Nuveen Real Estate

How will real estate emerge in 2022?

2022 has come with uncertainty. Inflation continues to have a wide range of implications for real estate, but which sectors will prevail? How will geopolitical tensions affect real estate? The outlook for 2022 is positive, but longer-term implications persist.

Recently, **Chase McWhorter,** Institutional Real Estate, Inc.'s managing director, Americas, spoke with **Shawn Lese,** CIO and head of funds management, Americas, for Nuveen Real Estate, about the outlook for the real estate investment market. Following is an excerpt of that conversation.

Describe the effect the rising interest-rate environment is having on real estate.

Up until June, the year was looking a lot like 2021. Operationally, real estate was performing strongly, and the capital-markets component of real estate investing was healthy. There was a very efficient and competitive debt market, and a good amount of equity was being raised. With the first Fed interest rate hike of 75 basis points in mid-June, all that changed. The market recognized that the Fed raised interest rates in response to the high inflation number that had come out the previous week. The debate about whether inflation was transitory versus persistent ceased. The hike confirmed the Fed had recognized inflation was not transitory and that it needed to do something to fix the problem. Their previously stated dual objectives of maintaining price stability and full employment couldn't both be maintained, so they decided to fight inflation by proverbially slamming on the economic brakes.

Almost overnight, the inflation dialogue changed to: "Are we in for a soft landing, or a mild or severe recession?" Accordingly, the commercial real estate debt markets responded and pretty much stopped functioning, as lenders waited to see what would happen to operating fundamentals and valuations.

Today, the debt markets are starting to open slowly, but only to the best sponsors in the best kinds of projects. It is a lot more expensive to get mortgages than it was two months ago: Spreads are out maybe 100 basis points as risk has repriced. And this is affecting property valuations. We still are seeing trades involving the highly desirable property types – multifamily, industrial, some types of alternatives – but these are clearing at prices that are 5 percent to 15 percent lower than in the first half of the year.

How do you manage in light of this current situation?

For our existing portfolios, we drive performance through active asset management. The good news is that operating fundamentals remain strong. Vacancies are low and rental growth is high in a lot of sectors. For new acquisitions, we're patient and pursuing only appropriately priced deals, with a focus on the most resilient sectors and locations. If we do have a higher period of volatility going forward, we will see a return to "location" being a super-critical determinant of the success of the investment. As a result, we are deftly looking at markets with the best demographic trends.

In 2021, investors concentrated on sectors showing resilience during the pandemic. In 2022, will investors shift their focus?

Investors are going to look at the fundamentals, which come down to supply and demand. A number of sectors that had very strong tailwinds in 2021 and the beginning of 2022 continue – for instance, housing. Today in the United States, the largest age cohort comprises millennials in their early 30s. They are starting to form families and need new living places, so you've got a swell on the demand side. From a supply perspective, we slowed building houses back in the global financial crisis, and only in the past couple of years has production ramped back up to a steady run-rate level. The United States has a shortfall of housing units of between 3.5 million and 5.5 million, and with that kind of supply/demand dynamic, we think housing, in all its different forms, represents a strong investment thesis.

A similar dynamic is present on the industrial front. Ecommerce is only increasing, and with supply-chain dynamics moving from "just-in-time" to "just-in-case," we are seeing industrial tenants who need to expand their space to be able to accommodate additional inventory. Furthermore, onshoring continues to gain traction. All of this leads to more demand for warehouse space. On the supply side, delivering new supply in the market today is as costly as it's ever been. Raw materials are expensive, labor is expensive, and delivery of specialized materials is delayed. And then you need to get approval from municipalities and governmental bodies to build. Many of these processes are backlogged, and localities are less supportive than ever.

What geographic markets should investors be considering, and what effect is the parity between the dollar and the euro having for real estate investors?

If you are a dollar-based global investor, this is an exciting time to be in the market, with the exchange rate hitting parity between the dollar and the euro. The yen is also historically weak. From a currency perspective, now is a good time to take advantage of investing abroad. But when you're investing abroad, investors, of course, still need to scrutinize the fundamentals in those markets. In Japan, for instance, where the currency is cheap, the economy remains relatively strong. Inflation is higher than it has been for 25 years, but it is still only 2.0 percent to 2.5 percent. It is one of the world's most stable economies. In Europe, we like Central Europe for its valuations. The production of gas is a huge benefit to Norway's economy. Ireland has a booming tech industry, and it has been a beneficiary of Brexit, with numerous people and companies moving in. That said, we still think the United States is probably one of the best risk-adjusted markets into which to be investing, especially with growth in the Sun Belt and certain western markets.

The pandemic caused a major shift in employees' needs and lifestyles. What effect will this have on real estate, and will we begin to see the workplace transform?

The answer to this question seems to change every couple of months, as new COVID-19 variants or outbreak waves have repeatedly delayed a full-scale return to office. Europe and Asia have seen a much higher return-to-office rate than the United States. In the United States, about 40 percent of employees are occupying their office space, versus return rates of 70 percent in Europe and Asia. In Austin, a little more than 60 percent are back to the office. New York City, meanwhile, has one of the lowest rates, between 30 percent and 40 percent.

Until recently, U.S. companies have been reluctant to force anybody to get back on the subways or to return to the office. But this is changing. This higher risk of a recession may change the mindset of the office users, and cause employees to realize they cannot take their jobs for granted as they did in the recent past. There will be increased pressure for employees to show up to work and try to be as much of a team player and as present as possible. At the same time, employers have changed what they want from the physical space they are renting, focusing on places that will encourage employees to return. Tenants are thinking, first and foremost, about health and wellness. New or newly renovated properties have been developed with this in mind, including sophisticated HVAC systems and touchless functions controlled by an app. Secondly, the buildings that are amenity rich – with good food offerings, a gym, outdoor space, breakout space, coffee space – will make the most desirable locations for tenants. Employers want to make employees as happy as they can, while employees will feel the need to return to the office for perhaps competitive reasons.

Alternative real estate sectors, generally, have represented a small slice of the pie for private real estate investors. How do investors currently view alternative real estate? Is appetite increasing?

Appetite absolutely will increase. Alternatives have been on the radar of investors for more than a decade, with investors thinking of alternatives as one broad property sector. At this point, they are looking at alternatives, not just as a fifth category, but breaking it down into at least 15 different property types that fall within the alternatives bucket, each of which is driven by different factors. These include a host of healthcare-related alternatives, such as life sciences, medical office buildings, different levels of senior living and nursing facilities. Another broad category is technology-related, including data centers and cell towers. Other alternatives fall within the "heads on beds" category, such as student housing, manufactured housing and single-family rentals. These are all becoming institutionally accepted property subsectors and have been significant winners during and before COVID-19. I wouldn't be surprised if a typical portfolio in five years comprises 50 percent alternatives.

What are some factors creating a surge in funding for the life sciences sector?

There's a surge of funding going into the healthcare companies that are tenants in life sciences properties – something like $86 billion went to private companies in 2021, which is a record high. There are several reasons for these inflows. First, there are research breakthroughs and new gene therapies, combined with accelerated drug development, which are reducing sequencing costs. If you have an idea you want to research, performing that research is far more affordable today. Costs are decreasing, in part, because artificial intelligence and big data are creating complex algorithms that enable the analysis of large groups of data rapidly, which allows for quicker drug testing. Researchers can use predictive analytics to figure out more quickly whether the ideas they have are going to work. Finally, software has allowed for automation of routine tasks that these researchers have to do, which also reduces costs.

A lot of money is pouring into this property sector from the real estate investor side. There's a "silver tsunami" driving the dramatic increase in the amount of attention on healthcare. Add to that the tech innovation, which is influencing the tech startup companies. Third, there is very limited existing available space for this kind of work. Add the COVID-19 accelerant, and you understand why life sciences is expanding as a real estate investment sector.

What kind of operational expertise does a manager need to create value in this highly specialized field?

I'll highlight two things. First, operators need to know how to deliver the facilities tenants want, including the correct technical aspects of the space. For wet labs, this includes providing the right kind of plumbing, ventilation and HVAC; the right kind of redundancy for electricity; and all the other types of energy delivery that will be needed. Dry labs, where the computational analysis takes place and the engineering of the different genes or pharmaceuticals occurs, also have specific requirements. Also, the facility needs a high level of reusability, so when there is turnover, the space will be immediately attractive to new tenants.

Equally important to the design of the space is selecting the right kinds of tenants. This involves understanding the specific science the tenant is pursuing and how well capitalized it is. Many tenants are high-credit "big pharma" companies. But some are startups, requiring a critical analysis of the science and the landscape in which the therapy, pharmaceutical or instrument they are creating is going to compete. We also look closely at the leadership of that team. Have they done this sort of thing before? What is the M&A environment like? If they do come up with a new idea, will they be able to capitalize on it and continue to grow?

Where are the next big opportunities for investors in life sciences?

Within the life sciences space, most of the big investors are focused on R&D lab space. We like that area, as well. But there is a huge opportunity in biomanufacturing, which requires Good Manufacturing Practice certification from the FDA before drugs can be developed in a facility. While there are 7,000 drugs in the development pipeline, there are only 152 existing manufacturing facilities in the United States that can produce those. Roughly 88 percent of the drugs we consume in the United States are made outside the country. Onshoring will become a strategic priority, along with building space suitable for biomanufacturing. For this work, the building will be shell built, ready for GMP certification, but the tenant will come in at the last minute and customize it to their needs. Often, these markets are not considered to be the classic life sciences markets; consequently, there exists an opportunity for outsized returns.

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Shawn Lese serves as the CIO and head of funds management for Nuveen Real Estate's more than $100 billion Americas platform. He leads a team of seasoned portfolio managers in driving investment performance and partnering with clients on their current and prospective real estate investments. Lese oversees the end-to-end investment process. He is a member of the Global Executive Leadership Team and is chair of the Americas Investment Committee.

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CORPORATE OVERVIEW

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