National Association of REALTORS®

COMMERCIAL REAL ESTATE OUTLOOK: 2015.Q3

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Commercial Real Estate Outlook: 2015.Q3

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1 | ECONOMIC OVERVIEW

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Gross Domestic Product

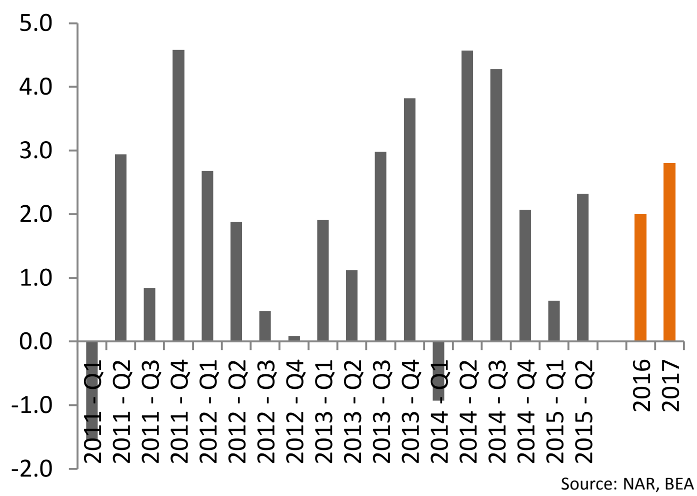
Macroeconomic conditions continued improving at a moderate pace in the second quarter of this year. Real gross domestic product (GDP) advanced at an annual rate of 2.3 percent, to $16.3 trillion, according to the Bureau of Economic Analysis. The gain remained below the long-run historical average of 3.0 percent.

The increase in GDP was driven by higher consumer spending, exports, residential fixed investment, and government spending. Consumer spending rose at an annual rate of 2.9 percent. Spending on goods—increased at an annual rate 4.8 percent—followed warmer weather and the approaching summer, with purchases of automobiles, recreational goods and vehicles, as well as clothing and shoes providing solid uplift. Consumer spending on services rose 2.1 percent on an annual basis, with financial services, transportation and health care leading the pack.

Business investments were disappointing in the second quarter, registering a 0.6 percent annual rate decline. The slide resulted from cuts in spending on equipment and commercial real estate. Business investments in structures decreased 2.6 percent on an annual basis. On the flip side, investments in intellectual property products rose at a 5.5 percent annual rate. Private residential fixed investment—home building—rose at an annual rate of 6.6 percent.

International trade provided uplift to GDP during the second quarter, as exports outpaced imports. While the balance of trade improved slightly, real net exports remained at a negative $536.3 billion.

Exhibit 1.1: Real GDP (% Annual Chg.)



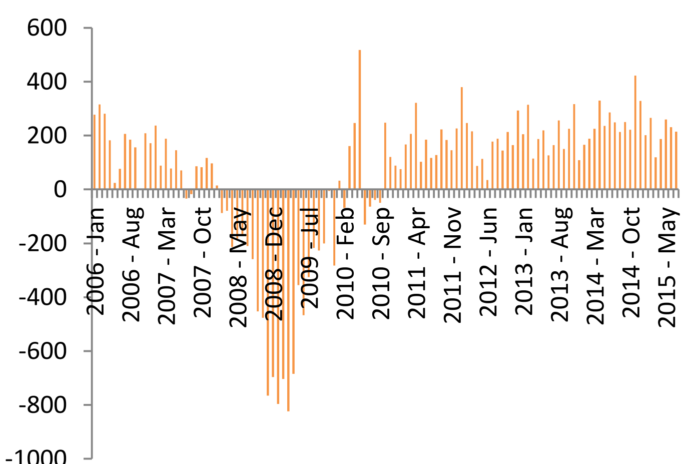
The economic impacts from government spending were mixed, with the decline in federal consumption (1.1 percent on an annual basis) being offset by increases in state and local government spending (2.0 percent on an annual basis).

Employment

Payroll employment continued rising, underpinning growing demand for commercial spaces. During the second quarter, 678,000 new employees joined payrolls nationwide, bringing the total for the first half of 2015 to 1.3 million. Median weekly earnings of private employees—adjusted for inflation—rose by 2.1 percent in the second quarter of this year, a significant improvement compared to 2014.

Private service-providing industries accounted for the majority of new jobs during the second quarter of the year. Employment in professional and business services rose by 203,000 jobs, the largest industry gain. Education and health services added 169,000 new positions, while leisure and hospitality accounted for an additional 88,000 new employees. Of particular interest for office demand, financial services and information industries added 33,000 and 13,000 new positions to payrolls during the period. With rising employment in office-using industries, higher demand for office space has been driving availability rates downward, leading to stronger fundamentals in the sector.

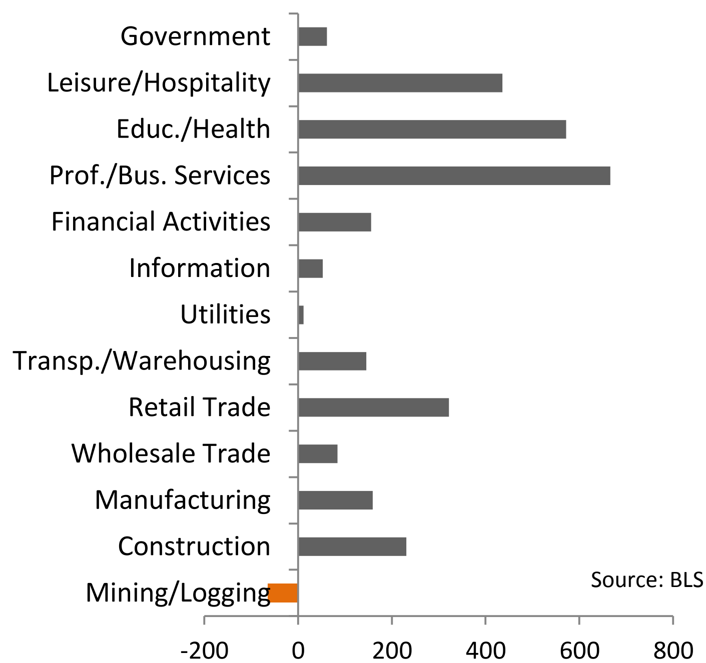
Exhibit 1.2: Payroll Employment (Change, '000)



Source: BLS

As industrial leasing has been gearing up to meet the higher demands from increased imports and stronger electronic commerce distribution volume, transportation and warehousing employment gained 39,000 new positions, and wholesale trade employment rose by 9,000 jobs during the second quarter.

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

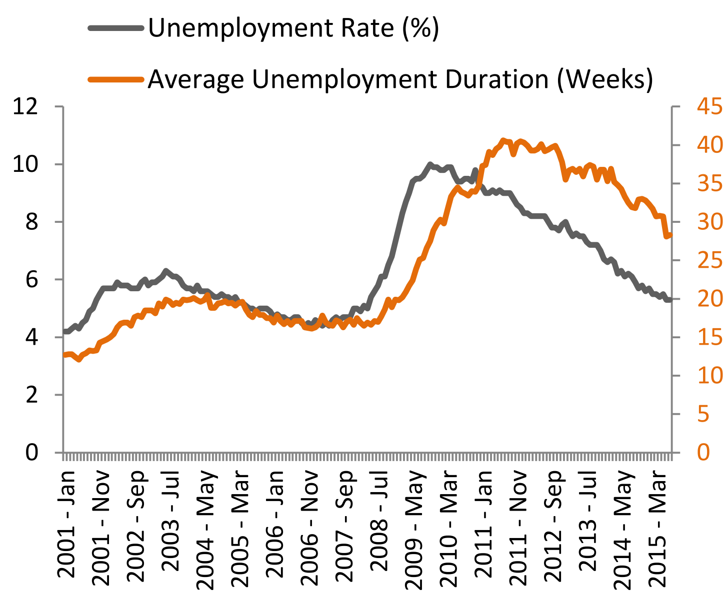


Source: BLS

The unemployment rate declined from an average 5.6 percent in the first quarter 2015 to 5.4 percent in the second quarter. The rate dropped further in July of this year, to 5.3 percent—movement in the right direction although still above the historical 5.0 percent benchmark. At the end of July there were 8.3 million unemployed Americans. The average duration of unemployment declined from 32 weeks in the first quarter to 30 weeks by the end of June 2015.

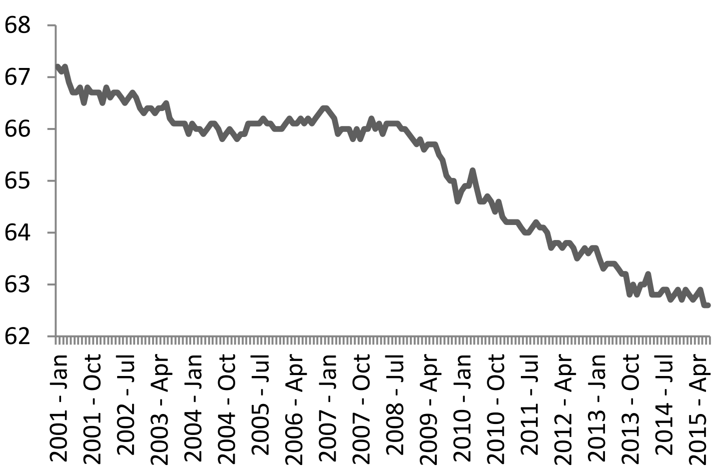
Having declined at a quick clip over the past decade, the labor force participation (LFP) rate registered a slight uptick. The LFP rate was 62.5 percent in the first quarter of 2015, and rose to 62.9 percent in the second quarter. In comparison, before the Great Recession the LFP rate was 65.9 percent. The decline in the LFP rate has been a factor in holding back the economic expansion as Baby Boomers have continued to retire and some discouraged workers have not returned to the labor force. Currently, 92.3 million Americans are not in the labor force, of which 6.4 million were estimated to want a job; this is in addition to the 8.5 million Americans currently in the labor force but unemployed.

Exhibit 1.5: Unemployment



Source: BLS

Exhibit 1.4: Labor Force Participation Rate



Source: BLS

Consumer confidence, as measured by The Conference Board, declined from 101.3 in the first quarter of this year to 96.2 in the second quarter. While it remains the second highest level since the third quarter 2007, it pointed to a slump in consumer expectations going forward. Separately, the Consumer sentiment index compiled by the University of Michigan also registered a slight decline from 95.5 in the first quarter of 2015 to 94.2 in 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).

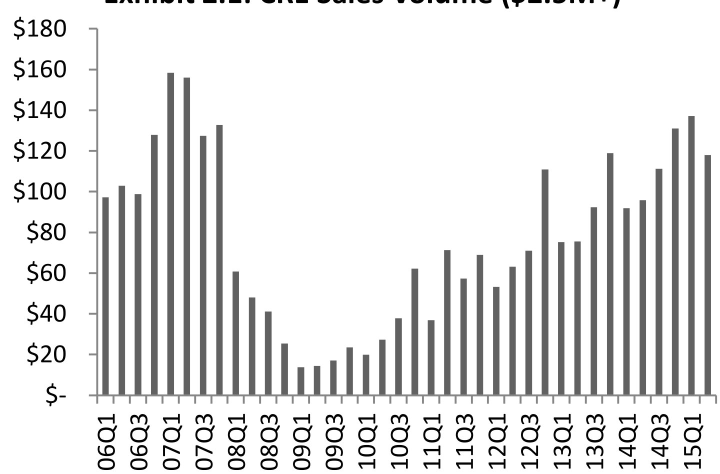
Commercial sales transactions span the price spectrum, but tend to be measured and reported based on size. CRE deals at the higher end—$2.5 million and above—comprise a large share of investment sales, and generally receive most of the press coverage. Smaller commercial transactions tend to be obscured given their size. However, these smaller properties provide the types of commercial space that the average American encounters on a daily basis—e.g. 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 been riding a growing wave of capital over the past six months. The volume of commercial sales in LCRE markets totaled $255 billion, a 36 percent year-over-year increase, according to Real Capital Analytics (RCA). The second quarter data indicated a slight slowdown in deal momentum for LCRE markets, as the yearly sales growth of 23 percent was noticeable slower than the first quarter's 49 percent.

In a sign of increasing investor optimism, portfolio transactions have been increasing, accounting for 22 percent of total in the first half of 2015. In comparison, portfolio transactions comprised 18 percent of the first half of 2014 volume. Individual transactions remained the largest group, accounting for 67 percent of sales volume in the first six months of this year.

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

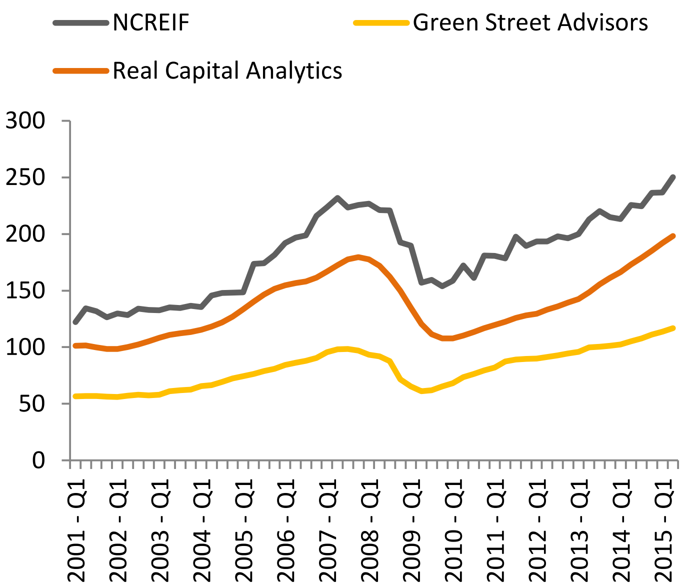


Source: Real Capital Analytics

[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 3.1 percent during the second 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



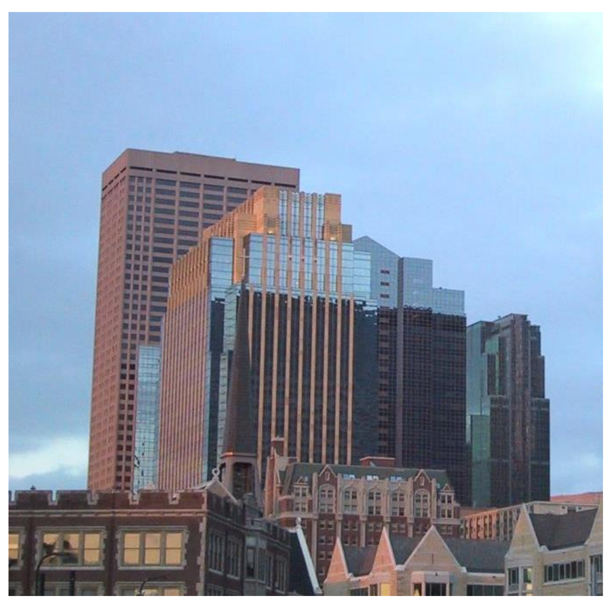
Separately, additional price indices reflected the strong gains in commercial valuations. The Green Street Advisors Commercial Property Price Index rose 11 percent in the second quarter, reaching a value of 117, the highest since the index's inception in 1998. The National Council of Real Estate investment Fiduciaries (NCREIF) Price Index also rose 11 percent year-over-year in the second quarter of 2015, to its highest recorded value—250.

Capitalization rates for transactions in LCRE markets averaged 6.7 percent in the second quarter, based on RCA reports. Transactions of office properties in CBD markets recorded the lowest cap rates, at 5.6 percent, followed by apartment, at 6.0 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 second quarter.

Exhibit 2.3: NCREIF Property Index Returns—2015.Q2

NATIONAL	3.14%
OFFICE	3.11%
INDUSTRIAL	3.78%
RETAIL	2.98%
APARTMENT	2.98%

Source: National Council of Real Estate Investment Fiduciaries

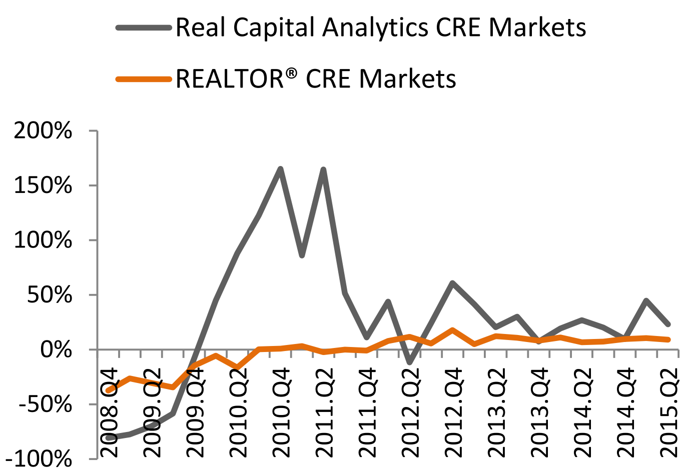


Small Commercial Real Estate Markets

In SCRE markets sales also advanced, with REALTORS® reporting rising investment volume. Sales of commercial properties during the second quarter rose 9.0 percent on a year-over-year basis. For the first half of the year, sales in REALTORS®' markets advanced 11.0 percent year-over-year.

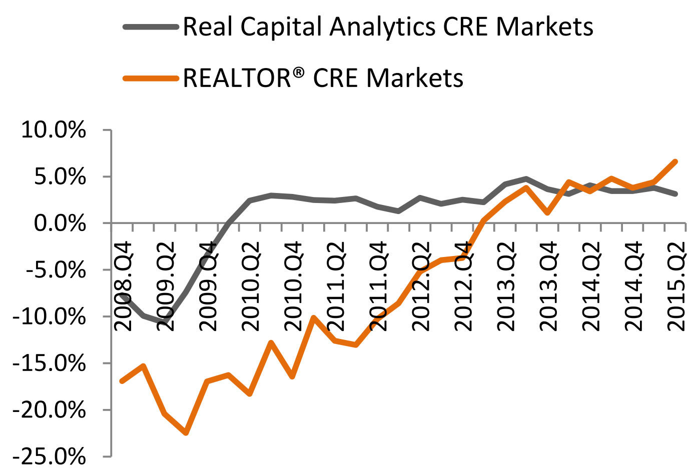
Capitalization rates in REALTORS®' CRE markets declined to an average of 7.5 percent across all property types, an 85 basis point decline on a yearly basis. Apartments posted the lowest cap rate, at 6.8 percent, followed by hotel properties with average cap rates at 7.4 percent. Office and industrial spaces posted cap rates of 7.7 percent and 7.5 percent respectively. Retail transactions reported the highest comparative cap rates—8.0 percent.

Exhibit 2.4: Sales Volume (YoY % Chg)



Sources: NAR, RCA

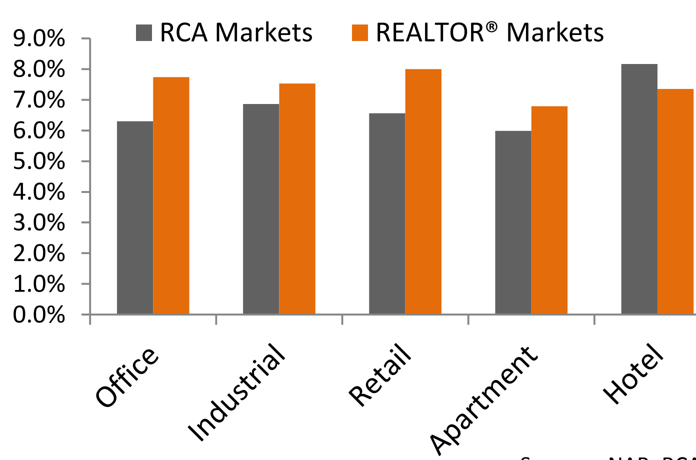
Exhibit 2.5: Sales Prices (YoY % Chg)



Sources: NAR, RCA

With the shortage of available inventory reported as the number one concern for NAR members, price growth accelerated in SCRE markets during the second quarter of 2015, with properties trading at 6.6 percent higher average prices compared with the same period in 2014. The average transaction price increased from $1.7 million in the first quarter 2015 to $2.0 million in the second quarter 2015.

Exhibit 2.6: Cap Rates

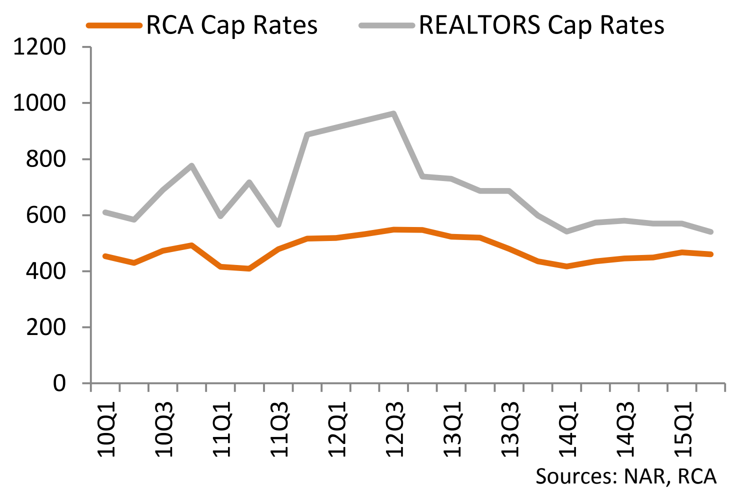


Sources: NAR, RCA

The interest rate on 10-year Treasury Notes—a standard measure of risk-free investments—averaged 2.1 percent during the second quarter of 2015, unchanged from the first quarter. Based on the prevailing rates, the spread between cap rates and 10-year Treasury Notes ranged from 462 basis points in LCRE market to 542 basis points in SCRE markets. The large spread denotes that CRE investors continue to enjoy healthy returns in rebounding markets.

With some investors concerned about the Federal Reserve hinting at a hike in the target rate during the latter half of this year, the impact on the CRE sector is likely to be minimal. The Fed's funds rate is essentially a short-term rate, whereas most CRE debt is longer termed. With the Fed's "forward guidance" having increased expectations through communications, the initial rate increase has likely been already capitalized in market prices. In addition, with spreads exceeding 400 basis points, CRE investors retain a healthy cushion, as cap rates are not likely to change dramatically in the short term.

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



3 | COMMERCIAL REAL ESTATE FUNDAMENTALS

Large Commercial Real Estate Markets

Demand for commercial lease space continued advancing in the second quarter of 2015, rebounding from the soft performance of the wintry first quarter. While construction has been ramping up across all property types, the gap between demand and supply continued to add downward pressure on availability. The apartment sector was the only exception, as new supply exceeded demand this year, resulting in a slight increase in vacancies.

Office net absorption totaled 14.4 million square feet in the second quarter of 2015, up from the weaker first quarter's 6.3 million square feet, based on data from JLL. Compared with 20.7 million square feet absorbed in the first half of the year, new completions totaled 15.5 million square feet over the period. Overall office vacancies declined from 15.6 percent in the first quarter to 15.3 percent in the second quarter. Based on JLL's research, office vacancies are expected to drop below 15.0 percent by the end of this year. Rents for office properties rose 2.5 percent over the first six months of 2015, leading to projections that—at the current demand pace—they will close the year higher by 5.0 – 6.0 percent from 2014.

Industrial space net absorption continued rising, totaling 102.9 million square feet in the first half of this year, based on JLL data. Warehouse and distribution account for the bulk of the demand (87.8M sq. ft.), followed by manufacturing (13.5M sq. ft.). Supply also rose, with new industrial completions adding 83.6 million square feet to total stock. With demand outpacing supply, industrial vacancies declined to 6.9 percent, a 14-year low, according to JLL. With a tight market, industrial rents rose 5.1 percent.

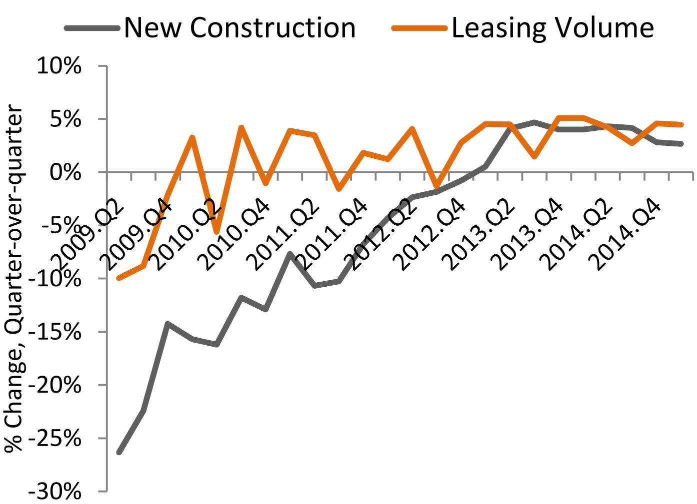
Retail demand has been outpacing supply over the first six months, but the pace lags the other property types. According to JLL, national vacancies reached 5.9 percent in the second quarter of 2015, driving retail rents higher by 1.2 percent.

Demand for multifamily properties continued on an upward path. Renter occupied housing units totaled 42,878 units in the second quarter of 2015, a 4.9 percent advance from the second quarter of 2015, based on U.S. Census Bureau data. National vacancy rates averaged 6.8 percent for rental housing during the second quarter, 70 basis points lower than the same period in 2014. Median rents for rental units averaged $803 in the second quarter of this year, 6.2 percent higher than the previous year.

Small Commercial Real Estate Markets

Fundamentals in REALTORS®' CRE markets moved in tandem with the broad markets during the second quarter 2015. Leasing volume during the second quarter rose 5.0 percent compared with the first quarter 2015. Leasing rate growth remained steady, rising 3.0 percent in the second quarter, compared with the 3.0 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 $629,000. New construction accelerated, posting a 6.0 percent gain from the first quarter of this year, a pace doubled the 3.0 percent rise recorded in the first quarter 2015.

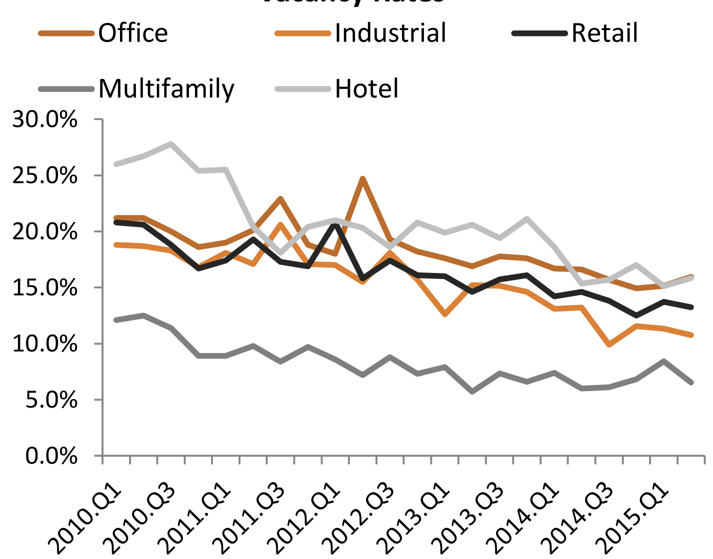
Tenant demand for REALTORS®' clients remained strongest in the 5,000 square feet and below, accounting for 84.0 percent of leased properties. Lease terms were steady, with 36-month and 60-month leases capturing 60.0 percent of the market.

Vacancy rates mirrored the regional and product variations REALTORS® markets, with most properties posting availability declines. With rising new supply, apartments experienced availability increases, as the national average rose from 6.0 percent in the second quarter of 2014 to 6.6 percent in the second quarter of this year.

Office vacancies declined 65 basis points to 15.9 percent compared with a year ago. Industrial availability posted the largest year-over-year decline—246 basis points—to 10.8 percent. Retail vacancies declined 137 basis points on a yearly basis, to 13.2 percent.

Lease concessions declined 8.0 percent. Tenant improvement (TI) allowances averaged $10 per square foot per year nationally. In keeping with higher vacancies, office properties recorded the highest TI rates at $17 per square foot per year. Apartments posted the lowest TI rates—$3 per square foot per year.

Exhibit 3.2: REALTORS® Commercial Vacancy Rates



Source: National Association of Realtors®

4 | OUTLOOK

Economy

Looking ahead at the second half of this year, GDP annual rates of growth for the third and fourth quarter are projected to reach 2.7 percent and 2.9 percent, respectively. Payroll employment is projected to remain at a steady 1.8 percent annual growth rate for both remaining quarters. The unemployment rate is projected to fall to 5.2 percent by the last quarter of the year.

While the markets are watching the Federal Reserve's actions in regards to the funds target rate, inflation remains contained. However, with the rental component rising at a faster pace, consumer prices are expected to rise. Expectations are that the Fed Funds rate will exceed 1.0 percent in 2016.

Consumer confidence has moderated at the midpoint of the year. Continuing gains in employment and wages should provide additional lift to the trend line.

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

	2013	2014	2015	2016
Annual Growth Rate, %				
Real GDP	2.2	2.6	2.0	2.8
Nonfarm Payroll Employment	1.7	1.9	1.9	2.0
Consumer Prices	1.5	1.6	0.2	3.2
Level				
Consumer Confidence	73	87	98	99
Percent				
Unemployment	7.4	6.1	5.4	5.2
Fed Funds Rate	0.1	0.1	0.2	1.2
3-Month T-bill Rate	0.1	0.1	0.2	1.4
Corporate Aaa Bond Yield	4.3	4.2	4.0	4.9
10-Year Gov't Bond	2.6	2.6	2.3	3.0
30-Year Gov't Bond	3.4	3.4	3.0	3.9

Source: National Association of REALTORS®

Commercial Real Estate

Exhibit 4.2: Commercial Real Estate Vacancy Forecast (%)

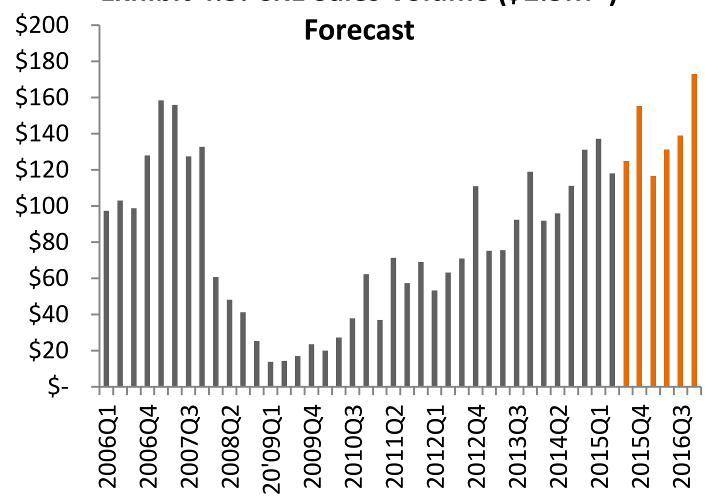
	2014.Q3	2014.Q4	2015.Q1	2015.Q2	2015.Q3	2015.Q4	2016.Q1	2016.Q2	2016.Q3	2016.Q4	2014	2015	2016
Office	15.7	14.9	15.1	15.9	15.8	15.5	15.3	15.1	14.9	14.8	16.0	*15.6*	*15.0*
Industrial	9.9	11.6	11.3	10.8	10.3	9.8	9.4	9.0	8.5	8.4	12.0	*11.7*	*8.8*
Retail	13.8	12.5	13.7	13.2	13.0	12.7	12.3	12.1	11.9	11.6	13.8	*13.2*	*12.0*
Multifamily	6.1	6.8	8.4	6.6	6.7	6.6	6.6	6.6	6.6	6.7	6.6	*7.1*	*7.1*

Source: National Association of REALTORS®

Fundamentals are projected to continue strengthening, as vacancies decline. With rising demand, office vacancies are projected to average 15.8 percent during 2015 and decline to 15.5 in 2016. Industrial vacancies are estimated to drop from an average of 11.7 percent in 2015 to 11.3 percent in 2016. Retail availability will continue shrinking, but at a slower pace. Retail vacancies are likely to decline from 13.8 percent in 2015 to 13.4 percent in 2016. Multifamily vacancies are expected to average 7.2 percent in 2015 and 7.0 percent in 2016, with availability on an upswing due to stepped-up new construction.

With capital availability continuing to improve and sources broadening, commercial real estate 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, and during 2016 move within striking distance of prior 2007 peaks, reaching $560 billion.

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



Source: NAR, RCA

Prices are poised to continue their strong advance in the latter half of 2015, as shortage of inventory and capital liquidity collide. Price growth is expected to moderate in 2016, as interest rates are likely to rise.

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	**249.8**	**249.0**
Green St. Advisors	86.1	63.5	74.4	87.1	92.2	99.4	106.7	**117.5**	**115.5**

Sources: NAR, NCREIF, Green Street Advisors

COMMERCIAL Real Estate
NATIONAL ASSOCIATION of REALTORS®

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