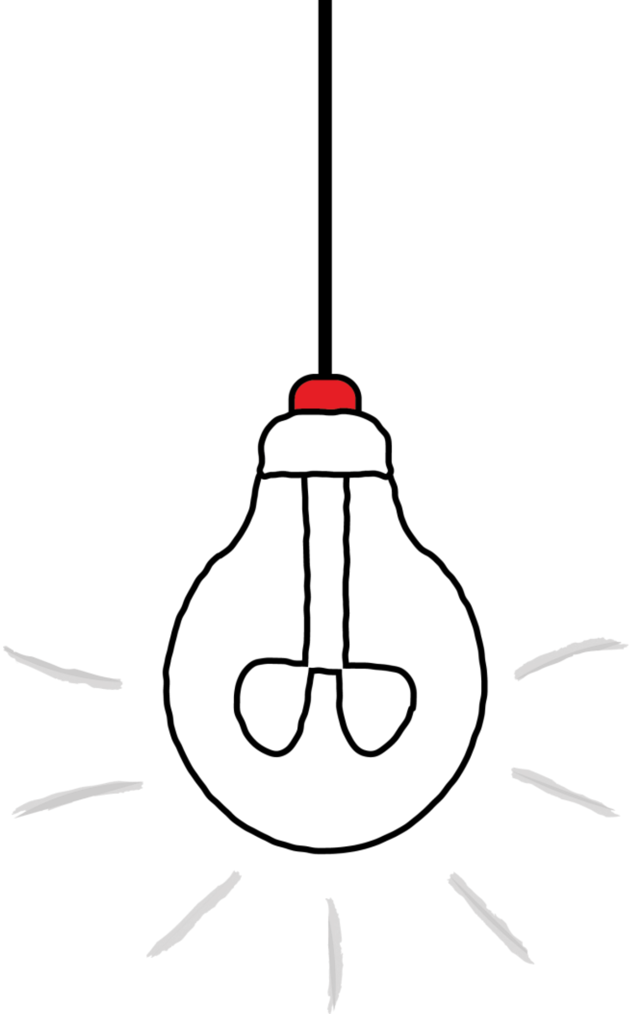
Key predictions

for real estate markets in 2022 | **January 2022**

Real estate
questions for 2022

What lies ahead?

We've narrowed it down to…



In our annual look into the year ahead, our research team gives answers to some of the key questions that real estate investors face.

A year ago, the impact of COVID-19 vaccines was at the forefront of everybody's minds. Our base case was that they would be effective, become widely available and allow the economy to recover, which proved largely accurate. However, COVID-19 very much remains with us, as the emergence of the new Omicron variant has reminded us.

A lot of the questions we looked at last year remain pertinent today. For example, we thought that logistics was not overpriced and it did indeed deliver phenomenal returns in 2021, even higher than we were expecting. We thought that office occupancy would increase, which it did, but trends have varied between markets and in some occupancy remains lower than we expected. We suggested that emerging sectors could become mainstream over time, which is starting to happen with lab space for example.

In 2022, the world will have to continue to grapple with COVID-19, made more difficult by the emergence of the Omicron variant of the virus. The new variant has the potential to both weigh on growth as new restrictions are put in place and provide a further boost to already high levels of inflation.

We look at ten important questions on the real estate sector (we address ESG questions in our separate publication here).

We look at topical areas such as the evolution of prop tech. And in office markets, we explore where we expect to see falls in values for secondary grade assets as occupiers bed down new hybrid working models.

We also look at whether the retail sector might finally be bottoming out and how feasible it is to make money from private rented residential given high prices. We ask whether the pandemic-ravaged hotel sector might now present some opportunities for investors. And again, we look at logistics and ask when it will run out of steam.

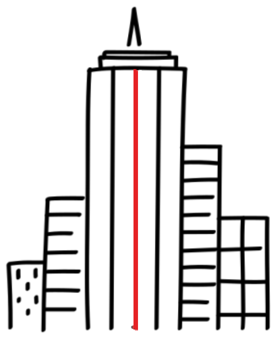
We also look at what impact sharp rises in construction costs have had on development margins, how real estate sits versus other asset classes and what strategy investors can follow should the outbreak of inflation prove asymmetric between countries. We hope you find our answers useful and insightful.

1 How do you define prop tech and how will it evolve?

Prop tech is a fast-evolving space that is poised to have large impacts on the real estate market. The sector has been loosely defined as any technology that touches the built world. However, most industry participants segment technology according to the value-chain of real estate. An example of segmentation would be site selection and negotiation; development and construction; analysis and financing; space identification and listing; space usage and management; payments and services; process automation; diligence.

The consumer-centric approach sweeping across industries has been adopted mostly by tech companies utilizing data to customize the consumer experience, drive revenue growth and lower customer acquisition and retention costs. Today, real estate is playing catch-up and requires technology to stay relevant to its consumers (the tenants). The drive to reduce carbon emissions will be partly achieved through hundreds, if not thousands, of building sensors, collecting real-time data to create a *digital twin* of an asset. This virtual representation can be stress tested by climate change and extreme weather scenarios to predict energy usage, emissions, and occupant health. The responsibilities of an active asset manager will undoubtedly require a focused approach to incorporating prop tech going forward.

2 What's happening in office markets and will we see a re-pricing?



Opinions on the office sector became highly polarized in 2021. Some commentators pointed to a rebound in occupier demand and the defensive nature of prime buildings against future working trends. More skeptical observers highlighted the slow pace of office workers returning to the office and the aggressive speed of obsolescence which will impact all but the prime buildings in a market. We would lean towards the latter point of view. We accept that the genuinely best office buildings can be quite defensive against future working trends. But such properties are a small proportion of the market.

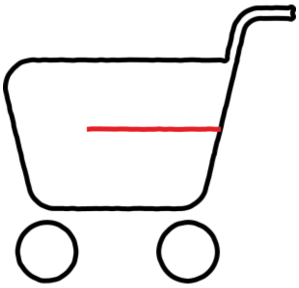
We think that increased levels of home working will have a negative net impact on office occupancy, and the costs to keep buildings relevant are rising. Significant amounts of capex will be needed to meet environmental regulations over the next decade. And with tenant requirements from office space changing considerably during the pandemic, reconfiguring buildings to match this new demand will also come at a high price. Assets in the best locations may deliver the rental growth needed to make this economically viable, but obsolescence in secondary locations could increase rapidly.

3 With residential pricing so high, can you make money from the private rented sector?

Record low transaction yields is not a phenomenon solely witnessed in multifamily markets. It is virtually the case for all commercial real estate sectors globally, particularly for prime assets. Despite low entry yields, we see a strong economic rationale for building multifamily exposure within a diversified real estate portfolio in the current market environment.

As cap rates have compressed to record lows in most sectors, it is reasonable to expect that income return will become the key component driving real estate investment performance in the near future. Especially while capital value growth gradually cools down. Keeping this in mind, multifamily assets in particular offer good income stability and are also an effective inflation-hedge. Strategically speaking, we expect agglomeration areas and attractive secondary cities to offer value compared to gateway city markets. This is mainly due to higher entry yield levels and rental growth prospects, as well as lower affordability concerns and regulatory pressure. Combined with a core allocation to plain-vanilla multifamily, we see good potential for investments in growing residential niche sectors such as student and senior housing, as well as micro-apartment projects. Indeed, these new sectors are lifted by strong socio-demographic trends and tend to offer higher yields when compared to regular multifamily due to the increased role and responsibilities of the manager in operating them.

4 Is retail bottoming out?



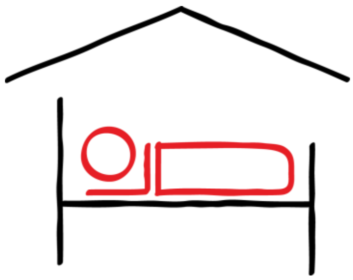
The retail sector has had a rough few years. Even before the pandemic it was experiencing severe disruption due to an ever-increasing share of retail sales occurring online, and is expected to rise further still. For example, in the US CBRE expects the share of online retail to breach 30% of total sales by 2030 from the current 20%. The pandemic was a further hit to retailers as it saw consumers turn online *en masse* as stores were forced to close by government mandated lockdowns. A lack of international tourists compounded the difficulties.

However, we are now seeing signs that the sector is bottoming out in some markets. For example, after several brutal years retail rental values in the UK look to be stabilizing and investors have shown some confidence in the sector. We expect MSCI data to show that UK retail warehouse capital values rose by 15% in 2021. Australia is another market where values look to be leveling off while South Korea is also well ahead in its adjustment. We expect retail to start to level out in more countries in 2022, with income returns and yields at elevated levels which are potentially attractive to investors. The highest grade retail is likely to perform best, along with grocery and convenience retail.

5 What is the best strategy should high inflation be asymmetric between countries?

What will happen to inflation is a key question heading into 2022 and it looks set to be much higher and to last for longer than originally expected. Moreover, it's quite likely that we will see asymmetric inflation which is more persistent in the US than in Asia Pacific or Europe. Inflation affects real estate performance in complex ways.

Typically, higher inflation has gone hand-in-hand with higher real estate returns, but at the same time it means that interest rates will also likely be higher, raising hedging costs for foreign investors. Overall, in 2022 we think that higher inflation will dominate and boost US returns for foreign investors by around 20bps compared to investment in the eurozone. With similar inflation, but higher interest rates and hedging costs, we think that returns in the Asia Pacific will be reduced by around 120bps compared to the eurozone. However, the pure inflation and hedging impact will likely be dwarfed by underlying market fundamentals. In countering inflation there is also the potential for central banks, intentionally or in error, to increase interest rates to levels that push the economy into recession, which would negatively impact real estate markets. Overall, if you are willing to take the downside risk, we think the US will deliver higher returns post-hedging in 2022.

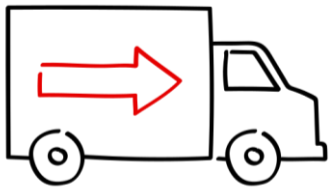


6 Is now the time for hotels?

COVID-19 has severely disrupted international travel and hit investor confidence in hotels hard, with Omicron denting a nascent recovery in confidence. According to data from Real Capital Analytics global hotel investment volumes fell from USD 25.9 billion in 4Q19 to USD 4.5 billion in 2Q20. Prior to Omicron, as the pandemic eased, people wanted to make up for missed holidays and business travel, which triggered some recovery. We think the sector may offer selective opportunities while prices remain depressed. In 3Q21, according to NCREIF data US hotel asset prices remained 16% below 4Q19, having fallen 19% between 4Q19 and 4Q20. In the medium-term, we think that hotels serving their domestic markets in developed economies should benefit from aging populations which lean towards domestic travel, and also from any lingering fears over COVID-19. More cumbersome international travel may see increased numbers opting for domestic vacations. Virus fears may also mean some vacationers prefer to rent villas and holiday homes instead of staying in hotels. Another factor supporting domestic hotels is a growing desire to reduce carbon footprints from leisure travel. At the same time, post-pandemic we think that lower tier tourist hotels in international cities will likely benefit from rising affluence in developing economies. This should see more people attain the financial resources needed to fulfil their desire for foreign travel.

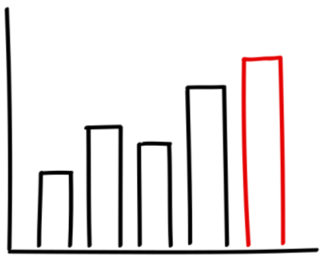
7 When will logistics run out of steam?

At the global level, we expect industrial to have been the strongest performing sector for the ninth year in a row in 2021 and that it will continue to outperform in 2022 as COVID-19 remains and continues to boost online retail. The logistics sector is enjoying significant tailwinds, riding the wave of strong rental growth, driven by booming occupier demand and low vacancy rates, along with strong investor interest. For urban logistics a lack of land and competition with residential is driving rents higher. Supply chain disruption is driving businesses to become more resilient by keeping higher levels of stock, which requires more warehouse space. We are also wary and conscious of potential disruptors though, such as labor shortages (staff and truckers) which can push up costs and lead to sites becoming uneconomical and new supply, especially for out-of-town warehouses.



The sector is also captive for taxation when governments eventually look to pay down debts built up over the pandemic. We think that caution is needed to ensure that investors do not pay excessive prices, as strong investor demand has driven risk premiums lower, and to be sure that rental growth assumptions are achievable. Overall though we think the party for industrial investors will continue into 2022.

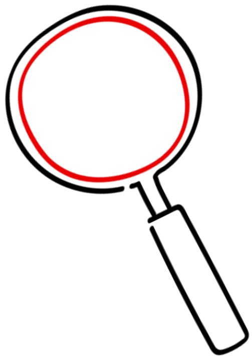
8 How does real estate sit versus other asset classes?



On the back of a strong global economic recovery, equities outperformed in 2021. As a consequence of stronger demand, inflation has spiked and expectations for monetary policy tightening have moved forward with a negative impact on bond pricing. Property has found a relative *sweet spot*, not yet impacted by the outward movement in bond yields but still benefiting from the economic recovery. However, it may not be such an easy ride from here.

Fixed income yields will not continue to provide the same level of support for property pricing as they have over the past decade. This does not necessarily mean interest rates will move out significantly, but even a stabilization could end the property bull-run which ultimately has been fueled by ever lower expectations for interest rates. As interest rate expectations shift, property investors cannot rely on market driven yield compression to support returns. Strong returns from property can still be achieved, though in a hawkish interest rate environment managers must shift their focus. They should look towards capturing future rental growth by adding value to their assets, rather than the buy-and-hold model which has relied on the market to do the heavy lifting until now.

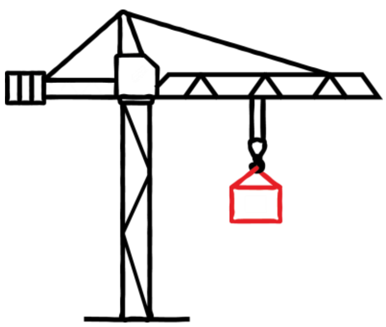
9 Do the niche sectors have the ability to absorb sizeable new capital inflows?



The data and available evidence suggest that niche property sectors do have the ability to absorb sizeable new capital inflows. Major niche sectors include data centers, healthcare facilities, life sciences, office life sciences, lodging, self-storage and manufactured housing. Certain niche sectors show greater ability to absorb capital than others. For instance, the life sciences market has never been stronger than in 2021. According to CBRE, all-time highs have been reached in funding, job growth, demand for lab space and new construction. Even if all planned developments in life science get completed, this portion would represent about 1% of the total US office sector inventory, according to Green Street.

Self-storage showed a post-Global Financial Crisis lull, which led to a construction boom starting in 2016 and incremental growth in annual returns during the same period. Self-storage in the US has a market capitalization of USD 460 billion, according to Green Street, and 15% is owned by public REITs. This suggests that the sector is still highly fragmented and able to absorb institutional capital. Overall, we suggest considering niche sectors with areas for growth, as the demand for capital could be greater there.

10 What are sharp rises in construction costs doing to development margins?



Sharp rises in construction costs are putting a dent in development margins. Rising costs (both materials and labor) along with stressed supply chains have strained development projects and delayed them. Rises, prior to beginning development, are generally manageable and development margins can generally be maintained.

But once a project has started and there are unexpected increases in construction costs, contingencies are quickly used up and the developer's profit is eaten into. Developers are getting more creative with their architects and contractors as they seek to find workarounds. New construction methods, different materials and a re-working of the supply chain are top of the mind for development teams as they attempt to keep cost increases and delays to a minimum. And while we are in a rising price environment for construction costs, we are also in an inflationary environment for rental rates in some sectors.

In the strong industrial sector, rents are rising at a breakneck pace and outpacing any rise in development costs. Therefore, development profits and margins are saved and still healthy. Apartments and self-storage are also keeping up with inflation. In other product sectors rent growth isn't as strong and with rising costs, some projects are no longer feasible.

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