THE NEW TAX REFORM
AN ANALYSIS BY ANDREW J. NELSON, CRE
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Welcome to a new quarterly publication, *The Counselor*, published by The Counselors of Real Estate, a 65-year-old international consortium of diverse, highly skilled professionals who provide reliable advice and counsel on a wide range of real estate matters. Membership is extended by invitation, a discerning process which ensures that practitioners awarded our “CRE” (Counselor of Real Estate) credential have attained the highest levels of expertise in their particular real estate specialty. Members include principals of prominent real estate, financial, legal and accounting firms as well as developers, economists, land planners, and ranking leaders of government and academia.

Counselors of Real Estate created and endowed the MIT Center for Real Estate; resolved the contentious dispute between the developer of the World Trade Center and its insurers after 9/11; led the privatization of U.S. Army Housing and valued both Yale University and the Grand Canyon. They brought parking garages to China and convinced America’s largest pension fund to adopt key tenets of responsible real estate investment — a practice now embraced by all major pension funds in the U.S. Those who hold the CRE Credential understand real estate — because they’ve worked with it — in all its forms, through all its cycles, in every market and stage of development.

Our new vision for *The Counselor* is a publication presenting both global and local perspectives on the issues, trends, and events that are shaping the international real estate market. For our cover story (page 3), Andrew Nelson, CRE, Chief Economist, USA, Colliers International, analyzes recently signed U.S. Tax Reform legislation and its implications for commercial real estate. Nelson breaks down the immediate and direct impact of the new law, while also examining its broader effects.

Timo Tschammler, CRE, CEO of JLL Germany, discusses European real estate investment in the EMEA and German office markets (page 4), sharing how changes in pricing and supply are impacting investment strategies.

Our piece on Fairborn, Ohio (page 5) highlights how the right real estate decisions can revitalize local communities. In this remarkable case study, we take a look at the challenges Fairborn faced, the recommendations made by the CRE Consulting Corps, and how the city changed as a result.

We’re excited about what’s in store for future issues of *The Counselor*. Upcoming content will include executive summary style review, analysis and discussion of timely topics, international perspectives, additional case studies from the CRE Consulting Corps and the CRE Foundation and more.

We welcome your feedback, as well as your ideas for future content.

Joseph G. Nahas, Jr., CRE
2018 CRE Board Chair
By just about any measure, the commercial real estate sector emerged fairly well from the 2017 budget reconciliation act (formerly known as the Tax Cuts and Jobs Act). Tax rates were lowered for property owners, traditional tax advantages for property taxes were largely retained if not expanded, and operating property fundamentals stand to improve. In assessing implications for commercial real estate, we must consider both direct impacts to owners of real property as well as indirect impacts that accrue to owners via impacts of the tax law on users of those assets and on the broader economy, as discussed more fully in my report “Washington’s Holiday Gift: Implications for the New Tax Bill on Commercial Real Estate” (see page 7).

LOWER TAXES FOR OWNERS

Most obviously and directly, there are the reduced tax rates. Both corporate and individual income were lowered, lessening tax liabilities for all owners of commercial property going forward. In addition, the property sector has long enjoyed some special benefits including tax-free exchanges, commercial mortgage interest deductibility, and generous asset depreciation schedules. All of these provisions seemed threatened at various points over the last year, but in the end, none saw material changes in the new law.

So even if the industry was not awarded many special new benefits under the tax law, commercial real estate gained just by not losing its special privileges. The tax advantages of property income relative to other types of income — such as on so-called “carried interests” and on REIT dividends versus C corporation earnings — are largely preserved.

IMPROVED PROPERTY FUNDAMENTALS

But the impacts of this tax law will be greater and broader than just these direct impacts. Just as building owners will enjoy lower taxes, so too will their tenants. Several business sectors will benefit disproportionately from the new tax law. These include retailing and wholesaling, sectors that traditionally incur relatively high marginal tax rates, and so benefit more from this tax reform, thus supporting more leasing.

The office sector looks to benefit the least of the major property sectors, however. Key office tenants will gain only limited to average tax savings from the new tax code. Moreover, many corporations will distribute much of their tax savings to shareholders instead of investing in new facilities.

And finally, the multifamily sector looks to gain from tax law changes that will reduce the benefits of homeownership in many markets, and thereby raise the incentives for apartment rentals. Limits on residential mortgage interest deductions and property tax deductions, while doubling the standard deduction, will make owning at least marginally less attractive for some households in higher-tax and higher-priced markets, to the benefit of local apartment markets.

Perhaps the primary impact for the real estate sector may well be through improved property fundamentals. The tax cut is likely to foster at least somewhat stronger economic and job growth this year, fueling accelerated leasing.

Still, most economists expect the boost to be both modest and short-lived as the economy is already operating at close to full capacity, so the stimulus may be more inflationary than expansionary. Plus, the tax cuts are disproportionately weighted to businesses over consumers, and to upper-income households over those less affluent, doubly blunting the impact relative to a more broad-based consumer tax cut.

(CONTINUE ON PAGE 7)
The business climate in Europe is still on a high level and proves to be resilient in an environment characterised by high political uncertainty. The economic conditions for commercial property investment markets remained robust during 2017. On the European office investment market, yield compression is still ongoing. In Q4 2017, the European prime yield amounted to approximately 3.99% (-17 bps YoY), clearly below the last low in Q2 2007 (4.31%). The strongest yield compressions from 2016 to 2017 have been observed in Dusseldorf (-30 bps), Hamburg (-20 bps), Berlin (-10 bps), The Hague (-20 bps) and Utrecht (-15 bps). Looking at the full year, €120.7 billion have been invested in office properties in EMEA, making 2017 an absolute record year (+14.9% YoY). Likewise, EMEA office take-up has been peaking with 13.7 million square metres in 2017, 23.0% above the 10-year average.

The same case holds true for the German market. In an environment still characterised by high levels of uncertainty, investors continue to perceive Germany as a safe haven. This results in a strong demand for German real estate. In combination with scarcity of suitable investment product, the situation in Germany is even more difficult for investors. Not surprisingly, 3 of the top 5 strongest yield compressions in Europe have been observed within the German market. From our experience as an investment broker, we at JLL personally can observe strong excess in demand, with deals being oversubscribed multiple times.

In the search for yield and real estate exposure, investors are facing supply shortage and increased prices. One observable investment strategy to mitigate the situation in Germany is ABBA. This strategy is described by investments in A-locations but (secondary) B-properties and B-locations but (prime) A-properties.

In 2013, the proportion of office transaction volume into prime and secondary locations within the German Big 7 markets had been equally distributed. Since 2013, the transaction volume in secondary B-locations increased steadily by 14 percentage points from 2013 till 2016. In 2017, a decline has been observed for the first time since 2013 (-11%) and investments in prime locations were back on the rise again (+20%). It remains to be seen whether this reversal of the trend is going to continue in 2018.

Trying to further understand this dynamic, a look at the Berlin market can help to assess the influence of the ABBA-strategy on pricing patterns.

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Like many American cities that experienced significant growth for several decades after World War II, Fairborn, Ohio, (population 33,000, located in the western part of the state, near Dayton) found itself beginning to stagnate in the mid-1970s. Completion of Interstate Highway 675 — which bypassed the city — deterred traffic and new customers for local businesses. Meanwhile, the adjoining town of Beavercreek (located closer to a highway interchange) grew, with newer housing, schools and shopping centers. Fairborn city officials engaged the CRE Consulting Corps to create a revitalization strategy.

THE CHALLENGE

City leaders had already identified a number of sites for potential redevelopment but agreed they needed a fresh perspective. The Fairborn assignment began as a request to analyze and make recommendations for redevelopment of one property — the Skyway Retail Center — a functionally obsolete and largely deserted shopping/office development. The project changed dramatically, however, once the team was onsite in Fairborn and met with stakeholders, and team members were able to view the property and the city.

THE TEAM

The team, led by CRE David McCoy (Hawaii), included:

- Swain Chapman, CRE (Arizona),
- David Lane, CRE (British Columbia, Canada),
- Demetrios Louziotis, CRE (New Jersey),
- and Thomas Shircliff, CRE (North Carolina).

The five-day assignment began with a city tour, orientation and data collection. Interviews with city elected officials, staff and community stakeholders assisted in completing the situation analysis, followed by two days of deliberation and analysis to determine findings and recommendations.

THE ASSESSMENT

The team reviewed market data and conducted interviews with 20 government, business and community leaders. A SWOT analysis revealed Fairborn’s strengths, including excellent medical services, proximity to Wright Patterson Air Force Base (largest employer in the state), the Air Force Museum, and Wright State University which has a student enrollment of 19,000. The city is also pro-growth, progressive and business-friendly. Downtown businesses, an eclectic mix of retail and service providers, are located in historic buildings, and new streetscaping is in place. Fairborn’s parks are numerous and large. However, lack of investment and economic development over the past several decades was a decided weakness, and lack of convenient public transit limits how easily people from the Air Force base, museum or University can access the businesses and recreational attractions Fairborn offers. Ultimately, the scope of the project was expanded to include downtown Fairborn and an area adjacent to Wright State University.

THE RECOMMENDATIONS

The team determined short-term and longer-term goals for the city. Rather than focus solely on the Skyway Retail Center, immediate action steps also addressed Fairborn’s central business district, including strengthening its downtown business association and focusing resources on promoting the history of Fairborn and its unique shops and businesses.
The team’s strategy also emphasized creating a “destination” in the CBD, which already is home to a new business incubator. They advised active partnering with the Air Force base and Wright State University, creating activity-based entertainment venues and establishing a motorized trolley to enhance access to downtown. As for the Skyway Retail Center: the team believed a Citizen Services, Health and Wellness Center would be a successful development and convenient concentration of service businesses.

Longer term, the team prioritized redevelopment of several other targeted sites, and made recommendations for each, identifying commercial and residential opportunities, including mixed-use, hospitality, retail, and student housing.

**THE OUTCOME**

After the departure of the CRE Consulting Corps team, a final written report was provided. The Consulting Corps looked back, and with the assistance of Rob Anderson, the City Manager, presented the case and an update with CRE members during the NAR meetings in November 2017.

Fairborn hired a downtown revitalization strategist to implement Consulting Corps recommendations. The city invested over $2 million to remove blighted property. They purchased a vacant restaurant and renovated for a new kitchen incubator, substantially reducing downtown vacancy. The city also purchased a former retail center site.

Fairborn began an aggressive branding and marketing campaign along with expanded events programming. In August 2017, Fairborn hosted its first Bluegrass & Brew event, bringing thousands to its downtown.

The CRE Consulting Corps, a public service program created and managed by The Counselors of Real Estate, not only solves real estate problems but invariably enhances a property’s performance. Depending on the problem to be solved, CRE Consulting Corps teams may include developers, work out strategists, urban planners, financiers, asset managers and experts in taxation and law: multi-disciplinary professionals who have the answers you need at a “below market price” you can afford. Counselors volunteer their time and you pay only a modest fee to the CRE organization.

**Learn whether the CRE Consulting Corps is right for you:**
[cre.org/consulting-corps]
EMEA REAL ESTATE INVESTMENT (CONTINUED FROM PAGE 4)

In 2017, the prime yield for office properties in Berlin stood at 2.90%. This reference applies for prime assets in prime locations (AA strategy). Prime assets in secondary locations (AB) were priced at a surcharge of approximately +25 bps on prime. This risk premium gradually decreased since 2014, where it stood at 30 bps. This development can be observed even clearer for investments in secondary assets in prime locations (BA), where the risk premium decreased by 35 bps since 2014 (2017: +70 bps on prime; 2014: +105 bps on prime) or the BB strategy, investing in secondary assets in secondary locations, where the risk premium even decreased by 55 bps since 2014 (2017: +85 bps on prime; 2014: +140 bps on prime). This provides clear evidence for increasing risk appetite by investors observable in the market.

If a potential reversal of the trend, which in terms of transaction volume began to show in 2017, will materialize in 2018, remains to be seen. Generally, forecasts still predict a small potential for decelerated yield compression in the majority of the EMEA and German office markets. In secondary submarkets this potential could be more prevalent, which could in turn lead to ongoing strong activity in this segment of the market.

Moreover, interest rates will likely rise faster after the tax cut due to the greater national debt and more aggressive Fed rate hikes. Such increases would not only lower returns on interest-sensitive investments (like REITs) and raise debt-funded acquisition costs, but would also start to slow economic growth and thus leasing, likely in late 2019 or 2020.

Impacts on real estate capital markets are less clear. Uncertainty as to the timing and nature of the tax reform likely kept some capital on the sidelines this year, so enactment of the tax act could encourage more transactions now that the uncertainty has been lifted. However, the act does not confer any new significant benefits specifically to real estate owners, and early signs do not point to any meaningful pickup in transactions so far this year.

In sum, this new tax reform seems generally favorable for commercial real estate, though not an especially generous gift to the sector. But a more complete assessment must await the weight of market evidence — and the creative scrutiny of talented tax accountants.

THE NEW TAX REFORM (CONTINUED FROM PAGE 3)

In addition to a strong North American base, The Counselors of Real Estate has a global reach, with a vibrant, international presence reflecting 25 countries. Recent conferences have been held in Berlin; Washington, D.C.; Los Angeles; London; and Montréal. Upcoming 2018 conferences will be held in Chicago, Rome, and Charlotte.

The organization is known for thought leadership, extraordinary professional reach, an uncompromising commitment to high ethical standards, and objective identification of the issues and trends most likely to impact real estate now and in the future.

For more information on The Counselors of Real Estate, our other initiatives, and membership, visit us at CRE.org.

FURTHER READING

“Washington’s Holiday Gift: Implications for the New Tax Bill on Commercial Real Estate”
Read online at knowledge-leader.colliers.com/andrew-nelson/
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