BGO

3Q2023 U.S. CRE Outlook

Highlights

- Industrial remains favored
- Apartments face short-term supply risk
- Retail still surprises
- Office facing unique challenges
- CRE capital markets poised to shift

Through mid-year, the U.S. commercial real estate (CRE) market has held up relatively well. While notable differences by property type and market remain, the asset class continues to weather the storm of higher interest rates, elevated inflation, and slowing economic growth. Property market fundamentals have bent but not broken under the pressure. CRE capital markets are clearly undergoing an adjustment. Yet overall, the sector has endured and stands poised for a turnaround. Our proprietary forecasting and market targeting, based on both advanced artificial intelligence and econometric techniques, demonstrate attractive performance ahead over our three and five-year forecast horizon.

Industrial

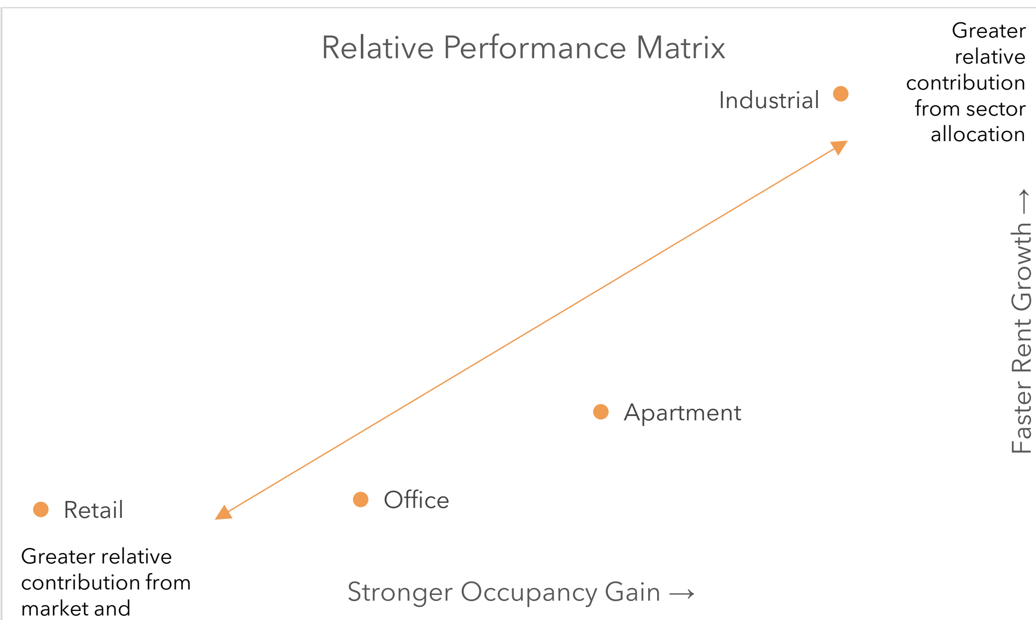
By many measures, industrial remains the darling of CRE, a position it has held for much of the last cycle. Although the sector has slowed in recent quarters, it remains in a position of relative strength. The national vacancy rate stood at 4.9% at midyear (according to CoStar data), up from its low of 3.8% during the second quarter of 2022. Correspondingly, CoStar's asking rent growth has also slowed from a peak during the third quarter of 2022 of 11.5% year-over-year to 7.9% year-over-year by mid-2023. A combination of factors caused this shift. Market strength spurred an increase in construction activity, with deliveries reaching historically high levels. At the same time, consumer spending patterns are slowly reverting back to pre-pandemic norms as consumption returns to more typical splits between goods and services. Consequently, demand for space is normalizing after reaching lofty heights during the pandemic.

Robust deliveries should continue to exceed demand in the short term, putting more upward pressure on vacancy rates and downward pressure on rent growth. However, the construction pipeline is already normalizing under the weight of factors such as higher interest rates and construction costs. Because of the structural changes in how industrial space is utilized, the sector has evolved and along with it demand. We foresee robust net absorption through our forecast horizon. Consequently, our modeling suggests that industrial should remain the top-performing property sector, deriving significant benefits from systematic tailwinds. Yet, we still anticipate a wide divergence in performance across markets, with our top projected markets set to double the performance of the average market. Therefore, we foresee significant outperformance potential via rent growth through industrial market selection in addition to strong property sector allocation benefits.

Apartments

The apartment sector also remains in a favorable position despite some recent headwinds. In fact, the broad dynamics between apartment and industrial are quite similar. The apartment sector consistently performed well since the global financial crisis (GFC), with demand consistently outpacing supply growth. While some have called into question sustained excess demand for housing, our proprietary research conclusively shows that this phenomenon is both real and recent, a post-GFC occurrence. That dynamic became turbocharged during the pandemic, with demand rising to record levels amidst a housing frenzy which pushed CoStar's national vacancy rate down to a historical low of 4.8% during the third quarter of 2021. As the market headed toward historically tight vacancy, CoStar's asking rent growth spiked to an all-time high of 10.7% on a year-over-year basis in the first quarter of 2022. But the significant tightening in the market spurred development while demand had normalized following a torrid during the pandemic. That combination caused the CoStar national vacancy rate to rise to 6.9% at mid-year 2023 while asking rent growth slowed dramatically to 1.2% year-over-year.

In the short term, the market must still digest elevated levels of development. But demand is normalizing quickly, which should limit the upward pressure on the national vacancy rate and downward pressure on asking rent growth. High interest rates and construction costs are already causing the supply pipeline to ease even as demand remains resilient. Like industrial, our modeling suggests healthy allocation benefits from the apartment sector. But a wide divergence in performance across markets should also produce strong market and investment selection benefits. We believe our top projected markets should significantly outperform the average markets.



Sources: CoStar, Moody's, BGO Research

Retail

In many respects, retail remains the most misunderstood property sector. It was once commonly derided as being overbuilt and under-demolished. But after enduring rampant overbuilding in the 2000s, the sector has made significant adjustments since the GFC. On the supply side a combination of demolitions of old, obsolete space as well as more restrained development has helped to right-size inventory. Meanwhile, demand for space has remained surprisingly resilient, especially in a post-pandemic world where shoppers have returned to physical spaces in greater numbers than many had anticipated. That potent combination pushed the CoStar national vacancy rate down to just 4.2% at midyear, a record low. Of the four major property sectors, it remains the only one at its historical low vacancy rate. This tightness in the market also drove CoStar's year-over-year asking rent growth to its record high of 4.4% year-over-year in the third quarter of 2022. Since then, it has decelerated to 3.4% at midyear.

With new supply growth largely in check, our modeling suggests relatively little change in the market. The national vacancy rate should move little, though sustaining such a low rate could prove challenging as the economy slows. We also expect rent growth to continue slowing from its all-time high. Despite some challenges at the property sector level, our modeling suggests strong performance from select markets and subtypes that will likely continue to confound many market participants who continue to paint with a broad brush and expect widespread weakness. That will likely prove important – because the sector should not perform as well as others, it should derive greater relative performance from market and investment selection than from systematic factors.

Office

Once upon a time, office ruled as the bellwether sector of CRE, a lodestar for the entire asset class. Yet those days seem long gone. Over the last 24 years and multiple business cycles, the sector has endured a period of booms and busts. But the challenges for the sector are increasing over time as it faces structural challenges. In the wake of the dotcom bust, the CoStar national vacancy rate increased near 12%. During the GFC, it rose to near 13%. And in wake of the pandemic, with increased prevalence of work from home (WFH), the national vacancy rate pushed above 13%. Reflecting this general pattern asking rent growth has peaked at lower rates over time.

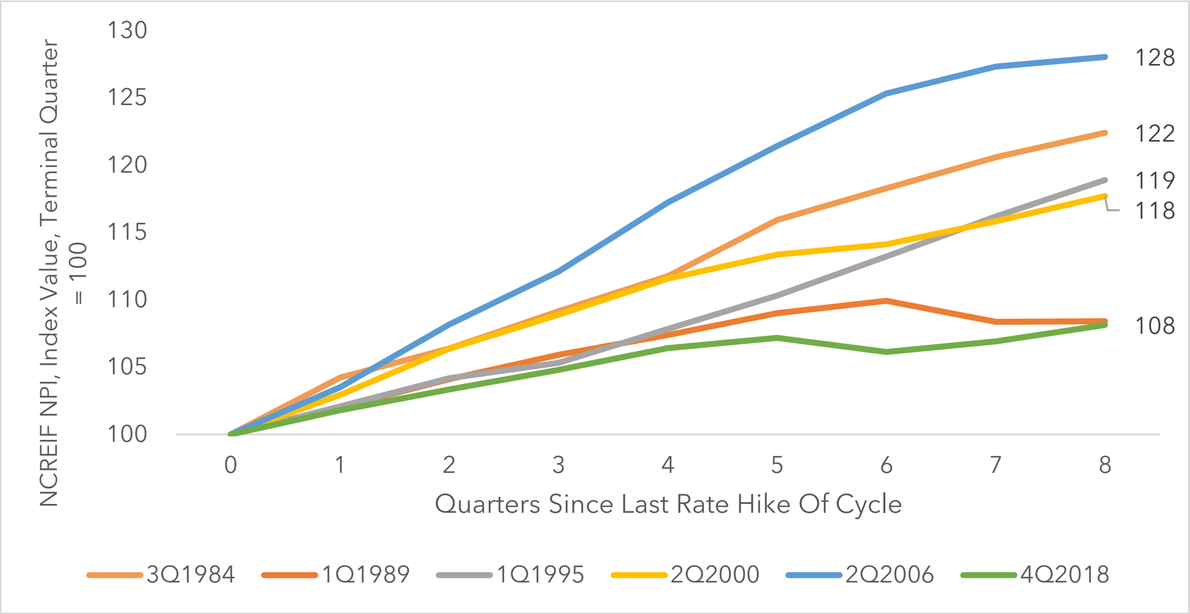
WFH should continue to pose challenges for offices. Vacancy rates should continue to rise which should limit rent growth. Given these sector-level headwinds, market and individual property selection should prove paramount for generating attractive returns. But the downside risks to mistakes increase in such an environment, particularly one where established methods of analysis will likely struggle amidst ongoing structural changes in the market. Yet shunning the sector entirely remains infeasible, especially in diversified portfolios. Thankfully, our modeling and market ranking systems enable what could be the best potential for relative outperformance. Many investors are recoiling at the challenges presented by the office sector. But our proprietary forecasting still shows selective opportunity. Like retail, office should derive greater relative performance from market and investment selection than from systematic factors.

Capital Markets

Undoubtedly, the CRE capital markets have suffered under the weight of repeated interest rates hikes since March 2022. During the second quarter, transaction volume continued to pull back, declining by 63%, year-over-year, according to MSCI. But clearly transaction volumes became inflated by historically low interest rates in the second half of 2021 and first half of 2022. Nonetheless, the pullback in transaction volume reflects a marked change as investors continue to reassess prospects for CRE investments. Relatedly, MSCI cap rates have also adjusted upward, putting downward pressure on pricing. Typically, cap rates decline during periods of rising interest rates. But during this tightening cycle, a slowing economy (including a contraction during the first half of 2022) and the commensurate softening in space market fundamentals could not exert downward pressure on cap rates.

This shift has resulted in two important, related developments. According to NCREIF, investment returns turned negative mid-year and both of their key domestic indexes continued to show negative returns. Many investors have not yet written down the value of some assets, meaning more negative appreciation returns likely lie ahead. Second, distress in the CRE debt markets continues to increase, as measured by various indicators such as delinquency rates and special servicing. Though predominantly driven by the office sector, the CRE debt markets are coming under increasing stress.

Distress seems likely to increase over the medium term, particularly in the more troubled property sectors. As asset classes with longer-term leases experience greater rollover, some will face performance challenges, putting stress not only on the assets themselves, but on the debt tied to these assets. But that should present opportunities for some well-positioned investors. Typically, CRE returns have performed well after the Fed ceases rate increases and turns toward stable or declining rates. In all cycles over the last 44 years that pattern holds. We see no reason why that would not occur during this cycle, and we foresee a resumption of positive returns over the medium term.



Sources: NCREIF, BGO Research

Closing Thoughts

Despite the challenges over the last year, CRE continues to bend but not break. If we are truly near the end of the tightening cycle, as we believe, then we foresee challenges becoming opportunities over the next phase of the business cycle. CRE equity returns will likely follow usual patterns of performance. Meanwhile, investors should find more opportunities to invest in distressed loans, also typical of historical patterns. CRE is not out of the woods just yet, but the clearing is drawing closer.

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