Newmark Realty Capital Looks at Defining Trends in the Commercial Real Estate Market for 2018

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Yale Apartments in South Lake Union. Image courtesy of Newmark Realty Capital

By Jack Stubbs

Two months into the new year, many companies are trying to keep a pulse on market trends that might impact the industry in the coming year and beyond.

We recently spoke with Mike Taylor, principal at Newmark Realty Capital's Seattle office, about the company's involvement in the Puget Sound region and factors that might impact the financial landscape of the commercial real estate market in the year ahead.

Michael Taylor has been in the commercial real estate industry for over 30 years with the past 25 in mortgage banking. Mike was a founding Principal of Newmark's Seattle office in 2006 and has arranged over $3 billion in financings during his career for properties located throughout the Western United States.

Newmark Realty Capital Inc. is the largest independent commercial mortgage banking firm in the Western United States. On behalf of commercial real estate developers and investors, Newmark arranges debt and equity financing from $1 million to over $200 million. Financing is arranged through major institutional real estate investors including life insurance companies, pension funds, government sponsored agencies, commercial and investment banks.

Michael Taylor

In many ways, 2017 was a record year for the industry. What were some of the trends that characterized this past year? Was there anything in particular that surprised you about 2017?

2017 was actually a very steady year for Newmark, in many ways similar to the previous 3 or 4 years with a little extra drama due to uncertainty of future changes. Our production volume companywide has been steady at roughly $2.5 billion in loans annually since 2014, and in excess of $2 billion for the past six years. Maybe there has been a lot of background noise, and a few lenders that have come and gone, but for the most part, 2017 was very similar to 2016, 2015 and 2014.

I'd say the 'trend' was 'more of the same' in a good sense. The pessimist in me thinks this must end soon but so far so good. The key is helping clients find the right solutions for their specific investment goals, and in this market, options still exist across a spectrum of lending platforms and structures.

Looking ahead to 2018, what are some of the broader trends that you think will define the commercial real estate market in the Puget Sound region in 2018? Are you seeing any indication today of how this year will shape up to be?

Our lenses focus mostly on the capital markets and specifically the long-term fixed rate debt variables. A couple things in that sector are interesting. I think everyone is aware of the rise in US Treasury rates. The 10-year has gone from just over 2 percent in early September [2017] to nearly 3 percent today, but the rise in short-term treasuries is even more dramatic, as the 1-year US Treasury has gone from .78 percent a year ago to just over 2 percent today.

Most fixed-rate commercial mortgages have a premium or penalty to prepay before maturity, and typically this is tied to the treasury rate that matches the remaining term on a specific loan. With the yield curve so flat now, there is an opportunity for borrowers that are midway into a 10-year loan to refinance. And although the prepayment may still be significant, the ability to lock in to a new long term loan can often make economic sense. We have several clients that are refinancing now 2 to 3 years before their loans mature to take advantage of this scenario. Also, with the run-up in values, many of these people are able to pull out a significant amount of cash.

What are some of the metrics and figures that you track, personally, that give you a sense of the health of the local market right now?

There are a wide variety of metrics to watch, and I'm not sure any one is more important than another. I watch the vacancy rates, rental rates, rate increases and construction starts in the Seattle region. We don't necessarily have any influence over the markets, but really need to be able to react to what is happening to serve our client's best interests.

Most of the business I do involves the refinance of existing loans that are maturing. In those instances, it doesn't really matter where the market is, what rates are, or how the economy is doing: the loan is due and the borrower needs us to get the best loan possible at that time. The past couple years have been very kind to borrowers refinancing as values have gone up on virtually all product types and rates have remained low. I hope that trend continues.

What were some of the broader economic trends that you anticipate will influence the commercial real estate market in Seattle specifically and the Puget Sound region generally in 2018?

One continuing trend that I don¹t necessarily see first-hand but certainly hear about is the skyrocketing cost of construction and shortage of labor. It seems as though this, as much as anything, may put a bit of a governor on how much gets built locally moving into 2018 and beyond. Another issue we hear about is the changing landscape of retail and retailers and its impact on commercial real estate. Lenders and buyers are a looking a bit more cautiously at retail deals now, and I expect that will continue as the retail landscape continues to evolve.

From an economic perspective, do you foresee the financial needs of real estate investors and developers changing in the year ahead? What factors might drive this shift?

The one interesting thing I see investors considering is refinancing assets rather than selling. The lack of quality up-legs to a traditional 1031 exit has many owners/investors looking at cash out refinancing as a preferred investment model for optimized ROI. Staying with the asset you know, banking on the increased valuations and capitalizing on the still historically low interest rates will make this an appealing course of action in the year ahead if market conditions remain consistent.

Where do you see cap rates going in 2018 and what impact to you foresee that having on the market?

I suspect some of my friends in the investment sales sector may have their hands more on the pulse of where cap rates are headed. However, if interest rates continue to inch up it would seem logical that cap rates would follow, although I really cannot picture a scenario where any upward movement is drastic.

The Puget Sound region, and Seattle in particular, is increasingly becoming known as a hub for tech and the growing Life Sciences sector. How important is the region in the national pecking order of places where to invest, and do you see the region gaining ground in that regard?

When I started in the industry almost 3 decades ago, our region was an attractive place for many national and international investors with specific investment interests, but for several years now Seattle has become a first-tier market. We hear from many of the lenders we work with that they cannot get enough product in our market because of how competitive it is and has been for several years.

Strong economic fundamentals, high quality of life and barriers to entry establish demand and support asset performance. The strength of our local economy is also attractive to lenders, who see this market fundamental as mitigating risk and ensuring performance. I don't know where we fall in the pecking order of ranking by investors, but it¹s high enough to ensure continued allocations and interest from the institutional lending community.

With all of the political uncertainty occurring in Washington, what may be some of the bigger challenges for the industry in the year ahead?

If you really want my opinion on what is happening in the 'other' Washington, you'll have to buy me a couple pints! All partisan politics aside, the key for our industry could be how tax reform plays out in the coming 12 to 18 months. This is a business issue regardless of which side of the aisle you sit on. The uncertainties will surely dissipate as the year progresses, but until a clear understanding of how new legislation impacts long-term commercial real estate investment strategies, this is a legislative agenda to closely watch in the coming months.

With a volatile stock market and presumably additional corrections to follow, what impact do you see this having on the commercial real estate industry?

I think that for the institutional investors, volatility in the stock market coupled with rising rates may make commercial real estate, and specifically commercial mortgages, look like a much better relative value. We saw most of our life insurance and pension fund lenders increase allocations in the second half of 2017, and this is an indicator supporting the above.

Most of our clients that own real estate locally are more concerned about their own properties and the specific markets they are in and are less impacted by fluctuations in the stock market, so long as we don't have another global meltdown like we had in 2008-2009. I don't know that normal corrections in the market will impact our industry tremendously.

Where do you foresee interest rates going this year, and what impact do you see that having on the industry?

Consensus among most of those "in the know" is that the 10-year treasury should bounce up and down this year with the over/under being roughly 3 percent. If rates move up too much, it may be a shock for some borrowers when all the loans we placed at 3.5 percent to 4.5 percent need to get replaced by something with a 6 or 7 in front of it. 2018 is a year when investors need to review their holdings and make decisions on refinancing at today's rates, even in advance of maturity.

In your mind, what are some of the other macro trends that will shape the investment picture in 2018?

The decision to refinance current holdings over selling assets could continue to tighten the market and push up valuations as scarcity of viable investment product takes hold. Incremental rate increases balanced to compressed spreads will keep rates attractive if all trends remain consistent, and it will be interesting to see how many investors make timely moves not compelled by maturity to capitalize on this opportunity before rates increase and we see the end of this cycle.

What do you think clients and investors should be keeping an eye on over the next 12 to 18 months?

The potential to miss the window of current low rates to position for the long-term hold should be top of mind for investors. The window to wait and see based on this extended period of lower rates should transition to the exploration of early refinance opportunities to maximize long-term ROI before the window closes.

What do you think people will be talking about 18 months from now? Is there anything else that we should be discussing or anything else you'd like to add?

I have a difficult time planning what I'll have for dinner each day, let alone guessing 18 months into the future, but I do think—although I have no idea when this will be—that we will look back on the low rates of this era and wonder why we didn't borrow as much as possible for as long as possible while the window existed.

Eastern Washington is a market sometimes overlooked where Newmark was extremely active in 2017. The market is strong throughout the state, and that is encouraging and reflected in the healthy allocations from institutional lenders in Washington particularly. We placed a significant number of loans across a broad spectrum of assets, [with] office, multifamily and industrial leading the way.