FEDERAL RESERVE BANK OF SAN FRANCISCO

Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

CRE Market Conditions in the West: A Turning Point

Overview: Commercial real estate has staged an impressive turnaround since the financial crisis. Improving fundamentals and price appreciation have spread from coastal to inland markets.

Much of the post-financial crisis CRE price appreciation was driven by declining cap rates. Further cap rate compression is likely to cease being a driving force and future price appreciation will need to come from fundamentals. But with the recovery well into its seventh year, slower absorptions, softer rent growth, and higher vacancies are in the forecast. While a severe price correction is unlikely at this point, CRE price appreciation may slow and prices in certain markets could fall. Transaction volumes are lower across CRE sectors and office prices are showing signs of slowing.

Despite the slowdown, most 12th District markets remain healthy and should perform relatively well, even if not at the impressive rent growth and declining vacancy rates seen over the past few years.

Office—A Slowdown Has Begun: CBRE-EA's forecast over the next year is for decelerating rent growth in almost all 12th District markets, and negative rent growth in San Francisco, Seattle, Las Vegas, and Ventura. The negative rent growth could lower debt service coverage ratios and property values which would in-turn mean higher loan-to-value ratios on CRE loans in these markets.

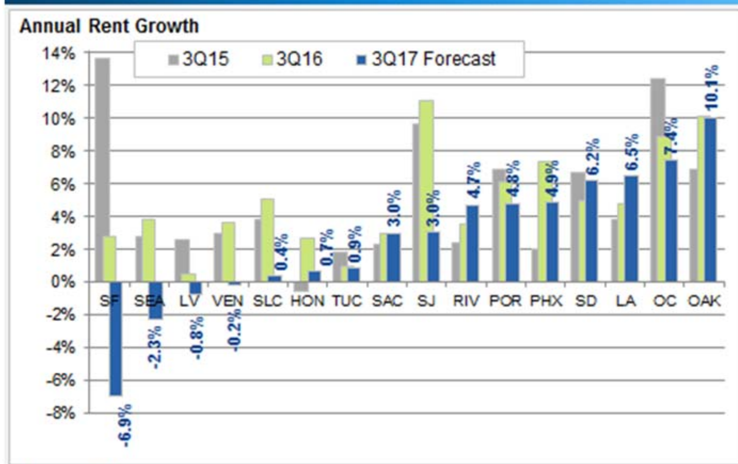
San Francisco's fundamentals illustrate the changing office landscape in much of the 12th District. Tech centric job growth pushed San Francisco vacancies down to 6.2% in 2Q16, and annual rents increased 19% in 2014 and 12% in 2015. But by 3Q17, vacancies may be back up to 10.5%, and annual rent down 7%. The change can be attributed to steady completions through 3Q17 and slack demand due to a slowing tech sector just as completions pause. Fundamentals in markets with more diversified economies (according to CBRE, 36% of San Francisco office stock is occupied by tech firms) are expected to soften, but not as dramatically as in San Francisco.

Vacancy rates in suburban properties are typically higher than downtown, but this gap has been shrinking helped by demand for suburban office space in markets like Phoenix. While vacancy rates have generally been declining, they are projected to rise in 8 out of 16 12th District markets by 3Q17. The biggest vacancy rate increases are slated for tech heavy markets like San Francisco (+340 basis points) and Seattle (+200 bps). Absorption rates should slow but remain positive through 2017 in most District markets. San Francisco and Salt Lake City could see negative absorption rates largely due to significant new inventory.

Apartments—Down From The Cyclical Peak: Apartment fundamentals remain strong with the 3Q16 12th District aggregate vacancy rate down to 4.2%, below the 20 year average of 4.9%. Demand remains healthy in most markets and the size of the millennial generation will keep demand elevated.

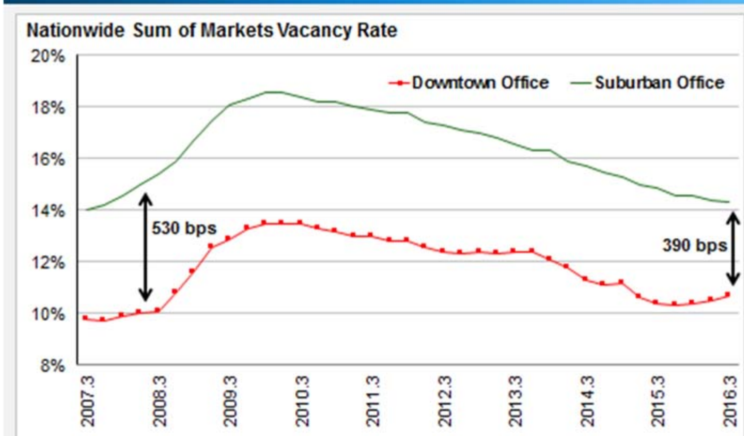
CBRE-EA's one year forecast shows annual rents in most markets retreating to match annual income growth which has hovered around 2%. Slower rent growth is not surprising given abundant apartment construction and the unsustainability of rent growth significantly above income growth.

Office Rent Growth is Slowing in Most Markets - Forecast to Turn Negative in San Francisco, Seattle, Las Vegas, Ventura



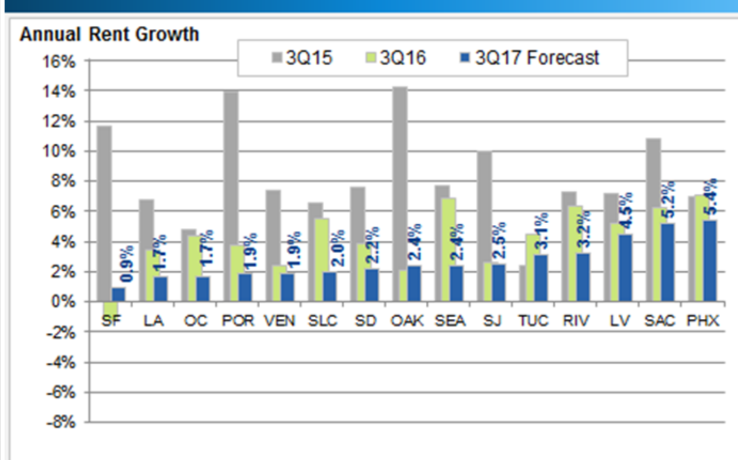
Source: CBRE-EA

The Difference Between Downtown and Suburban Vacancy Rates Has Narrowed to the Lowest Level Since 2007



Source: CBRE-EA

Apartment Rent Growth Moves Closer to 2% Wage Growth



Source: CBRE-EA

The District average annual apartment completion rate for the last 2 years is 1.1%, not far from 0.9% for the previous 20 years. But there are markets with annual completion rates significantly above their 20 year averages. Salt Lake City has a 2.8% completion rate vs 2.1%, San Francisco is 1.3% vs 0.5%, Seattle is 2.5% vs 1.2%. These markets could have oversupply risk, particularly in high-end units. In San Francisco, strong job growth fuelled near 8% rent growth in 2013, 2014, 2015 and spurred luxury apartment construction. But rent growth is cooling as demand wanes in the face of slowing tech job growth and affordability issues.

According to YARDI Matrix, in 2015 75% of nationwide apartment completions were high-end projects. This is due to a combination of growth in the so called renter-by-choice demographic and because the high costs to build apartments makes margins on low-end projects too slim. An oversupply of luxury units and undersupply of lower cost inventory is a developing trend. Some developers / investors are acquiring properties built in the 70s and 80s and modernizing these units, rather than building/buying new projects in the face of this emerging supply demand imbalance.

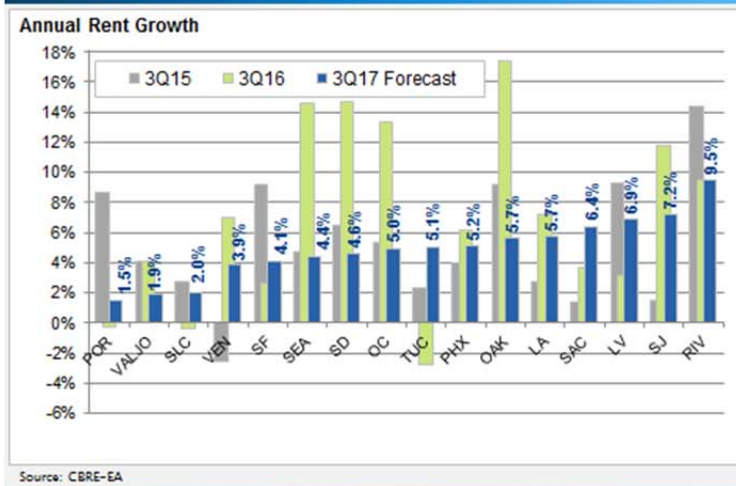
The Federal Reserve Senior Loan Officer Opinion Survey indicates multifamily lending standards have been tightening this year. This tightening has been driven by large banks. At the same time, Trepp reports multifamily CMBS issuance is down significantly year-over-year, while bank origination volumes are up. CMBS issuance is down in part due to risk retention rules. Small and regional banks may be picking-up some of the riskier loans that would have been originated through CMBS.

Industrial—Moderate New Supply Helps: The industrial sector has performed well this year aided by solid import and export growth, a continuing need for large distribution space, and demand for new R&D facilities driven by the tech and biotech sectors. But deep into the expansion cycle, signs of fraying are showing and forecasts call for industrial fundamentals to soften. Among the signs of a slowdown in demand are declining transportation and warehousing employment numbers and flat durable-goods orders.

According to CBRE-EA the 12th District aggregate industrial availability rate is expected to bottom at 6.3% in 4Q16 and gradually increase for the next several years. Rent growth is expected to slow in several markets, although it should remain positive and above 4% at least into 3Q17 in the six largest 12th District markets: Seattle, Orange County, Phoenix, Oakland, Los Angeles, and Riverside. One reason rent growth should stay positive despite rising availability is that supply of sought-after modern warehouse and R&D space has trailed pre-financial crisis construction levels. Out of the six largest markets, only Oakland has a higher current and forecast completion rate than before the financial crisis.

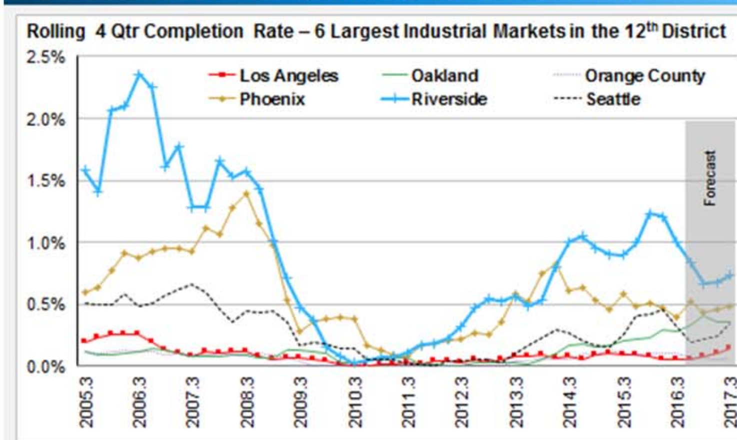
A key question to consider in the industrial sector is: are developers building the right type of industrial space? According to Reis, tenants' demand for R&D/Flex space has not abated, yet developers have been less eager to build smaller buildings, opting for larger warehouse space instead. In the 12th District, Riverside, Phoenix, and even small markets such as Las Vegas, are delivering significant new warehouse inventory. Only San Diego has a sizable amount of R&D/Flex space under construction.

Industrial Rent Growth Should Slow in Most Markets but Remain Health



Source: CBRE-EA

Industrial Completion Rates are Below Pre-Financial Crisis Levels in Five of Six Largest 12th District Industrial Markets



Source: CBRE-EA

Many More Warehouses Being Built Than R&D Spaces

Market	R&D / Flex: Completed YTD Buildings (#)	R&D / Flex: Completed YTD SFx1000	R&D / Flex: Under Construction Buildings (#)	R&D / Flex: Under Construction SFx1000	Warehouse / Distribution: Completed YTD Buildings (#)	Warehouse / Distribution: Completed YTD SFx1000	Warehouse / Distribution: Under Construction Buildings (#)	Warehouse / Distribution: Under Construction SFx1000
LV	1	291	0	0	5	1,128	16	2,284
LA	1	39	0	0	17	1,702	16	2,890
OAK	1	50	0	0	5	1,741	6	1,237
PHX	5	292	2	168	25	3,607	21	2,098
POR	4	93	1	67	4	578	5	1,991
RIV	0	0	0	0	49	17,831	48	9,831
SLC	0	0	5	182	10	1,035	2	479
SD	1	66	8	1,081	4	628	3	189
SJ	1	129	5	307	0	0	4	560
SEA	0	0	0	0	15	2,209	11	1,707
12th District Total	16	1,004	21	1,805	144	31,326	135	23,709

Source: CBRE-EA, 12th District Total includes markets not shown on the table.

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