Perspective

2017

UNITED STATES

01 EXECUTIVE OVERVIEW

02 ECONOMIC OUTLOOK

03 CAPITAL MARKETS

04 PROPERTY SECTORS

Bentall Kennedy

Anthology
Washington, D.C.

Table of Contents

01 Executive Overview 4
02 Economic Outlook 7
03 Capital Markets 13
04 Property Sectors
Apartment 19
Office 23
Medical Office 27
Retail 31
Industrial 37
About Bentall Kennedy Group 41

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Executive Overview: Persistent Economic Growth Supporting Attractive Returns

GLOBAL ECONOMY: SLOW GROWTH, HIGH UNCERTAINTY

The wave of national populism sweeping the globe—resulting in the Brexit vote and, to some extent, the election of Donald Trump in the U.S.—is creating significant uncertainty around the economic outlook. Global growth remains sluggish, weighed down by weakness in Europe and the slowest growth in China in over 25 years. The steady U.S. economy and recent gains in oil prices (which should benefit struggling oil exporting nations) suggest there is potential for brighter days ahead.

UNITED STATES ECONOMY: HOLDING FIRM, DESPITE HEADWINDS

U.S. growth may actually be poised to accelerate in the near term as the Trump administration is expected to lower taxes and increase government spending in 2017. This fiscal stimulus should ignite inflation, including faster wage growth, as steady job gains have already brought the economy near full employment. Such policies could result in heightened cyclicality in the medium-to-long term, however, if the economy overheats. We remain vigilant for immigration policy changes that crimp the flow of workers from abroad and/or actions that disrupt international trade relations.

CAPITAL MARKETS: REAL ESTATE MAINTAINS INVESTOR APPEAL

Capital markets have seen the Fed raise interest rates for the second time since the end of the recession and long-term rates rebound from mid-2016 lows. U.S. equity markets are at record high levels. REITS have seen mixed results recently, giving back some of their stellar gains from earlier in 2016 as interest rates rise. Direct investment in commercial real estate remains very strong, bolstered by foreign capital seeking stability and growth in the U.S. Banks are tightening lending standards, particularly for multifamily and construction loans. Healthy space market fundamentals are supporting attractive returns, but we expect investment performance to revert to the mean in the years ahead.

APARTMENT: NEW SUPPLY BALANCING A TIGHT MARKET

Apartment vacancy rose slightly over the past year, but it remains well below historical average levels, at less than 5.0%. Landlords continue to generate healthy net operating income (NOI) growth. Demand for apartments is strong with the propensity for households to rent near historical highs. High rent levels and low vacancy are impediments to demand growth in many markets, but rising employment and wages should continue to benefit the sector. Micro location and amenities are playing an important role in attracting tenants. High construction costs and tightening lending standards are tempering development. Multifamily housing starts are peaking out around 400,000 units/year.

OFFICE: TENANTS PURSUE TALENT AND BRAND IDENTITY

Office vacancy fell 40 basis points over the past year to 13.0% as of 3Q 2016, and current vacancy is on a par with early 2008 levels. Rents are rising nationally, albeit only at an inflation-like rate. Office-using employment growth continues to widely outpace non-office-using job gains, and improving corporate earnings should reinvigorate leasing in 2017. Office construction is well below levels observed prior to the recession and is not overpowering demand. Developers are emboldened by healthy market fundamentals, high prices, and rising rents, but they also face headwinds related to cost and availability of debt—not to mention some crowding out by apartment development.

MEDICAL OFFICE: SOLID FUNDAMENTALS, CLOUDY POLICY OUTLOOK

Medical office vacancy declined 70 basis points over the past year to 8.4% as of 3Q 2016, according to CoStar data. Vacancy is now below its 2007 trough. Net absorption has significantly outpaced its trailing five-year average, reaching 12.6 million sf over the past four quarters. An aging population and rising ranks of insured Americans will necessitate continued expansion by healthcare providers. Development should continue at a steady pace, led by outpatient treatment facilities closer to population and away from high-cost hospital campuses. Risks on the horizon include potential changes to the Affordable Care Act and rapidly developing medical technologies that could disrupt the sector.

RETAIL: MAINTAINING FOOTING ON A SHIFTING LANDSCAPE

Retail availability has improved, returning to levels last seen in 2008, but well-above prerecession lows. Dramatic growth in ecommerce sales activity, rising demand for experiential retail offerings, and a growing concentration of sales in urban retail nodes are disrupting the sector. Retailers continue to struggle with these dynamics, forcing the closure of entire retail chains (Sports Authority) or underperforming stores (Macy's). Rising employment and wages should support healthy consumer spending growth in 2017, while new construction remains relatively muted. Retailers are tempering expansions, focusing new store openings on infill locations, as they work to deploy effective omni-channel strategies.

INDUSTRIAL:
DEMAND GROWTH SHATTERS CONVENTIONAL MODELS

Through 3Q 2016, industrial availability has fallen for 26 straight quarters. At 8.4%, according to CBRE-EA, availability is at its lowest level in two decades. Growth in traditional demand drivers has been lackluster, but tepid growth in areas such as industrial production and inventories has given way to surging ecommerce demand. The need for modern, efficient distribution space with high ceilings, multiple dock doors, and ample trailer parking has spurred most of the recent industrial construction activity. Supply growth shows no signs of abating, with more than 200 million sf of distribution space underway, but we expect industrial demand to remain strong, keeping availability low.

Donald Trump's election has certainly elevated policy risks in 2017 and beyond, but it also raises the prospect of faster economic growth in the near term. This growth should benefit commercial real estate and, even while returns moderate from the double-digit levels of recent years, they should remain competitive with investment alternatives, particularly after adjusting for risk. Deeper analysis of these trends and discussion of our outlook are available in the pages that follow.

We hope you find this restyled edition of Perspective informative and insightful.

$51.91

NOMINAL PRICE OF OIL, WEEK OF DEC. 16, 2016, UP 71% FROM THE 13-YEAR LOW SET IN FEB. 2016

2.5%

10-YEAR TREASURY BOND YIELD, DECEMBER, 2016, UP FROM 1.4% IN JUNE, 2016

9.2%

NCREIF PROPERTY INDEX TOTAL RETURN YEAR ENDING 3Q 2016

Anthology
Washington, D.C.

Diridon Station Development
San Jose, CA

02

Economic Outlook

GLOBAL

—A wave of national populism is sweeping the globe resulting in changes in the status quo for geopolitical relations and creating social unrest in some countries.

—Global economic growth is persistent, albeit lackluster, as aggressive monetary policy has proven an insufficient catalyst for stronger economic activity.

—China's GDP growth has stabilized at just under 7.0%, the slowest pace in over 25 years.

—Weakness in Europe is weighing down the global economy. GDP growth is trending below 2.0% in the European Union.

—While they remain well-below peak levels, oil prices are rising, bolstered by recent production cut agreements.

UNITED STATES

—A tight labor market is driving wages higher, fueling healthy growth in consumption. Job gains are moderating as available labor is scarce.

—U.S. firms are benefiting from expanding domestic demand. However, weak growth abroad and a rising dollar have presented headwinds that should persist in 2017.

—Uncertainty is high as the incoming Trump administration poses both upside and downside risks to growth. Tax, trade, immigration, and regulatory policy changes are all expected.

—Our outlook remains positive with expectations for improved growth in 2017 aided by stimulative fiscal policy (lower taxes and increased government spending).

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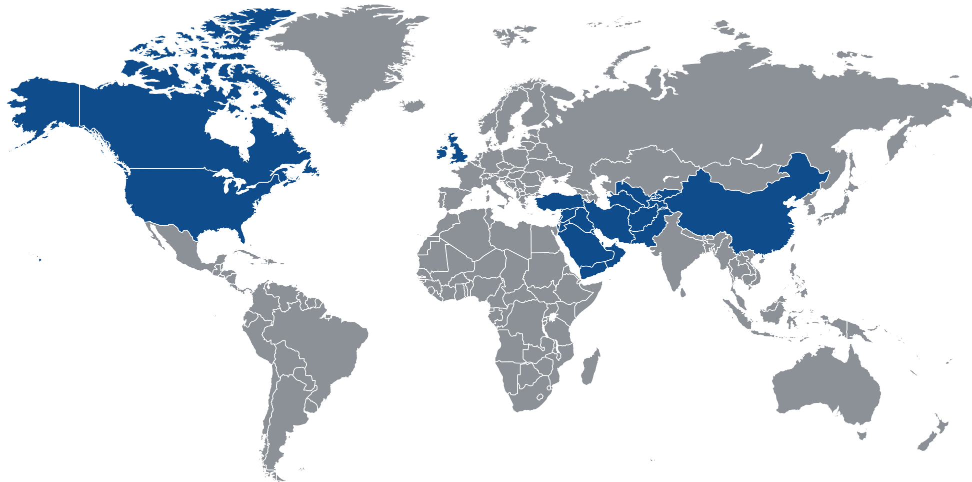
Global Economy: Slow growth, high uncertainty



No one event was more emblematic of global social, political and economic conditions over the past year than the June 2016 “Brexit” vote, in which citizens of the U.K. voted to exit the European Union. The heated debate leading up to and following the vote pitted national populism against globalism, with working-class voters essentially lashing out against the immigration and trade policies of their government—echoes of this were also evident in the election of Donald Trump as president of the U.S. Brexit elevated uncertainty across the global economy and exacerbated already volatile financial market conditions. After the vote, stock markets plunged worldwide and the British pound was heavily sold off. But reactionary market fluctuations seem to have given way to a wait-and-see approach. Markets have since rebounded, and it is even possible that Brexit may never actually happen.

In an uncertain economic environment such as this we must:

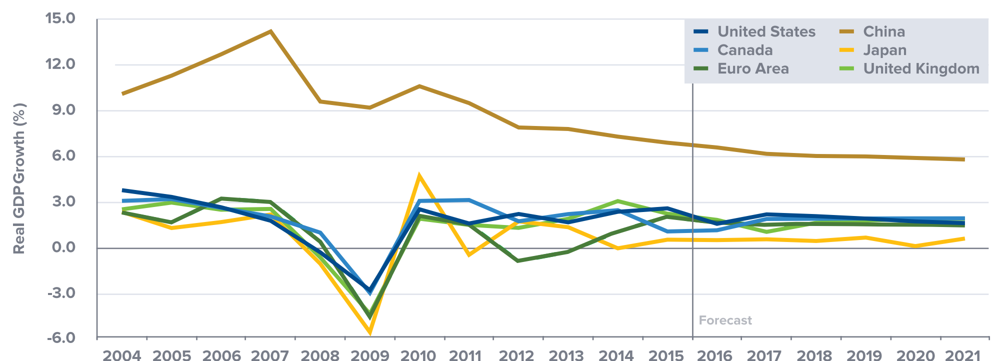
—Acknowledge known unknowns (Brexit vote, Trump election)
—Not become frozen by the prospect of unknown unknowns (black swan events: war, financial market shocks)
—Closely analyze trends in known data (slower growth in China, continued U.S. expansion)

Through this lens we see a global economy that is growing slowly, but persistently. We also see low and even negative interest rates as central banks across the globe work to stimulate their economies. The European Central Bank remains particularly active as it struggles with low growth and high unemployment. With inflation remaining low there seems to be little to deter them from keeping current policy in place.

Government bond yields in some countries are negative, even towards the longer end of the yield curve, and we are seeing negative rates on deposit accounts. In the short run these conditions deter savings and encourage borrowing, but in the long term they risk creating dislocations—such as overheated housing markets and even insufficient retirement savings for workers unwilling to risk their limited savings in volatile public markets. The U.S. is the most notable exception to this trend, with the Fed raising interest rates 25 basis points in December 2016—including its 25 basis point hike in December 2015, this is just the second increase in 10 years. With investment yields remaining low across the globe, the flow of capital to real assets will continue.

Interestingly, a corporate bond buying program instituted by the European Central Bank (ECB) has done very little to stimulate growth. A November 2016 article in the Wall Street Journal noted that, according to data from J.P. Morgan Chase, the corporate savings rate in the Eurozone hit its highest level in 22 years. Firms seem happy to issue debt at low rates, but have little interest in putting that capital to work. It looks increasingly likely that the marginal cost of monetary policy in Europe may be outpacing the marginal benefits.

2.1 PERSISTENT, BUT UNIMPRESSIVE GLOBAL GROWTH



SOURCE: IMF, OCTOBER 2016 GLOBAL ECONOMIC OUTLOOK

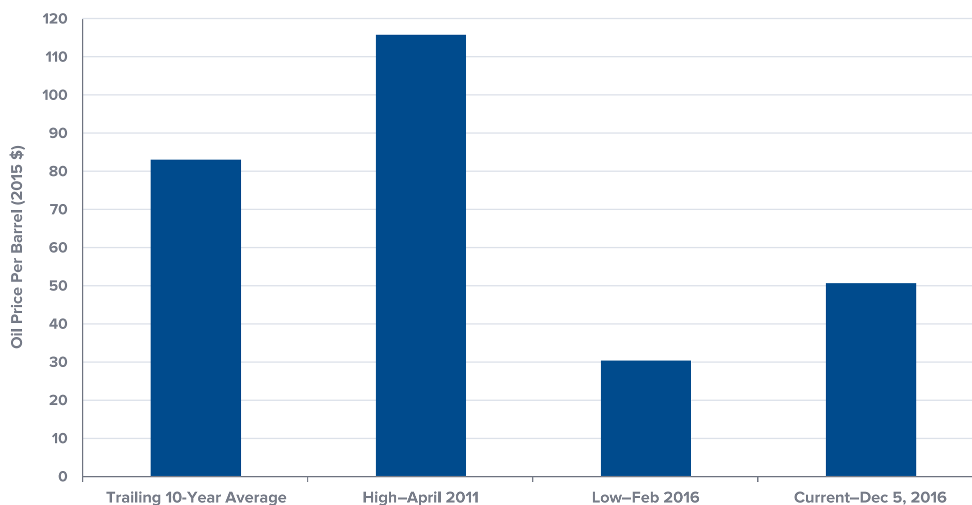
$51.91

NOMINAL PRICE OF OIL, WEEK OF DEC. 16, 2016, UP 71% FROM THE 13-YEAR LOW SET IN FEB. 2016

Low commodity prices are also creating issues across the globe. This is particularly true for oil-rich nations as a glut of supply and weak global demand have decimated prices. Fortunately, the price of oil seems to be stabilizing near $50/barrel, and the worst of the pain may be over as the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries recently reached an agreement to cut production. In Canada we had expected weakness in commodities and the resultant fall of the Loonie to precipitate a rotation to other exports, but we acknowledge this rotation has been slow to materialize. In the U.S., low oil prices have historically corresponded with faster rates of economic growth; but given the country's increased prominence as an oil producer, there have been isolated negative ramifications in the form of job losses in regions tied to oil production and related services. U.S. consumers have conserved much of their savings on fuel, diminishing the positive impact, but raising the prospect of elevated spending over the medium term.

China, as the world's second-largest economy, will continue to heavily influence global growth and geopolitical relations. The country has maintained stable reported growth over the past few quarters of 6.7% annualized, in line with government targets. Stabilizing growth is a positive sign as China has run up a significant amount of debt to fund real estate and infrastructure projects in an effort to fend off a slowdown. Cheap credit has also fueled a boom in home prices. Capital outflows have been significant as investors seek stability and safety abroad, a trend that has further weakened the Yuan and is spurring the government to take action to curb outflows. Restrictive actions on Chinese investment abroad represent one of the most significant downside risks for global investment activity.

2.2 OIL PRICES HAVE REBOUNDED FROM EARLY 2016 LOWS



SOURCES: U.S. ENERGY INFORMATION ADMINISTRATION (WTI SPOT PRICE); U.S. BUREAU OF LABOR STATISTICS

> U.S. consumers have conserved much of their savings on fuel, diminishing the positive impact, but raising the prospect of elevated spending over the medium term.

Geopolitics is also likely to factor heavily into the global economic growth equation in 2017. The U.S. may potentially be a significant disruptor in this regard as President-elect Trump's policies could impact immigration patterns and trade flows. The Trans-Pacific Partnership (TPP) trade agreement seems destined for the scrap heap and the North American Free Trade Agreement (NAFTA) could also be at risk. Uncertainty around Trump's policies and his fairly bellicose language related to international trade represent significant wildcards for global growth. Escalation of conflicts within the Middle East or aggressive military actions by Russia, China, or North Korea also present downside risks.

The largest potential upside scenario would come from the U.S. if trade policy is little-changed and fiscal stimulus has the desired effect of triggering a modestly higher growth trend over the short-to-medium term. U.S. policies that stimulate growth, such as lower taxes and infrastructure investment, could have positive spillover effects for major U.S. trading partners, but also carry with them the risk of more pronounced cyclicality over the long term.

United States Economy: Holding firm, despite headwinds

The U.S. sits in familiar territory as many of the headwinds and uncertainties facing its economy a year ago remain present today. This uncertainty is amplified by the presidential election as policies under a Trump administration are difficult to predict. It is fair to say that the U.S. economic cycle is maturing. Annualized real GDP growth averaged just 1.9% through the first three quarters of 2016—the poorest start to a year since 2012. But third quarter 2016 growth was fairly strong, at 3.5% according to the third estimate from the Bureau of Economic Analysis, and the run rate in 2016 is not off dramatically from the 2.1% pace of the prior five years.

Weak corporate profits, low unemployment, and rising wages have weighed on hiring. Employment increased by 1.6% during the year ending in November 2016—the slowest growth rate in over three years. Still, there are many reasons to be optimistic about U.S. growth, not the least of which are the 2.3 million new jobs created over the past 12 months. While the growth rate is not impressive, the volume of jobs created is significant in a historical context. Consider that job growth averaged less than 800,000 per year during 2006–15. While the employment story is a positive one, this is far from our most robust expansion cycle. The U.S. economy only employs 4.8% more workers than it did in January 2008.

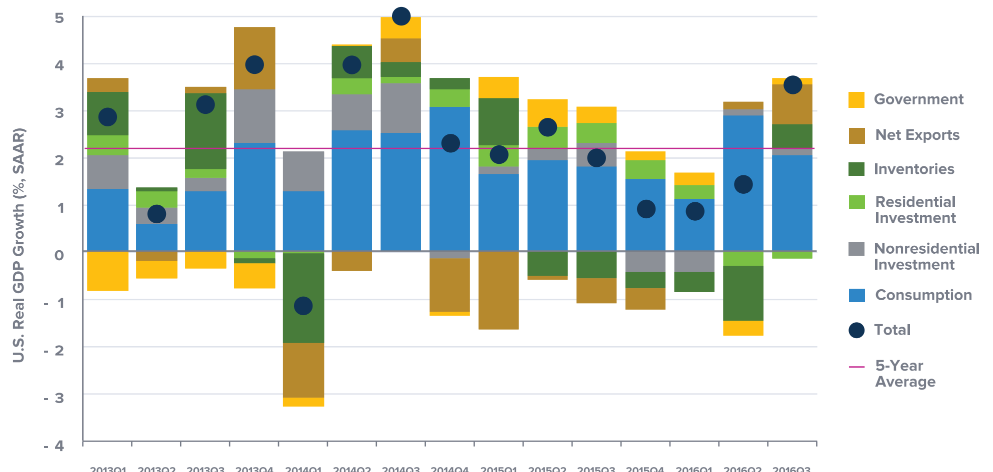
Slower job growth is broad-based, unfolding in sectors that have been key drivers of the U.S. economic recovery and, now, expansion. The professional and business services sector, which includes jobs in STEM and TAMI fields (science, technology, engineering, and math; technology, advertising, media, and information) grew at a 2.9% year-over-year growth rate as of November 2016, compared to 3.3% a year earlier. This is still one of the fastest growing sectors in the economy, employing over 13.0% more workers than at its prerecession peak. Healthcare, construction, and leisure and hospitality are among the other major sectors with slowing growth.

> Weak profits, low unemployment, and rising wages have weighed on hiring.

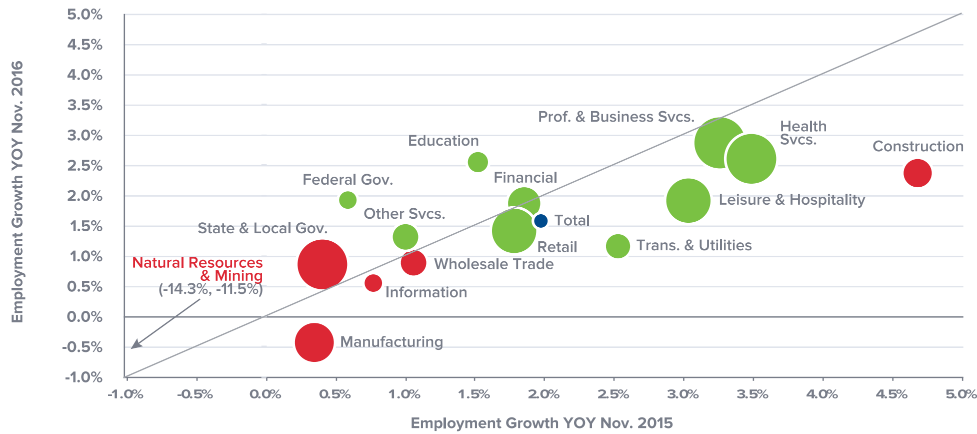
	UNEMPLOYMENT RATE	LABOR FORCE PARTICIPATION
MAY 2007	4.4%	66.0%
NOV 2016	4.6%	62.7%

2.3 U.S. GROWTH TRENDING AROUND 2.0%

- —Business investment declined in two of the last four quarters
- —Residential investment (construction) has declined over the past two quarters, impacted by rising mortgage rates and scarcity of skilled labor
- —Consumers continue to make a strong positive contribution to growth
- —Despite a strong dollar, net exports have been a tailwind



SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS



2.4 EMPLOYMENT GROWTH LED BY STEM/TAMI & HEALTHCARE

SOURCE: U.S. BUREAU OF LABOR STATISTICS
NOTE: RED BELOW PRERECESSION PEAK; GREEN ABOVE

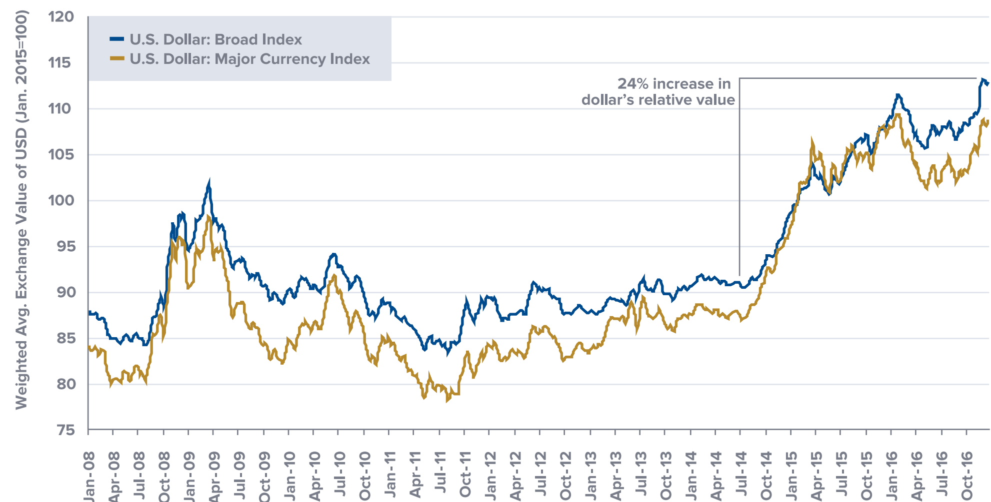
Conversely, government and financial activities employment are two of the major sectors that posted accelerating growth over the past year. Both sectors could continue to perform well in 2017, driven by the arrival of new government workers and the potential for some easing of the regulatory burden on financial activities firms. Financial activities employment has been a particularly soft spot throughout the recovery and expansion phases of this cycle, weighed down by regulation and also automation—with computer systems and algorithms being used increasingly to replace people. The financial activities sector now employs less than 1.0% more workers than it did in January 2008, but growth has been solid at 1.9% year-over-year as of November 2016.

Headline unemployment is low, at 4.6%—a level that suggests the U.S. economy is near full employment. But numerous workers remain on the sidelines and the labor force participation rate is 62.7%, compared to 66.0%+ in the years leading up to the Great Recession. Initial unemployment claims are low and job openings are high, suggesting that many of the workers on the sidelines lack the skills to fill available jobs and/or live in areas where firms aren't hiring. Unemployment for professional, management, and financial occupations is less than 3.0%. Even in a tepid growth environment, the limited supply of available skilled labor will put upward pressure on wages, and may constrain growth in some heretofore fast-growing segments of the economy (e.g. technology and healthcare-related research). These labor market conditions heighten the potential risks associated with tightening immigration policies under the Trump administration.

Unemployment clearly varies by age. Population ages 20-24 and 25-34 had 8.1% and 4.8% unemployment rates, respectively, in November 2016. By comparison, less than 4.0% of workers 35 and over are unemployed. This at least partially explains the relatively slow rate of household formation among these younger workers and the diminished rate of homeownership we have seen nationwide. High levels of student loan and credit card debt are exacerbating the labor market's effect on both housing market trends and the economy at large. Unemployment is tightening at an above-average rate for younger workers, however, creating some potential upside for household formation and consumption growth in the years ahead. Generally tepid global growth and fluctuations in interest rates and currencies are influencing U.S. growth. Much as uncertainty has kept U.S. consumers and businesses cautious, other countries are dealing with major economic, social, and geopolitical issues including:

—China's slower expansion
—Low commodity prices
—Rising populist/nationalist sentiment (culminating in both the BREXIT vote and, to some extent, the Trump election)
—Terrorism and military conflict

2.5 DOLLAR CONTINUES TO RISE VERSUS OTHER MAJOR CURRENCIES



SOURCES: U.S. FEDERAL RESERVE BOARD, BENTALL KENNEDY; NOTE: 7-DAY MOVING AVERAGE, DATA AS OF 12/16/16

Trump's policies could upend the "Goldilocks" U.S. growth story we observed in Perspective a year ago.

In this climate the U.S. is attracting investor capital, driving up the value of the dollar relative to other currencies.

The interplay of various global events and their impact on the U.S. economy is admittedly not easy to parse out, particularly with the Trump election. A strong dollar is hurting U.S. manufacturing activity by making U.S. goods more expensive on the global market, yet it is also enhancing the buying-power of U.S. businesses and consumers. Overall the implications of the global environment on the U.S. would seem to be disinflationary, but a tight labor market, stabilizing energy prices, and rising healthcare costs are all pushing inflation measures closer to the Fed's target—prompting its December 2016 rate hike.

Expectations for faster U.S. inflation and growth in the short run under a Trump administration coupled with the outlook for higher interest rates have, at least temporarily, invigorated the stock market and sent government bond yields higher. In December 2016 the 10-year Treasury rate was 2.5%, after dropping below 1.4% in June 2016. Major stock indices also reached record high levels in November. The Fed's rate hike in December 2016 will likely trigger additional inflows of foreign capital and boost the value of the dollar. Rising stock prices and expectations for a more favorable regulatory environment could put an end to flagging business investment in 2017. But, admittedly, this situation could play out in a myriad of ways.

The markets seem to be cheering a Trump presidency, due to expectations for:

—Reduced regulation
—Lower taxes
—Increased oil and gas exploration
—Potential for repatriation of dollars held abroad by U.S. corporations
—Additional military spending
—Investment in infrastructure

2.5%

10-YEAR TREASURY BOND YIELD, DECEMBER, 2016, UP FROM 1.4% IN JUNE, 2016

Yet there are clearly risks as well. Trump's policies could upend the "Goldilocks" U.S. growth story we observed in Perspective a year ago, triggering faster growth in the short-to-medium term, but leading to medium-to-long term imbalances that could be the catalysts for a recession. Specific downside risks include:

—Growing federal deficits
—Trade wars
—Regulatory changes that encourage financial risk-taking or harm the environment
—Escalating geopolitical conflict
—Immigration policy impacting availability of both skilled and unskilled labor

Some of these economic potholes will be hard to predict and may not materialize, but they will be important areas to monitor in the year ahead and beyond.

The U.S. economy is fundamentally sound and the potential for stronger GDP growth in 2017 is significant. Household incomes are rising, a trend that should continue as unemployment remains low. Personal savings is relatively elevated and consumer confidence, while far from exuberant, appears solid. Importantly, the earnings recession that afflicted U.S. companies in the first half of 2016 seemed to abate in the third quarter of the year. A solid fourth quarter could drive firms to invest, hire, and lease real estate more aggressively in 2017. Real GDP growth is likely to close 2016 below 2.0%. Faster growth is forecasted for 2017, with Moody's projecting a 2.8% growth rate. We are in general agreement with this outlook and the rate would be ahead of solid annual averages reported during 2014–15.

Capital Markets

TRENDS

—The Fed has raised interest rates for the second time since the end of the recession. Long-term rates are rising along with inflation expectations.
—U.S. equity market indices have risen into record territory, while REITs have had mixed results as investors react to higher interest rates.

TRANSACTION ACTIVITY

—Commercial real estate transaction volume is near 2007 levels, but the pace of growth is easing.
—Growth in apartment sales volume versus the same period a year earlier led the other three major property types. Industrial sales volume also increased, while office and retail volume declined.
—Portfolio and entity-level transactions were less of a factor in 2016 than they were in 2015.
—Global economic uncertainty and slow growth continue to attract foreign capital to the U.S.

LENDING

—Banks are tightening lending standards, lowering loan proceeds, and raising interest rates. CMBS issuance remains limited.
—Life insurers have stepped in to fill the void, lending at record high levels. Conditions are also creating opportunities for non-traditional lenders.
—Policy changes, such as Trump's pledge to dismantle Dodd-Frank, could encourage more risk taking by banks in 2017.

VALUES & PERFORMANCE

—Property values continue to rise year-over-year in each of the four major property types, according to the Moody's/RCA CPPI.
—There were signs late in 2016 that higher interest rates and economic uncertainty were weighing on pricing, but rising NOI offset this headwind.
—Total returns fell to single-digit territory for the first time in five years, and we anticipate continued reversion to the mean.

Hubbard Place
Chicago, IL

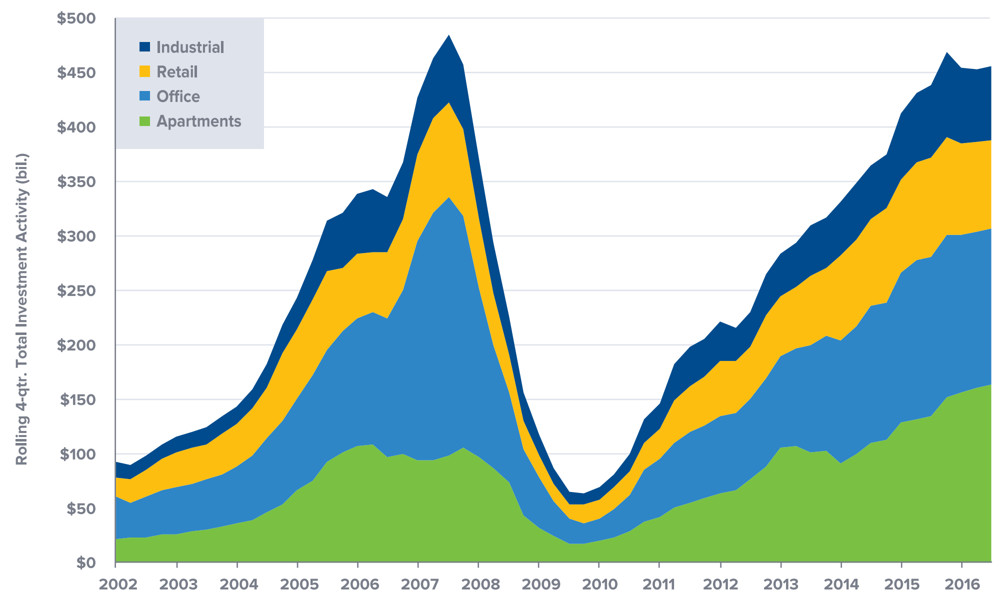
Capital Markets: Real estate maintains investor appeal

The volatile and uncertain economic climate has undoubtedly impacted capital markets. Wide swings in stocks, including REITs, have been evident over the past several months and interest rates have fluctuated dramatically. In the U.S., expectations for higher inflation and rising interest rates, elevated by the prospect of increased fiscal stimulus under a Trump presidency, have spurred a sell-off in the bond market, sending long-term rates higher.

The 10-year Treasury rate had dipped below 1.4% in June 2016 and averaged 2.5% in December 2016—a surprisingly quick 110 basis point swing. Investment in commercial real estate remains strong, but economic uncertainty unquestionably weighed on investors throughout the year. More recently, even as the economic outlook is positive and cap rates continue to offer a substantial spread over Treasuries, higher interest rates may be impacting pricing.

According to data from Real Capital Analytics, commercial real estate transaction activity is leveling out. Sales volume in the four major property types over the four quarters ending in September 2016 was stellar in a historical context, at $455 billion—but the 3.9% increase from the same period a year earlier is the slowest growth rate since 2010. Year-to-date activity is actually about 4.0% below the first three quarters of 2015 as recent quarterly trends have been sluggish. With sales volume on a par with 2007, some moderation is to be expected.

3.1 INVESTMENT VOLUME REMAINS STELLAR

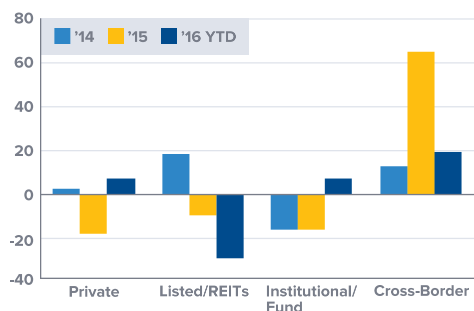


SOURCE: REAL CAPITAL ANALYTICS, INC.

Much of the drop off in quarterly sales volume has been owed to the decline in large portfolio and entity transactions—versus 2015, when multi-billion dollar sales involving the likes of Indcor, Home Properties, KTR, and IIT played a dominant role in sales activity. Large portfolio activity in late 2015 is still propping up the four-quarter total, however.

> Even as the economic outlook is positive and cap rates continue to offer a substantial spread over Treasuries, higher interest rates may be impacting pricing.

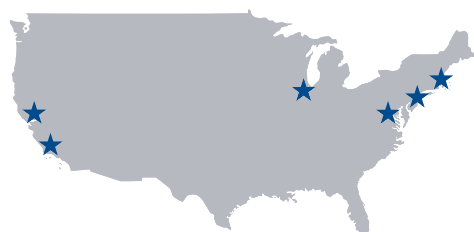
3.2 FOREIGN INVESTORS REMAIN NET BUYERS OF U.S. CRE



SOURCE: REAL CAPITAL ANALYTICS, INC
NOTE: DATA THROUGH SEPTEMBER 2016

Cross border investors were the most active net buyer of commercial real estate through the first three quarters of 2016, growing their exposure to the U.S. property market by nearly $19 billion. REITs on the other hand were the most active net seller, decreasing their holdings by almost $29 billion. This comes on top of over $9 billion in net sales in 2015. REITs could simply be taking advantage of current pricing with plans to redeploy this capital as new development. The relative safety and attractive returns offered by U.S. commercial real estate should continue to attract foreign buyers in the year ahead. But there are downside risks, including a potential move by the Chinese government to implement more stringent oversight over investments outside of the country.

Apartments experienced the strongest increase in sales activity when comparing the four quarters ending in September 2016 to the same period a year earlier. A significant portion of this growth was owed to portfolio sales in the final quarter of 2015, but apartments was also the only property type with higher year-to-date activity in 2016 versus 2015 (through September). Geographically, apartment sales growth was led by activity in the six major markets (Boston, New York, Washington, D.C., Chicago, San Francisco, and Los Angeles), but apartment activity also increased outside the major markets as investors sought higher yields within the sector. Office and retail trailing four-quarter sales activity decreased year-over-year and industrial activity rose modestly as it shared the late 2015 portfolio tailwind observed in apartments.



APARTMENT SALES GROWTH IN MAJOR MARKETS OUTPACED NON-MAJOR MARKETS, YEAR ENDING 3Q2016

The top markets for overall investment in 2016 have changed very little from a year ago. Manhattan, Los Angeles, Chicago, Dallas, Atlanta, Boston, and Seattle top the list in the same order they did in 2015. Denver rose up the ranks dramatically this year, supplanting San Francisco as the 8th most active investment market. Not surprisingly, Houston experienced the most significant pullback in investment activity—dropping from the 9th most active market in 2015 to the 15th most active market in 2016, as transaction volume dropped 36% year-over-year. Houston is still a relatively liquid market with $6 billion of property trading hands through the first three quarters of 2016. Stabilizing oil prices and signs of improvement in the metro's labor market suggest Houston could soon fall back into favor with investors, but the area undoubtedly has a supply overhang to contend with.

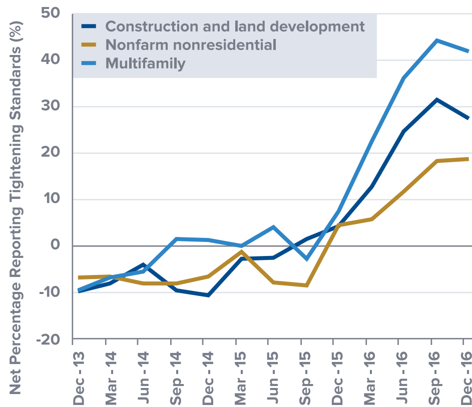
Prices continue to reflect healthy fundamentals and the large wall of capital flowing into U.S. commercial real estate. The Moody's/RCA Commercial Property Price Index (CPPI) shows prices in the four major property types each up at least 4.0% year-over-year as of October 2016. The aggregate index for all property types was up 8.6% during the period, led by the apartment and industrial indices which each rose by more than 10.0%. Office property values had been declining early in 2016, according to the CPPI, but they have been on a consistent upswing in recent months.

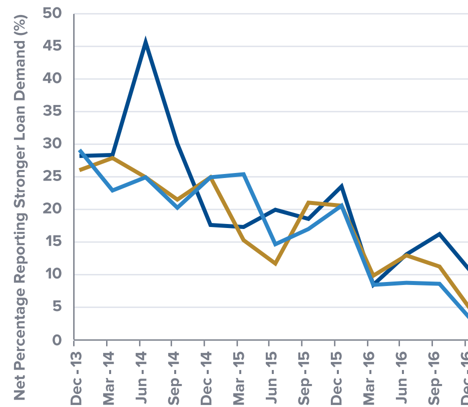
8.6%

INCREASE IN AGGREGATE VALUE FOR ALL PROPERTY TYPES, OCTOBER 2015–OCTOBER 2016

SOURCE: MOODY'S/RCA CPPI

3.3 MORE BANKS REPORT TIGHTENING LENDING STANDARDS





SOURCE: FEDERAL RESERVE SENIOR LOAN OFFICER SURVEY

BANK LENDING TIGHTENING

Tightening availability of public and private debt is a major concern for the commercial real estate capital market. Data from the Federal Reserve's Senior Loan Officer Survey, which primarily reflects the responses of domestically chartered commercial banks, shows that a large number of respondents reported tightening lending standards over the past year. The survey also showed that fewer respondents were experiencing stronger loan demand versus a year ago, but did not suggest demand for debt was on the decline.

Life insurance companies have stepped in to fill the void as banks tighten standards. According to ACLI data, commercial mortgage commitments by life insurance companies rose to record high levels over the past year. Couple these trends with limited CMBS activity and we expect numerous deals to encounter shortfalls in the capital stack that could create attractive opportunities for equity investors to offer mezzanine financing or shared appreciation mortgages.

Future regulations surrounding commercial real estate debt financing are a significant known unknown under a Trump presidency. Trump has stated he will dismantle Dodd-Frank, which includes regulations that may be hurting the availability of debt capital for CRE. In particular, the legislation requires elevated risk weightings for High Volatility Commercial Real Estate Loans (HVCRE), and another facet that took effect on December 24, 2016 requires CMBS originators to retain a stake in the conduit. Interestingly, the so-called risk-retention policy may not entirely be a negative as pricing was high on an origination taken to market in August of 2016, with Wells Fargo, Bank of America, and Morgan Stanley retaining a 5.0% vertical interest.

The rapid increase in interest rates in late 2016 and tightening loan standards could negatively impact property values—but one potential positive impact, at least as it pertains to operating properties, is the likelihood that construction activity will be constrained. Labor market conditions, land prices, and rising material costs were already impacting new supply. But, anecdotally, lower loan proceeds and higher interest rates are deterring new construction projects. These conditions could prevent the overbuilding pattern that so frequently drives downturns in commercial real estate.

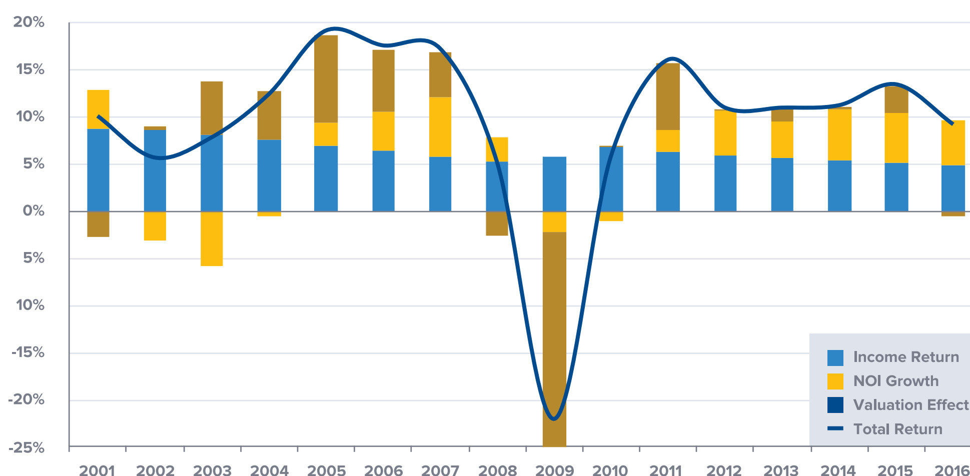
RETURNS MODERATING

Commercial real estate performance, as indicated by NCREIF returns, has moderated, but should continue to draw in new capital. Total return for the NCREIF Property Index (NPI) was 9.2% for the year ending in September 2016, after consistently running in double-digit territory during the previous five years (averaging over 12% during that period). Stocks and REITs performed better over the four quarters ending

Double-digit private real estate returns are likely a thing of the past, and performance should revert to the mean in the years ahead.

3.4 NPI RETURNS HAVE MODERATED BUT REMAIN ATTRACTIVE

—For the first time in over five years, NPI returns have fallen below 10%
—But they remain strong relative to long-term history
—All four property types saw returns drop vs. a year ago
—Retail 11.0% and industrial 12.5% posted the strongest returns over the past year



SOURCES: NCREIF, BENTALL KENNEDY
NOTE: ALL DATA FOR FOUR QUARTERS ENDING IN THE THIRD QUARTER OF EACH YEAR

in September 2016, but private commercial real estate investments as measured by the NPI have been competitive on both an absolute and risk-adjusted basis for some time now. Average annual returns over the past 10 years have been on a par with stocks and ahead of REITs. Investors should also keep in mind the lower relative risk of private commercial real estate investments, as recently evidenced by the 7.4% drop in the NAREIT All Equity REIT Index between September and November 2016 resulting from market reaction to rising interest rates.

Examining NPI returns for years ending in the third quarter, 2016 is the first year since 2009 where we see a negative "valuation effect" (i.e. the component of return tied to movement in cap rates)—although it was minimal at just 0.6%. Nowhere was this valuation drag more evident than in apartments (-2.9%) as buyers adjusted pricing to account for supply risks and signs of deteriorating rents in some locations. Fortunately, net operating income (NOI) growth is healthy across the four major property types, outpacing the prior five-year average, at nearly 5.0%. Industrial is experiencing the strongest NOI growth of the four major property types, but growth is healthy across the board, with office posting the slowest growth, at 3.0%.

Desirable trends in property fundamentals, capital market volatility, and comparatively lower yields in other asset classes should all continue to support U.S. real estate performance. Tightening credit availability, rising interest rates, and a strong dollar may present headwinds, but these are not expected to be insurmountable. Double-digit private real estate returns are likely a thing of the past, and performance should revert to the mean in the years ahead. The NPI's 10-year average return is 7.2%. We believe private U.S. real estate is an attractive investment alternative in the current uncertain, low-growth economic environment, but remain cognizant of the pace and magnitude of future interest rate increases.

12.5%

INDUSTRIAL TOTAL RETURN, YEAR ENDING 3Q 2016; THE HIGHEST OF THE FOUR MAJOR PROPERTY TYPES

SOURCE: NCREIF PROPERTY INDEX (NPI)

Capitol Hill Station Development
Seattle, WA

Property Sectors 04

Apartment

TRENDS

—Apartment vacancy rose slightly over the past year, but it remains well below historical average levels, at less than 5.0%.
—Landlords continue to generate healthy net operating income (NOI) growth.

DEMAND

—Demand for apartments is strong, but high rent levels and low vacancy are impediments to demand growth in many markets.
—Improving job prospects for younger workers should accelerate household formation.
—Micro location and amenities play an important role in attracting tenants.

SUPPLY

—High construction costs, limited availability of construction labor, and tightening lending standards are tempering development.
—Multifamily housing starts are peaking out around 400,000 units/year.

OUTLOOK

—The apartment market has peaked, but vacancy rates remain tight and rents will continue rising.
—Rising wages will support additional apartment rent growth.
—The defensive nature of the asset class will provide some risk mitigation in the event of a recession.

SUSTAINABILITY

—Apartment development is generally centered on dense, mixed-use neighborhoods, frequently in urban locations. Renters desire proximity to work, access to public transportation, and abundant retail and recreational amenities. In these locations, product with desirable amenities such as fitness centers, outdoor spaces, and pet-care facilities should thrive.

Bentall Kennedy

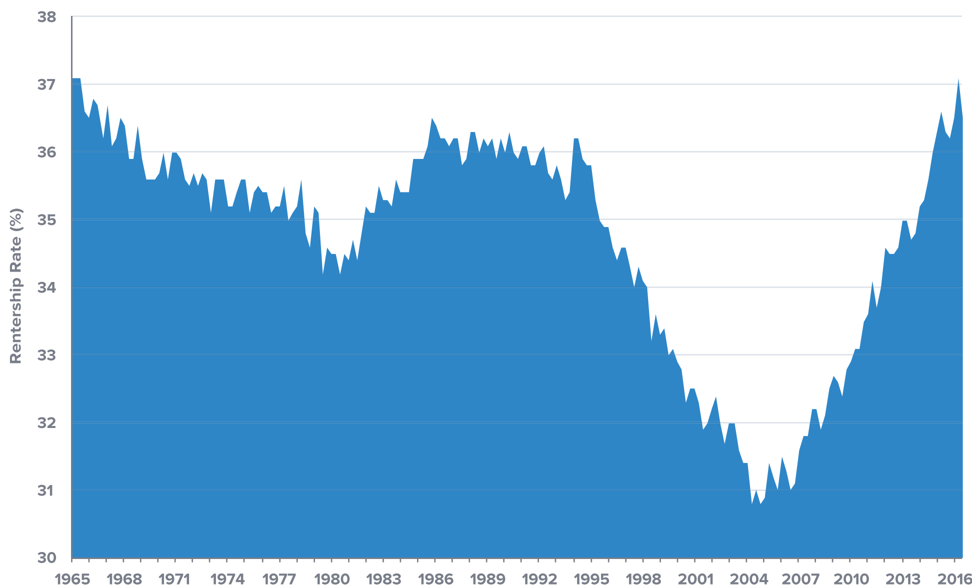
Apartment: New supply balancing a tight market

Apartment vacancy rose slightly over the past year, as we expected, due to heavy construction completions. According to Axiometrics, third quarter 2016 apartment vacancy was 4.9%, up 20 basis points from a year ago. For the first time since 2009 we are observing a concerted upward trend in apartment vacancy. It is important to keep these market trends in perspective. Apartment vacancy is still on a par with prerecession lows and is well below its average over the past 20 years (6.1%). Market conditions continue to favor apartment landlords over tenants.

Demand for apartments remains strong as the percentage of households who rent is near levels last seen in the U.S. in the 1960s, when Baby Boomers were dominating household growth. The drivers of the slight uptick in apartment vacancy are primarily supply and the cost of renting, the latter of which—coupled with high student loan and credit card debt—is suppressing even more robust renter household formation, particularly among the younger population.

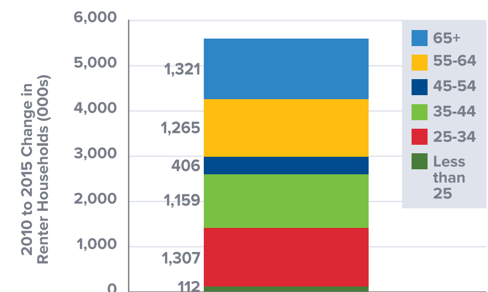
For example, according to Census data, renter households in the 25-29 year-old age cohort increased only modestly faster than population growth from 2010 to 2015 (7.7% vs. 6.2%) even as the propensity to rent among this age cohort increased by five percentage points. In fact, overall household growth among 25-29 year-olds was slightly negative during this period. Comparatively high unemployment for younger age groups has stifled household formation, keeping many would-be renters in their parents' homes or in multiple roommate situations.

4.1 PROPENSITY TO RENT NEAR HISTORICAL HIGHS



SOURCE: U.S. CENSUS BUREAU

4.2 GROWTH IN RENTER HOUSEHOLDS WELL BALANCED BY AGE



SOURCE: U.S. CENSUS BUREAU

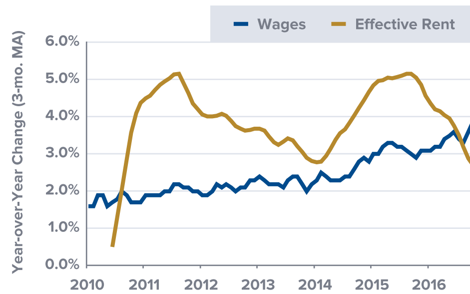
Year-over-year rent growth has outpaced wage growth for much of the past six years, reducing affordability. As unemployment falls, especially for younger age groups, this relationship is beginnning to reverse—year-over-year wage growth has outpaced rent growth since mid-2016. Barring an unexpected economic shock, rising wages should prevent a significant deterioration in rents. In fact, even with the slight uptick in vacancy, rents continue to rise, increasing 2.6% year-over-year as of October 2016, according to data from Axiometrics. Still, the cost burden of housing is likely to remain significant for the foreseeable future. This is true for both the for-sale and rental markets, however, as most home price measures put single family home values at record high levels.

Overall household growth among those 25-29 years old was slightly negative between 2010 and 2015.

4.9%

3Q 2016 APARTMENT VACANCY, UP 20 BASIS POINTS YOY, BUT WELL-BELOW 20-YR AVG. OF 6.1%

4.3 PACE OF NATIONAL WAGE GROWTH HAS OVERTAKEN RENT GROWTH



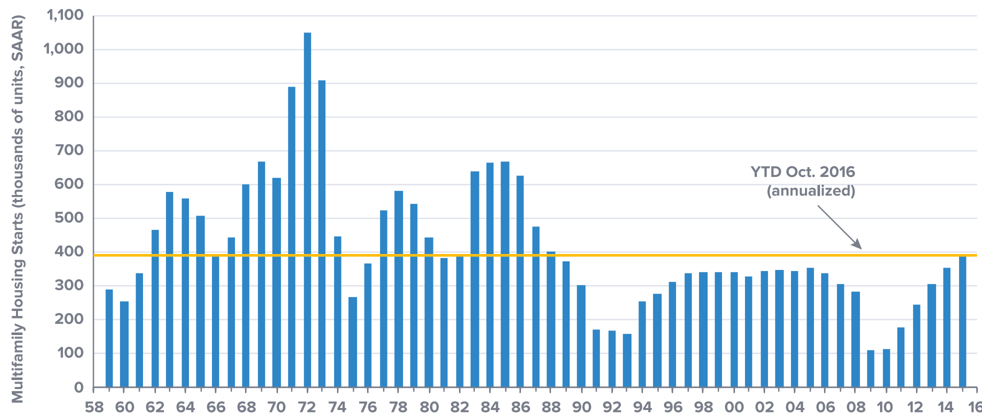
SOURCES: AXIOMETRICS, FEDERAL RESERVE BANK OF ATLANTA

Many of the submarkets most attractive to renters are seeing very active levels of new construction and landlords/developers competing heavily not just on price, but also amenity offerings. To attract and retain renters, the amenity “arms race” is delivering a caliber of product that is historically rare in rental markets like Boston, New York, and San Francisco. Landlords must acknowledge that renters value features such as:

—Outdoor recreational and social spaces
—Bike/car share access
—Dog-care facilities
—State-of-the-art fitness centers

Location is also a significant differentiator and investors should pay close attention to feedback from the marketplace. An NMHC/Kingsley survey published in late 2015 found that walkability of an area was highly important to renters; respondents heavily favored locations with walkable grocery stores, restaurants, and public transportation access. The study also found that one-third of renters own a pet.

Anthology
Washington, D.C.



4.4 MULTIFAMILY HOUSING STARTS MAY HAVE PEAKED FOR THE CYCLE

SOURCE: U.S. CENSUS BUREAU

Key determinants of rental demand—micro-location, and building amenities—are crucial factors for apartment investment performance, but we can observe broad trends in supply and demand movements at the market level. According to Axiometrics, Houston was one of the weakest markets in the country in terms of occupancy change and rent growth over the past year, as job growth stalled along with low oil prices. But even here the contraction in rent was material, but not dramatic, at 3.2%.

Despite its strong economy and outsized wage growth, the San Francisco Bay Area is also showing some signs of weakness due to both supply and the roughly 20% increase in rents over the previous two years:

—San Francisco and San Jose posted declines in effective rent of nearly 3.0% year-over-year as of October 2016
—Oakland rents also fell, albeit slightly
—Vacancy in the Bay Area increased faster than the nation, but San Jose had the worst performance in the region with a 0.6 percentage point increase to 5.3%
—Oakland and San Francisco both still maintain vacancy rates in the 4.0%-range

Labor force constraints are an issue for high-cost markets such as the Bay Area, Boston, and New York, and one that cannot be overcome without additional housing construction. Job growth has slowed in these locations, partially due to the business cycle, but also due to the challenges employers have in identifying workers. Major U.S. markets depend heavily on immigration to fill skilled jobs and any change in Federal policy that restricts the flow of skilled workers from abroad would be harmful to growth. Multifamily construction may be a short-term issue for apartment fundamentals in some markets; however, it is also a crucial factor in supporting long-term economic growth.

Many apartment markets continue to perform well, posting strong effective rent growth. Atlanta, Orange County, San Diego, Seattle, and Durham, among others, all posted year-over-year effective rent growth in the 5.0%-range. Portland and Minneapolis also recorded above-average rent growth of 3.2% and 3.7%, respectively.

Multifamily housing starts appear to be peaking out around 400,000 units per year, well -behind the recent annual pace of renter household growth (around a million a year over the past few years). Overall housing construction remains insufficient to keep up with demand growth and it is clear that some of the recent weakening in tracked multifamily inventory is owed to oversaturation of supply in specific micro-locations.

We continue to believe that this new supply is necessary in most markets and wage growth should help produce modest rent gains even as vacancy in the tracked inventory trends slightly higher. Rising construction costs, limited availability of construction labor, and shortfalls in the financing capital stack point to slowing, not accelerating, supply growth, helping to reduce downside risk. It must be acknowledged that lenders and equity investors are showing signs of caution due to current pricing and concerns about fundamentals. This caution should only further crimp the development pipeline.

We continue to believe that this new supply is necessary in most markets and wage growth should help produce modest rent gains.

Property Sectors

04

Latham Square
Oakland, CA

Office

TRENDS

—Office vacancy fell 40 basis points over the past year to 13.0% as of 3Q 2016.
—Although the improvement has slowed, current vacancy is on a par with early 2008 levels.
—Rents are rising nationally, albeit only at an inflation-like rate.

DEMAND

—Tenants were reluctant to lease space in 2016, but with the election resolved and earnings picking up, demand should improve.
—Office-using employment growth continues to widely outpace non-office-using job gains.
—Technology-related sectors are still expanding and financial activities employment growth is accelerating.

SUPPLY

—Office construction is well below levels observed prior to the recession and is not overpowering demand.
—Developers are emboldened by healthy market fundamentals, high prices, and rising rents.
—The same factors limiting apartment construction (high costs, limited availability of debt) are also at work here.

OUTLOOK

—The U.S. office market is healthy and the prospect of improved economic growth in 2017 bodes well for office landlords.
—Deregulation in the financial industry could help unleash additional job creation, extending the office market's improvement.

SUSTAINABILITY

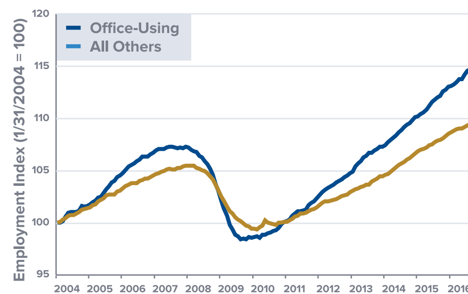
—Employers are migrating to and expanding in the active urban nodes that offer the lifestyle desired by younger workers. Within these locales, firms are placing value on sustainable building features that align with their corporate values and also appeal to discerning employees. High-quality space and amenities help attract and retain the best talent.

Office: Tenants pursue talent and brand identity

U.S. office landlords continued to enjoy falling vacancy rates and rising rents over the four quarters ending in September 2016, although the rate of improvement has slowed. According to CBRE-EA, office vacancy closed the period at 13.0%, 40 basis points below its year-ago level, and the lowest vacancy rate recorded since the first quarter of 2008. Despite this low vacancy rate, rents increased by less than 2.0%, due to a significant bifurcation in trends across the country. Much as we anticipated, employment growth continues to drive substantial, albeit off peak, levels of office net absorption, and development has failed to keep pace.

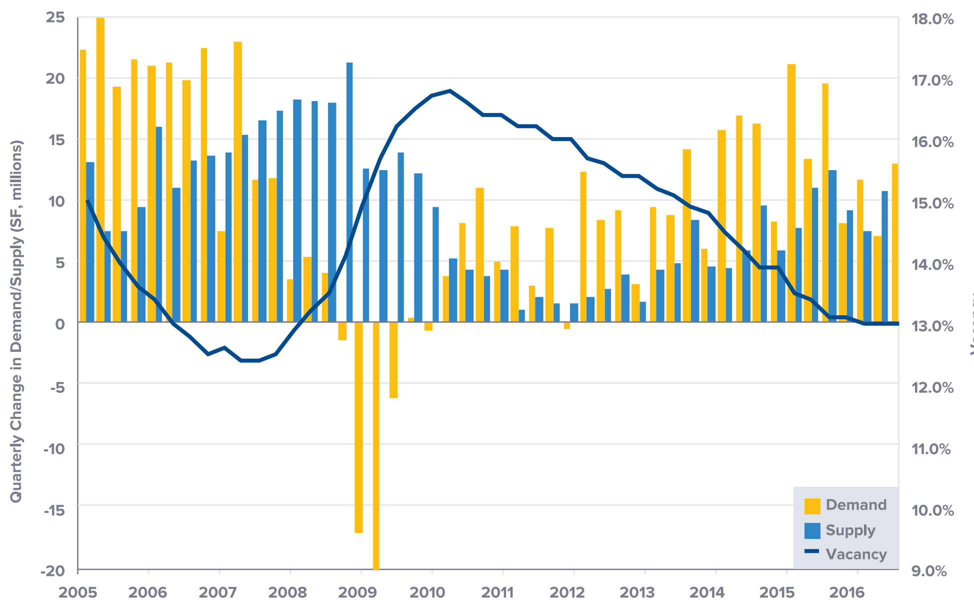
Data show office-using employment increasing by 2.4% over the past year, while all other jobs increased by a much more modest 1.4%.

4.6 ABOVE-AVERAGE OFFICE-USING JOB GROWTH CONTINUES



SOURCES: U.S. BUREAU OF LABOR STATISTICS; BENTALL KENNEDY

4.5 OFFICE FUNDAMENTALS FAVOR LANDLORDS



SOURCE: CBRE-EA

Office-using job growth has certainly moderated, however, with the year-over-year employment growth rate down about 30 basis points compared to a year ago. We discussed earlier in this report the low unemployment rate within key white-collar employment sectors and this undoubtedly impacted the need for space as firms have struggled to fill open jobs. But we also see that many employers took a wait-and-see approach to the economy in 2016, and were reluctant to invest in new growth and more apprehensive about leasing additional space.

Continuing the trend we have observed through much of the recovery, professional, scientific, and technical services employment was the fastest growing segment of office-using employment, while also adding the most new jobs. This sector, a component of professional and business services, grew by 3.5% over the past year, adding more than 300,000 new positions. Highly skilled sub-sectors, often related to technology—such as management and technical consulting services, and computer systems design—are posting impressive growth rates. Even in subsectors where unemployment has fallen exceedingly low, there remains evidence of healthy growth. For example, engineering and biological research grew by 2.8% over the past year. However, changes to U.S. visa policies under a Trump administration are a potential downside risk as these sectors are the most reliant on skilled labor from abroad.

3.5%

PROFESSIONAL, SCIENTIFIC, AND TECHNICAL SERVICES JOB GROWTH, 2015–2016

4.7 TECHNOLOGY-RELATED SECTORS OUTPERFORMING, BUT FINANCIAL ACTIVITIES GROWTH ACCELERATING

PROFESSIONAL, SCIENTIFIC & TECHNICAL SERVICES		
JOBS TODAY	YOY GROWTH OCT. 2016	YOY CHG. OCT. 2016
9,016.5	3.5%	302.4
SUBSECTOR	YOY GROWTH OCT. 2016	YOY CHG. OCT. 2016
MANAGEMENT & TECH. CONSULTING	6.8%	87.6
COMPUTER SYSTEMS DESIGN	4.1%	79.2
ACCOUNTING & BOOKKEEPING	4.3%	42.7
OTHER PROFESSIONAL SVCS.	4.6%	30.3
ARCHITECTURE & ENGINEERING	2.0%	28.2
ENGINEERING & BIOLOGICAL RESEARCH	2.8%	17.1
SPECIALIZED DESIGN SVCS.	5.9%	8.0
ADVERTISING	1.5%	7.5
LEGAL SERVICES	0.1%	1.3
SOCIAL SCIENCE/HUMANITIES RESEARCH	0.8%	0.5

FINANCIAL ACTIVITIES		
JOBS TODAY	YOY GROWTH OCT. 2016	YOY CHG. OCT. 2016
8,329.0	2.0%	165.0
SUBSECTOR	YOY GROWTH OCT. 2016	YOY CHG. OCT. 2016
INSURANCE	2.2%	55.3
REAL ESTATE RENTAL & LEASING	3.2%	49.4
OTHER CREDIT INTERMEDIATION	2.7%	22.4
SECURITIES & COMMODITIES INVESTMENT	1.3%	12.1
CREDIT UNIONS	4.4%	11.6
REAL ESTATE CREDIT	3.4%	7.5
RENTAL & LEASING SERVICES	0.8%	4.1
COMMERCIAL BANKING	0.3%	3.4
MONETARY AUTHORITIES (CENTRAL BANK)	0.0%	0.0
LESSORS OF NONFINANCIAL INTANGIBLES	-2.5%	-0.6

SOURCE: U.S. BUREAU OF LABOR STATISTICS; JOBS IN THOUSANDS

We remain encouraged by trends in the financial activities employment sector, which grew by 2.0% over the past year. The potential for higher interest rates and a rollback of financial regulations could produce even stronger growth in this sector over the next year. Financial market uncertainty, weak net interest margins, and the deployment of automation throughout the financial services industry have all hampered job growth in this sector throughout the recovery and expansion to date. Commercial banking, which shed jobs a year ago, has been stable over the past 12 months, managing very slight growth. Insurance and real estate rental and leasing continue to hold onto the top two spots for year-over-year job creation.

Important themes in the office market are well summarized as the concepts of "place-making" and "place-taking" described in an article released by CBRE in March 2016. Similar to the apartment market, we see landlords (and perhaps more frequently employers in the case of office) looking to create an environment that is conducive to collaboration, while boosting employee morale and productivity.

Cafes, indoor and outdoor activity and collaboration areas, and outdoor seating are just a few examples of the features being built into new office spaces. These features also become representative of the corporate brand and can be used to help recruit talent. In many cases these features also serve as an offset to the downsizing trend we have seen in employee workspaces. Place-making is an important consideration for employers today. It also serves as an opportunity to deploy energy conservation and other sustainability plans to promote a "green" culture and reinforce the environmental, social and governance aspects of a tenant's brand.

Place-taking is also clearly evident as we observe leasing activity in this cycle. In other words firms are selecting locations that bolster their corporate identity and allow them to easily tap into well-educated workers. Motorola moving operations from Schaumburg to Chicago's West Loop and GE moving its headquarters from Fairfield, CT to Boston's Seaport District are just two examples of firms choosing locations that give them better access to high-end talent and help improve their corporate image. GE wants to be viewed as an innovation company and its new location helps reinforce that image. These locations also offer walkable public transportation access, retail amenities, and even housing in relatively close proximity. They are places where young professionals want to live, work, and play; therefore, they are also locations where firms in need of such talent must locate.

Firms are selecting locations that bolster their corporate identity and allow them to easily tap into well-educated workers.

Bike sharing programs and car sharing services like Uber are improving urban mobility

In this environment, micro-location and building characteristics have been amplified—often creating significant disparities in performance across (and even within) submarkets. Metro-level factors are still important to monitor as evidenced by the strong performance of technology-focused markets and Houston's struggles due to the fall in oil prices. But we maintain that urban nodes (either in the Central Business District (CBD) or outside of it) with walkable retail and recreational amenities and proximity to public transportation infrastructure—and dense suburban locations that share similar attributes—will tend to outperform other locations in terms of office demand and rent growth. Bike-share programs and car services such as Uber in many cases are supplementing public transportation in these locales, enhancing mobility and convenience.

Office-using employment growth may moderate over the next year, but we expect employers to continue hiring. Further, with the election now behind us, some firms may feel more inclined to invest their capital in new growth, including additional office space. The Bay Area, Boston, and Portland, OR boasted some of the strongest locations for office rent growth over the past year. Labor force constraints will pose headwinds in high-cost, primary markets, but we expect office demand to continue growing even in these locales. There is also upside as financial centers across the country could receive a lift from Trump's policies, while the Washington, D.C. area specifically gets a boost from a more functional, aligned government.

Office landlords should be rewarded over the next year provided they have identified the locations and buildings most likely to draw in skilled workers and the companies that covet them. Although construction completions during 2017–18 should remain well below prerecession highs, new office construction is a growing risk. Tenants are finding existing available space in their desired locations often lacking the modern features and amenities they require. Investors must be mindful of both new projects and the potential backfill space they may create.

Office landlords should be rewarded over the next year provided they have identified the locations and buildings most likely to draw in skilled workers and the companies that covet them.

Property Sectors

04

Medical Office

TRENDS

—Medical office vacancy declined 70 basis points over the past year to 8.4% as of 3Q 2016.
—Vacancy is now below its 2007 trough.

DEMAND

—Net absorption has significantly outpaced its trailing five-year average, reaching 12.6 million sf over the past four quarters.
—An aging population and rising ranks of insured Americans will necessitate continued expansion by healthcare providers.

SUPPLY

—The inventory of medical office space has increased by around 10 million sf annually over the past six years, an annual growth rate of around 1.3%.
—Development should continue, led by outpatient treatment facilities closer to population and away from high-cost hospital campuses.

OUTLOOK

—Demographic trends and the increasing number of Americans with health insurance should provide a tailwind for the medical office market.
—Rising healthcare expenditures are in part a function of increasing costs, not just growing demand for care.
—Risks on the horizon include potential changes to the Affordable Care Act and rapidly developing medical technologies that could disrupt the sector.

SUSTAINABILITY

—Many health systems are targeting LEED certification for their new facilities to ensure efficient operations and modern, comfortable spaces for their employees and patients. Additionally, delivering care closer to patients' homes reduces the load on existing infrastructure and eliminates long trips for patients.

Bentall Kennedy

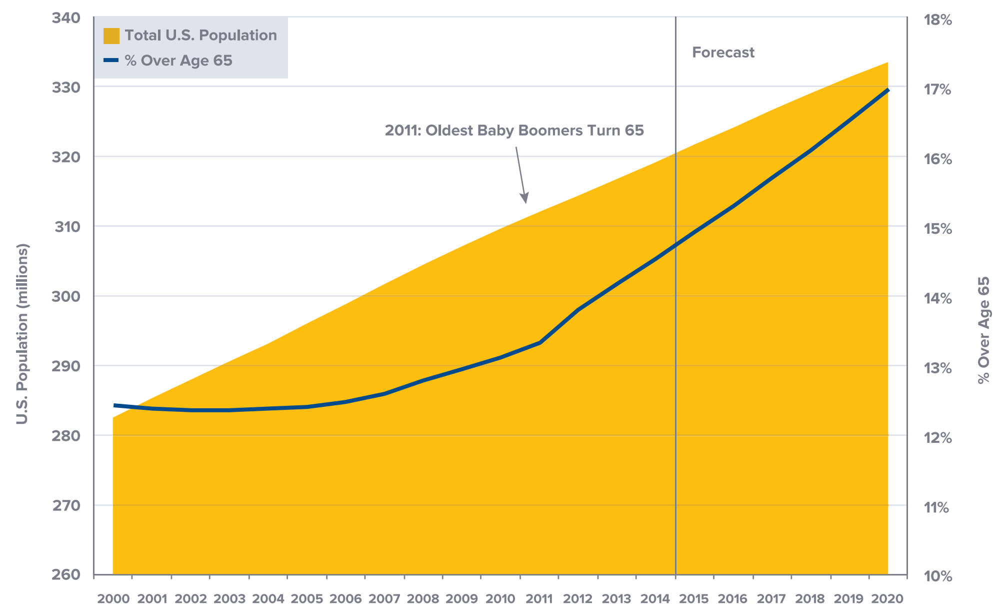
Medical Office: Solid fundamentals, cloudy policy outlook

Medical office drivers are supportive of long-term growth in space demand. As mentioned in last year's Perspective, the oldest members of the Baby Boom generation reached age 65 in 2011. Improving medical technology and access to care will also keep these and future Americans healthy and active longer, increasing the time during which they will demand healthcare. Notwithstanding a 0.1 year decrease in 2015, over the past 15 years average life expectancy in the US increased to 78.8 years—up two full years from its 2000 average. Obesity rates, drug abuse, and even economic conditions (e.g. decreased labor force participation) are hindering a more concerted rise in life expectancy, but data through the first half of 2016 suggest the drop in 2015 may be an anomaly.

The Affordable Care Act (ACA) has increased the number of Americans with health insurance. The Obama Administration estimates that 21.3 million Americans have gained health insurance since the ACA became law in 2010. During the first five years of the policy's enactment, the uninsured rate fell from 15.7% in 2010 to 8.6% in early-2016. The ACA went into full-effect in 2014. That same year, the Centers for Medicare and Medicaid reported that national healthcare spending increased 5.3%, accelerating from 2.9% growth in 2013. Policy under President-elect Trump presents some risks to the industry, but campaign promises to repeal the ACA may soften to amending and improving the existing bill.

Improving access to care amplifies the rise in spending we should see from an aging population. Data from the Centers for Medicare and Medicaid show the clear increase in healthcare spending as people age. In 2012, per capita healthcare spending among those Americans aged 45-64 was $9,513. Per capita spending for those aged 65-84 was nearly 80% higher—at $16,872; spending jumped again, to $32,411, for those Americans aged 85 and older. As more Americans age into the top healthcare spending brackets, national healthcare spending will accelerate.

4.8 NUMBER OF AMERICANS AGE 65+ WILL CONTINUE TO CLIMB



SOURCES: U.S. CENSUS BUREAU, MOODY'S ANALYTICS

The healthcare employment market is another indicator of strong growth in the healthcare industry. While the technology-driven professional and business services sector has been the story of the current economic expansion, healthcare employment has quietly been a major driver of employment growth nationwide:

- —Healthcare employment never recessed—as of November 2016 the sector is 20.8% larger than it was in early 2008, when national employment peaked
- —Year-over-year as of November 2016, healthcare and social assistance employment grew by 2.6%—making it the second fastest growing sector nationwide after professional and business services (2.8%)
- —The healthcare sector has demonstrated long-term stability and consistent growth—and future gains in the industry should follow historical trends

Healthcare employment has quietly been a major driver of employment growth nationwide.

Mobile or small in-home devices could decrease the need for certain in-person medical visits.

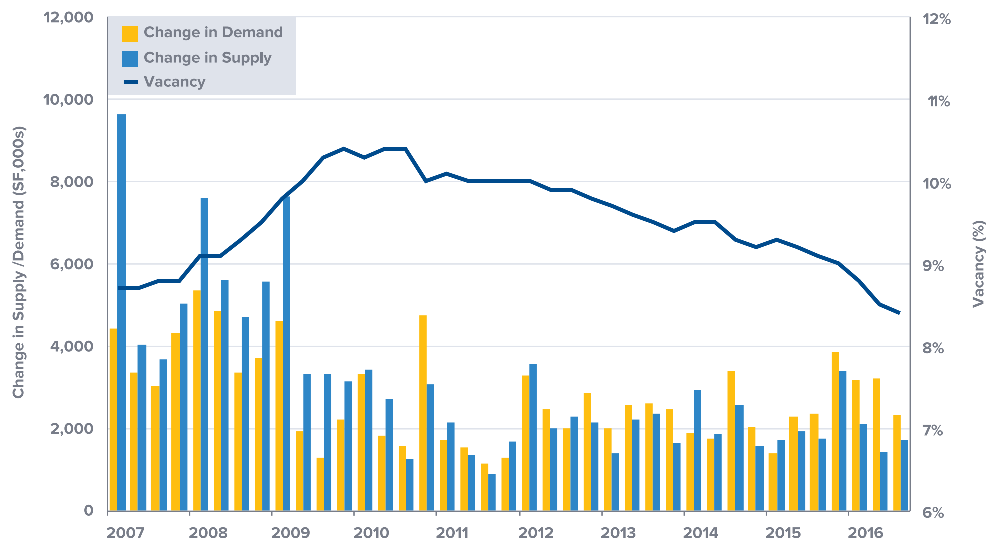
Up to this point, advancements in medical technology have largely supported medical office demand. Improving surgical techniques have reduced the amount of time that patients need to spend in the hospital after routine procedures. With few exceptions, the number of inpatient days has fallen consistently since the American Hospital Association began tracking the data more than two decades ago. Patients not forced to remain in the hospital are visiting outpatient centers—the number of outpatient visits has trended up dramatically over the same period. This growth in outpatient visits has and will continue to support medical office demand.

Future advancements in medical technology present both risks and rewards for the U.S. medical office market. Shrinking medical devices with easier-to-use interfaces are improving the ability to diagnose patients outside of a hospital setting. This increases medical office usage both by decreasing hospital visits and increasing the availability of diagnostic tests for those that otherwise may not get them. Conversely, should medical device technology improve significantly enough in the long term, there is a possibility that mobile or small in-home devices could decrease the need for certain in-person visits. Medical device advancements will be important to watch.

Medical office trends continue to improve along with the asset class's macro indicators. Our analysis shows:

—Medical office vacancy fell to 8.4% in the third quarter of 2016—down 70 basis points from the prior year (per CoStar)
—Vacancy is now below its 2007 trough, and should continue to fall in the near term
—Supply growth has been consistent, but not outsized
—Healthcare spending and trends in the delivery of care will support a growing medical office tenant base nationwide

4.9 MEDICAL OFFICE FUNDAMENTALS STRENGTHENING



SOURCE: COSTAR GROUP, INC.

Medical device advancements will be important to watch.

12.6m square feet

NET ABSORBTION, FOUR QUARTERS ENDING SEPTEMBER, 2016. PREVIOUS FIVE-YEAR AVERAGE: 9.1 MILLION SF

CoStar data indicate that medical office demand growth has accelerated recently. Net absorption for the four quarters ending in the third quarter of 2016 was 12.6 million sf, well above annual average demand growth of 9.1 million sf from 2010 to 2015. Demand growth has yet to return to prerecession peaks, but recent trends are encouraging. As medical office fundamentals continue to tighten, demand growth may slow despite a steady appetite for new space due to limited availability of modern medical office product.

4.10 TOP MARKETS FOR MEDICAL OFFICE CONSTRUCTION

MARKET	TOTAL SF
St. Louis	939,200
Philadelphia	873,265
Chicago	871,065
Houston	758,745
Atlanta	491,500
South Florida	387,483
Dallas/Ft. Worth	381,405
Northern New Jersey	380,400
Milwaukee/Madison	349,000
Long Island	306,872

SOURCE: COSTAR GROUP, INC.—MEDICAL OFFICE PROPERTIES GREATER THAN 20,000 SF

The national medical office market has maintained approximately 10 million sf of new space under construction since 2010—resulting in a 1.3% increase in medical office stock per year over the past six years. CoStar is currently tracking 10.3 million sf of new medical office construction across the country, which is still below prerecession peaks. New medical office supply is focused on the metropolitan areas that have attracted in-migration and employment growth over the past seven years, as well as those with aging populations. Florida, Atlanta, and the Texas metros all have a large number of projects underway while the Northeast's aging population has growing healthcare needs.

After another year of slow, steady growth, medical office rents are now at their highest level since 2009. Rent trends are difficult to track in the asset class due to limited lease rolls and a small inventory relative to traditional office, but the data continue to point to modest increases. The long-term outlook for medical office rent growth is strong. Macro indicators of medical office demand portray an industry on the upswing, from both a revenue and employment standpoint. Limited new construction has allowed vacancy to fall to its lowest level in nearly a decade. Healthy fundamentals should drive strong investment performance in the asset class.

Limited new construction has allowed medical office vacancy to fall to its lowest level in nearly a decade. Healthy fundamentals should drive strong investment performance in the asset class.

Property Sectors

04

Retail

TRENDS

—Retail availability has improved, returning to levels last seen in 2008, but well-above prerecession lows.
—Rising employment and wages should support healthy consumer spending growth.

DEMAND

—Dramatic growth in ecommerce sales activity, rising demand for experiential retail offerings, and a growing concentration of sales in urban retail nodes are disrupting the sector.
—Retailers continue to struggle with these dynamics, forcing the closure of entire retail chains (Sports Authority) or underperforming stores (Macy's).

SUPPLY

—Retail construction remains low as retailers temper expansions and focus store openings on infill locations.
—New industrial construction is substituting for retail development as retailers build out their distribution networks to handle growing ecommerce sales.

OUTLOOK

—Changes in the retail market are more than cyclical as ecommerce grabs a larger and larger piece of activity with each passing year.
—The market will continue to reveal stark differences between winners and losers, with successful retailers deploying effective omni-channel sales strategies.

SUSTAINABILITY

—Retail has been heavily disrupted by technology. Ecommerce in many ways is a sustainable development for the sector, cutting down the need for outlying stores in suburban locations and eliminating consumer shopping trips (although any positive environmental implications are up for debate, with increased truck activity and additional packaging materials). Restaurants and experiential retail are playing an important part in the success of walkable, mixed-use neighborhoods.

Renters at Anthology in Washington, DC have access to Petco on the property

Bentall Kennedy

Retail: Maintaining footing on a shifting landscape

Dramatic growth in ecommerce sales and shifting consumer preferences are disrupting the retail landscape and creating challenges for retailers. The market continues to reveal winners and losers, as it has in past years. Firms unable to compete due to location, product offering or a failure to develop a competitive online presence are either shuttering stores or going out of business altogether. Perhaps the highest profile example in 2016 was Sports Authority's announcement that it would close all 450 of its stores.

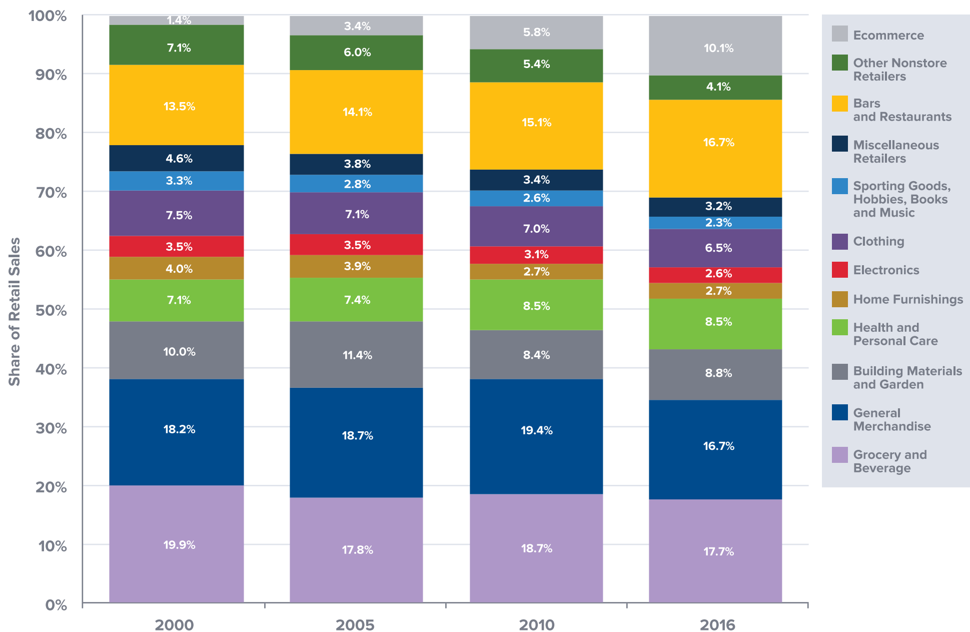
The struggle for survival is not limited to retailers alone, as landlords have struggled to retain tenants and shoppers. Lifestyle preferences among Millennials and young families have left many suburban shopping centers out in the cold, while walkable, small-format urban locations and destination centers capture much of the in-person retail sales volume.

Total retail sales including food services—but excluding motor vehicles, parts, and gas—grew at a healthy 3.4% over the past year. While this is down from its 4.2% growth rate from a year ago, growth in retail sales outpaced GDP growth during the year. This should be a good sign for retailers, yet many continue to struggle to increase their sales. A detailed look at the retail categories driving sales trends reveals why numerous retailers are struggling – ecommerce. Growth in retail sales less motor vehicles, parts, and gas slowed from 3.4% to 2.3% after backing out ecommerce sales—more or less in line with GDP growth. By contrast, ecommerce sales rose by 14.3% year-over-year as of 3Q 2016. The chart below illustrates the changing composition of retail sales.

14.3%

YEAR-OVER-YEAR ECOMMERCE SALES GROWTH, AS OF 3Q 2016

4.11 ECOMMERCE MARKET SHARE RISING



—Many retail sales categories fading as ecommerce rapidly grows
—Electronics and appliance stores (-3.6%) and general merchandise (-1.9%) saw sales decline YOY
—Those two sectors, along with home furnishings, now each have less than a 3% share of total sales
—"Fast-fashion" helping stem the tide in clothing
—Bars and restaurants and health and personal care are two notable areas of brick-and-mortar retail success

SOURCES: U.S. CENSUS BUREAU, BENTALL KENNEDY
NOTE: 2016 DATA AS OF 3Q, ALL OTHERS YEAR-END

As we have discussed in previous editions of Perspective, retailers have been working aggressively to shift to omni-channel business models to compete in the current environment. A significant portion of these efforts has gone toward opening more urban stores and improving ecommerce platforms. Retailers and landlords alike are also learning the importance of experiential retail, from restaurants to strategic game adventure venues. Target, Wal-Mart, CVS, and Walgreens, among others, have pushed new concepts for urban and dense suburban locations. These efforts have not always met with success. In January 2016, Wal-Mart announced that it would close all 102 of its Express concept stores and a number of other poorly performing locations.

Urban locations are not always smaller format or intended to offer narrower product lines. Target's location in Boston's Fenway neighborhood, for instance, is a multi-story store with more square footage than many traditional Target centers. Walgreens and CVS have in many ways expanded their product offerings in urban locations to include more food and personal services—it is notable that health and personal care retail sales grew by 7.4% during the year. An urban presence is not a panacea for struggling retailers as competition remains high. Product offerings, price, and service are also crucial. The recent arrival of Primark to Boston's Downtown Crossing shopping district is widely viewed as a major contributing factor to the shuttering of a neighboring H&M location.

Recently, Wal-Mart has had the most success fighting the headwinds created by ecommerce and slower population growth in many outlying suburbs:

- Wal-Mart is investing heavily in its online platform, including the acquisition of Jet.com
- In its fiscal quarter ending in July 2016, Wal-Mart finally ended a five-quarter trend of flagging online sales growth
- It has focused on polishing its brand image and improving service in its stores
- Efforts to penetrate the grocery business—a retail segment where ecommerce firms have so far struggled to compete—have also provided good returns

79% of Americans say they make purchases online
Source: Pew Research Center

5.6%

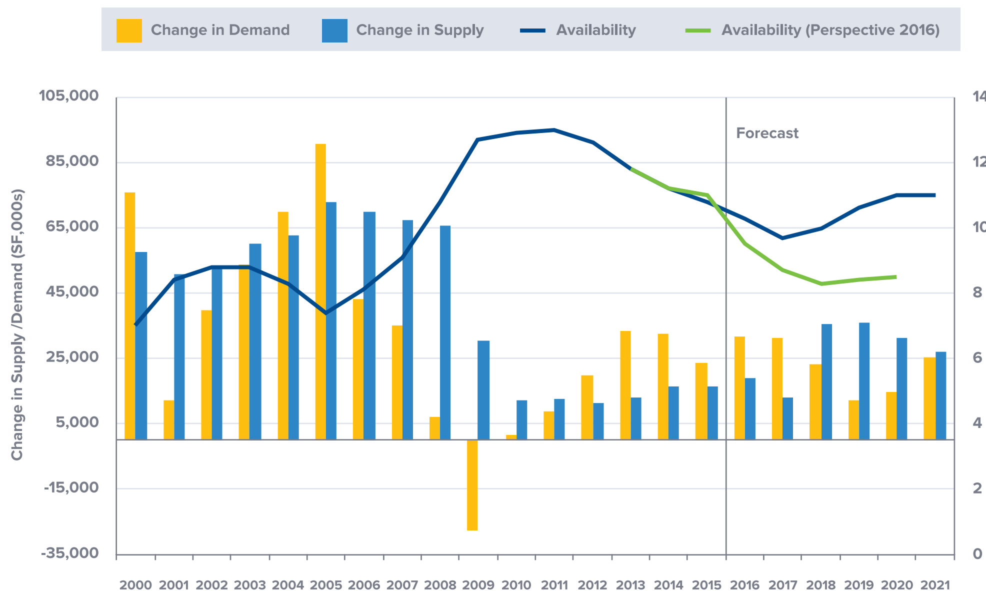
YEAR-OVER-YEAR BAR AND RESTAURANT SALES GROWTH, AS OF 3Q 2016

Some of Target's issues in 2016 have been pinned on its comparative shortcomings in the grocery segment versus Wal-Mart. Target has also sold-off its in-store pharmacies to CVS, a move that we will monitor in terms of its impact on consumer traffic and sales. We have talked in recent years about retailers offering space within their stores to other retailers to bolster store operations; this seems to be the latest variation on that trend.

Bars and restaurants have moved into the spotlight as urbanites have opted for lifestyle amenities and experiences over white picket fences. However, even suburban retail locations have added plenty of restaurants to their tenant rosters. Many of the most successful grocers, of which Whole Foods is the poster child, have pushed heavily into prepared foods in order to compete for these sales. Year-over-year, bar and restaurant sales grew by an impressive 5.6%.

These trends are relevant to the retail space market in that they demonstrate the shifting sands on which many of the nation's largest retailers (and retail centers) stand. Investors in the space need to be more cautious than ever with the tenants they choose to fill out their centers. Bars and restaurants have a high turnover rate, but they are essential to creating the foot traffic which supports other retailers.

4.12 SLOW RECOVERY CONSISTENTLY UNDERPERFORMING EXPECTATIONS



SOURCE: CBRE-EA

Lifestyle changes are increasing the importance of bars and restaurants in the retail sector

FUNDAMENTALS CONTINUE TO DISAPPOINT

According to CBRE-EA, as of the third quarter of 2016, national retail availability was 10.4%. Availability has fallen back down to 2008 levels but remains well above the low rates that would be expected at the peak of an economic expansion. Not unlike the struggle of individual retailers to survive in the current environment, there have been clear winners and losers among retail properties based on location and tenant roster—and fundamentals and investment performance have been mixed accordingly. CBRE-EA retail data reflect neighborhood, community, and strip center trends and these centers have struggled.

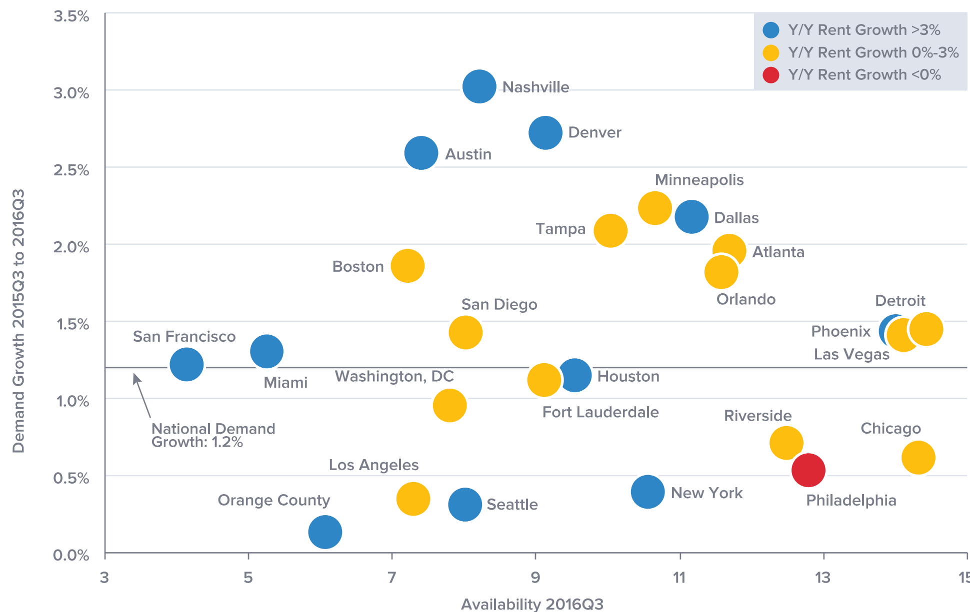
Bentall Kennedy believes the overall market will struggle with a higher structural availability rate in the years ahead, heightening the importance of asset selection and attentive management. Underlying this expectation is the view that older suburban strip centers and outlying big-box centers will struggle—while walkable, landscaped lifestyle centers and other experiential retail in strong locations should flourish. Household balance sheets have strengthened considerably since the end of the recession; successful retailers will be those that identify the strategies that best tap into this buying power.

During the past four quarters national retail absorption totaled nearly 32 million sf—among the highest annual totals of the past seven years. Annual demand growth remains a shadow of its previous levels, however. In the fourth quarter of 2005 alone, US retailers increased their footprint by 36 million sf, bringing total net absorption for the year to 90 million sf. Retailers are now more cautious than they have been in previous cycles. In many cases, investment in direct-to-consumer distribution strategies has replaced scouting new brick-and-mortar locations, save for those in the fastest-growing markets.

Older suburban strip centers and outlying big-box centers will struggle —while walkable, landscaped lifestyle centers and other experiential retail in strong locations should flourish.

32m square feet

NET ABSORBTION, FOUR QUARTERS ENDING SEPTEMBER, 2016. HIGHEST TOTAL OF THE PAST SEVEN YEARS—WELL BELOW THE PREVIOUS HIGH OF 90 MILLION SF (2005)



4.13 JUST AS IN RETAIL CENTER TYPES, BROAD VARIATION IN TRENDS ACROSS MARKETS

SOURCE: CBRE-EA

Developers have responded to tepid retail demand growth by curtailing development. Year-over-year retail developers added 17.7 million sf of new space to the national retail market. With the housing boom a distant memory, the nation's suburbs are not expanding in the way they once were. New retail centers have tended to be redevelopments or destinations intended to draw on wider trade areas. This will likely remain the case for the foreseeable future. Cultural trends have geographically concentrated much of the recent growth in retail foot traffic into urban, walkable locations. Until home building picks up again, new retail supply growth will continue to be strategic, helping to support healthy fundamentals.

While national demand growth has been sluggish both during the past year and for much of the recovery, a number of the nation's strongest demographic markets have outpaced the national average. Nashville saw the fastest year-over-year demand growth, with its retail tenant base expanding by 3.2%—more than 2.5 times the national rate of 1.2%. Employment and labor force growth in Nashville, Austin, and Denver have outpaced the nation for much of the past six years, which has translated to strong retail demand growth. High growth is not the only consideration for retail investors, however; strong infill locations in mature, low availability markets such as the Bay Area, Boston, and Washington, D.C. also have appeal for long-term investment.

Retail fundamentals are slowly but steadily improving and national retail rent growth has finally started to accelerate. National retail rents grew by 2.4% year-over-year as of the third quarter of 2016. Retail rents have been growing tepidly since 2014, but prior-year growth was the strongest of the current expansion cycle. Rent growth may accelerate further in the coming year, but outsized rent growth will be difficult to achieve for many of the reasons outlined.

The contrast between winners and losers among retailers and retail centers will remain stark. Brick-and-mortar retail is clearly not dead as the firm that has been driving the ecommerce trend, Amazon, seems increasingly intent on expanding its physical retail footprint as part of its own omni-channel strategy.

Cultural trends have geographically concentrated much of the recent growth in retail foot traffic into urban, walkable locations.

Property Sectors

04

Industrial

TRENDS

—Through 3Q 2016, industrial availability has fallen for 26 straight quarters.
—At 8.4%, availability is at its lowest level in two decades.

DEMAND

—Growth in traditional demand drivers has been lackluster, but tepid growth in areas such as industrial production and inventories has given way to surging ecommerce demand.
—Online retail has been a boon for the sector with distribution space replacing brick-and-mortar retail in many cases.

SUPPLY

—The need for modern, efficient distribution space with high ceilings, multiple dock doors, and ample trailer parking has spurred most of the recent industrial construction activity.
—Supply growth shows no signs of abating, with more than 200 million sf of distribution space underway.

OUTLOOK

—Econometric models forecasting industrial demand have broken down as traditional demand drivers have been supplanted by ecommerce.
—Strong industrial fundamentals should continue to favor landlords, even as new construction is substantial.
—U.S. trade and tax policies under the Trump administration pose some downside risks, but there is also the potential for stronger economic growth in the short run.

SUSTAINABILITY

—Distribution operations are taking advantage of technology through automation and increased use of robots. With growing demand for timely "last-mile" deliveries, firms are looking to locate infrastructure closer to consumers rather than in far-flung exurbs. Longer-term this sector could also be the beneficiary of driverless truck and drone technologies, which would allow for more efficient shipping without the constraints of human drivers.

Anaheim Concourse
Anaheim, CA

Bentall Kennedy

Industrial: Demand growth shatters conventional models

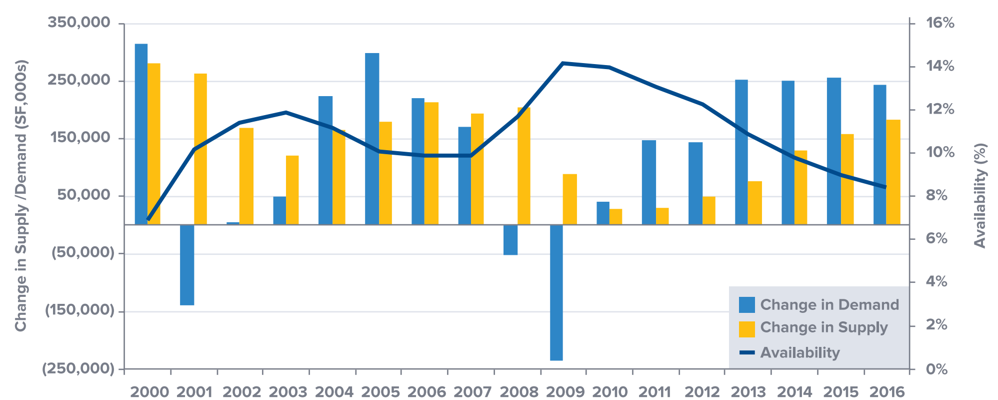
According to CBRE-EA, national industrial availability has fallen in each of the past 26 quarters. Nationwide availability was 8.4% as of the third quarter of 2016—its lowest level in more than two decades. Net absorption has been impressive, reaching a post-recession high during the third quarter. Year-to-date net absorption through the first three quarters of 2016 was the highest since the first three quarters of 2005. Healthy fundamentals and strong investment performance are encouraging new construction (industrial posted faster NOI growth and higher total returns than the apartment, office, and retail sectors over the past year). But demand growth continues to widely outpace supply.

The disconnect between traditional industrial drivers and market fundamentals is noteworthy. In last year's edition of Perspective we noted the strong relationship between inventory growth and industrial demand. At that time, we saw substantial growth in inventories and predicted this growth would slow in 2016. That expectation largely materialized, albeit with limited impact on industrial fundamentals. Similarly, consumption growth has been unimpressive, industrial production has been slow, and traffic is down in most major U.S. ports. The Cass Freight Index, which provides insight into shipping industry trends, has fallen to its lowest level since 2010.

26 quarters

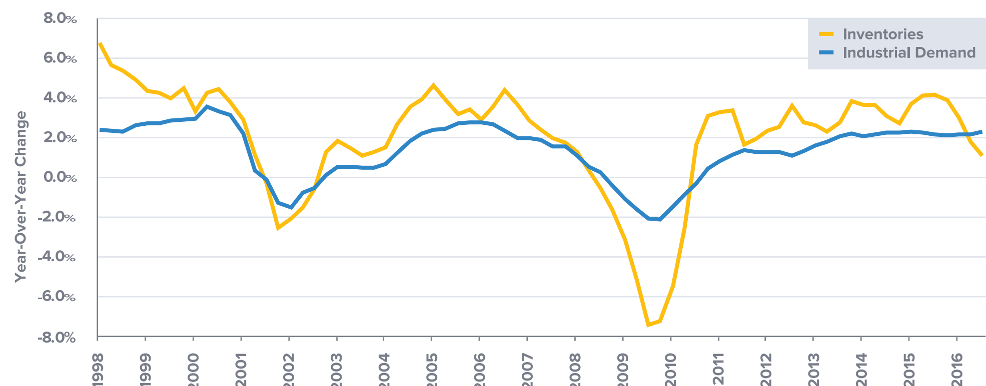
NATIONAL INDUSTRIAL AVAILABILITY HAS FALLEN IN EACH OF THE PAST 26 QUARTERS (AS OF 3Q 2016)

4.14 INDUSTRIAL FUNDAMENTALS POST ANOTHER IMPRESSIVE YEAR



SOURCE: CBRE-EA
NOTE: 2016 IS PROJECTED YEAR-END VALUE AS OF 3Q 2016

4.15 STRONG HISTORICAL INVENTORY/DEMAND RELATIONSHIP BREAKING DOWN



SOURCES: BUREAU OF ECONOMIC ANALYSIS, CBRE-EA

Industrial has recently been impacted by extensive retooling in supply chains as increased ecommerce activity drives demand.

In 2017 and beyond we will remain vigilant for changes in trade and tax policies that could severely disrupt the flow of goods through U.S. ports. President-elect Trump has been very vocal about his displeasure with existing U.S. trade policies and may look to renegotiate existing trade agreements. On the tax front, of particular concern is the concept of border adjustments, which were part of the U.S. House of Representatives' tax reform proposal. Border adjustments would prevent companies from expensing the cost of imported items for tax purposes. Such a change could hurt already-struggling retailers and encourage changes in where U.S. firms source their goods.

Rather than traditional drivers being the catalyst for demand growth, industrial has recently been impacted by extensive retooling in supply chains as increased ecommerce activity drives demand. In many respects the strength of industrial demand is a by-product of weakness in the retail sector. Amazon has been the primary disruptor in this regard, taking down large blocks of distribution space—often closer to population centers in order to efficiently deliver large numbers of packages directly to consumers. Amazon and third party logistics firms have also taken smaller infill spaces in submarkets traditionally reserved for light industrial uses to further bolster its last-mile capabilities, and to bring same-day delivery to more communities. Due to the immediacy of the space need, tenants have been willing to accept less modern functionality in these close-in locations.

Traditional brick-and-mortar retailers have invested heavily to keep up with Amazon and meet rising consumer expectations for delivery. Shipping individual items and accepting returns from online orders has been challenging. Notably, up to 33% of all goods purchased online are returned, and retailers must accommodate this substantial backflow of goods within their ecommerce distribution infrastructure. To date, Wal-Mart has been one of the more successful Amazon competitors—its 2016 purchase of Jet.com for about $3 billion is a reflection of its desire to further bolster these efforts.

Industrial trends show that the need for efficiency has created an appetite for new warehouses with high ceilings that can support sophisticated racking systems and sorting robots, as well as on-site trailer parking for large transportation fleets. This trend, in no small degree a reflection of growing ecommerce demand, has fueled net absorption within modern industrial properties. CoStar's Logistics industrial subtype, which includes buildings with high ceiling heights and numerous dock doors, encompasses the bulk of these properties and vacancy in this category has been consistently falling.

Among logistics properties there has been a divergence in vacancy patterns in the distribution category, which includes the largest buildings with the highest clear-heights and dock door counts. This divergence is driven by the impact of new supply. Distribution buildings built in 2000 or later are experiencing an upward trend in vacancy; while those older than 2000 show a downward vacancy trend.

We observe that:

- Distribution buildings built in 2000 or later account for just 7.7% of national industrial stock—but distribution buildings represented 60% of industrial supply growth from 2013 through 3Q 2016
- Vacancy in the 2000+ vintage distribution subset rose from 7.8% to 11.2% during that period due to new product in lease-up
- Demand for these properties is substantial, but construction activity increasingly bears watching
- CoStar is tracking more than 200 million sf of construction within the subset
- This is roughly twice the total completed from 3Q 2015 to 3Q 2016

Cold storage space is an attractive investment option, particularly in well-populated locations.

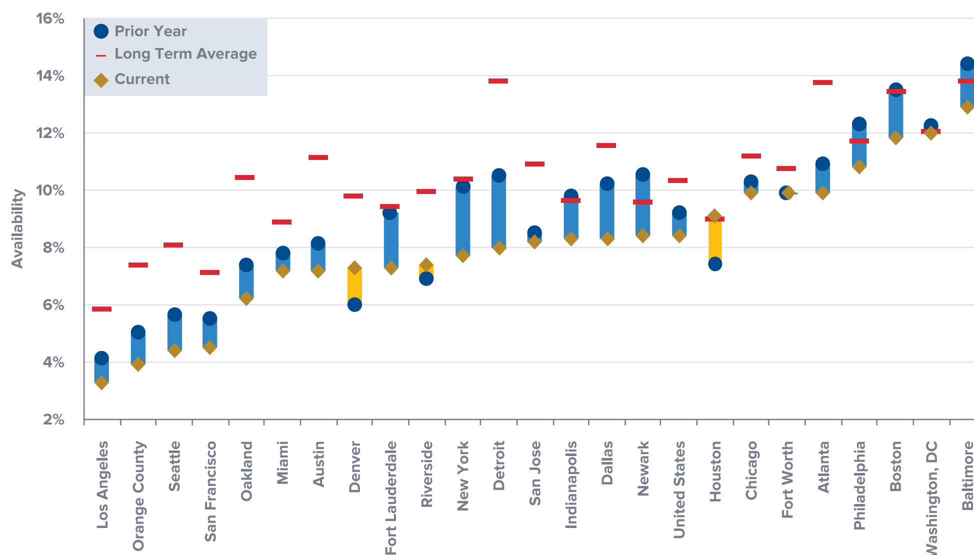
Economic and lifestyle trends have also created growing demand for cold storage space over the past few years. Consumers are eating more fresh foods and shunning processed items, and they are also dining more frequently at restaurants—these preferences heighten the need for cold storage space. Despite a small step back in the third quarter of 2016, demand growth since 2013 has been consistent, if not outsized, and vacancy has fallen. According to CoStar, vacancy as of the third quarter of 2016 was 7.5%—down 10 basis points from its year ago level.

Longer term, the relatively inelastic demand for food will provide this industrial subtype with a stable demand pattern, and speculative supply should be subdued given the high cost of constructing these facilities. These characteristics make cold storage space an attractive investment option, particularly in well-populated locations. It must be noted that functionality of layout and efficiency of operation are particularly crucial for cold storage, however, necessitating careful asset selection and due diligence. Investors should be mindful that food exports/imports are a significant source of cold storage demand and these trade flows could be disrupted by policy changes and/or potential trade wars under the Trump administration.

Demand growth and tight fundamentals within each of the industrial subtypes has reflected positive industrial property trends at the metro level. Bulk distribution markets with convenient access to the nation's highway and rail infrastructure—including Riverside, Chicago, Dallas, Atlanta, and Northern New Jersey—have fared well. But construction continues to accelerate in each of these markets, making them vulnerable in the event of slower demand growth. Smaller, more infill industrial markets with strong local and regional economic trends—including Seattle, Austin, Oakland and Miami—have benefitted from direct-to-consumer distribution and the need for distributors to be close to fast-growing population centers. But new development in these markets should be monitored as well.

Near-historically low industrial availability has kicked rent growth into high gear. Year-over-year CBRE-EA's national industrial rent index increased by 6.9%—the strongest annual growth rate of the current expansion period and the highest rate of rent growth in more than 15 years. Future growth rates will almost certainly be more subdued. Though industrial rent growth has accelerated since 2012, supply growth is reaching levels that could adversely impact fundamentals. On the upside, ecommerce-driven demand should continue to grow, and the potential exists for stronger performances from traditional industrial drivers should economic growth accelerate in 2017 as we expect.

4.16 AVAILABILITY IN MOST MARKETS CONTINUES TO FALL



—3Q 2016 availability below year-ago and long-term avg. levels in vast majority of markets
—Houston and Denver only markets to show a material increase in availability over past year
—Availability below 4% in LA/Orange County, driving development in Riverside
—Seattle & San Francisco also running low on space
—Tight market conditions should continue to support widespread rent growth

SOURCE: CBRE-EA

Bentall Kennedy Group

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For more information, visit www.bentallkennedy.com.

Oaks Logistics Center
Livermore, CA

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