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The Tectonic Forces of Global Real Estate

Abstract

[Excerpt] There are major shifts underway in the fundamental structure, or the underlying tectonic plates, of the global commercial real estate industry. These massive plate movements are creating an entirely new landscape within real estate and challenging long-held assumptions about commercial real estate investment, development, and ownership. The industry is transforming from a highly localized, deal-driven business to an international market characterized by lower transactions costs, abundant information, lower risk premiums, and increasing sophistication. Even the perception of real estate as an investment class is changing—investors increasingly see real estate as a stable, secure investment, producing solid returns with less volatility than stocks or many other investments.

Keywords

Cornell, real estate, AIG Global Real Estate, international, transaction costs, foreign direct investment, fixed capital investment, transparency, interest rates, global savings, treasury bonds, demographics, capital markets, urbanization, outsourcing

The Tectonic Forces of Global Real Estate

by David J. Lynn, Ph.D.

Tectonic (tĕk-tŏn'ĭk)

adjective: pertaining to the structure or movement of the earth's crust; "tectonic plates."

There are major shifts underway in the fundamental structure, or the underlying tectonic plates, of the global commercial real estate industry. These massive plate movements are creating an entirely new landscape within real estate and challenging long-held assumptions about commercial real estate investment, development, and ownership. The industry is transforming from a highly localized, deal-driven business to an international market characterized by lower transactions costs, abundant information, lower risk premiums, and increasing sophistication. Even the perception of real estate as an investment class is changing—investors increasingly see real estate as a stable, secure investment, producing solid returns with less volatility than stocks or many other investments.

Six fundamental and powerful tectonic forces are at work altering—in some cases irrevocably changing—the very bedrock of the global real estate industry and creating new opportunities for investors through the following real estate plate shifts:

- 1) falling transaction costs and greater information and transparency;
- 2) changing perceptions and growing investor interest in real estate;
- 3) lower interest rates around the world;
- 4) growing integration with the capital markets;
- 5) global growth and change: demographics, emerging markets and urbanization; and
- 6) international outsourcing and the mobilization of labor.

Many of these underlying factors are mutually reinforcing and compound the impact of any single transition. The moving magma underlying these plate shifts is a combination of accelerating globalization¹ and global economic growth.

¹ Globalization refers to the increasing integration of economies around the world, particularly through trade and financial flows. The term sometimes also refers to the movement of people (labor) and knowledge (technology) across international borders.

author

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1. Falling Transaction Costs: Greater Information and Transparency

Transaction Costs

Transaction costs are the costs of transferring goods or services from one individual to another.² Real estate has traditionally been a murky, high-friction sector with high transactions costs and is characterized in particular by two types of transaction costs: informational incompleteness and asymmetries. Informational incompleteness describes situations in which the parties to a potential or actual transaction do not have all the relevant information needed to determine whether the terms of the agreement are mutually acceptable, whereas asymmetries describes the difficulty of determining whether the implied or agreed upon terms are actually being or will be met.³

Traditionally most real estate firms have been locally based, rarely venturing out beyond their market areas. The cost of sourcing, investigating, bargaining, investing in and managing real estate outside of a particular investor's market was viewed as prohibitive for many investors, both large and small. Optimum economic decisions require information about preferences, resource availabilities, motivation of agents, and technological opportunities. Information pertaining to the above factors is localized and dispersed. But, even if the relevant information were available, determining what should be produced, for whom, by whom, and using which methods and materials is overwhelmingly large and complex, and a complete analysis would likely be cost ineffective. Nevertheless, as sources of information have expanded with broader media coverage, technology applications and the increasing popularity of the sector, transaction costs have been reduced.

Greater Information and Transparency

Globalization has assisted in driving down transaction costs by increasing the speed and reducing the cost of information transmission. This has improved transparency which in turn has brought more investment and increased information. The movement of the one tectonic plate reinforces the movement of another.

Shifts in technology, transportation, and communications are creating a world where anyone can invest in real estate in almost any part of the world that allows real estate foreign direct investment (FDI). The new public nature of commercial real estate thrives on information, which was once a scarce commodity. It is now an industry sustained by widespread information and a growing number of analysts.

Developed, maturing, and emerging markets around the world are making tremendous progress in the legal and institutional reforms necessary to allow and facilitate real estate FDI. From a political perspective, countries used to view real estate as one of the "crown jewels" of an economy. No longer does this view hold. Countries have recognized that real estate FDI is a way to encourage fixed capital investment, create jobs, and to introduce best practices from multinational corporations. India demonstrated its recognition of the benefits of real estate FDI when it liberalized a wide range of investments. Retail in particular experienced a surge of investment by foreign retailers, bringing in increased selection and lower prices for the Indian consumer.

² Coase, Ronald, "The Nature of the Firm," *Economica*, 4 (1937), 386-405.

³ The specialization of information economics is a relatively new one. Some of the pioneers include George Akerlof ("The Market for Lemons"), Michael Spence, and Joseph Stiglitz.

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The leading countries in terms of receiving real estate FDI are typically the most transparent, with high scores for public sector governance. The UK and the Netherlands consistently receive top scores for both the availability of public market indices and the quality of corporate governance. European real estate capital markets in general are becoming increasingly international, with some \$65 billion dollars of cross-border transactions undertaken in 2003, representing 48% of the total investment volume in Europe.⁴

Increasing transparency is also bolstered by economic growth, as the level of economic development of a country is directly correlated with its transparency.⁵ Transparency is resulting in greater capital flows and is, in itself, a reinforcing cycle. Public and corporate governance are also factors. The additional investment encourages governments or public organizations in less transparent countries to collect more real estate market data and make it accessible to investors. For example, transparency in Japan and Korea has improved significantly in recent years and is, arguably, both a cause and effect of international capital flows. The development of public real estate markets appears to be a catalyst for long-term transparency as this drives analysis of the sector that attracts additional investment. Taiwan is another good example of a nation that has improved its real estate market transparency. Over the past few years, more real estate data has become available to investors as the government regularly collects detailed tourism and housing data and makes this available to the public.

Transparency results in lower barriers to entry in a market and margins decrease. As yields lower in more transparent countries, private investors, institutions, pension funds, mutual funds, open-ended funds, and opportunity funds will seek higher risk-adjusted returns in less transparent markets, and investment turns to emerging markets. This influx in capital, in turn, is inducing these countries to make accommodations to become more transparent. In other words, transparency follows the money.

2. Changing Perceptions and Growing Investor Interest in Real Estate

Historical data has demonstrated how investment in real estate provides diversification and mitigates risk. It also shows a proliferation of investment vehicles and the growing importance of emerging markets. In addition to the evolution in vehicles and markets, an evolution of investor attitudes is also creating a shift in real estate landscape.

In the late 1990s there was a strong bias against “bricks and mortar” companies. It was believed that hard assets only weighed companies down, slowing their ability to maneuver deftly in high growth markets. This bias has been reversed to favor not only “bricks and mortar” companies, but also the *bricks and mortar themselves*. The comparatively tame performance of the U.S. stock market and the hesitation surrounding investment in the intangible products of technology, biotechnology, service and dot com companies has led many institutions to favor investments that have strong tangible value. The stock market decline of five years ago has also served to remind investors of the utility of portfolio diversification and has enhanced the attractiveness of stable, income-producing investments.

⁴ Jones Lang LaSalle, Global Real Estate Transparency Index, 2004.

⁵ The Fraser Institute, Economic Freedom of the World Index, 2005.

Moreover, in the post-Enron world, investors are attracted to real estate investments and operating companies that employ more straightforward accounting practices, with a high percentage of their value derived from current cash flow. Real estate investment is thus less susceptible to creative accounting and financial legerdemain.

The hard tangibility and the comforting transparency of real estate may explain why real estate draws many investors on an emotional level. However, real estate's qualitative "bricks and mortar" appeal is also supported by its ability to reduce volatility and enhance returns through income and appreciation, which is derived from the diversification and stability that it offers.

Recent empirical studies have shown real estate values are relatively stable compared to stocks. The volatility of private and direct real estate expresses a range of 6.5-9% annualized standard deviation.⁶ The boom and bust real estate cycles of the 1980s have been tempered by a number of trends that have been emerging since the 1990s. These include increased securitization, improved transparency, better market coverage and information, and increased investor sophistication.

In terms of stability, real estate's current income has been as good as, or better than, any major investment class over the last five years.⁷ The income derived from leasing and rental properties provides investors with a comparatively high yield. The income component of real estate returns has not been negatively affected by the recent influx of investment capital, even though cap rates have declined.

Real estate's relatively lower risk, its complementarities with other investments, and its longevity and stability are particularly appealing to the "Baby Boomer" demographic.⁸ This group, which in the U.S. refers to Americans who were born between 1945 and 1962, is the wealthiest demographic segment in history, and currently represents about 27% of the U.S. population. In the post-technology bubble era, with a large aging demographic becoming increasingly risk-averse, investors should continue to favor the stability, diversity, and income-producing attributes of "bricks and mortar" investments. As such, the level of real estate investment will most likely continue to increase for the next two decades.

"Real estate's current income has been as good as, or better than, any major investment class over the last five years."

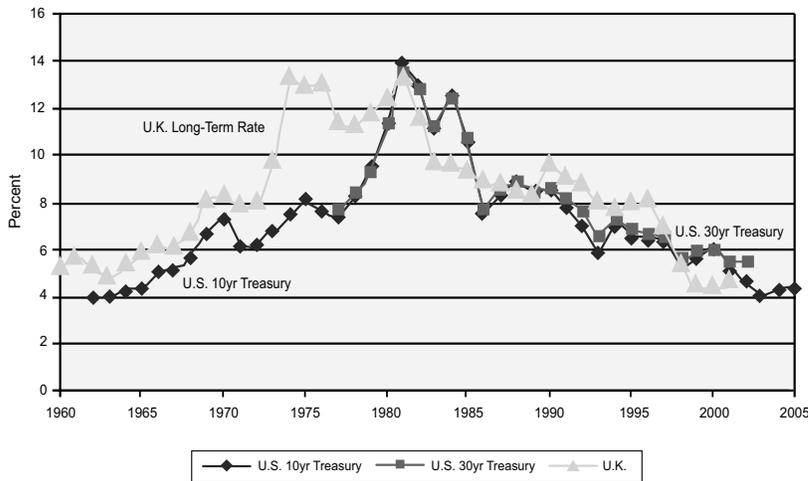
3. Low Interest Rates

Low interest rates in major markets around the world, including the U.S., UK and Germany, are fueling a growing appetite for commercial real estate. As indicated in Figure 1, interest rates on the 10-year Treasury and UK long-term gilts have not been this low since the early 1960s. Interest rates are vital in real estate investment because most commercial real estate is purchased with a substantial level of debt. Lower cost debt allows more real estate to be purchased at higher prices. With debt capital relatively plentiful and at historically low rates, returns do not have to be extraordinary in order for many investments to produce acceptable returns. At the same time, real estate's other competitors, bonds and treasuries, wilt under low interest rates. Many investors have been buying on the "spread," that is the difference between debt capital and current net operating income (NOI).

⁶ CISDM Research Department, "The Benefits of Real Estate Investment 2005 Update, June 2005.

⁷ IBID, 2005.

⁸ See section 5, global growth and change, for a detailed account of this phenomenon.



Source: AIG Global Investment Group, 2006.

figure 1

US and UK Long Term Interest Rates

There are many possible reasons for the low interest rates seen around the world:

Global Savings Glut. A contributing cause appears to be an increase in global savings—a savings glut. The aggregate savings ratio has fallen in the US, remained relatively stable in the Euro area and Japan, but increased sharply in Emerging Asia. This is particularly in the case in the People’s Republic of China and more recently in the Middle East⁹ The change in the global savings pattern seems to have contributed to the low long-term real interest rates because a significant portion of the increased savings in Emerging Asia and the Middle East has been held as official foreign exchange reserves and invested largely in US Treasury bonds.

Treasury Bond Purchasing Patterns. While it is true that central banks hold only a small share of the outstanding stock of U.S. Treasury bonds, they have become big buyers in recent years. For example, data from the Bank of International Settlements suggest that central banks financed about 80% of the U.S. account deficit in 2003. The corresponding figure for 2004 is only marginally lower. Such a large net purchase of U.S. Treasury bonds by central banks are believed to have lowered the long-term interest rate. Most estimates suggest that the large reserve accumulation in Asia alone has pushed down U.S. long-term interest rates by 0.4 to 1 percentage points. More extreme estimates place this figure at 2 percentage points.

Low Inflation. A low inflation environment is due in part to improved credibility of monetary policy and the general disinflationary trend in many countries such as China, India and the former Soviet Bloc countries. Major central banks around the world have acted promptly, even preemptively, to address potential inflationary pressures. While there remains some expectation of incipient inflation from strong global demand for raw materials, the reality is that the impact of higher oil prices has so far been much less than during earlier episodes of oil shocks.

With low inflation and increasing economic stability in many countries, interest rates may stay low for a while. While it is true that certain commodity prices are rising, the main component of most traded goods and services is still labor, and this has been declining in real terms. Global factor price equalization (a growing equalizing among countries of the factors of production, including labor, materials and capital) has forced

⁹ International Monetary Fund, 2005.

down the cost of many goods and services.¹⁰ This is not only serving to keep interest rates and inflation low, but it is also prompting additional investment in search of low cost markets for production activities. With GDP growth rates exceeding 6% per annum and a combined population of 2.3 billion, China and India alone are likely to keep factor prices (therefore global inflation) low for some time to come.

Bias Towards Long-Term Investments. Subtle changes in investment patterns in financial markets have been taking place in recent years. Insurance companies and pension funds have favored investments in long-term bonds over equities. This may be attributed to investor concerns over potentially devastating catastrophes, such as terrorist attacks, natural disasters, infectious diseases, or financial crises. Such concerns tend to raise investment in government bonds, which depress long-term interest rates. In the face of global uncertainties, the “flight to quality” argument recalls a time in the 1950’s and early 1960’s when World War III was perceived as possible. During that era long-term interest rates remained low while global growth was strong.

How long interest rates will stay this low is impossible to determine. Certainly, they must rise and revert to the historical mean. But this does not necessarily make real estate less attractive. A higher interest rate usually indicates a more buoyant economy. A stronger economy will boost the demand for real estate of all types, particularly office, industrial and apartments—sectors currently performing less well than the retail and single-family residential sectors. Investors will continue to acquire real estate if they expect increases in property cash flows to offset higher interest rates.

4. Growing Integration with Capital Markets

The perennial drawback to real estate has been its lack of liquidity. Real estate assets are large, lumpy, fixed in one location, and characterized by local (imperfect) information. These negative attributes can be mitigated with securitized real estate investment products which integrate real estate with financial markets and increase liquidity.

Real estate securitization enables the investor to obtain ownership of securities with creditor’s rights instead of a direct object ownership. Through securities the value of real estate transforms from a fixed capital state to a tradable security, thereby broadening investment and participation, and increasing the channels of capital collection for the industry. Essentially, securitization reduces the liquidity risk premium of real estate.

U.S. mortgage market securitization has been explosive—increasing by more than fivefold since the mid-1990s. Commercial mortgage backed securities (CMBS) bring a public financing aspect to what historically was a privately transacted area. These vehicles create supply and demand for funds that compete with traditional equity and fixed income (Figure 2). CMBS provide liquidity and hence allow for more frequent decision making and trading of real estate as a well-defined and analyzed class. This makes real estate amenable to inclusion in institutional portfolios.

Real estate investment trusts (REITs) combine equity and real estate characteristics. The market capitalization of U.S. REITs has increased more than sixfold as indicated in Figure 3. REIT legislation, often modeled after U.S. standards, is becoming common in both developed and developing nations around the world. In the last three years,

¹⁰ Begg, David and Rudiger Dornbusch, *Economics*, 1994.

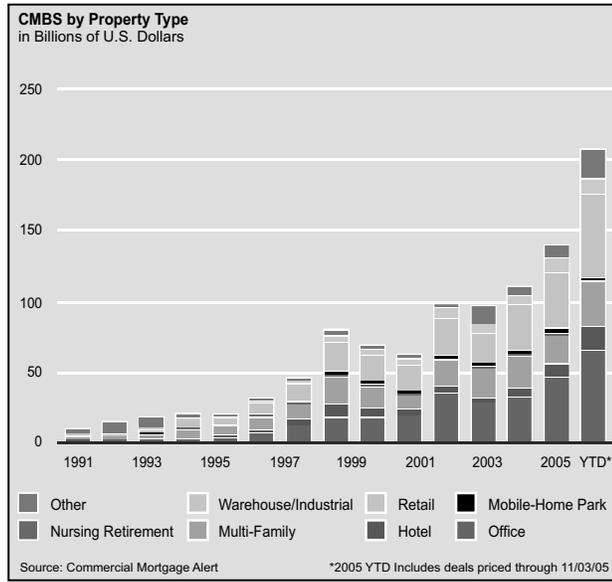


figure 2

CMBS Issuance by Property Type

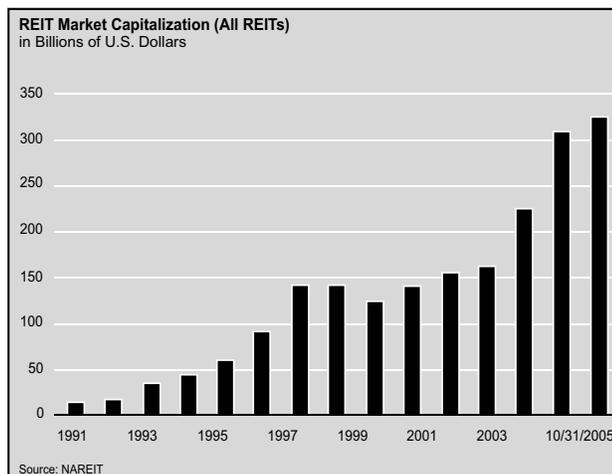


figure 3

Market Capitalization of US REITS

Bulgaria, France, Korea, Japan, Israel, Singapore and Taiwan have all adopted, or modified, legislation enabling REIT-style investment structures. The introduction of REIT legislation in the UK on January 1, 2007 has also encouraged Germany to consider the introduction of a competing structure, the G-REIT. It is anticipated that the G-REIT will be launched later this year. Not only is this legislation spurring the expansion of commercial real estate markets in these countries, it is also promoting more offshore investment by U.S. REITs. Many investors find it easier and less risky to purchase shares in a REIT rather than to make large-scale equity investments. Securitization, whether REITS, CMBS, or a variety of debt vehicles, allows many more investors to enter the market than ever before, enlarging the industry and making it more accessible and transparent. The popularity of securitized products will continue to drive the demand for debt and equity investments as well as mortgages of all types. The translation of real estate into stocks and mortgages has the advantage of making a liquid market with a range products to suit specific investor demand profiles. Most international real estate markets are just starting on the path of real estate securitization.

The integration with capital markets has been aided by the growing liquidity of capital itself. Capital is increasingly footloose as it looks to find the best investments around the globe. The movement of real estate capital worldwide has simply been a part of this general trend. In 2003, the U.S. real estate market witnessed a 59% increase over 2002 in capital from offshore investors.¹¹ This level is estimated to be at least 12% higher in 2004. In the last two years, U.S. opportunity funds have amassed more than \$60 billion in new funds for offshore real estate.

Interest generated by both institutional and individual investors has flooded real estate vehicles with capital. Assets under management of private real estate opportunity funds have grown from roughly \$36 billion in 1997 to \$96 billion in 2002, and it is believed they stood at \$120 billion or more at the beginning of 2005.¹² Over \$6 billion in new assets were gathered by private (non-listed) REITs in 2004 and almost \$4 billion through mid-year 2005.

Consequent with the flood of capital, the number of transactions has increased. The volume of investment real estate transactions worth more than \$5 million increased 24%, from \$118.9 billion in 2003 to \$185.4 billion in 2004.¹³ Within the first three quarters of 2005 transactions had already surpassed these levels, with \$190.3 billion in investments.

As the largest net buyers in 2004, REITs and other public companies increased their holdings of real estate by \$15.3 billion. Within the first three quarters of 2005, privately held national real estate firms acquired \$11.6 billion in property, while REITs purchased just over \$3 billion. Foreign investment continued to rise in 2005 acquiring \$5.9 billion through the first three quarters of the year, compared to \$4.5 billion in 2004.

5. Global Growth and Change: Demographics, Emerging Markets, and Urbanization

Demographics. A critical driver of real estate demand. Population growth worldwide rapidly accelerated in the 20th century and continues to increase. While growth may be leveling off in some industrialized countries, it is still robust in the majority of the world's countries. Increased population requires more housing, shopping, places to work (factories and office buildings), and more hotels for travel and recreation. However, the sheer numbers are only one facet of a growing global population. As people become wealthier, per capita consumption in all goods and services rises. This is particularly true in the real estate sector.

Throughout the world, populations are aging because people are adopting healthier lifestyles and healthcare systems are rapidly improving. In Western societies, and Japan in particular, death rates are declining. These regions are producing fewer children and the population is living longer. These changes alter the nature of the demand for all types of real estate.

The projected change in the demographic structure of Europe provides a striking example. The demographic histogram from 1950 depicts a broad base of young people (Baby Boomers) aged between 0-19 years with a substantial working population between 20-64 years. It is this middle tier which supported the top layer of retirement aged

¹¹ Association of Foreign Investors in Real Estate (AFIRE), 2003.

¹² Pension Consulting Alliance, Inc. (PCA) <http://www.pensionconsulting.com/research.htm>

¹³ Real Capital Analytics, 2005.

population (65 years old and above). The younger population of 1950 now constitutes the bulk of the working age population and the young base is considerably narrower than the working age base. With healthcare and increased life expectancy resulting in a broader retirement band, there will be fewer workers to support an increasingly large retirement population. (Figure 4)

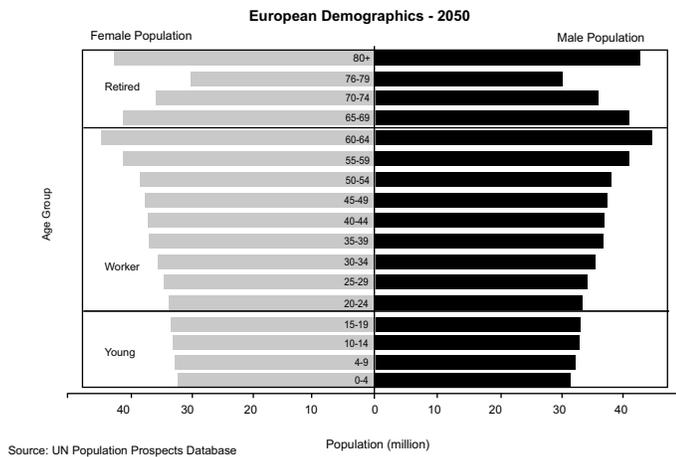
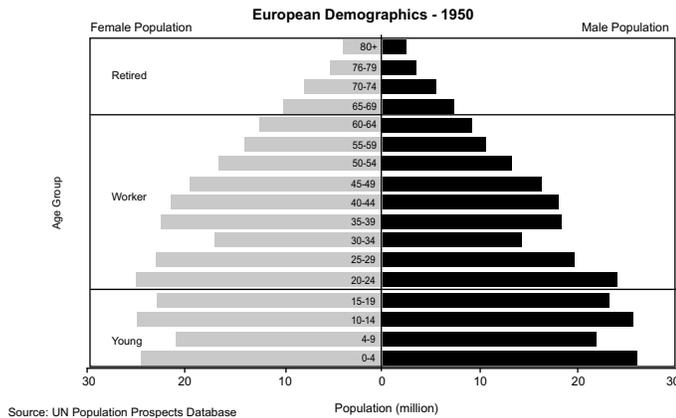


figure 4

Changing Demographics in Europe

By 2050, the retirement aged population is predicted to grow further and will result in an almost inverted pyramid. Pensions and retirement investments become more critical in this scenario.

As an aging population seeks less risky investments, the appeal of real estate will increase. An investor is said to be risk-averse if, when given the choice between a less risky investment with a given return and a more risky investment with the same return, the investor prefers the less risky investment.

Empirical data also supports the “lifecycle risk aversion hypothesis,” which predicts that the older a person becomes, the more risk averse he or she becomes.¹⁴ The underlying explanation for this lies in the relative importance of labor income and asset income over the lifecycle. It is believed that the further a person is from retirement the

¹⁴ Baksi, G. and Z. Chen, “Baby Boom, Population Aging, and Capital Markets,” *Journal of Business*, Vol. 67, No. 2, 1994: 165:202.

more risk they are willing to accept in their investments since the number of paychecks they expect to get is large and labor income can offset any adverse investment outcomes. Thus, as Baby Boomers near retirement they will shift to less risky investments. This heightens the importance of real estate investments as the current income produced by stabilized, institutional real estate is generally considered relatively stable when compared to stocks.

In the United States, the leading edge of the Baby Boomers just turned 60. The Baby Boomers are the wealthiest demographic segment in human history and there are about 75 million in the U.S. representing about 27% of the U.S. population.¹⁵ If we accept that Baby Boomers will increasingly shift to less risky investments, and that real estate is a low risk, high performing asset class, then the level of real estate investment will most likely continue to increase for the next two decades. In 2011, when the first Boomers hit age 65, we may see a dramatic increase in the level of real estate investment, along with a rise in interest rates in treasuries and bonds.

Emerging Market Growth. The National Intelligence Council predicts that global economic growth will be driven by political pressures for higher living standards, improved economic policies, rising foreign trade and investment, the diffusion of information technologies, and an increasingly dynamic private sector.¹⁶

Figure 5 shows that the world's population stood at 6 billion people in 2000. By 2050, the world's population, per the mid-range forecast, is estimated to be almost 9 billion people — a nearly one-third increase! It is not just the sheer numerical increase, but the distribution of the population that is important. In 2050, of the nearly 9 billion people living on the globe, 7.75 billion (85%) will be living in emerging markets while only 1.15 billion (15%) will be living in developed countries. Populations in Europe and Japan will actually decline, while the population in the rest of Asia will register an increase of nearly 70%. The U.S. is expected to add only 50 million people to its population over the next 20 years.

Many emerging markets are currently experiencing high GDP growth. These countries are in the basic stages of economic development with little useful building stock for their current economic and industrial demands. Countries are in essence leapfrogging from basic, extractive and agriculturally based economies that have been internally focused to industrial, diversified and externally focused economies. The demand for international class office, housing, industrial, retail, and hotel far outstrips supply in many emerging market countries. As a result, real estate markets in these countries are expected to experience disproportionate expansion in the real estate sector (new and renovated buildings of all types) to accommodate the growing demand for larger quantity and higher quality assets.

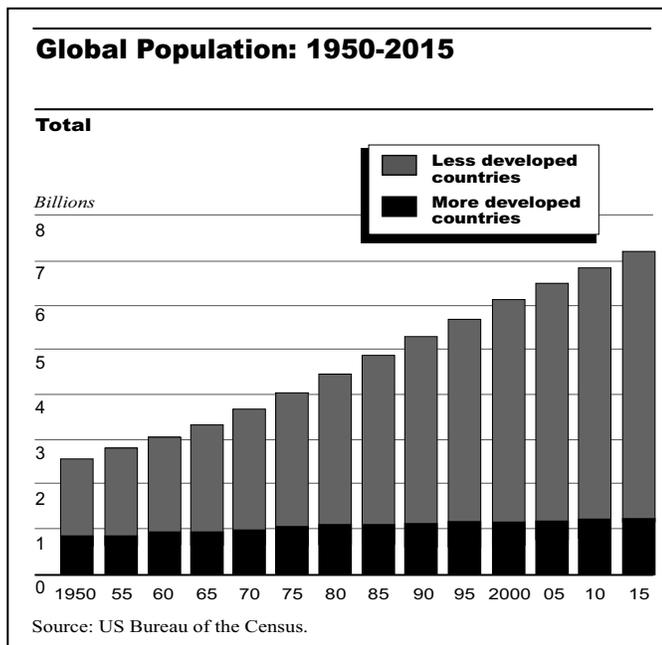
Moreover, the growth of the middle class in these countries and the convergence of global middle class aspirations are pushing the need for modern housing and retail. India alone requires some 30 million new housing units by 2015 to satisfy the demand from its growing population.¹⁷

“In 2011, when the first Boomers hit age 65, we may see a dramatic increase in the level of real estate investment.”

¹⁵ U.S. Department of Census, 2005.

¹⁶ National Intelligence Council, “Global Trends 2015,” 2000.

¹⁷ David J. Lynn, AIG Global Real Estate Group, “Strategic Analysis of the Indian Property Market, 2005.



Population Projections for World Regions, Three Scenarios for 2050

Region/country	Population in millions			
	2000	2050		
		High	Medium	Low
World	6,055	10,674	8,909	7,343
More developed	1,188	1,361	1,155	990
Less developed	4,867	9,313	7,754	6,353
Africa	784	2,102	1,766	1,467
Sub-Saharan Africa	641	1,804	1,522	1,272
Asia	3,683	6,316	5,268	4,312
China	1,278	1,686	1,478	1,250
Japan	127	117	105	92
Latin America & Caribbean	519	994	809	654
North America	310	464	392	324
Europe	729	746	628	550
Oceania	30	52	46	36

Source: UN, *World Population Prospects: The 1998 Revision* (1998).

figure 5

Population Projections

Accelerating Urbanization. People are increasingly able to relocate to cities, regions, and countries where they can find better economic and lifestyle opportunities. This is spurring growth particularly in so-called “global gateway” cities such as London, New York, Hong Kong, and so on. More significant than international immigration though, is the rural to urban migration occurring at a massive level within many emerging markets. With improvements in communications and transportation, people from rural areas are flocking to major cities in search of a better life. This trend will continue well into the 21st century as long as the income of urban areas outpaces that of the rural hinterlands. (Figure 6)

Up until World War II, most of Asia, Africa and Latin America were rural in nature. After the war, there was an acceleration of industrial production in many emerging

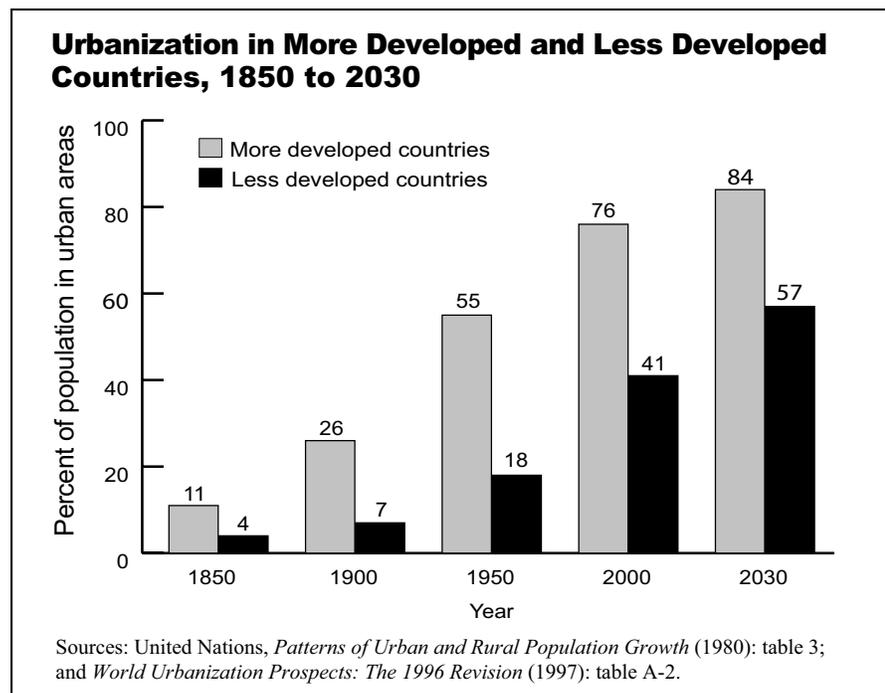
markets. Between 1950 and 1975, the urban populations of less developed countries grew at 4% annually, much faster than in more developed countries.¹⁸ The urban population more than doubled over that period and the percentage of residents living in urban areas in less developed countries rose from 18% to 27%. About 60% of the urban population growth came from natural increase and 40% from in-migration.¹⁹

Cities have long been the place of opportunity, and greater social and political freedom. In addition, as emerging market countries become less dependent on agriculture and as they automate, far fewer workers will be needed on the farm than today. In China alone, it is estimated that 200 million people will migrate to the cities from the countryside by 2020.²⁰

The combination of population increase and rapid urbanization will drive the demand and value of real estate in many emerging market cities. Even within developed countries, populations are congregating in ever larger urban agglomerations. Known as “megalopoli,” these urban areas are spreading across major regions of the U.S. pushing up land and building values and making real estate increasingly valuable.²¹ This explosive growth translates into hundreds of millions of new urban residents in major cities around the world. With greater numbers of people living in roughly the same urban areas, the value and economic returns of real estate will increase with its scarcity. Center city locations and transit-oriented sites should become disproportionately valuable.

figure 6

Urbanization Trends



¹⁸ Gelbard, Alene, Carl Haub, and Mary Ken, “The World Beyond Six Billion,” Population Reference Bureau, 1999.

¹⁹ IBID.

²⁰ Wu, Harry, “Research on Rural-to-Urban Labour Migration in Post Reform China: A Survey, 2005.

²¹ Peirce, Neal, “Megalopolis Comes of Age,” Courant.com, August 28, 2005.

6. Global Outsourcing

It is estimated that one-ninth of the world's service jobs can be done from anywhere in the world, including taking orders at a drive-through, researching stocks, designing aircraft cockpits and vetting medical X-rays. In fact, all four jobs are already being actively outsourced.²² The location of jobs impacts the demand for the buildings in which to perform them, even if they are thousands of miles removed from the end user.

The trend of global outsourcing is part of the larger trend of vertical industrial disintegration and globally dispersed supply chains. Increasingly, companies can locate assets and labor anywhere in the world to minimize costs and maximize profits. Outsourcing has been a fact of capitalism time immemorial, but has accelerated over the last decade due to the furthering of the dispersion of the supply chain. In the 1990s the service sector saw a significant amount of outsourcing. The main drivers of service sector outsourcing have been: 1) rising skill profiles of emerging market economies in terms of productivity adjusted for the cost of labor; 2) digitization of services and service provision, widespread use of networked computers as a consequence of the falling price of computing power; and 3) increased market access brought about by globalization.

Outsourcing has had the effect of reducing real estate demand in industrialized countries while stimulating demand in emerging markets, particularly for office and industrial. From 1990 to 2002, low and middle income nations increased their share of global services exports by 50%, as high income countries saw their share decline. According to the World Bank, India's and China's services exports expanded by more than 15% per year in the 1990s, compared with an increase of less than 6% per year worldwide.²³

As recent as the mid-1990s, the notion of a company shifting its entire programming department to Bangalore or Moscow was considered highly unusual. The basic concept of saving money by using knowledgeable, lower-paid employees was still the same, but telecommunications and computer technology had not advanced enough to make it sufficiently practicable.

Now, a decade later, it is a mainstream concept. A 2002 survey by Forrester Research²⁴ estimated that "demand for offshore outsourcing will account for 28% of IT budgets in Europe and the U.S. within two years," and a more recent study by the Gartner Group indicated that by 2004, eight out of ten CIOs in American companies had "direct marching orders to move offshore at least part of the technology services they provide to their businesses." Even more significantly, the study found that "four out of ten companies will already have done so."²⁵

Those statistics suggest a realignment of comparative advantages with the specializations of what each country does best. In India's case, opening the economy to world competition in the 1990s brought its advantage starkly into light. From 1996 to 2000, India's comparative advantage in exported services like software development grew 327% (according to the World Bank), while its advantage in manufactured goods

"Outsourcing has had the effect of reducing real estate demand in industrialized countries while stimulating demand in emerging markets."

²² Giridharadas, Anand, "India Seeks to Codify the Rules on Outsourcing," International Herald Tribune, December 19, 2005.

²³ World Bank, "World Development Indicators," 2005.

²⁴ Forrester Research, "Outsourcing Survey," 2002.

²⁵ IBID.

declined by 15%. The statistics reflect whether a country is more or less likely than its peers to export a particular good or service.

Accelerating the trend is the fact that developed economies will soon face acute shortages of working-age people. They will have to either import people or export work. The trend towards outsourcing jobs to foreign countries has clear implications for regional and national economies as well as office and industrial real estate in particular.

In countries such as China and India where many jobs are being created by multinationals, there is the prospect that real estate investors will be more interested in acquiring assets occupied and/or owned by Western corporate tenants. As the world becomes more integrated economically, we can expect outsourcing to become an ever increasingly important phenomenon.

In Western developed countries the demand for office and industrial real estate has been negatively impacted by this trend, though it is difficult to estimate the magnitude. Another implication is that demand, again mainly in office and industrial, will be much more specialized than ever and it will be much more global in nature. This will make it increasingly difficult to forecast demand strictly from the local market. Most of the new office and R&D demand for the city of Bangalore derives not from local companies, but from large multinationals outsourcing their back office operations in the city.

We can only expect the outsourcing trend to grow as the cost of transporting service work drops further and as wages continue to rise in industrialized countries.

Conclusion

These ongoing tectonic forces are permanently altering the underlying configuration of the global commercial real estate landscape. While these changes are creating tremendous challenges through increased competition and falling capitalization rates, they are also bringing about significant opportunities in the form of increased capital, better information, a wider array of real estate investment vehicles and a growing market. The transformation of real estate as a core asset class has also introduced more professionalism and talent into the industry. Real estate has become an essential and increasingly more significant component of most institutional investment portfolios. Low interest rates will make real estate easier to develop and own for firms and individuals. Rapid urbanization and population growth in emerging market countries will mean expanding and new demand for commercial real estate in countries around the world.