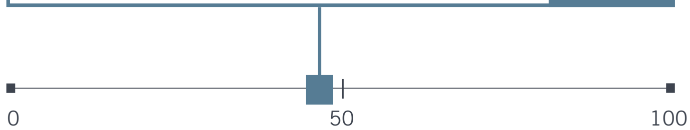
The NAIOP CRE Sentiment Index

Industry Leaders' Outlook for Commercial Real Estate

SPRING 2023

NAIOP CRE Sentiment Index 47

Survey Conducted April 5-13, 2023

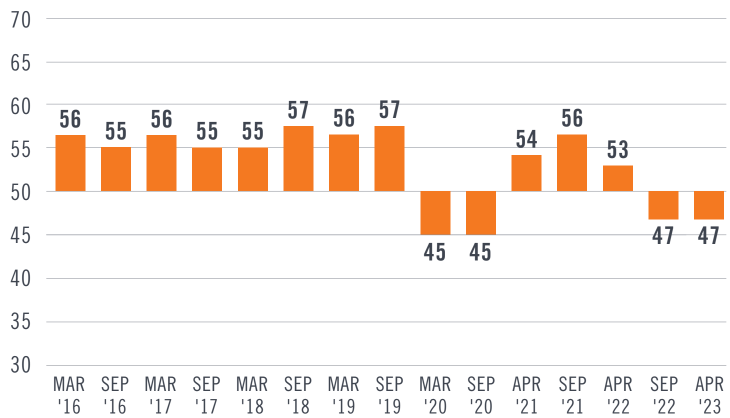


Below 50 means **unfavorable** CRE conditions are expected in 12 months.

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, 2016-2023**



Key Findings

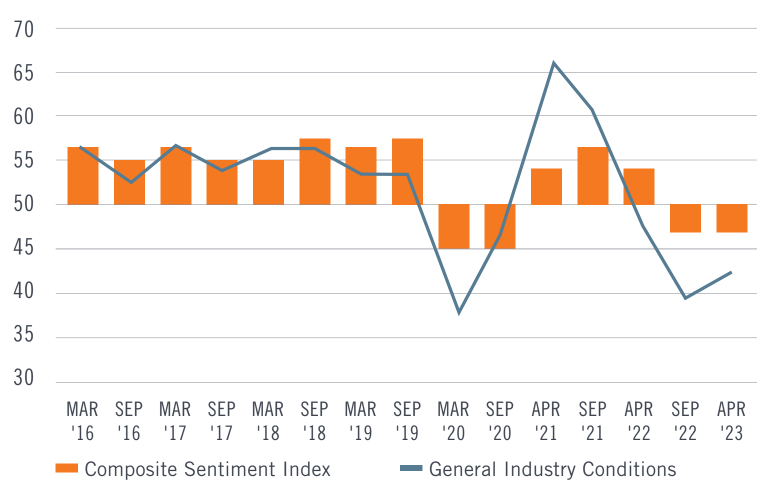
The NAIOP CRE Sentiment Index for April 2023 is 47, matching September 2022's reading, and indicating that respondents expect conditions for commercial real estate to worsen over the next 12 months (see Figure 1).

As in the September survey, respondents expect debt and equity to be less available in the future and for cap rates to rise. They predict that financial conditions will tighten slightly less than in the previous survey, but this likely reflects the substantial contraction in the availability of debt and equity that has already occurred since last fall. In response to a question that is not part of the Index, developers and building owners indicated that they expect interest rates next year to be slightly higher than they had predicted in September.

Commercial real estate practitioners also forecast a decline in occupancy rates and a slight decline in effective rents. Developers and building owners also predict that economic conditions will be slightly less favorable in the markets in which they are active, suggesting a more challenging operating environment.

Respondents expect general industry conditions over the next 12 months to continue to worsen (see Figure 2), albeit at a slower rate than in September. The score for general industry conditions (42) is calculated separately from the CRE Sentiment Index and may reflect respondents' outlook for other factors that affect the commercial real estate industry, such as macroeconomic conditions.

FIGURE 2: **COMPOSITE SENTIMENT INDEX VS. OUTLOOK FOR GENERAL INDUSTRY CONDITIONS, 2016-2023**



Reflecting growing concern about market conditions, **developers and building owners expect to initiate a smaller volume of new projects and acquisitions over the next year.** They project a sharper decline in the dollar value of these projects (score of 41) than in any previous survey since this question was first asked in March 2020.

Most respondents (54.3%) expect to be most active in projects or transactions related to industrial properties over the next year. Multifamily properties attracted the next-largest share of interest (31.7%), followed by office properties (7.5%) and retail properties (6.5%).

For the first time since the survey's inception, respondents do not expect construction material costs to rise over the next year. They continue to predict that construction labor costs will increase, though at a slower rate than previously predicted.

NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

Notable Changes in the April 2023 Survey

Figures 3 and 4 compare respondent expectations in April 2023 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.

Respondent concerns have expanded beyond financial market conditions to economic fundamentals and property performance. In the September 2022 survey, commercial real estate practitioner concerns about the decreasing availability of debt and equity and rising cap rates caused a drop in the CRE Sentiment Index. Those concerns persist, but respondents also now predict declines in occupancy rates and effective rents. These are offset somewhat by expectations that debt and equity financing will contract more slowly and that cap rates will rise less sharply than predicted in the previous survey, but financial conditions are already tighter than they were in the fall, as reflected in respondents' open-ended comments. Developers and building owners appear to be responding to worsening conditions by reducing their planned investments in new deals. In contrast with previous surveys that predicted growing commercial real estate employment, respondents now predict little change in employment within their own firms over the next year, suggesting firms are preparing for a slowdown.

Construction cost increases finally seem to be slowing. On average, respondents expect construction material costs to decrease slightly over the next year, and they predict that construction labor costs will grow more slowly than in previous surveys. Nonetheless, construction costs remain high in absolute terms, and several respondents indicated in open-ended comments that high costs are inhibiting new development and building retrofits. Respondent comments also suggest that regulatory costs remain high in some markets.

FIGURE 3: **SENTIMENT INDEX COMPONENT SCORES: OCCUPANCY, RENTS, CONSTRUCTION COSTS**

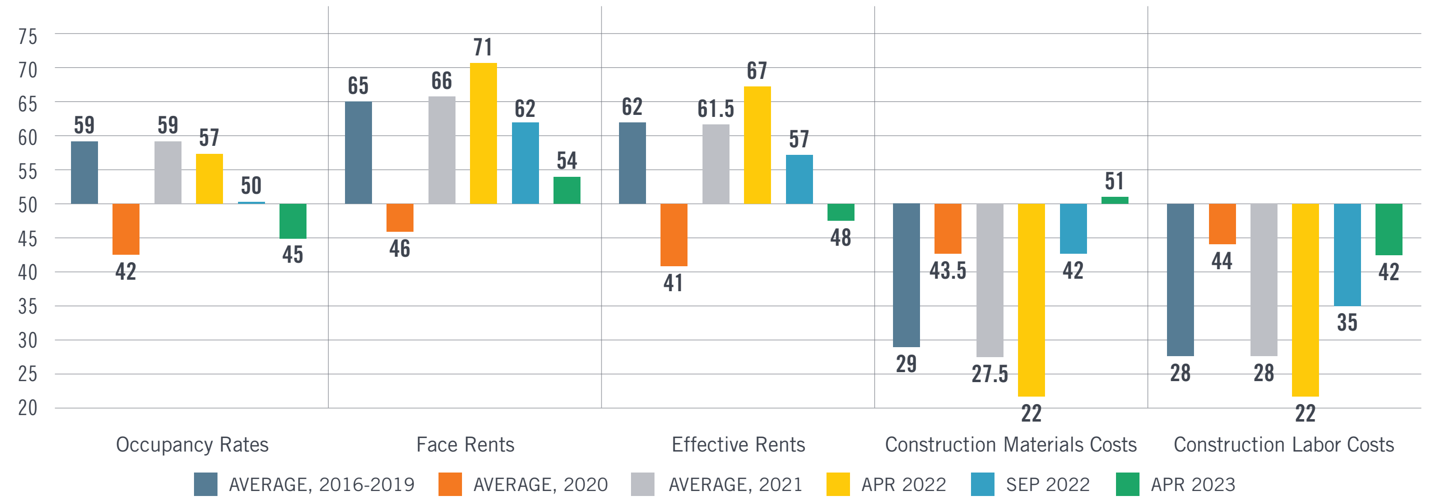
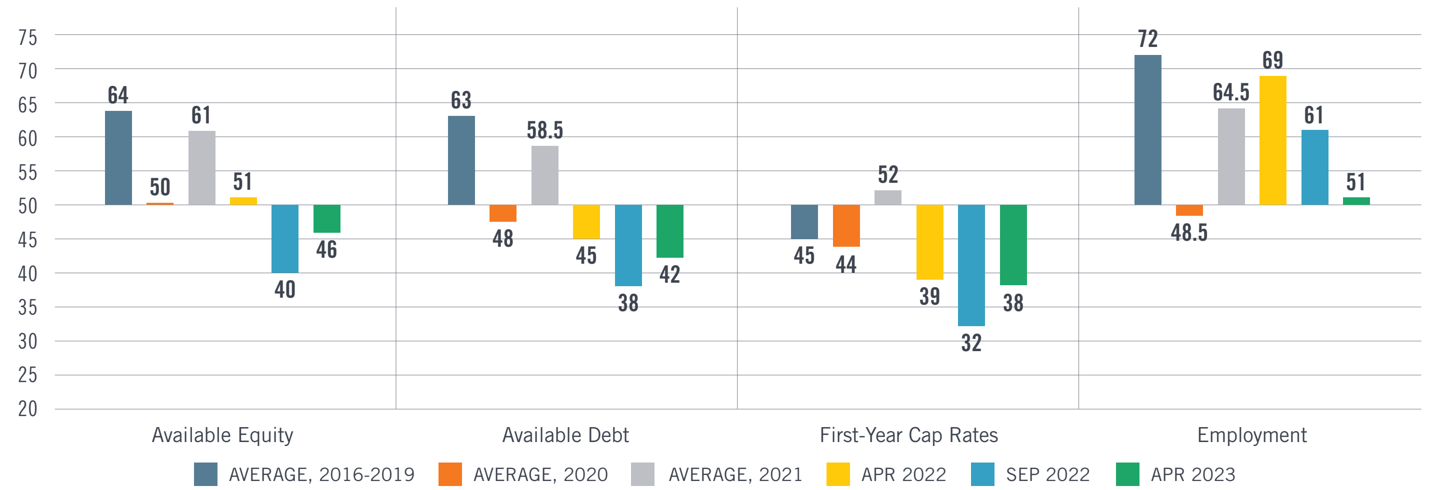


FIGURE 4: **SENTIMENT INDEX COMPONENT SCORES: EQUITY, DEBT, CAP RATES, EMPLOYMENT**



Expectations for Development Conditions

The survey asks developers and building owners to evaluate how important interest rates, local economic conditions, local development approvals processes, environmental regulations and other government regulations will 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 asks developers how favorable they expect 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, April 2023	Favorability	
		September 2022	April 2023
Interest Rates	83	24	23
Local Economic Conditions	82	52	47
Local Development Approvals	75	39	39
Other Government Regulations	67	40	36
Environmental Regulations	66	39	38

Respondents now rate interest rates as slightly more important than local economic conditions in their development decisions, and they continue to expect interest rates to be unfavorable for development. They are less optimistic about the economy than in September and now expect somewhat unfavorable local economic conditions next year. Respondents also expect more adverse environmental and other government regulations than they previously expected. They do not predict any improvement in local development approvals.

Differences Between Developers and Non-developers

Respondents were asked to identify their primary profession. When comparing the responses of developers and building owners to non-developers, only one statistically significant difference emerged: developers are slightly more optimistic (score of 51) than non-developers (score of 46) about future effective rents. Differing expectations about future rents may lead non-developers to value commercial properties and new development more conservatively than developers.

Direct From Survey Participants

"We anticipate continued cap rate decompression, a widening gap between seller and buyer expectations and a more restrictive lending environment while CRE professionals and investors adjust to higher interest rates."

"The biggest issue we're facing is that construction costs are still elevated (though finally stable), but the cost of debt has more than doubled while rents are either flat or increased slightly. This makes excellent deals harder to pencil and marginal deals not able to pencil at all. The NOI limits the amount of debt, requiring higher equity contributions."

"The office market will face significant challenges over the next 12 months with the best-in-class properties improving and the rest of the market struggling to capture limited demand. Tenants will continue to improve their offerings to their employees to attract them back into the office, but will be slow to make decisions, delaying capital expenditures as they face down a potential recession."

"Industrial real estate fundamentals [are] still very good."

"We are cold storage developers and demand from tenants in our sector remains strong. Whether interest rates end up higher or lower, interest rate volatility has made dealmaking difficult."

"As developers of lab-office space, we see very little new construction starting in the next 12 months and any starts will be 50%+ pre-leased. This will slow development activity but put pressure on existing space, making it a more favorable leasing environment for the next 24-36 months."

"We see [municipal] building and planning departments having a bit more bandwidth and less backlog over the next 12 months. [It is] hit or miss on whether local planning commissions see the importance of approving housing and density, even as state and local leaders are pushing housing production and affordability as key to economic security and development."

"In the state of California, we are finding it incredibly difficult to pencil projects. This is across product types and in both A and B markets (Bay Area + Sacramento). […] Fees for cities make it so tough on the math."

Methodology

The NAIOP CRE 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/April and August/September. The survey is sent to roughly 10,000 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 the participants chose the most pessimistic response to every question, the index would be 0. The survey includes questions that evaluate sentiment about conditions that are not included in the composite sentiment index score but are measured separately on a 100-point scale.

A cross-tabulation of the April survey results by respondent profession revealed only one difference that was statistically significant. Differences that were not statistically significant are not reported in this analysis.

A total of 523 respondents from 374 distinct companies participated in this survey. When individuals were asked what property types they worked on, 71.9% indicated they work on industrial properties, 60.4% work on office properties, 46.5% work on multifamily properties and 44.9% work on retail properties. A regional breakdown shows that 54.1% of respondents are active in the West, 36.1% are active in the South, 29.8% are active in the East and 25.6% are active in 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 April 5 and April 13. The response rate for this survey was 5.3%, and the margin of error for the composite index score was 4.3%.

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 was collected by NAIOP, and the survey questions were created, refined and finalized between 2014 and 2021 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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