Perspective

MID-YEAR 2017

UNITED STATES

ECONOMY

Despite a slow start to 2017 and the unsettled political environment, the U.S. economy continues to expand at a modest pace.

CAPITAL MARKETS

Transaction activity has fallen from peak levels, but remains high. Low interest rates are tempering upward pressure on yields.

PROPERTY MARKETS

Fundamentals are more balanced between supply and demand. Rent growth is showing late-cycle fatigue in some sectors.

Contents

Global Economy 1
U.S. Economy 2
Capital Markets 4
Apartment 6
Office 8
Retail 10
Industrial 12

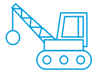
Key

PROPERTY TYPE METRICS

VACANCY / AVAILABILITY

NET ABSORPTION

NET COMPLETIONS



RENT

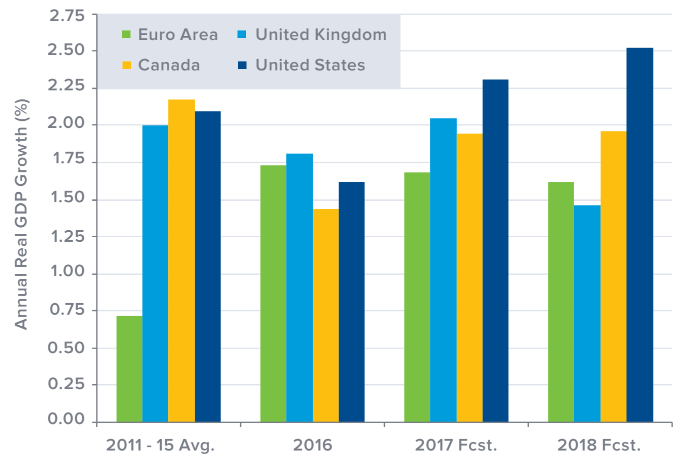
BENTALL KENNEDY RESEARCH SENTIMENT

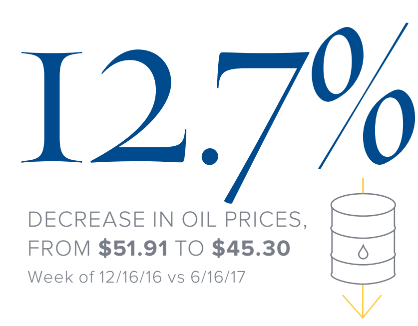
Positive ⟷ Negative

Global Economy

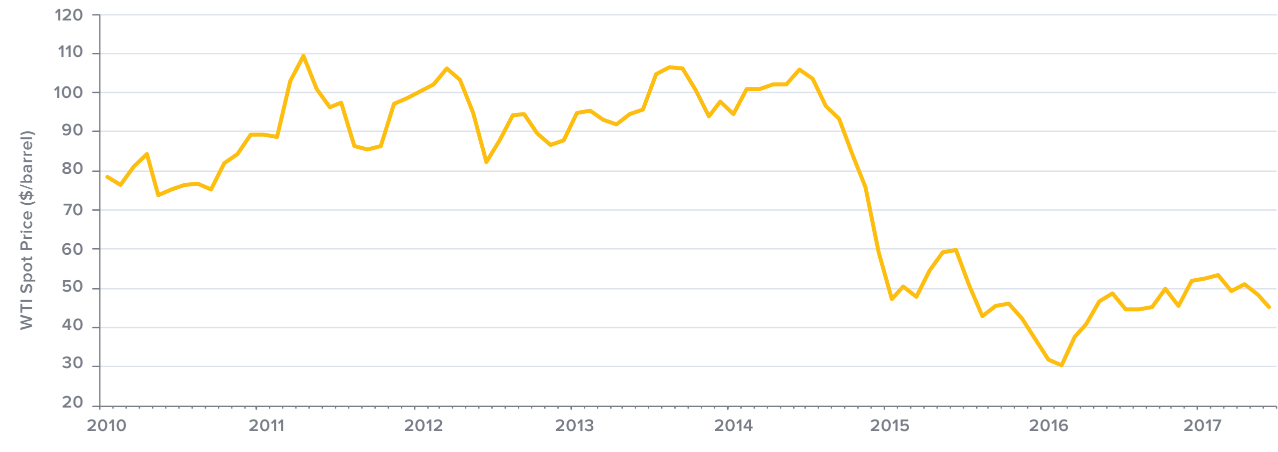
Growth on more solid footing across regions

A POSITIVE OUTLOOK FOR THE U.S. AND CANADA





OIL PRICES FAILING TO SUSTAIN A RECOVERY



- The U.S. and Canadian economies are poised for improved growth in 2017-18, and will lead many other industrialized nations.
- Europe provides upside as the French and, potentially, German elections favor status quo. "Free money" policies are finally having the desired effect on growth.
- German industrial production is strong and business and consumer confidence in the Euro-Area are near multi-year highs.
- Headwinds persist, however, as geopolitical uncertainty and recent terrorist attacks weigh on growth. Tourism in Europe has ebbed and flowed.
- China posted modestly better than expected GDP growth in 17Q1 of 6.9%, aided by government spending and export growth. Risks remain and Moody's recently downgraded China's credit rating due to rising debt levels.
- Oil prices have trended lower in 2017 as OPEC production cuts have been offset by Non-OPEC production and sluggish global oil consumption.
- Cheap oil remains a headwind for oil exporting countries, but benefits consumer driven economies, namely the U.S.

Sources: IMF | U.S. Energy Information Administration, Reuters (WTI Spot Price); June 2017 value = week of 6/16

U.S. Economy

Major indicators showing the U.S. expansion has legs

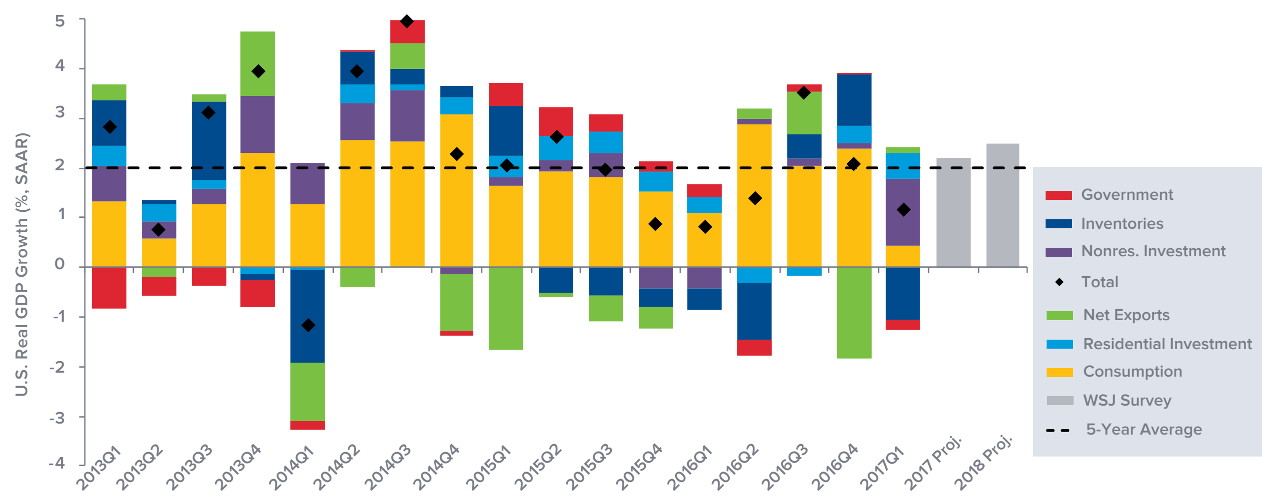
2.2%

PROJECTED 2017 GDP GROWTH

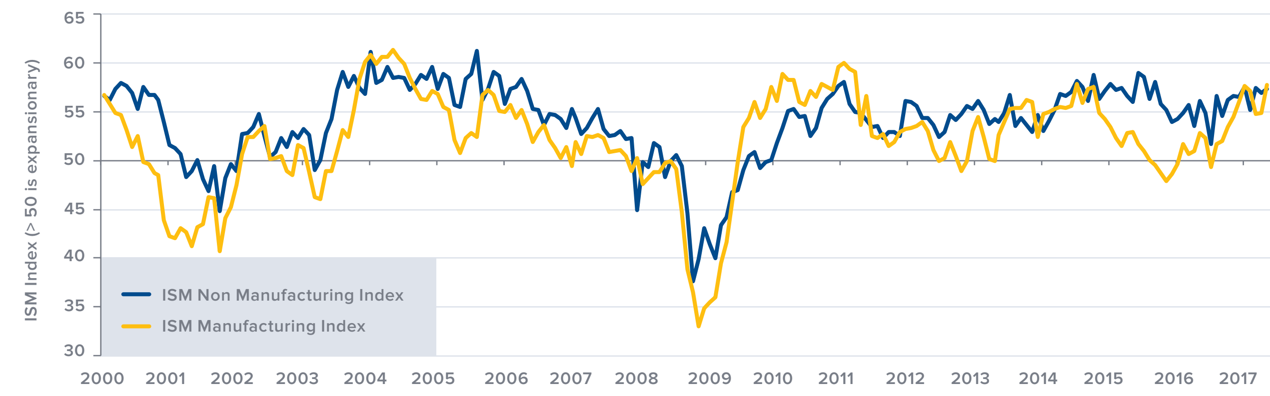
WSJ Economic Survey - May 2017

- U.S. GDP growth was slow out of the gates in 17Q1, but should improve as the year progresses. Still our expectation for upper 2.0%-range growth in 2017 has moderated.
- The post election climate is more unsettled than anticipated. Increased government spending and tax and regulatory reform are likely to take some time. Policy uncertainty will be a persistent drag on growth.
- The U.S. dollar remains strong, but has come down from its post-election bounce. A cheaper dollar may support a resurgence in U.S. exports.
- Corporate earnings and profits are showing signs of strength aided by a healthy domestic consumer and improving conditions in Europe.
- Industrial production is at its highest level in more than two years. Car sales have taken a step back, however, presenting a potential headwind.
- Major indicators such as the ISM indices point to expansionary conditions for both manufacturing and non-manufacturing sectors.

U.S. GROWTH EXPECTED TO IMPROVE SLIGHTLY



ISM INDICES POINT TO CONTINUED ECONOMIC EXPANSION



Sources: U.S. Bureau of Economic Analysis, Dow Jones (WSJ Economic Survey, May 2017) | Institute for Supply Management

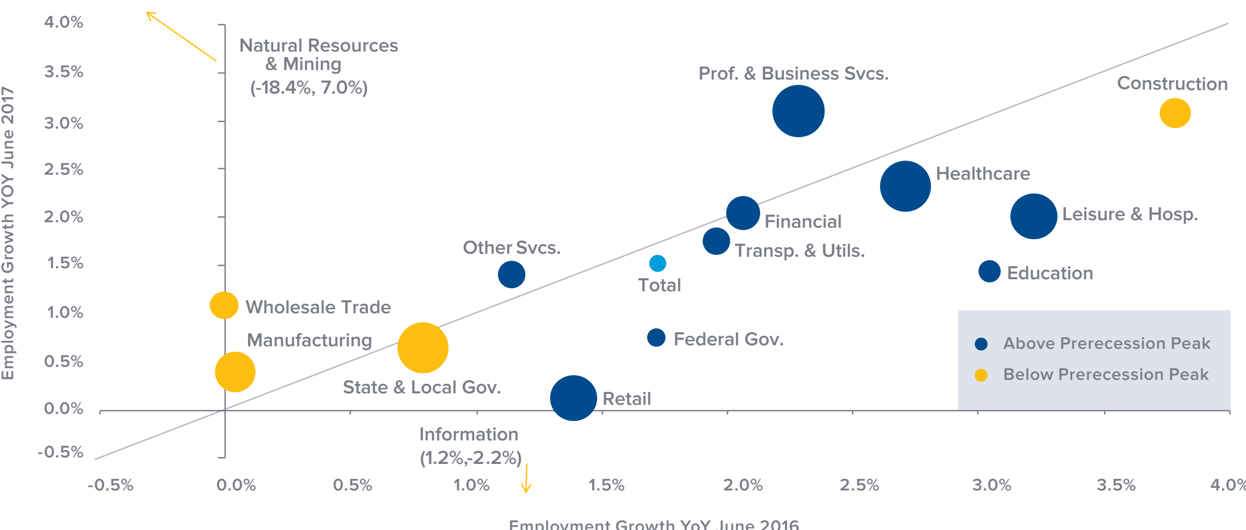
U.S. Economy

- Job growth is encouraging despite recent moderation due to the maturing business cycle and a labor market that is near full employment.
- Even with a slower rate of growth the economy produced nearly 2.2 million jobs over the past year. Knowledge-based sectors continue to perform well.
- Unemployment is now below its prerecession trough and strengthening wage growth is increasingly evident.
- In addition to wage growth and low oil prices, U.S. consumers benefit from the wealth effects created by record stock prices and home values.
- Younger workers have seen their job prospects brighten markedly, which should induce healthy household formation and housing demand in the quarters ahead.
- Low unemployment, rising labor costs, and affordable housing shortages are negatively impacting growth in some metro areas.
- In particular, markets in California have lost momentum, although growth in San Francisco and Oakland still outpaces the nation. Major northeast markets are among those that have gained momentum recently.

STARK DIFFERENCES IN METRO MOMENTUM AND GROWTH

	Metro	YOY Job Growth May 16	YOY Job Growth May 17
↑	Dallas-Ft. Worth	3.1%	3.2%
↓	San Francisco	4.5%	2.3%
	Minneapolis	1.4%	2.2%
↑	Boston	1.3%	2.1%
	New York	1.8%	1.9%
↓	Oakland	3.4%	1.8%
↑	Houston	0.2%	1.7%
—	United States	1.6%	1.6%
	San Jose	3.2%	1.5%
↓	Los Angeles	3.2%	1.1%
	Orange County	3.1%	0.2%

JOB GROWTH HAS MODERATED IN MOST SECTORS

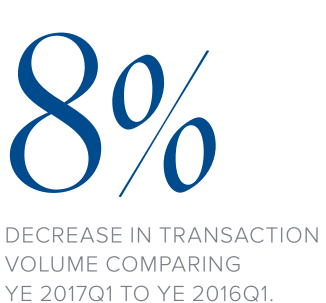


Sources: U.S. Bureau of Labor Statistics (select major markets shown) | U.S. Bureau of Labor Statistics

Capital Markets

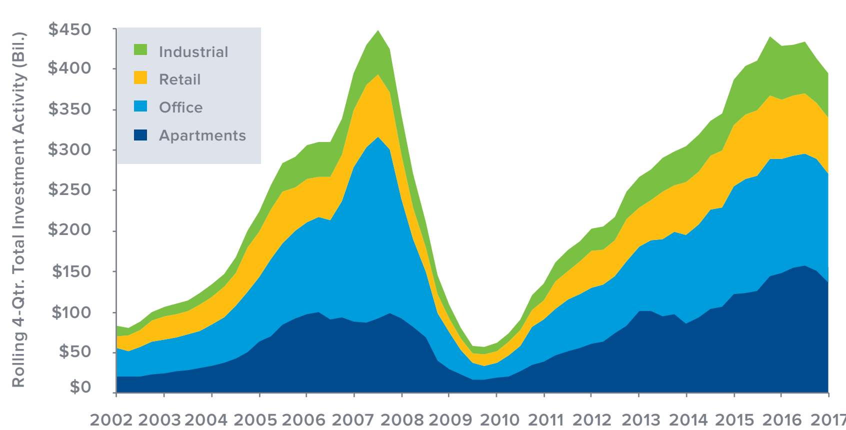
Attractive, but moderating investment performance

- Transaction volume has peaked for the cycle but remains high. Volume was down about 8% comparing YE 2017Q1 to YE 2016Q1. Most of this pullback came from major markets.
- Rolling four quarter sales volume contracted most sharply in the industrial market as portfolio activity abated. The other three property types were off 4-8% vs. a year ago.
- Foreign investors are the most active net buyer of U.S. CRE, but their net activity has fallen in half from 2015 levels. Private domestic buyers have picked up some of the slack.
- Tighter lending standards, particularly for construction and multifamily loans, are having an impact on the market. Fewer banks are reporting rising demand for CRE loans.
- Regulators began pressuring banks early this cycle to control CRE loan risks, particularly on multifamily construction.
- While reducing liquidity and capital availability somewhat, this tightening should limit the fallout in the event of an economic downturn. It also creates opportunities for investors willing to participate in the market as lenders.

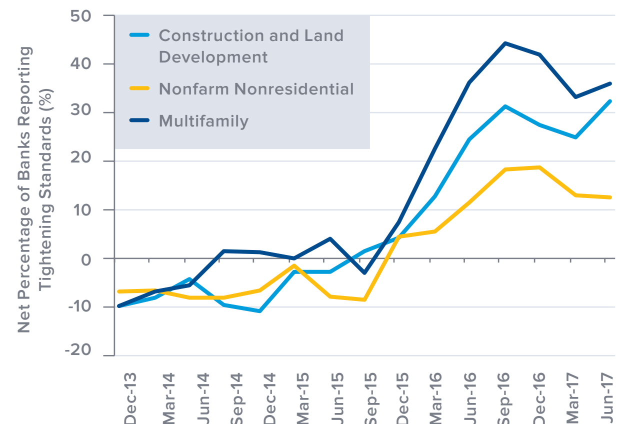


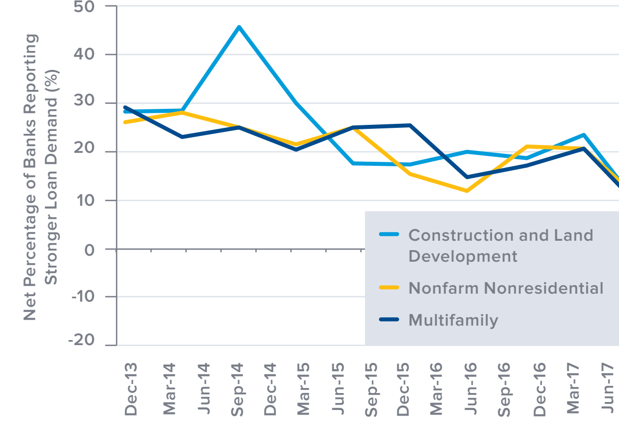
DECREASE IN TRANSACTION VOLUME COMPARING YE 2017Q1 TO YE 2016Q1.

INVESTMENT VOLUME FALLING FROM PEAK LEVELS



LENDERS TIGHTENING UNDERWRITING, LOAN DEMAND EASING

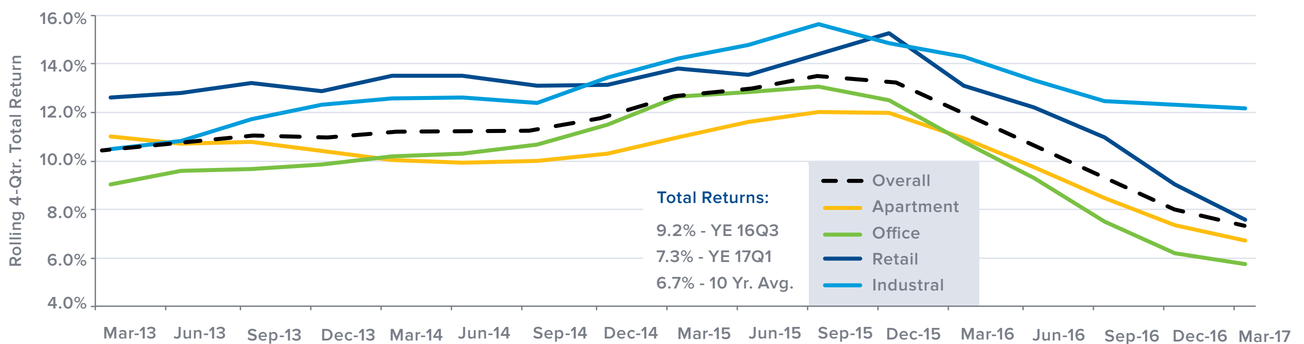




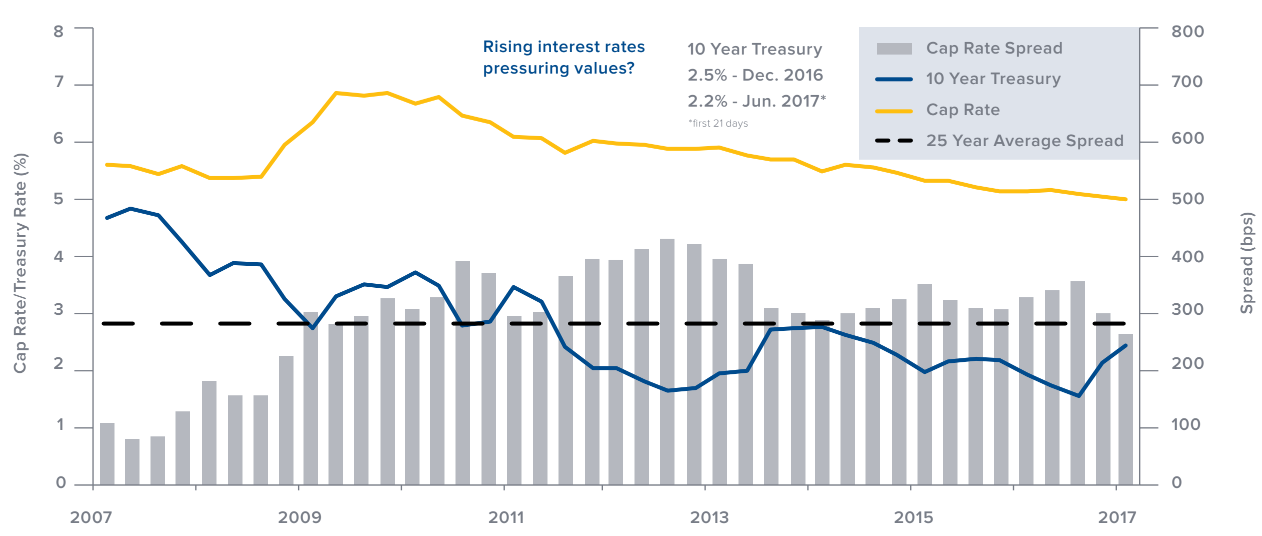
Sources: Real Capital Analytics, Inc. | Federal Reserve Senior Loan Officer Survey

Capital Markets

TOTAL RETURNS ARE REVERTING TO THE MEAN



SPREADS HAVE RETURNED TO MORE TYPICAL LEVELS



12%

TOTAL INDUSTRIAL RETURNS DURING THE YEAR ENDING 2017 Q1

- Cap rates have trended down and, with interest rates lower than they were at the end of 2016, upward pressure on yields has been slow to materialize.
- But spreads have narrowed markedly from cyclical highs and investors will be forced to lean more heavily on net operating income growth to generate future appreciation.
- Moderating appreciation is a major reason why returns have fallen from the double-digit levels posted through much of the recovery.
- Total returns topped 13.0% in 2015 and have since run steadily lower. Industrial has been the notable exception with total returns north of 12.0% during the year ending in 2017Q1.
- Much as we anticipated in Perspective 2017 returns are reverting to the mean and should continue to do so.
- The search for higher returns is one reason deal flow has undergone a pronounced slowdown in the six major U.S. markets. But we urge caution when chasing yield in secondary and tertiary markets this late in the cycle.

Sources: NCREIF (NCREIF Property Index) | NCREIF (current value cap rates), Federal Reserve, Moody's Analytics

Apartment

New supply is bringing market conditions into balance. Renters are showing some resistance to high rental rates.

Vacancy

5.5%
Vacancy
as of 17Q1

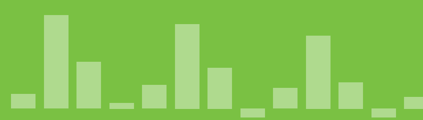
Quarterly Vacancy Trend

10-YEAR AVERAGE VACANCY **6.0%**

- Vacancy has been trending higher since mid-2015.
- Despite this uptick the national apartment market is very tight, limiting demand in some cases.
- Vacancy is holding below recent and long term historical averages.

Net Absorption

245k
Units
four quarters ending 17Q1



Quarterly Demand Trend

10-YEAR AVERAGE ANNUAL DEMAND GROWTH **251,000 UNITS**

- Even considering seasonal fluctuations, apartment demand has been more subdued in recent quarters.
- The shift away from homeownership has stalled, leaving the homeownership rate at multi-decade lows.
- Millennials have not dominated demand growth, but they are—and will remain—a major source of absorption.

Net Completions

351k
Units
four quarters ending 17Q1

Quarterly Supply Trend

10-YEAR AVERAGE ANNUAL SUPPLY GROWTH **255,000 UNITS**

- Apartment developers are very active and the large number of properties in lease up is pushing up vacancy.
- Construction activity is slightly above 2006-07 levels.
- Construction seems to have peaked for the cycle—raising the potential for a healthy and more balanced market.

Rent

2.4%
YoY Growth
as of 17Q1

Quarterly YoY Rent Trend

10-YEAR AVERAGE ANNUAL RENT GROWTH **2.3%**

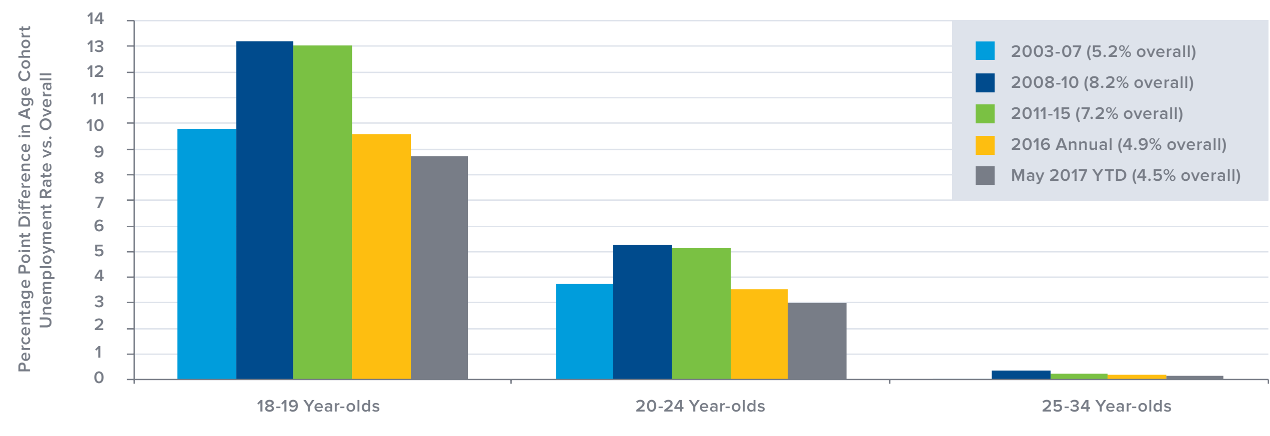
- Rents are increasing modestly ahead of inflation due to the still-tight market.
- But the exceptional gains seen earlier in the recovery are unlikely to return in the medium term.
- Affordability is a concern in some markets and concessions are increasing in many locales.
- Broad declines seem unlikely.

Source: Axiometrics Note: Charts show the past 13 quarters

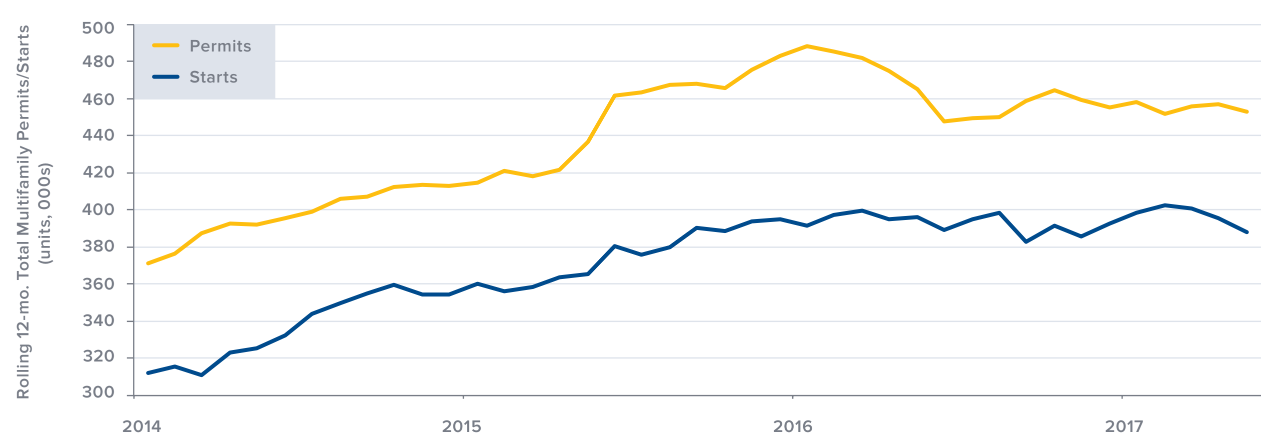
Apartment

- Homeownership remains low, perpetuating the upward trend in renter households.
- The adjacent chart shows unemployment for younger workers relative to the overall rate. Younger workers are finding jobs, which should support household formation and apartment demand.
- Low unemployment is providing some lift to wages, which should help alleviate affordability issues and allow landlords to push rents.
- Both starts and permits suggest construction has peaked for the cycle, but completions will remain elevated in the near term.
- Construction costs and tightening lending standards for new multifamily development are helping to keep supply in check.
- That said we see some markets where material increases in vacancy could unfold in 2017. These markets include, Boston, Nashville, Charlotte, and San Francisco.
- Baltimore, Norfolk, Minneapolis, and Denver are among the markets that could outperform the national vacancy trend over the next year.

STRONGER ECONOMY FOR YOUNGER WORKERS SHOULD LIFT DEMAND



CONSTRUCTION ACTIVITY HAS PEAKED FOR THE CYCLE



Sources: U.S. Bureau of Labor Statistics (BLS) I U.S. Census Bureau, Moody's Analytics Calculated

Office

Net absorption has moderated, but companies continue to soak up quality space in locations desired by highly-skilled workers.

Vacancy

13%

Vacancy

as of 17Q1

Quarterly Vacancy Trend

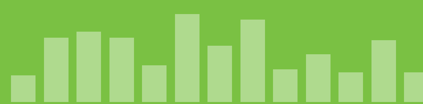
10-YEAR AVERAGE VACANCY **14.6%**

- Vacancy has ticked up slightly after briefly dropping below 13%.
- Relative to 10-year and long-term averages office vacancy is still very low.
- Recent trends have slightly favored Suburban submarkets over Downtown submarkets.
- Vacancy has likely reached its low point for the cycle.

Net Absorption

Million SF

four quarters ending 17Q1



Quarterly Demand Trend

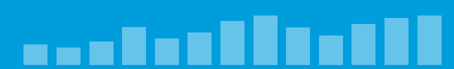
10-YEAR AVERAGE ANNUAL DEMAND GROWTH **30.0 MSF**

- Net absorption has moderated from 2015/early 2016 highs.
- Key office job sectors have lost little momentum, but weak business investment and an uncertain regulatory regime are a drag.
- Office demand may have limited upside in the short run as the economic outlook has cooled.

Net Completions

Million SF

four quarters ending 17Q1



Quarterly Supply Trend

10-YEAR AVERAGE ANNUAL SUPPLY GROWTH **35.5 MSF**

- Supply and demand are balanced and completions are only modestly above their 10-yr. avg.
- High costs and tightening debt availability are helping to manage the construction cycle.
- Tenant moves towards open, modern floor-plans with amenities have been a major driver of construction.

Rent

1.8%

YoY Growth

as of 17Q1

YoY Rent Growth Trend

10-YEAR AVERAGE ANNUAL RENT GROWTH **1.7%**

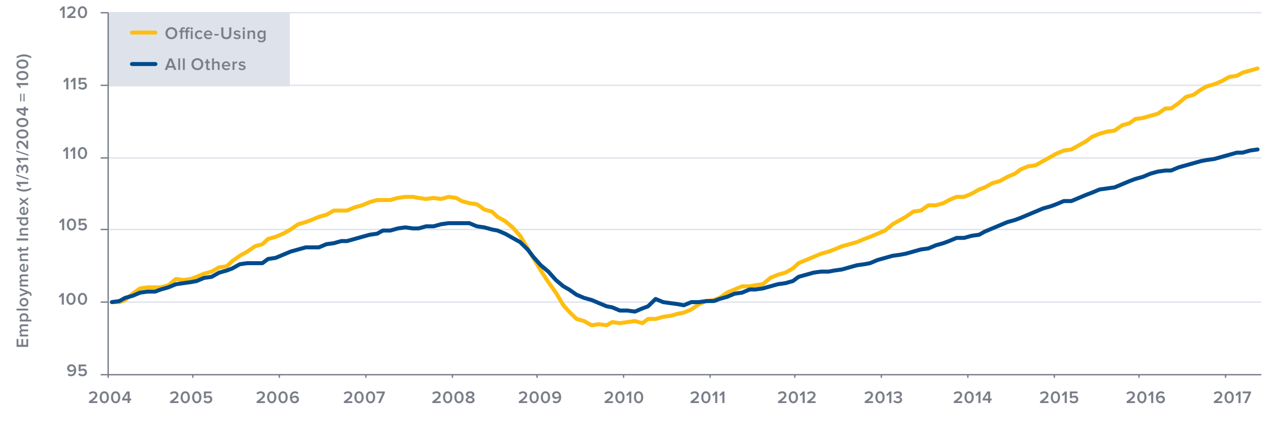
- Fundamentals are yielding only inflation-like rent growth.
- Rent growth is unlikely to see a material acceleration, particularly as growth cools in some technology markets.
- CoStar shows declining rents YoY in some locations, including the San Francisco and Denver CBDs.

Source: CBRE-EA Note: Charts show the past 13 quarters

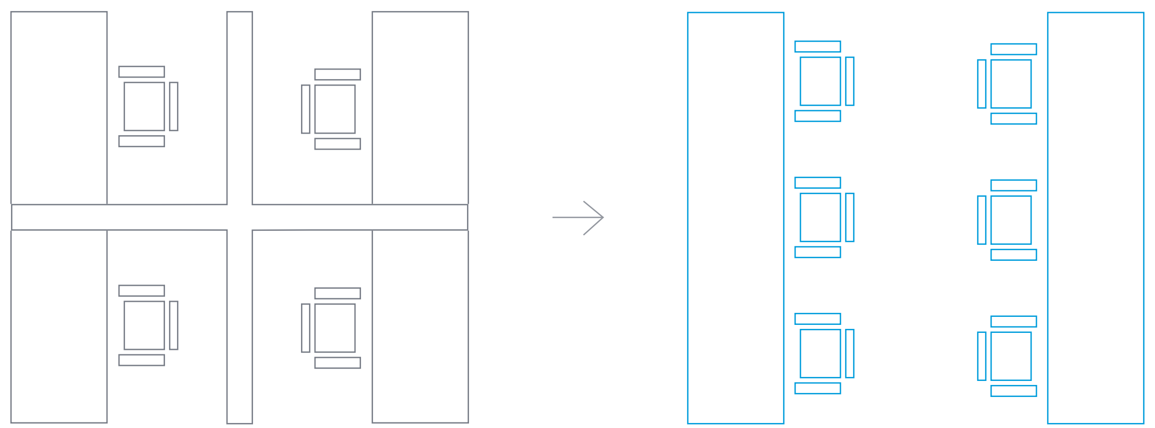
Office

- While conditions are becoming more tenant favorable, the office market is fundamentally sound, underpinned by healthy office-using job growth.
- Knowledge-based sectors such as computer systems design and management and technical consulting have seen their growth slow, albeit to still exceptional rates.
- A lackluster environment for IPOs and venture capital investment presents headwinds for tech firms. Tech job growth has slowed, although it remains relatively strong.
- Financial activities hiring has accelerated modestly led by real estate and credit intermediation (banking).
- Tenants continue to follow workers to dense live/work/play neighborhoods or expand existing facilities in these areas. Amazon, GE, and Uber are all underway on new urban space.
- New spaces are highly amenitized, which helps lure workers in a tight labor market, and may serve as a psychological offset to shrinking personal spaces.
- Firms looking to grow outside of desirable urban locations are forced to "place make," or build spaces that will appeal to workers (e.g. Toyota in Plano, TX and Nike in Beaverton, OR).

JOB CREATION CONTINUES TO FAVOR OFFICE LANDLORDS



A MOVE FROM TRADITIONAL TO OPEN LAYOUT IN THE OFFICE



Source: U.S. Bureau of Labor Statistics

Retail

Ecommerce remains highly disruptive to the retail sector resulting in large numbers of store closures even as consumers increase spending.

Availability

10.1%

Availability

as of 17Q1

Quarterly Availability Trend

10-YEAR AVERAGE AVAILABILITY **11.4%**

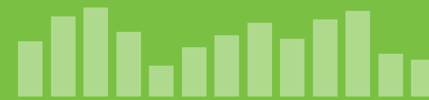
- Despite headwinds, retail availability is slowly falling.
- Gradual improvement is expected over the next year as consumption grows.
- Urban and dense suburban retail locations have tended to outperform.
- Malls may increasingly bear the brunt of new availability as anchor tenants close.

Net Absorption

28

Million SF

four quarters ending 17Q1



Quarterly Demand Trend

10-YEAR AVERAGE ANNUAL DEMAND GROWTH **17.8 MSF**

- Many national retailers are closing stores, dampening demand growth.
- Demand is healthy for experiential and personal care-related retail.
- Department stores, apparel, and electronics are struggling.
- Retail demand rising in metros with strong population and employment growth.

Net Completions

18

Million SF

four quarters ending 17Q1

Quarterly Supply Trend

10-YEAR AVERAGE ANNUAL SUPPLY GROWTH **27.4 MSF**

- Developers have been selective, focusing on strong infill locations with desirable demographics.
- Grocery anchored centers and neighborhood/community centers have seen the strongest supply growth.
- As with demand, supply is more prevalent where households and single family inventory are growing.

Rent

2.9%

YoY Growth

as of 17Q1

YoY Rent Growth Trend

10-YEAR AVERAGE ANNUAL RENT GROWTH **-0.5%**

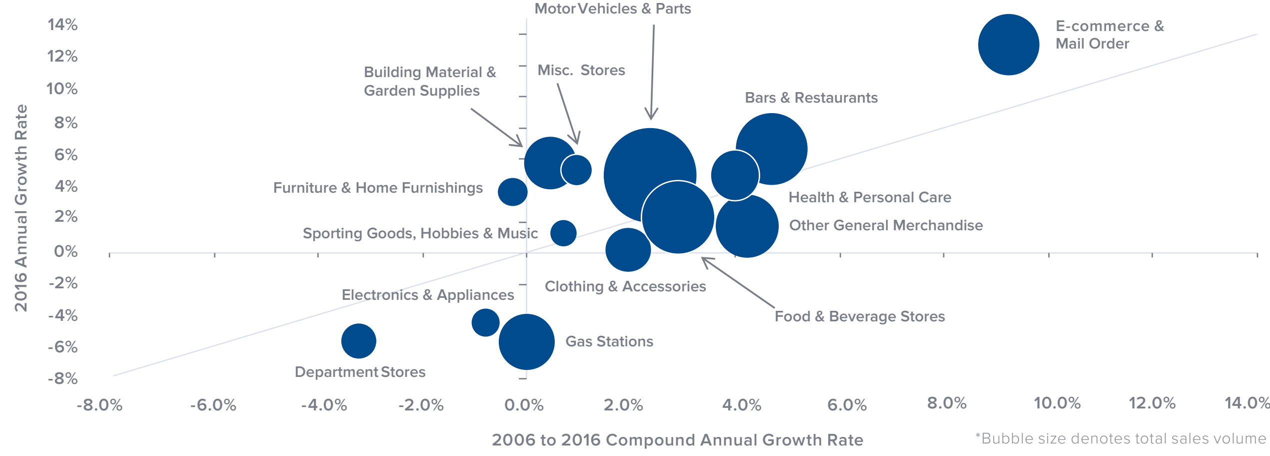
- Recent rent growth was the strongest since 2008, and ahead of the apartment and office markets.
- Rents should continue to rise, albeit slowly, with significant differences across markets.
- Landlords in urban and dense suburban locations are likely to have the most pricing power.

Source: CBRE-EA Note: Charts show the past 13 quarters

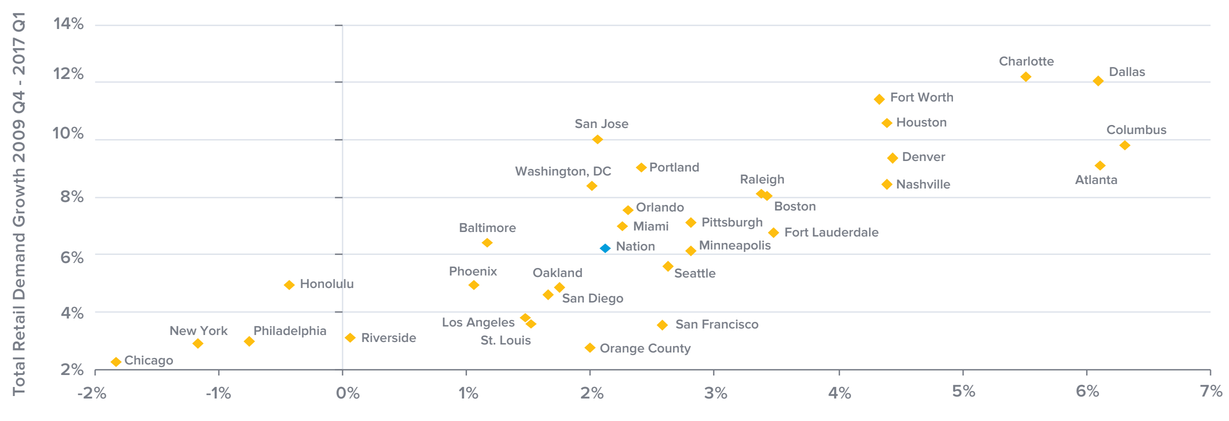
Retail

- Ecommerce remains far and away the sales growth leader, siphoning off sales from many brick & mortar categories.
- Retailers such as Target and Wal-Mart (other general merchandise) have seen revenue growth languish, while personal care stores with an urban footprint (e.g. CVS and Walgreens) have maintained some momentum.
- Store closures are expected to spike in 2017, led by chains in struggling retail categories such as department stores, apparel, and electronics.
- Ecommerce will remain a major disruptor. Amazon's proposed acquisition of Whole Foods could significantly alter the heretofore insulated grocery category.
- Metros in the top right of the adjacent chart have seen strong demand growth for retail space as national chains look to tap into their healthy economic expansions. Growth in these markets has been well in excess of new construction.
- Metros with less exuberant economic growth, including those in the lower left hand corner of the adjacent chart, have still seen demand rise, but at a slower pace—in some cases lagging supply growth.

SALES MOMENTUM HAS VARIED WIDELY BY CATEGORY

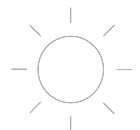


DEMAND GROWTH LED BY HIGHER GROWTH ECONOMIES



Sources: Moody's Analytics; US Census Bureau | CBRE-EA

Industrial



While supply warrants monitoring, demand growth is strong, availability is low, and rent growth leads the other major property sectors.

Availability

8.0%

Availability

as of 17Q1

Quarterly Availability Trend

10-YEAR AVERAGE AVAILABILITY **11.2%**

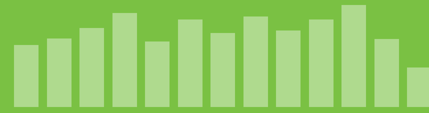
- Availability rose in 17Q1 for the first time since 2010.
- The current level is near 16-year lows and we expect only a slight increase over the next year.
- Most major markets remain extremely tight, facing shortages of modern space.

Net Absorption

248

Million SF

four quarters ending 17Q1



Quarterly Demand Trend

10-YEAR AVERAGE ANNUAL DEMAND GROWTH **127.2 MSF**

- Demand growth has moderated on a quarterly basis but has been stellar over the past two years.
- Industrial indicators bode well for healthy net absorption in the quarters ahead.
- Online and brick-and-mortar retailers are building out their distribution networks to support ecommerce growth.

Net Completions

195

Million SF

four quarters ending 17Q1

Quarterly Supply Trend

10-YEAR AVERAGE ANNUAL SUPPLY GROWTH **115.9 MSF**

- Construction has ratcheted up and will peak over the next two years.
- While above the long term average, annual completions are lagging demand and below prerecession peaks.
- Modern spaces in locations closer to urban cores are in demand, but often difficult to develop.

Rent

6.7%

YoY Growth

as of 17Q1

YoY Rent Growth Trend

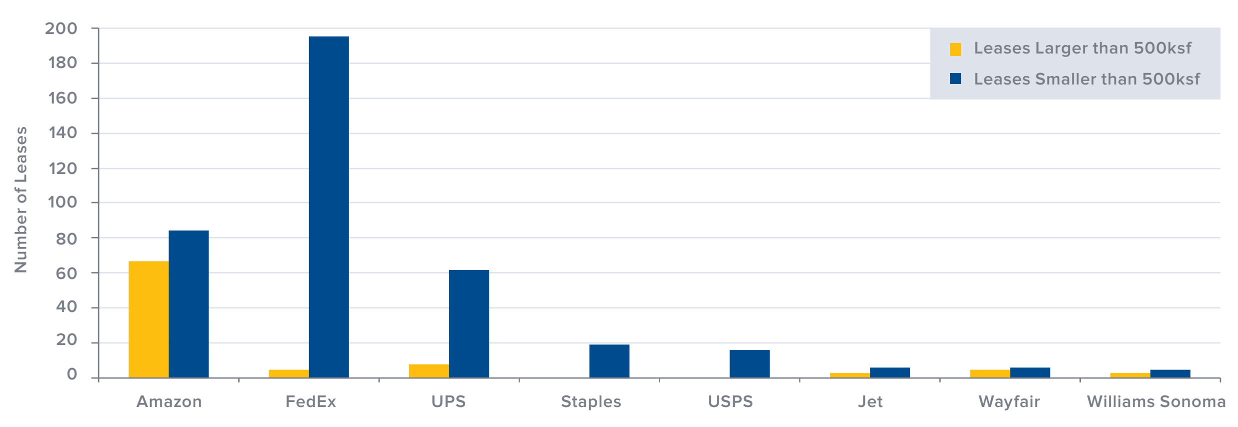
10-YEAR AVERAGE ANNUAL RENT GROWTH **0.8%**

- Market conditions are decidedly in favor of landlords.
- Industrial rents are rising at a faster pace than the other major property types.
- Miami, Oakland, Seattle, and New York have seen strong rent growth recently.
- Supply growth should begin to cool rent increases.

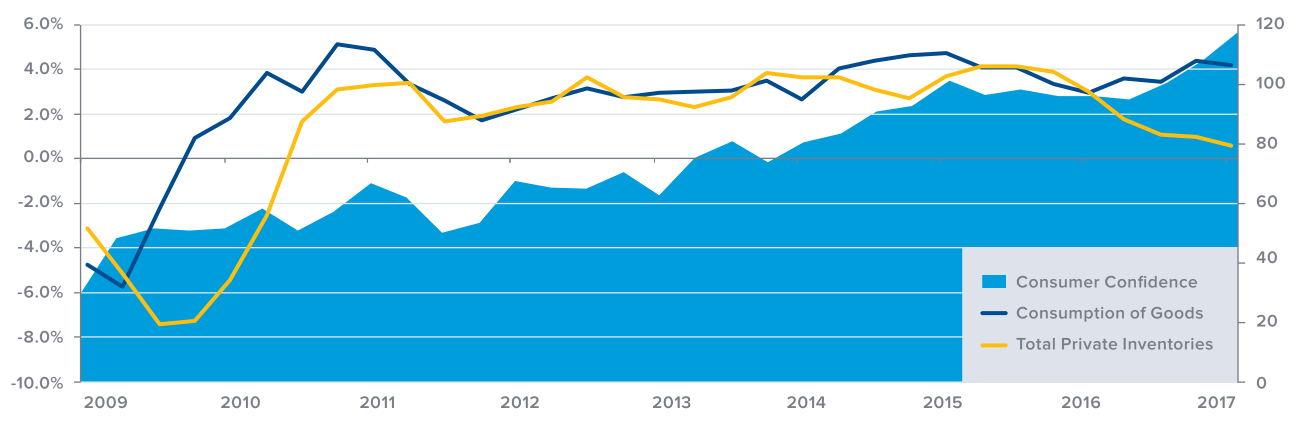
Source: CBRE-EA Note: Charts show the past 13 quarters

Industrial

ECOMMERCE DRIVING INFILL INDUSTRIAL DEMAND



CONSUMPTION LEVELS SUGGEST INVENTORIES MAY RISE



Sources: CoStar; Bentall Kennedy | Bureau of Economic Analysis; The Conference Board; Moody's Analytics; Bentall Kennedy

95%

OF ALL U.S. ECOMMERCE ORDERS ARE HANDLED BY USPS, UPS, AND FEDEX

- Mid-size to smaller, infill industrial spaces have been in high demand and should remain so.
- Tenants are focused on filling out their distribution networks to handle the rapid growth of direct-to-consumer deliveries and returns.
- Amazon's activity has been relatively balanced in terms of building size to support its stellar growth.
- FedEx CFO Alan Graf recently estimated that 95% of all ecommerce orders in the U.S. are handled by USPS, UPS, and FedEx.
- Healthy consumption growth, driven by a variety of positive economic factors, bodes well for space demand.
- Inventory growth has lagged consumption growth recently. Inventories may need replenishing.
- Expectations of moderately improving economic growth in the U.S. and abroad suggests industrial's strong run may continue.
- But development increasingly bears watching and conditions will become more balanced between tenants and landlords over the next year.

For institutional use only.

ABOUT BENTALL KENNEDY

Bentall Kennedy, a Sun Life Investment Management company, is one of the largest global real estate investment advisors and one of North America's foremost providers of real estate services. Bentall Kennedy serves the interests of more than 550 institutional clients with expertise in office, retail, industrial and multi-residential assets throughout Canada and the U.S. Bentall Kennedy is a member of UN PRI and a recognized Responsible Property Investing leader ranked among the top firms around the globe in the Global Real Estate Sustainability Benchmark (GRESB) for the sixth consecutive year since GRESB was launched.

For more information, visit www.bentallkennedy.com.

For more information about Perspective, please contact:

Paul Briggs, SVP, Head of Research,
Bentall Kennedy (U.S.) Limited Partnership
pbriggs@bentallkennedy.com, 617 790 0853

This document is intended for institutional investors only. It is not for retail use or distribution to individual investors. The information in this document is not intended to provide specific financial, tax, investment, insurance, legal or accounting advice and should not be relied upon and does not constitute a specific offer to buy and/or sell securities, insurance or investment services. Investors should consult with their professional advisors before acting upon any information contained in this document.