Situs RERC®

REAL ESTATE REPORT

FLASH REPORT | 3Q 2017

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LETTER FROM THE PRESIDENT

October 2017

Dear Subscribers,

While stocks continue to reach new heights, their volatility is cause for concern. Any correction is likely to be less pronounced in commercial real estate (CRE) than in the stock market because CRE is typically less susceptible to changing political and economic climates. This is good news because the overwhelming majority of our institutional survey respondents cited ongoing geopolitical and fiscal policy uncertainty as the major risks for U.S. investors.

As we embark on fourth quarter 2017, CRE remains a favored asset class, continuing to offer higher yields than most fixed-income investments in this low-interest-rate environment. The stable income component of CRE will be the major driver of total returns over the next couple of years as cap rate compression stalls, as seen in this report.

The following ***Situs RERC Flash Report*** presents a preliminary look at our third quarter institutional investment survey data. Although these preliminary results provide an adequate sampling of information and are statistically valid, the third quarter data reflect only information drawn from surveys received to date. Additional investment survey data continue to come into Situs RERC, and it will be integrated with current data and reported in the third quarter 2017 ***Situs RERC Real Estate Report.***

We would like to thank the hundreds of respondents who have completed our survey. Your responses are critical to the information available to the CRE industry as a whole, as well as to Situs RERC, and we thank you for your continued commitment and time in providing this comprehensive information each quarter.

Sincerely,

Ken Riggs
President
Situs RERC
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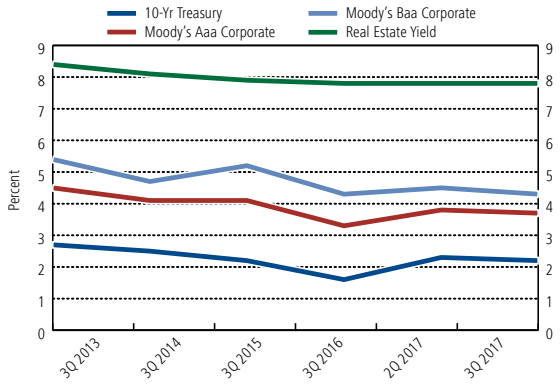
Situs RERC Required Real Estate Yields vis-à-vis Capital Market Returns						
	3Q 2017	2Q 2017	3Q 2016	3Q 2015	3Q 2014	3Q 2013
Real Estate Yield (%)	7.8	7.8	7.8	7.9	8.1	8.4
Moody's Baa Corporate (%)	4.3	4.5	4.3	5.2	4.7	5.4
Moody's Aaa Corporate (%)	3.7	3.8	3.3	4.1	4.1	4.5
10-Year Treasurys (%)	2.2	2.3	1.6	2.2	2.5	2.7
Yield Spread (Percentage Points)						
Moody's Baa Corporate (%)	3.5	3.3	3.5	2.7	3.4	3.0
Moody's Aaa Corporate (%)	4.1	4.0	4.5	3.8	4.0	3.9
10-Year Treasurys (%)	5.6	5.5	6.2	5.7	5.6	5.7

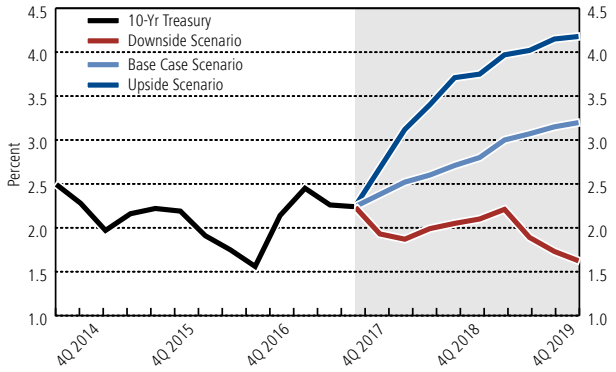
Sources: 3Q 2017 Situs RERC Investment Survey, preliminary data; Federal Reserve, Moody's, Moody's Seasoned Corporate Bond Yield©, retrieved from FRED, Federal Reserve Bank of St. Louis.



Sources: 3Q 2017 Situs RERC Investment Survey, preliminary data; Federal Reserve, Moody's, Moody's Seasoned Corporate Bond Yield©, retrieved from FRED, Federal Reserve Bank of St. Louis.

Preliminary data show that real estate yields remained constant in third quarter 2017 while Moody's Baa and Aaa corporate bonds, along with the 10-year Treasury, saw rates decrease slightly on a quarterly basis leading to increasing yield spreads. There was a slight dip in corporate profits compared to last quarter, which may be eating away somewhat at corporations' creditworthiness. The increasing spreads between the real estate yield and corporate bonds or the 10-year Treasury show the strength of CRE relative to similar securities.

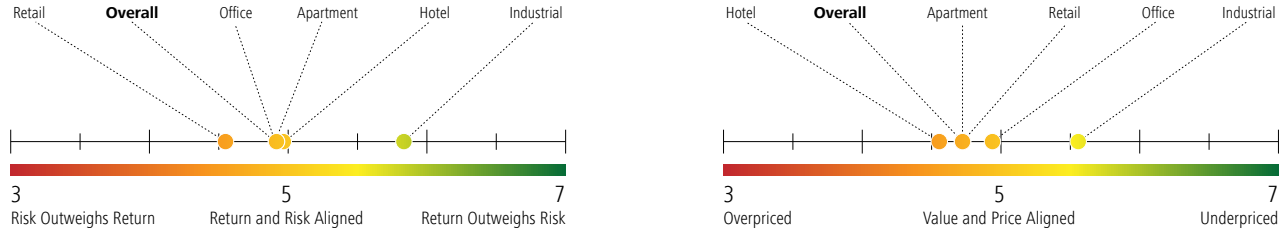
Situs RERC 10-Year Treasury Forecast



Note: Readings displayed are quarterly averages. Shaded area indicates forecast.
Sources: Federal Reserve, compiled and forecasted by Situs RERC, October 2017.

Expectations for stable but slow economic growth and muted inflation lead Situs RERC to forecast small, incremental changes in the 10-year Treasury rate over the next two years. Our base case scenario has the Treasury rate remaining below 3 percent throughout 2018, despite anticipated rate hikes by the Fed. While increases in short-term rates often lead to increases in long-term rates, the 10-year Treasury has not responded to the two rate hikes so far in 2017, likely because of low inflation and softening economic growth expectations. Similarly, the Fed recently announced a downward revision to its long-run forecast, but 10-year Treasury rates increased 15 bps in September. Investors cite potential tax reform as the main driver of this increase.

Return vs. Risk and Value vs. Price Ratings — 3Q 2017



Ratings are based on a scale of 1 to 10, with 10 suggesting that return greatly outweighs risk or value greatly outweighs price.
Source: Situs RERC Investment Survey, 3Q 2017, preliminary data.

Risk is beginning to exceed returns for the overall CRE market. Returns were lowest compared to risk for the office sector as headwinds from slowing employment growth (due to near-full employment rates), mediocre economic growth and increased tenant demands for innovative workspace designs. Value vs. price ratings also declined for overall CRE quarter to quarter, meaning that the CRE market is overpriced. Property prices for all major property types continue to reach new post-recession records while the pace of cap rate compression is slowing. The industrial sector was the only property type considered to be underpriced, which is not surprising given the low vacancies, supply constraints and stable demand in the sector.

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Situs RERC Investment Conditions and Current Quarter Capitalization Techniques								
	Investment Conditions[1]				Income Approach[2]		Cap Rate[3]	
	3Q 2017	2Q 2017	3Q 2016	3Q 2015	Direct Cap.	DCF	Before Reserves (%)	After Reserves (%)
Office - CBD	5.6	5.3	5.5	6.2	4.5	8.2	93%	7%
Office - Suburban	5.0	5.0	5.3	5.0	4.3	8.0	93%	7%
Industrial - Warehouse	7.1	6.8	6.4	7.1	6.2	6.8	80%	20%
Industrial - R&D	5.7	5.6	5.8	5.5	5.3	6.5	82%	18%
Industrial - Flex	5.4	5.4	5.5	5.5	5.0	7.3	82%	18%
Retail - Regional Mall	5.3	4.6	4.4	5.7	4.9	8.3	92%	8%
Retail - Power Center	4.5	5.0	4.7	5.8	4.8	7.5	91%	9%
Retail - Neighborhood	5.9	5.6	5.8	6.3	4.9	7.5	92%	8%
Apartment	5.3	5.2	5.5	6.0	7.2	5.4	25%	75%
Student Housing	5.2	5.3	5.7	5.6	6.2	6.5	20%	80%
Hotel	5.5	5.2	5.3	6.5	5.8	8.3	29%	71%

[1] Investment Conditions rated on a scale of 1 = poor to 10 = excellent.
[2] Income Approach rated on a scale of 1 = least relevant to 10 = most relevant.
[3] Percent of respondents who apply the cap rate before or after reserves. See the Scope and Methodology section in the full *Situs RERC Real Estate Report* for more information.
Source: 3Q 2017 Situs RERC Investment Survey, preliminary data.

Investment conditions improved for most property sectors compared to the previous quarter. It comes as little surprise that industrial warehouse investment conditions are doing well considering the growth in e-commerce and its need for distribution centers.

Contrary to popular thought, the demise of several major retailers does not appear to be hurting investment conditions for regional retail malls. It is important to note that these ratings represent institutional-grade properties that generally have top amenities, creditworthy tenants, higher rents, low vacancy rates and good locations.

The retail power center sector appears to be a different story, however. Not only are the large, big-box stores that typically anchor these properties facing stiff competition from Amazon and other online retailers, but they have unnecessarily large footprints that make it difficult for landlords to repurpose when the tenants leave.

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Situs RERC Expected Leasing Assumptions, Marketing & Holding and Investment Recommendations								
	Renewal Prob. (%)	Down Time (months)	Vacancy Loss[1] (%)	Marketing Time (months)	Holding Period (years)	Buy (%)	Sell (%)	Hold (%)
Office - CBD	67.9	7.0	6.5	5.9	10.0	0	27	73
Office - Suburban	65.8	8.4	8.5	6.2	10.0	27	27	46
Industrial - Warehouse	70.3	6.5	5.6	5.6	10.3	33	17	50
Industrial - R&D	66.7	8.0	7.5	7.3	10.2	10	40	50
Industrial - Flex	66.5	7.5	8.2	7.3	10.0	10	30	60
Retail - Regional Mall	68.5	7.0	6.2	6.3	9.7	13	38	49
Retail - Power Center	65.6	7.9	6.9	6.9	9.7	11	33	56
Retail - Neighborhood	68.2	7.2	5.9	5.7	9.6	10	30	60
Apartment	62.1	2.8	5.2	4.4	10.0	27	45	28
Student Housing	63.1	2.4	5.8	5.1	9.2	29	29	42
Hotel	N/A	N/A	N/A	7.4	6.7	20	40	40
All Types	**66.5**	**6.5**	**6.6**	**6.2**	**9.6**	**17**	**32**	**51**

[1] Vacancy loss reflects a typical holding period, not the current level.
Source: 3Q 2017 Situs RERC Investment Survey, preliminary data.

Property prices, as measured by RCA's CPPI, continue to reach new heights for the apartment sector – likely the main reason for the large percentage of institutional investors recommending a sell position. Renewal probabilities for this sector declined by two percentage points compared to last quarter and rental growth is expected to decline over the next year. Investors are concerned that rent growth may not keep pace with property prices.

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High prices in the apartment sector are slashing into pre-tax yield rates (IRR); IRR decreased 30 bps for the apartment sector compared to last quarter. IRRs declined across all major property types from quarter to quarter, perhaps indicating that the real estate cycle is retreating from its peak.

Across the major property types, cap rates either remained the same or increased slightly. The 20 bps change in power center going-in cap rates and 20 bps increase in power center terminal cap rates likely reflects investors' unease with the retail industry's current (and continued) transition period. However, these rising cap rates may be good for opportunistic investors searching for high-quality properties at low prices.

Slowing expected rental growth and expense growth rates (for most property sectors) may be signaling that CRE owners are offsetting expected declines in rental rates by reducing their expenses.

Situs RERC Real Estate Investment Criteria[1] by Property Type – 3Q 2017

	Office		Industrial			Retail			Apartment	Student Housing	Hotel
	CBD	Suburban	Warehouse	R&D	Flex	Regional Mall	Power Center	Neigh/ Comm			
Pre-Tax Yield Rate (IRR) (%)											
Range[2]	6.0 - 8.2	7.0 - 9.2	5.5 - 9.4	7.0 - 9.4	7.0 - 9.5	5.8 - 10.0	7.5 - 8.3	6.0 - 8.5	5.8 - 8.0	6.5 - 8.5	9.0 - 11.0
Average[2]	7.1	8.0	7.1	8.0	8.1	7.7	7.9	7.1	6.7	7.5	10.1
BPS Change[3]	-20	-20	-10	-10	0	-20	0	-10	-30	0	20
Going-In Cap Rate (%)											
Range[2]	4.5 - 6.5	5.5 - 7.5	4.0 - 7.3	5.5 - 7.3	5.5 - 8.3	4.8 - 9.0	6.0 - 7.3	5.0 - 7.0	4.0 - 6.0	5.0 - 7.5	7.0 - 8.5
Average[2]	5.5	6.5	5.5	6.5	7.0	6.2	6.7	5.9	5.0	5.7	7.8
BPS Change[3]	20	0	0	10	20	0	20	0	0	-10	10
Terminal Cap Rate (%)											
Range[2]	5.5 - 7.0	6.5 - 8.0	4.8 - 7.6	6.0 - 8.0	6.0 - 8.5	5.5 - 9.8	6.5 - 7.5	5.8 - 7.5	4.5 - 6.3	5.5 - 7.8	8.0 - 9.0
Average[2]	6.1	7.2	6.2	7.1	7.4	6.5	7.2	6.5	5.5	6.4	8.5
BPS Change[3]	10	10	20	10	-10	-10	30	10	10	0	0
Rental Growth Rate (%)											
Range[2]	1.0 - 4.0	1.0 - 3.0	1.0 - 5.0	1.0 - 3.0	2.0 - 3.0	1.5 - 3.0	1.0 - 3.0	1.0 - 3.0	1.5 - 4.0	1.5 - 3.0	1.0 - 4.5
Average[2]	2.6	2.4	3.0	2.5	2.5	2.7	2.3	2.5	2.7	2.6	2.4
BPS Change[3]	0	-10	0	-10	0	0	-20	-10	-10	10	-20
Expense Growth Rate (%)											
Range[2]	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0	2.0 - 3.0
Average[2]	2.7	2.7	2.7	2.7	2.7	2.7	2.8	2.8	2.7	2.6	2.8
BPS Change[3]	-20	-10	0	0	0	-20	-10	0	-10	-10	-10

[1] This survey was conducted in July, August and September 2017 and reflects expected returns for 3Q 2017 investments.
[2] Ranges and other data reflect the central tendencies of respondents; unusually high and low responses have been eliminated.
[3] The change in basis points (BPS) reflects the rate difference (+/-) between the current rate and the rate published in the prior quarter's issue of the *Situs RERC Real Estate Report.*
Source: 3Q 2017 Situs RERC Investment Survey, preliminary data.
Please note: The data reflect the preliminary results as compiled by Situs RERC. Our final numbers, which will be published in the full 3Q 2017 *Situs RERC Real Estate Report,* may be significantly different.

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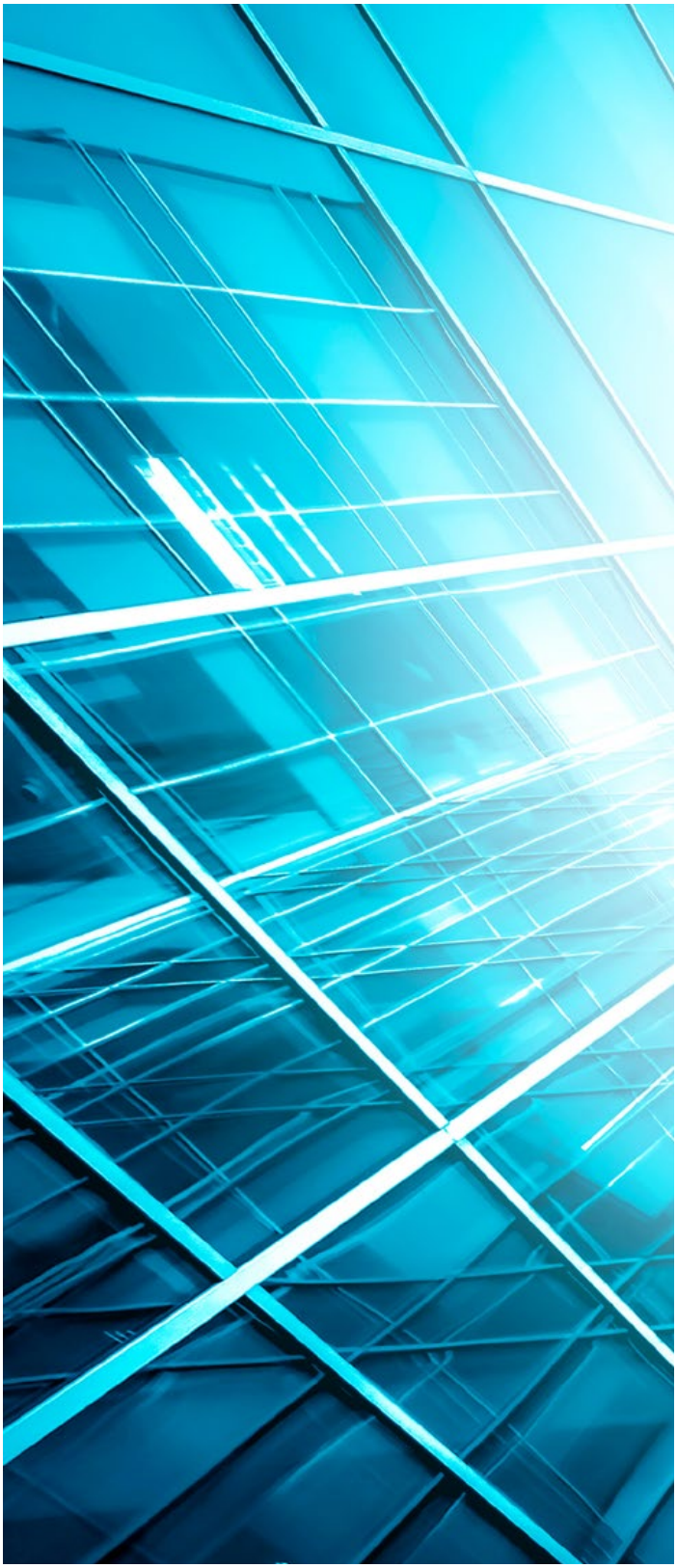

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