Real Estate sector report

FEBRUARY 2022

Sector conditions and outlook

Sector		Current condition	Outlook
APARTMENT	The apartment market has transitioned from recovery to expansion entering 2022. Demand remains robust and occupancy rates are once again rising following a brief lull in early 2021. Rental growth also set records during the second half of 2021. Regional performance remains strongest in the sunbelt and secondary high growth markets, which continue to outperform relative to densely populated gateway cities.	●	↑
HOTEL	The hotel sector continues to experience occupancy improvements despite the emergence of COVID-19 variants during the second half of 2021. While Delta and Omicron disrupted business travel, operators in the lower chain scales and those focused on leisure travel continued to make up ground lost during the pandemic. REITs continue to trade at a discount to NAV, but liquidity has increased within the sector.	●	↗
INDUSTRIAL	Industrial continues to outperform all other sectors in terms of demand, income growth, and appreciation. Returns have set new records over the past 12 months and all markets have experienced positive capital appreciation. Capital remains plentiful across the capital stack as investors favor its growth and yield in the current environment. Lofty appreciation returns continue to drive development, which warrants monitoring.	●	↑
OFFICE	The office market has transitioned from correction to recovery, as far as occupancy and demand are concerned. Vacancy rates remain elevated and rental growth will be challenged, particularly as corporate occupiers have not finalized return to work plans due to the emergence of new variants. Capital values have increased for private markets, but REITS continue to trade at discounts to both pre-crisis levels and NAV. The outlook remains clouded primarily due to uncertainty surrounding the sector’s demand profile in a hybrid work environment.	●	→
RETAIL	Retail turned a corner in 2021 when in-store sales outpaced e-commerce as shoppers were able to return to shopping centers. Store openings also outpaced closings over the past 12 months for the first time since 2015, a sign that operators are optimistic about future shopping trends. We continued to see a bifurcation of the market as grocery- anchored and value-oriented shopping centers performed well, but larger regional malls continued to underperform. Debt remains selective and appropriately priced for an uncertain sector. REITs continue to trade at discounts to NAV—though the gap has narrowed entering 2022.	●	→

KEY:

● Improving ● Neutral ● Deteriorating

↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

Sector conditions and outlook continued

		Current condition	Outlook
SINGLE-FAMILY RENTAL	The single-family rental sector continues to benefit from the acute housing shortage in the U.S. Demand for new units and rental growth remain elevated as supply has yet to ramp up in a more material way. Though the sector remains a small portion of the broader residential sector, investor demand remains elevated; however, private debt is somewhat restrained at the moment. Public market pricing has the sector trading at a slight premium to NAV.	●	↑
DATA CENTERS	Data centers remain one of the top sectors in terms of new demand, supported by both structural and cyclical trends. Valuations remain favorable and investor demand appears stable. Debt capital has increased in the market, but is priced similarly to high quality retail and office. Performance moderated toward the end of 2021, narrowing the gap between other property sectors. Headwinds caused by labor shortages, rising power costs and supply chain disruptions have had an adverse impact on the sector. Despite headwinds the sector remains well-positioned headed into 2022.	●	↑
STUDENT HOUSING	The student housing sector continued its recovery in 2021 with stronger leasing and income growth for the 2021-2022 academic year. With stabilized enrollments and a broad-based return to campuses nationwide, occupancies were driven into the mid-90% range for the year. Pre-leasing for the 2022-2023 academic year is also off to a strong start apparently undeterred by the emergence of new variants. Though the recovery is off to a stronger than anticipated pace, student housing is trading at a slight discount to NAVs.	●	↗
LIFE SCIENCES	Life sciences is perhaps the strongest of any sector today. Underlying fundamentals including growth in life-science employment and robust venture capital funding are far stronger than traditional office drivers. The market remains tight and demand continues to outpace new supply. Debt capital has increased over the past 12 months and pricing power remains in the hands of landlords. Life sciences stocks continue to trade at a premium to NAV.	●	↑

Key:

● Improving ● Neutral ● Deteriorating

↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

Source: Principal Real Estate Investors, February 2022

APARTMENT

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↑	→	↑	↑	↑	↘	↑

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

The apartment market has emerged as a top performer among all property types to start off 2022. Strong demand is driving occupancy rates higher and has led to record rent growth through the end 2021.

Private equity

The apartment market is seeing an unprecedented level of transaction activity, which is reflective of strong investor demand, lack of affordable housing, and abundant financing. As a result, cap rates continue to compress across most markets and regions, particularly in the sunbelt. Space market fundamentals continue to improve into the first quarter of 2022 with accelerating rent growth and minimal—if any—tenant concessions.

Regionally, performance in some gateway markets began to diverge in 2021. New York apartment rents now at or above pre-COVID levels in many areas of the city, despite continued delays in return to office throughout the Delta variant peak and at the onset of the Omicron variant. In contrast, downtown Los Angeles and San Francisco rents remain below their pre-COVID peak with fragmented pockets of demand dependent upon submarket and building profile.

Secondary or high-growth markets and suburban product continue to outperform as renters still demonstrate a preference for additional space and affordability. The construction pipeline, which had slowed due to uncertainty from COVID-19 and increased construction costs, has ratcheted up with stronger growth prospects due to favorable capital markets and buoyant investor demand. Despite a favorable supply outlook, we feel that rising construction costs—both for materials and labor—may act as a governor on new supply helping to keep occupancy rates high.

Private debt

Given the apartment sector's strong performance during the pandemic and still healthy fundamentals, lenders continue to view the sector (along with industrial) as a preferred property type. Lender favoritism for apartment, paired with competitive pricing and enhanced liquidity from the government-sponsored enterprises (GSEs), have made multifamily lending rates the lowest of any sector. Banks and insurance companies are routinely offering rates in the low 3% range for 55% to 65% loan to value (LTV) senior apartment loans secured by average-to-above-average quality properties. Fannie Mae and Freddie Mac are offering 75% to 80% LTV financing near 3.5% to 3.75% for some multifamily properties.

REITs

Apartments meaningfully outperformed other property sectors during 2021, as the pace of fundamental recovery surprised to the upside and institutional interest accelerated. Lower turnover and high occupancy levels are providing support to higher rental rates into 2022 with low-to-mid teen loss-to-lease, lower usage of concessions, and improving bad debt (partially supported by government rental assistance). Top line growth in 2022 has the potential to be the best post-recession recovery in several cycles. Strong demand is expected to outpace supply, especially given supply chain issues that are elongating construction timelines and putting upward pressure on construction inflation.

Unabating strength in the sunbelt was a highlight of 2021, both in terms of fundamentals and capital interest, however, investors are watching for signs of mean reversion between coastal and sunbelt markets as the spring leasing season approaches. Nonetheless, we expect another solid year across all geographies. The sector is trading at a slight discount to REITs overall (~10% NAV premium) with coastal portfolios at discounts to those in the sunbelt.

CMBS

Apartment loan origination volumes remain strong across the various sectors of the public debt quadrant. GSEs continue to be a dominant lender in the multifamily space, posting a record $131 billion in combined issuance for 2021, according to J.P. Morgan Securities LLC. Agency lending caps have been increased by 11% for 2022 with a growing emphasis on mission-driven investing aimed at more affordable housing and sustainability initiatives. The apartment share of conduit CMBS issuance grew to the highest level since the global financial crisis. The rapid growth of the single-asset/single-borrower (SASB) and commercial real estate (CRE) collateralized loan obligation (CLO) sectors also contributed to strong capital availability in more flexible formats. SASB offers borrower floating rate debt with flexible prepayment terms while CRE CLOs tend to lend to more transitional properties requiring some degree of bridge financing. Multifamily public debt loan performance has remained relatively solid throughout the pandemic, however current valuations and underwriting metrics require close attention given the downward trend in cap rates and debt yields.

HOTEL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	→	↑	↗	↗	↓	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

The hotel sector continues its recovery and has made solid progress heading into 2022, despite the emergence of new COVID variants throughout 2021. Market performance remains bifurcated, but both occupier and investment demand continue to increase as business operations are normalized.

Private equity

Hotel operating fundamentals improved in 2021 following a low point in 2020, particularly in the leisure sector. More recently the sector is grappling with the impact of the Omicron variant, which has waylaid some of the market's progress. Though clearly in recovery, the market remains bifurcated with leisure continuing to outpace business-oriented assets.

Capital is once again flowing into the sector, as transactions in 2021 topped $51 billion (based on deals of $5 billion and above), the highest level since 2015. Despite lofty sales figures over the past 12 months, capital values remain depressed, down 21% from their 2019 levels according to the NCREIF National Property Index (NPI) as of the end of 2021.

Private debt

We continue to see lenders re-enter the hotel lending sector through the start of 2022; as a result, the volume of debt available continues to increase. Yields for hotel loans compressed significantly as 2021 progressed, with spreads typically 100 to 200 basis points lower than they were a year ago.

Debt funds remain the primary source of capital for hotel financings, with senior loan LTVs up to 75% to 80% and spreads in the low- to- mid-300 basis point range over LIBOR for the best quality assets with 65% to 70% LTV financing. Spreads for average to lower quality senior hotel loans range from the high 300 bps to the low 500 bps.

Some banks and life insurance companies are pursuing high quality hotel loans with leverage near 50% LTV pricing in the high 100-to-low-200 bps range over LIBOR, and 60% leverage pricing closer to the high 200-to-low-300 bps range over LIBOR. Balance sheet lenders are often underwriting to a 10% debt yield based on actual 2019 net operating income. SASB CMBS senior debt remains available for very large ($200+ million) hotel financings, and debt funds are offering mezz debt for the highest quality hotels with yields, in some instances, in the 7% to 8% range.

REITs

Lodging REITs underperformed other property sectors throughout 2021, including the last six months of the year, due to a slower than expected ramp up in corporate travel. Throughout the summer and fall, suburban, limited-service hotels, and luxury resorts outperformed traditional urban properties. Consistent infrastructure and construction demand, in addition to traditional leisure demand, drove performance at the lower chain scales, while high-end leisure demand, which demonstrates a degree of price-inelasticity, propelled luxury destination resorts.

Lodging REITs have delivered better than expected earnings on a combination of strong pricing power and lower property operating expenses—despite labor shortages— which has resulted in improved profitability. Leisure demand is currently trending above pre-pandemic levels while corporate business travel is still lagging materially. The major issue investors continue to grapple with is when (and perhaps if) corporate travel will resume in full force. Expectations for a recovery had previously been pulled forward into late 2022, or early 2023, but the outlook has been clouded by the emergence of new COVID-19 variants, most notably Omicron. Currently, lodging REITs are trading at roughly 20% below consensus NAV estimates, a discounted level versus other REIT sectors.

CMBS

Hotels were the hardest hit property sector within CMBS, initially resulting in a spike in delinquency rates, however loan performance is improving significantly. The 30 day+ delinquency rate for conduit hotel loans is falling at a linear rate and currently stands at 13%, a material improvement from the 25% peak hit in July of 2020. Servicers have worked with borrowers throughout the pandemic to bridge the gap in property cash flows by offering a variety of short-term forbearance arrangements. The availability of fresh equity seeking core-plus returns is further improving the prospects of loans secured by better quality properties.

Leisure travel has spurred on a strong recovery in vacation destination markets; however, a more robust return of business travel is needed for a broad industry recovery. Smith Travel Research reports that revenue per available room for the 28 days ending January 22, 2022 is up 10% for midscale and 14% for economy hotels compared to the same pre-COVID period in 2019. Upper upscale and luxury demand continues to lag with revenue per available room down 30% and 16% respectively as business and convention travel has been slow to recover, especially with the recent impacts of the Omicron variant.

A more sanguine health and travel outlook has prompted more borrowers to carry cash flow impaired properties. Institutional sponsorship with stronger balance sheets and flexible capital sources are better equipped to weather the storm. Post-COVID CMBS issuances have included very little hotel exposure as borrowers are reticent to lock in long-term financing based on depressed cash flows. That said, we have seen hotel loans slowly return to new issue pools. To date, the market has priced for this risk while showing a willingness to provide a more conservative level of financing to the sector. Many of these loans require enhanced loan structure including debt service reserves to mitigate near term credit stress.

INDUSTRIAL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↑	↘	↑	↑	↑	↑	↑

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Sector overview

The industrial sector continues to outperform by nearly all measures. In the past 12 months the sector has set a record for new demand, occupancy, and sales volume. Nearly all markets are seeing demand outpace new supply. Though it is difficult to find a glaring weakness in the sector today, robust capital appreciation and strong supply trends warrant monitoring.

Private equity

Unlevered property performance of the industrial sector easily outpaced that of the other property sectors in 2021. The sector set a record for net absorption as 432 MSF was taken up in 2021 with tenant demand outpacing new supply in nearly all markets. As a result, availability across all markets has fallen to a record low of 5.2% entering 2022 and rental growth has ranged from the mid-to-high single digits to low double digits for top markets.

Robust capital market demand remains intact, despite continued yield compression in the second half of 2021. Transaction activity within the sector was $157 billion in 2021, 57% above the prior peak achieved in 2019. The sector's investment performance set a record in 2021 with capital appreciation of 38.1% and a total return of 43.3% according to the NCREIF NPI.

Industrial yields are essentially equal to multifamily yields in established distribution markets and some high-growth metro areas. New and existing investors continue to increase allocations within the property sector, resulting in bidding processes with multiple rounds, sealed bids, and sale prices well in excess of original guidance.

Secular demand drivers and mega-trends such as technology and continued e-commerce growth continue to favor niche sectors historically reported within industrial, including data centers and cold storage. Investor demand is tempered some by higher cap expense requirements, thus specialized, experienced owners and operators tend to dominate the space.

Given current pricing for core industrial and strong tenant demand, industrial development offers very attractive risk-adjusted relative value. Supply remains active entering 2022 with under construction projects totaling 3.8% of total inventory, well above the sector's historical average. Consequently, we remain concerned about the prospect of overbuilding, particularly in markets with limited barriers to entry, and there are some submarkets at risk for oversupply in near-term. That said, increased construction costs and significant materials and labor shortages are mitigating some supply pressures near-term.

Private debt

Lenders continue to view industrial (along with apartment) as a preferred sector. Under-exposure by lenders to the sector on a relative basis, combined with concerns regarding other property types (e.g., office, retail, and hotel) and robust market fundamentals, have fueled lender appetite for debt secured by core industrial properties. Lenders continue to offer industrial loan interest rates very near those offered for prime multifamily properties, with LTVs commonly up to 65%. Lenders are continuing to offer longer interest-only periods for industrial loans than in most other sectors.

REITs

Industrial REITs handily outperformed the broader index during the second half of 2021, as rent growth and cap rate compression greatly exceeded even the most optimistic market expectations. Healthy consumer spending, robust economic activity, and supply chain challenges have fueled unprecedented demand while new supply has not been able to keep pace due to scarcity of land and lengthy entitlements.

Market rents have risen rapidly because of tight market conditions, with the strongest performing coastal markets seeing year-over-year growth of more than 20%. The rapid ascent in rents and robust institutional appetite for industrial drove cap rates into record low territory. Development offers the most attractive returns and has been the preferred mode of growth for most REITs, though select REITs have utilized their attractively priced equity to aggressively pursue acquisitions. Industrial REITs continue to trade at premiums of between 20% to 30% relative to NAV, reflecting the favorable near-term fundamental outlook and price appreciation momentum.

CMBS

Industrial loans currently carry the lowest delinquency rate within the CMBS universe and hold the same “in favor” label as multifamily. The CMBS SASB borrower market has proven to be an efficient source of financing for very large portfolio financings; offering investors pure-play public debt exposure to the sector. Investor demand for bonds backed by industrial is one driver of the sharp increase in SASB issuance experienced year-to-date. In addition, the amount of industrial exposure in “post-COVID” conduit issuances have increased, benefiting the general diversification profile of these pools. While industrial allocations within CMBS issuances are generally considered positive, exposure to tertiary locations, less functional layouts, non-investment grade tenancy, and a concentration of e-commerce related credit must be properly considered and monitored.

OFFICE

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↘	↗	→	↓	→	↓	→

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Sector overview

It appears that the office sector is on the cusp of a nascent recovery with vacancy rates starting to fall and leasing activity accelerating. The emergence of new COVID-19 variants and uncertainty surrounding how increases in work from home arrangements going forward will affect aggregate demand for office space.

Private equity

Conditions within the office sector appear almost suspended in time. It is perhaps the sector most negatively impacted by COVID to date, though the magnitude and duration of that impact remain unknown. Return-to-office has once again been plagued by the emergence of a new variant, which has brought with it swiftly rising case counts. Omicron has delayed or indefinitely forestalled some corporate return to work plans, which will present headwinds for office demand through the first half of 2022. A tapestry of approaches is evident across the country, with some firms continuing a hybrid model while other firms have sent employees home from reopened offices. Differentiation across markets persisted throughout the year, with sunbelt and growth markets registering higher weekly office utilization, while more densely populated gateway office markets continued to trail.

We have yet to see signs of distress that would lead to a more significant correction in asset values. Cap rates have remained stable as institutional investors have continued to selectively deploy capital. To date, transaction activity remains focused on high quality, fully stabilized office properties with long-term leases and strong credit profiles. There has been little progress on price discovery for buildings with lower occupancy or transitional rent rolls. Unlevered property performance data from NCREIF aligns with broader office use patterns, whereby gateway CBD office has underperformed suburban office as well as high growth markets such as Austin and Seattle.

We continue to anticipate elevated vacancies for the near-term and, combined with pre-pandemic headwinds of increased capital requirements for landlords, traditional office will likely be less attractive than other sectors in the short- and medium-term. We continue to see a bias toward quality, with trophy and class A properties outperforming in terms of occupancy and absorption.

Private debt

Though lenders are generally willing to finance office properties on a conservative basis, some continue to avoid new office lending altogether. The quality of an office building; its tenancy; remaining weighted average lease term (WALT); the current physical utilization of its space; its rent collection experience; and its conformance with emerging design preferences are all impacting lenders' willingness to provide financing in the sector. A property's reliance on public transportation, which some tenants consider unappealing, is also impacting lender interest, particularly due to uncertainty, as additional COVID-19 variants continue to emerge.

Interest rates for senior office loans remain between 25 to 40 bps higher than interest rates for apartment and industrial properties with comparable leverage. In addition to lower LTVs, lenders may require larger escrows for potential downtime and rollover expenses, and more rapid amortization schedules for office than they require for preferred property sectors.

REITs

Office REITs started the year with strong performance as investors were optimistic most companies would return to the office in a more meaningful way in 2021. Delta and Omicron had different plans and ultimately delayed many large companies from a full return to office, particularly in large gateway cities on the coasts. As a result, office REITs underperformed significantly relative to other sectors.

Office utilization peaked at around 40% in the fall (with some sunbelt markets approaching 60%) but has since retreated as Omicron shifted many employees back to remote work. There have been some positive signs, however, for the office sector as leasing and tour activity have remained steady (albeit 25% to 30% off pre-pandemic levels). In addition, sublease space appears to have peaked and is slowly being taken off the market but will take years to return to a normalized level.

New and redeveloped office product continues to outperform but concessions remain elevated. Asset pricing also remains murky as most transactions to date have been limited to high quality properties with long weighted average lease duration. A significant privatization of an office REIT in late 2021 (at a 10% to 15% discount) gave public market investors a glimpse of pricing for REIT portfolios though it has not been enough to narrow the 20% to 30% discounts to NAV for the gateway-focused REITs.

CMBS

Office has represented the largest property type exposure in conduit CMBS over the past five years. This trend was amplified in 2020 but has since normalized as other property type allocations have grown to fill the hole left by hotel. Uncertainty around longer-term macro themes has caused investors to cool on the sector, but with a more measured approach. Some mitigating factors for office exposure in CMBS include conservative underwriting metrics providing a significant buffer to a drop in NOI; larger exposures to high-quality and well-positioned properties; a diverse mix of urban and suburban exposures; and generally stable credit performance to date.

The public debt markets are providing an efficient source of capital to owners of high-quality office product in fixed and floating rate formats. This aligns with the broader “flight to quality” theme seen across the office landscape as more recently constructed buildings are seeing an outsized portion of leasing activity. Competitive positioning of specific office properties carries significant weight in the current market and borrowers’ willingness and ability to invest in significant capital and tenant improvements are key variables to monitor. While current office delinquency rates remain low, investors still consider the office sector a developing story that will play out over a longer time horizon.

RETAIL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↗	→	→	↓	→	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Sector overview

The retail sector remains challenged, but is also benefiting from strong fiscal stimulus, improved labor market conditions, and remarkably healthy household balance sheets that have generated a surge in consumer demand through the end of 2021.

Private equity

The retail sector continued to outperform expectations as strong brick and mortar sales growth, increased foot traffic, and burgeoning demand for services including restaurant dining have paced a surprising recovery through the end of 2021. The repayment of rent deferrals granted in 2020 also outpaced expectations, augmenting net operating income growth in 2021.

Minimal new deliveries, stronger tenant balance sheets, and active consumers drove absorption in the sector, with neighborhood and community shopping centers, particularly those that are grocery-anchored, outperforming other formats. By contrast all but the highest quality regional malls have continued to struggle in the current environment. Performance remains bifurcated within the sector with freestanding retail and strip centers buoying returns, and grocery-anchored centers—where Principal Real Estate Investors has focused its retail exposure— remain the top performers in the sector. Liquidity for grocery-anchored retail increased throughout the year and will offer a significant yield premium relative to industrial and multifamily assets. Grocery-anchored formats in high-growth locations may offer strong risk-adjusted relative value in 2022.

Private debt

While some lenders continue to avoid all retail property investments, others have shown a nascent renewed interest in neighborhood and community shopping centers with strong tenancy. Major grocers, creditworthy discounters, and creditworthy home improvement stores with significant remaining lease terms may find receptive lenders. That said, interest rates for even the highest quality retail properties remain perhaps 10 to 20 basis points higher than debt for similarly leveraged apartment and industrial properties.

Debt for high street properties, power centers, and lifestyle centers remains difficult to procure even at low leverage levels, and significant loan structure (e.g., escrows and amortization) is often required. Debt for regional malls remains unavailable for all but the very best assets with top operators. Lenders continue to focus heavily on tenant creditworthiness, tenant sales history, remaining weighted-average lease terms and sponsor quality, with widely disparate loan terms offered.

REITs

Retail performance was mixed during the second half of the year, with malls outperforming and shopping centers modestly lagging broader benchmarks. However, both subsectors were sizeable outperformers over the full year after weak performances in 2020. A far more muted store closing/bankruptcy environment, sooner than anticipated occupancy inflection, and a strong in-store retail sales environment helped drive the group. Stable to improving rents and increased institutional investor interest helped shopping centers and fueled cap rate compression. Pricing power was more challenged and private market activity remained more elusive for malls.

The sustainability of the retail recovery is the biggest point of investor concern but a solid holiday shopping season—albeit with abnormal seasonality and negative impacts from Omicron—may support another lighter year of store closings and aid further occupancy gains in the year ahead. Both subsectors are trading near NAVs but are discounted to REITs overall.

CMBS

Despite a stronger than anticipated recovery in brick-and-mortar retail, the enclosed mall format remains out of favor with investors, reflected in the very small number of mall loans that have made their way into new issue deals in 2021. The conduit CMBS retail delinquency rate is improving but remains elevated at 8.2% as seasoned loans facing cash flow and capital market challenges are taking time to resolve.

CMBS servicers continue to work with mall operators in particular by extending loan maturities, often in exchange for fresh equity contributions. On a positive note, Simon Property Group recently paid off seven CMBS mall loans, accessing the unsecured corporate debt market as an alternative source of debt capital. While the overall trend of lower retail contributions to conduit CMBS issuances remains intact, the amount of retail contributed grew in 2021, approaching the 2019 mark. Notably, the retail subsectors contributed have followed broad fundamentals with a high percentage of loans secured by anchored retail centers and diversified pools of single tenant properties.

SINGLE-FAMILY RENTALS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↑	→	↑	↑	↑	↗	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

Single-family rentals remain a small but growing sector within the broader residential property type. An acute shortage of both rental units and single-family homes for sale is bolstering demand for alternative rental formats. Increased home prices and higher interest rates are conspiring to lower affordability, which should support demand for single-family rentals going forward.

Private equity

Single-family rentals—both scattered-site and build-for-rent communities—are offering attractive yields and compelling growth projections, as rapidly rising home prices make home ownership more difficult for a larger percentage of the population. Many institutions are actively entering or investing in this segment of the market, which in many cases, still offers a yield premium to traditional multifamily.

Private debt

The private debt market for single-family rental properties were bifurcated in 2021, with certain lenders expressing a growing interest in financing properties purposely developed for rent and located on contiguous parcels of land, while a dearth of private debt capital met other single-family rentals.

The government-sponsored enterprises, Fannie Mae and Freddie Mac, each began offering 70% to 75% LTV financing for the build-for-rent segment of the market, with interest rates today in the high 3% to 4% range. Several insurance companies also began financing built-for-rent properties on more conservative terms, and banks offer conservative leverage for build-for-rent construction loans. Private lenders generally avoid non-build-for-rent single-family rentals, with much of that product financed by CMBS conduits today.

REITs

The single-family rental sector outperformed the index in the second half of 2021 as well as the full year. Fundamentals remain solid with continued support from favorable demographic trends and affordability—relative to homeownership—that has resulted in historically high occupancy levels and robust pricing power. Supply also remains low, despite rising from restrained levels. Top line growth is expected to remain solid, though the potential for higher expense growth in the coming years warrants monitoring. REITs also remain aggressive on external growth, but competition is fierce, as institutional interest in the sector has increased and driven cap rates lower. The group trades at a slight discount to REITs overall, but at a premium to NAV of roughly 10%.

DATA CENTERS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↑	→	↑	↗	↑	↑	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Private equity

Data centers remain one of the strongest sectors across the commercial real estate spectrum being buoyed by cyclical and secular trends. Demand in 2021 once again eclipsed the level it was a year ago coming in just shy of 1,000 MWs, with Northern Virginia remaining the top market for overall absorption through the end of 2021. Demand momentum remains strong as we enter 2022 with companies prioritizing their digital strategies. Although performance has moderated on a relative basis as evidenced in listed markets, both investor and tenant demand remain robust with increased capital being deployed from across the capital stack.

Private debt

Insurance company and bank lenders are actively seeking to invest in data centers today, offering interest rates like those offered for high quality retail and office properties. However, loan terms and/or amortization schedules may be shorter for data centers than those offered for other core property types, as lenders seek to limit their balloon exposure to data centers subsequent to anchor tenant lease expirations and potentially at a time when technological needs may have changed.

REITs

Data center REITs underperformed most other property types during the year although the performance gap narrowed in the second half of the year. The big theme has been M&A activity, with three of the five U.S. public data center REITs attracting suitors. Notably, the group's performance was buoyed by takeout announcements of two data center REITs (one acquired by private equity and the other acquired by a fellow REIT) at forward EBITDA multiples of 20-30x. From a fundamental perspective, the data center REITs continued to report a healthy demand backdrop as evidenced by positive leasing and revenue results. Negatively, however, investors have also been paying closer attention to headlines around supply chain disruption, labor shortages, and rising power costs, which could adversely impact data center operations and construction plans over the coming quarters. While data center performance lagged the broader REIT index, the remaining companies continue to trade at a 25% premium to NAV—above average relative to other sectors.

STUDENT HOUSING

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↘	↑	↗	↗	↘	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

The student housing sector continues to emerge from the pandemic. Enrollments in four-year degree programs have increased following a period decline toward the end of the last decade and the return to campus has bolstered fundamentals. Student housing leasing for the 2021-2022 school year showed improved momentum from the previous year as additional clarity from schools on return to campus plans were communicated. Investor interest in the sector remains strong as evidenced by healthy sales volume in 2021, which saw just under $11 billion in sales based on transactions through the end of December representing the strongest single year since 2018.

Pre-leasing for 2022-2023 is already off to a strong start, on-pace or above pre-pandemic levels in select markets, and thus far has been unaffected by the rise in cases driven by new variants and the corresponding (short-term) returns to virtual learning on some campuses.

From a public market perspective, although trailing behind the index for the full year, performance improved in the second half of 2021. A strong finish to the 2021-2022 preleasing season drove occupancy above 95% and featured healthy rent growth as well. While further recovery is needed to get back to pre-pandemic occupancy levels in the upper 90's, the recovery is unfolding at a faster than anticipated pace. The lone publicly traded student housing REIT trades at a slight discount to NAV, the lowest valuation among residential peers.

LIFE SCIENCES

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↑	↘	↑	↑	↑	↗	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Private equity

Space market fundamentals for life sciences/lab office space remain among the strongest of any sector. Employment in life sciences related industries remains strong, growing 16% since 2017, according to CBRE Research. Venture capital within the sector more than doubled in 2021, supporting current demand and occupancy trends with national vacancy falling to 4.9% as of November 2021.

The life sciences sector benefits from structural drivers such as demographics, rather than traditional cyclical drivers, e.g., employment and GDP growth. As a result, strong tenant demand for laboratory and life sciences space is experiencing both rapid and durable growth. Investor demand increased significantly in 2021, resulting in cap rate compression across both core and value-add strategies. Life sciences properties are seeing cap rates in the low to high 4% range in primary markets, between 75 to 100 bps lower than traditional office space.

Markets with access to talent via top tier universities remain most attractive, traditionally Cambridge, Boston, and the Bay Area, but secondary markets like Raleigh, Washington D.C., Baltimore, and San Diego offer increasingly compelling value propositions as well. Emerging markets such as Atlanta, Dallas, and Phoenix have begun to attract more venture capital funding, tenant demand, and investor interest.

Private debt

Lender appetite for life sciences property investments increased over the past year. Many traditional core, senior lenders now seek to finance life sciences properties—particularly those located in prime research submarkets—with interest rates below those available for similar quality office properties (albeit higher than the rates available for multifamily and industrial properties).

REITs

Life sciences REITs experienced a reversion in performance in 2021 following a strong 2020 as investors favored stocks with greater economic sensitivity. Record levels of life sciences and biotech funding continue to drive unprecedented demand for life science space while significant supply constraints in the top cluster markets continue to dampen new construction. The supply-demand imbalance is giving landlords strong pricing power, resulting in higher rents. Venture capital and government funding show no signs of slowing, which typically translates into real estate demand on a one-year lag. Asset pricing remains at record levels as the asset class continues to garner new institutional investor interest. The favorable fundamental outlook has caused REITs with high life sciences exposure to trade at premiums to NAV—roughly 10%, in-line with the broader average across all sectors.

Risk considerations

Investing involves risk including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the many risks inherent to owning and investing in real estate, including: adverse general and local economic conditions that can depress the value of the real estate, capital market pricing volatility, declining rental and occupancy rates, value fluctuations, lack of liquidity or illiquidity, leverage, development and lease-up risk, tenant credit issues, circumstances that can interfere with cash flows from particular commercial properties such as extended vacancies, increases in property taxes and operating expenses and casualty or condemnation losses to the real estate, and changes in zoning laws and other governmental rules, physical and environmental conditions, local, state or national regulatory requirements, and increasing property expenses, all of which can lead to a decline in the value of the real estate, a decline in the income produced by the real estate, and declines in the value or total loss in value of securities derived from investments in real estate. Direct investments in real estate are highly illiquid and subject to industry or economic cycles resulting in downturns in demand. Accordingly, there can be no assurance that investments in real estate will be able to be sold in a timely manner and/or on favorable terms.

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