RASCW Commercial Economic Real Estate Forecast

January 19, 2017

Kevin O’Driscoll, Commercial Real Estate Executive

Jeff Kleinschmidt, Vice President – Structured Finance Group

Jessica Piatt, Commercial Relationship Manager

OLD NATIONAL®

Banking ▪ Wealth Management ▪ Insurance ▪ Mortgage ▪ Investments

Discussion Focus

1. National Economic Update
2. Commercial Real Estate Trends
3. Banking Industry Trends
4. Permanent Market Trends
5. What's Ahead?
6. Conclusions

National View

Employment

Consumer Spending

Monetary Policy

Interest Rates

Employment

- **Job growth**
  - Averaged 180,000 net new jobs/month in 2016
  - Down from 230,000 in 2015 and 250,000 in 2014
- **Slow-down in pace of job growth may reflect economy nearing full employment**
- **Unemployment**
  - Currently 4.7%, below fed estimated long-term average
  - Hit nine-year low (Nov. 2016)
  - 11 bps below historical long-term average of 5.8% (1948-2016)

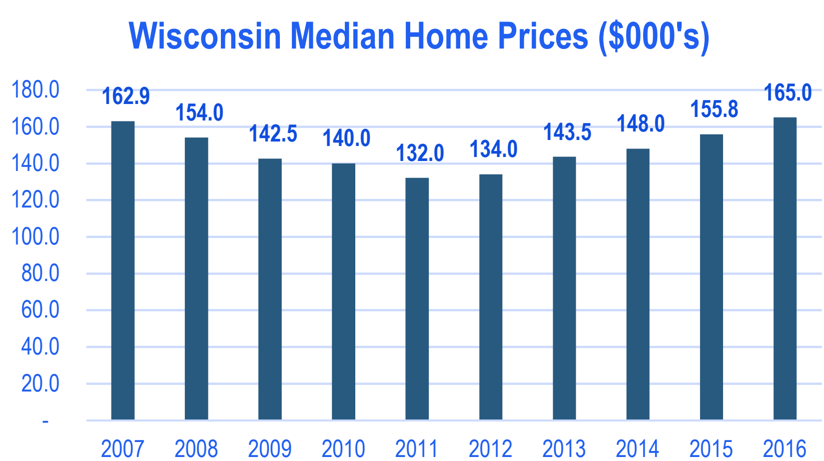
Household Wealth & Consumer Spending

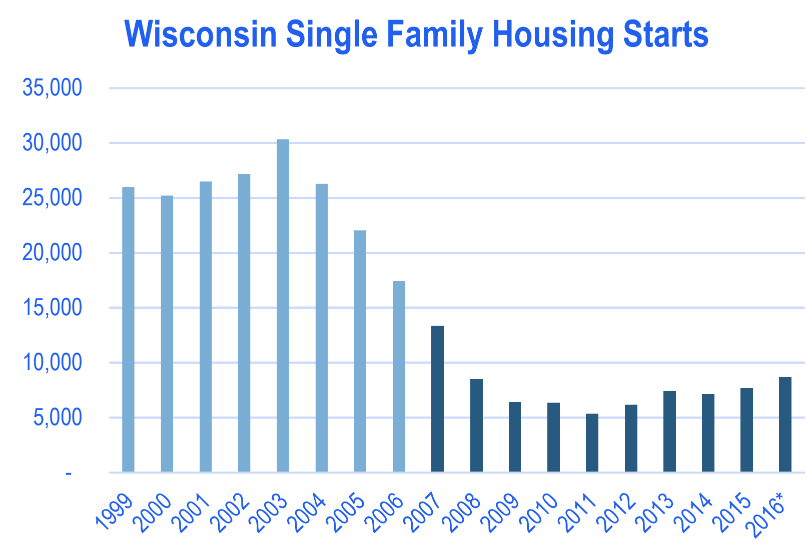
- Employment numbers include part-time work; larger than average segment working part-time (involuntarily)
- Real (inflation adjusted) median household income remains slightly below pre-recession levels

- Average hourly wages increased by 2.9% in 2016, largest post-recession increase

Household Wealth & Consumer Spending

- **US car sales reached peak levels over past two years**
  - 17.55 million vehicles sold in 2016, breaking prior year record of 17.47 million
  - 7 consecutive year-over-year increases in US auto sales
  - Industry experts anticipate modest decline in 2017 to 17.1 million
- **Wisconsin home prices are now above pre-recession levels, however homebuilding remains well below pre-recession levels**





GDP Growth

- **GDP up 1.70% in Q3 2016**

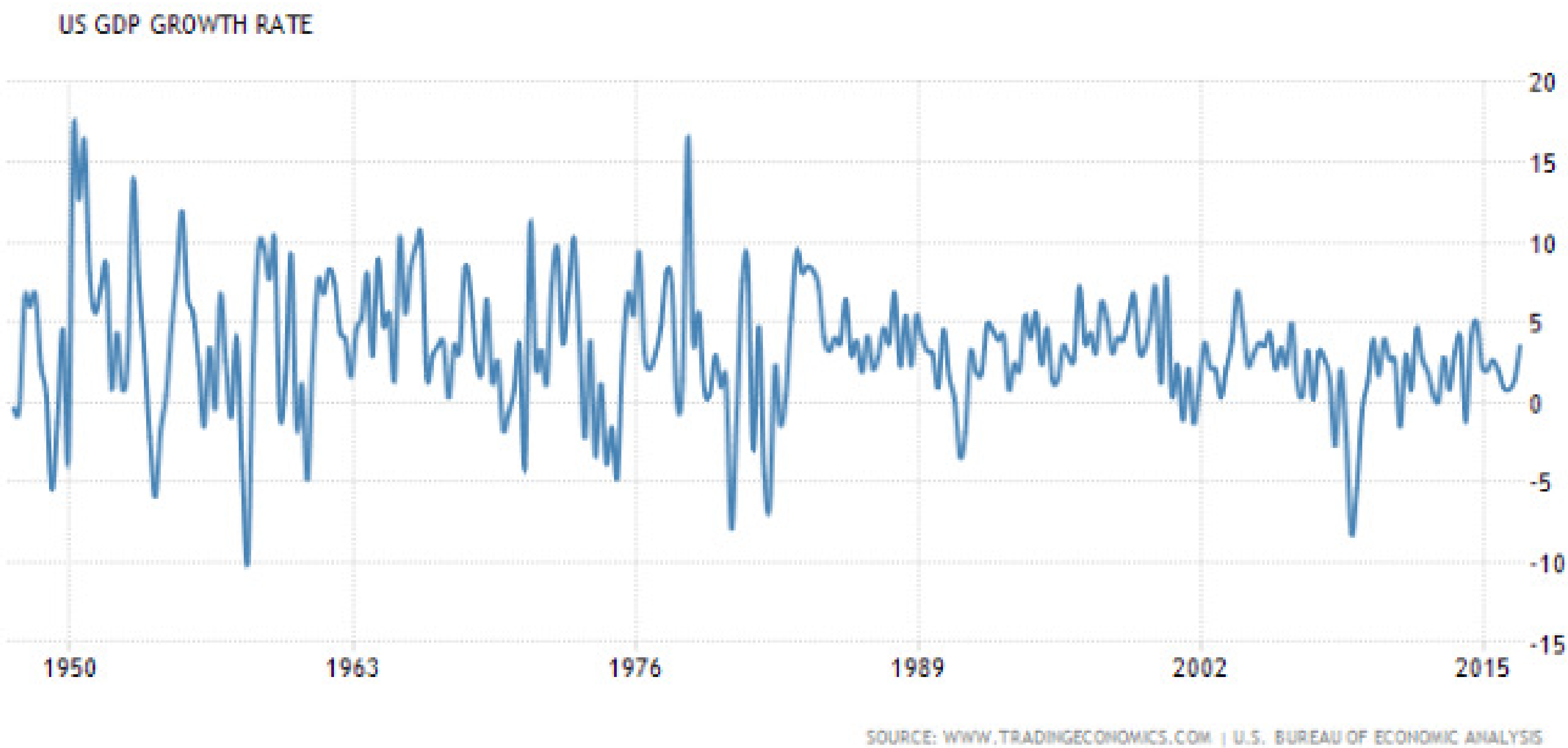
- **Fed forecast 1.9% for 2016 and 2.1% for 2017**
  - Each up 10 bps from prior forecast

- **Long-term historical annual GDP growth is 3.2% (1948 – 2016)**

- **GDP growth has been declining over past two decades, but volatility has also lessened**
  - 1950's – 60's: above 4% average annual growth
  - 1970's – 80's: around 3% annual growth
  - Last decade: below 2% annual growth

GDP Growth

Diminished growth, diminished volatility



Monetary Policy

- **Fed has statutory mandate to encourage max employment, stable prices, and moderate long-term interest rates**
  - Inflation target is 2%
  - Long-term GDP growth target is 2-3%

- **Factors named in December rate hike include**
  - Decline in unemployment
  - Moderate increase in consumer spending, though business fixed investment remains soft
  - Increase in inflation, offset by earlier declines energy prices and prices of non-energy imports
    - Core inflation up 1.6% year over year as of November
    - PCE more than 1 percentage point higher than previous year

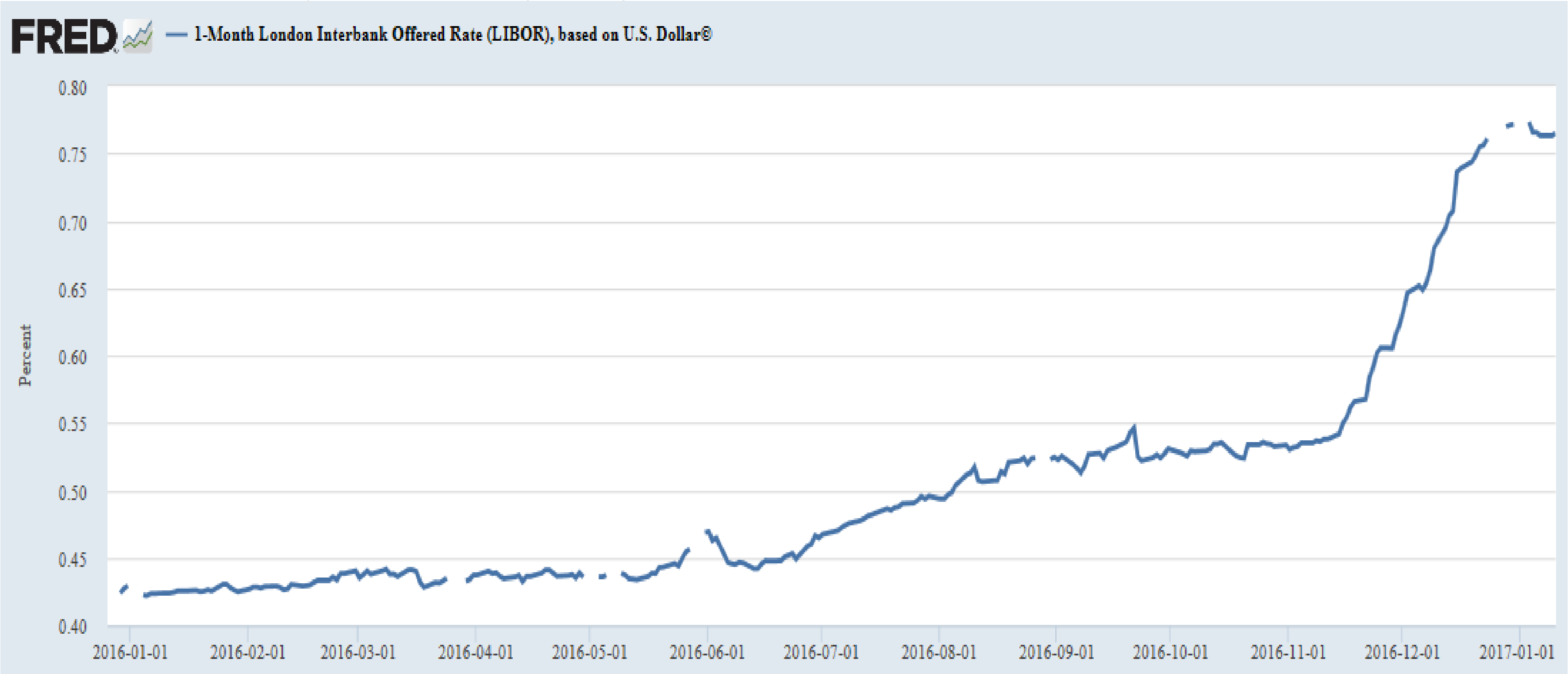
Interest Rates

- **Federal funds rate ⇧ by 25 bps on December 14**
  - Now 0.75%
  - Median projections (year-end rates)
    - **1.4% 2017 – 65 bps increase**
    - **2.1% 2018 – 70 bps increase**
    - **2.9% 2019 – 80 bps increase**

Interest Rates

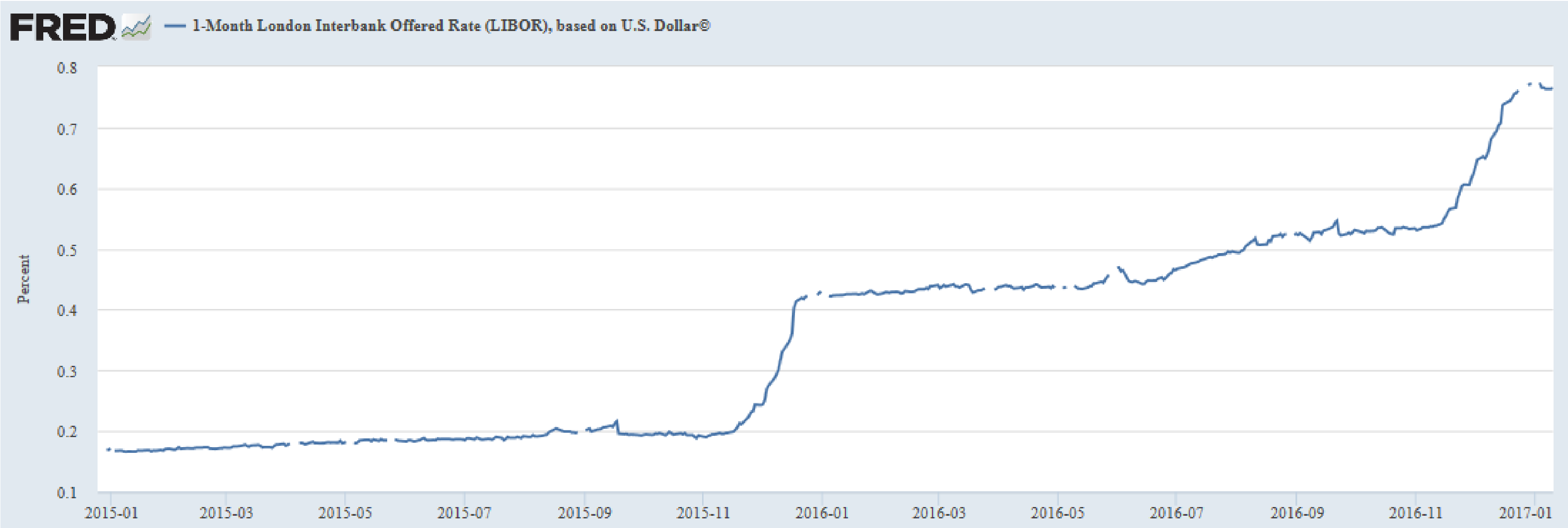
30 day Libor – past 12 months

- Now 0.77%
- 35 bps increase over the year
- Rate hike priced into LIBOR in mid-November



Interest Rates

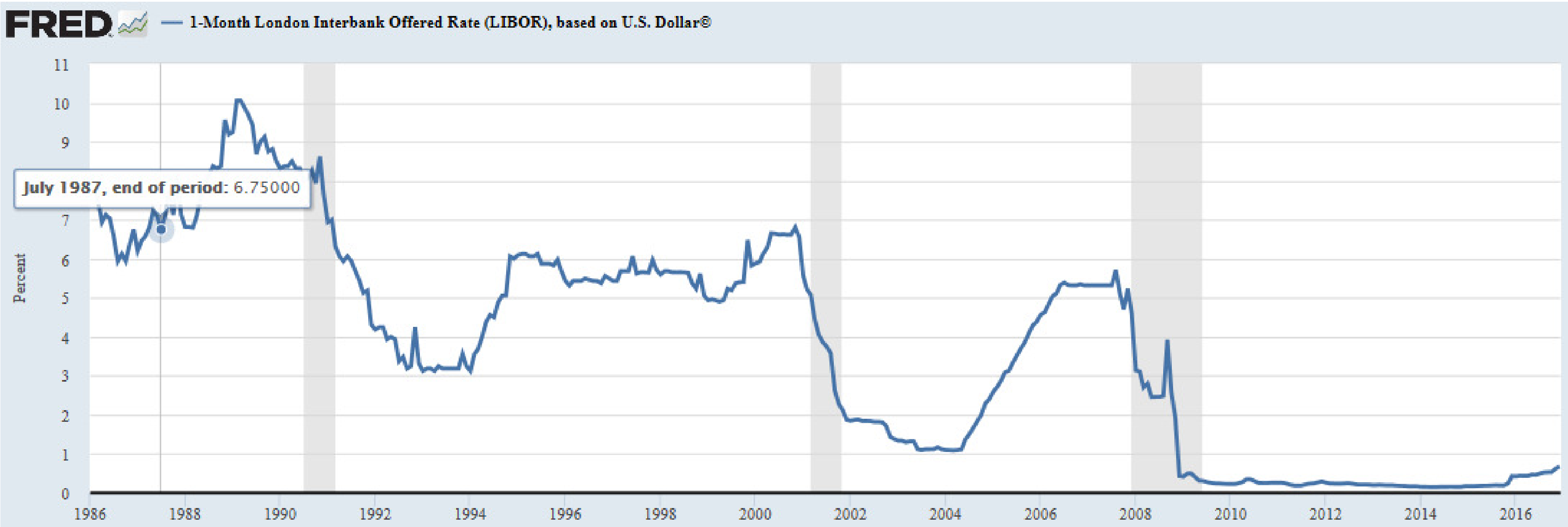
- **30 day LIBOR – past 24 months**
  - Prior 25 bps Fed Funds rate hike also priced into rates in November
  - Recent jump in rates does not appear to be election-related



Interest Rates

30 day Libor – since 1986

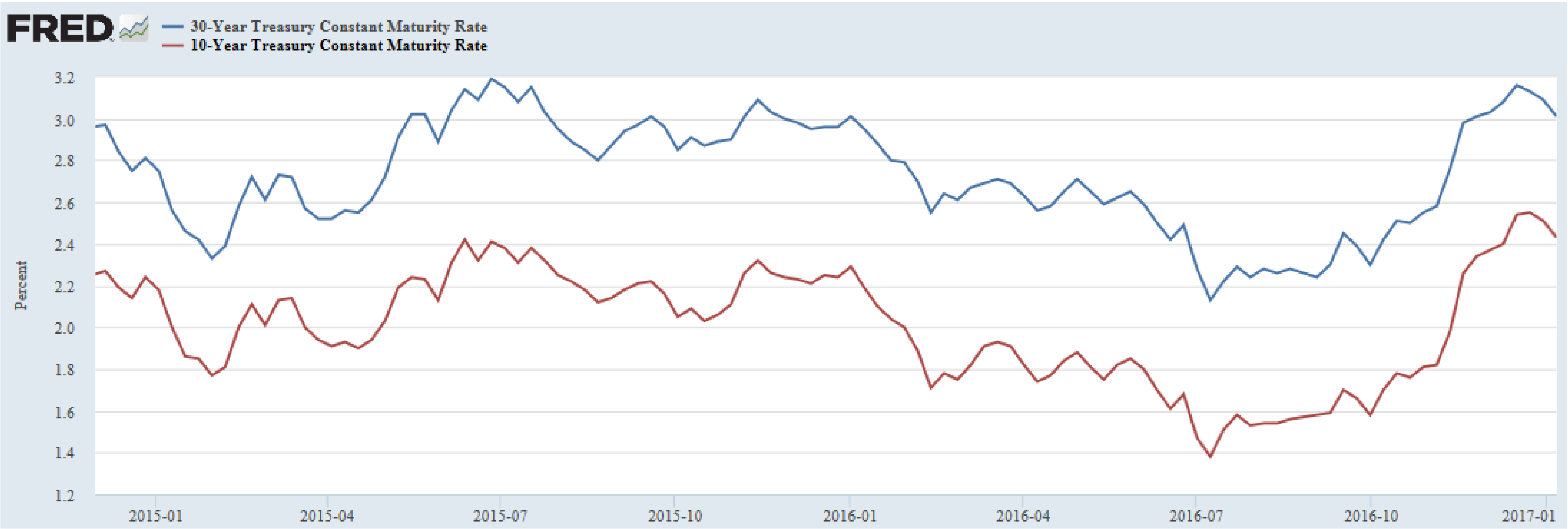
- Rates still very low by historical standards
- Lowest point 0.149% in May, 2014
- Previous low point around 1.09% in March, 2004



Interest Rates

10 and 30 year treasuries – last 24 months

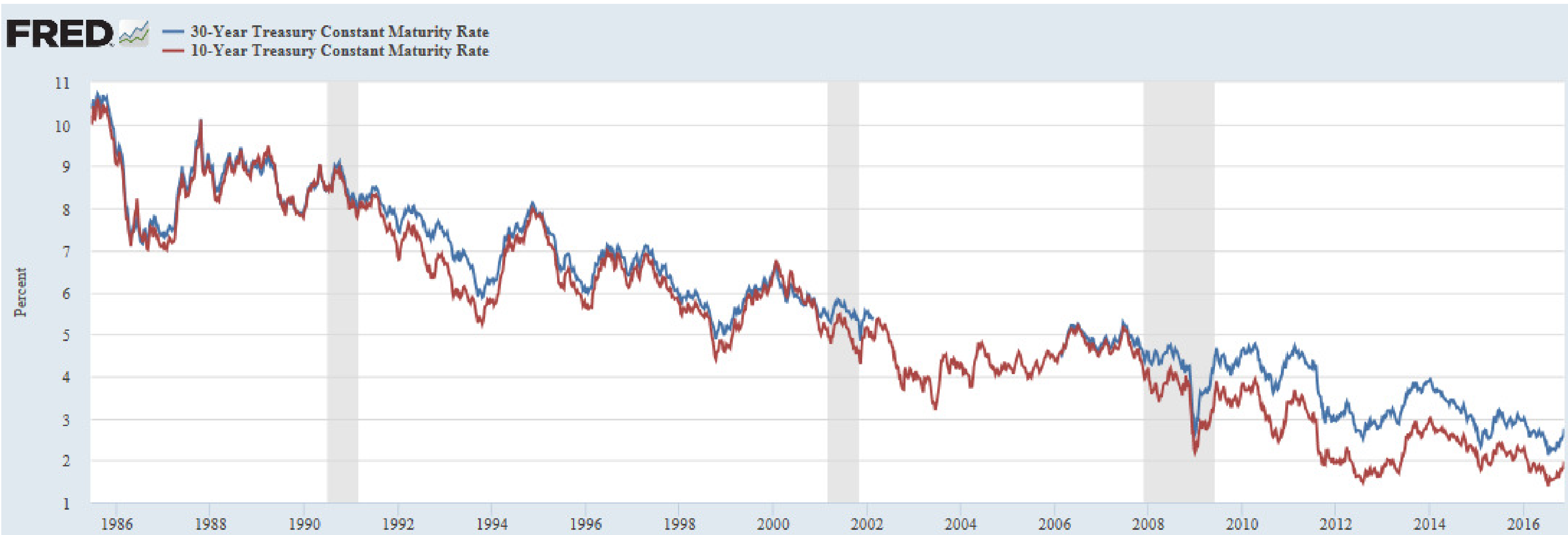
- 10 year – currently 2.43%
- 30 year – currently 3.01%



Interest Rates

10 and 30 year treasuries – since 1986

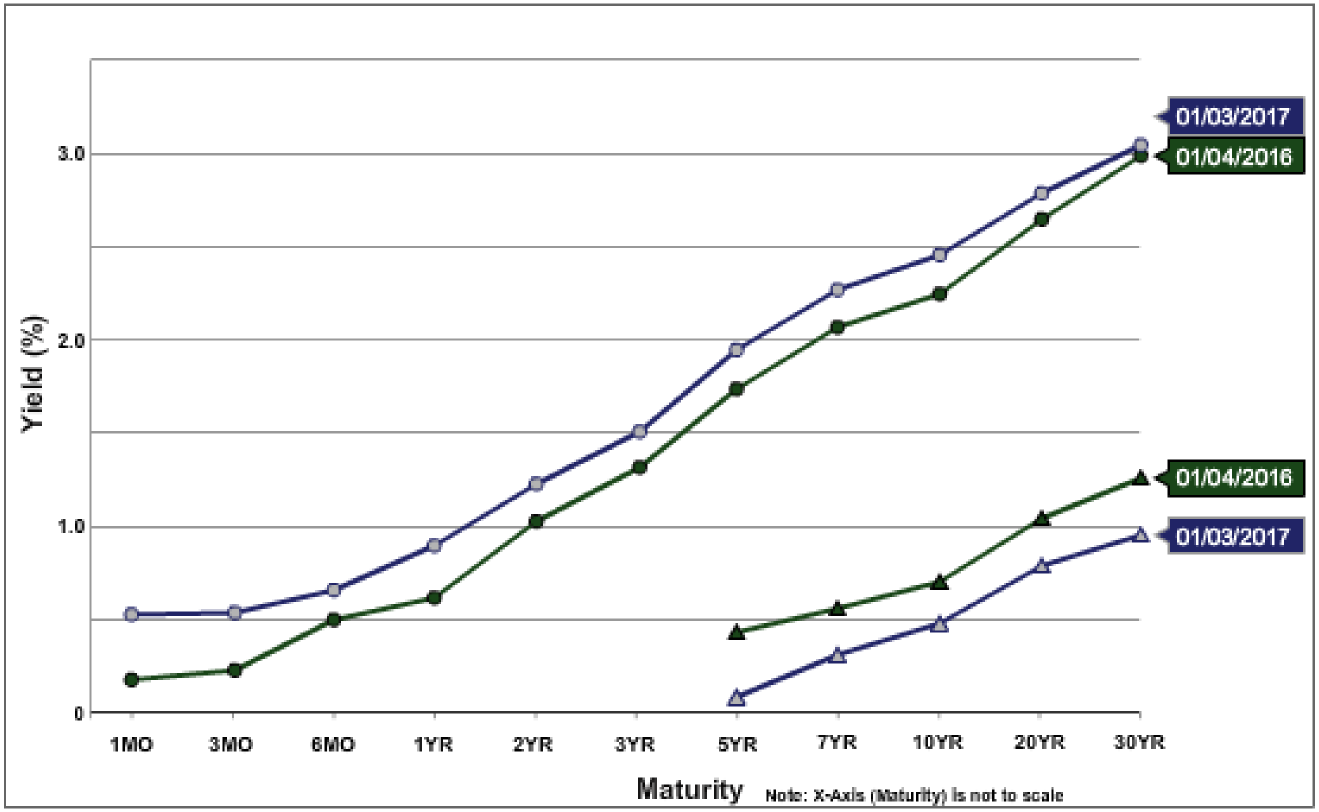
- Historically low rates, but also wider spread
- Limit on "lower for longer" – signals expectation of eventual rate increases



Interest Rates

Treasury Yield Curve

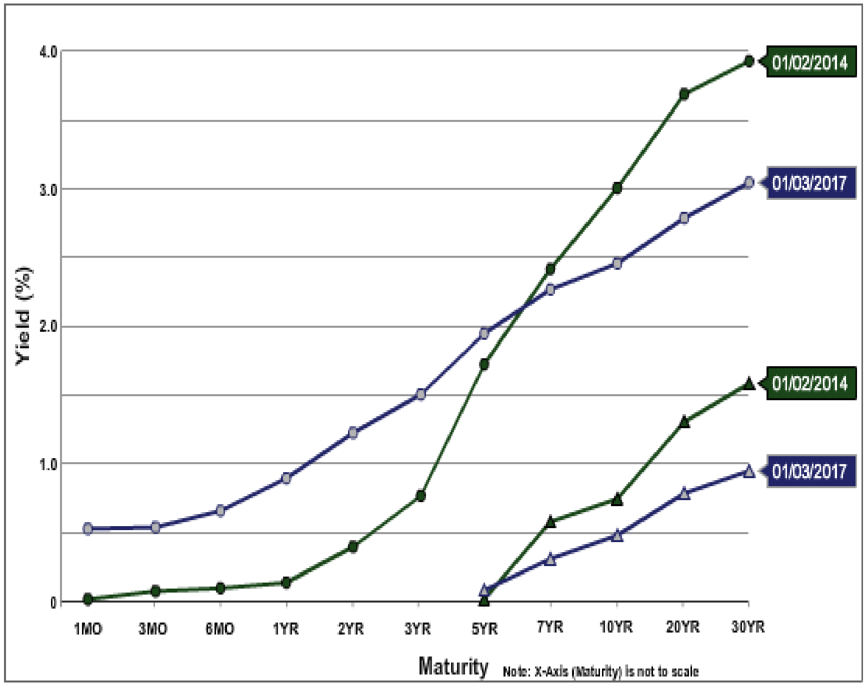
- Slightly flattened, minimal change since January 2016

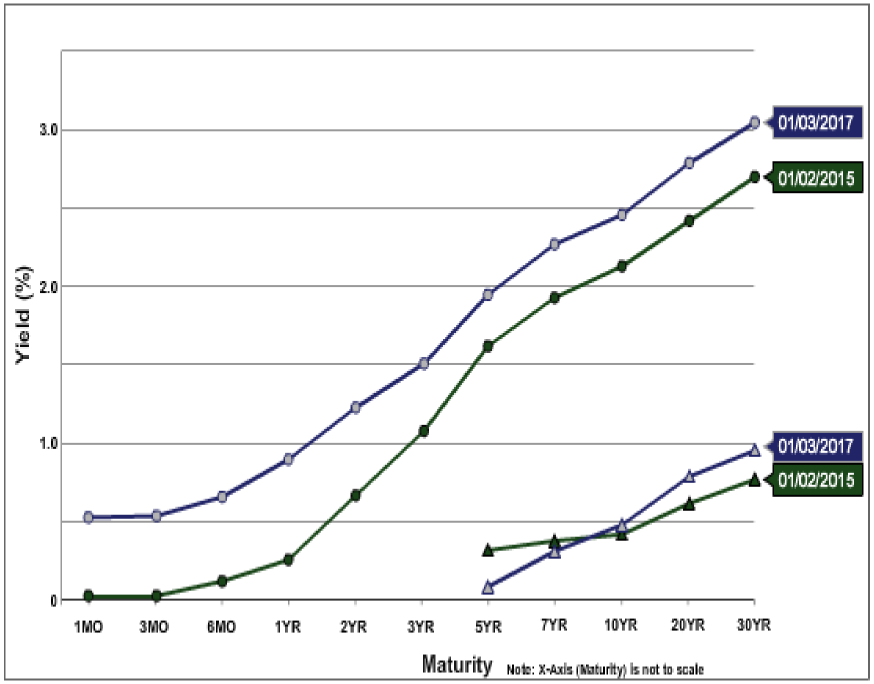


Interest Rates

Treasury Yield Curve

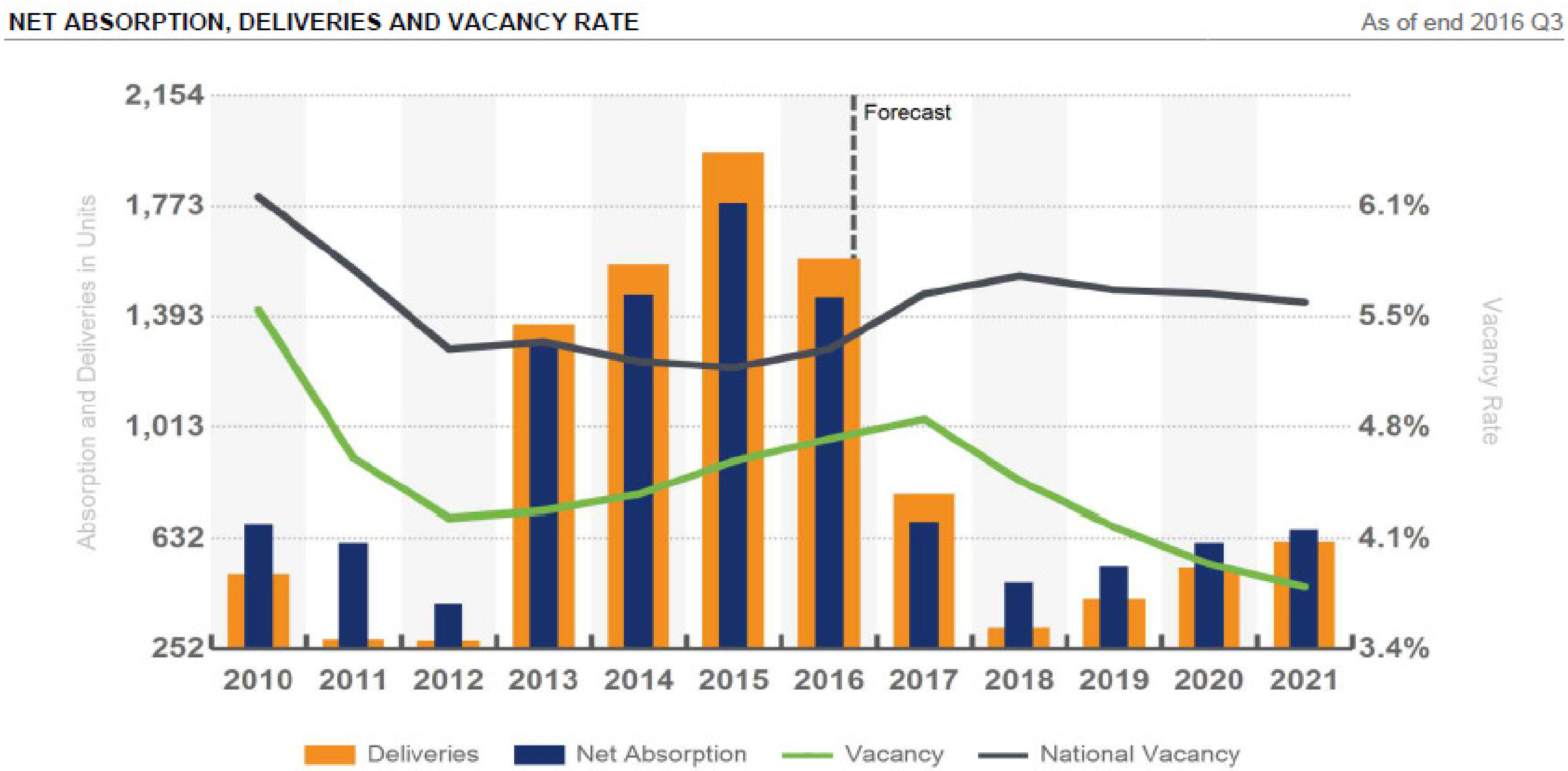
- Yield curve has continued to flatten since short term rates reached low point in 2014
- Short rates rising and long rates dropping





Madison Metro CRE Outlook - Multifamily

- **2016 deliveries down from peak in 2015, reduced pipeline**
- **Vacancy continues to tick up, approaching 5%**
- **Recent boom may be reaching maturity, cap rates remain low**



Madison Metro CRE Outlook - Office

- Absorption outpacing delivery for 3rd consecutive year
- 778,000 sf absorbed as of Q3 YOY
- Vacancy at record-low 5.0%
- Rents increased 1.5% over prior 12 months
- Limited new supply, some spec
- Space efficiency continues, decline in average office and cubical size

Madison Metro CRE Outlook - Retail

- **Performed well despite national headwinds**
  - Macy's and Sears closing stores, discounters making gains
  - Average SF continues to decline, measuring "profit per SF"
  - Competition from online retailers continues – expected to comprise 12.8% of total retail purchases by 2019
- **Absorption outpaced deliveries in 2016**
  - 428,000 sf absorbed
  - 179,000 sf delivered
- **Vacancy declined to 4.5%**
- **3.7% annual rent growth**
- **Nearly 600,000 SF forecasted delivery in 2017**
  - Vacancy expected to tick up slightly, remain below 5.0%

Madison Metro CRE Outlook - Industrial

- **Third consecutive year of outsized demand nationwide**
- **Impact of demand for distribution centers / logistics hubs**
  - E-Commerce: Amazon expecting to hire 100,000 FTE over next 18 months
  - Companies (retail and manufacturing) seeking efficiency; reduced inventory and shorter fulfillment times
  - New supply is constrained in dense urban areas; fastest growing markets are well-located secondary markets
- **Demand for newer, modern properties**
  - Docking equipment, clear heights, quality standards
  - Data centers
  - Tech and manufacturing favoring flex space

Madison Metro CRE Outlook - Industrial

- **1.97 million SF absorbed in 2016**
- **Overall vacancy 3.8%; Dane county vacancy 2.4%**
- **Starting to see some spec development**

Total Industrial Market Statistics

Year-End 2016

Market	Existing Inventory		Vacancy			YTD Net	YTD	Under	Quoted
	# Blds	Total RBA	Direct SF	Total SF	Vac %	Absorption	Deliveries	Const SF	Rates
Columbia County Ind	82	3,504,469	137,255	137,255	3.9%	249,038	0	0	$2.45
Dane County Ind	1,632	53,634,813	1,268,407	1,271,149	2.4%	1,057,687	479,957	718,280	$5.65
Iowa County Ind	30	1,566,222	15,820	15,820	1.0%	(15,820)	0	0	$0.00
Jefferson County Ind	263	12,074,773	362,870	362,870	3.0%	126,356	100,000	0	$3.29
Rock County Ind	298	23,883,443	1,795,197	1,795,197	7.5%	554,478	358,000	1,205,000	$3.69
Totals	2,305	94,663,720	3,579,549	3,582,291	3.8%	1,971,739	937,957	1,923,280	$4.42

Source: CoStar Property®

Commercial Banking

- **Increasing credit standards**
  - Lower leverage
  - More cash in (HVCRE)
  - Recourse
  - Sponsor experience and track record
- **Anticipation of rising rates – shorter maturities**
  - Longer maturities via swap
- **Some banks pulling back on multi-family**
  - Location, location, location
  - More conservative pro forma
- **Still robust competition for strong deals**

2017 Capital Markets Outlook

- Overall, CRE loan originations are projected to increase slightly from 2016 levels
- MBA predicts total commercial mortgage volume to be $537 billion in 2017
- This is a 4% increase from 2016 volume of $515 billion

Origination Volume Changes - 2016 v 2015

• Commercial Banks	+20%
• GSE's (Fannie, Freddie & HUD)	+13%
• Life Companies	+3%
• CMBS	-30%

Cause for Drop in CMBS Issuance in 2016

- Bond market volatility in late 2015 and early 2016
- Uncertainty with spreads/pricing and delivery execution
- Total CMBS issuance was $68 billion vs expectation of $100 billion for 2016

CMBS for 2017

- Even though issuance levels increased in the second half of 2016, expectations for 2017 are in the $70-80 billion range
- Uncertainty around new CMBS "Risk Retention Rules" requiring issuers to retain 5% of each deal issued
  - In what form?
  - Impact on pricing?

Thoughts for 2017

- GSE's --- Fannie Mae, Freddie Mac & HUD --- will continue to provide substantial funding in the multifamily and healthcare sectors
- Life Companies are expected to allocate similar loan volumes to 2016
- CMBS is somewhat of a wildcard due to new risk retention rules and the impact on pricing and execution
- Banks will continue to play a significant role for recourse debt

What's Ahead in 2017?

- **Trade Policy**
  - Immediate priority; Trans-Pacific Partnership, NAFTA, China
  - Possible supply chain disruptions near-term
  - Potential to boost domestic production long-term
- **Infrastructure Spending**
  - Focus on public-private partnerships; projects financed by private investors and repaid via tolls and/or state payments
  - Federal tax credits to companies that finance transportation projects
- **Tax Reform**
  - Lower tax rates for individuals and businesses, fewer deductions
  - Eliminate personal and corporate AMT and NIIT
  - Reduced tax on capital gains, distributions, and interest income
  - Repeal of estate and GST taxes, capital gains tax over $10MM

What's Ahead in 2017?

- **Administrative nominees**
  - Secretary of State – Rex Tillerson, CEO of Exxon Mobil
  - Secretary of Commerce – Wilbur Ross, private investor in distressed companies
  - Treasury Secretary – Steven Mnuchin, Goldman Sachs hedge fund manager
  - Transportation Secretary – Elaine Chao, former Secretary of Labor under George W. Bush
  - Health and Human Services Secretary – Tom Price, Congressman and retired orthopedic surgeon
  - Secretary of HUD – Ben Carson, retired neurosurgeon

Uncertainty: Beyond 2017

- **Technology**
  - Continued automation in manufacturing
  - Demand for skilled labor
  - Driverless cars – 3.5 million currently employed as truck drivers, hundreds of thousands more as bus/taxi/limo drivers
- **Demographic shifts**
  - Continued shift toward urbanization and density
  - Delayed household formation and smaller households
  - Millenials now largest demographic group in US
- **Consumer preferences**
  - Less demand for “things”, more entertainment spending
  - Favoring local and personalized purchasing experiences
  - Increasing diversity and globalization are informing preferences

Conclusions

- Economic indicators suggest current cycle is maturing, rates likely to rise in the near and mid-term
- Slow-down in multi-family market but still opportunity in retail, office, and industrial
- Banks continue to compete for recourse debt but with more cautious outlook, HUD and Life Companies outpacing CMBS in long-term markets
- Election results indicate more populist policy going forward, many investors taking a “wait and see” approach
- Many of the most impactful uncertainties are not linked to politics, but rather to changing technologies, demographic patterns, and consumer preferences