Real Estate Research

Commercial Real Estate Market Monitor

July 2014

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Peter Muoio, Ph.D.
Senior Principal
1 646-352-9510
pmuoio@auction.com

William Travers
Vice President
1 212-871-7778
wtravers@auction.com

Matthew Schreck
Analyst
1 212-871-2121
mschreck@auction.com

www.auction.com

EXECUTIVE SUMMARY

- **Commercial real estate transaction metrics are trending in a positive direction**, with deal volume and pricing up, and cap rates and risk premiums down.
- **Some sectors' transaction metrics appear to be tapering off**, like apartment, with relative volume down and pricing leveling off. **However, other sectors like industrial are on the rise**, alluding to expected future improvements in sector fundamentals.
- **Total transaction volume among the five major sectors is up from a year ago, as is pricing.** Year-on-year pricing growth is currently positive in each of the major CRE sectors.
- **Risk premiums**, the component of cap rates excluding the risk-free 10-year US Treasury rate, **have declined over the past year**, a sign of confidence in the CRE marketplace. The apartment sector currently boasts the lowest risk premium in the mid-3% range.
- **This issue's featured spotlight is on the office sector.** The office sector is enjoying steady pricing growth and cap rate compression, while the office risk premium is just 50 bps higher than its 10-year average.
- The office sector can be further subdivided into the CBD and suburban office components. **CBD office pricing is 77% higher than suburban office pricing**, and CBD prices have grown faster than suburban prices since 2012, widening the gap.

Commercial Market Activity Overview

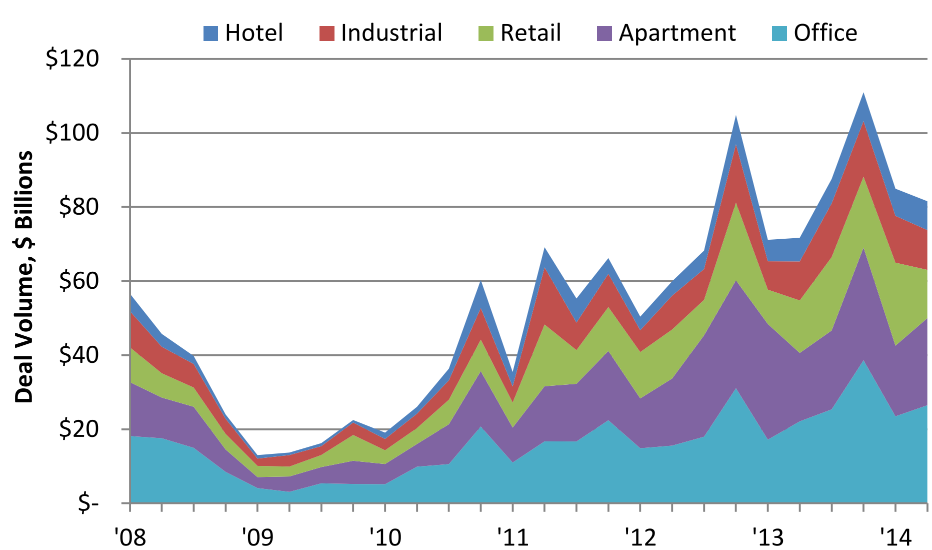
CRE transaction metrics are very healthy by-and-large, with volume and pricing up, and cap rates and risk premiums down.

The commercial real estate market picture continues to brighten, as investors pursuing yield in the current low-interest rate environment have driven transaction volume and pricing back up to healthy levels. Cap rates have also compressed significantly since 2008-09 notwithstanding increased Treasury rates since last June, and the risk premium component of cap rates is on the decline across a majority of real estate sectors, signaling confidence in the market via a lower return on the additional risk of investing in real estate.

Total commercial volume in the office, retail, apartment, industrial and hotel sectors combined for $81.6 billion in the second quarter of 2014, a nearly 14% increase from a year ago. Office and apartment transactions combined to account for more than 55% of the five-sector total in the second quarter, similar to their proportion of transactions a year ago. After accounting for more than 26% of five-sector total volume in the first quarter, retail transaction volume dropped back to 16% of the total in the second quarter, per RCA. We remain cautious of investment in retail, as the sector continues to face many headwinds, including the rise of online shopping and shrinking space needs per customer.

The apartment sector is making up a smaller portion of total volume lately, as the sector's cycle has matured. Retail, on the other hand, is seeing heightened trading volume.

CRE Deal Volume Is Healthy, Up from Its Recessionary Lows, Led by the Historically Dominant Office Sector



Sources: RC Analytics, Auction.com Research

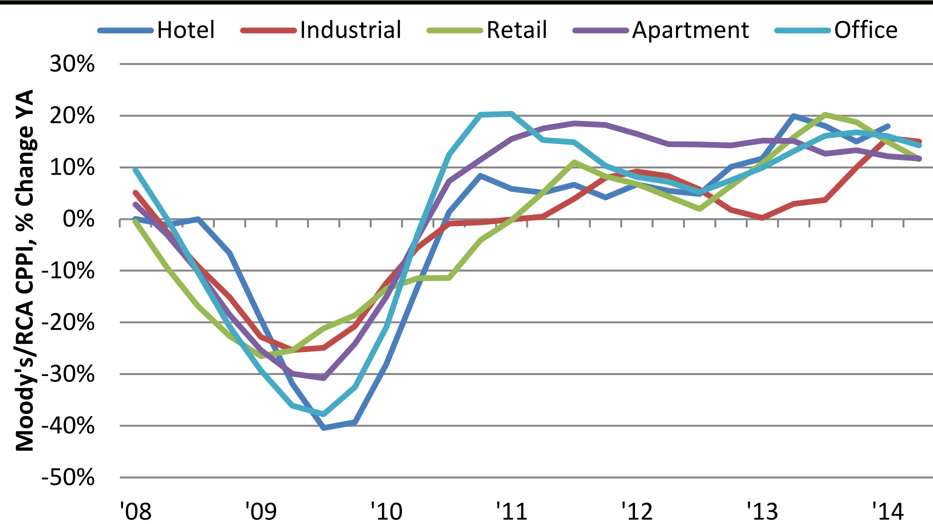
Consistent with increasing deal volume and frothy yield chasing, property pricing, per the Moody's/RCA Commercial Property Price Indices (CPPI), is on a steady upward trend. Year-over-year growth has been positive for each of the four major real estate sectors for nearly a year now, with industrial pricing making the most recent meteoric rise. The sector posted slightly negative year ago growth in July 2013, but price growth skyrocketed to 15% year-on-year in May 2014, the most recent data available. Industrial price growth is now second to hotel among the major sectors, which dovetails with our belief that the sector will be the next (after apartment but before office and retail) to stage a strong recovery in fundamentals.

Pricing is up across all CRE sectors, signifying widespread optimism.

Also of note, apartment year-ago price growth has flattened, reflecting the more mature portion of cyclical expansion for this segment following robust gains over recent years. The retail sector saw a surge in price growth in 2013, similar to what industrial pricing is seeing now, but year-ago gains have decelerated in recent months, dovetailing with our view that secular headwinds for retail make this a segment that investors need to take a rifle and not shotgun approach to investing. Office pricing continues to make steady headway.

Hotel sector pricing, which is most recently available through March 2014, has averaged between 15% and 20% year-over-year growth since June 2013, reflecting the recent strength in the hotel market nationwide.

Year-Over-Year CRE Pricing Shows Industrial Sector Growth Accelerating



Sources: Moody's, RC Analytics, Auction.com Research

Industrial price gains have led the way recently, with year-over-year growth surging to 15% most recently.

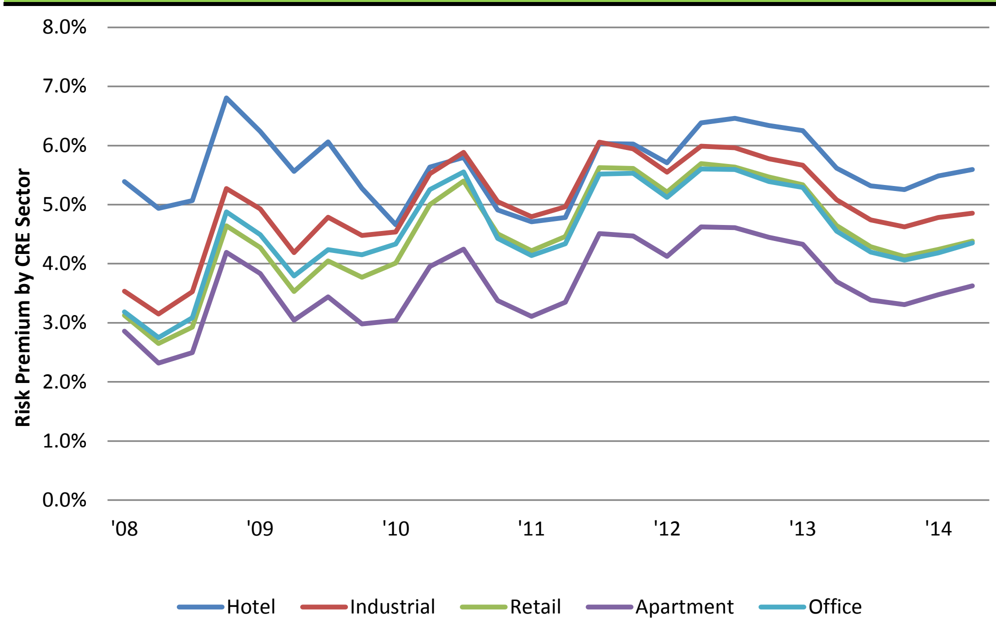
The risk premium we calculate is a component of cap rates that factors out the risk-free rate (typically the 10-year US Treasury) and focuses in on the return in excess of the risk-free rate that an investment is expected to yield. It is essentially the extra risk on top of the risk-free rate that investors tolerate when investing in a certain asset class.

Our calculations of risk premiums show that they have declined slightly from a year ago and more significantly from two years ago. This improvement has enabled overall cap rates to continue to decline despite higher interest rates. However, risk premiums are still higher than they were in 2008, in the midst of the recession and its aftershocks, which signals the potential for further cap rate compression even in a presumed higher interest rate environment as the Fed ends its quantitative easing.

Our risk premium calculations factor out the risk-free rate, and focus instead on the extra risk investors tolerate for certain asset classes.

The apartment sector currently offers the lowest risk premium, while hotel is the highest, as has been the case in recent years.

CRE Risk Premiums Have Declined Across All Sectors Since Mid-2012, with Apartment Offering the Least Return on Risk



Sources: RC Analytics, Department of the Treasury, Auction.com Research

CRE risk premiums have dropped in the past few years, with the apartment sector currently the lowest.

Cap rates have been trending down in all five major property sectors recently. Across all five sectors, values are now below their 10-year average, and apartment cap rates are currently at a 10-year low point. Hotel is the only sector that has seen rates rise modestly in the past few years, the sector cap rate bottomed at 7.9% at year-end 2011.

Cap Rates Are Below Their 10-Year Average Across All Five Major Sectors

CRE Sector	Current Cap Rate	10-Year Average	High	Low
Office	6.9%	7.2%	8.2%	6.6%
Apartment	6.2%	6.4%	6.9%	6.2%
Retail	6.9%	7.1%	7.9%	6.5%
Industrial	7.4%	7.6%	8.5%	6.9%
Hotel	8.1%	8.6%	9.4%	7.9%

Sources: RC Analytics, Auction.com Research

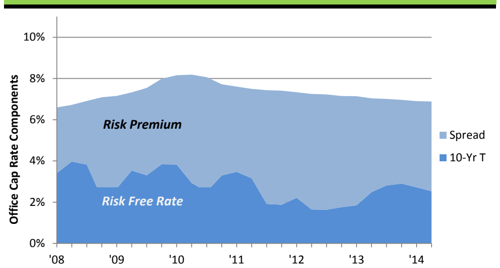
Segment Spotlight: Office

Each quarter we will be taking a closer look at one of the major CRE sectors. July's segment spotlight casts a more refined focus on the office sector. From a historical perspective, the office sector typically accounts for the largest share of CRE transaction volume, and runs in the middle of the pack in terms of average pricing and cap rates.

Office transaction volume has recovered to a healthy level from its recessionary lows, and has seen the most volume of any major sectors in each of the last five quarters.

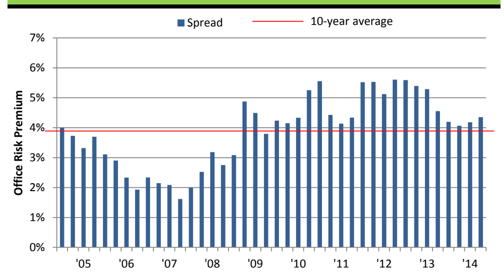
The sector's risk premium charts illustrate movements in both the risk-free rate and the risk premium. Treasury yields jumped in mid-2013 and stabilized at the elevated level just under 3%, before dropping back to 2.5% most recently. However, the overall office cap rate has compressed 10 bps from a year ago to 6.9%, owing to the drop in the risk premium over the same timeframe. The office risk premium has contracted 125 bps since its recent peak of 5.6% in mid-2012, and has been operating above its ten-year average. The 10-year average is skewed downward by the very low office risk premiums in the years leading up to the recession, specifically 2006 and 2007. Office risk premiums have compressed recently to within earshot of this 10-year average though. The current risk premium is 4.35%, lower than all other major sectors besides apartment.

Office Cap Rates Have Edged Below 7%, as a Drop in the Risk Premium Has Countered an Increase in the Risk-Free Rate



Sources: RC Analytics, Department of the Treasury Auction.com Research

Office Risk Premium Is 46 bps Higher than Its 10-Year Average of 3.9%

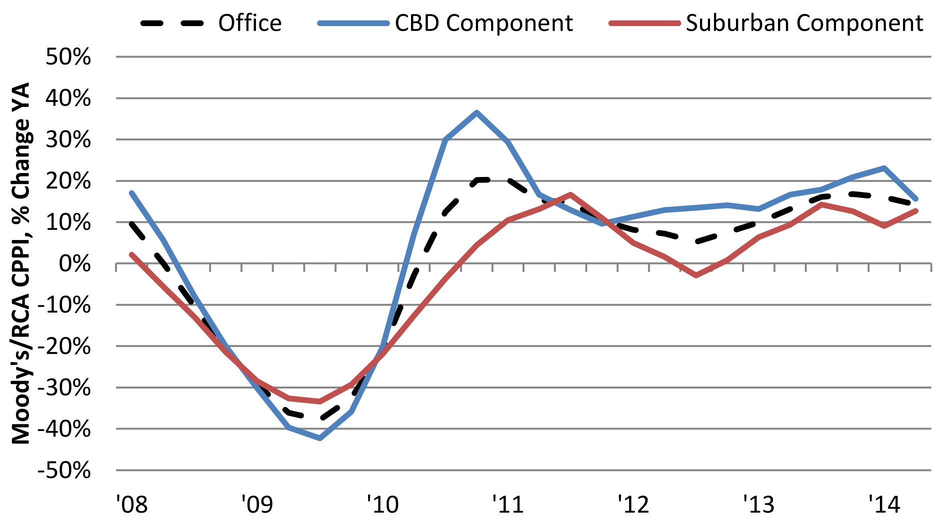


Sources: RC Analytics, Department of the Treasury, Auction.com Research

The office risk premium has declined to within 50 bps of its 10-year average, and pricing is on the rise among both CBD and suburban components.

Office space can be broken out into two components, CBD and suburban office space. CBD space is generally a safer investment due to its centralized location and generally more constrained supply, making it less prone to cyclical volatility. As such, vacancies trend much lower among the CBD breakout, resulting in a higher price per square foot. CBD office investment comes at a premium, with prices currently 77% higher than suburban office. However, CBD prices have also enjoyed consistently stronger year-over-year growth since 2012, widening the gap further.

CBD Office Pricing Has Seen Stronger Year-Ago Growth than Suburban Office Since 2012



Sources: RC Analytics, Auction.com Research

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