Emerging Trends in Real Estate®

The global outlook for 2016

pwc

Urban Land Institute

Introduction

The *Emerging Trends in Real Estate*® series is one of the key indicators of investor sentiment, and based on surveys and interviews with the most senior property professionals in the United States and Canada, Europe and Asia Pacific.

As in previous years, we have drawn together these regional insights for the global report, highlighting the investment and development trends most likely to shape their respective markets in the year ahead.

With such a rich resource of expertise and experience at hand, the research shines a light on new ideas and thinking that will have have a longer term impact on the real estate sector.

In the global outlook for 2016 we examine the changing nature and target of capital flows from a country-level approach to investment in favour of a highly selective strategy for cities, and not just the usual gateways but the more dynamic second tier cities.

We also analyse the disruptive combination of rapid urbanisation, new technology and social change, which is fostering a more consumer-focused property industry, a transition towards a more data-savvy investor and a changing perception of real estate as a critical part of social infrastructure.

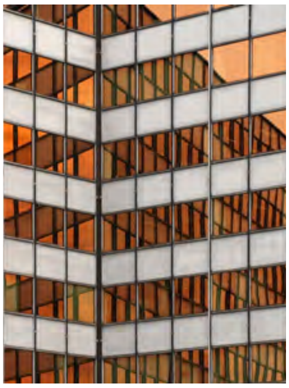
The report includes new interviews with industry leaders from some of the most respected organisations around the world, including APG, KKR, Prologis, Starr International and Unibail-Rodamco.

With the built environment and real estate industry being subject to huge change right now, we hope you find this report illuminating and thought-provoking.

"There is no amount of thinking we can do that will make us as smart as listening to our customers."

Hamid Moghadam
Chairman and CEO, Prologis

Contents


The outlook for the US

The US real estate industry's traditional focus on big cities and large employers is shifting with small businesses emerging as the growth engine for the economy, and as secondary markets move into view.

It is clear that investors are looking beyond the traditional "big six" US markets and favouring cities with better growth opportunities (see page 18) but also, as one broker with a large national office practice points out: "It is an extremely competitive market for placing capital."

That competition is driving money more and more into a discovery process – a process many describe using the term "granularity". Drilling down into markets and submarkets, working with smaller assets within the larger markets, specialised property types—these are all examples of the search to identify thriving niche opportunities.

There are also signs of a shift towards shorter-term horizons in the institutional space, a telling indication that active management is a growing trend following the Federal Reserve's increase in interest rates in December 2015 and some concerns over the US economy since then. "We are trying not to get into long-term investments. Instead, we are looking for investments where the capital returns sooner. The average life of investments should be three to five years," says one pension manager interviewee for *Emerging Trends in Real Estate® United States and Canada, 2016*.

Another interviewee warns: "In an increasingly volatile environment, whether it's weather or it's political instability and terrorism, pooling and sharing of risk is an important way to deal with uncertainty. That costs more. It's going to be an added cost of doing business, but I think it's more important than ever."

With such external factors influencing investor sentiment, this could be a pivotal year for US real estate. The concept of "path dependence" suggests that the movement to secondary markets together with a greater attention to value-add assets, and a still reasonable expectation of continuing US economic expansion, advantages real estate over other investments in the US and abroad.

Here is where the size, depth, and diversity of US real estate markets are of importance. The varying equity sources have distinct capacities, motivations, return requirements, and appetite for risk. It is not as though there is a single ocean of equity capital to be deployed, but instead there are streams of capital flowing to the markets.

The recovery of transaction volumes and pricing during 2015 to pre–financial crisis levels, especially in the gateway markets, is not prima facie evidence of a bubble. Much is different from a decade ago, not least the reduction in the amount of leverage in the market, and both the real estate and banking industries have been assiduous in limiting that risk.

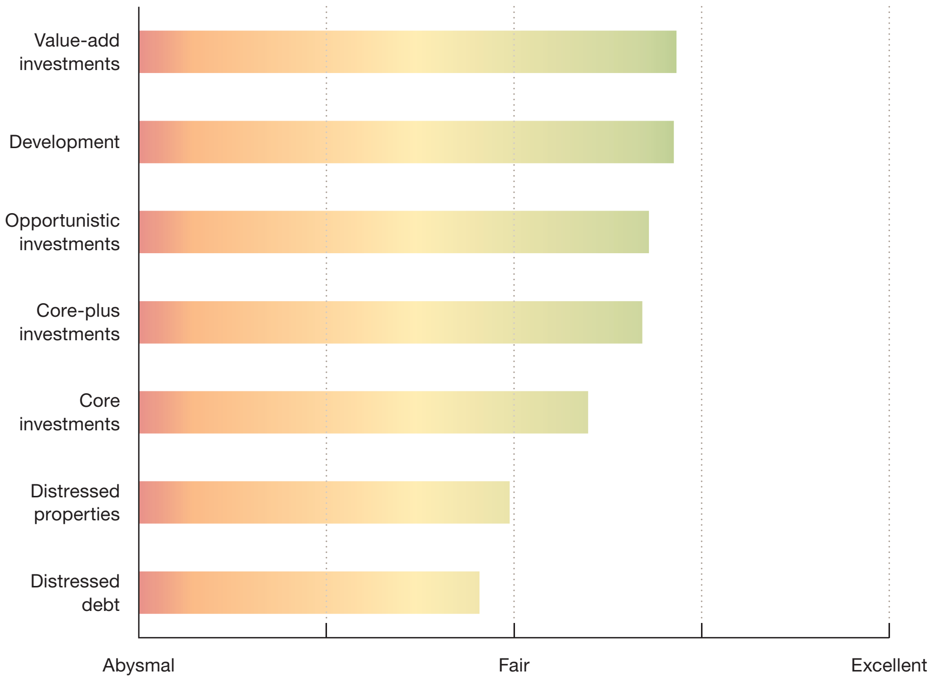
Nevertheless, it is difficult to be entirely sunny when 64 percent of the survey respondents describe the market as oversupplied with equity capital, and 34 percent believe that equity underwriting standards will become less rigorous in 2016.

As investors seek to balance capital conservation with capital growth, it will be harder to characterise investors as exclusively core, value-add, or opportunistic. Rather, the providers and the intermediaries of real estate capital are looking at the entire spectrum, moving deeper into the geography and the property-type mix available in the US.

For 2016 and the remainder of this decade, it seems safe to say that the amassing of capital oriented to US real estate will continue, but at a lesser pace than it has been from 2012 to 2015.

This is an extract from *Emerging Trends in Real Estate® United States and Canada, 2016*. The full report can be downloaded from: www.pwc.com/emergingtrends

Figure 1 **Prospects by Investment Category/Strategy, 2016**



Note: Based on U.S. respondents only
Source: Emerging Trends United States and Canada survey 2016

Ralph Rosenberg, KKR

Ralph Rosenberg is Head of Real Estate at KKR, the global investment firm that manages investments across multiple asset classes, including private equity, energy, infrastructure, credit strategies and hedge funds. The firm has $2 billion of real estate under management.

I am much more excited about investing in this environment than I was six months ago.

The view from the US – KKR

How are the prospects for KKR's real estate business over the coming year?

"The market dislocations that we are all experiencing across all risk assets in the current environment are actually quite constructive for our ability to find interesting real estate investments in 2016. Five months ago I would have complained about how expensive the US markets were, generally speaking, and that it was tough to find interesting ways to invest capital. We only invested in a couple of US deals in 2015, largely due to continued liquidity and capital flows coming into real estate. But now what I think we're seeing is that the real estate markets are very correlated to what's happening with other risk assets, and that is resulting in less liquidity, and therefore less access to debt and equity. Given global uncertainty and volatility, the cost of credit is increasing in this environment and thus the equity risk premium in the market has also gone up. This backdrop is actually quite good for investors like KKR who have capital and who have lots of different sourcing channels to leverage off to create deal flow."

How do you assess real estate against other asset classes?

"Credit spreads have widened in the corporate space as well as in the CMBS market. The cost of risk is higher and that has to translate into a re-pricing of equity risk in the real estate markets. I don't believe we can be sitting here in a world where corporate bond spreads and real estate credit spreads have blown out significantly across the risk spectrum and we can still have real estate trading at 4 percent cap rates. The argument that real estate is a safe, defensive trade might hold some integrity in the market we were in a year ago where relative to where risk assets were pricing, real estate looked like a reasonably good place to be. But now that we've seen other asset classes re-price their risk, in my view, this should translate into repricing in the real estate space."

How do you see that repricing going in KKR's key markets this year?

"Up until 90 days ago, robust global capital flows and a thirst for current yielding assets resulted in yield compression – driving values relative to fundamentals in many instances. I'd put 70 percent of the weight of that pricing on excess liquidity in the global market place and capital flows and money exposure to US assets, and the other 30 percent on fundamental property level performance. Today, the market is starting to re-think both of those components of pricing. There's less capital flowing into the space and capital is being more selective. There have been lots of well-publicised deals that broke down in the Fall, and, for example, Chinese buyers have walked away from assets in London. You cannot ignore the data or the anecdotes that suggest these international capital flows are much more tempered in today's environment. I think the world is also questioning whether or not there are real growth prospects in the US market. The reason the US 10-year Treasury is trading at 1.70 percent is because the market is questioning whether or not there's really going to be sustainable growth in the US economy. And if we're living in an economy where there's little or no growth, generally speaking we're going to see little or no growth in rents. That will result in real estate values being tempered as buyers will not pay for growth upfront. I am much more excited about investing in this environment than I was six months ago, for all of these reasons."

> In terms of investing in value-add assets – that we've been priced out of in the past in those gateway cities – those could be opportunities for us now.

Which global markets and real estate sectors look the most attractive to KKR?

"We are most focused on buying into assets or capital structures where the cash-flow is in place and we can re-invest some of that cash-flow into the asset to create an accretive return on investment. Typically, these will be deals where there has been a lack of active management or where the asset is not strategic to the owner and they're looking to liquidate. And we do feel that we're closer to the end of the US cycle than the beginning so we're trying to invest in assets where the road to stabilisation and creating a more core-type profile is short-dated – 18 to 24 months.

"Historically we've been players in US cities ranked from five to 20 because we've not been able to find interesting deals in the gateway cities. I suspect that over the next year you will see us invest in some of those gateway markets because capital flows are not as voracious as they were six months ago and the pricing of assets is backing up. That doesn't mean we're going to buy core or core-plus assets; that's not our business. But in terms of investing in value-add assets – that we've been priced out of in the past in those gateway cities – those could be opportunities for us now."

KKR is already in healthcare in the US and hotels in the UK; is the group planning to invest more in alternatives given current market conditions?

"In today's environment you're going to see alternative asset classes of real estate that are defensive against a cycle change. I think those alternatives – self-storage, student housing, telecoms-type assets – will hold their value. Other alternative real estate sectors – healthcare and hospitality – are more cyclical in nature or are in markets where there's been oversupply, and where, by definition, the public companies that own these types of assets have repriced dramatically. Those actually might be pretty interesting places to spend some time because values have dropped significantly. We look at any sectors in the market place that have repriced significantly over the last year."

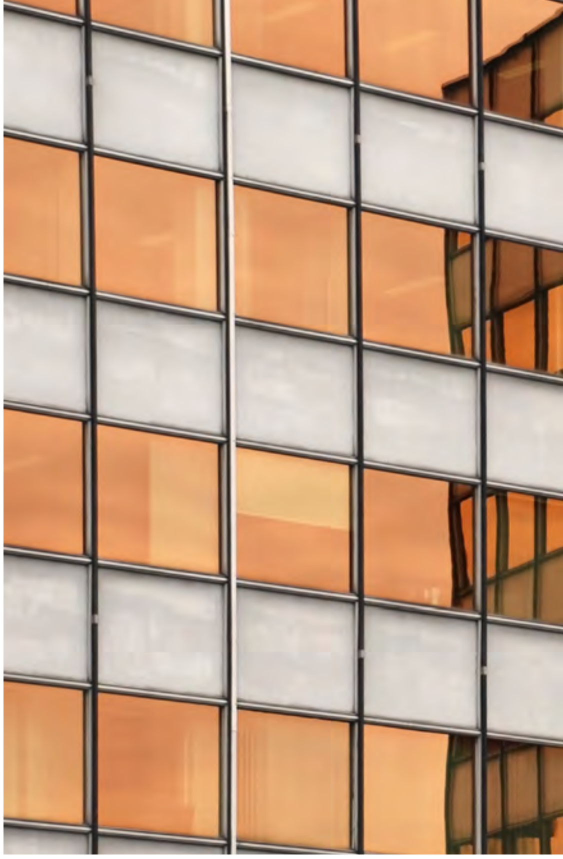
Economic uncertainty has created new opportunities for KKR but is there anything about the current climate that is a cause for greater concern?

"You have to be intellectually honest about what risk exists in the global macro environment and make judgments as to the probability of those risks causing global deflation in the intermediate to long-term or cause recessionary pressures in mature markets like the US or Europe. That's why assets and risks are pricing where they are because there is so much uncertainty in the world.

"On top of the global macro issues you can make it even more complicated by talking about migration into Europe, the risk of the UK leaving the European Union or political risk in Spain. There are lots of risks in the world and the major question is: are we getting paid fairly to invest capital in this market knowing all these risks exist but also knowing that we have a bias that we aren't going to be in a global recession and we're not going to be in a deflationary environment in the US or western Europe? That's just our house view. We're being selective, careful and intellectually honest but I think we are in risk-taking mode in the environment we're in today.

"There is definitely more caution because the world is riskier. But because the world is riskier opportunities have repriced and in my view will continue to reprice and make it a more interesting environment to invest capital today versus six months ago."

The outlook for Europe



Europe's real estate industry remains bullish about its business prospects this year, and though survey respondents to *Emerging Trends in Real Estate Europe 2016* are less confident than a year ago, the belief in the region as a safe haven for global capital persists.

The sheer weight of capital bearing down on European real estate has been a key influence on sentiment, once again boosting business for many of those canvassed for this year's report. As many as 87 percent of them believe that global capital flows will continue to influence their investment strategy over the next five years.

Survey respondents from the recovering economies of southern Europe are the most optimistic about business prospects for 2016. By contrast, there is widespread acknowledgement that markets in northern Europe, particularly the UK, are much further advanced in the property cycle, which has led to some caution in the outlook for the coming year.

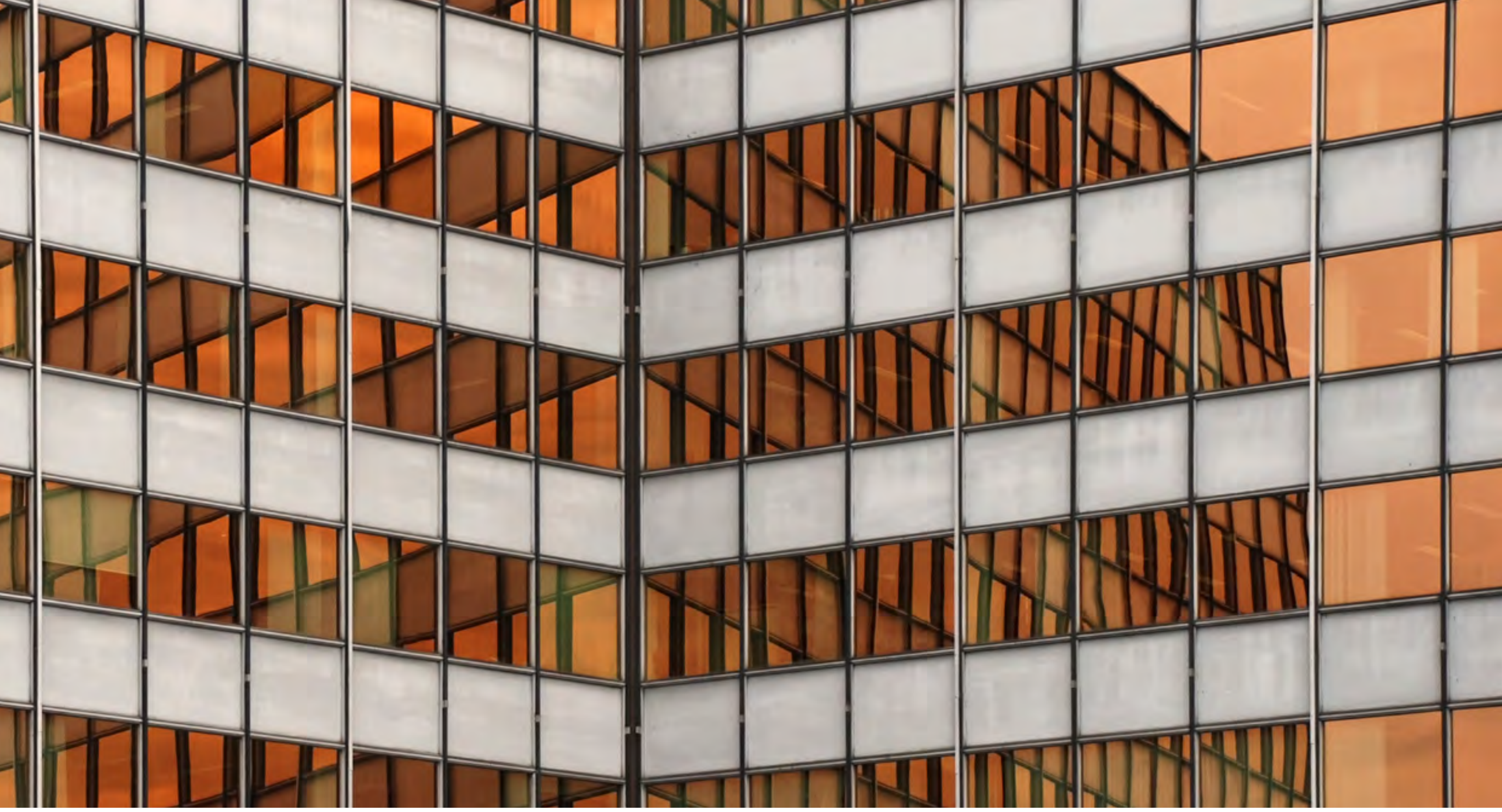
There also remains a disconnect between capital flows and fragile occupier demand in many of Europe's main markets. Though 39 percent of survey respondents expect the European economy to improve, there is a strong and increasing undercurrent of concern across Europe that geo-political issues, political uncertainty and economic decline elsewhere, especially China, could escalate and impact on real estate.

Last year's worries over the possible break-up of the Eurozone have been replaced by the possibility of the UK's exit from the European Union. And the wider consumer benefits of a prolonged slump in oil prices are off-set by an expected withdrawal of capital by some oil-producing states struggling with budget deficits. The recent terrorist attacks in Paris and the continuing mass migration of people into Europe loom large in the minds of many interviewees and survey respondents.

Despite such event risk uncertainty, one important reason for the overall positive view of European markets is that against a backdrop of low interest rates the difference between real estate and bond yields remains compelling to many pension funds, sovereign wealth funds and private equity investors. Cross-border capital flows are expected to increase, albeit at a more measured rate than 2015. Some 59 percent of respondents expect an increase or significant increase in capital from the Americas, against 65 percent last year, while two thirds believe there will be an increase in Asian capital.

According to many survey respondents and interviewees, one of the most important consequences of the increased liquidity has been and will continue to be a shortage of assets. Over 40 percent of respondents expect the availability of prime assets to get worse, and there are widespread concerns that an increase in prices will continue to outstrip the rise in rents. This is particularly true of London, where there is growing sentiment that values have peaked. Across continental Europe, prices are expected to continue upwards.

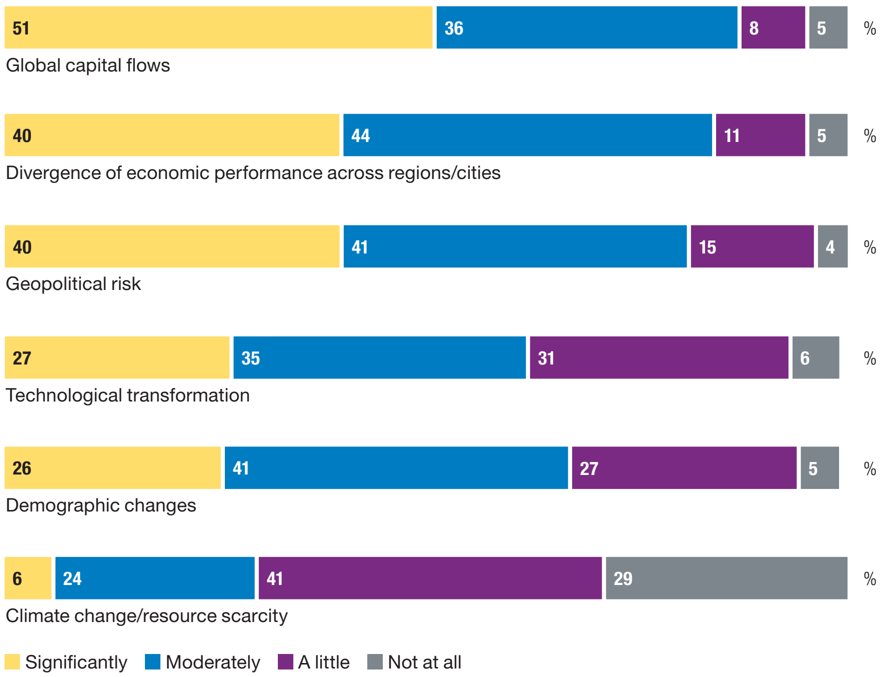
With high prices for standing investments, it is evident that a significant number of those canvassed by *Emerging Trends Europe* are confident enough to opt for development, not in a rash burst of speculation but as a measured and pragmatic way of securing returns. Though real estate debt is plentiful in most European markets, there is no sign of lenders loosening their criteria and re-introducing undue risk into the system, especially with development finance.



When prime property looks expensive, relatively high yielding alternative asset classes also start to look attractive and European real estate is at the tipping point. Healthcare, hotels, student accommodation and data centres are all expected to outperform core property. As many as 41 percent of survey respondents are considering investing in alternative sectors compared with 28 percent last year. This is not simply a chase for yield but an acknowledgement that many of these sectors will benefit from urbanisation and long-term demographic trends.

This is an extract from *Emerging Trends in Real Estate® Europe, 2016*. The full report can be downloaded from: www.pwc.com/etreeurope

Figure 2 **Influence on investment strategy over next 3-5 years**



Source: *Emerging Trends Europe* survey 2016

Patrick Kanters, APG

Patrick Kanters is Managing Director Real Estate & Infrastructure at APG Asset Management, one of the Netherlands' leading institutional investors, with €37.5 billion of real estate and €7.5 billion of infrastructure investment under management across the world.

The view from Europe – APG

As a global real estate investor, what is the outlook for APG's business over the coming year?

"If you look at the listed real estate markets, 2016 has not started very well – we've seen strong negative returns. But with direct real estate markets, 2016 globally does provide a stable background. Of course certain countries – Brazil and China – are in a very difficult position. But all in all, the fundamentals in most developed markets are still strong, and more favourable than the previous cycle. And importantly, the amount of leverage on the books of property companies and funds is reasonable, with the smarter investors' portfolios pretty much at 30 to 40 percent LTVs, so that provides more sustainable investment returns going forward."

What is driving performance in your chosen markets – is occupier demand feeding through to rental growth or is weight of capital and yield compression still fundamental?

"We think 2016 will be a turning point, and our key focus is how do we invest in assets that continue to provide us with cash flow growth? There will be markets, like the US and UK, where yield expansion is likely although in continental European markets you might see some further yield compression going forward."

> We are interested in investing not just in the properties but also the related operating companies that create the value for those properties, and often create a brand value.

Which real estate sectors look the most attractive to APG – either prompting you to increase investment or enter new markets – and why?

"We launched an investment in 2014 with e-Shang – they both own and develop logistic assets in China – and last year we expanded that into South Korea with much the same theme: there is a lack of modern-built logistic warehouses capitalising on e-commerce and further rationalisation of the delivery of goods and growing domestic consumption. We are investing not just in the development of these assets but the company, e-Shang, itself, and that is consistent with how we have invested since 2009 after the global financial crisis hit us all. We are interested in investing not just in the properties but also the related operating companies that create the value for those properties, and often create a brand value.

"We continue to be very active in expanding our exposure to residential. We started investing in the UK in 2011-12 but we have also invested in a company in Finland, focusing on the mid-income, affordable rental housing, where historically we have always had a large exposure in the Netherlands. We have built a lot of exposure by committing to this strategy in the US. And for Asia, we'd be keen to build [investment] platforms there although many markets still do not have an institutional private rented sector like in Germany, the Netherlands and the US. So in line with what we did in the UK where we have acquired portfolios and initiate those platforms together with strong operating companies, that's something we anticipate doing in other jurisdictions as well – Australia might be an interesting example."

Which sectors are the least attractive to APG?

"We've never been a large-scale investor in offices in Europe. We are convinced that offices are very much a timing play, and in the long run it's difficult to make a good return unless you are able to somehow time the property cycle. We are an investor in offices across all three main regions but continue to structure these vehicles in a way where we can influence the exit at a certain point in time."

One big theme in *Emerging Trends Europe* is the growing popularity of alternative real estate asset classes. How do you assess the investor-demand and the prospects for alternatives generally?

"For most market participants, they look for higher yielding product and that might take them beyond the traditional asset classes. At APG, we think alternative investments can capitalise on trends like tourism and urbanisation. That's why we have committed to investment in quite a few student housing funds and companies in the UK, continental Europe and Australia. It's related to housing dynamics but is called an alternative investment. One sector that's not on the radar of many investors is our exposure to outlet centres through Value Retail, McArthur Glen and Neinver. Of our total retail exposure in Europe, over 20 percent now is composed of outlet centres. Providing a unique shopping destination, they are very dominant in their catchment area and able to attract substantial tourism flows within Europe. It is a sub-sector of retail but you can also call it alternative. I think people need to take a different view of real estate and how they can continue to drive cash-flow growth, and that involves taking a closer look at the most important trends that are here to stay. That's why I think outlet centres will become a key sector complementing retail exposure and why student housing should no longer be called alternative."

Even though we have a globally diversified portfolio, the currency entry point has become more important.

The slowdown in China's economy, falling commodity prices and continuing geo-political problems have been reflected in volatile stock markets around the world this year. How are such issues influencing APG's approach to real estate investment?

"All of these events clearly show how inter-related all the different countries and regions are. It is extremely important that any portfolio is truly, globally diversified even though regions are more and more correlated with each other. One thing that is related to all these issues is ongoing currency volatility, and there has been a lot of currency volatility due to quantitative easing, commodity price developments and geo-political issues. In our case, we cannot ignore the valuation of other non-euro currencies. Even though we have a globally diversified portfolio, the currency entry point has become more important."

The outlook for Asia Pacific

As the bull market in Asian real estate enters its seventh year, both pricing and yields continue to tighten across most markets, creating a feel-good factor for many fund managers as they look to sell assets purchased in the wake of the global financial crisis.

While that strategy for such assets has proved profitable, the outlook for more recent purchases seems less certain. Regional economies are generally weak, exports are down, and currencies are depreciating. On top of that, today's ultra-compressed yields have taken prices to rarefied levels, suggesting we may be approaching a cyclical peak.

Investors are still seeking acquisitions although as one interviewee for *Emerging Trends in Real Estate® Asia Pacific, 2016* points out: "It's a difficult environment in which to deploy capital. There's no low-hanging fruit. There are no particularly obvious trades."

The growing preference among investors for core assets has been a consistent theme in Asian real estate for the last several years, with predictable consequences. As one investor says, "The challenge on the core side is that there are more people interested, but there's not a lot of stock." This competition for deals among so many well-capitalised players is one of the major factors adding to ongoing cap-rate compression.

One reason behind the enduring demand for core is Asia's changing mix of investors. With real estate in the West offering arguably better risk-adjusted returns, the flow of private equity to the region is probably not as strong as it might be. Institutional and sovereign capital, however, continues to pour in from a variety of sources, creating disproportionately high demand for core buildings. Much of this newly arrived capital hails from the Middle East, including Qatar and Abu Dhabi, with more coming from Europe, in particular Norway and the Netherlands.

Demand for defensive assets has also seen such investors crowding into gateway cities because, as one fund manager puts it: "As soon as you start going off piste into exotic sectors or peripheral markets, you're asking for trouble. From an evidence perspective, if you look back at all of our deals, even if you have to overpay for an asset in the middle of Shanghai, it's better than trying to be clever and get something cheap in Nantong."

The emergence of so many institutions in Asian markets has changed the investing dynamic in other ways. Investments tend to be longer-term – in the case of institutional buyers, 10 to 20 years. And deals are getting bigger, not least because the amount of new capital in circulation has outstripped the stock of assets available to buy. As a result, "a lot of the big investors are now very focused on platform or partnership-style investing", invariably favouring high-value deals involving a big local developer.

Equally important, there continue to be large increases in allocations of capital coming from Asian sovereign wealth funds – especially China – as well as from institutional sources, such as regionally based pension funds and insurance companies.

To an extent, this simply reflects increasing amounts of capital piling up on the sidelines of newly enriched Asian economies. Beyond that, however, it also reflects a changing regulatory environment where authorities recognise that defensive investments in local bond markets or other local assets are not providing good enough returns, and may also be actively distorting local markets. This has been the inspiration for economies such as South Korea and Taiwan to allow or force pension funds and/or local insurance companies to begin investing abroad.

Indeed, the other big story in terms of regional movement of capital has been the ongoing migration of money from Asian markets into real estate assets elsewhere in the world, as both institutions and private investors seek more diversification and higher profits.

Cash outflows from Asia began around two years ago but the volume today is greater than ever, and shows no sign of easing. As one fund manager says, "Outgoing capital is one of the biggest stories in our industry, that we're experiencing year-by-year. Over five years, it's going to be massively crazy."

This is an extract from *Emerging Trends in Real Estate® Asia Pacific, 2016*. The full report can be downloaded from: www.pwc.com/emergingtrends

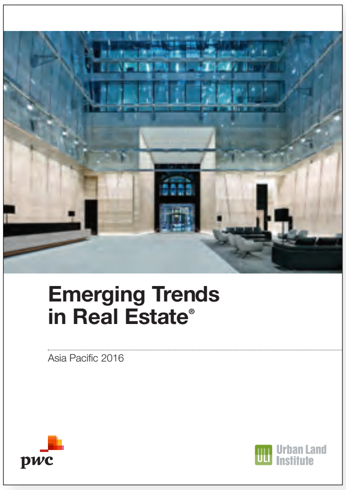
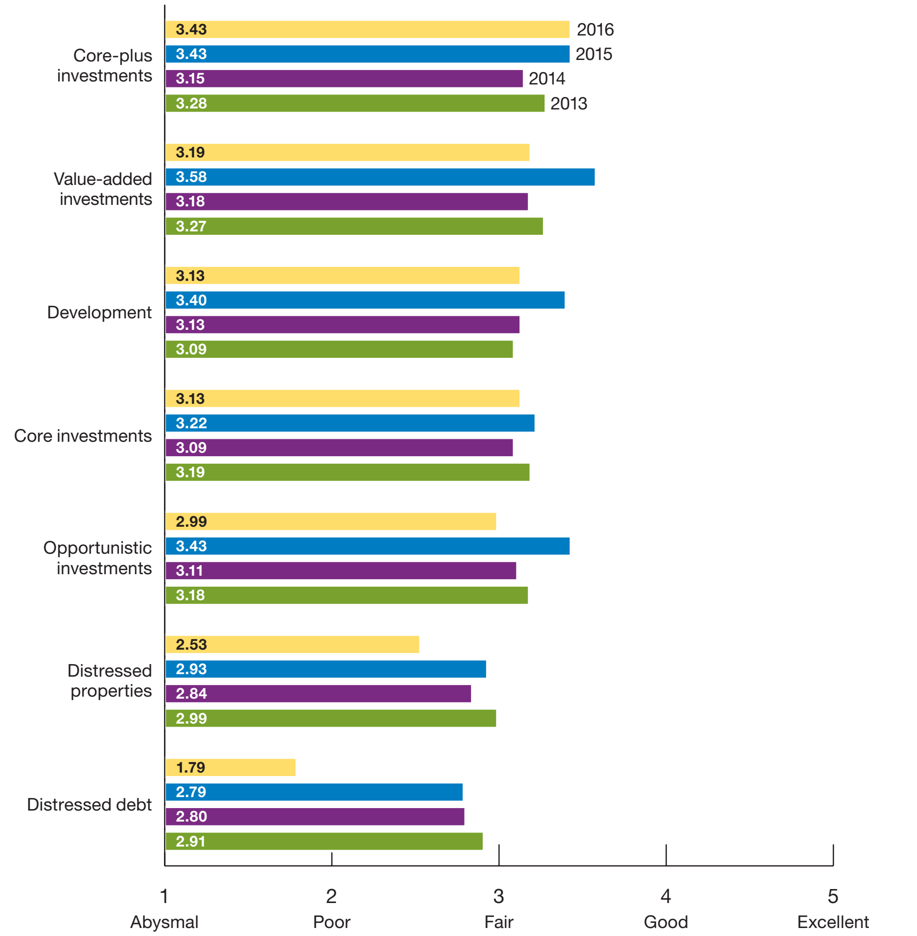


Figure 3 **Prospects by Investment Category/Strategy for 2016**



Source: *Emerging Trends Asia Pacific* survey 2016

Alison Cooke,
Starr International

Alison Cooke is Managing Director for Starr International's Asia Pacific real estate investments. Starr is a privately-held insurance and investment holding company that invests globally with an opportunistic strategy.

The view from Asia Pacific – Starr Int'l

What is the outlook for your business in Asia over the coming year?

"We are fortunate to have a diverse portfolio, with opportunities to add value through prudent asset management and meeting growing end-user demand. Looking around the region, fundamental demand is generally strong and we continue to focus on situation-lead investments where we can create or unlock value."

Real estate markets across Asia Pacific were for the most part very strong in 2015. How do you see the markets performing during 2016?

"Occupational markets look set for a stable year, good demand levels being tempered by a cautious approach to costs. Markets with falling rentals are generally those with over-supply, but established properties in good locations will continue to perform well despite this. We see some caution entering the investment market with macro concerns dominating for international investors. However, the weight of capital wishing to invest and the relative scarcity of investible stock mean that investment values will likely hold firm in 2016."

What is driving performance in the key markets in the region – is occupier demand fuelling rental growth or is weight of capital and yield compression the dominant force?

"Weight of capital is the dominant force at play, and we could see a little further yield compression in key markets with rising rents and high investor demand. With a healthy new supply pipeline across most markets, the expectations for rental growth are moderating, though the short-term outlook is good in markets which are coming off their lows, such as Japan and Vietnam."

> We see opportunities across the region to invest in operating real estate which meets changing demographic structures, social and lifestyle patterns and legislation.

Which markets and sectors offer the best opportunities for you, and why? And which ones are best avoided?

"We see opportunities across the region to invest in operating real estate which meets changing demographic structures, social and lifestyle patterns and legislation. These include retirement communities, logistics facilities for e-commerce distribution, self-storage and mass worker accommodation. All of these involve getting both the real estate and the operational model right. In Japan, the 2020 Tokyo Olympics will be good for sentiment and infrastructure improvements will add value to some submarkets. In India, the growth of e-commerce and changes in VAT laws are opening up opportunities for modern regional logistics properties. Whilst we wouldn't avoid the sector, we are approaching retail assets cautiously given the structural changes happening currently."

Our view is that deal levels will be moderate in 2016 despite strong demand.

The *Emerging Trends Asia Pacific 2016* report indicates that some investors are opting to take profits and exit from deals made in recent years while others are seeking the safety of core assets in gateway cities, perhaps indicating a peak in the cycle. What is your take on capital flows within the region right now?

"Given the run-up in values since the global financial crisis, most owners of Asia Pacific properties are sitting on healthy income yields with limited alternate investments and no pressure to sell. Asian owners often take a generational approach to their investments and are happy to sit through multiple cycles. Performance-driven managers will be taking profit where possible, so will be a source of stock. Our view is that deal levels will be moderate in 2016 despite strong demand."

Much is made of the global impact of the slowdown in China's economic growth. In the short to medium term, how do you see it affecting real estate investment in Asia as well as capital flowing out of the region to Western markets?

"We have a positive view on the long-term growth of China. We're seeing strong demand across the globe from Chinese companies as they develop and balance their international investment strategies. Looking forward, this will be influenced by any changes to China's capital controls. Changing patterns of Chinese tourism are having a major impact in the region, from falling high street retail rents and budget hotel rates in Hong Kong to significantly higher demand in Japan and other more traditional Asian resort destinations. A major issue occupying our minds for 2016 is the knock-on effect of RMB depreciation on other Asian currencies."

Leading logistics

Industrial real estate has been one of the most attractive sectors over the past few years, and it continues to prove its value to investors across the world.

It is a sector that is right at the centre of a collision of rapid urbanisation and technological change – two of the industry megatrends given particular attention in the following chapters of this report. Across the three regional reports it is clear that this journey still has a long way to go as real estate businesses compete for dominance with other businesses in areas like last-mile delivery.

Respondents to *Emerging Trends United States and Canada* not only place industrials at the top of the commercial property sector for investment and development prospects, but they have also posted the highest score for industrial properties in the surveys since 2004.

Investors there like the value-for-price relationship in a property type where the average cap rate is 6.9 percent. They also like the downside protection afforded by the triple-net leases that are typical in this sector, and the cash-in-hand quality of industrials.

Emerging Trends Europe points to a very strong capital flow and bigger allocations to logistics this year, with three quarters of those surveyed regarding its investment prospects as “good” or “very good”.

As one investor points out: “It is expensive but the yield compression is still coming through and you’re also going to see rental growth.”

For respondents to *Emerging Trends Asia Pacific*, logistics continues to be the most popular property type for investment prospects. Shortages of modern distribution facilities across almost all markets ensures that demand will continue to grow, especially in China.

The report notes that demand is being driven by the need for rapid delivery resulting from the e-commerce boom, build-out in the cold-food chain, and structural changes in regional manufacturing as operations move to emerging markets such as Vietnam.

Following such a ringing international endorsement, Hamid Moghadam, Chairman and Chief Executive of Prologis, the leading global logistics specialist, offers his perspective on the dynamics driving this market and its future investment prospects.

Hamid Moghadam, Prologis

Hamid Moghadam is Chairman and Chief Executive of Prologis, the leading owner, operator and developer of industrial logistics real estate with $57.3 billion of assets under management across the Americas, Europe and Asia.

Logistics – the Prologis perspective

What is the outlook for Prologis over the coming year?

"We're in a period of modest demand but very tight supply, particularly in the US. What's different about market conditions today from other cycles is that six years into our current recovery in the US, supply is yet to catch up with demand. So vacancy rates have been declining and supply is as tight as I can remember in my 33-year career."

What do you expect industrial property returns to do in Prologis' key markets this year?

"We've seen very healthy rent growth pretty much everywhere except for Brazil and Europe. Occupancies are at record levels and globally we're 97-percent occupied. Even in Europe, we're over 95 percent occupied. Supply has matched demand in Europe whereas in other places new supply has been trending below demand. Also in Europe, cap rates have been compressing from very high levels to more normal levels today, and these value increases have taken the pressure off landlords to push for higher rents. With cap rates stabilizing, we expect rental growth to return to most European markets in 2016.

Industrial real estate is once again judged to be the leading mainstream asset class in the regional *Emerging Trends* surveys and interviews. What's your take on this investor demand?

"Industrial real estate is a difficult asset class to access for institutional investors. In order to build a meaningful allocation, investors have to assemble a large portfolio of individual buildings. When the right opportunity comes along to deploy a significant amount of capital in a major portfolio transaction, large institutional investors jump on it because the next similar-sized opportunity may not come along for a while. This is a key factor in driving demand for logistics assets.

"We are the largest owners of logistics properties globally, and have a significant lead to our competitors in Europe. When the industrial business was in a nuclear winter after the 2008 financial crisis, no transactions were taking place. In 2012, we recapitalised the public company PEPR (Prologis European Properties) and some of our other properties in a joint venture with Norges Bank, and that basically gave the all-clear signal to other investors that the waters were once again safe for investing. Prior to that, there had not been any meaningful capital invested in the logistics sector in Europe since the downturn.

"There's nothing I'd like to tell you more than industrial is the best asset class. I talk to investors regularly and they're very focused on risk adjusted returns. While they want to increase their allocations to logistics real estate, they will not do so unless the returns meet their thresholds. Fortunately, locations, quality and return still matter, and not every decision is driven by a top-down allocation target."

> E-commerce is clearly a positive trend for our business ... I think an even more powerful driver is the need for companies to take cost out of their supply chains.

Much is made of the importance of e-commerce to industrial real estate. How do you see it developing?

"In my opinion, consumers are not buying more because of e-commerce. They're just meeting more of their needs through multiple channels. As a general rule of thumb, the e-commerce channel is about three times as warehouse-intensive as the brick-and-mortar retail channel. The shift in retail sales to this channel increases overall warehouse demand even in a flat consumption environment. So, e-commerce is clearly a positive trend for our business. To the best of our calculations, e-commerce represents about 9 percent (70 million sq ft) of our portfolio. In terms of new developments, it represents about 15 percent of our overall activity.

"E-commerce as a demand driver did not play a role in past recoveries. However, it doesn't explain the entire picture of demand for industrial real estate. I think an even more powerful driver is the need for companies to take cost out of their supply chains. In a world where top-line growth is challenged, the only way you can increase your earnings is to take cost out of the system, and one way to do that is by consolidating your warehouses. Instead of having 20 warehouses in the US, you go to six or seven large ones. This consolidation is made possible by the technology deployed in the supply chain. This trend is making some industrial real estate obsolete and it's creating demand for new, modern facilities in our global markets. There's nowhere you see this more clearly than in Japan, where the economy has been essentially flat for as long as I can remember yet we've built our most profitable development business there because of the trend toward consolidation into larger buildings."

The slowdown in China's economy, economic uncertainty everywhere, the collapse in commodity prices and continuing geo-political problems have been reflected in volatile stock markets around the world. How are such issues influencing Prologis' attitude to investment and risk?

"People don't lease warehouse space because they want to; they do it because they have to. It's a necessity for their business, and as long as you have population growth, people have to eat and they need to buy clothes, etc, and that creates demand for logistics space. If a company is going out of business, the last space they give up is where their goods are stored because that's where the value is.

"Supply chain costs and their impact on corporate efficiency is a top-of-mind issue for most our customers. There is no amount of thinking we can do that will make us as smart as listening to our customers. One of the key advantages of having a 700m sq ft global portfolio and more than 4,000 customers is that these are the very people who are making 4,000 separate decisions about where the world economy is going. The way that's translating into our business today is that we are 97 percent leased and our rents went up by double digits last year, and that's never happened before in my career. Either the logistics business has really lagged and the weaknesses will show up later, or supply of new product has been more disciplined in this recovery cycle. Our view is that people have not gone crazy with new developments. Instead, there is a bidding war for quality space in good markets."

The urban opportunity

Urbanisation is proving a key influence on investors as capital starts flowing into the more dynamic secondary cities as well as established gateways.

“We feel that urbanisation will have the number one impact on real estate. We don’t invest in countries any more we invest in urban areas,” says one of Europe’s leading institutional fund managers.

With widespread recognition of the impact of urbanisation, global investors are now thinking increasingly about how to identify the best cities in which to deploy capital. It is clear from all three regional *Emerging Trends* reports that for many investors it is no longer enough to target countries.

As one global fund manager declares: “We’ve all taken capital growth with cap rate compression but that story can only go so far.”

The US report goes as far as proclaiming 2016 as “the year of the secondary and tertiary markets,” reflecting the fact that participants are favouring cities with better growth opportunities – an astute strategy at a time when the US economy is adding jobs and new supply is still modest by historical standards.

Such opportunities represent a combination of traditional higher growth markets that offer favourable business conditions, markets that were hit by the global financial crisis but are in a position where demographics may drive future growth, and new markets that appear to be in a position to move up a class in the investment strata.

Figure 4 **Overall real estate prospects – cities in the US**

		Investment	Development	Homebuilding
1	Dallas/Fort Worth (2,3,1)	3.87	3.79	4.34
2	Austin (4,1,2)	3.82	3.83	4.17
3	Charlotte (11,5,4)	3.71	3.69	4.07
4	Seattle (3,10,5)	3.82	3.57	4.00
5	Atlanta (5,6,8)	3.79	3.68	3.93
6	Denver (8,13,3)	3.74	3.51	4.14
7	Nashville (7,2,14)	3.75	3.81	3.67
8	San Francisco (9,14,12)	3.73	3.51	3.77
9	Portland, OR (10,7,16)	3.71	3.63	3.64
10	Los Angeles (1,8,25)	3.87	3.61	3.50
11	Raleigh/Durham (20,15,10)	3.57	3.50	3.88
12	San Jose (6,11,17)	3.78	3.54	3.61
13	Boston (14,4,27)	3.66	3.69	3.48
14	Orange County (12,26,11)	3.68	3.31	3.78
15	New York - Manhattan (13,9,40)	3.67	3.59	3.26
16	San Diego (16,27,19)	3.62	3.27	3.57
17	Phoenix (17,38,15)	3.61	3.19	3.66
18	Minneapolis/St. Paul (19,16,37)	3.59	3.48	3.28
19	Miami (25,25,22)	3.48	3.31	3.54
20	San Antonio (36,47,7)	3.34	3.05	3.94
21	New York - Brooklyn (21,12,41)	3.54	3.51	3.25
22	Indianapolis (18,17,42)	3.60	3.45	3.25
23	Honolulu (40,50,9)	3.30	3.02	3.88
24	Washington, DC-District (28,39,18)	3.42	3.19	3.59
25	Charleston (38,18,29)	3.32	3.40	3.44
26	Chicago (15,24,46)	3.64	3.32	3.20
27	Columbus (31,20,31)	3.38	3.34	3.41
28	Oakland/East Bay (32,28,24)	3.37	3.25	3.51
29	Tampa/St. Petersburg (33,35,23)	3.36	3.20	3.54
30	Houston (50,59,6)	3.23	2.91	3.96

Weak Declining Average Improving Strong

Note: Numbers in parentheses are rankings for, in order, investment, development, and homebuilding
Source: Emerging Trends United States and Canada survey 2016

In this year of change, *Emerging Trends' US* markets-to-watch survey also reveals a new number-one as Dallas/Fort Worth climbs four places from last year's survey and leapfrogs state rival Austin in the process, which remains in the number-two spot. Nashville, Atlanta, and Portland, Oregon, are new entrants into the top 10 for 2016, while Minneapolis and San Antonio enter the top 20. Clearly the idea of second tier cities – also known in the US as 18-hour cities (see box) – as an attractive alternative to the "big six" US markets is starting to take hold.

Economic growth potential seems to be the reason behind the movement of markets within and into the top 20 for 2016.

But it is not all positive: Houston provides the most dramatic move, falling from number one to 30 as a result of concerns over the prolonged slump in oil prices combined with the current level of new development.

The negative sentiment towards Houston serves as reminder that institutional investors are acutely aware that their real estate holdings do not exist in a vacuum.

That markets-to-watch survey was completed last year and since then, if anything, the external influences on US real estate have been more profound. The Federal Reserve has raised interest rates, the slowdown in China's economy has kept commodity prices, particularly oil, trending down while there have been sharp falls in global equities markets. And as Ralph Rosenberg, Head of Real Estate at investment firm KKR, suggests, the US economy does not appear in quite as good shape as last year (see page 4). So much so that the big six US cities that had looked expensive relative to their second tier counterparts now appear to be worth considering again, at least for KKR.

The rise of the 18-hour city

The advent of the 18-hour city in the US marks a remarkable turnaround in sentiment towards secondary markets that barely two years ago were out of favour with investors.

Last year *Emerging Trends* identified the rise of the 18-hour city and this year the real estate industry is expressing growing confidence in the potential investment returns in the likes of Austin, Denver, San Diego and San Antonio.

The dramatic change in investor sentiment is evident in the 2016 top 10 rankings – with the exception of San Francisco and Los Angeles, the balance of the markets are 18-hour cities.

A stronger US economy and improving occupancy rates have clearly underpinned the change in fortunes. But these cities have also seen more moderate cap-rate compression than the major – 24-hour – gateway cities, and so provide an opportunity for superior yields. They also face lower-than-average supply pressure.

Equally important, the development and application of technology make it possible for these markets to offer the benefits of a larger urban area at a significantly lower cost. There is cultural capital as well as financial capital at work here, and what was once distinctly unfashionable is now tagged as "cool".

The dominance of domestic investors in US real estate has undoubtedly given the 18-hour city movement some momentum that would be difficult to replicate among secondary cities in Europe. But there are signs that global investors are starting to cast their nets beyond the big six gateway cities, which suggests that this US phenomenon will have lasting significance.

Either way, says Rosenberg, KKR's investment focus is at a city level. "We target and select urban centres where we think the long-term trends are very positive but where pricing has not fully priced in that potential positive momentum," he says.

A similar approach is evident at leading Dutch institution APG Asset Management, where the emphasis has been on cities rather than countries since 2009. "We have definitely implemented that in our strategy," says Patrick Kanters, APG's Managing Director Real Estate & Infrastructure.

"The focus has been on a smaller set of key growth cities throughout the world, with the main return driver of real estate being employment and demographic growth. We have very much concentrated our investment on those places where there is employment growth for the foreseeable future."

But Kanters points out that APG's strategy does not revolve around big cities exclusively. High-growth secondary cities figure, too. "These cities are definitely included. In the Netherlands, if you look at our retail and residential exposure, it is not just about Amsterdam but also other key Randstad cities, such as Utrecht and the Hague, which still show further growth and are expected to see further improvements in infrastructure and connectivity.

"These medium-sized cities can score very high in liveability standards. They are well-connected and though they might be slightly less densely populated they still have favourable growth prospects."

Shifting beyond the capital

The growing importance to investors of secondary cities across Europe has been documented in *Emerging Trends Europe* for the past two years, albeit this shift of capital has not shown quite the same momentum as the 18-hour city movement in the US.

According to this year's report, the five leading cities for investment prospects are Berlin at the top spot, followed by Hamburg, Dublin, Madrid and Copenhagen. Many interviewees expect the German capital to thrive well beyond 2016, based on its young population and its growing reputation as a technology and cultural centre, as well as having the land available for development.

Notably, London has slipped from the top 10, suggesting that investors are seeing better growth prospects in regional UK and European cities in the short term. In the long term, however, the UK capital remains the first choice in Europe for many international investors focused on wealth preservation with liquidity and the scale of the market, together with relatively robust economic performance.

The strong ranking of Birmingham, Britain's second city, reflects the positive view expressed during the interviews on property investment in UK regional cities. It is no accident. Birmingham is set to benefit from substantial infrastructure investment, in particular the HS2 high-speed rail line to London scheduled to open in 2026. But that is not the whole story. According to a separate study last year by ULI and TH Real Estate, entitled *The Density Dividend: Solutions for growing and shrinking cities*, Birmingham has become a master of its own destiny by establishing a long-term plan in 2010 that made the case for well-designed, higher density developments to achieve the levels of growth required in the city. A simplified planning process has been made possible by a City Centre Enterprise Zone, enabling business rates generated within the zone to be recycled into priority projects that all promote city living. Place-making has been at the centre of everything.

As *The Density Dividend: Solutions for Growing and Shrinking Cities* points out, Birmingham's city centre is already the setting for a thriving private rented sector, and a much more vibrant housing market overall. High yields and occupier demand are attracting institutional funds for the first time, and the city is witnessing significant investor interest in large lot sizes of €30-€140 million.

The report outlines how densification is the key to responding to population growth, economic changes, new lifestyle preferences, and the sustainability imperative in European cities. Birmingham is just one example of densification at work. But as its rise up the *Emerging Trends* city rankings indicates, the pay-back can be swift.

> The typical worker no longer wants to do the commute. They want to work, sleep and eat in the same place.

Figure 5 **Investment and development prospects, 2016**

		Investment	Development
1	Berlin	4.13	4.05
2	Hamburg	3.92	3.78
3	Dublin	3.86	3.70
4	Madrid	3.84	3.39
5	Copenhagen	3.76	3.71
6	Birmingham	3.75	3.53
7	Lisbon	3.72	3.06
8	Milan	3.69	3.22
9	Amsterdam	3.66	3.13
10	Munich	3.65	3.80
11	Stockholm	3.64	3.75
12	Barcelona	3.63	3.08
13	Budapest	3.59	2.76
14	Istanbul	3.58	3.63
15	London	3.55	3.39
16	Helsinki	3.55	2.96
17	Warsaw	3.53	3.06
18	Edinburgh	3.53	3.47
19	Prague	3.48	3.07
20	Frankfurt	3.46	3.41
21	Brussels	3.44	3.03
22	Paris	3.44	3.16
23	Vienna	3.44	3.45
24	Zurich	3.38	2.92
25	Rome	3.29	3.08
26	Lyon	3.24	3.10
27	Athens	2.76	1.76
28	Moscow	2.75	2.44

Good = above 3.5 Fair = 2.5-3.5 Poor = 1 to 2.5

Note: Respondents scored cities' prospects on a scale of 1=very poor to 5=excellent and the scores for each city are averages.

Source: *Emerging Trends Europe* survey 2016

Figure 6 **City investment prospects, 2016**

1	Tokyo	3.66
2	Sydney	3.52
3	Melbourne	3.43
4	Osaka	3.39
5	Ho Chi Minh City	3.21
6	Jakarta	3.20
7	Seoul	3.18
8	Manila	3.17
9	Shanghai	3.15
10	Aukland	3.14
11	Singapore	3.10
12	Bangalore	3.06
13	Mumbai	3.06
14	Beijing	3.02
15	Hong Kong	2.99
16	New Delhi	2.98
17	Taipei	2.92
18	Shenzhen	2.89
19	Bangkok	2.86
20	Guangzhou	2.84
21	Kuala Lumpur	2.76
22	China—secondary cities	2.54

Generally poor | Fair | Generally good

Source: *Emerging Trends in Real Estate Asia Pacific 2016* survey.

The outlook for Asia Pacific is different again because of the emerging market status of much of the region. For that reason, as much as any other, investors are targeting cities rather than countries. *Emerging Trends Asia Pacific* reveals that investors continue to be generally "skittish" about China, for instance. Concerns range from its soft economy and depreciating currency to oversupply, high values and compressed cap rates. Yet Shanghai nonetheless remains "a shelter in the storm" – its middling performance in the city rankings reflects its status as China's only true gateway, where prime assets will always be in demand.

Alison Cooke, Managing Director for Starr International's Asia Pacific real estate investments, argues that the city focus is prevalent throughout the region. "Absolutely. As elsewhere, Asia Pacific's cities have different economic and social drivers as well as supply dynamics," she says. "From a user's perspective, cities with cohesive planning and well-integrated commercial, residential and recreational facilities are naturally more attractive. Singapore is a great example of this. Authentic integration of heritage real estate gives cities a special character and often provides a strong focal point for commercial activity."

The urbanisation impact

Investors may stick with tried and tested gateway cities or they may venture into the more dynamic regional centres.

Either way, there is little doubt that urbanisation is the fundamental backdrop to their decision-making. All the megatrends are influential but in the *Emerging Trends Europe* survey and interviews there is a remarkable weight of importance attached to urbanisation, above all others.

One planning expert talks of the "extraordinary influence" of urbanisation. "It is both a correlation and cause related to the agglomeration effect. As people and workforce move to urbanised areas the prospects for those areas are best. The largest and best-connected cities will win."

It is also clear that urbanisation is increasingly viewed in the context of housing development and the prevailing supply shortages in many European cities, not least the growing need for single-person homes.

> The trend towards urbanisation, and its impact on housing, is going to be a massive issue.

"The nature of the work space, the hotel room and the apartment are changing," observes one global investor-developer. "We are creating new types of shopping and residential, and maybe where land is expensive we will create vertical city, mixed-use projects. The typical worker no longer wants to do the commute. They want to work, sleep and eat in the same place. There is a shift back into the urban environment in most major cities. Residential units are getting smaller and design is changing."

For real estate players as diverse as investment firm KKR and leading industrial developer-operator Prologis there is yet another dimension to the urbanisation question, and that is identifying not just areas of population growth but in particular those centres where there is clear evidence of a growing middle class.

"We do spend a lot of time thinking about long-term trends, and that could range from the continued emergence of a consumer middle class in India or China, and how we position ourselves to take advantage of that trend over the next 10 years," says KKR's Ralph Rosenberg.

"You want to look at countries or regions where population is significant and the area is moving from poverty into middle class," says Hamid Moghadam, Chairman and Chief Executive of Prologis. "Classic examples of that would be China, Mexico, even Brazil, because there is an 'S' curve in terms of consumption. As you move into the middle class you start consuming a lot and when you become very affluent you don't necessarily consume more than a middle income person. So that steep part of the 'S' curve are the markets that are most interesting to a player like us: populous areas with good middle-income consumption patterns."

Trending on infrastructure

Urbanisation raises many and varied issues for real estate but the industry is starting to come to terms with one challenge – or opportunity – infrastructure investment.

"In response to urbanisation, such investment makes sense but also in response to the broader economy and what will be required to spur growth in Europe and the US," says one global real estate player. "We will be seeing more movement to investment in infrastructure, and that investment will require public and private money."

Institutional investors have traditionally kept their capital allocations to real estate and infrastructure investment apart but there are signs that some are thinking of them in the round, not least because of the growing influence of megatrends, especially urbanisation.

"Consideration of these issues is a fundamental part of every investment decision we make," says Alison Cooke, Managing Director for Starr International's Asia Pacific real estate investments. "Urbanisation is happening at different rates in different cities and is strongly driven by new infrastructure and public transportation. For example, we are developing residences close to a major new ring road, flyover and proposed metro line, as the improved accessibility will unlock significant value in our land. We believe that activity-based working models will develop further and that building flexibility for that into new commercial properties will be a key differentiator."

According to one pan-European fund manager, a more strategic industry move into infrastructure investment is more likely than not. "The economy is weaker on the Continent [compared with the US and UK] and so the questions around megatrends become more pertinent," he says. "The thing we all learned in the last downturn was that location factors are so important. When we were trying to let our buildings, proximity to public transport stood out every time – connectivity."

Where people go, investment tends to follow. As one global fund manager says: "People in general want to be in the cities that provide opportunities. In order to develop opportunities smaller cities outside of global cities should develop a new strategy. They need to differentiate themselves to attract human capital."

City view

As the owner of 72 prime shopping centres across Continental Europe, Unibail-Rodamco has a commanding presence in the market. Chief Financial Officer Jaap Tonckens shares the corporate view of retail and city development.

Jaap Tonckens

Chief Financial Officer of Unibail-Rodamco, Europe's leading listed commercial property company. The group's €37.8 billion portfolio includes shopping centres, offices and convention and exhibition centres.

Unibail-Rodamco's shopping centre portfolio is spread across Continental Europe but mainly located in large metropolitan areas. Can you explain your investment rationale and what you're looking for in a city?

"Our approach hasn't changed actually for years now – the focus on large metropolitan areas in developed European countries. Simply put, what we look at first of all is generally the catchment area fundamentals and the competitive dynamic in the city. To give you an example, a mall with six million visits can be absolutely fantastic in a city like Dijon in France. But in Paris, way too small. There is no one single standard by which we judge an investment decision. The likelihood of being able to make an investment meet our risk-adjusted hurdle rates requirements is the key driver.

"The note of caution I'd bring in though is that when making an investment decision, we have to consider the long-term fundamentals. For example, an investment through development can take between seven and 15 years. So we have to look through the cycle … we don't change our strategy on a dime, depending on what's happening in the current political climate, for instance. We cannot operate our business chasing the latest flavour of the day. So for us, what we're looking for are generally cities that would appeal to large retailers, therefore we are aligned, we think, in terms of the presence of a catchment area, preferably with above-average purchasing power and overall population growth. But overall growth can vary and so you really also have to take a fundamental view of whether or not these cities and catchment areas have the potential to generate the required return on the investment. And that's when you start looking at the competition in locations, quality of the surrounding area, connectivity with the public transportation system and access by road. All of these elements come into play."

Are you interested at all in the faster-growing secondary or regional cities?

"Only if there's an opportunity to own or develop the market-leading assets, to be frank. Selective secondary cities, we do look at. But the question is also a definitional one. For example, I would not call Lyon or Barcelona secondary cities. They stand on their own."

Are you running out of large metropolitan areas in which to grow your shopping centre business and open new space?

"It's a fair question. Though it may appear so, the group won a large project in Brussels last year; the same in Hamburg. We're currently developing a large mall in Wrocław in Poland. But it is not just about new malls – 30 percent of our €7.4 billion development pipeline consists of extensions and renovations of standing assets. Size for the sake of size is not our objective, and building malls for the sake of building malls is not our goal. In addition to our development opportunities, we generate growth through rental uplifts in our standing assets. We are not in a position where we are desperate to deploy cash."

If the bigger property players concentrate on the larger metropolitan areas is there a danger that smaller cities may suffer from general disinvestment as a result?

"The key here is that there's always going to be a market. If the big players move out of some markets, you have smaller players moving in. Let's take the opposite example of what you describe. Minto, in Mönchengladbach (Germany), a shopping centre in the middle of a secondary city! This is the choice of local municipality to encourage private investment and relocate retail activities in the city centre.

"Is the local municipality alert and proactive, and encouraging or enabling renovation and profitable investment to occur? It's a mixed palette. Assuming the population is there, retailers also have a large role to play in terms of investing in their stores and investing in the in-store experience. If you no longer offer what consumers want, it becomes very tough to keep a business model alive."

What other forces or trends do you think are impacting on cities?

"Population growth or the lack thereof, infrastructure quality such as public transportation, quality of life, job creation, etc … all these elements are impacting cities. And it has consequences on the quality of the retail offer. If there is no critical mass of successful brands it's very hard for retailers to justify being there, and for retailers that don't differentiate themselves, they're facing a tough future.

"Furthermore, internet retail will have a significant impact. Retailers no longer need a store on every street corner and, thus, site selection and retail location become more important. It is cheaper to send a product that's been paid for with a driver to the front door of a client than it is to pay for an agent to find a location, pay the rent, stock the store and pay people before you've sold a single unit."

Longer term, how do you judge the prospects for shopping centres?

"I am personally very positive about the future for large shopping centres, the kind we specialise in: iconic architecture, places inspired by famous designers, a unique retail mix with international premium brands and personalised services for the visitors. The next generation of our assets will also take into account the growing demand for mixed-used programmes, such as Überseequartier in Hamburg (pictured) where the group will develop a shopping centre, offices towers, cruise terminal and housing in a single location. What we're going to see, I think, are companies that have found a model that works for them are going to stick with that. Again, a consistent strategy is key to future success.

"Naturally, some malls are going to continue to do well and some will not. There are always going to be new players ready to invest and if money is easily accessible there will be developments that shouldn't be built. Depending on the regulatory environment – zoning laws and the like – significant oversupply and dead malls are a possibility. You see some of that in certain cities in Poland and Spain, where there are very limited zoning rules that would limit the building of malls to ensure an appropriate balance between gross leasable area and the number of inhabitants. The cycle will always hold new surprises, some good, some not so much."

Connected cities

A disruptive combination of new technology, social change and more exacting occupier expectations is shifting the value equation within real estate from tenants to consumers, from space to experience, from asset class to service provider.

"If you're passive on holding real estate this can be a risky position," says the CEO of a major European REIT.

Negotiating the lease and waiting for the money to come in is no longer enough to deliver a favourable return. We are in an age in which there are much greater demands on our real estate. Population growth is putting greater pressure on available space and creating more awareness of the social and environmental impacts of real estate. Faster information flows make it easier for tenants and investors to compare and influence value.

At the same time, cities are competing against each other to attract investment, foster innovation and offer a favourable quality of life. The fate of real estate and cities are intertwined and investment in transport, digital communications and other infrastructure developments are set to become an ever more important element of real estate asset management.

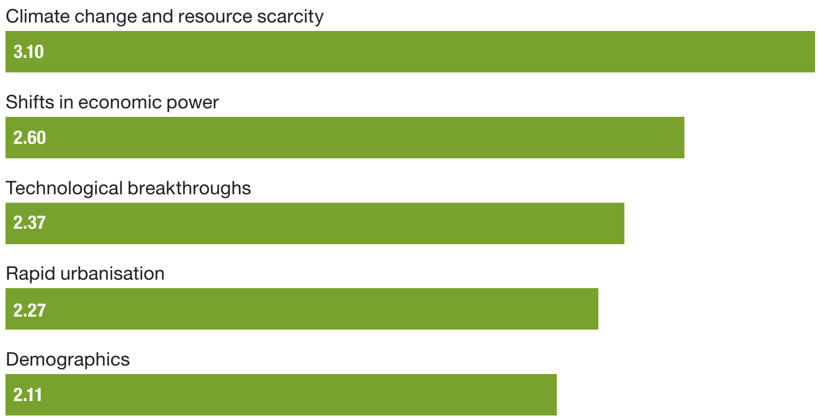
For investors, this translates into a need for a closer engagement with real estate as a service and its role as part of society's critical infrastructure. It's more important than ever to actively manage performance and return.

The move to more active real estate management is not new. Developments in technology and demands on space mean that buildings can quickly slip into obsolescence without regular renovation and investment.

Building brands

In turn, occupiers are coming to see buildings as a way to project their brand rather than just a place to work. They want buildings that create a positive impression and which encourage innovation and collaboration. Google's lengthy deliberations over its headquarters in London highlights the seriousness with which corporate tenants view their physical presence and the growing demand for full control over design and use of space, rather than adapting to a developer's formulaic blueprint.

Figure 7 **Megatrend impact on occupier expectations: Asia**



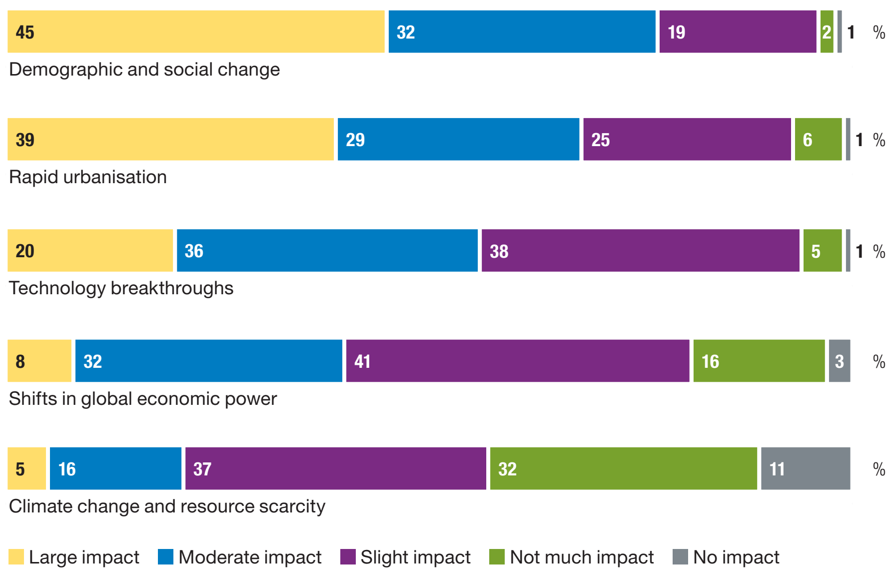
Source: Emerging Trends Asia Pacific survey 2016

For retailers in particular, the quality of the premises and how it projects their brand is becoming crucial once again as shopping centres become lifestyle centres and the choice of shopping online or instore gives way to a multi-channel experience, with the physical store at its heart.

But this is just the beginning. An even bigger transformation in occupier expectations lies ahead. The way people work and what they want from their working environment is increasingly reshaped by accelerated urbanisation, demographics, changing social attitudes and enabled by technology.

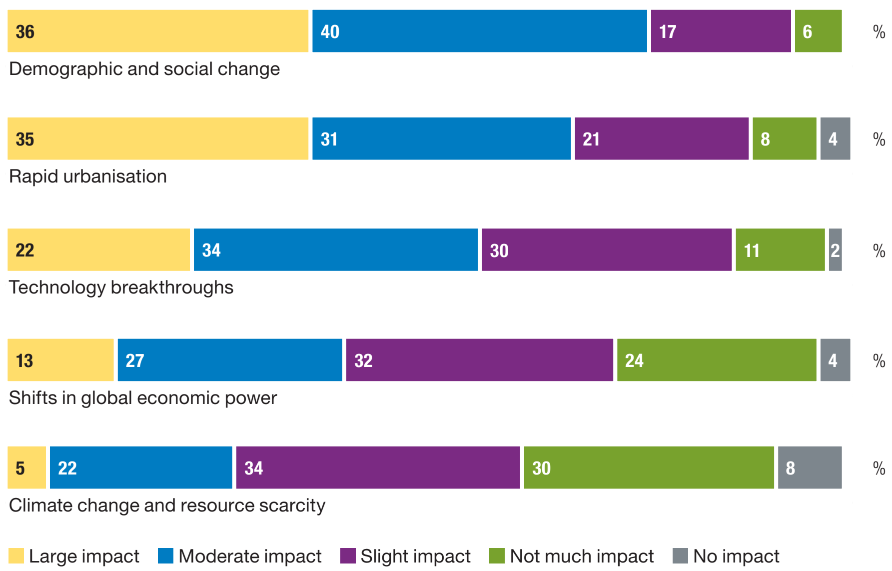
"Organisations used to crush people into a building and not spend any money on it during the lease. Real estate used to be regarded as a pure cost. Now, the building says something about your business, it is part of value creation; helping to recruit, enforce the brand and provide visible sustainability credentials that you can talk about," says an *Emerging Trends Europe* survey interviewee.

Figure 8 **Megatrend impact on occupier expectations: US**



Source: Emerging Trends US survey 2016

Figure 9 **Megatrend impact on business decisions: Europe**



Source: Emerging Trends Europe survey 2016

Technology-empowered tenants

We have apps to gauge our fitness or control the heating in our homes, and now tenants are beginning to use this hyper-connected and ultra-sensitive Internet of Things technology to manage their working environment.

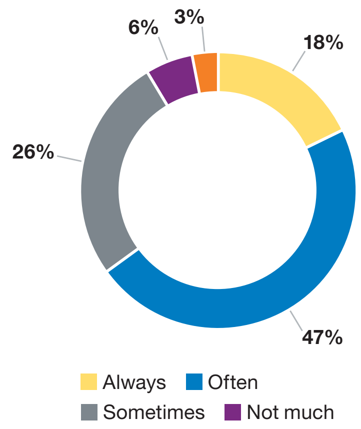
The ultimate end-goal around measurement is productivity. Optimising the use of space is clearly a crucial element of this. Savvy occupiers are using new sensors, booking-in systems and other finely-tuned measurement techniques to eliminate surplus space and make more effective use of what they have. Survey respondents in Asia report a marked increase in the efficiency with which occupiers use space (see Figure 10). In Europe, 85 percent of participants say that occupiers are using their space more efficiently now, the same proportion who believe that technology is changing the way we use buildings (see Figure 11 and Figure 14).

But the shift in expectations goes beyond just cost savings and use of space. The ability to create spaces that appeal to talent and support their health and wellbeing is equally, if not more, important. Key criteria include location, infrastructure, corporate brand, support for flexible working and corporate social responsibility. "The idea of measuring productivity by the number of hours spent at a desk is outdated," says a participant in our European survey.

As businesses come to recognise the full value of employee health and wellbeing in attracting, retaining and motivating their employees, a number of companies have adopted the Delos Well Building Standard®, which measures the quality of the environment across the component elements of air, water, nourishment, light, fitness, comfort and mind.

This will further increase the trend we are already seeing from occupiers to pay more for shorter and more flexible leases (Figure 13).

Figure 10 **Efficient use of space**



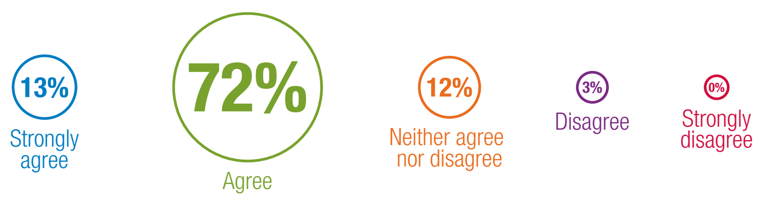
Source: Emerging Trends Asia Pacific survey 2016

90%

of business leaders worldwide are changing their approach to workforce rights and wellbeing in response to changing stakeholder expectations

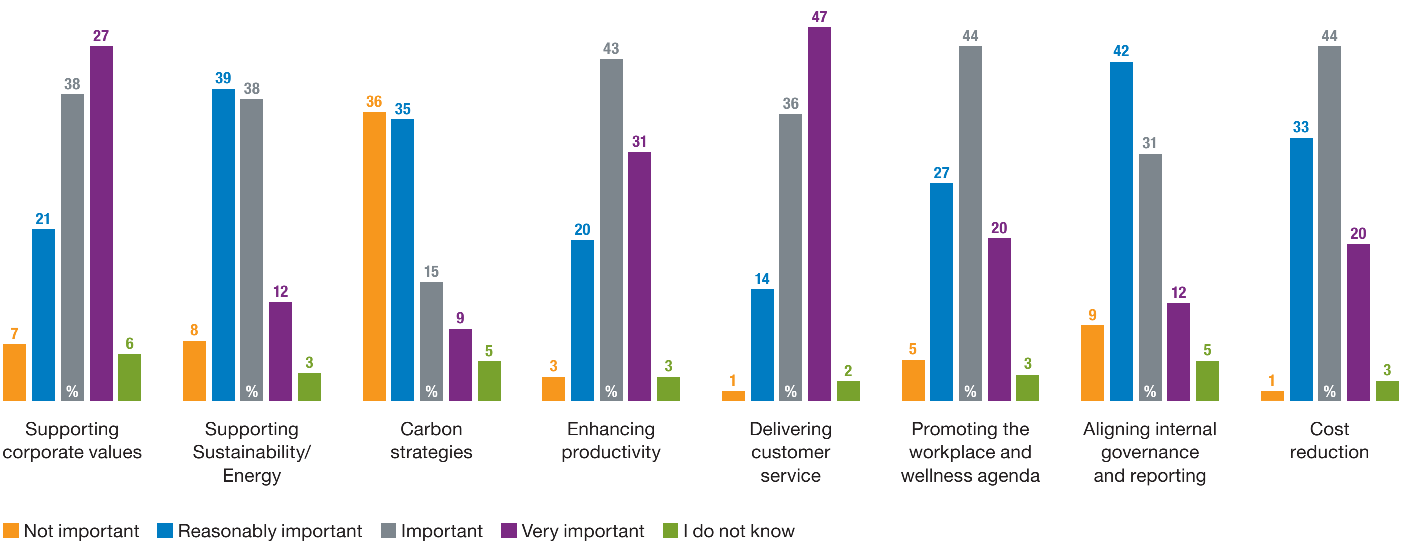
1409 CEOs from around the world interviewed for PwC's 19th Annual Global CEO Survey, 2016

Figure 11 **Occupiers are using their existing space more efficiently now**



Source: Emerging Trends Europe survey 2016

Figure 12 **How important are these elements to your/your corporate occupiers' property strategy?**



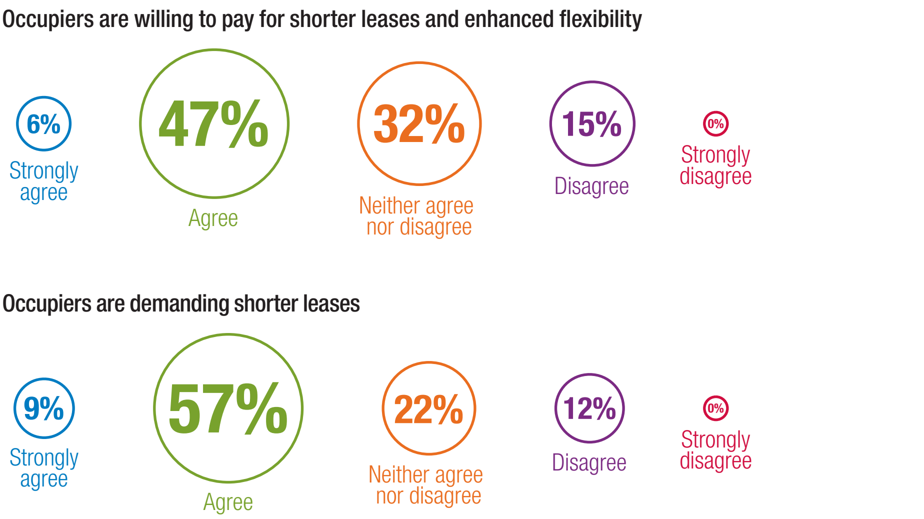
Source: Emerging Trends US survey 2016

Sustainable agendas

The wellbeing agenda is an extension of the already strong pressure for sustainability, but it has the potential to be a game-changer for the real estate sector. Environmental issues suffer from still being seen as a long-term concerns, whereas health and wellbeing is personal and immediate – affecting our lives and our families lives right now.

But as a reality check, many property owners will need to invest significant sums just to meet new energy standards. Nearly a fifth of commercial buildings[1] in England and Wales are at risk of being taken out of the letting market because they fail to meet new government energy standards, when, from April 2018, it will be unlawful to let any building with an energy rating below E.

Figure 13



Source: Emerging Trends Europe survey 2016

1) Cushman & Wakefield research, 17th February 2016
http://www.cushmanwakefield.co.uk/en-gb/news/2016/02/act-now-to-ensure-commercial-property-buildings-comply-with-energy-act/

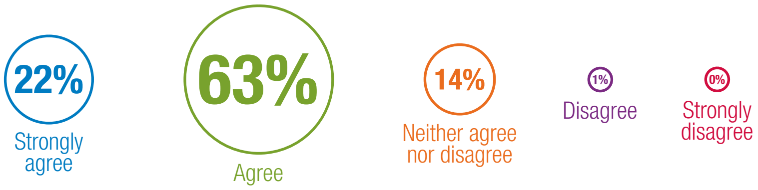
Nevertheless, as figure 12 shows, wellbeing is now judged as more important than sustainability in the US, Europe and Asia. But under current measures, sustainability and wellbeing may not necessarily be complementary. By way of example, the greatest contributor to embodied carbon in a typical office building is the travel of its occupants to and from that building. But while increasing the number of showers would encourage more employees to cycle into work, landlords and occupiers may be concerned about the impact on levels of water usage. There are many other similar examples which raise the question of whether the value equation encompasses the right breadth of measures and whether standards are incentivising the right behaviour.

Digital drives customers

Just as the digital developments in other sectors have made consumers more informed, able to compare value and switch service providers, data is empowering and beginning to raise expectations among real estate tenants. “The customer has historically been excluded, but more information means people are more aware,” says a participant in our *Emerging Trends Europe* survey. The risk is that owners and investors will be caught on the back foot as tenants use productivity measures to not only reduce the space they rent, but also in choosing the location, characteristics and operators of their buildings, or simply to press for more favourable terms on renewal. “Occupiers are increasingly asking questions about how they can monetise the negatives of a building’s performance,” says a participant. If tenants do not get what they want, they’ll look elsewhere, which will raise the bar for what owners and investors need to offer.

Figure 14

Technology is changing the way we use buildings



Source: Emerging Trends Europe survey 2016

Figure 15 **How important are these elements to your/your corporate occupiers’ property strategy?**

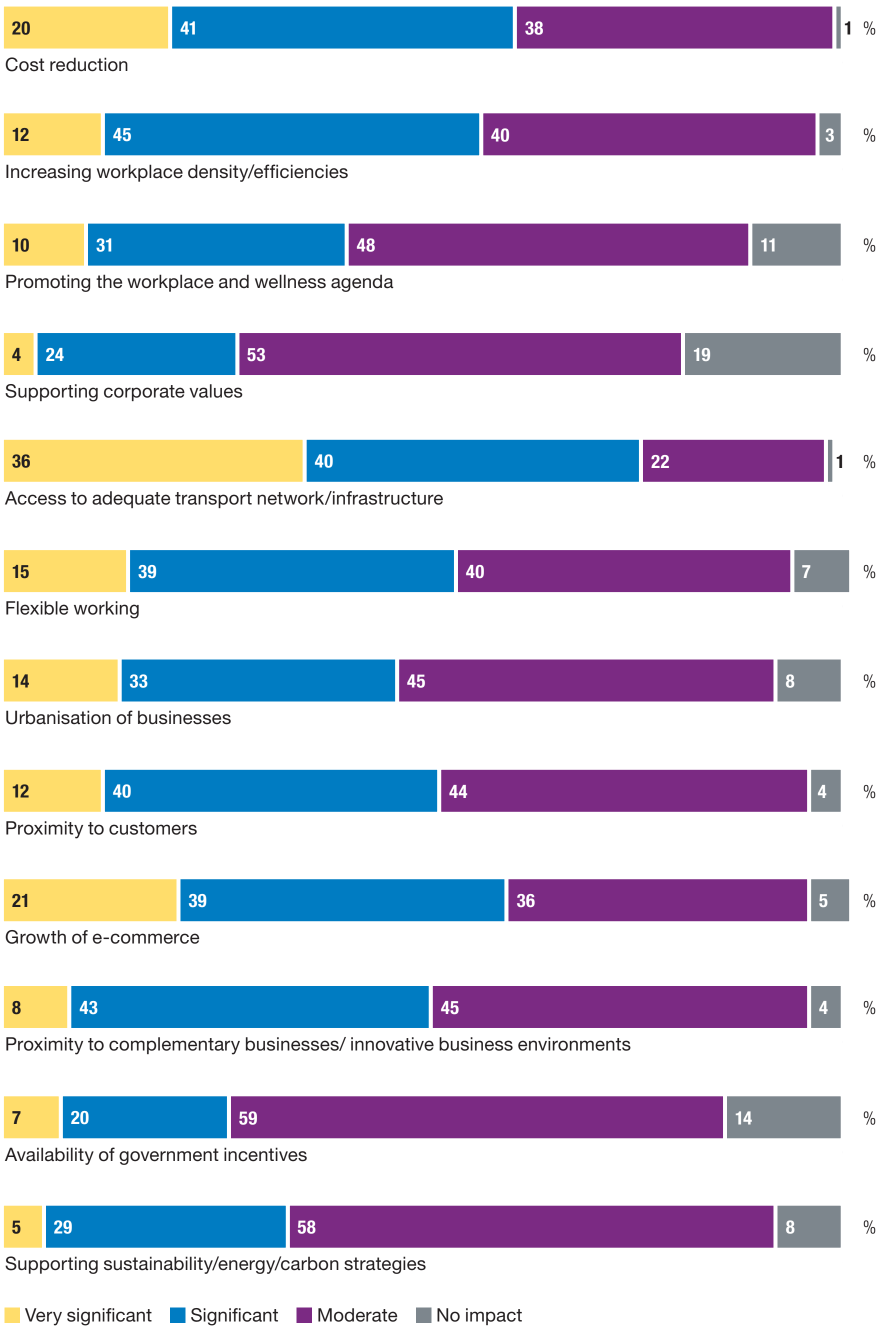
Source: Emerging Trends Asia Pacific survey 2016

It also raises the bar for the real estate managers in terms of data management. If tenants are using this data it will inevitably translate to real estate performance and valuation. So real estate owners and operators need to get ahead of the game as pressure is being applied at both ends of the spectrum. From an increasingly empowered occupier, to investors looking for greater transparency and speed of information flow across an evolving range of performance measures.

Are we in the middle of a digital revolution in real estate? Forward-looking businesses are successfully combining traditional yield measures with customer data in areas such as tenant satisfaction, health and wellbeing. They are using technology to speed up and cross-check their analysis.

> Data is changing the world fast and real estate is only just getting its head around it.

Figure 16 **Impact on occupiers' space requirements over next 3-5 years**



Source: Emerging Trends Asia Pacific survey 2016

Commercial property – the last imperfect market

New "PropTech" businesses are moving into this space. An example is Geophy, a Dutch-based company aiming to disrupt the opaque commercial real estate market, by using algorithms to value property even if it has never been on the market. Used by some of Europe's largest institutional real estate investors like PGGM, Geophy has developed a 'quality score' which enables investors to make better data-driven property decisions. Geophy uses data sets related to location, reliability and proximity to public transport, the local environment, whether there are nearby shops, vacancy rates, and the condition of the building.

Those investors that are slower to embrace new analytical developments may find it harder to understand and respond to tenants' fast-changing demands. And change might happen faster than many expect. Building Information Modelling (BIM) and Building Management Systems (BMS) will embed a full set of transferable information within properties and build a picture of the running of the building. New Blockchain technology is emerging as a solution allowing the due diligence for a property to be verified almost instantly using a combination of the above technologies.

How could this impact the industry? It promises to be an interesting time for many. Brokerage fees will be harder to justify, the need for large fund management teams might become obsolete, property managers or new entrants will become custodians of this data and will have to implement serious data security provisions.

From data on an individual occupying an office building, collected via wearable devices, to the increasingly connected components of a building itself via the Internet of Things, the built environment offers an overwhelming amount of data relevant to the assessment of real estate 'performance'. Could this revolution be the 'Uber moment' for the real estate industry?

So what do these converging trends mean for owners and investors? None of the shifts in technology, customer demand or the social role of the workplace we've described here are either sudden or revolutionary. Rather they build on developments that have been gathering in momentum for ten years or more. But the structure of the real estate industry, how it operates and how it gauges value and returns have changed little over this time. In fact, the way the industry is structured – with its multiple layers of investors and outsourced service providers – is specifically with a purpose to shield the ultimate investor from operational disruption. As we've seen in other sectors, businesses that are slow to see the writing on the wall can be dangerously susceptible to disruption.

It is all very well to talk about technology developments and the potential of data analytics, but real estate is an industry that has historically underinvested in IT. Taking relative size into account, global corporate real estate IT spend, as a percentage of revenue, is approximately 50 percent less than financial services and the public sector, including healthcare[2]. In the real estate industry, data is largely managed in silos and a third of the global real estate industry still uses spreadsheets as their primary tool for portfolio management.

> With just a few metrics, occupiers can now understand whether space is being used or wasted and whether it is a healthy place to be.

For most industry participants, there is an immediate need to bring technological efficiencies delivered by cloud computing to the basic business of real estate fund management reporting. The challenge for an industry that still largely relies on traditional performance measures and spreadsheet analysis, is how to quickly develop the necessary technological capabilities to deliver 'best in class' property and asset management skills in a more competitive market.

Learning to listen

The clear challenge to the wider industry is how to focus less on bricks and mortar as the primary source of value, and think more about service. More than half of participants in the European survey believe that how the building is used is now more important than the asset itself. And as such, the customer experience becomes as important as the space itself. Robert Noel, CEO of Land Securities, one of the largest UK REITs, summarised the challenge: "Twenty years ago we had tenants, now we have customers, in 20 years' time we'll have guests." Real estate managers will need to work significantly harder on a daily basis to keep their buildings occupied – just as hotels do.

2) Altus Group CRE Innovation Report – Oct 2015

That's not to say that leases will necessarily get shorter, or that offices will be like hotels. Rather, only those real estate businesses that are able to instil confidence in their ability to continuously adapt, innovate and deliver a truly superior built environment experience for the customer will get trusted as a provider of the space in the first place.

Property owners and investors may look to develop enhanced service capabilities in-house. But others now prefer to partner with businesses that have established a specialism and brand in creating desirable workplaces and residences. These include a new breed of leaseholder, who sublet on short and flexible leases, with a strong accent on creating collaborative spaces. A prominent example is WeWork, which is already one of the biggest leaseholders in Manhattan and is developing a strong footprint in London and other major cities. By using WeWork as the customer interface, owners can be more responsive to customer demand, help create an overall vibrancy of tenant mix and 'cool', while reducing their direct exposure to tenant default. But there is also a counter argument that such models concentrate risks that would ultimately fall back on the owner and investor.

Many market participants certainly face tough questions over how to sustain relevance and revenue. The key source of real estate value generation is increasingly the ability to understand and meet customers' very particular demands rather than the property itself. This would mirror an Uber or Airbnb business model built around digital connectivity and service, rather than physical assets. The property still has value of course. But to extract it, real estate businesses need a much more informed and active approach to service, which is blurring the line between operating and property company.

"Across residential, hotels and office we're seeing more of a blurring around the ownership and operation of real estate," says Anna Kavanagh, Global Head of Asset Management & Transactions, Real Assets, Axa Investment Managers. "In Europe, we're seeing the biggest wholesale switch of ownership in real estate – into the hands of the experts in operating. The amount of assets that have changed hands is phenomenal. A lot of real estate is moving to investors with the skills and expertise to actively manage. The industry overall is becoming more proactive. Which is a good thing."

However, many interviewees believe that these emerging trends and the opportunities they open up are being embraced by too few in the industry. Some express frustration at how "many seem stuck in a rut" and relying on old ways of working. "Landlords are in tune with the needs of occupiers like me. But asset managers are a long way behind …They need to realise life is changing and people need far more engagement than before," says a participant. "We are working with an occupier which wants to do something sensational with its new office space, but the developer will not be flexible because they want a standard design they see as being able to preserve value long-term. My argument is the way trends are going, tenants want openness and flexibility in a building and that is where values are," says another.

Lack of alignment between how owners, managers and occupiers see a well-performing building is an issue. There needs to be a new language around this.

The power of diversity

Diversity of talent and ideas is set to be an increasingly important source of competitive advantage in an increasingly customer-centric industry.

Drawing from a wider talent pool can help businesses to engage with a broader range of customers and gain insights into their strategies and aspirations. This might be the different tenants in a large shopping centre or the growing numbers of clients and investors coming from Asia, the Middle East and other parts of today's increasingly globalised market.

In turn, a team that can bring together a range of different perspectives can help the business to make sense of a fast moving marketplace and judge the right way forward. There is evidence to suggest that an organisation is more likely to predict customer trends if its workforce reflects its customer base and that tackling 'group think' can help to foster greater creativity and innovation.

Unibail-Rodamco (UR), Europe's largest property company, has put diversity, and the new ideas and innovation that come with it, at the heart of its business. "Diversity in skills, international mindset and operational discipline are absolutely critical to perform in today's business environment. But it is not simply about adding new skills per se. It is also about blending these new skills with our core functions," says Astrid Panosyan, Head of Resources and Management Board member of Unibail-Rodamco.

Panosyan sees innovation as a crucial element of this broader focus on talent, diversity and career development. "Our new digital profiles are embedded with our marketing team, which has allowed us to engage more proactively with our visitors, enrich their shopping experience and develop a location-based strategy, through increased smartphone UR apps download, enhanced SC websites and social media management platform. Our UR Lab is already fully integrated into our Talent Management Program. And now, as we are also looking into open innovation, we just launched UR Link, our retail startup accelerator located in our headquarters where selected startups paired with UR sponsors can test their concept in one of our centres," she says.

Panosyan also highlights the importance of new and creative thinking "The ability to think outside of the box with the positive energy to make it happen is vital. So the true challenge is to keep attracting and developing an international generation of UR top talents, strong performers of course, but also diverse and culturally agile, highly trained and enthusiastic ambassadors of UR culture," she says.

As the business looks to the future, Panosyan is mindful of the expectations of the new generations coming into the workforce, "Another challenge, like many companies, is to address the growing need of millennials," she says. "They are more looking for jobs that give them a sense of purpose, offer opportunities for learning and growth, and enables them to take initiatives. It is therefore key to continue supporting an entrepreneurial, creative and empowering environment. It is also becoming key to incorporate in our sustainable strategy not only environmental ambitions but also great corporate citizenship programmes in connection with UR business operations."

Astrid Panosyan
Chief Resources Officer
Unibail Rodamco

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We have drawn together those regional insights to focus on the most relevant investment and development trends across the globe, the outlook for real estate finance and capital markets, and the long-term influence of megatrends over the industry.

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