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Global Property Market Review & Outlook

2Q 2021

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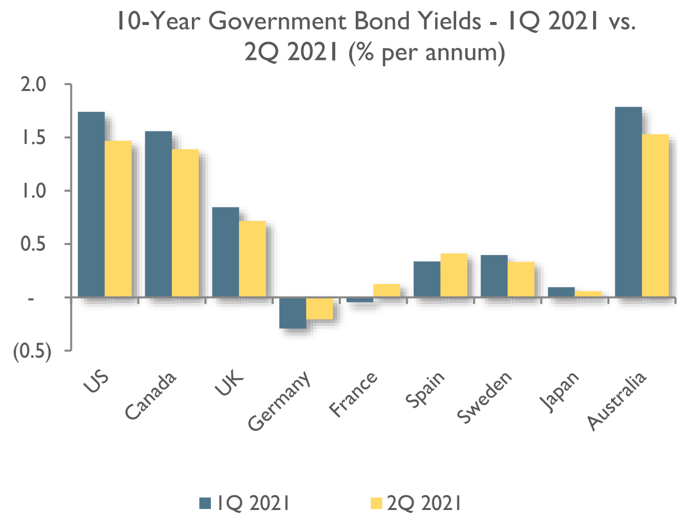
Conditions Improving But Highly Variable – And Unpredictable

Overview

While the efforts to vaccinate the global population gained momentum during the quarter, so too did the Delta variant of Covid-19 which appears to be highly contagious. This has tempered the enthusiasm for opening up major cities where Delta has been spreading and has led to lockdowns in cities like Sydney that were previously wide open. Adding to investor angst was the increasing concern over a return of inflation as the massive monetary stimulus and high savings rates face supply shortages. While this concern dominated the markets in mid-June, the impact on the bond markets and overall interest rates subsided quickly and as the chart below shows, the long bonds are roughly at their average levels for the quarter – and remain at historically low levels. With central banks flooding the market with liquidity and buying their own bonds, the information content that bonds normally contain regarding expected inflation rates is muted. However, based on the latest economic data to emerge from the quarter, there are signals that the global economy is slowing, increasing demand for yield assets like bonds – and REITs. Yields have continued to drop at the start of the third quarter as more economic data emerges regarding a potential slowing in the rate of economic growth.



Source: Bloomberg.

Dispersion Abounds Globally in the Real Estate Sector

For active managers focusing on the real estate sector, the markets continue to exhibit a high degree of differentiation for most property types and companies. This can be attributed to a number of factors including:

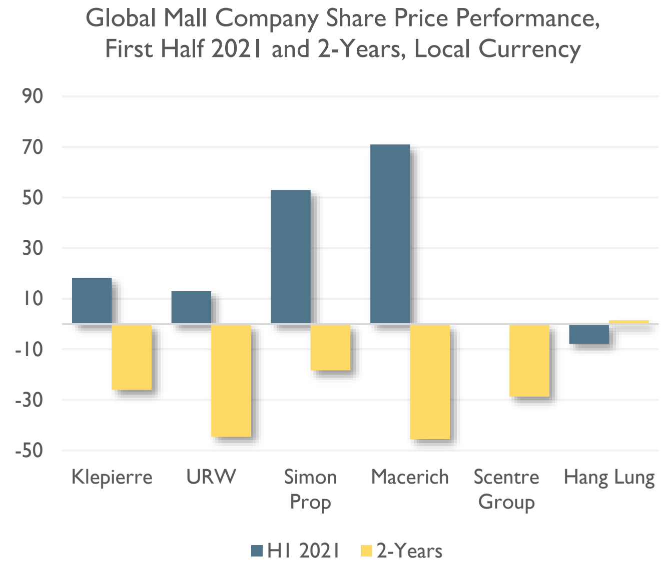
- **Vaccination levels and impact of Delta variant**. Not only are country reactions different but also major cities within those countries may have a different response to the virus and its variants. For example, New York and San Francisco have among the highest vaccination rates – 54% and 73% respectively, but have yet to hit an office physical occupancy rate of 20%. Hong

Kong is among the lowest at 27% (one shot, all data is from mid-June) and yet offices there are fully occupied

- **Variance of stimulus packages** – both in quantity and method of delivery, and in the US, this can vary by state
- **Record levels of new business start-ups in the US** may serve to offset softening of demand due to WFH
- **Culture** – Chinese and the Chinese diaspora in Asia as well as the Japanese have encouraged (required) workers to return to the office. The banking "culture" also appears to be headed in that direction with the CEO of Morgan Stanley effectively requiring everyone back to work in September – or else!
- **Rent/eviction regulations** are highly varied by country and local market
    - The UK extended their extension of a ban on "winding-up petitions" through March 2022 for commercial tenants
    - US – extended a similar ban for residential tenants an additional month (until July 31)
    - Berlin's rent control legislation was declared unconstitutional but alternative measures are planned to limit the potential for rent increases
- **Property types variability** – office and retail continue to struggle while investors remain very supportive of industrial properties, self-storage and rental housing. In some markets like London, warehouse space is trading at far lower yields than high quality office buildings – as below 3% versus 4-5% for high quality office buildings
- **Global trend to rental housing in markets like the US and UK that have been traditionally home-ownership oriented**. A shortage of supply, a vestige of the 2008 financial crisis, is partly to blame as well as low interest rates which allow for a greater range of potential buyers. Blackstone is once again making this sector a major target as is KKR as they made multibillion dollar acquisitions of rental home portfolios late in the quarter
- **WFH, WFA (work from anywhere), and BTO (back to office) have become hot topics in the office sector and vary greatly** depending on the tenant's industry and leadership mentality. Valuations are subject to a far greater range of assumptions regarding future tenant needs and rent levels given the concessions being offered by most landlords globally
- **Self-storage is the best performing property type globally this year**, although we might expect a supply response to temper future returns in the US. However, ex-US markets are far less developed and should provide ample opportunity for upside. In the UK and EU, self storage has become more of a "last mile" option for logistics companies as it is far more difficult in the EU in particular to develop the more traditional warehouse facilities used for this purpose

Market Dispersion – Mall Sector

The following charts illustrate the high degree of differentiation in performance of similar property types – retail and shopping malls - in different markets as well as the sharp declines experienced at the onset of Covid. As is evident from the companies varied performance, the mall sector is clearly not homogeneous and in the case of the US where the market is oversaturated with supply, the recovery has been led by the higher quality operators/locations. Note that Hang Lung, a shopping center and residential developer that caters primarily to the luxury segment, performed well throughout the pandemic. The company's focus on the wealthier Chinese demographic that formerly would travel to Paris and London for their luxury goods were forced to shop locally and this may become a longer term trend. US mall operators, Simon Property Group and Macerich, have also begun to benefit from the re-opening of markets that have been largely vaccinated. European mall companies represented by Klepierre have also started to benefit from increased footfall as well as a more outward facing design of the malls unlike the enclosed mall format that is common in the US and Asia. URW suffers from a large US/UK portfolio that is still struggling while its European properties are showing signs of recovery, albeit at a slow pace. This mall company has substantial upside potential if the EU can improve the pace of vaccination and the re-opening (again) of the UK market.

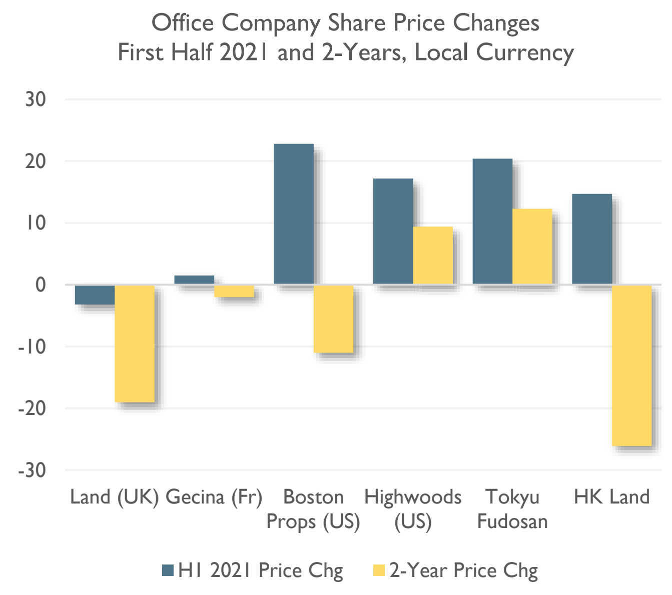


Source: Bloomberg.

Market Dispersion – Office Sector

The following chart of companies that focus on office development and ownership demonstrates a similar level of dispersion as the mall sector globally. This is mostly related to Covid, particularly when comparing urban centers with high rise buildings but is also dependent on local cultural attitudes. In the US, companies like Boston Properties which is primarily a high quality, and high rise, office owner have experienced minimal rental loss but also minimal leasing and occupancy. In contrast, office companies with low-rise buildings and easy car access – and located in "cool cities" like Austin, Texas – have performed well like Highwoods as shown below. Paris office company Gecina has also performed well and benefits from generally low rise buildings in a perennially tight office market. Tokyo office developer, Tokyu

Fudosan, reports that their buildings are essentially fully occupied throughout the pandemic and demand has been strong for more modern buildings. In fact, most Asian markets have averaged much higher physical occupancy rates in their high rise office buildings than New York and San Francisco which are struggling to get to a 20% level. In the case of New York, we expect that most financial services companies will effectively order their workforce back to the office after this summer and that trend is manifest in the most recent share price trends of companies like Boston Properties. The London office market has been struggling with the government's capricious approach to lockdowns/reopenings and this has had a clear impact on the UK office-focused REITs like Land.



Source: Bloomberg.

Abundance of Capital

As we noted in our last Outlook, the reduction in lockdowns and improving vaccination rates should lead to significant pent-up demand, especially in view of the unprecedented build up of savings by individuals and companies – not to mention the huge stimulus provided by governments and Central Banks. We would expect the key beneficiaries of this massive supply of capital will be travel and entertainment, followed by new clothing purchases as more workers head back to the office.

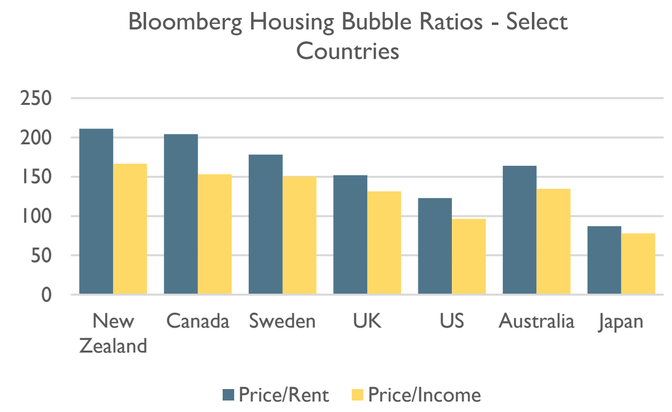
While most of the traditional property types were deeply affected by the pandemic, there is now an abundance of capital from a variety of sources, both debt and equity, available for even those sectors under the greatest duress like hotels and shopping centers. When the pandemic hit hardest last year, many PE funds and debt funds raised cash in anticipation of a wealth of workout opportunities and depressed prices. However, whether due to low leverage in the sector at historically low interest rates or forbearance by their existing lenders, the expected demise of the real estate industry hasn't occurred as was the case during the GFC.

There have certainly been some well-publicized bankruptcies in the US mall sector, but not the plethora of debacles resulting from the GFC where lenders were more inclined to foreclose than forebear. As might be expected, the relative dearth of properties available for sale has resulted in more M&A activity and joint ventures with public companies enabling the buyers to more quickly deploy their surfeit of capital as we will review later by region. US office specialist Boston Properties announced a JV with two SWFs, forming a $2 billion (equity) fund to invest in office buildings in the US. More astonishing was the successful financing of SL Green's high profile office development in Manhattan, One Vanderbilt, allowing SLG to take $3billion out of this development, including all of the company's equity. We understand that the deal was heavily oversubscribed notwithstanding the current office environment in New York (18% vacant) and high cost of the building. The 10-year loan bears an interest rate of slightly below 3% and is non-recourse to SLG, allowing them to completely de-risk the development which is roughly 90% leased.

Global Housing Sector

While the pandemic impact on the real estate has been sharp and severe for some property types and varies greatly by region, the housing sector in virtually all markets has been performing well, especially the ex-urban markets which had previously been struggling. WFH has altered demand patterns with an increasing preference for larger homes and more land farther from city centers – a complete reversal of the trend prior to the onset of the pandemic. This surge in demand has been partly fueled by low interest rates and, until recently, less restrictive lending practices. As noted earlier, housing supply has been generally lower than normal following the GFC and this has also added to price pressures. Until very recently, this phenomenon was most pronounced in the smaller cities while the larger and most expensive markets like London and New York languished. The notable exception to this is Hong Kong where sales for the most expensive properties has been stable.

As shown in the following chart of house prices as compared with rent and household income, there are some risks of bubbles that could deflate as more supply gets delivered to these markets – or workers return to the office and demand falters. Examples abound of bidding wars for homes, especially vacation properties that are now becoming more permanent due to WFH. Bloomberg reported that a very modest one bedroom home on a lake north of Toronto had 192 bookings to view the house within 24 hours of listing resulting in 71 firm offers – the house sold for nearly twice the asking. A high-end house in Sydney that was in derelict condition and received 30,000 enquiries and sold for $3.5 million. As the chart below indicates, the US is not as bubbly as other markets, although there are neighborhoods that are in bubble territory, while Tokyo remains modestly priced.



Source: Bloomberg.

Outlook/Portfolio Positioning

With capital readily available and recovery from the virus in sight, we would expect markets to continue to expand at a rapid pace, especially those property types that were hardest hit by the pandemic. However, as we have observed in some Asian cities that have emerged from lockdowns, there appears to be some resistance to spending the "excess savings" to hedge against the potential for more variants and lockdowns in the future. Consequently, it may be prudent to temper growth expectations for the coming quarters.

The logistics property market continues to benefit from rising demand for ecommerce and also supply chain disruptions that necessitates greater inventory levels than in the past – could this be the end of "just in time" inventory management? However, as with any sector that booms for an extended period, supply or other factors like an economic slowdown could ultimately slow the pace of value growth.

New business models are developing for retail operators that help to reduce operating costs and enhance long-term viability. As noted in a recent WSJ article (6/23) a company called Leap provides retailers with a turn-key/plug and play solution, finding them space, designing the store and handling the checkout system and data analytics, as well as store staffing. The concept of increasing economies of scale by having retailers share these costs and services is appealing while another concept that we highlighted in a previous Outlook, Showfields, showcases new retail concepts in a single building – more like a mall concept but on a vastly smaller scale.

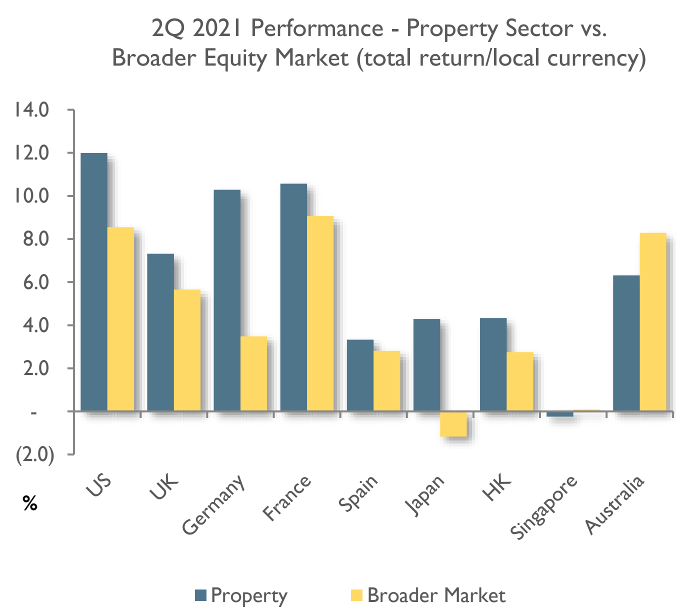
One of the key beneficiaries of the pandemic has been the data center property sector as WFH demanded more computing power and internet services. However, the realization that this sector uses massive amounts of electrical power has attracted more attention from ESG focused investors and the industry is responding with efforts to increase renewable energy sourcing. We would expect this pressure to intensify, and the increased cost of renewable energy could affect future profitability if the costs can't be absorbed by their clients. At the moment, the focus is on Amazon (AWS), Alphabet (Google), Facebook and Microsoft – which are also in the limelight for the social aspect of ESG. Our strong preference in this sector is for companies like Equinix that control many of the gateways to the internet and continue to expand in international markets that are underserved.

We have positioned our portfolios to include companies that will benefit most from an emergence from the lockdowns and increased rate of vaccination while also holding onto companies that tend to perform well during periods of market disruptions due to the spread of variants. In the case of companies that have the greatest potential upside as economies recover from the lockdowns - office, retail and hotels – our focus is on those companies that have minimal financial risk and can handle an increase in interest rates while enduring lower than normal revenues. These companies also tend to have secure revenue sources and high-quality management teams capable of managing through these challenging times. We also include in the portfolios those companies that continue to benefit from a shift in consumer demand and locational preferences as well as the ecommerce and data center/data transmission businesses that have flourished during the pandemic and still have solid growth prospects.

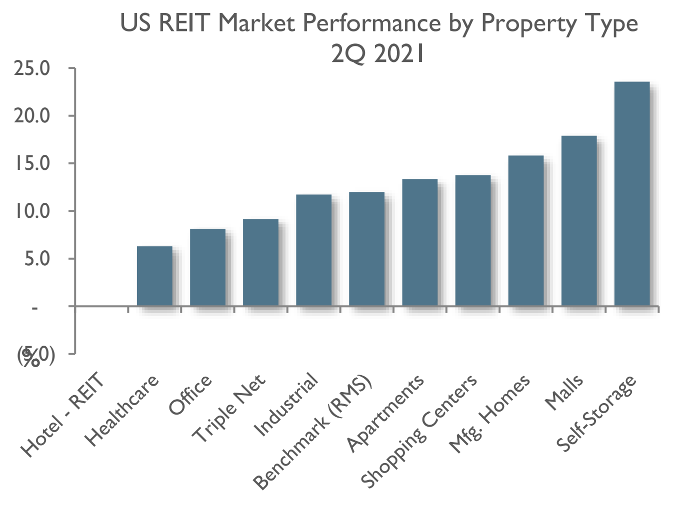
While global housing prices trends have been strongly positive over the past several quarters affecting affordability, this has also created an opportunity for rental housing, either apartments or single family rentals as in the case of the US. The pandemic has increased demand for larger residences to allow for an office area and/or fitness room and the lack of inventory and declining affordability has increased the demand for rental housing. Some caution may be warranted in less supply constrained markets, but we are positive on the housing sector overall, in particular student and low to moderate income housing segments.

The Chinese developers are trading at their lowest levels relative to fundamental value, reaching levels reminiscent of the GFC. This is partly due to global anti-China sentiment but also related to the government's efforts to cool demand by increasing down-payment requirements and developer leverage. For those developers that we prefer that are well-capitalized and managed, this is a great opportunity for them to gain market share without sacrificing margins.

Global Market Review By Region



Source: Bloomberg.



Source: Bloomberg.

US

While the headlines focus on job losses during the pandemic, a recent market analysis by the Bureau of Economic Research (published in June) indicates that there has been a surge in new business creations, concentrated in the southern states while lagging in NY, NJ and CA. The pace of new business applications since mid-2020 is the highest on record (2004) and is very different from the experience following the 2008 recession when applications declined sharply. Since job creation is an important source of real estate activity, this is a positive signal for the industry.

As noted previously, the combination of strong demand from global investors, readily available capital at low cost, shrinking deal flow and relatively cheap public equity prices for real estate has inevitably resulted in substantial M&A activity with some suitors achieving their targets while others were fended off. If successful, acquiring a REIT even at a premium allows the buyer to deploy substantial capital quickly and purchase a portfolio that has taken years to build.

These following are examples of recent transactions that demonstrate both the substantial amount of capital available for large transactions as well as the apparent discrepancy in public valuations relative to fundamental value:

- Extended Stay, a hotel company that was acquired by a combined bid by two PE firms, Blackstone and Starwood for $6 billion after raising their offer in June, resulting in a price that was over 20% above where the stock had been trading
- Two of the country's largest shopping center companies, Weingarten (WRI) and Kimco (KIM) – announced a $6 billion merger in April at a 14% premium to NAV
- Single tenant retail focused REITs Realty Income and VEREIT joined forces in late April in a $17bn all-stock deal at a 40% premium to NAV
- Monmouth (MNR) – Equity Commonwealth (EQC) – 5/4/2021 - $3.4bn all-stock deal – modest 7% premium to share price but ~30% premium to what GSA considers the unaffected share price (Dec 2020 when shareholder activism started: shareholder Blackwells made a $16.75 and $18.00 all-cash offer and joined forces with Litt's L&B in January – EQC offer implied $19.50 per share)
- QTS – Blackstone (BREIT/Blackstone Infrastructure Partners) – 6/7/2021 - $10bn all-cash deal – 21% premium to unaffected share price
- New Senior Investment (SNR) – Ventas (VTR) – 6/28/2021 - $2.3bn all-stock deal – ~30% premium to unaffected share price

As we noted earlier, the single family rental (SFR) property type is attracting substantial investor interest as evidenced by the efforts of PE giants Blackstone and KKR to acquire both properties and companies in this area. Blackstone acquired Home Partners which has a unique business model which is structured more like a deferred purchase program than a more traditional SFR model. In this case, a family that would prefer to buy a house but is unable to secure financing will contract with Home Partners to lease a house with an option to buy. In practice, apparently few tenants exercise the option and the business ultimately resembles the more traditional SFR approach. KKR acquired My Common Homes and both these PE firms look set to expand their platforms and exit through the public market as Blackstone did with Invitation Homes several years ago. One of the long-term concerns about this business is the increasing demand by home renters for amenities like a pool, clubhouse and office space to accommodate WFA demand. As long as these costs can be passed on to the tenants and the houses are substantially rented, but it does create a longer term burden for the owner.

At the end of the quarter, the restaurant and retail trades started to gain momentum with the increasing pace of the opening of many locales following restrictions due to the pandemic. New York restaurant operators reported that rents are now far more affordable and have declined as much as 70% in some locations (WSJ 5/26). Hoteliers are benefiting from renewed demand and despite a shortage of labor, are able to increase rates. “Bleisure” travel (business and leisure trips combined) is stimulating increased demand and we would expect the sector to continue to benefit throughout the year – if they can secure appropriate staffing levels.

UK

London rents jumped 4.3% in June MOM as tenants return to the City.

Despite the efforts of the UK to vaccinate their population, the Delta variant took its toll and the government responded with a short-term increase in restrictions which affected the property sector initially. One of the challenges for retail landlords is the decision to extend a rent moratorium through March of next year. Rent collection in this sector has been hovering around 40% while it is nearly 100% for office and logistics landlords. The government has announced a further extension on a ban on “winding-up petitions” (insolvency), leaving the market with an oversupply of moribund businesses. Regardless of the challenges due to the pandemic and/or Brexit, demand for office buildings remains strong and at far higher prices than are reflected by the UK REIT share prices. At the end of the quarter, the UK REIT Land Securities (now known simply as “Land”) was rumored to have sold a leasehold estate at a 3.5% cap rate (GBP 1500/sf), for a building leased to Deutsche Bank. In another example of public market value arbitrage, Blackstone has agreed to acquire the publicly listed property developer St. Modwen at the end of the quarter at a 25% premium to its pre-announcement price – after raising its initial bid. The company has developed residential, office and industrial properties over its history.

EU

The major news during the quarter was the merger of German residential companies Vonovia and Deutsche Wohnen that resulted in the creation of the largest residential property company in Europe with a combined property value of $100 billion. This combination has been in the works for some time and probably was boosted by a pending tax law change that would have dramatically increased the cost had the companies waiting any longer. The logistics sector continues to perform well and is probably aided by the lockdowns that continue to affect the region. However, we note that based on the recent economic data for the region, these setbacks have not proven to be durable and the trend for improving real estate conditions should continue. A good example of the discrepancy between investor expectations is the Madrid office market where high-quality office buildings remains solidly bid with yields in the 3.5% range despite weakness in office rents which are among the world's cheapest at around US$ 30/sf./yr.

KKR announced the formation of a EUR 9 billion fund to pursue value-add opportunities in Europe, adding another massive capital source to the long list of participants in the European market, which explains the trend to declining yields, and rising prices, for commercial real estate. KKR will have plenty of competition from local insurance companies struggling to find income in the land of negative yields and Korean investors have also entered the market.

The Nordic markets have been recovering and the Swedish economy in particular is performing well as this market has remained essentially open throughout the pandemic, with varying results. As in the case of the NY market, it seems that workers will enjoy a summer away from the office but return in September – not that unusual for this market in normal times. Office leasing activity is picking up although as in other global markets, tenants are looking for more flexibility in terms and space options.

Asia

The resumption of lockdowns in a number of markets like Singapore and Australia and the potential for the cancellation of the Olympics in Japan dominated the news, affecting the property sector most directly as the quarter ended. The Japanese development companies continued to perform well as their tenants are back in the office and leasing activity is increasing, at the same time supply of high-quality space is dwindling. Japan reinstituted a "state of emergency" which essentially means that the locals are free to move around but no one is allowed in from overseas. Our Japanese contacts indicate that restaurants and bars are open and masks are optional – not exactly an "emergency" state. The companies report low vacancies (sub 2%) for retail and office and larger tenants are not reducing space requirements and their housing divisions are experiencing increased sales and margins, as is the case in most global markets. Note that office space and housing costs in Tokyo are the lowest of all the major global urban centers and tenants/homeowners are not under the same historically high price pressures that these other markets are experiencing.

China's economy has been slowing and this appears to have affected overall regional growth trends, exacerbated somewhat by the variable pace of lockdowns and the government's pressure on the tech companies. Singapore is becoming a major beneficiary of the latest efforts to control growth of its largest companies as many wealthy families in China are setting up offices in this safe island state. Family office openings also include founder of Google, Sergei Brin, James Dyson of the eponymous firm Dyson Ltd., and Ray Dalio, founder of one of the world's largest hedge funds, Bridgewater. This has helped absorb some of the excess space generated by the pandemic and with supply starting to ease, the potential for rising rates is becoming clearer. Of the 221 wealthy family offices that opened in the midst of the pandemic, 27% are from North Asia and 8.5% from Europe.

Hong Kong is suffering from its perceived takeover by China but the actual outflow of businesses has not been significant and while office vacancies are high, property values are stable due most likely to the strong demand for residential and commercial property by Mainlanders.   For both HK and China, the property sector will remain under some pressure as the facts about the Chinese property-oriented conglomerate, Evergrande, unfold. This is a company that we have long avoided due to leverage and governance issues and the latest estimates of the company's total debt exceeding US$ 300 billion is hard to fathom. However, as noted previously, the share prices for the property companies are at or below GFC levels on any fundamental measure, so presumably much of the worst has been discounted.

HK retail landlords and retailers are employing pop-up stores and shorter-term lease strategies to encourage traffic while waiting for the international consumers to return. High street shop rents appear to have stabilized after dropping sharply from their pre-pandemic peaks (Q1 2013) of as much as 70-80% for the major retail centers. Shopping center rents dropped 45% on average from their peaks reached in Q2 2018 and also bottomed, rising 1.2% on average for the quarter according to local broker Savills. The government has implemented a voucher scheme to encourage locals to shop in the form of a HK$ 5,000 e-voucher ($650).

M&A and transaction activity kept pace with other global markets as the surfeit of capital and low interest rates stimulated major transactions. Most notable during the quarter was the acquisition of Soho China, a high profile Chinese-based office company, by Blackstone for $3 billion after an earlier attempt to buy the company for a price rumored to be $4 billon pre-pandemic. The purchase price represented a premium of 32% over the share price prior to the announcement, with the founders retaining a 9% interest in the new entity. This transaction was especially significant in the fact that it closed in a less than robust environment and a portfolio that in our view has some challenges., both in terms of leverage and rent prospects.

JLP Global Investment Team, June 2021.

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[1]**Property Sector includes**: United States TR Index (RMS G), Canada TR Index (RCAC), United Kingdom TR Index (RLUK), Germany TR Index (RPGR), France TR Index (RPFR), Spain TR Index (RPSP), Japan TR Index (RYJP), Hong Kong TR Index (RHHK), Singapore TR Index (RDSI), Australia TR Index (RDAU). **Broader Equity Market includes:** United States S&P 500 TR Index (SPXT), Canada TSX TR (SPTSXN), United Kingdom FTSE 100 TR Index (TUKXG), Germany DAX Price Index (DAXK), France CAC 40 TR Index (CACR), Spain IBEX Price Index (IBEX), Japan Nikkei TR Index (NKYTR), Hong Kong HIS TR Index (HSI 1), Singapore STI TR (FSSTITR) and Australia ASX 200 TR Index (AS51T)

[2]**Property Type includes:** Apartments Index (BBREAPT), Health Care Index (BBREHLTH), Hotel REITs Index (BBREHOTL), Industrials Index (BBREINDW), Malls (BBREMALL Index), Manufactured Homes Index (BBREMFDH), Office Index (BBREOFPY), Self-Storage Index (BBREPBST), Shopping Centers Index (BBRESHOP) and Triple Nets Index (BBREOUTL). JLP defines all companies listed above in the relevant sector based on Bloomberg's categorization of companies in the sector. There are no Bloomberg index/tickers available for Commercial Brokers, Data Centers, Homebuilders, Hotel C Corps, Mortgage REITs, Single Family REITs, Student Housing, Timber and Towers; therefore, approximate sector returns are calculated by JLP based on market cap weighted-average returns for all companies JLP identifies to fit into the relevant sector.