CYCLICAL EVOLUTION AND STRUCTURAL REVOLUTION

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It is often said that the only constant is change, a sentiment that seems more relevant than ever as the maturing and extended cycle intersects with increasingly disruptive forces. Recent technological advances have taken hold fast and have had far-reaching consequences, altering entire industries as they proliferate and creating new ones along the way. Technology changes and slower-moving but powerful secular shifts in demographics and human behaviour are driving the growth of "new economy" sectors, altering the way people live, work and shop, and directly transforming the demand for real estate.

Disruption and change create opportunity for real estate investors, which can recognize and capitalize on both cyclical turning points and structural trends that are expected to persist through cycles. An active and creative approach to asset and portfolio management can further enhance opportunities to maximize risk-adjusted returns.

Heading into 2018, investors appear more cautious and selective in acquisitions and more focused on portfolio positioning as cyclical and geopolitical concerns draw attention to downside risk. The extended expansion continues to support improvement in real estate fundamentals and present investors with an evolving set of opportunities, driven by shifting growth dynamics within countries and within cities. Success at this stage of the cycle requires thinking beyond the impact of shorter-term cyclical factors to secular and structural trends that will drive long-term performance.

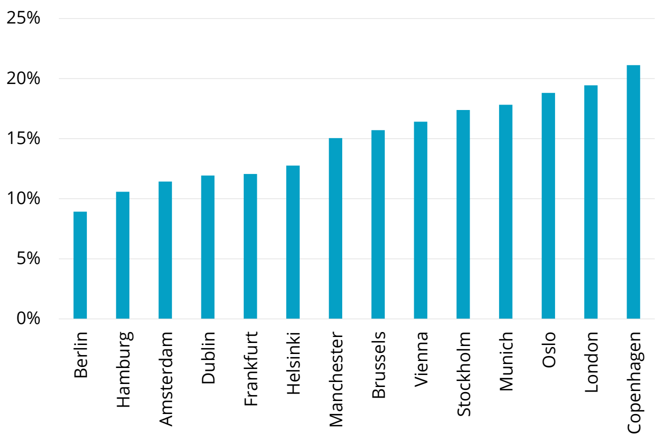
THE RESURGING ROLE OF CITIES AND CHANGING GROWTH DYNAMICS

Technology accelerations and demographic shifts have changed the power dynamic between cities globally. In the US and many industrialized Western economies, populism and political gridlock at the national level have highlighted the growing importance of cities as the engines of growth, competing to attract knowledge-based industries. In the most recent high-profile example, Amazon's very public proposal for its second US headquarters sparked a race among 238 applicants (mostly cities) to "beautify" themselves and stand out from the crowd.

To capitalize on these dynamics, real estate investors must stay attuned to the changing behaviours and preferences of an educated and discerning workforce. For instance, the fast-evolving "asset light" or "sharing" economy magnifies the importance of efficient public transportation accessible to attractively located, amenitized and affordable multi-family housing within urban environments. To succeed, cities need to facilitate the clustering of creative, innovative talent, which in turn attracts and rewards real estate investors aware of these trends and opportunities.

The increased importance of cities suggests national demand drivers are becoming less meaningful for local investment decisions. For example, population trends, which may suggest a dire picture for "old economy" regions like the US rust belt and some European countries, actually mask underlying local dynamism in many cities that are adapting to the new economy. Fig. 1 illustrates this dynamic in Europe, showing strong projected population growth over the next 15 years in a range of cities, despite an expected decline in overall population. In the US, Chicago is an interesting example, in that relatively weak top-line trends mask a diverse array of favourable urban core submarkets and assets.

Fig. 1: Population Growth: Cities Matter More than Nations (Projected Growth Rate, 2017-2032)



Source: Barings, Oxford Economics (October 2017)

Fig. 2: City Innovation Rankings: A Global Perspective

Global Rank	Metro/City
1	London
2	New York
3-5	Tokyo; San Francisco - San Jose; Boston
6	Los Angeles
7-9	Singapore; Toronto; Paris
10-15	Vienna; Seoul; Amsterdam; Barcelona; Sydney; Munich
16,17	Dallas-Fort Worth; Berlin
18-21	Atlanta; Montreal; Chicago; Seattle
22-27	Houston; Madrid; Vancouver; Melbourne; Miami; Washington DC
28-34	Milan; Beijing; Stockholm; Shanghai; Copenhagen; Philadelphia

Source: 2thinknow Innovation Cities™ Index 2016-2017 www.innovation-cities.com

Cities shown in groups on a single line all received the same innovation index score. Top 50 global cities also include Hong Kong, San Diego, Stuttgart, Oslo, Hamburg, Frankfurt, Denver, Lyon (France), Manchester (UK), Helsinki, Austin, Portland and Dublin (Ireland).

Global Gateway cities such as Tokyo, London and New York have historically provided productive benefits through both size (economies of scale) and density/proximity (agglomeration economies derived from both industry-specific and broader labour market dynamics). These three cities have demonstrated resilience and reinvention over time and through many economic periods. As illustrated in Fig. 2, London and New York top the 2016-2017 Innovation Cities Index global rankings. Tokyo is on par with Silicon Valley and Boston, two knowledge-based economies where industry, university and government support have fostered venture capital funding of technology, life science and clean-energy innovations that have in turn attracted highly educated workforces.

While global investors are often focused on the relatively small subset of Global Gateway cities, there is an expanding list of "non-Gateway" cities. These cities rank well innovation-wise and are also increasingly attractive to millennials, professional couples and growing families for both access to jobs and "lifestyle" considerations. Gateway metros have become increasingly expensive, pushing people and firms to alternative locations. The desire for creative talent to "densify" in urban locations is driving vibrant real estate markets in many cities, resulting in a broad spectrum of new developments and adaptive re-use/refurbishment initiatives.

Cities in this category well positioned to succeed in the new economy include Dallas, Austin, Atlanta, Charlotte, Raleigh, Denver, Seattle and Portland in the US and Munich, Berlin (the European tech hub rival to a much more expensive London), Manchester, Amsterdam, Barcelona, Copenhagen and Stockholm in Europe. Having a strong regional government, public-private partnership and a long-term view are essential to success for cities in this category. Denver in the US and Manchester in the UK are two examples. Denver's success in developing an integrated regional transit system that connects the airport and an expanding array of suburbs to the urban core is reshaping the downtown and the suburbs around train stations. In Manchester, the mayor sets local policy but also serves as an ambassador and figurehead for the city.

HOW CAN INVESTORS CAPITALIZE ON THESE EVOLVING TRENDS?

The structural shifts underway in cities across the globe are not taking place in a vacuum. The economic cycle continues to mature and investors must navigate how structural and cyclical trends may intersect in the years ahead. With the ability to increase value by taking advantage of broad-based macro drivers more limited going forward, return generation requires a shift toward more micro, locational and property-level considerations that can benefit from these structural tailwinds over the long term.

There are three areas where forward-thinking real estate managers can add value for investors:

1. **Asset selection:** value creation in a maturing expansion places increased focus on transaction selection by investment theme, submarket and asset. On the thematic side, assets supported by technological and demographic shifts are most likely to perform well even in the face of cyclical pressures. But uncovering the right submarkets and assets within them relies upon a deep understanding of local market dynamics.
2. **Thinking beyond the traditional definition of real estate:** increasingly, managers will need to look beyond the traditional four real estate sectors (office, retail, industrial, apartments). The lines are blurring between infrastructure and real estate, offering potentially attractive opportunities that may have previously been outside the scope of traditional real estate. Similarly, real estate investments are expanding beyond properties to include related operating companies in areas like self-storage and senior living.
3. **Taking a creative, active approach to portfolio construction and asset management:** optimizing the real estate portfolio for success in the current environment places increased emphasis on asset-level execution and portfolio construction. While this can be done in a number of traditional ways, the key to success today, in our view, is a solid understanding of, and ability to serve, the evolving needs of tenants as they relate to locational, space configuration and lease structure decisions.

THE TAKEAWAY

As investors consider their approach to real estate markets in 2018 and beyond, the massive structural changes taking place in technology and demographics cannot be ignored. While cyclical tailwinds may turn to headwinds in the years ahead, investing in assets and submarkets that benefit from these underlying structural trends will likely pay dividends going forward.

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