Market Observations

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Today's setup for the real estate market is quite intriguing. We have seen some rather seismic shifts in the market as a result of the pandemic, with several key trends expected to have a lasting impact. Here we provide a brief overview of both the residential and commercial real estate markets, highlighting the winners and losers of the past year, and where we see opportunity moving forward.

Residential

The residential real estate market has been particularly interesting to watch since the start of the pandemic as a confluence of factors have driven up home prices in an extraordinary fashion. Urban flight, more flexible work arrangements, and record low interest rates have driven unprecedented demand for single family homes while supply ran tight with a reluctancy to sell.

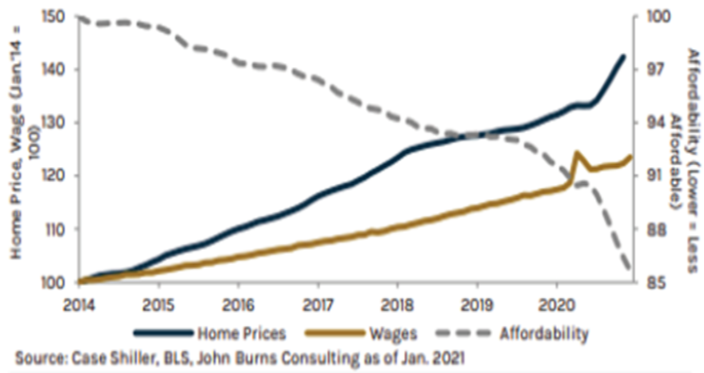
The migration of both businesses and consumers from urban centers to tier II cities and suburban, and even rural, areas has been on trend for some time now. However, the pandemic brought a new sense of urgency to the movement as people traded in cramped apartments for more spacious homes with dedicated work spaces during the height of lockdowns.

As a result, we are seeing lower in-migration to the likes of New York, Chicago, and San Francisco. States like Florida and Texas have certainly absorbed their fair share of city move-outs, though many people have simply migrated to the suburbs in surrounding counties. Home values have skyrocketed in some regions as a result with buyers often willing to pay higher than appraisal value while fronting the cash for the difference.

Homebuilders have been a beneficiary as well, unable to keep inventory in stock as of late. Given the pent-up demand from under-building for the last decade, homebuilders are expecting this cycle to last at least seven years.

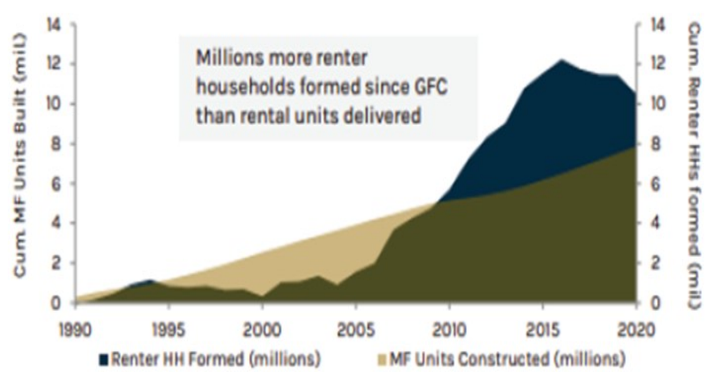
Multifamily housing has proven to be remarkably resilient during the crisis as well, largely due to declining home affordability and relative undersupply. Given strong demand and a tight supply of single-family homes, home price appreciation has outpaced wage growth, forcing some prospective home buyers into the rental market. The rise in new renter household formations has outstripped supply despite an uptick in new units.

Home Price Growth Continues to Outpace Wage Growth



Source: Case Shiller, BLS, John Burns Consulting as of Jan. 2021

U.S. Renter HH Formation vs. Cumulative Units Delivered



Source: Census Bureau as of Q4 2020

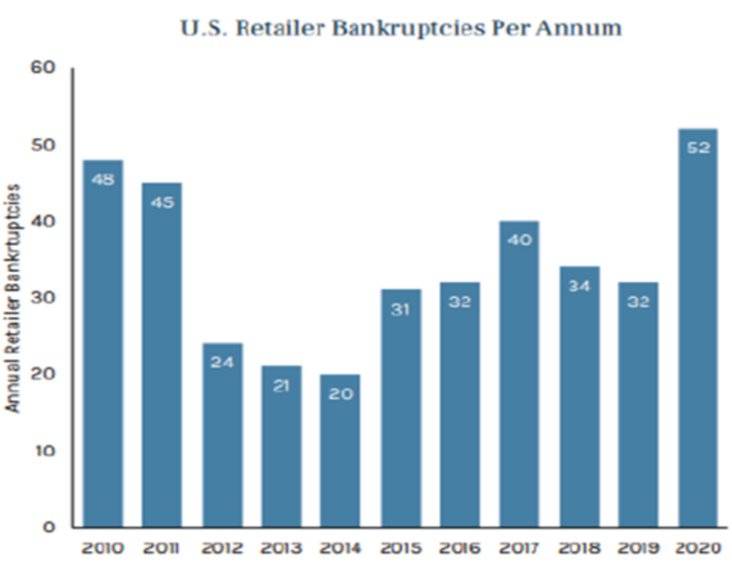
Rental collections have remained at a healthy level, despite the financial pressures of the pandemic. Collections hovered around 93% for the August-December 2020 time period, relative to the 95% range for the same time period in the year prior.

Commercial Real Estate

Relative to the residential market, the pandemic's effects on the commercial market have been more mixed. The surge in ecommerce growth has seen demand for warehouse space explode over the last year while malls and office space have languished.

E-commerce penetration in the US jumped from 11% to 16% of sales in 2020 as consumers shifted buying to the online channel during lockdowns. Industrial leasing saw a massive boom as a result. The leasing pace in 2021 will likely lag as customers digest their new space, though large outlets like Walmart have been explicit about increasing investments in distribution centers, automation, and fulfillment to improve delivery times and store replenishment moving forward. We may see new demand from a shortening of supply chains as well, as some companies are focusing on domestic or regional stockpiling of critical goods that came in short supply over the last year.

In contrast, malls became a victim of the pandemic as lockdowns and social distancing measures either forced them to temporarily close or challenged demand for key attractions, namely fashion and experiences. While retail isn't entirely a zero sum game, the rise in sportswear and outdoor activities has come at the expense of fashionable work and going out wear within the soft goods space. Store closings saw a strong uptick in 2020 as retailer bankruptcies reached the highest level since the '08 Financial Crisis. Consumers have also shied away from experience-based attractions that were previously a key draw for malls.

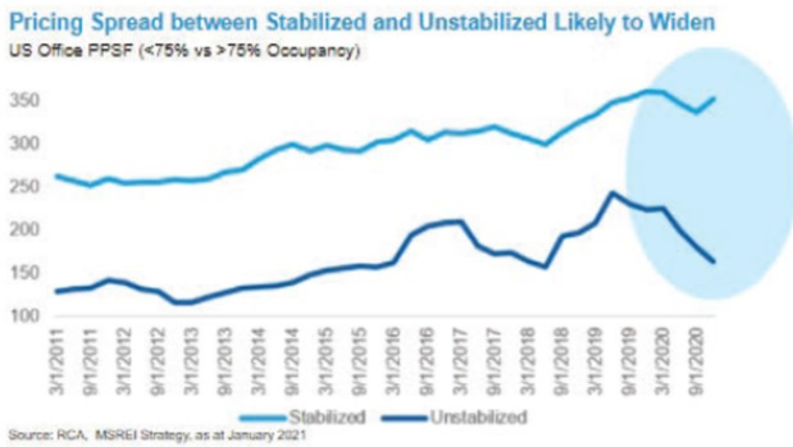


Source: S&P Global Intelligence as of January 2021

The outlook for fashionable wear remains hazy as demand for athleisure remains strong in several regions despite re-openings. With the work-from-home and casualization trends seemingly well-entrenched at this point, headwinds may persist well into the future.

One bright spot in the physical retail environment, however, has been shopping centers. Bix bog retailers like Target and Walmart saw strong growth during lockdowns as they pushed buy-online-pickup-in-store (BOPIS) services. BOPIS has been a win-win for shopping center REITS and retailers, improving store efficiency through higher inventory turns and traffic flow to the retail center. This may, in part, be the reason why some traditional mall tenants are now trialing off-mall concepts. Shopping centers are also seeing strong demand from large national restaurant and gym chains looking to expand their footprint in an apparent market share grab, all underpinning leasing velocity and rents.

Within the office space, we see a permanent shift toward a hybrid work environment, which we expect to significantly slow the demand for space. Some estimates call for a 10% decline in demand as the number of employees working from home continues to increase. The pullback in demand also suggests tenants can be more selective about their space, putting older buildings in inferior locations at a distinct disadvantage. Currently, the stock of pre-1990's office buildings in gateway cities is sitting at around 50% vacant. Such vacancy rates are also driving a large dispersion in pricing. Buildings with greater than 75% occupancy rate are currently priced around $350 per square foot as opposed to those with less than 75% occupancy at $150 per square foot.



Conclusion / General Outlook

REITs Industries that benefited from the effects of the pandemic (Industrials, Data Centers, Towers, Single Family), and were largely considered safe havens during the market downdraft in March of 2020 have lagged in recent months as the reopen trade swept through the market. This underperformance has more than corrected somewhat stretched valuations, presenting what we believe to be an attractive entry point in several good quality companies with strong fundamental growth outlooks at valuations that haven't looked this attractive in years.

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