HODES WEILL
& ASSOCIATES

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Hodes Weill's 2022 Market Commentary

Ten Takes on a Topsy-Turvy World

Global real estate and capital markets experienced torrid conditions in 2021 resulting from the twin accelerants of an enormous weight of capital and growth propelled by the "new economy." The NCREIF ODCE Index has announced its best performance year ever.[1] Though many predicted an improving economy and real estate market, few anticipated the exceptional results that were generated.

Now, just when we thought it was safe to get back to "normal", 2022 is starting out just as 2021 began. While COVID fears are starting to wane, other uncertainties abound. There are questions about the sustainability of economic growth, substantial inflation for the first time in forty years, the depth of tenant and consumer demand, the future of business travel, the free flow of capital globally, and access to investment opportunities in a world that is increasingly creating barriers.

Investors have been turning their outlook inward, investing closer to home, and lately showing more concern about rising seas than the rising tide of authoritarianism that may impede (or at least complicate) future growth. At the asset level globally, the market continues to assess if yields can go any lower; how many data centers, life science facilities, industrial and multifamily assets can be built and absorbed, and at what point the spread between in-favor and out-of-favor sectors reaches an inflection point.

Careful, objective observation and constant re-testing of assumptions is critical. We should never be complacent that what's past is prologue. The pace of change and catalysts for change are growing exponentially. We are regularly humbled by our inability to see all those things that look obvious in hindsight.

This is the 12th year that Hodes Weill is presenting its annual Market Commentary. While many organizations provide forecasts, we deliberately call this a Commentary. We ask our 34 global professionals to reflect on both dominant and overlooked trends affecting real estate and real asset investment management. We challenge ourselves to question "conventional wisdom." This year, dynamic views on ESG, nascent and traditional property sectors, and industry trends were on our minds. Given that we launched our Real Assets business last year, two of our commentaries are on infrastructure.

In summary, we hope that our Market Commentary helps you to make sense of the markets, re-think some of your basic assumptions, and enables you to do your job more effectively. We welcome your feedback and look forward to engaging with you (in person!) in the year ahead.

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1. Benson, Peter. ODCE is Set to Post Record 2021 Performance. PERE. 14 January 2022: https://www.perenews.com/odce-is-set-to-post-record-2021-performance/.

Reinventing the Office

Just as employers were gearing up for employees' post New Year's return to the office, omicron had other plans. As we reluctantly start to accept that coronavirus is here to stay, employers are asking themselves – what role does the office serve for our company?

Many realize that to attract and retain talent, it is imperative to have a flexible work-from-home policy. Three million additional jobs turned remote permanently in Q3 2021 alone, and the trend is accelerating.[2] Tech companies such as Facebook, Adobe, Salesforce and Twitter were some of the most prominent in this remote work trend. At the same time, tech companies drove some of the largest office acquisitions and leases of 2021. For example, Google acquired New York's St. John's Terminal for $2.1 billion and Apple leased 700,000 square feet in Sunnyvale, California.

White-collar workers have shown great productivity working from home. Employers keen on bringing their teams together realize they must offer an environment that far exceeds the alternative. Buildings that offer a work-life balance by enabling productivity and personal well-being will see strong demand. Features such as natural light, seamless technology infrastructure, commuter accessibility and world class amenities will be key differentiators.

This isn't lost on sophisticated investors. Several large high profile office sales share these characteristics—high quality, well amenitized space that has been recently built or significantly renovated.[3] Recently built examples include Blackstone's acquisition of an interest in Brookfield's One Manhattan West and Oak Hill's acquisition of 110 North Wacker. Renovations include Olayan's major repositioning of 550 Madison Avenue and Cove Property Group's redevelopment and sale of Hudson Commons that leased to Lyft and Peloton, and recently sold for $1.03 billion.

As investors set their 2022 priorities, some will position themselves with a simplistic aversion to office based on the uncertainties in today's world. We expect that those who evaluate the shifting nature of office demand will be rewarded with a bit less competition and the potential for strong returns.

Growth in European Life Sciences

The European life sciences sector has been red hot for several years though it remains in its relative infancy. Positive leading indicators signal that it is well positioned for significant further growth.

Corporate funding has historically been a strong indicator of future real estate demand. According to Savills,[4] European life science companies attracted €21 billion of venture capital in the last five years. This is more than

2. Data: Nearly 20% of All Professional Jobs are Now Remote. Ladders. 3 January 2022: https://www.theladders.com/press/data-nearly-20-of-all-professional-jobs-are-now-remote
3. Kirk, Patrick. Recent High-Profile Deals Show Institutional Investors Believe in an Office Comeback. Wealth Management. 11 January 2022: https://www.wealthmanagement.com/office/recent-high-profile-deals-show-institutional-investors-believe-office-comeback
4. *Spotlight: European Life Sciences,* Savills, 31 August 2021

double the preceding five years. An older demographic profile intensifying demand for life science innovation, a deep pool of talent to be employed in these facilities and growing government programs to support industry development create a powerful combination of positive catalysts. As seen in the US over the last three years, these factors accelerate demand for the property type and its operators.

"Kind of makes you feel large and significant, doesn't it?"

The UK has attracted a third of European life sciences VC capital. In response, significant institutional real estate investment has been focused on the "Golden Triangle" between London, Oxford, and Cambridge. This life science cluster competes globally with the established US hubs. Competition has become fierce among a skilled group of smaller, home-grown developer/operators and larger North American and Asian groups looking to leverage their expertise and expand into Europe. While we expect the "Golden Triangle" to continue attracting the most attention and capital, watch for other established and emerging European life science markets to grow in significance. The combination of well-established educational and research hubs and significant commercial real estate development experience in Berlin, Hamburg, the Cologne-Dusseldorf corridor, Amsterdam, Paris and Copenhagen make them all strong contenders.

Reflecting on the evolution of the US life science market over the last three years may provide insight into what's next for Europe. For example, a US expansion of the life sciences investment scope from lab space into biomanufacturing should export well. Skilled life science managers that pursue additional European clusters for investment and areas for expanded scope such as biomanufacturing are likely to give their performance a booster.

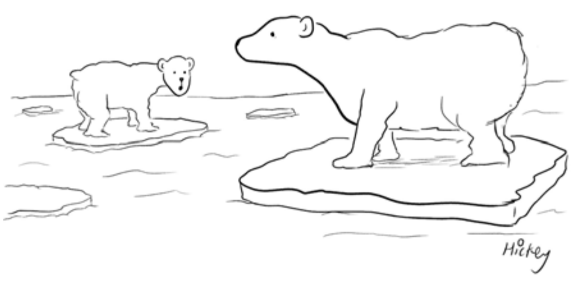
Future-Proofing Investment Managers

ESG is increasingly top of mind for investors, managers, and property owners. Many investors are demanding explicit consideration of, and proactive inclusion of ESG principles as a fundamental part of their managers' investment strategy and decision making. According to the 2021 Institutional Real Estate Allocations Monitor, 49% of investors reported that ESG policies impact their investment decisions, compared to 36% in 2020.[5] These expectations are becoming more concrete with formal targets, specific deliverables, and benchmarking.

While many managers are taking ESG - and DEI related considerations more seriously, few have put policies in place that demonstrate how it applies to their investment approach and business operations. Additionally, there can be meaningful costs associated with pursuing a proactive integrated approach. Time and money are needed for professional resources, measurement, and reporting tools. Lastly, managers need to show improving performance to their benchmarks to demonstrate accountability. While these demands are significant, managers should not see them as exclusively another cost burden on their business.

5. Weill, D. (2021). 2021 Institutional Real Estate Allocations Monitor. Ithaca, NY: Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, LP, November 2021. 25pp

The opportunity to improve ESG and DEI attributes are vast and should contribute to better performance. Research shows that buildings with superior sustainability credentials generate higher rents, lower rates of obsolescence, improved tenant satisfaction, reduced vacancy, and lower leasing incentives.[6] Crucially, progress needs to be made not just on new buildings, but on existing ones as well. Further, "companies in the top quartile of gender diversity in executive teams were 25% more likely to experience above-average profitability than peer companies in the fourth quartile."[7] While the investment management industry has started to build diversity in its junior ranks, executive teams remain a poor reflection of our society.

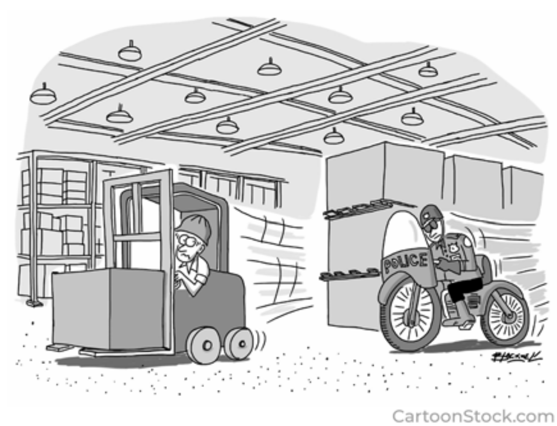


"Don't worry, I hear they're aiming for net zero carbon emissions for 2050."

ESG and DEI improvement strategies that are fundamentally integrated into investment manager's missions open attractive avenues for growth and value creation in these businesses. In a crowded competitive market, these principles can be clear points of differentiation. To some investors, these considerations are already essential. Managers seeking to future-proof their businesses to investors' ESG and DEI demands should redouble their efforts. Done well, we expect this to enhance managers' performance, talent pool for hiring, and client base. A win-win.

Industrial Derivatives

Industrial and logistics assets remain the darling sector for institutional investors and their managers. Insatiable demand for warehouse and distribution properties stems from e-commerce growth, on-shoring and supply chain challenges that are shifting inventories from "just in time" to "just in case" levels.



In 2021, US industrial net absorption was 533 million square feet, an 86% increase from 2020 and the greatest amount in the last 25 years.[8] Lower yields in more traditional industrial product and tenant demands for faster delivery times have contributed to the need for "derivatives" of industrial, not financial derivative products, but alternative asset types that play a similar role in the property market and benefit from common economic drivers. Common themes in these derivatives are consumer demand, flexibility, speed, and efficiency.

First, **Commercial Self Storage** meets the needs of businesses renting space to store inventory. Target users seek 500-2,000 sf spaces with 18-22 ft clear height and rolling doors. We expect to see more of this flex type storage to be purpose-built.

Second, **Co-industrial**, is driven by the dwindling supply of smaller multi-tenant spaces, coupled with high

6. "Decomposing the Value Effects of Sustainable Real Estate Investment: International Evidence", A. Devine, E. Yonder, 2017
7. Diversity wins: How inclusion matters, McKinsey & Company, May 2020
8. Marketbeat U.S. National Industrial Q4 2021. Cushman & Wakefield.

demand for flexible unit sizes and lease terms. Co-industrial operators that can adapt older product with lower clear height to meet this need. Like co-working, co-industrial offers businesses shared amenities, including heavy equipment, security, and administrative staff.

Third, **Integrated Service Facilities (ISF)**, offer tenants more speed and transportation cost reduction. ISF are critical as they consolidate and redirect cargo usually from a container to a truck or rail. They are typically found near major logistics hubs such as Northern New Jersey and the Inland Empire in Southern California. Cap rates are typically 1.5% higher than Class A warehouses but the spread is narrowing especially in high demand markets.

Managers who creatively respond to these innovative areas in industrial are expected to attract tenants and investors. These derivatives offer a possible route to deliver outperformance.

Japanese Offshore Wind Power

Historically, Japan has relied heavily on fossil fuels for their power generation with LNG, oil, and coal currently accounting for approximately 80% of the energy mix.[9] Now, the Japanese government has committed itself to carbon neutrality by 2050. To achieve this, it has revealed an ambitious plan. In Japan's Offshore Wind Industry Vision, the government has set targets of installing 30-45 GW of offshore wind power by 2040. Offshore wind power is essential for Japan's renewable strategy as solar and onshore wind power growth moderate given the limited availability of flat land.

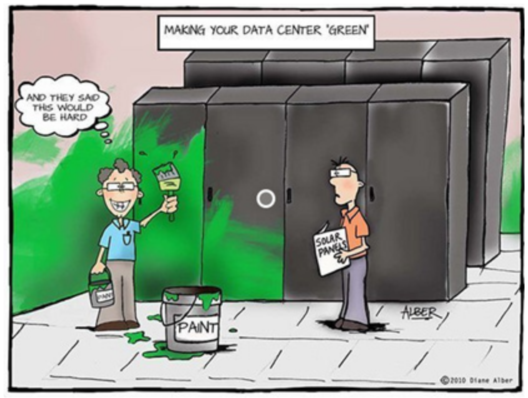
Being an island country with ample locations possessing high offshore wind speed, it is estimated that Japan's potential offshore wind power capacity is 552 GW.[10] This is equivalent to eight times the country's power demand. There are challenges such as the feasibility of floating platforms in deep coastal waters and installing a transmission grid across the nation. Yet, the potential opportunity scale coupled with a strong commitment from the government are expected to make this viable.

While this sector is still in its feasibility analysis phase and not yet investable, meaningful progress is being made. Public tenders are underway. The government will purchase power from the selected asset developers/ operators at a fixed price for 20 years based on a feed-in tariff scheme. We expect that bidders for these tenders will need significant infrastructure equity funding in the coming years. The scale of the opportunity, power source reliability, investment framework, and credit quality, combine to make a compelling investment opportunity in Japanese offshore wind power. Managers and investors would be wise to prepare to participate.

9. Agency for Natural Resources and Energy, composition of primary energy supply of Japan in 2020
10. Japan Wind Power Association. http://jwpa.jp/index_e.html.

Environmentally Governed Investment

The data center sector in APAC is proving to be one of the most promising globally, standing at 45% of the world market and growing faster than the US and Europe.[11] However, the high energy requirements of the asset class is clashing with institutional investor commitments to sustainability goals.



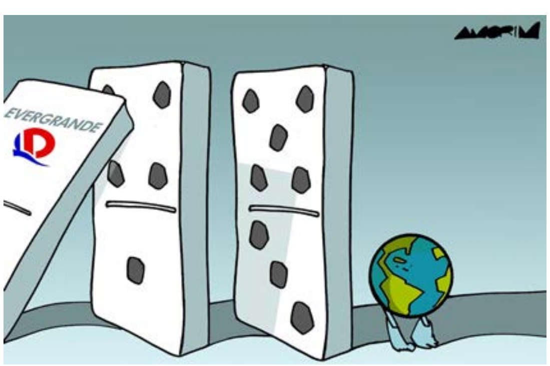
A growing number of global investors are setting multi-year carbon budgets in line with the Paris Agreement initiatives. Meanwhile, data center developers are being asked to commit to specific energy efficiency and renewable energy targets. In some markets of Asia, particularly those with hot climates and limited access to renewable energy, it is proving challenging if not impossible to meet these goals.

Ironically, in an advanced economy like Japan, which possesses some of the most attractive data center market fundamentals, there are currently few available sources of renewable energy. However, it is difficult to increase energy efficiency in the near term despite the plans for better options in the future. As a result, institutions are bypassing otherwise attractive investment opportunities and energy-efficiency gains.

Data centers in APAC will be developed to meet significant demand, regardless of whether they will be capitalized by environmentally minded investors or not. However, as investors increase demands on managers to adopt sustainability goals, they should recognize that longer term flexibility may prove to be the most environmentally and financially rewarding. Environmental performance can be achieved through emissions reduction requirements as renewable energy sources become available. With that flexibility, we expect investors should generate strong investment performance in a compelling sector, while delivering a more positive environmental impact than the non-environmentally minded investor that would otherwise capitalize these assets.

China Investment Despite a Credit Crisis

Even for those unfamiliar with the Chinese residential development sector, it would have been hard to ignore the headlines over the summer signaling the demise of China Evergrande Group and the pressure on other large scale Chinese homebuilders. Frequent and significant warnings about the potential contagion effect across property and capital markets were heard.



Despite the very real liquidity crisis that for-sale residential developers are now facing, institutional investors have largely shrugged off contagion concerns while reaffirming their strong conviction towards the world's second largest economy. A 14.9% growth in China Foreign Direct Investment ("FDI") was delivered in 2021 after already attracting more FDI than any other country in 2020.[12] Relative to an annualized FDI growth rate of 4.1% since 2010, it was a standout year.

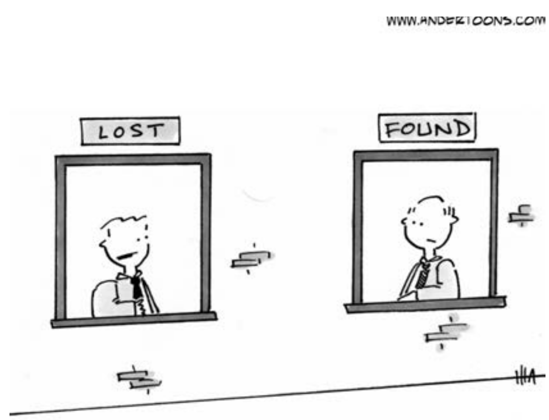
11. Global Data Centre Colocation market share report by Structure Research. December 2020.
12. Ministry of Commerce, PRC. February 2022

Institutional investors, notably those with a presence and/or experience in the region, remain active in real estate investments in China. This is most evident in preferred asset classes with strong fundamentals and favorable government policies, such as logistics (including cold storage), data centers and for-rent residential. In 2H-2021, over $4 billion was raised across four China logistics vehicles, outpacing the full year of 2020.[13] This doesn't even count significant China allocations expected from pan-Asian multisector funds.

With attractive attributes such as a large and relatively fast-growing economy, strong domestic consumption, and early recovery from the pandemic, investors shouldn't be too surprised if the Chinese real estate market sees a resumption and even an acceleration of capital inflows in 2022. This may occur well before the dust fully settles on the chaos still unfolding in the residential development sector. In global investment markets where post-COVID distressed investment opportunities have been less available than anticipated, investors should not overlook the strength in certain sectors of China's property markets.

Targeting Middle Market Manager M&A

2021 proved to be one of the most active years for real estate investment and fund management M&A on record with 33 transactions completed. This represents an 83% increase from 2020.[14] Factors such as geographic expansion, the maturing of companies and the industry, succession planning and tax considerations continue to be M&A catalysts. However, it is instructive to look a little deeper. We observed a notable shift from transactions involving large-cap managers (with more than $5 billion of AUM), to the middle market.



"Ever considered a merger?"

For both strategic investors and financial stakes buyers, a mid-cap or boutique target can provide higher growth potential. As one active investor in fund platforms commented: "it's easier to double your AUM from a starting point of $3 billion, as compared to $10 billion". This is especially true for those with top-quartile performance, operational capabilities, and specialization in sectors highly coveted by investors.

Accelerating technological advancement, altered living patterns and shifting demographics are dramatically changing real estate demand. Firms with skills in these newer areas often make smaller M&A targets due to their shorter lifespan for asset accumulation. Larger managers experiencing stagnant growth in traditional sectors, and seeking expansion in these areas, are faced with the question of "buy it or build it." They are focused on early-mover advantages and having trouble finding talent, especially in these newer technically demanding sectors. Increasingly, the answer is "buy it."

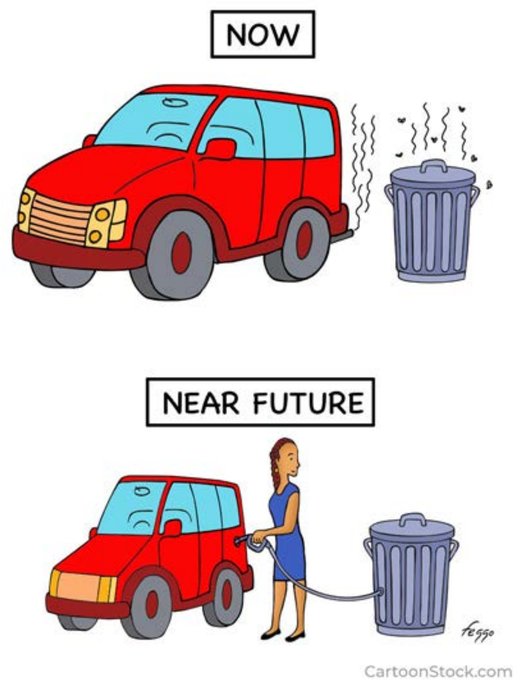
The next key question for buyers is how to value a manager with a higher growth trajectory, albeit with more concentration given only one fund series or strategy. To bridge valuation gaps, transactions are increasingly structured with earnouts that provide additional future consideration for achieving identified growth plans.

13. Preqin Pro. January 2022
14. Based on publicly available information, including transaction announcements, news releases, and company websites.

While this adds complexity to the transaction, sellers can benefit from higher overall proceeds, while buyers benefit from a well-aligned and highly motivated management team post-acquisition. As the middle market looks increasing attractive to buyers, heightened transaction volumes are expected to continue. Valuations will remain robust but future performance provisions will be necessary to seal the deal.

Waste-to-Energy Done Right

Interest has increased in investments that simultaneously fulfill growing energy demand and social infrastructure needs. One such opportunity is Waste-to-Energy (WtE), a sector that delivers renewable power and addresses the mounting social burden of global waste.



One of the significant issues associated with waste is the emission of methane. Methane reduction was a focal point of COP26. After CO2, methane is the most abundant greenhouse gas. It is estimated to be responsible for approximately 30-50% of human-induced global warming.[15]

The recently launched Global Methane Pledge aims to reduce methane emissions by 30% by 2030. This initiative identifies the methane reduction potential in waste management as greater than both fossil fuels and agriculture sectors. The value of this opportunity is compounded by urbanization and industrialization trends that are expected to drive waste levels up by almost 50% - from 2.6 billion tons annually to 3.4 billion tons by 2050.[16]

WtE technologies are intended to help significantly address this challenge by converting waste into a source of renewable energy, but it is not a panacea. "Conventional" WtE generates power through incineration, producing significant, even net-negative levels of CO2 emissions. Prudent investors will identify WtE opportunities with higher efficiency processes. These include alternative outputs such as "Waste-to-Pellet", or WtE paired with Carbon Capture, Utilization, and Storage (CCUS) technologies.

We expect WtE investments to grow over the medium-term. While the volume in this sector isn't as high as other "traditional" infrastructure verticals, deal sizes have gotten larger. In July 2021, a WtE platform was acquired for $5.3 billion. With strong government support based on COP26 commitments, this compelling yet somewhat overlooked sector has many reasons to turn managers' heads.

15. Intergovernmental Panel on Climate Change. January 2022.
16. The World Bank. January 2022.

Continuation Vehicles

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. Blackstone's nearly $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.

The benefits for the manager aren't hard to identify, nor are the challenges in navigating a sale with the manager on both sides of the table. What shouldn't get lost is the importance of articulating why a recapitalization is the best execution for existing investors.

For sectors experiencing long-term structural changes, a systemic imbalance in supply and demand might cause investors to prefer to hold assets beyond the execution of a value-add business plan. Many investors have already been pursuing "built-to-core / long-term hold" strategies so why not look to the assets held in their private closed-end funds?

Similarly, for hard-to-access investments, institutions might prefer to stay invested, rather than have capital returned and begin the search for a new opportunity again - even putting aside the frictional costs of this trading. In other instances, short term value creation plans may have played out, but longer-term portfolio expansion, rent growth, or densification opportunities could provide another leg to returns.

In any case, managers should remember that no matter how "mainstream" continuation vehicles may become, related-party transactions will always be met with healthy skepticism from investors.

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