SPECIAL ISSUE

NATIONAL REAL ESTATE

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2019 Outlook
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Market Trends and 2019 Outlook

Insights from more than 50 commercial real estate firms on what we learned in 2018 and what 2019 will bring.

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EDITOR'S NOTE

Opportunities Ahead

A momentous 2018 has set the stage for even bigger changes to come in 2019. The House changed hands, ending Republican's complete control of Washington. What seems likely is a year of gridlock on legislation and a ramping up of investigations by Congress into the the Trump administration. Meanwhile, the Federal Reserve continues the slow inching up of interest rates. Plus, there is wide consensus that the most recent commercial real estate cycle and broader economic expansion have stretched on to a point where a slowdown should be expected. But no one is quite sure when it will start or what might precipitate a dip.

Yet even with that backdrop, most commercial estate pros expect 2019 to be a smooth year. Some segments and markets still have room to grow. Others might have peaked, but there are few fears of a hard landing coming to pass.

It's in this context that more than 50 commercial real estate firms have provided us their best estimations of where we are and where we are going in the commercial real estate sector in our latest special outlook supplement. This is our third year putting this supplement together and it features the greatest number of firms and pieces contributed.

Of particular interest this year is the burgeoning area of Opportunity Zones, an investment vehicle made possible by the Tax Cuts and Jobs Act of 2017. A number of pieces center on the program and how its use will grow in the coming 12 months.

The pieces in this supplement once again cover every property type. Some delve into niche areas as well. What they have in common is they come from some of the best companies and best minds in the business.

Of particular interest this year is the burgeoning area of Opportunity Zones, an investment vehicle made possible by the Tax Cuts and Jobs Act of 2017.

David Bodamer
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Single-Family Rentals Growing as an Institution-Owned Asset Class

By **Sandeep Bordia**

Institutional ownership of single-family rental (SFR) homes in the United States has surpassed 240,000 homes owned, totaling nearly $40 billion of investment in the sector. In 2017, the number of SFR homes purchased by institutional investors increased year-over-year for the first time since 2013, and 2018 year-to-date purchases have thus far sustained the same pace as 2017, according to Amherst data. In our view positive macro tailwinds, supportive demographics and economies of scale have created an established foothold for institutional SFR operators to expand further in 2019.

Demand is expected to remain strong

Home prices and rents remain reasonably well-supported and continue to see tailwinds from a variety of factors related to demographics, economics and consumer preferences. Amid rising levels of student loan debt, relatively flat wage growth and tight mortgage credit availability, renting has emerged as an affordable solution for many consumers. While mortgage credit availability has improved marginally, it still remains at or around historically tight levels. And even as long term trends continue to favor rental demand, especially for single family homes, many SFR markets continue to trade at attractive cap rates.

Outlook for institutional SFR markets remains positive

Institutional SFR operators remain active in many U.S. markets. In particular, Southeast, West and Midwest, to a lesser extent, remain the most popular target markets. Las Vegas—the slowest big city to recover from the crisis—has finally showed signs of strength with double-digit price growth to date in 2018, according to Amherst data. Seattle maintained strong momentum driven by the tech boom and its tight housing supply. We believe these markets, as well as other high-growth mid-tier markets, will continue to grow in institutional SFR ownership through 2019.

Institutions improving in managing SFR portfolios at scale

Institutional SFR owner-operators have also become better at managing their SFR portfolios. There is increasing evidence of benefits they are reaping from professional scale management and better funding strategies for single family homes. Using proprietary technology and platforms, institutions can better identify acquisition opportunities, maximize occupancy and optimize rents as compared to mom-and-pop investors. With the help of tech-enabled infrastructure, institutions have also improved their ability to manage resources and repair homes. We expect these practices to continue to help generate growth and improve NOI margins in the long-term.

In sum, SFR continues to distinguish itself as a stable, long-term, institution-owned asset class. Expect plenty of noise especially on rising interest rates and what they mean for the housing market, but in all likelihood, 2019 should look a lot like 2018 for the SFR sector: a year of further expansion, steady home price growth, ongoing improvement in margins and additional injection of capital, solidifying SFR's emergence as an attractive alternative asset class for all types of investors. Operators focusing on the right asset and right location with full vertical integration are likely to shine most, in our opinion. ■

Photo: Getty Images

Sandeep Bordia is a managing director and head of research and analytics at Amherst Capital Management LLC.

The comments provided in this article are a general market overview and do not constitute investment advice from Amherst Capital and are not predictive of any future market performance. View full disclosures here.

Learn more at **www.amherstcapital.com**.

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Mid-Sized Industrial Tenants Fuel Growth in U.S. Markets

By **Chip Watson, SIOR**

The U.S. industrial market has seen a tremendous building boom in recent years—with 1.56 billion sq. ft. added since 2012 and another 337.3 million sq. ft. under construction nationally, as of the third quarter of 2018. While there is much attention paid to massive, 1 million-sq.-ft. distribution facilities and the positive economic benefits they generate, there is another story to tell about how small to mid-sized tenants are driving the market.

The backbone of today's industrial market is made up of industrial parts and services providers, e-commerce suppliers and consumer goods producers, among others. These companies typically have space requirements up to 75,000 sq. ft. and may account for 60 percent to 80 percent of leasing activity in a market.

These businesses are a major force in driving this robust industrial market in major markets across the country, such as Atlanta, Chicago and Dallas, as well as secondary markets such as Austin, Texas, Charlotte, N.C., and Indianapolis. While each market has its own dynamics, there are commonalities in how these types of users support the sector.

Atlanta is the sixth largest industrial market in the county and had 23.5 million sq. ft. of space under construction as of the third quarter of 2018. While Atlanta is known for its network of large users, it also has a thriving base of small to mid-sized tenants supporting the distribution cycle. The market had 921 transactions for space of 100,000 sq. ft. and smaller at the end of November 2018 and those leases totaled 12,125,222 sq. ft.

There are other markets where the tenants function as strong local and regional support for larger markets. Austin is strategically located near major distribution hubs including San Antonio, Houston and Dallas. While the city's transportation corridors are not as conducive to national distribution, the market has a growing flex and warehouse sector that supports Amazon and tenants such as LKQ, Coca Cola, Home Depot and other national industrial users on a more regional scale.

Austin also is known for its strong tech industry that has had a direct impact on construction in the market. Many of those users feed into nearby industrial activity, creating a network that brings products and services to major population bases throughout the U.S.

The Austin market has seen solid construction growth in recent years and had 2.15 million sq. ft. under construction near the end of 2018, with several facilities in the 100,000-sq.-ft. to 300,000-sq.-ft. range. Stable job growth and increasing housing starts are expected to generate growth in warehouse space for the home building sector, according to CoStar.

Industrial Lease Transactions 100,000 sq. ft. and Under

	Q1 – Q3 2018	2017
Chicago	1,341	1,523
Dallas/Ft. Worth	1,418	1,154
Atlanta	921	1,235
Orlando	412	598
Inland Empire and L.A. Co.	316	437

Source: Avison Young/Co-Star Research

As the U.S. industrial market continues to evolve into 2019, conventional wisdom suggests building smaller buildings—from 200,000 sq. ft. to 400,000 sq. ft.—to accommodate multiple tenants in smaller sizes. This poses challenges, however with rising land and construction costs.

In Chicago, some developers are debating moving toward mid-sized buildings in areas where land pricing allows. The market is absorbing a significant number of large new spaces and there is interest in evaluating whether buildings in the 350,000-sq.-ft. to 500,000-sq.-ft. range are viable.

For the first half of 2018, the market share for leases in the 25,000-sq.-ft. to 99,999-sq.-ft. range in Chicago was 73.5 percent, while leases from 300,000 sq. ft. to 499,999 sq. ft. were just 2.4 percent to 5.4 percent, supporting the need for mid-sized buildings.

Moving into 2019, the industrial market is heading for another strong year, as growth in e-commerce and corporate distribution space continues to fuel activity. The supply/demand equation will be a challenge for many tenants, however, as they scramble for space and face upward pressure on rents. ■

Chip Watson, SIOR, is an Atlanta-based principal with Avison Young with broad experience assisting local and national clients in the industrial and office sectors.

Learn more at **www.avisonyoung.us**.

2018—A Year of Sustained Market Growth

By **Ernie Katai**

In short, 2018 was a strong, and surprisingly consistent, year for commercial real estate.

At the end of 2017, coming off another strong year, there was some apprehension surrounding how the industry would deal with anticipated rate hikes. Yet with each of the three rate increases so far, deal flow on the lending and investing was undeterred, chugging along at about the same clip as 2017. Impressive to say the least.

Heading into 2019, we're feeling good but, like investors and borrowers, keeping an eye on additional rate increases, as well as the evolving regulatory environment and the anticipated impact that technology will have on the industry.

Economic momentum wins the day in key markets

The strength of the economy in 2018—marked by sustained job growth, wage growth and low unemployment—drove strong market performance across the board. The smile across the country—Southern California, Texas and Florida—saw particularly strong production on both the mortgage banking and investment sales sides.

Cities in Arizona and the Seattle area demonstrated strong performance for investment sales. Meanwhile, Washington D.C., Chicago and Atlanta led the charge for lending deals. We expect primary markets to remain strong in 2019 and continued momentum in tertiary markets with sustained growth, like those in the South and Southeast.

Getting creative in 2019

We expect additional interest rate increases in 2019, for an anticipated total of eight hikes in a 24-month period, which—on the investment sales side—may make returns too thin to sustain the current level of investor interest.

Deal structure and sophistication on the lending side will be crucial for success in 2019. We'll need to utilize all the tools in the toolbox—think more mezzanine pieces and bridge loans—to get good deals across the finish line.

Anticipated regulations

We can expect the regulatory landscape to be in somewhat of a holding pattern as there is a "changing of the guards" moment on the leadership front for the Federal Housing Finance Agency and government-sponsored enterprises (GSEs) including Freddie Mac. Progress on the regulatory front can only be made once this new leadership gets settled into their new roles.

Photo: Getty Images

Once attention does turn to regulation, GSE reform is expected to be one of Congress' priorities in 2019. While borrowers should certainly keep their eye on this critical issue, it may not be a priority until well into 2019.

Technology adaptation

Not to be overlooked, technology is and has been a growing focal point for the commercial real estate industry and will

become even more of a priority next year. In many ways, technology is still developing within the industry, we expect that as it's adapted, the industry will see increased efficiency, speed and streamlined practices.

The commercial real estate market has had an incredible run since 2010 and there is still plenty of capital looking to break into the market. We expect market conditions in 2019 may demand more discipline, creativity and sophistication to keep deal flow attractive, but that's what keeps things exciting!

Ernie Katai is head of production at Berkadia.

Learn more at **www.berkadia.com**.

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Multifamily Debt Financing Continues its Upward Climb

By **John Powell**

2018 saw plenty of liquidity in the multifamily debt market. While life insurance companies, debt funds, banks and, to a lesser extent, commercial mortgage-backed securities (CMBS) have all been very active, Fannie Mae and Freddie Mac remain the most dominant players. Through the third quarter, the two agencies' combined production was nearly $100 billion. They are on course to either match or potentially exceed their record 2017 production.

Green financing fuels production

While the Federal Housing Financing Agency (FHFA) cap for each agency was $35 billion, well over 50 percent of their combined production was considered uncapped business. The big driver of this has been green financing. Even though FHFA increased the required energy or water consumption savings to 25 percent in 2018, Freddie Mac and Fannie Mae are on pace to match or exceed their combined 2017 green production of $40 billion. As it is much cheaper, on average, to qualify for green financing by installing water retrofits rather than energy retrofits, 85 percent to 90 percent or more of the agency's green business was done with water consumption savings. Not surprisingly, the average monthly savings to the tenant is significantly greater (more than double) for energy savings retrofits than for water savings retrofits.

FHFA just announced the agency scorecard for 2019. As generally expected, the cap for each agency remained at $35 billion. Also, as widely expected, FHFA has announced changes that Fannie Mae and Freddie Mac will have to adopt for their green programs. These changes both raise the bar and place greater emphasis on energy savings. To qualify, the savings target has been increased to 30 percent. However, at least 15 percent (50 percent of the total) of the savings must come from investments to reduce energy consumption. Clearly, this requirement will increase the cost to the borrower to qualify. However, it will result in greater savings to the tenant, something both FHFA and the agencies were focused on.

Interest rates remain strong

While interest rates have increased during the course of the year, and especially during the third quarter, they still remain rather favorable. The 10-year treasury rose modestly in 2018, and economic data continued to be very strong despite rate hikes by the Fed.

With the Democrats regaining control of the House, the outlook for Treasury yields in 2019 is a little unclear although the likely trend will be for continued increases. All indications are the economy will remain strong, which would allow the Fed to continue on its current course. However, with Democratic control, further major fiscal initiatives may be slowed which could reduce how far and how quickly rates rise. Spreads, however, have been extremely volatile due to a variety of factors including geopolitical uncertainty, tariffs and trade war fears, as well as the sheer supply of mortgage securities trying to be absorbed in the investor community. Agency spreads as of early November were pretty much at their widest point of 2018. Volatility is likely to continue into 2019 with a bias towards further widening.

Notwithstanding the above, the 2019 outlook for multifamily debt availability will remain positive. Fannie Mae and Freddie Mac are projecting another good year, life companies will remain very active with allocations to at least match 2018, and debt funds will continue to be very competitive, as will banks and CMBS lenders. ■

John Powell is executive vice president at Bellwether Enterprise Real Estate Capital LLC.

Learn more at **www.bellwetherenterprise.com**.

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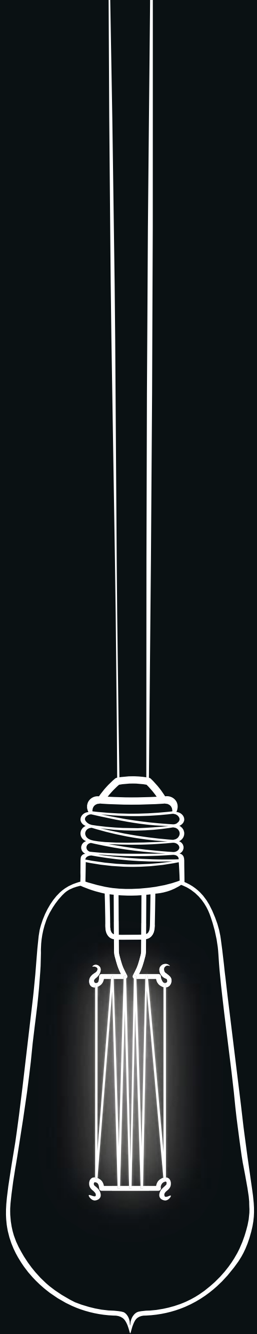

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CAPITAL ON A MISSION

Key Trends Impacting the Real Estate Industry in 2019

By **Stephen Polanski** & **Tim White**

In the coming year, class-A retail real estate should continue to be in high demand, but several key trends are shaking up traditional retail and restaurant site selection. These trends are driven primarily by the behavior of consumers—especially younger ones focused on comfort and convenience. They prefer to stay at home rather than go out to shop and dine, and technology makes it possible for them to obtain practically anything they desire with a few clicks. When they do go out, they crave premium experiences that go above and beyond the ordinary. Restaurants and retailers are responding to these evolving consumer behaviors in interesting and sometimes surprising ways.

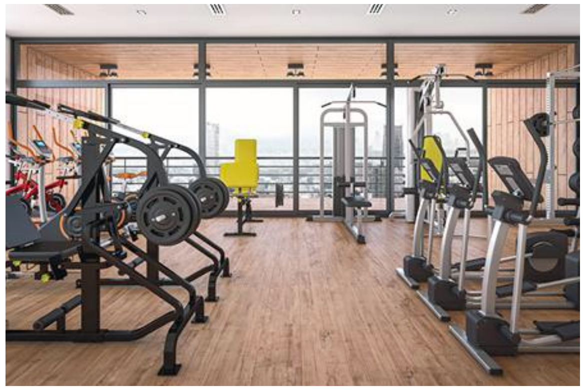

Photo: Getty Images

Pumping up growth in fitness centers

The next generation of fitness centers is here, making old-school workout options look weak by comparison. Consumers are signing up in big numbers for fitness classes that use high-intensity interval training to burn more calories in a shorter amount of time. As a result, we should see heightened interest in sites near large numbers of affluent, fitness-oriented consumers. Retailers and restaurants with a strong health or exercise focus could also find opportunity near these popular fitness centers.

Offering the next generation of entertainment

A hunger for new experiences is also leading to rapid growth in location-based entertainment (LBE). Some of these businesses provide a wide range of entertainment like bowling, arcade games, laser tag and virtual reality, while others feature outdoor activities brought inside, from indoor skydiving to surfing. To appeal to both younger consumers and families, LBE often includes alcohol and gourmet dining options. Because of the significant investment, decision makers should ensure they're choosing sites that offer potential for long-term growth.

Delivering fast-casual dining

In the past several years, the fast-casual sector has been one of the few bright spots in a sluggish restaurant industry. One factor fueling growth is third-party delivery services. Some restaurants report that 40 percent ot 60 percent of their business comes from delivery services like UberEATS and Doordash. This plays into the larger trend of younger consumers preferring the convenience of eating at home to going out. In response, some brands are opening restaurants with smaller footprints and fewer dining tables. Others are devoting entire food preparation and payment counters to third-party delivery orders. As these restaurants expand, they should carefully comb trade areas for consumers who match their profiles for both dine-in and delivery.

Managing assets for greater efficiency

In the retail real estate arena, companies are repositioning their portfolios to limit losses and boost profits. For example, a brand with three locations in a specific trade area might close two and maintain a single store in the best location. When deciding which stores to close and keep, it's critical that planners clearly understand which ones are simply underperforming and which are truly in a poor location. Careful examination of data can provide answers that result in the optimum placement of stores within a trade area.

Going forward

As more consumers pursue greater convenience and new experiences, we expect these real estate trends to continue into the near future. Retailers and restaurants that are positioned to transform their services and give consumers what they want should experience the greatest success. ■

Stephen Polanski and **Tim White** are senior vice presidents at Buxton, an analytics firm that advises brands on real estate strategies.

Learn more at **www.buxtonco.com**.

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Downside Protection for the Late Cycle Economy

By **Michael Orsak**

Reading the financial news, it's hard to avoid predictions of a slowdown in the U.S. economy. Smart investors will seek downside protection, and a strategic allocation to student housing provides portfolio diversification with downside protection for institutional real estate investors. Unlike multifamily, retail, industrial or commercial real estate, demand for student housing is demographically-driven, offering recession resilience. For example, using publicly traded REIT net operating income (NOI) as a proxy, in the last recession, student housing NOI increased by 11.9 percent between 2007 and 2010, while conventional apartment NOI decreased by 3.4 percent.

Three factors will continue to make student housing a good investment alternative during the late cycle economy:

1. **Full-time undergraduate enrollment in four-year, not-for-profit colleges and universities continues to increase in the U.S.** According to the National Center for Education Statistics, enrollment is expected to grow 11.8 percent from 2016 through 2026—an increase of 1.12 million students. While enrollment growth projections have slowed somewhat nationally, enrollments remain on the rise, with above-average growth in many markets.
2. **Student enrollment tends to rise as the economy falls.** According to Caroline Hoxby, professor of economics at Stanford, college attendance has increased during every recession since 1960. With jobs in shorter supply, college education is viewed as an opportunity to improve employability and as a buffer against future downturns. Additionally, students may remain in school seeking advanced degrees rather than entering the job market during a downturn.
3. **Today's students increasingly come from higher income households.** According to a report developed by the Pell Institute for the Study of Opportunity in Higher Education and the University of Pennsylvania Alliance for Higher Education and Democracy, there's a continuing trend in economic stratification with regards to college enrollment. Specifically, enrollments—and degree completion—are more prominent among students from higher income households. While an economic downturn may have some affect, students tend to look for the finer things in their accommodations; for example, today 80 percent of students have their own bedroom.

For those seeking strategic student housing investments, focus on markets that have not recently been in the news related to strong enrollment growth. While this may seem counterintuitive, good press tends to peak interest from multiple developers, and such markets can quickly become saturated. Lower profile markets often offer lower competition.

Additionally, while students demand location and are usually willing to pay for it, we believe core pedestrian-to-campus properties are currently overpriced. The highest performing assets are typically near four-year

public or private not-for-profit universities with at least 10,000 students and located within one mile of campus, dependent on relation to the rest of the market.

Student housing is a highly nuanced market. If you are considering a student housing investment for downside protection and are new to the space, consider partnering with an experienced student housing investment manager to reduce risk. ■

Michael Orsak is senior vice president of investments at Campus Advantage.

Rate Forecasts and Their Impact on Lending and Investor Decisions in 2019

By **Jake Clopton**

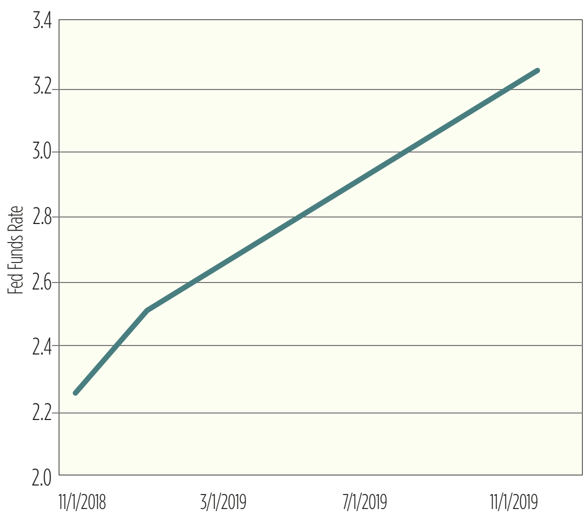
As everyone has noticed by now, we are in a rising rate environment. 2019 rate forecasts are showing a continuation of this trend and investors should expect to pay more for money as the year progresses.

According to the U.S. Federal Reserve dot plot chart, Fed Funds rates are predicted to settle the 2019 year in a range of 3.00 percent to 3.25 percent. As of this writing we are currently in the 2.00 ercent to 2.25 percent range, which would mean we are looking at four rate hikes between now and the end of 2019, with one predicted to occur in December 2018. This will directly impact lending across the board in the economy and should have an almost immediate affect once the rate decisions are announced. Look for commercial real estate loans that use short-term indexes like Fed Funds, prime rate, 30-day LIBOR, to be the most sensitive to Fed Funds movements. Typically, shorter term loans such as construction and bridge loans are tied to short-terms rates, which could see a meaningful drag if we are looking at a 100-basis point increase by he end of 2019. It will also be important to pay attention to floating rates that are originated earlier in the year, as loan costs will increase as 2019 goes on.

Long term rate guidance is more difficult to pin down as many factors influence rates in long term treasuries, however most guidance we see is for the 10-year treasury rate to end the year in the mid to high 3 percent range, specifically around 3.6 percent to 3.7 percent. The main driving factors for 2019 that will determine long term rates will be inflation in prices and wages, U.S. budget deficits, global interest rates (specifically Eurozone), and geopolitical risks such as trade wars. Look for higher than normal volatility in long term rates throughout the year, with periods of sharp increases and decreases, however with an overall trend of increasing rates. Commercial real estate deals most affected by higher long-term rates will be stabilized properties looking to fix rates. Look for low cap rate acquisitions to struggle as funding costs increase and more equity is required to capitalize projects. Additional difficulties will be seen in highly leveraged and/or struggling properties looking to refinance in the face of higher borrowing costs. Investors should look to lock in longer term rates earlier in the year rather than waiting as the risk is certainly to the upside in long term rates.

The overall trend in 2019 will be higher rates, marked by periods of high volatility in long terms rates. Investors should take these concerns into account with considering property values and acquisition prices, as cap rates should move upward as the economy digests higher costs of funds. Properties most at risk are going to be the ones that had tight margins to begin with, struggling properties on variable rates, or highly leveraged deals needing refinancing. Look to also see acquisitions slow or stagnate for deals where sellers are not willing to come off of high prices and borrowers' willingness to stomach lower returns diminishes. ■

Fed Funds Rate Projection 2019



Jake Clopton has been the President and Owner of Clopton Capital for almost 10 years. During that time, he has arranged almost $1 billion in financing on various commercial property types and worked with a wide range of capital sources to fund loans for his clients. Prior to this position, he traded interbank interest rate hedging products for a proprietary trading firm in Chicago.

Learn more at **www.cloptoncapital.com**.

Clopton Capital

The Blurring of Logistical Lines

By **Gregg Healy**

In today's world, we think of commercial real estate space mostly in terms of separate sectors: retail, office, multifamily, industrial, etc. But in the future, it's inevitable that these lines will become blurred. As e-commerce has continued to captivate the way consumers buy goods of all kinds, people are increasingly expecting faster and faster delivery times. This trend has, and will continue to, change the face of logistics entirely.

Photo: Leon Neal/Getty Images

The e-commerce industry surpassed the 10 percent of overall retail sales threshold in 2017 and shows no signs of slowing down. Over the next four years alone, e-commerce retail sales are anticipated to grow by a whopping 55 percent. By no means surprising, this is the fastest growing segment of retail. Retailers are quickly recognizing that they need both a strong brick and mortar presence as well as a robust online platform as part of their omnichannel fulfillment strategy. The ability to provide an abundant variety of products at the convenience and speed which the consumer demands will continue to significantly disrupt traditional logistics models. While this trend grows, companies will need to get creative with space to keep up with the demand, as developable land shrinks in the most population-dense areas of the country. So just how will this rapid growth change logistics and blur the lines of commercial real estate in the next few decades to come?

In the future, we'll likely see spaces that are a vast mix of uses. Picture this: you live in a high-rise in the center of a core market like New York City. On the first floor sits retail space, with a distribution center taking space on the second and third floors above, accessible by ramps that smaller, space-efficient driverless trucks can easily access. Above that lies several floors of class-A office space, followed by several floors of multifamily housing. All in one building, you have a multitude of commercial real estate property classes meshing together.

Not only does utilizing a model like this make a lot of sense in terms of shrinking availability and the rise of e-commerce, but it also plays into how younger generations increasingly value instant gratification and convenience, especially as they continue to migrate back to urban environments. Additionally, we'll likely see the impact of 3D printing affect logistics in the years to come. As the technology behind it develops further and is more cost-effective for wider mass production, the ability to manufacture a product on demand will save a lot of time and money—appealing to companies and consumers who can get what they want with the click of a button. ■

Gregg Healy, senior vice President, leads the supply chain & logistics team and is based out of Colliers' Ontario, Calif., office. With more than 20 years of global manufacturing and supply chain experience, both as a senior executive in the corporate world, as well as owning a supply chain consulting practice and a third-party logistics business, Gregg has real world experience that brings unique perspective to the commercial real estate world.

Learn more at **www.colliers.com**.

Trends in Self-Storage

By **Tom de Jong, SIOR, MBA**

Coming out of the depths of the recession the self-storage industry has become one of the darlings of niche commercial real estate investing and has been attracting an immense amount of new capital from new sources, including hedge funds, venture capital, public and private REITS, family offices and more. This capital has led to a record wave of new development.

Development activity during this cycle began in 2015 with new project deliveries peaking mid-year in 2018 with this cycle adding 10 percent to the total inventory of storage units across the country. While some markets like Portland, Ore., Nashville, Tenn.,, Denver, Seattle and Boston have seen higher levels of development, high barrier-to-entry markets such as Los Angeles, New York City and San Francisco have seen lower levels of development.

Development trends

Gone are the days of first-generation storage sheds! Today's modern storage facilities look more like retail or apartment buildings. Modern facilities are multi-story, elevator-served buildings with climate-controlled spaces, modern security features and are well lit and very clean with inviting retail space to complete your rental booking process, buy boxes, locks, packaging materials, etc. With the ongoing troubles for big-box retailers 2019 will see more retail to self-storage conversions.

Another trend is the automation of front office operations with self-storage kiosks able to lease units, dispense locks, take client payments, establish auto-pay, and provide 24-hour connections to an offsite call center. Fully autonomous facilities are still relatively rare but as a new generation of renters, those having grown up with mobile phones as their primary lifeline to the world, gain a larger share of the market, facility automation will pick up steam.

Technology trends

As an industry still dominated by operators with one or two facilities there are still a tremendous amount of facilities with limited web presence, static websites and no mobile device strategy.

Large operators have invested millions in the latest web search technologies, mobile search functionality, dynamic price modeling, mobile access control and high-tech security systems. The latest innovations include electronic locks operated via mobile device, automated text reminders, e-sign rental agreement management and facility automation kiosks.

Photo: Getty Images

Investment trends

Cap rates have remained at historically low levels for the past two years, with assets trading at or near 5 percent in the top 50 MSA's. The market for entitled land, properties in lease-up, and Certificate of Occupancy sales has softened considerably over the past six to nine months with spreads pushing up 50 to 100 basis points from their prior levels. Cap rates will slowly migrate upwards pushing down values as interest rates are normalized.

Entering 2019 we will see more self-storage properties coming to market as sellers are coming to the realization that we are nearing the end of this cycle and the downside risks are considerably higher for those that wait too long!

Big data storms self-storage

Data providers Yardi Matrix, Radius, REIS, STR, Union Realtime, SSDMS and others have recently begun tracking different metrics in the self-storage market and selling that data to self-storage owners, investors, developers and other interested parties. Look for this trend to continue. ■

Tom de Jong, SIOR, MBA is senior vice president with Colliers International's national self-storage group and is active in self-storage brokerage, site selection and self-storage consulting across the U.S.

Learn more at **www2.colliers.com**.

Top Five Tips to Divest Unneeded Corporate Real Estate

By **Gerard Staudt**

The world of selling and leasing excess real estate (dispositions) is fraught with pitfalls. Many companies find book values and appraisals **higher than** what the market will pay. Transactions can unravel due to complexities that non-disposition specialists encounter when disposing of excess space, often because they do not have the necessary dedicated expertise.

While typical real estate service firms have individuals conducting both acquisitions (securing new space) and dispositions (leasing and selling surplus space), the market does not generally offer dedicated individuals whose focus is solely on the sale and lease of corporate excess space.

As president of CoreDispo's dedicated global real estate leasing and sales team, below are my top-five tips to divesting (leasing and sales of) corporate real estate.

1. Have the necessary corporate approvals in place prior to marketing.

Corporations with excess space often go to market without having approvals required to complete the transaction. This can result in corporations taking 20 percent to 30 percent of property off the market after they have spent enormous time and money marketing it. (Details in full article).

2. Every time you conduct a sale or lease, you have to do your homework up front.

It's far better to address issues at the start of a process, rather than wait for them to be uncovered on the day of the deal. First, this information allows the corporation to make an educated decision of whether they really are prepared to dispose of the space before going to market and, second, if they do go to market the data allows the tenant or buyer to make a quicker decision on whether the site works for them or not. (Details in full article).

3. Learn and understand the competition to set terms and price.

Know the worst and best possible terms and price that the market has accepted for similar properties. It is critical to state in all requests for pricing or value whether the pricing will be used for insurance, to buy the site, sell the site, lease a specific portion for a specific timeframe - or for some other use. Be detailed and specific. (Details in full article.)

4. Have your paperwork in place.

Draft all transaction paperwork and legal agreements prior to marketing—well before any prospect submits an offer.

5. Respond to offers quickly.

Following the long time it may take to bring in qualified prospects, corporations should be prepared to respond to all prospect offers **within three business days** by comparing offers to the corporate approvals that should already be in place and supply legal agreements to prospects within several days after agreement of basic business terms. That is the speed and the process by which the best competing sites may operate.

Read more here.

CoreDispo (Corporate Real Estate Dispositions, Inc.) was formed to help corporations avoid pitfalls involved in selling and leasing excess space with its sole dedicated focus on corporate excess space. The foundational principle of CoreDispo is to provide accurate pricing, timing, and cash flow results upfront and on time. ■

Gerard Staudt, president of CoreDispo, is a seasoned corporate real estate leader with 30 years' experience identifying problems, solving challenging surplus real estate issues, and delivering cash flow in a timely manner.

Learn more at **www.coredispo.com**.

CoreDispo
Corporate Real Estate Dispositions, Inc.

Photo: Getty Images

Opportunities Abound in 2019—But Nothing is Easy

By **Andy Jaffe**

As President of CORFAC International for the past year, I've made a point to visit as many of our affiliates as possible, to reinforce relationships and to get different perspectives on the real estate market. I didn't make it to all 80 cities worldwide, but I managed to visit 15 CORFAC firms throughout the U.S. and globally, and interacted with many more at events like our recent Fall Summit in London, the International Summer Affiliate Meeting in Romania, and ICSC in Las Vegas.

There's so much happening in the commercial real estate business that the future is impossible to know with certainty, but I like to think my conversations with colleagues have helped me to separate the signal from the noise. Here are some of the key trends I think we'll see in 2019:

It's a value-add market. Capital sources are increasingly focused on infill development, re-development, adaptive re-use and impact investing. One reason is the phase of the market cycle, where yield-driven capital can't rely on cash flow appreciation to do the whole job. An even bigger reason is the renaissance of urban neighborhoods, creating opportunities for industrial conversions to mixed-use properties, as well as creating a need for last-mile distribution space.

Perhaps the ultimate value-add strategy is impact investing, which focuses on housing and businesses in disadvantaged neighborhoods. Socially responsible investment vehicles are gaining traction, partly as a way for people to support development in their own communities. And now, U.S. investors can defer and reduce current capital gains taxes—and avoid tax on future capital gains--by investing in properties and businesses in economically-distressed Qualified Opportunity Zones. The range of available funding sources and methods, plus steady user demand, suggests we'll see a lot of value-add deals in 2019.

Industrial and retail real estate are getting more entwined. With e-commerce and home delivery services on the rise, retailers have adopted omnichannel marketing and logistics strategies that blur the lines between distribution and retail. Urban industrial space is at a premium, and there is rising demand for cold storage space as consumers seek out fresh foods. Meanwhile, many shopping centers are coping with too much vacancy and fading customer traffic. As these trends continue we may see some retailers use more of their space as logistics centers for quick customer fulfillment and to instantly restock in-store purchases.

Photo: Getty Images

Cross-border capital is still plentiful for the right deals. Despite a decline for foreign investment in U.S. real estate deal flow during 2018 compared to 2017, there's still a strong appetite for cross-border investments around the world. Our affiliates in Europe report that Brexit has had little impact on their real estate markets, and London is more popular with global investors than ever. Rising economies around the world make investors more confident in investing closer to home and less

dependent on the U.S. as a safe haven.

That doesn't mean investors have soured on the U.S.—far from it. Foreign capital is going deeper than ever into segments like industrial and seniors housing, and are increasing their focus on secondary cities across the country that are posting strong job growth. Some of the best deals are off-market opportunities, so it's as important as ever to build strong international relationships. ■

Andy Jaffe is senior vice president of sales and leasing for Commercial Properties, Inc./CORFAC International in Tempe, Ariz., (www.cpiaz.com) and serves as the 2018 President of CORFAC International.

Learn more at **www.corfac.com**.

CORFAC International

Indiana Industrial Space and CAVU

By **Jeff Castell**

During the recent memorial service honoring former President George H.W. Bush, there was a reference to CAVU, an acronym used in aviation meaning "Ceiling and Visibility Unlimited". Pilots commonly employ CAVU to describe any desirable or sought-after condition and Bush 41 memorialized the concept to describe his own life with Barbara on a small plaque unobtrusively displayed on the porch of their Walker's Point home in Kennebunkport, Maine. Ahh, but I digress…

Pivoting to the Indy industrial real estate market, we see a tradition of strong fundamentals worthy of a CAVU reference. We see a diverse economy powered by advanced manufacturing, information technology, life sciences and a robust logistics and transportation sector. The central Indiana industrial market benefits from population growth with the metro area tripling the statewide average and projected to expand by 2.8 percent over the next two years, placing Indy amongst the fastest growing Midwest markets and top half of all U.S. metros, as an answer to the universally recognized tight labor and unemployment challenge. Indianapolis is uniquely resilient as one of only six U.S. industrial markets that registered positive net absorption during each of the past two recessionary periods with occupancy expanding by over 10 million sq. ft., the strongest of any U.S. market.

Indiana boasts a stable political and economic environment with an exceptional S&P AAA bond rating reflecting the highest quality credit and associated confidence, second place ranking by *U.S. News and World Report* for States With the Best Long-Term Fiscal Stability. The Cost of Doing Business ranking by *CNBC* places Indiana fifth in the U.S., while *Forbes* pegs the Hoosier State third for Best Regulatory Environment and the Tax Foundation places Indiana second in the nation on their Property Tax Index. Moreover, our first place ranking in pass through interstates, second largest worldwide FedEx Hub (located on Indianapolis International Airport—ranked best in the bation during the past four consecutive years) and position as third in total freight railroads all contribute to Cushman & Wakefield's *National Industrial Forecast* calling for leasing demand to outpace supply in coming years, contributing to solid rental growth (14.9 percent since the third quarter of 2015), continued robust expansion (5.93 million sq. ft. per year average net occupancy growth since the third quarter), abundant new construction (5.78 million sq. ft. per year since the third quarter of 2015) and impressive tightening with available industrial space declining 130 basis points since 2015 to historically low direct vacancy at 4.1 percent.

The central location of Indiana accommodates more than 1.5 billion tons of annual interstate freight movement, projected to grow 60 percent in the next 30 years. Access to 80 percent of the U.S. and Canadian population within a one-day drive establishes the backdrop for the region as home to 1,500 logistics-focused firms employing over 100,000 workers and accounting for more than half of our near-term GDP growth.

Indy demonstrates balanced fundamentals with impressive population growth in a stable fiscal environment, central geographic location boasting unparalleled infrastructure and producing liquidity reflected in year-over-year industrial capital flows nearly 30 percent greater than the U.S. average during 2018, placing Indianapolis solidly in the top 10 of a recent *NREI* article ranking best industrial markets, amongst peers predominantly comprised of primary markets.

By virtually any meaningful measure, the Indy industrial market enjoys no barriers, boundaries, limits or, to borrow a phrase from Bush 41, CAVU. ■

Jeff Castell, SIOR, CCIM is a 33-year industry veteran and leads the industrial capital markets group as executive director of Cushman & Wakefield in Indianapolis.

Learn more at **www.cushmanwakefield.com**.

CUSHMAN & WAKEFIELD

Photo: Getty Images

EB-5 and Opportunity Zones: Chutes & Ladders for Developers and Investors Alike

By **Carlos Rodriguez Jr.**

Though the ubiquitous sight of cranes might indicate otherwise, industry norms and political-economic trends have created a challenging climate for commercial real estate development. The construction industry has historically been non-innovative, and output-per-employee has actually declined since the 1990s. There are new challenges in the form of infrastructure, safety and environmental efficiency, which have led to stringent building codes and permitting processes that are costlier and more time-consuming than in prior cycles. Add rising labor costs and price increases because of "trade wars" and the development environment is tougher than casual observers would assume.

Against this backdrop consider two government programs: the EB-5 investor-visa program and the tax incentives surrounding Opportunity Zones. Theoretically, these programs should be win-win "ladders" for developers and investors alike, allowing returns to climb higher by utilizing inexpensive financing and harnessing tax benefits. However, there are pitfalls posed by these programs, and these ladders could easily become "chutes" sending investments plummeting.

The EB-5 investor-visa program allows foreign-nationals to gain lawful permanent U.S. resident status by making $500,000+ investments in projects creating at least 10 jobs per investor. Early on, the program gained notoriety following high-profile fraud cases committed by new-to-the-game developers taking advantage of access to inexpensive capital provided by EB-5 applicants.

To date, many EB-5 developments have failed to deliver on their promises because of a lack of thoughtful structuring and a disregard for development fundamentals. Many developers have fallen victim to the "chutes" of the program, relying on EB-5 capital that either never arrives or arrives later than anticipated. Many investors have been burned by projects that do not ultimately earn visas when the over-ambitious, over-costly or over-levered projects fail. Projects need to be able to stand on their own irrespective of EB-5 capital. Developers must structure deals with upfront bridge financing and conservative underwriting so that the project's success doesn't depend on EB-5 financing.

Our company first explored the potential of EB-5 financing in 2010. Due to the cavalier attitude pervasive in the industry, we decided to directly structure and finance our deals to ensure we controlled the process and balanced the capital stack in a prudent manner. Today, we have successfully financed and built five EB-5 hotel developments, often starting construction without finishing the EB-5 capital raise by utilizing our company's own bridge financing capacity. We also use a bifurcated offering structure allowing EB-5 investors to choose between debt or equity investing, which allows for a more balanced capital stack and simpler exit plans.

The same cart-before-the-horse mentality has already taken hold in Opportunity Zones. This new tax program allows deferment of existing capital gains and avoidance of future capital gains by investing in Opportunity Zones

Photo: Getty Images

(specific distressed census tracts throughout the U.S.) While additional IRS guidance is forthcoming, the potential benefit is being heralded by developers as "free cash." As with EB-5, many developers and investors are getting caught up in the frenzy.

As we analyze this new investment model (note that we are underway in raising two Qualified Opportunity funds), our concern is sellers overvaluing land solely because it is located in an Opportunity Zone. Considering the 10-year hold period required to maximize program benefits, we see the value of Opportunity Zones equating to a 3 percent IRR premium on a risk-adjusted basis. However, if land prices increase too much, the value proposition of the Opportunity Zone investment is lost. ■

Carlos Rodriguez Jr. is COO of Driftwood Acquisitions & Development L.P.

Learn more at **www.dadlp.com**.

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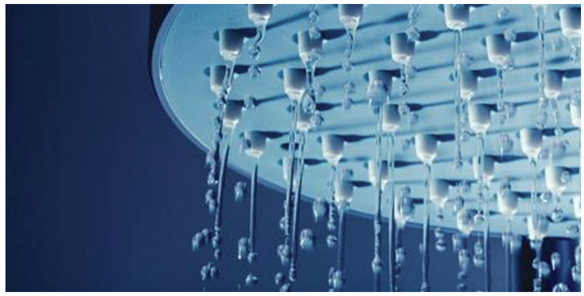
The Vast Impact of Water Conservation on the Triple Bottom Line

By **Richard Lamondin**

Water scarcity is one of the greatest threats to humanity in the 21st century, with more than one billion people lacking access to water. In the U.S., residents face issues of scarcity and waste, with 10 percent of homes leaking more than 90 gallons of water a day, which totals 1 trillion gallons of water annually. The majority of the waste originates in the bathroom—over 25 percent of all clean water consumed in U.S. homes is used to flush the toilets.

Local governments, businesses, and citizens are only just beginning to act. The CRE industry has an opportunity to reduce its impact on water supply while improving profitability and social impact in the process.



Environmental impact

By 2030, humanity's annual global water requirements will exceed current sustainable water supplies by 40 percent. One of the most impactful solutions to reduce demand is the implementation of water conservation programs on the property level.

The right conservation partner can implement a program to produce quantifiable results in a matter of months. A company like EcoSystems will consult and audit a property's water bills, rate structure, age, condition and flow rates of existing bathrooms. From there, installations of water-saving, leak-proof plumbing products are made including high-efficiency toilets with flow rates as low as 0.8 GPF, showerheads, valves, sinks and aerators. This process has resulted in EcoSystems saving more than two billion gallons of freshwater with an average of 6 million gallons saved annually per property.

Financial impact

Alongside water waste comes an affordability crisis. A 2017 Michigan State study found that 36 percent of U.S. households could struggle to pay their water bills within five years. Dwindling supply and costly replacement of aging infrastructure is driving an increase in water and sewer bills, with rates rising 48 percent nationwide from 2010 to 2016.

Properties that reduce water consumption can avoid rising fees and experience financial benefits—both on monthly savings and at the time of sale. To date, more than 100 properties in EcoSystems' portfolio have saved $15 million and on average, experience a return on investment in 22 months. Consider the vast impact water conservation can have when committed to and implemented portfolio-wide.

Looking ahead to 2019, green finance programs offered by Freddie Mac and Fannie Mae will continue to encourage more property owners to commit to reducing water in order to get better pricing on loans and funding to make the improvements.

Social impact

Incorporating water conservation programs impacts resident retention and the health of the community. In fact, incorporating sustainable practices can result in the ability to charge higher rents. A recent study found millennial renters claim they are willing to pay more for sustainability and energy-efficient housing.

We also see more local governments and utilities at the forefront of water issues and housing affordability. For example, Denver Water uses EcoSystems to implement their water conservation programs, installing free water savings fixtures for low income and nonprofit customers, and implementing large-scale conservation projects on the most wasteful properties in the city.

As we embark on a new year, keep in mind that in roughly one decade, we will have a serious water supply issue on our hands. Those who are providing access to water must step up and do their part. ■

Richard Lamondin is the CEO and co-founder of EcoSystems, a leading water efficiency and savings company that serves multifamily owners, managers, and investors across the U.S.

Learn more at **www.ecosystems.com**.

Savings that mean the world.

Photo: Getty Images

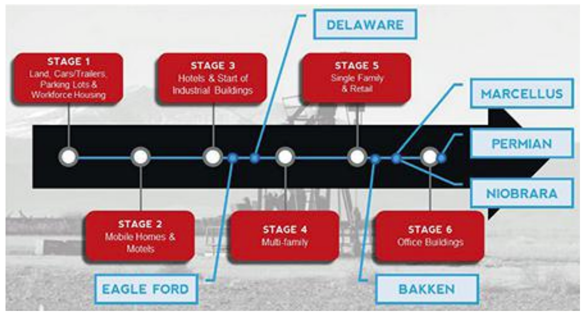
Riding the Upcycle: Opportunities in Shale Play Real Estate

By **Mike Elliott** & **Tom Bradley**

Real estate investment in shale play markets can bring some of the highest returns in North America. During the 2014 oil boom multifamily rates in rural North Dakota towns were higher than both New York and San Francisco, peaking at $2,500/bed per month. Five years later, after weathering the bust after the boom, investors and end users once again find themselves amidst growing energy markets on the rebound.

Since mid-2017 the United States has slowly increased its monthly crude oil output, eventually smashing historic records and surpassing Russia and Saudi Arabia to become the world's largest producer. If 2019 production continues the same steady climb, the year ahead poses outstanding real estate investment opportunities across key domestic shale plays.

Shale Play Lifecycle



As shale play production grows, so does the need for real estate support. This lifecycle is an indicator of where investment and development opportunities exist in each shale play.

Sources: WWW.ENERGYRECO.COM

Shale play investment strategies

While real estate markets in and around every shale play have the potential for high returns, here are a few strategies to consider as you look for your next energy market investment.

Buying below replacement costs

Construction in energy markets is expensive no matter the product type due to labor shortages, material costs, etc. During the early days of the oil recession, investors assumed that it would only be a matter of time before distressed properties hit the market in hot areas like Williston, N.D. and Midland, Texas. Some prime opportunities manifested themselves and created an overall favorable climate for investment, however, a true "fire sale" situation never materialized.

That said, one investment type has bucked the trends and provided more favorable opportunities for investors —multifamily.

Multifamily development was extremely popular in emerging energy markets from 2011 to 2014. With population flooding many of these areas, developers quickly mobilized and added thousands of units. The returns on successful developments caught the eye of private equity, family funds and high net worth individuals alike. Market conditions and overzealous investors have led to a saturated market and an overdeveloped product type.

With expensive labor and materials and, in some markets, a short building cycle, the cost to construct skyrocketed. In some cases, as high as $225,000 to $275,000 per door!

Investors have leveraged this scenario to their advantage spurring a recent uptick in multifamily trading at an extreme discount, as low as 30 percent of replacement costs. With the increase in demand for apartment units across all energy markets, new owners can be more competitive with their lease rates and still capture double digit returns. With no new apartment development in sight (barriers to entry include lack of debt, cost to construct) owners can better weather the fluctuating oil prices and its impact on apartment demand.

Focus on the core energy markets

Increased global oil demand will undoubtedly continue to create shale play real estate opportunities, but it doesn't come without risk. Tied to infrastructure support and the ebbs and flows of the commodities market, to ensure success investors should always (i) stay in core energy market areas and (ii) utilize a boots-on-the-ground partner to navigate the nuances of these specialized markets. ■


Mike Elliott is the CEO and **Tom Bradley** is the president of Energy Real Estate Solutions (ERES), the only full-service commercial real estate provider entrenched in secondary and tertiary North and South American energy markets.

Learn more at **www.energyreco.com**.

ERES
ENERGY REAL ESTATE SOLUTIONS

The Economy Affects Markets and There is a Risk Going Forward

By **Rick Chichester**

From an economic, market and political standpoint, 2019 looks to be the year of caution, transition and turbulence. We are ten years into the economic recovery and expansion. The Federal Reserve is reducing its balance sheet and trying to move rates to neutral, albeit by only 3 percent (this is long overdue and will test the real fundamental strength of the economy). Further, the U.S. tax reform/stimulus has reduced federal revenues significantly and will most likely have less impact going forward. The stock market looks fully priced and volatile. With geopolitical issues, threats of tariffs, and debt (global, national, corporate and personal) at a record high, these factors might all be inflection points that U.S. leaders need to manage responsibly, or the ramifications could project us into an economic contraction.

It is important to note that all of our economic recoveries and expansions have been debt-financed (the most recent being the most aggressive) and as we have expanded the debt, we continue to lower its costs to keep stimulating the economy. However, if not appropriately managed, over the long term, the debt risk will increase faster than the income/revenue necessary to pay for it which would lead to a deflationary state. By way of example, the national debt to GDP was 68 percent in 2008 and is estimated to be 104 percent by the end of 2018 and 108 percent in 2019, and this is with the current Federal Funds rate at 2.25 percent and the trailing 12-month inflation rate at 2.52 percent.

Retail investment challenges and opportunities

Retail real estate has had many challenges. However, it is not dying as the media headlines might have you believe. It is merely evolving to a new normal. Retail has always been fluid and dynamic. Sears has disrupted and changed retail with the catalog. Now the internet drives bricks and mortars to evolve and follow consumption trends. There is an oversupply of physical retail real estate today, but there is a unique and compelling value to most physical retail space which is entirely location dependent. Retail is the most diverse of all commercial segments. It will always be relevant. Even though dependent on the vision and strategic development of the retailer as well as the investor/developer, Retail is not passive.

In 2019, e-commerce and demographic trends will continue to weaken the outlook for lower-productivity retail assets.

Sharp bifurcation in the shopping center sector has emerged (have and have-nots), retail-backed 30 days, plus delinquencies increased in October 2018 reversing a long-term decline. They currently make up the most significant percentage of loans in special servicing. But "high-quality" retail locations/stores will continue to be the center of the retail distribution, sales, and experience.

From an investment perspective, core, grocery and in-fill retail remain in high demand. Strip centers will expand as more investors appreciate its value and diversity. Single-tenant net lease will continue to stay strong. In general, the buyer pool has narrowed, but we expect to see new buyers enter and/or renter the market as pricing and competition result in significant value-add and opportunistic opportunities for the sophisticated and contrarian investor. ■

Photo: Getty Images

Rick Chichester is president and CEO of Faris Lee Investments, a leading retail advisory and investment sales firm.

Learn more at **www.farislee.com**.

What to Expect for Commercial Insurance Rates in 2019

By **Matt Harrell**

Photo: Win McNamee /Getty Images

The most frequent question I'm asked today is "How will the 2018 hurricane season impact the insurance market in 2019?" As the current marketplace struggles to find its footing between hard and soft markets, rates are scattered, and carriers are targeting anywhere from a 5 percent decrease to a 20 percent increase.

Although an overall pricing decrease is becoming less common, it is still achievable for the right type of portfolio. Generally, newer construction risks with few losses are getting the best terms and pricing at renewal. We're now seeing most markets satisfied with a 5 percent average overall increase, though a few markets are pushing for higher rates on certain asset classes with significant exposure to natural catastrophe perils.

Fortunately, the harrowing images of the damage caused by hurricanes Michael and Florence are not indicative of the actual impact they will have on insurance rates. Total insured losses from these storms are expected to be at most $13 billion. However, the insurance marketplace is capitalized to withstand a $100 billion-plus event, and these storms should not dramatically impact the property insurance marketplace. Renewals in hurricane-prone regions are expected to be somewhere between flat and a moderate 7 percent increase, which is the result of a strong, well-capitalized reinsurance market flush with alternative capital.

The flood events from hurricanes Harvey, Irma, Florence and Michael in recent years have created an increased awareness of the importance of adequate flood coverage. The majority of flood insurance is purchased through the National Flood Insurance Program (NFIP), which has continued to take on record debt each year, reaching a total of $30 billion in 2017.

The Federal Emergency Management Agency has made significant changes to the program recently, including rate increases across almost all policies. NFIP rate increases are averaging 8 percent, with the most significant increases coming in as high as 25 percent for pre-FIRM, non-primary residential and commercial locations.

Alternatively, the private flood insurance market has proven to be a competitive option for mitigating the rate increases and uncertainty associated with the NFIP. Flood insurance is a difficult coverage to underwrite, and the increasing sophistication of the private market can deliver a more price-stable alternative for property owners.

The insurance market in hail exposed regions has become very challenging. Hail-related claims in Texas, Oklahoma, Colorado, Kansas, Missouri and Nebraska have increased significantly both in frequency and severity over the past few years. Carriers that have not exited the market in these states have responded by increasing both rates and deductibles. Depending on loss history and location, rate increases for portfolios in these states can range from 5 percent to 15 percent.

Multifamily has become the most challenging sector within the real estate industry when compared to retail, office and industrial. Over the past several years, carriers have aggressively underwritten multifamily risks to gain market share and grow premium volume. Unfortunately, these aggressive underwriting practices have caught up to carriers not charging enough premium to cover the inevitable underwriting losses. Rate increases for multifamily risks that have experienced significant losses can be as high as 20 percent. In these scenarios, aggressive risk management practices should be implemented to prevent and minimize future losses.

In conclusion, although we are not in a hard market, rate increases are expected in 2019. An awareness of what to expect for your portfolio will be an important part of planning for your insurance renewal. ■

As managing Director, **Matt Harrell** brings a wealth of industry experience to Franklin Street Insurance Services.

Learn more at **www.franklinst.com**.

During Another Record Year, Freddie Mac Looks to Continue Innovating

By **Debby Jenkins**

As 2018 comes to a close, Freddie Mac Multifamily is on the verge of another record year. This year, we expect to finance more than $75 billion, totaling over 800,000 rental units, which exceeds both the number of units and dollar volumes we financed in 2017. And most importantly, nearly 90 percent of the units financed are affordable to moderate- or low-income families.

For Freddie Mac, our strong, responsible growth is part of a transformation that has been a decade in the making. Today we are the market leader, having grown our business to nearly $290 billion—more than $100 billion larger than its size in 2010. We have achieved this significant pace of growth while maintaining a historically low delinquency rate and while protecting taxpayers by transferring a significant portion of risk on over $300 billion in multifamily mortgages to the private market.

Our success is primarily built on our people, including our integrated network of seller/servicers, borrowers, and investors—not to mention our dedicated workforce. It is also built on strong market fundamentals.

For example, in 2018 the multifamily market surpassed expectations as values continued to rise and the influx of capital continued in tandem. Investors have seen that as the multifamily market has matured, it has proved to be a reliable source of stable returns relative to other commercial real estate classes.

To be sure, we are seeing moderation in comparison to the past few years of growth, but not in a way that is cause for concern. Property prices continue to climb and are up nearly 11 percent year-over-year. Rent growth has continued at both the national level and in most major metropolitan areas. Although rising interest rates are expected to slow origination growth modestly, overall performance has remained healthy. We expect that to continue into 2019.

As we look ahead, the trajectory of the multifamily market is promising, but as a company we are also intently focused on innovating to meet the challenges of the marketplace for both renters and borrowers.

Paramount among those challenges is our persistent housing shortage. As policymakers and municipalities focus on affordable housing and developers focus on class A rentals, the needs of moderate income families continue to grow.

More than half of renter households in this so-called "missing middle" are cost burdened, spending more than 30 percent of their income on housing. To address the challenges facing these families, Freddie Mac is building a suite of offerings that are targeted at the preservation and rehabilitation of affordable rental properties for workforce families. These include our Mezzanine financing program, and our offerings with a social Impact focus, among others. In the coming years, we will speed our efforts to find new solutions that leverage private capital and that are affordable-by-design.

Beyond addressing affordability, Freddie Mac is working to redefine the commercial loan customer experience through a digital transformation. The commercial real estate industry has been slow to incorporate technology, and we aim to reshape the way mortgage processing is done through a multi-year effort that improves transparency and creates new efficiencies and cost-savings.

Ultimately, we believe that Freddie Mac's unique and durable business model will allow for our success to continue well into the future. From our boots-on-the ground regional office approach, prior approval underwriting, and an innovative, first-of-its-kind risk transfer model, Freddie Mac and its partners have set a new standard for the industry. As our transformation as a company continues, we are optimistic about 2019 and the years ahead.

Debby Jenkins is the head of Freddie Mac Multifamily, the leading provider of multifamily debt capital in the U.S.

Learn more at **mf.freddiemac.com**.

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Photo: Getty Images

2019...Rising Interest Rates and Falling Returns—The New Normal!?

By **Gerald Guterman**

The current "inside word" declares that rising interest rates are lifting the outlook for multifamily rental properties.

If you are an investor in multifamily properties and are depending on the rise of interest rates to limit demand for ownership housing and therefore increase the demand for multifamily rental housing to determine your probable success, it's time to go into any other business except real estate.

If you are investing in a fund, and the fund is ready to accept lower returns as a consequence of increasing interest rates, beware of sleight of hand tactics.

Fund investment advisors, managing members and general partners are taking ongoing management fees based on gross assets only, with little of their renumeration based on overall performance. Whether they are capitalizing normal and usual operating costs, hiring an outsourced manager to earn a minimum acceptable cash flow and are otherwise dis-involved, or purchasing a portfolio and apportioning their own cost/basis to benefit the stronger properties in the portfolio for which they actually overpaid, the returns to investors always suffer.

As an investor and/or owner operator, it should be crystal clear to you that the rise and fall of interest rates in an intermediate range, has little to do with the economic viability of your investment and your ultimate success in multifamily rental housing. Very often, even multifamily ownership housing will not be significantly affected.

Rather, your willingness to do the proper due diligence revolving around the demographics of your specific local area, combined with the demographics of the city and region, will usually provide the information that guides your choices and ultimate success. Look at the property and its physical condition, the location and neighborhood, the current demand.

The ability of the property to rent at a price per sq. ft. consistent with the disposable income of the area, the rent history of comparable rents and comparable sales, the current and historical revenue and expenses of the property. Look for patterns, look for needed replacements and upgrades, then confirm adequacy of replacement reserves to ensure that funds are available and of course, confirm current cash flow and cash flow history.

Of course, the exception is significant and immediate short-term increases in interest rates (not experienced at this time in our economic history) which are well above what could be normally tolerated, as well as any localized and specific surprise government regulations, which may reduce or even eliminate the economic viability of certain specific projects.

The dangers that will more likely affect successful investment, development, operations and profitable exit, will generally be found in adequate demographic investigation, followed by matching the results, to the type of project to be developed or acquired.

Of course, matching results to the "type" of project, must incorporate the pragmatic actuality of immediate demand for the product, as well as the leasable or saleable square feet of the project to the disposable income available to be utilized by the target demand.

Photo: Getty Images

In business, we call it homework. In real estate, the name is demographic due diligence. ■

Gerald Guterman is senior principal partner and chief investment officer at Guterman Partners; since 1969, members of Guterman Partners have been investors, owners and operators of multifamily residential high-rise buildings and garden communities, multi-tenant office properties as well as full-service and luxury hotels throughout the United States.

Learn more at **www.gutermanpartners.com**.

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Property Inspection and Analysis Reach New Heights

By **Grant M. Hall**

If you look at unmanned aerial vehicles and see elaborate toys or an invasion of privacy, you are most likely missing out on an entire slew of data analytics that drive efficient facility operations and maintenance. Property managers, building owners, general contractors and engineering firms are all using data collected by drones..

Benefits of UAV data collection and analysis. The actual hardware (cameras and drones) is secondary in importance to the types of software analytics that result from the corresponding UAV flight. Aerial thermal/visual inspection, precise mapping and Drawing Exchange Format file origination all provide a property manager with a means to make intelligent decisions on maintenance and operational procedures, budget forecasting, capital project planning and execution, building acquisition and marketing to potential lessees.

Facility managers receive several different types of exterior building reports resulting from a single flight. The imagery/data captured by the UAVs payload is processed by a variety of software applications converting the raw data into a concise building intelligence report. The corresponding reports provide a bevy of facility operation functions.

Scaled facility renderings. Ultra-high resolution, ortho-mosaic imagery captured by drones can generate scaled renderings (images/models with precise dimensions) of the facility, through various software platforms, which can be useful for lost or damaged drawings as well as custom measurements for tenant or capital improvements. Annotated 3D models can serve as integrated software platforms for entering and reporting maintenance logs, building anomalies, customized building/ equipment dimensions, exterior equipment inspection and inventory, Infrared/ thermal inspection and analysis, and construction planning and progress. Essentially, building owners and managers can integrate most software applications they currently use within a scaled facility rendering for a more intelligent, visually oriented workflow and reporting process.

Infrared/thermal inspection and analysis. Through the development of more efficient IR cameras, prices dropped as the overall technology improved. New color pallets provided for more detailed thermal tuning and material analysis. Excess moisture, leaks, mechanical, electrical and plumbing equipment performance, insulation, windows and envelope efficiency are a few of the elements inspected by aerial thermal sensors.

The future of building analysis and operations using UAVs. Advances in both hardware and software components will expand the types of spaces drones enter to collect data.

Building engineers will have access to reports, maintenance schedules and other logistical activities through a scale rendered building model utilizing a virtual reality platform. This will not only streamline and visually organize building operations but also help to recruit better talent at the building engineer and management levels.

With this brief introduction to drone technology and the types of analysis and operation platforms it can incubate, you may think of other ways to manage and monitor your facility or building. The processing of the data occurs through complex software applications that can help determine building health and conditions or amend building management software to provide a more detailed, intelligent interface for all building stakeholders.

Some say the worker is only as good as their tools. Effectively utilizing UAV-based technology can elevate performance of nearly every element of property management. ■

Read full article here.

Grant M. Hall is managing director at Halkin Aerial Services.

Learn more at **www.halkinaerialservices.com**.

Trends in Farmland Values

By **Doug Hensley**

As we conclude 2018, farmland values across the Midwest show varying results. Many recent sales have maintained surprisingly strong price levels, while others appear softer. In areas where growing season success is once again bursting bins, values appear more stable than those in areas where variable summer weather cause less than ideal crop yields. When viewed in total, farmland values in Iowa, Illinois, and Nebraska, appear to reflect pressure and overall characteristics of slightly decreasing markets.

Iowa farmland decreased during the second half of 2018

The Iowa Chapter of REALTORS Land Institute released its September 2018 *Land Trends and Values Survey*, which showed a statewide average decrease of cropland values of 1.7 percent for the March 2018 to September 2018 period. The chief factors currently influencing the Iowa farmland market include crop production levels, commodity price levels, the limited amount of land on the market, and increasing interest rates.

2018 Illinois farmland values trended lower

According to the survey by the Illinois Society of Professional Farm Managers and Rural Appraisers (ISPFMRA), the value of excellent quality Illinois farmland also trended slightly lower during the first half of 2018, with a 2 percent weaker reading. Like Iowa, crop production and commodity price levels, rising interest rates, and the general disruption being felt from the tariff dispute(s), were all cited as factors for the weaker trend.

Nebraska farmland values continued downward

According to the 2018 survey from the University of Nebraska-Lincoln, the average market value of farmland in Nebraska declined by 3 percent, marking the fourth consecutive of downward pressure, although the rate of weakness has improved from 2017 levels. Survey participants in Nebraska indicated that low commodity prices and current tax policies are the primary reasons for declining land values.

Looking to the future

As we look to the future of Midwestern farmland values, keep an eye on several key issues that are likely to directly impact farmland prices. First, local factors and production success/disappointment from area to area generally sets the mood in the countryside. High-quality farms with the most productive soils, solid drainage, easy farm-ability and strong

Photo: Getty Images

fertility will continue to sell best—these are the farms that most consistently produce year-in and year-out.

Second, the Federal Reserve appears committed to continuing their policy of removing 'accommodation' from the U.S. economy. This means short-term interest rates are likely to continue increasing over the next few months. And while short-term rates don't directly impact long-term borrowing costs, short-term rates directly impact farm operating notes, which will be in focus as operating loan renewal season is upon us at year-end. Anything that adds cost to farm operations just creates pressure.

Third, the disruption created in the commodity markets by the enactment of global trade tariffs is real, and has softened markets, particularly for soybeans. How global trade negotiations play out in the weeks and months ahead will continue to impact commodity prices and, ultimately, underlying asset values including farmland. This issue seems particularly important as it relates to 2019 crop insurance price levels, which appear likely to reset at much lower levels in 2019 than those we enjoyed for the 2018 growing season.

Finally, relating to crop insurance, negotiations are currently underway for the new Farm Bill in Congress. Both the House and the Senate have proposed various adjustments to current farm policy, which may significantly impact production agriculture, and farmland values, in future years. ■

Doug Hensley is the president of real estate services for Hertz Farm Mangaement and based in Nevada, Iowa.

Learn more at **www.hertz.ag**.

Be Quick, But Don't Hurry

By **Bill Asher**

My advice to clients in a transitioning market is similar to what the legendary basketball coach of UCLA John Wooden would say: "Be quick, but don't hurry." When athletes rush they can lose their technique. Wooden wanted his players to learn to do the right things but learn how to do them quickly. So, what strategies do sellers need to learn to move quickly?

Strategic pricing

Projected rising interest rates have caused buyers to be more cautious in their purchasing decisions, and, in many cases, sale cycles are taking longer than in previous years. Therefore, it is important to be strategic in properly pricing assets for sale to appropriately engage prospective buyer interest.

The single-tenant net lease (STNL) category continues to possess the largest transaction velocity and the highest number of potential buyers seeking a flight to quality. These buyers specifically want properties with new construction, long-term corporate guaranteed leases, and internet-resistant tenants in good locations. They are also showing more willingness to acquire new investments nationally rather than in their local market.

STNL pricing $5 million and under remains the most consistent with the smallest separation between asking and final sales price due to this category having the largest buyer pool and being less reliant on financing. However, the depth of formal offers submitted from this buyer pool has started to shrink. Typical listings are generating an average of five offers or less compared to approximately five to 10 offers 18 to 24 months ago.

STNL assets priced $5 million and higher have seen similar results but are experiencing longer marketing periods to procure a buyer due to sellers' rearview mirror pricing expectations, rising interest rates, and the fact that most buyers need financing to transact. Institutional buyers are approximately 30 basis points to 50-plus basis points higher on pricing compared to private investors. The separation between asking and final sales price has widened in this category.

Top performers

Demand remains at an all-time high for grocery-anchored investments, which have traditionally been considered a safe haven for both institutional and private investors. Watch for institutional buyers to look at markets outside of their typical criteria due to the lack of quality opportunities. Well-located properties with daily needs and internet-resistant tenants with sustainable market rents continue to be key acquisition criteria characteristics. Food and more service-driven retail properties, including successful mom and pop restaurants, nail and hair salons, and dry cleaners are examples of internet-resistant tenants that investors prefer. Prospective buyers are carefully assessing these types of assets where a grocer is not the top performing store in the market or a grocer has transitioned to a second-tier option in the trade area.

Break-up sales plan

As demand and pricing for non-core grocery-anchored shopping centers continue to slowly decrease, a break-up sale can help provide an owner with better overall proceeds. By selling a shopping center in pieces, a seller can realize an improved value compared to selling the entire center as a whole. Furthermore, the pricing of separate, smaller offerings, typically appeals to a much larger buyer pool. For example, within the last year, Hanley Investment Group sold six pad buildings within a Walmart-anchored shopping center that resulted in approximately 100 basis points more in total value as compared with the center being sold as one property.

Success is where preparation and opportunity meet, so looking ahead to 2019, consider being quick, but don't "hurry!" ■

Bill Asher is executive vice president at Hanley Investment Group Real Estate Advisors.

Learn more at **www.hanleyinvestment.com**.

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Late Cycle Investors Find Benefits in Bridge-to-Permanent Executions

By **Precilla Torres**

With cap rates compressing to new cyclical lows, multifamily investors often struggle to find opportunity in—and attractive returns for—stabilized communities. Many owners are turning to bridge-backed value-add acquisitions as a result. Let us examine why.

Photo: Getty Images

The state of late cycle multifamily

First, there is the issue of plateauing rent growth. Down from a cycle high of 5.8 percent in 2015, rent growth is projected to be 4.6 percent for 2018[1]. Apartment operators have realized they can no longer rely on organic rent growth alone to increase net operating income. Second, it is clear that we are operating in a rising interest rate environment, at least for the short term. While spreads between multifamily cap rates and the 10-year Treasury yield remain wide in the grand scheme, margins are now at late-2005/early-2006 levels[2].

This tightening has triggered a flurry of activity in the value-add sector, where opportunities for unlocking upside remain attractive. This strategic shift can be quantified by looking at how the value-add component of the average commercial lender's loan profile shifted from 15 percent to 18 percent between 2015 and 2017[3].

The value-add strategy creates attractive returns for investors in the medium term by boosting NOI through physical and/or operational overhauls. Furthermore, returns are enhanced because this strategy pairs with attractive financing options through the bridge loan market, where spreads on transitional floating-rate loans remain low. These floating-rate loan spreads are in turn supported by a robust capital markets environment for commercial real estate collateralized loan obligation floating-rate bonds that continue to be bid aggressively, allowing borrowers to obtain attractive leverage to finance a property's capital improvements.

Benefits of a bridge-to-permanent solution

No matter what the purpose of your bridge loan, it is imperative that your permanent financing needs drive the loan structure. Working with a 'one-stop shop'—that is, a single lender who can provide both the bridge and permanent loan—provides several strategic and financial benefits. By streamlining the due diligence process and underwriting the bridge loan with a permanent agency takeout, a one-stop shop lender can provide more speed and transparency than two separate lenders and loan processes. Financial incentives usually come in the form of reduced fees. Hunt Real Estate Capital's proprietary bridge loan program, for example, typically waives the bridge loan exit fee when Hunt is also the source of the permanent takeout financing.

That waiver, in addition to the flexible yield maintenance and nonrecourse debt, is what attracted a Southeast investment group to a Hunt bridge solution when it came time to acquire and renovate a garden-style community in Greensboro, N.C. The $10.3 million bridge loan was structured as a 36-month floating rate, interest-only note with $1.2 million earmarked for property renovations and improvements. With a value-add repositioning well underway, the borrowers are currently looking to transition to a long-term, fixed-rate solution.

In summary, a bridge solution can provide the speed and flexibility needed to capitalize on the unique opportunities that arise late in the multifamily cycle. To be in the best position for a smooth transition into a long-term, fixed-rate solution that takes advantage of today's low—by historical standards—interest rates, consider working with an experienced 'one-stop' lender. ■

1. Reis, Inc., November 2018.
2. NAREIT, 'Property Prices and Cap Rates in a Rising Interest Rate Environment'. April 2018.
3. CRE Finance Council, '2017 Market Outlook Survey'.

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Predictions for Hospitality Investors

By **Teague Hunter**

My team and I are regularly asked where we are in the cycle—is it too early or too late to buy or sell? That question can be answered by looking at three metrics. First, hotel investment is a street corner business. Every day we are presented with macro level stats on new supply and future projections, supply and demand. These are averages, and need to be considered on a local basis as it relates to an individual asset. Second, cost of replacement. Does it make sense to buy or build? How do these stats compare? Third, is what is the investor's motivation? Yield? Value-add? Long term or short term?

It's a sign when new investors begin look to invest in the hotel space. The yields for the traditional real estate types have become so compressed, and the transaction market hyper-competitive that investors with capital begin to explore the higher returns possible in hospitality assets. The 2019 projections of 1 percent to 2 percent RevPAR growth and 500,000 new hotel rooms are national stats that consist of local markets that are up and down. Development of new hotels has increased to a current pipeline of over 500,000 rooms. There are MSAs with a skyline outlined with cranes, and there are submarkets where nothing is on the horizon. To analyze new competition, it is important to research what, when, and where the new projects sit. The competition may be shiny and new but how does the location compare? Older properties often have superior locations near points of interest, making available land a second-best. The impact of new supply cannot be considered without the impact of new demand. Using Atlanta or Nashville, Tenn., as examples, these cities continue to grow and attract corporate relocations. There is significant interest to buy/build in these markets because new supply is projected to be absorbed by growing demand.

This leads to the second consideration: building or buying. All things being equal, a newer project is superior to an existing asset. The brands, designers and developers work together to capture the current tastes and trends of the consumer. However, hotel construction costs are facing the same upward pressure as all asset types: shortage of labor, tariffs and other demand. It is often cheaper on a per unit basis to buy the existing project than to develop, but the returns of each need to be considered beyond price to the investment yield. The cost to build may result in greater revenue and profits. The existing asset may have 'good bones' and an irreplaceable location, and strategic renovation could enhance occupancy and profit.

Buyers need to consider their investment goals for every opportunity, but hotels are a complex asset class. This is a business not just a piece of real estate. There is the critical franchise element and the employees that will make it successful. And when you look at the branding, the equation changes again. Brand market position and asset class adjust the value. A new brand can be built in the market or potentially converted from another brand.

No one can truly predict a cycle—each investor wants to sell at the top and buy at the bottom. That's why it's so important to get advice from a trusted source at every stage of the cycle.

Hunter Hotel Advisors is a hotel-only commercial brokerage, and owner of the Hunter Hotel Investment Conference. ■

Teague Hunter is President of Hunter Hotel Advisors.

Learn more at **www.hunterhotels.net**.

What Property Managers Need to Know as Legalized Marijuana Keeps Growing

By **Andrew Lomo**

The midterm elections recently wrapped up and marijuana legalization continues to be a hot-button issue. On November 6th the list of states legalizing marijuana in some form grew to 33 as voters in Missouri and Utah approved it for medical use. Additionally, Michigan became the tenth state to legalize its recreational use.

The legalization of marijuana at the state level has been gaining momentum since California first legalized medical marijuana in 1996. In 2018, 19 states considered bills to legalize recreational marijuana, but Vermont remains the sole state to enact legalization through its legislature, rather than by ballot initiative.

According to a 2018 Gallup poll, 66 percent of U.S. adults support legalization, while only 32 percent oppose it. Regardless of one's personal feelings on the issue, it is hard to imagine the trend reversing anytime soon. However, while two-thirds of the states have legalized marijuana, it is important to remember that under federal law marijuana is still classified as a Schedule I controlled substance.

Property owners and managers may have mixed opinions on legalization. Some have embraced it as a means to increase commercial and residential property values, and have noted that strict zoning laws and significant infrastructure modifications required to grow marijuana mean tenants tend to stay longer. Others look at it as carrying too much risk. In addition to the possible impacts on the tenants such as odors and smoke, there could be an impact on the property too. For example, improperly growing marijuana can pose significant mold risks as it grows in a humid climate, and each plant can require up to a gallon of water per day. Growing operations can also bring about fire hazards as growing indoors uses an immense amount of electricity. For example, a four-plant lighting module uses as much electricity as 29 refrigerators.

So, how can you prepare yourself, your property, and your tenants?

First, you need to decide whether or not the property will accommodate marijuana use, and if so, under what terms. Like tobacco use, marijuana use can be regulated by your lease. There are many options to consider when forming a policy.

One option is to enact a smoke-free policy prohibiting smoking of all kinds regardless of what is being smoked. However, this would not address other means of ingestion such as vaporizing and consuming edibles, so be sure to explicitly list what is prohibited.

Alternatively, you may wish to enact a drug-free policy with or without prohibiting smoking. This would, in turn, prohibit marijuana in all forms. While more complex and harder to enforce, this may be beneficial for federally owned housing or property covered by federal housing programs as drug use is explicitly prohibited by the U.S. Department of Housing and Urban Development.

Or, you may wish to allow it, but only within designated areas, or with a fee for smoke/odor damage and clean-up after move-out.

Whichever approach you take, implementation is key. Clearly indicate in the lease what is, and what is not prohibited, advertise vacancies clearly, post information in the office, and always be consistent when enforcing the policy.

Also, remember that medical marijuana use is not protected by the Americans with Disabilities Act or federal fair housing law. However, some states have introduced protections for people seeking accommodations for medical marijuana use that is consistent with their state laws. Be sure to speak with an attorney licensed in your state about what is required in these situations. ■

Andrew Lomo is government affairs coordinator for IREM.

Learn more at **www.irem.org**.

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Redevelopment of Workforce Housing

By **Art Rendak**

There has been a heavy focus on the multifamily housing market and various analyses have attempted to determine where the product is in the business cycle. Cranes are seen throughout the skylines of almost every major metro as developers race to take advantage of supremely liquid debt markets and abundant equity capital sources in order to build state-of-the-art multifamily projects with newer and newer amenity packages. Demographics have been analyzed and pundits have issued the generalizations of whether millennials will buy houses or if baby boomers will continue to downsize and rent. However, one segment of the multifamily market that is commonly overlooked is workforce housing.

Developed in the 1960s through the 1990s, the current monstrous supply of class-B and class-C multifamily projects have often not been modernized since their development. Yet, dense population centers with working-class tenant bases continue to fill these projects at occupancy rates comparable to their class-A projects. Redevelopers seem to be overlooking the opportunity to upgrade these projects and provide modern amenities, instead focusing on developing new class-A and upper level class-B properties.

Many workforce housing projects are located in submarkets with increasing population projections. Further, class-B and class-C projects that we have observed have shown strong occupancy and solid collection reports. Property managers and tenants indicate that renters of these projects desire unit upgrades such as modern appliances, hardwood flooring and newer bathroom fixtures, and have interest in community amenities, including upgraded fitness centers, package delivery facilities and community centers/activities. There is room in the demographic metrics for some rent increases to offset the costs, and often these projects are garden-style developments with less density than their modern counterparts to allow for some expansion of the common area amenities. However, rents—even after the projects are upgraded—are often reported solidly below the 30 percent median household income level. Additionally, median incomes do not yet support a satisfactory return on investment for new development, providing an effective barrier-to-entry. Combined with stricter mortgage requirements and the price of housing at near pre-recession peaks, renting is often the only option for a majority of the tenant base.

There are stereotypes that class-B and class-C projects require a higher degree of skilled property management and operating expenses, and that unemployment often tends to increase in these working-class markets during a potential economic downturn. While some of these arguments are valid, it would seem that if the return on costs are better in the class-B and class-C market, then these opportunities should be considered with the proper underwriting and redevelopment cost analysis. Redevelopment of these properties should improve the long-term outlook

Photo: Getty Images

as the elimination of deferred maintenance, improved amenities and interior renovations should attract a better class of tenants and more stable source of net operating income. The agency lenders are seemingly flush with lending programs for these type of projects, once stabilized occupancy can be achieved. ■

Art Rendak is the president of Inland Mortgage Capital LLC, an experienced private lender specializing in intermediate-term mortgages for value-add commercial real estate in need of bridge financing.

Learn more at **www.inlandmtg.com**.

A Review and Outlook for the National Senior Housing Market

By **Nick Stahler**

The senior housing space experienced a very interesting year in 2018. While some product types within the asset class experienced some growing pains, the overall long-term outlook is very bullish. Senior Housing is divided into three major market segments: independent living (IL), skilled nursing facilities (SNF), and assisted living facilities (ALF). We will focus on licensed healthcare facilities, SNF and ALF, in this analysis.

Across the country in the first half of the year, SNF assets experienced decade-low occupancy rates, although occupancy did begin to stabilize in the third quarter. As a result, we saw a considerable number of distressed SNF dispositions, particularly from the industry's REITs. For stable-performing SNF assets, however, the capitalization rates held consistent between 10 percent and 13 percent, but the average price per bed dropped due to the disproportional number of distressed assets sold. The consensus is that SNFs will likely enjoy a stable 2019. With occupancies leveling off, operators should be able to budget appropriately for the year. In budgeting, keep in mind that there will be a new payment system employed by CMS in October 2019, the Patient-Driven Payment Model (PDPM). Many operators are welcoming this change; the only negative response appears to come from therapy companies that may see decreased income under the new system.

The ALF sector of the industry also faced unique challenges, including a new international presence. Major oversupply issues vexed some markets, as their robust construction cycle was based upon a "gray wave" that will not actually hit at the asset level until 2025. Because of this, some markets are struggling with absorption rates, but they should reach equilibrium as demand levels off supply.

Two international transactions were announced in 2018 that may have significant impact. Singapore-based Keppel Capital arranged to acquire a 50 percent stake in the operating platform of Watermark Retirement Communities, Inc. Additionally, Sino-Ocean, a Chinese real estate development company, acquired a 40 percent stake in Meridian Senior Living's operating platform. It should be noted that these two transactions point to a genuine need for this type of care in China and other Asian countries.

JCH anticipates that some ALF markets will experience a turbulent 2019 as new product is absorbed—or potentially not absorbed—at a rate acceptable for investors. Cap rates for stable ALF assets experienced some downward pressure in 2018, which was illustrated in the MBK and West Living transaction, reportedly near a 5.2 percent blended cap rate at closing in July 2018. Overall the valuations and operations in the segment will remain strong throughout 2019 even with anticipated interest rate increases. We believe quality operators with cash on the books to acquire assets in 2019 will have a very fruitful, opportunistic year ahead.

Overall, 2019 will be a very exciting year for senior housing. Despite changes coming to the SNF market and some potential turbulence in the ALF market, we expect decent transaction volume with a wide range of assets types available to the marketplace. The takeaway? Operators need to stay diligent on their marketing and operations as new product is absorbed and remain focused on employee retention as labor shortages continue to have an impact in the space. ■

Photo: Getty Images

Nick Stahler is senior vice president of JCH Senior Housing Investment Brokerage. Nick has 13 years of experience in the senior housing investment industry with over $1 billion in closed sales.

Learn more at **www.theJCHgroup.com**.

What Investors Need to Know About the Opportunity Zone Program

By **Lauro Ferroni**

Property developers in the U.S. are eager to invest in Opportunity Zones, federally-designated areas where real estate can get a significant tax break.

Known as 'OZs', these zones were created as part of the Tax Cuts and Jobs Act, which passed last December. Since then, sales of developable sites in OZs are up 80 percent year-over-year in the first three quarters of 2018, according to Real Capital Analytics.

But until recently, investors remained unclear on how to reap the capital gains tax deferral offered by the plan. The Treasury Department's anticipated interim guidance, released October 19, answered some of the most pressing questions, allowing fund managers to begin gathering money and investing.

Here are the key takeaways.

1. Hotspots like L.A.'s Arts District included

The Treasury designated 8,700 census tracts as OZs: under-developed or distressed areas.

However, because the 2010 Census was used to select the OZs, many neighborhoods that have already attracted a flurry of development over the past eight years were included.

Those areas, including Downtown L.A.'s Arts District, are likely to be favored by developers. If you look at a map of where development has taken place in Los Angeles over the past eight years, and then you look at a map of the OZs, they mostly overlap.

2. Two ways to invest

Investments must be made through a Qualified Opportunity Fund (QOF) in order to qualify.

According to Michael D. Haun, a partner at international law firm Paul Hastings, the new guidance clarifies that the funds can either be used directly, to purchase or improve property, or indirectly, to acquire equity interests in partnerships or corporations.

3. Less than 70 percent of a fund can be invested in an OZ and still qualify

The IRS guidance clarifies how much of a fund's property needs to be in an OZ.

The original legislation dictates that a QOF must have 90 percent of its assets in qualified opportunity zone property, and that a business operated through an equity interest in a partnership or a corporation held by the QOF only qualifies if "substantially all" of its tangible property falls within an OZ.

The new guidance now explains that "substantially all," for OZ businesses, means 70 percent.

Combining the 90 percent asset requirement for opportunity funds with the 70 percent tangible property requirement for qualifying businesses could mean an opportunity fund may only need to indirectly invest 63 percent of its assets in a zone.

4. Longer hold periods mean bigger tax breaks

Investors holding a property for five years or less can defer taxes on gains from the sale of their original asset either until that investment is sold, or at the end of 2026. Assets held for five to seven years have their capital gains taxes reduced by 10 percent. Those held for seven to 10 years reduce them by 15 percent, and properties held over 10 years have all capital gains taxes forgiven.

5. Continued investment into OZ projects is required

According to the IRS, investors are required to invest into a building at least as much capital as they acquired it for. Additional capital to improve or develop the asset must be invested during any 30-month period.

Still, more clarity is needed on the role of land value in this equation. Current guidance does not seem to include it as part of the calculation. ■

Lauro Ferroni is JLL director of investor research.

Learn more at **www.jll.com**.

Photo: Getty Images

E-commerce Brands Will Get Physical in 2019

By **Taylor Coyne**

The rise of e-commerce and the subsequent changes to big box retail have brought about a lot of new digital native brands and a lot of vacant retail space. E-commerce retailers like Bonobos, Warby Parker, and Casper may all be lining up to fill those empty spaces. According to a recent report by JLL that looked at the expansion plans of 100 of the top digital retailers, digital-native brands have plans to open 850 stores over the next five years.

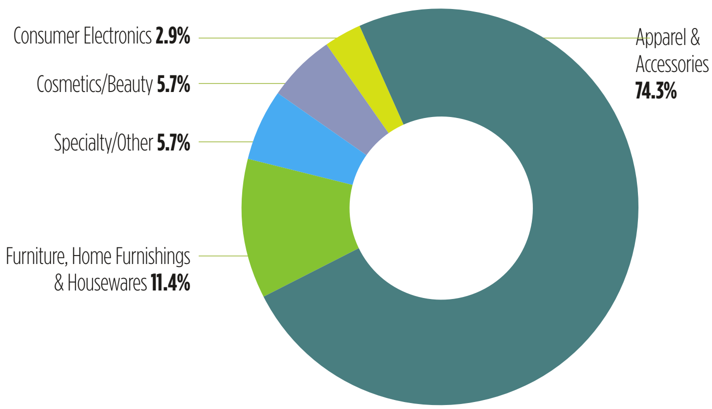
The first major retail sector to make the jump from digital to physical has been apparel and accessory retailers (74.3 percent). Furniture, home furnishings, and houseware brands make up the second largest sector to make the move at 11.4 percent. It makes sense for these retailers since both types can appeal to customers' desires to touch, try, and feel products before purchase.

Clicks-to-bricks brands are innovating the retail model by testing new concepts and challenging the way retail businesses have traditionally operated. These retailers are using pop-up shops and showroom style stores to connect with their existing customers while also finding new customers. Retailers like Casper and Bonobos are using showrooms to increase brand awareness. These showrooms are retail spaces that carry just enough inventory for customers to touch and try before deciding on which products they would like sent to their home and that also allow store employees to become brand experts rather than spending more time managing back-store inventory. This works well for a brand that moved from mail order to physical retail locations since these brands can maximize smaller retail spaces and avoid storing large amounts of product at each individual location.

While location is always important in real estate, the location of a clicks-to-bricks retailer's first pop-store has a major impact on the physical retail business. More than half (59.5 percent) of JLL's studied clicks-to-bricks retailers opened their first pop-up locations in New York City. Similar large cities like Los Angeles, Toronto, San Francisco, and Chicago are all popular destinations for digital-native retailers. While most of these e-commerce retailers are targeting major consumer markets initially, as they expand they may begin to move into secondary and tertiary markets.

As physical retail continues to evolve, and clicks-to-bricks expand, we will see a shift in the types of stores in malls and shopping centers across America. As more customers want to see and feel products that digital native brands are releasing, the more they will expand their physical presence to meet that customer need. ■

Clicks to Bricks



Taylor Coyne is a research manager at JLL, covering U.S. retail research. Taylor works on a team that creates industry-leading research and thought leadership for both owners and occupiers of retail developments. Most recently Taylor helped author a research report on the top tech trends changing retail and the strategies behind renovating malls. Taylor received her undergraduate degree from the University of Michigan. She is a member ULI and ICSC.

Learn more and download the full report at **www.jllretail.com/home**.

JLL

Good Things Ahead for Brick-and-Mortar Retail

By **Matthew K. Harding**

Gone is the perception that brick-and-mortar retail is a dying breed. In fact, current performance and the short-term outlook point to great things ahead for the industry in 2019.

In October, Moody's made headlines when it raised its outlook for the retail sector from "stable" to "positive" for the first time since 2015. The National Retail Federation over the summer adjusted its retail sales forecast for 2018, anticipating annual sales to increase at least 4.5 percent over 2017 (upped from an increase of 3.8 to 4.4 percent forecasted earlier this year).

Performance among Levin Management's tenants here in the Northeast reflects the industry's momentum as well. A record 72.1 percent of participants in our latest Retail Sentiment Survey conducted this fall reported year-to-date sales levels at or above their volume last year at this time. This is up from 71.0 percent—the former record—posted in our mid-year 2018 survey.

A healthy economy—and resulting confidence by consumers and business owners alike—undoubtedly is fueling retail's positive momentum. However, equally important is the evolving role of retail as consumers once again embrace shopping as a pastime. A trip to a shopping center has become more than an outing to purchase goods and services. That's not to say retail properties are transforming entirely into places for recreation and socialization. Rather, the most successful properties today are striking a balance by offering a diverse tenant mix that provides ample reason for consumers to visit.

In terms of leasing trends, we are, indeed, seeing increased activity among entertainment concepts, restaurants, personal services and fitness brands. However traditional retail is also quite active, especially discount brands that operate under the TJX Cos.' umbrella such as Marshalls, HomeGoods and T.J. Maxx. Activity among grocery tenants continues to shape our marketplace as well, with expansions and store renovations by long-time regional brands, notable new entrants (think Lidl), and ongoing activity among specialty and ethnic grocers. And physical store expansion among ecommerce-founded brands like Casper and Wayfair provides further proof that physical retail is alive and well.

The most successful retailers across categories are offering quality products and finding new ways to engage customers. They understand that personal touch, human interaction and "experience" will always distinguish physical store retail from online shopping. They also are working to give the new generation of shoppers what they want and need.

In terms of leasing trends, we are, indeed, seeing increased activity among entertainment concepts, restaurants, personal services and fitness brands.

Consider grocery, where we are seeing online ordering with pickup or delivery, in-store nutritionists and classes, and the incorporation of more prepared foods with healthy grab-and-go options for busy lifestyles. Even department store monoliths are getting creative.

Look at Walmart's new "town center" model incorporating a mix of uses in its stores and the surrounding land—think community engagement via entertainment and recreational opportunities, food vendors, and health and fitness services.

We also are seeing increasing connections between traditional and online retailing. Physical stores are offering an online option for purchasing goods, scheduling appointments for services or placing orders for pick-up. And technology-centered marketing is playing a key role as stores work to compete in an increasingly digital world. This includes leveraging a variety of platforms to engage customers before they shop, and to provide real-time, in-store incentives and conveniences.

The bottom line? By the numbers and through tangible changes in the brick-and-mortar environment it is clear good things are happening in—and for—physical retail.

Follow LMC on Twitter, LinkedIn and Facebook. ■

Matthew K. Harding is president of commercial real estate services firm Levin Management Corp. (North Plainfield, N.J.), which maintains a growing, retail-focused portfolio of 105 properties totaling 15 million sq ft. in the Northeast and Mid-Atlantic states.

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The Trade War's Imminent Impacts on Real Estate: Can China Manipulate the Future of the U.S. Housing Market?

By **Brett Lyon**

In an attempt to reinforce U.S. hegemonic status, the Trump administration commenced the year with the initiation of a trade war with China that has led to a spiral of retaliation that seems to have no end in sight.

The U.S.-China trade war impacts a variety of American industries, but its impacts on the U.S. commercial real estate market is routinely overlooked. Gearing towards the end of 2018, the market is characterized by rising interest rates, halted construction, and record high multi-family housing prices.

Are any of these components linked to the trade war? What does this entail for the future of the commercial real estate market?

Rising interest rates

One of the major drivers of increasing interest rates is inflation. China maintains a strong influence over U.S. inflation rates because the current trade war is directly driving up inflation. Chinese consumer goods are now, because they've been forced to be through tariffs, more expensive. In turn, the purchasing power of the dollar has lowered. As long as tariffs continue to rise, the fed will continue to increase rates to combat inflation. Trump's latest tariffs are set to rise January 1st, leading to questions of how the economy will be hit after the tariff hike.

The effect on commercial real estate

Rising interest rates are causing investors and developers concern over potential negative impacts it has on commercial real estate property values and investment performance. Fortunately, data shows that higher interest rates do not necessarily result in lower commercial property values and total returns. There are a number of factors that help protect overall real estate performance. Factors such as cap rate spreads, strengthening economic conditions and underwriting practices protect overall commercial real estate performance and mitigate investor concern.

Halted Construction

The high demand for housing, specifically in California, requires an influx of new construction at all price points. The administration's hefty tariffs on imported steel, on top of the Canadian lumber tariff, imposed last year, drives up the cost of new construction. The imposed tariffs add on 25 percent to the cost of steel and 10 percent for aluminum from foreign suppliers. Trade tariffs on pervasive goods such as steel and aluminum caused by the trade war exacerbate anxieties about the market.

Commercial buildings will be hit the hardest from the steel tax because they require a significant amount of steel and aluminum in their construction. The tariff is expected to limit development in office, retail, industrial, and multifamily construction. In 2017, the construction industry accounted for about 40 percent of all U.S. steel demand. The steel and aluminum tariff will only create more price pressures in the multifamily space, and will further drive up home prices. ■

Photo: Getty Images

Brett Lyon is a broker and co-founder of Lyon Stahl Investment Real Estate, an investment brokerage firm specializing in the sale and exchange of multifamily, redevelopment, residential, and commercial real estate throughout Southern California.

Learn more at **www.lyonstahl.com**.

LYONSTAHL INVESTMENT REAL ESTATE

Real Estate Investment Diversification is Key in a Maturing Cycle

By **John Chang**

As the economic expansion approaches its 10th year, many investors have begun to transition their real estate strategies to a more balanced portfolio that integrates geographic and property-type diversification. On average, commercial real estate values have increased by 68 percent since 2009, offering investors significant appreciation and, in many cases, a large pool of equity. Numerous private investors have focused their real estate investment approaches on a sole property type and often a single metro. Investors tend to focus on asset types and markets they know, but this strategy poses a significant portfolio risk.

Recent natural disasters such as the hurricanes that affected Texas and Florida or the wildfires in California reiterate the importance of geographic diversification. Investors who concentrate their portfolios in their local markets have a clustering of risk susceptible to major natural disasters and local economic volatility. The Houston metro recently demonstrated both environmental and economic risks as the downturn in oil prices softened the local economy and the real estate market. Hurricane Harvey in 2017 compounded the local downturn, inflicting $125 billion of damage on the metro. For commercial real estate investors with all their holdings in Houston, this sequence of events dramatically impacted their cash flow and asset values.

Geographic diversification across multiple states helps reduce the risk potential of a natural disaster and localized economic risk. Investors holding multiple assets in a single market, particularly one dependent upon a single employer or industry, face disproportionate risk. Acquiring properties in dynamically different metros can reduce the impact of such an event. Assets in upper Midwest markets like Detroit and Cleveland may have higher reliance on the auto industry, whereas the Bay Area is strongly influenced by the tech sector. Each industry has its own cycle and by holding assets in each, an investor could mitigate some cyclical risk.

Diversification across property types also helps investors manage their risk. Not only does this reduce exposure to specific cycles tied to individual asset types, but it also gives investors much more flexibility when setting strategies. For some investors, shifting a portion of a portfolio from multifamily assets into retail or office properties could boost portfolio yield, while also reducing risks associated with the housing sector. Single-tenant retail assets have become particularly favored in recent years because they tend to be less management intensive than other property classes and they offer a steady, predictable yield. Self-storage is another asset type with minimal direct management needs that can be part of a favored diversification strategy. Both property types tend to have less risk associated with economic cycles.

Property Type Diversification Can Boost Portfolio Yields

As of 3Q 2018. Includes sales $1 million and greater; $2.5 mllion and greater for hospitality

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics; NICMap

The length and durability of the current growth cycle has boosted investor equity and market liquidity. Investors face a favorable climate to consider portfolio strategies and mitigate downside risk. Although no signs of economic softening have yet appeared, many economists anticipate slower growth in the coming years, making now an opportune time to consider a range of investment options both in terms of location and property type. ■

John Chang serves as the senior vice president and national director of research services for Marcus & Millichap Inc.

Learn more at **www.marcusmillichap.com**.

Medical Office Outlook Remains Strong as Employment Gains Buoy Tenant Demand

By **Alan Pontius**

The medical office sector is poised for a healthy 2019, though the pace of improvement is anticipated to ease as the imbalance between supply in demand narrows. A newly split Congress should keep significant legislation sidelined and provide healthcare providers at least two years of a predictable regulatory environment. Nationally, mergers are expected to remain an attractive business strategy within the industry as rising healthcare costs promote efforts to create cost-saving synergies.

Employment in the healthcare sector is healthy, though year-over-year growth began to ease in 2018. A tight labor market and specialized training required of many positions is limiting the industry's ability to expand payrolls. Furthermore, mergers within the industry that generate duplicate roles that will be eliminated. Approximately 300,000 new jobs in the healthcare sector are forecast for 2019. Barring an unexpected downturn in the economy, patient demand should also remain strong. More than 3.5 million people will qualify for Medicare in 2019, including many baby boomers that have already dropped out of the labor market. Low unemployment, meanwhile, will keep a significant share of workers covered by corporate-sponsored healthcare plans. Overall, demand for healthcare, and therefore medical office space, will grow through 2019.

The long-term outlook also remains optimistic as public funds funneling into the healthcare sector continue to rise. By 2020, healthcare expenditures are projected to increase to 20 percent of GDP, up from 13.3 percent in 2000. As demand continues to rise, medical office space users are shifting their focus. Off-campus and suburban space has become more attractive as providers bring services closer to patients. Additionally, the rising prevalence of outpatient care reduces costs and increases geographical flexibility for providers.

Builders are responding to dispersing demand by focusing on off campus and suburban medical office properties. These typically smaller developments will contribute to a slowdown in deliveries in 2019. Overall, new supply should account for between 8 million and 9 million sq ft. Vacancy, meanwhile, is expected to hover in the low-8 percent range, where it has been since the beginning of 2017. Two years of stable vacancy is an additional factor in more measured development. Stable vacancy is expected to keep rent growth modest next year.

In the investment arena, medical office listings will garner elevated interest in 2019. The maturity of the current economic expansion has investors scouring for opportunities that will continue to perform through the next recession. Medical office buildings, in particular, will continue to draw interest in 2019 as demand for space remains strong outside of a major downturn. Single-tenant properties draw bids from private and institutional capital. When backed by a long lease to a major healthcare provider, average cap rates for these deals start in the mid-5 percent range and drift into the low-6 percent area depending on the market. The popularity of single-tenant properties is creating demand for sale-leaseback opportunities for private owners that purchased early in the recovery. Profit-taking will be most successful if tenants guarantee lengthy leases that should eclipse a potential downturn. Investors generally require a 100-basis point spread for assets occupied by private physician groups rather than a hospital or healthcare group.

Multi-tenant assets will also remain attractive, though investor due diligence could increase in 2019 as tenant creditworthiness moves to the forefront of buyer consciousness. Investors are seeking stabilized deals regardless of the assets' proximity to a major hospital or medical office district. Overall, the medical office market is expected to be one of the stronger sectors in 2019. ■

Alan Pontius is senior vice president, national director of specialty divisions at Marcus & Millichap.

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Photo: Getty Images

The Arts Fuel Economic Growth as Developers Flock to Denver's RiNo Art District

By **Andrew Sobel**

Denver's construction boom is transforming RiNo, Denver's hip, arts and culture-focused River North Art District that is Colorado's hottest real estate market. A magnet for residents and visitors—and developers—RiNo is rewarding those who are racing to invest here. The sources of RiNo's economic power include its location, young entrepreneurial population, site of proposed riverside parks, proximity to ambitious transportation development, and its general reputation as what Trip Advisor calls "one of the coolest neighborhoods" in the nation.

Once a hub for foundries, pattern shops, and industrial uses, RiNo was left with vacant warehouses when industry moved away. Local artists who wanted to connect the artists and arts organizations in Denver started The RiNo Art District as a grassroots movement.

The Art District neighborhood enjoys the advantages of Denver's prime location, energetic culture, smart infrastructure investments, and educated workforce. A rapid transformation has attracted a new generation of young, creative entrepreneurs, drawn to the working art studios, tech startups, cool coworking spaces, and spacious industrial lofts. RiNo is on the short list for creative and tech companies both inside and outside of Colorado, who are drawn to its gritty, industrial-chic atmosphere and easy access to downtown.

Every day seems to bring a new redevelopment, adaptive reuse, urban infill or new construction project, many of them rehabilitating existing industrial buildings into new restaurants and creative office spaces while retaining the original charm. Between 2006 and 2016, commercial lease rates in RiNo increased by 33 percent, and property values by almost 46 percent. Forecasts predict 20,000 additional residents by 2035.

Major RiNo developments include 2900 Brighton, an ambitious, mixed-use "live-work-play" environment created by Mass Equities, Inc., in partnership with AECOM Capital on Brighton Boulevard, RiNo's main drag. Other developments underway include the 16-story World Trade Center Denver; Giambrocco, a mixed "true 24-hour neighborhood"; The Hub, a 275,000-sq.-ft. mixed-use development; the 14-acre, mixed-use North Wynkoop; the mixed-use Zeppelin Station; and The Source, a major hotel development with three restaurants and a brewery.

The neighborhood is also the site for bond-funded, transformational projects including the RiNo Promenade that will create a dynamic linear park along the Platte River. The River North Park, currently under development, will be a major neighborhood destination on the South Platte River Greenway.

RiNo is close to the gateway of Denver's growing public infrastructure system, and benefits from new streets and other infrastructure building. The FasTracks program, a $6.1 billion plan to build and operate high speed rail lines and expand and improve bus service and Park-n-Rides throughout the region, will also have a major impact on RiNo.

Photo: Doug Pensinger/Getty Images

"Even as The Mile High City expands, RiNo still clings to its punk-rock roots," wrote Lonely Planet's Greg Benchwick. "He cited the street murals that seem to pop up overnight, the experimental galleries that play open house on Friday nights, and the innovative food halls and rockabilly microbrews that play host to the city's young, bold and tattooed. "RiNo is cultivating its unique personality and character and playing center stage for the resurgent arts and cultural scenes that have transformed Denver into a cultural dynamo of the American West." ■

Andrew (Drew) Sobel is founder and CEO of Mass Equities Inc., a private equity real estate investment firm with multiple commercial assets in Colorado, Nevada and California.

Learn more at **www.masseq.com**.

MEQ MASS EQUITIES

Nine Real Estate Forecasts for 2019

By **Tom Londres**

2018 was a dynamic year for real estate. While big-box retail closings sent shock waves through the industry, they opened the opportunity for non-traditional, even non-retail users, to fill vacancies. Shifts in how we as a society want to live, work, and shop also impacted the residential, office, and industrial sectors.

Real estate players who want to thrive in the new year should have a keen understanding of how the industry performed and where it's going. Here are my nine forecasts for 2019.

Photo: WeWork

The one-two punch in retail

1. Retailers can no longer solely have an online presence or brick-and-mortar stores. If they want to survive, smart retailers will strike a balance between the two channels —the "one-two punch."
2. In 2018, U.S. store closings more than doubled the number of openings. To fill vacancies, non-traditional retail users such as medical, fitness, entertainment, sports training facilities, hotels and co-working office spaces will move in. Companies with a strong online presence will also look to put down roots.
3. We are going to start seeing parking lots full of rideshare delivery drivers picking up goods. Currently, for every 1,000 sq. ft. of retail space, four or five parking spots are needed. Moving forward, developers will have to reserve two out of every five parking spots to accommodate rideshare deliveries.
4. Millennials and Gen Zs are looking for experiences. Aging baby boomers are downsizing and spending more time outside of the home. To appeal to all age groups, traditional retail centers will transition to mixed-use. Those that offer an assortment of uses, including retail, residential, and office, will stand out.

A shift for residential

5. Instead of big houses with a backyard and two-car garage, people want denser high-amenity living. This will hold true in 2019, as residents seek multifamily offerings that provide everything they could find in a suburban shopping center—for example, a car rental in the basement or a dry cleaner on the first floor. If the residential is located within a mixed-use development, it's a win-win.

Office evolves and industrial flourishes

6. Gone are the days of large office complexes with multiple tenants. Growth in the office sector is now dominated by temporary workspaces, oftentimes located in retail centers. Office owners will continue to consider fluid work environments or look at single-tenant buildings depending on their size and capabilities.
7. Industrial parks near rail lines, airports, and highways continue to boom. Why? Because retail fulfillment has changed how goods are warehoused, stored, and delivered. Proximity to population centers provides speed of delivery.

Final thoughts

8. Investors looking to build their portfolios in more affordable cities will turn to 2019's growth markets, primarily located in central and southeast United States. They can expect a reasonable return on their investment in areas like Texas; Tennessee; the Florida Panhandle; and Denver.
9. Online real estate platforms such as Zillow will likely expand into the commercial real estate space. Think analytical tools that determine the best location for a business based on demographics, price, space, geolocating, and access.

Undoubtedly, technology and the changes in consumer behavior as a result of technological advances will continue to affect the way we do business. Those who can stay nimble and innovative will come out on top. ■

Tom Londres is CEO and Principal of Metro Commercial.

Learn more at **www.metrocommercial.com**.

The Year Ahead for Seniors Housing: A Dynamic Setting, An Emerging Time

By **Beth Burnham Mace**

Photo: Getty Images

Location, location, location. Whether its retail, office, industrial or seniors housing, location matters—and it matters a lot. In seniors housing, one size does not fit all. One broad characterization does not apply. Performance varies. Operators matter. Assumptions count…about potential resident demand, about participation by adult children in move-in decisions, about lease-up rates, and about labor availability.

In the year ahead, proformas will be met, but not all the time. Expectations from two years ago may or may not be panning out. Development pipelines may be fuller than planned or may be emptying out. Occupancy rates are near record highs in some locations, at record lows in others. Regardless, NOI pressures continue to mount, as wage growth is pushed higher due to 50-year record low national unemployment rates and as rent growth is often decelerating.

Capital will be available—in active deal-making and as dry powder waiting on the sidelines for distressed deal opportunity. Investor surveys place seniors housing among the top commercial real estate property types for both development and acquisition prospects. Interest from REITs, private equity, institutions and private funds remains keen. While not yet generally considered a core investment, increasingly seniors housing is fitting into core funds, offering diversification as well as steady and consistent income and appreciation returns. And, in a time of rising interest rates, investor attention toward the sector may act as a hedge against upward pressure on cap rates to keep the risk premium at or near today's levels and valuations more stable.

The integration of the health care and housing for seniors will continue to alter the landscape for both seniors housing operators, developers, and capital providers. The recognition of seniors housing as a lower-cost and efficient service setting will allow operators to bend the nation's health care cost curve by providing care offerings to their residents that allow them to remain in place healthier and longer with less likelihood for the need to move to a higher-cost and more intense care setting.

And the elderly consumer is morphing. No longer content to simply retire into a setting that provides safety, security and comfort, tomorrow's seniors housing residents are demanding engagement, enrichment, and connection. Program content for seniors is becoming more "purpose-full," where volunteerism and making a difference are increasingly part of the daily activity offerings from which residents can choose.

And the demand pool of potential residents for seniors housing is growing. First, it is increasing from our nation's evolving demographics as seniors shift from being part of the Greatest Generation to the Silent Generation and toward the baby boomer generation. Second, the demand pool is increasing as operators begin to serve the burgeoning pool of middle-income seniors.

Property design features are changing too, with distinct dining options, greater access to light, and the repositioning of a single space for multiple purposes. And location—there's that word again—is being reconsidered too. Two words (well technically, maybe three words) will increasingly be part of the vernacular for seniors housing in 2019: cross-generational interaction and walkability. Increasingly, developers of new seniors housing properties are selecting sites that have high walkability scores, sites that are often on Main and Main, near retail, and fully integrated into a community.

Taken in its entirety, the seniors housing sector will remain an intriguing and compelling—albeit potentially challenging—property type for capital providers and seekers in 2019. And equally important, the seniors housing sector allows these groups to do well by doing good for our elderly population. ■

Beth Burnham Mace is chief economist and D\director of outreach for National Investment Center for Seniors Housing & Care.

Learn more at **www.nic.org**.

Politics, Policy and the Outlook for Multifamily Housing

By **Doug Bibby**

Democrats winning control of the U.S. House of Representatives was the top story coming out of the midterm elections, but the resounding defeat of a California ballot initiative was a much bigger deal for multifamily owners, operators and investors.

California's Proposition 10 ballot initiative sought to overturn long-established state law that restricts the scope of rent control policies. The measure threatened to usher in new and aggressive rent control regulations that would have negatively affected the multifamily industry.

In the lead up to Election Day, industry experts estimated multifamily property values could drop by as much as 10 percent under the proposed regulations. Given the uncertainty around the ballot initiative, many multifamily owners looked to unload California assets before the elections.

Fortunately, California voters wisely rejected the measure. While this is certainly a win, the fight is far from over. New rent control measures are cropping up all over the country, posing nothing short of an existential threat to the multifamily industry.

Two factors are driving support for rent control. First, localities across the country are facing severe housing affordability challenges. Policymakers are increasingly seeing rent control as a potential easy fix, even if the proven effects are at odds with the intended goals.

And their constituents increasingly agree. One pre-election poll in California showed that even though just over a third (36 percent) of respondents said they would vote yes on Prop 10, more than half (52 percent) agreed that rent control is a good thing.

Second, Democratic gains on the state level were substantial. Democrats won more than 300 seats in state legislative chambers, took control of six chambers previously held by Republicans and flipped seven governorships. In fact, 14 states now have a Democratic trifecta with blue control of gubernatorial seats, state senates and houses. Many of those incoming officials campaigned on addressing the housing crunch in their respective states.

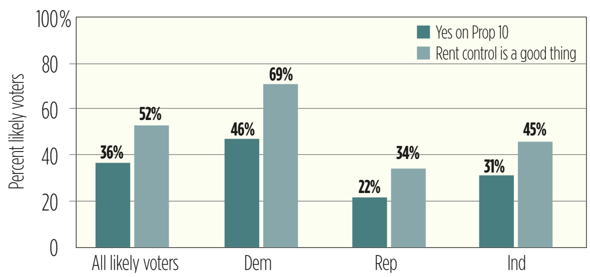
In Oregon, Democrats built on their majority in the state legislature and retained control of the governor's office. Over the past several years, rent control has become a hot-button issue throughout the state. In 2017, the State House of Representatives passed a measure to repeal the preemption. While the bill did not make it through the Senate, it will likely be revisited in 2019.

Similarly, Illinois moved to a Democratic trifecta with J.B. Pritzker's defeat of Republican incumbent Governor Bruce Rauner. Pritzker has supported lifting the Illinois rent control preemption, and state legislators have already begun holding hearings on rent control measures they intend to introduce in 2019.

In Colorado, Democrats picked up control of the General Assembly and now lead both chambers of the legislature and hold the governor's office. State officials have signaled that they will focus on affordable housing in 2019 and activist groups are aggressively pushing for rent control.

Against such a landscape, multifamily owners, operators and investors can expect more debate over rent control in the year ahead, even as research continues to prove that it's an ineffective and harmful policy. These policy debates will create uncertainty and muddy the industry's investment outlook. That's why the industry needs to come together to strike down rent control initiatives, while engaging state and local governments on alternatives that better address housing shortages and affordability challenges and provide for a wide range of housing options.

Voters More Positive on Rent Control than Support of Policies Suggests



PPIC Statewide Survey, September 2018.
From: PPIC Blog, October 2018.

Doug Bibby is president of the National Multifamily Housing Council in Washington, D.C. He can be reached at dbibby@nmhc.org.

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The Three Keys to Long-Term Success in the Opportunity Zone Program

By **Reid Thomas**

Since the Great Recession, a select few geographic areas of the United States have enjoyed record growth, while others have descended into historic levels of distress. The Opportunity Zone program—built around a set of tax incentives introduced last year—may hold the key to correcting this troubling disparity.

> **The Opportunity Zone program combines a typical private equity investment fund structure with a tax program *and* a community development program.**

The basics of the Opportunity Zone (OZ) program are refreshingly simple: individuals who reinvest realized capital gains into Opportunity Zone Funds are able to temporarily defer, and eventually reduce (at five- and seven-year milestones), their tax burden on those capital gains. After 10 years, any capital gains realized from the appreciation of the investment in the OZ Fund are tax free.

The areas defined as Opportunity Zones have been agreed upon, at least for the next decade, and the straightforward benefits associated with the program have already begun to funnel capital into distressed communities around the country.

While all of this sounds great, unfortunately, the fact remains that many well-intentioned (and in some cases well-designed) investment-motivated economic development programs have failed in the past—whether due to fraud and abuse, or to debates about their effectiveness. Left unchecked, the OZ program may suffer the same fate.

Stakeholders in the OZ industry have an unprecedented chance to establish a regimen of standards and best practices to prevent fraud and abuse in this burgeoning industry, and to guard against misconceptions that could ultimately harm public perception of the program. Specifically, we see the need to establish best practices in three key areas: security, transparency and compliance.

1. Security: Use an independent, third-party administrator

In more mature financial industries, the use of independent, third-party controls and record keeping is standard. As a best practice in the OZ industry, fund managers should utilize—and investors should insist upon—the same level of third-party oversight to ensure funds are directed as intended.

2. Transparency: Make all material information accessible

The OZ program combines a typical private equity investment fund structure with a tax program and a community development program. As a best practice, fund managers should implement a policy of transparency in all three areas—because their investors will be interested not only in ROI, but also the tax and social impact benefits of the program. Moreover, the long-term sustainability of the OZ program will depend on whether it achieves its intended good. Tracking the social impact of OZ funds' investments will help to ensure that community benefits are properly acknowledged.

3. Compliance: Develop a platform that exceeds the minimum standard

The OZ program was developed with a minimum in initial regulatory requirements and oversight, aiming to encourage the flow of capital. However, implementing compliance standards to the lowest bar leaves open the potential for abuses. Fund managers in OZ should embrace the rigorous compliance best practices of other, more established industries (such as private equity) from the beginning to avoid costly retrofits down the road.

•••

The OZ program holds tremendous promise. But this promise will only be realized if stakeholders truly embrace the intention of the program—positive social impact— and take steps to protect the young industry from common pitfalls. To this end, establishing best practices in security, transparency and compliance at the fund level is paramount. ■

Reid Thomas serves as the executive vice [resident for NES Financial. Responsible for global sales and marketing, he brings over 20 years of sales and marketing leadership in both public and private companies in high-growth Silicon Valley technology companies.

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NES Financial℠

Empowering Freddie Mac and Fannie Mae to Solve the Affordable Housing Crisis

By **Eduardo Padilla**

A solution to the affordable housing crisis in the U.S. continues to evade disparate groups battling this growing problem. Whether its chronic homelessness or workforce housing, the core elements begin with a supply and demand imbalance impacted by capital availability and negative social perception of "low-income" rental housing. Over 35 percent of Americans live in rental housing and that percentage continues to grow. According to Freddie Mac, nearly 30 percent of renters—that is more than 11 million households—spend at least 50 percent of their income on housing. Affordable rental housing is key in the effort to solving this crisis, and Freddie Mac and Fannie Mae (commonly referred to as the GSEs), play a key role in this battle.

Availability of capital drives the creation and sustainment of rental housing, but driving significant dollars into affordable housing generally requires some element of government support or incentive. The most prolific suppliers of capital in the affordable rental market—Freddie and Fannie—deliver capital through mortgage programs that have come at no net-cost to the U.S. taxpayer for over two decades. Even in the midst of The Great Recession, the multifamily divisions of Freddie and Fannie were profitable. Since the end of the Great Recession, Fannie and Freddie have, on a cumulative basis, provided total dividends of $279.7 billion to the U.S. Treasury compared to the approximate $180 billion provided from the U.S. Treasury. If these agencies had been allowed to retain these profits, the risk to taxpayers would have been effectively eliminated.

Even with virtually 100 percent of their profits paid to the Treasury Department, the agencies have dramatically reduced their risk exposure by changing the fundamental way they execute transactions. They now transfer most of the credit risk to the private capital markets. In addition, with many years of experience and a record of accomplishment, the multifamily divisions have proven their keen ability to underwrite risk. Freddie Mac's delinquency rate is currently 0.01%.

Freddie Mac's Multifamily Targeted Affordable program for 2017 and year-to-date 2018 contributed $12.7 billion in financing for affordable housing. In addition, they have also introduced a new mezzanine-financing product for affordable housing that will effectively reduce the equity required in rental property development and acquisition. Fannie Mae's affordable lending programs exceed $8 billion for 2017 and year-to-date 2018, so the GSEs have combined for over $20 billion since 2017.

Other key mechanisms for driving down the cost of housing are Section 8 direct rental subsidies and the federally supported low income housing tax credit program. While these programs are essential to the creation of affordable housing, Freddie and Fannie exceed the total capital amounts provided by these other programs.

GSEs lending for a broad quality spectrum of rental properties at very competitive rates leads to sustained value in a marketplace that is often dominated by older, moderate rental-rate properties. We must fight to retain naturally occurring affordable housing. Mortgage capital with attractive terms will

be key to the achievement of this essential goal.

If Freddie Mac and Fannie Mae were allowed to capitalize their balance sheets from their own profit and add another layer of extremely low-cost capital, affordable rental housing for lower income Americans could be dramatically improved. They have proven that a large volume can be balanced with low risk, and low-cost execution. This no time to restrict the agencies or seek out far-fetched criticisms where none is deserved—Freddie Mac and Fannie Mae should be encouraged to do more. ■

Eduardo "Ed" Padilla has been CEO of NorthMarq Capital since 2000.

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Photo: Getty Images

2019: The Year of RON

By **Rick Triola**

Much like their residential counterparts, commercial real estate closings haven't changed all that drastically in the last 20 to 30 years. That will soon change.

Thanks to several forward-looking state legislatures, real estate closings of all varieties are set to be transformed through remote online notarization (RON). Not only does this technological shift drastically streamline the closing experience, but it also enables a level of coordination and convenience that the commercial real estate closing has been lacking up to this point.

RON refers to a notarial act conducted electronically using audio-visual equipment wherein the participants are not located in the same physical space. This should not be confused with eNotarization, which usually refers to an in-person notarial act in which documents are notarized using an electronic notary stamp and signatures.

In 2011, Virginia became the first state to authorize its notaries to conduct RON transactions not just for Virginians, but individuals worldwide. While state-level adoption stagnated for several years after the passage of Virginia's bill, legislative activity regarding RON has increased significantly over the past 18 months.

This past year, 32 different RON bills were introduced during the legislative sessions of 17 states, and to date, Indiana, Michigan, Minnesota, Montana, Nevada, Tennessee, Texas and Vermont have all joined Virginia and passed their own RON legislation, many of which also allow their notaries to conduct RON transactions nationwide. Furthermore, several states are expected to introduce and/or pass RON legislation within the next year, including California, Colorado, Florida, Mississippi, Nebraska, Ohio and Pennsylvania, among others, as well as the District of Columbia.

With entities like the National Association of Secretaries of State, the American Land Title Association, the Mortgage Bankers Association and others offering their full support, RON is rapidly gaining steam and for good reason. Today's real estate closing process bears little resemblance to the environment in which the majority of the transaction is being conducted. Unlike a residential transaction where either the buyer or the seller typically resides in the same location as the property, commercial real estate deals often involve a property that may not be located in the same city, much less the same state, as the buyer or seller.

Furthermore, both the buyer and seller in a commercial transaction are usually represented by attorneys, even if the state in question does not require an attorney to be present at the closing. Factor in the closing agent, the notary and any other interested parties, such as the real estate agent, and the number of participants in the closing can become quite large.

RON not only jettisons the need for these parties to all congregate in a single office on the day of closing, but it also eliminates the document swapping that occurs between the buyer's and seller's representatives to complete the transaction, resulting in a more streamlined, efficient and secure closing process.

Ultimately, RON represents the modernization of the real estate closing process. As more states begin to legalize this practice, commercial real estate investors would be wise to jump on board early to take advantage of the convenience, efficiency and secure RON brings to closings. ■

Residential and commercial real estate expert **Rick Triola** is founder and CEO of NotaryCam, a provider of remote online notarization and identity verification systems.

Learn more at **www.notarycam.com**.

Photo: Getty Images

The E-Commerce Resistance: Why Grocery-Anchored Retail Stands Tall in the Face of Disruption

By **Jeffrey S. Edison**

Amazon's Whole Foods acquisition validated the need for an omni-channel model that combines online delivery with physical stores.

When Amazon purchased Whole Foods, many envisioned the online giant would dominate traditional grocers. Get ready for a tougher fight. Grocers are probably better prepared than any retail segment to push back.

Recent headlines around store closures such as Sears and Toys 'R' Us are a testament to e-commerce's ability to disrupt retail business models, and, consequently, pose headwinds to retail real estate. We believe the grocery industry will prove much more resistant to the e-commerce impact, however, and that demand within grocery-anchored properties will remain high.

In many ways, Amazon's Whole Foods acquisition validated the need for an omni-channel model that combines online delivery with physical stores. From that perspective, the risk profile of grocery-anchored real estate has improved. At the time of Amazon's acquisition, Whole Foods only held about 1.2 percent of the U.S. food and grocery market. Meanwhile, Wal-Mart held the largest share at 14.5 percent, with Kroger second at 7.2 percent[1]. To have success in the grocery business, Amazon will likely need additional properties to deliver groceries in the last three miles to people's homes. Neighborhood grocery centers would fit the bill.

While Amazon may need more properties to expand its strategy, we don't believe it will displace traditional grocers. Instead, several factors should leave them well entrenched. Those include:

Grocery convenience remains undefined. The perishable nature of food forces customers opting for in-home delivery to stay near home during an hours-long delivery window. Many shoppers may find it more convenient to order online and pick up groceries on the way home from work. Traditional grocers are investing heavily in click-and-collect services, betting many working adults will prefer this option.

Grocery shopping is a more price-sensitive experience than discretionary retail purchases. The average grocery store checkout is only $30. Delivering such small loads comes with a fee that many consumers are unwilling to pay. Ultra-low margins associated with the industry prevent e-commerce companies from introducing new or improved delivery offerings without price increases.

Customer loyalty could favor incumbent grocers. A clean store with good service builds customers' trust about their food. That trust could carry over to the supermarket's online model. Looking ahead, customers' loyalty could increase. Grocers are honing their use of big data to pinpoint the discounts or rewards that drive loyalty. While Amazon is no stranger to data and analytics, only 2% of grocery sales take place online. This gives traditional grocers a data advantage that is hard to replicate.

Most importantly, grocers aren't approaching e-commerce complacently. The industry has invested heavily to capture the portion of sales that will migrate online. Kroger's minority stake in Ocado, a company that perfected the online supermarket in the U.K., serves as an example.

The Ocado partnership will place up to 20 high-tech warehouses in the U.S. that utilize robotics and artificial intelligence to fine-tune online grocery delivery. For example, the company is developing robot hands that can pick fruit without damaging it and vision systems that allow robots to grab items without needing a 3D model of them, among other innovations[2]. Such technology rivals anything in Amazon's warehouses and is arguably superior when it comes to food delivery.

We believe new definitions of convenient grocery shopping, price sensitivities, consumer loyalty and grocers' own innovations could all help entrench neighborhood grocers as the preferred food option among consumers and underpin strong demand for grocery-anchored real estate. ■

1. www.cnbc.com/2017/06/21/dont-worry-wal-mart-amazon-buying-whole-foods-is-just-a-drop-in-the-bucket.html
2. www.fortune.com/2018/05/17/ocado-kroger-warehouse-automation-amazon-walmart/

Jeffrey S. Edison serves as hairman and CEO of Phillips Edison & Company Inc., an internally-managed REIT and one of the nation's largest owners and operators of grocery-anchored shopping centers.

Learn more at **www.phillipsedison.com**.

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Real Estate in 2019: Investors Prepare for a Turn

By **Tom Carr**

At the end of 2018, Preqin interviewed over 170 institutional investors in real estate to gauge their views on the industry, how it had performed in 2018, and what they expected 2019 to bring.

2018 is set to become the fifth year in a row to see more than $120 billion flow into PERE funds—while this is slightly less than the $140 billion raised in each year 2007-8, as a period it far outstrips any previous period. On the back of that, assets under management have grown to $900 billion as of March 2018 (the latest available data). This raises the prospect that the industry could break the landmark $1 trillion barrier in 2019.

The industry has also bounced back from a performance dip seen in 2016, and one-year horizon returns have remained above 10 percent in the year to March. It is no wonder, then, that investors are generally very satisfied with the returns they have seen from their PERE investments—64 perceht said they had met expectations in 2018, and 26 percent said they had exceeded them.

However, two-thirds of real estate investors believe the market is currently at a peak, and 45 percent think that assets are overpriced and due for a correction—25 percent believe that correction will come in 2019. Rising interest rates, asset valuations and competition for deals rank as the primary concerns for investors going into 2019, suggesting they think that it will be extremely challenging to put capital to work.

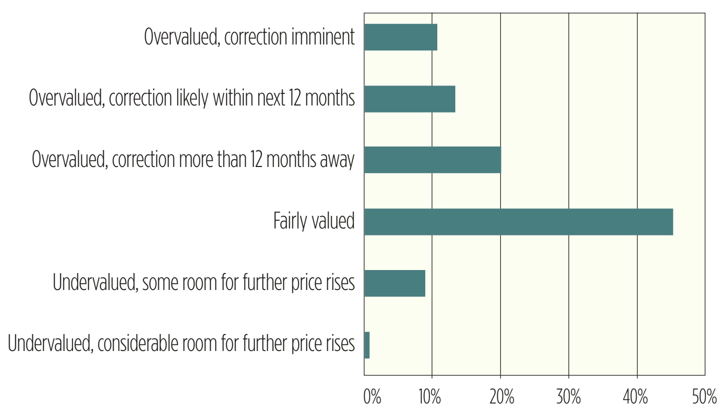
This might explain why investors are more negative about performance prospects in 2019 than they are about the returns they've seen in the past 12 months. A third believe real estate will perform worse in 2019 than 2018, with just 7 percent saying they think performance will improve.

Despite this, real estate investors are broadly balanced on their commitment intentions in 2019. Twenty-three percent will commit more to real estate in 2019 than in 2018, while 19 percent will invest less. In the longer term, the trend is still to increase allocations, with 36 percent saying they will raise their allocations while just 9 percent will decrease them. This is partly because absolute return is not real estate's key appeal to investors. They instead choose it for its asset class and vintage year diversification, income stream and inflation hedging benefits.

So where will investors be looking in 2019? By far the largest proportions will be looking to developed markets: 84 percent say they will target only or mainly developed markets-focused funds, while just 5 percent will be focusing on emerging markets. They will also be staying to the lower end of the risk/return spectrum. Sixty-four percent say the best opportunities in 2019 will be in core and core-plus funds. While some will be looking at value added and opportunistic vehicles, just 15 percent will look to debt funds and 12 percent to distressed real estate in the year ahead.

The indications, then, are that real estate remains very popular with investors, and their longer-term commitment to the asset class remains strong. But many think 2019 may be the year in which the market turns, and they are not certain that real estate investments will be able to maintain their historic returns in that environment. In a defensive posture, they are targeting lower-risk investments in developed markets to insulate themselves from potential corrections, and to reap the diversification and hedging advantages of real estate. ■

Investor Views on Whether Real Estate Asset Pricing is Fair



Tom Carr is head of real estate at Preqin.

Learn more at **www.preqin.com**.

Property Performance, Written in the Stars

By **Alan James**

Two stars? Five stars? Whether we're looking for air conditioners or auto mechanics, most of us today rely on star-based ratings as a quick aid in gauging performance.

Wall Street caught on long ago, with star rating services that provide a high-level view of stock and fund performance without the need to dig deeply into the data.

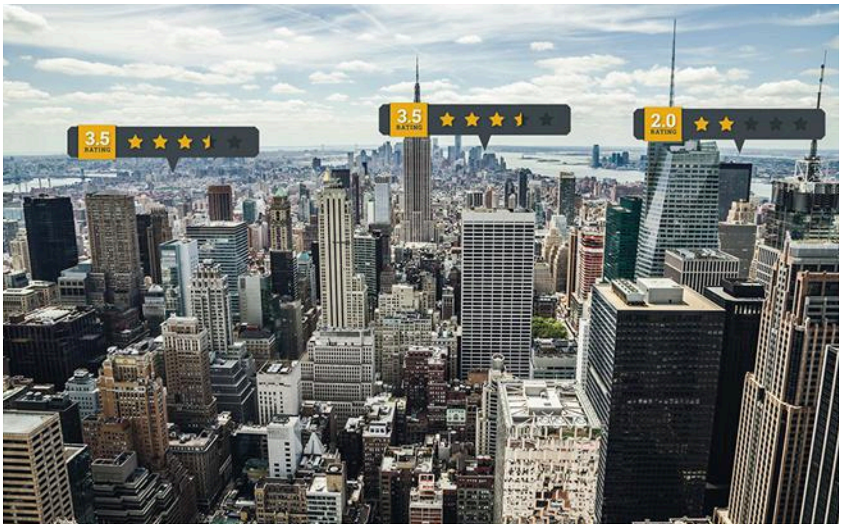
Now, for the first time, the technology is in place to put star ratings to work for real estate investors and asset managers, allowing them to identify problems in their portfolios without having to parse spreadsheets and reports. The ratings are driven by key performance indicators that can be weighted according to the manager's expectations for each asset.

This ability to customize the standards by which various assets are judged is critical, since you may have different strategies for different properties or groups of properties. Is occupancy paramount at this stage? NOI? Are certain properties in lease-up? What are the local market conditions? By tweaking the parameters underlying the ratings, you set the expectations for your assets. A five-star rating means the property is doing just what you want it to according to your strategic objectives. A two-star rating means it's time to drill down into the data to learn why the asset is underperforming, and then decide what to do about it.

In summary: you can now see at a glance which properties are cruising along and which need attention, based on your own standards. There's no more time wasted sifting through data to determine where to direct your efforts in boosting performance.

The arrival of star ratings represents this decade's second major breakthrough in decision support technology for real estate investment managers. The first was the development of software that automatically gathers performance data, replacing the laborious manual data gathering of prior years. Now, with both working in tandem, managers can fire up a dashboard for an eagle's eye view of their portfolio, then drill down where a star deficit indicates problems that need troubleshooting.

It's important to note that using a star rating system does not in any way minimize the role of asset managers and their expertise. The technology merely helps them do what they do more quickly and efficiently. While managers have long understood the metrics underlying performance and the associated calculations, they haven't been aided by automation in these calculations, nor have they had a way to generate an overall performance score that considers an array of underlying metrics so as to indicate property health at a glance.



The overarching payoff of star rating technology is in allowing asset managers to shift valuable time from assessing property performance to strategic decision-making in pursuit of nudging it higher. For the first time, managers can quickly see where they need to dive in and put their skills and creativity to work in addressing problems and opportunities in their portfolios. ■

Alan James is senior vice president of investment management, accounting and commercial at RealPage. Over the last 25 years. Alan has worked with top fund and institutional managers in providing technology solutions to increase shareholder value.

Learn more at **www.realpage.com**.

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Prospects For Multifamily Market Performance In 2019

By **Daniel J. Hogan**

"You want me to be all gloom and doom, or just shut up?"
—Stephanie Meyers

A strong market exists for forecasts of gloom and doom. It is a fundamental element of human nature and, indeed, appears to have a neurological basis: experts have determined that a linkage exists between neurological processes in the right hemisphere of the brain and pessimistic thinking.

After an eight year multifamily boom it is easy to fall prey to the pessimistic temptation. But, facts are impossible to ignore. Economic, demographic and fundamental trends are generating strong tailwinds behind the multifamily market, and the phenomena that may cause the winds to shift direction seem less probable by the day.

As for the economy, 2019 appears likely to be a transitional year that will serve as a bridge from the robust conditions observed this year to sluggish "new normal" growth in 2020. But little evidence exists that this slowdown will be a precursor of an imminent recession. Barring an overreach by the Fed our macro models indicate that GDP will rise about 2 percent; establishments will create an average of 125,000 payroll jobs per month (versus 200,000 in 2018); and nominal personal income will rise nearly 4 percent.

Growth along these lines will preserve the multifamily market rally. Household formation will moderate from the 20-year high 1.6 percent rate observed through September, but remain vigorous by post-recession norms, and incomes will rise fast enough to foment constructive rent growth.

Apartment supply will subside but remain heavy by historic standards. RCR expect about 180,000 units to be delivered in 2019 to the top 50 metro markets it models econometrically (the RED 50), down from 250,000 in 2018. Our demand models project absorption of nearly an equal number, implying stable occupancy next year near 94.9 percent, using the Reis baseline.

Rent trends were constructive over the summer, propelling RED 50 rents up 4.5 percent year-on-year. Supply pressures and slower economic growth will tend to bend the rent growth down in 2019 to about 3.5 percent.

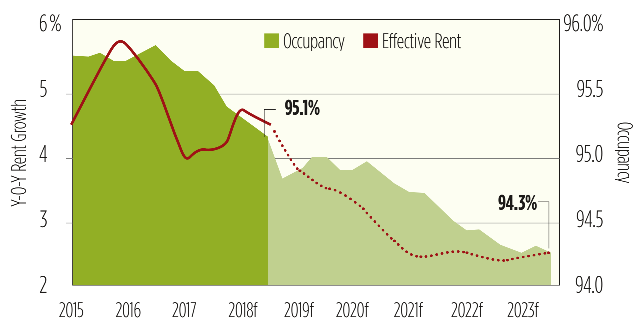
Net operating income growth will descend commensurately, but gains nevertheless will be investor- and lender-friendly. Highlighted by improved performance in the Northeast, Bay Area and Pacific Northwest, RED 50 NOI should advance nearly 5 percent next year.

While rent and NOI growth is set to decelerate somewhat cap rate trends in 2019 are likely to remain favorable to owners. RCR models do not foresee much additional upward movement in 10-year Treasury and Baa-rated bonds yields, nor is there reason to anticipate a material change in investor appetite for multifamily assets. Although yields may drift higher for older properties should buyers sour on value-add investments the probability of an across-the-board repricing seems slight.

Considering our outlook for an economic "soft landing" and a benign cap rate environment, it stands to reason that expected investment returns should please stakeholders. Our models now estimate average RED 50 annual, unlevered five-year expected total returns of 7.0 percent, up about 30 basis points from mid-year. The gain is largely attributable to better forecast 2020-2021 economic performance and a tighter spread between average purchase (5.10 percent) and projected terminal (5.36 percent) cap rates.

In sum, it may be natural for those of us with right-hemisphere dominant brains to be inclined toward pessimism. But the multifamily market seems determined to deny us psychic satisfaction, at least for a couple of years. ■

RED 50 Base Rent and Occupancy Forecast



Sources: Reis, Inc. Histories/ RED Research Econometric Forecasts

Danial J. Hogan is nanaging director of RED Capital Research.

The views expressed here are Mr. Hogan's and may not necessarily reflect the official policy of RED Capital Group, LLC. Mr. Hogan's market research can be found on his Twitter Page (@RED_DanielHogan) and at https://redcapitalgroup.com/news-resources/market-overviews/.

The Market for Net Lease Investments is Still Going Strong into 2019

By **Tyler Ellinger**

Net lease properties can be extremely advantageous for investors who are looking for low-risk real estate investments that produce consistent returns over a long period of time. Not all net lease locations are created equal; they key factors in a strong net lease investment are a well-located property with good access, strong traffic counts, and proximal anchor tenants.

As 2019 approaches, net lease properties are moving at a premium rate, particularly in areas that are experiencing a higher than usual influx of new residents moving in and patronizing the city. Investors should look at population growth over the past 10 years, as well as expected population influxes in the future to find the best cities for net lease investments. Where are people moving at faster than usual rates? Figure out what desirable areas people are chasing, and then invest there.

Current high-growth areas include; Boise, Idaho; Salt Lake City, Utah; Austin, Texas; San Antonio; Portland, Ore.; Seattle and the California metro area. While net lease assets can be scarce in these markets, the ones that do hit the market generally sell quickly and for a premium. In areas such as these, we're also seeing very strong cap rates on net lease properties, which is great for the seller, as long as you list with a broker who knows how to sell your single-tenant net lease property and list it at a price where you're going to generate offers.

Another trend we will continue to see in 2019 is 1031 exchange buyers turning to net lease properties as a safe asset for investment. Investors from large markets like California, Texas, New York and Florida are selling their apartment complexes at historically low cap rates, and then investing in net lease locations at 200 basis points or higher and as a result, seeing a large increase in their cash flow while having less landlord responsibility.

Choosing the right net lease property also has a strong impact on how successful the investment will be long term. One asset that investors are turning to is convenience stores, which are generally well located and can provide potential tax advantages (consult with your CPA on the tax benefits of specific investments). Even though rates vary based on location, operators can typically get at least 5 percent, and we're seeing even higher yields in smaller towns (upwards of 7 percent). National credit convenience store are trading between 4.50 percent and 5.50 percent cap rates (such as 7-Eleven, Circle K, Wawa, RaceTrac and Maverik), while non-credit convenience store operators have a large number of properties hitting the market at 6.75 percent to 7.50 percent cap rates.

Photo: Joe Raedle/Getty Images

Right now, Sands Investment Group is listing quick service restaurant and convenience store portfolios, which are generating high activity levels with properties closing and moving at aggressive cap rates. A recent portfolio of Burger King properties in the inner mountain states includes properties that have closed at cap rates from 5.00 percent to 5.75 percent, depending on the strength of the location.

SIG brokers work collaboratively with net lease property sellers and buyers, and listings are marketed to our proprietary database of more than 100,000 of the most active principals and brokers. Your property will reach the right investors for seamless transactions and exceptional results. ■

Tyler Ellinger is an advisor at Sands Investment Group for the Austin, Texas, and Salt Lake City, Utah, markets.

Learn more at **www.signnn.com**.

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Demographic Change is Reshaping the Role of Technology in Real Estate

By **Evan Schmidt**

The real estate industry has become increasingly agile in its use of technology over the last decade. Much of the industry's investment has been focused on back-office automation, with the goals of increasing efficiency, improving accuracy, and generally making operations run more smoothly. Today, however, new market forces are compelling property owners and managers to think more strategically about the role of technology across their business in order to stay competitive.

One of the biggest drivers we have observed is the changing demographics of the real estate management workforce. With an estimated 60 percent of commercial property managers due to retire in the next few years, recruiting and retaining professional talent has become a well-documented issue. Tech-savvy millennials entering the workforce are in demand. And they want to work for firms that make smart use of the technology they are accustomed to using in their everyday lives, particularly mobile devices and cloud-based applications. Firms competing for this talent pool need to be thinking about mobile-ready, device-agnostic technologies that will empower workers to be connected and productive on the go.

We are seeing this trend even among family-owned real estate businesses that are passing to the next generation. The sons and daughters taking over these companies are more technologically informed than their parents, and looking to transform their operations through automation, mobility and cloud-based technologies.

If property managers' employees are more and more tech-savvy, so too are their customers. In the multifamily segment, technology has become a consideration in rental decisions, driving a trend toward smart apartments. To keep up with the growing demand, landlords offer resident portals through which tenants can conveniently place service requests and pay their rent online. The logical evolution of this is toward Internet of Things applications that enable tenants to control their utilities, lighting and appliances through their mobile devices.

On the commercial side, we're seeing a growing propensity of building owners marketing office space through their own online portals, and connecting directly with prospective tenants while foregoing the services of a traditional agency broker. Of course, looking for space and negotiating leases require a substantial time commitment, and many firms continue to rely on the specialized expertise of brokers rather than diverting their own resources away from core activities. Still, forward-thinking brokerage firms are seeing the writing on the wall and getting ahead of the game by partnering with tech companies so they can offer their clients an entire platform of technology and services.

The movement of technology from the back to the front office is one of the more pronounced trends we are seeing in the market today. There are still efficiency gains to be uncovered, however. For example, we've seen a growing demand to automate the recoverable expense billing and reconciliation process. Typically, landlords will use spreadsheets to calculate the common area maintenance or CAM fees they bill to tenants, which makes for a very time-consuming, error-prone process. Automation could potentially save them 20 to 40 hours of process time per building.

The role of technology in real estate is clearly evolving. Beyond improving efficiency and cutting overhead, landlords and property managers have begun to see technology as an opportunity to differentiate their service offerings and workplace environments, and to gain a competitive edge in a changing industry. ■

Evan Schmidt is the national territory manager of SKYLINE Property Management Technology Solutions.

Learn more at **www.ssctech.com**.

SS&C

Photo: Getty Images

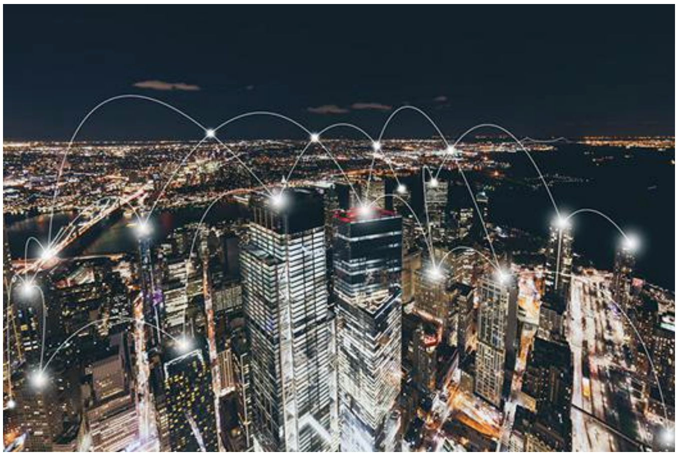
The Future of Brokerage: Opportunities for Those who Advise and Adapt

By **Kevin Maggiacomo**

Technology advancements and changes in consumer behavior are impacting and disrupting the commercial real estate industry as we know it. The digitization of the workplace, the growing role of robotics, the Internet of everything, our gig economy, the introduction of automation and artificial intelligence (AI) are all creating a biosphere of promise and challenge. On the brokerage side, access to information will make it easier for buyers and sellers to make more informed decisions. As a result, brokers will no longer control the conversation.

The reality is that a broker's role will never truly go away, but there will be radical changes. While we won't see an AirBnB or Uber-like company disintermediate CRE soon, technological enhancements will disrupt the traditional brokerage model that has already minimized much of the need for human touch. By revolutionizing data ubiquity and transparency, whether it's through the blockchain or other means, brokers will need to provide more advisory information to clients.

What does this mean for brokers? Three things:



1. **There will be no room for "C" players who hoard information and simply serve as connectors.** In the future, information will be more readily available to clients and transparency will rule the day. We will see that the matching of a particular property in a particular asset class to a particular client can and will be done by AI. In fact, we are already seeing this being tested in CRE tech companies. In short, the obvious will be automated, whereas specialization and adding cerebral value to a transaction in an advisory capacity will be demanded and rewarded.
2. **Double-ending deals with a finite group of clients will be rendered obsolete.** Every day new and unlikely buyers are entering the market. In the past this meant international buyers in gateway markets. Today we see not just international buyers entering into secondary markets, but we also see family offices, previously local investors expanding out of market, and even crowdfunding. These new investors are more sophisticated, expect real-time information and access to all data. As a result, landlords are going to demand that their brokers make their properties available to the entire brokerage industry in order to drive value.
3. **There will be no more secrets in CRE.** As real estate becomes more commoditized, data more readily available, clients more sophisticated, and the basics automated, the industry will be forced to operate with an open playbook. Fees will need to be clearly stated and they will be earned through creativity and adding value to the process. Those who built their businesses through obfuscation will no longer have an advantage and may in fact be relegated to "C" player status.

The reality is that the service that too many brokers in our industry offer clients today is simply not good enough. Changes in CRE client behavior, coupled with emerging technologies will radically change both the way in which transactions are facilitated, and the industry functions as a whole. This creates new opportunities for skilled participants. Those who lead and adapt today will sit in the pole position; those who seek to maintain the status quo are at risk of being disintermediated.

Photo: Getty Images

Kevin Maggiacomo is the CEO and president of SVN International Corp., a commercial real estate franchisor with over 200 offices and 1600 advisors and staff, located in 8 countries and expanding.

Learn more at **www.svn.com**.

The Impact of Economic Headwinds on Tenant Credit

By **Bradley Tisdahl**

The capital stack in commercial real estate has evolved in recent years, showing significant increases in both mezzanine and preferred equity, which were in turn abetted by low interest rates. During this time, lenders and investors might have righty de-prioritized tenant credit in the hunt for yield.

Today, the Fed's wait and see approach to rate hikes, lagging international growth in China and the Eurozone, and sovereign trouble in Italy and the U.K. could, and should, change this landscape.

Capital landscape

Traditional and private capital will continue to carve out their respective niches in 2019. There is plenty of dry powder among private capital funds, and if benchmark interest rates rise, some investors may seek more conservative strategies. With so much available private capital, more money is sure to find its way into borrowers' pockets in 2019, and with fewer regulations, it seems possible that their lending standards could slip. While standards may slip for traditional lenders like banks and insurance companies, it is less likely to deter private capital and other direct lenders, many of which could be pushed into deals with weaker credit profiles. Tenant credit will be a leading consideration for these funds as they originate and refinance debt. The need for diligence, especially in vulnerable industries and markets, should grow.

Vulnerable industries

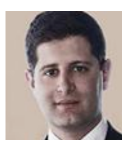
As rates rise, conventional wisdom dictates economic growth will slow. This could put pressure on tenants in capital-intensive industries including manufacturing, construction, and telecom, which rely on debt to fund large capital projects. As the cost of borrowing increases, many in these sectors could close their wallets, focusing instead on their existing debt—especially floating rate debt—to preserve margins and financial flexibility. Overly extended tenants could be at particular risk.

The same is true for oil and gas companies, many of which have been weighed down by volatile energy prices stemming from supply fluctuations. These tenants face challenges on both sides. If oil prices fall, certain oil and gas companies will be pushed closer to insolvency due to high debt burdens associated with exploration and production. That, coupled with rising rates, could produce a scenario not unlike that of late 2014.

Coworking and other technology companies, especially high growth, venture backed companies, are also at risk. Many of these companies are stretched, having taken on capital to fund expansion. A slowing economy could force them to cut back on space needs, especially for those that miss growth targets with high burn rates.

Headwind mitigation

Those with exposure to markets like Houston, San Francisco and Seattle would be wise to monitor their tenants. For existing tenants, requesting and reviewing financial statements will help identify distressed situations. For new leases, we believe it is wise to include language allowing the landlord to request tenant financial statements. On material leases, we recommend conducting proper due diligence up front and ensuring credit enhancements are commensurate with the tenant's risk and structuring lease security in landlord friendly ways. Barring a significant external shock, the market appears likely to change slowly, and 2019 will likely introduce new challenges stemming from the evolving capital stack and slowing economy. ■



Bradley Tisdahl is CEO of Tenant Risk Assessment (TRA), the leading tenant credit consultancy advising institutional real estate companies. TRA has underwritten over 150 million sq. ft. of commercial and industrial leases on over $1 billion in tenant improvements.

Learn more at **www.tenantriskassessment.com**.

tra

California Leads Strong National Demand for Industrial Commercial Real Estate Space

By **Peter Muoio**

Industrial real estate continues to be one of the strongest sectors in the industry nationwide. Average industrial pricing is $85 per square foot as of September 2018, up an impressive 6.25 percent from $80 per square foot in 2017. Additionally, deal volume rose 21.5 percent year-over-year to $18.9 billion in the second quarter of 2018, while market vacancies decreased slightly from 2017. Amid a solid backdrop for industrial demand, healthy net absorption is projected to top 10 million sq. ft. for 2018—the fifth straight year of increase.

According to Ten-X Commercial's recent *Industrial Market Outlook*, today's industrial market benefits from a number of secular shifts that have led to an increase in demand for warehouse space, including the rise of e-commerce, cloud computing and the legalization of marijuana in some states.

Although U.S. trade policy with China has recently generated some uncertainty within the sector, the United States-Mexico-Canada Agreement (USMCA) has alleviated some of that uncertainty among investors.

California is dominating the industrial sector, solidifying its place as the premier state for investors to purchase industrial assets. The top five investment markets for industrial real estate—or the top "buy" markets—are all located in California: Los Angeles, Sacramento, San Francisco, Oakland and San Jose. When considering demand drivers for warehouse space—most notably, the increase in tech developments and the legalization of marijuana—it makes sense that the sector is particularly strong in California. The state is home to a booming tech industry and one of the nation's most prosperous legal marijuana markets, creating a consistent need for industrial real estate assets.

Additional factors that have specifically boosted the industrial sector in the top five "buy" markets include overall economic expansion and population growth. Sacramento and San Jose are both experiencing thriving industrial job sectors, while San Francisco's booming tech sector continues to push its economy forward. Additionally, Los Angeles and Oakland's economies are growing steadily, with employment in Los Angeles up 1.1 percent from last year and employment in Oakland up 10.3 percent from its prior cycle peak.

However, not all of California's industrial markets are thriving. Southern California's Inland Empire is currently stagnant, as the area is plagued by a massive supply pipeline that is expected to increase vacancies and stifle local rent growth. Additional nationwide "sell" markets—or areas where investors should consider selling their assets—are Cleveland, Dallas, San Antonio and Suburban Maryland. Despite strong national demand for industrial real estate, these markets are suffering due to factors such as declining populations and imperfect supply pipelines. For instance, Cleveland's population is declining and its unemployment rate is at 5.2 percent, well above the 3.9 percent national average. Similar to California's Inland Empire, Dallas is facing a heavy supply pipeline, causing industrial vacancies to increase. Finally, in the event of a modeled downturn in 2019-2020, both San Antonio and Suburban Maryland's industrial markets would prove significantly less resilient than the national average.

Top 5 Buy Markets	2017 Rents ($ psf)	2022 Rents ($ psf)	Change in Rents (%)	2017 Vacancies (%)	2022 Vacancies (%)	Change in Vacancies (bps)
Los Angeles, CA	6.94	8.10	16.7%	2.4	2.8	+40 bps
Sacramento, CA	3.69	4.16	12.7%	7.9	6.4	-150 bps
San Francisco, CA	7.50	8.66	15.5%	9.0	9.1	+10 bps
Oakland, CA	6.08	7.02	15.5%	6.3	7.5	+120 bps
San Jose, CA	7.73	8.66	12.0%	13.5	13.2	-30 bps

Despite these five struggling regions, the overall industrial sector will likely continue to thrive throughout 2019 – especially as tech developments and marijuana legalization continue to increase and impact the country's commercial real estate market. Heading into a new year, the industrial sector will surely be an interesting market to watch. ■

A real estate economist and trusted industry analyst and forecaster, **Peter Muoio** is chief economist at Ten-X Commercial.

Learn more at **www.ten-x.com/commercial**.

The Commercial Real Estate Market is Fundamentally Misunderstanding Co-Working—Why Does That Matter for Investors?

By **John Williams**

Media hype around WeWork has led the conventional real estate market to misunderstand the rise of coworking and its implications for landlords and investors. The market is in the middle of a radical shift in mindset from a landlord/investor focused market to one that gives greater credence to the "client".

Much of the press coverage of WeWork and Coworking at large focuses on a user model that is only relevant to a small percent of the total market. The media views co-working in terms of the tight, membership model of workers from different companies occupying a desk next to each other and doing so in a collaborative way. The future growth of the market depends on appealing to larger, corporate clients and creating private, bespoke space for them.

Co-working has been growing relatively fast across the U.S. at 10+ percent each year but is in fact hybrid space—incorporating private offices and more flexible, coworking areas—that has been expanding more quickly at 20+ percent for the last two years.

The main driver behind the increased popularity of the hybrid office is the agility it offers—choose a private office for a confidential meeting, co-working to collaborate. Coworking operators are pulling off this balancing act quite seamlessly, but this is an entirely new challenge for the landlords of commercial property that have maintained the model of passive ownership.

Landlords have never needed to diversify their workspace product this way before—their strategy has usually been focused around creating a "vanilla" product—a blank canvas for tenants to work with. Market demand has changed—clients want the operator of their space to curate the environment around them and generate atmosphere. Most landlords would freely admit that this is not in their DNA.

Clients are not only asking for larger requirements of flex space—with 20+ desk requirements increasing by more than 35 percent last year alone—but they are also taking the space for longer. Nearly 50 percent of all flex space deals in the U.S. are for 18 months or more now.

Flexible workspace has become the most exciting story in the commercial real estate market. This has in turn begun to attract a variety of investors—but mostly alternative investors or private equity, rather than the vast pools of capital that the institutional investment market represents. The limiting factor for this latter party has been the inability to value this new model, to understand value of amenities, curation of space and the collaborative qualities of coworking.

The market needs to work harder to value the other income streams—to assess a model that is more akin to the hotels market. This might include revenue associated with reception facilities, the provision of IT infrastructure and support, executive assistance, and event management.

Critics from within the conventional property market point to the variability of these income streams and also view client contracts as being fundamentally risky and short-term. But the average client agreements we now see

Photo: WeWork

are well over 2.5 years. The sheer diversity of clients might well be argued to present less risk than relying upon one or two key tenants under a conventional lease.

The property market will need to adapt and evolve to this challenge of meeting consumer demand in a way it has never had to do so before. Investors need to keep up with this game-changing market shift.■

John Williams is CMO at The Instant Group.

Learn more at **www.theinstantgroup.com**.

Secondary & Tertiary Markets: The New Mexico Case Study

By **Drew Dolan**

Secondary and tertiary markets will offer many attractive investment opportunities in 2019. As diminishing returns shift investments away from primary markets, cities like Colorado Springs, Phoenix, Albuquerque, N.M., Santa Fe, N.M., and San Antonio stand to benefit. Titan has had great success investing in smaller markets by looking at non-traditional indicators in conjunction with traditional underwriting. This New Mexican case study will highlight some of these non-traditional indicators to consider when analyzing investments in smaller markets.

Explore the local cultural scene

Markets that are ahead of the curve for cultural pursuits generate positive economic activity and signify future growth. The arts and food are two such industries to explore.

New Mexico has a burgeoning microbrew culture with 67 craft breweries, accounting for $333 million of economic impact. These breweries are also home to progressive eateries. Eating and drinking locally supports the economy: 68 percent of consumer dollars spent stay to benefit the local economy—quite different than the 43 percent buying a Budlight at an Applebee's.

Meow Wolf is another example signifying economic development and potentially explosive future growth. The art collective is as the fastest growing creative company in New Mexico, and attracts regular national attention. Last year, the company won Santa Fe City and County financial incentive dollars with the pledge to create yet another 250 jobs.

Look for job growth in non-traditional industries

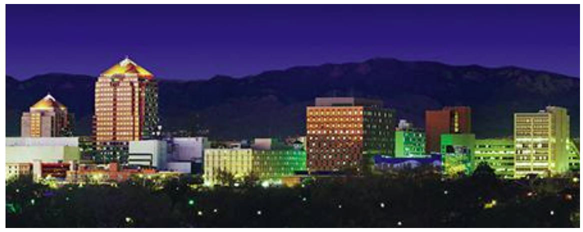
Job growth in "standard" industries only tell half the story. Look for new, cutting-edge high growth industries that will provide job growth in the future.

Leisure and hospitality job growth in New Mexico has improved by 19 percent. Last year nearly one million people visited Albuquerque for the Balloon Fiesta. *Travel + Leisure Magazine* recently listed Albuquerque on its top 50 best places to travel in 2018.

Tech companies have noticed as well. Netflix has recently announced its purchase of Albuquerque Studios, a commitment to $1 billion in production, and the addition of 1,000 jobs to start. Facebook recently opened a data center expansion in Los Lunas, just 20 miles south of Albuquerque.

Direct Flights and Travel

A growing number of domestic and international travelers



bring economic growth.

New Mexico's Albuquerque Sunport is offering some of the nation's best incentives to carriers offering direct flights. Recently, direct flights from Dallas and Austin to Taos bring more people than ever to enjoy the state's natural beauty.

Real vision from political leadership

Underwrite the political landscape. Politicians and leaders should be paying attention to growth opportunities and encouraging that growth in the right ways.

Albuquerque's mayor, Tim Keller has impressive private sector credentials and has surrounded himself with a team that wants to drive responsible economic growth. New policies include an aggressive "buy local" initiative, expanding the police force by 40 percent and developing Albuquerque's urban core using the tenets of placemaking.

Applying lessons learned

Applying academic discipline to market analysis requires a wide lens. While there is no doubt that traditional data points drive decisions, they cannot predict every growth undercurrent. Secondary and tertiary markets around the nation are experiencing similar indicators, but each market's specifics are unique. Ultimately it is the business of a real estate investor to seek the frontiers of growth that unlock the greatest potential for upside, but also to be part of positive change that enhances communities all around us. Looking into 2019, the principles used in the case study above will influence investor decisions and drive investment to secondary and tertiary markets. ■

Drew Dolan is fund co-manager at Titan Fund Management.

2019: Anticipating an Inverted Yield Curve

By **Will McIntosh**

Some market participants have described the U.S. economy, and the commercial real estate (CRE) sector for that matter, as being in the "Goldilocks" zone (not too hot and not too cold). However, a bear market could be on the horizon, and the most likely signal of an imminent recession may very well be the same one that has preceded the last seven recessions—an inverted yield curve sparked by a monetary policy misstep.

Remind me again, what is a yield curve inversion?

An inversion happens when short-term bond yields exceed those on the long end of the curve. For instance, a yield curve inversion has occurred between the three-month Treasury and the 10-year Treasury before every recession dating back to around 1970. Recently, the spread between these two securities dropped to 73 basis points in the third quarter of 2018, the tightest range since just before the global financial crisis (GFC) in 2008. History tells us that when this spread turns negative, meaning the yield for the three-month Treasury bill exceeds the 10-year Treasury bond, a recession tends to occur within five to 17 months.

Could the outcome be different this time around?

The short answer is, maybe! One reasonable argument in support of "this time is different" is rooted in the idea that quantitative easing—the extraordinary monetary policy adopted by the Federal Reserve during the GFC in which it purchased more than $2 trillion in market securities to lower interest rates and increase the money supply—was an unprecedented event.

Therefore, the unwinding of such an extreme monetary policy could result in unusual economic conditions that in turn negate the historically reliable predictive power of an inverted yield curve. Whatever the effects of the reversal of quantitative easing may turn out to be, the very notion that short-term bonds should receive a higher yield than longer-term bonds with comparable credit quality (effectively ignoring inflation, opportunity cost, and potential market risk) would seem to suggest the market is not only functioning poorly, but quite possibly in need of a correction. So, while things might be different this time, it is difficult to turn a blind eye to a signal which has proven 100 percent accurate over the last half-century.

How soon and how severe?

While no one can presume to pinpoint both the timing and severity of a recession, particularly as it relates to CRE markets, there does appear to be a consensus regarding the seriousness of the next downturn. We do not expect a repetition of the GFC experience, where CRE prices fell almost 40 percent; however, a 10 percent to 15 percent correction in core prices seems plausible. Concerning timing, a growing number of market watchers have begun to focus on 2020 being the target date. Assuming the Federal Reserve sticks to its current interest rate trajectory, a yield curve inversion appears likely in 2019. If history proves an accurate guide, a

recession will follow within the next 17 months (probably in 2020), which is a position we have voiced for a few years now.

How should investors prepare for the potential shift in market conditions?

At USAA Real Estate, we have taken a defensive, but active, approach to the market for several years now, anticipating this scenario and preparing our portfolio accordingly. While market conditions are unwieldy, investors may want to consider the increasingly strong probability of a downturn over the next few years. ■

Will McIntosh is the global head of research at USAA Real Estate.

Learn more at **www.usrealco.com/research**.

Win McNamee/Getty ImagesGetty Images

The Stability of Multi-Level Diversification

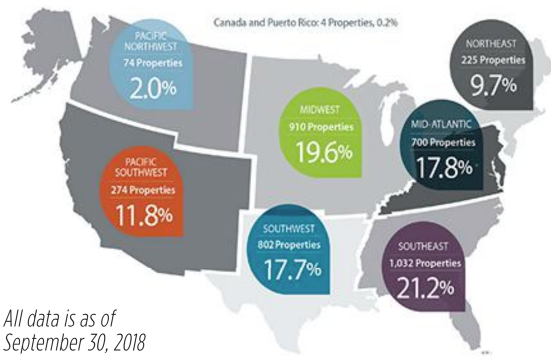
By **Glenn Rufrano**

In today's complex economic environment, stability can be an important factor in a strong investment. With so many variables at play, consistent growth is more appealing than ever. Developing economic factors such as the state of employment, interest rates and government policies present risk that requires proactive portfolio management at every stage of the real estate process.

With a portfolio of more than 4,000 properties, VEREIT, a full service real estate operating company, has the unique opportunity to guard against shifting variables through diverse investments across the country. Multi-level diversification in a real estate portfolio includes factors such as geography, asset class, industry and tenant credit. **Curating a portfolio with diversification on each level guards against cyclical changes, such as consumer spending, and secular changes, such as the emergence of e-commerce.** Examples of some of these changes are discussed below. VEREIT has committed to building a strong portfolio with multi-level diversification by keeping each tenant below 5 percent, no industry or geography more than 10 percent, investment grade tenants between 30 percent and 40 percent and proper levels of retail, restaurant, office and industrial property types.

The emergence of e-commerce is a secular change with wide-reaching implications across commercial real estate. Evolving consumer habits, like the expectation of next-day delivery when ordering online, have significant effects on the commercial real estate market. Distribution facilities, traditionally located in outlying markets with a low price per sq. ft., are moving inward towards dense metropolitan areas to be closer to consumers. This means secondary and tertiary markets are growing quickly as empty space with low gross leasable area is filled with small-concept distribution facilities. Space which was previously occupied by convenience stores or restaurants is now being leased by online-native retailers or omnichannel savvy stores to prioritize last-mile delivery. The Commercial Real Estate Development Association predicts quarterly net absorption for U.S. industrial properties will be 56 million sq. ft. in 2019.[1] Consumer habits have transformed the real estate landscape and a portfolio with multi-level diversification has the flexibility to accommodate these changes.

Although diversification is an important element in handling cyclical and secular changes, within real estate, it is also important to have exceptional management capabilities. As metropolitan markets grow, a local presence is necessary to understand the intricacies of a real estate



All data is as of September 30, 2018

investment. Brokers, underwriters, acquisition experts, construction managers and leasing professionals must be involved in each step of the real estate process. Although there is much to learn from predictive reports on cap rates, annualized rental income and market demographics, a ground-level assessment and site visit are invaluable. To effectively manage the multi-level diversification of a portfolio, it's necessary to synchronize the minute details of a local market with the overarching trends of an industry. This is possible with our seasoned team of diverse real estate experts who have experienced numerous secular and cyclical market evolutions.

Developing a commercial real estate portfolio which is diverse across tenant mix, geography, asset class and industry type mitigates risk across many disparate factors. The current economic environment comes with numerous developing variables including regulatory fluctuations, industry growth, evolving buying habits and changing consumer sentiment. With a robust team of industry experts to specialize in each unique variable, it's possible to create a stable and consistent portfolio of commercial real estate properties. ■

1. The NAIOP Industrial Space Demand Forecast Third Quarter 2018 Report

Glenn Rufrano has served as VEREIT's CEO since April 2015. VEREIT is a full-service real estate operating company which owns and manages one of the largest portfolios of single-tenant commercial properties in the U.S.

Learn more at **www.VEREIT.com/capabilities**.

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Opportunity Zone Investment Structure Alternatives

By **Peter DiCorpo**

Opportunity Zone investment is expected to be among the hottest commercial real estate strategies in 2019. However, most investors are unsure which structure best suits their investment objectives.

Real estate investment managers are focused on offering optionality to those investors desiring access to Opportunity Zone investments. Many are forming Qualified Opportunity Funds (QOFs), which are commingled funds set up to invest in numerous Opportunity Zone properties. Other managers are focusing on single asset offerings of Opportunity Zone investments.

Both structures provide identical tax treatment. However, while QOFs offer diversification, they may also present capital deployment challenges and uncertainty around geographic concentration. A single asset offering, with its associated transparency of capital deployment timing and greater clarity about investment exit timing, may be more appealing to some investors.

A brief recap

Created by the Tax Cuts and Jobs Act of 2017, Opportunity Zone legislation was enacted to spur economic development and job creation in distressed areas across the United States. Subject to certain timing and other restrictions, the Act allows investors to defer capital gains that would otherwise be payable in connection with the sale of an appreciated asset by investing those gains in an Opportunity Zone.

In addition, some or all of the future gain that would be recognized on the sale of an Opportunity Zone investment may be permanently excluded from taxation, depending on the hold period of the underlying investment.

Qualified opportunity funds: potential pitfalls

Participating in a QOF may seem simpler than one-off transactions. An investor places the gain from an appreciated asset sale into a fund and the fund manager then identifies multiple projects in Opportunity Zones and proceeds. However, this simplicity can be deceptive. Funds may have difficulty deploying capital efficiently, which can reduce or eliminate the intended tax advantages.

By design, Opportunity Zones are located in secondary and tertiary markets that are new to many commercial real estate investment companies. Managers may find limited deal flow in these markets, especially if the market is unfamiliar.

Transactions are also smaller—in the $30 million to $50 million range—so it is difficult to concentrate investment capital into a few large deals.

Further, the legislation requires that extensive investment be made in a property post-acquisition, which means that most Opportunity Zone projects will focus on ground-up development or properties that require substantial repositioning.

An investor's ability to receive tax benefits depends on compliance with strict timing requirements. Every investor has a distinct 180-day deadline by which the gains from an appreciated asset sale must be invested in an Opportunity Zone fund. Additionally, the fund has its own 180-day timeframe within which it must deploy capital.

One-off investments: control and certainty

One-off transactions are another avenue for participating in Opportunity Zones. They give investors more flexibility and certainty.

A real estate investment manager identifies opportunities in designated zones and then secures capital to finance each project. Investors can select from a number of qualified deals and closing dates with confidence that the funds will be deployed before the fund's 180-day deadline. Investors can also choose to invest with real estate investment managers possessing experience developing or repositioning properties in the manner anticipated for Opportunity Zone investments.

This includes firms with expertise in ground-up development in the $30 million to $50 million range, as well as those with experience in smaller markets across the United States. Investors might also look for companies that typically hold these assets long-term and have expertise managing them.

Savvy investors should carefully weigh one-off transactions and QOFs before choosing the Opportunity Zone investment structure that is best aligned with their objectives. ■

Peter DiCorpo is the COO of Waypoint Residential, LLC, a vertically integrated real estate investment firm specializing in acquisition and development of conventional multifamily, student and senior housing properties throughout the United States.

Why Sale-Leasebacks? Why Now?

Long-term Capital on Favorable Terms

By **Gino Sabatini**

Corporate America owns trillions of dollars of investable commercial real estate despite the fact that historically these assets have delivered lower returns compared to other types of equity investments. For every dollar a company monetizes through the sale of its corporate real estate and reinvests into its core business, positive leverage can be created. That's why CFOs and private equity fund general partners (on behalf of their portfolio companies) should consider the sale-leaseback of their critical operating real estate assets.

Cap rates are at historic lows, making now a particularly good time to secure favorably priced, long term capital via a sale-leaseback. When compared to the overall cost of corporate debt, which requires the repayment or refinancing of the principal at the end of the loan term, the cost of sale-leaseback capital is substantially less. A sale-leaseback with a term of 15 to 25 years and renewal options can provide a hedge against shorter-term market uncertainties including, rising interest rates, trade war tensions, stock market volatility and other economic/political risks.

Interest rates have remained relatively low, but a trend of rising rates appears to be taking hold. It is no longer a matter of if rates will rise, but when, how quickly and by how much. As rates rise and quantitative easing ensues, we expect upward pressure on cap rates and borrowing costs to continue.

Tax code changes have also shifted efficiencies from owning to leasing for many businesses as a result of restrictions on interest deductibility that do not apply to rental expenses. The value of the full deductibility of related rent payments may in many cases be a critical factor in structuring a successful bid for a new investment or in refinancing an existing portfolio company.

Record-level dry powder among general partners is driving competition and incentive to invest funds. Buyout multiples are at industry highs with middle market buyout multiples having nearly doubled since 2009 (*Pitchbook*). One consequence of these higher multiples is that secondary buyouts, where portfolio companies sold by private equity firms are purchased by other private equity firms, accounted for more than half of exit activity, marking the first time secondary buyouts have outpaced investments made by strategic corporate investors.

Whether it be corporate CFOs or private equity fund general partners looking to lock in longer-term, more efficient capital, the confluence of these benefits, along with current market conditions and the uncertainties surrounding rates, makes now an opportune time to secure sale-leaseback capital. A well-structured transaction with an experienced capital partner enables corporations and PE fund portfolio companies to optimize tax positions and access an efficient, alternative and flexible source of capital to address tomorrow's business needs while unlocking the value of critical operating assets. ■

Photo: Getty Images

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W. P. CAREY

2019: Year of the Opportunity Zone?

By **Paul Fiorilla**

The hottest investment of 2019 could be opportunity zones, a program created by tax reform in 2017 that could pave the way for a flurry of investment activity in struggling communities nationwide.

Created by the Tax Cut and Jobs Act of 2017, the incentive allows investors to defer or avoid taxes on capital gains if the money is reinvested in designated Opportunity Zones. The goal is to generate economic activity in low-income areas. To qualify as an Opportunity Zone, areas had to have above-average unemployment rates and income significantly below the regional median. More than 8,700 areas in the U.S., encompassing about 35 million residents, have been certified by the Treasury Department as opportunity zones.

It's taken a while to gain momentum, but by late 2018 dozens of managers were raising upwards of $25 billion to invest in opportunity zones and by the end of 2019 more than $100 billion could be parked in funds. The nature of the program makes it unlikely to move the needle for institutional investors or core commercial real estate, but opportunity zones have the potential draw capital from non-traditional sources—such as high-net-worth individuals, family offices and endowments—and to spur revitalization in blighted urban areas and tertiary markets.

The heart of the program is to incentivize investors to reinvest capital gains. That are invested in a Qualified Opportunity Fund Zone. Shareholders who keep their investments for five years will pay no taxes on 10 percent of the investment's gains. After seven years, 15 percent of the gains will not be taxed. Shareholders who hold opportunity zone investments for 10 years can avoid paying taxes on all gains.

Revitalizing hard-luck areas

Opportunity zone funds are intended to help inject life into markets that may have once thrived. The idea is to incentivize investors to rehabilitate buildings in areas that have fallen on hard times. The designated zones were submitted by state governments and include a mix of urban, suburban and rural areas. That means capital will be concentrated in small and middle-market projects and transitional properties that need substantial upgrading.

Successfully rehabilitating a low-income submarket, though, requires more than just a facelift, although that's a good and necessary part of the plan. To operate and increase in value, commercial properties need demand from tenants. One concern is whether revitalization will change the character of neighborhoods and make it too

expensive for existing residents and businesses to stay.

What's more, the success of projects in low-income areas might be dependent on government support beyond the tax breaks for opportunity funds. For example, tenants in apartments in low-income communities don't have the means to pay higher rents that might be needed for a project to produce the kind of yield sought by developers.

Investors should be prepared to access the "alphabet soup" of government programs available for projects in low-income communities, said Sherry Wang, a managing director in the Urban Investment Group of Goldman Sachs. "Most projects (in low-income areas) don't pencil without government support," she said.

Shekar Narasimhan, managing partner of Beekman Advisors, which is raising an opportunity zone fund with Enterprise Community Partners, said the fund is scouting out dozens of small communities in the Southeast that have the potential for growth. That involves not only real estate that can be rehabilitated but also partnerships from governments and the business community. Key to the redevelopments will be commitments from the government and local businesses to spend money on things such as education, transportation and infrastructure to stimulate economic activity, Narasimhan said. ■

Paul Fiorilla is director of research at Yardi Matrix.

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