2017
United States
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THE OUTLOOK FOR 2017
UNITED STATES

ECONOMIC OVERVIEW/ MACRO OUTLOOK

The election of Donald Trump has the potential to change the economic landscape for years to come. Several of his proposals (infrastructure in particular) could boost the economy later in 2017, just as growth may be slowing. Other potential policies (tariffs and other trade restrictions) are more concerning and may be a drag on growth over the longer term. We remain mildly optimistic for the U.S. economy, but the variance of possible outcomes has grown. Watch for multiple Fed moves in 2017.

Post-election market optimism and policy changes may lead to higher growth

OFFICE

The U.S. office market is poised for a moderate slowdown in 2017 due to a combination of increasing new supply and softer tenant demand, with firms finding it increasingly difficult to secure qualified workers. Competition for talent is particularly acute in the tech industry, and finding skilled labor will be critically important to that sector’s expansion and to office demand. Whether any new immigration policy will hinder this remains an open question. More broadly, competition for talent has firms continuing to explore a range of workplace innovations.

2017 rent growth projected to reach 1.5%

CAPITAL MARKETS

Wide availability of capital should continue in 2017, though bond volatility and regulatory pressure may dampen CMBS and bank-lending activity. The spread between cap rates and Treasurys is wide enough that the incremental moves the Fed is likely to make next year will not necessarily result in significantly higher cap rates. A comparatively strong economy and a scarcity of high returns elsewhere has kept the U.S. a favorite destination for foreign capital.

International capital flows into the U.S. will likely remain very strong

OCCUPIER

Talent attraction and retention continues to be a leading enterprise priority, even as continued slow economic growth has many occupiers renewing their focus on containing costs. These concerns will persist through 2017 as companies are likely further challenged by economic uncertainty and changes in availability of workers and skillsets. Ongoing technological and workplace innovation will continue to be a critical element in how companies leverage their human resources, and in how buildings best serve their tenants.

Attracting and retaining talent continue to be leading enterprise priorities
THE OUTLOOK FOR 2017
UNITED STATES

INDUSTRIAL & LOGISTICS

After a strong year, we continue to ask, “How much longer can this go on?” The market remains well-positioned to benefit from both cyclical and structural changes in 2017. Perceived economic risks have dissipated and consumer demand remains buoyant. Technology continues to generate growing demand. Provided there is no major change to trade policy, a big question mark, rising supply growth will be the market’s greatest short-term risk—and not a huge one, given that vacancy rates are at historic lows.

U.S. e-commerce sales forecast to rise by a 9.3% annual average over the next five years

RETAIL

Consumer spending and e-commerce will maintain healthy growth rates in 2017. Retailers and landlords will continue to innovate in their efforts to attract customers—particularly in delivering shopping experiences centered on entertainment concepts, dining and technology. Rising demand for non-traditional brands and venues will continue to encourage new leasing structures that account for greater risk to both landlords and tenants. The strongest rent growth is expected in markets with the strongest job growth.

National retail rents forecast to grow at a 1.7% annual average over the next five years

MULTIFAMILY

Expect slower rent growth and rising vacancy in 2017. The current cycle’s development peak will likely occur in 2017, and oversupply is the market’s most prominent near-term risk. High-end development, prevalent in recent years (particularly in downtowns and gateway markets), may be approaching a turning point, as fundamentals for these newer buildings have slowed considerably. Suburban growth is outpacing urban in an increasing number of markets, resulting in strong suburban rent and occupancy growth, as well as public and private efforts to reproduce downtown amenities in the lower-cost setting.

Nearly 260,000 multifamily completions expected in 2017

HOTEL

Economic conditions promise continued demand for the hotel industry, leaving the sector’s prospects for 2017 largely to local market fundamentals. Nationally, the year-over-year changes in supply and demand are converging, but conditions vary by market. The greater opportunity will be found in markets with significant investment in infrastructure or private capital projects, while the greater risk will be in markets facing oversupply.

U.S. ADR expected to grow by 3.3% in 2017
At 2:29 a.m. on November 9, 2016, the announcement that Donald Trump would be the 45th president of the United States surprised the world. The immediate reaction of global markets to Mr. Trump’s election resulted in sharply falling stock market futures, lower bond yields, higher gold prices and other indicators of negative sentiment. But by the end of first day of trading, it was business as usual, and by November 11 the mood had shifted completely from uncertainty to optimism.

At least two important economic changes occurred on November 9. The first is that with the election of Mr. Trump, combined with Republican control of Congress, most economists revised their U.S. growth expectations for 2017 upward by 50 to 75 basis points (bps) because of the president-elect’s proposed policies of lower taxes, less regulation and increased infrastructure spending. While we expect to see more fiscal stimulus, increased growth of 50 to 75 bps is optimistic from our point of view due to the time it takes for Congress to enact legislation. We think the bigger impact is likely in 2018. This, combined with Mr. Trump’s expected pro-business attitude, has positively shifted growth expectations and investor sentiment.

The second change is the market’s demonstration of increasing resilience to unexpected news events such as the Chinese stock market correction in August 2015, the drop in the price of oil in February 2016, and the Brexit vote in June 2016. In each instance, the market’s initial negative reaction faded—to the point that concerns over Mr. Trump’s election lasted for less than a day. Positive growth, plus a resilient market, translates into stronger economic expectations for 2017 than existed only a few weeks ago.

In this 2017 U.S. Market Outlook, we balance this post-election market optimism with the understanding that market conditions have softened for many major asset classes. Old-school notions of commercial real estate supply and demand still matter and are the primary driver of our forecasts. Neither do we ignore the massive secular changes that are underway, especially with respect to technological advances that impact job growth.

Market optimism and the prospect of stronger economic growth have recently led to a substantial spike in interest rates, which raises the specter of rising cap rates. At the time of this writing in early December, the market has shown some immediate concern, manifested by lower loan-to-value ratios, some owners delaying refinancing decisions, and additional buyer-seller negotiation on price. We will track changes in interest rates closely in 2017 and have taken these factors into consideration in our forecasts.

Please read on and learn more from our 2017 market forecast. We encourage you to reach out to your local CBRE professionals for their up-to-the minute view of market conditions, which, as the events of the past month have demonstrated, can change at any moment.
The election of Donald Trump as the 45th U.S. president has the potential to change the economic landscape for years to come. Until Mr. Trump has settled into office, it will be difficult to know the exact form his policies will take or how the Republican Congress will react to his proposals. Several of his campaign proposals have the potential to give the economy a boost later in the year, just as growth may be slowing. Others are more concerning and may manifest drags on growth over the longer term.
**POTENTIAL GROWTH: INFRASTRUCTURE**

Among Mr. Trump’s campaign proposals, higher investment in infrastructure holds the greatest potential to benefit the economy. It has been several decades since the country has upgraded and replaced aging infrastructure at a sufficient pace to keep things running smoothly. Mr. Trump has promised to spend a trillion dollars over a decade to fix, repair and update many of these structurally deficient areas. If this spending is done in a well-considered manner—contrasting the rushed transportation bill passed by Congress during the financial crisis of 2007-2008—it has the potential to raise GDP growth by 50 to 75 basis points (bps) annually. If Congress and the president take the time to do this properly, the spending won’t contribute to GDP growth until 2018, just when the economy may be slowing. This would boost GDP without causing inflationary pressures, since the economy would have begun to slow.

Changing the tax code also could create economic gains. President-elect Trump has promised to simplify the tax code while cutting tax rates. Several members of Congress have also addressed this issue. If this is done well, a simpler tax code with lower rates has the potential to boost GDP growth. Any tax reform takes time, so this likely wouldn’t go into effect until 2018, just as the economy might be poised to slow. The added spending power it would grant consumers might be just what is needed for the economy.

![Figure 1: GDP Growth by Forecast Scenario](image-url)

Source: CBRE Econometric Advisors, Q3 2016.
RISKS: TRADE POLICY AND IMMIGRATION

Two potential risks to the economy are trade policy and immigration. As the president has considerable latitude on trade and immigration policy, Mr. Trump could cancel or suspend compliance with NAFTA and the World Trade Organization, as he has promised. During the campaign, Mr. Trump called for the imposition of tariffs on imports from Mexico and China, but he has moderated his position since then. Were he to move forward on trade policy as he has proposed, it could negatively impact GDP growth by 50 to 75 bps over the next few years.

Mr. Trump's election and the recent U.K. vote on Brexit have shined a light on the concerns many people have about free trade's impact on domestic jobs. The Trans-Pacific Partnership (TPP), which might have boosted GDP growth by 25 bps, will not be submitted for congressional approval. If Mr. Trump follows through with his tariff promises, we would expect higher prices on foreign-made goods and U.S.-made goods made largely of foreign parts. There also is the potential for retaliation in the trading sphere, particularly from China, dampening U.S. exports and possibly resulting in a trade war. Trade restrictions might accelerate automation in U.S. manufacturing, rather than create import-substituting jobs.

There may be substantial changes to the H1B and EB-5 visa programs. Immigration proposals have the potential to effect a growing skills mismatch in the labor market—particularly in the technology sector. Any restrictions that slow the immigration of skilled workers might exacerbate this mismatch for the types of jobs that cannot currently be automated. This would hurt the office market, which is already slowing.

A change in the EB-5 program could raise the cost of capital for certain projects, or prevent them from getting financing. This could impact construction job growth, cap rates and movement of skilled labor into the U.S.

We are still mildly optimistic for the U.S. economy, but the variance of possible outcomes for the economy have grown. Prior to the election, our forecast for economic growth was in a tight range of 2.0% to 2.5%. That range has now widened to 1.5% to 3.5%.
The 2017 outlook for the U.S. capital markets—encompassing debt and equity investment activity, pricing and performance, as well as investment strategy—is largely favorable. Acquisitions activity should remain high, if slightly lower than 2016. International capital flows into the U.S. will likely remain very strong, with China again the leading source. Most types of debt capital should remain widely available. As asset appreciation abates, investment returns are likely to decline, but nevertheless still achieve favorable levels. The year is likely to start slowly as buyers and sellers await the new administration’s policies.
INTEREST RATES AND CAP RATES
The interest rate environment is one of the largest influences on the capital markets. With the U.S. economy continuing to expand, the Federal Reserve Board is likely to engage in two rounds of monetary tightening, increasing short-term rates in 2017. Longer-term interest rates, however, should remain stable or increase only modestly, as they have already jumped nearly 50 bps in the two weeks since the election. The 10-year Treasury yield will likely remain between 2.25% and 2.75% throughout 2017. Investor demand for the inherent safety of U.S. debt should continue to offset upward pressure on long-term yields from the Fed and the prospect of higher inflation.

Slightly higher bond yields will have a limited impact on capitalization rates, thanks to strong economic and commercial real estate fundamentals, in addition to solid demand from foreign investors. The spread between cap rates and Treasurys—a proxy for the additional returns commercial real estate is expected to yield relative to low-risk government bonds—is wide enough that the incremental moves the Fed appears poised to make will not necessarily result in higher cap rates. We expect CRE cap rates to remain steady in the markets where fundamentals are still improving. Similarly, commercial real estate values should remain steady during this period.

FOREIGN CAPITAL
Although accommodative monetary policy has kept bond yields low relative to their historical levels, a comparatively strong economy and a scarcity of high returns elsewhere has kept the U.S. a favorite destination for foreign capital. This is particularly true of commercial real estate, which has performed well during the current economic expansion. As of Q3 2016, total deal volume for all CRE property types was down 2% from a year earlier; however, the volume of foreign capital remains robust, with more than $80 billion invested in U.S. CRE in the past 12 months.

Plans for expansionary fiscal policy with the incoming presidential administration have raised expectations for economic growth and inflation, both of which make investment in real assets like CRE more attractive. As a result, we expect foreign institutional investors and sovereign wealth funds to increasingly look to the U.S. to fill their real estate portfolios in 2017.

The preference for liquidity will keep highly sought-after properties in gateway markets popular, but secondary markets such as Dallas/Ft. Worth and Atlanta are poised to attract a greater portion of foreign capital as investors become more comfortable investing outside of premium core product. For example, foreign investors in multifamily may look to secondary markets with better fundamentals, since rental growth has turned negative in some gateways, such as San Francisco and New York.

DEBT CAPITAL ABUNDANT; SOME CLOUDS ON THE HORIZON
Capital for financing commercial real estate in the U.S. (where debt, on average, represents roughly two-thirds of total investment) should continue to be widely available in 2017. There remain two challenges to mortgage capital availability, however: CMBS and bank lending, especially for construction loans.
The CMBS market fell in 2016. Volatility in the bond markets during Q1 and a changing regulatory environment led to substantially lower levels of issuance (about $75 billion, versus 2015’s $101 billion) and a smaller number of CMBS shops. The CMBS industry will likely adapt adequately to the risk-retention rules taking effect in late 2016; however, the new rules will add costs to the conduit lenders, and it is not yet clear how those costs will be absorbed. Another 2017 challenge for CMBS—though it is difficult to predict—might be periods of high volatility in the bond market. Such volatility can create pricing uncertainty in CMBS, and make conduit loans less attractive to borrowers.

Banks are also facing regulatory pressure, which may reduce their financing activity in 2017 for both existing assets and development projects. The latter is particularly problematic, since banks are the primary source of construction capital in the U.S. For construction financing, the industry is likely to see continued tightening of credit standards and higher loan costs at a minimum; a notable decrease in the actual volume of construction loans is quite likely as well.

Other sources of mortgage capital—particularly life insurance companies, Fannie Mae and Freddie Mac—are expected to remain very active in 2017, with lending most likely exceeding 2016 volumes.

Figure 2: NCREIF NPI Capitalization Rates: National Sectors

NCREIF Cap Rate, Treasury Rate

Source: NCREIF, CBRE Econometric Advisors, Q3 2016.
Banks are also facing regulatory pressure, which may reduce their financing activity in 2017 for both existing assets and development projects. The latter is particularly problematic, since banks are the primary source of construction capital in the U.S.
The U.S. office market is poised for a moderate slowdown in 2017, due to a combination of softer tenant demand and an increase in new supply. Firms are finding it increasingly difficult to find qualified workers, which is reflected in the low unemployment rate, the near-record number of job openings, a steady increase in the number of “quits” (an indicator of worker confidence), and real wage growth. Given the labor force constraints, we expect 2017 to register a lower net gain in office-using jobs: 273,400—down from 2016’s anticipated 413,600 and the 2010-2016 annual average of 418,100.

Meanwhile, we expect more than 50 million sq. ft. of office space completions in 2017—the most since 2009. Though this will be low compared to previous cycles, the introduction of new product at a time of anticipated slow demand will likely result in a modest increase in the vacancy rate (our forecast indicates 30 bps, to 13.3% from 2016’s 13.0%). Rents will likely increase by about 1.5% over the year, continuing to slow from the 2014-2015 rates of 4.0% to 4.5%, the current cycle’s fastest growth.
DOWNTOWN MARKETS TO SOFTEN

The suburban office market, which has lagged the downtown market during this cycle, will likely outperform in 2017, although this will vary significantly according to each submarket’s unique demand drivers, quality of office product and live-work-play environment. We expect the suburban vacancy rate to increase by just 10 bps in 2017, to 14.5%, with rent growth to exceed 2%.

With demand in some of the largest downtown office markets beginning to slow in 2016, the national downtown market will likely soften further in 2017, due in part to nearly twice as much new supply coming online in 2017 as did in 2016. We expect the vacancy rate to increase by 30 bps for a second consecutive year, to 10.9%—still well below the suburban vacancy rate. Downtown rent growth is expected to slow further as higher vacancy shifts bargaining power in the direction of tenants.
TECH REMAINS A CRITICAL DRIVER

Growth in the tech sector will be critical for continued office-using job growth and demand. The high-tech industry accounts for nearly one-fifth of the major office leasing activity since 2014. As CBRE’s Tech Thirty 2016 report notes, however, tech employment growth slowed to 4.0% in 2016, significantly below the past five years’ annual average of 7.3%. As the pool of high-tech workers shrinks, the industry relies more heavily on recent graduates and foreigners on work visas. With competition for talent particularly acute in the tech industry, finding skilled labor will be critically important to the tech sector’s continued expansion and to office demand, both in established tech hubs such as the San Francisco Bay Area and Manhattan and in emerging, lower-cost markets such as Phoenix, Atlanta and Portland.

The promotion of innovation and an entrepreneurial spirit are cornerstones of the U.S. tech sector, and this is true of startups and established companies alike. Expanding STEM program enrollment, facilitating the flow of high-skilled tech workers into the U.S. and fostering an environment that supports innovation will reinforce the U.S. high-tech sector’s global strength and thus support demand for office space domestically. Given the uncertainty in the wake of the recent U.S. presidential election, we will continue to monitor policy actions that relate to these growth drivers and to report on their potential impact on the tech sector and office demand.

Figure 5: U.S. Leasing Trends by Industry

Note: Includes the 25 largest transactions by sq. ft. each quarter for the 54 markets tracked by CBRE Research.
Source: CBRE Research, Q3 2016.
SHRINKING TENANT FOOTPRINTS

We expect markets in the South and West to see the strongest office-using job growth in 2017; these include many that have been slower to recover during this cycle, such as those in Florida. Many of these have little or no new supply underway, which will limit options for tenants interested in the most desirable submarkets and the highest-quality buildings, and give owners greater leverage. These markets may offer attractive development and investment opportunities as tight market conditions push rents up further.

Tenants’ increasing efficiency in their use of space is a trend that will continue to broadly affect demand, yielding less absorption for each job created than occurred in previous cycles. Many tenants are using their greater space efficiency to trade a larger footprint for higher-quality space, offering employees a more appealing work environment. This will become increasingly important as the competition for talent intensifies. Buildings whose infrastructure is capable of handling higher employee headcounts will likely benefit from this trend, while older, non-renovated buildings in less desirable locations will struggle.

Figure 6: Forecast Office-Using Job Growth by Metro, 2016-2017

Note: Ranking includes markets with at least 150,000 office-using jobs as of 2016.
Source: CBRE Econometric Advisors, Q3 2016.
Growth in the tech sector will be critical for continued office-using job growth and demand.
DEMOGRAPHICALLY DRIVEN DEMAND

As an asset class, medical office buildings (MOB) are recession-resistant. Their tenant demand is fueled by demographic trends, rather than economic growth. Throughout the current cycle, MOB has been a strong segment, and a bright spot in many markets where improvement in other office-using sectors has been slower. Within the broader U.S. office market, it should remain an attractive niche in 2017 and through the long term, benefitting from demographic trends, increased healthcare utilization and spillover from ongoing expansion in the life sciences industry.

Investment volume has trended down slightly over the past year, but the 2016 average through Q3 is still 45% above the 10-year quarterly average, according to Real Capital Analytics (RCA). Moreover, competition for quality MOB investments remains high, and cap rates have fallen to record lows this year. Cross-border investment has been a growing source of capital in this segment, and MOB assets are well-positioned to capture more foreign dollars in 2017 as buyers seek out higher yield—but still relatively safe—investment opportunities.

The healthcare industry continued to see marked consolidation activity in 2016, including mergers among major health systems, hospitals acquiring physician and specialist practices, and small physician groups combining their practices to save on real estate and overhead costs. This trend will continue in 2017 as providers of all sizes stay focused on cost-cutting in the face of declining reimbursement rates from both Medicare and private insurance companies. On the whole, this should be a net positive for real estate investors, as the credit profile for medical tenants strengthens in line with their growth and diversity.
CONSOLIDATION DRIVES CONSTRUCTION

Consolidation has been the major driver of new MOB construction in recent years, as many markets have lacked the necessary large blocks of space to meet the requirements of newly expanded healthcare providers, particularly in proximity to hospitals. With merger and acquisition activity expected to increase, tenant demand for smaller medical office space is likely to weaken. This market dynamic will benefit MOBs that can accommodate large practices, and will likely improve tenant retention.

Although completions will remain well below the prior cycle’s averages, supply-side pressure may increase somewhat in 2017. MOB space under construction totaled 18.4 million sq. ft. at the end of Q3 2016; this new product will come online in an environment of slower demand, as tenants react to the uncertainty of a new presidential administration.

The Trump presidency poses a significant number of unknowns to the healthcare industry, and many healthcare providers will delay making new commitments until there is more information about potential regulatory changes. A full-scale repeal of the Affordable Care Act (ACA)—and the steep decline in healthcare utilization such a change would precipitate—is highly improbable, given the millions of Americans that would immediately be without insurance, as well as the implications it would have for higher deficit spending.

Over the long term, the wave of aging baby boomers will drive rising demand for healthcare services, irrespective of any regulatory changes. U.S. education and health services (EHS) employment (of which healthcare represents about 70%) is projected to increase by 1.7% in 2017—roughly 350,000 jobs, on net—and by 7.8% (1.3 million, on net) over the next five years (see Figure 7). Growth in this sector correlates strongly with expected population growth, particularly of older residents. Among large metros, the strongest EHS employment growth is expected in the South and West, whose markets, with their moderate climates and affordable costs of living, are attractive places for relocating retirees and working professionals. The metros with the weakest expected EHS employment growth are in the East and Midwest—big cities whose retirees tend to move to warmer climates. However, many of these slow-growth metros also have the highest concentrations of healthcare employment relative to the total employment base, and their well-established healthcare networks and infrastructure will remain appealing to both landlords and investors.

Overall, both tenant and investor demand for MOB should remain solid in 2017. Fast-growing metros will provide more new product and opportunities for expansion, while many slower-growing metros will offer large, reliable tenant pools and more value-add investment opportunities.

Within the broader U.S. office market, MOB should remain an attractive niche in 2017 and through the long term, benefitting from demographic trends, increased healthcare utilization and spillover from ongoing expansion in the life sciences industry.
**Figure 7a: Healthcare Employment is Less Concentrated in High Growth Markets**

Top 10 Markets by Forecast Job Growth in Education and Health Services

- Phoenix
- Tucson
- Las Vegas
- Salt Lake City
- San Antonio
- Orlando
- Dallas
- Austin
- Atlanta
- Riverside

Healthcare Location Quotient (R)

2017 EHS Job Growth (L)

Avg. Location Quotient, Top 10 (R)

Note: The location quotient represents the ratio of an occupation’s share of employment in a given area to that occupation’s share of employment in the U.S. as a whole.

Rankings are for metros with populations of at least 1 million.

Source: BLS, Moody’s Analytics, CBRE Research, 2016.

**Figure 7b: Healthcare Represents a Larger Share of the Local Economy in Low-Growth Markets**

Bottom 10 Markets by Forecast Job Growth in Education and Health Services

- Philadelphia
- Baltimore
- New Orleans
- Boston
- Pittsburgh
- Hartford
- Cleveland
- Buffalo
- Providence
- New York

Healthcare Location Quotient (R)

2017 EHS Job Growth (L)

Avg. Location Quotient, Bottom 10 (R)

**Figure 8: Medical Office Space Under Construction vs. Growth in Healthcare Employment**

Source: CBRE EA/Dodge Pipeline, BLS, Moody’s Analytics, 2016.
COMPETITION FOR TALENT DRIVES INNOVATION

Attracting and retaining talent remain leading enterprise priorities, though the enduring slow economic growth has prompted many occupiers to renew their focus on containing costs. We believe this focus will persist through 2017 as companies are likely challenged further, given continued economic uncertainty across industries.

Talent attraction and engagement will continue rising in importance as demographic shifts affect in-demand skillsets. Of particular note, if President-elect Trump implements the immigration reform he promised during the campaign, the pool of available tech workers—which has been increasingly augmented by foreign talent in recent years—may diminish.

Although millennials are the largest and fastest-growing contingent of the workforce, it is important to recognize that they, Gen Xers and baby boomers each make up roughly one-third of the workforce. Occupiers will continue to consider this diverse workforce as they implement workplace enhancements that maximize their competitiveness. Today’s highly skilled and flexible workforce values a well-designed workplace; space for private, focused work; and services and amenities that align with their lifestyle.

A recent CBRE survey found that more than 70% of corporate employees are willing to trade benefits such as employer recognition and ease of commute in exchange for better office environments. The cutting edge in office environments favors activity-based workplace design—which enables employees to customize their workplace on demand—over one-size-fits-all...
solutions. Activity-based floor plates are currently among occupiers’ most piloted efforts; we believe their adoption will likely increase.

Alongside the trend toward creating more modern, user-focused work environments, increasing workplace amenities has become the norm. Occupiers now aim to provide more than a pleasing aesthetic; the goal is a multi-faceted environment that provides users with an unmatched experience, connecting their personal and professional personas and improving their well-being. Many office workers now expect the workplace to incorporate wellness considerations and experiences, such as access to green space. Responding to this trend, 91% of corporate real estate executives expect their level of engagement in health and wellness to increase. Health and wellness is no longer an afterthought; rather, how it might be built into a workplace is deliberated as early as the site-selection stage. Accordingly, 45% of CRE executives report a preference for buildings that offer a connection with nature, such as running trails and rooftop gardens, while 38% are piloting fitness and well-being amenities.

SMART SPACE USAGE: CO-WORKING AND TECHNOLOGY

Whether a traditional workplace is updated in design and appearance, it often remains an inflexible liability on its occupier’s balance sheet. Organizations and end-users alike are seeking workspace flexibility through shared-workplace options like co-working. Innovative partnerships among tenants, co-working operators and landlords are becoming more commonplace.

Significant advancement in CRE technology has dramatically raised the efficiency and effectiveness of a mobile workforce, and real estate strategies are now being devised in response. The typical user of a co-working facility was once a freelancer who worked out of a home office. More recently, typical users are employees who previously occupied space in traditional offices.

Technology is affecting not just how occupiers use space, but how they manage it. Real estate technology firms are growing rapidly in both number and value as a consequence. The trend is pervasive, affecting everyone from brokers to CRE executives, to everything from office to residential. Effective use of occupier-related applications will allow managers to produce and collate data that can be instrumental in more efficiently assessing and deploying real estate strategies. From smart buildings to space utilization, technology’s uses and implications for real estate are boundless.

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A VERY STRONG YEAR

Entering 2016, the general expectation for the U.S. industrial & logistics real estate market was that it would transition into a slower-growth phase. This was based on a combination of broad economic uncertainty and the inevitability of a slowdown after such a long period of expansion. The market has continued to confound expectations, however, with a year that has been among the strongest in a decade. Now nearing the end of 2016, the market has achieved some impressive milestones: a recovery stretching to 26 consecutive quarters of positive net absorption, the longest such streak since CBRE began tracking the data; availability at 15-year lows; and an overall net rent figure that has surpassed the previous cyclical high and is on target to reach an all-time high by the end of the year. From a capital markets perspective, the sector is favored, with record-level acquisition pricing and widespread low cap rates. For both users and investors, pricing is at record highs across the board. New entrants to the market should expect rents to continue rising next year at roughly the same rate as the past few years. For investors, the news is that cap rates and investment prices are showing signs of stabilization.
HOW MUCH LONGER?
Add the near-term economic uncertainty posed by a new presidential administration, and it’s understandable if some observers are skeptical of how much upside is left in this cycle. Our view, however, is resolutely positive: Industrial market conditions will remain favorable through 2017. Our position is rooted in how the industrial sector is uniquely positioned to benefit from both cyclical and structural changes throughout the coming year. On the cyclical side, although a global economic downturn and Brexit rattled the U.S. outlook, perceived economic risks have dissipated over the course of the year. The industrial sector handled the early-2016 slowdown in trade and manufacturing without a hitch, thanks to unwavering consumer demand with household confidence and spending near post-recession highs. These tailwinds bode well for both traditional retailers and distributors, as well as those focused on e-commerce.

TECHNOLOGY CONTINUES TO INCREASE DEMAND
On the structural side, new technologies continue to reshape the logistics landscape. In particular, e-commerce continues to have far-reaching implications, prompting manufacturers, suppliers and distributors to adapt their supply chains to meet the new service demands it creates. U.S. e-commerce sales are forecast to rise by 9.3% annually over the next five years, to $523 billion in 2020, according to research firm Forrester. For industrial real estate, this growth represents a huge opportunity. E-commerce users require three times more space on average than traditional warehouse users. Further, growth in e-commerce sales causes growth in demand for additional warehouse and distribution space: For every $1 billion in new e-commerce sales, an additional 1 million sq. ft. of new distribution space is needed, according to CBRE’s Global Supply Chain Practice. Given current forecasts of e-commerce growth, this translates to an annual average of 40 million sq. ft. of new warehouse space demand between 2017 and 2020.

The supply side is growing in response to user demand. One of the most notable features of the current cycle has been the relatively tepid development market, adding new logistics product at a slow pace. Since 2010, for example, demand in the United States (as measured by net absorption) has outpaced supply by a factor of two, despite rapidly growing rents and shrinking vacancy. On the whole, the discipline shown by developers has been healthy and has allowed for steady rental growth, bringing many markets to or near full recovery. The
supply side also represents the greatest risk to the market. If demand were to slow at a greater rate than expected, or if the economy were to experience an unexpected shock, the sudden addition of new, vacant space could slow growth more than any slowdown imposed by external economic forces. However, while this risk is real, the overall impact of such a slowdown would be tempered by the fact that vacancy rates are at historic lows, both at a national level and at the local level in many major markets. The addition of new space would be a welcome change in key markets such as Los Angeles and Oakland, both of which have vacancy rates below 2%.

TRADE POLICY
The biggest external concern for industrial expansion is the potential impact of changes in federal government policy on international trade. Congress has granted presidents considerable latitude on trade policy, and President-elect Trump’s stated desire to unilaterally cancel existing trade deals like NAFTA may be the biggest wild card in determining the trajectory of the U.S. and global economies. During the campaign, Mr. Trump called for the imposition of tariffs on imports from Mexico and China; combined, the two countries accounted for more than $735 billion in trade with the U.S. during 2015. Were Mr. Trump to follow through on his tariff promises, we would expect to see higher prices on imported goods and parts. Retaliation is also a possibility, particularly from China, which would limit U.S. exports. Trade restrictions might accelerate automation in U.S. manufacturing, rather than creating import-substituting jobs. Our outlook assumes that any potential changes to trade policies will not be radical, as already evidenced by Mr. Trump moderating his position on trade since the election.

Figure 10: U.S. Industrial Supply and Demand
As a percentage of stock (%)
CONSUMER SPENDING GROWTH TO CONTINUE APACE

Consumer spending in 2017 is expected to repeat the growth it recorded in 2016, with retail and food-service sales (excluding motor vehicles and gasoline) forecast to rise by 4% to 5%. Although the new presidential administration brings the potential for significant legislative changes, the fundamental metrics driving consumer spending—job growth, wage growth and consumer confidence—are unlikely to change in the next 12 months. Luxury retailing is more dependent on global economic forces and will face challenges from the strong U.S. dollar and lower tourist spending by Asian and Latin American luxury shoppers. E-commerce retail sales are expected to grow by an additional 15.5%—on pace with recent years—and to account for approximately 9.2% of total retail sales by the end of 2017.

INVESTING IN EXPERIENCES

Categories and retailers that focus on a brick-and-mortar experience are expected to benefit from an increasing share of spending growth. Recent growth in the food & beverage category, and increased tenant demand for entertainment concepts, will continue. In slower-growing soft goods categories like apparel, both new and established retailers will seek to expand their in-store experience offer through workshops, new technologies and services. As more retail sales shift to e-commerce, success in physical retail will increasingly depend on the experience and services offered to customers.
“ROGUE RETAILING” DRIVING DEMAND FOR NEW LEASE TERMS

The rapid rise of non-traditional retail brands and venues—such as pop-ups, food trucks and other formats that operate outside of typical retail real estate spaces—is driving changes in leasing structures. Although landlords have historically preferred long-term leases with creditworthy national or multi-national brands, there is a growing willingness to work with shorter-term and non-national tenants. The greater financial risk associated with such agreements is driving more flexibility in lease terms and, in some cases, deeper financial partnerships between landlords and tenants. These partnerships may take the form of equity stakes, percentage rent or greater contributions to store fit-outs. As 2016 saw a strong rise in rogue retailing for brands both large and small, 2017 will see much more integration of these concepts in traditional mall and real estate spaces, where efforts to deliver experiences may benefit from their flexibility.

RENT GROWTH CONCENTRATED IN JOB-GROWTH MARKETS

Over the next five years, we expect national retail rents for neighborhood, community & strip centers to grow at an annual average rate of around 1.7%, with large variation across markets. For markets that have historically shown strong growth in both employment and rent, we expect continued rent growth: San Francisco and Denver, for example, with annual rent growth of 4%. Markets that have shown strong employment growth over the past five years, but that have lagged in rent growth, are expected to catch up over the next five years: Orlando and Atlanta, for example, with annual rent growth of 3% or higher. The rest of the top 30 U.S. retail markets are plotted in Figure 11.

Figure 11: Growth Rates: Retail Rents vs. Total Employment, Past 5 Years

Source: CBRE Econometric Advisors, Q3 2016.
A QUESTION OF BALANCE

Hotels’ financial performance depends upon leisure and business travelers having the resources and the comfort level to travel. Income and wealth determine the former, and absence of fear the latter; both conditions will be met in 2017, notwithstanding any unforeseen political and economic disturbances. Among households and most businesses, balance sheets appear sound, and although profit growth is thin, corporations have plenty of cash. Working households are experiencing stronger wage growth each year and the probability of recession remains low.

We expect to see year-over-year growth rates for the demand and supply of U.S. hotel rooms come into balance in 2017. As Figure 12 illustrates, the difference between the two national rates has been gradually shrinking. Across the six market segments, six location types and 60 city markets covered in CBRE’s Hotel Horizons forecast, the two are balanced in varying degrees; where there is imbalance, some locations present opportunity while others carry excessive risk.
IMBALANCE—OPPORTUNITY IN 2017

Notwithstanding new proposals for infrastructure spending, fixed capital investment is increasing in cities across the U.S. Such investment—whether public, private or both—likely leads to targeted areas receiving an over weighting of hotel demand. Airports are a good example: Placing new airports in major metropolitan areas creates economic realities that give rise to large-scale airport expansion projects. The city of Atlanta and Delta Airlines will invest $6 billion into a variety of terminal, runway and maintenance facility improvements over the next 10 years, for instance. Opportunities to own and operate hotel real estate around many such ongoing airport expansions will become increasingly available in 2017.

Private investment has Nashville, Charleston and Reno ripe with hotel real estate opportunity. Nashville is transforming into a regional center with strong professional employment growth, due in large part to the expansion of automobile manufacturing in the region. Charleston’s economy will be a direct beneficiary of automobile-manufacturing plant development. In Reno, sparks of growth are apparent 20 miles east of the city. Hotels positioned in the path of growth created by large private capital placements should be considered one of 2017’s dominant hotel investment themes.
IMBALANCE—RISKS IN 2017

Local oversupply is currently the biggest risk to profitable hotel investment. In Figure 13, we present the supply growth picture for the 60 cities covered in Hotel Horizons, illustrating the relative associated risk of holding capital positions in the various city markets. Markets deemed oversupplied—such as Seattle, Charleston and San Jose—are those where the number of new rooms slated to come into service during 2017 exceeds the number forecast to be needed. Some notable markets—such as Philadelphia, Minneapolis and Orlando—will receive too few new hotel rooms in 2017, given their fundamentals. The implications of these conditions for dividend growth and potential appreciation are apparent.

WHAT TO DO?

The current cycle’s up-phase may have a gray beard, but nowhere has it been proven that downturns occur a certain number of years into a recovery and expansion. U.S. hotel markets could continue to expand for an extended period. Hotel income and appreciation growth are slowing, but investors’ ability to place capital in hotel real estate for excess returns will persist as long as local supply growth remains in check. Deals involving upscale hotel property around selected airport locations and within growth corridors created by large-scale public and private investment should be carefully screened over the coming year.
As the multifamily sector has progressed in this cycle, a few market dynamics have taken center stage: the supply pipeline, rental affordability and the emergence of what we call the “quiet giants”—suburban multifamily markets.
SUPPLY CHALLENGE

Supply will be the most prominent near-term challenge for the U.S. multifamily market. Completions outpaced demand in 2016 for the first time since the recession, and we expect the same in 2017. These two years will likely be the peak of this development cycle, and 2018 should bring noticeably fewer deliveries.

Although market conditions remained healthy in 2016, strong supply numbers have affected markets across the U.S., moderating rent growth and reversing the downward movement in vacancy. These trends are expected to continue through 2017, with annual rent growth projected to slow to 1.2% and vacancy expected to rise 80 bps to 5.5%.

Recent development activity in American cities has reshaped the landscapes of many established infill markets and carved out new upscale neighborhoods in urban cores. These trends have helped to enhance urban livability and provide new opportunities for millennials, empty nesters and others.

However, urban infill neighborhoods are also the areas with the highest concentrations of development—those that will experience the greatest impact from supply, with rent growth rates that are markedly slower than metro averages.

Suburban markets are generally less affected by strong supply trends, while Class B and C multifamily communities that do not compete with the high-end and high-priced new product will perform relatively well in 2017.

Figure 14: U.S. Multifamily Outlook

Source: CBRE Research, CBRE Econometric Advisors, Q3 2016.
**HOW MUCH MORE CAN TENANTS AFFORD?**

As the trend in high-end development continues to rise nationwide, renters’ budgets are feeling the squeeze and landlords—especially those in gateway markets—are asking “How much more can our tenants afford?”

Half of renter-occupied households in the U.S. are now cost-burdened, according to the National Low Income Housing Coalition. That is, they spend more than 30% of their household income on rent—and the numbers are worsening. Half of those households are now considered severely cost-burdened, spending more than half of their income on rent.

Our research also shows that the least-affordable markets in 2011 have become increasingly unaffordable in the years since. For the assets built over that period, fundamentals have slowed considerably, with properties built since 2011 consistently experiencing lower rent growth and occupancy and higher concessions than any cohort of older buildings.

*Figure 15: Twenty of the Nation’s Most Expensive Rental Markets*

<table>
<thead>
<tr>
<th>City</th>
<th>Average Annual Effective Rent as a Percentage of Median Household Income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>53.6</td>
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<tr>
<td>San Francisco</td>
<td>48.0</td>
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<tr>
<td>Los Angeles</td>
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<td>Miami</td>
<td>40.3</td>
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<tr>
<td>Orange County</td>
<td>40.0</td>
</tr>
<tr>
<td>Ft. Lauderdale</td>
<td>37.2</td>
</tr>
<tr>
<td>San Diego</td>
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</tr>
<tr>
<td>San Jose</td>
<td>35.7</td>
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<tr>
<td>Boston</td>
<td>35.7</td>
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<td>Oakland</td>
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<td>Honolulu</td>
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<tr>
<td>Providence</td>
<td>31.3</td>
</tr>
<tr>
<td>Riverside</td>
<td>31.2</td>
</tr>
<tr>
<td>Chicago</td>
<td>30.0</td>
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<tr>
<td>Seattle</td>
<td>29.3</td>
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<tr>
<td>Portland</td>
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<tr>
<td>Sacramento</td>
<td>27.2</td>
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<tr>
<td>Denver</td>
<td>25.9</td>
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<tr>
<td>Philadelphia</td>
<td>25.7</td>
</tr>
<tr>
<td>Washington, D.C.</td>
<td>21.9</td>
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</table>

Source: CBRE Research, CBRE Econometric Advisors, Q3 2016.
SUBURBAN GROWTH

The 2014 American Community Survey of the U.S. Census (the most recently available annual data) shows that 2.8 million people moved from the suburbs to urban cores that year, while 4.6 million people moved from urban cores to suburbs. The trend was consistent across age cohorts, levels of educational attainment and professions.

While more people are leaving urban cores for suburbs than vice versa, many of them remain partial to the amenities of urban life and are helping create dense, quasi-urban enclaves that offer the qualities of downtowns—things like access to public transportation, high walkability, shopping, restaurants and bikeable commutes—without the high rents of downtown.

Broad-based migration to the suburbs has helped fuel strong rent and occupancy growth in suburban apartment markets, particularly in recent years. The percentage of markets with annual suburban rent growth exceeding their respective urban rates by more than 100 bps has consistently increased—from 22% in Q2 2012 to 63% in Q3 2016.1 For most of the past two years, the suburbs have significantly outperformed urban cores in more than half of these markets—a pattern that we haven’t seen in the past.

With strong development pipelines squarely focused on downtown Class A product, lack of affordability is expected to remain a challenge for the overall apartment market, especially in the more urban areas. As such, the shift toward the suburbs is projected to continue, and suburban apartment markets will likely continue to perform well relative to urban cores.

1CBRE Econometric Advisors tracks 51 markets that have both urban and suburban apartment submarkets.
WILL CLOUD SERVICE PROVIDER DEMAND CONTINUE?

Globally over the past two years, cloud service providers (CSPs) have largely replaced colocation providers as the largest consumers of multi-tenant wholesale data-center space in core data-center markets. In the U.S., absorption in 2016 is on pace to equal or match the previous year’s record occupancy gains, though a large portion of this activity dates back several quarters to pre-leasing of yet-to-be-completed projects. Leasing volume has showed signs of slowing in the second half of 2016, which sets the sector up for potential oversupply in 2017.

There will be a lot riding on the accuracy of hyperscale CSPs’ internal forecasts of customer demand, and how they have provisioned capacity to align with these projections. With most hyperscale providers leasing space while also building their own facilities, there is a short-term risk that they will pivot away from multi-tenant leasing in the near-term if their demand forecasts prove to have been too high. If projections prove to be accurate, subdued leasing volume will likely result in less absorption than the past two years’ historically high levels. With added scrutiny from investors who are new to evaluating and understanding the fundamentals of the asset class and data center REITs, there is a risk that such a slowdown would be perceived as a pullback—potentially affecting access to capital and investment opportunities.

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2 Data centers that provide their customers with space, power, cooling and physical security for server and networking equipment, while connecting them to telecommunications and network service providers.

3 CBRE considers Atlanta, Chicago, Dallas, New York/New Jersey, Northern Virginia, Phoenix and Silicon Valley to be the core data center markets in the U.S.

4 Hyperscale data centers use a specialized software-based architecture to scale efficiently; expansion is usually just a matter of adding “nodes”—small, inexpensive, off-the-shelf servers.
“For enterprise users evaluating their data center requirements in 2017, the evolution of pricing models and contract terms should be a key consideration in any strategic decision. Rental rates may have stabilized, but they are as low as they’ve ever been. More importantly, pricing is no longer simply a function of rent-based space and power; tenants’ ability to incorporate flexible contract options into their data center spend—which could include cloud, additional services and even the ability to expand or contract their footprint—will prove to be a significant opportunity for occupiers.”

- Pat Lynch
Managing Director,
CBRE Data Center Solutions
IS THERE RISK OF OVERSUPPLY?
In many markets, more speculative data center supply is slated for delivery in 2017 than we have seen for several years. However, several core markets—Silicon Valley, Ashburn/Northern Virginia and Chicago in particular—are currently extremely supply-constrained, with vacancy rates for existing/commissioned capacity ranging from 4% to 6%. While demand from enterprise users is unlikely to match the recent size of CSP deployments, the commissioning of new high-quality facilities will likely help facilitate market activity and increase deal flow in many markets that recently have been supply-constrained or underserved by existing inventory.

In certain markets, the next 12 months will also see an increase in legacy corporate data centers becoming available at or below replacement costs. While these assets don’t pose any imminent supply-side risk to the multi-tenant market, the appetite for them during 2017 could go a long way toward predicting momentum in data center investment trends over the next few years. There is already enormous demand for sale-leaseback opportunities in facilities with in-place tenants and longer lease terms; however, to date, interest in legacy assets in non-strategic locations or with high vacancy has been limited. The effort and cost to re-engineer such highly specialized facilities often prove too high to justify.

THE SHAPE OF GROWTH TO COME
One of the biggest wildcards of 2017 is the evolving size and scope of traditional enterprise users’ third-party requirements. For the foreseeable future, corporate demand for computing power and information storage will continue to grow at nearly double-digit rates annually. However, a transformative shift is underway that will have a meaningful impact on demand in the sector.

Figure 17: Data Center Market Maturity

Source: CBRE Research, 2016.
Historically, enterprise computing and storage needs were satisfied in facilities owned and operated by the user. Today, most enterprise users are shutting down their owned facilities and migrating their requirements to cloud and third-party colocation providers, who can handle considerations like security, compliance standards, and physical proximity and access to network and cloud providers with greater cost efficiency. Typical enterprise demand will likely evolve to require smaller, hybrid solutions that incorporate elements of wholesale and retail data center leasing as well as public and private (on-premise) cloud solutions, and will prove to be a strong, steady growth channel for data center operators going forward.

Demand is also being re-shaped by a growing need among large enterprises and content and cloud providers to locate some IT infrastructure as near as possible to “the edge” of the network or to end users in order to reduce latency, better manage data traffic and provide the best user experiences. As a consequence, interconnectivity is emerging as a key growth engine, and data center operators developing their network/connectivity and cloud services offerings are poised to capture significant demand. Moreover, with the increased adoption of latency-sensitive, data-intensive technologies—running the gamut from mobility (devices, wireless networks, etc.), the Internet of Things and content delivery/distribution to future technologies like self-driving cars and augmented/virtual reality applications—well-connected real estate near critical population centers is poised to enjoy above-average demand and pricing.
With its companies developing everything from over-the-counter medications to gene therapy cures, life sciences is among the world’s most impactful industries. And like most industries in today’s ever-changing world, it is undergoing significant changes. Heated competition among these companies for both talent and specialized lab space has become an important determinant of the type, quality and location of commercial real estate that this industry demands. Cost too remains a factor; the industry’s subdued demand for manufacturing and conventional office space persists as life sciences companies seek lower-cost alternatives.
CHANGING SPACE NEEDS AND MARKET CLUSTERING

The traditional large-scale pharmaceutical campus is increasingly unrepresentative of the industry’s current state. As firms seek to acquire brands and product innovations via mergers and acquisitions, they are also divesting their capital infrastructure holdings in order to become more efficient and agile. It was typical of larger entities to control product chains from concept to realization, marketing and distribution, but now many components of product development and distribution are being outsourced to companies that specialize in specific parts of the process. This allows life science firms to concentrate on the competencies they know best, while minimizing labor and occupancy costs. This trend toward specialization is observed not only among established firms, but also newer companies exploring the cutting edge of medical science. It has been evident in the strong growth that biotechnology and healthcare services have experienced; Figure 18 shows that venture-capital investment in those sectors spiked in the past three years, far above historical levels.

Specialization has also caused the industry to segment and to form concentrations based upon its needs. For core research and development, life sciences firms have been clustering in places like Boston and San Francisco, where innovative world-class universities produce not only valuable research and development, but also highly skilled and specialized talent. New England and Silicon Valley continue to capture an increasing share of venture capital investment in biotech and healthcare services, as Figure 19 shows. Consequently, markets such as these have the most active development pipelines, the highest rents and the greatest scarcity of available space. Such market constraints encourage smaller footprints, which has given rise to new ideas about how to utilize lab space. Development of multi-tenant facilities with specialized lab build-outs has begun in the hottest markets. These buildings are specifically geared toward smaller companies that do not wish to own their real estate, but also do not want to be stand-alone lab-oriented occupiers in a sea of regular office users. Established firms are also seeing a new wave of talent that does not mind sharing lab space and being more collaborative. The sharing of equipment not only lowers the required footprint, but also significantly lowers costs for furniture, fixtures and equipment, which outpace occupancy costs substantially.

CHALLENGES AND OPPORTUNITIES

Two significant challenges facing established life sciences companies right now are patent expiration and the increasing cost of research to generate new products. Revenue that was once guaranteed has become less so with the loss of such exclusivity. The once-high demand for large blocks of office and lab space in places like Research Triangle, New Jersey and Philadelphia has diminished, as newer talent prefers to locate elsewhere. Offshoring and outsourcing manufacturing and distribution operations continue to occur as companies seek to minimize labor costs and gain incentives from lower-cost markets.

Although these dynamics are likely to persist through 2017, the economic and political landscape appears to support higher space demand from the life sciences industry. A positive outlook for economic growth in 2017 should support demand for the industry’s products and services, in turn supporting continued demand for top-quality lab space and slowing the downsizing trend among the largest pharma companies. The incoming Trump administration appears to support less regulatory oversight, which may result in more activity in the life sciences industry. And for those companies seeking to set up shop in hotspots like Cambridge or Silicon Valley, the delivery of some new developments in 2017 may bring some relief to these tight space markets.
Figure 18: Venture-Capital Investments by Industry (4-quarter rolling sum)

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Source: PwC, 2016.

Figure 19: New England and Silicon Valley Share of Venture-Capital Investment in Biotech and Healthcare Services

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Source: PwC, 2016.
“The sharing of equipment not only lowers the required footprint, but also significantly lowers FFE costs, which outpace occupancy costs substantially.”

-Todd Richardson  
Senior Managing Director, CBRE Global Workplace Solutions (Global Life Sciences Sector)
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