MOMENTUM 2017

Commercial Real Estate Outlook:

Agility and Discipline in a Time of Uncertainty

A 2017 CohnReznick LLP Report

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noun: impetus and driving force gained by the development of a process or course of events

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Preface

David Kessler

In the years following the Great Recession, property fundamentals stabilized across all sectors. Coupled with a continually improving economic outlook, the various constituencies of the real estate industry have enjoyed something close to open-field running. Their imperative then was to move quickly in the face of opportunity and thus cover as much ground as possible in the pursuit of high returns.

In 2016, we saw those conditions begin to evolve as deals became harder to find. In 2017, these supply-demand challenges are being joined by political ambiguities and fundamental changes in several sectors. In retail, for example, the biggest factor isn't availability of capital or property, but serious uncertainty over what the future holds for the industry. Hotel developers are contending with stalling vacancy rates. And with significant CMBS debt coming due, some are wondering how much refinancing the market will be able to absorb without stalling.

As the industry moves to a late cycle footing, the open field running of previous years has become more of an obstacle course, putting an emphasis on different skills and strategies: discipline, due diligence, operations management. But if the game has changed, the prize remains the same—yield in a highly competitive world where investors' expectations remain irresolutely strong while lucrative deals seem to be precipitously diminishing.

On the following pages, CohnReznick's National Commercial Real Estate Industry Practice shares ideas and perspectives on how key areas of this dynamic market are developing in 2017, as well as strategies and tactics to consider as you plot your course for the year.

We hope you find *Momentum 2017: Commercial Real Estate Outlook* to be a useful guide to the state of the industry, and look forward to your comments.

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Capital and Operations

Over the last several years, speculation regarding the future direction of the commercial real estate market has tended to center on various interest rate scenarios. With upward pressure in interest rates now a given, it is more important, as Jim Sullivan, President of Green Street Advisors, recently pointed out, to ask why interest rates are rising. Is it because of strong economic growth, or a poor unwinding of the Fed's QE policies? One interpretation points in a positive direction for the real estate industry, the other in the negative.

Such a prediction helps guide high level strategy. Regardless of how one views the interest rate question, however, on a tactical level the emphasis must now shift from cap rate compression to fundamentals and income generation. This applies both at the micro level (the demographics and net operating income of a particular property) as well as the macro level (will the new administration be able to spur the domestic economy?)

A second looming factor is the wave of CMBS debt set to mature this year and next. While market analysts say it's not certain that this much recapitalization can be absorbed by the market all at once, the investors we talk to seem confident that the available capital will be able to accommodate this development without undue stress.

Funds and Fundraising

2016 saw fundraising drop approximately 25% compared with the previous year, and the same sluggishness is likely to continue through 2017. Fund managers remain focused on deploying the considerable amount of dry powder that has built up in the midst of a market that is seeing compelling deal opportunities becoming increasingly scarce. This lack of available deals, combined with heightened concern about overpaying, will slow deal flow down even further—conditions that can easily redirect more investment capital into alternative holdings.

Student housing, self-storage, and healthcare properties all remain strong. The question will be how long these markets will offer opportunity given the level of competition that has quickly arisen. Larger funds are providing a range of alternative products to their clients and smaller funds are able to compete on equal footing due to their agility and entrepreneurialism. We also expect an uptick in redemptions in open-ended funds as investors look to realize the appreciation that has accrued over the last five years.

In terms of fund types, we are seeing capital move away from opportunistic and development strategies and toward well-defined, high-quality value-add funds where there is more headroom to create value

through revenue enhancement. Increases in the FIRPTA threshold for foreign holders of publicly traded stock from 5% to 10% immediately doubles the positions foreign investors can hold without tax consequences on the sale of shares or realization of capital gains. As foreign investors continue to look to the United States, we expect increased interest by some domestic investors in overseas opportunities.

If the recent proliferation of debt funds has been one of the more evident results of the Feds continuing over-regulation of banks and other traditional lenders, then it stands to reason that the new administration's scaling back a significant number of these regulations could quite possibly dampen the continued proliferation of these funds as an alternative lending source.

On the U.S. REIT front, with the total market capitalization now reaching the $1 trillion mark, REIT-focused funds will continue to multiply. We expect REITs will maintain consistent leverage profiles and access attractively priced equity and unsecured bond capital. This year should bring better, more clearly defined portfolio strategies and less risky external growth strategies, along with generally more conservative financial policies.

The industrial sector was the top performing equity REIT market segment in 2016 with a 31% total return for the year. That sector will likely remain a popular investment target for 2017. Infrastructure should also remain strong, given the early indications of potential policy initiatives from the Trump Administration. Federal infrastructure spending could boost the overall national economy and, consequently, improve the fundamentals of the real estate industry. In addition, most retail, industrial, and office REITs should enjoy positive growth this year.

Investors and regulators emerged from the downturn with new expectations regarding transparency of fund operations, and funds have since responded accordingly. But the bar has been raised further, with institutional investors now taking a harder line on fees. Funds need to be scrupulously transparent here as well, looking at matters from the investors' perspective. Even so, some investors are taking things into their own hands by building their own sourcing and deal-making capabilities and eliminating fund management and performance fees altogether. This will further increase the pressure on funds to demonstrate and communicate how they add value.

We expect that 2017 will be a strong year for foreign investment... there remains significant opportunity for foreign syndicates of high-net-worth individuals, for example, to invest in properties that are too small for larger players.

The implementation of Dodd-Frank and the Volker Rule has dampened the involvement of traditional lenders, especially in development loans—as it was designed to do. Community banks filled as much of the gap as they were able, followed by debt funds and, more recently, preferred equity funds. Nevertheless, the availability of capital for construction is still tight. All eyes will be on changes the Trump Administration may make to the application of Dodd-Frank and the Volker Rule and the impact those changes will likely have on development financing.

The implementation of Regulation A+ as part of the JOBS Act laid the groundwork for crowdsourcing real estate deals. At the time, we predicted that crowdfunding would have little impact on an industry where a $50 million deal is considered small. So far, this has proven correct. Indeed, if crowdsourcing has had an impact, it is to make funding more challenging. The institutional lenders we hear from tell us that they are wary of lending to "dumb money"—that is, a crowdfunded deal that lacks a proven general partner at the center. This isn't elitism. It's a simple recognition that if things go south, the lender needs someone on the other end of the phone. This wariness is part of a larger lending trend: when underwriting a loan, lenders are evaluating the borrowers even more critically than they are the underlying asset.

Foreign Investment

2016 ended sluggishly for foreign investment as many of those investors waited out the results of the presidential election. The outcome has since been digested and, while the rhetoric has at times been harsh, the collective hope is that there will be a significant gap between rhetoric and reality.

We expect that 2017 will be a strong year for foreign investment. As we noted in last year's report, while sovereign wealth funds and foreign institutional investors have long participated fully at the top end of the market, there remains significant opportunity for foreign syndicates of high-net-worth individuals, for example, to invest in properties that are too small for larger players. And while large foreign investors may need to grapple with the scrutiny that can come with sizable investments, acquisitions by midsized Gulf banks of a garden apartment complex in Memphis are likely to fly under the radar.

This is not to suggest that middle market investors are insignificant. To the contrary—we see our foreign clients quickly climb the learning curve and grow from initial deals to diversification across geographies and sectors. As an example, a foreign fund that started by investing in industrial properties in Boston two years ago has since moved to the Mid-Atlantic and expanded into office properties and multifamily.

Forward thinking funds and operators can accelerate their own digital transformations by spending time studying and visiting companies in Silicon Valley and elsewhere...

U.S. funds and developers that have not yet worked with foreign investors should consider doing so. Foreign investors, who tend to have long return horizons, can be a particularly good source of replacement equity when domestic private equity funds are looking to privatization as a means to cashing out ahead of schedule in order to provide investor liquidity. The primary issue is one of finding them and having them find you—the middle market is by definition highly diffuse and uncoordinated, as are the middlemen who can broker the connections. For U.S. funds that do take on foreign investors, however, it is critical to stay on top of the associated tax and compliance requirements.

Foreign investors, for their part, will find that being a bit more flexible will significantly increase their range of opportunities. We've noticed more than a few foreign investors come into the market with highly specific shopping lists specifying sector, location, deal size, and ownership stake. But in most cases, this level of detail really stems less from deep research than a lack of comfort with risk. In particular, foreign investors would do well to become more comfortable with taking minority ownership stakes from which they now shy away. With some exposure and education, we expect they will come to appreciate how the alignment of investor interests that naturally occurs in a market economy serves as a self-regulating mechanism. And, as we've mentioned previously, foreign investors should also give more thought to development projects. While private equity debt funds have filled some of the void left by the reduced involvement of traditional lenders, there is still plenty of unmet need for construction capital.

Technology

In the face of rising interest rates and more expensive capital, the ability to harness analytics and technology in operations and decision making will continue to be a significant differentiator for both developer/operators and funds. On the investment side, there is opportunity for more accurate modeling and forecasting. In operations, the ability to reduce spend by, say, 5% will bring obvious benefits to the bottom line. In both of these realms, the key is not the technology per se but rather the organizational transformation necessary to harness the data gleaned from that technology. This is the challenge faced by every legacy organization seeking to become operationally digital, whether in retail, banking, media—or real estate. And the fact is, that while commercial real estate has made significant strides in its use of technology and analytics compared with where it was even five years ago, it still lags behind other industries in making this leap.

Forward thinking funds and operators can accelerate their own digital transformations by spending time studying and visiting companies in Silicon Valley and elsewhere, or attending gatherings like CES, the annual technology expo held every January in Las Vegas. The benefits of doing so will be two-fold. First, it will allow real estate practitioners to really see what it means to "go digital" by examining enterprises that have either led the way or have had to evolve in order to survive. Second, it will give a greater sense of the ongoing pace of change in personal technology. This remains a leading indicator of where expectations are headed in virtually all professional environments.

The Trump Effect: Policies That Will Drive CRE

It is hard to think of a time in which more issues of concern to the real estate industry have been on Congress' agenda. To highlight some of these developments and how they are likely to impact the commercial real estate industry, CohnReznick's ***David Kessler****, CPA, Partner, and National Director, Commercial Real Estate Industry Practice, sat down with* ***Jeffrey D. DeBoer****, President and Chief Executive Officer of the Real Estate Roundtable, the industry's leading advocacy organization.*

DK: This year has brought not just a new Republican Administration, but Republican control of both houses of Congress. What's your view on the legislative outlook?

JD: The country's conventional economic metrics, like inflation and unemployment, have been positive for some time. But GDP growth is still anemic. So we're excited at the prospect of a tax and regulatory policy discussion that focuses on trying to unshackle GDP growth through tax reform, infrastructure investment and changes to banking regulations—all of which would let capital take a bit more risk and hopefully would create more jobs, business formations and general economic activity.

DK: Let's start with tax reform. Many people in the industry are looking unfavorably at the elimination of the deductibility of interest on business debt.

JD: The House tax reform framework is centered on moving away from an income tax and toward much more of a cash-flow or consumption tax. When you keep this underlying philosophical shift in mind, it makes sense to replace depreciation with an immediate, full write off and that any interest on debt to acquire the asset would no longer be tax deductible. The end result may be more favorable to many new business activities and might enable Congress to put our corporate tax rate on par with other countries while also reducing individual tax rates.

Despite its potential, we are very concerned about this untested and risky approach, which would upend decades of financial practices. So, we are very focused on this issue. If it did gain traction, the challenge would be to figure out how best to treat the debt that's already been issued. There's $7 trillion invested in income-producing real estate in this country and that capital was invested under a certain set of assumptions. We're going to have to move very carefully so as to not disrupt that immense apple cart. We saw what happened with poorly constructed transition rules in the 1986 tax reform and we don't want to see that occur again.

DK: What's the Real Estate Roundtable's priority on the regulatory front?

JD: Our concern isn't regulation per se, but rather the effects it can have when it builds up layer by layer. Look at what's happened in construction lending—it's one thing to have some guardrails against over-leveraging, but it's quite another to have major capital sources dry up. To take a broader example, over the next three years, more than $1 trillion in commercial real estate debt—approximately $1 billion per day—is maturing, most of which was written in the pre-recession environment. Most of these loans are commercial bank and CMBS loans. Overlapping regulatory changes under Dodd-Frank and Basel III appear to be contributing to an apparent slowdown in bank commercial real estate lending and the fall off in CMBS issuance—the two largest sources of credit for the commercial real estate sector. So, we think that it is important to take a closer look at these regulations and find a way of refinancing this massive block of debt that the market can handle and not unnecessarily discourage appropriate lending.

DK: The 2016 election put infrastructure back on the public agenda. How do you see that issue unfolding?

JD: Everyone agrees that our infrastructure—not just bridges and roads, but the water grid, the electrical grid, the connectivity grid—is in bad shape. But addressing this problem brings up two main challenges. How would Congress prioritize everything that needs to be done? And how could the program be structured to incentivize more private capital to become part of the infrastructure solution through public-private partnerships, private activity, bonds, or other vehicles? Congress can't just put this on the metaphorical credit card. The country needs to figure out ways to creatively finance this activity. One thing to consider is further reform to the taxation of foreign capital invested in U.S. real estate and infrastructure. There are tens of trillions of dollars in foreign capital that would like to get involved and, while we were able to secure some reforms during the last Congress, it might be time to go further.

DK: In the White House, we have not just a new Administration, but a President who is himself a real estate developer and entrepreneur. How does that change your work on the front lines advocating policy on behalf of the industry?

JD: In some ways, there's no change at all—the basic blocking and tackling of fact finding and advocating for your perspective remains the same. But we also know that every proposed policy or regulatory change affecting the real estate industry will undergo extraordinary public scrutiny because of President Trump's professional background. In our work at the Real Estate Roundtable, we've always made a point of taking the big picture perspective and the current environment just reinforces that responsibility. It's not enough for a policy to be good for the real estate industry—it has to mean a stronger economy, more jobs, and stronger communities as well.

Market Sectors

As was the case in 2015, 2016 market activity reflected long-term shifts in how people across generations live, work, and play. But as we move forward, this societal and demographic-driven momentum begins to encounter the reality of a market that is on many fronts reaching its peak.

Office

After several boom years, 2017 should bring a slight retraction in the office sector. The end of 2016 brought negative absorption tied to weaker demand in downtown markets. Among those with whom we consult, we are hearing a general concern about overpaying for properties. Additionally, office space may be developing into a surplus as the space required per employee declines and hot desking become the industry norm. Co-working companies have become an established part of the office sector ecology having moved past the stereotypical small startup to serve as an on-demand headroom buffer for scaling tech companies. In the same way that ridesharing companies have upended the traditional economy around car ownership, so too is the modularization of the workplace nudging part of the office sector from 10-year leases to monthly co-working memberships. These trends—and the speed at which they are unfolding—inject additional uncertainty into the sector.

While foreign investors are still willing to pay top dollar for Class A office properties in major cities, domestic investors are continuing to shift to emerging markets or to Class B buildings in established markets, possibly segueing into a more value-add strategy. We also expect accelerated interest in suburban office parks. There will still be the demand for 18-hour or even 24-hour live/work/play environments, and there is simply more space and opportunity outside of dense urban centers to accomplish such endeavors. The development that occurs here, however, has to take place without capital from REITs or institutional investors. Those organizations typically lack the capacity and the latitude to delve into the level of operations management these properties require to maximize their investment. And those campuses need to be near, if not adjacent to, transit hubs. Moving to the suburbs is one thing. Being cut off from the city altogether is another.

Retail and Industrial

In this year's *Outlook*, we group these two sectors together because their fates have become increasingly and surprisingly intertwined. In traditional bricks and mortar retail, the brutal bifurcation continues. High-end stores and "lifestyle towns" pushing the customer experience envelope continue to do well as prized investments. For everything below that, the future is unclear. As retailers have mastered the challenges of providing customers with access to the same products on their phones or their laptops as can be found and sampled in physical stores, those physical stores become less and less compelling. This trend will accelerate further as technologies like artificial intelligence and virtual reality become further integrated into the retail arsenal. In 2017 and beyond, we expect to see significant de-malling, converting Class B malls to open-air centers with upscale shops, restaurants, and other sophisticated amenities.

In fact, from a long-term real estate perspective, the retail industry seems far more focused on industrial facilities than on storefronts. When the customer can buy a product on his or her phone, the job of the retailer shifts from selling to distributing and, most pointedly, to solving the last-mile problem. But building micro-distribution networks means moving beyond the long-established pool of industrial properties clustered in exurban areas. Retail facilities such as auto parts centers and big box stores thus are being reborn as warehouses and distribution centers. When considered at the transaction level, these moves appear to be the growth of one sector at the expense of another. But viewed from a higher level, these moves simply represent the rearrangement and repurposing of real estate assets along the distribution chain.

From a long-term real estate perspective, the retail industry seems far more focused on industrial facilities than on storefronts.

Investors in industrial properties need to pay close attention to the records and categorization for tax purposes of improvement to fixed assets. Conducting periodic repair and maintenance studies allows cumulative errors in the handling of expenses to be identified, aggregated, and deducted from the next tax return filing. It is also important to ensure that they have the right structure in place to maximize capital gains in disposition. Generally, this means shunning the traditional C-corp structure for an S-corp or LLC that allows income and expenses to be passed through and thus avoid double taxation.

Multifamily

Speculation over the "multifamily bubble" has been a long-running discussion within the industry. While there will consistently be shifts in individual markets, we believe this sector still has runway ahead of it. Millennials as a group will still rent rather than buy and, with 75 million of them and counting, it should be no surprise that confronting the national single family housing shortage by reconfiguring much of the nation's rental housing stock to meet their needs and expectations remains a very long-term endeavor. Even in established millennial hot spots like Boston, San Francisco and Washington, D.C., we will still see significant development/repurposing to create both condos and rental properties. In fact, we are finding that, in many cases, the limiting factor for multifamily expansion isn't demographics, but infrastructure. A third-tier city like Fargo, which has a well-defined downtown, thus has an advantage over a second-tier city like Atlanta, where the population is more diffuse.

Multifamily origination volume experienced another record year in 2016 because of increasing property prices, new completions, maturities, and consistently solid property fundamentals. All of these positive trends continue to make for sound investment opportunities within this sector along with critically interlinked sectors such as self-storage. Moving forward, and assuming demographic trends remain consistent, any new regulatory changes at the federal level designed to boost the economy, improve GDP growth, revitalize infrastructure, and, in particular, boost employment, will likely contribute to the continuing success of the multifamily industry.

Hotels

For the past several years, development in the hotel industry has been largely defined by the substantial supply-demand imbalance of available rooms that came out of the Great Recession. We entered 2016 expecting things to even out by 2019 or 2020. As 2017 begins, however, our view is more conservative with supply likely to catch up to demand by next year. We are nearing the peak of the curve. We can see this in the way that occupancy rates slowed their growth in the last half of 2016, buffeted by lower corporate spending, a stronger dollar, and overall geopolitical turbulence.

There is a good chance that the development side of the industry will experience a soft landing. Banks have begun to pump the brakes, becoming more selective in the loans they make.

There is a good chance, however, that the development side of the industry will experience a soft landing. Banks have begun to pump the brakes, becoming more selective in the loans they make. This move is welcomed by industry veterans who have cast a wary eye on the less-experienced developers who crowded the field when times were flush. Less available capital, the expectation of higher interest rates on that capital, and the continued growth of entities like Airbnb, are all thinning the herd in a productive way. But it would be a mistake for seasoned hotel developers to interpret less competition for deals as an opportunity to become more aggressive. To the contrary, it's time for a disciplined reevaluation of strategies across the board—from fundraising to investments to geographies to the demand of amenities. Developers need to downshift from the pace of the last three years when the common impulse was to get the deal done and worry about the details later.

A gradual dampening of supply, however, will only soften the landing to an extent. Much will depend on the continuation of a favorable economy that can absorb rate increases and sustain an appetite for add-on amenities. With occupancy peaking, analytics-driven revenue management combined with relentless cost control take center stage for managing the top and bottom lines. This is all the more so given the increase in labor costs following last year's ruling regarding exempt employees under the Fair Labor Standards Act.

Conclusion

For the commercial real estate industry, 2017 will confirm near rock-solid property fundamentals and primary market strengths. The year will also test agility and discipline along with the ability to remain hyper-alert and to read signals early. By every qualitative and quantitative measure, we are in a time of ambiguity and complexity.

Potential interest rate changes, demographic trends, regulatory reductions and/or developments, infrastructure investment—it is not enough to understand what is happening without the why. Navigating this complex terrain, however, will not be easy, and not everyone will succeed. Those who do, however, will still find significant reward.

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