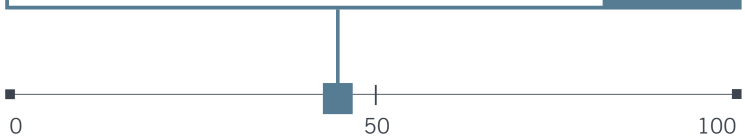
The NAIOP CRE Sentiment Index

Industry Leaders' Outlook for Commercial Real Estate

NAIOP CRE Sentiment Index 45

Survey Conducted August 19-September 2, 2020

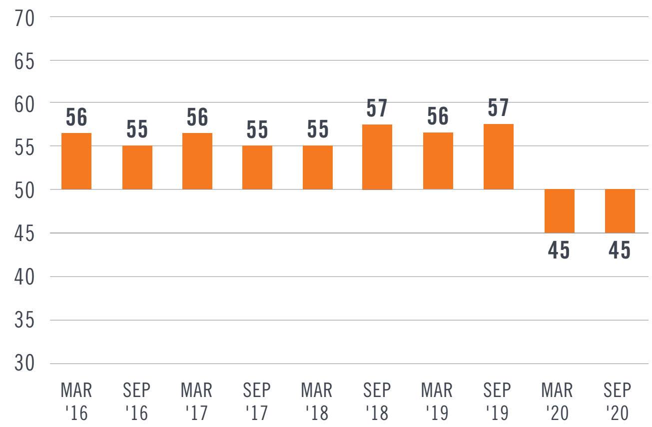


Below 50 means **unfavorable** CRE conditions are expected in 12 months.

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

Above 50 means **favorable** CRE conditions are expected in 12 months.

FIGURE 1: **COMPOSITE SENTIMENT INDEX, 2016-2020**



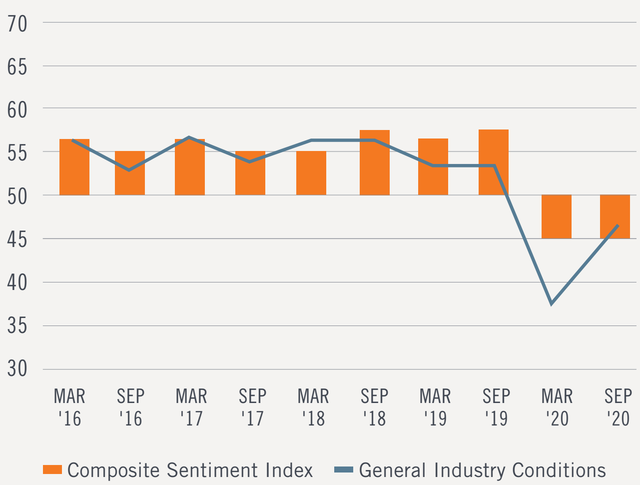
Key Findings

The NAIOP CRE Sentiment Index for September 2020 is 45, matching March's reading. This indicates that respondents expect unfavorable conditions for commercial real estate over the next 12 months (see Figure 1).

Relatively high standard deviations in survey results suggest continued uncertainty about future industry conditions. Although respondents know more about COVID-19 and its immediate effects on the economy than they did in March, it remains difficult to predict the duration of the pandemic or the shape of the economic recovery.

Greater-than-usual differences between respondents may also reflect the markets and property types in which they are active. The NAIOP CRE Sentiment Index measures sentiment across the U.S. commercial real estate industry as a whole, rather than focusing on any individual sector or market, but respondent comments suggest a more favorable outlook for industrial and multifamily properties than retail or office properties.

FIGURE 2: **COMPOSITE SENTIMENT INDEX VS. OUTLOOK FOR GENERAL INDUSTRY CONDITIONS, 2016-2020**



Respondents expressed a more negative outlook on conditions related to the performance of commercial properties than in March. They were more pessimistic about occupancy rates, face rents, effective rents, and employment within their own firms (see Figure 3, page 2). Respondents also predict cap rates to rise slightly, but they held the same expectation in March.

On the other hand, respondents are less pessimistic about construction costs and the availability of financing. Respondents expect debt to be about as available in 12 months as it is now, and for equity to be slightly more available. While respondents predict construction labor and material costs to be higher than they are currently, they expect these costs to rise less rapidly than in March and much less rapidly than in earlier surveys.

Respondent expectations for general industry conditions rebounded to a score of 47 from their low of 38 in March (see Figure 2). Measured separately from the components of the sentiment index, the alignment of this score with the index indicates that respondents' general outlook for the commercial real estate industry is much closer to their expectations for their own properties and markets than in March.

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Notable Changes from the March 2020 Survey

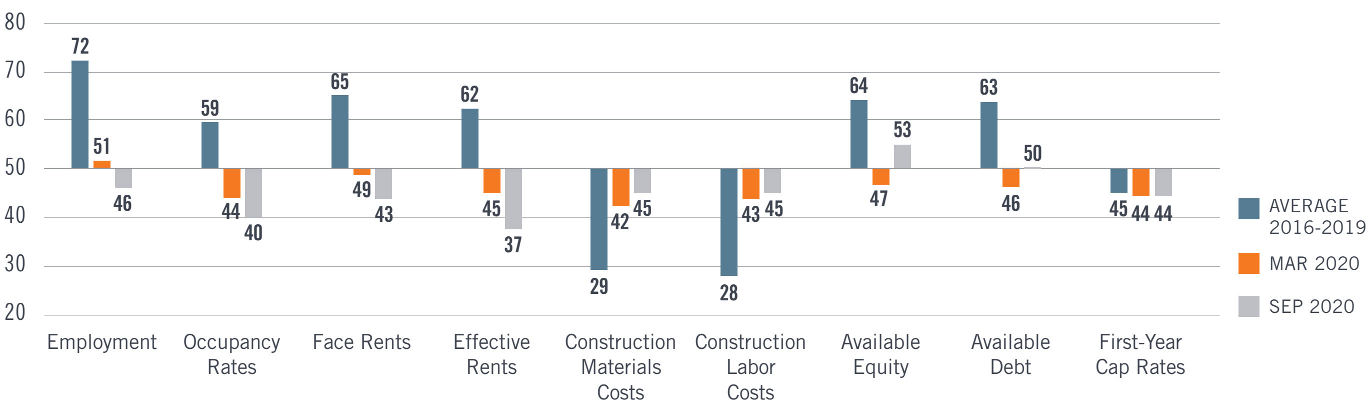
Figure 3 compares respondent expectations in late August/early September 2020 for the individual components that comprise the NAIOP CRE Sentiment Index to expectations in past surveys. Values above 50 represent expectations that a condition will be more favorable for development in 12 months (e.g., higher face rents, lower construction labor costs or lower cap rates). Values below 50 represent expectations that a condition will be less favorable during the next 12 months.

As noted in the key findings, respondent predictions for individual conditions measured in the index differed from March, but they remain generally pessimistic, with a negative outlook for every condition except for the availability of debt and equity. Respondent expectations for employment in their own firms, occupancy rates and rents are lower than in March and substantially lower than in earlier surveys. As noted in March, less pessimistic expectations for construction costs may reflect a belief that demand for construction inputs will be lower than in previous years due to reduced development activity.

Levels of agreement/disagreement between respondents are similar to those observed in March. Variation in the range of answers that respondents provided for most survey questions remains substantially higher than in surveys before March 2020, suggesting continued uncertainty about future conditions. Lower-than-usual levels of agreement between respondents may suggest that the CRE Sentiment Index for September is less predictive of future market conditions than surveys from previous years.

Some of the variation in the survey results may also reflect differences between respondents who specialize in different property types. Open-ended comments suggest that respondents are more optimistic about conditions for industrial and multifamily properties than they are for retail or office properties (see page 3). While this survey does not directly measure differences in outlook for different property types, the NAIOP Coronavirus Impacts Survey has identified notable differences in rent collections, acquisitions, and development activity between different property types since the survey first launched in April.

FIGURE 3: **NAIOP CRE SENTIMENT INDEX COMPONENT SCORES**



Expectations for Development Conditions

As in March, the September 2020 survey asked developers to evaluate how important interest rates, local economic conditions, local development approvals processes, environmental regulations, and other government regulations would be to their decisions to initiate or continue development projects over the next 12 months (answers to these questions are not factored into the NAIOP CRE Sentiment Index). The survey then asked developers how favorable they expected these conditions to be. The results are described in Table 1 on a 100-point scale.

TABLE 1: **IMPORTANCE AND FAVORABILITY OF DEVELOPMENT CONDITIONS OVER THE NEXT 12 MONTHS**

Condition	Importance	Favorability	
		March	September
Local Economic Conditions	87	53	48
Local Development Approvals	75	42	44
Interest Rates	71	80	75
Other Government Regulations	69	43	39
Environmental Regulations	67	42	42

Respondents identify local economic conditions and local development approvals processes as the most important of these factors. The most significant qualitative change since March is that respondents now expect conditions in their local economy to be slightly worse over the next 12 months instead of the slight improvement respondents expected in March. This aligns with their more pessimistic outlook on rents and occupancy rates. Although expectations for other conditions shifted slightly, the outlook for development approvals processes, interest rates, and government regulations are qualitatively similar to those in March: a generally negative outlook for government regulations and approvals processes, and a positive outlook for interest rates.

Differences Between Developers and Non-Developers

Three statistically significant differences emerged when comparing the responses of developers and building owners to non-developers (see Table 2). Developers and owners are less pessimistic than other respondents about future face rents, effective rents, and first-year cap rates. This suggests that developers may be more willing to engage in new development or building acquisitions than the sentiment index would otherwise indicate. However, this difference in expectations also suggests that other market participants, such as lenders, investors and brokers, are likely to adhere to more conservative property valuations.

TABLE 2: **DIFFERENCES BETWEEN DEVELOPERS AND NON-DEVELOPERS**

Metric	All Respondents	Developers and Building Owners	Non-Developers
Face Rents	43	46	40
Effective Rents	37	42	34
First-year Cap Rates	44	47	41

Direct From Survey Participants

“ Industrial and multifamily still seem to be strong in the markets I work in, and we look for that to continue over the next 12 months. Retail, office space and hospitality are where we have concerns for the next 12 months.”

“ I primarily handle office and industrial in my market. I believe that industrial will fare well and has been holding steady during this time. Office, however, has been hit hard — tenants vacating, not paying rent, vacancy increasing.”

“ Landlords will be aggressive to complete transactions with lower rents and shorter-term deals. They just want to fill the space. Tenants are aggressive on all points of the deal. It seems from national and regional reports and surveys [that] it will be a year before business gets back to what will be the new norm. Even in our Utah bubble, negotiations are aggressive, [and] sublease availability has increased with employees given a choice to work at home or [at the] office.”

“ I think we're in about the second inning of the fallout from COVID-19. I see industrial faring well overall, though weighted heavily toward Class A product in infill markets. For most other property types, I would expect sublease space to continue to increase through midyear 2021, and direct vacancy to gradually increase as leases expire and companies downsize in an orderly fashion, probably through 2022. There is going to be a process of deleveraging which should be painful but not as bloody as the Global Financial Crisis, mostly due to high amounts of liquidity in CRE.”

“ I think the economy has been affected by all the COVID-19 closings and slowdowns, but things are currently being buoyed by federal stimulus. When that ends, I think things will get worse — not bad, just worse — than where we are now, and will eventually bounce back by the middle of the decade.”

“ Capital markets are constantly adjusting to market factors including Treasury rates, local supply and demand, and tenant credit. There is no broad-brush approach to valuation right now. Each market and deal are unique. [...] Private capital seems to be the dominant influence right now as investors seek to redeploy equity between asset classes and geographically.”

“ I am the CEO of a national commercial and multifamily mortgage banking firm. In order of highest [to lowest] level of distress: hotels, retail, office, multifamily and industrial. Capital is widely available for multifamily and industrial, and that will continue. Markets are healthy, but we anticipate some multifamily distress as unemployment stays high. Capital is less available for the other product types and the underwriting will be more stringent for debt, forcing more [expensive] equity into transactions.”

Methodology

The NAIOP Sentiment Index is designed to predict general conditions in the commercial real estate industry over the next 12 months by asking industry professionals to predict conditions for their own projects and markets. The NAIOP CRE Sentiment Survey is conducted biannually, in March and August/September. The survey is sent to roughly 10,500 NAIOP members in the U.S. who are developers, building owners, building managers, brokers, analysts, consultants, lenders, and investors in the office, industrial, retail and multifamily sectors. It asks questions about jobs, space markets, construction costs, capital markets, and other conditions for real estate development. The questions that comprise the Sentiment Index are not equally weighted. Instead, weighting varies based on whether 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 every question, the index would be 100. Conversely, if all of the participants chose the most pessimistic response to every question, the index would be 0. The survey includes questions first added in the March 2020 survey that evaluate sentiment about conditions that are not included in the composite sentiment index, but are measured separately on a 100-point scale.

A cross-tabulation of the August/September survey results by respondent profession revealed only a few differences that were both observable (at least one point apart on a 100-point scale) and statistically significant. Differences that were not observable or statistically significant are not reported in this analysis. Unlike the March 2020 survey, NAIOP did not cross-tabulate results by respondent property sector specialization, as the question used to identify this specialization measures projected development or transactional activity over the next 12 months. Given a sharp decline in retail and office activity, this question is less predictive of a respondent's property type specialization than in normal market conditions.

A total of 341 respondents from 266 distinct companies participated in this survey. Product types owned/under development by respondents broke out to roughly 15% office, 62% industrial, 3% retail and 20% multifamily; western regions were slightly more represented than eastern regions, followed by the South and the Midwest.

Survey participants receive a summary of results showing the percentage breakdown of responses to each question after the survey closes. This report is released to all NAIOP members and the public three to four weeks later. Survey responses for this index were gathered between August 19 and September 2, 2020. The response rate for this survey was 3.26%, and the margin of error for the composite index was 5.33%.

The statistical methodology for the Sentiment Index was originally developed 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 were collected by NAIOP, and the survey questions were created, refined and finalized between 2014 and 2020 with the assistance of several NAIOP Distinguished Fellows. NAIOP's Director of Research, Shawn Moura, Ph.D., authored the current edition of the survey and this summary analysis. For questions about the CRE Sentiment Index, please contact Shawn at **moura@naiop.org**.

Media Inquiries

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