Second Act of Market Recovery Takes a Bow

Commercial market barometers in 2014 point to continued growth in 2015

By Dianne P. Crocker

With 2014 coming to a close, an analysis of the year past reveals a commercial real estate market that is continuing its second act of recovery. The end of the year offers an opportunity to take a look at the current state of the commercial real estate dealmaking climate, how attitudes toward risk are changing, what the year ahead is likely to bring, and what it all means for mortgage brokers planning for 2015.

Recovery gains traction

The market's recovery from the financial collapse has been prolonged and choppy. Despite a rocky start to the year during the first quarter — blamed by many on Mother Nature and a harsh winter — the strong rebound in economic growth during the second and third quarters did much to improve the outlook for all major commercial real estate sectors.

With 2014 nearly over, a list of barometers from the past year point to a healthier environment for real estate transactions:

- **Job market:** This has been a bright spot of the economy this year, with the U.S. unemployment rate declining from 6.7 percent in December 2013 to 5.9 percent this past September.
- **Corporate earnings:** These have continued to improve, building executive-level optimism and driving more investment in commercial space.
- **Investment:** Investors are actively closing deals, not, as it may have seemed in the recent past, peeking out through the blinds to see if it is safe to come out.
- **Market fundamentals:** Lower vacancy rates, higher property pricing, higher rents and better returns for investors indicate improving fundamentals.
- **Low interest rates:** The market is still enjoying a low-interest-rate environment.
- **Investment allocations:** Major investors are increasing their allocations to commercial real estate.
- **Loan and lease increases:** As of mid-September, total loans and leases for commercial real estate at U.S. banks were 7.3 percent higher than they were at the same time in 2013.
- **Construction and design work:** This category is finally up, marking an important start to a new development cycle as projects stalled during the downturn get underway again.

Deals expand outward

Another trend characterizing 2014 has been double- digit growth in property transaction volume. Large sales of principal properties were up a strong 23 percent over the first two quarters of 2013, nearly rivaling the midyear total in 2006. For small-cap property sales, the trend was even more impressive. Midyear sales were nearly 33 percent above the 2013 pace, which was the highest level the market had seen in seven years.

Also noteworthy is that a different mix of properties is changing hands. The geographic hot spots are transitioning from lower-risk primary metros to secondary ones as investors seek higher yields and less-intense competition.

Much like the American Institute of Architects Architecture Billings Index is used as a barometer of construction to come, the output from EDR's ScoreKeeper model shows where the attention of investors is growing in terms of rising demand for environmental site assessments (ESA). Up until recently, the strongest growth metros for ESAs — and therefore real estate investment — were the primary gateways like Chicago, New York City, Los Angeles, Boston and Washington, D.C.

ScoreKeeper output for the first three quarters of 2014 reflects that the greatest increases in environmental due diligence are found in secondary metros like Cincinnati, Austin, Texas, and Oklahoma City. Notably, three of the top 10 fastest-increasing metros are in Texas, which is not surprising considering the strength of the Texas economy and the state's job market. Austin in particular is currently one of the strongest commercial real estate markets in the country.

These findings provide evidence that a number of secondary markets that were severely challenged by the recession are now recording sharp gains and attracting the attention of investors.

The fuel for a healthy commercial real estate market is liquidity, and EDR Insight's data from a survey this past September of commercial real estate lenders suggests that conditions are improving dramatically. Survey results indicate that economic growth is strengthening, which encourages more demand for property loans from creditworthy borrowers.

The survey collected data from environmental risk managers and loan officers at banks of all sizes across the U.S. The vast majority,

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89 percent, said they have seen either meaningful or marginal improvement in credit availability for commercial real estate in 2014.

The survey also revealed increased borrower interest. Compared to the same time period last year, 46 percent of lenders said there was more serious borrower interest on loans for commercial properties, with only 11 percent of respondents reporting fewer inquiries.

Elevated risk aversion

A companion survey to the lender survey was conducted among environmental due-diligence professionals that serve lenders, investors and other types of clients to determine whether risk tolerance was tightening or relaxing at the current stage in the market's recovery.

In response to a question about their clients' risk tolerance in 2014 versus 2013, 53 percent of respondents said they observed the same level of risk aversion, while 30 percent reported their clients were now more risk-averse. Only 17 percent characterized their clients as less risk-averse than they were in 2013. Similarly, the majority of respondents agreed with the statement that clients are demanding more thorough due diligence on properties — not less.

New opportunities

As market fundamentals improve, property interest expands into secondary markets and risk aversion remains high, opportunities are materializing for commercial real estate brokers, lenders, investors and other parties who serve the commercial property market.

Many commercial property owners, developers and local governments positioned themselves well during the Great Recession so that previously shelved projects could be restarted in this strengthening economy. Because of the quest for more investments and increased interest in suburban locations, once-questionable sites are now being considered — sites that buyers would have walked away from in the past.

The slow start in first-quarter 2014 gave way to healthy levels of commercial real estate lending and investment in the second and third quarters. More dollars were steered into property deals, more investors got in on the action and transactions took on a broader geographic reach.

As the year winds down, loan-origination volumes are growing, if uneven, and are expected to continue to increase over time. Looking ahead to 2015, momentum is expected to continue building, especially as job growth sets the stage for more property deals involving a wider array of properties in a greater number of markets.

There is an across-the-board viability to the market recovery that bodes well for continued overall growth, yet the sentiment remains one of high caution as recovery marches on. With the caveat that the accuracy of the proverbial crystal ball depends on a number of factors outside of anyone's control — including concerns about Middle East tensions — the outlook for 2015 is generally positive.

Barring an unforeseen upset, 2015 should bring a sustained acceleration that will break the U.S. commercial real estate market out of its postrecession pattern of choppy, halting growth. ■