REO

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Real Estate Outlook – US

De-risking amid uncertainty.

UBS

UBS Asset Management

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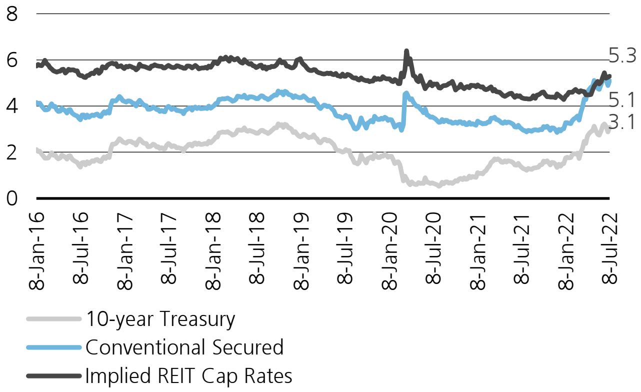
Mounting pressure on pricing

Commercial real estate
Private real estate finished the second quarter of 2022 with record-setting NFI-ODCE total annual returns at 29.5%. Robust second quarter returns did not fully capture the most recent activity of re-trades and value declines that are now pervasive in bidding pools. Transaction volume increased by 17% YoY, but examining the underlying data shows a decline in volume among deals sized below USD 50 million.

Figure 1: Yield spreads (%)



Source: Moody's Analytics, as of 8 July 2022; Green Street Advisors, as of 8 July 2022. Past performance is not a guarantee for future results.

Financing a real estate asset has become more difficult and expensive. Rates on conventional secured loans jumped from 3.9% in March 2022 to 5.1% in June 2022, creating a negative gearing situation where the cost of debt is above the income yield (see Figure 1). Investors in liquid markets have reacted, pushing public REIT share prices lower, which partially implies cap rate expansion at the property level.

Private real estate typically trails large movements in implied cap rates by three-to-four quarters, but impact will vary by sector depending on the persistency of demand growth. For example, supply constrained warehouse markets in port-related metros have 1% or below availability and have lease rollover opportunities where in-place rents are 15-30% below market. The office sector, in contrast, is struggling to achieve current levels of demand as expected capital expenditure is rising. New products which were planned before the pandemic, will now be delivering over the next four quarters.

Real estate development requires significant planning and time to deliver. Supply chain disruptions impacted developments across sectors in 2021, pushing planned deliveries into 2022. Completion rates in the second half of 2022 are forecast to surpass levels seen over the past five years. However, we believe the apartment and industrial sectors will be able to absorb the new supply without much impact on rent and vacancy levels.

Cooling from record highs

Private sector review

Figure 2: August US real restate return forecasts

Total return (%)	2019	2020	2021	2022 forecast	3-year forecast
Apartment	5.5	1.8	19.9	9.0	6.7
Industrial	13.4	11.8	43.3	15.2	9.2
Office	6.6	1.6	6.1	4.7	4.4
Retail	1.9	(7.5)	4.2	5.5	5.0

Source: Oxford Economics Forecasts, as of August 2022. Note: Total return: NCREIF as of June 2022. Data shows unlevered NCREIF Property Index total returns. Expected / past performance is not a guarantee for future results.

Apartment

The apartment sector delivered an annual total unlevered return of 24.4% in the year ending 2Q22, the highest since 1980 (see Figure 2). Apartment rents continued to soar by 14.6% YoY in 2Q22, even amid negative absorption during the quarter. Occupancy rates fell by 70bps from a quarter ago, but were above 4Q21 levels and remain near record highs. Transaction volume accelerated in 2Q22, up 28.7% from a quarter ago and 39.1% from a year ago. We expect a moderation in returns from record-breaking levels, but steady performance over the next three years.

Industrial

The industrial sector posted near-record annual total returns of 47.6% in 2Q22, indicating that the sector powered through sustained supply chain bottlenecks and economic headwinds. Demand slowed from the prior quarter but matched the pace of supply, which kept the occupancy rate unchanged from 1Q22. Transaction volumes were down 7.2% from a quarter ago, but were 5.9% above 2Q21 levels. We anticipate continued outperformance of the industrial sector over the next three years, albeit at less robust rates.

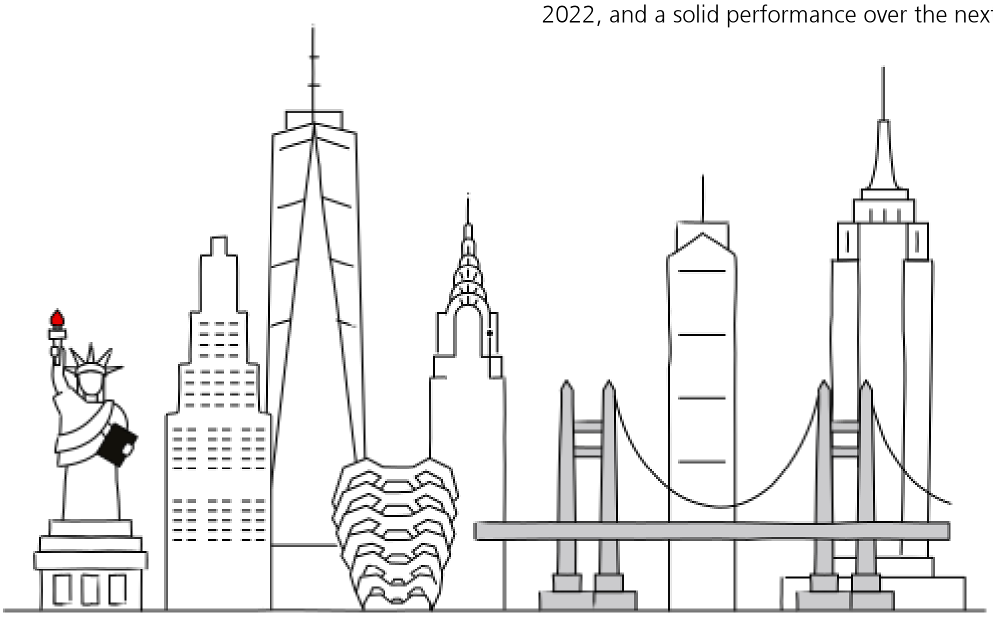
Office

The office market continues to face a succession of headwinds, from increasing workforce demand for hybrid and remote work to elevated inflation rates. Total annual returns for the sector slowed to 5.9% in 2Q22, as income returns held steady while capital returns moderated.

Supply outpaced demand for the second consecutive quarter, driving occupancy rates lower. The pace of 2Q22 office transactions were 19.9% below 1Q22 levels and 3.2% below 2Q21 volumes. We expect structural vacancy to be higher and capital expenditures to rise as landlords compete for a shrinking office-using workforce. Our outlook supports the below long-term average return forecast over the next three years.

Retail

Retail demand remains steady, while the pace of supply continues to diminish, driving growth in both occupancy and rent. Transaction volumes are back to pre-pandemic levels and were 4.8% above 1Q22 volumes and 49.9% above 2Q21 levels. Total returns accelerated to an annual rate of 7.9% in 2Q22, as the sector recouped losses from pandemic disruptions. We expect above average returns for retail in 2022, and a solid performance over the next three years.



Select niche sectors

Moderating near-term expectations

Self-storage

Self-storage same-store net operating income (NOI) continued to soar during 2Q22, even with declining occupancy rates. Among self-storage REITS, same-store NOI grew at an equal weighted-average of 21.3% in 2Q22[1]. Despite the double-digit growth, occupancy rates tempered slightly to ~94%, but remains above the sector's long-term average of 92%. Occupancy rates inched lower as move-in rates softened and move-out rates picked up. An uptick in the move-out rate is partly due to both seasonality and a slight cooling of pandemic-related demand drivers. Often classified as a defensive sector, self-storage is expected to remain resilient during the current economic slowdown, but robust NOI growth expectations may temper.

Cold storage

Cold storage fundamentals beat expectations in 2Q22, as occupancy rates rose amid supply-chain and food production challenges. Americold, a major cold storage REIT in the US, reported a nearly 100bps increase in occupancy for US-based warehouses to 76%[2]. Americold also reported solid same-property revenue growth of 3.1% YoY, which is partly due to tenants absorbing additional costs incurred from inflation. These positive results come as the sector is challenged with transportation bottlenecks and labor shortages which has led to diminishing inventory levels of food commodities. However, a recent uptick in US imports of perishable foods has helped generate new sources of demand for cold storage. Near-term fundamentals are proving more resilient than initially projected and the long-term outlook for the sector remains strong, as increasing online grocery consumption drives demand for temperature-controlled spaces.

Senior housing

Senior housing occupancy rates continued to rise in 2Q22. According to NIC MAP, occupancy rates in primary markets rose to 81.4% in 2Q22[3], 90bps above a quarter ago, 340bps above its pandemic-driven trough in 2Q21, but still 580bps below March 2020 levels. Rental rates continued to accelerate, growing by 3.7% over the trailing year. Senior housing has made positive gains in occupancy for four consecutive quarters, and we expect continued recovery in sector fundamentals as demographic tailwinds drive long-term demand.

Life sciences

Life sciences fundamentals held strong during the second quarter, but growing economic uncertainties are weighing on the sector's near-term outlook. Strong demand for lab space during the quarter drove vacancy rates down by 10bps to 5.2% in 2Q22[4]. Despite historically low vacancies, economic uncertainties have weighed on venture capital funding, which slowed by 13.3% QoQ in 2Q22. Initial public offerings by life sciences companies also decelerated during the first half of the year. A pullback in funding is primarily impacting smaller-sized companies who are not as well capitalized to weather near-term headwinds. Long-term trends continue to favor the life sciences sector, but current market conditions might cause temporary disruptions.

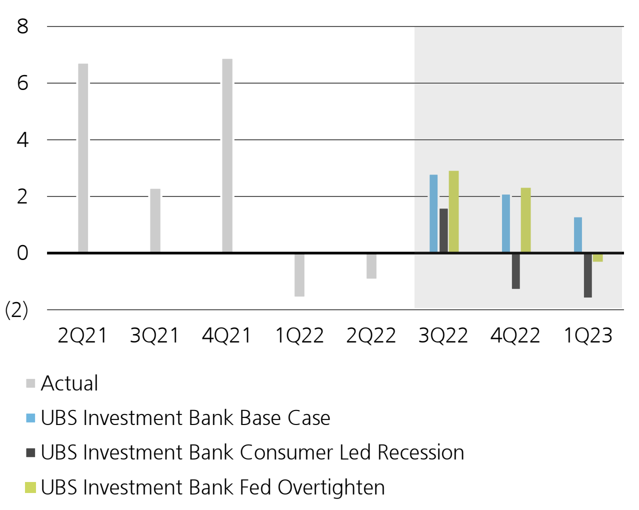
Source: **1** Green Street, as of August 2022; **2** Americold Company Report, as of 2Q22; **3** NIC MAP, as of July 2022; **4** CBRE, as of August 2022.

Sending mixed messages

Economic viewpoint
The US economy shrank at a 0.9% annualized rate in 2Q22, as weakness in rate sensitive sectors such as residential structure, business structure, and equipment investments weighed on output. GDP contracted for the second consecutive quarter, meeting a commonly accepted definition of a recession. However, the National Bureau of Economic Research (NBER), the official arbiter of a recession, requires a broad-based slowdown across multiple economic factors including the labor market, which continues to remain strong.

July payrolls increased by 528,000 workers, which far exceeded UBS Investment Bank's expectation of 150,000, and the unemployment rate fell from 3.6% to 3.5%. This may provide the Fed cover to raise the Fed funds rate by another 75bps in September to tame inflation. The July CPI eased to 8.5% but stood near its highest level in 40 years. Inflation moderated by 50bps over the month but was 320bps above July 2021 levels. The core PCE, the metric that the Fed uses to guide policy, accelerated to 4.8% in June.

Figure 3: Real GDP quarterly annualized forecast (%)

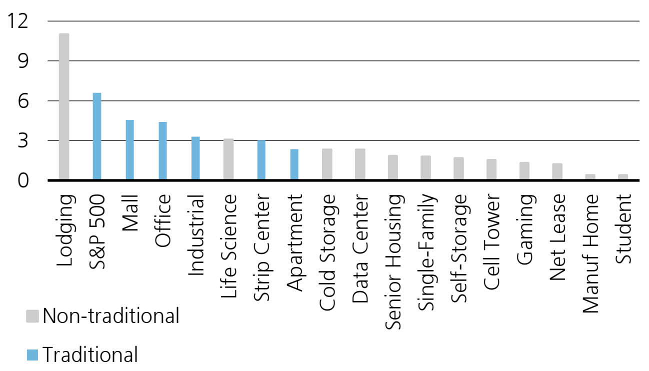


Source: Actual Moody's Analytics as of 28 July 2022, UBS Investment Bank forecast, as of 11 July 2022. Note: Shaded area indicates forecast data.

UBS Investment Bank's base case in 2022 is for positive but moderate GDP growth (see Figure 3). However, with the probability of a recession increasing, UBS created two recession scenarios. The first being driven by an increasing weakness in consumers' financial health and declining demand for services. The second being the Fed's overtightening where,by the target policy rate increases to 4.5% by December of 2022.

In the consumer-led scenario, the recession is relatively mild and lasts for 8-months. We would expect disinflation and job losses heading to over 2 million annualized before the Fed eventually returned the funds rate to the effective lower bound in 2023. In the overtightening scenario, GDP contracts between 1Q23 and 3Q23, while the unemployment rate jumps to 5.8% by the end of 2023. Cap rates and risk premiums across asset classes expand in both scenarios. The consumer-led scenario would negatively impact real estate fundamentals in 2022, while the overtightening scenario would leave the currently strong fundamentals in place until the second half of 2023.

Figure 4: Historical sensitivity of rental income to 1% GDP change (%)



Source: Green Street, as of June 2022. Note: Rental income refers to market rent multiplied by occupancy rate. Sensitivity is based on regressions of performance since 2001 for most property sectors. Data commences later for the student and senior housing sectors.

We allocate a higher probability to the base case scenario of positive but slow growth over the next three quarters. We expect sectors driven by necessity, such as residential and data infrastructure, to be less volatile across our base case scenario and across the two recession scenarios. An analysis from Green Street Advisors shows that these sectors exhibit lower sensitivities relative to their peers in response to a 1% change in GDP (see Figure 4). As a result, we expect that NFI-ODCE index exposure to these sectors will increase as investors adapt to a shift in the market.

We continue to focus our strategies on defensive positioning while economic uncertainties persist. This typically includes marginal movements around strategy targets; less leverage, a lower amount of value-add activities, and a focus on increasing occupancy over rent growth in retail and office. However, there may be attractive opportunities to dollar-average into sectors with general repricing that also exhibit strong demand forecasts over the next three-to-five years.

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