ARA
HOUSE VIEW
H1 2023

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AMERICAN
REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

U.S. REAL ESTATE INVESTMENT OUTLOOK

Depth and Duration of Coming Slowdown Prompting Investor Pause, Asset Repricing.

Macroeconomic Context

- A recession base case: Domestic growth weakening amidst dual impact of prolonged inflation and Fed tightening.
- Inflation slowing, but not enough: Moderating inflation a positive, though lags in the way it is measured suggests CPI is unlikely to fall below Fed target before H2 2023.
- When good news is bad news: Positive data on job growth and consumer spending is perceived as a sign the Fed will remain aggressive in its policy moves, a negative for stock markets.

Real Estate Impacts

- Volatile stock-bond markets drive denominator-effect rebalancing.
- Real estate transaction volumes decline as bid-ask spreads widen and liquidity diminishes.
- Strategic rationale for residential, industrial, self-storage over the long term remains intact, despite near-term softening.
- Office continues to face secular headwinds and high capex burdens. Retail continues to be portfolio stabilizer.

I. MACRO OUTLOOK

Labor markets are too tight:

- Fed policy continues to seek to dampen labor demand to fight inflation.
- It will take a considerable amount of labor pain to get nearer to equilibrium levels.
- Non-official data suggests we may already be well on our way.

Contribution to GDP growth from businesses unlikely:

- Despite record-breaking profits in 2021, private business investment was a drag on GDP growth in 2022.
- Traditional avenues of profit growth are more challenged, further weighing on economic growth.

Consumers – the lone domestic bright spot – may be dimming:

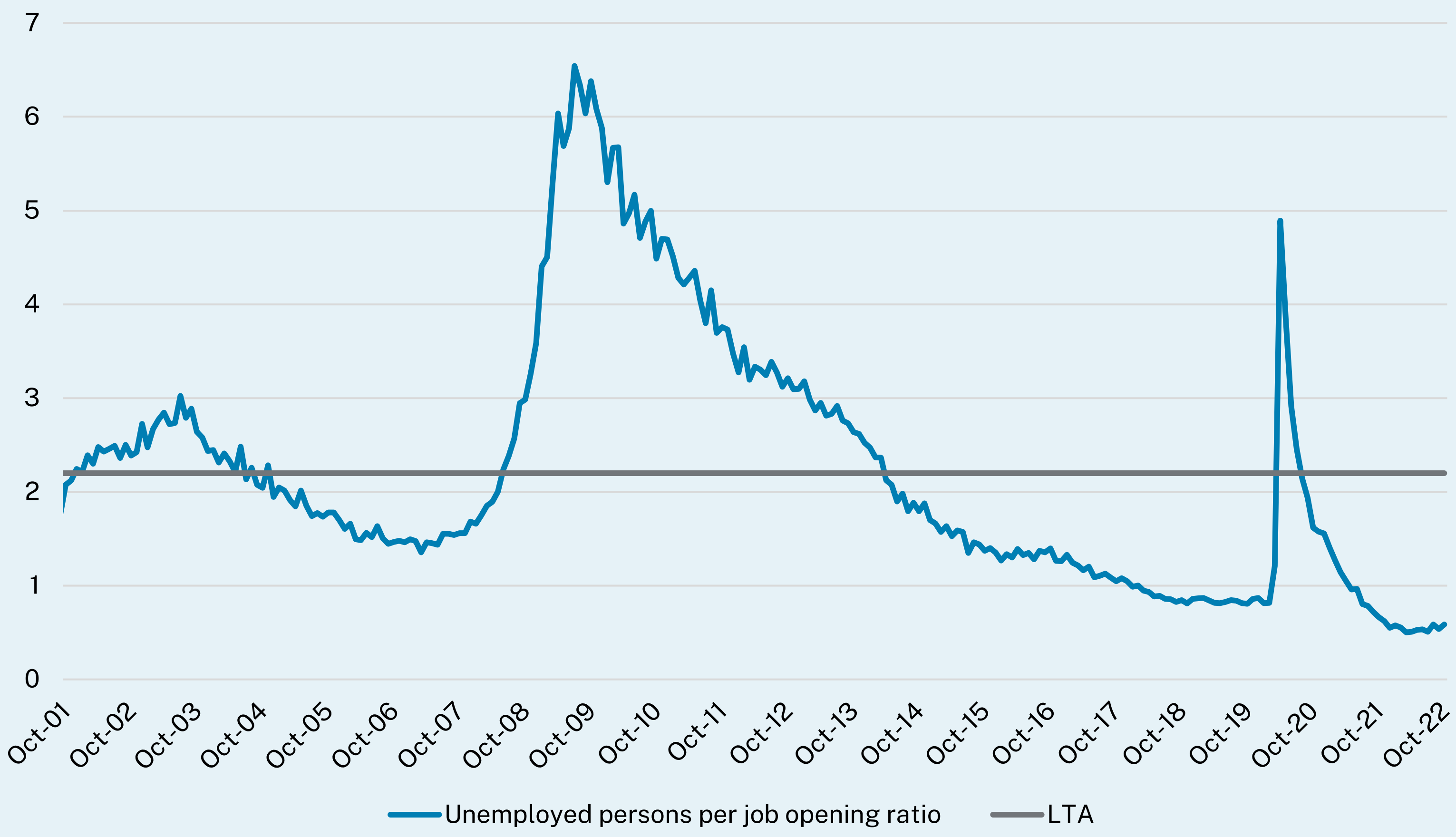
- Spending has remained resilient despite rising costs.
- Credit card usage is raising concerns.
- Households' concerns on inflation and recession could create a self-fulfilling prophecy.

AN UNPRECEDENTED LABOR BACKDROP

- The acute tightness of the labor market (0.5 unemployed persons for every open job) complicates the prospects of a "soft landing".
- A downturn may be a necessary evil to move the labor market nearer to a long-run equilibrium that's compatible with a 2% inflation target.

By our count, there are ~2.3 million open or existing jobs too many relative to worker supply – a key challenge to the Fed's inflation fight.

Unemployed persons per job opening ratio, October 2001 – October 2022



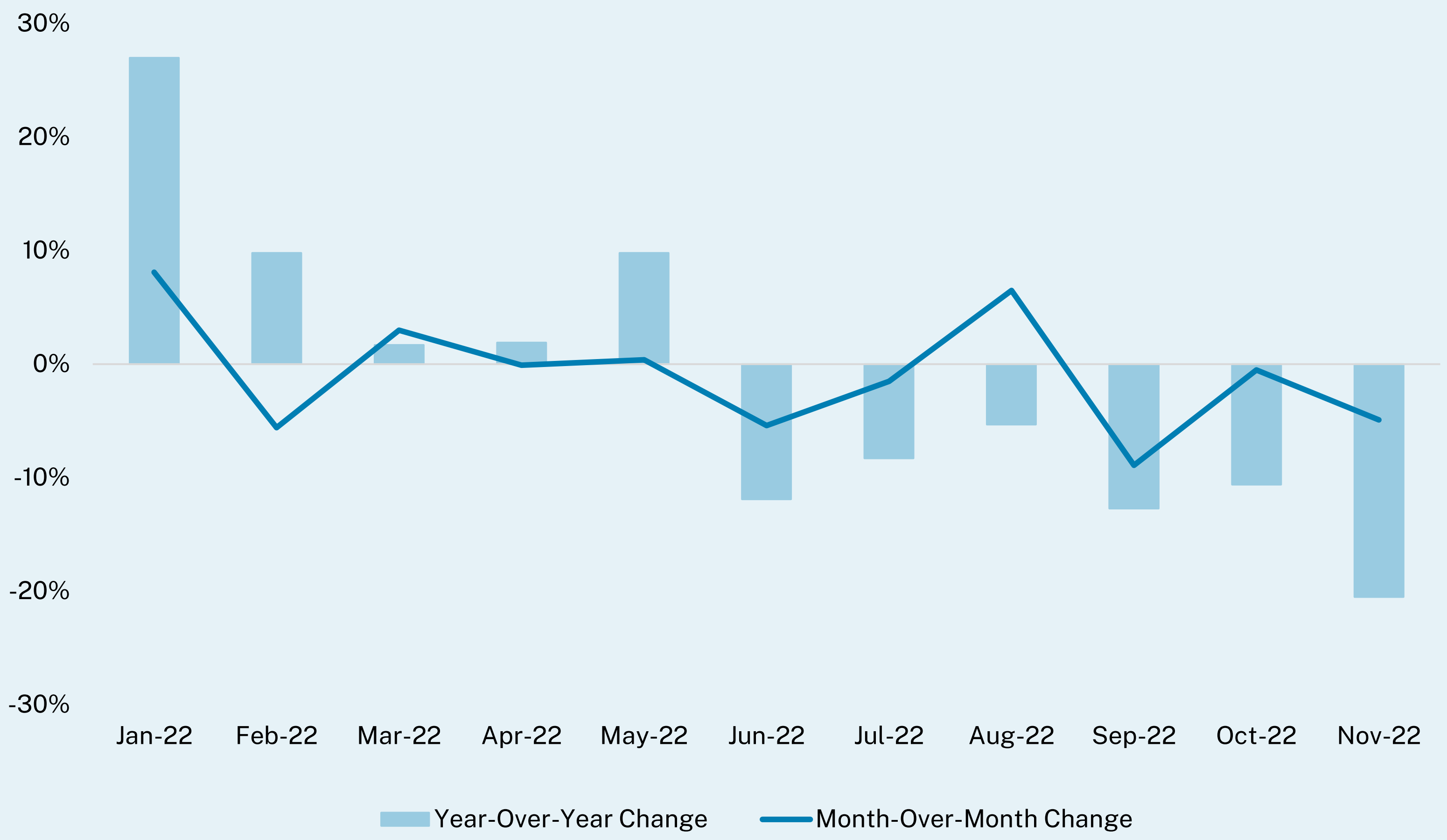
Source: American Realty Advisors based on data from the Bureau of Labor Statistics, Job Openings and Labor Turnover Survey as of December 2022. LTA = Long-term average, 2000 – 2022.

MIXED JOB SIGNALS

- Happenings on the ground can send very different signals than official data.
- According to LinkedIn, the U.S. hiring rate in November was down 20% YoY and has been on a clear deceleration trend since April.
- This suggests labor conditions may be deteriorating more quickly than expected.

> **A stubbornly tight labor market could spur more aggressive Fed policy, but there is reason to believe slack is increasing.**

Month-Over-Month and Year-Over-Year Change, LinkedIn Hiring Rate, January – November 2022



Note: The LinkedIn Hiring Rate is a measure of new hires in a month divided by LinkedIn membership.
Source: American Realty Advisors based on data from LinkedIn as of December 2022

BUSINESSES CHALLENGED

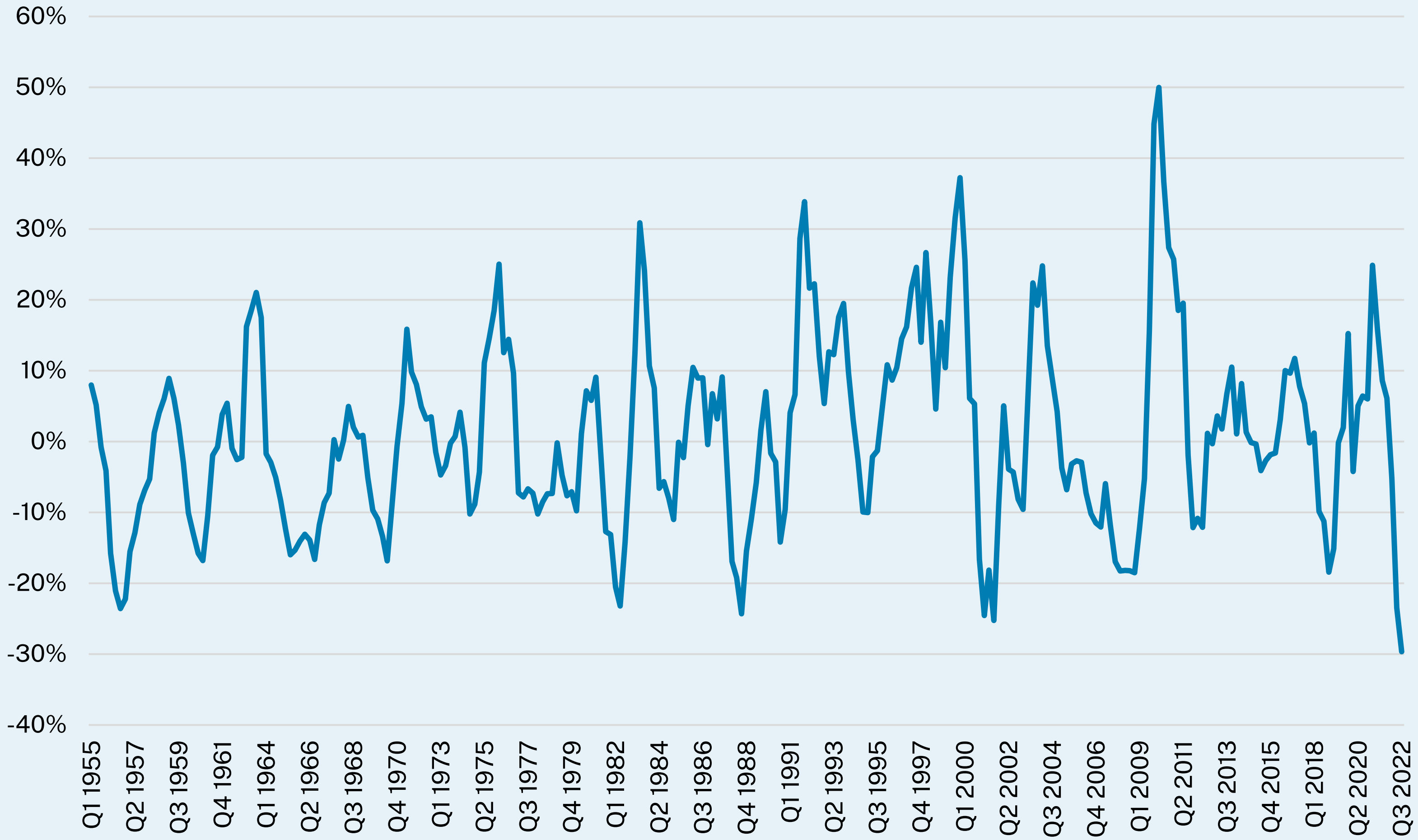
Corporate cash flows relative to their immediate liabilities plummeted nearly 30% on an annualized basis in Q3 2022.

Faced with this, corporations have three prospects:

1. Borrow to fund expansion (though this may be less feasible in a higher rate environment);
2. Postpone expansions (which hampers company stock price growth); or
3. Cut costs, likely via slowed hiring and/or layoffs.

> **A challenged business backdrop could extinguish this driver of GDP growth.**

Percent Change: Corporate Liquid Assets to Short-Term Liabilities, Q1 1955 – Q3 2022 (Annualized, Not Seasonally Adjusted)



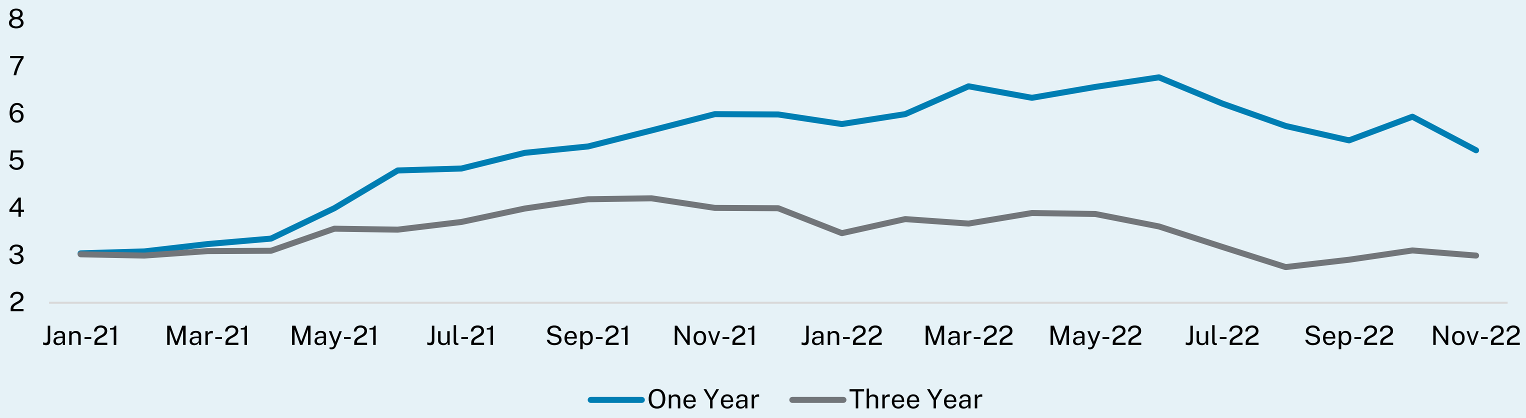
Source: American Realty Advisors based on data from the Federal Reserve Bank of St. Louis (FRED) as of December 2022

EXPECTATIONS BECOME REALITY

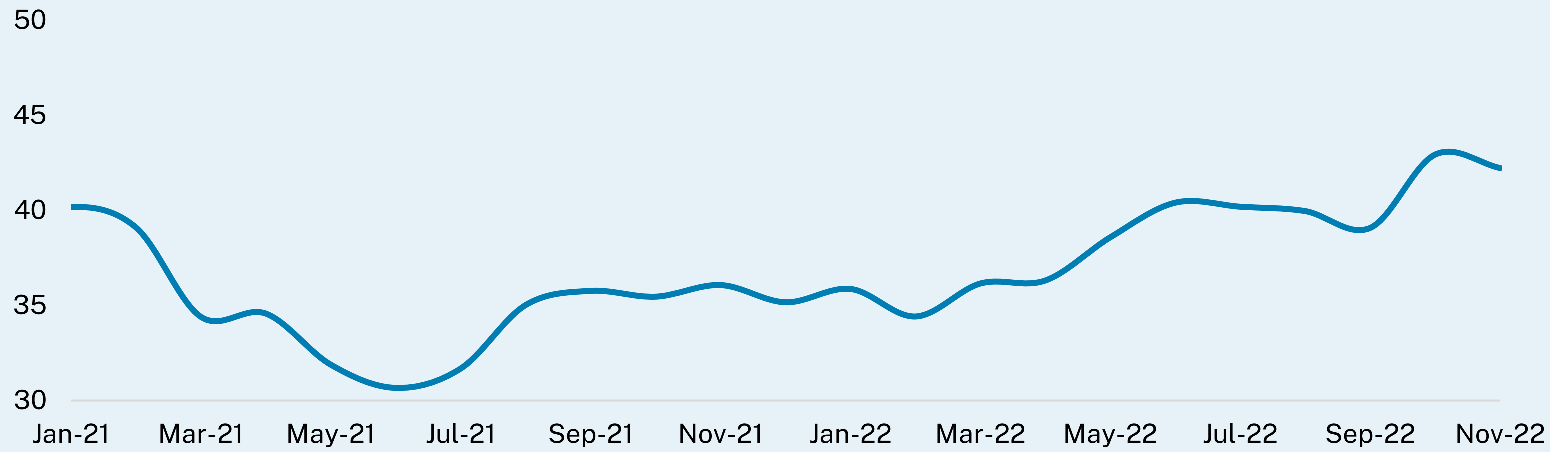
- Consumer expectations for near-term inflation remain well above the Fed's target.
- Expectations of higher unemployment may also prompt a larger pullback in spending.

> **Consumer spending comprises 70% of GDP – souring sentiment regarding a possible recession could end up triggering one.**

Median Inflation Expectations, 1- and 3-Year Outlook (%)



Probability that U.S. Unemployment Rate Will Be Higher One Year From Now (%)

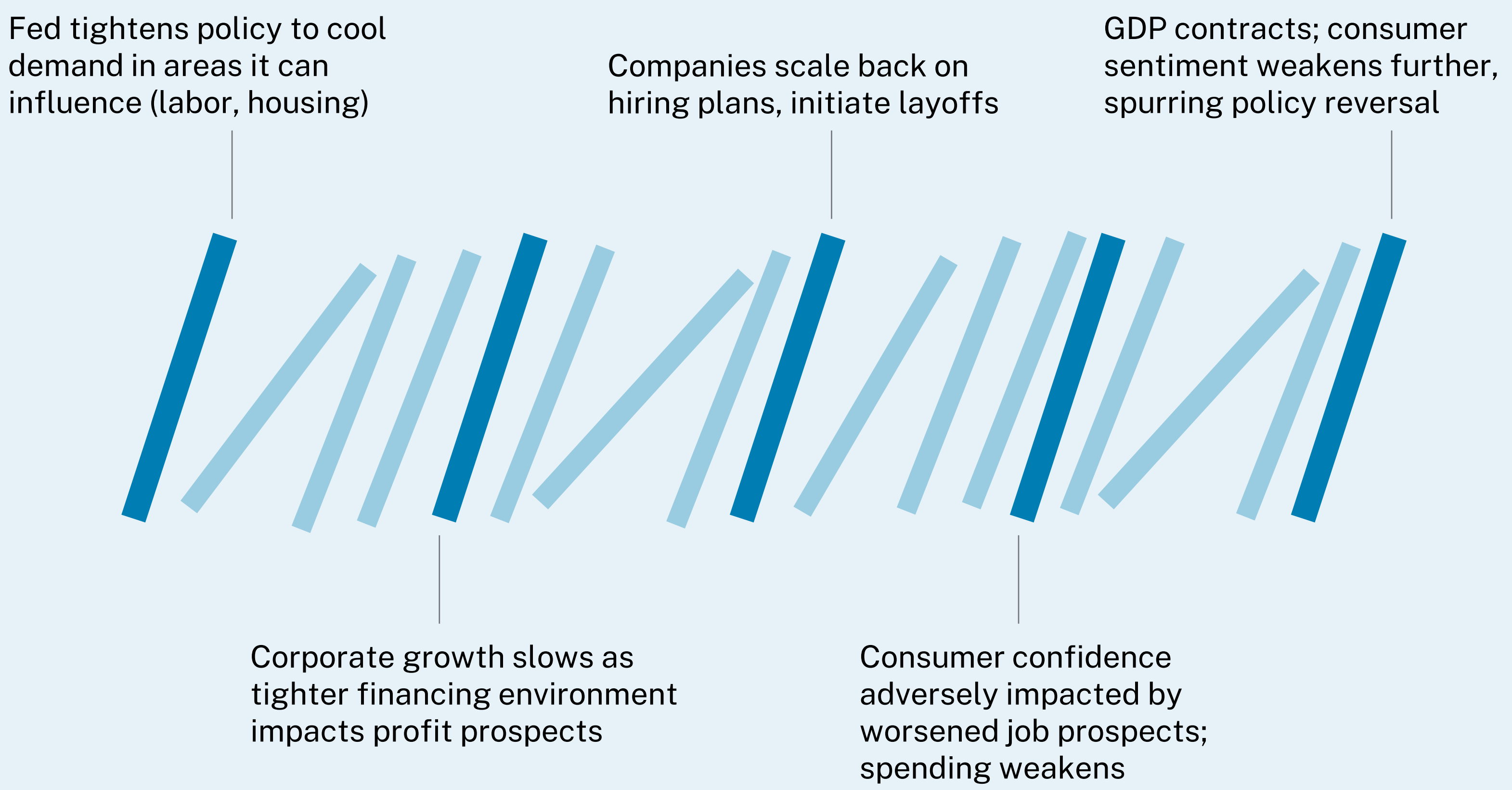


Source: American Realty Advisors based on data from the New York Fed Survey of Consumer Expectations as of December 2022

INFLATION DOMINO EFFECT

- The main conduits of Fed policy are housing, investment and labor.
- Tightening will be effective in moderating inflation over the coming 12 months, but with a considerable lag.
- In the interim, each domino that falls complicates the likelihood of a soft landing.

Fed hiking periods have rarely led to positive outcomes; today's problems will require pain to solve.



KEY MACRO ASSUMPTIONS

	ARA's Outlook	Risks
Asset Values	• Equity markets remain volatile, begin upward recovery path in H2 2023 • Real estate depreciates in 2023, though magnitude differs by sector • For-sale home prices flat/decline YoY	• Equity markets double dip as Fed reigns in doves • Real estate value decline comparable to GFC • Home prices decline >20%
Employment	• Unemployment increases to ~5% in H2 2023, normalizes above pre-COVID levels • Current weakness in real wage growth, cracks in hiring momentum lead Fed policy moves and creates deeper recession	• Unemployment increases above 6% • Wages contract
Consumers	• Consumer activity continues to moderate as weaker economy, worsened job prospects and lower savings weigh on sentiment	• Growing household use of higher interest-bearing debt restrains growth further into the future
Supply Chains	• Peak energy prices in Winter 2022-23 • Weaker international demand weighs on U.S. firms and exports	• Reacceleration of Russian weaponization of oil spurs fuel-related inflation inconsistent with Fed goals

II. CAPITAL MARKETS

Market reactions and Fed policy:

- Markets exhibited a few short relief rallies last year but had trouble interpreting forward policy and growth trajectories.
- The Fed wants to crush inflation, avoid a hard landing and simultaneously circumvent too strong a market recovery.
- More likely they will risk overtightening given how pervasive price pressures remain.

Transaction volumes down as denominator/liquidity effects take hold:

- Equities and bonds have been volatile and ended 2022 down.
- Lags on the private side are increasing exposure to private real estate.
- Transaction activity has declined while investors have paused commitments and increased redemptions.

Dry powder defense:

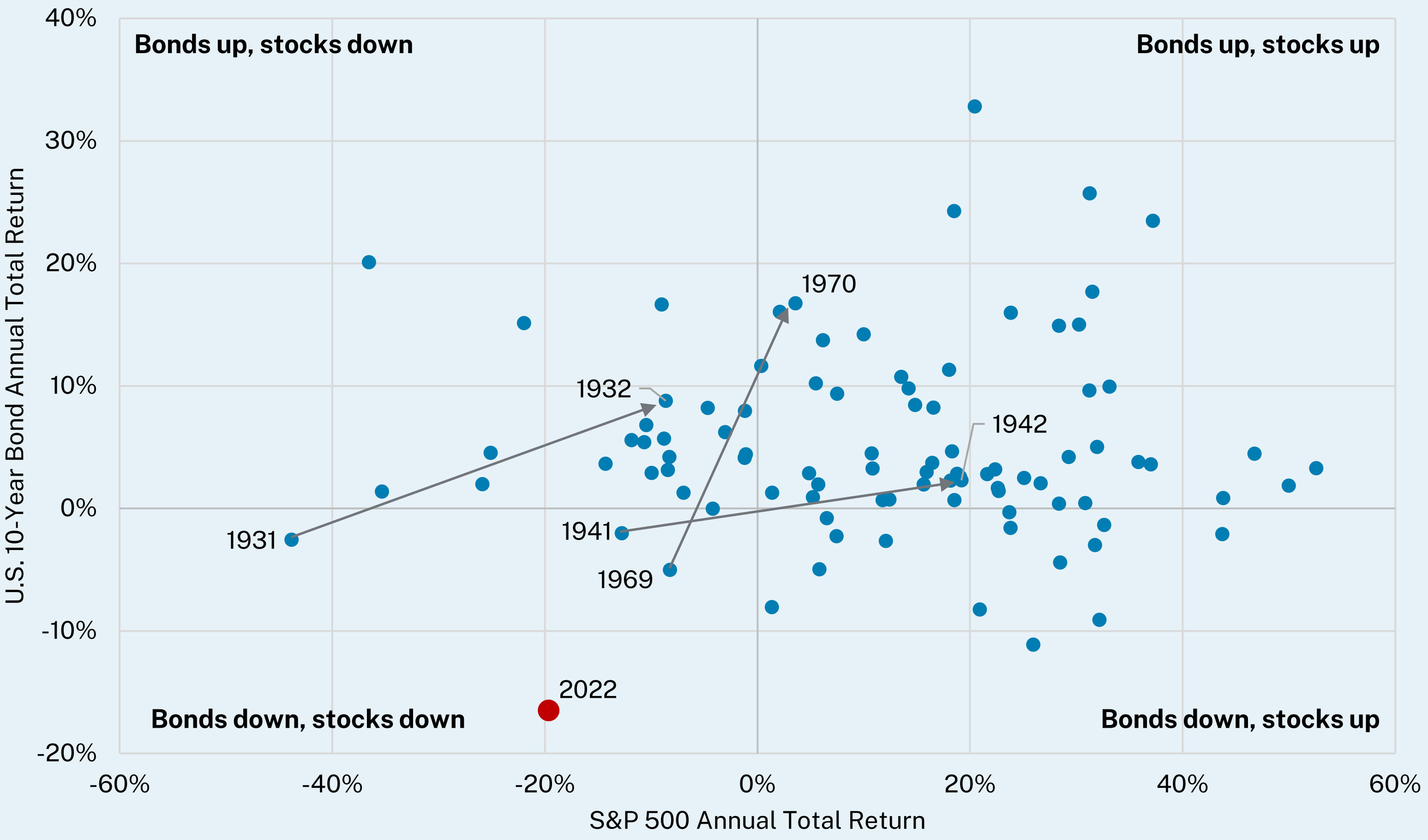
- Cap rates for deals on market have increased.
- This suggests valuations for held assets will decline in the near term.
- The amount of dry powder awaiting deployment could serve as a backstop.

A HARD YEAR FOR STOCKS AND BONDS

- Downdrafts in both stocks and bonds in 2022 increased exposure to real estate given a smaller denominator.
- This is unusual; there have been very few instances in the last 100 years where both stocks and bonds have declined.

We expect stocks, bonds, or both likely to have positive returns in 2023, reducing rebalancing pressures.

Annual U.S. Stock and Bond Total Returns, 1928 – 2022



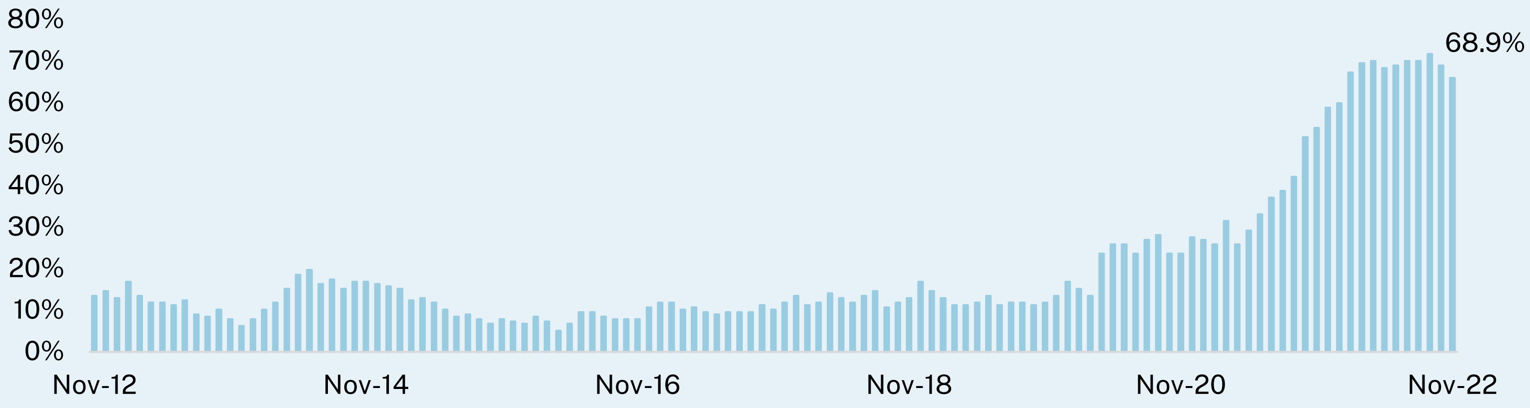
Source: American Realty Advisors based on data from Macrobond, NYU Stern, BlackRock and Slickcharts as of January 2023

BREADTH OF INFLATION

- CPI figures in Q4 2022 surprised to the downside, sparking optimism that further Fed rate hikes would be milder.
- However, the sources of inflation remain too broad based for the Fed to pause.
- As of November, 69% of CPI components were still increasing at a 4%+ YoY rate, which account for 77% of the total CPI weightings.

We expect further increases to align the Fed funds rate with the latest Fed projections of 5.1-5.4%.

Share of CPI Components Increasing at a YoY Pace Greater Than 4%



Weightings of CPI Components Increasing at a YoY Pace Greater Than 4%

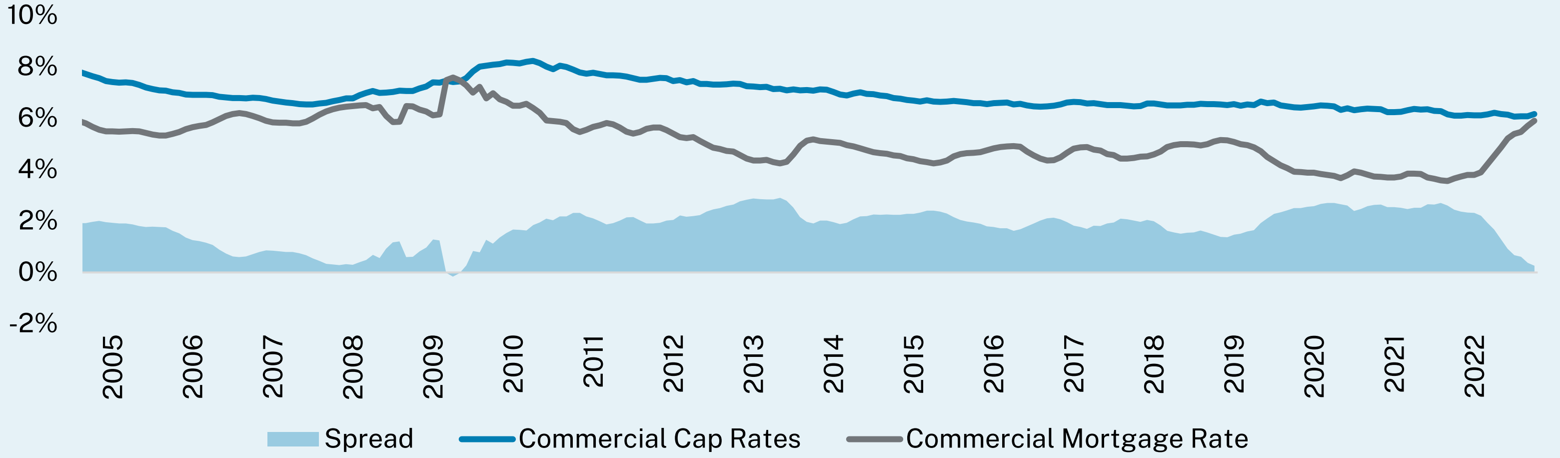
Source: American Realty Advisors based on data from Macrobond and the U.S. Bureau of Labor Statistics (BLS) as of December 2022

DEBT: MORE (EXPENSIVE) AND LESS (OF IT)

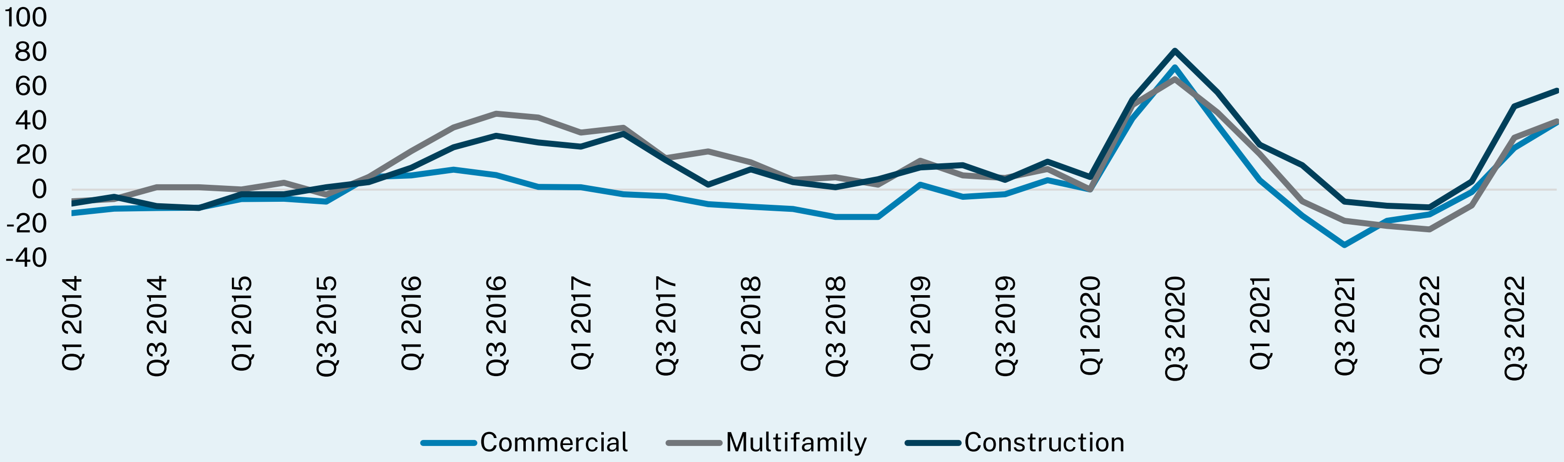
- Rising interest rates have increased the cost of debt, eliminating the positive impact of leverage on returns.
- Availability and terms of debt have also tightened – roughly half of banks are tightening lending standards for real estate today.

Reduced availability of leverage may provide non-bank capital opportunities to step into the gap at higher rates.

Commercial Cap Rates and Debt Costs, January 2004 – October 2022



Net Percentage of Banks Tightening Lending Standards for Commercial, Multifamily and Construction (%)



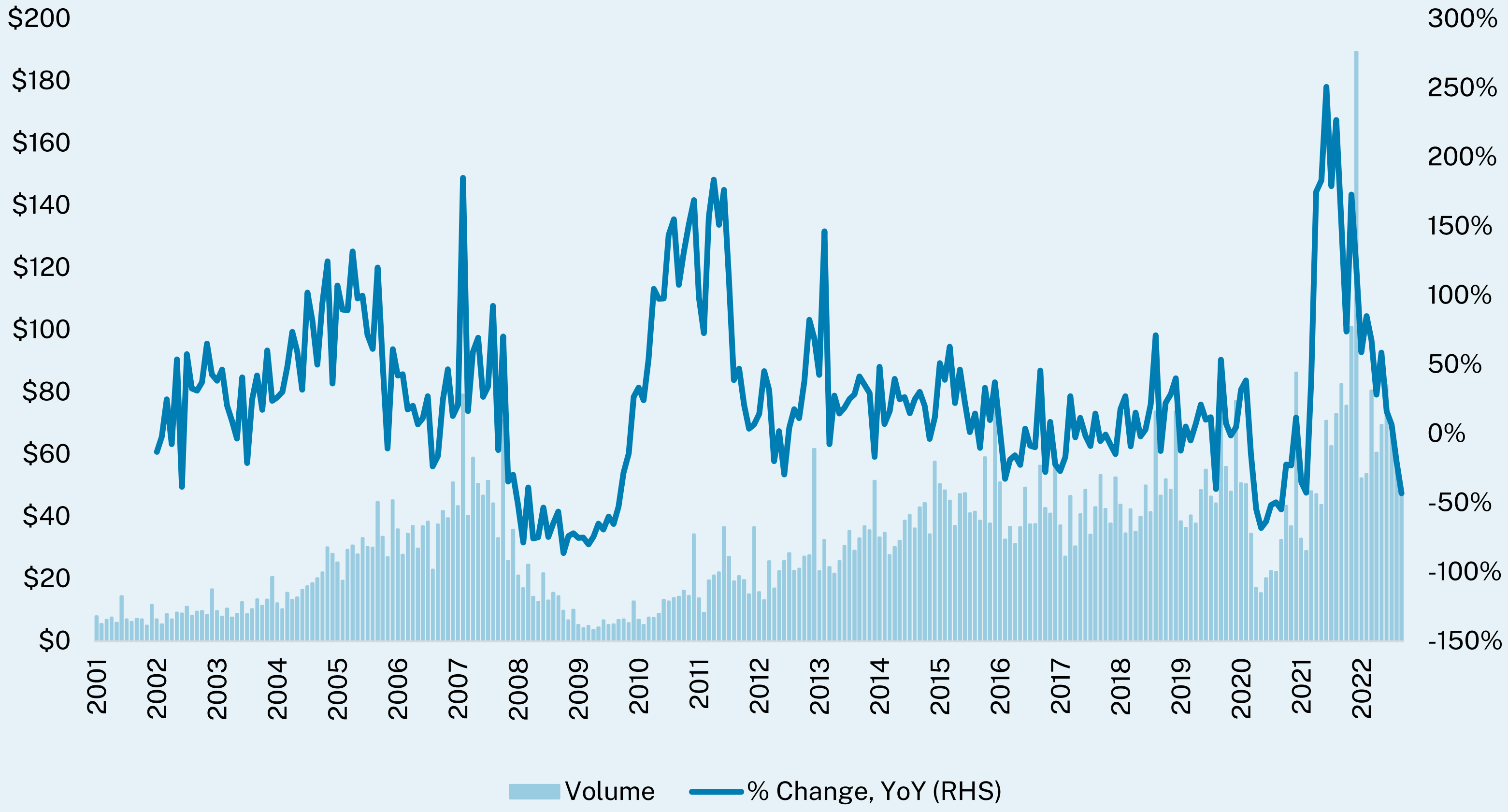
Note: Mortgage rates are based on first mortgages. Cap rates include refinance transactions and exclude portfolio transactions. Commercial is defined as office, retail and industrial properties.
Source: American Realty Advisors based on data from Real Capital Analytics and the St. Louis FRED as of November 2022

REAL ESTATE TRANSACTION VOLUMES

- Real estate transaction volume was down 21% YoY in Q3.
- This was a function of a less-accommodative capital markets backdrop and lesser growth prospects.
- Owners that do not have imminent cash requirements may opt to hold rather than sell at a discount, keeping activity muted until the backdrop stabilizes.

> **Necessity-based sales will complicate the value of year-over-year pricing comparisons in 2023.**

U.S. Real Estate Transaction Volume, Monthly ($, billions) and Year-over-Year, January 2001 – September 2022



Source: American Realty Advisors based on data from MSCI Real Capital Analytics as of November 2022

IMPACT OF CAP RATE EXPANSION

- Real estate cap rates are adjusting as deals reprice to account for higher risk-free rates.
- Cap rate assumptions are material when it comes to values.
- For example, a 100-bp increase equates to a ~21% value decline unless there's a corresponding 26% increase in NOI to offset – no small feat.

> **With NOI growth prospects moderating, purchase prices and values will decline from recent highs.**

Illustrative Example: Value Impact of Change in Cap Rate

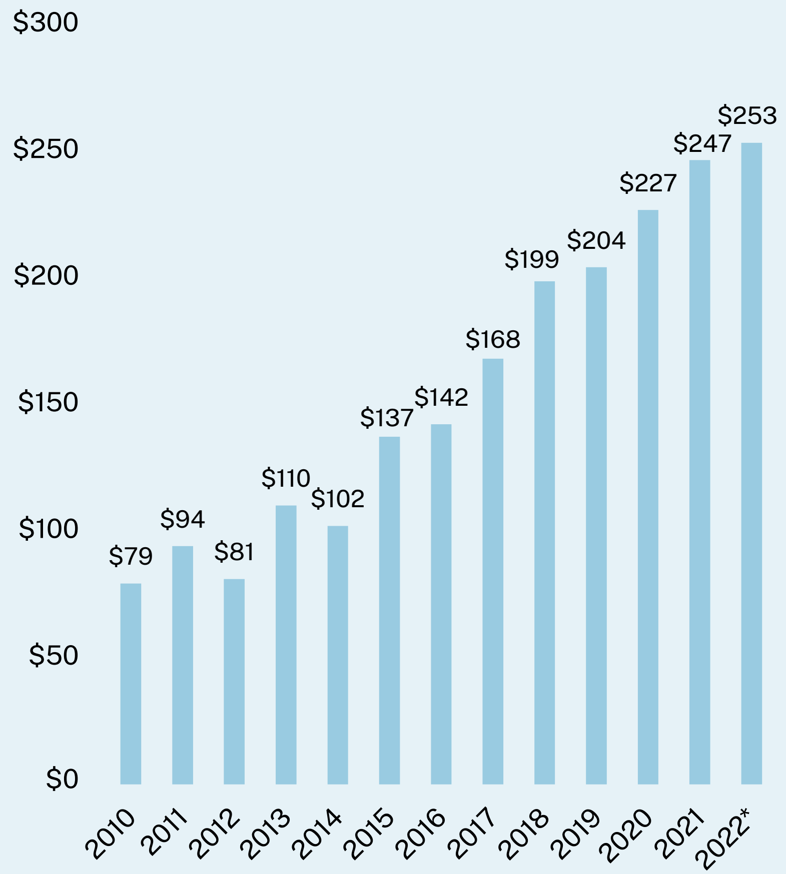
	Purchase of building at last year's cap rates	Revalued based on current expanded cap rates in 2022
Purchase price:	$50,000,000	$50,000,000
Net Operating Income (NOI):	$1,900,000	$1,900,000
Cap Rate:	**3.80%**	**4.80%**
Implied Market Value:	**$50,000,000**	**$39,583,333**

RISK-ON DRY POWDER

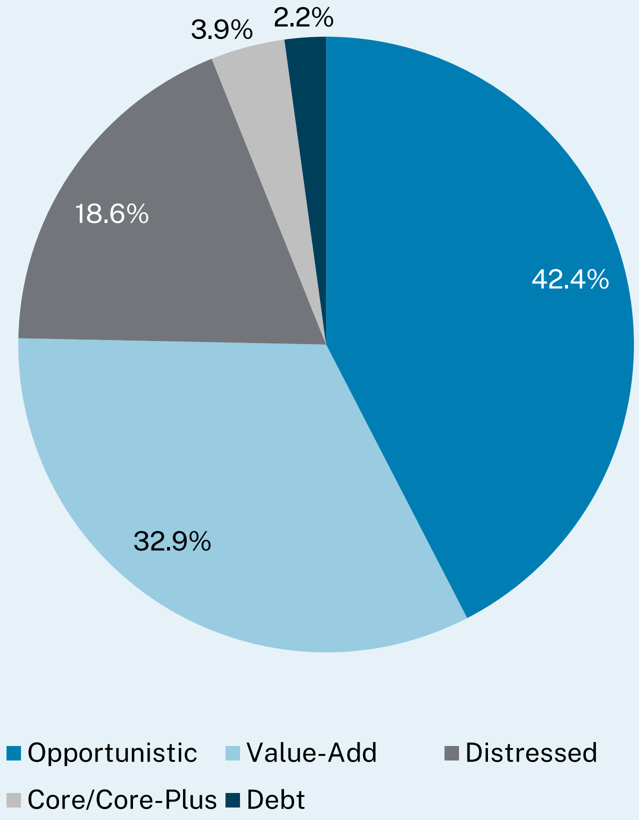
- U.S. real estate dry powder totals $253 billion, with more than half targeting distressed or opportunistic returns.
- Higher-risking strategies are often executed in closed-end funds– the pressure to deploy may make selling broken core with remaining "meat on the bone" a compelling prospect.

Waiting dry powder could reignite sales activity by virtue of competition for deal flow in 2024-25.

Real Estate Dry Powder, 2010 – Q3 2022 (billions)



Share of Real Estate Dry Powder by Strategy



Note: 2022 figures are as of Q3 2022.
Source: American Realty Advisors based on data from Preqin as of November 2022

III. PROPERTY MARKETS

Industrial demand slowing amidst peak deliveries:

- A leading indicator of industrial absorption points to a material deceleration in demand in the near term.
- Construction is elevated, but market vacancies are well below average.

Home builder prospects worsen, providing a supply-side silver lining for rentals:

- For-sale home prices are declining amidst lessened buyer affordability.
- New home starts are also early in their decline cycle.
- This is creating intermediate tailwinds for rental housing as there will be net fewer homes delivered in 2024-25.

An era of office disruption:

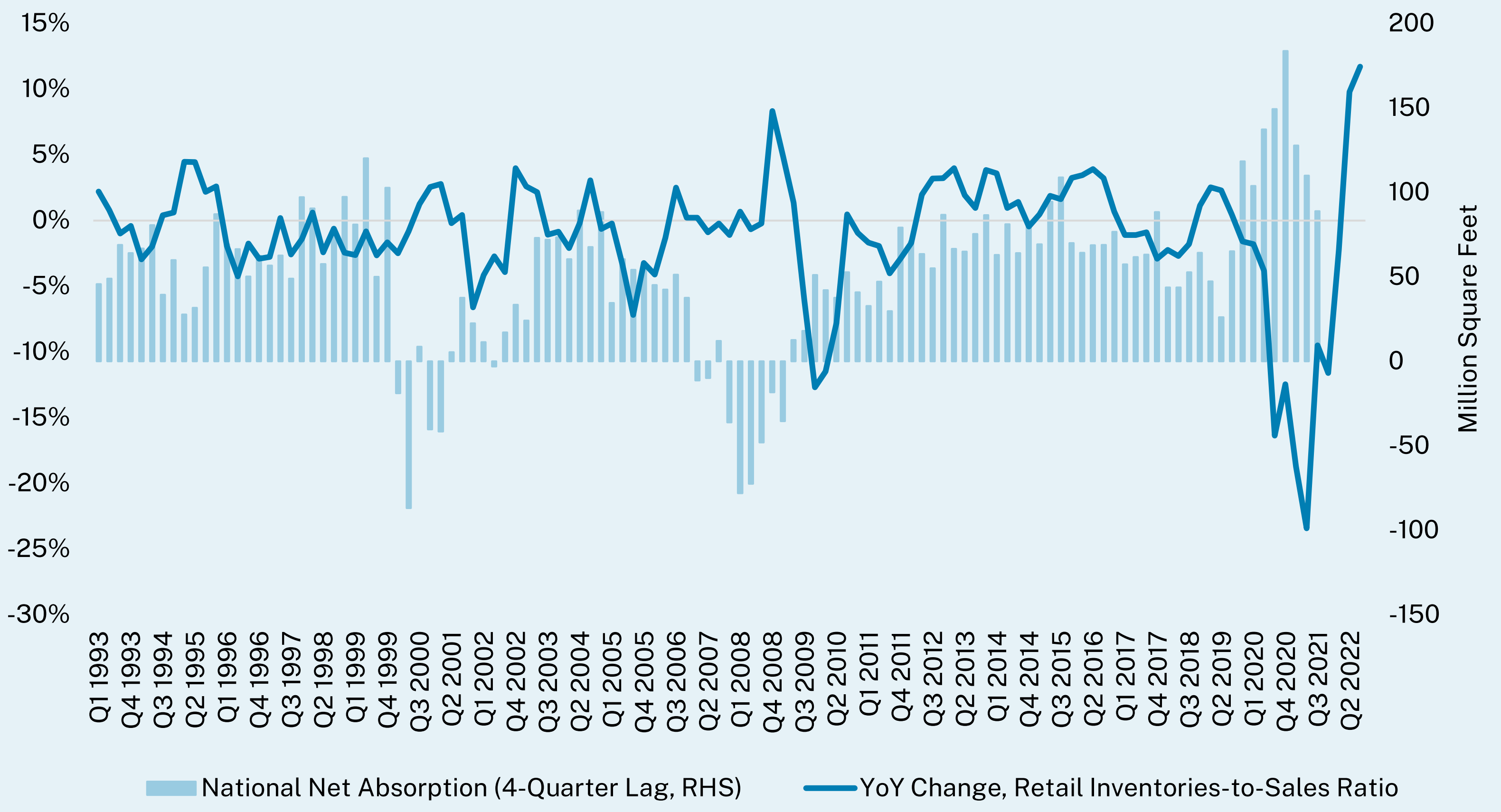
- Work-from-home and a recession will continue to challenge office fundamentals broadly.
- Preleasing for supply under construction suggests higher appetite for brand-new product.
- Landlords will need to budget for increasingly larger tenant improvement packages to maintain occupancy.

INVENTORIES, SALES, AND INDUSTRIAL

- Warehouse demand is a function of how many goods companies need to store relative to sales.
- In periods where inventory on hand relative to outgoing sales (inventory-to-sales) rises materially YoY, industrial net absorption has slowed considerably with a 4-quarter lag.

With inventories full, industrial demand through at least Q3 2023 is expected to soften relative to recent norms.

YoY Change in Retail Inventory-to-Sales Ratio and National Industrial Net Absorption, Q1 1993 – Q3 2022



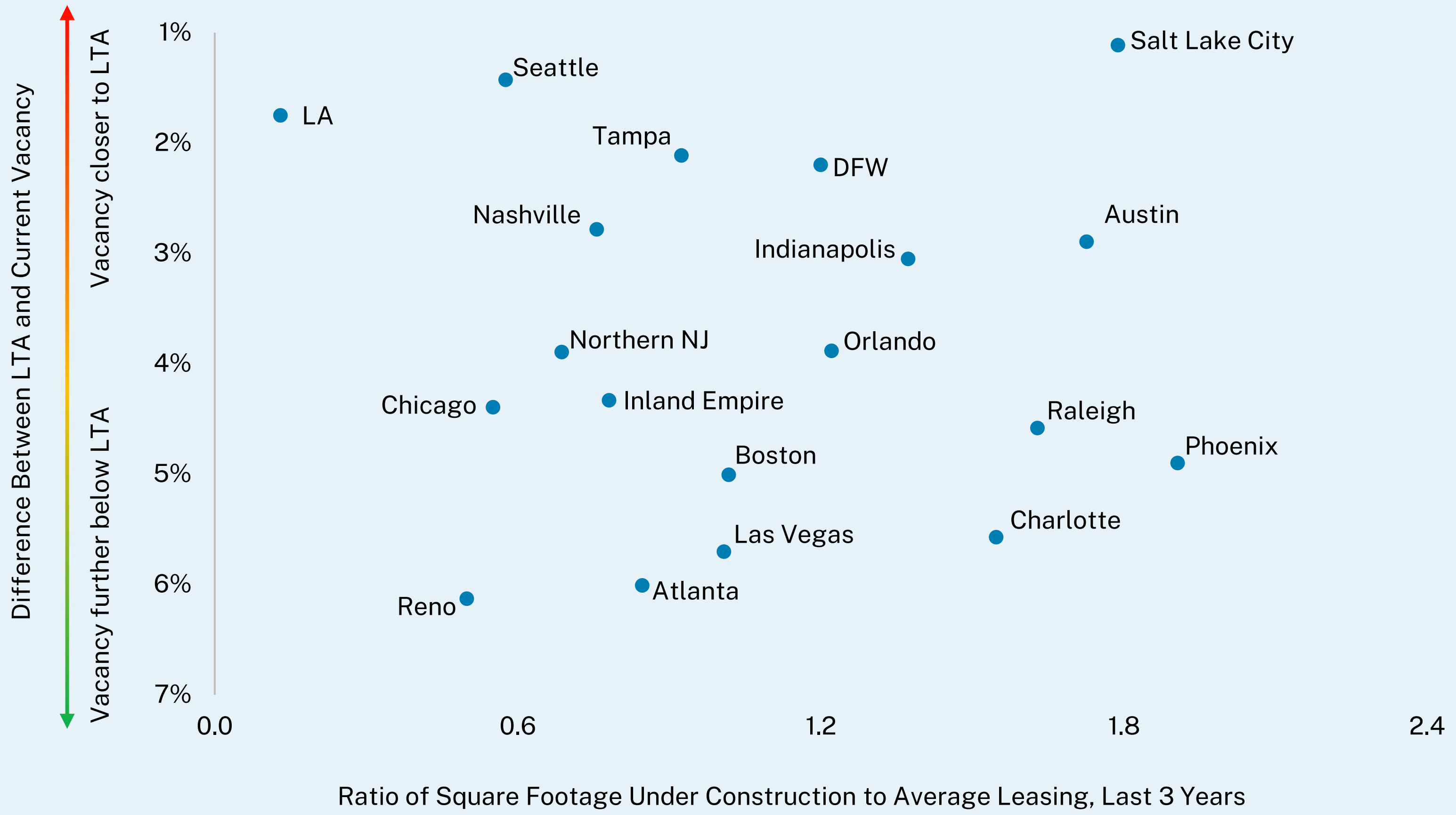
Source: American Realty Advisors based on data from CBRE-EA and FRED St. Louis as of November 2022

INDUSTRIAL SUPPLY CONTEXT

- Industrial construction is elevated heading into a moderating demand backdrop.
- The positive is that virtually all industrial markets are still well below their LTA vacancy.
- In fact, some pipelines represent less than half recent years' leasing activity.

High current occupancy suggests most markets can accommodate lesser demand without vacancy surpassing LTAs.

Industrial Market Vacancy and Supply Under Construction as a Multiple of Recent Leasing Activity



Note: LTA = Long-term average, 2000 – 2021.
Source: American Realty Advisors based on data from CoStar as of December 2022

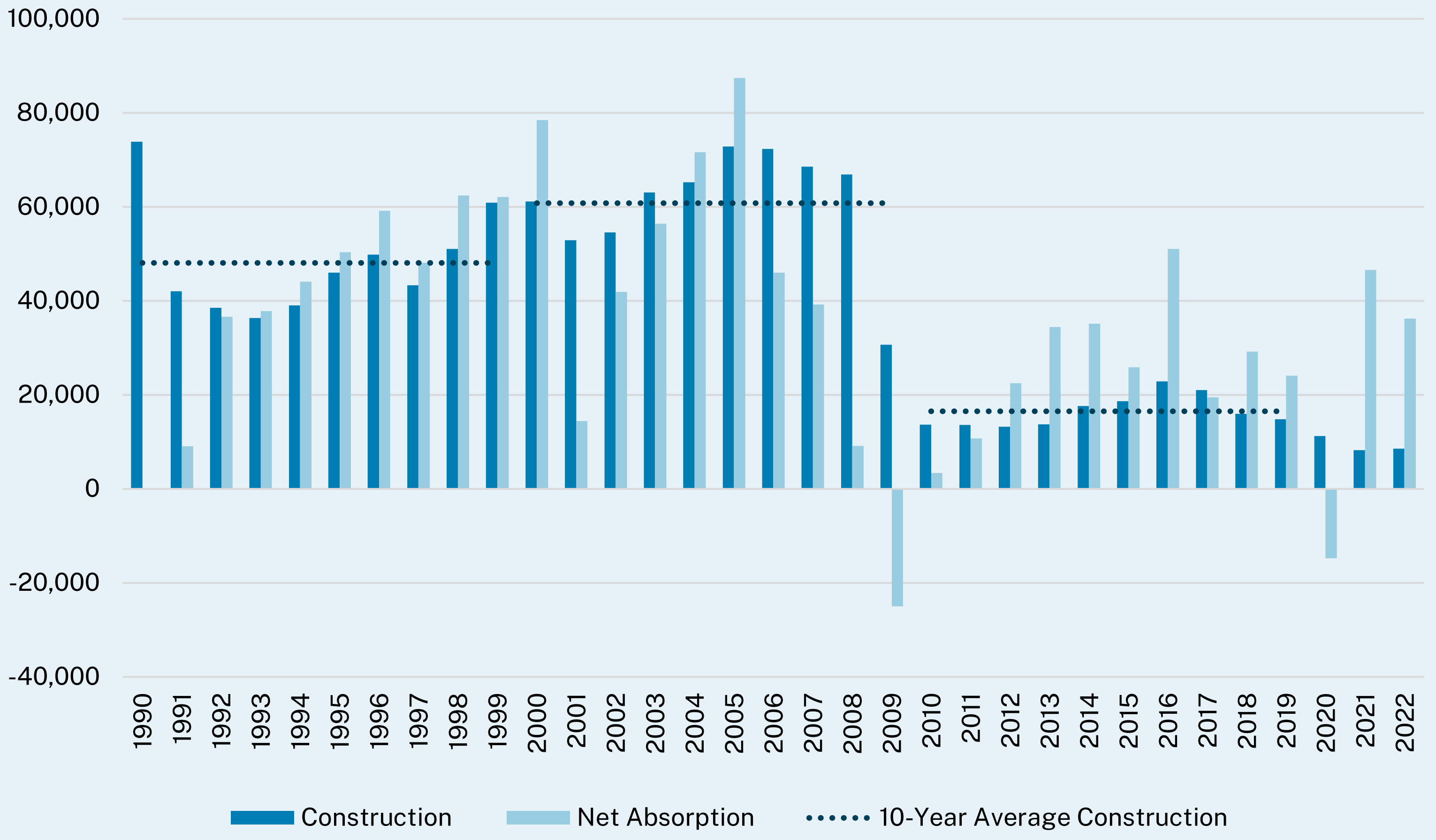
CONTINUED RATIONALE FOR (SOME) RETAIL

- The resiliency of grocery-anchored centers is especially valuable during downturns.
- Decent demand and minimal completions in recent years has strengthened fundamentals, providing a stabilizing effect in portfolios.

Holding well-located, well-leased retail is going to benefit portfolios in the near-term by virtue of stable cash flows.

Source: American Realty Advisors based on data from Green Street Advisors and CBRE-EA as of December 2022. e=estimate.

Neighborhood Center Completions and Net Absorption (Million SF), 2005 – 2022e

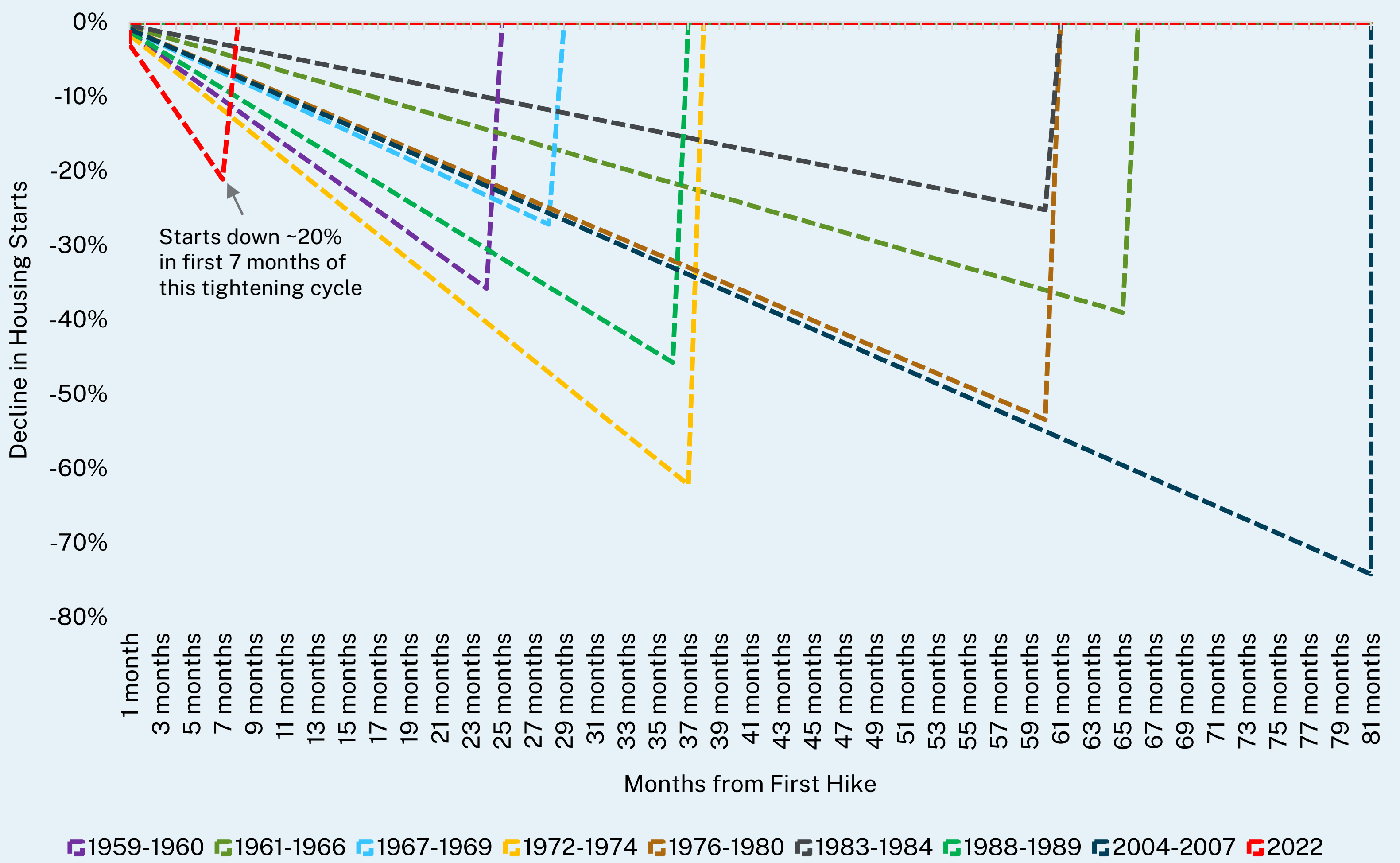


RATE HIKES AND HOUSING STARTS

- Single-family home purchases and starts decline during periods of rising rates, as fewer buyers lessen incentives for builders.
- It takes, on average, 49 months to reach the housing start trough after a rate hike cycle has been initiated.

Further contractions in housing starts over the coming 18-34 months is expected, perpetuating the supply-demand imbalance and insulating rental demand.

Change in Housing Starts from Start of Hiking Cycle, 1959 – 2022



Source: American Realty Advisors based on data from Macrobond, U.S. Census Bureau, and U.S. Department of Housing and Urban Development as of November 2022

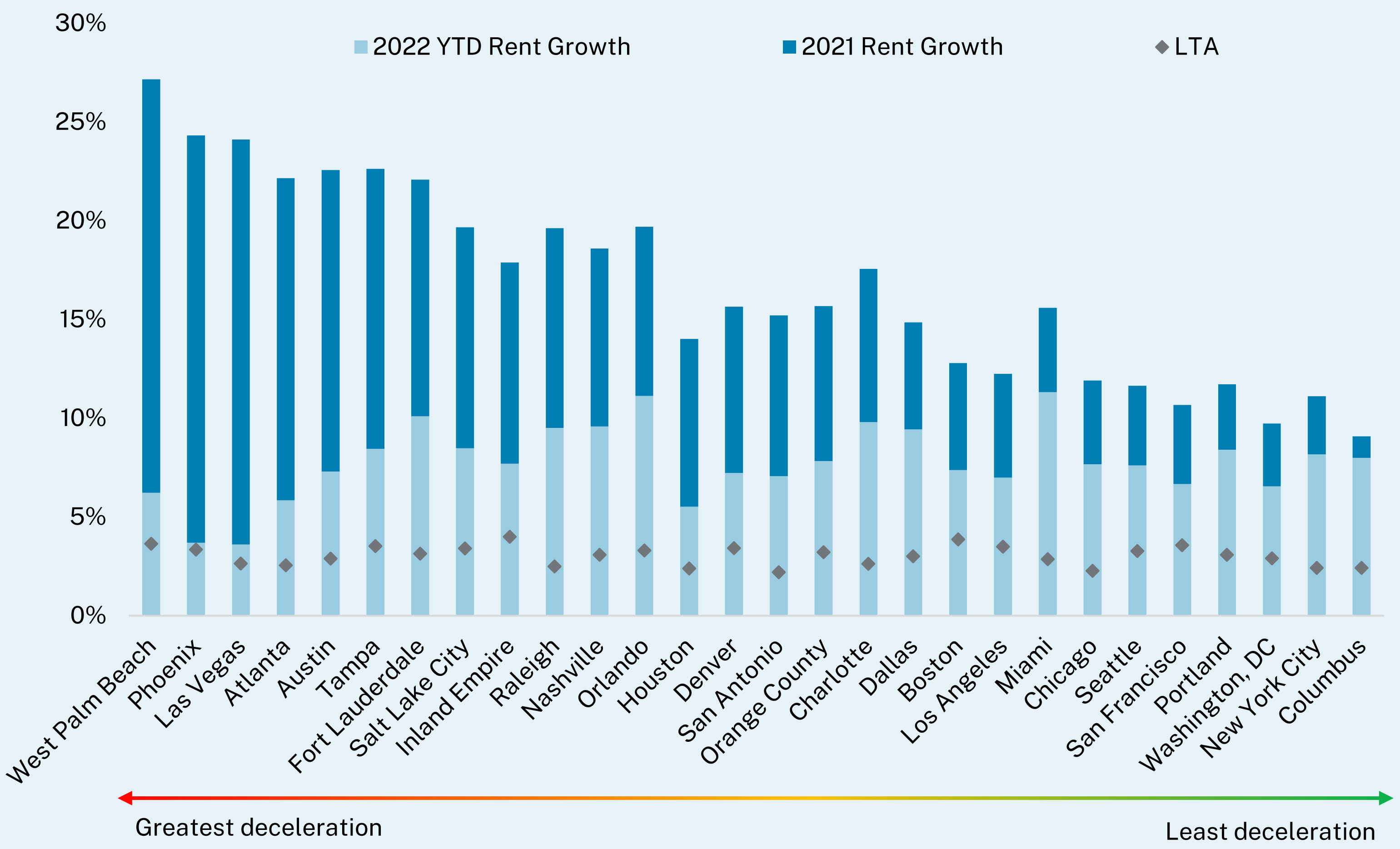
DECELERATING APARTMENT RENT GROWTH

- A deceleration in rent growth after 2021 was wholly expected.
- The magnitude of deceleration varies between markets – those with the highest growth last year are experiencing the greatest slowdown.
- Even still, the current pace is well above most markets' LTA.

Rent growth is slowing to more normal YoY trends.

Source: American Realty Advisors based on data from CBRE-EA as of November 2022. Markets sorted from left to right based on magnitude of deceleration between 2021 rent growth and YTD rent growth. LTA = long-term average, 2001 – 2021.

Multifamily Rent Growth Momentum: Year-To-Date through Q3 2022 vs. 2021

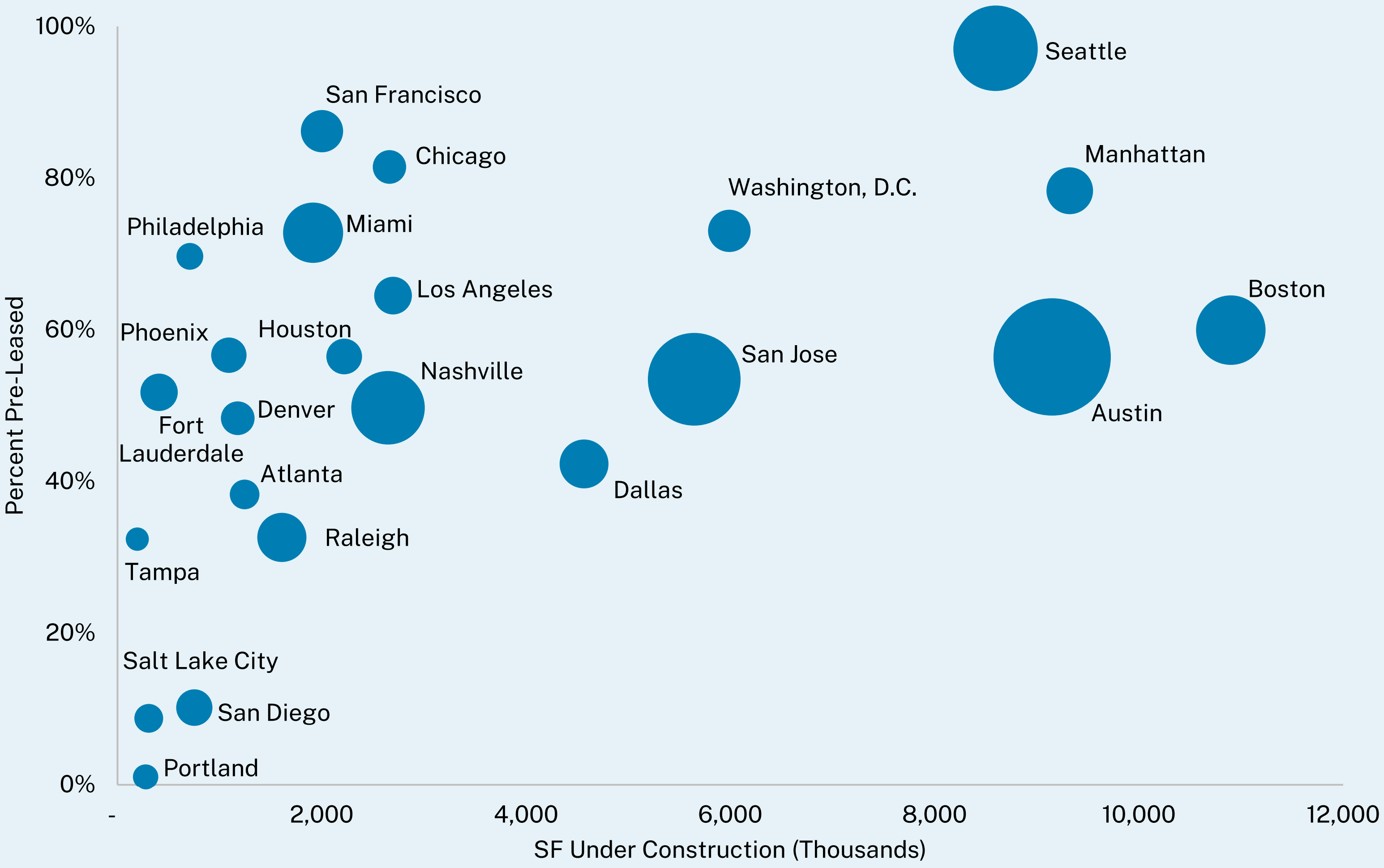


PRELEASING PROTECTION

- Preleasing data for office development shows healthy demand for new buildings in most markets.
- Even in markets where today's pipeline represents a sizeable share of existing inventory (such as Austin), preleasing levels seem to suggest some insulation for owners of modern space, despite elevated market-wide vacancy.

> **Office is being challenged by structural (WFH) and cyclical (recession) factors – new supply just may not be one of them.**

Office Space Under Construction, Total and Percent of Inventory, Relative to Pre-Leasing, Q3 2022



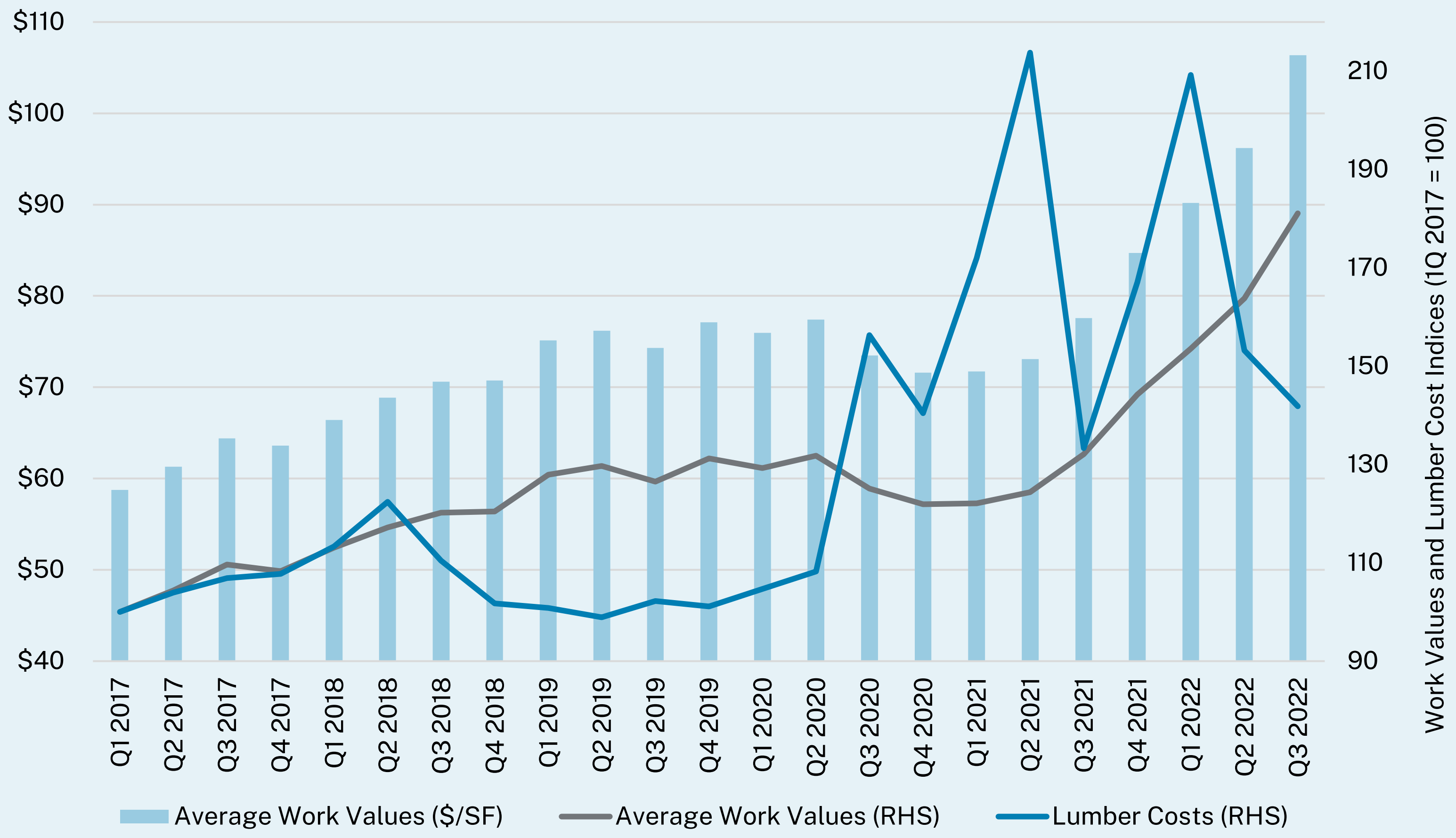
Note: Bubble size represents sf under construction as a percent of existing office stock.
Source: American Realty Advisors based on data from CBRE EA as of December 2022.

THE COST OF OFFICE OCCUPANCY

- Weaker demand prospects have prompted landlords to spend more to better position office assets.
- While some of this is from higher materials costs, the pace of TI increases has far exceeded that of lumber.
- This suggests cost creep is a function of expanded scope of improvements required to keep up with tenant expectations.

Owners will have to underwrite spending more going forward to maintain competitive occupancy levels.

Growth in New York City Office Average TI Dollars Per Square Foot on Direct Office Leases and Lumber Prices, Q1 2017 – Q3 2022



Source: American Realty Advisors based on data from Compstak and Macrobond as of November 2022

OUTLOOK FOR PROPERTY SECTORS

As the economic climate becomes more challenged, those sectors with recession-resilient fundamentals are better positioned as anchors in investment portfolios.

> **Property revaluations will take time to play out – but the secular drivers of industrial and residential remain intact, reinforcing our long-term overweight convictions.**

Industrial

- Demand expected to weaken amidst high levels of inventory on hand.
- Supply risks are manageable given most markets' vacancy is well below LTA.
- With the sector having the lowest starting cap rates heading into a rising rate environment, industrial could be positioned to see the most relative repricing.

Residential

- Housing starts decline perpetuates supply-demand imbalance, providing relative insulation to rental demand.
- Despite ongoing deceleration, rent growth remains well above LTAs in most markets.
- Persistent affordability gap between owning and renting makes the latter more resilient heading into recessionary territory.

Office

- WFH plus a probable recession is giving a one-two punch to occupancies; perpetually above-average market vacancy may become the new norm.
- Landlords must trade higher and higher TI packages for a shot at occupancy.
- Capital earmarked for distressed or opportunistic strategies will most likely find the deepest opportunity set in this sector.

Retail

- Consumer spending has remained robust despite inflation; household concerns about the outlook could prove self-fulfilling.
- Supply remains exceptionally muted; that, plus higher starting cap rates could limit repricing downside.

Specialty Sectors

- Material power and water requirements for data center operations mean future community opposition to new development is likely (net positive for existing assets).
- If past recessions are any indicator, self storage occupancy and revenue will likely fair relatively well.

IMPLICATIONS FOR CORE AND VALUE-ADD STRATEGIES

With a 2023 recession all but assured, the possibility of weaker returns has increased; now is the time to focus on the resiliency of income streams.

Asset Management

- Continue to push to capture mark-to-market spreads on industrial and residential lease expirations given the robust rent growth of 2021-22.
- Implement office leasing strategies on renewals and new leases that minimize leasing costs and downtime in a rising cost environment to maximize occupancy.
- Actively manage operating expenses and evaluate bottom-line benefits for all discretionary capital projects.
- Pursue reductions in real estate taxes based upon downward pressures on valuations.
- Carefully evaluate construction starts for new development projects in light of changing market conditions.

Portfolio Construction

- Focus on strategic dispositions in period of intensive price discovery.
- Less-strategic holdings that can be marketed as broken core may find more willing buyers in H2 2023 and beyond.
- Maintain early-mover advantage in purpose-built SFR given challenged backdrop for would-be buyers.
- The tightened traditional lending environment has made debt more accretive – pursue opportunities to provide mezzanine/preferred equity and rescue capital.
- Multifamily starts likely to drop meaningfully in coming quarters; continue to pursue residential investments at or below replacement cost.

SUMMARY AND STRATEGY IMPLICATIONS

The investment backdrop is going to worsen before it improves – variation in performance over the coming year will be the result of prior prudent asset and sector selection.

- Some segments of the economy are seemingly still running too hot, but there is more to the data than meets the eye – cracks are forming.
- Rising interest rates are a threat to real estate, which in turn poses an even-greater risk to the economy given commercial and residential activity comprises ~10% of GDP.
- Effects of policy moves are often lagged – we believe full impacts will materialize in a more severe recession than markets may be pricing in.
- Fundamentals in most sectors are normalizing nearer to historical averages – this wouldn't necessarily be a negative, were it not for the need for higher NOI growth to offset significant upwards pressure on cap rates.
- The era of easy money seems to be fading more permanently into the rear-view mirror; while this will require some pain for markets to recalibrate, it will serve to reset and eliminate excesses that compressed returns across asset classes – as a result, we expect equity flows to resume in H2 2023.
- We continue to believe in the long-term benefits to holding real estate; nevertheless, 2023 will be tough on investors' portfolios, and real estate will not be immune, though shouldn't suffer as much as in previous downturns given a more insulated starting point. And when returns turn positive, they return quickly.

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