CONFIDENTIAL – Presentation Briefing

Date: November 30, 2022

Re: Real Estate Investment Advisory Council
Fourth Quarter Presentation: **Forecast 2023 – It Gets Better, Right?**
The Buckhead Club

On Wednesday November 30th, The Real Estate Investment Advisory Council dared to issue its 2023 real estate and economic forecast.

Meeting at the Buckhead Club, members and guests dined on breakfast burritos and French toast in a new, morning format.

REIAC presented its 2023 Forecast from both the academic economist point of view, and the experiences of three real estate developer/ owners/brokers who interpret the economy and trends from the ground level.

The REIAC audience was treated to the high-level expertise and experience of:

Dave Welk, Managing Director, Origin Investments
K.C. Conway, Principal and Futurist of Red Shoe Economics
Amy Curry, Partner and Chief Strategy Officer, Dermody Properties
Chris DeCoufle, Moderator and Managing Director, CBRE National Retail Capital Markets

In the final quarter of 2022, the real estate industry finds itself mired in the "everything bagel" part of the cycle; everything happening at one time, creating confusion (but thus creating opportunity).

The Industrial Outlook

Industrial is a tale of two worlds: the leasing brokers are busy as ever, having their second-best year (just behind last year) while the capital brokers are having a horrible Q4. Vacancy is way down, rents are way up. Similar behaviors are observed in comparable properties, so it is not a localized phenomenon.

But capital has dramatically shifted and is disconnected. There is no agreement on value between buyers and sellers, but since there is no economic pressure to transact, each side stands down, and will wait until Q3 2023 to transact.

Peak industrial real estate occurred in Q1 of this year. Cap rates were 3.75% then, and are 5.0+% now. Debt was cheaper in Q1 as well to facilitate those low cap rates; cap rates are still too slow to catch up with 6.0% debt. And rates continue to be so unstable that no one can understand pricing.

The Apartment Outlook

The previous year was off the rails on how much capital was in the system, and how much rent growth was happening. Now, on a national basis, we are going to peel off a lot of that upside this year, and return to 2019 / 2020 levels. Valuation will drop to pre-COVID levels, but due to demographic growth in the sunbelt, the fall will not be as hard here.

Rents are turning down across the board, and the country's biggest rent gainers (Phoenix, Tampa, etc.) will be the biggest drops. **Likely decline of 20%, but those markets were up 40% to begin with**, so there will not be a crisis there.

Operating expenses are up, although most asset managers still don't focus on that enough. Insurance and property taxes will continue to take big leaps, followed by increases in payroll due to labor cost inflation. Payroll might be offset, though, by replacing personnel with "remote leasing" which is increasingly being tested by larger operators, especially in the Build to Rent (BTR) space.

The Economic Outlook

Distribution has been changing ever since the expanded Panama Canal opened, energizing new ports of entry for shipping into the United States (see Savannah, Charleston, Mobile). Now, the slower-to-change parts of the distribution network (railroads) are experiencing crunch time as they try to react and pivot (or merge) to the new distribution paradigms.

Capital – the Fed has been very slow to react to inflation. Multifamily will always have the benefit of the GSEs, but the **Fed is telling bankers to stop lending. Lending is viewed as inflationary,** so real estate lenders have retreated to the sidelines, or are hiding in bunkers. Bankers don't even want to be seen on speaker panels lately.

We are in the early stages of a pricing reset; expenses are increasing at twice the rate of rent, which will push value down by 15%, and higher interest rate costs mean the "band of investment" of cap rates will push value down by 25%. This could mean an all-in value decline of 40% before all is said and done.

The Retail Outlook

Retail is a different animal; property sales prices **are 20% to 40% less than replacement cost**, so there is still upside in the eyes of investors. Retail properties are typically built on great real estate locations at Main and Main which will always have intrinsic location value. Selling retail properties at a 7.0% cap rate for the past few years means that there is a better cushion from rising interest rates, so there hasn't been much divergence in value lately.

Also, there is no new supply of retail in the near future, leading to higher leasing demand from tenants in the existing properties. The retail leasing brokers are, frankly, hoping that Bed, Bath & Beyond goes bankrupt so as to free up some space for re-leasing at better rates.

"Moving the back walls" is an ongoing trend whereby retail tenants shrink the amount of floor space up front to make room for warehousing the merchandise in back. But retail properties as a whole will likely not be converted *en masse* to infill industrial. There's too much NIMBY-ism from surrounding neighborhoods that don't want 18-wheelers chugging down Main Street.

Economic Clouds

COVID lockdowns in China will drive down China's GDP by 40%, and disrupt the ability of manufacturers to get all those iPhones to American markets. Witness the Port of Los Angeles – at one point there were 140 cargo ships at anchor waiting to unload; now it's down to four ships.

One rare benefit of higher interest rates – single family housing construction is slowing way down**, freeing up building materials and land sites for multifamily or other uses**. Those commodity prices are dropping for commercial real estate developers.

In the southeastern US, people are moving into these markets in droves. It's the only place you can out-run inflation. Western states are in trouble due to the most basic of issues – water. The Colorado River basin drought is impacting the seven states surrounding it; new rules going into effect next year will require water usage to be cut by one-third. **Any business that is heavily reliant on water as part of its manufacturing process is seeking to move out.**

Industrial Opportunities

The future lies in investing in logistics firms and properties in the sunbelt. This is where the people are moving, and if possible, investors seek infill industrial logistics sites. The buildings will be smaller but more profitable, not like the commodity "aircraft carrier" warehouse way out along the interstate. **And the tenancy will be sticky: full build-out of a logistics facility is reaching $500 per square foot**, so these tenants won't get up and leave anytime soon.

Apartment Opportunities

Historically, institutional capital flowed to the Big Six coastal markets, and private capital filled in the rest. In the middle of the current cycle, institutional capital "discovered" the smaller markets of the sunbelt. Now, capital is searching everywhere in southeastern cities. The investor's challenge is to be able to analyze at a granular level, block by block, where the most attractive sites should be developed.

Build to Rent (BTR) is very attractive but developers need to go out into the far suburbs to find suitable land. But if one can find a site and get it zoned for rental in these hyper-NIMBY markets, then "it is gold."

Can Atlanta apartments get overbuilt? Not likely. Atlanta is big enough now, and with strong continuing population growth, it would be difficult to drive down occupancy based on recent levels of residential deliveries**. So, no fear of overbuilding.**

Affordable housing crisis – and yes, it is a crisis. It can't be fixed by the federal government, as affordability is a local issue to be solved by local municipalities. In the sunbelt, the lower cost of living is why people of low or moderate means are moving to Atlanta, exacerbating the issue. The NIMBYism concern looms large over development of affordable housing. **But the bottom line issue is cost** – it still costs too much to construct decent housing unless there are massive government subsidies. Or, new technologies could be the ultimate answer. Witness the 3D printed houses in the experimental stage with an Austin developer.

Capital inflow to Opportunity Zone funds is slowing down; the appeal was the deferral of taxable gains that investors racked up elsewhere. **Now that the stock market is down, there is not as much gain to offset**, and OZ funds are losing their appeal.

Much of that capital is being directed to safer investments, such as Freddie Mac bonds for a risk-off strategy. Development funds are also in decline. And this capital is coming in from high net worth, qualified investors who know a thing or two. Their sentiment is **"it just doesn't feel good right now."**

The "A" word

Amazon, once on a tear to lease as much industrial space as could be built, is **now putting much of that space back on the market via subleasing**. The e-commerce side of Amazon is still growing, but not at the torrid COVID pace, and as a whole, that side of the business is not profitable as is the Amazon Services side (AWS). Fortunately, the rest of the domestic logistics industry is still growing, and the sublease space is not impacting the overall supply / demand dynamic.

Speaking of delivering packages, apartment developers kept ahead of the daily surge of FedEx dumps by building out larger mailrooms and package centers, complete with technology to alert tenants when their shipments arrived. **Now, in a reversal, technologies such as Fetch are replacing these storage spaces.** Apartment owners sign up for Fetch services, which provides an alternative address to deliver packages. Then, Fetch notifies tenants to provide a three-hour window of individualized deliveries, thus obviating the need for the apartment's leasing office to act as mailroom. Apartment mailrooms can now shrink back to the small cubicle they once were, and apartment management can repurpose the 2,000 or so square feet of space.

Bonus

Top three discussion points in the Emerging Trends 2023 report just out:

1. There is no price agreement between buyers and sellers of any property type;
2. We are in the early state of a large price reset;
3. Hotels have finally replaced office and retail as the third most popular investment type.

About REIAC

The Real Estate Investment Advisory Council (REIAC) was established as a nonprofit trade association to provide a forum for the exchange of ideas, concerns and experiences among senior executives who conduct commercial real estate transactions. The Southeast chapter of REIAC was founded in 1994.

REIAC is an exclusive, **principals-only** national fellowship of top real estate executives that offers superior educational events, networking opportunities and community service. REIAC's institutional quality programs are presented in a social environment where members can share experiences and knowledge with their peers. REIAC events encourage members to broaden horizons and develop personal relationships that further their success within the industry.

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