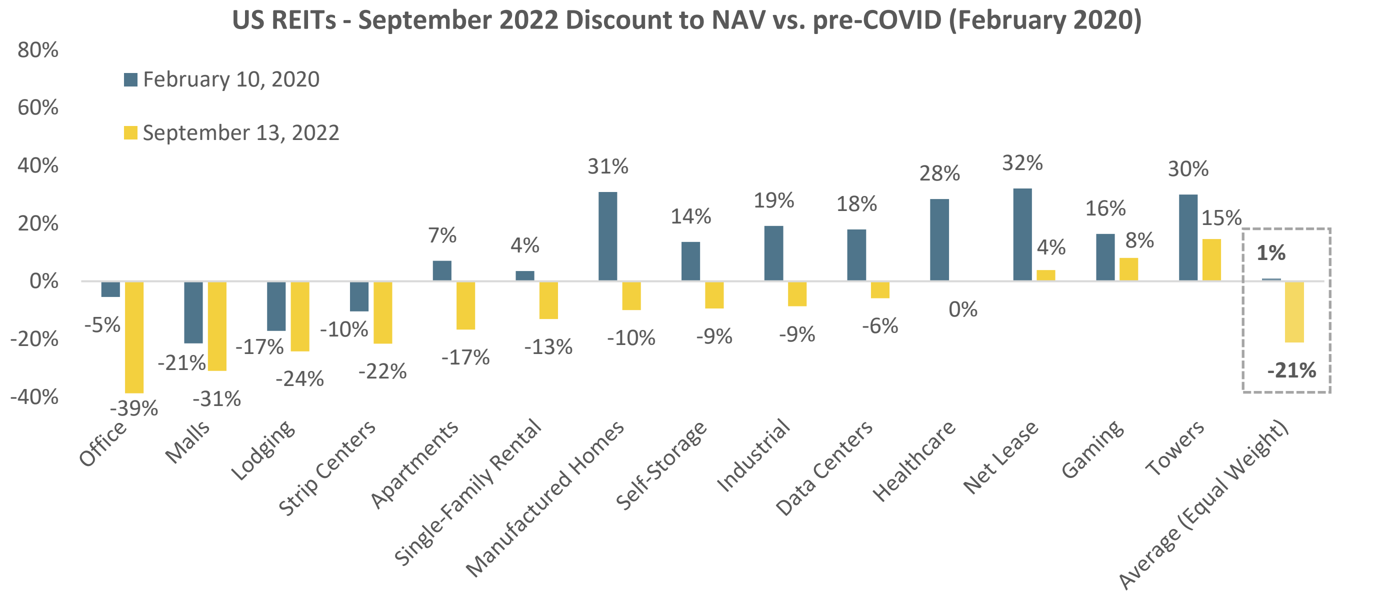
JLP ASSET - QUICK TAKE

SEP 2022

QUICK TAKE: THE PUBLIC REAL ESTATE MARKETS ARE PRICED FOR ANOTHER GREAT FINANCIAL CRISIS

The global markets have struggled to gain much traction in August and early September as the latest economic data in most countries are signaling an economic slowdown, particularly in those markets that are experiencing unusually high levels of inflation and rising interest rates.

The challenge for investors in most markets is determining valuations as sellers are holding out for "last year's" prices while buyers are holding off on bids or reducing bid prices and re-trading at closing. In the absence of certainty, the publicly listed real estate sector has effectively slashed property prices and development values while we are hearing that the private equity funds are suggesting to their clients that the adjustments to value will be much more modest – if at all. As the following chart of US property companies shows, the public markets have fallen sharply relative to fundamental values where there remains strong demand for real estate and recent transaction pricing that suggests the discounts are excessive.



Source: JLP and SNL Consensus. Data from February 10, 2020 and September 13, 2022.

The US presents a variety of challenges as we try to forecast future economic developments. House prices in many markets are softening despite the housing shortage as higher mortgage rates and an apparent increasing reluctance by buyers to accept current pricing. This also may reflect home buyers concerns about the economy and the potential for house prices to decline in the future. Apartment rents in the Sun Belt markets that have surged over the past several years appear to be softening and Chandan Economics reports that landlords in these markets are now experiencing rising payment delinquencies. In contrast, the gateway cities from which many of the tenants fled during the peak of Covid's impact are now experiencing rising demand – which also could be attributed to companies stiffening their resolve to get workers back in the office. Mitigating the long-term risk for the apartment/rental housing sector is the increasingly challenging development environment. Not only are the companies facing rising construction costs and interest rates, but many local communities are seeking to cap rental rate growth or fight new construction.

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QUICK TAKE: THE PUBLIC REAL ESTATE MARKETS ARE PRICED FOR ANOTHER GREAT FINANCIAL CRISIS (CONTINUED)

In the UK, the latest version of NIMBY (not in my backyard) is being replaced by BANANA (build absolutely nothing near anything). Resistance to new construction and/or rent caps will clearly dampen supply growth and there is already a housing shortage in most markets around the world. Also, given the rise in mortgage rates, the spread in the US between the median monthly rental rate and mortgage payment is now nearly $600, there is ample room for rental increases. According to the WSJ (09/02/2022), the monthly mortgage rate has risen nearly 60% since Q4 2020 while the median rental payment is up only 10%. Given current market conditions of shortage of housing, difficulty in adding to future supply and relatively attractive public market pricing, we continue to favor rental housing of all types – apartments, single family rental homes and manufactured housing.

Mixed signals are also coming from the office sector as some markets like New York City are experiencing a slow return to the office and yet the city just reported a surge in leasing in July and August with year to date up 71% (YOY). In contrast, real estate brokers Colliers and CBRE note that offsetting this positive trend, sublease availability is up nearly 70% over that same period. Combine this data with the news that tenants are seeking longer lease terms to lock in today's low rates and the picture becomes even cloudier. Our view is that cities like New York will start to experience rising occupancy rates next quarter (now estimated at 35-40%) and this will benefit the office REITs focusing on major urban markets that are now trading at 30-50% below our estimates of value.

Institutional investors and pension funds have been reluctant to invest in this property type given the degree of uncertainty as to future occupancy and rental rates. As one of the largest PE firms specializing in suburban office investment noted that the present environment makes cash flow forecasting very difficult and yet the firm's clients are pushing them to invest. As is the case throughout the industry, there is far more capital than transactions, which further reinforces our view that the public market has mispriced the office REITs in particular. Most recently, one of the world's largest funds, GIC Singapore, announced a major investment in suburban office, buying a large portfolio of properties from a non-traded US REIT for over $1 billion. At the same time, major pension funds like CalSTRS, Texas Teachers and the Canadian fund, Ontario Municipal Retirement System, announced that they would be seeking to reduce exposure to the office market and instead investing in life science buildings, airports and industrial/warehouse space. However, as noted ironically by the Wall Street Journal, these same pension funds are either developing or have acquired office buildings for their own use, suggesting that there is value to having employees return to the office.

The office sector in markets outside the US are highly varied but generally consistent with the trend seen in the US of a preference for higher quality space that allows for a more flexible work environment along with better ventilation systems and common areas. London landlords are now able to scale back rental concessions due to rising demand for space and Singapore is experiencing rising rental rates. Both markets are becoming stretched for supply as projects have been delayed and availability of high quality space is dwindling. Regardless of the high degree of differentiation of these markets from their US peers, the publicly listed property companies are being discounted to an even greater degree than the US REITs with discounts to NAV hovering around 2008 financial crisis levels.

QUICK TAKE: THE PUBLIC REAL ESTATE MARKETS ARE PRICED FOR ANOTHER GREAT FINANCIAL CRISIS (CONTINUED)

Asia, and China in particular, is experiencing much less inflation at an average of 3.3% for the region in Q2 and only 2.2% for China, as compared with over 8% for the US and Europe. However, this is more reflective of a deterioration in economic conditions, although there are some key exceptions. As noted previously, Singapore's office market is robust due to rising demand and the general re-opening of this market. Now that it is open to international travel, Singapore's hotel market is reporting a sharp recovery in room rates that are now the highest in 10 years and occupancy is back to pre-Covid levels.

China remains a major enigma given its capricious approach to eradicating Covid with lockdowns that are affecting its major cities and stifling the economy. While much of the risk appears to be fully discounted in the massive gap between value and share price of over 60%, the sporadic and sudden implementation of various levels of lockdowns makes this market virtually un-investable. We expect that the government will soon implement a massive stimulus program to re-invigorate the economy, but this will be stymied by lockdowns until the government adopts a more realistic approach to the virus and increases the level of vaccination. We continue to follow companies in the region and also note the impact to the overall region and global economy if China's financial condition worsens.

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