The NAIOP CRE Sentiment Index
Industry Leaders' Outlook for Commercial Real Estate

NAIOP CRE Sentiment Index
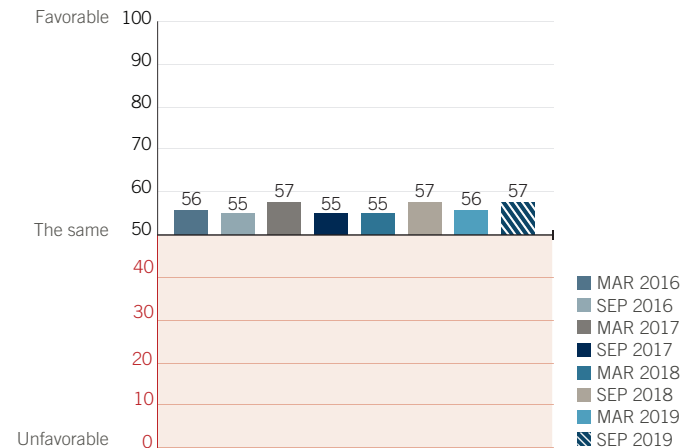Survey Conducted September 4-18, 2019

57

0 — 50 — 100

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.

Favorable 100

Unfavorable 0

The same

Chart values: 56, 55, 57, 55, 55, 57, 56, 57

Legend:
- MAR 2016
- SEP 2016
- MAR 2017
- SEP 2017
- MAR 2018
- SEP 2018
- MAR 2019
- SEP 2019

Notable Changes From the March 2019 Survey

NAIOP has converted the overall index from a decimal to a whole number, and it is now on a 100-point scale (similar to the Purchasing Managers' Index). A rating above 50 indicates favorable sentiment, while a rating below 50 indicates unfavorable sentiment over the next 12 months. The methodology and scale of the 10 survey question responses remained the same.

The two most positive changes in the survey that helped keep the index above zero were improvements in first-year capitalization rates and effective rents. Over the coming year, respondents expect lower first-year cap rates, which is a 5.0% improvement compared to six months ago. Additionally — and for the first time since the survey began — the responses swung this question from "higher" in the next 12 months to "lower" in the next 12 months. Lower expected future cap rates and associated higher prices, along with the 0.8% improvement in the respondents' expectation for stronger effective rents, helped to keep the overall index above 50. Face rents may also yield positive contributions to real estate development in the next 12 months (an improvement of 0.8%) as projects are completed. Expectations for adding employees in CRE firms within the next 12 months fell slightly.

Despite these mostly positive views for the near-term future, the respondents' overall sentiment about the commercial real estate industry declined. This is perplexing given respondents' generally favorable outlook for the individual components that make up the Sentiment Index score. These apparently contradictory responses may be a sign of the times — a strong economy, low interest rates and low unemployment combined with the headwinds of a late real estate cycle, uncertain trade policy, slowing growth in China and Europe, and an upcoming U.S. presidential election.

Key Findings

The NAIOP CRE Sentiment Index for September 2019 is above 50, indicating that the commercial real estate market should continue steady, sustainable growth over the next 12 months, and overall commercial real estate development conditions should improve slightly through at least the end of 2020. Respondents predict increases in occupancy rates, face and effective rents during the next year, along with steadily available equity and debt financing for projects in their pipelines. A majority plan to hire employees, even though the costs of construction materials and labor continue to cause concern. Also, for the first time, respondents expect first-year cap rates to be lower (associated with higher value) 12 months from now. The index has remained between 55 and 57 for the past four years, a sign that the commercial real estate market is not currently overheated and should experience continued expansion over the next year. However, it is interesting to note that while the scores for the first nine questions, which relate to respondents' businesses, generally increased, the scores for the tenth question on general sentiment continued to decrease. The low score, which is not included in the calculation of the index, may be related to overall economic and political uncertainty in the U.S. and abroad despite favorable conditions within the respondents' markets.

Agreement/Disagreement Among Respondents

The most consistent responses (meaning there was the most agreement among survey participants) were related to questions about project face rents, occupancy and first-year capitalization rates. More consistent and favorable expectations for face rents and first-year capitalization rates contributed significantly to the index's improvement from the March 2019 survey. Respondent expectations for the future availability of capital (both debt and equity), and improved views regarding the future cost of construction materials and labor, also helped raise the index.

The questions with the least consistent responses (most dispersion) regarded employment (within CRE firms and from contractor labor) and construction materials costs. The three questions were about 20% less consistent than expected, meaning that not all respondents believe these components of the development process are equal across the U.S.

About the NAIOP CRE Sentiment Index

The NAIOP CRE 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; it represents a look into the future by real estate developers, investors, operators and brokers. 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 the last page.)

NAIOP
COMMERCIAL REAL ESTATE
DEVELOPMENT ASSOCIATION

EMPLOYMENT

1. How likely is it that your company will add employees within the next 12 months?
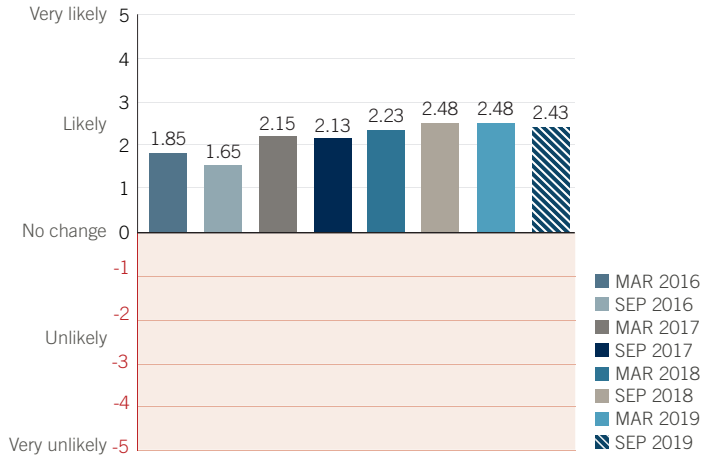
Employment growth expectations are expected to decline a small amount at CRE companies during the next year. Responses to this question have consistently ranked as the most positive market indicator in the survey; however, the current survey responses were widely dispersed indicating disagreement among respondents. As such, in this survey, the employment question contributes less weight to the overall Sentiment Index. Even so, the overall employment outlook remains positive, indicating that survey **respondents expect they are likely to continue adding more jobs going into 2020 signaling continued growth in the commercial real estate development market**.

OCCUPANCY RATES

2. Based on your own projects, where do you believe occupancy rates will be in 12 months?
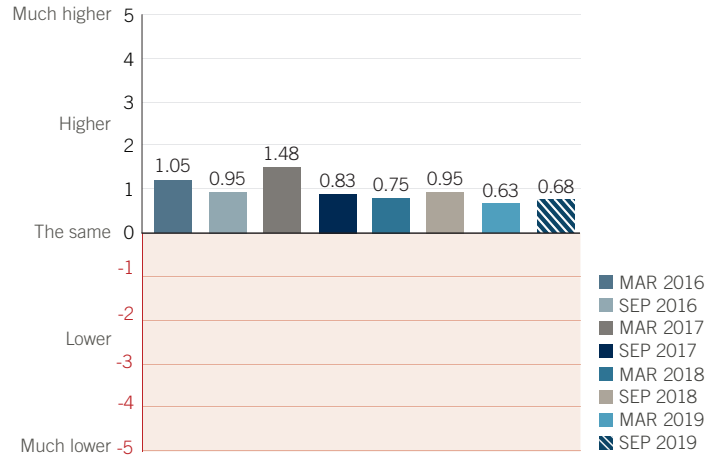
The occupancy rate score (0.68) increased 0.5% compared to March 2019, and it had slightly less-than-typical dispersion among survey respondents. This positive score means there is greater-than-average certainty among respondents that occupancy rates could increase over the next 12 months. However, the slight increase still did not get the response back to the September 2018 level, when the occupancy rate score was 0.95. This continued lower expectation level might indicate that **demand will continue to grow but at a tempered pace over the next 12 months**.

FACE RENTS

3. Based on your own projects, where do you believe face rents will be in 12 months?
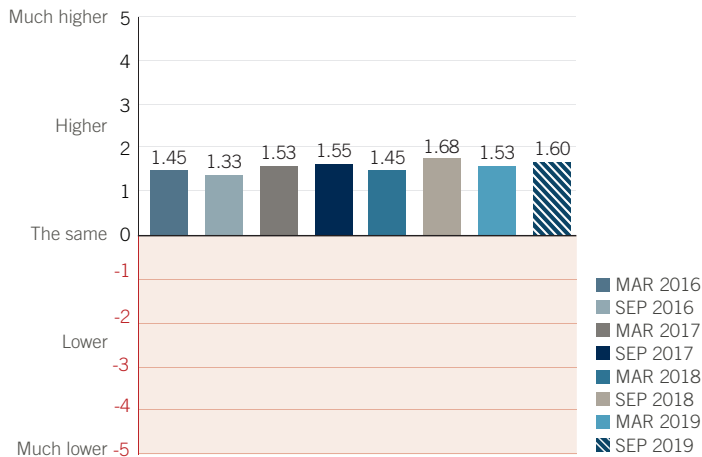
Responses relating to face rents have stayed relatively stable and highly positive since March 2016. For the past two years, this question featured the least dispersion among the responses, indicating significant agreement among survey participants regarding face rents increasing into the next year. This survey question, along with effective rents, employment levels, and both equity and debt capital availability, has helped keep the overall index positive over the past 48 months. **Overall, face rents are expected to remain positive and improve between now and the end of 2020**.

EFFECTIVE RENTS

4. Based on your own projects, where do you believe effective rents will be in 12 months?
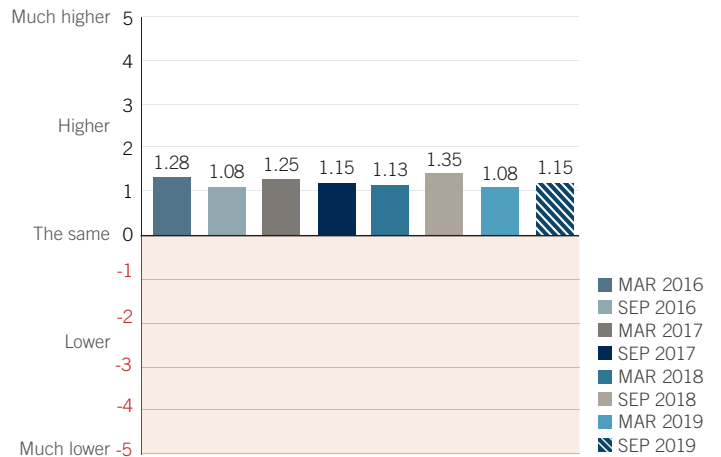
Expectations regarding effective rents (score of 1.15) increased 0.80% compared to the March 2019 survey. This indicates that expectations have moved back to longer-term norms, meaning effective rents are expected to continue to rise at a modest rate over the next year. **With readings for face and effective rents remaining in solidly positive territory, it appears that respondents anticipate that property rental income should grow modestly over the next year**.
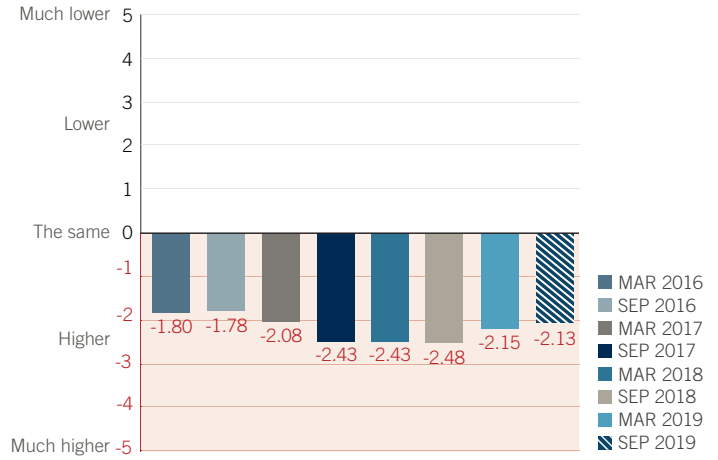
CONSTRUCTION MATERIALS COSTS

5. For projects on which you are seeking bids, where do you believe the cost of construction materials will be in 12 months?
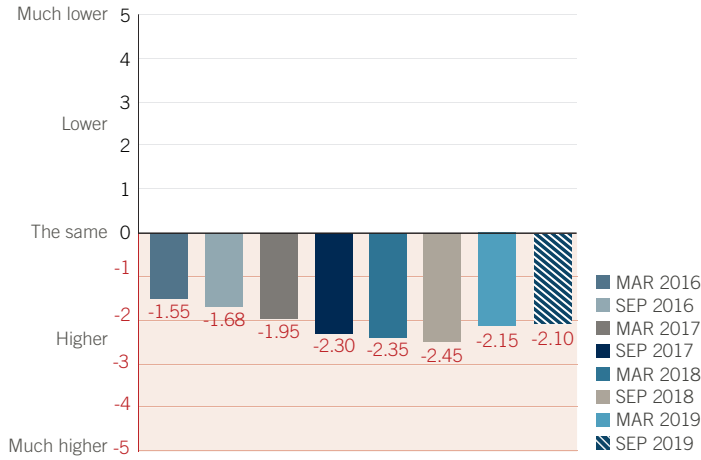
As with every survey result going back to its inception, construction materials costs (score of -2.10) provided significant downward pressure on the overall Sentiment Index. Compared to the two most recent surveys, the score for construction materials improved by 0.30% since March 2019 and is up a solid 3.50% over the prior 12 months. Lower-than-typical consistency of responses to this question indicates that expectations of rising costs are neither uniform across the country nor across product types, and negative perceptions remain high. **Survey respondents see the cost of construction materials rising over the next year but at a slower pace than the prior four surveys**.

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 (-2.13) is slightly more positive in this survey compared to a year ago (3.50% improvement). It is the same level as March 2019. Along with construction materials, these two items remain the most negative components of the overall Sentiment Index. Survey responses were more inconsistent (more dispersed) than those relating to construction materials costs; however, given the large negative score for this question, **respondents expect construction labor costs to keep rising over the next year, although less rapidly than in previous surveys**.

AVAILABLE EQUITY

7. For projects you will be financing/refinancing, how plentiful do you believe equity will be in 12 months?
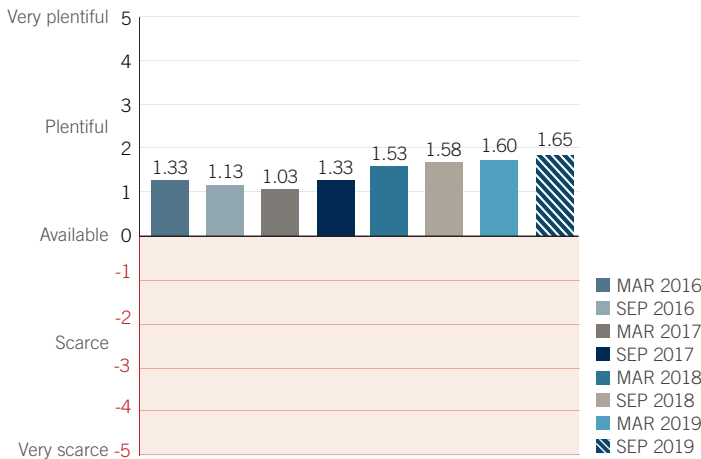
The score for available equity (1.65) continued its steady rebound in this survey. Since hitting a low point in March 2017, the available equity score has increased 6.20%. The available equity measure contributes to keeping the overall Sentiment Index's score above 50. **Respondents remain optimistic about the continued availability of equity capital through the end of 2020**.

AVAILABLE DEBT

8. For projects you will be financing/refinancing, how plentiful do you believe debt will be in 12 months?
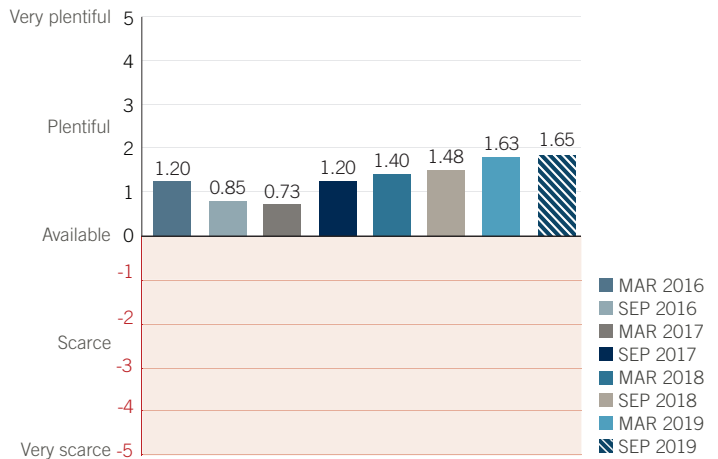
The question regarding available debt (score of 1.65) continues to rise since the March 2017 survey, registering highly consistent responses from survey participants. This is a reversal of the consistent and sharp decline that existed between March 2016 and March 2017. Responses for this question were consistently positive across survey participants. **Like equity, debt capital should be available at favorable rates over the next 12 months**.

FIRST-YEAR CAPITALIZATION RATES

9. Where do you expect first-year cap rates to be for deals you will close 12 months from now?
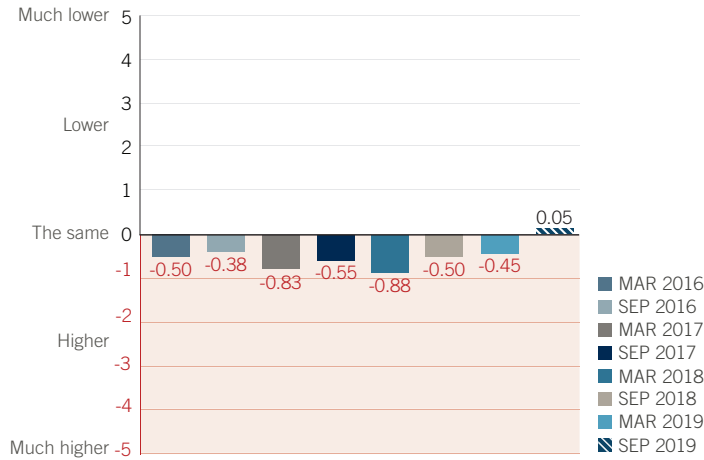
Survey responses indicate that first-year cap rates (score of 0.05) will probably decrease slightly in the coming year. This survey's score improved by about 5.50% over the past year and 5.00% since March 2019. This question's score had been negative since the inception of the survey in March 2016, so the move into positive territory is significant. The change in response direction may align with lower interest rates. Response volatility for this question is now lower than prior surveys; this would indicate that survey participants are more bullish in their responses. **Therefore, respondents believe cap rates will fall over the next 12 months**.

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?
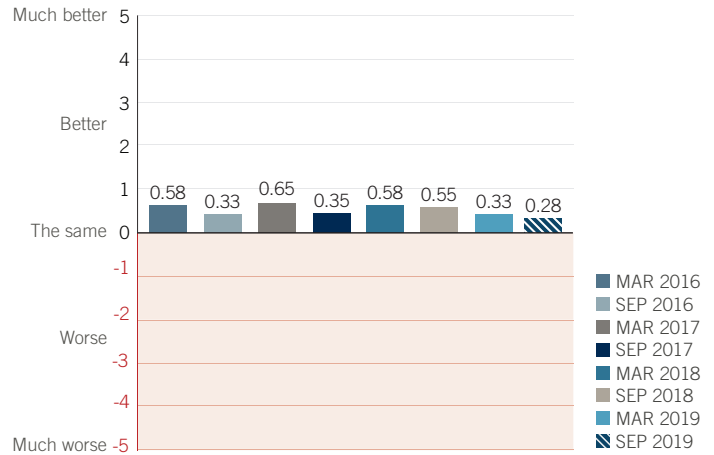
The survey's final question about overall sentiment regarding future conditions is designed to serve as a verification of the Sentiment Index and is not included in the calculation of the index. The general-sentiment positive score in this survey (0.28) fell by 0.5% compared to the reading taken in March 2019. This score is perplexing; nearly every individual question in this survey improved compared to responses gathered in March 2019, and results were similar to the September 2018 survey. Additionally, the September 2019 score for this question is the lowest ever recorded, which is also concerning. Although this question's score is low, it is in positive territory, which means there still is **a slightly optimistic view of the real estate development market over the next 12 months**.

Direct From the Survey Participants

" Recession worries loom based on geopolitical issues, Fed movements and the pending presidential election. We are seeing lenders getting more conservative and prospective tenants moving more slowly to lease and/or wanting shorter-term deals (more flexibility for them if/when the economy slows)."

" I foresee a stabilization or small dip in the market in the next 12 months. Once the global trade issues are resolved and the election is decided ... we'll see."

" Commercial real estate development remains stable to robust in key geographies and property types. The principal economic drivers will be land and construction costs. All elements of hard construction are rising and lead times are growing, which potentially increases the interest cost of the project."

" I see a slight recession, which will bring with it lower labor/materials costs, lower occupancy and lower/equal face rate/effective rate. Equity and debt will be available for well-established firms, though it will certainly not be 'plentiful' and will be very diligently underwritten."

" It's been a wild few weeks with rates and forecasts lowering. We will see how 2020 starts and how the impending election affects the market."

" Our markets will remain in a somewhat stable position maintaining the status quo. Rates will remain in place but concessions may tick up a bit. Multifamily is getting overbuilt, and there are concerns about the volume of industrial that is under construction with little or no preleasing."

" Markets are still healthy. The buy side is underwriting with much more discipline than a few years ago."

" It's very difficult to predict in a presidential election year, especially this one. It's complicated due to immigration issues (labor availability) and the trade situation with China (prices). All factors discussed in this survey could go up or down in the scenario we are in."

Understanding the Index

Changes in the scores of the individual survey questions between the March 2019 and the September 2019 surveys ranged between -0.50% and +5.00%. This differs from most surveys in that the individual scores were mostly positive (seven of nine questions were positive), and the most consistent responses were highly positive. **The overall composite index for September 2019 (57) indicates that there is optimism in the CRE industry due to mostly positive CRE economics, with the noted exceptions of construction labor and construction materials costs (negative influences)**.

Note: The score for question 10 regarding overall sentiment in the CRE marketplace is 0.28 (53 on a 100-point scale), whereas this survey's composite Index is 57. This single question's response (question 10) is somewhat less than the Sentiment Index which had been fairly consistent with the single question over the prior four years. Said differently, 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 specifically asked a single, subjective question regarding overall sentiment toward the CRE marketplace. When these two indicators are very close to each other (they are only different by 4 points in this survey), the single General Sentiment question is validated. The response rate for this survey was 5.55% and the margin of error for the index was 4.66%.

Methodology

The NAIOP Sentiment Survey is conducted biannually, in March and September. The survey is sent to roughly 7,000 NAIOP members in the U.S. who are developers, investors, brokers 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 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.

A total of 295 distinct companies are represented in this survey. Product types owned/under development by respondents broke out to roughly 32% office, 35% industrial, 18% retail and 15% multifamily; western regions were slightly more represented than eastern regions followed by the South and the Midwest.

Survey participants receive a three-page summary of results showing the%age breakdown of responses to each question 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 between September 4 and September 18, 2019. The first two readings in this survey series were beta tests sent to approximately 600 NAIOP members in February and September 2015, generating response rates of around 17%. 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 costs, construction labor costs and employment being the least consistently answered questions. As such, the 2016 and 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, CCIM, CRE, the Gerald Fogelson Distinguished Chair of Real Estate in the Chicago School of Real Estate at Roosevelt University. The survey data is collected by NAIOP and the survey questions were created, refined and finalized between 2014 and 2016 with the assistance of several NAIOP Distinguished Fellows.

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