The Future State of Real Estate Investing

Disruptive Forces in Investing **December 14, 2021**

Anu Rajakumar: As 2021 draws to a close, many are reflecting on the past 12 months and preparing for the year ahead; personally, professionally, and from an investment perspective; which often means reevaluating long-term asset allocation. Particularly important as we enter another long, potentially volatile, economic cycle. In this current market environment, yield and diversifiers are particularly important to investors, which brings us to today's topic of discussion: real estate. My name is Anu Rajakumar; and joining me today is Matthew Wolpert, portfolio manager for Almanac's public-market real estate strategies, to share his thoughts about the real estate investment outlook ahead. Matt, thanks very much for joining me today.

Matthew Wolpert: Thank you for having me.

Anu: So Matt, you have an interesting perspective on this topic, considering your role as an investment decision maker, which is primarily on the public real estate side; but your team, Almanac, generally focuses on private real estate. So just to get us started, what do you see as the main components of the current real estate investment landscape at play? And maybe just compare and contrast trends from the public and the private side.

Matt: Yes. Thank you. You know, it, it's really interesting, sitting between public and private markets, particularly in real estate; because at the end of the day, public companies, their underlying assets are real estate. On our private side, we're investing in real estate, and we try to bring a long-term focus to both. And yet the public markets, prices move every single day. And whatever the headline of the day is can cause huge swings in the prices of public real estate companies, where the assets they own haven't really changed very much. And on our private side, when we're making decisions for the next five, seven, 10 years, you have to take that long-term view. And real estate is this stable, hard asset that generates cash flows, that has stability. And so, sitting between the two, what ends up happening is, you can really see when opportunities come up. And whether that's in the public markets, where prices are changing, but the underlying assets aren't; or whether the public markets are signaling that prices in the private market aren't right; maybe they're too low for specialized real estate, or they're too high for legacy real estate, I'll call it, like office or retail or malls. And so, it's really a great place to sit and try and make good long-term investment decisions, seeing both sides at the same time.

Anu: Yes. No, that, that's a great primer. And real estimate's something that, I think, affects everyone. So now, turning to real estate sectors, as we all know, office space has been very challenged because of the pandemic; and at the moment, you and I are sitting about six feet apart in our New York headquarters. And like Neuberger, a lot of companies have launched hybrid work programs or are fully back in the office. So maybe this is a good place to start. How has the office-space real estate sector been impacted?

Matt: Yes. So that's a good advertisement for return to office. I think –

Anu: [Laughs] Right.

Matt: – anyone who invests in real estate appreciates your advertisement. You know, office is indicative of what COVID – and the long-term changes that COVID has really caused on the real estate market. And I think, if you take a step back, you go back to March of 2020 and look at what the impact has been, there's really been this dichotomy between sectors that really had a huge detriment from the physical world shutting down, and office is case in point. I think people largely would think about hotels in the same way, where, you know, not only did offices empty out, because no one went to the office; no one went and traveled to a hotel. No one wanted to walk around a mall. No one wanted to access the healthcare system. And on the other side, you had these subsectors that benefitted from this shift to the digital world. So industrial real estate, had a huge benefit from e-commerce as the share of total sale's skyrocketing and everyone ordering from Amazon at home.

Same thing with a move to the cloud; you know, again, we at Neuberger Berman, we all went remote; and we were all accessing our computers via the cloud. And there was a huge pickup in demand for data-center space, really, in that movement to the cloud; and then towers, with the rollout of 5G and the importance of 5G and connectivity, in a much more digitally enabled world. So those, the different impacts to subsectors have been very stark. The outlook for office is probably a little bit more uncertain than others. I think everyone is trying to feel out what works best for their organization and their employees. It does seem like employees appreciate a flexible work environment. And so what that means for office longer term is, if people aren't going into the office five days a week, let's say they're going in four days a week. Well, that's 20 percent less people flowing through an office building. And, maybe, you still need the same amount of space to distance people; but at the street level, the ground level, there's a real impact to businesses that, maybe, are, you know, selling food or selling goods. And now there's 20 percent less foot traffic during the week, so office in particular probably has the cloudiest outlook, I'd say, over the medium term. And the longer that COVID goes on, and the longer we're remote, probably the more it's impacted.

Anu: Yep, sure. Absolutely, and you know, you mentioned a couple of other sectors there, where there's, you know, potential opportunity. One that I find interesting is lodging and hospitality. You know, it has impact from both business and from leisure travel. And there's a lot of pent-up demand. What's your view there, and how do you weigh up some of the risks, particularly as we think about new variants of, of COVID that have come along, and probably will continue to, to evolve and come along, too?

Matt: Yes. So it's very topical with Omicron and the impact Omicron's had on public markets over the last two to three weeks. You know, it's interesting. If you put office in the camp of cloudy forecast, hard to know, there'll be winners and losers. It's really dependent on the asset and the market. I'd say, in my opinion, lodging, the outlook over the longer term is a little more clear. So, we've seen leisure, travel, well above pre COVID levels. And so Americans have shown, they want to go travel on their own. People are more comfortable staying in hotels. We've seen rates in leisure markets 20, 30 percent above where they were pre-COVID. We saw TSA travel, you know, the amount of people actually flowing through airports during the Thanksgiving week, was nearly back to 2019 levels. And so Leisure demand is there, and the question longer term is, when does business travel come back. How does it come back? When do groups come back? But my opinion is, people have already shown they're comfortable staying at hotels; and once we get a little further out, from Omicron, from, you know, the initial wave, the, the vaccines work. The people are comfortable traveling; businesses are going to want to travel, too. People are going to want to see the client on the other side of the table. People are going to want to meet with the people that they do business. And if anything, maybe you travel less; but every time you travel, you travel longer, because now you can work from anywhere. And so, you know, the outlook for lodging, as one of those really impacted sectors from COVID, I think is pretty favorable, relative to some of the other sectors, where it's a little hard to know how it's going to play out.

Anu: Yes. Sure, absolutely. So, I want to shift a little bit to talk about some macro topics. You know, real estate, for example, has often been considered somewhat of a hedge against inflation. Would love to know what you're thinking about inflation, you know, rates going forward. And how is your outlook on these macro themes impacting the opportunity set within real estate?

Matt: Yes. So real estate, in the current environment, seems like a pretty favorable asset class. So first of all, it's a hard asset that should have some inflation protection embedded in it. It generates current cash flow, and that yield helps generate your total return. And that yield is something that is relatively straightforward to forecast over the near term. And real estate benefits from overall growth in the economy. And so, unlike a bond, where you get, largely, a fixed coupon and your money back at the end; real estate cash flows can reprice every year or every month or every day, if you're talking about hotels. And so, if we have inflation, we obviously have a good deal of it now relative to historical; but if inflation continues, or it picks up, you should see growth in cash flow. And that should help mitigate some of the impact that inflation can have on asset classes.

As we move forward, certainly the environment's changing a little bit from a macro perspective. we have, a Federal Reserve who is likely to start pulling back on, some of the quantitative easing, including, you know, tapering; potentially faster at the next meeting, potentially raising rates next year. So that's a big shift. We've had this huge tailwind from the Fed, easing; and now we're going to go the other way.

And then, you know, the federal government, we passed a lot of stimulus. And that stimulus flowed through the economy, and as you look to next year, it's unlikely that we continue to have the same level of stimulus that we had during COVID. So you have two big macro drivers, that were tailwinds for all asset classes, that might be shifting in modest headwinds. And so, in that kind of environment, real estate still looks pretty good, because real estate remains somewhere discounted relative to other asset classes. You do get the current yield, like I said before; and you do have some inflation-protection characteristics inside of it.

Anu: Great, no, thanks for sharing your favorable outlook on the asset class, and some of those macro factors which – the ones that you mentioned – are generally U.S. centric. Looking outside of the U.S., just in terms of the opportunity set, what else are you seeing; and are you seeing those, those macro themes sort of are impacting the global opportunity set outside of the U.S., as well?

Matt: Yeah. You know, one thing that remains true across the globe, despite potential tightening by the Federal Reserve or other central banks, is, yields are incredibly low. And so real estate screens attractive relative to sovereign debt in most major economies. And real estate remains an asset class that most investors are comfortable that it will retain its value over the long term; particularly relative to some more speculative investments that really came to the fore in 2021, in my opinion.

So globally, real estate remains attractive relative to sovereign debt. And then the second thing that we've really seen globally is housing, and a shortage of housing is a global theme. It's something that's pertinent here in the U.S. It's something that's certainly pertinent in other markets across the globe. So, you know, those two things, I think, are relevant everywhere; and lastly, other real estate markets tend to be a tiny bit behind the U.S.

And so some of the investment themes that we saw here in the U.S., like I mentioned; industrial and the tailwinds from e-commerce, housing, storage, life science; all of these asset classes are investable in these other markets. And the investment thesis is actually pretty good, because they're several years behind where the U.S. is in terms of the market maturity and opportunity.

Anu: OK, interesting. Thank you. Now, Matt, what innovations or impact are you seeing on real estate when it comes to ESG factors? You know, this is very important to many folks in the investment community, some of whom are certainly striving for net-zero carbon emissions in the near future. How does all of that affect real estate?

Matt: Yes. So ESG is, obviously, a prime topic with investors; whether it's public or private markets. And real estate is particularly heavy in the E, in energy. So, you know, the amount of energy it takes to build a new building, as well as operate a building over time, that is something that we're seeing is a large topic. I think real estate can do better in terms of becoming more ESG friendly. Part of the driver of that is technology, and there's this relatively new sector called PropTech, with a lot of companies trying to disrupt the real estate market as it exists today. And one of the things that they can do is help real estate owners more efficiently manage their buildings. And whether that's energy, whether that's water, whether that's the cost and how we build buildings. All of those topics are at the very forefront of real estate investing today.

And so, you know, particularly as governments like here in New York City, there's, a big push to regulate the carbon emissions for buildings. They're going to have to get more efficient over time. We're going to see that theme. The G is important, too. So really interesting within Almanac, you know, for us, whether it's investing in public markets or private markets, in public or private, governance is really top of mind. And the reason behind that is, when, when Almanac does investments in the private market, one of the key things we do is put in place a board of directors. And in the public markets, obviously publicly traded REITs and real estate companies and board of directors and gap financials and transparency. And so, most real estate investment, particularly in the U.S., the G is lacking, because you're making a private investment in an asset or portfolio; and the governance is, is really based on a document that you agree to.

The way that we look at it is, governance is one of the most important drivers of a great investment. And so, you know, the public markets, I think, REITs are really well positioned; because almost any other real estate investment you're going to make, the governance doesn't match what you get in the public markets. And so, at least two of the three components of ESG, we see as really important and differentiating in how Almanac, at least, looks at investments.

Anu: Yes. No, that, that's great. Thank you very much, Matt. Now, as we start to wrap up here, would love for you to share with us some of the key trends that you're anticipating in real estate investing for the next year or coming years ahead, if you can just summarize a few key takeaways.

Matt: Yeah. You know, as we look forward to 2022, there's a few key topics. Obviously we talked about how the macro is changing, and we're not macro investors, but, we believe we're going to have volatility; and if I look back in public markets, you know, over the last 14 months, the public REIT benchmark has only been down in two of those 14 months. And prices are up more than 70 percent off the bottom from COVID. And so, it might not be that easy, going forward, to generate great returns consistently, just by owning a benchmark or by investing in every piece of real estate across the globe. And so more volatility is probably case in point, and that's driven by both, you know, the run that we've had and the change in the macro environment.

Secondarily, you know, real estate remains really well positioned. So if we have a pickup in volatility, and if we have a pickup in inflation, and if growth is either faster or slower than everyone thinks, real estate is still going to do pretty well. Because you get current cash flow, and that yield is something you can take home, you know, every month or every quarter or every year. And the economic growth that we see going forward on a multiyear basis, on a longer-term basis, should help real estate values grow over time. And so, lastly, I would just say, we believe REITs themselves, particularly in the U.S., remain incredibly well positioned; whether it's those same secular tailwinds from e-commerce or data, or whether it's a reopening in the U.S. economy that still is taking hold, which really could benefit some of these sectors that were impacted, like lodging, office, senior housing, and a long-term shortage of housing in the U.S. that really benefits single-family rentals and multifamily. And so, REITs have this diverse set of underlying growth drivers that should position them really well for 2022.

Anu: Yes. No, that, that is perfect. Thank you very much. So now my bonus question for you, which you are unprepared for, is you know, we're almost at the end of the year; so I'd love to just ask you, Matt, what's your New Year's resolution?

Matt: New Year's resolution, um, listen to more podcasts?

Anu: [laughs] That is the correct answer!

Matt: OK, good.

Anu: That is excellent. Matt, thank you very much for all of your thoughts today on real estate. You've given us lots of food for thought. And clearly you've summarized, there's a lot of potential for real estate, as we move forward here; so appreciate you joining the podcast. And hopefully we'll have you, again, on soon.

Matt: Yes. This was a lot of fun. Thank you.

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