2023 OUTLOOK: OPPORTUNITIES EXIST, JUST NEED TO FIND THEM

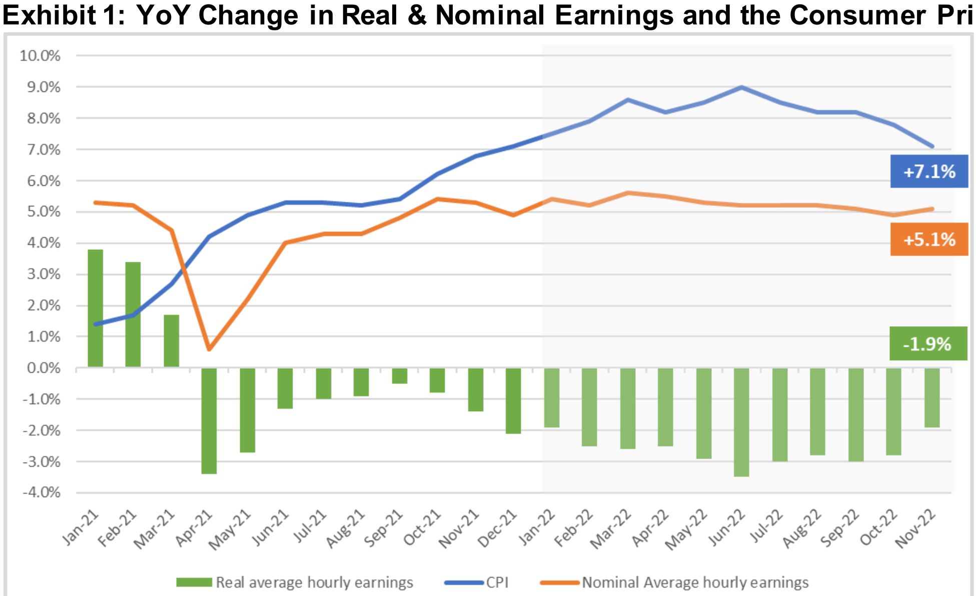
POPULATION GROWTH IS KEY TO INVESTMENT ACTIVITY IN 2023

While we are not officially in a recession, inflation is surging and real wage growth is negative. Despite two open jobs for every one unemployed person, a shortage of labor is weighing down the U.S. economy today; labor is the critical issue above all else because you can't grow despite demand *if* you can't find workers to run the shop. This has culminated in slowing down CRE activity and uneven consumer spending across most of the U.S. during 3Q 2022. And now bank lending has paused as the Fed's steep and frequent rate hike changes have made it very difficult to price a loan.

All is not bad – the CRE market today is much healthier than in 2008-2009. Property owners are not overleveraged and have a lot of equity in their assets so can afford to wait for a reset. Commercial real estate is still a more desirable alternative to a volatile stock market and uncertainty in international economies.

We are seeing gaps in the market between buyers and sellers and tenants that are uncertain about long-term space needs – CRE decision makers are pausing and terminating deals. There's a big disconnect between buyer and seller expectations, as cap rates have moved up a lot (100-200bps on average) while sellers are not yet willing to accept price adjustments. Even though there are owners who want to offload property and buyers with cash to deploy, the uncertainty in the market is causing both sides to suspend any decision making. According to our industry experts, this period of "sitting on the sidelines" may last for 6-12 months as investors wait to understand pricing, interest rates and demand for commercial property assets. In the meantime, we will be in a period of deferring decisions, delaying loans and postponing deals.

Exhibit 1: YoY Change in Real & Nominal Earnings and the Consumer Price Index



Source: U.S. Bureau of Labor Statistics.

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Growth opportunities do exist. Sentiment is very strong in markets experiencing an influx of working-age people and big corporate relocations/expansions (e.g., Arizona, Florida, Texas). Business-friendly policies (aggressive tax credits and increased access to capital) and a much lower cost of living (compared to metros like San Francisco and NYC), are attracting excellent labor pools, big corporate growth (from semiconductors to hospitality & entertainment), and record numbers of entrepreneurs opening businesses. Suppliers to big companies have been relocating in droves to support the construction of megaprojects. Developments that were planned for these markets are all still taking place – with no signs of a slowdown. Investors are taking note and continuing to pay premiums for this growth. Our commercial professionals expect megaprojects to attract more suppliers and people (particularly Gen X and Millennials) to these markets over the next year, which in turn should keep driving demand for industrial, multifamily and retail in these markets.

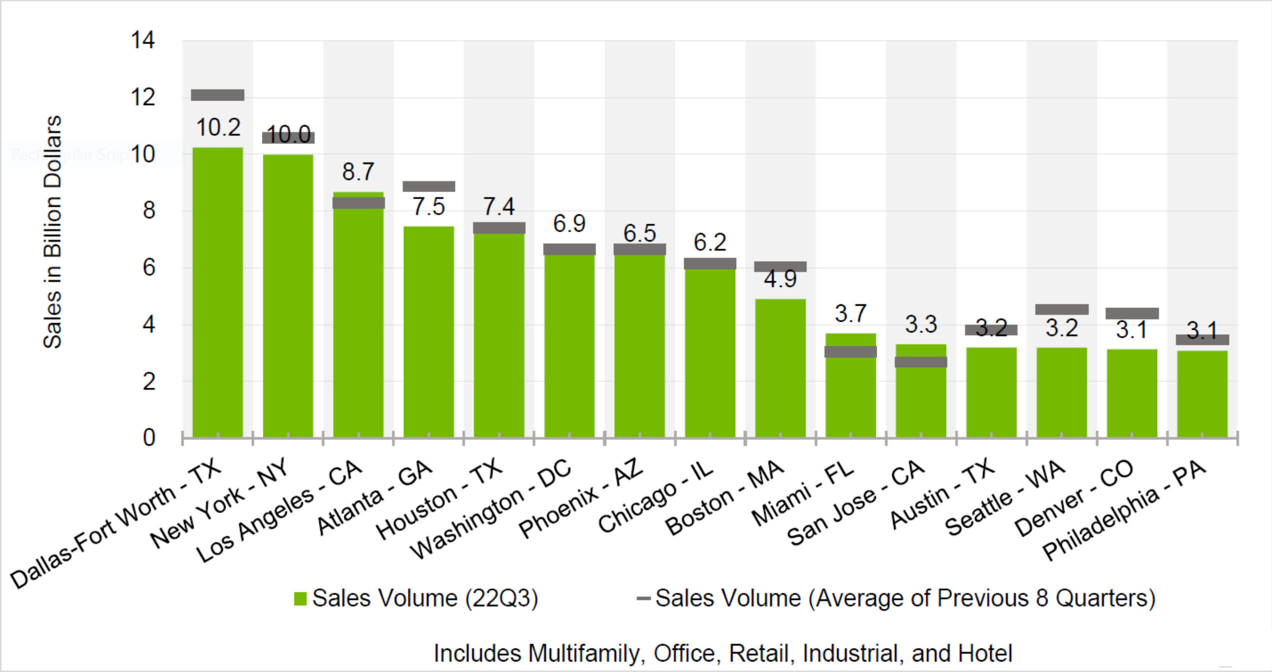
Exhibit 2: Top 10 States for Population Growth: 2021 to 2022

Rank	Geographic Area	April 1, 2020 (Estimates Base)	July 1, 2021	July 1, 2022	Numeric Growth
1	Texas	29,145,428	29,558,864	30,029,572	470,708
2	Florida	21,538,226	21,828,069	22,244,823	416,754
3	North Carolina	10,439,414	10,565,885	10,698,973	133,088
4	Georgia	10,711,937	10,788,029	10,912,876	124,847
5	Arizona	7,151,507	7,264,877	7,359,197	94,320
6	South Carolina	5,118,429	5,193,266	5,282,634	89,368
7	Tennessee	6,910,786	6,968,351	7,051,339	82,988
8	Washington	7,705,247	7,740,745	7,785,786	45,041
9	Utah	3,271,614	3,339,113	3,380,800	41,687
10	Idaho	1,839,092	1,904,314	1,939,033	34,719

Source: U.S. Census Bureau.

For the other markets, there are pockets of opportunity – you just have to find them. While most sellers are opting to wait it out, owners that are overleveraged or have lots of vacancies will discount and put property up for sale because they need to offload it. Some owners have turned to sale-leasebacks (to generate more free cash to operate the business) and seller-financing (to get the deal done).

Exhibit 3: Q3 2022 CRE Sales Volume vs. Average Investment – Top Markets



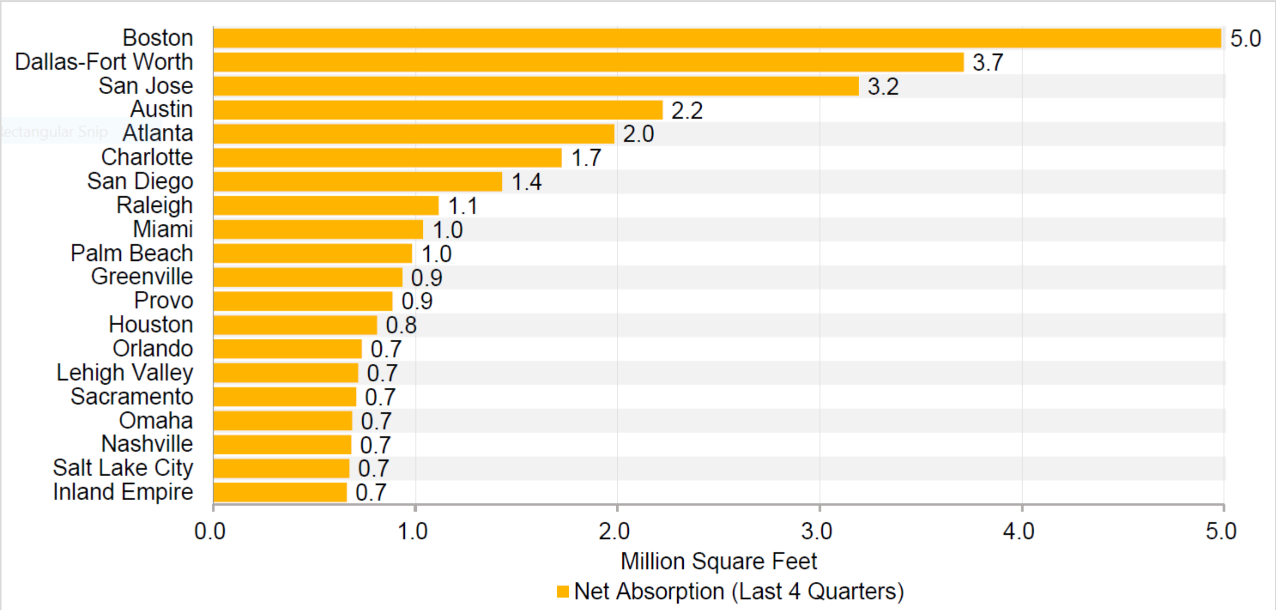
Source: CoStar (data through November 2022).

Office remains bifurcated. Smaller markets and smaller buildings continue to see a lot of activity, while downtown high-rise demand keeps softening. Work-from-home is a permanent change, so people with 30 minute commutes or document processing desk jobs are not returning to the office. This could force a lot of companies to downsize their space requirements. Office leases are long-term commitments and there's a lot of uncertainty today as businesses struggle to determine the best way to reconfigure their space to attract workers back to the office or adjust to lower in-office headcount. Low-rise and midsize buildings are seeing good activity because landlords have been approaching tenants nine months in advance and offering better amenities (like new paint and carpet cleaning). The greatest demand is coming from biotech, life sciences, R&D labs, investment banking & trading, medical doctors, and school districts. We are also seeing retailers (that provide services you can't get online: hair salons, massage therapists, facial spas, homecare, food packaging) moving into office condos because it's cheaper than traditional retail space.

High-rise building cap rates are staggeringly high with vacancies well over 20%. Landlords are keeping asking rents high but giving out free rent and more TI allowances. Sublease space may continue to flood the market as tenants decide to adjust occupancy to current needs or mitigate the risk of long-term space commitments vis-à-vis an unknown in-office work force. Property owners may be challenged to lock-in tenants as leases expire over the next 24 months. Our commercial professionals expect to see the most impact on downtown office properties over the next two years as well as a lot of lease term restructuring and short-term leases (one to three years). With lower market-adjusted rents, well located modern Class A properties may be able to benefit from tenants moving up to higher quality properties at affordable lease rates.

A tenant's market. Over the last quarter we've seen landlords getting more and more nervous about where their next tenant will come from – setting up the stage nicely for tenants to have the upper hand in negotiations in 2023. While this is a great opportunity for occupiers to take advantage of a slowing landlord market, the tenant still needs to have strong cash flows.

Exhibit 4: Office Sector Net Absorption – Top Markets



Source: CoStar (data through November 2022).

Industrial still doing very well – driven by retail demand (logistics; 3PL; distribution centers; and food companies). Vacancies in some markets are up to 1.5% from 0%. Demand is coming from everywhere: small mom & pop shops that need to store inventory for the first time; new businesses entering the market; and large companies looking for dropshipping storage and more parking space. Bigger metros (like Seattle and Las Vegas) are beginning to see developers slowing down and prices starting to come down to a more reasonable pace as users choose to wait for rates to come down. Even if industrial demand slows, increased space availability may help return markets to historical norms.

Exhibit 5: Industrial Rent Growth, Top Markets

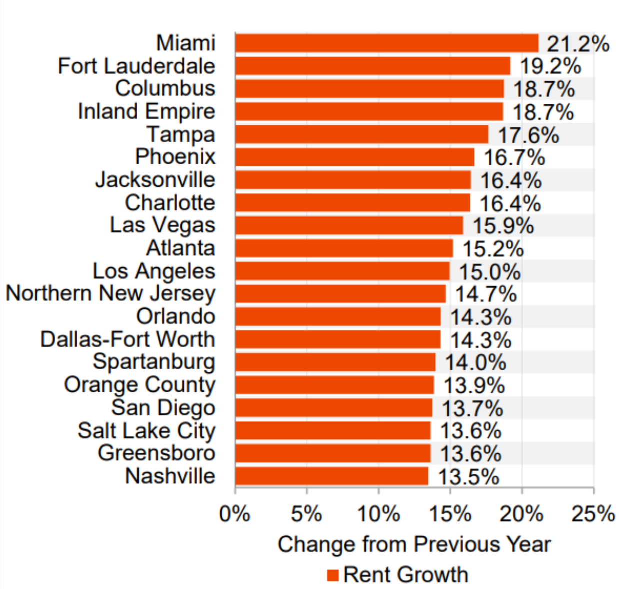
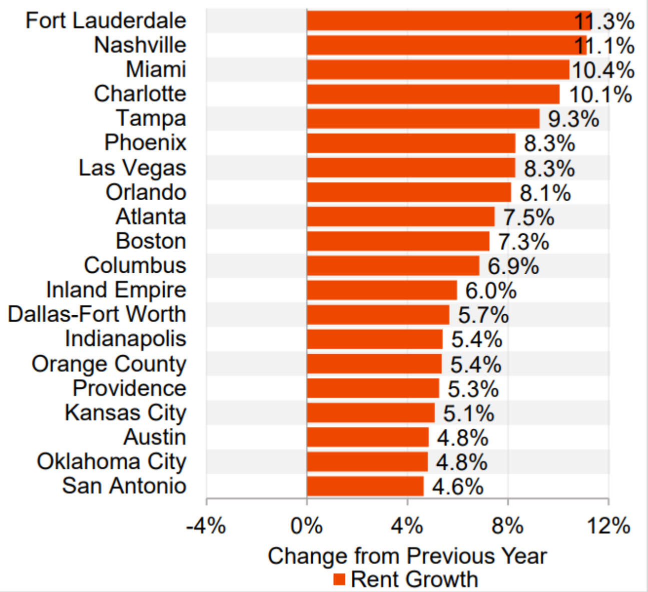


Exhibit 6: Retail Rent Growth, Top Markets



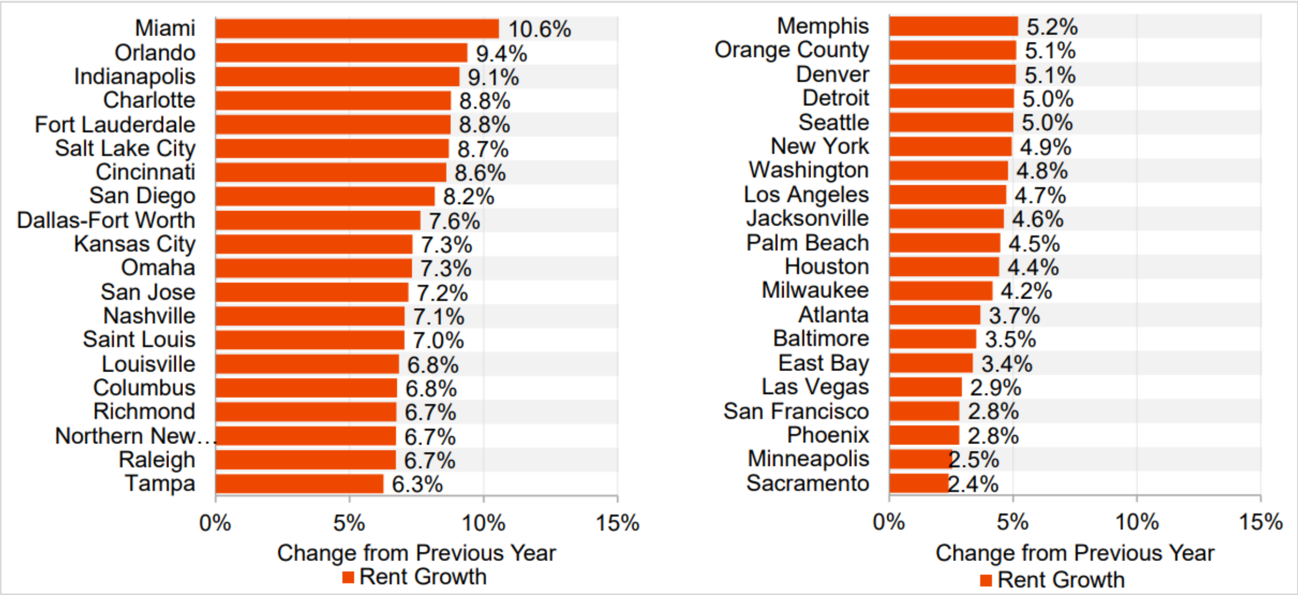
Source: CoStar data through November 2022.
Note: Includes markets with 100M+ Square Feet inventory.

Retail is in high demand across all markets. Neighborhood centers are filled with small, less leveraged local businesses looking to expand (e.g., boutiques; tap rooms; coffee shops; ice cream parlors; gyms; exercise shops; small bank branches; independent pharmacies). Strip malls are focused on getting really good anchors (grocery; restaurants; hair & nail salons; bubble tea shops). Malls are pivoting to experiential and service-driven tenants – replacing Macy's with fun houses for adults, kids' playgrounds, sit-down restaurants, medical spas, and co-working space. Every landlord wants a salon in their center and all developers want a gym tenant on their property. Other spaces in the mall are turning into "pop-up" shops. Uncertainty and concern on the landlord side is enabling whatever concepts are doing well to win space (even if they are not the traditional type of tenant).

Urgent cares keep medtail in high demand. Walgreens is accelerating plans to go into the urgent care business by creating standalone centers in addition to carving out space inside their stores. AdventHealth, University of Florida, Cleveland and the Mayo Clinics are all competing now to have urgent cares brought into their neighborhoods. At the same time, big hospital operators (like HCA) are building standalone ER spaces within 20 minutes of their hospitals across Florida. Aggressive expansion of "local" point of care locations are quickly taking up spots in neighborhood shopping centers, standalone retail boxes (ER), and inside grocery stores.

Multifamily is slowing down. After years of strong double-digit rent growth, we are now seeing condensing family units (in response to the steep rise in the cost of living and recession fears) creating more vacancies in the market. Many homebuilders are worried about the impact of further rate hikes (as they navigate a challenging bank financing, construction cost, and labor shortage environment), so they are temporarily stepping back from building new product. Many builders are offering free rent concessions just to get occupants in the building. Our commercial professionals expect to see increased rent concessions and slow rent growth over the next year.

Exhibit 7: Multifamily Rent Growth, by Market



Source: CoStar (data through November 2022).
Note: Includes markets with 75,000+ units inventory.

Are property conversions happening? It's a mixed bag. Big box retail spaces are being converted to storage, indoor kids playgrounds and climate controlled warehouses. Hotels are being converted to affordable housing. Outlets and big malls are being converted into multifamily and entertainment town centers. Boat storage and truck parking spaces are also in high demand. Converting high-rise offices to multifamily is much harder and a longer-term process (as you need to make sure it's zoned for that new use) and will likely require the building owner to sell at a loss. When this happens it's not a cap rate deal, it's a completely different acquisition model – it's done because there is no other choice. Our commercial professionals expect to see a rise in this type of activity.

Conclusion. As many CRE investors sit on the sidelines waiting for interest rates to stabilize, all-cash buyers and 1031 exchanges have been driving the bulk of activity today. While the universe of investors willing to put up all equity is not big, there are enough out there and if you can find this type of buyer, it's very advantageous for a seller because it takes the guesswork out of whether or not the deal will close quickly and easily. Notably, all-cash buyers have been paying for cap rates that are much lower than current borrowing costs. 1031 exchange investors are also in the market to buy today (and willing to pay a premium) – however, preferences have been for high population growth markets. As such, our industry experts expect deal flow over the next six to nine months to slowdown. Over time the difference in pricing expectations between buyers and sellers should narrow; rates will have to come down. In the meantime, property owners should focus on preparing product now (to be ready to release in the middle of 2023) and investors just need to pick their spots and ride out this next year.

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