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INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

REAL ESTATE & CONSTRUCTION IN THE REAR VIEW + OUTLOOK FOR 2022

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2021 was the first full year that the global economy cycled through the pandemic. What were the predictions going into 2021 and where did we actually end up? Here we take a look at how the real estate and construction industries fared last year and where they're headed in 2022.

Jump to the Predictions and Outlook for:

2021 Prediction: ? - Shaped

2021 Reality: K - Shaped

2022 Outlook: K - Shape will continue

ECONOMIC RECOVERY

As 2020 wound down and economists and prognosticators put 2021 in their sights, there were plenty of theories about which direction an economic recovery would take, with U-, V- and W-shaped graphs peppering news segments.

In reality, over the course of 2021 the impact of the global pandemic has greatly varied according to the number of Covid cases and their consequent impact on workers' ability to contribute to local or regional business activity. Economists have settled on a K-shaped recovery that captures this variation — while some sectors and regions improved, others have continued to struggle.

Thriving: For real estate and construction the winners are clear: The industrial and residential sectors have outperformed.

Supply chain disruptions and an explosion in e-commerce growth contributed to the success of industrial real estate, with cold storage warehousing leading much of that growth. Demand for industrial space continues to outpace supply, with net absorption at record highs and vacancy rates at record lows. On the construction side, there were 85 million square feet of industrial space delivered in the 3Q21, according to JLL, and 637 million square feet of industrial warehouses are under construction, almost double the volume five years ago, according to Transwestern Real Estate. Continued supply chain disruptions could, however, impede the pace of industrial construction in 2022.

On the residential side, the Great Migration — urban populations migrating to the suburbs in favor of more space and a better quality of life — has led to a surge in demand for homes and limited supply, further exacerbating the existing housing shortage. New home construction, however, has slowed because of supply chain issues and labor shortages, further weighing down supply. At the same time, residential rental market rates continue to grow at significant levels, creating a problem for renters who are approaching the end of their leases, as most states don't have protection against rental increases. Renters in certain areas are confronted with either paying the higher rate or finding another place to live.

Looking forward to 2022, home sales are expected to increase, as are home prices. Affordable housing policies will likely gain traction as the need for this segment will likely increase dramatically, and mortgage rates will track inflation, although the emergence of COVID-19 variants could prompt the Federal Reserve to hold back on increasing interest rates.

Surviving or Struggling: Some Retail (brick and mortar), Hospitality, Restaurants, Offices.

Retail: The pandemic has rescripted the old real estate adage "Location, location, location." It typically refers to a local market, but COVID-19 has expanded that local focus. Retailers could fall anywhere on the spectrum between thriving, surviving and struggling depending on where in the country they are located and whether they have an e-commerce arm. Consumers will likely want the best of both worlds going forward — continuing to enjoy the conveniences of e-commerce, while also enjoying in-person shopping, which will contribute to new brick-and-mortar leases.

- **Malls:** Many malls are being reconfigured as foot traffic has taken a hit from the pandemic. Some stores have been repurposed as distribution hubs for businesses like Amazon. While many consumers prefer to return to in-person activities, just as many seem to prefer conducting their purchases online, and malls will continue to be reconfigured to meet evolving consumer behavior and shopping preferences.

Hospitality: The recovery of the hospitality and restaurant sectors in the larger gateway cities is hitched to business and leisure travel as well as community health. With international tourism down more than 50% in 2021 and projected to be only slightly better in 2022, according to the United Nations World Tourism Organization, the hospitality sector's recovery will continue to vary depending on market. Cities like New York and San Francisco that suffered from precipitous drops in occupancy rates will rebound in 2022, though the ongoing emergence of COVID-19 variants may dampen recovery rates.

Restaurants: Restaurants are in the same boat as retail and hospitality in many ways. Like retail and hospitality, restaurants' performance has depended on location, but also on the type of restaurant (quick service and fast casual restaurants fared better than fine dining, for example). In larger cities, restaurants have been working with local governments to approve year-round outdoor dining, which could outlast the pandemic. As the industry, which has been forced to transform over the course of the pandemic, moves into 2022, well-capitalized restaurants will be better positioned to expand their real estate footprints. Regardless, restaurant owners will see lease (re)negotiation as a key tactic to conserve cash.

Offices: A rush of workers returning to offices never happened as the Delta and now Omicron variants gained steam, and while business has not returned to a pre-pandemic state, it has adapted. Leasing activity rose in Q3 and there is a healthy construction pipeline, but the office sector's recovery will depend on more workers returning to the office.

The "Great Resignation" — the trend of employees resigning en masse in favor of higher salaries, passion careers or projects, or, for those in industries like retail, hospitality and restaurants, job security — is further exacerbating performance around the country at hotels, restaurants and retailers. This trend will continue to pressure organizations as reduced staffing numbers have resulted in reduced services and amenities.

HUB AND SPOKE

2021 Prediction:

Offices would transition to a hub-and-spoke model, downsizing their urban presence and opening satellite offices in suburban locations.

2021 Reality:

While this trend began, it didn't take off as expected. The phenomenon of employees working — and liking to work — from home, and the emergence of variants that have delayed the return to office, have slowed the hub-and-spoke model's deployment. Meanwhile, employers continue to noodle over the culture question.

2022 Outlook:

As the hybrid workplace mentality gets more firmly embedded in the culture of work, the hub-and-spoke model will coalesce around a more efficient (read: likely smaller) hub and fewer spokes. While workers enjoy working remotely, many have reached a saturation point with working out of their bedrooms or kitchens, yet don't necessarily want long daily commutes to the office. We are more likely to see businesses accommodate employees by offering closer (but fewer) locations that meet the needs of most employees.

DIGITAL TRANSFORMATION

2021 Prediction:

Real estate and construction leaders would adopt more digital technologies and solutions into their day-to-day operations.

2021 Reality:

This prediction came to fruition. Leaders in both real estate and construction integrated digital solutions into their operations, but nowhere is this more impressive than in the construction industry. Before the pandemic, the construction industry was believed to be about 10 years behind in terms of technology adoption. The pandemic galvanized the industry to adopt technologies that enabled construction companies to bridge workforce and supply gaps, from project management software to drones and robotic dogs.

2022 Outlook:

As the benefits of implementing technologies accrue, leaders will become more digitally savvy and look to create a digitally connected ecosystem of technologies that work together and talk to each other to deliver a better experience. We expect adoption to continue throughout both industries.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG)

2021 Prediction:

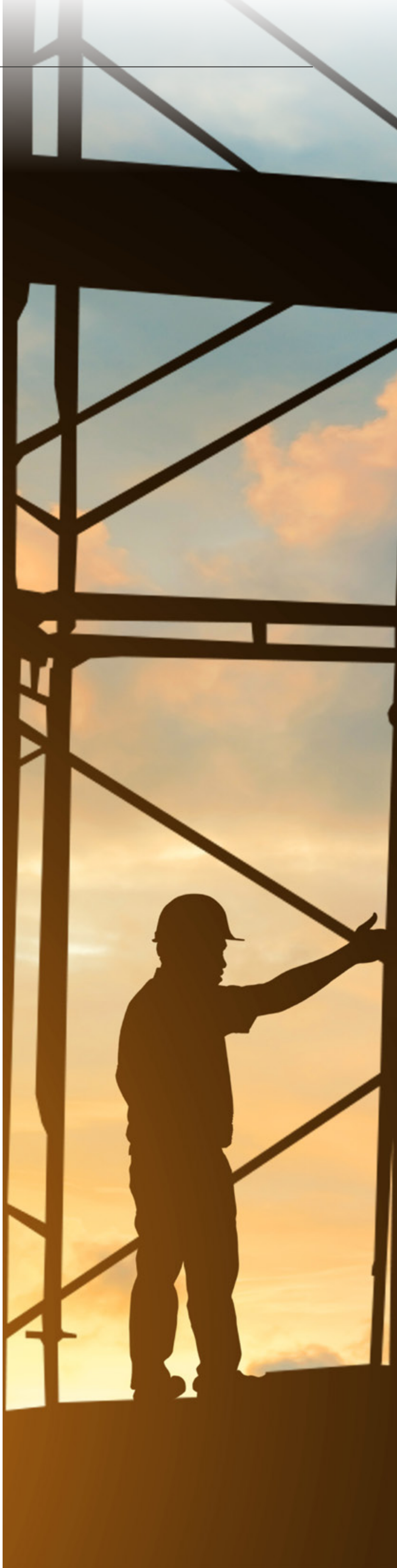
The environmental aspect of ESG is entrenched already in real estate and construction — smart buildings, energy efficiency and LEED certification are testament to this. As public and investor awareness has grown around the social and governance aspects of ESG, real estate leaders and investors in the U.S. will significantly expand their efforts to incorporate ESG considerations more deliberately throughout the property lifecycle.

2021 Reality:

2021 was a year of education and some adoption for the U.S. real estate industry. Other countries are further ahead with ESG adoption, in part because their reporting across asset classes is more standardized, facilitating adoption. In an effort toward standardization, some commercial real estate trade groups are advocating for establishing consistent ESG standards in real estate and construction loans and green bonds.

2022 Outlook:

ESG's prominence in the U.S. will continue to grow as real estate and construction investors and customers alike expect ESG values to be reflected in a company's brand and commitment. One of the major ESG considerations for investors in this sector going forward is how companies are addressing the goal of carbon neutrality as both residential and commercial buildings are responsible for a significant portion of energy and process-related emissions. Moreover, ESG considerations are expected to drive institutional investment in the sector and ESG strategies will continue to be increasingly important to ensure access to capital.



The global pandemic will hit the two-year mark in March. With this much pandemic experience under businesses' belts, the emergence of new variants is not likely to replicate the impact that COVID-19 had on the global economy in the spring of 2020. But the Omicron variant has proven to be significantly disruptive, prompting countries to close their borders and cities to lock down.

Currently, there are expectations that Omicron could hit its peak soon. Its impact is likely to perpetuate the trends we've been seeing. In 2022, the bifurcation between the sectors that are thriving and surviving will continue along that K-shaped track until the unpredictability of the pandemic winds down and confidence in economic fundamentals returns. This year we will likely begin to see a state of normalcy return; at the same time, the definition of normal has changed as industries have shifted and will need to continue to adapt to significant change. Inflation concerns will likely continue to drive investors to real estate — fueling the price increase trend, most notably in the industrial and residential sectors and with owners seeking to tie rents to certain indexes as a hedge against inflation. Affordable housing will remain elusive.

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