UNITED STATES

Perspective

2022

Pivoting to a post-covid economy

INSIDE

BentallGreenOak

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Pivoting to a post-covid economy

BentallGreenOak

PIVOTING TO A POST-COVID ECONOMY

Our outlook for the year ahead is heavily influenced by three key themes: the decline of the pandemic and resultant economic expansion; digitization and technological disruption; and demographics, labor, and housing affordability. These forces are acting as both drivers and disruptors of real estate space demand, in many cases dramatically altering the behaviors of both companies and individuals. Underlying these forces is a continued focus on environmental, social, and governance issues, with the global push towards decarbonization increasingly guiding real estate investment decisions. In this edition of *Perspective*, we examine the impact of these factors on both the economy and property sectors.

- **Robust economic growth is straining the labor market and spurring inflation.** Stellar GDP growth and the creation of 6.7 million jobs in 2021 set the stage for healthy real estate demand in 2022. These conditions combined with significant COVID-related disruptions to supply chains and labor supply have driven inflation to multi-decade highs.
- **High inflation, including rapid wage growth have spurred the Fed to act.** Expectations have risen for four hikes in the Fed Funds rate and financial markets have responded including a marked shift in longer duration bond yields. Tightening, but still ample spreads, and healthy property fundamentals should limit any negative impact to property values this year. It is noteworthy that periods of higher inflation have historically yielded stronger investment performance.
- **The COVID reopening and limited housing supply have driven an unprecedented surge in rental rates**. Over the past year, rents in nearly all apartment markets easily erased any decline in rent during the peak of the pandemic. Growth should moderate in 2022, but conditions will continue to favor property owners.
- **Office properties have been acutely impacted by the pandemic and the shift to work-from-home.** We are beginning to see a stabilization in the sector despite the limited return of workers. Investment opportunities are likely to present themselves as owners digest the new reality for demand and headwinds from higher interest rates. Opportunities in subtypes such as medical office and life science can insulate investors from challenges faced by traditional office.
- **Industrial properties are outperforming all other sectors and setting records for total returns.** Demand will continue to benefit from rapidly growing ecommerce sales and increased demand for modern buildings. Strong valuations have enticed developers and new supply is significant, but outsized demand should keep fundamentals healthy.
- **The global push to net zero greenhouse gas (GHG) emissions has implications for real estate performance and capital flows.** While the impact may be gradual over the next decade, the trend is clear, with corporations in many cases taking the lead. The impact on property operations and value will vary based on geography, sector, and building quality. BGO is already developing a net zero decarbonization roadmap.

QUICKTAKE: 2022 SECTOR OUTLOOKS

	Operating Fundamentals	Investor Sentiment	Overall Outlook	In Short
Residential	Positive	Positive	Positive	The strong labor market supports rising demand and rent growth. High for-sale housing prices will remain a tailwind for both traditional multifamily and single-family rental.
Office	Negative	Mixed	Mixed	COVID variants are disrupting office demand. But employers seeking to recruit top talent and optimize productivity will desire high quality office space.
Retail	Mixed	Mixed	Mixed	The sector has benefited from economic growth and declining restrictions. Well located retail is garnering attention from investors and users. Ecommerce is a headwind.
Industrial	Positive	Positive	Positive	Stellar demand growth has supported record-setting investment performance. Supply has ramped up, but significant demand drivers will keep fundamentals healthy.

Outlook Key

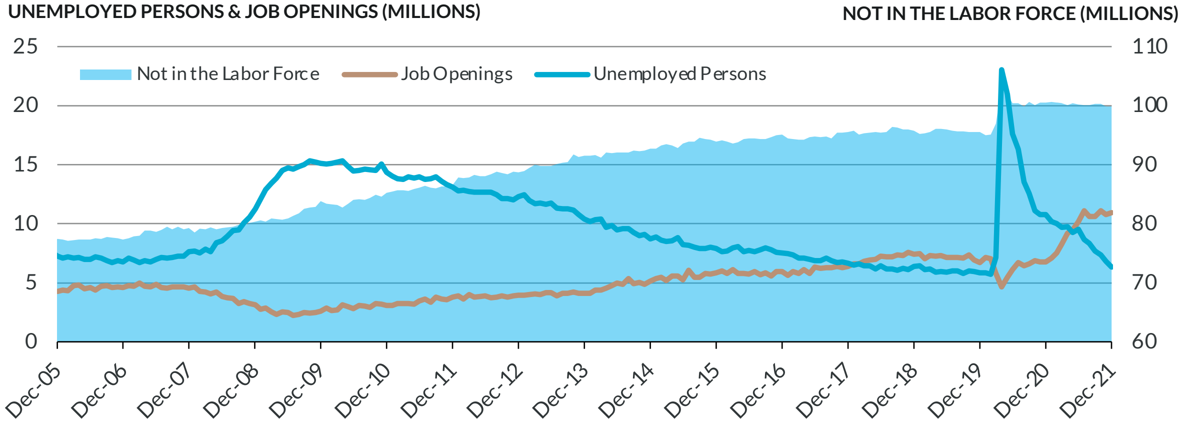
Positive Mixed Negative

Source: CoStar Group, Inc., NCREIF, BGO Research

ROBUST RECOVERY DRIVES EMPLOYMENT & INFLATION

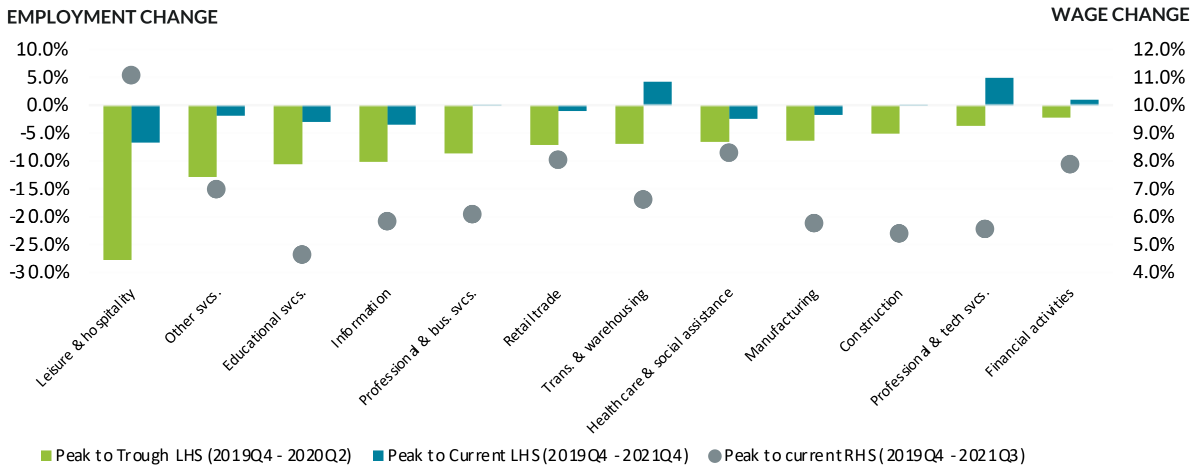
- Despite disruptions from the Delta and Omicron variants, surging consumer demand and the rebuilding of business inventories have driven a remarkably strong economic rebound. The resultant labor market tightening paired with the continued struggle of supply chains to create a negative feedback loop, increasing inflationary pressures with the potential to suppress economic growth.
- Price inflation, fueled by supply chain delays and bottlenecks, and rising energy prices, driven by sub-optimal production levels, plagued the globe throughout 2021, eventually leading companies to pass those costs onto consumers. The ensuing competition for workers caused wage and salary increases prompting the Fed to signal intervention after shifting its inflation designation from transitory to persistent.
- The economy added nearly 6.7 million jobs in 2021 and unemployment fell nearly three percentage points, to 3.9%. But payrolls remain 3.3 million jobs below their pre-pandemic peak. Employers are struggling to hire with almost 11 million job openings and only 6.3 million unemployed workers available to fill them. Even pre-pandemic unemployment rates hovered near modern historical lows, 3.5%, as the number of Americans outside the labor force trended higher due in part to aging demographics.
- As the economy expands, labor supply remains constrained due to a myriad of issues; the inability to find adequate, affordable childcare, health concerns or illness, vaccine mandates, retirements, reduced immigration, and a desire for improved work-life balance. Domestic migration trends driven by lifestyle and affordability considerations were amplified by the pandemic as well, increasing labor market friction owed to skills and or geographic mismatches.
- Employers are substantially increasing wages and salaries, signaling the difficulty in rehiring or finding workers. Interestingly, despite lapsing unemployment benefits, the lower-skilled service industries most disrupted by the pandemic, leisure and hospitality and retail, struggle to attract workers even with significant compensation growth.
- Healthy economic growth should continue in 2022 as the bumps created by the pandemic recovery smooth out. An easing of labor market friction and demand will reduce the rising cost pressures on businesses and consumers, tapering inflation and providing further room for economic expansion.

EMPLOYERS FACING EXTREME LABOR SHORTAGES



Source: U.S. Bureau of Labor Statistics, BGO Research

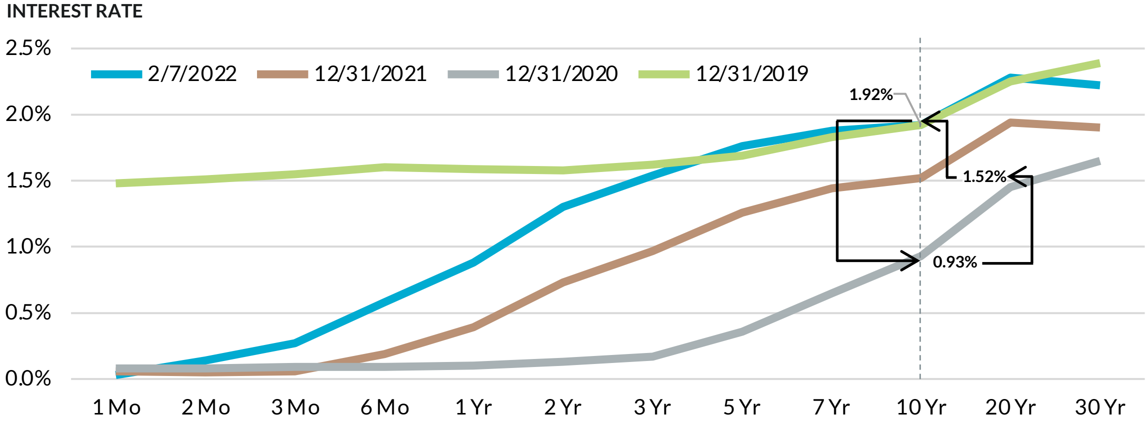
HIGHER WAGES REFLECT COMPETITION FOR WORKERS



Source: U.S. Bureau of Labor Statistics, BGO Research

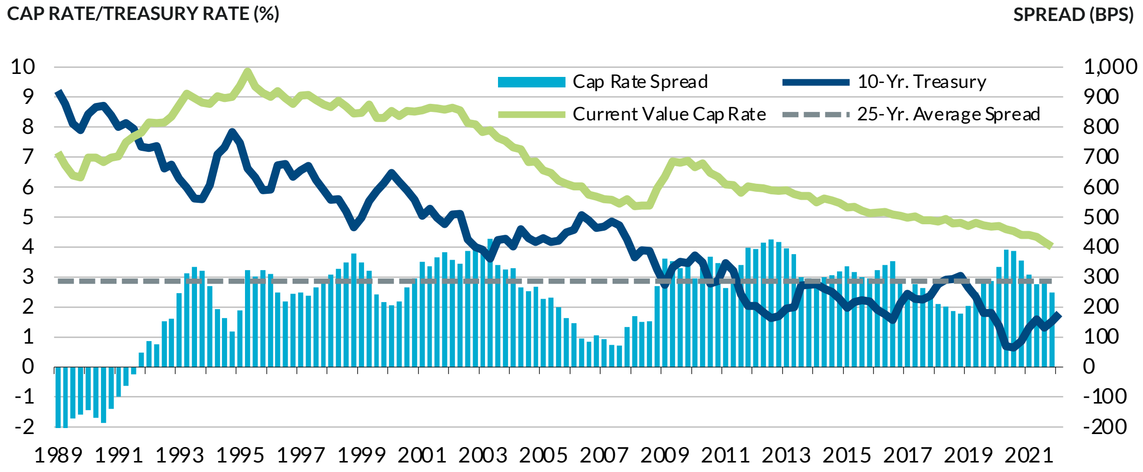
INVESTORS PREPARE FOR MORE HAWKISH FED

LONG TERM BOND YIELDS HAVE RETURNED TO PRE-PANDEMIC LEVELS



Source: U.S. Department of Treasury

RISING INTEREST RATES ARE NARROWING CAP RATE SPREADS



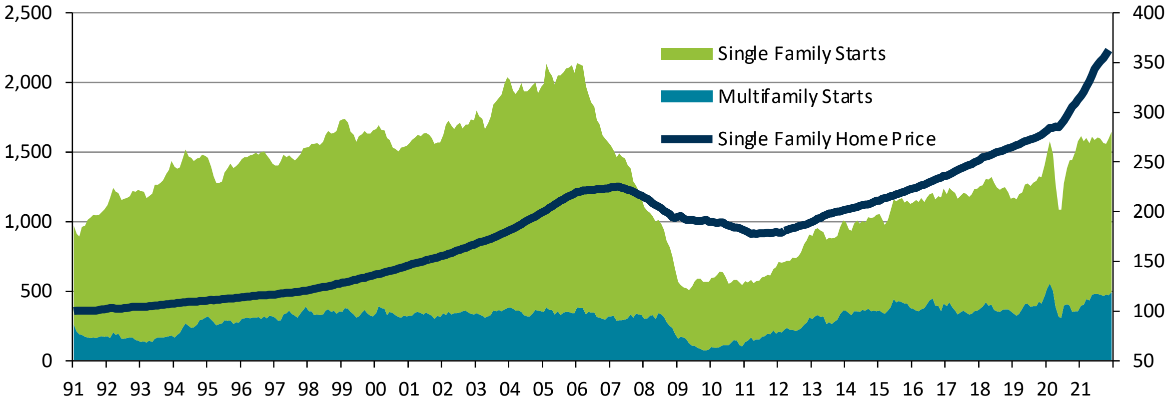
Source: Federal Reserve, NCREIF, BGO Research

- Financial markets reacted less than favorably to the Fed's more hawkish pivot on inflation. The Fed Funds rate is expected to move to near 1% by the end of 2022 from near 0% currently. The Fed should also begin to slowly reduce its balance sheet around the middle of 2022. These moves are both necessary and somewhat belated.
- Monetary policy has been stimulative to the economy and asset values, and commercial real estate has been a beneficiary. Cap rate compression and accretive leverage have helped fuel property value appreciation. Higher relative yields continue to draw in new investment.
- Higher inflation will generally benefit CRE. Rents are rising and new construction will be tempered by material and labor costs. Investments where expenses are passed through to tenants (e.g., NNN industrial leases) or leases that can be rapidly marked to market due to shorter lease durations (multifamily) should fare particularly well. The asset class has historically offered a modest inflation hedge with higher total returns tending to correspond with periods of higher inflation.
- The key questions are whether or not the Fed will move too aggressively on rates and if the economy can sustain its growth trajectory in a higher rate environment. Four quarter-point Fed rate hikes should help materially cool the inflation trend. Recent flattening of the yield curve likely reflects a complex mix of factors: risk that the Fed will overstep, concerns about the economy's growth potential, and the relatively high long-term bond yields in the U.S. versus other major economies.
- While differences exist across markets and sectors, property values have benefited from healthy fundamentals, rising rents, accretive leverage, and attractive yields. Many institutional investors remain under allocated to the sector, even with recent stock and bond performance. The weight of capital entering the asset class is significant.
- Cap rate spreads have fallen below historical average levels, but this has happened numerous times in the past, particularly in periods of high NOI growth expectations. We do not expect a significant shift in how buyers are pricing current income streams. But given expectations for rising interest rates, and the potential implications for future yield requirements, it is crucial to select the property sectors, strategies, markets, and assets that will provide material operating income growth.

SURGING DEMAND, LIMITED SUPPLY DRIVE HOUSING COSTS HIGHER

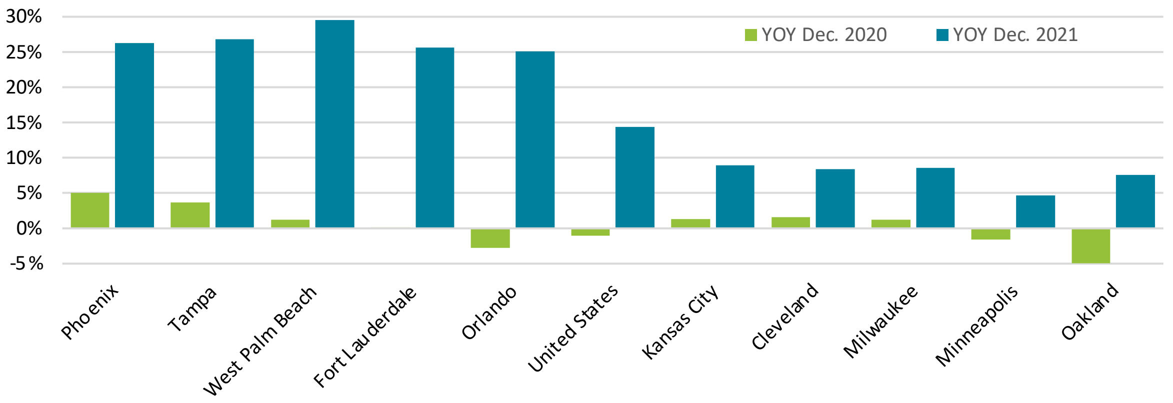
- The pandemic collided with demographic and homebuilding trends to dramatically disrupt the U.S. housing market. Home construction was slow to rebound following the Global Financial Crisis and low rates and steady demand led prices higher for much of the past decade. Similarly, in the rental market, a healthy economy and steady household formation led to landlord-friendly conditions.
- With the onset of the pandemic in 2020, construction stalled and falling interest rates caused an acceleration in home price appreciation. The rental market simultaneously experienced significant demand-side disruption as renters who were able to, fled urban cores in major markets just as significant new rental supply was coming online in those locations. Many young professionals moved back to their parents' home. College students, a foundational element of rental demand in many major cities, stayed home.
- While COVID variants have tempered a normalization in housing choices, the reopening has unleashed a wave of household formation and apartment demand. The Census Bureau estimates that the number of young adults aged 18-34 living at home dropped by 662,000 in 2021 after rising by nearly 1.5 million in 2020. Spiraling home prices have kept buying out of reach for many and demand for apartments and single-family rentals (SFR) has been the beneficiary. Census data show rental vacancy at its lowest level since the early 1980s and homeowner vacancy near an all-time low.
- Prospective renters found themselves with improving job prospects, rising wages, increased savings with the help of federal stimulus payments and student loan forbearance, and declining housing options. Further, with many renters working from home, cohabitating with multiple roommates lost some appeal and they needed more space in which to work.
- RealPage data show dramatic rent growth on a year-over-year basis of 14.4% nationally as of December 2021. Among the 50 largest markets none experienced year-over-year rent declines and a stunning 12 markets had growth of 20% or more. Not surprisingly, many of those leading rent growth markets were in Texas, Florida, and Arizona, the states with the largest population gains from 2020 to 2021. Outside of the Bay Area, most markets easily erased any rent declines experienced in 2020.
- Limited overall housing supply, prohibitively high home prices, and healthy demand will continue to drive the rental market in 2022. Preliminary data from CoStar show 12-month absorption above 700,000 units in the second half of 2021 and apartment construction underway easing to levels slightly below this mark.

INSUFFICIENT HOMEBUILDING AND RAPID PRICE ESCALATIONS BOLSTER THE RENTAL MARKET



Source: U.S. Federal Housing Finance Agency (FHFA), Freddie Mac, Fannie Mae, U.S. Census Bureau

NEARLY ALL APARTMENT MARKETS HAVE ERASED THE RENT DECLINES OF 2020



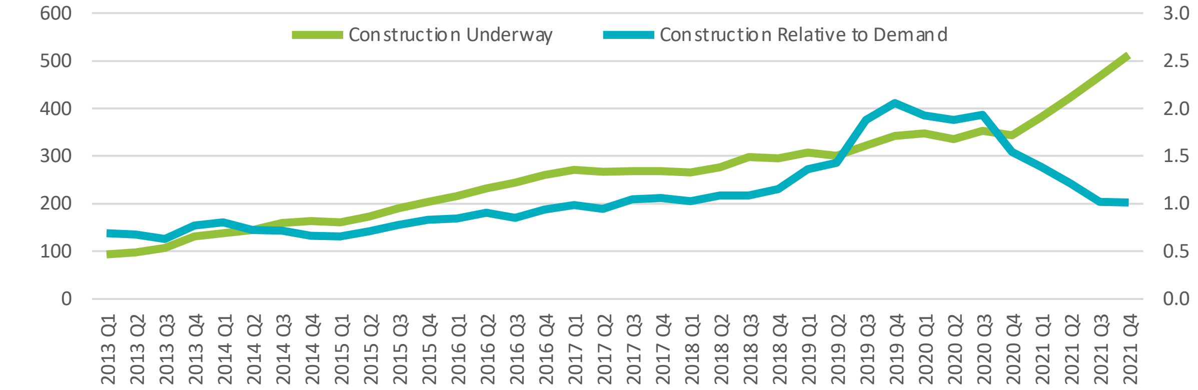
Note: Top/bottom 5 markets for YOY rent growth as of Dec. 2021; 50 largest markets by inventory; sorted by '20-21 net change Source: RealPage

TECHNOLOGY AND DEMOGRAPHICS UNDERPIN INDUSTRIAL BOOM

- Technology innovation coupled with lifestyle and behavioral changes due to demographics and the pandemic are driving change across the economy, and specifically in the demand for industrial space. Stellar net absorption has resulted in record-low industrial vacancy. Total returns generated by the industrial sector, as measured by the NCREIF Property Index, set a record high in 2021, exceeding any other property sector during any four-quarter period in history, at over 43%.
- Ecommerce has been the leading driver of demand growth in recent years, and this was only amplified by the pandemic, but a myriad of factors are contributing to the sector's success. Inadequate supply chains – particularly in the cold storage segment, new economy uses such as life science, data centers, and advanced manufacturing have all supported growing industrial demand.
- The obsolescence of existing industrial stock has driven particularly high demand for modern space. Careful analysis of existing inventory at the building level can reveal locations with an undersupply of newer buildings. This is particularly true in growing population centers where shortages of modern industrial stock are often acute.
- Specific considerations for layout, clear-height, power availability, and slab specifications, among other factors greatly limit the suitable supply for certain users. Increased automation within logistics facilities also enhances the need for modern buildings.
- In addition to our examination of broadly-used third party industry outlooks, BGO's proprietary research and analytics figure prominently in our industrial strategy at the national, metro, and local level. With a heavy emphasis on ecommerce sales and industrial production our expectation for national industrial demand growth remains very strong.
- But, similar to CoStar, which calls for average annual rent growth in the 3%-4% range over the next five years versus 5%-6% over the previous five years, we do expect significant supply and more moderate levels of demand to bring rent growth down to more sustainable levels. Through our predictive models, location analytics, and on the ground experience we remain focused on assets in locations with high economic growth potential, limited modern stock, labor availability, and manageable levels of construction.
- The ecommerce growth trend is still in its early stages and increased adoption across age-groups on a widening array of products should continue to provide a secular tailwind for the sector. Demographics will play an important role in future growth as younger households with much higher technology adoption rates become the more dominant spending cohort in the U.S. Further, migration patterns will define the areas in highest need of new supply.

SIGNIFICANTLY RAMPED UP DEVELOPMENT IS INLINE WITH STRONG DEMAND

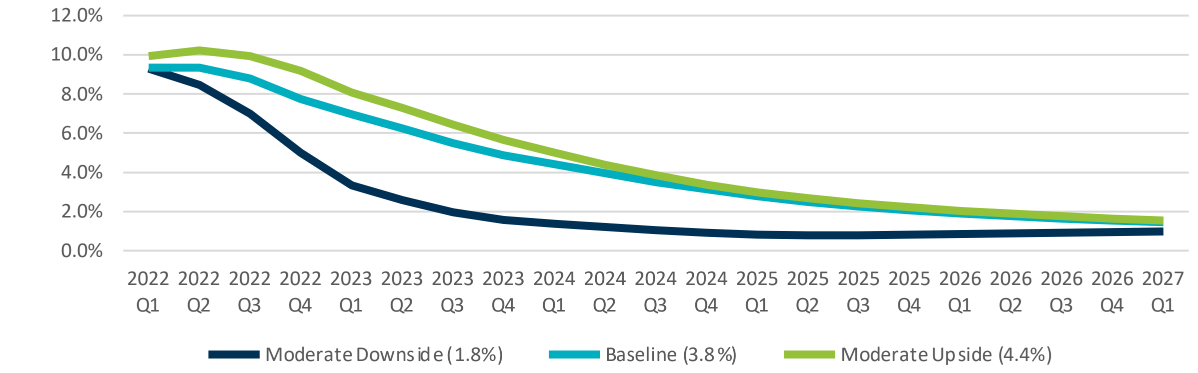
CONSTRUCTION UNDERWAY (SF, MILLIONS) | **CONSTRUCTION UNDERWAY VS. TRAILING 12-MO. NET ABSORPTION**



Source: CoStar Group, Inc.

EVEN IN A MORE PESSIMISTIC ECONOMIC SCENARIO INDUSTRIAL RENTS CONTINUE TO RISE

YOY RENT GROWTH



Note: 2022-26 average annual growth shown in parenthesis

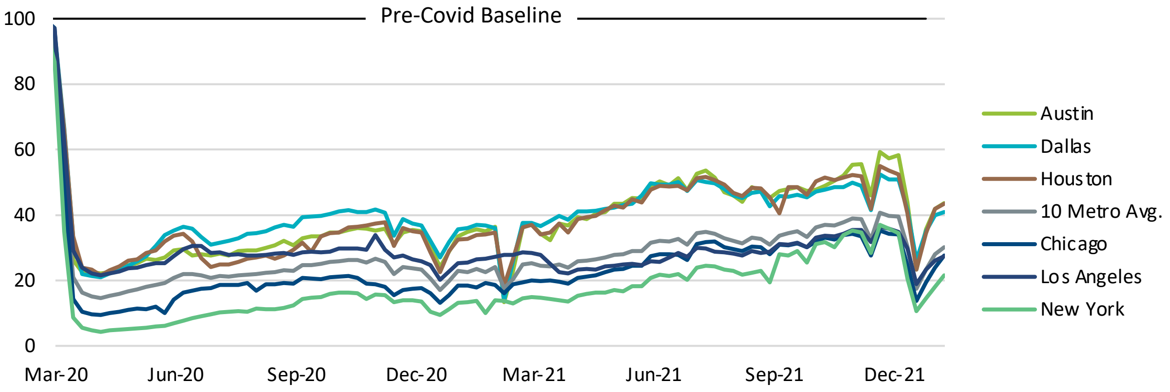
Source: CoStar Group, Inc., Oxford Economics

PANDEMIC DISRUPTION MAY LEAD TO OFFICE OPPORTUNITIES

- Still the largest sector in the NCREIF Property Index by value as of 2021Q4, the office sector continues to garner significant attention. The sector may well have stabilized, with CoStar showing vacancy leveling out and a variety of sources indicating that net absorption closed 2021 in positive territory. Suburban locations seem to be leading recent improvement, but the rapid escalation of CBD vacancy has slowed.
- Uncertainty lingers with high-frequency data showing workers are slow to return to office and potentially that leasing activity – already below trend – could moderate. Office likely faces further challenges in the near term, which may create opportunities for investors. Even employers who have asked their workers to come back to the office have embraced more flexible work schedules that mitigate demand. GreenStreet Analytics expects a 15% reduction in demand due to changes in office utilization. Loan maturities may also put some office owners under stress, particularly as interest rates rise.
- Demand for unique, high-quality space that caters to creative and collaborative knowledge workers remains high. Firms will want to have a landing pad for these teams but won't require these workers to always be there. Lifestyle amenities, a focus on health, wellness and sustainability, and highly functional/efficient space will be the expectation of these workers and their employers. Beyond these high-quality traditional office spaces, medical office and life science represent strong alternatives for investment.
- Key investment themes of demographic change, technology, and the post-pandemic environment are converging to significantly disrupt the office sector. Highly educated markets with strong existing or rapidly maturing technology industries like Seattle, Phoenix, San Jose, Atlanta, Austin, Raleigh, Portland, Miami, Boise, and Tucson should perform well and our proprietary machine learning models suggest they will be rent growth outperformers. Demographics remain a significant factor here as firms need to follow the labor.
- We do not anticipate broad and significant revaluation of the office sector. Office investment volume rose 57% in 2021, according to RCA, including a 50% rise in CBD transaction volume. Investors are clearly active in the sector. But considerable risks remain that we expect will create opportunities to buy mispriced assets in the year ahead. Additionally, the number of attractive office markets is growing as domestic migration bolsters the white-collar labor supply of certain markets and firms grow their footprint to offset labor constraints in primary markets.

COVID VARIANTS DEAL SETBACK TO RETURN-TO-OFFICE

OFFICE OCCUPANCY VERSUS PRE-PANDEMIC BASELINE

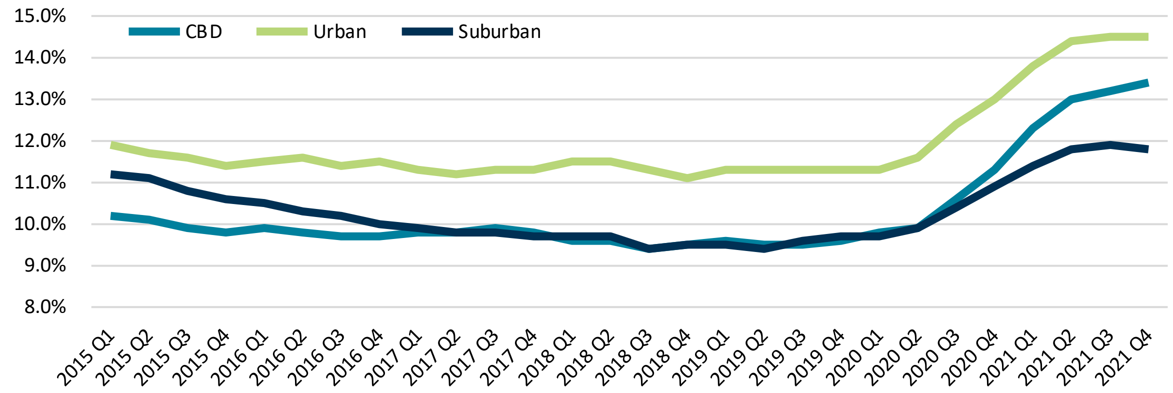


Note: 10 Metro Avg = DC, NY, Chicago, Houston, Philadelphia, SF, LA, Dallas, San Jose and Austin

Source: Kastle Systems

SUBURBS LEAD AS DETERIORATION IN OFFICE FUNDAMENTALS BEGINS TO EBB

VACANCY



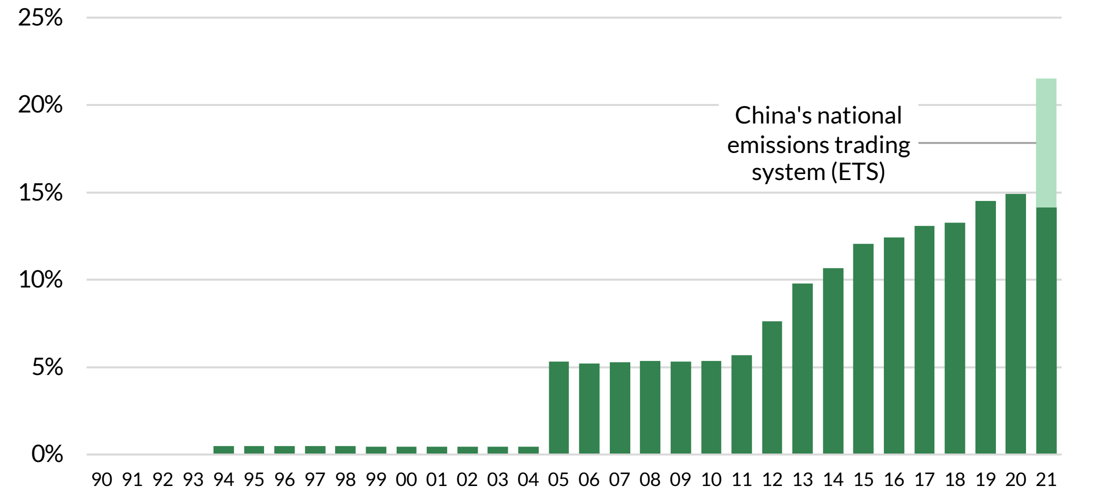
Source: CoStar Group, Inc.

DECARBONIZATION: THE ROAD TO NET ZERO

- If not the defining real estate theme for 2022, "decarbonization" will undoubtedly be the one that defines the balance of the decade. In order to adhere to the goal of the Paris Agreement—limiting future global warming to 1.5 degrees Celsius over pre-industrial level by 2050—there will need to be a monumental shift in how buildings are operated and constructed.
- Net zero targets have now been set by countries, industries and companies representing 90% of global GDP. Of the 2,000 largest public companies in the world, more than 600 have net zero strategies. But the effectiveness of such pledges will depend on the details—meaningful action—and not just "greenwashing". BGO has joined the Net Zero Asset Managers initiative, which commits the company to achieving Net Zero GHG emissions by no later than 2050 for its entire global commercial real estate investment portfolio.
- We are now in the process of developing an interim target and ensuring that this goal can be achieved through a combination of direct action and quality carbon offsets (wherever there are no viable alternatives to eliminate emissions).
- To achieve this goal, our strategy is being developed through a combination of both top-down and bottom-up approaches. We are looking to understand what it will take to achieve net zero by initially developing a portfolio-level decarbonization roadmap.
- Once established, a bottom-up evaluation is taken at each of our existing assets to develop a carbon transition action plan to reduce emissions over time, optimizing equipment renewals with the capex strategy for the asset where possible.
- It's encouraging to see that investors, occupiers, consumers, and employees are all demanding action towards decarbonizing in the built environment ahead of government regulation.
- Europe is leading the way from a regulatory perspective. The percentage of global GHG emissions covered by taxes or carbon exchanges jumped from 15% to more than 20% in 2021 with the introduction of China's emissions trading system (ETS).

SHARE OF GLOBAL GREENHOUSE GAS EMISSIONS COVERED BY TAXES OR CARBON EXCHANGES

% OF TOTAL EMISSIONS



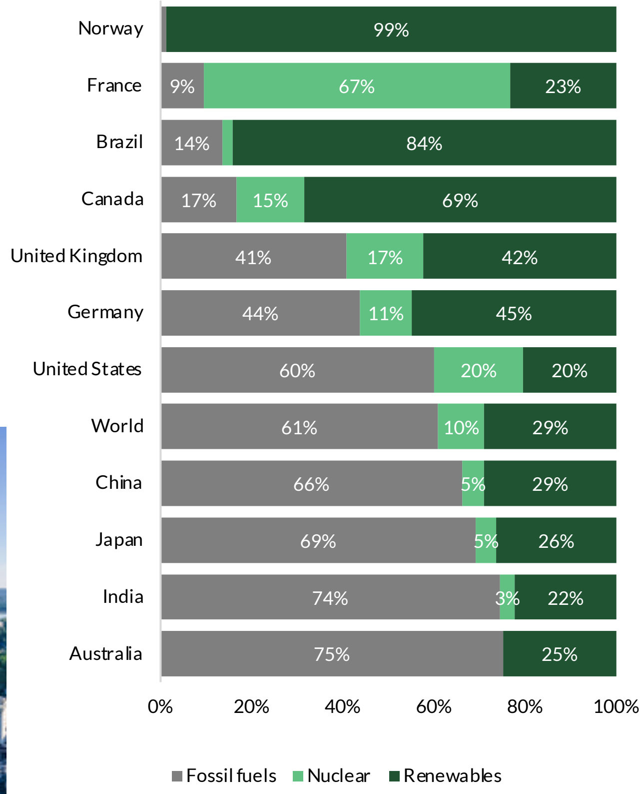
Source: Our World in Data

DECARBONIZATION: THE ROAD TO NET ZERO

- While North America lags, state/provincial and more local levels of government are beginning to adopt "green deals" and building performance standards. Meanwhile, the private market is collaborating and getting out in front of regulation. But with such a complex problem, oversight would be helpful in developing a global standard of measurement and disclosure.
- In the wake of COVID-19, increasing ESG and tenant requirements have accelerated building obsolescence. Energy efficiency, health and well-being, and technology requirements have all been elevated, particularly in the office sector.
- We are now starting to see the negative impacts on leaseability, valuations and liquidity for assets that don't meet these rising expectations. Building retrofits and greater capex are solutions to maintain a building's competitive position. But many buildings could become "stranded assets" in the years ahead as it may be uneconomical to spend the required capex without a commensurate increase in rent to justify an acceptable yield.
- However, where tenants are willing to pay a premium for quality, owners are seeing a growth opportunity and return enhancer, rather than a cost burden. Obsolescence is shrinking the investable universe which could increase the value of high-quality assets with more capital chasing a smaller pool of properties.
- The risks surrounding net zero will be unevenly distributed. For example, while data centers and cold storage may have some of the highest expected returns, they are also two of the most emission intensive sectors. These may require more green capex to electrify, improve energy efficiency, and explore ways to generate renewable energy which if not offset through higher rents, could end up as a drag on returns. On the other hand, sectors such as apartments are lower emitting and because they provide a social good, there is likely to be less political will to impose higher costs on them to decarbonize.
- The "greening" of the electrical grid is also a key consideration. The U.S. is only slightly ahead of the world overall in this regard, with many key trading partners generating much higher shares of electricity from renewables. Further, beyond the power source, the age and resiliency of the power grid is a consideration that will lead to varying power costs and business disruptions in different parts of the world. This was evidenced in Texas in 2021 as severe winter storms disabled portions of the state's power grid.
- As GHG emissions are increasingly scrutinized, winners and losers will emerge among regions, and capital and liquidity are likely to follow green infrastructure investment.

U.S. RELIANCE ON FOSSIL FUELS REMAINS SIGNIFICANT

PER CAPITA ELECTRICITY FROM FOSSIL FUELS, NUCLEAR, AND RENEWABLES, 2020



Source: Our World in Data

BentallGreenOak

ABOUT BENTALLGREENOAK

BentallGreenOak is a leading, global real estate investment management advisor and a globally-recognized provider of real estate services. BentallGreenOak serves the interests of more than 750 institutional clients with approximately $74 billion USD of assets under management (as of December 31, 2021) and expertise in the asset management of office, industrial, multi-residential, retail and hospitality property across the globe. BentallGreenOak has offices in 28 cities across thirteen countries with deep, local knowledge, experience, and extensive networks in the regions where we invest in and manage real estate assets on behalf of our clients in primary, secondary and co-investment markets. BentallGreenOak is a part of SLC Management, which is the alternatives asset management business of Sun Life.

The assets under management shown above includes real estate equity and mortgage investments managed by the BentallGreenOak group of companies and their affiliates, and as of 1Q21, includes certain uncalled capital commitments for discretionary capital until they are legally expired and excludes certain uncalled capital commitments where the investor has complete discretion over investment.

For more information, please visit **www.bentallgreenoak.com**

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