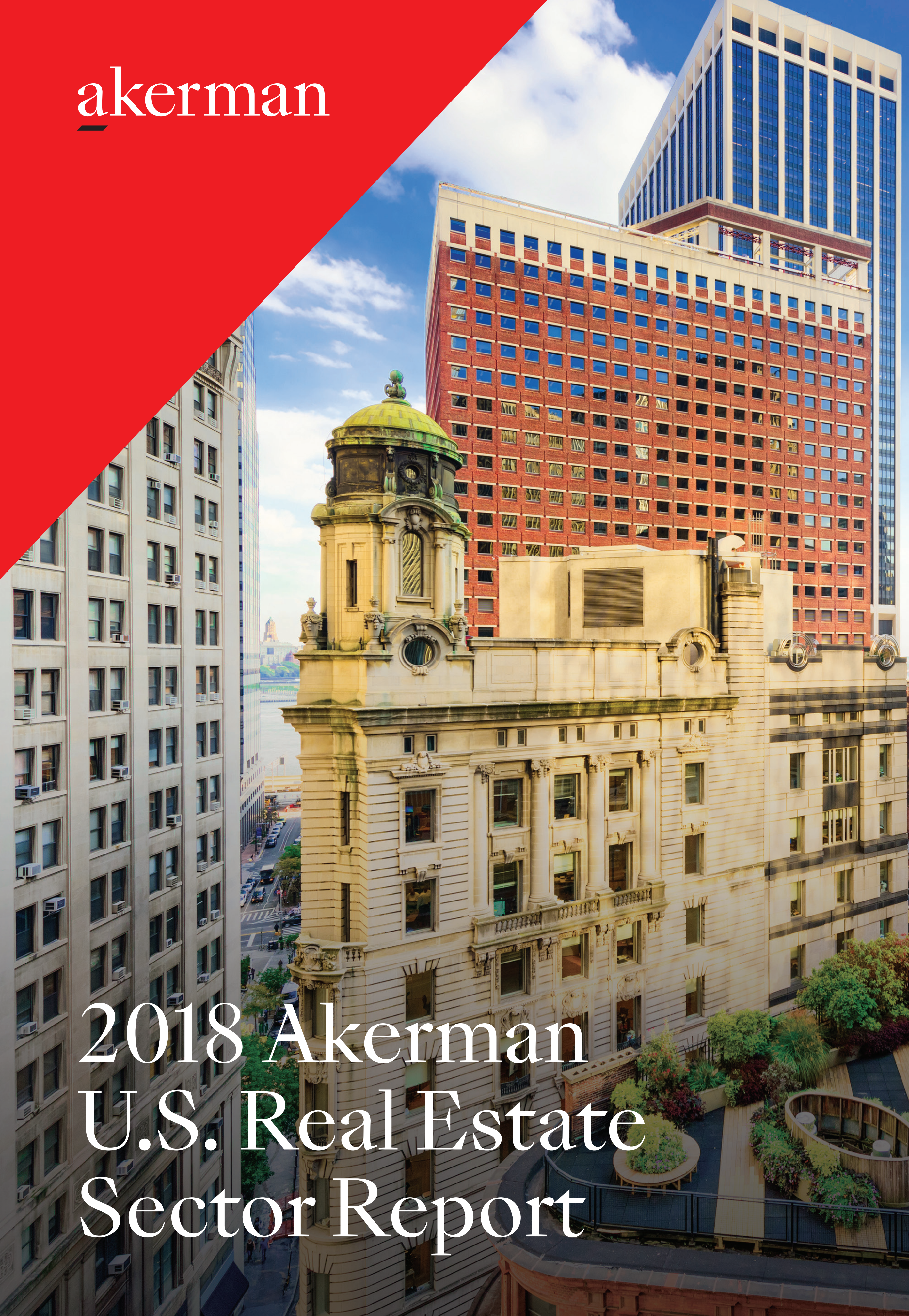
akerman



2018 Akerman U.S. Real Estate Sector Report

The 2018 Akerman U.S. Real Estate Sector Report provides insights on the economic conditions affecting the U.S. commercial real estate market. Akerman clients and other top real estate executives across the United States contributed through online interviews as part of an annual Akerman Survey. For nearly a decade, the Akerman Survey has captured the perspectives of industry executives to provide a view from the C-suite, highlighting the complexity of key market conditions, including capital availability, investor trends, and drivers of growth.

Recognized as a national Tier 1 law firm for real estate and construction law by *U.S. News – Best Lawyers* (2017), Akerman offers substantial sector experience and local market insights. Akerman's professionals manage the legal aspects of large land deals and major construction projects, assist developers in meeting environmental regulations and green building standards, conceptualize and obtain development incentives, advise on all aspects of transactional work, including leasing, acquisitions, sales, and financings, and represent clients in litigation matters.

Akerman is a top 100 U.S. law firm recognized by the *Financial Times* as among the most forward thinking firms in the industry. Our more than 700 lawyers and business professionals collaborate with the world's most successful enterprises and entrepreneurs to navigate change, seize opportunities, and overcome barriers to innovation and growth. We are known for our results in middle market M&A and complex disputes, and for helping our clients achieve their most important business objectives in the financial services, real estate, and other dynamic sectors across the United States and Latin America.

Our Findings

> I think there's a cautious optimism out there, and for the next few years commercial real estate appears to be a big winner in tax reform.
>
> – Eric Rapkin

Chaos and Commercial Real Estate

Doing business when chaos is not a bug but a feature of government

Before November of 2016, no one could have been blamed for thinking, as many commercial real estate executives did, that the year's presidential election boiled down to a choice between a Democrat — whose likely effect on the sector would range, in part because of her connections to business and investment communities, from *Not Too Shabby to Not So Bad* — or to the Republican long-shot change candidate, a tax-averse, pro-business real estate tycoon, whose experience in the industry portended an unprecedented opportunity. This strong industry-wide signal — that a Trump presidency, however unlikely, would be great for business — suggested a theme for last year's Akerman Report: "Predicting the Unpredictable." That analysis made a case for successful real estate investment and development, framed by an election year contest and set against the backdrop of looming uncertainties — a sense that a maturing economic cycle couldn't go on forever. A sense that, if the election favored the Democrats, the fragile economy might stall because of legislative gridlock between two polarized political parties. And, a healthy skepticism about whether a Trump presidency, should that come to pass, could actually live up to all of its promises of deregulation, tax cuts, and an overall pro-business desire to correct perceived excesses of the past administration.

Post-election, the much-anticipated bobsled run of swiftly passing legislation, the *swooshing* sound of business-friendly bills racing through a Republican-controlled Congress and signed into law by a Republican president — tax cuts, bank deregulation, an infrastructure bill, the repatriation of billions of offshore corporate taxes — all these things kept appearing and dissolving. With the exception of a tax bill at year's end — a significant piece of legislation that this year's Akerman Report will explore — the commercial real estate sector, ever attuned to the rhythm and flow of government affairs, has watched as gridlock continues to grip the capital with intensified partisan rancor.

Which of the following trends do you predict will have the most significant impact on U.S. real estate development over the next three years?

"Allowing that chaos will be part of the given context for doing business, what sectors will likely thrive, despite all the commotion, what investment and development strategies will cut through the chaos to find ways to engage with the emerging signals of opportunity that transcend the noise?"

Against this kind of backdrop, who would volunteer to predict what will happen tomorrow, let alone forecast how policy and legislative decisions in the "Trump era" will play out for the commercial real estate sector as a whole? The 2018 Akerman Report reframes this question to ask what most commercial real estate observers will find themselves asking, anyway: allowing that chaos will be part of the given context for doing business, what sectors will likely thrive, *despite all the commotion*, what investment and development strategies will cut through the chaos to find ways to engage with the emerging signals of opportunity that transcend the noise?

Happy Hour in America: The U.S. Economic Signal –Good, For Now

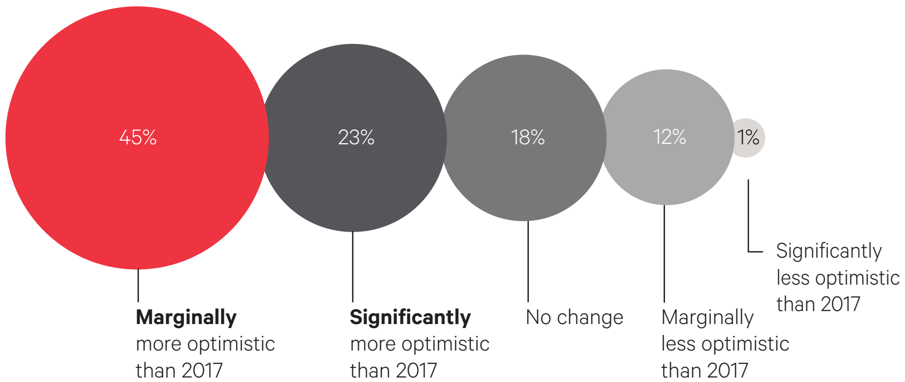
One way to start is with something less susceptible to the inexorable churn of news cycles —with the proverbial economic ship navigating choppy seas. Not much can alter its course, and it seems to be headed in the right direction: the U.S. economy grew 2.3 percent in 2017, for instance, compared to 1.5 percent in 2016. Some economists suggest the GDP could even hit an annualized rate of 3 percent by the end of 2018.[1] "I think there's a cautious optimism out there," says Akerman's Eric Rapkin, "and for the next few years commercial real estate appears to be a big winner in tax reform." While there may be some headwinds, primarily in the form of rising interest rates, "if that means that of 15 projects in a neighborhood that only 3 or 4 of them will now get built, maybe that's a good thing," says Rapkin.

All of this looks promising, of course, but some of the rise in GDP will come from one-time benefits to corporations from the recently passed tax bill and new additional incentives for global companies like Apple, Facebook, Google and others to, in effect, repatriate their earnings. Part of the GDP bump over the next two years, in other words, will likely represent changes in accounting methods rather than real economic growth, which some project will be in the neighborhood of 2 percent.[2] A consensus view of economic forecasters, moreover, seems to echo the International Monetary Fund's recent projections that US GDP will begin decreasing after 2020. One forecaster likened the nature of the tax bill's effect to "happy hour in America," a temporary state of economic euphoria before the inevitable hangover to come.[3] "The prevailing view of the real estate community is that they came out on the right side of this tax bill. For the most part, incentives to invest in and to improve real property, have survived the gauntlet," says Akerman's Marc Heller. "All other things being equal, real estate investment should continue on as it has been for the reasonably foreseeable future, tempered perhaps by interest rate pressure," Heller adds.

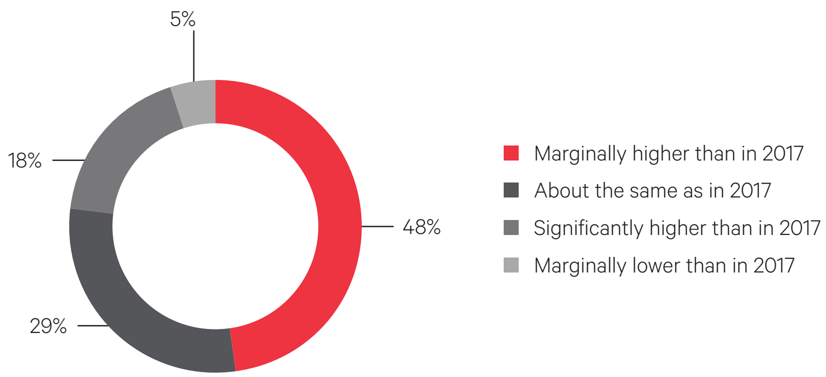
A view with some perspective on the festivities would seem to be in order. Rising GDP is a notoriously ham-fisted indicator, for instance, that can't be relied upon, according to some analysts, to generate an accurate picture of how an economy is performing, and for whom, and what this might tell commercial real estate investors about where to invest and what to invest in.[4] In a more granular assessment of economic performance, the United States ranks fifth among the world's top seven economies, according to the World Economic Forum.[5] And when it comes to who is enjoying the benefits of economic growth, the U.S. is bouncing along the bottom of the world's top 30 economies — ranking 28th in terms of economic inclusiveness and 29th in both net income inequality and in wealth inequality.[6] What's more, middle-income households, the often-cited engine of the economic ship, experienced a 6 percent decline between 1999 and 2014, losing ground financially in 222 of 229 U.S. metropolitan areas studied by the PEW organization over that same period.[7] Some of that movement was upwardly mobile, but in nearly half of the U.S. metro areas studied, middle-income households dropped downward to lower income levels.[8]

"All other things being equal, real estate investment should continue on as it has been for the reasonably foreseeable future, tempered perhaps by interest rate pressure."

Which of the following best describes your outlook for the U.S. real estate market in 2018?



Do you think U.S. job creation in 2018 will be...?



Indeed, a profound and besetting economic disconnect exists — some have called it two entirely separate economies, each rubbing the other the wrong way — one in which a middle-income male earned 9 percent less in 2014 than his historical counterpart did in 1973, even though the economy has grown 200 percent and high wage compensation has jumped 41 percent over roughly the same period.[9] For one demographic segment that is vital to the commercial real estate industry — the more than 80 million millennials who now represent the largest generation in the labor force — disposable income is scarcely higher in real terms than it was 30 years ago.[10] As one publication put it, "the three-decade-long exacerbation of income inequality, wage stagnation, and regional economic disparities threatens the breadth of the demand drivers across the economy, and for real estate as well."[11] It also seems unclear if wages have really started to grow, and if and when they do, how will this impact various sectors within the real estate markets. "When wage growth really takes hold, will rentals become less attractive, will this drive more buyers towards home ownership, be it single family or condominium," questions Akerman's Cecelia Bonifay. "Does this continue to drive people to areas where they can experience the more traditional suburban comforts of a bigger yard, and access to great schools — thereby creating need for the growth of the retail/restaurant "surb" in which the live/work/play concept has been adapted to a more suburban use?" It will be interesting to see how this plays out, and the ripple effect of those changes.

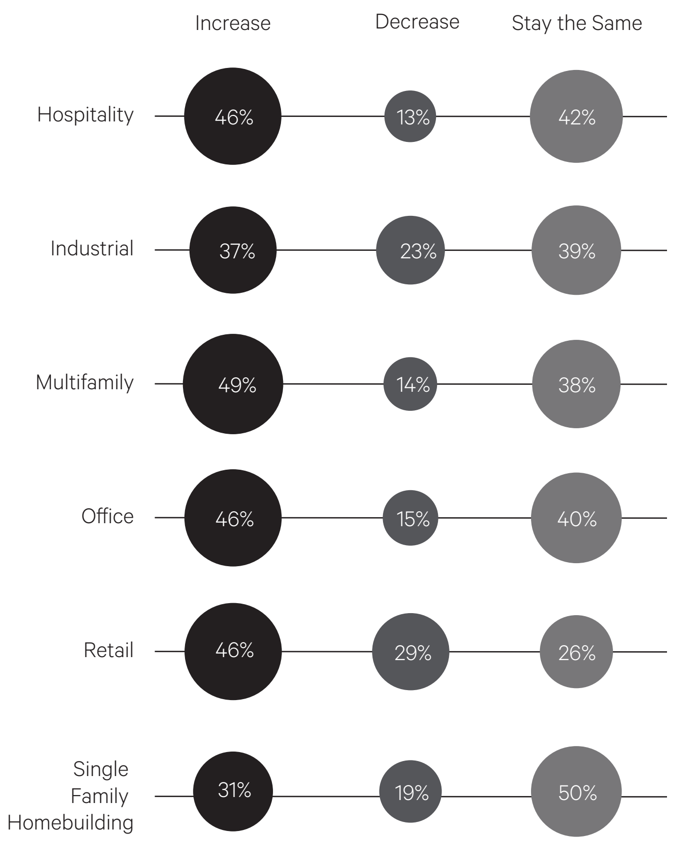
The spread of automation, moreover, beyond manufacturing jobs and into office support, clerical, legal support, long-haul transportation and other fields will require up to 54 million people — one-third of the projected 166 million workforce in the United States — to find new occupations by 2030, with the percentage share of middle-income occupations representing the largest share of employment declines.[12] The numbers show an economy that's doing well, however the reality is that the way the economy is doing well doesn't give many people a feeling of security or confidence in their futures.[13] This alone, if true, should give everyone in commercial real estate pause. Happy hour may be here, but then what?

> "It seems unclear if wages have really started to grow, and if and when they do, how will this impact various sectors within the real estate markets"

Happy Hour, or Faustian Bargain?

The further down the economic road you look, the more you see a constellation of improvident alignments taking shape that will likely make the next economic downturn very painful for low to middle-wage Americans and very difficult, some say, for policy makers to correct. The debt load held by the public, a significant indicator of economic drag, is projected to grow alarmingly over the next thirty years. The Congressional Budget Office recently projected the country's public debt-to-GDP ratio (now at 75 percent) will hit 89 percent by 2027, but the nonpartisan Tax Policy Center suggests that public debt-to-GDP will reach 106.5 percent by then and soar to 148 percent by 2038, reaching nearly 200 percent in 2048.[14] That future, if it comes to pass, would make the U.S. economy look something like Japan's current economic quagmire. Indeed, Japan's stalemated economy has a current public debt-to-GDP figure of 126 percent and an anemic GDP growth of 0.40 percent, compared to the 2.3 percent U.S. GDP growth, as of Q-1 2018. This should provide a cautionary glimpse of what may lie ahead for the U.S. economy if corrective measures aren't taken.[15] More problematic, however, is what will be required in the near term to keep the debt-GDP ratio from getting so far out of line: immediate and permanent tax increases or spending cuts totaling 4 percent GDP starting in 2018 to bring the debt-to-GDP ratio in 2048 in line with today's current levels, according to the Tax Policy Center.[16] That means immediate spending cuts of about 21 percent or tax revenue increases of 24 percent relative to current levels.[17]

How do you expect cap rates to perform in 2018 for the following market segments? Do you expect them to increase, decrease, or stay the same?



Some analysts, pointing to the deficit, say that tax cuts during times of economic growth are profoundly improvident.[18] A "hard landing" argument suggests that when the next downturn happens, policy makers will be unable to do much about it. On the one hand, lawmakers, pointing to the already enormous deficit, will be loath to vote for a rescuing fiscal measure that adds more to it. "The nation's debt-to-GDP ratio rose by about 35 percentage points in the most recent recession," The Tax Policy Center noted recently. It is hard to believe that policy makers or financial markets would look kindly on the U.S. needing to borrow another 35 percent of GDP should another recession hit.[19] But the only other course-correcting tool at their disposal — monetary policy in the form of the Fed lowering interest rates — won't work if those rates are already low, as they are now. The Fed will need higher interest rates to acquire some throttle power over the economy, but, lacking that, as another analyst noted recently, "the simple fact is that right now the United States is largely bereft of weapons to fight a recession."[20]

Hardly anyone thinks that a recession is about to happen — but it's worth remembering that economists are historically terrible at forecasting recessions. One recent long-term study, in fact, found that the average, private sector GDP forecast in the April preceding a downturn was more than 200 percent off the mark.[21] The IMF's famously mistaken forecast in April of 2008 — that

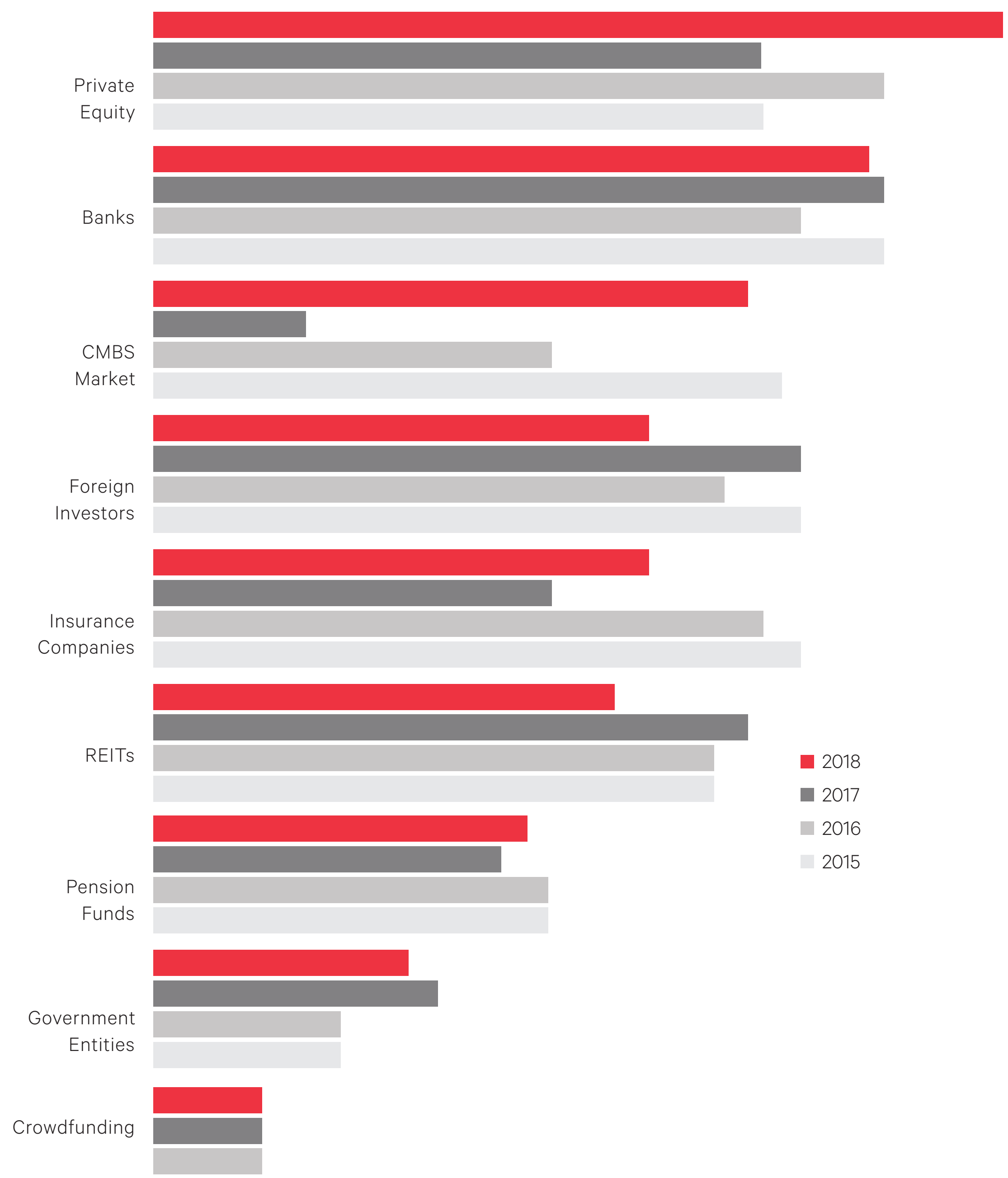
> "Some analysts, pointing to the deficit, say that tax cuts during times of economic growth are profoundly improvident."

"The markets, right now, still seem to be strong, the demand is still strong. The fundamentals are strong."

the U.S. economy would grow 0.6 percent the following year — was wrong by 123 percent, yet this was still better than the 200 percent average margin of error.[22] And that may be worth noting when economists in The Wall Street Journal put the probability of a recession with the year at a distant 14 percent, or the New York Fed puts the chances at 10.4 percent, or the St. Louis Fed puts the number at 28 percent.[23] And when economists finally do begin speaking of recessions, it seems they can't be sure that their projections are accurate until the tenth month of a recession year—so they're a bit less like Nostradamus, a bit more like witnesses to a train wreck.[24] That said, there are those who would appear to be alarmist like Ray Dalio, the billionaire investor who told Lawrence Summers during a forum at the Kennedy School of International Politics this year that the probability of a recession prior to the next presidential election was relatively high —around 70 percent.[25] Or Joachim Fels, a global advisor at PIMCO, who put the chances of a global recession within the next five years at 70 percent.[26] So are these projections laughably wrong, or — late into an economic cycle already showing warning signs that have been predictive of all nine of the last recessions since 1955 — will they prove to be remarkably prescient?[27] "The markets, right now, still seem to be strong, the demand is still strong. The fundamentals are strong. People will say, it's the longest running recovery we have ever had and eventually must come to end," says Akerman's Richard Bezold. However Bezold notes, "There is a sense of caution as to what the markets may look like in a year or two's time."

Maybe neither is the right answer. The point would seem to be, as we examine the results of the Akerman Real Estate Sector Survey for 2018, about the fiscal burdens we are leaving to future generations, on the one hand, and the quicksilver flash of a tax cut which, when the inevitable recession comes, may be remembered as a near-term Faustian bargain that left future decision-makers without the two main tools — fiscal policy, monetary policy — that others in history, facing calamitous economic times, have used to steer the U.S. economy out of trouble.[28]

Which three of the following do you believe will fund the most commercial real estate debt and/or equity in 2018?



"A recent study of lower-wage workers concluded that no full-time minimum-wage worker can afford a 2-bedroom apartment in any U.S. state."

A Renter Nation?

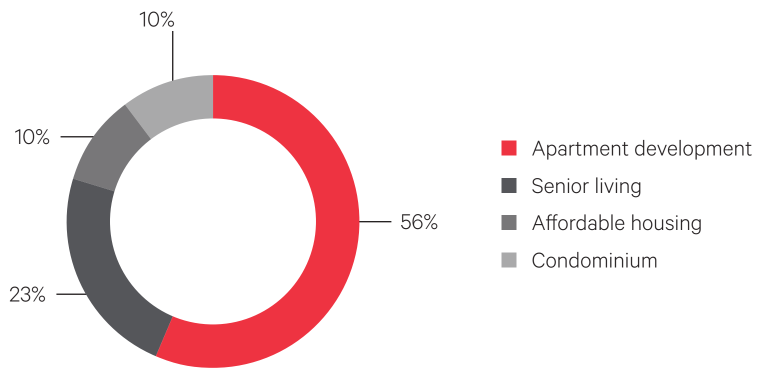
Driven in large measure by automation, the great economic divide has gone a long way toward creating an economy of workers, middle-income families, and millennials who can shop online, who increasingly have come to expect fresh groceries to be delivered to their door — but for whom home ownership feels, more and more, like a door closing on a dream.[29] While millennials continue to purchase more homes than other generations (one third of all homes were purchased this year by millennials), the effect of this demographic on the marketplace has been dampened by high student debt and high housing prices. By and large, America has become — and will in increasing proportions remain — a nation of renters, and this, in turn has had a dramatic effect on one section of the real estate market.

On the other end of the spectrum, you have rent as an appealing alternative, a reaction in some of the higher priced markets to tax code changes limiting their deductions on real estate. "When you look at real estate taxes on some of the big condominiums being built in Chicago," says Akerman's Jack George, "you are looking at upwards of $60,000 in real estate tax." Based on the new changes, this may be a large investment pill to swallow. George adds, "Some of those people will instead decide to rent a luxury apartment and avoid the burden. "We don't yet fully know the scope of these changes, as to how that is going to shift ownership to the rental of luxury apartments," notes George, "but we do know that there will be an effect on the rental market."

Even within the spectrum of renting, affordability looms large: on the one hand, middle-income rental households are discovering that rent is eating into more of the family budget. In a report published this year, average fair market rents rose faster than weekly wages in 266 out of the 447 counties, or 60% of housing markets.[30] The Joint Center for Housing Studies at Harvard estimated last year that over 9 million people living in the United States are "moderately burdened" by rent (where rent constitutes 30 to 50 percent of their income) and 11 million are "severely burdened"— people for whom rent is 50 percent or more of income.[31] Putting it all together, a startling figure emerges about the great American economic divide — when you combine renters and homeowners together, more than 39 million people live in housing that they cannot afford. At the lowest end of the scale, the situation is more dire: a recent study of lower-wage workers concluded that no full-time minimum-wage worker can afford a 2-bedroom apartment in any U.S. state.[32] In many larger cities we are seeing creative responses, such as the micro-unit, as well. "For years, the trend was increase in zoning code minimum unit sizes, and now for the last three to five years, we are beginning to take a radical turn back to the past to allow these micro-units," says Akerman's Neisen Kasdin. In Miami a micro-unit ordinance is being passed which would allow units under 400 sq. ft., more like a dormitory style development. We are seeing these units being unveiled in other markets such as Chicago and New York, and even in other sectors such as hospitality.

Which of the following market sectors do you predict will be the most active for real estate transactions in 2018?

Within the multifamily sector, which do you think will be **most active**?



"...technology has had — and will continue to have — a profound effect on the basic structure of the U.S. economy."

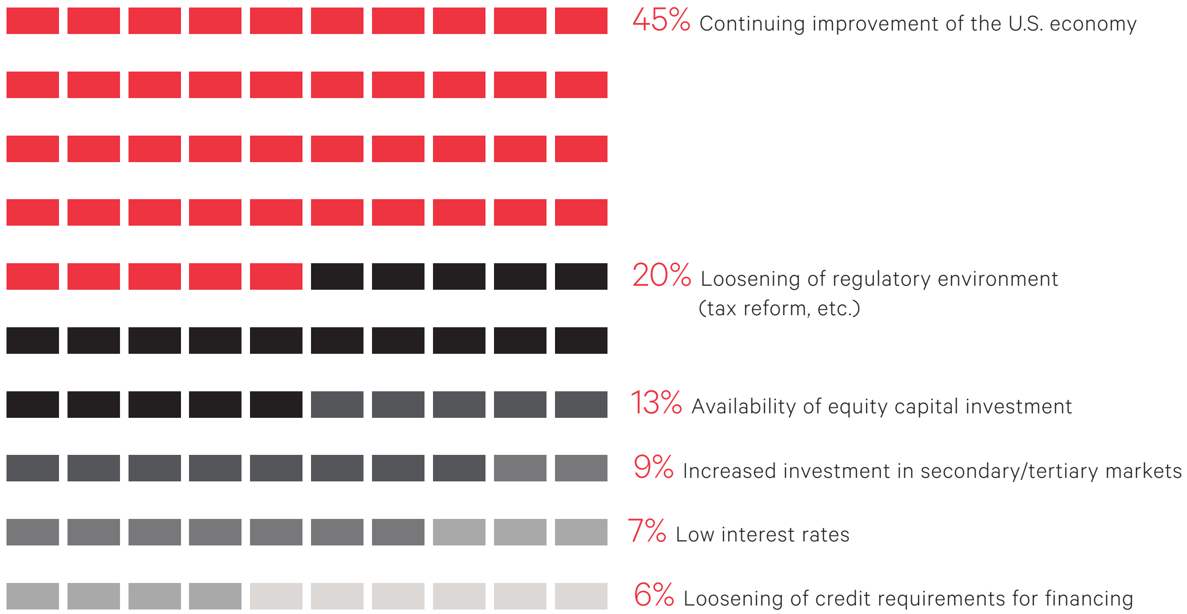
Optimism Remains for the 2018 Akerman Real Estate Sector Survey

Against this backdrop, the 2018 Akerman Survey reflects near-term optimism for the commercial real estate sector, with 45 percent saying their confidence is largely due to improved economic conditions, as well as to changes in the tax code and the promise of a loosening regulatory environment. The respondents are bullish on the job market, with two-thirds (66 percent) saying that job creation this year will be either marginally (48 percent) or significantly better (18 percent) than last year — and this was even before the April labor report showing the unemployment rate had dipped below 4 percent, to 3.9 percent — the first time it had done so since 2000.[33] "In Los Angeles we have major project developments that recently completed and that are on the horizon – from major mixed use projects to stadiums, re-envisioning convention center space and preparing for the Olympics," says Akerman's Susanne Zabloudil, "There is no shortage of people coming into the city to visit and to live, and the real estate community is responding." Taken together, the next few years look sunny for the industry, with almost two-thirds (63 percent) of real estate executives surveyed saying that they are optimistic for the coming year compared to last year. "I think the economy is rather robust," says Akerman's Allison Nelson. "We may see rising interest rates, and this will shift things slightly, but that may be a healthy thing."

Technology's Impact on CRE is Top Trend in 2018

The Akerman Survey asked respondents to identify the top two trends — out of six total — that will have the most significant impact on the real estate market in the next three years, and the results, given the significance of the tax bill for the commercial real estate sector, were surprising: nearly half of the respondents (48 percent) ranked the "effects of technology on real estate" as either the most important trend — jumping two places from last year's Akerman Survey to the top spot this year. The "tax reform/changes in the tax code" was clearly important — but it ranked second, with 36 percent of respondents identifying the effect of the tax bill as the most important trend in the next three years. But this is less surprising than it seems, as technology has had — and will continue to have — a profound effect on the basic structure of the U.S. economy.

Which of the following is your primary reason for confidence in the U.S. real estate market?



Which of the following is your primary reason for any lack of confidence in the U.S. real estate market in 2018?

46% Interest rate uncertainty

29% Uncertainty in global economic conditions

14% Pace of recovery for fundamentals in core sectors

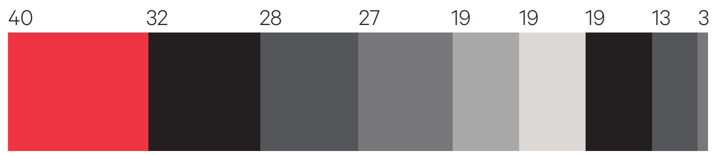
7% Federal gridlock and uncertainty of government policy

4% Tax reform/ Changes in tax code

Top Concerns for the Sector: Interest Rates and Economic Uncertainty

But these feelings of confidence are also tempered by genuine concern that an economic reckoning may not be too far from view: asked to choose their primary concern with the commercial real estate marketplace, nearly half (46 percent) of all Akerman Survey respondents pointed to "interest rate uncertainty"— which represents a jump from last year from the third-most important concern to the topmost industry-wide bugaboo. Indeed, asked to rank 8 concerns facing real estate, 40 percent of Akerman Survey respondents ranked "interest rate uncertainty" as a top 1 or 2 concern. "Interest rates rising is something everyone is keeping an eye on, and could very much impact the real estate market," notes Akerman's Rick Leland. Leland adds, "There's no shortage of people with money to invest, and what we don't want to see is rates pricing up assets and making transactions more difficult." Despite the over-arching near-term economic boosterism, a significant portion of respondents--nearly a third (32 percent) — are keeping a sober weather eye on the dark part of the far horizon — ranking their "uncertainty of economic conditions" as a first or second primary concern. This concern about longer-range economic uncertainty aligns with the results of several other recent surveys and forum discussions in the real estate world.[34]

Which of the following do you believe are the **most significant** factors affecting the real estate industry right now?



- Interest rate uncertainty
- Uncertainty in global economic conditions
- Availability of institutional credit
- Rise in purchase prices or reduction in cap rates
- Availability of equity and mezzanine financing
- Decreased foreign investment in the U.S.
- Need for new infrastructure
- Federal gridlock and uncertainty of government policy
- Other

> "The market became creative and will continue to do so in the face of change, whether it be driven by tax and economic policy, or market conditions."

Interest Rate Concerns Spur Growth of Debt Funds

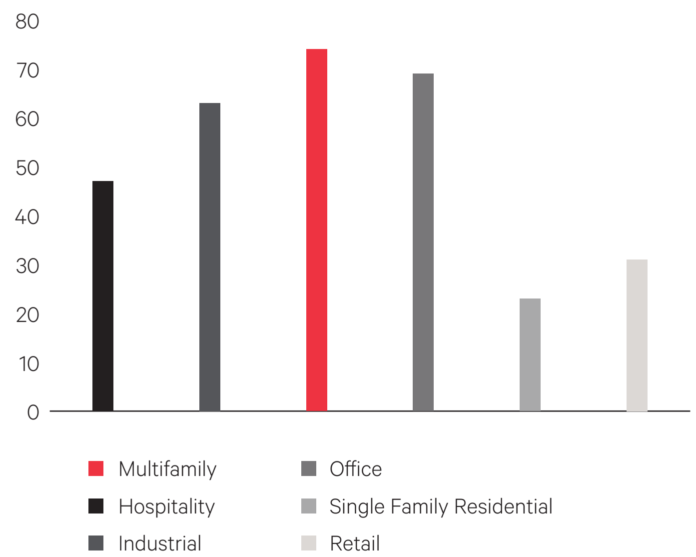
That interest rates have jumped to a top of mind concern is probably not about whether those rates will rise, but how often and how fast. The Fed lifted the federal funds rate to between 1.5 and 1.75 percent recently, and the minutes from the March Fed meeting suggest that the Fed is inclined to escalate the pace of rate rises to 2.9 percent in 2019, to forestall overheating the economy.[35]

For the commercial real estate industry, rising rates are expected to put upward pressure on capitalization rates, with one sector, industrial, faring better than others, but the longer-term, cumulative effect over time is what sets many on edge. Indeed, the Akerman Survey results reflect this concern, with about half of the respondents projecting that cap rates will increase in multifamily, hospitality, office, and retail.[36] As a response, the appetite for debt funds is booming, with nearly a third (32 percent) of investors surveyed this year by CBRE saying they are actively pursuing real estate debt funds in 2018.[37] Indeed, investors — especially foreign investors – are increasingly looking to the safer harbors of real estate debt funds which, at the end of Q-1, 2018, are on pace to match the record level of $28.6 billion set last year, making debt funds one of the most robust alternative real estate investment markets this year.[38] "The lending market as a whole has become progressively more challenging with the advent of BASEL III and HVCRE regulation," noted Akerman's Steven Polivy, "but this has also created opportunity with the debt funds and transitional lenders, as well as alternative lending sources, who have come in to fill that void. Polivy added, "the market became creative and will continue to do so in the face of change, whether it be driven by tax and economic policy, or market conditions."

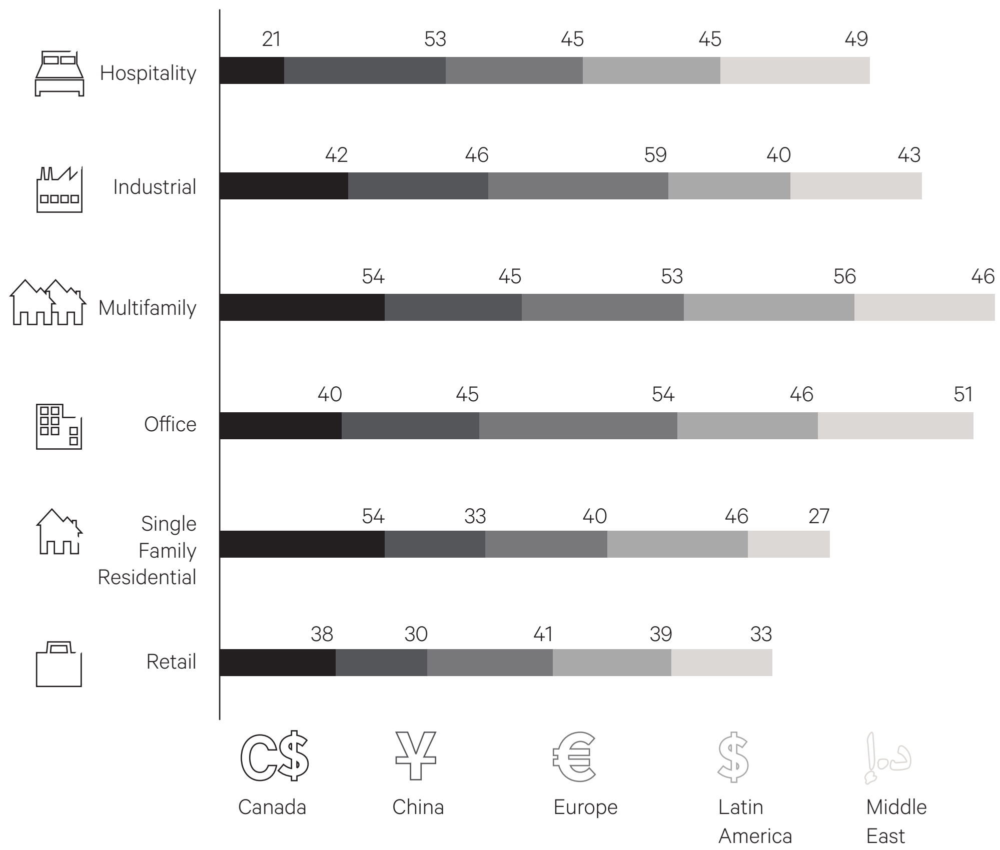
What to Watch throughout 2018—Markets, Sectors, Technology Trends, and Funding Sources

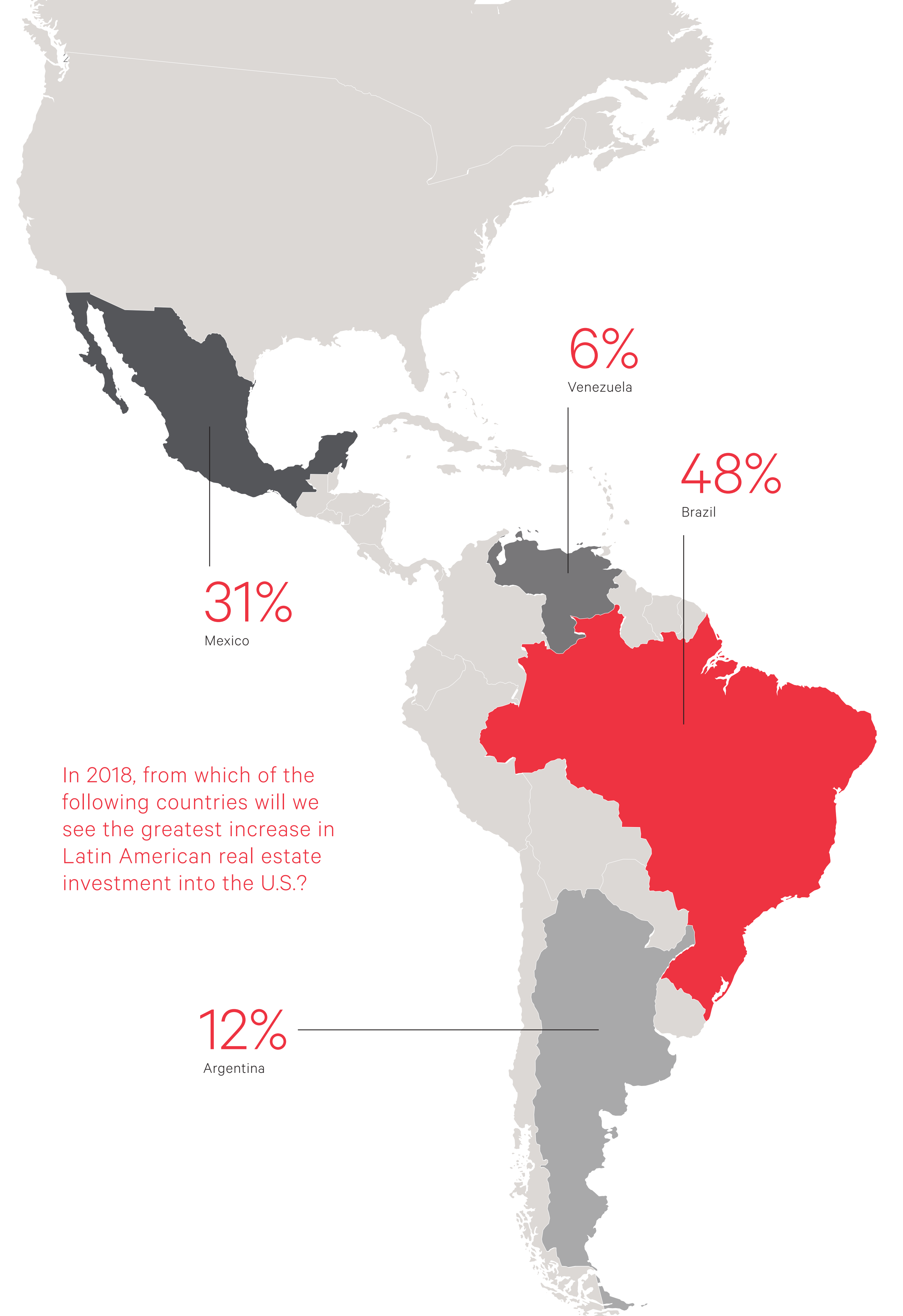
Akerman thought leaders will further investigate the ideas that have risen to importance throughout our Survey including the impact of technology on commercial real estate including such trends as automation, stagnant wage growth, and the national migration trends for several real estate sectors and how these features have played a significant role in the burgeoning multifamily sector — about which nearly two-thirds (64 percent) of this year's Akerman Survey respondents feel will be the most active real estate sector this year. We will also examine why three quarters of this year's Akerman Survey respondents feel that the multifamily and industrial sectors will be the most active markets, especially for foreign investment, and why most of each sector's growth will be focused primarily in secondary cities, in the American interior, in suburban centers, and in selected alternative real estate sectors. Because of the importance to the industry of the Tax Cuts and Jobs Act, we'll take a close look at which sectors will likely benefit the most and how the new tax code will likely alter investment strategies moving forward. We'll also take a look at the likely outcomes of other important proposed pieces of legislation and policy — in bank deregulation, in infrastructure, and in the proposed economic trade tariffs. Finally, we will further examine the ways that real estate markets are adapting to drought, particularly in California and the southwest, and to the prospect of multiple, consecutive years of catastrophic losses from hurricanes.

Which of the following market sectors in the U.S. do you believe will receive the most foreign investment in 2018?

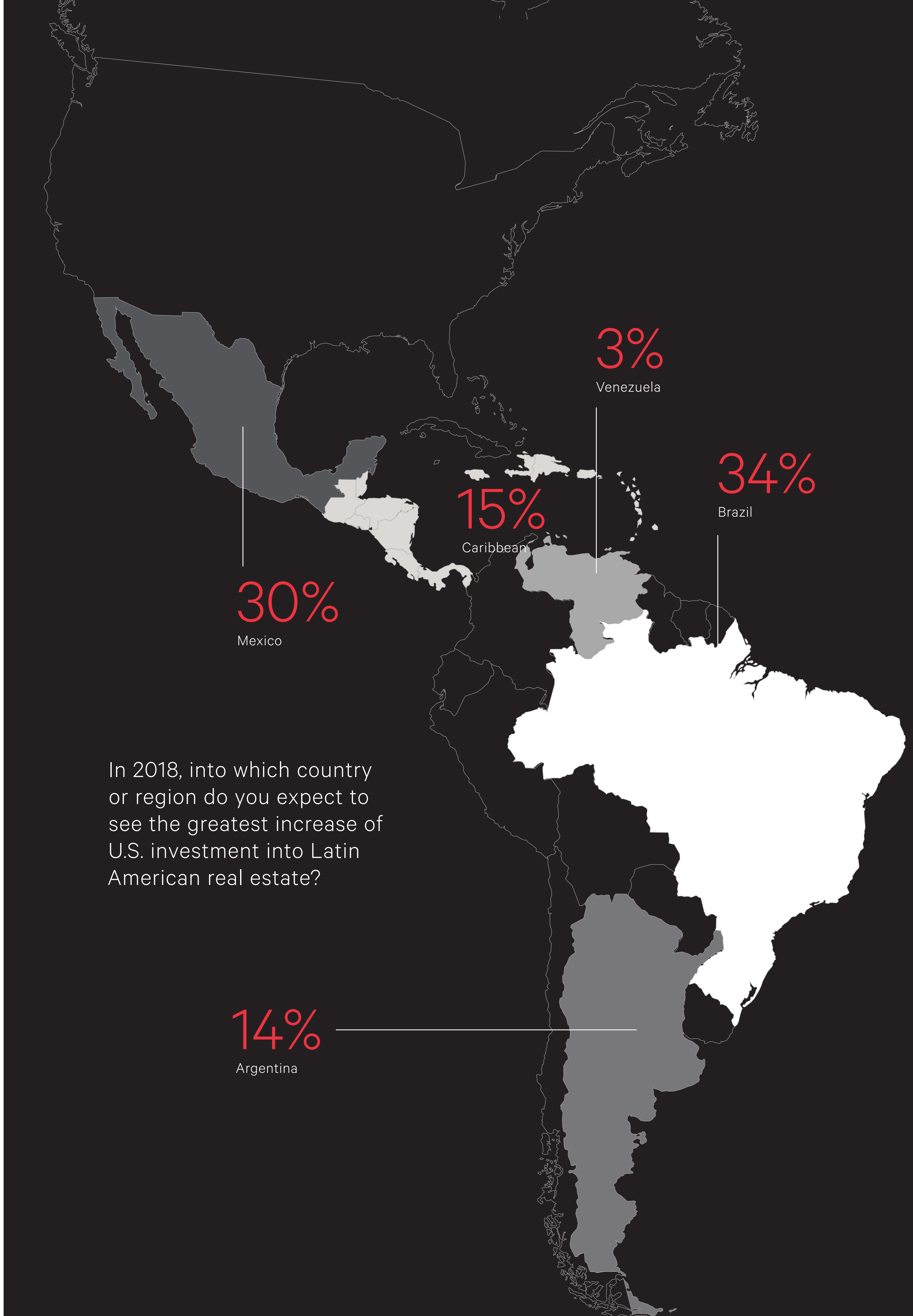


For each market sector you mentioned, which of the following countries or regions will contribute to this activity?





In 2018, from which of the following countries will we see the greatest increase in Latin American real estate investment into the U.S.?



In 2018, into which country or region do you expect to see the greatest increase of U.S. investment into Latin American real estate?

700+ Lawyers
24 Offices

akerman