September 2021
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INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

Q&A: AN ECONOMIST'S TAKE ON THE U.S. REAL ESTATE INDUSTRY

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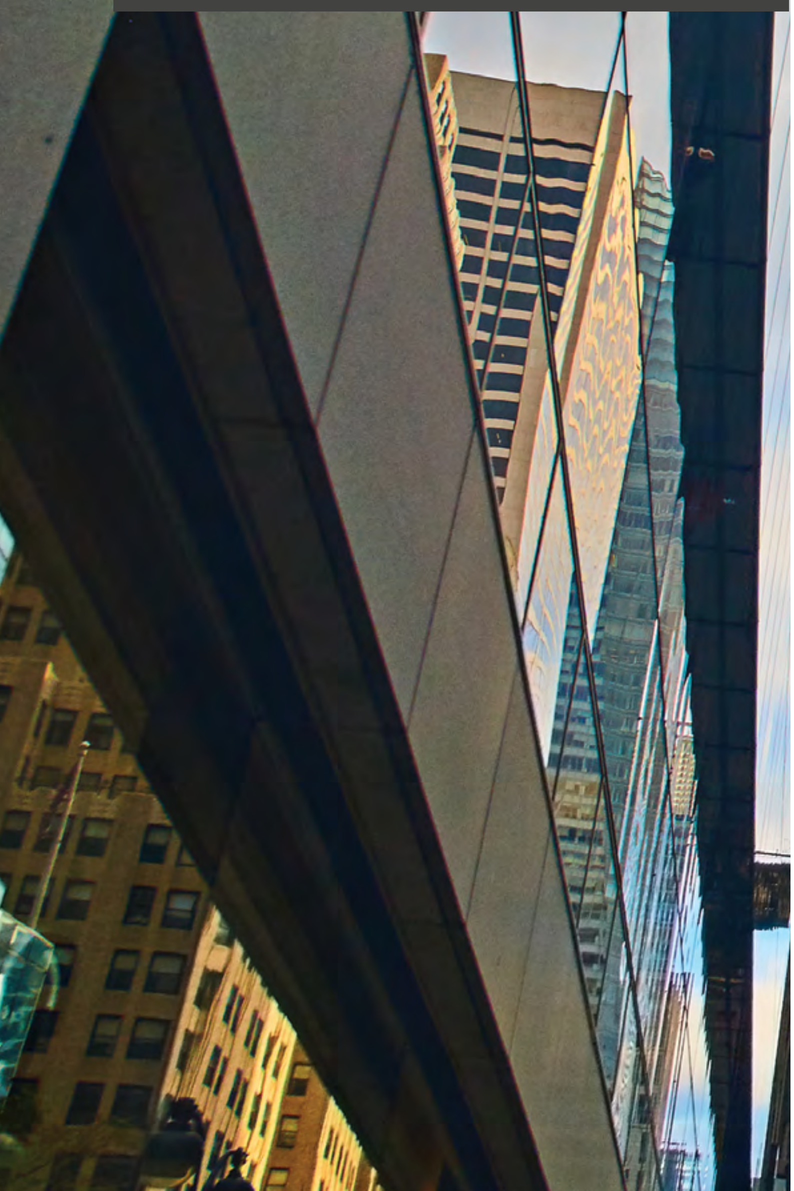
In this Q&A, National Real Estate & Construction Co-Lead Kristi Gibson speaks with Mark about his outlook for the industry.



Kristi: Hi Mark, thanks so much for participating in this Q&A. You joined us for our webcast in June, "**Post-pandemic trends in private equity real estate**," where you talked in part about the recovery trajectories of different sectors of the real estate industry in light of macroeconomic dynamics. We wanted to continue the thread of that conversation here.

First, briefly, can you recap for us where you see the real estate sector today vis a vis the economy?

Mark: Sure, Kristi. Back at the beginning of 2021, I said that the economic recovery would be 100% correlated with the percentage of people who were vaccinated. That is playing out, but the percentage of people who have been vaccinated started to peak at just over half the population, so our economic recovery is peaking, too. With this new delta variant of the virus taking off, the risk is greater that health mandates get put back into place, which will restrict businesses' ability to operate to the fullest of their ability and consequently slow down economic growth. The delta variant is becoming a real drag on the economy and is contributing to inflation fear.

In terms of economic recovery, I've mentioned how we might have two V-shapes and then a jobless recovery. We saw the first V-shape in the spring as vaccination rates increased. But the second leg of the V has been short-circuited by delta. We appear now to be moving into the jobless recovery, where job growth slows substantially.

"When inflation fears run high, global investment demand for real estate intensifies. ... We'll continue to see capital flow into real estate, with more and more institutional funds raising capital to invest in this space."

Kristi: With that in mind, what's the impact on the real estate industry?

Mark: The power of the initial recovery this spring caused a dramatic increase in the Consumer Price Index. CPI inflation is now running about 5% and this has exacerbated latent fears of "runaway inflation." When inflation fears run high, global investment demand for real estate intensifies. That's why we are still seeing cap rate compression and extraordinary price increases in houses. Unless Congress or the Fed does something to dampen inflation concerns, we'll continue to see capital flow into real estate, with more and more institutional funds raising capital to invest in this space.

Kristi: Within real estate, capital is flowing to different sectors. The industrial and residential sectors have truly come out on top of this pandemic, but the response of other sectors is a bit more complex, isn't it?

Mark: Definitely. Retail, for example—and I spoke about this in the webcast, but I'll just summarize quickly here, too—is a mixed bag. Certain retailers are doing really well, and others aren't. A triple net lease on a freestanding building leased out to a major pharmacy chain is gold plated. But a little shopping center two blocks down that used to have a small grocery store, a flower shop and other little stores is a totally different ballgame. But retail is more on the dance floor than it was just 90 days ago. Even if the fundamentals aren't there, when the headlines come out that retail is performing better than expected, that piques investor interest again.

Kristi: The office market is another sector where judgment is being reserved a bit. Can you talk a bit about that?

Mark: Until delta, it appeared that after Labor Day, we would start to get a clearer picture of what stabilized office demand will look like. Now that clarity won't be revealed until next spring. The office market hasn't had price discovery yet, and I don't think we'll see that until we know what stabilized demand looks like. The back-to-office movement has plateaued in tandem with the vaccination rate, and if in the fall public schools are hybrid and parents have to stay home, that'll put a further damper on the office sector.

The real darlings are industrial and multifamily. This has been pretty well covered. What I will say about industrial is that it's the asset class most vulnerable to overbuilding. There's capital available for building and it's a very attractive asset right now in the U.S. It's not overbuilt, but the risk there is higher than with the other asset classes.

Multifamily is my favorite in terms of the supply/demand balance. Investor demand is strong and cap rates are still compressing. Nobody can build class B and C apartments, and some are being torn down and replaced by other land uses, so it's the only asset class that has a negative supply.

The last sector I'll mention is single-family-built-for-rent, which has gained significant momentum in the last few years. There's a housing shortage in every market that is experiencing job growth, and now there are homebuilders who build houses, even entire communities, that can then be bought up by companies that turn around and rent them out. I see a lot of positive momentum—and returns—in this sector.

"Net domestic migration is the metric you want to be watching for when shopping for the right investment opportunity."

Kristi: Let's talk about another big influence: tax reform. Where do you think we will net out, and what do you think the impact on real estate will be?

Mark: Seven months before the tax reform bill was signed into law in 1986, transaction volume dried up. That's going to be the signal for me. As long as transaction volume is holding up, the market is saying it isn't going to happen. But as soon as transaction volume starts to stall, that's the market saying tax reform is coming.

Currently, there is extra selling pressure in the market that wasn't there four or five months ago—some investors are exiting investments now to get out ahead of anticipated tax law changes. If the momentum for tax reform builds, there will be more selling pressure between now and the end of the year. If there were ever going to be any distressed buying opportunities, this is going to be one of them. But for every investor with a distressed asset to sell, there are 100 investors who want to deploy capital, so a huge impact on prices is unlikely.

A slowdown in deal volume will occur if buyers see a greater probability for a tax law change, at which point they'll either lower their bid prices or step to the sidelines until tax reform passes. Sellers are historically slow to respond to lower bid prices, so deal volume could be sluggish for months after tax reform is signed into law. Then, when the first sellers (likely distressed) come back into the market, the bid/ask spread will begin to narrow, and as that happens, deal volume will pick up again and the market will reach a new, lower equilibrium price.

> ***"Work from home is opening up new development opportunities outside the traditional 45-minute commute radius."***

Kristi: How do you see the work-from-home paradigm changing the real estate landscape? I co-authored a piece on **suburban migration** and the impact population migration may have on the industry, so I'm interested in your thoughts as well.

Mark: Net domestic migration is the metric you want to be watching for when shopping for the right investment opportunity. Work from home is opening up new development opportunities outside the traditional 45-minute commute radius. That 45-minute rule of thumb came from studies done on how much time an employee commuting five times a week would tolerate. But if employees are working just two or three times per week in the office, perhaps that radius expands a bit as a moderately longer commute becomes more tolerable—say, 60 minutes. That means opportunity for all types of land development in that 15-minute geographical gap that just opened up—single family, apartment, retail, even office. People working in the same space together all day every day may find it beneficial to pay $500/month for office space outside their homes.

Kristi: You alluded to the urban office market earlier. Can you elaborate a bit on what the **opportunities might be for big cities** going forward? We've seen potential foreign investors expressing interest in the major cities—New York, San Francisco, Chicago—operating under the belief that there is enough of a bottom in the market now that they will benefit greatly from a market upswing over a five- to seven-year hold period.

Mark: That's not surprising—those are considered the "gateway" cities for foreign investors. For people looking to invest in cities, it's important to evaluate where there's momentum behind a positive urban environment and look at the quality of urban lifestyle. When evaluating urban investments, you should be using a secondary set of criteria, other than population growth, because when you lose a positive urban environment, past historical population trends are moot.

Kristi: Do you have any last thoughts before we go?

Mark: For the first time in nearly 40 years, inflation is here. Whether it's transient or not, current investor fervor for real estate is a reflection of that. The level of interest in all segments of real estate investment is going to rise in tandem with the fears that inflation is not transitory. Prices are high today and yields are low, but higher inflation expectations could push prices higher.

Kristi: Thanks for your time and for sharing your thoughts with us, Mark.

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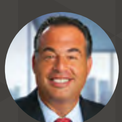

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