

Hodes Weill's 2021 Market Commentary

Won't Get Fooled Again

As we reflect on the year just ended, it is hard to imagine anyone anticipating the events that transpired, though in hindsight, maybe we shouldn't be so surprised after all. We'll leave that debate to the politicians, pundits, scientists, immunologists, and climatologists to decide, but 2020 was a year during which we saw a confluence of risks that have been hiding in plain sight for years.

We will skip the now familiar, and overused, references to Zoom, WFH, social distancing, and virtual-everything, though we would like to recognize the real estate investment management industry for evolving, adapting and finding creative solutions to advance business initiatives in a difficult year. Our industry largely maintained the continuity and intensity of work and investment plans when all the familiar ways of doing business suddenly had to change. Investors and managers navigated these challenges and rose to the occasion.

When we were drafting this annual commentary last January and projecting about the year ahead, we commented that we were “struck by the remarkable similarity” of our outlook to the prior couple of years. Well, we imagine that our readers would have been happy if the markets in 2020 had been as “boringly the same” (our words!) as the prior years. We acknowledge that we missed the mark by a wide margin.

That being said, we also went on to write that “despite conflicting market signals, geopolitical tensions, and another year of increasing valuations, global investors are staying the course and continuing to deploy capital into real estate assets...”.

So, while we were as wrong as possible about market conditions once the impact of the Global Pandemic was felt, especially the uncertain outlook for future tenant demand across many property sectors, we nailed it with respect to the increasing impact of geopolitical considerations, and a continued rise in valuations for a couple of the hottest real estate sectors.

The point is not that we were almost right. Rather, we want to focus on how institutional real estate investors addressed and underwrote these “unprecedented” (the most overused word of 2020) risks. We began the year knowing that the world was awash in geopolitical risk; that there was a significant divide in the US that was likely to be inflamed in a Presidential election year; and that there was substantial evidence of climate change that could have a major impact on real property — from forest fires to hurricanes to rising waters. We even had the first inklings about COVID-19, given that an event like the pandemic had been predicted for years.

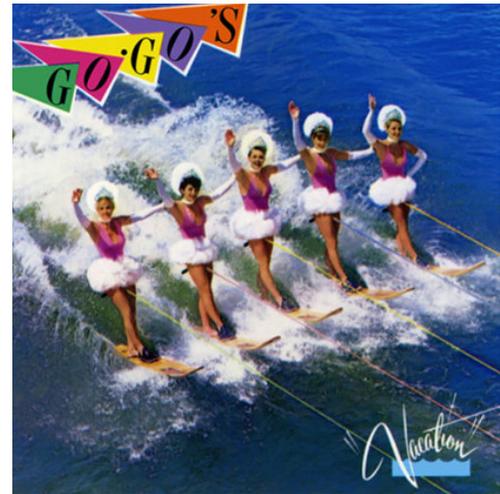


And now, even with the benefit of the knowledge of the past 12 months, have we changed how we underwrite and assess these risks? Do we see more risk or opportunity ahead?

So, as a new decade unfolds, amidst unprecedented (there's that word again) change and challenges to how we originate, underwrite, diligence, value, and forecast, we are pleased to share our 2021 Market Commentary.

Vacation, All I Ever Wanted. Vacation, Had to Get Away.

The refrain from the Go-Go's song may ring true this year as pent-up demand for leisure travel drives up occupancies and revenue in certain segments of the hospitality sector. Families and leisure travelers have demonstrated a continued desire to take vacations as travel restrictions are eased. End of year holiday travel picked up in many markets, especially those that are more accessible by car. Drive-to leisure markets on the coasts and in the mountains, by way of example, have maintained surprisingly high levels of occupancy in the face of the ongoing pandemic.



This focused demand is expected to get a further boost as vaccinations roll out and more people feel comfortable traveling and re-scheduling leisure trips that were postponed and canceled. Investor interest for downtown and urban-located hotels is likely to remain on the sidelines, as group sales, conferences, and events/conventions are not likely to rebound as quickly. Hotels with multiple demand drivers such as growing local (drive-to) populations, unique amenities, and nearby growth industries seem to be more resilient and should rebound quite nicely.

The PE-ification of Real Estate

Given recent demographic and secular shifts, institutional investors are increasing their focus on sector-specific and niche strategies. Often blurring the line between real estate and private equity, many of these strategies, while dependent on real estate, are operationally intensive businesses. In addition to renting the physical space, the tenants pay for services — which creates additional revenue sources for owner-operators of assets, including data centers, hotels, cold storage, marinas, studio/media assets, and ski resorts. For institutional investors, understanding the sponsor's operating capabilities and concomitant risks is a critical component of underwriting the strategy and investment opportunity.

First, investors need to understand the proportion of rent generated NOI versus operational NOI, which will inform due diligence. What is the quality of the platform and the team's experience executing both the real estate and the service component of the strategy? Is the team cycle-tested and prepared to operate through unforeseen challenges such as COVID? How are services priced, relative to rents?

These newer institutional property types present a learning-curve for many in the industry who are accustomed to investing in the traditional sectors. These strategies require an understanding of the appropriate metrics to evaluate operations. For example, the value metric of cold storage warehouses is pallet positions per cubic feet,

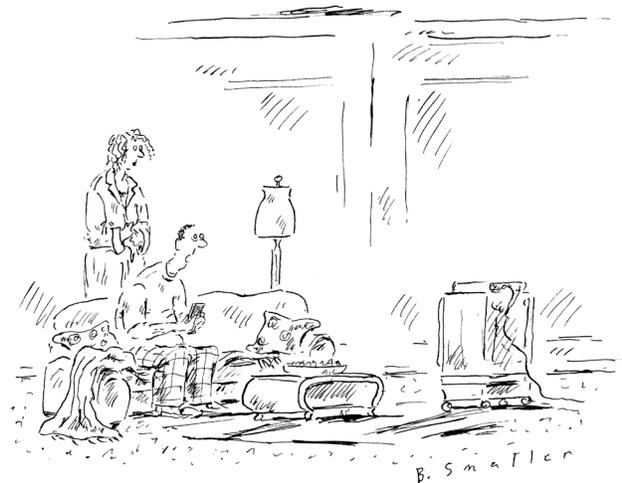
while rents are quoted by square footage and bespoke automation is critical. Who would have thought real estate investors would have to understand the nuances of the global food supply chain?

Additionally, investors need to assess whether there is proper alignment between commonly owned OpCos and PropCos, to ensure that one revenue stream is not subsidizing or cannibalizing the other.

Many of these niche strategies that straddle the line between real estate and private equity provide the opportunity to achieve strong, uncorrelated returns for investors that understand both the real estate and the operational component of the strategy.

Work-From-Home Leaves Us Starved for Content; and Creators are Starved for Space

Nearly twelve months into the COVID pandemic, you might be finding yourself running out of new shows to help pass the seemingly endless time at home. Media and production companies are acutely aware of this insatiable demand for new content and are scrambling to keep their pipelines full. The only issue - they are finding themselves running out of space to film.



"It's only insomnia if there's nothing good on."

The pandemic has accelerated what was already an increasing need for more content. From 2015 through Q1 2020, there was a 146% growth in the number of total subscribers among the top five cable companies plus Netflix, Hulu, Prime Video, and Disney+.¹ Then, in just the first three months of the pandemic (from March to June 2020), consumption of video content took another step up, surging more than 15%, from 57 to 66 hours per week per household.² Media companies are desperate to meet this demand with their own original content in order to acquire and retain subscribers, which explains an estimated 22% annualized increase in production spend by “over-the-top” players from 2019 to 2023.³

In the face of increasing demand, studio space has remained relatively static. Studios have a similar footprint and “feel” to industrial warehouses, but typically require infill locations in major production markets in order to access talent as well as take advantage of tax incentives and support crews. As such, a new studio asset is rarely the best use for a land parcel that meets the criteria, leading to historically high utilization of existing space.⁴ One consequence is that some production companies have transitioned from booking space on an as-needed basis to signing multi-year leases to secure space in prime locations. This is improving the stability and credit of cash flow, which is driving an increase in interest from institutions to acquire studio properties.

While there is a significant operating component to studio space worthy of its own commentary, real estate supply and demand fundamentals suggest that studios are ready for primetime in institutional portfolios.

1. Analysis prepared by Eastdil Secured, May 2020; Axios: “Video streaming growth in U.S. stunted by crowded market” - August 2018, “The battle for the future of TV” - October 2018, and “The streaming battlefield is getting crowded” - September 2019.

2. Deutsche Bank, June 2020: Content Production Facilities & Services Market Review.

3. McKinsey – March 2019 (VI Insights, BFI, CMPA, SNL Kagan, Expert interviews) Deutsche Bank estimates, Box Office Mojo, NATO, FilmLA, Press.

4. Estimates provided by Hackman Capital and The MBS Group as of September 30, 2020.

The Demographic Winners of COVID

In the past few months, a flurry of companies announced plans to move their headquarters, or a portion of their workforce, to smaller, “second-tier” cities. Large tech companies, including Hewlett Packard, Oracle, and Tesla recently decided to leave Silicon Valley in favor of cities in Texas that offer more affordable housing,



lower taxes, and fewer regulations. Similarly, big New York City-based financial firms, including Elliott Management, Goldman Sachs, Blackstone, and Moelis & Co, are looking to relocate business units or employees to lower-cost cities in Florida. This trend highlights an important shift in corporate sentiment and decision making.

As we approach the one-year mark of the pandemic, there continues to be a focus on health, safety, and quality of life, which companies can provide to their employees in smaller cities while also reducing real estate and overhead costs. The cities in the U.S. benefiting from this pivot include Austin, Charlotte, Denver, Nashville, Miami,

Phoenix, and Tampa. Interestingly, the drivers were becoming evident well before the onset of COVID-19 — over two-thirds of residents in global cities wanted to move to less densely populated areas prior to the pandemic.⁵ However, the shift towards work-from-home has certainly accelerated this migration as companies are now able to reevaluate their real estate footprints with a new lens.

While it is unlikely that large companies will completely abandon their presence in major metropolitan markets, cities that offer a high quality of life and lower cost of living are quickly becoming attractive alternatives. As such, while we wouldn't write off major markets like NYC, office and housing investors that are focusing on these second/third-tier cities should be well-positioned to capitalize on these migration trends.

Brexit: Freedom or Folly?

Britain finally left the European Union at year-end. Many hoped that this would lift the uncertainty in the market since the 2016 referendum. However, foreign investors that had been concerned about the impact on the UK economy and the British Pound remain in uncharted waters.

Concerns over increased border controls that could disrupt supply chains led many companies to stockpile inventory coming into the new year. European industrial managers say that just-in-time supply chains are now a thing of the past due to Brexit and COVID. This is driving further an increase in demand, adding an accelerant to an already buoyant market.

We observed with interest that the German insurer, Allianz, made its first office equity investment in London recently. Offices in major European cities still trade at lower cap rates than those in London, which we noted this time last year as an anomaly. However, interest rates across Europe are more



5. City Pulse Briefing, Gensler, 2020 (<https://www.gensler.com/research-insight/blog/the-rise-of-second-tier-cities>).

in line today as most central banks have lowered rates to practically zero to fight the impact of the pandemic. It is far from clear if investors are speculating that there will be more demand for continental offices as employees relocate or if there will be a reversion to the mean, which could make this a good entry point for London offices.

So, while uncertainty remains despite the UK’s departure from the European Union, it seems industrial assets will continue to benefit from tailwinds whilst office will not be for the faint of heart.

Doubling up in Tokyo

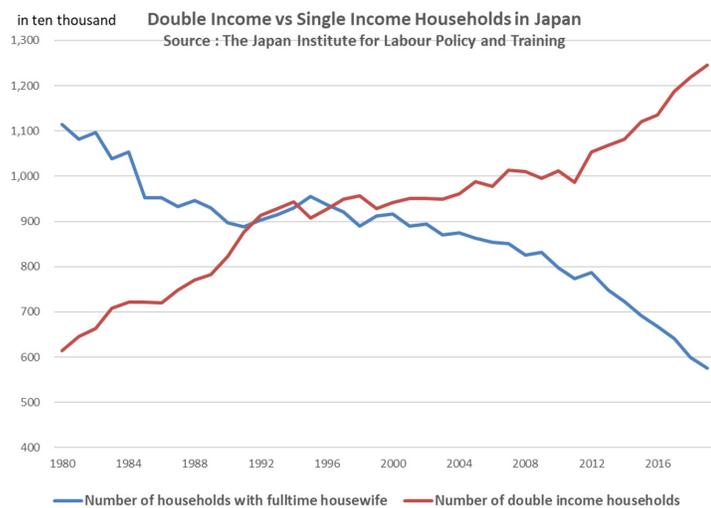
Even in Japan, a society not known for its pace of change, the pandemic has brought about increased flexibility in working arrangements for certain business sectors, which in turn is having a subtle impact on residential markets. Having registered strong growth over the past decade, Tokyo experienced net population outflow for five consecutive months in the second half of last year. More people have been moving to suburban areas in the neighboring prefectures of Kanagawa and Chiba, in search of

lower living costs and more spacious housing, while staying within commuting distance of Tokyo. The impact on the Tokyo residential market is still limited with net outflows of 2,000-4,000 residents on a monthly basis against Tokyo’s total population of 14 million. In the near-term this is unlikely to dampen interest in the multifamily sector in Tokyo, which has seen strong institutional demand.

However, over time we could see a more nuanced investment market developing with winners and losers emerging across the different wards of Tokyo. Suburban residential areas such as Ota-ku and Setagaya-ku, which are currently seeing the most significant outflow, may suffer. On the other hand, more central areas like Chiyoda-ku and Chuo-ku continue to see net inflows. These central areas have been popular among young families and professionals who are seeking good accessibility to central office districts. This has coincided with an increase of double income households resulting from Abenomics measures to increase the number of women in the workforce. As the number of double income households continues to grow, the residential market in central areas is likely to benefit from these structural changes and remain the focus of investment capital.

Who’s on First...

Whenever markets correct quickly as they did at the start of the COVID crisis, property owners and valuers are left to figure out the impact on long-term portfolio investments. Mark-to-market is a basic tenet of every asset class, and real estate does not get a free pass. In our industry, this was particularly hard felt in the public



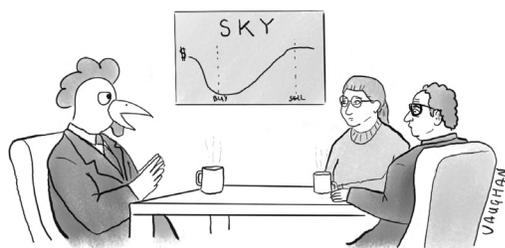
securities markets, with listed real estate debt securities (and their investment vehicles) plummeting in value, and in some case, failing altogether. The impact on public REITs was also significant, though less dire given the prudent leverage they employ. While valuation for privately owned assets remained relatively stable, public real estate companies have been very volatile, broadly declining in value by approximately 25% over a period of two months, only to see certain sectors rebounding to pre-COVID levels over the past few months. The private market, with limited trading volumes, is now navigating how to determine year end values for real estate in an uncertain, volatile market. The stakes for getting this right are significant — in particular, for the large open-end funds in the US that manage aggregate gross assets of \$267.1 billion as of September 30th, 2020.

We have seen “consensus valuations”, whereby managers (and even some appraisers) assess what other managers are doing, with many of the largest managers now public and reporting performance on a quarterly basis. With this knowledge in hand, and with the benefit of consultation with their portfolio managers, valuers, industry colleagues, they then address their portfolio marks. It’s not a bad substitute in a market lacking transactions or when a sudden shift in demand complicates the valuation exercise. On the other hand, institutions like a little more science and therefore many open-end funds put up the gates, not for lack of liquidity but to ensure that investors were exiting at fair market value.

We believe that this “group think” phenomenon will continue to be a feature of the market as economic uncertainty and volatility persist for the foreseeable future. Investors have pressured their managers to get quarterly results sooner and sooner, which doesn’t help either. So, while \$\$ in / \$\$ out is still the ultimate test of performance, if liquid vehicles are going to continue to proliferate as they have the past ten years, investors should expect to see the gates rise more frequently, even during periods of adequate liquidity.

Smoke on the Water. Fire in the Sky?

With so much stress in economies around the world, many investors have been surprised that real estate values have remained so stable over the past year. Blackstone, the industry’s bellwether with \$187.2bn of global real



**"If they believe its falling, it'll fall.
... And that's when we buy, buy, buy!"**

estate AUM, reported 5.5% and 4.3% total returns in the 4th quarter for their portfolio of core and opportunistic investments, respectively. But the expectation is that distress is on the horizon. For many institutional investors, the prevailing view is that the next several years will prove to be good vintage years for investing capital and will provide the opportunity to achieve investment returns consistent with the three years that followed the onset of the Global Financial Crisis when top quartile opportunistic funds delivered an average net IRR of 18.7%.⁶

With the exception of hotels and retail assets, owners have so far been able to hold onto assets in the current environment as evidenced by the historically low transaction volumes. Unlike the Global Financial Crisis which saw widespread systemic distress and hence opportunities to acquire large NPL portfolios, distress in the current environment has been more situational to date. We are only now beginning to see signs that lenders are forcing recapitalizations as they become less willing to agree to forbearance.

6. Cambridge, represents average top quartile return for opportunistic funds: vintage 2009-2011.

As we like to say, no one pays us to invest their money. With the substantial volume of dry powder waiting to take advantage of any distress, there is always the risk that pricing may get ahead of the risk-adjusted opportunity set. But clearly, managers see smoke on the water, and expect to see fire in the sky.

China Back on the Radar

The US-China trade war has dominated headlines in respect of China over the past year and diverted attention from the realities of capital investment into the country. Despite a contraction in global growth, China attracted record FDI of US\$163bn in 2020, more than any other country and an increase over the prior year. This underscores the importance of intra-Asia trade and investment flows, and the attractiveness of China as an investment destination. With outbound investment from Asia to North America slowing, Asian investors, joined by global institutions with a presence in the region, have been placing more importance on opportunities within Asia itself. China is benefiting from having largely subdued the pandemic and resumed its economic growth trajectory, becoming the only major economy to have expanded in 2020. Importantly, domestic consumption is on the rise as China implements policies to prioritize its domestic market.

We are seeing renewed interest for investment opportunities in China that play into the domestic consumption story, particularly in logistics, cold storage, data center, and rental housing sectors. The office sector has also seen selective demand from both core and value add investors. The preferred investment format has been asset- or sector-specific joint ventures and clubs, usually involving domestic operating partners. While Chinese institutions have largely withdrawn from international investment, they are displaying strong appetite for domestic cash flowing assets and represent a ready takeout market for foreign capital once assets are stabilized. We anticipate that capital flows into Chinese real estate will continue to grow, especially once travel resumes and investors refocus on diversification and growth.

The Changing Face of Real Assets

Infrastructure as a real asset class has long been recognized for its strong risk-adjusted returns, protection against inflation, and relative resilience against downturns. Annual infrastructure fundraising has more than doubled from \$91bn in 2010 to \$203bn in 2019⁷ and infrastructure deal volumes rose 8% in 2020 over the prior year.

With a growing number of institutional investors investing in both real estate and infrastructure, we believe several factors will continue to influence investment activity in 2021 and beyond.

We have observed that institutional investment decisions are increasingly driven by ESG factors, with a global shift towards energy decarbonization and sustainable infrastructure. Increased environmental regulation and cost competitiveness



“They’re powered by Internet outage.”

7. Preqin Pro.

has led to reduced use of fossil fuels and rising adoption in renewable energy generation such as wind and solar. Moreover, meeting global energy targets will require significant investment. Not surprisingly, renewable energy has led the way and remains the most active sector for investment activity, accounting for more than 50% of all transactions.⁸

At the intersection of real estate and infrastructure, digital assets offering connectivity such as data centres, cellular towers, fiber, and investment in 5G network rollout have seen strong deal activity. The pandemic's effect on remote working and e-commerce has only reinforced the demand in this sector from real estate and infrastructure investors alike.

For populations worldwide, upgraded or new infrastructure will be pivotal to the future availability of clean drinking water, lighting, sanitation, and other vital resources. As a result, the total global requirement for infrastructure investment is estimated at US\$3.9tn annually.⁹ The pandemic's economic fallout on top of already high levels of public debt and a large funding gap for essential projects, presents opportunities for private capital to fulfil financing needs. Most countries faced a gap between infrastructure needs and financial resources before the pandemic hit; that gap has now grown larger as a result due to the severe economic impact of the pandemic.

8. IJ Global Infrastructure Journal.
9. PWC Global Infrastructure Trends, 2020.

NEW YORK

850 Third Avenue,
16th Floor
New York, NY 10022
(212) 867-0888

DENVER

1401 Seventeenth Street
12th Floor
Denver, CO 80202
(720) 443-9950

HONG KONG

2102 Two Exchange Square
8 Connaught Place Central
Hong Kong
+852 3589 6940

LONDON

18 Pall Mall,
London SW1Y 5LU,
United Kingdom
+44 (0)20 3427 3624



HodesWeill.com

Hodes Weill & Associates (“Hodes Weill”) is a leading, global advisory firm focused on the real estate investment and funds management industry.* The firm has offices in New York, Denver, Hong Kong and London. Founded in 2009, Hodes Weill provides institutional capital raising for funds, transactions, co-investments and separate accounts; M&A, strategic and restructuring advisory services; and fairness and valuation analyses. Clients include investment and fund managers, institutional investors, lenders, property owners and other participants in the institutional real estate market.

This document is only intended for institutional and/or professional investors. This material is intended for informational purposes only and should not be relied upon to make any investment decision, as it was prepared without regard to any specific objectives, or financial circumstances. It should not be construed as an offer, invitation to subscribe for, or to purchase/sell any investment. Any investment or strategy referenced may involve significant risks, including, but not limited to: risk of loss, illiquidity, unavailability within all jurisdictions, and may not be suitable for all investors. This publication is not intended for distribution to, or use by, any person in a jurisdiction where delivery would be contrary to applicable law or regulation, or it is subject to any contractual restriction.

The views expressed within this publication constitute the perspective and judgment of Hodes Weill & Associates, L.P at the time of distribution and are subject to change. Any forecast, projection, or prediction of the real estate market, the economy, economic trends, and equity or fixed-income markets are based upon current opinion as of the date of issue, and are also subject to change. Opinions and data presented are not necessarily indicative of future events or expected performance. Information contained herein is based on data obtained from recognized statistical services, issuer reports or communications, or other sources, believed to be reliable. No representation is made as to its accuracy or completeness.

* All U.S. regulated capital market and securities advisory services are provided by Hodes Weill Securities, LLC, a registered broker-dealer with the [SEC](#), and a member of [FINRA](#) and [SIPC](#), and internationally, by non-U.S. Hodes Weill affiliates.

For more information, please contact us at info@hodesweill.com or visit us at www.hodesweill.com