

The Deloitte logo, consisting of the word "Deloitte" in a bold, blue, sans-serif font, followed by a small green dot.

2015 Commercial
Real Estate Outlook
Enhance technology.
enable innovation.

Deloitte Center
for Financial Services

The Deloitte Real Estate logo, featuring the words "Deloitte Real Estate" in a blue, sans-serif font, with "Deloitte" in blue and "Real Estate" in green.

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Foreword

Dear colleagues:

In many ways, the commercial real estate (CRE) industry is on more solid footing than it has been for quite some time. The U.S. economy continues to improve, although concerns remain in both Europe and some emerging markets. Investors are generally seeing solid performance, and profitability continues to improve across most property types and markets.

The sector is poised for strong growth over the next 12 months. Availability of financing through traditional and nontraditional channels is likely to continue to drive domestic investor interest in U.S. CRE. In addition, U.S. CRE is increasingly gaining international investor interest. Investor sentiment is a bit cautious going into 2015, despite profitability being quite strong in many sectors.

Property fundamentals continue to improve, and owners will likely benefit from investing in redevelopment of existing properties to enhance competitiveness with newer building stock. Companies cannot afford to ignore adoption of sustainability measures and smart building technology. Leveraging technologies such as social, mobile, and analytics will be increasingly important to drive operational efficiency and improve tenant loyalty.

But concerns — some new, some old — are keeping industry executives on their toes. Whether it's the pressure coming from nontraditional competitors, the evolving threat of cybercrime, or the rising cost of regulatory compliance, CRE executives have ever evolving challenges. Companies that are able to effectively steer through these challenges and build on the positive momentum in the industry by leveraging technology will maintain a competitive edge.

We are pleased to share with you our views on industry trends and priorities for 2015 based on the perspectives and firsthand experience of many of Deloitte's leading real estate practitioners, supplemented by research from the Deloitte Center for Financial Services.

Producing Outlooks of this type has the result of exposing the authors to second-guessing; hindsight is 20/20. Nevertheless, we feel it is important to reflect on what we said a year ago and put our prior prognostications to the test by analyzing what we got right — and perhaps not exactly right — in our 2014 CRE outlook. You will find this "looking back" analysis leading off this year's edition, followed by a "looking forward" summary of our views on the coming year.

The report will then explore 10 top issues of importance for the industry over the coming year, with each including a specific look at the "Focus for 2015" and a "Bottom line" that provides some actionable takeaways for industry leaders to consider.

We hope you find this report insightful and informative as you consider your company's strategic decisions for 2015. Please share your feedback or questions with us. We value the opportunity to discuss the report directly with you and your team.

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Looking back

“It’s tough to make predictions, especially about the future,”

Lawrence Peter “Yogi” Berra

As we move into the 16th year of our publication, we would like to first take a step back and compare our expectations for 2014 vis-à-vis the way things actually panned out in the industry for some of the top trends.

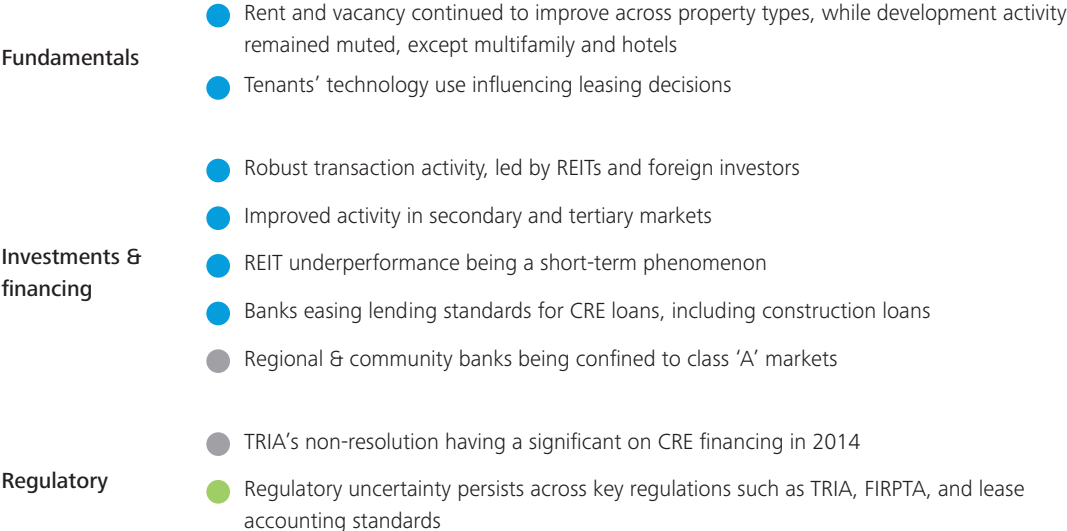
At first glance, we believe our central theme of last year’s Outlook: “Trimming the Sails for Growth — Business Transformation is Key” holds true to a major extent. We have seen an accelerating trend of real estate industry leaders investing in enhanced information technology and processes to streamline operations, which provide enhanced visibility into current and future business performance. However, we also had our share of misses and surprises.

To dig a little deeper and garner a better understanding of how the story unfolded last year, we have categorized our assessment of what happened within three broad themes:

- Fundamentals
- Investments and financing
- Regulations

First, as anticipated, CRE fundamentals — rent and vacancy — continued to improve across property types, while development activity remained muted. Many of the improvements in construction activity were led by the apartment and hotel sectors. We also expected that tenants’ technology use would have an influence on space demand and eventually supply. Public statements

Figure 1: Dashboard of 2014 issues and relevance to 2015



Real Estate Industry Focus
● Turned out as expected
● Partially turned out as expected or unresolved
● Did not turn out as expected

Source: Deloitte Center for Financial Services

from many CRE c-suite executives allude that tenants' or their end-customers' technology use influenced leasing decisions. However, it's a little challenging for us to quantitatively assess the technology influence on leasing demand.

We forecasted improved real estate capital markets in 2014, brought about by global investors and improved lending conditions. However, capital market activity gained better-than-expected strength with strong foreign capital inflow into U.S. CRE and a broad-based recovery in lending activity. As expected, banks eased lending standards for CRE loans, including for construction. As per the April 2014 Senior Loan Officer Opinion Survey on Bank Lending Practices, banks reported net easing for CRE loans across loan size, loan-to-value (LTV), and debt service coverage ratio (DSCR). Improved lending by regional banks was a positive surprise. From an investment perspective, we thought that real estate investment trust (REIT) underperformance would likely be a short-term phenomenon as a

result of an interest rate spike in 2013. And we were right: as of September 23, the FTSE NAREIT All REIT index outperformed benchmark indices such as the S&P 500 and Russell 2000. The increased availability of financing resulted in a stronger transaction and pricing environment. As a result, the improvement in activity in secondary and tertiary markets was much better than we expected.

Lastly, regulatory uncertainty continued, albeit much more than we had anticipated. We expected the Terrorism and Risk Insurance Act (TRIA) impasse to be over. However, the political logjam over the regulation is still not resolved. Yet, contrary to our expectation, the non-resolution has not significantly impacted CRE financing thus far.

In summary, the 12 months from our last Outlook probably turned out to be better than anticipated due to the broader recovery in financing availability that strengthened capital inflows, transactions, and pricing.

Looking forward

Enhance technology and enable innovation to capitalize on positive market fundamentals

As we look forward to 2015, the macroeconomic environment is expected to continue to improve. Our Deloitte Economics team expects positive change in important parameters such as job market indicators, including initial claims, unemployment rates, and job openings. Car sales remain strong, industrial production is accelerating, and exports are growing. The single-family housing sector — pricing and sales — continues to strengthen, albeit at a slow and inconsistent pace. These positive macroeconomic parameters could potentially provide a further boost to the strengthening CRE recovery.

Looking at trends likely to dominate in 2015, to begin with, an improved economy will continue to bolster global investments in U.S. CRE. REITs are likely to continue to offer positive returns against benchmark indices, and investors will benefit from additional diversification opportunities from the growing number of REIT conversions in nontraditional property sectors. The private equity real estate (PERE) funds appear to be having more success raising new capital and have increased opportunity to recycle capital due to higher property prices. Therefore, both domestic and foreign capital inflow will continue.

Compelling reasons exist for the increased interest in U.S. CRE. Geopolitical instability in a number of emerging markets may continue to lead to investment into safer and stable regions such as the United States. Closer to home, there is strong capital availability with traditional financing sources such as banks increasing lending. In addition, CRE players have opportunities to consider targeted capital raising using innovative sources such as green bonds and crowd funding. While construction loan availability from banks might fall short of actual demand, the industry will benefit from nontraditional funding sources and mezzanine and equity capital from private equity and international sources.

The extensive availability of financing through domestic and international sources will likely support continued strong growth in transaction activity and asset pricing. Distressed assets as a percentage of transaction volume will likely continue to decline as prime markets turn expensive and more capital flows into secondary and tertiary ones.

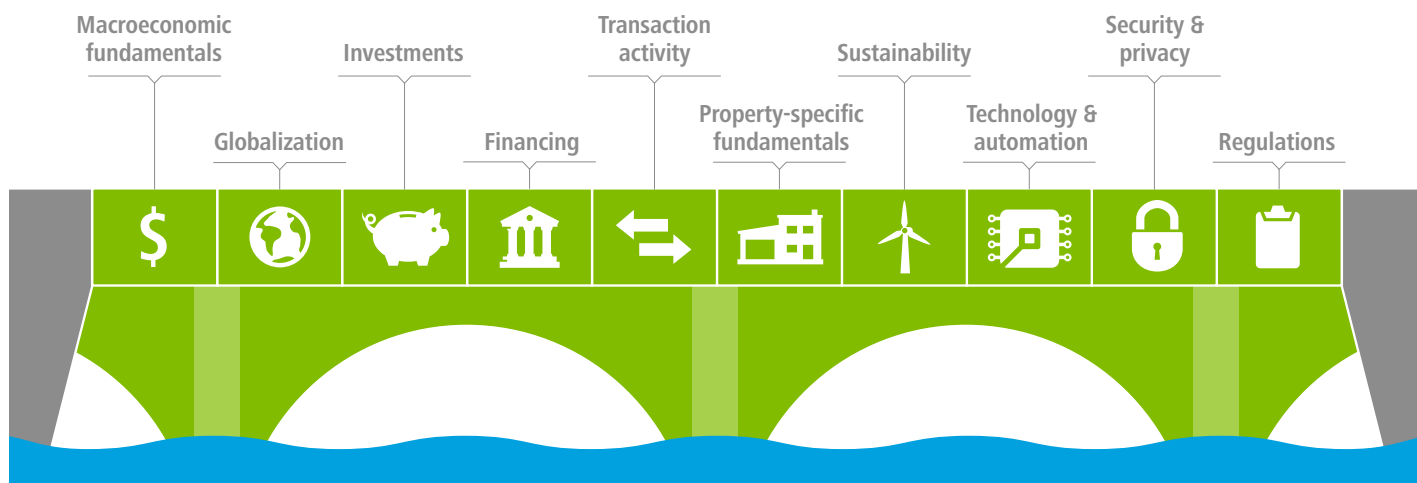
From a CRE fundamentals perspective, rents and vacancies will potentially continue to improve across property types, although development activity coming online may have a greater impact on this improvement in 2015, especially in the multifamily and office markets. We believe that tenants' sustainability focus and technology use will have a greater influence on space demand and supply than just market dynamics, not only in 2015 but longer term. Consequently, we expect to see increased redevelopment of existing properties to better position those properties to compete with new development.

Technology also will be integral to development activity as there will be higher demand for sustainability-enabled intelligent buildings. Further, adoption, measurement, and reporting of sustainability initiatives will be a business imperative, given its broader benefits on rental growth, yield premiums, total occupancy costs, asset values, and marketability. Lastly, as companies increase technology adoption, they will potentially benefit from adopting appropriate security and privacy measures.

On the flip side, regulatory uncertainty will persist. Particularly, the indecision on the renewal of TRIA, which is scheduled to expire by December 31, 2014, is cause for concern. Many insurers have included sunset clauses that withdraw terrorism risk coverage in 2015 in the event that TRIA is allowed to expire by the end of this year. Even if TRIA is renewed, insurance premiums may still rise. Therefore, along with uncertainty from a regulatory perspective, a nonrenewal or higher premiums may impact financing costs.

Overall, as we move into 2015, strong market fundamentals and the availability of a diverse array of funding sources will likely fuel industry growth. Increasingly, companies will seek to differentiate their appeal to tenants and capital sources based on their level of technology use to enable service and design innovation and operational excellence.

Figure 2: Ten focus areas for 2015



Macroeconomic fundamentals

Positive economic growth supporting the CRE industry



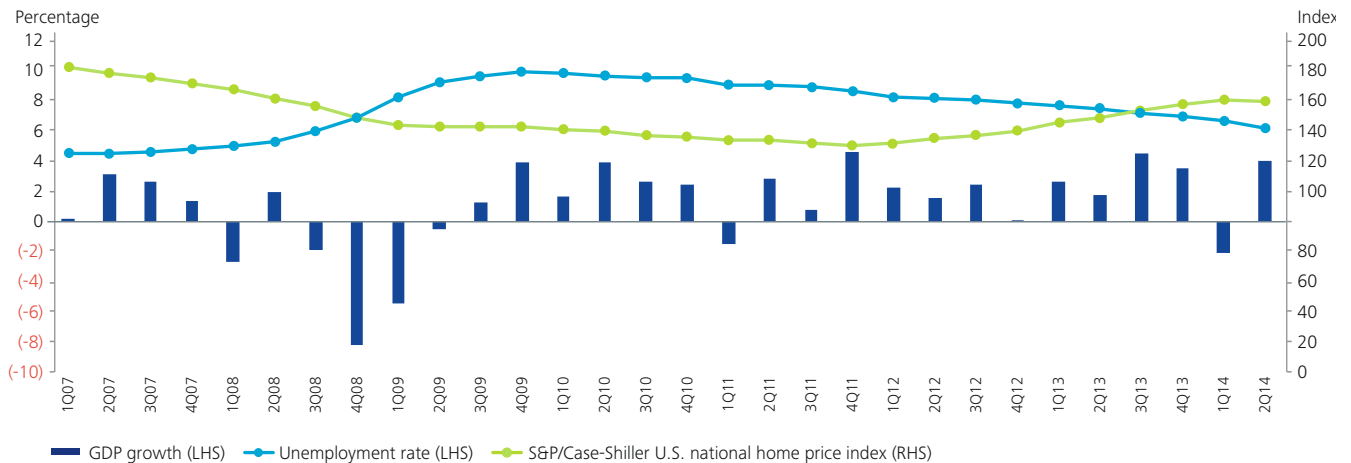
The global economy appears to be settling into a new normal of modest growth in developed economies, stabilization of growth in emerging economies, and a decline in systemic risks emanating from policy mistakes.¹ While geopolitical risks have emerged in 2014, financial market volatility has been low. According to Dr. Daniel Bachman, senior manager, U.S. Macroeconomics, Deloitte Services LP, “the stability will benefit the United States, which is likely to see acceleration from the relatively slow growth rates we’ve experienced in the past few years.” Further, U.S. interest rates have remained stable.²

Let’s look at some of the top macroeconomic indicators (Figure 3) that will influence the CRE industry:

Labor markets

The unemployment rate fell to 6.1 percent in August, the lowest since the 2008 financial crisis and closer to pre-recession levels.³ And the pace of employment growth appears to have picked up. The long-term unemployed as a percentage of total unemployed has fallen recently.⁴ While labor force participation remains low, a tightening labor market is likely to bring some of those people back into the labor force. The labor force participation rate could rise almost a full percentage point (from 62.8 percent in August to an average level of 63.7 percent in 2019) as many of the latent unemployed re-enter the labor market and are employed.⁵

Figure 3: GDP growth, unemployment, and home prices



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, and S&P/Case-Shiller, September 2014

Gross domestic product (GDP) growth

U.S. GDP rebounded strongly in 2Q14, growing by 4.2 percent compared to -2.1 percent in the prior quarter following an increase in exports, as well as state and local government spending.⁶ According to Dr. Bachman, “although GDP growth may be lower in the third quarter 2014 because of a drop in inventory accumulation, faster job growth is likely to boost consumer spending and lead to higher levels of GDP growth in the future.”

Housing

The housing market continues to improve, albeit at a slow pace. Many housing statistics, such as prices and sales, trended positively in 1H14. However, a large portion of existing home sales seems to be purchases by investment groups, rather than individuals.⁷ Housing starts remain low as construction activity continues to be impacted by stringent lending standards and rising mortgage rates. That being said, recent international interest in the single-family housing market may act as an alternate source of funding and provide the much-needed boost to construction activity in the short to medium term.⁸

Focus for 2015

The improvement in GDP and employment numbers is supported by high consumer confidence, which is now at its highest level since the 2008 recession. Further, the personal savings rate has drifted down in the last few months, suggesting an increase in spending. According to the Deloitte Economics team, the positive news from labor markets suggests that there is a high probability of an acceleration in economic growth sometime in the next year or two.⁹ Further, interest rates will likely increase by July 2015.¹⁰ In addition, housing construction is probably less than required to meet the long-term need, so there is considerable pent-up demand for housing, which should result in robust starts in the future.¹¹

From a CRE perspective, the improved economy will strengthen rent growth and occupancy rates. The industry will likely continue to benefit from easy financing availability and strong investment activity from both domestic and international sources. As a result, competition will continue to intensify for quality assets. However, the risk of rising interest rates can potentially impact property cap rates and the cost of financing real estate, which could mitigate the otherwise positive news impacting CRE transaction activity and pricing.

The bottom line

Risks related to interest rate hikes and regulatory uncertainty will potentially impact the CRE sector growth, although important parameters — fundamentals, transactions, lending — continue to strengthen. This suggests a cycle of investment and (re) development in many areas. Hence, CRE companies should capitalize on the increase in domestic and international capital inflows.

Globalization

U.S. gaining traction as the preferred investment destination



Investors are pursuing international real estate investments to grow and diversify their portfolios, given more relaxed foreign investment regulations in many countries and improving global economic conditions. Investors are putting their committed capital to work, as highlighted in the growth in CRE investments across regions discussed below. The United States continues to regain its stature of “safe haven” for CRE investments with foreign investors. U.S. investors are also increasing their global presence, especially in Europe and China, with cross-border investments rising 100.8 percent YOY in 1H14 to \$31.2 billion.¹² (Figure 4)

Global CRE transaction trends by region

Global CRE transaction volume totaled \$570.9 billion in 1H14 (Figure 5), an increase of 10.7 percent compared to 1H13. The 1H14 growth is slower compared to the 29.8 percent YOY volume growth in 1H13. This is primarily because of a relatively lower growth (+3.6 percent) in the Asia-Pacific (APAC) region, which is the largest contributor to global transaction volumes.¹³ The Americas and Europe, Middle East, and East Africa (EMEA) sustained their positive clip with volume growth of 14 percent and 18 percent YOY in 1H14, respectively.¹⁴ Consequently, both regions increased their share in the global transaction volume in 1H14 compared to the same period last year.

Figure 4: Foreign CRE investments in and out of U.S.

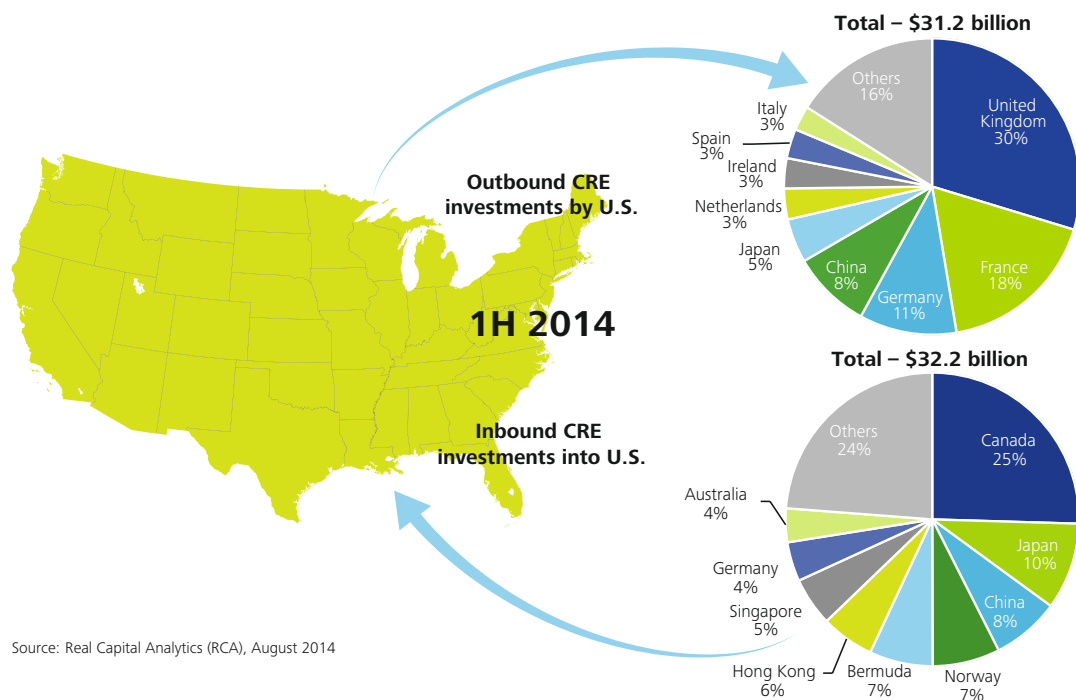


Figure 5: Global CRE transaction volume



Americas includes USA, Canada, and Latin America; EMEA includes UK, Western Europe, Eastern Europe, Middle East, and Africa; Asia-Pacific includes China, Japan, Australia, New Zealand, India, Hong Kong, Singapore, Malaysia, South Korea, Taiwan, and Others
Source: RCA, August 2014

Looking at the investment activity across regions, the slowdown in APAC was due to a decline in investment activity in top markets such as Australia, Japan, Singapore, and Hong Kong. In China, although volumes grew 12.9 percent YOY in 1H14, limited opportunities due to restricted bank lending and differing price expectations between buyers and sellers added pressure. The Americas continues to be dominated by the United States, where investors see opportunities in both primary and secondary markets. Canada, while continuing its “slow and steady” progress, is dominated by a limited number of institutional investors for premium assets. Elsewhere, in the EMEA region, there is broader and improved investor demand, as concerns over the future viability of the Eurozone gradually dispel. While the UK, France, and Germany continue to lead the region’s activity, markets like Spain, Netherlands, and Ireland have shown strong YOY growth.

Foreign investor interest continues to grow in the United States

In 1H14, cross-border investment in the United States as a percentage of total CRE transaction activity was 10.8 percent, the highest in more than a decade.¹⁵ The increased investor interest is driven both from a demand and supply perspective. Limited home-country options and the gradual relaxation of outbound investment norms are driving investors to scout for international options such as a more stabilized U.S. CRE market. Consequently, foreign investors are finding both core and opportunistic investment options. Therefore, we are witnessing foreign capital inflow not just in primary markets like New York and Chicago but also in secondary markets such as Houston, Dallas, and Seattle.

A case in point is the surge of [Chinese investments in U.S. CRE](#), which in the 20 months through August 2014 was nearly thrice the cumulative amount invested in the previous eight years. Consequently, China has emerged as one of the top foreign investors (second in 2013 and third thus far in 2014 as of August) with nearly an 8 percent share of the total cross-border investments in U.S. CRE in 2013 and 2014YTD August.¹⁶

Focus for 2015

Unlike last year, we expect Europe to receive increased investor interest across both gateway and secondary markets, in line with stability in the Eurozone as well as continued distressed asset opportunities. That said, the United States is likely to remain the most attractive market in 2015. According to the 2014 Association of Foreign Investors in Real Estate survey, more than two-thirds of respondents consider it to be the most stable and secure real estate investment destination. Going forward, an equal number of respondents plan to increase their investments in U.S. secondary markets.¹⁷ In addition, the United States is the leading target for single-country focused funds as 46 percent of the funds currently raising capital are targeting the country.¹⁸

The bottom line

The rising foreign investor interest bodes well for U.S. CRE players as it can provide an additional funding source, especially for development. In addition, these investments can help clear some of the distressed pipeline in the secondary and tertiary markets as seen with foreign investor deals in cities like Detroit. Companies looking to access foreign capital should understand the investment pattern and objectives of these investors to build long-term and mutually beneficial partnerships. However, many of these international investors lack knowledge of U.S. CRE markets, entitlement processes, and relevant regulations and tax laws, and seek out domestic partners to leverage their local marketplace and regulatory knowledge. Tax-efficient investing for foreign investors also remains challenging but can be accomplished with the help of professional advisers. According to Jeff Rubin, partner, Deloitte Tax LLP, “investments through intermediate vehicles and structures can reduce the overall tax burden and in some cases eliminate the requirement to directly file U.S. income tax returns.” Similarly, with respect to outbound investing, U.S. CRE players can leverage long-term partnerships with foreign investors to better navigate international markets.

Investments

REITs and PERE funds demonstrate strong performance



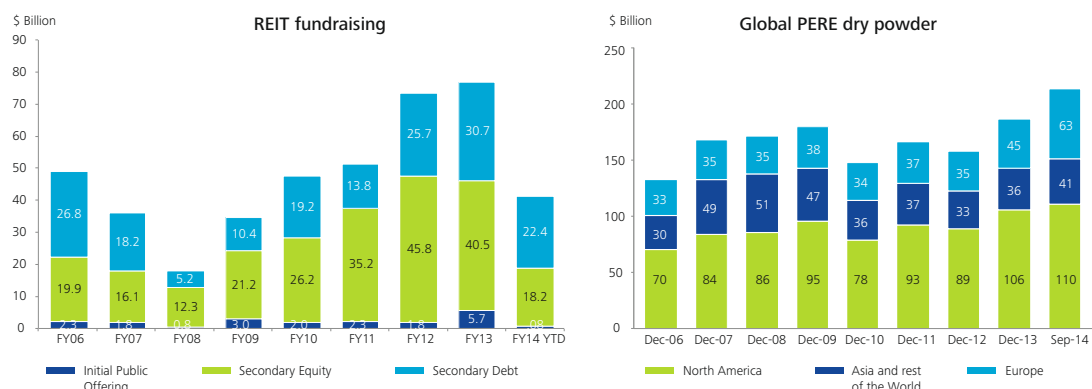
The CRE sector continues to post strong returns, resulting in significant investor interest. After a period of lower returns in 2013, REITs bounced back in 2014 with relatively better returns against benchmark indices such as S&P 500 and the Russell 2000. PERE funds have continued to raise more capital on a YOY basis, reflecting investor confidence in U.S. CRE.

REITs

REIT fundraising declined 23.5 percent YOY to \$41.3 billion as of August (Figure 6). The lower issuance is primarily due to REITs' preference for raising capital through asset disposition as property prices continue to head north.

From a performance perspective, REITs have had a strong year so far, unlike the last one. At September 23, YTD returns for the FTSE NAREIT All REIT Index totaled 13.1 percent, compared to 8.9 percent for the S&P 500, 2.9 percent for the Dow Jones Industrial Average, and -3.0 percent for the Russell 2000 (Figure 6).¹⁹ Strong fundamentals have contributed to the equity outperformance through the year. Further, existing corporate governance practices are increasingly influencing investors' investment decisions. In this context, REITs continue to improve their corporate governance practices, specifically with respect to including/adding independent directors, eliminating staggered terms for board members, and publishing board

Figure 6: REIT fundraising, PERE dry powder, and returns by asset class



Returns by asset class	FY09	FY10	FY11	FY12	FY13	FY14 YTD*
Public REIT (All REIT Index)	27.5	27.6	7.3	20.1	3.2	13.1
S&P 500	26.5	15.1	2.1	16.0	32.4	8.9
DJIA	18.8	11.0	5.5	7.3	26.5	2.9
Russell 2000	27.2	26.9	-4.2	16.4	38.8	-3.0

* FY14YTD for REIT fundraising is as of August 2014 and for returns is as of September 23, 2014
Source: NAREIT and Preqin, September 2014

guidelines.²⁰ According to a recent survey conducted by the Institutional Shareholder Services, equity REITs ranked seventh among 43 industries on 80 corporate governance factors organized around four broad parameters such as board structure, compensation, shareholders rights, and audit.²¹

The U.S. PERE funds continue to maintain positive momentum of capital raising. In 1H14, they raised approximately \$30.2 billion, an increase of 26 percent compared to 1H13.²² These funds exhibited improved performance with an average internal rate of return (IRR) of 8.1 percent during the year ended March 31, 2014, compared to 6.7 percent in the prior year, driven by the sustained recovery in real estate prices.²³ In addition, PERE dry powder available for investment in North America continued to swell and aggregated \$110 billion, accounting for 51.4 percent of the global total.²⁴ Overall, PERE funds continue to have a high risk appetite, as 85 percent of U.S. PERE funds that closed in 1H14 used a value-added (54 percent) or opportunistic strategy (31 percent).²⁵

Focus for 2015

REITs as an asset class will continue to remain attractive in the near to medium term given a healthy operating environment. Notably, they now provide additional diversification opportunities with the advent of **nontraditional**²⁶ and single-family home REITs. However, there is uncertainty being generated by the U.S. Treasury Department looking at REIT qualifications and the impact on REIT conversions, as well as potentially broader portions of the REIT industry, remains to be seen. This may act as a potential headwind to investments in this asset class.

PERE fund managers plan to commit more capital — according to a recent Preqin survey, 37 percent and 26 percent plan to invest significantly and slightly more capital, respectively, over the next 12 months.²⁷ There are also likely to be more recycling of capital through exits and capital reinvestments due to improved financing conditions, robust transaction activity, and strong property valuations.

The bottom line

REITs will continue to benefit from the favorable transaction pricing and financing environment, as well as generally improving rental growth and occupancy fundamentals. Companies will potentially benefit from monitoring the developments around the REIT qualification guidelines, assess its potential impact on their business, and take appropriate action.

PERE funds also have a favorable financing environment with easy debt availability. This will likely lead to an increase in transaction activity in both core and non-core markets. As such, competition is on the rise and fund managers will likely search for value and attractive opportunities across wider markets and/or property types.

Financing

Innovative funding options increase financing availability



CRE financing is certainly more buoyant compared to a year ago, with lenders increasing commercial mortgage issuance on the back of improved property valuations and an active transaction pipeline. Unlike last year, we are seeing a broad-based recovery where lenders are increasingly competing for commercial mortgage issuances across all markets — primary, secondary, and tertiary. Further, construction financing is also showing signs of revival, albeit at a slow pace.

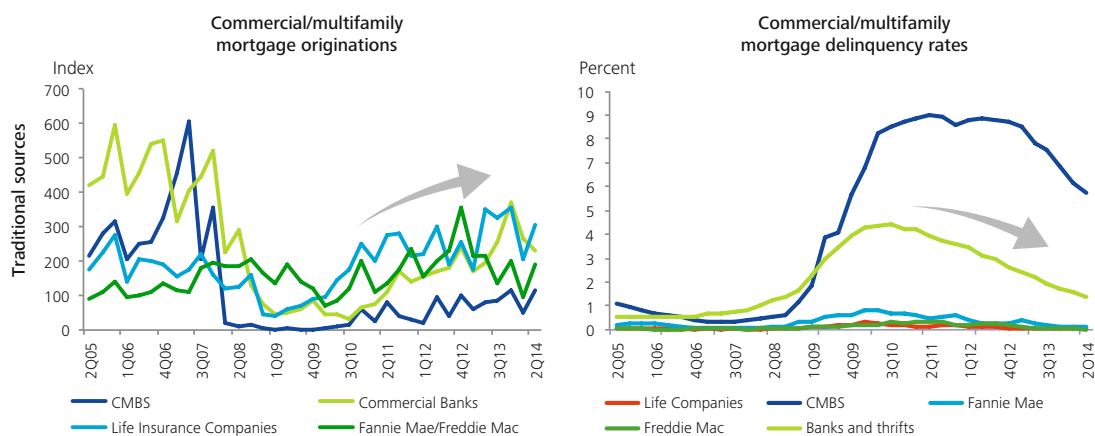
Lending scenario — Banks and CMBS

Compared to a year ago, banks continue to ease lending standards on CRE loans, including construction financing, although it varies by purpose and loan terms such as size and maturity.²⁸ As a result, commercial mortgage origi-

nations (CMOs) registered an 18.9 percent YOY growth in 2Q14.²⁹ Regional and community banks marred by troubled mortgages and confined to class “A” markets until last year are now going beyond core opportunities, driven by healthier balance sheets and increased risk appetite. The increase in bank lending has been supported by improved loan performance as visible in lower delinquency rates of 1.4 percent in 2Q14 — a 78 bps YOY decline.³⁰ (Figure 7)

Recovery in commercial mortgage backed securities (CMBS) markets, which accelerated in 2013, seems to have halted with 12.6 percent YOY decrease in issuance through August 2014 to \$49.3 billion.³¹ This is likely due to increased uncertainty around resolution and loss severities of \$346 billion of CMBS maturing in the next three years, much of which was issued in 2006 and 2007.³²

Figure 7: Traditional and nontraditional financing trends and options



Non-traditional sources

Green bonds
 CRE companies have started to issue innovative fixed-income instruments such as green bonds. These bonds now provide access to low-cost and long-term debt capital for CRE companies to pursue their sustainability initiatives.

Crowd funding
 CRE companies, especially the private ones, are using crowd funding, which essentially provides a mechanism to raise capital for diverse project needs directly from accredited investors.

Source: Mortgage Bankers Association, September 2014 and Deloitte Center for Financial Services analysis

Alternate financing sources

CRE players are also considering innovative ways (Figure 7) to fund specific requirements. One such source is **green bonds**, which are fixed-income instruments that tie bond proceeds to environment-friendly investments.³³ In 2Q14, a couple of CRE companies issued green bonds totaling \$700 million to finance their sustainability efforts, such as construction or retrofitting of buildings to make them LEED certified.³⁴ These bonds now provide access to low-cost and long-term debt capital for CRE companies to pursue their sustainability initiatives.

Another innovation is crowd funding, which essentially provides a mechanism for private CRE players to raise capital for diverse project needs directly from accredited investors.³⁵ This financing mechanism got a boost from the 2012 Jumpstart Our Business Startups Act. Within a span of two years, real estate firms and new entrepreneurs have set up a dozen crowd funding firms, specifically targeting real estate project financing. Real estate is one of the leading sectors leveraging crowd funding, with \$135 million of capital raised through June 2014.³⁶

Focus for 2015

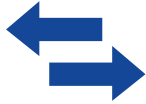
We expect regional and community banks to increase lending outside of primary markets, given their improved financial positions. Hence, we expect a further strengthening of the overall CRE lending environment, with large banks likely increasing CMOs as delinquency rates trend down. Also, with CRE players exploring new financing options such as green bonds and crowd funding, it will be interesting to see if competition intensifies among traditional and nontraditional lenders. That being said, nontraditional funding options run the risk of getting more regulated as the market evolves. For instance, crowd funding is coming under the lens of the Securities Exchange Commission and the Financial Industry Regulatory Authority to protect the interests of small investors. Further, maturity concerns and increased competition from regional and community banks will likely affect CMBS lenders. In summary, we believe it will likely be a win-win for the CRE industry, especially as lenders continue to ease standards for construction loans.

The bottom line

The robust financing environment is likely to benefit for the broader CRE market as players can not only refinance their existing mortgages at favorable terms but also have improved access to financing for a broader range of deals across various markets. An improved lending scenario is likely to increase investments for both developed and under-construction properties. Companies can leverage the newer sources of funding for targeted objectives such as sustainability investments. However, they also need to exercise caution as these sources come with their own quirks. For instance, green bonds require issuers to increase disclosure and transparency about sustainability goals and targeted use of funds to meet the stated objectives.

Transaction activity

A sweet spot driven by a broad-based recovery in deals and pricing



Transaction activity continues to be the highlight of this CRE recovery, with solid growth in both primary and secondary markets. In fact, capital availability is increasing competition as both domestic and international investors show significant interest in CRE as an asset class. Consequently, asset pricing continues to show sustained growth.

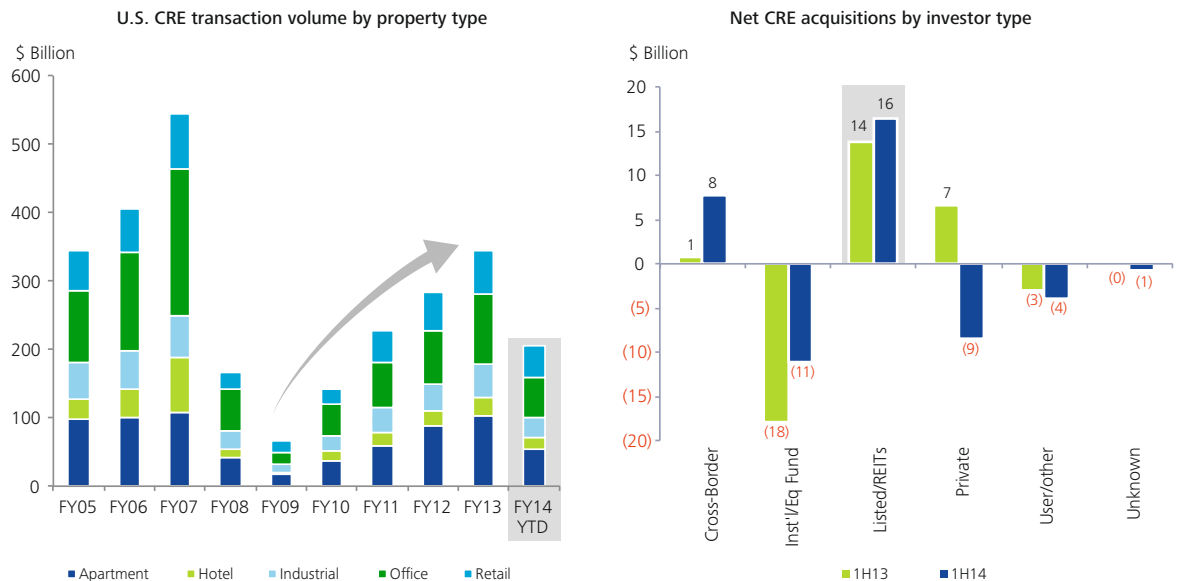
Transactions and pricing update

U.S. CRE transaction volume (Figure 8) grew 16.4 percent YOY in the first seven months of 2014 to \$204.2 billion, driven by REITs and international investors.³⁷ Similar to 1H13, REITs and cross-border investors (Figure 8) continued to lead in terms of net investments in 1H14, which aggregated to \$16.5 billion and \$7.8 billion, respectively.³⁸ Within the broader REIT subsector, non-traded REITs have

done significant asset purchases and provided individual investors an opportunity to own income earning CRE. Further, secondary markets have seen a strong pick-up in activity across property types, as investors seek opportunities in markets less competitive than the primary gateway markets.³⁹

By property type, retail led the growth with a 40 percent rise in property sales in the first seven months of 2014,⁴⁰ as companies reposition portfolios by divesting underperforming assets and reinvest the proceeds in updating existing centers to attract new tenants and improve customer traffic. However, apartment sales seem to have cooled off a bit, being the only property to register a sales decline during the same period.⁴¹

Figure 8: CRE transactions by property and investor type



*YTD through July 2014
Source: RCA, August 2014

The overall favorable transactions landscape continues to have a positive impact on asset prices as shown by Green Street Advisors' Commercial Property Price Index, which rose 6.2 percent in the first eight months of 2014 and is up 11.3 percent from the 2007 peak.⁴² Cap rate compression across property types continues to drive higher asset prices.⁴³

Distressed asset holders have been the beneficiaries of the significant investor interest and strong pricing environment. The outstanding distressed CRE of \$64.4 billion as of 1H14 (18.7 percent of the 2013 transaction volume of \$343.8 billion) is significantly lower than the \$97.2 billion at the end of 1H13 (34.2 percent of 2012 transaction volume aggregating \$284 billion).⁴⁴

M&A activity

M&A activity declined by 50.3 percent YOY in the first seven months of 2014.⁴⁵ This follows a rather strong year of M&A activity in 2013 as many companies sought to leverage discounted valuations in the listed REIT space, resulting from a rise in interest rates after the [Federal Reserve's decision to taper its quantitative easing program](#). In fact, at the end of 2013, all property sectors, except hotels and health care, were trading at a discount to their net asset values.⁴⁶ In addition, there is an increase in spin-off activity, especially by REITs, as they capitalize on the healthy transaction market to refine their portfolio.⁴⁷

Focus for 2015

We expect disposition activity is likely to continue in 2015 as CRE players evaluate and reposition their property portfolios in light of changing tenant demands and low development activity. In addition, we expect increased reinvestment activity by PERE investors as they find opportunities to liquidate their legacy investments with relative ease. Overall, transaction activity will likely continue to rise in 2015 with improving fundamentals and easier capital availability. This will likely benefit secondary and tertiary markets and distressed assets as numerous investors are moving up the risk curve in search of higher yields, given the increased competition and cap rate compression in primary markets.

The bottom line

CRE companies can take advantage of the robust transaction and pricing environment to reassess their portfolios. Companies can begin with a thorough due diligence of their existing portfolio, identify the non-accretive properties for disposal, and eventually plan new developments, redevelopments, and/or acquisitions. Players will potentially benefit from capitalizing on the improved liquidity in the secondary and tertiary markets as competition will likely continue to intensify in prime markets. Many companies can also take the spin-off route to retain a portfolio of core properties while carving out non-core properties into a separate entity to simplify and focus their company. This is a visible trend among large retail real estate players that can be considered by others as well.

Property-specific fundamentals

Tenants' sustainability focus and technology use redefines space demand and supply



Leasing activity continues to gain momentum. As a result, CRE fundamentals, including rent growth and occupancy levels, are now witnessing sustained improvement across property types (Figure 9). Technology and sustainability measures are increasingly influencing tenants' leasing decisions and vary across most property types. Increasingly, tenants are considering the positive impact of sustainability measures on employee morale, productivity, and well-being. According to the 2013 World Green Building Council report titled "The Business Case for Green Building," certain design attributes of a green office building enhance occupant health and well-being, therefore resulting in healthier, happier, more satisfied, and ultimately more productive workers. Consequently, CRE owners need to assess the usability of existing space and new supply in context of the changing demand dynamics.

Industrial

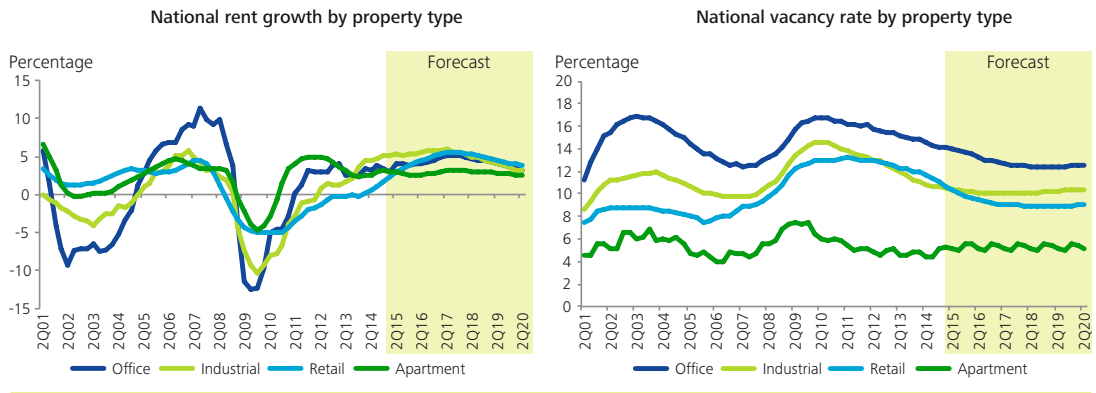
Increase in online shopping, international trade, and manufacturing activity continue to have a positive impact on industrial fundamentals — rent growth for industrial space inched up to a solid 4.5 percent in 2Q14 from 1.6 percent in 2Q13, and vacancy declined to 10.8 percent, compared to 11.9 percent during the comparable prior year period.⁴⁸ Net absorption was a strong 53.4 million square feet in 2Q14, compared to 49.4 million square feet in 2Q13.⁴⁹ The increased use of technology and online sales in particular is redefining the supply chain. As omni-channel retailers with e-commerce activity focus on speed of delivery to improve competitiveness, location of the warehouse and distribution centers is likely to play a more critical role than before. Warehouse owners should collaborate and plug into the tenants' supply chain and strategically determine location for new developments. Further, industrial real estate owners need to be more flexible and responsive to the dynamic inventory levels and space requirements of

their tenants, which implies a focus on size and design of warehouse and/or distribution centers. This will require extensive use of technology to build adaptable warehouses and distribution centers, specifically using advanced supply chain and automated warehouse management systems.

Retail

Retail vacancy and effective rents improved as higher consumer confidence led to an increase in spending. Vacancy was down 50 basis points YOY in 2Q14 to 11.7 percent⁵⁰ and effective rents increased 0.5 percent YOY, which is better than the 0.2 percent YOY decrease in 2Q13.⁵¹ Further, retailers are embracing technology like never before to enhance both their brand and customer experience. Physical stores continue to remain core to creating an innovative and long-lasting shopping experience. Unlike the past, retailers position physical stores differently and consider them to be a part of the seamless omni-channel customer engagement model, rather than the "only channel." Commonly referred to as concept stores, they blend physical inventory, online access, and experiential retailing to customize and enhance the customer experience. With the focus on converting existing stores into concept stores, real estate owners will have to support technology-enabled retailing. For this, companies need to partner with tenants to understand their technology needs and incorporate them as integral to store redesign. The retail real estate sector is experiencing a spurt in redevelopment activity compared to new construction. A case in point is the contraction in net absorption to 7.4 million square feet in 2Q14 compared to 9.6 million in 2Q13.⁵² CRE companies will also potentially benefit from continued increase in the use of mobile, social media, and predictive analytics to drive customer traffic in continuous support of their tenants' **customer engagement strategies**.

Figure 9: Fundamentals and technology and sustainability trends by property type



Tenants' sustainability focus and technology use redefines space demand and supply



Source: CB Richard Ellis — Econometric Advisors (CBRE-EA), August 2014, and Deloitte Center for Financial Services analysis

Office

Improved business sentiment and employment prospects have led to sustained recovery in office vacancy rates and rental growth. In 2Q14, vacancy rates and rental growth were 14.5 percent and 3.1 percent (compared to 15.2 percent and 2.5 percent, respectively, in 2Q13),⁵³ and net absorption was approximately 15.4 million square feet (compared to 10 million square feet as of 2Q13).⁵⁴ However, new development activity is likely to remain low as tenants continue to focus on flexible work spaces through efficient space utilization. Therefore, office property owners will potentially benefit from including design features that meet their tenants' flexibility and sustainability requirements, as redevelopment and refurbishment of existing space will likely prevail in the near to medium term.

Multifamily

The improving job scenario continues to support apartment-sector performance, with vacancy rates down to 4.4 percent in 2Q14 compared to 4.6 percent during 2Q13.⁵⁵ However, rent growth was 2.6 percent compared to 3.1 percent in 2Q13.⁵⁶ Net absorption totaled 145,429 units compared to 119,805 units in 2Q13.⁵⁷ The sector continues to witness a strong development pipeline. This will likely be supported by changing tenant preferences for multifamily homes over single-family ones, particularly among younger and older generations, in the medium term. While apartment owners/operators are comparatively less impacted by the onslaught of technology from a demand-supply perspective, they need to continue to leverage it in the leasing and tenant service processes to establish better rapport with existing and potential tenants.

Lodging

The lodging sector continues to post strong growth. In 2Q14, higher occupancy (+3.6 percent YOY to 68.1 percent) and average daily rates (+4.4 percent YOY to \$115.5) led to an 8.2 percent YOY growth in revenue per available room.⁵⁸ However, hotel owners should consider

adopting technology to offer innovative designs such as door lock technology (smartphone or finger print-enabled access) and in-room content (lighting and temperature control), among others.⁵⁹ This is important as competition from nontraditional and new players such as Airbnb⁶⁰ could potentially disrupt the industry in the long term.

Focus for 2015

Overall, in 2015, CRE fundamentals will likely demonstrate moderate and sustained growth across all property types, with improvements in vacancy, rent, and absorption levels. While construction activity will continue to pick up, it is unlikely to see the pre-recession heights across many property types (except hotel and multifamily). This is because of relatively lower demand for new space driven by tenants leveraging technology and more efficiently using existing space. Ultimately, CRE players will potentially benefit more from allocating resources to newer formats and design for redeveloping existing property than just solely focusing on new construction.

The bottom line

To maintain a positive momentum of rental growth and occupancy in the medium to long term, CRE players should change their demand-supply assessment and factor in the influence of technology and competition from new and innovative players along with traditional macroeconomic factors. While development activity is beginning to show signs of life across many property types, redesigning of existing space will likely be dominant. CRE players should consider using predictive analytics to conduct tenant and/or end-customer demography analysis, understand their needs and preferences, and determine demand for new or redesign of existing space. Thereafter, CRE players should increasingly collaborate with potential and existing tenants at the design stage to understand their technology needs and incorporate them as an integral part of design and/or redesign.

Sustainability

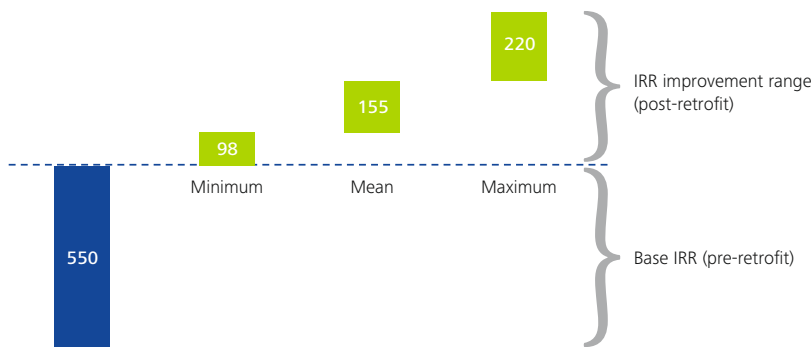
Adoption, measurement, and reporting is a business imperative



Sustainability initiatives have a significant bearing on CRE operations, which manifest themselves in various forms — environment, portfolio performance, top and bottom line, asset values, stakeholder engagement, and brand perception. Among other things, buildings with relatively better sustainability credentials tend to enjoy increased marketability to both tenants and investors.

have lower sensitivity to energy and operational and maintenance cost savings compared to top-line benefits arising from higher rental and occupancy rates and an eventual rise in property values. Further, the relatively higher LTV ratios provided to finance a LEED-certified building have a significant impact on the post-retrofit IRR of the equity investment.

Figure 10: IRR improvement post sustainability retrofit (in basis points)



Source: *IRR represents the unlevered internal rate of return on the overall building investment.
Source: Deloitte Center for Financial Services analysis

There is an increase in awareness and implementation of sustainability initiatives aimed at energy, water, and waste efficiency as indicated by the growth in green building certifications. That being said, the incremental cost of greening an existing building continues to influence sustainability decisions of many CRE players. A Deloitte Center for Financial Services analysis (Figure 10) of retrofitting an existing office building with sustainable measures suggests that CRE owners are likely to have broader benefits and higher IRR from their green investments than from comparable but non-sustainable investments. The study also suggests that the overall returns of a building

According to Jon Lovell, director of sustainability, Deloitte Real Estate, United Kingdom, "strong sustainability performance has become a prerequisite for prime market expectations of quality, and the narrowing of capital flows to core product in recent years has arguably inflated values to the extent that some of the subtleties of sustainability performance have become hidden in the competition for stock. Moreover, it is reasonable to expect that rental growth will be more heavily suppressed in properties in which energy and other utility costs are high compared to rental levels. In this sense, sustainability is driving a greater divergence between prime and non-prime property. That said, these effects remain clouded by a deficit in proper in-use performance data across the sector."

Along with adopting sustainability measures, it is equally important for companies to measure internally and report externally (implementation and results) in a credible and reliable manner, and in accordance with recognized frameworks that demonstrate commitment to transparency around sustainability performance. For instance, investors require increasing levels of disclosure of credible narrative and nonfinancial information and greater rigor in related risk management processes.

The impact of measurement and reporting is also visible on brand value. Impact on brand value is at two levels — building and enterprise. This impact will vary across companies, and each CRE company needs to have the right metrics in place to measure its green performance.

Focus for 2015

Looking ahead, the combined demands of occupiers, investors, and regulators are such that tangible benefits can be derived from embedding sustainability into the full investment process. A range of property value fundamentals such as rental growth, yield premiums, total occupancy costs, and the like are increasingly sensitive to sustainability factors.

According to Jon Lovell, "Critically, value impacts are, and will continue to be, property specific, influenced as they are by local market context, tenant and leasing profiles, and climate conditions. We have every expectation that, as reliable data becomes more widespread, the transparency of real estate performance will increase and more informed capital pricing and rental decisions can be made."

As the wider market begins to transition toward integrated reporting, an opportunity exists for the CRE industry to further reinforce the value it delivers to investors as a result of the interface between the financial and nonfinancial aspects of its business processes. We therefore expect positive engagement with integrated reporting principles to be the next vanguard for sustainable business practices for the CRE sector.

The bottom line

Three critical factors to improve measurement and reporting of sustainability practices are awareness, analysis, and action. According to Will Sarni, director and practice leader, Enterprise Water Strategy, Deloitte, "It may not be long before all of these sustainability-related measurement trends become standard operating practices. As a business leader, what should your company begin doing now to get ready?" Hence, CRE players should put processes in place that drive environmental performance, which reinforce or enhance investment returns. In addition, companies need to embed enterprise sustainability risk management into core investment processes, and across the entire property life cycle. Further, companies should focus on quality over quantity i.e., disclosing the right metrics rather than a large volume of metrics, of which many may be redundant. Numerous industry organizations (Sustainability Accounting Standards Board, Global Reporting Initiative, and Carbon Disclosure Project) lay down the guidelines for measurement, reporting, and disclosure. In fact, these guidelines also highlight the market expectations from green buildings in general.

To read more about sustainability, please refer to our report [Breakthrough for Sustainability in commercial real estate](#) and our blog [Sustainability in commercial real estate: Walking the green talk](#).

Technology and automation

Adoption integral to enhancing tenant engagement

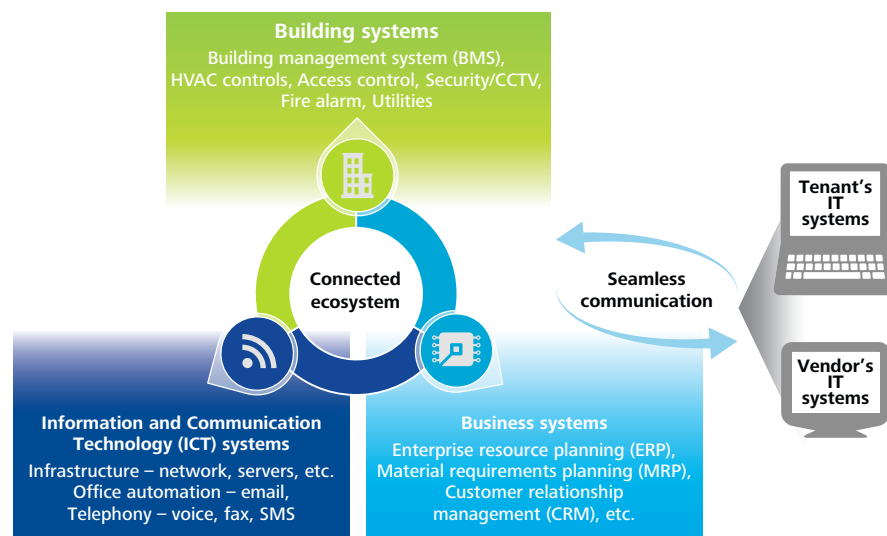


Technology-enabled operating efficiency and mobility are factors driving fundamental shifts in the CRE industry. For instance, mobility continues to significantly influence people's behaviors related to how one works, where one lives, and how one shops. As a result, a radical change has occurred in the need for physical space and the approaches used to engage and retain tenants. This requires companies to collaborate with their tenants beginning at the design/redesign stage to determine the latter's unique technology needs.

CRE owners can potentially implement smart building technology for maintenance and operations. This can help them realize the benefits of low-hanging fruit such as operational efficiency and cost savings through improved energy efficiency and reduced personnel costs, among other things. As such, CRE owners may be at a competitive disadvantage by relying on manual and traditional processes in building design and maintenance.

CRE owners are beginning to implement technology-enabled solutions at a building-level, although on a piecemeal basis. Some of the commonly implemented solutions pertain to HVAC, lighting, and/or safety systems. As building automation advances, CRE players can derive greater benefits beyond the above-mentioned low-hanging fruit by increasing connectivity among various electronic systems. Referred to as intelligent buildings (Figure 11), it implies integration between building management, communication technology, and business systems. As a result, companies can get a comprehensive and real-time view about various facilities and better adapt needs per the requirements of specific tenants and buildings. In addition, inter-linkage with other IT systems can aid real-time reporting and efficient portfolio management through better availability of information from various sources at the same time and place.

Figure 11: Intelligent buildings framework



Source: The Institution of Engineering and Technology, UK, and Deloitte Center for Financial Services analysis

Next, as tenant retention is largely driven by interactions and relationships between landlords and tenants, mobile and social media (Figure 12) can act as the perfect tools to increase tenant engagement. Social media adoption is gaining traction, as highlighted by 46.3 percent of the 1,400+ respondents to a polling question for a September Deloitte Dbriefs Webcast titled “Technology in Real Estate: Time to Cover New Ground.” Importantly, mobile and social media can be used effectively to enhance employee engagement as well. According to the 1,400+ responses to another polling question of the same Dbrief, nearly 28 percent use social media to interact with employees.

Further, CRE companies are generating a large amount of data through multiple sources — internal and external such as market data, tenant property use through security passes and customer information generated through social media. And capturing, storing, and analyzing large sets of structured and unstructured big data appropriately and in real time can be used to identify business trends and opportunities (Figure 12). While this sounds simple, having the appropriate technology is critical to derive maximum benefits from large sets of data. Particularly, until very recently, data commonly resided in multiple, disparate systems — inside and beyond the firewall, which made it difficult to conduct meaningful analysis. Consider the case wherein retail property owners are using footfall technology that tracks movement of people into their property. Mining this data can help companies understand consumer behaviors, sales per store, and conversion rates per store in real time and appropriately drive rent increases.

Next, cloud computing (Figure 12) is helping CRE companies drive agility and scalability in a cost-effective manner. Typically, relatively less critical information is stored on the public cloud, whereas mission-critical data is hosted on the private cloud. Hence, a hybrid approach, using a mix of public and private cloud, can be an effective strategy for CRE companies.

Figure 12: Leveraging new technologies



Source: Deloitte Center for Financial Services analysis

Focus for 2015

Resistance to technology adoption remains, although the sector has increased its overall technology focus in the past few years in response to opportunities to drive more efficient operations and increase connectivity to tenants. Companies will likely increase their investments in intelligent buildings, as highlighted by the U.S. building automation systems market, which is expected to grow by 7 – 9 percent annually during the 2014 – 2017 period to \$2.2 billion by 2017.⁶¹ Further, according to the September Deloitte Dbrief, nearly 69 percent of the 1,100+ respondents to a polling question related to technology transformation foresee transformation over the next year or two. We believe this may include an increase in the adoption of one or more technologies. As technology adoption advances, CRE owners can consider using a combination of cloud, social media, big data analytics, and mobility to drive more informed decision making rather than on a stand-alone basis. Further, CRE owners should also ensure appropriate security and privacy measures for every technology adoption.

The bottom line

Adopting more advanced technology is rapidly becoming an imperative in CRE. Companies need to have a structured big data strategy that should be teamed with advanced analytics, business intelligence, and visualization that provides insights for strategic planning and decision making, and relative trend analysis and correlation to draw actionable insights. Companies at a nascent stage of adoption can begin with educating themselves about the value proposition of each of these technologies. They need to involve a wider array of people in decision making, particularly at three key stages. First, understand and align technology needs with that of the tenants. Second, assess the value proposition of these new technologies. Third, decide on the required systems from the multitude of options available in the marketplace, keeping scalability and adaptability in mind. Ultimately, CRE companies need to be progressively aware of new advancements in technology, and anticipate and step up adoption on a regular basis. They also need to ensure use of appropriate risk frameworks to manage any potential security and privacy concerns, which we will discuss in more detail in the next section. Having said that, companies will need to develop a customized plan for individual as well as overall technology adoption as a “one-size-fits-all” approach is unlikely to work.

Security and privacy

Appropriate measures important for successful technology adoption



As is the case with using any technology, security and privacy concerns tend to affect CRE players' decisions related to adoption, upgrade, and maintenance. This is because an increase in technology use within an organization and in automating building management results in inter-linkages between systems of property owners, tenants, and vendors. Information is now available through multiple entry points, and property owners and their tenants are vulnerable to cyberattacks such as information security breaches, hacking, malware, and viruses. For example, at a building management level, CRE companies currently focus more on the security of building management systems and less on the potential threat of information loss through cyberattacks.

Companies should manage three broad areas of vulnerability (Figure 13) at an entity and building management level:⁶²

- **Access management:** Ensure that only authorized users are able to access the company's data or IT assets. With the advent of new technologies that allow anytime, anywhere availability, access management has become more complex.
- **Safeguarding personally identifiable information (PII):** Real estate companies, like many other companies, deal with sensitive data, including confidential tenant, vendor, and employee information. Companies need to protect the PII that is stored within their firewalls as well as prevent access to interconnected tenant and vendor systems. Perpetrators are conducting attacks and aggregating PII through diverse channels such as social media sites, mobile devices, and offshore cloud service providers. According to the 2013 Trustwave Global Security Report, out of 450 global data breach investigations, 63 percent were due to lax security with third-party providers of IT services.⁶³
- **Software vulnerability:** This is another important area over which companies may have less control. For instance, applications and software downloaded on different electronic devices, networks, and applications used by employees and vendors can potentially divulge PII and other data, including calendars, contacts, and passwords, to unknown perpetrators. In addition, software vulnerabilities across systems and devices provide opportunities for hackers to introduce malware into companies' systems.

Figure 13: Security and privacy framework



Focus for 2015

We expect companies to be exposed to new and complex risks as they step up their use of new technologies in 2015. Across these technologies, access management, loss of PII, and/or software vulnerability risks can have different manifestations. Use of the cloud involves risks through modes of data storage. For instance, the public cloud moves data management outside a company's walls and reduces direct control. Mobile and social media use provide an opportunity for perpetrators to steal sensitive information, introduce malware into company systems, or inflict reputational damage. The ongoing trend of bring your own device, commonly referred to as BYOD, potentially adds to the complexity as employees connect to unknown networks and applications. As CRE systems become more interconnected with systems of tenants and vendors, enhanced cybersecurity will become necessary to protect not only CRE company information and systems, but also to prevent unintended access to or information loss from tenant and vendor systems. It is important for CRE companies to appropriately secure data as any breach will have ramifications such as tenant loss, reputational damage, regulatory investigations, and privacy law violation penalties.

The bottom line

CRE companies can consider taking a step-by-step approach (Figure 13) to address the above-mentioned security and privacy concerns. To begin with, companies should develop a robust and comprehensive security and privacy framework, with specific strategies for unique risks related to individual technologies to be secure, vigilant, and resilient. For example, companies can consider appropriate tools for advanced user authentication; applications and data encryption; malware protection; and rigorous threat monitoring systems. Next, companies need to increase employee awareness by proactively educating them about the importance of strong passwords to reduce system vulnerability and accessing seemingly unsecure content or downloading freely available external apps. Third, companies should have a business continuity plan whereby, in case of a hacking incident, systems and processes can be restored with minimal business disruption and appropriate communication protocol is followed with partners, clients, regulators, and law enforcement agencies. Similar to technology adoption, a one-size-fits-all approach will likely not work with implementing security and privacy measures. Hence, it will be critical for companies to identify the appropriate course of action based on different assessment criteria such as size and complexity of the organization, interconnections with tenant and vendor systems, existing security systems, and plans to adopt new technologies.

Regulations

Continued uncertainty!



CRE players are currently dealing with varied regulatory issues that can have a direct impact on the industry from a tax, insurance, and accounting perspective.

Terrorism Risk and Insurance Act (TRIA)

The impending expiration of TRIA continues to be a top regulatory consideration for the CRE industry as the renewal stalemate in Congress continues. While the Senate passed a TRIA reauthorization bill in July with a clear majority, the House has proposed stiffer conditions to trigger a federal backstop for insurers.⁶⁴ Based on their recommendations, different scenarios can play out, which will potentially have a different impact (Figure 14) on both new and ongoing project financing.

Figure 14: Potential scenarios for TRIA and likely impact

TRIA — Scenarios	Likely impact
Renewed — Senate proposal accepted	↑
Renewed — House proposal accepted	↘
Renewed — A mix of Senate and House proposal passed	↘
Not renewed	↓
Short-term extension	↓

Source: Deloitte Center for Financial Services analysis

To begin with, the Senate proposal is very close to the existing regulation and if enacted will likely cause minimal disruption. The House proposal, on the other hand, suggests a smaller backstop for insurers, which, if passed, will increase insurance costs for CRE players.

A third scenario could be a compromise with elements from both proposals. In such a case, terrorism insurance costs will still rise, albeit potentially lower than in the prior scenario.

A fourth scenario, and one with the most far-reaching implications for the CRE industry, is letting TRIA expire. Such a situation may create a double whammy for the industry as not only will coverage become more expensive and/or unavailable, but financing will also, as a result, be hard to come by or significantly more expensive for the existing \$1.6 trillion⁶⁵ in CRE loans scheduled to mature in the next five years.

There is also a fifth scenario, wherein Congress may pass a short-term extension so that the program does not expire, giving more time for lawmakers to work out a longer-term agreement. However, that would leave both the insurance market and CRE policyholders in limbo and have many of the same effects as if TRIA was allowed to expire altogether.

Foreign Investment in Real Estate Property Tax Act (FIRPTA)

The long-awaited FIRPTA reform continues to gain prominence given the rising foreign interest in U.S. CRE and increased government focus on promoting infrastructure investment and job creation. In addition to the earlier proposal of doubling the maximum tax-exempt foreign stake in public REITs from 5 percent to 10 percent,⁶⁶ another proposal is to allow the sale of foreign ownership interests in domestically controlled REITs to be treated as sales of stock, effectively exempting them from taxation.⁶⁷ If and when passed, these measures will likely result in U.S. CRE attracting more foreign investments (Figure 15).

Corporate tax reforms

In February 2014, the House Ways and Means Committee proposed a draft bill in an effort to reform and simplify the U.S. tax regime. It includes several proposals that, if enacted, will have a direct impact on the CRE industry. These potential changes include the repeal of the tax deferral provided by section 1031 like-kind exchanges, an extended cost recovery period for real estate, a higher individual tax rate (39.6 percent instead of 25 percent) on recaptured real estate depreciation on a retroactive basis, and the repeal of several other tax deductions, credits, and exemptions.⁶⁸

Put together, the proposed tax reform, in its current form, may negatively impact (Figure 15) the bottom line of CRE companies due to higher effective tax paid and impede liquidity and stability of real estate markets. In addition, it will likely lead to inefficient use of capital, especially for REITs, which have limited ability to retain capital, given the distribution requirements.

Figure 15: Regulations and likely impact

Regulation	Issue	Likely impact
TRIA	Risk of non-renewal	↓
FIRPTA	Higher exemption limits	↑
Corporate tax reforms	Repeal of several tax benefits	↓
Lease Accounting Standards by IASB and FASB	Capitalization of operating leases	↓

Source: Deloitte Center for Financial Services analysis

Lease accounting standards

On the accounting front, U.S. and international standards-setters continue to work on issuance of new guidance that will require tenants to record leases as right-of-use assets and financing liabilities, instead of the “off balance sheet” operating lease treatment used for a majority of current real estate leases. While accounting boards aim to create greater transparency and consistency in lease accounting presentation, industry stakeholders have raised concerns about the potential negative impact (Figure 15) of the new standards on tenant behavior, existing CRE debt covenants, lending, and property valuations.

Focus for 2015

Looking ahead, the imminent uncertainty around renewal of TRIA may end up being an impediment to an otherwise strong lending environment. Some insurers have included sunset clauses that withdraw the terrorism risk coverage in 2015, in the event of the expiry of TRIA by the end of 2014.⁶⁹ In the past, Congress has used a wait-and-see approach on TRIA and extended it at the last minute. However, with diverse proposals in the Senate and House, it will be interesting to see if Congress manages to reach a consensus before year-end and, if it does, the shape of the final act that is passed. The delay in decision on FIRPTA is unlikely to have a significant impact as foreign investors are buoyant enough about U.S. CRE even without these reforms, but relaxing FIRPTA is likely to generate even additional foreign investor activity. While any movement in corporate tax reform is unlikely in 2015, the existence of the proposals creates future uncertainty as some or all provisions may be revived in the future as potential revenue raisers.

The bottom line

With the decision on most regulatory proposals still uncertain, CRE companies can use this time to prepare themselves for different outcomes. Companies can reach out to their insurers and bankers to assess the potential impact on their business across the different possible scenarios for TRIA. With respect to FIRPTA, companies can work with foreign investors to create tax-efficient deal structures, such as investing through a U.S. REIT, which will be a win-win for both stakeholders. Lastly, while companies need not take any immediate action on the proposed tax reforms and lease accounting standards, they will benefit from a thorough due diligence, assessment (scenario-based approach), and development of an implementation plan as these potential reforms move toward finalization.

Where do CRE executives go from here?



The CRE industry is likely to be on a stronger footing in 2015. The sector will likely experience strong capital flows — domestic and international — and availability through traditional and nontraditional sources. This will continue to strengthen transaction activity across primary, secondary, and tertiary markets at attractive valuations. Consequently, companies can take advantage of these trends, harvest gains from improved property valuations and financing conditions, and redeploy capital in development and redevelopment of properties to respond to changing tenant demand dynamics driven by technology. CRE executives can also consider using a wider variety of capital sources to fund targeted areas such as construction or sustainability implementation.

The industry will likely continue to feel the impact of the tectonic shift in the way it does business due to the growing influence of automation and technology on real estate use, design, operations, and service. CRE senior management and their directors should increasingly ask “Why not automate and use technology?” and “Where do we automate and use technology?” rather than “Is automation and technology required?” This will likely be important as technology usage will increasingly determine tenant leasing decisions, asset values, and real estate demand. For instance, companies could potentially benefit from leveraging technology such as analytics to assess tenant and/or end-customer demand and align design/redesign of physical space and enhance service. This may

take the form of improving sustainability implementation, using smart building technology, and/or taking advantage of social media and mobility to attract and retain tenants, or, in the retail sector of CRE, retail customers. Another area where technology use will be critical is improving measurement and reporting of sustainability. Use of predictive analytics will help preempt potential risks, increase transparency, and meet tenant, investor, and regulator expectations. And while companies plan technology adoption across various business lines and functions, it is critical that they consider appropriate security and privacy measures to safeguard against data breaches and/or cyberattacks.

Another important focus area and an immediate one for CRE executives will be navigating the uncertainty around the renewal of TRIA. Companies will likely want to assess and prepare for a wide range of possible outcomes such as non-renewal, short-term extension, renewal with higher insurance costs, or passage of renewal legislation that maintains TRIA in its current form.

Technology will play a major role in generating differentiated returns, both in proactively responding to the impact technology is having on tenants’ use of real estate, and by embracing technology to improve CRE design and performance. In conclusion, 2015 will be an exciting year for CRE growth, which will be enhanced by innovation.

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