Recovery Gathers Further Momentum

U.S. Real Estate Research Quarterly

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Executive Summary

ECONOMY

- The U.S. economy rebounded rapidly in the first half of the year with more than 6% annualized growth, led by consumer spending and business investment.
- Strong job growth projections and pent-up savings should support growth over the near term. Meanwhile, monetary policy remains accommodative with the Fed committed to keeping short-term rates low through 2022.
- The Delta variant remains a potential headwind to this optimistic growth outlook, and could slow or delay the return to a post-COVID normal.
- While upside risks in the form of pent-up savings and policy changes have the potential to boost productivity and growth, additional downside risks remain in the form of higher energy prices and supply chain issues that could pose headwinds to the growth picture.

PROPERTY MARKETS

- The U.S. property market recovery continues unabated in the current economic climate.
- Occupier demand is strengthening and fundamentals are improving across all major property types, including office and retail. This optimism is flowing through into capital markets, which reported a record level of aggregate deal volume in September.
- The bifurcation in price recovery between in-favor and out-of-favor sectors continues, but the spread differential is narrowing—led by a recovery in select sub-sectors such as suburban office and necessity-driven retail.
- Public REIT markets have staged a complete recovery in pricing and seem poised for further growth.
- Core property performance, as measured by the NCREIF Property Index (NPI), is on an upward trajectory, and returns (both appreciation and income) are once again in positive territory across property sectors, lending support to the broad-based recovery in commercial real estate (CRE).

Economic Outlook

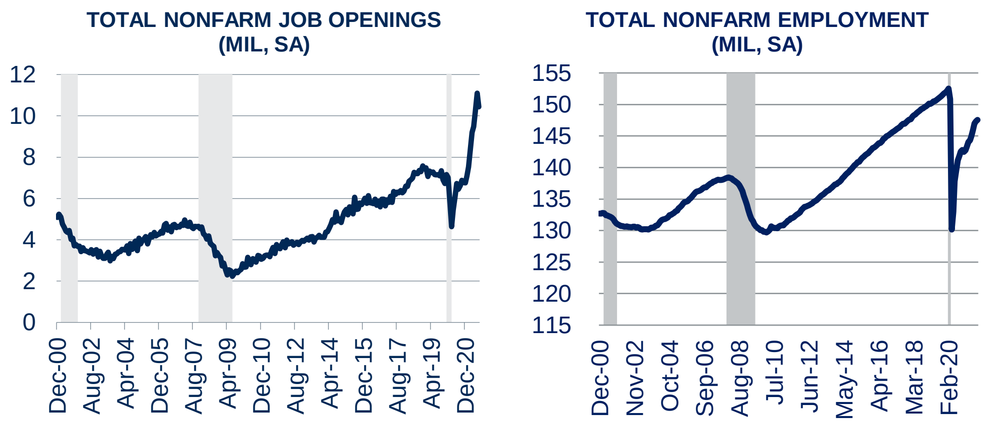
The U.S. economic recovery continues apace, consistent with the outlook from earlier in the year. Near-term growth projections remain sanguine and employment is forecast to reach its pre-pandemic level by the second half of 2022, according to Moody's Analytics. Although headwinds from the Delta variant have not completely dissipated, the variant's grip on the economy appears to be loosening—as evident in high-frequency data metrics such as higher restaurant reservations and box office receipts, which lends further support to near-term growth projections.

On the consumption front, although U.S. consumer sentiment in recent months has been weighed down by Delta variant concerns, inflationary pressures, and concerns over the debt ceiling, the outlook remains positive, supported by higher income and job growth tailwinds.

On employment, the recent September jobs report disappointed. Payroll gains of 194,000 were well-below consensus expectations, due largely to unfavorable seasonal adjustments made to government payrolls. However, significant revisions to payroll gains in earlier months helped the three-month average exceed a healthy threshold of 500,000 jobs, bringing the cumulative employment recovery closer to its pre-pandemic level. The recent expiration of unemployment insurance benefits didn't appear to have a significant impact on payrolls, however, the current labor supply shortages are expected to ease as constraints to participation diminish with schools in session and higher vaccination rates projected over the near term.

The current recovery is further supported by the Federal Reserve's (Fed) monetary policy, which remains accommodative for now. Although the Fed may initiate the tapering of asset purchases, there is currently little consensus among policymakers on the timing of the first rate hike. In this "lower for just a bit longer" rate environment, commercial real estate looks well-positioned to benefit from secular tailwinds in-play. Near-term headwinds to the economic outlook remain—most notably, a shift in the trajectory of the virus could derail the hard won economic momentum to-date and consequently impact space demand for recovering property sectors.

FIGURE 1: EMPLOYMENT RECOVERY CONTINUES APACE



Source: Moody's Analytics, U.S. Bureau of Labor Statistics, Barings Real Estate Research. Total nonfarm job openings as of August 1, 2021. Total nonfarm employment as of September 1, 2021.

Capital Markets

The U.S. property market recovery continues unabated in this economic climate. Occupier demand is strengthening, and fundamentals are improving across all major property types, including office, where the pace of vacancy increase has slowed.

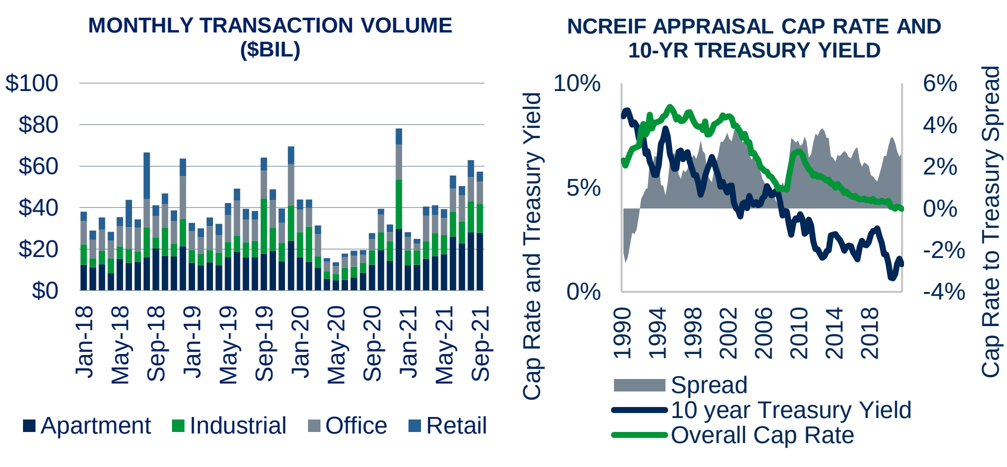
This optimism in property markets is flowing through into capital markets as well. Year-to-date (YTD) aggregate deal volume as of September totaled $462 billion, a record high exceeding the prior 2007 watermark and indicating healthy investor appetite for commercial real estate. Risk appetite, however, remains bifurcated, with YTD volume for the office and retail sectors nearly 20% and 10% below their respective pre-pandemic levels—albeit a significant improvement from the depressed volumes reported last year. Pricing remains similarly bifurcated for in-favor and out-of-favor sectors, but the spread is narrowing, led by improvements in suburban office and necessity-driven retail.

Public REIT markets have staged a complete recovery in pricing and are trending up, with private markets following suit. Third quarter NCREIF Property Index (NPI) returns are on an upward trajectory, led by the strength in apartments and industrial returns. Meanwhile, office, hotel and retail returns also stayed positive and are improving, driven by the recovery in select sub-sectors.

Lastly, spreads between cap rates and U.S. Treasury bond yields at the end of the third quarter came in above their long-run average. With yields near historically low levels, commercial property continues to maintain its relative value advantage with respect to other asset classes in the current economic climate.

Looking ahead, we expect a continued recovery in property fundamentals over the near-term and a further normalization in capital markets as risk appetites recover. Longer-term, the case for investing in private real estate remains secure as ever given the durable and stable nature of cash flows provided by the asset class in a yield-hungry, potentially inflationary environment.

FIGURE 2: CAPITAL MARKETS REBOUND AND SPREADS REMAIN ATTRACTIVE



Source: Real Capital Analytics (September 2021), NCREIF (Q3 2021), Barings Real Estate Research. NCREIF market-weighted cap rate spreads versus 10-year Treasury bonds.

Property Markets

APARTMENTS

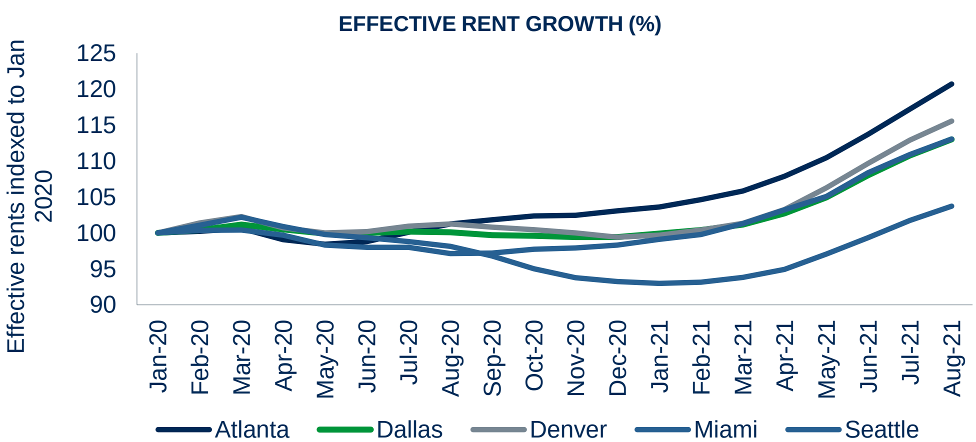
Apartment vacancy in the third quarter declined substantially, falling 150 basis points (bps) year-over-year (YoY) to just 2.9%, the lowest vacancy rate recorded since 1994, according to CBRE-EA. Effective rents are rebounding across most markets, with the advent of prime leasing season resulting in a sharp rebound in apartment demand and COVID-related concession burn-offs across all major metros. With the relaxation of social distancing guidelines, demand in major cities has increased, with most gateway markets now reporting YoY vacancy declines.

Capital markets activity remains healthy for the apartment sector, with YTD transaction activity as of September comfortably above both year-ago and pre-pandemic levels. Pricing remained similarly robust, with average apartment prices rising 16.3% on a YoY basis, outperforming the national CPPI index.

Looking forward, we expect a slowdown in momentum as we enter the winter months, but aggregate supply-demand fundamentals should remain balanced in the near-term with healthy performance expectations. The supply pipeline remains active, however, and it shows no signs of slowing. Nationally, multi-family permitting on a trailing 12-month basis is up 14% YoY to an all-time high. Although completions are forecast to top out this year, supply is forecast to remain elevated over the next two years.

Looking ahead, while the secular tailwinds for apartment demand remain in place, increasing levels of single-family housing construction, in response to rising household formation and attendant housing demand, could pose some headwinds to apartment demand on the margin.

FIGURE 3: NON-GATEWAY APARTMENT MARKETS OUTPERFORM



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

INDUSTRIAL

The national industrial sector availability rate in the third quarter decreased by an additional 30 bps to 6.0%, the fourth consecutive quarter of a decline in availability for the sector. Net absorption exceeded 100msf for the second time in the past four quarters with supply active but lagging demand. Rising construction costs driven by material and labor shortages put a lid on completions, which came in short of expectations for the first half of the year.

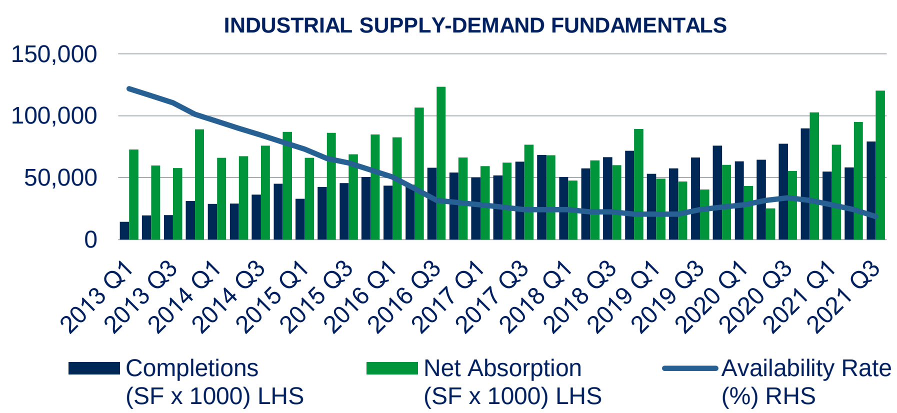
Macroeconomic factors including manufacturing and global trade conditions have rebounded since the pandemic-induced recession, and the e-commerce share of total retail sales remains elevated relative to pre-pandemic levels—which are factors that remain tailwinds for the sector.

Of the 69 markets covered by CBRE-EA, 51 reported either no change or a further decline in their YoY availability rates. Among the major national distribution nodes, Dallas and Northern New Jersey were the only two markets that reported a YoY increase, a trend from the second quarter, while YoY availability continued to decline in most major markets.

YTD industrial sector transaction volume through September totaled $94.8 billion, 48% and 18% above the same-period levels in 2020 and 2019, respectively. Individual asset sales totaled $23.9 billion in the third quarter, according to RCA, the highest quarterly single asset sales watermark in history, indicating the broad-based nature of the capital markets recovery. Pricing continues to tighten as cap rates for stabilized properties trend lower. Average industrial prices through September rose 16.9% YoY, according to RCA, outpacing both the national index as well as apartments.

We expect both consumption and trade activity to hold up over the near term, with an improving economic outlook providing continued tailwinds for industrial demand. Additionally, the current labor and material shortages have the potential to moderate supply, further strengthening fundamentals for the property type. Longer-term tailwinds propelled by e-commerce and functional obsolescence remain in place, supporting both the space and capital markets outlook.

FIGURE 4: FAVORABLE FUNDAMENTALS SUPPORT THE INDUSTRIAL SECTOR



Sources: CBRE-EA, Barings Real Estate Research. As of Q3 2021.

OFFICE

U.S. office vacancy increased 30 bps during the third quarter to 16.8%. This increase comes as no surprise as the recent surge in COVID cases has pushed back firms' return-to-office plans, while new supply continues to exert upward pressure on vacancies. On a positive note, net absorption continues to improve, and totaled -5.2msf during the quarter, versus -7.3msf in the second quarter and -31.3msf in the first. Sublet availability has also begun to retreat, down 10 bps to 3.7%, another sign that demand for office space is stabilizing.

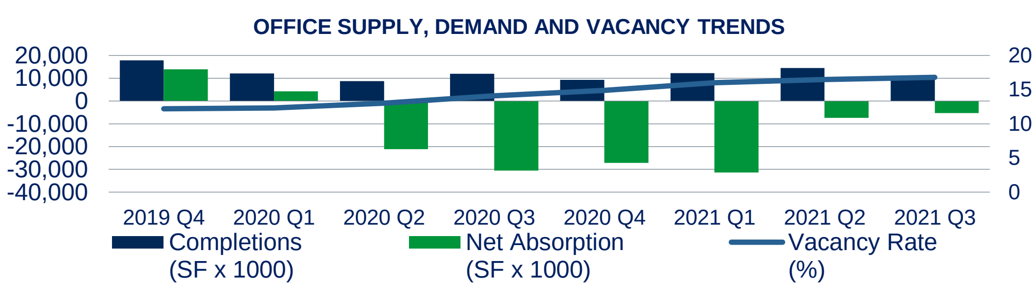
Downtown vacancy continued to expand at a pace faster than suburban vacancy, rising 50 bps to 16.3% in the third quarter. In the suburbs, vacancy increased by a more moderate 30 bps to 17.1%. At the market level, 39 of the 64 markets covered by CBRE-EA reported vacancy increases during the quarter, an improvement from 45 in the second quarter. Leading net absorption were some of the dynamic markets including Austin, San Francisco, San Jose, Nashville and Seattle. Encouragingly, Manhattan has posted its first quarterly positive net absorption reading since the beginning of the pandemic, while Washington D.C. is also showing signs of stabilization. Among the six "gateway" markets, Chicago and Los Angeles continued to post sizable negative net absorption numbers.

Capital markets activity through September remained subdued relative to pre-pandemic levels across office sub-sectors, with the exception of medical office, which is relatively immune to the work-from-home impact and, as a result, further along the recovery spectrum. YoY office pricing grew at a double-digit pace in September driven by the recovery in suburban office, which was partially offset by a detraction in CBD-office pricing.

The office sector could endure the most profound long-term impact from COVID-19 among the five major property types, thanks to the forced, full-scale, work-from-home experiment. New supply will pose an additional challenge to the sector in the near term. However, we believe that physical office will remain an integral element of company culture despite a further delay in the return-to-office expectation.

As competition for talent escalates and transition to a hybrid workplace unfolds, demand for high-quality office space should also increase. The current lack of consensus/conviction in the sector will provide a window for savvy investors to acquire assets that will outperform over the next cycle. While the suburbs are faring slightly better than CBDs for now, we do not expect a mass migration from CBDs to the suburbs, and believe high-quality space in both the suburbs and CBDs present investment opportunities.

FIGURE 5: OFFICE SECTOR RECOVERY CONTINUES



Sources: CBRE-EA, Barings Real Estate Research. As of Q3 2021.

RETAIL

Heading into the holiday shopping season, neighborhood and community centers demonstrated continued strength into the third quarter. The availability rate fell another 50 bps quarter-over-quarter according to CBRE-EA, and now stands 30 bps below its pre-pandemic level. A bifurcation in the retail recovery remains, though. The resiliency of neighborhood and community centers does not represent all center types. Enclosed centers, such as malls, for instance, have yet to record a significant drop in their availability rate as they remain challenged with lingering availability spurred by pandemic-driven bankruptcies and store closures.

Capital markets, likewise, are echoing the trend in space markets, with YTD transaction activity for necessity-driven retail, such as grocery-anchored centers and drug stores, outperforming both year-ago and pre-pandemic levels. Pricing grew in tandem for the month of September, rising 12.4% on a YoY basis according to RCA, driven by improvements in necessity-driven retail.

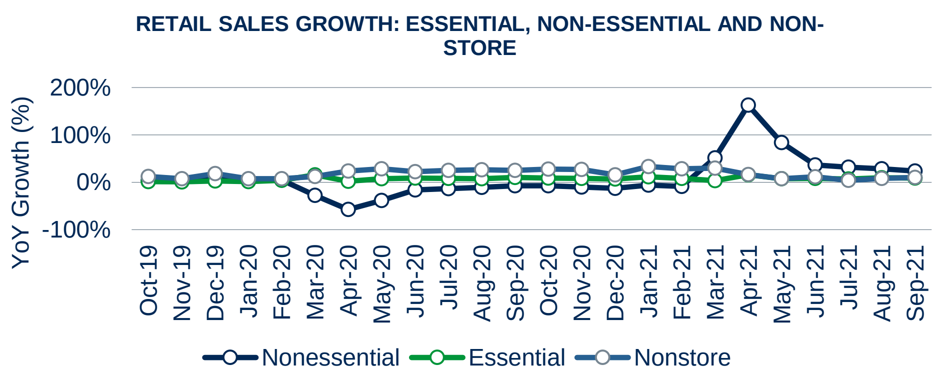
The consumer recovery is projected to remain intact as we head into the all-important holiday shopping season, despite weakened consumer confidence from the rise in Delta variant cases and supply bottlenecks. As of September, core retail sales continued to record double-digit growth (YoY) for the seventh consecutive month.

Despite a rise in cases over the past few months, consumers are continuing to spend at their local retail centers. However, consumers will likely continue to utilize the omni-channel methods they became so accustomed to during the past year. Hence, we believe omni-channel retailing with local fulfillment through retail centers will likely remain an important part of retailers' strategies moving forward.

While spending on essential goods will continue, we expect the holiday shopping season will also lead to a pickup in spending at discretionary and services retailers, as well as restaurants. This should result in continued foot traffic and sales at neighborhood and community centers, supporting the ongoing recovery in fundamentals for the sub-sector.

Neighborhood and community centers, with their resilient tenant mix and open air design, appear to be well-positioned to withstand and thrive in the post-pandemic retail environment.

FIGURE 6: ESSENTIAL AND NON-ESSENTIAL SPENDING REMAINS AT ELEVATED LEVELS



Source: U.S. Census Bureau, Barings Real Estate Research. As of Q3 2021.

HOTELS

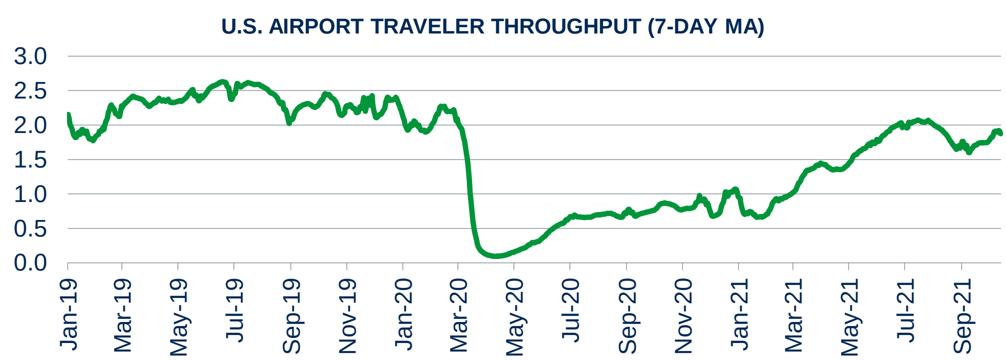
The recovery in the lodging sector continued to improve in the third quarter as travelers took to the highways and, increasingly, the airways to get away for vacation or business meetings. According to Smith Travel Research, average trailing 12-month U.S. hotel occupancy through September climbed to 53.7%, still roughly 13% below pre-COVID levels in 2019—but it has improved 440 bps YoY. As the vaccinated share of the population (both domestic and international) increases and confidence returns, travelers are looking beyond local drive-to destinations and quiet getaways. TSA data through September shows airport traveler throughput has slowed from peak activity reported over the summer, in line with pre-COVID trends, but still significantly above YoY levels.

That said, the demand recovery remains primarily leisure-driven. Business travel has started to revive, but most companies are focusing first on getting workers back to the office. As large format business meetings and conventions are planned for the upcoming calendar year, we expect the focus to then return to in-person attendance. The current 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 in either the luxury or economy segments.

Looking forward, we expect the hotel recovery to gain momentum and broaden beyond leisure demand as companies restore travel budgets and begin welcoming visitors into the workplace again. International arrivals will continue to be the slowest traveler demographic to rebound as international restrictions and varying vaccination rates across the world create headwinds. As with most things in the post-COVID economy, meeting increased demand will pose challenges for hotel operators, especially as it relates 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, in luring workers back to work.

The capital markets echo the improving trend in aggregate space market fundamentals for the hotel sector. YTD activity as of September totaled $30.1 billion, 16% above pre-pandemic levels with sales volume for limited-service hotels more than 60% above its pre-pandemic level.

FIGURE 7: AIR TRAVEL REBOUNDS TO PRE-PANDEMIC TRAJECTORY



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

SUMMARY

In conclusion, a broadly improving economic climate has the potential to provide persistent tailwinds for a continued recovery in space markets. A low-yield but increasingly inflationary environment supports the case for sustained investment in commercial real estate due to its durable cash flows, diversification advantages and potential hedging properties. With a comfortable yield spread to other asset classes, we believe CRE is well-positioned to attract further inflows in a yield-hungry, post-pandemic economic cycle.

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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