Cautious optimism
The 2017 real estate outlook in the United States

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The United States 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 affect profitability. How can companies gain a competitive advantage and drive top- and bottom-line growth? Here are some trends to which we should pay attention in 2017.
Economic outlook: Growth tempered by higher interest rates?
US gross domestic product growth will likely increase by 2.5 percent in 2017, according to Deloitte’s 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 private equity investors, 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.

Private equity real estate: Focus on niche sectors may ease the pressure on returns
US 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 US$74.2 billion, possibly due to funds’ focus on deploying their existing dry powder.

Investors are mostly focusing on primary markets and high-growth secondary markets in the United States.

Global private equity real estate fundraising

<table>
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<tr>
<th>US$ Billion</th>
<th>Nb. of funds</th>
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<tr>
<td>Aggregate capital raised</td>
<td>NB. of funds (RHS)</td>
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*YTD* is as of 3Q16
Despite the challenges, fund managers remain confident about deploying their capital into niche sectors, such as student housing and healthcare real estate.

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.

**US commercial real estate: 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.

Industrial and distribution center real estate will potentially continue to benefit from the rise in ecommerce activities, especially in non-core 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, because of 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.

US Homebuilders: Demand-supply mismatch may offset rising confidence
Homebuilders’ confidence is on the 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 the second half of 2015, but deliveries by homebuilders declined by 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.

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.
The Q3 2016 Deloitte US Economic Forecast suggests housing loan standards may be loosening at a slower rate.

Decline in unemployment has been driving housing demand.

Household income has been on the rise and is contributing to improved demand.

Demand for home purchases by Millennials is on the rise as they are now older and beginning to start families.

In September, the National Association of Home Builders/Wells Fargo Housing Market Index increased to 65 points from 61 points during the same period last year.
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 Q3 2016 forecast.

Home mortgage originations and delinquency rates improved in 2015, but they could be affected 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.

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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 after being essentially flat in the first nine months of 2016 with 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 had 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.

The 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.

In closing:

Cautious optimism is the overall sentiment for 2017. Although real estate fundamentals such as occupancy and rent growth continue to improve in many US markets and property types due to modest economic growth, increasing development activity and supply additions to the market may begin to negatively affect fundamentals in 2017. In addition, the threat of higher interest rates will likely negatively affect the volume of transaction activity and pricing. There continues to be significant investor interest in US commercial real estate, with significant amounts of private equity capital, REIT financing, and foreign investor capital looking for opportunities in US commercial real estate.