Property Type Outlook

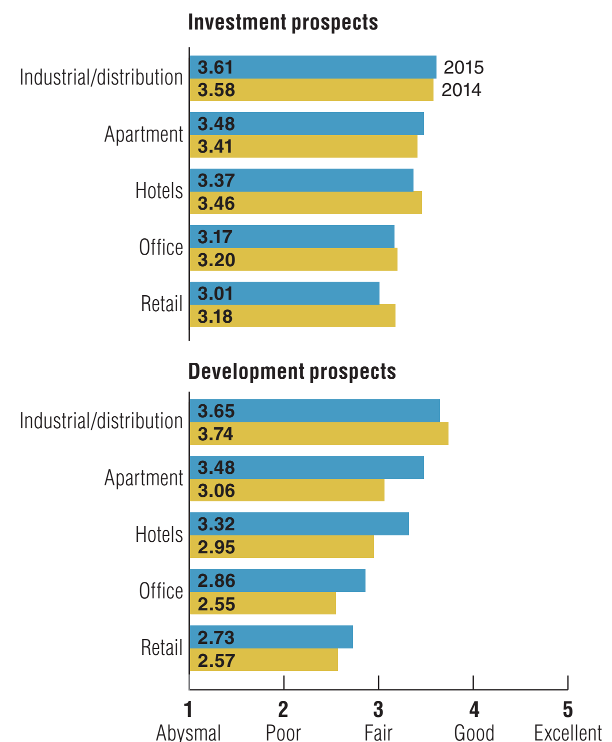
"The collaborative aspect of open space is overdone. I don't think people need to talk to their coworkers all day long."

In the course of a 162-game season, major league baseball teams know that even the best clubs are going to wind up losing five dozen games or more. The late baseball commissioner A. Bartlett Giamatti said of the sport, "Baseball is designed to break your heart." Indeed, is there any other pastime where failure is so expected that errors are posted in every day's box score? Where an offensive player is counted as superior if he makes out merely seven times out every ten attempts? Where a pitcher is credited with a "quality start" if he allows just three runs and completes six out of the game's nine innings?

Because of this expectation of disappointment, positive streaks stand out. Statisticians, in their cold, analytical way, say that streaks are mathematically normal. But every batter in an inning's rally and every pitcher handed the ball the day after a win has one phrase in mind: "Keep the line moving." Winning is thought to be contagious, and it is one syndrome that everyone wants to experience.

Real estate's current winning streak started with the multifamily sector, and we have been watching the other property types queue up in their turn. In 2014, *Emerging Trends* sounded the theme "Gaining Momentum." This year, we see the industry's momentum broadening to encompass many more individual markets, and most property types. Momentum—mass times velocity, in the classical formula of physics—can be viewed by measures of size and measures of speed. Let's look at the trends emergent in each property type and get a sense of real estate as it accelerates into 2015.

Exhibit 4-1 **Prospects for Major Commercial Property Types, 2015 vs. 2014**

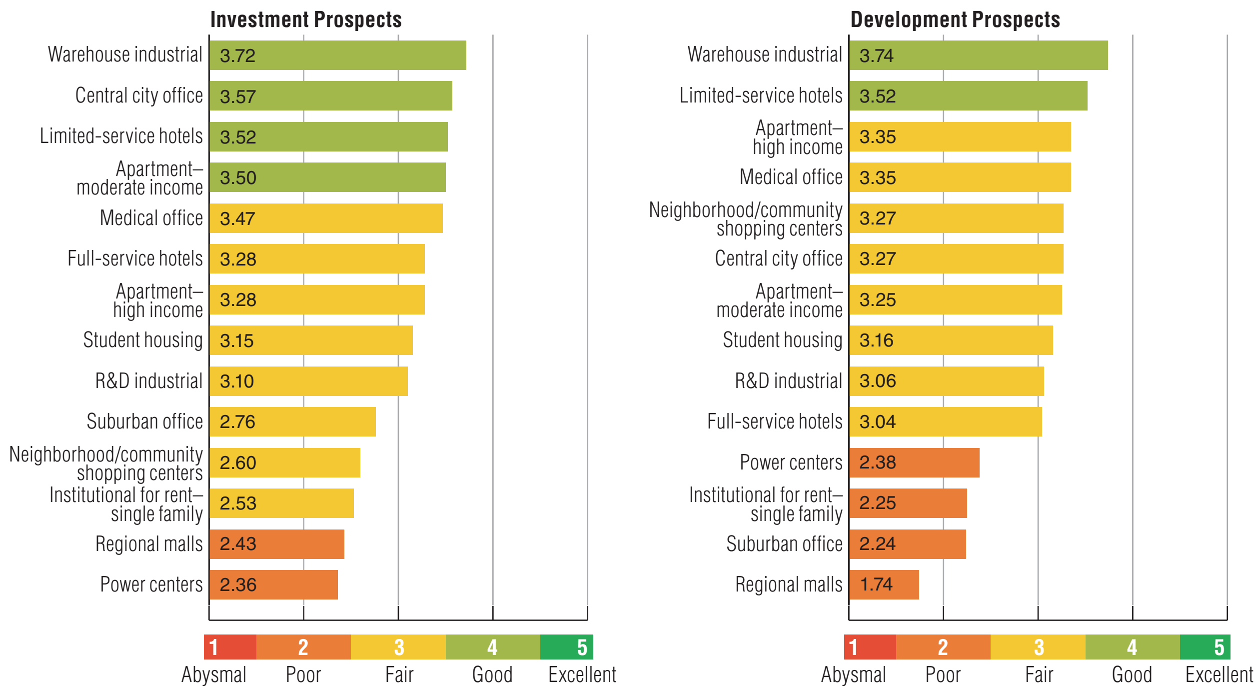


Source: *Emerging Trends in Real Estate* surveys.
Note: Based on U.S. respondents only.

Industrial

One of the basic principles of market analysis is that of equilibrium. Like so many things in life, the business of real estate is a balancing act. The principle of equilibrium says that market operations will lead toward the price point where supply and demand match up. This fundamental rule supports everything from the theory of cycles to the concept of "reversion to the mean." It lurks in the background of every discussion of excess

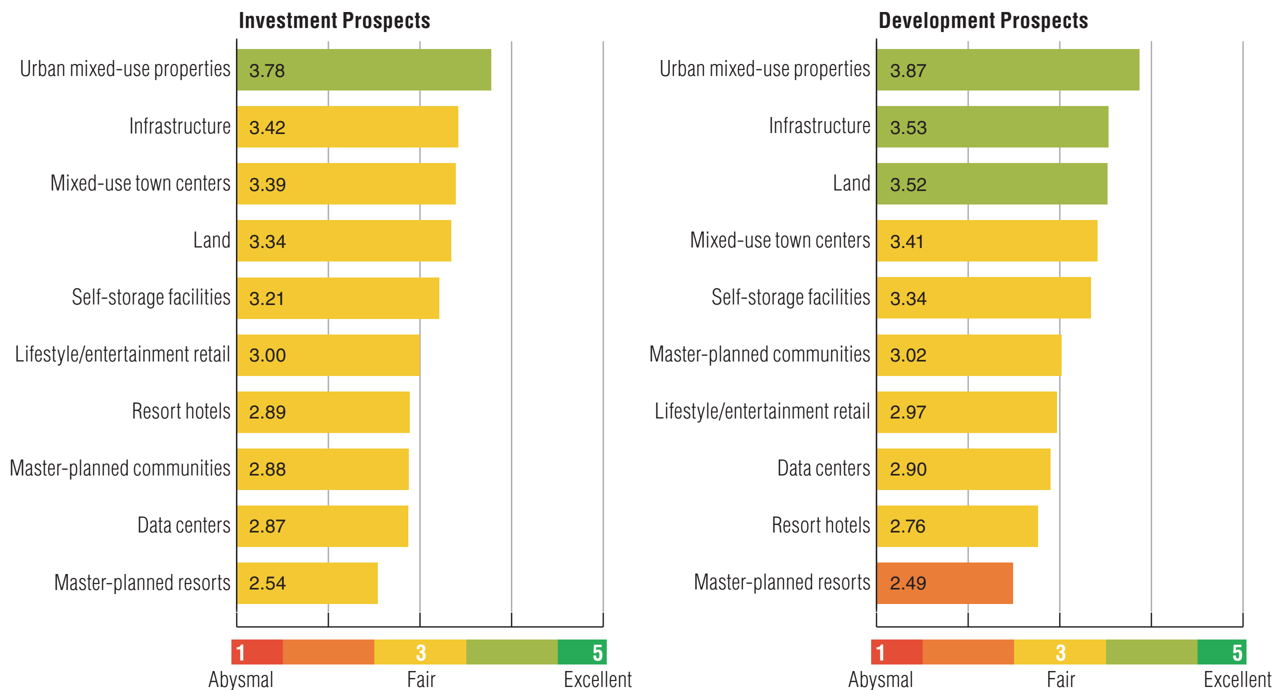
Exhibit 4-2 **Prospects for Commercial/Multifamily Subsectors in 2015**



Source: *Emerging Trends in Real Estate 2015* survey.

Note: Based on U.S. respondents only.

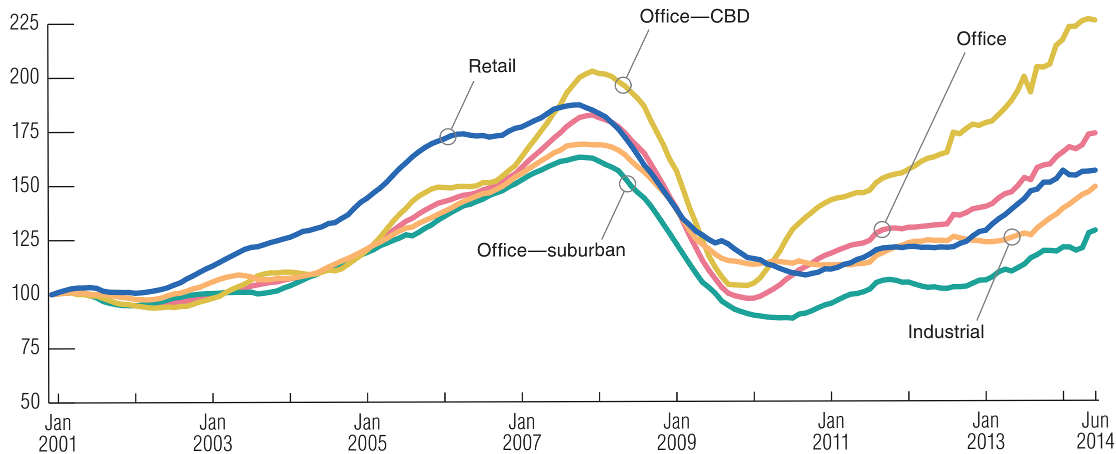
Exhibit 4-3 **Prospects for Niche and Multiuse Property Types, 2015**



Source: *Emerging Trends in Real Estate 2015* survey.

Note: Based on U.S. respondents only.

Exhibit 4-4 **Moody's/RCA Commercial Property Price Index, by Sector**



Sources: Moody's and Real Capital Analytics.

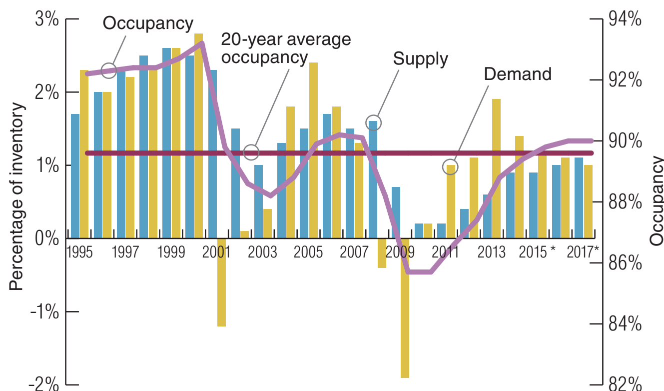
Note: Updated August 2014; data through June 2014.

or deficiency. It is also—critically so—what keeps real estate dynamic, the source of risk as well as opportunity.

So far, that's Econ 101. What makes real estate so especially interesting, for good or ill, is that it is "asynchronous." It takes time for supply to adjust to demand, so the market can stay out of balance for considerable periods of time. Sometimes real estate strays far from equilibrium, leaving real estate practitioners to cope with extreme dislocations for quite some time. That is where real money can be made or lost.

For the industrial property type, that balancing act could be getting very tricky very soon. As the graph illustrating historical and projected supply/demand fundamentals shows, since 2010 this

Exhibit 4-5 **U.S. Industrial: Change in Supply and Demand**



Source: CBRE Econometric Advisors.

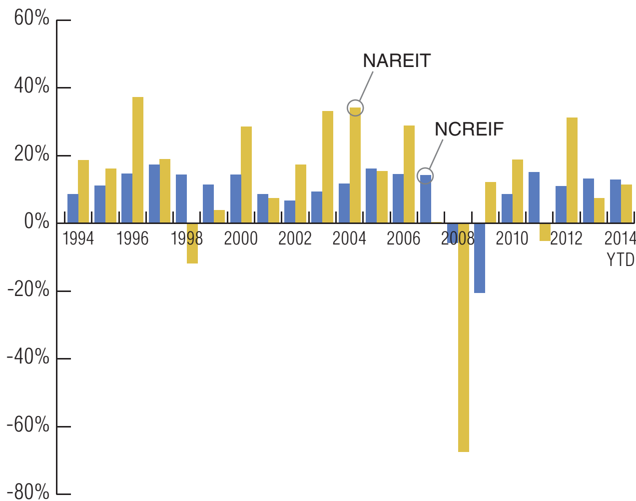
*Forecasts.

vast (more than 12 billion square feet of space) sector has enjoyed a rising demand trend and supply additions that have not kept pace. Come 2015, however, industrials are entering a period when projected construction is accelerating, but demand is anticipated to decelerate. What's the right price to pay under those circumstances? What do you do when two most relevant trends diverge?

Last year, our interviewees and survey respondents really liked industrials. For many, that has not changed. A public sector pension fund executive still has this sector as a top choice, seeing 2015 as a period of active buying, developing, and rehabbing of space. A New England–based investment manager who focuses solely on office and industrial properties is bullish on the warehousing sector this year, projecting that it "could be the most sought-after property type in commercial real estate, doing very well and continuing to do so even with some new supply." Midwest and secondary markets such as Nashville, St. Louis, Charlotte, and Louisville provide cap-rate premiums in his view, while "you can build industrial in these markets and get good returns."

Views like these account for the industrial sector standing atop the sector rankings for investment, with a robust score of 3.61 in this year's *Emerging Trends* survey (exhibit 4-1). Moreover, in the more granular subsector evaluation, warehouses posted an even higher rating of 3.72 for investment and 3.74 for development (exhibit 4-2). In each case, these results were well ahead of the second-place choices.

Exhibit 4-6 **U.S. Industrial Property Total Returns**

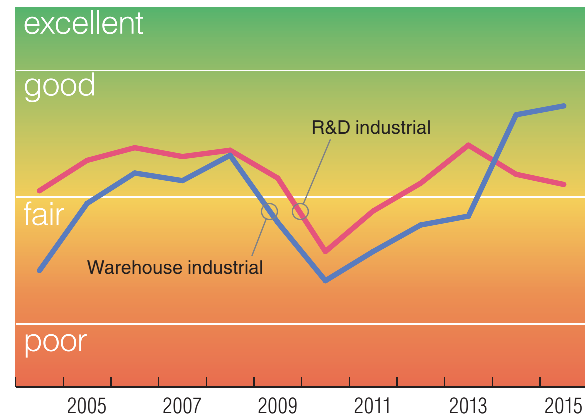


Sources: NCREIF Fund Index Open-End Diversified Core (ODCE) NAREIT Equity REIT Index.
*Returns as of June 30, 2014.

A renowned valuation/consultant figure reinforces this viewpoint. "Logistic space demand [is] growing steadily. Warehouse cap rates are 'dropping like a rock.' Investors like the stable cash flow, and retailers need the goods." Given international trade volumes, he likes industrial properties near ports. Many others like the evolving relationship between industrial and retail. "Industrial is cannibalizing retail sales as internet commerce grows. How does the same-day-delivery effort impact megasized distribution facilities? Will we see the return of smaller break-bulk facilities versus the major distributor air-hub strategy? And what about 'reverse logistics' as vendors promise consumers 'free return' of unwanted purchases?" Simplistic Econ 101 supply/demand graphs are not going to provide useful answers to such complex questions.

Some trends highlighted in *Emerging Trends 2014* remain solidly in place. The return of manufacturing activity to the United States with the associated evolution of our economic relationship with China prompted affirmation among this year's interviewees. This trend is positive for several regions. A prominent investment strategist sees a revival in the Midwest, and a top broker has a similar observation about the Carolinas and Tennessee stimulating a whole roster of suppliers. Industrial real estate markets are in robust shape. A real estate investment trust (REIT) executive sees the return of manufacturing helping not just the United States but also Mexico, which was undercut by lower costs available in the Asian labor markets. Though some still consider "onshoring" to be only anecdotal at this point, others think some very basic factors point to its sustainability as a trend:

Exhibit 4-7 **Industrial/Distribution Investment Prospect Trends**



Source: *Emerging Trends in Real Estate* surveys.

U.S. warehouse industrial

2015	Prospects	Rating	Ranking
Investment prospects	3.72	Good	1
Development prospects	3.74	Good	1

Buy	Hold	Sell
57.6%	29.9%	12.5%

Expected capitalization rate, December 2015: 6.2%

U.S. R&D industrial

2015	Prospects	Rating	Ranking
Investment prospects	3.10	Fair	9
Development prospects	3.06	Fair	9

Buy	Hold	Sell
26.0%	48.0%	26.0%

Expected capitalization rate, December 2015: 7.0%

Source: *Emerging Trends in Real Estate 2015* survey.
Note: Based on U.S. respondents only.

- The decline of labor as a percentage of product cost;
- Rising shipping expenses;
- Lower energy costs in the United States bolstering our advantage; and
- Intellectual property security—or lack thereof—in the Asian nations.

Those rising shipping expenses ripple through the distribution sector, where logistics firms seek "better, faster, cheaper" paths from producer to consumer. This has tempered the optimism

about the overwhelmingly positive effects of the deeper and wider Panama Canal—and the Panamax container vessels plying it. East Coast ports now face some sobering numbers. The logistics chain has many, many interlocking parts—among them, the multibillion-dollar expansion and modernization of the canal cost big. Shippers will have to face higher tolls, with the levy for the largest ships roughly tripling from a reported $375,000 to $1 million. Not all the upland improvements on the East Coast will be ready in 2015 and 2016, reducing efficiency and adding to cost. It's going to take some ports a while to realize the anticipated shipping benefits. Taking into account the existing infrastructure on the West Coast, one observer noted, "You can see why Warren Buffet bought a railroad."

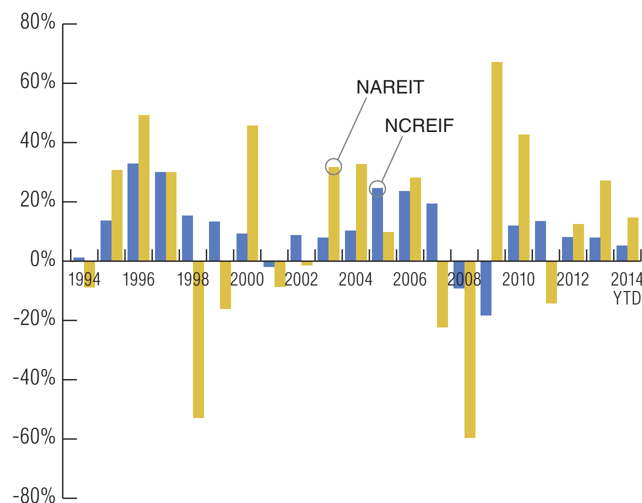
The industrial sector is far from boring. It is still rated a solid "buy" among *Emerging Trends* survey respondents, and has been sustaining double-digit returns to investors in both the National Council of Real Estate Investment Fiduciaries (NCREIF) and National Association of Real Estate Investment Trusts (NAREIT) indexes. On balance it all looks very good—for now.

Hotels

The prospects for liquidity in the hospitality sector shape up as excellent for 2015. Our survey respondents would be quite happy to hold hotel assets, and there is good balance on the buy/sell recommendations for full-service hotels. Limited-service hotels have upside in pricing, if the spread of 31.6 percent of "buy" advocates over 23.9 percent "sell" proponents is a proxy for bid/ask pressure. Remarkably, and in distinct comparison with most other property types, the survey shows no expectation of any alteration in cap rates for hotels—not even a basis point. How often does that happen? The expected cap rates for December 2015 are anticipated to stand at 7.1 percent for limited-service hotels and 6.6 percent for full-service lodging facilities.

Hotels have been in high favor, and have seen exceptional demand. Transaction volume tracked by Real Capital Analytics was up 24.1 percent through July 2014, compared with the same year-to-date figure for 2013. A few major transactions pushed the full-service sector up 28.8 percent while the limited-service segment was up 14.3 percent in total dollar volume. In all, $18.4 billion in hotel deals was concluded over the first seven months of 2014. This is a volatile sector, though, and closely correlated with gross domestic product (GDP). While the economic consensus is favorable for the next couple of years, this is a difficult sector to time—especially in an era when geopolitical events can stifle travel with just a few headlines.

Exhibit 4-8 **U.S. Hotel/Lodging Property Total Returns**



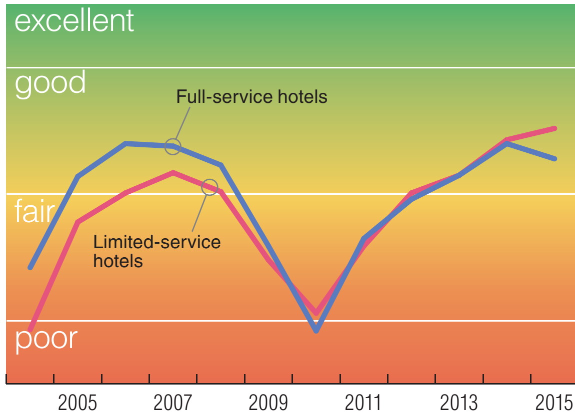
Sources: NCREIF Fund Index Open-End Diversified Core (ODCE); NAREIT Equity REIT Index.
*Returns as of June 30, 2014.

An executive of a private REIT with exposure to the sector says, "From a lodging perspective, I see a 2 percent new supply in hotel space, which keeps us focused. There is no surprise that hotel numbers are growing in the cities, but it is concerning to see them ramping up in the suburbs right now." Nevertheless, he says, "Hotels will surprise on the upside at the end of 2014, and the same solid growth will continue into 2015."

Boutique hotels are sprouting up like wildflowers. For decades, the integrated reservation systems of the national chains made a "flag" a necessity for success in the hotel business. The internet changed that, as individuals became their own travel agents and could comparison-shop online. The standardization of the chains is a comforting factor for those who seek a "known commodity" in lodging (not to mention points in the affinity programs). But increasingly sophisticated travelers are seeking a more customized experience, a hotel that is "different" in layout, amenities, and theme.

The rise of online personal rentals aims right at the customer base seeking a nonstandard experience, with the significant twist of do-it-yourself (DIY) style travel. Low cost, obviously, lies at the heart of the market penetration question—and the potentially vast expansion of supply is an as-yet-unquantified threat to pricing in conventional facilities. One offsetting positive impact could be that lodging-sharing customers at the most inexpensive levels could be a net expansion of overall hospitality demand—travelers who were not likely to go on the road except for the "cheap and hip" crowdsourced option. The personal

Exhibit 4-9 **Hotel Investment Prospect Trends**



Source: *Emerging Trends in Real Estate* surveys.

U.S. limited-service hotels

2015	Prospects	Rating	Ranking
Investment prospects	3.52	Good	3
Development prospects	3.52	Good	2

Buy	Hold	Sell
31.6%	44.4%	23.9%

Expected capitalization rate, December 2015 7.1%

U.S. full-service hotels

2015	Prospects	Rating	Ranking
Investment prospects	3.28	Fair	6
Development prospects	3.04	Fair	10

Buy	Hold	Sell
30.3%	38.7%	31.1%

Expected capitalization rate, December 2015 6.6%

Source: *Emerging Trends in Real Estate 2015* survey.
Note: Based on U.S. respondents only.

rental industry estimates that 11 million people worldwide use its network. There's a lot of "buzz" associated with this short-term rental market in its exciting startup phase. But most products have a shake-out period when glitch meets buzz. That shakeout hasn't happened yet. Keep an eye on this niche product, but don't let it distract you from the economic basics that are the foundation of the traditional hospitality industry.

One developer/operator in the hotel field says, "At this point, it is cheaper to build than to buy." But costs are rising, especially in markets with strong economies based on energy or technology. Sites are expensive, permitting is slow, and skilled labor is in short supply. This Texas-based developer was particularly sensitive to the deleterious consequences of cutting down on immigration, seeing this as constricting the flow of blue-collar workers—not just unskilled laborers, but also those with skills in plumbing, electrical work, and vertical construction.

That developer cited ample financing capacity for new projects, and enviable returns. Leveraged purchases of existing product can return internal rates of return (IRRs) in the upper teens, and new construction in the 20 percent–plus range. Loan-to-cost at 60 to 65 percent means substantial equity in the deal, and that is not bothersome to him. The money is there, and lower leverage means lower risk—always important in a cyclical business.

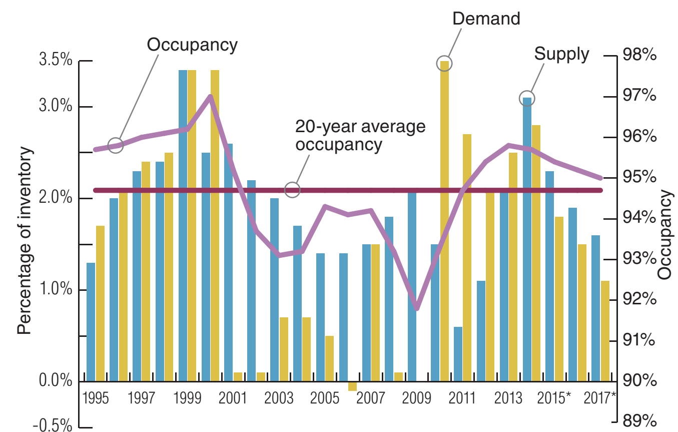
This year's *Emerging Trends* survey shows hotels rated strongly in participants' 2015 prospects for investment and development, especially in the limited-service category. For hotels, apparently, the welcome mat is out.

Apartments

Multifamily was unquestionably real estate's trendsetter in the first years of recovery. Now that apartments have reached a more mature phase of their cycle, we get to a more interesting period. More interesting, in the first place, because the investment/development questions become more complex and nuanced. And more interesting because it is probable that issues and strategies that will be tested in 2015 in the multifamily sector will help shape the template for 2016–2018 in other property types. Keep your eye on apartments this year.

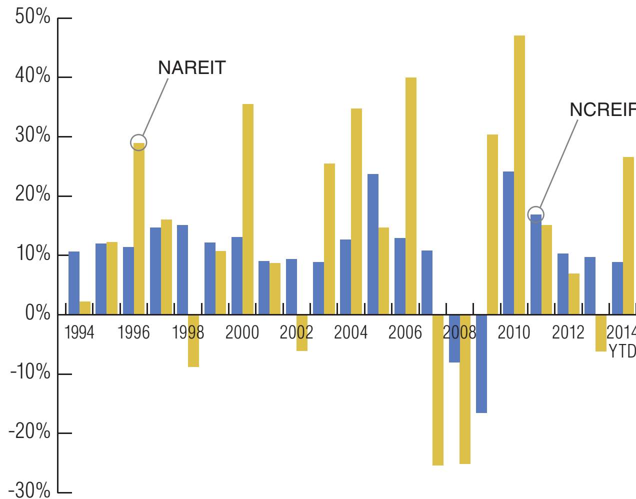
If you go by just the numbers, the opinions of the *Emerging Trends* survey respondents seem sharply divided. For high-end

Exhibit 4-10 **U.S. Multifamily: Change in Supply and Demand**



Source: REIS Inc.
*Forecasts.

Exhibit 4-11 **U.S. Apartment Property Total Returns**



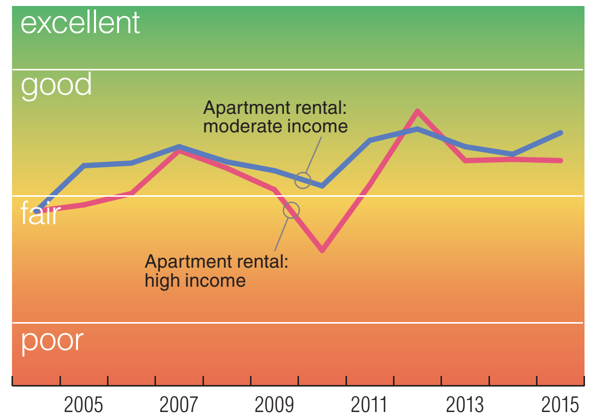
Sources: NCREIF Fund Index Open-End Diversified Core (ODCE); NAREIT Equity REIT Index.
*Returns as of June 30, 2014.

multifamily, nearly half of the respondents (48 percent) felt it would be smart to divest in 2015, while 30 percent consider it worthwhile to hold for a longer period. Only 21 percent suggest this is a good time to buy. At the more moderate income level, that relationship was reversed. Only 28 percent recommend selling while holding and acquisition are more attractive, with 37 percent and 35 percent recommending these strategies, respectively, in the year ahead.

What gives? The survey subtly distinguishes between the moderate- and upper-income tiers' investment and development prospects. For investment, more moderately priced apartments have the edge, with a 3.50 rating versus the higher-income properties at 3.28. Despite this, the upper-income units have such an attractive price-to-cost spread that they have the edge in development prospects, 3.35 to 3.25.

Survey respondents expect upward cap-rate adjustment, though most of the shift will not happen in 2015 but in the 2016–2018 period. The sense of urgency to sell just isn't at hand right now. Although 48 percent think it's a good time to sell luxury, the coming year is not anticipated to see major change. Time to book profits remains. Impacts are forecast to be "at the margin." The luxury end has had cap rates driven down the most, and should expect greater cap-rate expansion—90 basis points—by 2018, while more middle-income properties face a rise of 70 basis points. The investment pricing differential, in other words, is expected to narrow as we go into the future. That's a trend to watch.

Exhibit 4-12 **Apartment Investment Prospect Trends**



Source: *Emerging Trends in Real Estate* surveys.

U.S. high-income apartments

2015	Prospects	Rating	Ranking
Investment prospects	3.28	Fair	7
Development prospects	3.35	Fair	3

Buy	Hold	Sell
21.4%	30.4%	48.2%

Expected capitalization rate, December 2015 5.2%

U.S. moderate-income apartments

2015	Prospects	Rating	Ranking
Investment prospects	3.50	Good	4
Development prospects	3.25	Fair	7

Buy	Hold	Sell
35.2%	37.1%	27.7%

Expected capitalization rate, December 2015 6.0%

Source: *Emerging Trends in Real Estate 2015* survey.
Note: Based on U.S. respondents only.

What might account for this? Developers' preferences for upper-end apartments notwithstanding, the depth of demand for luxury rental units goes only so far. Wealthy households prefer to own their homes—and most already do. The bulk of pent-up and emerging demand comes from the battered middle-income and lower-middle-income sector, predominantly renters. As the forecasted gains in employment take hold, millennial sharers, "boomerang children," domestic migrants, and international immigrants represent the bulk of new residential renter demand. Developers may actually be able to "make up in volume what they can't achieve in price."

The overarching context is that next year and beyond, the demand fundamentals for moderate apartments continue to

look very good. Many interviewees expect the millennials to move into homeownership in some significant numbers, but that won't happen until 2020 or later.

One economic forecaster sees terrific opportunities to buy value-add multifamily and suggests as a "best bet" purchasing "B" buildings in "A" markets. The thinking is that such properties can be repositioned and that the overheated luxury market exerts upward pressure on even more modest rentals. Should the acceleration in the job market begin to push incomes up for the middle class—a hope or a reasonable guess, but not a certainty—there could be a nice bump in rents for those Class B apartment buildings.

Yes, supply is still on the rise. But that, too, is tiered, and a disproportionate share of new construction is at the high end. This makes sense when urban high-rise property in the gateway markets is priced at 20 to 30 percent more than the cost to construct. Of course, this spurs the developers on! Interestingly, though, the urban housing surge is now extending into the Nashvilles, Greenvilles, and Raleighs—cities where even until recently the central business district (CBD) emptied out in the evening as commuters returned to the suburbs in their cars. Now, while the cities themselves are still labeled "car dependent" by Walkscore.com, their downtowns have good to excellent walkability scores—and builders have caught on. One hallmark of these Southeast markets is their cost-competitiveness in comparison with the large coastal cities. Locally low cost of living, in turn, argues for moderate-rent apartments as the better investment opportunity.

Some earlier favorites are already victims of their own success. A local investment manager looks at Boston's lively apartment development scene and says, "Whoa! Too much!" And a veteran institutional investor looks at Washington, D.C., multifamily and sees one of the nation's biggest real estate risks for 2015. Sure enough, the *Emerging Trends* survey has Boston down in 20th place for multifamily investment prospects and 21st for development, and D.C. ranks 30th in investment prospects and 32nd for development. Several interviewees singled out Boston and Washington as multifamily markets that have "gotten ahead of themselves."

Interestingly, though, survey respondents still felt that both Boston and Washington represented "buy" opportunities, by 49 percent and 41 percent of the respondents, respectively—which must mean they are looking beyond 2015 to longer-term market strength. Otherwise, it is many of the "usual suspects" that are in the top 20 rankings, as well as many newcomers such as Nashville, Austin, San Jose, Orange County, Portland, and Brooklyn (see Markets to Watch). Brooklyn, New York, ranked number one, has long been in the shadows of Manhattan's skyscrapers. It has become the "hip" borough in recent years as the young "creative class" element has been priced out of many Manhattan neighborhoods.

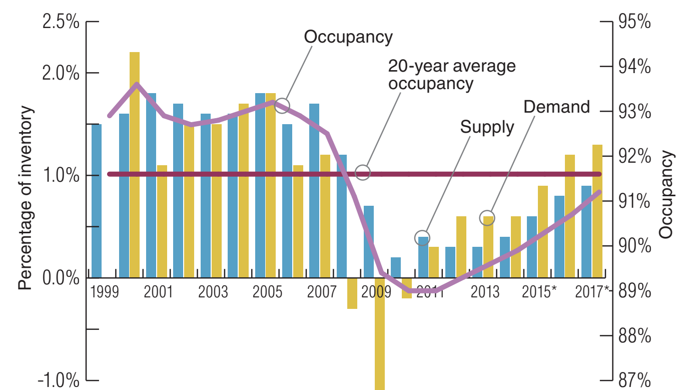
As a screening device, one investor looks for markets with science, technology, engineering, and math (STEM) strength—which usually means a big research university drawing young tech and engineering talent in need of apartments, with salaries that are attractive to the owners of rental complexes. The real strength in multifamily, though, is that it is not dependent upon just one demand segment. As local economies grow and the number of jobs rises, rental housing is required. This is not rocket science.

Unless you are a contrarian, though, don't expect a rapid upward turnaround for suburban garden apartments. Once a classic vehicle for developers and investors riding the wave out of the center city, these are now out of favor with millennial renters and portfolio managers alike. Still, transaction data show that there's a steady parade of buyers for garden apartment product, which has about a 150-basis-point-higher cap rate than mid- and high-rise multifamily. As potent as the urbanization trend is, there is still a huge base of suburban units out there—and they are a lot cheaper.

Retail

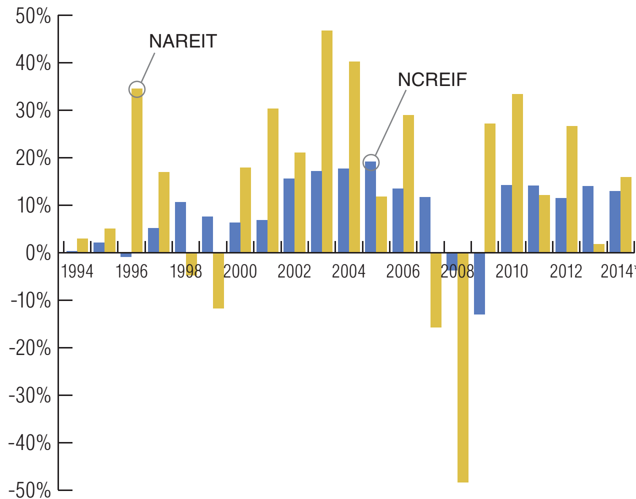
Investment and development strength in the retail sector ranks the lowest of all the major property types in the 2015 *Emerging Trends* survey. Just as the slow recovery in jobs has hindered

Exhibit 4-13 **U.S. Retail: Change in Supply and Demand**



Source: REIS.
*Forecasts.

Exhibit 4-14 **U.S. Retail Property Total Returns**

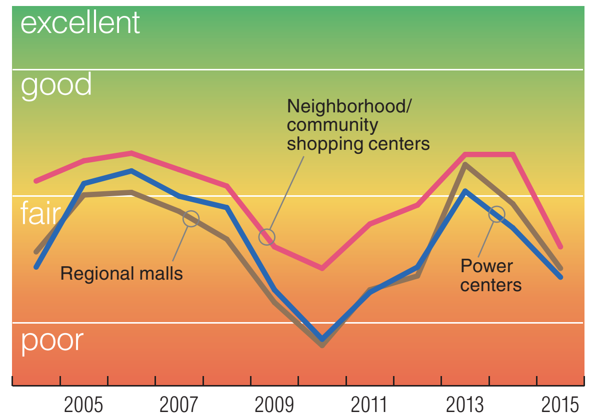


Sources: NCREIF Fund Index Open-End Diversified Core (ODCE); NAREIT Equity REIT Index.
*Returns as of June 30, 2014.

many other economic growth indicators, so too has the jobs recovery made real estate professionals wary of calling a bounce back in retail. Optimism has seemed premature—or even unrealistic. It is time to question that. The trend for retail for the second half of this decade should be a story of expectations exceeded—expectations that continue to be set too low by those wounded in the last battle.

Many fall into that camp, including a substantial cadre of *Emerging Trends* interviewees. Even in the surging Southeast markets, things still seem very slow to some top brokers. You can hear the caution in one such voice: "The suburban retail overhang has mostly been absorbed, but prices are low. There is some opportunity in 'shadow-anchored' space, such as pads close to big boxes. Successful deals are purely driven by national anchors. But, on balance, it is still slow." An investment manager observes, "Retail is a worrisome sector. Consumer preferences are so volatile that obsolescence comes ever more quickly." A top executive recruiter with an overview of the industry is concerned about the context of our economic structure: "In the U.S., there is this increasing story of haves and have-nots. Office and retail are both impacted by this divide." An institutional investor reveals that his portfolio allocation to retail has dropped to just 5 percent—one dollar out of every 20 available for acquisition. The chief investment officer of a public pension fund concurs, "Retail is our least favored property sector."

Exhibit 4-15 **Retail Investment Prospect Trends**



Source: *Emerging Trends in Real Estate* surveys.

U.S. neighborhood/community centers

2015	Prospects	Rating	Ranking
Investment prospects	2.60	Fair	11
Development prospects	3.27	Fair	5

Buy 47.3% | **Hold** 35.4% | **Sell** 17.3%

Expected capitalization rate, December 2015 6.6%

U.S. power centers

2015	Prospects	Rating	Ranking
Investment prospects	2.36	Poor	14
Development prospects	2.38	Poor	11

Buy 14.6% | **Hold** 39.5% | **Sell** 45.9%

Expected capitalization rate, December 2015 6.7%

U.S. regional malls

2015	Prospects	Rating	Ranking
Investment prospects	2.43	Poor	13
Development prospects	1.74	Poor	14

Buy 9.1% | **Hold** 38.3% | **Sell** 52.6%

Expected capitalization rate, December 2015 6.5%

Source: *Emerging Trends in Real Estate 2015* survey.
Note: Based on U.S. respondents only.

Such trepidations may be entirely understandable. But they may also be out of step with changes in fundamentals and

with sentiment shifts that are likely to alter the direction of retail property trends.

Like every other property type, retail has its cyclical ups and downs. But one REIT CEO urges keeping an eye on the big picture. “America averages an increase of 3 million–plus in population annually. We’ll be up by 100 million come 2050. What does this mean for retail real estate? More groceries, more drugstores, more outlets for goods of all kinds.” An investment manager thinks that as job growth becomes more self-sustaining in 2015, retail will benefit from pent-up demand, saying, “There’s a lot of ‘alpha’ in shopping centers.” An East Coast pension fund executive is convinced that retail is “in recovery,” and is placing money alongside retail specialists in properties it considers undercapitalized but poised for a turnaround.

An officer with an international investment fund sees the retail sector in transition. “The retail property sector may be poised to outperform in 2015. Its business model is adjusting to multichannel retailing. Obsolete retail is transitioning to other uses. The consumer looks poised to be in better shape in 2015.” Then he makes a most intriguing comment—one that suggests that the template of multifamily and office investment distribution will appear in the retail sector soon. “Interest will remain in gateway markets, but the increase in capital will likely begin to move to more secondary markets.” As the ball players say, “Keep the line moving.”

As the shift in trend takes hold, attention to detail is critical.

Urban/high street. Anyone who hasn’t focused on how radically downtown retailing has changed has missed one of the great stories of the early 21st century. Remember when everyone lamented the “hollowing out” of the downtowns, and the nostalgia for the iconic department stores that anchored Main Street? Main Street has come back big time. If the millennial wave has the influence that is expected over the next ten to 15 years, the high street revival trend is just gathering force. This trend is not to be missed, especially as those smaller cities willing to promote downtown residential density join the parade. A Mid-Atlantic investment manager calls urban retailing one of the winners, a top prospect for 2015. A colleague calls this sector one where e-commerce is a boost rather than a drain. Some see the nation’s top retail streets as being as much display or advertising as they are distribution points. Others aren’t so sure, pointing to the large number of international tourists carrying goods home. And the notion that “high street” is all about luxury goods needs to be revisited, says a prominent retail broker. “Just walk down Fifth Avenue or North Michigan Avenue and actually take a look at the tenants—then tell me that the middle market isn’t being served!”

Neighborhood/community centers. In contrast to regional malls and power centers, neighborhood and community centers are rated a “buy” by a 47.3 percent plurality of this year’s *Emerging Trends* survey respondents. And they feel that such centers have relatively less exposure to cap-rate expansion than other retail property, and indeed most other commercial property types. That’s a very favorable outlook for the future. Although these smaller shopping centers rate only 2.60 as an investment prospect according to our survey respondents, development prospects are a stronger 3.27—the same as CBD office. That reflects survey respondents’ confidence in future growth in spending power.

Flexibility in use is seen as a key to the future. Brick-and-mortar retailing is increasingly about service, convenience, “experience,” tangibility, and linked demand. So medical services combine with drugstores, healthy-product retailers, and even athletic-oriented stores in a new tenant array. A public pension fund is seeking undercapitalized retail assets, provided they believe in the local market. “We like grocery-anchored, pharmacy-anchored [preferably both] centers,” says that institutional investor, “and we also like to see the tenants invest their own money to upgrade their facilities.” So add “alignment of interests” to the deal desiderata. One of the leading pension fund consultants smiles on such a strategy, but notes that such transactions “are very hard to come by.”

What makes sense near a power discounter? Maybe DIY chains or a restaurant, thinks an industry executive. “Dollar stores” have been shadowing power discounters for some time, seeking to capture some of the spending of value-oriented buyers. A Midwest specialist in strip centers observes, “The big-box format is maturing. These category-killers were a huge shock, but surviving competitors have figured out how to coexist.” And to no one’s surprise, these power discounters are counterpunching with an aggressive program rolling out hundreds of smaller stores. They are making their presence felt in mixed-use developments and in downtown shopping districts.

In the face of urbanization trends, some investors are seeing the neighborhood/community center as a chance to get a “bite-sized piece of an outward-facing city”—an interesting characterization of the many U.S. metro areas still expanding on their perimeters, including Charlotte or northern Virginia. One of the great opportunities in real estate is its diversity of scale. Bigger is not always better. A wide range of investors and developers can find a market niche for themselves.

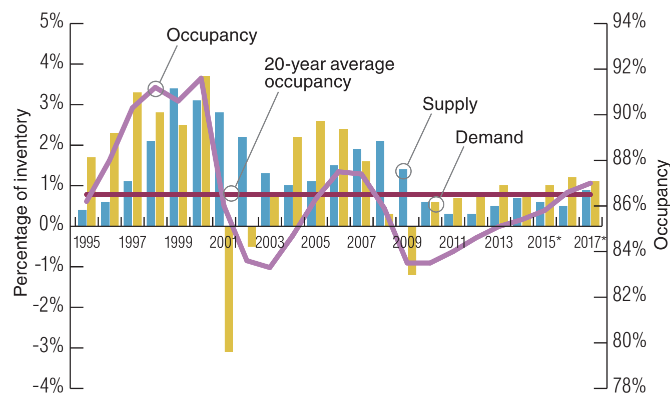
Malls. On a scale of 1 to 5 (where 5 is best), regional malls are rated just 2.43 for investment and 1.74 for development in 2015, with more than half (52.6 percent) of the survey respondents recommending "sell" and only 9.1 percent advising "buy." One Wall Street specialist sees this as painting with too broad a brush. "Don't buy generalizations pooh-poohing Class B malls. In places like Chattanooga and Minot [North Dakota], these may be consumers' only option and still a center of suburban activity." An asset manager echoes the sentiment: "In secondary and tertiary markets, stick to absolutely best retail properties. High-quality malls are always good; but now more of the busted retail properties are seeking to reposition." That's an acute perspective, and one shared by some top names. Malls are viewed as being in a binary state. Opportunity funds seem to be seeking turnarounds, and some notable firms have been aggressively accumulating mall assets. A Midwest broker speaks of "quality bifurcation," and at least one interviewee remarked that "bifurcation seems to be a permanent feature of the market."

E-commerce and multichannel distribution. The fear factor concerning the internet is subsiding noticeably. The adaptation of traditional retailers to e-commerce is now well advanced. To the surprise of many, there is the countervailing trend of e-merchants opening stores. The "pop-up store" phenomenon is turning out to be an interesting experimental approach for nascent brands to sample the "bricks" side of retailing as a complement to "clicks." The internet turns out to be a great venue for innovation, with a positive real estate outcome for winners who survive the online sorting-out process.

"E-commerce has hit certain parts of retail but not across the board; people still like to congregate and buy and touch," said a pension plan sponsor. Who should be more prone to internet shopping than the urban hipster? However, one retail veteran pointed out, "Technology [e-commerce] is not impacting what I develop. Right now, urban retailers' priority is to break into new locations." That's real places, not virtual places. The trendiest spots still blossom with boutiques, coffee shops, ethnic restaurants, and other experiential retail that just cannot be duplicated in cyberspace. You can't eat the internet.

The whole point of merchandise distribution is to get to customers with comprehensive coverage, speed, and service. If e-commerce now represents about 9.5 percent of consumer sales, merchants are well aware that stores account for more than 90 percent. That's opportunity. Still, some savvy interviewees look at the growth of e-commerce as potentially doubling in market share, and think that internet retailing should be rated a "best bet." Let the debate continue!

Exhibit 4-16 **U.S. Office: Change in Supply and Demand**



Source: CBRE Econometric Advisors.
*Forecasts.

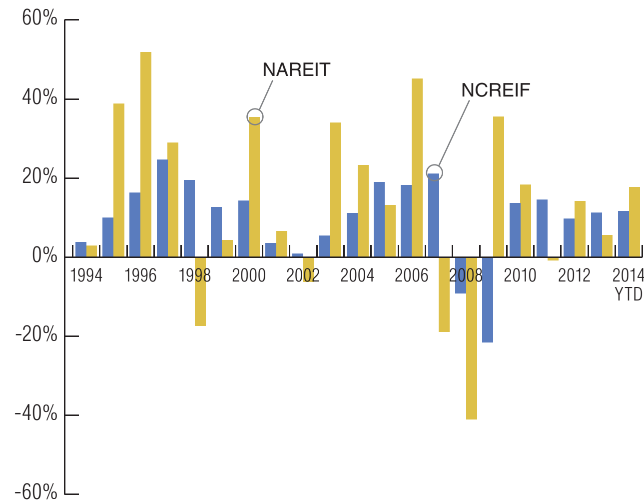
Offices

Offices—CBD offices in particular, and CBD offices in the leading 24-hour cities especially—followed apartments in the lineup of property types cycling upward after the financial crisis. This would be no surprise to *Emerging Trends* readers, interviewees, and survey respondents, since it was this publication that brought the concept of "24-hour real estate markets" to public attention 20 years ago. It is gratifying, however, to see that the academic literature is finally catching up to the industry's intuition and experience. Papers in such respected publications as the *Journal of Real Estate Portfolio Management* have been testing and validating the claim, published here in our 1995 edition, that 24-hour cities would provide superior investment performance. The live/work/play theme is not just hype; it is statistically significant.

In fact, that might very well be one of the more powerful trends for offices, and not just in the gateway cities. The resurgence in downtown living is bolstering secondary office markets around the country. It turns out that workers like the urban feel and lunchtime amenities better than employee cafeterias. Moreover, as transit-oriented developments become more common, more-complex urban centers with a variety of uses provide "externalities" that enhance "quality of work life" while buttressing office building values.

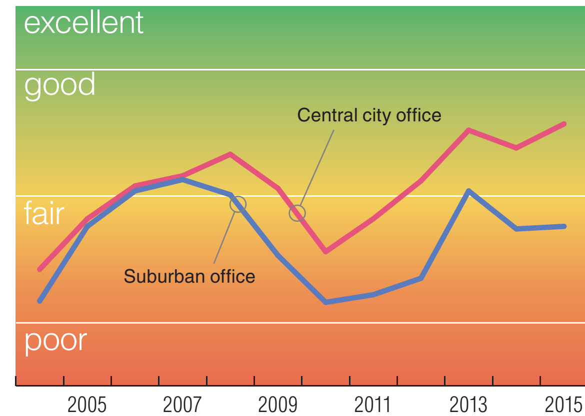
Austin, ranked tops for both office investment and development in this year's survey, has garnered national and international recognition as a live/work/play downtown. Houston, ranked number two, has effected an incredible downtown transformation and is one of America's most diverse and globally connected cities. One cross-border investor characterized Houston as "the

Exhibit 4-17 **U.S. Office Property Total Returns**



Sources: NCREIF Fund Index Open-End Diversified Core (ODCE); NAREIT Equity REIT Index.
*Returns as of June 30, 2014.

Exhibit 4-18 **Office Investment Prospect Trends**



Source: *Emerging Trends in Real Estate* surveys.

U.S. central city office

2015	Prospects	Rating	Ranking
Investment prospects	3.57	Good	2
Development prospects	3.27	Fair	6

Buy	Hold	Sell
37.3%	34.0%	28.7%

Expected capitalization rate, December 2015 5.8%

U.S. suburban office

2015	Prospects	Rating	Ranking
Investment prospects	2.76	Fair	10
Development prospects	2.24	Poor	13

Buy	Hold	Sell
25.1%	32.7%	42.2%

Expected capitalization rate, December 2015 7.5%

Source: *Emerging Trends in Real Estate 2015* survey.
Note: Based on U.S. respondents only.

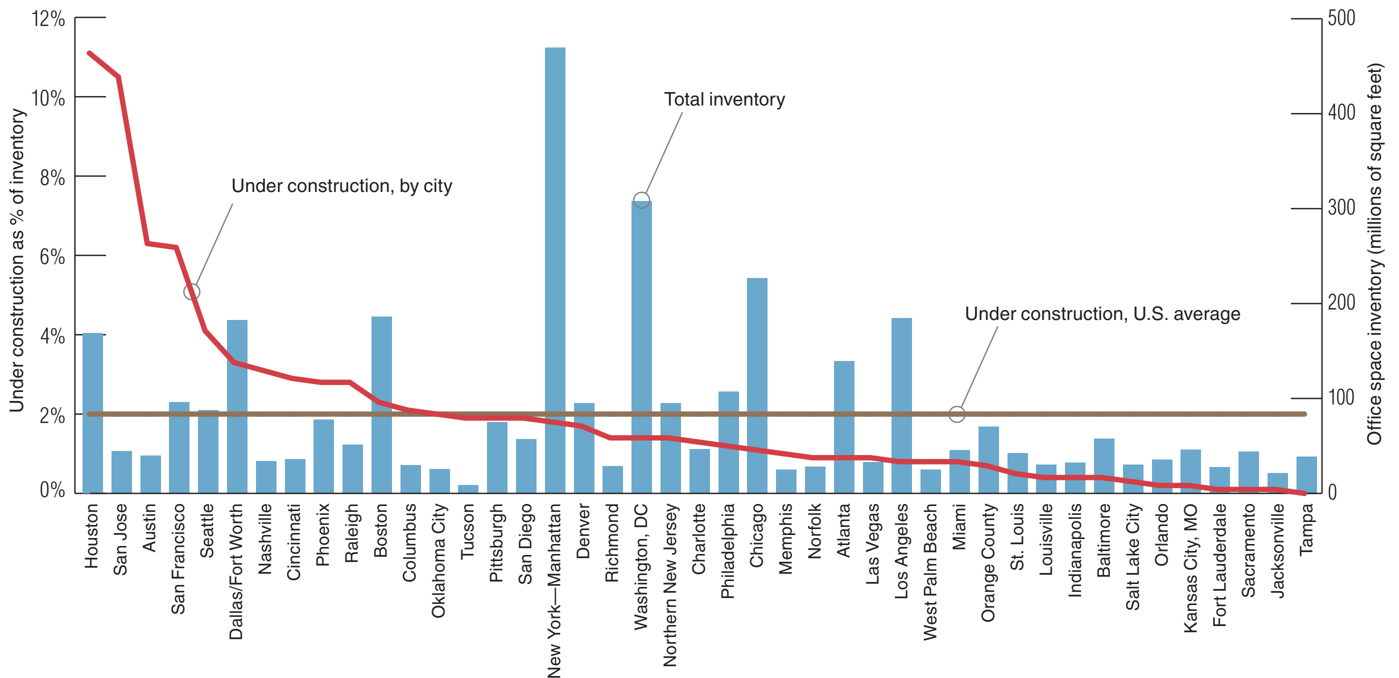
perfect storm for commercial real estate." Denver's LoDo neighborhood has helped concentrate that city's economic energy. A finance professional thinks that "Denver's discipline is better" than a number of other growth markets, and thus more capable of sustaining its upward trend.

Dallas, long the epitome of the edge-city configuration, is now seeking "to fully capitalize on the potential to be a 24-hour, 21st-century urban neighborhood" in its plan, Downtown Dallas 360. It is enlightening to see how similar the rankings for top cities are across property types, showing how a variety of land uses interact to create value. What a difference from the "separation of uses" zoning that influenced most cities in the last century. More and more, cities around the country are looking to stick with the mixed-use downtown winners—a reasonable basis for seeing this as a trend with decades to run.

Office activity has been strong in the first half of 2014, with Atlanta, Boston, Dallas, Denver, Houston, Los Angeles, and Manhattan all reporting good absorption levels. Rent growth is positive across the United States. With more than 77 million square feet under construction, the office inventory is expanding by 2 percent. A number of markets with especially high rent growth are also seeing rapid supply additions. Leading the list of office construction volume relative to existing inventory are Houston, San Jose, Austin, San Francisco, Seattle, Dallas/Fort Worth, and Nashville. The ratings of the *Emerging Trends* survey about office development markets match nicely with the observable data.

Office transaction volume was up 35 percent in the nation's downtowns and 25 percent in suburban markets through June 2014 compared to the same year-to-date figure for 2013, according to Real Capital Analytics (RCA). That investment preference is likely to continue, say our survey respondents. The "buy" recommendations for CBD and suburban office match the RCA volume data almost exactly, with 37 percent of the respondents saying it's a good time to buy CBD office and 25 percent recommending acquisition of suburban office. And while only 29 percent of survey respondents say that 2015 is a year to sell CBD office, 42 percent would sell office assets if they were in the suburbs. (Interestingly, the "hold" recommendations for downtown and suburbs are about the same at 34 percent.)

Exhibit 4-19 **Office Space under Construction as a Percentage of Total Inventory, 2Q 2014**



Source: CBRE Econometric Advisors.

That "sell the suburbs" call says a lot about the expectations for future trends.

Our interviewees season these numbers with their experience. A Midwest institutional investment officer explains, "Suburban office is not doing well for us. No one wants to buy it right now. The reemergence of suburban office is not likely soon, as the office sector is becoming more infill/urban, dense suburban, and less auto-dependent. "No one wants to pull into a big parking lot with no place to eat." The commodity-like character of many office parks is discounting their value, and impeding the ability of owners to drive rents upward. A Chicago-based interviewee describes the business parks around his city as "desolate." The millennial preference for downtowns contributes to the bleak outlook that some express for suburban office, and even recent trends toward office space compression have created problems—namely, parking allocations—for those suburban offices enjoying decent occupancy.

But we should have learned long ago to question assertions made with too broad a sweep. There is an articulate minority of the *Emerging Trends* interviewees who see suburban office "battling back," taking the position that "the death of suburban office has been greatly exaggerated," and seeing a contrarian opportunity for those investors willing to buck the majority opinion. A Texas-based value-add investor is one of these: "Everybody seems to want a luxury car, but dealers sell an awful lot of sensible sedans." Perhaps a pension fund investor strikes a balance, in identifying dense clusters of offices linked to strong downtowns, a subset of the classic "edge cities" distinguished by being networked to healthy hubs, as the best opportunities. This investor names as examples such places as Tysons Corner, Virginia; Bellevue and Kirkland, Washington; and Mountain View, California.

Let us take one other observation from our interviewees that points to a trend that is bound to set off controversy. In a word, the drive toward space compression in office use is about at its end, and in the coming years the quality of the office environment will be used as a marketing tool to recruit talent. The millennial generation will not put up with the space cram-down much longer, especially as it gains seniority in the workforce. "We space" is going to have to accommodate "me space." Greater flexibility—and variety—in office space design will be superseding cost cutting as a prime imperative. "The collaborative aspect of open space is overdone," one interviewee noted. "I don't think people need to talk to their coworkers all day long."

Not all our interviewees agree with the perspective that space compression is nearing its limits. Feeling the recent trends

still affecting future plans, one owner sees space sharing as being institutionalized in a profound way. "Companies such as WeWork are revolutionizing the way we think about office space." A global real estate asset manager ratifies this: "Technology plays a large role in office spaces since people are doing more with less space." A Northeast brokerage executive advises a nuanced view: "One size does not fit all when it comes to office space occupancy; firms are mixing/matching work-at-home, free-address locations in office, and management-directed floor planning." An institutional investor notes, "There is sure to be a different use of office space other than the old-fashioned kind of office space."

Nevertheless, our interviewees are signaling that it is time to reexamine what has become the conventional wisdom that cost control, higher worker densities, and worker bullpens are the wave of the future. That same institutional investor continued, "But the trend of no privacy and very high density is going to swing to the other direction." A peer with another institution concurs, "Office space compression has been a theme for more than 20 years. Be careful: people like to talk too readily about game-changers. We heard a lot about the paperless office."

A top broker in the Carolinas ran an interesting experiment with his staff. He asked his millennial staff members to design what his company's next office space should look like. All of them had private offices built into their plans, the "collaborative advantage" of open space notwithstanding. Inflection points—times when trends change—are notoriously difficult to pinpoint. But as startling as this claim may seem to some, a "back to the future" movement in space design could have an impact on offices as profound as the emergent 24-hour city movement of two decades ago. Forward-thinking real estate professionals should be alert for a tipping point in the space crunch, especially as the bidding for skilled workers intensifies over time.

And if the millennial generation's impact is still evolving, so too is the boomers'. While the Affordable Care Act's influence should not be ignored, the actuarial tables tell us that the need for medical care systematically increases with age. A REIT executive sees this as just a question of demographics: "People are getting older, and this favors medical offices and other forms of health care facilities."

The *Emerging Trends* survey respondents intuitively grasp the inexorable path of demand growth for medical offices, rating it at 3.5 in terms of investment prospects (right behind CBD offices) and at 3.3 for development, tied with downtown offices as a top choice. Moreover, medical office is seen as a "buy" for 2015 by 36.3 percent of respondents, and a "hold" by 40.6 percent, with only 23.1 percent advising "sell." For one thing, medical office cap rates are expected to hold firm in 2015 at 6.6 percent, before experiencing the upward drift of cap rates that is an across-the-board expectation by 2018.

One private equity interviewee said this: "Medical office looks good on all metrics. We see a two-pronged trend where hospital campuses provide concentration for doctors, but diffusion [into communities, into malls] provides convenience for consumers. Health care is going to be 20 percent of GDP, so the real estate opportunity is great."

Housing

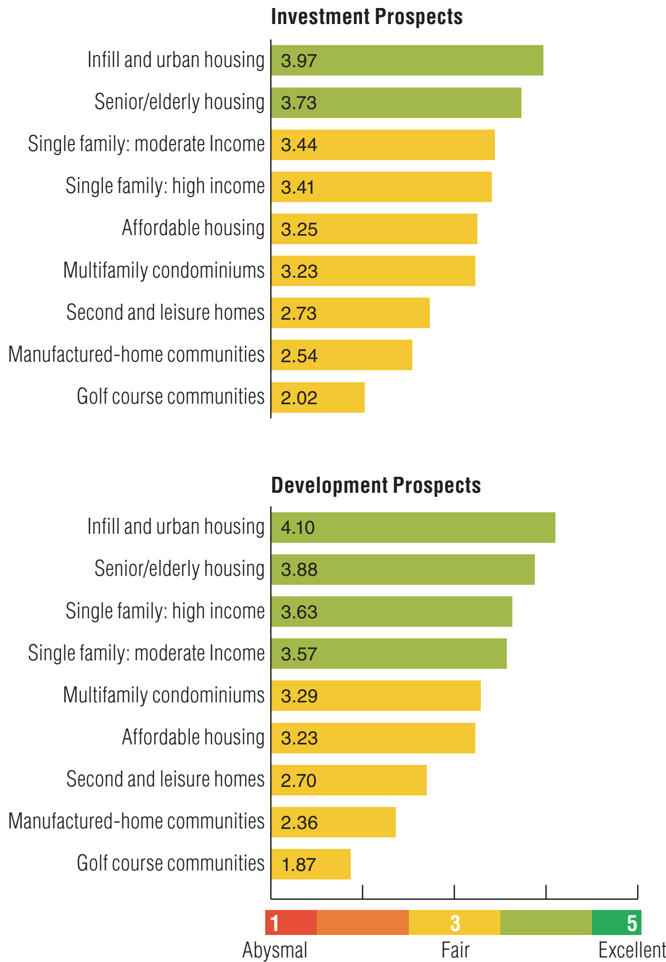
A minority opinion out there says, "The 'back to the city' trend is oversubscribed; not so many people care about walkability to a coffee shop; the majority of the U.S. is not on board with this. Don't discount housing affordability as a factor for families, and this disadvantages gateway cities." No doubt there's a kernel of truth there, and one size does not fit all. But keep in mind Damon Runyon's streetwise advice: "The battle is not always to the strong, nor the race to the swift—but that's the way to bet!" Housing is well on the way back, say the *Emerging Trends* survey respondents, and they rank urban/infill as the top opportunity for 2015.

Despite talk of lingering overindebtedness and the lack of savings on the part of potential homebuyers, the consensus reads this way: both for investment and for development, upper-income housing and moderate-income housing score equally well. Multifamily condominiums are just behind, and roughly in the same ballpark as affordable housing. An interviewee sees significant infill condo opportunities in 2015. A private equity investor thinks a serious look should be given to "condos where the markets haven't take off yet. Remember that millennials will become homeowners at some point, but where—city or suburb?" The answer is probably "both/and," not "either/or."

Condominium prices rose a modest 3.7 percent year over year during the second quarter of 2014, according to data from the National Association of Realtors. The inventory of condos for sale is very limited—just a 4.8 months' supply. Such a tight market, coupled with continued low interest rates (as expected), suggests a resumption of price escalation in the near future. Watch for that in 2015.

What is lagging? Exactly the sort of product that resort and retirement community developers were counting on as the baby boomers reached retirement age: golf course communities, second-home and leisure development, and the like. Who would have thought that the over-65 cohort would elect to

Exhibit 4-20 **Prospects for Residential Property Types in 2015**



Source: *Emerging Trends in Real Estate 2015* survey.

Note: Based on U.S. respondents only.

return downtown from their suburban homes, instead of migrating to Florida and Arizona en masse? Further, both for financial reasons and because of an unwillingness to detach from work, boomers are staying in the workforce longer and in greater numbers than forecasted. That also has altered the housing picture for this cohort.

Developers are catching on. Outside the CBDs, urban village concepts are repositioning tired malls with ground-floor retail under small offices or residential units, complementing the mix with denser mid- to high-rise office, apartment, and hotel. Such mixed-use development approaches have been meeting with marked success.

The hangover of the housing bubble has not fully dissipated, and this will partially shape demand for the next several years. Even with jobs on the rise, doubling up in either parents' homes or with several roommates is an accepted norm, even if temporarily, for millennials. This version of a "new normal" is not forever, but it will linger because of the combination of high student loan indebtedness, meager wage and salary growth, and inadequate savings. Millennials who do desire the big backyard home will be deferring that dream into the 2020s if current trends are any indication. But valuing the quality of urban life does not necessarily mean wanting a tiny box in Manhattan forever. In that sense, the enthusiasm for "micro units" may be disappointing, prompting development of such units to be stalled in the thousands, rather than growing to millions nationally. A respectable middle course is bound to be found. One investor with a portfolio of single-family homes purchased in bulk for rental purposes believes that the millennial demand will be migrating to smaller cities, and can serve as that "middle course" transition product for those seeking greater affordability. He's ready for that trend.