KPMG

KPMG Real Estate Outlook Survey

Room to run in 2016

But how much more?

kpmg.com

KPMG

Contents

Foreword

Investors have been optimistic about the U.S. real estate market, and that looks to continue into 2016 and possibly beyond. Capital is flowing into the United States and the economy is growing, bringing knock-on effects that make real estate a good investment. And that was before the recent interest rate rise and tax changes that will only accelerate these trends. At the same time, however, investors are becoming more cautious about future prospects. They are becoming less aggressive in their risk-taking and more uncertain as to how the market will look when they exit these investments several years down the line.

An uneven recovery, instability in the Eurozone and other critical markets, and growing geopolitical risk has created a market increasingly characterized by the military acronym "V.U.C.A.", or volatility, uncertainty, complexity, and ambiguity. Investors aren't waiting to see what happens. They are beginning to move down the risk curve in thinking about future investment and looking for safer investment options.

Institutional investors have put a lot of money into high-risk, high-reward "opportunistic" real estate, but are starting to pull back as interest rates and cap rates rise. Funds are still looking for good deals, but they are accepting lower returns in exchange for lower risk. Waiting for market movements to make transactions profitable is no longer the smart play. Instead, many investors and owners are even more focused on real estate fundamentals and leveraging cost efficiencies.

Adding to the pressure on profits, capital from Canada, Norway, the Middle East, and Asia continues to pour into the United States, a traditional safe haven, and it is not expected to let up any time soon. Recently passed reform to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) will only extend this trend. These changes allow complete exemptions from FIRPTA for Qualifying Foreign Pension Funds and increase the FIRPTA exemption for all foreign investors from 5% to 10% of publicly-traded REITs.

Competition from this increased capital could make the hunt for investment opportunities all the more difficult, and investors are looking increasingly toward M&A and organic growth through product expansion. Additionally, investors are looking to secondary and tertiary markets, where they consider pricing to be more rational.

Adding to the changing marketplace, demographic forces are having a significant impact on investment. Millennials remain skeptical about investing in home ownership, and "empty-nesters" are looking to downsize to smaller homes. This has made multi-family housing a continued strong performer, especially in urban centers. Healthcare-related real estate is also a notable performer in response to increased healthcare demand from an aging population.

Overall, the market has seen shifts from both demographic pressures as well as financial conditions. While the outlook for 2016 is mostly positive, how these changes play out in the next year or two will likely signal the near-term future of the real estate market.

How can investors, owners, managers and service providers effectively prepare for the coming change in momentum? We hope that KPMG's research–and our interpretations of the data collected–will lend clarity to the premise of this report: "Room to run in 2016. But how much more?"

Survey highlights

- **Cautious optimism:** There is continued but cautious optimism in the real estate market, as GDP and job growth lend themselves to the positive view. But there is also growing uncertainty which will likely have significant effects across commercial real estate asset classes. Additionally, rising geopolitical and economic risk worldwide contribute to uncertainty and increased investor interest in U.S. markets.
- **Investors are beginning to "de-risk":** Investors' growing caution can be seen in efforts to "de-risk" portfolios, as investors are concerned about the longevity of the current expansion cycle. They are becoming less aggressive in taking risks and are taking measures to adjust their portfolios in preparation for the flattening or downturn ahead.
- **More capital than opportunities:** Executives see a market in which the available capital far exceeds the opportunities to put it to use. This has driven up prices in primary markets and forced investors to look elsewhere. A substantial inflow of foreign capital into the United States, a primary cause of this capital surplus, is not expected to slow, and the recently passed reform to the Foreign Investment in Real Property Tax Act (FIRPTA) will only increase this imbalance.
- **Hunt for yield:** With little room for cap-rate compression left, many investors are focusing on real estate fundamentals and are looking for incremental returns in the form of yields instead of depending on market movements to profit on transactions. Investors are using easy access to equity and debt in the "hunt for yield" in a variety of assets and markets.
- **Growing cyber concerns:** The real estate industry may not be sufficiently prepared to prevent or mitigate cyber security threats as many respondents indicate they haven't taken significant steps to prepare for a breach, including creating a written cyber incident response plan or other concrete actions. This is especially true for smaller firms."

KPMG LLP surveyed senior commercial real estate executives in the United States between August and October 2015 to better understand sentiments in the marketplace as well as to help identify emerging opportunities.

On behalf of KPMG LLP, I would like to thank those who participated in this survey and hope their input and KPMG's insights will be useful to you in addressing market challenges and opportunities. I also welcome the opportunity to discuss our findings and how they relate to your business decisions in the year ahead.

Greg Williams
National Sector Leader
Building, Construction & Real Estate /
Asset Management, KPMG LLP

KPMG

The real estate sweet spot

It is KPMG's belief that solid domestic demand will benefit much of the U.S. real estate industry, especially in the multifamily and retail sectors. When one also considers that interest rates remain low, this provides a positive backdrop for the continuation of happy days in building and construction. The Fed lifted its policy rate in December 2015, but policymakers made it clear that future rate increases will be much more gradual than previous rate hiking cycles. The Fed believes economic growth will run slightly above potential over the next few years, labor markets will continue to improve and inflation will show signs of sustaining itself at or above 2 percent.

Nonresidential construction as a whole has also picked up. Spending on private nonresidential construction increased 13.6 percent during the year ended in November 2015. The gain was led by lodging, communications, manufacturing, and recreation projects (including casinos and sports facilities.) Thus, at this point in the cycle with growth remaining steady, rates remaining low, and the consumer gathering momentum from five years of jobs growth, real estate remains in the sweet spot for growth for at least another year if not more.

KPMG projects the 2016 outlook for the real estate sector to remain mostly upbeat. Interest rates are expected to stay low. Strong jobs growth will continue to lift demand for apartments and retail space. Demographic trends will drive the use of healthcare and assisted living properties. Real estate investors, however, should be aware that risks are always present. The slowdown in the young-adult population may dampen the demand for apartments, and currency shifts or a rout in the bond market could sway demand in a variety of sectors.

Constance Hunter
KPMG Chief Economist

Detailed findings

Cautious optimism

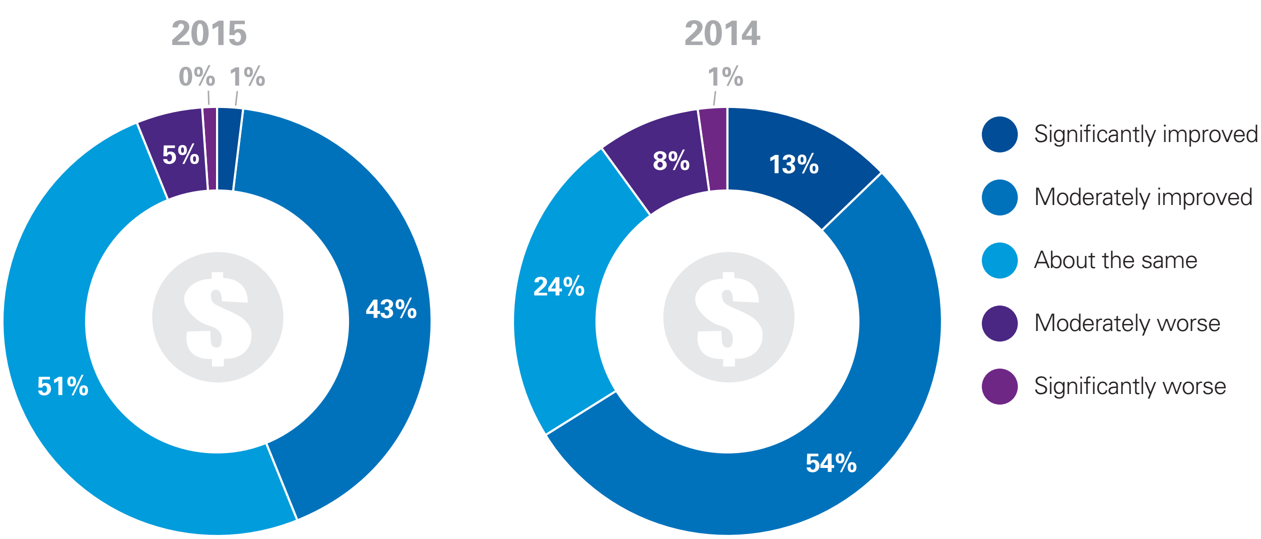
Real estate investors continue to be optimistic about the real estate market given sustained jobs growth and gains in GDP. Nonetheless, they are more cautious than they were previously, as uncertainties around interest rates and geopolitical risks are weighing on respondents. Investors have been locking in debt ahead of the likely gradual rise in rates. While higher interest rates could have a detrimental effect on demand, real estate should continue to be a strong and relatively low-risk opportunity in a market with lower returns.

Positive expectations for the U.S. economy

The vast majority of respondents predict the economy will either stay the same or moderately improve over the next 12 months. Compared to the more bullish assessment in our previous survey, this suggests that they believe the U.S. economy will begin to slow over this period.

"The respondents are understandably unsure if the pace of Fed rate increases will take away the punch bowl," said Constance Hunter, Chief Economist, KPMG LLP. "Although the U.S. will face global headwinds, domestic demand looks strong enough to keep the economy growing in 2016 at a 2.5% rate."

Q. What are your expectations for the U.S. economy in the next 12 months?

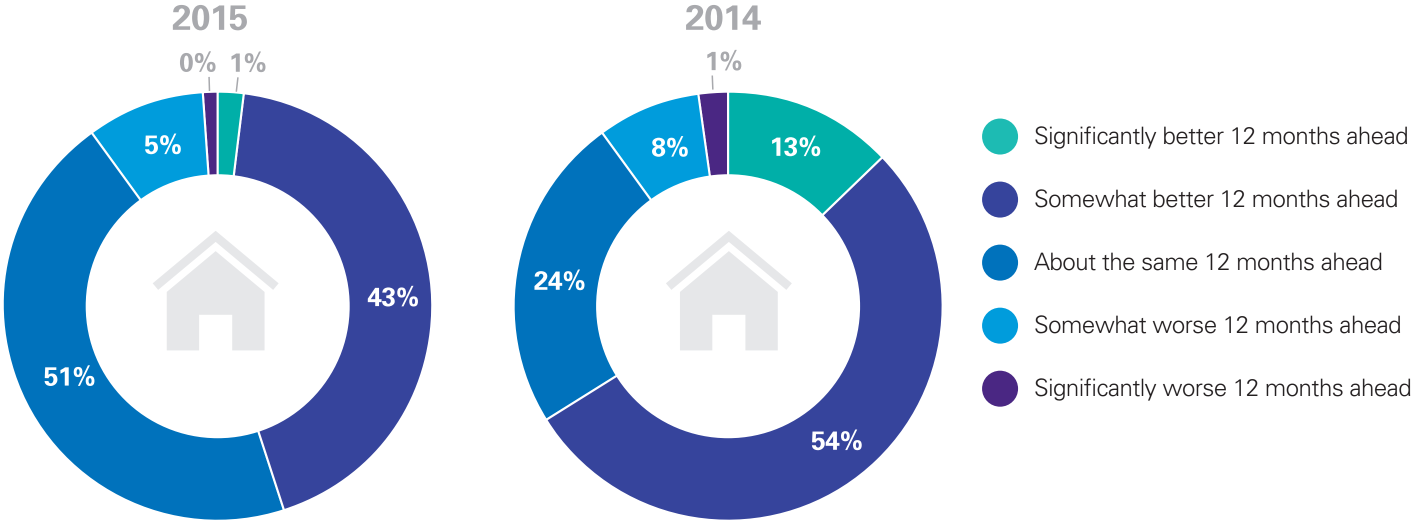


Source: KPMG Real Estate Outlook Surveys

Real estate fundamentals expected to be about the same a year from now

The vast majority (91%) expect real estate fundamentals to be about the same or better a year from now, slightly lower than last year, when 93% expected real estate fundamentals to be about the same or better a year out. However, respondents have moved down the optimism scale, signaling that we may have reached, or are nearing, a market plateau.

Q. How would you compare today's key real estate fundamentals (vacancy/occupancy, rental rate, deal velocity, etc.) in your primary markets with those you expect in mid-2016/mid-2015?



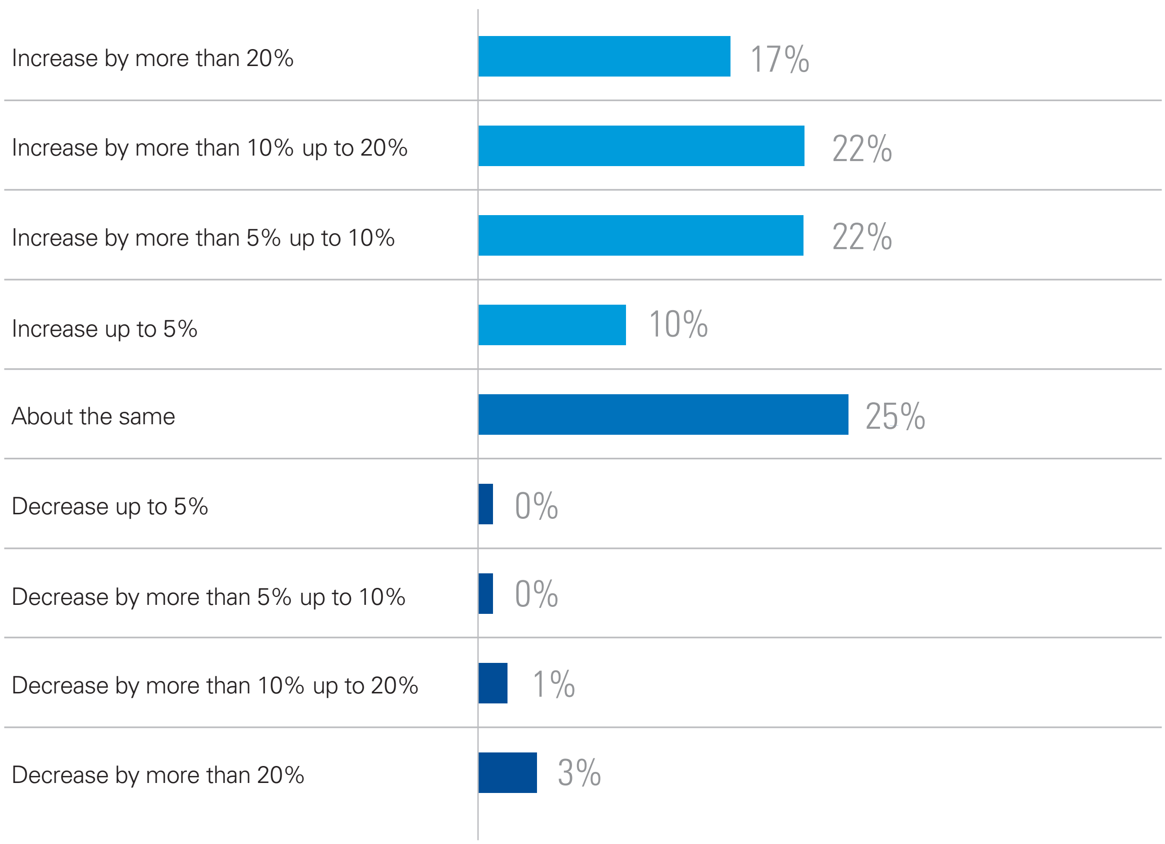
Source: KPMG Real Estate Outlook Surveys

> *Real estate fundamentals continue to improve and executives have a positive outlook for the next 12 months, but there is growing uncertainty over the longer term. The current economic cycle has matured, and executives are concerned about exiting the investments they make now when the market weakens.*
>
> ***Greg Williams***
> *National Sector Leader*
> *KPMG Building, Construction & Real Estate/*
> *Asset Management*

Positive investment outlook over the next 12 months

The willingness to invest is strong, as nearly all respondents said they would either increase investment or keep it the same over the next year. Nonetheless, an increasing amount of capital in the market could make it more difficult to find investment opportunities.

Q. What is the outlook for investment by your company over the next 12 months?



Source: KPMG Real Estate Outlook Surveys

Development expected across all U.S. sectors

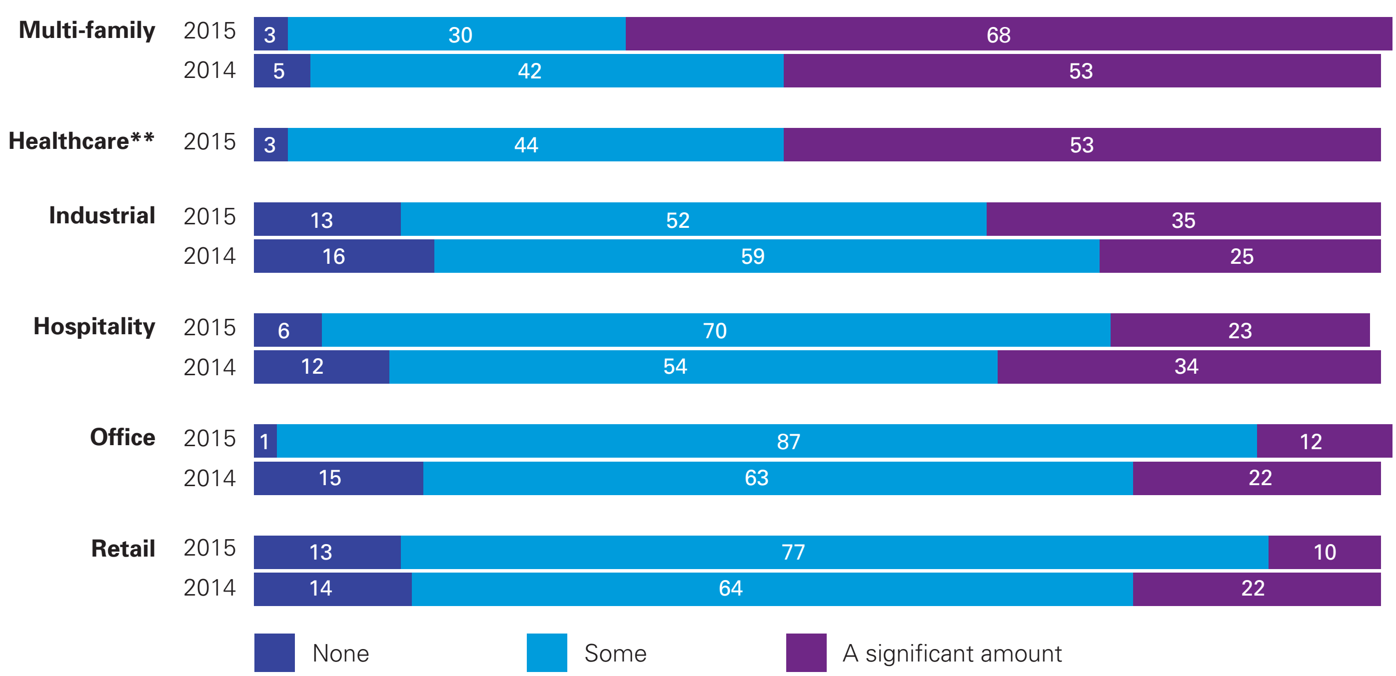
Significantly, upwards of 80% to 90% of respondents said that there would be at least some development in every asset class in 2016.

Multi-family continues to be a high-performer, as Millennials, who witnessed the impact of the financial crisis on housing, are either currently unable or unwilling to purchase a home or who have at least decided to delay the purchase. Many Millennials see home ownership as an anchor that limits their mobility rather than as an aspiration. Additionally, many do not have the credit to qualify for a home loan, as the average credit score for college grads with a Bachelor's degree is just four points above the minimum required to obtain home loan.*

Aging baby boomers are also looking to downsize as their children reach adulthood. Both of these demographic trends converge in a move toward multi-family properties in walkable urban centers or suburban centers close to public transit.

Healthcare, the newest asset class in this survey, is expected to see major investment in development in 2016 likely due to increased healthcare demand from aging baby boomers.

Q. How much development will commence in the U.S. in the year ahead in each of the following sectors?



Note: Totals may not sum to 100% due to rounding.

Source: KPMG Real Estate Outlook Surveys

* Source: Inman.com, "Infographic: What the real estate industry needs to know about millennials", October 13, 2015, (Credit Karma).

** Healthcare answer added to 2015 survey.

Investors are beginning to "de-risk"

The growing caution in investor optimism can be seen in efforts to "de-risk" their portfolios. Many investors see the end of the growth cycle approaching and are becoming less aggressive in taking risks. These investors are looking for opportunities in the real estate market that might not have as significant a downturn as some riskier opportunities. For example, investors with significant investment in ground-up condo development may shift their focus to multi-family properties to take advantage of the trend toward urbanization.

Types of assets in the market to acquire/invest in 2016 is mixed

Investors are still very interested in Class A assets in primary markets, but they are also demonstrating high interest in secondary and tertiary markets when demand for the top assets gets too "frothy." Class A assets in primary markets still represent more certainty versus riskier secondary and tertiary markets, even if this means sacrificing some returns. However, investors are willing to take some risk in development in secondary and tertiary markets.

Q. 2015: Which of the following types of assets will you be in the market to acquire/invest in the next 12 months? (Select up to two asset types)

	% in 2015		% in 2014	
	1st priority	2nd priority	1st priority	2nd priority
Class A assets in primary markets	30	12	25	16
Development opportunities	25	22	24	29
Class A assets in secondary and/or tertiary markets	22	30	16	26
Class B/C assets	10	17	14	12
Distressed assets	9	9	17	15
Other	4	10	4	2

1st priority 2nd priority

Source: KPMG Real Estate Outlook Surveys

KPMG

Organic growth and M&A are the top management initiatives

Not surprisingly, senior management is focused on growth. Their interest in entering new markets has waned, as they are looking at M&A and organic growth through product expansion that includes debt and core-plus funds.

The difference in public markets versus private returns has recently fueled the privatization of several public REITs. This M&A trend is positive but could indicate that we are nearing the end of the real estate investment cycle. Private equity funds have the dry powder and will invest it when the opportunity is right.

Phil Marra
National Real Estate Funds Leader
KPMG LLP

Q. Over the next 12 months, what initiative will consume most of senior management's time and energy?

	% in 2015	% in 2014
Significant investment in organic growth (new product development, pricing strategies, geographic expansion)	31	11
Merger/acquisition	21	13
Strategic divestiture of current assets	16	14
Significant improvement of operation processes and related technology	12	9
Entering new markets	8	28
Navigating significant changes in the regulatory environment	3	8
Significant changes in business model	3	5
Improve enterprise risk management programs/processes	3	2
Significant changes to financial processes and related technology	1	2
Significant cost reduction initiatives	0	6

Might not equal 100% due to rounding
Source: KPMG Real Estate Outlook Surveys

Acquisitions are expected to be biggest driver of revenue growth

According to our data, a higher percentage of larger firms is seeking acquisitions than are smaller ones. In fact, 71% of firms with assets greater than $10 billion listed acquisitions as their top revenue driver. By contrast, smaller firms focused on general economic conditions to help them drive revenue. Improving real estate fundamentals was the top choice of firms with assets of less than $500 million.

Q. Which of the following areas do you believe will be the biggest drivers of your company's revenue growth in the next three years?

	% in 2015	% in 2014
Acquisitions	57	40
Improving real estate fundamentals	40	62
Better/cheaper access to capital	25	16
Geographic expansion	21	34
More aggressive leasing	18	27
New services	13	23
Other	12	2

Multiple responses allowed

Source: KPMG Real Estate Outlook Surveys

More capital than opportunities

Investors also face a market in which an excess of capital is chasing the available investment opportunities, driving prices up and altering the risk-reward calculus. In response, many are looking to secondary and tertiary markets, where pricing is more rational. The inflow of foreign capital into the United States is expected to continue and will likely gain some momentum from the recently passed reform to the FIRPTA.

A substantial amount of capital continues to flow from Asia, specifically China, Singapore and Korea, into the U.S., and these flows are not expected to decline. Asian investors believe the U.S. market is fairly priced.

Phil Marra
National Real Estate Funds Leader
KPMG LLP

The inflow of foreign capital into the United States is only going to increase given the year-end tax changes to FIRPTA. The changes allow complete exemptions for Qualifying Foreign Pension Funds and increase the exemption for all foreign investors from 5% to 10% of publicly-traded REITs.

Chris Turner
National Real Estate Tax Leader, KPMG LLP

Executives have mixed outlook on marketplace for investment opportunities

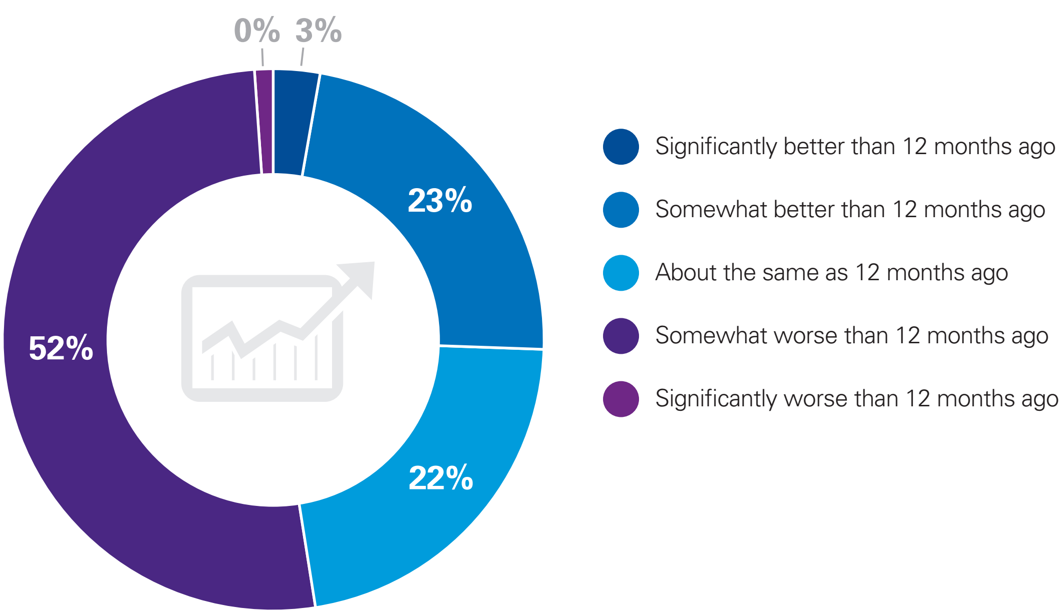
Executives view the current market as having investment opportunities but with intense competition, as there has been an increase in the amount of capital pursuing those opportunities. Previously, the inflow of capital into the market created value through a cap-rate decline. More than half (52%) now say the market is somewhat worse than it was 12 months ago, while 22% say it's about the same. Institutional-grade assets still are the focus of many investors—including those from abroad.

Interestingly, the smallest firms had the most positive outlook, as half of firms with less than $500 million in assets said the marketplace was somewhat better than it was 12 months ago. By contrast, more than half (57%) of respondents from larger firms said the market was somewhat worse now than it was 12 months ago.

There is less competition on smaller deals, but those deals need just as much, if not more, asset management focus as larger deals.

Phil Marra
National Real Estate Funds Leader
KPMG LLP

Q. How would you rate the marketplace for investment opportunities?



Source: KPMG Real Estate Outlook Surveys

Foreign investment in U.S. real estate expected to increase over next 12 months

Nearly three quarters of executives (74%) expect foreign investment in real estate to increase over the next 12 months, continuing a major industry trend. The stable U.S. market continues to be a safe haven from the ongoing economic, financial, and security issues in the Eurozone and the weakness in emerging markets. In addition to strong economic fundamentals, its broad and diverse real estate markets offer foreign investors more opportunities than they can find abroad, as well as a reliable legal system and other structural advantages.

Q. How do you expect the amount of foreign investment in U.S. real estate to change in 2016, versus 2015?

	% in 2015	% in 2014
Increase by more than 20%	6	8
Increase by more than 10% up to 20%	16	16
Increase by more than 5% up to 10%	30	39
Increase up to 5%	22	17
About the same	19	16
Decrease up to 5%	3	3
Decrease by more than 5% up to 10%	4	0
Decrease by more than 10% up to 20%	0	1
Decrease by more than 20%	0	0

Note: These results predate year-end tax reform changes, so KPMG believes that respondents would be even more optimistic today.

Source: KPMG Real Estate Outlook Surveys

Hunt for yield

Despite an overall positive outlook for the economy, yields are trending downward, which is making individual and institutional investors more willing to accept lower returns in exchange for greater certainty in their investments. Respondents are focused on increasing returns from existing assets instead of looking to market movements, which entails even greater focus on real estate fundamentals and asset management strategies.

Larger institutional investors have invested heavily on more opportunistic investment, but they are now more focused on yield, while smaller firms tend to focus on total return and not necessarily on cash return. An assessment of their revenue growth drivers shows that larger investors are moving toward lower-end risk while smaller investors may have a larger risk appetite.

Q. What issues pose the biggest threat to your business model?

	% in 2015	% in 2014
Inability to find investments delivering sufficient return	66	23
Speed/magnitude of economic recovery	29	32
Impact of new regulations/legislation	18	22
Inability to find capital	17	11
Inability to find visionary leadership	6	10
Lack of qualified workforce	6	10
Cyber-threat	6	9
Customer/employee mobility	6	8
Lack of job growth	6	30
Energy costs	3	10
Other	6	3

Multiple responses allowed

Source: KPMG Real Estate Outlook Surveys

Inability to find investments is the biggest threat to business models

A significant number of executives see the inability to find investments as the top threat to their business model in 2016. Gateway cities are seeing extremely high prices and strong competition, which are driving yields down. Many investors are turning to second- or third-tier cities, including in the Sun Belt, for higher returns as well as development deals.

Investment properties are available, but sufficient returns are difficult

While quality properties are available, investors are now finding it more difficult to find quality properties delivering sufficient returns.

Q. What types of investment properties is your company finding in today's marketplace? (Select up to two)

	% in 2015	% in 2014
My organization is finding quality properties at prices that deliver sufficient returns	31	40
My organization is finding quality properties, but not at prices that deliver sufficient returns	55	44
My organization is finding lesser-quality properties at prices that deliver sufficient returns	12	*
My organization is finding lesser-quality properties at prices that don't meet our return requirements	9	23
My organization is not finding anything suitable in which to invest	10	3
My organization is not actively seeking investment at this time	4	16

* Didn't offer this option in 2014.
Multiple responses allowed
Source: KPMG Real Estate Outlook Surveys

The risk-versus-return equation looks favorable for real estate companies when compared to the volatility and expected returns in stocks and the possibility of a rise in bond prices leading to negative returns. Investors want lower risk and will accept lower returns to get it.

Phil Marra
National Real Estate Funds Leader
KPMG LLP

Perspectives on Equity and Debt

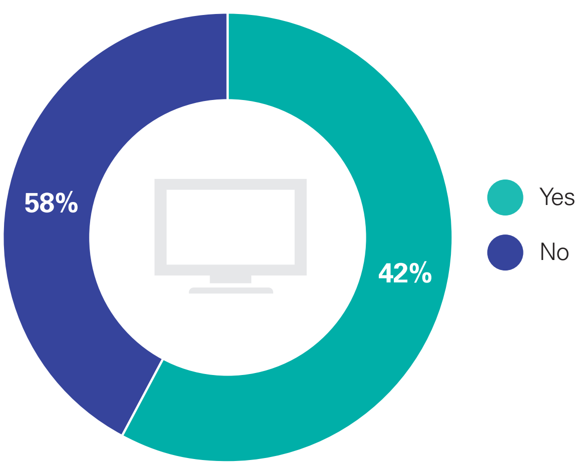
More than two thirds of executives expect access to both debt and equity markets to be about the same in 2016. However, more than three quarters (76%) of executives think debt financing is going to be more expensive in 2016, while the majority (61%) sees the cost of equity capital to be about the same in 2016. This means that many companies considering debt are likely looking to leverage up now before the interest rate increase takes effect.

Growing cyber concerns

While cyber security is a growing concern across all business sectors, many in the real estate industry indicate that their firm is less than fully prepared. Smaller firms tend to be less prepared than larger ones. A significant number of respondents say that they did not have a written cyber incident response plan and that they are not prepared for such an event. The vast majority (79%) of the largest firms, those with more than $10 billion in assets, had a response plan, while 81% from firms with less than $500 million in assets said they did not yet have one. Similarly, 79% of the largest firms said they were adequately prepared for a cyber-attack, while 63% of the smallest firms said they were not prepared.

> *The nature and sophistication of cyber threats are rapidly evolving and the size and severity of cybersecurity breaches and incidents are rapidly growing. Thus, unfortunately, the risks of reputational and financial damage are greater than ever. Being able to reasonably prevent, better detect, and properly respond to a cybersecurity incident is no longer optional, but a requirement of real estate industry firms of every size.*
>
> ***Kevin Goldstein***
> *Advisory Director, KPMG LLP*

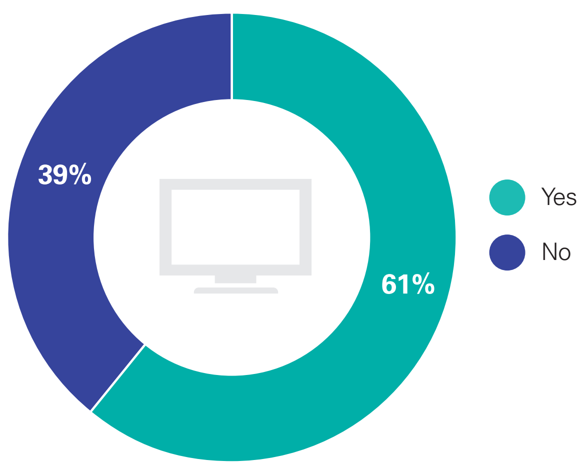
Does your organization maintain a written cybersecurity incident response plan?



Source: KPMG Real Estate Outlook Surveys

Cyber-attack mitigation

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



KPMG has identified five top cyber risks and threats for real estate owners, managers, investors, and service providers:

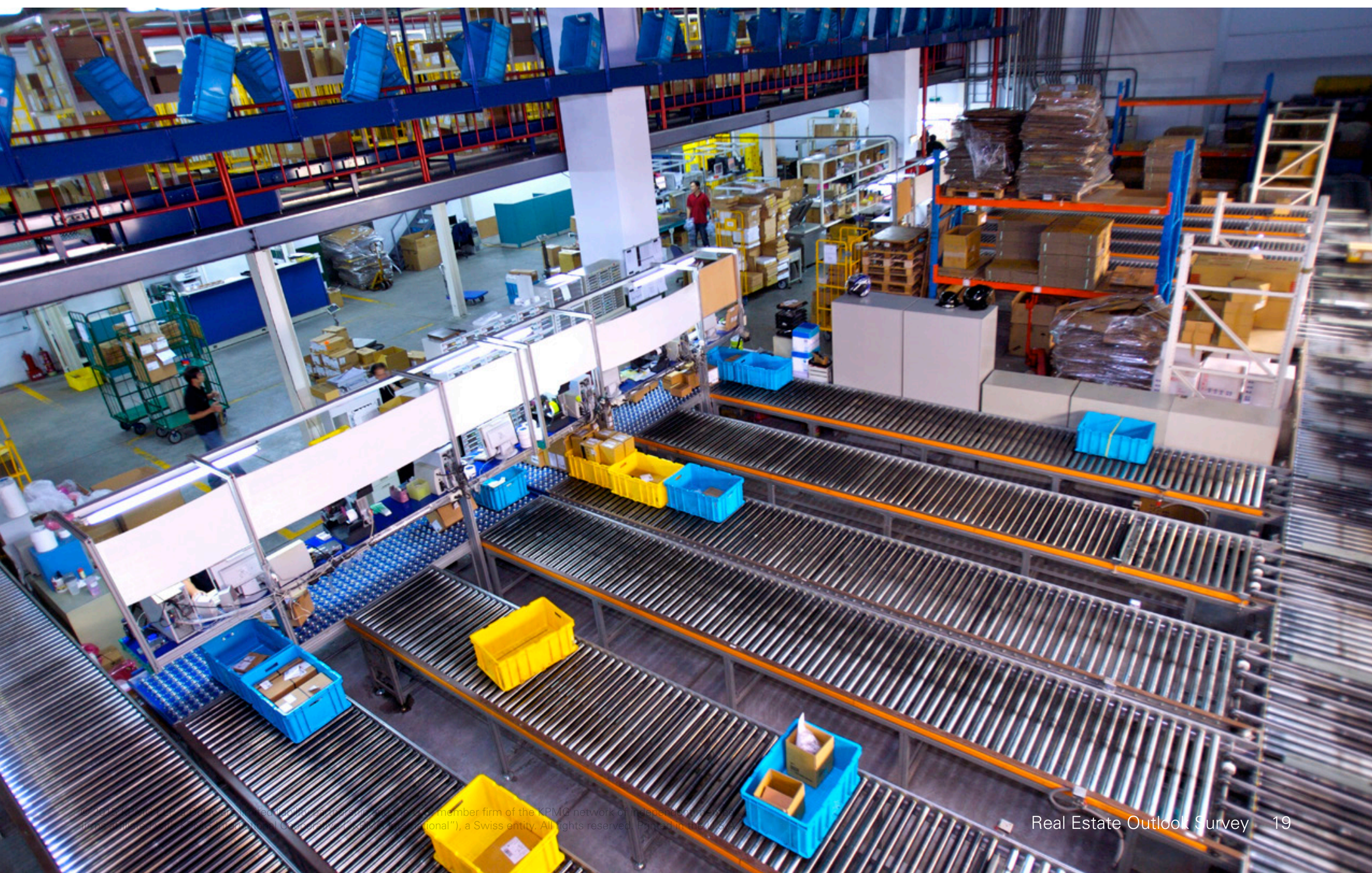
1. Technology to engage with tenants and guests is creating challenges in protecting sensitive tenant information, including bank accounts.

2. Solutions for building management, such as automation in utilities, fire alarms, and security, bring new exposures and risks.

3. Third-party applications through mobile hardware and software are increasing exposure to theft of sensitive information, including potential employee-related incidents.

4. Vendors and third-parties are creating vulnerabilities and exposure of sensitive intellectual property, employee data, and tenant data.

5. Regulatory and compliance requirements, particularly those related to state privacy laws and notification requirements, are a growing concern.



Conclusion

Concerns about the longevity of the ongoing economic expansion as well as the implications of rising interest rates make for a market characterized by growing uncertainty.

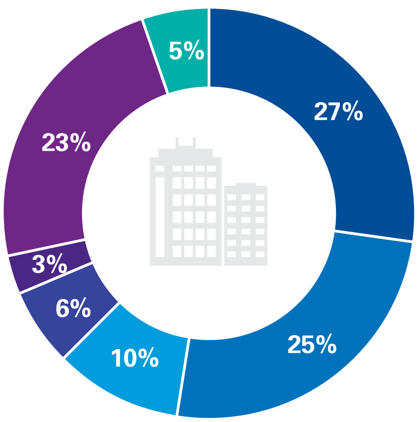
Investors are becoming more risk-averse and are beginning to "de-risk" by decamping to traditional safe havens, like the United States, and by opting for lower-risk opportunities. However, the massive inflow of foreign capital has led to a significant increase in competition for the best investments.

This has left many investors with a major challenge in their "hunt for yield" across a variety of assets and markets. The pursuit of incremental returns through asset management and cash flow improvements has replaced market movements and cap-rate compression as the way to profits in this market.

KPMG sees 2016 as another positive year for the U.S. real estate market. On the question posed at the beginning of this report–namely, how much longer we expect these favorable conditions to continue–we believe that we are indeed coming to the end of the cycle. This change in momentum will have significant implications for the marketplace, primarily influencing the timing of investment, operations, and portfolio management decisions. As to what happens after 2016, it remains to be seen whether there is "room to run" beyond.

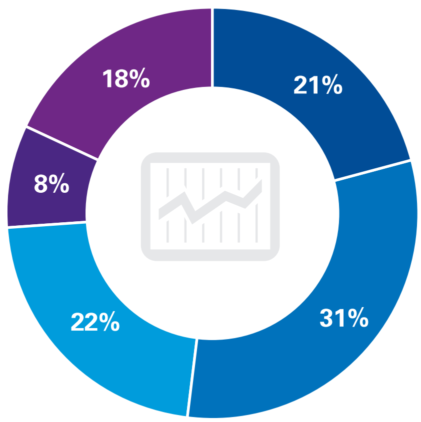
Methodology

KPMG's 2016 Real Estate Industry Outlook Survey reflects the viewpoints of senior executives in the United States. The web survey was conducted August – October 2015.



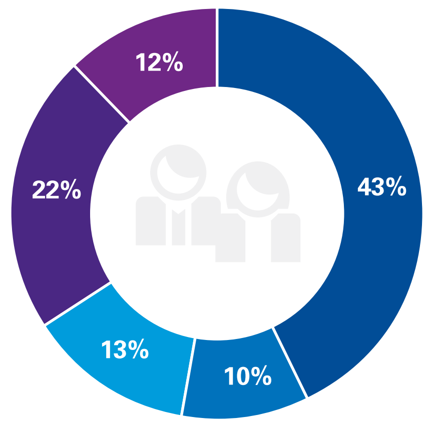
Company type

- Real Estate Fund Manager
- Publicly Traded REIT
- Real Estate Services Firm
- Real Estate Investor
- Non-Traded REIT
- Other private real estate owner
- Other



Market value

- Less than $500 million
- $500 million to $2 billion
- $2.01 billion to $5 billion
- $5.01 billion to $10 billion
- More than $10 billion



Titles

- C-Class
- Executive Vice President/ Managing Director
- Senior Vice President/ Director
- CEO/President
- Other


KPMG

Authors

Greg Williams is KPMG's National Sector Leader for Asset Management, and is responsible for the strategic direction over the firm's Building, Construction & Real Estate (BC&RE) practice along with its Alternative Investment and Public Investment Management practices. He has more than 28 years of tax experience in the private equity real estate and hospitality industries.

Phil Marra is the National Audit Leader for KPMG's BC&RE practice, as well as the leader of the firm's U.S. Real Estate Funds practice. With more than 28 years of sector experience. Phil has a wide range of experience in providing audit, accounting, due diligence, and advisory services to real estate, finance, parking, construction and hospitality clients.

Chris Turner is the National Tax Leader for KPMG's BC&RE practice, with significant experience with real estate funds, real estate investment trusts, developers and engineering and construction clients. He has more than 30 years' experience in public accounting.

About KPMG's Real Estate Practice

KPMG LLP 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 LLP's Building, Construction & 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 1,300+ 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.

Contact us

For additional information, please contact any of the following:

Greg Williams
National Sector Leader
KPMG Building, Construction & Real Estate/
Asset Management
214-840-2425
gregorylwilliams@kpmg.com

Phil Marra
National Real Estate Funds Leader
KPMG LLP
212-954-7864
pmarra@kpmg.com

G. Chris Turner
National Tax Leader, Building, Construction &
Real Estate
KPMG LLP
404-222-3334
cturner@kpmg.com

kpmg.com/socialmedia

kpmg.com/app

Download on the App Store