Uneven Recovery Broadens and Gains Pace

U.S. Real Estate Research Quarterly

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Executive Summary

ECONOMY

- The U.S. economy delivered strong growth in the second quarter and will carry significant momentum into the second half of 2021.
- The Fed remains committed to keeping short-term rates low through 2022; consumers are unleashing pent-up demand and excess savings; service businesses are scrambling to find workers to meet surging demand.
- COVID remains at the top of the list of risks, and the rapidly spreading Delta variant could slow or delay the return to a post-COVID normal—the details of which remain somewhat fluid.
- Lingering effects from supply-chain disruptions and bottlenecks are also creating headwinds, constraining production and driving up prices across a wide range of inputs, goods and services.

PROPERTY MARKETS

- The surge in economic activity is flowing through to the U.S. property markets, albeit unevenly and with its usual lag.
- Occupier demand is stabilizing and transaction activity is picking back up after a sluggish start to the year.
- Competition among lenders and investors for apartment and industrial properties continues to drive cap rates and debt costs lower in those sectors as investors reposition portfolios to reflect changes accelerated by the pandemic.
- Transaction data for June suggests that some of the ample liquidity in the apartment and industrial markets may be spilling over to out-of-favor sectors and markets, a sign that risk appetite in the private capital markets may follow the REIT market's lead.
- Despite uncertainty around office valuations, core property performance, as measured by the NCREIF Property Index (NPI), has clearly bottomed, even if returns in coming quarters decelerate after the outsized Q2 gains in industrial.

Economic Outlook

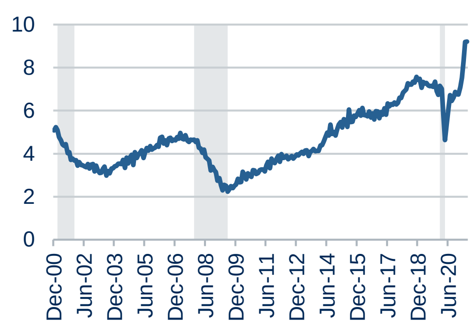
The U.S. economy delivered strong growth in the second quarter and will carry significant momentum into the second half of 2021, even as the tailwinds from fiscal stimulus and the initial boost from pent-up demand begin to ease. The Federal Reserve (Fed) has reaffirmed its commitment to keeping short-term rates low under its new policy framework, which allows inflation to run above the central bank's 2% average target rate for an extended period. Consumers are spending, and employers are actively seeking workers to fill a record number of open positions. Job growth reaccelerated in May and June as service businesses tried to keep pace with resurgent demand. Through June, nonfarm payrolls added 3.2 million jobs, roughly half of which were in the battered leisure and hospitality sector.

We expected a strong rebound this year, but the strength and breadth of the recovery, evident in the sharp improvement in consumer and business sentiment, have exceeded expectations. Total employment remains nearly seven million below its pre-pandemic level, but the labor market, like many parts of the economy, is still working through a supply-demand imbalance caused by the pandemic-induced recession. We will learn more about the labor market after the summer, when schools are back in session, unemployment benefits expire and workers return to the office. However, survey data and job growth forecasts are encouraging. Moody's Analytics now expects the economy will return to full employment in the first half of 2022.

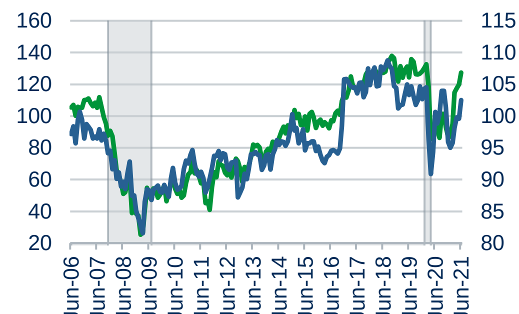
The surge in economic activity is flowing through to the U.S. property markets, albeit unevenly and with its usual lag. Occupier demand is stabilizing and fundamentals are improving across all the major property types except office, which continues to face a perfect storm of excess supply, weak leasing and heightened uncertainty about future office demand and use. Transaction activity also appears to be picking up, potentially a sign of improving risk appetite and similar to what is playing out in the public REIT market. While we expect the recovery will continue to gain momentum over the second half of the year, COVID and inflation, the most prominent risks, could create near-term headwinds. We are monitoring developments on both fronts, but have not revised our base case outlook. Longer term, we believe private real estate will remain relatively attractive for investors seeking durable, uncorrelated cash flows in an aging, low yield world awash in liquidity.

FIGURE 1: RECORD JOB OPENINGS AND IMPROVING CONFIDENCE

TOTAL NONFARM JOB OPENINGS (MIL, SA)



CONSUMER AND BUSINESS SENTIMENT



Source: Moody's Analytics, U.S. Bureau of Labor Statistics, The Conference Board, National Federation of Independent Business (NFIB), Barings Real Estate Research.

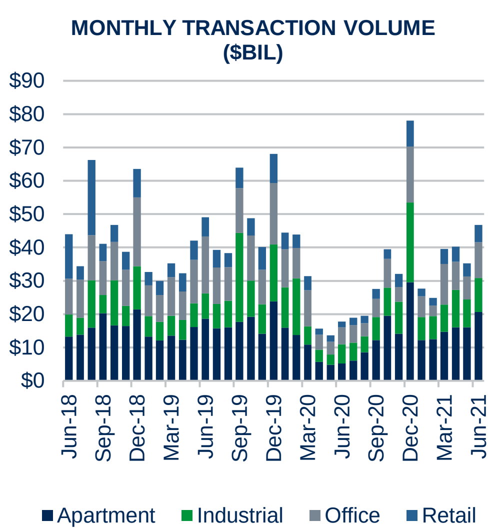
Capital Markets

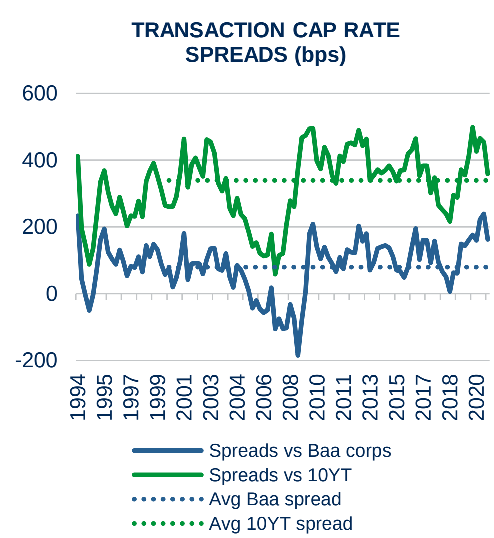
After a sluggish start to the year, real estate transaction activity appears to be gaining traction. According to Real Capital Analytics (RCA), deal volume in June accelerated to nearly $60 billion, the highest monthly total since December last year, and a 50%-plus increase over the upwardly revised estimate for May. With the June bounce, total Q2 volume this year is now 3.6% above the average quarterly volume over the three years prior to the pandemic (2017-2019). Transaction activity increased materially across all the major property types, but volumes in the office and retail sectors remain depressed, with Q2 volume in each sector nearly 25% below the pre-COVID three-year average, while activity in the apartment and industrial sectors was more than 20% above its pre-COVID average.

The intense competition for apartment and industrial deals continues to drive pricing higher and cap rates lower in both sectors. Per RCA, average transaction prices for apartment properties increased in June by about 12% year-over-year (YoY), outpacing the 9.8% YoY average price gain for industrial properties. But there are also signs that risk appetite may be improving beyond the most-favored sectors. Although one month does not make a trend, office and retail deal volume in June increased sharply month-over-month.

Looking ahead, we expect transaction volume will accelerate over the second half of the year as improving occupancy and utilization rates encourage investors to move out the risk curve. Whether risk appetite in the private markets will follow the public REIT market's lead remains an open question. REIT share prices are up sharply since last November and M&A activity in the U.S. REIT market has surged this year, with four of the five deals announced so far in 2021 involving retail REITs. Core property continues to screen attractively relative to traditional fixed income alternatives. Spreads between cap rates and bond yields narrowed during the second quarter, but with the roughly 30 basis points (bps) retreat in bond yields since the end of Q2, they remain above their long-run average.

FIGURE 2: SPREADS REMAIN ATTRACTIVE AS DEAL ACTIVITY ACCELERATES





Source: Real Capital Analytics (July 2021), NCREIF (Q2 2021), Barings Real Estate Research. Average cap rate spreads versus 10-year Treasury bonds and Baa corporate bonds (averages since 2000).

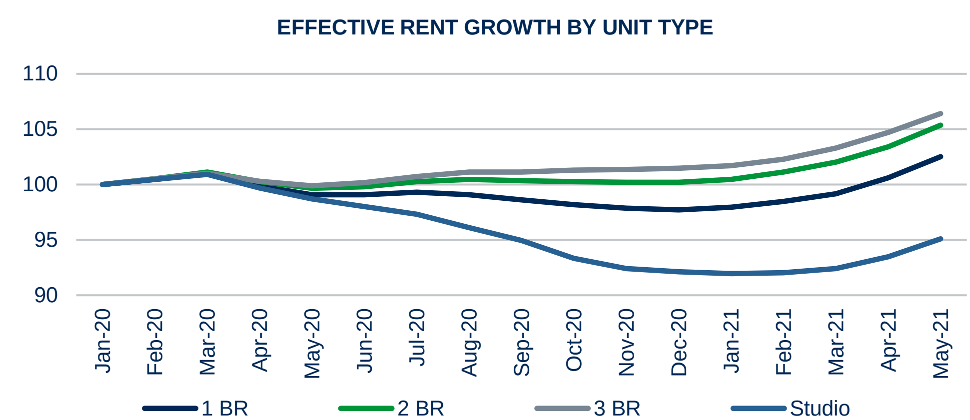
Property Markets

APARTMENTS

Apartment vacancy in Q2 declined substantially, falling 60 bps YoY to just 4%, or about 10 bps below the pre-COVID low at year-end 2019, according to CBRE-EA. Effective rents are rebounding across most markets as prime leasing season generates a sharp rebound in apartment demand and COVID concessions burn off. The bifurcation in performance continues, with the recovery lagging in CBD-apartment product types compared to suburban submarkets. A closer look at effective rent trends since the onset of the pandemic illustrates how demand has changed over the past 18 months. With most people working from or spending more time at home due to COVID restrictions, demand for more living space has translated into material outperformance in effective rents for larger units.

While the secular tailwinds for apartment demand remain in place, the sector continues to face pressure from new supply. The multifamily supply pipeline remains active and shows no signs of slowing. Nationally, multifamily permitting is up 3% YoY on a trailing 12-month basis to an all-time high. Although completions are forecast to top out this year, supply is projected to remain elevated over the next two years. Additionally, increasing levels of single-family housing construction in response to rising household formations and attendant housing demand will add to the demand headwinds, if only at the margin.

FIGURE 3: LARGER UNIT TYPES OUTPERFORM POST-COVID



Sources: Barings Real Estate Research, RealPage. As of July 2021.

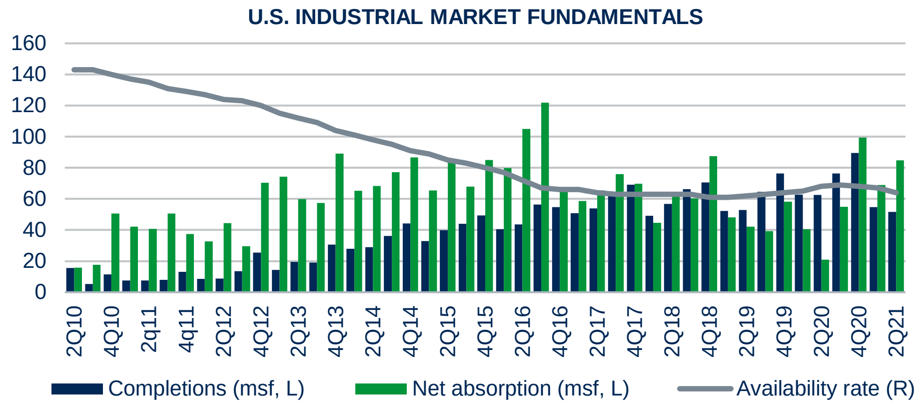
INDUSTRIAL

The national industrial sector availability rate in Q2 decreased 40 bps YoY to 6.4% and is now just 30 bps above the cyclical low of the previous expansion. Quarterly net absorption continued its torrid pace with the three-quarter average coming in well above the average quarterly pace reported in the last expansion, a welcome improvement over the muted levels at the height of the pandemic. E-commerce tailwinds continue to propel fundamentals and have helped industrial demand exceed supply additions since Q3 2020.

The strength in industrial demand is widespread across major and secondary markets alike. Industrial availability rates in Q2 improved or remained stable YoY across more than 60% of the 69 markets covered by CBRE-EA. Among the major national distribution nodes, Dallas and Northern NJ were the only two markets that reported a YoY increase. Investor demand also remains strong and continues to drive pricing and returns higher. Trailing one-year total returns for industrial properties in the NCREIF Property Index spiked to 23% (unlevered) in Q2 2021, a new high water mark and the 42nd consecutive quarter of double-digit trailing one-year total returns.

Looking forward, we expect that an improving economic outlook will support both consumption and trade activity in the near term, while the structural tailwinds of e-commerce and efforts to improve supply-chain resiliency continue to drive demand for modern warehouse and industrial assets over the long run.

FIGURE 4: INDUSTRIAL FUNDAMENTALS CONTINUE TO FAVOR LANDLORDS



Sources: Barings Real Estate Research, CBRE-EA. As of June 2021.

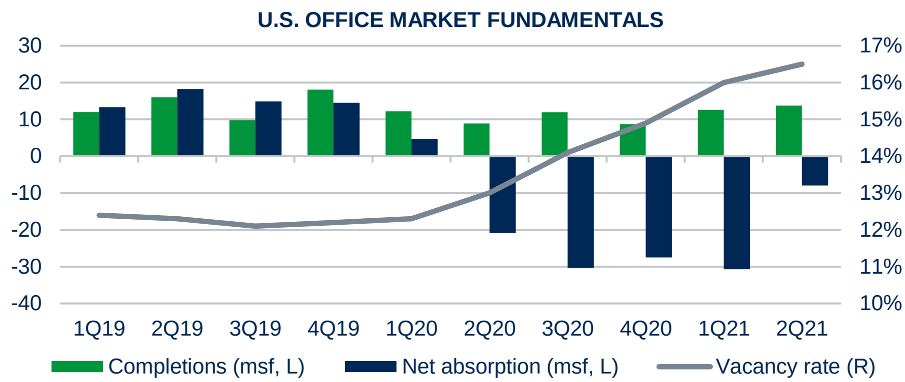
OFFICE

As more companies prepare to fully reopen offices in the fall, the U.S. office market is showing encouraging signs of stabilization. In Q2 2021, net absorption remained negative but dropped sharply from -31 million square feet (msf) in Q1 to just -8 msf in Q2. Moreover, sublet availability has begun to retreat in several of the hardest hit markets such as San Francisco, Austin and Seattle. New supply, however, continues to trend higher, pushing overall vacancy up by 50 bps during the second quarter to 16.5%. Downtown vacancy increased by 80 bps to 15.8%, while suburban vacancy expanded by a more modest 30 bps to 16.8%.

Performance during the second quarter varied greatly among major markets due to different local supply-demand dynamics. While quite a few markets, led by Boston, Atlanta, San Jose, Nashville, San Francisco and Raleigh, registered sizable positive net absorption during the quarter, Manhattan, Chicago and Washington D.C. continued to see tenants give back space totaling over 6 msf. On the supply side, rising deliveries in Atlanta, San Francisco, Denver, Austin and San Jose drove vacancy up despite improving demand. Unfortunately, new supply is set to increase further in the coming quarters, keeping upward pressure on vacancy.

Remote work's potential impact on office demand post-pandemic remains uncertain. Companies are eager to bring employees back to the office, and have shown a willingness to be flexible in future workplace arrangement. Employees, however, appear reluctant to give up the increased flexibility to work-from-home, at least for now. It will take some time for companies and employees to explore options and settle on whatever the new balance will be going forward. Despite this uncertainty, Barings Research continues to believe that a confluence of three forces—a transition to a hybrid workplace, growth in creative office employment and the escalating war for tenant—will drive demand for high quality office space post-pandemic.

FIGURE 5: SUPPLY CONTINUES TO DRIVE OFFICE VACANCY HIGHER



Sources: Barings Real Estate Research, CBRE-EA. As of June 2021.

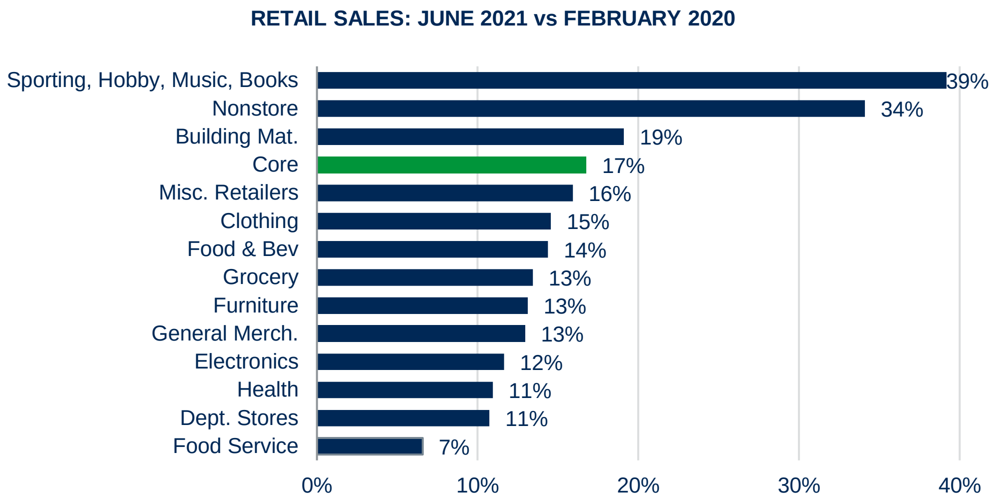
RETAIL

Neighborhood and community centers remained resilient in the second quarter as the national availability rate posted its second consecutive quarter-over-quarter decline, according to CBRE-EA. While still elevated compared to a year ago, and still 20 bps above Q4 2019, the drop in availability speaks to consumer shopping behavior during the pandemic and now in the midst of the recovery. A jagged recovery lies ahead in 2021 as consumers return to pre-pandemic spending patterns and seasonal effects from the pandemic wear off. However, neighborhood and community centers are positioned as the relative “winners” in this bifurcated retail downturn and recovery.

Although non-store sales, a proxy for e-commerce, increased sharply during the pandemic, many consumers continued to shop for necessities at local neighborhood and community centers, and increasingly are returning to service businesses and inline shops that have been shuttered or operating at limited capacity since the pandemic began. As of June, sales for all major retail categories are above their February 2020 (pre-pandemic) levels, and most are higher by double-digits. The ongoing shift in consumer spending to more discretionary and services retailers (including restaurants) has driven many categories that were hit hard by the pandemic to record strong growth in recent months.

With over half of the population fully vaccinated and restrictions lifted in most states, pent-up demand should continue to drive consumers to their local retail centers. Entrenched shopping behavior will remain as consumers utilize the omni-channel methods they became accustomed to during the pandemic. That, in turn, should drive retailer demand for well-located store space as a local point of fulfillment and customer engagement. While spending on groceries and other essentials will likely slow to pre-pandemic rates, we expect the shift to discretionary and services retailers and restaurants to continue near term, which should bring foot traffic and sales to neighborhood and community centers.

FIGURE 6: RETAIL SALES HAVE SURPASSED PRE-COVID LEVELS



Source: BRE Research, U.S. Census Bureau. As of June 2021.

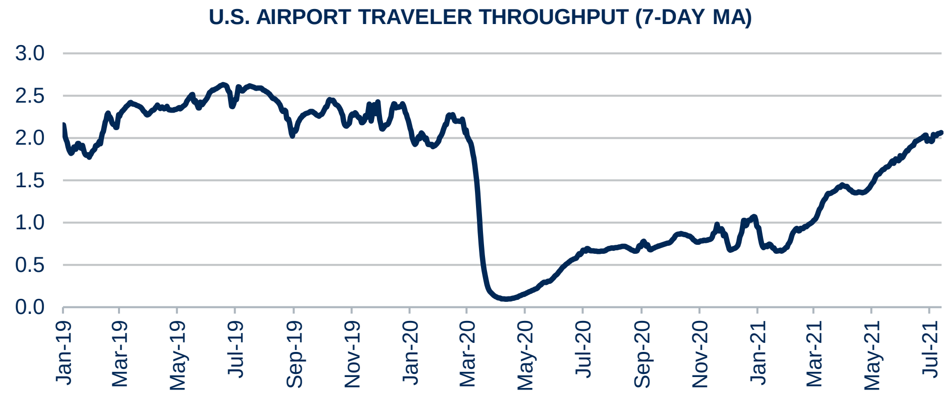
HOTELS

The recovery in the lodging sector accelerated into Q2 as travelers, eager for a change of scenery and a break from the stresses of living through a pandemic, took to the highways and, increasingly, airways to get away. According to Smith Travel Research, average U.S. hotel occupancy in June climbed to 66%, still below the 73% rate in June 2019 but well above the depressed 42% level last year. Moreover, as the vaccinated share of the population increases and confidence returns, travelers are looking beyond local drive-to destinations and quiet getaways. TSA data through July shows airport traveler throughput has finally climbed back above the two million daily threshold that was typical before the pandemic—and group bookings have rebounded as delayed weddings and celebrations finally move forward.

Unfortunately, the demand recovery remains mostly a leisure story. Business travel has barely started to revive as most companies focus first on getting workers back to the office, and as large format business meetings and conventions look to 2022 to resume in-person attendance. The lack of demand from business travelers is weighing most heavily on the upper-upscale segment of the hotel market, where performance is materially weaker than either the luxury or the economy segments. With the Delta variant spreading rapidly, the risks that leisure demand weakens in the near term have clearly increased, and the chances of a rebound in corporate room demand in the second half of 2021 are down to almost nil.

However, we do expect that the hotel recovery will gain momentum and broaden beyond leisure demand in 2022 as companies restore travel budgets and begin welcoming visitors into the workplace again. As with most things in the post-COVID economy, meeting increased demand will come with challenges for hotel operators, particularly with regard to labor. Employment in the leisure and hospitality sector plunged by more than eight million jobs at the start of the pandemic, and while the sector has since added back about six million jobs, anecdotal reports suggest hotel operators face a difficult road ahead (and higher costs) luring workers back.

FIGURE 7: TRAVELERS ARE GETTING BACK ON PLANES



Source: TSA, Barings Real Estate Research. As of July 2021.

SUMMARY

Midway through 2021, the rebounding U.S. economy and promising success of the vaccination program is driving a recovery in property sectors and markets that have suffered during the pandemic and a boost in those that have been more resilient (apartments) and/or “benefitted” (industrial) from the trends accelerated—or set in motion—by COVID. Office continues to be a wildcard, but price discovery in both the leasing and transaction markets is limited and likely biased to the best quality properties. With office utilization rates still below 50% and tenants still paying rents, there is little urgency for buyers or sellers to narrow the bid-ask spread until there is greater clarity on leasing demand and effective rents.

The near-term risks that could delay or derail the property market recovery, mostly COVID and inflation, pose a greater and more immediate threat than last quarter. However, we believe the fallout from both will be limited and short-lived. The Delta variant is spreading rapidly among populations with lower vaccination rates, and is causing authorities in some jurisdictions to re-introduce COVID protocols or restrictions; but it is unlikely that we will see the widespread shutdowns implemented at the onset of the pandemic. Likewise, inflation has surged and will likely move higher before it peaks, but we agree with the Fed that inflationary pressures are mostly transitory and will fade as supply catches up with demand—especially if higher prices erode demand. So while the risks of a near-term slowdown have increased, the healing process in the U.S. property markets is well underway and liquidity is broadening, which should support valuations as leasing and transaction activity resume.

About the Team

BRE's research team efforts are led by Philip Conner in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team's diverse backgrounds include appraisal, legal, technological and academic applications across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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