



Real Estate Lending Risks Monitor

Federal Reserve Bank of San Francisco

Real Estate Market Conditions in the West

In this issue of the Monitor, we focus some attention on retail and industrial commercial real estate sectors and on the housing market.

Retail—Lots of Gloom Not All Doom: Recent retail sector headlines including high levels of retailer defaults, bankruptcies, and falling retail REIT prices, suggest brick-and-mortar retail is in critical condition. Competition from e-commerce, an oversupply of retail space, and consumers' spending shift toward services and experiences are indeed posing significant challenges to the sector.

While many retailers are struggling, retail property owners are generally holding their own. Among retail property owners, there are meaningful differences in performance based on location, tenant quality, and property subtype. Malls, not neighborhood and community centers (N&CCs), are the focal point for retail woes, particularly the second or third mall in a market, as well as malls anchored by midlevel retailers Sears, Macys, JC Penny etc.

Historically, malls have had lower vacancy rates than N&CCs, and although that still holds, since the financial crisis, vacancy rates at malls have receded at a much slower pace than at N&CCs. Markets in the 12th District do not seem overexposed to malls versus other areas of the country. Many District markets rank among the best 20 nationally in terms of personal income, total employment, and population per square foot of mall space. Only Honolulu (mitigated by tourism), Riverside, San Diego, and Tucson stand out as overexposed to malls by at least two of these metrics.

Malls that have to deal with large spaces vacated by anchor tenants pose a challenge to N&CCs. As malls repurpose large anchor spaces into smaller options, they create spaces that more directly compete with what N&CCs are offering.

Positive, but meager rent growth forecasts for N&CCs reflect the challenges a transforming retail sector is facing. The 12th District average annual rent growth forecast per CBRE-EA, is just above 2% for 2017 and 1% in 2018. At the market level, forecasts for cumulative rent growth over the next two years are strongest in San Diego (+6.2%) and Portland (+5.3%), and slowest for Riverside (-5.9%) and Fresno (-4.3%).

It may be prudent for bankers underwriting loans on retail properties to evaluate if projections for net operating income consider possible additional expenses of repurposing portions of the property to meet shifting consumer preferences as well as prospects for potentially slower future rent growth.

Industrial—Strong District Conditions with Smaller Markets Gaining: Current availability rates in 12th District Tier I Markets are near lows last seen in 2000. In District Tier II Markets, availability rates are at records lows, a remarkable 740 basis points below previous lows. The spread between availability rates in District Tier I and Tier II Markets has been decreasing

Retail: Honolulu, Riverside, San Diego, and Tucson May Have too Many Malls, Overall the 12th District Does not Look Oversupplied

Source: CBRE-EA, rank out of 62 largest markets, worst 20 in red, best 20 in green

	National Rank / Sq. Ft. of Mall Space (62=bad, 1=good)		
	Personal Income	Employment	Population
Bakersfield	16	27	2
Fresno	30	38	10
Honolulu	61	62	62
Las Vegas	51	39	35
Los Angeles	21	34	29
Oakland	9	40	30
Orange County	36	43	49
Phoenix	35	25	16
Portland	13	10	9
Riverside	47	55	18
Sacramento	4	5	1
Salt Lake City	39	15	24
San Diego	31	47	42
San Francisco	1	1	7
San Jose	6	28	43
Seattle	5	8	13
Tucson	57	57	46
Ventura	20	50	22

Retail: Rent Growth is Far Below Pre-Financial Crisis Levels

Rent Growth – 12th District N&CCs* (Year-Over-Year % Change)



Fastest Forecast Rent Growth (%) 1Q17-1Q19**

San Diego	6.2
Portland	5.3
San Jose	4.4
Sacramento	3.9
Los Angeles	3.9

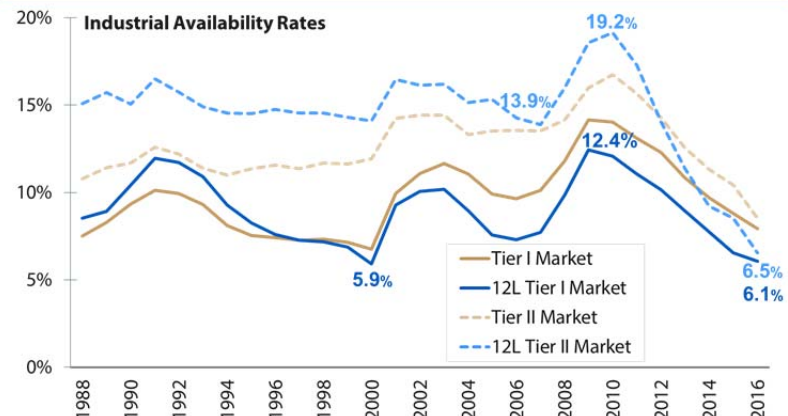
Slowest Forecast Rent Growth (%) 1Q17-1Q19**

Riverside	-5.9
Fresno	-4.3
Bakersfield	-3.4
Honolulu	-3.1
Oakland	0.3

Source: CBRE-EA, *Rents for Neighborhood and Community Centers, **Cumulative two year rent growth

Industrial: Since the Financial Crisis, Availability Rates Have Fallen Faster in Smaller Markets

Industrial Availability Rates



Source: CBRE-EA, Availability rate data is based on weighted averages to account for available industrial square footage as a percentage of total stock for the nation and the District. Tier I Markets include cities such as Los Angeles, Tucson, and Honolulu while Tier II Markets are the smaller markets of cities such as Boise, Reno, and Santa Cruz.



since the end of the financial crisis, and is currently down to just 40 basis points. Nationally, the trend is similar although not as dramatic.

Helped by low availability, recent industrial sector rent growth is strong. Tier II Market rent growth, which is traditionally more volatile, has been on a steady upswing since the end of the financial crisis.

The superior performance of Tier II Markets is driven by the warehouse/distribution subsector. Supply constraints and costs of operating in Tier I Markets, coupled with improvements in distribution logistics, look to be the cause for shifting demand into Tier II Markets. However, Tier II Markets are getting comparatively more expensive, and economic slowdowns can hit them harder. Their availability rates may again move above those of Tier I Markets, although the spread between them may not be as wide as in the past.

Residential —Low Inventory Rising Prices: Following trends from recent years, rapid home price appreciation has continued into 2017. Home prices increased 8% on average annually across 12th District markets. Limited supply of homes for sale (both new and existing) is prevalent throughout the District and a significant factor pushing prices higher.

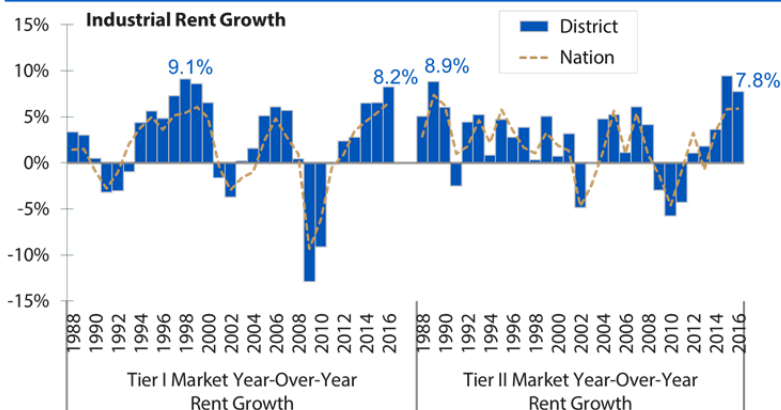
New entry-level properties currently face the tightest inventory. Although pricing power is strong, and acquisition and development capital is readily available, labor constraints and local fees and assessments are pushing builders toward higher margin construction. Existing homes are also in short supply despite high valuations. Distressed homes are no longer a significant source of supply, and increased immobility among job seekers and baby boomers means another source of supply has shrunk. Finally, the lack of suitable move-up homes on the market is dissuading potential sellers from listing their homes.

On the demand side, Zelman & Associates noted that home purchase applicant credit quality has increased and credit standards eased in recent quarters. However, demand is strongest for entry-level homes, precisely where supply is most limited. Prices are likely to continue their above trend appreciation until entry-level supply can adjust to meet this demand.

Even with strong price appreciation, only about half of District markets are above their pre-financial crisis peaks. Metros most above their previous peaks are San Francisco and San Jose. These markets generally didn't have as much ground to recover as areas like Las Vegas and central California which are still well below their pre-financial crisis peaks.

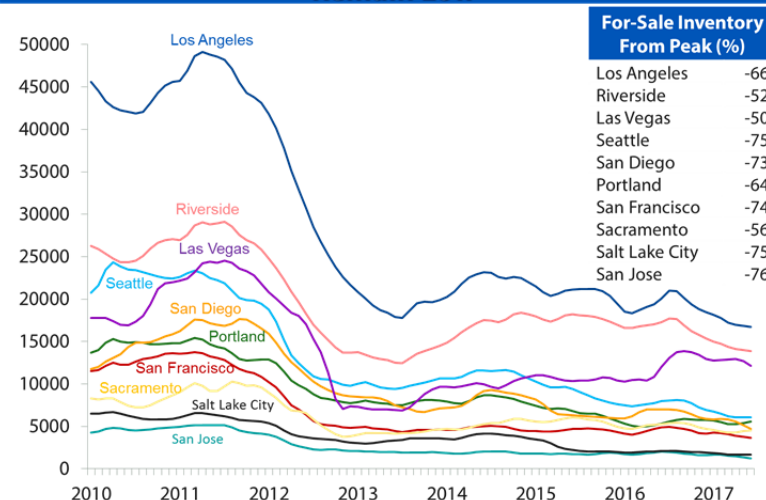
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Industrial: Rent Growth has Been Strong in District Tier I and Tier II Markets



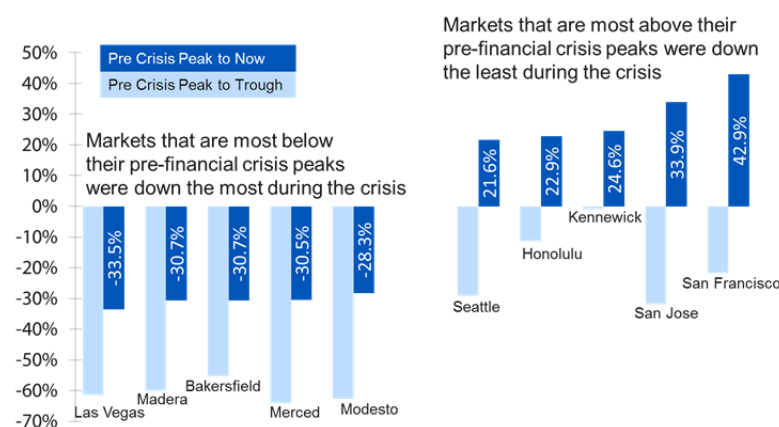
Source: CBRE-EA, Availability and year-over-year rent growth data is based on weighted averages to account for available industrial square footage as a percentage of total stock for the nation and the District. Tier I Markets include cities such as Los Angeles, Tucson, and Honolulu while Tier II Markets are the smaller markets of cities such as Boise, Reno, and Santa Cruz.

Residential: Monthly For-Sale Levels of Existing Homes Remain Low



Source: Zillow For-Sale Inventory, Ten largest 12th District Markets

Residential: Almost Half of the Markets in the District Have Reached or Surpassed Previous Peak Home Prices



Source: CoreLogic Single Family Detached and Attached Home Price Index, Markets with Populations >= 75,000