2018-2019© TOP TEN ISSUES AFFECTING REAL ESTATE™

from The Counselors of Real Estate®

Counselors' clients seek advice on today's issues which will impact property today–and today's issues which will impact their decisions over the next ten years. In a break with how The Counselors' has announced its Top Ten list in past years, the Top Ten Issues Affecting Real Estate™ 2018-2019 differentiates between current and longer-term impacts on real property.

CURRENT ISSUES

1. Interest Rates & The Economy
2. Politics & Political Uncertainty
3. Housing Affordability
4. Generational Change/Demographics
5. E-commerce & Logistics

LONGER-TERM ISSUES

1. Infrastructure
2. Disruptive Technology
3. Natural Disasters & Climate Change
4. Immigration
5. Energy & Water

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1. Interest Rates & The Economy

For years the market has anticipated rising interest rates. With the Federal Reserve now nudging rates upward, flattening of the yield curve is underway. Historically, this has been a powerful signal of market expectations of an economic down cycle.

The Tax Cut and Jobs Act passed into law in December, 2017 enacted fiscal stimulus by cutting individual and corporate tax rates, and pumping money into the economy via the Omnibus Spending Bill passed in March, 2018. That bill is projected to increase spending by $1.3 trillion but the consequence is a large required increase in Federal borrowing to fund a growing deficit. Some see the effects as a "crowding out" of private borrowers from the debt markets, and such borrowers may face higher interest rates; an economic slowdown could result.

For real estate, the issues that must be faced include:

- Is it time for investors to focus on playing defense at the end of this long cycle?
- Will it become more difficult or more expensive for commercial real estate participants to finance deals, and will this further slow transaction volume which has already dropped 13% since 2015?
- Will residential mortgage rates rise in tandem with the increase in Fed Funds?
- As consumer rates pegged to Treasuries increase, will this slow retail purchases, placing additional stress on the already beleaguered retail sector?
- Cap rates have remained decidedly flat, despite the fact that risk-free benchmarks like the 10-year Treasury rate have broken the 3% mark. When will cap rates begin rising, and what will that mean for asset valuation? Will that mean less financing availability for tertiary markets, as investors pull back into standard gateway markets perceived to provide more liquidity in case of the need to exit?

2. Politics & Political Uncertainty

The most pertinent near-term issues about U.S. politics driving real estate right now can be divided into two topics:

Policy changes with indirect effects on real estate:

- The Tax Cuts and Jobs Act – whether it benefits corporations more than individuals and whether or not it will result in a boost in GDP growth in 2018, but then revert to recent averages closer to 2%. Corporate benefits appear to be resulting in increased investment and business spending, not just stock buybacks.
- Trade wars with China, Canada, Mexico, and the European Union, and geopolitical fears about how the North Korea and Iran situations are being managed.

Policy changes with direct effects on real estate:

S.2155, recently signed into law, likely has the most effect on real estate.

Broadly speaking, the bill frees smaller lenders from the toughest requirements of the Dodd-Frank Act, such as the Volcker Rule. It also provides banks with less than $250 billion in assets a pathway to shed the 'too-big-to-fail' stigma as well as certain enhanced prudential standards. The bill increased the asset threshold for automatic designations of banks to $100 billion – subject to a discretionary review by the regulators. In effect, this gives the Fed the ability to apply the stricter standard on a case-by-case basis to a bank with $100 billion to $250 billion in assets to promote its safety or mitigate risks to the financial system.

HVCRE: This provision would exempt income-producing property, allow banks to continue to use the 15% borrower contributed capital exemption, allow borrower distributions if the minimum-required capital is maintained, allow current appraised value of real property to be counted in equity contributions, and grandfather loans closed prior to January 1, 2015. The legislation does leave regulators leeway about applying these rules, including the risk weight that should be applied to higher-risk construction lending.

HMDA: This provision reduces the number of data fields collected by insured depository institutions (but not non-depository institutions) which have originated, in each of the two preceding calendar years, fewer than 500 closed-end mortgage loans and fewer than 500 open-end lines of credit.

Overall, S.2155 is broadly viewed as a modest tweak of existing regulation – more targeted toward community banks than larger regional and systemically important institutions.

3. Housing Affordability

The crisis of affordability squeezes from both sides of the supply/demand equation.

- The U.S. has had general underproduction of housing for almost two decades, even accounting for the boom that accompanied the subprime housing bubble. However, since 1999, the net underproduction of housing has been nearly 2 million units.
- But there has also been a demand side weakness. Income stagnation for all but the highest income households has hampered access to affordable homes and rental units. A 2017 study by the Hamilton Project at the Brookings Institution calculates that since 1979, real wages for the top income quintile have risen more than 24%, while the bottom quintile has seen a decline in real wages. The next lowest quintile, the lower-middle class, has had less than a 1% gain in real wages over more than 35 years, and the middle quintile (the heart of the middle class) has gained less than 3.5% over that span.

Within this context, there is also pressure growing in cities, and now in select suburbs, as gentrification by Millennials and others directs demand toward neighborhoods and older housing stock that has been serving as the de facto affordable housing in older but growing metropolitan areas. As this issue plays out in the next year or two, key questions in order to find solutions are "Who pays?" and "How?"

4. Generational Change & Demographics

One could argue that historically real estate markets have primarily been driven by key demographic groups, 25 – 34, 35 – 54, etc. But real estate now is seeing and reacting to the influence of FOUR groups: the Millennial generation, aging baby boomers, Gen X (those born between the mid-1960s and the early-1980s, which exhibit characteristics of the two large groups on either side of the age spectrum), and Gen Z (born between 1995 and 2010).

The direct real estate impact is already being seen in the changes in work processes, space utilization, and where companies choose to locate. The housing market must adjust to changing demands as these groups age. This will impact student housing, single family, and multifamily housing markets.

There are similarities between the wants and needs of the generations, but ultimately the differences in timing (Millennials forming households later) and differences in desires (move to walkability) will offer risks and opportunities.

5. E-commerce & Logistics

The U.S. Department of Commerce estimates there were $123.7 billion in retail sales through online channels in the first quarter of 2018. That represents 9.5% of total retail sales, up from less than 1% in 1999, when the Commerce Department began tracking the data. The growth in online sales has also outstripped the growth in total retail sales during that entire – almost twenty year-period.

CURRENT ISSUES

For example, in the first quarter of 2018, online sales grew by 16.4%, while total retail sales only grew by 4.5%. Adjusting total retail sales, and deducting numbers from automobile and gasoline sales (which typically are not sold through online channels), e-commerce or online sales as a proportion of total retail sales rises to near 30%.

Media articles have largely focused on "the death of the U.S. mall" and coverage of store closures. But as some businesses close, others open. As Toys "R" Us closed stores, Ulta, The Gap, Target, and others continue to open stores. Employment in restaurants and other service-related retail establishments has consistently been positive. Amazon is known for its dominance of online channels – but when Amazon buys a brick and mortar chain like Whole Foods, it indicates it is not about "online versus brick and mortar" – but rather an ongoing quest for firms to dominate every available business channel.

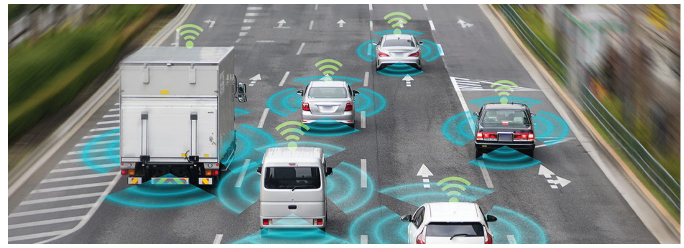
Retail real estate is directly impacted by these evolving channels, with discount retailers and high-end luxury stores surviving the onslaught best. And e-commerce has been a major boon for warehouse/distribution properties, in response to the need for storage space for that "last mile," ensuring the fulfillment of one- or two-day delivery promises.

LONGER-TERM ISSUES

1. Infrastructure

Infrastructure tops the 2018-2019 longer-term impacts list (and has been included on several past year lists) as there has been little serious effort to address America's needs despite political efforts to do so. Long-term underinvestment has elevated the level of risk – both in the short- and long-term – of economic drag due to inattention to physical infrastructure (roads, bridges, dams, levees, transit – all of which are rated "D" or lower by the American Society of Civil Engineers) and human capital infrastructure (education, health) directly affecting economic productivity.

Real estate – both existing properties and needed new development – depends upon reliable, well-maintained infrastructure. Consider housing without access to utilities, roads, bridges; offices with poor transit routes; warehousing and shipping of goods with poor-condition roads; hotel properties if guests have difficulty getting there over poor roads, inadequate airports, risky bridges, as examples.

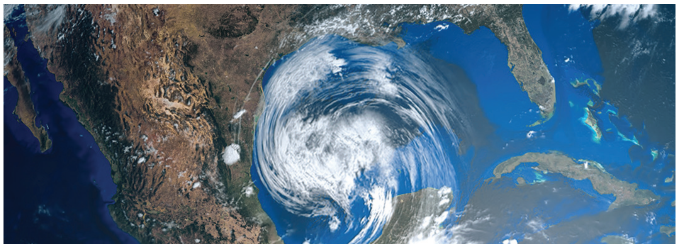


2. Disruptive Technology

The real estate industry, like the rest of the world, is poised to adopt new technologies – blockchain, artificial intelligence, autonomous vehicles, cryptocurrencies, transaction platforms that disintermediate human agents – all of which will qualify as "this changes everything" interventions in the real estate industry or real estate markets.

E-commerce has drastically changed the retail property sector and has linked online sales to stores, with online retailers buying store groups or opening new store models (Amazon Go stores). Ride-sharing companies such as Uber and Lyft are altering transportation, and likely will alter the need for garages in future housing and multi-family development. Data has been, in general, commoditized, from transaction transparency to enhanced demographic targeting to nearly unlimited interconnectivity to sophisticated cybersecurity and privacy controls. Homes, offices, warehouses, hotels, multi-family properties, and every facet of real estate – from business and property management to architectural design – is enhanced by adopting ever-improving technology.

Real estate practitioners, owners and investors can embrace new technological tools, but ultimately must carefully choose which is most appropriate for the business, property, service, or problem/solution – not be pressured to rush toward "technology for technology's sake."



3. Natural Disasters & Climate Change

The impact of climate change and natural disasters on real estate is perceived to be increasing over time. Insurance analysts at Munich Re, a major reinsurer, forecast that rising sea levels and increasing storm frequency could raise average annual losses by 170% in the coming decades. Since 2006, a significant share of overall loss has come as a result of climatological events such as extreme temperature, drought, and forest fire. During 2017, Seattle set a record of 55 consecutive days without rainfall. During that time, and afterwards, haze from wildfires in the Cascades and as far away as British Columbia degraded air quality in the Puget Sound region.

While the percentage of total U.S. area under drought conditions has fallen from 38% to 26% as of late August, 2017, the fraction under the most severe category of drought has risen.

Communities are responding with initiatives that are intended to mitigate the effects of disasters, such as Miami/Dade County, which has embarked on efforts to limit the impact of rising seas on its water and sewer systems, while seeking more compact developments limiting urban sprawl and tackling automobile dependence.

Municipalities and real estate developers must navigate a myriad of state and local energy and sustainability regulations; there are no overarching Federal policies. This continues to make it difficult for companies to work with state and local officials in multiple locations regarding corporate relocation, or to expand operations while satisfying green building and operations demands. Companies with multiple locations (or brands with multiple outlets, branches, or restaurants, etc.) may even avoid some locales to avoid the maze of regulations.

4. Immigration

The RAISE Act (Reforming American Immigration for Strong Economy) affects undocumented workers by restricting legal immigration, thus dropping the number of green cards from the present 1.1 million annual number to 500,000. The arguments in favor of the bill emphasize the putative impact of low-cost immigrant labor on wages for lower-skilled U.S.-born workers. The bill seeks to recast immigration policy to apply a "merit-based" points system favoring highly educated, English-speaking, and often already affluent candidates.

Alex Nowrasteh, a senior immigration policy analyst at the Cato Institute's Center for Global Liberty and Prosperity, has published an analysis which disproves such a system results in a positive wage effect, noting that the current system is actually quite effective in matching immigrant skills to U.S. economic needs. The National Immigration Law Center stated that the RAISE bill "inaccurately suggests less legal immigration means more jobs for American workers." Importantly, the technology industry – which has long coveted larger immigration volumes from the STEM (science, technology, engineering, and mathematics) skill set – maintains that RAISE "would severely harm the economy and actually depress wages for Americans."

There are economic impacts on real estate, which start with the fundamental growth dilemma facing the U.S. for the coming decade: the labor supply shortage driven by age demographics.

The policies of the Immigration and Naturalization Act of 1965 – which the RAISE bill explicitly seeks to undo – enabled the United States to supplement demographic "natural increase" (the surplus of births over deaths) to a degree unmatched by our major global competitors, where immigration exclusions were more severe.

Immigration was therefore able to bolster the U.S. agriculture sector, as an example. Decreasing immigration could also hamper one of industrial real estate's principal sources of demand – ecommerce. Amazon's August 2, 2017 job fairs around the nation sought to hire 50,000 employees for picking, packing, and shipping jobs at its fulfillment centers.

5. Energy & Water

Municipalities are increasingly enacting policies that require real estate owners to invest in storm water management systems and devices, and also create new green space. The impact for real estate is the ability to create value, such as through increased development yields, providing tangible amenities for residents and tenants, reduced operating costs, and improved preparedness for flooding and drought.

"Smart" buildings are becoming more common because of new technology, which impacts building operations, and provides both efficiencies and connectivity which is increasingly being sought by tenants. The challenge is in ensuring cybersecurity, to avoid service impacts and prevent intrusions by hackers.

While the majority of buildings do not depend on oil, but rather natural gas, and other energy sources (including solar and wind), it is noteworthy that trends in energy production and prices have taken a turn lately, with oil and gasoline prices increasing as a response to OPEC moves. Gasoline prices rose 3% month-over-month, pushing headline inflation to a 14-month high in April, 2018 at 2.5%. There is a chance that higher energy prices, combined with higher financing costs due to increasing interest rates and mortgage rates, may act as headwinds to the most optimistic growth forecasts for 2018.

Recent studies suggest that only 1.2% of the U.S. suffers from disastrous levels of water shortage, but some states (California, for example) are more severely affected by water shortages and drought. While the percentage of total U.S. area under drought conditions has fallen from 38% to 26% over the past year (as of late August 2017), the fraction under the most severe category of drought has risen. In a developed country like the U.S., where 80% of the population live in urban centers or highly urbanized suburbs, the demand for water is likely to remain concentrated, and rise, putting pressure on these centers of real estate to both protect resources, and provide for the population.

Other impacts on real estate include increased risk of widespread wildfires, poor growing conditions in some sections of the U.S., water-rationing days, and poor air quality days which all can affect location choice for residents, investors, and companies seeking to mitigate risk and experience better quality of life. Some communities and states could experience significant population loss as homeowners, renters, companies, and corporate employees settle elsewhere.

ON THE WATCH LIST

Construction Costs

Rising construction costs are impacting the timing and overall costs of commercial development, redevelopment and tenant improvements. In addition, rising costs are contributing to higher residential housing prices.

To a developer, rising costs make it more difficult to get new projects to "pencil out" economically, especially in an environment where construction lenders are being more conservative. But on the other side of the issue, more subdued levels of new supply have allowed fundamentals to improve despite the slower rates of growth in the current economic cycle.

Engineering News-Record's construction cost index has risen 3% in the past year, with labor costs up 2.9% over the same term. But components such as lumber are up 9.8%, concrete block 4.5%, and asphalt paving 4.4%. The tariffs announced on steel and aluminum are poised to put upward pressure on these building materials. In all likelihood, inflation in construction costs will be sharply higher than the Consumer Price Index itself.

If construction costs continue to rise, companies and practitioners may react with changes as to how space is utilized, moves to lower-cost markets, and introduction of technology to reduce costs.

Tax Cuts

The Tax Cuts and Jobs Act of 2017 has prompted expectations that changes in the deductibility of state and local taxes (SALT) will advantage states with low SALT levels, and disadvantage states with a relatively high SALT burden. Consider, however, these benchmarks:

The most recent twelve-month job change data for the 10 highest and 10 lowest tax burden states show that in the past year, the low-burden states (led by Texas, Nevada, and Tennessee) have added 462,100 jobs, for a 2% growth rate (above the U.S. average of 1.6%). But high-tax states (such as California, New York, and Oregon) have generated more jobs (657,600). However, because of their larger economies, there was a slower growth rate (1.3% versus the U.S. 1.6%). It is possible that in coming years, the cumulative result of the recent tax cuts may have the putative effect of accelerating growth overall and thereby widening the gap between low-tax and high-tax locations.

Note also the impact on productivity. The ten low-tax states have a total Gross State Product (GSP) of $2.9 trillion (15.5% of GDP), or an average of $124,039 per worker. The high-tax states contribute an aggregate GSP of $7.3 trillion (38.0% of GDP), or $146,478 per worker. Productivity in the high-tax states is 18.1% higher than in the low-tax states. Government incentives which redirect economic activity to low-tax states carries risk of diluting output per worker on a national basis. It is relatively easy to make a simple business case for seeking lower-tax locations, but productivity gains demand investment in physical and human capital – such as infrastructure and education. Low-tax states historically have not committed as much public spending to such investments as high-tax states have done. That is a significant part of the reason that taxes are low in the low-burden states.

For real estate, the direction of job movement and of capital flows could be affected, especially if the argument that low costs, especially low taxes, is a primary motivating factor turns out to be persuasive. However, strength in output per worker and the ensuing top line benefit could trump the low-cost argument and point to a reason why the high-rent, high-value cities maintain strong occupancies when compared with many of the Sunbelt markets that are competing on the basis of cost.

Urbanization/Suburbanization

Recent comments on "the plight of suburbs" or whether or not Millennials will continue to pursue urban living into their late 30s and early 40s present the Urban/Suburban divide as unnecessarily binary. Similarly, when the Tax Cuts and Jobs Act specified restrictions on the ability of homeowners to deduct mortgage interest, as well as state and local taxes, from their tax bill – numerous articles were written ranking "high-tax states" and estimating how much home prices would fall, with speculation about how people would relocate to lower-tax geographies.

But these examine only parts of the overall equation. Individuals and institutions with the ability to move decide where to locate based on their preferred package of goods, services, and benefits conveyed. Urban areas offered diversity, entertainment, job opportunities and other such benefits. But in the 1980s, the costs (and negatives) associated with city living – crime, congestion, poor quality schools – prompted a larger proportion of the population to move to the suburbs. That trend began reversing in the mid-1990s as cities became safer, and a larger share of the population began preferring to commute less and enjoy city benefits – even if it meant smaller, more expensive living spaces.

This does not mean that suburbs are not evolving. Real estate developers who wish to capitalize on the theory that older Millennials will want larger suburban space with urban-like amenities have begun producing mixed-use developments a stop or an exit away from the nearest urban enclave.

High-tax areas do not necessarily lose population: homeowners move into high-tax locations knowing they will be paying relatively higher bills – and higher home prices – because there are benefits such as good schools and a safe community.

Local government competition has become formalized and professional, with most cities and suburban areas staffed with economic development officials – often offering tax abatements and other enticements for firms and individuals to locate in their area. For example, Amazon's quest for their "HQ2" demonstrates an example of location consulting, which is now a standard offering of accounting and consulting firms. As cities and suburbs evolve, what's valuable in real estate is also changing (mixed-use residential/office/retail, for example) and not so valuable (regional malls).

Societal Leadership

How can the real estate industry be a leader in providing environments in which people live, work, play and interact safely, securely, sustainably, and productively?

The Millennial generation, as a whole, looks beyond the bottom line and shows a broader desire to be involved in more social and environmental improvement. In response, many companies are changing approaches to their real estate footprint and how these companies can facilitate improvement through their business model.

It now appears that this generation, and even those in their teens and early 20s, may be unwilling to accept the status quo – something unseen since the 1960s. This type of activism has potential to move beyond the issues of sexual harassment and gun control, to issues such as homelessness and housing affordability.

Another issue to consider is whether growing political polarization makes it more difficult to own real estate – and whether differences of political views can influence variables such as tenant mix – and whether property owners must develop and have in place action plans to manage an incident should it occur at a property.

Perhaps the greatest shift over the past two years has been in the surge in women to the forefront of issues discussions. As of April 30,2018, 527 female candidates were in races for seats in the U.S. Senate or House of Representatives. An additional 40 women filed to run for governor in various states this year. The #MeToo movement is having impact in politics and in private business. In real estate – especially in the commercial property business and in the previously male stronghold of construction/development – women are rising to senior positions, and are holding a greater proportion of jobs preparing for the top echelon.

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