

Hines Investment Perspectives

U.S. Overview



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Economic Overview

We began this year with the expectation that the world and real estate markets would normalize, on the back of a more controlled pandemic and the reopening of most economies and markets. Little did we know that the first quarter would welcome us with a war in Eastern Europe, rising inflation, increased cost of debt and the prospects of a recession looming in the United States.

The U.S. Federal Reserve (“the Fed”) rose interest rates in March and in May, and it is expected to continue with an additional four hikes. Our research indicates the Consumer Price Index (CPI) has been self-correcting over time, and that a surge in oil prices and inflation historically has been a sign before a recession hits, although the odds are still relatively low.¹ Key economic indicators we monitor to anticipate the Fed's next move include CPI, Producer Price Index (PPI), unemployment rate and initial jobless claims.

It is within this economic climate that we share our perspectives on the investment opportunities in a pivotal market in the Americas: The United States.

Capital Availability

In the post-COVID lockdown period, the real estate industry has benefited from historically low rates, supporting record capitalization (cap) rate compression and elevated values. We are now faced with the reality of negative leverage, wherein the cost of debt is higher than project-level yields.

On March 14, 2022, the 10-year U.S. Treasury rate quickly ascended to near 3%. Short-term floating rates are expected to more than triple over the next 12 months, directly influenced by the Fed’s monetary policy.² With increasing lender credit spreads, all-in financing costs for floating rate debt are up approximately 70% off recent lows. Floating rate costs may average above 5% if the forward projection curves hold course.³

These interest rates are within normal bounds experienced post- the Great Financial Crisis (GFC) and as recently as early 2019. Elevated volatility and the steepening of the Secured Overnight Financing Rate (SOFR) forward curve has resulted in increased hedging costs. Interest rate caps were upwards of 10 times more expensive compared to the third quarter of 2021.

What is known is that rates have been rising at an unanticipated velocity. What remains unknown is how much is enough to tame inflation, and at what cost to the economy. We should expect continued volatility throughout 2022.

¹ Pitchbook’s research as of May 14, 2022 models the chance of a U.S. recession at 25 percent

² <https://www.cnbc.com/2022/05/25/fed-minutes-may-2022.html>

³ <https://selectcommercial.com/commercial-mortgage-rates.php>

Investment Impacts

An increase in interest rates and volatility in the markets typically brings on concerns about impact on value and cap rates. The reality is that cap rates have indeed increased, but not uniformly across asset classes.

Over the recent weeks we have observed transactions re-traded, and values being impacted⁴:

- Our team in Raleigh heard an industrial deal (15-yr lease) with a global internet powerhouse in Raleigh that would've been a 3.5% cap as of March 30, 2022, moved to a 4%+ in April 2022 guiding to 4%+ yield. We're starting to see cap rate expansion on longer leased deals across product types as long weighted average lease terms (WALTs) are very sensitive to financing costs.
- Our deal teams reported that residential and shorter-term leased deals continued to achieve guidance but from our recent conversations with main U.S. brokers, bidder pools are thinning out. Price guidance is critical to generate enough interest – too high and investors just won't show up to bid.
- According to the deal team, a buyer of a large multifamily asset in Miami for more than \$460 million was unable to secure financing and fell out of contract, with the asset likely trading \$30mm or 7% lower than initial pricing.
- Other pricing volatility our deal teams observed include a nine-year creative office lease for a global internet company with an initial yield that, in the first quarter of 2022, shifted from 4.5% to 4.9% in Seattle. A grocery anchored multi-story retail asset in Harlem has shifted from a 5% to a 6.0% initial yield.

There are multiple other transactions that are experiencing re-trades, and we remain open to reviewing deals for opportunistic entry. Cash and certainty of close are vital in buyer interviews and having financing in place is a premium in today's environment.

One of our investment vehicles acquired West Lakes Vista in northwest Austin,⁵ Texas from a private seller just two months after the original bid winner dropped out over deal terms. This vehicle stepped in as an all-cash buyer to acquire the 344-unit mid-rise multifamily unit that resides on a hilltop with unobstructed city views and minimal barriers to entry.⁶

⁴ Represents the observations and experience of Hines. Other market participants may have different views.

⁵ Acquired 10-28-21.

⁶ This acquisition case study is for illustrative purposes only. It should not be assumed similar opportunities will be available in the future.

Real Estate Sectors

Investment momentum in the United States has remained strong but uneven, depending on the asset class. Warehouse and multifamily demand continued to be high, driven by e-commerce, consumption growth and demographic trends. But some caution should be factored in going forward, as some of the 2021 growth rates in rents and prices are likely to be unsustainable. The office sector is still in a state of change, as corporate users assess their real need for space in the wake of the return to the office while retail, which in recent years has been the laggard and less favored asset class, appears to be making a comeback, particularly in service-oriented assets.

In 2022, alternative asset classes, notably life sciences, self-storage, data centers and single-family home rentals have continued to be highly demanded by investors, while supply remained still relatively limited.



1. INDUSTRIAL AND LOGISTICS SECTOR

- Demand remained strong in 2022, accelerated by last mile and distribution needs. So far, the sector has experienced limited impact by the recent volatility. Warehouse demand is highly linked to GDP growth; however, e-commerce moves the margins.
- Although warehouse demand should remain high, we will be attentive to market signals. Amazon has recently announced its intention to slow the growth of their real estate footprint (as well as hiring of employees⁷), which is particularly relevant in the U.S. as they have increased their share of the total market absorption from 30% in 2019 to over 50% in 2021.
- Modern industrial availability in the U.S, reaching 2.5% of total inventory in the first quarter 2022, is close to historic lows while e-commerce share of total retail sales is down from 18% in 2020 to 14% in 2022.⁸
- More careful analysis of oversupplied markets is warranted, despite strong demand.
- Financing still widely available for industrial but with increased rates some deals don't meet investment targets. Negative leverage on deals in the 3% cap rate range has been common in 2022.
- Strong rental growth rates may be still warranted in some markets, but some cap rate expansion at exit is increasingly prudent to account for future uncertainty.



2. MULTIFAMILY

- Apartments have experienced unprecedented growth in absorption. In the last 12 months, ending March 31, 2022, over 500,000 units have been absorbed in the U.S., 2.5x the average of the prior five years (~200,000 units). Rent growth in 2021 was at close to 12% nationally, compared to 2-4% during the prior five years.⁹
- In the first quarter of 2022, rents remained high, while affordability has been stretched, so future rental growth is likely to be impacted. Some investors still factor high rental growth to justify their way out of negative leverage, which is a risky assumption.
- Value-add multifamily has continued to be highly sought after by investors in the United States. The ability to reposition assets, update them with modern appliances and achieve higher rents may still be possible, although cost increases are making it more challenging.

⁷ Seattle Times: as of April 28, 2022, "Amazon Stock Tumbles as Company Reports \$3.8 Billion Loss"

⁸ Hines Research, CoStar as of March 31, 2022.

⁹ CBRE: [yieldpro.com/2022/05/cbre-reports-strong-q1-multifamily-fundamentals](https://www.yieldpro.com/2022/05/cbre-reports-strong-q1-multifamily-fundamentals)

Represents the observations and experience of Hines. Other market participants may have different views.



3. OFFICE

- Recovery has lagged but we should be in for an accelerated improvement as the population growth red line is back to pre-recession levels and rents are stabilizing. Corporate relocations and population growth boosted by the pandemic bring office opportunities back on our radar. That road back to demand could take two to three years, but base employment levels may be on a fast track.
- As of the week of April 20, physical office occupancy is exceeding 50% in markets like Houston and Dallas.¹⁰ There should be attractive opportunities to acquire smaller, select office buys in these markets with greater worker returns.
- The west submarket of Los Angeles has seen stronger office performance due to the concentration of technology, gaming, and content creation firms.



4. RETAIL

- Retail performance differs. Assets with good consumer demographics- well located area with population growth, strong resident employment and income levels, etc. - plus a desirable anchor tenant have performed better than any other retail type. These assets have the potential for considerable growth in value.
- Grocery-anchored, service-oriented assets, F& B and entertainment, and open-air lifestyle centers have drawn increased investor interest.
- The sector has shown signs of improvement, as consumers have shifted some of the spending habits from online to physical stores.
- Weakened shopping centers could present attractive covered-land opportunities for repositioning and redevelopment. Our discretionary capital is looking for opportunistic buys with grocery-anchored and food and beverage focus. One of Hines' investment vehicles have agreed to acquire an open-air, Whole Foods-anchored center in a major southeast market, at an attractive yield.



5. ALTERNATIVE SECTORS

- Life Sciences has become the darling of the niche asset classes attracting considerable attention and capital from institutional investors.
- There has been strong demand, from the public and private sector, based on growth in funding for Life Sciences while investment momentum is a good leading indicator for lab growth. We have a strong positive view of life science developments in major clusters, including newer markets like San Diego and Houston.
- Self-Storage has been attractive for acquisitions with Hines branching out from our experience in the Southwest to other parts of the country via geographically diverse portfolio pursuits.

¹⁰ <https://fortune.com/2022/05/02/return-to-office-workers-highest-these-cities/>
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U.S. Markets Overview

The Sunbelt and high growth markets have been outperforming more established gateway markets which likely explains increased investor interest in cities like Denver, Austin, Dallas, Nashville, Atlanta, Raleigh-Durham, Charlotte; and Florida, including Miami, Palm Beach, Tampa and Orlando.¹¹ Asset values have increased considerably in these markets, primarily in the residential and industrial sectors. Land values remained high in the first quarter 2022, and rental growth rates have driven investor and manager optimism. We would favor caution in these markets and focus on the strength and durability of the cash flows, with an eye to rising construction and labor costs.

The more established and traditional gateway markets, in the Northeast like New York, Boston and Washington, D.C. as well as West Coast metros like San Francisco and Los Angeles, have experienced a more subdued recovery from the pandemic and therefore, less interest from institutional investors, primarily in less favored asset classes like office and retail. This could present an opportunity going forward as values and yields do look more attractive in some of these markets.

Conclusion: Capital Strategies

Our U.S. focused funds are actively seeking investment opportunities, while maintaining a cautious stance due to recent volatility in pricing, financing costs and expectations of growth. More than ever, underwriting should be more focused on the quality of the cash flows and expected growth rates. Construction costs and overall capital and operating expenses are also an important area of attention given the increased inflationary pressures. Focus on adding value at the asset level and incorporating more cushion in exit cap rates – cap rate expansions, we believe, are a must.

We have several active investment vehicles targeting investments in the U.S. market, all with different mandates and seeking opportunities across the risk spectrum.

In these turbulent times, Hines plans to remain disciplined in its underwriting, focused on the durability of the cash flows as well value-added improvements to help generate returns to our investors. Inflation, interest rate increases, material and labor costs, contingencies and rent growth are the key assumptions to test and sensitize. Hines anticipates that there will be tactical opportunities available, with location and asset quality likely being the drivers of returns.

¹¹ <https://www.globest.com/2022/05/23/lessons-from-the-past-for-offices-new-normal/>.
<https://www.globest.com/2022/05/16/kkr-buys-five-sunbelt-self-storage-assets-for-98m/>

About the author and Hines' Investment Management Group

Hines operates with the philosophy that what is good for the investor is good for the firm. Our global Investment Committee, with an average tenure of 20 years, executes our role as an owner and operator of real estate, and as an investment manager to our clients and partners, with the highest ethical standards.

Mr. Munk is responsible for developing investment strategies for North and South America that are in line with global views of the firm. He is a member of the firm's Executive and Investment Committees and brings more than 20 years of diverse experience in real estate investing activities in the U.S., Europe, and Latin America.

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