Special Report
Emerging Trends

Fourth Quarter 2016

Real Estate Investors Re-Evaluate Transactions Amid Shifting Landscape; Strong Performance Supports Extended Outlook

Unforeseen events tap the brakes of the investment market. The unanticipated results of the presidential election sparked a shift in several macro-level dynamics that have begun to ripple through the commercial real estate market. A rapid 60-basis-point increase in the yield on the U.S. 10-year Treasury followed the election, combining with expectations of changes to the tax code in 2017 to inspire many commercial real estate investors to step back and reassess their strategies. Some transactions that were targeting a 2016 close will likely be delayed or canceled as investors and lenders recalibrate their underwriting assumptions. Typically the fourth quarter constitutes 28.2 percent of the annual commercial real estate transactional activity, and last year a record 15,350 transactions pricing for more than $1 million in the four main property types were closed in this period. The unexpected result of the election and its implications will likely downshift transaction activity this year.

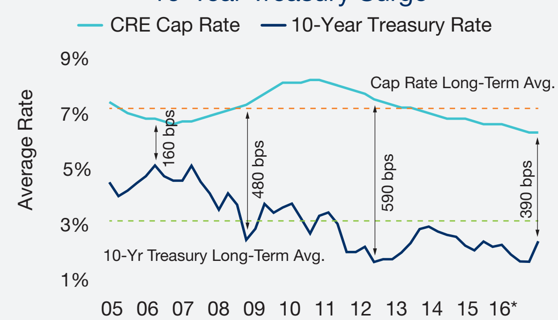
Sales of investment properties hit a post-recession high last year. Commercial real estate sales had already shown signs of moderating from the peak levels set in 2015, but the rapidly evolving 2017 outlook under a new president has added an additional element of uncertainty for some investors. Prospective modifications to fiscal, monetary, regulatory and trade policies brought on by the new administration could hold significant implications for investors in commercial real estate. While the expected changes are not likely to dramatically impact the underlying drivers that are supporting commercial real estate performance, an anticipated increase in the cost of capital and potentially substantive tax consequences were sufficient for many to reconsider the deals currently in process.

Prospects for strong property performance remain intact. The proposed policy changes of the new administration have inspired numerous economists to boost their growth forecasts for 2017, which bodes well for commercial real estate performance and fundamentals. However, the strengthened economic outlook, together with prospects of a more aggressive Federal Reserve acting to normalize monetary policy, combined to quickly boost the value of the U.S. dollar versus foreign currencies in the aftermath of the election. This 4.1 percent rise in the dollar added a near-term hurdle for foreign investors, who must now reassess any transactions they had in process. Although foreign capital comprises a relatively small portion of the U.S. commercial property buyer pool, a temporary pullback in activity by these investors because of their loss of purchasing power could influence total transactional counts for the fourth quarter and affect asset pricing.

Executive Summary

- A sharp increase in the yield on the 10-year U.S. Treasury, along with expectations of changes to the tax code in 2017, encouraged many investors to reassess their strategies. The shifting landscape will likely reduce transaction activity in the fourth quarter compared with 2015.
- Even assets in secondary and tertiary markets have faced renegotiation as the rising cost of capital forced many to recalibrate their yield expectations and reconsider closing, widening the bid/ask spread.
- Liquidity remains in commercial real estate capital markets, although the rise in the 10-year U.S. Treasury will increase rates for borrowers. Overall, lenders are exercising more caution and tightening LTVs.
- The Federal Reserve will continue to monitor the impact of new fiscal policies and could make more frequent and aggressive rate increases.
- A strengthened economic outlook and positive performance outlook will support long-term commercial real estate investor demand.

Yield Spread Tightens Amid 10-Year Treasury Surge



* Through November 30

Several Factors Slowing Transaction Volume in 4Q; Uncertainty Persists for Investors

The anticipated pullback in fourth quarter commercial real estate closings from last year's record levels reflects uncertainty surrounding a variety of changes. It is probable that the slowdown will be modest and many of the transactions will simply be delayed rather than canceled, but the final outcome could take several months to evolve.

Rising Interest Rates: After averaging 1.64 percent for the six months leading up to the election, the yield on the 10-year Treasury jumped to the 2.4 percent range in November, the highest level since mid 2015. Most lenders held their spreads steady through this increase, passing the additional cost of capital on to borrowers. For some investors, particularly those using leverage to buy high-quality assets in gateway markets with cap rates in the 4 percent range, this rate movement dramatically eroded the effective yield of the assets, forcing a complete re-evaluation of the assets' investment potential. For other investors, this change in the cost of capital represented an opportunity to re-trade deals in an attempt to gain greater concessions from sellers who have yet to reconsider their expectations on cap rates and pricing. Even higher-yield assets in secondary and tertiary markets have faced renegotiation as the rising cost of capital forced many to recalibrate their yield expectations and reconsider closing. This has resulted in a widening of the already present bid/ask spread that emerged in the beginning of 2016.

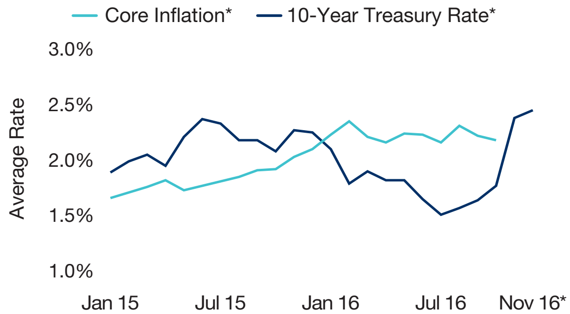
Taxes and Fiscal Policy: President-elect Trump's vow for comprehensive corporate and individual tax reform could hold far-reaching implications for commercial real estate investment. The proposed tax code modifications under a Trump plan could substantively reduce taxes for some investors. Unfortunately, many details of the proposed changes have yet to be defined, let alone implemented, but some investors have stepped back from deals to await further clarity. Some of the proposed changes such as a reduction in capital gains taxes, a lowering of corporate tax rates and reductions in the number of personal tax brackets could have significant implications for investors. Other changes, such as the elimination of the carried interest loophole, could affect specific segments of investors, including developers and some investor syndicates. Fiscal policies centered upon reduced taxes could accelerate short-term economic growth and intensify inflationary pressure. The Federal Reserve will continue to monitor the impact of fiscal policy on economic trends and could initiate a campaign of more frequent and aggressive rate increases to prevent the economy from potential overheating.

Other factors: Investors, lenders and property owners can make sound judgments on interest rates and fiscal policy, but other factors must also be considered before uncertainty eases. These include:

- Understanding the effects of potential trade policies that restrict the flow of U.S. goods to foreign markets. Stringent policies could reduce the commercial space needs of companies involved in international commerce. These include warehousing and transaction clearing.

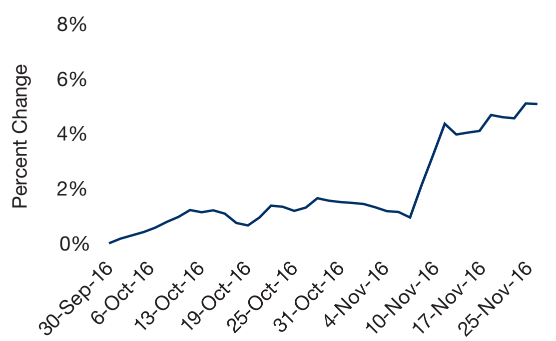
- Potential reform of the Dodd-Frank financial market regulations holds implications for the operation of the CMBS market and could also affect lending activity and risk appetites of other debt providers.

10-Year Treasury Sees Postelection Surge



10-Year Treasury Low By Historical Standards

U.S. Dollar Climbs Rapidly



* Treasury rate through Dec. 1, 2016; Core inflation through Oct. 2016

Drivers of Property Performance Strong; 2017 Outlook Positive

Against the backdrop of higher long-term interest rates and an evolving economic landscape, U.S. commercial property sectors are performing well. A steady decline in vacancy rates for the major property types has been a hallmark of the current cycle, while construction lenders have effectively guarded against potential overbuilding. The 2017 economic outlook points to another positive year for apartment, retail, industrial and office properties, but emerging trends in government policies and global markets will encourage investors to become more tactical in their buying decisions.

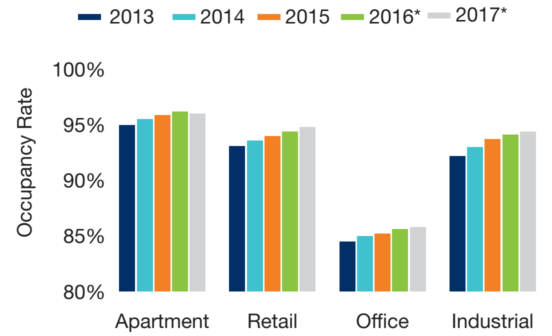
Apartment: Consistent hiring and robust household formation will drive demand for apartments, particularly as the 80 million strong millennial cohort comes of age. Nearly 70 percent of 20- to 34-year-olds live in rental housing, and the population in this age group will increase by 1.4 million over the next five years, a positive trend for multifamily property performance. Apartment construction was elevated throughout 2016 and will continue in 2017 with the delivery of 370,000 new units, with about half of that total in just 10 markets. Projected completions in 2017 will likely mark the peak of the current building cycle. Though submarket level performance will vary, the supply influx will not disrupt the broad-based performance momentum of the sector. The U.S. vacancy rate is expected to close the year at 3.8 percent and then rise nominally in 2017.

Industrial: Led by the expanding warehouse needs of e-commerce tenants, the industrial sector remains in a growth cycle and is highly favored by investors. Low inflation and rising incomes are fueling growth in retail sales and generating new warehouse and distribution needs. This trend has been enough to overcome a surge in development and maintain the U.S. vacancy on course to fall to 5.9 percent in 2016, the lowest level in 16 years. In 2017, the vacancy rate will tighten further to the mid-5 percent range. The possibility of protectionist trade policies, though, could restrain industrial asset performance, particularly in port markets, but a potentially strengthening dollar that reduces the cost of imported goods could partially offset this trend.

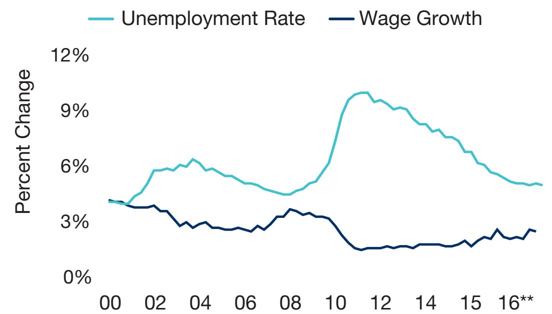
Office: Job gains in office-using employment sectors are maintaining office space demand and generating new requirements for larger offices. A key factor behind asset performance is subdued development, which will support a continued downtrend in the national vacancy rate to 14.4 percent in 2016. The limited construction pipeline will amplify the effects of even small increases in space demand and contribute to a decline in the national vacancy rate next year to 14.2 percent, providing encouragement for additional investment.

Retail: Rising wages will lift per capita discretionary income and spur additional spending on retail goods, generating new retail space demand amid a period of limited construction. In 2016 and 2017 combined, only 104 million square feet of space will come online, comprising primarily pre-leased single-tenant formats. Restaurants and non-retail tenants including healthcare and personal services are emerging as strong generators of traffic at shopping centers and are driving property owners to reconsider tenant mixes. This year, net absorption of 85 million square feet will trim U.S. retail vacancy 40 basis points to 5.6 percent. Additional growth in space demand will underpin a reduction in the vacancy rate in 2017 to 5.2 percent and sustain investment activity.

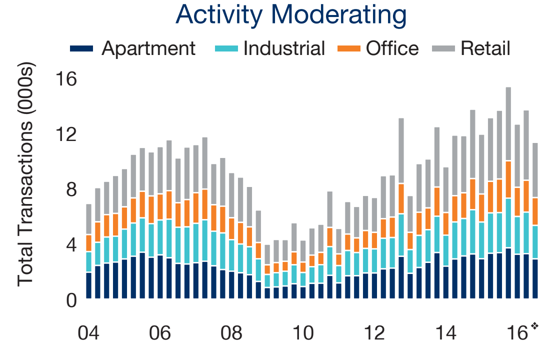
Commercial Real Estate Occupancy



Full Employment Beginning To Push Wage Growth

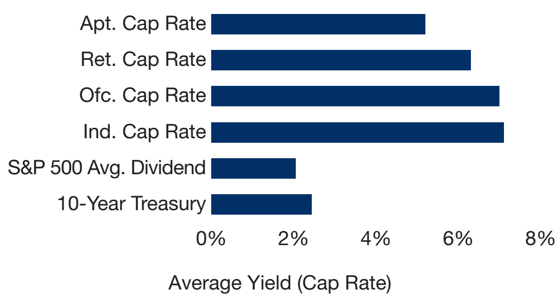


Commercial Real Estate Activity Moderating

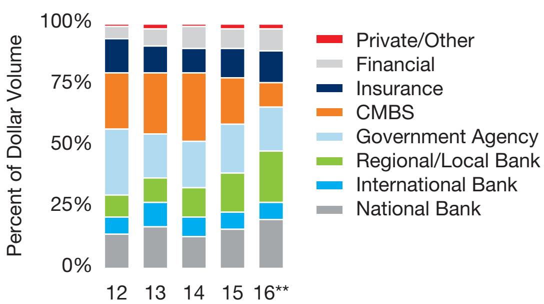


* Forecast
** Wage growth through 3Q; unemployment rate through Oct.
♦ Through 3Q, 2016 Estimate

Commercial Properties Offer Compelling Yields*



U.S. Commercial Real Estate Lender Composition



* As of Dec. 1, 2016
** Through 2Q; Includes apartment, retail, office, industrial and hotel properties $2.5 million and greater

Capital Markets

Moderate economic growth and muted inflation over the last 8 years allowed the Federal Reserve to hold off on rate hikes. However, the Trump administration's plans built on fiscal stimulus and reduced taxes could accelerate economic growth and encourage the Federal Reserve to quicken the pace and aggressiveness of its efforts to raise its short-term benchmark.

Banks and other providers of debt financing remain active, though the rise in the 10-year U.S. Treasury will increase borrowing rates. Overall, lenders are exercising more caution and tightening LTVs. In the CMBS market, issuance will likely be lower in 2016, reflecting market volatility early in the year and uncertainty regarding the implementation of risk-retention rules specified under the Dodd-Frank set of regulations. The first CMBS offerings written under the new Dodd-Frank risk-retention rules were issued last summer and comprised a relatively low risk pool of loans issued at low LTVs. The offerings were well received and provide a blueprint for future deals.

The administration's plans to roll back regulations have implications for real estate capital markets. Under this scenario, a significant revision of the Dodd-Frank reforms is probable. The risk-retention requirements affecting the mortgage bond market will likely survive in some form, and a potential lifting of restraints on some financial institutions could create additional lending capacity.

Construction lenders are also exercising considerable discretion, critically assessing the experience of development teams and closely scrutinizing return projections before financing new projects. The more conservative stance by lenders has already curbed potential overbuilding during this cycle, but greater caution in 2017 will provide a yet stiffer defense at a point when overbuilding risks often intensify.

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