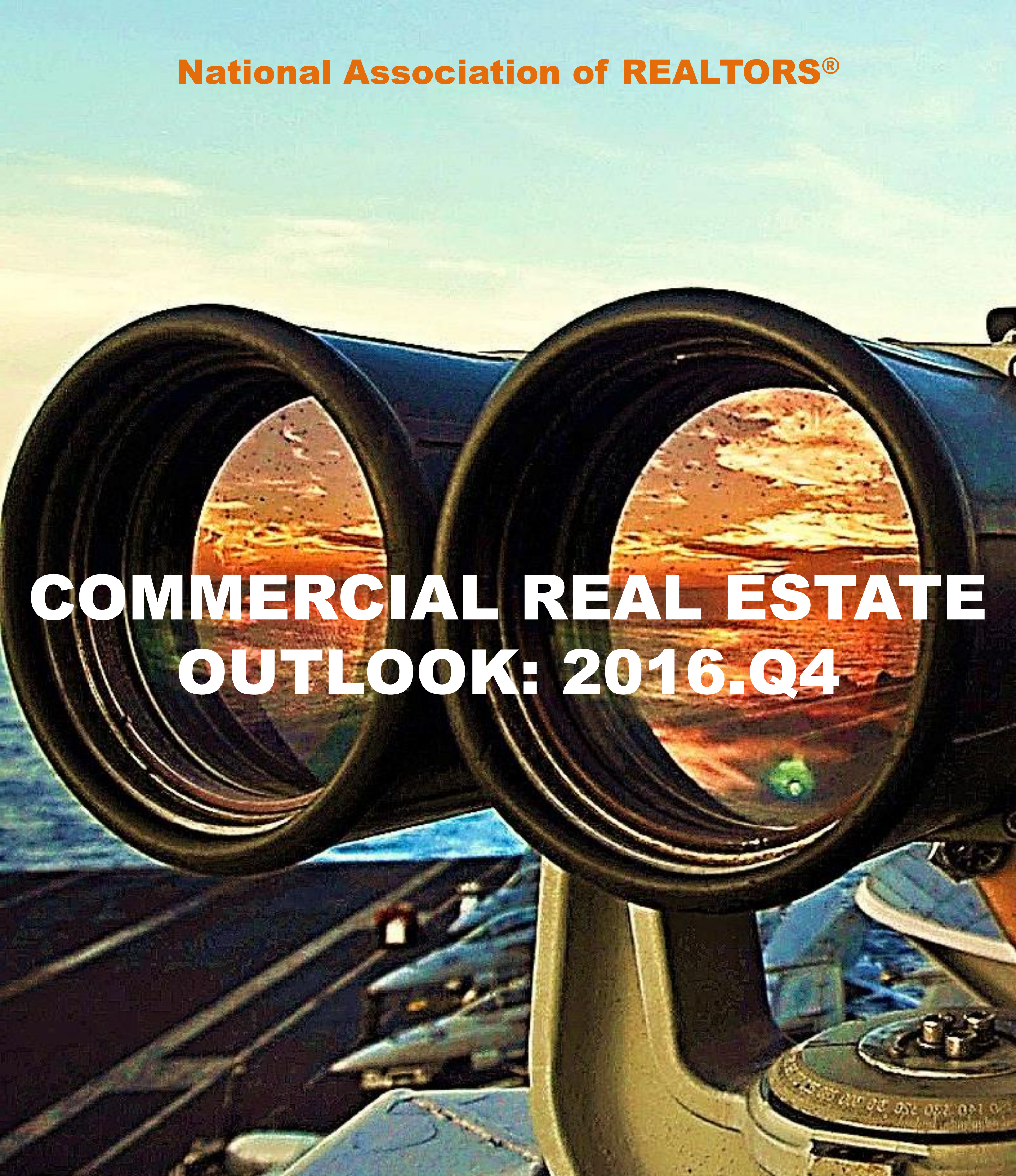
National Association of REALTORS®

COMMERCIAL REAL ESTATE OUTLOOK: 2016.Q4



COMMERCIAL Real Estate

NATIONAL ASSOCIATION of REALTORS®

REALTOR®

Commercial Real Estate Outlook: 2016.Q4

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1 | ECONOMIC OVERVIEW

Gross Domestic Product

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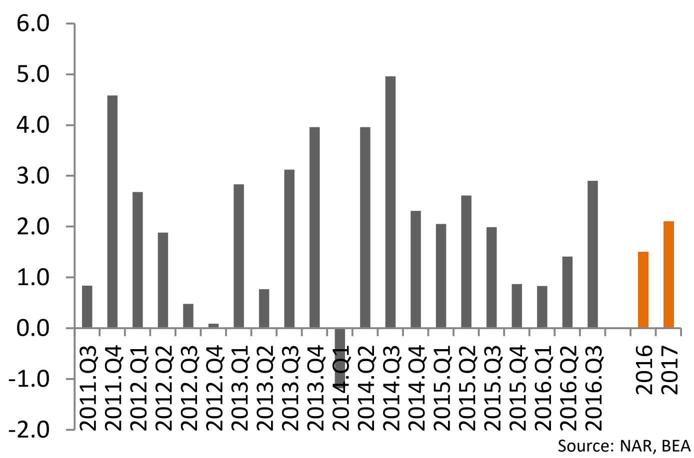
The U.S. economy picked up the pace in the third quarter of this year, boosted by positive consumer spending, as well as improved business investments and a jump in export activity. The first estimate from the Bureau of Economic Analysis pegged real gross domestic product (GDP) at an annual rate of 2.9 percent, a welcome change from the weak first half of 2016 figures.

Consumer spending continued as the mainstay of economic growth. Personal consumption rose at an annual rate of 2.1 percent in the third quarter, with the gain driven—in fairly equal parts—by purchases of goods and services. Spending on durable goods rose a solid 9.5 percent, driven by double-digit increases in consumers purchasing cars and light trucks (up 16.2 percent). Spending on recreational goods and vehicles was also strong (up 9.0 percent). Sales of nondurable goods declined 1.4 percent on an annual basis, as consumers cut back on clothing, shoes, and gasoline. Consumer spending on services was focused on lodging and restaurants, health care, housing and recreation.

Personal income—adjusted for inflation rose, with real disposable personal income posting a 2.2 increase in the third quarter, on the heels of a 2.1 percent advance in the second quarter. The personal saving rate was 5.7 percent in the third quarter, unchanged from the previous one.

Following a negative first quarter and a flat second quarter, business investments rebounded slightly in the third quarter, with a 1.1 percent annual rate of growth. While companies continued cutting back on investments in equipment, they boosted their spending on buildings (up 5.4 percent) and intellectual property products (up 4.1 percent).

Exhibit 1.1: Real GDP (% Annual Chg.)



Spending on software has been growing consistently at double-digit rates for the past two years. Investments in residential real estate decreased at a 6.2 percent annual rate, following the second quarter's 7.8 percent decline.

International trade recorded a solid quarter, assisted by accelerating exports, which rose 10.0 percent in the third quarter. Imports—which detract from the GDP figure—also picked up, notching a 2.4 percent annual rate of growth.

Government spending turned positive in the third quarter, with a 0.5 percent annual growth rate. The federal government increased both defense and nondefense spending by 2.1 percent and 3.0 percent, respectively. State and local governments cut back at 0.7 percent annual rate, due to cuts in infrastructure investments (down 9.2 percent).

Employment

Employment continued growing during the third quarter, with a gain of 619,000 net new jobs. Over the January through September period, there were 1.6 million net new payroll positions, with 1.5 million in the private sector. Average weekly earnings of employees rose by 2.0 percent in the third quarter of this year, compared to one year earlier.

Employment in private service-providing industries accounted for the bulk of new job growth during the third quarter of the year, with 539,000 net new jobs. Professional and business services added 190,000 net new payroll positions, while financial services added 39,000 new positions to payrolls, maintain upward demand for office space. Education and health services had the second highest number of net new employees—137,000. Employment in leisure and hospitality advanced by a softer 53,000 new positions, mirroring slower demand for the hotel sector. With demand for industrial properties rising, transportation and warehousing employment gained 28,100 new positions, while wholesale trade employment rose by 18,300 jobs. The retail trade added 51,200 new positions during the quarter.

Exhibit 1.2: Payroll Employment (Change, '000)

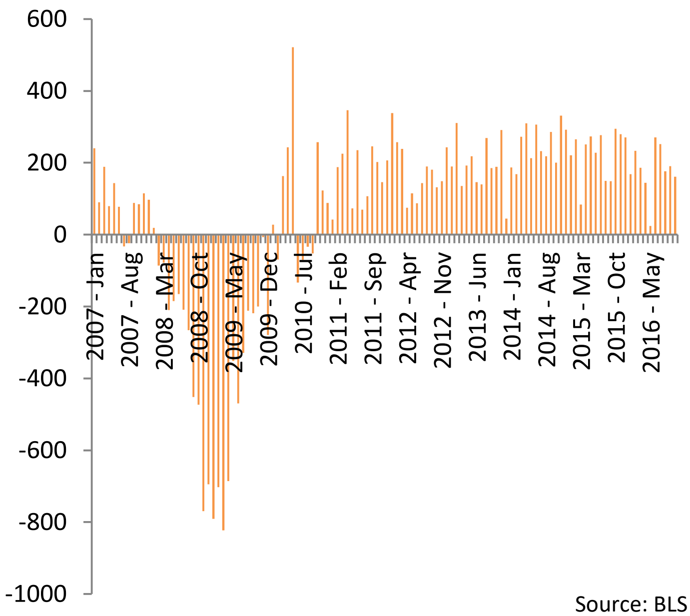
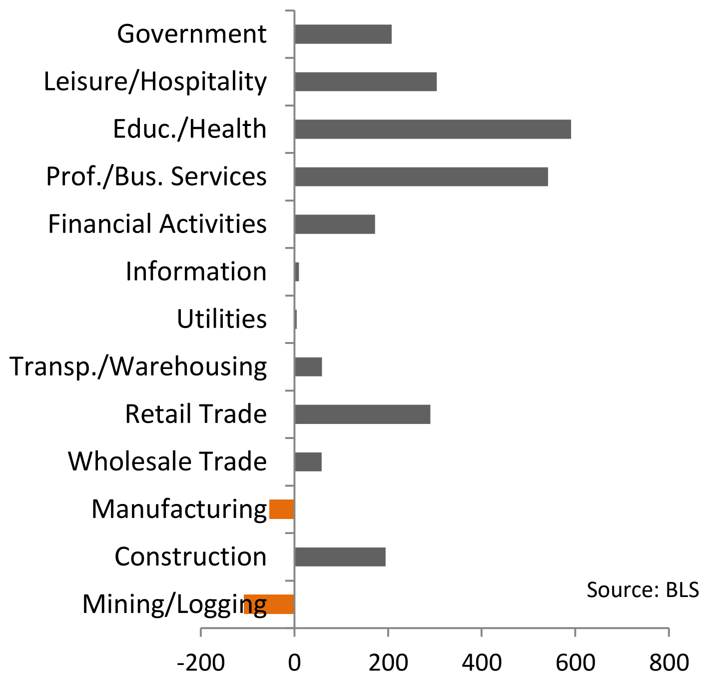


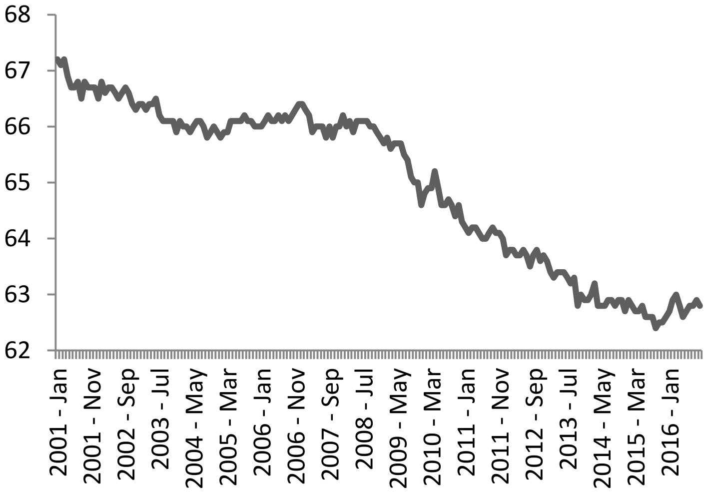
Exhibit 1.3: Payroll Employment: 12-Month Change ('000)



The unemployment rate has been flat—at an average 4.9 percent—in the third quarter of 2016, at the same level for the first nine months of 2016. At the end of September there were 7.9 million unemployed Americans, while an additional 5.9 million were employed part-time for economic reasons. The average duration of unemployment was unchanged, at 27 weeks in the third quarter of 2016, compared with the prior year.

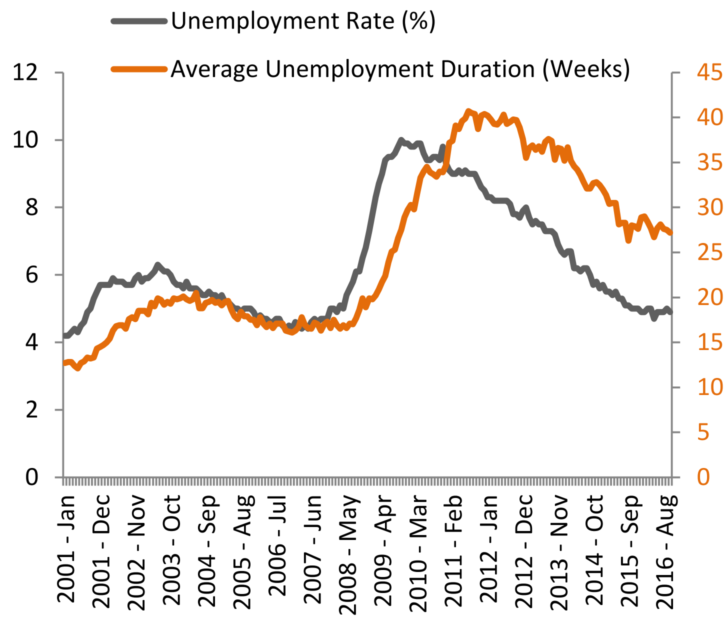
The labor force participation (LFP) rate bumped up slightly, as more Americans returned to the workforce, moving from 62.7 percent in the second quarter to 62.8 percent in the third quarter. In comparison, before the Great Recession the LFP rate was 65.9 percent.

Exhibit 1.4: Labor Force Participation Rate

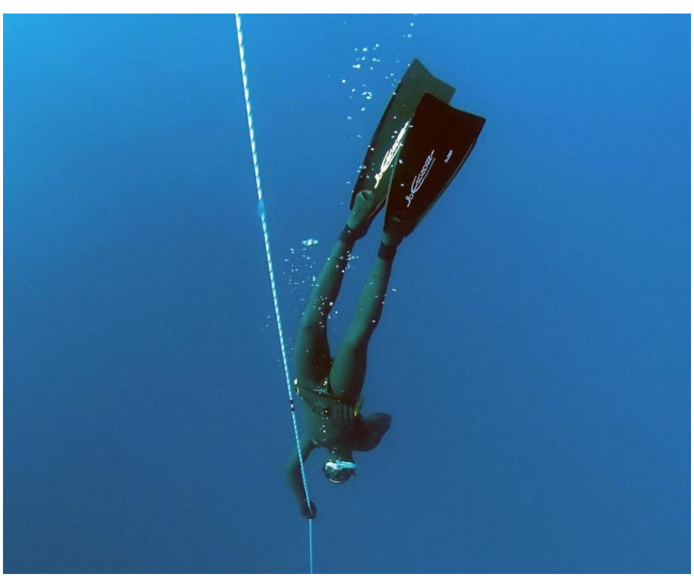


Source: BLS

Exhibit 1.5: Unemployment



Source: BLS



Consumer confidence, as measured by The Conference Board, declined to rose to 100.7 in the third quarter of 2016, from 94.8 in the second quarter. It marked only the second instance of a quarterly value over the 100-threshold since the third quarter of 2007. Separately, the Consumer sentiment index compiled by the University of Michigan slid in the third quarter of the year to 90.3, compared with the 92.4 value from the second quarter.

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. CRE 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 average 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.

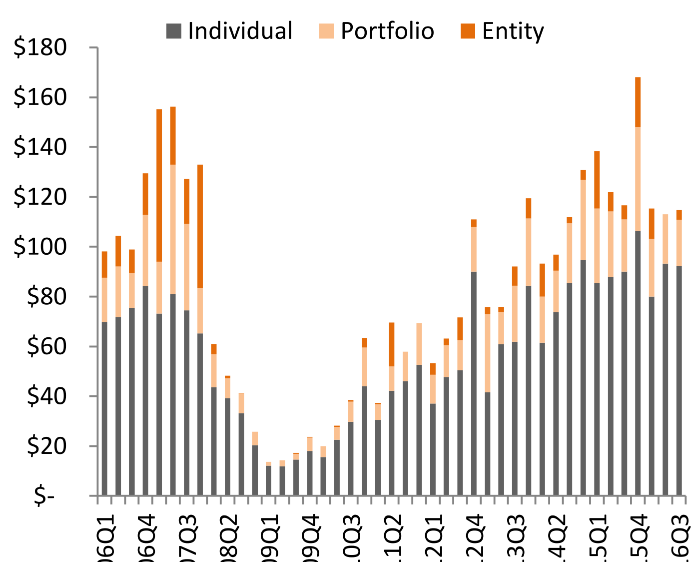
[1] Smith and Ratiu, (2015), "Small Commercial Real Estate Market," National Association of REALTORS®

Large Commercial Real Estate Markets

The decline in large cap CRE sales volume which began at the beginning of 2016 continued into the third quarter of this year. The volume of commercial sales in LCRE markets totaled $114.8 billion, a two percent year-over-year decline, according to Real Capital Analytics (RCA). The decline curve moderated from the double-digit drop recorded in the first quarter. In addition, sales of single assets rose two percent, with weak sales of portfolios driving most of the decline. Given the preponderance of portfolio and entity-level transactions in 2015, their absence is casting a long shadow over this year's activity.

The trend of diverging markets continued in the third quarter, with sales in the six major metros tracked

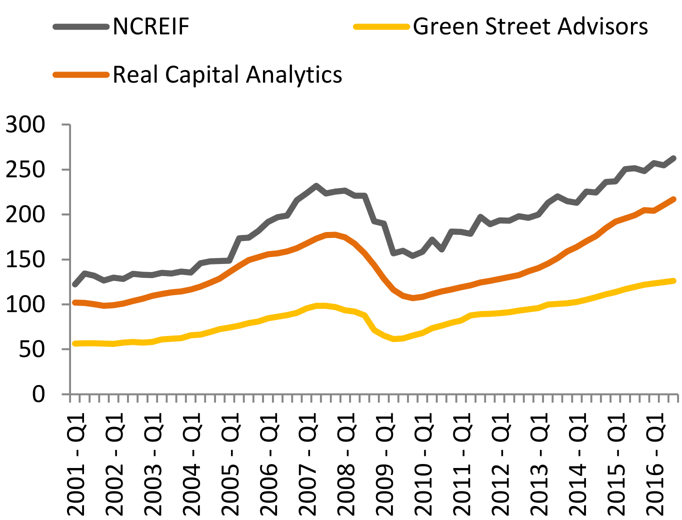
Exhibit 2.1: CRE Sales Volume ($2.5M+)



Source: Real Capital Analytics

by RCA posting an eight percent decline year-over-year. In comparison, sales in secondary markets declined only one percent, while volume in tertiary markets rose a noticeable 17 percent in the third quarter. Apartment transactions comprised the largest share of volume, with $36.8 billion in sales, followed by office properties, which accounted for $33.9 billion. Retail and industrial sales totaled $18.4 billion and $14.2 billion, respectively. Office and retail volume were down on a yearly basis, while apartment, industrial and hotel transactions posted positive yearly growth.

Exhibit 2.2: Commercial Property Price Indices



Underscoring investor approach to risk in the current markets, prices in LCRE markets rose. Based on preliminary data, prices in markets covered by RCA gained 8.9 percent during the third quarter of 2016. The advance was driven by strong appreciation in prices of apartment and industrial properties, which advanced 12.9 percent and 7.7 percent, respectively. Prices for retail properties increased 5.1 percent year-over-year, while office properties recorded a 4.4 percent rise.

Separately, additional price indices also advanced. The Green Street Advisors Commercial Property Price Index advanced 5.7 percent on a yearly basis during the third quarter, reaching a value of 126.2. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased at 4.3 percent year-over-year in the third quarter of 2016, to a value of 262.5.

Exhibit 2.3: NCREIF Property Index Returns—2016.Q3

NATIONAL	1.77%
OFFICE	1.26%
INDUSTRIAL	2.89%
RETAIL	1.98%
APARTMENT	1.72%

Source: National Council of Real Estate Investment Fiduciaries

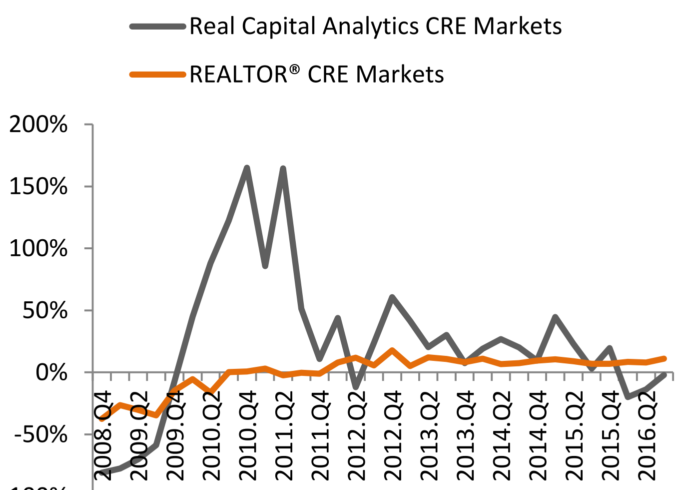
Capitalization rate compression continued into the third quarter in LCRE markets. Based on RCA data, cap rates averaged 6.6 percent, 30 basis points lower compared with the prior year. The cap rate compression was registered across all property types, except hotels, but was more pronounced for apartment and office properties—down 60 and 40 basis points, respectively.

Small Commercial Real Estate Markets

Commercial real estate in small cap markets found its path diverging at a higher rate, with sales volume accelerating during the third quarter of 2016. REALTORS® reported continued improvement in fundamentals and investment sales. Following on the first quarter's 8.5 percent and second quarter's 8.5 percent increases in sales volume, third quarter transactions advanced 11.0 percent on a yearly basis.

During the third quarter, 61 percent of REALTORS® closed deals, a slight decline from the prior quarter's 66 percent. The direction of commercial business opportunities during the third quarter of 2016 rose 2.3 percent from the prior quarter.

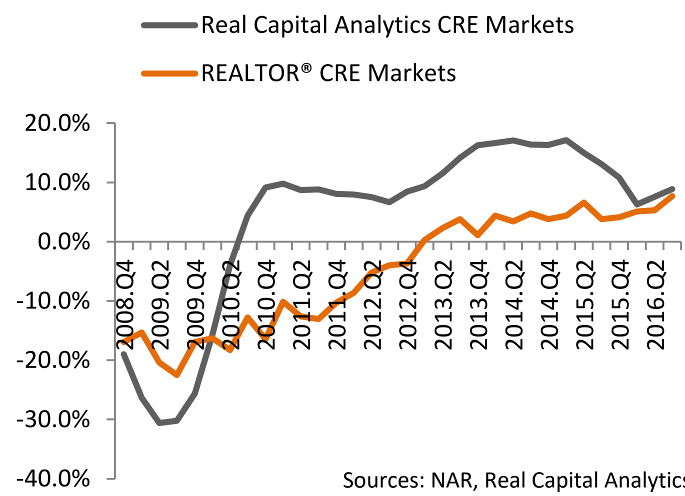
Exhibit 2.4: Sales Volume (YoY % Chg)



Sources: NAR. RCA

As investors across the value spectrum broadened their search for yield into secondary and tertiary markets, the shortage of available inventory remained the number one concern for commercial REALTORS®. Prices for CRE properties accelerated, posting a 7.7 percent yearly advance in the third quarter of this year. The pricing gap

Exhibit 2.5: Sales Prices (YoY % Chg)

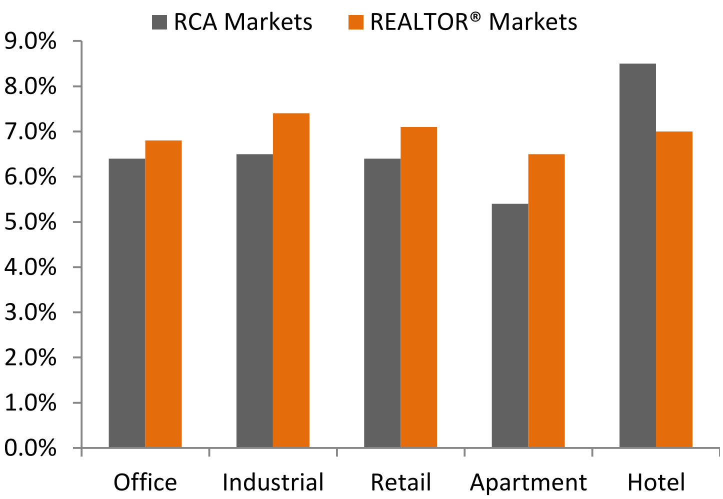


Sources: NAR, Real Capital Analytics

between sellers and buyers remained the second highest ranked concern. With banks continuing to tighten underwriting standards for commercial loans in the wake of increased regulatory scrutiny, financing availability was a concern in REALTORS®' markets—14.0 percent of members ranked it as a main challenge in the third quarter.

Capitalization rates in SCRE markets continued compressing, to an average 7.2 percent across all property types, a 70 basis point compression on a yearly basis. Apartments posted the lowest cap rate, at 6.4 percent, followed by office properties with average cap rates at 6.8 percent. Retail and industrial transactions recorded cap rates of 7.1 percent and 7.6 percent, respectively. Hotel transactions posted the highest comparative cap rates—8.3 percent.

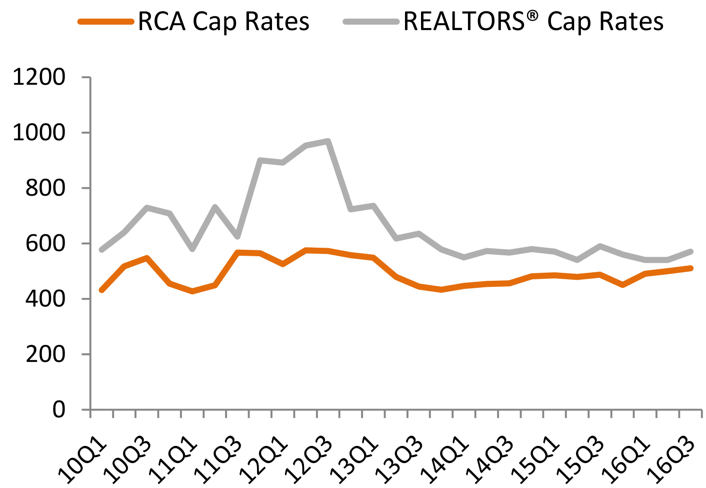
Exhibit 2.6: Cap Rates - 2016.Q3



Sources: NAR, Real Capital Analytics

The interest rate on 10-year Treasury Notes—a standard measure of risk-free investments—averaged 1.5 percent during the third quarter of 2016, the lowest point since 2013. Based on the prevailing rates, the spread between cap rates and 10-year Treasury Notes ranged from 510 basis points in LCRE markets to 570 basis points in SCRE markets. With the large spread, CRE investors remain well-positioned for healthy returns, even with a projected bump in interest rates.

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



Sources: NAR, Real Capital Analytics

3 | COMMERCIAL REAL ESTATE FUNDAMENTALS

Large Commercial Real Estate Markets

Third quarter fundamentals in LCRE displayed an even picture, with solid demand and rising construction. However, for most property types absorption took a breather, giving supply time to catch up, a trend which was reflected in flat availability.

Office net absorption totaled 7.1 million square feet in the third quarter of the year, based on data from CBRE, a slower pace than the previous two quarters. Office construction accelerated, adding 10.7 million square feet to the supply pipeline during the quarter. As demand softened, office vacancies were flat at 13.0 percent. Rents for office properties rose 1.5 percent during the third quarter, to an average of $31.33 per square foot.

The industrial sector continued on an upward trend with fundamentals in the third quarter, as demand outpaced supply. Industrial net absorption totaled 76.8 million square feet, marking the 26th positive demand quarter, according to CBRE. Industrial developers capitalized on rising demand with additional construction, as new completions totaled 54.5 million square feet. As demand continued outmatching new construction, industrial availability hit 8.4 percent—the lowest level since the first quarter of 2001—as vacancies declined to 5.0 percent. Industrial rents rose 5.2 percent on a yearly basis, to an average of $6.47 per square foot.

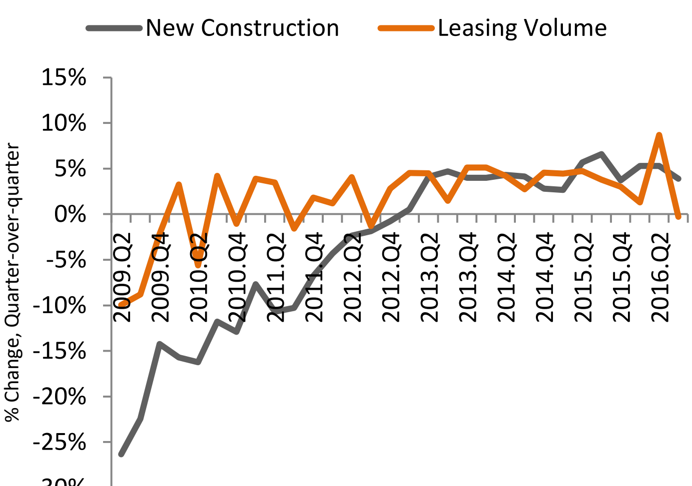
Demand for retail properties picked up in the third quarter, as employment growth and rising wages boosted consumer spending. Retail net absorption totaled 9.0 million square feet, according to CBRE. Retail development activity also advanced, with 5.2 million square feet of new completions. With demand outpacing supply, availability declined to 10.4 percent during the quarter. Retail rents rose to $14.9.

Demand for multifamily properties maintained its upward path. The national vacancy rate averaged 4.8 percent for apartment housing during the third quarter, according to Axiometrics. Apartment rents rose 2.9 percent year-over-year, to $1,290 per month.

Small Commercial Real Estate Markets

Commercial fundamentals in smaller markets maintained an even pace during the third quarter of 2016. While leasing volume moved sideways, with a 0.3 percent slide over the prior quarter, leasing rates advanced, rising 1.8 percent. Office properties posted rents averaging $41 per square foot, while retail and industrial leases recorded $53 and $30 per square foot, respectively. Average apartment rents for the third quarter were $705 per unit.

Exhibit 3.1: REALTORS® Fundamentals



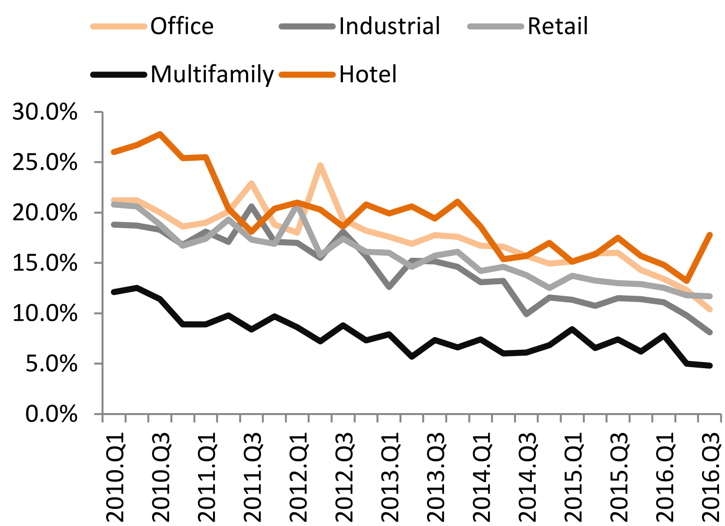
Source: National Association of Realtors®

NAR members' average gross lease volume for the quarter was $776,782, representing a 36.9 percent gain from a year ago. New construction continued during the third quarter, posting a 3.9 percent gain from the second quarter of 2016.

Tenant demand remained strongest in the 5,000 square feet and below segment, accounting for 84.0 percent of leased properties. Lease terms remained steady, with 36-month and 60-month leases capturing 56.0 percent of the market. One-year leases comprised 13.0 percent of total, while two-year leases tied up with those longer than 60 months, at 11.0 percent of total for each category.

Vacancy rates continued shrinking across the spectrum of property types. Office properties recorded the largest decline—365 basis points year-over-year—to 10.4 percent. Industrial availability witnessed a yearly decrease of 95 basis points—to 8.1 percent. Retail vacancies slid 144 basis points on a yearly basis, to 11.7 percent, and multifamily vacancies saw a 155-basis point decline, to 4.8 percent. With declining vacancies, lease concessions declined 3.1 percent.

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

4 | OUTLOOK

Economy

Contemplating the last quarter of 2016, the GDP annual rate of growth is expected to move sideways. Owing to a weak first half of the year, the annual growth is projected to settle at 1.5 percent. Payroll employment is expected to post 1.7 percent annual growth rate for the year. The unemployment rate is forecast to decline to 4.8 percent by the end of 2016.

The markets continue to weigh the expected Federal Reserve's increases in the funds target rate at the December meeting. The broader economic consensus expects a modest quarter-point hike. Inflation is expected to average 1.2 percent over 2016, accelerating in the last quarter to 2.9 percent.

Exhibit 4.1: U.S. ECONOMIC OUTLOOK—November 2016

	2014	2015	2016	2017
Annual Growth Rate, %				
Real GDP	2.4	2.4	1.5	2.1
Nonfarm Payroll Employment	1.9	2.1	1.7	1.6
Consumer Prices	1.6	0.2	1.2	2.5
Level				
Consumer Confidence	87	98	97	104
Percent				
Unemployment	6.2	5.3	4.9	4.4
Fed Funds Rate	0.1	0.1	0.4	1.3
3-Month T-bill Rate	0.1	0.1	0.3	1.4
Corporate Aaa Bond Yield	4.2	3.9	3.5	4.5
10-Year Gov't Bond	2.5	2.1	1.8	2.9
30-Year Gov't Bond	3.3	2.8	2.5	3.5

Source: National Association of REALTORS®

Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

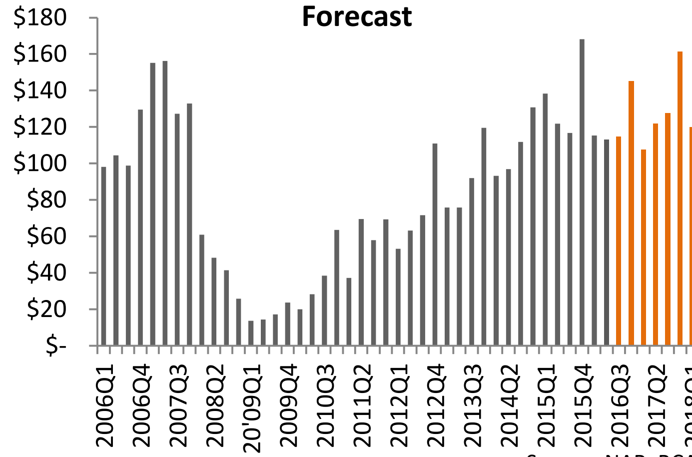
	2015.Q2	2015.Q3	2015.Q4	2016.Q1	2016.Q2	2016.Q3	2016.Q4	2017.Q1	2017.Q2	2017.Q3	2017.Q4	2018.Q1	*2015*	*2016*	*2017*
Office	15.9	16.0	14.3	13.4	12.3	10.4	9.9	9.5	9.1	8.6	8.0	7.4	*14.3*	*11.5*	*8.8*
Industrial	10.8	11.5	11.4	11.1	9.8	8.1	7.9	7.6	7.2	6.9	6.5	6.0	*11.4*	*9.2*	*7.1*
Retail	13.2	13.0	12.9	12.5	11.8	11.7	11.5	11.3	11.1	10.8	10.6	10.3	*12.9*	*11.9*	*11.0*
Multifamily	6.6	7.4	6.2	7.8	5.0	4.8	5.7	6.5	6.2	5.9	5.6	5.4	*6.2*	*5.8*	*6.1*

Source: National Association of REALTORS®

Commercial fundamentals are expected to continue on a positive trend, with three of the four core sectors favoring landlords. With employment gains expected to close the year on a high note, office vacancies are projected to decline to 9.9 percent by the end of 2016 and average 8.8 percent in 2017. Industrial availability is estimated to drop from an average of 8.1 percent in the third quarter of 2015 to 6.9 percent in the same quarter of 2017. Retail availability will continue compressing, with vacancies expected to decline from an average of 11.9 percent in 2016 to 11.0 percent in 2017. The multifamily sector is experiencing increased new supply, which adds upward pressure on availability. Multifamily vacancies are expected to increase over the next couple of years, from 5.8 percent in 2016 to 6.1 percent in 2017.

On the investment side, while financial markets' volatility left a mark on the sales volume in large cap CRE markets during the first half of 2016, volume is expected to rebound slightly in the latter half of the year. In small cap CRE markets, increased scrutiny from banking regulators has tightened lending conditions, leading to more cautious capital flows into CRE transactions.

Exhibit 4.3: CRE Sales Volume ($2.5M+) Forecast



Source: NAR, RCA

While the U.S. CRE markets have experienced diverging trends in 2016, the U.S. economy's comparative strength coupled with low global yields translate into enduring appeal for commercial assets. While investors are approach risk from a defensive position, investment performance retains safety buffers even as the Federal Reserve is weighing acting on rates. Properties in secondary and tertiary markets remain well-positioned for growth.

Exhibit 4.4: Commercial Property Price Indices Forecast

	2009	2010	2011	2012	2013	2014	2015	2016	2017
NCREIF	165.1	168.2	186.5	195.2	211.9	224.9	246.7	**246.0**	**251.9**
Green St. Advisors	63.5	74.4	87.1	92.2	99.4	106.7	118.0	**118.7**	**121.6**

Sources: NAR, NCREIF, Green Street Advisors

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