The NAIOP Sentiment Index

Industry Leaders' Outlook for Commercial Real Estate Fall 2016

NAIOP Sentiment Index **0.47**
Survey Conducted September 7-9, 2016

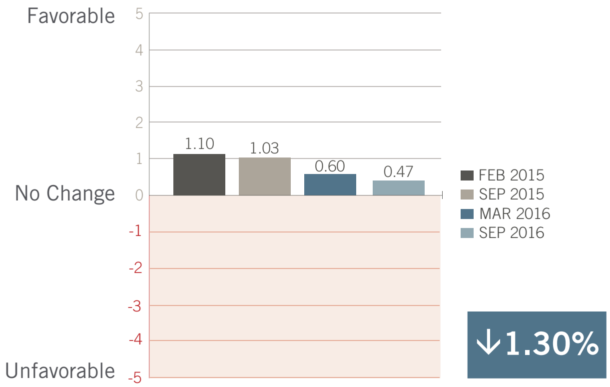
-5 0 5

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



PERCENT CHANGE BETWEEN MARCH AND SEPTEMBER 2016.

Key Findings

The NAIOP Sentiment Index for September 2016, a composite of nine survey questions, is 0.47. This means that respondents believe overall market conditions in 12 months (September 2017) will continue to be favorable for the commercial real estate industry, and that they will be slightly better than they are today. While still positive, the Index has declined steadily, by 0.63 points (that is, by 6.30 percent on an absolute basis) since the first beta test of the survey was conducted in February 2015. This seems to reflect an expectation that the CRE market is approaching a period of slowing growth. The results of this biannual survey provide a quantitative assessment of key metrics relating to the commercial real estate industry, providing figures that can be compared to anecdotal activity or other industry benchmarks.

Notable Changes From the March 2016 Survey

The two main positive changes in the survey that helped keep the Index positive relate to the cost of construction labor and capitalization rates. Respondents expect labor costs to rise a bit more slowly and cap rates to rise at a lesser rate than they expected six months ago. The readings for labor costs and first-year cap rates demonstrated improvements of 0.20 and 1.20 percent, respectively.

The most notable declines relate to questions regarding capital availability and effective rents. The composite score for availability of equity declined by 2.00 percent (falling from 1.33 to 1.13); the score for availability of debt declined by 3.50 percent (falling from 1.20 to 0.85). The score for effective rents declined by 2.00 percent (falling from 1.28 to 1.08). Despite this downward trend, the readings are still positive, meaning respondents expect capital to remain available and effective rents to rise.

Agreement/Disagreement Among Respondents

By far, the most consistent responses (meaning there was the most agreement among respondents) were to the question regarding face rents, indicating positive growth over the next year. The least consistent responses were to the question about employment growth, indicating uncertainty about employment growth over the next year. (This was the least consistent reading in the previous survey as well.) This reading is in line with the unsteady job growth that has occurred in the recent past and reflects uncertainty due to the upcoming U.S. presidential election.

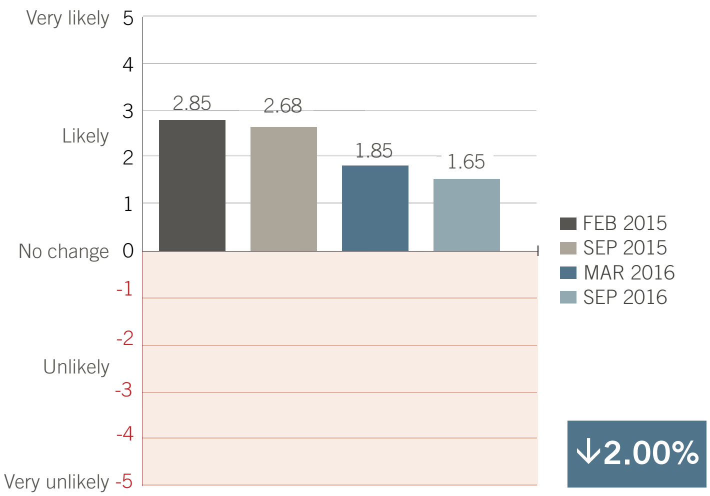
About the NAIOP Sentiment Index

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 the outlook of commercial real estate developers, owners and investors. 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

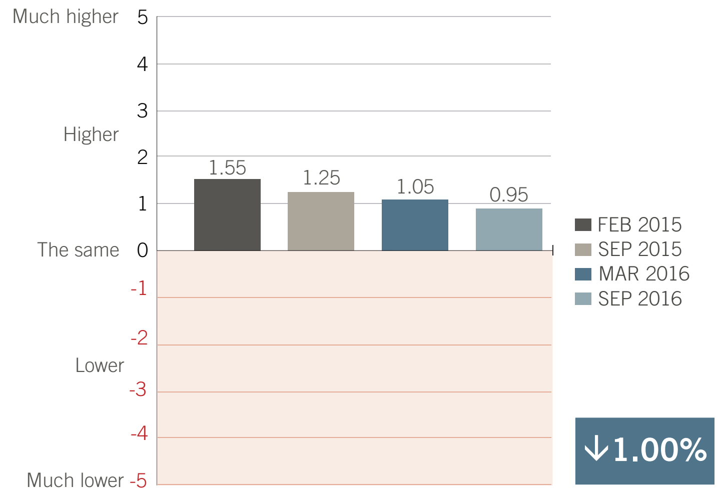
1. How likely is it that your company will add employees within the next 12 months?



Expectations regarding employment growth over the next 12 months declined slightly (by 2.00 percent) since the last survey in March 2016, and by much less than they did six months ago, when the score fell by 8.30 percent. The score for this question is still highly positive (1.65). Essentially, survey respondents indicated that they are likely to add jobs over the next year, but at a modest rate.

OCCUPANCY RATES

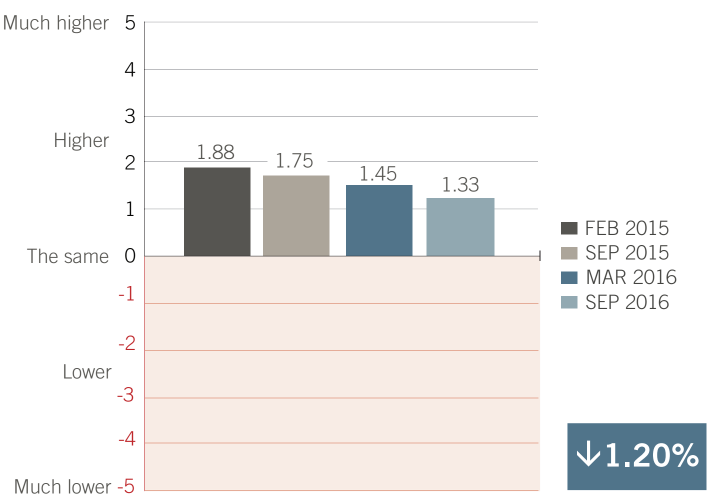
2. Based on your own projects, where do you believe occupancy rates will be in 12 months?



The 0.95 score for occupancy rates is positive and showed the least amount of change from the last survey in March 2016, declining by just 1.00 percent. Occupancy is expected to increase, but at a decreasing rate.

FACE RENTS

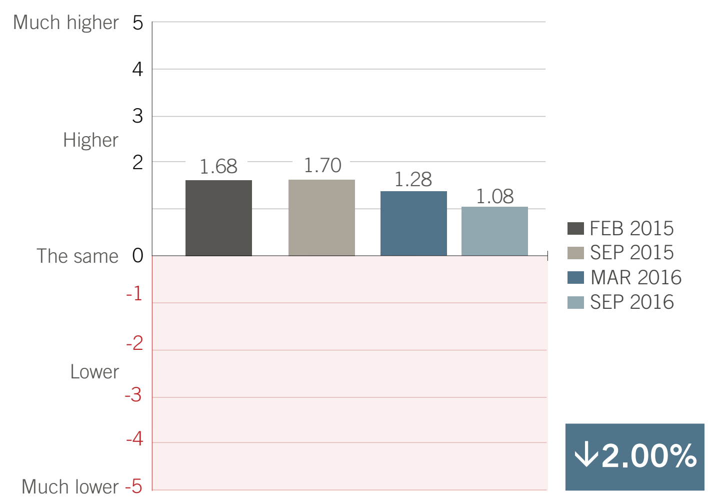
3. Based on your own projects, where do you believe face rents will be in 12 months?



With a score of 1.33, face rents, much like occupancy rates, are expected to grow, but at a slower rate over the next year. The survey-to-survey reading fell by 1.20 percent, from 1.45 in March 2016. The overall growth in face rents is expected to remain positive.

EFFECTIVE RENTS

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

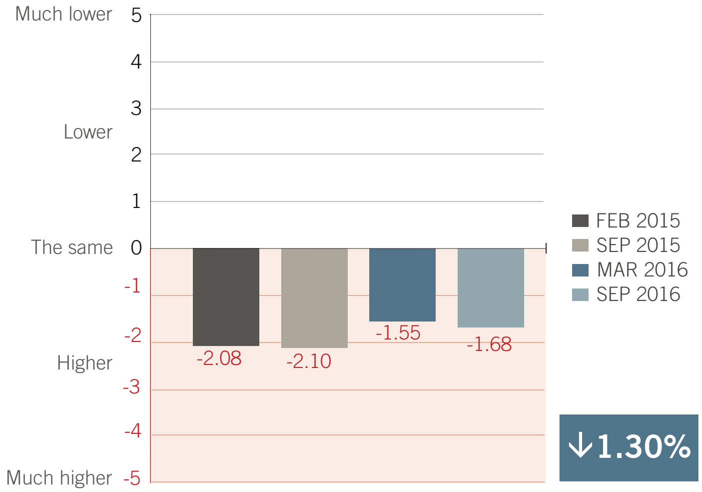


Effective rents, with a score of 1.08 and a decline of 2.00 percent, are expected to increase at a moderate rate in the coming year. Respondents expect effective rents to continue to grow at a slightly lower rate than face rents. Relative to face rents, this score may indicate that operating expenses and/or concessions are expected to increase over the coming 12 months.

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

CONSTRUCTION MATERIALS COSTS

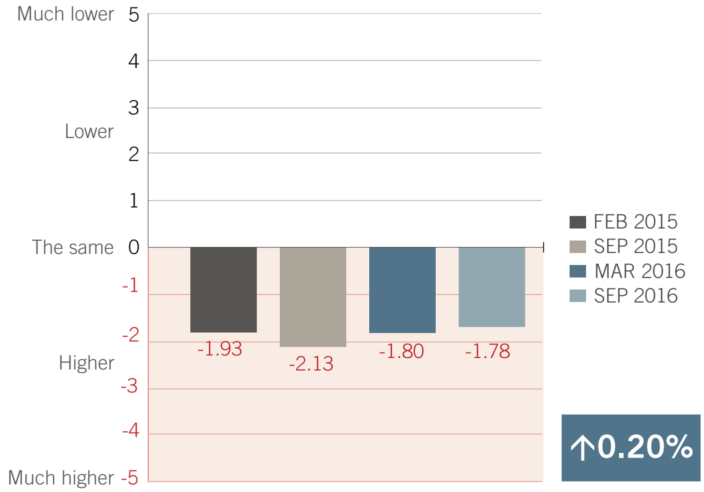
5. For projects on which you are seeking bids, where do you believe the cost of construction materials will be in 12 months?



A score of -1.68 and a decline of 1.30 percent indicate that respondents expect the cost of construction materials to be slightly higher in the next year. After being the biggest "winner" in the last survey (with the best gain to help the composite Index), expectations regarding the cost of construction materials turned; costs are expected to rise by more in this survey than in the previous one.

CONSTRUCTION LABOR COSTS

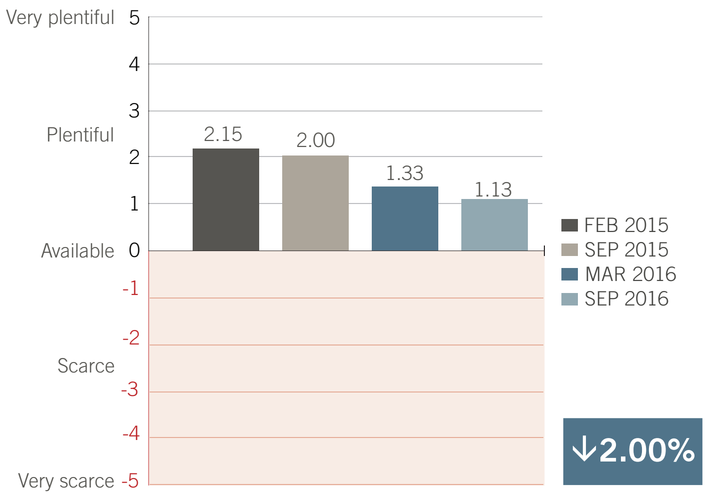
6. For projects on which you are seeking bids, where do you believe the cost of construction labor will be in 12 months?



The score for construction labor costs, -1.78, remains basically unchanged from March 2016 (when it had a score of -1.80), but remains better than those reported in the February and September 2015 test surveys. This means respondents expect construction labor costs to rise, but not by as much as they did a year ago.

AVAILABLE EQUITY

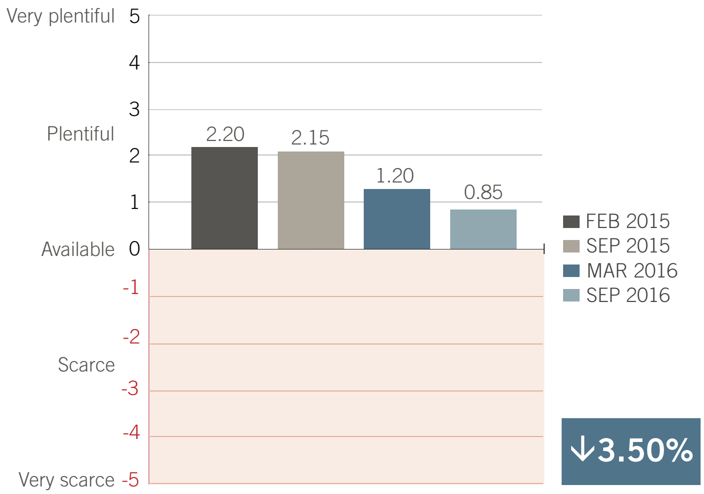
7. For projects you will be financing/refinancing, how plentiful do you believe equity will be in 12 months?



Equity is expected to remain available, with a reading of 1.13. However, the view is not as optimistic as it was six months ago, when the reading was 1.33. This decline is a continuation of the downward trend that started in February 2015, but the decline is much less severe than the September 2015 to March 2016 drop of 6.70 percent. Overall, respondents believe equity will still be available, but less plentiful.

AVAILABLE DEBT

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

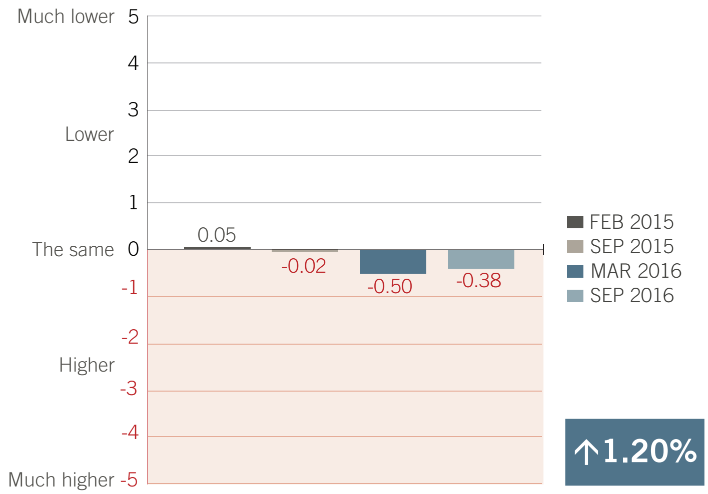


Like equity, debt capital, with a score of 0.85, is expected to be available. For the second consecutive survey, this question's score declined by the largest amount, contracting by 3.50 percent between March and September 2016, reflecting continuing concerns about increased equity requirements as well as the possibility of higher interest rates. Since February 2015, this score has fallen by 13.50 percent.

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

FIRST-YEAR CAPITALIZATION RATES

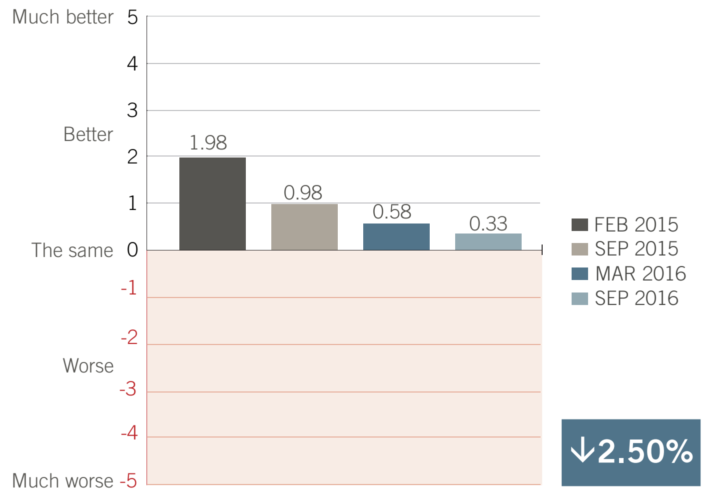
9. Where do you expect first-year cap rates to be for deals you will close 12 months from now?



Since the beta test surveys were conducted in 2015, survey responses have indicated that cap rates will increase slightly in the coming year. The March 2016 score was -0.50, while the September 2016 score was less negative (with a score of -0.38), resulting in a 1.20 percent change. This indicates that respondents may anticipate slightly more risk, a slight increase in interest rates or both.

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 of 0.33 indicates that respondents expect a positive commercial real estate market over the next 12 months, albeit a less positive one than indicated by the March 2016 survey and in the two test surveys in February and September 2015. Compared to the previous reading of 0.58 in March 2016, this reading fell by 2.50 percent; compared to September 2015, it fell by 6.50 percent (from 0.98).

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

Direct From the Survey Participants

“The top of this cycle is a plateau versus a peak, and [we will be there] for the next year.”

“I used ‘The Same’ many times due to the uncertainties brought about by the upcoming election, which I feel is the most stratified in terms of future business environment policies in my lifetime.”

“It is difficult to assess the position of the industry in 12 months; many research analysts and survey results indicate the cycle is peaking. Publicly traded REITs have been net sellers [throughout] the first six months of 2016. Brokers are saying they have more listings but fewer closings year-over-year. I believe we will hit a pause, but since supply and demand are in an acceptable ratio, if there is a correction, real estate will fare quite well compared to other industries.”

“[The] low [interest] rate environment is going to bite us again. People are making foolish decisions based on cheap money. The Fed needs to raise rates.”

“CRE today is [an asset-driven investment type]. For office, we are bullish and see improvement in all areas; industrial, we continue to be optimistic; retail, [we are] very selective at the opportunities that we are willing to look at. With multifamily, [we are] concerned about overbuilding in some urban core markets while suburban markets with high barriers [to entry] and low rental rates look very attractive.”

“For the next twelve months, we see the market staying strong. We will be watching the horizon for signs of a slowdown, however.”

“We are entering a small correction. Not a bad storm but cloudy days for sure. Should be short lived.”

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 0.33 (a weak but positive expectation), while the Index is slightly higher at 0.47. 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.

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).

The changes to the scores for the questions between March and September 2016 ranged between 0.20 and 3.50 percent, a more narrow range than that recorded between September 2015 and March 2016 of 0.20 and 9.50 percent. In September 2016, the composite index declined by just 1.30 percent (from 0.60 to 0.47 points) compared to a 3.30 percent decline between September 2015 and March 2016.

The response rate for this survey was 7.30 percent and the margin of error for the Index was 5.19 percent. 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. Survey responses for this Index were gathered Sept. 7-9, 2016. The first two readings in this survey were beta tests sent to 600 NAIOP members in February and September 2015, generating response rates of 17.29 and 17.00 percent, respectively. Comparing this survey to the prior beta tests, respondents' consistency across questions was nearly the same, with face rents being the most consistently answered question and construction materials and labor costs being the least consistently answered questions. As such, March and September 2016 results did not vary significantly from those in the beta tests.

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

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