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Guggenheim Real Estate: Market Update

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Economic Outlook and Key Themes[1]

Economic growth should remain strong through 2018

Economic activity finished 2017 strongly, and should benefit in the coming months from tax cuts, higher government spending, and favorable financial conditions both in the U.S. and abroad, pushing economic growth well above 2%. Real GDP above that level would indicate that the economy is performing comfortably above potential, as demographic factors and slowing productivity growth have dragged trend supply-side growth down to 1.0-1.5%.

Consumer confidence near cyclical highs, along with continued disposable income growth and healthier household balance sheets, bodes well for consumption in the coming quarters. The trend rate of job growth should continue to slow. Even so, the unemployment rate could fall to 3.5% by the end of 2018. A tighter labor market and increasing worker shortages will put upward pressure on wage growth, which has been held back by meager productivity gains. Elevated business optimism and tax changes could boost capex plans in the coming quarters, which would be positive for growth and productivity.

Core inflation will likely remain below the Fed's 2% target for the next several months. However, stronger growth and reduced labor market slack should push core inflation closer to the Fed's target by the middle of 2018, when favorable base effects kick in.

We expect several Fed rates hikes this calendar year

Despite weak realized inflation, the Fed continues to believe in the Phillips Curve framework, suggesting that inflation will pick-up with the unemployment rate well below the Fed's definition of full employment. Moreover, financial conditions remain highly accommodative, giving the Fed further room to raise rates, and fiscal stimulus will give the economy an additional boost. As inflation rises and the unemployment rate falls lower than the Fed expects, our projection is that it will deliver four rate hikes this year, which exceeds market expectations. Because the real neutral fed funds rate is currently close to zero, the Fed is already closing in on a neutral stance of policy, and by early 2019 will be sufficiently restrictive to invert the yield curve. While the 2018 economic outlook is positive, the Fed is moving to increasingly tight policy, which could have recessionary effects.

Continued European economic progress while China exhibits moderation

While the eurozone economy continues to improve, core inflation is expected to remain below the European Central Bank's ("ECB") target in the coming quarters due to substantial slack and a stronger euro. The accelerating economy warranted the tapering of QE by the ECB, but ongoing purchases and continued low rates should provide significant accommodation to the European economy through 2018.

Leading indicators, such as credit conditions, are pointing to a moderate slowdown in the Chinese economy. The post-Party Congress focus of policymakers is shifting to better quality growth and reducing risk in the financial system. Meanwhile, Japan's economy continues to show signs of life but inflation remains far from the Bank of Japan's target. The yield curve control policy should remain in place and continue to drive capital abroad.

Oil prices likely to trend upward as oversupply is reduced

Tightening global fundamentals warrant gradual increases in the price of oil. Recent fears of surging U.S. production have pushed the price closer to fundamentals, but the price still faces near-term downside as speculative longs remain elevated. We expect the OPEC production quota will continue until the end of 2018. However, the quota could be lifted sooner if crude prices are sustained above $60.

Real Estate Market Update[2]

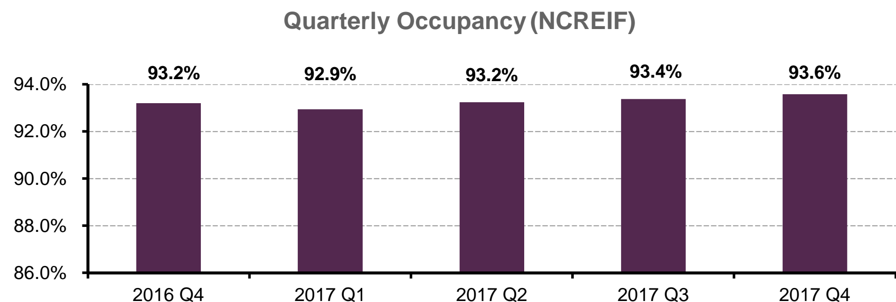
Occupancy at historically high levels with stable NOI growth, albeit decelerating

Commercial real estate fundamentals in the private sector remain healthy and stable. The NCREIF Property Index (NPI) unlevered total return for the fourth quarter was 1.8% for the fourth quarter 2017, comprised of 1.2% income and 0.6% appreciation. On an annualized basis, the NPI was 7.4%. Although returns have been moderating, the fourth quarter total return was the highest quarterly return for 2017 and the highest total return for the last six quarters by a narrow margin.

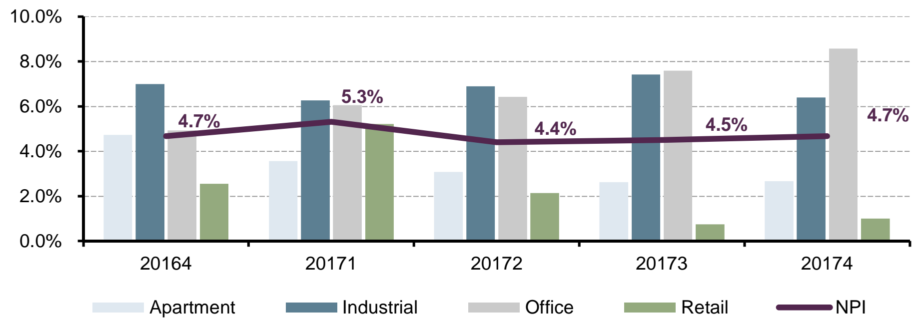
Income yields remain low but maintain an average spread over the 10-year U.S. Treasury. The current spread between the fourth quarter NPI annualized income yield and the 10-year Treasury rate is 2.3%[3], slightly more than the long-term average spread of 2.2%. While the income return has trended lower through most of the recovery, it now comprises the majority of the total return as appreciation is significantly lower than it had been.

Occupancy reached an historical high of 93.6% during the fourth quarter. Once again, the Industrial sector outperformed other property types by a wide margin for both the fourth quarter and 2017. The West region continued to outperform other regions for both the quarter and 2017, followed by the South region. Same-store net operating income (NOI) growth for the rolling four quarters slightly increased to 4.7%. The rolling four quarter growth still exceeds the 10-year average of 3.2%. In general, fundamentals are healthy and new supply remains subdued, while some sectors in certain major markets exhibit variations. The Industrial sector is experiencing increased new supply in major coastal markets like Seattle, however absorption is bolstered by strong tenant demand. Further, the Office sector is facing supply headwinds in large metros like New York, as tech and financial services job growth is lackluster.

Quarterly Occupancy (NCREIF)



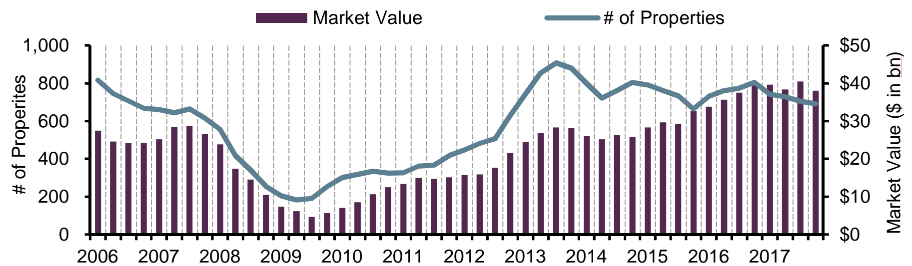
Rolling Four Quarter Same-Store NOI Growth (NCREIF)



Transaction volume is elevated

Liquidity is strong for high-quality, well-located assets. As measured by NPI, the trailing four-quarter volume slightly decreased from third quarter but remains at historically elevated levels. According to Real Capital Analytics (RCA), sales volume has moderated over the last two years, though total activity is still relatively strong (2017 volume exceeded that of 2014). Quarterly sales volume decreased from the third quarter 2017 driven mostly by weak entity level transaction activity. However, single asset sales volume increased from quarter to quarter and was only 5% down year-over-year. Further, transactions in the industrial sector were especially active, resulting in a 20% annual growth rate for 2017 with single asset sales for the sector at record high levels.

Historical Property Transaction Volume (Rolling Four Quarters)[2]



Debt financing is readily available but rising interest rates are likely

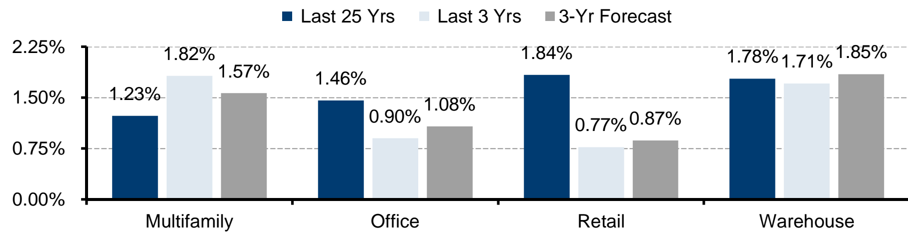
Leverage is available at moderate levels and can be secured from a variety of sources (banks, insurance companies, CMBS, agency, etc.). Overall, debt capital is accessible at rates that remain attractive by historical standards. Senior mortgages with fixed rates, 10-year terms and 60% loan-to-value on stabilized properties were available at approximately 4% interest rates during the fourth quarter, implying nearly a 130 to 150 basis point spread over 10-year U.S. Treasuries.[4]

New supply is lower than historical averages for most property types

Supply growth remains modest overall. While some markets have seen increases in development, all property types, with the exception of multifamily and industrial, remain below their long-term averages. Multifamily construction has primarily been concentrated in urban markets that have experienced higher growth, and the absorption has validated most of the demand. However, the pace of rental growth is expected to decelerate in markets with the most supply. Though industrial supply has increased, it is manageable given the strong pent-up demand which has been sufficient to absorb new product. In addition, a favorable economy, strong import

activity, increased manufacturing sentiment and shifting dynamics related to e-commerce have bolstered the industrial sector.

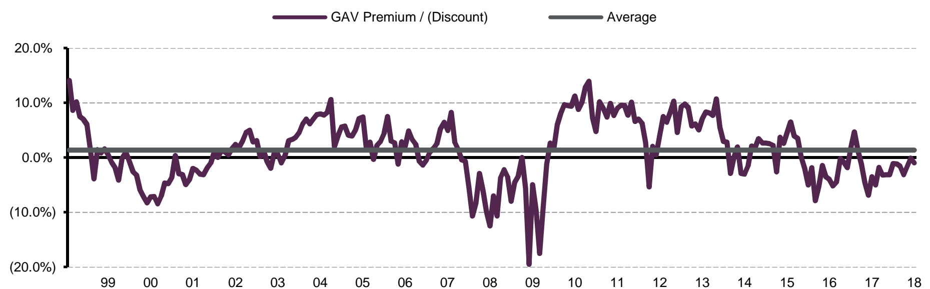
Average Commercial Property Supply Growth[5]



U.S. REITs demonstrate positive momentum

U.S. REITs, as measured by the FTSE NAREIT Equity REITs Index, posted the fourth consecutive quarter of positive performance with a total return of 1.5% for the fourth quarter (marking four straight quarters of positive performance). November performance of 2.7% compensated for lackluster returns in October and December. REITs experienced some volatility due to expected interest rate increases, while broader equities garnered favor on the backdrop of a more direct positive impact from recent tax reform and a growing economy. The retail sector was the top performing sector in the fourth quarter, benefitting from merger and acquisition activity and investor activism in the mall subsector. General Growth Properties received a takeout bid from Brookfield Property Partners LP and activist investors accumulated positions in Macerich and Taubman. The hotel sector was also a top performer, driven by its greater economic sensitivity. REITs are roughly trading near private market values overall, with moderate variations by property type. As of the fourth quarter, the implied unlevered public real estate market value traded at a 1.0% discount to private values, which is modestly below the trailing 20-year average premium of a 1.4%.[6] Regarding performance in early 2018, U.S. REITs experienced a sharp selloff and higher volatility during the first six weeks of the year, predominately caused by heightened inflation expectations and consequently a rise in 10-year treasuries, with which REITs exhibit significant correlation.

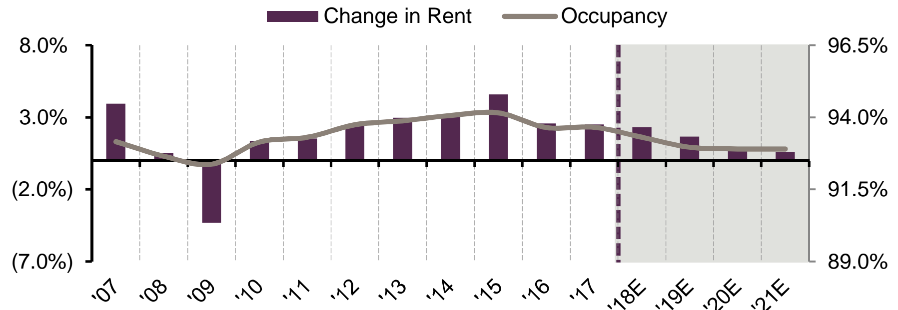
Public to Private Market Premium/Discount[6]



National Real Estate Market Update by Property Sector[7]

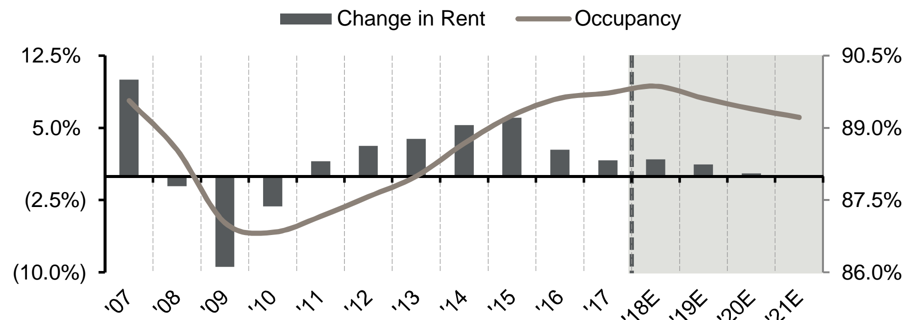
Multifamily

Apartment fundamentals are showing some signs of tapering as supply pipelines increase and job growth decelerates. Transit-oriented, amenity-rich assets remain well-positioned. The 25-35 year-old cohort is still an attractive demographic, but renter formations have slowed as homeownership rates have begun to elevate. West Coast tech job downward trends pose a challenge, but New York City is experiencing improvements. Fourth quarter occupancy was 94% and market rents averaged $1,250 per unit.



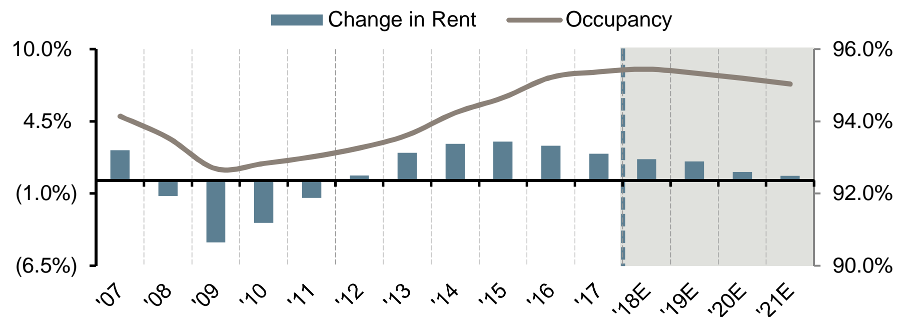
Office

Office fundamentals remain intact, but are moderating in certain markets. Areas with strong STEM (Science, Technology, Engineering and Math) exposure and vibrant urban cores continue to outperform. As job growth flattens, absorption has moderated and leasing concessions have elevated. New supply growth is rising in specific markets like New York and D.C., while remaining at moderate levels in the Sunbelt. Nationally, fourth quarter occupancy was 90% and market rents averaged $31.11 per square foot.



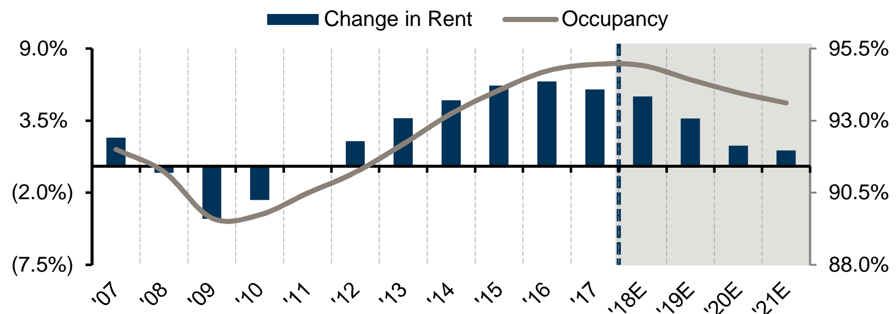
Retail

Higher quality retail centers that offer convenience and a unique shopping experience are well-positioned. In addition, grocery-anchored centers remain strong and less impacted by e-commerce disruption. The sector still faces headwinds, although performance has yet to decline significantly. New supply has been limited. Bidding for power centers and non-core centers is soft. Tenant sales have showed signs of improvement in high quality malls, but rent growth is still unlikely in this tenant controlled market. Bankruptcies continue to pose a threat. Overall, fourth quarter occupancy was 95% and market rents averaged $20.54 per square foot.



Industrial

The industrial sector continues to outperform with strong demand from e-commerce and a favorable U.S. economy. Demand fundamentals have been boosted by increased import activity and manufacturing sentiment. Occupancies are near record highs, driving rental pricing power for landlords. Coastal locations with growing port activity and infill locations near large population centers have been strong performers. The opening of the Panama Canal has positively impacted the East Coast. New supply has increased, but has generally been followed by strong absorption. Fourth quarter warehouse occupancy was 95% and rents averaged $7.94 per square foot.



Topic of Interest: Tax Reform Implications for the Real Estate Industry[8]

Tax reform expected to provide a moderate benefit to the real estate industry overall

On Dec. 22, 2017, the Tax Cuts and Jobs Act was signed into law by President Trump. The tax reform is the most significant overhaul of the U.S. tax code since 1986 and includes meaningful changes for both individuals and business, although some language in the law will require further clarification by the IRS. Some supporters expect the tax reform to accelerate economic growth by encouraging more investment, job creation and consumer spending. An extension of the economic cycle would also be expected to drive demand for the real estate industry. However, certain provisions in the new tax law may impact various property sectors, markets and investment strategies differently.[9]

Individual tax provisions

Key changes to individual tax provisions:[8,10]

- Seven-bracket tax structure is maintained, but includes lower statutory rates across most brackets
- Standard deductions are nearly doubled, but personal exemptions are eliminated
- Child tax credit is doubled and the income threshold is increased

- Mortgage interest reduction is maintained, but the mortgage limit is lowered from $1mm to $750k and home equity loan interest is no longer deductible
- State and local tax deductions (including property tax) are capped at $10k
- Health insurance mandate required by the Affordable Care Act is eliminated
- Estate tax exemption thresholds are roughly doubled and the step-up in basis is preserved

Business tax provisions

Key changes to business tax provisions:[8,10,11]

- Corporate tax rate is reduced from 35% to 21% and the alternative minimum tax is eliminated
- Certain pass-through businesses (such as partnerships and limited liability corporations whose owners pay taxes via individual tax returns) are allowed a 20% deduction of qualified business income, subject to certain limitations
- Carried interest profits for certain businesses taxed as long-term capital gains now require a three year holding period versus one year holding period
- Interest deductibility for most businesses is capped at 30% of earnings before interest, tax, depreciation and amortization (EBITDA), although real estate companies can opt out of the limitation
- Territorial tax system is adopted, eliminating taxes on multinationals overseas profits; the new law also permits a one-time, reduced tax rate on the repatriation of existing overseas profits

Other real estate related provisions

Other key changes relevant to real estate:[8,10,11]

- Like-kind (or 1031) exchanges are retained, but only for real property transfers (excludes personal property like furniture and equipment)
- Cost recovery (depreciation) schedules for real property are maintained, but real estate companies opting out of the interest deduction limitation are required to depreciate based on an alternative period of 40 years (versus 39 years) for nonresidential property, 30 years (versus 27.5 years) for residential property and 20 years (versus 15 years) for qualified improvements
- Expensing election qualifications expanded to include certain property and improvements like furniture, roofs, HVAC, etc.; bonus depreciation is increased from 50% to 100% in the first year (subject to expiration); no bonus depreciation for real estate companies opting out of the interest deduction limitation

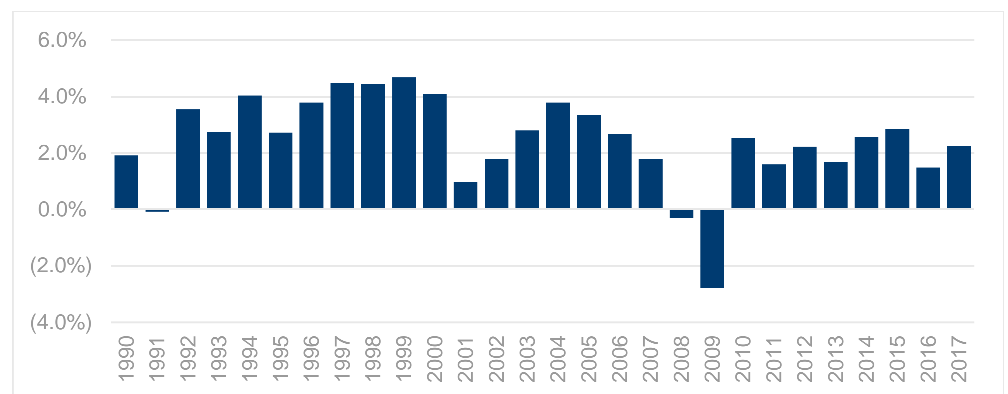
Job growth and consumer spending may drive additional demand for real estate

The most significant change to the tax code is likely the lower corporate tax rate, although many households may receive an income boost as well. Proponents of the tax reform argue it will result in a positive impact for the larger economy, spurring greater economic growth and job creation. Many top chief executives attending the World Economic Forum in Davos expect the tax overhaul to boost U.S. growth, elevate wages and increase investment.[12] Several companies, including Bank of America, American Airlines, Starbucks, Apple and Walmart amongst others, have already announced cash or stock bonuses to employees attributed to the corporate tax cuts. Any increase in job growth and consumer spending is expected to further drive demand for the real estate industry.[13]

Tax cuts are expected to boost GDP growth, even after accounting for higher interest rates

The economy is already growing at a healthy rate. Real GDP growth climbed to 2.3% for calendar year 2017 and was the best year of growth since 2014. Annualized GDP growth in the fourth quarter was 2.6%.[14] Some industry experts expect the tax cuts to bring GDP growth closer to 3% per annum from the near 2% rate that has prevailed throughout the expansion. However, static scoring indicates that the tax cuts may increase the deficit and debt by as much as $1.5 trillion dollars over the next ten years.[9] The government may need to issue Treasury securities to finance the debt, resulting in a higher trajectory for interest rate increases which could offset some of the intended reduction in corporate after-tax cost of capital. The tax cut at full employment could also lead to capacity strain and higher than expected inflation. The commercial real estate industry may benefit investors as an inflation hedge given its ability to capture rent growth and appreciation in an inflationary environment. Accounting for the interest rate increase, the tax cuts are still expected to grow the economy, albeit with a real GDP growth boost closer to 3-9basis points per year on average over the next decade.[15]

GDP Growth By Year



Homeownership incentives reduced, driving more demand for multifamily

Although stronger economic growth, even if marginal, would benefit the entire commercial real estate industry, some sectors and markets may benefit more than others from the tax reform. Homeownership incentives are reduced by the doubling of the standard deduction for tax payers who previously itemized, elimination of home equity loan interest deduction and the cap on property tax deduction. Limitations to deductions, along with increasing interest rates, may put downward pressure on home prices and impact own versus rent economics. On the other hand, the reduced ownership incentives are expected to be a positive driver for the multifamily sector and single-family rentals. The new cap on deductions for state and local taxes (SALT) may place a higher tax burden on residents of high-tax areas like New York and California. While the cap could influence both corporations and individuals to relocate from high tax areas to low tax areas, REIS researchers do not expect a mass exodus given that many high tax cities serve as major employment hubs. Alternatively, residents might be more likely to move from urban centers to suburban areas.[16]

Office, retail and industrial sectors also likely to benefit from stronger tenant demand

A stronger economy and growth in corporate earnings may also result in stronger tenant demand. For instance, the office sector may benefit from the reduction of the statutory tax rate on its corporate tenants. Retail sector tenants pay the highest effective corporate tax rate of any sector in the U.S. economy and the lower corporate tax rate might encourage retailers to increase investment in operations. Retail is also expected to benefit from an increase in the discretionary income of consumers. Stronger retail fundamentals would benefit both traditional retail properties as well as industrial properties serving retailers and eCommerce businesses. The industrial sector may also benefit from full expensing of capital improvements and equipment, a critical component for industrial businesses, capital goods and manufacturing.[10,15,16]

Healthcare, student housing and lodging sectors may be negatively impacted, but only modestly

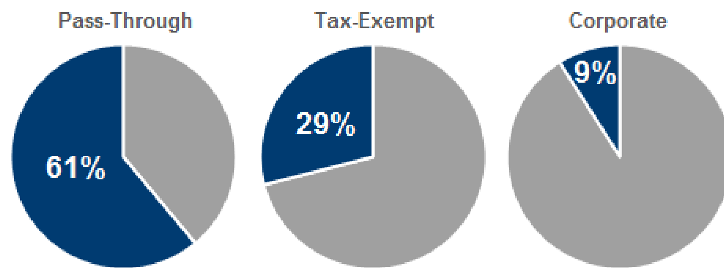
Despite overall benefits to real estate, the tax reform may negatively impact some sectors. Demand for services in the healthcare industry may be somewhat curtailed by the elimination of the individual mandate for health insurance. An increase in deficits under the tax reform plan could trigger automatic cuts in Medicare and Medicaid spending. While medical facilities and reimbursement dependent senior housing could see some disruption in the short-run, demographics continue to drive the sector such that the long-term outlook remains positive. With respect to student housing, the taxing of university endowments could potentially lead to reductions in enrollment or university development of student housing. However, the 1.4% tax on endowment earnings may only be applied to roughly 30 colleges with the largest endowments.[17] Hotels may likely benefit from the increase in consumer discretionary income, but may be negatively impacted from the 1031 provision that now excludes personal property like furniture, fixtures and equipment.[10]

Pass-through entities benefit from tax reduction, but sponsors with short-term holding strategies may be negatively impacted

In addition to impacting real estate fundamentals, other changes in the tax reform are expected to more directly impact real estate investors and investment strategies. The tax reform did not change FIRPTA withholding requirements imposed on non-U.S. sovereign wealth funds and insurance companies investing in the U.S. real estate market, but foreign nationals may benefit from the significant rate reductions. The tax reform also maintains the status quo for tax-exempt private activity bonds (PABs), as well as tax credit programs including the low income housing tax credit (LIHTC), new markets tax credit and historic preservation and rehabilitation credits. However, tax credits may become less meaningful with lower tax obligations from reduced rates.[18] Additionally, the new tax deduction for pass-through entities may benefit real estate investment vehicles given the widespread use of pass-through structures within the industry. Cushman & Wakefield estimates that approximately 61% of commercial real estate investment is conducted through pass-through entities while

another 29% flows through to tax-exempt entities either directly or via pass-through entities.[15]

Distribution of Investible Commercial Real Estate by Holder Taxable Struxture[15]



Unfortunately, the change in the carried interest provision is expected to negatively impact investors who operate a shorter term repositioning or development strategy. These strategies typically generate appreciation quickly and certain sponsors that receive a larger share of profits as promoted or carried interest will now be required to hold investments for a three year period (versus a one year period) in order to receive long-term capital gains treatment.[8,10] On the other hand, some value-add investors may benefit from immediately expensing capital improvements given the expanded definition for qualified investments now includes improvements like new roofs, HVAC, and fire protection systems.[19]

Commercial real estate would benefit from a prolonged expansion within the economic cycle

The Tax Cuts and Jobs Act is undoubtedly the most sweeping overhaul of the U.S. tax code in more than 30 years. Proponents of the reform expect the changes to result in greater economic growth and job creation, but headwinds from a growing deficit, increased interest rates and inflationary pressures could curtail the momentum. Other than the reduction in corporate tax rates, most of the provisions within the tax bill are not permanent and would either expire within 10 years or need to be extended by Congress.[18] Although the long-term impacts are less clear, the stimulus package is expected to provide near term benefits that could extend the cycle for another three to five years. Ultimately, commercial real estate may stand to benefit from a growing economy and prolonged economic expansion.

Footnotes

1 Guggenheim Partners Economic Outlook and Key Themes as of 2/14/2018.
2 Data sourced from the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index Quarterly Detail Report and Trends Report for the fourth quarter 2017. As of 12/29/2017, the NCREIF Property Index (“NPI”) included 7,527 investment-grade, income producing properties with a market value of $560 billion. Occupancy calculation is based on leased square footage. NOI Growth reflects the change in NOI from quarter to quarter for properties that are in the index at the beginning and end of the respective quarter.
3 4Q17 Annualized NPI income return of 4.7% vs. 10-year UST as of 12/29/17 of 2.4% = spread of 2.3%. Analysis based on data sourced from NCREIF and the U.S. Department of the Treasury.
4 Commercial Mortgage Alert newsletter as of 1/26/2018.
5 Based on the average of 3Q17 Dodge and 4Q17 CoStar supply growth data.
6 Source: Green Street Advisors; GAV = Gross Asset Value.
7 Analysis based on data sourced from CoStar 4Q17 and Green Street Advisors. Shading represents forecasted period.
8 KPMG, “New Tax Law [H.R. 1] – Initial Observations”, Dec. 22, 2017.
9 National Real Estate Investor, “How CRE Investors Could Cash in On the Tax Bill”, Dec. 27, 2017.
10 JLL Research, “How will tax reform impact CRE”, Dec. 19, 2017.
11 NAIOP, “NAIOP Welcomes Implementation of Sweeping Tax Reform Measure”, Dec. 22, 2017.
12 CNN Money, “Davos loves the Trump tax cuts”, Jan. 23, 2018.
13 S&P Global Market Intelligence, “Commercial real estate execs laud tax-code changes”, Jan. 10, 2018.
14 Bureau of Economic Analysis, “GDP: 4th Quarter and Annual 2017 (Advance Estimate)”, Jan. 26, 2018.
15 Cushman & Wakefield, “The Great Tax Race”, December 2017.
16 National Real Estate investor, “The Tax Bill is a Clear Boon to the CRE Industry. Will it Prove Too Much of a Good Thing?”, Dec. 20, 2017.
17 POLITICO, “The new tax on Harvard”, Dec. 22, 2017.
18 Manatt, Phelps & Phillips, LLP “New Trump Tax Plan’s Impact on Real Estate”, Dec. 21, 2017.
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