The NAIOP CRE Sentiment Index



Industry Leaders' Outlook for Commercial Real Estate Fall 2017

NAIOP CRE Sentiment Index
Survey Conducted September 6-18, 2017

0.49

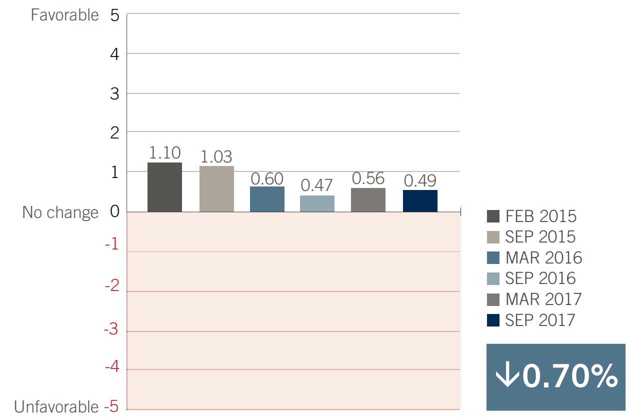
-5 0 5

Below zero means **unfavorable** CRE conditions are expected in 12 months.

Zero means **no change** in CRE conditions is expected in 12 months.

Above zero means **favorable** CRE conditions are expected in 12 months.

NAIOP CRE SENTIMENT INDEX



PERCENT CHANGE BETWEEN MARCH AND SEPTEMBER 2017

Key Findings

The NAIOP CRE Sentiment Index for September 2017, a composite of nine survey questions, decreased slightly to 0.49 (from 0.56, as measured in the March 2017 survey), but posted the second lowest reading in the history of the three-year old survey. It returned to the level noted in September 2016, when commercial real estate fundamentals were generally positive but uncertainty regarding the U.S. presidential election clouded the general economic outlook. Since the survey's Index is greater than zero, this indicates that respondents believe, as a group, that general market conditions over the next 12 months will continue to be favorable for the CRE industry, and overall conditions will be better in 12 months (September 2018) than they are today. This survey reflects an expectation that the CRE market will be moving ahead at a more cautious pace than what was expected six months ago, and at about the same pace as measured one year ago.

Notable Changes From the March 2017 Survey

The two largest positive changes in the survey that helped keep the Index in positive territory were much greater confidence in the availability of debt and equity capital. Survey scores for both debt capital (a 3.00 percent increase) and equity capital (a 4.70 percent increase) show a major trend reversal for these two categories after both slid consistently over the prior three surveys. At the same time, however, respondents are more concerned about the costs of construction materials and labor, as these survey components each slid by 3.50 percent, hitting all-time lows. Expectations for first-year cap rates rebounded 2.80 percent (although they are still expected to be higher in 12 months) and optimism for occupancy rates fell by 6.50 percent to a new low-water mark in this survey.

Respondents continue to be generally optimistic about the CRE market in the coming year; however, the score for the survey's individual, general sentiment question fell 3.00 percent (from 0.65 to 0.35) between March and September 2017.

Agreement/Disagreement Among Respondents

The most consistent responses (meaning there was the most agreement among survey participants) continue to relate to the questions regarding face rents and occupancy rates. Tendencies among both of those responses indicated steady, continuing growth in these areas over the next year. The least consistent responses, signaling disagreement among the respondents, were about employment growth and the expected costs of construction labor and materials over the next year. In fact, construction labor costs registered the most disagreement among the respondents. These employment-related readings are consistent with the uneven real estate-related job growth that has occurred in various regions across the country since the U.S. presidential election last November.

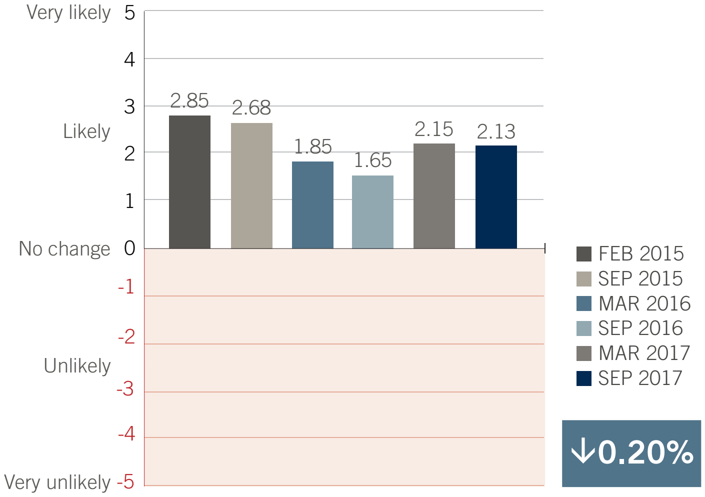
About the NAIOP CRE Sentiment Index

The NAIOP CRE Sentiment Index is designed to predict general conditions in the commercial real estate industry over the next 12 months. The forecast is not based on an analysis of historical data, but rather it represents a look into the future by real estate developers, investors and operators. These NAIOP members are asked to respond to questions based on their ongoing work, including projects in their pipelines (For more information, see "Understanding the Index" on page 5.)

NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

EMPLOYMENT

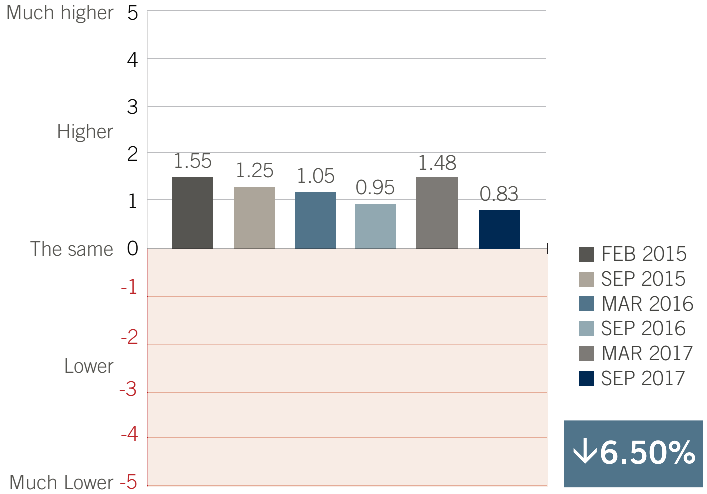
1. How likely is it that your company will add employees within the next 12 months?



Expectations regarding employment growth over the next 12 months remain basically unchanged (down by 0.20 percent) since the last survey, conducted in March 2017, and they are still much better than readings from both surveys conducted in 2016. The score for this question is highly positive (2.30), indicating that survey respondents expect that they are likely to add more jobs over the next year than they thought they would in 2017.

OCCUPANCY RATES

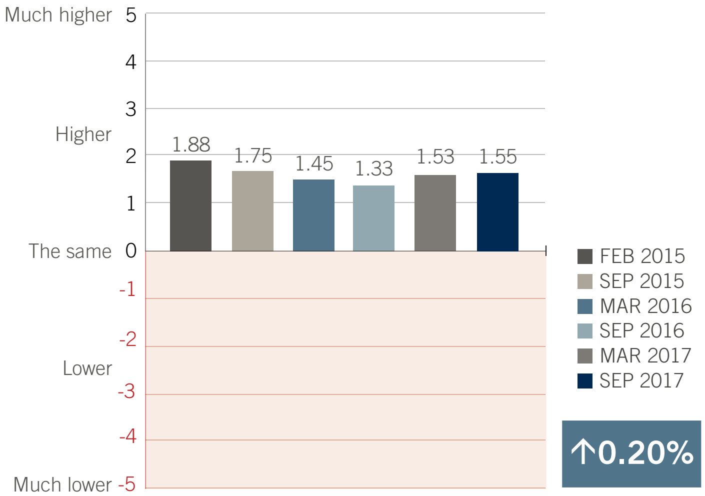
2. Based on your own projects, where do you believe occupancy rates will be in 12 months?



The 0.83 score for occupancy was a significantly negative change compared to the March 2017 survey, and its level is lower than it was for all prior surveys. The 6.50 percent decrease is the greatest change among all questions in the current survey and continues a downward trend that began with the September 2015 survey. Based on this survey's responses, occupancy rates are expected to grow, but more slowly than expected six months ago, underscoring respondent comments about the maturing cycle.

FACE RENTS

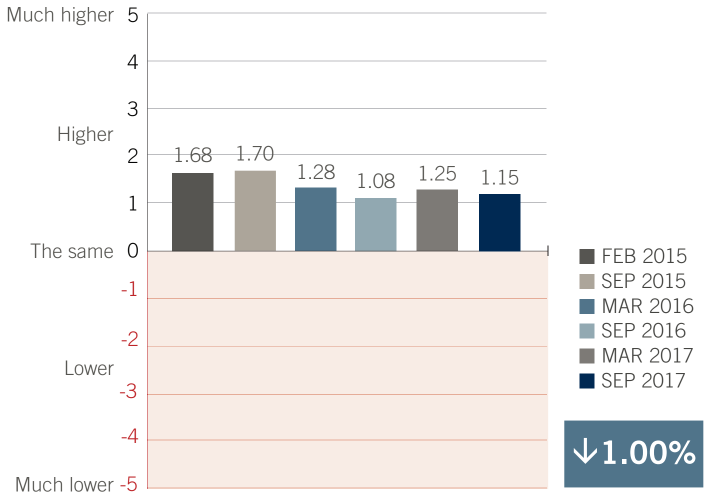
3. Based on your own projects, where do you believe face rents will be in 12 months?



Unlike occupancy rates, the 1.55 face rent score represents a slight up-tick and is an indicator of continued improvement over expectations from the prior 18 months. This score denotes a 0.20 percent increase in expectations among survey respondents and was, like employment, a major contributor to the positive reading of this survey's Sentiment Index. Overall, face rents are expected to remain positive and improve between now and the summer of 2018.

EFFECTIVE RENTS

4. Based on your own projects, where do you believe effective rents will be in 12 months?

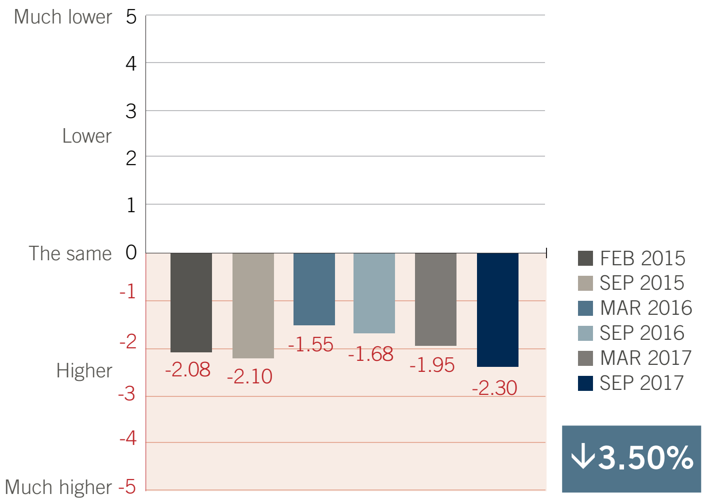


Expectations regarding effective rents decreased 1.00 percent in this survey, yet the reading remained positive (1.15) for CRE markets. As such, effective rents are expected to rise somewhat over the next year, however, at a slower pace than what was expected six months ago. Consistent with the March 2017 survey, effective rents and face rents are expected to converge and start growing at similar rates, possibly indicating that operating expenses and/or concessions are expected to rise slightly in the coming year.

THE PERCENT CHANGE NOTED IN EACH GRAPH RELATES TO THE SURVEYS CONDUCTED IN MARCH AND SEPTEMBER 2017.

CONSTRUCTION MATERIALS COSTS

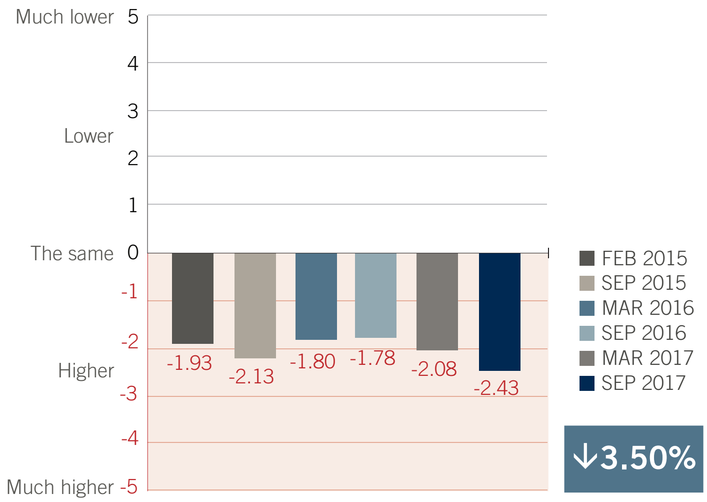
5. For projects on which you are seeking bids, where do you believe the cost of construction materials will be in 12 months?



There was much less optimism about construction materials costs in this survey than in prior surveys with a 3.50 percent decrease. The score reached its lowest point ever (became more negative), going from -1.95 to -2.30. This decrease indicates that respondents expect the cost of construction materials to be much higher in the next year, as rebuilding following the recent hurricanes and earthquakes generates competition for both materials and labor.

CONSTRUCTION LABOR COSTS

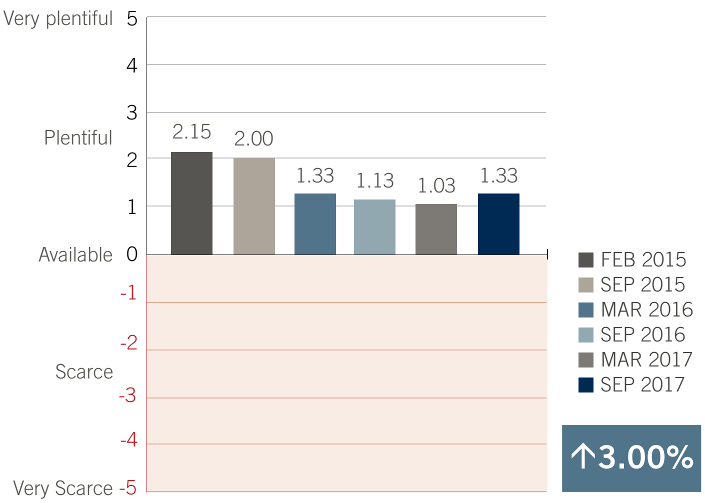
6. For projects on which you are seeking bids, where do you believe the cost of construction labor will be in 12 months?



The score for construction labor costs (-2.43) is about 3.50 percent "greater" than the score reported in the March 2017 survey. It is now a greater negative than ever recorded in this CRE index, surpassing the previous low of -2.13 in the February 2015 beta survey. This large negative score indicates that respondents expect construction labor costs to rise during 2018 at a greater rate than they expected in both 2016 and 2017.

AVAILABLE EQUITY

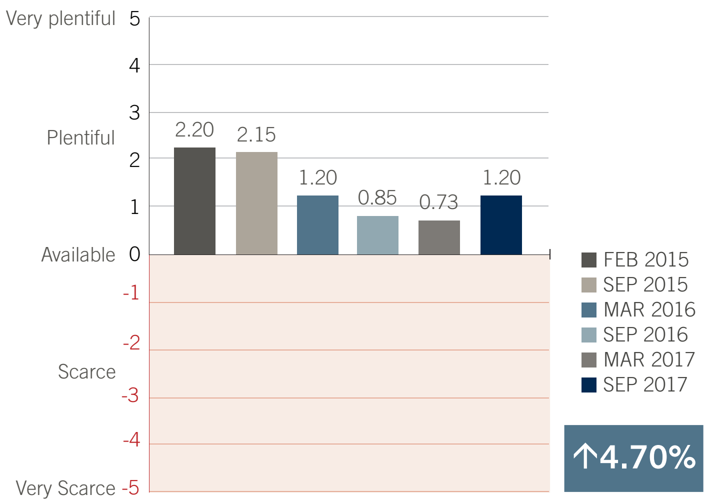
7. For projects you will be financing/refinancing, how plentiful do you believe equity will be in 12 months?



The reading regarding available equity rebounded after declining steadily over the prior two years. In the past six months, this score increased by 3.00 percent and is where the reading stood in March 2016. Any time this attribute's score has a value that is greater than zero, equity is expected to be available for new projects.

AVAILABLE DEBT

8. For projects you will be financing/refinancing, how plentiful do you believe debt will be in 12 months?

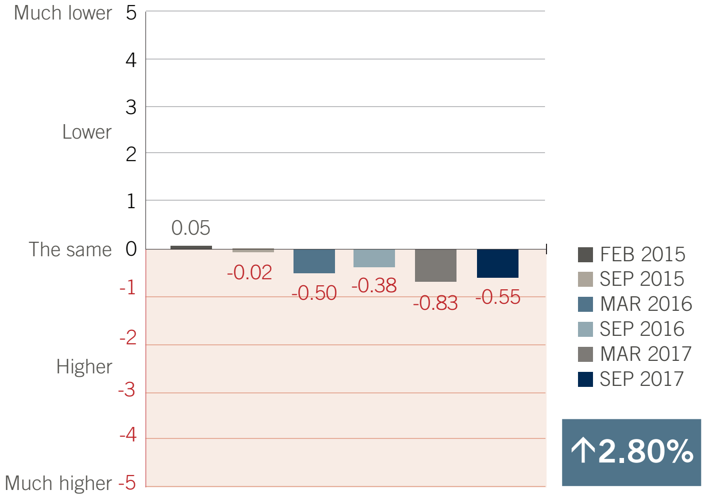


Like equity, the index figure regarding available debt registered a large rebound (4.70 percent), reversing a consistent decline since the February 2015 survey. Like equity, debt capital is expected to be available at still favorable rates. Some real estate owners have reported receiving quotes from multiple lenders for some office but especially industrial projects in key submarkets.

THE PERCENT CHANGE NOTED IN EACH GRAPH RELATES TO THE SURVEYS CONDUCTED IN MARCH AND SEPTEMBER 2017.

FIRST-YEAR CAPITALIZATION RATES

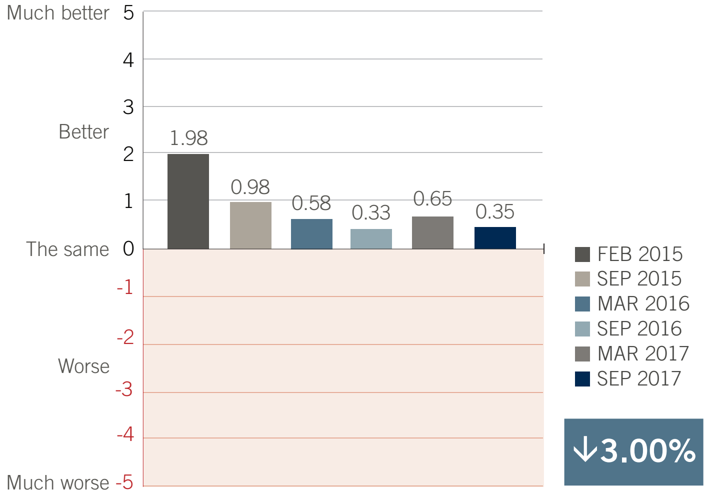
9. Where do you expect first-year cap rates to be for deals you will close 12 months from now?



Survey responses indicate that first-year cap rates are expected to increase in the coming year, but less severely than they were expected to rise six months ago when the March 2017 survey was conducted. The September 2017 score was less negative (with a score of -0.55), resulting in a 2.70 percent positive change. In other words, the current survey score rebounded significantly from the March 2017 score of -0.83. This result indicates that respondents anticipate an increase in project risk, however, the expectation is less severe than what was reported six months ago.

GENERAL SENTIMENT

10. What is your general sentiment regarding conditions in the commercial real estate industry; as a commercial real estate professional, how do you see the industry in 12 months?



The general sentiment score — much like the scores for occupancy rates and both construction labor and materials costs — moved downward in this survey. The 0.35 score for this question is 3.00 percent lower than the reading noted six months ago and it is at about the same level as it was one year ago. The score is still a positive sign for the CRE industry in that survey respondents expect an upbeat commercial real estate climate over the next 12 months, but a slightly less positive one than six months ago.

THE PERCENT CHANGE NOTED IN EACH GRAPH RELATES TO THE SURVEYS CONDUCTED IN MARCH AND SEPTEMBER 2017.

Direct From the Survey Participants

"[I] think a lot of people are waiting for [the] bid/ask spread to narrow with sellers becoming realistic, along with … more opportunities [to purchase] … distress[ed properties] from those who were undercapitalized or over-levered."

"I am nervous about geopolitical issues created by our unpredictable president. I am concerned about the loss of environmental protections under the current administration. I am worried about the widening wealth gap in the USA."

"[There is a] big difference between office and industrial [properties]. In office, face rates will be up and net effective [rents will be] flat or slightly lower. In industrial, both will rise."

"The last few years have seen a very high rate of rent growth, particularly in the industrial sector. That combined with cap rate compression and long-term loans continuing to refinance at exponentially lower rates, has yielded an extremely strong performance in asset returns. [It] does not appear that [this] will subside in the next 12 months with e-commerce driving a new wave of demand [together] with a more timid pace of speculative construction that is likely caused by more expensive land … and less aggressive financing. In short: lease rates have been skyrocketing and that pace will continue."

"[The] impacts of natural disasters — hurricanes Harvey and Irma — will have a significant impact on construction costs — labor and materials — in the south and the west, if not nationwide."

"The large and coastal regions and markets will do fine; secondary/tertiary markets are starting to suffer from poor local economies as all things consolidate to major population centers."

"Things remain competitive on the acquisition front, but I think the bulk of the cap rate compression is done. But there is still too much capital chasing too few deals."

"Fundamentals are still solid and development hasn't gotten out of line, but the cycle feels mature and pricing is past peak levels in many markets. However, demand remains strong in the markets we're looking to acquire in so as long as investors stay disciplined, I don't think the market will change a whole lot over the next 12 months, unless there is a black swan event on the horizon."

Understanding the Index

The survey's final question about overall sentiment regarding future conditions is designed to serve as a verification of the Sentiment Index and is not included in the calculation of the Index. **The score for the final question is 0.35, whereas the Index is slightly higher at 0.49. Said differently, when responses to the first nine questions—which relate to real estate fundamentals—are combined into the composite Index, the result is slightly more positive than when respondents were asked a single, subjective question regarding overall sentiment toward the CRE marketplace.**

The NAIOP Sentiment Survey is conducted biannually, in March and September. The survey is sent to roughly 5,000 NAIOP principal members in the U.S. who are developers, investors and operators in the office, industrial, retail and multifamily sectors. It asks 10 questions about jobs, the space markets, construction costs and the capital markets. Respondents indicate whether their 12-month outlook for each category is positive, negative or neutral. The responses are not equally weighted. Instead, weighting varies based on whether the responses to a question are tightly packed or dispersed. Questions with tightly packed responses (meaning there is more consistency among the answers to that question) are more heavily weighted than those with more dispersed responses (which indicate less consistency).

If every participant in the survey selected the most optimistic answer to each and every question, the Index would be positive 5. Conversely, if all of the participants chose the most pessimistic response to each and every question, the Index would be negative 5. The Index is on a 10-point scale, meaning that changes to the composite scores—and the Index itself—will range between zero and 10. A one-point change in the Index equates to a 10 percent change (on an absolute basis).

Changes in the scores of the individual survey questions between the March and September 2017 surveys ranged between 0.20 and 6.50 percent. This is a much wider range than that recorded in the previous two surveys (September 2016 and March 2017), but a narrower range than what was posted between the September 2015 and March 2016 surveys (0.20 and 9.50 percent). The overall composite index for September 2017 (0.49) decreased by 0.70 percent since March 2017 and is at about the same level as the Index in September 2016 (0.47). It is also within 1.00 percent of readings from the three prior surveys. **This latest survey indicates that there continues to be guarded optimism in the CRE market.**

To help increase the number of respondents, both the March and September 2017 surveys were open over a longer period of time than were for the prior surveys (12 days compared to two days) and that, coupled with tailored email outreach to previous survey participants, resulted in a slight increase in responses between March and September 2017, (increasing from 433 to 443). There were 328 distinct companies that responded to this survey. Product types owned/under development by respondents broke out to roughly 33 percent office, 34 percent industrial, 18 percent retail and 15 percent multi-family; east and west regions were slightly more represented in the sample than the south and Midwest. The response rate for this survey was 8.60 percent and the margin of error for the Index was 4.67 percent—both of which were improvements over the September 2016 and March 2017 surveys.

Survey participants are sent a summary of results showing the percentage breakdown of responses to each question just three days after the survey closes. This final report is released to all NAIOP members and the public three weeks later. **Survey responses for this Index were gathered between September 6 and 18, 2017. The first two readings in this survey were beta tests sent to approximately 600 NAIOP members in February and September 2015, generating response rates of around 17 percent.** Comparing this survey to the previous beta tests, respondents' consistency across questions was nearly the same, with face rents being the most consistently answered question and construction materials costs, construction labor costs and employment being the least consistently answered questions. As such, the 2016 and 2017 results do not vary significantly from those in the beta tests.

The statistical methodology for this survey was developed and the data analyzed by Tom Hamilton, Ph.D., MAI, CCIM, CRE, the Gerald Fogelson Distinguished Chair of Real Estate in the Chicago School of Real Estate at Roosevelt University. The survey data are collected by NAIOP and the survey questions were created, refined and finalized between 2014 and 2016 by the NAIOP Distinguished Fellows listed below.

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