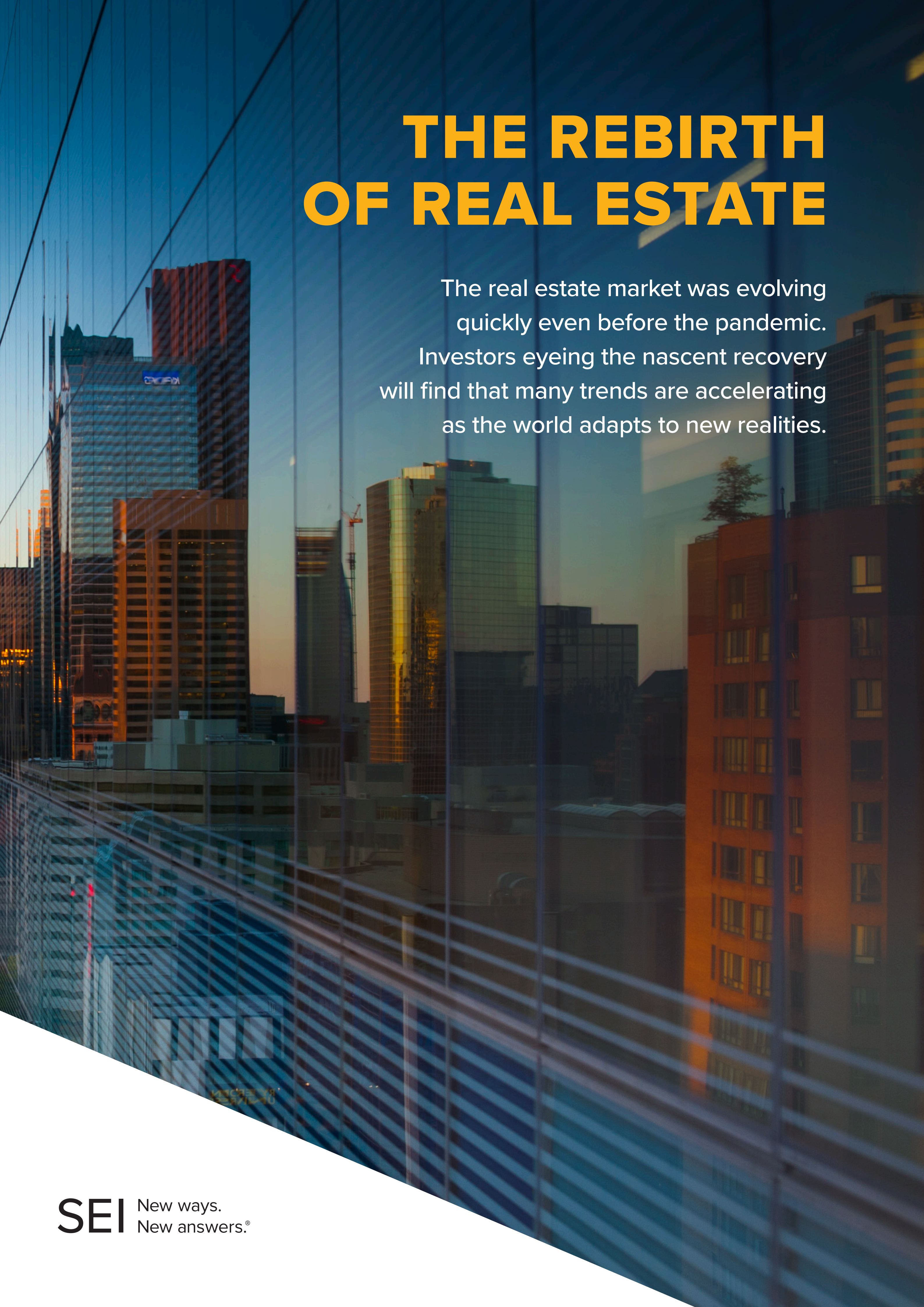

THE REBIRTH OF REAL ESTATE

The real estate market was evolving quickly even before the pandemic. Investors eyeing the nascent recovery will find that many trends are accelerating as the world adapts to new realities.

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A SHOCK TO THE SYSTEM

When we released *The Future of Real Estate Investing* in early 2020, we noted that investors "are facing rapid-fire change whether they like it or not." This much was evident even before anyone was aware of the extent to which life and commerce would be disrupted in the subsequent months. It is now clear that the pandemic acted—and continues to act—as a catalyst, accelerating the rate of change beyond anything we anticipated.

This development is particularly notable in light of the prevailing stance we found among many of the general partners surveyed in 2019, whose attitudes toward macro trends might best be described as nonchalant. Focused on their own business models and investment theses, many chose a blinkered view of the market that could prove problematic. Limited partners, on the other hand, were more inclined to weigh external variables in their investment decisions. As the industry begins to pull itself out of its pandemic-induced slump, we thought it would be a good time to re-examine the continued evolution of market trends.

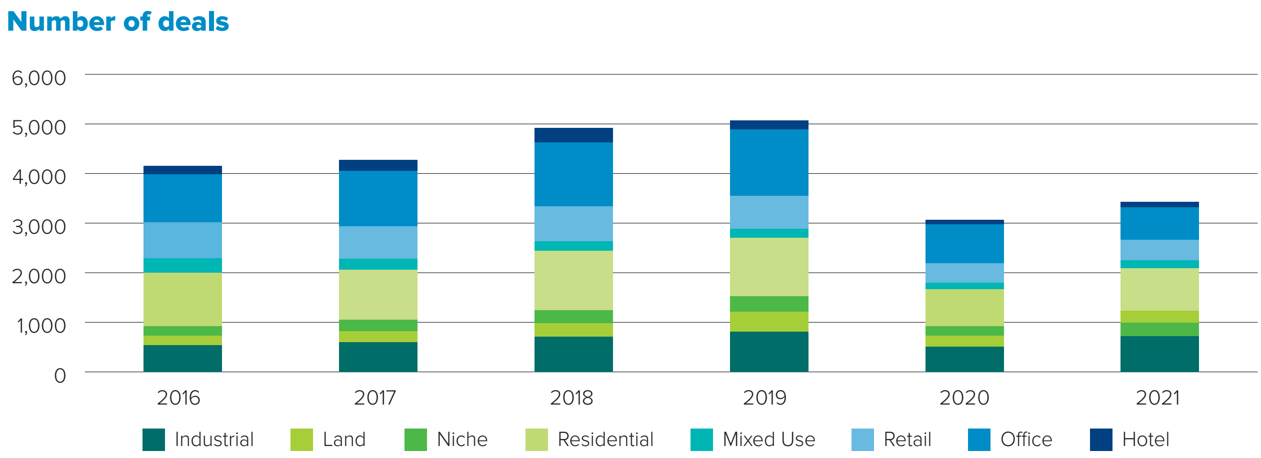
AN UNEVEN RECOVERY

Secular trends will be harder to ignore going forward. Remote work is reshaping market dynamics, with implications far beyond the growth of smaller markets. Untethered from working in specific locations, many more people can now choose to live wherever they like, adding a new wrinkle to pre-existing issues such as climate change and the affordable housing shortage. Meanwhile, e-commerce suddenly became the standard model, quickly and permanently altering the retail and industrial property sectors. Technological innovation is also driving change, with proptech streamlining investment workflows, smart buildings promising unprecedented efficiency, and habitable buildings being produced by giant 3D printers.

The pandemic briefly slammed the brakes on real estate investments, but the commercial market is now recovering. After a traumatic year in which many businesses stood vacant and new construction slowed to a trickle, we are seeing an uneven recovery. On the one hand, the number and aggregate value of real estate deals has climbed steadily after plummeting in early 2020. On the other hand, fundraising continues to drift downward with the number of new funds and aggregate value raised in the second quarter of 2021 at (or near) the lowest levels seen in at least five years. Capital is being called up more quickly than it is being distributed, which is something we have not seen in a decade. Until dry powder is drawn down more significantly, however, we are not likely to see fundraising rebound strongly.[1]

The industry is at an inflection point, not only in terms of recovery but in terms of direction. Recent deal activity reflects shifting priorities. Hotel deals, for example, are happening at only half the rate we saw pre-pandemic. Office buildings are not much better. Industrial deals, on the other hand, are actually outpacing the average rate of deals pre-Covid. Savvy investors thrive on uncertainty and change, and current conditions in the real estate market fit the bill. Investors who successfully decode all of these changes and move forward with a clear-eyed vision will be rewarded with long-term success.

FIGURE 1. Global PERE Transactions by Property Type – H1 annually



Source: Preqin

COMING TO GRIPS WITH THE NEW WORLD

Because it is an experience shared by virtually everyone at this point, it is easy to discount how radical the global experiment in remote work has been. Being geographically tethered to a job used to be an unquestioned part of life, but the notion of "where" one works is beginning to seem quaint. The future of work is coming into focus, and it appears that many companies are settling on hybrid models that emphasise flexibility, capitalising on the myriad benefits of remote work while encouraging vary degrees of attendance in physical offices.

Affordability and mobility in the residential market

Residential markets are already being reshaped. Pre-existing interest in secondary and tertiary markets has shifted into overdrive as individuals choose to live outside of dense urban environments, reasoning that longer commutes are a reasonable proposition if only required once or twice a week. Working from home has also caused many people to prioritise space to work, exercise, cook, and engage in hobbies or side hustles.

Affordability plays no small role in this shift, as purchase and rental prices can be considerably lower in these markets. In the US, states such as Utah and Idaho are growing the fastest, with 18.4% and 17.3% population growth over the past ten years respectively.[2] Many of the fastest growing cities are exurbs of larger metro areas such as Salt Lake City, Phoenix, or Dallas Fort Worth.[3] Some of these have doubled in size over the past decade.

Additionally, cultural amenities and healthcare facilities are other reasons many people are loathe to stray too far from major metropolitan areas. Notable exceptions include college towns that punch above their weight class in both categories, prospering despite their diminutive size. Already demonstrating attributes that attract new residents, such communities are being chosen by developers as sites for non-traditional residential developments that incorporate various amenities, are less auto-centric, and cater to residents at different points in their life cycle.

Rental properties are another major area of interest, with surging institutional participation in the residential rental market. Investment activity is not limited to multi-unit properties. Single family home rentals are an increasingly hot commodity, with some even being built specifically as rentals. Such build-for-rent (BFR) projects accounted for 6% of new construction last year, up from 4% in the prior year. This is projected to double by 2024.[4] This trend is being driven by demographics (i.e. Millennials starting families and needing more space), the lack of affordable housing, and a more transient lifestyle encouraged by the ability to work remotely. BFR developments are increasingly being conceived as communities complete with fitness and pool facilities for residents to enjoy.

Back to the office?

With nicer and more affordable living quarters tempting many to work from home indefinitely, there are understandably questions around the viability of office space as an investment proposition. It is not that demand will vaporise. The pandemic and subsequent move to remote work initially resulted in some apocalyptic forecasts for the future of office space, but those appear to have been overdone. The market bounced back strongly and seems to be reasonably healthy, albeit reflecting some changes as more corporate tenants shift to flexible work arrangements.

If anything, new offices may be developed at a fast clip, given the accelerated obsolescence caused by changing needs post-pandemic, according to David Lowery, Head of Research Insights at Preqin. There is clearly more need for collaboration spaces, as hybrid models become the norm. Speculative development will probably cluster very closely to transport hubs in order to minimise commute times. Creating inviting spaces has also become a priority for firms looking to recruit and retain the best talent. Significant capital is being directed at value added refurbishment to address all of these issues, but they are also important considerations for new construction.

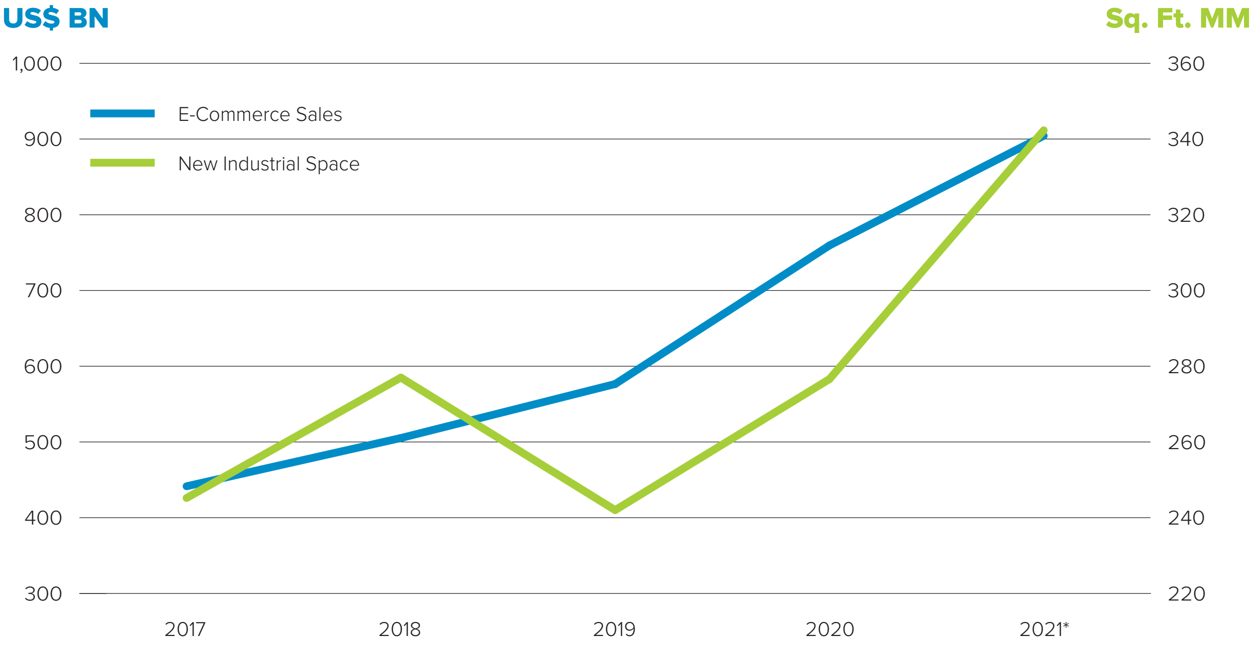
22 Bishopsgate—a recently completed skyscraper that ranks as London's second tallest and the largest commercial building ever built in the UK—may prove to be an interesting litmus test for the level of overall demand for what (if any) design qualities and amenities are most successful in enticing people back to the office. In addition to traditional concerns such as space utilisation and elevator efficiency, the developers of 22 Bishopsgate devoted considerable effort to making the tower a destination where work is "sociable and pleasurable." They even went so far as to commission a signature scent for the building, with "hints of sage and mandarin." As genuine as these intentions may be, it remains to be seen if they resonate with tenants and investors. While the building is pitched as a thoughtfully conceived vertical community, one otherwise admiring architectural critic observes that it is "hard to be a container ship and a village at the same time."[5]

The reinvention of retail

Future demand for office space may be questionable, but there is no denying the need for logistics centres. The sudden and almost universal shift to e-commerce precipitated by the pandemic decimated many traditional retailers, but the industrial sector is booming as the world reorganises distribution infrastructure around home delivery. Already employing one out of every 153 Americans, Amazon announced in September 2021 that it was planning to hire another 125,000 permanent employees.[6,7] This is on top of an additional 40,000 corporate and technology professionals as well as 150,000 seasonal workers the company plans to add for the 2021 holiday season.[8]

This retail revolution is sometimes reflected in the repurposing of existing structures, as empty malls are adapted for use as local logistics centres facilitating "last mile" deliveries that are proving critical amid widespread expectations of next (or even same) day deliveries. More centralised warehouses are likely to be purpose built, if for no other reason than they are being designed differently to be more efficient. Over the past decade, starting in 2011, average new warehouse buildings started becoming significantly bigger and taller.[9]

FIGURE 2. Distribution Centres to Service E-Commerce Sales are Driving Surge in US Industrial Construction



* Projected sales and completions

Source: U.S. Census Bureau, Commercial Edge, Anzu Research

It may be time to designate retail logistics as a discrete property type. A recent CBRE Research study found that for each incremental US$1 billion growth in e-commerce sales, an additional 1.25 million sqare feet of distribution space is needed to support this growth.[10] The Covid-19 pandemic caused 2020 e-commerce sales to surge more than US$180 billion in the US alone, compressing five years' worth of e-commerce growth as a percentage of total retail compressed into only six months.[11] A market for 230 million additional square feet of space materialised virtually overnight.

Demand for logistics infrastructure was building long before the pandemic, but the surge caught some investors off guard. A lot of repricing has already happened, and we are seeing more portfolio deals for investors looking to rebalance and get more exposure. Others are selling into this strong demand, choosing to reduce their exposure after five or six years of stellar returns, according to Preqin's Lowery.

The secular trend is undeniable, but the traditional retail sector may be on the path to a partial recovery. In the first half of 2016, industrial property deals accounted for only 75% of the volume of retail deals. Five years later, it was retail that accounted for only 56% of industrial deals during the first six months of 2021. Reasoning that the market overcorrected, some investors are now being tempted back. Here again, it is the details that matter more than overall direction. Conditioned by the pandemic to avoid the indoors wherever possible, there is growing interest in retail properties that include outdoor space. Uncertain footfall means traditional fixed rents are also being replaced by turnover-based rents, injecting additional risk into an asset class that is otherwise becoming more attractive once again.

Evaluating environmental risk

As if navigating these changes was not challenging enough, environmental considerations are more pressing than ever before. Climate-driven changes to the physical environment are no longer theoretical, and real estate investors and developers must come to grips with how to address these changes by mitigating risk, reducing carbon footprints, or building in resilience as a selling point.

Real estate investors made peace long ago with the fact that cities are often built on rivers or coastlines, making them vulnerable to rising water. However, they are increasingly uncomfortable with the fact that this flooding is becoming more frequent. According to the EPA, every site measured along the US coastline experienced an increase in coastal flooding since the 1950s, and the rate of increase is accelerating at most locations along the East and Gulf Coasts.[12] Hurricane seasons are also getting more active and expansive, repeatedly threatening wider swaths of coastline and traveling further up the east coast of North America each year.

In the American west, wildfires consume more area each year, incinerating towns, dislocating people, and polluting the atmosphere. The total acreage burned by wildfire in the US has risen steadily over the past three decades and now regularly tops ten million acres (4.05mm hectares) annually.[13] Already the largest fire in California history, with close to 1 million acres (404,700 hectares) burnt, the Dixie fire is still burning (as of this writing), over 3 months after it started. The pace of destruction in 2021 is a historical record and at the end of Q3 is already ahead of the preceding year, which was already the worst annual fire season ever with 4.3 million acres (1.74mm hectares) burned, according to Cal Fire.[14]

Often flaring up in remote tracts of wilderness, wildfires traditionally did not threaten built environments as often as floods or storms. As remote workers move to vulnerable areas in search of a better quality of life, people are increasingly finding themselves in harm's way. After scorching a popular ski resort, the recent Caldor fire was stopped at the very edge of South Lake Tahoe, a world renowned tourist destination and hub for remote workers who fled the San Francisco Bay Area during the pandemic.

Risk parameters clearly need to be recalibrated. Black swans are not as rare as once thought, and any preconceived notions around "hundred year droughts" or "thousand year floods" need to be carefully appraised in light of newly available information. Luckily, intense scientific scrutiny means the data is available to inform actuarial models that could significantly reduce ambiguity. The simple fact is that real estate investors will not be competitive if they do not get a handle on their environmental liabilities.

The focus is naturally on risk factors with near-term implications. From a portfolio management perspective, few investors are inclined to seriously consider environmental impacts in the distant future. The feedback loops that drive climate change mean this is not a sustainable approach. Short-term thinking is likely to lead to suboptimal, if not ruinous, results. After years of being tolerated or ignored, ESG is quickly entering the mainstream of real estate investing. In our earlier paper, our research showed that more than half of all managers turned down otherwise attractive investment opportunities due to ESG concerns. Only a small minority did not consider ESG to be a factor in their decision making. In today's market, however, institutional investors are looking for the ESG credentials of managers, and developers are trying to come up with ways to address ESG issues in the design and build stages. Some are going a step further by trying to capitalise on climate change as a theme, choosing to develop particularly resilient properties and incorporating renewable energy into developments.

A NEW ECOSYSTEM

Real estate is an interesting asset class, not least of all because it has the capacity to directly address secular trends such as aging populations, growing environmental risk, the lack of affordable housing, and the widespread adoption of e-commerce. Any of these can pose a threat to existing portfolios, but developers, fund managers, and investors are in a unique position to respond by building properties that alleviate societal challenges while delivering a return on investment.

The need to generate these returns in such a volatile environment is behind another trend: The rapid adoption of technology across an industry that traditionally changed at glacial speeds. Some technological innovations are being packaged as new business models for consumers. 3D printed homes can now be configured and purchased online from Mighty Buildings.[15] Remote workers can lean into the experience with a membership in Landing, which facilitates a nomadic lifestyle with a network of furnished apartments.[16]

What is being invested in is not the only thing changing. How those decisions are being made, how strategies are being packaged, and how properties are being developed and managed are all changing. Technology can smooth the way as managers try to adapt. Many already recognise proptech tools can help them screen a higher

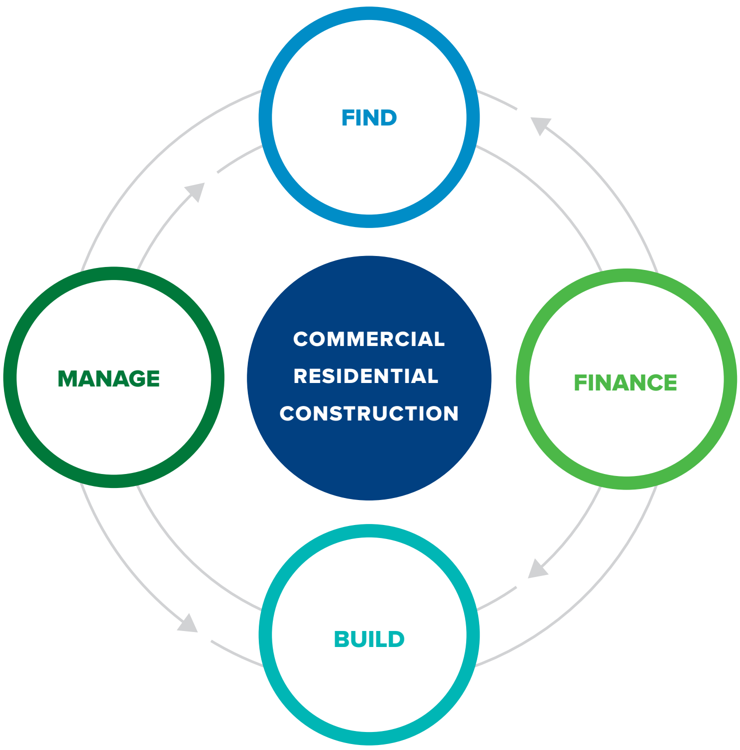
FIGURE 3. Proptech Ecosystem

FIND
Agent Tools
Viewing & Imagery
Listings & Marketplace

FINANCE
Digital Brokers & Lender Lead Gen
Equity Financing Platforms
Property Data & Appraisal
Transaction Management
Lending Technology

BUILD
Construction Marketplace
Digital Collaboration
Planning & Design
Pre-Fabrication
New Materials

MANAGE
Indoor Navigation
Occupancy Analytics
Tenant Management
Energy Management
Property Management
Building Automation & IoT



Source: Adapted from Proptech Collective market map volume of projects more quickly in greater detail. Digital transformation can streamline workflows, provide scalability, improve operational efficiency, reduce carbon footprint, and mitigate the volatility of business cycles with predictive analytics. All of these are likely to make smaller managers more competitive with their larger rivals.

Moving real estate transactions to a blockchain environment could theoretically level the playing field even more, reducing costs and time along the way. It remains to be seen whether such an application of technology could ever take hold. Lawyers are not likely to be keen on being replaced by Ethereum-based smart contracts. Technology that is less disruptive and more of a win/win situation might stand a better chance of being adopted, at least in the short-term. Tools aimed at improving building efficiency fit the bill: Inexpensive sensors, the internet of things, and rapidly improving AI tools mean lower operating costs, higher margins, and greater sustainability.

New technology partners will increasingly be joined by service providers, fleshing out an ecosystem that should ultimately permit real estate managers to focus more on their core investment activities. As seen in other asset classes, outsourcing is gaining acceptance as real estate becomes more operationally mature. As noted in Global Custodian, "the ability to leverage robust systems, processes, and platforms, coupled with increasingly complex fund structures, has set the stage for a continued shift towards outsourcing."[17] As they work to unravel and leverage myriad trends over which they have little control, real estate managers will need to focus all of their energy in order to make prescient investments that stand the test of time.

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