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PCCP Market Commentary

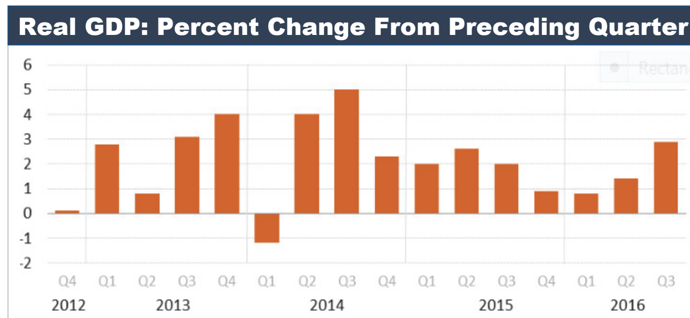
Searching for Investment Opportunities in an Uneven GDP Growth World

First Quarter 2017

Our job at PCCP is to find solid real estate investment opportunities in an often volatile economic environment. This quarter, we examine how concentrated industry sector growth by metro area affects risk and value in real estate investing.

Let's start with the economic cycle. There is much market discussion about whether we are at or near the end of this real estate cycle. While the equity markets continue to gain under the expectation of swift economic and regulatory changes under the new administration, several economic indicators support a conclusion that real estate is taking a balanced view:

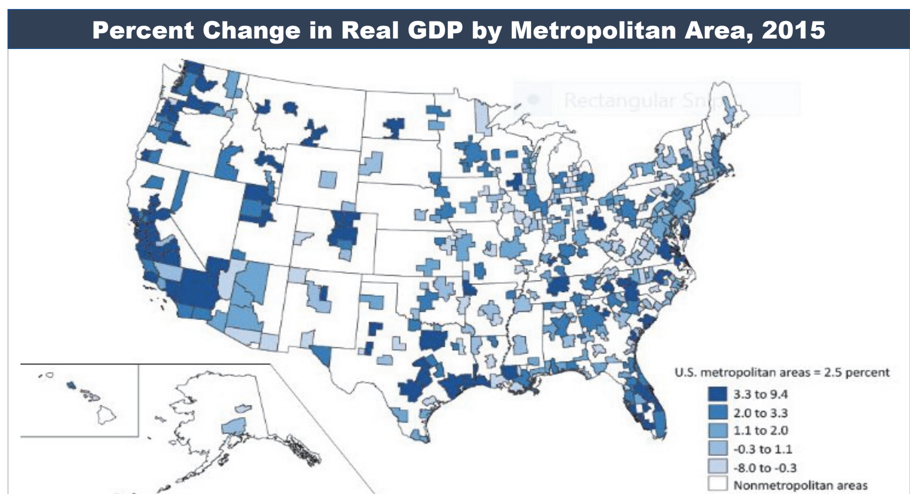
- Banks are reducing risk. So, although overall real estate lending is up, evidence shows that loan to value ratios are down 10% or so since the prior peak.
- Open-end real estate fund redemptions are up 80% YoY for Q2 2016.
- There has been a 9% decline YOY in real estate private equity capital raised Q1-Q3.
- Real estate is more expensive than ever. The Moody's CPPI is 20% above its December 2007 peak.



U.S. Bureau of Economic Analysis *Seasonally adjusted annual rates*

GDP growth is painting a mixed picture. As of the date of this letter, it looks like Q3 2016 GDP growth will annualize at over 3%, however, the Federal Reserve is forecasting growth over the next three years at just 2%. This is a significantly lower level of growth than projected by the incoming administration. Nevertheless, the adjacent chart shows this economic recovery cycle can be best described as anemic.

However, GDP growth is not distributed evenly across the U.S., and a number of substantial domestic markets have outstripped the macro picture with a 4% growth rate since 2010. Since real estate returns correlate highly with growth and jobs, we took a deeper look at these markets.



U.S. Bureau of Economic Analysis

As the heat map indicates, several substantial metropolitan areas have shown solid growth over the past year, particularly the coastal and southern markets. To understand why this is happening, we look at "Location Quotient." Location Quotient is a fraction where the numerator is the percentage share of an industry sector in a particular real estate market and the denominator is the national market average. So, for example, San Jose's Location Quotient for technology is 5.2,

which means technology as an industry is more than 5 times more concentrated in San Jose than the U.S. average. At some level, investing in a high growth metro with a concentrated industry mix is like investing in a basket of equities in a certain industry: one is making a bet on future prospects of that industry.

Of the significant high growth markets in the heat map above, we can break down some elements of growth:

Market	LQ	Comment
San Jose	Tech 5.2	Technology Capital of the World
Austin	Tech 2.5	Technology, tempered by education
San Francisco	Tech 2.0	Surprisingly balanced (but Biotech separately is at 2.2)
Seattle	Tech 1.5	Technology, balanced by defense
Houston	Energy 9.8	Oil capital of the world
Denver	Energy 2.2	Still an oil town
Dallas	Energy 1.5, Finance 1.1	Fairly diverse economy

We all know that San Jose is the tech capital of the world, and Houston is the oil capital of the world. Dallas, on the other hand, is a more balanced market. The Dallas-Fort Worth area has enjoyed 4% GDP growth since 2011. Dallas has energy business, but also has seen growth in health care, IT, finance, and an ongoing construction boom for insurance and financial back office operations. Technology and energy have been major drivers of GDP growth, however, when a Location Quotient is 5 or 10 times the average, an investor must pause and think about whether one is really making a real estate bet.

Demand is of course only half of the equation. Barriers to new supply have made San Francisco and Seattle interesting investment markets, but this has led to record prices per square foot. On the other hand, Dallas and Houston remain supply friendly, which have kept prices down.

Our conclusion is that GDP growth is an important indicator of investment performance, but at some point, a real estate investment in a concentrated market can becomes an investment in a particular industry and caution is required. We take these concentrations into account as we build our portfolio and evaluate them as we evaluate new investment opportunities.

SOURCES: Real Capital Analytics "US Capital Trends, the Big Picture", CBRE "Global Office Rent Cycle Q2 2016", Morgan Stanley "The State of the CRE Credit Cycle: 3rd Edition" , Pensions & Investments "Redemptions, investor shifts put pain on real estate open ended funds", Preqin "Q3 2016 Fundraising Update", The Real Deal "The next big short?", Morgan Stanley NA Insight May 2016 "Real Estate Investment Trusts" , CBRE Research "CRE Credit Cycle Jul 2016", Pensions & Investments "IACPM Credit Managers Still Believe Defaults Will Rise", "Bureau of Economic Analysis: Gross Domestic Product", CoStar's Location Quotient tool

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