jlp asset management

Market Commentary

March 14, 2022

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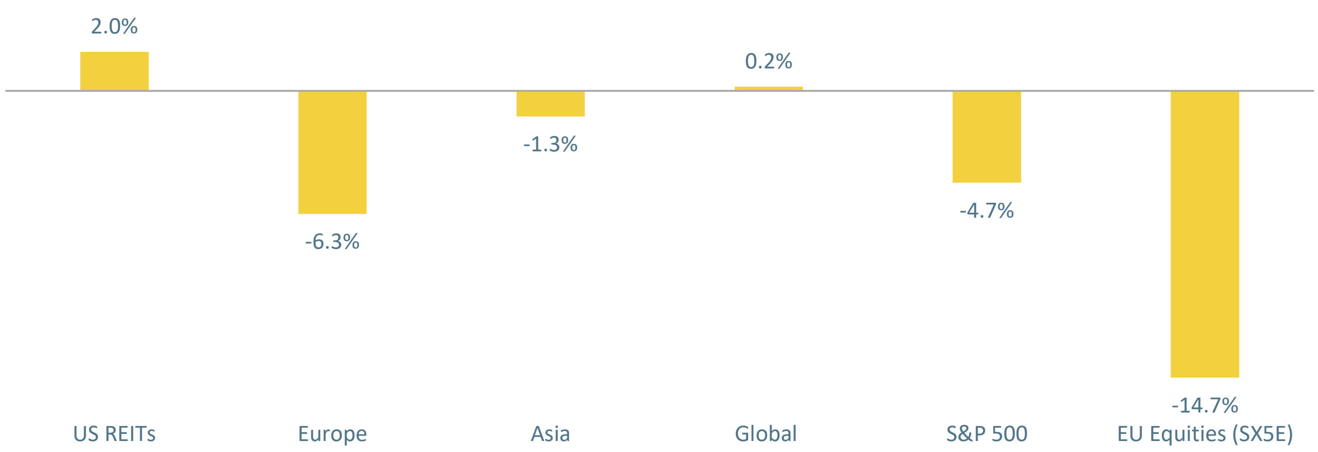
MAR 2022

HIGHLIGHTS AND CURRENT EVENTS AFFECTING REITS

Just as the world was emerging from the effects of Covid and economic growth indicators were accelerating, the Russians invaded Ukraine and added another risk to investors that is equally challenging to assess. Prior to the invasion, the consensus seemed to be that this would not escalate as it has, and also raises the threat of a nuclear catastrophe either through a Russian army mismanagement of the recently captured power plants, or through the use of nuclear weapons – or both. As the tragedy in the Ukraine continues to unfold, the impact on commodity prices that are directly related to the conflict – oil, palladium and wheat – has also raised the specter soaring inflation. This has the Central Bankers on edge as they seek to manage through an environment of rising prices and a potential economic slowdown that could result in stagflation. Further adding to the turmoil are the sanctions imposed on Russia that could result in unintended consequences in the financial markets.

While we are not going to speculate about political developments or potential outcomes, we can report on the current state of the various real estate markets and the latest transaction data, both public and private. Not surprisingly to us, the short-term impact on the public real estate equities has been negative, although generally less than the broader markets, as shown on the following chart. Private equity/institutional investment in property has not abated, nor have we experienced a decline in rental rates or demand for housing in several markets.

Total Returns: Major Public Market Property and Equity Indices
February 15-March 10



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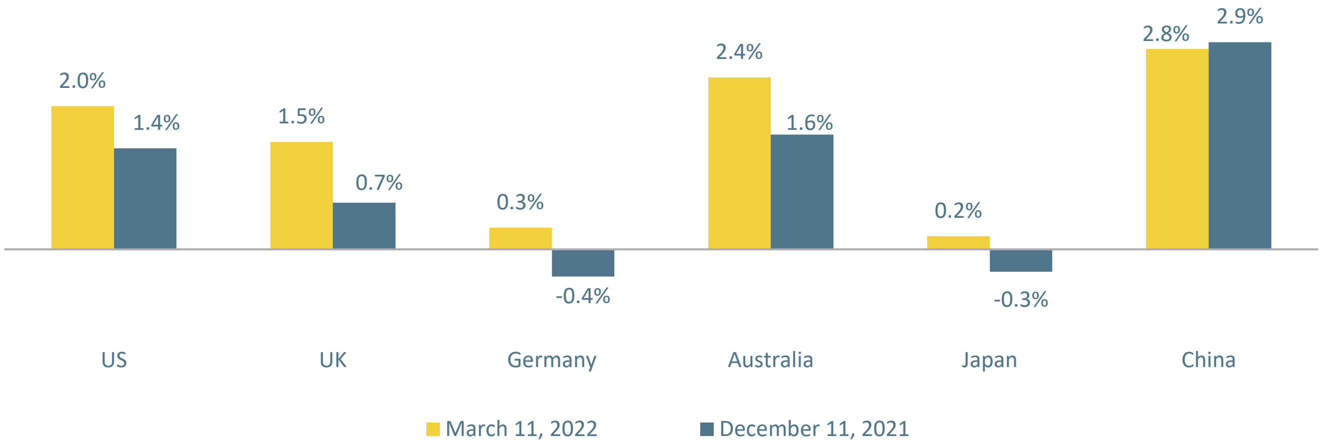
Despite the prospects for rising interest rates which at the long-end have risen considerably over the past 90 days, as is illustrated in the following chart, we are finding that demand for residential property worldwide has been robust. We believe the public real estate companies should not be affected by increases in interest rates as many have taken advantage of availability of low cost financing that was available last year and locked in not only low interest rates but also extended debt maturities. Not that they are bullet proof, but should there be a tightening of lending conditions – which is currently not the case – we believe the companies are well-prepared.

10-Year Bond Yields for Major Global Markets:
Change Over the Past 90 Days



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With Russians losing their property rights, others are trying to pick up bargains, particularly in London. The city, often referred to as "Londongrad" given its large and hugely wealthy Russian population, is attracting a global crowd of scavengers from Asia in particular. Apparently, "bargain" is a relative term given the recent Singapore family's acquisition of the nearly US$1 billion building in central London known locally as the "Scalpel" due to its unique shape. The yield is estimated to be 4%, according to Singapore's Straits Times, at or above replacement cost – not much of a bargain for most investors.

As property share prices in many markets are well-below the underlying values of their portfolios, some of the companies are taking advantage of strong institutional demand by selling partial interests in their portfolios or lower quality assets. British Land announced the sale of a 50% interest in one of the company's largest development projects, Canada Water, to Australia's largest pension fund for nearly GBP 300 million. This provides the company with several major benefits – it validates a much higher valuation for the project than the public market, reduces development risk, and allows the company to move ahead faster with the development plan.

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We are seeing that rising land prices, commodity prices and a shortage of labor continue to impede the ability of companies to increase supply, and with many markets undersupplied in most property types, rental rate increases have been exceeding expectations. New York apartment rents are up 28% y/y (median), the highest level since the broker (Douglas Elliman) started tracking this data ten years ago. Given the surge in demand, can a return to work be on the near-term horizon?

China is currently facing a number of issues that are self-inflicted and therefore could be remedied by stimulative measures that are under way. Recent news about their support of Russia, slowing economic growth due, in part, to their Zero Covid stance, as well as the government's attacks on their own tech companies (down by nearly $2 trillion, or 50% from the peak) have not been helpful. However, the leadership has been clear about its efforts to improve the economic environment and one recent sign of a change in direction with respect to Covid was the government's recent approval of an anti-viral pill, Paxlovid from Pfizer. This would seem to be a sign that they are heading toward an endemic approach rather than zero Covid. Another positive note for this economy was reported by the WSJ (March 4) that household savings rose by $855 billion in January and loans "declined by 50%" – the consumer is ready to spend but needs a catalyst.

Apartment rents in the US are soaring – major apartment REIT Camden had originally capped rental increases at 15-20% in response to concerns about landlords gouging tenants due to an ongoing shortage of supply, the strength of demand is so high that the company felt compelled to raise the cap to 25%. One large US REIT put two of its properties on the market and received 150 inquiries from qualified bidders and dozens of offers. The company reported that cap rates for high quality properties are now in the 2.5% range which suggests that the buyers are expecting even higher rental growth rates in the future.

The retail sector, particularly in the US, has been especially hard hit by ecommerce and a dearth of property investors, notably Blackstone whose COO, John Gray, has been vocal about avoiding the sector. That sentiment appears to be changing given the recent transaction data, as shopping centers are (finally) attracting buyers – and the deals are huge and at higher prices than expected. According to Citi, even Blackstone is now back in the game, acquiring a $500 million portfolio of shopping centers and entering into a JV with one of the largest retail REITs, Kimco. Blackstone is buying out Kimco's 50% partner so that each - Kimco and Blackstone - will own 50%. Kimco's CEO estimates that Blackstone has been building up a portfolio of as much as $8 billion of open air retail centers – we suspect largely grocery-anchored.

While the leasing and purchase activity in London and certain Asian cities has been strong for office, the US gateway city office markets are still in the midst of transitioning from the WFH to RTW mode with rental concessions higher than normal and tenants having the leverage. The most significant development in the office sector is the increased potential for obsolescence as tenants avoid older buildings with lower quality ventilation systems and column spacing that limits the potential for open space. ESG/Covid have combined to present a double threat to the long-term viability of lesser quality buildings. Although some buildings may be converted to residential use, we would expect that for most older buildings, even if an upgrade is possible, it may prove to be prohibitively expensive.

As the war in the Ukraine continues, it remains difficult to forecast the near to long-term impact on global markets, but we can at least ascertain that the property sector is healthy in terms of supply/demand and poised for a rebound as markets stabilize and lockdowns end.

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