The NAIOP CRE Sentiment Index

Industry Leaders' Outlook for Commercial Real Estate Spring 2019

NAIOP CRE Sentiment Index **0.56**

Survey Conducted March 13-27, 2019

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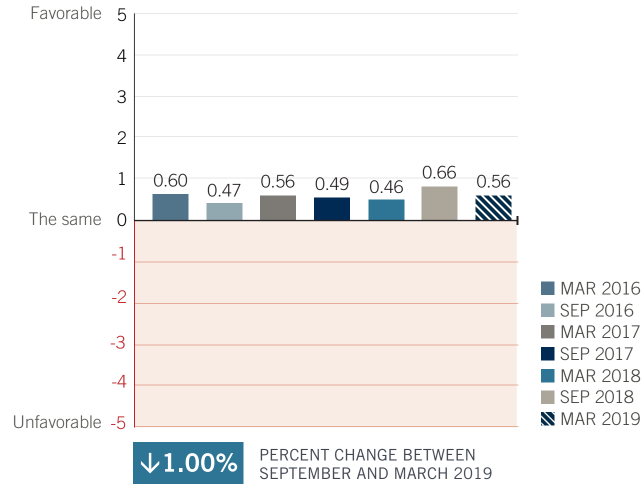
Below zero means **unfavorable** CRE conditions are expected in 12 months.

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

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

NAIOP CRE SENTIMENT INDEX



Notable Changes From the September 2018 Survey

Year-over-year, the 3.50% improvement in the cost of construction labor and the 3.30% improvement in the cost of construction materials helped keep the overall Index positive. The availability of debt was also seen as a positive contribution to development in the next 12 months (an improvement of 1.50%). In earlier surveys, the availability of capital had been a concern, but those worries appear to have eased in the past 18 months. Respondents indicated that rents (both face and effective) and occupancy rates now appear to be more pressing issues for developers. In terms of contribution to the overall index, occupancy rates fell by 3.20%, effective rents fell by 2.70% and face rents fell by 1.50%. These three items were the major contributors behind the 1.00% overall fall in the Sentiment Index since September 2018.

Key Findings

The NAIOP CRE Sentiment Index for March 2019, a composite of nine survey questions, fell to 0.56, a 1.00% decline from the September 2018 level of 0.66. The September 2018 level was the highest for the Index since the full survey commenced in March 2016. The latest results again show consistent responses compared to the six prior surveys. Even with the Index's slight decrease, the general indication is that commercial real estate will continue steady, sustainable growth during the next 12 months. Additionally, overall market conditions should be slightly better into the first quarter of 2020. This consistent, positive Index level is a sign that the overall real estate development market should support continued expansion for another year.

Agreement/Disagreement Among Respondents

The most consistent responses (meaning there was the most agreement among survey participants) were face rents and the availability of debt into the next year. These two categories were both strong contributors to the overall Index change since September 2018; however, they had differing effects. Face rents retracted a bit (down 1.50%), although they remained quite positive, and the availability of debt reached its highest level since the survey began (up 1.50%).

Questions regarding employment received the least consistent responses among survey participants. Even though the highest average score for any question was in the category of adding employees, there was a lot of variation in the individual responses. Likewise, the cost of construction labor and materials appeared to be a strong negative concern, but that was tempered somewhat by variation in the individual responses. The employment-related readings are consistent with the uneven real estate-related job growth in various regions across the U.S. during the past few years.

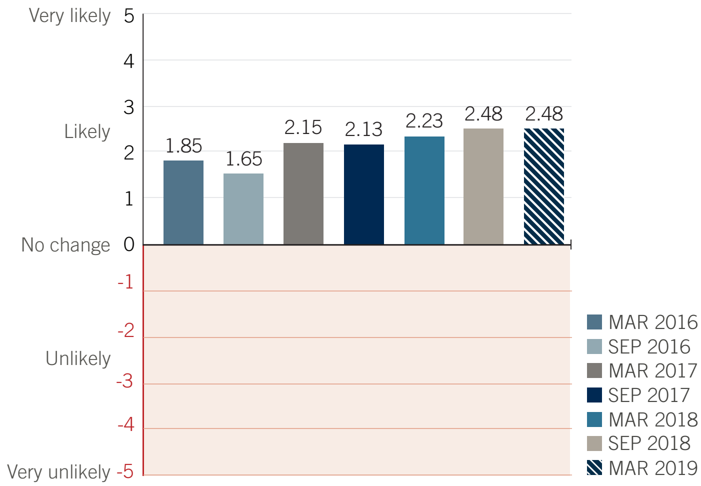
About the NAIOP CRE Sentiment Index

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; 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 page 5.)

NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

EMPLOYMENT

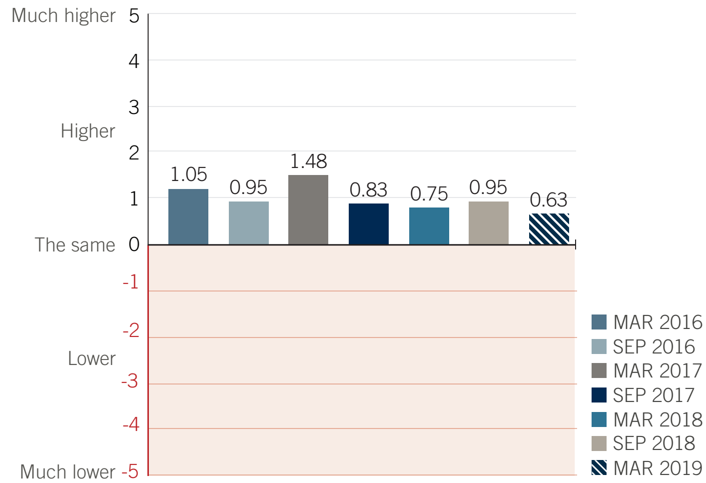
1. How likely is it that your company will add employees within the next 12 months?



Employment growth expectations remained steady at CRE companies with a score of 2.48, which is unchanged from September 2018. This level represents a 3.50% increase during the past 18 months and 8.30% growth since the September 2016 survey. Responses to this question have consistently ranked as the most positive market indicator in the survey; however, responses in the current survey were widely dispersed, indicating disagreement among respondents. Because of this, the employment question contributes less weight to the March 2019 Sentiment Index. The overall employment outlook remains positive, indicating that survey **respondents are likely to add more employees going into 2020**.

OCCUPANCY RATES

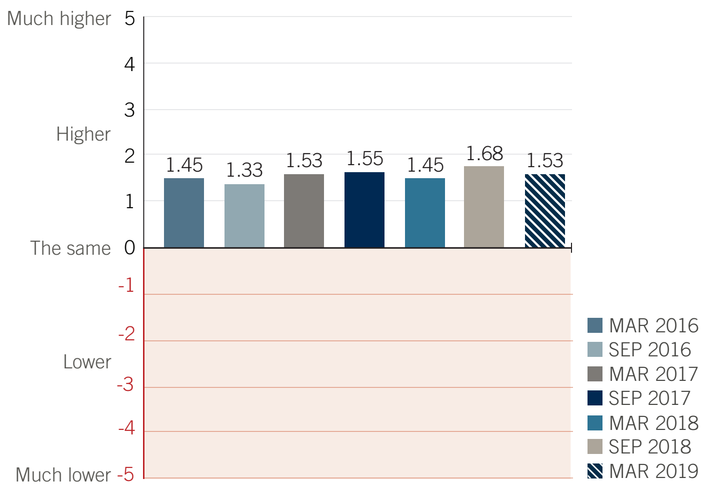
2. Based on your own projects, where do you believe occupancy rates will be in 12 months?



The occupancy rate score (0.63) fell 3.20% from September 2018 and is the lowest individual positive response in this survey. It also is tied with the effective rent category for the most consistent agreement among survey respondents. The positive 0.63 score means there is greater-than-average certainty among the respondents that occupancy rates are likely to increase during the next 12 months. The decrease is a reversal of what appeared in the September 2018 survey, and it might indicate that **demand will increase at a more tempered pace through the next 12 months**.

FACE RENTS

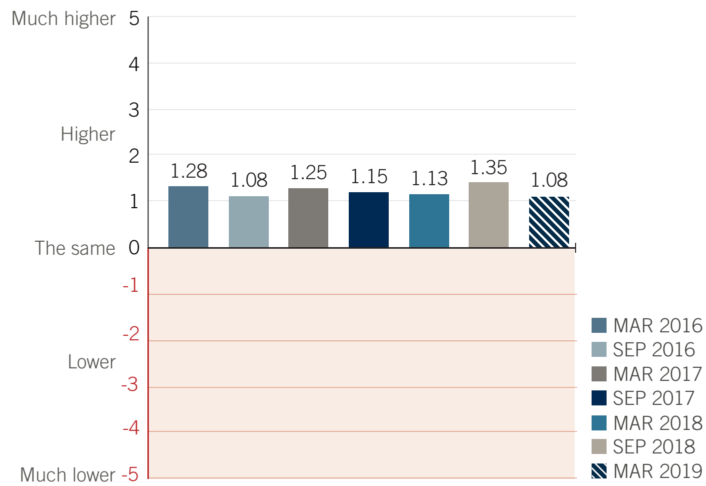
3. Based on your own projects, where do you believe face rents will be in 12 months?



Responses regarding face rents have maintained a stable, positive level since March 2016. For the past 18 months, this question featured the least dispersion among the responses, indicating significant agreement that face rents will rise into the next year. This survey question, along with employment and the availability of both equity and debt capital, has helped keep the overall Index positive during the past 3.5 years. The score for face rents (1.53) is on par with scores recorded since the survey's inception, but it is 1.50% lower than it was six months ago. **Overall, face rents are expected to remain positive and improve between now and early 2020**.

EFFECTIVE RENTS

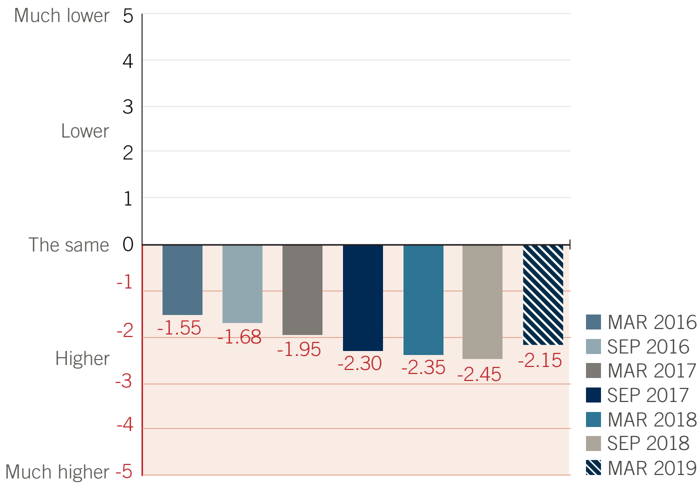
4. Based on your own projects, where do you believe effective rents will be in 12 months?



Expectations regarding effective rents (score of 1.08) decreased 2.70% compared to the September 2018 survey and are about equal to levels recorded between September 2016 and March 2018. This indicates that expectations have tempered 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 both face rents and effective rents remaining in solidly positive territory, respondents appear to anticipate modest growth in property rental income during the next year.

CONSTRUCTION MATERIALS COSTS

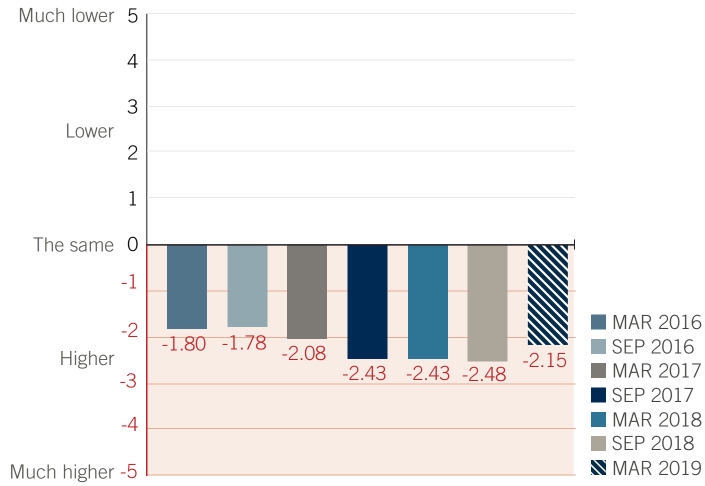
5. For projects on which you are seeking bids, where do you believe the cost of construction materials will be in 12 months?



As with every survey result going back to its inception, construction materials costs (score of -2.15) provided significant downward pressure on the overall Sentiment Index. Compared to September 2018, however, the score for construction materials improved by a solid 3.30%. Survey respondents expect the cost of **construction materials to rise during the next year, but at a slower pace than the prior three surveys**. Inconsistent responses to this question indicate that expectations of rising costs are neither uniform across the country nor across product types, and the negative perception is lessening.

CONSTRUCTION LABOR COSTS

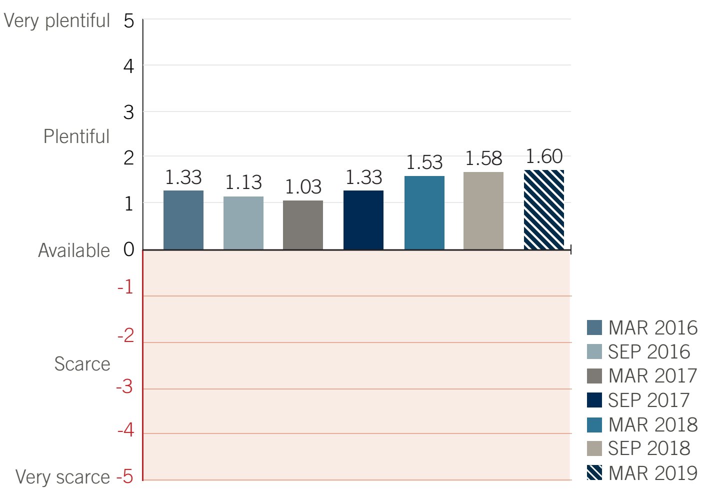
6. For projects on which you are seeking bids, where do you believe the cost of construction labor will be in 12 months?



The score for construction labor costs (also -2.15) is less negative in this survey compared to September 2018, and much better than the three most recent surveys. Along with construction materials, these two items remain the most negative components of the overall Sentiment Index. Survey responses were more inconsistent than those relating to construction materials costs; however, given the large negative score for this question, survey **respondents expect construction labor costs to continue to rise during the next year, though perhaps at a slower rate than indicated in previous surveys**.

AVAILABLE EQUITY

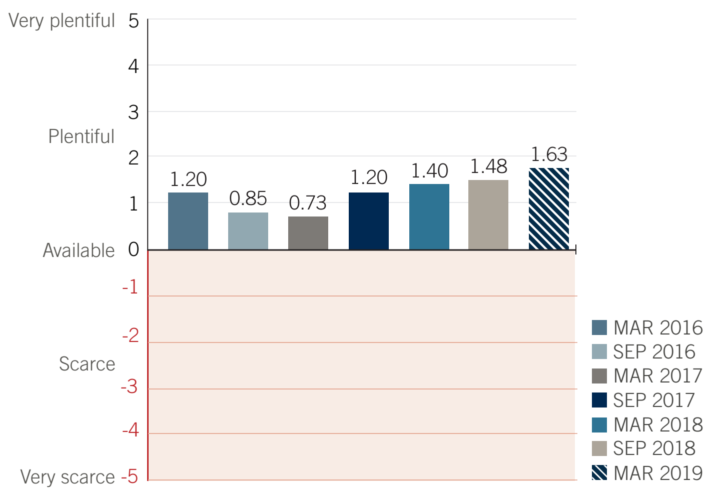
7. For projects you will be financing/refinancing, how plentiful do you believe equity will be in 12 months?



The score for available equity (1.60) continued its steady rebound, increasing 0.70% over the prior year and 2.70% since the September 2017 survey. Since hitting a low point in March 2017, the available equity score has increased 5.70%. The available equity measure contributes to the overall Sentiment Index's positive level. **Respondents remain optimistic about the continued availability of equity capital into 2020**.

AVAILABLE DEBT

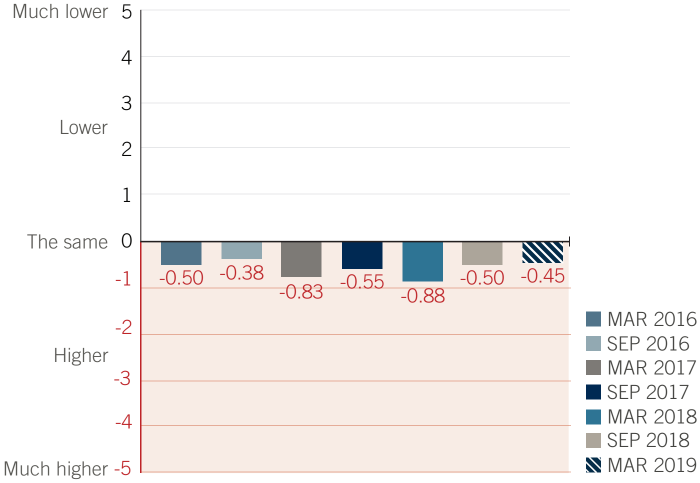
8. For projects you will be financing/refinancing, how plentiful do you believe debt will be in 12 months?



The question regarding available debt (score of 1.63) continues to increase and continues to register highly consistent responses from survey respondents. This is in direct contrast to the consistent and sharp decline that existed between March 2016 and March 2017. Like equity, **debt capital is expected to be available at still favorable rates over the next 12 months**. Responses for this question were positive and fairly consistent across survey participants.

FIRST-YEAR CAPITALIZATION RATES

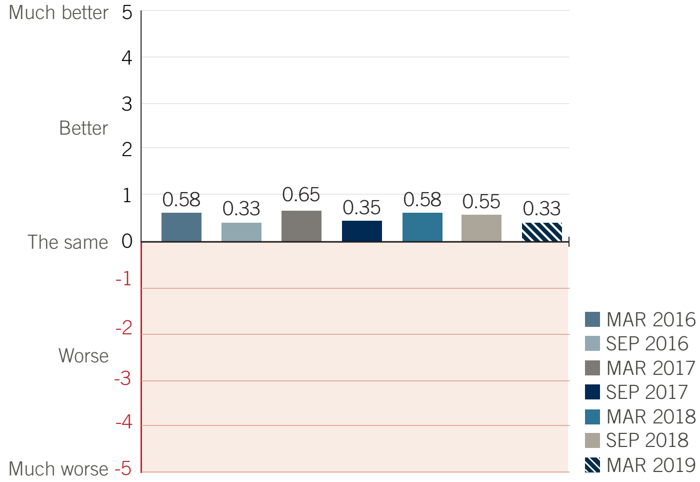
9. Where do you expect first-year cap rates to be for deals you will close 12 months from now?



Survey responses indicate that first-year cap rates (score of -0.45) could increase less in the coming year, with this survey's score rebounding by about 4.30% over the previous year. This score had oscillated consistently between March 2016 and September 2018, so this survey's improvement breaks that prior trend — which indicated a decline between September 2018 and March 2019. The volatility in responses for this question is nearly proportional, indicating that **some believe cap rates will rise, while a slight majority believe they will be steady or fall**.

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 (0.33) fell by 2.20% compared to the reading taken in September 2018; however, it is roughly equivalent to the score reported in both September 2016 and September 2017. Although this score is lower than the prior two surveys, it is still **a positive value, indicating a tempered yet optimistic view of the real estate development market during the next 12 months**.

Direct From the Survey Participants

"Working with industrial assets, demand for product is outweighing the supply. Rents and absorption levels are high across the board, with vacancy at historic lows. Do not see the trend stopping, recession or not, as the infrastructure of commerce has a large footprint. That will only continue to expand."

"We see a continuing disconnect between values determined by historically low cap rates, and the risks and realities of capital requirements to keep multitenant buildings well occupied and maintained."

"I am optimistic about the overall outlook for the next 12 months — especially the availability of capital — but cautious about rent growth. Occupancy will likely remain constant."

"We have been worried about a possible recession and higher interest rates for several years. I don't expect any meaningful increase in interest rates in the near future, but the fears of a recession seem more real now. It may not start in 12 months, but is likely in the next 24 months."

"The fundamentals of the economy (job demand/interest rates/corporate profits) and demand/supply still support continued growth. The main concerns remain labor availability for tenants and construction. The black-swan event is not evident unless it [turns out to be] trade wars (somewhat likely) or impeachment (not likely)."

"While I think that as a whole the industry will be the same or better, I do think there is a shift in product type that may leave large spec projects in a weaker position."

"Supply/demand conditions for industrial remain in balance except for select low-barrier-to-entry submarkets. Construction costs, labor availability and entitlement friction will keep a lid on rampant supply growth. The key is the continued demand drivers as supply chains shift and adjust to demands of new distribution networks."

"Coworking will be an even bigger force in real estate strategies in the coming year, across all segments, as rents get higher, owners become more open to it, debt/equity get comfortable with it, and valuations for this use improve."

Understanding the Index

Changes in the scores of the individual survey questions between the September 2018 and the March 2019 surveys ranged between -3.20% and +3.50%. This spread is larger than what has been seen in surveys since March 2016. The overall composite index for March 2019 (0.56) decreased 1.00% from September 2018 (0.66) and increased 1.00% from March 2018 (0.46), and it has been near this positive level since March 2016. **The current survey indicates optimism in the CRE industry due to mostly positive CRE economics with the noted exceptions of construction labor, materials costs and first-year cap rates (negative influences).**

Note: The score for question 10 regarding overall sentiment in the CRE marketplace is 0.33, whereas the survey's composite Index is 0.56. This lower score for question 10 has been fairly consistent during the prior three years. 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 regarding overall sentiment toward the CRE marketplace. When these two indicators are very close to each other (they are only different by 2.30% in this survey), the single General Sentiment question is validated. The difference may also be attributed to the fact that the response rate was much lower for this survey (268 responses compared to 413 responses in the September 2018 survey). The overall margin of error for this survey is 6.01% compared to 4.84% in September 2018.

Methodology

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 was also sent to 2,000 commercial brokers, bringing the total to 7,000 potential respondents. The survey poses 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 10.0% change (on an absolute basis).

A total of 197 distinct companies are represented in this survey. Product types owned/under development by respondents broke out to roughly 31.0% office, 34.0% industrial, 18.0% retail and 17.0% multifamily; western regions were slightly more represented than eastern regions followed by the South and the Midwest. The response rate for this survey was 3.34% and the margin of error for the Index was 6.01%.

Survey participants are sent a three-page summary of results showing the percentage 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 March 13-27, 2019.

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 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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