Americas

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We began 2022 hoping to put the existing critical challenges in the rearview mirror, but as the year progressed, new risks and uncertainties emerged. The war in Eastern Europe, spiking energy prices, and the looming prospect of a recession all carried major market impact. In addition, during the second half of the year, interest rate increases from the Fed's fight against inflation has resulted in a dislocation of real estate markets. Increased financing costs and reduced bank lending have decreased transaction volumes and asset prices. This environment, while unnerving to many investors, is a natural part of the business cycle which patient investors can exploit.

SILVER LININGS

These undercurrents of concern have overshadowed some good news. Most global economies and markets did reopen in 2022. Many U.S. businesses carry healthy balance sheets and have moved past the worst of the supply chain crisis. Employment figures are favorable, and retail fundamentals continued to recover during the busy holiday shopping season. Corporate America's return to the office is picking up steam—two Midtown Manhattan buildings managed by Hines now have surpassed 60 percent daily building occupancy for the first time since the pandemic began. Given these positive signs, combined with the ongoing repricing of real estate assets, we believe our research-driven investment approach will continue to uncover new opportunities.

Looking ahead to 2023, we will keep a close eye on certain macroeconomic data, including U.S. employment trends, discretionary spending, real estate transaction volume, and lending activity. We cannot predict how the next 12 months will unfold given the significant employment headwinds, particularly in technology. However, we are well-positioned to work through a down cycle and emerge stronger in the Americas.

INVESTMENT IMPACTS

We are entering what is likely to be the most difficult part of the cycle for tactical investment. A defensive posture will remain essential and underwriting asset pricing will be critical. Conservative projections for rental growth and investing at the right going-in basis will be key to generating attractive returns.

This summer we started to see evidence of pricing declines of 25% and that number extended up to 40% this fall. In some instances, price discovery has been nullified by a sheer lack of bids. The United States is experiencing a steep decline in investment transactions. However, that is not a surprise because our markets typically are the first to be repriced.

Activity has likewise trended down elsewhere in the Americas, notably in Mexico and Brazil, with four-quarter investment volume down 71% and 53% respectively from year-ago levels per RCA. The Canadian market has remained liquid with Q3 2022 trailing four-quarter volume equal to year-ago levels, but third quarter trading has slowed, suggesting Canada's downturn has been delayed rather than avoided. Brazil may be on the fastest track to recovery as inflationary pressures eased in the third quarter, which may lead to an easing of the SELIC benchmark interest rate, and the uncertainty of its presidential election cycle now behind it.

With interest rates continuing to climb, capital markets have been dislocated. The general upward pressure on interest rates and instability in the market has challenged underwriting for both acquisitions and development as negative leverage is pervasive and widening. However, debt providers are reluctant to say they are "on pause" and remain selectively available, albeit at lower leverage and significantly elevated rates. Such lending conditions make it difficult for the smaller players but tend to favor well-established capitalized investment managers like Hines.

Investors are still recalibrating their portfolios, as they have seen downturns on both the equity and fixed income sides of their ledgers. Meanwhile, corporate tenants everywhere have been reviewing their growth plans for the year ahead and pausing on new activity. Not surprisingly, we expect a wave of distressed office assets seeking workouts or facing defaults to hit the market in 2023. Given the amount of loan maturities in 2023, which are expected to roll at lower loan to value (LTV) levels and higher all-in rates, we are looking for the funding gap to widen, generating capital needs or funding gap to widen, generating opportunities for those with dry powder to invest. Also, investors who acquired assets with short-term financing, credit lines and bridge facilities will be facing considerable difficulties in obtaining permanent financing, which will generate capital losses. We will be on high alert to take advantage of distressed asset sales and projects with refinancing issues.

Nevertheless, real estate is typically an investment hedge against inflation. While market fundamentals have downshifted recently in response to economic headwinds, real estate assets have typically increased in value through multiple cycles. We view disruption in property value as an opportunity for investment and remain committed to our conviction that real estate holds up well during economic downturns. The investments that should be the safest will be those that have a favorable risk profile, construction pipeline or supply constraints, a strong core score and a realistic pricing discount. In addition, generating outsized returns in this market environment will require more active management and operation of the assets. Vertically integrated investor operators will likely have an advantage as they will have direct contact with tenants as well as the data to support value-enhancing opportunities. During periods of negative market performance (such as 2008-2010), Hines alpha-generation capabilities were able to overcome the value decreases experienced in the U.S. market.

SECTORS IN OUR SIGHTS

We believe the investing landscape will continue to experience headwinds during 2023, however there is potential for some bright spots and opportunities during the second half of the year. Drawing on our research and local team intelligence, we are seeing and seeking opportunities in:

INDUSTRIAL *Approaching the market with prudence*

- Industrial fundamentals are still strong in most markets, but others like Dallas, Indianapolis, and Phoenix are red flagged on development due to supply imbalance.
- Demand will drop if discretionary consumer spending is negatively impacted by the downturn.
- Opportunities can still be found, but will require more active selection and analysis, as higher returns are typically achieved in developments which are harder to pencil due to land pricing and constructions cost increases.
- The most interesting opportunities are in high barrier markets like Inland Empire, Northern New Jersey, and South Florida, where yield premium to acquisition value is substantial.

OFFICE *Quality and differentiation beats commodity*

- Continued caution is warranted, with weaker demand per economic conditions and work-from-home impacts. The full impact of WFH and demand rationalization by tenants has not been fully absorbed yet.
- Flight to quality is evident in new development performance as well as better designed, modern, sustainable product, such as Hines T3 developments.
- There is very limited debt available for office assets, and generally at low leverage levels and high all-in rates. This is causing officing prices to decrease, particularly for commodity product, up to 40-50% below peak pricing.
- Product catering to future tenants in specific industry micro-sectors – like content creation, media and entertainment – are likely to be more demanded, as we expect office utilization and occupancy to continue to improve going forward.

LIVING *investing for future demand*

- Higher mortgage costs are crimping for-sale housing demand, but apartment absorption is slowing while rents are flatting or decreasing. Some markets are oversupplied and affordability ratios are elevated, so careful submarket selection will be paramount.
- The pandemic has reinvigorated design with demand for larger units, activated green space, and single-family rentals. Newer, better located product with modern amenities and services are experiencing better performance.
- Secondary and tertiary markets may provide outsized opportunities arising from migration trends, particularly as we look at sunbelt markets in the southeast, notably South Florida as well as Texas.

RETAIL *Challenged, but pockets of opportunity*

- Sentiment is reaching a point at which we may see more pricing upside than downside as retail has been repricing for some years.
- Compelling opportunities are emerging to redevelop dated retail for highest and best use, such as high-density living and last-mile logistics.
- Performance of grocery-anchored, lifestyle, and open-air service-oriented retail is improving as post-Covid consumption has increased. Assets are performing well while pricing is attractive (7% plus cap rates) which presents opportunities.

EMERGING SECTORS

Selectively approaching key themes

- We see opportunities to ride secular tailwinds in fragmented industries.
- We are reviewing interstate migration, data creation, pharmaceutical R&D, and agriculture supply chains.
- Opportunities may be emerging in life sciences, data centers, and self-storage, among other sectors.

Analyzing U.S. markets, the Sunbelt and other high-growth markets like Denver, Austin, Dallas, Nashville, Atlanta, Raleigh-Durham, Charlotte, and Florida are still outperforming, relatively speaking. The traditional gateway markets in the Northeast, including New York, Boston and Washington DC, as well as West Coast metros like San Francisco and Los Angeles, have experienced a more subdued recovery from the pandemic and therefore less interest from institutional investors, primarily in cooling asset classes such as office and retail.

We are keeping our eyes open for opportunities in the year ahead, as we see values and yields improving in certain submarkets. The key to unlock transaction volume will be debt availability and the reset of pricing levels more in line with expected fundamentals. Future acquisitions and developments need to be underwritten with positive leverage and conservative assumptions.

RESPONSIBLE INVESTMENT

The U.S. has experienced the jarring impact of high energy prices alongside a reawakened focus on sustainability. The planet-friendly provisions of the Inflation Reduction Act and the decisions made at COP 27 are noteworthy steps forward. In terms of action, the U.S. lags Europe in both the public and private sector, but we expect that gap to close in the next few years.

In the absence of direct U.S. regulatory pressure, corporate occupiers want to understand the ESG profile of each asset they lease or own. They are expecting green leases to support their own corporate ESG goals, and to boost hiring and employee retention. Demand for energy retrofits and other ESG upgrades is likely to increase in 2023.

A recent Hines example of sustainable innovation is New York City's 555 Greenwich, anticipated to be one of the first office developments with a circular energy infrastructure that aims to reduce energy usage. Energy simulations suggest that 555 Greenwich will reduce operational carbon by 45%, electricity consumption by 25% and save 800,000 gallons of water per year— exceeding New York City 2030 carbon targets by 50%.

Disruption provides the opportunity to ramp up efforts to achieve resiliency and move to carbon-neutral status. Over the long term, we expect intelligent and consistent investments in ESG upgrades to produce higher occupancy rates, driven by tenant demand, and more liquid assets, protecting investors from the downside of "brown discounts'' and achieving stronger pricing at exit.

CONCLUSION

In these turbulent times, we are maintaining a cautious stance in response to recent pricing volatility, financing costs and revised growth expectations. We remain disciplined in our underwriting, focused on the durability of the cash flows as well as value-added improvements to help generate returns to our investors. Nevertheless, as always, we are actively monitoring attractive investment opportunities across the risk spectrum, with location, asset quality and attractive basis being the likely drivers of returns. As noted earlier, we see the likelihood of distressed asset sales and refinancing risk as problematic for some investors in 2023. However, our organization has never been better positioned to capitalize on a downturn in terms of dry powder and local insights, and we are committed to capturing opportunities when the time is right.

PAIRING GLOBAL PERSPECTIVES WITH LOCAL INSIGHTS

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