Second Quarter 2013 Commercial Real Estate Investment Outlook

Investor confidence hits record high

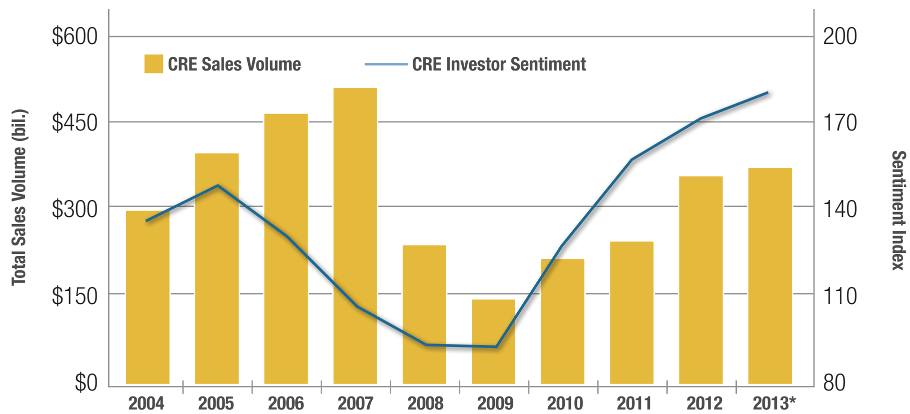
Enthusiasm defies obstacles such as higher taxes, sequestration and rising interest rates.

Investor confidence notched steady gains in the first half of 2013. The latest results from an exclusive investor survey conducted jointly by *National Real Estate Investor* and Marcus & Millichap shows a continued positive outlook for property performance and a strong appetite to increase investment over the next 12 months.

The NREI/Marcus & Millichap Investor Sentiment Index reached a new record high climbing from a mark of 174 in the first quarter of 2013 to 180 in the second quarter—the highest level since the index launched in 2004 **[Figure 1].** The current reading also is nearly double the mark of 91 that was achieved at the low point of the Great Recession in 2009.

"That is a tremendous sign of confidence and increased enthusiasm for commercial real estate. It validates the theme of improving fundamentals combined with very competitive yields, as well as the opportunity to lock-in still low interest rates ahead of the true recovery cycle for most property types," says Hessam Nadji, Chief Strategy Officer and Director of Specialty Groups at Marcus & Millichap Real Estate Investment Services in Calabasas, Calif. The Investor Sentiment index measures investors' views on anticipated changes in property values and plans to increase or decrease total real estate holdings in the coming year. Above 100 indicates a positive outlook.

FIGURE 1. INVESTOR SENTIMENT INDEX HAS ALSO BEEN A STRONG INDICATOR OF CRE CAPITAL FLOWS



** Forecast*

2012 investor sentiment index: 171; 2Q 2013 investor sentiment index: 180 Includes all apartment, office, retail and industrial sales $1 million and greater. Sources: Marcus & Millichap Research Services, CoStar Group, Inc., M&M/NREI Investor Survey

Investors have not been deterred by the recent rise in interest rates. Yields on 10-year Treasury notes have ticked up from 1.8 percent in May to around 2.6 percent as of mid July. In spite of this, the majority of survey respondents (62 percent) said they plan to increase their commercial real estate investment in the next 12 months. An additional 20 percent expect investments to remain the same. Only 3 percent expect their real estate portfolio to decrease over the next year, while 15 percent were unsure or had no answer. Among respondents who expect their real estate investment to increase, an average 21 percent increase is predicted.

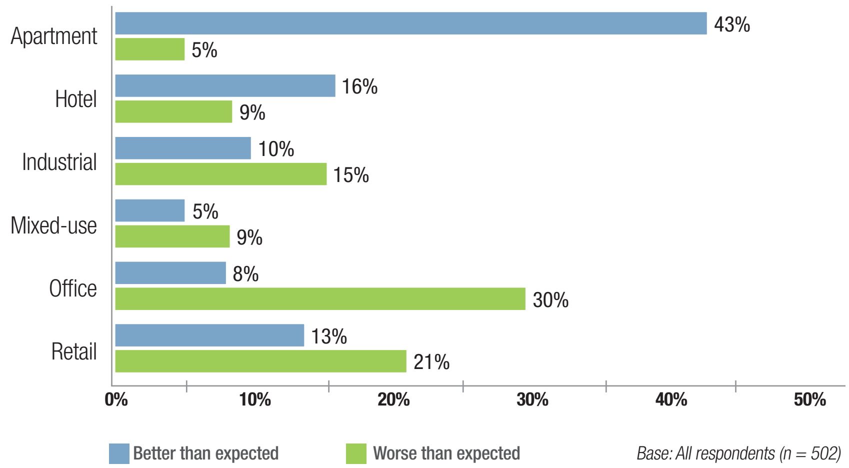
That is not to say that rising interest rates is not a significant concern. Certainly, there is a real risk that measurably higher rates from current levels could lead to price uncertainty and a decrease in investment sales activity. Yet those concerns are offset by improving fundamentals.

Survey Methodology

In April 2013 and May 2013, National Real Estate Investor's research unit and Marcus & Millichap emailed invitations to participate in an online survey to public and private investors and developers of commercial real estate. Recipients of the survey included Marcus & Millichap clients as well as subscribers of NREI selected from commercial real estate investor, pension fund, and developer business subscribers who provided their email addresses. The majority of respondents are private investors (33%), developers (18%) and private partnerships (16%) with an average of $41.1 million invested in commercial real estate. REITs and institutional investors represent 6% of all respondents. The survey yielded 502 valid responses.

FIGURE 2. PROPERTY SECTOR PERFORMANCE

Which property sector performance has most surprised you over the past 24 months?



"Investors are still bullish on commercial real estate, despite increases in interest rates, because the fundamentals are likely to improve now at a more rapid pace," says Nadji. Investor reaction to rising interest rates also may be tempered by the timing of the survey.

Confidence starts to expand

Apartments have been the clear leader in the commercial real estate recovery and are still a strong favorite among investors. Overall, 43 percent of respondents said that apartments performed better than expected over the past 24 months. At the opposite end of the spectrum, respondents were most surprised that retail and office performed worse than expected over the past two years at 21 percent and 30 percent, respectively **[Figure 2].**

Those results are not surprising given the stellar fundamentals among apartment properties in terms of strong occupancies and rent growth, and the challenges that both the office and retail sectors have faced related to high vacancies and discounted rents. However, there are clear signs that investor sentiment on individual property types is beginning to shift with a more positive outlook for recovery in other property types.

For the first time since 2009, fewer than half of apartment investors consider now the time to buy more apartments. In the current survey, 42 percent of respondents believe now is the time to buy more apartments, while 31 percent believe now is the time to hold and 26 percent believe now is a good time to sell. That is a significant drop compared to the 72 percent of respondents who believed it was a good time to buy apartments two years ago, and even a notable decline compared to first quarter when 55 percent of respondents said it was still a good time for acquisitions.

That pullback is likely due to the increased demand and cap rate compression for apartment properties. "It is becoming more expensive to buy. So the enthusiasm to buy is waning a little bit, while the appetite for other property types at higher cap rates is rising," says John Sebree, national director of the National Multi Housing Group at Marcus & Millichap. Because apartments are ahead of all of the other property types, their rent growth expectations are beginning to slow, while all other property types are now going into a period of improving rental growth rates.

In addition, survey results indicate that investors are already looking ahead to the possibility of a new development cycle in the next two to three years. Nearly half of respondents (49 percent) who already own land believe now is the time to buy more. **[Figure 3].**

Values continue to rise

Investors have very strong expectations that both occupancies and rents will continue to rise across property types in the coming year. Despite gains already achieved, apartments remain firmly at the front of the pack. A majority of respondents—76 percent—expect apartment values to increase in the coming year with an average increase in values of 6.5 percent.

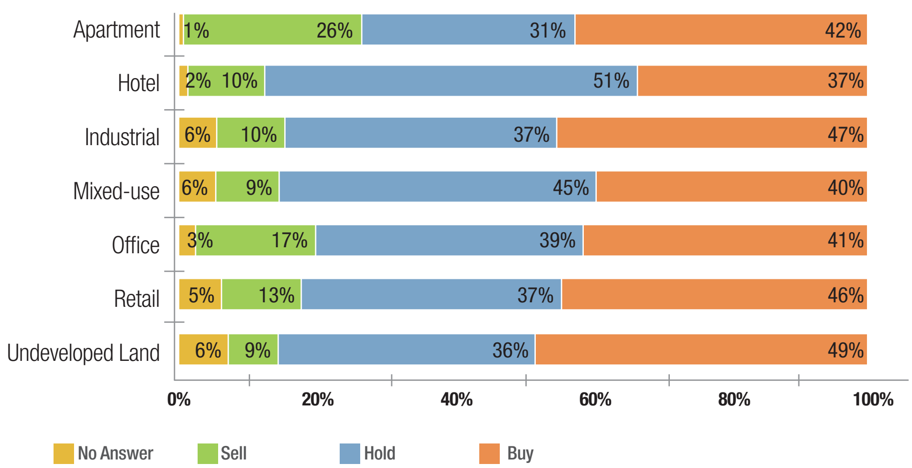
Respondents continue to be the most bullish on the long-term outlook for apartments out of all of the property types. Although many respondents anticipate gains across all commercial real estate property types, 44 percent of respondents expect apartment values to increase over the next 12 months; 22 percent anticipate gains over the next 24 months and another 20 percent predict improving values over the next five years.

There is ample data to support the positive outlook for apartments. Occupancies are back to 95 percent and many properties have recaptured or even exceeded pre-recession rent levels. During 2012 effective rents rose 4.3 percent to average $1,019 monthly rent on an apartment unit with rents forecast to rise another 3.5 percent this year, according to Marcus & Millichap. However, Marcus & Millichap is predicting that rent growth will likely slow in the next two to three years as new supply ramps up and for-sale housing continues to recover.

"The reality is that given the amount of improvement the apartment sector has had, both in occupancies and rents, it is reasonable to expect a slowdown in rent growth, while the other property types—particularly office, which has been the laggard—starts to show some better numbers," says Nadji. Among other properties, a majority of respondents in each sector—except for office—expect the value of properties in their portfolio to increase 12 months from now. **[Figure 4].**

FIGURE 3. BUY/HOLD/SELL

In your view, is now the time to buy, hold or sell each of the following property types?
Percentages reflect the opinions of respondents invested in each property type.



Base: respondents invested in each property type (n varies).

Spending buoys retail/industrial

Industrial and retail are firmly on the radar screen for investors. In fact, the two property types ranked second and third respectively, behind undeveloped land, in respondents' views that now is the time to buy. Overall, 47 percent of industrial owners believe it is an ideal time to add to portfolios, while 46 percent of retail owners believe conditions are ripe to buy more.

Both retail and industrial are benefitting from the economic recovery and improving consumer confidence. Investor sentiment that retail values will rise in the coming year has been steadily growing since hitting a low point of 32 percent in fourth quarter 2011. Currently, 54 percent of respondents expect retail property values to rise in the coming year. In comparison, 41 percent anticipate no change and 5 percent either expect a decline or did not answer.

That growing confidence is tracking closely with the improving economy, which has helped to spur demand for space. Retail and industrial properties have shown tremendous improvement in occupancies. Retail vacancies are expected to decline a further 80 basis points to 8.6 percent this year, while effective rents are forecast to rise 2.1 percent to average $16.34 per sq. ft., according to Marcus & Millichap. The industrial vacancy rate is expected to log another 70 basis point improvement to reach 10.5 percent by year-end with effective rents rising 2.4 percent to average $4.58 per square foot, according to Marcus & Millichap.

"The next most exciting and vibrant category is retail, with industrial following very closely," says Bill Rose, national director of the National Retail Group and the Net Leased Properties Group for Marcus & Millichap. "Retail has gone through a lot of reinvention. Store closures have diminished substantially, and there are a number of new concepts that are looking for expansion space." Industrial is so intertwined with the movement of goods and general economic activity that the increase in global trade and U.S. consumer sales bodes very well for warehouse and distribution, he adds. At the same time, there is still very little new construction, and both of those sectors have had a good opportunity to absorb excess space.

Meanwhile, 59 percent of industrial investors expect the value of their properties to improve with an average increase of 3.5 percent.

Turning the corner

Office is still the laggard among all property types. Although the percentage of respondents who expect office values to increase has ticked up compared to a year ago, sentiment has not changed dramatically over the past three quarters. The largest percent of respondents, 53 percent, expect no change, while 43 anticipate an increase and 4 percent predict a decline. On average, respondents expect values to increase 2.7 percent over the next 12 months.

However, the office sector could start to gain momentum in the second half of 2013 and into 2014. "Companies have burned their supply of excess space. Judging from the recent employment numbers, companies are realizing that they need workers to expand and to increase their revenues," says Al Pontius, managing director, Commercial Property Groups for Marcus & Millichap. Therefore, the demand for office space will rise in a market where very little new space is being built, he adds.

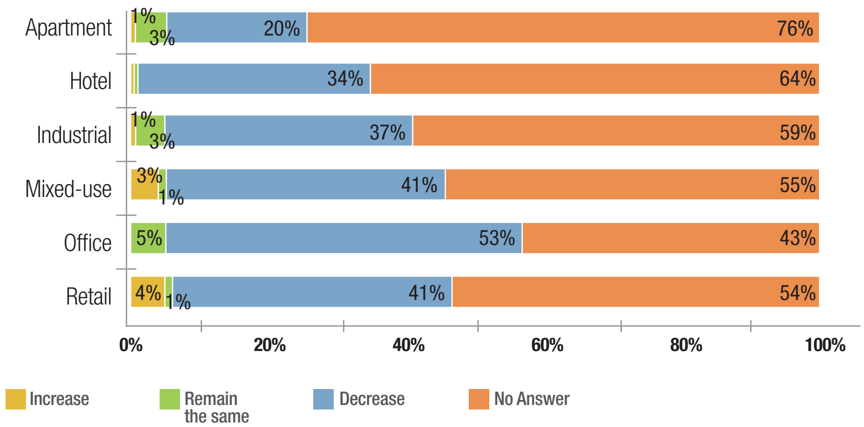
Despite the slow pace of recovery in the office sector, investor demand for this property type has held steady in the past three years. Overall, 41 percent of those respondents who already own office properties consider now the time to buy, while 39 percent think it is better to hold, and 17 percent believe it is time to sell.

In the U.S. hotel sector, underlying property fundamentals remain strong, with continued positive year-over-year performance. During the week of June 16-22, STR Global reported that occupancy rose 0.5 percent to 72.5 percent, average daily rate increased 4.1 percent to $111.64 and revenue per available room grew 4.6 percent to $80.96.

This trend line reinforces the survey results, as nearly two-thirds of hotel owners (64 percent) believe hotel values will rise in the coming year compared to 55 percent who held a similar view in first quarter. An average 6.4 percent increase is expected over the next 12 months.

FIGURE 4. **PROPERTY VALUES**

Considering only the property currently in your real estate portfolio, do you expect the property values to increase, decrease or remain the same 12 months from now? By what percentage?



Base: respondents invested in each property type (n varies).

"With occupancies and revenues returning to pre-recession levels and at near-record highs, investors remain encouraged by the near-term prospects for hospitality properties," notes Gregory A. LaBerge, national director of Marcus & Millichap's National Hospitality Group. "They are also motivated by the ability in many instances to buy assets at less than the projected replacement cost."

Economy remains key focus

Investors are clearly cognizant of the compounding effect that sequestration, higher taxes and the threat of higher interest rates could have on the broader economy. The top concern for investors remains the state of the U.S. economy for an overwhelming majority of respondents—80 percent. Rising interest rates also have become a more notable concern at 59 percent. Other worrisome issues that rate high with respondents are higher taxes (53 percent), unforeseen shocks to the economy at (45 percent), global economic issues (45 percent) and availability of financing (44 percent).

"The rise in interest rates has certainly impacted some transactions, but has been well absorbed by the overall marketplace," says Bill Hughes, senior vice president and managing director of Marcus & Millichap Capital Corp. "Further increases in interest rates should be more balanced since inflation is in check and unemployment is above the Fed's target. Investors still have an attractive window of opportunity to lock-in incredibly low interest rates," he adds.

On its own, sequestration appears to be a minor issue. Nearly three-fourths of respondents say that sequestration has not affected their business, while one-fourth report that sequestration has at least somewhat affected their business. Only 1 percent reported that sequestration has significantly impacted their business.

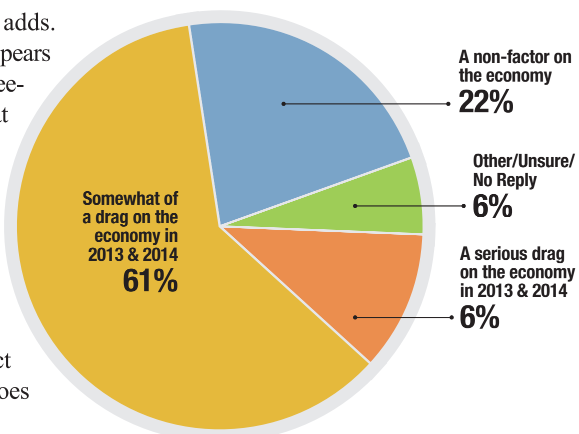
However, the combined impact of sequestration and higher taxes does weigh more heavily. On that front, 61 percent of respondents expect the combination of recent tax increases and sequestration will create somewhat of a drag on the economy in 2013 and 2014 with an additional 6 percent predicting that sequestration and higher taxes will create a serious drag. **[Figure 5].**

Despite these challenges, the majority of respondents agree that commercial real estate remains an attractive alternative and that they have an abundance of capital ready to invest. Nearly three-fourths of investors (72 percent) agree that commercial real estate offers favorable returns relative to other investment classes, while 23 percent disagreed with that statement and 5 percent had no response. More than half of investors (55 percent) say they have an abundance of capital ready to invest.

"If the bell didn't ring loud enough last quarter that commercial real estate is a great alternative investment, this quarter echoes the fact that commercial real estate is one of the best places you can put money," says Nadji. "Overall, commercial real estate is well positioned to get more attention and to capture more capital flows coming into the sector."

FIGURE 5. **SEQUESTRATION**

Do you expect the recent tax increases and the sequestration to be:



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