Park Madison Perspectives

Outlook 2023

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About Park Madison Partners

Park Madison Partners is a boutique New York-based capital solutions and advisory firm for global real estate alternative investments. Since its formation in 2006, Park Madison has advised on over $25 billion in private capital placements for a wide range of real estate vehicles including closed-end funds, open-end funds, separate accounts, programmatic joint ventures, and recapitalizations.

Park Madison Partners was founded to offer clients capital raising and strategic consulting services with a high degree of customization, integrity and accountability. The firm provides a relationship-driven approach to structuring and marketing assignments and offers its clients access to global institutional investors. Our team comprises professionals with backgrounds across the buy-side and sell-side, and we leverage this experience to provide a thoughtful approach to global real estate markets.


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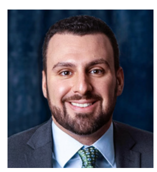
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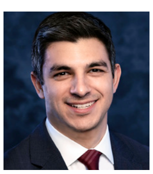
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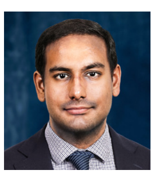
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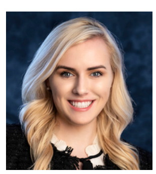
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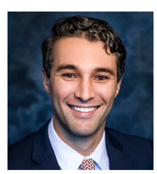
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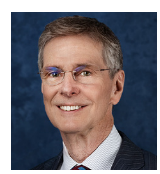
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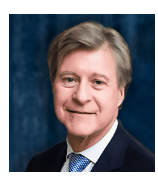
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> **"Every government intervention in the marketplace creates unintended consequences, which lead to calls for further government interventions."**
>
> **– Ludwig von Mises**

The last three years have been quite the roller coaster of market interventions. In 2020, pandemic lockdowns took U.S. unemployment to Depression-era levels virtually overnight. Fiscal and monetary stimulus came to the rescue, sending unemployment to historical lows and asset prices to new highs. As the unintended consequence of inflation became apparent, the Federal Reserve was forced to quickly pivot from the easiest monetary policy on record to the fastest pace of rate hikes in 40 years. Investors are certainly feeling the whiplash.

When markets are this volatile, the most extreme predictions tend to get the most airtime. They also tend not to age well. For instance, the pandemic was not followed by an L-shaped recovery, and the "Roaring 20s" roared much less after the first rate hike. For investors in private markets, filtering through the noise and retaining a longer-term perspective can be difficult, but it is essential for sound decision-making. A commitment to vintage year diversification also helps.

Each year we try to predict what the future might hold, and we always hope our predictions will age well, or at least prove entertaining. We examine what we got right and wrong last year in our "2022 Scorecard" at the end of this piece. But first, here are our top 10 predictions for 2023:

1.	Inflation will normalize following a Fed-induced recession	**4**
2.	Real estate capital markets will stabilize, but valuations will weaken amidst higher interest rates and cap rates	**7**
3.	Residential segments will see a price correction, but fundamentals will remain solid	**9**
4.	Industrial will continue to experience moderate rent growth amidst low availability	**11**
5.	Office will see further bifurcation as tenant "flight to quality" is exacerbated by recession and a more permanent WFH culture	**13**
6.	Retail's post-pandemic recovery will continue despite a slowing economy	**16**
7.	Niche property types will continue to gain favor as investors seek new sources of diversification and alpha	**18**
8.	Real estate capital formation will remain challenging amid low transaction volumes and the "denominator effect"	**20**
9.	ESG's political battle lines will harden and create divisions among the institutional real estate community	**23**
10.	Climate migration risk will cause investors to reassess their exposure to less resilient geographies	**25**

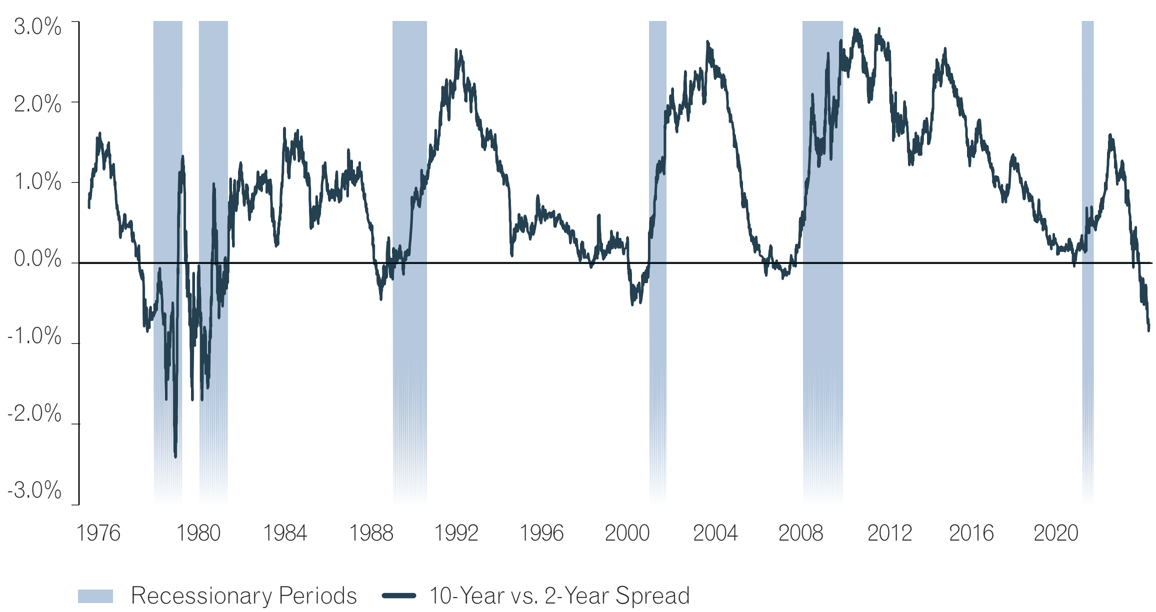
1 Inflation will normalize following a Fed-induced recession

With the Federal Reserve aggressively hiking interest rates and shrinking its balance sheet, most market participants are treating a 2023 recession as a given. The Fed appears poised to take interest rates above 5 percent, in what would be the fastest rate of tightening since the early 1980s Volcker era. The Fed's actions have raised the cost of borrowing and led to a rapid deterioration in financial conditions. Quantitative tightening, or "QT," will further drain market liquidity as the Fed shrinks its balance sheet by $95 billion per month. QT just started to ramp up in late 2022, and its full impact on financial markets will not materialize until early 2023.

Such a restrictive monetary stance appears likely to trigger a recession, and several leading indicators are already flashing warning signs. The Treasury yield curve is heavily inverted, reaching extremes also not seen since the Volcker era. Such inversions have preceded the last ten U.S. recessions. Other leading indicators such as manufacturing orders, construction spending, and credit conditions are also signaling a slowdown.

Danger Ahead

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity, 1980-Present



Source: Federal Reserve Economic Data

With recession almost a foregone conclusion, all eyes are now on inflation readings for clues on when the Fed can ease up. Thankfully, most indicators suggest inflation will moderate in the coming quarters. Supply chain pressures are easing, input prices are falling quickly, and shelter inflation – which comprises 40 percent of core CPI – should decline in coming months in tandem with slowing home price appreciation.

Cooling Off

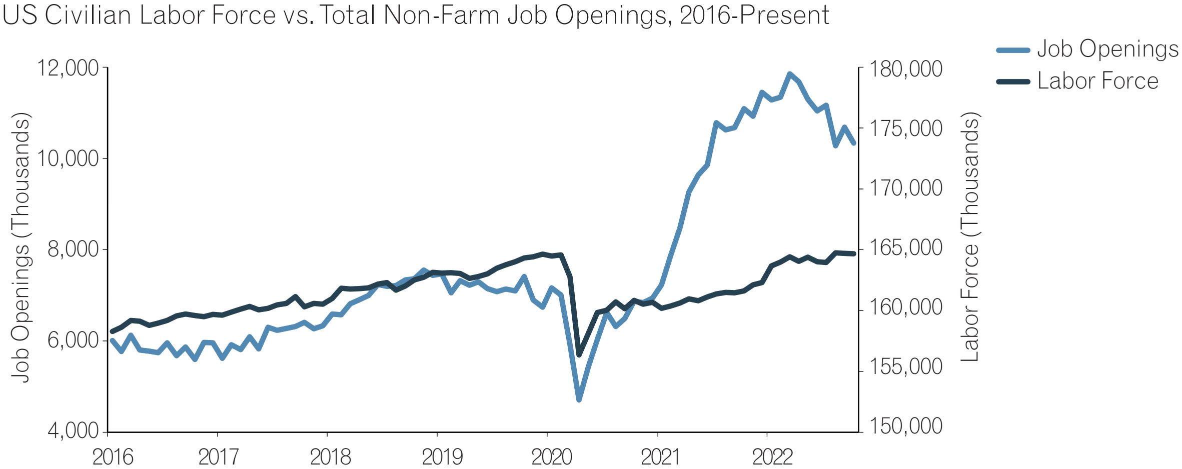
U.S. Shelter CPI vs. Case-Schiller National Home Price Index, Annual Percent Change

Source: Federal Reserve Economic Data

Despite this good news, tight labor markets are a stickier inflation driver, which we believe will cause the Fed to err on the side of keeping rates higher for longer. Unemployment is still abnormally low, and job openings remain at a historically high level of 1.7 jobs per unemployed worker. Such imbalances pressure wages higher as companies compete for labor, threatening a wage-price spiral that would undermine the Fed's efforts to curb inflation. As such, we do not believe the Fed will lower rates until there is a meaningful rise in unemployment.

Out of Balance

US Civilian Labor Force vs. Total Non-Farm Job Openings, 2016-Present



Source: Federal Reserve Economic Data

The Fed therefore appears poised to engineer a recession to ensure the inflation fire is thoroughly extinguished. Despite this risk, we expect any pain from a recession to be short-lived. Because recession is so widely anticipated, investors, consumers, and businesses have been able to plan for it well in advance. The Fed also seems resolved about front-loading the economic pain to tame inflation quickly. This would presumably allow the Fed to pivot to less restrictive policy, providing the set-up for the next recovery and expansion. While the coming quarters may be difficult, we expect that investors that remain disciplined and plan accordingly will be well-rewarded on the other side.

Climate Supply Shocks

While the Fed can fight inflation by cooling demand, central banks have limited policy tools to curb inflation caused by supply shocks, such as those experienced during the pandemic. Climate change is likely to increase the frequency of such supply shocks in the coming decades. Extreme weather such as drought, heat, and flood – to which climate change is a contributing factor – can reduce crop yields and create shortages.

The recent mustard shortage in France offers an interesting case study. While France is the global center for mustard consumption, approximately 80 percent of the mustard seeds used to make authentic French Dijon are actually grown in Canada. But a two-year drought caused Canada's annual mustard harvest to fall by half in 2022, resulting in mustard shortages throughout France. Similar scenarios could easily play out with other agricultural products such as avocados in Mexico, oranges in Florida, or almonds in California. Mediterranean nations are currently bracing for an olive oil shortage after the worst drought in modern history slashed harvests. Rolling shortages could become a part of everyday life in a warming world.

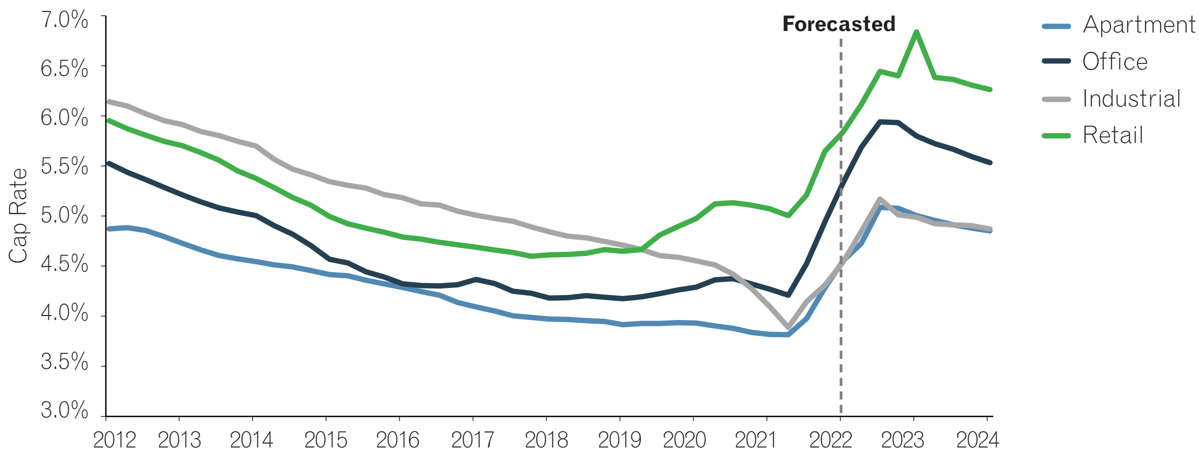
As extreme weather events become more frequent, the resulting supply shocks could create longer-term inflation pressures that monetary policy would struggle to contain. In the event of such a scenario, we expect real estate's reputation as an inflation hedge to gain additional currency.

2 Real estate capital markets will stabilize, but valuations will weaken amidst higher interest rates and cap rates

Commercial real estate enters 2023 in the midst of a deep winter in capital markets. Uncertainty over terminal interest rates – and by extension terminal cap rates – have led to a buyers' strike, with many institutional investors staying on the sidelines. Cap rates have materially expanded in every major property type, and there is a general consensus that they will move still higher. Lenders have also pulled back, with banks lending primarily to stabilized assets in favored property types, and some even pausing real estate lending altogether. As a result, price discovery remains elusive.

A Little Less Sizzle

U.S. Cap Rates for Major Property Types, Q4 2012-Q4 2024F



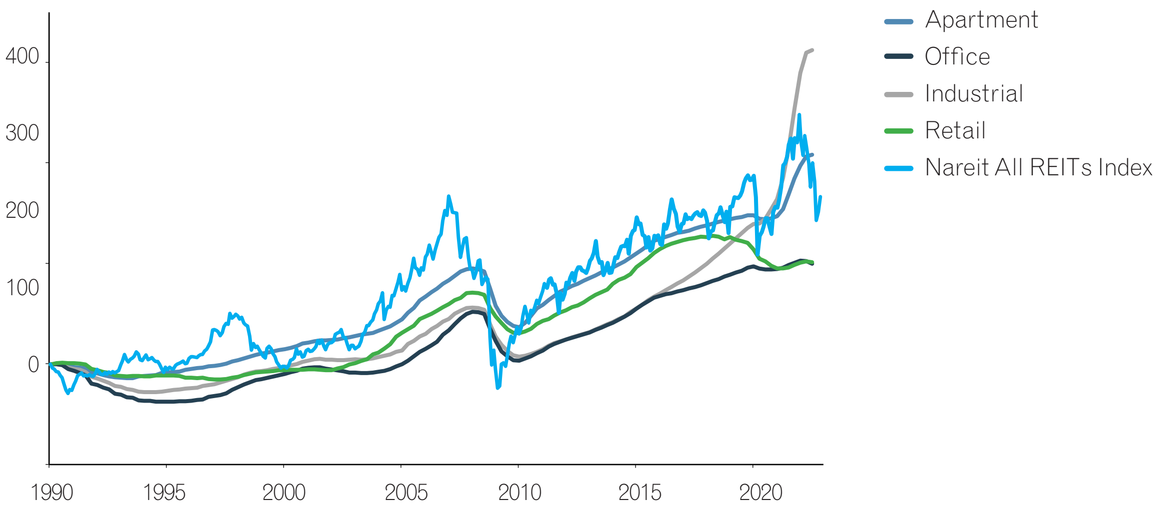
Source: CBRE

The sudden freeze in capital markets seems paradoxical. With the exception of office, real estate operating fundamentals held up fairly well in 2022 as rents increased and vacancies remained low. But a recession would likely challenge fundamentals across all property types. Recessions reduce demand, leading to rising vacancies and softer rents.

As real estate fundamentals deteriorate, we believe a price correction is likely. While an imperfect barometer, the public REIT market may offer clues for what to expect. Public REIT share prices have historically led private real estate valuations by about a year, and REIT shares have fallen approximately 30 percent from their December 2021 peak according to the FTSE Nareit all REITs Index. However, private real estate valuations have yet to see meaningful declines across the four major property types according to the NCREIF Market Value Indices, suggesting further write-downs ahead.

Public Market Harbinger

NCREIF Market Value Indices (Apartment, Office, Retail, Industrial) vs. FTSE Nareit All REITs Index, 1990-Present

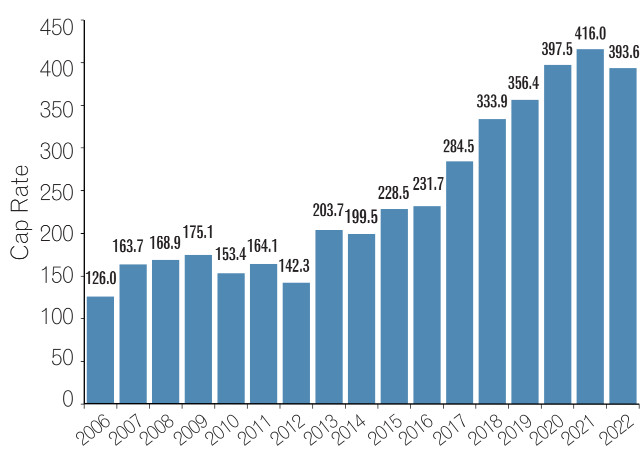


Source: Nareit, NCREIF

While the near-term looks challenging, we believe the longer-term picture holds opportunities for real estate investors. Monetary policy uncertainty – along with the capital market volatility it creates – has been one of real estate's biggest headwinds in 2022. As inflation falls and monetary policy normalizes, we expect real estate capital markets to thaw as cap rates stabilize and lending activity resumes. With investment managers sitting on nearly $400 billion of dry powder and continued strong demand for U.S. assets from offshore capital, investment activity could recover quickly once a new market equilibrium is established.

A Large Safety Net

Closed-End Real Estate Dry Powder, 2006-2022



Source: Preqin

Of course, some uncertainties and risks will remain. The pandemic's effects are still coursing their way through real estate fundamentals, and demand for certain property types may never return to "normal" levels. Approximately 40 years of steadily falling interest rates also appears to be over, removing a steady tailwind that has spanned the careers of most of today's real estate professionals. Investment performance will therefore become increasingly dependent on growing NOI, rather than cap rate compression.

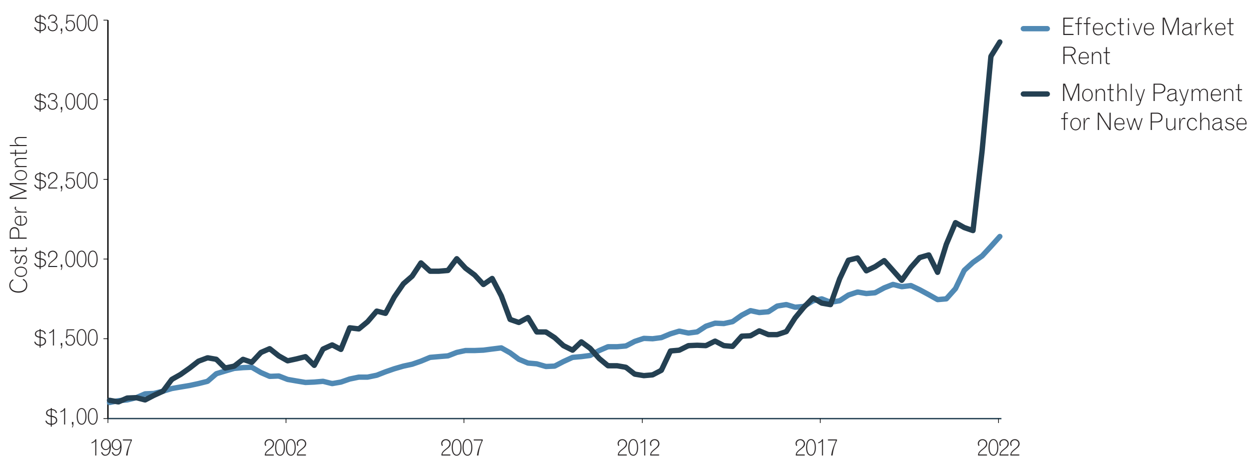
3 Residential segments will see a price correction, but fundamentals will remain solid

After an incredible post-pandemic run, residential real estate enters 2023 in the midst of a price correction. Cap rates have expanded at least 100 to 200 bps as interest rates rise. Rent growth is expected to moderate amid softening home prices and a near-term surge in new deliveries. CBRE estimates 450,000 multifamily units being delivered in 2023, adding 2.6 percent to total inventory. Though residential remains a favored asset class, uncertainty over capital markets and fundamentals have made investors more cautious.

While a price correction seems likely, we believe residential fundamentals will remain supported by long-term secular demand drivers, starting with barriers to homeownership. Median U.S. home prices in the for-sale market have topped $450,000 – a 41 percent surge since Q2 2020. Buyers could perhaps afford to pay these prices when 30-year mortgage rates were 2.75 percent. But with mortgage rates more than doubling in 2022, the cost of renting versus buying has hit its widest gap on record. CBRE estimates monthly mortgage payments are 57 percent higher than the cost of renting as of Q3 2022, versus an 8.5 percent gap before the pandemic. This differential should lead to continued strong demand for workforce housing multifamily, single-family build-to-rent ("BTR"), and other rental housing segments.

The Mortgage is Too Damn High

Effective Market Rents vs. Monthly Mortgage Payments, 1997-Present



Note:
The monthly payment for a newly purchased home assumes 30-year mortgage with a 10% down payment (in line with historical trends for first time buyers from the National Association of Realtors), the median listing price according to Realtor.com, as well as a presumed PMI payment of 0.75% and state and local tax payment of 1.8% of purchase price.

Sources: CBRE Research, CBRE Econometric Advisors, Freddie Mac, Census Bureau, National Association of Realtors, Q3 2022.

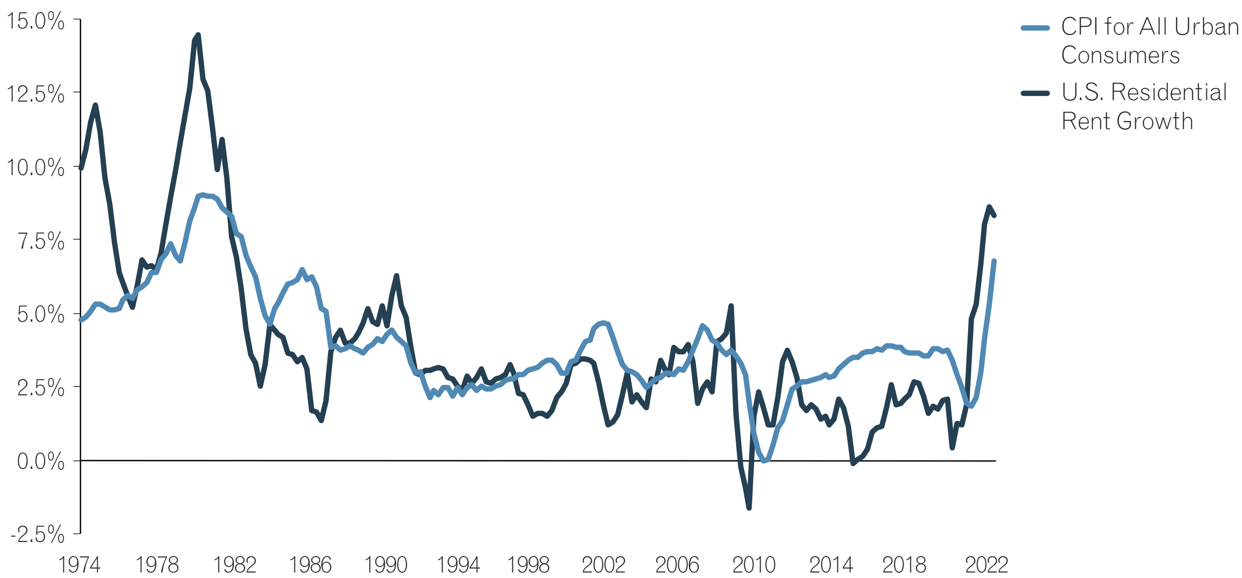
Low vacancies should also provide residential landlords with steady pricing power. Nationally, occupancy rates are down from their pandemic highs but remain above 95 percent. The number of renter households also continues to grow. The U.S. Census Bureau estimates that from 2007 through 2021, the number of renter households increased from 35.2 million to 43.1 million.

The pending wave of new supply could undercut landlords' ability to push rents in the near term, but these pressures should subside in the years ahead. Elevated construction costs and higher interest rates are creating barriers to new development. Single-family and multifamily construction activity have historically been closely correlated, and single-family housing starts have declined over 30 percent since February 2022. Market sentiment among homebuilders is also deteriorating, which typically corresponds to a reduction in future deliveries.

Ultimately, we believe any price correction in residential will provide an attractive entry point for investors across the risk spectrum. Residential rentals have once again proven their effectiveness as an inflation hedge due to shorter-term leases and close correlation to nominal household incomes. Value-add multifamily strategies should continue to offer strong risk-adjusted returns. BTR remains one of the most compelling development opportunities in real estate today, with both tenant and investor demand continuing to expand. Additionally, less activity from traditional homebuilders should lead to lower land prices and better development margins on BTR projects in the near term. We believe the residential sector's low volatility, stable cash flows, and secular growth story will continue to serve investors well over the foreseeable future.

An Effective Hedge

Multifamily Rents vs. Inflation, 1974-Present



Source: Federal Reserve Economic Data

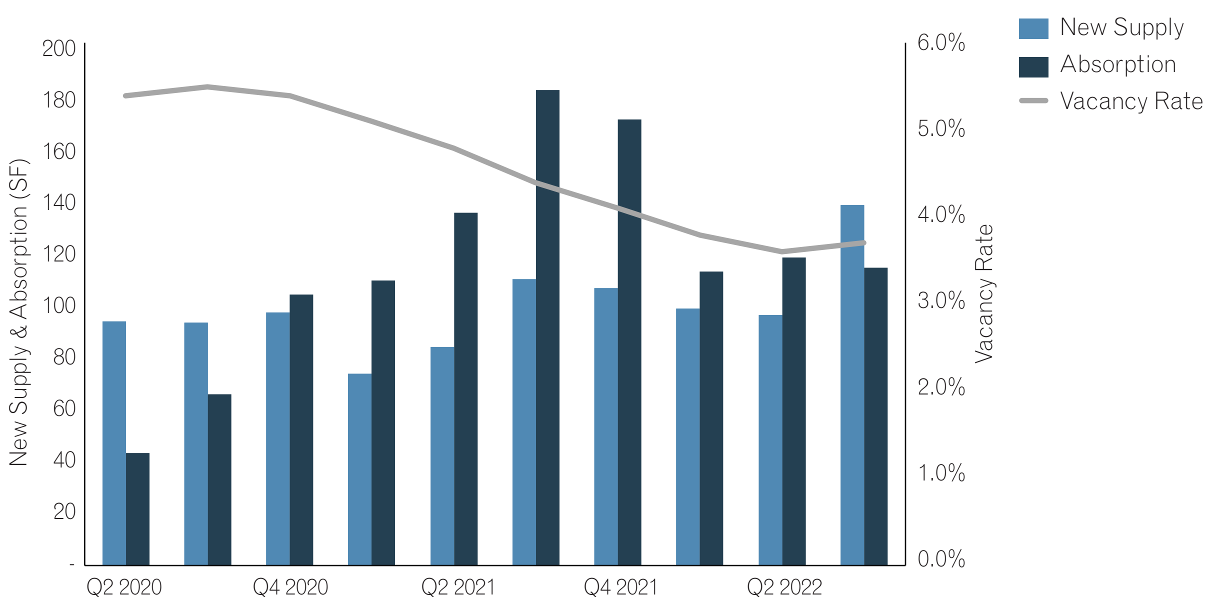
4 Industrial will continue to experience moderate rent growth amidst low availability

As recession risks rise, investors are being reminded of industrial real estate's cyclicality. Historically, industrial has been prone to overbuilding and is sensitive to reductions in business investment. News that Amazon and other large e-commerce tenants are pulling back at a time when new deliveries are at record highs underscores the point. A record 656.9 million square feet were under construction as of Q3 2022 according to Colliers, while absorption is down 19 percent versus 2021.

While an economic slowdown could cause vacancies to rise from current record low levels, we believe industrial occupancy will remain historically strong amidst continued tenant demand. The powerful secular demand drivers that have propelled industrial real estate since the GFC remain intact, and newer catalysts are adding fuel to the fire. High interest rates have also slammed the brakes on new construction starts, with completions expected to drop to 250 million square feet by 2024 according to CBRE. As such, we believe vacancies will remain low across industrial segments, causing rents to grow at a moderate pace throughout 2023.

Keep Calm and Build On

U.S. Industrial New Supply, Absorption, and Vacancy, Q2 2020-Q3 2022



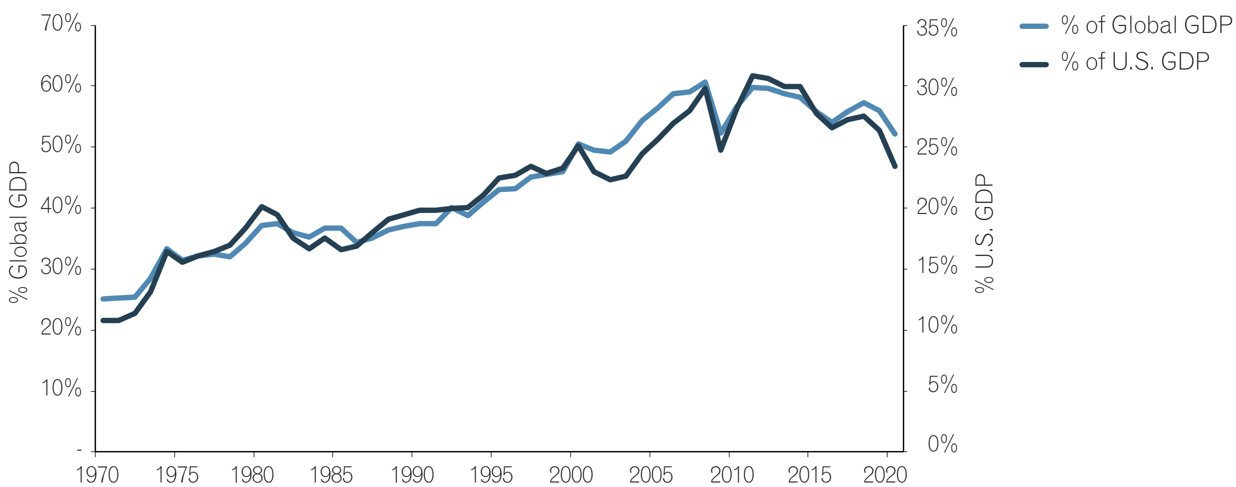
Source: Colliers

The growth of e-commerce has of course been a key driver behind industrial's recent outperformance. E-commerce sales growth continues to outpace the growth in consumer spending overall, as online sales steal market share from traditional brick-and-mortar retail. CBRE estimates that every $1 billion increase in online sales translates to an incremental 1.25 million square feet of industrial warehouse demand, and online sales are expected to grow by an additional $600 billion by 2025. This suggests an additional 750 million square feet of industrial space needed within the next three to four years just to accommodate expected growth in e-commerce.

Onshoring of manufacturing is also still in its early innings. Disruptions caused by the pandemic and the Russo-Ukrainian War have laid bare the vulnerabilities of global supply chains. U.S. policy circles have also become increasingly protectionist, creating more risks to offshore manufacturing from sanctions and tariffs. These are still relatively nascent trends, and we believe onshoring will gain momentum as more companies invest in supply chain resiliency.

Peak Globalization

Trade as a Percent of GDP, U.S. vs. Global (1970-2022)



Source: The World Bank

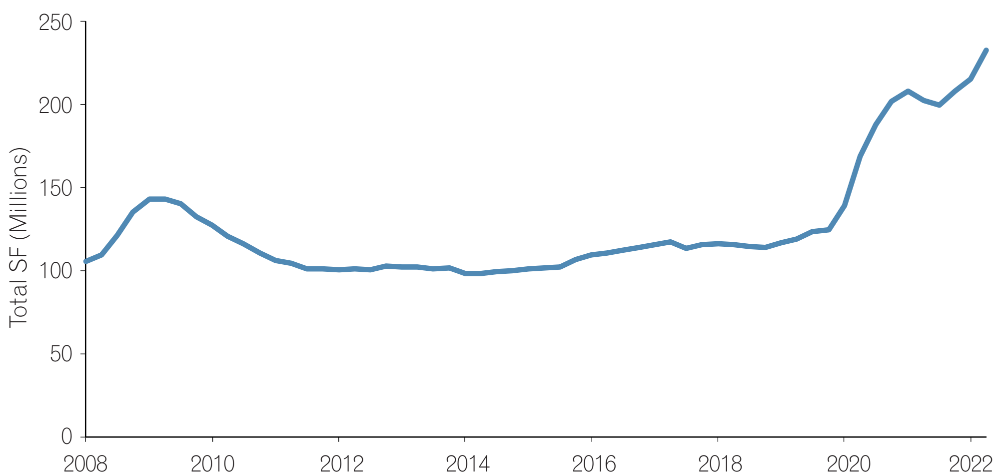
Despite a favorable long-term outlook, industrial properties could still see a further price correction in 2023 as cap rates rise. But industrial is probably one of the best-positioned sectors to weather the impact of rising cap rates. Surging rental rates in recent years have created embedded NOI growth as leases roll; tenants who signed 5-year leases coming due in 2023 are likely to find that their renewal rate is at least 25-35% higher. With vacancies expected to remain low and businesses competing for strategic, well-located industrial facilities, we expect industrial landlords will continue to enjoy considerable pricing power in the years ahead.

5 Office will see further bifurcation as tenant "flight to quality" is exacerbated by recession and a more permanent WFH culture

The post-pandemic outlook for office is challenging. As COVID-19 became less dangerous following the omicron variant, we expected most workers to start returning to the office and for work-from-home ("WFH") to become less prevalent. By March 2022, it was clear that this wasn't happening. Vacancies kept rising. Sublease space availability, which looked like it was turning a corner at the end of 2021, resumed its upward climb.

False Summit

U.S. Office Market Sublease Availability, Q1 2008-Q3 2022

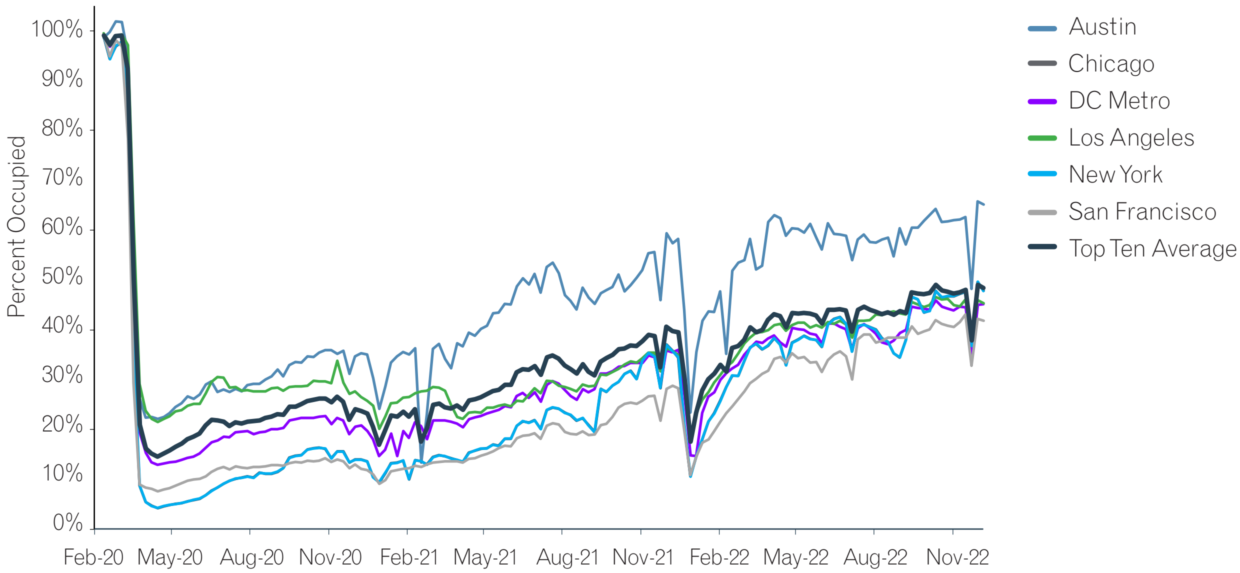


Source: Colliers, CoStar

Workers' reluctance to return to the office can no longer be attributed to health concerns; restaurant traffic returned to pre-pandemic levels in mid-2021 and has held steady ever since. Rather, many workers are simply holding on to the WFH privileges they acquired during the pandemic. Jobs considered to be "office-based employment" have risen above pre-pandemic levels nationally, but office occupancy remains stubbornly low. In New York City for instance, office-based employment is approximately 10 percent above pre-pandemic levels, but office occupancy is less than 50 percent of pre-pandemic levels.

L-Shaped Recovery

U.S. Office Occupancy, February 2020-Present



Source: Kastle

As WFH becomes more entrenched, long-term demand destruction for office looks almost inevitable. Much like the retail experience of the last decade, the U.S. now appears "over-officed" and will likely undergo a years-long adjustment before stabilizing. No one knows just how much overall demand for office will shrink as a result of WFH, but estimates range from 10-40 percent. As a result, we expect office to see more distress than any other property type in the years ahead as leases roll and debt matures.

As demand shrinks, we expect office performance to become heavily bifurcated based on building age and quality. Newer, high-quality buildings with modern amenities and mechanical systems should continue to see strong tenant demand. As availability increases, more tenants are finding they can "trade up" as their leases in older buildings expire, which is particularly compelling for businesses trying to convince workers that their office space is "commute-worthy." While intense competition on amenities will pressure operating margins, we expect tenant flight-to-quality will continue to support occupancy and rents in newer buildings.

Older, more commodity-like properties on the other hand likely need expensive upgrades to remain competitive. But real estate investors are increasingly skeptical of value-add "creative office" projects, and many institutional investors have adopted blanket prohibitions on any new office investments. Lenders have also become more wary of such projects. With little capital available for improvements, antiquated office assets face increased risk of deteriorating fundamentals and functional obsolescence.

Still, there is a contrarian case for office investment in this environment. The existing U.S. office stock of over 11 billion square feet represents a huge opportunity set, but investor sentiment is extremely negative and competition for deals is low. New supply risks are also fading: construction activity peaked in Q3 2020 and has been steadily declining ever since. Opportunities to acquire well-located buildings at a low or distressed cost basis are becoming more prevalent. At the right basis, adaptive re-use to residential might look attractive, and interest in such conversion opportunities is gaining traction. Investing in office today carries considerable risks, but the right assets and strategies could yield significant rewards for discerning investors.

Recession to the Rescue?

We often hear the argument that a recession-induced rise in unemployment could help the office market by reducing labor's negotiating power. Less competition for workers would finally allow more businesses to enforce a return to the office without triggering an employee exodus, or so the thinking goes. But historically, recessions are an unequivocal negative for the office sector as companies delay new leases, reduce their footprints, or go out of business altogether. We see no reason why this time would prove any different. Far from providing any relief, unfortunately we expect a recession will simply exacerbate the myriad challenges currently facing the office sector.

6 Retail's post-pandemic recovery will continue despite a slowing economy

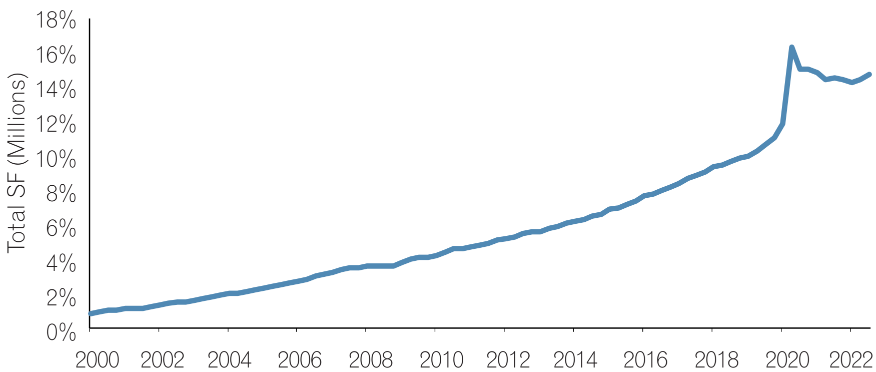
After a decades-long readjustment, retail fundamentals appear to have stabilized. Net absorption has been positive for seven straight quarters. More stores are opening than closing, which hasn't happened since 1995. At 6 percent, U.S. retail vacancy is at its lowest levels in 15 years. Retailers looking for modern, Class A space will find it is in short supply. The "retail apocalypse" may finally be over.

Retail is benefiting from a painful but badly needed supply rebalance. Retail was a victim of decades of overbuilding, with retail square feet per capita steadily expanding from the 1970s until the 2008 GFC. But construction activity has been depressed in the years following the GFC, with deliveries hovering near record lows for the last three years. Antiquated space is also being demolished to make way for other uses. According to JLL, roughly 17 million square feet of retail space was demolished in the first three quarters of 2022, including 800,000 square feet of mall space.

E-commerce is also not the same existential threat to brick-and-mortar retail it once was. After a pandemic-induced surge in e-commerce volumes, the market share of brick-and-mortar retailers has held steady around 85 percent. New brands are increasingly adopting a "digital first" approach, followed by opening physical locations once they become more established. Physical stores provide strategic advantages to retailers. Online advertising has become more expensive and less effective at acquiring new customers. Physical stores on the other hand tend to increase online sales in addition to the new in-person sales they generate, and a growing share of online sales are fulfilled in-store. This suggests a more balanced duopoly between e-commerce and physical retail going forward.

Topping Out?

E-Commerce Share of Total U.S. Retail Sales, 2000-Present



Source: Federal Reserve Economic Data

As retail's fundamentals stabilize, we believe the sector's risk-reward for investors has vastly improved. As other property types cope with rising cap rates, most retail properties already trade at cap rates of 6 percent or higher, providing steady cash flow and positive leverage despite higher interest rates. More investors have started to take note of the outsized yields available versus other asset classes, particularly at well-performing power centers and grocery-anchored neighborhood shopping centers. Certain malls should also continue to provide interesting redevelopment plays, as they tend to be well-located near population centers.

Of course, retail will continue to be a challenging investment sector given today's rapid pace of technological change. Consumers pinched by inflation or recession could also lead to a near-term slowdown in retail sales. But the retail landscape is always evolving, and historically retail has been forced to adapt to change faster than most property types. The pandemic was the ultimate Darwinian stress test, and the survivors are presumably the strongest and most resilient. If retail continues to show relative strength through a 2023 economic slowdown, we expect institutional investor interest will increase and for retail to once again become a more significant part of institutional portfolios.

7 Niche property types will continue to gain favor as investors seek new sources of diversification and alpha

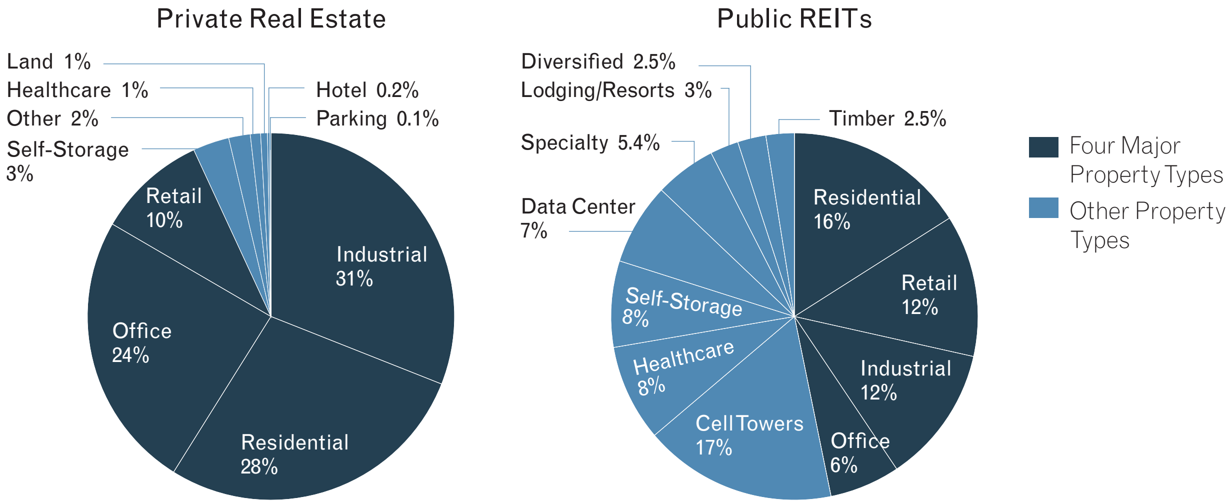
Given the challenges in office and retail, institutional investors increasingly recognize building a diversified real estate portfolio requires a more granular approach than the four major property types. As a result, more investors are turning to niche property types that do not fit neatly within the definitions of office, multifamily, industrial, and retail. These niche sectors include self-storage, student housing, senior housing, manufactured housing, data centers, cold storage, industrial outdoor storage, medical office, lab/life-sciences, parking, single-family built-to-rent, media/studios, and cell towers, among others. All these sectors tend to have specialized uses, unique demand drivers, and risk factors, thereby providing attractive diversification benefits and – in some cases – the potential for outsized returns.

Niche property types are differentiated from traditional real estate sectors in that they typically have idiosyncratic demand drivers, providing investors with diversified income streams. Senior housing and medical office demand are influenced by evolving demographics and an aging population. Data centers and cell phone towers are driven by digital transformation and growth in data consumption. In both examples, the primary factors impacting demand are not closely correlated with the macroeconomy, and historical returns data show that many niche sectors exhibit low correlations to the four major property types. As such, niche properties can provide investors with better diversification in their real estate portfolios.

Most investors lack material exposure to niche property types due to legacy exposure which is heavily weighted toward traditional property types. As of Q2 2022, 93 percent of the ODCE index is comprised of office, multifamily, industrial, and retail. By contrast, niche properties make up a much larger share of the public REIT market, comprising over half of the FTSE NAREIT All Equity Index – a rare example of public markets appearing to out-innovate private equity. But NCREIF is looking to modify its benchmark to provide greater representation to niche sectors. We believe this will encourage higher allocations to niche properties, particularly among institutional investors who manage their portfolios against a NCREIF benchmark.

Opposite Ends

Property Type Diversification, Private Real Estate vs. Public REITs



Sources: NCREIF Open End Diversified Core Equity ending market value as of Q2 2022 via NCREIF, FTSE Nareit All Equity Index

In addition to the diversification benefits, exposure to niche property types presents investors with the opportunity to generate outperformance relative to the traditional property types. Many niche property sectors remain highly fragmented and dominated by non-institutional "mom-and-pop" owners. The often-small equity checks of $20 million or less have historically deterred institutional buyers. Aggregating smaller niche assets into larger, institutionally-scaled portfolios can therefore be a lucrative strategy, with such "roll-up plays" often resulting in significant portfolio premiums upon exit.

In addition to their attractive characteristics, niche real estate sectors also bring unique complexities relative to investments in traditional property types. Demand for niche property types is impacted by changing demographics, technology and innovation, de-globalization, and digitization. In a rapidly evolving economy, investors in niche property types are susceptible to incorrectly interpreting these demand drivers. For example, data centers must continually update their technology related to power supply, cooling systems, and latency to keep pace with evolving tenant needs or risk physical obsolescence. Student and senior housing have a limited demographic catchment, and miscalculations about current or future demand can lead to material underperformance. As such, we expect that the best investment performance will be generated by managers who establish (or partner with other groups that have established) specialized operating capabilities within their respected niche sectors.

8

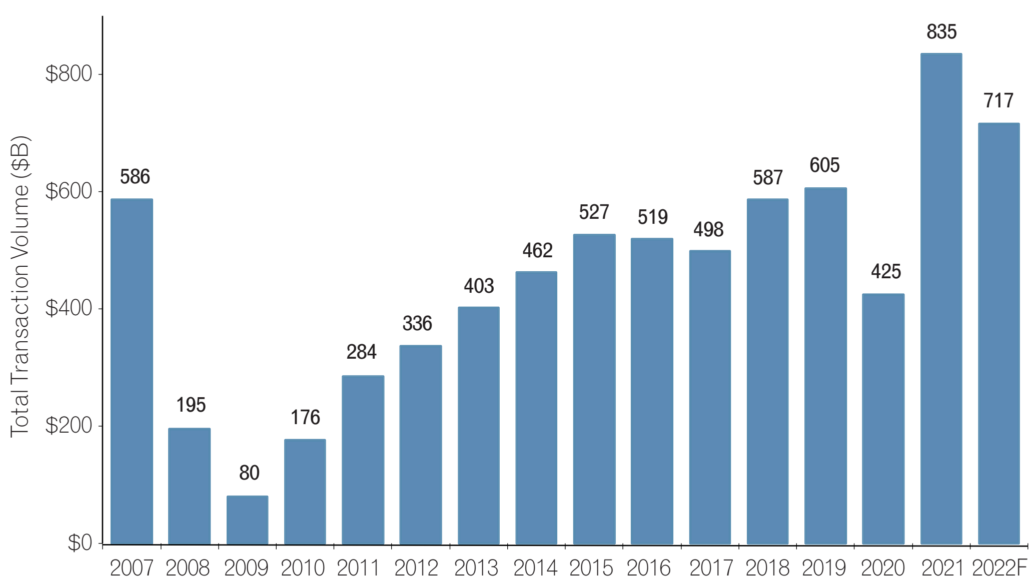
Real Estate capital formation will remain challenging amid low transaction volumes and the "denominator effect"

The next year is shaping up to be challenging for real estate capital formation. Investors are likely to dial back their capital commitments amid the denominator effect, market uncertainty, and liquidity pressures. Emerging managers will face additional difficulty competing with more established incumbents. We expect overall fundraising volumes to fall in 2023, with more managers exploring alternative capital solutions to traditional closed-end funds.

Declining transaction volumes mean investors will receive fewer distributions from asset sales, thereby reducing liquidity for new capital commitments. After notching a record high in 2021 and continuing to surge in H1 2022, commercial real estate transaction volumes look set to fall in the coming quarters. According to CoStar, transaction volumes in Q3 2022 were 25 percent lower on a year-over-year basis. This suggests that while the 2022 annual total may show only a modest decline over 2021, a deeper contraction is underway. As a result, most institutional real estate investors are receiving fewer capital distributions than they had budgeted, giving them less capital to redeploy into the asset class next year.

Worse Than It Looks

U.S. Commercial Real Estate Investment Volume, 2007-2022F



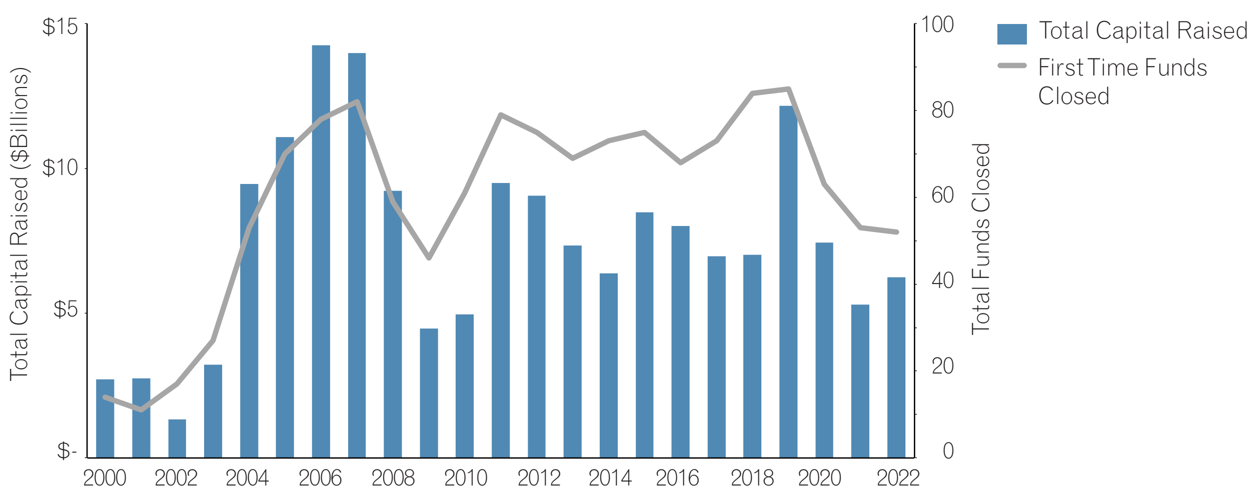
Source: CBRE

Declining valuations in other asset classes are also expected to pinch real estate allocations. Private real estate values have yet to decline meaningfully as insufficient transaction data make appraisers reluctant to write down assets. The tension between managers looking to "rip the bandaid off" and appraisers who require transaction data to support write-downs is evident. The traditional "smoothing" effect of private real estate is being viewed through less rosy glasses as open-end fund investors and managers struggle to manage their incoming and outgoing exit queues. As public equities and fixed income have sold off and private equity is written down based on the public market corollaries, private real estate values have held relatively steady. For some CIOs, this is seen as stabilizing portfolios; however, many institutional investors are now finding themselves over-allocated to real estate versus target. This "denominator effect" often necessitates a slower pace of capital commitments.[1]

We expect the 2023 fundraising environment to be especially difficult for emerging managers, who already faced high barriers to entry before the latest downturn. As alternative investment portfolios become more mature, institutional investors are increasingly focused on re-upping with existing managers, and the bar for adding a new manager is high. Preqin data suggests that the number of first-time funds reaching a final close has been at cyclical lows for the last three years.

Cyclical Lows for Emerging Managers

First-Time Closed-End Funds, Value-Add and Opportunistic, 2000-2022



Source: Preqin, Park Madison Partners

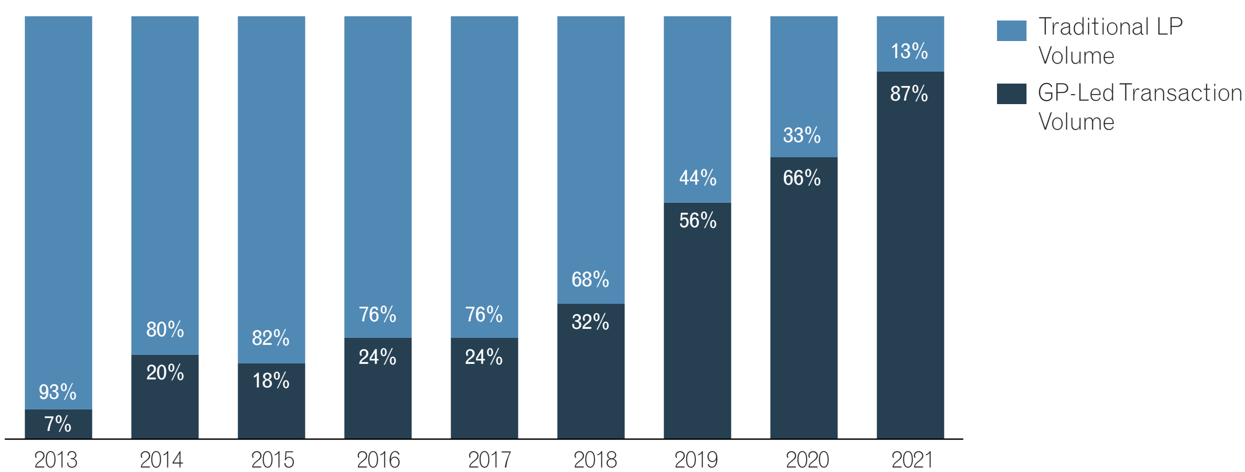
The good news is that average institutional target allocations to real estate continue to increase. Target allocations to real estate expected to increase above 11 percent for the first time in 2023. As real estate investors seek additional diversification, investment managers with differentiated strategies and specific competitive advantages should continue to attract new sources of capital. For instance, managers with established lending platforms have been

[1] The denominator effect is typically an issue of timing, as private real estate appraisals tend to lag public markets in valuation adjustments. Paradoxically, this often causes institutional investors to reduce or pause new capital allocations during downturns, which are often the best-returning vintages for private real estate. Some institutional investors recognize this problem and try to avoid cutting real estate allocations due to denominator-induced imbalances. But other are restricted by the rules of their allocation processes and are likely to allocate less to real estate over the next year.

able to quickly capitalize on higher interest rates and credit spreads; according to PERE, real estate debt funds made up 26 percent of 2022 real estate fundraising as of Q3, the second highest proportion ever recorded. Managers with expertise in favored or niche property types have also been successful.

As the closed-end fundraising route becomes more difficult, real estate managers are increasingly pursuing alternative private capital solutions. In particular, single-asset or portfolio secondaries have gained in popularity as a way for managers to secure new institutional capital partners, refresh business plans, restructure ownership, and reset GP economics. These types of GP-led recapitalizations now account for most real estate secondaries trades. As the economy slows and disposition timelines get extended, GP-led recapitalizations could be a way to provide existing investors with liquidity while avoiding a forced sale in a weak market. We expect to see more managers exploring these types of transactions in 2023.

Secondary Transactions Led by GPs vs. LPs, 2013-2021



Source: Park Madison Partners

9 ESG's political battle lines will harden and create divisions among the institutional real estate community

Environmental, social, and governance standards ("ESG") continue to be a focus of investors, and over half of global institutions have implemented a formal ESG policy. In 2022, however, ESG gained newfound popularity as a political punching bag among right-leaning politicians, who allege that ESG is a smokescreen for pushing left-leaning policy objectives. More right-wing politicians are taking the anti-ESG fight to the public pensions that they oversee and control, sometimes implementing prohibitions against ESG-conscious managers and strategies. We expect this battle to escalate in 2023, creating divisions within the investment community.

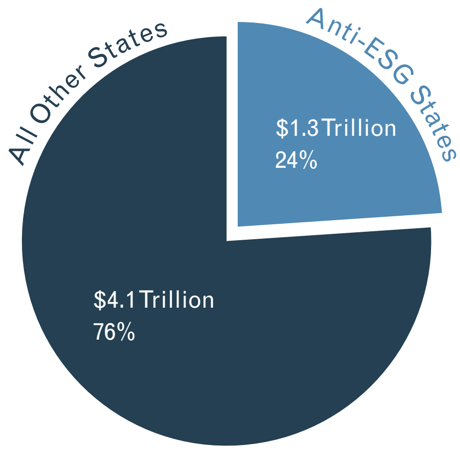
The anti-ESG push has so far mostly played out in public markets, where divestment decisions can be more quickly executed. In August 2022, attorneys general from 19 Republican-controlled states penned a joint letter to BlackRock condemning the firm's commitment to ESG initiatives, particularly regarding the promotion of clean energy at the expense of fossil fuels. Several states have subsequently pulled money out of BlackRock-sponsored funds. Some of this could just be political posturing, but at the very least it shows a willingness to throw public pensions' weight into America's "culture wars."

While the anti-ESG fight has yet to spill into private markets, we believe 2023 could see battle lines start to form. Most of the states pushing back on ESG mandates are passing rules simply stating that ESG should not be a factor in an investment decision, suggesting that investment managers could still have ESG policies without being penalized. But unlike passive investments in public markets, private fund limited partners generally have more influence over their managers' business practices. ESG-focused investors are increasingly pushing managers to adopt explicit investment guidelines, benchmarks to measure progress, and reporting requirements to investors. This could create friction with anti-ESG investors who believe managers should only be focused on maximizing returns.

Any anti-ESG offensive within private markets would likely face stiff resistance. Limited partners have the strongest influence over managers when they are aligned, coordinated, and form a majority. Despite 19 states joining forces in the anti-ESG push, public pension funds in those states only represent 24 percent of the total public pension AUM in the U.S. No such division exists currently among Canadian and European pension funds, which typically have even stricter ESG criteria than their U.S. peers. Any concerted effort to avoid participating in a majority ESG-conscious investor base could therefore lead to adverse outcomes on manager selection, which runs counter to the goal of maximizing returns.

Vocal Minority

Public Pension AUM:
Anti-ESG States vs. All Other States



Source: Texas Attorney General, Preqin, Park Madison Partners

Though pro-ESG investors clearly hold the high ground, we expect several anti-ESG states to start picking battles in private markets in 2023. Recent public market divestments are likely to have little impact, which will leave anti-ESG constituencies hunting for new ways to make their voices heard. The 2024 presidential primary race will also start to ramp up, and ambitious politicians will be eager to shore up their culture warrior bona fides. Private market commitments, and the outsized influence they command over managers, may be too tempting of a target to ignore.

Unmitigated Disasters

While the insurance industry is in the business of managing risk, to date U.S. insurance companies have taken little action to mitigate rising property and casualty claims from climate-related disasters. The largest U.S. insurers hardly mention climate risks in their annual reports despite the steadily rising frequency of extreme weather events, which tend to result in higher insurance losses. The insurance industry's reticence on climate realism encourages risky behavior among other parties: banks continue to lend, developers continue to build, and investors continue to buy.

We think federal agencies could put an end to this complacency sooner than markets appreciate. FEMA, HUD, and the Army Corps of Engineers have already started withholding aid to certain flood-prone areas. Fannie Mae and Freddie Mac have also acknowledged their exposure to climate-related "moral hazard" given their obligation to buy loans from private lenders. Given the Biden Administration's strong commitment to climate action, coordinated federal policy action to reduce climate risk-taking would not be surprising. Any such action could raise the cost of owning real estate in regions more prone to climate risk.

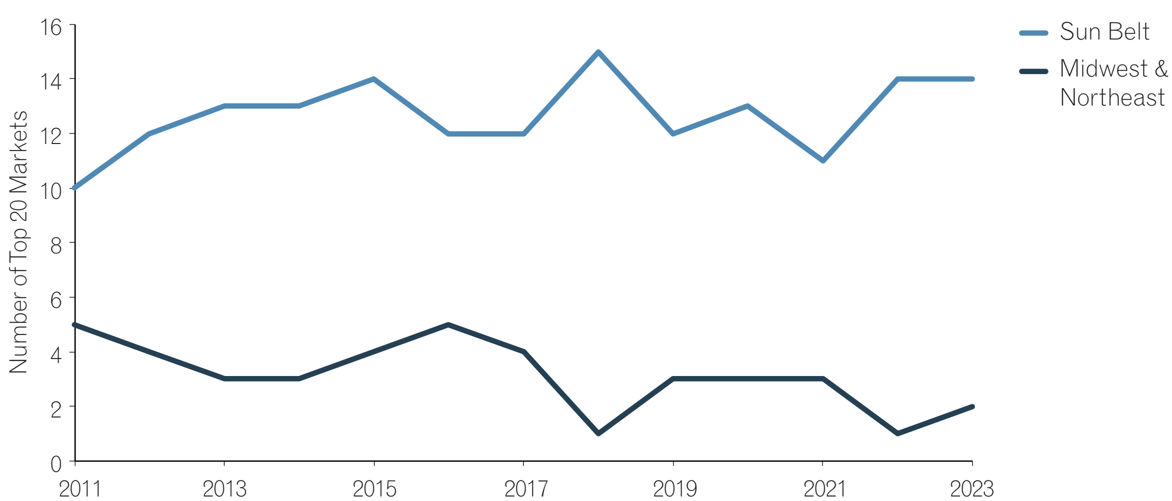
10 Climate migration risk will cause investors to reassess their exposure to less resilient geographies

The real estate industry is starting to pay more attention to the long-term risks posed by climate change, but we believe current thinking misses the bigger picture. Real estate investors focus primarily on the physical and transition risks associated with climate change. Physical risks involve damage caused by extreme weather, or interruptions caused by sea level rise or shifting climate patterns. Transition risk mostly refers to the regulatory response to climate change, including decarbonization requirements like New York City's Local Law 97. While these risks are real and should be taken seriously, such literal categorizations lack imagination and fail to identify what we believe is the most relevant threat to real estate investors: migration risk.

Most real estate investment strategies are predicated on population growth and rising tenant demand. The Sun Belt, for instance, has been a major geographic focus of real estate investors since the GFC as more people are attracted to the region's warm weather, job growth, and (mostly) low taxes. In the Urban Land Institute's annual survey of favorite markets, Sun Belt markets have consistently dominated the Top 20, with institutional capital flows following suit. So, insight on future migration patterns would obviously be quite valuable to real estate investors seeking to get ahead of migration trends.

Concentration Risk

ULI Emerging Trends' 20 Highest Rated Markets, Sun Belt vs. Midwest & Northeast



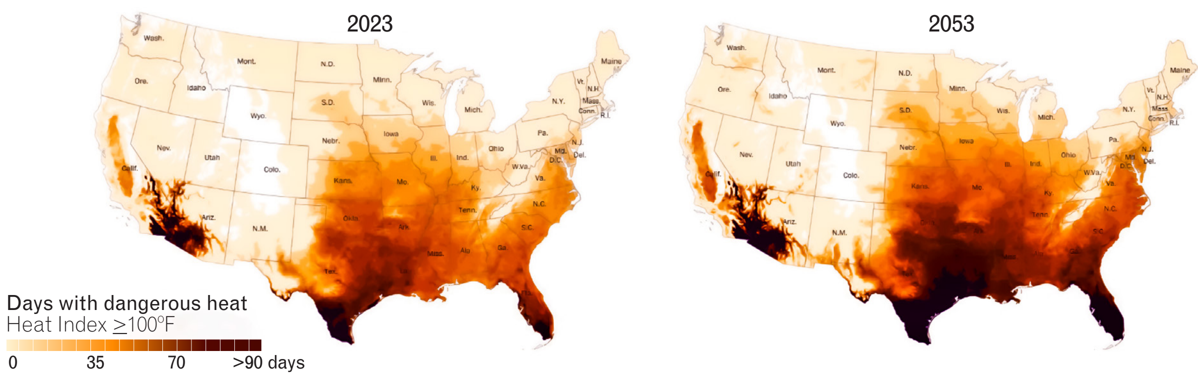
Source: ULI Emerging Trends in Real Estate surveys; compiled by Nelson Economics

Climate change models provide such insight. The Paris Agreement set a goal of limiting global temperature rise to 1.5°C above pre-industrial levels, which would substantially contain the long-term damage caused by climate change. The optimist inside each of us wants to believe this is achievable, but reality is more challenging. Maintaining the 1.5°C threshold would require halving global emissions by 2025 and reaching net zero by 2050. However, emissions are still rising, and a 2.5 to 3°C temperature rise this century appears more probable than not. Warming at this scale would displace millions of people seeking to escape extreme heat and rising sea levels.

Given the current trajectory, the effects of extreme warming will likely be felt in a matter of decades. By the 2050s, the prevalence of 100°F+ days will increase substantially. In parts of Texas and Florida, summers could see at least 70 consecutive 100°F+ days, with some days topping 125°F. In these conditions, residents' energy bills will increase and critical infrastructure will be strained. At 100°F, asphalt surfaces begin to soften and even power lines can melt, increasing the risk of outages. Higher temperatures would also lead to more water shortages from drought. Much of the U.S. Southwest is already subject to water rationing, and some planned developments are facing new roadblocks due to concerns about inadequate water supply.

Heat Wave

Number of Days per Year with Heat >100°F, 2023 vs. 2053



Source: First Street Foundation, The Washington Post

As extreme heat becomes more common, we believe people will start migrating to cooler northern climates rather than stay and sweat it out. Over time, rising sea levels could lead to additional population displacement. Real estate fundamentals in less resilient geographies will likely suffer. Many institutional real estate investors may find their portfolios asymmetrically exposed to this risk, with their capital increasingly stranded in shrinking markets. Some of the more climate-conscious institutional investors, particularly in Europe and Canada, have already begun "redlining" certain regions to avoid this outcome.

In 2023 and beyond, we believe more investors will start to realize this dynamic and adjust their investment postures accordingly, with long-term implications for capital flows and investment performance. Certain locations that are considered very in-favor today will likely become less attractive destinations for capital, while certain out-of-favor locations could become new investment hotspots. For investors with sufficiently long time horizons, the next decade could provide a window of opportunity to acquire quality assets and development sites in more resilient locations ahead of competitors.

2022 Scorecard

In the spirit of staying honest with our readers, we continue our tradition of providing a short "scorecard" on the previous year's Outlook. Each of our market calls is scored on a scale of 1 to 10, with 10 meaning "nailed it" and 1 meaning "not even close." We also include some brief (highly subjective) commentary to explain why we scored ourselves the way we did.

We opened last year's Outlook with an acknowledgement that 2022 carried more uncertainty with monetary and fiscal stimulus effects fading, but we largely expected the recovery to continue and for real estate to perform well. Underpinning that belief was the assumption that inflation would prove transitory, which we now know was wrong. Of course, much depends on monetary policy, and getting that one call wrong led to underperformance in several other predictions. Suffice to say, 2022 was not our best vintage.

1 Inflation will prove transitory and moderate by year-end

SCORE: **1/10**

Oops. We acknowledged that inflation was surging, but believed it was primarily the result of "too much money chasing too few goods" and would moderate as supply chains cleared up and stimulus burned off. Ironically, we also acknowledged that the tight labor market presented the biggest risk to our outlook, a warning we should have taken more seriously. Limited labor availability and rising wages turned inflation into a contagion affecting the whole U.S. economy, and inflation risks remain to the upside going into 2023.

2 The U.S. economy will expand at a moderate pace as Fed policy remains accommodative

SCORE: **1/10**

No point trying to spin this one either. Going into 2022, the Fed had announced an early end to quantitative easing and was forecasting three quarter-point rate hikes by year-end. We knew that might be too optimistic, but still thought based on past rate hike cycles that the Fed Funds Rate was unlikely to exceed 2 to 3 percent during this economic cycle. However, the Fed Funds Rate ended 2022 at 4.25-4.5 percent and is projected to go still higher. The U.S. economy's performance for the year remains TBD. But with contractions in Q1 and Q2 and tepid growth in Q3, we expect we probably missed the mark on that as well.

2022 Scorecard

3 Real estate will remain attractive amid low interest rates and stable cap rates

SCORE: 4/10

Because we thought interest rates would remain low, we assumed cap rates would also stay low. Rising interest rates rendered both calls wrong. While the headline is a clear miss, we scored some redemption points by calling out the potential dangers of expanding cap rates. We warned that rising borrowing costs could push cap rates higher, and that cap rates' historically low levels could lead to outsized losses in value due to price convexity. Given these risks, we stated our strong preference for investment strategies focused on growing NOI and stabilizing at yields that exceed market cap rates. We give ourselves partial credit on this one despite the miss overall.

4 Big cities and downtowns will outperform

SCORE: 5/10

After two years of struggling in the wake of the pandemic, we believed that denser urban environments offered an attractive risk-reward going into 2022, with significant potential for outperformance. A driver of this thesis was the imminent return of urban cultural amenities – theaters, museums, concerts, events, college campuses, etc – that were shut down during he pandemic. By some metrics we appear to have been correct. Urban retail has largely recovered as restaurant occupancy returns to pre-pandemic levels and consumer retail spending steadily expands. Urban multifamily occupancy also remains strong as people move back to cities. But urban real estate performance is inextricably linked to office, which continues to struggle. This one is hard to score, even subjectively, but 5/10 seems fair.

5 Office valuations will stabilize, but fundamentals will remain challenged amid heated competition

SCORE: 4/10

We really thought we saw green shoots in the office sector. Net absorption was getting less bad and sublet inventory appeared to be peaking, which corresponded with market bottoms in both the Dotcom crash and the GFC. It turned out to be a false dawn. Sublet inventory continues to rise, and property values are starting to see cracks. We also said that office would remain an "indispensable property type" within institutional portfolios, but that hasn't been the case; many institutions now have blanket prohibitions against new office investments. We did well, however, in identifying likely winners and losers across geographies and asset quality. We also said that operating fundamentals would remain challenged due to a renewed amenity war. We'll take our 4/10 here.

2022 Scorecard

6 Residential segments will benefit from shifting demographics and favorable capital markets

SCORE: 9/10

Finally a good one… We predicted that residential sectors would continue performing well amid rising barriers to homeownership. Indeed, rent growth across residential segments was robust throughout 2022. We also sounded a note of caution regarding low cap rates and intense competition for deals, suggesting that investors stick to strategies with a clear path to growing NOI. Finally, we said that BTR would be one of the best risk-reward opportunities in the residential segment, attracting new institutional investor interest. The only reason we aren't claiming a perfect 10/10 on this one is we did not anticipate the current wave of uncertainty regarding rising cap rates and debt availability.

7 E-commerce and shifting supply chains will continue to propel industrial higher

SCORE: 10/10

No need to belabor the point here. Industrial had another very good year, driven by e-commerce growth and investment in supply chains, which is what we expected. Despite some headlines about Amazon and other e-commerce tenants pulling back, vacancies remain near record lows and rents continue to expand.

8 Stabilizing fundamentals will draw more capital into the retail sector

SCORE: 10/10

Who would have thought? A bullish call on retail was one of our best performers. We believed that retail's Darwinian evolution was close to running its course, with signs that the sector was finally stabilizing. We also said retail property values appeared to have found an appropriate risk-reward balance after a multi-year repricing, with some investors starting to take note of the sector's outsized yields. Indeed, these themes appear to have become firmly established in 2022 and are gaining momentum going into 2023.

2022 Scorecard

9 Private capital flows into real estate will remain elevated as institutional investor allocations expand further

SCORE: 10/10

Private capital flows continued to surge throughout H1 2022, though capital market uncertainty caused a pullback in investment activity in H2. But institutional investor allocations to real estate continued to expand further towards the 11 percent threshold. We said that fundraising would be challenging for emerging managers, and indeed it appears that emerging manager fundraising remains near cyclical lows. Finally, we predicted rising interest in recapitalizations and a subsequent increase in recap transaction volume in the years ahead, and 2022 appears to have been another strong year for GP-led secondaries. We'll keep our day jobs for now.

10 Republicans will sweep the 2022 midterms

SCORE: 3/10

Given rising inflation, President Biden's low approval ratings, and the historical pattern of the President's party performing badly in midterm elections, we assumed 2022 would be a "shellacking" on par with 2010. Far from it. Republicans took control of the House, but by the slimmest of majorities with a net gain of only nine seats. Elsewhere, Democrats outperformed expectations across the board. Democrats expanded their majority in the Senate by one seat, gaining full control with a 51-49 majority. Democrats also performed historically well in state races, scoring a net gain of two governors and flipping five state legislative chambers. In fact, 2022 was the first midterm election since 1934 that the incumbent President's party did not lose any state legislative chambers or incumbent governors. We also predicted gridlock and partisan brinkmanship over issues such as the debt ceiling following the midterm results. While that remains to be seen, with razor thin majorities splitting control of the House and Senate, we have a feeling we'll be proven right.

About Park Madison Partners

Park Madison Partners is a boutique New York-based capital solutions and advisory firm for global real estate alternative investments. Since its formation in 2006, Park Madison has advised on over $25 billion in private capital placements for a wide range of real estate vehicles including closed-end funds, open-end funds, separate accounts, programmatic joint ventures, and recapitalizations.

Park Madison Partners was founded to offer clients capital raising and strategic consulting services with a high degree of customization, integrity and accountability. The firm provides a relationship-driven approach to structuring and marketing assignments and offers its clients access to global institutional investors. Our team comprises professionals with backgrounds across the buy-side and sell-side, and we leverage this experience to provide a thoughtful approach to global real estate markets.

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