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U.S. Market Report, Issue 7

Market Report

International Realty Valuation, Inc.

United States

A Market Report published by International Realty Valuation, Inc.

In this Report:

A market correction will not merge in 2019, making it a good year to continue building liquidity.

- **Alfred R. Brooks – Head of JP Morgan Chase CRE**

Investment Barometer

Going into 2019 there are several key indicators that are perplexing. The most relevant are stable interest rates. They started 2018 at 4.00% and are now at 4.20%. They peaked in November 2018 at 4.95%. Overall, hardly anything to get excited about. There were expectations for rate increases but the "goldilocks principle" is in place – not too hot or too cold. Projections for 2019 are modest rate increases but they said that for 2018 too.

We are in the longest expansion in US history and that makes many people nervous. But we have historically low unemployment, continued rent growth in most property types (except retail), and a general pull-back in the lending market to continue scrutiny of most investments. Skin in the game is the 2019 mantra which mitigates the past 2007 mantra of OPM (Other People's Money). The economic brakes appear to be working. But with any cycle (even long historical ones) there will be downward trajectory – expect early 2020.

2019 is an extension of 2018 - *stay firm to the fundamentals.* What are the fundamentals? 1) Do Not overleverage – this leads to laser thin returns which cannot be recovered in a downcycle, 2) Occupancy is King. Don't get greedy with rents – 3 months of lost income in a 3-year lease is a 10% reduction in gross revenue, and 3) Don't overpay. If your going-in cap rate is under 4% - you are at the Mendoza Line, but unlike a batting average –higher is not good for your investment.

By the Numbers

According to **Costar National Market Reports**

Office – Cap Rates

National: 6.6%

Top Sale Markets (Total Price): New York, Boston, Washington D.C. Los Angeles, Chicago.

The national office vacancy rate was 9.8% with an average all class annual rent of $25.03 psf.

Retail – Cap Rates

National: 7.10%

Top Rent Growth Markets (Annual Rent): Nashville, Orlando, Tampa, Palm Beach, Denver.

The national retail vacancy rate was 4.4% with an average annual rent of $21.10 psf.

Industrial – Cap Rates

National: 6.70%

Top Sale Markets (Total Price): *Los Angeles, Chicago, Inland Empire, New York, Atlanta.*

The national industrial vacancy rate was 5.0% with an average annual rent of $8.46 psf.

Apartment – Cap Rates

National: 5.80%

Top market by Sales Volume (Sales Price): *New York, Los Angeles, Atlanta, Washington D.C., Phoenix.*

The national apartment vacancy rate was 6.0% with an average monthly rent per unit of $1,335.

Hotel– Avg. Occupancy Rates

National: 72.75%

Top market by Sales Volume (Sales Price): *New York, Washington D.C., Las Vegas, San Francisco, Phoenix.*

The national hotel price per room was $159,000.

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Dead Calm and Rising Tides

Lance W. Doré, FRICS, MAI

In demography – you always look for relationships in the information. We do the same in real estate. We seek the truth behind the numbers to reveal to us which way the economic winds are blowing, what are the leveraged readings in the barometer and what SPF levels to protect your skin from the sun.

When the red sky at night brings calm weather tomorrow morning, the opposite is true when the red sky in the morning brings us today's warnings. As the sailor steers the boat, it is said "we are in unchartered economic waters".

2019 brings us into waters that no man has gone before.

We are experiencing synergy in the markets where both the stocks and real estate are favored and both are at all-time highs. There is $19.4 trillion on the sidelines from Main Street available for investment but the question is where to place it? It's like having too many choices in the candy store and when faced with too many choices – we freeze. The markets in many ways are frozen with indecision on what property type to invest. Some choices are clear like Industrial and Multi-family (select markets) – their luster has not fully faded. Office is stable. Retail, while it repositions, can see some light at the end of the tunnel.

If you can answer which property type to invest – the next question is geography. The choices are accepting sub 5% cap rates in Tier 1 markets, 6% cap rates in Tier 2 markets and 7%+ cap rates in Tier 3 markets.

All are viable choices when you consider your penchant for risk. Lastly, if you can decide on property type and geography – do you go with long term investment, or short-term, or value add?

Think non-traditional real estate – Data Centers, Health Care, Senior Housing, and Cell Towers. These alternative investments may diversify your portfolio with the expanding proptech sector and the aging demographics sector.

The waters in this market are relatively calm, but the storm surges lurk on the horizon.

To mitigate the calm before the storm, you need to fully own risk and talent. They will provide the barometer you need to prepare you for what is coming.

The areas to focus on in 2019, to mitigate risk in an economy that has peaked are:

1. Invest in areas that are geographically stable and have strong fundamentals in employment, labor, affordable housing, a predictable regulatory environment and sound infrastructure. These include Seattle, Nashville, Austin, Dallas/Fort Worth, Charlotte, and Salt Lake City.

2. Be proactive with compliance and regulatory risk both internally and externally. These include trade policy (impacts retail and industrial), labor force (Impacts all property types), and cyber security (Impacts all property types, but hotels and retail are more susceptible).

While you move to mitigate risk for each project, the panacea or apocalypse that will drive your project to success or failure will be the Talent.

The continued reliance of real estate on using predictive and artificial intelligence and the required skill sets leans on Millennials and the Gen Z pools. Consider your real estate like a *startup* project. Retain the best and stop using old school methods to manage and analyze your real estate. Use social media, be flexible, be green and provide opportunity away from the traditional vertical chain of corporate command.

The flip side of this talent pool are the baby boomers. They are retiring in masses and corporate/ organizational memory will be lost. Implement a succession plan for those that are transitioning, and retool those that stay. This will provide a stable platform to fully integrate the changes that are inevitable.

Overall, *stick to the fundamentals, be agile, and be ready to transform.* 2019 will be the turning point. The pivot point may not be recognized, but make sure you know which way is true north so you can find your waypoint.

Remember – *The good seaman weathers the storm he cannot avoid, and avoids the storm he cannot weather.*

"The possibility of a market correction or downturn is set to remain a nagging doubt for markets during 2019 and implies a dilemma: take some risk off the table and accept lower returns, or take on additional risk to capitalize on favorable momentum and aim to grow values in the short-term.

—PGIM Real Estate – Dec. 2018

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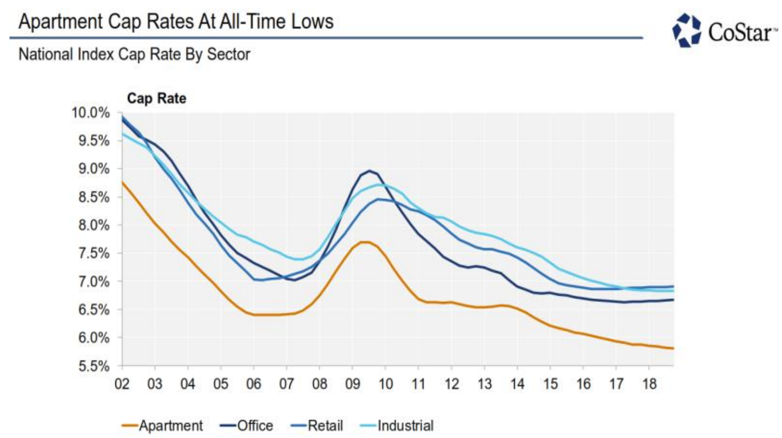

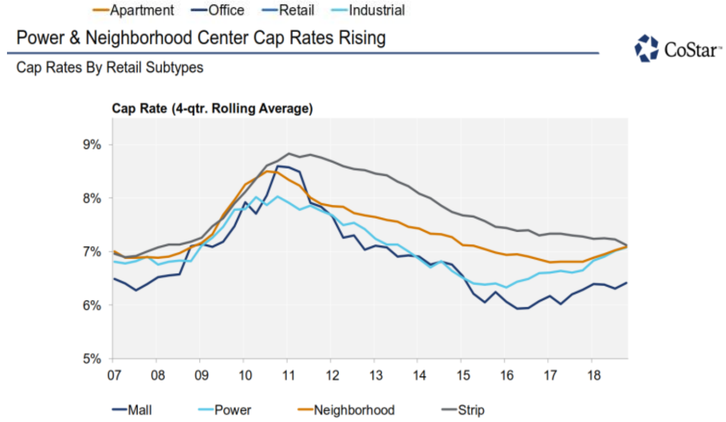

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As a Founding Partner and President of International Realty Valuation, Inc., Lance values a wide variety of conventional and complex properties, serves as litigation support to public and private clients, and provides expert advisory services. His geographical expertise is focused in the western U.S., and his professional expertise is focused in energy facilities, investment property, lands and special purpose.

About IRV, Inc.

International Realty Valuation, Inc. (IRV) is a global network of independent and highly competent professionals committed to providing expert financial reporting, forensics, consultation, and valuation services for both tangible and intangible assets to the most discerning of public and private clients. With a number of affiliate firms in several countries, our team has cumulative cutting-edge knowledge of global and regional markets, as well as international standards and requirements. This enables us to complete a wide variety of assignment, including valuation of large portfolios with multiple locations, in a thorough, objective, timely, and cost-effective manner. We serve major national, regional and international banks, lenders, developers, investors, governmental agencies, public and private companies.