The NAIOP Sentiment Index

NAIOP Sentiment Index
Survey Conducted March 9-20, 2017   **0.56**

-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.

SENTIMENT INDEX

Favorable 5

No Change 0

Unfavorable -5

1.10   1.03   0.60   0.47   0.56

- FEB 2015
- SEP 2015
- MAR 2016
- SEP 2016
- MAR 2017

↑0.90%

PERCENT CHANGE BETWEEN SEPTEMBER 2016 AND MARCH 2017

Key Findings

The NAIOP Sentiment Index for March 2017, a composite of nine survey questions, reversed a consistent two-year downward trend moving up slightly to 0.56. Since the survey's Index is greater than zero, this indicates that respondents believe, as a group, that overall market conditions 12 months from now (in March 2018) will continue to be favorable for the commercial real estate industry, and conditions will be better than they are today. Although the Index is positive, it has declined by 0.54 points (that is, by 5.40 percent on an absolute basis) since the first beta test of the survey was conducted in February 2015. However, it is 0.90 percent higher than the previous survey conducted in September 2016, reflecting an expectation that the CRE market will be moving ahead at a more robust pace than what was expected six months ago.

Notable Changes From the September 2016 Survey

The two largest positive changes in the survey that helped keep the Index in positive territory were much greater confidence in employment and in occupancy rates. Survey scores for both adding employees (a 5.00 percent increase) and occupancy rates for new projects (a 5.30 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 were much more concerned about the costs of construction materials and labor and about first-year cap rates than they were six months earlier. Expectations for both materials and labor costs fell to larger negatives (decreases of about 3.00 percent) and optimism for first-year cap rates fell by 4.50 percent.

Overall, respondents were generally more optimistic about the CRE market in the coming year. The score for the survey's individual, general sentiment question increased from 0.33 to 0.65 between September 2016 and March 2017.

Agreement/Disagreement Among Respondents

The most consistent responses (meaning there was the most agreement among survey participants) relate to the questions regarding face rents and occupancy rates. Those responses indicate that steady, continuing growth is expected in these areas over the next year. The least consistent responses align with questions about employment growth and the expected costs of construction labor over the next year. For three surveys in a row, consensus about employment growth within the respondents' firms has been one of the least consistent. These employment-related readings are consistent with the uneven real estate-related job growth that has occurred in various regions across the country in the recent past and reflects uncertainty both before and since the U.S. presidential election.

About the NAIOP 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?

FEB 2015
SEP 2015
MAR 2016
SEP 2016
MAR 2017

↑5.00%
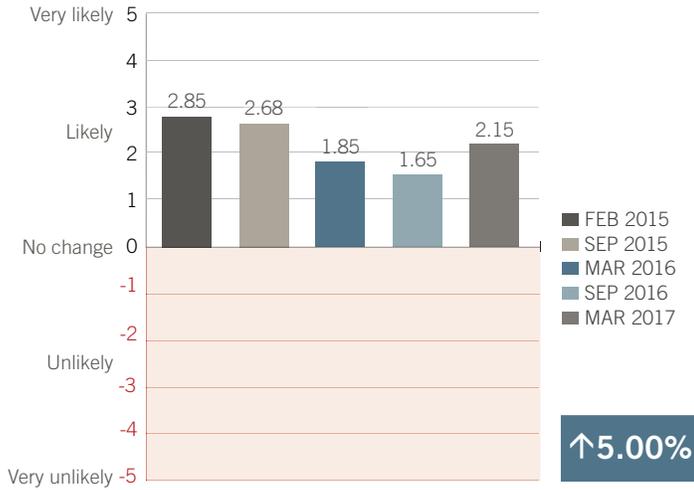
Expectations regarding employment growth over the next 12 months increased by 5.00 percent since the last survey in September 2016, reversing a steadily decreasing trend since the survey's inception in February 2015. The score for this question is highly positive (2.15), indicating that survey respondents expect to add more jobs over the next year than they thought they would over the prior 18 months.

OCCUPANCY RATES

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

FEB 2015
SEP 2015
MAR 2016
SEP 2016
MAR 2017

↑5.30%
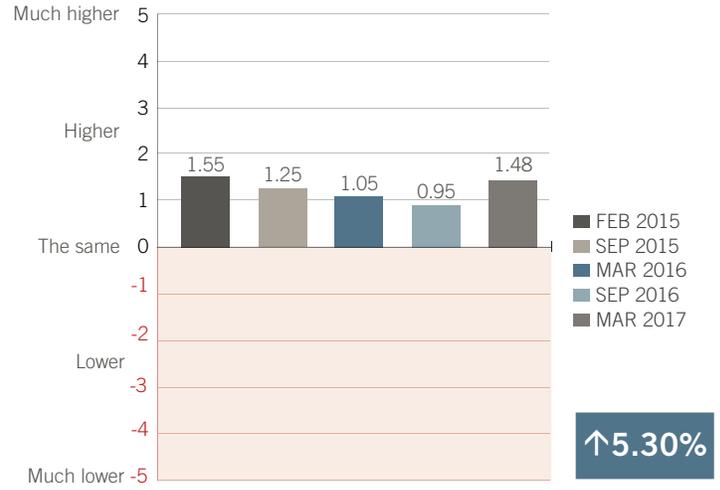
The 1.48 score for occupancy was a significantly positive change compared to the prior three surveys, and its level is nearly as high as it was for the first survey conducted in February 2015. The 5.30 percent increase (the highest among all questions in the current survey) reversed a three-survey trend that started with the second survey in September 2015. Based on this survey's responses, occupancy rates are expected to show strong growth over the next year.

FACE RENTS

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

FEB 2015
SEP 2015
MAR 2016
SEP 2016
MAR 2017

↑2.00%
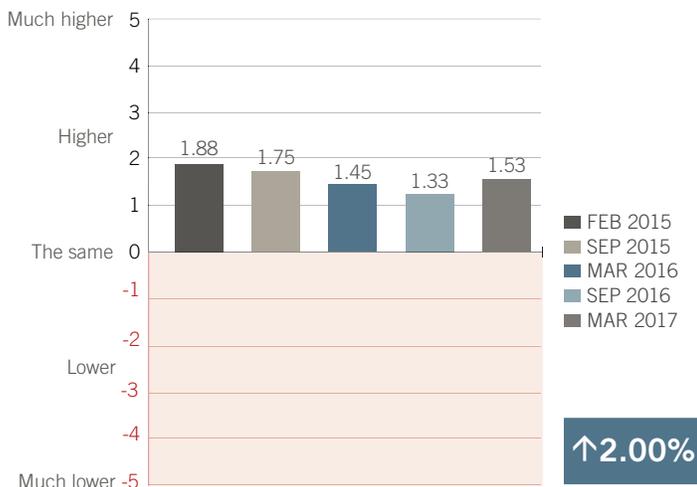
Like occupancy rates, the 1.53 face rent score represents a solid rebound from the steady downward trend of the prior three surveys. This score denotes a 2.00 percent increase in survey respondents' expectations and was a major contributor to the positive reading of the Index. Overall, face rents are expected to remain positive and improve in 2017.

EFFECTIVE RENTS

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

FEB 2015
SEP 2015
MAR 2016
SEP 2016
MAR 2017

↑1.70%
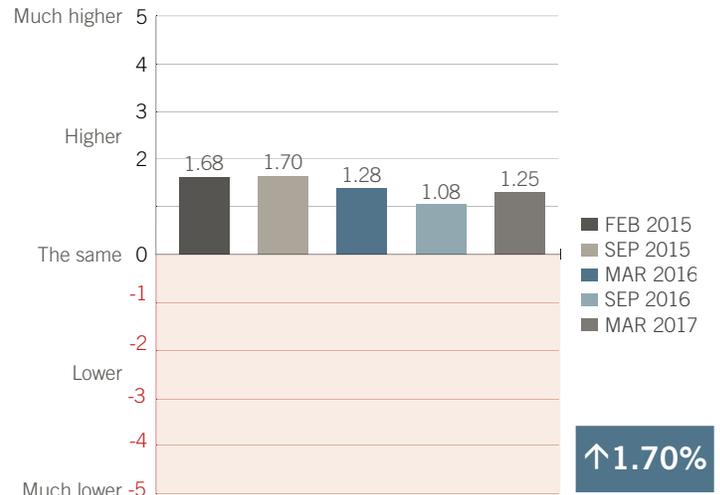
The effective rents score increased 1.70 percent after declining 4.20 and 2.00 percent in the prior two surveys. As such, effective rents are expected to rise somewhat over the next year. Effective rents and face rents are expected to converge and start growing at similar rates, possibly indicating that operating expenses and/or concessions are expected to stabilize over the coming 12 months.

THE PERCENT CHANGE NOTED IN EACH GRAPH RELATES TO THE SURVEYS CONDUCTED IN SEPTEMBER 2016 AND MARCH 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?
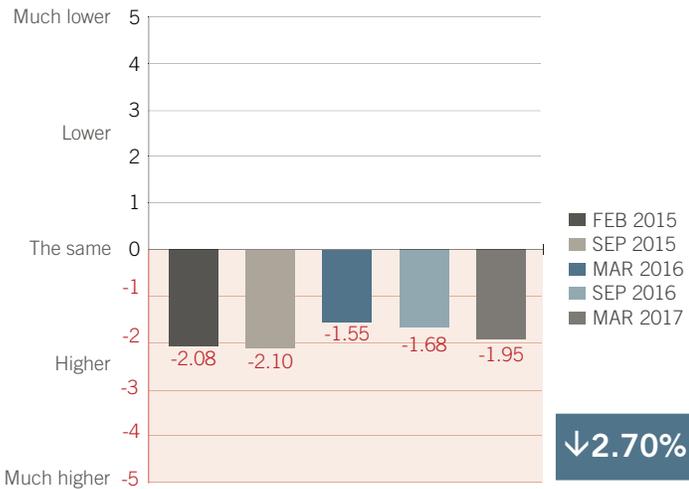
There was less optimism about materials costs in this survey than in the prior two surveys with a 2.70 percent decrease in the score for this survey question. The score became more negative, going from -1.68 to -1.95. This decrease indicates that respondents expect the cost of construction materials to be slightly higher in the next year. This negative score reflects respondents' belief that the cost of construction materials is expected to continue rising in the next year.

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?
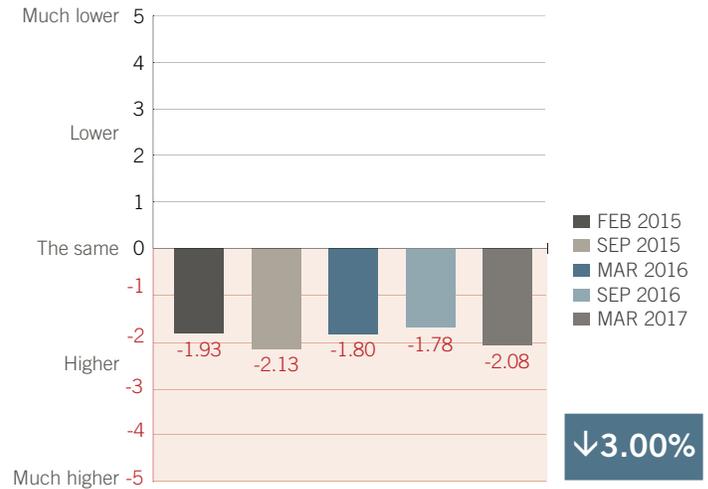
The score for construction labor costs, -2.08, is about 3.00 percent "greater" than the score reported in the September 2016 survey. It is now nearly as "high" as ever recorded in this Index (it was -2.13 in September 2015). This large negative score indicates that respondents expect construction costs to rise over the next year at a higher rate than in 2016.

AVAILABLE EQUITY

7. For projects you will be financing/refinancing, how plentiful do you believe equity will be in 12 months?
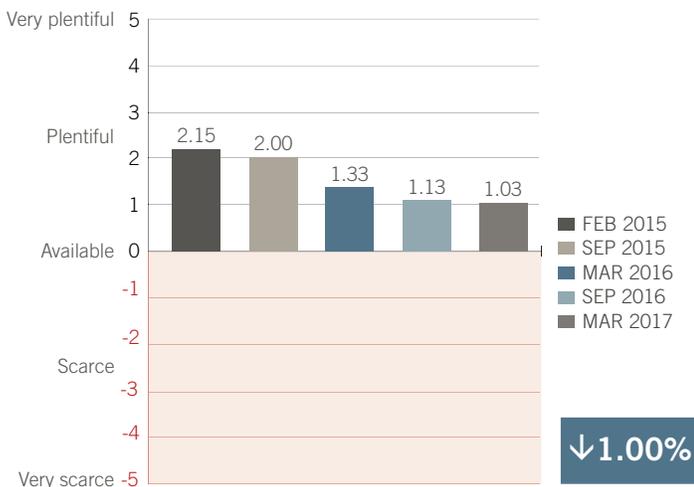
The reading regarding available equity has declined steadily over the past two years; however, it is still positive. In the past six months, this score has decreased by about 1.00 percent, and only 2.00 percent over the past year. Any time this attribute's score has a value that is greater than zero, equity is expected to be available for new projects — although at lesser quantities and possibly higher rates than in the past two years.

AVAILABLE DEBT

8. For projects you will be financing/refinancing, how plentiful do you believe debt will be in 12 months?
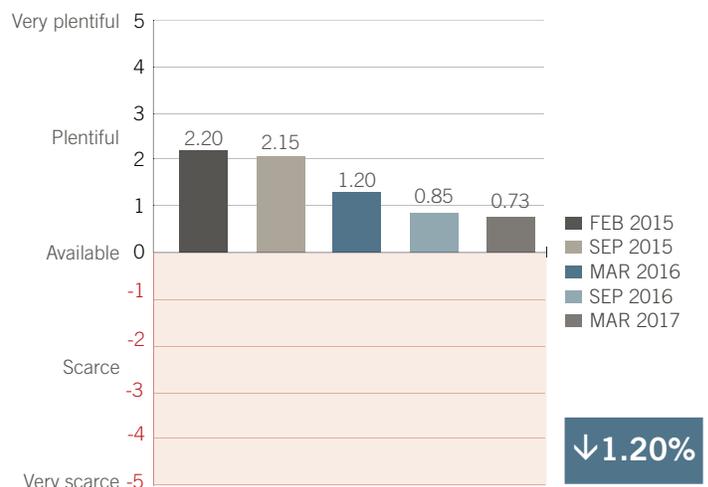
Like equity, the Index figure regarding available debt declined slightly (by 1.20 percent), continuing a consistent decline since February 2015. Like equity, debt capital is expected to be available, but at higher costs, which is consistent with recent increases in interest rates by the U.S. Federal Reserve.

THE PERCENT CHANGE NOTED IN EACH GRAPH RELATES TO THE SURVEYS CONDUCTED IN SEPTEMBER 2016 AND MARCH 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?
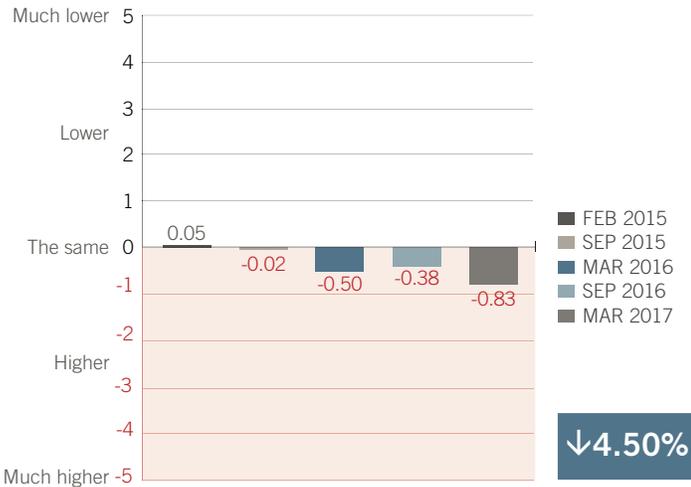
Survey responses indicate that first-year cap rates are expected to increase in the coming year. The March 2016 score for this question was -0.50; the September 2016 score was less negative (with a score of -0.38), resulting in a 1.20 percent positive change; however, the current survey score dropped significantly to -0.83, a negative six-month change of 4.50 percent. This result indicates that respondents anticipate an increase in project risk, an increase in interest rates or, most likely, both over the next year.

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?
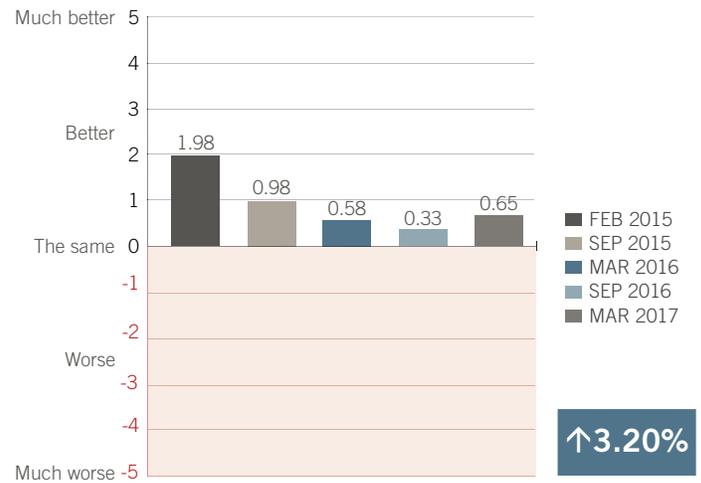
The general sentiment score — much like the scores for employment growth, occupancy rates and both face and effective rents — posted a highly positive response in this survey. The 0.65 score for this question is 3.20 percent greater than the reading six months ago, and is the highest it has been since September 2015. This is a good sign for the CRE market in that survey respondents expect a positive commercial real estate climate over the next 12 months.

THE PERCENT CHANGE NOTED IN EACH GRAPH RELATES TO THE SURVEYS CONDUCTED IN SEPTEMBER 2016 AND MARCH 2017.

Direct From the Survey Participants

"I am comfortable with a strong market over the next 12 months, however I believe we will be facing a much more difficult economy 12-24 months from now. The market exuberance about [President] Trump will fade, interest rates [will] begin to rise, the implications of overbuilding multifamily product will kick in, and the cyclical economy will begin a downward turn."

"In my region, things seem to be improving, though materials and labor costs are going up as construction companies are getting busier."

"As long as the equity and capital markets stay as strong as they are, I think any downturn we experience in the markets will be able to be offset and controlled."

"Thanks to [President] Trump, the overall economy is looking more positive — people are hiring in manufacturing, companies are expanding in logistics, so we are bullish!"

"The economy is incrementally better, but still feels fragile."

"I see an unprecedented degree of uncertainty about [the] cost of money (interest and cap rates), market fundamentals (supply and demand), unforeseeable economic changes in the age of [President] Trump, and tax reform if it gains traction (loss of historic, new markets, and low-income housing tax credits; carried interest; new taxes to offset new spending; etc.). Benefits from promised deregulation may be counteracted by dysfunctional government managed by unaccountable appointees. We may have a series of re-starts in Washington."

"The market for core industrial is extremely strong today and I expect that trend to continue for at least the next 12-24 months."

"A mixed bag; retail will be [the worst] (the 'Amazon' effect) while office and industrial will [improve]. Online sales are creating a seismic shift and uncertainty, both for retailers as well as the cities and towns that host their facilities and are losing a ratable base, tax revenue and jobs."

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 0.65, whereas the Index is slightly lower at 0.56. Said differently, when responses to the first nine questions — which relate to real estate fundamentals — are combined into the composite Index, the result is only slightly less 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 September 2016 and March 2017 surveys ranged between 1.2 and 5.3 percent. This is a much wider range than that recorded in the previous survey (September 2016), but a narrower range than what was posted between the September 2015 and March 2016 surveys (0.2 and 9.5 percent). The overall composite Index for March 2017 increased by 0.90 percent since September 2016 (from 0.47 to 0.56), whereas between March 2016 and September 2016, the composite Index declined by 1.3 percent (from 0.60 to 0.47 points). For comparison, there was a 3.3 percent decline between the September 2015 and March 2016 surveys. **This latest survey indicates that there is more optimism now in the CRE market than in the prior 12 months.**

To obtain more data from market participants, this survey's data was compiled over a longer period of time than prior surveys (12 days compared to 2 days) and that, coupled with e-mail outreach to eligible survey participants from members of NAIOP's

Corporate Board of Directors, resulted in a 21 percent increase in responses received (increasing from 359 to 433). More than 300 distinct companies were represented in the survey. Product types developed, financed and operated by respondents broke out to roughly 40 percent office, 40 percent industrial, 10 percent retail and 10 percent multifamily; East and West regions were slightly more represented in the sample than the South and Midwest.

The response rate for this survey was 8.4 percent and the margin of error for the Index was 4.72 percent — both of which represent improvements over the September 2016 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 roughly three weeks later.** Survey responses for this Index were gathered March 9-20, 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 cost, construction labor costs and adding employment being the least consistently answered questions. As such, the March and September 2016 and the March 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, 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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