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KPMG Outlook: Riding the 2014 Renaissance in U.S. Commercial Real Estate

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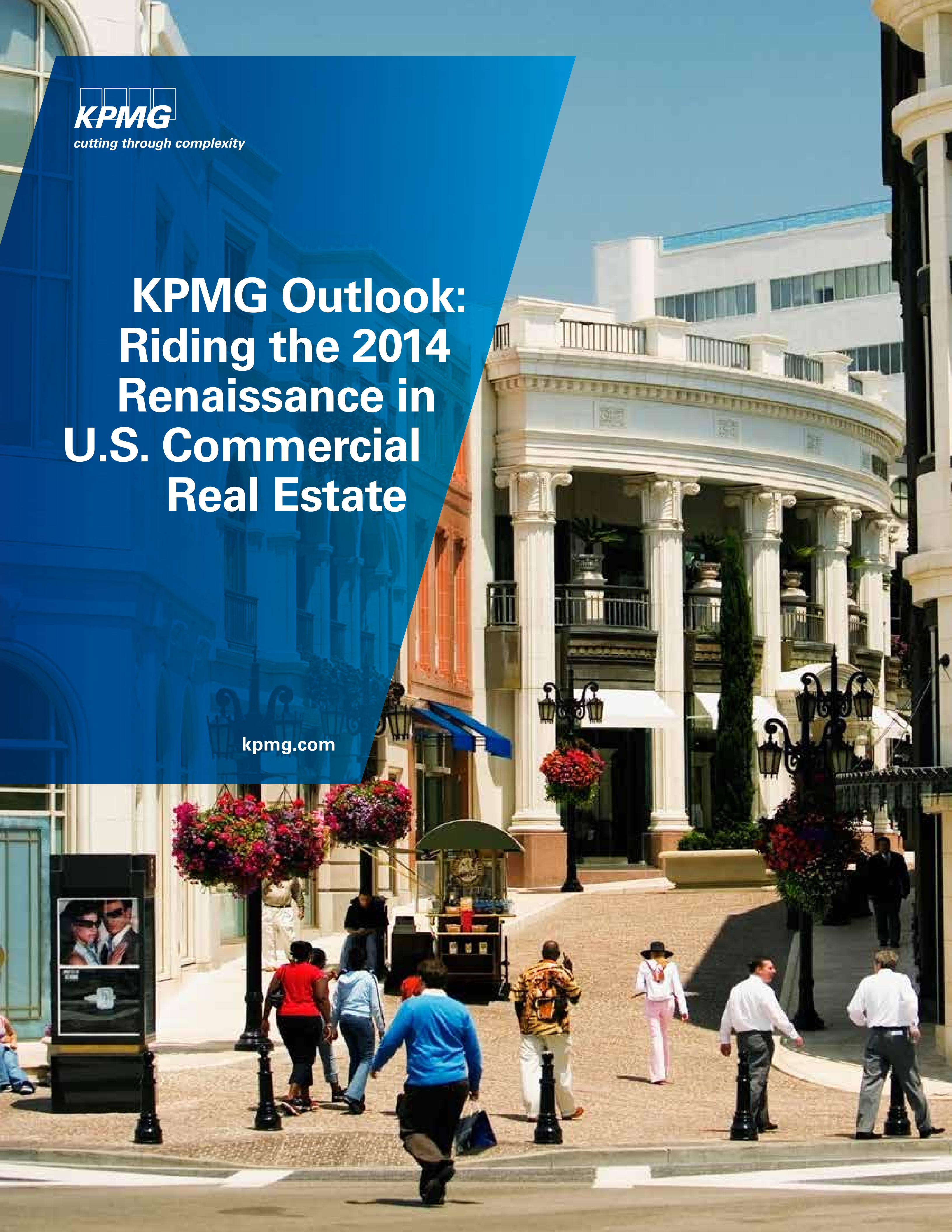


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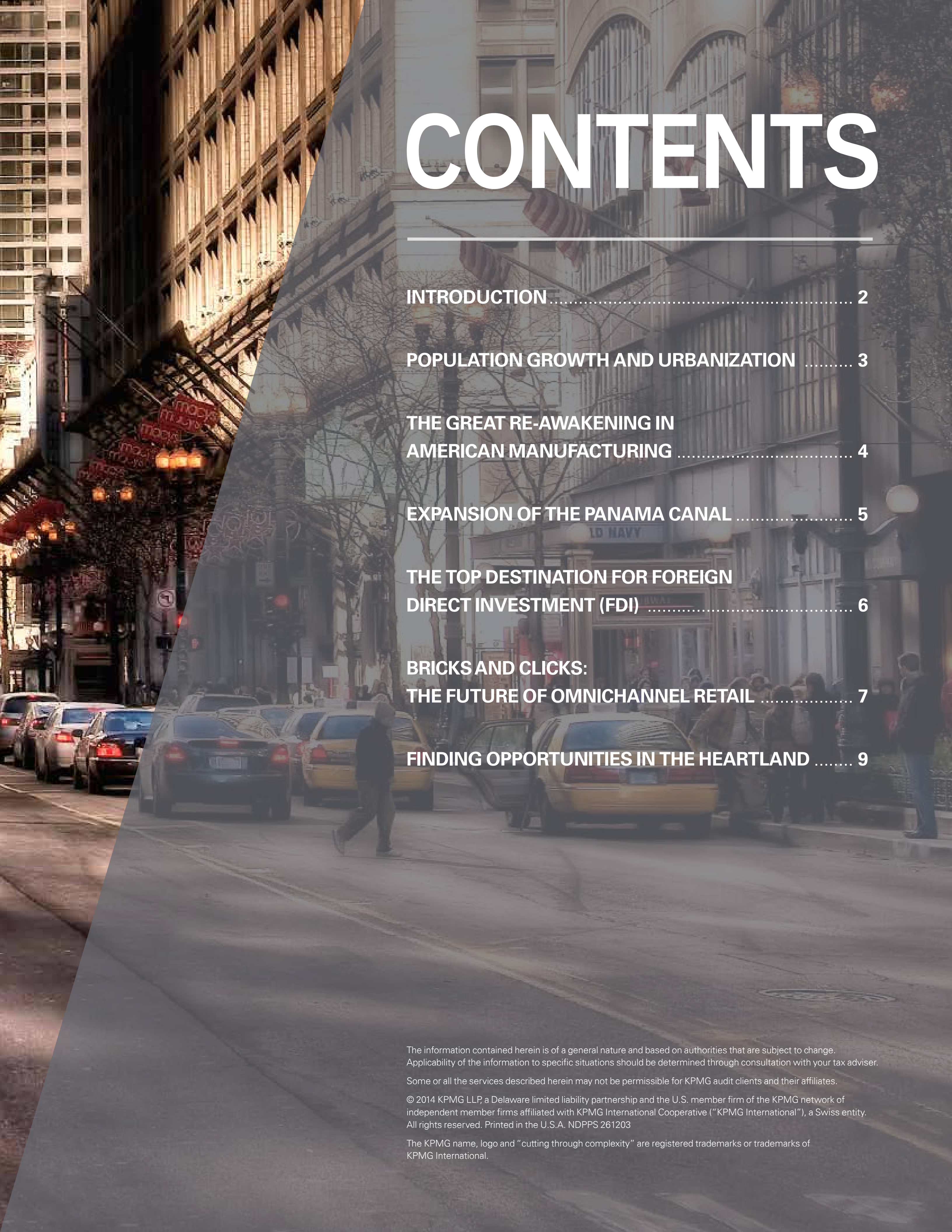

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INTRODUCTION

Since the beginning of the financial crisis in 2007, the news emanating from the commercial real estate (CRE) industry had been grim. Between 2007 and 2011, CRE transactions dropped 90 percent and private construction spending on commercial projects fell by 40 percent.[1] Massive layoffs killed demand for office, retail, manufacturing, warehouse, and hotel space. Rising vacancy rates in turn forced rents down, which led to declining profits, losses, and bankruptcies for many property owners.

All that should now be considered the "old normal." Sales of office, industrial, retail, multifamily, hospitality, and land totaled $366 billion in 2013, a 17 percent increase over 2012, industry watchers CoStar COMPs recently reported.[2] That organization's preliminary figures for full-year 2013 indicate the strongest year for CRE investment since 2007, when $489.6 billion in total transactions were recorded.

We expect the commercial real estate industry will continue to see significant gains across sectors and regions in 2014 and beyond. This conclusion is founded on our belief that the economic recovery we're seeing now will be sustained through 2014, which will fuel steady (albeit modest) growth in GDP, employment, and consumer spending. The extended downturn and current Federal Reserve System (the Fed) policy also have created favorable real estate investment conditions. Positive fundamentals can be seen in higher occupancy rates and rent gains in office, multifamily, retail, industrial, and lodging.

We expect this positive growth trend to impact not just trophy buildings in prime markets; in fact, secondary and tertiary markets stand to benefit from a variety of demographic and business trends, including population growth and urbanization; manufacturing shifts; domestic energy development; realignment in transportation and shipping; foreign investment; and e-commerce, among other factors.

Unemployment in some of these alternative destinations is running well below trophy markets and the national average.[3] In many cases, these destinations are marked by a diverse economy, which provides investors with less risk than one that is dependent on any one industry or economic sector. Deep valuation knowledge and local expertise will be needed to uncover secondary or tertiary markets that possess the right mix of long-term trends, stable industries, and undervalued real estate that meet the needs of each investor.

1 "The Imminent Commercial Real Estate Crisis and the CRE Solution," Architecture 2030.

2 Randyl Drummer, "U.S. Property Markets Post Strongest Sales Volume Since 2007," CoStar Group, January 15, 2014.

3 "Local Area Unemployment Statistics Information and Analysis," U.S. Bureau of Labor Statistics, January 7, 2014.

POPULATION GROWTH AND URBANIZATION

The U.S Census Bureau estimates the U.S. population will reach 400 million by 2060, an increase of nearly 100 million from the 2010 census.[4] These new residents are largely expected to continue residing in urban (densely developed residential, commercial, and other nonresidential) areas. They currently account for 80.7 percent of the U.S. population, up from 79.0 percent in 2000.[5] The population will be older as well. The 65-and-older group is expected to more than double from 43 million to 92 million. The number of people aged 85 or older is expected to more than triple from 5.9 million to 18.2 million.[6]

Such population shifts are already transforming urban and suburban real estate markets. Whether they are retiring Baby Boomers or young professionals, what buyers appear to want is "walkability"—easy commutes, good restaurants, convenient shopping, and nearby nightlife.

As a result, American cities are becoming new meccas, with formerly overlooked neighborhoods leading the way. For example, in New York City, some investors are looking past Manhattan to the borough of Brooklyn where new development is attracting new residents—and prices are starting to rise. Approximately 15,000 new rental units are under construction or in development in Brooklyn, with the borough's newly chic neighborhoods of Bushwick, Greenpoint, and Crown Heights attracting Manhattan-like rents, according to reports from Bloomberg News and Real Capital Analytics.

This same urban redevelopment can be seen in secondary markets. Overall, top secondary market sales soared past $25 billion in 2013, according to Bloomberg.[7] "New economy" activity has driven office sales in Miami, Houston, Las Vegas, Phoenix, San Diego, Seattle, Austin, and Atlanta.

Retirees are heading for the cities, too, as health issues force them to give up driving yet be within proximity of cutting-edge medical facilities. Many of these "Top Hospitals"[8] are located in smaller cities such as Baltimore, Houston, Cleveland, and Rochester, Minnesota. These locations offer investors and developers an opportunity to participate in a growth industry[9] uncorrelated to the equity markets. Rochester's Mayo Clinic, for one, has a $5 billion plan to secure Minnesota's status as a global medical destination. The plan would create 35,000 to 45,000 new jobs.

Longer life spans have in fact created a new real estate category called "extended care communities," with most clustering around the nation's hospitals. These communities offer a tiered approach, from independent and assisted living to part-skilled nursing home. The communities also offer an attraction to real estate developers and investors, since entrance fees can range from $100,000 to $1 million, with monthly charges ranging from $3,000 to $5,000.[10]

In Orlando, a new $665 million, state-of-the-art facility (VA Medical Center at Lake Nona) will increase accessibility to healthcare for approximately 400,000 of Central Florida's veterans. The facility is expected to create 30,000 jobs and add $7.6 billion in economic activity. Over the next decade, the facility is expected to attract some of the nation's top hospitals, universities, research institutions, and life science companies.[11]

4 "2012 National Population Projections," U.S. Census Bureau. Projections based on July 1, 2011 estimates, which are based on the 2010 Census, and provide population projections for July 1, 2012 to July 1, 2060.

5 "2010 Census Urban and Rural Classification and Urban Area Criteria," U.S. Census Bureau.

6 "U.S. Census Bureau Projections Show a Slower Growing, Older, More Diverse Nation a Half Century from Now," U.S. Census Bureau, December 12, 2012.

7 Dan Levy, "Burbank to Brookline Soar in Suburb Shift," Bloomberg Personal Finance, January 7, 2014.

8 "Best Hospitals" is a yearly U.S News survey that ranks hospitals nationwide. Many of the top hospitals are located in second- and third-tier cities.

9 The share of the economy devoted to healthcare increased from 7.2 percent in 1970 to 17.9 percent in 2009 and 2010, according to the Henry J Kaiser Foundation.

10 "About Continuing Care Retirement Communities," AARP.

11 "CBC: Orlando's Top of the Heap for CRE," Real Estate Forum, January 2014.

THE GREAT RE-AWAKENING IN AMERICAN MANUFACTURING

Creating CRE Investment Opportunities

Outside the cities, another great re-awakening is occurring. Manageable wage growth, lower-cost energy, highly developed infrastructure, a skilled and flexible labor force, and world-class universities have all put U.S. manufacturing on its most competitive footing since the 1980s. America's considerable legal system (such as due process and the right to own private property) also stands out when compared to doing business in some emerging markets.[12]

This attractive combination—while just a starting point—is leading to a rejuvenation of American manufacturing, and building potential for sometimes-hidden CRE investment opportunities. According to a recent study by the Boston Consulting Group[13], more than half of executives at manufacturing companies with sales of more than $1 billion plan to return some production to the United States or are considering it. That's up from 37 percent in February 2012. More than one-fifth said they were already returning work to the United States, a figure that doubled over the prior year. These geographical shifts will create jobs and the real estate investment opportunities that follow.

Another factor is the growing emergence of the United States as a major energy producer, and its potential impact for CRE investment cannot be underestimated. The United States is expected to surpass Saudi Arabia in oil output—and Russia in gas—by 2020. IHS Global[14] estimates that fracking will generate between $890 billion to $1.15 trillion in new infrastructure spending between 2014 and 2025. Together, the potential for new jobs, new distribution centers, and residential construction appears to be significant in the years ahead.

Fracking projects offer classic blue-collar jobs at high pay to people without college degrees. Each shale well, for example, requires up to 100 tons of high-quality steel pipe; fleets of specially adapted trucks and trailers; a small hangar of earthmoving, drilling, and other equipment; specialty chemicals, sands and ceramics; and high-end seismic and other underground imaging gear.

New energy development would appear to offer multiple entry points for investors, but we advise treading carefully in the oil patch. In Midland, Texas, for example, fracking has swelled the population by 5 percent. Payrolls have expanded 6.2 percent and rents have nearly doubled.[15] But locals have seen this movie before. When the spot price of West Texas Intermediate oil collapses, so does Midland.

Austin, Texas, by contrast is 300 miles to the south and outside the Permian Basin. Yet it has enjoyed double-digit growth in GDP, jobs, and population. As the 11th-largest city in the U.S. and the fourth-largest city in Texas,[16] Austin features a diverse mix of tech companies, state government, and universities. It also attracts the creative class through a longstanding focus on music and the arts.

"When assessing which trends—and demand drivers—to pursue, it's important to understand both the long-term impacts as well as the risks; determination of the proper reward for the risks taken continues to be one of the more challenging questions investors face, regardless of market cycle," explains Greg Williams, KPMG's National Sector Leader for Building, Construction & Real Estate.

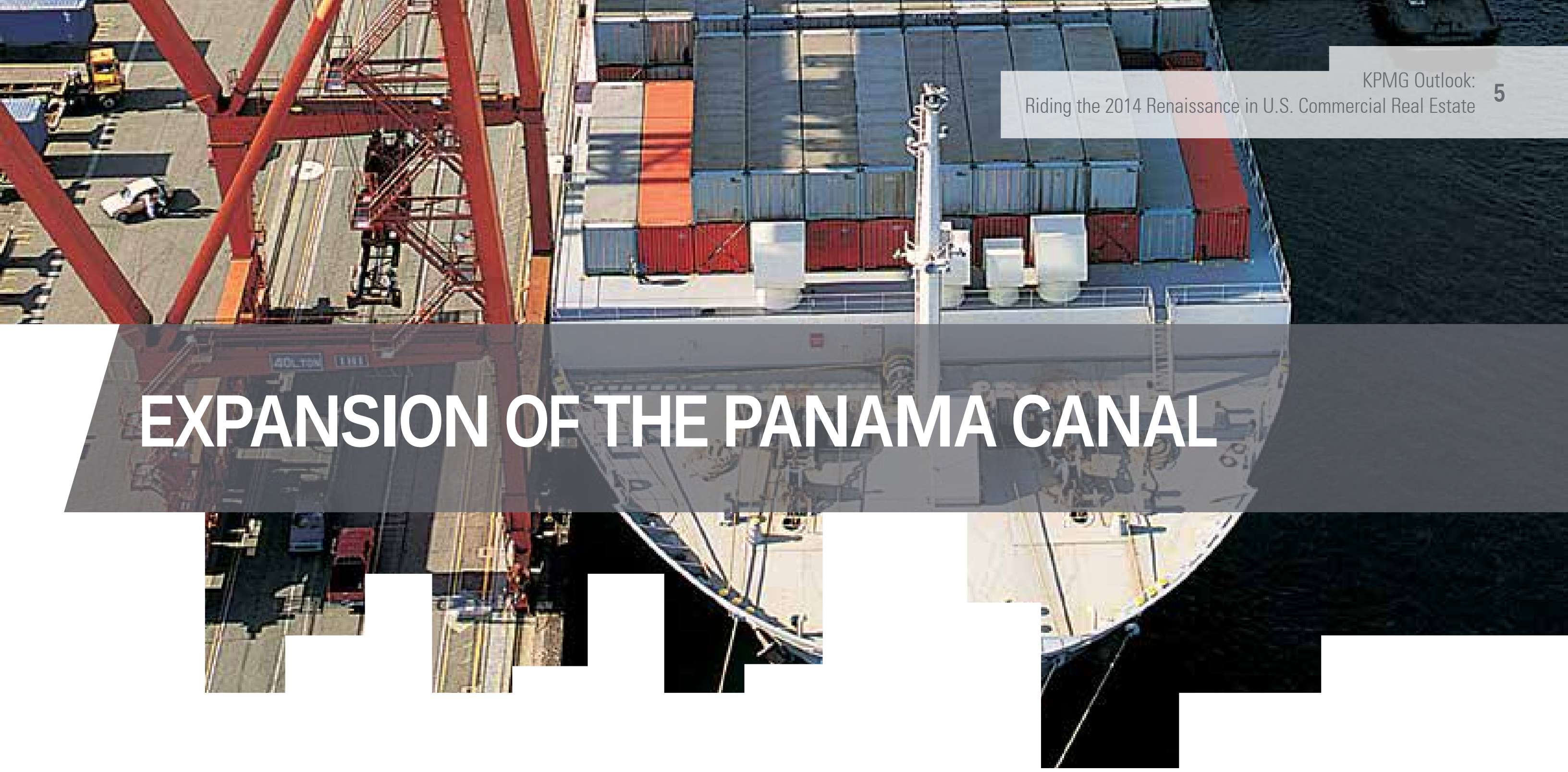
[12] "Ease of Doing Business" rankings conducted by the World Bank for complete head-to-head comparisons. http://www.doingbusiness.org/data/exploreeconomies/united-states/

[13] "Majority of Large Manufacturers Are Now Planning or Considering 'Reshoring' from China to the U.S." Boston Consulting Group, September 23, 2013.

[14] "America's New Energy Future: The Unconventional Oil and Gas Revolution and the US Economy," IHS.

[15] Mike Maciag, "Oil Boom Fuels Fastest-Growing Metro Area, Midland, Texas – But at a Price," Governing, September 12, 2013.

[16] Ranks are based on July 2012 population estimate from the U.S. Census Bureau.



EXPANSION OF THE PANAMA CANAL

The $5 billion expansion of the Panama Canal—set for completion in 2015—represents another major development in America's revitalization. Wider and deeper shipping lanes will enable Chinese exports, for example, to reach major population centers on the East Coast without having to dock at the Port of Los Angeles, unload, and then ship over land. The U.S. Department of Transportation estimates that, by 2020, canal expansion will lead to a 50 percent increase in total cargo traveling through U.S. ports. International container traffic will more than double. With billions of dollars being spent on docks, dredging and infrastructure projects will increase in and around select port cities up and down the East Coast of the United States.

These developments will bring dramatic changes to ports, cities, warehouses, distribution centers, manufacturers, and trucking and transportation hubs. For real estate investors, opportunities abound in understanding how the canal will affect supply chain route configurations and by analyzing which communities are maximizing Federal infrastructure grants to expand Canal readiness.

The Transportation Investment Generating Economic Recovery (TIGER) grant program allows the U.S. Department of Transportation to invest in road, rail, transit, and port projects critical to national objectives. As a result, ports in Baltimore, Charleston, Houston, Jacksonville, Miami, and Savannah (among others) are at various stages of expanding to accommodate larger vessels.

The Port of Baltimore, for example, is moving forward with a new $90 million intermodal facility at the Mount Clare rail yard in southwest Baltimore. Once complete, the facility will increase the Port of Baltimore's overall efficiency by allowing double stacking of containerized cargo.[17] Canal anticipation has reached Baltimore's warehouse market, too. Amazon is expected to build a one-million-square-foot fulfillment center in southeast Baltimore, which will create more than 1,000 full-time warehouse jobs. Sephora, a French cosmetics retailer and distributor, has signed a lease for a 656,000-square-foot distribution warehouse that is currently under construction.[18]

Similar growth is underway at the Port of Charleston, South Carolina. Projects involving more than 20 million square feet of speculative, class A industrial space are in development within 30 miles of that city. Approximately one million square feet has come on the market and been absorbed. In addition, two large logistics centers are being planned within a 60-mile range of Charleston, including a planned $600 million project to deepen the port of Savannah, Georgia. Miami's investment reportedly is in excess of $2 billion.[19]

Impact of Canal Expansion

Select East Coast and Gulf ports that should be Post-Panamax- (the term used to described much larger ships that will use the widened and deeper canal) ready by the time the Panama Canal expansion is completed include New York, Newark, Norfolk, Baltimore, Charleston, Houston, Miami, and Mobile. U.S. ports likely to be Post-Panamax-ready after 2015 include Savannah, Wilmington, Jacksonville, Tampa, and New Orleans.

"Panama Canal Expansion: Hugely Significant For U.S. Trade, Ports, Railways, Many Businesses And Your Portfolio," Seeking Alpha, June 10, 2013

17 "Panama Canal Expansion: Port of Baltimore Update," Cassidy Turley, September 2013.
18 MacKenzie Market Report, Fourth Quarter 2013.
19 Panama Canal's Growth Prompts U.S. Ports to Expand," The New York Times, August 20, 2012

THE TOP DESTINATION FOR FOREIGN DIRECT INVESTMENT (FDI)

America's newfound competitive strengths are attracting foreign investors as well. In A.T. Kearney's June 2013 FDI Confidence Index, the U.S. surged past China, Brazil, and India to become the world's leading FDI destination.[20] The last time the United States claimed the top spot was in 2001. The prime beneficiaries of this trend have been in the South, with Texas, South Carolina, Alabama, and North Carolina leading the way.

Eight of the top automakers, for example, have major manufacturing facilities in the Southern United States. These hubs are now attracting auto suppliers. Korean tire manufacturer Hankook Tire Co. announced in October 2013 that it would invest $800 million in a state-of-the-art manufacturing facility in Clarksville, Tennessee. Yokahama recently broke ground on a new tire manufacturing facility in Mississippi.

[20] Participating companies represent 27 countries and span 17 industry sectors across all six inhabited continents. Together, the companies comprise more than $1 trillion in annual global sales.

BRICKS AND CLICKS: THE FUTURE OF OMNICHANNEL RETAIL

Real estate investors generally shunned the retail sector during the past several years, citing high unemployment figures and the "inevitable" transition to Internet sales. There is no doubt that Internet sales are growing. The Department of Commerce announced in February 2014 that fourth-quarter 2013 retail e-commerce sales increased 3.4 percent from the prior quarter. Forrester predicts that by 2017, 60 percent all U.S. retail sales will be via the Internet.[21]

The question is whether e-commerce sales will cannibalize bricks-and-mortar retail. This view suggests that retail stores are dying, they exist mainly for "showrooming", and that shopping will devolve into a few clicks and a smartphone method of payment.

Rather than being mutually exclusive, each retail channel has certain strengths that can support a brand's overall marketing mix or balance out the weaknesses inherent in a single channel strategy.

Finding Value in Bricks and Clicks

Digital (Web/Mobile)	Bricks & Mortar
• Broad selection • Easy to research and comparison-shop • Allows for multitasking • Customer reviews and tips	• Ability to test and try on • Personal assistance • Convenient returns • Instant gratification • Easy comparison of similar products

We see a future in which bricks, clicks, and mobile commerce converge into a more holistic omnichannel retail marketing structure, offering savvy investors a wide array of opportunities to get involved in the retail sector, such as in malls, strip centers, warehouse distribution centers, and transportation hubs.

A 2012 survey of consumers by Wanderful Media revealed extensive overlap between bricks-and-mortar shoppers and those who shop online. More than 90 percent of survey respondents reported visiting a store after searching online, while 77 percent checked online to find product information while shopping in-store.[22] In addition, the widespread assumption that retail is on shaky ground is not borne out by the latest jobs figures. In 2013, retail added 381,000 jobs.[23]

[21] "U.S. Cross-Channel Retail Forecast, 2012 To 2017," Forrester Research.

[22] "Technology Blurs The Line Of Online Vs. In-Store Shopping: A Survey Of Consumers Who Use Mobile Devices To Shop," Wanderful Media, December, 13, 2012.

[23] "Local Area Unemployment Statistics Information and Analysis," U.S. Bureau of Labor Statistics, January 7, 2014.

From bricks to clicks

In many cases, the growth in e-commerce is attributable to traditional retailers. They are choosing to fight fire with fire by becoming more competitive with online competitors. One avenue is to use real estate differently; for instance, some retailers are creating new store formats—including stores with smaller footprints—to cut overhead and adapt to demographic trends. By reducing store footprints, big-box stores are winning consumers in urban centers and suburban strip malls. One home improvement retailer's format will shrink to 5,000 square feet or less of retail space. Current trends indicate that grocery stores are slimming down, too.

For investors, the value play may involve some counterintuitive thinking. "Rather than looking to invest in a traditional shopping mall with anchor tenants, changes in store footprints may create opportunities in different types of retail properties—including strip malls and other retail centers—in markets that aren't currently on investors' radar," suggests Greg Williams. "Knowledge of local markets and their demographics are critical to assess the investment implications of these new dynamics."

Some large retailers are addressing the e-commerce challenge by turning their stores into mini-distribution centers. "Ship-to-Store" enables customers to pick up their purchases at a conveniently located facility. And Ship-to-Store saves money through shorter and speedier delivery routes. It also brings the online customer into the physical store for additional and perhaps contiguous purchases.

From clicks to bricks

Most of the news regarding e-commerce moving to a physical location has centered on one high-profile online retailer's efforts to acquire distribution center space across the country. But that only tells part of the story. We expect that internet-only retailers will be forced to compete by opening physical locations as bricks-and-mortar retailers become more sophisticated in their e-commerce efforts, but offering the instant gratification that traditional shopping offers.

Investing in the fulfillment center of tomorrow

Population shifts, the revitalization of manufacturing, the expansion of the Panama Canal, and the influx of foreign investment are expected to continue to reshape the American economic landscape. Right now, behind every "click to order" is a global fulfillment system straining to provide an error-free, timely delivery.

E-commerce has already begun to affect distribution centers, including rendering a number of existing facilities largely obsolete. They may not have the power load to handle the automation, the ceiling height to accommodate the stacking, or the bay areas needed to respond quickly to fulfillment requests. These facilities may have to be torn down and rebuilt, creating powerful opportunities for CRE investors who are first-movers—and even for fast followers.

There is now great demand for bigger and more efficient distribution centers, with warehouse space greater than 500,000 square feet. Typically, they feature 32- to 36-foot ceiling heights and offer 50x50-foot bay sizes. Users are also looking for these facilities near logistics hubs, such as a port, airport, rail station, and major highway, plus within proximity of an order-fulfillment or parcel-delivery company location.

FINDING OPPORTUNITIES IN THE HEARTLAND

We expect the U.S. commercial real estate industry will see significant gains across sectors and regions in 2014 and beyond. Continued economic recovery and low interest rates have created a favorable environment that will provide appreciation in office, multifamily, retail, industrial, and lodging properties.

"There continues to be significant upside for real estate investors in secondary and tertiary cities, where attractive valuations and a confluence of trends are creating new opportunities for investors willing to venture outside their traditional comfort zones," concludes Williams.

To uncover and seize these new opportunities, investors will need to look beyond standard quantitative real estate measures, incorporating more complex analysis. The bottom line: The best real estate markets in the years ahead will be those that are well positioned to take advantage of long-term trends and can attract diverse industries and sectors that offer a wide moat against any subsequent economic downturn. Some of these will be traditional gateway cities, but others—like Austin, Texas—will offer investors new places to deploy their capital.

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