AMERICAN REALTY ADVISORS HOUSE VIEW

Midyear 2022

AMERICAN
REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

AMERICAN REALTY ADVISORS HOUSE VIEW: MIDYEAR 2022

Twice a year, the ARA Research team presents our views on current and future market conditions and the implications for the commercial real estate market through our ARA House View suite of materials. The primary goal of the House View is to develop and drive internal strategy by identifying where we see the greatest opportunities and, equally important, where we see potential risks in the years ahead.

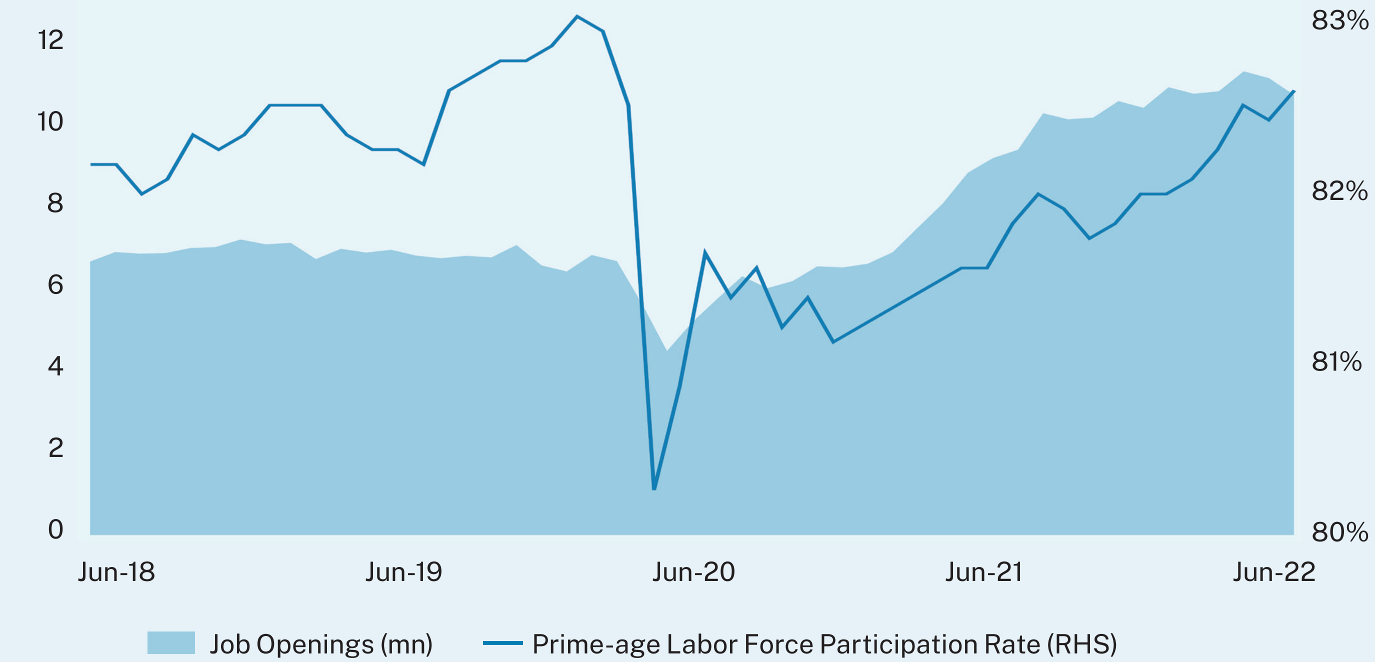
KEY TAKEAWAYS

- Economic risks are skewed to the downside as the Fed proceeds with a renewed fight against persistent inflation.
- Borrowing and bond rates likely to remain highly volatile over the coming 6-12 months impacting real estate transaction volumes and pricing.
- Broad shifts in supply-demand balances in multiple property types are creating windows of opportunity but also increased risks.
- Property sectors with shorter-term leases can be particularly powerful additions to portfolios as inflation-hedges, especially when balanced with resilient longer-leased assets in a high inflation slowing growth environment.
- Uncertainties surrounding the direction of cost of capital, market fundamentals, and tenant demand are creating larger bid-ask spreads, leading to opportunities for careful buyers with conservative underwriting and ready capital.

FIGURE 1

Labor Market

Job Openings and Prime-Age Labor Force Participation Rate, 2018 - 2022



Note: Prime-age is defined as those aged 25-54 years old.
Source: American Realty Advisors based on data from Macrobond as of July 2022

MACROECONOMIC ENVIRONMENT

The economic backdrop has become more complex over the last six months. A longer drawdown of stimulus savings combined with rounds of zero-tolerance COVID lockdowns in China and the war in Ukraine, has kept supply and demand firmly imbalanced, making the once seemingly transitory inflation more persistent than predicted.

It would seem through this lens that the Fed's recent 75-basis point hike in June (and the high likelihood of another to follow as this goes to print in July) was the right move. The challenge is that, having only just embarked on their rate hike path, the Fed faces increasingly conflicting data points about the health of the overall economy and its ability to withstand tighter monetary conditions.

On one hand, the labor market remains exceptionally strong for job seekers. Though down from the March peak, job openings remained firmly in excess of 11 million as of May. Despite the tightness of the labor market, total nonfarm employment rose by 372,000 jobs in June, far stronger than the 250,000 consensus estimates, as labor participation has trended back up (Figure 1). Wages, though trailing the pace of inflation, have increased at a +/-5% year-over-year rate. This should signal to the Fed that they have achieved and arguably surpassed their goal of maximum sustainable employment and that it should continue to tighten so this component of the economy does not overheat.

On the other hand, there is an increasing disconnect between this apparent strength in the labor market and final demand. Consumer sentiment, having been on a downward trajectory since peaking last summer, has plunged to levels not seen since the Global Financial Crisis. Spending in May rose at the slowest rate thus far this year, and, while the slowdown in spending is no doubt a function of higher prices forcing households to scale back purchases, it doesn't bode well for an economy whose overall strength has always been reliant upon consumers.

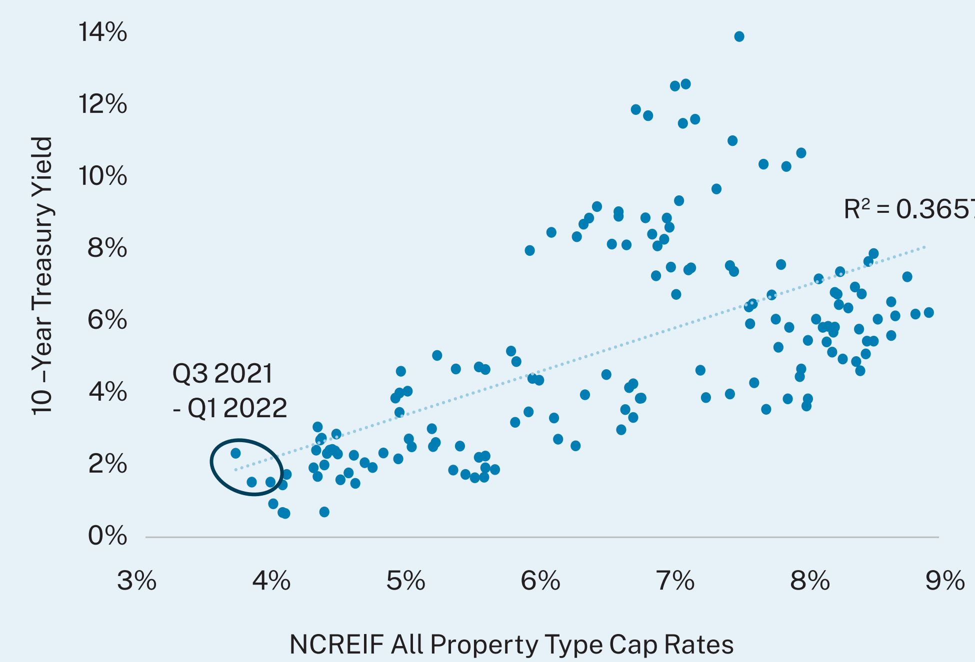
Consumer spending in the first quarter contributed two percentage points to Q1 GDP figures, more than its contribution in Q3 or Q4 of 2021 (Figure 2). Yet, GDP was

NAVIGATING TO A SOFT LANDING

FIGURE 5

Cap Rates and the 10-Year

10-Year Treasury Yield and Overall Cap Rates (1983 – 2022)



Source: American Realty Advisors based on data from Charles Schwab, Chatham Financial and the National Bureau of Economic Research as of July 2022 is feeding fears of recession. Whereas the June dot plot suggested reaching peak Fed Funds rate by December 2023, the futures market is now projecting meaningful rate cuts as early as next year (Figure 4).

Our outlook assumes the Fed will continue to hike rates through the end of 2022 to suppress more of the demand-driven inflation pressures and loosen employment conditions, much to the discomfort of consumers and investors. We believe the Fed Funds rate could reach a peak level of +/-3.5% before year-end and that the first cut may be required as soon as the spring.

Naturally, this leads to questions about the outlook for commercial property prices and ultimately total returns. With ultra-low rates and fixed-income yields serving as a conduit for cap rate compression in the most recent cycle, there is an assumption that a reversal in the trajectory of rates could spell repricing for real assets to maintain an appropriate risk spread.

However, cap rates and bond yields (a proxy for yields on perceived risk-free assets) have historically demonstrated a fairly weak statistical relationship. In fact, since the Fed began targeting the Federal Funds rate as a policy lever in 1982, the two have moved in the same direction only 37% of the time (Figure 5).

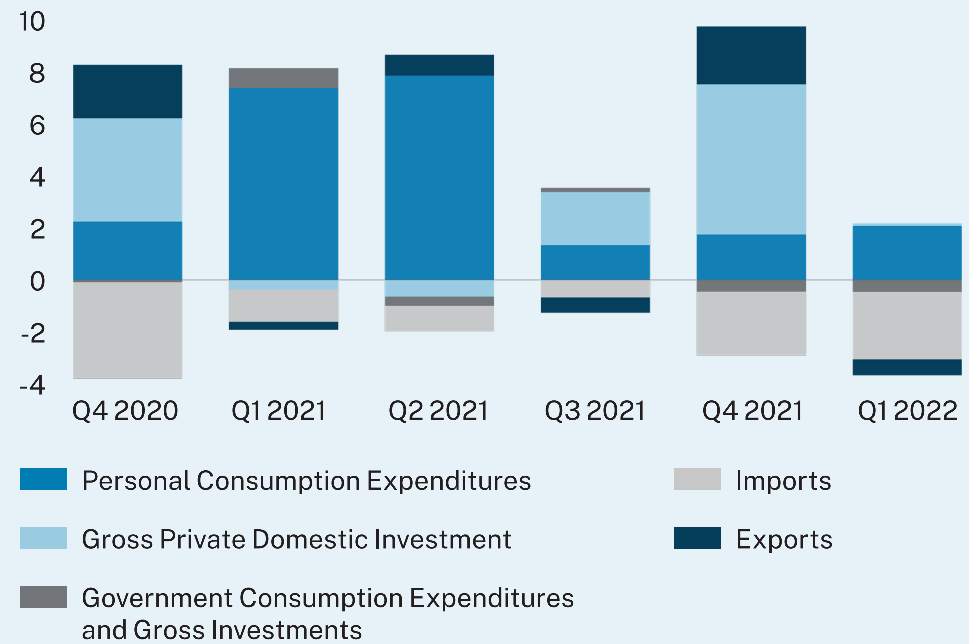
That's not to say there won't be any impact to real estate values. On the contrary, we believe that total returns will come down from recent highs, as cap rate compression will be a less-reliable driver of appreciation, and transaction pricing slips as higher-leverage buyers take a pause from bidding and lower-leverage and all-cash buyers seek more favorable terms.

The impact, however, may not be the same across markets and sectors. There is more to cap rate spreads than just interest rates. The outlook for GDP growth, the amount of capital flows into the asset class, calculations for replacement costs, and sector/market/asset-level fundamentals also have strong influence. On balance, these drivers seem to suggest a relatively short-lived period of negative impacts on real estate prices with the intermediate-term outlook more positive.

FIGURE 2

Contributions to GDP Growth

Contributions to GDP, Percentage Points, Q4 2020 – Q1 2022

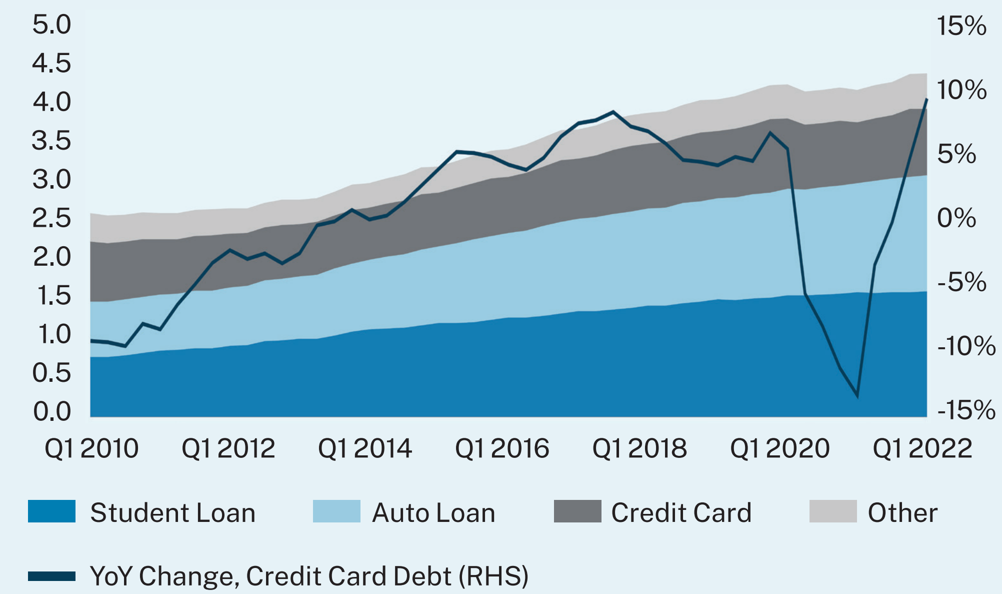


Source: American Realty Advisors based on data from the Federal Reserve Bank of St. Louis (FRED) and Macrobond as of May 2022

FIGURE 3

Household Debt

Non-Housing Debt Balance ($, Trillions) and Year-over-Year Change in Credit Card Debt

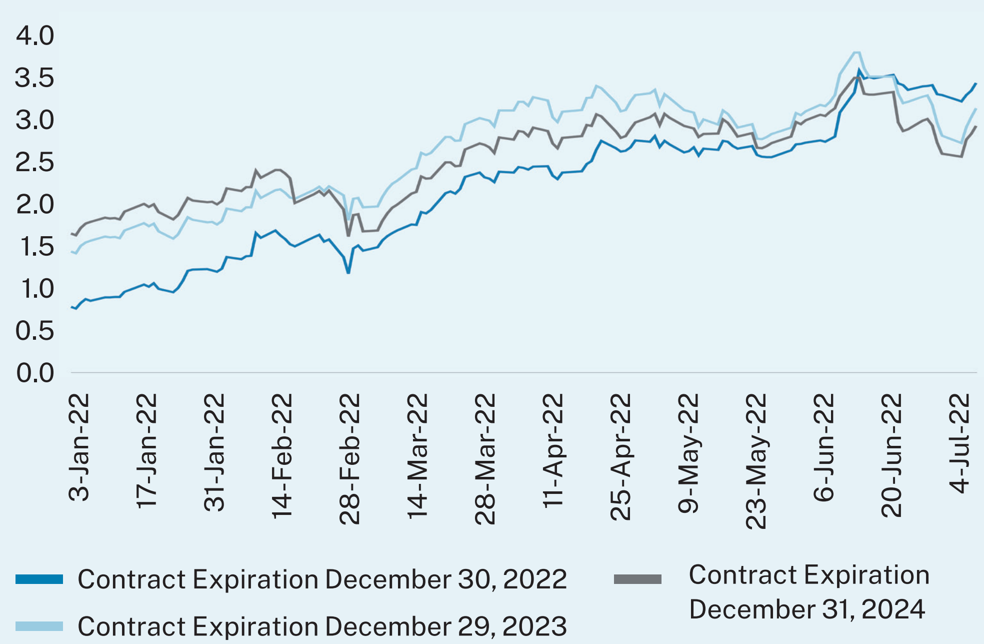


Source: American Realty Advisors based on data from the Federal Reserve Bank of New York Household Debt and Credit Report as of Q1 2022

FIGURE 4

Futures Expectation of Fed

Futures Implied Fed Funds Target Rate at Date Noted, %



Note: Lines denote the expectation for Fed Funds rate at year-end 2022, year-end 2023 and year-end 2024 at date the futures contract was executed. Source: American Realty Advisors based on data from the Chicago Mercantile Exchange and Macrobond as of July 11, 2022

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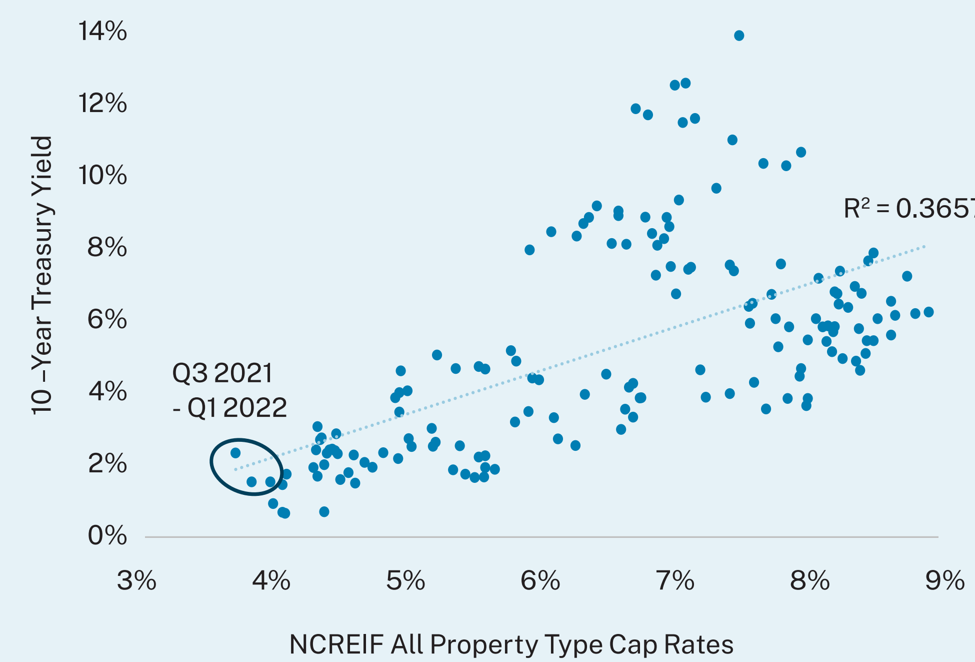


Source: American Realty Advisors based on data from Charles Schwab, Chatham Financial and the National Bureau of Economic Research as of July 2022

DRIVERS OF VALUE

CAP RATE SPREAD TO BONDS

Yields on the U.S. 10-year have increased ~150 basis points since the start of the year, reaching levels on par with the most competitively bid infill industrial assets not 12 months ago. This creates headwinds to the attractiveness of ultra-low cap rate product in particular, though if the market is to be believed, rates may be coming down as early as next year.

Trend: Rising in the near term, then stabilizing. **Impact on pricing:** Negative ➡ Positive

GDP GROWTH

While we are uncomfortable saying a recession is imminent, neither are we comfortable saying one can wholly be avoided. As GDP growth slows, broader demand prospects are likely to moderate with it.

Trend: Slowing. **Impact on pricing:** Negative

CAPITAL FLOWS

This is less to do with capital earmarked and desirous of real estate as an asset class (as of year-end 2021 there was approximately $402 billion of real estate dry powder awaiting deployment globally[1]) and more to do with a pause in transaction volumes as bid-ask spreads widen during this period of price discovery and debt becomes less accretive. We believe this is temporary and may even lead to an unleashing of pent-up capital in the coming 6-12 months that could restore cap rates to prior low levels.

Trend: Slowing, at least for now. **Impact on pricing:** Negative ➡ Positive

REPLACEMENT COSTS

Inflation has made constructing new buildings all the more expensive, in turn increasing the replacement value of existing assets. As labor and material costs have risen, fewer projects are getting out of the ground, lessening future supply.

Trend: Stabilizing, but elevated. **Impact on pricing:** Positive

FUNDAMENTALS

The demand prospects for industrial and for-rent residential remain wholly intact. Even in the event of a macroeconomic slowdown, construction costs and delays have created a dearth of supply relative to demand such that fundamentals are likely to remain tight compared to historic norms, creating conditions accretive to positive rental rate growth. Ongoing uncertainty and looming lease expirations pose headwinds to office. Retail is a mixed bag, though discretionary seems more exposed to dwindling consumer spending than necessity.

Trend: Varies by sector.

Impact on pricing:
Positive for industrial and residential
Neutral for retail
Negative for office

PROPERTY MARKETS

We believe the current period will be marked as one of broad shifts in supply-demand balances, both in the economy and across property types. Imbalances in the former are driving the inflationary conditions we are faced with today; those in the latter are elevating both risk and opportunity in the real estate space. And despite the importance of the goings-on in the macroeconomic background, there seem to be more sectors positively positioned in the supply-demand see-saw than not. In an environment where we cannot control the winds, but merely adjust our sails, leaning into sectors that offer a better relative starting point seems prudent.

Through this lens, our property markets analysis considers the supply-demand backdrop for each sector and highlights where imbalances are tilted more favorably to owners and investors, and where they are slated to be less so.

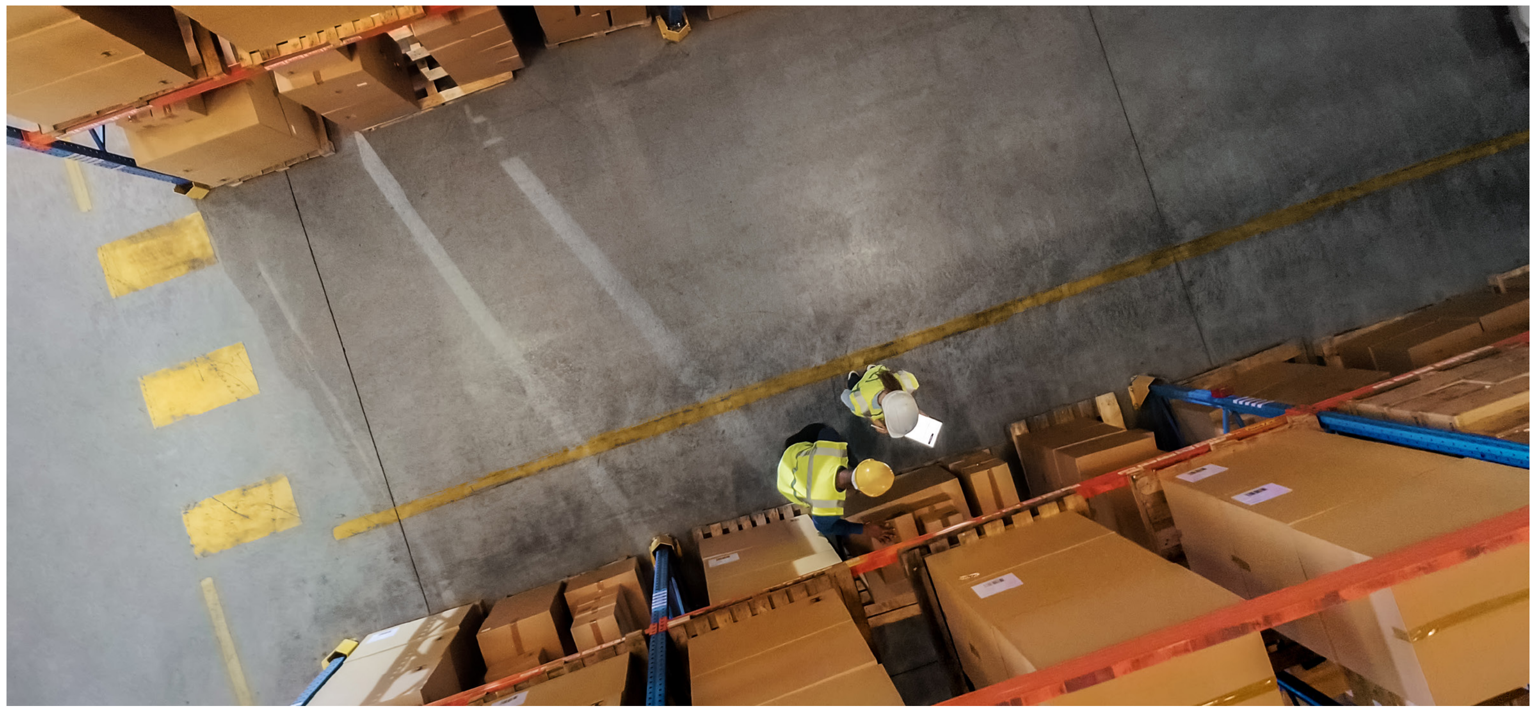
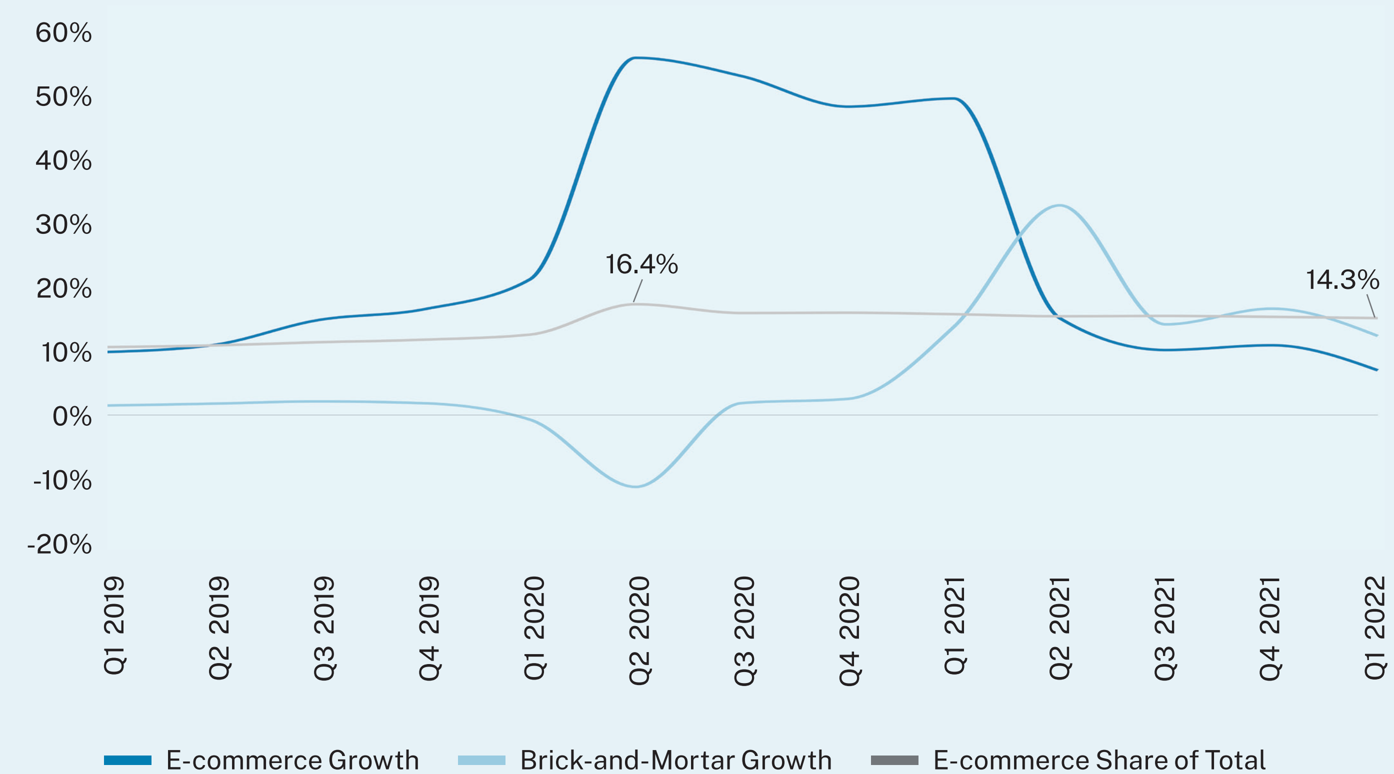


FIGURE 6

Retail Sales Growth by Source

Retail Sales Growth by Source and E-Commerce Penetration Rate, Q1 2019 – Q1 2022



Source: American Realty Advisors based on data from Green Street Advisors, the U.S. Census Bureau and Macrobond as of June 2022

INDUSTRIAL

Strategic Takeaways:

- Focus on capturing leasing from 3PL and traditional occupiers that may have been temporarily sidelined by Amazon competition.
- Capture mark-to-market upside in near-term lease rollovers.
- Continue to lean into structural e-commerce trends, using short-term repricing opportunities to bolster long-term overweight allocations.

Over the past six years, the industrial sector has been running on all cylinders, achieving the highest total returns of all property types since 2016. Throughout this time, investors have continued to speculate how much gas remains in the tank; but one anomalous event after another occurred, providing further tailwinds to the sector and extending the industrial buying spree. However, it seems that the foot of industrial demand drivers is finally easing off the accelerator as market fundamentals begin to show signs of cooling.

After an unprecedented bring-forward of e-commerce-related demand over the last two years, momentum has begun to normalize as shoppers returned to in-person shopping at brick-and-mortar retail centers (Figure 6). Naturally, this has prompted investors to contemplate whether e-commerce has finally hit its saturation point, a concern that has been exacerbated by recent headlines of Amazon being over warehoused. Investors have become accustomed to Amazon's ever-growing demand for industrial space. Having doubled their footprint during the pandemic, the warehouse giant has started to sublease select properties as cooling online goods orders has allowed the company to reduce excess capacity.

Despite these negative signals, we would argue that the industrial sector is still poised to be the top-performing property type in the near and intermediate term. At even half the pre-pandemic (2015-2019) rate of e-commerce growth, e-commerce sales could still feasibly increase by an additional ~$252 billion by year-end 2025, adding an additional 315 million square feet of demand over the next five years.

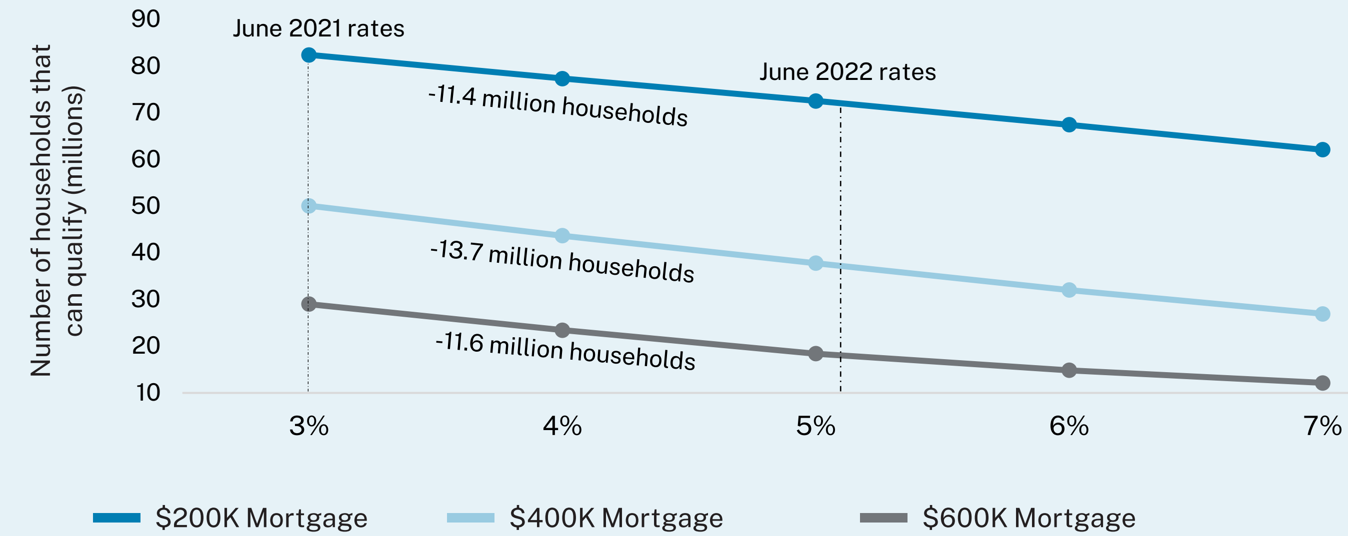
At the same time, completion timelines from entitlement through construction for new projects are now averaging 5 months longer than they were prior to the pandemic[2], creating delays that are perpetuating landlord-favorable supply-demand imbalances. That is why, despite an anticipated moderation in the pace of e-commerce demand, rent growth has continued to remain robust, as tenants with immediate move-in requirements must continue to compete for the best-located facilities. We believe the supply-demand balance will move nearer to neutral later in 2023 as the pipeline releases the backlog of delayed projects, though overall fundamentals will continue to be supportive of above-inflationary rent growth.

Though investors have long expected a fundamental normalization in the industrial sector, the real headwind to the property type comes from the Federal Reserve. As rate hikes increase the cost of borrowing, investors who must finance their deals are facing negative leverage scenarios as debt service payments and ultra-low cap rates eat into investor returns. As a result, we may see less transaction activity and asset repricing in the sector in the near term, though the longer-term structural drivers remain compelling.

FIGURE 7

Accessibility of Mortgages

Number of Households Priced Out of Mortgage by Price Point and Mortgage Rate



Source: American Realty Advisors based on data from John Burns Real Estate Consulting as of June 2022

RESIDENTIAL

Strategic Takeaways:

- Target markets that have a greater deceleration runway from current rent growth highs, as those markets will normalize at higher levels in a period of rent growth deceleration.
- Continue to invest in or develop purpose-built single-family rental communities as affordability and inventory issues will continue to provide demand tailwinds.
- Maintain overweight position and lean on ability to drive rents to hedge inflation.

The residential sector has experienced a series of anomalous events over the last two years unlike any other period in the asset class's history, taking fundamentals for a wild ride. Having weathered an unprecedented rise in unemployment and subsequent eviction moratoriums during the pandemic, rentals in virtually every market experienced a rapid unleashing of pent-up demand that culminated in unprecedented rent growth in 2021.

Normally a cloudy macroeconomic backdrop would be a headwind for rental demand – and while a deep recession would no doubt create ripples throughout property sectors, the structural tightness in the for-sale market combined with rising interest rates are providing some shelter. While historically rising interest rates often lead to a deceleration or even contraction in the pace of home price growth (which theoretically would make ownership more compelling), higher rates also erode purchasing power.

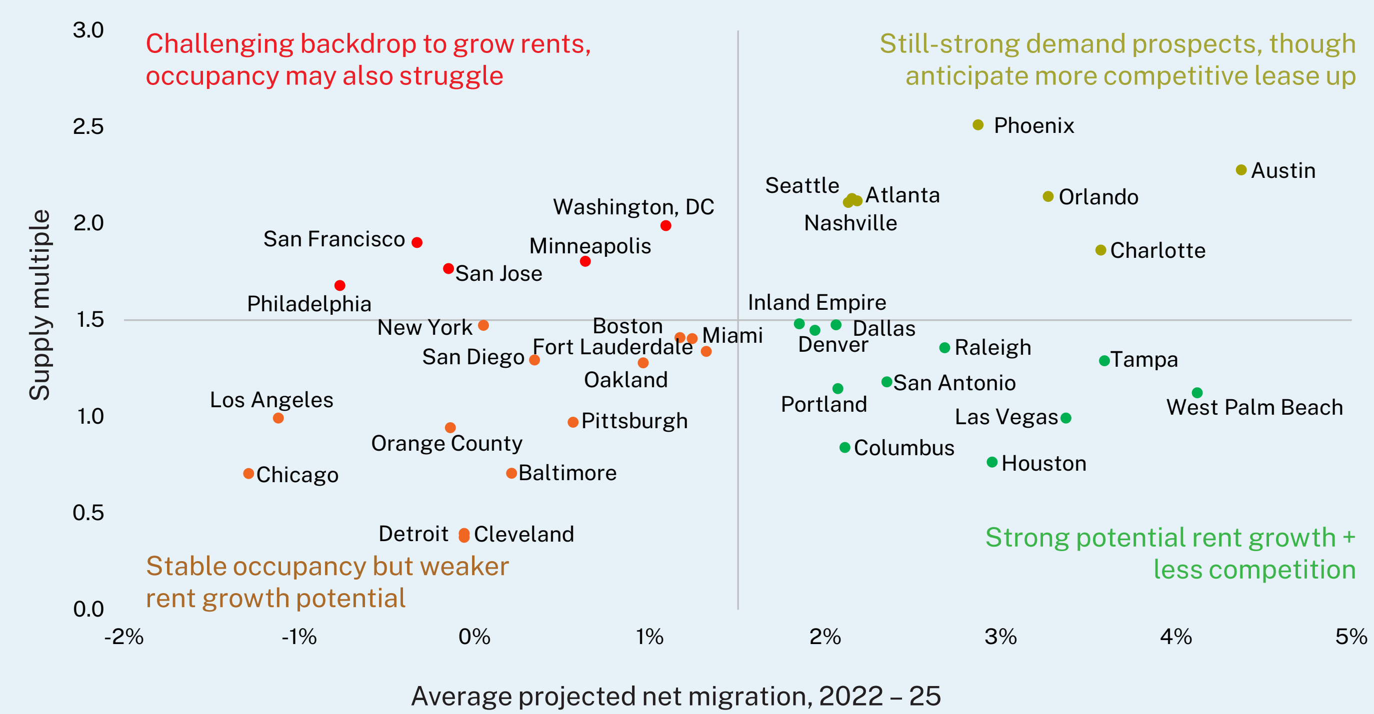
According to research conducted by John Burns Real Estate Consulting, a ~2% increase in mortgage borrowing rates reduces the number of households that could qualify for a $400,000 mortgage by 13.7 million (Figure 7). This furthermore creates a trickle-down effect as would-be buyers are forced to target lower priced housing, adding additional pressure onto an already-tight entry-level housing market and keeping more households in the rental market for longer.

Despite these structural tailwinds, there are two components that underpin our expectation that rent growth will moderate in the coming few years: renter affordability and new supply. Recent rent growth has made markets that have historically been viewed as more affordable increasingly less so. While development has returned and is a key component to easing affordability strains, competition amongst new supply will encourage a moderation in the pace of rent growth. Of course, the magnitude of rent growth deceleration will vary by market – we are viewing supply pipelines through the lens of recent demand and projected inflows to influence our market strategy (Figure 8).

FIGURE 8

Multifamily Supply & Demand

Supply Under Construction as Multiple of T-24 Net Absorption and Per-Annum Projected Net Migration, 2022 – 2025



Source: American Realty Advisors based on data from CBRE-EA, Oxford Economics and ESRI as of June 2022

OFFICE

Strategic Takeaways:

- Be aggressive and get renewals signed to stabilize building occupancy given a forthcoming wave of lease expirations in the next few years.
- Ensure portfolio holdings are well positioned to capture a larger slice of the smaller demand pie through technology enhancements, amenity offerings and environmental improvements.
- Continue to underweight sector and take cautious approach to vetting opportunities.

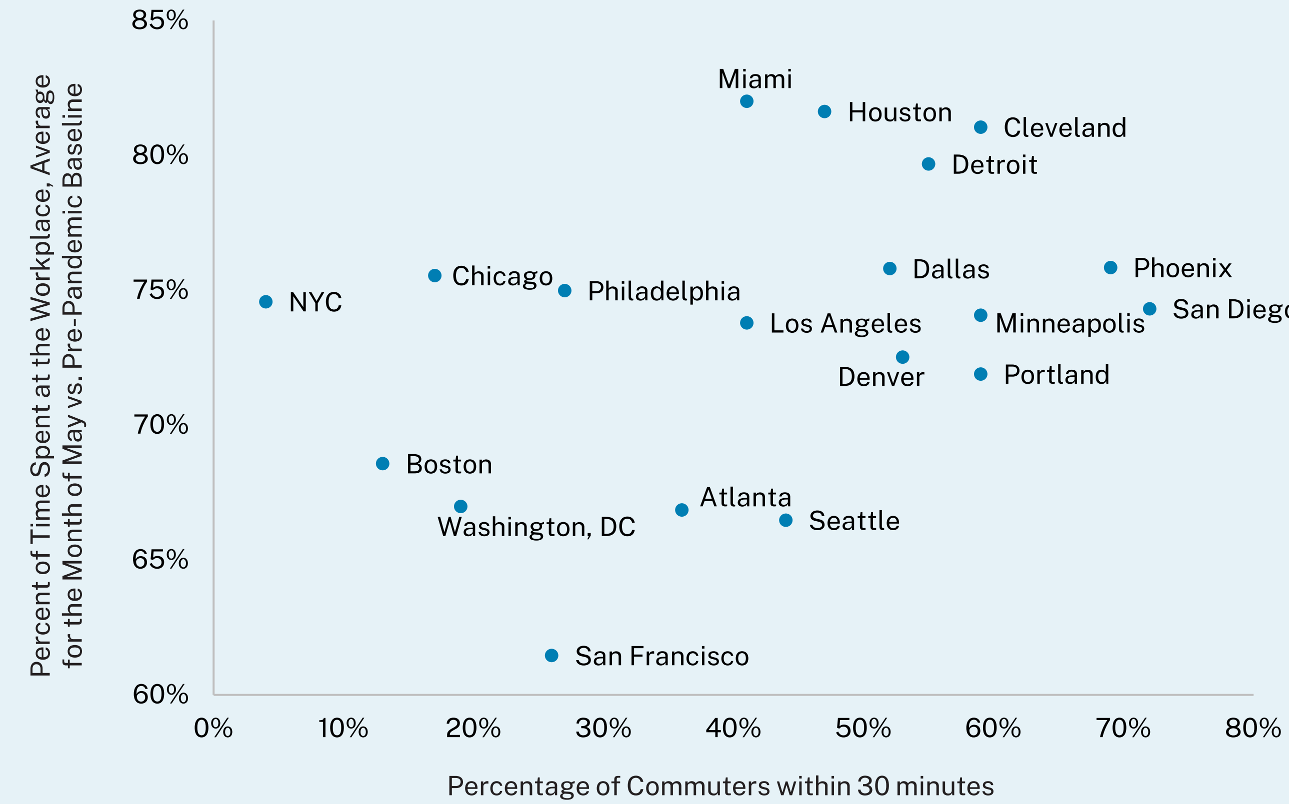
With office assets comprising nearly a quarter of core portfolios' holdings, decoding the future of the sector remains a key area of focus for investors. For months companies continued to delay finalizing their post-pandemic office plans and were able to refrain from making final decisions given the various COVID variants that kept health concerns top of mind. But with public concerns surrounding the virus diminishing and 80% of workers reporting they are already in their post-COVID-19 working arrangements, the current environment seems to confirm what many already suspected – that the hybrid, 3-days-in, 2-days-out model, represents the new standard embraced by employees and, perhaps less enthusiastically, by employers. Firms will increasingly make decisions regarding their space needs as leases roll through this lens. Whether they will opt to expand to accommodate more intentional and dedicated team collaboration areas and peak-day occupancy or contract due to anticipated under-utilization remains the million-dollar-question. The general sentiment from recent surveys favors contraction over expansion, an inclination that would likely intensify in a recession.

Given the structural headwinds to the office sector, investors are eager to identify and latch onto indicators that may indicate outperformance, or at the very least, more insulated performance. One such theory that has gained traction is looking to cities' average commute times as a predictor of stronger return-to-office potential. However, Google Mobility data shows markets with distinctly different commute times have a comparable return-to-workplace percentages (Figure 9). The lack of clear relationship between commuting time and workplace presence suggests that lengthy commutes are not the only factor preventing a broader return to the office.

FIGURE 9

Commutes and Return to Office

Percent of Commuters Within 30 Minutes Relative to Percent of Time Spent at the Workplace (May 2022)



Source: American Realty Advisors based on data from Geotab and Opportunity Insights Economic Tracker as of June 2022

FIGURE 10

Trajectory of Household Savings

Personal Savings Rate, Q1 2010 – Q1 2022

Source: American Realty Advisors based on data from the Federal Reserve Bank of St. Louis (FRED) as of Q1 2022

RETAIL

Strategic Takeaways:

- Hold position in necessity-anchored retail centers as discretionary retail is likely to be impacted disproportionately by inflationary pressures.
- Accelerate leasing plans already in motion while occupiers are still active in advance of an anticipated slowdown.
- Maintain overall underweight to sector, with carefully curated necessity centers comprising portfolio holdings.

Consumer spending has been the lifeline of the post-pandemic recovery. Armed with stimulus savings, consumers resumed in-person spending with vigor as restrictions eased. While partially a function of repressed brick-and-mortar sales during pandemic lockdowns, the year-over-year pace of brick-and-mortar sales growth has consistently outpaced that of e-commerce for four consecutive quarters, demonstrating the strength of the consumer recovery.

However, the life support is now beginning to falter, as stimulus savings have largely been depleted and inflation weighs on consumer spending power (Figure 10). With above-average inflation, consumers have had to increasingly rely on credit cards as wage growth has not kept pace. As the largest price increases are occurring in food and gas, consumers will be unable to avoid spending on these necessities; as such, many anticipate spending on other discretionary goods will likely suffer. This serves as a headwind to the retail sector, as consumers are likely to remain increasingly discerning in their spending patterns the longer inflationary pressures persist.

Inflationary pressures are beginning to erode the temporary (and short-lived) discretionary retail rebound, serving to reinforce the longer-standing bifurcation between necessity and discretionary retail. Grocery-anchored centers will come out the winners, as consumer food sales increase due to inflationary prices, while discretionary and experiential retail suffer as consumers conserve their funds.

CONCLUSION

We noted in our last House View that we believed the economy had already surpassed peak GDP growth and would revert to another low-growth era. That prediction seems to have been largely accurate. Inflation has proven stickier, stinging household budgets, and, while there are signs some contributory pressures may be abating (shelves and backrooms are now fully stocked with core goods that may wind up being discounted, for-sale home prices are softening, logistics logjams are clearing), it will take time for them to work their way through to consumers. This assumes the recent downtrend in commodities and oil prices in July continues and there isn't another bout of geopolitical upheavals.

There is much that needs to align for inflation to improve and many junctures where things could go wrong (causing a recession). The Fed, in its delay, has now created a situation where an even-more-forceful policy response is necessary to sustain confidence in their ability to maintain price stability, but may also tip us into contraction. Perhaps there is no other choice.

For investors in real estate, the best course of action when the outlook is this cloudy is to lean into those sectors, markets, and assets that are fundamentally in a better starting position to weather uncertainty – those with lower vacancy, more resilient structural demand, and less cyclical. Best case, a soft landing is achieved, and these positions flourish even more; worst case, they provide a more insulated and resilient profile in which to shelter.

1 Source: Pitchbook Q1 2022 Global Fund Strategies Report
2 Source: Newmark as of June 2022

DISCLAIMER

FORWARD-LOOKING STATEMENTS

This newsletter 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 newsletter, 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.

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