Urban Land Institute
Chicago

Real Estate Forecast 2016

This is a summary of the November 12, 2015 meeting of the ULI Chicago District Council, which gathered at the Renaissance Chicago to hear a national real estate forecast outlined in the **Emerging Trends in Real Estate**® report for 2016.

The keynote speaker was Mitch Roschelle, *Partner & Real Estate Advisory Leader*, PwC. Following his overview of the real estate forecast, the moderator for a Chicago-centric real estate discussion was Keith Largay, *Managing Director*, *Real Estate Investment Banking*, JLL.

He was joined by panelists Kim Adams, *Managing Director*, J.P. Morgan Global Real Assets, and Christine Akins, *Managing Director*, LaSalle Investment Management. They discussed the outlook for Chicago-area real estate in the coming year and beyond.

Whereas last year's Emerging Trends report sounded a cautiously optimistic chord, this year the tone might be described as urgent optimism. While the generally favorable economic cycle appears to have some staying power, anyone who has stayed on the sidelines during the upswing should seek ways to spring into action sooner than too much later.

That's the consensus among the 404 people interviewed and 1,465 surveyed by ULI and PwC researchers. Throughout the 75 markets, from Albuquerque to Westchester, New York, expectations of "good to excellent" prospects for profitability in the coming year were expressed by 84% of those surveyed. That's up from 74% last year, and 56% the year before.

The 84% figure mirrors the sentiment from the 2006 survey. Unlike a decade ago, however, we do not appear to be anywhere close to the brink of a historically harsh recession. "I don't think we are in the same situation we were in 10 years ago," said Roschelle, "and I don't think we have a bubble risk."

Among the mega-trends, Roschelle pointed to some that were carry-overs from the previous year, including accelerating urbanization, demographic shifts, global shifts in economic power, technological breakthroughs, and climate change & resource scarcity.

On the shift in global economic power, Roschelle said that seven “emerging” countries, dubbed the E7 (China, India, Brazil, Russia, Indonesia, Mexico and Turkey), by 2050 will double the G7 countries (U.S., Japan, Germany, the UK, France, Italy and Canada) in collective Gross Domestic Product. One statistic that he finds “provocative” is E7 countries produce three times the number of college graduates than G7 countries.

The middle class in the Asia Pacific will surpass the size of the middle class in North America and Europe combined, he said, noting that the growth of the middle class has spawned the American Dream, and that aspiration is global. In addition, property ownership is a key component of that ideal. So as middle class individuals globally look to invest in property and are in areas of the world struggling with instability of one kind or another, they will increasingly look to invest in the U.S.

“Everybody deems the safest place in the world to invest in real estate is the United States,” Roschelle said. “So this inbound flow of capital that we’re experiencing now…the cap rate compression that has resulted in this foreign wall of capital isn’t going away.”

He also touched on population trends, including the distribution by age group of populations, and their effect on the global labor pool. Nigeria and Costa Rica, for example, are especially younger populations and could be “part of the solution to some of these labor shortages” in other parts of the world.

There are also an estimated 300,000 known jobs for computer coders that are unfilled around the world. “Why is all of this relevant?” Roschelle continued. “Because, when we think about the sustainability and growth of our economy, we need to remember that we’re competing for talent in a global workforce and where that talent sits will have an impact on real estate in the United States.”

He touched on the “disruptive nature” of not only technological breakthroughs, but the rapid pace of those changes. The number of interconnected devices per person, globally, is projected to nearly double from 3.5 in 2008 to 6.6 in 2020, changing the way commerce occurs across all sectors, including real estate.

The ability for entities like Google to track buying patterns will also have a rising influence on real estate. “Big Data is going to be a game changer for real estate in the years to come,” said Roschelle.

The other side of that coin is the impact of cyber-security breaches. Quoting a colleague who specializes in cyber-security, Roschelle said, “It’s not a matter of ‘if,’ it’s a matter of 'how bad,'" he said. "The real estate industry should brace itself, because it's probably been hacked."

Although compromised credit card information that has beset other industries is not the issue, real estate professionals possess sensitive business and personal information that, if accessed by hackers, can create problems, said Roschelle.

Further fueling the vulnerability is that only 60 percent of small businesses and privately owned businesses intend to invest in cyber-security protection.

On a brighter note, the survey revealed that professionals feel interest rates will go up, even as the prospects for profitability are improving.

"What that says to me is the industry is braced and prepared and has baked in a rate growth," Roschelle said. "And they feel that modest rate growth is something the industry is probably impervious to."

As for the top emerging markets, they tend to have a low cost of living and a low cost of doing business. The top 10 cities in 2010 collectively had 112% of the national average cost, and that figure for the top 10 cities in 2016 has dropped to 99%.

Among the other developments that Roschelle touched on:

*Nationally, the leading edge of Millennials is increasingly looking to move to the suburbs, with the top reason being access to quality public education. As a result, investment in public education is a significant infrastructure need, said Roschelle.

*Office space has become more crowded, and that trend will continue. "We have aging office stock and we have a lot of people in them," he said.

As a result, anyone in the office subsector should consider whether there may be sufficient demand soon for the creation of new office space. On the other hand, nearly 1 million people are projected to leave the office workforce in the next decade, while only 410,000 are expected to join it, thus lessening demand.

*The peak of home ownership came in December 2007, but has declined dramatically since then, although it's more expensive to rent (39% of income) than to buy (31%).

"Every generational cohort has dropped the home ownership rate," Roschelle pointed out. "So that American dream, which included owning a home, has certainly been modified to include renting a home for a while."

*Existing home sales have returned to the 15-year average (median: $217,700), while new home sales (median: $293,400) are not there yet. “Affordability is the biggest issue slowing down new home construction and new home sales,” he said.

*Of the industry “dry powder,” he said the caution that it reflects “isn’t a problem.”

“If we have dry powder, it means the industry is being responsible. Not such a bad thing,” said Roschelle.

*On the question of where to locate industrial space in urban areas, “we have to think about where (customers) work” more than where they reside, since they usually ship those online purchases to their office, he said.

During the discussion that followed, Keith Largay asked panelists their view of Chicago as a place to invest, in light of the Emerging Trends report that ranked the city 26th of 75 markets evaluated nationally.

For LaSalle Investment Management, said Christine Akins, “Chicago is much further up on the list.” Other cities that are higher on the list, such as Indianapolis, are “interesting,” but may have less absolute growth and more volatility than Chicago, she said.

Another aspect to note is that in certain sectors, such as multi-family and industrial, Chicago ranks much higher than its overall rating. The office sector, meanwhile, is “very difficult,” she added.

Kim Adams, of J.P. Morgan Global Real Assets, echoed Akins’ views and added that liquidity is a key to keep in mind. “When things go bad again, what’s your liquidity as an institution?” Adams said. “It’s a lot tougher to make a case for Indy than Chicago when you think about it from that perspective.”

As for factors that might prompt an investor to steer clear of Chicago, Akins pointed to the city’s fiscal crisis and rising real estate taxes. “That’s a real concern,” she said.

The discussion turned to predicting the timing and depth of a future recession in real estate, and while nobody anticipated it happening over at least the next few years, Adams offered this upshot: “When our country goes into a recession, the real estate cycle follows…within three to six months.”

Akins noted that in a downturn, it is difficult to replace business tenants, rendering the office market “really volatile.” Meanwhile, investing in the multi-family sector provides a more secure hedge.

The panel tackled the question of market pricing on very large deals, such as Heitman's $330 million purchase of the new 504-unit apartment tower at 111. W. Wacker Drive, which Adams' and Akins' firms explored.

"Very broadly speaking, we have come to terms with, in this environment, we will be conservative in our rent growth, so there's room for cash flows to outperform and we'll accept a lower yield," Adams said. "I think that's really the way we're starting to look at things."

"Only time will tell," she added, "if we missed an opportunity and Heitman was right, or they overpaid for the asset."

At Largay's prompting, she also discussed the acquisition of the site of a former furniture mart that was redeveloped by Shorenstein Properties LLC and occupied by Twitter, in San Francisco's Tenderloin district. Though in a gritty part of the city, "there's a coolness factor that is really relevant to these renters…..it's something unique about the building," said Adams.

Another factor is that the area is "emerging" and the neighborhood has "long-term viability" in case Twitter leaves and new tenants need to be secured. The roughly one million square feet of space is hard to find anywhere else for headquarters in San Francisco, she added.

Also key—and largely overlooked by the media, she said—is that J.P. Morgan reduced its exposure on the deal by sharing the equity with a sovereign "and then we levered it up."

"So the net asset investment for the fund was less than 1 percent of the fund," Adams said. "I wouldn't have done that deal if it was a greater exposure. I do think there's some risk in it, but I think the real estate itself is quality and that if Twitter leaves, there's an opportunity to raise rents."

She went on to describe the Twitter office in Chicago, at 111 N. Canal, as "a core fund manager's dream" with a great location by the train stations, a high-quality asset and the prospect of rent growth "a bit of a risk, but it makes sense."

When asked what opportunities she sees in the Chicago market, Akins said "niche strategies" such as medical office, self-storage, and parking. With regard to parking, Akins said that it represents a "great exit strategy" in urban settings to be transitioned later to a "highest and best use" with another product type.

Roschelle affirmed Akins' views, noting that some of the best bets for 2016 were medical office, adaptive reuse of suburban office space into specialty medical offices, senior housing and student housing.

In terms of money flow, Akins and Adams agreed that it should continue to be strong, between foreign investors (Akins anticipates much more Japanese investment, for example) and, said Adams, domestic public and private pension plans.

"We're still raising significant amounts of capital," Adams said. "A lot of it has to do with risk profile of a lot of these guys, and how funded they are. When you look at longevity tables, everybody's retirement plans are shifting out. They're living longer and when they thought they were 70 percent funded as a plan last year, now they're only 60 percent funded as a plan."

Among the subjects covered during the closing question-and-answer segment with the audience was industrial and retail real estate prospects. In the industrial sector, said Adams, there is "still opportunity for rent growth, but it's moderating a little bit."

The most important words over the next 12 to 18 months in industrial real estate will be "the last mile," referring to the final phase of delivering products to consumers, said Roschelle.

"The last mile is going to connect retail and industrial," he continued. "The last mile may very well be in a stick-and-brick traditional retail store, where the customer has to go and pick it up."

On that thread, Akins said LaSalle has been looking into the truck terminal "way station" concept, in which huge trucks unload products that are then distributed by smaller trucks.

"There's no storage, there's no manufacturing happening," Akins said. "It's just a long, skinny building with a million doors on one side and a million on the other side…It speaks to the last mile. It's very much connected to e-commerce."

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