American Realty Advisors

# House View: H2 2021

Investment Outlook Data Slides Set

# U.S. Real Estate Investment Outlook – H2 2021

## Real estate prospects look bright in the light of a new economic cycle

### Macroeconomic Context

- With GDP reaching pre-pandemic levels and the pace of growth moderating, conditions are ripe for another low-and-long cycle.
- Infrastructure spending could serve as an additional stimulant in the outer years given the delayed effect.
- Key near-term risks are related to policy and inflation via Fed tapering and rate hikes, but we're also positioning for the longer-term risk landscape.

### Real Estate Markets

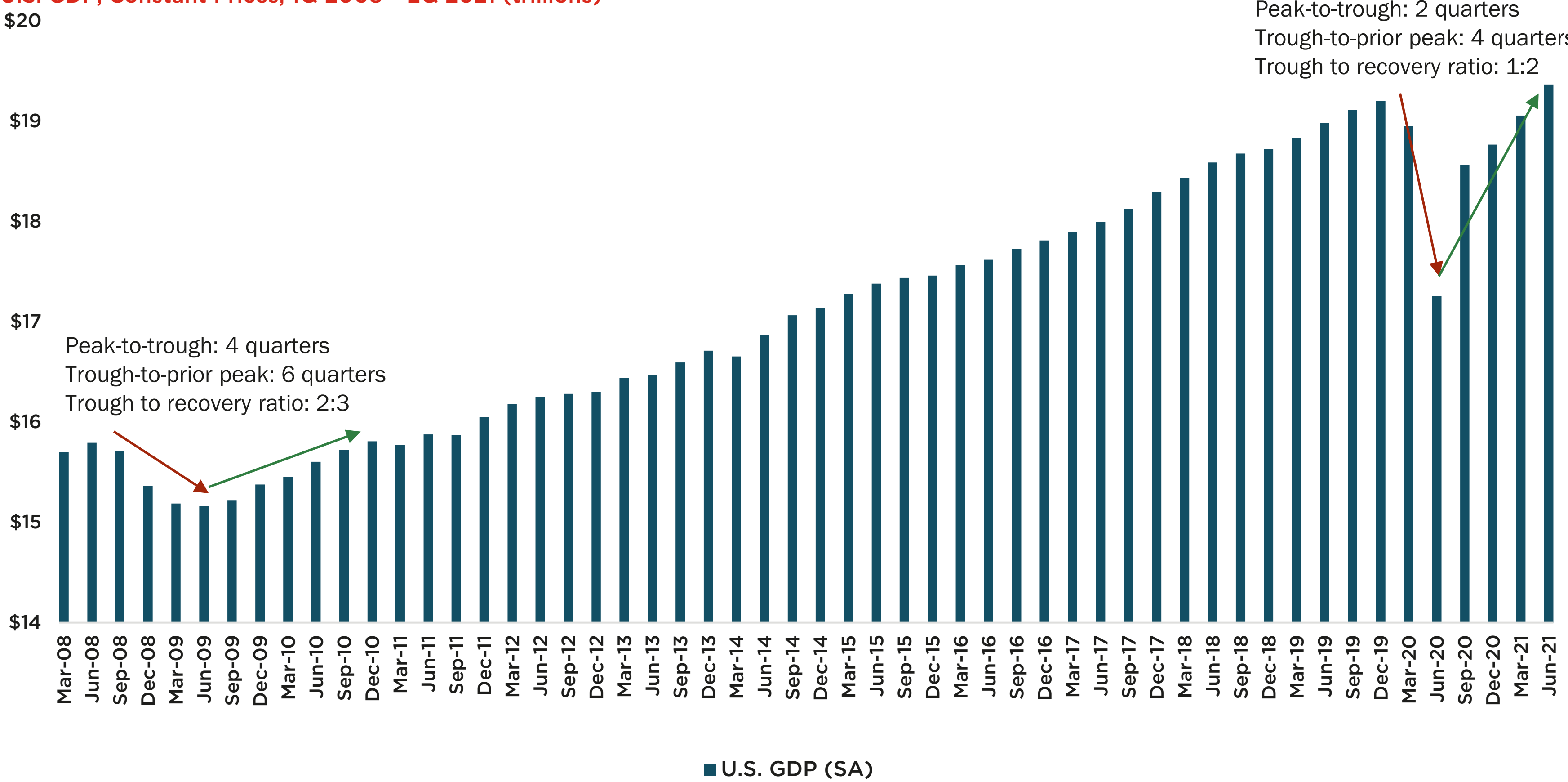
- The Delta variant has spurred delays in return-to-work timelines, though demand green shoots are emerging.
- Residential, industrial rent growth has accelerated in an unprecedented way as robust demand has far outpaced supply.
- Real estate returns in the coming years look to be even stronger than they were pre-pandemic, with fundamentals reinvigorated by a new economic cycle.

Images: (Above) Rising vaccination rates have invigorated residents' return to cities, though not yet the office. (Below) Supply chain backlogs continue to drive demand for warehouses as firms seek to hold more inventory on hand.

# Strong Rebounds Don't Mean Short Cycles

- **The U.S. economy surpassed pre-pandemic levels in 2Q '21, four quarters after the trough.**
- **Given the relative shortness of the contraction, a proportionately short recovery doesn't necessarily signify a shorter cycle – just look at the GFC!**

U.S. GDP, Constant Prices, 1Q 2008 – 2Q 2021 (trillions)

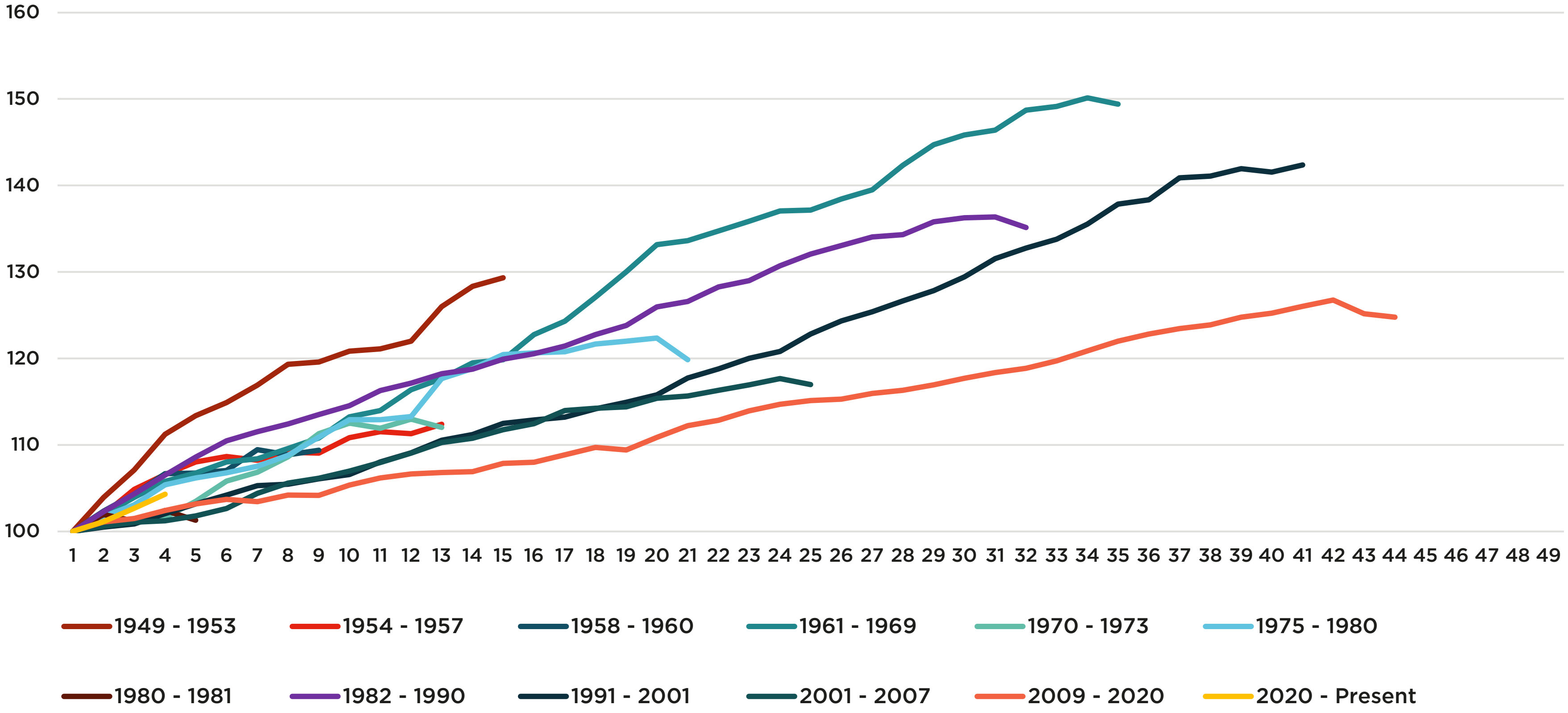



Source: American Realty Advisors based on data from Macrobond as of October 2021

# The Context of a New Cycle

- **The post-pandemic recovery marked the start of a new economic cycle.**
- **The relative strength of the expansion thus far reminds us of many traditional cycles before it, suggesting we're still in early innings.**

U.S. Real GDP Expansion, Number of Quarters, Past Economic Cycles, 1945 – Present (End of Contraction Represents Beginning of New Cycle = 100)




Note: As defined by the National Bureau of Economic Research (NBER) makes a determination of the calendar quarter of a peak or trough based on measures of aggregate economic activity over the relevant quarters; generally, the peak or trough quarter contains the peak or trough month, though there are exceptions, with Q4 2019 the most recent.
Source: American Realty Advisors based on data from the National Bureau of Economic Research and the Federal Reserve Bank of St. Louis (FRED) as of September 2021

# Low and Long

**We expect a slower relative growth setting will create conditions for another lengthy economic cycle.**

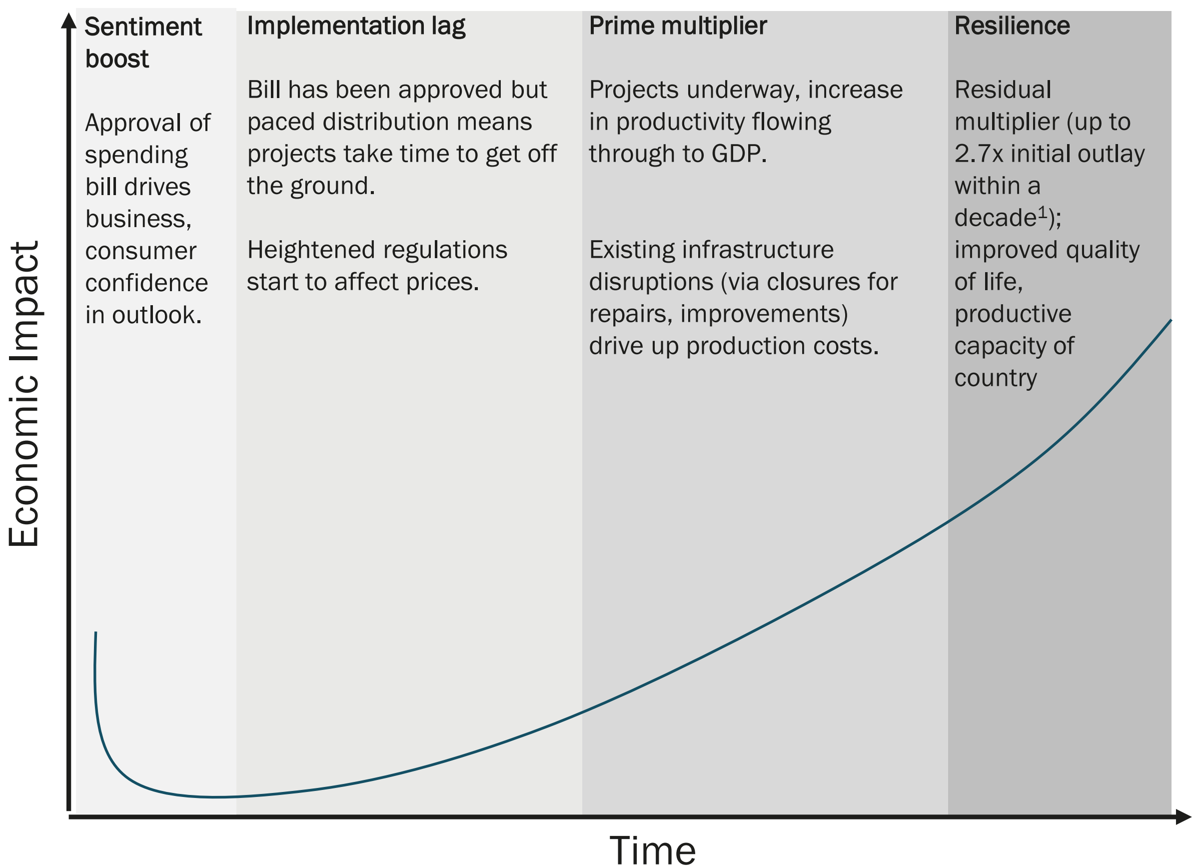
| Decade Averages | 1970's | 1980's | 1990's | 2000's | 2010's | 2020's (f) |
|---|---|---|---|---|---|---|
| Job Growth (Annual Average) | 2.5% | 1.9% | 1.9% | -0.1% | 1.6% | 0.4% |
| GDP Growth (Nominal) | 10.2% | 7.8% | 5.6% | 4.0% | 4.0% | 4.2% |
| Inflation (Average) | 7.4% | 5.1% | 2.9% | 2.6% | 1.7% | 2.3% |
| Average length of economic cycles (in years) | 4.25 | 4.75 | 10.25 | 6.25 | 11 | 7.5-8.75 |

Source: American Realty Advisors based on data from Oxford Economics as of September 2021. f=forecast.

# Navigating the Long Road to Infrastructure Impacts

**Federal infrastructure spending viewed as a positive for longer-term growth, but it will take time for effects to flow through to the economy and in the interim would likely add to inflationary pressures.**

Timeline and impact framework from federal infrastructure investments




<u>But only if….</u>

- State and local jurisdictions don't reduce their own contribution ("it's being paid for, so I can allocate monies elsewhere").
- The positive effects can offset impacts from the source of funding (increased taxes or deficit funding, which has the effect of increasing interest rates over time and thus crowding out private investment).

For illustrative purposes only. [1] Source: Deloitte, Standards & Poor's (S&P), *Infrastructure as an economic stimulus*, October 2020
Source: American Realty Advisors based on data from Deloitte and Standard & Poor's as of October 2021

# Evaluating the Risk Landscape for the Coming Cycle

## As long-term investors, we're focused on identifying (and mitigating against) risks today and tomorrow

### Environmental

- Extreme weather events continue to increase in frequency, impacting market- and asset-level risk profiles
- Scarcity and accessibility of natural resources make certain types of new development in impacted markets less feasible
- Policy-related changes targeted at reducing $CO_2$ emissions could increase op-ex, cap-ex costs for older/less efficient buildings

### Societal

- Income disparity pushes to the forefront, creating impetus for widespread changes to employment and local instability
- Skills gap leaves more workers permanently out of workforce, increasing structural unemployment and weakening economy
- "Pandemials" (young adults experiencing their 2$^{nd}$ major global crisis in a decade) may be academically, financially, socially disadvantaged, creating long-term drags on sectors like for-sale housing

### Geopolitical

- Rise in nationalism reverses cost gains achieved from globalization, potentially lessens immigration
- International conflict (economic, political or technological) fractures relations and increases global instability

### Technological

- Governance and regulations adversely impact existing firms, curtail future activity in leading growth sector
- Productivity gains via technological advancement occurs at the expense of lower-skilled labor
- Cybersecurity attacks threaten to shutdown critical digital infrastructure, costing companies and governments millions

### Economic

- Persistent price pressures create strongarm Fed response, increasing benchmark rates and resetting asset class values
- U.S. government in ongoing political battle to continually raise debt ceiling, creating market instability
- Prolonged period of  stagnation (low- or no growth) globally drags domestic prospects down

Source: American Realty Advisors based on data from the World Economic Forum's Global Risk Report 2021.

# Capital Markets

AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

# Private Real Estate Yield Prospects Look Highly Attractive

## Compared to the premium being offered in other risk assets, the income yield from private real estate is offering the most

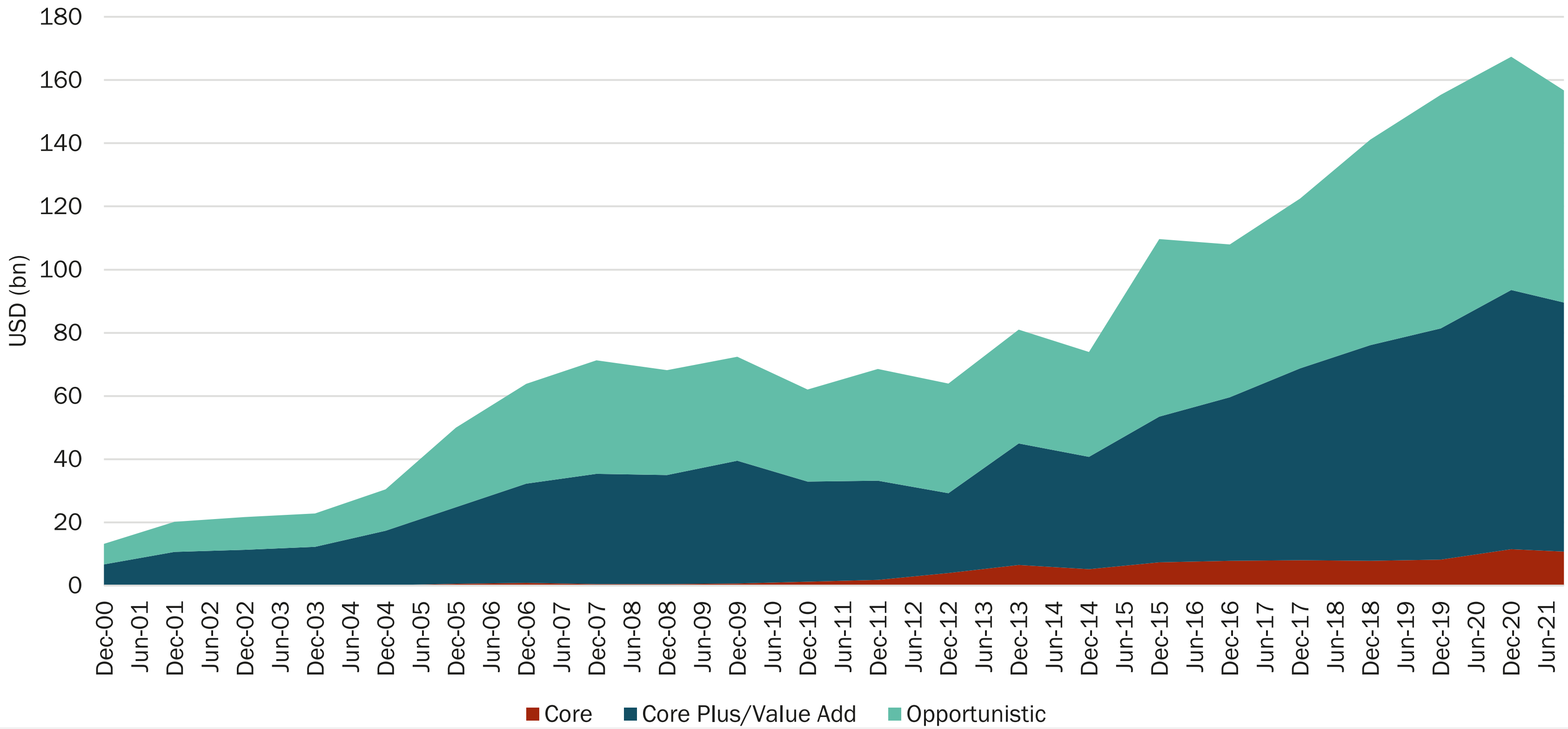
Dividend yield/cap rate spread to long-term government bonds, public and private real estate, BAA-corporate & equities


Note: Asset classes sorted from left to right by current spread to long-term government bonds (largest to smallest). Private real estate yields represented by the NPI equal-weighted current value cap rate, REITs are represented by the dividend yield from the FTSE Nareit All-Equity REITs Index, and equities represent the dividend yield from the S&P 500. Data reflects quarterly values.
Source: American Realty Advisors based on data from NCREIF and Macrobond as of September 2021. LTA = Long-term average, 2007-2021.

# At the Core of the Dry Powder Pile

## Copious amounts of capital chasing higher returns may offer a window of opportunity for core investors

Dry powder by real estate strategy in North America, 2000 - 2021



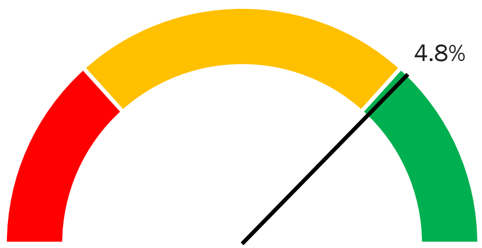

- As significant sums of capital seek out opportunistic strategies, yields have continued to trend downward, compressing returns across the risk spectrum.
- As a result, now may be an attractive time for investors to lean into core, as the risk-adjusted returns have become quite attractive in comparison.

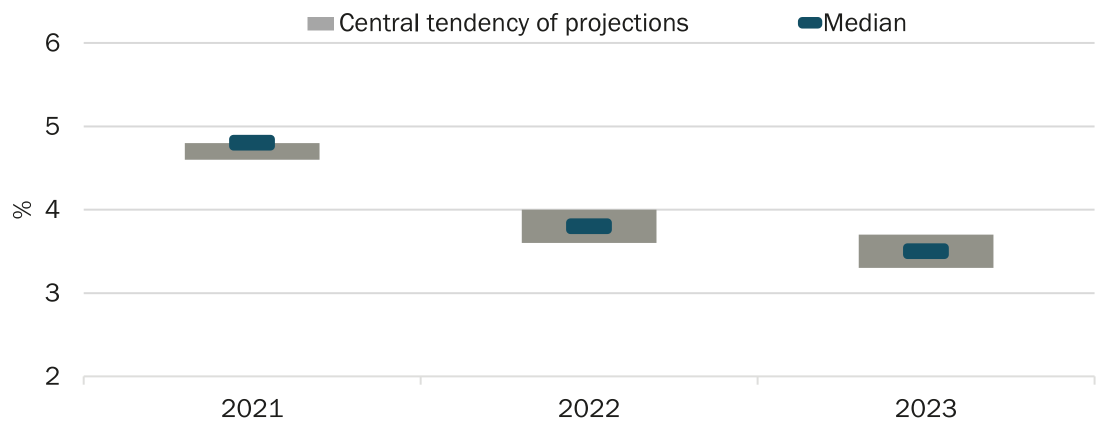
Source: American Realty Advisors based on data from Preqin as of September 2021.

# Progress Towards Fed Rate Hike

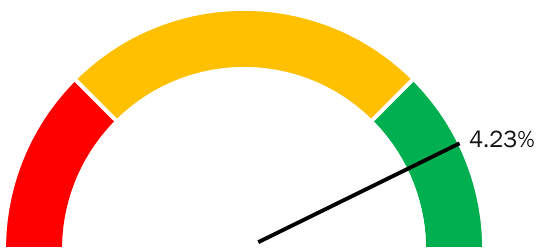
**Progress towards critical Fed thresholds will determine timing of next rate hike**

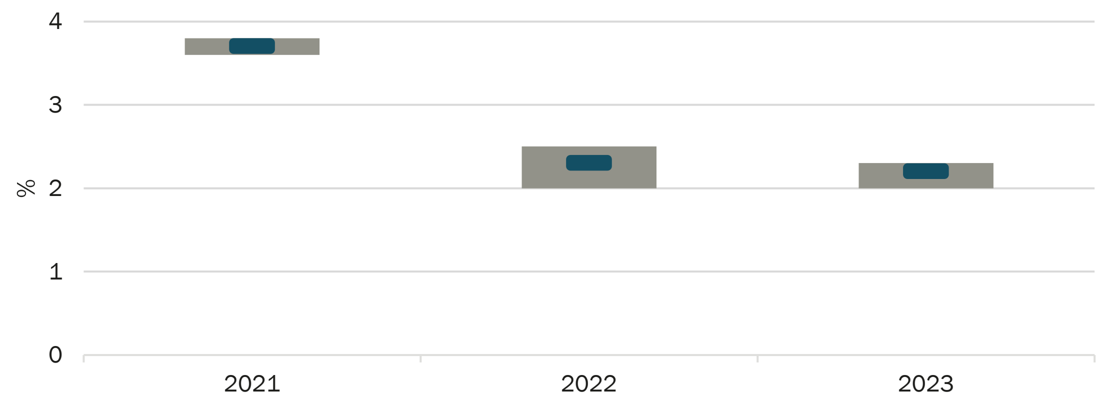
### Unemployment




### Core PCE Annual Inflation



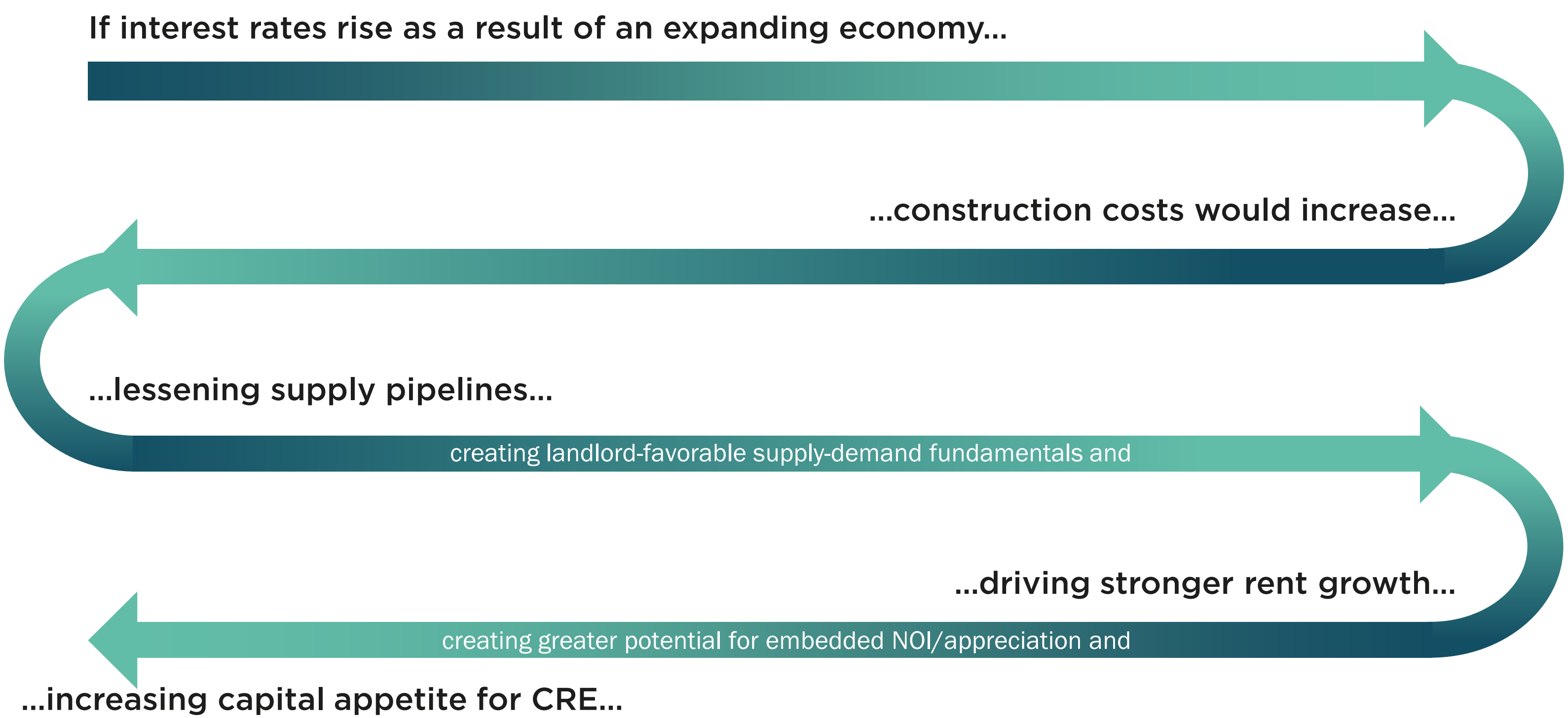

**We anticipate the first 25-bp rate hike in early 2023 but expect the Fed funds rate to remain below 1.5% through at least 2024.**

.Source: American Realty Advisors based on data from the Federal Open Market Committee Summary of Economic Projections dated September 22, 2021

# Flow-Through Effect of Higher Interest Rates on Real Estate Pricing

## Considering what the trickle-down effects on real estate cap rates might be from higher interest rates

Cause and effects of higher interest rates on real estate cap rates



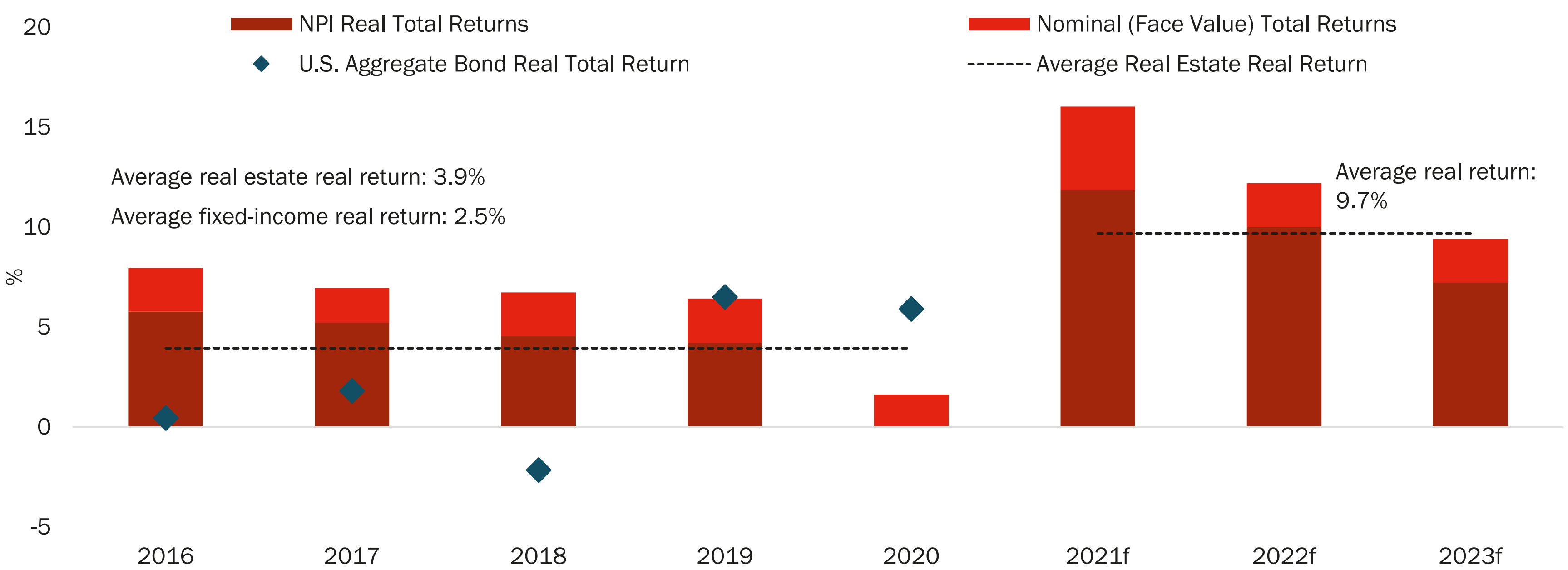

**…which can serve to at least partially offset relative repricing of CRE purely as a function of higher benchmark rates.**

Source: American Realty Advisors as of September 2021

# *Real* Real Estate Return Outlook: How Does It Stack Up?

**Adjusted for inflation, returns are expected to be stronger than they have been and more than three times what's been offered in the fixed-income market**

Nominal and real (inflation-adjusted) NCREIF Property Index (NPI) unlevered total returns, 2016 – 2023f




- Real estate's strong nominal returns in recent years have continued to drive capital allocations to the asset class.
- But with some degree of inflation expected in the next few years, investors need to consider what their returns could look like after accounting for the erosive effects of inflation – this is known as *real returns*.
- In this regard, real estate returns on an inflation-adjusted basis look to be even more attractive going forward than they had been over the last 5 years, and materially stronger than recent fixed-income returns.

Note: Forecasts for 2021-2023 reflect ARA's total return forecasts as of Q3 2021 and the median core inflation expectations from FOMC Economic Projections. Nominal returns adjusted by core PCE inflation.
Source: American Realty Advisors based on data from NCREIF, Federal Open Market Committee Summary of Economic Projections dated September 22, 2021, Morningstar and Macrobond as of October 2021

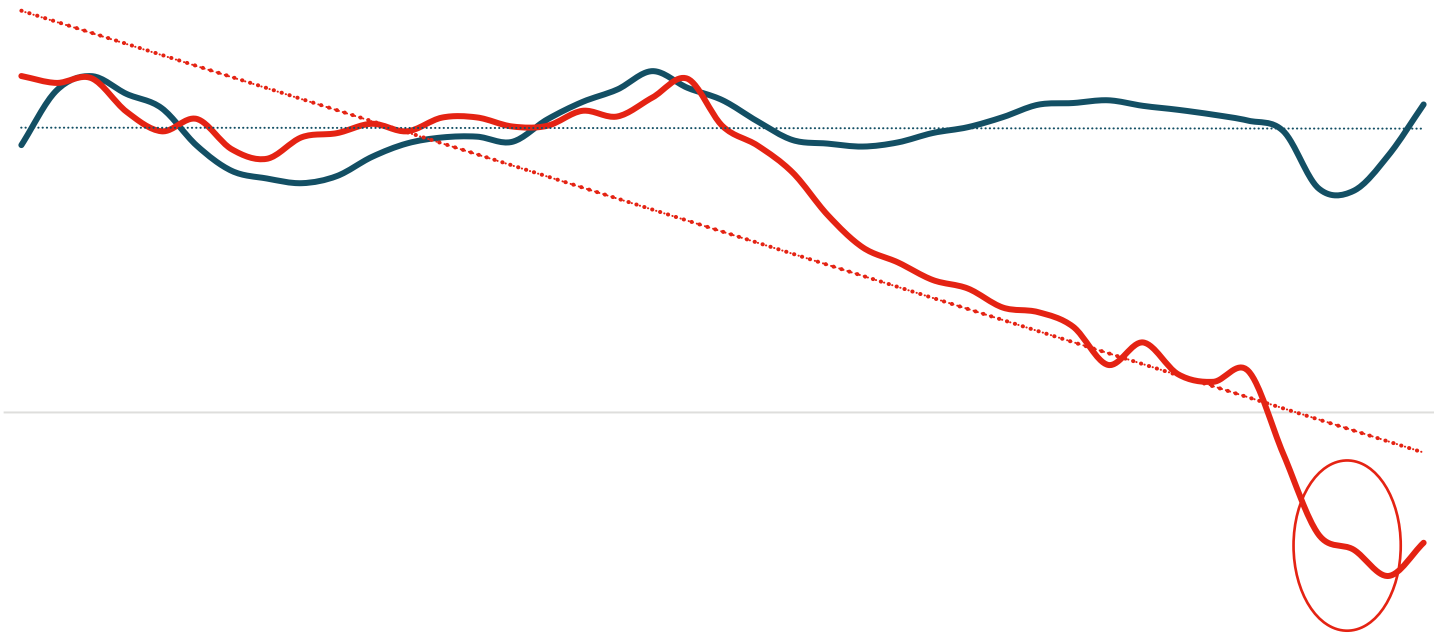
# Property Markets

AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

# Sending Mixed (Opportunity) Signals: Cyclical and Secular Drivers

**Cyclical and secular forces seem to be pointing in opposite directions; both can be compelling – it just depends on your timeframe and risk tolerance.**

Industrial versus retail total return example: Identifying cyclical and secular opportunities



Over the long term, investors should ensure their exposures are tilted towards structurally supported sectors (like industrial) whose overall trajectory is more resilient...

...but there are cyclical windows in which counter-structural segments (like retail) may yield attractive upside.

- Investors have been told to pursue sectors and markets with structural tailwinds that suggest the potential for long-term outperformance (think: e-commerce tailwind for industrial, ageing Millennial tailwind for lower-density rentals).
- Over the long term, this is the right strategy, as structural forces tend to prevail; however, there may be cyclical opportunities to capture upside in otherwise structurally-challenged areas (like retail) in the shorter term when rising tides are lifting all boats.

Source: American Realty Advisors based on data from NCREIF as of October 2021

# Ways to Play: Now and Later

**We advocate maintaining flexibility to pursue tactical opportunities driven by the upcycle while continuing to trend towards longer-term strategic goals**

### PLAYING THE TRENDS: NOW AND LATER

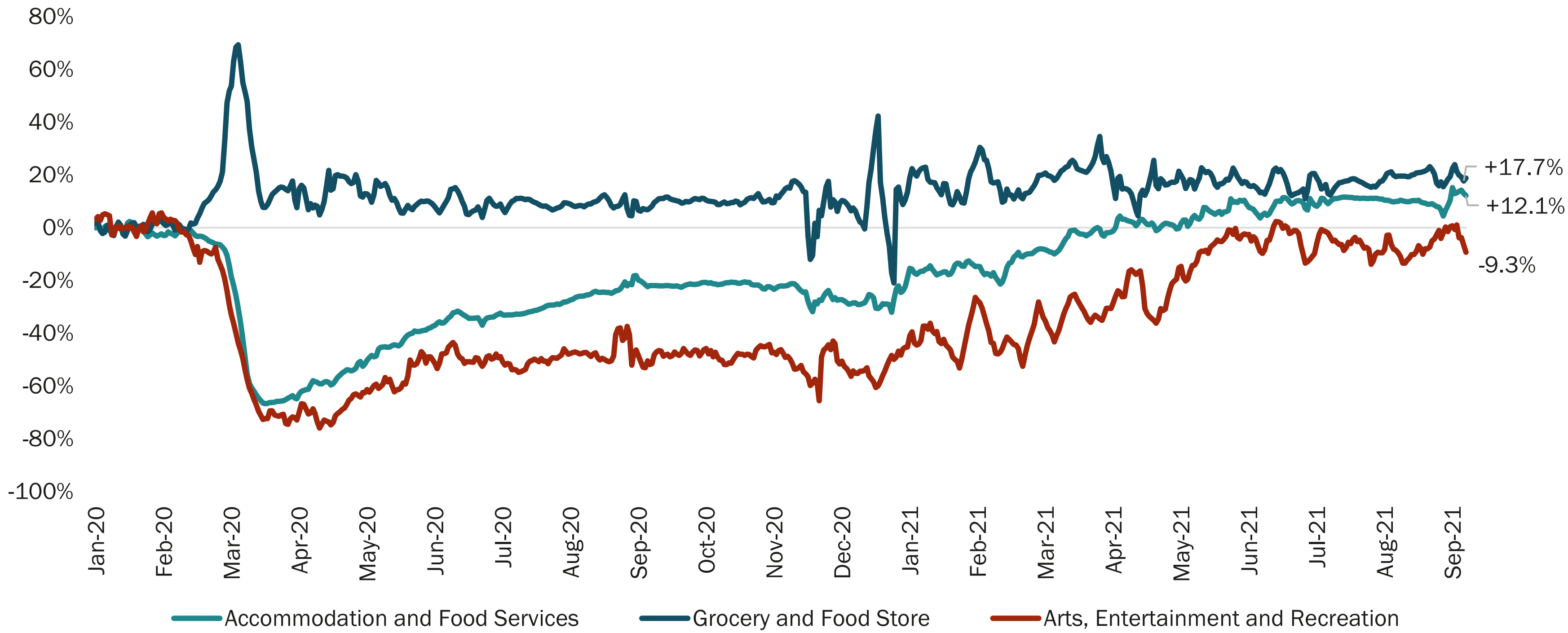
| Trend | Cyclical/Near-Term/Tactical | Structural/Long-Term/Strategic |
|---|---|---|
| Consumer Spending | • Ride the in-person spending rebound<br>• Sell non-strategic retail amidst visitor recovery<br>• Buy/build infill, distribution and cold storage warehouses | • Overweight to industrial (all types)<br>• Minimize exposure to non-necessity retail<br>• Reposition under-utilized retail |
| Shift to Suburbs | • Build low-density SFR<br>• Take on lease-up plays in urban multifamily<br>• Aggressively increase rents in market-rate units | • Target mix of urban, suburban residential<br>• Lean into in-migration markets<br>• Lessen exposure to unfriendly jurisdictions |
| Work-from-Home (WFH) | • Refrain from selling CBD assets at steep discount<br>• Buy CBD offices in ‘22 in anticipation of rent growth, demand recovery | • Do not compromise on location<br>• LEED/wellness part of “great distinguishing”<br>• Overall reduced office exposure |

Source: American Realty Advisors as of October 2021

# Consumer Spending: Ongoing Discretionary Spending Recovery

**Spending on entertainment and recreation still lags other categories but is recovering; grocery and other necessity-based retail firmly above pre-pandemic levels**

Retail, grocery, and entertainment/recreation spending, relative to January 2020 baseline



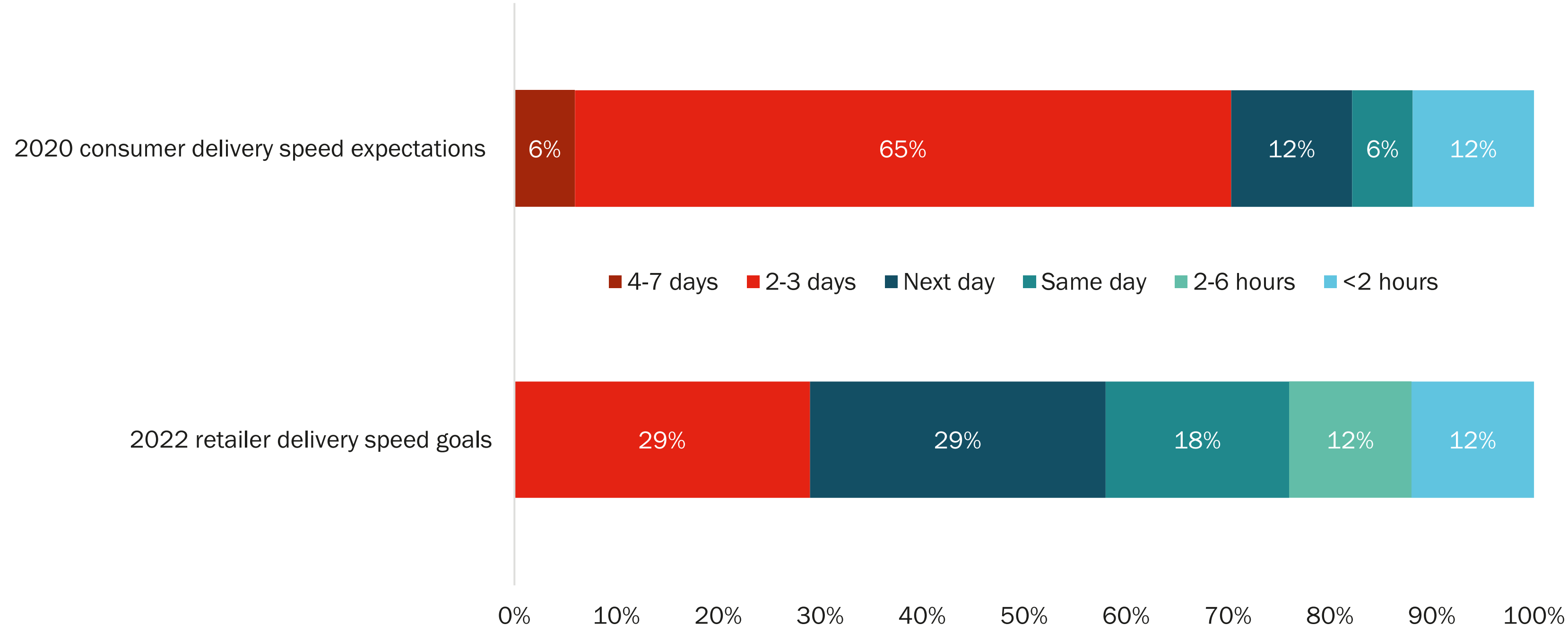

- In line with rising vaccination rates, consumer revenge spending in "in-person only" categories has continued to recover, though is still below pre-crisis levels in more experiential offerings, suggesting more room to run for centers with these tenants.
- Meanwhile, spending in necessity offerings barely skipped a beat, demonstrating how, over the long-term, investors' retail holdings should reflect a selectively curated portfolio of grocery-anchored centers.

Source: American Realty Advisors based on data from Opportunity Insights and Affinity as of October 2021

# Consumer Spending: Need for Speed

## Ambitious delivery targets will require retailers to invest heavily in building out their last-mile presence

Current consumer delivery speed expectations and retailer delivery speed goals by 2022



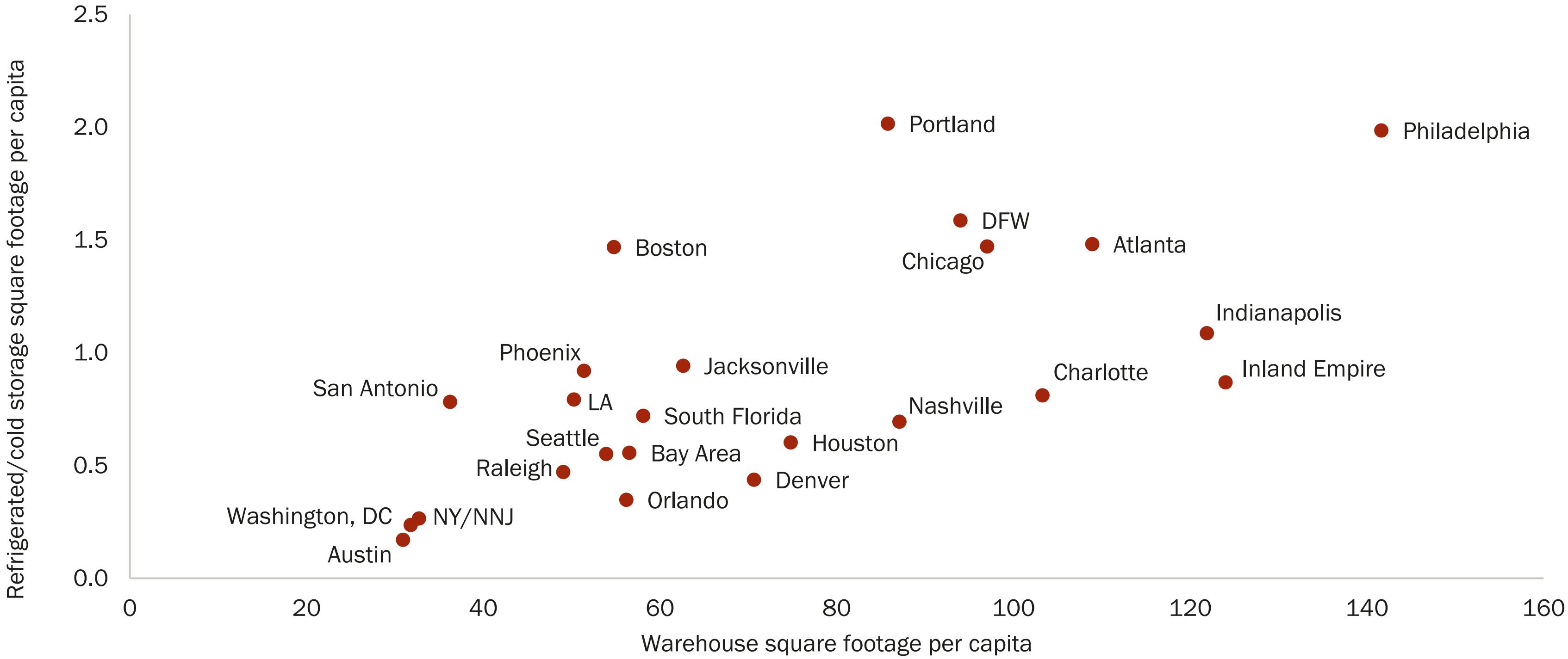

- Relative to expectations today, retailers are aiming for dramatically condensed delivery timelines in the near term to cater to heightened consumer expectations.
- Meeting these goals will require trimming 2-3 days from today's delivery times on average, increasing demand for last-mile/infill distribution facilities.

Source: American Realty Advisors based on data from McKinsey & Company's *Retail Speaks: Seven Imperatives for the Industry* report dated September 2021

# Consumer Spending: Need for Cold Storage

## Compared to traditional warehouses, the amount of existing cold storage is woefully inadequate to service faster delivery windows for perishable goods

Traditional warehouse versus cold storage square footage per capita



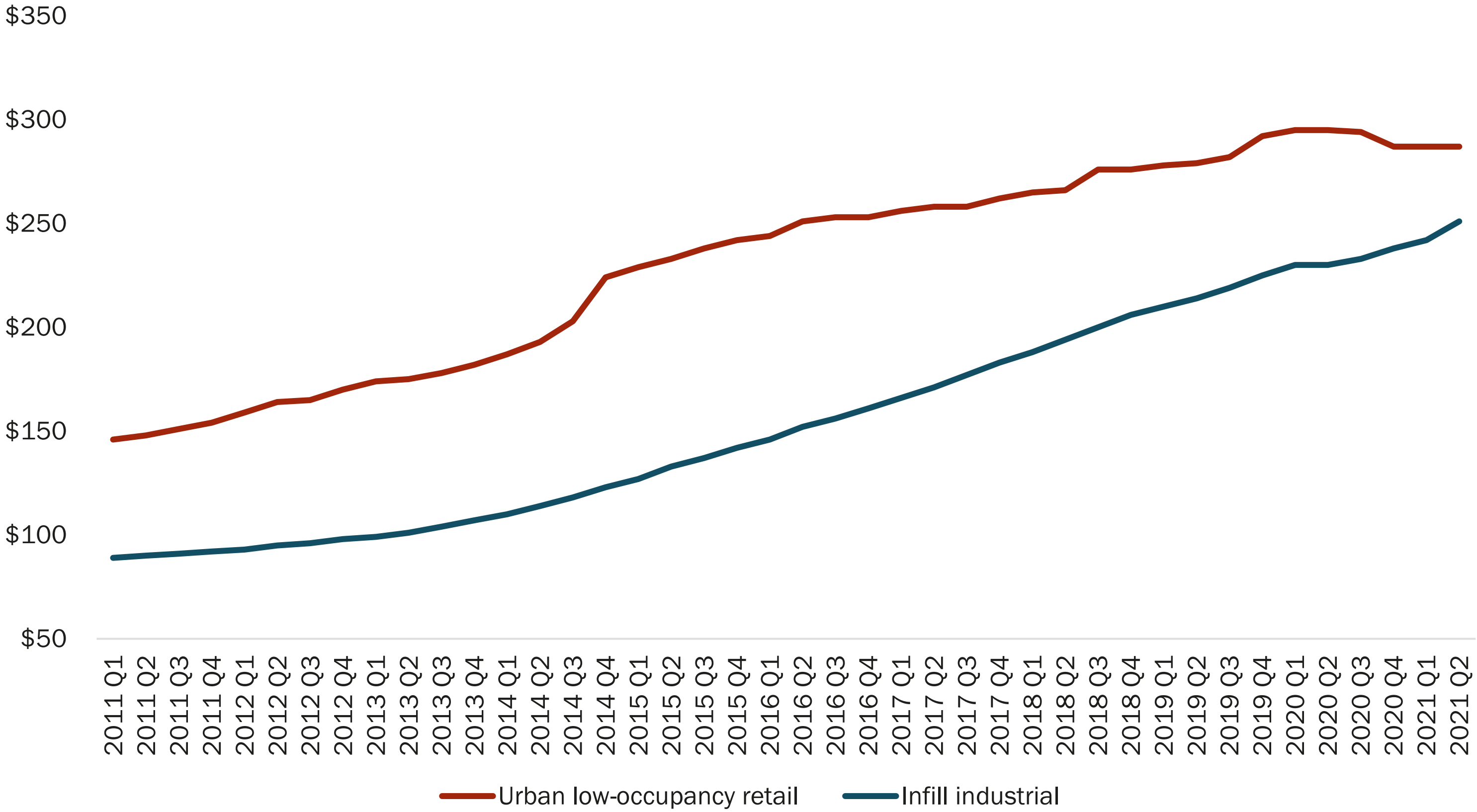

- No product is arguably more sensitive to delivery timelines and distance than perishable items like groceries and vaccines.
- Yet compared to the scale of traditional warehousing in most markets, existing cold storage appears woefully inadequate to satisfy growing occupier demand.
- Coupled with heightened functional obsolescence (average age of a cold storage facility = ~40 years), we anticipate there will be strong appetite for new BTS product.

Source: American Realty Advisors based on data from CoStar as of October 2021

# Consumer Spending: Why Not More Retail-to-Warehouse Conversions?

## Despite rising logistics values and weak retail fundamentals, infill retail spaces have not sufficiently repriced to make retail-to-distribution conversions attractive in most instances...yet

High-vacancy retail space compared to industrial space in infill LA, market values per square foot

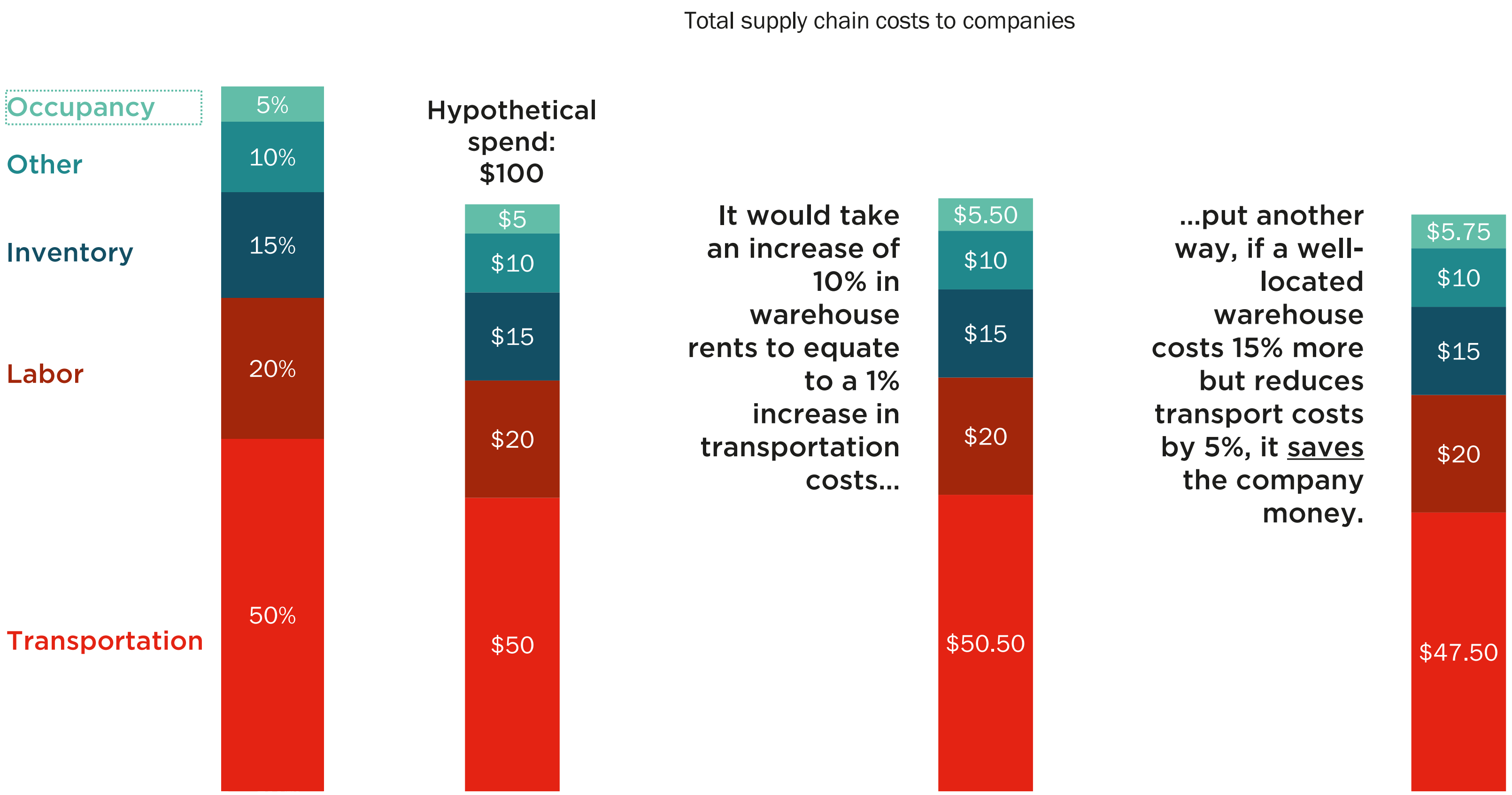



In infill LA, retail market values are still 15% higher than urban logistics on a per-square-foot basis; even with higher rent growth projections, the cost to reposition to last-mile distribution is not yet economically viable.

Note: Data reflects retail properties 10,000 sf or larger within a 5-mile radius of downtown LA that are 50% occupied or less and industrial properties within the same 5-mile radius of 10,000 sf or greater.
Source: American Realty Advisors based on data from CoStar as of September 2021

# Consumer Spending: Reducing Transport Allows for Higher Rents

**Warehouses that can offset rising costs in other parts of the supply chain can continue to push rents, which makes paying more for existing infill properties justifiable**

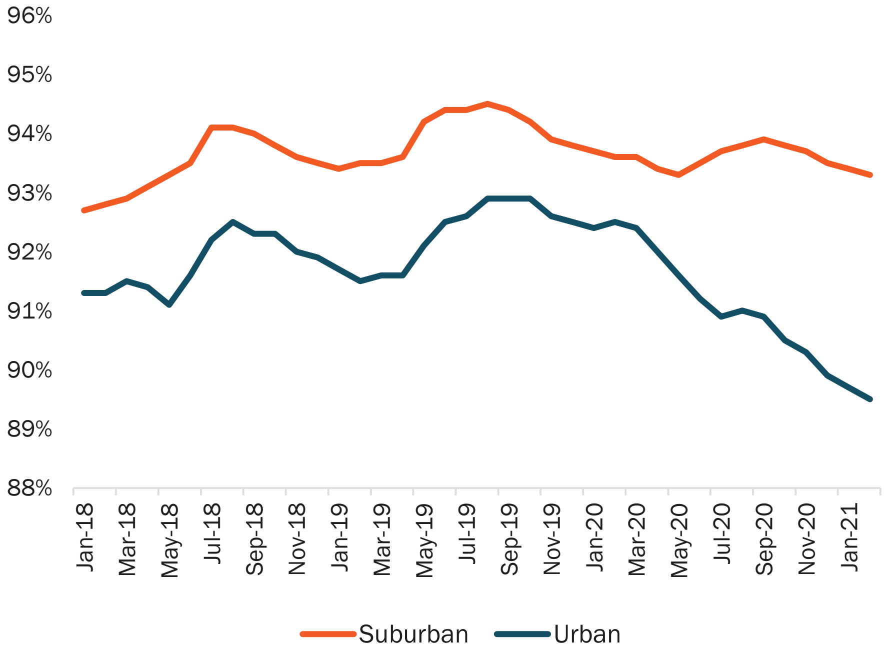



Note: Occupancy reflects fixed facility costs, including rent. Other is related costs not explicitly accounted for in transportation, fixed or variable facility costs, labor, or inventory carrying costs.
Source: American Realty Advisors based on data from CBRE Supply Chain Advisory 2021

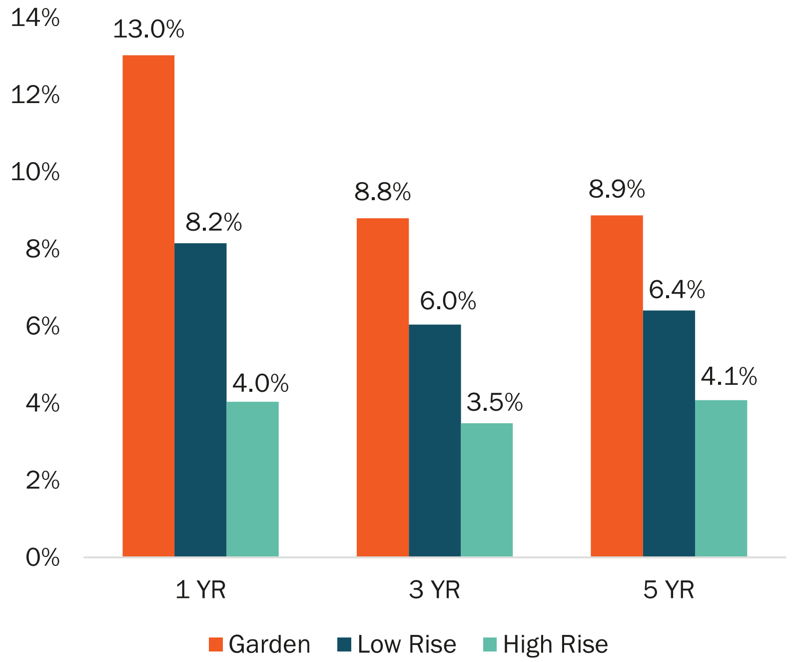
# Shift to Suburbs: Continuation of Pre-Existing Trend

**Looking at relative occupancy and returns, low-density/suburban apartments were holding their own well before the onset of the pandemic**

Urban versus suburban occupancy nationally, January 2018 – January 2021




NCREIF 1-, 3- and 5-YR total returns by multifamily subtype (through Q2 2021)



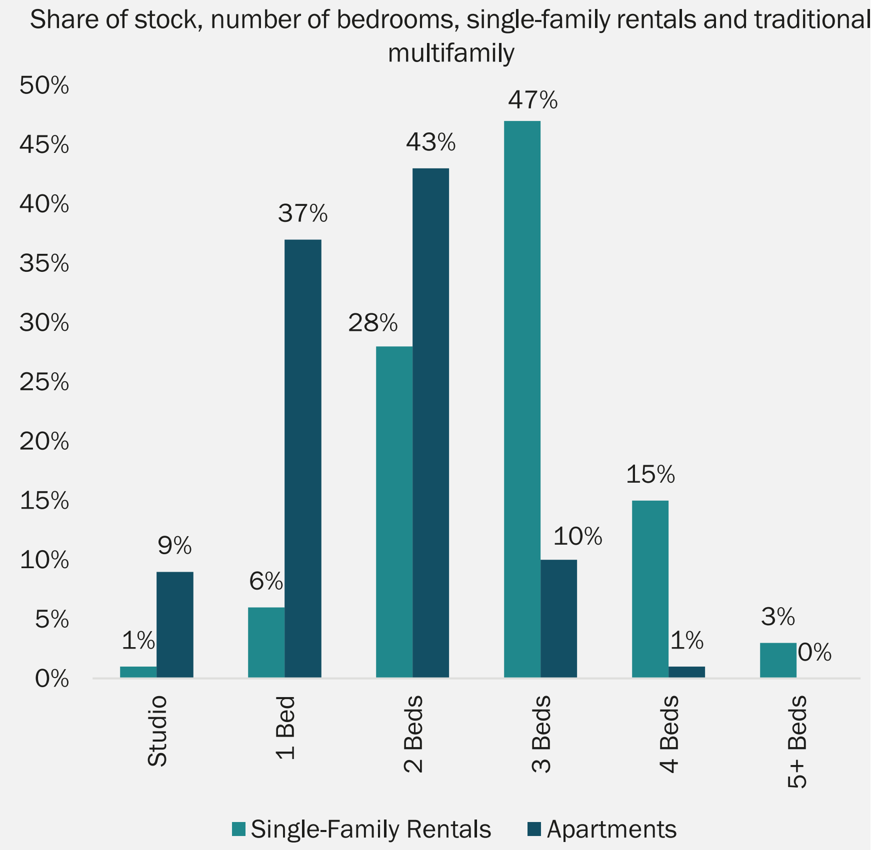

- Suburban apartment occupancies on average have been higher than their urban counterparts for some time, a function of lesser supply in the most recent cycle coupled with changing lifestyle preferences by older renters.
- As a result, low-density, garden-style apartments have provided much stronger total returns in recent years, with the pandemic only serving to reinforce the existing pattern.

Source: American Realty Advisors based on data from NCREIF Property Index and RCLCO as of October 2021

# Shift to Suburbs: Chase the Space

**The pandemic reinforced Millennials' gradual transition to the suburbs in search of larger units; rapidly appreciating for-sale market and high student loan burdens prevent significant leakage to ownership**

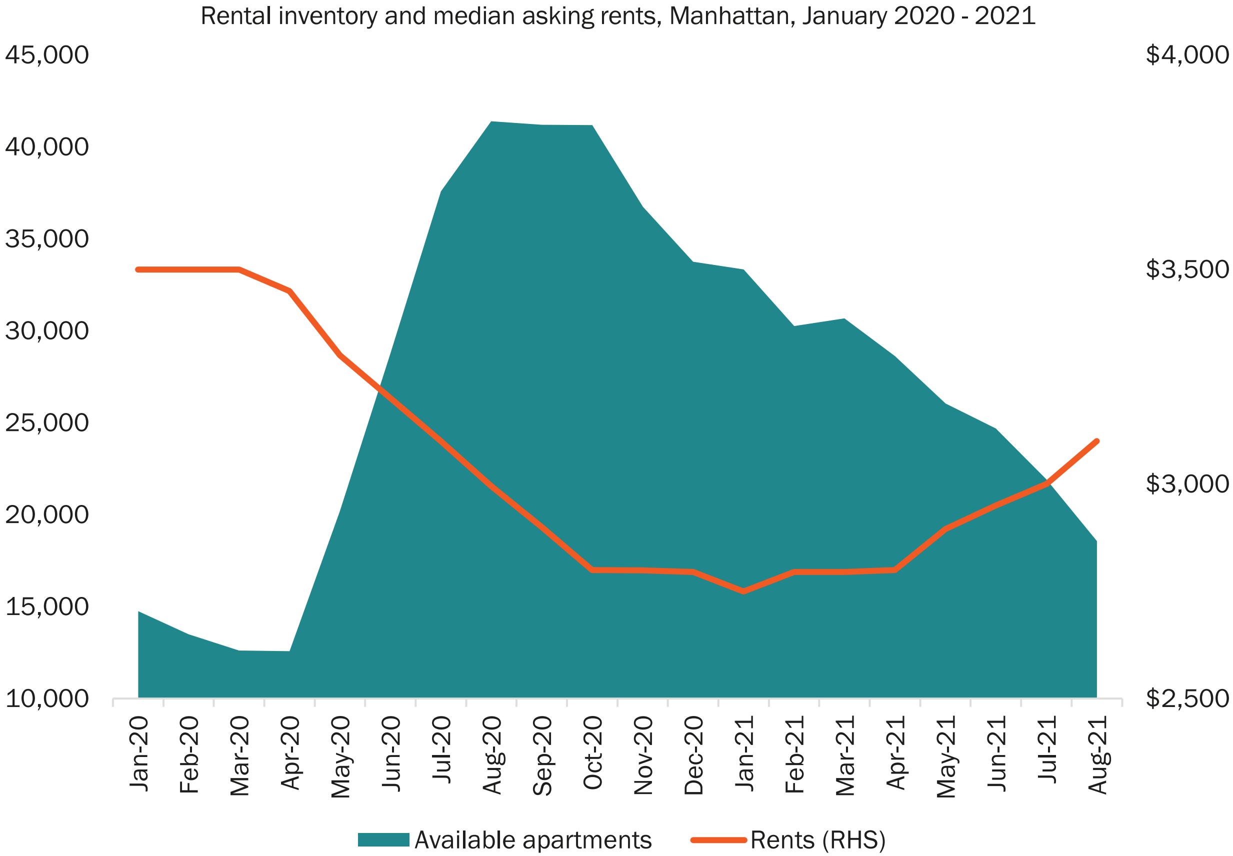
- While change-of-address data suggests the "urban exodus 2020" story was overblown, the pandemic did serve to highlight Millennial renters' desire for less-dense dwellings.
- Single-family rentals (SFR) have been a natural destination for this cohort, as these properties tend to offer a greater number of bedrooms to renters (in addition to private outdoor and garage space in certain communities).
- With the structural drivers of SFR demand (affordability, preference and availability) expected to persist in the coming years, we favor opportunities to both buy and build in high-growth and low-affordability markets.




.Source: American Realty Advisors based on data from John Burns Real Estate Consulting and JCHS tabulations of the U.S. Census Bureau American Community Survey 1-Year Estimates

# Shift to Suburbs: Bright Lights Beckon

## Despite the anticipated structural demand for lower-density rentals, the city remains a draw for renters




- As we anticipated, pandemic-induced weakness in urban apartments was relatively short lived, with demand surging back once vaccines were made available and cities reopened.
- Nowhere is this perhaps more evident than in Manhattan.
- Compared to the peak, the number of available apartments is down 55%, while asking rents have recovered to within 11% of the pre-pandemic peak.
- This suggests two things:
  1) That there remains more runway for the urban rebound narrative, and
  2) That the allure of cities, particularly for young people, persists even in the post-COVID era.

Source: American Realty Advisors based on data from StreetEasy as of October 2021

# Shift to Suburbs and WFH: Converging on Office?

## Unlike the longer-standing trend in apartment sub-types, suburban office has only recently begun to outperform, and by small margins

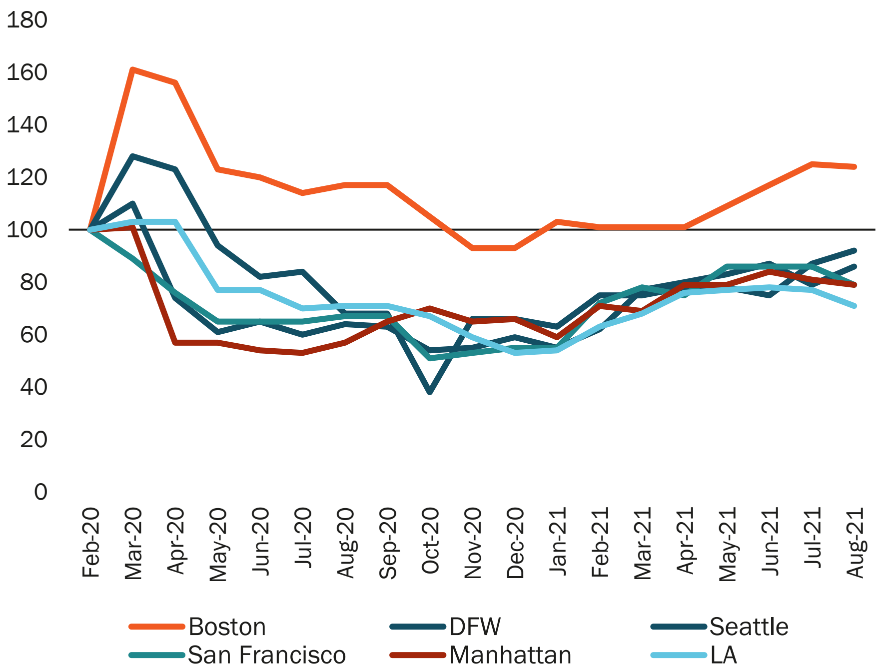

- The hub-and-spoke model has arisen as a viable solution for companies whose employees may be more geographically dispersed, with suburban office a clear potential beneficiary.
- While the pandemic may be the catalyst of permanent change, we believe most companies will opt for flexible/hybrid schedules in HQ as opposed to leasing a greater number of spaces.
- History suggests CBD offices are generally a stronger bet – when they outperform (~60% of the time) it is by a much higher margin (485 bps on average compared to 230 bps when suburbs outperform the CBD).

Source: American Realty Advisors based on data from NCREIF as of October 2021

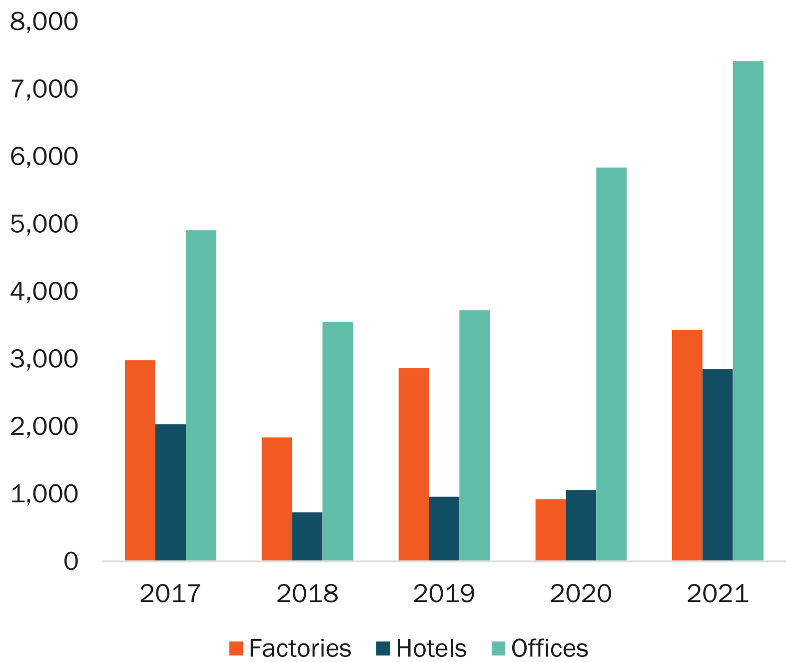
# WFH: A Favorable Combination of Improving Demand, Shrinking Supply

**With tenant activity gradually ticking up and offices a prime target for conversion to apartments, office fundamentals are expected to strengthen going forward**

Tenant requirements, select markets, indexed to 2018/19 average




Number of rental units created from conversions by original building type, 2017 - 2021




- Though most markets' activity is still down from pre-COVID levels, requirements have started to trend back up from the trough, suggesting companies have sufficiently firmed up their return-to-work strategies enough to justify searches for space.
- What's more, more than half of the apartment units being converted from other building types are coming via office conversions; while these are likely lower-quality, low-occupancy buildings to begin with, the removal of excess office stock is a net positive.

Source: American Realty Advisors based on data from Rent Café, Yardi Matrix and CBRE as of October 2021

# WFH: The “Haves” Have It

## Tenants’ flight to quality expected to remain prevalent post-pandemic even as companies contemplate lesser, but better, space requirements

- Class A office buildings have historically represented the lion’s share of leasing activity in the office sector, despite only accounting for 1/3 the total office stock.
- With tenants focused on the safety and well-being of their employees upon their return to the office, health and wellness characteristics (such as indoor air quality) have been at the forefront of current requirements.
- We believe that demand between Class A and other, lesser-quality office buildings is slated to bifurcate further in 2022/23.
- This creates opportunities for potential value-add repositionings of well-located Class A-/B+ properties as well as for owners of existing Class A buildings


Source: American Realty Advisors based on data from Cushman and Wakefield and CoStar as of October 2021

# Outlook for Property Sectors

## Industrial

- Pandemic-induced shifts to online shopping likely to result in permanently higher e-commerce penetration in previously insulated segments like food.
- Strong demand for infill assets will continue to drive rents higher, as these facilities' ability to offset other supply chain costs make them highly desirable.

## Multi-Family

- Despite continued WFH policies, a meaningful return to the city has resulted in robust rent growth.
- With tenants renting longer, lower-density product in good school districts and commutable distances to major employment hubs should also fare well over the medium term.

## Office

- Data suggests that there has historically been more upside in urban offices than suburban.
- With demand returning (even in a stunted state), we believe this will continue as CBD assets tend to be newer/higher quality which receive a disproportionate share of net demand.

## Retail

- Necessity retail will continue to outperform malls and experiential retail as Delta concerns linger.
- Though discretionary retail is experiencing a rebound, it comes by virtue of record lows; structural challenges present pre-pandemic will continue to challenge long-term performance.

**As we assess prospects in the post-pandemic period, we are focused on teasing out the cyclical opportunities from the headline risks.**

## Single-Family Rental

- With record-breaking home appreciation occurring over the summer, ownership is moving further out of reach for many renters.
- 25 SFR markets experienced average rent growth in excess of 5.4% over the last 12 months.
- With SFR catering to a different segment of the renter market, increasing exposure to the sector provides additional diversification.

# Implications for Core and Value-Add Strategies

## Core

### Asset Management

- Hold face rates but remain competitive on TI dollars and concessions to procure credit-worthy term office leases.
- Pursue opportunities to engage technology solutions that simplify leasing (virtual tours, 3-D floor plans) and tenant activities (touchless entry, 5G).

### Portfolio Construction

- Continue to overweight structurally sound sectors (industrial, residential).
- Diversify demographic cohort exposure through a mix of urban and suburban/lower-density investments.
- Orient portfolio towards high-growth, business-friendly markets.
- Hold well-located Class A office to benefit from gradual demand recovery.

## Value-Add


### Asset Management

- Pursue cap-ex projects that improve building health and wellness given growing preference from office tenants.
- Remain flexible to retail leasing opportunities amidst non-necessity consumer spending rebound.
- Deploy low-cost smart building technologies related to energy consumption to strengthen buildings' green appeal.

### Portfolio Construction

- Aggressively pursue industrial investments that have a clear path towards outsized rental rate growth.
- Lean into broader range of specialty sectors with clear demand drivers (cold storage, life sciences, single-family rentals).
- Move swiftly in cyclical window for retail repositionings/re-leasing plays.

# Summary and Strategy Implications

With the start of a new cycle serving as the backdrop, we are focused on maximizing cyclical opportunities while progressing towards strategic longer-term goals.

- With U.S. GDP now firmly above pre-pandemic levels, all eyes have turned to contextualizing the "shape" of the new economic cycle.
- Policy-related missteps represent the greatest potential near-term risk; with the Fed telegraphing its movements well in advance, we think the likelihood is generally low.
- Absent the anomalous nature and speed of the cycle's start, we believe conditions will prevail in a lower, longer period conducive to both higher-returning and core real estate strategies.
- There are ways to play the macro forces influencing real estate fundamentals on both sides of the "disrupted" and "disruptor" coin.
- With structural tailwinds guiding our allocations over the longer term, we are focused on identifying complimentary cyclical plays that can enhance returns during the upcycle.

# Disclosures

**Disclaimer:** The information in this presentation is as of October 30, 2021 unless specified otherwise and is for your informational and educational purposes only, is not intended to be relied on to make any investment decisions, and is neither an offer to sell nor a solicitation of an offer to buy any securities or financial instruments in any jurisdiction. This presentation expresses the views of ARA as of the date indicated and such views are subject to change without notice. The information in this presentation has been obtained or derived from sources believed by ARA to be reliable but ARA does not represent that this information is accurate or complete and has not independently verified the accuracy or completeness of such information or assumptions on which such information is based. Models used in any analysis may be proprietary, making the results difficult for any third party to reproduce. Past performance of any kind referenced in the information above in connection with any particular strategy should not be taken as an indicator of future results of such strategies. It is important to understand that investments of the type referenced in the information above pose the potential for loss of capital over any time period. This presentation is proprietary to ARA and may not be copied, reproduced, republished, or posted in whole or in part, in any form and may not be circulated or redelivered to any person without the prior written consent of ARA. Photos used in this presentation were selected based on visual appearance, are used for illustrative purposes only, are not necessarily reflective of all the investments made by ARA or which ARA may make in the future.

**Forward-Looking Statement:** This presentation contains forward-looking statements within the meaning of federal securities laws. Forward-looking statements are statements that do not represent historical facts and are based on our beliefs, assumptions made by us, and information currently available to us. Forward-looking statements in this newsletter are based on our current expectations as of the date of this presentation, which could change or not materialize as expected. Actual results may differ materially due to a variety of uncertainties and risk factors. Except as required by law, ARA assumes no obligation to update any such forward-looking statements.

# For More Information, Please Contact:


**Jay Butterfield**
Executive Managing Director,
Head of Business Development
213.233.5743
butterfield@aracapital.com

**Sabrina Unger**
Managing Director,
Research & Strategy
213.233.5846
sunger@aracapital.com

**Britteni Lupe**
Analyst,
Research & Strategy
213.233.5780
blupe@aracapital.com


AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT


**Headquarters Office**
515 S. Flower St.
49th Floor
Los Angeles, CA 90071
T 213.233.5700
F 213.947.1480


Signatory of: PRI Principles for Responsible Investment

GRESB 2019

Printed in-house

LOS ANGELES | CHICAGO | NEW YORK | ORLANDO | PHILADELPHIA | SAN FRANCISCO