Allison Nathan: The real estate market has been a near surefire investment in recent years. But it looks like that's about to change.

Jeff Fine: I think we're going to see supply/demand fundamentals within markets and within sectors really be much more nuanced. And so, from an investor standpoint as we think about cycles, it's going to be about capturing those opportunities.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.
Allison Nathan: To help explain the opportunities and challenges facing real estate investors in the current economic environment, I'm sitting down with Jeff Fine, Global Head of Real Estate Client Solutions & Product Strategy. And Nora Creedon, an investor in our Private Real Estate business within Goldman Sachs Asset Management. Jeff, Nora, welcome to the program.

Jeff Fine: Good afternoon. Thank you for having us.

Nora Creedon: Great to be here.

Allison Nathan: Jeff, let's start by framing for our listeners where we are in the real estate cycle today. We had an incredible expansion off the bottom of the financial crisis with very accommodative capital markets and a prolonged period of very low rates. But then we had the COVID crisis, which we know upended many real estate markets. And now we're grappling with high inflation and higher interest rates. So, where are we in the traditional sense of the cycle at this point?
Jeff Fine: Look, I think it's important to go back as far as you did, Allison, in your intro because a lot's happened over the last ten to 12 years since the financial crisis and we've seen major changes in the investment landscape in real estate.

It started with the recovery period and a number of demographic changes that we saw. People moving from historic gateway markets into sunbelt markets in secondary cities that historically had not been magnets for capital the way they had been. We saw a sector shift taking place, where in the past the market was really about office and retail and industrial and housing. And we started to see with the rise of e-commerce, a shift away from traditional retail, which really took a bite out of that segment. And a move into industrial or logistics in order to facilitate that e-commerce consumerism. So, those were the big shifts that we saw coming about.

When we came into the pandemic, which was obviously an unforeseen turn, a lot of unnatural things started to happen. But we also talked about accelerants. And we talked about certain sectors, the growth of which we really saw amplified by some of the events that went on during
COVID. And others that really accelerated their decline or their demise. And so, it was a nail in the coffin for many retail assets.

We saw this tremendous interest, both from tenants, as well as from the capital markets in logistics sectors and housing sectors. And that's really where the market was focused. That's where the investing capital that was being raised was focused, trying to invest in growth and to take advantage of those tail winds that we were seeing coming out of the pandemic.

We're now in a different part of the cycle. And there's been a lot of focus, obviously, on the macro. And I know we'll talk a lot about that during this podcast today. But a combination of inflation and interest rates obviously puts a spotlight on real estate. Real estate, historically, is the epicenter of the hedge against inflation discussion because, historically, we've seen inflation translate to higher rental growth.

I think what we're seeing unique to the current landscape though is that it's not necessarily going to translate evenly across sectors. So, much in the way that the sector shift
has taken place away from retail, away from office, and we'll talk a little bit about return to office and the way that's impacting that investing category, I think we're going to see supply/demand fundamentals within markets and within sectors really be much more nuanced.

And so, from an investor standpoint as we think about cycles, it's going to be about capturing those opportunities to take advantage of inflation where we think it's going to exist, to stay away from the types of assets that we think are not going to participate in that inflation because a rising interest rate environment is going to have some cost, both from a financing standpoint, as well as from the general capital markets standpoint under a lot of categories.

**Allison Nathan:** So, what I'm hearing you say is real estate is not functioning as an inflation hedge in the same way that it, perhaps, has in the past. But does that mean that investors shouldn't be buying real estate today as an inflation hedge at all?

**Nora Creedon:** We would agree that real estate makes sense intuitively in a period of higher inflation because real
estate is, generally, we're talking about hard assets. They tend to go up in value when the input costs for those values go up. As the replacement cost for assets goes up, it tends to be a beneficiary if you're an owner of assets like that. You also have the ability to raise rents in most of these asset classes. And so, you can keep pace with increases in inflation.

But I like Jeff's word, nuance. Because we don't think that inflation is just a universe buy signal for real estate. We think the answer here is really quite nuanced.

So, a couple of the governing factors that you have to think about on the negative side of inflation, the first is lease terms. So, can you get at the ability to raise rents? In some cases, you have assets with very long lease terms that have pretty moderate increases from a year-to-year standpoint in the rental income. Something like 1 or 2 percent because that was the world we lived in for a really long time. And so, if you can't get at that piece of property with the ability to raise rents, that's going to be a challenge.

The second is that real estate, in many cases, has offsetting costs that inflation will flow through in a negative sense.
So, think about labor, for instance, in hotels. It's great that you can reprice your assets nightly. And so, you can take advantage of higher inflation. But the cost of the labor to service those hotels is also going up by quite a bit. And so, that's an offsetting factor.

And then finally, I think the big kahuna, Jeff hinted at this, is that there's really never been a period in history where you could have inflation like this and not have significantly tighter financial conditions, whether that comes in the form of higher rates, but also less capital availability, more tightened financial conditions. And that's then typically friendly to real estate.

I think there has been a lot of focus on real estate as a great asset to hedge inflation. We think that can be true in select cases. But to Jeff's point, we're going to want to focus on property that has pricing power. And what kind of property has pricing power? It's assets with really great demand from people who can pay for those assets. Meaning that they can pay the rents to either be in that multi family community or be at that hotel or be in that great office building at Main & Main. And then also that type of real estate that isn't contending with significant new supply.
And the intersect of that strong demand and limited supply is really where you're going to see the pricing power that can offset inflation.

**Allison Nathan:** So, obviously, as we've seen inflation go up, we're in a different rate environment. The Fed has increased rates dramatically. Interest rates are on the rise. Mortgage rates are much higher than they were. So, how is that affecting this sector?

**Jeff Fine:** Yeah, look, it's having a meaningful impact on the sector. Notwithstanding that there is a record amount of dry powder that's been raised in order to invest in real estate, because I think a lot of investors saw a cycle out of public markets, a rotation out of fixed income in light of what was happening in the macro environment. But part of the game for real estate for quite some time now has been the ability to finance real estate and create a mid to high single digit cash on cash yield. And that yield as a segment of one's portfolio allocation was really valuable.

One of the things that you're seeing as a result of some of the repricing going on in the market right now and the tightening that Nora mentioned is financing costs have
gone up. But we have not seen cap rates necessarily go up commensurate to the degree to which financing costs have gone up. And so, it's creating a situation where there's actually non accretive leverage day one to an investment.

In other words, you buy a piece of property at a 4 percent cap rate today and it may finance at 4.5 or 5 percent. 12 months ago, that same asset financed at 2 - 2.5 percent. And so, you're able to create really high cash on cash returns that were really attractive, especially on a tax adjusted basis to many investors.

So, how that plays through we're going to have to see. A cap rate is the yield at which a property trades. And we've spent a lot of time focusing on the relationship between interest rates and cap rates. And intuitively, people think one goes up, the other must go up. But really, what happens with real estate is the degree to which revenues can inflate over time, expenses can be controlled, if your total return over your hold is significantly higher than the risk-free rate, then that's okay and that shows us that the cap rate that somebody's willing to pay today to buy that future growth may be tighter than the commensurate increase in interest rates would suggest.
And so, we're in a little bit of a waiting game right now. We are focused for all those reasons on the places where we think rental inflation, based on supply/demand can outrun the interest rate increases that we think we will continue to see going forward. But it's a very tactical game right now.

Nora Creedon: And to the point on being well resourced, you know, in addition to the higher interest rates that real estate investors are contending with, you also have to focus on credit availability. And there's no doubt that financial conditions have tightened materially over the last three or four months. You know, there's a number of ways to look at this from a real estate perspective in terms of the level of bank issued loans that are being securitized in the market. That declined by almost a third from Q1 to Q2. And so, banks are tightening the spigot. And less credit availability is going to have an impact on liquidity in the market and on values.

Allison Nathan: Right. So, ultimately, it's more expensive to borrow. And there's less ability to do so. And that's impacting the sector.
The other topic that we're all focused on today is recession risk amid this inflationary and higher rate environment. So, are there property types that hold up better in a slowing economy than others?

**Jeff Fine:** We haven't seen the material impact. So, we've seen a little bit of cap rate widening. We've seen a little bit of slowing of transaction volume. But interestingly, because there is so much capital that is chasing investments, we have not seen a material reset in asset pricing yet. We think it will come over time based on all the factors that we discussed today.

But it's interesting, we have not hit that hard wall. And we didn't hit that hard well during the pandemic either. And when we think back to what happened in the financial crisis, there was a debt crisis that caused a broad repricing of the overall market. And a lot of it came from the housing market as the origin point. And we haven't really seen that this go around.

So, it's just interesting. As significant as the Fed moves have been, and as directly correlated as we think the impact should be to property, it's still, on a relative value
basis, a pretty good bet within certain parts of the market that are transacting right now.

**Nora Creedon:** To the point around what should perform a little bit better in a recession, I think we can talk about residential because, historically speaking, '01, '08, other recessionary periods, residential tends to perform better. If we look at the public companies, they report their same property cash flow. And the declines in both of those recessions were fairly mild and shallow, relative to other property types.

To Jeff's point, this pandemic was unique in the sense that residential actually really benefited from what we went through. People were spending all their time at home. And they needed to do more of their daily activities at home. So, you wanted more home. More space in your home. A home office. A home gym. And that was very positive for the residential sector, both for sale and for rent.

And so, we would expect that residential should do better if we go through a more recessionary period than many other types of real estate. But again, it's going to be nuanced. We think there are going to be markets that are going to
perform better than other markets where people are moving to that are favorable to live in and to work in. And we think the rental versus ownership dynamic is also going to evolve with higher interest rates.

The last few months we've had a tremendous spike in mortgage rates to buy a home. And that has caused a real affordability crisis in the housing market. So, you're seeing the monthly cost to pay mortgages has gone up by quite a bit over the last several months. And that's helped residential landlords be able to charge more rent because the other option is, obviously, to own a home. And that cost has been going up.

I'd say on the positive side, we are certainly finding areas in residential, including niche areas of residential like student housing and age restricted and senior housing where we do think there's tremendous ability to grow rents over time. And those are places that we're going to want to be in over the next five and 10 years. But we would expect that to be an area that should, hopefully, perform better in a recession.

**Jeff Fine:** I think with residential in particular, the
ability to reset rents frequently is important. I think the country as we know is dramatically undersupplied in terms of new inventory.

And so, we've gone through a ten-year development cycle. We took the view coming out of the financial crisis that the amount of new inventory that's amenitized, that's high quality was just underserved in most markets. And so, we built into that growing trend.

There was also a preference element though that came through the financial crisis. So, the idea of homeownership as an imperative is something that a younger, working population coming up cared about less. And so, we saw that demographic moving to the markets that I mentioned before in the sunbelt and other lower tax areas where lifestyle was a factor and something that they were chasing. Jobs followed them. And there was a need for more housing to accommodate them. They're a more transient population and they didn't want the commitment of buying a house and having to put down roots.

And that all played out really well. And I think there is still, largely, an under supply of new inventory. And it's one of
the big themes that we focus on a lot across the board, is new versus old. Because new property, sustainability, is such an important aspect of how tenants think about property. What are the sustainability credentials? How much carbon emission does a property have? What's the flexibility that it offers coming out of COVID where, you know, the ability to have more flexible workspace matters?

And we talk a lot about technology and the evolution of technology. We see it a little bit in terms of what residential offerings can now provide for in terms of some work from home flexibility.

**Allison Nathan:** Let me grab onto a couple of points that you made because everyone does talk about the real estate sector and the move out during the pandemic and that the boon to certain types of real estate, the move away from office. Ultimately, that seems to be driving some of your outlook. But to what extent do you think the structural changes that we saw are headed for retrenchment?

**Nora Creedon:** This is a big focus of what we spend our time talking about as a team because you're trying to make a prediction years into the future. And there's no doubt
that some elements of the way people lived and worked during the pandemic are going to reverse. And one doesn't want to be caught in the assets that were really benefiting and maybe over earning from some of those trends if some of these trends do reverse.

But I think if we have to take a five- and 10-year view, which we do with many of the investments that we make, you'd be hard pressed to say that there won't be changes in how people use the office environment, in particular. And I think the period of the five-day workweek has really evolved and changed.

And for the last couple of years as we went through this pandemic, people could delay a lot of these decisions. Because, again, you're under long-term leases. So, you weren't forced to make an immediate decision.

Now when corporates are making decisions, I think we're observing two factors. The first is we're observing they generally need less space. They find a way to use less space than they had before. The second is they want that space to be awesome. They want it to be new. Sustainable. And have all the bells and whistles that justify bringing people
together.

And I wouldn't say that you can't invest in office as a result of point number one, because point number two gives you a reason to be a really terrific developer of new assets in certain markets where people do want to be.

I think the migration dynamic has slowed. We saw a tremendous amount of migration during the pandemic. Almost any way you measure that, we saw a tremendous amount of people moving from the coastal, urban markets, in particular, to many of the sunbelt markets. And I think that has slowed. And we'll see where we go from there.

The other dynamic I would mention is that technology companies, who are big beneficiaries by and large during the pandemic as people had to digitize as much as possible of their life, they drove a lot of demand for space in general, not just office, but space in general. And that could be evolving a little bit here.

So, since the spring we've seen over 30 percent decline in job listings for technology companies. And that could have some profound implications for the cities in which those
companies are predominant.

So, again, I go back to the point Jeff made earlier which is it's hard to make blanket statements right now about real estate as an asset class and about these sectors in particular. I think it's going to be really tactical and nuanced, as he said.

**Jeff Fine:** Our belief is people are going back to work. There may be some changes to the work patterns. There may be more flexibility built in. There may be certain industries that care about in person, in office a lot less. But by and large we still believe in the office tenant market. It's just a question of with are the right buildings that are going to benefit from the tenants that will continue to grow and can afford to pay over time, versus those that are going to kind of stagnate and that don't have the pricing power that we talked about earlier?

**Allison Nathan:** So, we've already started to touch on this, but given these opportunities and these risks, how are you positioning your portfolio between equity and credit and across the sector?
Jeff Fine: So, we are being highly opportunistic right now. We are coming into a period where we think the opportunity set for credit is really interesting as a result of some of the pullback that we've seen from some of the more traditional liquid credit sources.

On the equity side, we think that there are lots of opportunities forthcoming. This is actually a really interesting period that we're going into. We wait for these periods. We don't love them given the destruction, sometimes, that it can cause to the broader market. We talked about recession. We talked about rising rates. But as an investor, these are the moments you wait for. This is when the inefficiency creates opportunity.

We want to make sure that we're being really careful from a timing perspective because people sometimes jump in too early. And our view is there's enough uncertainty in terms of when inflationary conditions are going to be under control to the point to where continued tightening isn't necessarily needed at the same level.

But I think you're going to see us investing tactically in the sectors that we talked about, that we think are going to
participate in the inflation, where the supply/demand fundamentals are attractive. We'll talk about some of what we're seeing in the public markets right now, Nora can speak to that, that tell us some pretty interesting things about the way that the market generally is pricing assets relative to their long-term intrinsic value.

But I think we're going to have to be really nimble, really opportunistic. Again, we're not just going out and buying everything in a particular sector and a particular geography. And there are some geographical differences right now that we should spend a little bit of time on as well because I do think the world moved in lock step in certain ways on a lot of these trends that we've talked about. And we're seeing it move a little bit less in lock step as we go into this new period.

**Allison Nathan:** Let's talk about that a little bit. So, how are the risks and opportunities that we're seeing in the US, how do they compare to other parts of the world?

**Nora Creedon:** That's actually one of the most interesting parts of our investment committee on a weekly basis because they're actually quite different. So, think about the
costs of financing, for example, in other parts of the world. It has not moved nearly as much as it has here in the U.S. over the last six months. Office utilization, really different in different parts of the world. Some of which for structural reasons. Just having smaller homes, let's say, in some other cities around the world that don't make work from home as attractive of an option. There are different investable universes on the residential side in different markets. So, I would say it's quite different across the world.

The unifying themes around trends, logistics, and the attractiveness of residential and some of the niche areas like life sciences, I think that is more universal. But a lot of the other factors, I would say, are quite different around the world.

**Jeff Fine:** Yeah. And I think, look, even in terms of goings on, the war in Eastern Europe has had a profound impact on Europe.

When we look at Japan, which is a market that we've been focused on for almost 30 years, the low-rate environment there, not withstanding that, we're starting to see a little bit
of inflation creep in. The commitment to keeping rates low is a bit of an anomaly in the world right now.

So, I think a lot of the sector trends are very similar in terms of what we're seeing. I think the appeal to new and sustainable is real. But I think across regions, we spend a lot of time talking about inefficiencies in one part of the world or another. And that's going to dictate capital flows.

And as we know, it's the financing markets and it's the equity capital flows that really impact performance and returns over time in our space.

**Allison Nathan:** The other topic that I think is worth exploring is the difference between what's going on in the public market versus the private market. Clearly, we have seen a big decline in valuation across real estate investment trust REITs in the public markets. And so, should we expect the private markets to follow?

**Nora Creedon:** We need to frame that. Because the public markets had a terrific year last year. REITs had one of their best years on record last year as the recovery from the pandemic played out. And they actually started the year
quite strong again this year on the back of stronger inflation as people, we started our conversation, people tend to think real estate is a good hedge against that.

What caused the REIT market to really get dislocated in the late spring was this idea around interest rates moving up very rapidly and fears of recession. And the REITs are not terribly levered. They actually have leverage only in the range of about 30 percent to their asset value, five or six times to their EBITDA or cash flow levels. And so, that's quite a bit lower than it was in the financial crisis that was a freeze of all credit markets and quite a difficult period of time if you had any debt rolling. So, the REITs are not very levered. And that, I think, helps their performance.

But you're right, they did see quite a bit of carnage as we went through absorbing that level of interest rate increases. And now I think they're down 15 or 16 percent on the year, which is round about what the broad market is down. And again, I think most people who trade the REITs think of them as, in the end, they're reflective of the broad economy. And so, it's logical that if there are concerns around a recession and higher rates impacting general equities, it's going to impact the REITs as well.
Sometimes there is great signaling information in how the REITs are trading. Sometimes the public markets, because you can effectuate your view very quickly with the snap of your fingers in trading securities, sometimes the market is just ahead of what will happen in the private markets. It happens quickly. And there can be value in that. And sometimes it's just noise.

So, I'd be hesitant to say I think the private market is going to follow exactly what the public market has done. And interestingly enough, even though we see the REITs trading at something like a 10 or 15 percent discount to their net asset value, that's not always a great signal as to what's going to happen or who's right. Because, in fact, the companies that tend to trade at the largest premium to their asset value are often the ones who signal the strength of the sector that they're in, as opposed to a valuation point.

And we think, in general, the opportunity to take advantage of these dislocations in the public markets, they can come in lots of different forms, not just in privatizations, which can be difficult to actually get accomplished, but maybe in
the form of REITs that are looking to sell assets or find partners if they're more capital constrained.

And so, I think we'll see whether the absolute magnitude of the decline we've seen there is really indicative of what will happen. But I would say there's no doubt in my mind that a more stressed sector will hopefully create more opportunities for us and for other players in the private market side.

**Jeff Fine:** Yeah, look, I would just add I think a lot of people are watching the public markets to try and figure out if privatization opportunities are the opportunities of choice going forward. A lot of our competitors are focused in that space.

As Nora said, time will tell. A lot of these companies don't want to privatize. A lot of them, when you really dig into the underlying net asset values, right, they can be a collection of some good assets and some less good assets. And they're a composite of the total. And so, oftentimes you have to be willing to take down the whole lot, if, in fact, you have a public company that is receptive to privatization.
The other big change that I think we've seen in our capital markets is the move to more permanent capital. Even in private markets where you're seeing lots and lots of capital being raised in more evergreen formats to buy assets and hold them for a long time. And that's okay. Real estate, if you talk to any intergenerational, multigenerational family, it's been a great store of wealth and transfer of wealth over time. And so, that's a good thing from a tax efficiency standpoint and the way to think about real estate as opposed to as a trading business. But it's also taken a lot of the inventory out of market. And assets are acquired. And they don't resurface two, three, four years later, necessarily, because the disposition incentive of those managers oftentimes is very low.

And so, I think you're going to see more of a shift into long-term permanent capital. I think investors like that model. And they like having the more permanent beta exposure, not having to redeploy that capital. Which is also going to have an impact on the broader markets because a lot of that more permanent capital we saw in the public markets historically, as opposed to in the private markets.

**Allison Nathan:** Let's just end with key messages for
individual investors as they're looking at their portfolios. What role should real estate be playing?

**Nora Creedon:** I guess I would start and say I think real estate is a critical part of individual investor's portfolios because the real estate, whether in public form or private form, tends to be less correlated to other investments that you have. It tends to be less volatile than many other investments. It tends to have income aspects, which are favorable for my investors. And so, I think it needs to be a part of everyone's portfolio.

I don't think the next ten years look like the last ten years. And so, we go back to the point around being really tactical around not just investing in the right themes and the right sectors that are benefiting from changes in the economy, but really the right assets. Because to Jeff's point earlier, we don't think the market will carry you. But we absolutely think real estate belongs in individual and institutions' portfolios.

**Jeff Fine:** Yeah, look, I am a big believer in real estate as what should be a reasonably sized segment of anybody's investment portfolio. We think it is a great asset class for
all the reasons we've talked about, particularly in the type of environment that we're in.

I think there is a relative perspective that it's important to have right now, which is the entire market is going through a repricing. Right? When we go through a period of raising rates this quickly, and we all know why we're raising rates this quickly, it has to have an impact. The thing about real estate is we are always on a little bit of a lag to the broader market, right? Our capital structure, our debt doesn't start rolling. And once it does and it reprices, then you start to see what the derivative consequence of that can be.

Similarly, we house the broader economy. Right? So, our office buildings house the corporate market. Our apartment buildings house the individual. And so, we are as much as bellwether for the overall economy, but we generate real, free cash flow. There are still tax attributes that are really valuable on a relative basis that individual investor can take advantage of.

And I think if investors are willing to be patient, time has showed us that over time, real estate is a great segment in which to be invested. You may not be able to perfectly time
the one year or 18 month or two-year cycle. But over time, it's a great place to stay invested.

None of us know where cap rates are going to be in five years or six years or seven years. And we can make educated predictions based on things that we know. But the one thing that we do know is if you grow the bottom line over time, which means focus on where revenues are going to inflate, but also where we can control expenses and where margins are attractive, we should be able to outperform and to make money over time for our investors.

**Allison Nathan:** Jeff, Nora, thanks so much for joining us.

**Jeff Fine:** Thank you.

**Allison Nathan:** Thanks for joining us this Wednesday, August 31st, 2022, for another episode of Exchanges at Goldman Sachs. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to like, share, and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.