National Association of REALTORS®

COMMERCIAL REAL ESTATE OUTLOOK: 2017.Q2

COMMERCIAL Real Estate

NATIONAL ASSOCIATION of REALTORS®

Commercial Real Estate Outlook: 2017.Q2

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1 | ECONOMIC OVERVIEW

Gross Domestic Product

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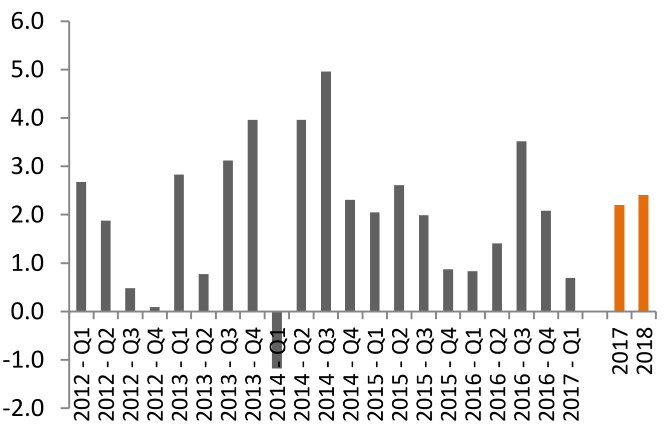
Following in the wake of a moderate 2016, the rate of economic growth slowed further during the first quarter of 2017. Based on the first estimate of real gross domestic product (GDP) from the Bureau of Economic Analysis (BEA), the United States economy rose at an annual rate of 0.7 percent, far below the average 3.4 percent typical of first-quarter GDP growth over the 1950-16 period, and lower than the 1.0 percent experienced over the more recent 2000-16 stretch.

Exhibit 1.1: Real GDP (% Annual Chg.)

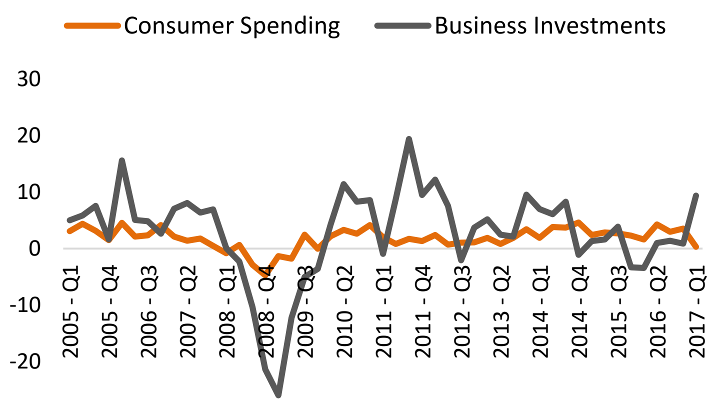


Source: National Association of REALTORS®, BEA

The first quarter moderation in economic activity was driven mostly by a pullback in consumer spending, and to a smaller extent, a decline in government expenditures. Consumer spending—the main component of GDP—was barely positive, posting a 0.3 percent annual gain during the quarter. With the winter months milder than expected, consumers cut back on auto purchases to the tune of 16.1 percent, bought fewer clothes and shoes, as well as less gasoline, oil and energy goods. The silver lining during the quarter were higher purchases of furniture and household appliances, which rose 2.6 percent, recreational goods and vehicles (up 14.7%), and grocery store items (up 4.2%). Spending on services rose 0.4 percent on an annual basis, with recreation, transportation and financial services leading the modest gains.

Disposable personal income—adjusted for inflation—increased 1.0 percent in the first quarter, according to the BEA. The personal saving rate was 5.7 percent in the first quarter, higher from the previous quarter's 5.5 percent.

Exhibit 1.2: GDP - Consumers & Business (% Chg Annual Rate)

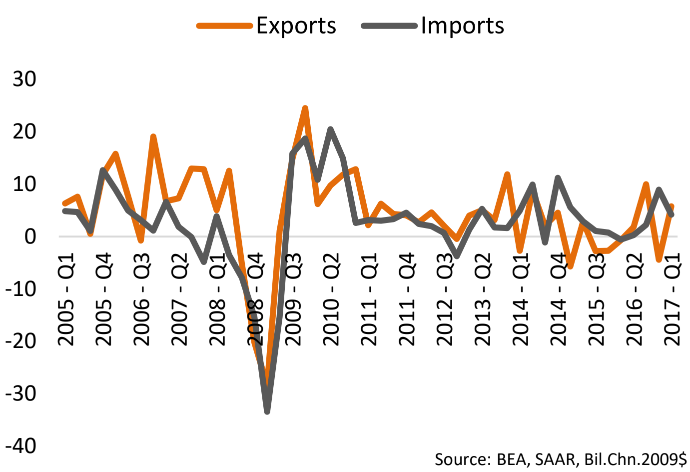


Source: BEA, SAAR, Bil.Chn.2009$

The corporate outlook—still riding the high winds of the presidential election outcome and the promise of less regulation—mirrored gains in the private domestic investment figures. Nonresidential fixed investment increased at a 9.4 percent annual rate, the strongest quarterly gain since the fourth quarter of 2013. Companies boosted investments in equipment—with double-digit advances for industrial and transportation equipment. Spending on intellectual property products—software, research and development—advanced by 2.0 percent in the first quarter. Investments in commercial real estate jumped at a 22.1 percent annual rate, while investments in residential real estate rose at a 13.7 percent rate.

Exports provided a positive contribution to GDP in the first quarter of 2017, with a 5.8 percent annual gain. Imports—a negative factor in GDP calculations—also increased, at a 4.1 percent annual rate.

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

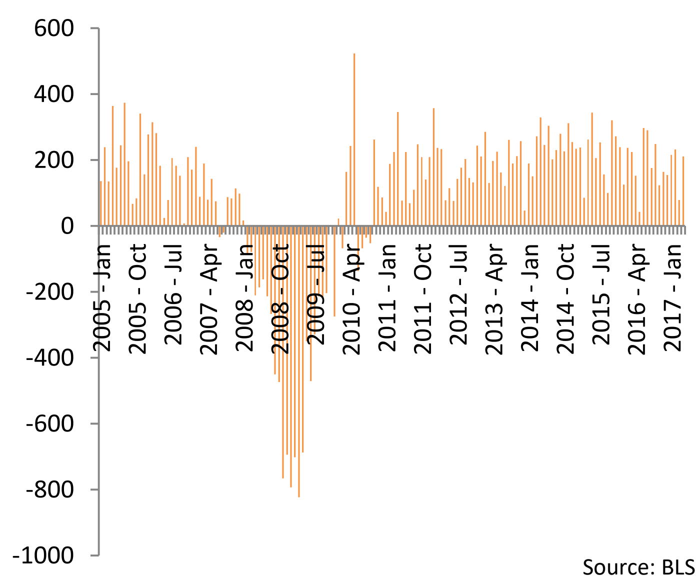


Government spending declined at a 1.7 percent annual growth rate, following cuts in federal as well as state and local spending. Federal government spending declined by 2.0 percent, as defense spending retrenched at a 4.0 percent annual rate. State and local governments' spending decreased by 1.5 percent.

Employment

Payroll employment advanced in the first quarter of 2017, with a net gain of 527,000 new jobs, according to the Bureau of Labor Statistics (BLS). Private service-providing industries continued as the growth engine during the quarter, with 341,000 net new jobs. Within the service industries, professional and business services posted the highest number of net new employees—151,000. Financial services added 39,000 new positions, previewing increased demand for office space for the year ahead. The education and health services sector added the second-highest number of net new positions—95,000, followed by leisure and hospitality, with 57,000 net new payroll jobs. As a direct response to the hundreds of department store closures announced during the first quarter by retail companies, such as Macy's, Kohl's, JC Penney and Sears, retail trade employment declined by 20,800 jobs. The wholesale trade sector added 18,300 new

Exhibit 1.4: Payroll Employment (Change, '000)

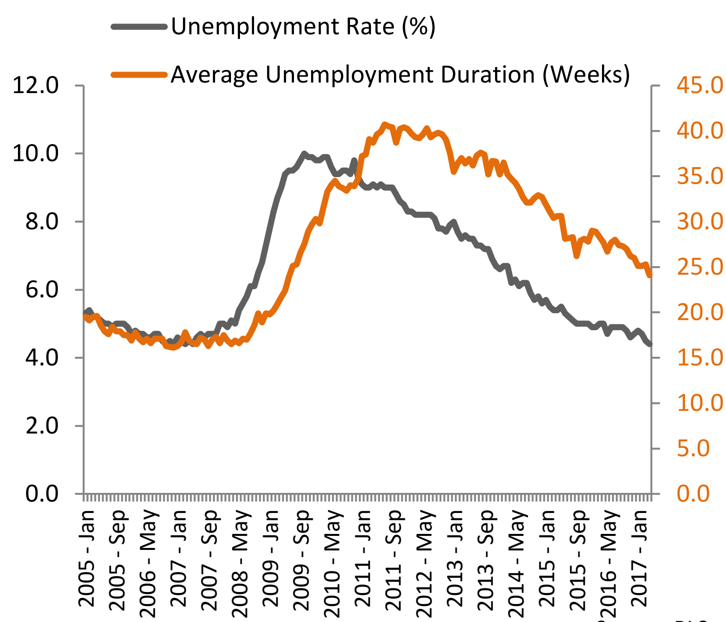


jobs during the quarter. The transportation and warehousing sector started the year at a slower pace, adding 1,300 new positions on payrolls.

The unemployment rate remained flat at 4.7 percent compared with the last quarter of 2016, based on data from the BLS. However, on a monthly basis, the unemployment rate declined with each successive month from 4.8 percent in January 2017 to 4.5 percent in March. The rate slid further in April to 4.4 percent. The average duration of unemployment also declined from 26 weeks in the fourth quarter of 2016 to 25 weeks by the end of March 2017.

The labor force participation (LFP) rate picked up slightly, moving from 62.7 percent in the last quarter of 2016 to 63.0 percent in the first quarter of this year. In comparison, before the Great Recession the LFP rate was 65.9 percent. The number of workers in part time positions due to economic reasons declined from 6.1 million in the first quarter of 2016 (3.8 percent of the labor force) to 5.6 million (3.5 percent of the labor force) at the end of March 2017.

Exhibit 1.6: Unemployment



Source: BLS

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

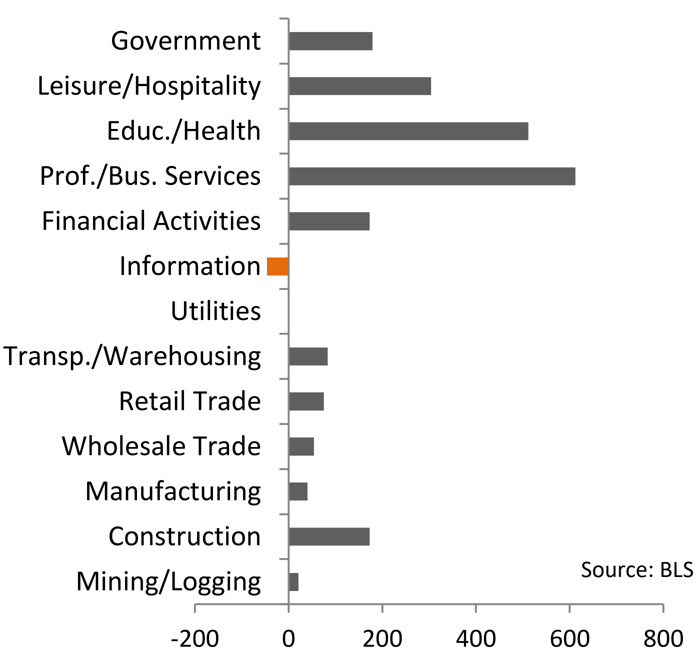
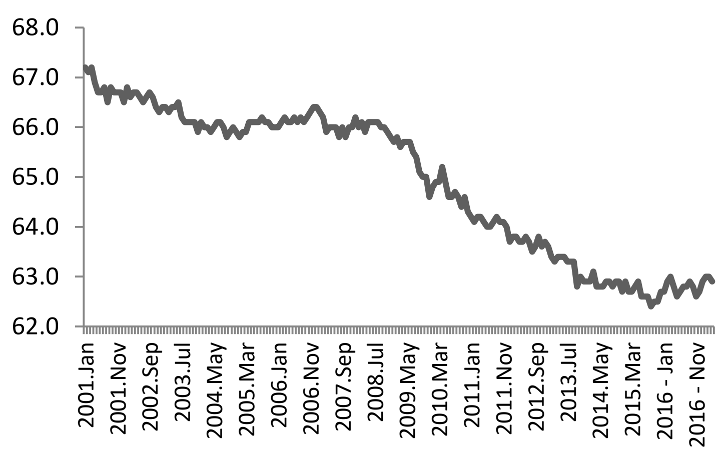


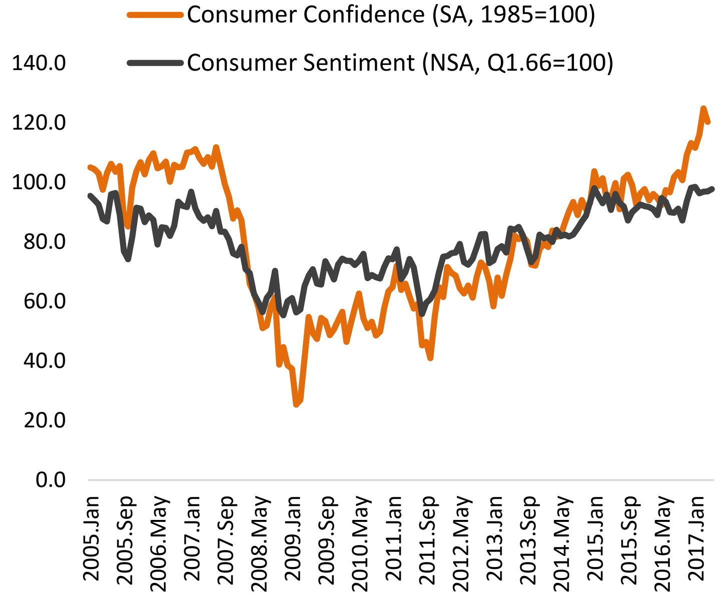
Exhibit 1.7: Labor Force Participation Rate



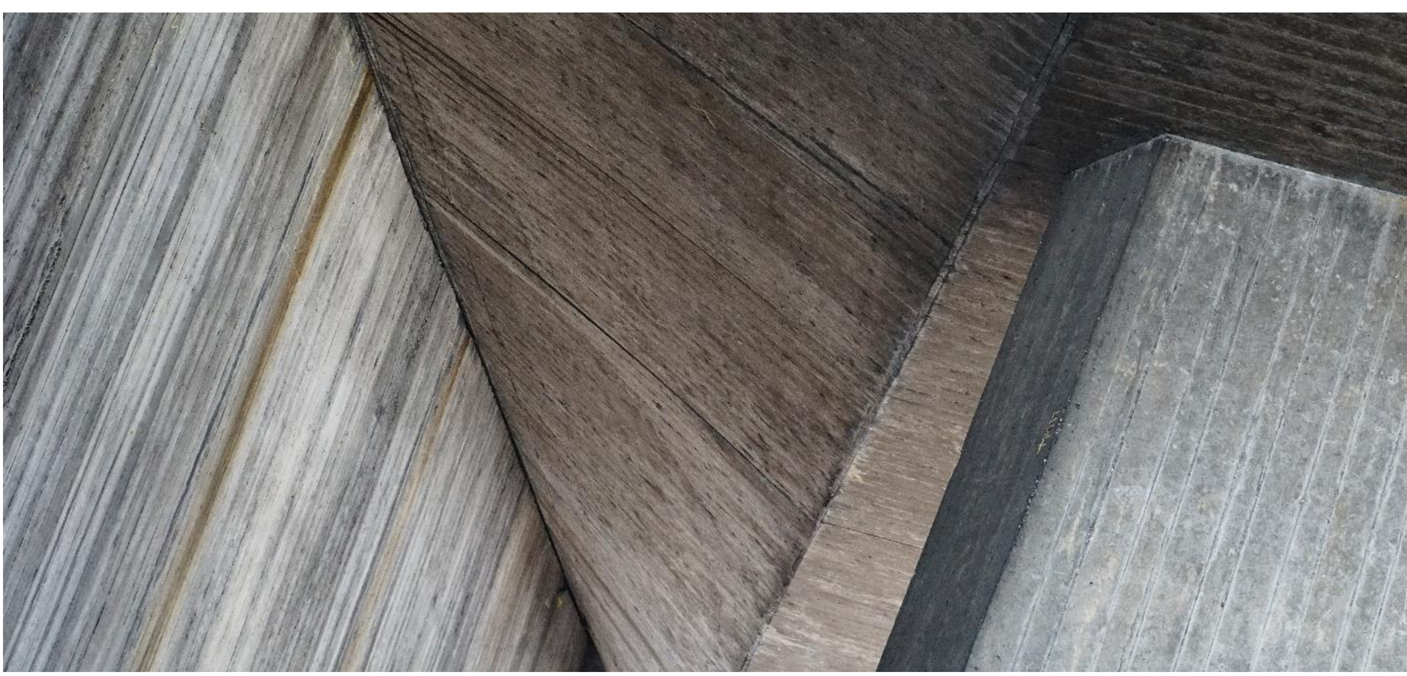
Source: BLS

In the wake of employment gains, consumer confidence strengthened. The Conference Board's Consumer Confidence index advanced 22.4 percent year-over-year, to 117.5, the highest value since the fourth quarter of 2000. The value for April 2017 was 120.3, indicating growing optimism about the 2017 outlook. Separately, the Consumer sentiment index compiled by the University of Michigan also advanced in the first quarter of the year to 97.2, compared with the 91.6 value from the first quarter of 2016.

Exhibit 1.8: Consumer Confidence/Sentiment



Sources: The Conference Board, University of Michigan



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.

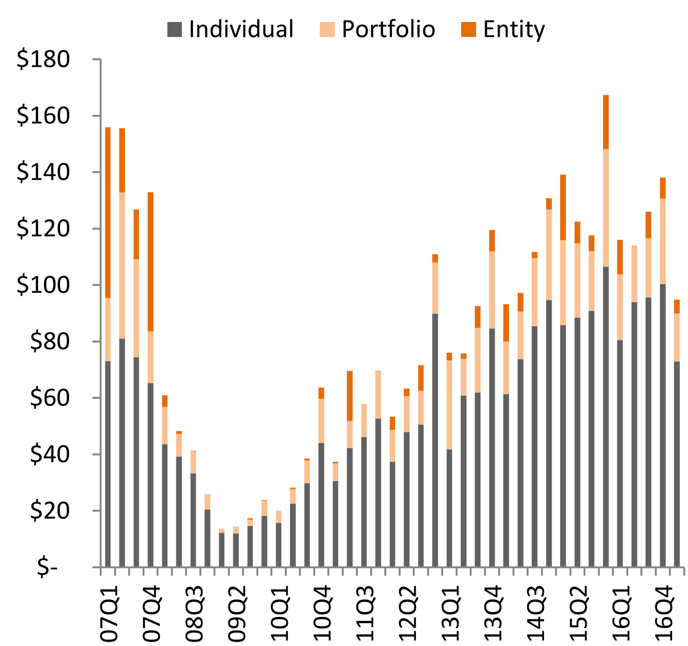
[1] Smith and Ratiu, (2015), "Small Commercial Real Estate Market," National Association of REALTORS®

Large Cap Commercial Real Estate Markets

Investments in LCRE markets maintained the downward trend from 2016 into the first quarter of 2017. Sales volume totaled $94.8 billion, an 18 percent year-over-year decline, according to Real Capital Analytics (RCA). Sales of single assets declined 10 percent, while portfolio sales decreased 27 percent and entity sales dropped 60 percent, compared with the same period in the prior year. The trend meets at the intersection of two currents: for one, investors have clearly taken a significantly more cautious approach to investing in commercial assets, and for the other, markets across the country are experiencing tight inventories.

Sales in the six major metros tracked by RCA posted a 22 percent decline year-over-year during the first quarter of 2017. In comparison, sales in

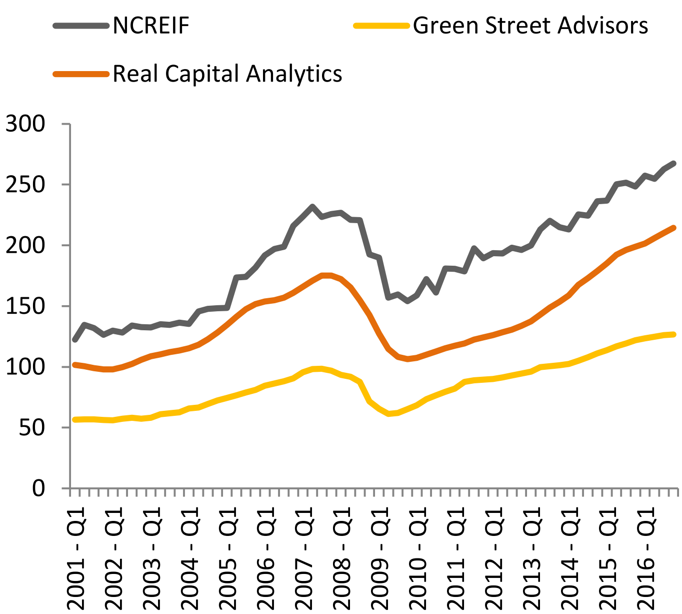
Exhibit 2.1: CRE Sales Volume ($2.5M+)



Source: Real Capital Analytics

secondary markets declined 19 percent, while tertiary markets experienced a nine percent slide. With higher comparative yields, smaller markets continued to pique investor interest. Office transactions comprised the largest share of volume, at 29 percent, followed by apartment sales, at 27 percent. Retail and industrial sales accounted for 19 percent and 17 percent, respectively. Industrial transactions were the only sector to register growth during the quarter.

Exhibit 2.2: Commercial Property Price Indices



While investment volume declined, with tight inventories, prices in LCRE markets appreciated. Based on Moody's/RCA Commercial Property Price Index data, prices gained 7 percent during the first quarter. The gain came from strong appreciation in prices of apartment and office, which advanced 10 percent and 9 percent, respectively. Prices for industrial properties increased 8 percent year-over-year, while retail properties recorded a 1 percent decline.

Separately, additional commercial real estate price indices were mixed. The Green Street Advisors Commercial Property Price Index advanced a more modest 2.5 percent on a yearly basis during the fourth quarter, reaching a value of 126.5. The National Council of Real Estate Investment Fiduciaries (NCREIF) Price Index increased at 2.1 percent year-over-year in the first quarter of 2017, to a value of 262.9.

Exhibit 2.3: NCREIF Property Index Returns—2017.Q1

NATIONAL	1.55%
OFFICE	1.26%
INDUSTRIAL	2.83%
RETAIL	1.56%
APARTMENT	1.30%

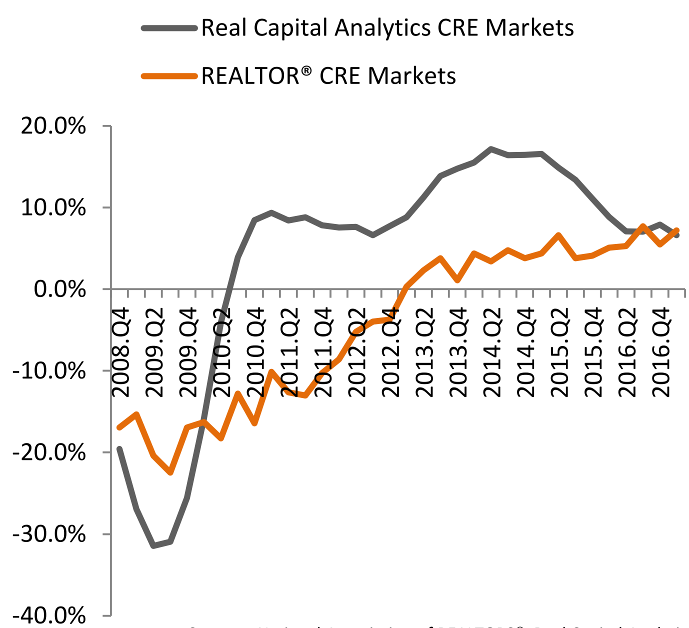
Source: National Council of Real Estate Investment Fiduciaries

Beyond the price indicators and reflecting similar investor caution, capitalization rates in large cap markets moved sideways in the first quarter of this year. Based on RCA data, cap rates averaged 6.8 percent. While the first-quarter rates were 20 basis points lower on a yearly basis, the average values have been hovering around 6.8 percent for the past several quarters. On a yearly basis, office and hotel properties posted slight cap rate bumps—21 basis point and 11 basis points, respectively. The other property types recorded cap rate declines for the year.

Small Cap Commercial Real Estate Markets

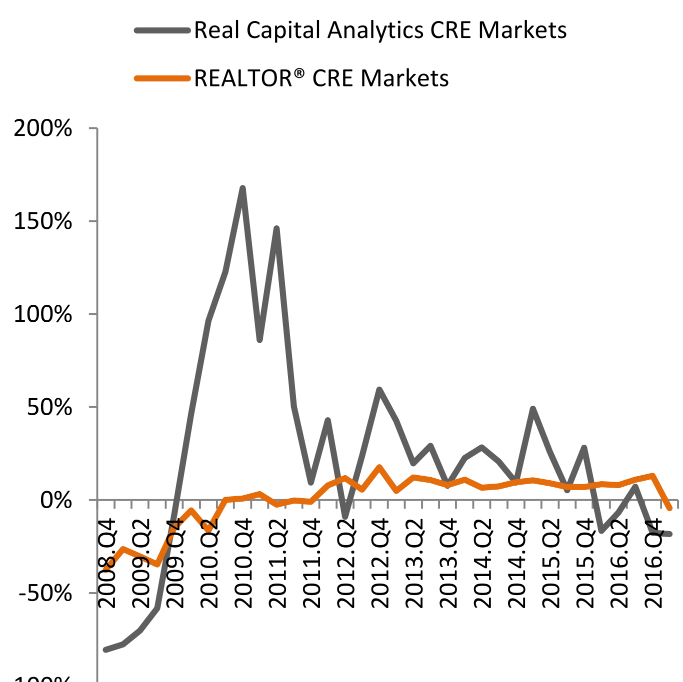
Commercial real estate in small cap markets (SCRE) experienced a divergent path during 2016, compared with LCRE markets, posting accelerating sales throughout the year. However, the first quarter of 2017 reversed the sales trend. REALTORS® reported a 4.4 percent slide in sales, the first year-over-year decline in five years. In addition, a smaller percentage of REALTORS® reported closing transactions—61.0 percent in the first quarter, compared with 69.0 percent the prior quarter—a sign of slowing activity. The direction of commercial business opportunities also moderated in the first quarter, posting a 3.3 percent advance (compared with 6.2 percent in the last quarter of 2016).

Exhibit 2.5: Sales Prices (YoY % Chg)



Sources: National Association of REALTORS®, Real Capital Analytics

Exhibit 2.4: Sales Volume (YoY % Chg)

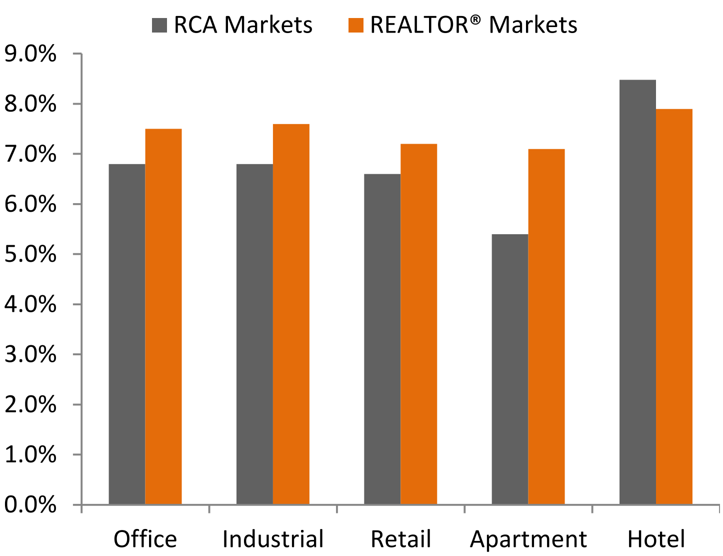


Sources: National Association of REALTORS®, Real Capital Analytics

With domestic and cross-border investors continuing their search for yield in secondary and tertiary markets, the shortage of available inventory remained the number one concern for REALTORS® engaged in commercial transactions. Capitalization rates in SCRE markets averaged 7.5 percent across all property types. Prices for CRE properties increased 7.2 percent year-over-year during the first quarter of 2017, a 70 basis point decline from the same period a year ago. The pricing gap between sellers and buyers remained the second highest ranked concern. With banks tightening underwriting standards for commercial loans in the wake of increased regulatory scrutiny, financing returned as a top concern in REALTORS®' markets, with 14 percent of members finding inadequate funding for commercial transactions.

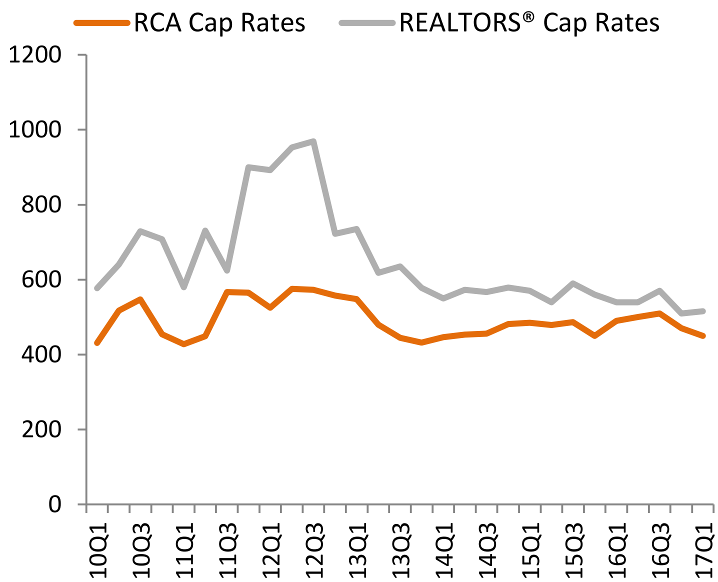
International transactions remained a noticeable share of REALTORS®' activity, comprising 8 percent of responses to a national survey of market conditions. The average international sale price was $1.0 million in the first quarter of this year.

Exhibit 2.6: Cap Rates - 2016.Q4



Sources: National Association of REALTORS®, Real Capital Analytics

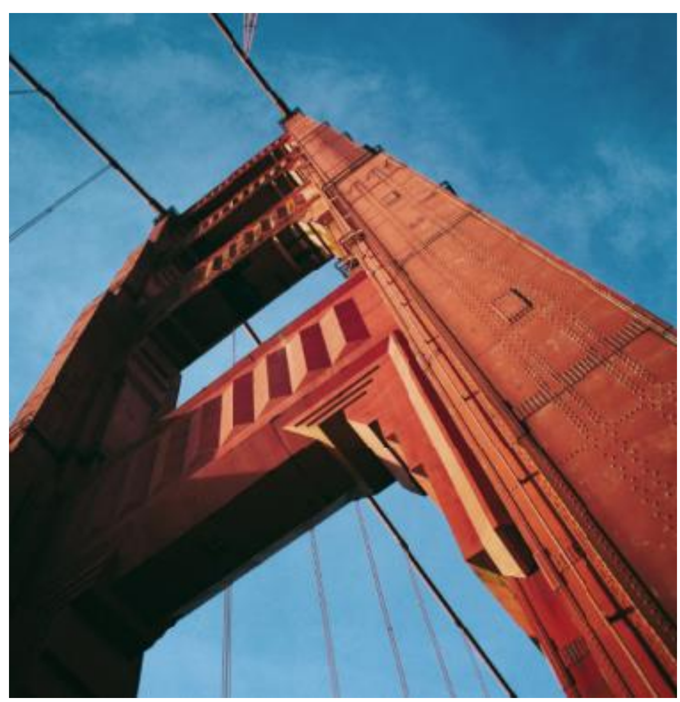
Exhibit 2.7: CRE Spreads: Cap Rates to 10-Yr. T-Notes (bps)



Sources: National Association of REALTORS®, Real Capital Analytics

Longer-dated bond yields spent the better part of 2016 below 2.0 percent. Following the post-election bump to 2.5 percent, the 10-year Treasury note yield declined to 2.3 percent. For commercial real estate investors, the spread between the 10-year Treasury note yields and cap rates remained at over 400 basis points.

On the monetary side, the Federal Reserve took a measured approach to its monetary policy during 2016. The Federal Open Market Committee (FOMC) increased the funds target rate in December 2016 and then again in March 2017. Additional rate hikes are expected this year, and as rates begin an upward migration, CRE investors can expect a moderation in the trajectory of pricing.



3 | COMMERCIAL REAL ESTATE FUNDAMENTALS

Large Cap Commercial Real Estate Markets

Commercial fundamentals in LCRE echoed the economic slowdown during the quarter. Demand for office and apartment properties remained steady, while industrial and retail found a softening in absorption. Vacancy rates experienced slight increases, but rent growth remained solid.

Office demand was steady in the first quarter of 2017. Net absorption totaled 7.2 million square feet, based on data from CBRE. Suburban office space was in high demand during the quarter, accounting for 74 percent of total net absorption. Office construction picked up the pace, contributing 12.0 million square feet to the supply pipeline during the quarter, with new suburban completions totaling 8.3 million square feet. With the solid construction, office vacancies increased 10 basis points, to 13.0 percent. Rents for office properties experienced a slowdown as new space entered the market. During the first quarter, asking rents averaged $31.99 per square foot, a 4.9 percent annual rate of growth.

Industrial properties experienced a slowdown in demand and increased supply during the first quarter of this year. Industrial net absorption totaled 33.1 million square feet, the 28th quarter of positive demand, according to CBRE. However, absorption was 48 percent lower on a yearly basis. Industrial developers have been busy building new product over the past few years. In the first quarter, completions outpaced demand, as 44.9 million square feet of space came to market, a 13.5 percent increase from the prior year. Industrial vacancy posted a 10 basis point uptick, to 8.0 percent. Industrial asking rents advanced 7.4 percent on a yearly basis, the highest gain since 2007, to an average of $6.71 per square foot.

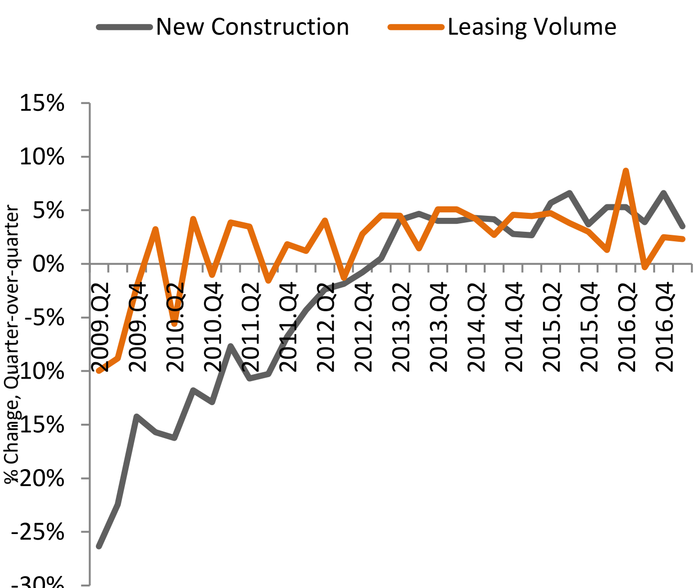
With weak consumer spending in the first quarter, demand for retail spaces was unchanged. Retail net absorption totaled 14.5 million square feet during the quarter, according to CBRE. Retail construction activity picked up speed, with completions advancing 12.4 percent year-over-year, totaling 10.5 million square feet. Availability declined 30 basis points on a yearly basis, reaching 7.0 percent. Retail rents continued accelerating—up for 13 consecutive quarters—and averaged $16.97 per square foot, a 6.0 percent increase from the first quarter of 2016.

The improvements in the employment landscape have been leading to rising household formation, and solid demand for multifamily properties. Net absorption of multifamily units totaled 30,500 in the first quarter of 2017, according to CBRE. In tandem with rising demand, development of multifamily properties also advanced, with 44,600 units delivered to market during the quarter. The national vacancy rate averaged 4.9 percent, flat compared with the prior quarter, but 20 basis points higher from the same period in 2016. With increasing supply and rising vacancies, rent growth was unchanged, posting an annualized 4.1 percent growth rate.

Small Cap Commercial Real Estate Markets

Commercial fundamentals in SCRE markets remained positive during the first quarter of 2017, but the pace of growth moderated. Leasing volume advanced 2.3 percent from the prior quarter. New construction increased by 2.3 percent from the prior quarter, the slowest pace since the first quarter of 2015. Leasing rates rose by 3.8 percent, as concessions declined 11.1 percent.

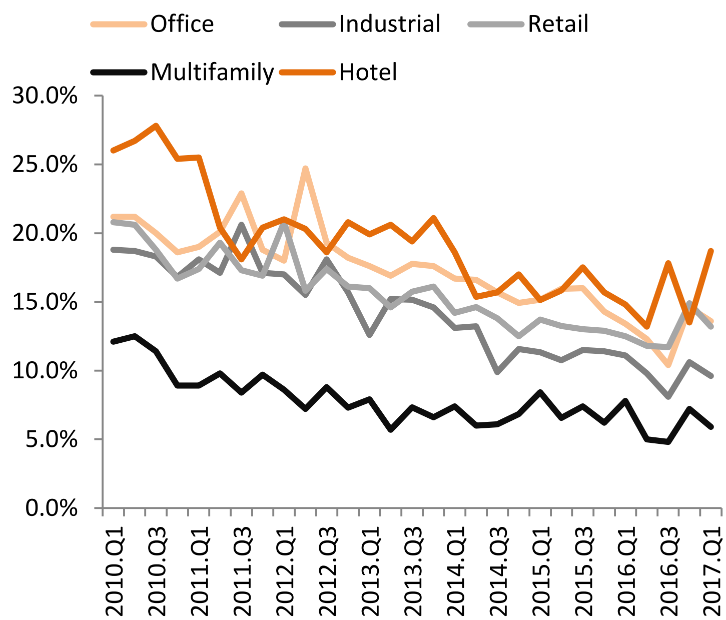
Exhibit 3.1: REALTORS® Fundamentals



Source: National Association of Realtors®

Vacancy rates continued declining in the first quarter of this year. Lease terms remained steady, with 36-month and 60-month leases capturing 61.0 percent of the market. One-year and two-year leases made up 23.0 percent of total.

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

Tenant demand remained strongest in the “5,000 square feet and below” segment, accounting for 84 percent of leased properties. Demand for space in the “Under 2,500 square feet” segment was practically flat from the prior quarter, accounting for 45 percent of REALTORS®’ responses. Demand for properties in the “10,000 - 49,999 square feet” notched a noticeable jump, accounting for 11.0 percent of total responses, an almost two-fold increase from the prior quarter.

4 | OUTLOOK

Economy

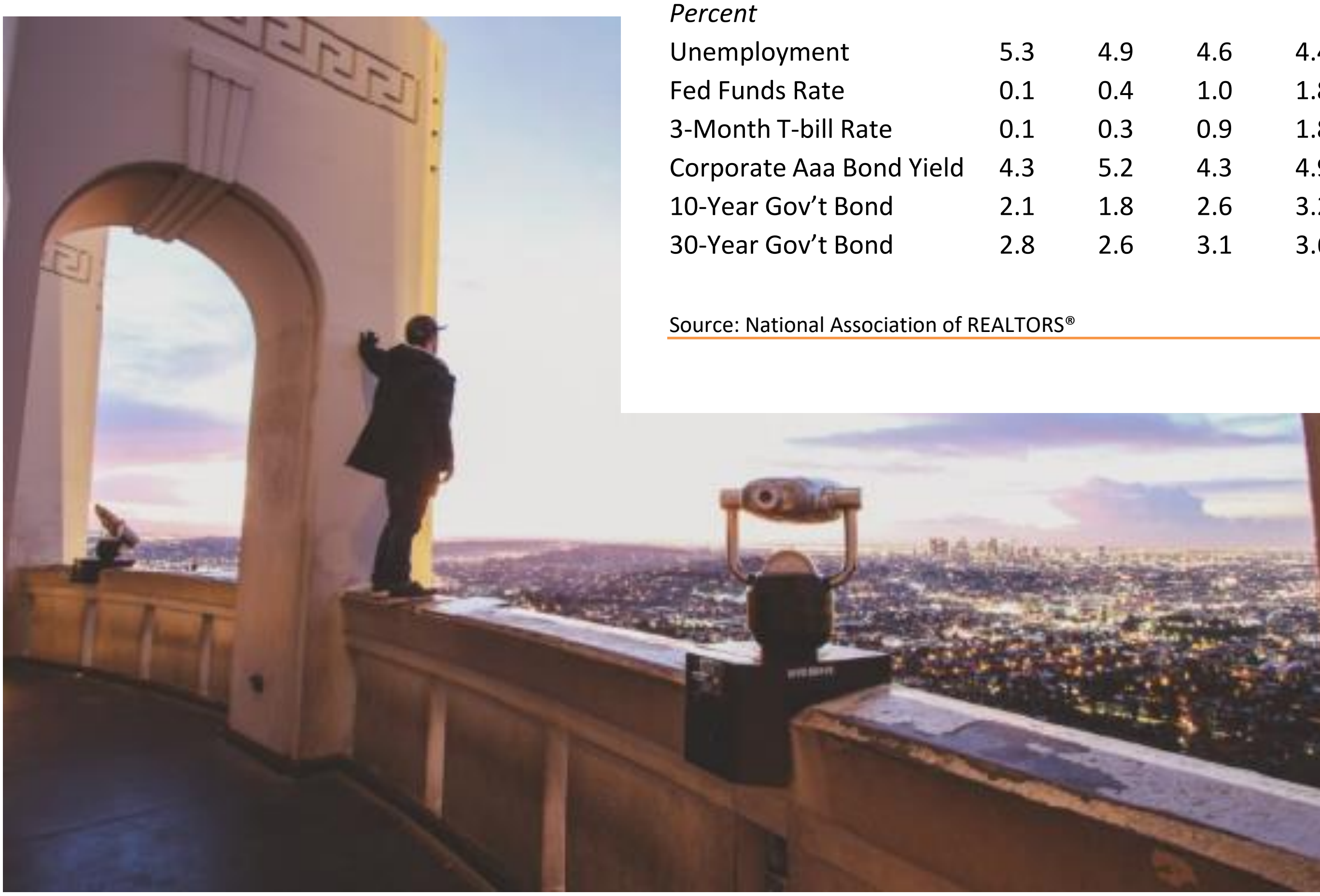
The economic outlook for 2017 calls for moderately positive expansion, with GDP projected to close the year 2.3 percent higher on an annual rate. Payroll employment is projected to advance at an annual rate of 1.7 percent, driving the unemployment rate to 4.6 percent by the end of the year.

With the Federal Reserve expected to continue increasing the funds target rate, NAR forecasts the short-term rate to reach 1.2 percent by the fourth quarter of this year. Inflation is expected to reach 2.6 percent in 2017.

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

	2015	2016	2017	2018
Annual Growth Rate, %				
Real GDP	2.6	1.6	2.2	2.4
Nonfarm Payroll Employment	2.1	1.7	1.6	1.7
Consumer Prices	0.1	1.3	2.3	2.2
Level				
Consumer Confidence	98	100	118	125
Percent				
Unemployment	5.3	4.9	4.6	4.4
Fed Funds Rate	0.1	0.4	1.0	1.8
3-Month T-bill Rate	0.1	0.3	0.9	1.8
Corporate Aaa Bond Yield	4.3	5.2	4.3	4.9
10-Year Gov't Bond	2.1	1.8	2.6	3.2
30-Year Gov't Bond	2.8	2.6	3.1	3.6

Source: National Association of REALTORS®



Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

	2016.Q1	2016.Q2	2016.Q3	2016.Q4	2017.Q1	2017.Q2	2017.Q3	2017.Q4	2018.Q1	2018.Q2	2018.Q3	2018.Q4	*2016*	*2017*	*2018*
Office	13.4	12.3	12.9	13.4	13.6	13.5	13.3	13.0	12.7	12.5	12.4	12.4	*13.0*	*13.3*	*12.5*
Industrial	11.1	9.8	8.1	8.7	9.4	9.2	9.0	8.7	8.4	8.1	7.9	7.9	*9.4*	*9.1*	*8.1*
Retail	12.5	11.8	11.7	12.0	13.2	12.5	12.5	12.5	12.6	12.7	12.8	13.1	*12.0*	*12.6*	*12.8*
Multifamily	7.8	5.0	4.8	7.4	5.9	6.5	6.3	6.1	6.5	6.2	6.1	6.2	*6.3*	*6.2*	*6.2*

Source: National Association of REALTORS®

Commercial fundamentals are expected to continue on a positive trend. With employment in business and professional services remaining solid, demand for offices will continue to add downward pressure on vacancies. The industrial sector remains well-positioned to capture gains from increased trade and e-commerce. Retail properties diverge along quality lines, with Class A spaces projected to continue advancing, as Class BC assets find a less favorable environment. The wave of department store closings announced in the first quarter of this year is disproportionately impacting smaller and rural markets around the country. Apartment properties remain in high demand due to the increase in young people, even as new supply is adding upward pressure on vacancies.

On the investment side, the slowdown in sales volume in LCRE markets during 2016 and the first quarter of this year indicates a maturation of the current cycle. While volume will likely stagnate in 2017 in LCRE markets, the quarterly decline in SCRE markets poses a question: is it just a blip or the beginning of a trend?

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	**247.0**	**253.6**
Green St. Advisors	74.4	87.1	92.2	99.4	106.7	118.0	125.2	**119.0**	**122.9**

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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