



Investment Strategy Quarterly  
Outlook 2019

# Industrial, Opportunity, and CRE

## OUR 2019 OUTLOOK FOR COMMERCIAL REAL ESTATE

### Introduction

The past year has been a strong one for both the economy, and for commercial real estate investors. The benefits of economic growth, however, have not been equally distributed across the real estate sector. Demand growth in the office, apartment, and retail sectors remained strong, but trailed far behind that of industrial. The trends driving the outperformance of the industrial sector are well known, but our analyses suggest that they are only partially understood. We believe that those trends will not only continue, but that many market participants will also continue to underestimate their strength. By contrast, the market seems to have well understood the impact of changes in regulatory policy, with the clarification of HVCRE restrictions and the designation of opportunity zones already beginning to have an impact on the capital markets.

## Fundamentals Moving Into Balance

Economic growth and labor market conditions both improved substantially in 2018, largely due to stimulus from Washington. Job growth averaged 223,000 per month, a significant improvement from the prior two years that drove strong absorption in the office and apartment sectors. With the labor market growing ever tighter though, this performance will be difficult to replicate in 2019. We expect job growth to slow to a range of 170,000 – 180,000 and office and apartment demand growth to moderate as a result. Wage growth, which accelerated to 3.2% in 2018 is likely to accelerate still further as the imbalance between the supply and demand for labor continues to grow. This should provide a boost to both retail and industrial, particularly in markets with strong population growth.

As outlined in our December Investment Strategy Quarterly, *Real Estate and Reflation*, recent stimulus from Washington may also come at a cost. We believe the Federal budget deficit—now rising at the fastest non-recessionary rate in U.S. history—will put upward pressure on inflation in the short term. The threat of a U.S. credit rating downgrade may push the Fed towards a more accommodative position, which would be consistent with their recent comments regarding a pause in rate hikes and a future end to balance sheet roll off. This accommodative stance will likely contribute to core inflation trending above the Fed's 2.0% target in 2019 and beyond. As an inherently inflation protected asset class real estate equity is well positioned for such an environment and will likely see an increase in capital flows from investors hoping to hedge against its effect.

With real estate demand growth expected to marginally slow along with employment growth, our outlook for supply has taken on even greater importance. As the first quarter draws to a close, early indications are that conditions may not be as negative as initially feared. In fact, 2017 may have been the peak year for commercial real estate construction this cycle. Office completions totaled 51 million square feet in 2018, down from 52 million in 2017. The apartment, retail, and industrial sectors were all narrowly below 2017 levels as well. Initial forecasts for 2019 envision modestly higher levels across property types, but these forecasts have proven overly aggressive in recent years.

As we wrote last August in *Tariffs Add to The Tally*, construction costs rose by around 20% between 2015 and 2018, which slowed the rate of new construction overall and also delayed the completion of existing projects. We expect that trend to continue into 2019, such that supply growth will likely be lower this year, and modestly higher next year, than current forecasts suggest. With similar levels of construction and slightly lower demand growth, we expect U.S. commercial real estate fundamentals to fall into balance in 2019 with the possibility for marginally higher vacancy rates in a handful of property types and markets. Historically, balanced fundamentals have resulted in net operating income growth at or around the rate of inflation, but given today's low starting vacancy rates we believe net operating income growth will likely exceed inflation, falling in a range of 2 – 3%. Performance in one major sector, however, is likely to be considerably stronger. The best performer across nearly all metrics in 2018 was the industrial sector, which we believe will continue to outperform in the years ahead.

## Industrial Delivers

Over the last three years the office, apartment, and retail sectors have produced annual returns of approximately 6.4%, 6.5%, and 5.6%, respectively.<sup>1</sup> The industrial sector more than doubled these figures, producing annual returns of 13.3% over the same period.<sup>2</sup> This degree of outperformance was not localized to only a handful of markets. The best performing office market during the 2016 – 2018 period was Cambridge with an annual total return of 11.6%.<sup>3</sup>

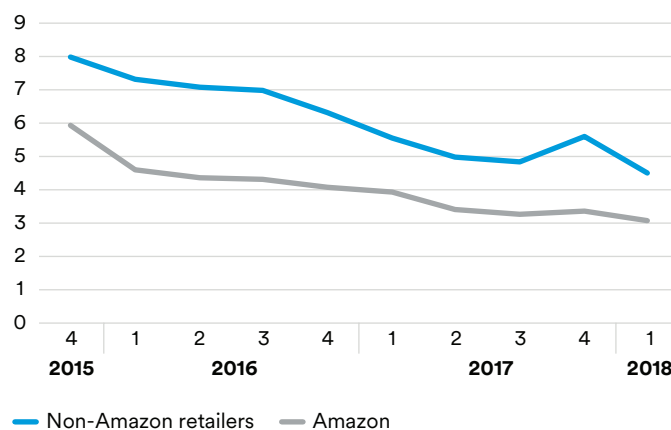
If that was an industrial return, however, it would only have been enough to rank Cambridge 24th in the nation.<sup>4</sup> The best performing retail return during this period, Nashville's at 9.80%, would have ranked 38th.<sup>5</sup> In the apartment sector, only Santa Rosa and the Inland Empire would have achieved strong enough total returns to rank in the top 20. With the benefit of hindsight, it now appears that many industrial property acquisitions made just prior to this timeframe may have been underwritten too conservatively. The industrial sector's shift towards consistent, significant outperformance in 2016 was not at all a coincidence, but its cause does not appear to be well known.

Rising online retail spending has played an important role in the industrial sector's outperformance, but growth in e-commerce neither began, nor even accelerated, in 2016. Instead, we believe recent outperformance occurred due to an acceleration in the rate of order fulfillment. Amazon has been a market leader in decreasing delivery times, with approximately 51% of U.S. households subscribing to their "Prime" service, up from just 23% in 2015.<sup>6</sup> Prime subscribers pay an annual fee and receive two or one-day deliveries at no or reduced cost. In late 2014 Amazon also began offering two-hour deliveries in Manhattan, and has since expanded this service to approximately 60 U.S. markets.<sup>7</sup> Retailers including

Walmart, Target, Apple, Best Buy, Costco, and CVS have all launched two-day or next-day shipping programs in response. The impact on average delivery times has been substantial. E-commerce research firm eMarketer estimates that average "click-to-door" delivery times declined from around seven days in 2015 to less than five days by 2018 (Exhibit 1). Greater still is the impact that these shorter delivery times have had on industrial demand growth.

To estimate future industrial demand, we examined the relationship between occupied space and both online and brick & mortar retail sales. We also analyzed publicly available information from major retailers. Our analyses produced two clear conclusions. First, retail sales have increasingly become a strong leading indicator of industrial demand. Our analyses suggest that retail sales growth leads industrial demand growth by approximately four to six months, perhaps reflecting the time between sales growth, recognition of greater space needs, and the execution of new leases. Second, and most importantly, our analyses suggest that each dollar of online sales growth requires about seven times as much warehouse space as each dollar of brick & mortar sales growth. This disparity is driven heavily by the decline in average click-to-door delivery times. Advances in distribution have allowed retailers to move products within warehouses at an ever more efficient pace, but the pace of transit between warehouses has remained relatively stable. Facilitating these short delivery windows therefore requires not only a larger amount of stock at each location, but also a larger number of warehouse locations in close proximity to population centers. Unlike brick-and-mortar retailers, online retailers also lack the shadow industrial space offered by stock rooms and store shelves at retail locations.

**Exhibit 1 | U.S. Click-to-Door Delivery Time (Days)**

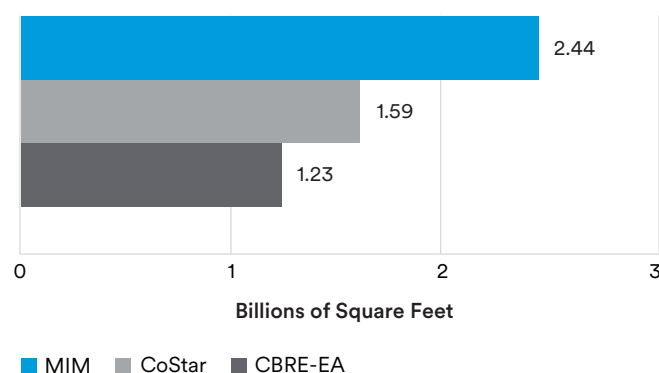


Source: eMarketer



Applying these conclusions to the base case forecast for retail sales provided by Moody's analytics implies warehouse demand will grow by about 250 million SF per year over the next decade, well above the 119 million SF added per year from 2008 – 2018.<sup>8</sup> This forecast is well above the expectations of other major real estate forecasters (Exhibit 2). We believe that while these forecasters have recognized the strength of online sales growth, they may be underestimating how much industrial demand each dollar of that growth is capable of producing.

**Exhibit 2 | Industrial Demand Growth 2019-2029**



Source: MIM, Costar, CBRE-EA, Moody's

Our forecast of industrial demand is based on trends in click-to-door speeds today, and is therefore subject to changes in those trends. The biggest downside risk is a decline in consumer demand for shorter delivery times or an unwillingness to pay the membership fees required to gain access to them. We suspect that short delivery times may be viewed as luxury goods, such that consumers' willingness to pay for them may decline in the event of a recession. This, however, would likely only be a hiccup in what we believe has become a firmly established structural trend. As it stands today, it appears that while supply growth in the industrial sector is accelerating, it may continue to struggle to meet the demand growth being created by rising e-commerce sales and decreasing delivery windows.

## Risk and Opportunity (Zones)

While accelerating in recent years, commercial real estate construction during the current cycle has been relatively low compared to that of past cycles. Although we believe this is partially due to rising construction costs, more restrictive banking regulations have played a role throughout the cycle. One of the most significant banking regulations was the High Volatility Commercial Real Estate ("HVCRE") designation. Loans categorized as HVCRE received higher capital charges, reducing their capital efficiency for lenders. While the nation's major banks continued to provide construction financing, many regional and local banks grew uncomfortable with the ambiguity of the language used to define HVCRE. In 2018, this definition was revised to reduce that ambiguity, and banks with assets below \$10 billion were exempted from its restrictions if certain other criteria were met. As a result, banks previously on the sidelines have once again entered the construction lending space. This could lead to greater availability of construction financing in 2019, just as other legislative efforts are increasing demand for it.

The Tax Cuts and Jobs Act of 2017 included a provision for the creation of "Opportunity Zones," specially designated areas where real estate investors could enjoy significant tax advantages. Much like HVCRE, however, the language used in the legislation lacked clarity. That clarity finally arrived in late 2018. The program allows investors to defer paying capital gains by rolling them into opportunity zone investments. They are eligible for a tax credit on part of those gains, and are eligible to not pay taxes on any of the gains made during the first 10 years of the new investment. Overall, we estimate that these tax advantages may be worth approximately 12% of the cost of an average development project.<sup>9</sup> The magnitude of this benefit has not gone unnoticed, and opportunity funds have emerged at an astonishing pace in recent months. As the year progresses we will continue to monitor the pace of capital raising in this space, and more importantly, the pace of capital deployment. While unlikely to impact our supply growth outlook for 2019, the popularity of Opportunity Zones could significantly impact our outlook for the years ahead.

## Capital Market Conditions

We expect capital market conditions to remain largely stable this year. Transaction volume totaled \$562 billion in 2018, above our initial expectations and a roughly 15% increase over the prior year.<sup>10</sup> At the beginning of 2018 all signs pointed to a moderation in foreign capital flows as economic growth in Europe appeared poised to accelerate. The reality was far different. Growth in the Eurozone stalled and fears around Brexit led to a “flight-to-quality” that led many investors back to the United States. Non-U.S. buyers increased their total share of acquisitions from 11% in 2017 to 17% in 2018.<sup>11</sup> The outlook for foreign capital flows remains somewhat uncertain in 2019, but a repeat of the last year seems to be the most likely outcome unless conditions in the Eurozone improve or a more orderly Brexit than current conditions suggest appears likely.

Capital market conditions will likely vary significantly by property type. The industrial and apartment sectors remain largely in favor, while an increasing number of investors choose to moderate their allocations to the office sector and approach retail with caution. As outlined in our previous pieces on the retail sector, *The Age of Experience-Based Retail* and *A Red Herring in Retail*, we continue to believe that the sector offers opportunities, but agree that many centers will struggle. Cap rates in the retail sector have already started to rise, and those of the office and apartment sectors may do so as well if the 10-year Treasury yield once again climbs above 3.00%. For now, however, commercial real estate values seem well supported by current conditions and are likely to rise marginally higher in 2019.

## Conclusion

Ultimately, we believe commercial real estate conditions will remain positive in 2019 as fundamentals fall into balance and capital market conditions remain largely stable. Rising construction costs and labor shortages should keep supply growth in check and vacancy levels only marginally higher. The industrial sector is likely the best positioned as cyclical and structural forces converge to drive its outperformance. The office and apartment sectors seem likely to witness further growth as well while conditions in the retail sector continue to vary by format. As a whole, the real estate sector should manage net operating income growth of 2 – 3% in 2019, ahead of inflation, but slightly weaker than in 2018. Similarly, we expect value growth to slow to approximately 1 – 2% as cap rate spreads to the 10-year Treasury continue to compress. Values should remain supported by healthy capital flows and inflationary pressures that will increase the relative attractiveness of commercial real estate.

## Endnotes

<sup>1</sup> National Council of Real Estate Investment Fiduciaries

<sup>2</sup> Ibid

<sup>3</sup> Ibid

<sup>4</sup> Ibid

<sup>5</sup> Ibid

<sup>6</sup> “10 charts that will change your perspective of Amazon Prime’s growth”, Forbes, March 4, 2018

<sup>7</sup> “Amazon is expanding Whole Foods, Prime Now, into the suburbs”, Fool.com, January 30, 2019

<sup>8</sup> CBRE-EA, 2018 Q4

<sup>9</sup> MIM Real Estate Estimate based on a theoretical development with an 8.00% unlevered 10-year IRR, 5.00% terminal cap rate, and 21.00% effective tax rate.

<sup>10</sup> Real Capital Analytics

<sup>11</sup> Ibid

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