National Association of REALTORS®

COMMERCIAL REAL ESTATE OUTLOOK: 2017.Q3

COMMERCIAL Real Estate

NATIONAL ASSOCIATION of REALTORS®

Commercial Real Estate Outlook: 2017.Q3

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1 | ECONOMIC OVERVIEW

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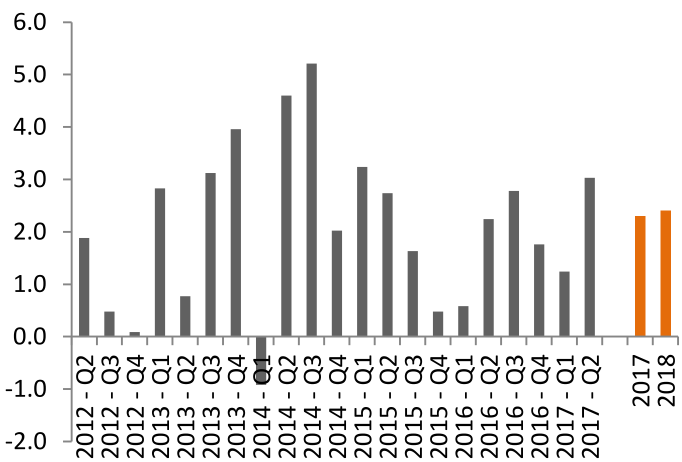
Gross Domestic Product

Moving beyond the economic growth moderation from 2016 (1.6 percent) and the weak first quarter of 2017 (1.2 percent), real gross domestic product (GDP) growth strengthened to a 3.0 percent annual rate in the second quarter of 2017, buoyed by stronger private consumption and private investment spending.

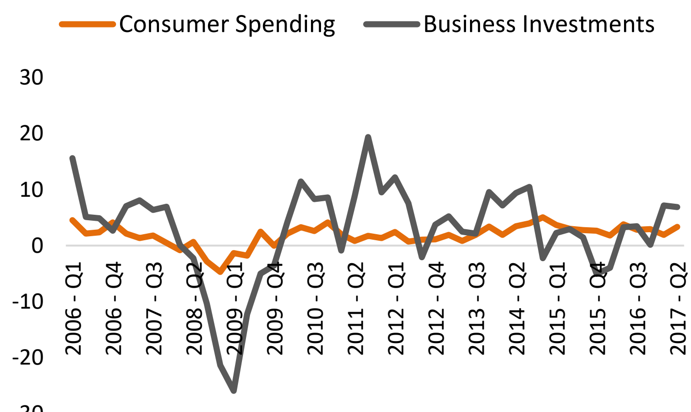
Exhibit 1.1: Real GDP (% Annual Chg.)



Source: National Association of REALTORS®, BEA

Private consumption spending—the biggest component of GDP— rose to 3.3 percent after a pullback in in the first quarter (1.9 percent) as spending for motor vehicles and parts, other durable goods, food and beverage, clothing and shoes, and housing and utilities rose at a stronger annual pace in the second quarter. From a historical perspective, private consumption was on an uptrend in 2014 (2.9 percent) and 2015 (3.6 percent), making the 2016 moderation in consumer spending a concern. The advance in growth in the second quarter of 2017 indicates that consumption spending is strengthening again. The Conference Board's Consumer Confidence Index indicates that consumers are more bullish: the index was at 122.9 in August 2017 compared to 101.8 in the same period last year. Sustained job growth and tame inflation have fueled the recovery in consumer spending. Since March 2010, private payrolls have increased by an average of 190,000 jobs per month, to a total of 16.8 million new jobs as of the second quarter of 2017. The total number of post-recession net new jobs more than offsets the 8.8 million jobs lost during the 2008-09 recession.

Exhibit 1.2: GDP - Real Consumer Spending & Business Investments (% Chg Annual Rate)



Source: BEA, SAAR, Bil.Chn.2009$

The corporate outlook remained bullish, with a healthy dose of caution. Private investment spending expanded at an annual pace of 3.6 percent as business investments rose at 6.9 percent, offsetting the contraction in residential fixed investment spending (-6.5 percent). The pace of business investments picked up for equipment (9.6 percent), information processing equipment (11.4 percent), industrial equipment (13.4 percent), and other equipment (14.3 percent). Investments in commercial structures continued to expand at a strong pace (10.2 percent). Real private non-residential investment slowed in 2015 (2.3 percent) then contracted in 2016 (-0.6 percent), mainly from the reduced investment in the oil sector, from the collapse in crude oil prices starting in July 2014 to as low as an average of $37/barrel in the fourth quarter of 2015. With oil prices firming in 2016 to an average of $53.8/barrel toward the end of the year, business investments rose an annual pace of growth of 7.0 percent over the first half of 2017.

On the other hand, private residential investment spending, adjusted for inflation, contracted by 6.5 percent. The number of building starts, an indicator of the level of residential investment spending, was essentially unchanged at 1,165 in the second quarter of 2017 compared to 1,158 in the second quarter of 2016, while the cost of residential construction has increased, in part due to rising lumber prices.

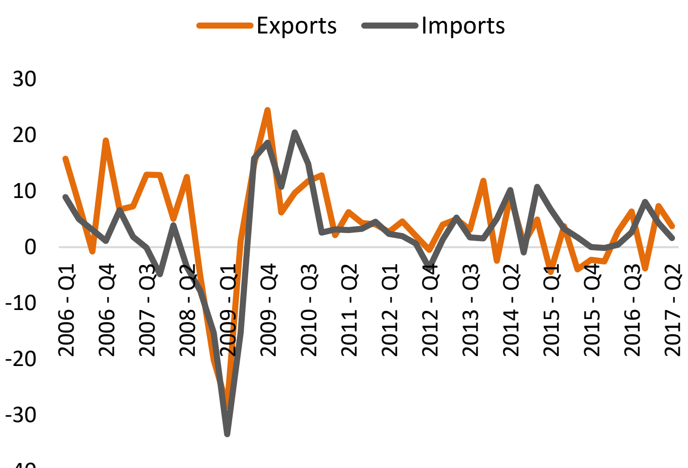
Exports expanded at a slower annual pace of 3.7 percent as exports of inedible crude materials contracted in the second quarter compared to the first. Exports rose for all other commodities, including transport equipment and minerals/fuels/lubricants, the two largest U.S. export commodities. Imports also rose at a slower pace of 1.6 percent. With export growth outpacing import growth, the real trade deficit improved.

Government spending declined at a 0.3 percent annual growth rate, following cuts in state and local spending (-1.7 percent). Federal government spending increased by 1.9 percent.

Employment

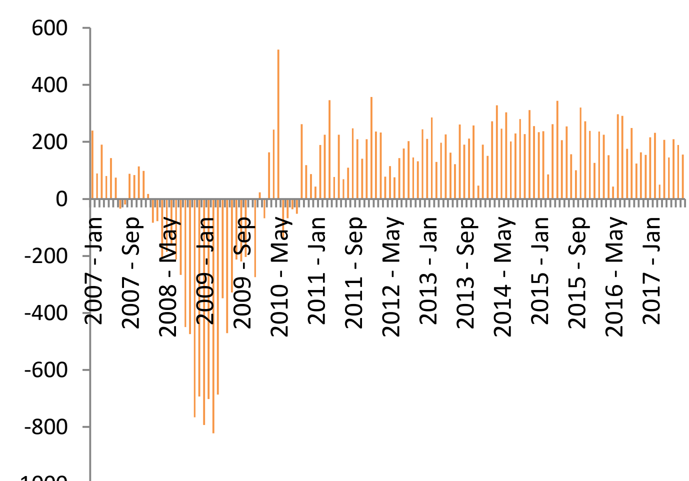
Payroll employment advanced in the second quarter of 2017, with a net gain of 484,000 new jobs, according to the Bureau of Labor Statistics (BLS). Private service-providing industries continued as the growth engine during the quarter, with 396,000 net

Exhibit 1.3: Real Exports & Imports (% Chg Annual Rate)



Source: BEA, SAAR, Bil.Chn.2009$

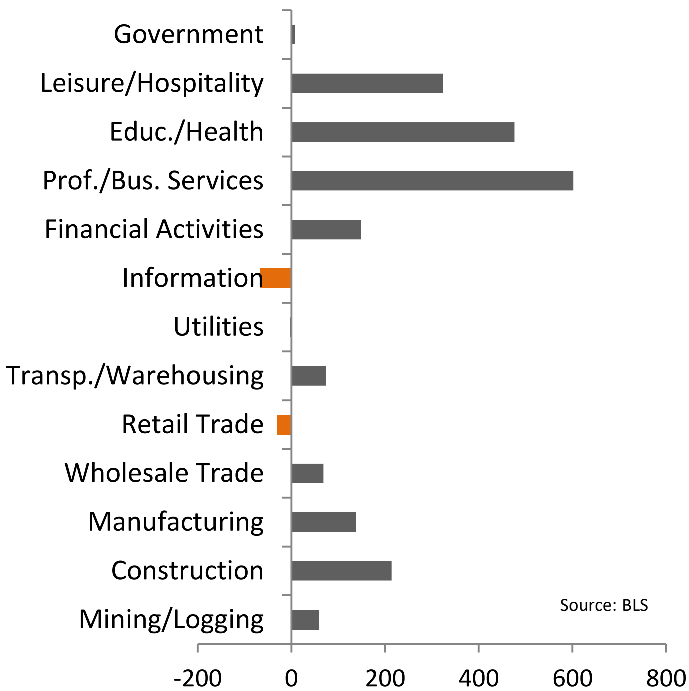
Exhibit 1.4: Payroll Employment (Change, '000)



Source: BLS

new jobs. Within the service industries, the sectors with the largest gains were professional and business services (144,000), education and health (116,000), and leisure and hospitality (113,000). Other major industry groups with net new jobs: manufacturing (31,000), construction (28,000), and mining and logging (24,000). The noticeable declines came from retail trade (-48,000), resulting from department store closings across the country, as well as utilities (-2,000) and information services (-22,000).

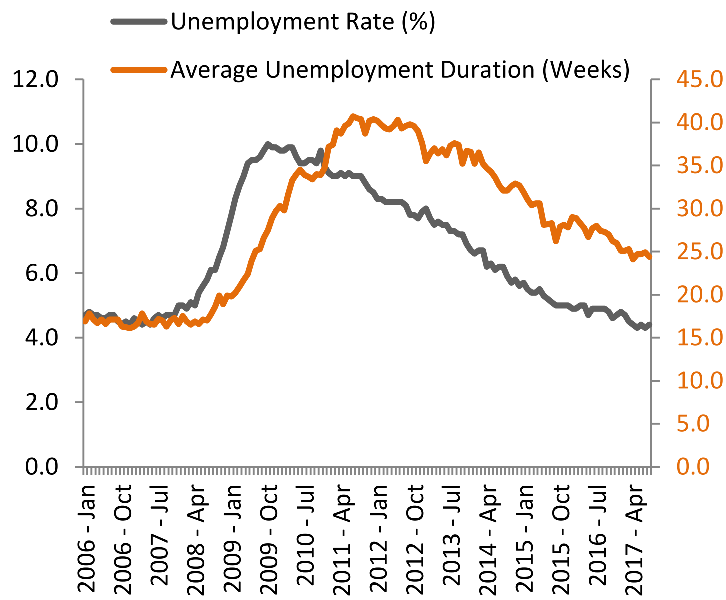
Exhibit 1.5: Payroll Employment: 12-Month Change ('000)



The unemployment rate dropped to 4.4 percent in the second quarter compared to the rate in the first quarter (4.7 percent). Among the unemployed, the average duration of unemployment was 24.4 weeks.

The labor force participation (LFP) rate slid to 62.8 percent in the second quarter from the first quarter's 63.0 percent.

Exhibit 1.6: Unemployment



Source: BLS

Inflation

Inflation tapered in the second quarter to an average of 1.9 percent after an uptick in the first quarter (2.5 percent). Core inflation, which excludes food and energy items, stood at 1.8 percent rose (2.2 percent in the first quarter). Non-food prices have increased at a faster pace, with rent leading, at an annual rate of 3.4 percent, followed by transportation (3.0 percent), and medical care services (2.7 percent). Core inflation ticked up to the FOMC's two percent inflation target in November 2015 through March 2017. The uptick in core inflation was a major consideration that led to four rate hikes in the federal funds rate starting in December 2015, from the zero lower bound to the 1.0-1.25 percent range as of the latest rate hike on June 15, 2017.

2 | COMMERCIAL REAL ESTATE INVESTMENTS

Commercial space is heavily concentrated in large buildings, but large buildings are a relatively small number of the overall stock of commercial buildings. Based on Energy Information Administration data approximately 72 percent of commercial buildings are less than 10,000 square feet in size.[1] An additional eight percent of commercial buildings are less than 17,000 square feet in size. In short, the commercial real estate market is bifurcated, with the majority of buildings (81 percent) relatively small (SCRE), but with the bulk of commercial space (71 percent) in the larger buildings (LCRE).

Commercial sales transactions span the price spectrum, but tend to be measured and reported based on size. Commercial deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their size. However, these smaller properties provide the types of commercial space that the typical American encounters on a daily basis—e.g. neighborhood shopping centers, warehouses, small offices, supermarkets, etc. These are the types of buildings that are important in local communities, and REALTORS® are active in serving these markets.

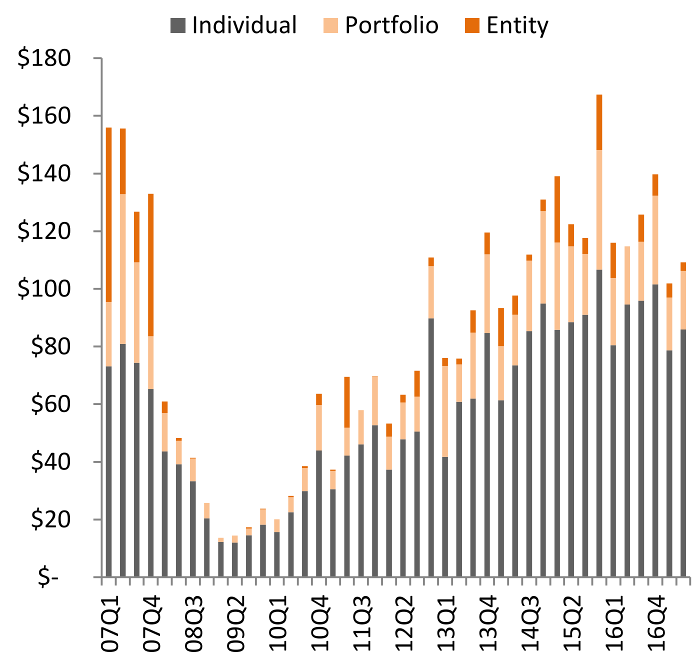
[1] Smith and Ratiu, (2015), "Small Commercial Real Estate Market," National Association of REALTORS®

Large Cap Commercial Real Estate Markets

Investments in LCRE markets signaled a maturing phase in the current cycle. Sales volume totaled $109.2 billion in the second quarter of this year, a 5.0 percent year-over-year decline, according to Real Capital Analytics (RCA). Sales of single assets declined 10.0 percent, while portfolio sales were virtually flat, with a slight 0.2 percent uptick, compared with the same period in the prior year. Investors have been much more cautious in their approach, while sellers seem to lack a sense of urgency to dispose of properties due to a more stable financing environment.

Sales in the six major metros tracked by RCA posted a 20 percent decline year-over-year during the second quarter of 2017. In comparison, large cap sales in secondary markets declined a more

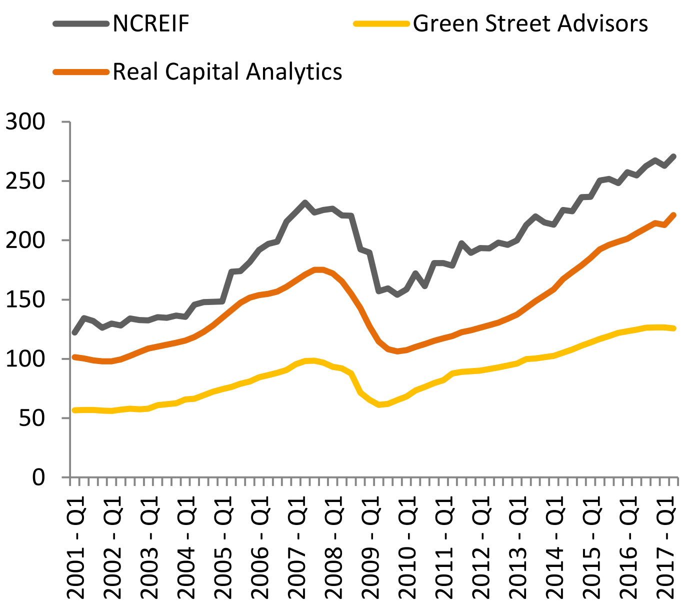
Exhibit 2.1: CRE Sales Volume ($2.5M+)



Source: Real Capital Analytics

modest 3.0 percent, while tertiary markets experienced no change during the period. Sales of apartment properties dominated the second quarter landscape, with $35.2 billion in transactions, followed by sales of office properties. The industrial sector was the only one to experience growth in transaction volume, with a 10.0 percent year-over-year gain.

Exhibit 2.2: Commercial Property Price Indices



Prices maintained an upward trend, yet at a slower pace. Based on Moody's/RCA Commercial Property Price Index data, prices gained 7.1 percent in the second quarter compared with a year ago. The gain came from strong appreciation in prices of apartment and office, which advanced 9.1 percent and 9.4 percent, respectively. Prices for industrial properties increased 6.2 percent year-over-year, while retail properties recorded a 0.1 percent decline.

Other commercial real estate prices offered mixed performance. The Green Street Advisors Commercial Property Price Index—focused on large cap properties—was flat, with a 0.1 percent gain on a yearly basis during the second quarter, at a value of 125.8. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased 6.3 percent year-over-year in the same period, to a value of 270.7.

Exhibit 2.3: NCREIF Property Index Returns—2017.Q2

NATIONAL	1.75%
OFFICE	1.58%
INDUSTRIAL	3.07%
RETAIL	1.52%
APARTMENT	1.45%

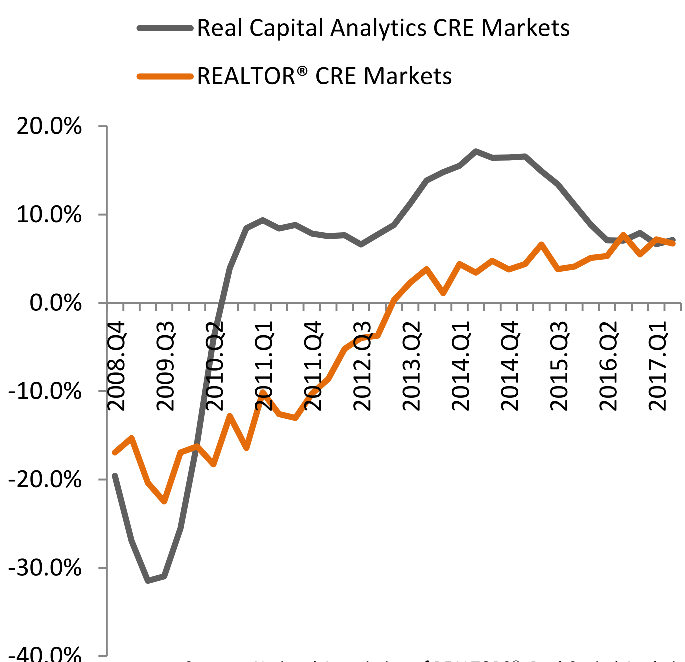
Source: National Council of Real Estate Investment Fiduciaries

Capitalization rates in large cap markets posted a 10 basis point uptick in the second quarter of this year. Based on RCA data, cap rates averaged 6.9 percent. Given the current outlook for interest rates and the position in the cycle, cap rates are not likely to compress any further. On a yearly basis, retail and hotel properties posted slight cap rate bumps—17 basis points and 18 basis points, respectively. Office and industrial cap rates were practically flat, while apartment caps slid 21 basis points from a year ago.

Small Cap Commercial Real Estate Markets

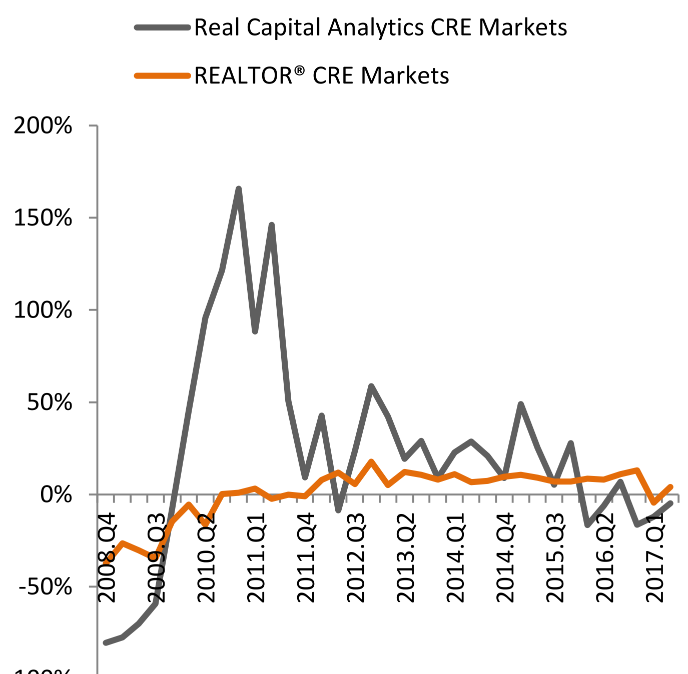
By the midpoint of 2017, the investment landscape returned to its bifurcated trend. While large cap markets have experienced declining sales for a year and a half, commercial real estate in small cap markets (SCRE) returned to an upward trend after the first quarter's slide, advancing 4.4 percent in the second quarter, based on data from the National Association of REALTORS®. In addition, a larger percentage of REALTORS® reported closing transactions—75.4 percent, compared with 61.0 percent in the first quarter—a sign of growing activity. The trend was also mirrored in the larger average transaction value for the quarter—$1.8 million vs. $876,500 during the first quarter of 2017.

Exhibit 2.5: Sales Prices (YoY % Chg)



Sources: National Association of REALTORS®, Real Capital Analytics

Exhibit 2.4: Sales Volume (YoY % Chg)



Sources: National Association of REALTORS®, Real Capital Analytics

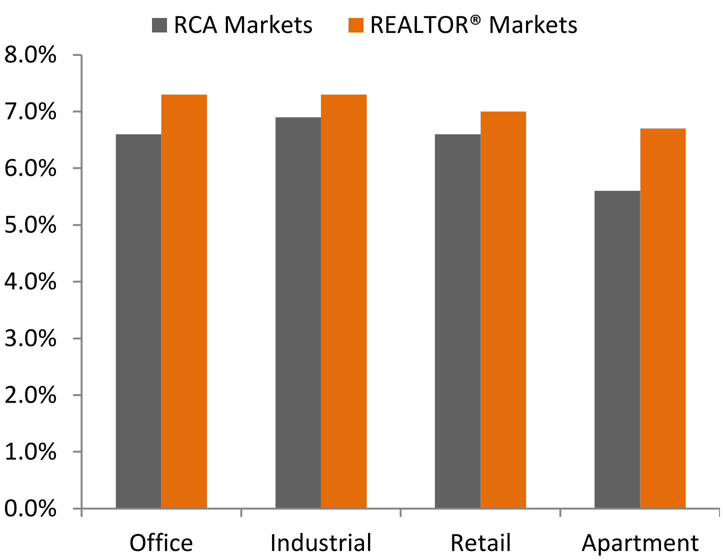
The shortage of available inventory remained the number one concern for REALTORS®, and was the main driver of price movement. Prices for commercial properties increased 6.7 percent compared with the second quarter of 2016. However, capitalization rates changes indicated a likely shift in investor risk preferences. Average national cap rates reached 7.3 percent in the first quarter, 30 basis points higher than the same period in 2016.

In light of the tight inventory, the gap in pricing between buyers and sellers weighed on REALTORS®' markets, ranking at number two of top concerns. Financing tied with local economic impacts as the third highest concern for REALTORS® markets, with 10.0 percent of members finding inadequate funding for commercial transactions.

International transactions comprised a noticeable share of REALTORS®' activity, comprising 14.0 percent of responses. The average international sale price was $1.4 million in the fourth quarter of this year. The average cap rate for international deals was 6.6 percent.

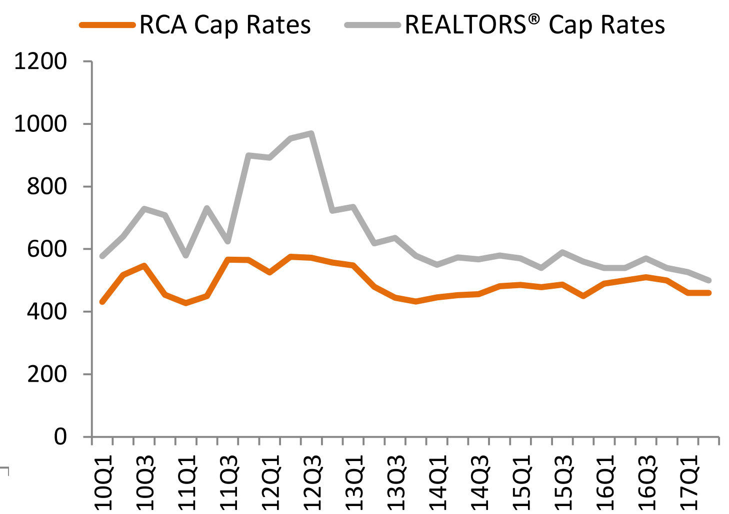
Longer-dated bond yields spent the better part of 2016 below 2.0 percent. During the second quarter, 10-year Treasury Notes averaged 2.3 percent, maintaining a wide spread to cap rates in REALTOR® markets.

Exhibit 2.6: Cap Rates - 2017.Q2



Sources: National Association of REALTORS®, Real Capital Analytics

Exhibit 2.7: CRE Spreads: Cap Rates to 10-Yr. T-Notes (bps)



Sources: National Association of REALTORS®, Real Capital Analytics

3 | COMMERCIAL REAL ESTATE FUNDAMENTALS

Large Cap Commercial Real Estate Markets

Commercial fundamentals in LCRE markets experienced solid demand during the quarter, in tandem with the uptick in economic activity. Even with new supply, solid absorption led to increases in rents.

Office demand was stable in the second quarter of 2017, fueled by higher tenant interest in technology, advertising and marketing, healthcare and life sciences sectors. Net absorption totaled 8.8 million square feet, based on data from JLL. Office construction advanced, contributing 11.7 million square feet to the supply pipeline during the quarter. With the gain in construction, office vacancies increased 10 basis points, to 14.8 percent. Rents for office properties moved up 3.2 percent on a yearly basis.

Industrial properties found new energy from e-commerce and distribution warehouse demand. Industrial net absorption totaled 101.0 million square feet over the first half of the year, according to JLL. The demand for space has also energized developers, with new supply matching demand during the period. In the first six months, completions totaled 100.0 million square feet. Moreover, the market has a total of 225.4 million square feet under construction. Industrial vacancy posted a 10 basis point slide, to 5.2 percent. Industrial asking rents hit a new high, at $5.35 per square foot.

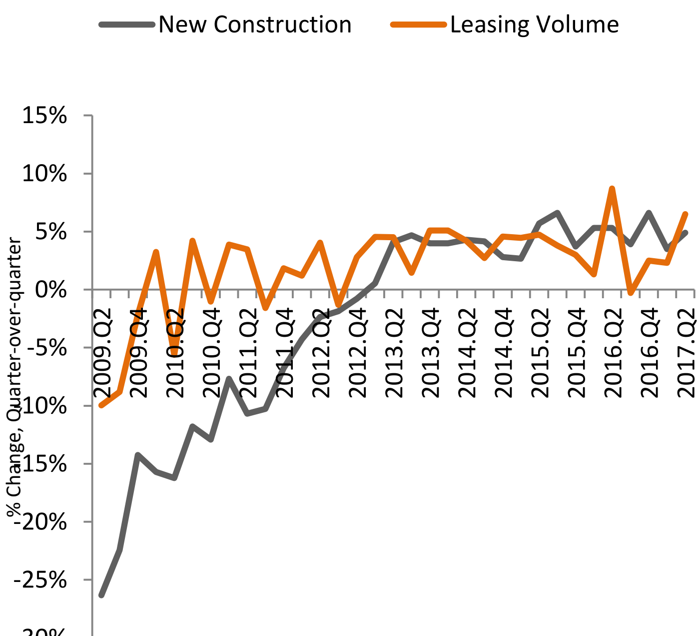
As consumer spending trended up in the second quarter, demand for retail spaces firmed, despite the much-publicized department store closures. Retail net absorption totaled 14.1 million square feet during the quarter, according to JLL. Retail construction activity slowed from the prior quarter, with completions totaling 17.3 million square feet, a 3.0 percent decline. Vacancy held at 4.9 percent in the second quarter, as retail rents rose 5.0 percent.

Continued advances in employment have improved household formation figures, maintaining demand for multifamily properties. Net absorption of multifamily units totaled 113,200 in the second quarter of 2017, a 1.2 percent gain year-over-year, according to CBRE. Development of multifamily properties maintained a solid pace, with 64,800 units delivered in the second quarter, bringing the first six months total to 150,000 units. The national vacancy rate averaged 4.6 percent in the second quarter, 20 basis points higher from a year ago. Apartment rents declined 0.5 percent year-over-year, to an average of $1,648 per month during the quarter.

Small Cap Commercial Real Estate Markets

Commercial fundamentals stayed the course, riding an upward trend in the second quarter of 2017. Leasing volume accelerated, posting a 6.5 percent advance from the preceding quarter. New construction increased by 4.9 percent from the prior quarter, as developers accelerated the pace of projects. Leasing rates rose by 2.8 percent, as concessions declined 4.6 percent.

Exhibit 3.1: REALTORS® Fundamentals

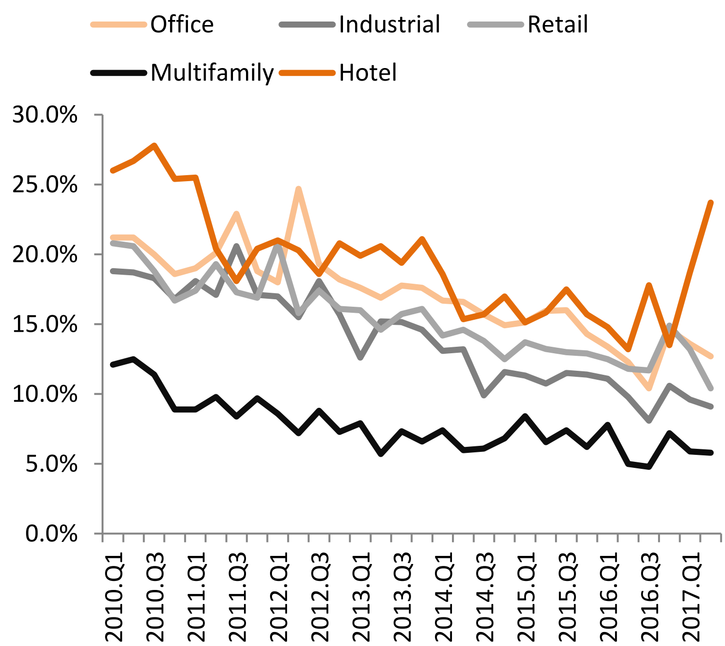


Source: National Association of Realtors®

Tenant demand remained strongest in the 5,000 square feet and below segment, accounting for 76.0 percent of responses. Demand for space in the "Under 2,500 square feet" segment softened from the last quarter, capturing 37.0 percent of responses. Demand for properties in the "2,500 - 4,999 square feet" picked up, accounting for 39.0 percent of total responses.

Vacancy rates continued declining in the second quarter of this year. Lease terms remained steady, with 36-month and 60-month leases capturing 60.0 percent of the market. One-year and two-year leases made up 17.0 percent of total.

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

4 | OUTLOOK

Economy

Looking forward to the second half of 2017, economic output is expected to advance by 3.0 percent annual rate in the third quarter and a slightly slower 2.8 percent in the last quarter, closing the year at an annual rate of 2.3 percent. Payroll employment is projected to pick up speed over the latter half, averaging 1.6 percent for the year, which would push the unemployment rate down to 4.3 percent by the end of the year. As consumer prices have experienced softer-than-expected gains, the Federal Reserve is likely to moderate its approach to the funds target rate increases. NAR forecasts the short-term rate to reach 1.2 percent by the fourth quarter of this year. U.S. inflation is projected to average 2.0 percent in 2017.

Exhibit 4.1: U.S. ECONOMIC OUTLOOK — August 2017

	2015	2016	2017	2018
Annual Growth Rate, %				
Real GDP	2.6	1.6	2.3	2.4
Nonfarm Payroll Employment	2.1	1.7	1.6	1.6
Consumer Prices	0.1	1.3	2.0	2.3
Level				
Consumer Confidence	98	100	118	121
Percent				
Unemployment	5.3	4.9	4.5	4.3
Fed Funds Rate	0.1	0.4	1.0	1.8
3-Month T-bill Rate	0.1	0.3	1.0	1.8
Corporate Aaa Bond Yield	4.3	5.2	4.1	4.9
10-Year Gov't Bond	2.1	1.8	2.5	2.9
30-Year Gov't Bond	2.8	2.6	3.0	3.6

Source: National Association of REALTORS®

Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

	2016.Q2	2016.Q3	2016.Q4	2017.Q1	2017.Q2	2017.Q3	2017.Q4	2018.Q1	2018.Q2	2018.Q3	2018.Q4	2019.Q1	*2016*	*2017*	*2018*
Office	12.3	12.9	13.4	13.6	12.7	13.0	12.6	12.4	12.1	11.9	11.8	11.8	*13.0*	*13.0*	*12.1*
Industrial	9.8	8.1	8.7	9.4	9.1	8.9	8.6	8.3	8.0	7.8	7.8	7.6	*9.4*	*9.0*	*8.0*
Retail	11.8	11.7	12.0	13.2	10.4	12.1	11.8	12.2	11.9	11.7	11.4	11.0	*12.0*	*11.9*	*11.8*
Multifamily	5.0	4.8	7.4	5.9	5.8	6.6	6.3	6.4	6.1	6.1	6.2	5.9	*6.3*	*6.2*	*6.2*

Source: National Association of REALTORS®

As the economic underpinnings advance at a moderate pace, commercial fundamentals are expected to maintain an upward trajectory. With employment in business and professional services still driving growth, demand for offices should remain solid. The industrial sector continues to ride the tail winds of trade and e-commerce. Even as store closures have dampened the outlook for the retail sector, demand for space is likely to continue, driven by consumer spending and changing shopping patterns. Multifamily properties benefit from a double-dose of boost—rising household formation and a shortage of residential housing—which will keep vacancies in check, even with rising new supply.

On the investment side, the slowdown in sales volume in LCRE markets during the past year and a half points to a stabilization period in the current cycle. Price growth in large cap markets is slowing down and likely to flatten over the coming months. The upshot on the investment front comes from small cap markets, where investors continue to seek stability and higher returns.

Exhibit 4.3: Commercial Property Price Indices Forecast

	2010	2011	2012	2013	2014	2015	2016	2017	2018
NCREIF	168.2	186.5	195.2	211.9	224.9	246.7	260.5	**259.7**	**260.2**
Green St. Advisors	74.4	87.1	92.2	99.4	106.7	118.0	125.2	**121.6**	**119.3**

Sources: National Association of REALTORS®, NCREIF, Green Street Advisors

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, representing over 1.2 million members, including NAR's institutes, societies and councils, involved in all aspects of the real estate industry. NAR membership includes brokers, salespeople, property managers, appraisers, counselors and others engaged in both residential and commercial real estate. The term REALTOR® is a registered collective membership mark that identifies a real estate professional who is a member of the National Association of REALTORS® and subscribes to its strict Code of Ethics. Working for America's property owners, the National Association provides a facility for professional development, research and exchange of information among its members and to the public and government for the purpose of preserving the free enterprise system and the right to own real property.

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