Real Estate Market Outlook 2007

10 Factors that Will Shape the Global Real Estate Market in 2007 and Beyond

1. And, the New "Hot" Investment Market Is …

"According to Ernst & Young" – The infrastructure investing market will quickly rival other real estate-related investment markets – such as CMBS, REITs, and private equity – in terms of market size. Why? It's the "hot" alternative investing market right now and shows little sign of cooling. Plus, the capital requirements in this sector potentially dwarf those of other markets. This is great news for construction firms and contractors, especially firms able to compete on a global basis for mega-projects, such as bridges and dams. This is also great news for investors and commercial developers, who will see tremendous opportunities in the next 10 years as infrastructure projects spur more commercial projects, such as hotels, retail, and transit-oriented residential.

There is one market to follow in 2007, although it may not be one you know about today: the infrastructure market. With hundreds of billions of dollars needing to be spent to bring existing infrastructure up to standard in the United States alone – and trillions needed globally – the immediate impact for the construction sector is evident. What's less clear is whether the construction sector has the capacity to handle the weight of work required. The huge spend likely to occur in the next 10 years may push prices of labor and raw materials far higher – as happened last year because of China's huge building program – putting even greater pressure on municipalities, states, and countries in their quest to replace and build infrastructure vital to their economic growth. However, an emerging private-funding sector fueled by pension funds, major banks, and equity funds may provide some of the capital needed to enable public agencies and states – such as California, the eighth-largest economy in the world, where voters just approved US$37 billion in infrastructure bonds – to push ahead with ambitious infrastructure development plans. The bottom line for the real estate industry is that improved infrastructure – roads, bridges, ports, airports, mass transit systems, water, and energy supply – will only fuel additional development opportunities for homebuilders and commercial developers from Mumbai to Maryland and many points in between. Contacts:

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2. Never Mind a Bubble, the Housing Market Just Feels Ready to…

"According to Ernst & Young" – There will be rising loan defaults on adjustable-rate home mortgages (ARMs)through next year, resulting in more drastic price reductions on existing homes in order to sell (especially in tough markets, such as outlying suburbs of major cities) and a tough year for real estate agents. In the United States, the domino effect will reach into mortgage-backed securities markets (through higher defaults) and even into retirement savings (through IRAs, etc.), making it a challenging year for mortgage lenders, banks, and institutional investors. Around the world, housing markets are currently faring better, especially in France, where residential construction is likely to spike in 2007, the UK, where price appreciation has spread far beyond the major cities and into rural areas, and the Gulf States, where new housing, particularly multifamily, is seeing rapid growth.

No real estate market has captured the imagination of the investing public in recent years as much as the residential sector. Housing values in many markets around the world – from Australia, India, China, and Japan, to Denmark, Germany, and France, to Mexico and the United States – have been very much in the ascendancy for some time. A recent survey of housing prices in the UK put average home appreciation at 200 percent over just the last 10 years. In parts of the United States, values have risen even more. However, in the latter part of 2006, U.S. home prices began to level off and, in some markets, began to slide. Like much of real estate, housing is a local issue and trends tend to be localized. However, even in this sector, some global trends are emerging. One of the most potentially damaging is the long-term economic impact of homebuyers financially stretching to buy homes. In the UK, mortgage lenders are now beginning to offer loans at up to five times buyers' incomes, in addition to the traditional "3.5 times income" loans. In the United States, adjustable rate mortgages (ARMs) have been far more popular than the more predictable fixed-rate mortgages, since more buyers qualify for their low introductory rates. However, rising interest rates can quickly hurt over extended buyers. In the San Francisco Bay Area, one of the hottest residential markets in the United States in 2006, notices of default on residential mortgages – the first step in foreclosure – jumped 89.2 percent in the third quarter to their highest level in more than seven years. It's been estimated that more than 10 percent of new homebuyers in the United States have no equity in their homes, and with more than US$1 trillion in ARMs set to adjust upwards this year, potentially causing a ripple through the economy. Contacts:

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3. Private Equity Rocks and Rolls

"According to Ernst & Young" – Private equity was behind the record setting year of M&A deals – totaling almost US$160 billion last year – that made real estate the second most active M&A sector after telecommunications. There's not much doubt that private equity will continue to dominate the headlines in real estate in 2007.

By its very nature, the private equity market is exactly that: private. But it has fast become a driver of trends in the real estate sector. Real estate private equity funds dominated the capital markets in 2006 and, barring major swings in interest rates in the United States and other major economies, look likely to continue to dominate real estate transaction activity in 2007. Recently, more than two dozen bidders competed to buy Chicago's iconic John Hancock Center; all of the eight finalists represented private equity. According to our Market Outlook (November 2005), value-added and opportunistic private equity funds at that time held almost US$120 billion in leveraged capital to invest in real estate. A significant amount of this capital was invested in 2006. Ernst & Young's 2007 Real Estate Private Equity Market Outlook – due this spring – will shed light on the extent of the capital raise achieved by private equity funds in 2006, but some key trends are already evident. Not surprisingly, funds are getting larger. Sponsors in their second or third funds who have a demonstrable track record for investors are able to raise significantly more capital – sometimes as much as 100 percent more – in new funds. Private equity is also consuming public equity at a frantic pace. Even before Blackstone announced its US$20 billion bid last year for Equity Office Properties, the trend was overwhelming toward going public to private. (see No. 4, below). In addition, more funds are looking outside the United States into offshore investing in Europe, Asia, and also in emerging markets, such as Brazil, Russia, India, China, and South Africa. There's no shortage of interest from funds in most property types, with office assets being one of the most popular. However, the hotel sector, which has seen three consecutive years of growth, has been particularly attractive. Contacts:

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4. Worldwide REIT-Building Surpasses the U.S. Market

"According to Ernst & Young" – For the first time ever, REIT formation outside the United States will be greater than inside the country. While we don't see the rest of the world overtaking the United States in terms of market cap of REITs in 2007, we expect the shift to happen perhaps as early as 2008, with countries like Germany and the UK showing the greatest rate of growth.

While the United States is still the largest REIT market in the world by market cap (US$395 billion), the rest of the world (US$213 billion) is rapidly catching up and is on a pace to overtake the U.S. market in 2007–2008, according to a report released last year by Ernst & Young. While the United States is likely to remain the largest single REIT market for some time, due to the size of the country's real estate market, the emergence of REITs in the rest of the world is nonetheless significant and indicative of a period of REIT-building worldwide, as many jurisdictions move to adopt REIT or REIT-like legislation. In fact, 27 countries now have REIT legislation and this movement will see a tremendous boost in 2007 as the UK and Germany open their doors to REIT formation. In 2005, Malaysia saw the formation of the first Islamic REIT founded on Sharia law. Meanwhile, in the United States, where public funding of real estate has been the dominant capital trend over the last 20 years, markets are witnessing a shift toward public to private activity for even the largest REIT portfolios. This trend is mirrored in the broader equities market, where more than US$37 billion in public to private transactions occurred in the first nine months of the year. In November, Blackstone Group, one of the most active private acquirers of public real estate portfolios, announced plans to acquire Equity Office Properties Trust (NYSE:EOP), the largest public REIT and a major owner of U.S. office buildings. With private capital valuing public assets at a premium, further privatization is anticipated into 2007. Contacts:

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5. There's More "Green" in Green Building

“According to Ernst & Young” – “Green” officially becomes the new black in 2007. Green building – once dismissed by major developers as “too expensive” becomes almost a necessity as tenants, lenders, residents, and even investors push for sustainability. Nor is green restricted to building. Look for green principles to become synonymous in the real estate industry with solid, cost-efficient operating principles.

If you aren’t at least meeting LEED (Leadership in Energy and Environmental Design) standards in new construction, there’s an increasing risk – one likely to accelerate in the next five years – that your project may falter. Most cutting-edge developments in the years ahead will, like Vancouver’s Jameson House, a 37-story luxury residential condo project under construction today, look to exceed LEED – not just meet it. However, green is no longer a luxury. Look for energy and design solutions driven by sustainability to quickly filter down from high-cost projects such as biotech labs to more mundane office and retail projects as the Green Movement gains further traction. San Francisco, New York, and Chicago are fostering green building, fast-tracking developments that meet green standards; even smaller cities like Buffalo, N.Y. are looking at ways to encourage this trend. The implications of the change are huge for real estate and lenders are only now coming to grips with green building’s underwriting implications. When will we see our first green REIT or CMBS issue? Tough to predict, but look for more major pointers in 2007. Contacts:

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6. Searching for the Next India

“According to Ernst & Young” – Emerging markets such as Brazil, Russia, India, and China will become “established” markets in the next few years with strong flows of direct foreign capital to buoy their real estate markets. In terms of new emerging markets, South Africa, Mexico, Romania, and Turkey are moving up the list.

The desire (and need) for capital to seek investments abroad, along with major state programs to develop better infrastructure (in order to attract that capital) has led to the emergence of new – and sometimes surprising – markets for real estate investment. Least surprising, however, is India, given its predominant location for offshoring of technology and back-office functions for many global businesses, and which has the second-fastest growing economy in the world. In 2006, India formally opened its doors to increased foreign direct investment in certain types of real estate development, a move which spurred the creation of several billion-dollar funds aimed at opportunistic investing in the country’s emerging real estate economy. More capital looks set to follow, since the four recognized BRIC nations alone – Brazil, Russia, India, and China – are projected to overtake the combined gross domestic product of the G6 nations (the United States, the UK, France, Italy, Germany, and Japan) before 2040. Other markets that emerged as real estate investment havens in 2006 include Brazil and South Africa, both countries where significant infrastructure programs are anticipated or underway. However, China, which had been one of the most successful nations in attracting capital – at one point in 2006, it was estimated that China produced the equivalent of Manhattan's office space every 20 days – has gone in the other direction and adopted more stringent foreign direct investment (FDI) rules that may dampen capital flows into the country's real estate sector. So, which markets will emerge in 2007? Look for the Philippines and Mexico – both growing targets for offshoring – to attract particular attention. So, too, will some Eastern European countries, such as Turkey and Romania (in Bucharest, for example, less than 3 percent of the office stock is professionally owned and managed, giving established real estate operators a tremendous growth opportunity). Contact:

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7. And, You Get Miles with It …

"According to Ernst & Young" – Good news for the airline, travel, and hospitality sectors: cross-border capital flows – which have been increasingly steadily over the last three years or so – will take off as investors step up the search for higher yields and new opportunities in markets previously untouched by many. Look for particularly strong capital flows from the Middle East and Southeast Asia into North America, and U.S. capital to flow into China, India, Europe, and Mexico.

Real estate is no longer just a local business. Since 2001, we estimate there have been upwards of US$500 billion in real estate transactions in North America and Europe alone, with a sizable proportion of this total occurring through cross-border transactions. Given the emergence of new investment markets such as China, India, Brazil and Russia, the growing power of petrodollar economies in the Middle East, Asia-Pacific, and even Northern Europe, and the increasing sophistication and access to "global" data enjoyed by real estate investors, we expect capital flows to become increasingly complex among major regions of the world over the next 10 years. Adding to the growing cross-border investing phenomenon is the emergence of public investment vehicles – such as REITs, which, in theory, allow even individual investors to acquire an interest in real estate, even if it is half a world away. Also, despite the huge amounts of capital ploughed into real estate by pension and other major funds over the last 10 years, many investors are still significantly under-allocated in real estate. This has been a spur for cross-border activity – as witnessed in 2005 when almost AU$10 billion of Australian capital flowed into U.S. real estate markets. The emergence of new, but allied, investment sectors, such as infrastructure and green development, will further enhance the likelihood of cross-border investment activity by a broader range of investors. Contact:

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8. Real Estate Is Ruled by Numbers

"According to Ernst & Young" – More than ever, demographics are driving new real estate development patterns, not only in the United States, but everywhere. In India, a booming population and rapid urbanization is spurring housing construction. More importantly, the wealth created by offshoring and the rise of the technology services sector is creating a huge demand for upscale retail and, even at the lower economic levels, retail is hot – as witnessed by Wal-Mart's recent push into the India.

Once just viewed as a post-war U.S. phenomenon, the “baby boom” generation has become a global reality, as has the role of demographics in planning real estate strategy. In the United States, 10,000 “boomers” are expected to retire every day over the next 15 years, the first wave of 76 million or so retirees from the post-war population boom. This has spurred another boom in the development of retirement communities for active retirees, second-home developments, and acute-care and other facilities to accommodate the doubling of the U.S. population over age 65 that is anticipated over the next 25 years. Similar trends are underway in parts of Europe and Japan. However, some countries in Asia, Africa, and the Middle East are actually getting younger, as life expectancy is cut short by diseases such as HIV/AIDs, and also because they have experienced population booms only in the last two decades. In India, the country’s median age is 24 (compared to 33 in China and 43 in Japan) and more than half the population is under 25 years of age. Hence, developers are focusing much of their efforts on creating housing to support family formations and retail centers to cater to the population’s appetite for consumer goods, rather than senior-care centers. That boom will happen 20 years from now. Shrinking work forces in Japan and Western Europe raise issues as to who will fill office space. Contact:

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9. The Growth of the “Café Workforce”

“According to Ernst & Young” – Have you noticed the number of people using laptops in coffee shops? They can’t all be buying on eBay can they? In fact, they are an indicator of one of the biggest potential trends to impact corporate real estate in 2007: reduced need for office space. From Best Buy’s “results only” work environment to the fact that 57 percent of companies now offer some form of flextime, telecommuting has arrived. Look for corporations to shrink their “rule of thumb” space requirement per employee from today’s 175-200 square feet to closer to135-150 square feet or lower over the next few years. In the largest corporations, such moves could put US$1 million to the bottom line for every square foot save per employee.

When looking for major trends, the corporate sector can’t be overlooked: it’s too big a part of the overall real estate market. As an example, the top 10 corporations on last year’s Buildings magazine census – companies as diverse as Ford Motor, Wal-Mart, and HP – collectively controlled (through ownership and/or leasing) more than 2 billion square feet of real estate. And corporations have come to realize that the value of their real estate, along with the rest of the market, has risen dramatically. Real estate played a key part in several high-profile M&A transactions in 2006, including takeovers of Kmart and Toys R Us with – in each case – an experienced real estate operating company brought into the deal by the acquirer. A key aspect of

M&A deals going forward may be the involvement of a real estate operator that can add value to the real estate portion of the deal, often as much as 40 percent of the total deal value. In another strategy to access untapped real estate value, Ford Motor announced in November an US$18 billion dollar borrowing plan, using its huge North American real estate portfolio as collateral. Corporations such as Safeway, Sun Microsystems, and Cisco have announced plans to monetize all or part of their sizable real estate portfolios either through refinancing, the outright sale of excess assets to developers, or the sale/leaseback of facilities to investors. In each scenario, there is a direct impact on the broader real estate market, either for lenders, developers/operators, or investors. Contact:

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10. Building for the Ages

"According to Ernst & Young" – Look for more U.S. developers to embrace building techniques followed in Europe and design new projects to defy obsolescence. Chiefly, this means creating flexibility in the project to allow other uses should the market change or a new path of development occur. In 50 years, this trend may have a major impact on redevelopment cycles by minimizing the need for redevelopment on the scale we see today.

Brick and mortar doesn't become obsolete quite as fast as that new desktop you purchased last Christmas, but the useful life of much real estate is shortening dramatically. Take, for example, the vast swath of new data centers built in the United States and abroad in a building boom touched off by the dot-com craze of the late 1990s. Quietly and without much fanfare, many of those "state of the art" properties are being redeveloped or abandoned in favor of newer buildings capable of housing (and powering) far larger data operations. Even after the bust of the dot-com bubble, the old generation of data centers has been quickly made obsolete by the growth of mobile technologies and the need for larger servers to accommodate growing data demands, as well as more stringent requirements laid down by the Sarbanes-Oxley Act over the control and operation of such centers. The new generation of blade servers used in these buildings requires greater power supplies and often, it is cheaper for companies to build new rather than retrofit older data centers. In July 2006, developers broke ground on a 350-acre "data park" in Austin, Texas, which could become the model for similar developments worldwide over the next five years. But the question remains: will it still be a model after 10 years? Contact:

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