Global Property Market Review & Outlook

3Q 2021

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Another Lehman Moment or Just Some China Housecleaning?

Market Overview

The end of the quarter news was dominated by the impending demise (?) of Evergrande, one of China's largest and most indebted property conglomerates. We refer to them as a "conglomerate" due to the company's disparate businesses that at one point were viewed as major drivers of future growth – a budding electric vehicle business, a football (soccer) team, a bank, an insurance company, a $9 billion theme park – appropriately named "Fantasy Land" - and the list goes on from there. We have followed this company for many years and avoided it due to leverage and our lack of comfort with the CEO's business strategy and have been surprised that the company has lasted this long. It is likely that the government's efforts to rein in the level of leverage among some of the developers earlier in the year as exemplified by the "Three Red Lines" program may have precipitated the company's sharp decline this year. As we all remember from the 2008 financial crisis, liquidity can evaporate quickly when confidence is eroded and in the absence of government support. By the end of the quarter, it became clear that the Chinese government is very involved and we expect a relatively orderly liquidation of the company's major assets.

While the unraveling of Evergrande and most likely some other equally overleveraged companies has had a major impact on equity markets, both domestic and international, it is interesting to note the performance of China government bonds over the past quarter and year-to-date. One major research group in the region, Gavekal, cites that China bonds have substantially outperformed the G7 bond index in Q3 (Greed and Fear, 9/30, and Gavekal) and the currency is up against USD unlike most other EM and/or DM currencies. In their view, the bond market is not concerned about longer term effects on the economy due to the Evergrande fiasco. We shall see…

One of the greatest challenges confronting investors, particularly real estate focused investors, has been the variability of lockdown strategies by both national and local governments, constantly changing travel restrictions internationally and contradictory approaches – full football stadiums with no masking and then the attendees return to their homes with masks and limitations on restaurant attendance/night clubs. The obvious ramification for local businesses of such capricious policies has been to constantly adjust business plans and revenue expectations – mostly to the downside. New York City has opened but the low rate of office occupancy (now at 29%) and lack of tourists has resulted in the closure of nearly 30% of the 311 store fronts near Grand Central (major commuter hub, BB news 10-07). In Hong Kong, where travel is severely restricted off-island but offices are 100% open, the locals have developed the concept of "Eat-cations" where dining out has become the new "vacation" activity.

We now have only two countries that continue to strive for Zero Covid after Australia and New Zealand dropped out at quarter end – HK/China – a real Sisyphean task. While HK is reporting virtually zero cases, although until recently, the rate of vaccination had been low – it is now estimated to be 60% but only 15% of those over 80 have received at least one jab (Economist 10-9). This could pose a risk to the market in the future as was the case for the Kiwis given the lower potential for herd immunity.

The impact on the property sector for those markets that have experienced a series of lockdowns has been dramatic and traumatic, as best exemplified by markets like Sydney,

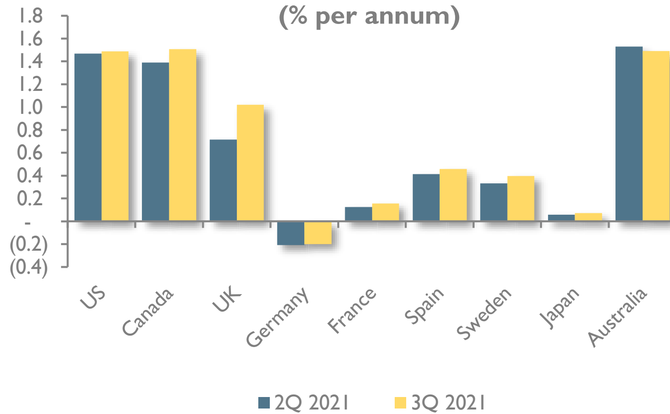
Australia, where the office physical occupancy rate dropped from 70% in June to 4% in September. The pre-Covid occupancy rate was 94% which clearly demonstrates the severity of the decline for office use with the obvious deleterious impact on the local community shops and restaurants. Note that this is local market dependent as Hong Kong has also experienced its share of capricious lockdown strategies but office physical is now 100% (Google Mobility Data). Despite fully re-opening in June, New York office tenants remain reticent to occupy their space and many major corporations have deferred the date for having staff return to the office until Q1 2022.

Aside from the Evergrande fiasco and Covid, investor concerns of inflation began to emerge late in the quarter, along with deflation and more recently, stagflation – we now have all the "-flations" covered. Ordinarily as a fund manager, we don't like to weigh in on economic debates, but this one has direct implications for the real estate sector. Neither stagflation nor deflation are positive for real estate as inflation erodes values and a slowing economy reduces demand. Inflation is generally optimal as long as it is driven by an expanding economy and long-term growth – even if interest rates are rising. Our current view on the matter is as follows:

- Shortages that have resulted in price spikes of certain commodities are driven more by short-term scarcity fears than actual long-term shortages and we believe these will abate. We remember well the sudden shortage of toilet paper in the early days of Covid in the US caused by hoarding with grocery stores limiting purchase amounts. This is best explained by MIT professor Jay Forrester referring to this as the bullwhip effect – now incorporated in the "Beer Game" at the business school[1]. The best example for this has been lumber prices which shot to over $1700 (futures contract price) and now are nearly 65% lower. (price per 111,000 board feet)
- Residential costs are rising rapidly for both renters and home buyers due to rising demand, and in most markets worldwide, an unusually low supply of housing. This inflation looks more durable until supply can be increased which has been made more difficult by rising commodity costs and a shortage of labor. As they say in Australia, "it's not the bricks, it's the tradies" that are the biggest challenge for homebuilders
- Deflation has occurred in the case of retail and office properties due in part to excess supply, but also related to Covid. Office rents in Tokyo are expected to decline due to increasing supply and even where the landlords can increase rents substantially, they tend not to do this, favoring strong tenant relationships over investment returns. However, we would not expect much downward pressure on values even in these markets as the global surfeit of capital seeking real estate investments overwhelms these concerns

Regardless of one's views on inflation, 10-year bond yields moved up sharply at the end of the quarter and this trend has continued into early October. While the chart below does not seem to indicate much of a move, many of the major country bond yields are at one-year highs – which certainly suggests that bond investors are starting to price in a potential rise in inflation in most markets.

[1] The Beer Game was developed by an MIT professor as a training exercise in supply chains and supply management. It demonstrates that the real enemy of smooth supply chains is human psychology – the urge to hoard overtakes rational responses to shortages, fueling panic buying and a distrust in suppliers and a lack of collaboration – which further exacerbates the situation. Buyers send in oversized orders to cover for expected shortages and this is replicated throughout the chain. Bloomberg News 10/07/2021.



Source: Bloomberg.

Real Estate Sector Trends to Watch

Given the challenges presented by Covid and the local market response variability, the key issue for real estate investors will be to assess which of the changes in current use and practice will become enduring and which are ephemeral. We are focusing on a number of market developments that could have a major impact on future value for a wide variety of property types and markets:

- **Office – RTO (return to office) or WFH?** The implications for office occupancy and its impact for adjacent businesses is significant. As noted earlier, most of the Asian office buildings (ex-Australia) are fully occupied while the rest of the world is experiencing a much slower pace RTO and this may be more enduring than we originally thought. While we continue to believe that office space will become more fully occupied as vaccination rates increase and various treatments are developed, it appears that the higher quality buildings with more flexible office space layouts and other enticements to bring back workers will outperform. This could lead to an acceleration of the pace of obsolescence for older buildings – which may be further hastened by environmental and energy concerns. This has already become reflected in building values in most if not all markets. At the end of the quarter, Google announced the purchase of a newly developed building (completion in 2022) in New York City at a price of $1600/sf, a very strong price for that particular neighborhood and location adjacent to a bus terminal and sanitation truck depot. Note also that, during the quarter, NY experienced the highest sales volume of apartments than at any time in the past 30 years – a sign of both a pending rise in RTO and also a recognition by sellers that they needed to accept lower prices (NYT 10/7).
- **Retail – Ecommerce forever or RTS (return to shop)?** Covid has accelerated a trend that was already occurring as both retailers and their landlords were not keeping pace with the trends. In the case of the landlords, rents had become prohibitively high and have been sharply reduced in the current environment with many leases reverting to a sales-based model (percentage rents). Where a US mall owner might expect a rent that was equal to 20-25% of the tenant's sales, this has been reduced in the US to 12-15% which is more affordable. As rents have adjusted and communities have come off lockdowns, we expect more consumers to RTS but the impact of ecommerce will remain a challenge, resulting in closures in markets like the US and UK which have the greatest amount of excess retail capacity.

  Retail is not dead but has become much more location/quality sensitive than in the pre-Covid

past. Sales are holding up – shoppers come with a purpose and are likely to spend more per trip.

- **Warehouse/Logistics – Soon to become the most expensive type of real estate!** As most investors know, a warehouse is not necessarily a logistics facility and each has very different cost and revenue profiles, but the latest trends in ecommerce have caused these differences to fade based on market pricing data. Now that yields are lower than virtually all other property types, we would expect this would attract more development and that the increased supply would slow the pace of rental and value increases. However, there are a number of factors that could allow this market strength to continue as supply chains encounter disruption due to a variety of causes – labor shortages, trade disputes, hoarding. The long-term trend appears to be "just-in-case" instead of just-in-time as vendors need to increase inventory levels to allow for unexpected shortages.
- **Self-Storage is the new "last mile" distribution story.** This relatively recent development may explain the strong performance of this property type this year. The storage industry is becoming a last mile distribution opportunity as their facilities are often in urban areas which are more difficult to develop for larger industrial players and the rent is low. We have seen more of this phenomenon in Europe than the US where land is more abundant and cheaper.
- **Lodging – the return of the corporate traveler/conferences?** Resorts have performed well and managed to raise rates but staffing shortages and Covid restrictions have limited occupancy rates. Ironically, the lower occupancy rates and lower staffing combined with higher rates may have resulted in some resorts making more money during this period. Resort hotels are also offering all-inclusive packages (all meals, drinks) to compete with the cruise lines operators as this sector begins to get clearance to sail. The hotels that are still struggling are more reliant on the business community and this may take more time to recover given the ability for companies to maintain revenues while dramatically reducing travel budgets. Some analysts and the airlines, like the CEO of Delta, are forecasting a recovery in business travel only in 2025. Investment demand for hotel properties and publicly listed hotel companies and REITs is improving and this looks like a longer term trend. This was clearly exemplified at the end of the quarter with Blackstone's sale of the casino/hotel property, the Cosmopolitan, for $5.6 billion which it acquired from Deutschebank in a workout sale in 2014, recording a $4.1 billion profit.
- **Rental housing is going global as home prices blow past affordability ratios.** This trend has become particularly appealing in markets where buyers are getting outbid and/or priced out, even in those markets where home ownership has been the norm and the stigma of renting a home was too great. Formerly more of a cottage industry with mostly smaller private players, this business is becoming dominated by larger rental property developers and home builders. These new developments have larger units and many offer other amenities like childcare, pools and office space for the WFH crowd. Although residential property rents can be subject to local government controls that affect long-term values, the lack of supply of quality housing in many markets is encouraging more potential home buyers to rent and demand remains high. This sector is attracting massive amounts of global

capital, including sovereign wealth funds, and supply could become an issue over the long-term, particularly if local governments seek to control rents but subsidize home ownership. In fact, at the end of the quarter, two very expensive housing markets, the UK and California, announced major efforts to encourage home supply. However, the measures are not expected to have much of an impact as both markets have a high degree of NIMBYism which could delay construction starts.

- **Declining in future supply.** From a property investor perspective, one relatively certain outcome will be a decline in future supply as lead times for property development become extended due to both market uncertainties and rising input costs (labor and materials) as well as the decline in the availability of those key inputs. The potential for a future shortage of real estate probably explains the strong demand for real estate globally despite the potential for rising interest rates and inflation.

Performance – Hits and Misses

The global REIT market took a breather during the quarter, droping -0.7%. Winners during the quarter were some of the "usuals" that have been performing well through much of the year like storage, housing and industrial/logistics. The star performers were US apartments, storage and industrial/logistics in almost every market and Japanese developers (high quality mixed use – office, retail, residential).

Aside from the Chinese developers declining due to all the negative news regarding Evergrande and other highly levered companies in that market, the top Hong Kong developers were also hit by fears that the Politburo in China would intervene in their businesses. These HK companies are very well-capitalized with modest leverage and are controlled by wealthy families ("hongs") and there was a rumor that these wealthy families might be targeted like the tech leaders in China (Jack Ma, for example). The rumor is not supported by any facts but the Evergrande crisis has the market on edge – which in our view is a buying opportunity.

Other markets that suffered during the quarter included retail-oriented companies in most markets with very few exceptions other than Australia. Some of the weakness could be attributed to profit-taking after the prior quarter rise and also the impact of the spread on the Delta variant on local regulation.

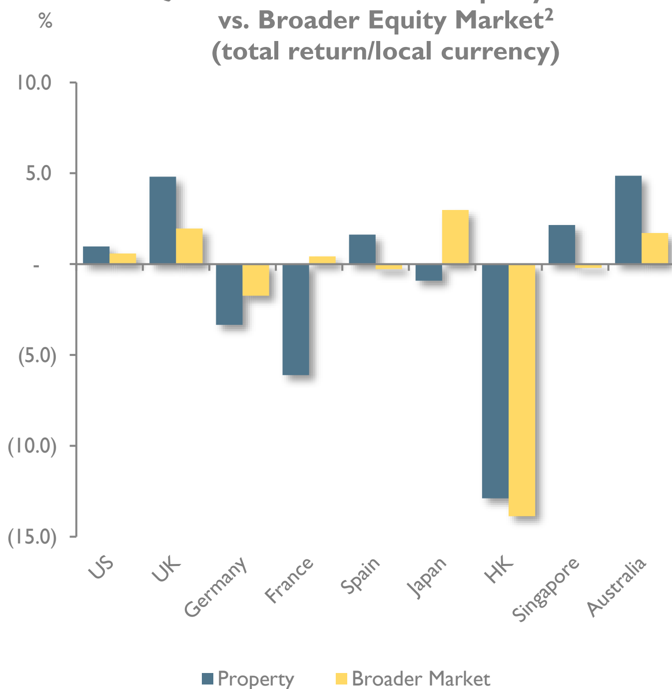
Portfolio Positioning

- Invest in companies that can benefit from the re-opening trade tempered with some more Covid beneficiary holdings that have solid growth prospects given the "lockdown volatility"
- Exited a senior living operator that was not performing as expected
- Adding to stocks that were hit unjustifiably hard by the Evergrande crisis and initiated a position in a pan-Asia logistics company that is more heavily discounted than warranted relative to other logistics company peers
- Reviewing more companies that will benefit from the re-opening trade like retail and hotels. The single-family housing rental business has now become a global phenomenon and we are reviewing opportunities in the segment
- Reduced positions in Japan after a strong run and the disappointing election result that occurred at the end of the quarter
- Office markets are beginning to firm globally and adding to positions selectively here

- Given the potential for rising rates, we are focusing on companies with strong balance sheets and low cost of capital relative to peers

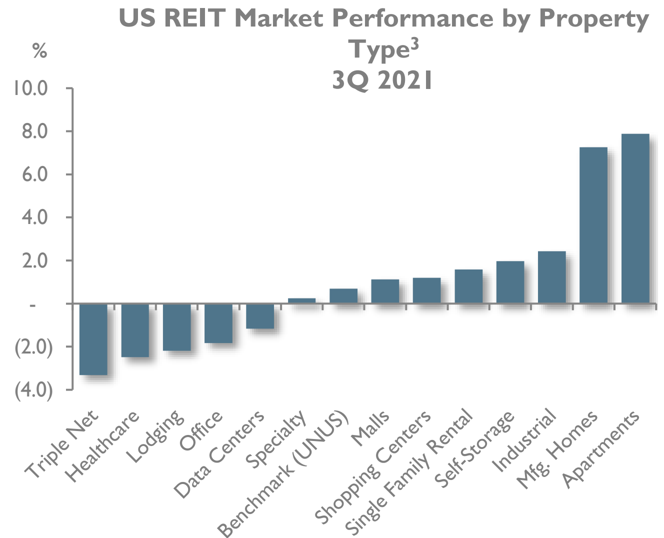
Q3 Local Market Highlights

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.



Source: Bloomberg.

US



Source: Bloomberg.

US REITs took advantage of highly favorable market conditions, raising a record amount of capital this year ($108 billion through September) as investors continue to favor the sector, although the US REIT market exhibits a high degree of dispersion - as the following chart shows. The property types that benefited most from the WFH trend, data centers and tower companies, have languished while the "re-opening trade" beneficiaries, notably malls, have lost some steam after a strong second quarter. The rental housing sector continues to outperform despite the fact that the group (manufactured housing, apartments, single family rental) are trading well-above pre-pandemic valuation levels. Self-storage remains an investor favorite as noted earlier, and in the US, the self-storage REITs are estimated to be trading 40% higher than pre-pandemic pricing (GS 09/07). With rents for this property growing at an 8-10% rate p.a. and supply trending down due to higher construction and land costs, there is ample reason to expect this trend to continue.

The office sector continues to lag as the RTO trend that we expected to occur after the summer holidays has been delayed and this is reflected in it lackluster performance relative to the other property types. In the major office markets like NY and SF, it does appear that "shadow space" (sublease space that is either officially or unofficially on the market) is either being retracted by the existing tenants or taken up by new tenants. C&W estimates that current sublease space is roughly 5.5% of the overall market in Manhattan (22.4 million sf) and 9.1% of the San Francisco market. We expect that Manhattan's office market will benefit from the RTO approach taken by the financial services industry while the tech-heavy SF market may continue to suffer from a preference among tech workers to stay home. The C&W data also shows that the shift out of the urban centers into suburban markets may not be as prevalent as expected, as the majority of sublet space is in the suburban markets and not the major cities (57% v. 43%). Tracking sublease space is important as the rent for such space tends to be heavily discounted (20%) with more flexible terms and competes directly with building owners, resulting in overall market rent declines until the situation stabilizes.

EU

France. After instituting a national "Health Pass" permitting access to restaurants, stores and other venues, rent collections are starting to improve markedly for retailers although the sector remains under pressure. Landlords accept shorter term leases and offer incentives that ultimately reduce returns but help to retain tenants, but at least the landlords can benefit from inflation adjustments that are automatic and running at a higher rate than CPI. The latest news from the office brokers is that office leasing and enquiries have accelerated over the past several weeks and are expected to continue.

Germany. Residential market issues continue to plague the companies as governments seek to rein in rental increases but the lack of supply and strong demand will militate against a major impact on future rents. While it is politically popular to try to cap or reduce rents, the government needs private owners/developers to continue to supply the market with residences. The recent elections in Germany may have also weighed on the market in anticipation of the left wing party gaining more power, but this did not happen, further reducing the potential for rental rate rollbacks. Rising property values and rents seem inevitable and we are optimistic about the future share price trends for the residential companies, especially after the pullback in September.

UK. The best indicator of office activity and the ultimate revival of London's business district is the "Pret" index developed by the coffee shop, Pret a Manger, which reported its sales are now at 82% of the pre-pandemic levels. Google mobility data shows office physical occupancy at a less than stellar 51% but rising steadily now that all restrictions on activities and mobility have been lifted. Real estate companies are reporting rent collections are back to normal for office and recovering for retail and it appears that the return to urban life is in process. The end of the "furlough scheme" (9/30) is expected to result in an increase in employment, although there is some debate as to how quickly this will occur.

Investor appetite for UK commercial real estate remains strong as investors from Europe and Asia - notably Korea, HK, Singapore, and Australia, as well as the Canadian government funds are actively pursuing investments, supporting higher valuations than is reflected in public company share prices.

ASIA

Australia. While most of the traditional property types were deeply affected by the pandemic, there is now an abundance of foreign and domestic capital flowing to the commercial real estate market. Sydney began a hard lockdown (essentially home confinement) in June and the impact was immediate and damaging to retailers. Rent collection fell to 65% by the end of the quarter whereas it had been up to 82% prior to the hard lockdown - based on a report by Re-Leased that covered over 21,000 properties and 45,000 leases. The State (NSW) has mandated that the vaccination level must reach 90% (now 70%) before stores and restaurants can be fully open – the national hurdle is 80% for full opening which is another example of the variability of regulation. While this is a high bar to hit, it is decidedly better than the government's aim for "Zero" cases. The Australian government has also been supporting the economy with its "Covid Disaster Payment" program which pays workers from A$ 450-750/week depending on their job situation. This has resulted in a massive build up of funds for future shopping as is clearly reflected in the recent deposit data.

Japan. While the chart above suggests the property market is not keeping pace with the broader market, the major developers had a strong performe all year (up 25-30%) as RTO has been fully "enforced" and shoppers have returned to stores. As noted earlier, the pause may be due to some concerns about future supply, but also can be attributed to disappointment with the recent change in leadership where the more dynamic candidate lost to the "old guard".

Singapore. After enduring a period of excess office supply, the market has tightened and despite lockdowns and restrictions on office occupancy (50% max), this is one of the few markets in the world experiencing rising rents. Office demand from the Tech and Fintech sectors as well as private wealth management firms from China and other markets have moved to the city, that is known for its high level of security and quality of healthcare. The city is well-endowed with high quality buildings most favored by tenants as they plan for a post-Covid world.

Over 80% of the population is fully vaccinated but there was a surge in new cases at the end of the quarter that resulted in more restrictions – although the actual numbers are very low compared to global standards both in an absolute sense and relative to the overall population. This should be short-lived and the government has announced a reduction in travel restrictions that will take effect later in the month – a major positive development for this tourist and export-oriented island nation.

JLP Global Investment Team, September 2021.

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[2]**Property Sector includes**: United States TR Index (RMS G), 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), 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).

[3]**Property Type includes:** Triple Net Index (FNFRETR), Healthcare Index (FNHEATR), Lodging Index (FNLODTR), Office Index (FNOFFTR), Data Centers Index (FNDCTR), Specialty Index (FNSPTR), FTSE EPRA/NAREIT United States Index (RUUS), Malls Index (FNMALTR), Shopping Centers Index (FNSHOTR), Single Family Rental Index (FNFHTR), Self-Storage Index (FNSELTR), Industrial Index (FNINDTR), Mfg. Homes Index (FNMANTR) and Apartments Index (FNAPTTR). JLP defines all companies listed above in the relevant sector based on NAREIT's categorization of companies in the sector.