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## TOP TEN ISSUES AFFECTING REAL ESTATE™

The Counselors of Real Estate®

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## TOP TEN ISSUES AFFECTING REAL ESTATE™

The Counselors of Real Estate®

The Counselors of Real Estate has identified the current and emerging issues expected to have the most significant impact on real estate, with U.S. infrastructure being the leading concern of the 1,100-member organization. The Counselors once again released its annual list of the Top Ten Issues Affecting Real Estate™ as the keynote address of the National Association of Real Estate Editors' annual conference in Austin, Texas.

"Many of these issues are interrelated and thus influence one another," said Julie Melander, 2019 Chair of The Counselors of Real Estate. "Clients of Counselors seek unbiased, objective advice on the critical factors that will impact all property sectors today, as well as those issues that may affect their decisions over the next ten years. This thought leadership initiative is an invaluable service to those clients and to the real estate industry in general."



### 1. Infrastructure

In our survey, more than 50% of responding Counselors ranked Infrastructure as one of the top three issues. Respondents urged that this not be "put on the back burner" even though it is often displaced from public attention as more controversial matters capture headlines. One CRE commented, "Without substantial infrastructure improvements, several large U.S. cities (including New York and Washington D.C.) will become untenable for corporate expansions and top talent." Much of America's future economic growth depends upon improved productivity. Productivity, in turn, will be a function of efficiencies across the core systems in the economy.

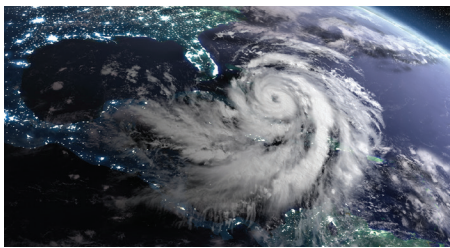


### 2. Housing In America

Millennials and Gen Z have trouble affording housing in neighborhoods near employment centers. Meanwhile, Baby Boomers have had difficulty selling their homes. The underlying causes are on both the supply and demand side. Construction costs have increased, and new construction has occurred mainly in the high-end market. On the demand side, younger households have student loan debt and high healthcare costs. Unemployment may be at a fifty-year low, but real income for 80% of the population has diminished. This widens the gap between an increasingly expensive supply of housing and a decreasing ability to pay.

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### 3. *Weather and Climate-Related Risks*

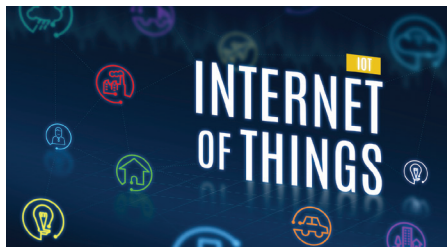
Climate risk has emerged as an important aspect of fiduciary duty and investment risk management. Weather and climate-related events present physical and operational risks for real assets, both in terms of acute risk from natural disasters, but also chronic risks from sea level rise, drought, heat waves, water scarcity, and food security. The year 2017 was the most expensive year in recorded history, costing the U.S. more than \$300 billion in weather and climate-related insurance losses. For all property types, natural disasters dramatically decrease property values.



### 6. *Political Division*

Political gridlock and/or infighting is either creating problems or frustrating solutions to many of the other issues identified on our list. The state of America's political dysfunction has intensified over the past several years. Policies which might otherwise elicit bipartisan action have been blocked by the political chasm.

While our members hold a broad spectrum of political views, it is the effect of the partisan division itself that prompts concern. One CRE described it this way, "Political differences make our options more limited, increase the cost of solutions, and cost us more and more of our competitive advantage around the world."



### 4. *The Technology Effect*

Real estate has had a different technological adoption path from other industries. Technological advances move faster than the industry can adopt them and have a wide variety of solutions and results. This has operational and cybersecurity risk implications. In the back office, data costs and needs for specialized skills pose a challenge for small businesses competing with larger firms. Building technology is rapidly transformed by occupant experience and behavior monitoring, requiring integration and automation like never before. Consumer adoption of e-commerce has impacted industrial real estate positively and retail somewhat negatively.



### 7. *Capital Market Risk*

Long-term treasury rates declined recently as investors seek safety reflecting recent market volatility and uncertainty, and inverted to levels below short-term rates as of mid 2019, a frequent indicator of upcoming recessions. Transaction volume fell by 4% year-over-year in Q2 2019 according to Real Capital Analytics as cap rates are at record lows in high demand markets. Public REITs faltered in 2018 but posted solid returns so far in 2019, and high-grade debt issuance is strong. Since 2008, the outstanding aggregate mortgage balance for GSEs, which include Ginnie Mae, Freddie Mac, and Fannie Mae, has grown from under \$100 billion to over \$670 billion.



### 5. *End-of-Cycle Economics*

The U.S. economy is in the tenth year of recovery. While there are a greater number of available jobs than workers to fill them, inflation and interest rates remain low and consumer confidence levels are relatively elevated. Low unemployment rates create little room for growth and yield curves have recently inverted. Watching the property markets specifically, construction cycles are well underway in growth markets and cap rates reflect a mature cycle. A Counselor warned, "Lessons never seem to be learned. Market participants are once again lacking discipline."



### 8. *Population Migration*

The map of population change from 2010 to 2018 shows gains in coastal cities. Big cities are prospering in California, the Pacific Northwest, Florida, the major Texas metros, and the Atlantic corridor from Boston to Washington, DC. Secondary cities are also growing. Meanwhile, there has been demographic shrinkage in the rural Midwest, South, the "Rust Belt", and Appalachia. Long-term trends have altered opportunities for workers in agriculture, heavy industry, and mining. Population growth has decelerated due to constrained immigration and the lack of "natural increase" (the excess of births over deaths) from the existing population. (CONTINUE ON **PAGE 7**)

# Swimming in Capital Markets Liquidity: Sources of Commercial Real Estate Debt

BY CONSTANTINE KOROLOGOS, CRE®, MAI, MRICS  
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As we enter into the second half of 2019, we approach 10 years of recovery in the real estate markets. One question on the mind of investors is the concern over when the end of the cycle hits, one of the 2019-2020 Top Ten Issues Affecting Real Estate. While transaction volume has slowed, there is a growing disconnect between seller prices and buyer bids. One place where the market continues to be flush with liquidity is on the debt side of the capital stack. While CMBS continues to be a viable product, volume of issuance is down almost 15% year over year for the first quarter 2019 vs. 2018, and down over 12% for year end 2018 vs. 2017. Other capital markets debt products have grown in popularity and are contributing to the liquidity in the market.

Mortgage REITs is a product that has been around since inception back in 1969. While they had perception issues that impacted them in the late 1970's, they have made a comeback over the last decade, with firms like Blackstone, TPG, ARES and Starwood creating publicly traded Mortgage REITs over the last few years. The Mortgage REITs have many financing tools at their disposal today. Part of their financing toolbox include leveraging the equity raised in the public markets with commercial real estate CLO transactions as well as securing multiple warehouse lines from investment banks and large commercial banks. Pricing, flexibility and cost will drive which financing levers are pulled.

The commercial real estate CLO market, which is a way for lenders to leverage their business, has been growing over the last few years, and is expected to continue as long as there is investor appetite for bonds. Commercial real estate CLO's are structured finance securities collateralized primarily by below investment grade floating rate commercial real estate loans backed by bridge/transitional loans. The lender that is using the commercial real estate CLO execution, will securitize a pool of floating rate loans creating various rated bonds for investor consumption. The commercial real estate CLO issuer retains the "equity" in the commercial real estate CLO, being the most subordinate part of the structure.

The commercial real estate CLO business is a far cry from the CDO business of 12 years ago where everything and "the kitchen sink" could be put into a deal. Post crash, deals tend to be more conservative and deals tend to see senior mortgages only. Early on CRE CLO transactions were static only and like CMBS transactions needed all loans contributed in the pools by the closing. That said, CRE CLO's still tend to have more transitional assets than CMBS whether static or not.

As the market has matured, there has been a growth of a more flexible pool, the managed pool. A managed pool differs from static in a couple of key ways. First, there is a ramp up period to add loans into the pool after the deal closes. Second, loans can be replaced in the pool. In so doing,

the duration of the deals can be pushed out longer, as it is less impacted by prepayment since loans are replaced. That said, investors pay more for a static deal, not managed, because of the certainty of what the make-up of the pool is. To mitigate this concern, managed deals do have eligibility criteria to keep the quality of the pool similar to the level at closing. Managed pools are becoming more popular and the spread premium is tightening. In 2018, 54% of all deals were managed and 46% were static. In 2016 the percentages were quite different, with 25% managed and 75% static. On a year over year basis, Q1 2018 had \$3.2B of issuance while Q1 2019 was at \$3.6B, so the size of the market continues to grow.

Another source of significant capital in the marketplace is coming from Debt Funds, which have been established to provide both senior bridge loans as well as mezzanine loans which are secured by the equity in the borrower. The number of Debt Funds has grown exponentially over the last few years, with a universe which includes small-balance high-yield shops, and large debt funds raising capital from high net worth investors, pension funds and endowments (like Calmwater Capital) or from foreign and domestic institutional capital (like Acore Capital and Prime Finance). Time will tell if capital will shift to troubled or distressed loans in the never-ending search for yield as rough waters lie ahead.

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AFFORDABLE HOUSING

## The Benefits of Creating an Affordable Community Standard

BY LAURA BAILEY

HEAD OF COMMUNITY FINANCE | CAPITAL ONE

A look at the 2019-2020 Top Ten Issues Affecting Real Estate tracks the growing awareness among real estate professionals that affordable housing has reached a crisis point, not just for the real estate industry but also for the nation as a whole. Recent lists have called attention to “the growing affordability gap and limited availability of housing in locations with significant job growth, particularly in metropolitan areas and coastal regions,” pointing to a host of supply and demand issues.

On the supply side, these include two decades of underproduction that have left the nation’s housing supply short by 7.4 million units of affordable housing for those most in need, according to the Joint Center for Housing Studies of Harvard University and its 2019 “The State of the Nation’s Housing” report. The gentrification of older neighborhoods that were historically home to people on limited incomes only exacerbates this. On the demand side, The Counselors has pointed to a variety of factors, including income stagnation for all but high-income households and the paralyzing burden of student debt (2018-2019 Top Ten Issue, 2019-2020 Top Ten Issue).

### THE DEVELOPERS’ DILEMMA

From my perspective as an affordable housing investor and lender, I can best

speak to the supply side of the equation. My experience is that our communities could build affordable housing more quickly if not for the obstacles of restrictive zoning, convoluted approval processes and NIMBYism. The amount of time, energy and money needed to secure approval for affordable housing can wear down the most committed developer. These issues are compounded by the sheer variation in regulations and processes from one jurisdiction to another. These differences often require developers to customize designs for each new jurisdiction they enter and master an entirely new permitting process, losing efficiencies that might come from repetition.

We need a way to break the gridlock. The Counselors, responding to the May 2019 survey upon which the 2019-20 Top Ten Issues was based, noted that “public policy responses have tended to be blunt instruments.” Clearly, we need a method that provides a modicum of uniformity, while respecting local differences.

### AFFORDABLE COMMUNITY CERTIFICATION

One approach might be to create a set of standards, much as the U.S. Green Building Council did when launching the Leadership in Energy and Environmental Design (LEED) certification. One of the

advantages of the LEED approach is that it sets ambitious goals while accommodating site-specific circumstances. There are many ways, for instance, to achieve LEED certification.

I believe it would be possible to create an Affordable Community standard with a similar certification process as long as this standard acknowledges the positions of all stakeholders, local community members as well as developers.

An Affordable Community certification could include any of the following categories:

- *Coherent Zoning and Regulation.* Many of the barriers to affordable development are inadvertent. They include land use restrictions that have the unintentional effect of making developable land more costly and rules to ensure environmental protection and historic preservation. Others, like density restriction and building heights, were sometimes designed expressly to exclude multifamily or affordable housing. As a first step, government leaders, with input from the general community, could explicitly delineate community goals for affordable housing and review and revise their zoning and permitting to align with them.

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Insurance companies like NY Life, Principal, John Hancock, MetLife and Nuveen, are leveraging their organization's infrastructure and managing third party accounts interested in issuing debt. Even several major development firms like Silverstein, Mack Real Estate, Related Properties, S.L. Green, and Brookfield have entered the lending business. Private equity has its role in the marketplace as well, with Blackstone, Colony, Oaktree, INVESCO, CIM and Starwood providing liquidity to the market, particularly

on larger deals. Investment Banks and Commercial Banks like Morgan Stanley, Citigroup, JP Morgan, Wells Fargo and Bank of America are wearing multiple hats, originating loans, providing leverage via warehouse lines, or managing the execution of CLO's. In fact, the Commercial Banks use their ability to provide warehouse lines to garner the CLO business from their borrower clients! Whether a borrower needs a \$2M, \$20M or \$200M loan, there are multiple options for the debt.

When we look at the composition of lenders in the market, CMBS, Debt Funds and REIT's represented 26% of total issuance in both 2017 and 2018. Within that segment, we did see a shift from CMBS to Debt Funds and REITs, with CMBS at 19% of the 26% in 2017 and 16% of the total in 2018. Liquidity from Funds and REITs are providing alternatives, and with the debt markets flush with liquidity and competition for transactions fierce, the question to ask is whether we are headed for rough waters with the possibility of credit and structural deterioration. •

## DISASTER RESPONSE GROUP FORMED

Counselors are known for supporting each other and giving back to their communities and industry. As the frequency and intensity of hurricanes and other disasters has increased in recent years, The Counselors of Real Estate has begun formalizing efforts through its new Disaster Response Group to assist members, their clients, and communities. In addition to reaching out to members to offer support in response to disasters, The Counselors is assembling a volunteer team to take calls from Counselors seeking assistance in areas hit by disaster. In addition, we have developed a list of disaster-related resources with key insights from CREs. These resources will be available soon at [cre.org](http://cre.org) and we welcome comments and additions.

Please contact Samantha DeKoven, Director of CRE Public Service Initiatives, at 312.329.8431 or [sdekoven@cre.org](mailto:sdekoven@cre.org), for more information or to join the Disaster Response Group.



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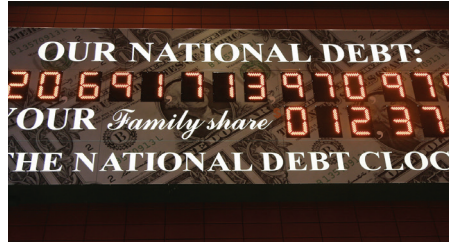
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#### 9. Volatility and Confidence

Market sentiments are prone to change rapidly and sometimes quite dramatically. Consumer confidence often reaches high points just prior to recessions, yet many mistakenly interpret these polls as predictors of future consumer behavior. The deceleration in employment over the first half of 2019 may combine with financial market jitters over tariffs and the inverted yield curve to weaken confidence. Investment in existing and new property is an expression of performance expectations, and data suggests that confidence in sustained demand for residential and commercial property assets is faltering.



#### 10. Public & Private Indebtedness

The real estate industry typically views debt as a financial tool that can enhance return for equity investors, when used responsibly. Therefore, it is telling when CREs sound alarms about debt. U.S. consumer debt has hit record highs, with rising delinquency rates damaging credit scores and the residential mortgage market. The U.S. Federal budget deficit has widened after tax cuts and increased spending. Most states are constitutionally obligated to maintain balanced budgets, driving property and real estate transaction tax increases. In Europe, the economy is largely buoyed by household debt subsidized by negative interest rates. •



### TOP TEN ISSUES AFFECTING REAL ESTATE™

The Counselors of Real Estate®

The Counselors' annual Top Ten Issues reflect the collective experience of a wide range of Counselors who are experts in their fields and are known for innovation and creative problem-solving. To locate a Counselor with expertise in these areas or for press inquiries, please contact [info@cre.org](mailto:info@cre.org).

For a more detailed discussion of these topics, visit:

**CRE.org/TopTen**

### AFFORDABLE HOUSING (CONTINUED FROM **PAGE 5**)

- *By-Right Development.* Most affordable housing development is subject to discretionary review, which almost always generates NIMBYism and delay. When community goals for affordable housing and zoning requirements have been established through an open process, a more productive approach would be for communities to allow as-of-right and by-right development when proposals meet local requirements.
- *Entitlement Processes.* Communities as well as developers lose when locally subsidized affordable developments are delayed by prolonged permitting, inspection and utility-hookup. Communities can create expedited permitting for affordable housing by taking such measures as appointing a single municipal point of contact for permitting and publishing a permitting timeline. While local governments are responsible to their citizens to keep their staff

lean, they can set local priorities and run a unified queue to enable developments to proceed from planning to completion.

- *Inclusionary Zoning.* Another approach to breaking the affordable housing bottleneck is to encourage developers of market-rate housing to set aside a percentage of their units for low-income residents in exchange for density bonuses or fast-track permitting. Inclusionary zoning is particularly important in light of recent research that shows that the most effective means to upward mobility for low-income families is moving to a high-opportunity neighborhood.
- *Tax Relief.* Some communities provide tax incentives for developers who construct affordable housing. All too often, however, securing tax relief can be a difficult, time-consuming process. One way to spur the development of affordable housing is to better align tax

policy with affordable housing goals, clarify requirements for abatements and streamline the approval process.

#### PROUDLY DECLARE YOUR COMMUNITY'S AFFORDABILITY

This list is meant to be suggestive, not prescriptive, but it highlights the potential of an Affordable Community designation to jumpstart development. The certification process is itself an opportunity to raise awareness of affordable housing as a public good, one that reduces sprawl, attracts new businesses, boosts tax revenues and increases equity and diversity.

Housing, however, is just one element of what makes a community affordable. Others include easy access to transportation and fresh food, safety and security, and public amenities. The Affordable Community designation could be expanded to embrace them all, signifying a community that is not merely affordable, but thriving. •



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