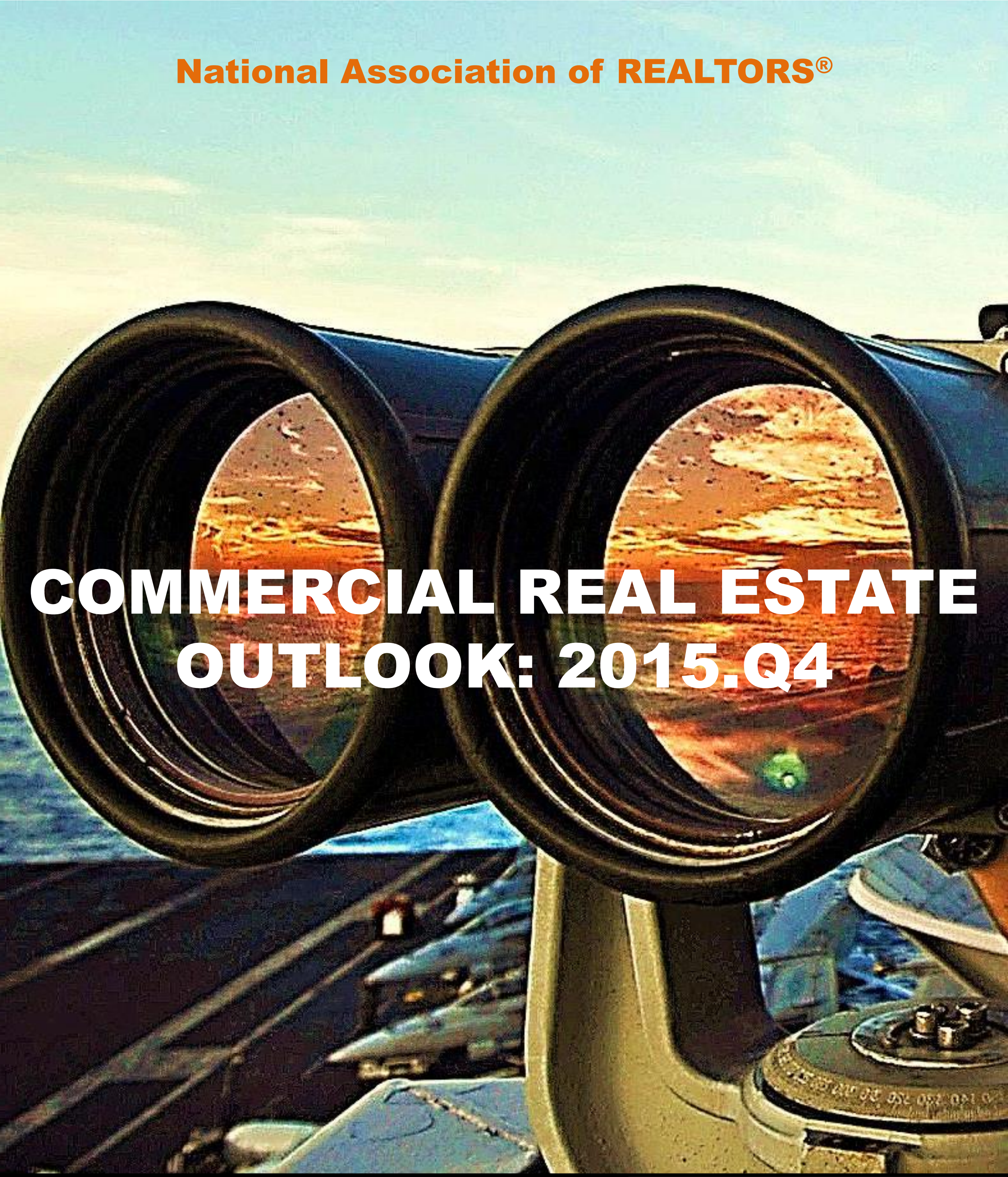
National Association of REALTORS®

COMMERCIAL REAL ESTATE OUTLOOK: 2015.Q4



COMMERCIAL Real Estate

REALTOR®

NATIONAL ASSOCIATION of REALTORS®

Commercial Real Estate Outlook: 2015.Q4

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1 | ECONOMIC OVERVIEW

Gross Domestic Product

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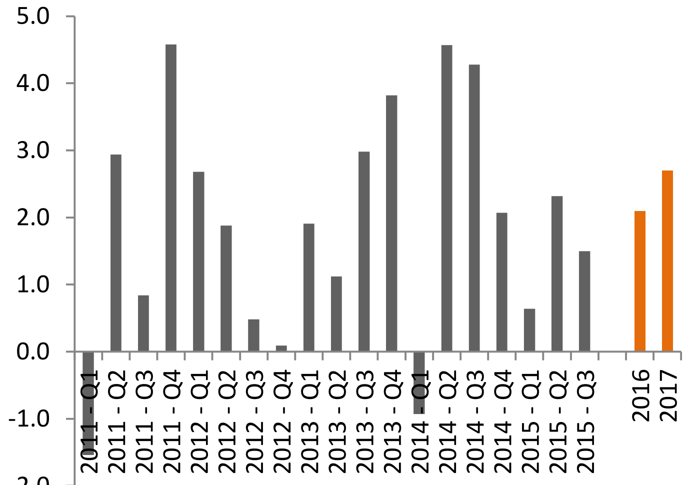
Macroeconomic activity lost steam during the third quarter of this year. Based on the first estimate from the Bureau of Economic Analysis, real gross domestic product (GDP) rose at an annual rate of 1.5 percent. In comparison, second quarter growth measured 3.9 percent, while the third quarter 2014 rate of growth was 4.3 percent. The gain remained below the long-run historical average of 3.0 percent.

Consumer spending advanced at an annual rate of 3.3 percent in the third quarter, benefiting from the summer holiday season. Spending on durable goods increased at a positive 6.7 percent, as consumers purchased automobiles, furniture, household appliances and recreational goods and vehicles. Nondurable good purchases also advanced, driven by sales of clothing and shoes, as well as gasoline. Consumer spending on services rose 2.6 percent on an annual basis, with transportation, financial services, and health care driving growth.

While business investments remained sluggish and barely positive, with a 2.1 percent annual rate of growth in the third quarter, the change in private inventories was a significant negative contributor to the GDP. The figure signaled a throttling back of production likely spurred by a downward change in business outlook. Business investments in equipment rose at 5.3 percent, lifted by double-digit increases in information processing and transportation equipment. Spending on commercial real estate declined 4.0 percent on an annual basis, while private residential fixed investment—home building—rose at an annual rate of 6.1 percent.

Exhibit 1.1: Real GDP (% Annual Chg.)



Source: NAR, BEA

International trade took a milder pace in the third quarter, as slower growth in the Chinese economy and higher global economic volatility coupled with a stronger dollar impacted exporters. Real net exports totaled a negative $536.2 billion during the quarter, virtually unchanged from the prior quarter.

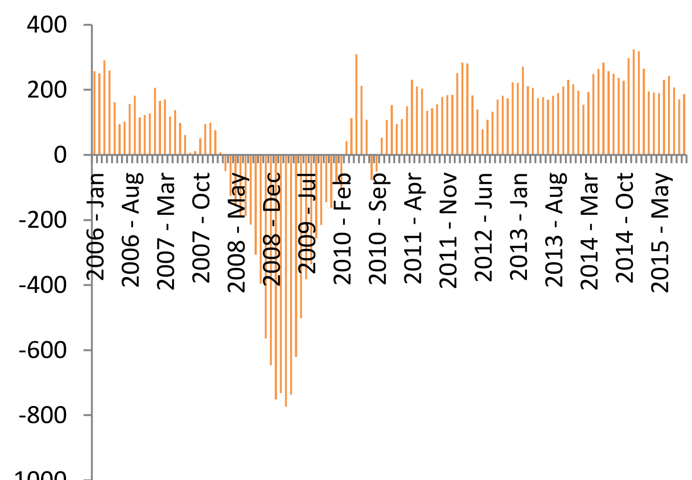
Government spending also moderated, as defense spending cuts continued. Spending at the federal level rose at an annual rate of 0.25 percent, held back by 1.4 percent drop in defense expenditures. State and local government spending advanced at a 2.6 percent annual rate.

Employment

The number of new jobs increased in the third quarter of 2015, but at a slightly slower pace compared with the same period in 2014. During the quarter, 501,000 new employees were added to payrolls nationwide, bringing the total for the January to September period to 1.8 million. Average weekly earnings of private employees—adjusted for inflation—rose by 2.3 percent in the third quarter of this year.

Employment in private service-providing industries provided the main thrust for new job growth during the third quarter of the year. Employment in education and health rose by 118,000 jobs, the largest industry gain during the quarter. With the height of summer travel, leisure and hospitality added 99,000 net new positions, while professional and business services accounted for an additional 98,000 new employees. Financial services and information industries added 27,000 and 11,000 new positions to payrolls during the period, keeping demand for office space positive.

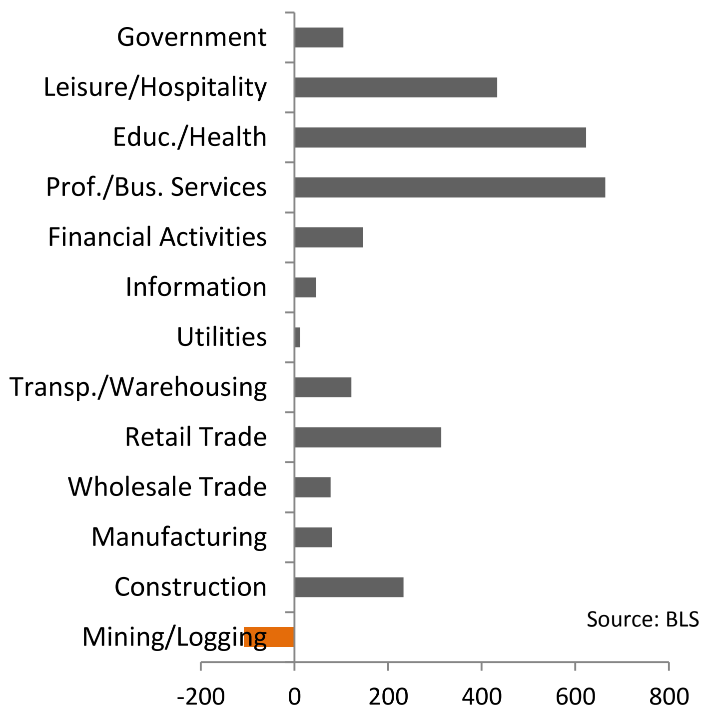
Exhibit 1.2: Payroll Employment (Change, '000)



Source: BLS

With demand for industrial properties rising, transportation and warehousing employment gained 23,700 new positions, while wholesale trade employment rose by 4,000 jobs.

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



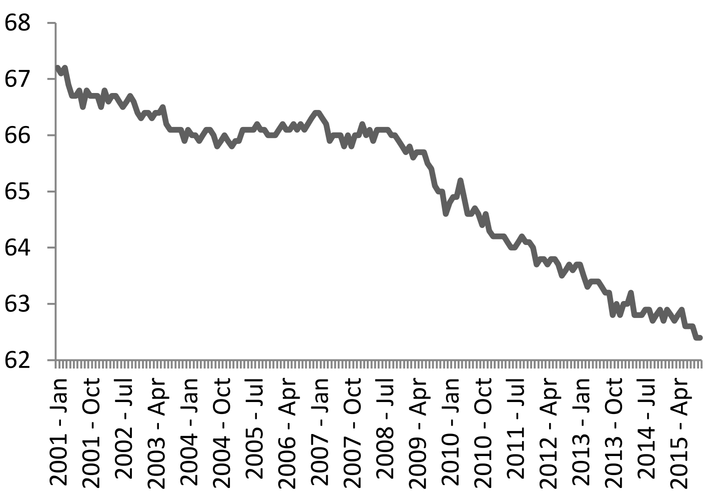
Source: BLS

The unemployment rate declined from an average 5.4 percent in the second quarter 2015 to 5.1 percent by the close of the third quarter. At the end of September there were 7.9 million unemployed Americans. The average duration of unemployment declined from 32 weeks in the first quarter to 26 weeks by the end of September 2015.

The labor force participation (LFP) rate decreased slightly and continued to hover at historic lows. The LFP rate was 62.8 percent in the first quarter of

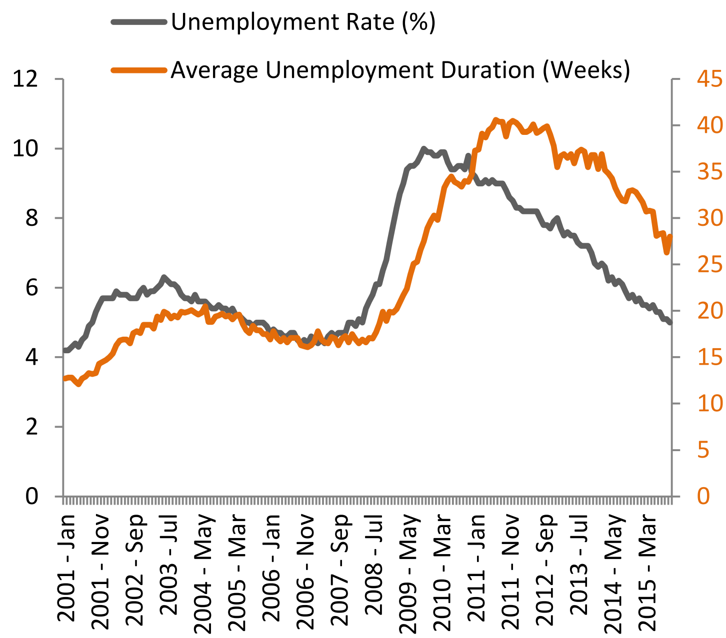
2015, remained flat in the second quarter, and slid to 62.5 percent in the third quarter. In comparison, before the Great Recession the LFP rate was 65.9 percent. With the Baby Boomers retirement wave rising and discouraged workers keeping out of the labor force, economic growth is likely to remain moderate. Currently, 94.7 million Americans are not in the labor force, of which 5.6 million were estimated to want a job; this is in addition to the 7.9 million Americans currently in the labor force but unemployed.

Exhibit 1.4: Labor Force Participation Rate



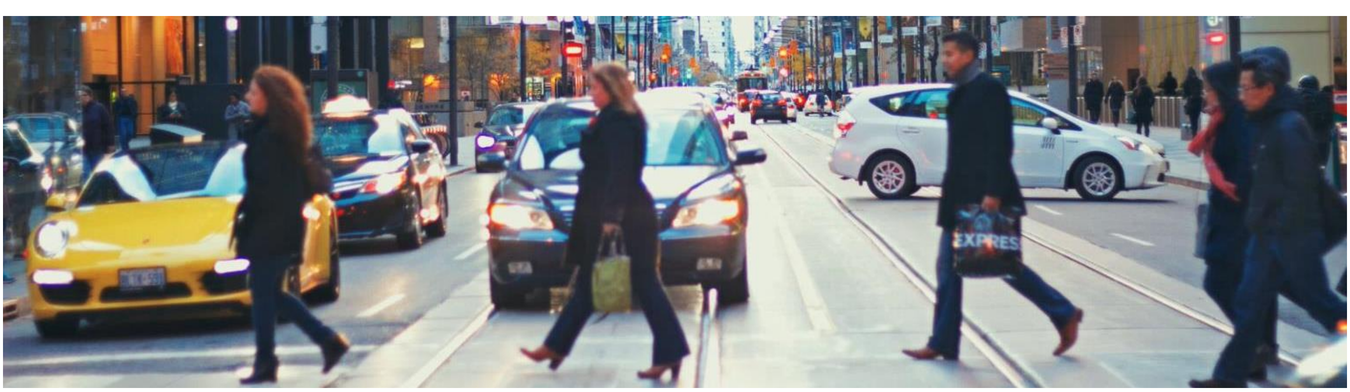
Source: BLS

Exhibit 1.5: Unemployment



Source: BLS

Consumer confidence, as measured by The Conference Board, rebounded from 96.2 in the second quarter of this year to 98.3 in the third quarter. Separately, the Consumer sentiment index compiled by the University of Michigan continued on a downward trend from the first quarter's high of 95.5. The second quarter value was 94.2 while the third quarter dropped to 90.7.



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).

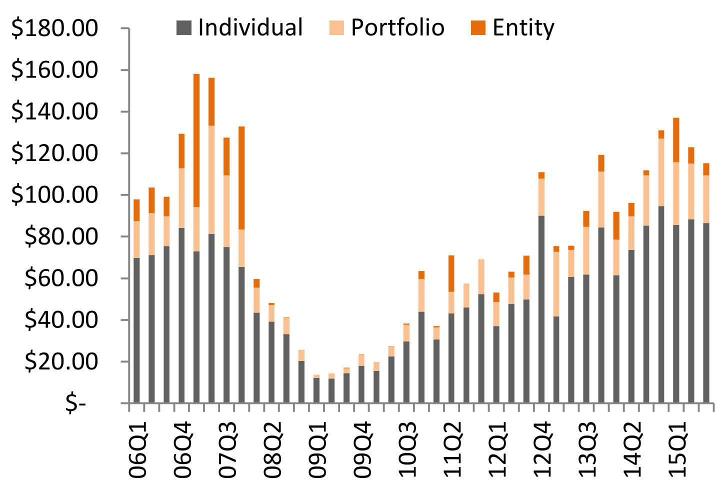
Commercial sales transactions span the price spectrum, but tend to be measured and reported based on size. CRE deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their size. However, these smaller properties provide the types of commercial space that the average American encounters on a daily basis—e.g. strip 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.

Large Commercial Real Estate Markets

Commercial transactions have slowed in the third quarter of the year, after strong gains at the onset of 2015. The volume of commercial sales in LCRE markets totaled $115 billion, a 3.0 percent year-over-year increase, according to Real Capital Analytics (RCA). The third quarter data marked a noticeable slowdown in deal momentum for LCRE markets, with September's sales volume dropping 10 percent year-over-year. In comparison, sales volume advanced 49 percent in the first quarter and 23 percent in the second quarter.

Whereas portfolio and entity level transactions dominated the landscape in the first half of the year, large deals comprised a much-smaller 30 percent of total in the third quarter. Given their importance in the current market, their absence in the latest quarter underlines the general decline in total LCRE transactions.

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

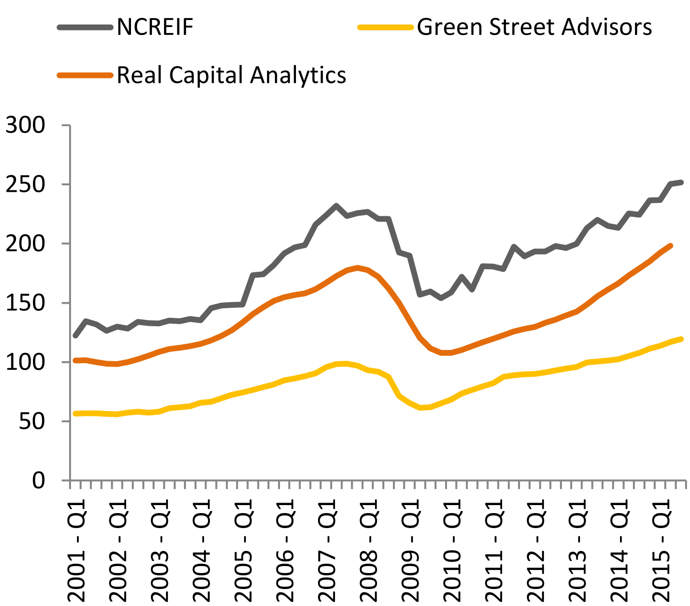


Source: Real Capital Analytics

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

Buoyed by rising sales and investor optimism, prices in LCRE markets rose by 14.2 percent during the third quarter of this year, based on RCA's Commercial Property Price Index. The advance was driven by strong appreciation in prices of apartment and CBD office properties, both of which have exceeded their prior 2007 peaks.

Exhibit 2.2: Commercial Property Price Indices



Separately, additional price indices reflected the strong gains in commercial valuations. The Green Street Advisors Commercial Property Price Index rose 10.6 percent on a yearly basis during the third quarter, reaching a value of 119.3, the highest since the index's inception in 1998. The National Council of Real Estate investment Fiduciaries (NCREIF) Price Index also rose 12.1 percent year-over-year in the third quarter of 2015, to its highest recorded value—251.61.

Capitalization rates for transactions in LCRE markets averaged 6.9 percent in the third quarter, based on RCA reports. Transactions of office properties in CBD markets recorded the lowest cap rates, at 5.3 percent, followed by apartment, at 5.8 percent. Retail and industrial properties also posted sub-7.0 percent cap rates, while hotel transactions averaged cap rates of 8.2 percent in the third quarter.

Exhibit 2.3: NCREIF Property Index Returns—2015.Q3

NATIONAL	3.09%
OFFICE	2.97%
INDUSTRIAL	3.67%
RETAIL	3.11%
APARTMENT	2.92%

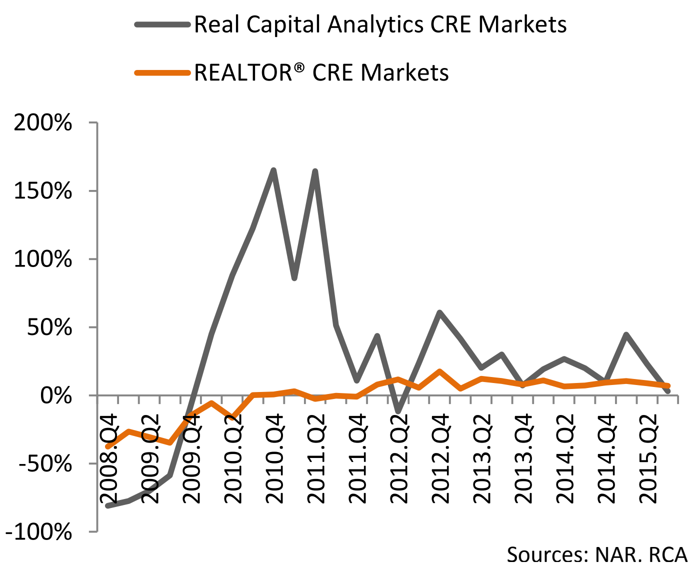
Source: National Council of Real Estate Investment Fiduciaries

Small Commercial Real Estate Markets

Commercial real estate continued on a positive trend during the third quarter, with REALTORS® reporting continued improvement in fundamentals and investment sales. However, REALTORS® indicated a deceleration in momentum. The direction of commercial business opportunities during the third quarter 2015 rose 18 percent year-over-year, slightly higher than the second quarter's 17 percent.

A higher proportion of members closed deals in the third quarter 2015—63 percent. Sales volume rose seven percent from the third quarter of 2014.

Exhibit 2.4: Sales Volume (YoY % Chg)



The shortage of available inventory continued as the number one concern for NAR members, pushing price growth upward. Commercial properties traded at average prices four percent higher compared with the same period in 2014. The average transaction price slid from $2.0 million in the second quarter 2015 to $1.9 million in the third quarter 2015. A perceived pricing gap between sellers and buyers remained the second highest ranked concern.

Average capitalization rates moved up to an average 7.9 percent across all property types, a 26 basis point decline on a yearly basis. Apartments posted the lowest cap rate, at 6.7 percent, followed by retail properties with average cap rates at 7.7 percent. Office and industrial spaces posted identical cap rates of 7.8 percent. Hotel transactions reported the highest comparative cap rates—8.8 percent. It is worth noting that these cap rates are higher than those in LCRE markets, reflecting activity in markets where REALTORS® are more engaged.

Exhibit 2.5: Sales Prices (YoY % Chg)

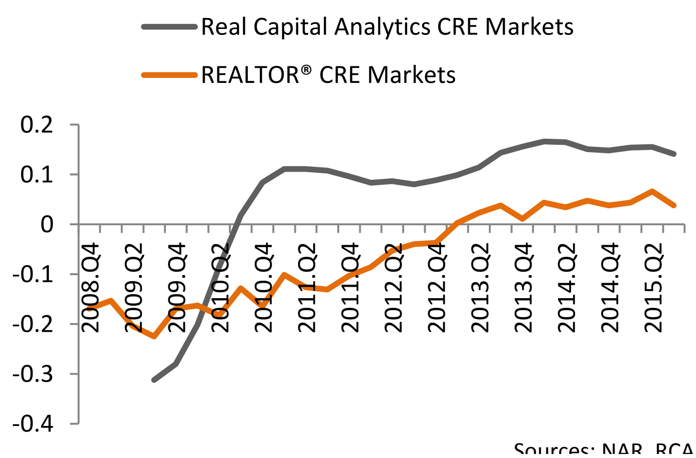
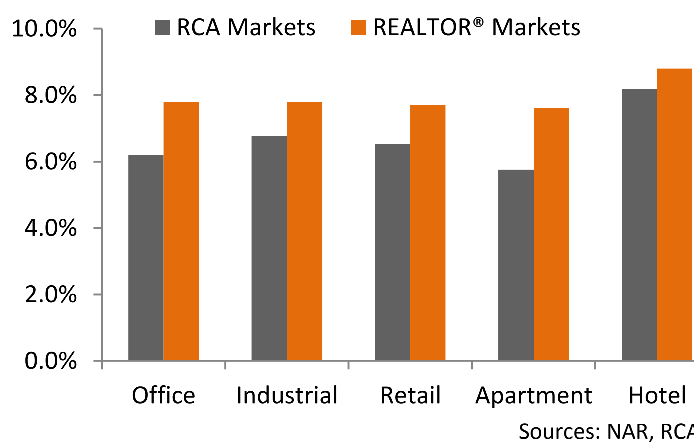
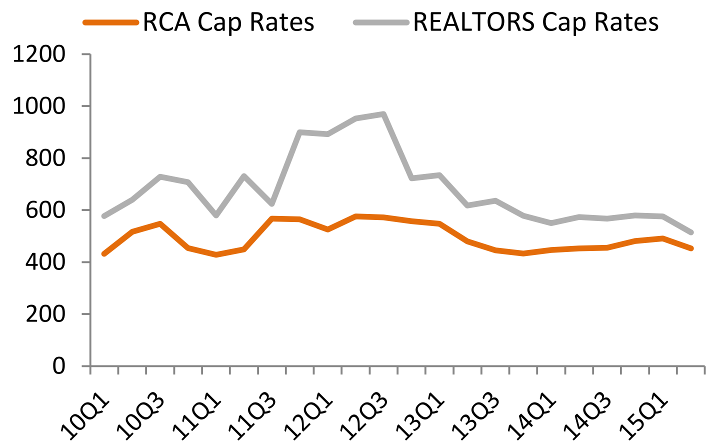


Exhibit 2.6: Cap Rates - 2015.Q3



The interest rate on 10-year Treasury Notes—a standard measure of risk-free investments—averaged 2.2 percent during the third quarter of 2015, higher than the second quarter. Based on the prevailing rates, the spread between cap rates and 10-year Treasury Notes ranged from 470 basis points in LCRE market to 573 basis points in SCRE markets. The spread denotes that CRE investors are continue to enjoy healthy returns in the rebounding markets.

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



Sources: NAR, RCA

3 | COMMERCIAL REAL ESTATE FUNDAMENTALS

Large Commercial Real Estate Markets

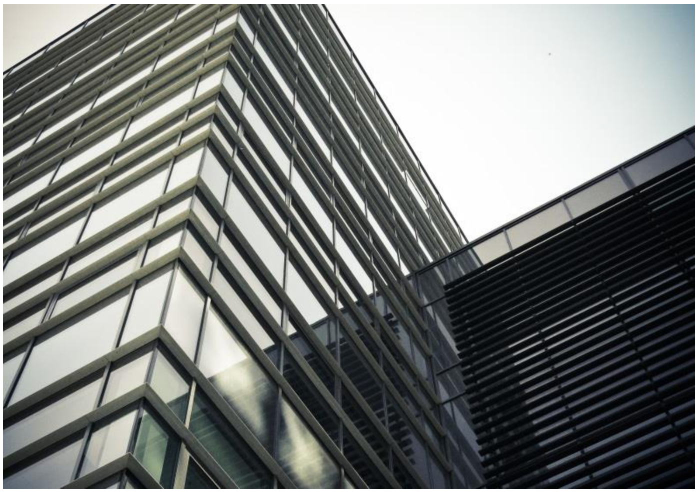
Demand for commercial leases kept a positive pace in the third quarter of 2015. Construction has been growing across all property types, but the gap between demand and supply exerted downward pressure on availability.

Office net absorption totaled 14.6 million square feet in the third quarter of 2015, gaining strength with each consecutive quarter this year, based on data from JLL. New completions totaled 26.6 million square feet over the first nine months of this year, with the development pipeline gaining 8.5 million square feet in the third quarter. Overall office vacancies declined 20 basis points from the second quarter, to 15.1 percent in the third quarter. Rents for office properties rose 1.6 percent during the third quarter, bringing the 2015 cumulative gain to 4.3 percent.

The industrial sector posted a strong third quarter, with rising demand and declining vacancies. Industrial net absorption totaled 61.9 million square feet in the third quarter, bringing the total for the first nine months of 2015 to 164.8 million square feet, according to JLL. Warehouse and distribution centers accounted for the lion's share of demand, followed by manufacturing. Supply picked up as well, with new completions ringing at 50.2 million square feet in the third quarter. Demand continued outpacing supply, driving industrial vacancies down to 6.7 percent, a 14-year low, according to JLL. With a tight market, industrial rents rose 6.0 percent, to an average of $4.89 per square foot in the third quarter.

Demand for retail properties has picked up in tandem with rising employment and confidence. Retail tenants are expanding, leading developers to increase construction. Supply of new retail spaces is projected to total 47.0 million square feet by the end of 2015, a 4.1 percent increase from a year ago, according to Marcus & Millichap. Vacancy rates for retail buildings are expected to close 2015 at 6.1 percent, 40 basis points lower than in 2014. With declining availability, rents are rising by 2.3 percent to $18.43 per square foot, based on Marcus & Millichap data.

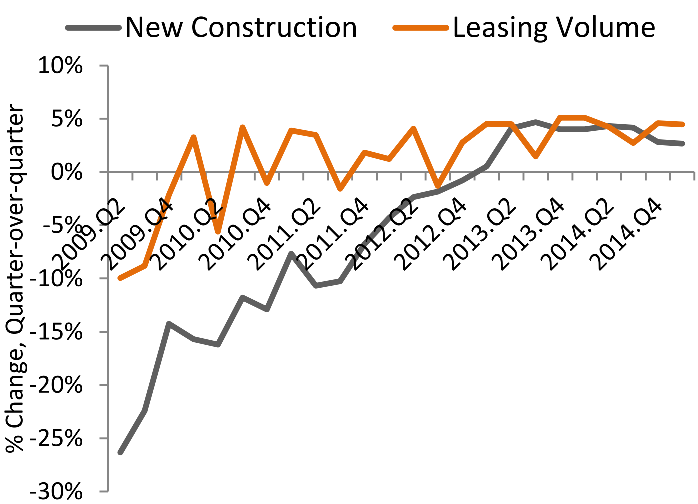
Demand for multifamily properties continued on an upward path. Renter occupied housing units totaled 42.6 million units in the third quarter of 2015, a 3.2 percent advance from the third quarter of 2014, based on U.S. Census Bureau data. National vacancy rates averaged 7.3 percent for rental housing during the third quarter, 10 basis points lower than the same period in 2014. Median rents for rental units averaged $802 in the third quarter of this year, 6.1 percent higher than the previous year.



Small Commercial Real Estate Markets

Commercial fundamentals continued improving during the third quarter 2015. Leasing volume during the second quarter rose 3.8 percent compared with the second quarter 2015. Leasing rates advanced at a steady pace, rising 2.5 percent in the third quarter, compared with the 2.7 percent advance in the previous quarter.

Exhibit 3.1: REALTORS® Fundamentals



Source: National Association of Realtors®

NAR members' average gross lease volume for the quarter was $567,257, 9.8 percent lower than the previous period. New construction accelerated, posting a 6.6 percent gain from the second quarter of this year.

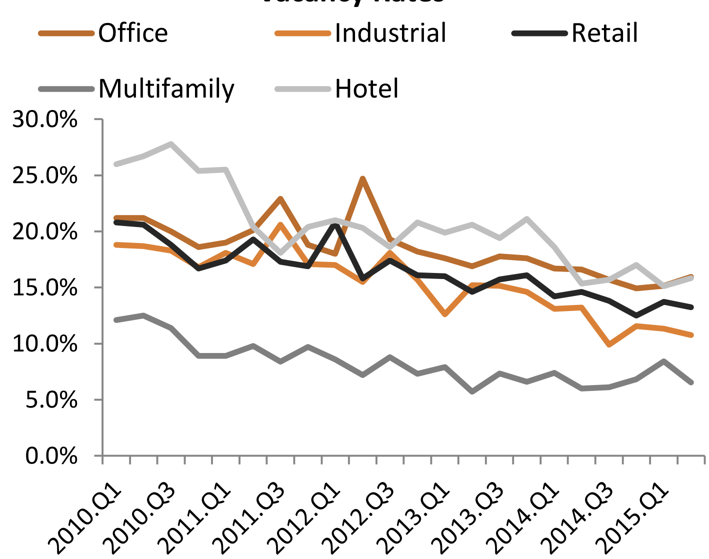
Tenant demand remained strongest in the 5,000 square feet and below, accounting for 72 percent of leased properties. However, demand for space in the 5,000 – 7,499 square feet more than doubled during the third quarter, comprising 13 percent of total. Lease terms remained steady, with 36-month and 60-month leases capturing 64 percent of the market.

Vacancy rates mirrored the regional and product variations REALTORS® markets, ranging from a low of 7.4 percent for apartments to a high of 16.0 percent for office properties. With rising new supply, apartments experienced availability increases, as the national average rose from 6.1 percent in the third quarter of 2014 to 7.4 percent in the third quarter of this year.

Office vacancies increased 30 basis points to 16.0 percent compared with a year ago. Industrial availability witnessed a yearly increase of 160 basis points—to 11.5 percent. Retail vacancies declined 80 basis points on a yearly basis, to 13.0 percent.

Lease concessions declined 4.5 percent. Tenant improvement (TI) allowances averaged $30 per square foot per year nationally.

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

4 | OUTLOOK

Economy

Looking ahead at the last quarter of this year, the GDP annual rate of growth is projected to reach 2.0 percent. Economic growth is expected to pick up in the first half of 2016 to the tune of 2.0 percent in the first quarter and 2.5 percent in the second one. Payroll employment is projected to remain at a steady 1.7 percent annual growth rate for the remaining quarter of this year and into 2016. The unemployment rate is projected to fall to 4.9 percent in 2016.

While the markets are closely watching the Federal Reserve's December decision in regards to the funds target rate, inflation remains contained. Prices are expected to rise 1.5 percent in the last quarter of 2015. With rents rising at a faster pace, consumer prices are projected to rise in 2016, with yearly projections of 3.2 percent.

Buffeted by market volatility and slowing economic growth, consumer confidence has moderated toward the tail-end of the year, leaving a cloud over the retail holiday season. Continuing gains in employment and wages may provide additional lift to the trend line.

Exhibit 4.1: U.S. ECONOMIC OUTLOOK—November 2015

	2013	2014	2015	2016
Annual Growth Rate, %				
Real GDP	2.2	2.6	2.1	2.7
Nonfarm Payroll Employment	1.7	1.9	1.8	1.7
Consumer Prices	1.5	1.6	0.1	3.2
Level				
Consumer Confidence	73	87	99	100
Percent				
Unemployment	7.4	6.1	5.3	4.9
Fed Funds Rate	0.1	0.1	0.1	0.9
3-Month T-bill Rate	0.1	0.1	0.2	1.0
Corporate Aaa Bond Yield	4.3	4.2	3.9	4.5
10-Year Gov't Bond	2.6	2.6	2.1	2.7
30-Year Gov't Bond	3.4	3.4	2.9	3.6

Source: National Association of REALTORS®

Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

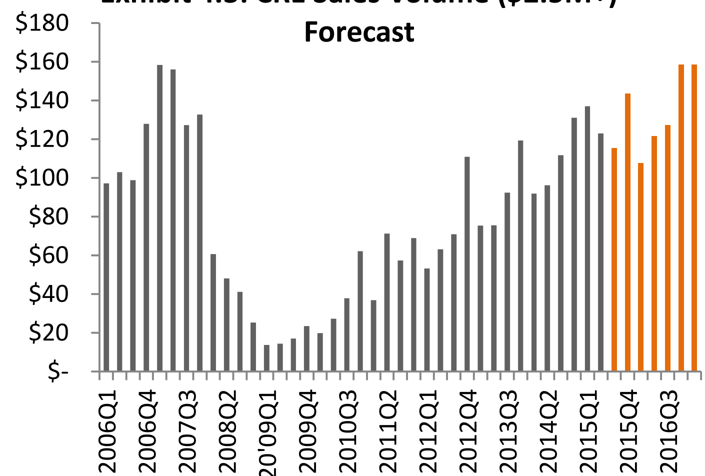
	2014.Q4	2015.Q1	2015.Q2	2015.Q3	2015.Q4	2016.Q1	2016.Q2	2016.Q3	2016.Q4	2017.Q1	2014	2015	2016
Office	14.9	15.1	15.9	16.0	15.6	15.2	14.9	14.8	14.8	14.6	16.0	15.6	14.9
Industrial	11.6	11.3	10.8	11.5	11.1	10.9	10.5	10.1	9.7	9.5	12.0	11.2	10.3
Retail	12.5	13.7	13.2	13.0	12.6	12.2	11.8	11.6	11.3	11.0	13.8	13.1	11.7
Multifamily	6.8	8.4	6.6	7.4	6.1	7.0	6.9	7.1	7.3	8.3	6.6	7.1	7.1

Source: National Association of REALTORS®

Commercial fundamentals are expected to improve, with vacancies continuing on a downward trend. As employment gains drive demand, office vacancies are projected to average 15.6 percent by the end of 2015 and decline to 14.9 in 2016. Industrial availability is estimated to drop from an average of 11.2 percent in 2015 to 10.3 percent in 2016. Retail availability will continue shrinking, as vacancies are projected to decline from 13.1 percent in 2015 to 11.7 percent in 2016. Multifamily vacancies are expected to average 7.0 percent at the end of 2015 and then rise to 7.5 percent in 2016, as stepped-up new construction is adding upward pressure.

While global and financial volatility has dampened the pace of CRE investments in the third quarter, the decline can partly be traced to smaller portfolio deals. As individual properties remain the backbone of the current market landscape, with higher capital availability, investments are expected to continue on an upward trend. At the current sales pace, sales of LCRE properties are projected to total over $500 billion in 2015. Investment volume in 2016 is projected to match the 2015 figure.

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



Source: NAR, RCA

Prices are poised to continue their advance in the last quarter of 2015, as shortage of inventory and larger capital pools—both equity and debt—search for yield. Property prices rose significantly for Class A buildings and other trophy properties captured in the NCREIF and Green St. Advisors' indices over the past six years—by 50 percent for NCREIF and by 86 percent for Green St. Advisors. With cap rates already compressed to very low levels, property prices will decline slightly in2016 as the Federal Reserve starts to raise interest rates.

Exhibit 4.4: Commercial Property Price Indices Forecast

	2008	2009	2010	2011	2012	2013	2014	2015	2016
NCREIF	215.2	165.1	168.2	186.5	195.2	211.9	224.9	249.6	245.3
Green St. Advisors	86.1	63.5	74.4	87.1	92.2	99.4	106.7	118.0	116.0

Sources: NAR, NCREIF, Green Street Advisors

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