Decelerate NOW. *Slowdown* ahead

Inflation, supply chain challenges and geopolitical conflicts present significant challenges for everyone, but as research heads **Sabrina Unger** *at American Realty Advisors,* **Albina Reydman** *at Lendlease,* **Lee Menifee** *at PGIM Real Estate, and* **Chris Caton** *at Prologis discuss, one of the biggest concerns facing commercial real estate is the deceleration in demand, and the subsequent risk of repricing.*

Transaction markets are already pricing in lower valuations, but that is expected to become more pronounced over the next six to 18 months, according to the researchers. As a result, the focus for real estate investment managers has to be on long-term drivers of growth or 'change agents' — education, demographics, sustainability and technology — with a deep focus on the needs of the tenant.

By Zoe Hughes

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PARTICIPANTS

Chris Caton
Managing Director, Head of Global Strategy and Analytics, **Prologis**
Chris is responsible for the research, advanced analytics and valuations capabilities at Prologis. These teams create and interpret industry data; identify and project emerging trends; and communicate and develop tools to drive business strategy. Prior to Prologis, Chris held various real estate research and strategy roles at Morgan Stanley and, before that, CBRE.

Lee Menifee
Managing Director, Head of Americas Investment Research, **PGIM Real Estate**
Lee is responsible for leading PGIM Real Estate's research efforts and overseeing the research teams that support PGIM Real Estate's investment management activities in the US and Latin America. He is a member of the US and Latin America Investment Committees. Before joining PGIM Real Estate, Lee led American Realty Advisors' research capability, supporting portfolio, asset management, acquisitions and marketing functions.

Albina Reydman
Head of US Research, **Lendlease**
Albina provides leadership and management oversight in developing and implementing Lendlease's research framework in the Americas region. She has established and standardized analytics and reporting to ensure a proactive, data-driven and strategic approach across Lendlease's development and investment management platforms. Albina joined Lendlease from the Market Analytics/Portfolio Strategy team at CoStar Group.

Sabrina Unger
Managing Director, Head of Research & Strategy, **American Realty Advisors**
Sabrina is responsible for leading the firm's research initiatives and working closely with the firm's Investment and Portfolio Management teams in developing investment analysis in support of new acquisitions and strategy implementation. She is also a member of the firm's Investment Committee. Prior to joining ARA, Sabrina was a member of the Global Research team at Invesco Real Estate.

Given the current state of affairs, what is top of your mind? How are you thinking about your research and the investment strategies your research informs your firms?

Chris Caton, Prologis: As a logistics real estate company, we are acutely focused on the structural changes happening in the industry, many of which were accelerated by the Covid-19 pandemic. One is the future of retail and the change in shopping habits as customers globally move from in-store to online. The other is the future of supply chains and change in fulfilment requirements, including the need for more resiliency.

For an owner of logistics real estate, the change is positive. In the top 30 markets in the US, a typical year for demand growth is 200 million to 225 million square feet (msf). It was 400[msf] in 2021. This year, we are on pace for nearly 400[msf], so demand is running roughly double its historical average as these structural trends translate to real market activity. The vacancy rate in those 30 markets is 3%, whereas the typical functional range is 6[%] to 9[%]. Rents have spiked in a durable way.

Lee Menifee, PGIM Real Estate: We have a lot of embedded growth in our real estate assets as well. If rents stood still, we would see continued growth and rising income for the next few years. But what worries me is that there are a lot of lagging factors in the system — specifically, rising interest rates and inflation, and the risk that inflation now becomes pervasive rather than pesky, with central bank reactions that follow.

This is another way of saying I am less worried on the property income side and more worried that, as expectations of income growth come down from double digits to single digits, we will see much lower returns over the next six to 18 months.

Sabrina Unger, American Realty Advisors: To Lee's point, when we talk about lag, we believe we still have six to 12 months' worth of inflationary pressures to work through the system. We envision that creates the potential for a lot of slowdown on the macroeconomic growth side that we are focused on monitoring.

The other thing that keeps me up at night is the politicization of our asset class. There is a lot of pushback against multifamily and for-rent single-family residential, purpose-built and otherwise. Affordability is a key issue, and local jurisdictions and communities are beginning to look more and more at things like rent control. Institutional ownership is viewed as a negative. I think that creates a challenge in these sectors where we are seeing strong investor appetite. What could be described as NIMBYism [not in my backyard] against developers adding new stock is really a headwind for residential. When it becomes harder to develop, less development occurs. Studies have shown time after time that rent control and restrictive regulations often end up worsening prospects for renters. Rather than protecting renters, it exacerbates affordability.

Albina Reydman, Lendlease: We are all concerned about economic momentum but, when you really dig into it, there are just a few core issues that are influencing a lot of what is going on. For example, supply chain issues that began years ago are still a concern for us, especially for specialized products on projects underway. Now we have the conflict in Ukraine and tensions in China which could prolong that further.

Chris mentioned the very low vacancy rates in industrial. Life science may be the industry where vacancy rates are even tighter than that. In Boston, the vacancy rate is sub-2%, and that has created outsized rent growth. We bought a development site in Boston during the pandemic last year, and I can say that we are now expecting rents to be 30% to 40% higher than our original underwriting. As there has been significant embedded growth, we are also having to stay disciplined as we are looking at new deals and understanding what is going on globally in terms of geopolitical and macroeconomic risks.

THE COMING SLOWDOWN

What are you expecting on inflation and what are the challenges for you as you look to the current inflationary environment?

LM: A lot of inflation is coming through via cost-push inflation, as well as through the war in Ukraine and the supply chain. Our view is that the supply chain bottleneck is easing, but as energy and food are two huge contributors to inflation, the outlook for Europe is more troublesome than the outlook for the US, which is less affected and is self-sufficient in both energy and food.

Much of the reported inflation is going to occur no matter what. For example, housing and shelter costs have about an 18-month lag between when they go up and when they show up in the inflation rate. Measured inflation is going to be high, but we are not necessarily concerned with that number because that is a measurement issue rather than an actual underlying problem. Having said that, these measurement issues matter because policymakers have to respond to those measured numbers.

Therefore, our expectation is that inflation probably is less pervasive than the Federal Reserve Bank forward curves indicate. Financial markets are implying that inflation is going to be a receding problem as soon as early next year. That is all contingent on a relatively sanguine geopolitical outlook, which could yet change. The good news is that inflation should be less of an issue next year. The bad news is underlying real estate demand is likely to be less than it has been over the last few decades.

AR: I completely agree, Lee. There is so much inflation already built in that the headline rate almost matters less than our response to it. I am most concerned with the central bank response globally and whether they overcorrect. It is very hard, I think at this point, for them to separate out how much of this is the product of lagging indicators, and how

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much are things completely out of central bank control. Raising rates further may not solve the issue of commodity price volatility caused by geopolitical conflict, but it may slow down the economy too quickly.

This is something we are hearing across all of our regions. Lendlease is an Australia-based company; Australia has not had a real recession in 30 years, and they are also concerned that rate hikes might trigger one. Fortunately, for a global business that develops, builds and manages across multiple asset classes, challenges for one arm of the business can be opportunities for another.

CC: We also have to ask ourselves as real estate investment managers, in what ways does the inflationary outlook impact our view of our business? There are at least three channels: one is required returns, two would be replacement costs and the third would be implications for the macroeconomy. Given the events which took place over the summer, the third scenario around inflation being a negative macro has been discounted to where the probability is very low.

As a large owner of real estate, we are perfectly happy to see replacement costs go up. The fact that it costs 20% more to replace buildings is a positive. In addition, the supply chain for building a building has been really challenged, and access to scarce building products separates winners from losers. We have been pre-buying steel, for example. By locking in pricing and commitments on commodities and other products, we are essentially getting ahead of cost inflation.

I would also say that there is a clear pause in the repricing of risk in the financial markets, including real estate. It is really about picking the right opportunities at the right price at the right returns.

SU: Naturally we are focusing on what the current inflationary environment means for real estate investment strategies, but I would add that we think through not only the next 12 to 18 months, but the next 10 to 20 years. Real estate is a longer-hold asset class. For our firm's investment strategies, we identify key trends, what we have dubbed 'change agents,' that are forces that may not be proven with data today, but that we can envision fundamentally changing future demand patterns in a way that will create material under- and outperformance. These factors fall neatly into either a technology bucket, a demographic bucket or an environmental bucket.

When you start to pinpoint these forces, they all seem to point to lower demand and lower growth. Looking at long-term structural components of the domestic economy, we see productivity growth not offsetting a lack of population growth. As a result, we do not believe inflation gets entrenched at its current levels, but we should assume it may settle at a rate marginally higher than where we were last cycle.

FORWARD STRATEGIES

When you are underwriting some of that lower growth, what does that mean in terms of property types or strategy?

SU: We are leaning into areas that are supported by our change agent hypotheses — for-rent residential, industrial and select specialty sectors like self-storage. That said, we are being very prudent in the growth assumptions, especially regarding new acquisitions. We would love to be surprised to the upside, but it really comes down to being appropriately conservative. I come back to this point of discipline in our underwriting, of not thinking that the current growth environment can last forever.

LM: Compared to six months ago, the outlook appears worse than what we were planning for and maybe materially so. There are two things happening now. The first is repricing. The outlook for occupier demand is weaker and that is occurring across all property types. It is not necessarily a decline in demand, but rather a deceleration that raises the risk of repricing. We have already seen that in transactions markets. Some of the higher frequency indices that we look at already say values have come down on a transaction basis in those sectors. The second is the pressure from higher base interest rates means that the valuation of private real estate relative to other asset classes, has gone from being pretty inexpensive, as recently as the beginning of 2022, to pretty expensive based on those metrics.

Over the next six to 12 months, we need to focus on the long-term drivers of growth, by property type and then by geography. Specifically, a focus on education — the human capital that is going to drive real estate values over the longer term and investing in markets with high-quality human capital — is going to be the most powerful risk mitigator in this environment.

Then there is transformation. Sabrina and I may use different words for saying the same thing, but we have a similar focus on demographics, decarbonization and digitalization. Those are also the overlying themes as we think about which geographies and which property types are best positioned.

Given the economic and geopolitical outlook, where do you want to steer capital?

LM: We are looking for a combination of an absolute level of growth and the quality of that growth. The key distinction for many investors has been Gateway versus Sunbelt. We no longer think that is the distinction; rather we expect to see a real divergence in performance within those two categories. For example, Austin, Denver and Raleigh will screen very well from a human capital perspective; we think they will do better in the future and, at a minimum, hold on to the very significant gains that they have had over the last couple of years.

SU: We have a robust methodology tailored for each product type that we use for market selection. We are looking at the things Lee is talking about: human capital, the quality of folks moving in, their income levels, the types of jobs that are expanding in certain metropolitan areas and the companies expanding there. For for-rent residential, it is home price appreciation relative to the trajectory of rent growth. We then go more granular, to the submarket level, in order to profile and identify turning points in local submarkets.

In terms of market selection, we like the outlook for Austin. We also have looked at San Antonio as a more cost-conscious tag along to that strategy. We like central Florida, as well as certain markets in the South and West, but there are also some of the more traditional markets along the coast that we actually think can do reasonably well. Boston would be top of the list.

AR: We are both a developer and an investment manager, and the vast majority of our portfolio are assets that we have developed. For that reason, we are highly selective in what opportunities we pursue, and we are following trends we find attractive long term more so than maybe a nimbler investor who does not function on that five- to 10-year development horizon. Because of that, we have a very rich understanding of market dynamics.

For years, we struggled to buy land in Boston to build multifamily because assets were trading under the assumption that they would be developed as a life science property. Now there is a pipeline of 20-plus million square feet of life science space that is going to get delivered over the next five to 10 years, but developers have not been progressing multifamily sites. There are going to be a lot of very highly paid workers entering the market and not much institutional multifamily supply. That gives us a lot of conviction in Boston and other similar markets where residential has been priced out by other asset classes.

CC: Over the last decade, never has more alpha been generated than by being focused on logistics real estate and being focused on the high-barrier and major markets on the coasts. That will not change over the intermediate term. We are overweight on coastal United States and then equally on other places that have high barriers in economically dynamic markets, such as the UK, Northern Europe, Tokyo, Osaka and coastal China.

FORESIGHT DIRECTION

Where else does commercial real estate need to be paying attention?

CC: What it means to be an owner and developer of logistics real estate has changed over the last decade. I will highlight three things. The first is customer-centricity. We have a chief customer officer who heads a team to partner with logistics real estate users to help them think about their network, growth and build-outs. We also have a standard lease that we say is the shortest lease in logistics real estate. These come from a mindset of prioritizing and partnering with the customer, which will ultimately attract and retain them through cycles.

The second is technological innovation, whether it is automation or new business models. We have a venture arm, Prologis Ventures, where we invest in supply chain start-ups focused on best-in-class solutions. These companies also create opportunities to reinvent our business.

The third is sustainability. In the US, we are the third largest provider of solar, which is a feature that is becoming more front and center as we partner with our customers to improve their own sustainability performance. Earlier this year, we committed to a net zero pathway by 2040 across our entire value chain.

AR: We are very committed to ESG. The property sector is responsible for about 40% of all greenhouse gas emissions and, as we both develop and build, we are starting to see people actually allocate money around that. We delivered the first all-CLT (cross-laminated timber) hotel in 2016 and we are

For work and for pleasure

What are you reading or watching both professionally and personally?

Albina Reydman: I am just finishing up a book called *St. Marks is Dead* by Ada Calhoun. It highlights how every couple of decades going back all the way to Peter Stuyvesant, each generation claims that the spirit of St. Marks Place in the East Village is dead, yet somehow the street just reinvents itself. It is very inspiring as we are thinking about creating places that will thrive for generations to come.

Chris Caton: I am reading business books: *Working Backwards*, *Good to Great*, *Built to Last*. I think once you are good to great, you want to be built to last. And then *Only the Paranoid Survive* is one that is probably 30 years old and is still true today. In terms of watching, I will admit to being hooked on the F1 show on Netflix called *Drive to Survive*.

Sabrina Unger: We are doing a lot of thought leadership on demographics and the potential impacts on real estate by generational change, so I am rereading *What to Expect When No One's Expecting* by Jonathan Last. For fun, I have been enjoying reading snippets of *New Yorkers: A City and Its People in Our Time* by Craig Taylor whenever I am on the train. It is the same author who wrote *Londoners*. I am not ashamed to admit I am re-watching *The Office* for the umpteenth time.

Lee Menifee: I have been following *Barry* on HBO Max. In terms of what I have been reading for work, I am reading about what I think is the most important thing in real estate right now, which is the changing regulatory environment and, in particular, housing. I have on my desk *Arbitrary Lines* and *From the Ground Up*. From the narrow perspective of a real estate investor, we could say supply constraints are good, but those constraints have been affecting the overall economy and demand for all types of real estate. I am spending a lot of time on them and I hope to understand them better.

continuing to invest in CLT. We are actively investing in green concrete and lower-carbon steel.

We can quantify the environmental side of ESG pretty well. Now we are working on improving how we quantify the social side. We have invested in a team that is figuring out how we can track engagement on the programming we are doing. How can we make sure that we are actually hiring people from the local community? How can we make sure that the climate resiliency projects we are doing are actually having the impact that we want them to have? It has been an investment because there are not any external social sustainability raters to our satisfaction, so we have been tracking it ourselves.

SU: I would love to see the industry evolve to bifurcate passive versus active social impact and to be able to measure that. Of the ESG, social is the hardest to measure as it stands — where 'E' and 'G' are pretty standard, everyone's 'social' is different. As an example, we are currently in fundraising for a dedicated essential housing fund to serve what we describe as the 'missing middle' — renters by need who are squeezed between affording a house and limited rental options. This is a strategy that we feel is an active social solution.

There is a huge gap in the middle where millions of households here in the US cannot afford Class A apartments, do not qualify for subsidized housing, and are left with very little choice. They are often in neighborhoods that are transit deserts, lacking access to quality infrastructure and far from jobs. We are working to solve that problem actively by owning and maintaining properties that fit the profile of the middle-income worker, but also delivering new product that is priced for those people.

I would like to see our industry lean more into active social solutions that can demonstrate the benefits achieved to investors. We look at 'doing well by doing good' — producing attractive performance while serving the communities in which we are investing. Executing on ideas, measuring the social good and incentivizing investors to want to be a part of that solution is where I would like to see the commercial real estate industry go next.

LM: We are focused on reducing the number of key performance indicators that we produce. I do think we need to distinguish between the table stakes and the areas that we have a lot of discretion over. You have to decide what is important and what is your return on investment (ROI); that is not a limitless set of possibilities. There are things that you need to prioritize.

From a research perspective, the most important thing that my team can do is identify where we have the maximum impact, in terms of both measured impact as well as the ROI that comes from that. We are still at the early stages of quantifying that ROI. ◆