Market Report

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U.S. Market Report, Issue 10

International Realty Valuation, Inc.

United States

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In this Report:

Investment Barometer

Like meerkats poking their heads out from their burrows – real estate investors are assessing what risks and rewards are in the real estate landscape. COVID is mitigated and life has returned to some semblance of normal. But which normal? Are we in 2018/2019 where investment performance was strong and trending upward, or are we in 2007/2008 at the precipice of the next big recession? The prognosticators are on both sides of the pendulum with Camp A predicting the worst is over and Camp B predicting we *ain't seen nothing yet*. What we do know is that inflation is around 8.2% and mortgage rates are up about 300 basis points from 2021. This will put the brakes on the housing and slow the commercial markets. The most active sectors are All Cash purchases in the Trophy Commercial Asset Class and Trophy Residential Locations, but expect values to retreat a minimum of 5% and upwards of 20% in the next 6 to 12 months. If the fundamentals don't change expect values to decrease 15% to 30%. The last time we saw this was in 2008-2010 during the Great Recession. The mantra then was that *everyone was hurt, and some died*.

Expect contrarian trends – don't believe the hype.

The US Government can only support the economy for so long – at some point there will be no net catching us.

According to REIT Sector Returns Mid-Year 2022:

Residential - down 20.3%
Retail – down 20.5%
Office – down 27.4%
Lodging – down 16.1%
Industrial – down 26.6%

Every sector is negative.

By the Numbers

The markets have been moving, but slowly and cautiously. Any RE Asset that trades must have strong fundamentals, great location, or significant upside, or all three.

According to **CoStar**

Office – Cap Rates

2022 - National: 6.90%

2021 - National: 6.90%

2020 – National: 7.30%

Retail – Cap Rates

2022 - National: 6.70%

2021 - National: 6.70%

2020 – National: 6.70%

Industrial – Cap Rates

2022 - National: 6.00%

2021 - National: 6.00%

2020 - National: 6.20%

Multi-Family – Cap Rates

2020 - National: 5.00%

2019 - National: 5.00%

2018 – National: 5.00%

Office – Work From Home impact not fully realized.

Retail – Static asset. The weak do not survive and the healthy will have leverage.

Industrial – next stage is logistics connectivity and life sciences. Still hitting on all cylinders.

Multi-Family – watch for the canary in the coal mine. Many agencies are increasing density, allowing asset conversions to expand residential supply. This will be a win for tenants and a long-term softening for landlords.

Lodging – pent up demand has kept this asset class strong. Cap Rates are stable at 8.6% for past few years.

Flatline for 3-years. Is there brain activity?

While effects from the pandemic have receded in most parts of the world other headwinds have appeared and strengthened in the second quarter. Inflation accelerated sharply for a number of reasons including the war in Ukraine, sanctions against Russia, Covid restrictions in China and ongoing supply chain disruptions. This triggered an accelerated tightening cycle by central banks. These are all feeding into heightened uncertainty and are dampening sentiment.

JLL – Global RE Perspective– 2022 Commercial Real Estate Outlook

International Realty Valuation, Inc.

The 3 L's in Real Estate

"The use of technology across all aspects of business, personal life and commerce is growing at a rapid rate, is driving shifts in consumer behavior and is increasing the demand for real estate and infrastructure solutions to meet growing data requirements."

—PGIM Real Estate – 2022 Global Outlook

Lance W. Doré, FRICS, MAI

Repositioning in all asset classes will have to occur going forward in 3 main areas. In the past it has always been Location, Location, and Location. This is the underlying foundation for successful real estate because it is unmovable. See Real Estate 101. However, with the macro analytics showing inflation, and consumer debt at an all-time high of $16.5 trillion, any hiccup in rates and employment may lead to disaster. The focus on real estate in 2022/2023 falls into the 3 L's.

Logistics – mirroring the industrial market trend real estate of all types should focus on meeting supply and demand chains. Connectivity in all areas of technology and infrastructure from highways, railways, airways, and ports for warehousing, distribution, fulfillment, and intermodal hubs. The innovators will transition to electric transportation (land, sea, and air) in order to stay competitive. This is not limited to infrastructure but also in communications to connect the infrastructure with satellites, Infrared, Microwave, and Wi-Fi. Logistics in real estate will be the integration of *sticks and bricks,* with *waves and wires.*

Labor - the talent pool for operating, managing, and analyzing real estate is at a crossroads. Baby Boomers are retiring or burnt out. Millennials are in demand and can pick and choose the best opportunities regarding salary, work environment, and quality of life. Gen X will pick what brings the best match with the type of life they prioritize. The reason for our labor issues (aka low unemployment) is a simple lack of supply. To get the *right people in the right place* all real estate environments must create quality space, competitive compensation, and flexibility in the work environment. The belief that anyone is returning to the workplace on a full-time basis is delusional. The only full-time workplace is essential personnel. Employers must understand employees have the upper hand because there are alternatives.

Lifestyle – sacrificing the well-being of an individual for the benefit of the common good at the job was the mantra of the 1950s, and 1980s. The 1950s gave us Mad Men and the 1980s gave us Greed - both believed to be noble causes at the time. The 2020s give us lifestyle, which is a balance between work life and personal life. Real Estate needs to allow us to integrate the demands of users from employees to tenants. The belief or idea that one party should be sacrificed for the benefit of the bottom line is short-sighted. Long-term positioning is absolute.

The impact on the primary asset classes will be:

Office – Tenants will have a reduced square foot footprint of 15% to 25%. Vacancies will increase as Lessors and Lessee adjust to the paradigm. Expect cap rates to increase for the short-term. Smaller spaces may allow for increased rents per square foot. These impacts are the result of Lifestyle and Labor dynamics.

Retail – Tenants will be very selective and very price sensitive. The best space for the best price will be required. All or nothing scenario – multi-tenant projects will see long term fixed vacancies, or near full occupancy. Quality and location are essential. These impacts are the result of logistics created by on-line competition and labor shortages due to low entry level wages.

Industrial – the anchor of real estate because it is Logistics. The market requires distribution hubs for connectivity. The downside is that industrial is labor intensive and a strong workforce is required. New builds need to be near employment/labor centers. Lifestyle is minimal. It is important to have good work environments and competitive salaries.

Multi-Family – urban centers will attract split WFH and WFO platforms due to desired lifestyle choices near amenities and services. Suburban and rural centers will attract WFH platforms and due to lifestyle choices for space and safety, as well as labor. WFH in suburban and rural areas are nomadic and bring big city salaries to secondary and tertiary markets.

See Anchors Away

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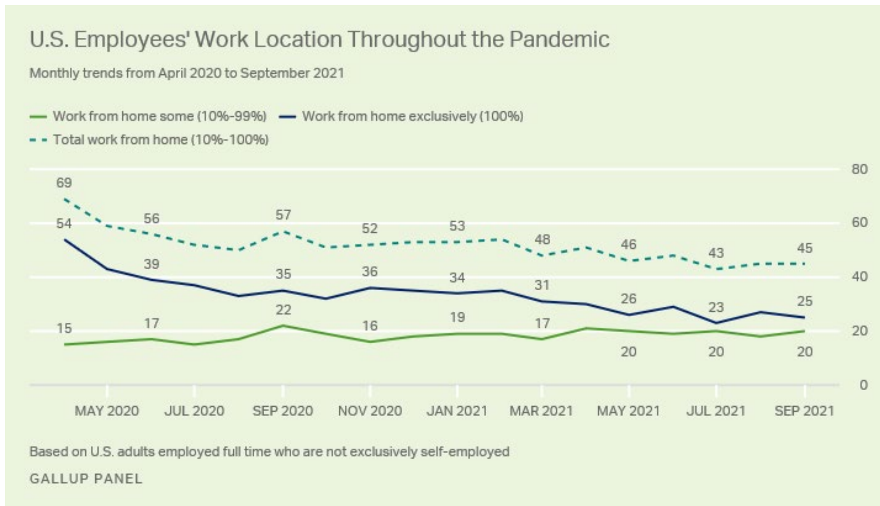
Anchor’s Away

The impact of the WFH v. WFO debate is no longer a debate. Real Estate must have the flexibility to accommodate lifestyle choices for owners and tenants. Office square footage requirements are less, and users need quality space when they WFO. Retail benefits when located near desirable WFH locations. Industrial benefits for the same reason as retail, where micro or sub-distribution hubs are located near WFH locations. Multi-family benefits as a staple for quality of life and a flexible lifestyle. The shift that allows flexible working in Real Estate is no longer a paradigm shift – it is reality.

The options for WFH locations are numerous, but the common themes are A) Connectivity, B) Natural Resources (mountains, streams, lakes), C) Boutique Main Street or Old Towns, and D) Affordability.

Bottom line – 45% of all full-time employee work partly or 100% remotely. Time to sail across the US landscape. Anchor’s Away!



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As a Founding Partner and President of International Realty Valuation, Inc., Lance values a wide variety of conventional and complex properties, serves as litigation support to public and private clients, and provides expert advisory services. His geographical expertise is focused on the western U.S., and his professional expertise is focused on energy facilities, investment property, lands, and special purpose.

About IRV, Inc.

International Realty Valuation, Inc. (IRV) is a global network of independent and highly competent professionals committed to providing expert financial reporting, forensics, consultation, and valuation services for both tangible and intangible assets to the most discerning of public and private clients. With a number of affiliate firms in several countries, our team has cumulative cutting-edge knowledge of global and regional markets, as well as international standards and requirements. This enables us to complete a wide variety of assignment, including valuation of large portfolios with multiple locations, in a thorough, objective, timely, and cost-effective manner. We serve major national, regional, and international banks, lenders, developers, investors, governmental agencies, public and private companies.