The NAIOP CRE Sentiment Index

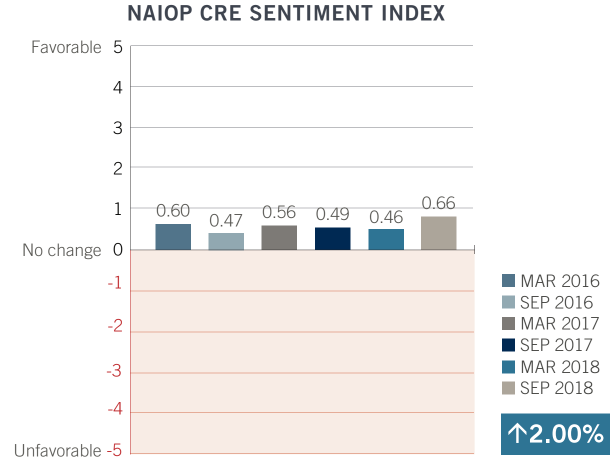
Industry Leaders' Outlook for Commercial Real Estate Fall 2018

NAIOP CRE Sentiment Index **0.66**

Survey Conducted August 28-September 26, 2018

-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.



PERCENT CHANGE BETWEEN MARCH AND SEPTEMBER 2018

Key Findings

The NAIOP CRE Sentiment Index for September 2018 (a composite of nine survey questions), showed positive changes in seven of the nine questions that underpin the Index. This survey's 0.66 Sentiment Index reading is the highest posted since the full survey commenced in March 2016. The results of the individual questions in the survey are fairly consistent with responses posted over the five previous surveys, but in the aggregate, there is more support for the notion that the fundamentals underpinning commercial real estate will be stronger in 12 months than they are today. This consistent, positive Index level over the past 36 months is a sign that the greater commercial real estate market has been operating at a steady pace and it is expected to support continued expansion for at least 12 more months.

Notable Changes From the March 2018 Survey

The most positive changes in the survey that helped keep the Index above zero were positive expectations regarding the availability of capital (both debt and equity), as well as the outlook that effective rents will rise over the next 12 months. Year-over-year, the readings for the availability of equity and debt capital increased by 2.50 percent and 2.80 percent respectively, and the prospects for effective rents increased by 2.50 percent. This continues the strong reversal for both capital sources after each slid consistently between March 2016 and March 2017. Anticipated levels for effective rents are at their highest since March 2016. At the same time, however, respondents are still greatly concerned about the costs of construction materials and labor as indicated by the lowest score recorded for each category since the survey started.

Agreement/Disagreement Among Respondents

The most consistent responses (meaning there was the most agreement among survey participants) were in the categories of face rents and the availability of both equity and debt capital sources. Scores for these categories were highly positive contributors to the overall Sentiment Index. Readings for these categories have risen over the past year, and the outlook for the availability of debt and equity sources has improved consistently since early 2017. The questions with the least consistent responses (most dispersion) among survey participants regarded employment, construction materials and construction labor costs. The employment-related readings are consistent with the uneven real estate-related job growth that has occurred in various regions across the country over the past few years, and the construction-related readings are consistent with a steadily growing economy over the past six months, with 2.2 percent annualized GDP growth in the first quarter of 2018 and 4.2 percent growth in the second quarter of the year.

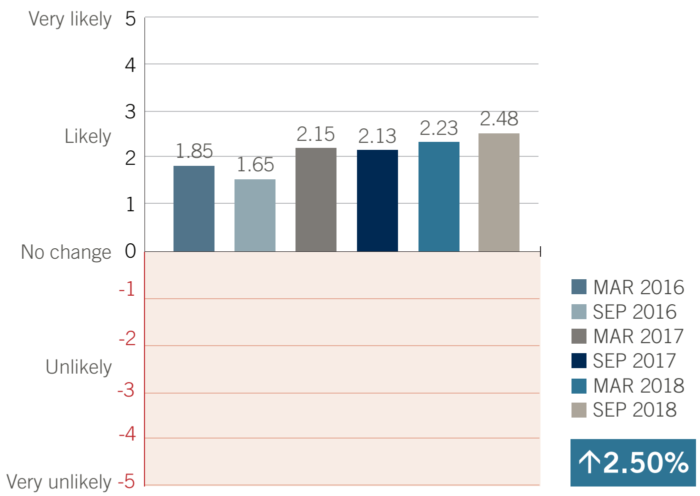
About the NAIOP CRE Sentiment Index

The NAIOP 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

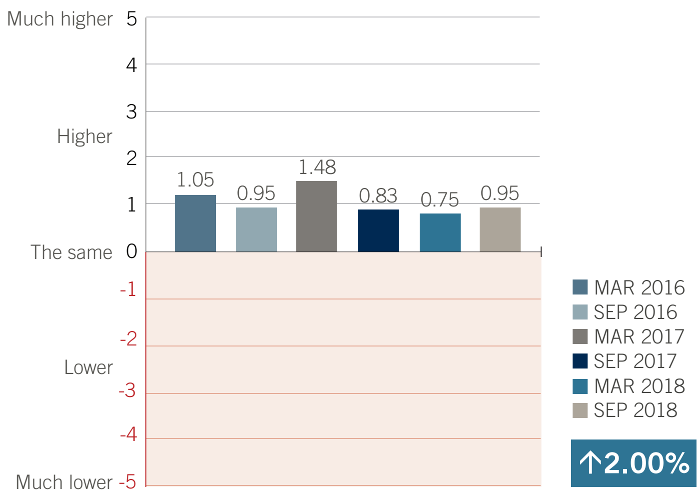
1. How likely is it that your company will add employees within the next 12 months?



Employment growth expectations at CRE companies (with a score of 2.48) continue to rise and are the highest since the September 2015 survey. They represent a 3.50 percent increase in the employment score over the past year and 8.30 percent growth since the September 2016 survey. Responses to this question have consistently ranked as the most positive market indicator in the survey since its inception in 2015; however, as noted above, responses were widely dispersed in the current survey, indicating disagreement among respondents. As such, in this September 2018 survey, the employment question is contributing less weight to the overall Sentiment Index. Even so, the overall employment outlook is still quite positive, indicating that survey respondents expect they are likely to add more jobs in 2019 than they thought they would in 2017 and 2018.

OCCUPANCY RATES

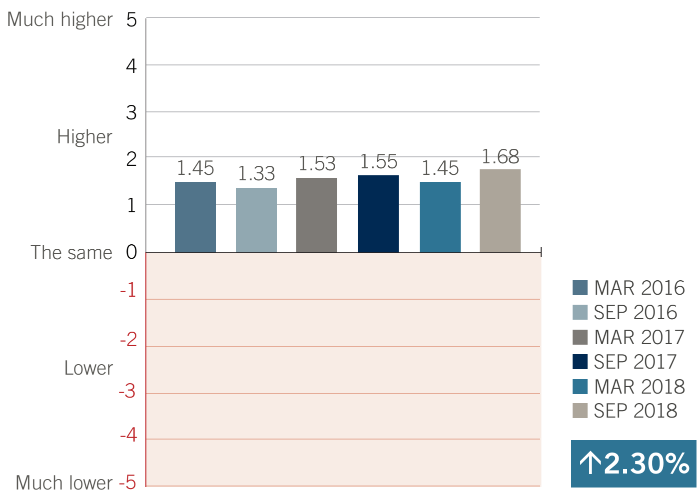
2. Based on your own projects, where do you believe occupancy rates will be in 12 months?



The occupancy rate score (0.95) is the lowest of the positive responses in this survey, and it carries significant agreement among survey respondents. This means there is greater-than-average certainty among the respondents that occupancy rates are likely to increase. The positive reading indicates that respondents expect occupancy rates to rise over the next 12 months. This is a reversal of a downward trend since inception of the survey (with the exception of the March 2017 score, which appears to be a bit of an anomaly). This reversal might indicate that demand is expected to continue to increase due to forecasts of steady growth in the general economy.

FACE RENTS

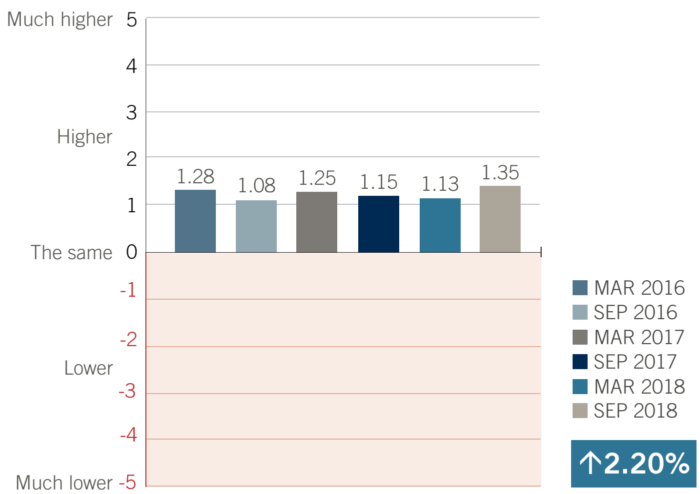
3. Based on your own projects, where do you believe face rents will be in 12 months?



Responses relating to face rents have maintained a relatively stable, highly positive level since March 2016. In both the March 2018 and the September 2018 surveys, this question featured the least dispersion among the responses, indicating significant agreement among survey participants regarding the outlook for face rents. This survey question, along with employment, has helped the overall Index stay positive over the past three years. The score for expectations regarding face rents (1.68) is 1.30 percent greater than it was a year ago and 2.30 percent greater than it was six months ago. Overall, face rents are expected to remain positive and improve between now and the later quarters of 2019.

EFFECTIVE RENTS

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

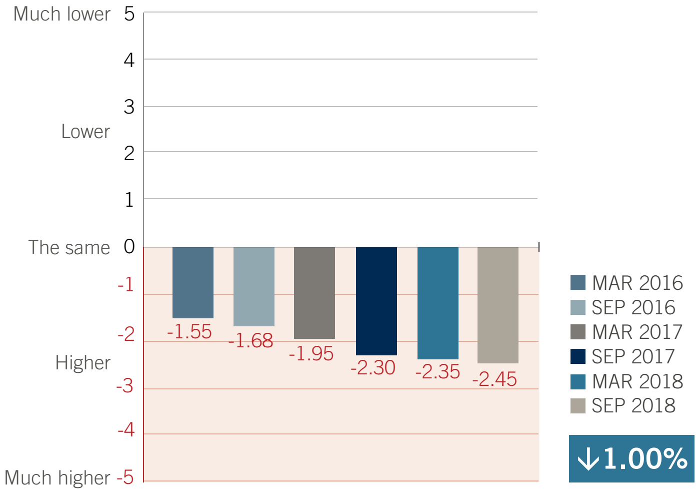


Expectations regarding effective rents (with a score of 1.35) increased 2.20 percent over the previous six months. This is the highest score for this question in three years, indicating that rents are expected to increase by more than previously anticipated. With readings for both face rents and effective rents remaining in solid positive territory and expected to rise over the year, respondents anticipate property rental income will grow over the next year. This is consistent with expectations observed in the prior four surveys going back to March 2016 where the trend indicated a slow, steady growth rate. It also parallels positive sentiment regarding overall growth of the U.S. economy into 2019.

THE PERCENT CHANGE NOTED IN EACH GRAPH COMPARES THE SURVEYS CONDUCTED IN MARCH AND SEPTEMBER 2018.

CONSTRUCTION MATERIALS COSTS

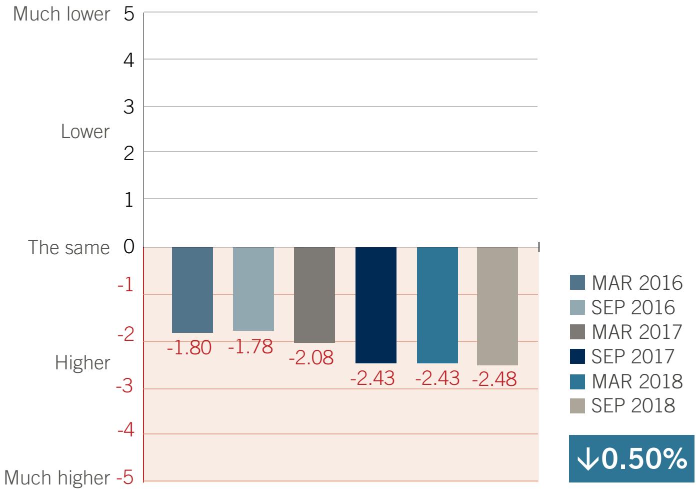
5. For projects on which you are seeking bids, where do you believe the cost of construction materials will be in 12 months?



As with survey results going back to early 2016, construction materials costs (score of -2.45) provided significant downward pressure to the overall Sentiment Index. Compared to September 2017, the score for construction materials fell by 1.50 percent, and again is at an all-time low. This indicates that survey respondents expect the cost of construction materials to continue to rise over the next year. The low level of consistency among responses to this question indicates that expectations of rising costs among survey respondents are neither uniform across the country nor across product types.

CONSTRUCTION LABOR COSTS

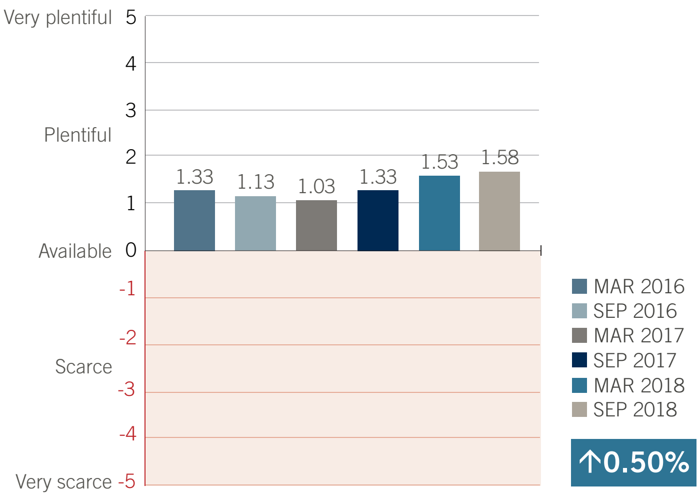
6. For projects on which you are seeking bids, where do you believe the cost of construction labor will be in 12 months?



The score for construction labor costs (-2.48) became more negative (by 0.50 percent) over the past year and continues to be the most negative component of the overall Sentiment Index. Survey responses were slightly more consistent (less dispersed) than those relating to construction materials costs; however, given the large negative score for this question, survey respondents expect construction labor costs to continue to rise over the next year, more than they did in all years going back to 2016.

AVAILABLE EQUITY

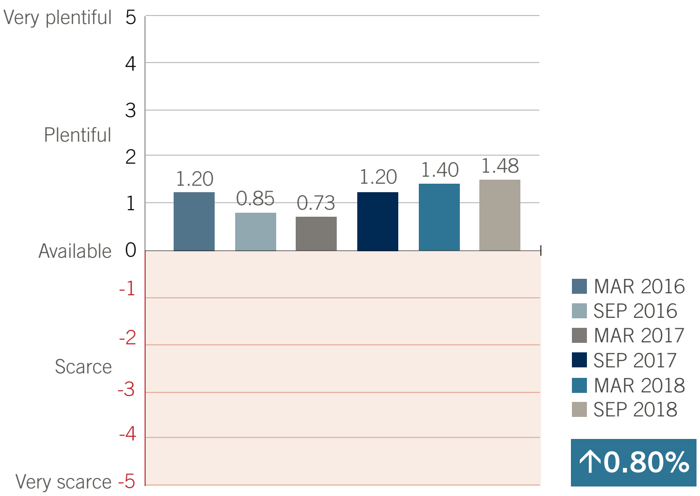
7. For projects you will be financing/refinancing, how plentiful do you believe equity will be in 12 months?



The score for available equity (1.58) continued its steady rebound in this survey, increasing 2.50 percent over the prior year and 0.50 percent over the previous six months. Since hitting a low point in March 2017, the available equity score has increased 5.50 percent and is at its highest level since the September 2017 survey. The available equity measure is one of the most positive contributors to the overall Sentiment Index, and since there was good consistency among the responses, it contributed greatly to the positive level of the overall Sentiment Index.

AVAILABLE DEBT

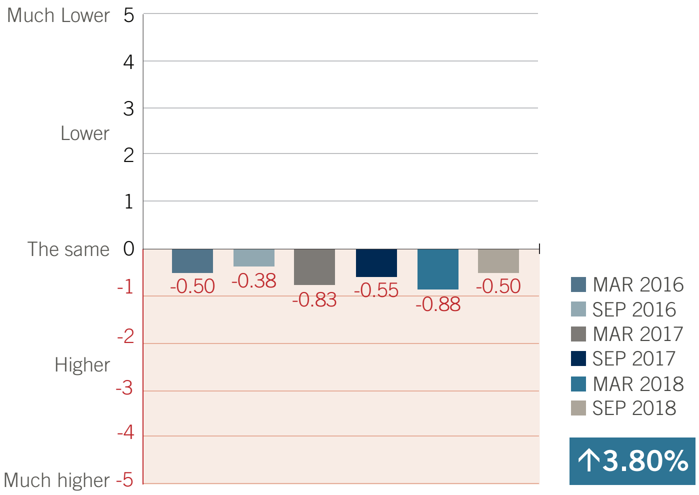
8. For projects you will be financing/refinancing, how plentiful do you believe debt will be in 12 months?



The question regarding available debt (score of 1.48) continues to increase and registered a moderate rebound for the third consecutive survey (2.80 percent since September 2017), continuing the reversal of a consistent decline that existed between February 2015 and March 2017. Like equity, debt capital is expected to be available at still favorable rates over the next 12 months for projects in the pipeline at companies that responded to this survey.

FIRST-YEAR CAPITALIZATION RATES

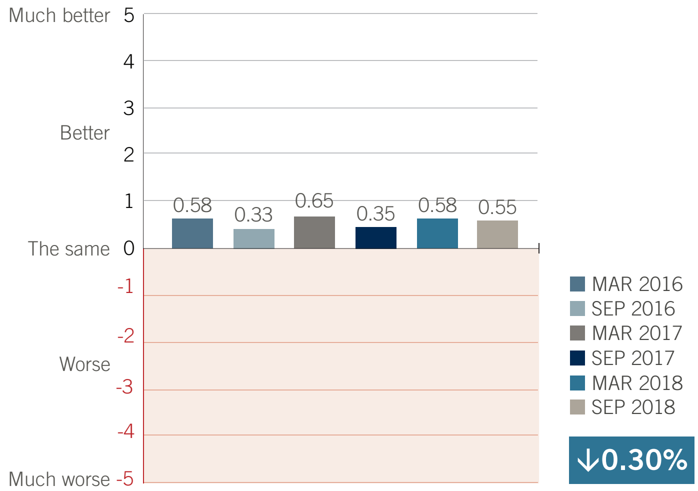
9. Where do you expect first-year cap rates to be for deals you will close 12 months from now?



Survey responses indicate that there is a chance that first-year cap rates (score of -0.50) will increase slightly in the coming year. However, this score was slightly "less negative" than the score posted six months ago, indicating that expectations for rising rates have weakened. This score has oscillated consistently between March 2017 and March 2018. The silver lining for this question is that survey participants were less consistent in their responses, indicating that some believe cap rates will rise, while others believe they will be steady or fall. Though the score was negative, inconsistency among the respondents means that the question carries a low weight in the overall composite Index.

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 final question of the survey is designed to verify the Sentiment Index and is not included in the calculation of the Index. (For more information, read "Understanding the Index" on page 5.) The general sentiment score in this survey (0.55) rose by 2.00 percent compared to the reading taken in September 2017; however, it is down slightly (by 0.30 percent) over the previous six months. Although up over the year, it is interesting to note that this direct question regarding overall market expectations fell slightly since the March 2018 survey, whereas the majority of other survey responses became more positive (except for the outlook relating to construction labor and materials costs).

THE PERCENT CHANGE NOTED IN EACH GRAPH COMPARES THE SURVEYS CONDUCTED IN MARCH AND SEPTEMBER 2018.

Direct From the Survey Participants

"Capital is driving the market. You are starting to see some questionable developments and investments, but not to the extent that would lead to a major correction. If interest rates only creep up gradually, I think we are in for a good run for 12 to 18 more months [at a] minimum. Consumer sentiment is off the charts. [The] U.S. economy [is] not even hitting on all cylinders yet. Times are good right now. Don't sleep; just make deals!!!"

"Lack of construction labor is causing delays and construction cost increases. The shortage of labor in all sectors of the economy is the No. 1 issue businesses are dealing with. Overall, capital spending is good and corporate earnings are healthy for continued expansion."

"Don't believe rents can go much higher from here unless oil prices go up significantly, which will reduce demand and, in turn, reduce rents..."

"The confluence of [a] tight labor [supply], increasing materials costs, rising cap rates and increasing rates are slowing investment, changing outlooks and expectations. We expect a downturn to begin in the next 12 months and to accelerate for 12 to 18 months thereafter. The reason is the oversupply of products and too many funds increasingly chasing too few reasonable opportunities."

"Well-leased and executed product will sell at cap [rates] we see today. Poorly leased and executed [projects] will be discounted or altogether ignored. Watch the maturities on deals started over the past year; if lease-up is slow and the market is flooded with supply, there will be significant paydowns. [On a positive note,] most lenders in this cycle have strong recourse and equity backing."

"Historically speaking, we are in a very good market. [I] don't see this getting appreciably better. Interest rates [are] likely to rise; construction and labor costs [are] likely to rise."

"Almost all gains in [the] stock market have come from … four companies: Facebook, Amazon, Netflix and Google. If they falter, we are in for a big downturn."

"… Basically, the landscape of commercial office buildings is changing faster than we have ever seen in the past. Based on the speed of changes happening in technology, I predict substantial changes to our traditional real estate cycles."

Understanding the Index

The NAIOP Sentiment Survey is conducted biannually, in March and September. **This 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. For the first time, it was also sent to roughly 2,000 commercial real estate brokers, bringing the target list to 7,000.** 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 question, the Index would be positive 5. Conversely, if all of the participants chose the most pessimistic response to each 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 2018 and the September 2018 surveys ranged between -1.00 percent and +2.50 percent. This is typical of what was seen in all surveys since March 2016, with the exception of the September 2017 survey. The overall composite index for September 2018 (0.66) increased by 2.00 percent since March 2018 (0.46) and increased by 1.70 percent since September 2017 (0.49), and it has been at or above this positive level since March 2016. **The current survey indicates that there appears to be optimism in the CRE industry due to mostly positive CRE metrics with the noted exceptions of construction labor and materials costs (negative influences). The margin of error for this survey is 4.84 percent.**

A total of 287 distinct companies were represented in this survey. Product types owned/under development by respondents broke out to roughly 31 percent office, 37 percent industrial, 17 percent retail and 15 percent multifamily; western regions were more represented than eastern and southern regions, followed by the Midwest. The response rate for this survey was 5.78 percent and the margin of error for the Index was 4.84 percent — both of which were declines from the March 2018 survey.

Survey participants are sent a three-page summary of results showing the percentage breakdown of responses to each question just three days after the survey closes. This report is released to all NAIOP members and the public three weeks later.

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.

Shaun A. Bond, University of Cincinnati
David L. Funk, Roosevelt University
Tom Hamilton, Roosevelt University
Joshua Harris, New York University
Barry F. Hersh, New York University
Andre Kuzmicki, York University
Craig Tsuriel (Tsur) Sommerville, University of British Columbia
Michael Maxwell, Nova Southeastern University
Gerard C.S. Mildner, Portland State University
Mark Stapp, Arizona State University
Charles C. Tu, University of San Diego

For more information visit, naiop.org/sentimentindex. Send your feedback to index@naiop.org.