REAL ESTATE

Three Themes Creating Opportunities in Global Real Estate

Executive Summary

- While some investors may be hesitant to invest in real estate in today's environment, our experience shows us that uncertain markets—and investors who remain nimble and ready to deploy capital—often generate the most attractive returns. We believe that cycle is happening now.
- Real estate fundamentals for high-quality assets in markets around the world remain healthy. And while macroeconomic forces are uncontrollable, focusing on what you can control—a low acquisition basis, active asset management and operational enhancements—can help drive great outcomes.
- We are anticipating opportunities to invest for value in housing, logistics, hospitality, science and innovation, and entertainment. These are stemming from three key themes: demographics and affordability, changing consumer preferences, and deglobalization.

Introduction

Global economies and capital markets are awash in uncertainty, with elevated volatility, high interest rates and persistent inflation. Consumers are facing increasing costs at crucial phases in their lives, such as buying their first home or managing their healthcare in retirement. Meanwhile, governments and businesses are responding to post-pandemic and geopolitical pressures to strategically deglobalize and support critical industries.

Sentiment is cautious in today's environment, but headline writers are missing a more encouraging angle: Real estate fundamentals remain healthy across many asset types. In fact, we are beginning to see compelling real estate investment opportunities emerge in housing, logistics, hospitality, science and innovation, and entertainment.

And while the time is ripe for real estate investors to take advantage of the volatility in the capital markets, this isn't only a short-term story. Three key themes are shaping the world in new ways—and driving real estate opportunities over the long term: demographics and affordability, changing consumer preferences (what we call "the New Normal"), and deglobalization (see Figure 1).

FIGURE 1

Investment Themes to Watch

Demographics and Affordability	The New Normal	Deglobalization
Housing Shortages High Cost of Homeownership R&D	Experiences and Leisure Flexibility Working and Shopping Habits E-Commerce	Security Domestic Biomanufacturing Supply Chains Onshoring / Reshoring
SECTOR OPPORTUNITIES		
Housing Science & Innovation	Hospitality Entertainment Logistics / Fulfillment Self-Storage	Science & Innovation Logistics / Fulfillment

Finding Value in Real Estate

Capital market dynamics are creating attractive conditions for those seeking to acquire real estate assets on a value basis.

We expect elevated interest rates and a wave of near-term debt maturities—approximately $400 billion of commercial real estate debt is coming due in 2023 in the U.S. alone[1]—to put increasing stress on many property owners who were previously able to finance assets at historically low rates. Because of the uncertainty this has created, transaction activity has slowed—bid/ask spreads have widened as asset owners have been reluctant to accept lower prices and buyers take a wait-and-see approach on the economic environment.

Despite the overall transaction slowdown, there has been activity in the market for high-quality logistics, multifamily and science properties at values well below previous peaks. In addition to higher debt service costs, many owners have underinvested in their properties and do not have the capital required to renovate them to today's standards. Owners with in-house operating expertise can acquire those properties at attractive values and pursue value-add plans to boost growth.

While negative sentiment is dominating headlines, the fundamentals for high-quality real estate remain strong; demand is outpacing supply in many markets; and rising replacement costs and supply chain issues are shrinking future pipelines. This is leading to positive upward pressure on rents in countries and regions around the world. For example, hospitality average daily rates are well ahead of pre-Covid levels; multifamily net operating income is up meaningfully as rents remain strong; and logistics vacancy levels continue to remain at historical lows, creating attractive rent growth.

Forward rates and forecasts suggest that the rate cycle is nearing maturation, with interest rate increases and inflation moderating. This should bring more stability to global markets and prompt an increase in investment activity. And as activity increases, the bid/ask spread should begin to narrow as buyers and sellers find equilibrium. We believe that capital will be ready to flow back meaningfully once conditions become less uncertain, and that a short window of opportunity will open to acquire attractive investments on a value basis.

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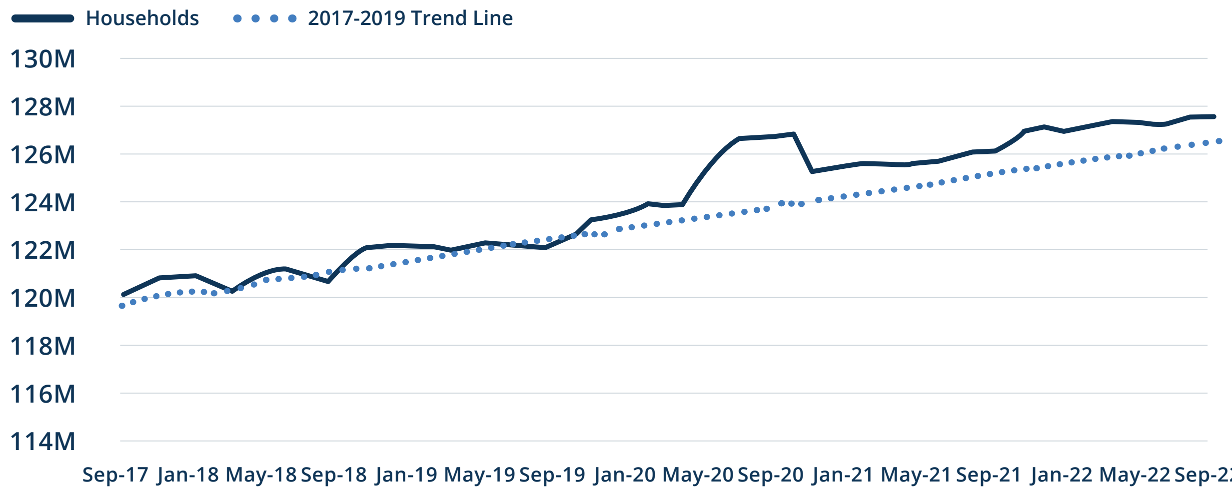
Demographics and Affordability Trends Point to the Need for Housing

Growing global demand coupled with a chronic undersupply of new homes paints a compelling picture for all types of housing. These dynamics are creating attractive opportunities to capture rising demand by building new supply, renovating existing assets and optimizing operations.

The key demand drivers of rental housing are household formation, population growth, ongoing urbanization and desire for professionally managed properties with amenities. For example, the rate of household formations is growing in the U.S. (see Figure 2), and the propensity to rent is also rising along with the cost of homeownership. In the U.S. today, it costs almost $1,200 more per month to own a home than to rent (see Figure 3).

FIGURE 2

Household Formations Continue Above Trend

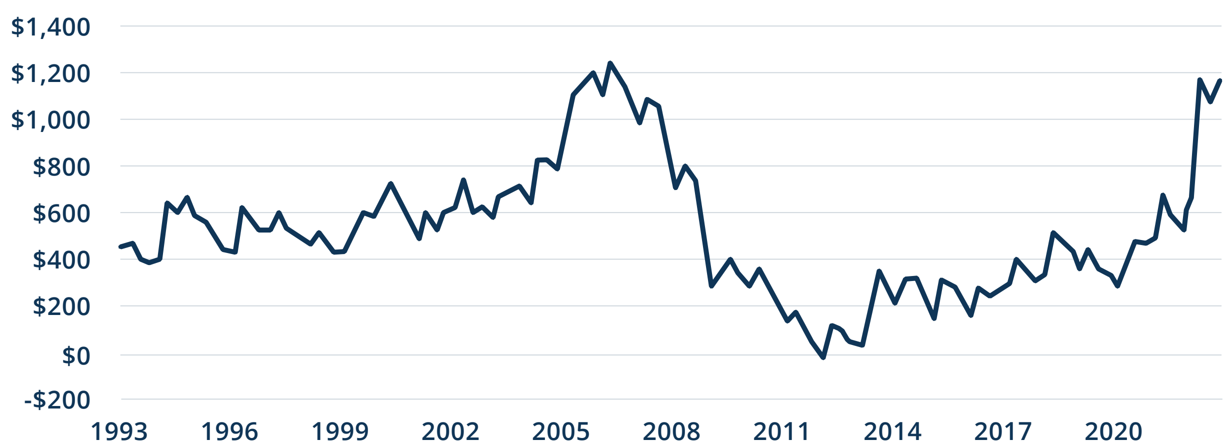


Source: Morgan Stanley Research and U.S. Census Bureau as of September 2022

FIGURE 3

Owning Costs Much More Than Renting in the U.S.

Monthly Premium to Buy vs. Rent (4Q 2022 Dollars)



Source: NMHC tabulations of data from RealPage, The National Association of Realtors, The Federal Reserve, The U.S. Bureau of Labor Statistics and The American Housing Survey

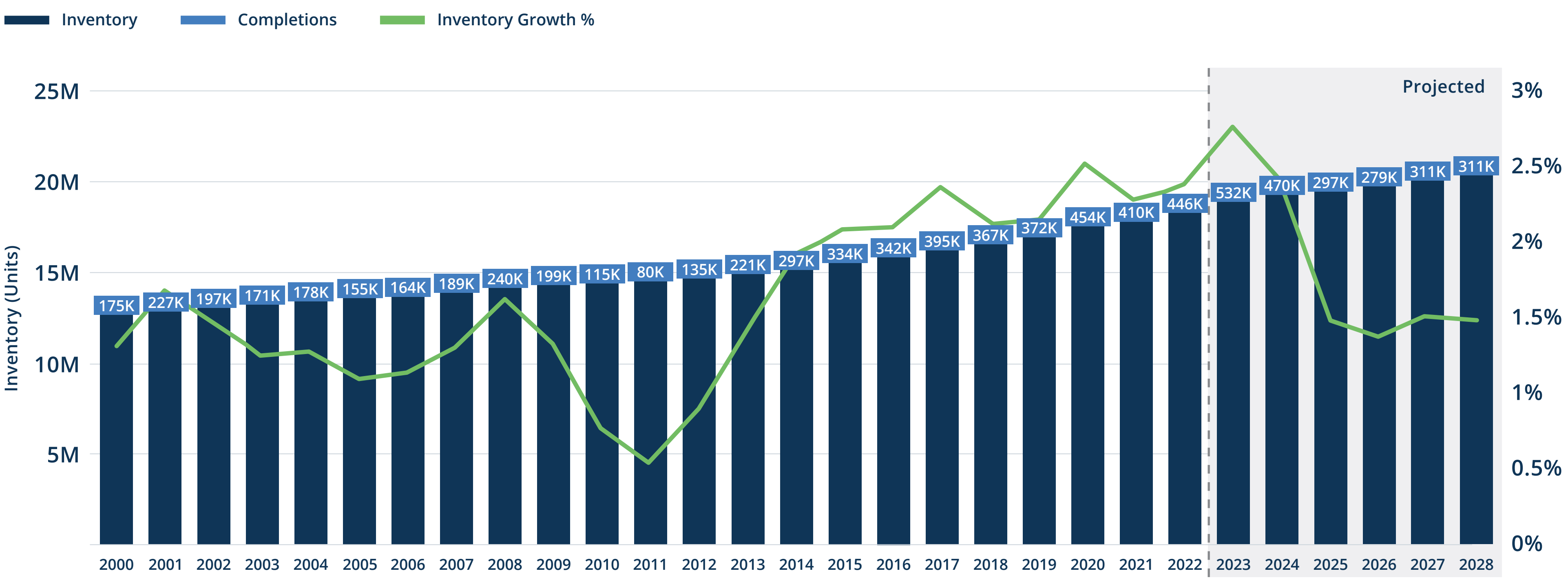
The U.S. market provides a good illustration of these trends, where multifamily supply has failed to match demand every year for the last decade (see Figure 4). Since 2000, multifamily inventory growth has been only ~1.6% per year, which has resulted in a shortage of apartments. Over that same period, the sector has continued to absorb new supply as occupancy has averaged approximately 95%. Going forward, supply is expected to moderate even further due to zoning constraints, rising construction costs and a dearth of financing. The National Apartment Association and National Multifamily Housing Council expect that 4.3 million new apartments will be needed by 2035, which implies that the U.S. will need to deliver more apartments per year than it has historically.

This undersupply has been exacerbated by rising land prices, limited land available for development, and higher building material and labor costs. According to the National Multifamily Housing Council, from 2014 through 2022, the producer price index for materials related to residential housing went up 48%. Over the past two years, the index increased almost 30%.[2]

FIGURE 4

The U.S. Multifamily Supply Shortage

National Multifamily Supply & Demand Analysis



Occ.	96.8%	95.3%	93.7%	93.1%	93.3%	94.3%	94.1%	94.3%	93.3%	92.0%	93.4%	94.7%	95.3%	95.6%	95.6%	95.7%	95.8%	95.4%	95.2%	95.3%	94.8%	95.2%	95.5%	95.4%	95.4%	95.2%	95.2%	95.2%	95.3%

Source: CoStar & REIS

Similar trends are visible across Europe and Asia Pacific. In Europe, we believe the widening gap between the cost to own and the cost to rent will increase the number of renters as interest rates remain high and supply is scarce.[3] China and India are both experiencing growing populations and continued urbanization, coupled with an ongoing housing shortage, which we expect will give rise to demand for institutional quality housing.[4] With a median age of 28 years, India has one of the largest millennial populations, which is driving demand for rental housing among this demographic.[5]

When we think about housing, we see attractive opportunities not only in the traditional sense—multifamily, affordable housing, single family rental—but also in alternative types such as student housing, senior living and manufactured housing. These are supported by similar sector tailwinds and a resulting supply and demand imbalance. For example, manufactured housing stock in the U.S. is expected to decline 14% over the next 10 years, from 6.7 million units to 5.7 million units, further reducing the supply of affordable housing and strengthening occupancy.[6]

Students are seeking newer, modern accommodations with amenities, and we think there are opportunities to buy for value, renovate older stock and build modernized portfolios of scale. Across the U.K. and Continental Europe, increased demand from international students and interest in English-taught programs are coming up against a lack of higher quality purpose-built student accommodation. For example, in major university cities like London and Amsterdam, the provision rate of students to beds is roughly 30% and 27%, respectively.[7]

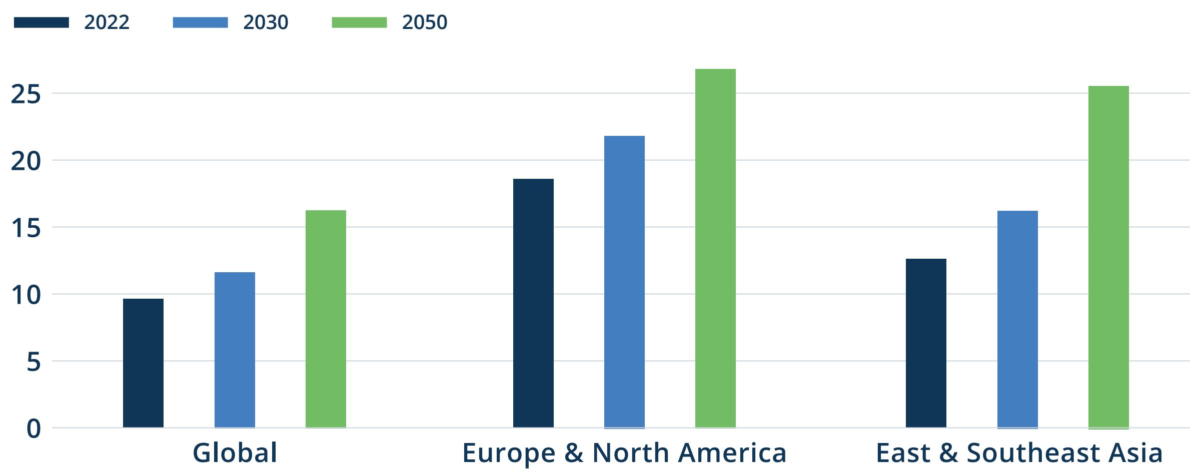
In the U.S., top university cities are seeing supply and demand imbalances with college-age or near-college-age populations exceeding U.S. averages.[8] There are about 2.7 million purpose-built student housing beds compared with 20 million undergraduate students in the U.S. today, a provision rate of about 13%.[9]

Australia has also become an increasingly popular higher education destination, with one of the largest proportions of international enrollment. This is driving demand for purpose-built student accommodations.

FIGURE 5

Growing Populations Age 65+

Population % Aged 65 and Over



Source: Citi Global Wealth Outlook 2023

Aging populations are also increasing demand for senior living properties, particularly in developed countries (see Figure 5). Meanwhile, the average cost to develop senior housing has increased by 17.8% since 2020.

Senior living is a relatively fragmented sector with high barriers to entry. We see opportunities to capture growing demand for high-quality properties—from senior apartments to higher acuity needs—by renovating assets. For example, Australia presents a very compelling opportunity, with 17% of Australians age 65 and over. That share is expected to reach 20% over the next 10 years, with less than 1,000 new units being delivered each year.[10]

Consumer Trends in Hospitality, Entertainment and Logistics

For the last several years, certain trends in consumer behavior have accelerated, creating a "New Normal."

These include a growing desire for experiences over more traditional goods as lifestyle changes like work-life flexibility have become more prevalent.

The pandemic also accelerated the shift toward e-commerce and online shopping that was already underway. These trends have had a significant impact on the use and growth prospects of real estate assets such as hospitality, entertainment and logistics.

Hospitality

Hotel demand has experienced a rapid recovery from pandemic lows. Moreover, supply is at record lows relative to the past 20 years due to the higher cost of land, rising construction costs and labor shortages.

As many workers are now able to work remotely (see Figure 6), they are traveling more and staying at hotels for longer. In particular, Millennials are showing an increasing propensity to spend on high-quality experiences—which we expect to support leisure demand for decades.

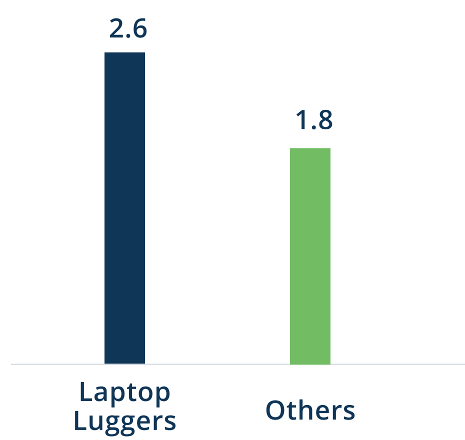
In the U.S., resort hotels have seen 2022 revenue per available room (RevPAR) rise to 20% above pre-pandemic levels. And while recovery in group and urban travel has lagged relative to resort and transient, RevPAR in these segments has now recovered to pre-pandemic levels as well.[11]

Europe is experiencing a similar recovery in which tourism and leisure demand remains resilient—especially at the higher end luxury class, where 2022 RevPAR was 17% above 2019 levels.[12] In addition, new supply under construction in Europe represents a small share of total existing stock, particularly in Southern European leisure destinations such as Spain and Italy (see Figure 7).

In India, luxury hotels have performed well due to strong domestic travel. We expect this positive trend to continue as international travel resumes and demand continues for assets with amenities focused on health and well-being. For example, across Brookfield-owned hotels in India, revenue has surpassed pre-pandemic levels.

FIGURE 6

Average Number of Trips



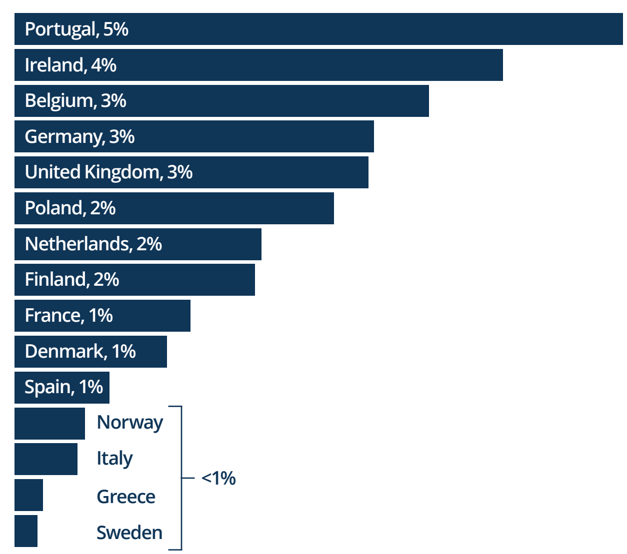
On average, laptop luggers are **adding over a week (eight days) to their travels** due to the ability to work remotely.

Source: 2022 Deloitte Holiday Travel Survey
Note: Laptop luggers are those who plan to work during their longest trip of the season.

FIGURE 7

Rooms Under Construction Vs. Total Stock (Q4 2022)

% of # Rooms



Source: Lodging Econometrics, STR, MKG, Green Street

In the current inflationary environment, experienced owner-operators with a proactive and hands-on management approach are better positioned to react quickly to re-price rates and recalibrate costs to improve profitability.

As the hospitality sector continues to recover, we expect operating complexity, higher debt service, and the capital-intensive nature of hotels to create motivated sellers. We see opportunities to target undermanaged and undercapitalized assets and platforms with exposure to markets with increasing demand.

Entertainment

As younger generations become the dominant global consumers, they are also spending more on various forms of media. This is creating more demand for properties like performance venues and soundstages where content creators and global media companies create new video and musical content.

Historically, much of the demand has had to rely on converted properties due to a lack of supply. But purpose-built stages have the infrastructure to support the technological needs of modern high-budget productions, including virtual soundstages and high power and data capacity.

Further, we see opportunities to use these entertainment demand sources to establish vibrant, mixed-use communities that can take advantage of housing and commercial uses.

Logistics

The pandemic accelerated e-commerce and online shopping and the need for more logistics warehouse space. Every sale that happens online requires three times more warehouse space than in-store sales,[13] spurring growing tenant demand. As a result, in 2021 and 2022, we saw unprecedented absorption driven by e-commerce growth as customers rapidly shifted their shopping habits online.

This in turn has continued to drive rents. For example, rent growth in the U.S. and Australia was up 19% and 16%, respectively, year-over-year.[14] And while we do not expect to see the same level of absorption going forward, we do expect continued strong demand for high-quality, modern logistics facilities as companies continue to optimize their supply chains and meet consumer needs.

Looking into 2023, we may see a rise in vacancies and a slowdown in absorption. However, vacancy in select regions is still at record lows and construction starts are slowing, which we expect will keep vacancy low in the coming years (see Figure 8).

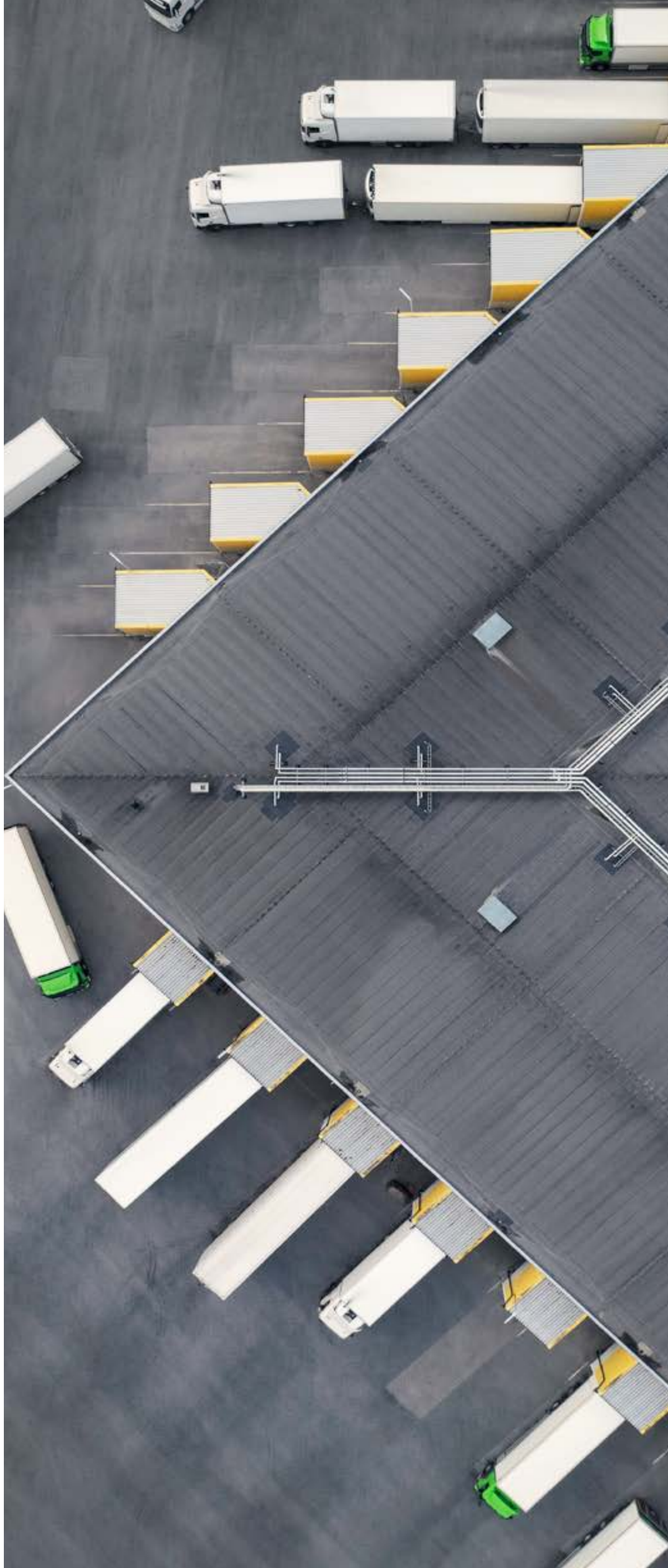
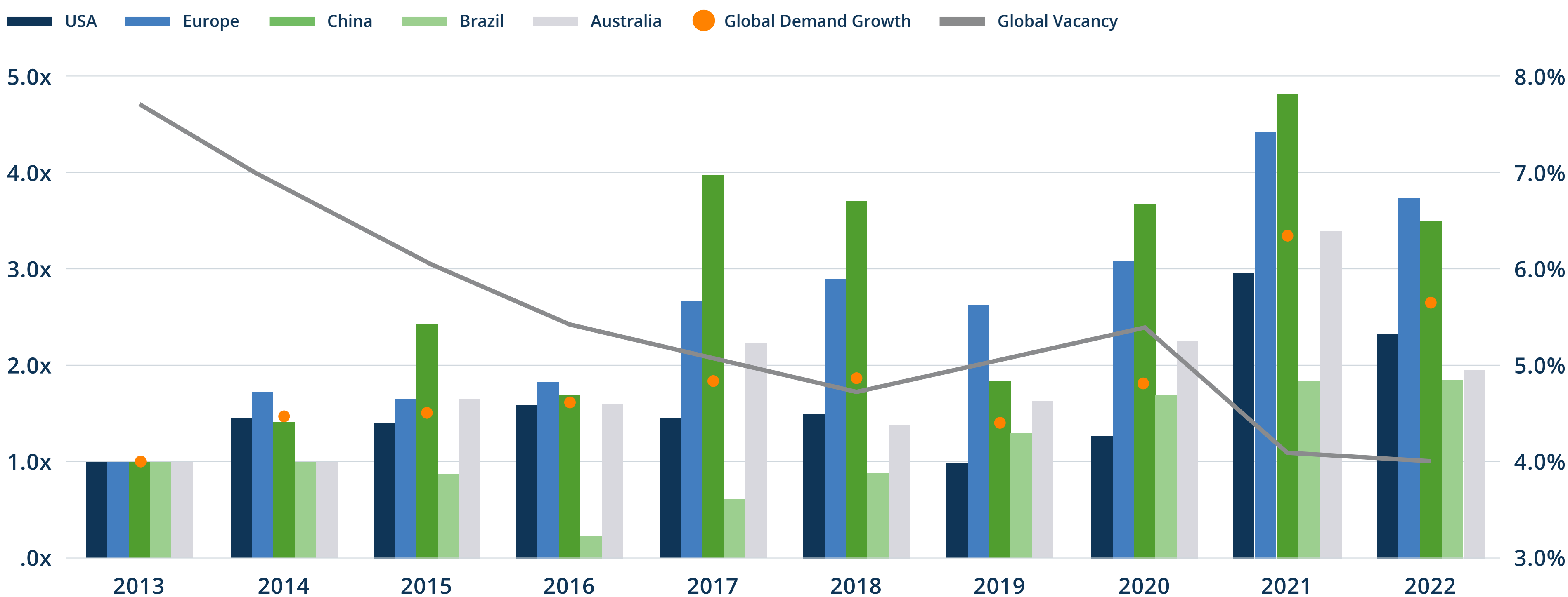


FIGURE 8

Vacancy Is at Record Lows

Global Logistics Demand Growth & Supply



Source: Brookfield, CoStar (US), CBRE ERIX (EU), CBRE & Colliers (CN), Buildings (BR), CBRE & Jll (AU) as of 4Q22

In Brazil, we see favorable supply and demand dynamics as e-commerce penetration continues to rise. In Australia, increased e-commerce adoption and limited supply of quality logistics centers have commanded one of the lowest vacancies globally. And in China, modern warehouse space per capita is a fraction of that in developed countries.[15]

Deglobalization Opportunities in Science & Innovation and Logistics

Before the pandemic, companies focused on maximizing efficiency in their supply chains by holding less inventory and manufacturing in low-cost offshore locales.

But the pandemic pushed complex global supply chains to their breaking point, causing price spikes and shortages of many of the goods people rely on. Deglobalization has also become a necessity for national security reasons, particularly in critical industries, such as semiconductors and pharmaceuticals, that have been bolstered by industrial policies.

As a result, companies—and countries—are now focusing on securing their supply chains, adding inventory, and onshoring or near-shoring manufacturing. We believe that this will drive a tremendous amount of demand for logistics and advanced manufacturing real estate assets.

Science & Innovation

The pandemic made it clear to governments that their countries need to be able to perform research and development (R&D) and biomanufacturing onshore to support continued innovation and access to critical healthcare inputs.[16] Separately, private companies with complex global supply chains have realized that in periods of stress, they need to have those critical functions housed domestically.

For example, the U.S. government, through the President's Council on Science & Technology, has determined that a lack of domestic biomanufacturing is a national security risk—and that the current supply of manufacturing facilities is inadequate. We expect that most companies will want to onshore components of their supply chain—in fact, surveys show that about 85% of biomanufacturers are working on addressing this need.[17]

So now both governments and private companies are putting tremendous amounts of funding behind these capabilities. In the U.S., annual funding by the National Institute of Health has increased by 5.8% annually from 2013 to 2023. The U.S. government has also allocated nearly $50 billion of funding to support R&D in 2023 alone.[18] Additionally, major U.S. life science companies secured $36 billion of venture capital funding in 2022.[19]

We're seeing similar initiatives across the U.K., Europe's most established science and innovation market, as well as an increased emphasis on these issues across continental Europe. The U.K. government, for example, is targeting an investment of nearly 2.5% of U.K. GDP into R&D by 2027. And in France, the government is implementing a €7.5 billion Health Innovation Plan to support the acceleration of healthcare research initiatives and advancements.[20]

Scientific advancements are further backed by governments providing accelerated approval programs and designations. For example, approximately 3,000 active cell and gene therapy (CGT) clinical trials are underway globally. While CGT is still in the early stages of R&D, we expect mRNA-based vaccines and the adoption of new drugs to continue to drive R&D budgets and fund innovation.[21] In China, the number of new drugs approved by the National Medical Products Administration has grown by a compound annual growth rate of 43% from 2016 through 2021, further strengthening demand for science-ready sites and lab space.[22]

The U.S. government has also allocated nearly $50 billion of funding to support R&D in 2023 alone[18]

Both public and private industries need infrastructure to create science and innovation assets onshore, including research facilities where new medical therapies are discovered and created, manufacturing facilities where scientists then commercialize and make such therapies ready for sale, and facilities for general scientific endeavors, including space exploration and clean energy research.

Meanwhile, the fundamentals of science and innovation real estate are robust across several markets. In the U.S., the major markets are Boston and San Francisco, where we've seen vacancy at less than 5% and rent growth between 5% and 10% per year over the last few years (see Figure 9).

For companies to meet growing demand, they will need to invest heavily in their infrastructure and R&D capabilities. This means that the real estate market will need to provide more science-ready sites with premier facilities, co-working spaces and business support. As a result, new development has increased, driving a flight-to-quality trend. We believe that tenants will prioritize purpose-built space.

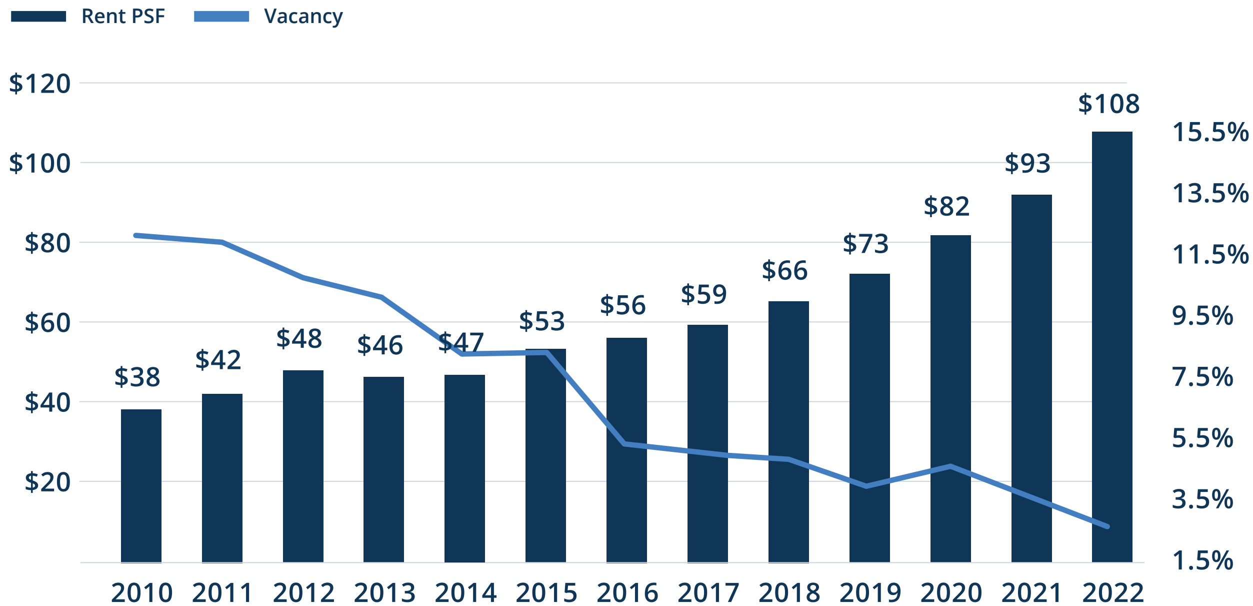
Logistics

Manufacturers are shifting from just-in-time inventory management to just-in-case to secure and optimize their supply chains. We expect that the increase in domestic manufacturing will drive demand for well-located logistics space. Supply-constrained markets near major transportation and distribution centers and/or large population hubs are poised for continued growth in major markets around the world. In the U.S. and Europe, we expect onshoring and supply chain optimization to drive demand in already supply-constrained locations.[23]

FIGURE 9

Fundamentals Are Strong in the Greater Boston and San Francisco Bay Areas

Weighted Average Rent and Vacancy



Source: JLL Research, October 2022. Chart represents weighted average rent and vacancy for Boston and SF peninsula (~50% of U.S. stock)

A Time to Buy

When investors feel that market conditions are benign, optimism rides high and value can be hard to find. But when psychology swings in the opposite direction, it is reasonable to believe that bargain hunters and providers of capital who invest behind long-term demand drivers will be at an advantage and will have opportunities for better returns.

While some investors may be hesitant to invest in real estate in today's environment, our experience shows us that uncertain markets—and those investors who remain nimble and ready to provide capital—often generate the most attractive returns. We believe that cycle is happening now. Real estate fundamentals for high-quality assets in markets around the world remain healthy. And while macroeconomic forces are uncontrollable, focusing on what you can control—a low acquisition basis, active asset management and operational enhancements—can help drive great outcomes.

The objective is to invest in strong assets and portfolios that can not only survive—but outperform—in all business cycles. We believe there will be a short window of opportunity to acquire attractive investments at a value basis, and investors need to be agile and ready to deploy.

Disclosures & Endnotes

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Investors should consult with their advisors prior to making an investment in any fund or program, including a Brookfield-sponsored fund or program.

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