



Real estate expansion lives on

**2017 Real Estate Industry
Outlook Survey**

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Introduction

Continued growth despite uncertainties in 2017

Since the instant the Big Bang created the universe, scientists assert that it has been expanding for 13.7 billion years. The same cannot be said of the real estate markets. For more than 200 years, the average full U.S. real estate cycle runs its course, from peak to trough and back again to peak, every 18 years.¹

That is what is so remarkable about the historically long upturn in real estate we are currently experiencing. It began with the recovery and stabilization following the housing market collapse in 2007. Now, a decade later—when we might expect the industry to plateau or even decline—it shows few signs of slowing down.

Can the real estate expansion really continue? Industry leaders seem to think so.

For KPMG LLP's (KPMG) annual Real Estate Industry Outlook Survey, we asked senior U.S. commercial real estate executives about their view of the industry and their strategic plans for the next year. Our research captured the feeling of resilience in the market—that despite so much speculation that the current expansion simply cannot continue much longer, there will still be growth in 2017 and perhaps beyond.

Real estate leaders say 2017 may be the year of moving down the risk curve. They predict promising opportunities ahead—if they can see through the noise in the market and make the strategic choices necessary to seize them. The industry is grappling with how to capitalize on a growing domestic economy and strong real estate fundamentals, yet manage growing uncertainty and complexity in the market, including a surprise Trump presidency, potential tax reform, and rising interest rates.

Read our 2017 outlook report to explore what micro and macro factors are contributing to this sustained optimism in commercial real estate and learn what actions investors, owners, managers, and service providers will take in the coming year to get ahead of anticipated challenges, seize near-term opportunities, and “sustain the boom.”

Most of the signals we are seeing in the market and hearing from our clients indicate that we aren't nearing the end of the current real estate cycle just yet. The economy is healthy, with strong access to financing and capital, and real estate fundamentals are strong.

Greg Williams

National Sector Leader

Building, Construction & Real Estate/Asset Management

¹ How to Use Real Estate Trends to Predict the Next Housing Bubble, Teo Nicolais (Harvard Extension School, March 11, 2014)



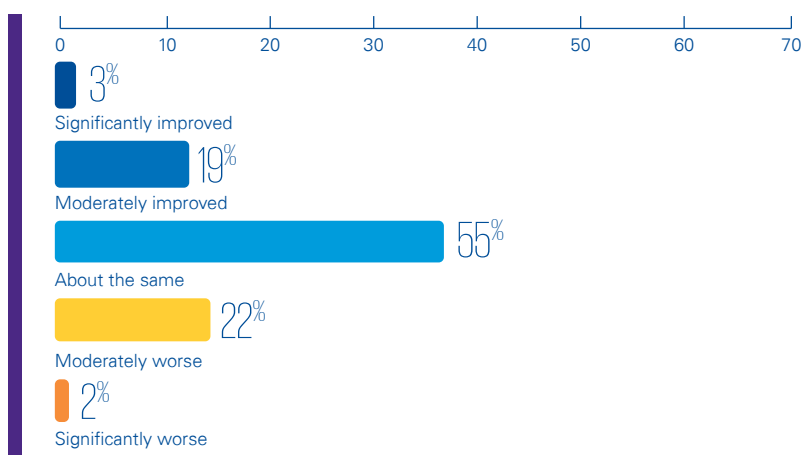
Key findings

Nope, it's not over yet

The current real estate upswing cannot last forever and a downturn is inevitable. But it probably will not occur in the year ahead—real estate industry leaders are bullish about the market's prospects in 2017.

Conditions continue to be favorable in U.S. markets. Seventy-seven percent of executives say the U.S. economy will be the same or better in 2017 versus 2016. Additionally most companies expect to be able to find funding for real estate deals, as debt financing is readily available. According to our survey, 86 percent of respondents say their company's access to debt financing will be the same or better in 2017.

What are your expectations for the U.S. economy for 2017?



In addition, 91 percent of real estate leaders expect their access to equity capital to be the same or better in 2017.

How will your company's access to debt financing change in 2017?



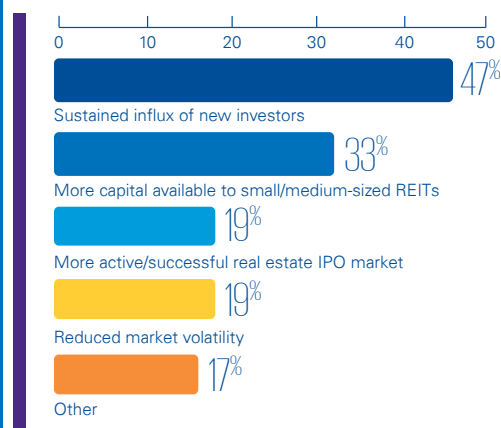
Survey data may not total to 100 percent due to rounding.



Financial market indices reclassify real estate

On September 1, 2016, the Global Industry Classification Standard (GICS®) taxonomy introduced a stand-alone real estate sector, separating these shares from the more volatile financial services sector. This move—a reflection of real estate's importance to the global economy—is expected to attract new investors to the sector and cause many existing investors to increase their allocations. This sustained influx of new investment should provide greater access to capital for small- to medium-sized REITs and could reignite a stagnant IPO market.

On September 1, 2016, the GICS taxonomy introduced a stand-alone real estate sector. What long-term implications will this have for the real estate industry? (select all that apply)





How will a Trump presidency affect commercial real estate?

President Trump has promised to lower taxes, deregulate business, and increase infrastructure expenditures. These policies, designed to create jobs, could cause new households to form, increasing homebuilding and home sales. Young adults may move away from home into multifamily properties. And with more discretionary income, consumers may purchase more household goods or travel more.

Trump also campaigned on bringing companies back to America. If these efforts are successful, it could increase demand for office space, manufacturing facilities, data centers, and other property types.

Trump's goal to put U.S. interests first in economic and trade policy could cause some foreign governments to block U.S. investments by their citizens, decreasing overall capital outflows to the United States. However, most large foreign investors are unlikely to curb interest in U.S. property assets, as the market offers safety and security, especially relative to other potential locations.

Finally, if Trump's campaign vision for immigration and trade translates into policy, it could also impact demand for real estate in some markets with a high concentration of foreign and immigrant buyers, such as Miami.

Finally, real estate fundamentals are expected to improve in the coming year. More than three-quarters (76 percent) of executives say real estate fundamentals in their primary markets will be about the same or better in mid-2017. Even more striking is that 52 percent say improving real estate fundamentals will be the biggest driver of their company's revenue growth in the next three years.

Market noise loud, but not deafening

Behind all of the good news, there are some uncertainties in the real estate market. They have not dampened real estate leaders' bullishness, but they do present some risks that must be understood and managed.

One significant question mark for the industry is a new administration in the White House. How President Donald Trump's policies—from tax reform to immigration—will impact the sector, for good or bad, remains to be seen (*see sidebar*).

And there are other risks and challenges on the horizon.

Interest rates are rising. On December 14, 2016, the Federal Reserve raised its key short-term rate to a range of 0.5%–0.75% from 0.25%–0.5% and announced three planned hikes in 2017, a more aggressive approach than expected.² Higher rates may impede first-time home buying. However, they reflect a healthy economy and may be a sign of sustained job growth to come, which could lead to more household formation and increased activity in the multifamily, retail, and industrial sectors.

The impact of regulatory change also continues to play out across the sector. Our survey reveals that the Affordable Care Act and changes to federal tax laws have been the most

Chances are increasing we will see a comprehensive tax reform bill enacted in the next two years—legislation which would almost certainly impact the real estate industry. While clarity on the details is lacking, real estate holders should be assessing how possible corporate tax rate reductions and changes in the tax treatment of new property development may impact investment choices and structures down the road.

G. Chris Turner

National Tax Leader

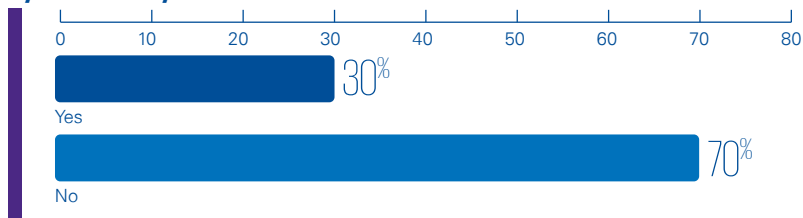
Building, Construction & Real Estate

² Fed raises interest rates and adds another hike to its 2017 forecast (MarketWatch, Dec. 14, 2016)

impactful regulatory changes on real estate businesses. Given the fundamentally important nature of these regulations, any changes to them in the future may have a significant impact on real estate companies' operations and bottom line.

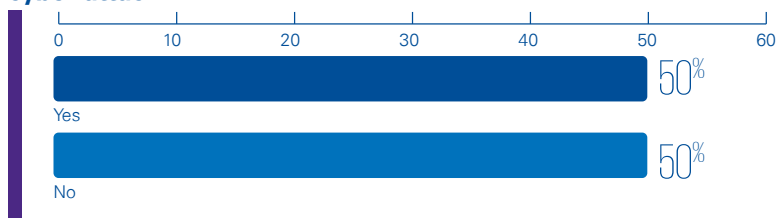
Finally, real estate firms can no longer solely focus on the physical threats to their assets or their tenants/occupants. Data breaches are now a clear and present danger, potentially leading to serious financial loss and reputational damage. Thirty percent of executives say their firm, or one or more of their properties, have experienced a cybersecurity event in the last two years.

Has your firm (or one or more of your properties) experienced a cybersecurity event within the last 24 months?



The real estate industry has some catching up to do on cybersecurity. Half of respondents (50 percent) say their organizations are not adequately prepared to prevent or mitigate a cyber attack (see sidebar).

Do you feel you are adequately prepared to prevent or mitigate a cyber attack?



Given how widespread the threat has become and how potentially damaging failure could be for their business or brand, real estate companies must be more proactive in cybersecurity preparedness.



Asset protection in a digital world

All industries, including real estate, are under pressure to step up cybersecurity due to both the business and regulatory risk it presents. Real estate investment advisors are especially in the spotlight, as the U.S. Securities and Exchange Commission (SEC) included investment advisors and companies in its list of 2017 examination priorities.³

What are some of the key cyber threats facing the real estate industry?

- Residential and office building tenants could be vulnerable to intrusions through connected technologies, such as smart alarms, environmental controls, locks and lights, or even voice-assisted devices.
- Property managers have significant amounts of personally identifiable information (PII) about customers and tenants contained in leases, rental applications, credit reports, etc. This data is valuable to hackers seeking to steal identities or sell data on the black market. Hotels and retailers also have immense exposure to highly targeted consumer data, such as credit card numbers.
- Internal systems could be targeted for their data or even their cash. For example, REITs must protect confidential information on the financing of deals, leasing agreements, and private account information.

³ Press Release: SEC Announces 2017 Examination Priorities (U.S. Securities and Exchange Commission, Jan. 12, 2017)



Disruption is coming: Are you ready?

Only five percent of executives say technology disruptors are the biggest threat to their business. But technological disruption is changing the ways consumers use and interact with all types of commercial real estate, including office space, hospitality, retail, and others, thereby impacting real estate company and investor strategies.

Disruptive innovations will also almost certainly affect real estate owners to a significant degree:

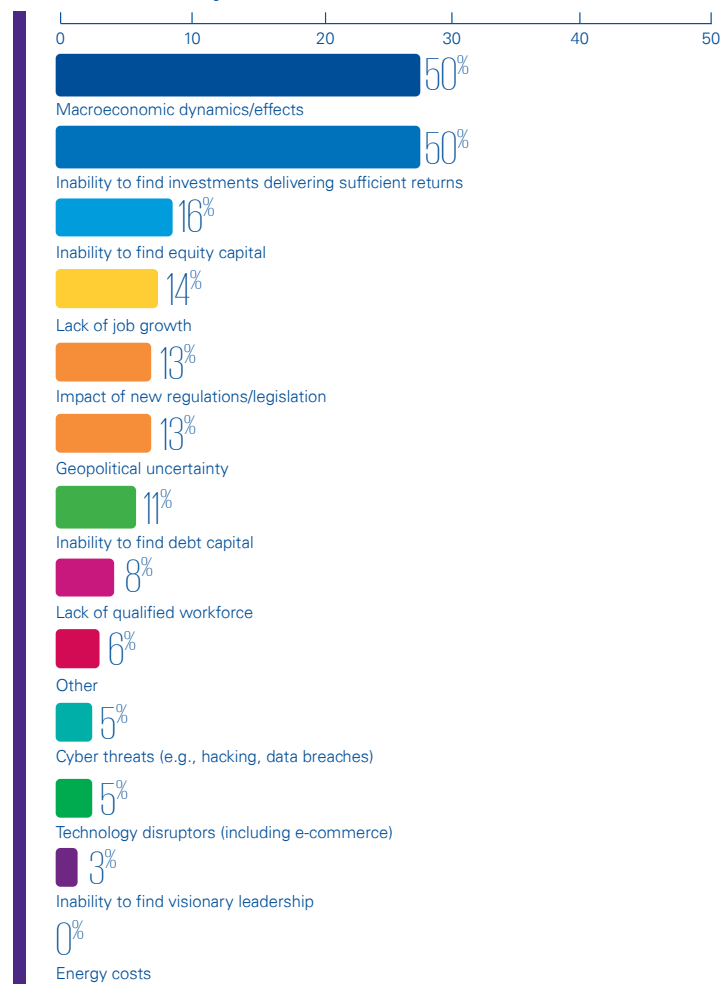
- Autonomous vehicles may reduce standard ratios for parking space, allowing developers to use this highly valued space for other purposes.
- Artificial intelligence could replace human jobs, meaning workforces would need less physical property to operate their businesses. This might also impact some rules-based processes, such as investor reporting.
- New models for retail engagement will continue to evolve, leading to customer-centric and channel-agnostic approaches to satisfy consumers' shopping needs.
- Online companies in "the sharing economy," such as Airbnb, Craigslist, and HomeAway, could shift business away from hotels or even apartments.

No room for complacency

How are commercial real estate executives responding to the challenges of today's complex real estate landscape? Not by being complacent. Ever-confident in their outlook, there will likely be substantive activity in the sector in 2017 as executives continue to focus on growth, efficiency, and customer satisfaction. Organizations are prepared to seek out the best deals in what is becoming a tougher market as far as supply. They also plan to embrace significant change and transformation to seize emerging opportunities, while at the same time focusing on improving bottom-line efficiency and optimizing or balancing high-risk investments.

Our research shows that good deals are hard to find despite today's continued favorable economic conditions. Fifty-six percent of real estate leaders are able to find high-quality properties, but not at the yields they want. Eighty-one percent rate the marketplace for investment opportunities as the same or worse than 12 months ago. In addition, the biggest threat to real estate businesses (tied with macroeconomic dynamics/effects) is the inability to find investments delivering sufficient returns, according to 50 percent of respondents.

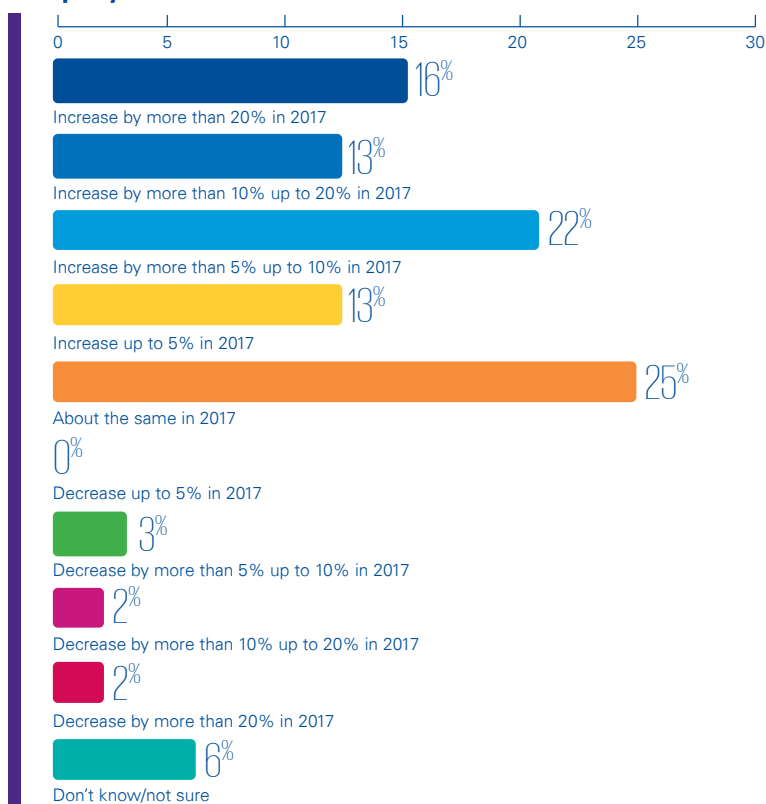
What issues in 2017 pose the biggest threats to your business model? (select up to two)



Fewer opportunities coupled with high demand is spurring competition and deal-chasing, thereby driving up prices. But our data doesn't support the notion that investors are necessarily abandoning primary markets in search of better deal economics.

Expecting pressure on returns, some organizations are starting to consider strategies on the lower end of the risk spectrum and consequently underwriting lower yields. At the same time, though, according to our survey, investment activity is not slowing; in fact, 89 percent of executives forecast the same or more real estate investment by their company in 2017.

What is your forecast for real estate investment by your company in 2017?



Despite heavy competition for the highest-quality properties, Class A assets in U.S. primary markets remain hot areas of investment. Prices may be higher than expected, and yields lower, but the promise of reliable returns are attractive enough to warrant sustained attention in the industry.



Roger Power
Pacific Northwest Leader
*Building, Construction &
 Real Estate*

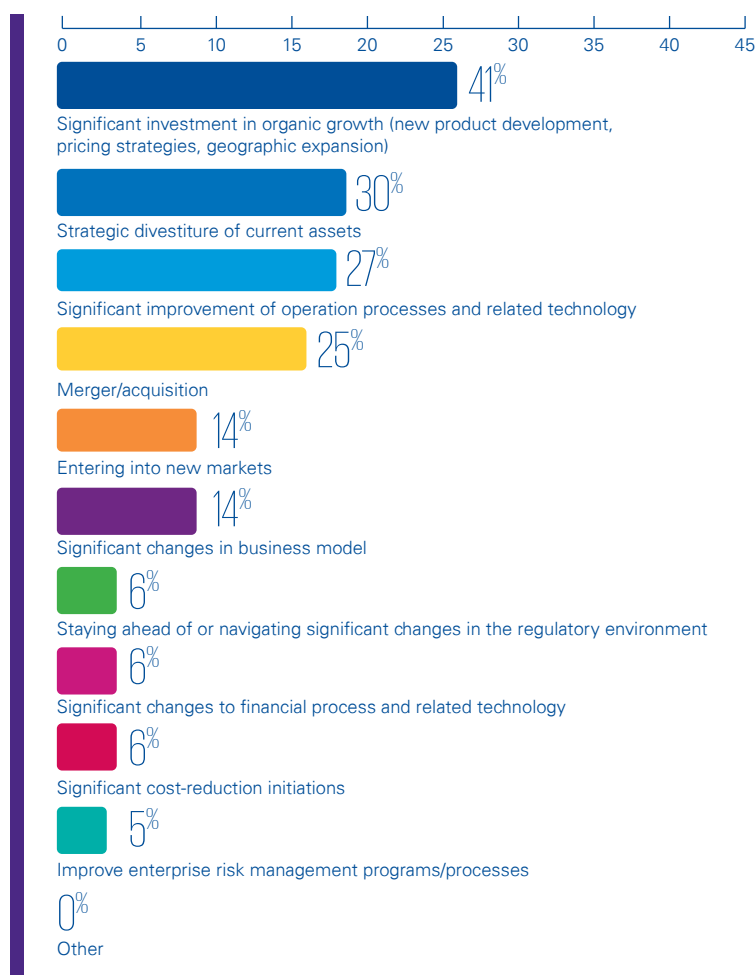
Many real estate investors today are seeking lower-risk strategies, with greater levels of portfolio diversification. And we expect to see an influx of new investment in real estate, both from existing investors as well as new entrants.

Phil Marra
National Real Estate
Funds Leader

However, our respondents expect the best opportunities to be concentrated in the hottest locales and property types: the Southeast region of the United States, industrial properties, and niche businesses, such as single-family homes and data centers. In addition, our respondents personally plan to target prime asset classes, with the highest percentage (27%) saying their companies will invest in Class A assets in primary U.S. markets.

When it comes to strategic initiatives, 41 percent of companies plan significant investment in organic growth, including new product development, pricing strategies, and geographic expansion.

In 2017, what initiative(s) will consume most of senior management's time and energy? (select up to two)



We anticipate especially heavy growth in the open-ended fund and debt fund space. These newer vehicles are desirable because they enable real estate investors to diversify their investments and, in some cases, maintain a higher level of liquidity, while potentially concentrating their investments in fund managers with broader portfolios.

Finally, companies are pursuing various cost-related strategies to improve bottom-line results, especially implementing technologies to address inefficiencies (58 percent) and process improvements (also 58 percent). Some of the key technologies in the industry are systems to help manage and automate back-office processes, human capital management, and property management activities, especially as companies get pressed to deliver more information, faster, and more efficiently.



Capitalizing on exploding household formation

Demographics play a huge role in how people use land and property. Insights into the key demographic trends taking place in society today are unbelievably valuable, helping real estate decision makers understand where to invest and how to develop.

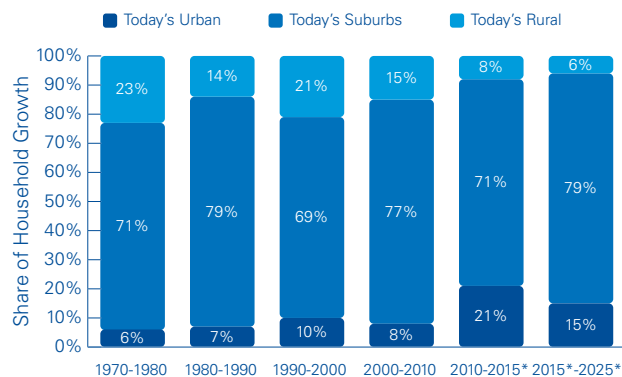
Based on data on population statistics, KPMG economic analysis forecasts the working age population will add 4.3 million people over the next 10 years. Young adults—such as millennials born in the 1990s—represent one of the biggest demographic opportunities for real estate companies. The largest age group in the country, this segment is expected to lead a surge in net household formation and therefore a boom in single-family and multifamily real estate.

According to research conducted for the Urban Land Institute (ULI) and the ULI Terwilliger Center for Housing,⁴ the South stands to benefit most. Young families in their 30s are expected to flock to affordable markets in progrowth states—especially suburban markets where housing is typically more affordable and school quality is higher. Driven by this migration, the South region will take 62 percent of the U.S. household growth over the next decade. The majority—79 percent—of household growth will occur in the suburbs.

Rental housing, particularly detached, single-family rental homes in these areas, may be a prime investment, as millennials are more likely than others to defer homeownership due to high levels of student debt and tough economic conditions.

Both urban and suburban locales will capture a higher share of growth.

Share of Household Growth by Decade



⁴ Demographic Strategies for Real Estate (John Burns Real Estate Consulting, 2016)





Final thoughts: Sustain the boom

All signs point to the U.S. real estate market sustaining its momentum throughout 2017. How can U.S. real estate executives manage economic, political, and business uncertainties to seize the opportunities ahead? KPMG subject matter professionals offer their top tips for capitalizing on strong market conditions in what is shaping up to be a good year.

- 1. Leverage technology for competitive advantage.** In every industry, technology is a critical enabler not only of process efficiency, but also of customer satisfaction, sales, and growth—and real estate is no exception. Use cloud, mobile, and social to connect more closely, quickly, and transparently with tenants and buyers and vastly improve leasing and sales activities. Invest in smart buildings and high-tech, nontraditional office environments to capitalize on market trends. Use data analytics to uncover insights about success factors, opportunities, and risks and use those insights to enhance core processes, such as property valuations and assessments and site selection.
- 2. Prepare for what comes next.** What will the recent and upcoming interest rate hikes do to real estate investing, long-term fundamentals, and customer use? What are the factors that could impact the overall return of a property or portfolio, and how well are you prepared to exploit those opportunities? What types of resources are you dedicating to your internal R&D efforts to identify worthwhile ideas to pilot? Mining internal data—and going beyond it with data points from nontraditional sources—can help owners, operators, and investors identify trends and patterns in demographic, economic, geographic, and investment signals that impact business decisions. Always think 1, 5, and 10 years ahead so you can act—not react—ahead of change.
- 3. Maintain a robust compliance program.** With the Trump administration in office, long-term predictions on regulation are hard to make. However, the fiduciary and regulatory requirements for an SEC-registered investment adviser do not appear to be changing anytime soon. It is important to continually review your compliance program to ensure that items such as conflicts of interest, valuation, expense allocation, code of ethics, and the allocation of investment opportunities by and among investment and coinvestment vehicles are properly monitored, documented, and addressed.

Real estate investments and transactions will continue to be closely regulated. Developers, owners, and fund managers should regularly seek new strategies to strengthen in-house compliance and governance programs to manage risk.

Larry Godin
National Leader
Asset Management Regulatory
Practice

Tax reform is certainly not guaranteed in 2017, but there is a strong chance it moves forward with the Republican party in control of both the executive and legislative branches.

John Gimigliano
Principal in Charge

Federal Legislative and Regulatory
Services, Washington National Tax

Alternative lenders offer financing options to offset challenging bank-lending market conditions for U.S. real estate.

Nathan Abegg
Partner
Risk Consulting

- 4. Be proactive on tax reform.** Comprehensive tax reform is possible in the next few years given Republican control of both Congress and the White House. What the final proposal will look like—or whether Congress enacts a tax bill at all—remains to be seen, but there appears to be general alignment on the House GOP “Blueprint” as a starting point for reforming the tax code. The Blueprint includes several significant departures from current law, including general nondeductibility of interest, full expensing of buildings, and a tax on imported materials. Real estate leaders must evaluate how those changes, along with lower tax rates, affect their business model. These conclusions should be shared at the appropriate time with legislators to ensure the industry’s needs are well represented.
- 5. Ramp up your cybersecurity capabilities.** Data breaches are happening every day across industries, and the consequences can be catastrophic. Are you proactively investing to protect your company? If you do not have a plan to secure your real estate assets, it is time to get one. If you do have a plan, it is time to evaluate it against the ever-changing threat landscape. Don’t forget to assess not only your own security vulnerabilities, but those of your partners and vendors. Any business with connection to your operations—whose systems touch yours—could expose you to cyber risk.
- 6. Tap into private lenders.** Banks have become increasingly risk-averse to lending for real estate transactions in response to market contraction, global regulatory requirements, and market pressures in the post-financial-crisis era. However, nontraditional, nonbank lenders have largely stepped up in their place to provide financing for global real estate development, construction, and acquisitions. Real estate developers should consider private lenders as a potential source of financing, as they may be more willing to meet capital needs, especially funding for riskier projects and to less established borrowers.
- 7. Diversify your talent.** All organizations can benefit from a diversity of experiences, thinking, and perspectives—especially in fast-changing industries like real estate. In fact, research shows hiring, retaining, and promoting talent from underrepresented groups is not only the right thing to do—it is a profitable workforce strategy.⁵ Glass ceilings are being shattered across industries, but there is still much work to be done. In 2017, real estate leaders should consider how to transform company policies to attract and retain more talented women and minorities, mentor and develop them, and promote them into decision-making roles.

⁵ Why It Pays to Invest in Gender Diversity (Morgan Stanley, May 11, 2016)

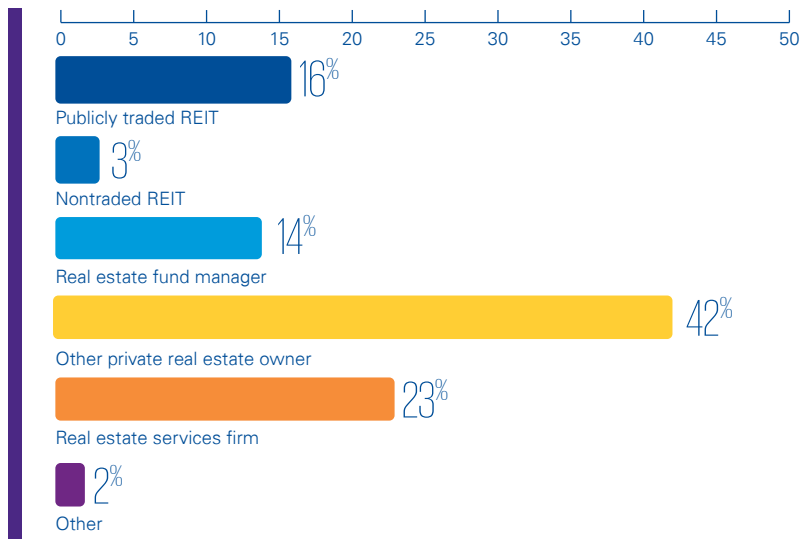




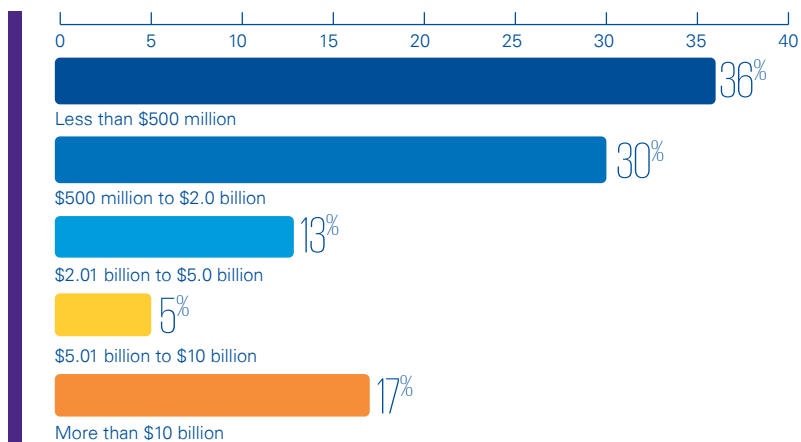
Methodology

KPMG's 2017 Real Estate Industry Outlook Survey reflects the viewpoints of senior industry executives in the United States. The Web survey was conducted in fall 2016.

What type of firm do you work for?



What is the fair market value (in U.S. dollars) of the real estate in your portfolio or under management as of today?



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About KPMG's Real Estate practice

KPMG advises owners, managers, developers, lenders, intermediaries, construction and engineering firms, and investors in effectively executing complex transactions ranging from acquisitions and dispositions to securitization of real estate assets for individual properties and portfolios to entity-level mergers and acquisitions. We believe that our experience and knowledge can help you successfully address today's challenges while preparing for tomorrow's opportunities.

KPMG's Real Estate professionals provide strategic insights and relevant guidance wherever our clients operate. We provide services on a local and national level—with a network of 1,500+ dedicated professionals in the United States—and through the global network of KPMG International member firms, comprising more than 9,000 professionals in 110+ countries.

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