LANDandBUILDINGS

A Vaccine Mirage

– Land & Buildings believes pent-up demand in 2021 will create a Vaccine Mirage obscuring the ultimate winners and losers in real estate –

– Sees secular headwinds in urban office, retail, business hotels, and movie theaters overwhelming any short-term demand bounce –

<u>What is the Vaccine Mirage?</u>

The human impact of COVID-19 as it has swept around the world has been nothing short of tragic. Unfortunately, the capital markets wait for no one and nothing. Market participants have been forced to grapple with the existential scope of the virus, while simultaneously evaluating the opportunities and risks presented for their investment portfolios.

Clear losers will likely see a "Vaccine Mirage" from pent-up demand before fundamentals and shares roll over	
Urban Office	Employees will return to office in 2021, but WFH is here to stay and value is permanently impaired
Retail	Malls may see mini traffic boom temporarily, but adoption of e-commerce has accelerated
Business Hotels	Backlog of business trips will occur in 2021, but the Zoom affect has forever reduced business travel
Movie Theaters	Simultaneous theater and streaming release likely to lead to substantial theater closures

The Vaccine Mirage, as we have come to refer to it at Land & Buildings, is like an oasis of palm trees in the desert, fueled by excitement about the economy reopening and resulting in the most impacted real estate stocks ripping higher and higher. The rising tide has lifted all boats – but there will be winners and losers. The difference is that the losers may be obscured for a time, as the initial burst of post-vaccine activity will cause investors to second guess the likely secular headwinds for a variety of businesses.

For consumers who have been cooped up in their homes, there will likely be a voracious return to leisure activity whether it is travel, amusement parks, shopping in stores, or restaurants. For businesses it will mean workers enthusiastically returning to the office, trading the Groundhog Day-esque existence of work from home for the variety of commuting, collaborating, and working without lovable (but irksome) children and pets interrupting every meeting.

Investors and management teams will be beguiled by the strong rebound in activity and revenues post-pandemic as life returns to normal. For many businesses, what was truly needed was a vaccine and a return to pre-pandemic life. For example, K-12 schools as well as universities will likely see a return to normalcy for the academic year 2021/2022. Leisure travel and social gatherings will enjoy a surge as people indulge in previously dangerous or forbidden activities before normalizing to more historic levels.

The Vaccine Mirage businesses will likely enjoy a spike in activity due to pent up demand which may well prove a fleeting commodity. For example, a return to the office will likely rise to pre-pandemic levels initially, and gradually fade as the novelty wears off. When the dust settles, office workers will likely on average spend one less day a week at the office than they did pre-pandemic, or a potential 20% reduction to the number of people in the office on any given day. Urban office will likely experience substantial rent declines, lose occupancy, and assets values may fall as much as 40% over the next several years.

In addition, business travel will likely spike in response to Zoom fatigue as workers want to meet clients, attend conferences, and host offsite meeting with teams. But a new normal is emerging and corporate travel has likely seen a permanent impairment. Amazon's CFO recently commented that the company saved $1 billion on travel in 2020, and while he expects travel to return, it will be at a much lower level. We have been increasingly hearing similar anecdotes from executives about business travel, work from home, and on-line shopping versus in-store.

Yet the market does not appear to be differentiating closely enough between stocks likely to sustain a fundamental rebound from those likely to merely experience a mirage of normalcy. For example, share prices of hotel companies have rallied as much as the share prices of student housing, with the prospect of returning to pre-pandemic earnings pushed further out for lodging and much sooner for student housing.

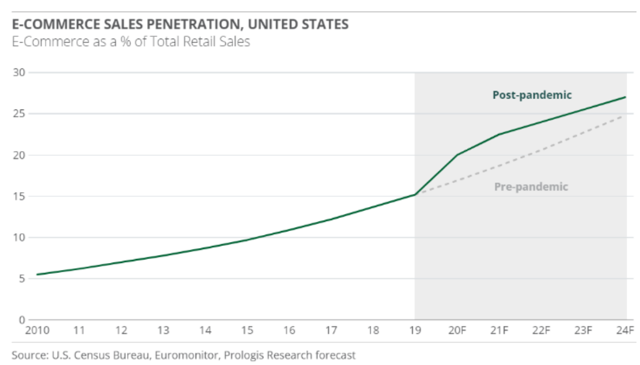
The Vaccine Mirage may confound investors about the ultimate impact from COVID-19. We believe real estate companies which have the clearest path to returning to pre-COVID-19 earnings should be embraced while real estate companies with a more uncertain future, many of which are trading at comparable discounts to NAV as better positioned property types, should be avoided.

<u>The Real Estate Sectors Most Likely to See a Vaccine Mirage</u>

Retail

Before the pandemic retail real estate was facing secular challenges as e-commerce penetration steadily rose from 5% 10 years ago to 15% in 2019. The pandemic supercharged the shift, with e-commerce penetration forecasted to rise to 25% in 2023. Buying online became a necessity, not just a convenience, during the pandemic and consumer preferences are likely forever changed. The purchase of groceries online has continued to accelerate since the depths of stay-at-home orders in March, suggesting consumers positive experience and rapid adoption of one of the few holdouts pre-pandemic from e-commerce.

E-Commerce Has Significantly Accelerated Post Pandemic

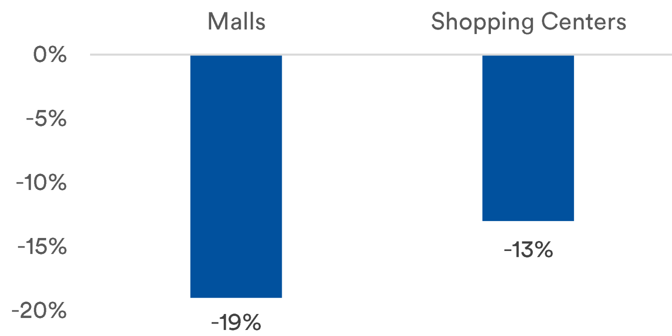


Source: Prologis

While next year we will see headlines on consumers returning to the stores in droves, it is unlikely visitation and revenues of the stores overall will be able to return to pre-pandemic levels longer term given fundamentally changed consumer behaviors around the convenience of buying online. L&B photographers recently toured malls this holiday season and traffic was significantly more muted than in years past. Christmas shopping is taking place online at never-before-seen levels and it will be difficult to put that genie back in the bottle. Mall same store real estate revenues are expected to decline by 19% from pre-COVID levels by the end of 2021, from a combination of occupancy declines and lower rents, according to leading independent research. Shopping centers are expected to experience a decline of 13% over the same period. These estimates may prove conservative.

Consider that the impact of a likely 10% reduction to brick-and-mortar sales once the dust settles versus pre-pandemic levels. This lost revenue will force an accelerated demise for many retailers while others grind it out but shrink their store footprint. There will be winners of course that invest in their business and flourish, but the headwinds from the former group will almost certainly outweigh the latter, leading to continued declines in rents, occupancies and values at many retail assets.

Negative 2019 – 2021 Same-Store Revenue Forecast for Retail Assets



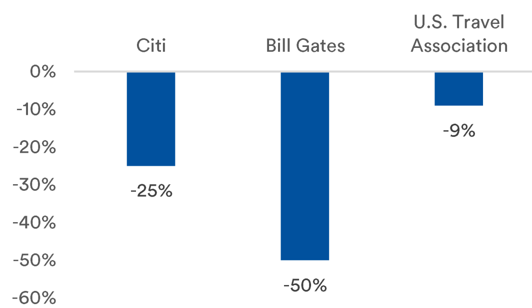
Source: Sell-side research

What will not be a mirage after the holiday season is a likely flurry of store closures and bankruptcies as retailers that have been limping along throw in the towel. There will be 8,000 to 9,000 retail store closures in 2021 according to Bank of America, well above average of less than 6,000 over the past 10 years and down from a record 15,000 in 2020.

Business Hotels

Business travel, the lifeblood of the hotel industry, makes up approximately 60% of hotel revenue and is likely changed forever because of the new practices adopted during the pandemic. It is not a question, in our view, of if, but by how much, corporate travel will decline post-pandemic. The proliferation of video conferencing with the likes of Zoom have made substantial portions of previously necessary travel unnecessary. Virtual conferences have seen substantially higher attendance than in person conferences, and new and existing business relationships after a pause have continued to proceed.

Business Travel Forecasts Have Significant Downside Risks



Source: Various

A salesperson planning a trip to say, Chicago, for five meetings pre-pandemic, may find post-pandemic that only two of those meetings will now be scheduled as three of the clients/prospects are working from home and not inclined to commute to the office for one meeting.

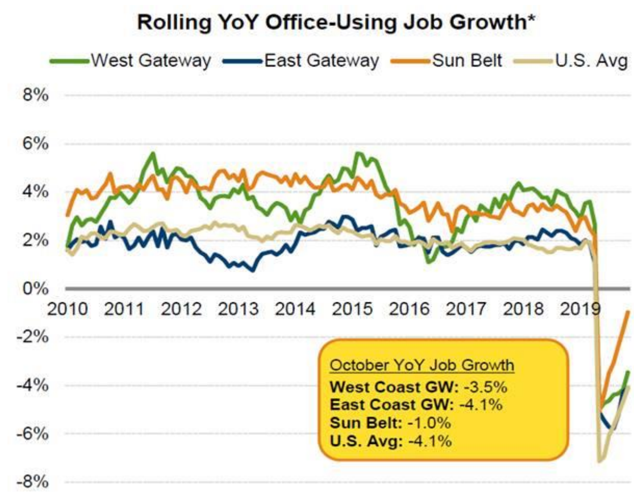
There will undoubtedly be a surge of pent-up travel activity following the vaccine, but do not be fooled – corporate travel is unlikely to return to 2019 levels anytime soon. Citi estimates there will be a 25% decline in corporate travel while others like Microsoft founder Bill Gates have a more dire outlook, expecting 50% of business travel will disappear. All else being equal, hotel occupancies could decline by 15 percentage points from a 25% reduction in business travel. Supply will effectively increase given lower demand as room rates and EBITDA come under pressure.

Urban full-service hotels, which are the most dependent on the business traveler and operate at lower operating margins, are likely to see the most pronounced impact.

Office

Gateway office assets are at the top of the mirage list. The combination of Work from Home ("WFH"), big city demographic trends shifting as millennials move to the suburbs to start families, and business relocations to low or no tax states, will ultimately put considerable downward pressure on costal office landlords. In a recent survey, Morgan Stanley found that at least 44% of employees would prefer one to two days per week to WFH post-pandemic and more than 80% of the companies the firm tracks will offer hybrid work alternatives post pandemic.

Office-Using Job Growth Moving Away From Gateway Cities



Source: Green Street

Consequently, if employees work one fewer day on average at the office and companies adopt hoteling of office space, demand for office could drop 20% as leases expire. Forecasts much less draconian would still have massive impact on office economics. Historically, every 100bps drop in office occupancy (demand) decreases rents by about 3%.

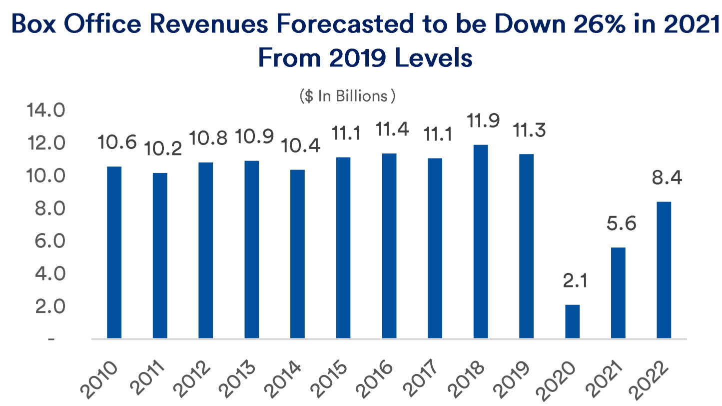
The steady procession of corporations relocating to low tax states Florida and Texas will leave California and the Northeast with an additional demand headwind. Facebook is looking to lease 1 million square feet in downtown Austin. HP, Cisco, and Tesla also recently announced plans to move to Texas while Goldman Sachs, Elliott Management, and Blackstone have announced plans to move some operations to Florida.

SL Green (NYSE: SLG) gave investors a sneak peek at what is to come for NYC office, with 2020 leasing levels 50% below 10-year average leasing and more of the same expected in 2021. SLG Manhattan asking rent to have been reduced by 3% while concessions are up ~30%, suggesting that net effective rents are already down 10% across Manhattan since the start of the pandemic. That may just be the beginning.

Movie Theaters

Consumer preferences for streaming media content are here to stay and movie theaters are likely to suffer as a result. The two largest movie producers are releasing former content in theaters to their streaming services, which over time should create more predictable subscription revenue stream, but this is bad news for theaters. Warner Bros. will be releasing all its films in 2021 simultaneously in the theaters and HBO Max while Disney will be putting 80% of its new content, including Marvel and Star Wars, on Disney+.

Goldman Sachs is projecting U.S. box office revenues to be 26% lower in 2022 than 2019, which could cause many theaters to shut their doors permanently. The largest movie theater chain in the country, AMC, is on the ropes teetering on bankruptcy which will likely result in a substantial number of theaters closed. There will be pent up demand for consumers to go to the theaters after wide distribution of a vaccine and theaters are not going away overnight, but the sector is a rapidly melting ice cube.



Source: Goldman Sachs

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