U.S. URBANIZATION TRENDS:
INVESTMENT IMPLICATIONS FOR COMMERCIAL REAL ESTATE

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The way that many people choose to live is changing. In 2011, for the first time in nearly one hundred years, the rate of urban population growth outpaced the suburbs.

Americans once flocked to the suburbs in search of a better life. Today it is America's cities that entice younger workers with better options for their careers and lifestyles.

More than ever, talent is clustering in dense, urban areas. There is a locational advantage to living and working in cities. America's primary global competitiveness as a country is centered around its urban areas and the amenities and opportunities that they offer.

The suburbs are clearly not going away. The shift to urban living remains incremental and much of it is actually taking place in suburban areas. For commercial real estate investors, this presents pockets of opportunity across the country.

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BACKGROUND

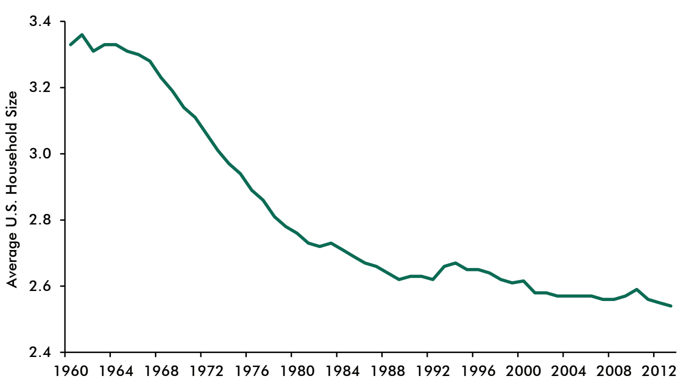
Cities became dirty and dangerous after the industrial revolution with the rise of factories and crime. After the suburban flight of the 1950s, large-scale social unrest in the 1960s and the crack epidemic of the 1980s, the term "inner city" took on increasingly negative connotations. The deterioration of cities then became a prime focus of city officials, and many urban areas have become much safer and more appealing. Downtown areas have become not only a place to work but also to live.

Millennials are becoming an integral part of the workforce, and they are looking to reduce time and expenses spent on commuting and transportation. As a result, millennials are forgoing the comforts of larger detached homes they grew up in and are instead opting to live close to work, transit and amenities.

Several factors have contributed to the renewed interest in urban living:

1. Deindustrialization of central cities
2. Changing lifestyle preferences
3. Shifting demographics:
   a. **Living single:** the overall share of married Americans declined from 72% in 1960 to 51% in 2010
   b. **Marrying later:** median age at first marriage has never been higher for brides (26.5 years) and grooms (28.7 years)
   c. **Smaller families:** 3.33 persons was the average household size in 1960, down to 2.58 in 2010 **(Exhibit 1)**

EXHIBIT 1: The Average U.S. Household Size Has Declined

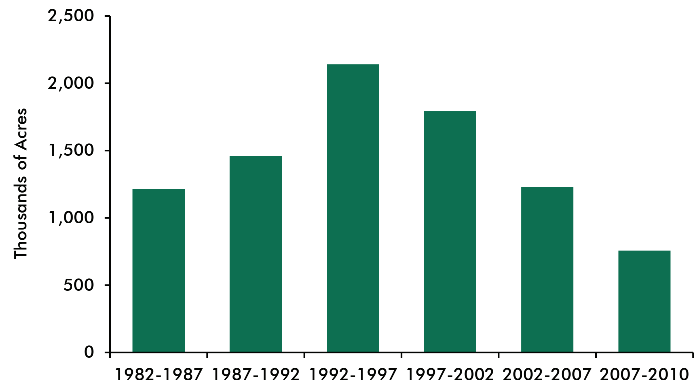


Source: U.S. Census Bureau

URBANIZATION DRIVERS

Another reason for slower outward growth is that many cities have reached their boundaries, and it is much more difficult to build on unincorporated county land. Developers crunch the numbers, look at the path of least resistance and decide that it is simply easier to focus on infilling areas that were initially bypassed during past periods of urbanization.

EXHIBIT 2: Acres of Land Developed



Sources: Payton Chung (West North), National Resources Inventory

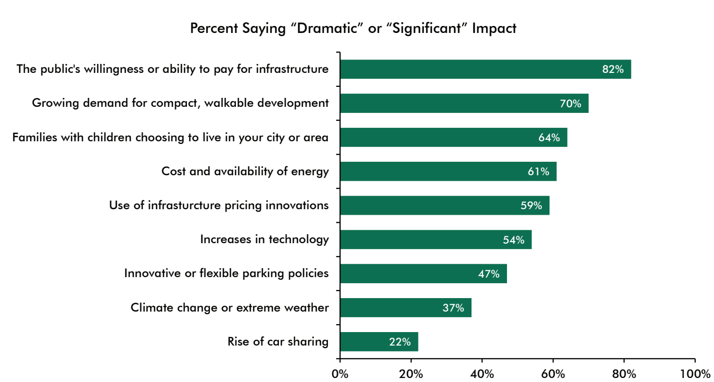
The drop-off in developed land started before the housing bubble and Great Recession. It is a fact, not just urbanist wishful thinking. **(Exhibit 2)**

Many national retailers are realizing that densely populated urban areas are undersupplied and are focusing on scaled down facilities for future growth. WalMart and Target, which built their businesses in recent decades by focusing on the suburbs, have dramatically changed course. After seeing the suburbs saturated and sales growth flatten, they are now intensely focused on smaller store formats in urban locations to capitalize on one of the nation's few underserved retail opportunities. Other retailers are following suit.

Governments, especially local officials, are recognizing the role urbanization plays in creating productive, vibrant, cultural and social spaces.

As Americans continue to weigh the trade-off between location-location-location and access-access-access, the country's largest urban areas are looking more like a patchwork of urban nodes. This can mean more polycentric areas with mini pockets of urbanism connected to each other by improved public transit options. This is one of the several factors driving urban growth. **(Exhibit 3)**

EXHIBIT 3: Key Trends Driving Urban Growth



Source: ULI *Infrastructure 2014*

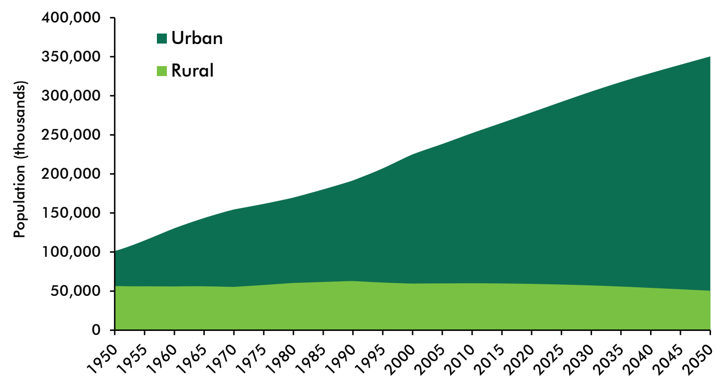
Researchers at MIT and NYU that study urban physics (analyzing urban variables such as crime and traffic to understand emerging patterns, problems and opportunities for change) say that offices need to be designed more like neighborhoods. Companies are phasing out conventional workspaces in favor of connected spaces that encourage innovation and collaboration.

POPULATION TRENDS

The pace of U.S. population growth is trending down. However, the U.S. has 39 counties with one million-plus people, and almost all of them are growing at a much faster rate than the nation (the counties that include Detroit and Cleveland are exceptions). More of the U.S. population growth in the last few decades has been attributable to urban locations. **(Exhibit 4)**

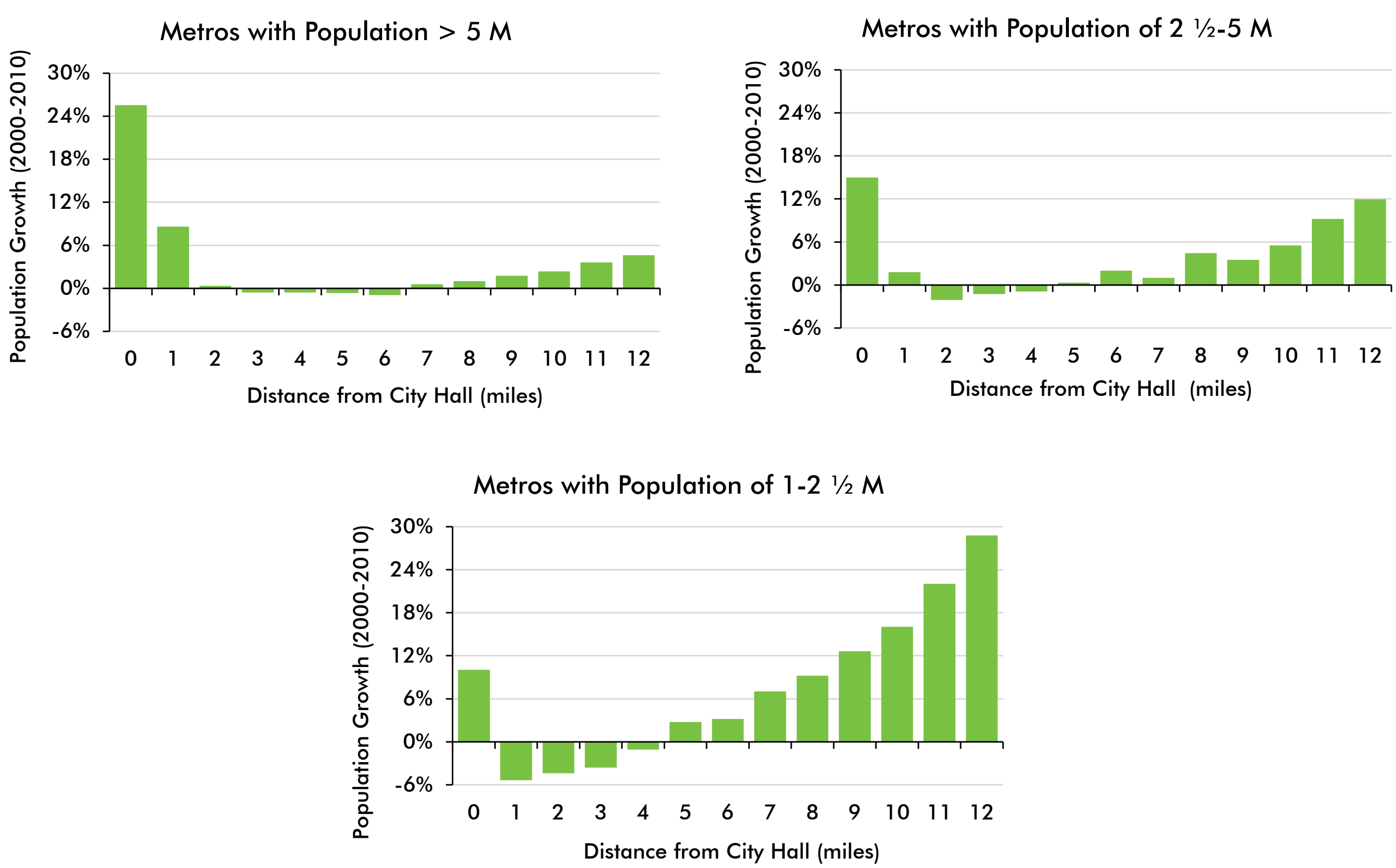
Metropolitan areas with five million or more residents increased on average by double-digit percentage rates between 2000 and 2010. The city that had the greatest increase in its downtown population (defined as within two miles of the central city's city hall) was Chicago, where 48,000 people moved into the area. Runners-up include New York, San Francisco, Philadelphia and Washington, D.C. The major population losers were the inner-suburbs. Thus, while downtowns and the more far-flung periphery areas showed population growth, it was the inner-suburbs that tended to decline. **(Exhibit 5)**

EXHIBIT 4: The U.S. Urban Population Will Continue to Grow



Source: United Nations

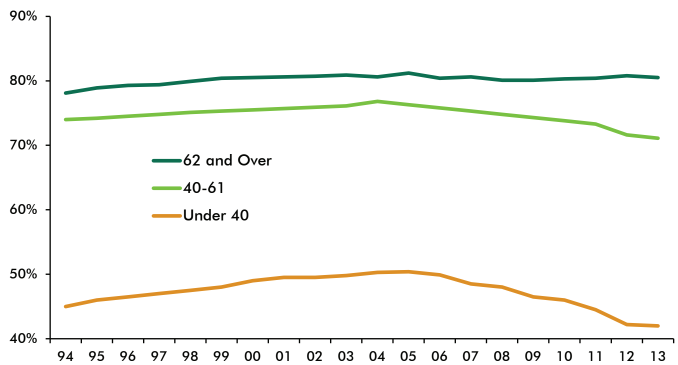
EXHIBIT 5: Recent Population Growth Has Been Concentrated in City Centers



Note: Calculations are based on the averages of all the metro areas and the average of all metro areas within each specified segment
Source: U.S. Census Bureau

The Department of Housing and Urban Development and the U.S. Census Bureau have released statistics saying that by 2025, only 10% of new households (ex: adult children leaving their parents' households, singles moving out of shared housing, etc.) will have children. Some forecasters have even said that by 2025 only 25% of all U.S. households will have children. **(Exhibit 6)**

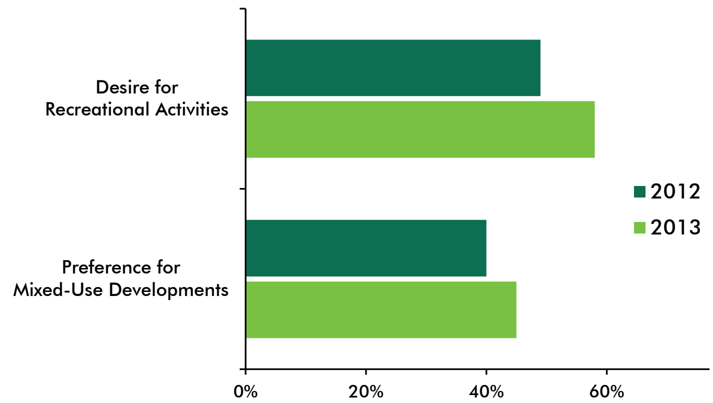
EXHIBIT 6: Homeownership Rate by Age of Family Head



Source: U.S. Census Bureau

There will definitely be demand for more detached homes in the future, but many of them will be closely clustered around urban nodes with walkable streets and improved amenities. The American Institute of Architects' 2013 Home Design Trends Survey shows an increased preference among all homeowners for mixed-use developments. **(Exhibit 7)**

EXHIBIT 7: What Homeowners Want

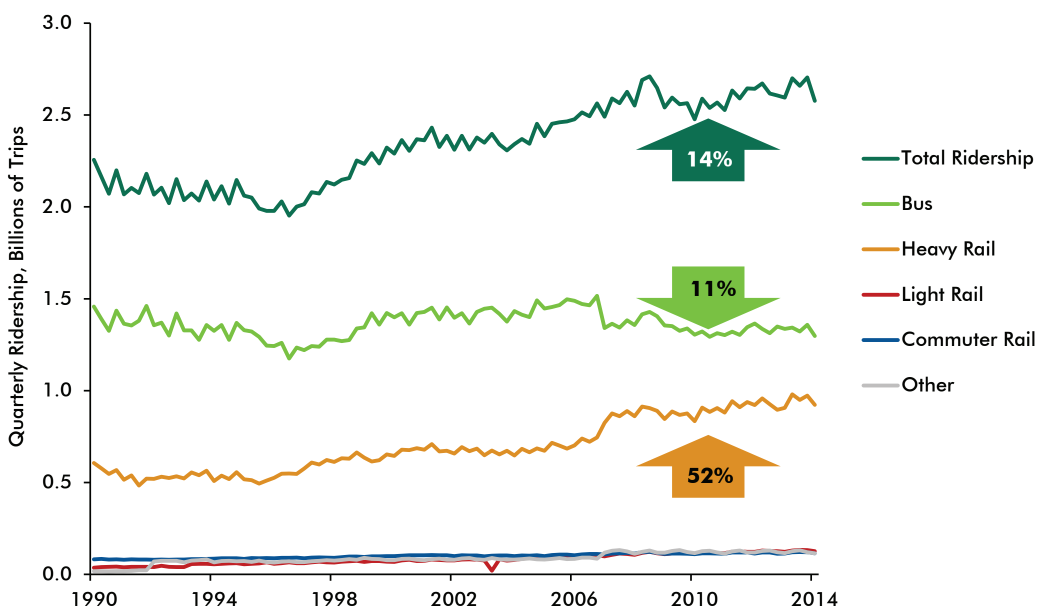


Source: American Institute of Architect's 2013 Home Design Trends Survey

PUBLIC TRANSIT

Public transportation use in the U.S. in 2013 rose to 10.7 billion trips – the highest number in 57 years. However, recent growth in public transit ridership is almost entirely attributable to increased heavy rail (subway) ridership, which is almost exclusively located in ultra-urban locations. Ridership on light rail, commuter rail and buses has increased at a much slower pace, or even declined, over the past decade. **(Exhibit 8)**

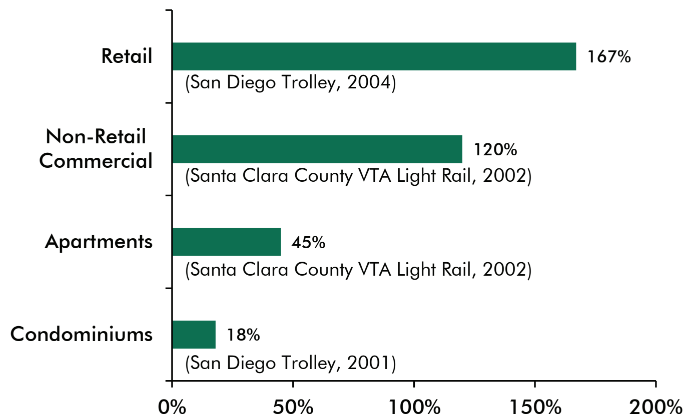
EXHIBIT 8: Transit Ridership



Source: APTA; % change represents cumulative change from 1990Q1 - 2014Q1

Studies have definitively shown that properties located near transit have a higher value. This difference in property net income and market values from proximity to transit increases even further for suburban properties. **(Exhibit 9 & 10)**

EXHIBIT 9: Examples of Increased Property Values Following the Opening of Nearby Public Transit



Source: Center for Transit-Oriented Development, 2008

EXHIBIT 10: Properties Near Transit (1998-2008)

	Suburbs	CBD
Net Income	+12.70%	+4.50%
Market Values	+16.20%	+10.40%
Cap Rates	– 0.30%	– 0.20%

Source: "Investment Returns from Responsible Property Investments: Energy Efficient Transit-oriented and Urban Regenreation Office Properties in the US from 1998-2008," Pivo and Fisher (2008).

Car ridership in the U.S. has stopped increasing, and is actually trending down, when measured by vehicle miles driven and adjusted for population growth. **(Exhibit 11)**

THE DEBATE

The suburbs are not going away. Many Americans still want tree-lined streets, soccer leagues and tranquil cul-de-sacs. But they are also getting tired of punishing commutes and endless sprawl. More people are placing a higher value on cultural amenities and are shunning isolated, single-class communities. Popular culture frequently highlights the negative qualities of chain-store-laden tract-housing-dominated suburban sprawl.

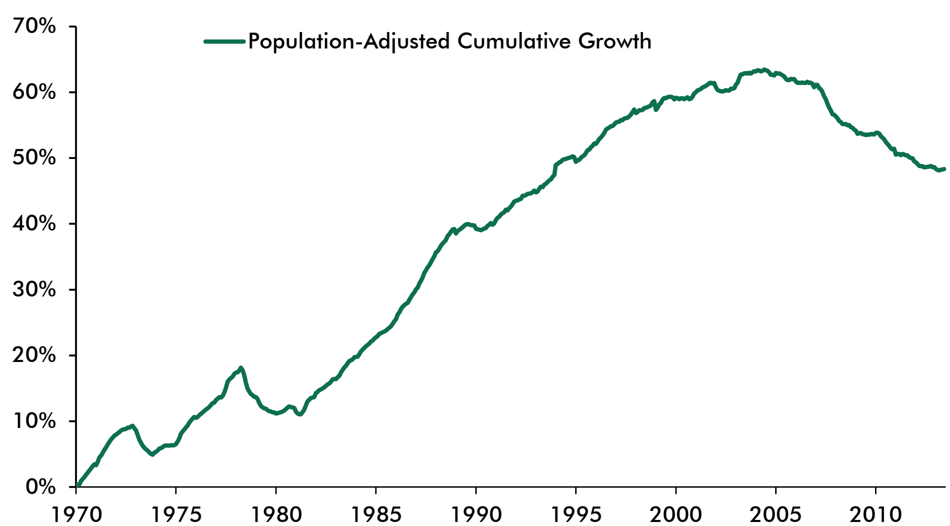
The indie rock band Arcade Fire took home a Grammy for "The Suburbs," an entire album dedicated to teen angst and isolation as felt by the band members after growing up in Houston's The Woodlands master-planned community; but that may just be what they felt at the time. Many of today's younger urban professionals may eventually be drawn to the suburbs as they begin to raise families and they search for better-quality schools, a yard of one's own and more space for storage.

SUBURBAN CHANGES

Many suburbs are getting an urban makeover. Mixed-use development, thoughtful public space, transit options and community-focused street-level development are allowing some suburban cities to redevelop themselves into more walkable communities.

Richard Florida, writing in *Urban Land*, describes what he calls "The Great Reset," the movement from simply creating denser communities to creating more people-friendly communities: "The Great Reset is not just about the intensification of cities but their extensification, as great metropolitan areas morph into even larger mega-regions. Our suburbs need to be reimagined and rebuilt as more walkable, human-scale, mixed-use places. They are the next arena and next agenda for large-scale place making."

EXHIBIT 11: Estimated Vehicle Miles Driven On All U.S. Roads



Source: Federal Reserve, dshort.com

More than half of Americans live in suburbs. Approximately 75% of postwar construction has happened in the suburbs. Diverse suburban neighborhoods in the U.S. now vastly outnumber diverse city neighborhoods. Many suburbs have created urban pockets by building high-quality public transit to ease traffic congestion and are encouraging mixed-use or high-rise construction instead of more single-family housing.

William Frey, one of the most respected demographers in the U.S., has written that the distinction between cities and suburbs is falling apart. He believes that suburbs are becoming more diverse ethnically, socioeconomically and in their real estate, with more housing and retail options in close proximity to office, flex space and other uses.

Furthermore, opportunities are arising as efforts to reduce our "carbon footprint" are becoming engrained into the culture of real estate investment management firms. The built environment is by far the largest contributor to greenhouse gas emissions, dwarfing both industrial production and automobile driving. Retrofitting and redeveloping suburban real estate has the potential to be very profitable while also helping firms achieve their goals for environmental stewardship.

There now numerous reports and websites that study and analyze walkability in U.S. cities. A study by George Washington University[1] indicates that metros found to have high walkable urbanism are models for the future development patterns of many – and possibly most – of the largest 30 U.S. metros. These trends suggest future demand for tens of millions of square feet of walkable urban development and hundreds of new walkable urban places. This demand would provide an economic foundation for the U.S. economy, similar to the building of drivable suburbs in the mid-to-late 20th century. The author writes that, "I believe the future, based on my research throughout the country, belongs to the urbanization of the suburbs."

MILLENNIALS

Millennials, people born between the early eighties and late nineties, are driving the steady movement toward more compact suburban growth. This 80 million-member demographic is entering the market for housing and jobs, and they tend to favor the convenience of urban-style environments. **(Exhibit 12)**

Millennials are multi-modal; they choose the best transportation mode (driving, transit, bike or walk) based on the trip they are planning to take. Communities that attract millennials have a multitude of transportation choices and urban lifestyle components (whether they live in cities or in the suburbs). As a result, the top 15 markets will represent a larger percentage of the labor force in the future. **(Exhibit 13)**

EXHIBIT 12: Percentage Ranking at Top (6-10 score out of 10)

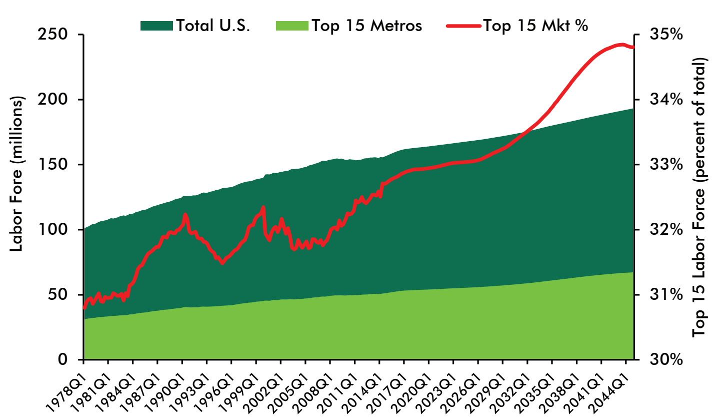
	Millennials	Gen X	Baby Boomers
Short distance to work and school	82%	71%	67%
Walkability	76%	67%	67%
Distance to family/friends	69%	57%	60%
Distance to shopping/ entertainment	71%	58%	67%
Convenience of public transportation	57%	45%	50%

Source: ULI America in 2013 Survey

Millennials will dominate the workforce by 2015 and will comprise 75% of the workforce by 2030, according to the BLS. They are the workers that employers want to attract and retain – especially in the TAMI segment (technology, advertising, media and information businesses). The oldest millennials are approaching their mid-30s and are now in positions to start making decisions on office space.

Will millennials commit to cities as a place to remain, settle down and raise families? There is not yet enough evidence to say yes or no.

EXHIBIT 13: The Largest Metros Will Account For a Higher Share of Future U.S. Job Growth



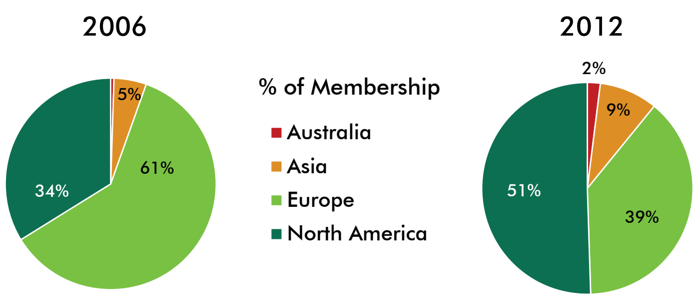
Source: United Nations

Millennials have a stronger preference for city living and a high propensity to rent – factors that have contributed to urban gentrification, strong apartment demand and development activity in markets across the country. And while millennials tend to want to live alone, they are also highly social creatures: they want newer apartments with well-appointed indoor and outdoor common areas, coffee bars, communal grills and high-speed internet access in public areas.

[1] Foot Traffic Ahead: Ranking Walkable Urbanism in America's Largest Metros; Christopher Leinberger and Patrick Lynch, George Washington University, 2014

The choice to live in cities is no longer economic; it is cultural. Millennials prefer to live downtown and closer to work. North America used to account for only one-third of the worldwide car sharing market in 2006. That share had increased to over 50% by 2012. **(Exhibit 14)**

EXHIBIT 14: **Worldwide Car Sharing Services**

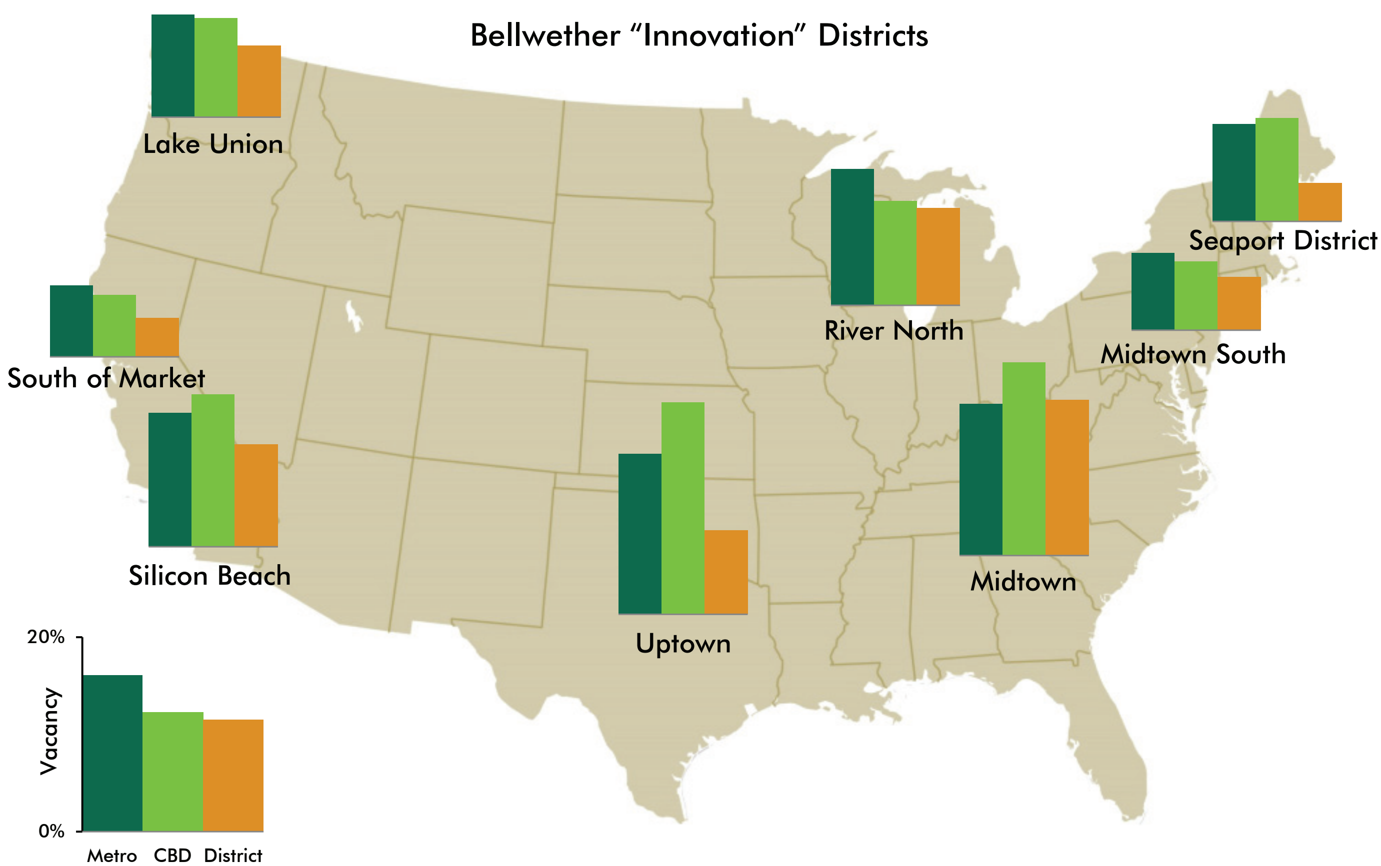


Source: United Nations

The cultural shift of millennials has not gone unnoticed by employers. Companies are opening offices in CBD adjacent locations so that employees can have the desired urban-amenitized lifestyle in close proximity to work. These areas are rapidly growing in popularity and have now become known as "innovation" districts due to the high-concentration of industry-leading companies and vibrant startups. These districts have been historically underdeveloped, but cutting-edge companies are now embracing the alternative location as a way to break-out from the traditional CBD office space profile and to design creative, open-plan environments that promote collaboration. This trend is most prevalent in the millennial-driven high-tech industry where competition is fierce to attract and retain top talent. Many "innovation" districts now have lower vacancy rates than their respective metro average and even the CBDs. The growing corporate presence in "innovation" districts has led to a boom in apartment and retail development as well. **(Exhibit 15)**

Of course, cost is still an enormous challenge. Studies show that millennials may say they want to live in a nice building near Main and Main, but they frequently choose to live further away where they can actually afford the rent; and boomers also say they want to live near developments with a mix of shops, but they are focused on preservation of their capital and are not interested in taking on more expenses by moving to a city with a high cost of living. Developers should make their offerings attractive and appealing, but they cannot lose sense of costs and affordability as supply increases.

EXHIBIT 15: **Bellwether "Innovation" Districts**



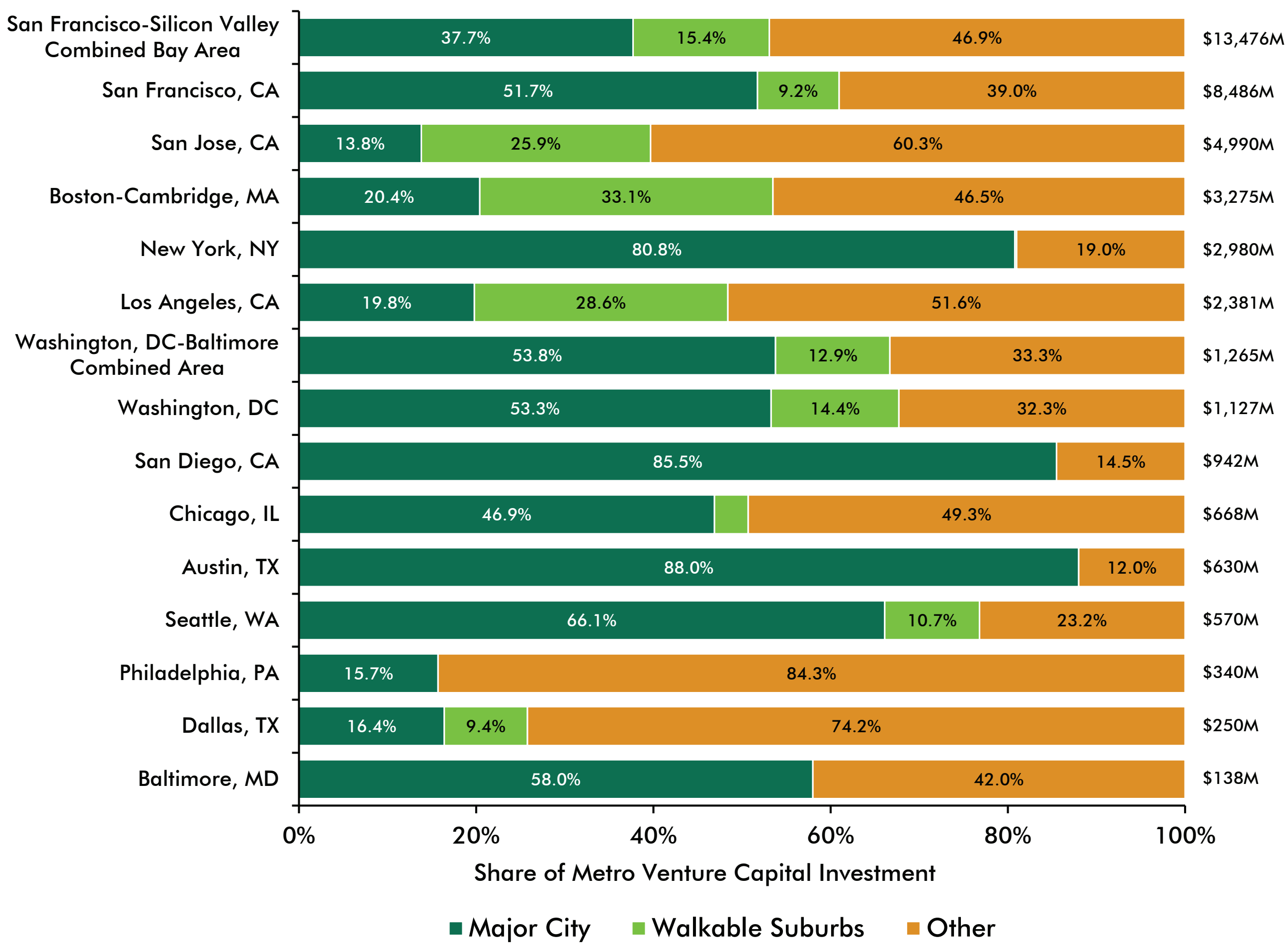
Source: CBRE Econometric Advisors

BENEFITS FROM CITIES

- More than 10% of global GDP growth through 2025 will come from large U.S. cities.[2]
- Suburban office parks are no longer attracting all of the newer and more innovative companies. The share of venture capital investment in the U.S. that is going to central city areas and to walkable suburban areas is growing. **(Exhibit 16)**
- 80% of the U.S. population lives in large cities, vs. less than 60% in Europe.[2]
- Three-fourths of the U.S. lead in per capita GDP over Western Europe is explained by differences in the regions' largest cities.[2]

[2] Urban America: U.S. Cities in the Global Economy; McKinsey Global Institute; April 2012

EXHIBIT 16: **Share of Venture Capital Investment Going To Center Cities, Walkable Suburbs and Other Places**



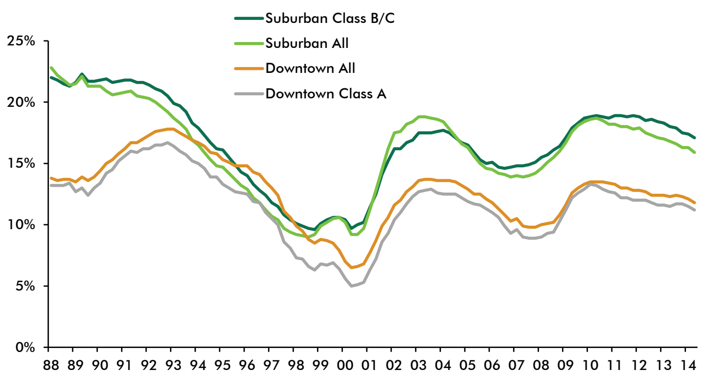
Source: Martin Prosperity Institute; The Atlantic

IMPLICATIONS FOR COMMERCIAL REAL ESTATE

Urban commercial real estate has historically outperformed its suburban counterpart. High-rise apartment rents, located primarily in urban cores, have grown almost twice as fast as garden-style apartments. A similar trend has persisted in downtown office versus suburban office. Strong rent growth and lower vacancies have given investors the confidence to deploy capital in the urban areas.

The spread between urban and suburban office cap rates, and high-rise versus garden-style apartments, are near the widest point in over 14 years. The prominence of urbanization will continue to fuel sustained demand for real estate in core, urban areas, which is beneficial for commercial real estate.

EXHIBIT 17: Office Vacancy Rates



Source: CBRE Econometric Advisors

There are three main factors that drive real estate investment values: land, buildings and tenants. Many businesses will continue to pay for property that provides access to a broad, skilled labor pool that is available in central locations. Urban office and apartments will be a perk for employees, and investors will continue to demand property in central business and "innovation" districts.

Although the macro trends support urbanization, urban investing is difficult and requires experience. Investors and developers will need to be selective in choosing a building or potential development site. Preferred locations for investment and development should show strong projections for solid demand, higher occupancy, strong rent growth, and elevated marketability and liquidity.

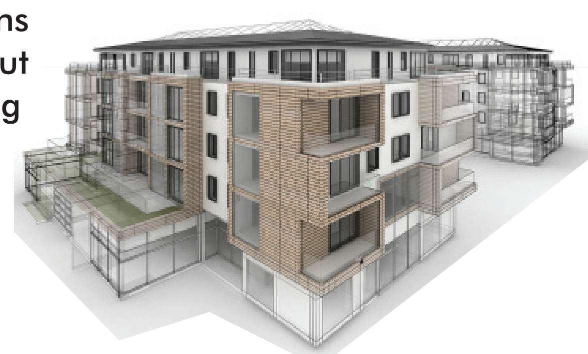
Below are some key qualities to consider:

A) Properties should be located on streets not roads. Streets have life, pedestrians, cyclists, tourists, workers, commuters, cyclists, etc. Roads convey cars from Point A to Point B.

B) Good locations have handsome buildings with old bones and urban fabric that has become fine-grained over time, drawing in both millennials and boomers.

C) Access to amenities and public transportation is vital for tenants and will drive long-term demand.

Investors and developers should focus on only locations that will hold value in the long-term, in part because community opposition will make it difficult for competitors to add new supply. Find the locations that are expected to grow in population but that can no longer grow outward, where going vertical is an inevitable part of the long-term viability of the region.



OFFICE – WHERE AND WHAT TO BUY AND BUILD

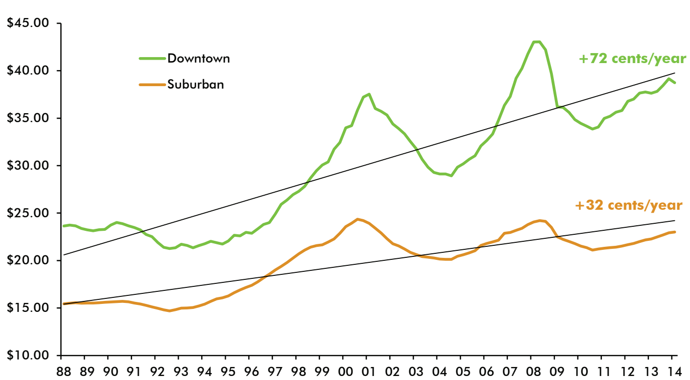
Location

- CBDs or "innovation districts" that provide work/live/play environments and attract business services and creative industries
- Suburban nodes that provide a highly amenitized "edge city" environment
- Readily accessible mass transit

Building Features

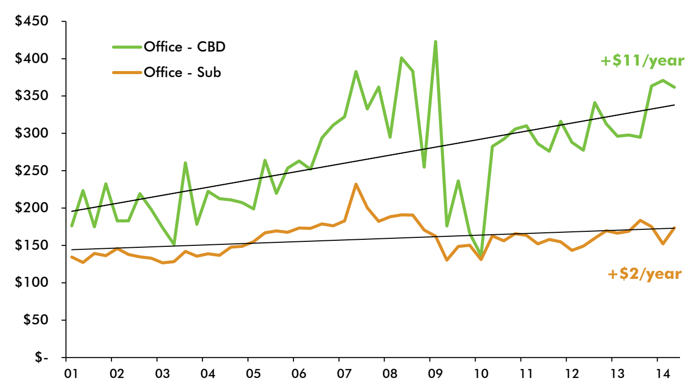
- Rectangular floor plates between 23k and 35k SF
- High parking ratios for buildings not near mass transit
- Green, such as LEED certification, high HVAC efficiency and natural lighting
- Ability to provide on-site amenities e.g. fitness center, meeting/concierge facilities

EXHIBIT 18: Office Rents



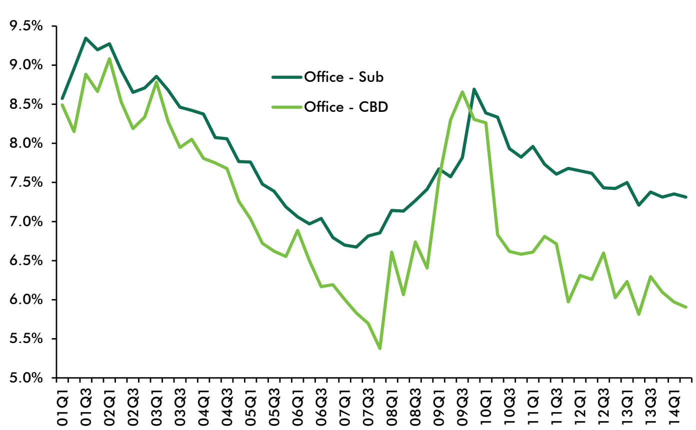
Source: CCBRE Econometric Advisors

EXHIBIT 19: Office Price Per SF



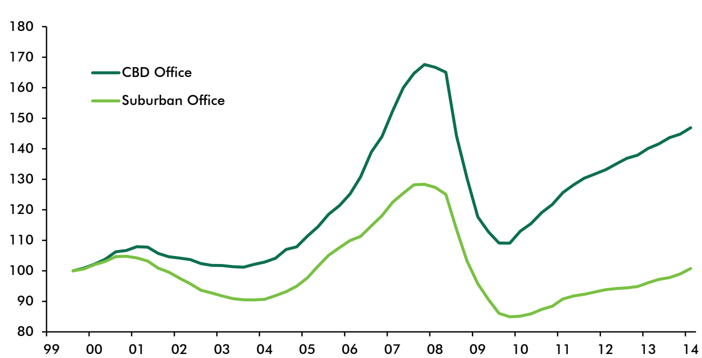
Source: Real Capital Analytics

EXHIBIT 20: Office Cap Rates



Source: Real Capital Analytics

EXHIBIT 21: Office Appreciation



Source: NCREIF, 1994=100

APARTMENTS –WHERE AND WHAT TO BUY AND BUILD

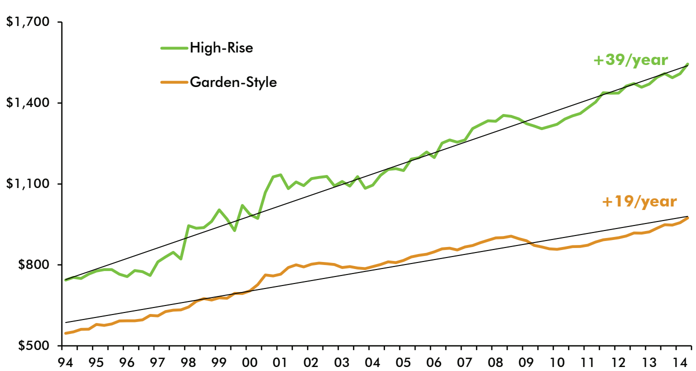
Location

- Major population centers in coastal markets where low housing affordability is a barrier to homeownership
- High population/job growth markets, primarily in the West and South
- Infill neighborhoods close to growing employment nodes or "innovation districts," preferably with good transit access and quality school

Community Features

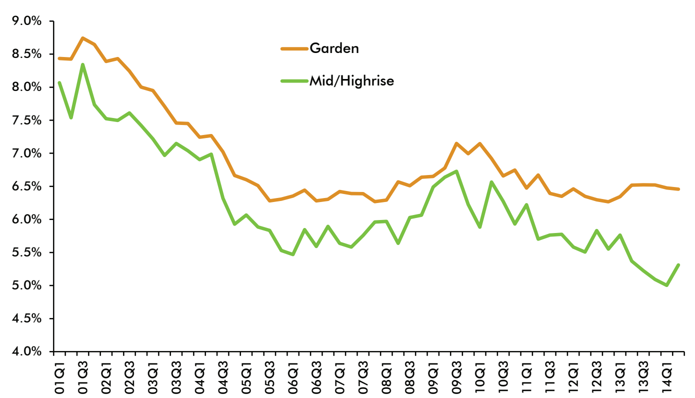
- "Lifestyle" apartments that appeal to affluent renters-by-choice
- Comprehensive amenity package including resort pool, club house, fitness center, social areas with Wi-Fi, concierge services and "green" features
- Building height, unit mix and size, and parking provision that's competitive in the market area
- Upgraded unit features such as granite countertops, stainless steel appliances, washer/dryers and high ceilings

EXHIBIT 22: Apartment Rents



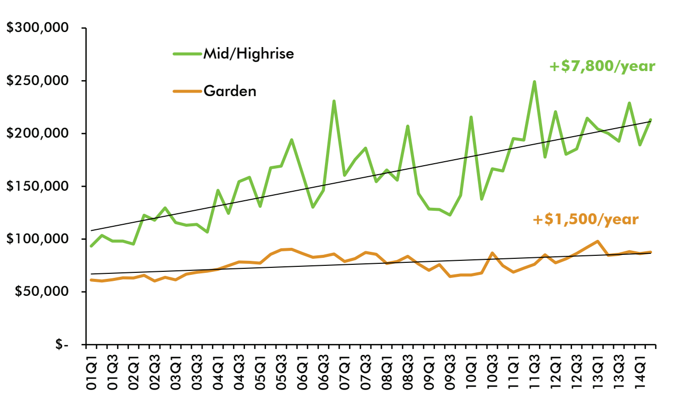
Source: CBRE Econometric Advisors

EXHIBIT 23: Apartment Cap Rates



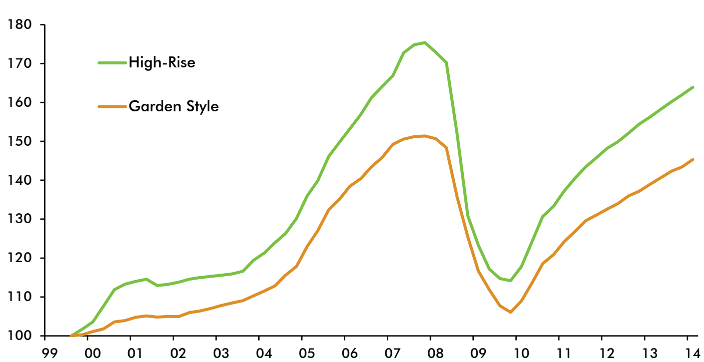
Source: Real Capital Analytics

EXHIBIT 24: Apartment Price Per Unit



Source: Real Capital Analytics

EXHIBIT 25: Apartment Appreciation



Source: NCREIF, 1994=100

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