The NAIOP CRE Sentiment Index

Industry Leaders' Outlook for Commercial Real Estate

SPRING 2022

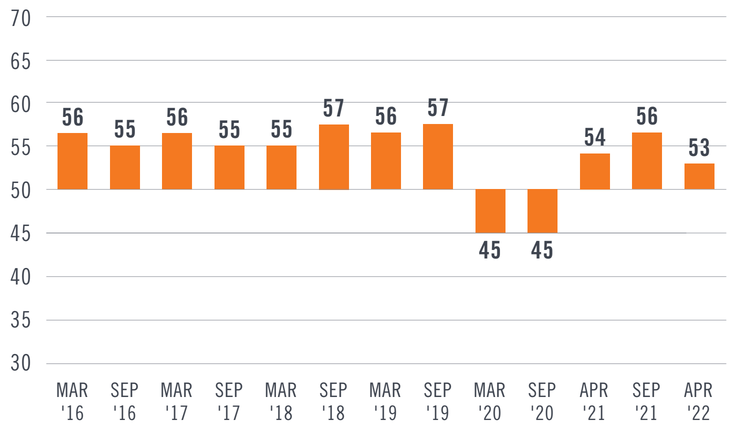
NAIOP CRE Sentiment Index **53**

Survey Conducted April 5-14, 2022

0 — 50 — 100

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

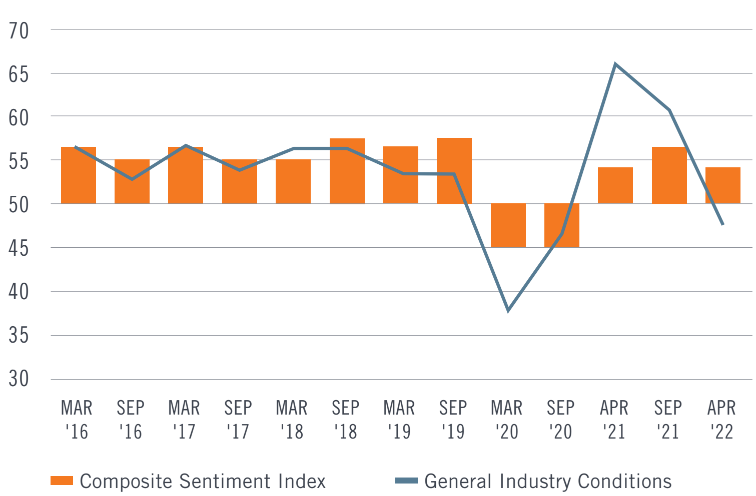
The NAIOP CRE Sentiment Index for April 2022 is 53, down slightly from September 2021, and below the pre-pandemic range. However, this reading still indicates that respondents expect conditions for commercial real estate to improve slightly over the next 12 months (see Figure 1).

Respondents are concerned about the effect of rising interest rates on capital markets and real estate valuations. In contrast with September 2021, they now expect first-year capitalization rates to rise and debt to be less available. Scores for these two components of the index are the lowest recorded since the survey began in 2016 (see Figure 4).

They also expect the cost of construction labor and materials to continue to rise at a record pace. Reflecting recent inflation, respondents are more pessimistic about construction costs than in any previous survey (see Figure 3).

Increased respondent optimism about rents and employment within their own firms has kept the index in positive territory. Respondent expectations for face rents and effective rents are higher than at any point in the past two years and higher than the 2016-2019 average. Higher rents could offset the effects of inflation and rising capitalization rates. Employment expectations are higher than in 2020 or 2021, but still slightly below the pre-pandemic average.

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



Respondents now expect a slight deterioration in general industry conditions over the next 12 months, in contrast to their general optimism in September 2021 (see Figure 2). The score for general industry conditions (48) is calculated separately from the CRE Sentiment Index and may reflect respondent expectations for other factors that affect the commercial real estate industry, such as macroeconomic conditions.

A large majority (59.5%) of respondents 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 (26.7%), followed by office properties (8.9%). Only 4.9% of respondents indicated that they expect to be most active in retail properties.

Notable Changes from the September 2021 Survey

Figures 3 and 4 compare respondent expectations in April 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 in 12 months.

The most notable change since September 2021 is that respondents are now more concerned about the effects of inflation and how rising interest rates could affect real estate valuations and the availability of financing. These concerns reflect the continued acceleration of inflation in recent months and the expectation that the Federal Reserve will raise rates over the coming year. The yield on the 10 Year Treasury has more than doubled since last September. Respondent expectations for future first-year capitalization rates have reversed from optimism that rates would decline over the next 12 months to the current expectation that they will increase at a rate not previously recorded in the survey.

Respondents' outlook for the availability of debt also reversed sharply from expectations that debt would become more available to current expectations for a modest contraction in lending. This is likely tied to expectations that interest rates will rise, as higher rates translate to higher debt service ratios, reducing the volume of debt that lenders are willing to issue. The outlook for equity availability is more sanguine, with respondents expecting little change over the next 12 months.

Respondents were already concerned about construction material and labor cost inflation a year ago, and their outlook for cost inflation for these inputs over the next year has worsened further.

The changes in respondent expectations for inflation, capitalization rates and financial markets are also reflected in their outlook for general industry conditions, which dipped from positive territory in September (a score of 61) to slightly negative in the current survey (48). This metric is not factored into the Sentiment Index but allows for a comparison of respondents' overall expectations with their outlook for the fundamentals of commercial real estate development that are measured in the index. The slight difference between a positive Sentiment Index and slightly negative general industry conditions score may be due to factors not directly measured by the Index, such as respondents' outlook for the economy or their expectations for local development approvals.

Offsetting concerns about inflation and rising rates, respondents remain optimistic that occupancy rates will continue to improve, and they also believe that face rents and effective rents will rise faster than in past surveys, as building owners pass some cost increases on to tenants. These positive sentiment trends help explain why respondents expect employment growth at their own firms to accelerate.

Levels of agreement/disagreement between respondents remain higher than levels recorded in surveys from 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 April 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 strong demand for industrial and multifamily properties and continued difficulties for office buildings (see page 3).

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

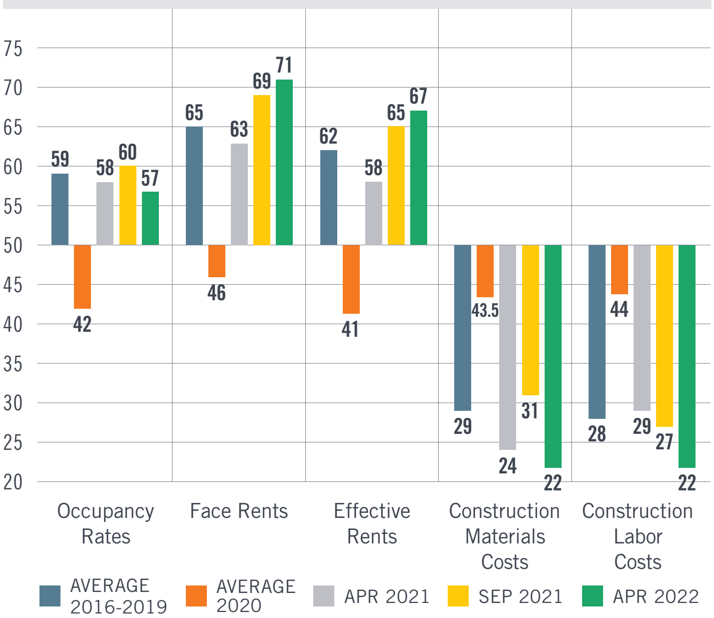
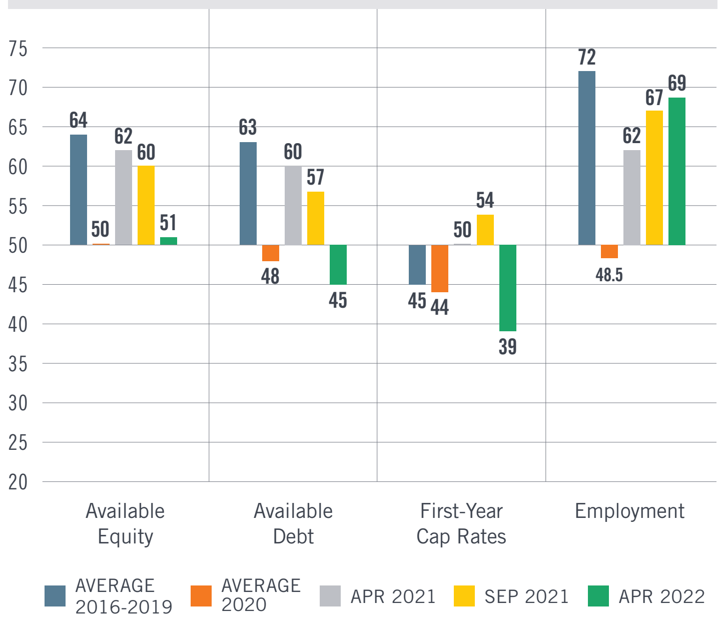


FIGURE 4: **SENTIMENT INDEX COMPONENT SCORES: EQUITY, DEBT, CAP RATES, EMPLOYMENT**



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 April 2022	Favorability	
		September 2021	April 2022
Local Economic Conditions	82	70	65
Local Development Approvals	77	44	38
Interest Rates	75	70	39
Other Government Regulations	72	42	39
Environmental Regulations	70	42	39

Mirroring changes in expectations for capitalization rates, respondent expectations for interest rates over the next 12 months reversed from favorable conditions in the previous survey to somewhat unfavorable conditions in the current survey. Respondents remain optimistic about local economic conditions, though slightly less so than in September. They are slightly more pessimistic in their outlook for local development approvals. The survey did not record a change in the relative importance of the five factors identified in Table 1. Local economic conditions are still considered the most important factor, followed by development approvals and interest rates.

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, two statistically significant differences related to the conditions that comprise the Sentiment Index emerged (see Table 2). While both groups have a positive outlook on face rents and effective rents, developers and owners are slightly more optimistic about rents than other respondents. Differing expectations about future rents may lead non-developers to value commercial properties and new development more conservatively than developers.

TABLE 2: **DIFFERENCES BETWEEN DEVELOPERS AND NON-DEVELOPERS**

Metric	Average of All Respondents	Developers and Building Owners	Non-developers
Face Rents	71	73	69
Effective Rents	67	70	65

Direct From Survey Participants

"Construction costs are getting so out of control that developers are close to walking on a lot of projects."

"Timelines for construction are the biggest problem that we are currently facing."

"Higher rents and compressed cap rates have been able to keep up with the huge increases in construction costs, but as interest rates and cap rates rise, I expect there to be a slowdown from the current pace."

"Despite high inflation rates, COVID-19 and the war in Ukraine, the U.S. economy will be better than most economists are predicting, and [conditions for] commercial real estate, including office buildings, will improve significantly over the next three years. Industrial will continue to improve along with multifamily residential."

"The office sector will likely go through a two- to three-year transition period as employers consider work-from-home options, new office layouts, amenities and other flexible work options, before settling on a strategy and policy that works for their organization. This will create some uncertainty for investors."

"The continued shift from brick-and-mortar retail to e-commerce, onshoring as a result of decreasing globalization, and inventory builds due to supply chain issues will all continue to drive industrial demand and occupancy. This will be partially offset by decreased demand from Amazon."

"Debt costs have risen dramatically since the invasion of Ukraine. Higher oil prices are signaling a recession in the near term. It seems virtually impossible for the Fed to slow down growth and inflation without causing a short recession."

"Borrowing rates will trend upward, putting pressure on asset valuations."

"There is significant capital that needs to be placed, and real estate is a great hedge against expected inflation. I strongly believe we will continue to see a strong market with quality, well-located offerings outperforming B/C product."

"Many municipalities have not replaced employees that were let go during COVID. This has caused approval processes and other development processes to move much more slowly. We have not observed these municipalities staffing up and are concerned that the next 12 months will be characterized by even slower approval processes."

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 9,000 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 April survey results by respondent profession revealed only two differences that were both observable (at least one point apart on a 100-point scale) and statistically significant. Differences that were not observable or statistically significant are not reported in this analysis.

A total of 348 respondents from 259 distinct companies participated in this survey. When individuals were asked what property types they worked on, 73.3% indicated they work on industrial properties, 62.1% work on office properties, 42.2% work on multifamily properties and 38.8% work on retail properties. A regional breakdown shows that 50.9% of respondents are active in the West, 39.4% are active in the South, 30.8% are active in the East and 22.7% 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 April 5 and April 14, 2022. The response rate for this survey was 3.8%, and the margin of error for the composite index score was 5.3%.

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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