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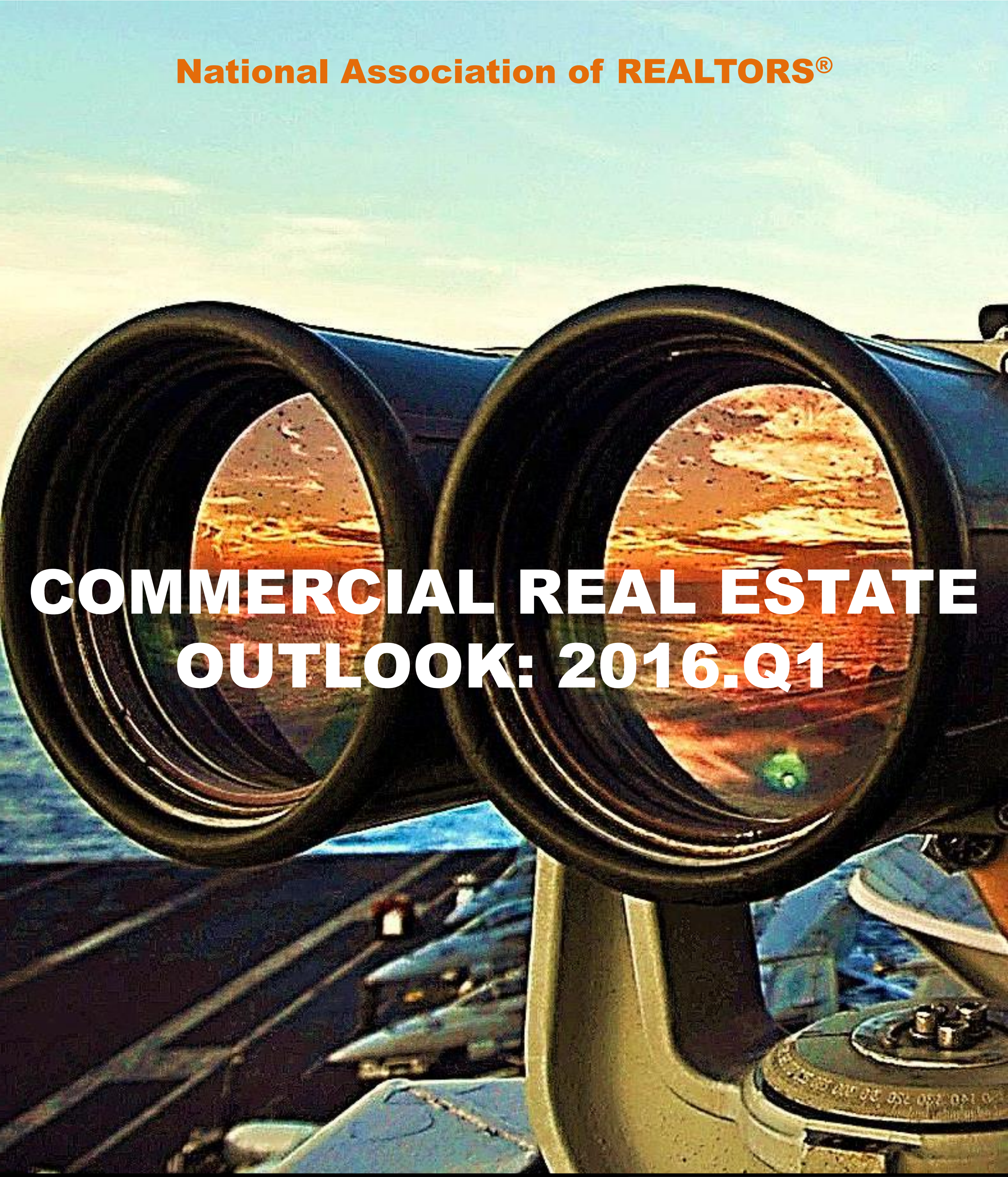

COMMERCIAL REAL ESTATE OUTLOOK: 2016.Q1

COMMERCIAL Real Estate

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NATIONAL ASSOCIATION of REALTORS®

Commercial Real Estate Outlook: 2016.Q1

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CONTENTS

2016.Q1

1 | ECONOMIC OVERVIEW

Gross Domestic Product

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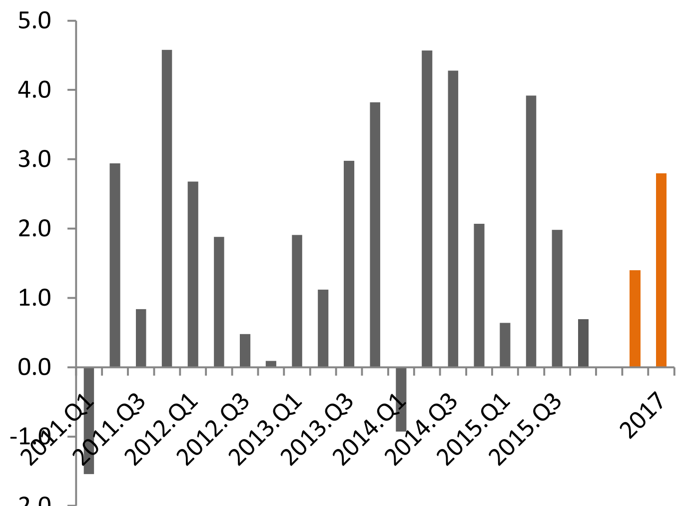
U.S. macroeconomic momentum dropped during the fourth quarter of 2015, buffeted by global economic slowdown and financial volatility. Based on the first estimate from the Bureau of Economic Analysis, real gross domestic product (GDP) rose at an annual rate of 0.7 percent. In comparison, second quarter growth measured 3.9 percent, while the third quarter 2015 rate of growth was 2.0 percent. The gain remained below the long-run historical average of 3.0 percent.

Consumer spending advanced at an annual rate of 2.2 percent in the fourth quarter, benefiting from the winter holiday season. However, with soft retail sales, brisk electronic commerce proved the silver lining. Spending on durable goods increased by 4.3 percent, as consumers purchased furniture, household appliances and recreational goods and vehicles. Nondurable good purchases advanced modestly, driven by sales of clothing and shoes. Consumer spending on services rose 2.0 percent on an annual basis, with recreation, lodging and restaurants, as well as transportation, and health care driving growth.

In comparison with consumer spending, business investments declined 1.8 percent on an annual basis in the fourth quarter. Businesses cut back investments in equipment and commercial real estate. Investments in residential real estate continued at a healthy clip, rising by 8.2 percent annual rate. Spending on intellectual property products—software, R&D—rose by 1.6 percent.

Exhibit 1.1: Real GDP (% Annual Chg.)



Source: NAR, BEA

International trade felt the impact of the stronger dollar in the fourth quarter. Exports declined by 2.5 percent, while imports rose 1.1 percent, pegging real net exports at a negative $566.5 billion during the quarter.

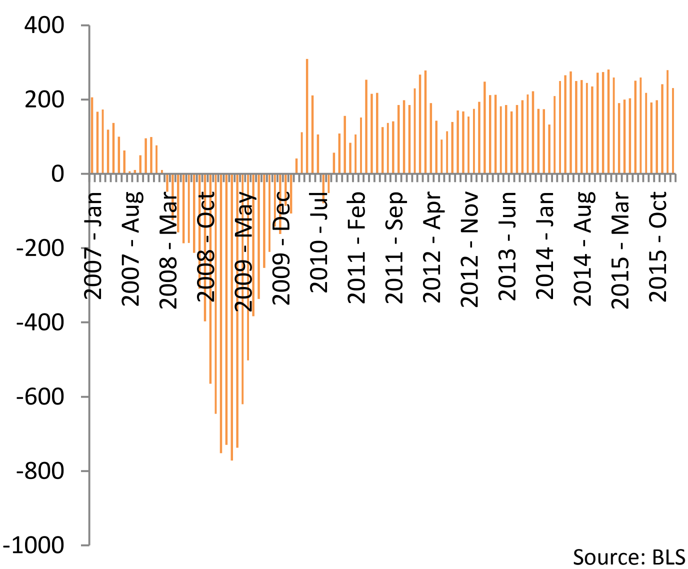
Government spending moderated as well, notching a 0.7 percent annual growth rate. The federal government's 2.7 percent spending increase offset the 0.6 percent cut in spending incurred at state and local levels.

Employment

The fourth quarter offered a silver lining on the employment front. Payroll employment rose at the strongest pace in the last stretch of the year, adding 837,000 new jobs. The figure closed the year with a total net gain of 2.7 million employees. Average weekly earnings of private employees rose by 2.4 percent in the fourth quarter of this year, compared to one year earlier.

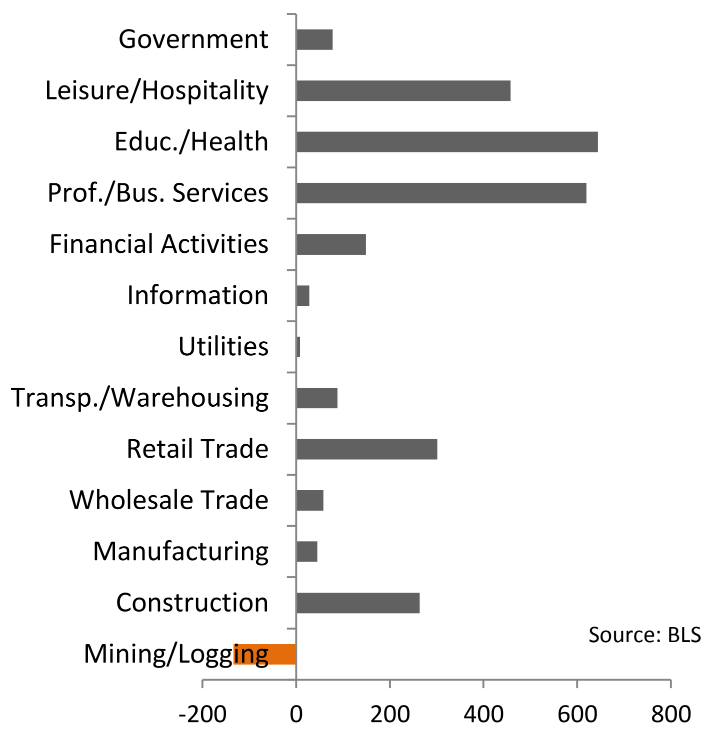
Employment in private service-providing industries provided the main thrust for new job growth during the fourth quarter of the year. Employment in professional and business services gained 199,000 net new jobs, followed by education and health with 177,000 net new jobs. With the holiday travel season in full swing, and warmer-than-usual weather, leisure and hospitality added 130,000 net new positions, while retail trade gained 72,400 jobs. Financial services added 39,000 new positions to payrolls during the period, keeping demand for office space positive.

Exhibit 1.2: Payroll Employment (Change, '000)



With demand for industrial properties rising, transportation and warehousing employment gained 22,200 new positions, while wholesale trade employment rose by 24,100 jobs.

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

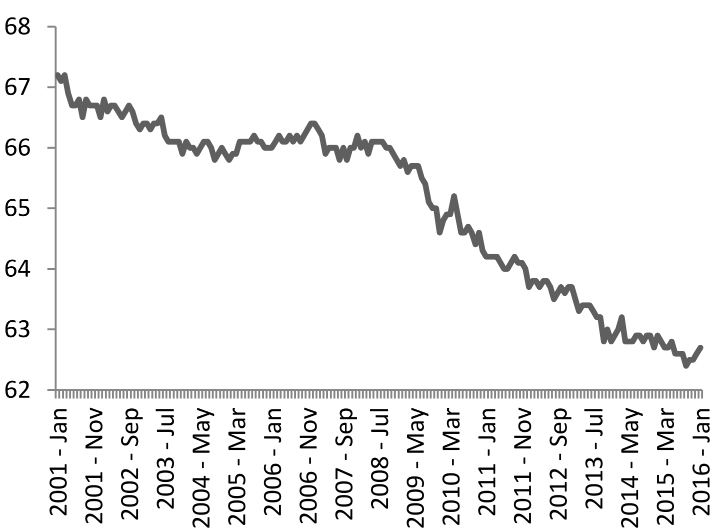


The unemployment rate declined from 5.6 percent in the first quarter 2015 to 5.0 percent by the close of the year. At the end of December there were 7.9 million unemployed Americans. The average duration of unemployment declined from 31 weeks in the first quarter to 28 weeks by the end of 2015.

The labor force participation (LFP) rate stayed flat compared with the prior quarter, but continued to hover at historic lows. The LFP rate was 62.8 percent in the first quarter of 2015, slid to 62.7

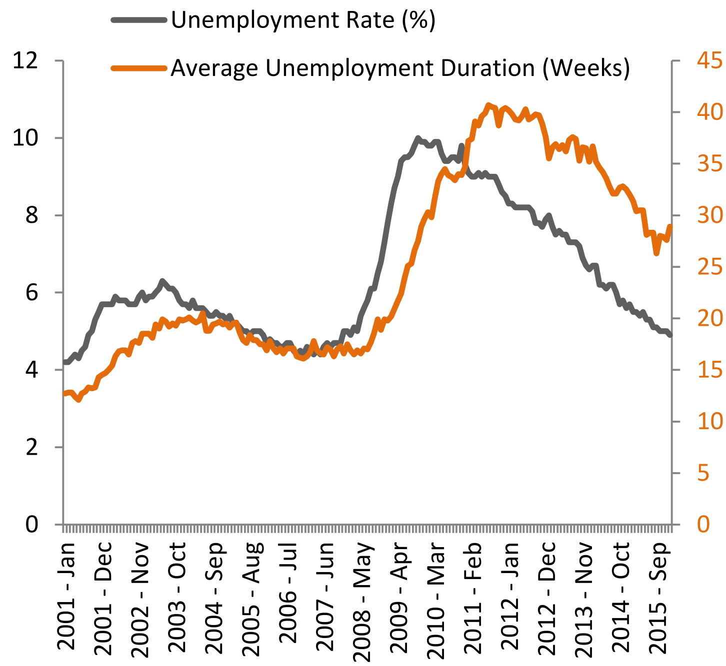
percent in the second quarter, and fell to 62.5 percent in the third and fourth quarters. In comparison, before the Great Recession the LFP rate was 65.9 percent. With the Baby Boomers retirement wave rising and discouraged workers staying out of the labor force, economic growth is likely to remain moderate. As of the end of 2015, 94.3 million Americans were not in the labor force, of which 1.8 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, declined to 96.0 in the fourth quarter of 2015, the lowest reading of the year. Separately, the Consumer sentiment index compiled by the University of Michigan moved up slightly in the last quarter of the year to 91.3, compared with the 90.7 value from the third quarter. The second quarter value was 94.2 while the third quarter posted 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).

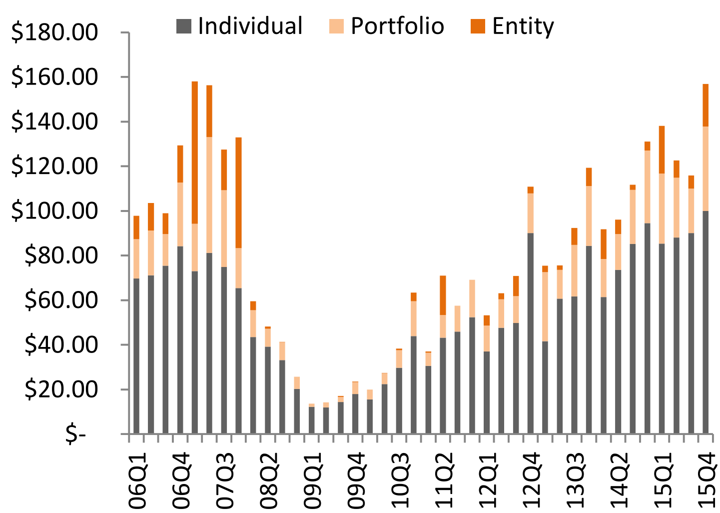
Commercial sales transactions span the price spectrum, but tend to be measured and reported based on size. CRE deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured 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

The pace of commercial transactions rebounded in the fourth quarter of 2015, after the third quarter slowdown. The volume of commercial sales in LCRE markets totaled $157 billion, a 20 percent year-over-year increase, according to Real Capital Analytics (RCA). The fourth quarter data saw gains in both individual and portfolio transactions, with a marked jump in entity level exchanges, which rose 224 percent.

Across the entirety of 2015, apartment transactions comprised the largest share of volume, with $150.0 billion in sales, followed by office properties, which accounted for $145.8 billion. Retail and industrial sales totaled $87.6 billion and $76.5 billion, respectively. Industrial sales posted the largest year-over-year change in transaction volume—54 percent.

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

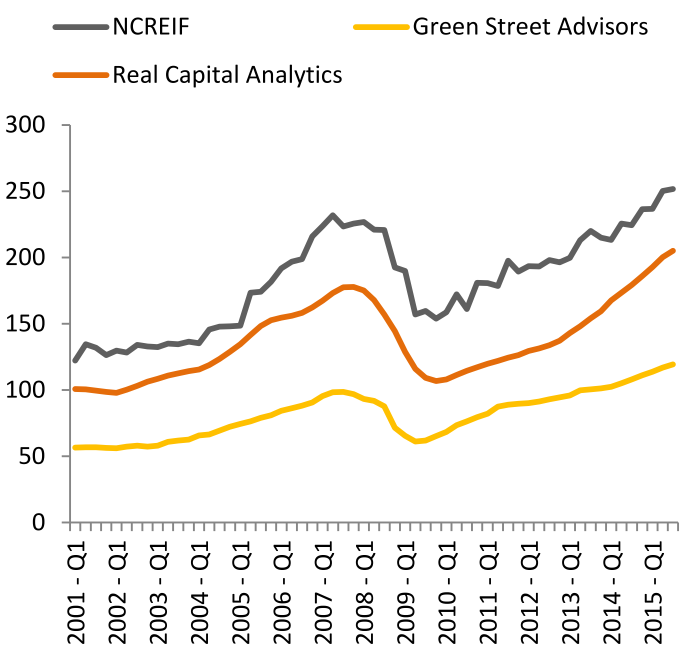


Source: Real Capital Analytics

[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 12.3 percent during the last quarter of 2015, based on RCA's Commercial Property Price Index. The advance was driven by strong appreciation in prices of CBD office and hotel properties, which advanced 18.9 percent and 16.1 percent, respectively. Apartment and retail properties also posted strong gains of 13.0 percent and 12.8 percent.

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 9.7 percent on a yearly basis during the fourth quarter, reaching a value of 122.0, the highest since the index's inception in 1998. The National Council of Real Estate investment Fiduciaries (NCREIF) Price Index moderated from its third quarter record of 251.61, but increased 5.1 percent year-over-year in the last quarter of 2015.

Capitalization rates for transactions in LCRE markets averaged 6.7 percent in the fourth quarter, based on RCA reports, 20 basis points lower than the prior period. Transactions of office properties in CBD markets tied for the lowest cap rates with apartments, at 5.8 percent. Retail and industrial properties also posted sub-7.0 percent cap rates, while hotel transactions averaged cap rates of 8.3 percent in the fourth quarter.

Exhibit 2.3: NCREIF Property Index Returns—2015.Q4

NATIONAL	2.91%
OFFICE	2.58%
INDUSTRIAL	3.19%
RETAIL	3.46%
APARTMENT	2.73%

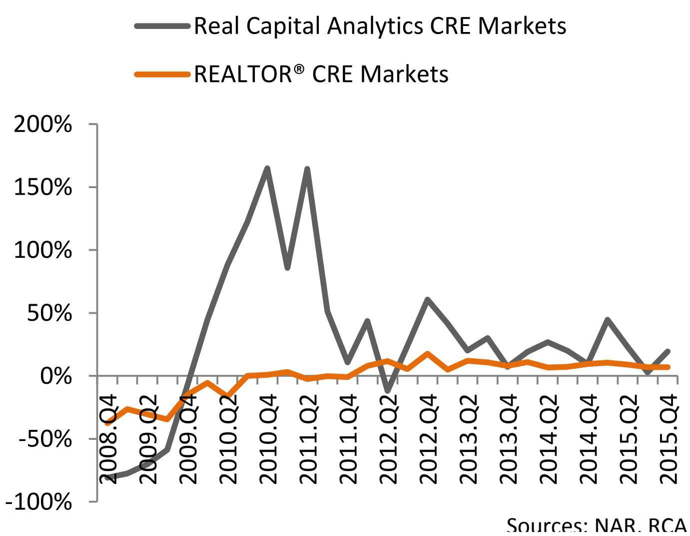
Source: National Council of Real Estate Investment Fiduciaries

Small Commercial Real Estate Markets

Commercial real estate in smaller markets continued on an upward trend during the fourth quarter, with REALTORS® reporting continued improvement in fundamentals and investment sales. The direction of commercial business opportunities during the last quarter of 2015 rose 2.8 percent from the prior quarter, but was up 19.0 percent year-over-year.

The proportion of members who closed deals in the fourth quarter of 2015 rose to 66 percent, from 63 percent in the third quarter. Sales volume rose 7.4 percent from the fourth 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 4.1 percent higher compared with the same period in 2014. The average transaction price declined from $1.9 million in the third quarter of 2015 to $1.6 million in the last quarter. A perceived pricing gap between sellers and buyers remained the second highest ranked concern.

Average capitalization rates declined to an average 7.8 percent across all property types, a 13 basis point compression on a yearly basis. Apartments posted the lowest cap rate, at 7.2 percent, followed by industrial properties with average cap rates at 7.4 percent. Office and retail spaces posted cap rates of 8.2 percent and 7.8 percent, respectively. Hotel transactions reported the highest comparative cap rates—8.6 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)

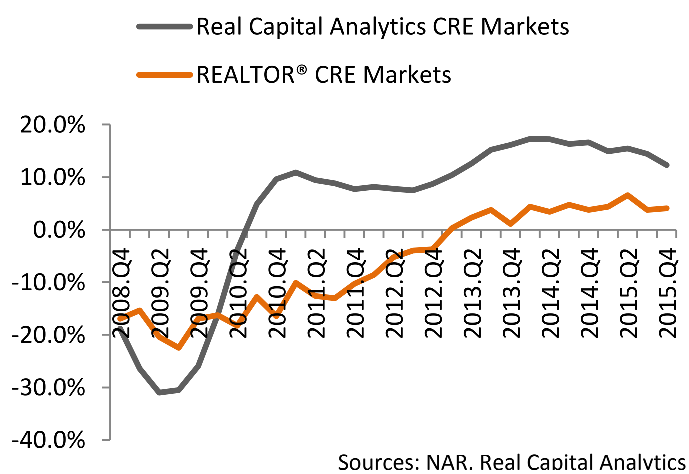
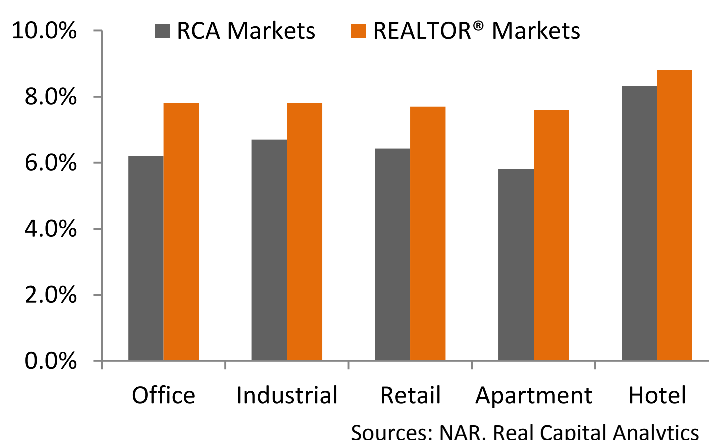
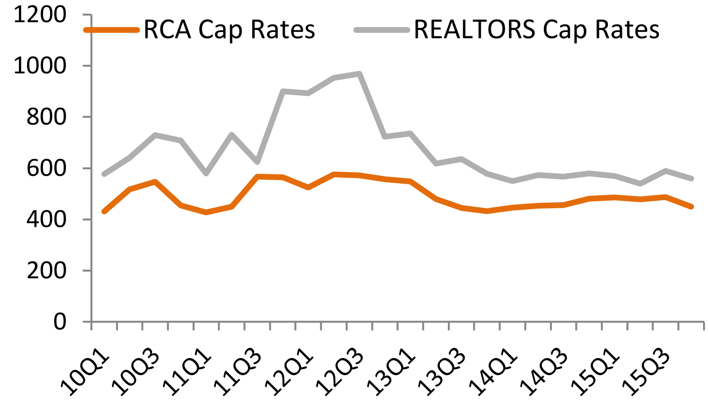


Exhibit 2.6: Cap Rates - 2015.Q4



The interest rate on 10-year Treasury Notes—a standard measure of risk-free investments—averaged 2.2 percent during the fourth quarter of 2015, higher than the first three quarters. Based on the prevailing rates, the spread between cap rates and 10-year Treasury Notes ranged from 450 basis points in LCRE markets to 560 basis points in SCRE markets. The spread indicates that CRE investors continue to enjoy healthy returns in the markets.

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

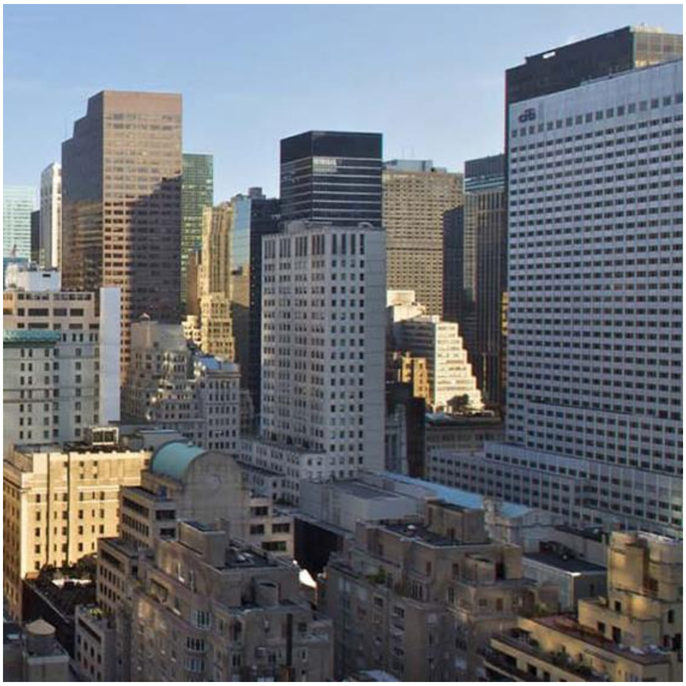
Demand for commercial leases continued rising during the fourth quarter of 2015. Construction has been growing across all property types, but the gap between demand and supply exerted downward pressure on availability.

Office net absorption totaled 18.7 million square feet in the fourth quarter of 2015, gaining strength with each consecutive quarter this year, based on data from JLL. Office space under construction totaled 88.3 million square feet in the fourth quarter, with 7.3 million square feet of new office starts. Overall office vacancies declined 40 basis points on a yearly basis, to 14.7 percent in the fourth quarter. CBD office properties continued posting lower availability than their suburban counterparts. Rents for office properties rose 2.2 percent during the fourth quarter, to $31.26 per square foot.

The industrial sector recorded stronger fundamentals in the fourth quarter, with rising demand and declining vacancies. Industrial net absorption totaled 66.3 million square feet in the fourth quarter, bringing the total for 2015 to 231.2 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 the year end at 115.0 million square feet. Demand continued outpacing supply, driving industrial vacancies down to 6.4 percent, a 14-year low, according to JLL. With a tight market, industrial rents rose 5.6 percent, to an average of $4.93 per square foot in the fourth quarter.

Demand for retail properties has picked up in tandem with rising employment and confidence. Retail tenants are expanding, leading developers to increase construction. Vacancy rates for retail buildings declined 10 basis points in the fourth quarter, to 11.2 percent, based on CBRE data. With declining availability, rents are expected to rise.

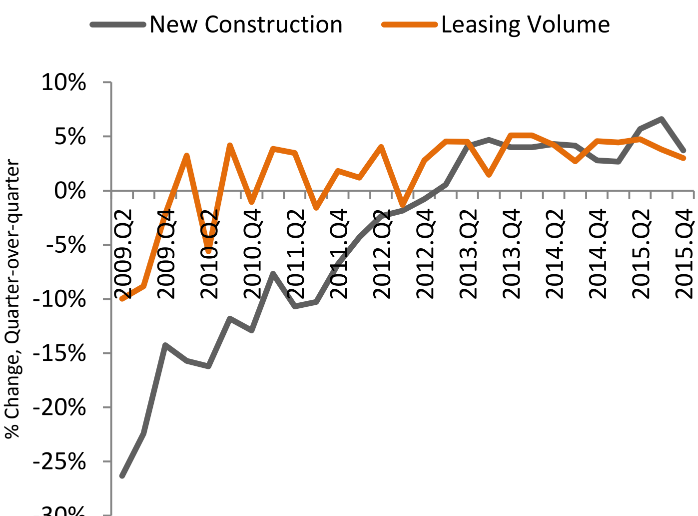
Demand for multifamily properties continued on an upward path. Renter occupied housing units totaled 42.6 million units in the fourth quarter of 2015, a 300,000 unit advance from the fourth quarter of 2014, based on U.S. Census Bureau data. National vacancy rates averaged 7.0 percent for rental housing during the fourth quarter, unchanged from the same period in 2014. Median rents for rental units averaged $850 in the fourth quarter of this year.



Small Commercial Real Estate Markets

Commercial fundamentals in smaller markets continued improving during the fourth quarter of 2015. Leasing volume during the quarter rose 3.0 percent compared with the third quarter of 2015. Leasing rates advanced at a steady pace, rising 2.5 percent in the fourth quarter, compared with the 2.5 percent advance in the previous quarter.

Exhibit 3.1: REALTORS® Fundamentals



Source: National Association of Realtors®

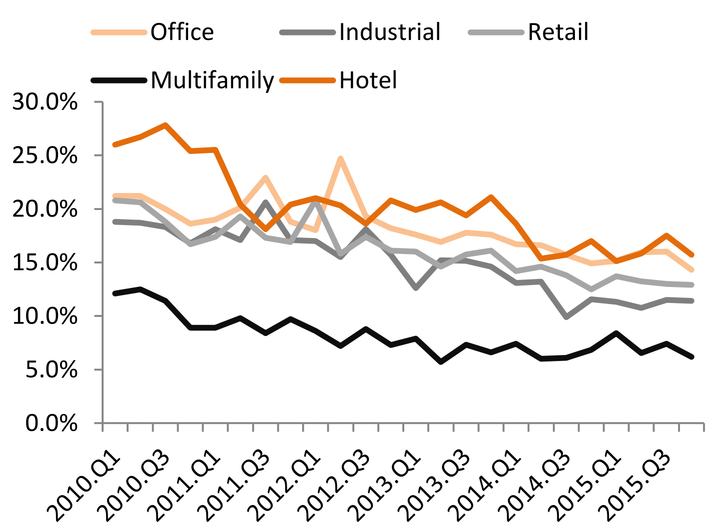
NAR members' average gross lease volume for the quarter was $743,400, 31.1 percent higher than the previous period. New construction slowed, posting a 3.7 percent gain from the third quarter of this year, compared with 6.6 percent in the prior quarter.

Tenant demand remained strongest in the 5,000 square feet and below segment, accounting for 75 percent of leased properties. Demand for space in the 10,000 – 49,999 square feet segment picked up during the fourth quarter, comprising 10 percent of total. Lease terms remained steady, with 36-month and 60-month leases capturing 59 percent of the market.

Vacancy rates varied across regional and product types in REALTORS® markets. Office vacancies declined 62 basis points, to 14.3 percent during the fourth quarter. Industrial availability reached 11.4 percent, a 17-basis point decrease on a yearly basis. Even with a soft holiday shopping season, retail vacancies declined 40 basis points, to 12.9 percent in the last quarter. As rising new supply is a concern in major markets, apartments in SCRE markets experienced availability decreases, with the national average declining 63 basis points, to 6.2 percent in the fourth quarter of 2015.

Lease concessions declined 3.1 percent. Tenant improvement (TI) allowances averaged $47 per square foot per year nationally.

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

4 | OUTLOOK

Economy

Looking ahead at 2016, the GDP annual growth rate is projected to moderate, with a 1.4 percent advance. Following what is shaping up to be a weak first quarter, economic growth is expected to pick up in the second half of 2016 to the tune of 1.6 percent in the third quarter and 2.0 percent in the fourth one. Payroll employment is projected to post 1.3 percent annual growth rate for the year. The unemployment rate is projected to fall to 4.8 percent by the end of 2016.

While the markets are concerned with the Federal Reserve's expected increases in the funds target rate, inflation remains contained. Prices are expected to rise 2.5 percent over 2016, accelerating in the latter quarters as housing costs are adding upward pressures.

In light of increased market volatility and slowing economic growth, consumer confidence has moderated and is expected to hover below its long-term average.

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

	2014	2015	2016	2017
Annual Growth Rate, %				
Real GDP	2.4	2.4	1.4	2.8
Nonfarm Payroll Employment	1.9	2.1	1.3	1.9
Consumer Prices	1.6	0.2	2.5	3.1
Level				
Consumer Confidence	87	98	96	100
Percent				
Unemployment	6.2	5.3	4.9	4.7
Fed Funds Rate	0.1	0.1	0.9	1.8
3-Month T-bill Rate	0.1	0.1	0.9	1.8
Corporate Aaa Bond Yield	4.2	3.9	4.4	5.0
10-Year Gov't Bond	2.5	2.1	2.6	3.2
30-Year Gov't Bond	3.3	2.8	3.5	4.2

Source: National Association of REALTORS®

Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

	2014.Q3	2014.Q4	2015.Q1	2015.Q2	2015.Q3	2015.Q4	2016.Q1	2016.Q2	2016.Q3	2016.Q4	2017.Q1	2017.Q2	*2015*	*2016*	*2017*
Office	15.7	14.9	15.1	15.9	16.0	14.3	14.0	13.7	13.6	13.4	13.1	12.9	*14.3*	*13.7*	*12.7*
Industrial	9.9	11.6	11.3	10.8	11.5	11.4	11.3	10.8	10.4	10.0	9.8	9.6	*11.4*	*10.6*	*9.6*
Retail	13.8	12.5	13.7	13.2	13.0	12.9	12.5	12.3	12.1	11.9	11.8	11.6	*12.9*	*12.2*	*11.5*
Multifamily	6.1	6.8	8.4	6.6	7.4	6.2	6.2	6.2	6.3	6.5	6.7	6.6	*6.2*	*6.3*	*6.7*

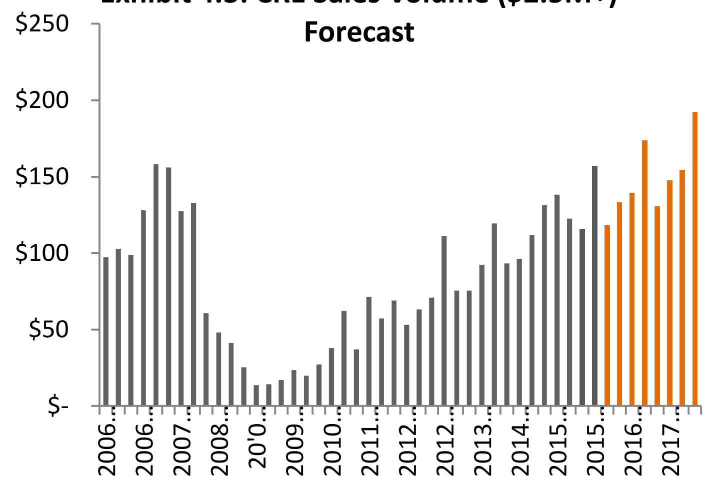
Source: National Association of REALTORS®

Commercial fundamentals are expected to improve, with vacancies continuing on a downward trend. As employment gains drive demand, office vacancies are projected to decline to 13.4 percent by the fourth quarter of 2016 and decline to 12.7 in 2017. Industrial availability is estimated to drop from an average of 11.4 percent in 2015 to 10.6 percent in 2016. Retail availability will continue shrinking, as vacancies are projected to decline from 12.9 percent in 2015 to 12.2 percent in 2016. Multifamily vacancies are expected to average 6.5 percent by the end of 2016, as new supply continues to add upward pressure on availability.

With strong fourth quarter volume, CRE investments closed 2015 on an upbeat note, moving toward the 2007 peak. In addition, January 2016 sales maintained the momentum, totaling $44.5 billion and registering the second most active January on record, according to RCA.

Given the global uncertainty and financial market gyrations, CRE is likely to remain an attractive alternative for investors this year. At the current sales pace, sales of LCRE properties are projected to total over $560 billion in 2016.

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



Source: NAR, RCA

However, after a steep upward trajectory over the past few years during which they surpassed the prior 2007 peak, CRE prices are expected to throttle back. With cap rates at very low levels and interest rates expected to rise, the price slowdown is projected to impact Class A assets in top-tier markets, where inventory shortages and crowding of capital have led to the recent run-up. Properties in smaller markets, where the recovery only began in 2013 are likely to see continued price appreciation.

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	**246.2**	**251.3**
Green St. Advisors	63.5	74.4	87.1	92.2	99.4	106.7	118.0	**115.9**	**117.8**

Sources: NAR, NCREIF, Green Street Advisors

COMMERCIAL Real Estate

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