A Special Research Report

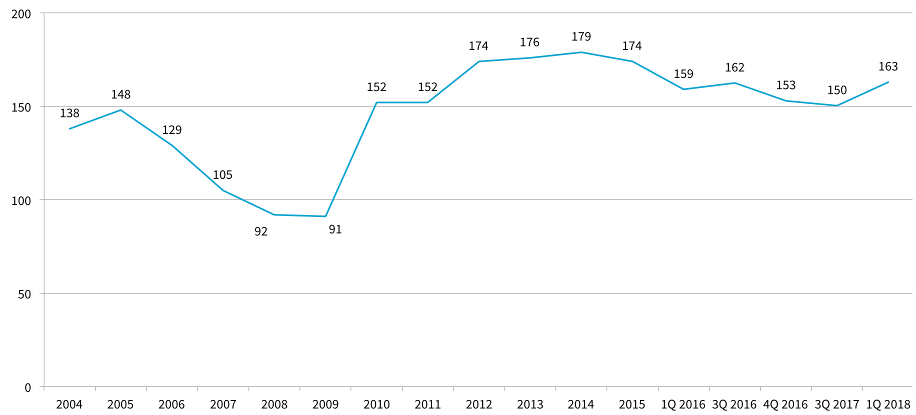
1st Half 2018 Commercial Real Estate Investment Outlook

Tax Reform Boosts Investor Sentiment

New legislation fuels confidence in economic growth and commercial real estate space demand, while expectations of a rising interest rate climate keep exuberance in check.

By Beth Mattson-Teig

FIGURE 1. INVESTOR SENTIMENT INDEX



Commercial real estate investors look to the coming year with increased optimism thanks in large part to the approval of new tax legislation.

Details are still unfolding on some of the finer points of the recently passed Tax Cuts & Jobs Act. The country is still waiting for guidance from the IRS and the Treasury Department on exactly how the new rules will be applied in a variety of situations. "There are still a lot of pieces that have to be defined," says John Chang, national director of research services at Marcus & Millichap. "But investors have a basic framework of the new rules, which is giving them more confidence in the economy and the performance of commercial real estate."

Exclusive research from the first half NREI/Marcus & Millichap Investor Sentiment Survey shows that the Investor Sentiment Index climbed to 163 **[Figure 1].** The move marks a significant change in course for the Index that had been on a downward trend since early 2016. Sentiment started slipping as uncertainty surrounding the presidential election began to take hold, and the trend continued through 2017 as the direction of federal fiscal, tax and monetary policies came into question.

"There were a lot of new conversations that emerged after the election about tax reform, infrastructure spending, economic growth and the new administration's approach to fiscal policy," Chang says. The Sentiment Index didn't collapse, but it did move gradually lower as investors became more cautious. The approval of the new tax law has provided more clarity and is giving investors renewed confidence in their ability to make informed decisions. "That alleviation of uncertainty is reflected in the boost in the Sentiment Index," Chang adds.

Sixty-eight percent of respondents expect the economy to grow faster as a result of the new tax law, while 71 percent believe tax reform will have a favorable impact on commercial real estate. Survey respondents also are more bullish about their plans to increase their commercial real estate investment in the coming 12 months when compared with the third quarter survey. Two-thirds of respondents (67 percent) plan to increase their commercial real estate investment compared with 59 percent who felt the same in the third quarter last year. Among respondents who expect to grow their real estate holdings, an average increase of 23 percent is predicted.

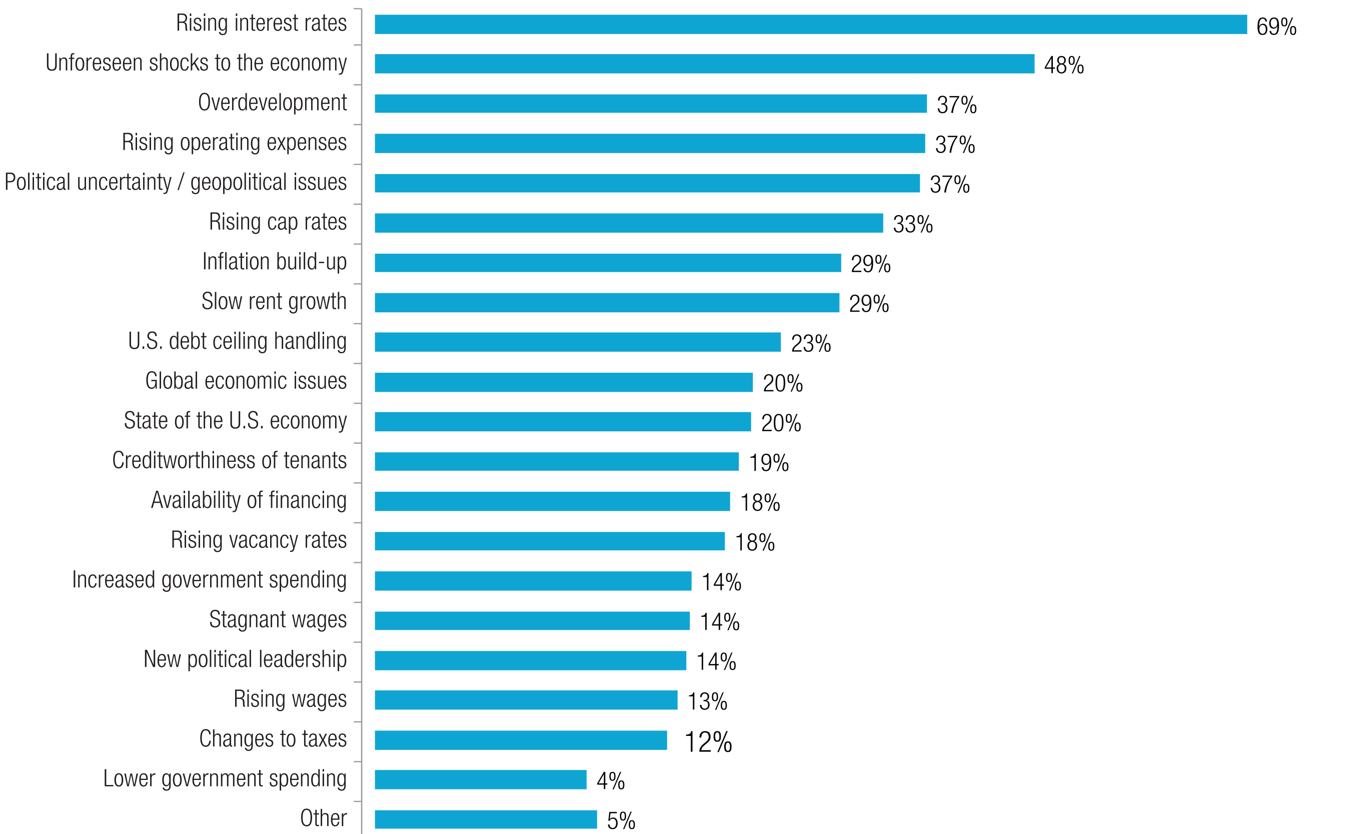
Economy Could Gain Momentum

Tax reform could act as a stimulus to the economy on a variety of fronts, such as boosting consumer spending and fueling job growth. Ninety-four percent expect that job growth will be the same or better in 2018 compared with 2017. That optimism continues into 2019 with 83 percent who expect job growth to be the same or better than 2017.

"We believe that companies will have increased staffing needs, but they will be battling the particularly tight employment market to acquire talent," says William E. Hughes, senior vice president of Marcus & Millichap Capital Corp. "The byproduct of that will likely be accelerating

FIGURE 2. **INDUSTRY CONCERNS**

As a real estate owner/investor, what are your top concerns over the next 12 months?



Base: all respondents (n=582).

wage growth, and, potentially, inflation risk as we go forward." Yet respondents do not view inflation as their top concern in the year ahead. Investors rated rising interest rates and unforeseen shocks to the economy as more significant issues at 69 percent and 48 percent, respectively, while inflation was noted as a concern by 29 percent of respondents **[Figure 2].**

Although most respondents (92 percent) anticipate that interest rates will move higher in the coming 12 months, opinions vary on how much rates will rise. Thirty-nine percent predict an increase of less than 50 basis points; 41 percent expect hikes of 50 to 99 basis points and 12 percent believe 100-plus basis points is more likely. However, those expectations also come on top of rate increases that have already occurred. Based on the survey closing date of Feb. 14, the 10-year Treasury had already increased by 45 basis points this year.

"The new tax law will likely have a stimulative effect on the economy, and the Federal Reserve is very cautious about rapidly accelerating inflation. So, they will be tapping the brakes on the economy using the tools at their disposal, including putting upward pressure on interest rates," Hughes says. Sixty-four percent of respondents cited Fed action as the main factor driving interest rates higher, while 49 percent also predict that rates will rise on expectations of higher inflation.

Reform Strengthens CRE

One of the biggest benefits of the new tax law for commercial real estate is that it alleviates uncertainty that had been building in the marketplace. Various proposed tax plans included radical changes to commercial real estate tax rules such as the elimination of 1031 tax-deferred exchanges, mortgage interest deductibility and real estate depreciation. Fortunately, the new tax law retained these important features with few material changes.

A major change to the tax law that will impact real estate investors is the introduction of a 20 percent deduction on pass-through income. Though an interpretation of exactly how this new deduction will be applied has yet to be released by the IRS, investors who hold their real estate investments in a pass-through entity such as an LLC could see a sizable benefit. "This new provision creates an additional lift for commercial real estate investors. It should increase their after-tax yield from these investments, which is very positive," Hughes says. Fifty-eight percent of respondents

FIGURE 3. IMPLICATIONS OF TAX LAW

Do you believe the new tax law will cause commercial real estate property values and the flow of investment capital to:

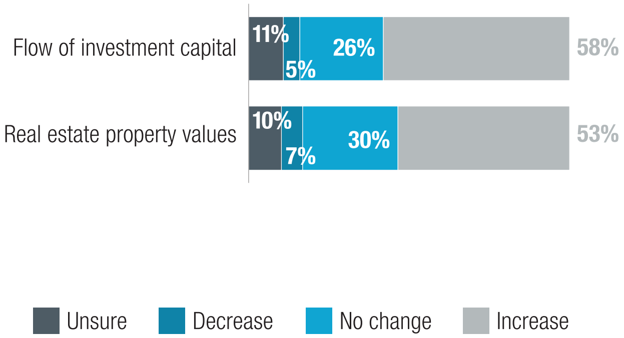
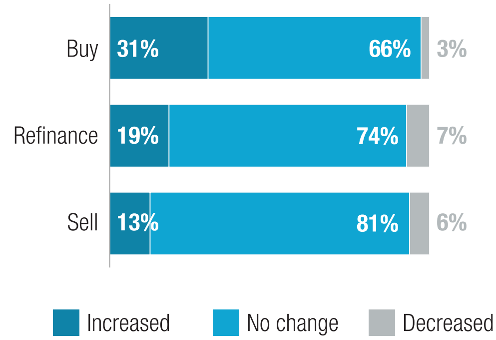


FIGURE 4. IMPLICATIONS OF TAX LAW

As a result of the new tax law, how have your plans to sell, buy and refinance properties changed?



Base: all respondents (n=589 for chart on left and n varies from 562 to 581 for chart on right).

expect the new tax law to raise the flow of investment capital into real estate and 53 percent believe new tax law will result in higher property values **[Figure 3].**

The new tax law could impact the flow of capital into the sector as 31 percent of respondents indicated that the tax law increased their plans to buy real estate. Though intentions to refinance or sell assets rose by a less significant level, these perceptual changes could invigorate investment activity **[Figure 4].** In addition, stronger economic growth created by the tax law changes has the potential to accelerate demand for all types of real estate. When asked how the tax law will influence demand for space across specific property types, more respondents said industrial and apartments will benefit the most at 58 percent and 53 percent, respectively. A reduction in tax obligations should boost discretionary spending, which will benefit the entire logistics supply chain. In addition, the significantly higher standard deduction for taxpayers tips the scales slightly in favor of renting versus homeownership, Hughes says.

Industrial Engine Remains Strong

Investors signaled a modest boost in optimism that real estate values will rise over the next 12 months. However, they are most bullish on industrial with 71 percent of respondents anticipating that values will move higher. Apartment investors followed with 64 percent anticipating gains and 52 percent of mixed-use investors expect values to rise **[Figure 5].** Industrial investors also believe this sector will realize the biggest percentage value gain compared with other sectors, with 6 percent appreciation expected. Apartments followed with a 5 percent increase and a 4 percent gain is anticipated for hotels **[Figure 6].**

E-commerce continues to provide a strong tailwind for industrial. "We have seen vacancies fall to their lowest level on record, and that has occurred even as construction accelerated," says Alan L. Pontius, senior vice president, national director specialty divisions of Marcus & Millichap. Despite the 240 million square feet of new space that was completed in 2017 and another 190 million square feet planned for 2018, Marcus & Millichap predicts that vacancies will decline from 5.1 percent to 4.9 percent by the end of this year.

"Investors see the positive big picture related to the secular shift in industrial, and they also see positive supply and demand dynamics at the local level. So, investors are very optimistic about where industrial is going," Pontius adds. Industrial investors remain consistent in their views on whether it is a good time to buy, hold or sell. About half (51 percent) of industrial investors consider now the time to buy, while 37 percent consider it a better time to hold and 12 percent prefer to sell.

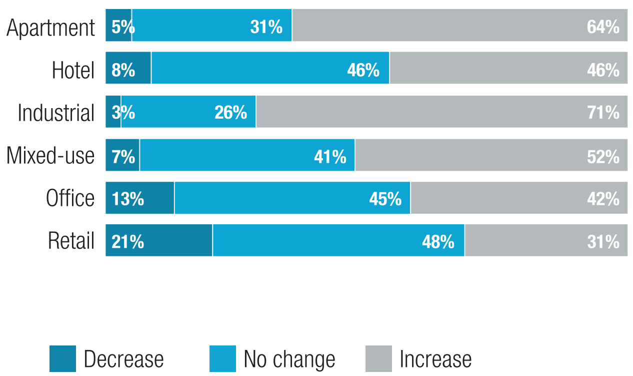
Apartments Adapt to New Supply

Investor sentiment for apartments is holding up under a heavy load of new supply. In fact, respondents are more optimistic that values will rise in the coming year compared with a few months ago. Nearly two-thirds of investors (64 percent) think values will elevate in the coming year compared with 58 percent who held that view in the third quarter survey. The average increase expected also is higher at 5.0 percent compared with 3.8 percent.

"The apartment sector has experienced a dramatic wave of construction over the last five years, but development is still falling short of household formation," says John S. Sebree, first vice president, national director of the National Multi Housing Group at Marcus & Millichap. Millennials continue to fuel demand for rental housing, with the peak age of that cohort still in the mid-20s. "The number of millennials moving out on their own and into an apartment is a key driver of rental demand, and this generation is transitioning into homeownership much more slowly than prior generations. Both

FIGURE 5. **PROPERTY VALUES**

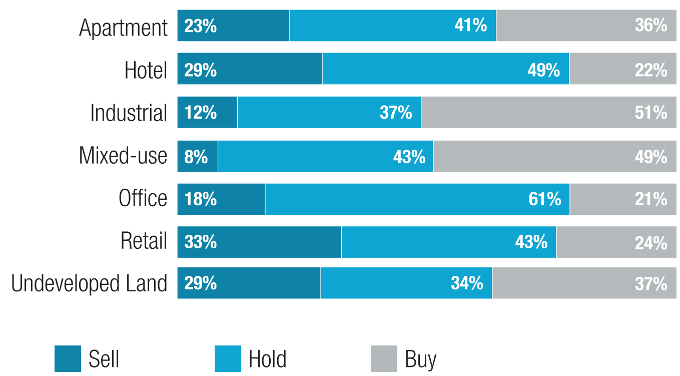
Considering only the property currently in your real estate portfolio, do you expect the property values to increase, decrease or remain the same twelve months from now?



Base: respondents invested in each property type (n varies).

FIGURE 6. **BUY/HOLD/SELL - INVESTORS**

In your view, is now the time to buy, hold or sell each of the following property types?



Base: respondents invested in each property type (n varies).

trends are favorable for apartments, and we don't anticipate a substantive behavior shift anytime soon," he adds.

Another trend that bodes well for apartments is that 2017 was likely the peak in construction activity for this cycle. Developers completed 364,000 units last year and deliveries will taper to about 335,000 in 2018. The concentration of new Class A properties has created some challenges within the upper-tier rental segment, but traditional workforce housing remains exceptionally tight. According to Marcus & Millichap, this has restrained the broader rise in vacancy rates to just 30 basis points this year, with year-end vacancy rates forecast at 5.3 percent.

Apartment owners are split in their views on whether it is a good time to buy, hold or sell. Forty-one percent believe it is better to hold, while 36 percent think it is still a good time to buy and 23 percent see an opportunity to sell.

Office Sentiment Still in a Holding Pattern

Investor perception of office properties adjusted modestly, with a notable reduction of sellers. Sixty-one percent of office owners consider it a good time to hold properties rather than buy or sell assets, which is higher compared with the 46 percent who held that view in the third quarter survey. Sentiment is likely more subdued because improvement in fundamentals, although positive, has been overshadowed by more aggressive gains in other property types, Pontius says. Forty-five percent of respondents believe that property values will remain the same in the coming year. Even though a near equal number, 42 percent, predict an increase, the anticipated climb is a slight 1.3 percent.

Companies growing during this economic cycle have been relatively cautious in their appetite for space. However, confidence has increased significantly over the past year for both corporations and small businesses, and the new tax cuts are expected to spark space demand. "We anticipate companies will become more aggressive in their expansion, which will include office space," Pontius says. "We're already seeing a significant increase in investment into both infrastructure and staffing, and this should translate into rising demand for office space." Marcus & Millichap is forecasting that vacancies will remain steady this year with a slight 10-basis-point drop to 13.7 percent, while rent growth will maintain a positive pace at 1.9 percent.

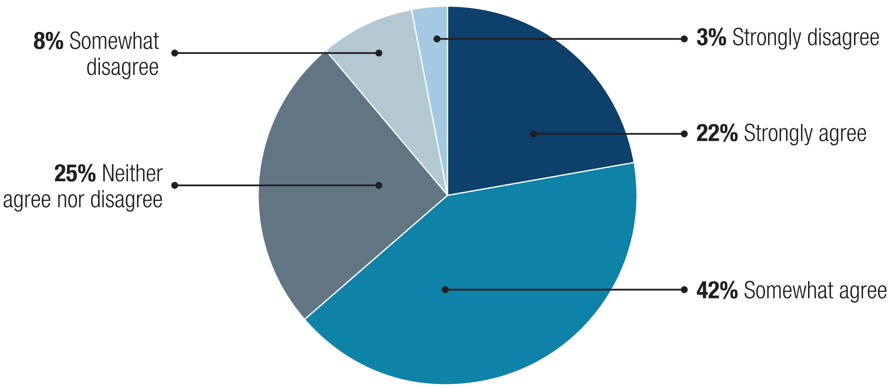
Retail Perception Swayed by Headlines

Retail is having a tough time shaking negative sentiment. "Retail is still living under the media-driven cloud of e-commerce and a perception that brick and mortar retail will face dramatic challenges," says Scott Holmes, senior vice president, national director of the National Retail Group and Net Leased Properties Group of Marcus & Millichap.

Forty-three percent of retail owners think it is a better time to hold properties compared with 24 percent who want to buy more and 33 percent who prefer to sell. Although nearly half of investors believe retail values will remain unchanged, the overall prediction is for a slight decline in values by 0.3 percent.

"People think that if e-commerce is winning, then traditional retail centers must be losing, and that is not the case," Holmes says. E-commerce and traditional retail centers are becoming more intertwined as online sellers like Amazon expand their real-world footprint, and traditional retailers enhance their online presence. Retail vacancies reached 5.1 percent at the end of last year, their lowest level in more than 17 years. Rents grew by 4.0 percent last year and have returned to parity with pre-recession levels that

FIGURE 7. **MARKET OPINIONS**
To what extent do you agree or disagree with the following statements?
"We have an abundance of capital ready to invest."



Base: all respondents (n varies from 584 to 590).

existed in 2007, according to Marcus & Millichap. The key to that performance is that owners are successfully repositioning properties with services, restaurants and experiences that are difficult to replicate online, Holmes adds.

Hotels Find Second Wind

Investor sentiment on hotels, although still cautious, has strengthened notably. Part of that shift is tied to the more favorable outlook on the economy, which drives demand from both business and leisure travelers. Nearly half of respondents (46 percent) predict that hotel values will rise over the next year with an average 4.1 percent increase expected.

A year ago, survey respondents were more cautious about the outlook for the hotel sector. Investors were concerned about overdevelopment risk and whether the sector had reached a peak, notes Peter Nichols, vice president, national director of Marcus & Millichap's National Hospitality Group. However, perceptions that there will be an extension of the growth cycle along with declining construction are giving investors more confidence. Nearly half of hotel owners think it is a better time to hold at 49 percent compared with 22 percent who believe it is a good time to buy and 29 percent who would rather sell.

Another positive for hotels is that there is a lot of reinvention occurring in the space with new brands and concepts emerging, such as experience-related stays and hotels that cater to millennials, Nichols adds. "So, investors are looking at hotels with a little bit of rejuvenated optimism," he says. Marcus & Millichap is predicting that occupancies will rise 30 basis points to an average of 66.3 percent this year, while ADR and RevPAR growth will remain positive with growth of 2.5 percent and 2.8 percent, respectively.

Potential Headwinds Linger

Increased clarity on tax policy is a positive for investors because it alleviates uncertainty and strengthens views that there is still room for late cycle growth. Most respondents continue to agree that commercial real estate offers favorable returns compared with other investment classes, and 64 percent have "an abundance of capital" ready to invest **[Figure 7].** "Even though we are in a rising interest rate climate, the flow of capital into commercial real estate remains quite strong," Chang says.

Yet investors are cognizant of potential headwinds that could come into play. "You have very positive dynamics that are likely to accelerate growth and demand for real estate space, and then there are counterweights including the potential for increased inflation and rising interest rates," Chang says. "So, if inflation materializes and a prolonged period of rate increases comes into play, it could weigh on the invigorated enthusiasm for the sector." ■

Survey Methodology

National Real Estate Investor's research unit and Marcus & Millichap e-mailed invitations to participate in this online survey to public and private investors and developers of commercial real estate. Recipients of the survey included Marcus & Millichap clients as well as subscribers of NREI selected from commercial real estate investor, pension fund, and developer business subscribers who provided their email addresses. The survey was conducted between Jan. 31 and Feb. 14, 2018, with 592 completed surveys received. Survey respondents represent a broad cross section of industry respondents that include private investors, developers, advisers, lenders and REITs. The largest percentage of respondents are private investors at 45 percent. Respondents are invested in a variety of property types with a majority of 61 percent invested in apartments. On average, respondents have $36.3 million invested in commercial and/or multifamily property.

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