

Emerging Trends in Real Estate®

The Global Outlook for 2016

*Insights from PwC's global
asset management practice*

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

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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 real estate 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 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.

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 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.

This 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% of the survey respondents describe the market as oversupplied with equity capital, and 34% 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

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% 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% 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 offset 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% of respondents expect an increase or significant increase in capital from the Americas, against 65% 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% 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% of survey respondents are considering investing in alternative sectors compared with 28% 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/etreurope

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."

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