DIVIDEND CAPITAL
RESEARCH

Cycle Monitor — *Real Estate Market Cycles*

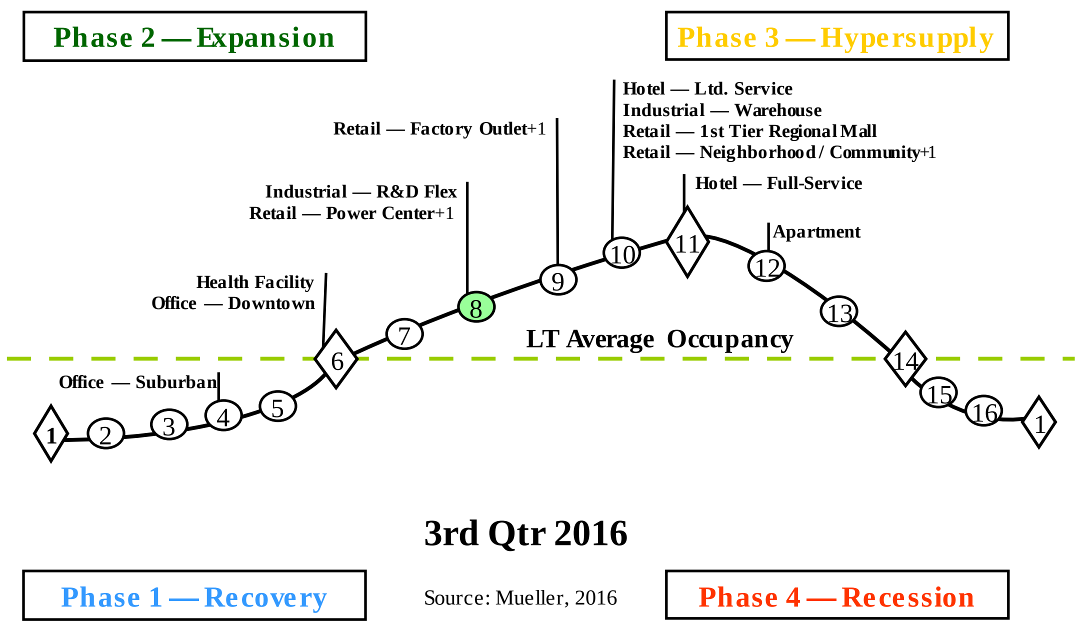
Third Quarter 2016 Analysis

November 2016

Commercial Real Estate Physical Market Cycle Analysis of All Five Major Property Types in 55 Metropolitan Statistical Areas (MSAs).
The surprise result of the presidential election was greeted with strong, positive business and stock market reactions. All post-election economic forecasts improved. The Wall Street Journal's survey shows Gross Domestic Product (GDP) increasing 2.2% in 2017 and 2.4% in 2018. Consumer Price Index (CPI) inflation is forecast to increase 2.3% in 2017 and 2.4% in 2018. The 10-year Treasury bill rates are expected to rise from 2.5% in 2017 to 3.0% in 2018. These moderate increases should all continue to create increased demand for income-producing real estate, while increasing operating costs only moderately.

Office occupancy **improved** 0.2% in 3Q16, and rents grew 0.8% for the quarter and 3.6% annually.
Industrial occupancy **improved** 0.2% in 3Q16, and rents grew 1.8% for the quarter and 6.9% annually.
Apartment occupancy **declined** 0.1% in 3Q16, and rents grew 0.6% for the quarter and were up 3.2% annually.
Retail occupancy **improved** 0.2% in 3Q16, and rents grew 0.8% for the quarter and 2.9% annually.
Hotel occupancy **was flat** in 3Q16, and room rates increased 0.4% for the quarter and 2.2% annually.

National Property Type Cycle Locations

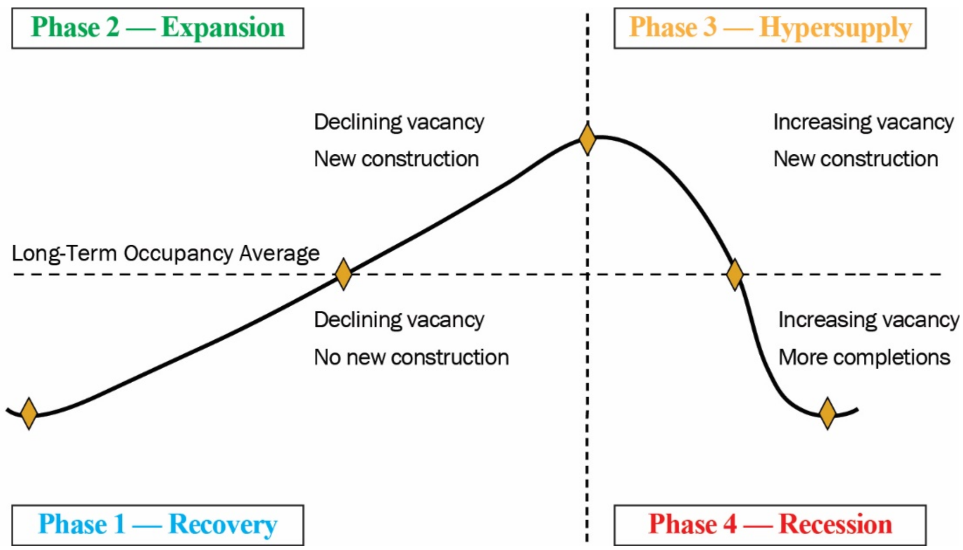


National Property Type Cycle Graph shows relative positions of sub-property types — major markets are reviewed inside.

DCG-BD-MCM-NOV16

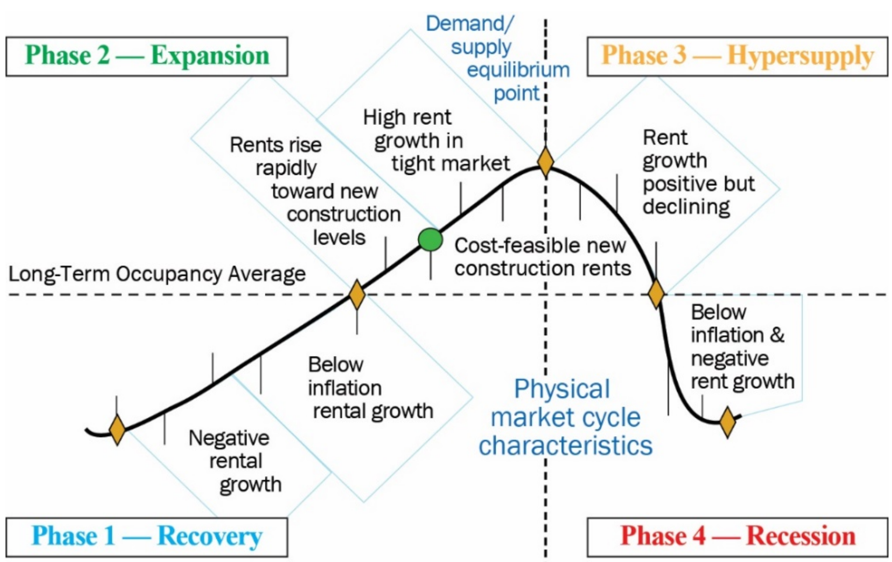
The cycle monitor analyzes occupancy movements in five property types in more than 50 MSAs. Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Commercial real estate markets are cyclical due to the lagged relationship between demand and supply for physical space. The long-term occupancy average is different for each market and each property type. ***Long-term occupancy average*** is a key factor in determining rental growth rates — a key factor that affects commercial real estate returns.

Market Cycle Quadrants



Source: Mueller, Real Estate Finance, 2016.

Rental growth rates can be characterized in different parts of the market cycle, as shown below.



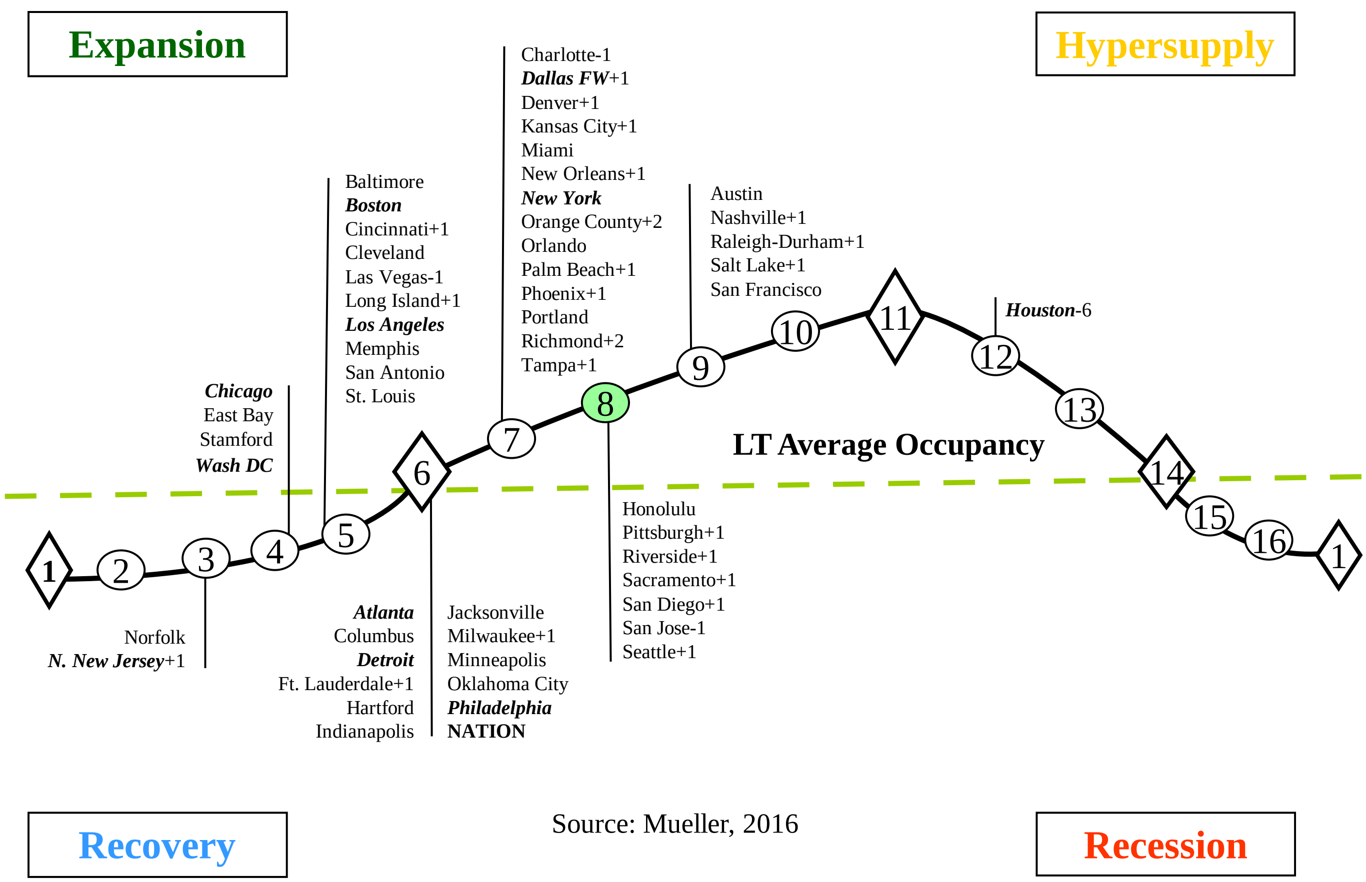
Source: Mueller, Real Estate Finance,

OFFICE

The national office market occupancy level improved 0.2% in 3Q16, and was up 0.5% year-over-year. Office job growth has averaged 2.5% over the past year, which outpaced the total employment growth of 2% in all categories. Office space demand was up only 1.3% as tenants continue to put more people in less space. New supply was up 5% over the previous year, with almost 64 million square feet of new space. However, demand is still outpacing new supply, producing positive net absorption year-over-year, and this absorption was spread across many markets. Sub-lease space is now below 2% of space available — another healthy market indicator. Average national rents increased 0.8% in 3Q16 and produced a 3.6% increase year-over-year.

Office Market Cycle Analysis

3rd Quarter, 2016



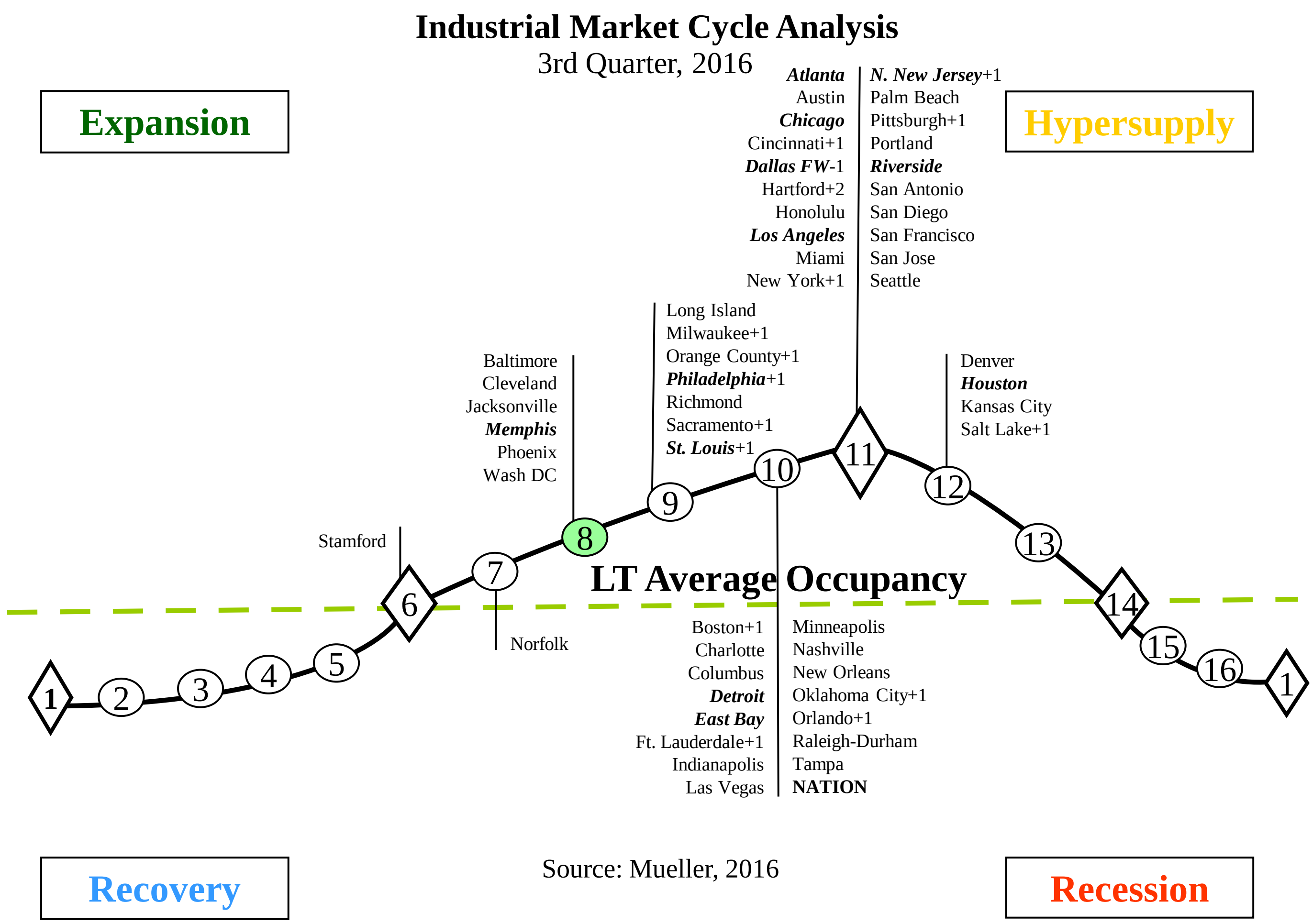
Source: Mueller, 2016

Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

INDUSTRIAL

Industrial occupancies improved 0.2% 3Q16 and were up 0.6% year-over-year. Demand from e-commerce and retail chains led the way to more than 76 million square feet of new leasing in 3Q16. New supply did not keep pace, with only 53 million square feet of completions in 3Q16 — mostly Class A distribution space. Atlanta, Chicago, Dallas and Riverside led the way in new construction. Net absorption has averaged more than 40 million square feet per quarter in this cycle, versus the 2002-2008 cycle average of 35 million square feet per quarter. Amazon.com signed two million-plus square foot leases during the quarter. Industrial national average rents increased 1.8% in 3Q16 and were up 6.9% year-over-year.



Source: Mueller, 2016

Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor. Thus, the 12-largest industrial markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

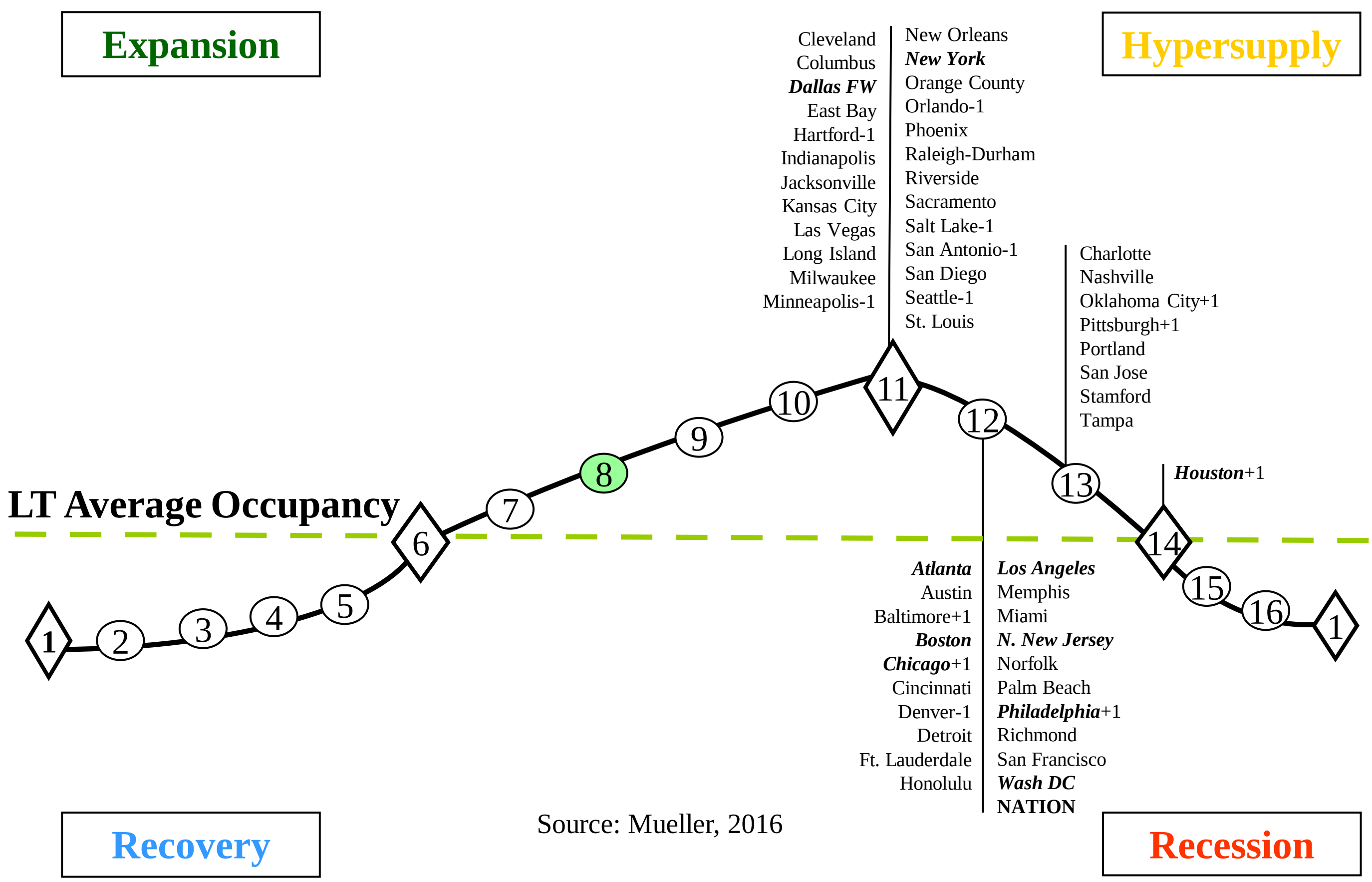
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

APARTMENT

The national apartment occupancy average declined 0.1% in 3Q16 and was up a modest 0.3% year-over-year. Occupancies declined in 37 of the 50 largest markets lead by Austin and Houston. However, seven markets had occupancy improvements that moved them to higher points on the cycle graph. Household formation continues to be strong as Millennials graduate from high school and college. Downtown rents are now high enough that many Millennials are opting for suburban apartments near public transportation. Developers have responded with new supply that is quicker to build than downtown high rise apartments. Single-family home ownership construction is still at historic-low levels, keeping many Millennials in rental apartments. Thus, the apartment market could move back into the growth phase of the cycle if new construction slows. Average national apartment rent growth remained at a 0.6% increase in 3Q16, and was up 3.2% year-over-year.

Apartment Market Cycle Analysis

3rd Quarter, 2016



Note: The 10-largest apartment markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest apartment markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

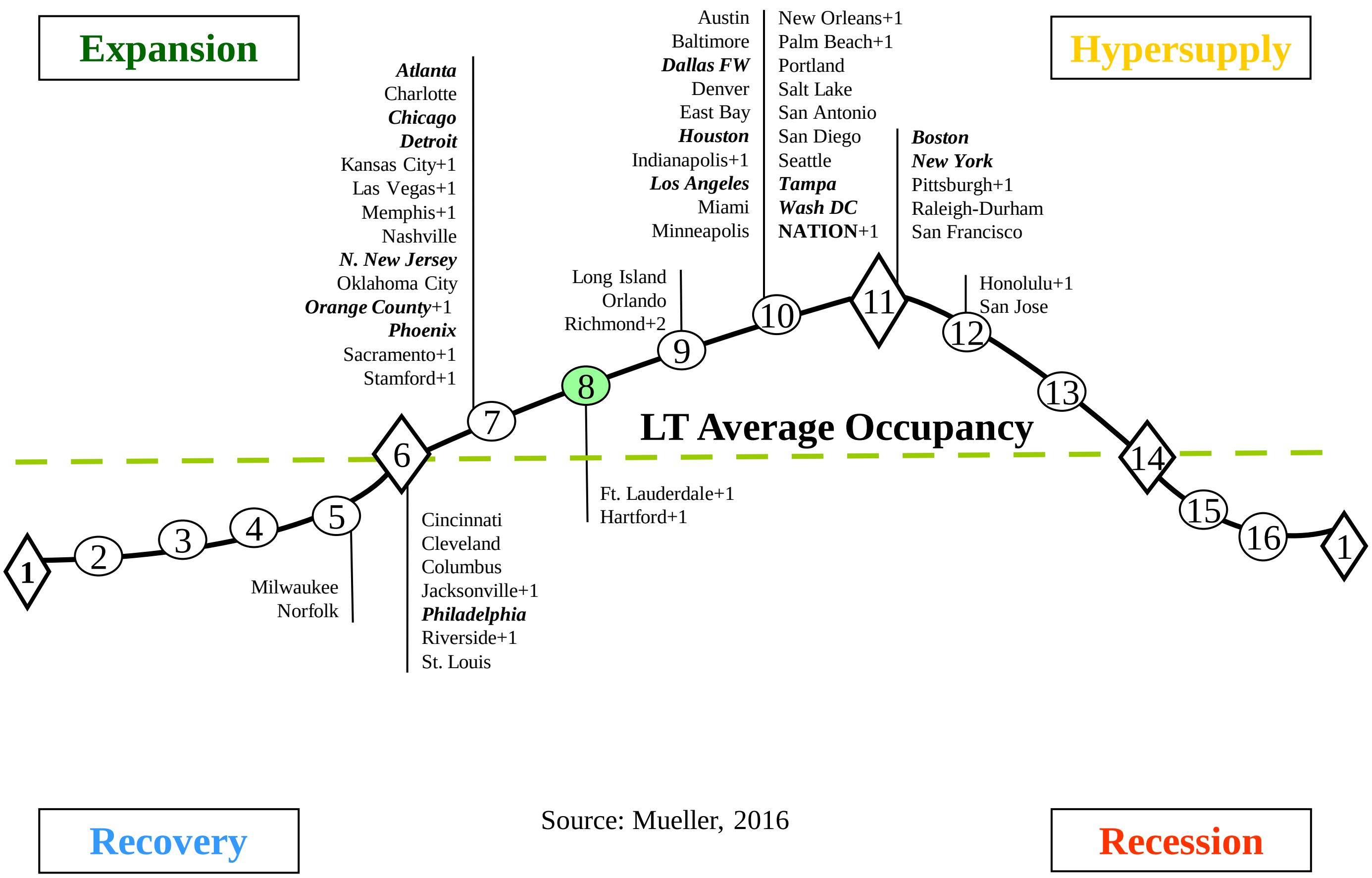
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

RETAIL

Retail occupancies improved 0.2% in 3Q16 and were up 0.5% year-over-year. Consumer spending continued to be moderately strong in 3Q16, providing landlords with the confidence to expand. Dominant retail hubs, urban cores and affluent suburbs experience most of the demand, while low population density locations continue to suffer. High-end centers in prominent retail clusters are performing best. New supply continues at low levels, allowing the market balance to improve. National average retail rents increased 0.8% in 3Q16 and were up 2.9% year-over-year.

Retail Market Cycle Analysis

3rd Quarter, 2016



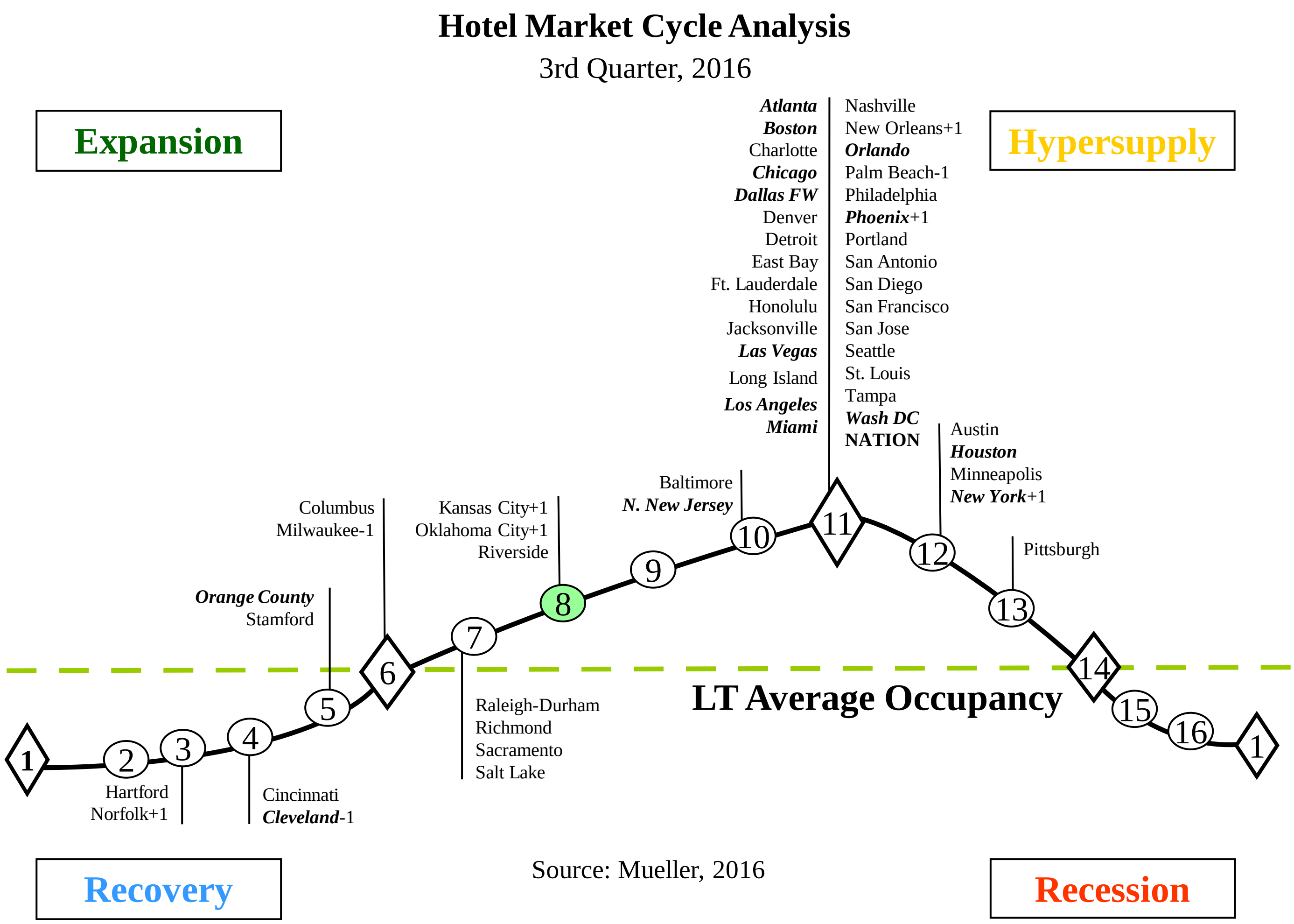
Source: Mueller, 2016

Note: The 14-largest retail markets make up 50% of the total square footage of retail space we monitor. Thus, the 14-largest retail markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

HOTEL

Hotel occupancies were flat in 3Q16 and up 0.8% year-over-year. The national average occupancy rate of 72% (an all-time historic high) held for 3Q16, hopefully pointing to a consistent demand in these moderate economic times. Both business and leisure travel continue to be strong. The expectations for stronger economic growth under a business-friendly administration bode well for future hotel demand. The national average hotel room rate increased 0.4% in 3Q16, and was up 2.2% year-over-year.



Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space that we monitor. Thus, the 14-largest hotel markets are in boldface italics to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

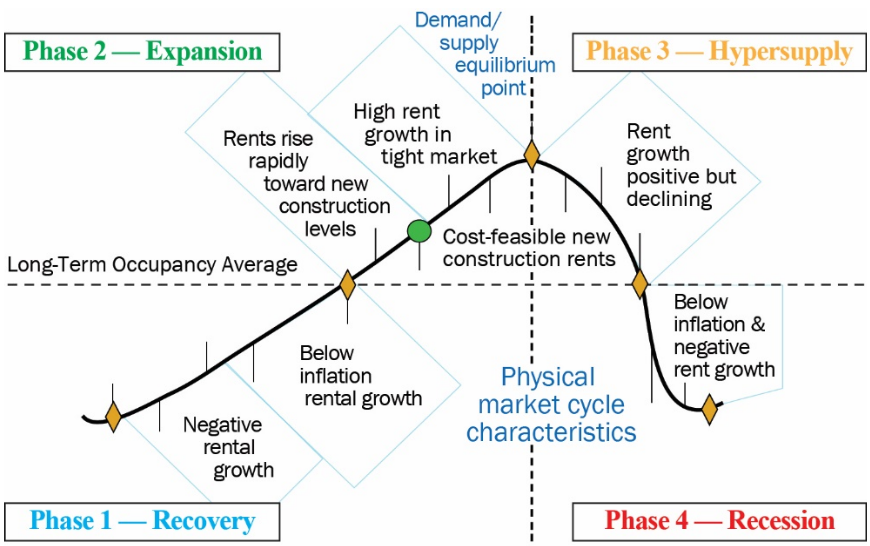
MARKET CYCLE ANALYSIS — Explanation

Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle (see chart below), the marketplace is in a state of oversupply from either previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall, allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its ***long-term occupancy average,*** whereby rental ***growth is equal to inflation***.

In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space. As vacancy rates fall below the ***long-term occupancy average***, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a cost-feasible level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call “rent spikes.” (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate ***or equilibrium.*** Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth. Most real estate participants do not recognize this peak / equilibrium’s passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth. The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive. As a result, they then lower rents to capture tenants, even if only to cover their buildings’ fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid–ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 2016.

This research currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

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