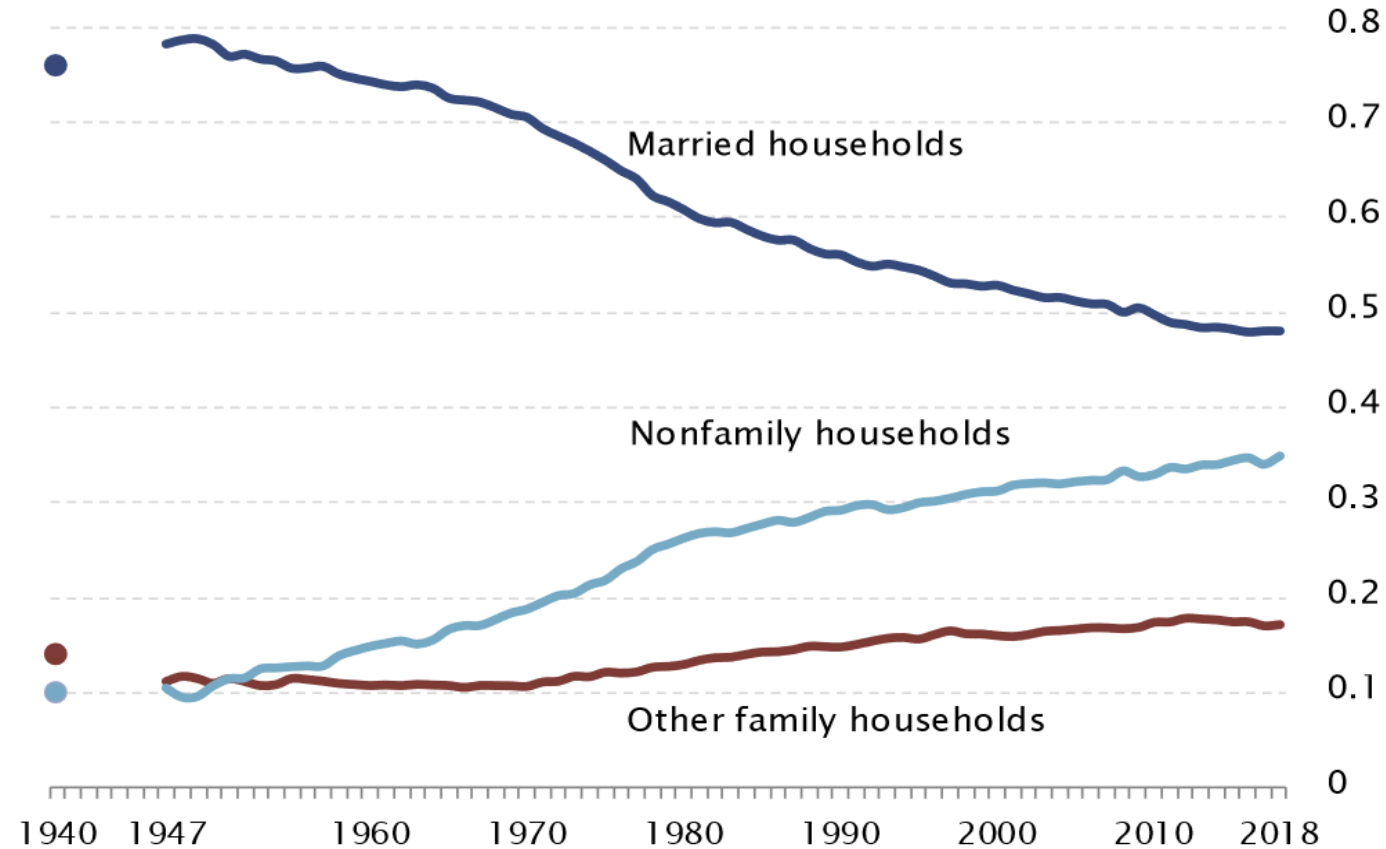
The demographics for multifamily are very strong

Median age at first marriage: 1890 to present



. . . . more strong multifamily demographics

Percent of households by type



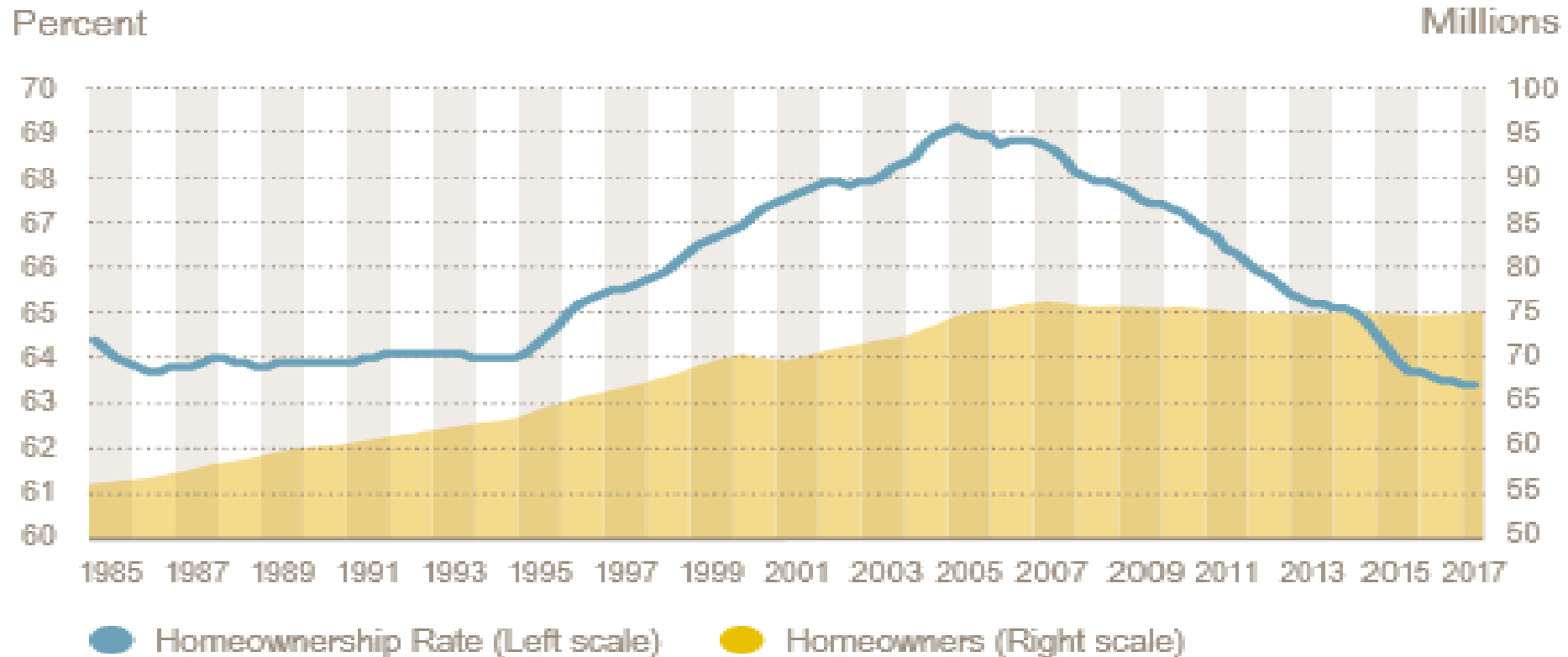
. . . between 2006 and 2016 there were

8 million new households created

with 400,000 fewer homeowners.

. . . . since 2006 homeownership and homeownership rates have declined

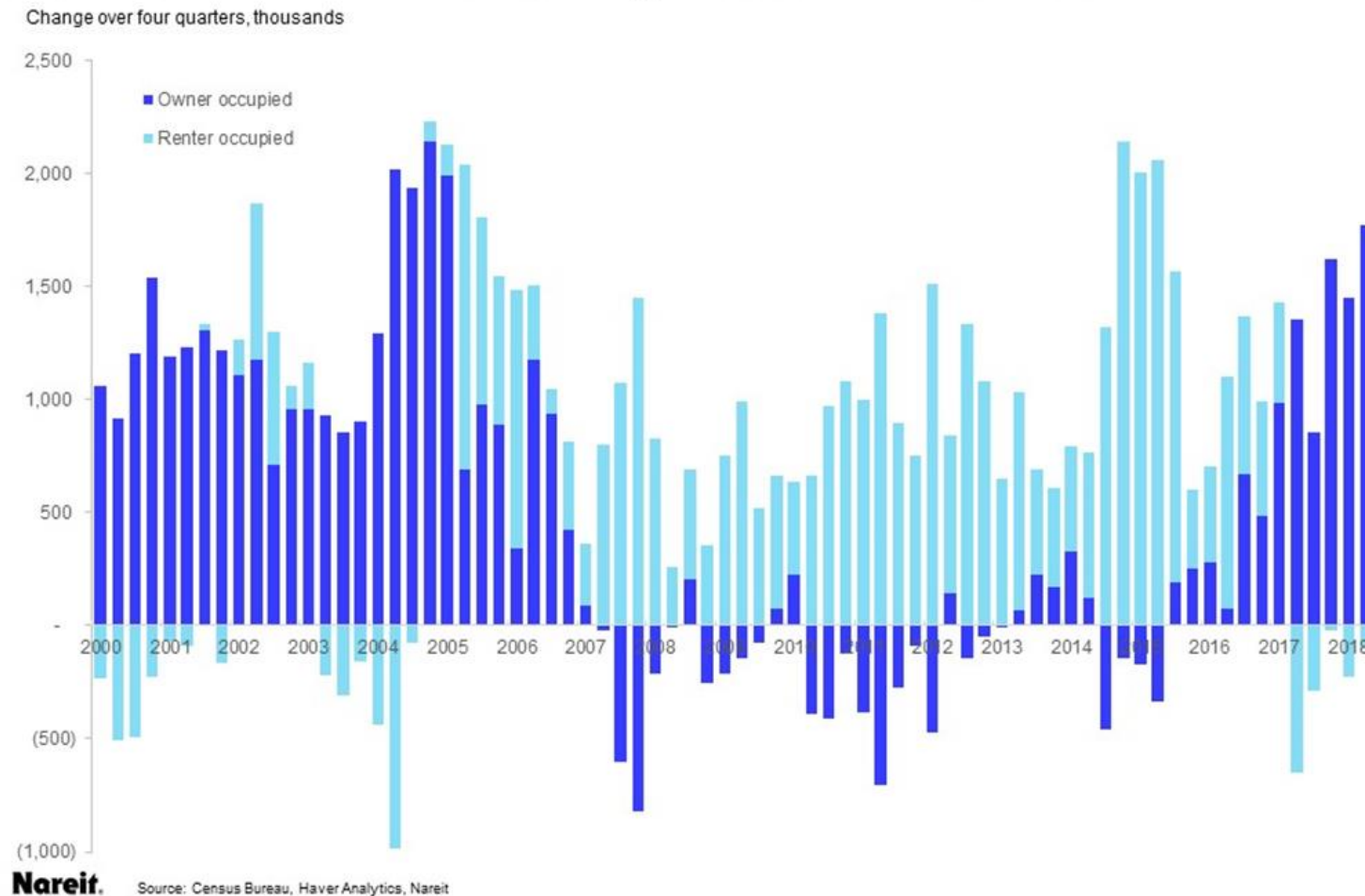
Despite Growth in the Number of Owners, the National Homeownership Rate Fell Again in 2016



.... housing
tenure
decisions
have shifted
to owner-
occupied ...
.

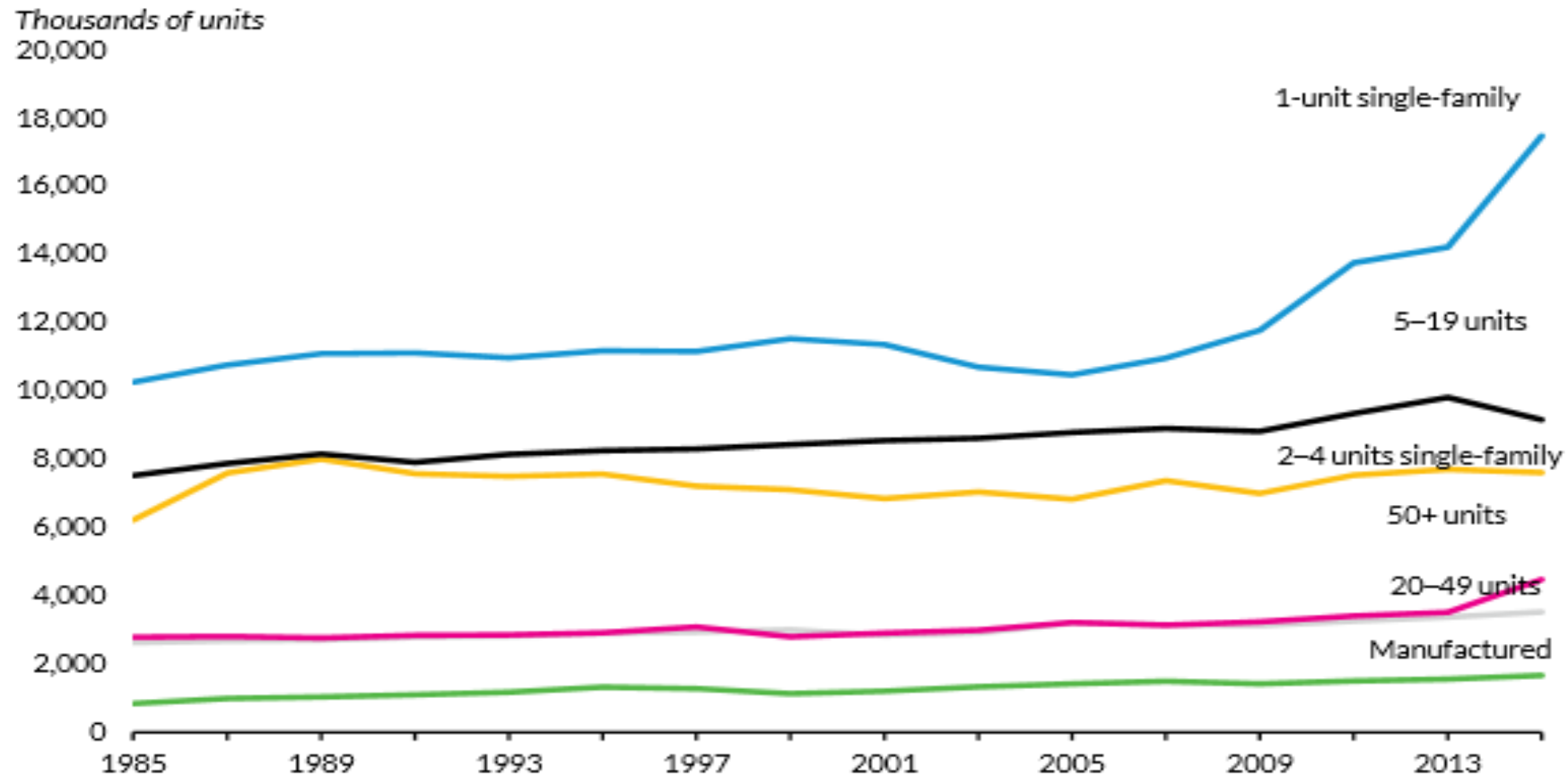
Chart 2. Household formation

Homeowner households are increasing while renters are flat to down

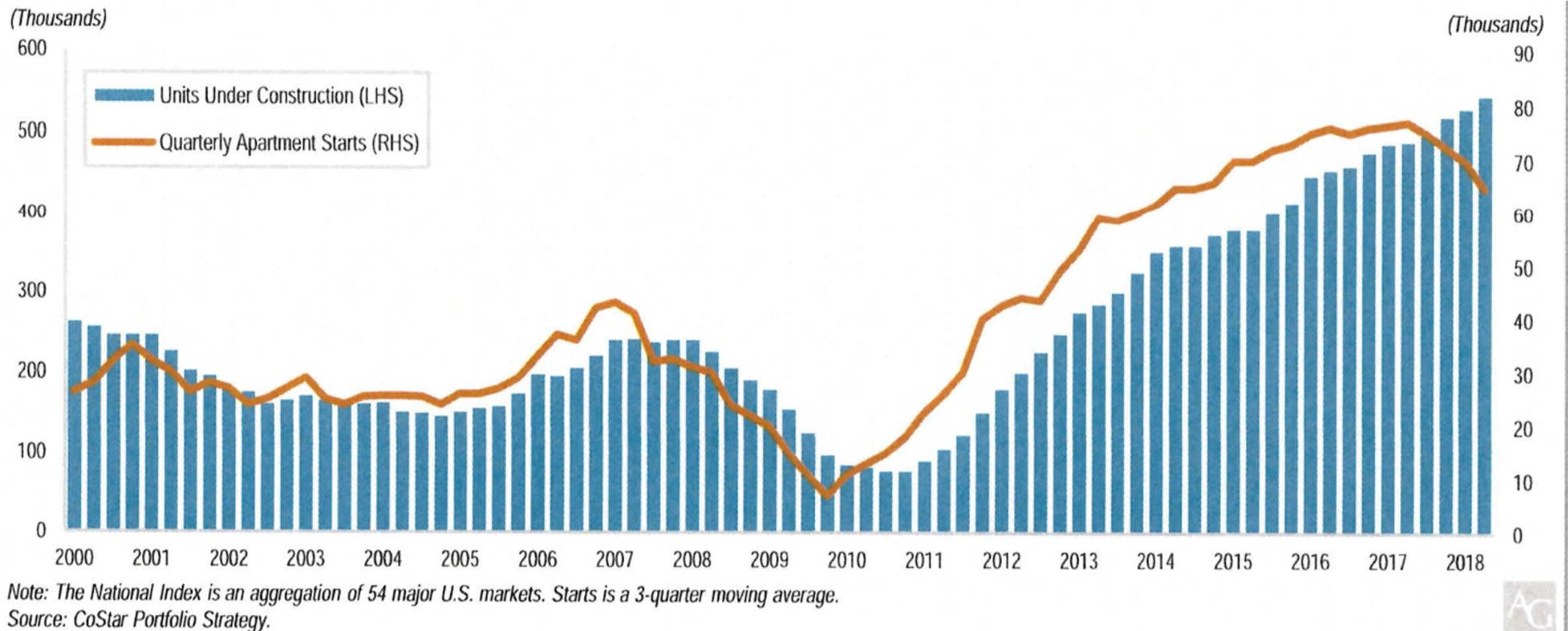


. . . . over the past decade, almost seven million single-family homes went from owner- to renter-occupied

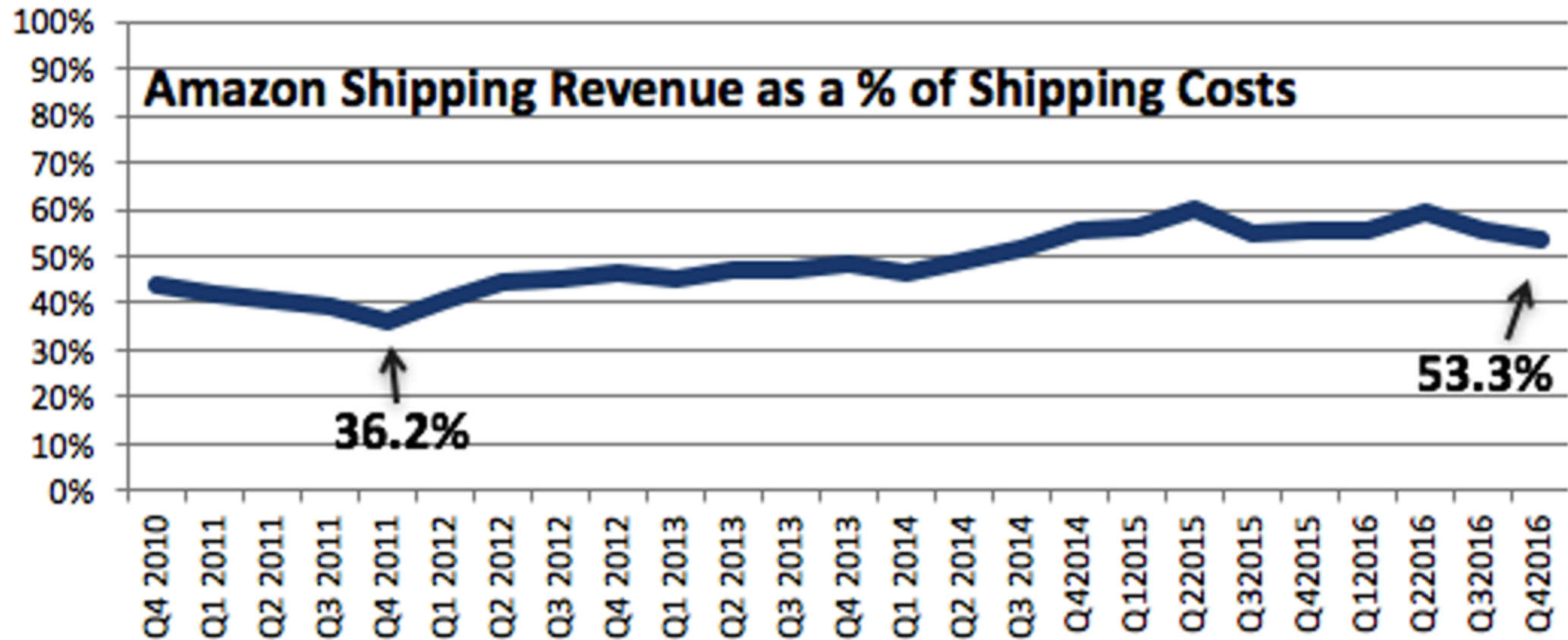
Occupied Rental Housing Units, by Number of Units in Structure



... your next multifamily deal will not lease up like your last deal ...



Warehouse, one slide, fix this problem for Amazon!



The Forecast

Asset prices:

- Cap rates will widen out by 25-50 bp to account for new risk premiums

Equity capital:

- Transaction volumes will fall by 5-10% over economic and pricing concerns

Debt capital markets:

- Will be robust, but tighten near year end

Space markets:

- Apartment overbuilding and weak absorption will reduce YOY NOI

GDP growth:

- 2.0% YOY and falling

Wage inflation will push interest rates higher, weak economy as an offset

- 10-year UST at 3%+/-

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