RYAN DRAVITZ

Emerging Trends in Real Estate®

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PwC Advisers and Contributing Researchers

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*Canada-based.

Notice to Readers

Emerging Trends in Real Estate® is a trends and forecast publication now in its 40th edition, and is one of the most highly regarded and widely read forecast reports in the real estate industry. *Emerging Trends in Real Estate® 2019*, undertaken jointly by PwC and the Urban Land Institute, provides an outlook on real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues throughout the United States and Canada.

Emerging Trends in Real Estate® 2019 reflects the views of individuals who completed surveys or were interviewed as a part of the research process for this report. The views expressed herein, including all comments appearing in quotes, are obtained exclusively from these surveys and interviews and do not express the opinions of either PwC or ULI. Interviewees and survey participants represent a wide range of industry experts, including investors, fund managers, developers, property companies, lenders, brokers, advisers, and consultants. ULI and PwC researchers personally interviewed 750 individuals and survey responses were received from more than 1,630 individuals, whose company affiliations are broken down below.

Private property owner or commercial real estate developer	26.6%
Real estate advisory or service firm	25.8%
Private equity real estate investor	11.6%
Homebuilder or residential land developer	10.6%
Bank lender	5.9%
Investment manager/adviser	5.7%
Equity REIT or publicly listed real estate property company	3.9%
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Private REIT or nontraded real estate property company	1.6%
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Other entity	2.4%

Throughout the publication, the views of interviewees and/or survey respondents have been presented as direct quotations from the participant without attribution to any particular participant. A list of the interview participants in this year's study who chose to be identified appears at the end of this report, but it should be noted that all interviewees are given the option to remain anonymous regarding their participation. In several cases, quotes contained herein were obtained from interviewees who are not listed. Readers are cautioned not to attempt to attribute any quote to a specific individual or company.

To all who helped, the Urban Land Institute and PwC extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.

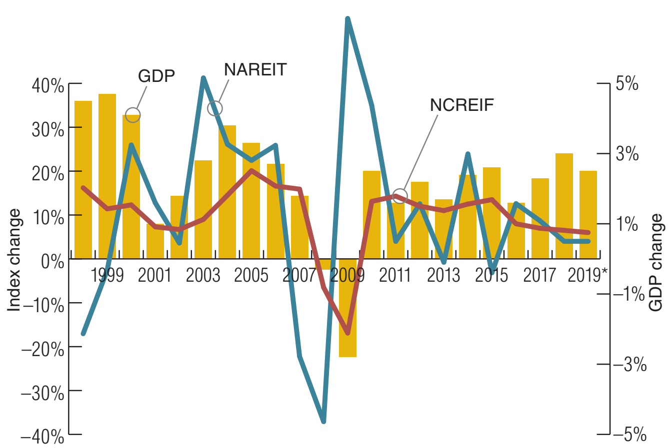
New Era Demands New Thinking

"Real estate as an asset class has matured. Market participants need to realize this and make the appropriate adjustments."

In complicated conditions, organizing principles matter. When a disparate array of circumstances present themselves, the advice frequently comes, "Connect the dots." Many of us will recall puzzle books from childhood where "connect the dots" brought us to a solution that showed a line drawing that revealed the puzzle's theme, the unifying concept that makes sense of an otherwise confusing array of facts.

It is difficult to apply this approach to the emerging trends we discern from our review of the real estate industry this year. Survey responses, commentary from interviewees, and a deep dive into third-party data lead persuasively to the conclusion that the outlook is complex.

Exhibit 1-1 **U.S. Real Estate Returns and Economic Growth**



Sources: NCREIF, NAREIT, Bureau of Economic Analysis/U.S. Department of Commerce, *ULI Real Estate Economic Forecast*.

*NCREIF, NAREIT, and GDP data for 2018 and 2019 are based on forecasts for these indicators in the *ULI Real Estate Economic Forecast*, October 2018.

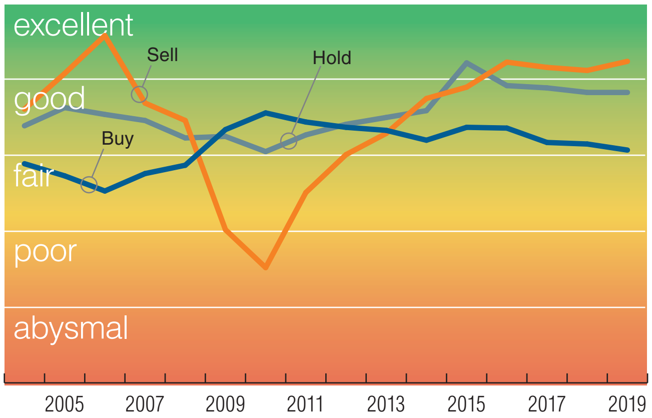
Let's note an important distinction: complex does not mean the same thing as complicated. A 500-piece jigsaw puzzle is complicated, but it is static. Complexity is descriptive of systems, especially dynamic systems, where the elements of the system interact with each other in subtle ways. Those interactions may bring different results in the short term versus the long term, because complex systems evolve and adapt. Sometimes that evolution is surprising.

Surprise is actually a key feature, and a positive one. In a simpler view of things (however apparently complicated), there is some "correct" answer to the question, "What is going to happen?" That is because the modeling of the future is linear, much in the way that lines are the basic tool in connecting the dots. In a world where "what's going to happen" is not so easily predicted, we need to retain a capacity for surprise. A degree of uncertainty is what makes for innovation and creativity. It is the space where our behaviors make a difference.

So instead of using a connect-the-dots model, think of this year's trends as circles in a Venn diagram. One difference between a dot and a circle is dimension. Dots are one-dimensional; circles have area in mental space. Trends will overlap, indicating that they interact, and over time those interactions (sometimes involving more than just two circles) foster new conditions that can alter either the features of the trend, its relative strength, and even its duration. We aren't in coloring-book world anymore.

So, for instance, we will be discussing a trend among investors that proposes a selection process directing some toward "trans-cyclical" markets and others toward "pro-cyclical" markets. That trend has implications for the volume of debt and equity capital that will be required going forward. Some of the industry's "dry powder" may remain in reserve indefinitely, especially if slowing long-term growth accurately depicts the coming decade.

Exhibit 1-2 **Emerging Trends Barometer 2019**

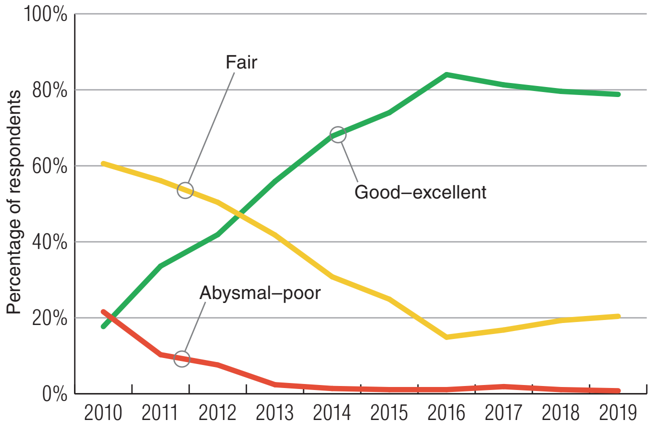


Source: *Emerging Trends in Real Estate* surveys.
Note: Based on U.S. respondents only.

It seems obvious that technology will penetrate the real estate industry in ever more powerful ways as time goes on. But will technology empower real estate by unlocking capacity and enhancing productivity? Or will it accelerate consolidation by favoring those with the capital to deploy technology (including artificial intelligence) and disintermediating more vulnerable participants? Does this lead to a downsizing of the industry?

Suppose that America's multilayered demography is considered in all its complexity, instead of presuming the baby boomers and the millennials will predictably behave as homogeneous units. We can speak about retailing and housing preferences, but how does that relate to conditions of broad income inequality, a falling fertility rate, and rising interest rates? With tens of millions in each of those cohorts, surely diverse paths can be found within each age group. How will those paths influence real estate decision making, taking into account the increasing power of the environmental, social, and governance (ESG) trend affecting owners and users of property?

Exhibit 1-3 **Firm Profitability Prospects for 2019**



Source: *Emerging Trends in Real Estate* surveys.

Certainty, in other words, should be in short supply in considering the future. It helps to be a bit humble. But it is also one of the great joys of living into the future: the capacity for discovering new things and forming new insights. There is, after all, no reason to do research unless you are willing to be surprised.

1. Intensifying Transformation

The pragmatic ancient Romans honored Janus—the deity of transitions, of passages, looking to both past and future. The long-forgotten Janus seemed to lurk quietly in the minds of many real estate practitioners as they reflected on property as a capital asset.

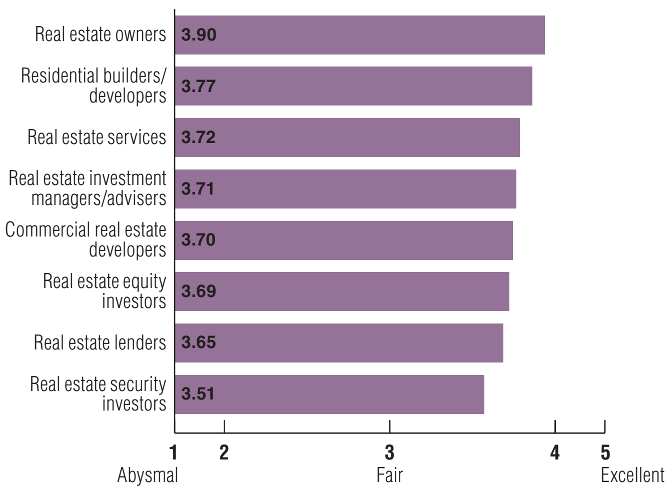
A veteran asset adviser said that "2019 will be a turning-point year. I think about the capital markets correction that is coming. We have been used to easy money and very low rates for so long. Now is the time to harvest, to hedge, to be cautious." Even those who see expansion continuing to 2020 and beyond stress elements of change. The key word for real estate's future performance is *transformation*—in technology, in generational choices, in a reconfiguration of preferences by geography and by property type, and in the potential for new investors in the asset class.

"Coming off a peak" seems to be a theme. One major institutional investor whose base case is for a continuation of the upcycle acknowledged, "We are adjusting a little bit right now." But most interviewees express the opinion that coming off peak does not automatically mean a sharp correction. *Plateau* is a word often used regarding expectations.

It helps to recall the basics about capital. Capital is an accumulated stock of wealth. That is the face of Janus that looks to the past. Capital that lies fallow not only cannot grow, it is subject to erosion from various forces (inflation, most commonly). Because of that, capital is deployed to earn future returns. That is the other face of Janus. Successful investment entails being paid for risk. As an institutional investment manager put it, "I don't get paid to sit in cash. I get paid to invest smartly."

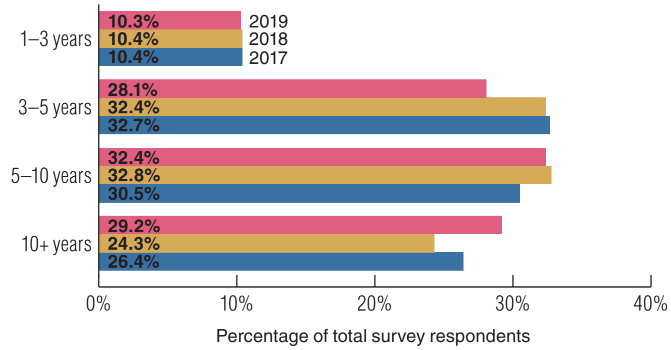
Transformation, therefore, encompasses change in threshold investment criteria, in asset allocation, and in the deployment of technologies that can help identify investment opportunities or enhance the risk/return profile.

Exhibit 1-4 **Real Estate Business Prospects for 2019**



Source: *Emerging Trends in Real Estate 2019* survey.

Exhibit 1-5 **Time Horizon for Investing**



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

As chapter 2 ("Capital Markets") describes, a dynamic story is emerging concerning stratification and selection in real estate financial capital. As investment margins have compressed, capital is being deployed across a spectrum ranging from core assets that are perceived to be "priced to perfection," to opportunistic investments with prospectively higher yields subject to significant questions about future liquidity, price, and user-market attractiveness.

The diversity of investor goals and choices is healthy—far healthier than the herd behavior that has sometimes characterized markets. As an international investment fund executive told us, "The differentiation of opportunities has—to a degree—expanded; niche product types like senior housing and self-storage are being viewed as ways to 'round out' real estate holdings, taking advantage of specialized uses that are not 'averaged out' in major trends."

Many interviewees pointed to the data revolution behind more sophisticated investment behaviors as one of the most thorough-going transformations in real estate, intensifying over time. As one senior researcher put it, "Transparency in data is very powerful. For one thing, it has driven transaction time down." As data have become commoditized (and cheaper), real estate financial markets have become more efficient. Competition is sharper. There is little "low-hanging fruit" left.

To cope with speed requirements and competitive exposure, real estate has been incorporating and developing new technology. Platforms for fintech—a portmanteau of "financial technology"—have been introduced to automate routine functions. Some see a threat of widespread disintermediation in the worlds of brokerage, transaction due diligence, and even institutional investment execution. Blockchain technology is only one of the fintech tools emerging for the real estate capital markets.

We tend to think of investment in terms of financial capital, but physical capital and human capital are very much part of the equation.

Physical capital is undergoing functional transformation. Investment decisions are intensely concerned with elements of obsolescence—locational, technological, design—under the potential impact of innovation. The CEO of an established advisory firm discussed a logistics acquisition where the key property feature is a throughput system designed for last-mile delivery. "Drivers come in at 6 a.m., and the trucks are fully loaded and ready to go. What's important in proptech [property technology] is not apps, it is autonomous [transportation] and related services—a sea change in how we look at real estate 20 years from now." One office portfolio manager remarked something we have been talking about for several years in *Emerging Trends*: "One of my top concerns is that I may purchase an office building that in five years won't meet the needs of the market."

The notion that real estate is a people business has, thankfully, not dropped out of the conversation. Human capital has been very much part of the driving forces in real estate demand, especially in the past 20 years when the competition for talent has become so intense. In an era of slower growth in population and employment (as discussed in trend 2), the market for talent will only be more competitive. Human resource management often is the key to where a company locates and what type of amenities it offers. Real estate that supports that talent competition—in location, design, and live/work balance—will enjoy enhanced financial returns flowing from returns on human capital. Bring in the ESG movement discussed in "We're all in this together" (trend 10) and we see a focus on the "triple bottom line" coming to the fore.

One 40-year veteran in commercial property investment noted this change in his business. "There is more 'joint decision making' now. Executives once made a major decision within the confines of a small, senior group. Now, more stakeholders are brought into the decision. And there is more diversity [in age, ethnicity, culture] among those stakeholders." That's taking advantage of the attributes of human capital, fresh, forward thinking from the upcoming generation of property professionals.

Having established its place as a key asset class, real estate is likely to see increasing capital allocations. Motivations will differ, of course. Offshore private capital seeks a safe harbor and its flow will only be compromised if governmental action in the United States and abroad stifles the otherwise inexorable trend of a more tightly linked world economy. Domestically, the market will need to provide the trillions in individual retirement accounts (IRAs) and defined contribution plans with wider options for direct real estate investment to go along with the real estate investment trust (REIT)–based approach common in the mutual fund industry.

The real estate market is experiencing more than just a transition from one stage of the typical real estate cycle to another. The market is dealing with transformation on multiple fronts. While all the changes may seem daunting, and there are increased risks, there also are opportunities for those who are prepared to move forward in the transformed real estate market.

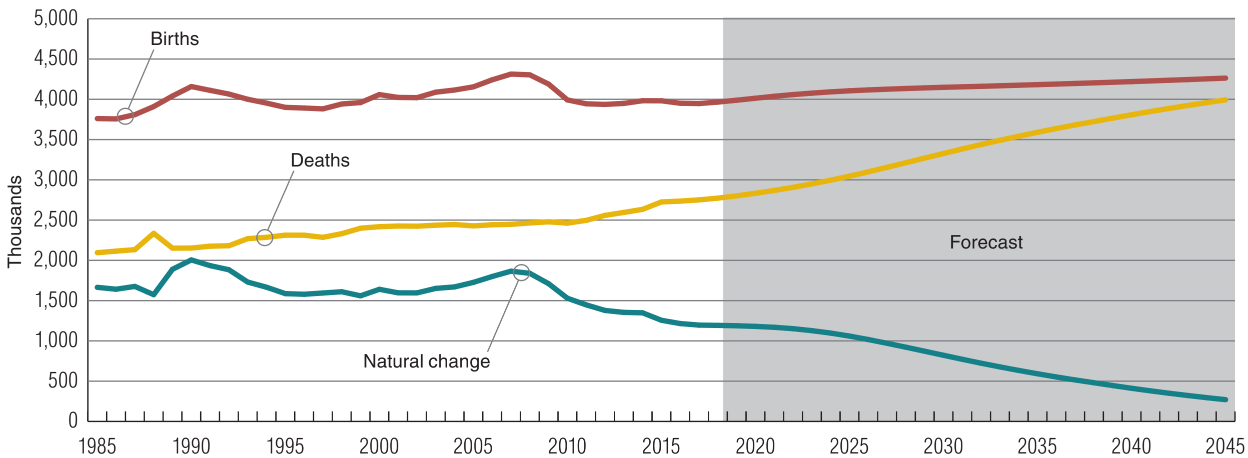
2. Easing into the Future

Don't underestimate the power of the comics pages! For those who might wonder, the terms *whammy* and *double whammy* (now included in *Merriam-Webster's*) were coined in the popular "Li'l Abner" cartoons in the Sunday funnies. But now double whammies are taken seriously, as a senior consultant and investment adviser characterized conditions. "One of the scariest things is that U.S. fertility is way below population replacement. We are not replacing ourselves, but we have always [grown] through immigration." A declining birth rate and sharply reduced immigration represent a double whammy for the U.S. economy.

For some time now, concerns about labor force availability have been top-of-mind for business leaders, in real estate and across the spectrum of industries. It is now nearly two decades since "talent" was identified as the spark for 24-hour city growth, and more recently, for the 18-hour cities. The agglomerative power of talent is the key to productivity, profits, and urban vitality. The top two economic and financial issues highlighted in our 2019 survey results are related: job (and income) growth and qualified labor availability.

The CEO of a construction company active in several gateway cities explained that this issue is not just a question of blue-collar workers. He is having difficulty securing and retaining engineers, architects, and estimators needed to get the most out of advancing technologies. "Building information management [BIM], for example, gets a lot of attention because of its

Exhibit 1-6 **Natural U.S. Population Change**



Source: U.S. Census Bureau, IHS Markit Forecast.