Finding Opportunities in Real Estate

Times of crisis reveal new opportunities. The pandemic, high inflation and changing consumer habits have shifted the real estate landscape.

Few sectors received as much attention as real estate during the pandemic. The stark changes—empty malls, offices and hotels—stirred panic in some. But Robert Merck, global head of real estate and agricultural finance at MetLife Investment Management (MIM), which manages $110 billion in private real estate assets, took things in stride and saw opportunities amid the crisis.

"Although the pandemic was definitely different, I'd say how we navigated it was similar to other downturns," he says.

Dealing with the impact of the pandemic required the same process of analysis and decision-making as other crises, Merck says. It's important to have that process in place to manage existing investments and identify new opportunities. After a tumultuous couple of years, the dust is starting to settle, revealing a changed real estate landscape.

"Many institutional investors are only targeting one or two property types, and that's a fairly significant difference from how capital markets worked before the pandemic." — Will Pattison, Head of Real Estate Research and Strategy, MetLife Investment Management

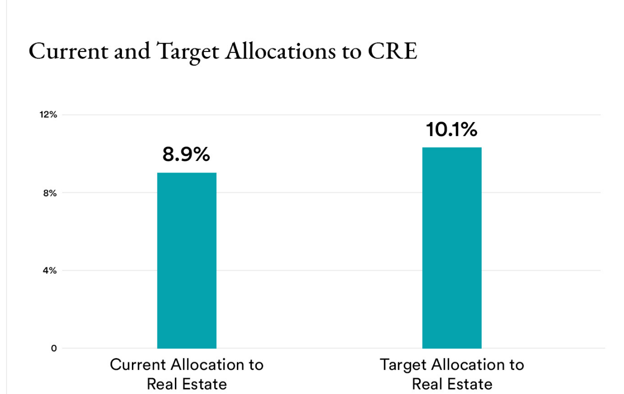
"There was a strong bifurcation in performance between property types, and that's something that never happened during prior downturns," says Will Pattison, head of real estate research and strategy at MIM. Rapid e-commerce growth drove increased demand for warehouses, while offices, malls and retail spaces saw a precipitous drop in demand.

That's created changed investing patterns. In the past, real estate investors might focus on several property types. "Many institutional investors today are only targeting one or two property types, and that's a fairly significant difference from how capital markets worked before the pandemic," Pattison says.

Hedge against inflation

Inflation has been top of mind for many investors, and that could be beneficial for real estate. Commercial real estate historically outperforms other sectors during inflationary periods. With inflation currently at a 40-year high of 8.5%, real estate is in an unusually attractive position, which MIM expects will draw more inflows into the sector.

"Insurance companies usually focus on fixed income investments, but I think you'll see more of the insurance companies investing in direct real estate



Source: PREA Investor Intentions Survey. January 2022.
Based on global investment managers/strategies.

through acquisitions and development. More capital will come into the sector from the insurance side because of the recently lowered capital charges," Merck says. Insurance regulators recently lowered the amount of capital that insurers are required to hold for real estate investments. The change effectively increases the pool of capital that insurance companies can invest into the sector.

A focus on apartments and warehouses

One of the best inflation hedges in real estate is apartments. Apartments typically have short-term leases, which are ideal during inflationary times because owners can easily adjust to the short-term impact of inflation by resetting the lease. MIM estimates that apartment rents will increase an average of 3.2% a year through the current decade. Migration out of certain metropolitan areas—such as from New York to Florida—accelerated during the pandemic and will impact supply and demand and housing prices in various markets.

Another sector to watch is warehouses, which are benefiting from enormous e-commerce growth. "I don't think the market fully understands that online order delivery speeds have been at least as important as the total number of goods being purchased online," Pattison says.

A few years ago, order fulfillment might take seven days. Today, it's closer to one or two days—or even a few hours in some markets. That faster fulfillment means e-commerce companies can no longer rely on a handful of supersized regional warehouses. Instead, there's a need for smaller warehouses located in all major cities. These infill warehouses, or last-mile delivery centers, range from 50,000 to 200,000 square feet, compared to regional or super regional warehouses that are often a million square feet.

Shifting habits: office space and retail

The abrupt shift to remote work during the pandemic and the increasing popularity of hybrid work led to uncertainty about the future of the office. But Merck says these reports overstate the matter. Remote working has diminished demand in the short term, but MIM does not expect significant long-term impact. If anything, the pandemic reversed a long-standing trend toward shrinking square footage per person. Offices are getting bigger, even as fewer people go in.

"People want a little bit more space. They don't want to share space or use hoteling to reserve a desk. I think COVID helped solidify that," Merck says.

Longer term, Merck doesn't see a significant impact from the growing acceptance of hybrid work. MIM estimates that 9% of the traditional office-using employment sectors will become fully remote, up from about 5% before the pandemic. But lessening demand for office space will be partially offset by a slowdown in new office construction. As a result, office leases today in most markets are being signed at pre-pandemic prices. While companies with offices in markets such as New York or San Francisco, which rely heavily on public transit, are more likely to downsize in the near term, MIM believes the impact will be temporary. Not only that, but some of the markets seeing the worst short-term impact may also see the strongest demand over the next decade.

Another real estate sector that saw many vacancies in the last two years was retail, which struggled even before the pandemic due to e-commerce growth and overbuilding. The pandemic accelerated the closing of retail centers that likely would have closed anyway. Of course, not all properties are the same. Merck says there's been a flight to quality, with higher-end malls with strong sales per square foot bouncing back. "We're starting to see that play out in a positive way," Merck says.

In any time of crisis, new opportunities appear. "Real estate has made a really good comeback, both in 2021 and especially this year," Merck says. The last two years were tumultuous for some parts of real estate, but buoyed by high inflation and rising consumer demand, overall the sector's outlook is bright.

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