FEDERAL RESERVE BANK OF SAN FRANCISCO

Real Estate Lending Risks Monitor

Real Estate Market Conditions in the West

The first part of this Monitor focuses on capital flows into the office, retail, and industrial sectors. The second part delves deeper into apartment fundamentals.

Office: The flow of capital into office properties continued at an impressive pace in 1Q18. However, nine years into the economic expansion, there are fewer good buying opportunities available. Investors now prefer to pick through individual assets, making large portfolio deals less common. Reflecting this slowdown, the number of transactions peaked in 1Q16, and prices have generally trended lower since 3Q17.

Significantly, a slowdown in gateway markets (despite some higher pricing in 1Q18) is influencing overall office trends. Values in gateway markets reached their highs partly on the flow of capital from cross-border buyers, who made up 27% of office dollar volume in Los Angeles and San Francisco in 2016, according to Real Capital Analytics (RCA). But as foreign investors pulled back their capital spend (largely due to Chinese capital controls), their share fell to 19% in 2017, and 8% in the first four months of 2018. This put downward pressure on gateway sales volume, which fell from $4.3 billion a year in 1Q17 to $3.2 billion in 1Q18, and prices which declined from a high of $488 per square foot (SQFT) in 2Q17 to $445 in 1Q18.

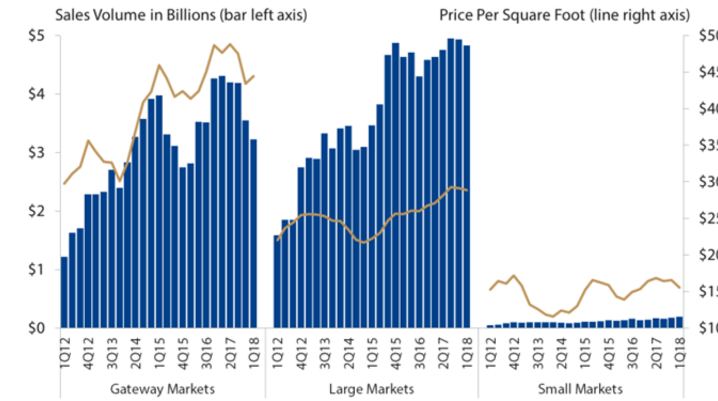
Both domestic and cross-border buyers are increasingly looking outside gateway markets for higher returns. Per RCA, District markets with the largest increases in rolling 12 month year-over-year sales volume in 1Q18 were the Inland Empire (up 92%), Las Vegas (up 64%), and Phoenix (up 33%). San Francisco and Los Angeles were down 52% and 15%, respectively.

A move from gateway to less bid-up and higher yielding markets also shifted sales from central business districts (CBD) to suburban office space, which accounted for 80% of total office sales volume in 1Q18. As domestic and cross-border buyers increased their allocations, suburban prices closed the CBD premium to $145 per SQFT, from $163 in 1Q17.

Retail & Industrial: Capital flows into retail and industrial sectors are diverging. The growth of e-commerce fueled a need for distribution space and the industrial sector has emerged as an investor favorite. Industrial sales volume surpassed retail in each of the past three quarters, and average sales prices increased steadily from $77 per SQFT in 1Q12 to $124 in 1Q18. In contrast, the growth of e-commerce and the financial woes of retailers made retail properties less attractive. Sales volume has dropped and prices for retail space declined sharply from $315 per SQFT in 2Q17 to $252 in 1Q18. Part of the price drop was due to sales of lower quality or distressed malls to opportunistic buyers, while other owners and buyers wait for the retail shakeout to sort itself out.

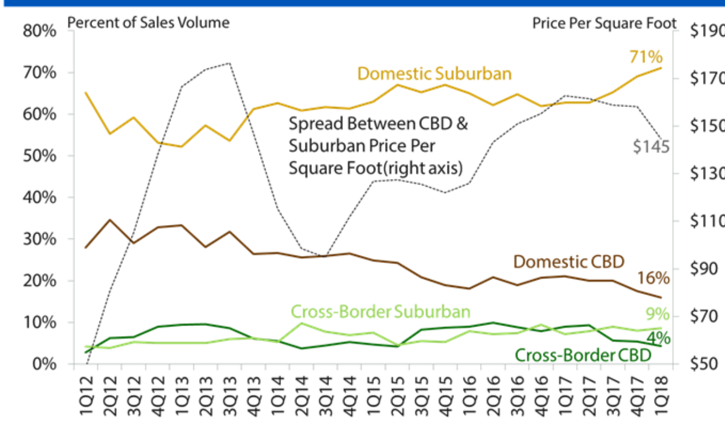
According to industry professionals, large amounts of capital remain on the sidelines looking for the right deals. With 2017 tax reform favorable to real estate, these investors may move, and capital flows could increase into markets and sectors that are already priced with no margin for a market downturn.

Office: Prices Have Peaked in Most 12th District Markets; Sales Volumes are Declining in Gateway Markets as Investors Look for Opportunities Elsewhere



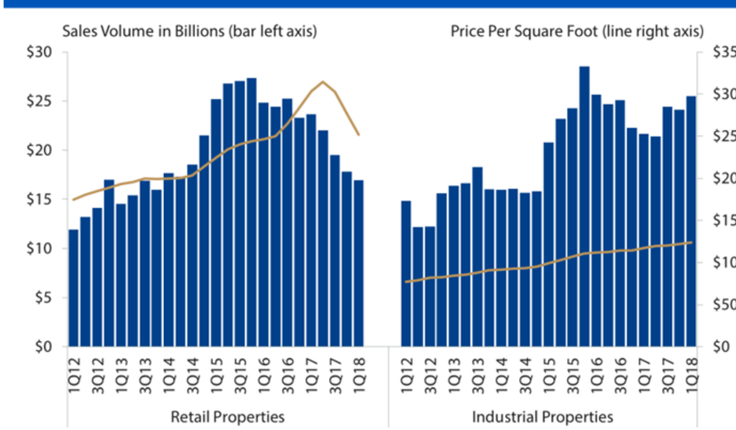
Source: CoStar, Sales volume and price per square foot based on rolling four quarters. Sales >$1 million. Gateway : Los Angeles, San Francisco. Large: East Bay, Inland Empire, Las Vegas, Orange County, Phoenix, Portland, Sacramento, Salt Lake City, San Diego, San Jose, Seattle. Small: Bakersfield, Boise, Eugene, Fresno, Modesto, Reno, Salem, Spokane, Stockton, Tucson.

Office: 12th District Suburban Office Properties are Taking a Larger Share of Investors' Dollars as They See Fewer Opportunities in Central Business Districts



Source: Real Capital Analytics, Percent of sales based on total dollar sales for rolling four quarters. Spread based on rolling four quarter dollar difference in average price per square foot. Sales >$2.5 million in AK, AZ, CA, HI, ID, NV, OR, UT, WA. CBD is Central Business District.

Retail & Industrial: Industrial Properties Have Become a Favorite Investment; While Retailers' Problems Have Soured Investors on the Sector



Source: Real Capital Analytics, Sales volume based on total dollar sales for rolling four quarters. Price per square foot based on rolling four quarter average price per square foot. Sales >$2.5 million in AK, AZ, CA, HI, ID, NV, OR, UT, WA.

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12th Federal Reserve District

Apartment: The apartment sector has been a standout performer among commercial property types since the end of the financial crisis, both in terms of price appreciation and property fundamentals. That strong performance generated a wave of new supply, which hit many District markets over the last several years.

Fortunately, strong job growth and favorable demographic trends among age groups with the highest propensity to rent, created strong demand for apartments and helped absorb much of the new supply. The change in supply over the last three years was within 100 basis points of demand in most District markets. Exceptions were Anchorage, which had negative demand due to economic contraction, as well as Flagstaff and Portland, where supply overshot solid demand by 234bps and 209bps, respectively.

Although new apartment starts are down, the pipeline of projects scheduled for completion is still significant. It is also being pushed out to 2019 due to construction delays, particularly in high-rise buildings. District markets to monitor include downtown Los Angeles, as well as Las Vegas and Sacramento, two markets where construction has only recently accelerated post financial crisis lows.

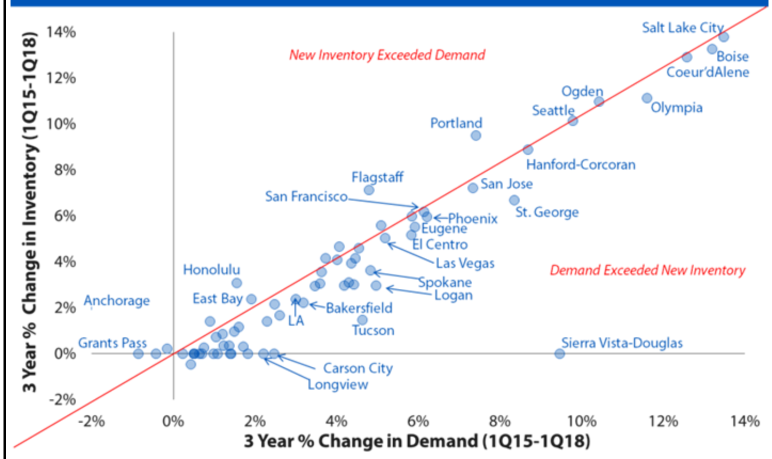
In addition to supply, other trends are also turning against the apartment sector. The homeownership rate, which began declining in 2005, started edging higher in 2016, taking hundreds of thousands of potential renters with it. This most directly impacts luxury rentals which could be a substitute for homeownership, but population growth in the primary renter age cohorts is also expected to moderate over the next decade. Finally, job growth is also past its strongest growth rates.

In these headwinds vacancy rates have been trending higher in the majority of District markets, and are forecast to continue increasing at a faster pace over the next two years. Salt Lake City could see the largest increases among larger markets, while vacancies are forecast to fall in Tucson.

Increasing vacancy rates make raising rents difficult. Although rent growth has slowed in some larger markets, the overall slowdown has been modest, and is attributable to significantly weaker growth for new luxury properties. For example, 2017 Los Angeles rents in B and C class properties rose about 200bps more than in luxury properties. However, rent growth is forecast to slow further over the next two years. While rents are unlikely to decline, only Anchorage (where rents fell over the past two years), San Jose, and Santa Barbara are projected to have stronger rent growth.

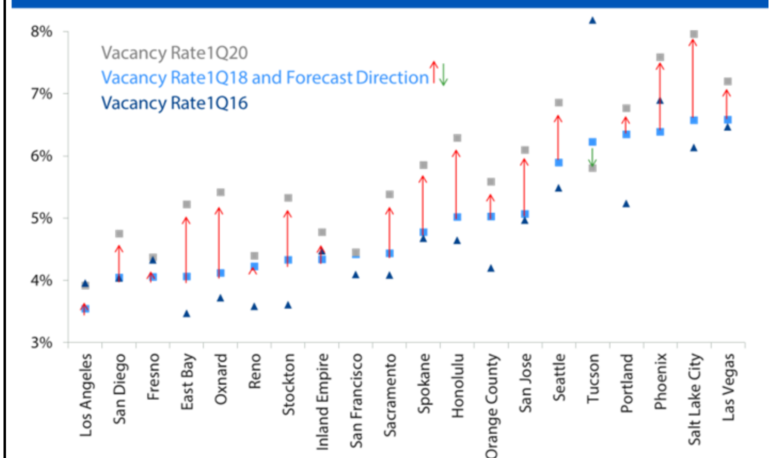
Higher vacancy rates and weaker rent growth would pressure operating income and thereby already elevated apartment values. The end of declining cap rates, and the possible repeal of Costa Hawkins in California (which would expand rent control to newer buildings), could also reduce values. In a higher inflation environment, these negatives may be partially offset by the benefit properties with short lease terms provide as an inflation hedge.

Apartment: Demand has Kept up With Robust Supply Growth in Most 12th District Markets



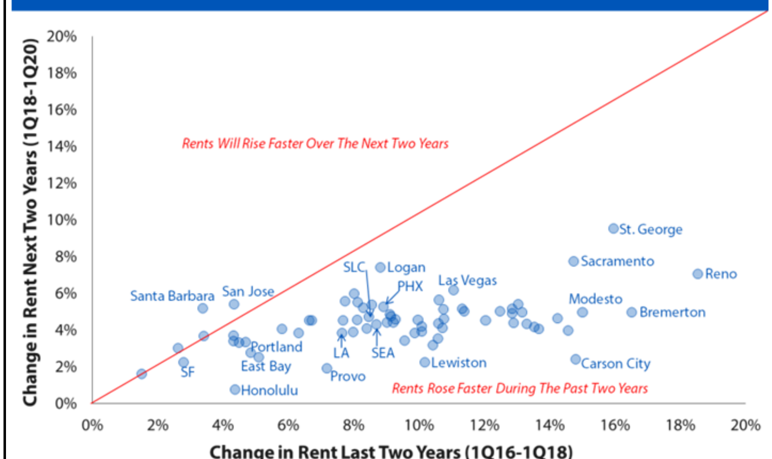
Source: CoStar, Demand = Inventory * Occupancy Rate.

Apartment: Vacancy Rates are Expected to Move Higher in Most 12th District Markets



Source: CoStar, Top 20 markets by inventory. Sorted by 1Q18 vacancy rate.

Apartment: Rent Growth is Projected to Slow in Almost All 12th District Markets Over the Next Two Years



Source: CoStar, Two year change in asking rents.

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