asset management

Global Property Market Review & Outlook

4Q 2021

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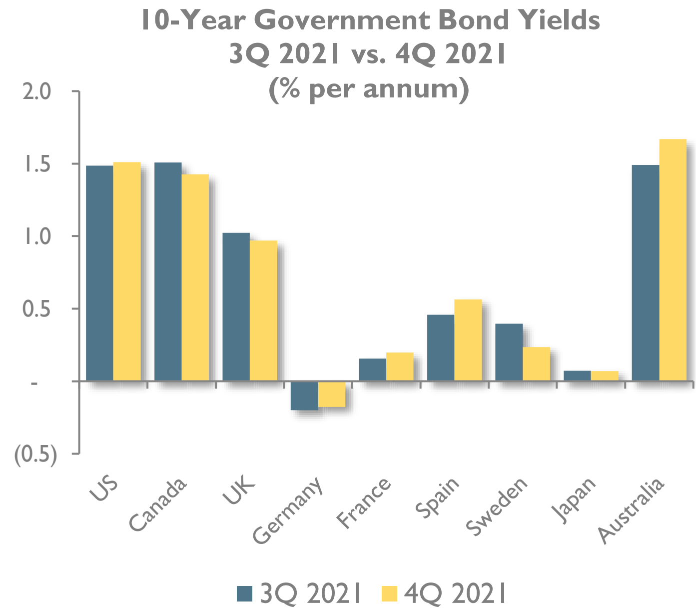
Enduring Another Virus Variant, Inflation Fears and Lockdowns

Market Overview

Just when it looked like it would be safe to venture out again, the Omicron variant appeared, further delaying plans for return to work in the US and lockdowns in many other markets/countries. Adding to the mix, concerns about rising inflation that may in part be due to supply chain bottlenecks and the resulting product shortages combined with strong demand dominated the news and initially was reflected in interest rates. However, as the chart shows, the anticipated up-shift in interest rates had not occurred by the end of the quarter, raising the question as to the durability of recent strong inflation numbers in many markets. Except for Australia, this has not been the case for the major Asian countries where inflation and interest rates remain low. China recorded a CPI increase of only 1.5% in December (YOY) and has been on a downtrend since October 2020 when it peaked at 5.4% (Government data).

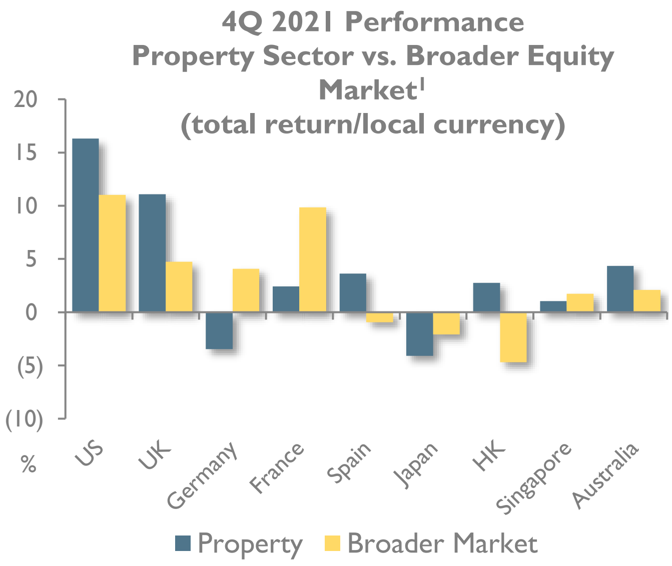
Immediately after the close of the quarter, we must note that the US Fed's review of its plan to reduce stimulus and raise rates sooner than expected caused global interest rates to rise in unison – except for China. 10-year government bond yields rose substantially from early December through January 7 in the US, UK, EU and Australia from 20-40bps, a significant swing in percentage terms with Germany finally approaching zero (!). In absolute terms, the long bond rates remain in accommodative territory and the latest economic data (PMI and GDP growth data) suggest that the impact of Omicron on the pace of economic growth could slow the pace of interest rate increases going forward.

We are not going to get into the debate about inflation but, based on our experience, real estate investment tends to perform well during periods of inflation unless there is an oversupply of property relative to demand – which is not the case in virtually all of the global markets and most property types. It is also worth noting that inflation usually results in rising construction and financing costs which tend to further reduce the potential for new supply as development returns fall to levels that are not sufficient to offset the risks.



Data from Bloomberg as of 12/31/2021. Bonds analyzed: US (USGG10YR Index), Canada (GCAN10Y Index), UK (GUKG10 Index), Germany (GDBR10 Index), France (GFRN10 Index), Spain (GSPG10YR Index), Sweden (GSGB10YR Index), Japan (GJGB10 Index) and Australia (GACGB10 Index).

Last quarter was dominated by the news of the Chinese real estate conglomerate, Evergrande, heading toward restructuring if not a total collapse, which continued throughout the quarter, weighing on the Hong Kong and Chinese property sector. However, it also became more apparent that the Chinese economy was weakening most probably due to the lockdowns, and the government has become more concerned about stimulating growth and easing financial conditions. Conversely, the US, UK and other economies that have been less restrictive on mobility are experiencing rising inflation which is raising the notion of measures to slow demand – and not just raising interest rates. Singapore raised its home buyer stamp duty by 5-15 percentage points of the purchase price at the end of the quarter, from 20% to 30% for foreign buyers (Straits Times), and the Bank of England is considering various measures to slow the pace of credit growth and overall consumption, according to local press reports. As a result, we now have even greater dispersion in growth rates and property sector valuations than we noted last quarter – an ideal opportunity for active managers.



Data from Bloomberg as of 12/31/21.

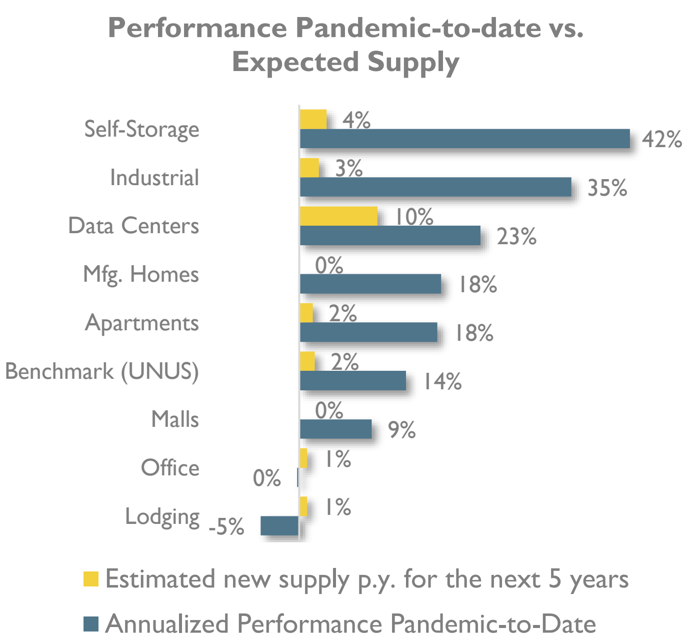
China

At the end of the quarter, China implemented a number of easing measures to mitigate the damage caused by earlier tightening and lockdowns. Banks were encouraged in late December to lend more to the property developers, a fact which only became known to the market at the end of the first week of January, resulting in a sharp increase in share prices. The latest developer data shows that of the 31 largest publicly listed developers, residential sales achieved 92% of their initial target for 2021 except for Evergrande which was under pressure throughout the second half of the year (JPM 1/3/2022). Based on our estimates, with discounts to NAV exceeding 60%, the valuations are appealing provided that the company's liquidity and access to capital remain solid. Based on numerous discussions with the management teams, we are confident that demand for housing will support the better-quality companies and the valuations are very attractive in that context.

We remain concerned about the country's "zero Covid" approach and expect that the highly contagious Omicron variant will thwart their efforts at staying at zero. Shutting down entire cities with populations of over 10 million for any length of time will undoubtedly affect the nascent overall economic recovery. Given the latest unrest in Xi'an (population 13 million, 1% of GDP) after a recent lockdown and the "virus fatigue" that seems to be developing, we expect that this "zero Covid" approach will be softened over the coming months. In fact, this may already be occurring with the recent implementation of **"dynamic clearing"** which essentially allows for local determination as to steps to be taken in the event of an outbreak and seek to minimize damage to the local economy. This is our base case for the region, but we will be monitoring the situation closely. With the Chinese New Year starting the first week of February (and the Olympics in Beijing), we may get an early indication as to the next steps as this holiday normally entails a massive movement of people on all modes of transport throughout the country.

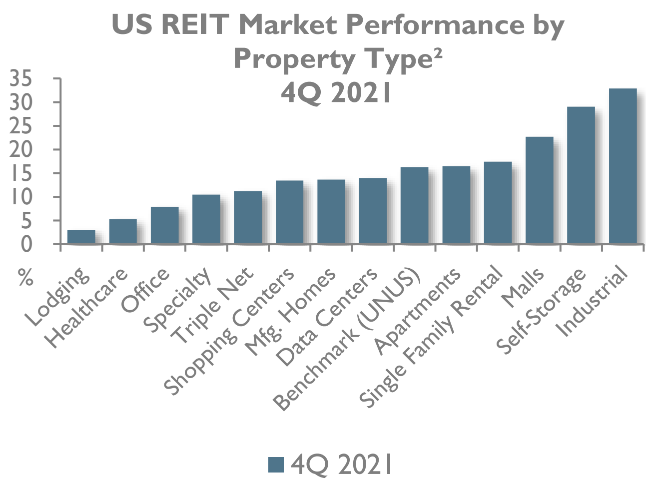
Dispersion Abounds – The US and Europe

US. While we cannot predict the turning point in the spread of Omicron, we can infer from the latest lockdown activity that there is "virus fatigue" and unless the virus proves to be more dangerous than it currently appears, we would expect this to augur well for those property types and markets that will benefit most from a trend toward pre-Covid "normalcy". The following chart based on the US real estate market clearly demonstrates the winners since the virus began to impact the markets through early December 2021 – and these trends are similar in many other markets – and also demonstrate the homogeneity in demand by private equity and institutional investors for Covid-favorable property types. The chart also illustrates the general lack of a supply response to the sharp increase in demand except for data centers which suggests continued upside.



Data from Bloomberg as of 12/31/2021 and JLP estimates.

The US public market performed well all year and the fourth quarter was no exception, dominated as expected by the more popular property types noted above as well as the Mall sector which rebounded strongly off a very low base. While shoppers are returning to the malls in the US, valuations remain challenging given the lack of transaction data and widely varying quality/performance.

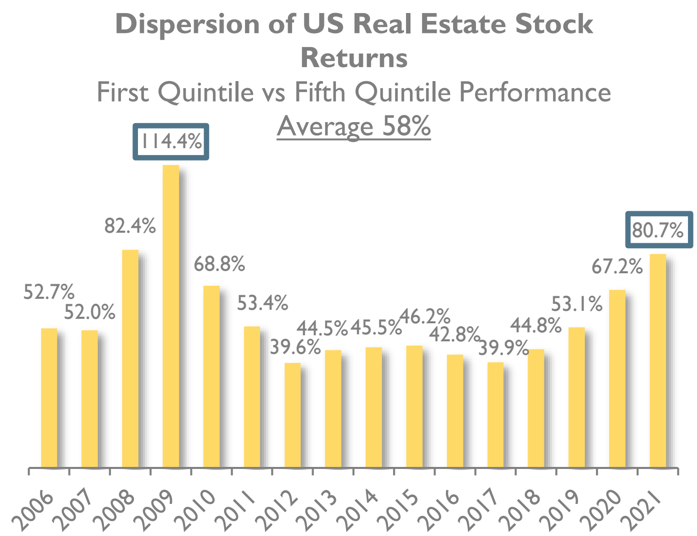


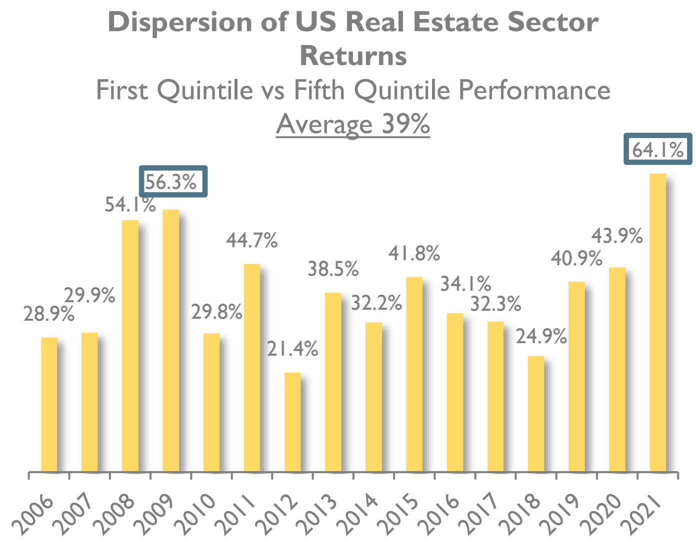
Data from Bloomberg as of 12/31/2021.

It is important to note that although the return for the "average" REIT was exceptional (up 43% for the year), the dispersion in return expectations for the companies was also substantial, ranging from negative 14% to a positive 27% according to the REIT analyst team at Jefferies. The dispersion occurs not only between property types, which is not so surprising, but also within each property category as shown below:

- Healthcare: -3 to +27%
- Apartments: -14.1 to +8.6%
- Office: -4.2 to +25.3%
- Industrial: -9.1 to +18.2%
- Retail (malls, strips, NNN): -7.4 to +25%

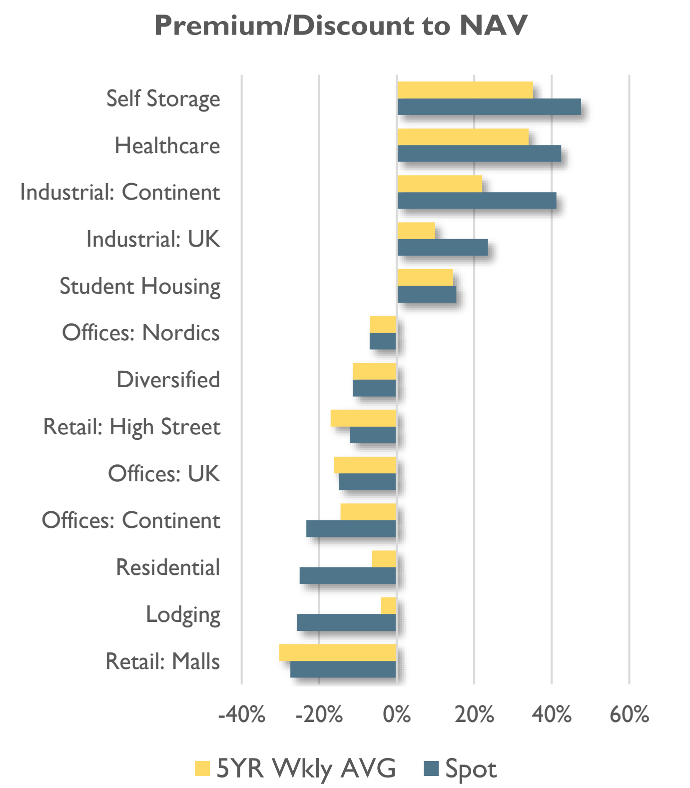
The following chart also shows the extreme the current level of dispersion relative to prior periods and the trend to a more normalized level that occurred after the previous peak. The variance in valuations/upside price targets really presents a great opportunity for active managers.



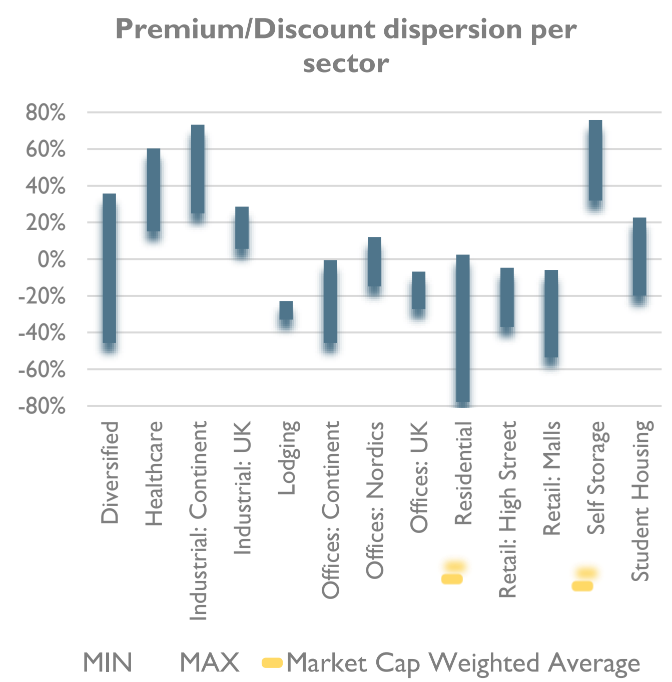


Data from Bloomberg as of 12/31/2021. Analysis made by JLP Team considering FTSE EPRA/NAREIT United States Index (UNUS Index).

Europe. According to Bloomberg data and our research, the European property markets also reflect some of these same property trends as in the US generally, but there are some notable exceptions reminding investors that real estate is still a "local business". Demand for self-storage in Europe mirrors that of the US as shown in the following chart, where the sector is trading at a premium to NAV of nearly 50%, well above its long-term average and far exceeding other property types. Unlike the US, the residential rental market is substantially undervalued by public market investors relative to actual transaction data. Public market investors appear to be pricing in more rent control risk than their private market peers, especially in Germany.



Data from Bloomberg as of 1/31/2022 and JLP estimates.



Data from Bloomberg as of 1/31/2022.

Note that the "averages" shown above illustrate the level of divergence in valuation in the various companies versus the average.

Review of Global Trends in Key Property Types

Self-Storage

The massive surge in self-storage valuations, public and private, since the onset of the virus even more surprising considering the sharp sell-off experienced by this sector at the outset of virus in early 2020. The value decline was expected given the normal trend for the storage sector to perform well during periods of increasing mobility (home sales/relocations) and economic growth. However, as the virus drove more people indoors and working from home, there was a sudden need for more storage space as bedrooms and basements were converted to home office space and fitness areas. In addition, a relatively new source of demand developed where self-storage facilities are also becoming a "last mile" distribution option as ecommerce expands and encounters limited availability of warehouse distribution space – and rapidly rising rents. New supply may ultimately slow the pace of rental growth and occupancy in markets where new development is most feasible – mainly the US – but the near-term trends remain favorable. Investors particularly like the low cap ex requirements for this property type as opposed to most others and the shorter-term leases allow for a faster adjustment to market rates – especially beneficial in an up-trending market.

Office

The global office market recovery will be highly variable due to the different approaches tenants take to managing through the next virus wave, but London may offer some insight into the future of gateway city office markets. The government has decided to treat Covid as endemic and remains open, although companies are reticent to require workers to head back to the office. However, international investor interest in UK office buildings has been particularly strong for its high-quality office buildings that afford greater space and ventilation to accommodate the changes wrought by the virus – more open space and better air quality. For the buyers, the other key benefit is that the rise in construction costs and concerns about future demand have reduced the amount of new supply to be developed in the future. London Grade A office vacancy is 3.5% currently (according to British Land data) and demand is expected to be stable at 4.5millon sf/year through 2025, for a total demand of 18 million sf, while only 8 million sf will be delivered during that period. This suggests that rental growth for the higher quality buildings is on a firm uptrend and makes the low cap rates at which the buildings trade (3-4%) seem reasonable (WSJ 1/7/2022).

Retail

As is evident from the US data above, the retail sector is on the mend but there have been plenty of casualties and more to come. The latest estimate in this market for 2021 regarding store closures nationwide is for the year to end with 3500 closures, 25% of the 2020 total (Bloomberg 12/2021). With investors concerned about the future of retail globally, valuations are challenging given the paucity of transactions and the wide range of pricing depending on the quality/location of the center.

Until the lockdowns intensified in Asia, mall traffic was reasonably normal and mall owners were not as deeply affected as in the US. In Europe, the Nordic region essentially stayed open while the rest of the Continent and the UK endured capricious lockdown conditions. As a result, performance of the EU and UK properties, rents and valuations vary between and within countries. The most recent global trends in retail include the following:

• Increased foot traffic, according to Bloomberg, nearly back to pre-Covid levels – on average – which also masks the failure of many retailers/restaurants during 2021, like Pier 1 in the US, and Arcadia Group in the UK (Topshop). The relatively healthy foot traffic data is helped by retailers' use of the BOPIS concept (buy-online-pickup-in-store), according to the data collection service Placer.ai.

• Covid combined with ecommerce forced all retailers to up their game and increase the volume for order online, pick-up in store and this trend should continue.

• Brick and mortar presence is important for "digitally native brands" as any reduction in the return rate will help with profitability – currently a big problem for ecommerce. Also, the physical store owner/operators like the department stores have ample back of the store space that they can use instead of expensive warehouse space. Essentially, these stores can become their own "last mile" distributors (WSJ 12/15/2021).

• Return rate for ecommerce is roughly 3 times the in-store rate and now that FedEx and UPS have raised rates 6% already in 2022 on average, the effective cost for e-tailers is rising. Their response has been to offer "returnless refunds", but this is also a costly option. The fashion industry is most affected by shelf-life issues as the longer the return takes, the greater the decline in value for the retailer. The optimal solution for them is to have the customer return the item in store. In the meantime, the rising return volume has resulted in increased business for resellers like Shopify and Poshmark (WSJ 1/5/2022).

• Strong demand for luxury goods may continue as those most affected by lockdowns are increasing their purchases which are now more affordable due to build-up in savings from a lack of travel/vacations. This is especially the case in HK and much of Asia where the affluent can no longer travel to Paris to splurge. In these markets, ecommerce penetration is low (8% for HK) due to the proximity of stores and the need to get out of the apartments (Savills 1/2022).

Industrial/Logistics

As is obvious from the previous comments/charts, the industrial/logistics sector is booming with rising rents and values that in some markets are higher per square foot than office space. The landlord is clearly in control as tenants now seek to renew far in advance of the lease termination to secure space – and thank the landlord for allowing them to remain after enduring a sizable rent increase! Despite this seemingly inelastic demand for space, the public companies have been resisting the temptation to maximize rents in exchange for maintaining a steady progression of increases – and retaining the tenant.

Demand for logistics portfolios from PE firms and institutional investors continues to drive up values, and the appetite for this property type seems to be unlimited. However, some recent developments could impact the future of rental growth. As noted above, department stores and retailers with sufficient storage areas are increasingly using this space as "last mile" in the absence of alternatives. While we don't view this as a near-term threat, it could result in a slower rate of growth in rents for the "last mile" logistics-focused companies.

Housing

While it is always problematic to generalize about global trends, particularly for a sector as idiosyncratic as housing, there are several recent trends that are becoming a more global than local market specific phenomena. As noted in a recent article in The Economist (1/8/2022), there are several elements of the global housing industry that are commonly found in most markets and suggest that house prices may remain elevated, contrary to the typical boom/bust cycle to which we have grown accustomed. They note that even a sleepy community like Halifax, Nova Scotia (Canada, population of 450,000) has experienced a 50% increase in house prices since 2019 and the locals are mystified by this surge for an area with limited (if any) traditional demand drivers. There are numerous other examples worldwide of these smaller cities experiencing substantial increases in rents and home prices of over 30% in 2021.

The Economist identified three "fundamental forces" that appear to be manifest throughout the developed world that may be more than ephemeral which could keep house prices elevated for some time to come:

- Financial health of consumers. In the US, the average credit scores are far higher than at the time of the 2008 financial crisis and mortgage debt service payments at 3.7% of disposable income is the "lowest on record". In addition, the US concept of a long-term fixed rate mortgage has expanded to many other countries, reducing the borrower's exposure to short-term rate swings. Further enhancing financial health, many markets exhibit unusually high savings rates that can be attributed to both government subsidies and Covid – saving on commuting, travel, and other forms of recreation that have been curtailed. This is one trend that could be short-lived.

- Shifting home size/location preferences. Demand has increased for more spacious houses that allow for home office/fitness areas as well as outdoor space. While this may be partly due to the spread of Covid, it may become a more enduring trend.

- Supply of housing may continue to lag demand. Shortages of building materials – which may not be a longer-term trend – and labor, as well as rising land prices are impeding new development. In the aftermath of the GFC, many skilled construction workers left the sector and for those markets with tough immigration laws, this could take much longer to correct. The data for the UK and US suggest that the pace of new construction is far below the rate of increase in demand and this gap will take some time to fill – unless there is a major recession in the offing.

In our view, this global housing supply/demand imbalance will be met by rental property of all types - multifamily apartments, single family rentals (SFR), office conversions to rentals, and manufactured housing. Consequently, as we noted in our last Outlook, this sector which performed so well in 2021 is likely to continue to do well over the coming year.

The Singapore market is representative of the global phenomenon that suggests that rising house prices can continue despite the government's best efforts to cool the market with a massive increase in the buyer's stamp duty. The government raised this tax on home purchases with a special focus on foreign buyers who now must pay a tax of 30% of the purchase price, up from 20% (Mingtiandi 12/24/2021). Demand will likely continue despite the cooling measures due to relatively low housing supply and the fact that income growth has outpaced housing cost increases since 2011. In addition, household balance sheets are in great shape. Average liabilities to financial assets are at the lowest level since 1995 at only 22% (Greed & Fear 1/6/2022) and cash and deposits are at $550 billion ($122,000 per person).

Outlook/Portfolio Positioning – Our Base Case

As we start the New Year, we expect more countries to move in the direction of Singapore and treat Covid as endemic, reducing the potential for lockdowns. After the close of the quarter, Thailand announced it would follow this policy and the EU and Norway are now considering it. Barring another more viral variant, this could lead to a rapid rate of expansion for those markets that adopt this position, in which case, economic growth could accelerate at a faster pace than expected by most economists. This may explain the strong interest in gateway city office acquisitions by the larger PE firms and sovereign wealth funds that emerged at the end of the quarter. Based on articles from WSJ, New York Times and Straits Times (01/2022), other major trends that we expect in 2022 include:

- Tourist-oriented markets and property types. One of the hardest hit sectors over the past two years has been lodging and hospitality landlords more reliant on international travel and a resumption of travel, both business and leisure, has not been priced into the markets.

- Capital, both debt and equity, remain freely available and the current conditions look to continue. Blackstone's private REIT (BREIT) is raising $3 billion per month, giving it $8-9 billion of firepower with leverage, very supportive for future commercial real estate values.

- China recovers and ensures that the stronger, better-quality developers can continue to thrive while allowing the weaker ones to disappear – this process appears to be well underway as of the early part of 2022.

- M&A activity will continue due to the surfeit of capital and shortage of opportunities globally. This should continue to support higher valuations for public companies as the gap between NAV and private market pricing narrows.

- Retailers continue to improve their ability to compete with ecommerce, enhancing property values – which will also be supported by ecommerce companies as they look to shrink return costs and delivery times.

- Strong household balance sheets and improving labor market conditions should continue to support the economic recovery from the depths of the Covid crisis.

- The best performers last year which benefited most from lockdowns/restricted movement may come under pressure due in part to re-opening but also to increased supply, particularly self-storage. As noted previously, the logistics sector still has room to run, but bulk warehouses far from city centers may struggle as supply chains gravitate to "last mile" solutions.

Risks

- Labor availability may continue to be challenging until the response to a positive virus test changes from isolation to return to work upon recovery, as in the case of a normal flu.

- Ukraine/Russia turmoil develops into a major East European fiasco affecting the region.

- Central banks shift from their current "docile" approach to a more aggressive effort to stifle inflation and "kill the patient".

- Inflation could stifle future consumption, but this is more of a US issue as countries in Asia have used less stimulus and, in the case of China, were already slowing due to local financial policies.

We have been gradually shifting our portfolios in the direction of a return to a "new" normal but maintaining positions in those sectors and markets with solid upside regardless of the pace of re-opening. The rental housing sector as noted previously should continue to benefit from the longer-term trends of rising demand and inadequate supply of housing in general. As we expect the markets in Asia, especially China and Hong Kong, to recover from lockdowns, we remain positioned in the better-quality companies with ample access to capital.

JLP Global Investment Team, December 2021.

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[1]**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 TR

Index (DAX), France CAC 40 TR Index (CACR), Spain IBEX Price Index (IBEX), Japan Nikkei TR Index (NKYTR), Hong Kong HSI TR Index (HSI 1), Singapore STI TR (FSSTITR) and Australia ASX 200 TR Index (AS51T).

[2]**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 (UNUS), 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.