

CloserLook

2017 Commercial Real Estate Outlook



The real estate industry is increasingly influenced by rapid technological advancements and significant demographic shifts, which include growing urbanization, longevity of Baby Boomers, and differentiated lifestyle patterns of Millennials. In addition, macroeconomic and regulatory developments continue to impact profitability. How can companies gain a competitive advantage and drive top- and bottom-line growth? Here are some trends to pay attention to in 2017.

Economic outlook: Growth tempered by higher interest rates?

Gross domestic product growth will likely increase 2.5 percent in 2017, according to Deloitte's Q3 2016 US Economic Forecast. The modest economic improvement could temper the pace of commercial real estate (CRE) transaction activity.

Volatile global markets have led to continued low interest rates. The Deloitte economics team anticipates the Federal Reserve is likely to raise interest rates in the short-to-medium term. Higher interest rates are likely to increase mortgage costs and could deter real estate investments to some extent.

An improving employment scenario and rising labor participation are expected to result in an unemployment rate of less than 5 percent. The employment-to-population ratio is projected to peak in 2018, as retiring Baby Boomers may reduce the share of employed. The improving labor markets and household wealth will likely boost consumer confidence.

Regulatory outlook: Greater compliance costs on the horizon

New accounting standards on lease accounting and revenue recognition will likely increase the compliance and administration costs for real estate investment trusts (REITs) and engineering and construction (E&C) companies.

While increased exemptions under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) will increase foreign investments in CRE, risk retention rules will likely lower commercial mortgage-backed securities (CMBS) issuance and reduce capital availability in secondary and tertiary markets.

In addition, the Protecting Americans from Tax Hikes (PATH) Act of 2015 will not only ease REIT tax provisions and research and development (R&D) tax credits for E&C companies, it will also increase the flexibility to invest in startups for R&D experimentation. At the same time, corporate tax reforms will reduce flexibility for corporations to spin off real estate assets into REIT structures.

Disruptive trends: Shaking up the CRE marketplace

Collaborative economy. Startups based on the sharing or collaborative economy, like Airbnb or WeWork, are disrupting the way organizations lease and use CRE. Companies face challenges from new competitors that are providing dynamically configurable spaces and flexible leases. Owners need to rethink their approach toward space design, lease administration, and lease duration.

Disintermediation of brokerage and leasing.

Technological advancements are making CRE data more ubiquitous and transparent. These changes are enabling online leasing in a cost-effective, real-time manner and threatening the traditional brokerage model. Traditional brokers should consider diversifying their core business focus to include consultative opportunities, invest in data and technology, and collaborate with startups to get ahead in the game.

Competition for talent. A shortage of candidates with strong skills in science, technology, engineering, and math (STEM); rising urbanization; and Millennials' preference for an open and flexible work culture are changing the employment marketplace and will result in significant competition for talent. There is likely to be greater demand for mixed-use developments as consumers prefer to "live, work, and play" in proximity; office space usage will be redefined and even rationalized. Companies should choose locations in areas that have concentrations of STEM talent and revamp design and development teams to cater to changing consumer preferences.

Last mile. Online retailing, on-demand manufacturing, and innovations in speed and mode of delivery (such as same-day delivery and e-lockers) are disrupting the retail and industrial markets. Demand for large retail and industrial spaces will contract, and there will be a blurring of lines between these two property types. For example, retail properties could double as fulfillment centers. While retail owners can try different store formats and enhance end-customer experience, industrials should potentially focus on smaller and more flexible spaces within cities to enable faster delivery.

Future of mobility. Emergence of "pay-per-use" is beginning to challenge the model of personally owned vehicles. Along with this, the advent of self-driving vehicles will potentially transform the entire mobility ecosystem. This has the potential to change demand-supply dynamics, free up large parking spaces in prime areas that can be put to different uses, and shift tenant demography. Companies need to be more strategic in analyzing the impact of mobility patterns and options on their long-term revenue and profitability, exploring design changes to existing spaces, and revisiting tenant strategies.

REITs: Favorable performance will continue amid increased caution

New supply may offset positive net absorptions, though technology advancements and changing consumption patterns will have more influence on CRE demand. Demand for **office space** will reduce as corporates adapt to employees' "live, work, and play" behavior and leverage technology to automate tasks. Industrials will potentially continue to benefit from the rise in ecommerce activities, especially in noncore markets. Improved consumer confidence and rising urbanization will likely support **retail and multifamily demand**, even though excess supply may limit the improvement in multifamily fundamentals. **Retail real estate owners** will continue to creatively reuse the space vacated by anchor retailers to offer a variety of entertainment options and ultimately enhance customer experience.

Transaction activity will continue to decline and upward momentum in pricing is likely to slow down due to modest economic growth and ongoing political uncertainty. Investors are mostly focusing on primary markets and high-growth secondary markets in the United States. The Association of Foreign Investors in Real Estate's 2016 survey reiterates that the United States continues to be the most favored destination for real estate investments. The survey suggests that foreign investors are most concerned about a potential interest rate hike in the United States and economic slowdown globally. Investors will have to develop unique capabilities to distinguish themselves. They will also have to be very creative about where they seek value opportunities—secondary/tertiary markets or niche asset classes, such as student housing, healthcare, and single-family homes, could all be explored.

Credit availability may be a concern going forward, due to the continued low CMBS issuances and banks tightening the lending standards across all CRE loan categories due to increased federal scrutiny. However, companies should consider accessing alternate sources of financing, such as life insurance companies, mezzanine debt, and other investment vehicles. REITs are likely to continue to leverage the positive CRE market fundamentals and increase fundraising and investments to reposition their portfolios.

Homebuilders: Demand-supply mismatch may offset rising confidence

Homebuilders' confidence is on a rise due to improved employment, household income, and strong demand from Millennials. However, a demand-supply mismatch may continue due to ongoing labor shortages and permit issuance delays. Housing starts increased by 0.9 percent year-over-year in August 2016, even though housing permits reduced 1.2 percent year-over-year in August. Deloitte's Q3 2016 US Economic Forecast suggests that housing starts are likely to reach 1.5 million in 2017 compared with an estimated 1.3 million in 2016. In contrast, in the first half of 2016, orders for homebuilders grew by an average of 29 percent compared with in the second half of 2015, but deliveries by homebuilders declined an average of 14 percent. As a result, the average order backlog has climbed to 36 percent, due primarily to labor shortages and permit issuance delays.

Home prices are likely to grow, albeit at a slower pace, due to limited inventory and supply. According to the quarterly Zillow® Home Price Expectations Survey, the Midwest region may witness a surge in demand due to job growth and relatively lower prices compared with the coastal markets.

In 2016, total home sales are expected to grow at approximately 3.6 percent on an annual basis. The slower growth is likely to be driven by supply constraints, potentially higher interest rates, and rising prices. Sales for new homes are expected to grow by 21.3 percent year-over-year to 609,000 homes. In contrast, sales for existing homes are expected to grow at a slower rate, approximately 1.9 percent year-over-year, to 5.3 million homes. This is in line with the Deloitte economics team's 3Q 2016 forecast.

Home mortgage originations and delinquency rates improved in 2015, but they could be impacted by an imminent interest rate hike, even though banks have gradually loosened residential mortgage standards.

Homebuilders are building more units for rent, as rental demand and rental values have been strong and homebuilders look to grow and diversify. This strategy is likely to influence homebuilders' business models and blur lines with multifamily owners.

Engineering and Construction: Improved construction spending alongside financial performance headwinds

Spending on nonresidential construction and defense is likely to grow at a slow pace due to muted expansion in manufacturing, mining, and oil exploration. In July, US nonresidential construction spending grew 1.4 percent year-over-year on the back of a 7.3 percent increase in private spending, even as public spending declined 6.3 percent year-over-year. According to Deloitte's 2016 US defense outlook, DoD spending is expected to stabilize and grow from 2016 onward after a continuous decline in the previous five years due to budget cuts. As of September, commodity prices were flat year over year due to weak global demand, implying limited exploration and mining activity. However, prices are expected to improve slightly in 2017, due to tighter supplies.

Commodity prices are expected to improve slightly in 2017, due to tighter supplies after being essentially flat in the first nine months of 2016 due to weak global demand.

Continued volatility in architectural billings and construction backlogs signals slow growth in 2017.

The Architecture Billings Index continues to be volatile and declined below 50 in August 2016, suggesting a decline in billings. The Construction Backlog indicator remained flat at around eight months' backlog over the past few quarters, suggesting muted construction growth in the near-to-medium term.

Key enablers of future growth IOT, geospatial, and mobile technologies can help E&C companies improve operational efficiency in a slow-growth environment, while 3D printing and sustainable construction can help save costs, improve quality, and enhance brand value.

Private equity real estate: Focus on niche sectors may ease the pressure on returns

Global private equity real estate (PERE) fundraising will potentially continue to slide as fund managers' focus on deploying existing funds. As a case in point, global PERE fundraising declined 24.5 percent year-over-year in the first three quarters of 2016 to \$74.2 billion, possibly due to funds' focus on deploying their existing dry powder. Despite the challenges, fund managers remain confident about deploying their capital into niche sectors, such as student housing and healthcare real estate.

There will be difficulty in finding attractive investment opportunities due to high asset prices and global volatility. In fact, a majority fund of managers in Europe, Asia, and ROW believe that

there is increased competition despite concerns over Brexit and the Chinese economic slowdown, though less so in North America.

PERE returns have also been affected as many large institutions are opting to invest in real estate directly rather than going through a fund to save management and performance fees. We could see an increase in redemptions in open-ended funds as investors try to book profits on the appreciation over the past five years, considering the uncertainty about strong returns in the future.

Key enablers for growth: Making space future-ready

2017 key enablers for growth

Internet of Things
Identify appropriate applications, integrate with existing systems, and invest in data analytics capabilities.

Sustainability/health and wellness
Consider design elements that promote health and wellness, collaborate with tenants, invest in obtaining LEED and WELL certifications.

Demographic data and predictive analytics
Use appropriate tools, partner with specialized consultants and startups, and upskill existing talent.

Cybersecurity
Elevate cyber risk as a strategic issue, develop policies and frameworks, spread awareness, and invest in implementation.

3D printing
Reposition existing properties, invest in firms building 3D printers, and partner with universities for research and development efforts.

Cloud and mobile technologies
Assess suitable applications, identify key functions and processes, improve integration, and address security issues.

Enhanced productivity outsourcing
Identify activities for outsourcing and factor in regulatory, scalability, and cost aspects.

Homebuilders

PERE

E&C

REITs

The icons highlight the sectors where these trends may enable growth.

A time for reinvention and change

Real estate companies will need to reinvent their strategies in 2017 to prepare and respond to the changes in the macroeconomic and built environment. Specifically, companies will need to:

- Consider the influence of technology advancements, urbanization, changing consumer preferences, security, climate change, and resource scarcity concerns on real estate decisions.
- Leverage technologies such as the Internet of Things, cloud computing, mobility, 3D printing, and advanced analytics to be innovative with respect to locating future developments.
- Resolve integration issues with legacy systems while adopting new technologies.
- Adopt a targeted and multipronged cybersecurity strategy that is secure, vigilant, and resilient.
- Drive innovation by partnering with existing startups, establishing research and innovation labs, and creating corporate accelerators.
- Invest in the tools and talent to respond to the changes in the ecosystem at a desirable pace.

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