Themes and Forecasts

US – Real Estate Outlook 2021

Ready for recovery.

UBS

UBS Asset Management

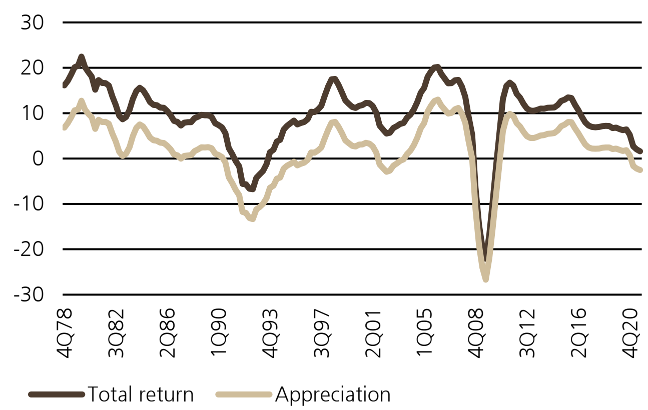
Investment themes

Macro – *Price in a rebound*

Downturns are rare in private commercial real estate, *exhibit 1*, but when they happen, the disruption brings new and unique opportunities for investors. Some weakness should persist into 2021 as effects from the pandemic and 2020 recession ripple through society and economy. Retail and Office write-downs could pull values slightly lower in 2021, see US Performance Scenarios page 7. Investors and appraisers are waiting for more comparable lease and sales transactions to support or refute the magnitude of adjustment.

Exhibit 1: US real estate returns

Returns (%)



Source: NCREIF Property Index as of December 2020. Past performance is not indicative of future results.

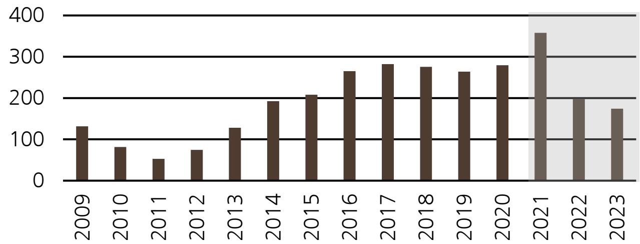
It is challenging to underwrite starting rents and required risk premiums in the sectors most affected by the pandemic. Investor confidence is higher in the Industrial and Apartment sectors, given the persistent, necessity-driven tenant demand. In Retail, Office and Hotels, limited transactions and higher capital expenditure (capex) burdens make it difficult to assess whether current risk premiums compensate adequately for the risk. We expect Industrial and Apartments to continue to diverge and outperform Retail and Office, *exhibit 9*.

As the year progresses, positive news on vaccine distribution, competitive lending markets, and fiscal stimulus should support a meaningful rebound in economic growth and a turnaround in aggregate real estate performance. In this low interest rate environment, real estate should continue to be viewed as a partial substitute for fixed income, a good portfolio diversifier and a pathway to sustainable and impact investing.

Apartments – *Find opportunity*

Exhibit 2: Supply pipeline

Units (Thousands)



Source: CBRE-Econometric Advisors as of December 2020. Shaded area indicates forecast data.

Apartment returns held up overall in 2020, but it was a year of mixed results. Housing is a necessity, and consumers prioritized paying rent, even in Class C buildings where the threat of unemployment loomed higher than on Class A rent rolls. Buildings actively leasing-up typically faced elevated concessions.

Landlords negotiated better results for renewals than new leases. Suburban locations offered better fundamentals than Downtowns. Metros with large downtown clusters or high construction levels suffered most. Cap rates declined, which offset rent declines, as the sector benefitted from continued investor demand, low interest rates and steady debt availability.

When underwriting new investments, pricing in future rent growth will be easier from a lower base. Disruption to transactions, permitting, and construction could lead to reduced supply in some markets over the coming years, *exhibit 2*. Look for development opportunities in equity or debt while the supply is diminished and adjust designs to accommodate work-from-home amenities. Consider Suburban sites carefully and discount any surges in demand that might be pandemic-driven. Inner-ring suburbs with proximity to employment, transit connections and moderate rents appear attractive. Niche concepts abound to help diversify traditional portfolios, see Emerging Sectors *page 6*. The Apartment sector's ability to monetize changes in the economy quickly, coupled with low capex burdens, position the sector well in 2021.

Industrial – *Challenge old trends*

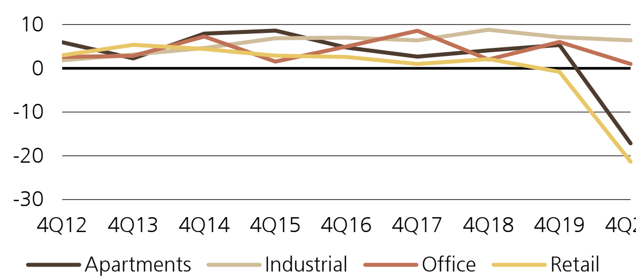
Investors may still find upside by adding Industrial exposure. Supply chain disruptions and logistics challenges were no match for sustained customer demand in 2020. Income is holding up, *exhibit 3*. Growing investor appetite should reinforce good performance while tenant demand is supported by accelerating online ordering and increasing inventory build-up. Cap rate compression plus income growth should lead to another year of Industrial outperformance relative to other sectors. We like the flexibility that comes with Industrial's low cap-ex requirements. In fact, for strategies like infill renovation, cold storage and flex, a little more capital spending may be warranted to stay competitive.

Challenge traditional investment approaches and diversify Industrial portfolios away from massive concentrations in any single strategy or region. Build-to-suit can be an effective path to increased spread. Study tenant needs continuously, as trends will change. Higher-tech firms may begin to require a changing skill set with more expertise in automation and digitalization.

Consider broad opportunities to lead in environmental, social and governance (ESG), whether it be sustainable development, energy-use management or enhanced health and wellness amenities for tenants. Warehouse and distribution still dominate, but opportunities are growing to seek further diversification within modern Industrial portfolios through emerging concepts in technology, in-fill, cold and self-storage.

Exhibit 3: Net operating income growth

Four-quarter rolling (%)

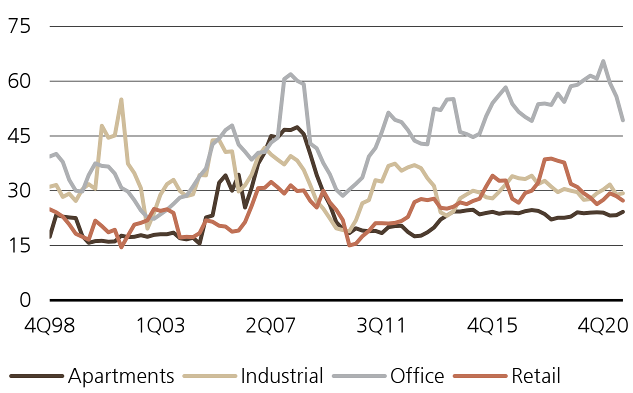


Source: NCREIF Property Index as of December 2020.

Office – *What's priced in? What isn't?*

Exhibit 4: CapEx trends

Capital improvements to NOI (Rolling four-quarter average %)



Source: NCREIF Property Index as of December 2020.

A substantial drop in Office rents is not priced in right now, but there is downward pressure. Values will likely adjust downward when more leases are signed and allow comparisons to current assumptions. Opportunities in the Office sector will be very specific to individual deals. Capex is likely to continue to weigh down cash yields post-pandemic, *exhibit 4*. In 2021, look for value in post-renovation assets with a focus on improving the portfolio's sustainability profile. Firms will still need office space, even if the rise of flexible ways of working lowers demand potential somewhat over the long term. We are more optimistic about the urban edge than the traditional urban core. Yet, all suburban locations are not equal. Despite the need for space and fresh air, locations closer to density remain more attractive.

As for Downtown Office, as the pandemic eases, urbanization should return, albeit at a diminished pace. Think more broadly than traditional office buildings and traditional gateway cities. Life science and medical office exposure help diversify portfolios. The potential of secondary business districts and lower cost metros – like in the South – is attractive. It's more than just low tax. It's a lower cost of doing business.

Retail – *Nothing lasts forever*

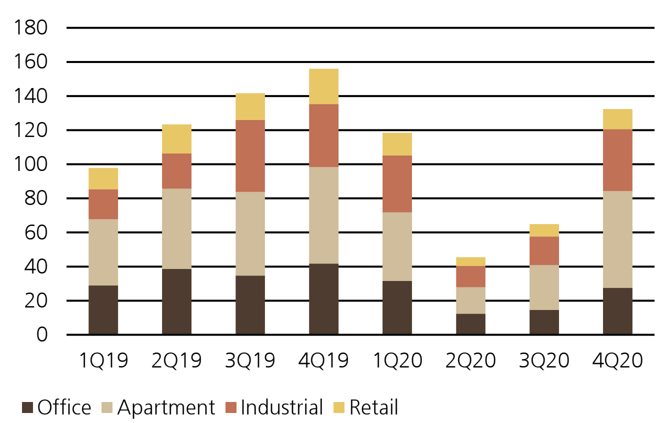
Demand doesn't look good. Even when landlords find strong tenants, they will likely negotiate significant concessions. Fewer small businesses are opening, and credit risk remains high. We expect 2021 to be the fourth year of Retail depreciation. The situation looks dire, and Retail transactions are low, *exhibit 5,* but don't count Retail out forever. The sector already offers the widest spreads, and often occupies valuable locations. As recovery begins to take hold, retail should benefit from pent-up consumer demand for goods, entertainment and food. When experienced investors have better clarity on competitive leasing terms, it may be possible to find attractive spreads, but be wary of future capital needs.

Modern spaces will need to accommodate quick drive-up turnaround for order pickup and returns. Tenant mixes need to be curated to meet local consumer and business demands. Smaller shopping centers should offer less risk than malls with a faster payoff. As malls are repositioned, lose anchor tenants, or add new uses, a return to strong cash flow growth may still be years away. Retail industry transformation will likely come from increased mergers and acquisitions, tech-oriented innovations and integration of more advanced logistics capabilities.

Transformation is expensive and could increase debt burdens, driving up risk in the near-term. Traditional thinking needs to change and change quickly including deeper partnerships with operators and tenants as well as cooperation with municipalities.

Exhibit 5: Transaction volume

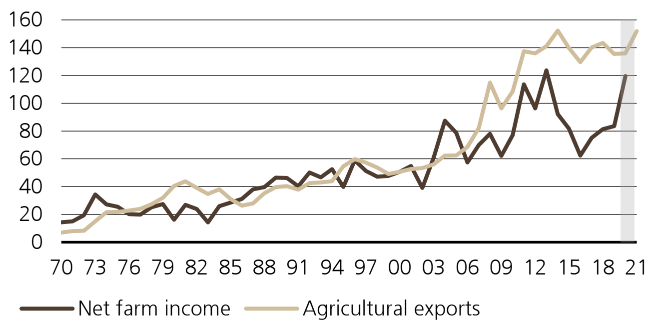
USD billions



Source: Real Capital Analytics as of December 2020.

Farmland – *Steady and sustainable*

Exhibit 6: Net farm income and agricultural exports
USD billions



Source: USDA as of August 2020. Shaded area indicates forecast data.

Despite weak income returns since 2013, a trade war, and COVID-19, there is no evidence of any significant or widespread financial stress in the US agricultural sector, only some pockets of stress observed in parts of the Midwest. Government payments, designed to offset the adverse effects of COVID-19, are not expected to continue in 2021; yet, most observers believe that cropland rents will remain steady in 2021 despite the outlook for income to farm operators.

Debt in the farm sector remains low with a Debt-to-Equity ratio of 16.2 cents of debt for each USD 1.00 of equity. Total debt has increased in the past year by approximately USD 16.6 billion or 4.0% with non-real estate debt up by about 0.2% and real estate debt increasing USD by 6.1%. Rental increases have not kept pace with farmland value gains. While rents have been rising, the rate of increase has been slower than the rate of increase in farmland values, *exhibit 6*. The result is lower current yields or cap rate compression.

Using national USDA cropland data, the nominal rent-to-value ratio declined from 4.7% in 2001 to 3.4% in 2020. The dearth of investment-grade properties available for sale is a challenge for deploying investment capital. The overall strength of the US farm economy, with solid farmland values and income returns, provides little, if any, motivation for farmland owners to liquidate their land holdings.

Moreover, there are very few alternative investments that offer equal or more attractive long-term potential returns if one were to sell farmland. When the absence of any significant financial stress in the sector is added to this, the result is very few attractive farmland buying opportunities. Investors seeking to deploy capital into farmland must be patient in this challenging market.

Emerging sectors – *Diversify and grow*

Emerging or niche property sectors encompass more than half of the listed Real Estate Investment Trust (REIT) market capitalization, *exhibit 7*, and a growing portion of the private real estate investable universe. The potential for portfolio diversification and growth will need to be balanced carefully against the unique risks inherent in new strategies. Investors will approach these opportunities differently. We advocate three key investment parameters for underwriting emerging property sectors. 1) Effective operating partners matter. 2) Sustainability and impact matters. 3) For long-term holds, low capital expenditure (cap-ex) strategies are preferred over high cap-ex sectors.

Self storage – A low capital expenditure (capex) burden makes Self Storage an attractive sector. High supply stunted rent growth in recent years, but the wave of development is subsiding.

Cold storage – Direct-to-consumer food delivery is poised for growth, and yet, new cold storage supply was limited over the past decade. Cold storage an attractive diversifier for Industrial portfolios and provides sustainable and impact investing benefits.

Data centers – Long term leases and huge growth in cloud computing support near-term demand. Be wary of rising risks of obsolesce and supply growth.

Life science – Specialized research space for bio-tech and pharmaceutical tenants is highly-concentrated now but poised for decades of growth and expansion. It was one of the few sectors to see tenant demand accelerate during the pandemic.

Medical office – Demographics support demand. Income growth should remain fairly steady. Tenants are sticky. We expect Medical Office to be a low-beta portfolio diversifier over the long-run.

Manufactured housing – Low capex, steady demand and barriers to new supply attract institutional attention to a sector dominated by small, private owners. Cap rates show potential to decrease.

Affordable housing – Demand is high. Supply doesn't keep up. Developers typically rely on government incentives. The pandemic recession and strain on household balance sheets exasperates the social need for affordable housing.

Coliving – Real Estate Investment Trust implications are still under review for this emerging sector, but it is possible to test co-living leasing on a small scale within some traditional buildings, which positions it as a potential area of growth.

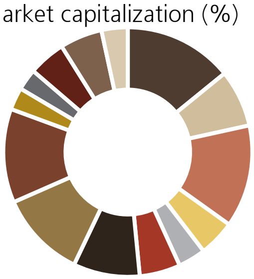
Senior housing – Demographics support demand for Senior Housing increasing for the better part of the next two decades, as the first Baby Boomers turn 75 in 2021. Five years of heavy new construction is winding down but only for a few years. Developers will likely ramp up construction again by 2023.

Student housing – The sector performed better-than-expected during the pandemic, but risk remains that undergraduate enrollment could temper demand in coming years. Slower supply growth help balance the outlook; however, outcomes can be very different school-by-school.

Single family built-for-rent – Institutional scale and management takes on neighborhoods of detached housing at a time when demand for suburban living is booming. Demographics support good demand even as the pandemic eases, though leasing velocity is likely to moderate.

Hotels – Profit margins were under pressure even prior to 2020, when the pandemic caused a negative tail-risk event. Deals can be made at discounts to 2019 pricing. We expect pent up demand for travel and hospitality, but it will likely taper off before a full recovery is achieved.

Exhibit 7: Public-market allocations to niche
Market capitalization (%)



- 14% Industrial
- 5% Shopping Centers
- 9% Office
- 3% Manufactured Homes
- 6% Specialty
- 7% Self Storage
- 4% Regional Malls
- 11% Health Care
- 3% Single Family Homes
- 3% Lodging/Resorts
- 13% Data Centers
- 5% Free Standing
- 12% Apartments
- 5% Diversified

Source: FTSETM, Nareit® as of January 2021. Notes: Implied market capitalization is calculated as common shares outstanding plus operating partnership units, multiplied by share price.

Market expectations 2021

A quick look at US real estate expectations for 2021 shows recovery underway, *exhibit 8*, but one forecast total return number does not tell the whole story. Returns continue to diverge across underlying property types, *exhibit 9*. Retail and Office are expected to experience weakening income and value declines. Apartments should experience a year of recovery, and Industrial continues to outperform.

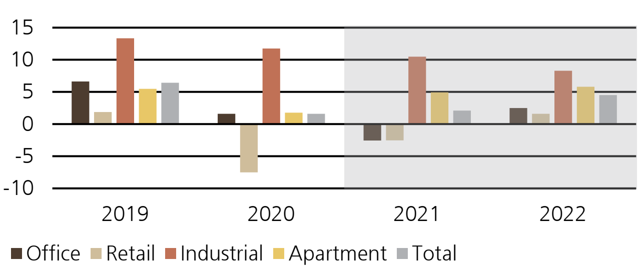
Exhibit 8: 2021 Real estate market expectations

2020	2021			
Estimates*		Downside	Base case	Upside
-6.0	NOI growth (%)	-3.8	-1.0	1.4
-20	Cap rate change (bps)	10	5	-5
4.2	Income return (%)	4.3	4.0	4.2
-2.5	Appreciation (%)	-5.9	-1.9	2.7
1.6	**Total return (%)**	**-1.6**	**2.1**	**6.9**

Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy – US based on data from UBS Investment Bank, NCREIF and Moody's Analytics as of February 2021. *2020 Estimates based on actual data as of December 2020. Past performance is not indicative of future results.

For steady tenant demand and near-term performance, we favor the Industrial and Apartment sectors. Investors may begin to find opportunities in Office and Retail as sector stress could lead to price declines. Investment outcomes in the Office and Retail sectors will likely vary dramatically, and risk is elevated. If the recovery turns into expansion again in 2022 as expected, private real estate should perform well overall with better returns possible across even the hardest-hit sectors.

Exhibit 9: Forecasts by property type
Total returns (%)



Source: NCREIF Property Index and UBS Real Estate as of February 2021. Shaded area indicates forecast data.

Base case
Our *Base Case* assumes that economic recovery continues in 2021 with expansion in 2022. The vaccine rollout is successful, allowing most Americans to resume travel and work outside of the home by year-end. Interest rates and inflation are likely to stay low for years, *exhibit 10*, and low borrowing costs support transaction growth and low cap rates in commercial real estate.

We believe our *Base Case* is the most likely outcome, but it is important to consider the investment landscape if growth is faster than we expect in an *Upside scenario* or if an unexpected setback sends the US into a *Downside scenario*.

Exhibit 10: 2021 Real estate market expectations

	2019	2020	2021	2022
Inflation (%)	2.0	1.2	2.6	2.0
Employment (million jobs)	2.0	-8.8	5.9	3.0
GDP (real, %)	2.3	-2.5	6.1	1.1
10-year US Treasury rate (%)	1.8	0.9	1.5	1.7

Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy – US based on data from UBS Investment Bank, NCREIF and Moody's Analytics as of February 2021. Past performance is not indicative of future results.

Upside
We still anticipate widely different outcomes across property types in most *Upside scenarios* with Industrial and Apartments outperforming Retail and Office. Upside for the Retail sector would mean that the pandemic accelerated closure of the weakest mall and centers, leaving the sector with flat results after years of struggling to find bottom. Office returns would equal the income return as risk of lower tenant demand is offset by the revival of cities, while Apartment and Industrial stretch into double-digit performance, backed by investor demand driving down cap rates and tenant demand supporting positive income growth.

Downside
If a new strain of COVID-19 emerges or vaccines prove less effective than hoped, the US could slip into a *Downside scenario* in 2021. Only the Industrial sector would be expected to post positive returns. Two years of high unemployment and continued development could stress the Apartment sector into a near-zero return. Outcomes would go from bad to worse for Office and Retail with falling values and income. Distressed opportunities would likely increase as the market appears to believe in a return to growth in 2021 and does not appear to be pricing in much downside risk.

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