SUMMIT

AFIRE SPRING 2022

09

SUMMIT

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ABOUT

Summit Journal is the official publication of AFIRE, the association for international real estate investors focused on commercial property in the United States.

Established in 1988 as an essential forum for real estate investment thought leadership, AFIRE provides a forum for its senior executive, institutional investor, investment manager, and service provider members to help each other become Better Investors, Better Leaders, and Better Global Citizens through conversations, research, and analysis of real estate capital markets, cross-border issues, policy, economics, technology, and management. AFIRE has nearly 200 member organizations from 24 countries representing approximately US$3 trillion in assets under management.

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The new 2022 AFIRE International Investor Survey Report reveals future institutional investment trends as the pandemic further alters preferences for how we live, work, and play.

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NOTE FROM THE EDITOR

SPRING 2022

One of the defining philosophical principles of commercial real estate investment the past few years is the acceptance of uncertainty.

Of course, this principle isn't quite novel. We're in the business of developing ideas and deploying capital based on long-term thinking (and imagination). We know that the future is unknowable.

But the human struggles of the pandemic, rising economic pressures, and intensifying geopolitical tensions have weakened the tried-and-true methods we've come to rely on for real estate prognostication.

This hasn't made such tools irrelevant. Instead, it has underscored the need for continuous improvement in how we do everything from investing and operating to management and corporate citizenship.

And at AFIRE, we believe that continuous improvement starts with honest conversation. This has been the guiding philosophy of Summit Journal the past few years, and it's why, beginning with this issue, we are adding a new dimension to the journal: the voice of our inaugural editorial board (p. 5).

Formed last year, the editorial board for Summit is a collection of experts from across the AFIRE membership and broader real estate investment community, responding to the articles and ideas we publish as they happen. As you read through this issue, you will see specially marked sections with comments from various editorial board members responding to the ideas from our contributors.

Academically, this is a form of "transparent peer review," or the idea that the contributors should be able to hear from their readers, and that readers should be able to interact with authors. But more critically, this nascent practice is central to AFIRE's mission of helping each other become Better Investors, Better Leaders, and Better Global Citizens.

We advance this mission through conversation. Nobody knows what's in the future, and while some insights may see farther into the distance than others, absolute certainty will always remain elusive. As we face unprecedented historical conditions—climate change, threats against globalism, technological innovation—connection and conversation with others (especially those with fresh thinking beyond the so-called tried-and-true) will be increasingly critical to the health and success of our businesses and communities.

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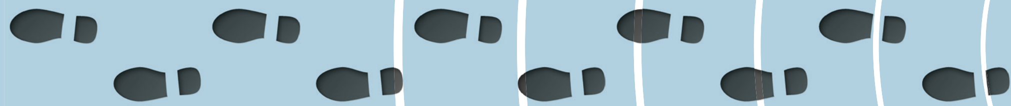
MARCHING BACKWARDS INTO THE FUTURE



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Summit Journal

The new 2022 AFIRE International Investor Survey Report reveals future institutional investment trends as the pandemic further alters preferences for how we live, work, and play.

If only we could live our lives and run our businesses backwards, life would be a lot easier. Instead, we exist in the present, blind to the future but looking for any glimpse or insight about what might be coming next. As long-term investors serious about how current trends shape future moods and events, we are forced to act without certainty.

If we could look back at the future, we would all be geniuses and our investment strategies bullet-proof. But as twentieth-century media theorist Marshall McLuhan once quipped, we march backwards into the future.

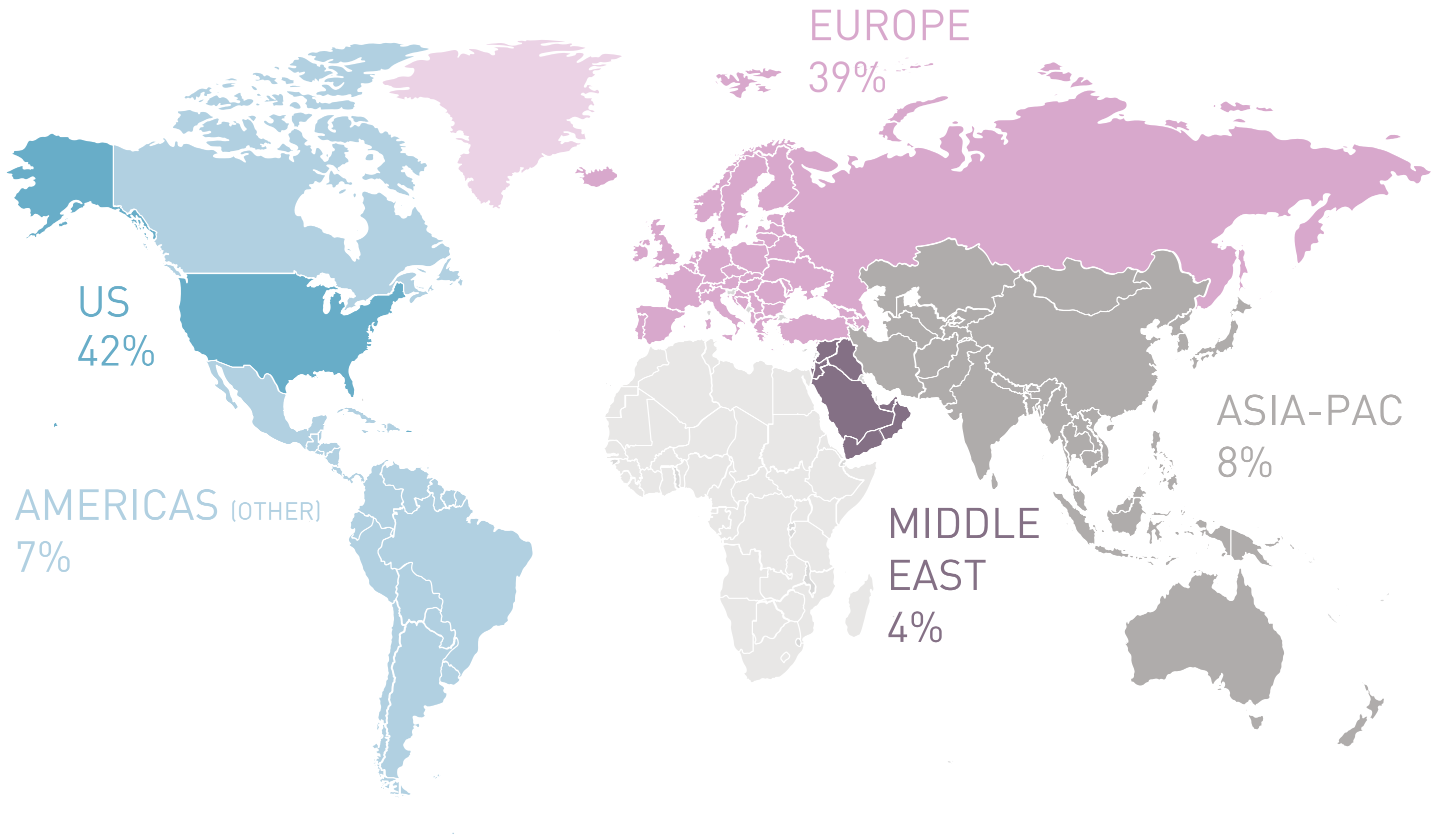
So how can we navigate a changing environment while blinded to what it might be? The most successful among us—both within and beyond the global real estate investment community—can acknowledge uncertainty and still feel out the way ahead. They listen to others to find out what they've seen, and, through this, they avoid the pitfalls of assuming that something will work simply because that's how things worked in the past.

After another year of COVID, the pre-pandemic past has retreated further into the distance, and the future landscape is filled with change and uncertainty. The AFIRE Research Committee, ever focused on the issues at the heart of our business, once again collaborated diligently to find insight from AFIRE membership in this year's survey—including what AFIRE's leaders have seen and learned over the past two years, and what these lessons might say about the future.

REPORT SUMMARY

For more than thirty years, the AFIRE International Survey has gathered the opinions of AFIRE members, comprised of 175 institutional investors, pension funds, asset managers, and other leading global organizations from nearly two dozen countries with approximately US$3 trillion AUM *(Exhibit 1)*.

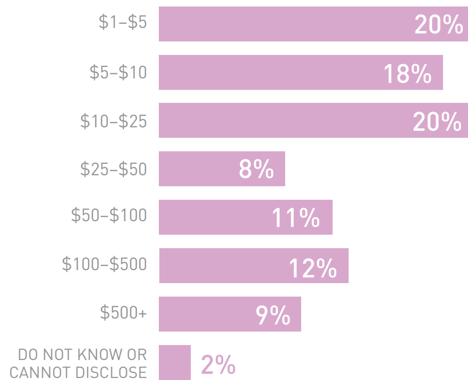
EXHIBIT 1: RESPONDENT PROFILE



COMPANY'S PRIMARY ACTIVITY

Activity	Share
INSTITUTIONAL/ NON-US-BASED INVESTORS	64%
US-BASED INVESTORS/ INVESTMENT MANAGERS	23%
ACCOUNTANTS, LAW FIRMS, BROKERAGES	13%

ASSETS UNDER MANAGEMENT ($ BILLIONS)



The results of this annual process produce this benchmark report; a useful tool for understanding the goals, challenges, and long-term thinking underscoring the international view of commercial real estate opportunities in the US.

Acknowledging that opinions can change rapidly, especially more than two years into a global pandemic, AFIRE has made all efforts to adapt this survey and meet the needs of our "new normal" in real estate—an age of heightened risk, diverse opportunity, and necessary innovation.

Investor outlook for the US remains positive amidst the dynamic context, as 75% of respondents expect their volume of investment activity and revenue growth to increase over the coming year *(Exhibit 2)*. Roughly 80% of investors estimate allocating up to US$5 billion for US investment in 2022 *(Exhibit 3)*.

Investor outlook for the US remains positive amidst the dynamic context, as 75% of respondents expect their volume of investment activity and revenue growth to increase over the coming year.

EXHIBIT 2: PLANNED INVESTMENT BY REGION IN 2022 / EXPECTED CHANGE IN 3-5 YEARS

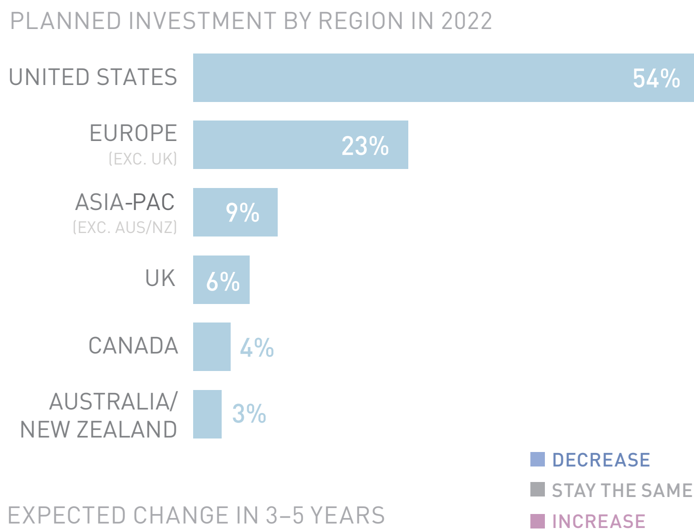
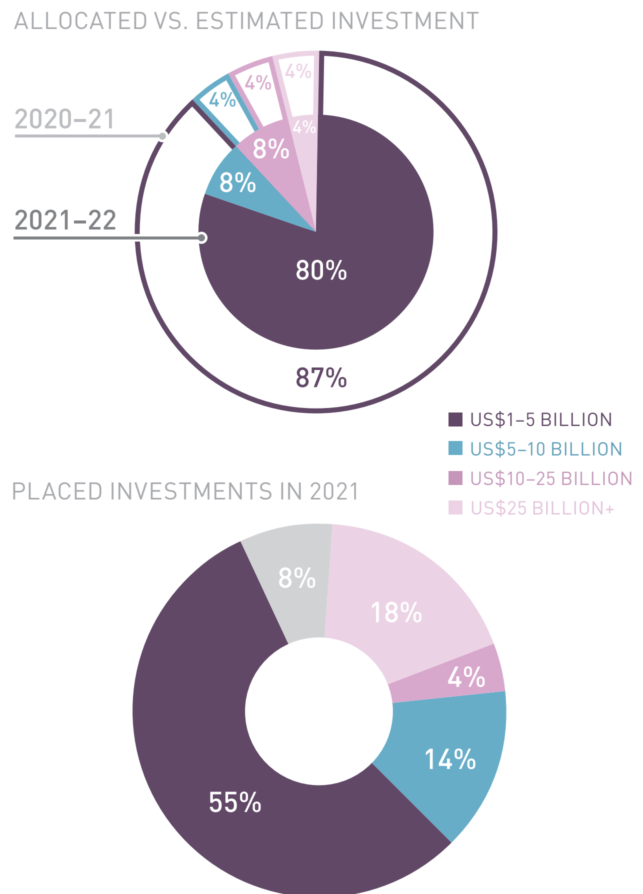


EXHIBIT 3: ALLOCATED VS. ESTIMATED INVESTMENT / PLACED INVESTMENTS IN 2021

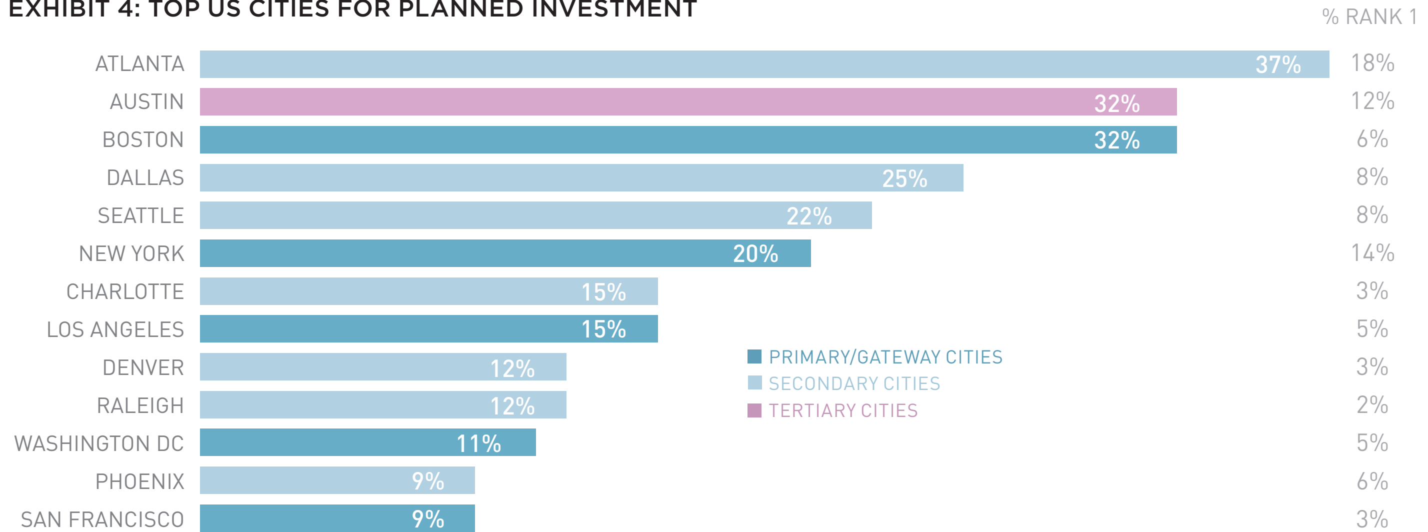


This positive outlook is underscored by a majority acceptance (8 in 10) that many cultural fundamentals have been permanently changed by the prolonged pandemic. Similarly, both institutional and public interest in environmental, social, and governance (ESG) leadership and implementation has grown in kind—a notable trend that overlaps with investor forecasts related increased risks related to climate change, economic conditions, and other factors.

PRIMARY, SECONDARY, AND TERTIARY CITIES

Accounting for shifts in both fundamentals and risks, Atlanta, Austin, and Boston are the top three cities for investment in 2022, as well as increased investment over the next five years. As these preferences indicate, investors are also moving beyond traditional gateway markets with a growing interest in both secondary and tertiary US markets *(Exhibit 5)*.

EXHIBIT 4: TOP US CITIES FOR PLANNED INVESTMENT



Atlanta rises to the top of the US city ranking for 2022 *(Exhibit 4)*, driven by a strong economy, diverse talent pool, and amenable climate. Atlanta also ranks higher in preference as the top city choice by non-US-based investors (28%), compared to US-based investors (18%).

Austin remains in favor in the second spot after topping the list in 2021, and Boston falls from second to third. Additionally, US-based investors are more likely to rank Austin in their top three planned real estate investment cities for 2022 (55%), compared to 32% for investors overall.

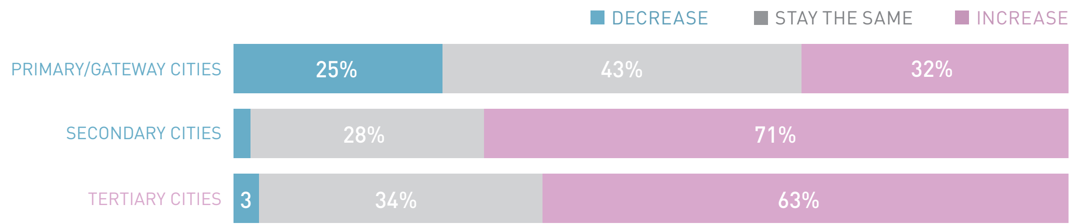
Austin and Atlanta also lead the way for planned exposure increase. The greatest decreases are forecast for Chicago and New York.

The current dominance of US secondary and tertiary cities in this survey is supported by a shifting preference beyond traditional gateway markets, as six in ten respondents plan to increase their investments in tertiary cities over the next few years (e.g., Charlotte, Raleigh, etc.), and seven in ten planning an increase in secondary cities (e.g., Dallas, Seattle, Denver, etc.).

These findings are tempered by a long-term view that gateway cities will maintain their preferred status over the next decade, even as investors largely agree that the pandemic has permanently altered cultural attitudes towards live-work preferences *(Exhibit 6)*.

Austin and Atlanta also lead the way for planned exposure increase. The greatest decreases are forecast for Chicago and New York.

EXHIBIT 5: CHANGE IN MARKET PRIORITY (3-5 YEARS)



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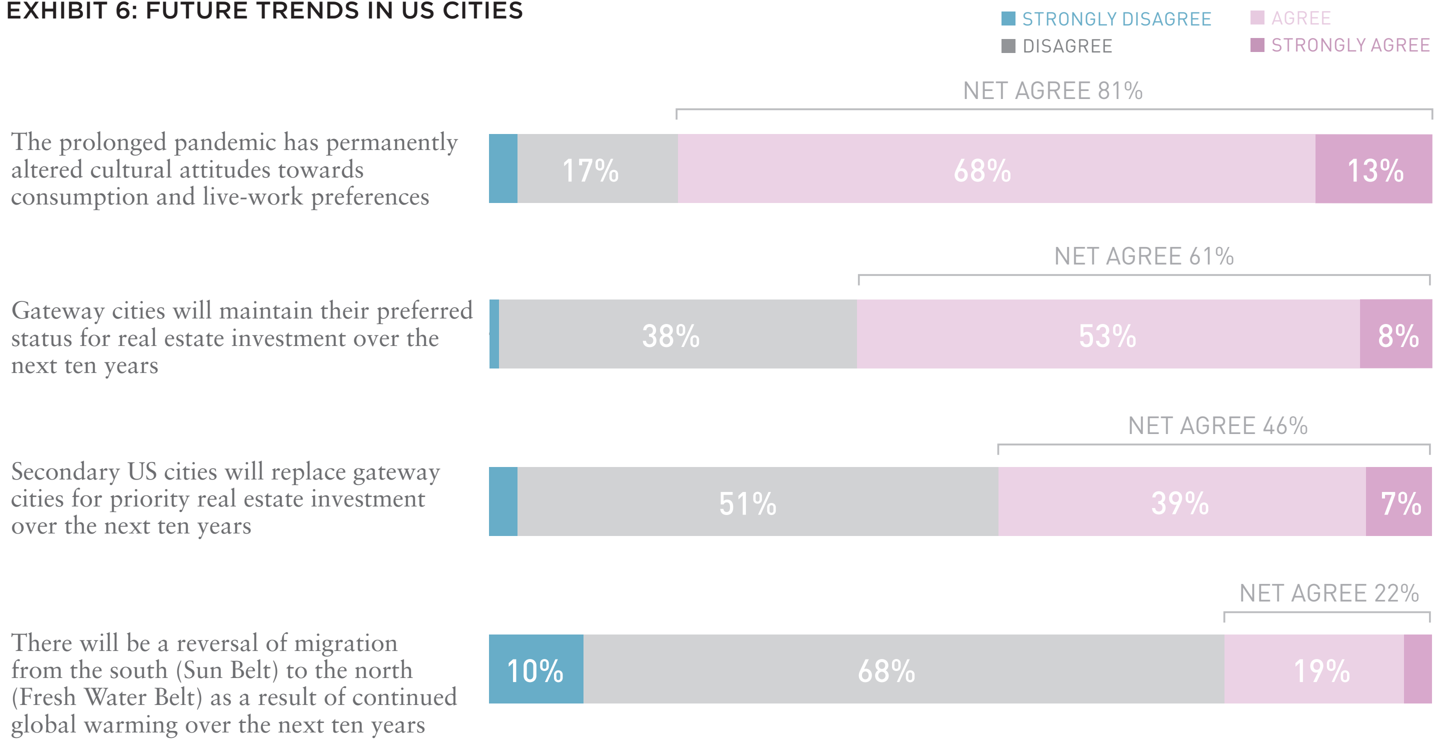


CROSS-BORDER CAPITAL

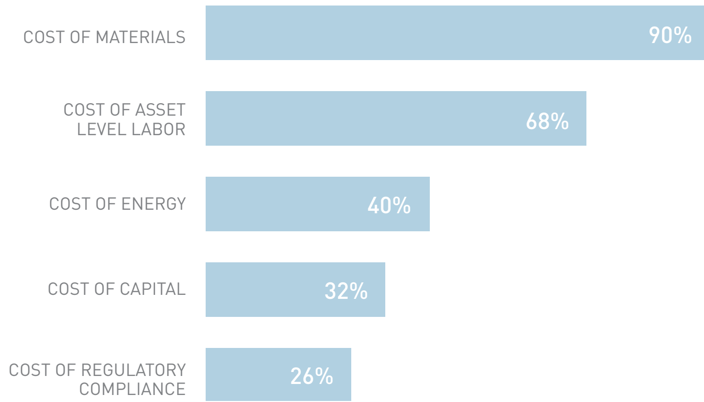
The net inflow of capital for US real estate is anticipated to increase over the next five to ten years, from 77% indicating current net buyer intentions, expanding to 82% into the next decade.

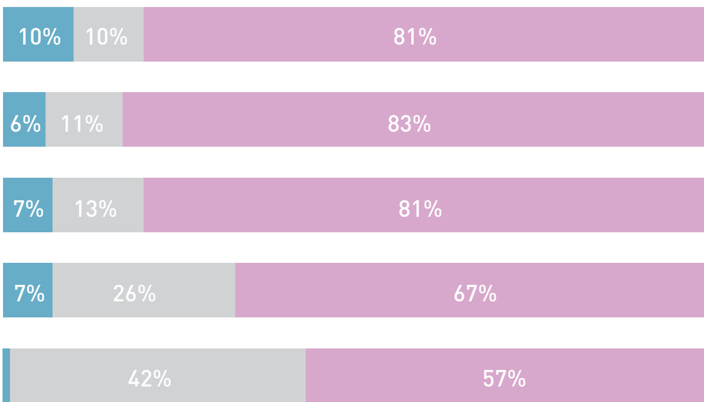
These current intentions have not changed much from 2021 to 2022, and three in ten investors were unable to place up to half of their 2021 allocations. However, most respondents are set to allocate up to US$5 billion each over the next year.

Nearly a third of investors were unable to place up to half of their allocations for real estate in 2021, with the costs of investments partly to blame. Respondents indicated that the cost of materials has had the biggest cost impact on investment over the past year, and eight in ten respondents foresee continued increases. Cost of labor and energy are expended to rise in equal measure over the next three to five years *(Exhibit 7, next page)*.

Citing other risks to allocations, investors also discussed broader macroeconomic factors, such as capital market volatility and inflation, as well as changes in tenant behaviors, geopolitical trends, and ongoing pandemic stressors.

EXHIBIT 7: COSTS IMPACTING REAL ESTATE INVESTMENT (12-MONTH OUTLOOK) / (3–5-YEAR OUTLOOK)





US economic growth prospects, and fluctuating interest rates were top-of-mind for ongoing business concerns.

In 2021, survey respondents noted that tax rates, US economic growth prospects, and fluctuating interest rates were top-of-mind for ongoing business concerns. And while these factors have long been ranked at the perennial concerns in this survey, inflation tops the list of trends to watch in 2022 (90% net concern).

Tax rates still rank on the list but fall to the fifth spot in this ranking as pandemic-accelerated changes in consumption and live-work preferences rises to the third spot. Such changes are posed to transform long-held orthodoxies about social and economic philosophies and their impact on real estate predictions.

Just as changes in consumer habits and cultural live-work preferences now rank among the top three business concerns for survey respondents, related changes in demographic trends are at the top of concerns specific to real estate (with 29% ranking these as the top concern).

Effective institutional understanding of issues related to affordability, changes in tenant demand, and changing cultural attitudes will be crucial for investment performance in the post-pandemic period, while also accounting for continued challenges posed by construction costs, asset pricing (and related factors), and regulatory nuances.

ENVIRONMENT, SOCIAL, AND GOVERNANCE TOPICS

As investors account for heightened concerns related to the environment, affordability, and corporate behavior, their consideration of environmental, social, and governance (ESG) criteria in decision-making will become increasingly critical, with eight in ten viewing it as very important in the next few years. In 2021, for example, 69% of respondents indicated that ESG criteria would be very important over the next five years. This year, that number jumped to 81% *(Exhibit 8)*.

Currently for 2022, energy and waste management, green building certification, and carbon footprint are the top three ESG criteria considered by investors for making their real estate decisions *(Exhibit 9)*. Each of these environmental criteria have proven, built-in systems for measurement, thereby making them more reliable ESG performance measures. As more sophisticated systems evolve for assessing social and governance metrics, these priorities are likely to continue changing.

EXHIBIT 8: IMPORTANCE OF ESG CRITERIA IN REAL ESTATE DECISION MAKING

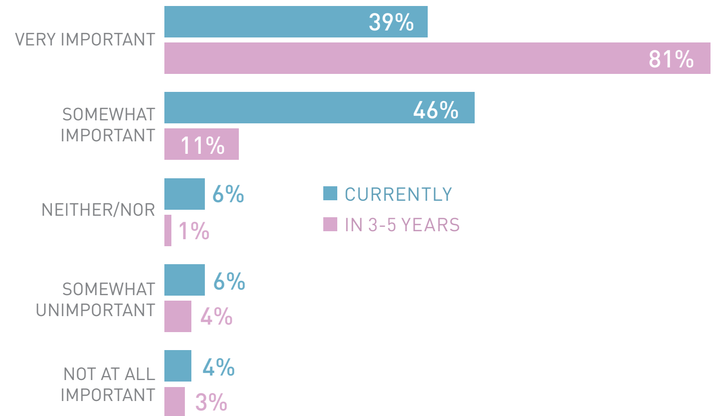
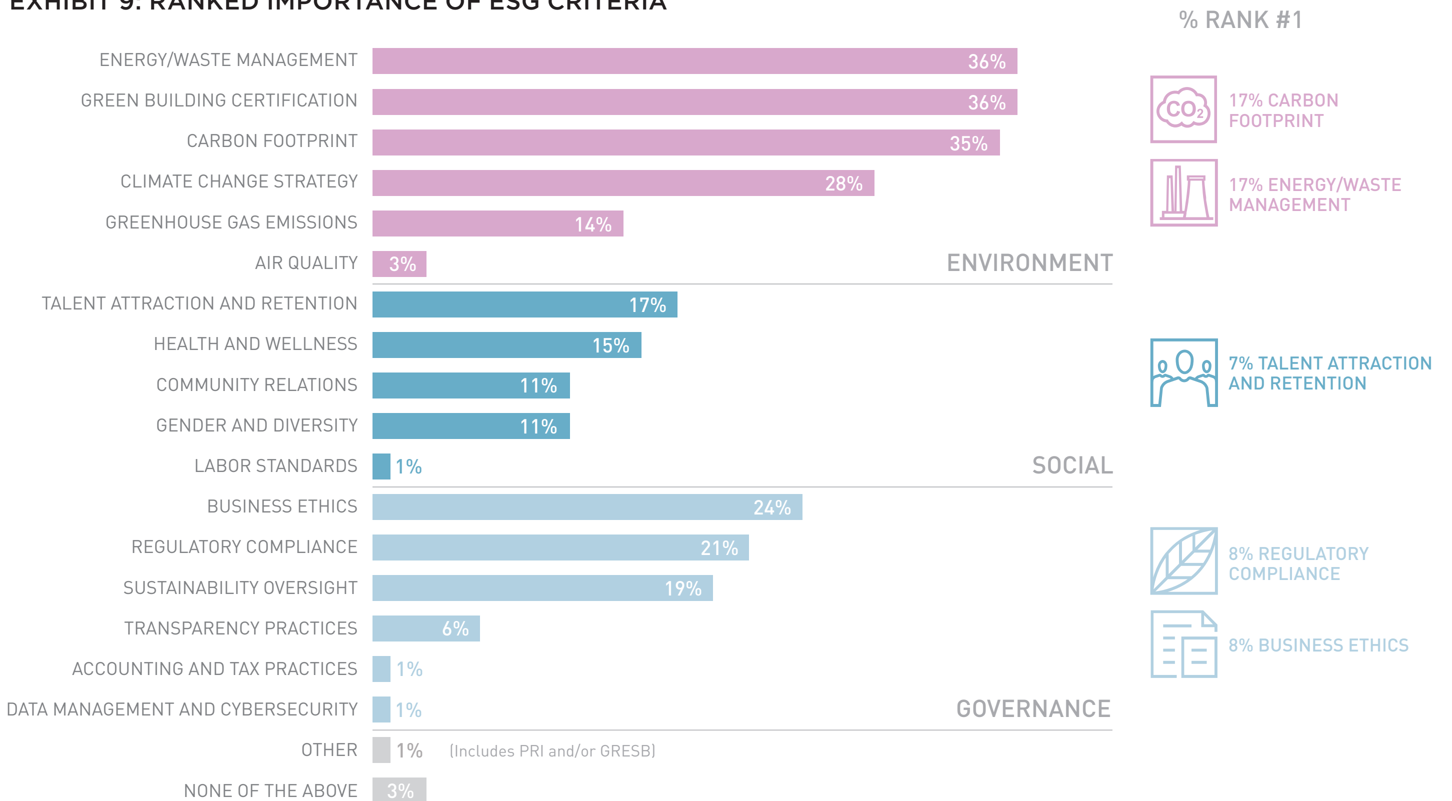
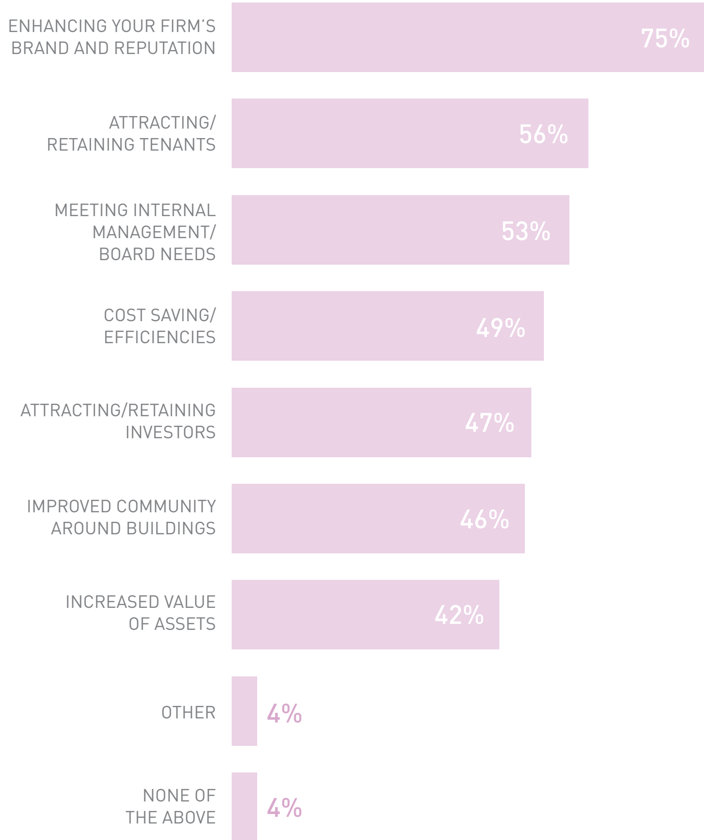


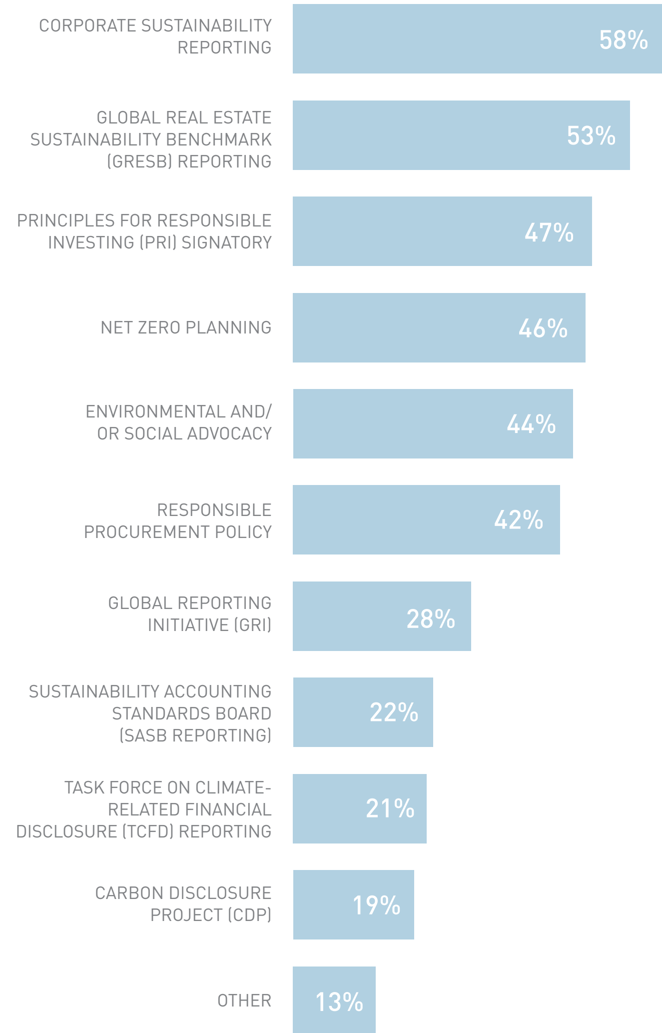
EXHIBIT 9: RANKED IMPORTANCE OF ESG CRITERIA



In 2021, for example, 69% of respondents indicated that ESG criteria would be very important over the next five years. This year, that number jumped to 81%.

EXHIBIT 10: CURRENT ESG MEASURES UTILIZED / CURRENT PERCEIVED BENEFITS OF ESG PRIORITIZATION





While non-US-based respondents are significantly more likely to consider environmental factors such as greenhouse gas emissions when making real estate decisions (23% compared to 14% of overall respondents), actionable climate change strategies and carbon footprint reduction measures are rated as the most important ESG priorities for US real estate investments in the near-future.

Few factors are expected to decrease in importance over the next five-year period, with strategies for diversity and talent attraction/development ranking secondary on the list, after environmental factors.

When asked which ESG planning, monitoring, and reporting activities were currently being implemented by investors *(Exhibit 10)*, respondents ranked general corporate sustainability and Global ESG Benchmark for Real Assets (GRESB) reporting at the top of the list, followed by Principles for Responsible Investing (PRI) signatory and planning for net zero, respectively.

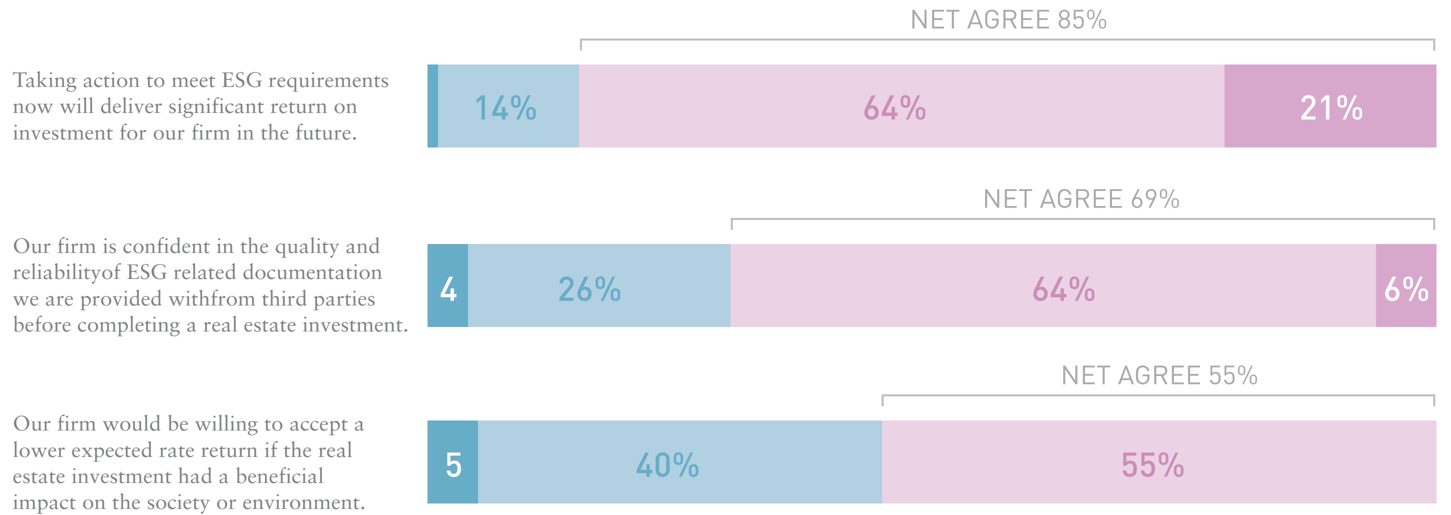
While tenant attraction, internal corporate compliance, and operational efficiencies rank as some of the top business benefits of ESG, brand reputation management remains the top business benefit of ESG leadership for respondents.

Strategies for diversity and talent attraction/development ranking secondary on the list, after environmental factors.

FUTURE TRENDS

As the importance of ESG leadership will continue to grow in the coming years, almost nine in ten respondents recognize the future financial benefit of taking action now on ESG. Notably, more than half of respondents (55%) agree that they would accept a lower-than-expected rate of return if it meant realizing other social or environmental benefits *(Exhibit 11)*.

Even as measurement remains elusive for tracking the social aspects of ESG, respondents also emphasized the long-term importance of using this time to address gender, diversity, and talent and labor issues.

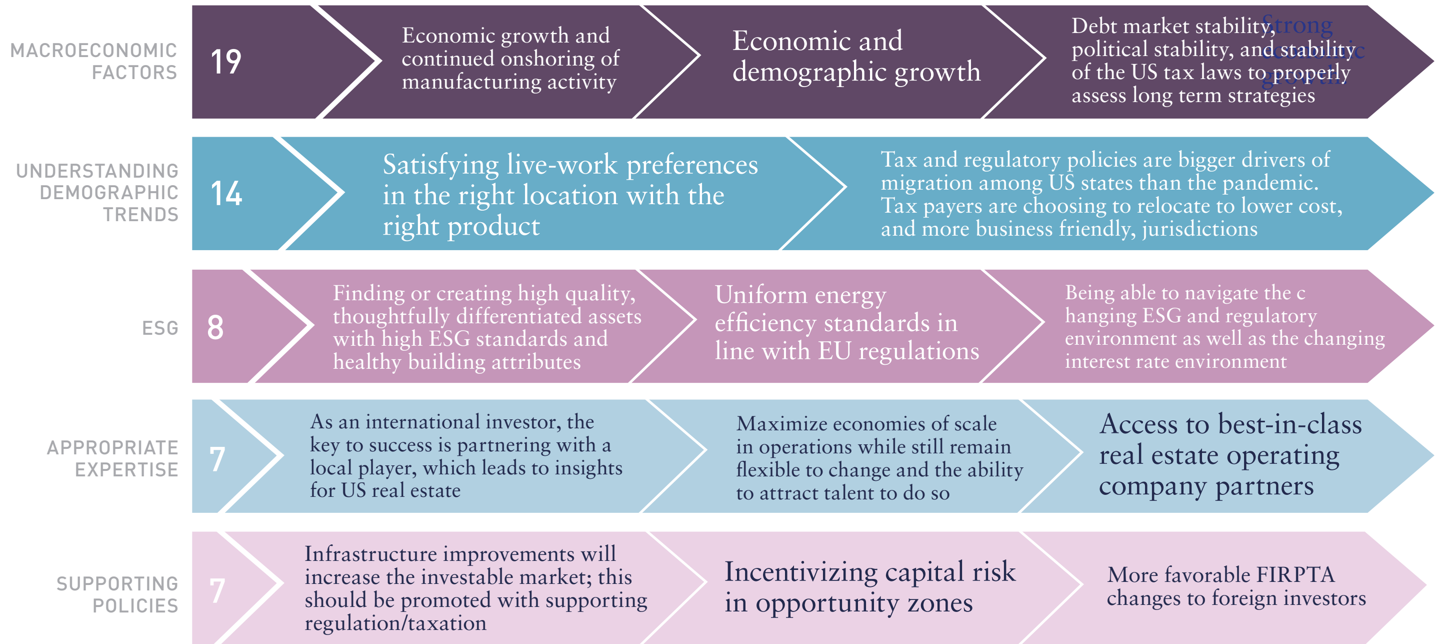


Climate risks are already impacting capital allocations in the near term. More than eight in ten investors cite these risks as affecting their 2022 capital allocation plans, and two in ten say these risks are having an extremely high impact on their allocation plans. The effects of these impacted allocations are expected to reverberate well into the future.

As climate risks alter long-term strategies, respondents also indicated which other factors would be critical to US investments over the next decade. Winners will be sorted from losers based on their understand of economics, demographics, and ESG priorities, and both favorable regulations and strong local expertise will be critical to asset performance and success *(Exhibit 12, next page)*.

> Winners will be sorted from losers based on their understand of economics, demographics, and ESG priorities.

WHAT WILL BE THE KEY SUCCESS FACTORS FOR REAL ESTATE INVESTMENT OVER THE NEXT DECADE?



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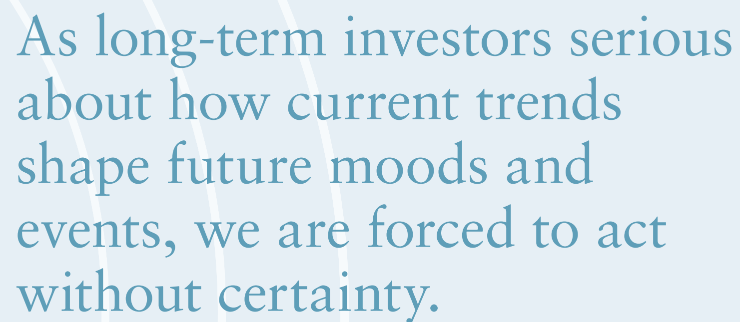

As long-term investors serious
about how current trends
shape future moods and
events, we are forced to act
without certainty.

CITIES THAT WORK

Megan Walters, PhD
Global Head of Research
Allianz Real Estate

Allianz Real Estate "Cities That Work" study* applies a current office sector outlook to understand what makes London, Stockholm, Berlin, Amsterdam, and Paris the top cities for office investment.

The world and the way we work has radically changed over the last year. Working from home has gone from a niche practice to a key part of many firms' future strategies; however, offices will likely remain crucial for collaboration, training, and maintaining corporate culture. Changing practices will fuel continuing bifurcation between prime and secondary offices, and the location and quality of assets will be more important than ever. The pandemic has also accelerated existing structural trends, in particular the rise of the tech sector.

To compile this study, we have made significant methodology changes to reflect this new environment.* Growing internal and external ESG awareness is represented in a new category with distinct environmental, social, and governance components. In addition, our tech and connectivity category has increased in sophistication and is weighted much heavier. Highly unusual market conditions mean we can only provide structural scorings; the lack of liquidity in most markets has made many of the short-term indicators used previously within the tactical scorings unreliable or even misleading. All these changes have resulted in considerably different rankings for many of the cities scored.

Top 5:

1. London
2. Stockholm
3. Berlin
4. Amsterdam
5. Paris

WHAT MAKES A CITY ATTRACTIVE?

Our model contains seven categories we think are essential to a city's attractiveness for office investments: global city status, office market size, office market balance, economic strength, human capital, technology and connectivity, and ESG.

Our model contains seven categories we think are essential to a city's attractiveness for office investments: global city status, office market size, office market balance, economic strength, human capital, technology and connectivity, and ESG.

Office market size, office market balance and economic strength

A healthy local economy and office market are important to all real estate investors. Long-term investors would typically target core offices with a strong preference for large markets with a good stock of modern assets. Solid forecasted rental growth is important for maintaining capital values and income streams; this is balanced with low market volatility, which helps to limit downside risks. Population density is increasingly important; in dense cities workers are more likely to rely upon external office space. Finally, the value of offices is strongly correlated with local GDP and growth in the service sector.

Global city status

Alongside these traditional real estate factors, we believe a city's global prominence will strongly influence its future success. A city with a solid globally recognized brand will be able to attract international corporations, workers, students, and capital. As talent and business arrives, they are integrated into a network that is difficult to leave. The stronger the city's brand, the stronger the network and cultural offering and thus higher incentive for more participants to join. A city's ranking in this category was the best predictor of its overall ranking.

Human capital

The quality of human capital available in a city underpins its long-term prospects. Competition for high-quality labor has increased: the reservation wage—the minimum wage a worker would accept to take on a new job—spiked in 2021 in many countries. The size and quality of local universities will affect the supply of young and educated talent that firms require. On average, a third of graduates will live and work in the city they studied in, rising to two thirds in the most globally prominent cities. At all levels, widespread acceptance of working from home gives workers more options for where they want to live. As a result, high quality of life is more important than ever for attracting and retaining talent.

Technology and connectivity

The tech sector has grown faster than any other in recent years, and there are good reasons to believe the pandemic will only further strengthen small and big players. Global venture capital funding in the first half of 2021 shattered records at US$288 billion—US$110 billion higher than the previous record. Tech firms now make up nine of the ten most valuable companies globally, with many drastically increasing in value over the course of the pandemic. Traditional office occupiers face an existential threat; JP Morgan's last annual shareholder letter discusses the "enormous threat" of competition from tech competitors.[1] High-quality transport infrastructure has also increased in importance as a result of environmental concerns and the availability of an alternative to commuting.

ESG

ESG factors are now widely accepted internally and externally as a part of the investment process. The importance of environmental concerns is well understood as countries commit to more stringent green targets and markets price in measures like carbon taxes. However, awareness of social and governance factors is lower, particularly in real estate. Our model incorporates a social cohesion metric that includes city-level inequality, crime rates and happiness; low scores may leave a city vulnerable to brain drain. Also included is a governance score incorporating city-level corruption, strength of legal rights and political stability; good scores should indicate both lower reputational risks and volatility of future prospects.

1. LONDON

This year London comes out significantly ahead of the other 25 cities ranked, with excellent scores in every category.

England's capital is ranked first for global city status: it is consistently ranked as one of the top three global cities and often ranked as the world's most important. Its network of six major airports makes up the world's busiest air transport system. This prominence has enabled it to be a truly international hub with more than 37% of the population born outside of the UK.

London is also ranked first for human capital: a growing population and more than 400,000 students at more than 43 institutions mean it has an excellent labor supply. The size of London's universities is matched by their quality: four are ranked in the Times Higher Education top 100, a number only equaled by Los Angeles. Although London's population growth is not massive it still is the sixth highest of the cities scored.

The rise of the tech sector will disproportionally benefit London, which is Europe's most important tech hub. The city receives far more in venture capital funding than anywhere else in Europe: around EUR 16 billion in 2020, four times its next rival Paris. In recent years, tech hubs such as "silicon roundabout" and King's Cross have emerged around some of the key central universities. London also benefits from an expansive network of public transport including the world's fourth largest subway system.

Alongside these structural strengths, London's office market is one of the most important globally. In Europe, by transaction volume over the last five years, London is second only to Paris, and is nearly three times larger than third-largest Frankfurt. International investors hungry for trophy assets and stable income have a strong preference for London; the city has often received more foreign capital than any other city globally. The UK's economy is starting to move on from the twin crises of Brexit and COVID-19, and so is expected to grow exceptionally well in the short to medium term. This strength alongside predicted falls in vacancy rates help London achieve the highest forecasted rental growth in Europe.

This year London comes out significantly ahead of the other 25 cities ranked.

2. STOCKHOLM

Although Stockholm is unexceptional in terms of global city status and real estate market size, it earns second overall ranking through top scores in all other categories.

Stockholm's biggest strength is its office market balance with a top ranking. Low volatility has resulted in significantly above average risk-adjusted returns over the last fifteen years. Stockholm also has the second highest rental growth: despite presently challenging conditions, falling vacancy and growth in key sectors should lead to excellent growth in the medium term. The long-term prospects for the office market are aided by above average population density.

The economy of Stockholm is very robust, with some of the highest rankings for both overall GDP growth and service sector growth. Since the 1990s, Stockholm's tech industry has been a continual source of growth, with three times as many people employed now in IT and communications as the EU average. The sector is supported by a healthy start-up scene that has produced notable successes including Spotify and Klarna.

Alongside all four Nordic cities scored in this report, Stockholm receives a top ESG ranking. The city was awarded Europe's first European Green Capital in 2010 and aims to be fossil fuel free by 2040. Furthermore, 99% of solid waste is recycled and 50% of Sweden's electricity comes from renewable sources. Alongside environmental strengths the city does well on governance and social cohesion. Sweden's legal rights are ranked as the fourth strongest in the world, only beaten out by three other Nordic countries. In addition, Stockholm is ranked as the ninth happiest city in the world by the World Happiness Index.

3. BERLIN

The most globally connected city in Germany has used its accessibility to attract international talent and cultivate a growing tech sector.

Berlin's rich history, world-class cultural offerings and open values have helped it gain third place for global city status. The relatively low cost of living makes Berlin much more affordable than many other global cities. The city is the most multicultural in Germany with more than 800,000 of the 3.7 million residents possessing a foreign passport. Furthermore, Berlin has profited from steadily increasing tourism and the continuing relocation of government ministries from other parts of Germany.

The city's aforementioned accessibility helps it receive a third place ranking for tech and connectivity. Global outreach and solid universities have helped fuel a booming start-up scene that has produced eight tech unicorns. Access to global talent has been crucial to this growth as almost 30% of start-up staff are from abroad. Berlin's transport infrastructure is also excellent: research has shown the city's public transportation system is the fastest in the world, alongside Paris.

Berlin's office market receives consistently good scorings that allow it to take 3rd place for market balance. Despite an uptick in 2020, Berlin's office vacancy rate remains one of the lowest in Europe, due in part to the city being also almost twice as dense as other major German cities. Forecasted rental growth and risk-adjusted returns are both above average. A potential risk is that the floorspace per worker is higher than cities like London and Paris, and so working from home may impact the local market more.

The largest office market in Europe has a world-class startup ecosystem, but is held back from the very top of our scorings by weak ESG scores.

4. AMSTERDAM

The forward-thinking capital of the Netherlands has unexpectedly benefitted more than any other city from the fallout of Brexit.

Amsterdam's office market's attractive qualities allow it to take second for office market balance. Risk-adjusted returns over the last fifteen years are more than double the average of the cities scored. Local office vacancy is at its lowest since the early 2000s and is now below the European average. Unlike many other markets, rental values did not fall in 2020, albeit with increased incentives. This strength is expected to continue; Amsterdam is expected to grow at the same high rate as Stockholm in the future.

Like most of the highest scoring cities, Amsterdam receives a top five scoring for global city status. Dutch regulation and a more than 90% English-speaking population help make the city an attractive hub for international business. As a result, Amsterdam made significant gains in the wake of Brexit, as shown by the city briefly recording a higher trading volume than any other European financial center. The city also benefits from extensive tourism with more than 5.3 million international visitors and 16 million day-trippers visiting the city every year.

The city's forward-thinking approach helps it get good scores in technology & connectivity, human capital and ESG. Alongside London, the city has developed into a key green finance hub and is ranked 1st on the Green Finance Index. The cities vibrant start-up scene has produced two of the most valuable tech companies in Europe: Adyen and Takeaway.com. Amsterdam is also renowned for its urban planning, with excellent walkability, green spaces and bike access—by some estimates the city has more bikes than people.

5. PARIS

The largest office market in Europe has a world-class startup ecosystem, but is held back from the very top of our scorings by weak ESG scores.

The strength of Paris's start-up scene and high patent applications secure it the top ranking for technology & connectivity. In and around east Paris's thirteenth arrondissement are several of the world's best start-up incubators, including Station F, the world's largest. The French government wants to capitalize on this advantage with president Macron recently stating a goal of ten tech companies worth EUR 100 billion by 2030. Paris's already extensive metro system will more than double in size when the Grand Paris project completes towards 2030.

The only other city in Europe that approaches London's global prominence, Paris wins second for global city status. Paris is the largest of the cities scored by population and by metro economy—the fifth largest in the world. For centuries, the city has been renowned as a cultural hub for its high gastronomy, art, and literature. This status is part of why it is has the second most international visitors of any city globally, falling behind only Bangkok.

As the finance and business center of France, Paris remains a key European office market. By transactions from 2016 to 2020, Paris is the largest market in Europe with EUR 20 billion of transactions over the period. Limited availability of space has resulted in relatively smaller pipeline than most of the cities scored.

CITIES TO WATCH

COPENHAGEN (#8)

Copenhagen's growing service and export-oriented economy helps bring it into the top ten with the 5th highest forecasted GDP growth. This economic strength is supported by population growth: the city is one of only three scored with forecasted population growth above 1% a year.

Like the other three Nordic cities scored it also has strong forecasted service sector growth and a top six ESG ranking. However, the limited size of its office market and past volatility keep it out of top five.

FRANKFURT (#10)

Germany's premier business and finance hub contains the Frankfurt Stock Exchange, the headquarters of the European Central Bank, Deutsche Bank and DZ Bank amongst others. Frankfurt is Germany's largest office market by transactions and the third largest of the cities scored.

Frankfurt's office market is particularly attractive: it has the fifth smallest relative incoming supply, third highest risk-adjusted returns, and above average forecasted rental growth.

BARCELONA (#11)

Barcelona punches above its weight in global city status, helped by its position as an important European transport hub and far-reaching cultural exports. The city is the fourth most visited in Europe and has the busiest European passenger seaport.

The city also has a fast-growing tech ecosystem fueling the 4th highest service sector growth of the cities scored. Relatively low labor costs make Barcelona a natural location for international firms' development centers, including Nestle and Asics.

BRUSSELS (#13)

Sitting right in the middle of the pack Brussels receives generally good scores, but is held back by limited past and forecasted rental growth.

The heavy presence of EU institutions has been a major source of resilience during the pandemic. Government lettings in Brussels are extremely secure and had some of the highest rents agreed in 2020. The EU is planning to give back some office space by 2030 but not in assets in the city center.

PRAGUE (#18)

The low overall ranking Prague receives masks some notable strengths: excellent ESG scores in all categories, fourth highest economic growth and well-regarded universities.

It could be argued that Prague is the most well-rounded target for investors interested in Eastern Europe. By some measures, Prague is more developed than Budapest, and its office market does not have the oversupply issues seen in Warsaw.

> The world and the way we work has radically changed over the last year. Working from home has gone from a niche practice to a key part of many firms' future strategies.

ABOUT THE AUTHOR

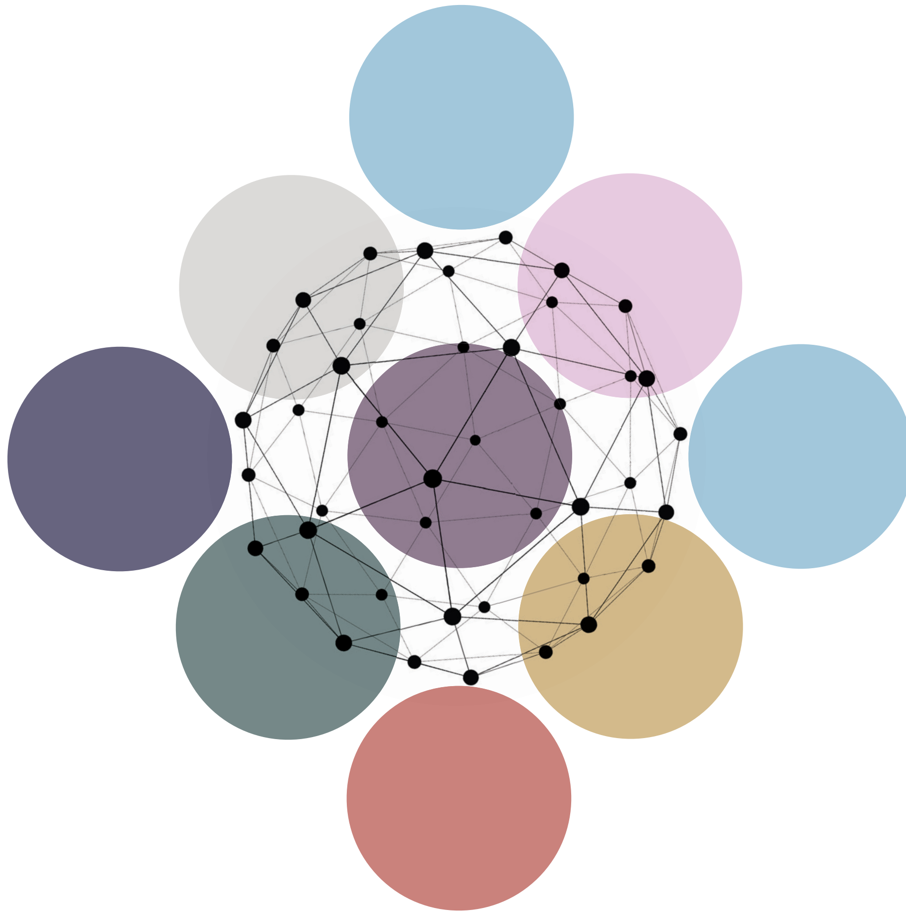
Megan Walters is Global Head of Research for Allianz Real Estate. Additional contributors for this research include Gizem Bartu, Dr. Clemens Ernst, and Luke Latham.

NOTES

* The Allianz Real Estate Office City Index is a proprietary ranking of European cities for office investments. From this ranking of European cities with a population greater than 500,000, a shortlist of 26 cities has been created based on a number of screening criteria. The index was compiled using data across seven dimensions, incorporating twenty proprietary and external indicators, which were used to generate structural scores for each city.

[1] JP Morgan Chase & Company, "Annual Report 2020,"JP Morgan Chase & Company, updated April 7, 2020, reports.jpmorganchase.com/investor-relations/2020/ar-ceo-letters.htm#banks-enormous, accessed April 29, 2022.

SURVEY SURFEIT



Jim Costello
Chief Economist
MSCI Real Estate

Be careful about advice you hear from surveys—it will not always play out as expected.

People do not always make decisions in a straightforward manner. In a survey they may tell you that they want to go to the gym and lose weight so that they can look like George Clooney or Brad Pitt, but then there is that donut in front of them in the here-and-now beckoning to be inhaled.

In other words, be careful about advice you hear from surveys—it will not always play out as expected.

No need to worry. I am not going to try to lecture you about response rates and arcane issues around sample sizes and probability distributions. All surveys are not the same, however, in the sense that the types of data collected and the conclusions that one can draw from them vary.

Surveys are often used to get at data points on where prices are today. The broadest index of prices in the economy comes from Consumer Price Indexes where government workers go out in the field to conduct surveys of a wide basket of goods, such as the price of pickles in Poughkeepsie or candle costs in Cleveland and a myriad of other items consumers use. These data points are rolled up to create an index that guides much thought about the credit markets globally, but at the base, these things start with a messy collection of survey responses.

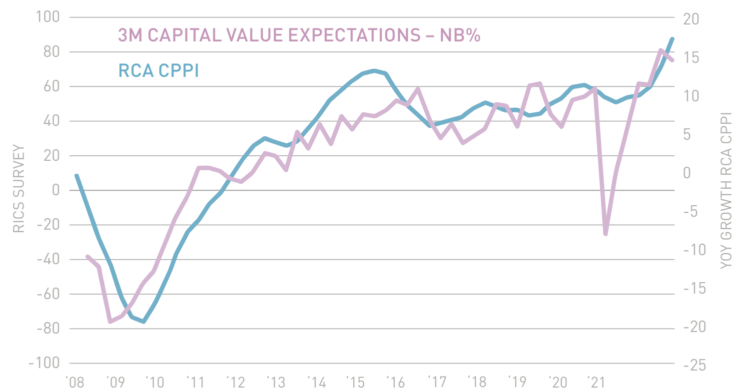
Closer to home for real estate investors, surveys of market data can provide clarity as well. Before Real Capital Analytics started publishing deal-level information in 2000, investors had to rely on surveys of brokerage professionals to see how prototypical assets might price under current conditions. This approach is still valid to get a general sense of the market, but it cannot be applied to your individual building.

Surveys of current conditions have utility in that they make a simple statement about where conditions are at the moment. Stepping forward to expressions of intentions and expectations becomes a trickier business.

Commercial real estate markets have numerous friction points that make them predictable even without fancy econometrics over the short run. Take supply issues, for instance. If surveys show that there are no construction cranes in your city, in the near term there will be little new supply to worry about simply because of the friction of supply timelines: construction is a long process. Surveys around price expectations over the short run tend to lead the RCA CPPI as well, because it can take months for deals to close, and participants have a sense of where the chips will fall in the near future. That said, there have been some misses.

EXHIBIT 1: RICS SURVEY OF SHORT-TERM PRICE EXPECTATIONS GENERALLY LEADS THE RCA CPPA . . . GENERALLY.

Sources: Real Capital Analytics, RICS



The Royal Institute of Chartered Surveyors (RICS) has conducted the Global Commercial Property Monitor opinion survey over many years to provide forward-looking views on market conditions. Studies have shown that changes in this survey generally lead changes in market pricing trends.[1] *Exhibit 1* shows the trend for the US industrial market with the expectations for changes in capital values over the subsequent three months versus the RCA CPPI. The survey clearly led the bottom of the market cycle in the aftermath of the GFC and the run up in the subsequent years.

The COVID-19 pandemic, however, seems to have caught many investors off guard. The prospect of large swaths of the economy shutting down led to fears that even the now-superheated industrial sector would experience price declines. It seems that nobody anticipated the massive fiscal and monetary responses that put a floor under price changes in 2020. With that support in place, investor expectations turned around, with prices subsequently off to the races.

The mass-emigration of millennials from large cities in the aftermath of the COVID-19 pandemic also caught many investors off guard.[2] I am not going to name and shame here, but some investment managers were out raising funds over the previous ten years with the thesis that millennials wanted to live in cities moving forward and therefore it made sense to pay higher prices for urban housing assets. This thesis was flawed because it relied on short-term desires expressed in surveys and ignored longer-term demographic issues that drive household tenure choice (i.e., rent vs. buy).

The thesis that millennials were somehow different than previous generations and that they wanted to live in cities forever seemed compelling to many. Surveys conducted in the aftermath of the GFC showed that the millennial generation preferred urban living.[3] But the preferences people exhibit tend to change as they age. The preferences of people in their late 20's and early 30's interact well with the incentives offered in urban locations. But for people settling down and having children into their mid- to late 30's and early 40's, the incentives offered in suburban locales and smaller cities can often work better.

To understand where these office workers will end up in the future, do not trust surveys of the here-and-now. Look instead to the mix of risks and rewards workers will face moving forward to determine how they will act.

Surveys of expectations over the short term have some explanatory power, but investors in commercial real estate need to understand the forces driving preferences over a longer horizon. Investing in a commercial property is a long-term commitment. When underwriting a commercial real estate investment, it is important to have a structural view of the forces that drive the performance and how those forces will evolve throughout the holding period of an investment. One observation point from a survey of short-term expectations cannot paint a suitable long-term structural view of the patterns of performance.

And yet, while some investors were burned by a thesis tied to the short-term preferences revealed in surveys, many are once again responding to short-term fears over survey responses around office use. In the here-and-now, surveys are suggesting that some office workers are hesitant to return to the office. Following 9/11, similar fears were seen for office workers in the trophy towers in Manhattan and Chicago, but as the risks faded, expectations returned to where they were before the attacks.[4] Investors running away from office tower investments because of short-term fears lost out on the subsequent run up in prices in the CBD offices.

Intentions are not always realized as actions. To understand future actions, one should look to economics. (What else do you expect the economist to say?) Seriously though, people respond to economic incentives. You want me to work in Dubai? You will need to offer up quite a lot to incentivize me to pick up and move there. Rank-and-file office workers are hesitant to return to the office today because there are still perceived risks, and the rewards have not stepped up enough to incentivize every worker to return.

To understand where these office workers will end up in the future, do not trust surveys of the here-and-now. Look instead to the mix of risks and rewards workers will face moving forward to determine how they will act. Surveys alone are not a problem; these can be useful tools that can guide investors. Like any tool though, they can be misused.

Sure, one could drive a nail with a socket wrench, but a hammer works much better.

ABOUT THE AUTHOR

Jim Costello is Chief Economist for MSCI Real Estate. MSCI is a leading provider of critical decision support tools and services for the global investment community.

NOTES

[1] Andrew Kanutin, Umberto Grossp, Catarina Braga, "Opinion Survey Indicators: What Can They Tell Us About Commercial Real Estate Markets," RICS, September 13, 2021, rics.org/globalassets/wbef-website/reports-and-research/13-september-2021---opinion-survey-indicators---what-can-they-tell-us---full-version-030921.pdf

[2] Jade Sciponi, "Millennials Have Been Moving Out of Big Cities — Here's Where They Are Going," CNBC.com, updated April 15, 2021, www.cnbc.com/2021/04/15/millennials-moving-out-of-big-cities-where-they-are-going-smartasset.html, accessed April 29, 2022.

[3] Samantha Sharf, "Survey Says Millennials Want To Live In New York, Research Suggests They Should Live In Philadelphia," Forbes.com, updated June 13, 2016, forbes.com/sites/samanthasharf/2016/06/13/survey-says-millennials-want-to-live-in-new-york-research-suggests-they-should-live-in-philadelphia/?sh=46b022dfb939, accessed April 29, 2022.

[4] Norman G. Miller, Sergey Markosyan, Andrew Florance, Brad Stevenson, and Hans Op't Veld, "The 9/11/2001 Impact on Trophy and Tall Office Property," Journal of Real Estate Portfolio Management 9, no. 2 (2003): 107–26, jstor.org/stable/24882314

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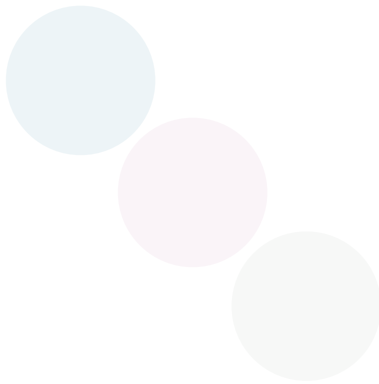

REVIEWER RESPONSE

To loosely paraphrase, reports of the death of the office are greatly exaggerated. Indeed, we are experiencing fundamental changes to the way that people work as the economy reorders itself post-COVID, but office real estate is unlikely to disappear entirely. Rather, office will evolve to accommodate new models of work and employee preferences. Other asset classes weren't immune to pandemic disruption, either. Warehouse and housing were expected to struggle as the global economy locked down, but both soon experienced explosive growth beyond what even the most seasoned real estate practitioners predicted.

As the author rightly points out, it's important to distinguish between short-term trends and long-term structural realignment. Compare, for example, economist Ed Glaser's Triumph of the City, written in 2011, to his Survival of the City from 2021. Both books are thoughtful and well-researched, providing invaluable utility for understanding conditions at the moment. But the contrast in their perspective points to how difficult it is to predict a longer-term future.

Surveys report sentiment, but not necessarily actual behavior. And even if accompanied by comprehensive behavioral data, the conclusions are likely short-term and not necessarily timely. The long-term nature of real estate assets may have them drifting in and out of favor over time, making strategy decisions even harder. Technology will provide an assist, here, with artificial intelligence and deep learning used to process immense amounts of historical and real-time data, thus coming closer to predicting the future.

– Steve Weikal
Editorial Board Member, Summit Journal
Head of Industry Relations, MIT Center for Real Estate
CRE Tech Lead, MIT Real Estate Innovation Lab

NEW WORKING AGE

Stewart Rubin
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New York Life Real Estate Investors

Dakota Firenze
Senior Associate
New York Life Real Estate Investors

Except during two World Wars in the first half of the last century, when troops were deployed overseas, the US working age population has never declined.[1] As of 2021, that statement is no longer true.

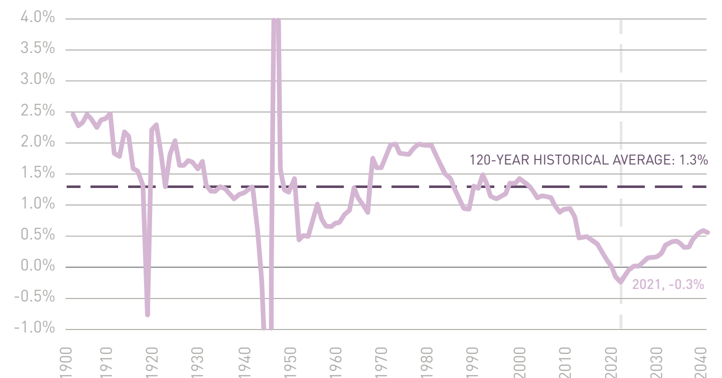
According to data recently released by the US Census Bureau, the total US population grew by only 0.1% between 2020 and 2021. Looking specifically at the working age population cohort (ages 20 to 64), *Exhibit 1* shows the annual growth rate since in 1900.[2] Over the past 120-year period, the working age population grew an average 1.3% per year. The annual growth rate in working age population has declined since 2000 and turned negative for the first time in 2019.

Except during World War I and II, when troops were deployed overseas, the US working age population has never declined.

As of 2021 – that statement is no longer true.

EXHIBIT 1: HISTORICAL AND PROJECTED GROWTH IN WORKING AGE POPULATION

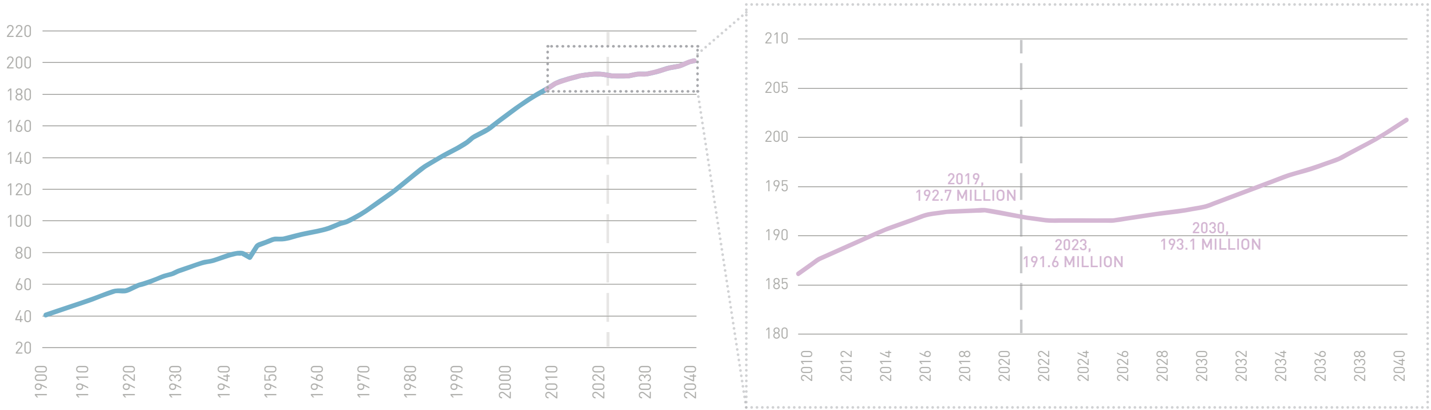
Sources: Oxford Economics; CoStar Group. Forecast begins in 2021.



The working age population in the US peaked in 2019 at 192.7 million before starting its decline. This population is forecast to decline to 191.6 million by 2023 before resuming its ascent, and returning to its 2019 level by 2030, according to projections from Oxford Economics.

EXHIBIT 2: HISTORICAL AND PROJECTED WORKING AGE POPULATION

Sources: Oxford Economics; CoStar Group. Forecast begins in 2021.

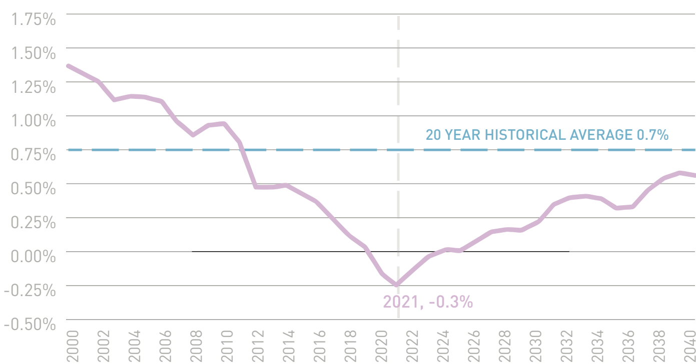


Not only has the working age population declined for the first time during a non-war time period, but its projected growth starting in 2023 is expected to be substantially lower over the next twenty years than it was during the previous two decades. Working age population growth has generally ranged from 1.0% and 1.5% in the seven years before the GFC, but then declined precipitously until turning negative in 2019. The growth rate was expected to bottom out at -0.3% in 2021 and then begin to recover thereafter. The twenty-year historical average of 0.7% is not expected to be regained over the next twenty years. In fact, growth in excess of 0.5% per annum is not expected to be achieved until 2037.

Working age population growth in excess of 0.5% per annum is not expected to be achieved until 2037.

EXHIBIT 3: HISTORICAL AND PROJECTED GROWTH IN WORKING-AGE POPULATION

Sources: Oxford Economics; CoStar Group. Forecast begins in 2021.



NATURAL POPULATION GROWTH CONTINUES TO DECLINE

Contributing factors to forecasted stagnating growth in working age population include a decline in the fertility rate over the last few decades. After reaching a recent high of 69.3 births per 1,000 women in 2007, the fertility rate has steadily declined. In 2020 alone, the general fertility rate decreased to 55.8 from 58.3 in 2019—a reduction of 4.3%, the largest single-year decline since 1973.

EXHIBIT 4: GENERAL FERTILITY RATE IN THE US

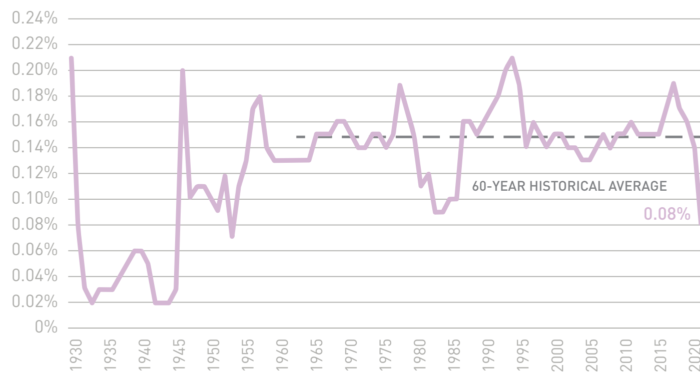
Sources: US Center of Disease Control and Prevention National Center for Health Statistics

INTERNATIONAL IMMIGRATION OFFERS LITTLE SUPPORT

Another factor contributing to slower growth in the working age population is the reduction of legal international immigration into the US. Historically, new immigration arrivals have accounted for roughly 0.15% of the US population. In the years leading up to 2016, this number increased to a recent high of 0.19%, or about 618,000 new arrivals that year. Beginning in 2017, with less immigration-friendly policies under the Trump administration, and compounded by limitations due to COVID-19, this figure has declined precipitously in the past four years. In 2020, fewer than 264,000 new arrivals represents a 67-year low of 0.08% of the population.

EXHIBIT 5: INTERNATIONAL MIGRATION: ANNUAL AND NEW ARRIVALS (AS % OF US POPULATION)

Sources: Data analysis by the Cato Institute; US State Department, "Immigrant Visa Statistics," "Annual Reports of the Visa Office"; Immigration and Naturalization Service, "Annual Reports.



Note: Immigrant visa statistics were used where available from 1925–34, 1939–53, and 1996–2000. "New arrivals" were used from 1954–95. Visas were note required before 1924. Refugees and asylum-seekers are not included in these figures.

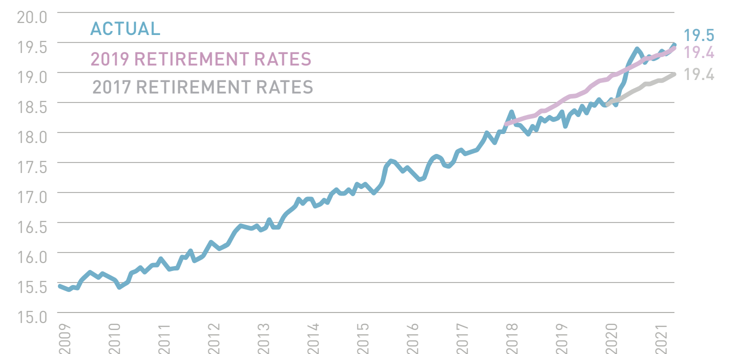
RETIREMENTS ARE ON THE RISE

According to data from the Federal Reserve Bank of Dallas, 2.7 million more individuals reported being retired relative to pre-COVID levels.[3] Assuming 2019 retirement rates, the Dallas Fed estimates that 1.2 million would have retired regardless of the pandemic. The additional 1.5 million retirements that currented during this period represent an increase of 125% over 2019 retirement rates.

However, the chart below shows how a strong labor market in 2018 and 2019 likely prompted some older workers to delay retirement, "causing the share of the population in retirement to increase more slowly than the rate of aging would have implied," according to the Dallas Fed.[4] In the time since COVID began, the rate of retirement has returned to its 2017 trend.

EXHIBIT 6: SHARE OF POPULATION RETIRED (%)

Sources: Federal Reserve Bank of Dallas using IPUMS-CPS University of Minnesota data; as of April 2021.



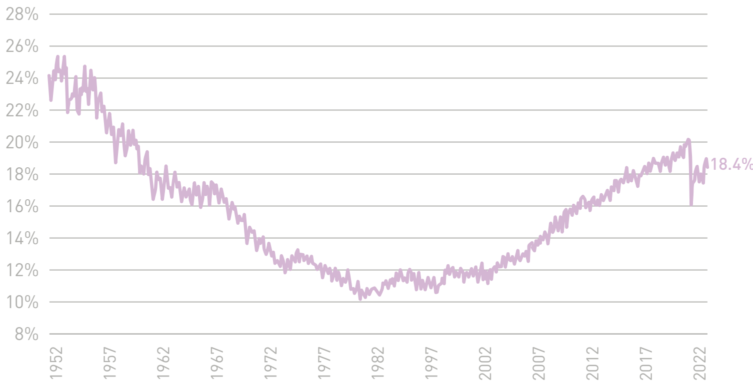
Since COVID began, the rate of retirement has returned to its 2017 trend.

Nevertheless, even if the increased level of retirement seen during the pandemic does not represent a significant departure from the longer-term retirement trend, it still constitutes fewer workers in the labor market. As evidenced by the employment to population ratio for age 65+, this age cohort has experienced a 1.7% decline from its pre-COVID high of 20.1% to 18.4% as of January 2022. This reduction in employment-to-population ratio translates into roughly 570,000 fewer employed workers from this age cohort.

By historical context, the employment to population ratio for age 65+ remains elevated. Prior to 2015, the last time this level was observed among older workers was in 1964 during the Johnson administration.[5]

EXHIBIT 7: EMPLOYMENT-POPULATION RATIO: 65 YEARS AND OVER

Sources: US Bureau of Labor Statistics, January 2022.

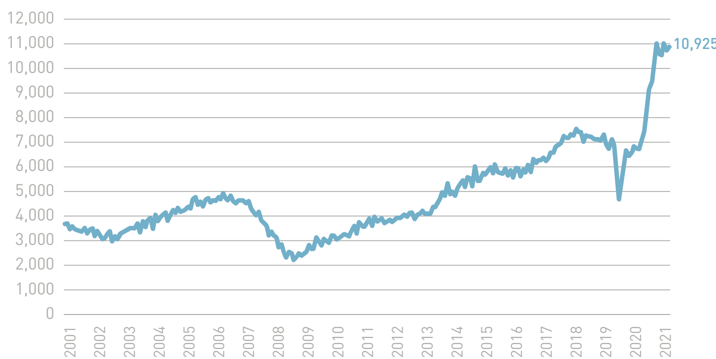


LABOR MARKET

The impact of a declining working age population may be apparent in the historically high level of job openings along with historically high job quits rate, as detailed in *Exhibits 8 and 9*. As a result, wage pressure in the labor market has already been exhibited. The employment cost index increased 4.0% year-over-year in Q4 2021, the highest level in the history of the time series, and notably higher than the 2.7% average over the three years prior to COVID.[6] In addition to offering higher wages, some employers may respond to labor shortages with incentives to keep older workers from retiring. Furthermore, in the face of higher labor costs, certain companies may accelerate plans to introduce further automation into their businesses.

EXHIBIT 8: JOB OPENINGS (TOTAL NONFARM)

Sources: US Bureau of Labor Statistics; as of December 2021.



> The impact of a declining working age population may be apparent in the historically high level of job openings along with historically high job quits rate.

EXHIBIT 9: JOB QUITS (TOTAL NONFARM)

Sources: US Bureau of Labor Statistics; as of December 2021.

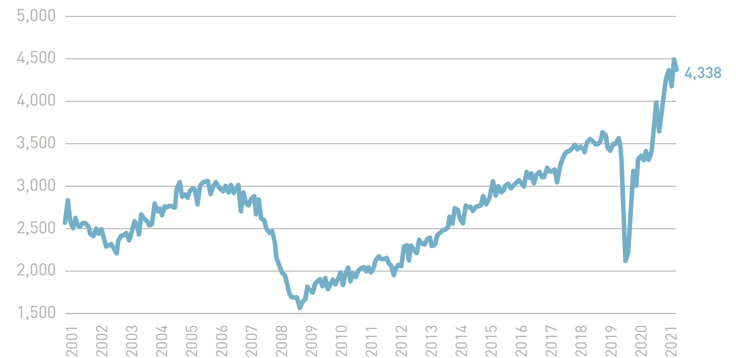
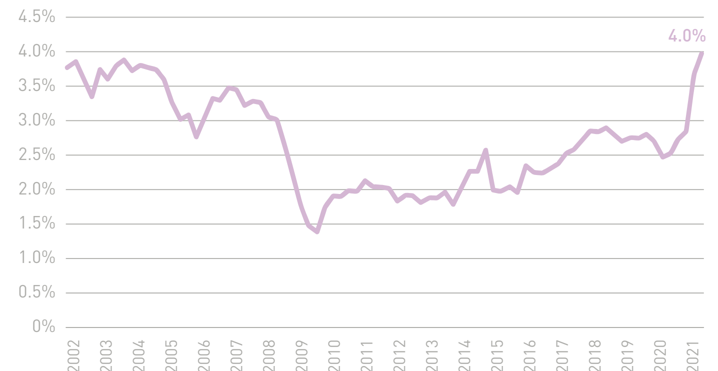


EXHIBIT 10: EMPLOYMENT COST INDEX: TOTAL COMPENSATION

Sources: US Bureau of Labor Statistics; as of Q4 2021.



DOMESTIC MIGRATION

Regional differences in the growth of working age population exist across the US Positive net domestic migration to regions like the Southeast, Southwest, and Intermountain West provide population growth tailwinds to those regions that may offset the headwinds listed above.[7] Likewise, regions like the Pacific Coast, Northeast, and Midwest may experience declines in working age population worse than the national figures cited above.

Ultimately, the first decline of the US working age population since WWII has been exacerbated by declining international immigration and an increase in retirements. A declining fertility rate could also imply that future challenges remain, even as the impact of the declining working age population may already be impacting labor supply and wages. Companies may respond to worker shortages by providing incentives to keep workers and stave off retirements, or by increasing automation.

Regions like the Pacific Coast, Northeast, and Midwest may experience declines in working age population worse than the national figures.

ABOUT THE AUTHOR

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NOTES

[1] US working age population in this chart as non-institutionalized (not in the military, incarcerated, or in a long-term health institution) adults ages 20-64. Obviously, there are many people under 20 and over 65 who work, however, since many people in those categories are in school or retired, the aforementioned age category is used.

[2] Working age population figures (historical and forecast) are based on Oxford Economics data provided by CoStar Advisory Services. Last historical year is 2020. 2021 and onward are forecasts from Oxford Economics.

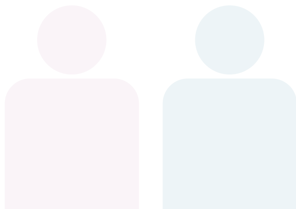
[3] Based on data from February 2020 to April 2021, the observation period used in the analysis by the Dallas Fed.

[4] Robert S. Kaplan, Tyler Atkinson, Jim Dolmas, Marc P. Giannoni and Karel Mertens, "The Labor Market May Be Tighter than the Level of Employment Suggests" Federal Reserve Bank of Dallas. May 27, 2021

[5] The employment to population ratio for 65+ is calculated with the numerator represented by those over 65 who are working and is skewed heavily towards those aged 65-70. At the same time the denominator of the ratio includes everyone over 65. The ratio during earlier time periods is inflated since the denominator includes all those age 65+ and life expectancy at birth was 70.1 years in 1964 versus 77.0 in 2020. Because life expectancy was lower in 1964, the age cohort 65-70 (who are more likely to be employed) represented a greater portion of the broader 65+ age cohort than it does today. In 2021, with relatively more individuals older than 70 or 75 than in 1964, achieving a similar employment to population ratio is even more notable.

[6] The employment cost index is a measure of employer's costs for employee wages and salaries, as well as employer costs for benefits.

[7] Based on data from the US Census Bureau.



REVIEWER RESPONSE

An attention-grabbing headline and insightful perspectives about an important first—but not one to be celebrated. Both slower growth and aging of the population in many countries have been on the radar for global investors, but the outright decline in the working age cohort in the US that the authors highlight might be new information to these investors. While the oft-used phrase "demographics is destiny" may overstate the importance, there is no denying that population dynamics are crucial to the health of the macroeconomy overall—and local real estate markets, in particular.

Looking under the hood to get into the details, the authors highlight the secular decline in fertility rates and more recent policy induced elephant in the room, that being the sharp drop in international immigration. The sheer number of immigrants not arriving in the US over the past five years represents a cumulative deficit of about two million people—adding diversity, youth, entrepreneurial drive—assuming the number of new arrivals at 0.15% of the US population, the average over the past sixty years.

The article touches on domestic migration and the differential contribution of immigration to regional and metro population dynamics, a topic that warrants further research effort, as does the real estate investment implications of these phenomenon. I suspect that the authors are well aware and already at work on these follow-ons. Prior to Donald Trump becoming President, immigration was playing an outsized role in propping up population in California, Illinois, and the Northeast. Without strong flows of new international arrivals, population would have been declining (NYC) or declining more (Chicago), given the strength of domestic out-migration. The authors' conclusion is consistent with a warning that, without a reversal in policy, and maybe even a more robust immigration flow, there would seem to be significant risk of decline in some regions of the economy.

– Jim Clayton, PhD
Editorial Board Member, Summit Journal
Professor and Timothy R. Price Chair Director, Brookfield Centre in Real Estate & Infrastructure, York University Schulich School of Business

SELECTIVE FRAMEWORK

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Two years after offices closed in the US due to the COVID pandemic, the debate over the long-term future of the office continues. What should office investment look like going forward?

Two years after offices closed in the US due to the COVID pandemic, the debate over the long-term future of the office continues. What should office investment look like going forward? During the second half of 2021, COVID variants postponed an unofficial return to work for many workers leaving current physical occupancy still less than half of what it was before the pandemic.

And yet the office sector is not obsolete.

APAC and the EMEA are host to plenty of cities where office workers have returned en masse following vaccination programs. And across the US, office transactions in the fourth quarter of 2021 reached $52 billion, the second strongest quarter on record, pointing to ample transactional liquidity.[1]

Investors should nonetheless be cautious proceeding in a post-COVID era. Unlike in Europe and the UK, the US had an oversupply of commodity space facing functional obsolescence even before the pandemic *(Exhibit 1)*. Investing in office in the current market environment will likely require a higher degree of precision than during prior cycles. For example, Barings' approach is to target areas with a predominance of scientific, technology, education, and/or mathematical (STEM) employment sectors in a location. In addition to clusters of STEM tenancy, local amenities and building characteristics should also be considered. Given an estimated US$2.8 trillion of US office properties, creating a framework for selectivity is a practical necessity for prospective investors in the "post-pandemic" era.[2]

OFFICE STILL MATTERS, BUT MORE SO IN CERTAIN CITIES

The office sector is still a significant component of most institutional investor real estate portfolios; 30% of the gross asset value (GAV) of the institutionally owned NCREIF Property Index is office. In 2021, there was US$144 billion in office property trades, up 62% from 2020 and in line with 2015–19 annual average of US$143 billion.[3] Boston, Manhattan, San Jose, Seattle, and Dallas were the top five most active transaction markets in 2021 and are perennially within the top ten.

Those who have followed the evolution of major metropolitan areas over the past quarter century recognize that, as global economic output has been increasingly knowledge- and services-oriented, clustering (also known less colloquially as agglomeration) factors more into the location decisions of businesses and residents. The benefits of clustering are essentially related to economies of scale and reducing the frictional costs of production. It is no coincidence that each of the aforementioned places that led in office transactions also host world-renowned, thought-leading firms and institutions of higher learning.

Famed urban economist Ed Glaeser refuted the proclamation that "cities are dead" even as most cities were still under pandemic lockdowns that seemed disproportionately harder on those inhabiting urban cores relative to those in the suburbs.[4] Despite COVID, the advantages of clustering still far outweigh its inconveniences. The World Bank's measure of global urbanization rose in 2020 as it has each year since 1960, when the time series starts. In other words, if cities are not dead, then neither is the office.

However, one cannot dismiss how deeply the pandemic has changed tenant demand preferences, at least over the next several years. Office vacancy is at its highest in a decade, as of Q4 2021.[5] While early forecasts expected that a broad-scale return to the office would bring vacancy down from its current cyclical high, recent baseline expectations are for vacancy to remain at elevated levels over the next several years. While a handful of firms and even municipal governments have called their employees back to their offices full-time, most are generally allowing for flexible—if ambiguous—hybrid work arrangements. Whether or not one believes that tenant preferences will normalize to their pre-pandemic state eventually, a strategy founded upon that conviction would seem speculative at this point. As investors, we need to identify properties and locations that are relevant *today*.

Screening by educational attainment and the proportion of STEM employment results in a set of metro areas that demonstrate persistent and sizeable unlevered total return outperformance of 53 BPS since 1994, driven by more favorable fundamentals *(Exhibit 2)*. At Barings, we refers to these sixteen metro areas as the B.E.S.T. (Barings Education, Science, and Technology) metro areas. By focusing almost exclusively on these geographies, we greatly increase our chance of identifying the right office investments for the post-pandemic era.

As investors, we need to identify properties and locations that are relevant *today*.

EXHIBIT 1: UK VS. US OFFICE OCCUPANCY

Source: Weighted average occupancy via CoStar, as of Q4 2021

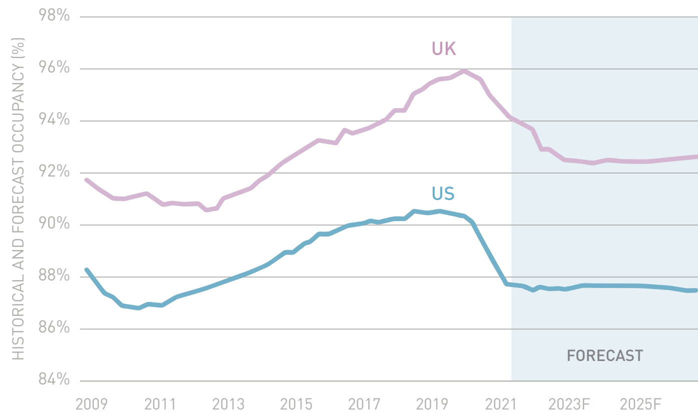
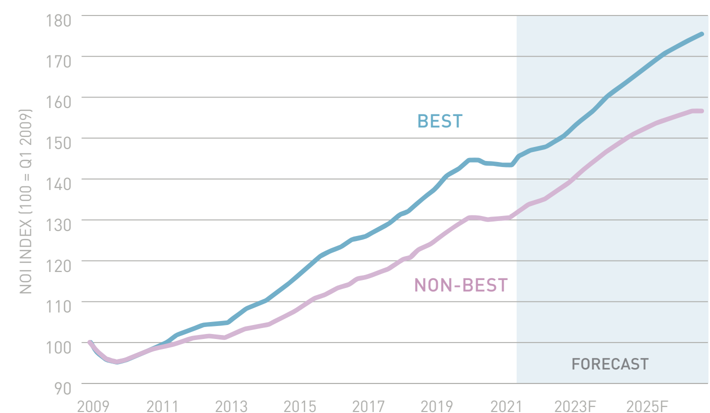


EXHIBIT 2: B.E.S.T. US OFFICE METROS NOI TREND VS. OTHER METROS

Sources: Weighted average NOI index; CoStar, as of Q4 2021



GETTING LOCAL

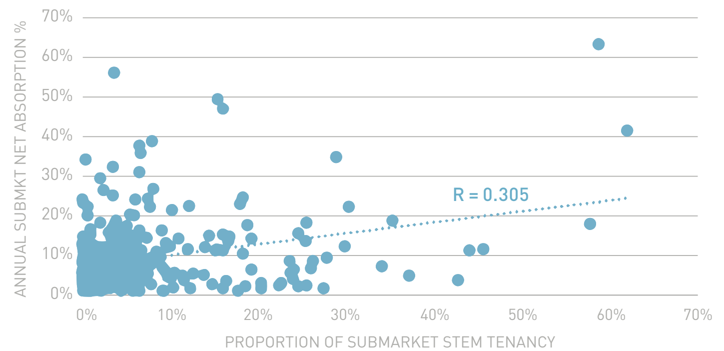
That this curated set of metro areas is already highly investible and deeply institutional is not incidental. The aggregate gross property values for these combined office markets total US$1.8 trillion out of an estimated US$2.8 trillion of total value.[5] A significant proportion of office properties even in these outperforming metros could underperform. The selection framework detailed here is meaningfully more granular.

Geographically, property markets are comprised of submarkets whose delineations are drawn along terrain markers such as major roads. The sixteen BEST markets contain 480 distinct submarkets. We filter close to 95% of submarkets and cover the remaining 5%, amounting to about two dozen submarkets.

A high percentage of STEM tenancy in and of itself is not necessarily a reliable indicator that a submarket has performed or will perform better than a submarket with low STEM tenancy. We have found only modest correlation between proportion of STEM tenancy within a given submarket pre-pandemic and the annual rate of historical net absorption (R = 0.305, *Exhibit 3*). Certain submarkets are geographically diffuse and/or may have a large inventory of existing, aged stock—all of which can be factors associated with weak performance. Atlanta's Central Perimeter submarket is an example. Despite having a sizeable share of STEM tenancy, submarket vacancy pre-pandemic was five percentage points above the metro average, and Central Perimeter's rate of net absorption was flat from 2015 to 2019, despite little in the way of new construction.[6] The predominance of office towers—many past the thirty-year mark—dispersed across a terrain with low walkability means the Central Perimeter is unlikely to attract dynamic STEM tenants who place a premium on clustering. Additionally, the area is likely to struggle with unfavorable supply and demand fundamentals at least for the remainder of the post-COVID cycle.

EXHIBIT 3: MODEST BUT MEANINGFUL CORRELATION BETWEEN STEM EMPLOYMENT AND SUBMARKET FUNDAMENTALS

Sources: BRE Research; CoStar, as of Q4 2021; regression on a subset of those 480 submarkets that demonstrated positive net absorption from 2015 to 2019.



INCORPORATING "STREET LEVEL" OBSERVATIONS

You do not have to be an urban economist to understand the appeal of neighborhoods such as East Cambridge in Massachusetts; Hudson Yards in New York; the Domain in Austin; Downtown Bellevue, Washington; Sunnyvale, San Jose; and Charlotte's South End—to name a handful. It is not only the predominance of STEM tenancy combined with shops and restaurants that actually make people want to be in these areas, even though business and living costs are relatively steep. "Street-level" observations suggest that these areas should benefit from greater office tenant demand, and the data largely bears that out *(Exhibit 4)*.

EXHIBIT 4: OBSERVATIONS SUBSTANTIATE QUANTITATIVE OUTPERFORMANCE

Sources: CBRE Econometric Advisors, as of Q4 2021

SUBMARKET	MARKET/ METRO AREA	SUBMARKET VACANCY	MARKET VACANCY	VAC. DIFF. (BPS)
CAMBRIDGE EAST	BOSTON	2.6%	12.4%	-980
SUNNYVALE	SAN JOSE	6.3%	13.7%	-740
NORTH UNIVERSITY CITY	SAN DIEGO	7.3%	14.1%	-680
BELLEVUE CBD	SEATTLE	7.2%	13.4%	-620
MIDTOWN	ATLANTA	14.4%	18.8%	-440
MIDTOWN/SOUTH END	CHARLOTTE	13.9%	18.0%	-410
NORTHWEST/DOMAIN	AUSTIN	11.8%	15.4%	-360
SOUTH SAN FRANCISCO	SAN FRANCISCO	11.5%	15.1%	-360
HUDSON SQUARE	MANHATTAN	10.8%	13.5%	-270

Factors that make a neighborhood or submarket desirable to live and work in likely make it attractive from an investment perspective, as well. When Barings analyzed the top fifty large submarkets ranked by historical and forecast fundamentals, we found that 28 submarkets had all of the three following characteristics:

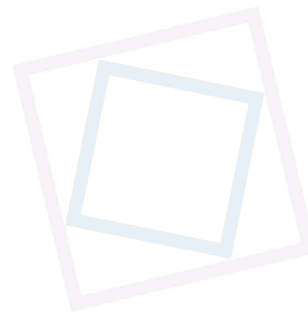
- Concentration of STEM tenancy: 5% or more of tenants across the submarket were in STEM sectors
- Concentration of amenities: Recreational, cultural, social, educational institutions including the presence of one or more universities, museums, sports stadiums, and entertainment districts
- Above average apartment and office development activity: while new supply is an investment risk, the prevalence of active development is more often indicative of clustering and "place-making"

Criteria filters around building characteristics including flexible floorplates, collaborative spaces, and substantive ESG implementation can aid in the property selection process.

EXHIBIT 5: FACTORS FOR NEIGHBORHOOD AND SUBMARKET DESIRABILITY

Sources: BRE Research; CBRE Econometric Advisors

SUBMARKET SELECTION CRITERIA	# OF TOP 50 SUBMKTS
CONCENTRATION OF STEM TENANCY	35
CONCENTRATION OF AMENITIES	36
ACTIVE APARTMENT/OFFICE DEVELOPMENT	46
ALL 3 ABOVE CHARACTERISTICS	28



These submarket characteristics are fairly intuitive. However, the process of setting up quantitative screens and criteria weights is a more involved and time-consuming process. However, this process is increasingly necessary in an era of rising risk premiums for office. Taken individually, these criteria are useful, but when combined, they yield potent investment insights.

Furthermore, criteria filters around building characteristics including flexible floorplates, collaborative spaces, and substantive ESG implementation can aid in the property selection process. Importantly, determining the balance of criteria and the correct thresholds require the interaction and input of portfolio and asset management in addition to the acquisition teams.

LOOKING AHEAD

There were moments over the past two years when many of us sequestered in our residences wondered if we would ever return to an office building again during our lifetimes. Looking back, we can more deeply appreciate at least some of the reasons offices have existed for hundreds of years. The office workspace at its best enables the cultivation and enhancement of corporate culture, fosters innovation and productivity through collaboration, and helps to attract and retain talent especially among younger workers.

Today those justifications resonate more meaningfully following an extended period of pandemic-imposed isolation. Whatever you may believe about the office long-term, it remains an investible property type today, especially as income yields in other property types have reached once unimaginable lows. Having said that, investing in the office sector after COVID without establishing a rigorously selective framework likely paves a path to disappointment - if not outright failure.

ABOUT THE AUTHOR

Dags Chen, CFA, is Head of US Real Estate Research and Strategy; Ryan Ma is Managing Director of Research and Strategy; and Ryan LaRue is Director of Innovation and Portfolio Strategy for Barings Real Estate, a global real estate platform with extensive capabilities across both debt and equity strategies.

NOTES

[1] Real Capital Analytics, rcanalytics.com, accessed January 30, 2022.

[2] CoStar, costar.com, accessed February 2022.

[3] Real Capital Analytics, rcanalytics.com, accessed January 30, 2022.

[4] James Pethokoukis, "The Future of the American City: My Long-Read Q&A with Ed Glaeser," American Enterprise Institute, updated September 14, 2021, aei.org/economics/the-future-of-the-american-city-my-long-read-qa-with-ed-glaeser/, accessed April 29, 2022.

[5] CoStar, costar.com, accessed February 28, 2022.

[6] CBRE Econometic Advisors, cbre-ea.com, accessed December 31, 2021.

Rigorously selective framework likely paves a path to disappointment – if not outright failure.

REVIEWER RESPONSE

The authors raise one of real estate's central questions from the pandemic—how our relationship to the office has changed and what it means for investment strategy. Their insights speak to the even larger issue of changing space-use patterns across sectors and the spatial distribution of activity within and across metropolitan areas. While the vagaries of the pandemic have delayed experimentation with hybrid working models, the authors emphasize the fundamental value of co-location as an input to long-term innovation and firm performance; in other words, firms that brings people together intentionally will outperform.

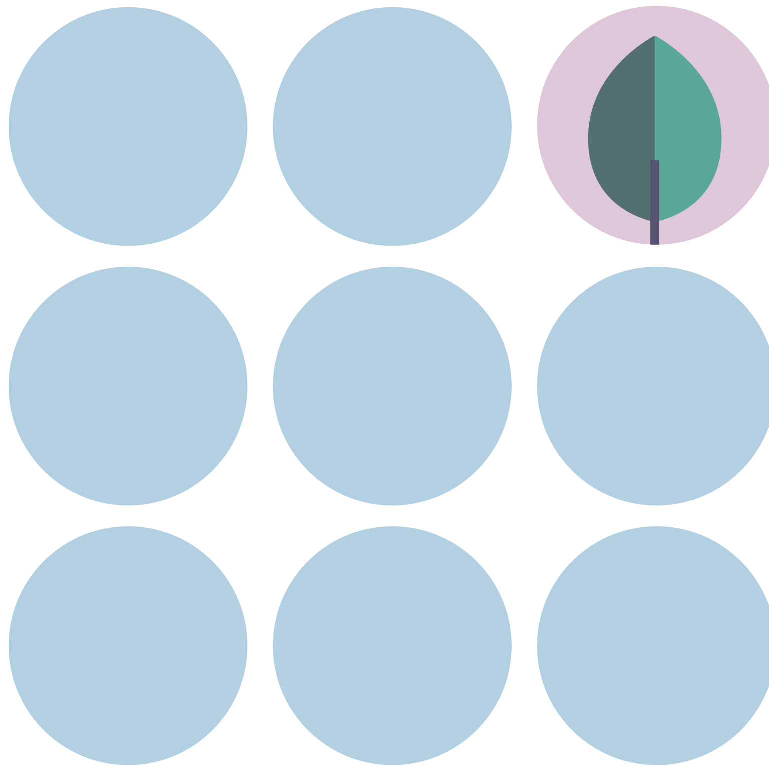
The criteria for market selection emphasized in this paper focus on industry clustering and the enhancement to economic productivity from co-location. These are likely top-of-mind for executives, economists, and city officials depending on diversified tax revenue streams. The other side of equation includes myriad factors that will also be determinative of office market and submarket competitiveness. Among them, the quality of the transportation infrastructure, labor market dynamics, and local tax efficiency are two standouts. As our understanding of the post-pandemic office evolves, further incorporating these drivers into analyses will prove efficacious. As one example, early data suggest greater transportation autonomy and lower dependence on public transit are correlated with higher office occupancy, independent of a market's industry concentration.

For many major metropolitan areas, the data show a robust return to leisure and hospitality activities, with sold-out concert and sports venues and rebounding dinner reservation activity. The return to office is a laggard. This divergence underlines that health concerns are not the sole of consideration of employees. Instead, the emergence of new hybrid models of work will reflect a bending to post-pandemic realities, including a more intentional role for the office that will drive utilization and sector performance.

– Sam Chandan, PhD, FRICS, FRSPH
Summit Journal Editorial Board Member

Professor of Finance & Director, Stern Center for Real Estate Finance, New York University Stern School of Busines

GARDEN VIEW



Martha S. Peyton, PhD
Managing Director, Real Assets Applied Research
Aegon Asset Management

US garden apartment investments are offering outsized return potential –but access remains a challenge.

The garden apartment subtype of the apartment sector is producing very encouraging total returns for property investors, beating all sector returns outside of industrial. The outperformance of garden apartments prevailed throughout 2021, but over the twenty-year average as well.[1]

Affordability limitations and constraints on homeownership contribute to the strength of garden apartment investments by locking in demand by necessity. Such properties are concentrated in the medium-quality range and offer lower rents when compared with high-rise apartments.

However, such properties have also not traditionally been held by institutional investors, which have historically focused more of their apartment holdings on high-rise properties where new construction is more plentiful.

A LOOK BACK

In 2021, institutional investors appeared to be noticing the attractiveness of garden apartment properties as net acquisitions more than doubled versus the ten-year average. Joint ventures comprised more than a fifth of this activity.[2]

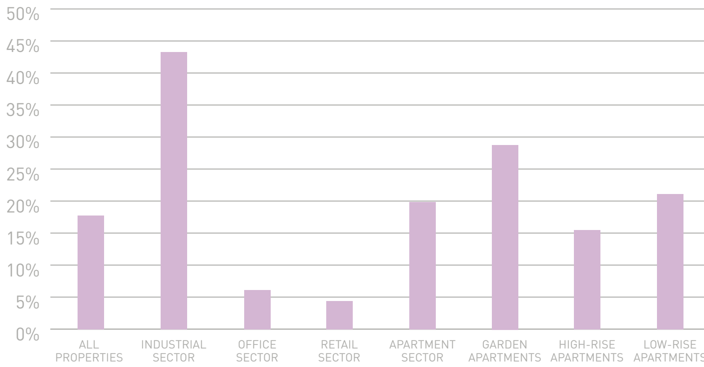
In light of the generally older vintage of garden apartment stock, more investment opportunity is available—especially for value-add investments that will prolong the useful life of these properties.

Investors in US commercial property have been solidly rewarded for understanding the apartment sector and its subtype nuances. In 2021, apartments were the second strongest performing sector, with total return of 19.9%. This performance handily beat the all-property total return of just over 17%. Within the apartment sector, garden apartment properties posted a stunning total return of almost 29% *(Exhibit 1)*. This performance rewarded investors for focusing their capital away from architecturally striking high-rises (defined as four stories or taller) and toward more conventional garden apartments (defined as three stories or less on "sizeable" landscaped lots).[1]

The impressive performance of garden apartments is not surprising given an intense backdrop comprised of a pervasive national housing affordability burden and barriers to homeownership. However, it bears noting that superior investment returns for garden apartments versus both high-rise and low-rise properties (defined as three stories or less, typically in one structure) has prevailed for the last twenty years. Moreover, as shown in *Exhibit 2*, as of 31 December 2021, the twenty-year average of garden apartment total returns bested the performance of the total of all properties, as well as that of the office and retail sectors separately. Only the industrial sector produced a better twenty-year average total return performance.

EXHIBIT 1: NCREIF-NPI TOTAL RETURN (YEAR ENDING 31 DECEMBER 2021)

Source: National Council of Real Estate Investment Fiduciaries. As of 31 December 2021.



Solid demand and relatively inelastic supply have helped total return on garden apartments to beat high-rises every year since 2014.

EXHIBIT 2: NCREIF-NPI TOTAL RETURN (20-YEAR AVERAGE)

Source: National Council of Real Estate Investment Fiduciaries. As of 31 December 2021.

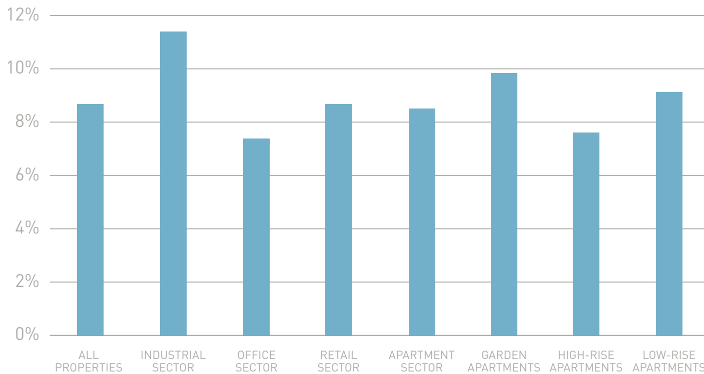
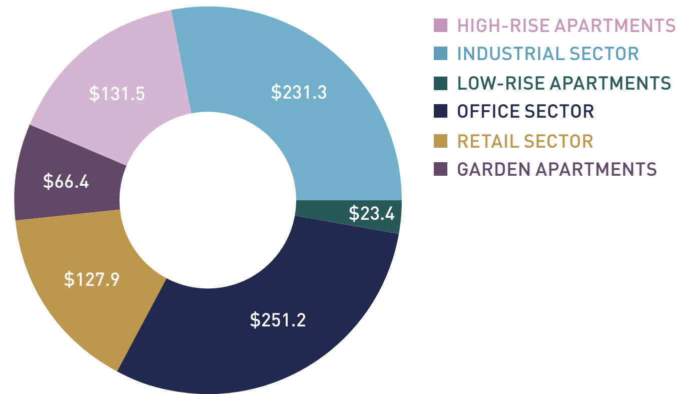


EXHIBIT 3: PROPERTY COMPOSITION OF NCREIF-NPI

Source: National Council of Real Estate Investment Fiduciaries. As of 31 December 2021.



Property portfolio managers are doubtlessly well-aware of the superior performance of garden apartments versus both high-rise and low-rise apartment sub-types. Yet, holdings in the NCREIF National Property Index (NCREI-NPI) portfolio, tilt toward high-rise properties which totaled US$132 billion and 1,085 properties as of 31 December 2021, versus US$66.4 billion and 753 properties in the garden sub-type *(Exhibit 3)*. The tilt is surprising not only because of the historical difference in total return performance, but also due to the historical difference in cap rates: The twenty-year average cap rate for garden apartment properties in the NCREIF-NPI is 5.5% versus 4.8% for low-rise properties and 4.6% for high-rise.[1]

ATTRACTION OF HIGH-RISE PROPERTIES DIMMING

High-rise apartments overtook garden apartments as a percent of the NPI portfolio in 2012 after a prolonged period of slow convergence *(Exhibit 4)*. The pace of high-rise allocation accelerated after 2000 and corresponded to an accelerating pace of high-rise construction that plateaued in 2018 *(Exhibit 5)*.[3] In that year, more than 60% of apartments under construction were in buildings of at least fifty units.[4] The surge in high-rise construction responded to renewed interest in cities, especially as millennials (b. 1981–1996) matured. Investors recognized their preference and were attracted to high-rises partly because they make maximum use of expensive land to create the highest quality apartments at the highest rents that a given location can bear. High-rises also offer deal sizes that are relatively large. High-rises in the NPI average US$121.2 million versus US$88.2 million for garden apartment properties.[1] The lag in high-rise investment performance reflects too much of a good thing when developers overshoot market demand that has perhaps been influenced by maturing millennials looking for more spacious garden apartments in the suburbs.

EXHIBIT 4: NCREIF-NPI APARTMENTS HOLDINGS AS % OF TOTAL

Source: National Council of Real Estate Investment Fiduciaries. As of 31 December 2021.

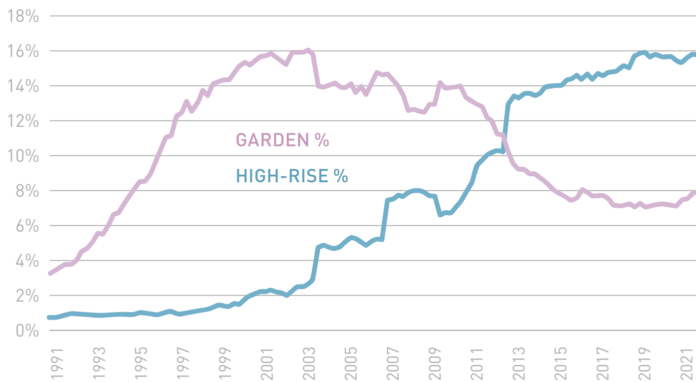


EXHIBIT 6: MORE GARDEN APARTMENTS AVAILABLE AT AFFORDABLE RENTS

Source: CoStar Realty Information Inc. As of 28 February 2022.

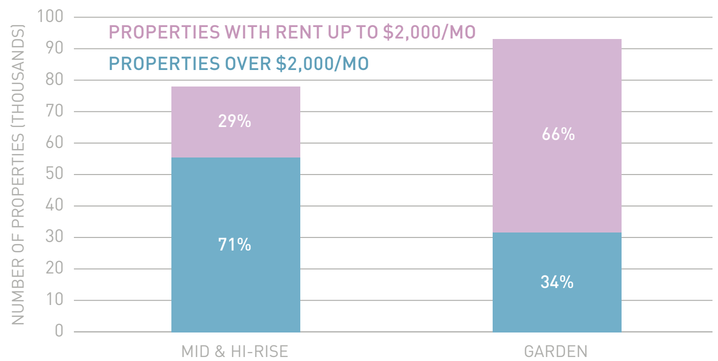


EXHIBIT 5: MULTIFAMILY HIGH-RISE (OVER 4 STORIES) COMPLETIONS (%)

Source: US Census Bureau. Survey on Construction. As of 1 June 2021.

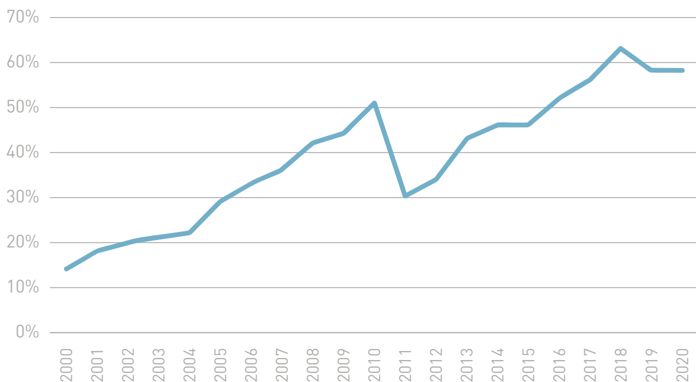
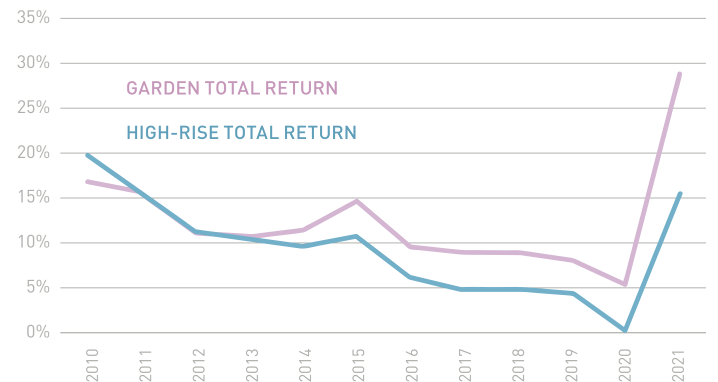


EXHIBIT 7: TOTAL RETURN HIGH-RISE VS. GARDEN APARTMENTS (YEAR-OVER-YEAR)

Source: National Council of Real Estate Investment Fiduciaries. As of 31 December 2021.



Garden apartments are less subject to demand-supply imbalances because they are less dense, with generally lower rents, and therefore less attractive for developers. As shown in *Exhibit 6*, 66% of garden apartments have rents of US$2,000/month or less versus only 29% of denser apartment properties. The lower rent profile of garden apartments is crucial in light of affordability constraints. Solid demand and relatively inelastic supply have helped total return on garden apartments to beat high-rises every year since 2014 *(Exhibit 7)*.

The affordability issue is well-illustrated in metrics showing that roughly 24% of renter households were severely cost-burdened in 2019, paying 50% or more of household income for housing, while another 22% of renter households were moderately cost-burdened, paying 30%–50%. Middle-income households in the US$30,000–US$74,999 income cohort were not spared, with 41% reported as cost burdened.[5]

Overall rental housing affordability is not likely to improve in the years ahead. On the demand side, student debt will continue to weigh on younger renter households without enough income growth to materially ease the burden. J.P. Morgan reports that 40% of millennials have student debt and that it consumes 40% of their income on average.[6] Moreover, single-family home prices and mortgage down-payment requirements put homeownership out of reach for many. A recent survey of millennials finds that only 15% have set aside $10,000 or more for a home purchase down-payment.[7] On the supply side, as long as land prices remain high, apartment developers will continue to have incentive to build high-rises. These conditions will likely continue to promote attractive investment prospects for the more affordable garden apartment segment of the rental universe.

SIZING THE INVESTMENT OPPORTUNITY

Costar data show a total of almost 94,000 garden apartment properties scattered across the US.[8] The bulk of these properties were built between 1960 and 1999 *(Exhibit 8)*. Few of these properties were renovated during the last ten years, suggesting that most need attention—if not extensive renewal *(Exhibit 9)*. The capital expenditure needs of these properties provide investors with an opportunity for making careful value-add improvements that can produce higher rents and longer useful life. As long as rents remain affordable compared to alternatives, investors can garner incremental return.

EXHIBIT 8: GARDEN APARTMENT PROPERTIES BY AGE

Source: CoStar Realty Information Inc. As of 28 February 2022.

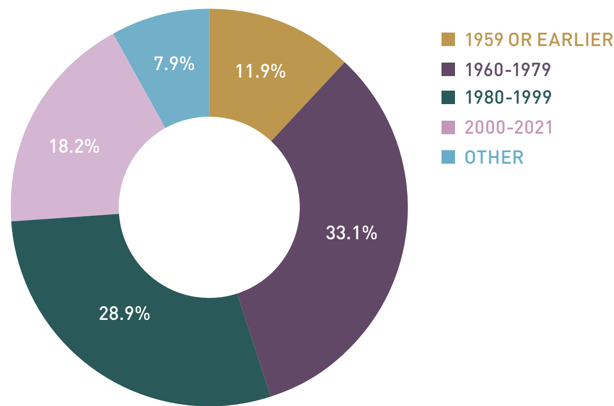


EXHIBIT 10: OWNERSHIP OF GARDEN APARTMENTS

Source: CoStar Realty Information Inc. As of 28 February 2022.

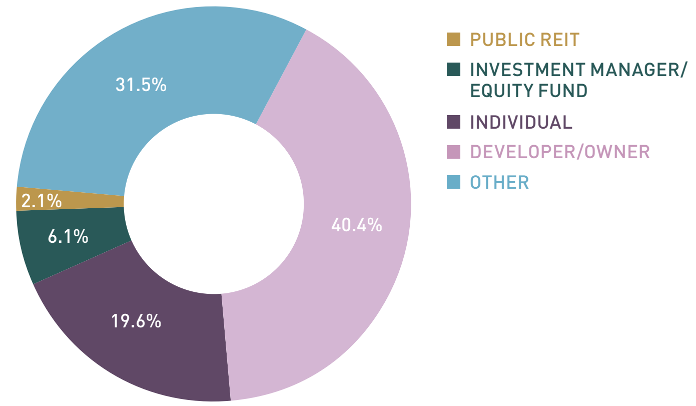


EXHIBIT 9: GARDEN APARTMENT PROPERTIES RENOVATED IN THE PAST 10 YEARS

Source: CoStar Realty Information Inc. As of 28 February 2022.

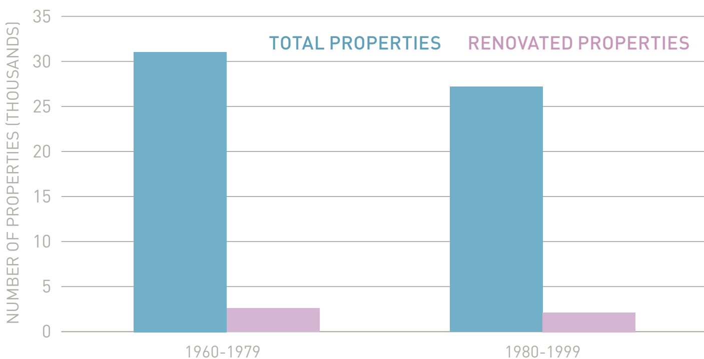
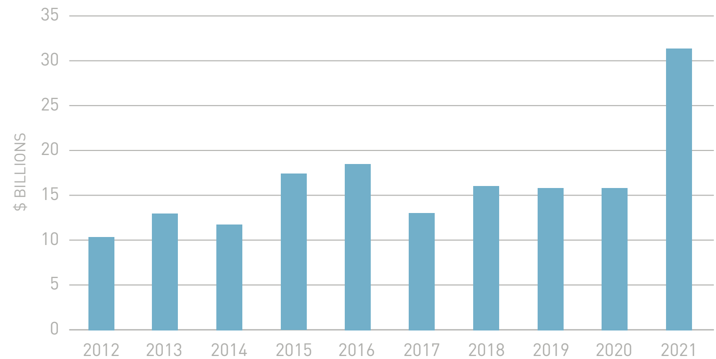


EXHIBIT 11: INSTITUTIONAL INVESTOR NET ACQUISITIONS OF GARDEN APARTMENT PROPERTIES

Source: Real Capital Analytics. As of 31 December 2021.



Despite this opportunity, Costar data shows that ownership of garden apartment properties is concentrated among developer-owners holding 40% and individuals holding 20% *(Exhibit 10)*. Properties owned by developers are largely medium- to lower-quality; only 18% of their 47,810 properties are in the highest quality category. For individual owners, almost 100% of holdings are in medium to lower quality categories. Investment managers and equity funds hold only 6% of garden apartment properties.[8]

In recent months, institutional investors seem to be paying more attention to the attractiveness of garden apartment properties. Their 2021 net acquisitions were more than 110% over the average of the prior nine years *(Exhibit 11)*. Moreover, more than a fifth of those acquisitions were joint ventures typically involving developer-owners. Such ventures might be undertaking value-add capital expenditures, or perhaps they simply reflect an appetite for experienced property management.

Institutional investors may be recognizing the attractiveness of garden apartment investments in light of their strong investment performance, depth of stock and value-add opportunities. Ongoing, pervasive affordability limits and homeownership constraints support demand for garden apartment rentals, while supply remains constrained by developers' preferences for high-rises.

ABOUT THE AUTHOR

Martha Peyton is Managing Director of Applied Research for Aegon Asset Management, the global investment management brand of Aegon Group.

NOTES

[1] National Council of Real Estate Investment Fiduciaries, ncreif.org, accessed December 31, 2021.

[2] Real Capital Analytics, rcanalytics.com, accessed December 31, 2021.

[3] "New Residential Construction," United States Census Bureau, census.gov/construction/nrc/index.html, accessed June 1, 2021.

[4] "America's Rental Housing 2020," Joint Center for Housing Studies of Harvard University, jchs.harvard.edu/americas-rental-housing-2020, accessed April 29, 2022.

[5] "America's Rental Housing 2020," Joint Center for Housing Studies of Harvard University, jchs.harvard.edu/americas-rental-housing-2020, accessed April 29, 2022.

[6] Jack Manley, "Millennials: Unique Challenges for Younger Investors," JP Morgan Asset Management, updated July 14, 2021, am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/market-updates/on-the-minds-of-investors/millennials-unique-challenges-for-younger-investors/, accessed April 29, 2022.

[7] Rob Warnock, "Apartment List's 2021 Millenial Homeownership Report," Apartment List, updated February 9, 2021, apartmentlist.com/research/millennial-homeownership-2021, accessed April 29, 2022

[8] CoStar, costar.com, accessed December 17, 2021. Data excludes military, dorms, condos, co-ops, and vacation units.

REVIEWER COMMENTS

The data in the article speaks and is compelling. On a national average basis, high-rise and high rent properties have underperformed compared to low-rise and low rent properties. Moreover, prospects for future garden apartment demand growth appear bright due to housing unaffordability. That said, with US population growth plummeting and migration moving away from the demand centers of the pre-pandemic decade, this excellent analysis might be cut a little finer for future investments.

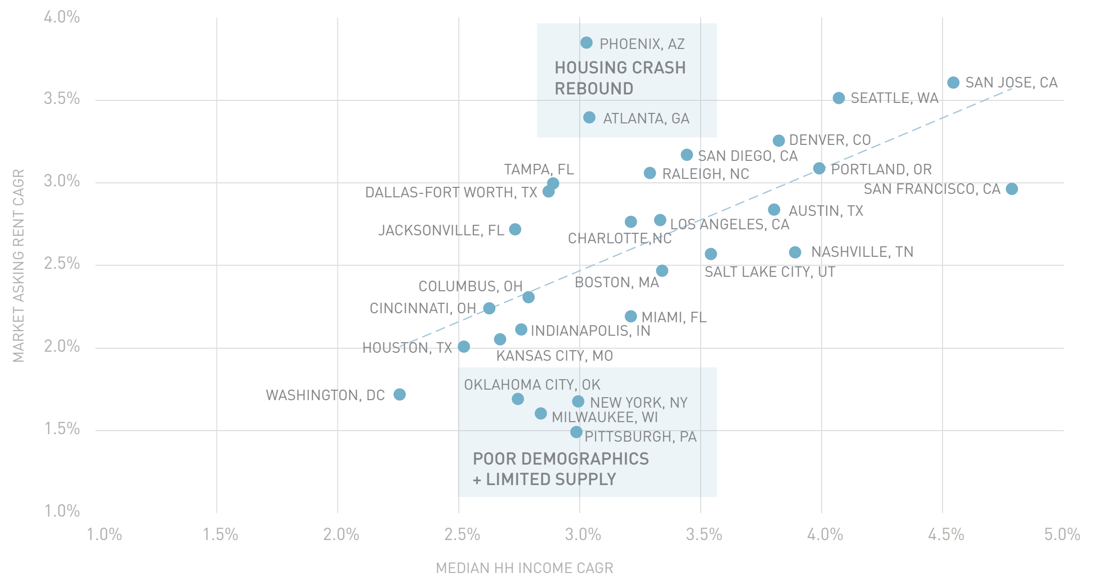
Until recently, some analysts believed garden apartment investment broadly benefitted from sale prices below replacement costs. In effect, these assets were sheltered from the impact of new supply as it was not economical to build non-high-rise suburban or non-CBD-urban apartments. Today, sales prices for garden style assets often appear to be above replacement cost, stimulating supply in low-rise assets where development was not previously economical. As a result, the dynamics of investing in garden-style apartments might require even more careful analysis of where local income growth can support already onerous rent burdens.

As the author points out, more institutional investors are moving into the garden apartment space and prices are rising. As a result, it may behoove investors to also focus on geographies enjoying household income growth, which is highly correlated with rent growth. The downside exceptions occurred when overall population growth was low and development versus demand growth was high, a risk that bears watching in the 2020s.

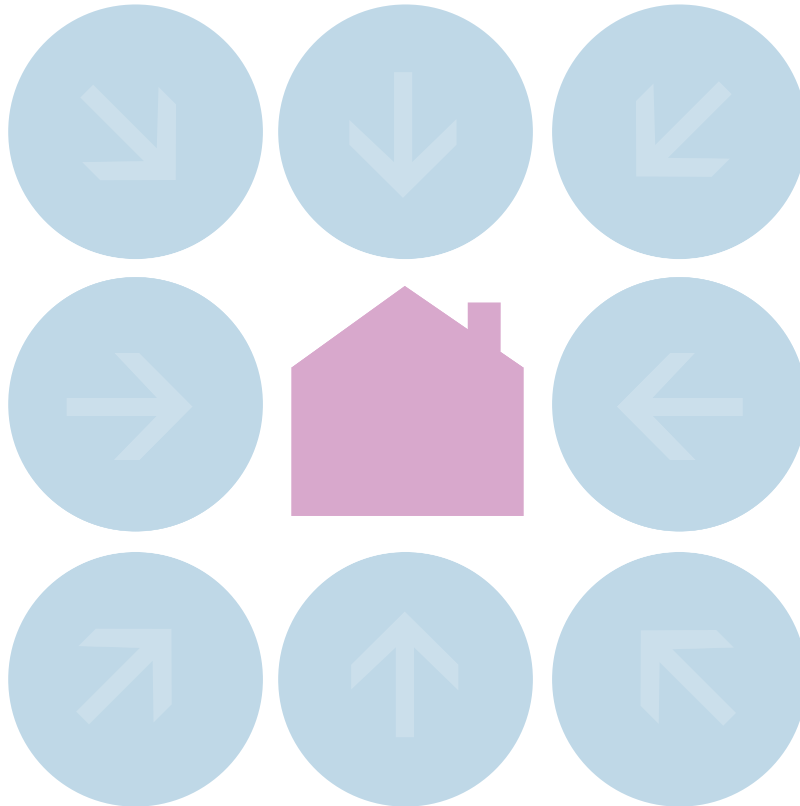
– Hans Nordby
Summit Journal Editorial Board Member
Head of Research and Analytics, Lionstone Investments

10-YEAR MARKET ASKING RENT CAGR VS. MEDIAN HOUSEHOLD INCOME CAGR (DATA AS OF 2019)

Source: Lionstone Research and CoStar, as of January 2022



SINGLE-FAMILY DEMAND



Daniel Manware
Director
Nuveen Real Estate

As an increasingly popular asset class for institutional investors, single-family rentals are supported by strong future demand drivers to propel sector outperformance.

Single-family rentals (SFRs) are a sizeable investment opportunity, as the sector comprises one-third of US rental inventory with nearly 16 million units. The SFR market is currently valued at US$4.4 trillion. The majority of new SFR inventory comes from owner-occupied stock, indicating that there is potential to invest in the owner-occupied single-family housing market, currently valued at US$26.6 trillion.

In total, the single-family housing market is valued at more than US$30 trillion, which is more than double that of the traditional commercial real estate market (valued at US$13.4 trillion). The SFR market is 98% dominated by non-institutional players. In recent years, REITs and private players have entered the SFR market, starting the institutionalization of the sector.

During the next decade, institutional real estate portfolios will likely transform as investors gain more familiarity with SFRs and start increasing their allocations to them. Google Search Trends data indicates that the search for "Single House for Rent" has significantly increased over the last decade *(Exhibit 4)*, signaling the overall interest and curiosity in this property type from both potential renters and investors. We anticipate SFRs will play a more significant role in institutional real estate portfolios in the coming decades as investors have recognized their resiliency throughout the COVID-19 pandemic. But before SFRs become a part-and-parcel component of institutional real estate portfolios, investors should consider adding them to their portfolios as a way to drive outperformance and generate enhanced returns.

EXHIBIT 1: OVERALL HOUSING AND RENTAL INVENTORIES

Source: JCHS tabulations of US Census Bureau, 2022

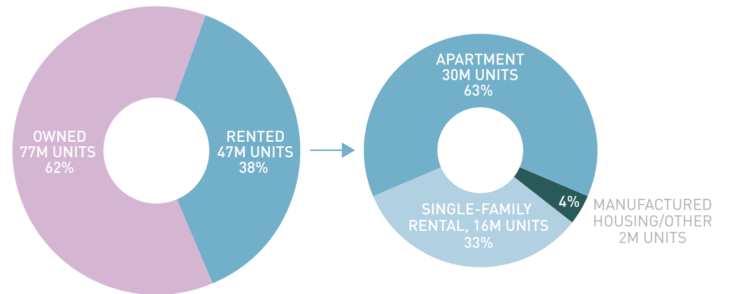


EXHIBIT 2: MARKET VALUE OF SINGLE-FAMILY HOUSING VS. CRE

Source: Nuveen; US Census Bureau; CoStar, February 2022

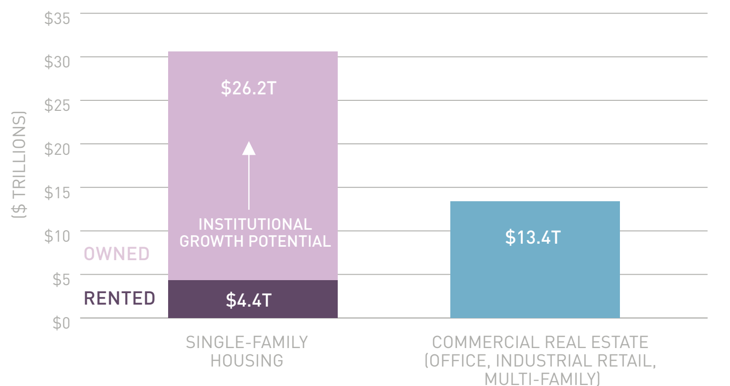


EXHIBIT 3: SFR MARKET BY DISTRIBUTION PORTFOLIO SIZE OF INVESTOR-OWNED HOMES

Source: John Burns, January 2022

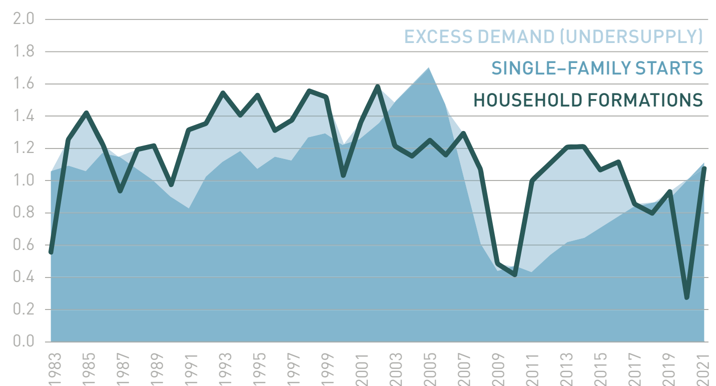
EXHIBIT 4: GOOGLE SEARCH: "SINGLE HOUSE FOR RENT"

Source: Google Trends, February 2022

Note: Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular.

EXHIBIT 5: SINGLE-FAMILY HOUSING STARTS VS. HOUSEHOLD FORMATION

Source: US Census Bureau; Moody's Analytics, February 2022



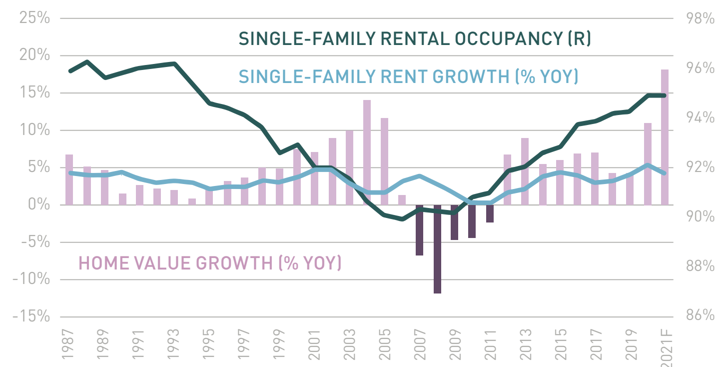
LACK OF SUPPLY AND OUTSIZED DEMAND

Our analysis of single-family housing starts compared to household formations *(Exhibit 5)* indicates that there is currently an undersupply of approximately 4.7 million homes. The lack of single-family housing supply has driven months' supply of inventory to historical lows and home price appreciation to record highs, further inhibiting homeownership for many aspiring families. Specifically, construction for homes under 1,800 SF, an applicable proxy for a starter home, is well below historical levels.

SFRs have boasted healthy operating fundamentals throughout the last decade, including during the COVID-19 pandemic. SFR demand has improved significantly in recent years as occupancy has grown 500 BPs since the GFC from 90% to 95% in 2021 *(Exhibit 6)*. SFR rent growth remained positive throughout prior recessionary environments, unlike overall home value growth, which turned negative.

EXHIBIT 6: SINGLE-FAMILY RENT GROWTH AND OCCUPANCY VS. HOME VALUE GROWTH

Source: John Burns, January 2022



KEY DEMAND DRIVERS

SFRs are favorably positioned to benefit from various demand drivers in the next several years including:

- Demographic wave into the prime SFR age cohort
- Continued migration to suburbs and Sunbelt markets
- Millennials outgrowing apartments
- Millennials' financial headwinds to homeownership

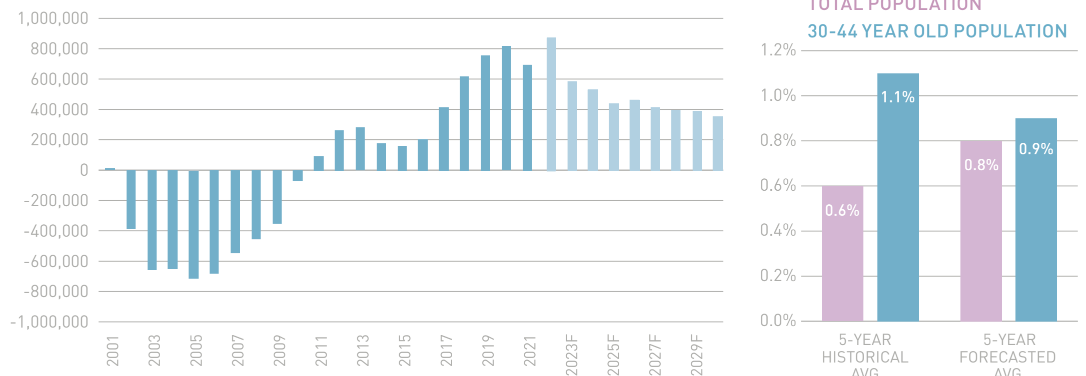
The aging of millennials into the key SFR cohort (ages 30–44) is a critical secular tailwind for the sector.

DEMOGRAPHIC WAVE INTO KEY RENTER COHORT

Certain key demographic shifts occurring in the US will have profound implications for alternative housing sectors, including SFRs. The aging of millennials into the key SFR cohort (ages 30–44) is a critical secular tailwind for the sector *(Exhibit 7)*. This key age cohort is projected to grow from 65.7 million in 2021 to 70.2 million in 2030. The growth of this cohort has outpaced the overall US population over the last five years and is projected to continue outpacing the US population over the next five years. Historically, the growth of this key age cohort has empirically proven to be a driver of SFR rent growth *(Exhibit 8)*.

EXHIBIT 7: US POPULATION GROWTH OF 30–44-YEAR-OLDS

Source: StratoDem Analytics, January 2022

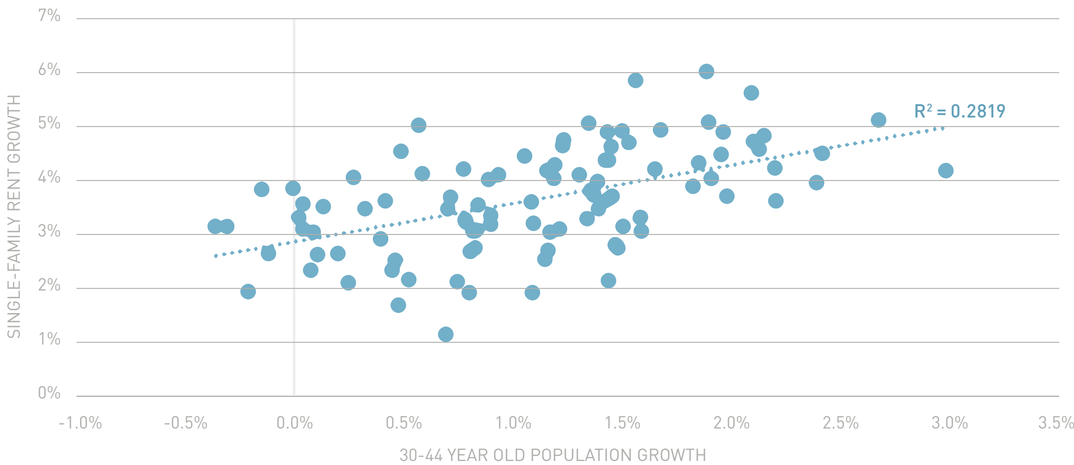


SFRs have boasted healthy operating fundamentals throughout the last decade, including during the COVID-19 pandemic.

Forecasted migration data indicates Sunbelt markets will continue to lead the nation for population growth.

EXHIBIT 8: POPULATION GROWTH OF 30–44-YEAR-OLDS VS. SFR RENT GROWTH

Source: StratoDem Analytics; John Burns, February 2022



Note: % p.a. growth

SUBURBAN RESURGENCE AND MIGRATION TO THE SUNBELT

It is important to recognize that millennials are more mobile than prior generations and are not necessarily prepared to purchase a home and settle in one area. Consequently, the top reason single-family renters prefer to rent than buy is due to the flexibility to move if desired or needed. SFRs are favorably positioned in a post-COVID-19 environment given the pandemic's profound impact on urban areas.

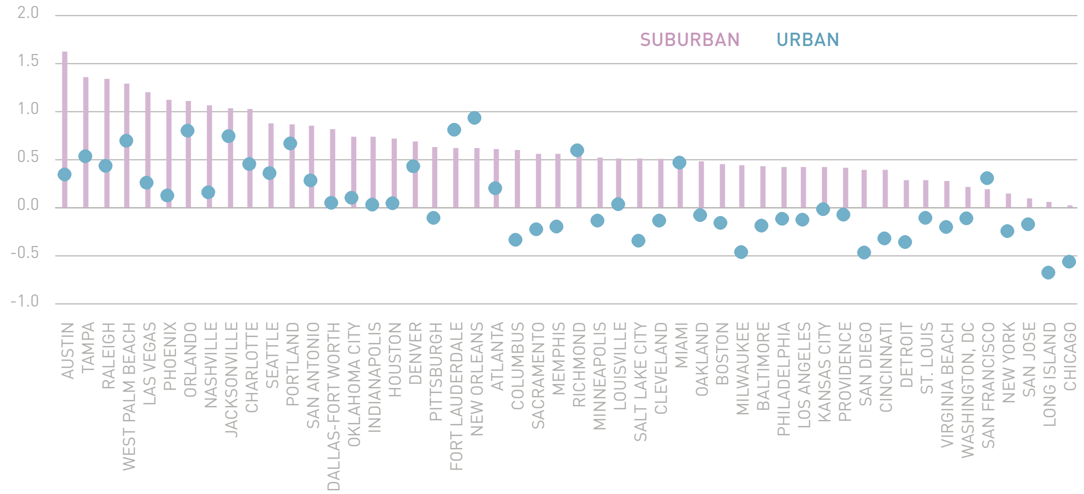
The suburban resurgence forecasted for this decade is likely to accelerate as a result of the COVID-19 pandemic, fueling demand for SFRs. During the COVID-19 pandemic, city dwellers fled major urban areas for nearby suburbs and Sunbelt markets. Across the majority of metropolitan areas in 2020 and 2021, net migration rates were stronger in suburban areas than urban areas. According to the National Association of Realtors (NAR), 54% of homes purchased by those ages 31 to 40 were located in suburban locations, and the leading factor that led to moving was a life change (e.g., addition to family, marriage, etc.).

An analysis of Placer.AI geolocation mobility data validates that the majority of those moving to Sunbelt markets have migrated from more expensive coastal markets. For example, over the last two years, the most migrants to Tampa, originated from New York City, while the most migrants to Dallas-Fort Worth originated from Los Angeles. We believe the out-migration from coastal markets will accelerate due to unfavorable affordability, high taxes, and elevated impacts from the COVID-19 pandemic. Forecasted migration data indicates Sunbelt markets will continue to lead the nation for population growth. This trend is favorable for SFRs given the large opportunity set available in the Sunbelt markets.

Several Sunbelt markets have benefited from favorable employment growth tailwinds in recent years given the region's favorable business environment and in-migration of an educated workforce. Employment growth has empirically proven to be a critical driver vs. SFR rent growth. Markets including Nashville and Charlotte have benefited from strong employment growth and consequently have exhibited strong SFR rent growth. The COVID-19 pandemic sparked numerous company expansions and relocations to the Sunbelt markets for a more business-friendly environment. The imminent employment growth in this region as a result of these expansions and relocations will further bolster the SFR market.

EXHIBIT 9: SUBURBAN/URBAN NET MIGRATION RATES ACROSS TOP FIFTY METROS (2021)

Source: StratoDem Analytics, January 2022



Note: Urban/suburban classifications are census tract-level definitions as classified by HUD's 2017 American Housing Survey Neighborhood Description Study

EXHIBIT 10: TOP OUT-OF-STATE MIGRANT ORIGINS USING REAL-TIME PLACER.AI MOBILITY DATA (DECEMBER 2019-DECEMBER 2021)

Source: Placer.AI, February 2022

	TO: TAMPA, FL	TO: DALLAS-FORT WORTH, TX
#1	NEW YORK, NY	LOS ANGELES, CA
#2	CHICAGO, IL	CHICAGO, IL
#3	ATLANTA, GA	NEW YORK, NY
#4	WASHINGTON, DC	RIVERSIDE, CA
#5	PHILADELPHIA, PA	SAN DIEGO, CA

EXHIBIT 11: FORECASTED POPULATION GROWTH BY METRO (2021-2026 % P.A.)

Source: StratoDem Analytics, February 2022

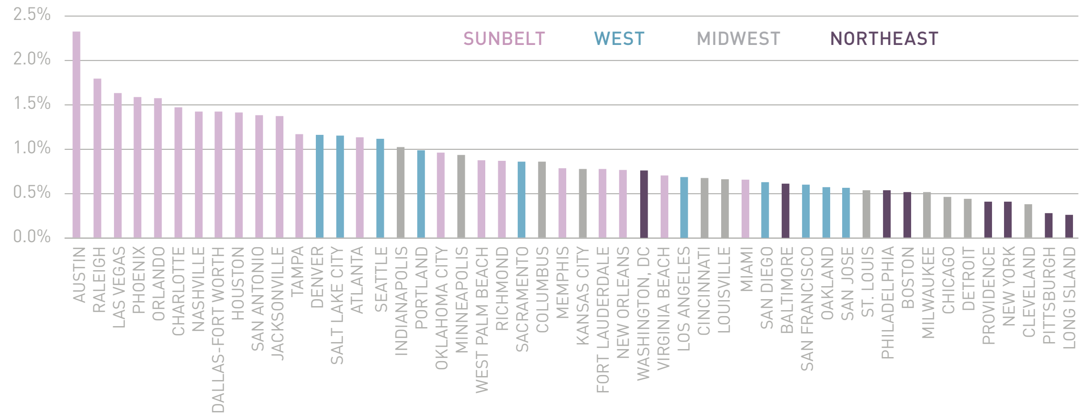


EXHIBIT 12: EMPLOYMENT GROWTH VS SFR RENT GROWTH

Source: StratoDem Analytics; John Burns, February 2022

Note: % p.a. growth

MILLENNIALS OUTGROWING APARTMENTS

Throughout the last decade, millennials have been a major driver of conventional apartment demand. As millennials age, start families, and demand space for home offices and remote learning, they are likely to outgrow their one and two-bedroom apartments. Yet, only 12% of apartment units in the US have three or more bedrooms, compared to 65% for single-family homes. Nearly one-half of new single-family renters in Q3 2021 moved from apartments, according to John Burns' SFR Survey. The permanent adoption of flexible WFH policies as a result of the pandemic is likely to serve as an additional tailwind for SFRs as professionals demand more space in their homes to conduct business.

The permanent adoption of flexible WFH policies as a result of the pandemic is likely to serve as an additional tailwind for SFRs as professionals demand more space in their homes to conduct business.

EXHIBIT 13: ORIGIN OF NEW SINGLE-FAMILY RENTERS

Source: John Burns SFR Survey, November 2021

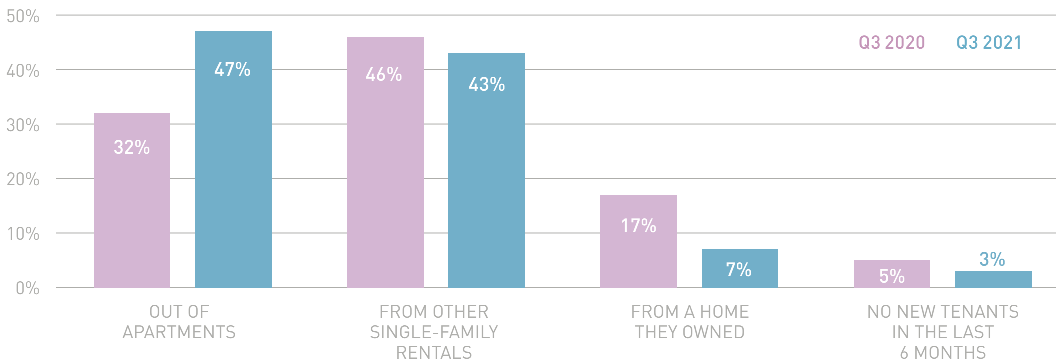
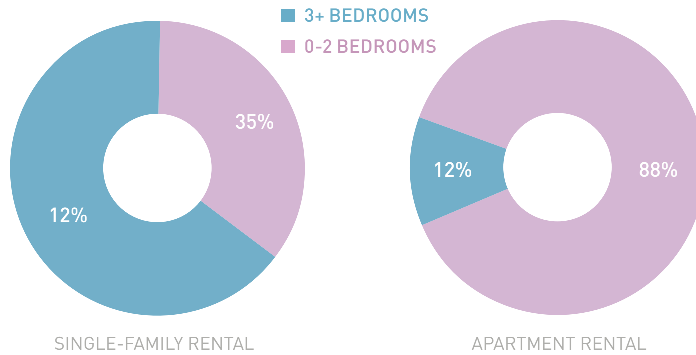


EXHIBIT 14: BEDROOM COUNT: SFR VS. APARTMENT

Source: JCHS tabulations of US Census Bureau, 2022



MILLENNIALS' FINANCIAL HEADWINDS TO HOMEOWNERSHIP

Purchasing a single-family home would be the next natural step for millennials as they age, but this is out of reach for many. Millennials have experienced two recessions in their young adult lives (GFC and COVID-19) and are largely unable to afford a 20% down payment and mortgage. This will be a key future driver of SFR demand.

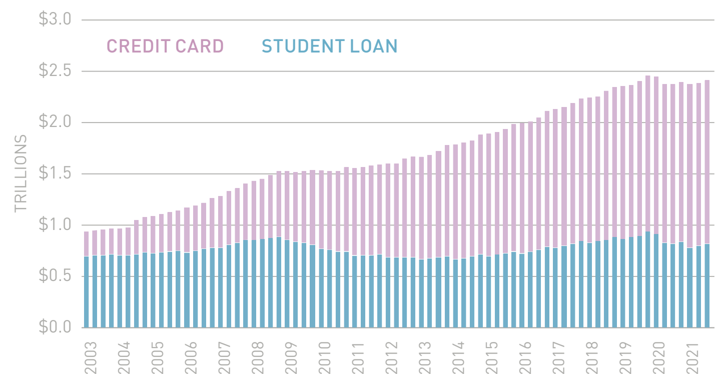
Mortgage lenders have remained conservative relative to the GFC. A poor debt-to-income ratio was the leading reason mortgage lenders rejected buyer applications for those ages 31–40, according to NAR. Experian data indicates that student loan debt continues to be the major driver of debt compared to credit cards. Poor credit is an additional headwind for millennials. Consequently, millennials currently have disadvantaged FICO scores compared to older generations, posing additional challenges for homeownership. High amounts of debt and low FICO scores will prevent millennials from owning homes at the same rate as previous generations. Our analysis of household net worth for those under 44 years old indicates that across 64% of metropolitan areas, households under 44-years-old do not have adequate funds for a 20% down payment.

As a result of these affordability headwinds, coupled with current supply constraints, younger households have grown pessimistic at near-term homeownership. A recent Fannie Mae poll indicated that a record-low 25% of respondents reported that it's a good time to buy a home, compared to 69% of consumers who reported that it's a good time to sell. While potential homebuyers believe that now is a bad time to buy a home due to elevated pricing, the relative pricing remains attractive for institutional investors.

Institutional investors are accustomed to placing a value on an income stream, unlike traditional homeowners. By this metric, cap rates on single-asset SFR purchases are approximately 100 BPs wide of apartment properties, indicating a compelling discount. Moreover, once a small portfolio of SFRs has been aggregated, the income stream for an investor is much more stabilized and represents a more efficient investment, resulting in a further 75–125 BP premium to a single-asset SFR purchase. As such, while home values may seem elevated to an individual owner, we believe now is a compelling time to buy single-family homes to rent.

EXHIBIT 15: DEBT OUTSTANDING ($T)

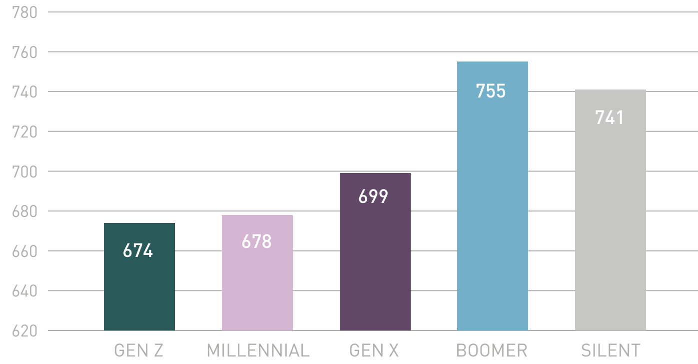
Source: New York Fed Consumer Credit Panel; Equifax, January 2022



Millennials have experienced two recessions in their young adult lives (GFC and COVID-19) and are largely unable to afford a 20% down payment and mortgage.

EXHIBIT 16: CREDIT SCORE TRENDS BY GENERATION

Source: Experian, 2021



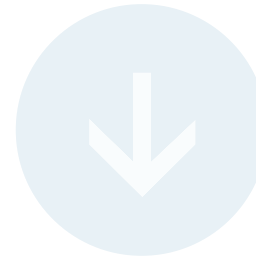
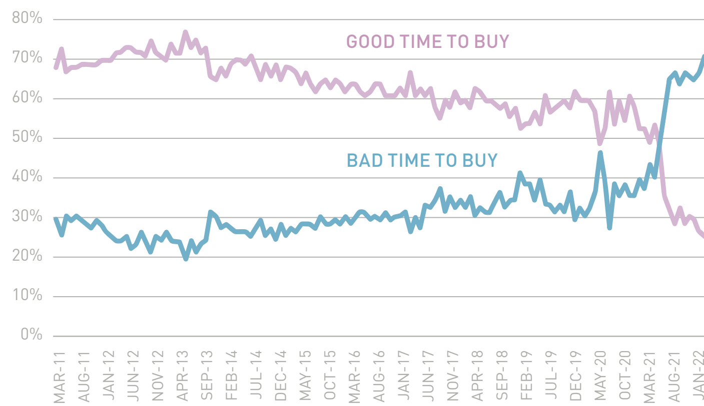


EXHIBIT 17: HOME PURCHASE SENTIMENT INDEX: FANNIE MAE RESPONDENTS SURVEY

Source: Fannie Mae, February 2022



RESILIENT HISTORICAL AND PROJECTED PERFORMANCE

Historically, SFRs have achieved stronger rent growth, NOI growth, and overall commercial property price index (CPPI) growth than apartments. SFR rent growth has consistently been extremely resilient as it has never turned negative. Throughout several recessions, apartment rent growth has turned negative and has had higher volatility compared to SFR rent growth, which was steadily positive and less volatile. Similarly, SFR NOI growth has remained positive throughout the COVID-19 pandemic, unlike apartments and traditional real estate property types overall that turned negative. Given the sector's numerous tailwinds, SFRs have favorable NOI growth and return projections. Further, the SFR sector has historically been higher yielding than the apartment sector. Since 2017, SFRs have achieved nearly a 40 BP premium over apartments. This spread has widened since COVID-19 and is currently over a 100 BP premium.

Given the sector's favorable pricing relative to other property types and resilient demand drivers, SFRs are expected to achieve higher risk-adjusted returns than apartments and traditional commercial real estate property types overall. Therefore, investors should consider adding SFRs to their portfolios as a way to drive outperformance and generate enhanced returns.

EXHIBIT 18: EFFECTIVE RENT GROWTH (% YOY)

Source: RealPage; John Burns, January 2022

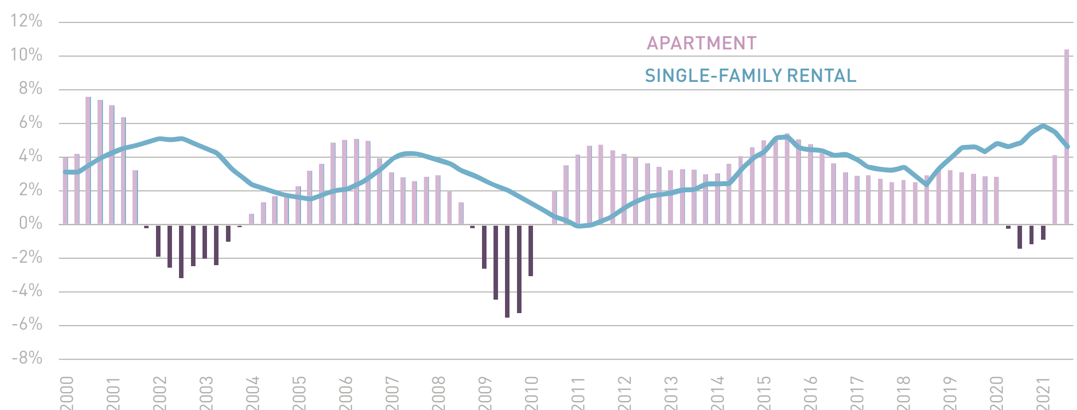
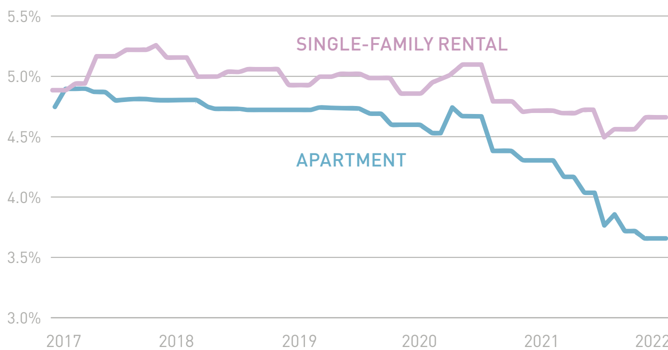


EXHIBIT 19: CAP RATES AND SINGLE-FAMILY SPREAD TO APARTMENTS

Source: Green Street, February 2022



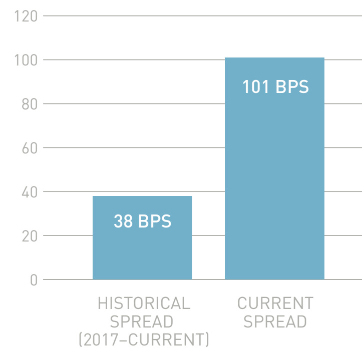
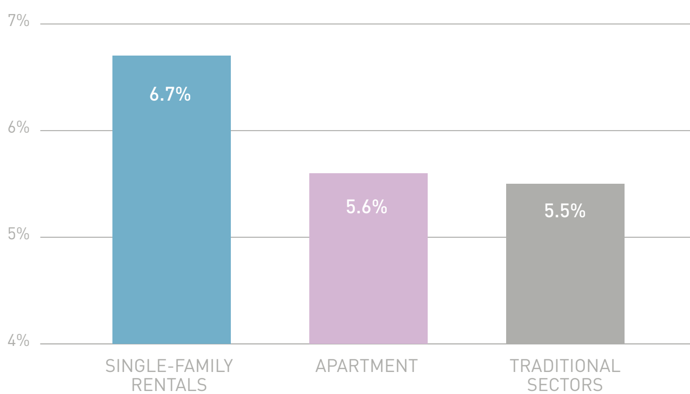


EXHIBIT 20: EXPECTED RISK-ADJUSTED RETURNS

Source: US Census Bureau, 2021



ABOUT THE AUTHOR

Daniel is a Director for Nuveen Real Estate. He is responsible for evaluating market dynamics and trends across all property types in order to create strategic investment recommendations for portfolio management teams.

Given the sector's favorable pricing relative to other property types and resilient demand drivers, SFRs are expected to achieve higher risk-adjusted returns than apartments and traditional commercial real estate property types overall.

REVIEWER COMMENTS

The author presents a compelling investigation of the demand drivers for SFR in the US, reasoning that millennials have outgrown urban apartments and are looking for more space, particularly in low-cost Sunbelt suburban areas. The increasing cost of home ownership, in addition to economic shocks resulting from the COVID-19 pandemic, has accelerated the demand for this type of housing. Investors in this potentially immense asset class could achieve higher returns for relatively lower risks than other types of real estate, including multifamily apartments.

While the author offers evidence that in the past two years suburban areas saw greater growth than urban areas and suggests that this is the acceleration of an existing trend, it is unclear if there is any risk of reversal. It is not impossible to imagine a scenario in which suburban dwellers once again seek easy access to amenities of urban areas (e.g., childcare), especially as pandemic restrictions dissipate. What evidence is there that this trend will remain?

The article identifies a supply shortage of new SFR homes, but does not explore the reasons. Is the shortage potentially related to COVID-19 market disruptions, which could be reversed in the short- or mid-term? Or is this a structural issue that a potential investor could benefit from as a long-term barrier to entry?

Although it is beyond the scope of this article, further investigation should also discuss the mechanics of gaining exposure to this sector. It is challenging for an institutional investor to build a platform of significant scale and manage the operations of an SFR portfolio. This challenge may explain why the vast majority of SFR is not currently institutionally owned and most existing portfolios only include one to two homes.

– Peter Grey-Wolf
Summit Journal Editorial Board Member
Vice President, Wealthcap

ESSENTIAL HOUSING

Todd Williams
Chief Investment Officer
Grubb Properties

The US is facing an unprecedented housing crisis as the current housing market is 5.24 million homes short of what is needed to meet demand.[1] Much of that shortfall is in the moderately priced rental housing segment. This gap in "essential housing" is caused by both a demand issue, resulting from a long-lasting shift in demographics, and a constraint in supply caused by the rapidly rising costs to build housing.

Multifamily housing historically has been an effective hedge against inflation compared with other commercial real estate asset classes. Lease terms are generally shorter and more favorable, which gives investors the opportunity to reprice rents as prices increase. But when inflation rises, so too does the cost of living, pushing housing further out of reach for many hard-working citizens. Essential housing is well-placed to benefit from accelerating demand as inflation pushes rents higher.

The US is in the middle of one of the biggest housing crises that the country has ever seen. A more resilient approach to housing will be critical as inflation pushes rents ever-higher.

WHAT IS ESSENTIAL HOUSING?

For this article, we can define essential housing as product for households earning more than 60% of an area's median income (AMI), putting these households above the cutoff for a public housing subsidy, but less than 140% of that AMI, putting them below the threshold to afford luxury housing. Under this definition, essential housing should serve about 41 million households in the US, offering working professionals an affordable, quality housing option in urban markets.

Essential housing is not to be confused with workforce housing, which largely serves middle-income working families through existing rental product. Workforce housing often has a greater number of configurations, with 2–4 bedrooms, and is typically located in suburban areas close to schools. While this is a critically important component of the US housing stock, these unit configurations and locations largely don't fit the needs of young people entering the workforce today. Essential housing is also not luxury housing, which targets those earning above 140% of the AMI, and which is currently saturating the market in most cities. The Wall Street Journal found that 80% of the 371,000 new rental apartments expected to be built in 2020 were luxury properties.[2]

One issue driving the shortage in essential housing is the growing demographic demand from the large millennial and Gen Z generations who are already in or about to enter the workforce. Given that peak births occurred in 2007 (making that population 15 years old in 2022), this demographic force is expected to last at least another decade. In addition to this overall demand, there is also pent-up demand for housing among this population: in February 2020, largely before the COVID-19 pandemic came to the US, 47% of 18–29-year-olds were living with at least one parent, according to the Pew Research Center.[3] In 2020, the impact of the pandemic only created more pent-up demand and pushed more than 52% of this age group to be living at home.

Despite this demand, housing supply has remained at historic lows because of the cost challenges in building new housing. Several factors contributing to the rise in cost are:

Rising land costs. Between 2012 and 2017, the value of land used for single-family housing in the US rose almost four times faster than inflation. As a result, the median price per acre of land under existing single-family homes rose 27%.[4] In 2019, the median land value of a quarter-acre lot occupied by an existing single-family home was a staggering 60% higher than it was in 2012.[5] This land trend suggests that land costs play a key role in the runup in home prices, with no relief in sight.

Rising construction costs. Another significant challenge is the unprecedented inflation in construction costs, something that has affected the entire housing industry. The Turner Building Cost Index found the ten-year average compound annual growth for construction costs is 3.95%—approximately 25% higher than the average wage growth over the same time period.

Pandemic ripple effects. Supply chain problems are interfering with the cost and availability of construction inputs such as lumber, concrete, steel, and many fixtures needed to complete new builds. For example, lumber, which normally fluctuates between US$200 and US$500 per thousand-board-feet, reached a record high price of US$1,700 per thousand-board-feet in April 2021 and has continued to vary significantly. This rise in lumber prices caused the price of an average new single-family home to increase by nearly $18,600 as of January 2022, according to the National Association of Home Builders.[6]

Housing costs have outpaced wage and inflation growth for some time. With the coronavirus pandemic and related economic contractions, it's expected this trend will accelerate precipitously, putting housing out of reach for an even larger swath of younger, employed Americans.

This economic pressure will expand the "missing middle" renters who don't qualify for subsidized housing but cannot afford the luxury housing that is the majority of new construction. For example, Trulia recently found that teachers could afford less than 20% of the homes for sale in 11 of 55 major US metro areas studied. The essential housing gap leaves the "missing middle" without a tangible path to homeownership and, ultimately, to economic stability and mobility. The Financial Times recently found that in 2020, many millennials, now in their 30s, own just 3% of all household wealth. Comparatively, baby boomers had 21% of household wealth when they reached their late 30s in the 1990s.[7]

This "missing middle" population needs quality housing that they can afford in locations that work for them—making essential housing even more essential at this exact moment in time.

Although the essential housing gap is a considerable problem, it also presents a significant opportunity for investors to be part of what we believe to be one of the most resilient asset classes, where there is little competition.

HOW DO WE TACKLE THE PROBLEM?

There is an achievable solution to the housing gap that serves all stakeholders: investors, potential residents, and our broader community. For example, Grubb Properties enacts this solution through our Link Apartments℠ brand, which is focused on intelligent design and resident amenities to provide a lower cost, urban infill living opportunity.

In developing Link Apartments℠, Grubb Properties has focused on two key differentiators: location and price point. We choose urban locations that are near community amenities, transit options, and major counter-cyclical employment anchors such as research universities and medical centers. We also target rents that are affordable to residents earning 60-140% of area median income.

How are we able to achieve those prices in these target locations, where virtually no other multifamily product is being developed at this price segment? We drive value through a variety of proven proprietary methods, such as innovative site acquisition, shared parking, tax incentives, grants, and more. For example, we focus on just six highly efficient floor plan types that we replicate across all our communities. This is unique in the industry, where the standard is often more than 25 unit-types.

We also rely on our 59-year-history and deep experience in both multifamily office investment to help with innovative site selection, which helps us reduce costs. For example, in many markets we acquire office buildings in urban infill locations with acres of surface parking. We then develop a community on that land, including a parking garage that is shared between the office tenant and the new residents. This strategy saves on construction costs and provides a steady non-tenant revenue stream.

We also look at sustainability and ESG principles as investment tools that can drive down the recurring cost of utilities for our residents, further enhancing affordability. Our most recent community earned a National Green Building Standard (NGBS) Silver designation. Our 2021 combined GRESB Sustainability Benchmark improved 19% over our 2020 score, while our 2021 GRESB Sustainability Benchmark Development Score is 81 out of 100, above the global average.

Focusing on the customer delivers both a better resident experience and the returns investors expect through a truly differentiated product that addresses a major market gap.

WHAT IS THE BENEFIT FOR INVESTORS?

For the investor, essential housing provides a stronger margin of safety than building luxury apartments, because essential housing is driven by demographics rather than by how well the economy is performing at any given moment. The large millennial and Gen Z populations are already facing a housing shortage, and the cost pressures constraining the supply are only going to intensify over the next few years.

By targeting the missing middle population, essential housing can reach a larger audience that is drastically underserved by most of the product being built today. This provides an opportunity for investors to participate in a resilient, risk-mitigated strategy, with little competing product in urban markets throughout the US.

Essential housing is desperately needed in both gateway markets and high growth cities and can be an appealing product for investors looking to enter those markets. Gateway markets like Los Angeles, the Bay Area, and New York City have experienced decades of housing challenges, and the problem is worsening.

The pandemic created a unique opportunity for developers to enter these resilient markets at a discount as people temporarily shifted from high-density cities to lower-density ones. This short-term shift in demand for housing created buying opportunities for sites in these dense markets, lowering the cost and availability of one of the most critical inputs: land.

High-growth markets, by definition, have a high demand for housing that is driving construction costs up even further. These cities, such as Charlotte and Atlanta, are struggling to build enough housing, and the housing they are building is mostly luxury and therefore unaffordable to many of their residents.

While fast growth makes these markets challenging, Grubb Properties is often able to deploy techniques to drive down our effective cost, such as sourcing land for free through our commercial division or negotiating tax abatements in exchange for moderate-priced housing, among other creative methods. This allows for a diversification of markets in an investor's portfolio, and an opportunity to invest in some of the most resilient markets with economies and job centers that perform well even during economic downturns.

The growing need for essential housing ultimately fuels our belief that providing essential housing is not just a smart policy and a good investment strategy—it's also a moral imperative.

ABOUT THE AUTHOR

Todd Williams is the Chief Investment Officer at Grubb Properties and is responsible for leading the company's private equity real estate investment programs and institutional joint ventures, including the development, launch and fundraising for discretionary funds that provide equity capital for the company's real estate investments.

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REVIEWER RESPONSE

What stands out here is a view of essential housing that specifically carves out middle-income working families. Per data from the Harvard JCHS tabulations of the US Census Bureau ACS (which, understandably, is reported on a considerable lag), roughly half of moderately cost-burdened renter households were over the age of 45 in 2019. This suggests the other half is under the age of 45, and perhaps that is the subset the authors are focused on here, but to expand the conversation, it would be insightful to understand why their approach is to focus solely on a portion of the larger cost-burdened pie.

The authors also seem to infer that luxury apartments aren't driven by demographics. It could be argued that the rise and relative successes of luxury properties in the most recent cycle were precisely due to demographics—namely, millennials moving to the urban cores. Instead, one could argue that essential apartments are more insulated from economic cycle risk because there is always someone to backfill a more affordably priced apartment in a downcycle.

One thought inspired by this article, perhaps for further exploration in a different conversation, was the mention of tax abatements from local municipalities as a mechanism for securing below-market land. In the example given in this article, it would be interesting to see what percentage of their Link Apartment deals were subsidized in this way, and if there's a risk that budget deficits at the local level could stymie this funding avenue in the future.

– Sabrina Unger
Summit Journal Editorial Board Member
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LODGING TAKES THE LEAD

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As a labor-intensive and service oriented asset class, hospitality is uniquely positioned to be a leader in advancing sustainability goals for investors.

The pandemic has caused a reckoning of sorts and has demonstrated the importance of embracing more environmentally friendly and socially responsible governmental policies and business practices. As active influencers of the world we live in, corporations and governments are being pressured to contribute and more aggressively advance their efforts in creating a sustainable, healthy, and just world.

Environmental, social and corporate governance (ESG) standards have evolved beyond corporate statements into the actual demonstration of action and proof of positive results. The hospitality industry is amid one of the most profoundly transformative periods of its history, as it continues to recover from the most dramatic drop in performance brought on by COVID-19. At this moment in time, the hospitality industry is uniquely positioned to be a leader in advancing sustainability goals as hotels are a labor-intensive and service-oriented asset class that relies heavily on workers, utilities, water, energy, and waste elimination processes.

COVID-19 accelerated and brought to the forefront the important and urgent changes the industry needs to prioritize. With the lessons learned, the industry can play a critical role advancing impactful environmental and social considerations.

OPERATIONAL EFFICIENCIES

Prioritizing efforts that lower the industry's carbon footprint and reduce climate risk will be imperative in managing operational costs and, more importantly, in helping protect communities and the environment.

Operators are looking for cost efficiencies, particularly in the face of inflation and workforce retention. Investors are seeking environmentally conscious assets, and consumers are increasingly making reservation choices based on sustainability protocols. In fact, a recent Booking.com survey (Booking.com, 2021) of 29,000 travelers found that 64% of hotel guests prefer sustainable accommodations, prompting on-line travel agencies to add a "sustainability badge" to those hotels meeting certain criteria.

Hotels are income-generating properties, and income is affected by both revenue and expense. Enhancement of the former and containment of the latter maximize value.

Utilities tend to range between two and five percent of gross operating revenue. Adding energy-efficient systems is one of the best ways to reduce overall costs. For example, a one-percent reduction in energy costs for a property with US$20 million in revenue results in a savings of $200,000. Applying a direct capitalization rate of 8% translates to US$2.5 million in value. This increase does not include the likely reduction in maintenance and replacement costs, which will surely add to the bottom line.

Maximizing operational efficiency is the first step toward net-zero carbon emissions. Retrofitting existing buildings, whenever possible, will be essential to meet market demand for net-zero carbon space and is considered the responsible course of action. For the lodging industry, the implementation of even the simplest sustainable measures (e.g., LED lighting, smart thermostats, etc.) have the potential to reduce utility costs of up to 40% and the installation of solar panels can reduce energy costs even further.

EMPLOYEE RETENTION

Workforce turnover is one of the costliest hotel expenses. Reducing turnover would undeniably enhance productivity and efficiency by reducing the need to hire temporary staff and providing training for new employees.

This is an area in which hoteliers are uniquely positioned to make an impact and should go beyond improved compensation by providing:

- Safer working conditions
- Robust career and upward mobility opportunities
- Cross-training programs to allow employees to learn new aspects of running a hotel
- Flexible work arrangements and schedules
- Advance pay options for employees

Satisfied and well-trained employees provide better customer service, which promotes repeat stays and increased recommendations.

Institutional investors comprise 75% of global ESG investment, and the size of the global ESG investment market is growing.

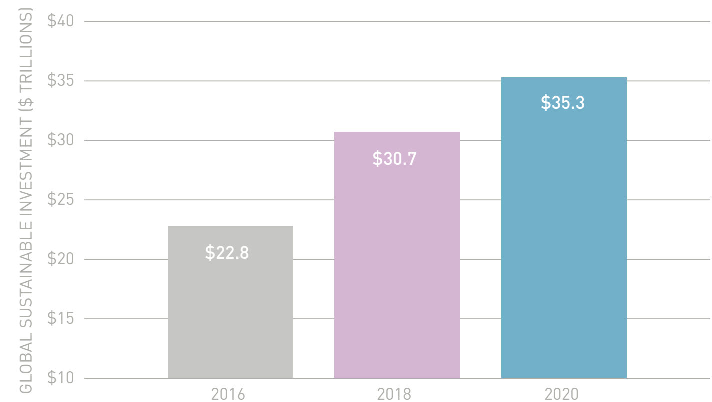
INVESTOR APPETITE

Appetite for ESG focused investments is on the rise. In fact, JLL Research shows that institutional investors comprise 75% of global ESG investment, and the size of the global ESG investment market is growing. According to Global Sustainable Investment Alliance's 2020 Global Sustainable Investment Review (Global Sustainable Investment Alliance, 2020), between 2016 and 2018, global sustainable investment grew 34% to US$30.7 trillion. From 2018 to 2020, it grew an additional 15% to $35.3 trillion. As such, by the end of 2020, the number of ESG assets under management was 35.9%, a noted increase from the 27.9 percent reported at the end of 2016.

For the right product and market, competition will surely drive value.

EXHIBIT 1: GLOBAL SUSTAINABLE INVESTMENT (2016–2020)

Source: JLL Research, Global Sustinable Investment Alliance



SOCIAL IMPLICATIONS

For hotels, transitioning to lower carbon footprint will also support the health and wellness of the surrounding communities, as research shows, cutting emissions can bring with it large health co-benefits for surrounding communtiies. . In addition, positive social impacts can be achieved through programs that benefit upskilling, training, or living wage projects. Increased social value can also be reached by responsible procurement, supplier diversity, community engagement and a focus on the health and wellness of its employees and the community at large.

GOVERNANCE

Governance involves a set of protocols and standards that support the greater goals of balancing people, planet, and profit, including ethics, corporate culture, internal controls, and data security. Most established businesses have best practices supporting governance of operations and assets; however, moving forward, businesses will need to focus on best practices that advance corporate responsibilities beyond achieving profit targets. As an example, Marriott has created different committees with a specific focus, including diversity, social impact, and governance. Each of these committees ensures Marriott is working towards accomplishing its goals. Hilton hires an independent third-party company to verify that the figures it reports on carbon, water, and waste consumption are accurate.

COMPANIES TAKING THE LEAD

Hilton is committed to cutting emissions 61% by 2030 and is taking crucial steps to increase sourcing renewable energy at its hotels around the world. Between 2008 and 2018, Hilton reduced its carbon emissions intensity by 34%, waste intensity by 41%, energy use intensity by 24% and water use intensity by 20%, delivering more than $1 billion in operating efficiencies. In 2020, the hotel parent brand company took one step further and began sourcing 100% renewable electricity at the majority of its managed hotels in the UK and added renewable energy options for US managed hotels. Currently, 100% of its hotels are being mapped against climate risks.

IHG Hotels & Resorts launched a new program to tackle environmental, social, and overall ESG goals titled, "Journey to Tomorrow." The series of commitments aims to make a positive difference to people, communities, and the planet over the next decade. It also launched "IHG Green Engagement," which enables the brand to set and track property-specific reduction goals for carbon, energy, water, and waste. In 2021, IHG saw a 12% reduction in total global carbon emissions compared to 2019, albeit this was largely due to lower occupancy levels across its hotels.

In Marriott's 2021 Serve 360 Report presenting data from 2020 and demonstrating its ESG efforts, the company announced that it is committed to reducing carbon intensity 30% and water intensity by 15% by 2025. In fact, Marriott is slightly ahead of schedule in its carbon intensity reduction and reduced its intensity by 32% relative to its 2016 baseline in 2020. Further, Marriott has 184 open adaptive reuse hotels, with a goal of having 250 by 2025.

LOOKING FORWARD

ESG for hotels is a tremendous opportunity to drive revenue and reduce overall expenses while setting the hotel apart from the competition, building a loyal customer base, helping the environment, and promoting social responsibility.

Retrofitting existing building stock, whenever possible, will be essential to meet market demand for net-zero carbon space and is considered the responsible course of action.

To meet these demands, increased capital investment will be needed to convert an asset, implement social programming, and/or execute stronger governance protocols. While some programs will provide an immediate and long-term impact, others will be indirect.

However, the reality is that there is still a great deal to learn, as stronger evidence of actual transactions to quantify the impact of ESG is still trickling in.

Awareness is the first step.

ABOUT THE AUTHORS

Charlotte Kang is National Hotel Practice Group Leader, Valuation Advisory for JLL. Geraldine Guichardo is Global Head of Research, Hotels and Director, Americas Living Research for JLL. Lori Mabardi is the Global ESG and Sustainability Research Director for JLL. Emily Chadwick is Lead Risk Advisor - ESG, Valuation Advisory for JLL. JLL has committed to being Net Zero Carbon by 2040 and to supporting clients on their journey to a low carbon world.

CARRY ON, CARRY OVER

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While continuation vehicles were once viewed as a signal of delay or failure, market sentiment is rapidly changing.

Over the past few years and with increasing frequency, real estate investment managers and their investors have been exploring ways to recapitalize opportunistic or value-add investments with longer-term (and often lower cost) capital.

While continuation vehicles were once viewed in a negative light, due to the potential conflicts between GP and LP interests, or to the tendency for such vehicles to be utilized only when there had been a failure or delay in accomplishing a fund's objectives, market sentiment is rapidly changing. Blackstone's nearly US$15 billion recapitalization of BioMed Realty at the end of 2020 took what might have been a taboo conversation with an LP and brought it to the mainstream, and their announced €21 billion recapitalization of Mileway just sixteen months later established this type of transaction as a mainstay liquidity strategy for the private equity giant.

Blackstone is by no means alone. In a January 2022 update, Landmark Partners noted that GP-led transactions involving the recapitalization of funds and property portfolios reached US$7 billion of net asset value in 2021, representing a 25% increase year-over-year and a 38% annual growth rate over the last five years.[1] Anecdotally, the authors have also seen a similar increase in interest for these types of transactions among both clients and institutional LPs.

CONTINUATION FUNDS 2.0

Traditionally, secondary trades have been driven primarily by end-of-life fund situations or LPs otherwise seeking liquidity. In those cases, the buyer is typically seeking higher returns for providing such liquidity. More recently, however, most secondary trades have been led by the GP *(Exhibit 1)*, and in 2021, 74% of these trades comprised "in-favor" sectors such as rental housing, logistics, and data centers *(Exhibit 2)*.[2]

EXHIBIT 1: TOTAL TRANSACTION VOLUME, LP- VS. GP-LED

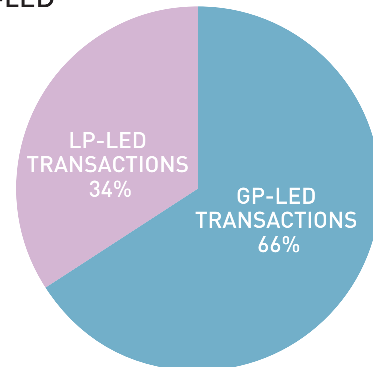
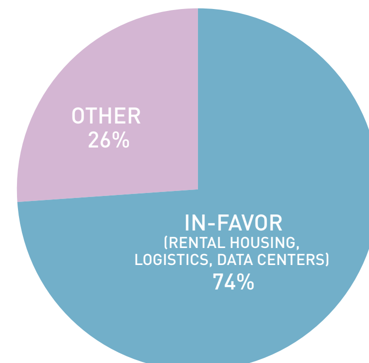


EXHIBIT 2: TOTAL GP-LED TRANSACTIONS IN FAVORED AND OTHER SECTORS



Rather than end-of-life scenarios, the new iteration of recapitalization transactions typically (1) provide an early liquidity event that demonstrates strong performance for the fund and (2) provide the continuing investors with a high-quality portfolio, sometimes with potential future value creation opportunities that could not be executed in the prior fund due to an expired investment period. Increasingly, these continuation funds may serve as the formation transaction for an open-end fund, where managers can raise additional capital to make new investments over time.

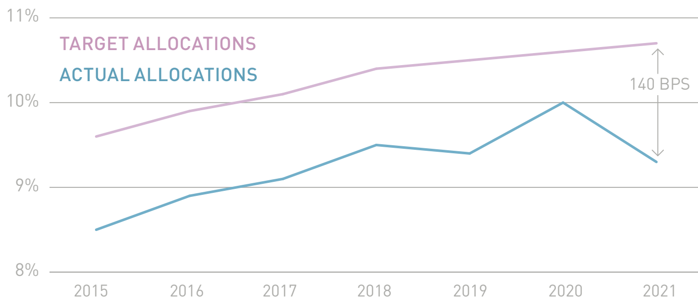
MANAGER'S PERSPECTIVE

As a benefit for managers, a continuation fund represents a way for the manager to recognize a capital event (and therefore earn a promote) while retaining the asset base on a go-forward basis. These transactions can also unlock tremendous enterprise value, as we have seen some of the highest EBITDA multiples for fees on perpetual capital. In addition, maintaining a larger portfolio can generate better proprietary information and increased relevancy to potential tenants—benefits which should also translate to better investor returns.

INVESTOR BENEFITS

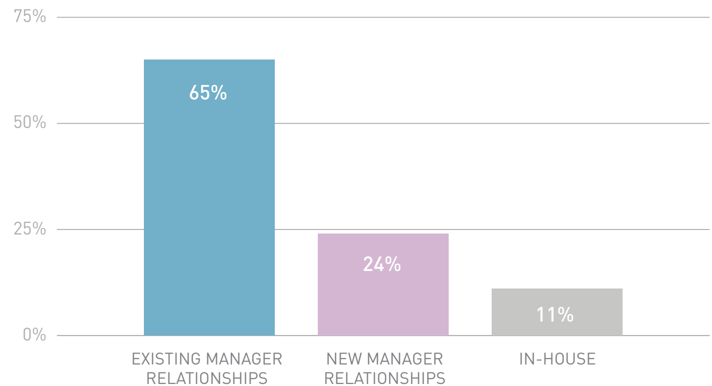
The benefits for the fund's existing investors may be slightly less apparent but can be similarly powerful. At a high level, institutions on average remain significantly below their target allocation to real estate. According to Hodes Weill's most recent Institutional Real Estate Allocations Monitor, conducted in partnership with Cornell University's Baker Program in Real Estate, target allocations to real estate are at 10.7%, but actual allocations are only at 9.3%; that 140 BPS spread is the largest since we began conducting the survey nearly a decade ago.[3]

EXHIBIT 3: ACTUAL VS. TARGET ALLOCATION, 2015–2021



It follows that institutions should be more interested in finding ways to stay invested rather than have capital returned to them via asset sales. This is particularly true for certain sectors experiencing long-term structural changes, such as data centers or life science real estate, where systemic undersupply is creating not only a strong fundamental outlook, but a limited number of investable opportunities. Indeed, many investors have already been pursuing "built-to-core/long-term hold" strategies for similar reasons, so why not look to the assets already held in their private closed-end funds?

EXHIBIT 4: ESTIMATED BREAKDOWN OF 2021 INVESTMENTS, ALL INSTITUTIONS



Another macro trend at play is the preference among institutions to do "more with fewer." In 2021, 65% of investments were expected to be allocated to managers with which the institution had a pre-existing relationship. As investors expand their relationships with their current roster of managers, they stand to benefit from reduced frictional costs (e.g., diligence, legal, etc.) and streamlined portfolio management of their investments. When contemplating "doing more" with a sector specialist, expanding across various risk strategies makes sense.

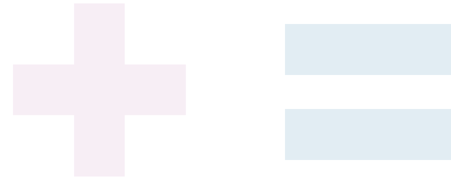
Putting aside allocation decisions and preferences, continuation funds also offer certain benefits with respect to the underlying real estate. If an investor were to choose the best manager for its core real estate holdings, it would likely be the same group who initially developed or otherwise improved the asset. For investors seeking core or core-plus exposure, a fund recapitalization can provide access to a diversified portfolio of considerable scale while saving on the transaction costs of acquiring new assets. Investors may also capture certain tax benefits of recapitalizing limited partner interests not available when trading real estate.

POTENTIAL CONFLICTS

With all their potential benefits, continuation funds also pose obvious challenges to investors. With the manager on both sides of the table for a recapitalization transaction, investors are right to approach these opportunities with a certain amount of skepticism. As Thomas Albright, a private equity investment manager for the Teacher Retirement System of Texas puts it, “Our model historically has been built on alignment of incentives, and GP-led vehicles, continuation vehicles, break that model a little bit.”[4] In addition, the option put to the investor of whether to cash out or roll its interest is more decision making than an LP might be accustomed to (and often in a tighter timeline than an LP typically operates).

Reflecting the sharp increase in activity for these GP-led recapitalizations and the complicated nature of these transactions, the SEC recently proposed new rules for adviser-led secondaries, which they defined as any transaction initiated by an adviser or manager that offers investors of a private fund the choice to either sell their interest in the private fund or convert their interest into another vehicle advised by the same manager. The proposed rules would result in increased reporting requirements as well as new procedures in the event of a manager-led secondary transaction. Specifically, a registered private fund adviser would be required to provide investors a fairness opinion from an independent opinion provider, which the SEC believes provides “an important check against an adviser’s conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.”[5]

Regardless of the adoption of these proposed rules, the industry, via investor demand, has shifted towards more rigorous processes for these transactions. Using the recent Mileway transaction as an example, existing investors were provided with two fairness opinions (one with respect to the consideration to be received and the other to the real estate value) as well as a “go shop” process run by Blackstone. Indeed, LPs expect their managers to be transparent about the options, benefits, and costs associated with continuation vehicles as well as the process being run. Managers should communicate their intentions as early as possible to allow ample time for LPs to evaluate the opportunity, particularly in light of the very different underwriting process of a portfolio of assets compared with that of a blind pool fund, where the LP spends more time on the manager’s strategy, track record, and investment process.



NEXT STEPS

As continuation funds continue to proliferate in the market, we expect increased institutionalization and uniformity of the terms and processes for these types of transactions. Investors should not be surprised to see fund documents with language that specifies upfront how a recapitalization or continuation fund might take place.

While continuation vehicles were once viewed in a negative light—a tool to be used for hard-to-sell assets or funds at the end of their lives—they are now growing increasingly popular and are often stocked with the best assets from promising sectors. And with continued investor under-allocation to real estate, we don’t see the trend slowing anytime soon, despite the complexities.

ABOUT THE AUTHORS

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RENEWING ETHICS

El Rosenheim
CEO
Profimex

A note from AFIRE's Ethics Chair on the need for maximizing ethics in an age where globalization is under threat:

In the current era of globalization, failures of governance, investment, and development can no longer be easily swept under the rug. The basic principles of how digital social networks operate through lack of hierarchy, transparency, authenticity, and cooperation, have also had a serious impact on the old patterns of power distribution between the corporations and their stakeholders.

The necessity and importance of transparency as a tool for building trust—particularly within the real estate industry—has grown immeasurably. Accessibility of information for everything from procurement and supply chain operations to tax incentives and executive compensation has sharpened corporate understanding of the need for value-based conduct, and the willful imposition and acceptance of barriers and self-restraints.

With globalization now under threat, doing the right thing is not just the right way to do business, but in the end, it's the only way to do business.

SOS (SAVE OUR SOULS)?

The inherent raison d'être of the business world is profit. According to this assumption, is it possible to attribute moral responsibility to a business organization? Should companies create intra-organizational mechanisms to ensure moral behavior?

On this note, internationally respected author and business consultant Patrick Dixon once said, "Strong ethics keep corporations healthy. Poor ethics make companies sick. Values are the immune system of every organization."

Despite broad agreement that businesses can and should according to prescribed moral standards, there are still businesses who perceive integrity as a constraint rather than a motive. As a result, they operate according to moral codes only to the extent that the market or law requires. But what is legally allowed may not be always the right thing to do. While law often merely imposes minimum standards of behavior, ethics set the maximum. Ethics are aspirational.

Such businesses will often tout their actions as a benefit for society under the broad guise of social responsibility. They seek to win moral bona fides, even as these "responsible" actions are merely moral substitutes, or what has become an acceptable kind of business strategy to bolster reputation as one means of many leveraged merely to support the bottom line

But it is not the pursuit of profit that creates injustice. Instead, it is the pursuit of maximum gain; that is, *proper profit versus maximum profit*.

SOCIAL IMPACT AND RESPONSIBILITY

At a fundamental level, even before ethics, the cooperation between the professional teams in a company plays a crucial role in its chances of success. In order for any productive cooperation to take place, employees must share a similar set of beliefs and values, themselves instilled by the company's management.

At this point, ethical problems arise from conflicting personal and work values or from values not aligned.

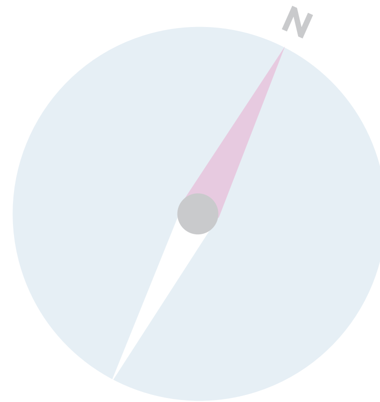
Setting business standards based on core values helps employees play by the same rules. Most people want to work in a company where they feel trusted and where they can trust others; a place where the values and ethics are known, shared, and followed. Working in an organization with people who share the same values and goals makes people feel that they are part of something bigger than themselves and supports commitment, retention of staff, and continuity of business development.

Beyond internal cohesion, ethical standards ultimately provide organizations with a collective ability to resolve ethical dilemmas. Without standards, we restrict our ability to do business effectively. When organizations don't articulate clear values, individuals are left to their own devices to determine which values should guide them.

Even as it can seem that our ancestors have had little influence over our generation, we have the duty and privilege to understand right now how we are shaping the world for future generations.

THE BEST THING YOU CAN DO IS THE RIGHT THING

The Edelman Trust Barometer defines trust in business as a combination of competence and ethics, with ethics being defined as having a purpose, sharing it transparently, and delivering it with integrity. And integrity itself consists of the actions, values, methods, measures, principles, expectations, and outcomes of a given action.



It is the will and responsibility of a company's leaders to set the moral tone and to create a day-to-day example of ethical behavior. If the management philosophy is based on ethical practices, it has the ability to inform an employee's conduct and business decisions, which will not only beneficial to them as individuals, but also to the organization as a whole.

Building a business on a foundation of ethical behavior helps create lasting, positive benefits, including reputation, cultural cohesion, and personal fulfillment. And as newer generations of business stakeholders demand increased transparency and responsible investing, a clearly stated ethical imperative within a business allows them to efficiently respond to stakeholder needs and demands.

As we have seen in the start of 2022 and the unprecedented global economic response to Russia's invasion of Ukraine, in the modern era of globalization, moral failure cannot be secreted away. The assets and investment vehicles of Russia's wealthiest oligarchs are being seized, and some of Russia's largest businesses are being crippled by global sanctions—all the result of a moral failing.

RENEWING ETHICS: A BRIEF STUDY

CONFLICT WITH LOCAL MANAGEMENT

A real estate investment firm focused on large, commercial assets offers diverse investment opportunities to its investors, executed through an experienced local manager with a deep familiarity with their local markets. The firm's relationships with local managers include ongoing monitoring and protecting investors' interests in existing investments.

One of the firm's local partners is a US real estate company that develops and manages assets. The investment firm participated in several, well-performing investment opportunities offered by this local manager, by raising funds from investors and representing their interests in the different projects.

After several years of collaboration, the local manager offered the investment firm an opportunity to raise funds for a new project. The proposed opportunity was located in the same area and had characteristics similar to one of the manager's previous investments, though that previous investment was so far not performing as expected. Notably, the occupancy rate drastically lower than anticipated in the business plan. The investment firm was not involved in this underperforming existing project, but was well aware of its challenges.

The investment firm's executives believed that the new offer represented an inherent conflict of interest, because the new asset competed with the existing investment for tenant demand and management resources. The firm therefore turned down the offer from the manager.

Unsatisfied with the firm's decision, the local manager claimed that even though the new offer shares similar characteristics with an existing investment, the new asset would not compete for tenants. The investment firm nonetheless disagreed and added that the new investment would rob management resources, vital for ongoing underperforming investments. The firm urged the local manager to refrain from purchasing the asset and indicated that it will cease to participate in new projects if the manager decides to proceed with the new opportunity.

Facing various pressures, the local manager exited the opportunity to purchase the new asset. And although the investment firms' executives approved of the local manager's final decision, the manager's conduct throughout the proposal process left doubts in their minds. As such, they began to more closely moderate the manager's business, including any new investments publicly announced.

After a few weeks of monitoring, the investment firm noticed that the local manager posted a picture of its latest investment: the property that the manager had otherwise indicated that it would exit. The manager's website showed the same picture and same address for the asset, but under a different project name.

The investment firm felt that it had been misled by the local manager, calling into question the firm's existing projects with the manager—and the possibility of conducting any further business together.

FOR FURTHER EXPLORATION

1. What responsibility does the investment firm have with its investors related its soured relationship with the local manager? would you share with investors in the project? And when?

2. What are the short- and long-term ramifications of this conflict between the investment firm and the manager? Should the investment firm end the partnership while there are ongoing investments?

3. How should the investment firm's partners reply when asked by investors and other business partners and peers about the local manager? Are the partners obliged to share this experience?

BE THE CHANGE YOU WISH TO SEE

At the organizational level, businesses have a social responsibility for their decisions and behaviors, which affect the quality of our lives in almost all areas.

Even as it can seem that our ancestors have had little influence over our generation, we have the duty and privilege to understand right now how we are shaping the world for future generations. Our decisions in the present cannot be subject to our individual needs, because our stakeholders aren't only focused on their needs, either. We can make a positive impact by preserving the earth and environment—perhaps one of the most critical issues of our time (and one in which the real estate industry can have a massive impact)—but we can also establish a moral heritage. Even if we are unaware, we are establishing this heritage in our homes, with our families and our friends, and we should codify it in our work, as well.

From a moral point of view, the interests of future generations are equivalent in importance to the interests of our generation.

When we act with integrity, we make society better. When we help make society better, we improve the lives of our families, our friends, and ourselves.

As business and investment leaders, it is in our hands to make a difference.

ABOUT THE AUTHOR

El Rosenheim is CEO of Profimex, the Israel-based private equity real estate arm of Bamberger-Rosenheim Ltd., founded in 1969. Profimex has co-invested in assets valued at more than $60 billion since its inception in 1997 and specializes in diverse, cross-border investments and serves high-net worth individuals (HNWIs), private and public companies, as well as institutional investors.

Although a given building may not be at immediate risk, the economic health of the entire community may be at risk, and thus, the commercial value of buildings is very likely to be impacted.

REVIEWER RESPONSE

These days, there seems to be an often-spoken thought that capitalism and ethical business practices cannot abide in the same place. This article does a good job of identifying that ethics have seemed to shrink as a strong influence on corporate/business practice, but it does not make a strong enough case for why it is important for business to refocus on the impact and importance of being an ethical concern.

It is unlikely that at any point in the history of business, unethical practices were non-existent, but it was hoped that unethical firms were the exception, not the rule. Is the question now whether the world really cares enough about ethical business practices to consistently call them out and push them to either do better or disappear? Should we be asking how business leaders infuse their organizations with values and ethics so that their imprint on the world is positive and one that others look to emulate? What about the heightened value that the current generation of talent is looking to find in their work, providing yet another reason for companies to look at how their values are displayed and integrated into the very fiber of their 'being'? Isn't there a need to equate "success" with "ethical?"

It seems expected that the reader already shares the same perspective of the moral value of being ethical and doing business for the "good of being good," though it is important to push the business case for the outcomes of being ethical and having the type of values that leave positive imprint on the world. Even with the discussion scenario offered at the end of the article, the "capital" value of being ethical is left for conjecture, when there are true quantitative and qualitative examples of that value. This topic should be top of mind, though we must take every opportunity to leave the reader with clear examples and reasons to look at the tangible outcomes of how to be successful and ethical at the same time.

– Collete English-Dixon
Summit Journal Editorial Board Member

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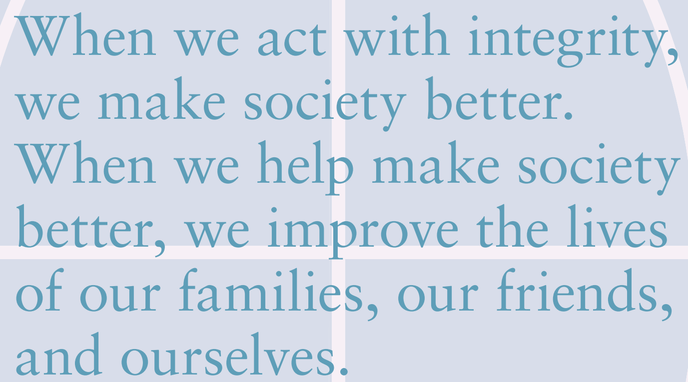

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