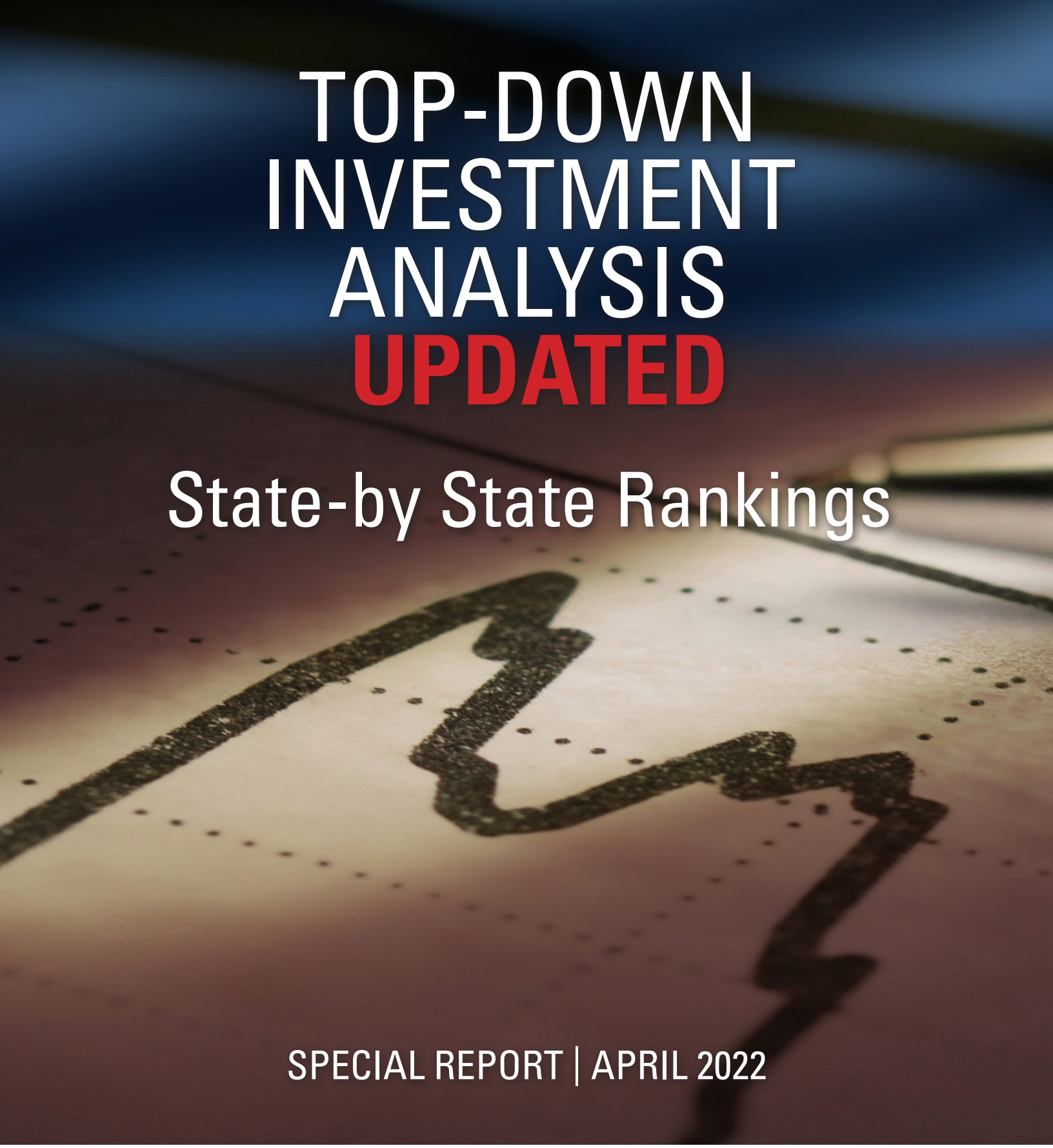

# TOP-DOWN INVESTMENT ANALYSIS UPDATED

## State-by State Rankings

SPECIAL REPORT | APRIL 2022

MORRISON STREET RESEARCH

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SOURCES:
Morrison Street Research
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# Letter from the Editor

**RANCE GREGORY**
CEO

*We are honored and pleased to present a comprehensive 2021-2022 update to our initial 2019-2020 special U.S. States report from Morrison Street Research. The enclosed analysis takes a bird's-eye view of U.S. states currently most favorable for commercial real estate investment based on their recent and near-term potential for growth.*

*In developing our analytical framework, we reviewed population and employment statistics, state fiscal considerations, quality of life, and key demographic measurements to create both component and overall ranking systems. Most importantly, the study illustrates regional job and population changes over the latest 10-year period.*

*To help investors balance the contrary indicators of near-term growth and long-term climate change, we have included a due diligence supplement that provides a sample framework for evaluating potential risk and return.*

*We hope you'll find this report interesting and informative. We look forward to any questions or comments you may have regarding this report's data and our conclusions.*

*ABOUT US:* Morrison Street Research ("MSR") is a division of Norris, Beggs & Simpson Companies, LLC, a 90-year-old commercial real estate firm based in Portland, OR. MSR publishes newsletters, special reports and white papers to serve clients of its affiliated companies, Morrison Street Capital and NBS Real Estate Consulting.

# Overview of the Top-Down Investment Study

Thoughtful commercial real estate investing requires an approach that considers both a top-down perspective of important economic drivers in a subject property's broader geographic area, as well as a traditional bottom-up due diligence process factoring a subject property's rent roll, income and expense information, leasing and sale comps, and supply/demand data within the relevant submarket.

We frequently have the opportunity to communicate to our clients the results of our bottom-up analysis of specific investments in commercial real estate properties. However, we less often have the occasion to share the factors that inform our top-down analysis of markets that have more or less potential for growth and value creation. To that end, we would like to share our recently completed review for all 50 States and the District of Columbia of 26 high-level measurements that we believe are relevant in the context of making investment decisions.

There are many ways to interpret the results of the data enclosed. Our purpose here is to provide a filter for viewing the potential for investment risk and return in various geographic locations. In other words, someone applying a different analytical filter could draw a different conclusion from the same set of data. What is important for this study is to detect and project the movement of population and jobs in and out of particular regions and specific states. In a separate report, we also work this data down to cities, beginning with the top 50 MSAs.

As a quick look backward, Exhibit A illustrates total population movements among regions since 1970. As you can see, there has been a long and substantial migration of residents from the Midwest and Northeast into warmer (and in many cases, lower tax) climates in the West, Southwest and Southeast regions.

**Exhibit A**

| Region | 1970 Population | 2021 Population | Total Population Growth 1970-2021 | % Growth 1970-2021 |
|---|---|---|---|---|
| Northeast | 48,999,999 | 57,159,838 | 8,159,839 | 17% |
| Southeast | 49,042,364 | 93,710,749 | 44,668,385 | 91% |
| Midwest | 56,577,067 | 68,841,444 | 12,264,377 | 22% |
| Southwest | 16,544,465 | 42,906,773 | 26,362,308 | 159% |
| West | 32,020,877 | 69,274,941 | 37,254,064 | 116% |
| **Totals** | **203,184,772** | **331,893,745** | **128,708,973** | **63%** |

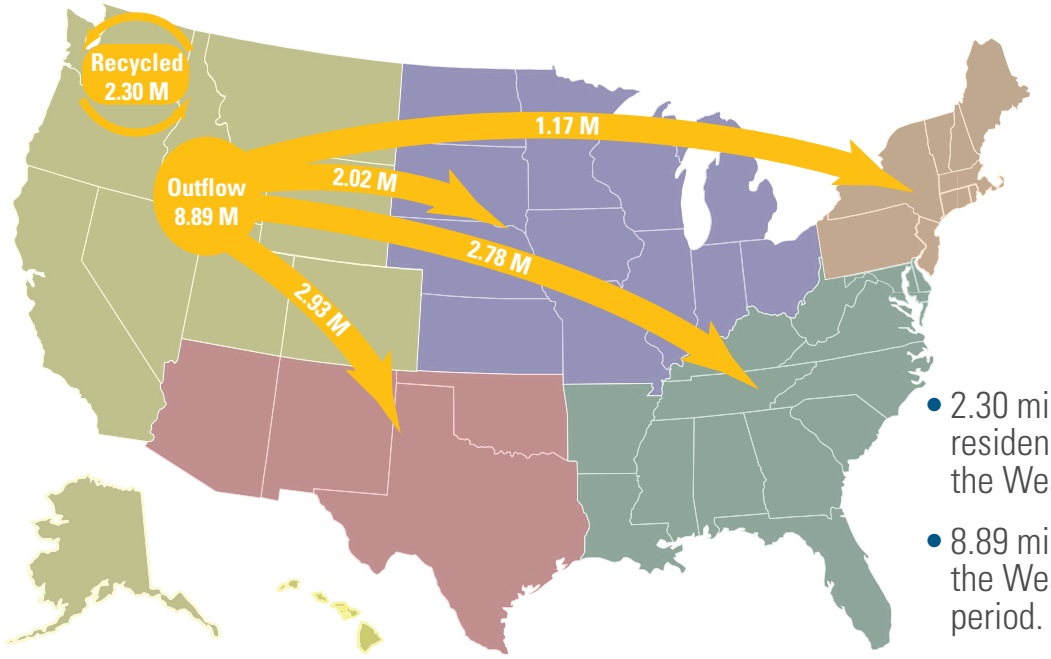
To determine the states most suited to near-term investment, we conducted the following top-down study applying 26 distinct measurements to all 50 States and the District of Columbia. We separate our analysis into five key categories, shown in order of relative importance:

- Population Statistics
- Employment Statistics
- Financial Considerations
- Quality of Life
- Demographics and Education

As we like to say, commercial real estate houses the economy. Other than periods of temporary oversupply of new product, larger cities and states with growing job markets should produce additions to occupied space. Higher occupancies led to greater rental rates, which can produce more net operating income, and lead to higher property values. Conversely, areas experiencing slow or negative growth in population and jobs could be expected to lose ground in achieving gains of property income and value. For many key population and employment statistics, we factored in both the absolute size of the state (the more people and the more jobs in a state, the better), and we also weighted the rate of increase on a percentage basis (to adjust for states experiencing more or less relative growth).

## Gross Population Outflows

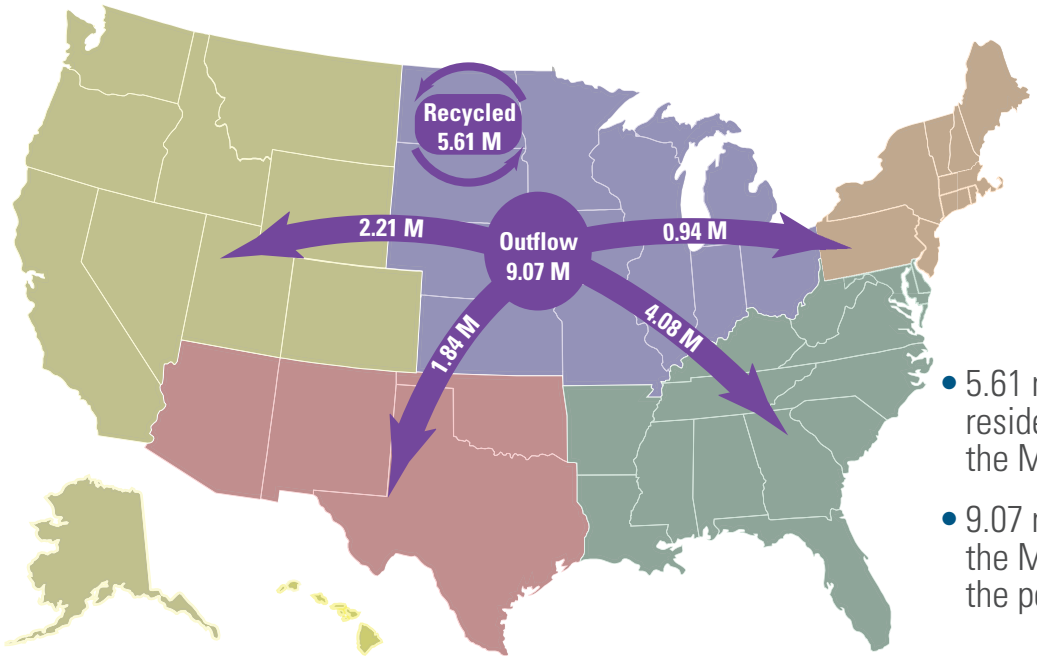
### **WEST REGION** | 2010-2019




- 2.30 million people changed residence but remained in the West region.
- 8.89 million people departed the West region during the period.

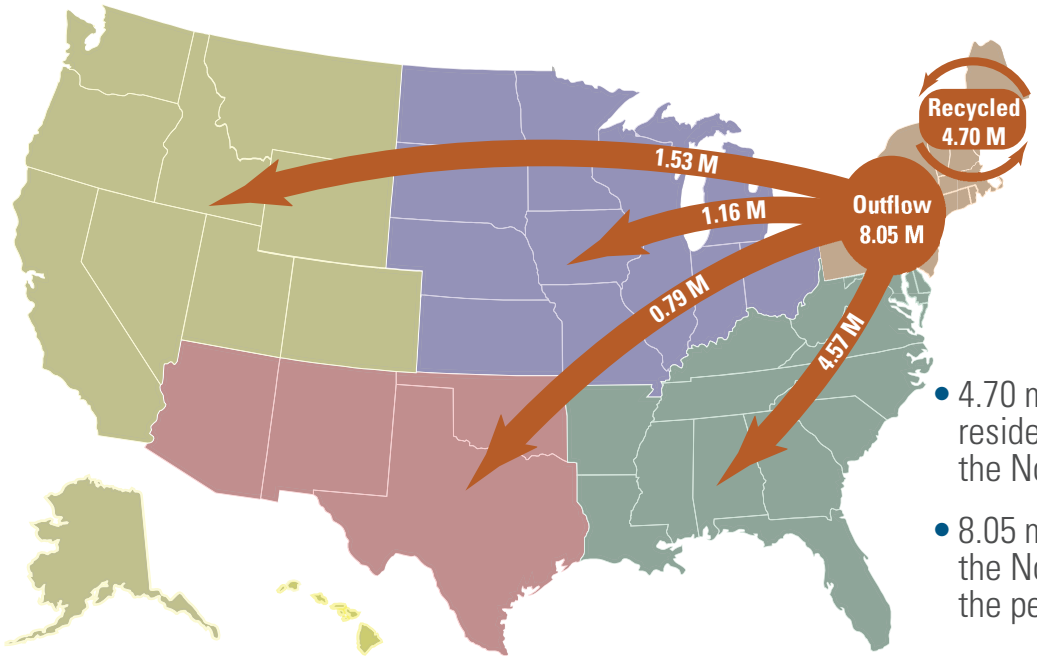
# Gross Population Outflows

## MIDWEST REGION | 2010-2019




- 5.61 million people changed residence but remained in the Midwest region.
- 9.07 million people departed the Midwest region during the period.

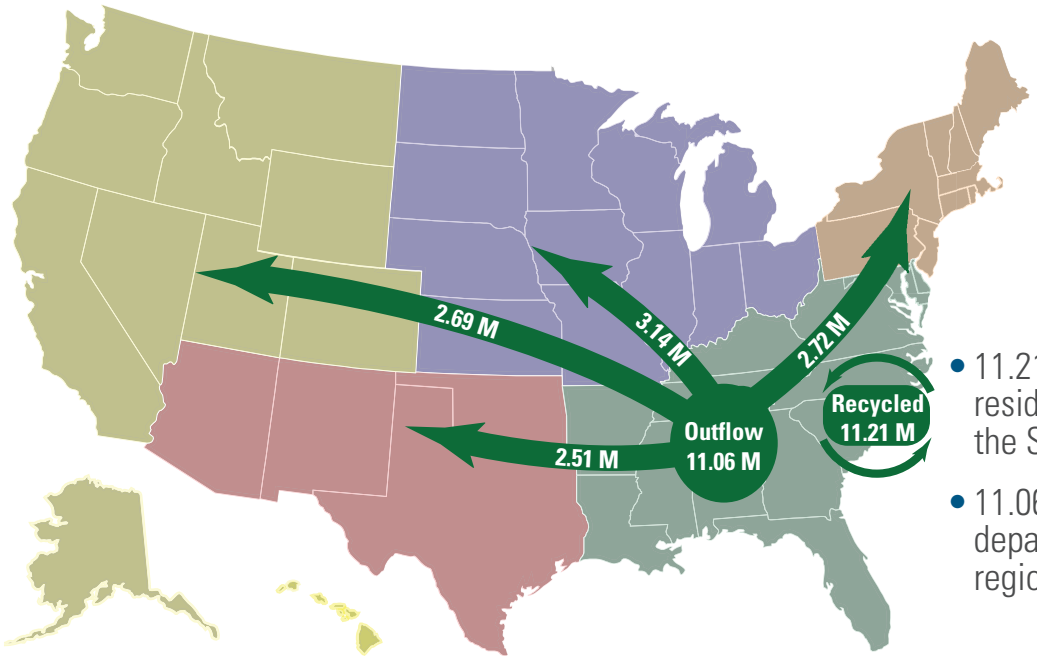
## NORTHEAST REGION | 2010-2019




- 4.70 million people changed residence but remained in the Northeast region
- 8.05 million people departed the Northeast region during the period

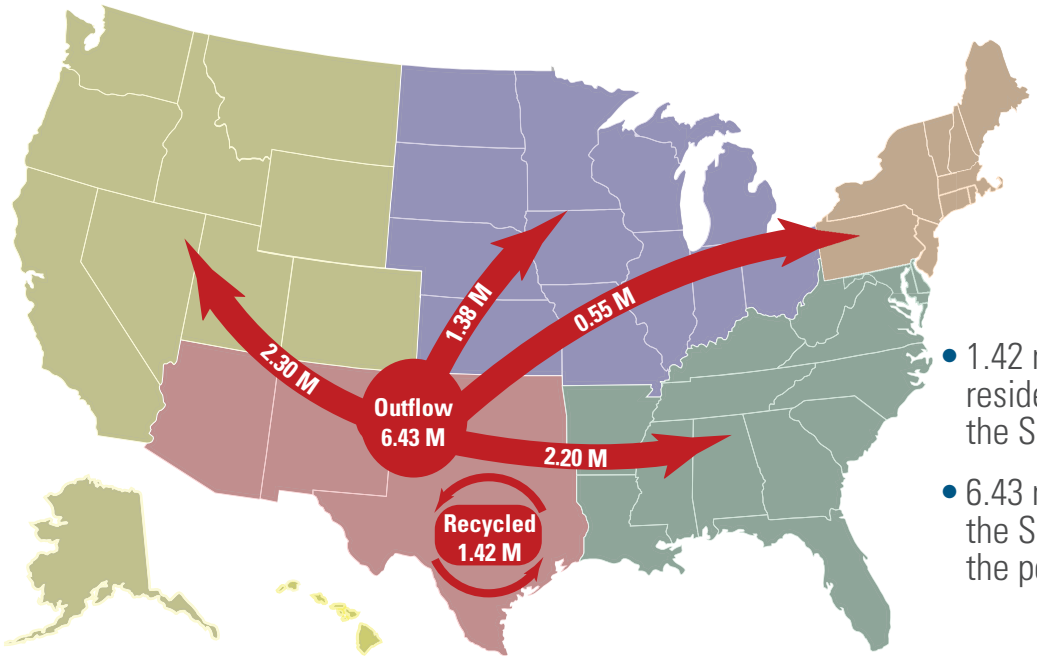
# Gross Population Outflows

## SOUTHEAST REGION | 2010-2019




- 11.21 million people changed residence but remained in the Southeast region.
- 11.06 million people departed the Southeast region during the period.

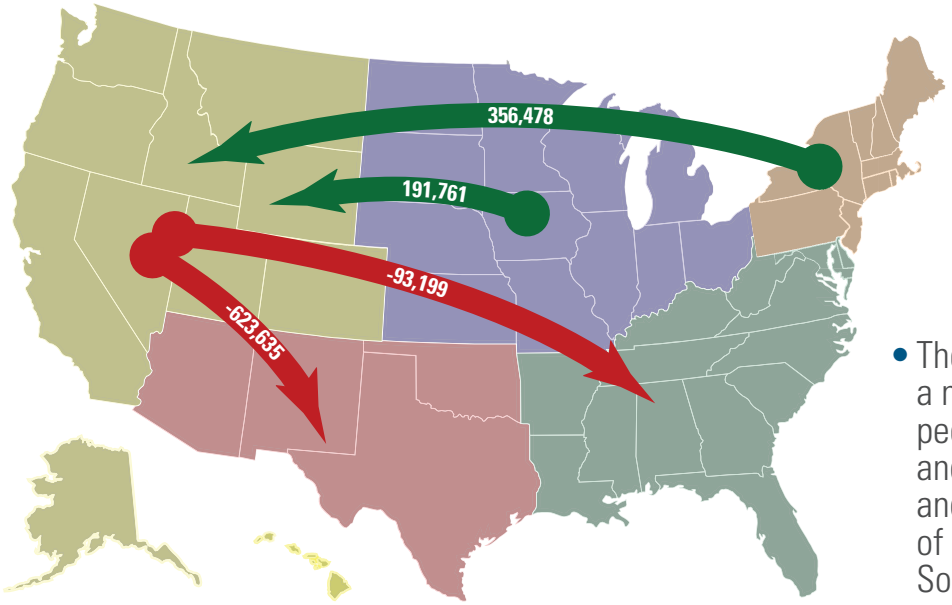
## SOUTHWEST REGION | 2010-2019




- 1.42 million people changed residence but remained in the Southwest region.
- 6.43 million people departed the Southwest region during the period.

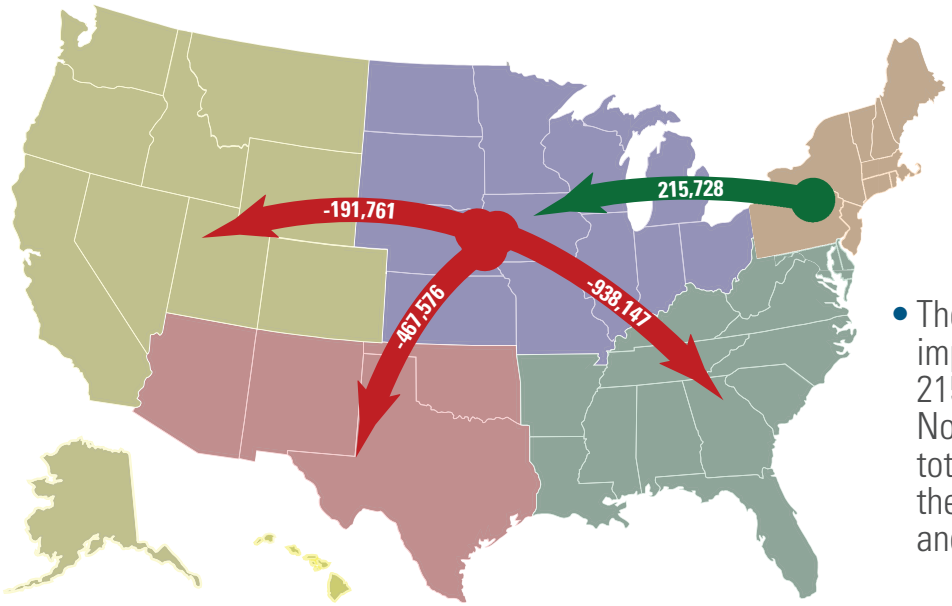
# Net Migration (inflows minus outflows)

## WEST REGION | 2010-2019




- The West region imported a net total of 548,239 people from the Northeast and Midwest regions and exported a net total of 716,834 people to the Southwest and Southeast regions.

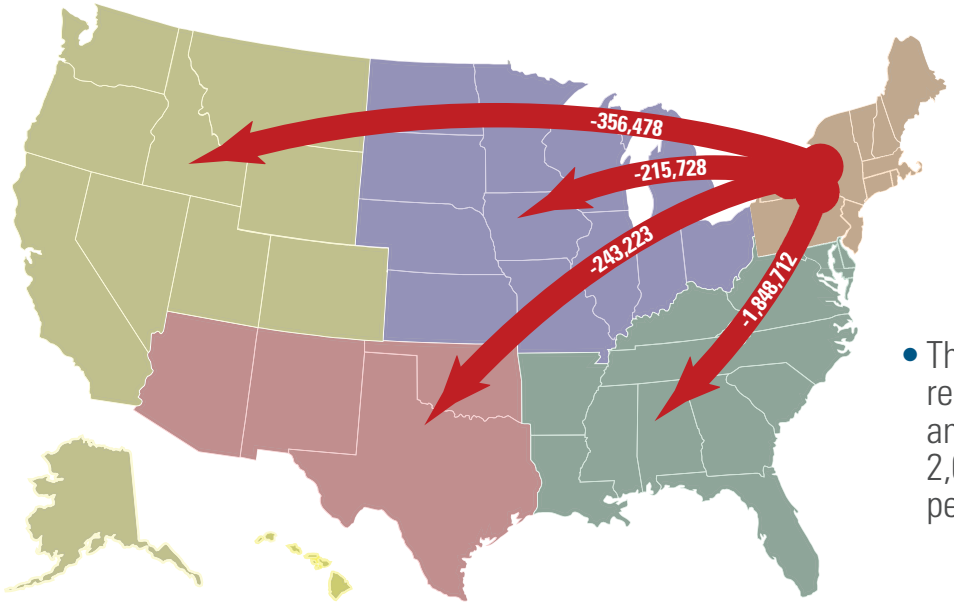
## MIDWEST REGION | 2010-2019




- The Midwest region imported a net total of 215,728 people from the Northeast and exported a net total of 1,597,484 people to the Southeast, Southwest and West regions.

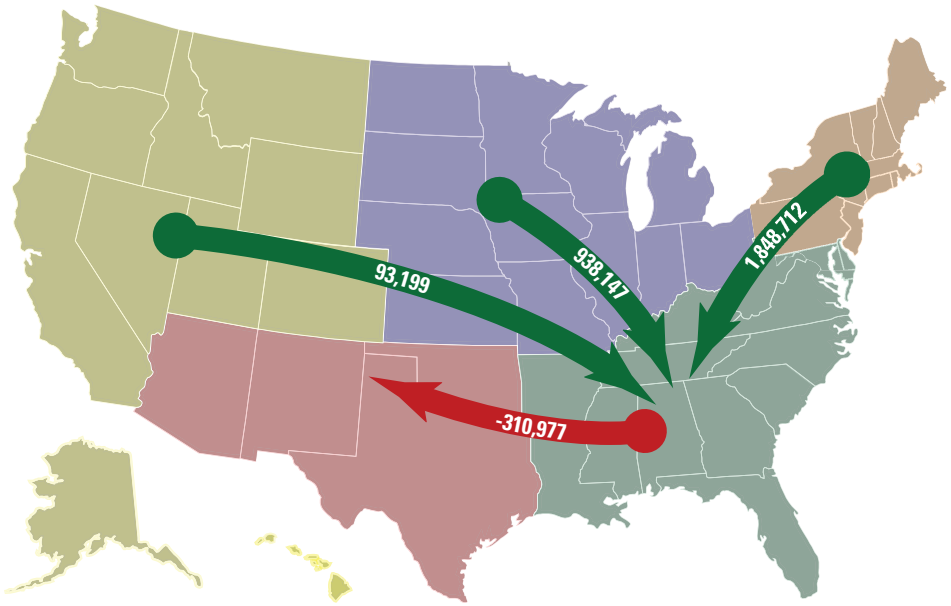
# Net Migration (inflows minus outflows)

## NORTHEAST REGION | 2010-2019




- The Northeast did not receive any net inflows and exported a net total of 2,664,141 people during the period.

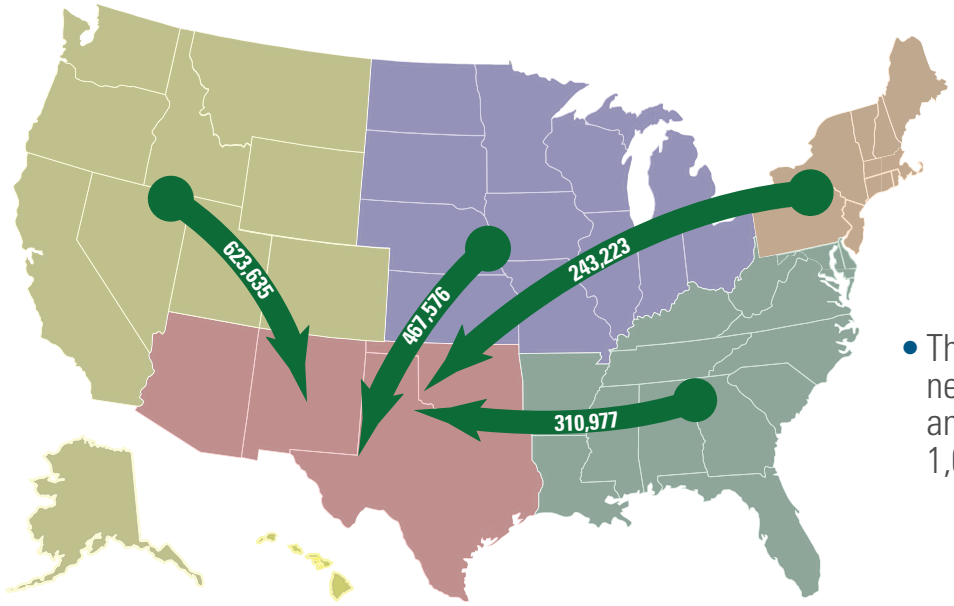
## SOUTHEAST REGION | 2010-2019




- The Southeast region imported a net total of 2,880,058 from the Northeast, Midwest and West regions and exported a net total of 310,977 people to the Southwest region.

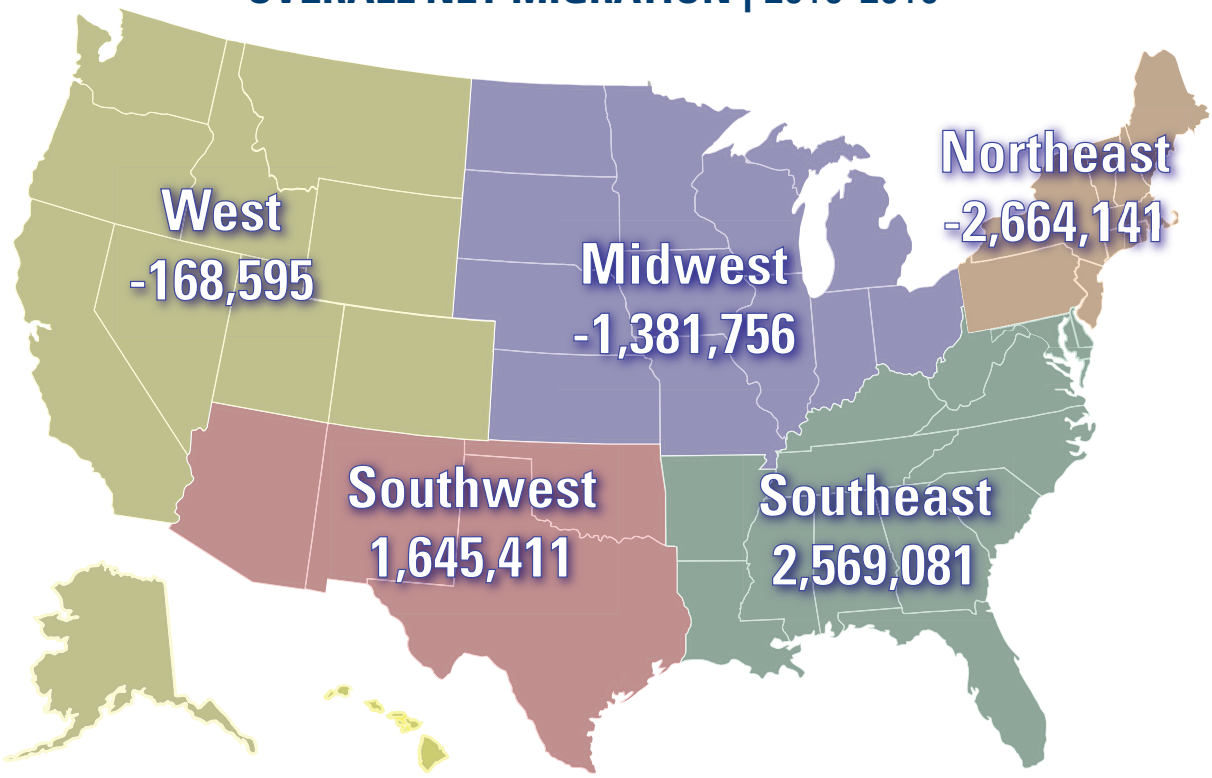
# Net Migration (inflows minus outflows)

## SOUTHWEST REGION | 2010-2019



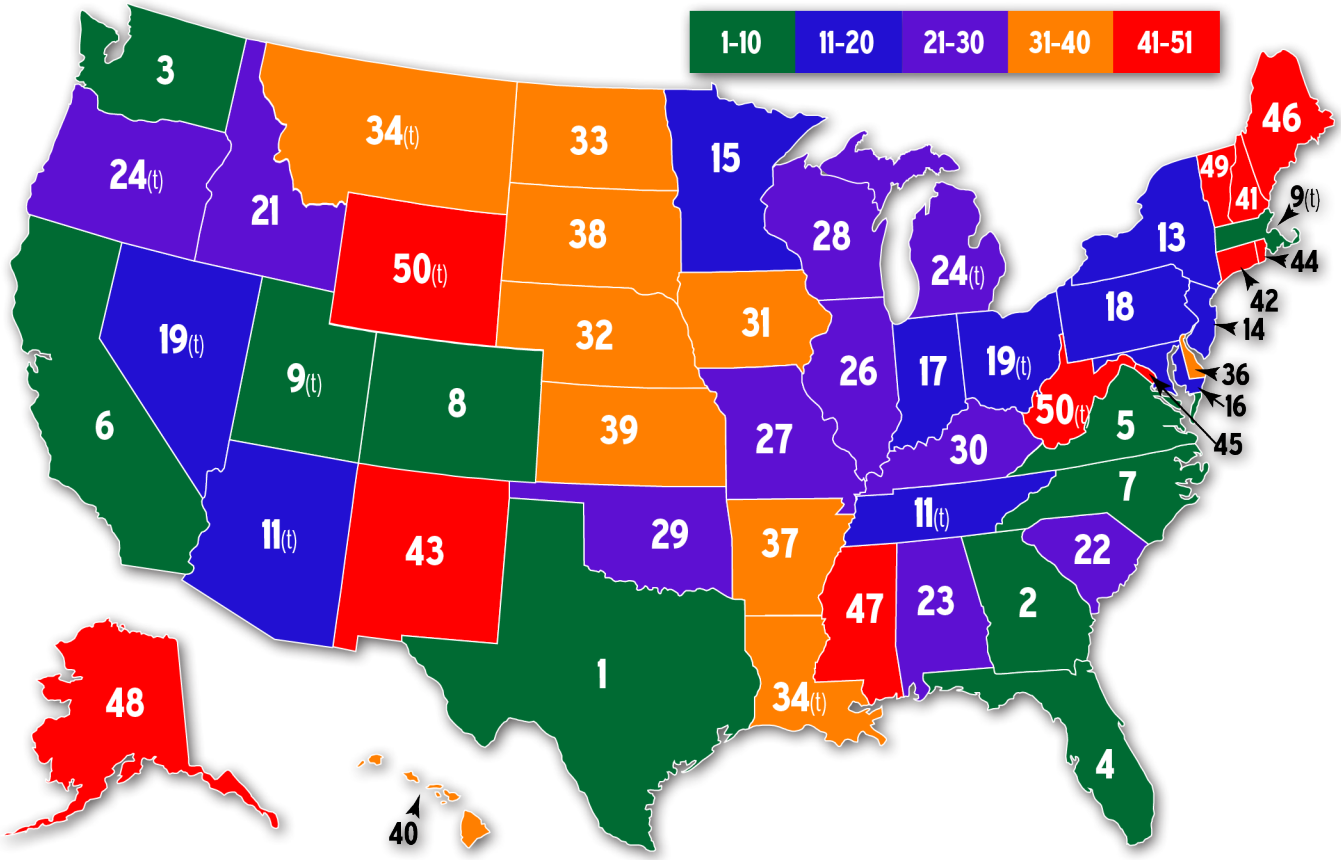

- The Southwest did not have net exports to any region and imported a net total of 1,645,411 during the period.

## OVERALL NET MIGRATION | 2010-2019



# Population Rankings | 2011-2021

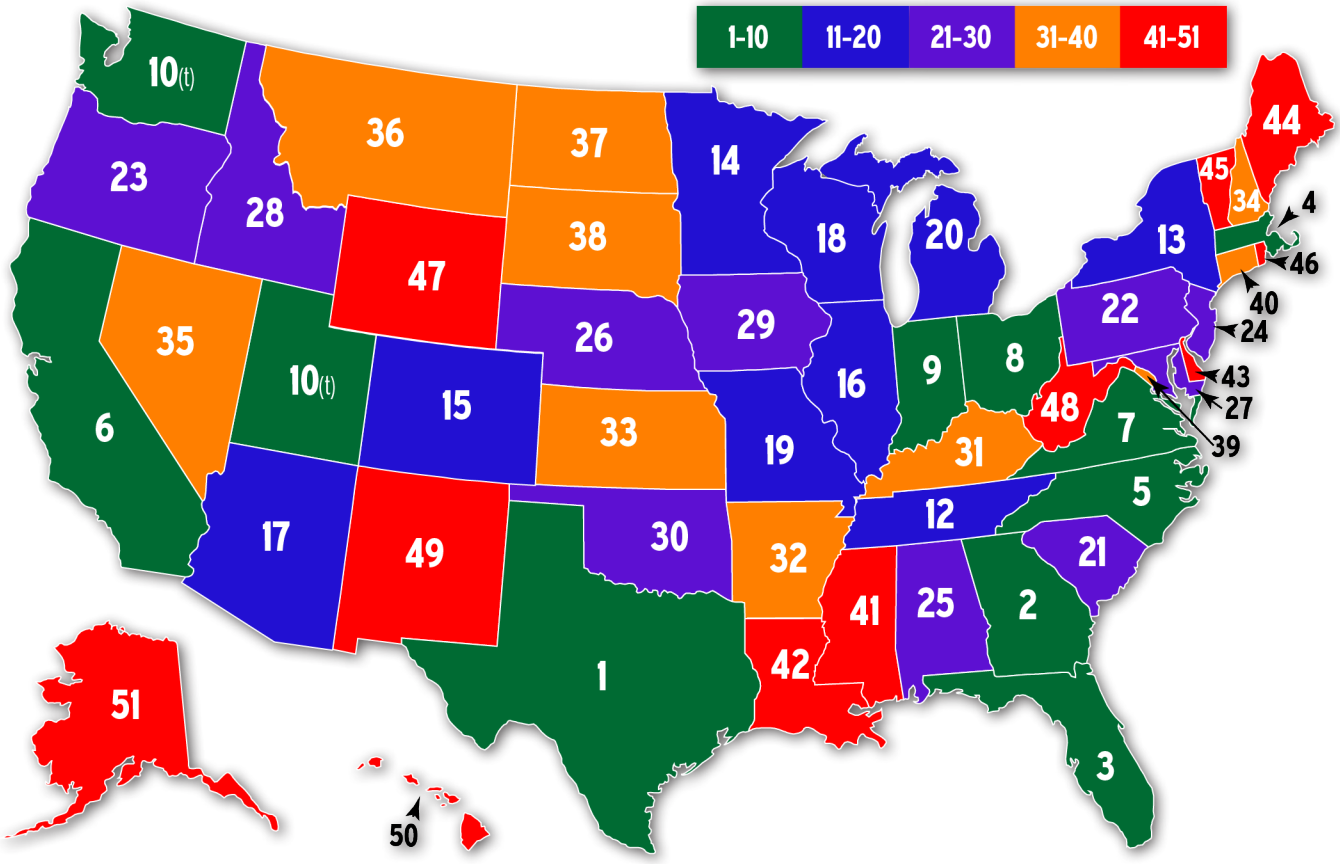
For population growth statistics, we measured state-by-state changes from July 2011 to July 2021. By using both absolute growth numbers and the percentage change, we were able to take into account both the size of a state and the growth rate relative to size.




Morrison Street Research's formula weighted the following factors by state:

- State population
- Absolute population growth
- Growth as a percentage change from 2011 to 2021
- Absolute net migration from 2011 to 2021
- Net migration as a percentage change from 2011 to 2021
- Absolute organic growth (births minus deaths) from 2011 to 2021
- Organic growth as a percentage change from 2011 to 2021

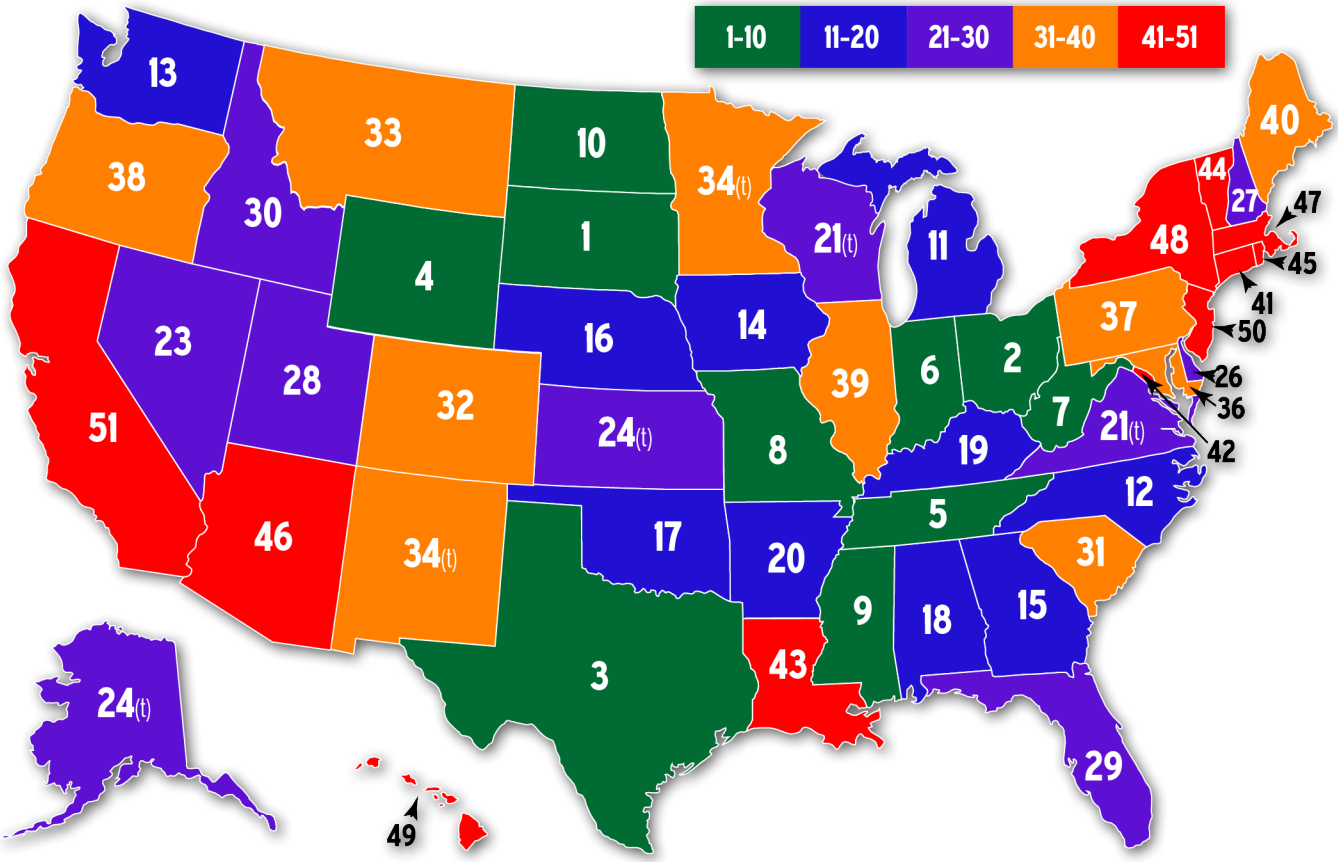
# Employment Rankings | 2011-2021




For the ranking method by employment statistics, Morrison Street Research weighted by state:

- Total employment by state
- Absolute change in employment from 2011 to 2021
- The percentage change in employment from 2011 to 2021
- The state unemployment rate
- The percentage of the state population employed

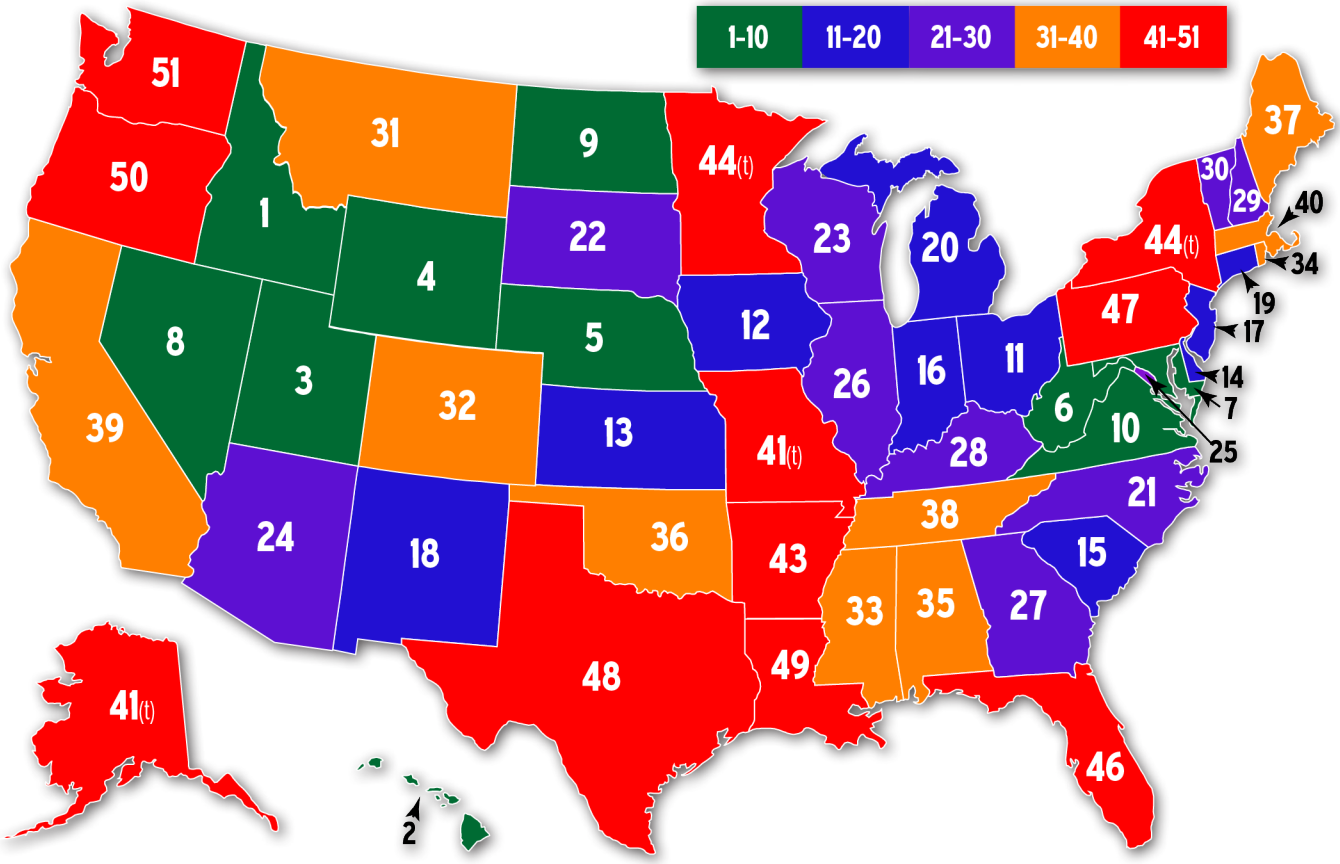
# Financial Rankings | 2011-2021




To assess the financial impact to individuals and businesses located within each state, Morrison Street Research took into account:

- Overall tax burden (combined state income, other state and local taxes, and property taxes)
- Median Home Price
- Median Income
- Ratio of Home Price to Median Income
- Cost of Living (includes groceries, housing, utilities, transportation, health care, misc)
- State Fiscal Stability (state revenue and expenses, reserves, tax revenue volatility, pension funding gap)

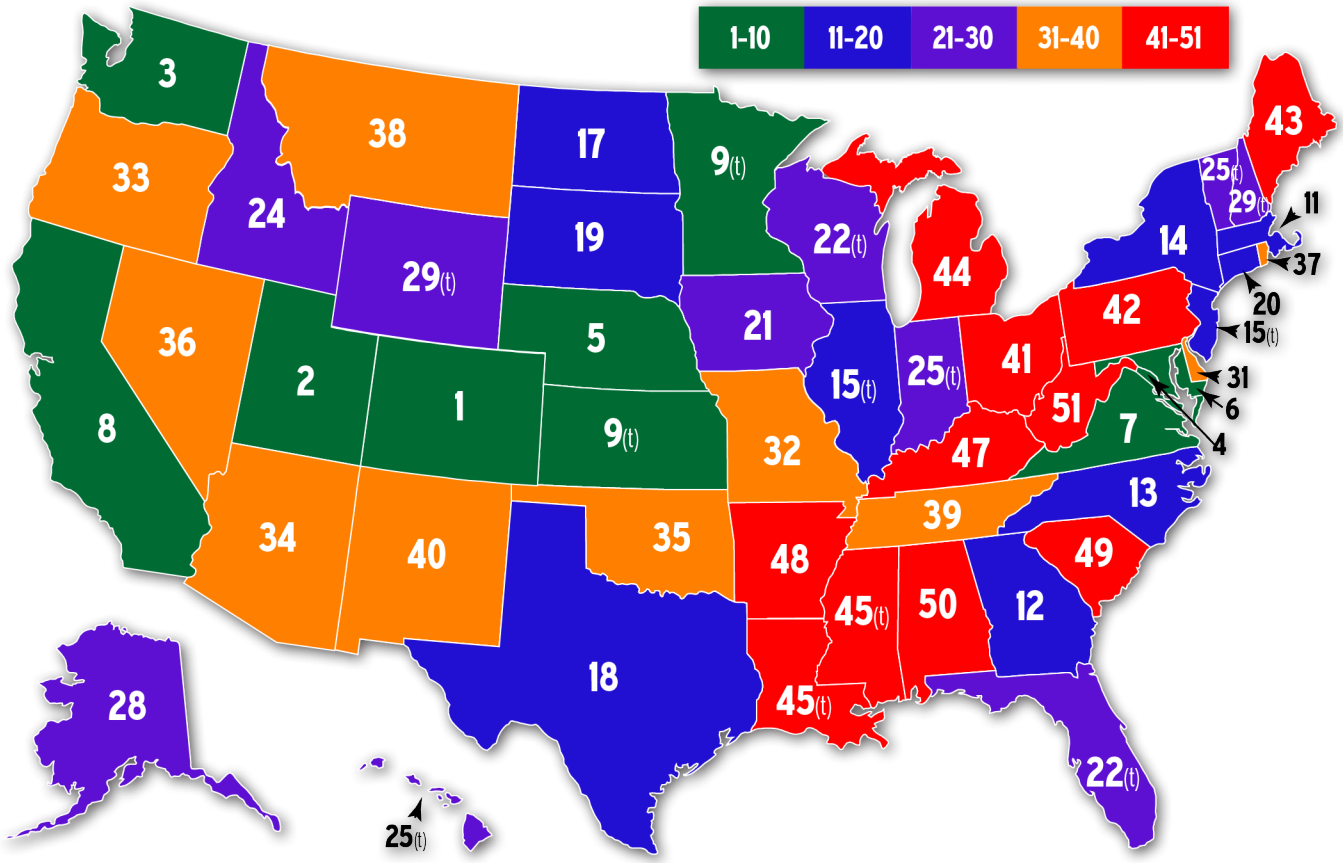
# Quality of Life Rankings | 2011-2021




To determine the overall quality of life in each state, Morrison Street Research weighted factors including:

- Weather (month-by-month average high and low temperatures, precipitation and dew point)
- Traffic (peak hours of congestion per commuter)
- Crime (property and violent crime data)
- Number of Disaster Declarations since 1953

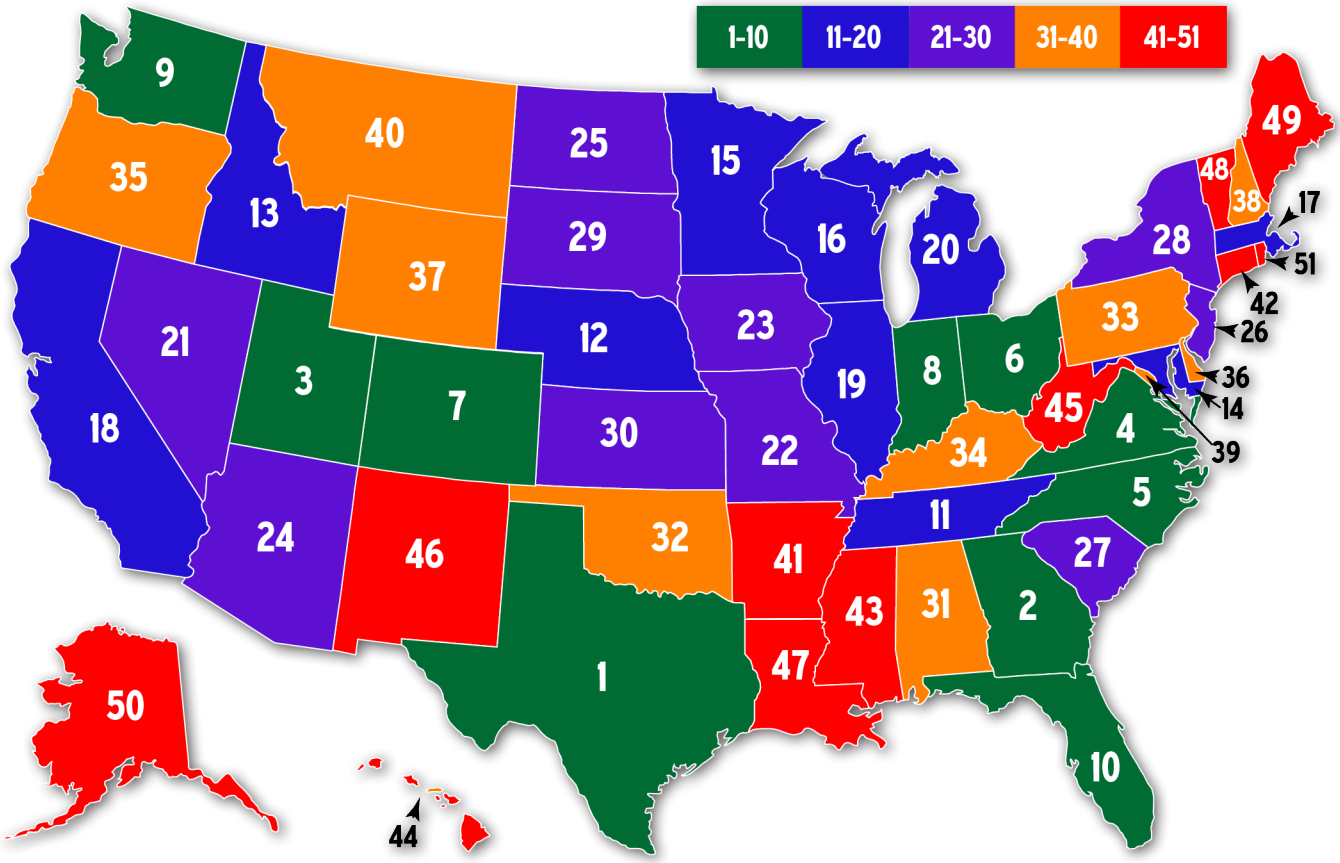
# Demographic Rankings | 2011-2021




Demographic factors that affected the Morrison Street Research ranking of potential economic performance in a given state include:

- Pre-K through 12 Education Ranking
- Advanced Education Ranking
- Educational Attainment (college graduate percentage)
- Median Age (younger states favored for growth potential)

# Overall Rankings | 2011-2021




The overall formula included a weighted ranking of the following number of factors in each category:

| | |
|---|---|
| Population: | 7 |
| Employment Statistics: | 5 |
| Financial Statistics: | 6 |
| Quality of Life: | 4 |
| Demographic Statistics: | 4 |
| **TOTAL:** | **26** |

# Investigating the interactions and trade-offs between near-term economic growth and long-term climate change

In conjunction with this top-down analysis, we also wanted to address the future economic impact of climate change on specific states and regions, and how climate-related movements may affect commercial real estate values over time. Note that our purpose here is not to debate whether climate change is caused by humans or is a natural cyclical phenomenon, nor is it to advocate policy solutions. We are simply applying the cautious assumption that the planet is, in fact warming, and asking how this change could positively/negatively impact real estate in various geographies over time.

A complete picture of the potential climate impact on a given investment will be influenced greatly by the relevant property type, geographic location, and the future availability of property insurance. No matter how one weights these factors, a proper conclusion should be most heavily dependent on the potential holding period of an investment.

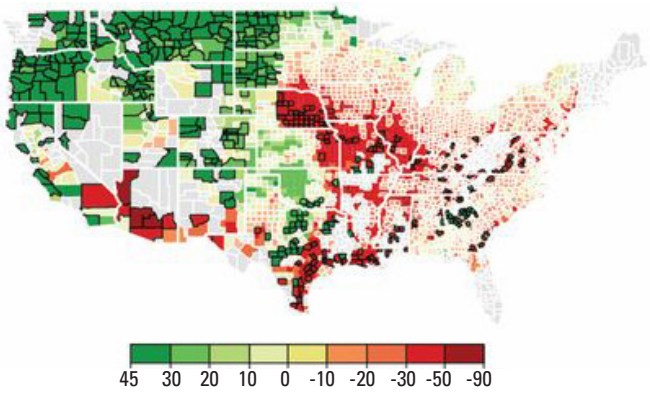
What the report data shows is that in the short run, population and jobs noticeably continue to migrate to warmer southern climates, including those potentially most affected by long term climate change. Therefore, any near-term focus solely on climate change impacts could cause an investor to prioritize investments in markets that are currently experiencing the greatest losses of jobs and population. Our objective is to continually update a comprehensive analysis that properly balances near-term population and employment movements against potentially long-term trends in markets likely to be negatively impacted by climate change.

The concern is that as climate change progresses through this century, if economic and property damage increases in southern states, a tipping point could cause a reverse migration to occur back to the colder northern states. The following maps and data borrowed from the Climate Impact Lab illustrate the potential annual impact of climate change on county-by-county GDP in 2080 to 2099 under a business-as-usual approach to carbon emissions.

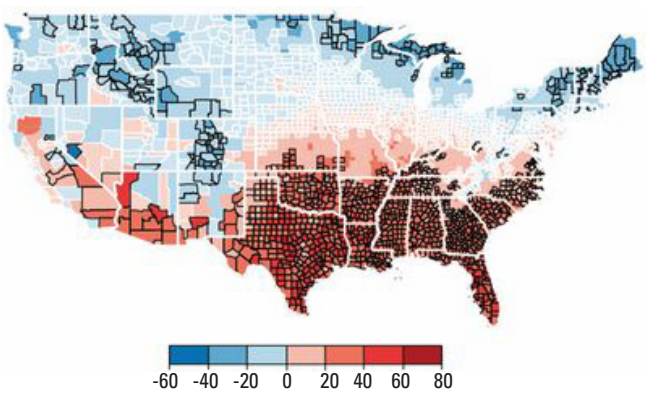
**Selected variables underlying total climate-related costs**

Projection by 2080-2099

**Agricultural yields** (% change)




**Mortality** (change in deaths per 100k)

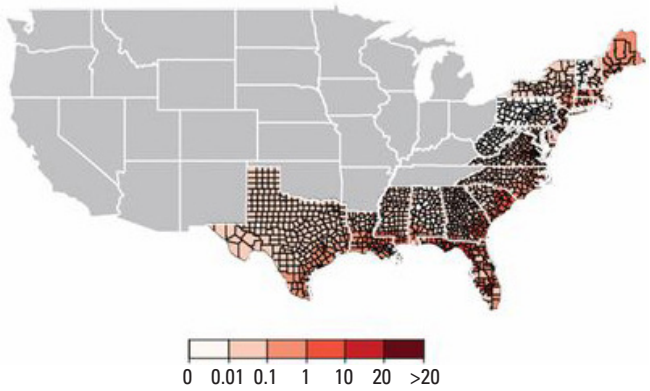



*Source: Climate Impact Lab: Estimating Economic Damage from Climate Change in the United States, Hsiang, S., Kopp, R.E., Jina, A., Rising, J., Delgado M., Mohan, S., Rasmussen, D.J., Muir-Wood, R., Wilson, P., Oppenheimer, M., Larsen, K., and Houser, T. (2017). Estimating economic damage from climate change in the United States. Science. doi:10.1126/science.aal4369*

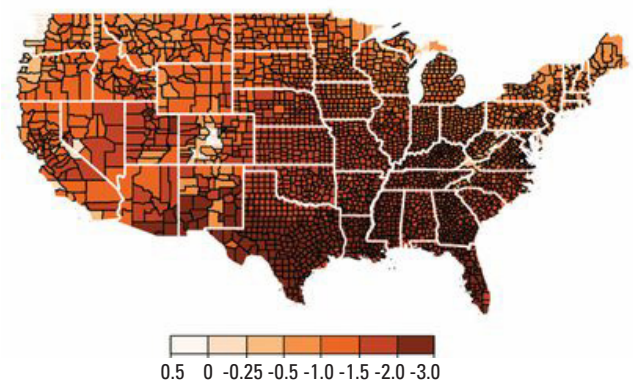
## Selected variables underlying total climate-related costs

Projection by 2080-2099

**Coastal damage** (% of county GDP)




**Supply of high-risk labor** (% change)

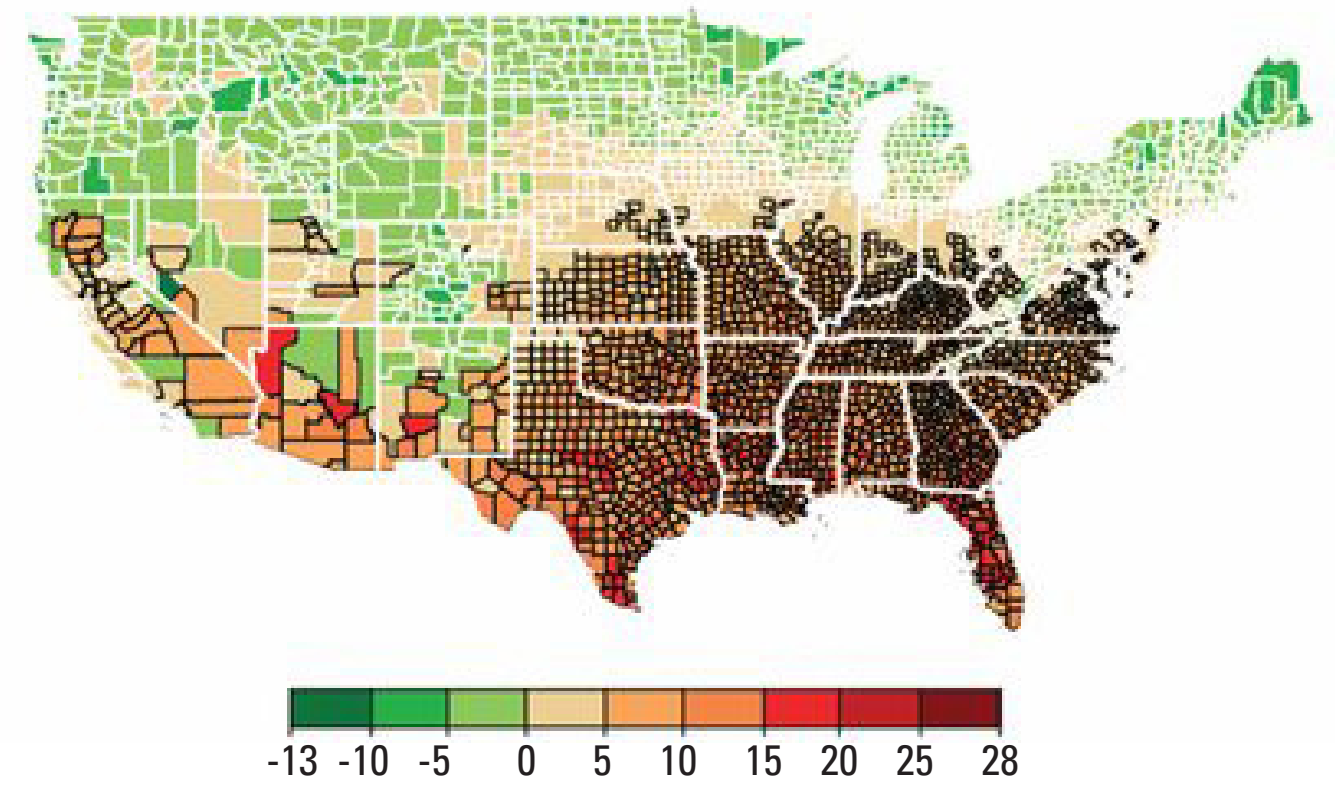



*Note: "High-Risk" labor includes jobs that expose workers to outdoor temperatures*

## Climate-related costs by 2080-2099

Share of 2012 county income

**Total direct damage** (% of county GDP)




*Source: Climate Impact Lab: Estimating Economic Damage from Climate Change in the United States, Hsiang, S., Kopp, R.E., Jina, A., Rising, J., Delgado M., Mohan, S., Rasmussen, D.J., Muir-Wood, R., Wilson, P., Oppenheimer, M., Larsen, K., and Houser, T. (2017). Estimating economic damage from climate change in the United States. Science. doi:10.1126/science.aal4369*

Given these considerations, it appears the most important investment question relative to climate change could be: in what year might the inflection point occur? In other words, when could the near-term benefit of population and employment migration to the Southwest and Southeast regions revert and instead shift toward the northwest portion of the West region, and back to the colder climes of the Midwest and Northeast?

Keep in mind that employers and employees make relocation decisions based numerous other considerations including taxes, economic incentives, politics and home prices. Some people simply prefer warmer weather and may only move inland from coastal exposure itself without necessarily migrating all the way to the northern states.

Nevertheless, toward the latter part of this century, we expect a movement away from low lying tidal areas and certain warmer climates disproportionately exposed to hurricanes, flooding and wildfires.

**Of particular interest, several areas with relatively colder climates such as Utah, Washington, Virginia, Indiana, Ohio and Colorado are also experiencing strong recent projected population and/or employment growth. This analysis leads us to conclude that markets which are both growing rapidly and less exposed to climate change may merit a favorable investment bias and special consideration.**

# SUPPLEMENT


A properly trained investment team should perform multiple layers of due diligence before proceeding with each investment. That diligence process can be broken down into four major categories:

**Market Study:** an analysis of demographic trends, economic drivers, employment outlook, supply and demand characteristics of the relevant property type, a comprehensive analysis of the property's competitive position in its broader market and local submarket. The market study should include consideration of relevant environmental risks specific to the property's location and its broader geographic area including probabilities for flood, wildfire, tornado, hurricane, and disruptions to availability of power or water.

**Borrower / Sponsor diligence:** an analysis of the sponsor entity including its capitalization, expertise of the management team, investment and asset management personnel and process, past performance, and background checks (legal, financial and reputational) of key members of the borrower/sponsor.

**Property due diligence:** Audit of the property's historical financials, the budget and future financial projections. Review of the property's rent roll, operating expenses, contracts, leases, and tax assessments. Include a report on the physical condition of the property, a study of the environmental risks that impact (or may impact) the property directly or indirectly, a study

of the seismic strength of the property and flood risk if warranted by the local area and/or property condition. Investors should also consider the property's access to energy, water and emergency services. Investors should seek to put in place appropriate levels of general property insurance, with typical casualty coverage for most assets, and special coverage for increased risks in a given location (i.e. a separate policy for fire, flood, seismic, environmental conditions, or terrorism).


**Price/Investment Basis:** a comparison of the subject property's price and/or investment basis compared to replacement cost and comparable sales within the subject market and in relationship to alternative investment geographic locations. Does the price or investment basis fully account for the economic risks, including those posed by climate change?

The combination of those four focus areas (Market, Borrower/Sponsor, Property and Price) help determine which investment tool to use in a given situation – preferred equity, bridge loan, structured equity, mezzanine loan, B note, or equity. Additionally, the complete evaluation of these four key factors does allow for identification of the primary risks to each investment posed by continued climate change and/or catastrophic events. Taken together with broader economic and climate considerations, each property's specific location, condition, age and construction will help determine the overall level of potential exposure.

Following identification of the primary environmental factors or natural hazards that could impact an investment, specific risk management techniques might include a combination of asset-level insurance, Fund-level insurance, and investment structure (e.g. sponsor guarantees/recourse, equity subordination, reserves, etc.). In rare cases, certain mitigation or adaptation techniques may apply, such as flood management systems (levees, seawalls), earthquake retrofitting, and landscape management to reduce fire risk. These types of mitigation techniques may involve consultation with insurers to confirm the impact on cost and availability of ongoing insurance coverage. A thorough analysis should also consider local policies, laws and regulations that may positively or negatively impact the subject property. Of greatest concern is that as time passes, the cost and availability of property insurance could be affected in cities impacted the most by climate change and other natural hazards. In the case of specific properties or areas where there might be uncertainty surrounding whether insurance would remain available and affordable during the desired holding period, prudent investors should decline to invest.

Of paramount importance to the risk analysis is the expected holding period of a given investment or portfolio of investments. We should all be mindful of the longer-term risks of climate change and other natural hazards. Over a shorter-term investment horizon of 5 to 10 years, investors should target assets in the path of growth, and should not broadly redline potentially exposed geographies (other than very low-lying areas and those especially prone to fire) since the markets most at risk from climate change are precisely the markets currently growing at the fastest rates and which have the most potential for value appreciation.

More specifically, in the near and medium term, as a result of lifestyle advantages, lower taxes and currently favorable climates, Southern coastal states are currently experiencing the greatest increases in population and jobs. Investors with a longer-term view of portfolio allocations may need to pay special attention to the risks posed to certain geographic locations by ongoing climate change.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