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# 2008 Real Estate Market Outlook



Each year for the last decade or more, professionals within Ernst & Young's Real Estate group have gathered informally to review the trends and issues impacting real estate over the last twelve months and to discuss how new trends might affect the development, financing, ownership, operation and even re-use of real estate in the year ahead.

We began last year optimistically. Interest rates were relatively low, capital was plentiful, transaction activity was strong and market fundamentals sound. Much of the optimism was due to the continued stellar performance of the housing sector which was a strong point of the US, and even global, economy.

Things can change quickly in a few months. As of writing this, the full impact of the subprime mortgage crisis is still to be felt in the US. We have already witnessed a huge flow of capital from foreign investors into US financial institutions hit hardest by the mortgage crisis. More funding is on the way. We have seen real estate transaction activity — especially investment sales and commercial mortgage-backed securities (CMBS) financing — dry up, giving pause to the overall real estate market. We have also seen a swift revision of deal terms and underwriting which, in the commercial mortgage sector has resulted in fewer loans being written and, in the investment sales sector, has led to significant attempts (and some success) by buyers to re-price pending deals. Lower interest rates, which are widely anticipated in 2008 to combat a US economic recession, may go some way to offset these trends, but we must at least be prepared for several more months of tighter terms throughout the market.

While most other countries around the world seem to have managed the crisis quite well, we believe that the broader crisis in the US mortgage industry will have further impact on real estate as a whole. Add to this the threat of inflation and a recession of uncertain depth and duration and 2008 does not appear to hold the promise of being a great year for those in the real estate industry.

So, this year we begin the year in a more pessimistic frame of mind. However, as we saw last year, events can change the industry almost overnight so it is vital that those in real estate and those observing the industry keep a close eye on trends that may change its course. Here are 15 major trends we expect to deliver the most impact to the industry this year.

**Dale Reiss**

Global and Americas Director of Real Estate



# 1. Selling the US by the Pound... or Euro...or Rial

In 2007, we pointed to global capital flows as one of the big stories of the year. If anything, 2008 is likely to be an even bigger year for the expansion of global capital. The dollar, once the main driver of real estate investment around the world, is taking a back seat to currencies like the euro. While not quite out of the game, US investors have been pushed to the side. With investors from countries such as Ireland, Sweden, France, Australia, and others increasingly looking beyond their own borders for investments, the global real estate industry isn't likely to slow down. But this year, we think that one market in particular will attract huge capital flows – the US. Even the threat of a global recession might not curtail the interest of foreign buyers – as long as their currencies continue to buy US dollars cheaply. It's the Canadian dollar's parity to the US dollar that's bringing Canadian investors back to markets like Phoenix, San Francisco, Denver, Palm Springs, and resort areas in Florida to buy single-family homes, condominiums, and timeshares, mostly as second or vacation homes. Rapidly increasing oil prices are providing petrodollars to invest in US and other real estate markets for the first time since the late 1970s and early 1980s. The rise of the Islamic banking sector has also created additional demand for real estate as an investment. A strong euro and British pound are bringing European buyers back to both commercial and residential markets in droves, and it seems likely that many of these investors will be looking for a few bargains in 2008.

## *Ernst & Young observation:*

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*We think 2008 could become a high-level mark for foreign real estate buyers investing in the US. With many US investors still left out following the credit market dislocation in August 2007, the US is for sale, so look for more foreign buyers to bid for commercial assets — especially in “gateway” US markets such as New York, Washington D.C., Miami, Chicago, San Francisco, Los Angeles, Florida, Seattle, San Diego, and other coastal markets.*

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## 2. Will Sovereign Funds Surpass Private Equity's Role in Real Estate?

A rapidly emerging subset of the global capital wave is sovereign funds investing on behalf of national governments. Estimates suggest that sovereign funds currently hold overall investments totaling nearly US\$3 trillion globally, giving them more financial weight than hedge funds. In addition, sovereign funds are typically among the first investors into emerging markets and are known to be fast decision-makers that can move quickly to tie up assets. With some forecasts suggesting that the funds' assets could rise to nearly US\$8 trillion by 2011, it's not difficult to see them having an even greater impact in real estate in North America and worldwide. In fact, some sovereign funds — such as Singapore's Government Investment Corporation — are already major investors in real estate in the US and elsewhere. The managers of these funds, like their private sector counterparts, are seeking higher returns at the same time as they are seeing greater investment power buoyed by the strength of their domestic currencies (relative to the US dollar) and expanding economies, so real estate — either at the direct property investing or entity levels — is a natural for them.

### *Ernst & Young observation:*

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*Look for sovereign fund investors to potentially outdo their private equity rivals in US real estate and emerging market investments in 2008. Acquisitions will range from trophy properties in major markets such as New York, Washington D.C., Chicago, and San Francisco, to large suburban assets and takeovers of companies. Look for some sovereign investors to seize the opportunity to focus on distressed assets and companies, particularly smaller and mid-sized homebuilders in the US. On the global stage, look for sovereign funds to increase their presence in emerging markets, accelerating yield compression in those markets in 2008.*

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## 3. Building a Bridge Over Troubled Waters

Last year, we predicted that the infrastructure market would be the hot market for investors, and we saw a number of infrastructure funds formed to invest in the US, as well as in emerging markets like India, Brazil, and China. Major pension funds such as the California Public Employees Retirement System (CalPERS) allocated billions of dollars to the new sector. The market potential for private investment in large-scale infrastructure is enormous. Even the US, a mature market, is estimated to need US\$1.6 trillion during the next few years just to keep its existing infrastructure operational. Meanwhile, in the US, the federal and state governments are already struggling with ballooning budget deficits and increasingly more states, like California, are looking to offshore models, such as the public-private partnerships or P3s popular in Canada, Australia and parts of Europe, to help the private sector keep up with infrastructure needs. Developing countries need huge capital flows just to build the infrastructure required to keep pace with their expanding economies and often don't have the revenue to support the huge programs required. Globally, private capital is key, and the political will to embrace private sector expertise is critical, especially in the growing US infrastructure market.

### *Ernst & Young observation:*

“*The capital flowing into infrastructure in 2007 was only the beginning. While most agree that the infrastructure sector is not yet a mature investment market, the need for a massive infusion of capital is undeniable, and even the credit crunch hasn't dampened investors' appetites. According to an Ernst & Young poll conducted in November 2007, 23% of respondents thought the credit crunch had no discernible impact on the new investment sector, and 22% thought the broad market crunch would actually spur greater investment in infrastructure because of the attraction of stable cash flows. Incentives and viable financial structures will be primary concerns as private financing becomes increasingly critical for the development of major public works in 2008. There is also an element of fear, especially with US state governments already predicting further budget shortfalls as a result of the collapse of the US housing market, and perhaps more bridge and other infrastructure failures as deferred maintenance inflicts a toll on the world's infrastructure. We also expect that the continuing interest in infrastructure will intensify public debate on the sustainability of private funding versus government spending and tax increases (e.g., through tolls or income tax.) Finally, with more deals to compare, US states will learn how to price their infrastructure, and this may have clear consequences for investment yields. Look for pension funds to lead the way as more of them consider infrastructure as an alternative asset class — loosely tied to real estate — through which they can invest capital over the long term at fairly attractive risk-adjusted returns. Also, don't be surprised if 2008 sees the formation of the first infrastructure REIT.*”

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## 4. Fair Value Accounting: No Entry

The real estate transaction industry – particularly private equity funds – should also pay close attention to two federal accounting standards coming into force in 2008 that focus on how assets are recorded. The Financial Accounting Standards Board (FASB)'s Statement 157 (FAS 157) redefines “fair value” as an exit price, not an entry price. As a result, companies that report under the Investment Company Audit and Accounting Guide, and therefore record assets at fair value, can no longer presume that the acquisition price (entry price) is fair value. For example, if a transaction takes many months to close, fair value at settlement could differ substantially from the original negotiated purchase price. Obviously, with real estate values apparently headed downward, this has huge implications for those involved in transactions. So, too, does FASB Statement 159 (FAS 159), which allows companies to elect to use fair value accounting for certain financial instruments such as fixed rate debt. Once a company does elect to use fair value, it can't change policy and must continue to book those assets under the guidelines laid down by FAS 157.

### *Ernst & Young observation:*

*Ernst & Young observation: Accounting standards don't usually cause CEOs of major real estate companies to worry, but FAS 157 and FAS 159 might. It's our belief that the vast majority of real estate companies aren't yet prepared for the major accounting changes these two standards demand. While some players, such as mortgage REITs, may benefit from FAS 159's "Fair Value Option" since they already use fair value in booking CMBS investments, equity investors may find both standards more difficult to accept.*

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# 5. Housing Markets: More Pain to Come in the US and Abroad

In January 2007, we predicted that there would be rising loan defaults in the US throughout the year as a result of upward adjustments in subprime ARM home loans and that those defaults could affect the broader mortgage-backed securities market. What we didn't envisage was the depth of impact that rising defaults in a market representing just two percent of the total home mortgage market and the effect that the subprime debacle would have on other mortgage products, such as Alt-A and even jumbo loans, or that the problem would need solutions as dramatic as a rate freeze. As it turned out, the impact is not only on housing markets in the US, but also on housing markets in the UK, Spain, Japan, and Germany, in credit markets abroad, and in the totally unrelated US commercial real estate credit markets. While the big Wall Street banks had written down losses totaling about US\$100 billion as of 31 October 2007, financial institutions globally have lost twice that amount of market capitalization. And the anticipated losses from the subprime market collapse are expected to be three to four times that amount, making the potential loss to the financial sector almost twice as much as was lost by lenders during the savings and loan scandal of the 1980s. Add to this the prospect of a recession and related job losses, and you get a fairly bleak picture for the industry for 2008 and into 2009. No one knows the magnitude of the housing and subprime problem short of reading the daily newspapers, but in the end, there's still a long way to go and far more pain to be felt before the residential market recovers.

## Ernst & Young observation:

*The bad news is that we aren't through the worst yet. Most experts now agree that defaults and foreclosures won't reach their peak in the residential market until well into 2008, when adjustments on perhaps US\$1 trillion in ARM and other variable rate mortgages reach their height. But most recent default estimates don't take account of the rising unemployment from the damage done to the economy so far, so we should brace for even higher default rates than first anticipated. Look for the residential mortgage market to continue to affect virtually all sectors of the real estate sector well into 2009, with homebuilders trying to eliminate large surpluses in supply. There is also likely to be a trickle-down of loan impairment charges into community and local bank sectors with an accompanying squeeze on credit for borrowers. The long-term view is that when the residential market eventually does recover — and given the unsold inventory of homes currently in the market, that's not likely to be before 2009 at the earliest, — the housing market will look very different. By then, smaller builders and less efficient operators will be out of business or will have merged into larger firms, and the speculators will have moved on.*

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## 6. It's a Repeat Scenario for Debt Markets

The August 2007 dislocation of the credit markets and the ensuing credit crunch have clearly changed the debt markets, which make up more than 50% of the overall real estate capital market in the US. The question is: how much have the markets changed and how long will the effects on the debt market last? Investor preferences have changed and risk premiums have risen. Commercial mortgage-backed securities (CMBS) spreads have widened and continue to be volatile. The market is entering a period of de-leveraging, with borrowers unable to access the levels of debt they have been used to. Loan pricing is up, but lenders are using stricter underwriting. It's a repeat scenario for a market that looks a lot more like the one of the 1980s than the one of the last few years and where 20% to 30% hard equity is required to obtain financing. All this has put downward pressure on property valuations or resulted in deals being pulled from the market. The market is faced with significant refinancing risk for the next five years, particularly for CMBS deals funded in the last few years and maturing construction loans. Will debt markets be back online by 2009? Let's hope so. To a great extent, the 2008 performance of the commercial real estate transaction market depends on how quickly the debt markets recover.

### *Ernst & Young observation:*

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*Expect to see increasing loan delinquencies and defaults in the commercial sector in 2008, but don't expect these to exceed historical norms. The CMBS market which, when everything is finalized, we estimate to have been equal to that of 2006 and to have recorded slightly over US\$200 billion in deals, will be lucky to see half that production in 2008. Upwards of US\$50 billion in loans are still in the CMBS pipeline following August's bombshell, and it remains to be seen how many of those deals will stay in place. Don't look for much "new" CMBS issuance until mid-year. There's never been a better time for lenders to test their loan portfolios, enhance their underwriting practices, and really understand their risk.*

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## 7. Lots of Land but No Sunny Skies

The dislocation of the credit markets in the summer of 2007 didn't just cause the housing markets in the US to founder. The nearly-instantaneous lack of financing resulting from investors' panic injured almost every real estate-related market, but it came close to killing the residential land development business. As of December, land financing was still dead, with little immediate relief in sight, and homebuilders collectively had taken upwards of US\$10 billion in impairment losses on land. Since then, major homebuilders have begun to move land off their books, some into land banking joint ventures with money partners, to allow them to pursue tax refunds using the two-year carryback provision on losses while still controlling access to lots for development when the market turns. On the commercial side, the issue isn't so much that developers are sitting on large land holdings – they aren't – or that demand has lessened – it hasn't – but that the lack of credit makes land far harder to finance.

### *Ernst & Young observation:*

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*It could be well into 2008 before the US commercial real estate lending industry comes to grips with the depth of its default and foreclosure problems. While we don't expect the industry to face the intense problems experienced in the days of the late 1980s and early 1990s, because few loans today carry recourse, we do expect there to be considerable pain and, as a result, there will be opportunity for both cash buyers and well-capitalized lenders. Also, because of the global nature of the credit markets, we expect the pain to spread from west to east, passing from the US to Europe and then to Asia. On the buy side, distressed property and loan funds are already forming, and we expect them to be formidable players in the year ahead. The lack of liquidity in the debt market makes cash “king” and private equity may find very attractive opportunities to buy now and leverage later. After all, this type of market is where the new fortunes are made.*

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## 8. Spreading the Investment Wealth Through Global REITs

Last year, we predicted that, for the first time ever, formation of real estate investment trusts outside the US and Canada would be greater than inside those markets. We also said that the rest of the world was on pace to overtake the US in terms of the market capitalization of real estate investment trusts – but that it wouldn't happen until 2008. Well, we were right on both counts, but even we couldn't believe how well the rest of the world fared in the REIT stakes. A combination of newly minted REIT legislation in markets like the UK and strong REIT formation in Japan, Hong Kong, and Singapore, plus a strong wave of privatization in the US and Canada, saw the composition of the global REIT market flip-flop in mid-2007. According to Ernst & Young's 2007 Global REIT Report, the rest of the world numbered 253 REITs as of June 30, 2007, compared to 195 in North America. Just one year earlier, North America numbered 253 REITs versus 198 around the world. In terms of market cap, US REITs totaled US\$381 billion compared with US\$380 billion in the rest of the world. Last year, the numbers were US\$395 billion in the US versus US\$213 billion in the rest of the world. Here is proof, if any is needed, that we do operate in a global market, and one that can change quickly.

### *Ernst & Young observation:*

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*With REITs coming online in Germany and the UK market ready to expand further this year, and with continued appeal of REITs in Asia, we expect the rest of the world's market cap to have surpassed that of the US before midnight on 31 December 2007. Look for a strong rate of growth in REIT markets to continue around the world through 2008 and even, perhaps, a privatization wave in more mature global markets such as Singapore. In the US, we anticipate the pace of privatizations to slow considerably over the next several months with a merger and acquisition (M&A) emphasis on smaller and poorer performing REITs, rather than the mega deals that characterized 2007.*

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## 9. No Turning Back as Private Equity Goes Global

If 2006 was a great 12 months for the private equity industry's move into real estate (the second most active M&A sector behind telecom), 2007 was a year of two halves. In the first half of the year, the industry was on pace to raise record capital for investment in real estate, new sponsors were entering the market to form funds, and established sponsors were seeing their new funds attract two or three times the amount of capital seen in earlier funds. But all bets have been off since August's credit market dislocation. As of this writing, many (but not all) funds are sitting out, waiting for deal terms to improve, and new fundraising is currently out of the question for some, although established funds are still able to raise capital quite freely. It remains to be seen if the real estate private equity sector sees the same meteoric growth it saw last year, but one thing is clear: there will be tremendous opportunities for private equity funds in the year ahead, not least in distressed property acquisitions, mezzanine loans, and hybrid loan products that can ease the credit crunch for real estate owners.

### Ernst & Young observation:

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*Last year we predicted that emerging markets such as Brazil, Russia, India, and China would quickly become established markets, especially as US and other foreign investors invested capital into their growing real estate economies. A second and even third wave of private equity capital has spread around the world as institutional investors and larger real estate operators enter into the next phase of global joint ventures. US and other real estate investors have pushed equity into country-specific funds with local partners. We are likely to see the first mega deals involving several types of investors collaborating to invest in countries or entire regions through multiple strategies. Each group will include one or more real estate operators to handle the real estate, with other investors taking entity-level and corporate risk.*

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# 10. Building Hospitality

A just-released Ernst & Young survey of 300 investors active in the hospitality sector points to new construction as the order of the day in US lodging markets and an emphasis on investing in upper-upscale and luxury hotels in most markets around the world. The construction industry estimates suggest that activity in the US lodging sector increased by 15% in 2007, making the sector one of the most appealing and profitable for engineering and construction firms as well as architects and contractors. Fears of overbuilding can be relieved by the fact that construction loans haven't been very easy to come by, even for stellar projects, since August 2007's credit market dislocation. Globally, Asia has surpassed Europe as the premier market for hotel investors as well as gaming customers who go to the casinos in Macau and Singapore.

## *Ernst & Young observation:*

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*Look for investment in the hospitality sector to remain strong, at least through the summer of next year, with an emphasis on new construction in the US, especially in high-barrier-to-entry markets like Washington D.C., and Los Angeles. Internationally, investment is likely to pick up in both new development and acquisitions, with investors keeping a wary eye on political risk in new ventures, especially in emerging markets in Asia and Latin America. However, relative returns outside the US, in markets in Western Europe, for example, will be a significant factor in attracting capital.*

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# 11. Construction Prospects Good, Despite Homebuilding

The construction sector will need to depend on something other than homebuilding to take it forward in 2008. Luckily, 2007 increases in US infrastructure (43%) and hospitality (15%) construction are likely to continue into 2008 and offset the sharp drop expected in housing starts. Leading-edge issues for the industry are rising commodity prices – especially copper, steel and asphalt – and staffing: although the industry is projected to create one million new jobs by 2012, one million current workers are expected to retire by then too, giving firms the worrying prospect of a shrinking labor pool. However, on the bright side, margins are increasing for construction firms, a trend that looks likely to continue into next year.

## *Ernst & Young observation:*

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*Concerning employment, project managers and craft workers will be in demand through 2008 if a 4% increase in architectural and engineering services employment in 2007 was a real leading indicator of construction sector performance. Look for more major joint ventures between construction and engineering firms to enable them to compete for mega projects in infrastructure in 2008.*

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# 12. Is Sustainability Sustainable?

Last year we said that developers who didn't at least meet minimum Leadership in Energy and Environmental Design (LEED) standards for new projects might falter. We haven't heard about too many projects coming off the drawing board that didn't have some kind of "green" design aspect to them, and the movement is only beginning to gain popularity. Sustainable building is a trend we believe will grow with even more intensity in 2008. But, while a lot of energy is being expended to make properties green, there's still not a clear idea within the industry as to what green really means. Along with standards proposed by various trade groups, look for much deeper thinking within the real estate industry. Will being green really add value to buildings, making them more efficient and attractive to tenants? The burning question is: which green elements and features make most sense in prolonging the useful life of the asset and how much will it cost to add them?

## *Ernst & Young observation:*

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*Developers of new products have it relatively easy because they can already choose from a long list of features that will make their buildings green. But for the really big market impact, watch what happens when sustainable concepts are applied to existing real estate assets. After all, there are trillions of dollars worth of buildings already up and functioning, with inefficient carbon footprints that have a huge negative impact on the environment. Once owners have changed the light bulbs and installed low-flow toilets, where do they go next? And what about the real challenge here: the economics of going green? Look for quicker, easier, economic solutions to flourish in 2008, such as San Francisco-based Recurrent Energy's "rooftop solar" installations — which provide lease revenue to owners and competitively priced clean energy to tenants without additional cost to either.*

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# 13. Water — The Oil of the 21st Century

Some have called water the oil of the 21st century. It's certainly that important to the global real estate sector. Housing developments, communities, cities, regions, and countries cannot grow without an adequate water supply. Water and sanitation are therefore a vital subsector of the huge infrastructure market, but one that deserves its own focus because of the high profile this issue has had globally. In Turkey, for example, water is the single most important barrier to growth, and water treatment and supply concessions are being tendered to private investors almost every day. In India, one of the main barriers to growth is lack of sanitation, and the World Bank is currently sponsoring more than a dozen major projects in the country with another dozen in the pipeline to start during the next few years. Even growth within developed nations such as the US is hampered by water issues. In California, the eighth largest economy in the world, a legislative wrangle has developed over the problem of funding the state's multibillion dollar need for an increased water supply.

## *Ernst & Young observation:*

*We expect to see significant privatization of water supply and water treatment systems across the globe, soon to be followed by sanitation system privatization, as countries and municipalities look to better leverage their resources and take advantage of private sector expertise and efficiencies. Investment funds that invest in water supply and water treatment are likely to be among the best performers in 2008 and beyond.*

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# 14. The Risky Business of Global Real Estate

Last year, we addressed some of the risks facing the global real estate industry. Among those risks, we listed demographics and the impact an aging global workforce could have on real estate demand, and we pointed to a growing trend in the workplace toward more flexible work environments, a trend we called “the café workforce.” These trends are only going to deepen and have a greater impact on the way companies plan, build, use, and dispose of real estate. A recent survey of global analysts conducted by Ernst & Young suggests that the “aging of the globe” ranks as high as third in the minds of those surveyed. Of most concern are regulatory and compliance risks, followed by global financial shocks like the credit crunch of August 2007. The survey involved a number of analysts in the real estate sector, and their ranking of risks was also enlightening: regulatory and compliance risks, global financial shocks, and emerging markets were identified as critical risk issues for real estate, with energy shocks not far behind. Interestingly, the real estate respondents failed to name a single risk associated with consumer demand.

## *Ernst & Young observation:*

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*Real estate executives need to open their minds to the likelihood of more than just financial and transaction risk if they are to be successful in a global environment. For example, one consumer-oriented risk that wasn't considered by most real estate owners five years ago (because it didn't really exist yet) is a rapidly growing demand among tenants — especially Fortune 500 companies — for green buildings. If buildings don't meet their ever-more-stringent demands for green compliance, tenants will leave — developing and owning their own green buildings.*

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# 15. Accounting Standards: The Unexpected Story of the Year?

Accounting standards are not always top of mind for non-accountants. But there's one trend in this area that could literally turn our world (and financial statements) upside down: the global shift to International Financial Reporting Standards, also known as IFRS. While most of the world already is committed to IFRS, the majority of US companies use Generally Accepted Accounting Principles (GAAP) as their accounting guideline. Not for much longer, however. The US Securities and Exchange Commission has already allowed non-US companies doing business in the US to file financial reports using IFRS, and now it is asking the accounting industry if US companies should be allowed to do the same. Why is this important? Because a mutually agreed upon method of valuing a real estate asset is the key to facilitating trade. It is becoming a norm for more and more global investors to reflect value on their accounting statements, and market forces are likely to force the US to conform, and soon. Again, the current estimates of US commercial real estate assets under either accounting standard run to the trillions of dollars. If valuations are adjusted, the perceptual impact alone could be massive.

## *Ernst & Young observation:*

*Our firm's position is that IFRS makes sense for US companies and, in the long run, will be more cost-effective and practical. In today's truly global economy, where a sneeze in the US capital markets can infect the rest of the world with a cold or even flu, there's no longer room for stand-alone national approaches to accounting. Having a uniform global standard for financial statements will help all companies, regardless of country of origin or business type, and is critical to the successful integration of the world's capital markets. We don't think this is a wait-and-see proposition; the US should make the switch to IFRS now so companies can begin making the change in their financial reporting. However, they also should be aware that conversion to IFRS is a costly and time-consuming process that is still undergoing major maintenance. It is not yet a stable platform.*

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## **About the Ernst & Young Global Real Estate Center**

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