Commercial RealEstate Direct

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What CRE Investors Can Expect in a Post-Brexit World

This research report is composed of information provided by Trepp, the leading provider of data, analytics and technology solutions to the global securities and investment management industries, and EDR, the leading provider of environmental data and technology to the property due diligence industry.

There was copious talk that if Britons voted for Great Britain's exit from the European Union, markets, specifically commercial real estate, would be impacted.

Markets don't like uncertainty, and the Brexit vote has provided plenty. It's no surprise that there has been a general pause in investment activity and some are expecting the British property markets to suffer as companies relocate to other E.U. countries.

But the decision is proving to be benign for the U.S. property market. The thinking had been that uncertainty in Europe would prompt institutional investors to plow capital into the safe haven of the U.S. property market. But data from EDR, which tracks Phase 1 environmental site assessments, shows that such a migration hasn't happened yet. This research delves into which markets have seen an increase and which a decrease in the volume of Phase 1 assessments - a leading indicator for investment-sales activity.

Having a potentially larger impact on property markets would be growing regulatory pressures, on both bank and securitized lenders, which could affect investor demand.

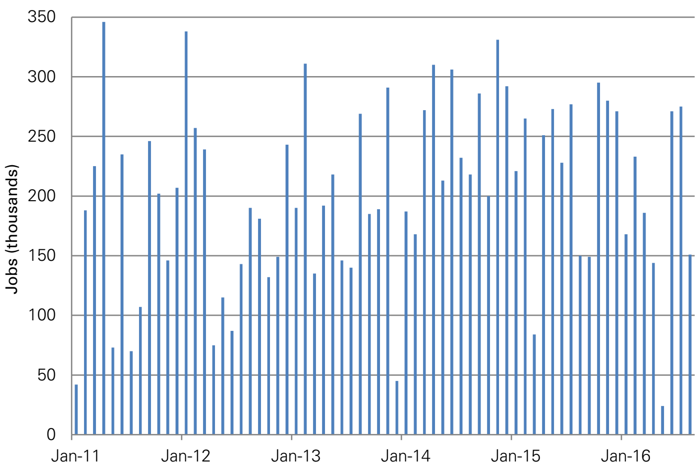
Global Economy

The U.K. faces the possibility of an extended economic downturn. A number of U.K. employers have announced cutbacks or put expansion plans on hold; the country's manufacturing sector is contracting and consumer confidence has declined. The Bank of England has cut interest rates, and the U.K. government is implementing a bond-buying program in an effort to stave off a recession. England's financial sector and office market are expected to be particularly hard hit because international firms very well could relocate to E.U. countries. In the wake of Brexit, opportunities are emerging for investment in the U.K. commercial real estate market by those seeking distressed opportunities.

U.S. Economy

In contrast to the U.K. economy, Brexit has had little impact on the U.S. economy. Unemployment has held steady at 4.9% for the past three months, and job growth is strong and healthy. U.S. payrolls grew by 271,000 in June, and the economy maintained momentum in July, when 275,000 jobs were added. A slower, but still healthy, growth of 151,000 jobs in August is indicative of an economy that is nearing full employment.

U.S Monthly Job Growth



But Brexit has had an impact on the U.S. economy, factoring into the Fed's decision not to raise its benchmark interest rate in recent months. The Fed is closely monitoring global economic events (i.e., the market's reaction to Brexit) for their impact on the U.S. economy. Following the relatively disappointing jobs report in August, a September rate increase is less likely, although a December increase is a distinct possibility. Low current interest rates, and even more importantly, the prospect of low interest rates for longer than had been anticipated, is good news for U.S. real estate.

U.S. Real Estate Market

The global community has been amassing capital during the past several years for commercial real estate investment, and the volume of foreign capital being plowed into U.S. properties is at record highs. Investors worried about what implementation of the Brexit referendum will do to the British economy and to a lesser extent, Europe's are incentivized to consider other global markets. Investors are widely expected to flock to the U.S. market, which is perceived as a safe haven in a time of turmoil.

"Institutional commercial real estate fund-raising is a primary driver of our transactional-focused business, and many of the investors we work with have a global view. The uncertainty in the U.K. post-Brexit, and perhaps Europe as a whole, provide them with an incentive to allocate more funds to U.S. real estate markets," observed Joseph Derhake, PE, Chief Executive Officer, Partner Engineering and Science, Inc., a leading property due diligence provider and EDR client.

EDR Insight's ScoreKeeper model tracks environmental due diligence activity, measured in terms of the volume of Phase I environmental site assessments, for the U.S. market. Since due diligence is performed prior to a property transaction, Phase I ESA activity is a leading indicator of commercial real estate investment—much like the Architectural Billings Index is an economic indicator of future commercial real estate construction.

For a look at whether Brexit impacted U.S. property markets, the accompanying table compares Phase I ESA activity this past July and August with the corresponding period of 2015. The data isolates the volume in the top 20 primary markets relative to the rest of the top 100 markets, as well as the U.S. market overall. The results suggest that pre-transactional due diligence activity post-Brexit was flat to declining overall with little difference in the top 20 primary metros relative to the rest of the U.S. When viewing these year-on-year comparisons, it is worthwhile to note that 2015 was the strongest year for property investment markets since the downturn. For instance, there was a roughly 10% decline in investment activity in major global cities this year when compared to 2015, even before Brexit.

Phase I ESA Activity: Year over Year

	Jul/Aug 2016	Jul/Aug 2015	YOY
20 Primary Markets	17,594	18,567	-5%
Remainder of Top 100 CRE Markets	14,475	14,516	0%
U.S. Market Overall	45,469	47,612	-5%

A closer look at the 20 individual metros, found on the follow page, shows a wide range of year-over-year performance in the July/August timeframe, from a contraction of 22% in Tampa to 14% growth in Phoenix. Among the three largest markets, New York City, Los Angeles and Boston, Phase I ESA activity declined by 17% , 9% and 1%, respectively, suggesting that a migration by foreign investors to these safe havens has yet to take root.

The robust inbound foreign investment of the past few years should intensify in the wake of Brexit. If this happens, it will be good news for clients supporting deals in metros like New York City, Boston, Chicago, San Francisco, Los Angeles, Washington D.C., and other cities that would be in vogue as targets for the risk-averse.

U.S. Lending Environment

In the lending world, the focus is on market pressures and regulator attention. Bank examiners have been vocal about lenders' increased exposure to commercial real estate. In the latest Semiannual Risk Perspective, Thomas Curry, U.S. Comptroller of the Currency warned: "It is at this stage of the cycle that we also see strong loan growth combined with easing underwriting to result in increased credit risk. CRE portfolios have seen rapid growth, particularly among small banks,

Phase I ESA Activity in the Top 20 Primary Metros

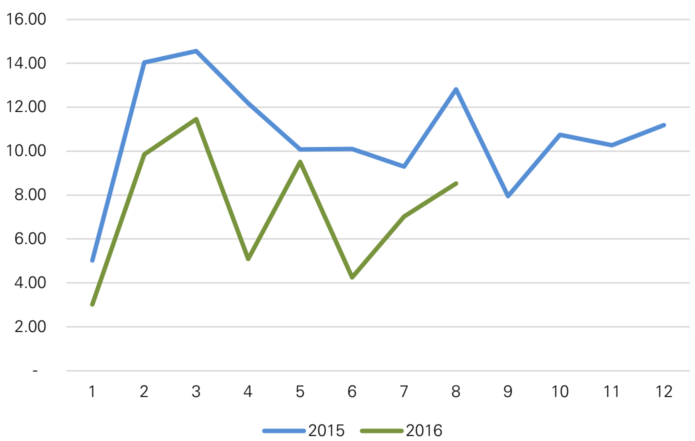
MSA	Jul/Aug 2016	Jul/Aug 2015	YOY
New York-Newark-Jersey City, NY-NJ-PA	2,489	2,993	-17%
Los Angeles-Long Beach-Anaheim, CA	1,709	1,875	-9%
Boston-Cambridge-Newton, MA-NH	1,263	1,272	-1%
Chicago-Naperville-Elgin, IL-IN-WI	1,256	1,202	4%
Dallas-Fort Worth-Arlington, TX	1,130	1,059	7%
Atlanta-Sandy Springs-Roswell, GA	1,040	1,085	-4%
San Francisco-Oakland-Hayward, CA	852	854	0%
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	851	1,056	-19%
Miami- Fort Lauderdale-West Palm Beach, FL	845	890	-5%
Houston-The Woodlands-Sugar Land, TX	811	789	3%
Seattle-Tacoma-Bellevue, WA	743	701	6%
Phoenix-Mesa-Scottsdale, AZ	711	624	14%
Detriot-Warren-Dearborn, MI	706	712	-1%
Washington-Arlington-Alexandria, DC-VA-MD-WV	673	680	-1%
Riverside-San Bernardino-Ontario, CA	619	715	-13%
San Diego-Carlsbad, CA	515	496	4%
Tampa-St. Petersburg-Clearwater, FL	357	455	-22%
Baltimore-Columbia-Towson, MC	350	425	-18%
St. Louis, MO-IL	344	320	8%
Minneapolis-St. Paul-Bloomington, MN-WI	330	364	-9%

and concentration risk management has become an area of emphasis for regulators. The Brexit decision appears to be less impactful on lending decisions than the promise of additional attention from regulators, combined with uncertainty over the timing of the next downturn.

CMBS Markets

Spreads have tightened and CMBS originations have increased during the July and August post-Brexit vote period. U.S. stock markets plummeted immediately after the referendum was passed, but quickly recovered. A strong June jobs report helped people realize that Brexit should have little impact on the U.S. economy, jobs, or real estate. The market's rapid recovery indicated to investors that a recession would not be imminent and helped unlock CMBS markets that were stymied during the first half of the year by recession worries and Brexit concerns. Spreads tightened, making CMBS more competitive with other sources of capital and causing CMBS originations to increase. The dollar value of CMBS originations grew from $4.25 billion in June to $7.02 billion in July and $8.53 billion in August.

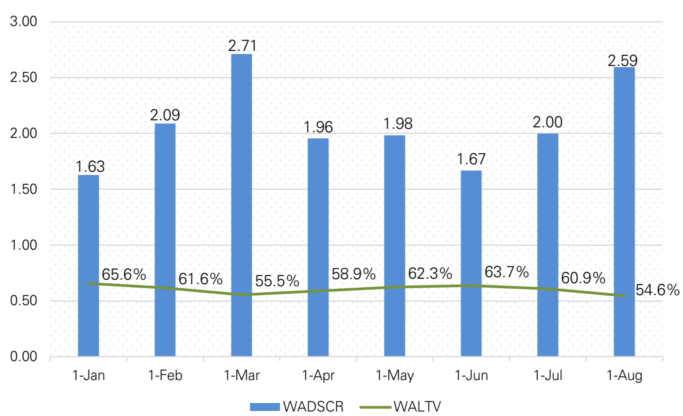
CMBS Originations: Year over Year



To be sure, the allayed Brexit fear wasn't the only factor that contributed to the resurgence in the CMBS market in July and August. A generally lethargic new-issue market helped, as did the Fed's decision not to raise interest rates. Financial market uncertainty created by Brexit has been expected to result in more global investment in the U.S., which would drive loan-origination activity and with that an increase in CMBS issuance. But the data don't show that yet.

Typically, lenders loosen requirements at this stage of the cycle, but recent CMBS deals have been characterized by tighter underwriting. The average weighted average debt-service coverage ratio for new CMBS originations climbed sharply from June to July and again in August. Also, the weighted average loan-to-value ratio fell from 63.7% in June to 54.6% in August. Because of their tighter underwriting, these deals, including the market's first deal designed to meet risk-retention requirements, have been well received.

Lending Requirements : Month over Month



Again, the data does not yet show any discernible change in specific markets because of the Brexit referendum. As expected, July and August originations were highest in gateway markets, including New York, San Francisco, Los Angeles, and Washington D.C. CMBS originations for the July-August period were up in some of these key markets compared to year-ago levels, but down in others.

Four markets experienced a sharp increase in originations during July and August compared to year-ago levels, even though origination activity is down nationally year-over-year. Real estate markets in San Francisco (+143%) and Boston (+75.6%) have been buoyed by strong tech sectors. Riverside-San Bernardino's (+55.3%) warehouse distribution market has experienced a resurgence. Strong employment growth in Washington D.C. (+45.4%) is also fueling its real estate market. A comparison for CMBS originations in the top 20 primary markets can be found on page 5.

Conclusion

So far, Brexit has not had any discernible impact on U.S. commercial real estate markets. But the expectation remains that as foreign investors seek safe havens for their commercial real estate dollars, they'll turn to major U.S. markets.

So the ultimate outcome of the Brexit Referendum is far from certain, which injects another layer of uncertainty on top of the Presidential election and other global political/economic uncertainty. The U.K. faces years of negotiations over its exit from the European Union, and no one knows whether other countries will follow the U.K.'s path, potentially causing the E.U. to collapse.

In the meantime, lenders and investors are proceeding with caution, but for reasons that have more to do with U.S.-based factors than with what is happening in the U.K. For instance, in the CMBS market, pending risk-retention rules are a much bigger issue than Brexit.

The more pressing issues that are impacting the U.S. commercial real estate markets are the likelihood of an interest rate increase by year-end, increased financial regulation, the market pause that typically characterizes the months leading up to a Presidential election and growing speculation about the timing of the next cyclical downturn—these factors, combined with Brexit's uncertainty, could make investors more skittish than usual leading into the fourth quarter.

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CMBS Originations in the Top 20 Primary Metros

MSA	2015	2016	YOY	WADSCR Jun-Aug Chg	WALTV Jun-Aug Chg
New York-Newark-Jersey City, NY-NJ-PA	2,583.45	1,484.54	-42.5%	32.5%	-2.0%
San Francisco-Oakland-Hayward, CA	388.72	823.01	143.0%	104.6%	-19.0%
Los Angeles-Long Beach-Anaheim, CD	1,504.82	739.62	-50.8%	48.3%	-3.7%
Miami- Fort Lauderdale-West Palm Beach, FL	465.83	677.25	45.4%	105.7%	-16.8%
Boston-Cambridge-Newton, MA-NH	271.36	476.47	75.6%	205.1%	-23.9%
Dallas-Fort Worth-Arlington, TX	576.20	373.93	-35.1%	23.4%	-3.5%
Phoenix-Mesa-Scottsdale, AZ	465.60	249.33	-46.5%	49.3%	-22.2%
Atlanta-Sandy Springs-Roswell, GA	253.74	246.26	-2.9%	32.7%	-2.5%
Houston-The Woodlands-Sugar Land, TX	326.23	217.82	-33.2%	-5.7%	7.2%
Chicago-Naperville-Elgin, IL-IN-WI	538.86	202.59	-62.4%	6.9%	-9.3%
Detriot-Warren-Dearborn, MI	221.99	179.22	-19.3%	30.1%	-14.2%
Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	210.78	178.67	-15.2%	-18.3%	5.4%
Riverside-San Bernardino-Ontario, CA	94.20	146.28	55.3%	2.7%	-12.9%
Baltimore-Columbia-Towson, MC	158.32	123.55	-22.0%	27.0%	-11.0%
Tampa-St. Petersburg-Clearwater, FL	218.77	101.38	-53.7%	45.3%	-3.6%
Seattle-Tacoma-Bellevue, WA	322.30	75.45	-76.6%	62.9%	-3.7%
San Diego-Carlsbad, CA	321.01	72.67	-77.4%	22.2%	-10.8%
Minneapolis-St. Paul-Bloomington, MN-WI	62.24	71.74	15.3%	NA	-44.0%
St. Louis, MO-IL	38.42	16.23	-57.8%	-19.6%	10.3%

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