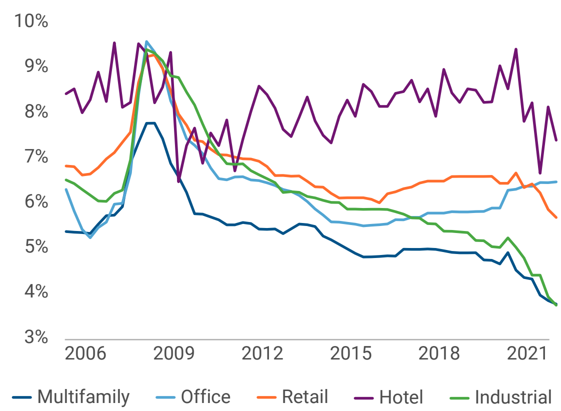
2022 Real Assets Market Oveview

Real Estate

July 2022 | Sabeen Jameeli, Senior Associate, Real Assets

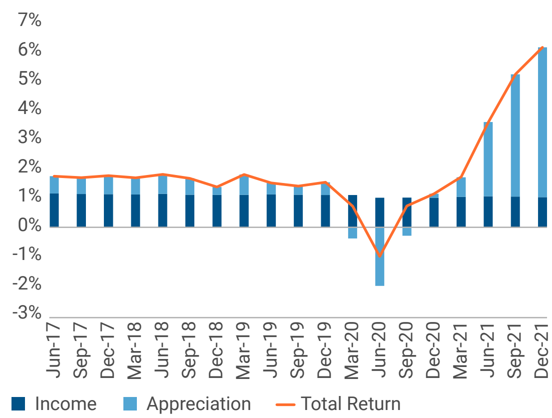
In 2021, the commercial real estate market experienced a rebound that surpassed forecasts, with national property values reaching all-time highs. The real estate market continued to observe a K-shaped recovery across sectors, fueled by consumer behavior and migratory patterns. The pandemic accelerated growth in sectors such as industrial and multifamily, while creating more headwinds for office, retail and hotel. Growth has primarily been appreciation-driven rather than income, with unprecedented dispersion between sectors.

Cap Rate by Property Type



Source: Green Street Advisors, LLC and Bloomberg as of December 31, 2021

NCREIF Property Index Returns
by Quarter

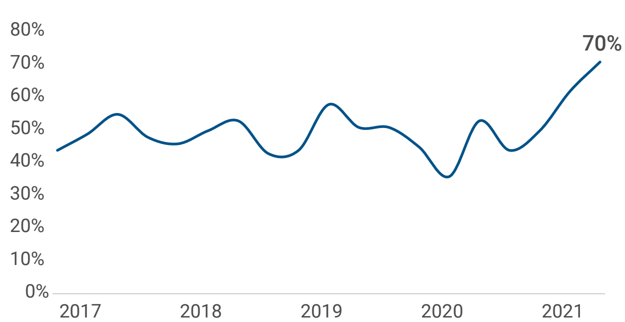


Source: NCREIF as of December 31, 2021

We can see this divergence observed in cap rates, as industrial and multifamily continue a downward trend, while office and hotel have trended up. Notably, the retail sector observed improved fundamentals, with 2021 marking the first year since 2017 that retail saw net-positive growth in stores, with an addition of more than 4,300 new openings in U.S. suburban shopping centers (grocery-anchored retail) and residential prime urban corridors continue to be the strong performers. Markets located in the Southeast and Southwest have seen strong leasing activity fueled by population growth and an increase in buying power, while urban and coastal markets have experienced a weaker recovery.

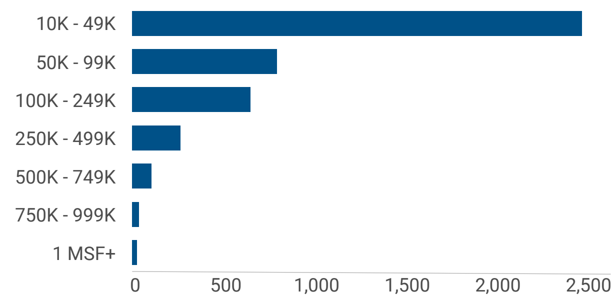
The U.S. industrial market continued its outperformance throughout 2021, with record-high rents and demand outpacing supply, and with no signs of letup so far this year. The increase in e-commerce has fueled demand for small- to mid-sized logistics facilities due to the growing need for last-mile delivery services. More than half of U.S. industrial leasing activity in Q3 2021 came from spaces between 10,000 square feet and 49,000 square feet. Even in the current competitive landscape, the outlook for the industrial sector remains positive. With increasing capital flowing into the sector and limited Class A product, we can expect new investors to shift their focus from Class A to Class B facilities, narrowing the cap rate spread between the two.

Industrial Inventory - Percent Preleased



Source: JLL U.S. Industrial Outlook, Q3 2021

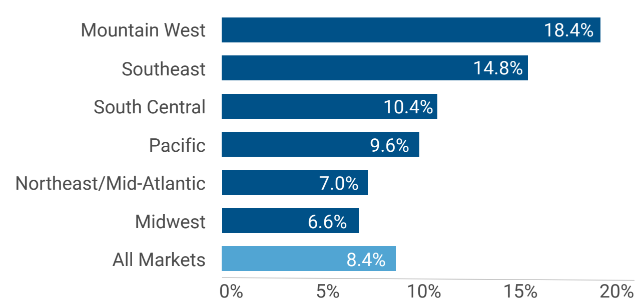
Number of Leases Executed by Facility Size



Source: JLL U.S. Industrial Outlook, Q3 2021

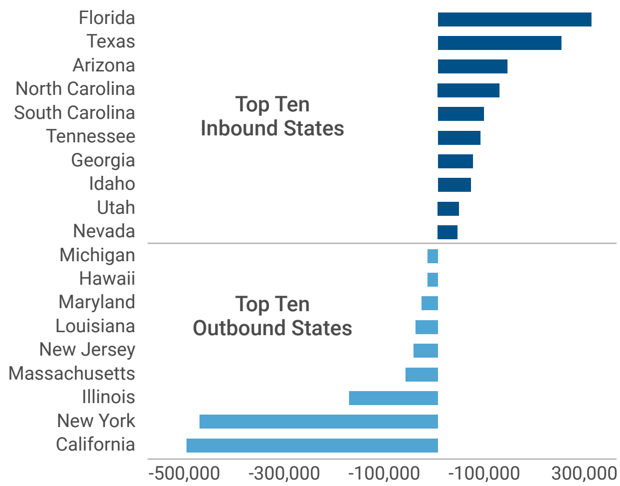
Multifamily has not only proven to be a resilient asset class through the pandemic but has further attracted investors under the prevailing high inflationary environment. Multifamily naturally provides for a hedge against inflation, with its annual lease mark-to-market. In 2021, the sector posted 24.8% annual NOI growth, with rent growth strongest in the Sunbelt and Mountain West regions, fueled by net migration patterns. While domestic out-migration from high-cost states was already occurring, the pandemic further accelerated this trend, coined “the great migration”. The new era of remote and flexible work created an opportunity for many to relocate from urban to suburban and secondary metro areas. Notably, in 2021, Phoenix, AZ; West Palm Beach, FL; Tampa, FL; Las Vegas, NV; and Tucson, AZ all posted year-over-year rent growth exceeding 20%.

Year-over-Year Rent Growth by Region



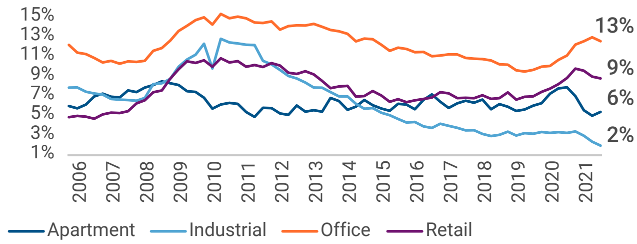
Source: CBRE Research, Q3 2021

U.S. Net Domestic Migration
April 2020 to July 2021

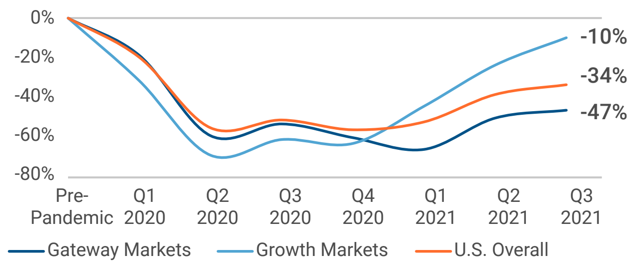


Source: CBRE Research, Q3 2021

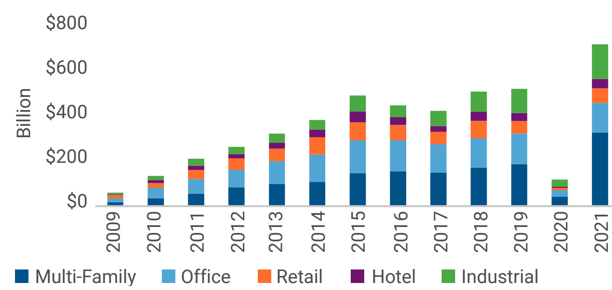
Vacancy Rates by Property Type



Office Quarterly Leasing Relative to Pre-Pandemic Normal (%)



Transaction Volume



Sources: NCREIF as of December 31, 2021. JLL Office Market Outlook, 3Q 2021. Bloomberg as of December 31, 2021

Through the pandemic, investors have had a greater emphasis on asset quality and fundamentals, which has been a key differentiator between performing and underperforming assets, specifically in the office sector. Even as the office sector shows early signs of recovery, the shift to hybrid work creates a level of uncertainty, signaling office may never return to a pre-pandemic normal. Though there have been improving fundamentals in the sector, recovery has been variable depending on asset quality and location. The office sector specifically has observed "flight to quality," as rents for premium, well-amenitized buildings have increased in select markets, creating heightened risk among the older Class B and C office products. Another contributing factor to the sector's weak fundamentals has been the historic high level of subleased space, which was up 80% from March 2020. Conversely, the sector saw many large technology companies leasing up considerable space, accounting for almost 24% of all leasing activity in Q3 2021. Though the sector's recovery has been variable, we can remain confident that office spaces will continue to be a necessity within the corporate culture.

In 2021, the U.S. saw record pricing for "in-favor" sectors, while more cyclical and "out-of-favor" sectors continued their rebound. Due to changes in consumer behavior and migratory patterns brought on by the pandemic, certain sectors have greatly benefited while others have faced headwinds. As property values soared, investors seeking strong downside protection and yield were drawn to the space, driving transaction volume to record highs. The strong pricing environment observed in 2021 was supported by excess liquidity and low interest rates due to the Fed's quantitative easing program. In the current competitive environment where property valuations remain high, we can expect to see value-oriented investors take advantage of some of the "out-of-favor" sectors as there may be opportunity to capitalize on mispriced assets. In an evolving macro-environment, we can also expect returns drivers to shift more towards income from appreciation.

ENDNOTES

Real Estate: NCREIF Property Index –The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors –the great majority being pension funds. As such, all properties are held in a fiduciary environment. Source: Bloomberg

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