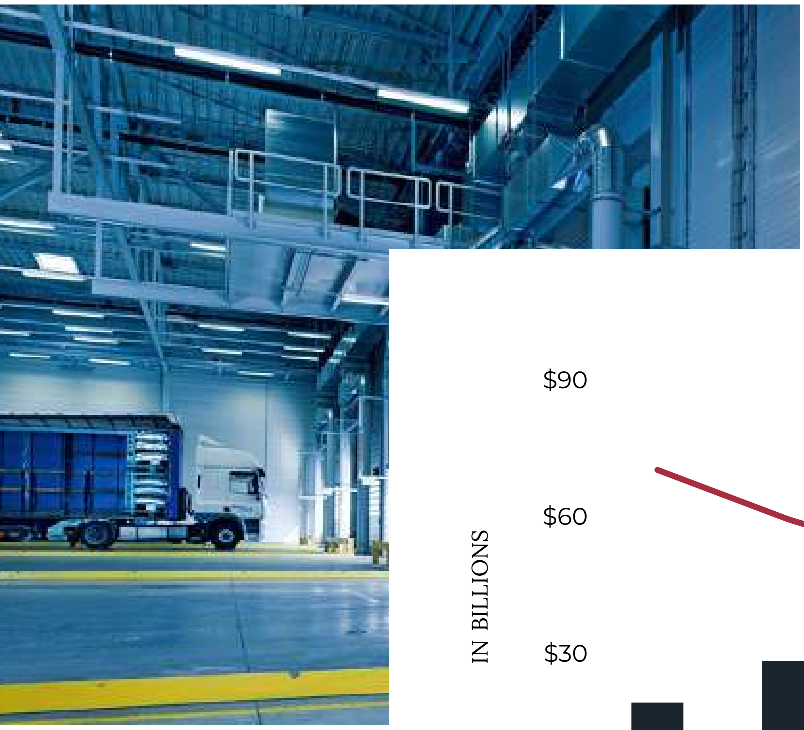
2022 — MidYear Review

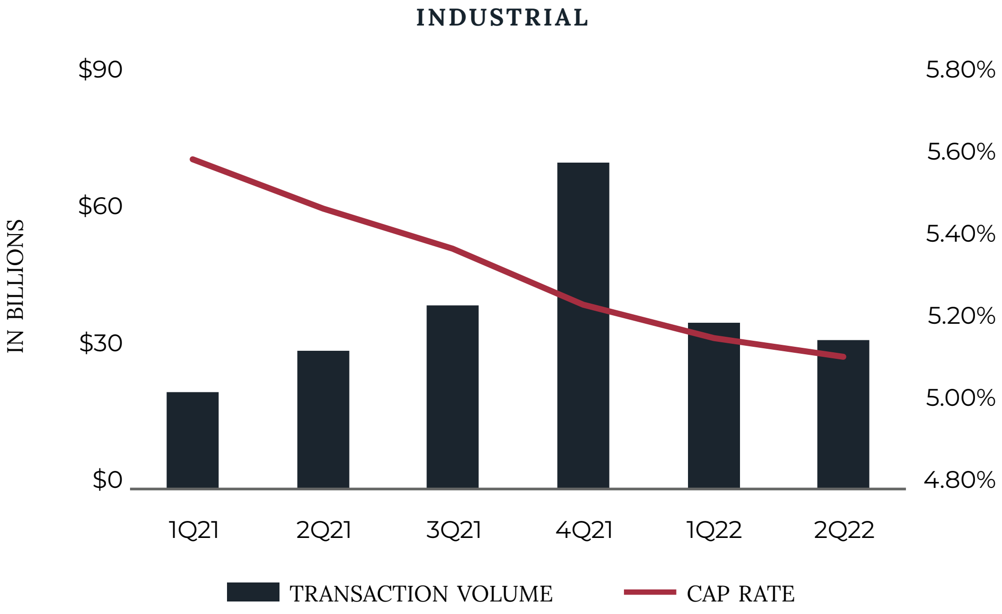
During the first half of 2022, persistent inflation, interest rate hikes, ongoing supply chain disruptions caused by COVID-19 and the conflict between Russia and Ukraine all contributed to a slowdown in economic activity and an annualized 1.6% decline in GDP in the first quarter.

These forces continued to exert downward pressure on the economy in 2Q22, resulting in an annualized .9% decline in GDP during the quarter. Despite the challenges facing the economy, in 1H22, commercial real estate trade activity increased by 38% YOY to $376 billion.[1] However, performance varies depending on the property type and market, and as the year progresses, the economic headwinds described above may begin to impact transaction volume, cap rates and valuations to a greater degree than they did in the first half of 2022.



INDUSTRIAL

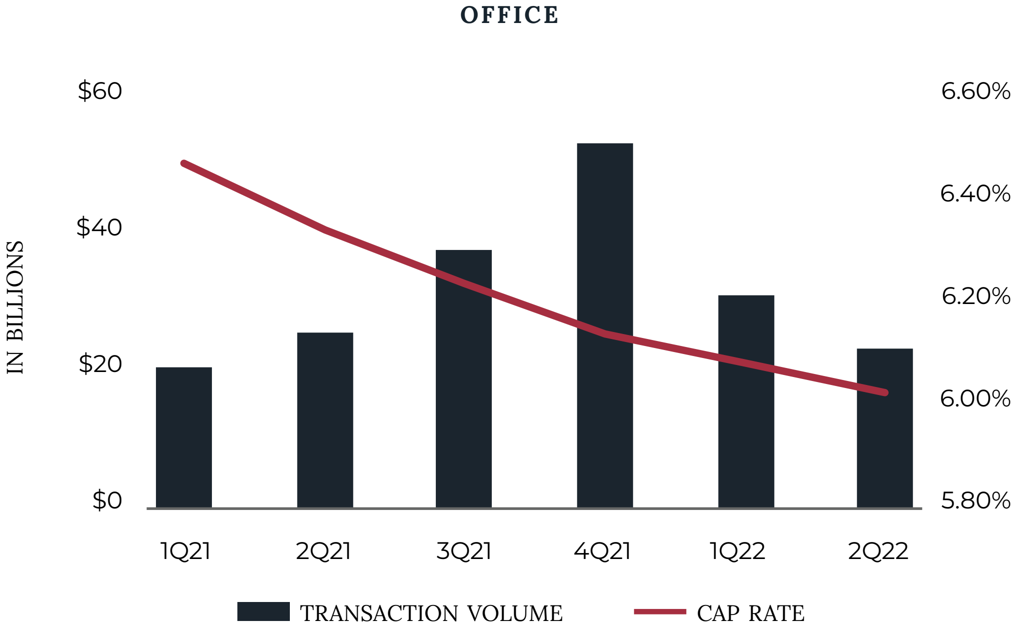
After a strong showing in 2021, the industrial sector continued to perform well in 1H22. The sector recorded $74.6 billion in transaction volume, a 35% increase YOY and the average cap rate fell to 5.2% in June, a 30 bps decline YOY.[2] Transaction activity was strongest in Dallas, which recorded $4.5 billion in trades, followed by Los Angeles ($4.1 billion), Chicago ($3.2 billion), the Inland Empire ($3 billion) and the Washington, D.C.-Northern Virginia market ($3 billion).[3] In May, Amazon announced that it would sublet some of its older warehouses, leaving some to wonder if the industrial market was cooling down; however, demand for industrial properties remained strong and contributed to a historically low national vacancy rate of 3.9% in June.[4] Demand for industrial properties is being driven by strong retail sales (inflation adjusted retail sales were up approximately 17% at the start of June when compared to February 2020) and increased onshoring.[5]



Source: MSCI/Real Capital Analytics. **www.rcanalytics.com**

OFFICE

In 1H22, the office market recorded $57.8 billion in transaction activity, a 17% increase YOY and the average cap rate fell to 6% in June, a 40 bps decline YOY.[6] The most active markets for transaction activity were Manhattan with $6.1 billion in trades, Los Angeles ($3.1 billion), Seattle ($3.1 billion), Dallas ($2.9 billion) and Boston ($2.9 billion).[7] Companies continued to assess their office needs during the period and vacancy levels remained elevated. Net absorption was negative 13.2 million sf and vacancy rose to 18.9% at the end of 1H22.[8] For CBD Class A properties, effective rents declined by 1.9% in 2Q22 and finished the quarter 6% less than their pre-pandemic levels. Reflecting a continuing flight to quality for leaseholders, the majority of negative absorption occurred among Class B and Class C units. Since the COVID-19 pandemic began, net occupancy has increased by 86.8 million sf for new supply, but declined by 246.5 million sf for older properties. Overall, 26.5 million sf of new supply was delivered in 1H22. This puts 2022 on track to eclipse 2021's 50 million sf in deliveries. The total construction pipeline at the end of 1H22 was 104.3 million sf, representing 2.2% of total inventory.[9]

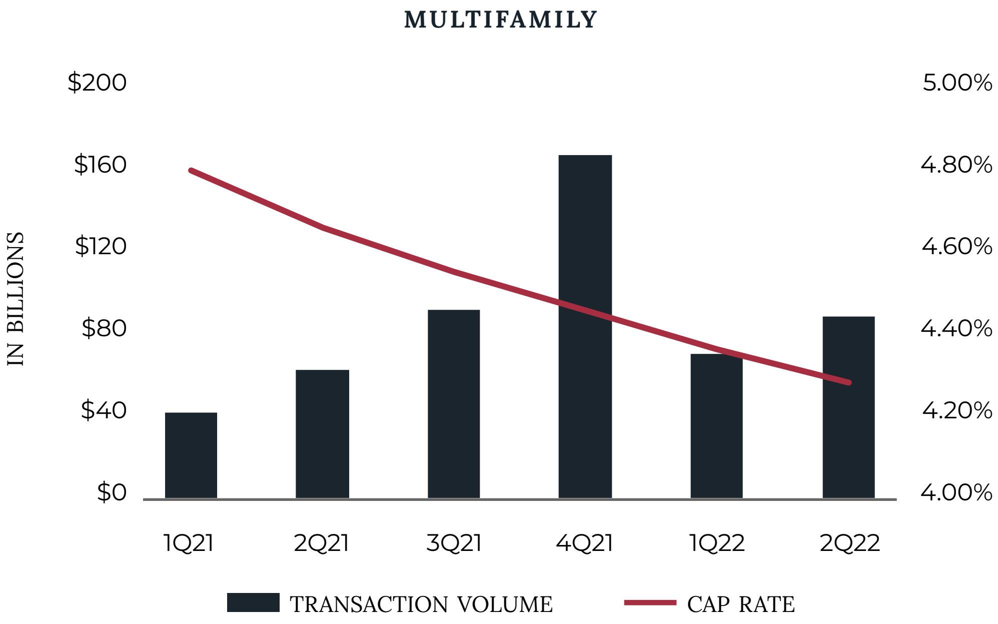


Source: MSCI/Real Capital Analytics. ***www.rcanalytics.com***

MULTIFAMILY

Fueled by a healthy labor market, consistent wage growth, and a shortage of affordable single-family homes for prospective home buyers, demand for multifamily assets remained strong during the first half of the year. The sector recorded $154.6 billion in transaction activity, a 53% increase YOY and the average cap rate fell to 4.3% in June, a 40 bps decline YOY. The most active markets for multifamily trades were Dallas ($12.6 billion), Phoenix ($8.1 billion), Houston ($8 billion), Atlanta ($7.8 billion) and Los Angeles ($5.4 billion).[10] Rent growth also continued in 1H22, albeit at a slower pace than 2021's record-setting clip. While rents increased by nearly 15% in 2021, asking rents increased by 5.7% in 1H22.

There are approximately 900,000 multifamily units under construction and 420,000 units are expected to be delivered in 2022.[11] If these deliveries take place, it would be the highest number of deliveries since before the Great Financial Crisis. Dallas is expected to deliver the most units with 23,600, followed by Miami (19,100 units) and Austin (18,300 units).[12] Going forward, multifamily property owners will be scrutinizing new supply to see if they are achieving the rates that were underwritten or if rent increases are beginning to discourage prospective renters from executing new leases.

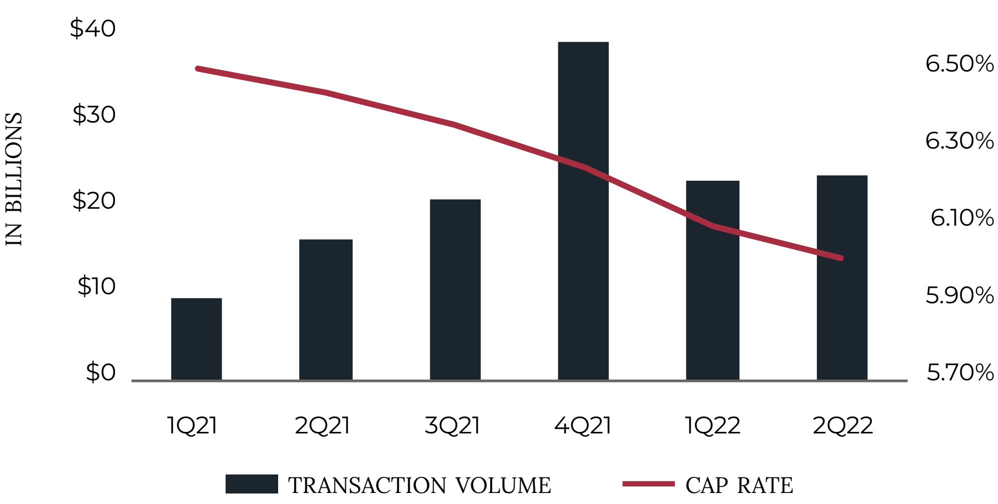


Source: *MSCI/Real Capital Analytics.* **www.rcanalytics.com**

RETAIL

In 1H22, the retail sector recorded $44.7 billion in transaction activity, an 81% increase YOY and the average cap rate fell to 6% in June, a 30 bps decline YOY.[13] The leading markets for trades were Los Angeles ($2.2 billion), Chicago ($1.7 billion), Atlanta ($1.5 billion), Dallas ($1.5 billion) and Houston ($1.3 billion).[14] Strong consumer sales contributed to demand for retail properties and a decline in the national vacancy rate to 4.9% by the end of the second quarter.[15] Net absorption was 39.2 million in 1H22, a 59% increase YOY and retailers announced almost seven times more store openings than closures.[16] Roughly 60 million sf of retail space remained under construction at the end of the second quarter, with Houston leading the way at 4.4 million sf, followed by Miami (3.5 million sf), New York (3.2 million sf), Dallas-Fort Worth (3.1 million sf) and Washington, D.C. (2.4 million sf).[17] The markets with the most total inventory in June were New York (622 million sf), Chicago (584 million sf), Dallas-Fort Worth (452 million sf), Los Angeles (445 million sf) and Houston (426 million sf). In addition, after four consecutive years of negative net absorption totaling nearly 20 million sf, malls reported positive net absorption of 2 million sf in 1H22.[18]

RETAIL



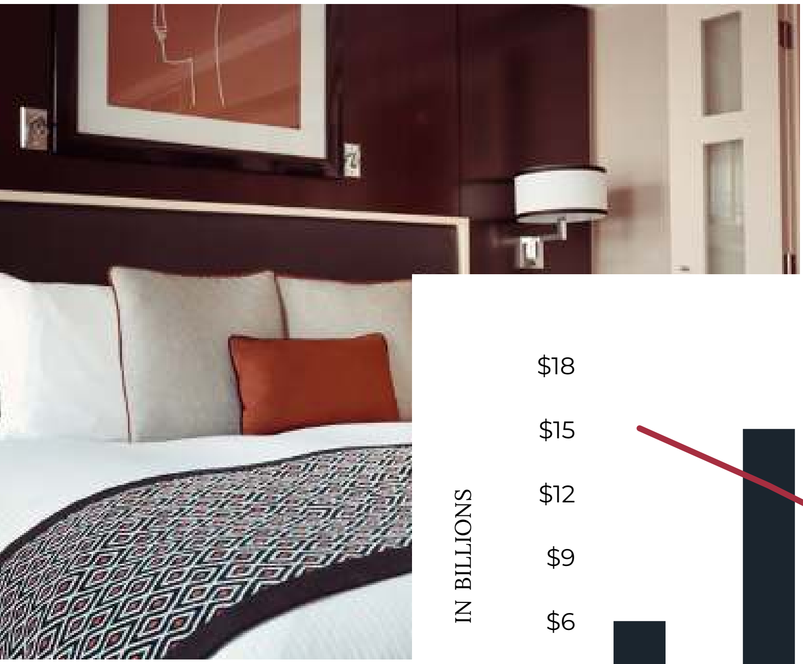
Source: MSCI/Real Capital Analytics. www.rcanalytics.com

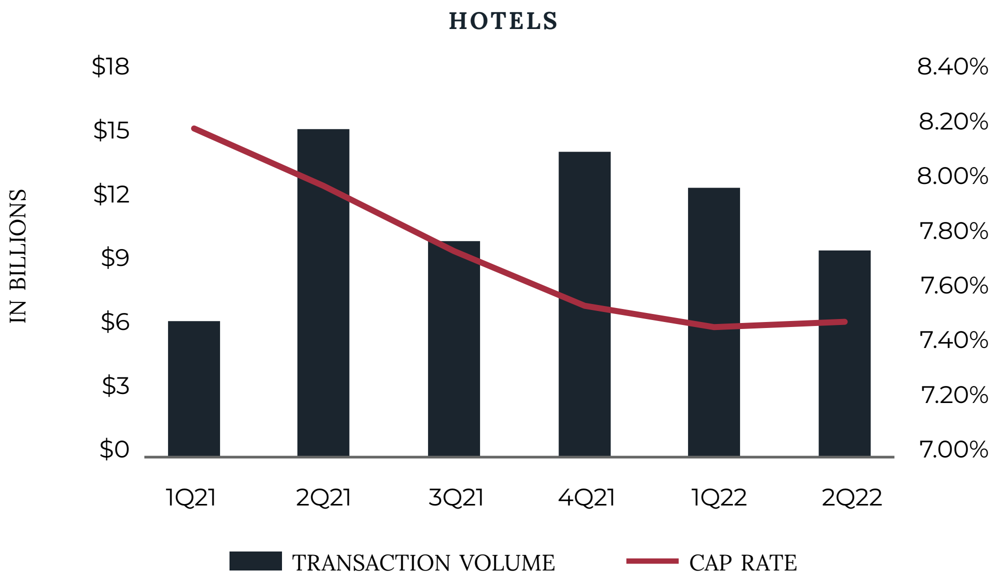
HOTELS

In 1H22, the hotel sector benefited from positive trends in leisure and business travel and continued its slow recovery from the pandemic-driven lows it experienced in 2020. The sector recorded $22.4 billion in transaction activity, a 2% increase YOY and the average cap rate fell to 7.5% in June, a 50 bps decline YOY.[19] Trade activity was highest in Dallas ($1.2 billion), Manhattan ($870 million), Austin ($839 million), Nashville ($714 million) and Los Angeles ($647 million).[20] To offset increasing labor and construction costs, hotel owners raised rates during the period and this helped produce an average daily rate (ADR) of $155 in June, a 15.3% increase over June 2019. Rate increases also boosted revenue per available room (RevPar) to $109 at the end of 1H22, up 10.3% when compared to June 2019, and the national occupancy rate was 70.1% at the end of 1H22, down 4.3% from June 2019.[21]

Regarding development, there were 149,198 rooms in the construction phase at the end of 1H22, a 20% decline YOY.[22] This decline is partly being attributed to uncertainty regarding when demand will return to pre-pandemic levels in central business districts and gateway markets, and to rising debt costs and supply chain disruptions that have led to a shortage of construction materials. The top 5 markets with rooms under construction as a percentage of existing supply at the end of 1H22 were New York (10.8% and 13,568 rooms), Nashville (7% and 3,939 rooms), Phoenix (6.3% and 4,388 rooms), Atlanta (5.5% and 5,991 rooms) and Detroit (5.1% and 2,382 rooms).[23]

STR and Tourism Economic are now forecasting that because of higher room rates, nominal RevPar will exceed 2019's levels this year. However, after adjusting for inflation, ADR and RevPar are not expected to return to pre-pandemic levels overall until 2024. RevPar for hotels in central business districts and gateway markets is not expected to return to pre-pandemic levels until after 2024. In a positive sign for the sector, lodging delinquencies and CMBS special serving rates continued to decrease in 1H22 as rates and revenues rose. The CMBS delinquency rate declined from 8.8% in December 2021 to 5.9% in June 2022 and the special servicing rate declined from 13.7% in December 2021 to 7.9% in June 2022.[24]





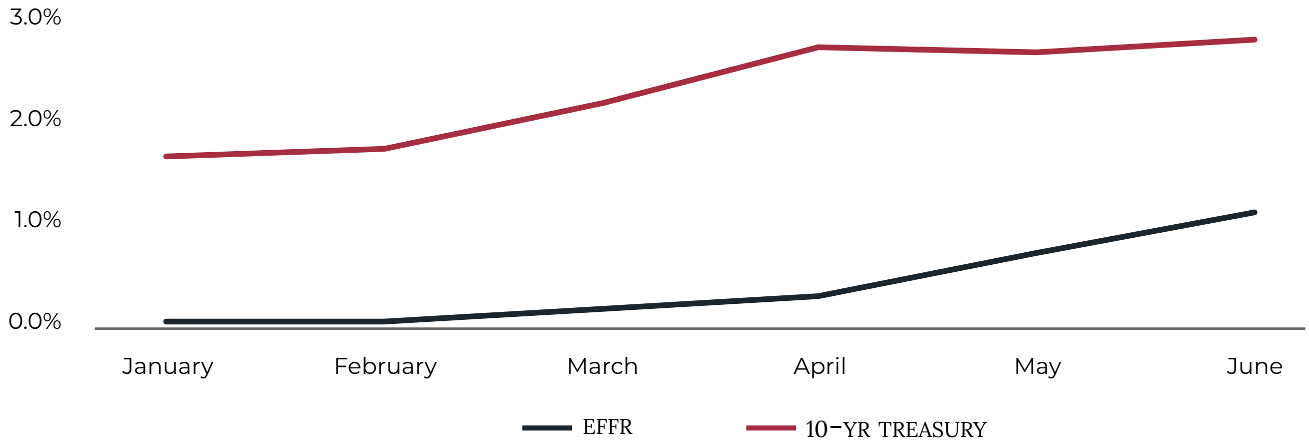
Source: MSCI/Real Capital Analytics. www.rcanalytics.com

CONCLUSION

Even with high levels of inflation and rising interest rates, trade activity increased by 38% YOY to $376 billion during the first half of 2022. This activity was supported by positive economic fundamentals, including the economy creating 2.2 million jobs, a 5% YOY increase in wages, and consumer spending increasing each month during the period despite inflationary pressures.[25] In response to persistent inflation, the Federal Reserve increased the target range for its benchmark federal funds rate from 0% to .25%, to 1.5% to 1.75% and Fed officials are projecting a median rate of 3.4% by the end of the year. Mirroring the increase in short-term interest rates, the yield on the 10-year treasury rose from 1.51% at the end of 2021 to 2.97% at the end of 1H22. In addition to rising interest rates, the cost of several major construction inputs increased by double-digits YOY through June 2022, including steel mill products (22.4%), concrete (13.5%) and plastic construction products (27%).[26] As the second half of the year gets underway, higher interest rates and elevated construction costs may have a greater impact on commercial real estate activity than they did during the first half of 2022.

EFFECTIVE FEDERAL FUNDS RATE VS 10-YEAR TREASURY YIELD

1H22



Source: Yahoo Finance, St. Louis Federal Reserve

ENDNOTES

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