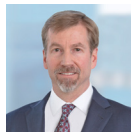




ALTERNATIVES

How the Pandemic Changes Real Estate

BARINGS INSIGHTS



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The global pandemic is changing the way we live, work and play. Such behavioral changes have been felt acutely across commercial real estate markets, and the impact may only accelerate from here. But which changes are short term and which are here to stay?

Executive Summary

In this article, we discuss the results from an internal survey of Barings professionals from around the globe and highlight key conclusions, including:

- How work-from-home (WFH) trends may equate to similar office footprints, but with lower costs, as well as larger living spaces
- Why lower density, lower cost U.S. cities and suburbs will likely be winners from the increased focus on health and hygiene
- Why e-commerce gains may stick, and the related impacts on the logistics and retail
- How warehouse demand could be boosted by occupiers' embrace of resilience
- How investors should consider all of these trends from a portfolio allocation standpoint

Real Estate's Reaction to the Shock Felt Around the World

The global economy is climbing out of a deep recession brought on by the coronavirus pandemic, a truly exogenous event. The unique nature of the pandemic and the containment measures employed to mitigate its impact have placed commercial real estate at the epicenter of the crisis. Due to the contractual nature of lease income, real estate normally offers some protection from disruptions in the economy, or a more muted, delayed response. But unlike most economic shocks, the pandemic has not only disrupted property cash flows with immediate effect across all property types, it also is challenging long-held ideas about the future demand for and use of different types of real estate and locational preferences.

Indeed, if there is one takeaway for the real estate industry from the past few months, it is that connectivity and the virtual world enabled by technology increasingly can act as a substitute host for many of the activities that previously could only take place in physical space. Although the timing and severity of the impact vary widely by property type and market, the virus and efforts to contain its spread are having a profound effect on leasing and transaction activity. Both have slowed dramatically for practical (lockdowns) and sentiment (uncertainty) reasons, and both will likely remain subdued for as long as the economy is forced to operate at reduced capacity.

Beyond the pandemic, however, the more interesting and relevant questions for real estate investors concern how COVID-19 might affect the long-term outlook for different property types and markets. The experience of living with a potentially deadly virus has elicited a broad range of actions and behavioral responses to adapt to life in a pandemic. Although many of these will fade away once the threat from COVID-19 recedes, some changes will be durable and will impact real estate demand and use well into the future. Investors, therefore, need to re-examine their pre-COVID expectations for each property type and market to assess whether and how the pandemic might change the distribution of future possible outcomes, and how portfolio allocations might need to change in response.

“If there is one takeaway for the real estate industry from the past few months, it is that connectivity and the virtual world enabled by technology increasingly can act as a substitute host for many of the activities that previously could only take place in physical space.”

Survey Results: Four Themes That Will Drive Behavioral Change in Real Estate

To better understand the pandemic’s long-term effects on real estate, Barings Real Estate (BRE) Research compiled a list of potential behavioral changes that we have either observed since COVID-19 upended daily life back in March, or that we believe might be possible in/after the non-normal pandemic world. Our project began the same way as most do these days, on a shared screen over WebEx, where our global team collaborated to produce a list of 40+ observed or potential behavioral changes, regardless of how likely or transitory they seemed. For each item we noted the motivations for each change (e.g., fear of density), the potential implications for different property types and markets, and some ideas for the best indicators to track how or whether the behavioral changes are playing out.

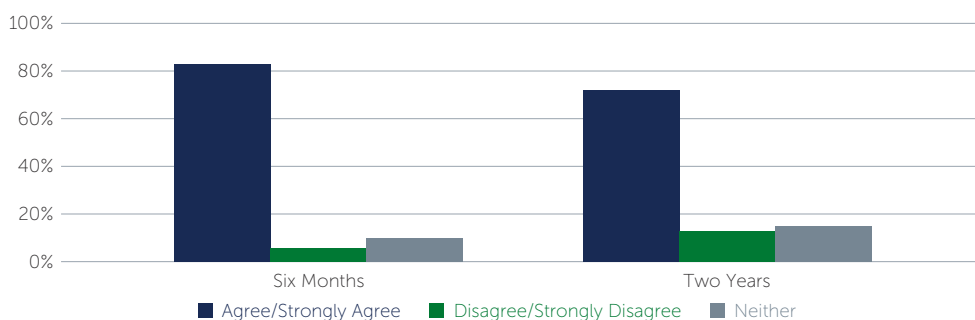
As expected, there were many common threads that allowed us to group the behavioral changes into four broad themes as a framework for thinking about how this unprecedented event might impact real estate. The four themes—Work-from-Home, Health and Hygiene, Tech Adoption, and Vulnerability and Resilience—were then used to develop a survey that was distributed to a cross-section of Barings investment professionals.¹ Likewise, while the team identified a range of motivations behind the behavioral changes, we ultimately distilled those into two familiar and powerful emotions: fear (risk) and greed (reward). As noted in the discussion below, the behaviors that are expected to persist long term tend to be associated with greed (reward), while those associated with fear (risk) are expected to fade.

Work-From-Home (WFH) Will Change Office Demand and Use

Perhaps the most visible and widely debated change in behavior, at least within the real estate industry and the office sector in particular, has been the Great WFH Experiment. While WFH is not an option for many workers, for jobs that can be done remotely, the surprising success of the experiment has the potential to change how employers think about their business model and real estate footprint, and how workers think about employers. There is consensus within our research team and survey respondents that the pandemic is a tipping point for acceptance of WFH. Going forward, we expect more companies will allow employees to work from home for some or all of the time, and more employees will elect to work from home with greater frequency.

A Tipping Point for Working Remotely

Q: Working from home is ingrained in corporate culture, allowing employees to work from home for some or all of the work week when needed or desired. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

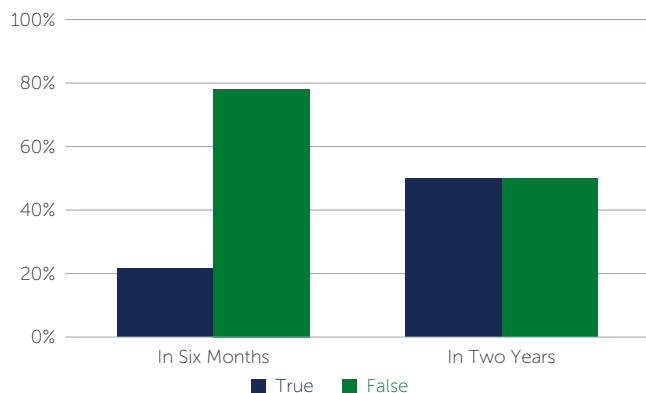
1. The survey data was collected in the first half of June and includes responses from ~100 participants across several Barings’ departments: Senior Leadership, the Investment Institute, Real Estate Equity and Debt, and Real Estate Research & Analytics.

The motives for greater acceptance are fairly clear and compelling, and while “greed” might sound a bit cynical, the advantages of working remotely have less to do with fear than with the rewards that accrue to the companies and workers. Corporate real estate costs represent a meaningful expense for most companies, and WFH may provide a path to higher margins if companies can reduce occupancy costs without compromising productivity, innovation or corporate culture. WFH may also help companies compete in the battle for talent by allowing them to tap into a larger talent pool unconstrained by geographic location. For workers, having the flexibility and support to work remotely as needed can alleviate many pain points, such as having to choose between long commutes or exorbitant living costs, and it allows workers to greatly expand their universe of potential employers.

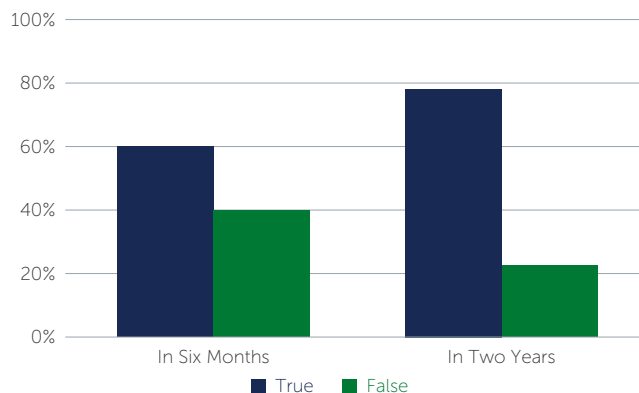
Broad acceptance of working remotely clearly has the potential to impact real estate demand and location preferences. Most survey respondents expect WFH will translate into demand for larger living spaces that incorporate home office functionality, and that the new (or renewed) focus on larger living spaces will be a durable trend. But whether WFH will lead to smaller corporate office footprints is more of an open question. Long-term leases make it difficult for companies to alter space requirements on short notice, but survey respondents were split evenly when questioned whether corporations would have materially smaller office footprints in two years. The uncertainty likely stems at least in part from the fact that for most companies the office serves not just as workspace, but also plays an important role in defining and nurturing corporate culture, training and mentoring new employees, recruiting talent, team building and a long list of other intangibles that would be difficult to replicate on a sustained basis in a virtual world.

Smaller Office Footprints, Larger Living Spaces?

Q: Corporations have a materially smaller office footprint than pre-COVID. Do you agree or disagree that this statement will be true at the following times in the future?



Q: Living spaces evolve (and grow) to incorporate home office functionality. Do you agree or disagree that this statement will be true at the following times in the future?

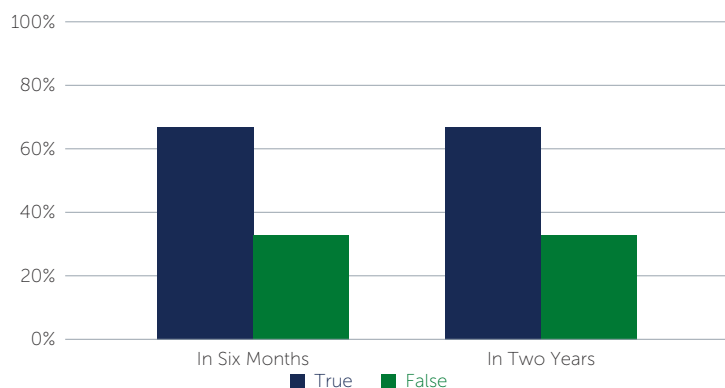


SOURCE: Barings Real Estate.

The answer for most companies is likely more complicated or nuanced than simply reducing (or not) the aggregate footprint, and probably varies more widely by region than other potential impacts from COVID. Office space per worker has declined steadily over the past three decades, interrupted only by episodes of headcount reductions during recessions. Even before the words “social distancing” became part of the everyday vernacular, however, critics were questioning whether density had gone too far, which may help explain why survey respondents believe a reversal of the shrinking space per worker is more than a short-term response to COVID.

Office Densification Trend Expected to Reverse

Q: Offices have greater square footage per desk/workspace than pre-COVID. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

While the prospect of having fewer employees in the office on any given day may allow companies to downsize, they will need to balance the potential savings with the more pressing need to succeed in the war for talent, as well as the practical considerations that might go along with having workers in the office on an “as needed” basis. For example, for employees who choose to work remotely some or most of the time, the office will likely be a place for more collaborative work, which implies less dense layouts with more meeting rooms and breakout space than might otherwise be required for the more routine work that will be done remotely.

Longer term, the office sector clearly is where the range of potential future outcomes is the widest, and that added uncertainty should command a higher risk premium. Competition for talent means companies will continue to tailor their workspace strategies to attract and retain the best workers, which involves thinking as much about where they choose to locate as how much space they might require. Companies are unlikely to give up their city center headquarters anytime soon. But if enough workers decide to decamp from high cost urban areas to secure larger living spaces—or for whatever reason—then companies with large concentrations of workers in expensive gateway markets will have more reason to rethink their office footprint. A decentralized model, with a reduced presence in dense, urban central business districts (CBDs) and a network of “remote” offices located in lower-cost suburbs or smaller cities, may not work in all markets or for all employers, but it would allow employers to establish a local presence closer to wherever talent prefers to live. Consequently, the office footprint may not change much, but total occupancy costs might be lower.

Health and Hygiene Will Mean Lower Density Cities Are Near-Term Winners

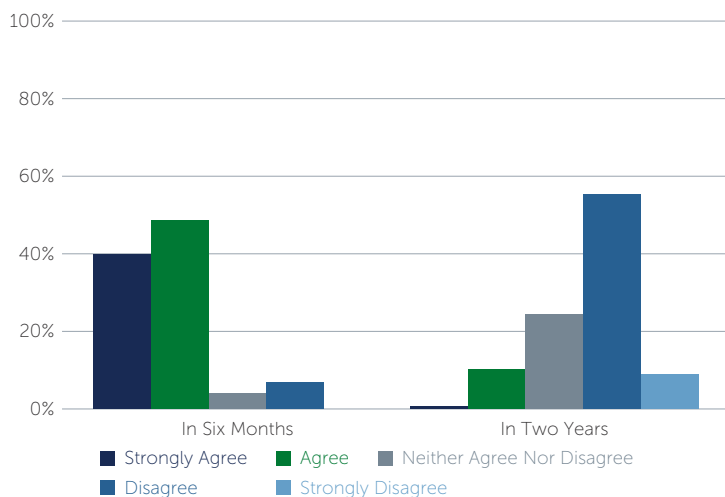
Understandably, many of the behaviors that are impacting real estate demand and use during the pandemic, and for as long as it continues,

are related to health and hygiene concerns. Social distancing and stay-at-home mandates effectively shut down much of the commercial real estate market in Q2, causing leasing and transaction activity to grind to a halt. Hotels and retail suffered the most immediate and severe impact, but with the economy on hold all property types experienced some disruption in cash flows and demand. Densely populated urban areas, which rely heavily on mass transit to transport millions of residents and workers, have been hit especially hard and face a difficult and potentially protracted recovery.

Although the timing of a medical solution to COVID-19 is impossible to predict, most survey respondents believe that people will be far less concerned in two years about health and hygiene. BRE Research’s operating assumption is that a medical solution will be found, hopefully sooner than later; but until a treatment, cure or vaccine is available, people will remain cautious and the economy will operate at reduced capacity.

Focus on Health and Hygiene Likely to Fade

Q: People are very focused on health and hygiene, and continue to practice social distancing, avoiding densely populated spaces and large gatherings. Do you agree or disagree that this statement will be true at the following times in the future?

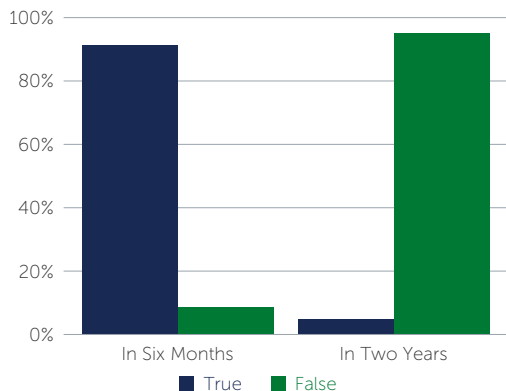


SOURCE: Barings Real Estate.

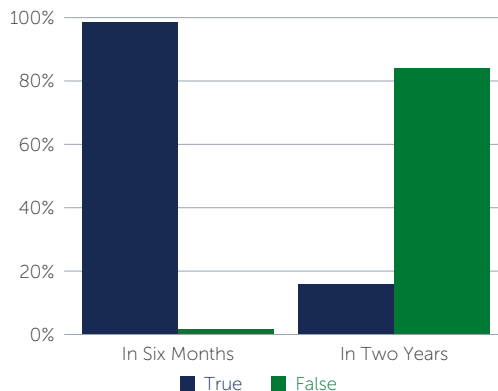
Retail and hotel cash flows will continue to be most challenged in the near term as people avoid unnecessary exposure to groups, particularly when enclosed spaces are involved. These behaviors will hold back the recovery in air travel, dining at restaurants, entertainment (e.g., movies, concerts, sports) and shopping in physical stores, especially in malls. But as fear-driven (risk) behaviors, they should recede once the threat from COVID-19 has been eliminated (or significantly reduced), and attitudes toward social activities revert to more normal standards. Encouragingly, respondents’ expectations for senior housing demand follow a similar pattern, with powerful long-term demographics outweighing short-term concerns about health and safety protocols.

Consumer Behavior Expected to Revert to Normal

Q: People reduce dining in at restaurants and congregating at other enclosed public spaces (e.g. movies, indoor concerts). Do you agree or disagree that this statement will be true at the following times in the future?



Q: Employees and companies shy away from conferences and conventions. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

Health and hygiene issues affect all property types to some degree. While the impact varies, the more important focus for investors will be how risk and return has changed within sectors for the near and long term. For example, because the pandemic poses greater near-term challenges for density generally, the risks for urban locations and high-rise buildings, mostly office and multifamily, will be higher as long as COVID remains a threat. Fear of urban density will fade and cities will regain their vitality as dynamic engines of growth, culture and innovation. But, as noted above, cities face many challenges in their recovery, including higher costs for implementing whatever adaptations become part of standard operating procedure. At a minimum, these will include cleaning protocols and monitoring systems for large, public spaces, including schools and huge networks of public transportation infrastructure—all to be funded on what in many cities is likely to be a badly damaged tax base.

In the near term, smaller, lower density and lower cost cities and suburbs in the U.S. look poised to be the relative winners in attracting jobs and households. For apartments, the density question and potential requirements for working remotely will favor larger, non-urban garden-style properties with walk-up or direct unit access. For offices, the sweet spot for demand in the early phase of the next cycle will likely be modern, state-of-the-art properties in the same lower density, lower cost cities and suburban locations where Millennials and Gen-Zers increasingly are choosing to live.

Lastly, while most behaviors associated with health and hygiene concerns appear to be relatively less durable, that does not mean that increased awareness of health risks won't influence real estate demand and use going forward. In all likelihood, the pandemic will shape the design and operation of all types of real estate, similar perhaps to how the industry adapted after the 9/11 terrorist attacks. Modern buildings with advanced health and safety features and tech infrastructure will clearly have advantages attracting tenants and capital, which means that going forward accelerating rates of depreciation and obsolescence will alter the risk-return profile of older stock.

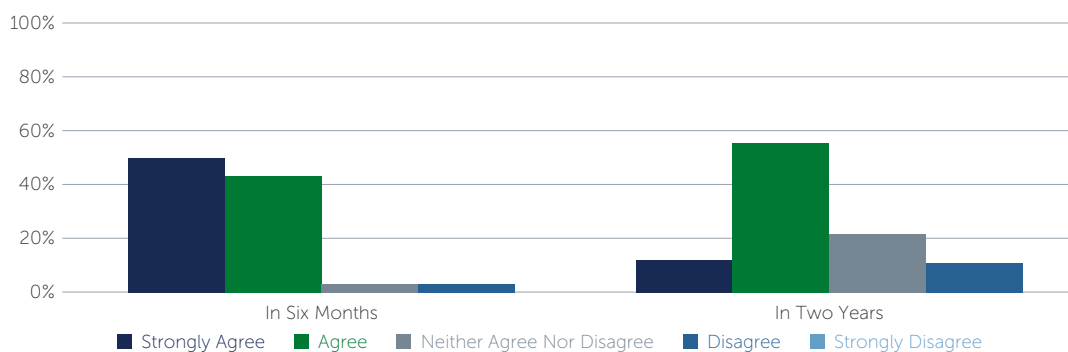
“WFH may provide a path to higher margins if companies can reduce occupancy costs without compromising productivity, innovation or corporate culture.”

Tech Adoption Will Disrupt More Than Retail

The third theme, broader adoption of technology, is probably the most impactful, and clearly represents an amplification and acceleration of a powerful force in the economy and society. COVID-19 has forced businesses and individuals to adopt technology to carry on the activities that ordinarily would take place in physical space, and both BRE Research and our survey respondents believe many of the changes will be durable, even if usage of certain applications retreats from the peak levels that were necessary in a pandemic. Tech innovation is a critical source of improved productivity and efficiency in the economy, with a broad range of rewards (greed) for adopters, both businesses and individuals, and society generally. But it can also be an important means for mitigating risk, and so appeals to the fear motivation as well.

Pandemic Has Accelerated Tech Adoption

Q: People continue to use the technology adopted during COVID-19 to replace physical actions and activities. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

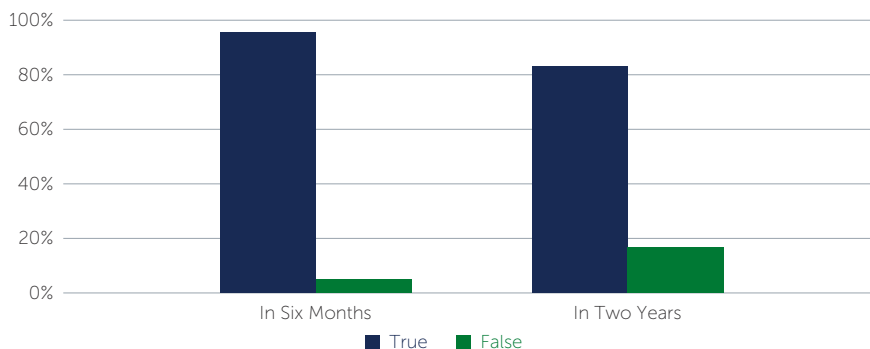
The biggest tech disruption story over the past cycle has been the ongoing disintermediation of physical retail stores by online platforms. Since the coronavirus outbreak forced all but essential shops to close in strip centers, high street and malls, consumers have had little choice but to do more of their shopping online. Unfortunately, even as the economy reopens, both the willingness and ability to shop in physical stores will likely be limited, adding to the struggles that many retailers were already facing before the pandemic.

A key question will be how much of the increased share of spending that is being captured online, particularly in segments and with consumers where penetration was low, goes back to physical stores. Online grocery sales in most countries have accounted for a tiny but rapidly growing share of e-commerce sales. But they have surged everywhere during the pandemic as millions of consumers who never shopped online for basic necessities had no other option. The sudden increase has tested (and exceeded) the limits of the still-developing grocery fulfillment infrastructure, creating frustrating experiences for some users that may discourage adoption once stores are fully operational again. But both BRE Research and survey respondents expect the gains for online sales will be sticky, even if penetration in low-margin segments like groceries lags behind.

“Few would argue with the notion that for many in society, higher education and advanced degrees are prohibitively expensive... Technology has proven incredibly effective at addressing resource scarcity and pricing inefficiencies, so it is more likely a question of when and how, rather than whether that disruption comes to education.”

E-commerce Gains During Pandemic Will Mostly Stick

Q: Online sales are significantly higher than pre-COVID, especially in previously low penetration products and cohorts (e.g., food and necessities; older people), and previously low penetration countries. Do you agree or disagree that this statement will be true at the following times in the future?



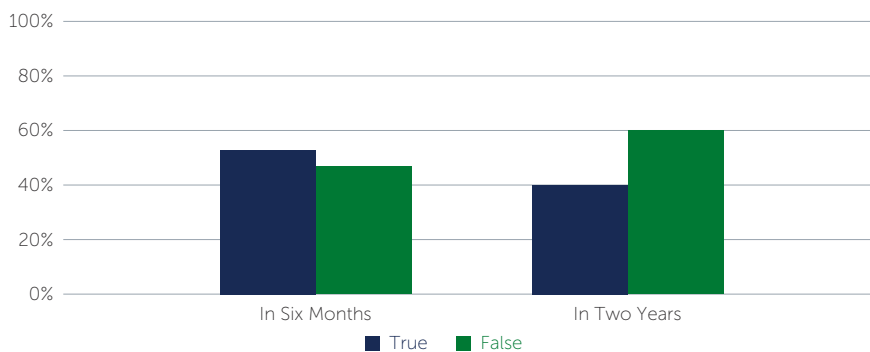
SOURCE: Barings Real Estate.

The combined effect of the economic toll from the pandemic and accelerated e-commerce growth will hasten the demise of secondary physical retail. As the economy reopens, however, the shrinking universe of retail space will provide additional support to the positive demand outlook for warehouse and distribution space, especially modern, “last-mile” space in close proximity to large, affluent populations—the same trade area metrics that have always applied to the retail properties that e-commerce fulfillment centers are threatening to replace.

The pandemic experience also has made clear that broader tech adoption has the potential to disrupt far more than retail and warehouse. The great online learning experiment gets less attention than WFH, but it raises interesting and important questions about the future of education, with many implications for real estate demand, and for student housing in particular. But there is considerably less consensus on this issue than most, among both the research team and survey respondents.

Online Learning Still Looking for Acceptance

Q: Distance/online learning has entered the mainstream. Online degrees gain credibility and students with online degrees are common and accepted in the recruiting and hiring process. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

In the near term, if students go back to physical classrooms before there is a medical solution to COVID-19, aggregate demand for student housing will likely increase to accommodate lower density, even if enrollment remains flat. Privately owned student accommodation typically provides more space per student and fewer residents sharing common areas, and should be well positioned to capture any excess demand.

The bigger unknowns concern the long-term outlook as online learning platforms improve and the cost and access benefits become harder to ignore. Few would argue with the notion that for many in society, higher education and advanced degrees are prohibitively expensive, in terms of both direct costs and the time required; and the consequences of this reality are painfully apparent in soaring student debt and a widening gap in educational attainment. Technology has proven incredibly effective at addressing resource scarcity and pricing inefficiencies, so it is more likely a question of when and how, rather than whether that disruption comes to education. Early adopters will likely include students pursuing advanced degrees—i.e., students who are unable or unwilling to attend classes on campus due to work and/or family commitments—and international students who either cannot travel due to COVID-19 restrictions or who would prefer to remain at home until the virus is no longer a threat.

Broader adoption of technology is, of course, another force that favors modern buildings with the most advanced health and safety systems and robust tech infrastructure. Indeed, one

outcome from the pandemic experience that seems certain is increased investment in technology—touchless everything, sensors, HVAC upgrades, UV lighting, etc. That investment may be difficult to recapture in the form of higher rents until demand recovers and the supply pipeline empties, but it will be critical to remaining competitive and mitigating obsolescence risk.

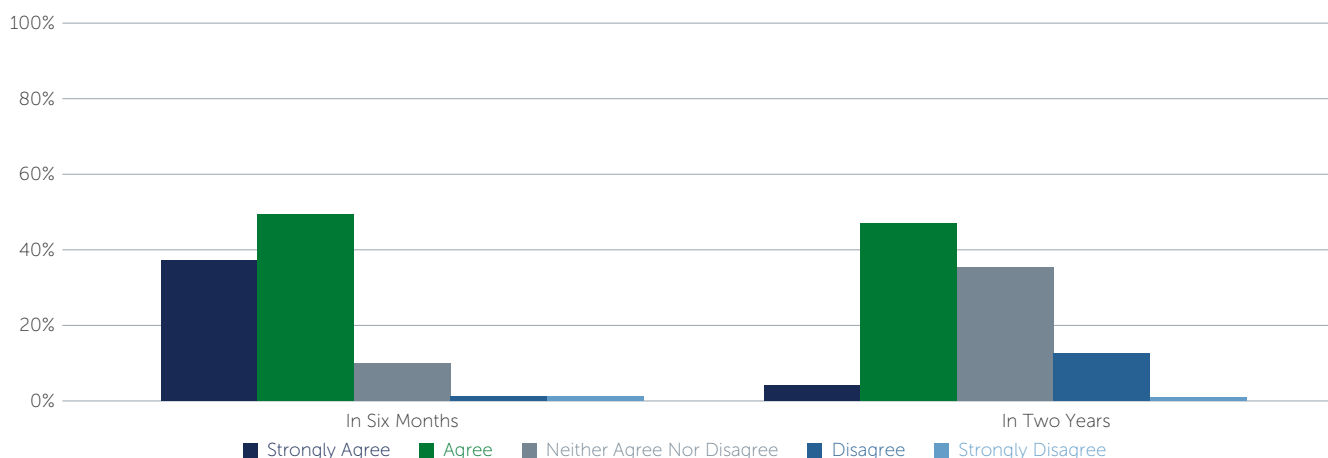
Vulnerability and Resilience Will Drive Warehouse Demand

The pandemic also has been a stark reminder of our vulnerabilities and a test of resilience. Survey respondents agreed that in the near term, there will be a heightened sense of social and economic fragility, as well as increased awareness of the important role of self, family and the community in providing comfort and safety. Longer term, however, that sense of vulnerability and community is expected to diminish—and presumably will diminish quite dramatically when a medical solution to COVID-19 is available.

The near-term implications for real estate stem partly from the macro consequences of badly damaged sentiment. In the near term, households and businesses are likely to be more cautious in their spending, and their reluctance will be a headwind for both the recovery and real estate demand. Survey respondents expect that in the near term savings rates will remain elevated, and college age and adult children will move home for security and to save money. But longer term, confidence is expected to recover and defensive behaviors, such as higher savings rates and families sheltering together, will revert to longer-term normal levels.

Sense of Vulnerability Should Dissipate Over Time

Q: There is a heightened sense of social and economic fragility and greater need to rely on self, family, and community for comfort and safety. Do you agree or disagree that this statement will be true at the following times in the future?

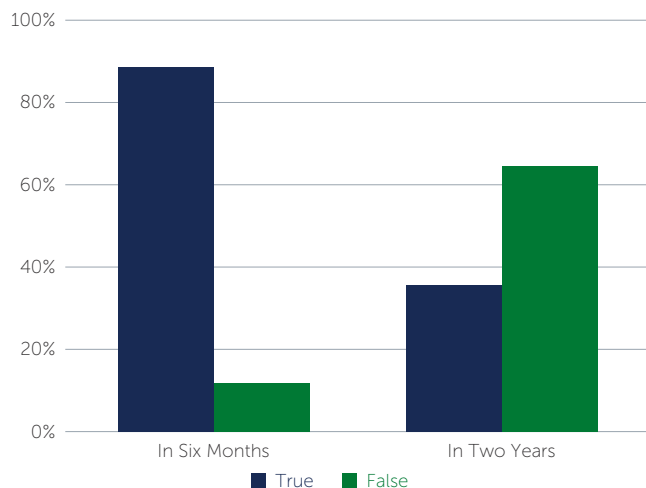


SOURCE: Barings Real Estate.

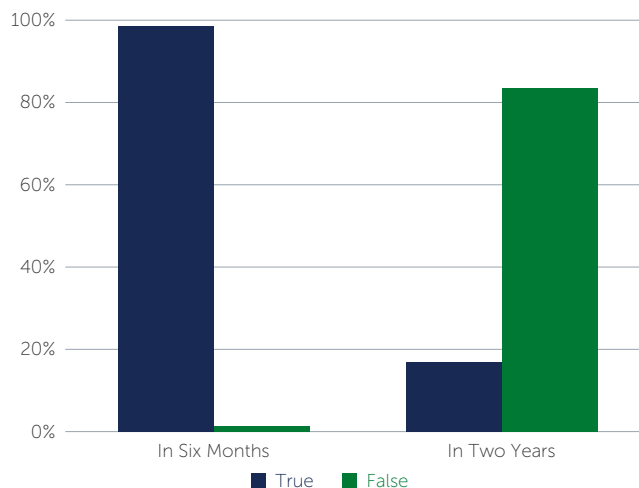
2. For a thoughtful discussion of online education, please see “Are Universities Going the Way of CDs and Cable TV?” by Michael D. Smith in The Atlantic (<https://www.theatlantic.com/ideas/archive/2020/06/university-like-cd-streaming-age/613291/>).

Focus on Savings and Family Likely to Recede as Sentiment Improves

Q: The personal savings rate remains elevated, as households fear another mass unemployment event and save at higher levels accordingly. Do you agree or disagree that this statement will be true at the following times in the future?



Q: For both cost reasons, as well as the security of the family unit, college age and adult children remain in the family home in greater numbers and for longer than pre-COVID. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

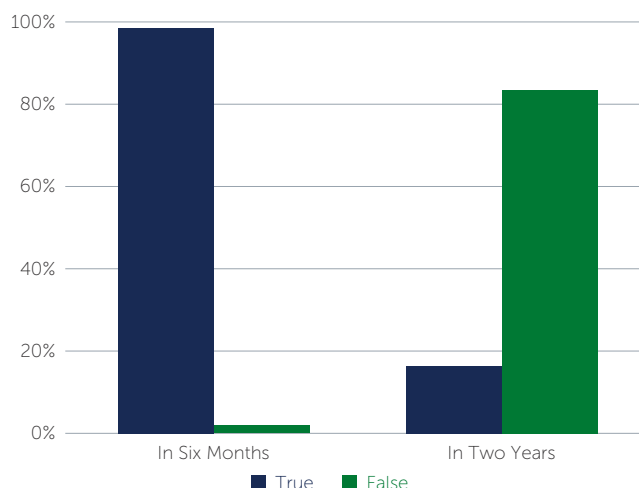
The resilience theme will likely have positive implications for warehouse demand. Even before the pandemic, companies were re-examining their supply chains to make them more resilient to disruptions. One approach involves companies carrying higher levels of inventory, which clearly would boost near-term demand. But if margin pressures ultimately compel companies to revert to leaner operations, as our survey respondents expect, then any additional absorption we might see in the near term is likely pulling future demand forward. A more interesting and potentially more impactful approach to improve resilience involves “re-shoring” or “near-shoring” to shift production of certain goods to domestic or proximate markets. Even on a small scale, such a manufacturing renaissance would have a multiplier effect in terms of industrial demand.

Structurally Higher Demand for Warehouse?

Q: Countries and States place a higher value on keeping the production of certain goods domestic/local and are willing to pay a higher cost for greater certainty of supply. Do you agree or disagree that this statement will be true at the following times in the future?



Q: Companies keep materially higher levels of inventory on hand, or nearby, than pre-COVID, pulling back from a “just-in-time” inventory model and migrating toward a “just-in-case” inventory model. Do you agree or disagree that this statement will be true at the following times in the future?



SOURCE: Barings Real Estate.

For other property types, the direct effects on demand from the vulnerability and resilience theme should be transitory. For example, hotel demand is showing tentative signs of recovery, with humble beginnings in leisure travel at drive-to destinations; and as the economy reopens and confidence returns, business travel will resume gradually, followed by group and lastly convention business. Broader adoption of technology could have some longer-term impact on corporate hotel demand, if only at the margin, as virtual meetings replace some of the more discretionary in-person meetings that otherwise would require travel. But the sense of vulnerability that is holding back demand for large segments of the lodging sector should fade with the threat from COVID-19.

Longer-term, the vulnerability and resilience theme has far broader and more profound implications for the economy, cities and communities. The economic shock caused by the pandemic and more tragic evidence of senseless violence and discrimination toward people of color have exposed deep-seated racial and social inequalities, and sparked encouraging responses from individuals, corporations and public institutions. As skeptical optimists, our research team remains hopeful that the commitments being made at all levels to be more inclusive and to work actively to address inequalities

and injustice will prove durable and will further promote ESG as a guiding principle in investing, policy and our daily lives.

Portfolio and Investment Implications

While the pandemic creates serious challenges for real estate assets and portfolios, it provides an important opportunity—if not imperative—for investors and portfolio managers to re-examine risk and return across and within sectors and markets in the context of a post-COVID world. Whether portfolio allocations change meaningfully or at the margin, to position the portfolio to benefit from long-term structural drivers, including the durable behaviors noted above, investors need to carefully examine how risk and return have shifted within and between sectors.

A well-constructed diversified real estate portfolio will always have allocations to all the major property sectors; but because both performance benchmarks and property markets vary widely in different regions, the starting point and opportunity set also differs by region. As detailed below, BRE Research shares the generally favorable consensus view of industrial and apartments as having the best risk and return expectations post-COVID, which makes both sectors natural overweights in a

diversified portfolio. But as consensus favorites, the margin for safety is thinner. Likewise, our recommended underweights to hotels and retail are neither surprising nor a departure from our position pre-COVID. While we believe both sectors offer attractive opportunities for investors who take the time to understand how demand might evolve post-pandemic, COVID-19 has altered the distribution of risk and return within each sector.

The more challenging questions concern the office sector, where it is more difficult to generalize across regions. The underweight in the U.S. stems in part from the challenging economics of owning and leasing office assets over multiple cycles, which the pandemic will exacerbate as rents fall while operating and capital expenses increase. However, in other regions, particularly where the multifamily rental sector is a relatively newer institutional property type, the current heavy underweight to retail means that pre-COVID office allocations will be closer to neutral by default. That said, the pandemic has shown that WFH is a viable business model, and while there are likely to be a wide range of corporate office models going forward, the uncertainty surrounding demand and pricing in the post-COVID world adds to the risk premium investors require for office investments today.

BRE Research Allocation Preferences

Sector	Pre-COVID Weighting	Post-COVID Allocation	Near-term Outlook
Apartment	Overweight	Increase	Moderate-risk
Seniors Housing	—	Stable	High-Risk
Student Housing	—	Reduce	High-Risk
Hotels	Underweight	Reduce	High-Risk
Leisure	—	Stable	High-Risk
Business	—	Reduce	High-Risk
Industrial	Overweight	Increase	Moderate-Risk
Office—Europe	Neutral	Stable	Moderate-Risk
Office—U.S.	Underweight	Reduce	Moderate-Risk
Life Science/Lab	—	Increase	Moderate-Risk
Medical Office	—	Stable	Moderate-Risk
Retail	Underweight	Reduce	High-Risk

SOURCE: Barings Real Estate. For Illustrative Purposes Only.

The above represents the views of Barings Real Estate as of June 30, 2020 and are subject to change at any time without notice. This chart was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This should not be treated as investment advice or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

“Since the coronavirus outbreak forced all but essential shops to close in strip centers, high street and malls, consumers have had little choice but to do more of their shopping online. Unfortunately, even as the economy reopens, both the willingness and ability to shop in physical stores will likely be limited, adding to the struggles that many retailers were already facing before the pandemic.”

There clearly will be winners and losers, and opportunities to benefit from shifting demand preferences set into motion by COVID-19. But how these play out across different regions and markets will vary, which means investors will need a flexible approach to asset selection that recognizes these differences to identify the assets best suited for their portfolios.

In the near term, we expect high-rise office towers in dense urban areas will face the biggest challenges in getting back to normal levels of operation and utilization. Longer term, we believe companies will probably continue to find ways to shrink their overall footprints, but we will likely see a slight reversal in that trend in the near term due to social distancing and reductions in head count. Whatever the outcome, the most competitive (i.e., least risky) office properties will be the most modern buildings in the submarket, offering state-of-the-art health and safety features, tech infrastructure and mechanical systems.

The underweights to hotels and retail are undoubtedly the least controversial. Hotel demand suffered an immediate and severe shock from the pandemic and containment efforts, and the sector faces a long and challenging recovery that will be further complicated by reluctance to travel and broader adoption of virtual meetings as a potential substitute for at least some discretionary business travel. While that substitution effect raises questions about future demand for business hotels, the longer-term outlook for leisure hotels is relatively unchanged by the pandemic, which may create opportunities for investors to take advantage of the ongoing dislocation in the lodging sector to acquire assets at a material discount to their pre-COVID valuations.

Retail was a structural underweight even before COVID-19 due to the ongoing assault from e-commerce. The pandemic will accelerate the demise of many retailers whose fortunes and chances of survival were already in doubt, but it will also destroy viable businesses that were simply unprepared for a black swan. The fallout will be felt across all retail segments, but most acutely in malls, which in recent years have managed to backfill retail tenants lost to e-commerce with new entertainment and leisure concepts that face extraordinary challenges in the near term. Necessity-based retail (i.e., grocers and pharmacies) historically has been most resistant to online penetration, and has been relatively resilient during the pandemic; but it too will face increasing pressure from online platforms.

The headwinds in the retail sector have been and remain powerful tailwinds for industrial property, and underpin our long-term overweight allocation to the sector. As noted above, a new focus on resilient supply chains and production adds to the already favorable demand outlook; and a persistent lack of modern supply in most markets will support demand for new development. While we believe industrial should continue to outperform in the near to medium term, competition for existing cash-flowing assets has driven industrial yields to historically low levels in many markets. Our preferred strategies include modern, “big box” warehouse with excellent connectivity to major distribution routes and modes, and “last-mile” distribution facilities in close proximity to large, densely populated consumer markets.

Structural drivers also underpin our favorable long-term outlook for the residential sector generally, and apartments specifically. Housing is a necessity, so it is not surprising that apartment demand and cash flows have been fairly insulated in the near term from the effects of the pandemic. That has not been the case for specialized housing sectors such as student and seniors housing; and a protracted slowdown in the economy with elevated levels of unemployment would take a toll on apartment fundamentals and rents. However, with most markets facing a persistent deficit in housing supply, we believe apartments will continue to be among the top performing sectors long term. Near term, we would favor garden-style and low-rise properties—ideally with some combination of walkable amenities, good schools and access to transit—in affordable small cities and densifying suburban locations outside major gateways.

BRE Research Investment Preferences

Sector	Risks and Potential Opportunities—Post-COVID
Apartment	<ul style="list-style-type: none"> • Risk profile: increased near-term risks for high-rise product in dense urban areas; may accelerate rising homeownership trend • Opportunities: garden-style, low-rise apartments with larger unit sizes (to allow for home-office functionality) in higher-growth, lower-cost cities and suburbs
Hotels	<ul style="list-style-type: none"> • Risk profile: travel restrictions and social distancing measures limit demand near term; reduced business and group travel longer-term risk • Opportunities: premium-branded select service and upper upscale hotels in leisure transient/corporate transient markets, with near-term focus on markets less reliant on air travel
Industrial	<ul style="list-style-type: none"> • Risk profile: broad economic weakness will hurt many occupiers near term; declining global trade and supply chain reconfiguration may impact port activity • Opportunities: modern, big box regional distribution and “last-mile” urban logistics assets
Office	<ul style="list-style-type: none"> • Risk profile: increased risk for high-rise office towers in dense CBDs heavily dependent on mass transit; longer term, potentially smaller office footprints as companies embrace flexible work arrangements • Opportunities: modern office stock with state-of-the-art health and safety systems and tech infrastructure; near-term focus on low-rise buildings with ample parking and good access
Retail	<ul style="list-style-type: none"> • Risk profile: job losses and higher savings rates increase near-term risk due to weak spending; longer term, accelerated adoption of e-commerce poses risks for groceries and daily necessities, historically the safest segments of retail • Opportunities: the best retail will survive and eventually may emerge stronger, but the path is uncertain and pricing does not yet appear to reflect the increased risks

SOURCE: Barings Real Estate.

Closing Thoughts

Behavior is notoriously difficult to alter, and in all likelihood few of the changes that seem possible today will prove durable once an effective treatment, cure or vaccine is available. But that does not mean the pandemic has not altered our collective psyche. Science will find a solution to COVID-19, but awareness of the looming threat of future pandemics will almost certainly have an impact on long-term behavior. More immediately, COVID-19 has mostly accelerated powerful structural trends that were already underway, but it also has altered the range of possible outcomes for all investments. For real estate specifically, investors need to re-examine portfolio allocations in the context of a post-pandemic world. Although the fundamental features of that world—aging population, massive debt burdens, low interest rates and slow growth—will look familiar, risk-reward relationships have changed in important ways that create new risks and new opportunities for investors.

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