2019 Akerman U.S. Real Estate Sector Report

The 2019 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* (2019), 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

Redefining Expectations

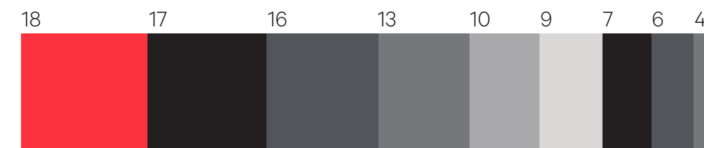
Redefining Expectations

Weathering super storms and relentless change requires a near-constant redefining of expectations, course correction, and new ways of thinking. As the Great Recession unleashed its deluge of pain more than a decade ago now, owners, developers, investors, and lenders alike retreated for higher-ground, taking their penchant for exposure with them. They have been doling out risk carefully and strategically ever since, gradually contributing to the slow but vigorous burn rate of the current U.S. economic recovery.[1]

Acute financial sense memory, a new conservative compass, and increased creativity in investment and development strategies continue to comprise the connective tissue between commercial real estate risk and return as we catch the last rays of sunlight from what is poised to be the longest economic recovery on record. Second only to the 1991-2001 tech bubble fueled by the frenzied architecting of the internet all those years ago, the brave new world of two-sided markets and the revolutionary effects of the sharing economy were not yet even a gleam in our eyes.[2]

"Acute financial sense memory, a new conservative compass, and increased creativity in investment and development strategies continue to comprise the connective tissue between commercial real estate risk and return."

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



- Interest rate uncertainty
- Affordable housing (need for, lack of, pressure to find)
- Uncertainty in global economic conditions
- Federal gridlock and uncertainty of government policy
- Rise in purchase prices or reduction in cap rates
- Availability of institutional credit
- Availability of equity and mezzanine financing
- Levels of foreign investment in the U.S.
- Need for new infrastructure

"The TCJA is the most significant tax legislation signed into law since 1986 and is generating much movement, activity, and collaboration in the sector."

The 2019 Akerman U.S. Real Estate Sector Report, now in its 10th year, provides an intimate look at the state of the U.S. real estate sector as seen by industry savvy executives and professionals standing on the shore watching another bank of clouds roll in. The report provides key insights on market conditions, capital availability, investment and development trends, and the market dexterity and imagination required to cultivate growth in an increasingly plateauing and uncertain environment.

Reliable Resilience

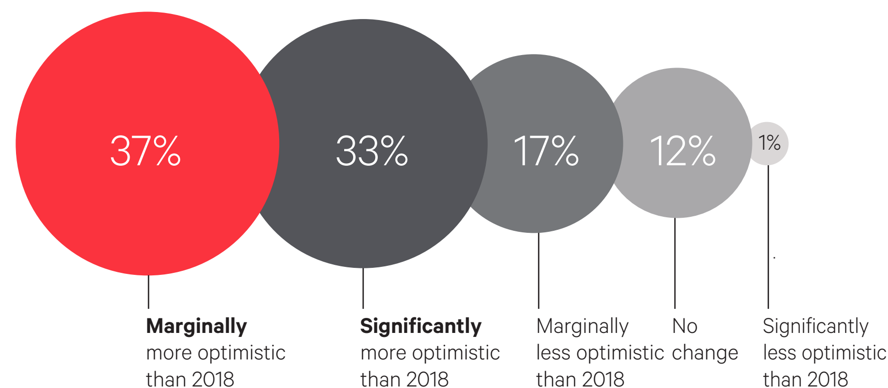
The U.S. commercial real estate sector has been reliably resilient during this time of broader economic recovery and a happy beneficiary of recent tax reform under the "new" Tax Cuts and Jobs Act (TCJA) signed into law in 2017. The TCJA is the most significant tax legislation signed into law since 1986 and is generating much movement, activity, and collaboration in the sector (as well as some hurry-up-and-wait hesitation). This is particularly the case among CRE professionals and other business owners seeking to capitalize on tax advantages, as well as decode the slow-rolling tide of regulations and increasing levels of complexity surrounding favorable deductions and new and expanded tax deferral strategies like Opportunity Zones and other incentives.[3]

"There's tremendous interest on both the developer and investor side of Opportunity Zones.

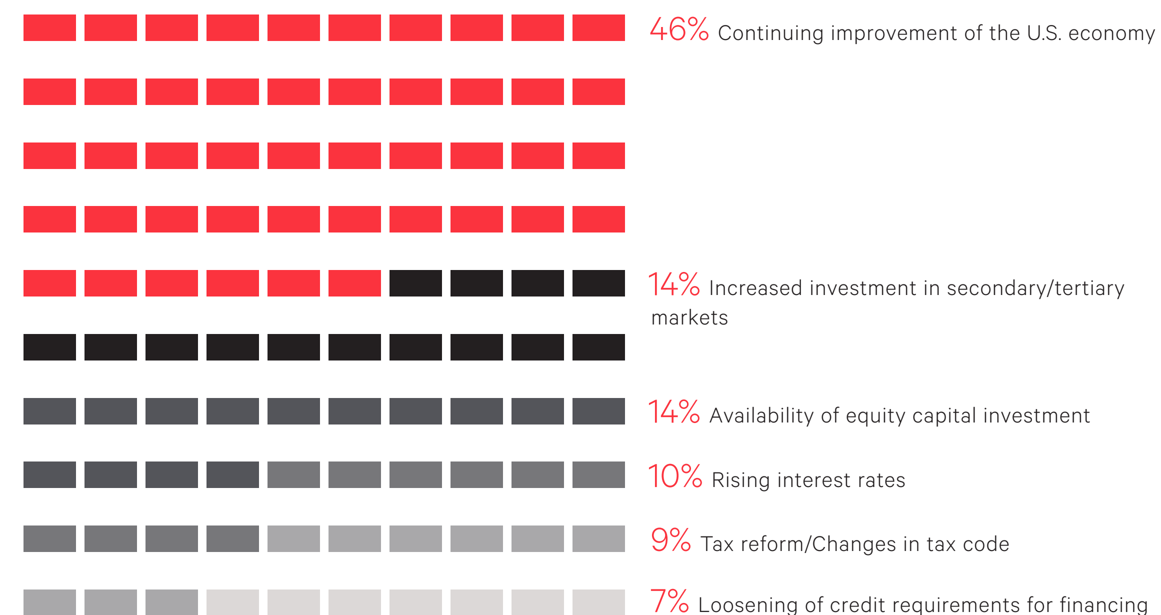
As we continue to see additional clarity to the program through new regulations, the fourth quarter 2019 is going to be a critical period for deal collaboration," notes Akerman's Steven Polivy. "In some respects, it's too early to tell what the ongoing effects of the Tax Cuts and Jobs Act of 2017 will have in the long term," notes Akerman's Eric Rapkin.

"Riding this wave of stimuli, the commercial real estate sector has remained relatively insulated from wider capital market turbulence even of late."

Which of the following best describes your outlook for the U.S. real estate market in 2019?



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



"Facilities need to be closer to the urban core, which is more land-constrained than other areas, so we're starting to see development of multi-level distribution centers."

Indeed changes in corporate real estate taxes, and deductions of state and local taxes (SALT) have created a challenging dichotomy between high-tax states like New York, New Jersey, and Illinois, and the low-tax states like Florida and Texas. "The cost of living and income tax variables across the U.S. are already contributing to migrations in corporate headquarters and organizational campuses, along with the families of those workers, who hope to cope with subdued economic growth as it relates to the tax environment," notes Rapkin. "It will be interesting to watch over the next few years as conditions continue to evolve and businesses continue relocating their headquarters in consideration of tax-rate disparities between high-tax versus low or no-tax states."

Which of the following market sectors do you predict will be the **most active** for real estate transactions in 2019?

These migrations are playing out in low-tax states, particularly in the Dallas-Fort Worth metroplex, where recent moves include Toyota, which opened its North American headquarters in Plano in 2017, with a billion-dollar, state-of-the-art facility, creating 4,000 jobs for skilled workers in the Lone Star State.[4] McKesson Corp., the nation's largest pharmaceutical distributor, relocated its headquarters from San Francisco to Irving, Texas in April 2019. Also Altair Global, a leading provider of relocation and assignment program services, plans to move its global headquarters to Frisco, Texas by fall 2019.[5]

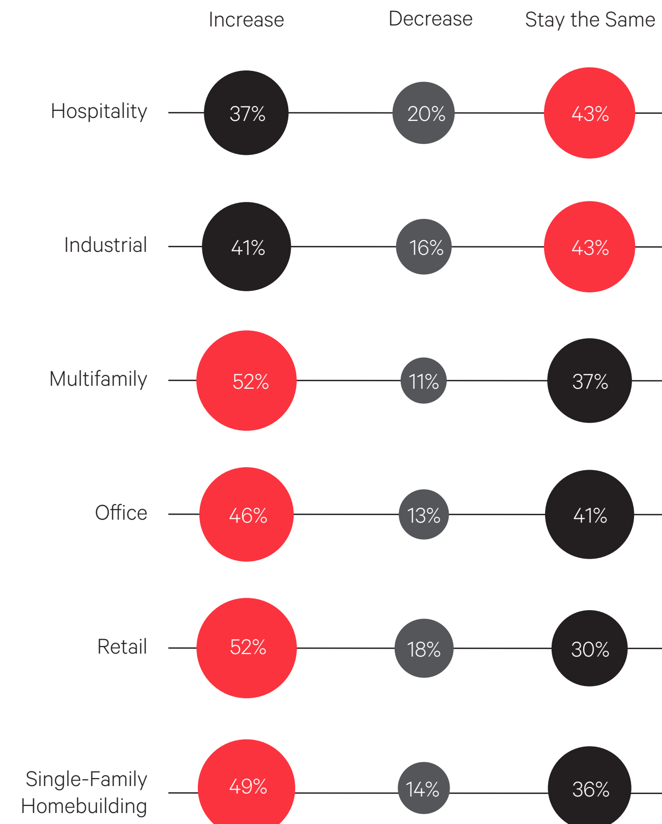
"We're seeing a significant influx of corporate headquarters coming from California and other high-tax states by companies seeking to avoid, or at least mitigate to some degree, the overall impact state income taxes have on employees and, thus, the company," observes Akerman's Mark McElree. "These inbound relocations are unprecedented in recent history, creating tremendous job growth across Texas."

Riding this wave of stimuli, the commercial real estate sector has remained relatively insulated from wider capital market turbulence even of late, continuing to expand steadily. Worries about fluctuating interest rates are abated for the time being and certain subsectors like industrial and multifamily are outperforming in major gateway markets like Chicago, Houston, Los Angeles, Miami, and New York. This presents opportunities in secondary and tertiary markets, eking out yield for investors as demand and absorption rates maintain a profitable equilibrium-for now.

By far, Akerman Survey respondents see housing – particularly the multifamily market subsector – as the most

"Despite continuing expansion and strong property fundamentals, sentiments of softening are establishing momentum in the collective consciousness."

How do you expect **cap rates** to perform in 2019 for the following market segments? Do you expect them to increase, decrease, or stay the same?



“There is a sense that growing uncertainty is beginning to take its toll on markets.”

active for real estate transactions in 2019, followed closely by the single-family residential market. Executives say that apartment development will be most active among the multifamily build options. More than half (61%) rank apartment development first or second. Almost another half (45%) rank senior living first or second.

“Multifamily remains vibrant and appealing to investors,” says Akerman’s Marc Heller. “It endures, even in declining markets, because it is fundamentally driven by unwavering demand and relatively unfettered access to capital.” Not surprisingly, industrial comes in solidly at the number three spot.

“Industrial has become the darling of the real estate world reacting to the demands of e-commerce, light manufacturing, and last-mile logistics. Facilities need to be closer to the urban core, which is more land-constrained than other areas, so we’re starting to see development of multi-level distribution centers. They’re not uncommon in Europe and Asia, but they’ve been virtually unknown in the United States until recently, and we expect this category to show increasing growth in the coming years,” notes Rapkin.

The need for distribution facilities to be as close to the core of the city is on the rise. “In the Chicago area, previous power plants are being converted to large e-commerce last-mile distribution facilities, which drives a lot of jobs and incentives,” says Akerman’s Meg George.

Curves Ahead

Relative resiliency notwithstanding, market forecasters and industry analysts are keeping a watchful eye on the U.S. commercial real estate sector as we near an economic off-ramp and end-of-cycle behavior continues to take hold in response to potential curves ahead (inverted or otherwise). Despite continuing expansion and strong property fundamentals, sentiments of softening are establishing momentum in the collective consciousness[6] and transaction volume is beginning to sputter as evidenced by a sharp first quarter decline in commercial property deals.

“We’re starting to feel the headwinds we expected coming into 2019 after such an extended period of expansion,” notes Rapkin. “Capital is still chasing deals, especially in gateway markets, but we are reaching a tipping point where things will begin to slow down.[7] It’s not a matter of if, but when.”

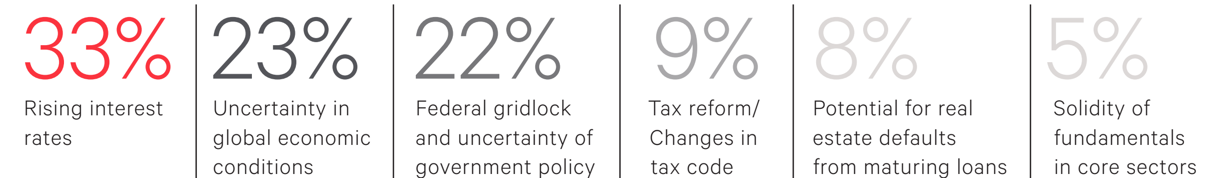
The prevailing industry ethos is that the pain will not be as deep as the Great Recession due in part to lower leverage, relatively moderate levels of speculative development, and a more disciplined focus on investor income.[8] That said, the inevitable downswing of an extended run of expansion, coupled with market-cooling factors like escalating trade wars, rising tariffs on critical raw materials like steel and lumber, a weakening global economy,[9] and the heightened partisan vitriol associated with the ramp up to the 2020 presidential election, are causing increasingly sustained economic palpitations that could motivate the behaviors associated with a market slowdown.

Bolstering this sentiment, Akerman Survey respondents see three primary reasons for concern with one prevailing theme – uncertainty. The first, mentioned by a third (33%), is “interest rate uncertainty,” which though stable for now, is a perennial indicator of anxiety among industry leaders and influencers.[10]

Further, two in 10 each say that “uncertainty in global economic conditions” (23%) and “federal gridlock and uncertainty of government policy” (22%) result in their lack of confidence in the real estate market. Ever a bedfellow of risk in any profitable endeavor, there is a sense that growing uncertainty is beginning to take its toll on markets.[11]

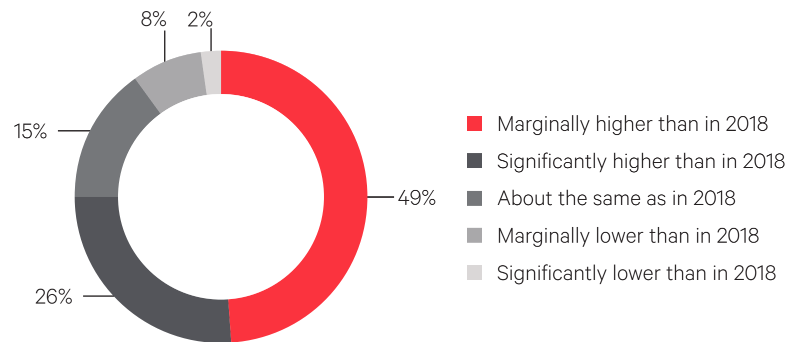
“One primary reason stands out for increased levels of confidence – the continuing improvement of the U.S. economy – almost half (46%) identify this reason.”

Which of the following is your primary reason for any **lack of confidence** in the U.S. real estate market in 2019?



"We see investor and developer collaborations taking unique tacks to address hampered growth."

Do you think **U.S. job creation** in 2019 will be...?



Confidence Crescendo

No need to cue the marketplace's down-market sad trombones just yet, however. Solid, albeit somewhat diminished expectations remain de rigueur among market observers and no major red flags emerged from the Akerman Survey in terms of overall optimism and confidence. An overwhelming majority of the real estate executives surveyed remain very optimistic about the U.S. commercial real estate market and the overall U.S. economy. More than two-thirds (70%) say that they are more optimistic than 2018; although 37% of those only marginally so. A scant two in 10 say they are less optimistic.

The balance say their levels of optimism remain the same compared to 2018. One primary reason stands out for increased levels of confidence – the continuing improvement of the U.S. economy – almost half (46%) identify this reason. The remaining half of executives identify a range of issues. About one in 10 each mention the "availability of equity capital investment," "increased investment in secondary and tertiary markets," "rising interest rates," and "tax reform/changes in the tax code."

As prognosticators busy themselves curating points of caution, strong fundamentals continue to confound expectations and buoy confidence.[12] U.S. economic growth exploded out of the gate at the beginning of 2019. First-quarter GDP grew at a 3.2% annualized pace – "the best [economic] start to a year since 2015."[13]

Employers are also hiring at a steady pace. In April, 263,000 jobs were added to the economy and the U.S. unemployment rate declined 0.2 percentage points to 3.6 %, its lowest level since 1969, according to the Bureau of Labor Statistics (BLS) April 2019 Report. [14] Job gains have averaged 205,000 per month in 2019.[14] Foreshadowing these upended expectations, 49% of those surveyed predicted that U.S. job creation in 2019 would be marginally higher than in 2018.

Regarding sector-specific job creation, according to the BLS April 2019 Report, in April construction employment rose by 33,000, with gains in nonresidential specialty trade contractors (+22,000) and in heavy and civil engineering construction (+10,000). Construction has added 256,000 jobs over the past 12 months.[14]

As a counterbalance to the rosy sector statistics, the BLS previously noted in its March 2019 report that the cost of materials and components for construction was up 0.2% from February 2019, and was 3.1% higher than a year earlier. Add to this the rising cost of developer-friendly land, and we see investor and developer collaborations taking unique tacks to address hampered growth. Akerman's Jim McNeil describes a joint venture between a national homebuilder and a large property management company who are building single-family residential neighborhoods together, "and instead of selling the homes, this partnership has come together to build homes and create a rental community."

A patient pause on rate hikes has also forced additional wind into economic sails, with the Federal Reserve signaling that it would suspend further interest rate increases this year as inflation remains below the central bank's 2% target.[15]

"Steady interest rates are motivating more borrowing, and in turn leading to swifter deal flow, as well as plumping the volume of deals," notes Akerman's Irán Hopkins.

Laissez les bons temps rouler? Not exactly, but maximizing the remaining market momentum appears to be top of mind across the board as CRE executives anticipate the coming pendulum swing writ large in an increasing number of recent market forecasts.

"With inevitable change as a universal constant, preparedness continues to be the mantra since the last recession."

"The calculations are changing not just in the cap rate calculus, but also in development and renting considerations that play out in those deals."

Universal Constant

With inevitable change as a universal constant, preparedness continues to be the mantra since the last recession and the most sophisticated long-view players are focused on staying healthy, accumulating capital, and differentiating to stay ahead of sector trends as we inch toward the top of the cycle. "CRE is likely nearing the end of a very long and bullish cycle and well capitalized firms will have a competitive advantage when the market enters a corrective phase," says Akerman's Alan Cohen. "There's a lot of dry powder waiting on the sidelines earmarked for commercial real estate that will be deployed for distressed opportunities."

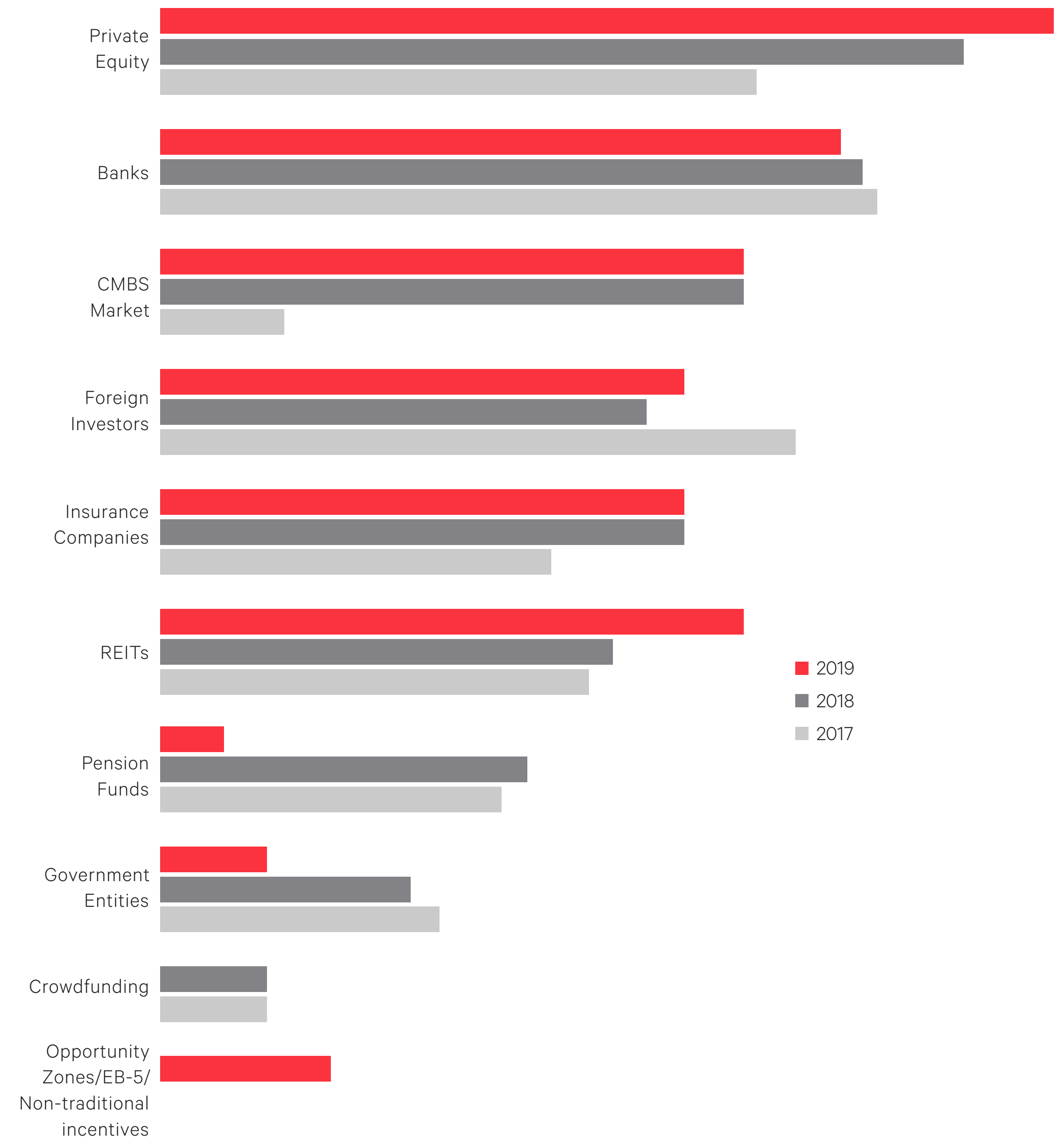
When we asked Akerman Survey respondents who they believe would fund the most commercial real estate debt and/or equity, their number one answer was "private equity." Cohen notes that, "perhaps this reflects the realization that commercial real estate has become an accepted alternative investment class in terms of asset allocations."

When we asked the Survey respondents how they expected cap rates to increase, decrease, or stay the same by subsector there was a 52% tie between multifamily and retail to increase. Some two in ten (20%) anticipated that hospitality would see a decrease in cap rates this year.

Cohen believes that "many funds and other non-institutional players have either been accumulating capital by making investments very selectively over the last few years (due to cap rate compressions) or raising new capital to prepare for distressed opportunities." Because marketplace demands, demographics, health and wellness, employment, and transportation are overlinked, the calculations are changing not just in the cap rate calculus, but also in development and renting considerations that play out in those deals.

As the U.S. economy begins to feel the impact of a slowdown in momentum, the cascading effects will be felt downstream on the commercial real estate sector, but many observers believe that it is well positioned to persevere in the face of eroding conditions. CBRE's New York Tri-State Region CEO Mary Ann Tighe noted in a recent *Bisnow* article that although the commercial market will weather the downturn, it will be recalibrated and provide valuable lessons to shape the next era of development, investment, and leasing.[8]

Which three of the following do you believe will fund the most commercial real estate debt and/or equity in 2019?



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**?

- Response to environmental concerns (Climate change, sea level, carbon neutrality)
- Trend toward more compact development
- Preference for city living
- Changes in office mobility, collaborative spaces, and next generation workplace design
- Tax reform/changes in tax code
- Aging population
- Effect of technology on real estate

Seismic Shifts

As the CRE bass line continues its steady, rhythmic pulse pushing the harmonics of the status quo along, come what may, the industry is also effervescing with innovation and disruption – the jazzy grace notes of change rising above the din, pushing the groove to a breaking point and heralding the onset of profound shifts in long-standing norms in development and investing.[16]

Aging demographics, evolving consumption habits, lifestyle and amenity demands, and increasing automation in manufacturing are combining to create a revolutionary amalgam that is redefining CRE investment and development from top to bottom. Digital transformation is the rocket fuel for this new frontier and market disruptors like AirBnB and WeWork are already having a deep impact on an industry that has traditionally been slow to evolve.[17]

Technology has created buildings that merge the same type of amenities across various sectors. “The workplace is coming into residential communities and the comforts of residential life are being transposed into the office and industrial space,” notes Akerman’s Allison Nelson.

The effect of technology on real estate and the aging of the U.S. population are predicted by Akerman Survey respondents to have the most significant impact on the real estate market over the next three years. Executives were asked to consider real estate industry development and then asked to rank which of seven trends will have the most significant impact. Of the seven, two trends stood out – “effects of technology on real estate” ranked by nearly a quarter (23%), and an “aging population” (22%) ranked next by a narrow margin. Akerman’s Cecelia Bonifay noted, “In the industrial sector, which has remained a top performer of late, the emergence of very highly automated distribution centers utilizing the newest technology are providing upward of 300 or 400 jobs in each location – higher paying jobs, requiring a more skilled worker.”

In fact, those properties not up-to-snuff in terms of the latest technology and design attributes may already be seeing value issues with regard to the new trend in luring millennials and their younger counterparts into urban core markets. Akerman’s Larry Eiben says, “One class to be concerned about is the aging Class-A buildings.” He explains that, ”Class-A office building landlords are having more trouble finding tenants because they are still seeking the higher rents to which they’ve grown accustomed. Many owners of these older buildings have remodeled common areas and added more modern amenities in an effort to retain current tenants and attract new tenants; and if a building is significantly older for a particular market then it may be prime for redevelopment for other uses such as hospitality or even multifamily residential.”

Almost as significant were the next two trends, ranked by another narrow margin – in order they are “tax reform/changes in the tax code” and “changes in office mobility” which collected another third of the cumulative responses at 31%. “In response to the aging population, we are seeing different types of health care facilities such as microhospitals, ambulatory surgery centers, and other medical uses within traditional retail locations”, says Nelson. Underscoring the inherent industry latency in responding and evolving to disruption and change, the last three trend choices “preference for city living,” “trend toward more compact development,” and “response to environmental concerns” combined for only about two in ten.

One cultural trend and reality on the ground in many regions is the drive to build and remodel with sustainability and new site conditions created by climate change models. In New York, for example, environmental concerns are “Baked into many projects to deal with sustainability in anticipation of more frequent flooding and sea level changes,” says Akerman’s Richard Leland. And it isn’t only rising sea levels and extreme weather preparedness, it is also the preferences of buyers and developers because, as Leland notes “Buildings that are LEED Gold appeal to people who want to move into a home or office that is trying to help, not contribute to environmental degradation issues.”

Another way that developers can creatively meet changing expectations is by re-imagining how properties are designed and equipped. One example from Hopkins is the “conversion of existing strip malls into vertically dense mixed-use parking structures with retail at the bottom or at the top.” Another tactic is the industry-wide pivot towards developing multi-use spaces that meet the demands and changing habits of the growing work-from-home hordes.

The numbers show that retrofitting and remodeling old buildings for market demands such as technological expectations, amenities, and the particular needs of elders opting to age in place present opportunities for developers of all stripes as well as the creation of new jobs for builders, carpenters, managers, and other skilled workers.

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"One cultural trend and reality on the ground in many regions is the drive to build and remodel with sustainability and new site conditions created by climate change models."

Wider World

As the next phase of the real estate cycle comes into view, developers and other investors will sprout more questions and face unpredictable decisions as they navigate oscillation in capital markets and an unbalanced global economy. Unfolding international developments like a protracted trade war with China, uncertain timing on a Brexit deal, saber rattling with Iran, North Korea's nuclear aspirations, and the Venezuelan political powder keg are hourly news items and being closely watched by global CRE players.

Add to that the political chaos that has become the standard operating procedure – even those most fatigued spectators will find it hard to look away from this election cycle – not only to keep an eye on partisan gridlock, but also to see where the opportunities emerge and how developers, lenders, owners, and investors can be prepared to take full advantage of them. All of this will come into sharp focus as election season ramps up over the next few months. President Donald Trump has boasted about the economy, especially the labor market, as being one of the big wins of his first term in office. Sluggish growth could pose a challenge to a Trump re-election in 2020.[15]

Trends indicate that the top-three U.S. industrial markets for foreign investment were Los Angeles, Dallas-Fort Worth, and Chicago, with a combined $2.4 billion in 2018.[15] According to CBRE senior research analyst Matthew Walaszek, industrial cross-border investment is not expected to match the huge volumes seen in recent years, given the significant amount of M&A activity that has occurred.[18] He also noted that foreign investors would continue to view industrial real estate as an attractive asset class, with secondary markets such as Columbus, Cincinnati, Denver, and Kansas City seeing more investment.[18]

International investors looking to balance their current account surplus with overseas capital investments are time and again selecting CRE.[19] We asked the executives which market sectors they believe will receive the most inbound foreign investment in 2019. Among multifamily, single-family, hospitality, office, industrial, and retail, respondents vigorously picked multifamily as the subsector to look at for the highest foreign investment.

By far, the executives surveyed see the multifamily market sector as the most astir for inbound foreign investment real estate transactions in 2019, and they chose single-family residential as the second most active sector for international financing.

When asked more granularly to predict where the international investments will galvanize activity in particular market sectors, China was predicted to invest most heavily in hospitality, industrial, and office. When asked to examine five Latin American countries as sources for increased investment in U.S. real estate, respondents selected Mexico at 38%. Behind was Brazil (30%). Some one to two in ten selected Argentina (14%) and Venezuela (12%).

Even when excluding large entity-level transactions (which vary greatly from year to year and can skew annual comparisons), the average annual volume of foreign investment in U.S. industrial real estate during the past five years rose by 68%, indicating strong

"International investors looking to balance their current account surplus with overseas capital investments are time and again selecting CRE."

Which of the following market sectors in the U.S. do you believe will receive the most foreign investment in 2019 and, **which of the following countries or regions will contribute** to this activity?

In 2019, **from which of the following countries** will we see the greatest increase in Latin American real estate investment into the U.S.?

38%
Mexico

12%
Venezuela

30%
Brazil

1%
Ecuador

14%
Argentina

In 2019, **into which country or region** do you expect to see the greatest increase of U.S. investment into Latin American and the Caribbean real estate?

11%
Cuba

30%
Puerto Rico

16%
Brazil

29%
Mexico

11%
Argentina

"We will continue to explore the new Opportunity Zone regulations with an eye towards uncovering positive outcomes for investors, developers, and the communities in which they operate."

demand for individual industrial properties and portfolios.[18]

Akerman's Neisen Kasdin remarked, "The repositioning of wealth from abroad could signal that while the numbers may vary widely, the trajectory is the same – upward."

Perhaps not surprisingly, given their continuing rebuilding efforts and other needs following the devastating hurricane season of 2017, Puerto Rico was selected by 30% of our respondents as the number one region into which they expect to see the greatest increase of U.S. investment. Fewer people selected Brazil (16%), Argentina (11%), and Cuba (11%).

What's Next?

Thought leaders from Akerman will take a further look at how market demands for automation, amenities in every sector, and sustainability will correlate with activity in all the sectors we asked of Survey respondents.

We will continue to explore the new Opportunity Zone regulations with an eye towards uncovering positive outcomes for investors, developers, and the communities in which they operate. We will also examine the foreign investment boom in the industrial sector, and the rapid change driving innovations in development. In the retail sector, we will delve into the trend towards experiential retail which weaves AI, amenities, and complementary services into new builds and remods as well as the market demands for automated manufacturing and shipping.

In the office subsector, we will continue to analyze how the Survey findings illuminate growing pains between developing and redeveloping for the needs and wants of a generationally bifurcated workforce, as well as inspect the implications of the co-working phenomenon in a softening market.

One of the most interesting trends we are following is the "surban" redevelopment move which sees millennials growing up and moving out of downtown to where they continue to have access to urban amenities and services, with the comforts and green spaces of suburban areas. Finally, we will continue to examine the ways that market demands for technologically augmented amenities in office, multifamily, healthcare, and elder services are driving market activity.

Survey Methodology

Top real estate executives from across the United States were interviewed by an online survey administrator on their perceptions of the health of the U.S. commercial real estate market. Two hundred and ten interviews were completed between February 19 and March 5, 2019.

Question No. 5 was calculated by using the mean rank (score). Selections were ranked 1-7 and then 1 = 7 points, 2 = 6 points, 3 = 5 points, 4 = 4 points, 5 = 3 points, 6 = 2 points, 7 = 1 point.

Question No. 6 was calculated by using the raw numbers (score), as multiple responses were accepted.

Question No. 7a was calculated by using the raw numbers (score), as multiple responses were accepted.

Question No. 7b was calculated using the raw numbers (score), as multiple responses were accepted. Respondents must have chosen the industry sector in question 7a to respond to portion 7b for the sector.

Question No. 8 was calculated by using the raw numbers (score), as up to three responses were accepted.

Due to rounding, all percentages used in all questions may not add up to 100 percent.

Resources

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