

SPECIAL ISSUE

NATIONAL REAL ESTATE Investor[®]

2020 Outlook
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Market Trends and 2020 Outlook

Insights from commercial real estate experts on
what we learned in 2019 and what 2020 will bring.



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EDITOR'S NOTE

A Critical Moment

A momentous year lies ahead. An uncertain presidential election, international trade wars, the culmination of Brexit, fears of a global recession, and a new low-interest rate regime hang over a commercial real estate industry that's now a decade deep into a growth cycle.

Within the commercial real estate industry major trends are having impacts as well. An unprecedented boom in investment in proptech is altering day-to-day business practices. The continued shift to

direct-to-consumer sales continues to reshape the retail and industrial sectors in a variety of ways. The office sector is being dominated by the activity of tech tenants, who are the biggest users of space and dictating trends in how office space more generally is being configured. The multifamily sector, meanwhile, continues to chug along unfettered. And alternative sectors, such as seniors housing, student housing, self-storage and others, continue to pick up market share as real estate investors seeking

An unprecedented boom in investment in proptech is altering day-to-day business practices.

yield stray some from the core property types.

All of these issues are addressed in our fourth Market Trends and Outlook supplement. Nearly 50 firms this year have contributed pieces covering every major property sector and most of the alternatives. Pieces cover leasing, investment and financing trends. Some also grapple with the macro issues overhanging the industry and how they will affect activity in the year ahead.

The pieces in this supplement once again cover the full gamut of the industry. What they have in common is they come from some of the best companies and best minds in the business. ■

A handwritten signature in black ink, appearing to read 'David Bodamer'.

David Bodamer
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Is CMBS Racing Toward a 2020 Inflection Point?

By **Toby Cobb & Jack M. Cohen**

The commercial mortgage-backed securities (CMBS) industry model has crossed into an era in which industry participants must rehabilitate its structure. As the sector continues to evolve in 2020 and beyond, lenders face an imminent choice: change and lift the fortunes of CMBS lenders across the board; or, face a potential downward spiral where origination volume will continually decrease, eventually causing consolidation, or worse—extinction.

To avoid this would-be “death spiral” in the CMBS community, platforms must rethink how the very CMBS ecosystem is set up, how they operate, and how they interact with one another. When CMBS was founded 25 years ago, traditional capital providers had limits to the availability of their capital, allowing CMBS vehicles to inject more money into the market and fuel growth. However, restrictions were put in place to enforce the notion that CMBS borrowers should not be trusted, requiring trustees, servicers, direct certificate holders and (eventually) operating advisors to impede on relationships between lenders and borrowers. As a result, trust between borrowers and lenders eroded as did the service proposition, making it difficult to establish meaningful connections.

Today, traditional conduit lenders still represent the vast majority of CMBS creditors. Conduit lenders seek arbitrage profits on CMBS securitizations while “passing through” the risk of their loans by selling them in their entirety to a third party, creating economic conflicts of interest and barriers to proficiency. When loan servicing is outsourced, borrowers are put in a precarious position with their investments. Moreover, conduit lenders practice vertical risk retention, meaning they only hold a small slice of risk and pass the majority through to the securitized pool. This fails to hold lenders accountable, and the lack of unified servicing leads to more dissatisfied borrowers reluctant to come back and borrow from this sector of the capital markets. To mitigate these issues, lenders must modify these practices as well as the underlying fabric of CMBS’ infrastructure.

To change the industry’s course, CMBS lenders must focus on borrower relationships, in addition to eliminating constraints in pooling and servicing agreements (PSAs) to allow servicers and direct certificate holders (on behalf of all the bondholders that make up the holder of the loan) to interact more easily. Balance-sheet lenders that retain the risk of each loan are leading this effort; risk retention can create a virtuous cycle between lender (and bond buyers),

borrower and intermediary by unifying servicing and all other loan decision-making responsibilities. This means that borrowers need not reach out to multiple parties for decisions to be made, and can instead have trust in their lender and their representatives to resolve any issues, which inevitably arise, in a timely, responsive and responsible fashion. By using securitization to finance lenders’ balance sheets, and not generate arbitrage profits, lenders

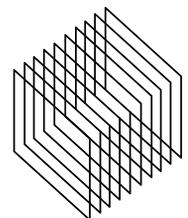


maintain equity in their receivables to align interests with borrowers and intermediaries—and are enabled to make only the best decisions for all parties throughout the life of a loan. This enhances the relationship with the borrower, increases borrower satisfaction, solidifies trust and mandates that lenders rely on pure real estate expertise to thoroughly vet each lent-upon asset.

In summation, if CMBS lenders look at an inflection point as an opportunity to better the industry, rather than a looming downfall, prospects for both lenders and sponsors will improve. In a decade that is sure to see prolonged uncertainty, platforms in 2020 must change key tenets of their operations. Otherwise, each may instead face the uncertainty of its own sustainability. ■

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3 6 5 0 R E I T

Welcome to the Roaring '20s: How CRE Financing is Changing for a New Era

By **Paul Letourneau**

In today's world of rapid transformation, the advent of the 2020s doesn't just mark the passage of time—it marks the beginning of an all-new era of strategic opportunity in commercial real estate financing.

From more expansive loan structure offerings to the rising value of strong community roots, investors should consider these go-forward trends with the '20s now roaring into view.

A broader view of CRE product types is here to stay

Where once financial institutions wanted to fund the four traditional property types—office, industrial, retail and multifamily—specialty properties now offer opportunity for lenders and borrowers alike. We expect to see more medical, self-storage, parking, hospitality and other niche facilities gain recognition as worthy asset classes.

But new opportunity also means new challenges that shouldn't be overlooked. Self-storage, for instance, can provide consistent cash flows and revenue, but investors should watch out for overdevelopment in certain markets. Deep knowledge of the local demographics and competitive landscape is key to success.

Loan structures are becoming more complex

Bridge-to-perm loans, loan-on-loan structures and other non-traditional approaches to financing are becoming more common, a trend we can expect to carry through the early part of the new decade. Why? Lenders and borrowers alike are seeing the benefit of moving beyond a one-size-fits-all loan structure.

For example, with a bridge-to-perm loan, investors can lock down rates for the long term on transitional property types, enabling them to secure financing beyond the initial redevelopment phase.

Loan-on-loan structures are also gaining favor, with borrowers often able to get access to capital faster than with traditional financing and allowing specialty lenders to partner with traditional lenders after loan closing to increase margins and returns.

Underwriting is becoming more sophisticated

Lenders, staffed by industry veterans who have gone through multiple cycles, are developing a new world of capability to go beyond traditional loans and property types.

By leveraging increased access to information and advanced analytical tools, experienced lenders are able



to evaluate risk from many different angles—discerning between trends and fads, and even utilizing predictive analytics to assess performance over time. Sophisticated technologies like default modeling and AI-enhanced due diligence tools are reshaping the financing process.

Credit is shifting from big brands to tangible value

In retail, a national brand name used to be the mark of a strong credit tenant—until so many started defaulting on their loans and walking away from lease contracts.

Today, the strength of a tenant's credit is more nuanced and subject to more scrutiny than in years past. Lenders are now looking for a tenant mix that will prove "e-commerce-proof"—offering a mix of well-known names but also experience-driven local businesses that can help bring in traffic, and in turn, long-term growth.

The same is becoming true in other product types, too, as the worlds of work and home shift with the winds of the rapidly-evolving sharing economy.

Evolving trends call for evolved strategy

The 1920s were a period of economic exuberance. In the 2020s, however, a freewheeling approach won't serve your long-term goals. In this fast-changing new era, the best financing plan is one that can evolve with you throughout any given property lifecycle, which requires more flexibility in loan structures.

Investors who stay ahead of the trends and risks of this new era, with some built-in flexibility, will be well-positioned to enjoy its great opportunities, too. ■



Paul Letourneau is manager of commercial loan originations for Alliant Credit Union. Learn more at www.alliantcreditunion.org



The Next Phase for CRE Crowdfunding: Consolidation

By **Adam Kaufman**

When the commercial real estate crowdfunding industry formed with the Jumpstart Our Business Startups (JOBS) Act in 2012, it opened up a new way to raise equity and immediately witnessed rapid growth with the creation of numerous platforms.

Most early entrants in the space were technology focused and backed by venture capital firms. This resulted in the quality of the underlying real estate transactions taking a back seat to the demand for volume in order to show quick growth and returns.

For the real estate crowdfunding industry to experience stable growth and truly achieve its potential, there must be a shift in priorities. 2020 will be the year where that will start to happen. There has already been early consolidation in the industry, most notably, with the unfortunate demise of RealtyShares. We have been privileged to experience the longest-running bull market in history, in which commercial real estate values have risen to new heights, masking a lack of experience and some of the effects of poor deal selection. Plainly stated, many people have gotten lucky.

This market run will not last forever. Platforms that have thrown every deal against the wall to see what sticks will be forced to face the consequences. This will result in a needed shift in focus and commitment to selecting quality transactions with strong fundamentals.

Real estate is an industry that requires experience and deep-rooted relationships to correctly source and analyze transactions—especially when real estate values are at precariously high levels. Technology can assist with these functions, but should not replace it.

We've witnessed many deals that have failed to meet our rigorous underwriting standards offered on other platforms. This is alarming because the returns projected were unrealistic and the deals will ultimately fall short, eroding trust in the industry and driving people away from investing in real estate crowdfunding.

Given the industry has only existed in an upcycle, a real track record has yet to be established and platforms have yet to be truly tested. Fearing volatility, prudent investors will flock to platforms that focus on the underlying product—the real estate—and are able to provide more transparency and accessibility into their businesses.

Platforms will realize that attracting investors is only

half the battle. Certainly, bringing in new investors is important, but cultivating relationships built on transparency, real estate experience and strong fundamentals will ultimately sustain the industry. This will only be possible if investors have positive experiences—meaning their expectations (projected returns) are realistic and they trust the company they are investing with. Of course, it's inevitable that there will be deals that don't perform, but investors



should not be doomed from the outset because of shoddy underwriting or a platform putting the interest of its own growth ahead of the interests of its members.

There is tremendous opportunity for continued growth in this emerging industry. The platforms that continue to prioritize technology and promote aggressive growth trajectories will suffer, while those that put the interests of investors first and are responsible, transparent, and present high-quality offerings will continue to gain market share. ■



Adam Kaufman is the co-founder and COO of ArborCrowd.

Learn more at www.arborcrowd.com.



ARBORCROWD

Opportunities for Large Multifamily Investment in 2020

By **John Richardson**

Investors looking to deploy capital continue to view the U.S. multifamily sector favorably for generating attractive risk-adjusted returns. While it's no surprise that the gateway markets continue to see substantial activity, large multifamily¹ investments are increasingly following labor demand and population growth into secondary and tertiary markets. No two markets have the same formula for success, though there are a few of common themes investors and lenders are looking for when considering which cities to bet on as we head into the new year.

Strong supply pipelines with robust demand

Markets with high levels of liquidity and robust pipelines of multifamily construction are certainly ones to watch in 2020. Boston displays both of these features, and lags only New York in terms of new multifamily structure permits. Bean Town registered 506 new permits in the year ending in June 2019, according to U.S. Census Bureau data—a signal that developers and investors believe the city's multifamily market has room to grow. Accounting for nearly 36 percent of the metro's total renter population, Millennials continue to elevate multifamily demand as the cohort places a high value on the financial flexibility and lifestyle balance provided by home-rentership.

Tech-centric employer base and talent

Several non-gateway cities are ripe for multifamily investment, especially those that are attracting top tech companies and talent. Seattle is a prime example, where 15.7 percent of renters work in science, technology, engineering, arts/design or mathematics (STEAM) jobs, according to the Census Bureau's latest American Community Survey. These renters tend to have higher incomes and can typically afford market-leading rents. The city is betting on this crucial group's need for apartments, as permitting for new multifamily units and structures in Seattle ranks among the highest nationally.

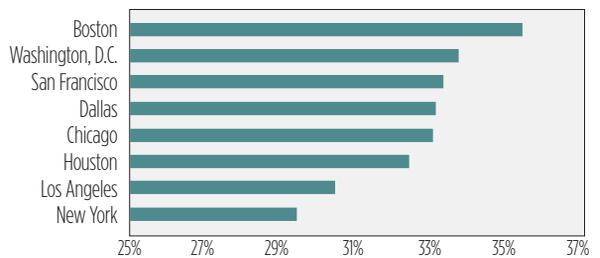
Rapidly growing labor markets

It logically follows that the cities with outsized labor market growth are the same ones with rising levels of new housing demand. Leading a state-wide renaissance, Orlando's multifamily sector is benefitting from a rapidly expanding workforce. The city's year-over-year employment growth as of July 2019 hit 3.8 percent, the fastest rate of all the top 50 metros, according to the U.S. Bureau of Labor Statistics. Orlando's renter popu-

lation is also significant, growing by an average of 2.1 percent annually,² second only to Omaha among the top 50 metros. The city's sizable renter base is the result of the metro's ability to attract key demographic groups, which bodes well for continued apartment demand. Among the top 50 metros, Orlando had one of the highest annual renter population growth rates of

Millennial Share of Renter Population

All metros measured at the MSA level



Sources: Census Bureau, 2017 American Community Survey

seniors (heads of households age 65 and older).

Investor and lender confidence in the metro is evident. Orlando captured a 47.2 percent share of total large multifamily loan volume in the state of Florida for the 12 months ending in June 2019, according to Chandan Economics' analysis of loans with original balances above \$15 million.

Overall, while investors and lenders will continue to find success in gateway markets, they are expanding their horizons by targeting relatively smaller cities with the ingredients for persistent multifamily demand growth. Keeping an eye on how our labor market evolves, both geographically and in capability, will help identify where multifamily investment will flow in the next decade. ■

1. For the purposes of this analysis, we define large multifamily loans as those with original balances above \$15 million.

2. American Community Survey, measured between 2015 and 2017.



John Richardson is managing director and chief underwriter of agency lending at Arbor Realty Trust Inc., a nationwide real estate investment trust and direct lender.

Learn more at www.arbor.com/blog.



ARBOR

South Florida Industrial Sales See Robust Activity, Off-Market Deals

By **Wayne Schuchts**

The South Florida industrial market continues to see robust sales activity, as investors look to warehouse and distribution facilities that support the region's strong population growth, connection to port activity and expanding e-commerce sector.

A third quarter 2019 review of industrial investment activity shows that quarterly sales volume in South Florida jumped 77 percent year-over-year to \$1 billion. A 12-month view shows volume of \$3.3 billion, a 48.7 percent yearly increase. Industrial pricing has also been strong over the same time period, increasing 14.8 percent to an average of \$140 per sq. ft. During that time frame, there were 249 properties sold with a total of 21.6 million sq. ft.

This steady flow of activity has presented some challenges for investors seeking institutional quality assets to acquire and developers looking for land for new construction. In such a land-constrained market, where many assets have traded hands, some are finding it difficult to expand their holdings or gain a foothold in the South Florida market.

One solution is the creativity found with off-market transactions, which are bringing unique opportunities to investors. These types of sales are generated by real estate brokers who are entrenched in the market and rely on their experience and relationships to bring assets to the marketplace. They might identify parcels through long-standing relationships or work to assemble acreage to create a development opportunity. Oftentimes, these deals take considerable effort and may involve rezoning parcels of land or repositioning assets for industrial uses.

One of the largest land sales this year in South Florida, for example, was an off-market transaction that created an opportunity for the seller, AVE LLC, to sell 123 acres in east Hialeah to Bridge Development Partners. The Chicago developer paid \$126 million for the property in the fourth quarter and plans to build up to 1 million sq. ft. of speculative industrial space near the Opa-Locka Airport.

This was a complex transaction that was years in the making and the result of longstanding history and strong relationships with the seller and the key people at Bridge Development. These types of transactions are vital for connecting land owners with developers or investors in today's market.

This sales activity is occurring as the market experiences strong leasing demand and steady absorption of new construction. Since 2018, the Miami-Dade County market

has seen 6.8 million sq. ft. of speculative development that is now 83 percent leased, according to Avison Young third quarter 2019 research.

The strong tenant demand and scarcity of land have pushed up average asking rents in the industrial sector by more than \$1 per sq. ft. over the past year, to a new high of \$9.09 per sq. ft. in Miami-Dade County.

Although there has been some concern about a global



economic slowdown and escalating trade tensions, Miami-Dade County, and South Florida as a whole, are likely to weather any threats posed by tariffs more easily than other industrial markets due to the region's vigorous population growth and robust port activity. As the region continues to benefit from its strong connection to international trade flowing through PortMiami and nearby Port Everglades, the industrial sector should continue to grow and prosper for the foreseeable future. ■



investors and corporate users.

Learn more at www.avisonyoung.com.

Wayne Schuchts, principal at Avison Young, has more than two decades of commercial real estate experience and specializes in office and industrial property transactions for institutional

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Multifamily Finance—It's All About Mission and Innovation in 2020

By **Jeff Patton**

The multifamily debt market is estimated to reach \$390 billion in 2020, bringing with it some key changes from federal agencies that could translate into opportunities for businesses. With the Federal Housing Finance Agency (FHFA) providing more clarity regarding the multifamily debt that Fannie Mae and Freddie Mac can purchase during the fourth quarter of 2019 and during 2020, both are focusing on mission-driven business and setting the framework for the end of conservatorship.

Mission-driven focus

The FHFA announced significant changes to the annual lending caps for both Fannie Mae and Freddie Mac, including establishing a hard cap of \$100 billion for each firm—and eliminating exceptions for affordable and green improvements to multifamily housing. The new structure also contains a requirement that at least 37.5 percent of business during the next five quarters be allocated to “mission-driven” developments. That mandate makes loans on affordable and workforce housing more important, and both firms will have to be more selective about financing class-A properties.

With all of these adjustments at play, there will be more of a focus on core products and a more limited appetite for rehab loans and lease-up programs designed for new properties nearing stabilization. That means there is a major opportunity for lenders in the multifamily debt market to step up and fill that void. In fact, according to a study conducted by the Mortgage Bankers Association, life insurance companies have the bandwidth to fund an additional \$10 billion of business in 2020, compared to 2018 volumes. That is a drop in the bucket given the expected increase in demand next year.

End to conservatorship

As Director Calabria stated in November, FHFA wants to end conservatorship by 2024 and is implementing changes to prepare the firms. Fannie Mae and Freddie Mac have been instructed to build capital by retaining earnings, and Director Calabria noted that there could be very large public capital raises in 2021 or 2022. Both will be aiming to highlight the strength of their portfolios and credit performance to demonstrate their ability to effectively manage the businesses after conservatorship. While an end to conservatorship may not change day-to-day operations, it will change how Fannie Mae and Freddie Mac interact with the government and may allow for more innovation. Both are



already ramping up efforts to modernize their business models through technology, including better use of data, access to operating metrics, pricing and underwriting, all of which will be powerful tools for their lending partners.

While legislative action is improbable, there could be an administrative solution in the coming years. The four entities—Fannie Mae Single-Family, Fannie Mae Multifamily, Freddie Mac Single-Family and Freddie Mac Multifamily—won't necessarily come out of conservatorship at the same time and it's not yet clear which business model is best suited for the post-conservatorship environment.

Outlook

Overall, the drivers for the multifamily industry are decidedly positive. Urbanization, demographic shifts and delayed household formation all point to increased demand—and the capital to support those projects is readily available. An increased marketplace for multifamily debt, along with a focus on mission-driven properties, will certainly drive a smaller footprint for Fannie Mae and Freddie Mac, which is exactly what the FHFA wants. ■



Jeff Patton is executive vice president, national director of agency relationships at Bellwether Enterprise.

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2020: The Year of the Institutional Investor

By **Dori Nolan**

As we set our sights on the year ahead, the potential of a market downturn continues to hang in the air. However, one group remains particularly bullish on commercial real estate investments: the institutional investor.

Why commercial real estate?

Institutional investors—whether an insurance company, hedge fund, pension fund or otherwise—pool their money to acquire a portfolio of assets. In doing so, they aim to diversify their portfolios with around 10 percent allocated to commercial real estate investments, and the remaining 85 percent being a mix of debt and equity securities.

While many set this goal, in reality, only about 3 percent of institutional investors' capital is actively invested in commercial real estate—meaning that these investors are significantly under-allocated. At the same time, there are simply not enough commercial real estate deals to fill this gap. This disproportionate relationship between supply and demand has led to intense competition amongst investors yearning for attractive risk-adjusted returns.

Despite this competition and current market uncertainty, institutional investors have generated attractive returns from their commercial real estate investments with a particular affinity for multifamily assets. The institutional investor sees multifamily as a vehicle for safe and defensive investments with great potential for strong returns. In other words, it is the best of both worlds for those who are not shy of a high price tag—as they can justify the price in relation to their investment's long-term intrinsic value. As a result, institutional investors are more active in the space than ever, even in the face of inevitable regulation.

Regulations shaping the investment landscape

As the country's largest cities—such as New York and Los Angeles—see an emergence of regulations stabilizing rents, when it comes to geographical focus, institutional investors turn their attention to secondary markets, such as Phoenix, Las Vegas and Atlanta. Institutional investors have identified these “second-tier gateway” markets as uncapped areas for potential growth, since local regulations are not as restricting. These markets are developing at a breakneck pace, with rising rents, accelerated job growth and tenant lifestyle preferences that mimic those of larger cities.

For example, research from Berkadia shows that average effective rent in the Phoenix area advanced 8.6



percent between the third quarter of 2018 and September 2019—a figure that has hit one of the highest annual rent growth rates for major metros in the last year. Additionally, Phoenix area occupancy rates are at an all-time high. The combination of the two—and current lack of regulation in the local area—has made Phoenix a no brainer for investor interest.

Another regulatory topic of interest to institutional investors is the reform of government sponsored entities (GSEs). We saw a slowdown of GSE activity this fall, and institutional investors were able to pick up the slack and provide alternative financing to owners. We can anticipate that they will continue to play a more active role in debt financing as uncertainty around GSE reform continues.

Smarter and larger investments in 2020

As they aim to diversify their commercial real estate investments, we forecast that 2020 will be another monumental year for the institutional investor. With capital to be allocated to commercial real estate, we can anticipate institutional investors will be writing larger checks for the properties they see as most desirable.

All-in-all, even with the potential of a market slowdown in the coming years, institutional investors have boldly staked their claim in the commercial real estate industry. As their investment in commercial real estate continues, institutional investors will persevere as major players in the space, no matter what. ■

Dori Nolan is senior vice president of national client services at Berkadia.

Learn more at www.Berkadia.com.



Cannabis Continues to Disrupt Retail Markets but Will Landlords Continue to Bet on Cannabis?

By **Robert Wilder**

The year 2019 was certainly a step backward for the cannabis industry—publicly traded cannabis stocks tumbled roughly 57 percent year over year as of the third quarter of 2019. Nevertheless, cannabis operators remain bullish and steadfast in their pursuit to expand their footprint and open new retail locations. State laws, local ordinances and financing restrictions have provided formidable challenges for operators to find suitable real estate; however, as in most cases with limited supply and strong demand, the lack of available cannabis real estate has aided in inflating prices for cannabis permissible trade areas across the country.

Intensifying the demand is the desire for the operators to be first to market. The first mover advantage has proven to be a driving force in the cannabis sector as cannabis operators realize substantial advantages over their competition with many municipalities' enacting anti-clustering provisions and minimum setbacks from other dispensaries. These setbacks can range from 1,000 feet to one mile, and effectively allow operators to control entire trade areas, or even entire markets. In ultra-restrictive municipalities like Orlando, Fla., municipalities have instituted citywide caps on the total number of dispensaries permissible; for example, Orlando permits only seven retail dispensaries for the entire city. All contributing to a more competitive marketplace and leaving cannabis operators with the decision to chase pricing and terms to outbid their competitors and traditional retailers.

Chicago is the sector's latest example of the first-to-market advantage. The city's recent adoption of recreational cannabis regulations brought the implementation of a district lottery system. The city granted 37 recreational dispensary licenses, designating specific geographies to specific license holders for their operation across the city's seven districts.

Preempting the lottery's reveal on Nov. 15, Chicago supplied the license holders with an unofficial set of permissibility guidelines, creating significant uncertainty in the site selection process. As a result, Chicago license holders flooded the city with offers on real estate in what turned into a feeding frenzy to secure the most valuable retail positions. Many landlords found themselves in situations with multiple offers, non-refundable deposits, pre-paid rent guarantees and even key money. An enviable situation for any landlord.

However, it hasn't been all tailwinds and windfalls for cannabis landlords. Both operators and landlords have



experienced significant challenges in 2019 with the faltering of the public markets. Investor confidence has waned and as a result it has been much more difficult for operators to raise capital, and despite an approval in the House, the federal government has yet to provide a solution that would unlock the traditional debt markets. Instead, operators and landlords have to structure all equity purchases or find private debt—a much more expensive and risky option. Consequently, free cash flows on potential real estate investments have compressed and investor's exit capitalization rates have risen—pushing the lease prices to even higher rates and in many cases leaving landlords left to ride out the storm until the capital markets normalize. ■

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BW STRATEGIES

Top Short-Term Impacts of New Statewide Rent Control Measures

By **Brian D. Milovich**

Rent control is a mystery to a large portion of the country and the default talking points are that it's bad for landlords, well-meaning but ultimately fails tenants and is steeped in politics more than in addressing affordable housing. As an owner of rent controlled apartments in the San Francisco Bay Area, all are true. However, the sky is not falling for most owners in California, Oregon or New York where state-wide rent and tenant protection measures were recently signed into law or implemented. As we see it from the sidelines in California, the three biggest effects from this legislation for the real estate investment community are the following:

Pullback in investment

Out-of-state investors and institutional owners will say "life is too short" to figure out how a state like California will monitor, resolve disputes and generally oversee this massive new law. The uncertainty surrounding the process and potential to be dragged into legal action will undoubtedly keep investors away. This has already been seen in Portland, Ore., where in the first three months after their rent control bill passed, total investment in apartments declined 38 percent and 60 percent of all investment came from in-state buyers, the opposite of the previous few years. It remains to be seen how California and its high-growth technology engine will offset any demand challenges from the new law.

Pricing dislocation

In the long term, rent controlled markets are some of the most expensive in the country. San Francisco has had rent control since the 1970s and we continue to discuss the out-migration of its residents due to high rent and other costs. Rent control turns apartments from what most of the country views as a cash-flowing asset to an appreciation-driven one. And, there's pain in making that switch. We specifically waited for the city of Mountain View, Calif., to enact rent control so that we could make our first purchase there as pricing fell post-election. Cities like San Francisco, Oakland, Los Angeles and Santa Monica, though, won't miss a beat as their rental ordinances are stricter than the new state-wide law and they have established processes in place.

Aside from the initial price shock due to the new law, pricing will suffer due to less investor interest and two types of properties will be impacted most. First, those apartment properties with long-term owners, who with the benefit of a low tax basis have not needed their rents to keep pace with out-sized market growth, will now find

Rent control turns apartments from what most of the country views as a cash-flowing asset to an appreciation-driven one. And, there's pain in making that switch.

that all of that "upside" can't be unlocked in a reasonable amount of time and investors won't pay as much for it. Second, the new law in California exempts properties built within the past 15 years. As buildings approach this mark, one must assume that valuation methodologies will vary and the ambiguity surrounding the future cash flow prospects will negatively impact value.

New opportunities emerge

Established operators of rent-controlled apartments will have an advantage in this new paradigm, but that doesn't mean new entrants can't be successful as well. As written, the new California law allows for annual rental increases of 5 percent plus the rate of inflation. Entering a slow growth economy, this should leave ample room for a successful business plan. If the prospective investment has more growth potential than the allowed increase, its price will likely reflect that circumstance and you will be able to purchase it at a much better basis than a year ago.

All is not lost for owners in the rent control battleground. Good owners who abide by the letter of the law will find ways to increase their property values and provide a quality product for their tenants. The short-term uncertainty surrounding implementation, potential for further deterioration in allowable increases and less investor interest will cause pricing volatility allowing those owners who are brave enough, to jump in. ■



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Learn more at

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INVESTING IN TRANSFORMATION

50 Years Later, Same Bumpy Roads

By **Spencer Levy**

2020 could be a pivotal year for the U.S. commercial real estate industry, with geopolitical, economic and local regulatory issues in keen focus.

As I turn 50 years old next year, I will remember that we've driven the same bumpy roads before. I think back to my formative years in the 1970s when big events like the end of the Vietnam War, the Iranian hostage crisis, the Cold War and an oil embargo that led to maddening gasoline shortages for American motorists had huge impacts on our economy.

The bumps may be different today, but the roads are the same 50 years later. The problem is that our approach to underwriting commercial real estate risks is also the same and needs to adjust to the times.

Our industry in the 1970s was characterized by a slow-and-steady mentality, with long-term leases offering a good hedge against the volatility of the broader market. High inflation led to a nasty recession, making commercial real estate a good inflationary hedge. But the 2010s are the exact opposite, with low inflation and steady job growth leading to a historic economic expansion.

The rise of coworking and material increases in license and short-term lease agreements have made the office and retail sector less predictable. The tech disruption of retail is increasingly encroaching on other asset types, including Airbnb's effect on the multifamily and hotel sectors. As inflation and interest rates ticked down, so did cap rates, yet we still underwrite with a 1970s "fear-of-inflation" rule of 50 to 100 basis points added to exit cap rates.

Despite these transformational changes to our business, CBRE's 2020 U.S. Outlook predicts a very good year for commercial real estate. And it can be even better if we help dispel some 1970s thinking, particularly around the fear of inflation. Transaction volume and cap rates are expected to remain largely stable, though we likely will see more fundamental/secular-driven cap rate compression in multifamily and industrial and, due to declining inflation and massive liquidity, some downward pressure on cap rates for other CRE sectors.

2020 will not be without its challenges. We expect some risk of oversupply in industrial and class-A multifamily, but secular shifts that have heightened demand far in excess of historic norms should mitigate material impact on fundamentals, which are expected to stay strong. While retail's overall troubles are well reported, the sector is expected to show good rent growth as it becomes more



experiential with limited new construction.

Though business confidence has weakened, and business spending has slowed, the office market is more dynamic today than ever before. Reasons for this include strong but slowing office-using job growth, the renaissance of the "new city" (new live-work-play neighborhoods in old-school cities), massive capital expenditure in older office inventory in major CBDs and agile office design. While a lot of the growth is expected in up-and-coming "tech cities," old-school cities and many suburban markets that have what I call the "five pillars of awesome" (talent, infrastructure, foreign capital, live-work-play and low regulatory burden) should shine as well.

As the CRE industry becomes more dynamic and operational risk increases, alternative investments are gaining popularity. As a result, we expect 2020 to be another big year for data centers, alternative forms of industrial like self-storage and alternative forms of multifamily especially manufactured housing which has become hugely popular in much of the private equity community.

Commercial real estate has changed a lot since the 1970s, but many of the mega geopolitical and economic risks still ring true today. In 2020, commercial real estate should be approached with "a-lot-has-changed" mentality economically, particularly with respect to inflation expectations, but have more perspective on geopolitics since we've been traveling this same bumpy road for at least 50 years. ■



Spencer Levy is chairman of Americas research and senior economic advisor for CBRE.

Learn more at

www.cbre.com/capitalmarkets.

CBRE

E-commerce Isn't So Easy

In-store retail can survive the digital revolution, but it'll need to evolve.

By **K.C. Conway, MAI, CRE**

A common myth blames the apparent collapse of brick-and-mortar retail primarily on Amazon and the growth of online sales. But the real villain is over leverage. E-commerce remains a relatively small portion of total retail sales—about 10 percent—and has yet to take a real bite out of retail store activity. Amazon and other online merchants tapped into technology to reinject growth into retail that has disrupted all market sectors.

E-commerce, however, is not the clear-cut winner when it comes to cost. According to Alix Partners, in 2017, apparel retailers' net margin from merchandise sold at brick-and-mortar stores was 32 percent, compared to 30 percent online. Despite its potential, e-commerce faces numerous challenges in its effort to bite into in-store sales—including difficulties in last-mile delivery, reimagined brick-and-mortar retail spaces and shifting tax burdens.

Last-mile

Logistics is the primary obstacle to e-commerce. Amazon demonstrated that fulfillment of any product is possible if profitability isn't an immediate priority. While FedEx spent billions on overnight delivery and processing virtually any package on a global scale, Amazon aims for same-day delivery without regard to profitability.

Retailers worry about the threat Amazon poses should it succeed at global fulfillment, but this fear is driving new fulfillment strategies. One example is FedEx's recent partnership with Dollar General for package fulfillment following its divorce from Amazon, increasing FedEx's retail presence to 62,000 stores in the U.S.

Retail fights back

While online purchases reduce the need for physical store space, it's not eliminating the need for retail real estate. Global customer data science company Dunhumby noted, however, that grocery stores are shrinking—not in number, but in size. The average sales area has contracted by 15 percent since 2010. Looking ahead, the grocery stores of the future will be a third to a half the size they are today, with a more limited, locally curated assortment of products.

Additionally, physical stores and e-commerce will become an increasingly connected omnichannel experience. One future model attaches a "dark store" to a smaller footprint store—with 5,000 items (a typical grocery store currently has 45,000 items) from which basic commodity products will be picked for pickup or delivery. This



model is similar to Kroger's experimental partnership with Walgreens for online fulfillment.

Taxes to come

The sleeper issue in retail's evolution revolves around property taxes. Changes in property tax legislation and shuttered retail stores will force state governments to find new solutions to fund education.

At state and federal levels, this topic has raised questions around the market value of empty big-box buildings and shopping centers, which are nowhere near what they once were. But local governments can't afford to lose revenue, so they may seek to recoup revenue in e-commerce warehouses.

Remember, the shopping mall is essentially the mid-20th century adaptation of the historical marketplace. The 21st century version will include Amazon and e-commerce. Each iteration disrupts the prior, which is what is occurring today. Those who adapt will avoid extinction. Those who don't will go the way of the dodo bird, rotary phones and Blockbuster.

The full *Commercial Real Estate Insights* report on retail is available at www.ccim.com/insights. ■



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Opportunity Funds Offer Tax Advantages for Investment in Low Income Areas

By **Jason M. Wolf**

Opportunity funds offer a new avenue for investors to benefit by helping to rejuvenate low-income areas. But real estate developers and investors don't need to rush into deals – there is time to look before you leap.

Investors facing sizable capital gains taxes can defer and ultimately reduce what they owe Uncle Sam by putting their money in qualified opportunity funds (QOF), which invest in properties and businesses in underserved neighborhoods. Done right, opportunity zone (OZ) investment provides an additional incentive for supporting small businesses and affordable housing options in communities designated as low-income census tracts. But it's as important as ever for investors to be sure these deals make financial sense.

The Tax Cuts and Jobs Act of 2017 allows investors to defer and eventually reduce federal tax liability on current capital gains by reinvesting in QOF assets and businesses. As a bonus, any capital gain on QOF investments may be tax-exempt if the asset is held for at least 10 years. A fund might focus on real estate opportunities such as new development or adaptive re-use projects, or it might support the growth of job-generating businesses in the area, or a blend of strategies that contribute to community development.

The three benefits of OZs—deferral and reduction of existing gains, plus tax-free status on additional gains—can add 300 to 500 basis points to annual yields, according to Brad A. Molotsky, Partner at the law firm Duane Morris LLP. Speaking at the CORFAC International Fall Summit in September, Molotsky noted that, even with the extra incentive, finding deals that pencil out can be a challenge. In the 8,762 OZs across the country, residents make just 60 percent of the surrounding area median income, and the average unemployment rate is 14.4 percent.

However, deals are getting done. Duane Morris has been involved in structuring dozens of OZ transactions, including several debt and equity placements to back commercial real estate and affordable housing projects. The law firm has also worked with several cities on economic growth plans to spur local OZ investment.

Investing in the future

Perhaps the biggest challenge to OZ investment is the relatively short time frame for investors to act. The program was rolled out in 2018, but it took time for investors, fund

managers and developers to understand the nuances of the new benefit. Investment interest was slow in the early part of the year, but has been gathering steam since the government issued clarifications in April 2019.

Molotsky noted that there are still some misconceptions about the program. For example, people have expressed concern that the program is ending on December 31, because that is the deadline for current capital gains re-in-



vestors to receive 100 percent of the benefits. Additional changes occur at the end of 2021 and the end of 2026 that can affect the benefits of the program. But real estate investors should not feel rushed into committing to deals because of looming deadlines.

The long-term nature of OZ investment makes it a good fit with real estate investment, which historically has been a long-term investment play. Because of the complexity of the law, investors need to understand both the tax implications and the investment value proposition before they make a major commitment. That said, there is a lot of opportunity in opportunity funds. ■



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The “Twist” to Sustained Apartment Demand

By **Brad Dillman**

As multifamily participants, we have listened to pundits repeatedly call for a market decline. They point to cranes and confidently claim that we are headed towards the inevitable overbuilding the industry historically engages in. Yet despite predictions, the multifamily industry continues to observe strong absorption and continued rent growth, particularly in the Southeast and Southwest. What we believe pundits and others are missing is a deeper understanding of the widely unrecognized structural underpinnings that drive the strength of today’s multifamily market—and are likely to continue to do so.

In 2011, the Federal Reserve implemented the Operation Twist program, an effort to lower long-term interest rates to induce capital investment and other “risk taking” activities in housing and elsewhere by reducing the cost to do so. The effect of this policy on the single-family market in 2012 can be viewed as a stimulant to sustained apartment demand that continues to defy expectations seven years later. Though few pundits consider it, Cortland believes Operation Twist may be the most influential development to shape American housing coming out of the Great Recession.

The greatest impact of Operation Twist was felt across 2012, in the form of prolonged and uncharacteristically low mortgage rates. In Cortland’s analysis, these low mortgage rates appear to have contributed to an explosion in home prices despite lingering single-family oversupply and a particularly weak labor market for full-time jobs. In getting the housing market going again, Operation Twist encouraged home prices to climb faster and higher than the market would have otherwise allowed. This marked the beginning of a stark divergence between the pace of home price appreciation and the pace of growth in American’s incomes and savings rates. This divide changed the calculus of new housing deliveries, as builders determined they could only profitably serve small, expen-

sive segments of the housing market. For most of the last seven years, we’ve seen subdued housing starts, resulting in today’s undersupply of residential real estate. By inflating the cost of housing, this stimulus ultimately served to channel demand toward rentals.

As Operation Twist’s effects spread throughout the housing market and the costs of housing rose, recovery from the Great Recession carried on. But the reality was



that housing and other asset prices were moving well in advance of improvement in the underlying economy. It wasn’t until 2015 that the number of full-time jobs returned to 2007 levels, and this despite the maturation of millennials and population growth of around eighteen million people. In response to this economic climate, adults lived at home longer and delayed getting married, buying homes and starting families. They are still doing so. Years after the home price stimulus, affordability challenges are widely evident. Take, for example, the difficulty many would-be home buyers have in coming up with a down payment even as the requirements to do so have declined.

We believe the affordability crunch, rooted in the legacy of Operation Twist, contributes to a sustained demand for multifamily housing, and has led to meaning-

ful and sustained increases in rental rates. We also believe affordability pressures have led to movement away from gateway markets and into what was otherwise deemed by the investor community to be tier two and three markets, as Americans have migrated en masse to affordability and opportunity. From 2012 through 2018, some 2.2 million Americans migrated to the top ten Sunbelt markets by population size, excluding Miami. This population transfer, which does not factor in immigration, is akin to redistributing the entire population of New Mexico across these markets.

While population shifted from costly coastal markets to those typified by better affordability and superior job growth—including Sunbelt markets—there has also been a movement towards the periphery within many metropolitan areas. This continued move to affordability, even within relatively affordable markets, has made suburban multifamily strategies attractive. All of this has translated to excellent apartment demand in Sunbelt markets where scarcer suburban multifamily housing offers a unique value proposition to an aging millennial demographic. These areas offer older millennials access to larger floorplans, as well as proximity to good schools—especially elementary schools—in addition to an overall lower cost of living.

Multifamily demand has consistently beat projections because the conventional wisdom that shapes expectations does not account for the legacy of recovery-era policy and its subsequent impact on the cost and profile of housing available in the here and now. In 2017 and 2018, for example, multifamily forecasts commonly used throughout the industry projected vacancies ticking up for the foreseeable future. To those looking more closely, several factors including the impact of high home prices, the timing and course of full-time job growth, pent-up demand and the undersupply of housing all suggested elevated apartment deliveries around the country would be successfully absorbed in relatively short order. Today, years after conventional wisdom first concluded “this cycle is long in the tooth,” multifamily markets are now tighter than they have been in nearly 20 years, according to RealPage and other data providers. Cortland estimates that if the rate of 25 to 34-year-olds living at home were to revert to pre-recession levels, roughly 2 million adults would form independent households. This pent-up demand may represent the next “twist” to the future of apartment demand. ■

Multifamily demand has consistently beat projections because the conventional wisdom that shapes expectations does not account for the legacy of recovery-era policy and its subsequent impact on the cost and profile of housing available in the here and now.

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CORTLAND

Flex Space: The New Strategic Occupancy Plan

By **Ron Steinbrink**

If you've been in the office leasing business long enough, you've likely experienced that dreaded day when your largest tenant tells you they're moving to a different office building. Suddenly, you've gone from 90 percent occupancy to 50 percent. Your head starts to spin just thinking about how you're going to fill that space again.

While you might be tempted to reflect on everything you could've done differently to prevent your tenant from moving out, don't. The sooner you forget about the past, the sooner you can start planning how you're going to get your occupancy back up to 90 percent or more.

Although attracting new tenants is never easy, there is one strategy that has worked wonders in recent years for commercial real estate owners: flex space. But just what is "flex space" and how can you leverage it to increase your tenancy levels?

What is flex space?

In effect, flex space is a way that commercial real estate owners provide tenants access to flexible but dependable office space on a lease term of anywhere from one month to three years. These spaces are usually smaller suites that are grouped together around shared facilities, like conference rooms and kitchens.

However, in contrast to co-working spaces—which are branded by the co-working company and are frequented by multiple small businesses and freelancers—flex space allows businesses to create their own office culture, even if they're not ready or able to commit to a long-term office lease.

Top three benefits of flex space in action

It sounds great in theory, but what does flex space look like in practice? And how can it help commercial real estate owners increase occupancy?

After working with multiple institutional clients, we've seen owners experience three key benefits from employing a flex space strategy:

1. Attract and Retain New Tenants

While in the past, traditional commercial real estate leases tended to span more than five years, the inflexibility of the terms deterred many potential tenants from pulling the trigger. With flex space, this barrier is removed—to the benefit of both the tenant and the landlord. In fact, one of the key attributes of offering flex space is that many of the tenants that sign short-term leases will even-

tually grow into long-term tenants.

2. Increase Your Price Per Square Foot

Another key attribute to short lease terms—the property can ask for a high price per square foot for leases of three years or less. In fact, rates are often double or more normal unfurnished rates.

3. Delight Tenants with Additional Flexibility



There's a big advantage to working with a vendor that can make floor plan changes happen quickly. It gives the tenant the ability to make the space their own in short order.

Flex space and the bottom line

Just remember when you have that moment of panic right after your largest tenant gives notice. There is always tomorrow. Clear your head, put together your plan, and if you want to join the flex space wave, be sure to partner with a company that makes your goal of 100 percent occupancy a reality. ■



Ron Steinbrink has been with CORT for 22 years, and as CORT's director of strategic business development, he is responsible for growing the commercial business segment in the Southeast Region.

Learn more at www.cort.com/office-furniture-rental.

CORT

Retail Investment Sales 2020 Outlook

By **Rick Chichester**

Looking back on our forecast for 2019, it is interesting to note that the economic baseline is much the same as we look into 2020 with the caveat of the Impeachment proceedings and Presidential election.

The economy was tested in the fourth quarter of 2018, early 2019 as the Federal Reserve raised rates to what they defined as the neutral rate of interest. The market responded to the downside which raised a cautionary flag on the fundamental fragility of the overall economy.

Since then, the Fed has reversed course and lowered rates several times in 2019. The market is now experiencing record highs. Analysts, at the current Administration, project that the Dow could reach 30,000 by year-end. With that said, we continue to accumulate debt at an ever-increasing rate (The U.S. national debt is \$22 trillion and the annual 2020 deficit is estimated to be \$1.2 trillion, or 4.4 percent of GDP). The unemployment rate is a 50-year low. This economic expansion is based on a formula (low interest and unemployment rates with high debt) contradictory to all economic metrics known to this day. We are in uncharted territory.

It is important to understand the market and its fluctuation, especially when considering real estate investment strategies. In all, 70 percent of annual GDP is driven by the consumer. We can say with confidence that the labor market is healthy. One of the most important leading indicators of the health of the market is the low and steady weekly jobless claims combined with increasing wages, albeit at a modest rate. Consumer confidence remains strong and consequently, retail sales are up 3.3 percent year over year.

Retail continues to be in transition. By way of example, Department store sales were down more than 5.5 percent from a year ago and online retailers' sales were up 14.2 percent. Clearly retail continues to experience a structural shift lead by technology and consumer behavior evolution. Successful and prosper retailers ought to strategically integrate the convenience of online with the customer service of bricks and mortar.

As for retail investments, not all retail is the same which statement is becoming increasingly apparent as the industry evolves. We expect real estate investors with retail expertise to continue to be active in all retail sectors but with a tendency to be more granular and cautious. Moving forward and in addition to the property's design and layout, the underwriting needs include robust local market expertise, demographics, tenant activity, tenancy demand,

tenant creditworthiness and relevancy to the market and property. Until now, Retail real estate has been grounded in the principle of "location, location, location," which going forward might be better defined as "location, experience and analytics."

Finally, the big influencer in retail and the economy



overall next year is Generation Z. Exclusively raised with internet and mobile devices, they are forecasted to spend \$143 billion in 2020 which represents an overall 40 percent of the consumer spend.

In conclusion, there is no compelling evidence of a recession in 2020, we anticipate interest rates and unemployment to remain at a historic low with the chance of another interest rate cut. Retailers will continue to close stores, but new concepts will emerge. Cross channel and omnichannel is the way of the future. As much as things change, much remains the same—retail is fluid, dynamic, and core to the economy, and our economy looks stable for 2020. ■



Richard Chichester is president and CEO of Faris Lee Investments.

Learn more at www.farislee.com.



A Healthcare Real Estate Outlook for 2020

By **Gordon Soderlund**

Healthcare real estate has been trending favorably for years. Yet, investing requires an astute assessment of the likelihood those tailwinds continue into 2020 and the challenges roiling the healthcare industry. Never has it faced so many regulatory, political and economic issues.

Hospital consolidations will continue apace in 2020. Creating scale is vital if health systems are to survive. Competition is converging from all directions—insurers becoming providers, pharmacies becoming insurers, physicians forming large independent groups backed by private equity, Walmart expanding into primary care services, and everyone demanding better care quality for less cost.

Healthcare will be a major 2020 election topic. And when politicians get involved, uncertainty ensues. Whether conservative reforms or Medicare for All, the health policy landscape will continue to shift as healthcare funding and delivery reforms are explored. The greatest risks will emanate from this arena, well after the elections are over.

As reimbursements trend lower, healthcare providers need venues to expand market share and shift care from hospital campuses to convenient community settings where patients live and work. During the decade ending in 2016, inpatient visits decreased 6 percent while outpatient visits increased 20.4 percent.

During the next decade through 2026, inpatient visits will decrease another 3.7 percent while outpatient visits will dramatically increase, by nearly 59 percent.¹ Outpatient and ambulatory facilities will be the primary beneficiaries of this significant, ongoing trend to deliver high quality care less expensively.

The financial flexibility and liquidity that monetization provides has more health systems evaluating the merits of selling and leasing back their medical properties. However, because hospital administrators are tackling far more important operational and regulatory issues, don't anticipate many hospital-owned medical real estate portfolios for sale in 2020.

Appealing to healthcare providers will be outpatient facilities such as medical office buildings, ambulatory surgery centers, primary/urgent care clinics and wellness centers that strategically improve patient access, facilitate care coordination among complementary tenants, serve as efficient gateways to enter new markets and to grow existing market share and enhance patient satisfaction and throughput.

Large medical office buildings with a broad mix of complementary services will share the spotlight with small,



conveniently located urgent and primary care centers. Freestanding emergency departments may face financial challenges such as higher bad debt and threats of reduced payor reimbursements. Micro hospitals, not subjected to site-neutral payment provisions, are an effective venue to enter a new market.

No real estate sectors are facing more disruption than retail and healthcare, yet they need each other more than ever. Healthcare providers must operate like retailers to deliver convenience, quality, transparency and easy access. Retailers need the foot traffic and complementary uses that healthcare generates. Repurposing retail assets into outpatient centers will continue to expand, from inline shop spaces to Sears mall boxes. Healthcare will be an integral component of mixed use developments.

The continuing imbalance of supply (properties) and demand (capital) will prolong the sellers' market. Cap rates, at historic lows, will plateau as buyers apply pricing pressure. Interest rates and inflation appear in check, ensuring a favorable ownership environment in 2020. ■

1. American Hospital Association's 2019 Hospital Statistics



As executive vice president of strategic relationships for Flagship Healthcare Properties, a full-service healthcare real estate acquisition and development firm, **Gordon Soderlund** is responsible for creating and enhancing business relationships with the company's healthcare clients throughout the mid-Atlantic and Southeast states.

Learn more at www.flagshiphp.com.



Commercial Insurance Rates Predicted to Continue Climbing in 2020

By **Matthew Harrell**

We are presently in the most challenging insurance market for commercial real estate in recent history. Insurance rates are expected to continue increasing into the first half of 2020 as market conditions did not begin to truly harden until the second half of 2019.

This market shift was inevitable, but the resulting change has come more quickly and severely than anticipated with the market still changing on an almost weekly basis. This hardening market is impacting the multifamily sector and portfolios with significant losses and low insurable values the most.

Property

This correction traces back to the beginning of 2017 when the industry was in a soft market with rates at a 15-year low. During this time, property carriers were already struggling to underwrite accounts profitably due to an increasing volume of attritional losses from fire, water damage, hail and wildfire claims. The frequency and severity of these attritional losses were consistently higher than expected however carriers were able offset these losses with the Hurricane premiums they were charging on their catastrophe exposed (CAT) book.

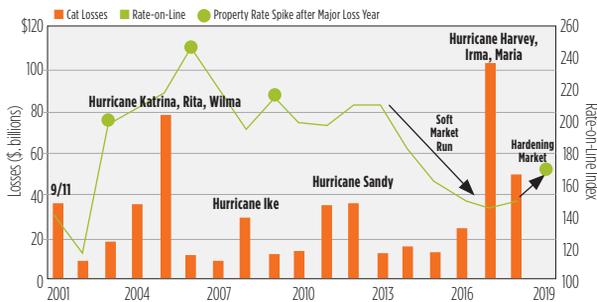
The situation grew more dire for carriers at the end of 2017 and 2018, which went on to become two of the top three worst years for the industry with over \$150 billion of insured losses. Having incurred billions in losses, carriers either stopped writing real estate accounts, reduced their capacity, or increased their rates.

When capacity is in short supply and demand is high, carriers are in a position where they can dictate pricing and terms, resulting in higher premiums, higher deductibles and lower coverage. The graph provides a good depiction of why a change in the property market was inevitable, as it compares historical property rates (green line) to insured losses (orange bars).

Liability

The liability market is arguably more challenging than the property market, which is having its greatest impact on the multifamily sector. Liability claims continue to rise in both frequency and severity with many large verdicts in certain jurisdictions causing carriers to leave the market altogether. Carriers are seeking to exclude coverage for Assault and Battery claims or exclude coverage for negligent maintenance and management operations with what's called a "Habitability Exclusion." Verdicts continued to rise, and we anticipate this to continue in 2020. This "frequency of sever-

Historical Property Rates & Industry Losses



ity” impairs underwriting performance in both primary and excess casualty (aka umbrella).

How to obtain the best results

Carriers are seeking to write the “Best-in-Class” risks, which means a greater emphasis on data. In this market, submission quality is of paramount importance to obtain the most favorable result.

The better and more detailed exposure data on the locations, the better your broker can negotiate terms. (i.e. Year of updates for roofs, electric, plumbing, HVAC). Carriers are also underwriting based on the operations and investment philosophy of the insured more than ever before. Providing detailed information on ownership experience, risk management, preventative maintenance, investment philosophy, CapEx budgets, replacement reserves, inspection processes, etc., are also extremely important.

Integrity of loss data is also very important, and most carriers are now requiring five years of hard copy loss runs for all locations regardless of ownership in order to underwrite based on a true five-year loss picture. Owners should be obtaining seller loss history during their due diligence period on all acquisitions.

Although compiling this level of detail takes time, it will be worthwhile as it will differentiate your portfolio in the marketplace and help you obtain the most favorable result possible. ■

As managing director, **Matt Harrell** brings a wealth of industry experience to Franklin Street Insurance Services. He can be reached at Matthew.Harrell@FranklinSt.com.

Learn more at www.franklinst.com.



Dollar General Continues its Growth, with Focus on Digitally Enabled Convenience (Offering Net Lease Investors Investment Grade Opportunities)

By **Bryan P. Bender**

Over the past 12 months (2019) Dollar General Corporation opened 975 new locations, remodeled 1,000, and relocated 100 into newly developed single tenant properties. For those that have not been following Dollar General over the past few years, these numbers are surely impressive, especially when juxtaposed to the widely documented and so-called retail apocalypse (renaissance). This rate of growth however has been the half decade trend for this Fortune 500 (No. 123), investment grade behemoth and undisputed leader within the dollar store market. Dollar General, coming off its 31st consecutive quarter of same-store sales growth, looks not to be slowing down, but to be continuing at this incredible growth clip.

With a store count greater than that of McDonalds U.S. operations at 16,000 plus, 75 percent of Americans live within five miles of a Dollar General store (per GlobalData Retail), whose goal is to cater to underserved communities and customers. By this year's end (2020) Dollar General will have opened stores in Wyoming and Washington, bringing their operational footprint total to 46 states, and will have added an estimated additional 1,000 locations. This is the direct result of offering products that are an estimated 20 percent to 40 percent cheaper than their grocery and drugstore competitors (per *Business Insider*).

While brick-and-mortar growth is a current constant, the expansion of their consumer demographic is of great interest as well. The acquisition of customers in the sought after 21- to 37-year age range (their average shopper is 35 to 55) will depend on their digital experience growth, by way of the convenience factor. Dollar General has recently launched several initiatives which seem to already be paying dividends as they report that upwards of 45 percent of their customers already use their digital apps or those of other companies.

DG GO! Mobile app is the foundation of this digital strategy, and the conduit to their digital functioning tools. Already having a Cart Calculator (allows product scanning via your personal phone), Coupon Push notifications, and with Mobile Checkout now being rolled out, I feel their latest test of BOPIS will be their most valuable digital tool. BOPIS, which stands for "Buy Online Pick Up in Store", will add another level of convenience for

their consumer base. Not only is Dollar General now able to cater to the Cost-Conscious shopper but also the Time-Conscious shopper. CEO of Dabbl, Susan O'Neal, says that if this can work for McDonald's and Starbucks, it can work for Dollar General Corp., which states that a "digitally engaged customer" spends twice as much as the average checkout receipt.

Dollar General Corp.'s focus on convenience has allowed



it not only to survive the proliferation of the online sales (The Age of Amazon), but thrive, and it's this convenience that will keep it strong for many years to come. For real estate investors, the copious Dollar Generals on market offer an opportunity to own an investment grade tenant, with an owner friendly absolute NNN lease. Opportunities to invest in now 46 different states, at purchase prices lower than the national average for single tenant net lease properties and at above average cap rates. Dollar General properties have become the most actively traded net lease asset over the past five years, and easy to see why this will continue to ring true in 2020. ■



Bryan Bender is a managing partner at Fortis Net Lease, where he has personally sold over 850 Dollar General Stores. He is also the owner of www.DollarStoreProperties.com.

Learn more at www.FortisNetLease.com.





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<p>BRAND NEW DOLLAR GENERAL 116 BEULAH CHURCH RD., MOUNT AIRY, NC 27030</p>	<p>PRICE: \$1,711,500</p>	<p>CAP RATE: 6.4%</p>	<p>LEASE TYPE: ABS NNN</p>
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<p>FIRESTONE COMPLETE AUTO CARE 905 DEL PRADO BLVD N., CAPE CORAL, FL 33909</p>		
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<p>PRICE: \$3,993,706</p>	<p>CAP RATE: INQUIRE</p>	<p>LEASE TYPE: ABS NNN</p>
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<p>TRACTOR SUPPLY COMPANY 1586 CENTER SQUARE ROAD, LOGAN TOWNSHIP, NJ 08085</p>		
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<p>PRICE: \$5,810,261</p>	<p>CAP RATE: INQUIRE</p>	<p>10 MILE POP: 334,728</p>
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Setting the Bar for a Growing Multifamily Market

By **Debby Jenkins**

Multifamily continues its healthy expansion, which began more than a decade ago. Generational changes in demographics and consumer preferences are driving increased demand, so rent growth and vacancies are healthier than long run averages. A limited number of markets are impacted by significant supply deliveries, but even those markets are generally not far off from normal historical performance. All-in-all, our outlook for 2020 remains strong.

The predominant challenge we face is a major overall housing supply shortage, especially in the workforce and affordable housing segments. Simply put, the market still isn't adding enough new units to keep up with demand. There is a lot of new supply in the pipeline, but much of it is class-A, and it's taking longer than expected to get to market. Given where markets are now, it will take multi-year changes to the supply and demand balance to impact the affordability of workforce housing.

All that said, the origination market is booming, driven by a declining 10-year Treasury throughout 2019. The Mortgage Bankers Association (MBA) projected in the spring of 2018 that multifamily originations for 2019 would be approximately \$100 billion less than current expectations of \$359 billion, up 6 percent from 2018. Further, the MBA expects another 8 percent growth in 2020.

As a result of this unexpected growth, throughout 2019 Freddie Mac worked aggressively to manage its volume to remain within the \$35 billion cap set by FHFA. Beginning in the fourth quarter of 2019 and moving into 2020, both Government-sponsored Enterprises (GSEs) are operating under a new cap structure, one that allows for \$100 billion in total volume from Q4 2019 to year end 2020 for each GSE. That annualizes to \$80 billion in volume for 2020. Rather than allowing for uncapped volume, which in the past included affordable, green and other mission-oriented products, this new structure requires that at least 37.5 percent of our capped volume be mission-driven, which no longer includes "green" loans.

Overall, market reaction to the FHFA cap structure has been positive, as it accounts for the substantial growth in the multifamily sector and helps to provide certainty to other secondary market participants about GSE volume in 2020. The net effect for Freddie Mac Multifamily is that our volume will be roughly consistent with the past two years. Our 2018 volume was \$78.5 billion, and we expect 2019 and 2020 to be right in line with that figure.

As we approach 2020, we're working to continue



serving our mission of providing liquidity, stability and affordability to the market. But we have another challenge: preparing for an end to conservatorship in the years ahead. We have several regulatory milestones to meet as we work to achieve this goal. In a big picture sense, that means we'll continue to strengthen our business in a way that would attract private capital.

We'll continue leveraging technology so that our business runs more efficiently and better uses data to minimize risk. We're also going to continue enforcing strong credit discipline in a way that maintains our near-zero delinquency rate. And it goes without saying that we'll continue to build out our credit risk transfer platform. Today, nearly 90 percent of the credit risk on new loans that we securitize is transferred away from taxpayers to private investors, and we plan do even better going forward.

As we look to the year ahead, we're optimistic about the market and about our efforts to lead it. From our executive leadership on down, we've built an incredible team, and along with our network of OptigoSM lenders, we're continuing to raise the bar. ■



Debby Jenkins is executive vice president at Head of Multifamily at Freddie Mac. Learn more at mf.freddie.com.





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The National Senior Housing Market: 2019 Review and 2020 Outlook

By **Cindy Hazzard**

2019 was a fascinating year for the senior housing sector. The construction cycle slowed, the popularity of multi-level facilities increased and skilled nursing is still as hot as ever, even with the new Patient-Driven-Payment-Model (PDPM) coming into effect. As investors are realizing the immense need for these facilities and services, the outlook for senior housing transactions in 2020 will remain bullish.

The senior housing industry is a need-driven business. Divided into three major market segments: unlicensed facilities such as independent living (IL) sometimes referred to as active adult, and licensed facilities which would be skilled nursing facilities (SNF) and assisted living facilities (AL), nearly every family, regardless of their financial resources, will require the specialized care from one of these segments. This fundamentally acts as a driving force for the senior housing industry no matter the overall climate of the economy.

IL/active adult communities continue to gain popularity as baby boomers consider retirement living options. This model typically isn't licensed and offers a living environment chock full of exciting amenities designed for a "healthy" senior looking for peers to live near. This type of community is typically significantly less costly than assisted living, yet offers a sense of comfort in knowing that people your age are nearby. Some even offer the added option of home health should the need arise.

SNFs continue to be in high demand with capitalization rates for stable-performing assets remaining at 10 percent to 13 percent. The new PDPM system that took effect in October 2019 may increase the exit of mom and pop operators that weren't prepared for the change. If a significant number of them come on the market as distressed assets, it may well affect the average per bed price being offered.

The AL sector continues to face several issues, including labor shortages, lower occupancy levels, higher acuity coupled with shorter stays, the desirability of multi-level facilities and how to best serve the middle market. Several factors are contributing to the labor shortages. First, the booming economy has resulted in a smaller pool of available workers. Second, and probably the most important is

rising minimum wages. It's a given that caring for seniors is much more demanding than working in retail, yet the pay is often the same. As development slows and the glut of new developments are absorbed, occupancy levels will continue to improve.

Savvy operators are discovering that improving culture at the facility level not only increases staff retention, it escalates census as well. An emerging trend for buyers in



the sector is the desire to have multi-level facilities; this could be independent living combined with assisted living or assisted living combined with memory care. We anticipate potential buyers continuing to look for multi-level assets or for ways of potentially adding an additional component to an assisted living facility acquisition in 2020. As more and more baby boomers come of age in 2020, astute operators will continue to develop creative ways to serve middle-market seniors who can't afford to live in today's senior living model. ■



Cindy Hazzard is principle of JCH Senior Housing Investment Brokerage.

Learn more at www.thejchgroup.com.



Retail Strengthens its Offerings Through Wellness Synergies

By **Naveen Jaggi**

Omnichannel retail has been touted as the next evolution of retail for several years now, especially as physical retailers focus more on experience over transactions. At the same time, we've seen an increasing trend in health and wellness, with a variety of food, fitness and retail options popping up to cater to this shift in lifestyle. In 2020, we expect to see continued synergies between all retail channels.

Retail getting back in shape

The concentration on health, fitness and wellness has led consumers to eat healthier, try different types of workouts and dress in more athletic gear, making athleisure an accepted and celebrated style. This inspired our research team to analyze 6,000 fitness tenant move-ins to see the impact it's had on retail real estate and how it contributes to our outlook for retail in 2020 and beyond.

As the number of fitness locations have grown over the last decade, so have the types of fitness offerings. Our research team found that specialized boutique studio concepts like Soul Cycle, Zumba and UFC boxing gyms—activities that were once classes offered by traditional gyms—are growing on average six times faster than traditional gyms.

The food court transitions to food hall

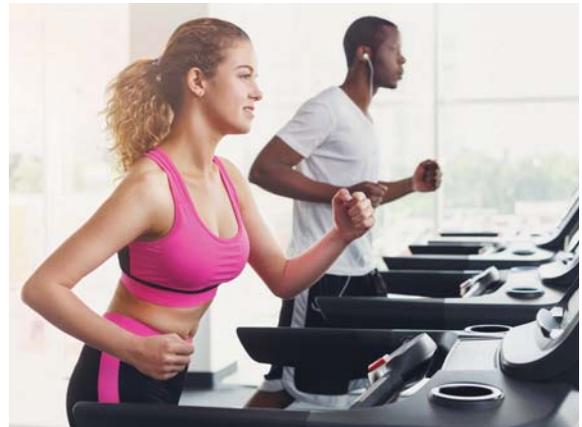
Food is one of the most important elements of retail, with each meal providing the opportunity for a fun, unique experience. Our research shows that transactions increase by up to 25 percent at centers with good F&B offerings and shoppers will spend up to 15 percent more, illustrating why many landlords have opened unique food concepts that elevate the once-humble food court to new gourmet dining heights. We expect to see retail centers moving away from standard fast food or sweet treat offerings, opting to source local concepts with healthier options that appeal to health-minded consumers.

Mirroring shoppers' active lifestyle

While we can spot and monitor which trends are popular amongst landlords at their respective properties, sometimes it's best just to ask the shopper what they're looking for in retail. Earlier this year, our research team surveyed shoppers to see what they expect from retail centers in the future, along with their thoughts on the overarching trends we identified.

We see wellness as a shift in consumers lifestyles highlighted by several retail trends. The three key aspects of

wellness our research examined include consumer interest in outdoor and green spaces, healthy food options and fitness centers. Just over 40 percent of respondents indicated that they want to see open space with lawns and greenery in their centers, while 37.6 percent wanted healthy food options. Nearly one-fifth of shoppers surveyed indicated that they wanted fitness centers and 40 percent said they choose which center to shop at based on food offerings.



According to our research, consumers will no longer be satisfied by frozen yogurt, pretzels and other mall staples of the past. Given this information, landlords must look to both local and healthy food options to design a concept that compliments the local food scene. This shift in lifestyle will impact retail in 2020 and the years ahead as consumers require new options to accommodate their changing preferences. ■



Naveen Jaggi is president of retail advisory services. He leads the retail brokerage business at JLL and is responsible for the overall strategy, business development and growth of the platform.

Learn more at www.us.jll.com/en/industries/retail.



The Risks in Purchasing a Triple Net Lease Property and a Potential Solution

By **Dwight Kay and the Kay Properties Team**

Purchasing a triple net lease property (NNN) provides many benefits to investors. They're usually single tenant retail, medical or industrial properties where the tenant is responsible for the majority of if not all of the expenses including insurance and maintenance costs. They also provide a potentially steady cash flow to the investor as leases are often 10 to 15 years in length with multiple renewal options.

However, just like any investment, there are risks involved.

Vacancies

NNNs are typically either fully occupied or totally vacant. Since they only have one tenant, if the company goes out of business, then you have no rent coming in. That means you're responsible for any debt service, maintenance, insurance and taxes. When purchasing a NNN investors must be very cautious when it comes to the tenants business model and industry and the potential for disruption that future changes in technology could bring—think Blockbuster Video and Borders Books.

Lack of diversification

The problem for many 1031 exchange investors is that they often have only between \$500,000 and \$3 million of equity to purchase a NNN property and this equity amount comprises a large portion of the investors net worth. Oftentimes, the most desirable NNN properties start at a \$2 million purchase price. This can be problematic because the 1031 exchange investor is placing a large amount of his or her net worth into one building, with one tenant and that is in one location. This often causes investors to over concentrate their net worth into a NNN property and if things don't go exactly right with the property or tenant, the consequences could be disastrous.

A potential solution

Many 1031 exchange investors are opting to instead of purchasing just one NNN property with a large portion of their net worth, to purchase fractional interests in NNN properties to build themselves a diversified real estate portfolio. As an illustrative example, instead of buying just one Walgreens for \$4 million, because of lower investment minimums, investors are purchasing \$500,000 in a Walgreens, \$500,000 in a CVS, \$500,000 in a Fresenius, \$500,000 in a FedEx industrial facility, \$500,000 in an Amazon distribution facility, \$500,000 in a Costco, \$500,000 in a Starbucks and \$500,000 in a U.S.-government-leased building.

This diversified real estate portfolio of NNN properties allows investors to potentially mitigate concentration risk and reliance on one tenant and potentially losing their entire principal if that one tenant goes bankrupt. Of course, there is still a risk of losing the entire investment, but it will be spread across multiple tenants. Investors are doing this through what is called a Delaware Statutory Trust or DST. The DST has been blessed by the IRS as like



kind for the purposes of a 1031 exchange via IRC Revenue Ruling 2004-86. Diversification does not guarantee profits or protect against losses. ■

If you would like more information about how investors are diversifying using DST 1031 properties or if you would like to view our current DST 1031 offering inventory, please visit www.kpi1031.com.

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Please review risk disclaimer here: www.kpi1031.com/disclaimer/.

Dwight Kay is the CEO and founder of Kay Properties & Investments, a national Delaware Statutory Trust (DST) investment firm with offices in Los Angeles, New York and Washington, D.C. Kay Properties team members collectively have over 114 years of real estate experience, are licensed in all 50 states and have participated in over \$7 billion of DST real estate.

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How to Achieve Enhanced Pricing for Cellular Assets

By **Ron Reiss**

Cellular lease relationships continue to be a desired source for enhanced revenue across the country. Although many landowners have become more experienced in the realm of lease negotiation, within this exclusive sector, the industry is still fraught with significant pitfalls.

Systematically, landowners negotiate new leases and convey these assets often without proper recognition for market changes. For those considering monetization of their wireless lease rents and trying to determine the value of lease/easement cash flows the existing wireless infrastructure, information on street-level, market pricing is not readily available.

Early 2019 found the market to remain static until the late third quarter when several large private investment groups elected to bypass the aggregation model and attempt to pursue assets directly from landowners and landowner representatives.

Additionally, the larger tower management companies continue to pursue ground lease extensions and easements directly with landowners, often consummating transactions without landowners researching market conditions or receiving any relevant support. There will be a significant adjustment period in 2020, as brokers and landowners begin to discover the new pricing ceilings, in a market that has been static for over 6 years.

Leasehold Finance Advisors, LLC recommends the following for landowner and brokers who are considering a transition within their wireless lease relationship in 2020:

1. Know your suitor: Whether the buyer of your asset is a private investor, a large international REIT, or a national aggregator it is important to understand that pricing within these models varies greatly. Capital limitations or corporate overhead will often lead to your landowner receiving a discounted price and that discount is continuing to grow larger as fixed costs continue to pressure these groups.

One of the larger facades that has been established in the marketplace is that of the advisor/consultant to the landowner. Both on local and nationwide level, these “consulting” houses often will have side agreements with the large investment groups and can sometimes benefit from your fee, as well as a fee from the buyer. In an unregulated industry, this reality impacts landowners more than any other.

2. Know what’s changing: Small Cells and DAS continue to impact the macro site, in metropolitan areas, while build-to-suits apply similar pressure to larger revenue

sources in remote areas. This along with the impending Sprint-T-Mobile merger, requires landlords to be vigilant in order to ensure maximum transactional value. Many aggregators will utilize market and technology updates to reduce overall purchase price two to three times below their actual pricing ceiling for that asset.

3. Know when to ask for help: While many transactions can be handled on a one on one basis, it’s important



to know that there is often no cost for evaluations. Some consulting groups will even engage you on a contingency basis which eliminates the concern for reduction in overall purchase price.

Although it may feel static for many brokers and landowners who are approached by aggregators, 2020 promises to be a year in which many landowners will lever their assets for multiples never achieved. ■

Ron Reiss is the founder and managing director of Leasehold Finance Advisors, a consulting group comprised of field agents who have spent their careers on the ground.

Learn more at www.celltowervalue.com.

Top Five Reasons to Feel Good About Retail in 2020

By **Matthew K. Harding**

Looking back on 2019 as the year winds down, it comes as no surprise that retail-related headlines reflect an industry in transformation. Tenants and the shopping centers that house them continue to embrace opportunities while, as always, facing challenges. Many national brands are growing on solid footing, yet others are facing bankruptcy. Newly popular categories are quickly leasing space while yesterday's hottest concepts begin to "shake out" weaker operators due to market oversaturation.

This story really is nothing new in this highly cyclical sector. What is different currently is that this movement reflects true paradigm shifting in an increasingly digital world. Following an extended period defined by uncertainty for bricks-and-mortar, the future is coming into focus. Here are five "top" reasons it is looking bright.

1. Sales and Traffic

Retailers are reporting strong sales and traffic numbers. In an October poll, Levin Management asked store managers in our 105-property, 15 million-sq.-ft. portfolio about these two key indicators. The percentage of respondents reporting same/higher year-to-date sales (71.4 percent) is just shy of last year's survey historic high (72.1 percent)—and a full 10 percent higher than the trailing prior five-year (2013 to 2017) average. Similarly, 67.8 percent of survey participants reported same/higher 2019 year-to-date traffic—the highest percentage in our fall survey's eight-year history.

2. Backfilled Anchor Vacancies

The past few months have brought a notable uptick in leasing within the LMC portfolio—reflecting solid performance throughout the Northeast and Mid-Atlantic regions. Notably, several sizable transactions have involved backfilled anchor vacancies. Among them, Burlington Stores will occupy a former Toys 'R' Us space at Somerville Shopping Center in Raritan, N.J. We also have leases in the final stages that will absorb another Toys 'R' Us and a portion of a Sports Authority vacancy. Landlords also are reconfiguring big-box vacancies for occupancy by multiple smaller tenants—an important point that not all spaces are being replaced with "like-size" retailers.

3. Moms & Pops

Independent retailers are increasingly active across the board and particularly in the dining and personal services categories. This is positive news for shopping centers. Mom-and-pop shops add flavor to a property's tenant mix, which is important today in creating competitive differentiation

Shoppers want to support local businesses and patronize shops that really offer something outside the norm.

and appeal. Shoppers want to support local businesses and patronize shops that really offer something outside the norm. Independent retailers typically have more flexibility than larger national chains when it comes to offering hyper-local promotions and customer experiences.

4. Landlord Reinvestment

We are observing an uptick in landlords reinvesting in and repositioning properties to better serve and succeed in their marketplaces. Whether a full redevelopment, expansion or simple cosmetic updates, investing capital into an asset is key to attracting next-generation tenants and retaining those transforming for success (think accommodations for online order pickup and outdoor seating for restaurant operators). These efforts also heighten a center's appeal for consumers and, ultimately, investors.

5. Technology Adoption

Every day, technology advancements are opening new doors for improved shopping center operation and marketing. Solar, LED lighting, automatic faucets and photo cells are enhancing sustainability. Best-in-class cloud software and newly emerging tools (think AI) are facilitating dealmaking. Further, the integration of digital tools with brick-and-mortar commerce—via property-specific business-to-consumer websites, social media and more—is essential to driving shopper engagement and interest.

Point by point, the retail and retail real estate industries are experiencing a proliferation of positive trending. For these five reasons—and more—there is reason to expect good things heading into the new year. ■



Matthew K. Harding is CEO of commercial real estate services firm Levin

Management Corporation.

Learn more at

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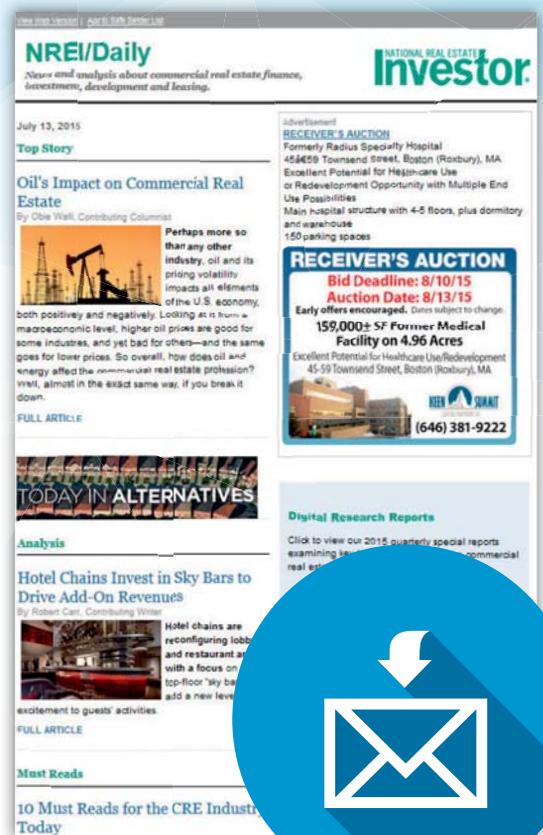
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Will the Expansion of Non-Core Cities Transform the Investment Landscape?

By **John Chang**

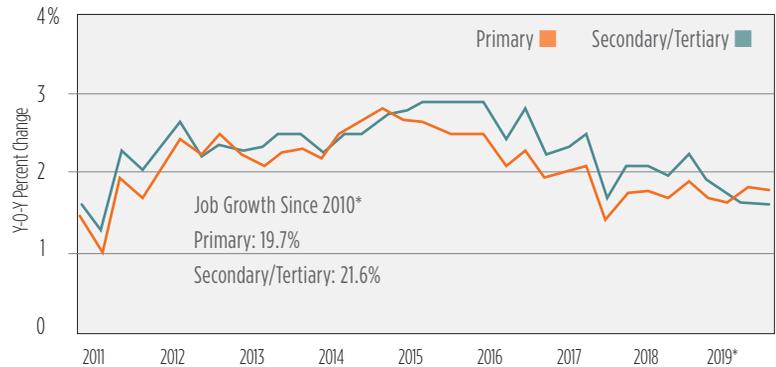
U.S. employers have created more than 21 million jobs over the past nine years, with an expanding share of new positions arriving in secondary and tertiary markets. In addition to local enterprises, employment gains in these smaller cities are being driven by large corporations opening local offices to tap new labor pools. With low unemployment in primary metros driving up wages and living costs, companies have become more flexible, moving jobs to the employees rather than making employees move for jobs. This change in hiring practice has helped expand the job market in non-primary metros by a higher rate than in gateway cities.

The shift in job creation toward secondary and tertiary markets is substantially improving the demand for local commercial real estate. Corporate expansions and relocations have absorbed vacant office space, while the added employment opportunities have increased the need for rental housing. Lower availability is in turn encouraging higher rent growth. The average multifamily vacancy rate in non-primary markets has fallen 130 basis points since the end of 2014 to 3.8 percent in September, supporting a 30 percent jump in the average effective rent in the last five years. Over the same span, vacancy in primary cities declined 80 basis points to 3.4 percent, contributing to a lower rent gain of 21 percent. While asking rents for office properties advanced at similar rates across all market sizes, operations improved by wider margins in the smaller metros. This drop in vacancy is particularly noteworthy as office inventory has expanded at a faster rate in non-primary cities than in gateway markets.

The strong performance of commercial properties in secondary and tertiary markets, fueled by abundant job creation, has led to a renewed interest among investors. More transactions are taking place in non-primary markets now than earlier in this business cycle or during previous economic expansion periods. In 2000, about 39 percent of all trading activity occurred outside primary markets, but the share has climbed to roughly 62 percent this year. Both local and out-of-market buyers are becoming more active in smaller cities, as those who may

have previously confined their search for opportunities to major cities are now entering secondary and tertiary areas. Beyond the above-average improvement in fundamentals, investors are also considering these metros for greater yield. The cap rates on apartment and office building exchanges in secondary and tertiary markets can be 100 basis points or higher on average than for acquisitions in primary markets. Longer-term value appreciation has

Outsized Job Growth Has Favored Secondary and Tertiary Markets



*Through 3Q 2019

Sources: Marcus & Millichap Research Services, BLS

been comparable, but the momentum has begun to favor secondary and tertiary markets. This is especially true for multifamily assets, where over the past year ended in the third quarter, the per unit sale price of apartment properties in secondary and tertiary cities increased by more than double the pace reported in primary markets. ■



John Chang serves as the senior vice president and national director of research services for Marcus & Millichap Inc. Learn more at www.marcusmillichap.com.



2020 Economic Outlook: Positioning Your Portfolio for the Maturing Cycle

By **John Chang**

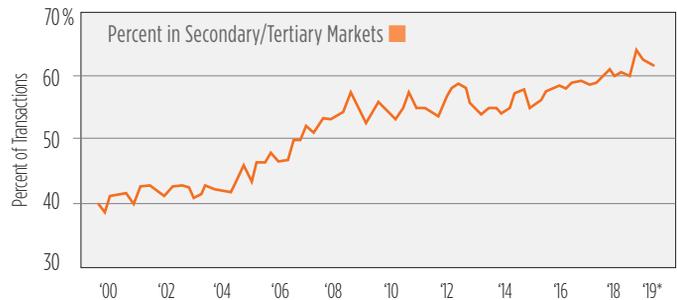
The U.S. economy remains in expansion, growing by 1.9 percent in the third quarter as the nation's economic momentum continues to surmount barriers to growth. Ongoing trade negotiations with China and softening global markets have remained restraints on the domestic economy in recent months, weighing on exports and manufacturing. The Fed has aggressively battled these challenges, issuing three 25-basis-point cuts to the overnight rate in less than 100 days; however, balancing these reductions with other economic variables is key. The national unemployment rate remains near a 50-year low at 3.6 percent as companies sustain hiring activity. Consumption also remains robust, delivering a 4.5 percent boost to core retail sales in the third quarter following a dip to the mid-2 percent range earlier this year. An extended cycle of strengthened wages has supported this trend, pushing disposable income to a record high. While the baseline economic forecast still points to modest growth in 2020, a variety of factors including the upcoming election, slowing international economies and the ongoing trade war could dramatically change the growth outlook. Portfolio diversification will be a key defense for investors should one of these factors weigh heavily on domestic growth.

The reevaluation of existing portfolios will be crucial for investors as they recalibrate their investment strategies to help disperse risk and position in the path of growth. With some recession risk indicators already triggered, defensive asset allocations merit consideration using strategies that anchor portfolios with more recession-resistant property types and tenants. Single-tenant net-lease retail assets with high-credit tenants may serve as viable options for many investors due to their steady returns, hands-off management and overall stability. Retailers in the multi-tenant segment offering consumer staples and low-cost convenience items can also help bolster defensive strategies. Dollar stores, general merchandisers including Walmart, and discount retailers such as T.J. Maxx can provide investors with relative stability should the economy weaken. Healthcare-related commercial real estate in both retail and office space has also proved its sustainability in economic slowdowns.

In addition to diversification across asset types, investing in markets with different economic drivers can also help investors manage portfolio risk. Targeting top-tier

assets in the nation's most prominent cities can provide investors with an additional layer of security if domestic growth continues to soften as these properties generally outperform during moderate downturns. However, expanding search parameters to include a variety of secondary and tertiary metros with more specialized economies can offer economic diversity that reduces downside risk that may affect just a segment of the economy. Though

Capital Allocations Moving Beyond the Core



*Through 2Q

Includes apartment, retail, office and industrial sales \$1 million and greater.

Sources: Marcus & Millichap Research Services; Real Capital Analytics; CoStar Group, Inc.

recession risk has moderated in recent months, prudent investors will still hedge their bets should trade negotiations with China falter or other international headwinds materialize; using a diversified strategy could sustain a portfolio. Some form of economic downturn will come at some point, though with the timing and severity remaining unknown, investors should use the available runway to brace their portfolios with a sustainable mix of assets. ■



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Seniors Housing is Positioned for Continued Growth

By **Adam A. Lewis**

With the U.S. economy in the longest expansionary period in post-war history, commercial real estate buyers are eyeing investments positioned to ride out a potential recession. Many investors' wish lists now include seniors housing, where the demand base is less impacted by economic downturns. Furthermore, the aging baby boomer population should begin to support a wave of demand for low-care properties within the seniors housing sector. In 2020, the assisted living market will shake off the remnants of a construction boom that weighed on operations and skilled nursing will turn a corner after several years of occupancy and inventory erosion.

Age-restricted apartments and independent living properties are beginning to see the front wave of baby boomers who are 73 years old, though peak demand remains several years away. However, some demand at amenity-rich senior apartments and independent living facilities could emerge earlier than previous generations as economic conditions reshaped retirement accounts. Seniors with active lifestyles may consider unlocking home equity and moving into rentals as assets that cater to seniors' lifestyles are increasingly available. The high price of a home in many popular retirement destinations can also make homeownership unappealing in those markets. As a result, investing in lower-care-level assets in these markets early could pay dividends for commercial real estate investors. Additionally, renter demand for age-restricted and independent living units will remain more consistent relative to market-rate apartments as older renters are less impacted by economic downturns. As a result, traditional multifamily investors will make their presence felt in the seniors housing segment into 2020.

The long-term outlook for the assisted living sector remains positive, though 2020 will be spent absorbing recently delivered stock. Supply has outpaced demand for the past several years, sending occupancy to the lowest level in a decade. Some relief is on the horizon as the development pipeline wanes, providing existing properties with an opportunity to stabilize while rents outpace inflation. Long-term, assisted living facilities are positioned as an integral part of late-life care. Developers' appetite for new skilled nursing properties has been weak, and inventory in that sector has remained relatively flat or fallen over the past several years. Assisted living properties are the best potential substitute for skilled-nursing demand and some residents may need to stay in these properties longer as

demographics eventually overwhelm the system.

Skilled nursing will find the elusive supply-demand balance that has hamstrung the sector over the past several years. Although dilapidated stock has been removed and development limited, occupancy struggled to find a floor until 2019. With occupancy stable, labor costs move to the forefront of concerns for operators and potential investors. The tight labor market increases competition for existing



workers, while reimbursements provide narrow flexibility to operators attempting to maintain bottom lines. Economies of scale provide REITs and large owners with a competitive advantage, though those groups are expected to spend much of 2020 maximizing the efficiency of their portfolios rather than expanding them. Smaller owners will remain the primary players on the buy side of the market, particularly those able to navigate the constantly changing reimbursement schedules. ■



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PropTech, AI, Smart Data and Customer Relationships will be Major Drivers of Real Estate Industry Change in 2020

By **Brian Zrimsek**

2020 will provide huge opportunities for both residential and commercial firms to differentiate themselves by fostering more positive relationships with everyone from investors to commercial occupiers to residents. Advancements in technology will underpin much of this approach, as industry professionals realize that PropTech is more than a buzzword; it's a real industry providing valuable tools.

One emerging technology that will transform the real estate sector is artificial intelligence (AI). 2020 will see AI move out of its initial hype cycle into a more practical phase centered on data and analytics. More firms will look to AI to bolster traditionally manual processes, such as lease abstraction, helping turn unstructured information in leases and other corporate and legal documents into data sets that can be mined for actionable insights. The result will be better business decisions and improved operational efficiencies.

Additionally, 2020 will see big data become smart data. The ability to gather data is rapidly growing, making analysis more challenging. The volumes of data, from transactional systems as well as IoT devices, provide many opportunities to unlock value if one can separate the signal from the noise. Next year will see companies make significant steps toward achieving ROI by using PropTech to federate data from many sources and applying increasingly visual methods to uncover key data elements for decision support and operational action. Results will inform long-term business strategies and improve efficiency in day-to-day operations and customer touchpoints.

Next year we are also going to see a shift in property management away from a traditional lease and asset focus to a more consumer-centric approach. As mentioned above, PropTech will enable real estate players to streamline processes that generate data offering real, tangible insights, positioning property owners and operators to create better customer experiences. This is something many multifamily operators are already doing, but even more will shift to this approach, and commercial firms will soon follow suit. The landlord-tenant relationship will increasingly be viewed as a vendor-customer relationship, making metrics around tenant satisfaction, appreciation and turnover more important than ever. At the property level, landlords will need to proactively invest in their properties and monitor them more closely to keep tenants happy.

One key area that will attract investment is digital services and amenities, particularly in multifamily units.

Today's tech-savvy renters are accustomed to constant connectivity and the ease and convenience it provides. Landlords who don't offer easy-to-use portals with modern consumer-friendly user experiences will have to get them; otherwise renters will gravitate towards those that do. Indeed, property owners and operators will also come to see digitalized rental processes—for everything from lease signings to online rent payments—as must-haves.



Any multifamily properties that have not yet gone digital already risk falling behind the competition.

2020 promises to be an exciting year for the real estate industry as technology continues to modernize traditionally manual processes and help property owners and operators provide services and amenities that meet the expectations of today's digitally savvy renters. By doing all of these things, the industry will be able to continue its shift towards a more relationship-focused approach, which in turn will see greater investment, more collaboration within the industry and happy tenants. ■



Brian Zrimsek is an industry principal at MRI Software, where he oversees product management and direction for the firm's residential solutions.

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Seniors Housing: Growing Older with Technology

By **Beth Burnham Mace**

In 2020, there will be an estimated 23 million Americans over the age of 75 and 8.9 million over 83, a common move-in age of a resident to seniors housing. These will be members of the Greatest Generation and the Silent Generation. And some of these older individuals—roughly 90,000—will be centenarians or older. It's not until the end of this upcoming decade in 2029 that the oldest baby boomer will have turned 83—effectively opening the proverbial floodgates for seniors housing.

But that doesn't mean it's time to sit back and just wait because there is a lot of change on the horizon for the seniors housing sector. This commentary highlights some of these changes, with a focus on technology.

Age-tech, gerontechnology, assistive technology, silver-tech are all descriptors of this emerging focus of technology applications as they specifically apply to older individuals. It's the intersection of the gerontology and digitization and the applications are wide spanning as older adults and their family caregivers adopt technology that can support their shared goals of safety, longevity, independence, quality of life and connection to friends and family.

Aging 2.0 identifies “Eight Grand Challenges” for this intersection of aging and technology: (1) Engagement and Purpose, (2) Financial Wellness, (3) Mobility and Movement, (4) Daily Living and Lifestyle, (5) Caregiving, (6) Care Coordination, (7) Brain Health and (8) End of Life.

While this commentary is too short to do justice to each these focus areas, below are a few applications being developed by a host of software and hardware entrepreneurs and businesses, including the mega-giants Amazon, Google and Apple. 4Gen estimates that revenues in the U.S. age-tech market exceeded more than \$350 billion in 2018, a significant industry indeed.

Brain Health. Technology has the potential to help with cognitive care and brain health issues related to memory, language, problem solving and other cognitive skills that affect a person's ability to perform everyday activities.

Caregiving, Mobility and Movement. From a health and wellness perspective, telehealth has the potential to reduce health care costs and improve health care coverage by allowing instant connectivity via video conferencing with live doctors. Hand-held devices with medical applications, remote monitoring of residents and connected equipment can provide visibility and insights about exercise regimens, diet and vital signs as well as help with



sensory functions such as vision, hearing and motor skills.

Engagement, Purpose and Socialization. Socialization, engagement and purpose are important considerations in aging. Studies have found that social isolation and loneliness among seniors has the same impact on health as smoking 15 cigarettes a day, while a strong purpose in life can add five or more years of life span to older adults. Smart phones and appliances, remote sensors, mobile personalized connectivity applications and software systems have the potential to better allow aging in place, independence and virtual socialization

Daily Living, Lifestyle and Care Coordination. Robots, virtual assistants, smart phone apps, iPads and other devices can help with medication management, emergency response services, fall detection, vital signs tracking, transportation, finance, sensory aids and mobility aids. The on-demand economy can also help address these issues. Japan, whose society is aging more rapidly than the U.S., and which has a more vexing labor shortage challenge than does the U.S., is a good place to look at advancements in this realm.

As these technologies get tested and winners and losers emerge, the operations, real estate, social and medical aspects of the sector will be forever changed. ■



Beth Burnham Mace is the chief economist of the National Investment Center for Seniors Housing & Care (NIC) and has a passion for the industry.

Learn more at www.nic.org.



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The Election Outlook

By **Doug Bibby**

The 2020 election season is officially underway. Historically, housing has rarely been discussed in national elections. However, this year is likely to be different. For the first time, housing—and rental housing no less—is likely to be a major point of discussion. The reason is simple: We’re facing a crisis.

Growing demand for rental housing has been unmet by new construction activity, creating a housing scarcity issue where too many renters face both housing availability and affordability challenges. Policymakers on both sides of the aisle are under pressure from constituents to come up with solutions that can help those households struggling to pay their rents.

New housing proposals

At press time, 15 Democratic candidates and three Republican candidates were vying for their parties’ nominations; and for the first time ever, housing affordability has become a topic in the Presidential election.

While consensus on the Democratic front runner may still be uncertain, housing-related issues have been a common theme across the majority of candidates. In fact, multiple democratic candidates have introduced legislation that addresses housing affordability and reducing regulatory barriers.

Most notably, Senators Elizabeth Warren (D-Mass.) and Cory Booker (D-N.J.) have released affordability-related legislation.

Warren’s bill expands the Fair Housing Act to include source of income as a protected class and creates new incentives for local governments to reduce barriers that drive up housing costs.

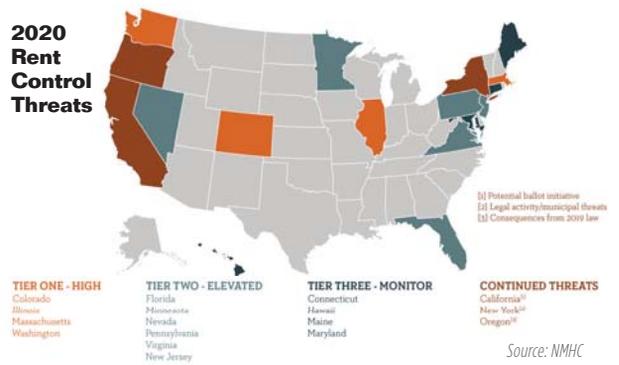
Booker’s bill includes a provision for a renter’s tax credit for taxpayers who pay 30 percent of their income on rent, including utilities. It also encourages inclusionary zoning as a means to increase supply of affordable housing and reduce housing discrimination based on race and income.

A move to remove barriers

Meanwhile the Trump Administration has focused on housing affordability. In June, President Trump signed an Executive Order that established a White House Council on eliminating regulatory barriers to affordable housing. Regulations account for 32.1 percent of development costs on average, according to an NMHC and NAHB study.

Chaired by HUD Secretary Ben Carson, the council seeks to identify and remove obstacles that impede the development of new affordable housing. NMHC participat-

2020 Rent Control Threats



ed in the council’s November housing affordability roundtable event, which brought together housing leaders from public and private sectors for a solutions-focused discussion.

As part of the initiative, HUD is also seeking public comment on the various laws, regulations, land-use requirements and administrative practices that artificially raise the costs of affordable housing development.

Clearly, there is a growing appetite to address housing policy at the federal level. We are encouraged by this shift and continue to engage with the various lawmakers and policymakers working to develop real, long-term solutions rather than stopgap measures such as rent control.

Today, rent control is mistakenly perceived as a method to improve affordability when in fact it can harm the very people it intends to help. Unfortunately, more states and localities nationwide are moving toward more rent control legislation.

We continue to push back against rent control in its various forms and are supportive of efforts to find alternative solutions. We hope that this election season will result in having policymakers in place who will work to create programs and incentives to support more development of affordable housing while removing the unnecessary and costly barriers to doing so. ■



Doug Bibby is the president of the National Multifamily Housing Council (NMHC) in Washington, D.C. Learn more at www.nmhc.org.



What Will Real Estate Look Like in 2020? A Look at Predictors

By **Brian Nelson**

According to Freddie Mac's November 2019 report, the U.S. housing market will "continue to stand firm" in 2020. And CBRE predicts that 2020 will be a great year for commercial real estate, with increased capital flows and solid property fundamentals. With fears of a looming broader economic downturn, it's good news the real estate is in a solid spot.

While there's a lot of good to come for real estate in 2020, the year won't be without its challenges. Here's what we expect to see in real estate next year:

Cybersecurity and tenant data privacy

For commercial real estate, cybersecurity and tenant data privacy are increasingly important issues. Into 2020, they will continue to pose a challenge and become core business issues.

"The commercial real estate (CRE) industry now has access to a wider variety of personal data such as user location, communication, behavior and sentiments," explains a Deloitte Insights report, "and cyber threats are increasingly real and pervasive."

As 2020 approaches, Deloitte recommends strengthening leadership and board involvement in technology adoption, addressing talent and vendor issues and incorporating privacy by design. These actions will help lessen the issues associated with cybersecurity and data privacy for your organization.

Increase in home sales and lower mortgage rates

The National Association of Realtors (NAR) has predicted that home sales will rise by 3.4 percent in 2020. But with new home construction down 2 percent as of September 2019, will housing inventory keep up? That's the hope.

Something else in the three-percent range? Mortgage rates. This year was a great year for mortgage rates, and next year they're expected to stay low. Freddie Mac forecasts "that the 30-year mortgage rates will be 3.7 percent for the remainder of 2019 and will tick up slightly to 3.8 percent in 2020." Because of the low mortgage rates, Freddie Mac predicts that there will be "\$785 billion in single-family refinance mortgage originations" in 2020.

Higher house prices

"It is very encouraging that buyers are responding to exceptionally low interest rates," Lawrence Yun, NAR chief economist, said. "Rising demand will reaccelerate home price

appreciation in the absence of more supply."

So just how much will house prices rise in 2020? Freddie Mac's prediction is 2.8 percent, compared with a rise of 3.3 percent in 2019. Now let's talk a bit more about that inventory shortage.

Continued inventory challenges

Home sales are expected to increase, but they would likely rise even more if there was inventory available. But there is a shortage of homes available relative to the buyers seeking homes. Inventory is particularly low at the entry-level end of the market.

What has caused the shortage?

"We've faced what has been called a perfect storm of supply-side challenges," Robert Dietz, chief economist of the National Association of Home Builders, said. "There has been an ongoing labor shortage, we lack the necessary land and lots to build homes, we've had building material cost concerns, and then probably the most important factor has been higher regulatory costs since the great recession."

ESG issues becoming more important

Environmental, social and governance (ESG) issues are important to millennials—and millennials are becoming bigger players in the investment market. With over 50 percent of millennial investors saying ESG policies impact their investment decisions, developers might want to put a heavier emphasis on honest business practices, occupational safety and responsible supply chain practices in 2020.

Cybersecurity, data privacy, ESG issues and low inventory will continue to challenge the real estate industry in 2020. But as home buying increases along with home prices, next year promises to be an exciting one for real estate. Stay tuned. ■



Brian Nelson is the founder and president of NB Private Capital.

Learn more at nbprivatecapital.com.



Technology is a Crucial Ingredient for Opportunity Zone Success

By **Reid Thomas**

What's the role technology will play in fund administration and Opportunity Zones in 2020? To answer that, we need to look at the factors surrounding the future of fund administration more broadly. Specialty Financial Administration is a rapidly growing sector of the overall fund market that are increasingly characterized by financial products that have unique and complex requirements. Today that boils down to using technology to close the information gap between funds and investors and funds and the public sector in demanding sectors like Opportunity Zones.

Why investors, communities and the public sector need transparency

Technology answers the call for transparency that investors, communities and the public sector need in order to help make the Opportunity Zones initiative a success across the country. Stakeholders such as investors not only want to see return on their investments, but also have a genuine and increasing demand to make a positive social impact from their investment. Community activists want transparency from reports with data confirming that the Opportunity Zones initiative is making a difference in their neighborhood.

Legislation was recently introduced to increase reporting requirements, such as the newly introduced Opportunity Zone reporting bills. Even without the proposed legislation the Opportunity Zone ecosystem should embrace and measure social impact. So how do we get there?

As pioneers of the industry we have been an advocate of social impact reporting since the beginning. We believe it will ensure the future of the Opportunity Zone initiative.

Why traditional, old-school technology is not good enough for Opportunity Zones

Traditional fund administration is focused primarily on automating operational tasks for the financial performance of the fund, such as calculating waterfalls, fund accounting and financial statements. In some cases, excel is still being used for traditional fund administration. While financial performance is a component of the Opportunity Zones program, it is not the only focus. To adapt traditional fund administration technology platforms for Opportunity Zones investments, too many expensive expert hours are needed to handle the complexity and speed required by the public sector and investors. In markets where complexity and speed are already high, the solution is a combination of technology,

In markets where complexity and speed are already high, the solution is a combination of technology, process expertise and domain expertise.

process expertise and domain expertise. That's brings us back to Specialty Financial Administration.

NES Financial chose to develop a purpose-built, technology-enabled solution designed specifically for OZ funds. Our purpose-built solution has dashboards for fund managers and investors to track and report key OZ fund metrics, including the required 90 percent ratio of a fund's investments into OZ property, "improvement" of a fund's assets, an investor's unique deferred-gain calculation, projected social impact of a fund's investments, and more.

Technology is needed that is agile yet boasts exceptionally strong software architecture and efficient data operations. Process expertise needs to include the combined soft and technical skills to migrate organizations to a digital approach. Domain experts can configure to exacting specialized markets, like those taking shape for Opportunity Zones.

These key characteristics achieved by Specialty Financial Administration, despite complexity or a fluid regulatory environment, include speed, savings and accuracy. A technology-driven fund administration platform delivers faster processing times, from onboarding investors to generating financial statements, without adding head count or managing inhouse technology.

If Opportunity Zones are to live up to their potential, technology and Specialty Financial Administration appear to be a critical factor. ■



Reid Thomas is executive vice president and general manager of NES Financial's Specialty Financial Administration, focusing on technology-enabled EB-5, 1031 and Opportunity Zone fund administration.

Learn more at www.nesfinancial.com.

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What to Watch for in the Multifamily Market in 2020

By **Trevor Koskovich**

The national multifamily market is forecast to continue to post strong performance in 2020. There are several factors supporting the favorable outlook, a few of which are outlined below. To be sure, there are also a handful of economic, financial and political conditions present that combine to add uncertainty to the market. Despite a few challenges, on balance, the pluses are expected to outweigh the minuses in the economy, the capital markets and the multifamily sector in 2020.

Healthy Labor Markets Driving Demand for Apartments: Sustained employment growth is forecast to continue to fuel household creation, and the multifamily market will capture its share of new households. As of this writing, employers were on pace to create approximately 2 million net new jobs in 2019, marking the ninth straight year where payroll growth came in at or above 2 million positions. With the country essentially at full employment, it will be tough for the economy repeat this performance in 2020; gains will likely be more modest in the year ahead.

Homeownership Rates Holding Steady: With the economy remaining in an extended growth cycle, employers expanding payrolls, consumer confidence high and mortgage rates low, conditions would seem ripe for a rise in the national homeownership rate. To this point in the current expansion cycle, however, homeownership rates have held steady around 64.0 percent to 64.5 percent, remaining essentially unchanged from five years ago and down 500 basis points from the pre-recession peak. An unexpected flight to homeownership could create a supply/demand imbalance for rental housing, but there is little indication of any significant shift in homeownership trends occurring in 2020.

Strong Absorption Bolstering the Class-A Segment: Multifamily developers have been active in the class-A space, bringing an average of approximately 215,000 class-A apartment units to the market annually since 2015. Despite the wave of new development, vacancy rates in the top tier of the market have been quite steady, ranging between 5.5 percent and 6.0 percent in recent years, as renters have moved into a net of nearly 1 million class-A units since 2015. While there are several markets where construction remains quite active, led by Dallas-Fort Worth, Seattle and Atlanta to name a few, demand at the high-end of the quality spectrum has proven strong enough to keep vacancy rates fairly flat.

Affordability to Remain a Challenge; Rent Control

Measures Likely to Have a Minimal Short-Term Impact:

Apartment rents have been rising faster than the rate of inflation for the past several years, and affordability has been one of the prevailing themes in the multifamily market. Late in 2019, California passed rent control legislation, but with the law allowing for annual rent increases of 5 percent, plus the rate of inflation, renters are unlikely to find significant relief. The more pressing realities driving



rents higher—in California and in other high-demand states—include: elevated demand for apartments, rising land and construction costs and a wave of higher-end, luxury projects coming online. With these conditions in place, renters are going to find themselves facing higher rents in 2020. ■



Trevor Koskovich, president-investment sales, joined NorthMarq in 2018 to lead the company's expansion into multifamily investment sales. At the end of 2019, the company has expanded eight of its debt and equity offices to include investment sales, growing the business to hundreds of active listings and more than 40 employees. Koskovich brings more than 20 years of experience in capital markets advising clients on investment sales opportunities in markets across the U.S. Learn more at www.northmarq.com.



The Sun is Shining on the Cayman Islands' Real Estate Market

By **Sue Nickason**

Despite global economic uncertainty, the real estate market in the Cayman Islands offers compelling opportunities for real estate investment.

According to PWC's *Emerging Trends in Real Estate 2019* report, real estate worldwide continues to attract capital as an investment asset class. The Caribbean offers those looking to own a piece of island paradise for investment purposes the perfect location.

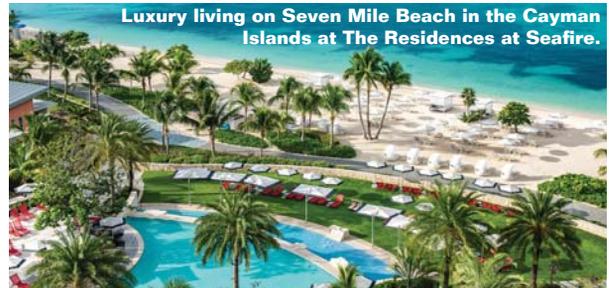
The Cayman Islands is one of the most affluent territories in the region, making it an attractive choice for residential and commercial real estate investments, with its lack of restrictions on foreign ownership of land and stable economy. The pristine beaches, warm climate, close proximity to the United States and tax-neutral status of the Cayman Islands add to its appeal.

The outlook for the Cayman Islands economy remains positive. The British Overseas Territory has experienced five years of 3 percent GDP growth, low unemployment and year-on-year government surpluses. As the world's sixth largest banking centre and its large international financial community accounting for around 55 percent of GDP, the Cayman Islands offers a thriving commercial arena.

High-end tourism is another economic pillar for the Cayman Islands, responsible for 30 percent of GDP. The tourist industry saw a surge of annual visitor arrivals exceeding two million in recent years, according to the Cayman Islands Department of Tourism, and tourist room stock just exceeded the 7,000 mark. This offers another influential factor in purchasing property in the Cayman Islands for those investors seeking to acquire properties catering to the travelling public.

The Cayman Islands development and construction industry also has a significant impact on the local economy. The Economics and Statistics Office's *2018 Annual Economic Report* reported that building permits increased by 5.6 percent to \$247.9 million in 2018, with 2019 growth expected to continue.

Demand is high for luxury long-term lease accommodation along Seven Mile Beach and George Town, and several leading developers, including Dart Real Estate, are developing housing to respond to market demand. Prices of condominiums have increased, with locations in the sought-after Seven Mile Beach area increasing by over 40 percent from 2016 to 2018 (source: DOKHPI, Dart's proprietary House Price Index), and an average two-bed unit currently renting for \$4,275 per month.



The local real estate market continues to produce strong sales across the residential sector as well, with the average single-family home on the coveted Seven Mile Beach corridor selling for \$430,000 more in 2019 compared with just two years prior, while high-end residences such as The Residences at Seafire have been in demand.

The Cayman Islands Government provides a streamlined and efficient process for permanent residency via real estate investment for high-net-worth individuals. This affords another alluring factor that has contributed to bringing so many investors to Cayman's shores—so many that the number of permanent residency applications granted through investment has quadrupled in the past year.

Commercial properties have also enjoyed an upward sales cycle as demand for business workspace grows. According to the Cayman Islands General Registry, the number of active companies registered increased by 8 percent between 2017 and 2018, with 107,309 registered companies as of 2018 year-end. Turnkey office spaces, such as Dart Real Estate's newly launched readyspaces at Regatta Office Park offers the business community an attractive and flexible solution to effortlessly establish an office in the Cayman Islands while also managing monthly costs.

According to a recent review by Charterland, 2018 saw record highs for the property market in the Cayman Islands, with more than \$800 million in total sales, demonstrating that the Cayman Islands offers investment opportunities with growth potential for the foreseeable future. ■

Sue Nickason is the vice president of real estate marketing, sales & leasing at Dart Real Estate.

Learn more at

www.provenanceproperties.com.


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Collaboration Overcomes the Biggest Threat to Project Delivery

By **Will Mitchell**

2020 brings more mixed signals for the real estate industry. The boon of the lowest unemployment rate in 50 years translates to an escalating labor shortage. Low interest rates are accompanied by the forewarning of an inverted yield curve. A record number of multifamily units are scheduled for delivery in 2020 as a trade war threatens to stall the longest economic expansion in modern history.

In the face of economic uncertainty, project stakeholders will rely upon increased trust and collaboration to navigate whatever environment 2020 brings.

Owners, developers, equity partners, lenders and contractors are ultimately aligned on the same goal: deliver construction projects on time and in budget. The single biggest threat to this goal is a shared problem: slow payments. Slow payments hurt contractors' ability to deliver on project goals—a responsibility born by developers, lenders and equity partners alike.

The *2019 Construction Payments Report* finds that contractors—who are subject to the longest days sales outstanding of any industry in the U.S.—estimate the cost of floating payments for wages and materials adds a combined average of more than 5 percent to total project costs.

Slow payments inflate project costs

General contractors and subcontractors include a combined average of 5.3 percent of additional overhead costs in bids to account for the cost of floating payments for wages and materials. 76 percent of subcontractors report considering a reputation for slow payments when deciding how much to bid on a project. Subcontractors reported a willingness to provide a 3.7 percent discount for payment within 30 days—representing \$44 billion in savings for faster payments.¹

Slow payments cause project delays

Labor shortages increased the average time to complete a project to 22 months in 2017, up from 16.5 months in 2013.² Further, 63 percent of subcontractors decided not to bid on a project in the last 12 months because of a general contractor or owner's reputation for slow payments. In addition to labor market impacts, 28 percent of subcontractors and general contractors report that work was stopped or delayed due to slow payments in the last 12 months.¹

Access to cash is essential for contractors to grow their business in an upcycle and survive in a downcycle. In the last 12 months, even while access to capital has been historically cheap, 21 percent of subcontractors report

choosing not to bid on a job due to cash flow concerns.¹

The problem of slow payments is distributed between owners, investors, developers and general contractors. To solve a distributed problem, the industry must come together to find collaborative solutions. Achieving faster payments requires processes and tools that eliminate siloed work and facilitate faster sharing of information.

It is imperative for industry participants to work



together to eliminate the manual, complicated processes involved in invoice approval and payment distribution. The developers and financiers in the real estate industry who achieve faster payments will see an advantage in both project costs and scheduling in a competitive labor environment.

In 2020, leaders in the real estate industry will work to close the gaps in the value chain between lender and contractor through collaboration. ■

Read the full report here.

1. Rabbet 2019 Construction Payments Report
2. Yardi Multifamily Bulletin, November 2017



Will Mitchell is the CEO of Rabbet, the only intelligent construction finance platform connecting developers, lenders, and equity partners.

Learn more at rabbet.com.



The Outlook for the U.S. Economy and Multifamily Housing Market in the First Half of 2020

By **Daniel J. Hogan**

The single inexpugible fact about the current economic recovery is that it is singularly long-lived. The expansion reached its tenth birthday over the summer, making it the longest period of unbroken growth in the nation's history.

Superannuation does not trigger the demise of a recovery but it tends to elevate the risk of those things that do: falling profit margins, rising labor and commodity prices, revelation of previously hidden financial excesses and government policy errors. Based on our knowledge circa late October, only the first poses a serious threat to interrupt the celebration of the expansion's eleventh and twelfth anniversaries, although the possibility of trade-related policy miscues cannot be dismissed.

Indeed, corporate profit margins have narrowed significantly this year, squeezed by a chronic absence of pricing power, moderately rising labor costs and tariff driven supply-chain dislocations. In response, corporate managements, especially those with over-levered balance sheets, have assumed defensive postures, taking steps to reduce recession exposure by scaling back capital spending and R&D and pursuing cost economizing acquisitions. Acceleration of these trend could readily trigger a spring recession.

Declining corporate investment is a necessary but not sufficient cause of recession. Also required are faltering consumer spending, employment losses, weak income growth and, most likely, ill-timed anti-inflationary monetary policy. None of these conditions is evident nor likely to develop in 2020. Consequently, RED Research models forecast that a 2020 recession is an unlikely outcome, reaching only a 5.6 percent probability during the first half of 2020 and 14.1 percent for the full year.

Rather, our models foresee sluggish Real GDP growth in the 1.5 percent to 1.7 percent range; average monthly payroll job growth of 150,000; and real personal income and consumption expenditure growth of 2.0 percent and 2.4 percent, respectively. Inflation will continue to run below the Fed's 2 percent target, holding the fed funds rate in a 1.75 percent to 2.0 percent range and the 10-year Treasury yield in the 1.9 percent to 2.2 percent vicinity. Low inflation and interest rates and modest corporate earnings growth may hatch surprisingly good equity returns.

Multifamily performance and investment returns should remain constructive. We forecast an occupied stock growth

rate of 1.9 percent, slower than 2019's 2.4 percent blowout but sufficient to maintain occupancy among the RED 50 large market peer group near 94.8 percent. Rent growth will moderate, falling from the recent low-4 percent Reis series baseline to about 3 percent in 2020. Measurements based on new lease, street rent data will gravitate toward the 2.5 percent level.

NOI growth will moderate further, slowing to roughly 3.6 percent in 2020. More cautious investment behavior will place

RED Capital Research Model Economic Forecast Summary

Year	History		Forecast	
	2017	2018	2019	2020
Real GDP	2.40%	2.90%	1.80%	1.70%
Consumption (PCE)	2.60%	3.00%	2.60%	2.40%
Nominal Personal Inc.	4.70%	5.60%	4.70%	3.90%
GDP Price Deflator	1.90%	2.40%	1.70%	1.50%
Net Payroll Jobs (000)	2,271.70	2,450.30	2,298.60	1,765.50
Fed Funds	1.00%	1.80%	2.30%	1.60%
10-Year UST	2.30%	2.90%	2.20%	2.10%
Baa Corporates	4.40%	4.80%	4.40%	4.50%

Sources: Federal Reserve Bank of St. Louis Histories, RED Capital Research Forecasts.

upward pressure on cap rates at the margins but low Treasury and Baa-rated corporate bond yields will keep average RED 50 purchase yields near 5.0 percent. We calculate that asset prices will appreciate about 3.8 percent, generating total investment returns in the 5.0 percent to 5.5 percent range.

High-yield Midwest and growth markets (Nashville, Charlotte, Denver and Atlanta stand out) will generate the most attractive total returns. The primary markets will not disappoint, led by Boston, Seattle and Northern California. Total returns in Florida markets may lag to a degree but should be quite respectable. ■

Dan Hogan is RED Capital's research managing director. His published works can be found at redcapitalgroup.com/news-resources/market-overviews/. RED is a division of ORIX Real Estate Capital.

Learn more at www.redcapitalgroup.com



Credit Tenants and Recession-Proof Businesses Will Shape the NNN Lease Market in 2020

By **Max Freedman**

One of the biggest trends that developed in the net lease market in 2019 (particularly in the fourth quarter) was a buyer shift into “wealth preservation” mode. Simply put, investors are looking for quality NNN real estate investments that will continue to provide long-term income streams with less risk.

This shift is in response to the state of the economy, and with mounting uneasiness in the stock market, investors are craving certainty. As a result, many are diverting their investments into lower risk (long-term reward) investments like NNN properties, especially those with strong credit tenants in place that are backed by big brands (like McDonalds, CVS, etc.).

During a volatile stock market, you get investors looking for recession-proof business. In the NNN lease space, this translates to a strong demand for gas stations, auto repair, fast food chains and service businesses. This is not a convenience business, but a necessity business. In times of economic downturn, people will seek out cheap food, opt to fix their own cars and buy the lowest priced gas—so the NNN lease market is shifting in that direction as well, with investors heavily favoring these property types.

The buyer pool of NNN lease properties is also asking more questions during the buying and underwriting process, and the questions are good ones. As a result of working with a more informed buyer pool, the quality of the tenant is paramount. Likewise, we’re seeing longer sales cycles for non-credit tenant properties and franchises. A strong credit tenant is typically more trustworthy and has demonstrated experience in business success.

Heading into 2020 (despite record low cap rates and yields in 2019), the market is still going to be a seller’s market. Investors are informed and understand the long-term value of a NNN lease property with a credit tenant that can guarantee income through reliable monthly rent payment and inventory is hard to come by.

Because NNN properties are great for investors looking for a conservative, low-touch investment with consistent returns over a long period of time, many investors look to NNN properties as a strategy to build their portfolios without adding management-intensive investment, such as apartment complexes.

Since 2020 is an election year (and we’re moving into the new year with a fair amount of stock market volatility), we predict that investors will continue their flight to safety by plugging into real estate that comes with a quality tenant, which will provide income and equity opportunities over the lifetime of the lease. An investment that can

weather the storm, if a storm is to happen.

The best long-term NNN investment opportunities are often seen in properties with tenants operating recession-proof businesses, which are not quickly affected by economic dips and will still see regular returns despite the economic climate.



At Sands Investment Group, we’re seeing strong movement in NNN lease properties as the year comes to a close. Recession-proof business types like C-stores, gas and auto repair will continue to be strong volume sectors for investors in 2020. ■



Max Freedman is the managing director of SIG’s Austin office and heads the SIG Restaurant Group. He is a recognized industry leader focused on restaurant/C-store real estate, and a founding partner at SIG.

Sands Investment Group (SIG) is a commercial real estate brokerage firm that specializes in the buying and selling of net lease properties for private investors and institutions across the United States. Our industry knowledge, experience and vast network of buyers and investors are integral in our client-forward strategies.

Learn more at signnn.com.



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Partial Sale Leaseback: A Third Option for Real Estate Owner-Occupants

By **Jeff Tracy & Matt Wrobleski**

Owner-users of real estate regularly evaluate their space needs, and in doing so, they often look at options in absolutes. I can stay at my current location, or I can move to a new property. But there's a third option—the partial sale leaseback—that is often overlooked. Here, we explore the characteristics of all three options and look at an example that illustrates the benefits of a partial sale leaseback.

“Landlord” Option: One option allows for an owner-user to retain ownership of their property and lease the portion of the building not utilized. This “landlord” option requires the owner to spend capital to build out space for the new tenant and also assume the landlord role—a role that many business owners aren't equipped to take on or simply don't want to handle due to the distraction caused by landlord responsibilities.

“Dark” Option: The second option is to move to a new location and sell the current property as vacant. This “dark” option often produces the lowest sale value, since the property will likely require additional investment and won't cash flow for the new owner on day one. Additionally, a move is costly and may result in significant business disruption.

“Partial Sale Leaseback” Option: A partial sale leaseback allows a current owner-occupant to sell their real estate to an investor and, at the same time, execute a long-term lease for a portion of the space, allowing the new owner to lease the remaining space to additional tenants. The partial sale leaseback allows the current owner to maximize value above what a “dark” sale would provide, minimizes business interruption and distraction, saves on relocation expenses and even saves on remodel or refresh expenses as those may be funded by the new owner.

To illustrate, let's examine the Widget Company. It owns a 100,000-sq.-ft. class-A building in a desirable location that it previously used for their headquarters and production. After moving its manufacturing off-site, Widget Co. is left with 50,000 sq. ft. of excess production space. What should they do?

The “landlord” option for Widget Co. is not a good solution. Widget Co. would need to commit resources to finding a new tenant, and then invest significant dollars in tenant improvements to build out the vacant space for the new tenant. Further, Widget Co. must then assume the obligations that come with being a landlord, taking time

and money away from Widget Co.'s core business.

Under a “dark” sale scenario, Widget Co. would likely only receive a fraction of the proceeds that a partial sale leaseback would bring. And since Widget Co. still needs space in which to operate its business, it would need to spend capital to relocate operations to a new property. Not only is Widget Co. leaving money on the table during the



sale, but it now would need to spend additional dollars to meet its future space needs.

In Widget Co.'s situation, the partial sale leaseback is the best solution. Through this sale structure, proceeds are maximized as an investor will pay a higher price for a building with guaranteed income from a long-term lease as compared to a “dark” sale. Additionally, Widget Co. would have no moving expenses, nor would they have the distractions associated with a relocation or assuming the landlord role. Would a partial sale-leaseback be the right solution for your business? ■



Jeff Tracy is an associate and **Matt Wrobleski** is a director at Stan Johnson Company.

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Saving Structures, Buildings and Lives with Earthquake Protection

By **Quinlan**

The structural safety of the buildings we live and work in is not something that many of us think about.

In the event of an earthquake, how protected are you, your family and your belongings from the crippling damage that follows?

In California, current building codes only require collapse prevention under an assumed maximum considered earthquake. They do not protect against damage that may leave a property unrestorable and families without a home.

Seismic dampers were designed to prevent the destruction following an earthquake that current building codes do not provide and can allow any building to be occupied immediately after a major earthquake.

Space race technology saving lives on earth

Technology that started as engineering specialty dampers and shock absorbers for NASA and the Apollo missions in the 1960's, has seamlessly transitioned into seismic protection devices for structures around the world.

Whether protecting our astronauts in space or protecting structures here on Earth, these devices are designed, manufactured and tested with superior materials, technology and quality assurance.

Protecting your investment

Like shock absorbers on a car, seismic dampers absorb the energy generated by an earthquake. Instead of allowing the energy to enter the structure and cause damage, it is absorbed by the liquid inside the damper and removed as heat. This technology absorbs a large portion of the harmful energy and harmlessly takes it away, thereby protecting buildings, bridges and other structures from devastating damage.

With seismic dampers, building owners can rest assured that in the event of an earthquake, not only will their building remain standing, but they will also be able to reenter and resume business activities quickly. Although current building codes require that structures must be stable enough to avoid collapsing, buildings are often demolished after an earthquake because they are past the point of restoration. This can leave families without a home, employees without a job and vast amounts of assets lost to destruction.

Most insurance risk scenarios greatly underpredict the number of months, years, or even decades that are involved with the evaluation, demolition, insurance, redesign and reconstruction of a structure after an earthquake. Investing in seismic dampers for your structures is the smart way to



protect your investment, your structure and the people who rely on its' safety.

Over 750 projects worldwide

Taylor Devices has developed seismic dampers for many important structures around the world, including the Millennium Bridge in London, Port Mann Bridge in British Columbia, Buddhist Headquarters in Taipei, Taiwan and the San Bernardino Justice Center in California. These structures depend on seismic dampers to protect the people, assets and surrounding community from detrimental destruction.

In the 1990s, Taylor Devices outfitted the tallest building in Mexico City, Torre Mayor, with seismic dampers. In 2003, the city experienced a major earthquake, completely demolishing several buildings in the surrounding area. However, the people inside of the building equipped with seismic dampers were unaware that an earthquake had even occurred. The dampers absorbed all of the seismic energy, eliminating any vibrations that the earthquake produced.

This event demonstrates the importance that seismic dampers have in areas around the world that may experience an earthquake. While buildings and homes are destroyed, structures fitted with seismic dampers should remain safe and habitable, regardless of the damage surrounding them. ■

Quinlan is a digitally-driven, creative advertising agency out of Buffalo, NY.

Learn more at www.taylordevices.com/building-owner/.



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Protect Yourself. Protect Your Investment.

In the event of an earthquake, current building codes will only keep most of your building standing. Damages can still be severe enough to leave families without homes and employees without a job. Or worse, buildings could require demolition, leaving families to start over from nothing. With Taylor Devices' Seismic Dampers, people can reenter a building immediately following a major earthquake – saving homes, jobs, and lives.



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2020 CRE Perspective: Pick Your Spots Carefully

By **Dr. Will McIntosh** & **John Kirk**

USAA Real Estate's investment outlook has been relatively straightforward. In our view, the Fed pursued an unsustainable rate-hiking cycle over the last three years (2015-2018). Consequently, we anticipated a yield curve inversion would occur, the cost of capital would increase, core cap rates would trend higher gradually, and core values (which have hovered near record levels) would eventually soften as economic conditions began to slow. This scenario was generally on target, evidenced by diminishing core prices in some markets in 2018 and a yield curve inversion in early 2019 that reinforced the likelihood of an economic slowdown due to overly aggressive interest rate policy. By mid-year 2019, the Fed had somewhat swiftly reversed course regarding interest rates, and consequently, many investors were forced to reassess their outlook with a slower growth environment and lower interest rates in mind. We will continually refine our market perspective in the coming months as the impact of lower interest rates reveals itself, but the following issues are top of mind:

- **Downward Pressure on Cap Rates:** Core cap rates are already near record lows across every major real estate sector. Lower interest rates could lead to downward pressure on cap rates as well as a surge in institutional capital chasing yield in CRE markets. Consequently, cap rates will likely remain flat in the near term and possibly trend lower in a sustained low-interest-rate environment barring a slowdown in capital flows or deterioration in fundamentals.
- **Cross-Border Capital Increases:** Foreign investment in U.S. real estate has slowed dramatically since peaking in 2015, mainly due to higher hedging costs, as the interest rate differential between the U.S. and many other countries widened during the rate-hiking cycle over the last three years. With a lower interest rate environment and the possibility of a weaker dollar on the horizon, cross-border capital flows could increase substantially.
- **Favorable Borrowing Conditions:** Lower interest rates are generally intended to encourage borrowing and new investment. In a CRE market awash in lending capital, one might expect loan volumes to surge, supply levels to rise and property prices to increase. However, these attributes are already above their long-run averages, which begs the question—could a substantial increase in CRE capital flows begin to compromise the relatively disciplined underwriting that has come to define the current

cycle? We expect the answer to this question, and many others, to be revealed in 2020.

From an investment perspective, we are picking our spots carefully. The impact of lower interest rates seems destined to compound uncertainty in an already challeng-



ing investment environment. **Given this backdrop, we will continue our defensive, but active, investment stance in 2020, bolstering our existing portfolio and seizing opportunities as the market continues to evolve.** ■

Important Disclosures

These materials represent the opinions and recommendations of the author(s) and are subject to change without notice. USAA Real Estate, its affiliates and personnel may provide market commentary or advice that differs from the recommendations contained herein.



Dr. Will McIntosh is head of research and **John Kirk, CAIA, CCIM**, is senior director of research at USAA Real Estate.

Learn more at www.usrealco.com/research.



How Passive Real Estate Ownership is Propelling the 1031 Exchange Market to New Heights in 2020

By **Ryan Gunn**

1031 Exchanges are on the rise. Analysts project the market will reach \$3.25 billion in 2019, a 31.3 percent increase from 2018. All indicators are pointing toward a similar growth profile moving into 2020 when the market is expected to top its 2006 peak. This could be aided by increasing adoption of straight through processing technology and more sponsors, RIAs and broker-dealers, entering the market.

An underlying reason for this increase in demand for 1031 exchanges lies in the way many of them are structured, allowing investors to reap the benefits of their investments without having to put in much work.

The rise of Delaware Statutory Trusts

The current 1031 exchange market stands at the highest point since before the last recession. But the resurgence of 1031 exchanges looks a lot different today than it did at its height in 2006. Pre-recession exchanges were primarily Tenant-In-Common (TIC) structure. After TICs were recognized by the IRS in 2002, the co-ownership market swelled to over \$3.6 billion in the first five years.

TICs allow multiple investors to pool their funds together to invest in and manage a property. However, there are drawbacks, such as a requirement that major decisions achieve unanimous approval of the co-owners.

After the recession, the Delaware Statutory Trust (DST) structure overtook TICs as the most popular form of 1031 exchange. Unlike a TIC, DSTs are comprised of passive co-owners, who buy into a trust, leaving the management of a property to a professional real estate sponsor.

Factors driving 1031 exchange growth

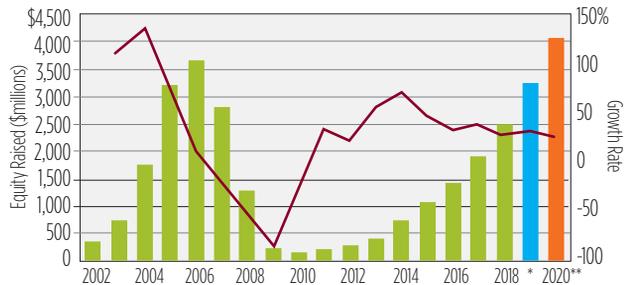
Passive ownership allows investors to avoid the Terrible T's of owning real estate—toilets, tenants and trash—microcosms of the endless maintenance required when managing a property. In a DST, individual investors are relieved from the responsibility of management. This is particularly attractive to aging investors who may be looking for more hands-off investing as they reach retirement age.

Currently, baby boomers are driving DST interest. Those that have owned and managed real estate investments of their own are seeking to diversify their portfolio, upgrade to more expensive properties, and get out of day-to-day management of their investments, all while deferring tax gains from the sale of those properties. And with

millennials expressing increasing interest in an investing trend called FIRE (Financially Independent, Retire Early), passive investments like DSTs should continue to garner demand for generations to come.

Even subscribing to DST investments can be relatively hands-off. While historically, nearly all DST investments have been made via an arduous manual process that can take three weeks or more, new straight through processing

1031 Market Growth



*2019 projection from Mountain Dell Consulting, Market Report Securitized 1031 Industry as of Q3 2019.
 **2020 projection from WealthForge, averaging the changes in growth rate from 2015-2019 and applying to 2019 growth rate and equity projections.
 Sources: 2002 - 2018 data from Mountain Dell Consulting, Market Report Securitized 1031 Industry 2018 (Year End).

technology tools have automated subscriptions, bringing cycle time down to one week or less and opening to the door for further adoption as the process becomes easier for both advisors and investors. With much of the market still relying on outdated manual processes, there is enormous potential for tech-enabled growth. ■

Investors should keep in mind that, DSTs are subject to substantial risks, including illiquidity, vacancies, general economic conditions, competition, potential adverse tax consequences, and the potential loss of invested capital. Diversification does not guarantee profits or protect against losses.



Ryan Gunn leads content creation at WealthForge, and his writings on fintech, alternative investments, and advisory best practices have been featured in Real Assets Advisor, Alternative Investments Quarterly, Equities, and other industry publications.

Learn more at www.wealthforge.com.

WEALTHFORGE

Residential Real Estate Investment/Development Trends (2019 into 2020)

By **Scott A. Meitus**

In our bi-annual report, the *2019 Residential Development Trends*, we examined 39 major metropolitan statistical areas (MSAs) and evaluated them according to their current (2019) and future (2020) climate for residential development and investment. It should be noted that in this analysis, we included most of the major MSAs in the country, however, a few of the largest areas were excluded, as my current client base is not active in these metros. These include Philadelphia, Baltimore and Detroit among several others.

In terms of methodology, we examined the relationship between past and expected employment growth and residential housing starts (as evidenced by building permits). As employment growth is perhaps the most significant contributor to new residential housing demand, examining the relationship between job additions (or losses) and the production of new housing provides insight into possible oversupply or undersupply conditions. Specifically, in an area in which job additions are significantly outpacing housing additions, we typically find undersupply. Conversely, in situations in which housing additions are exceeding job increases, we typically find oversupply. While there are certainly other factors affecting housing supply/demand balances, we have found that this ratio is as effective as any in its predictive capabilities.

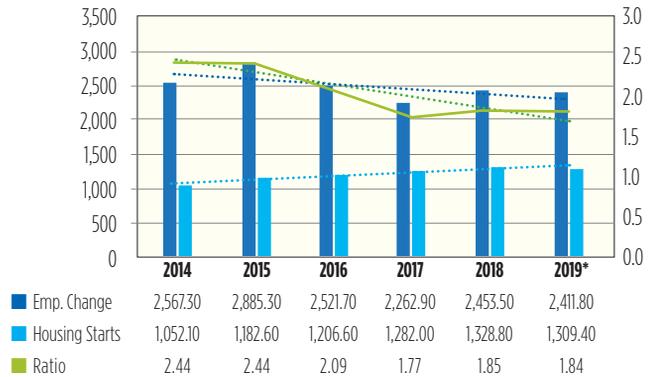
For the United States as a whole, slowing employment growth for the remainder of 2019 and into 2020, coupled with a continuation of the relatively high levels of housing construction seen over the past five or six years will begin to have a generally negative impact on housing supply/demand balances. Of course, all MSAs are unique, and some will continue to thrive, while others may be entering into some choppy waters.

Of the 39 MSAs examined, we find that only three warrant a grade of “A”, or “Excellent”. Conversely, 19 MSAs carried a grade of “C”, or “Average”, with three areas carrying a grade of “D”, “Negative”.

Our highest rated area is Houston, driven largely by the expected creation of 81,900 new jobs in 2019, coupled with housing additions, that while increasing, are not keeping up with employment growth. The rest of the Top 10 offers a few surprises, and in order, includes Memphis, Tenn., Orlando, Fla., Cincinnati, Las Vegas, Chicago, St. Louis, Oklahoma City, Boise, Idaho and Seattle. All of these MSAs carry grades of B+ or higher.

Conversely, our three lowest rated include a few surprises as well. At number 37 we have Jacksonville, Fla., at number 38 (And this pains me as I attended college there for four years, and lived there for 15) we have Madison, Wisc., and our lowest rated metro area is Minneapolis/St. Paul, Minn., as stagnant job growth in 2019 coupled with increased housing development will push supply/demand limits, especially in the multifamily sector.

United States Employment/Housing Start Ratios (in thousands)
2014 - 2019*



The remainder of the bottom 10 (in reverse order), includes, San Antonio, Indianapolis, Tampa/St. Petersburg, Fla., Raleigh, N.C., Austin, Texas, Denver and Boston.

The “middle of the pack” includes, in order, San Francisco, Phoenix, Washington DC, San Diego, Milwaukee, Dallas, New York City, Atlanta, Columbus, Ohio, Kansas City, Sacramento, Calif., Louisville, Ky., Los Angeles, Salt Lake City, Nashville, Tenn., Miami, Charlotte, N.C., Charleston S.C., and Portland, Ore.

The chart shows the relationship between employment and housing starts for the United States. ■

Scott A. Meitus is managing partner at The Windward Group, providing critical investment and market analysis services to real estate investors, developers and municipalities. Learn more at www.windwardinvest.com.



Diversification—A Critical Tactic for Growing Net Lease Portfolios

By **Gino Sabatini**

According to CBRE, net lease investment in the U.S. grew from less than \$12 billion in 2009 to nearly \$70 billion in 2018, with continued strength through the first half of 2019. Corporate property owners have become more familiar with this form of financing. In addition, investors are increasingly attracted to net lease as a long-term investment that can deliver stable, recurring cashflows.

A significant portion of net lease capital comes from REITs, many of which focus on specific property types. However, as the space has grown, net lease investment vehicles, both private funds and public and private REITs, are increasingly seeing the value of diversity. The net lease approach offers the opportunity to invest in multiple property types and geographies while applying a consistent criteria to mitigate risk and secure steady cashflows and steady returns.

The expanding net lease market

Traditionally, net lease REIT portfolios have comprised properties such as corporate headquarters, retail or industrial facilities located in the US and leased to credit rated companies with strong balance sheets. However, with the expansion of net lease in Europe and record-level dry powder fueling global M&A activity, the net lease landscape has continued to widen. Non-traditional net lease properties like healthcare clinics are now being consolidated by large corporations or private equity firms. With increasing scale and creditworthiness, these entities—and their critical real estate—have opened new avenues for growing net lease portfolios.

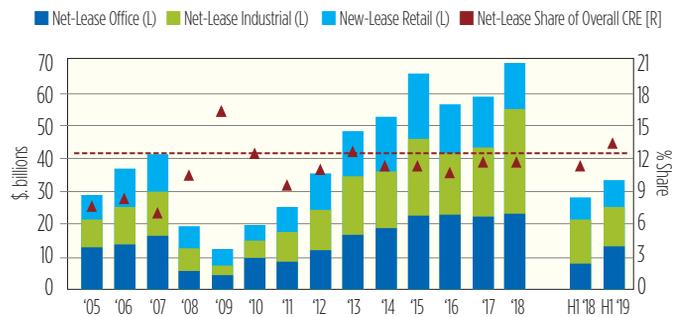
Self-storage is another example of a non-traditional net lease asset class offering an additional source of investment opportunity. W. P. Carey, a diversified net lease REIT, has been investing in self-storage for more than 15 years, having completed its first transaction in the sector in 2004 with a \$312 million sale-leaseback of 78 U-Haul facilities. More recently, the publicly traded REIT converted 36 of its self-storage operating properties into long-term triple-net leases with Extra Space Storage.

Consistent with its evolution to a pure-play net lease REIT, the innovative restructuring enabled W. P. Carey to maintain growing income from an asset class it knows well, while minimizing its exposure to capital expenditures. Currently, both U-Haul and Extra Space Storage rank

among W. P. Carey’s top 10 tenants by annualized base rent, underscoring the long-term value and portfolio growth that can stem from a diversified investment strategy that provides the flexibility to invest in these types of non-traditional asset types.

Diversification as a critical growth strategy

An analyst from a major financial institution recently pointed out the defensive strength of the net lease model and also



Source: CBRE Research, Real Capital Analytics, Q2 2019.
Note: Single-tenant asset acquisitions used as a proxy for net-lease asset sales.

emphasized that, to continue to attract investors, net lease REITs must grow their asset bases and cashflows. A diversified investment strategy combined with a strong balance sheet that provides access to low-cost capital can secure real estate acquisitions at attractive spreads across an increasing variety of net lease asset types. Extending this strategy to different geographies and property types can provide an even wider pool of growth opportunities, and in conjunction with established risk mitigation criteria, will support the steady cashflow and growth required for continued success of net lease REITs over the long term. ■



Gino Sabatini is head of investments at W. P. Carey Inc., one of the largest diversified net lease REITs. W. P. Carey is a long-term real estate investor with a diverse net lease portfolio, spanning a range of property types, geographies and tenant industries. Learn more at www.wpcarey.com.



Multifamily Success Prompts Calls for Rent Control

By **Paul Fiorilla**

Multifamily sector performance has been stellar since the early stages of this economic cycle, but its success has led to political pressure for laws to put a lid on rent growth. The average U.S. apartment rent has risen by 32 percent since January 2012, according to Yardi Matrix, well above inflation and income growth.

The number of rent-burdened households is rising. More than 20 million renter households pay more than 30 percent of income on housing, and fully 80 percent of renters and 63 percent of owners making less than \$30,000 are cost burdened, according to the Joint Center for Housing Studies at Harvard University.

As the situation worsens, it creates political pressure to act. Over the past year, legislators in three states—Oregon, New York and California—have passed rent control measures and more than a dozen other states are considering legislation to limit rent growth.

Three states enact laws in 2019

Oregon's rent control law is the least onerous, allowing landlords to increase rents by 7 percent plus the cost of inflation. The law only applies to properties that are 15 years or older. California's rent control law sets rent caps at 5 percent plus the cost of inflation. The law applies to properties that are 15 year or older, although the age limit rolls so each year it applies to more properties that reach 15 years in operation. In addition to caps on rent increases, California also made it more difficult to evict tenants that are in an apartment for a year.

New York's law is much more punitive and has thrown the New York City apartment market into turmoil. The worst parts are the limits on Major Capital Improvements (MCI) and Individual Apartment Improvements (IAI).

Unit Deregulation: Owners formerly had the ability to raise rents by 20 percent when stabilized units were vacated, and they were able to deregulate units when rents reached \$2,775 and/or the tenants had an income of \$200,000 per year for at least two years. Now increases are limited to a percent set by a New York city rent board that is indexed to inflation.

MCI, IAI: Owners formerly could increase rents in conjunction with capital improvements to properties. Now, however, landlords can only get rent increases on \$15,000 of improvements over a 15-year period.

If landlords can't recoup capital spent on improvements, they either won't make the improvements or will do it with lesser quality materials. It's also critical given that the law applies to older buildings that by definition are the most in need of fixing.

All these scenarios lead to the reduction of the type of stock affordable to middle-income households that legislators are trying to increase. The way the New York law is



designed it almost guarantees that the net income of stabilized properties will decline on an annual basis. Owners face a situation in which expenses—utilities, wages, property taxes, capital improvements—almost certainly will rise more than the 1 to 2 percent annual rent increases.

Needed: Smart housing policy

Legislatures need to address the affordable housing crisis, but the best solution involves making it easier to build units that low- and middle-class households can afford. That means reducing exclusionary zoning, allowing more density, reducing red tape and fees that reduce development and subsidizing developments. The solution will take commitment and cooperation from builders, municipalities and other stakeholders. ■

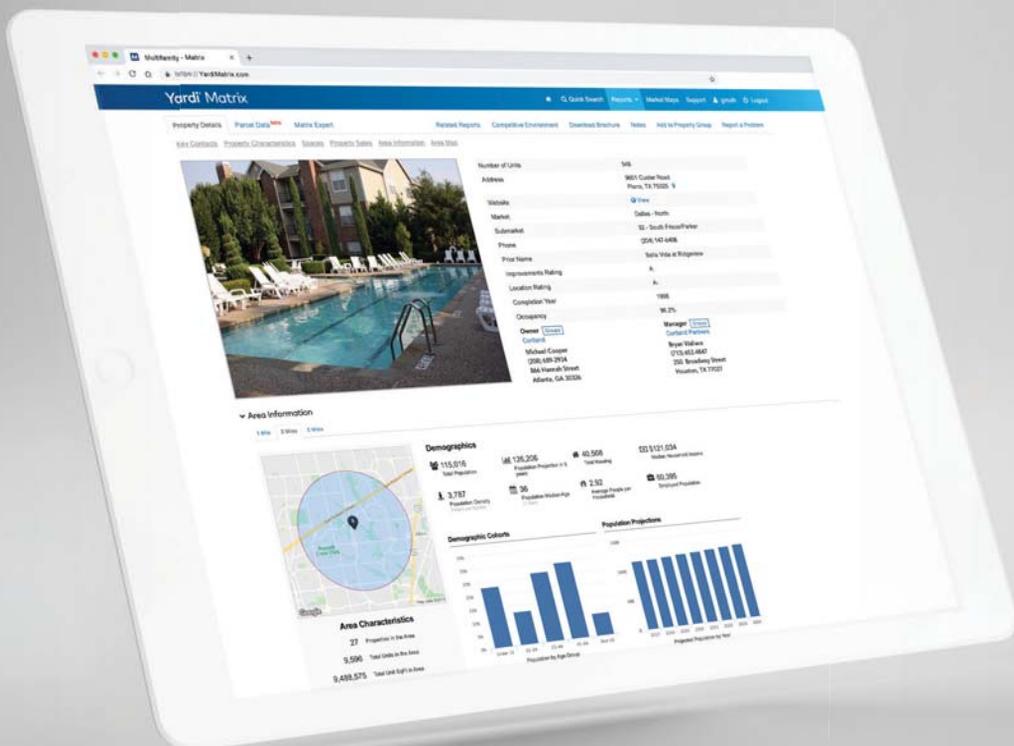
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