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REAL ESTATE MONITOR

MILLENNIAL SHOPPING HABITS AND WHAT THEY MEAN FOR RETAIL BUILDING OWNERS

By Stuart Eisenberg, Assurance Partner

Millennials – those born roughly between 1980 and 2000 – are changing the face of retail.

They have a combined purchasing power of $2.45 trillion worldwide – $600 billion in the U.S. – and they account for almost a third of all retail sales.

Their influence is only going to grow – by 2025, they will comprise 75 percent of the workforce.

Millennials are now major consumers, but they differ from previous generations in the following ways:

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MILLENNIAL SHOPPING HABITS

MILLENNIALS KNOW WHAT THEY WANT.

- **Thrifty**: Having come of age during the Great Recession, many are either underemployed or unemployed, and many have crippling student debts. They are keen bargain hunters and big users of discounts and coupons.

- **"NOwners"**: Prizing experience over ownership, they love shopping, but see it as a form of entertainment and are often inclined to browse, but not buy. Smart retailers are turning this to their advantage and offering shoppers a fun experience. For example, H&M's store in midtown Manhattan has a runway shoppers can walk down wearing their new clothes – they are filmed and the best videos are displayed on storefront screens.

- **Tech-savvy:** Millennials are glued to their mobile devices and have a strong preference for brands that offer seamless integration between online and offline sales. Technology also enables retailers to engage shoppers with discounts and special offers.

- **Impatient:** With all the world's stores at their fingertips, millennials do not like to stand in line or wait for purchases to be delivered. This desire for instant gratification was behind an uptick in so-called click-and-collect purchases during the UK's holiday shopping period – customers make purchases online and receive a discount when they pick up their purchase at a designated store. Some see retail stores eventually becoming more like distribution hubs, with qualified experts on hand to offer advice.

- **Multichannel shoppers:** Millennials do more shopping online than other generations, but they also still like going to the mall. According to OpinionLab, 37 percent of millennials prefer mall shopping while only 27 percent would rather shop online. They use their phones to browse and compare prices online, but online purchases can take too long to deliver and they do still enjoy the instant gratification of purchasing in-store.

The OpinionLab survey is good news for brick-and-mortar retailers, provided they have a strong and easy-to-use website, and attractive store interiors.

In order to attract them as customers and tenants, retail building owners should consider the following options:

- **Interiors:** Renovate and retrofit interiors to make them bright, attractive, aesthetically pleasing places to be. Install power points / charging stations in common areas, with comfortable seating and WiFi, so mall shoppers can recharge their mobile devices on the go. Rotate signage frequently to keep the center looking fresh, and include self-service kiosks to reduce line waiting times.

- **Tenant mix:** Have a wide variety of tenants including fitness and entertainment providers so that shoppers can also work out, relax and socialize. Include value-oriented retailers such as dollar stores, thrift stores, and drug stores. Pet stores are also a draw for millennials, who have tended to put off marriage and children, but do have a fondness for pets and pet accessories.

- **Co-locate:** Millennials like to live in dense, mixed use, walkable urban neighborhoods close to offices, shops and entertainment. Malls in downtown neighborhoods that offer a range of shopping and entertainment options will be a sure draw for the millennial customer.

- **PopUps.** Once an oddity, PopUp stores are becoming more common. Short-term leases – often lasting just a couple of weeks – are a way to increase mall occupancy, provide new and online stores with a temporary storefront to increase their brand awareness, and provide shoppers with a new and different experience each time they visit.

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WHAT'S NEXT FOR FOREIGN INVESTMENT?

By Anthony La Malfa, Assurance Partner

As a whole, foreign investment in U.S. commercial real estate is on the rise, totaling $45 billion in 2014, according to research firm Real Capital Analytics. This marks the highest level of investment in the industry since 2007. Even despite low oil prices and a strong U.S. dollar that has hurt exports in other industries, foreign investment in commercial real estate is only expected to grow throughout this year as international investors continue to be attracted by the stability real estate assets offer. According to the United Realty/ Zogby Real Estate Confidence Index for the fourth quarter of 2014, about 60 percent of 113 institutional real-estate professionals surveyed said they anticipate a significant increase in foreign investment.

Who Are the Leaders of the Foreign Commercial Real Estate Investment Pack?

Investments from Canada, Norway and China have been most significant, reports *World Property Journal*. While we've seen investment from nations across the globe, including emerging markets like Singapore and some Middle Eastern nations, these three players are currently pumping the most capital into U.S. commercial real estate and REITs. Canada was the largest buyer of U.S. real estate in 2014 with 26 percent of direct foreign investment, followed by Norway and China, with 12 percent and 10 percent, respectively.

Their dollars are primarily being allocated towards "trophy assets," as well as "gateway" markets. For example, the Government Pension Fund of Norway, one of the largest sovereign wealth funds in the world, recently closed on its purchase of a 45 percent stake in a 40-story skyscraper at 11 Times Square in Manhattan for $401.9 million, a deal that valued the 1.1 million square foot property at $1,273 a square foot, according to reports from *The Wall Street Journal*.

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FOREIGN INVESTMENT

Strong Demand for "Safe" Investments

Despite a stronger dollar, foreign investors are not shying away from U.S. commercial real estate as they continue to have an appetite for these hard assets thanks to low interest rates and strengthening property fundamentals. Foreign investors are attracted to the safety U.S. properties afford, especially when they might be experiencing financial distress in their own countries coupled with a weakening of currency.

Especially appealing to foreign investors are traditional "gateway" markets, like New York, Washington, Southern California, and Southern Florida. "Trophy assets" in these markets often come with consistent rent rolls and predictable streams of net cash flow. They are also considered more secure because the market is large, relatively liquid, and consistent over time. From a liquidity perspective, assets in these markets are easier to sell, which is beneficial for the foreign investor who is typically interested in the long-term holding versus the immediate return.

Foreign investors are also demonstrating an interest in secondary U.S. markets, such as Atlanta, Seattle and San Diego. For example, Bahrain-based Investcorp acquired a portfolio of multi-family communities in the metropolitan areas of Washington, Orlando, San Diego and Baltimore for $300 million. While these markets may not always be considered as safe as gateway markets, they offer investors an alternative with potentially higher returns than the gateway markets in which availability is limited due to high demand.

Investment in Central Business Spaces Indicates Strength in Office Real Estate Market

Foreign capital acquired $17 billion in U.S. office space assets in 2014, making up 45 percent of all foreign investment in U.S. commercial real estate, and this trend could continue throughout 2015. Of these investments, most were in central business district (CBD) spaces. And New York and Boston are the leading markets for foreign office investment. Testament to this is that in January, the Canadian investment firm

Ivanhoe Cambridge bought the office building 3 Bryant Park from Blackstone for $2.2 billion.

As in 2014, the first quarter of 2015 experienced year-over-year increases in both net absorption and rental rates for CBD office space, although the increases were somewhat subdued. The slower increases were partially due to seasonality and, with respect to absorption, partially due to new available space. As companies try to cater to the growing numbers of millennials in the workforce, the lack of demand for suburban office space has contributed to the strong performance of CBD office space. Therefore, it is noteworthy that the end of 2014 saw an uptick in foreign investment in suburban office space as well, indicating interest in office properties across the board, despite the trend toward centralized business space.

Foreign Investors Getting in On Ground-Floor Of Major Development Projects

The development landscapes of primary markets in the U.S. have long been dominated by local players, such as private-equity funds or pension funds. Wealthy foreign investors, including sovereign funds looking to shift funds away from oil markets, are now outbidding these traditional players, according to *The Wall Street Journal*. They're drawn by the potential for higher investment returns compared to an existing property and are less risk-averse than traditional players. While established, fully leased commercial real estate properties are safe investments and appealing, many foreign investors are enticed by potential for higher returns. There has been an onslaught of major towers in large metropolitan markets like Boston, New York and Washington, D.C., funded by newcomer foreign backers.

Foreign Investment Helps Pave Way For Brighter Industry Outlook

As international capital flows into domestic real estate markets, there could be investment across the board in domestic markets large and small. According to CoStar, the cross-border flow of investment dollars into U.S. commercial real estate appears to be gaining strength this year as foreign investors cast a wider net to cover markets outside the core gateway cities. Couple the influx of foreign investment across markets with a strengthening economy, and the future for commercial real estate looks bright.

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PRIVATE DEBT IS THE LATEST "SOUP DU JOUR" FOR YIELD STARVED INVESTORS

By Reza Khan, Senior Manager

STRONG TAILWINDS PUSH A SIGNIFICANT TIDE OF CAPITAL THROUGH THE U.S. REAL ESTATE INDUSTRY

This influx has been put to work as one can see building cranes in most gateway cities. While this is creating buoyancy in the market, the challenge is to find financing. As banks have been rigorous with their underwriting process due to regulatory constraints, the volume of loans from conventional sources has diminished. Investment managers and other investors have recognized this gap and have entered into the financing foray in order to fill the void and capitalize on the next opportunistic play. Competition in the commercial real estate debt market is quickly rising to pre-crisis levels and it is like shooting fish in a barrel.

The use of debt is an essential element of any capital stack. It is highly favored by borrowers because:

1. Lenders have no claim to equity and therefore there is no dilution of equity.
2. Financing is less complicated than raising equity, primarily around regulatory and legal compliance.
3. The lender has no claim to profits.
4. It amplifies the return on investment.

Private debt has attracted significant investor capital in recent years. In 2014, a total of 26 global debt funds raised $20 billion, which is up from the 29 funds that raised $16 billion in 2013[1]. The catalyst for this movement can be attributed to: 1) Regulatory developments have restricted the flow of debt from traditional sources; and 2) Between 2015 and 2019, approximately $1.5 trillion[2] of commercial real estate debt is due. The loans maturing in this period amount to 2.5 times more than the 10-year balloons that matured between 2012 to 2014.

Debt investments operate much like fixed income product with returns that are very close to equity yields, making debt funds very attractive on a risk-adjusted basis. Through creative deal structuring, some funds are able to generate low double-digit returns by taking a loan and selling off pieces. Also, by re-organizing sub-performing or non-performing portfolios, managers are able to generate returns slightly above equity yields.

Returns depend on a multitude of factors such as risk, value, asset quality and the strength of the sponsor. As there are more entrants into the private debt arena, it is likely that yields will drop given the aggressiveness of competitors in finding deals to utilize capital.

The prospect of steady cash flow and the priority of the capital stack make the investment profile very attractive to investors, even with the potential drop in returns. According to a recent Preqin study gauging investor's perceptions of debt investments, 47 percent of respondents held positive views toward debt; 37 percent were of neutral opinion; and 16 percent viewed the asset class negatively.

Preqin also noted institutional investors are allocating more capital to the alternative asset class and some were establishing private debt as a new category in the alternative space. This positive outlook is fostering the growth of the asset class globally.

The buoyancy of the industry has attracted non-conventional entrants like PE funds, insurance companies, pension finds and some sovereign wealth funds (SWF). The capital provided by the new sources is hunting for yields in a low interest rate environment. Based on another Preqin survey of private debt investors, direct lending (62 percent) is the most attractive investment option, closely followed by special situation positions (50 percent), with distressed and mezzanine (approximately 30 percent lending) rounding out the major areas of focus by all participants.

PE funds are looking to capitalize on the latest "opportunistic" play, and debt funds present the latest avenue to achieve at least low double-digit returns. As banks have pulled back on lending activities, bankers have relocated to investment management firms to continue their activity.

An investment manager notes insurance companies have a significant amount of capital and are not hobbled by allocation constraints. Insurance companies do care about interest rate risk but are more focused on performance to maturity. AXA established a $1.8 billion debt fund in 2014. Met Life registered with the SEC to offer a debt fund. It is likely other major insurance companies will follow.

In the past, SWFs focused on trophy assets around the world. That sentiment has changed and SWFs are now searching for yields fueling investments with enormous sums of capital.

Government agencies have a limited amount of funds to lend – approximately $60 billion in 2015. That amount is being transacted at a very quick pace and the year is not over. Industry veterans indicate the non-conventional participants will seek to fill the void. With ensuing competition, it is essential lenders remain disciplined with their underwriting process in order to avoid a repeat of the last cycle.

Another area of the lending industry that has gotten a second wind is commercial mortgage backed securities (CMBS). After coming to a grinding halt in 2009, CMBS is making a slow and steady return. Banks that closed down these units are reviving them to get in on the action. In 2014, there were $94 billion of transactions compared to $86 billion in 2013. Year to date, there have been about $35 billion, compared to $21 billion in 2014 for the same period.

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PRIVATE DEBT

With delinquencies at an all-time low, many borrowers are using this market segment to obtain debt. A New York-based mortgage broker cites securitization as a way to address the "lumpiness" of real estate transactions. It is easier and more efficient to work with an investment banking team than to pull together a consortium of banks to fund large financings. This indicates that single asset owners also are venturing down the CMBS path as CMBS were typically associated with portfolio deals.

Evidence indicates there is vibrant lending market filled with conventional sources and new entrants. Some are a bit cautious that this boom in real estate debt will turn into a game of musical chairs that will undoubtedly leave some parties holding non-performing or underwater properties. However, many in the industry argue the market dynamics are different from the 2006 to 2009 period. In the last cycle, debt was replacing equity which was a toxic formula when values declined.

Competition in the lending market will continue to grow given the demand for financing, and lenders will become more aggressive in order to win the best deals. However, many feel the underwriting process will not be compromised as in the last cycle. Lesson learned? Or will the hunt for high double-digit returns overshadow discipline? Only time will tell.

1 Preqin

2 Trepp Analytics

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PErspective in HEALTHCARE REAL ESTATE

While the number of senior housing real estate deals continues to rise, deal sizes seem to be on the wane. In 2011, the 312 senior housing and care deals totaled $27.6 billion in transaction volume, according to data from the National Investment Center for Seniors Housing and Care (NIC). By comparison, from the second quarter of 2014 to the first quarter of 2015, there were 609 deals totaling $19.9 billion, according to NIC data.

Healthcare property investors – real estate investment trusts (REITs) and private equity firms – are especially attracted to the senior housing sector because of its market fundamentals. Aging demographics mean growing demand, and since most facilities are private-pay, they are less susceptible to government funding decisions than other healthcare properties such as hospitals and skilled nursing facilities.

Some larger REITs have been concentrating their portfolios on the senior housing sector to limit their exposure to government reimbursement issues. Healthcare REIT Ventas announced in April it would spin off most of its skilled nursing facility portfolio into an independently traded REIT. Meanwhile, Health Care REIT raised $750 million through a benchmark offering of senior unsecured notes to fund, among other things, investments in healthcare and senior housing products.

However, since large portfolio deals in the senior housing sector have been harder to come by recently, some large REITs are downsizing to move the needle with smaller portfolio and single-asset acquisitions – and some industry insiders predict more REIT spinoffs could be on the horizon. These spinoffs make attractive targets for PE firms. For example, a number of PE firms are currently bidding for an operating company spun out of a recent merger between Ventas and hospital provider Ardent Health Services. The sale of the company could fetch upward of $500 million.

Analysts have predicted that senior housing will go from a niche sector to a mainstream asset class during the next 15 years as the population ages. The sector is highly fragmented, meaning there are plenty of opportunities for consolidation as smaller providers look to achieve economies of scale.

Distressed deals present additional opportunities. Bankruptcies – as a result of market forces and healthcare reform – are on the rise in the senior housing sector. Mid-sized providers are looking to grow by acquisition after a period where they were priced out of such deals. Although far from straightforward, a successful makeover of a distressed senior housing property can make it an attractive target for REITs and PE firms further down the line.

Big portfolio deals may be down, but there are still plenty of investment opportunities in the senior housing sector as large players spin off businesses and small players look to consolidate.

REPURPOSING OLD REAL ESTATE

By John Tax, Assurance Director

NOWADAYS, EVERYTHING IS BEING REPURPOSED OR RECYCLED – FROM ORDINARY HOUSEHOLD ITEMS SUCH AS PAPER, GLASS AND METAL, TO REAL ESTATE – WITHOUT REGARD TO WHETHER IT IS COMMERCIAL, RESIDENTIAL, RETAIL OR INDUSTRIAL REAL ESTATE.

The concept of repurposing is not a new one, but rather one that has taken on a new life amid the rush to go green. Owners, developers and re-developers have taken this concept to heart by reusing everything from office buildings to hospitals to auto dealerships.

There are a number of considerations when a building owner or a developer decides to reuse an existing structure. Some of these considerations are:

- **Cost** – Taking an existing structure and reconfiguring it for a new use is often less expensive than building a completely new asset, especially when you consider the costs of demolition and the cost of new construction.

- **Use** – When an existing structure goes dark, a new use for the asset could be just the ticket to returning the asset to profitability. In recent years, dark spaces in shopping centers, big-box stores, office buildings and auto dealerships have been repurposed into artists' spaces in Missouri, a YMCA in Texas, business school classrooms in Pennsylvania and a grocery store in Michigan, respectively.

- **Need** – Commercial real estate can be repurposed to fill a need in a community. Building owners must have a good understanding of the market and be ready to convert the asset to a new use quickly to capitalize on these needs.

- **Location** – The new use should be complementary to the existing area. For example, converting an existing big-box store to a gym or taking a commercial property and creating a school might be a great idea in an area with numerous multi-family residential properties.

Repurposing is definitely not without a downside and there are often difficulties faced by building owners when attempting to reuse a property. These risks could include:

- **Structure** – Converting a building from one use to another requires an understanding of the physical requirements of the new concept. Technology is rapidly changing and an existing structure may not be suited for the new use. Technology-heavy tenants, including medical facilities, call centers and Internet companies require significant supporting infrastructure, cabling and cooling units. These items may not have been originally contemplated in the existing structure.

- **Use** – Sometimes the new use for the property may seem like an easy conversion, but all factors must be considered or the unforeseen could occur. In a recent

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OLD REAL ESTATE

RealtorMag article, "Repurposing the Right Way," Meg White discusses one developer's project to convert an old mill house into a restaurant. The owner installed central air conditioning for the first time and shortly thereafter the property was infested with worms. It turned out that the humidity created by the air conditioning caused the worms to migrate out of the old beams.

- **Zoning** – Changing the use of a structure will necessitate a change in zoning. This will require working with the local government and zoning commission to effect the necessary change. This can be a time-consuming process which could ultimately delay or even stop the project if the appropriate zoning approval cannot be attained.
- **Americans with Disabilities Act (ADA) Compliance** – Older structures often are not ADA-compliant and upgrading an existing structure could be expensive. Reconfiguring entranceways, bathrooms and hallways for ADA compliance can be time-consuming and sometimes cost-prohibitive.
- **Parking and Traffic** – Changing the need for parking and changes in traffic flow around the building could be problematic. If the building's new use causes an increased need for parking, that must be taken into consideration. Other area residents could be against an increase in traffic and protest the new use.
- **Marketing** – Changing the use of an existing building requires a keen marketing program to change the public's perception of the building, especially when considering a new use for a historic building.

Repurposing a property requires commitment and creativity. Different stakeholders such as the owner, the developer, the local government and the community must work together toward a common goal. Any adaptive use requires vision, a detailed understanding of the local market and the marketing expertise to find a different category of tenant. The considerations and hazards listed above are just a few. There are numerous other considerations and difficulties that are market-specific which can arise. However, by working together, carefully weighing all necessary decisions and responding to issues as they arise, everyone can win in the end.

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