Commercial Real Estate Debt

A Bright Outlook for 2018

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The commercial real estate market is poised for income growth with stable valuations.

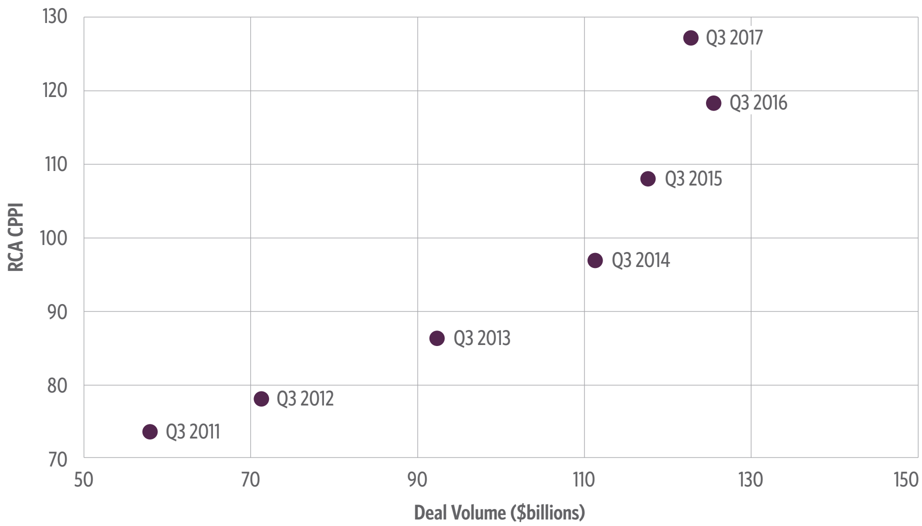
The market is poised for additional income growth and stable values in 2018. While annual deal volume has decreased since the peak in 2015, valuations have continued to rise. (see chart, top right). The majority of this increase has been in the apartment and industrial sectors. The apartment market has been particularly resilient given the glut of new units over the past two years, the highest since the early 1980s (see chart, bottom right). New home formation continues to exceed supply (apartment and single family combined), and concern over future oversupply seems to be waning. Unlike previous cycles, this favorable supply/ demand dynamic has been a major contributor to the stability in all sectors. This balance does not appear to be changing, as indicated by a pullback in construction lending by most national and regional banks in 2017. While interest rates and the changing retail landscape continue to be headwinds in further cap rate compression, the prospects for net operating income growth look favorable thanks to positive economic forecasts and tax law changes that should benefit long-term owners of real estate. There is also discussion in Washington regarding changes to the Dodd-Frank Act that could provide additional liquidity to the market. So while real estate may see an overall increase in cap rates in 2018, it should not offset the other positive impacts that occurred in 2017.

The Commercial Property Price index increased 7.0 percent in 2017, according to Real Capital Analytics data. Apartment and industrial sectors led the way, with 10.6 percent and 6.1 percent gains respectively. Retail and office properties had more modest 1.1 percent and 3.0 percent gains for the year.

With the recent increase in interest rates, especially in five- and seven-year yields, we are constructive on coupons on five-, seven-, and 10-year terms for loans at 65 percent loan to value and below. The bridge and construction loan space is still attractive, especially as Libor rates increased significantly in 2017 and will likely continue to rise in 2018. The pullback in construction lending by traditional sources is affording opportunities for nontraditional lenders. The spreads for these loans are particularly attractive as the loan to cost quoted by most lenders has decreased over the last 12–14 months.

Valuations Continue to Rise Despite Waning Deal Volume

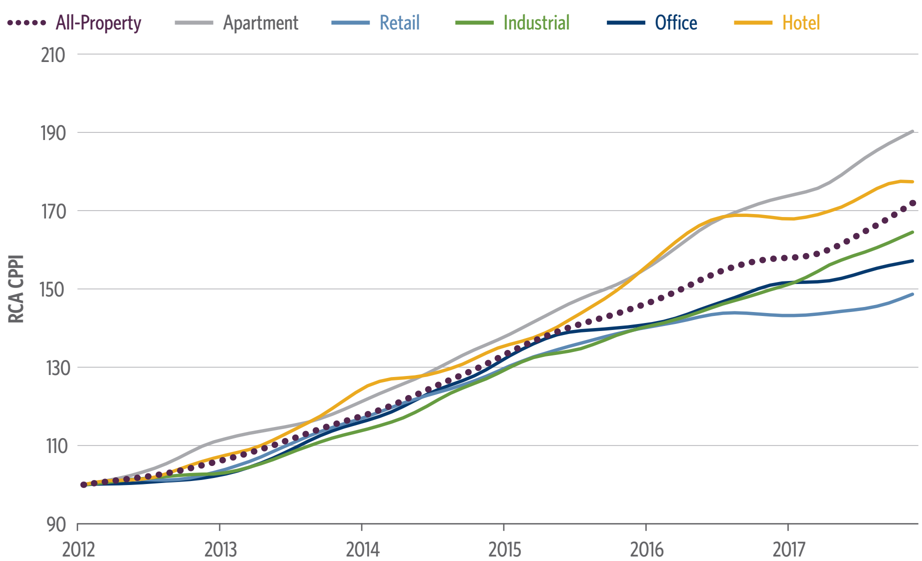
Volume vs. Pricing



Source: Real Capital Analytics (RCA), Guggenheim Investments. Data as of November 2017. RCA Commercial Property Price index (CPPI) is a national all-property composite index.

Property valuations have continued to rise even as annual deal volume has decreased since the peak in 2015.

Apartments Lead the Pack on Property Price Growth



Source: Real Capital Analytics (RCA), Guggenheim Investments. Data as of November 2017. Indexed to June 2012. RCA Commercial Property Price index (CPPI) is a national all-property composite index.

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