Grant Thornton

Real Estate

The future of growth and the real estate industry

Great opportunities require strong foundations

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Introduction

The real estate sector is still experiencing uncertainty and serious risk. For example, it is unclear how and when regulatory, tax or trade policy reforms might happen, or what the timing of interest rate hikes might be. There is still political uncertainty at home and abroad. Additionally, as always, technology delivers tremendous benefits, but also related risks.

Yet, despite this uncertainty, confidence has returned to the real estate sector. In this positive environment, real estate companies can prepare for the future by establishing a clear view of the steps they can take to create and protect value. The industry shows strong funding and access to capital, and has welcomed an increased interest from international companies and foreign investors looking for opportunities in the U.S. market. Also, large, private U.S. companies have expanded their range of investments to Europe.

Greg Ross, Grant Thornton's Construction, Real Estate, Hospitality and Restaurants partner and sector leader, notes: "Funding and access to capital is healthy, and global real estate investors who are looking for a safe haven are bringing new opportunities to the U.S. The sector is becoming more proactive in exploring technology-enabled approaches to improving their operations, managing their buildings and getting closer to their customers. And there is optimism that relaxed federal regulations and helpful tax reform are on the horizon."

A new reality for real estate

The profile of the real estate investor is changing

Real estate investors today are increasingly global, sophisticated and interested in a quicker return on investment (ROI). Foreign investors, including sovereign wealth funds and non-U.S. pension funds, are finding a safe harbor in real estate investments in the U.S. because they are wary of risks in developing markets and unsure what to expect in the midst of Brexit and political volatility in Europe.

There is growing interest from private equity funds and real estate investment trusts (REITs), which comprise investors with an expectation that technology is — or will be — leveraged for maximum ROI.

Yet, opportunity and optimism go hand in hand with risk, calling for real estate organizations to evaluate where they are on the risk (and opportunity) curve. What happens, if due to accelerating urbanization, the global market switches its focus to emerging markets? And will the influx of investments be allocated with consistency, or will this increasingly global industry exacerbate the cycles of boom and bust that define the industry?

As investors weigh risk and return, the U.S. market remains an attractive alternative that offers a reasonable rate of return and an environment that encourages business development.

U.S. market prospects: Improved opportunities for industrial real estate

Global trade and the massive growth of e-commerce are revitalizing interest in industrial real estate. Spaces close to population centers that support faster delivery of online orders are particularly attractive. As long as e-commerce and global trade continue unabated, industrial real estate will continue to be a lucrative investment; however, a change to trade policies could have an impact if it leads to declining imports.

Third-party logistics companies, or "3PLs," are racing to retrofit existing spaces to open new warehouses and distribution centers that allow them to claim the mantle of serving the last mile of delivery — yet another driver for industrial real estate investment.

Adapting to a culture of change

It's time for change. The tradition-bound culture of real estate is becoming more flexible, adaptive and technology-savvy. Organizations must drive innovation and partner with technology experts — including providers of cloud and data analytics — to create smart building infrastructures and connected systems to manage their properties better.

Boosting ROI means managing properties effectively, efficiently and with greater insights into how to improve value. Today's leading real estate companies are driving better returns through technology that improves their buildings' energy use and captures valuable data such as foot traffic. For instance, sophisticated analytics allow organizations to draw insight from the information about the performance of their buildings. Based on this data, organizations can optimize the use of space in their building portfolios. These data-driven insights can cement the relationship with tenants and support the case for higher rents.

A market prime for disruption

The real estate market is opaque and fragmented. Transactions are costly, with multiple intermediaries — brokers, title companies, escrow companies, inspectors, appraisers and notaries. In short, it is an industry that is ready for disruption from technology.

The time-stamped, distributed, ledger technology in blockchain, for example, could radically alter the speed, transparency, data accuracy and cost of real estate transactions. The technology's smart contract feature could make it possible for a transaction to be executed automatically once certain agreed-upon criteria have been met. To be ahead of the curve, real estate players will embrace the way in which blockchain can transform how they do business. They will need to learn the capabilities and skills required to take advantage of technology's full capabilities and familiarize themselves with the risks they will need to manage for their properties.

Building the future, today

Optimize the mix of capital

Most major cities have family dynasties that have long dominated regional real estate development. But the image of the real estate industry as primarily dominated by a few families is being transformed. The industry now includes buyers in private equity funds that have capital to invest and expand their real estate holdings. As a result, private equity is playing an ever-larger role, and many traditional real estate companies are beginning to look more like private equity firms as they acquire other companies and expand their asset classes.

As the profile of the real estate owner shifts, new owners are more technologically savvy and creative on deal structure. While the family dynasties take the long view, the new investor may not have the patience to hold on to assets in the same way. What implications will a more aggressive approach to ROI have on a market that has relied for generations on a more cautious, long-term view of investment?

Real estate dynasties: A question of control

Alvin Wade, Grant Thornton's Construction, Real Estate, Hospitality and Restaurants national managing partner, notes that owners of family-owned real estate companies are seeking a new path forward, regarding how they manage their properties.

"Family dynasties face typical family disputes: e.g., uninterested heirs and clashes in strategy. The worst-case scenario is a dynasty that is slow to relinquish control while the business is at risk from conflict between family members," Wade says. "But while some families see the answer in selling their real estate, others are increasingly open to bringing in outside talent to manage their business and remove some of the complexities of decision-making, in exchange for an equity interest in their portfolios."

Assess opportunities and risks of new technology

The future of real estate companies is intertwined with technological advances. In particular, data will determine how to manage key priorities — from how real estate companies handle their portfolios to predicting tenant demand.

But this sort of sophisticated analytics is impossible if complex legacy systems and siloed data stand in the way. Leading real estate companies undertake due diligence to assess and select best-of-breed IT solutions that are aligned to their strategy and growth goals, and that enable them to extract insight from their data.

As buildings become more connected through devices like security system monitors and internet-connected thermostats, cybersecurity becomes a key element of a firm's risk control environment. Additionally, any sensitive information stored in the cloud or handled by third-party contractors must be equally secured.

Managing the cloud

Cloud computing offers real estate companies the opportunity to optimize productivity and efficiency, but it also implies that they will lose control of some of their critical data.

This will force organizations to put in place a stringent set of standardized criteria for their evaluation of vendors, including vendor viability, technology functionality, security measures, and contractual and support needs. Service organization control reports will help to drive uniform selection standards.

Finally, real estate companies need to manage vendor relationships post-sale — and make changes if their goals are not being achieved. As part of the master service agreement, for instance, suppliers and partners must confirm their compliance with IT security regulations.

Build stronger balance sheets

Real estate leaders focus on managing assets and liabilities better to strengthen their balance sheets. They take a strategic approach to managing capital planning by linking it to their overall business or growth strategies. Finally, they remain vigilant, smart and cautious. The best offense to weather a cyclical real estate market is a solid defense, which includes a strong balance sheet.

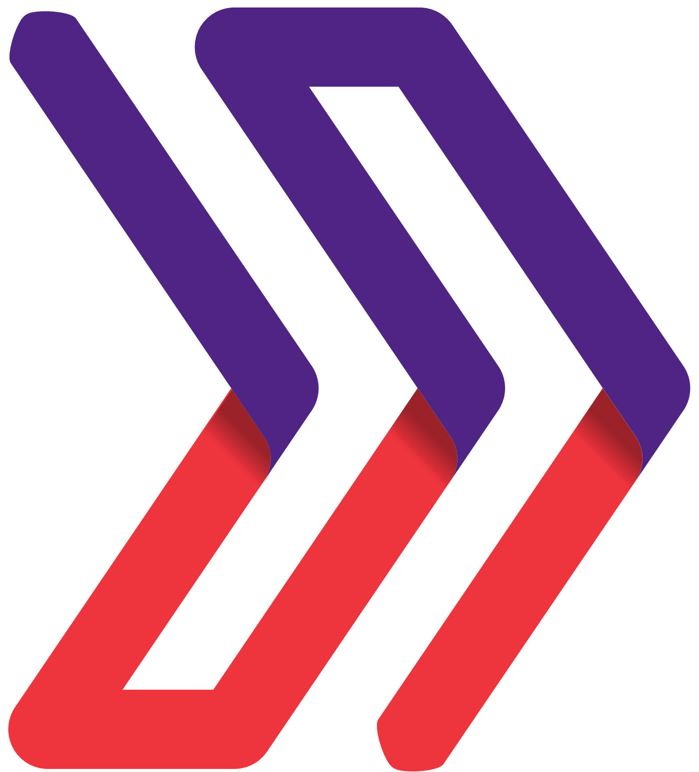
The 10-year collateralized mortgage-backed securities (CMBS) sold in 2006 and 2007 during the run-up to the global financial crisis are now maturing. While the CMBS market is more disciplined now than during the fast-money days pre-crisis, real estate leaders need to manage debt maturities carefully by keeping focus on portfolio quality, leverage and overall risk. If problems do arise, real estate companies need to restructure credit before debt maturities become difficult — if not impossible — to refinance.

Our research highlights that strong balance sheets are supported by establishing high benchmarks for asset performance. By evaluating all capital requests with uniform, consistently applied financial analysis criteria, high-performing real estate firms can assess if unprofitable projects can be turned around or require an exit strategy. Cost-classification studies help secure tax savings and improve cash flow, accelerating depreciation on reclassified assets for newly constructed projects, recently acquired properties or existing facilities. Scenario planning and financial forecast models to assess the potential impact of so-called black swan events help test the sustainability of the balance sheet.

Conclusion

Real estate firms are no strangers to cyclical disruption; the market is sure to have its peaks and valleys in rhythm with interest rates, population growth, economic strength and other trends. But to prosper in the future, the industry must manage new types of disruptions, from new investors with different interests and demands, shifts in owner profile — from family business to private equity and REIT ownership — to the necessity of finally embracing the benefits of technology innovation in constructing, operating and marketing buildings.

As this changing landscape takes hold and defines the future, being able to recognize and act on opportunities will depend largely on the ability to adapt. The future belongs to the bold.



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