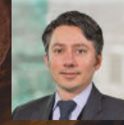
CONVERSATIONS

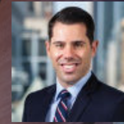
2023 OUTLOOK

GLOBAL REAL ESTATE

In this roundtable discussion, our experts across real estate debt and equity discuss how they are navigating today's challenges and weigh in on where investors can turn to find attractive returns.



NASIR ALAMGIR
Head of Real Estate Debt Portfolio Management



GREG EUDICONE
Head of U.S. Real Estate Client Portfolio Management

VALERIA FALCONE
Head of Europe Value-Add Investing, Portfolio Manager

JOE GORIN
Head of U.S. Acquisitions & Portfolio Management

SÉVERINE MAUMY-LAFFINEUR
Managing Director & Portfolio Manager, Barings European Core Property Fund

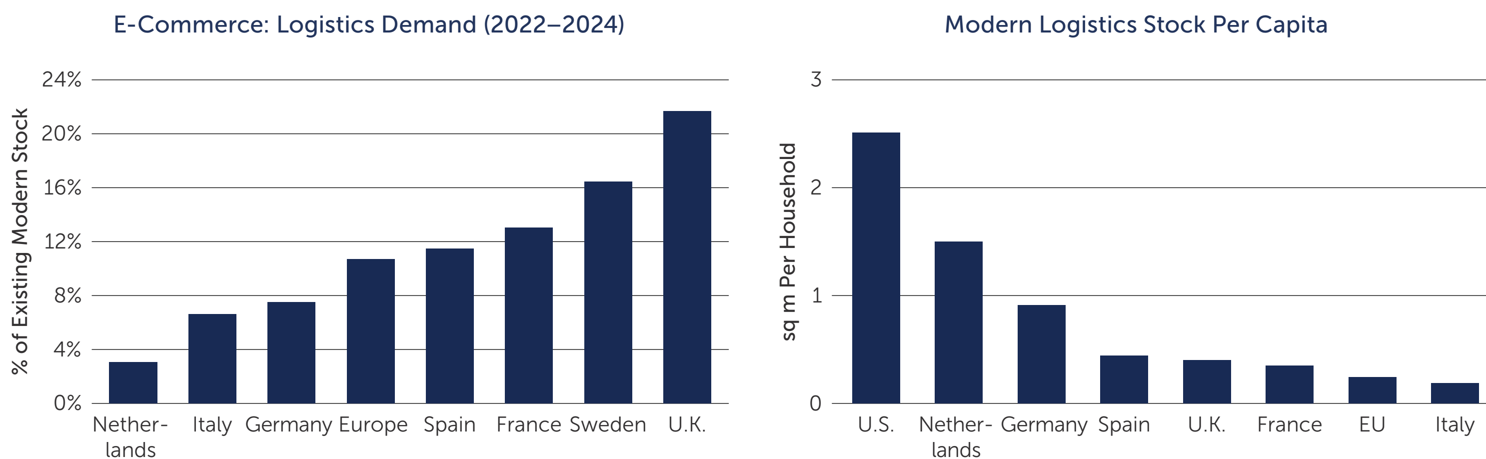
BARINGS

GREG EUDICONE (MODERATOR): From high inflation and the U.S. Federal Reserve's rate agenda, to the war in Ukraine and resultant energy crisis in Europe, there are plenty of challenges facing real estate markets today. Are there any "hot" markets or property types that are giving you pause in the current environment?

VALERIA FALCONE: What makes today's environment complicated is that we are not facing a real estate crisis, we are facing an inflationary crisis. While the external shocks you mentioned have completely disrupted the economy, most real estate sectors continue to hold up well from a fundamental perspective. That said, one "hot" market we are keeping a close eye on is logistics. With declining purchasing power affecting sales and distribution, it's possible the sector will lose some momentum in the short term, and perhaps experience some fundamental weakening.

However, while the short-term situation looks potentially challenging, the sector continues to look attractive from a medium to long-term standpoint, for a few reasons. For one, in Europe in particular, we expect to see growing demand from manufacturing companies as they expand their near-shoring business strategies. Additionally, as online sales continue to grow, the need will arise for new, modern logistics spaces to fulfill the resultant demand (**Figure 1**). The wide variation of Internet penetration rates between European countries also suggests there is considerable expansion potential in the sector—particularly given the more limited supply as a result of muted post-financial crisis development.

Figure 1: Structural Undersupply of Modern Space



Source: CBRE, Oxford Economics, Euromonitor, Barings. As of January 2022. (Demand); Prologis. As of 2021 (Stock)

JOE GORIN: In terms of "hot" markets, we are more cautious on the areas where purchases have been made at razor-thin cap rate spreads. The industrial and multi-family sectors, for instance, have experienced explosive rent growth in certain markets over the last two to three years. One question now is what a potential economic slowdown means for that rent growth going forward, and how those areas might be impacted as cap rates widen. Even though these sectors are often regarded as some of the safest, when cap rates move even by a small amount, it has a massive impact on value.

Another area we're monitoring is life science. While the sector has traded at higher cap rates than some others, it has also been trading at over $1,000 per foot—even eclipsing $1,500 per foot in markets like Boston and San Francisco. While those markets have seen significant rent growth and demand over the

last few years, there are signs that demand is starting to slow. As a result, while we believe life science continues to look attractive long-term, there are a number of deals that may face challenges going forward.

SÉVERINE MAUMY-LAFFINEUR: One area we are more cautious on in the short term is residential real estate. In the low-yielding environment of several years ago, the residential sector—particularly build-to-rent as well as operational assets like purpose built student accommodation (PBSA) and senior housing—served as an effective means of portfolio diversification and stable cash flow. Amid a more challenging economic backdrop, however, it's important to remember that this space is tied closely to the consumer—and, at times, consumers can face insolvency. It is also a regulated sector, which can be another cause of near-term volatility. Additionally, the sector has sustained increasingly aggressive CPI increases over the last several years, which in our view are not sustainable. However, a number of European governments including France, Germany and the Netherlands have decided to limit this year's CPI increase on residential real estate, which has not been priced into investors' cash flows as yet. Therefore, while we continue to see long-term value in residential real estate, we do not believe current prices have come down enough to warrant investment in the short term.

NASIR ALAMGIR: I would echo Séverine in saying that residential multi-family properties may warrant more scrutiny in today's challenging environment. In the multi-family space, an incredible amount of new supply has come online—in the U.S. there are over 900,000 units under construction right now, which is an all-time high.[1] While persistently high demand is offsetting that to some degree, there is still tremendous pressure on rent. And, while rents have been up nationwide across all sub-sectors of multi-family—almost 17% in 2021 and close to 13.5% as of Q3 2022[2]—we do not believe this is a sustainable growth pattern given that nearly one in every two households is paying over 30% of their income to rent.[3]

GREG EUDICONE: Valeria, given the risk-off sentiment in the market, where are you turning to find attractive risk-adjusted returns today?

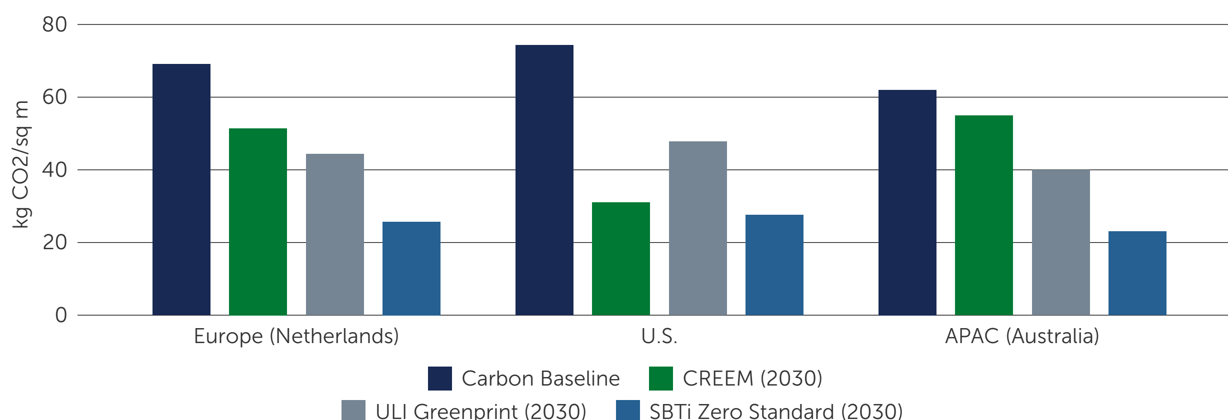
VALERIA FALCONE: Considering how difficult it is to price assets today, we believe some of the most attractive risk-adjusted returns are in value-add assets, for a number of reasons. First, the price re-adjustment for value-add deals in the months ahead should be swift and significant, which means assets may be available to purchase at cheaper prices. Additionally, heightened uncertainty often brings with it less competition and more off-market deal activity, which could translate into greater purchasing power. At the same time, the overall lack of financing in the market will likely delay projects, eventually resulting in an even tighter supply across sectors. Given the still-strong long-term fundamental picture

1. Source: National Association of Realtors. As of October 2022.
2. Source: Newmark Research. As of November 2022.
3. Source: Statista. As of May 2022.

across sectors like logistics and residential, we expect the aforementioned challenges to exacerbate demand for higher-quality assets and products—to the benefit of value-add strategies.

Another potential area of opportunity relates to the government's efforts to tackle climate change. As these efforts bring about more stringent regulations around energy consumption, it could result in a large portion of real estate assets being either non-leasable or in need of consistent capital for re-positioning. For European managers focused on value creation, these dynamics will likely present opportunities to buy assets at attractive prices and then expand or develop them with strong ESG credentials, or in a way that meets the evolving regulations (**Figure 2**).

Figure 2: Regulation Suggests the Premium on ESG Buildings is Inevitable (Global Offices: Required Emissions Reduction)



Source: IPF Pathways to Zero Net Emissions. As of January 2022.

GREG EUDICONE: Nasir, it seems like a great time to be a lender. What are your thoughts on risk and relative value from a debt perspective?

NASIR ALAMGIR: We believe real estate debt looks attractive today, from core to opportunistic lending, given that coupons are significantly wider than they have been for quite some time. We are also seeing a significant increase in base rates at the same time spreads are widening, which hasn't happened in three or four decades. Coupled with that, leverage, loan-to-value ratios, and loan-to-cost ratios are all lower today as a result of the pressure on valuations stemming from the lack of activity in the acquisition markets.

On balance, we see greater relative value in opportunistic lending versus core, given that the illiquidity premium is higher versus the historical liquid-illiquid premium. Construction lending, in particular, looks attractive, especially with the easing of some of the supply chain and cost pressures that have characterized the last six to nine months. While this is somewhat of a contrarian view heading into a recession, these assets have historically performed very well coming out of difficult periods. This is largely because the average duration of a recession is less than two years—and with most construction projects taking 18 to 36 months to deliver, the supply/demand picture looks fairly compelling. Another potential benefit with construction lending is that the assets are being built for the future, often to accommodate a new set of demands—whether related to ESG, clean technology, efficiency or other factors. In this respect, the assets being financed in this market are often best-in-class, and well-positioned to succeed going forward.

> "We believe real estate debt looks attractive today, from core to opportunistic lending, given that coupons are significantly wider than they have been for quite some time."

That said, deal flow going forward may be more challenging. Core transactions in Europe are virtually nonexistent, and it's a similar situation in the U.S. In the absence of acquisition financing, pipelines will likely be down roughly 30% to 35% through most of 2023, and possibly into 2024 depending on the economic backdrop. At the same time, there is still pressure on lenders across the board—banks have pulled back, life insurance companies have quieted down, and the capital markets have slowed substantially. That is to say, while it's a great time to be a lender if you have dry powder, this uncertain environment we're in today still warrants caution.

GREG EUDICONE: Let's put this conversation into practice—what is one of the last deals you've done or liked, and why?

SÉVERINE MAUMY-LAFFINEUR: The last deal we closed for the core strategy in Europe was a portfolio of four hypermarkets in France. One aspect of the deal that was particularly attractive was the potential for asset management opportunities in the medium to long term. It also offered the potential for a strong and stable income from a good covenant at a high yield. We secured the deal at the beginning of 2022, and then had an opportunity to renegotiate it over the summer—not only repricing the existing portfolio, but also adding land to what we initially purchased, setting ourselves up to potentially add assets in the future without renegotiating again. This is a good example of how when it comes to core, there isn't necessarily one right strategy—rather, the key is being able to be opportunistic and agile in the way we negotiate deals, while having a long-term mindset.

NASIR ALAMGIR: From the debt perspective, we have taken somewhat of a contrarian view when putting money to work recently—as a result of our hyper-local focus, where others see risk, we might see great relative value. As an example, in May 2021, still somewhat in the throes of the pandemic, there was a lot of uncertainty around office, which still exists today. One of the best-performing office sub markets in the country was Burbank, California. Intuitively this didn't make sense—Hollywood was shut down, movie production sites were shut down, and there wasn't much activity. However, due to the expansion of content providers like Apple, Hulu, Netflix and Amazon Prime, Burbank at that time was one of the few markets in the entire country with decreasing vacancy rates and increasing rents.

At the time, we had an opportunity to finance the acquisition of a property across the street from where one of the major studios was building a new campus. The property had recently lost a sizeable tenant and was experiencing continued rent pressure—when we financed it, it was 77% occupied, and it quickly dropped to just under 50% occupancy. However, within 12 months the owner had leased it back up to 91% and also has a letter of intent from a big content provider that would potentially take the balance of the space and bring the property up to 100% occupancy. This underscores the importance of being able to provide financing that is consistent with what we are seeing on the ground.

GREG EUDICONE: Zooming in on the office sector, Joe, what will distinguish the "haves" from the "have nots" going forward?

JOE GORIN: Much of the conversation in the office sector has historically been around market-level rents, but today it is more focused on asset-level rents. This reflects the desire of tenants not only to be in a good location, but also to have access to amenities and other physical attributes that encourage employees to spend time in the office. When a potential tenant sees the value in a building that has been developed or redeveloped, the rent for that building can be 100% to 200% higher than a building in the same location that doesn't fit those requirements. In other words, whether office buildings have the right amenities to attract talent will be a key differentiator between the haves and have-nots going forward.

GREG EUDICONE: Looking across real estate markets, if you could identify one area to put capital to work in 2023, what would it be?

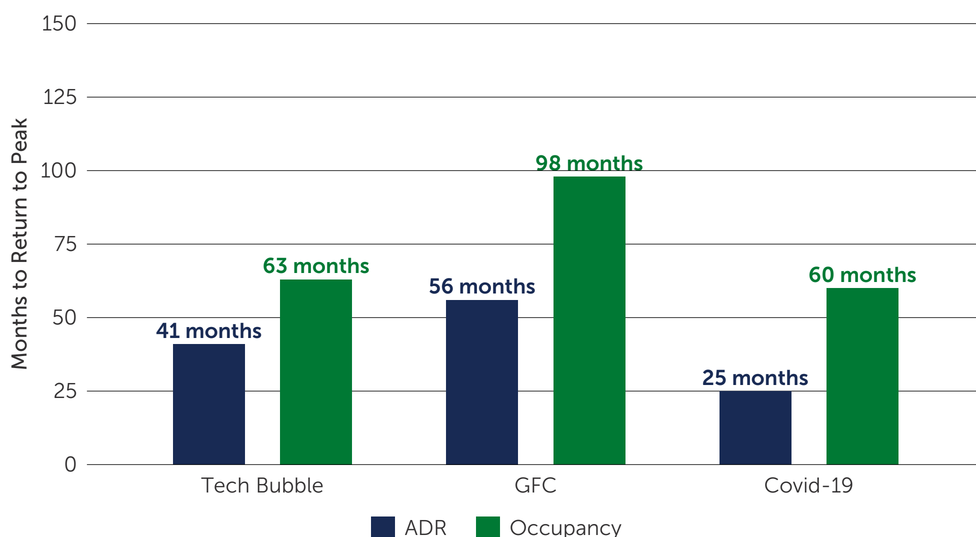
VALERIA FALCONE: While this year has been challenging in that we have yet to see a repricing in the market to the point we would like, we are more positive going forward. One area where we expect to see opportunities emerge is in buildable land in major European cities. In Europe, alternative lenders are less prevalent than they are in the U.S., with most developers preferring to partner with banks. As banks have pulled back more recently, however, we believe opportunities will emerge for alternative lenders and value-add investors to partner with developers. We also expect to see select opportunities to buy from vendors that are in a position where they need to sell, for example in the case where an open-ended fund is facing redemptions. There may be opportunities to purchase under-rented assets, for instance, that can then be improved and/or repositioned over a couple of years to meet the evolving needs of tenants. As Joe said, if you have the right product, then you will attract tenants.

NASIR ALAMGIR: Outside of construction lending, the hotel sector is an interesting place to consider deploying capital. While hotels can be susceptible to recessions, the average daily rate (ADR) for hotels—a measure of rental revenue earned per occupied room per day—has recovered in the post-pandemic period more quickly than it did following the great financial crisis or dot.com bust (**Figure 3**). At the same time, occupancy rates will likely take longer to recover—hotels continue to face staffing constraints, with the average number of open positions per hotel hovering around 26, which is over 50% higher than 2019.[4] This dynamic could create opportunities to push ADR, or reset room rates at hotels in a way that enables persistently higher inflationary costs to be passed through to guests. Further supporting the case for hotels, leisure destinations have been outperforming for nearly two years now, and travel is back,

4. Source: CBRE Hotel Research. As of September 2022.

with TSA throughputs in excess of 90% of pre-pandemic levels—leading to strong upper-upscale and upscale brand hotels outperforming pre-pandemic levels.[5] While we are more cautious on large group settings and convention center hotels given that they are still recovering, we believe there are plenty of spots within the sector to allocate capital.

Figure 3: ADR and Occupancy: Recovery by Cycle



Sources: CoStar, CBRE. Occupancy recovery following COVID-19 is estimated based on CoStar data. 60 months is an estimated period for recovery.

JOE GORIN: I agree with Nasir on hotels, and would also highlight retail as another contrarian sector that looks interesting. As consumers have returned to retail following the peak of the pandemic, sales have continued to improve. Additionally, many existing retail leases were signed at very low rents in the beginning of the pandemic or even before that. In our view, this paves the way for some potentially interesting mark-to-market opportunities over the next several years, particularly in grocery-anchored tenants and experiential retail centers.

This piece was adapted from a virtual panel discussion. Listen to the podcast version here.

5. Source: TSA. As of November 2022.

Barings is a $338+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

Copyright and Trademark
Copyright © 2022 Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings' consent.

The BARINGS name and logo design are trademarks of Barings and are registered in U.S. Patent and Trademark Office and in other countries around the world. All rights are reserved.

LEARN MORE AT BARINGS.COM

**As of September 30, 2022*

22-2620058