Executive Summary

With the year drawing to a close, we turn our attention to the outlook and identify the major occupier and investment trends that we expect to influence market conditions and investment performance in 2020 and beyond.

In the Americas, we identify four region-specific trends that reflect opportunities to benefit from diversification by strategy and geography.

1. **Office Demand to Slow as Key Drivers Moderate**: Office absorption is facing headwinds from the slowing pace of employment growth and uncertainty about flexible office demand.

2. **Office Tenant Expectations Continue to Rise**: Spending on tenant and building improvements is rising sharply as owners adapt to changing tenant requirements.

3. **Rising Debt Availability Across the Risk Spectrum**: Debt origination volume continues to rise, while debt funds are raising competition and pushing traditional lenders up the risk curve.

4. **Increasing Regulatory Burdens for Apartment Owners**: Regulation is increasing in response to societal need for affordable housing, impacting the pass-through from rental to income growth.

These region-specific trends, alongside our four key global trends, are set to have a significant aggregate impact:

1. **More Employment Growth to Come**: The current cycle continues to be driven by employment rather than productivity, while the stable outlook for global GDP growth points to another year of steady real estate returns.

2. **Low Supply Environment Persists**: The ongoing low supply environment continues to support prospects for rental growth, enhanced by a strong link with employment growth in the current cycle.

3. **Further Scope for Yield Compression**: Past interest rate increases have been weighing on real estate pricing, but the shift toward looser monetary policy paves the way for further yield compression in 2020.

4. **Cross-Border Flows Weakening**: Cross-border investment flows are weakening in the Americas and Europe, reflecting a wider slowdown in trade liberalization. Asia Pacific is bucking the trend.

In this excerpt we review the Americas trends in detail.

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AMERICAS

In the United States, employment growth is still feeding through into office demand but its impact is being dampened by rising density, while there are concerns about the outlook for flexible office providers which have been a key source of demand.

As in other parts of the world, supply is relatively modest in most sectors this cycle, supporting rental growth prospects, although landlords are having to work harder — and spend more in capex — to attract tenants in a fast-changing marketplace. In the apartment sector, a rising regulatory burden poses a threat to an otherwise favorable outlook.

Reflecting the global trend, pricing is set to be supported by low interest rates, and debt availability is rising. With capital still looking to get into the market and competition among debt providers rising, transaction volume should stay resilient in 2020.

Americas Trend 1: Office Demand to Slow as Key Drivers Moderate

Office absorption is facing headwinds from the slowing pace of employment growth and uncertainty about flexible office demand.

One notable feature of the current office market cycle has been the relatively modest pace in office demand growth given the prolonged, steady gains in office employment (see exhibit AM1).

A variety of factors have been responsible. Initially, there was an overhang of under-occupied space coming out of the last recession that weighed on the pace of absorption. In addition, many occupiers are consolidating rather than expanding and, reflecting the global pattern, shifting tenant preferences are favoring higher density occupancy. These include the adoption of open-plan workspaces and a preference among workers to locate in denser CBD locations that offer better amenities.

Exhibit AM1: Office Demand and Flexible Office Share of Absorption

Office-using employment growth forecasts point to slower demand growth in 2020…

…while the boost from flex office demand seen in recent years is expected to moderate

Sources: Costar, Oxford Economics, CBRE, ISI, PGIM Real Estate. As of December 2019.
In the past few years, the emergence of flexible office providers has provided a boost to office demand. Often referred to as coworking, these tenants, along with technology firms, have been one of the few net sources of new office demand. Flexible office leasing has accounted for more than 40% of net absorption since 2016, and the sector's share of U.S. office occupancy has doubled.

Looking ahead to 2020, there are signs that office demand is set to ease. While employment growth remains positive, its pace is expected to slow as historically tight labor markets mean a decreasing pool of available workers — especially for office-using jobs.

At the same time, the durability of flexible office demand is now in question, owing to concerns about several high-profile coworking operators. A pause or retrenchment in space demand among major players in the sector would exacerbate the slowdown in absorption linked to employment growth.

The moderate picture at the national level masks some differences among markets. Those office markets with the strongest demographic and migration trends, including Sunbelt metro areas such as Dallas, Raleigh, Charlotte, and Atlanta, are likely to see the strongest rates of net absorption going forward.

**Americas Trend 2: Office Tenant Expectations Continue to Rise**

Spending on tenant and building improvements is rising sharply as owners adapt to changing tenant requirements.

Office buildings have always been the most capital-intensive of the major property types, but U.S. owners are spending even more to meet the rising expectations of tenants.

Requirements for higher quality amenities — such as full-service cafeterias, fitness facilities and employee lounges — newer technologies, and non-traditional space configurations are forcing owners to upgrade space to compete for tenants.

According to the NCREIF Property Index, spending on both tenant and building improvements in office properties has risen sharply in recent years (see exhibit AM2) as landlords seek to upgrade properties to accommodate the changing needs of office users.
Landlords spending increasingly more to renovate office space and meet rising tenant demands…

This trend is set to continue, not least as office space is viewed as an important factor in talent recruitment. Linked to this, many occupiers continue to shift toward non-traditional office formats. In a recent CBRE survey, only 26% of occupiers expected to have a “traditional” office layout in 2020, down from 50% in 2018. For owners, converting from a traditional layout often requires capital-intensive space reconfigurations.

Landlords are also increasing investment in technology to meet tenant expectations. A recent Deloitte survey of private real estate managers and investors found that 73% of respondents anticipated increasing their spending on tenant experience-related technologies in 2020.

The upgrading trend is particularly prevalent in downtown office markets, with landlords spending a much higher percentage of NOI on improvements and upgrades than in suburban areas. New supply, which is higher in CBD areas, is playing a role, ensuring competition among owners of new and existing space to provide modern workplaces.

Américas Trend 3: Rising Debt Competition Across the Risk Spectrum

Debt origination volume continues to rise, while debt funds are raising competition and pushing traditional lenders up the risk curve.

In the commercial real estate debt space, there is no sign of a slowdown in the volume of new loan originations. Debt originations secured by commercial and multifamily properties have increased each year since 2016 and are estimated to reach $652 billion by year-end 2019 (see exhibit AM3).

Several factors suggest a further increase in loan origination volume in 2020. Low interest rates are supporting new originations, with real estate owners either choosing to refinance debt on existing properties, finance the purchase of new properties, or fund new construction.
In addition, strong fundraising among private debt funds is both an indicator of capital available for originations, and of sentiment toward lending in the wider market. Based on debt fundraising recorded in 2019, which points to an acceleration in lending activity next year, and trends in lending data from the Mortgage Bankers Association, origination volume is projected to increase to $700 billion in 2020.

Private debt funds are set to remain competitive, particularly in the value-add and construction lending space in which their share of the overall lending market is increasing.

An increasingly crowded lender universe is set to put further pressure on lenders to accept lower returns for increased risk. During the course of 2019, traditional lenders have begun to move up the risk curve — for example by accepting higher loan-to-value (LTV) ratios as shown in the distribution plot in exhibit AM3 — to win deals, a pattern that is expected to continue in 2020 owing to the volume of capital available for lending.

**Americas Trend 4: Increasing Regulatory Burdens for Apartment Owners**

Regulation is increasing in response to societal need for affordable housing, impacting the pass-through from rental to income growth.

After a decade of rising apartment demand and rental growth that has outpaced income gains in many cities, rental housing affordability has become a more prominent political topic at both the national and local levels. While the challenge of providing affordable housing is recognized by state and local governments, the proposed solutions are nowhere close to uniform.

The challenge of providing affordable housing — defined as homes for which the occupants are paying no more than 30% of their income for gross housing costs, including utilities¹ — is not new.

¹ U.S. Department of Housing and Urban Development.
Over the past three decades, a growing number of cities have adopted “inclusionary zoning” policies, which either provide incentives for or require new developments to keep a portion of units affordable to moderate- or low-income residents, sometimes coupled with tax abatements to offset lower property incomes. Between 2000 and 2010, for example, 115 new inclusionary zoning laws were adopted in the United States, and the number of new ordinances adopted this decade is on track to match that.

Yet even after the adoption of inclusionary zoning policies over the past three decades, rental housing affordability is, on average, declining in the United States. The share of renters paying more than 30% of their incomes on rental housing costs is 49% at the national level, and above 50% in 11 large metro areas.

In response to declining affordability, some state and local governments have enacted or strengthened rent control legislation (see map in exhibit AM4). Rent control goes beyond other incentives to provide affordable housing by restricting rent increases in some or most existing units. In New York, existing regulations were tightened in mid-2019, with smaller permitted rent increases and limits on permitted pass-throughs of capital improvement expenses. In addition, new statewide rent control laws have recently been adopted in two states, Oregon and California.

A look at the map suggests that rent control legislation should remain the exception rather than the rule in the United States. There are still 36 states that have no statewide rent control and laws that preempt local jurisdictions from adopting their own ordinances.

However, Oregon and California were in that group of states until recently, when their legislatures changed course. These changes were preceded by periods where rental growth substantially outpaced income growth in their major cities.

Looking ahead, some cities with no rent control, such as Denver and Seattle, have experienced substantially faster rent than income growth over the past five years, which merits close monitoring for the introduction of new laws. The prospect of more states adopting or allowing new ordinances, raises the risk for investments in the apartment sector.
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