

Real estate outlook 2022

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As we emerge from the pandemic, and “return to normal” remains underway, there have been significant changes to real estate fundamentals. Our private real estate team at Lionstone Investments shares its views on the investment climate for real estate, and the secular and cyclical trends that inform their investment positioning.

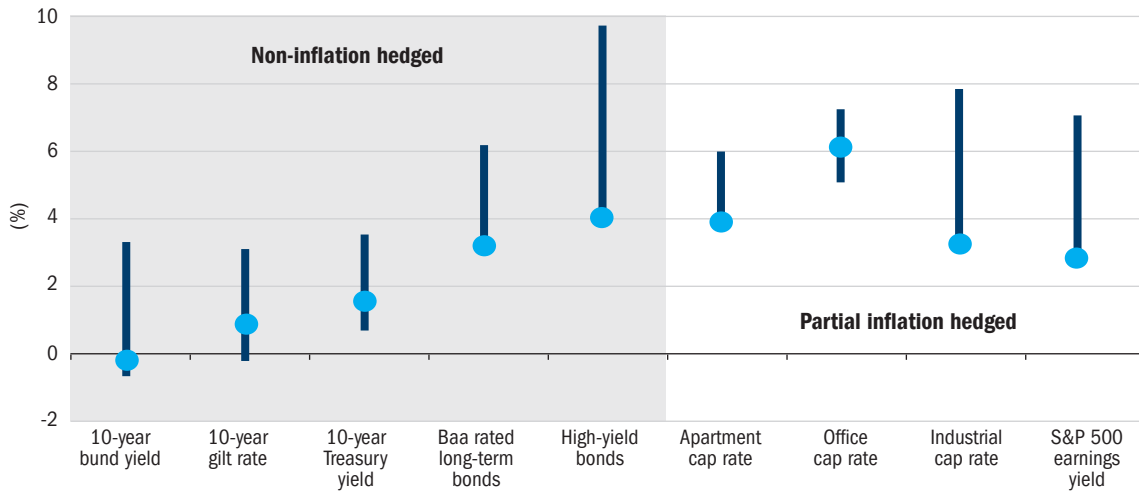
The macroeconomic environment is broadly conducive to real estate

The U.S. economy experienced a strong recovery in 2021, growing by 5.2% according to the International Monetary Fund, and is expected to continue expanding in 2022, driven by the fading impact of COVID-19 and pent-up consumer demand. While the removal of fiscal and monetary stimulus is likely to pose a drag on the economy, we believe it is still expected to grow above trend in 2022, which is supportive of real estate across all property types (e.g., retail, residential, office, etc.).

At the same time, inflation has proven to be both more persistent and higher than the Fed and the markets initially anticipated coming out of the pandemic. Rising costs are impacting a wider set of goods and services, and the supply distortions that are driving this are not likely to end quickly. During the third quarter of 2021, inflation consistently exceeded 6%. And in December, inflation hit 7%, its fastest pace since 1982. As the inflation story broadens from goods to services — which are the dominant driver of the U.S. economy — we believe inflation will be stubbornly high through the first half of 2022, and then decelerate through the end of the year. Traditionally, investors have perceived real estate as an asset class that functions as an inflation hedge, or at least a partial inflation hedge, depending on the specific property type. While that conventional wisdom has been debated, there are certain attributes that are likely to help this asset class weather the impact of higher prices relative to others, including increasing income and appreciating asset value.

Financial markets are flush with liquidity, and ultra-low interest rates are driving investors to hunt for yield, resulting in most asset classes looking expensive, especially as measured by their earning yields relative to their 10-year average (exhibit 1). At the same time investors who are seeking to add inflation hedges to their portfolio are finding that many of the “traditional” inflation hedges (e.g., Treasury Inflation-Protected Securities, commodities) are expensive and are locking in significantly negative real interest rates. Against this backdrop, real estate income yields — which offer at least a partial inflation hedge — continue to appear attractive versus both equities and fixed income.

Exhibit 1: Yields for most asset classes are at the lower end of their 10-year range



Source: Lionstone research, Green Street, CNBC, WSJ, Bloomberg, as of September 2021.

Secular drivers of outperformance: Employment, demographics, migration

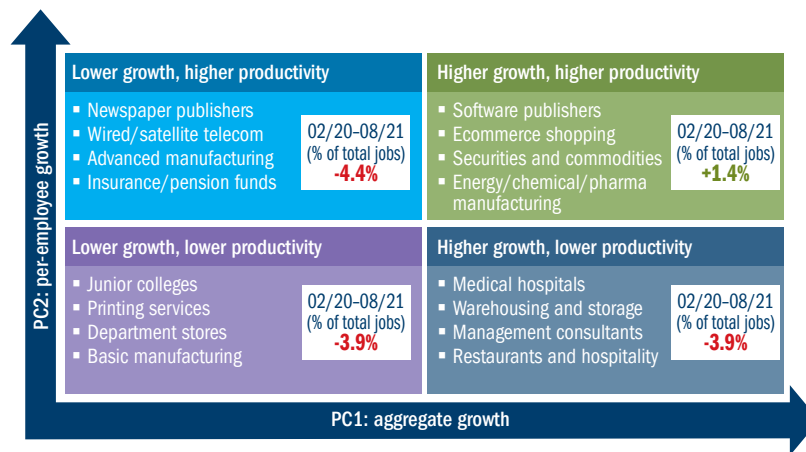
While the overall macroeconomic environment is supportive of real estate, given the potential headwinds from inflation and rising interest rates, it's critical to be selective. As we begin 2022, we believe that outperformance in real estate will be driven by three secular drivers: employment, demographics and migration.

1. Employment

Outperformance of certain U.S. cities, in terms of job growth and in-migration, has increased through the pandemic and the ongoing recovery in areas where the digital economy is strongly rooted. In the run-up to and during the pandemic, the only jobs to post gains were high-growth/high-productivity jobs that are best classified as “digital economy” and include fields such as software publishers,

ecommerce shopping, securities and commodities, and energy/chemical/pharma manufacturing. Heading into the downturn, we believed that these jobs would be more resilient in a recession and would emerge from any economic slowdown stronger and faster. The pandemic was a strong test of our theory, and it was proven correct. From February 2020 through August 2021, these jobs have increased their share of total jobs by 1.4%, while all other job classifications lost around 4%. In addition to their share of jobs, this group is also outpacing all others in terms of wages.

Exhibit 2: The digital economy pulls away



Source: BLS, Moody's, Lionstone Research, as of August 2021.

For the U.S. as a whole, jobs are expected to regain their previous peak by the end of 2022 and total jobs in five years should be about 15% higher than they were in 2006, a 20-year period. Our focus continues to be in “hockey stick” markets (exhibit 3), the section of the U.S. spanning from the Pacific Northwest, down through the Rockies into Texas and over through the Carolinas and Northern Virginia. In this region, jobs should recover their losses by mid-2022, and employment should be about 40% higher than in 2006. At the same time, big coastal markets (e.g., NY, Bay Area, DC, LA) are significantly weaker than U.S. trends, and we believe will continue to lag over the next three to four years.

Exhibit 3



Source: Lionstone research as of December 2021.

2. Demographics

It's never been more important to be aware of demographics (exhibit 4). When we look at the forecast for the next five years, we see that the overall working age population growth — the age cohort of 20 to 64 — is almost zero. The property investment implication of this trend may be zero or negative demand for real estate investments in certain U.S. metropolitan areas. In contrast, when we look at the “hockey stick” markets, we see projected growth in this age cohort of about 1.2%.

Furthermore, growth in the 30- to 44-year-old age cohort (roughly millennials), especially in the hockey stick markets, is expected to dominate growth of any demographic anywhere in the U.S. Members of this cohort are building families and acquiring homes. They are also trained, motivated and productive professionally. Such strong demographic support could drive superior demand and property investment returns.

Exhibit 4: Forecast by age group 2021-2026 (%)

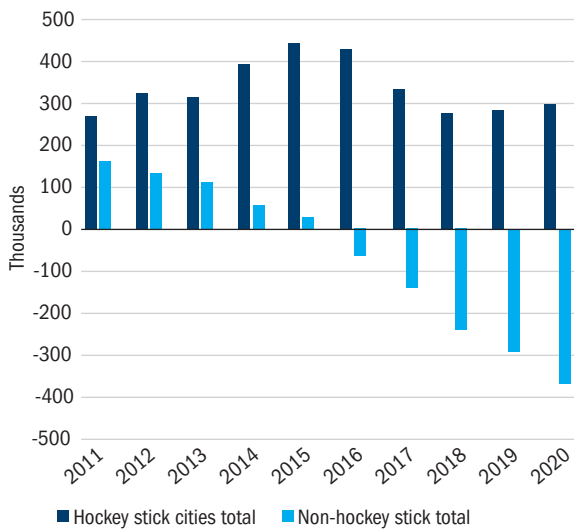
Investment geography	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60-64	Total 20-64
U.S. total	-0.3	-1.3	1.0	1.5	1.9	0.8	-0.7	-1.5	-0.3	0.1
IC markets	0.2	-0.1	1.5	1.6	1.9	0.9	-0.2	-0.8	0.2	0.6
Hockey stick IC markets	1.0	0.5	2.9	2.1	2.0	1.3	0.5	-0.4	0.7	1.2
Non-hockey stick IC markets	-0.4	-0.6	0.4	1.2	1.9	0.6	-0.8	-1.1	-0.2	0.1

Source: Esri as of October 2021.

3. Migration

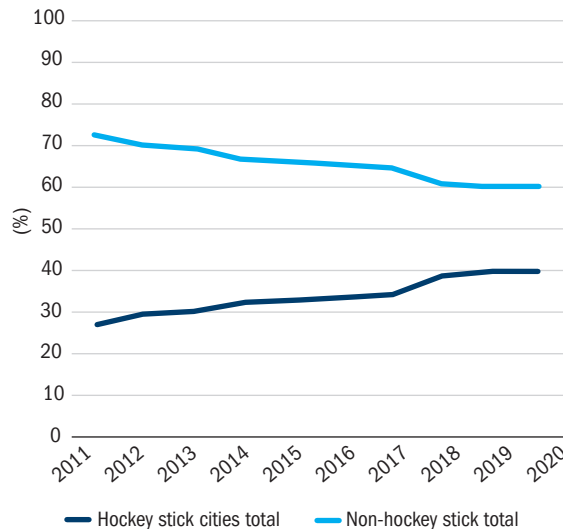
Since 2016, in-migration of legal residents within the U.S. has been negative for coastal cities (exhibit 5). And while this didn't accelerate during the pandemic — contrary to popular reports — it hasn't abated. We expect it to continue, especially given the demographic trends described above. Moreover, if we look at international migration, on which most of the coastal markets depends to grow their population base, we have observed similar trends. Specifically, the share of legal international migration to “hockey stick” areas has grown to 40% from 28% during the past decade. At the same time it has fallen to 60% from 72% in coastal cities (exhibit 6). This trend is likely to continue as international migrations follow areas of economic growth and opportunity.

Exhibit 5: Total migration



Source: Moody's

Exhibit 6: Percentage share of international migration



Source: Moody's

What are the implications of these trends for real estate?

As a result of these trends, functional obsolescence of real estate investments, especially in the office sector, appears to be accelerating in the 2020s. The people in high-growth industries, often millennials, want something different out of their real estate and that has accelerated functional obsolescence in most property types, especially office. Properties designed and built in the 1980s for the predigital economy appear to be at particularly high risk of value loss. These assets are typically hemmed-in by single-use infrastructure and located in high density single-use environments. The unfortunate reality of office buildings in this country is that they were built, on average, in the 1980s, to serve the industrial economy and old land use patterns. While it was well underway pre-COVID, the pandemic appears to have accelerated this trend. As a result, there is an opportunity to invest in new construction that is tailored to the needs of the working age cohort; a “modern village” that incorporates low/mid-density housing in a mixed use live/work/play environment.

Our approach: Active and highly selective

This challenging investment climate will require discipline, patience and investors’ very best thinking and decision-making. Our posture in this environment is active but highly selective about the risks we are willing to take. We will continue to look for opportunities in most of the 17 cities in which we invest, but we will prioritize cities and the neighborhoods within them with high concentrations of highly productive jobs without the high-cost structures of gateway coastal cities. Examples of these include Austin, Denver/Boulder, Raleigh and Salt Lake City. Mixed-use assets with limited obsolescence risk will be our highest priority. The ability to take advantage of demographic and technological change while also managing downside risk in a normal-grade recession is key.



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