August 2020

Timothy Bellman
Managing Director,
Global Research Strategist

Daniel English
President and Founder,
Legacy Investing, LLC

Nick Buss, PhD
Senior Director,
Research

Lauren van Aanholt
Associate Director,
Research

David Wertheim
Senior Director,
Client Portfolio Manager,
Listed Real Assets

Katie Seamans, PhD
Project Coordinator,
Global Research

Invesco Real Estate webinar: The Outlook for Global Specialty Sectors

This document is for Professional Clients and Qualified Investors (as specified in the important information); for Institutional Investors only in the United States, Australia and Singapore; in New Zealand for wholesale investors (as defined in the Financial Markets Conduct Act); for Professional Investors in Hong Kong; for Qualified Institutional Investors in Japan; for Qualified Professional Investors only in Republic of Korea; for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China; in Taiwan for Qualified Institutions/ Sophisticated Investors; for Qualified Institutional Investors and/or certain specific institutional investors in Thailand; for Wholesale Investors (as defined in the Financial Markets Conduct Act) in New Zealand; for certain specific institutional investors in Brunei and Indonesia and for qualified buyers in Philippines for informational purposes only; in Canada, this document is restricted to Accredited Investors as defined under National Instrument 45-106. It is not intended for and should not be distributed to, or relied upon by, the public or retail investors. Please do not redistribute this document. Circulation, disclosure, or dissemination of all or any part of this material to any unauthorized persons is prohibited. Telephone calls may be recorded. By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

Introduction

In this webinar, we explored the specialty real estate sectors such as self-storage, senior housing, student housing, medical facilities and data centers. We looked at their recent performance in the listed real estate space and what attributes these sectors could bring to a direct real estate portfolio.

In discussion, our panel concluded that whilst many of the demographic and structural demand drivers are consistent globally, the opportunities to invest in specialty sectors is geographically specific for regulatory and market reasons.

The growth in data generation and storage requirements globally is supporting opportunities in the data center sector. This webinar included a third-party speaker, Daniel English from Legacy Investing, to provide a deeper dive into what demand drivers are shaping the data center sector and why this sector is getting increasing investment interest.

Webinar Summary

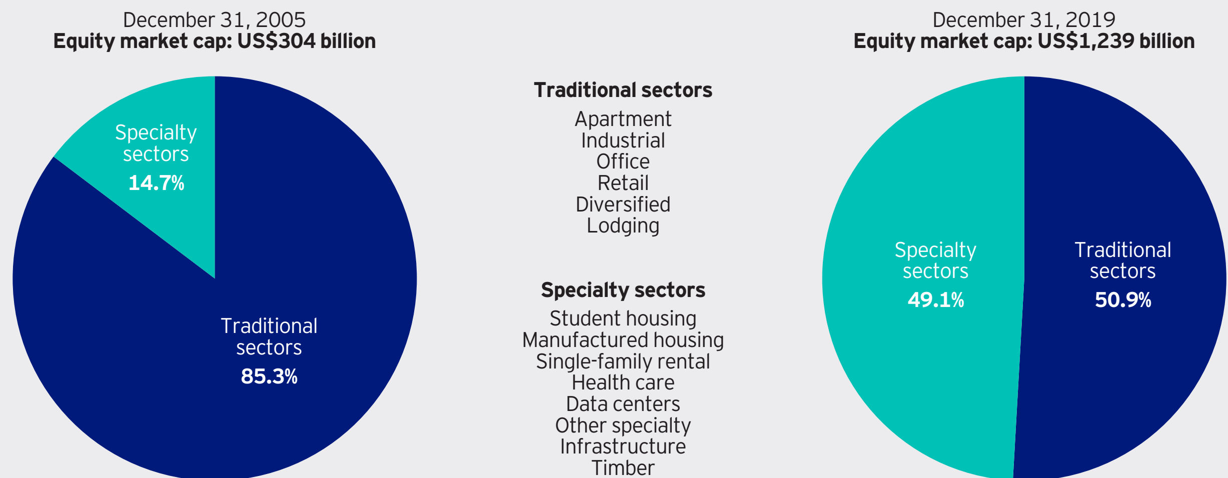
The listed real estate space has witnessed both dramatic growth and strong performance of the specialty sectors over the last 15 years. Between December 2005 and December 2019, the market cap of specialty sectors increased from 14.7% of total FTSE NAREIT equity REIT market capitalization to just under half (49.1%) (Figure 1).

In unlisted real estate, specialty sectors remain a small component of the global universe. In the context of global real estate portfolios, MSCI data shows that "other" property represent 4.7% of unlisted sector weightings globally. We expect growth in specialty sector REITs and anticipate that institutional allocations to specialty sectors may expand globally in listed and unlisted real estate in the future.

Figure 1 - Specialty sector growth: listed real estate

Over the last 15 years they have grown to almost half the investable universe

FTSE NAREIT equity REIT market capitalization



Source: Invesco Real Estate using data from NAREIT as of August 2020.

What has driven specialty sector growth in listed real estate?

There has been significant growth and strong performance of the specialty sectors in the listed space over the last decade. For many of the specialty sectors, their strong historical outperformance is attributed to high levels of demand from either digital transformation or demographic growth (Figure 2).

The earnings and cashflows for companies that own real estate sectors like data centers, self-storage or health care have grown dramatically over the last 10-20 years. These firms have additionally benefitted from both acquisitions and new development activity.

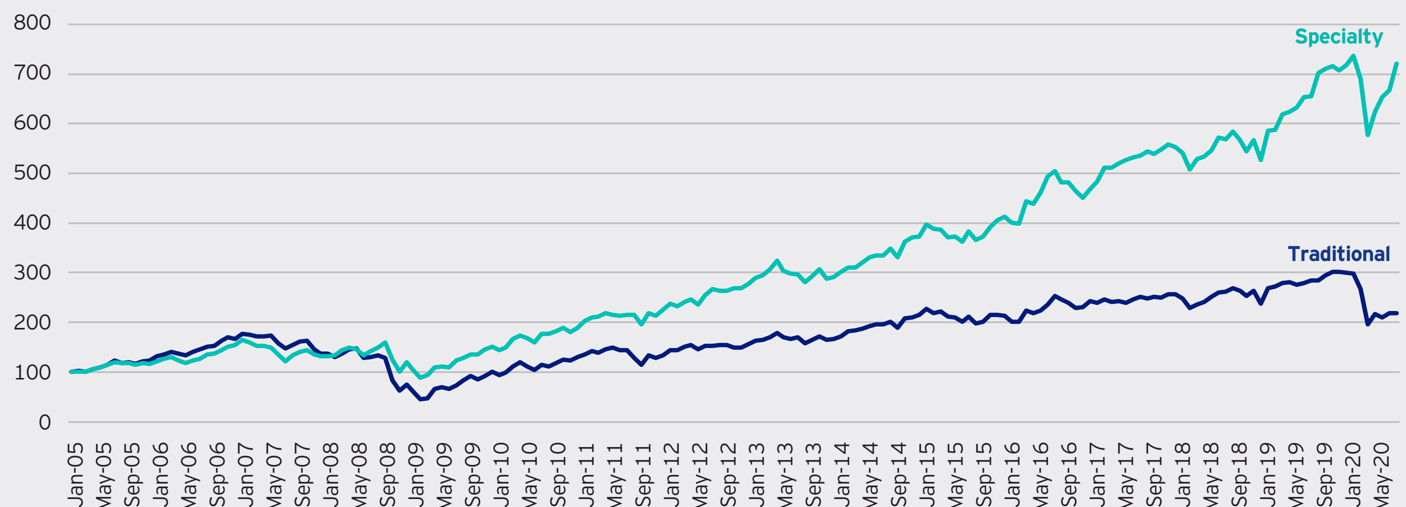
There is a high likelihood that some specialty sectors may continue to perform strongly, supported by the outlook of their fundamentals. Over the next three years, we believe that performance in sectors such as data centers and single-family rentals, for example, may be underpinned by robust cashflow and earnings growth.

Figure 2 - Specialty sector performance: listed space

They have outperformed traditional sectors significantly

As of Jun-20	Specialty	Traditional
10-year return	15.1%	6.7%
Beta vs. REITs	1.0%	1.2%

Total return index (equal weight by sector, Jan 2005 = 100)



Core sectors: apartment, industrial, office, retail, lodging and diversified. Full period: January 2005 - August 2020.
Specialty sectors: health care, self-storage, manufactured homes, single-family rentals, data centers, timber, infrastructure and other specialty.
Source: Invesco Real Estate using data from NAREIT as of August 2020. **Past performance is not a guarantee of future results.**

Why specialty sectors, and why now?

Comparing traditional real estate sectors and the specialty sectors, there are three main benefits of specialty sectors.

The first benefit is strong structural demand fundamentals, many of which have been strengthened in the COVID-19 shutdown periods. This includes:

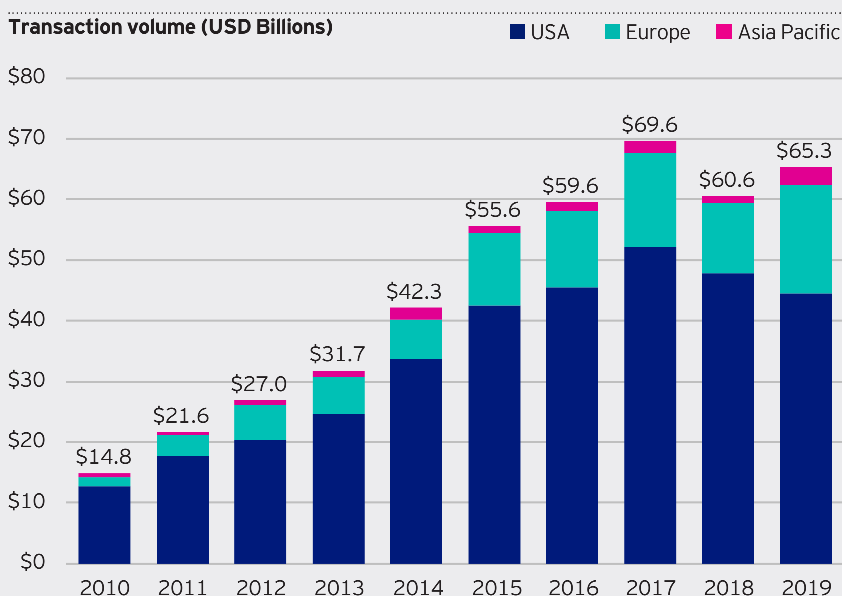
- Technology adaptation and a greater need for fast data – supporting data centers;
- Aging demographics – supporting health care and aged care sectors;
- Urbanization – supports embracing of new living concepts and self-storage sectors.

The second benefit is the yield/cap rate premium, especially in the current low interest rate environment. Specialty sectors still command a yield premium relative to the traditional real estate sectors. An example is in Asia, where the premium is greater than other parts of the world as specialty sectors are generally less established as an investment alternative. An example is China's Tier 1 cities where data center yields/cap rates are currently approximately 8%, representing around a 400-basis point premium to Tier 1 office yields/cap rates. This compares favorably to the US, where the premium between data centers and office yields/cap rates is about 110 basis points; a narrower premium but still a premium nonetheless.

Thirdly, there is more acceptance of specialty sectors as investment alternatives, and the institutionalization of these sectors is increasing (Figure 3). More investors are including specialty sectors when constructing portfolios, using the specialty sectors to provide additional diversification benefits. In addition, some large global investors are now active in this space and are bringing lessons learned from their experience in the US to Asia and Europe.

Figure 3 - Specialty sector liquidity: transaction volume 2010-19 (USD Billions)

Liquidity is increasing globally but remains low



Transaction volume includes the following sectors: data centers, student housing, self-storage, seniors housing, medical office and manufactured housing.
Source: Invesco Real Estate using data from Real Capital Analytics as of August 2020.

What role can specialty sectors play in an unlisted portfolio?

There are three important elements that specialty sectors add to a portfolio:

1. **Alpha:** due to the strength of secular demand drivers, these are sectors have stronger growth potential than many of the traditional sectors, combined with likely yield/cap rate compression as these sectors mature and institutionalize. Specialty sectors also typically have a higher and more stable income component than other property types.

2. **Durability:** along with the secular trends, the "needs-based" nature of the underlying occupier demand that drives many of these sectors is expected to provide durability of performance through cycles, potentially acting as a shock-absorber for a portfolio during recessionary periods.

3. **Diversification[1]:** broadening the number of property sectors that are investable provides diversification benefits for portfolio construction. In addition, the smaller deal size of many specialty sectors makes them a good fit for smaller portfolios without forgoing diversification.

Globally, specialty sectors make up less than 5% of unlisted portfolios in 2020. It is likely that investment in specialty sectors will increasingly fill a space in a portfolio that was previously occupied by some retail and some office properties. Retail has traditionally been 20-25% of a core portfolio but is expected to occupy a notably smaller portion going forward due to the many headwinds the sector faces from the rise of e-commerce. Similarly, office has been 30-40% of a portfolio historically, but this too may be influenced by a shifting pattern of demand, with less traditional office, especially commodity office buildings, and more life science and health care-related office.

1. Diversification does not guarantee a profit or eliminate the risk of loss.

What are the opportunities?

There are three areas where we believe the secular demand-side drivers, demographics and technology, may be particularly strong over the next decade.

1. **Single-family rentals (US as the starting geographic target, which is similar to the US leading other opportunities over last decade)**

This is a sector that has been largely flying under the radar in the US, but in terms of scale it is of similar size to the traditional apartment market (15 million units). The demographics will provide a strong tailwind, with the 35-44 year-old age cohort (the prime tenants for single-family rentals) expanding by 5.5 million over the next 10 years as millennials age and enter their family years, needing more space. Institutional ownership is at an early stage with larger owners (owning portfolios of 1,000 units or more) controlling just 2% of homes. There seems to be plenty of opportunity to drive net operating income (NOI) growth and yield compression with technology and economies of scale.

2. **Health care: Medical office (MOB), life science and seniors housing in the US, and hospitals in Asia**

The primary driver of this loose "health care grouping" is demographics and, in particular, the aging of the population. A "silver tsunami" is fast approaching, with the population of those aged 75 and older expected to double in size over the next 20 years, creating demand for all types of health care needs. This age cohort visits the doctor almost three times as often as the 25-44 year-old age group. In addition, for MOBs, improvements in medical technology has allowed many more procedures to move out of a hospital setting to a less expensive outpatient setting; we believe this trend may continue. Like MOBs, life science benefits from both aging – driving demand for new health care solutions – and technology, providing the ability to continue to push the bounds of research. Clearly COVID-19 has centered the world's focus on public health which should provide this sector a near-term boost. Lastly in this group is senior housing. This is a sector on which we are more cautious in the near term given the uncertainty resulting from the impacts of COVID-19 and because supply was beginning to outpace demand pre-COVID-19. That said, the longer-term demand due to demographics is undeniable, however the main wave of this demand surge will likely not hit until later in the decade.

3. **Data Centers**

Legacy Investing's data centers have outperformed within their portfolio over the 2020 pandemic period, with utilization up and cash flow collections remaining robust.

User demand for data centers is underpinned by significant structural tailwinds, as the data we increasingly rely on in our everyday lives also has to "live" in a data center somewhere.

Site selection for data center development is an important consideration, with four key characteristics:

- Access to key fiber roadways: Providing for efficient, fast and cost-effective connectivity to the data consumer. Key interconnection points of the fiber roadways have emerged as key data center locations, as operators want to be near them.
- Power costs: Power is one of the biggest operating expenses for data centers. Leases with the tenant are typically signed on a power basis of per kilowatt-hours per month. From a global perspective, the US has the lowest power costs, but they vary by submarket. Operators are choosing submarkets based on the power cost relative to latency and distance.
- Tax Incentives: This includes taxes for the purchase of the computer equipment and the real estate. Globally, cities are adopting favorable tax treatments to lure data center operators. An example is in Chicago, where operators are leaving to move to Wisconsin to benefit from the tax incentives that Chicago is refusing to provide.
- Risk of natural disaster: Position data centers in areas with low risk, due to sensitive nature of operations and equipment.

While risks persist, they may be largely skewed to the downside for the landlord. A key risk that is often identified for data centers is obsolescence risk, however given the landlords rent the space and power, and not the technology (racks and product are typically owned by the tenant), this mitigates the obsolescence risk of technology to some degree.

Leasing or vacancy risk is also mitigated by the high cost for tenants to relocate, with data relocation costs for the tenant significantly higher than other asset classes. This allows for underwriting of data centers to have higher renewal probabilities than other asset classes, including logistics.

A key risk in the future that needs to be underwritten is the impact of increasing power and heat densities as computers become more powerful.

Looking ahead, Legacy Investing expects yields/cap rates to continue to trend down, especially in markets that are just starting to grow. In China yields/cap rates are generally representative of where they were in the US five years ago. Supply and demand fundamentals will likely remain robust, with tailwinds for the sector providing increasing demand.

Overall, data centers remain relatively early in their investment cycle, and there are still significant tailwinds and growth that may benefit the sector and provide attractive returns for real estate investors.

Conclusion

Specialty sectors are benefitting from structural demand tailwinds, supporting continued growth in both tenant and investment demand. We expect specialty sectors to become more important in listed real estate portfolios and allocations to specialty sectors in unlisted real estate to increase.

Whilst demand drivers and structural headwinds are generally consistent globally, the opportunity for specialty sectors is geographically specific, varying from market to market. These differences are driven by both regulatory and market reasons.

We consider the specialty sector with the most immediate global investment opportunity worldwide may be data centers, driven by the growth in data generation and storage requirements globally, coupled with the current favorable supply, demand and pricing dynamics.

Risk Warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

Important Information

This document is for Qualified Investors in Switzerland, Professional Clients only in Dubai, Continental Europe, Ireland and the UK; for Institutional Investors only in the United States, Australia and Singapore; in New Zealand for wholesale investors (as defined in the Financial Markets Conduct Act); for Professional Investors in Hong Kong; for Qualified Institutional Investors in Japan; for Qualified Professional Investors only in Republic of Korea; for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China; in Taiwan for Qualified Institutions/Sophisticated Investors; for Qualified Institutional Investors and/or certain specific institutional investors in Thailand; and for certain specific Institutional Investors in Malaysia upon request; for Wholesale Investors (as defined in the Financial Markets Conduct Act) in New Zealand; for certain specific institutional investors in Brunei and Indonesia and for qualified buyers in Philippines for informational purposes only; in Canada, this document is restricted to Accredited Investors as defined under National Instrument 45-106. It is not intended for and should not be distributed to, or relied upon by, the public or retail investors. Please do not redistribute this document. Circulation, disclosure, or dissemination of all or any part of this material to any unauthorized persons is prohibited. Telephone calls may be recorded. By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

For the distribution of this document, Continental Europe is defined as Andorra, Austria, Belgium, Croatia, Czech Republic, Denmark, Finland, France, Germany, Italy, Luxembourg, Netherlands, Norway, Poland, Slovakia, Spain and Sweden.

Target figures, where mentioned, are not the actual allocations of a specific Invesco product. This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities or financial instruments. This marketing document is not an invitation to subscribe for shares in a fund or any other investment product and is by way of information only, it should not be considered financial advice. The information contained in this document may not have been prepared or tailored for any audience. It does not take into account individual objectives, taxation position or financial needs. This does not constitute a recommendation of any investment strategy for a particular investor. Investors should consult a financial professional before making any investment decisions if they are uncertain whether an investment is suitable for them.

You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco. This material may contain statements that are "forward-looking statements." These include, among other things, projections, forecasts, estimates of income, yield and return and are based on information available on the date hereof. They are based upon certain beliefs, assumptions and expectations, which can change over time. Accordingly, forecasts are not reliable indicators of future performance. You should not place undue reliance on these forward-looking statements.

Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice.

Australia

This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else. Information contained in this document may not have been prepared or tailored for an Australian audience and does not constitute an offer of a financial product in Australia. You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

+ may contain references to dollar amounts which are not Australian dollars;

+ may contain financial information which is not prepared in accordance with Australian law or practices;

+ may not address risks associated with investment in foreign currency denominated investments; and + does not address Australian tax issues.

Issued in Australia by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, Australia which holds an Australian Financial Services Licence number 239916.

New Zealand

This document is issued in New Zealand only to wholesale investors (as defined in the Financial Markets Conduct Act). This document has been prepared only for those persons to whom it has been provided by Invesco. Information contained in this document may not have been prepared or tailored for a New Zealand audience.

This document does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for, an opinion or guidance on Interests to members of the public in New Zealand. Any requests for information from persons who are members of the public in New Zealand will not be accepted.

Issued in New Zealand by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, Australia, which holds an Australian Financial Services Licence number 239916.

Singapore

This document may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 304 of the Securities and Futures Act (the "SFA"), (ii) to a relevant person pursuant to Section 305(1), or any person pursuant to Section 305(2), and in accordance with the conditions specified in Section 305 of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

This document is for the sole use of the recipient on an institutional offer basis and/ or accredited investors and cannot be distributed within Singapore by way of a public offer, public advertisement or in any other means of public marketing.

Issued in Singapore by Invesco Asset Management Singapore Ltd, 9 Raffles Place, #18-01 Republic Plaza, Singapore 048619.

Hong Kong

This document is provided to professional investors (as defined in the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules) only. It is not intended for and should not be distributed to, or relied upon, by the members of public or the retail investors.

Issued in Hong Kong by Invesco Hong Kong Limited, 41/F, Champion Tower, Three Garden Road, Central, Hong Kong.

Japan

This document is only intended for use with Qualified Institutional Investors in Japan. It is not intended for and should not be distributed to, or relied upon, by members of the public or retail investors.

Issued in Japan by Invesco Asset Management (Japan) Limited, Roppongi Hills Mori Tower 14F, 6-10-1 Roppongi, Minato-ku, Tokyo 106-6114; Registration Number: The Director-General of Kanto Local Finance Bureau (Kin-sho) 306; Member of the Investment Trusts Association, Japan and the Japan Investment Advisers Association, and/or 2) Invesco Global Real Estate Asia Pacific, Inc., Roppongi Hills Mori Tower 14F, 6-10-1 Roppongi, Minato-ku, Tokyo 106-6114. Registration Number: The Director-General of Kanto Local Finance Bureau (Kin-sho) 583; Member of the Investment Trusts Association, Japan and Type II Financial Instruments Firms Association.

Taiwan

This material is distributed to you in your capacity as Qualified Institutions/Sophisticated Investors. It is not intended for and should not be distributed to, or relied upon, by members of the public or retail investors.

Issued in Taiwan by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). Invesco Taiwan Limited is operated and managed independently.

United States

Issued in the US by Invesco Advisers, Inc., Two Peachtree Pointe, 1555 Peachtree Street, N.E., Suite 1800, Atlanta, GA 30309.

Canada

This document is restricted to accredited investors as defined under National Instrument 45-106. All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision. As with all investments there are associated inherent risks. Please obtain and review all financial material carefully before investing.

Issued in Canada by Invesco Canada Ltd., 5140 Yonge Street, Suite 800, Toronto, Ontario, M2N 6X7.

Continental Europe, Dubai, Ireland and the UK

The document is intended only for Qualified Investors in Switzerland and Professional Clients in Continental Europe, Dubai, Ireland, and the UK and is not for consumer use. Marketing materials may only be distributed without public solicitation and in compliance with any private placement rules or equivalent set forth in the laws, rules and regulations of the jurisdiction concerned. This document is not intended to provide specific investment advice including, without limitation, investment, financial, legal, accounting or tax advice, or to make any recommendations about the suitability of any product for the circumstances of any particular investor. You should take appropriate advice as to any securities, taxation or other legislation affecting you personally prior to investment. No part of this material may be copied, photocopied or duplicated in any form by any means or redistributed without Invesco's prior written consent.

Further information is available using the contact details shown:

Issued in:

Andorra, Austria, Belgium, Croatia, Czech Republic, Denmark, Dubai, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland, Slovakia, Spain, Sweden, Switzerland and The United Kingdom by Invesco Asset Management SA, 16-18, rue de Londres, 75009 Paris, France, which is authorised and regulated by the Autorité des marches financiers in France; Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main, Germany; Invesco Asset Management Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK. Authorised and regulated by the Financial Conduct Authority; Invesco Asset Management (Schweiz) AG, Talacker 34, 8001 Zurich, Switzerland

Invesco GL981 – 11/2020