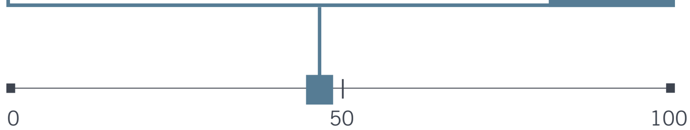
The NAIOP CRE Sentiment Index

Industry Leaders' Outlook for Commercial Real Estate

FALL 2022

NAIOP CRE Sentiment Index 47

Survey Conducted September 14-22, 2022

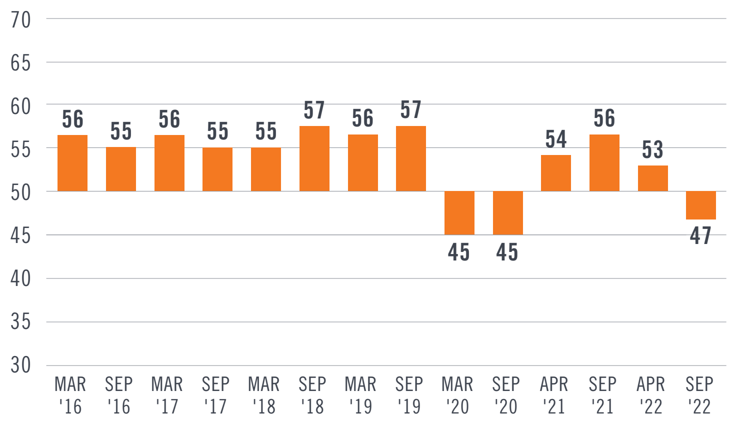


Below 50 means **unfavorable** CRE conditions are expected in 12 months.

50 means **no change** in CRE conditions is expected in 12 months.

Above 50 means **favorable** CRE conditions are expected in 12 months.

FIGURE 1: **COMPOSITE SENTIMENT INDEX, 2016-2022**



Key Findings

The NAIOP CRE Sentiment Index for September 2022 is 47, down from April's reading of 53. It is at the lowest level since September 2020. This reading suggests that respondents expect conditions for commercial real estate to deteriorate over the next 12 months (see Figure 1).

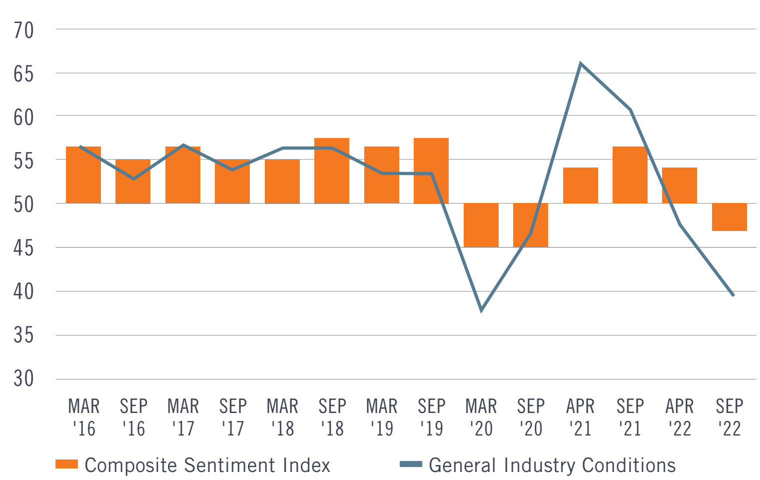
Respondents expect higher interest rates, higher cap rates, and a decrease in the supply of equity and debt over the next year. Respondents predict a sharper increase in cap rates and greater contraction in the supply of equity and debt than in any previous survey (see Figure 4).

Their outlook for occupancy rates, face rents and effective rents is also less optimistic, though they still expect rents to grow (see Figure 3).

Respondents also expect a sharp deterioration in general industry conditions over the next 12 months (see Figure 2). The score for general industry conditions (39) is calculated separately from the CRE Sentiment Index and may reflect respondents' outlook for other factors that affect the commercial real estate industry, such as macroeconomic conditions.

The only positive development in the September survey is that respondents expect a slower pace of construction cost inflation over the next year. Rising interest rates appear to have dampened inflation expectations. Respondents predict that construction material and labor costs will continue to rise but at a slower rate than was projected in the April survey or in the two surveys from 2021.

FIGURE 2: **COMPOSITE SENTIMENT INDEX VS. OUTLOOK FOR GENERAL INDUSTRY CONDITIONS, 2016-2022**



Despite a more pessimistic outlook for development conditions, developers plan to maintain recent deal volume over the coming year. Developers and building owners plan to complete about the same dollar volume of new projects and transactions over the next year as in the past year (score of 51). This may reflect greater optimism for the sectors and markets they are active in than for the commercial real estate industry as a whole.

Most respondents (54.9%) expect to be most active in projects or transactions related to industrial properties over the next year. Multifamily properties attracted the next-largest share of interest (31.5%), followed by office properties (9.9%). Only 3.7% of respondents indicated that they expect to be most active in retail properties.

Notable Changes from the April 2022 Survey

Figures 3 and 4 compare respondent expectations in September 2022 for the individual components that comprise the NAIOP CRE Sentiment Index to expectations in past surveys. Values above 50 represent expectations that a condition will be more favorable for development in 12 months (e.g., higher face rents, lower construction labor costs or lower cap rates). Values below 50 represent expectations that a condition will be less favorable during the next 12 months.

The most notable change since April is that respondent concerns about rising interest rates, and their effects on capital markets and real estate valuations have deepened. The Federal Reserve has continued to raise interest rates, and bond markets have priced in even higher rates in 2023. Respondents now predict the interest rate environment will be significantly worse in 12 months (see Table 1, below). This appears to be negatively affecting expectations for equity availability, debt availability and first-year cap rates. Each of these metrics may also be affected by perceptions of the economy. Respondents still expect local economic conditions in the markets they serve to improve slightly over the next 12 months, but they are less optimistic about local economic conditions than in the April survey (see Table 1). In open-ended comments, some respondents predicted that deal volume will slow until interest rates and cap rates stabilize.

Respondents appear less concerned about future construction labor and material cost increases. As in past surveys, respondents still expect these costs to rise over the next 12 months, but they expect the change to be much less dramatic than was projected in the April survey. This may reflect expectations that rising interest rates will cool demand for both materials and labor over the next year.

The survey also recorded a somewhat less optimistic outlook for occupancy rates, face rents, effective rents and employment. Respondents remain somewhat optimistic about rising rents and employment within their own firms over the next year, but they now expect occupancy rates to remain unchanged from their current level, in contrast to expectations for rising occupancy rates in the April survey.

Levels of agreement/disagreement between respondents remain higher than levels recorded in surveys conducted before the pandemic. This suggests continued uncertainty about future conditions. Lower-than-usual levels of agreement between respondents may suggest that the CRE Sentiment Index for September 2022 is less predictive of future market conditions than surveys from before 2020. Lower levels of agreement among respondents may also reflect a more challenging environment for some property types and geographic markets. The open-ended comments suggest that respondents are more pessimistic about conditions for office buildings than for other property types, but some also expressed concerns about softening conditions for industrial development. Several comments also suggested particularly challenging development conditions in San Francisco and Southern California.

FIGURE 3: **SENTIMENT INDEX COMPONENT SCORES: OCCUPANCY, RENTS, CONSTRUCTION COSTS**

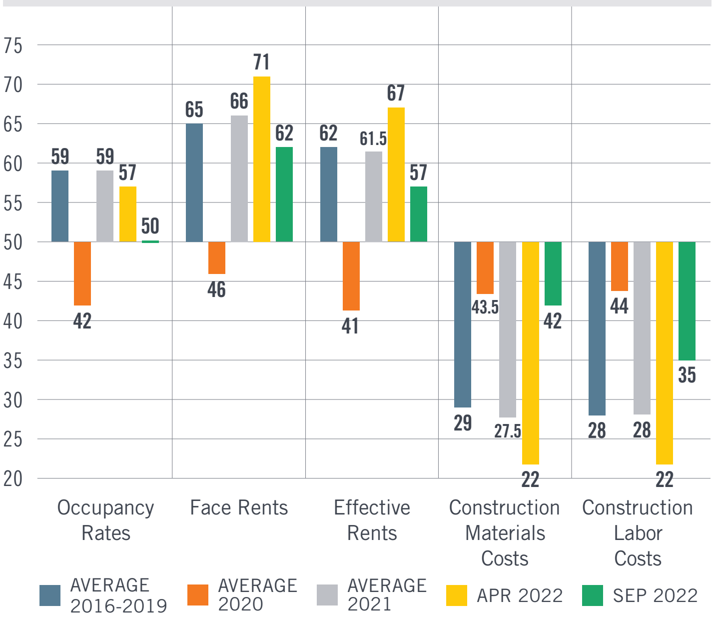
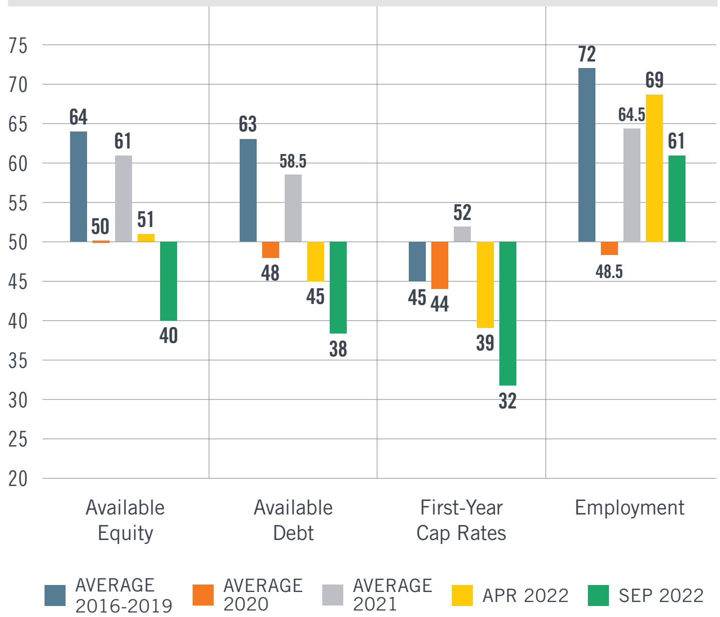


FIGURE 4: **SENTIMENT INDEX COMPONENT SCORES: EQUITY, DEBT, CAP RATES, EMPLOYMENT**



Expectations for Development Conditions

The sentiment survey asks developers and building owners to evaluate how important interest rates, local economic conditions, local development approvals processes, environmental regulations and other government regulations will be to their decisions to initiate or continue development projects over the next 12 months (answers to these questions are not factored into the NAIOP CRE Sentiment Index). The survey then asks developers how favorable they expect these conditions to be. The results are described in Table 1 on a 100-point scale.

TABLE 1: **IMPORTANCE AND FAVORABILITY OF DEVELOPMENT CONDITIONS OVER THE NEXT 12 MONTHS**

Condition	Importance September 2022	Favorability	
		April 2022	September 2022
Local Economic Conditions	86	65	52
Interest Rates	86	39	24
Local Development Approvals	79	38	39
Environmental Regulations	74	39	39
Other Government Regulations	73	39	40

Respondent expectations for local economic conditions have deteriorated since the April survey, as have their outlook for interest rates (to a new low). They also now rate interest rates as equal in importance to local economic conditions, marking the first instance in which interest rates have surpassed local development approvals in perceived importance. Respondents' outlook for development approvals, environmental regulations and other government regulations has remained nearly unchanged since April.

Differences Between Developers and Non-developers

Respondents were asked to identify their primary profession. When comparing the responses of developers and building owners to non-developers, only one statistically significant difference emerged: developers are slightly more optimistic (score of 65) than non-developers (score of 60) about future face rents. Differing expectations about future rents may lead non-developers to value commercial properties and new development more conservatively than developers.

Direct From Survey Participants

"We work on a broad range of property types. Each will likely be negatively affected by higher interest rates, vacancies and capitalization rates over the next 12 months, but not immediately and not at the same level."

"Once the Fed tames inflation, I believe there will be a normalization of cap rates and borrowing costs, which will reduce the bid-ask gap between buyers and sellers and free up capital from the sidelines. But it will be challenging to get deals done until then."

"The shift to hybrid work and non-traditional workspaces continues, driving occupancy and effective rents in urban and suburban areas down. Lease renewals are being treated as new leases, driving tenant improvement costs and lease commissions up. Very little good news in this sector."

"We expect a sharp increase in available space (both direct and sublease) in sectors that typically utilize more densely seated employee populations, especially in buildings with floor plates larger than 50,000 RSF."

"Today, industrial warehouse vacancy is low, and there is very little available space. However, when you take into consideration what will come available and that companies seem less pressed to lease new space, we will certainly have a real softening of the market. Put higher interest rates and construction costs into that mix, and there is a large degree of uncertainty in the economic success of near-term new development."

"I am seeing a positive change in the availability of products for construction, and I think that will continue. But I do not think this will bring down costs, although it may allow them to remain at or near current rates."

"The [development] approval process and permitting is an absolute mess. It appears that, broadly, most municipalities are not fully staffed and have not brought all employees back into the office in a central work environment. These conditions, combined with the retirement of more experienced staff and hiring of less experienced staff, are crippling the permitting and building-inspection process."

"Entitlements and regulations continue to be the bottleneck for all industrial projects, and it only appears to be getting worse. We are estimating that it will take at least three years to get a project entitled for redevelopment in nearly all markets we work in. Some jurisdictions are even worse than this; three years is the average, at least in the industrial infill markets where we are focused."

Methodology

The NAIOP Sentiment Index is designed to predict general conditions in the commercial real estate industry over the next 12 months by asking industry professionals to predict conditions for their own projects and markets. The NAIOP CRE Sentiment Survey is conducted biannually, in March/April and August/September. The survey is sent to roughly 10,000 NAIOP members in the U.S. who are developers, building owners, building managers, brokers, analysts, consultants, lenders and investors in the office, industrial, retail and multifamily sectors. It asks questions about jobs, space markets, construction costs, capital markets and other conditions for real estate development. The questions that comprise the Sentiment Index are not equally weighted. Instead, weighting varies based on whether responses to a question are tightly packed or dispersed. Questions with tightly packed responses (meaning there is more consistency among the answers to that question) are more heavily weighted than those with more dispersed responses (which indicate less consistency).

If every participant in the survey selected the most optimistic answer to every question, the index would be 100. Conversely, if all the participants chose the most pessimistic response to every question, the index would be 0. The survey includes questions that evaluate sentiment about conditions that are not included in the composite sentiment index score but are measured separately on a 100-point scale.

A cross-tabulation of the September survey results by respondent profession revealed only one difference that was statistically significant. Differences that were not statistically significant are not reported in this analysis.

A total of 463 respondents from 326 distinct companies participated in this survey. When individuals were asked what property types they worked on, 75.8% indicated they work on industrial properties, 61.3% work on office properties, 44.9% work on multifamily properties and 39.5% work on retail properties. A regional breakdown shows that 52.9% of respondents are active in the West, 33.0% are active in the South, 29.2% are active in the East and 21.4% are active in the Midwest.

Survey participants receive a summary of results showing the percentage breakdown of responses to each question after the survey closes. This report is released to all NAIOP members and the public three to four weeks later. Survey responses for this index were gathered between September 14 and September 22, 2022. The response rate for this survey was 4.6%, and the margin of error for the composite index score was 4.6%.

The statistical methodology for the Sentiment Index was originally developed by Tom Hamilton, Ph.D., MAI, CCIM, CRE, the Gerald Fogelson Distinguished Chair of Real Estate in the Chicago School of Real Estate at Roosevelt University. The survey data was collected by NAIOP, and the survey questions were created, refined and finalized between 2014 and 2021 with the assistance of several NAIOP Distinguished Fellows. NAIOP's Director of Research, Shawn Moura, Ph.D., authored the current edition of the survey and this summary analysis. For questions about the CRE Sentiment Index, please contact Shawn at **moura@naiop.org**.

Media Inquiries

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