Lack of Market Clarity Will Amplify Focus on Specific Asset Classes

By **John Kevill**

There has been much discussion over the past year about where commercial real estate is in the current cycle. Are we near the end? Does the cycle still have legs? What has become clear (at least to me) is that the answer to the question, " Where are we in the cycle?" varies for each market participant, depending on risk tolerance, cost of capital, preferences on asset class and need for debt capital. Just take a look at the top-line metrics for 2017 year-to-date, and you will see what I mean.

Generally, deal volume is off as much as 25 percent, but it's not uniformly lower across all asset classes and markets. Top-level pricing, however, has held steady. Year-to-date sales volume in office is off (10 percent) generally, but certain markets are up, and some are down significantly. New York, for example, is off—by some accounts 30 percent—in volume thus far in 2017. Multifamily sales, on the other hand, are down nationally from an overall volume standpoint, but pricing has continued to rise noticeably in more urbanized locations. Industrial has been another bright spot from a pricing standpoint. Volumes in the hotel and retail sector have been harder hit, with macro issues causing sellers to pull back dramatically from bringing deals to market. The bottom line here is that volume isn't necessarily an indicator of overall market health, but rather an indicator in the level of conviction of the various market participants.

When people look back at 2017, one of the main stories will be how specific the levels of conviction were across markets and property types:

- Office investors who are more IRR-driven are having a very difficult time making sense of near-term leasing exposure. In many instances, the largest underwriting variable is the amount of time to lease-up. And if that is unclear, IRRs are required to go up and a bid-ask spread can develop between buyers and sellers. Low level of conviction.
- The effects of e-commerce on industrial are still playing out, but there is no question that the sector has experienced tightening fundamentals. Global appetite for industrial assets has led to a surge in foreign investment into the U.S. and a preponderance of major deal activity. High level of conviction overall.
- Hotel owners are increasingly choosing to refinance debt in lieu of outright sales, opting to tap into low-cost debt rather than test the waters of a hotel investment sales market that has been generally stagnant from a pricing standpoint. Low level of conviction.
- Senior-housing momentum is growing. The mix of players is changing, and large institutional investors are now replacing some of the larger public REITs as buyers. Pricing remains favorable for sellers, with the average price per unit remaining near record highs, while cap rates remain relatively low. Many trades have involved older product selling to private buyers, but when institutional-grade product and an institutional operator are involved, deals are being made. Level of conviction high with institutional-grade product.
- Urban infill multifamily is in demand and seeing near-peak pricing for established properties with some markets still seeing build-to-core development. Conviction level high for amenity-rich properties.

For 2018, we expect this trend of specific asset class and market preferences to continue to amplify. We should also see an increase in demand coming from private investors fueled by strong debt markets and an increased desire for real estate exposure coming from the private sector, mitigating somewhat the recent slowdown in asset-level transactions. In fact, there may well be an increase in activity for institutional-grade product, particularly on the office side. ■

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