VIAONE

2022 Q1 INVESTOR | DEVELOPER TRENDS & FORECAST REPORT

"Geoeconomics and inflation are the most significant economic risks for private commercial real estate investing that will impact or in some cases compromise other investment trends in 2022. Ranging from the course of interest rates and construction cost fluctuation to multifamily valuation and appreciation movements."

Marc A. Bonilla, President & CEO
VIAONE Commercial Real Estate Group

As the pandemic moves past the two-year mark, the U.S. economy has experienced a solid recovery, with strong GDP growth and unemployment moving back to prepandemic levels. Commercial real estate investors and developers are navigating a complex landscape where demand and capital are plentiful but inflation is rising and the prospects of higher interest rates are creating tangible threats to the near-term outlook. These economic headwinds are arriving at a time of robust growth in some sectors (multifamily and industrial) and continued recovery in others (office, retail, and hospitality).

This report expresses executive level sentiments and data analytics about the commercial real estate and development sectors and the prospects for continuing a solid growth trajectory. Investors on a global scale view commercial assets as a safe haven that translates to higher yields and a hedge against inflation. While the outlook on commercial real estate investment is strong to bullish, there is growing uncertainty about how the current market factors will impact investment decisions and financial performance.

This report was conducted pulling from data through a time when optimism about the market was beginning to be impacted by the rapid spread of omicron and the rise in inflation. These elements served to temper a very bullish sentiment as 2022 began, however the data collection and its interpretation do strongly indicate a continued increase in investment activity through the year.

Research from Real Capital Analytics shows the U.S. commercial property market closing out 2021 with record activity, including more than $300 billion in sales across all asset classes during the fourth quarter alone. There also is significant capital allocated to commercial real estate and limited availability of assets in some sectors, putting upward pressure on pricing and fueling demand for new construction.

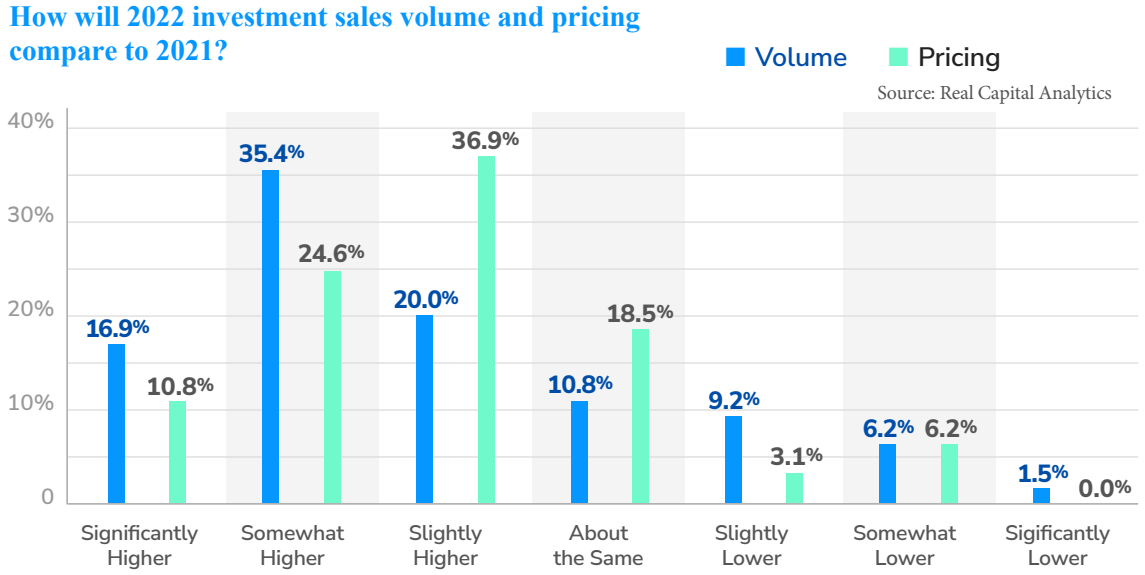
Investors are facing a landscape where strong consumer demand is dampened by significant issues such as supply chain backlogs, the impact of ongoing Covid-19 health protocols, and labor shortages. While rising inflation is not putting the brakes on investment activity, it is prompting some investors to reexamine projections and revise expectations for profitability.

Key Findings of the 2022 Q1 VIAONE Investor Sentiment Report

- Inflation, construction costs and rising interest rates are the biggest threats and are causing investors to revise profit expectations
- Multifamily and industrial assets ranked as top choices, with retail as the least favored
- The office sector continues to struggle with vacancy; suburban assets are preferred
- Population growth and household formation are top drivers of investment hot spots
- 72% of respondents expect commercial property investment to exceed 2021 levels

"Today's capital markets climate may be one of the most dynamic and intricate we have seen in many years. Investors are navigating a complex environment with significant opportunities as well as economic headwinds that are prescribing a more nuanced approach. Expect to see subtle shifts in investment approaches and strategies as a result."

2022 OUTLOOK: RISING INFLATION PUSHES AGAINST STRONG OUTLOOK



As investors look out over the next 12 to 18 month horizon, they are balancing strong investor sentiment, growing capital allocations, and many positive market indicators against a complicated set of economic issues. The multifamily and industrial sectors have seen record activity over the past several years, as shifts in population trends and housing formation, along with the meteoric rise in on-line shopping have shaped leasing, construction and investment sales activity. The office, retail and hospitality sectors are improving but the recovery has been disproportionate, with suburban office, experiential retail in lifestyle centers and "close-in" destination hospitality faring the best.

According to Real Capital Analytics, 2021 sales volume for multifamily ($326.8 billion), industrial ($167.9 billion) and suburban office ($96.2 billion) reached record levels. Retail and hotel assets lagged behind, although investors continue to focus on well-located assets supported by strong demographic and market fundamentals.

GEO-POLITICAL TURMOIL

The invasion of Ukraine by Russia has added another layer of uncertainty that is likely to impact capital markets activity, but not in a uniform way. A lot depends on the length of the geopolitical turbulence. Some players may adopt a wait-and-see policy or pull out of the market completely, which reduces demand-side competition and could lead to somewhat softer pricing. On the other hand, alternative institutional investments are likely to underperform as a result of such turbulence, which could end up boding well for an influx of new real estate capital seeking more attractive return profiles.

RISING INFLATION PUSHES AGAINST STRONG OUTLOOK

A surge in consumer demand was a welcome sight in mid-2021 and a clear sign that the market was beginning to return to business activity after the strict COVID-19 health protocols that kept office, retail and hospitality markets in limbo. One of the market's greatest challenges now, however, is that the strong demand and limited supply have fueled a more inflationary environment, characterized by pervasive shortages of products, materials and labor. Inflation has risen from 2.6% in March of 2021 to around 5.4% from June through September of 2021 to 7.5% at the end of January 2022.

The data reflects a pattern of concerns of various current-market indicators: interest rates, rising construction costs, inflation and supply chain disruption. However, very evident is an industry-wide investment and sales volume sentiment reflecting strong optimism that both levels would increase in 2022. Key indicators strongly suggest significant increase in sales volume and pricing profiles.

" One of the primary reasons 2021 investment activity was so robust is because there was money coming in from outside sectors as investors focused on commercial real estate as a safe or relatively safe haven, as the economy moved into an inflationary period."

With higher inflation and interest rate increases come concerns about the impact on asset pricing, construction costs, and myriad other factors that influence capital markets activity. These economic dynamics will likely affect the many juncture points where investors access capital. What inflation does in 2022, and the expectations for it beyond that, will have a tremendous impact on activity for the year ahead.

2022 Market Predictions:

- **Dow 8 to 10%**
- **10-year Treasury 2.5% to 2.6% by year-end**
- **Interest rates .25 x3 (.75 bps)**
- **GDP growth 4.5% in 2022 and 2023**

MULTIFAMILY INVESTMENT IS STILL BOOMING

The multifamily sector is heading toward Q2 of 2022 with significant tailwinds given the continued shifts in housing formation and strong demand for rental properties, along with the shortfall in housing production. Following several years of robust multifamily investment sales, activity in 2021 reached $326.8 billion, just slightly lower than the volume for 2019 and 2020 combined ($337.2 billion), according to Real Capital Analytics. Multifamily sales volume accounted for nearly half of the $300 billion sold across all asset classes in the fourth quarter of 2021.

The housing environment is a perfect world for homebuilders and multifamily property owners. Homebuilders are building to a higher price point and creating a greater delta between the pricing of single-family homes and apartment rents. This creates challenges for home buyers, and an ideal scenario for apartment owners to increase rents.

INVESTORS ADJUSTING EXPECTATIONS

Investors are predicting a solid 2022 for multifamily investment, but one that might include lower profit margins than 2021. As higher interest rates put upward pressure on borrowing rates and cap rates, earnings will be impacted. This is not the end of what has been a very strong multifamily market. Appreciation and multiples have been strong for so long that a modest reduction has been inevitable.

Higher inflation, rising interest rates and supply chain disruption headwinds that threaten to slow other market sectors are prompting some investors to adjust expectations for multifamily. The prospect of inflation and the mark-to-market capabilities of the sector suggest rents will continue to rise as higher wages provide workers with additional spending power. Also, remote and hybrid office trends support the need for larger and better accommodations, which is moving multifamily activity from urban developments into suburban markets, particularly in the Southeast, Southwest and other high population growth regions.

DEMAND FUELING MORE GROUND-UP CONSTRUCTION

Given the constrained supply and strong demand, ground-up construction is expected to increase in 2022. Fundamentals provide a favorable debt and equity climate which translates to significant capital in search of investment opportunities.

Many investors who have focused on value-add assets see continued opportunities and the need to adjust the approach. Historically, muti-family investors focusing on basic unit interior renovations to drive value has consistently yielded double digit returns, but today many assets have been through partial renovations having been traded multiple times over the last 10-15 years. Now, investors have to touch every aspect of the asset to generate value while leveling up amenity profiles renters expect in today's environment.

" Ground-up development could index 10% to 30% above replacement cost while value-add is trading at or just above replacement cost. As an investment option ground-up construction is here to stay, until rising land and construction costs thin margins to the extent a shift back to value-add strategies balance return profiles."

WORK FROM ANYWHERE MARKETS IN FAVOR

Among the top five markets for multifamily investment in 2022 are Raleigh-Durham, Atlanta, Austin, Seattle and Orlando, according to a Best Places to Invest Report. The data evaluated variables such as local demand drivers (job and wage growth), consumer confidence and the expense of single-family homeownership that influence continuing population growth. The data notes that the top cities tend to have major research universities, thriving tech/innovation sectors and unique cultural assets that make them attractive “work from anywhere” markets.

" Today, elements of a value-add programing likely include enhancing residents’ experience, technology updates, comprehensive unit interior upgrades and driving on-line awareness and reputation."

INDUSTRIAL SURGING DEMAND WITH NO END IN SIGHT

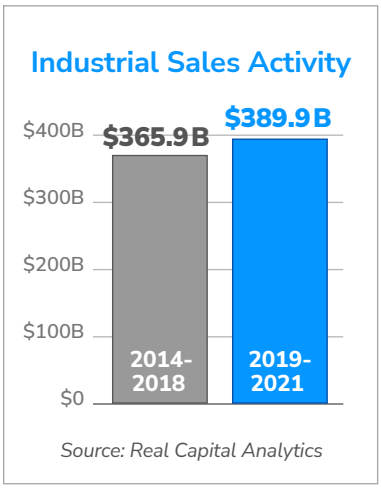
The transformative impact of e-commerce, and its strong performance during the pandemic, continue to drive leasing, investment and capital markets activity across the U.S. As population growth pushes outward from core markets into secondary markets, the industrial tentacles continue to expand, ensuring that consumers at every juncture can benefit from same day, second day and even one-hour deliveries.

This industrial expansion has created a frenzy among investors and developers as they look to secure strategic locations in the path of further expansion. Global investors have also moved into the sector in force, assembling large portfolios of warehouse, distribution and fulfillment properties across multiple markets to quickly scale up and gain a footing in this sector.

Industrial sales reached $389.9 billion between 2019 and 2021, an amount that exceeded the cumulative total for 2014 through 2018 by more than $24 billion, according to Real Capital Analytics. Sales volume in 2021 exceeded $100 billion for the third consecutive year, reaching a record $167 billion.

The industrial market experienced a dominant year in 2021 and is representative of the upward trajectory in the K-curve which illustrates that conditions and outcomes are good for some, but not necessarily for all.

"Expect 2022 to be more of the same. We will likely see more of the same through 2023 and 2024."



The sector relishes industrial assets as a consistent front-of-the-line asset class for investment dollars from domestic and global sources. Much of that capital brings with it a level of sophistication and technological innovation that benefits everyone. Technology sophistication, including automation and detailed order tracking, is present for most of the biggest users: Walmart, Costco, Target and Amazon, among others. It is a natural evolution of any company with a supply chain and the need for faster deliveries with a greater level of certainty.

INDUSTRIAL SURGING DEMAND WITH NO END IN SIGHT

In spite of the tremendous performance of the industrial market through the pandemic and going back even further, there are certain caveats to the outlook. Inflation will impact a developer or investor's buying power, for example. Commodity material prices are increasing due to supply and demand issues. Slower delivery times are extending the cycles of planning, development and construction. Some materials face severe shortages, which will have an impact on deliveries.

We may see an interim decline in new construction deliveries in the second half of the year, due to a shortage of materials, or the delay in getting them to the job site. Strong demand and less supply being delivered means that if you need to occupy space at the end of 2022 you may be slugging it out for the best available options. Demand for space is uninterrupted; delivery and occupancy are simply being delayed.

Notable shortage of readily developable "speed-to-market" land sites, specifically for industrial property, from coast to coast. The combination of land shortages in key markets across the U.S., coupled with changing dynamics in suburban office markets is creating unique opportunities for developers to acquire underutilized corporate campuses and reposition them for high end industrial use and last mile facilities.

" With all of this growth and optimism, comes the reality that higher inflation is more than transitory."

It is real and companies are all experiencing it. It is a matter of how long companies can continue to pass costs through and how long can users pass through to their clients. The concern is "how long can these pass throughs continue". In addition to the cost of capital; thus, exit cap rates likely to rise with predicted interest rate hikes.

OFFICE WORK-FROM-HOME & SUBURBAN GROWTH TRENDS

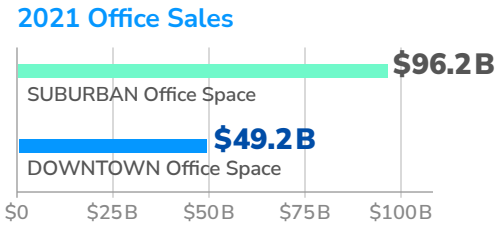
The office sector may be the most challenging sector to accurately forecast. It historically has been the epicenter of company culture, innovation, mentoring and collaboration. For nearly two years, pandemic-related closures have fueled a strong work from home momentum that is continuing to dampen the outlook for leasing, construction and investment despite signs of improving conditions.

The challenges facing the office sector are underscored by the sector-level breakdown Commercial Property Price Index (CCPI). While the overall CPPI increased 24% over the last 12 months, ending December 2021, the office sector's increase was the lowest at 6%. Further, based on pre-COVID-19 numbers, the CPPI for office showed a 4% decline—the greatest decline of all sectors.

For many investors, the key question is what happens moving forward after COVID-19 restrictions have been lifted, and companies are reassessing and implementing new workplace solutions. Will building owners be successful in enticing workers to leave the smaller, cost-friendly population centers they flocked to during the pandemic and return to Manhattan, San Francisco or Chicago? Or will employers be forced to adapt to appease employees and offer options in newer growth markets?

The bright spot for the office sector during the pandemic has been the growth in select suburban markets. This trend reflects the recent migration away from dense, city core-assets and toward locations close to suburban-assets closer to employees. For the second year in a row, the sale of suburban office buildings far outpaced, by a margin of nearly two to one, downtown office sales. In 2021 suburban office sales totaled $96.2 billion versus $49.2 billion for downtown assets, according to research by Real Capital Analytics.

" This growing demand for suburban office investments is being seen across many occupier categories, as labor dynamics have shifted to work-from-home models. As the workforce favors residential options in the suburbs, companies are moving the jobs closer to the potential employee base rather than expecting employees to come to the jobs. This trend is drawing more investors to well-located suburban assets."



Source: Real Capital Analytics

CORE ASSETS STILL A DRAW FOR OCCUPIERS

Many investors and developers who traditionally focused on core assets are staying the course as they look long-term at how market, employment and economic dynamics are shaping office occupier strategies. Several large institutional buyers remain bullish on core office focusing on well-located assets in gateway and supply-constrained markets. Some large-cap firms are even active outside of core markets, developing and investing in secondary growth markets such as Phoenix, Atlanta, Austin, Dallas, Denver, Minneapolis, and Salt Lake City.

Despite the sector challenges and uncertainties, some of the larger players are positive playing the long-game. An outlook that is shaped by realistic assessments of the opportunities and challenges afforded by patient capital. Companies are programming internal protocols so employees can safely return to the office. Virtually everyone agrees that firms are more efficient when people are working in collaborative environments spending time together.

The 2022 outlook underpins the importance of analyzing detailed market data and hyper-local expertise when evaluating office locations. Rather than selecting a large metro based on historical performance, investors are trying to accurately pinpoint which submarkets in a respective city that provides the best fit. Small differences in dynamics from one submarket to the next can have a significant long-term impact on asset value.

> Many companies are still wrestling with COVID uncertainty and debating tough questions about when to mandate employees return to the office and what healthcare protocols to have in place. No one has all the answers, and companies need to figure what the best path back to normalcy—whatever that may look like. The CDC has begun lifting guidelines and firms are instituting plans to get their people back working in dynamic environments figuring it out along the way.

RETAIL AND HOSPITALITY CONTINUE TO BATTLE BACK

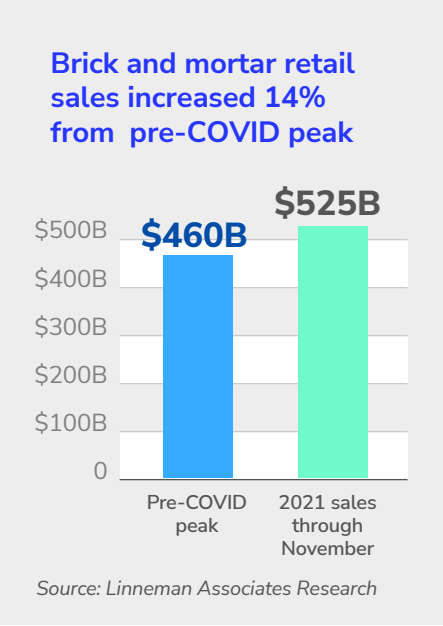
Retail has been one of the most tarnished sectors of commercial real estate for more than a decade, but rumors of its demise have been grossly over exaggerated. Retail is one of the sectors that has actually exceeded expectations from 18 months ago. While different markets face different realities, retail is generally seen as emerging stronger than expected. Necessity-based and grocery-anchored retail properties have performed very well, along with drive-thru restaurants leading the way, implementing a customer-driven trend model while creating value through lower-costs of operation. With third-party delivery services like DoorDash and Uber Eats become part of the reprogrammed retail drive-thru business model.

Through November 2021, brick and mortar retail sales totaled $525 billion, a 14% increase from the pre-COVID peak of $460 billion. As more, in the third quarter of 2021, e-commerce sales were a more typical 13% of sales rather than the 20% level achieved at the height of the pandemic. Many market observers see those spending trends continuing.

At the same time, older centers and fringe retailers have been increasingly challenged. Most concepts that went out of business during the pandemic were on watch lists already at death's door.

The notion that retail assets require a disproportionate amount of work, attention and risk compared to other asset classes, has been debunked. The result, by contrast, is a sector shaped by stronger retailers and centers that can endure the competitive forces at work while highlighting the downside of older disorganized, obsolescent retail assets.

Important to note: different markets face different realities and operating climates. As such, Arizona is a very different marketplace than Chicago, just as markets throughout Florida are very different than New York or the Bay Area. Retailers should pay attention to hyper-local market data on consumer buying trends, population growth and other factors as they craft their operational strategies.



LIMITED-SERVICE HOSPITALITY DRAWS ATTENTION

The hospitality industry battled back in 2021, trying to reverse the impact of changing travel patterns during the pandemic and investor interest in limited versus full-service hotels. Travel patterns reached their peak during the week between Christmas 2021 and New Years' 2022 when hotel demand was the highest ever recorded, according to a report from Hospitality Advisors.

Limited-service hotels, especially those in drivable vacation destinations, have bounced back well. Occupancies have increased, Average Daily Room Rates are above 2019 levels, and REV PAR is equal to or greater than two years ago, which was a record year. Major hotels, like those located in major urban cores like New York, San Francisco and Chicago, as well as those relying very heavily on conferences and conventions, are significantly more challenged.

Investor acquisitions in the U.S. in 2021 totaled approximately $47 billion, the highest level since 2015 when $51 billion in sales occurred. Those results were driven by limited-service sales activity which reached its highest level ever, $23.8 billion, and surpassed the sales for full-service hotels, $23.1 billion. Investor sentiment continues, at least for now, to suggest that some of the greatest opportunities moving forward include limited-service hotels.

Despite all the positives, the hospitality industry still faces questions and uncertainty. Most notably issues related to business and convention travel. Major conferences and trade show are continuing to delay a return to annual events which are the core of profitability for hotels and convention centers across the country.

Experts suggest that labor concerns may provide further complications even when those bookings come back. The labor shortage is our greatest challenge. It is why restaurants close early, retailers don't have people on the floor and why businesses are forced to operate at a slower pace.

DISTRESSED ASSETS WAITING FOR THE SHOE TO DROP

The impact of distressed real estate assets during the pandemic has been something of an enigma. No one questions the presence of distress in the market, however; it is yet to reach overwhelming levels.

There could be trouble surfacing from the shadows as market indicators shift. According to distressed asset authorities, the inevitable of the distressed asset pool has only been delayed. Although a potential tsunami of distressed property has not yet materialized, in part due to forbearance and foreclosure actions were deferred—those days may be over.

" With much of the data collected, clearly evident, are precursors of future activity, which indicates that we could see an increase in distressed property sales and auctions in 2022. Much of which, however, may be tier 2 supply."

Other findings include:

- Shadow Distress - assets, businesses and investors that have been propped up by relief efforts and/or relaxed regulations—will intensify the pain in 2022.
- Analysis of special servicer activity points to increasing potential distress moving forward, with nearly half to occur into 2023 and later.
- Today's focus is on office assets as companies plot the potential land mines of the post-pandemic work environment; some hotel and retail properties remain tenuous due to unaddressed fundamental issues.
- The marketing of loans/notes is heating up, especially for banks but less for special services whose protocols are more rigid.
- Distressed/opportunistic funds are flush with record levels of cash but short on ideal target opportunities.

TOP MARKETS TO WATCH

While core markets, particularly those with land constrained environments, will always remain a constant destination for investment capital placement, there is a growing movement toward expanding secondary markets that offer a lower cost of living, more housing choices (which is an important consideration during the pandemic) room to spread out. Some corporations have also started relocating to smaller metros, leaving costly, disaster-risk prone California for far less expensive locations such as Arizona, Texas and markets across the Southeast.

Changing tax laws around the country and the reverberation from pandemic closures pushed migration to destinations and markets in the Southeast and Southwest. By all accounts, those population shifts are having a sticky effect, with many residents deciding to stay, given the growing work-from-home momentum and strong employment market.

Among the top growth markets are, as we all know living in the valley, Phoenix (encompassing the entire MSA), multiple cities in Florida (Ft. Lauderdale, Miami, Orlando, Tampa and West Palm Beach) and Texas (Austin, Dallas, Houston, and San Antonio). Other cities to watch for investment growth are Atlanta, Charlotte, Las Vegas, Nashville, Raleigh-Durham and Salt Lake City. Investors are moving capital out of core markets such as New York, Los Angeles and Chicago as a means of diversifying and boosting yield. This capital mobility and portfolio migration is a reflection of investors' focus on adapting to where people see the future of real estate needs. As a result, this level of migration is creating a highly competitive environment pool causing downward pressure on investor return profiles in secondary growth markets.

2021 A TOUGH ACT TO FOLLOW

Commercial Property Price Index (CPPI) increased 24% in 2021 and represented a substantial turnaround from 2020 when the CPPI was negative 8%. Which means that from a pricing perspective, 2021 will be an incredibly tough act to follow.

The 2021 results included a COVID-19 rebound and the realized expectations of improvements in cash flows for specific sectors such as industrial and self-storage, which continued to perform at very high levels. The expectations for cash flow growth in industrial went from strong to very strong for most self-storage product.

Many investors are bullish on self-storage asset performance in 2022, but not like the extraordinary results seen in 2021. Experts are predicting low "double-digit growth" in 2022. That number is still a moving target for this year, however, a 10% growth index in 2022 would be a solid year.

Self-storage experts predict 2022 pricing levels to increase from 2021 levels anywhere from 24.6% to 36.9%. Non-traditional asset sectors may pull performance metrics up. Those sectors include manufactured homes, build-to-rent, single-family rentals, and healthcare facilities. Not the least of which, the life sciences sector—which suggests the emerging asset class moving into 2022 and beyond.

Healthcare and other sectors like retail and certain elements of the hospitality industry must negotiate potential headwinds—inflation, labor costs and labor cost inflation—to avoid lower cash flow expectations.

" The headwinds that will influence commercial real estate investment and development over the next 12 to 24 months are most certainly a moving target. However, today's investors possess a level of sophistication and creativity that will continue to drive investment gains and elevate new sectors and opportunities in 2022, 2023 and beyond."

CONCLUSION

Commercial real estate investors and/or developers are looking ahead with a sense of optimism about market fundamentals, demand drivers and the outlook for investment activity across the various sectors. That positive sentiment, however, is tempered with a dose of reality. After a 10-year growth curve, and all the disruption and resiliency seen throughout the pandemic, strong consumer demand is pushing up the inflation rate and 7 incremental interest rate hikes projected in 2022. Those hikes have been expected for awhile, however, some experts predict a more moderate response to rising rates, compared to an atmosphere where rates were increased unexpectedly.

Those inflationary pressures are prompting many industry experts to closely examine their transaction and construction pipelines and assess their exposure to economic shifts. Some are predicting modest increases in financing costs and material pricing. Also the potential of construction starts and completions decline for a short period, as the economic waves move through the market.

Occupier and investor demand is expected to continue at a healthy clip. Capital allocations will continue to shift into commercial real estate as investors look to buffer against inflation's impact on other investment vehicles.

For all of the challenges the economy faces—inflationary shifts, labor shortages and supply chain disruption—there is great and widespread optimism for what lies ahead for the economy and commercial real estate.

"Most sophisticated investors are optimistic about the economy for not just 2022, but for the next three to five years."

For many, the outlook requires some additional context. That perspective, in part, could influence such beliefs as actions like the Fed increasing interest rates 25 basis points seven times will not have as big an impact on the market as some fear. Particularly in strong fundamental and growth markets—such as Arizona but let's face it I'm biased and spoiled by the Valley.

Reflecting on the way the industry traditionally has responded as markets and conditions evolve, there is no question that the current headwinds we face will influence commercial real estate investment over the next 12 to 24 months. However, today's investors possess a level of sophistication and creativity that will continue to drive investment gains and inovate new sectors and opportunities in 2022, 2023 and beyond.

"Notwithstanding the current-market headwinds, sure to impact the broader CRE markets, investors and developers possess a level of sophistication and creativity that I strongly feel will continue to drive investment performance and elevate new sectors and opportunities well into 2022, 2023 and beyond.

Thank you for reading this 2022 Q1 VIAONE Report and I genuinely welcome your feedback!"

Sincerely,

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