CenterSquare Investment Management

Megatrend real estate investing

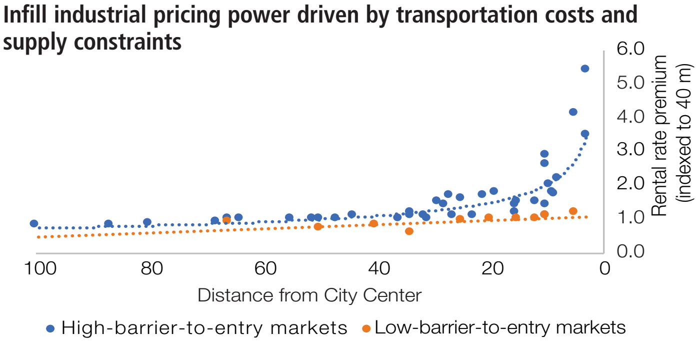
Demand patterns have changed significantly over the last decade, driven by technology, demographics and preferences. Consequently, the way we use — and value — real estate has also evolved rapidly. However, the tangible nature of the real estate that supports how we live, work and play has also meant that real estate has lagged the changing demand patterns.

Therefore, there is a need for our built environment to transform with how we live. New development is often prohibitively expensive due to scarcity of appropriate land sites, infrastructure constraints, construction costs and planning controls. Value-add investing is a strategy that can overcome the obstacles of new development through upgrading existing assets. The term "value-add" can be broadly applied, but our philosophy behind value-add investing is specifically the recycling of real estate to meet the needs of the new economy. Implementing this philosophy requires targeting well-located real estate that is architecturally and structurally sound, but has lost relevance to the marketplace due to passage of time and/or mismanagement. By focusing on off-market transactions, these assets can be accessed at an attractive basis. This creates the flexibility to apply capital and imagination to uniquely reposition the asset in its market, without the need to imagine new levels of rent.

We see three primary opportunities in today's market to undertake this "recycling of real estate." These opportunities are supported by the secular megatrends behind changing demand patterns, which can help investor capital benefit from demand disruption instead of being stranded in yesterday's real estate. These megatrends are e-commerce, affordable housing and modern office.

Former Quaker Oats facility, repurposed into modern logistics[5]

Infill industrial pricing power driven by transportation costs and supply constraints



Source: Prologis as of Jan. 2020

E-commerce

The shift of goods consumption from a retail storefront to the internet is well known. Today, e-commerce accounts for about 20 percent[1] of all retail spending, and our analysis leads us to believe this market share could double from current levels. We base this opinion on analysis of product types that have reached peak e-commerce penetration, such as books and music, where e-commerce accounts for more than 60 percent[2] of all sales. Further, e-commerce represents an efficiency gain, as it is generally cheaper for the retailer to distribute online. Given the key reasons people shop online — convenience and price — many other goods, such as general merchandise, fashion and jewelry, are likely to see significant additional e-commerce penetration. In turn, this is creating a need for the build-out of a sophisticated supply chain of modern logistics facilities and an opportunity for real estate investors.

We see two primary challenges to access this theme. The first is that industrial supply is forecasted to exceed demand for the first time this cycle in 2020. However, the industrial market is bifurcating. Most of this new supply is coming into the market in the form of large, bulk distribution centers in low-barrier markets. We believe smaller, more infill, last-mile assets are likely to continue seeing strong rent growth, driven by barriers to supply and the importance of location. Given the cost structure of online distribution, where transportation costs are typically 10 times the cost of rent,[3] it makes sense to pay higher levels of rent to be closer to the end consumer.

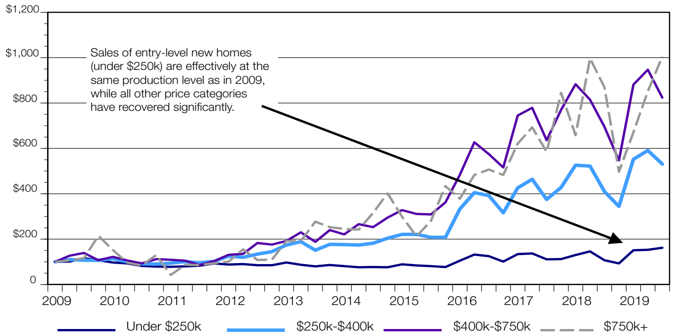
The second challenge is how to access the real estate at a reasonable price, given the large amount of capital seeking to take advantage of this megatrend. The answer is adaptive reuse. Although an entitled piece of land will attract broad interest, excess corporate real estate (e.g., an old manufacturing facility) has a very narrow buyer pool. Old manufacturing facilities that have become obsolete are often well located near infrastructure and a labor pool and have architectural elements that allow conversions to warehouse facilities. They also tend to require redevelopment and often a shrinking of the asset to allow for proper access and truck corridors.

Affordable housing

Both single- and multifamily-housing deliveries have just returned to their long-term average this cycle. Yet, housing supply relative to the working-age population remains depressed and is at its lowest level in the last 40 years. Further exacerbating the housing shortage is the lack of affordable housing, as most of the deliveries this cycle have been at high price points. As shown by the chart at right, supply of the fourth quartile of housing or entry level has been static this cycle. This is a consequence of bank regulation and risk aversion rationing capital away from borrowers with lower credit scores. Further, new multifamily rental deliveries have been disproportionately focused on higher price points (renters by choice) due to increasing construction costs that require higher rents. In short — there is an acute undersupply of affordable housing in the United States today.

Garden-style apartments, primarily with three to four bedrooms in high-price Austin housing market with good schools[5]

What is being built in single-family is high price-point supply



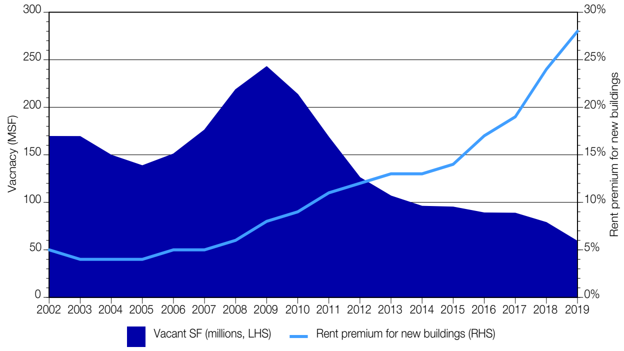
Sources: U.S. Census Bureau and Raymond James Research, as of December 2019

A strategy that can put investors ahead of this megatrend is redeveloping multifamily residential assets that can serve as single-family substitutes. This involves focusing on garden-style multifamily communities with a significant portion of three- and four-bedroom units with attached garages. Assets in submarkets with high single-family home prices and with good schools can lead to an inelastic demand profile, ensuring a strong operating backdrop. Given this type of housing can provide residents with access to a location and lifestyle that may normally be out of reach, residents are more willing to pay higher rents in response to investment from the landlord to upgrade the asset and community.

Modern Office

Firms today view their office space more strategically to attract and retain talent. Given the average firm's cost structure is composed of 70 percent[4] employee costs versus only 10 percent[4] rent costs, firms can rationalize paying a sizable rent premium

Low vacancy and rent premium expanding for new buildings



Source: CoStar, as of fourth quarter 2019

for the right space that attracts better talent and optimizes workforce satisfaction and efficiency. Therefore, all net absorption this cycle has been in four- and five-star buildings. Modern office space is experiencing low vacancy and rising rents, while rents for older commodity office space have barely moved this cycle. This older commodity office space generally also requires significant capex spend just to stay relevant. By identifying assets with easy access to public transportation and amenities, as well as unique architectural features (e.g., high ceilings, art deco facade, outdoor space) that can be upgraded to the demands of today's tenants, we believe creating modern, highly amenitized space is the strategy to capitalize on this megatrend that is changing how we work. Investors must be careful, however, as it is almost impossible to position older "commodity" assets to benefit from the modern office megatrend, regardless of the amount of capital invested.

Art deco building, formerly a vocational school, converted into creative office in Pittsburgh[5]

Rapidly changing demand patterns are giving way to megatrends: e-commerce, modern office and affordable housing. We believe value-add strategies focused on recycling and repositioning the right real estate can allow investors to benefit from these megatrends that are disrupting how consumers interact with the built environment today.

Notes:
[1] U.S. Census Bureau as of Sept. 30, 2019, ex auto and gas. [2] *The Geography of Transport Systems: Fifth Edition,* January 2020. [3] Prologis, as of January 2020. [4] World Green Building Council and CenterSquare Investment Management, as of January 2020.
[5] Photos are representative assets held in CenterSquare's Value-Added Fund Series as of Dec. 31, 2019.

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