BARINGS

U.S. Real Estate: Repricing of Risk Keeps Liquidity Low

U.S. Real Estate Research Quarterly

NOVEMBER 2023

23-3202405

U.S. Real Estate

QUARTERLY RESEARCH

Executive Summary

ECONOMY

- The third quarter saw additional evidence of a U.S. economy that—while slowing—is perplexingly steady amid tighter financial conditions.
- While third quarter data did not demonstrate resurgent inflation, neither did it show that inflationary pressures were receding.
- The threat of resurgent inflation brought about by armed conflict and other forms of geopolitical tensions combined with increasing systemic risks from overleveraged borrowers and higher rates mean that values and yield requirements are still adjusting amid dislocated capital markets.
- The probability of a U.S. recession over the next year has fallen from 65% in June to 55% in September. If one does materialize it is not expected to be deep.

PROPERTY MARKET

- Real estate debt distress, although primarily involving mortgages on office and retail mall properties, is rising in all sectors.
- Transaction activity, at $89 billion in the third quarter, was down 53% year-over-year. All major property types saw lower sales activity.
- Continued e-commerce driven consumption as well as supply chain reshoring and near-shoring drove up industrial rents by 9.6% year-over-year.
- New supply led to a 10 bps rise in U.S. apartment vacancy rates, to 7.0%, but increased demand nudged up year-over-year rent growth by 0.7%.

Economic Outlook

The third quarter saw additional evidence of a U.S. economy that—while slowing—is perplexingly steady amid tighter financial conditions. Despite forecaster reassurances that inflation will decline to its target, investors are moving their long-term yield requirements higher. The long-term real risk-free rate currently is at its highest level since 2007 even as longer-term inflation expectations are approximately aligned with the Federal Reserve's (Fed) target. Practically, this has pushed the 10-year Treasury yield to a 16-year high (Figure 2). The Fed's tightening campaign has awakened investors to uncertainty prevalent globally in the post-COVID era. The tragic breakout of the Israel-Hamas war in early October—along with other geopolitical events—serve as a reminder of how volatile the macroeconomic environment has been. As a result, continued downward pressure on property values was the primary theme of the third quarter as it has been since early 2022.

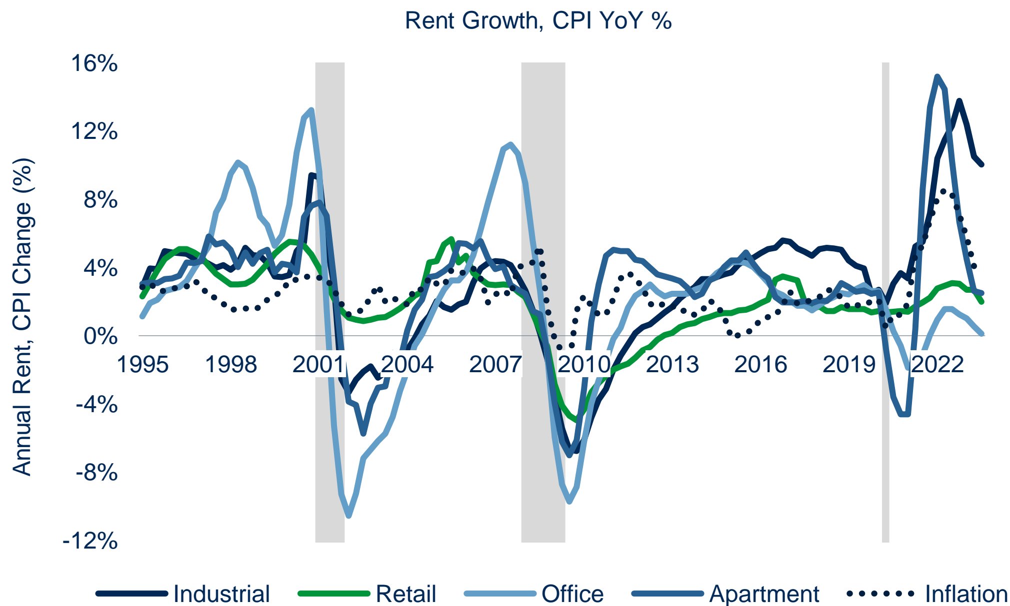
While third quarter data did not demonstrate resurgent inflation, neither did it show that inflationary pressures were receding. September 2023 headline CPI rose by 3.7% year-over-year, on par with the prior month, while core CPI slowed to 4.1%, down to nearly half its peak pace of 8.5% in the second quarter of 2022 (Figure 1). Employment strength has been noteworthy because of the labor market's linkage with property fundamentals. Non-farm payrolls rose by 799,000 over the quarter, consistent with the pace of the past three quarters.[1] Manufacturing PMI, which has been contractionary for close to a year, inched upward to 49.0 in September from 46.0 in June 2023.[2] Consumer sentiment, which has been improving since the University of Michigan sentiment index slumped to a decades-low level last year, is still commensurate with prior downturns even though the labor market is much tighter presently than it has been in past cycles.

The impact of tight financial conditions, which have been brought about by a combination of tighter monetary policy and greater investor risk aversion, has been felt primarily in property values. The threat of resurgent inflation sparked by armed conflict and other forms of geopolitical tensions combined with increasing systemic risks from overleveraged borrowers mean that values and yield requirements are still adjusting amid dislocated capital markets.

Real estate debt distress, primarily involving mortgages on office and retail mall properties, is rising as lenders attempt damage control with their loan portfolios. Working through this distress, which is expected to eclipse the level reached during the pandemic, will take time, but this period also presents opportunity.

[1] Source: U.S. Bureau of Labor Statistics. As of October 6, 2023.
[2] Source: S&P. As of September 29, 2023.

FIGURE 1: PROPERTY DEMAND, INFLATION SLOWING BUT NOT COLLAPSING



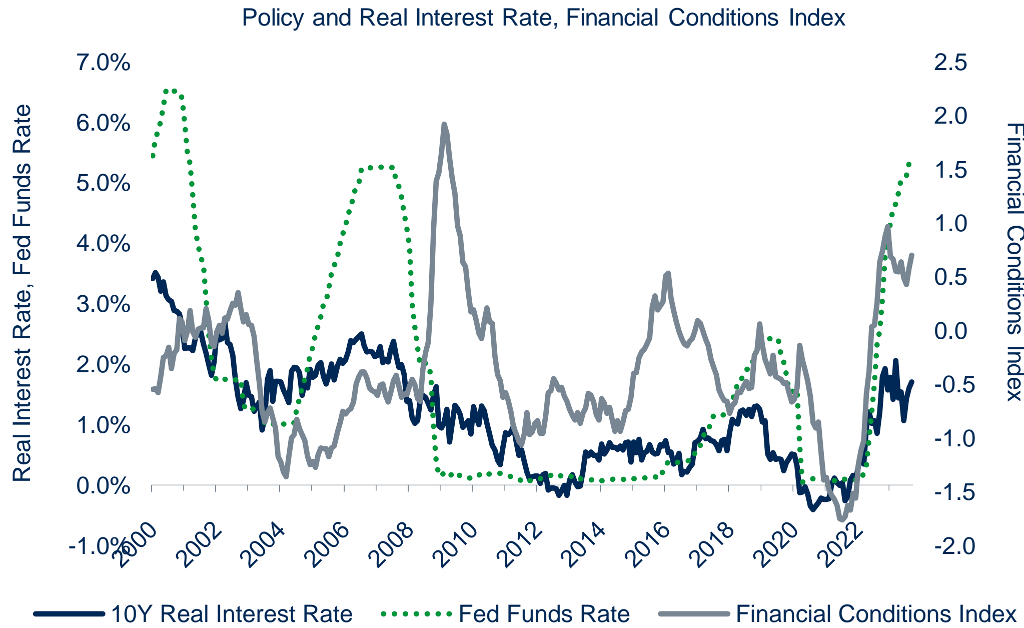
Source: CBRE-EA, BLS. As of September 29, 2023.

The probability of a U.S. recession over the next year has fallen from 65% in June to 55% in September.[3] If one does materialize it is not expected to be deep. A mild recession or even a “soft landing” is unlikely to forestall a substantial correction to property values especially for the office sector. A buoyant labor market, however, should support property fundamentals relative to prior real estate downturns, which also accompanied painful economic recessions.

Real estate demand has softened especially in geographies where recent rent spikes and new deliveries have cut into landlord pricing power. Nevertheless, occupancy and rent growth are not expected to crater across our baseline forecast. Still, a deep recession precipitated by a credit crisis cannot be discounted, though such an event is difficult to forecast. We have repeatedly emphasized that demographic and technological tailwinds have and will continue to benefit certain property types and geographies relative to others. More than three years after pandemic-related lockdowns, we see conclusive evidence of how population flows have been accelerated by COVID-19 and the adoption of hybrid work.

[3] Source: Bloomberg consensus estimates. As of September 29, 2023.

FIGURE 2: TIGHT FINANCIAL CONDITIONS REORIENT INVESTORS' LONG-TERM REQUIRED YIELDS



Source: Federal Reserve. As of September 29, 2023.

MSCI RCA reports that cumulative real estate debt distress across major property types has reached $80 billion, the highest level in a decade.[4] Unsurprisingly, office constitutes 41% of current distressed debt. However, distress is building across property sectors. Potential distress has reached $216 billion—up from $160 billion the prior quarter with 30% of potential distress composed of apartment properties. The longer inflationary pressures compel the Fed to keep its policy rate elevated, the more distress will likely build among commercial mortgage borrowers.

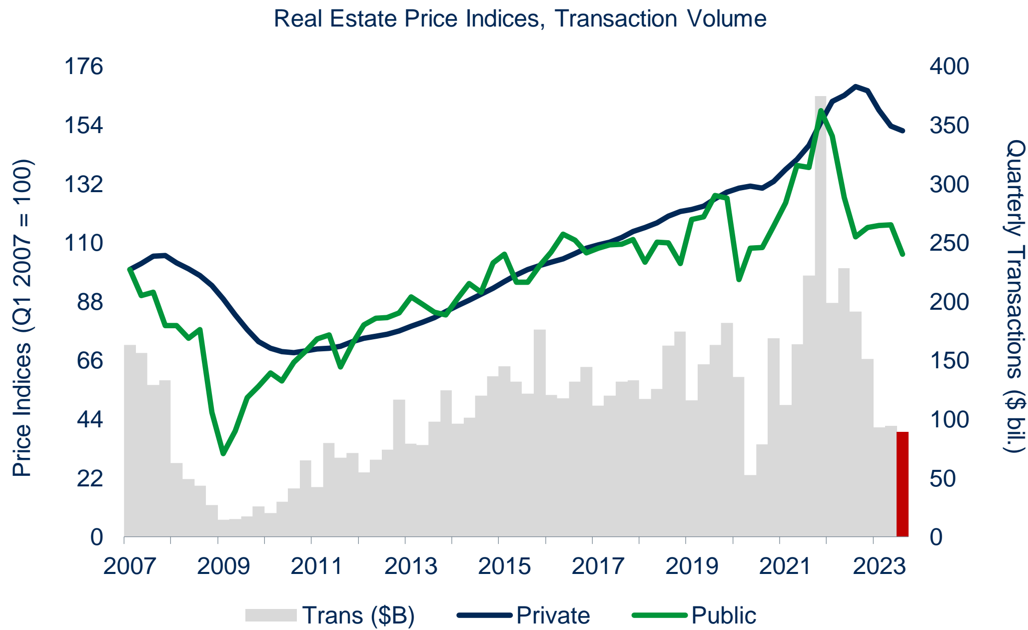
[4] Source: MSCI RCA. As of September 29, 2023.

Capital Markets

Transaction activity totaled $89 billion in the third quarter of 2023, a 53% decline year-over-year (Figure 3). All major property types saw meaningfully lower sales activity compared to the year prior. Apartment transactions were down by 64%, office down 65%, industrial down 45%, and retail down 31%. This marks the fifth consecutive quarter of falling transactional liquidity, a longer period of decline than during the pandemic.

Since the end of 2021, composite public REIT share prices have fallen by 34% with significant variation by property type (Figure 3). Unlevered privately-owned property prices have declined by only 10% from their recent peak, according to the RCA Property Price Index (CPPI). Private property values possibly have more to correct although anecdotally the stalemate between buyers and sellers is thawing as values reset materially lower in the face of higher base rates and greater macroeconomic uncertainty.

FIGURE 3: TRANSACTION LEVELS REMAIN DEPRESSED, PUBLIC VS. PRIVATE PRICE TRENDS



Source: Bloomberg; Real Capital Analytics. As of September 29, 2023.

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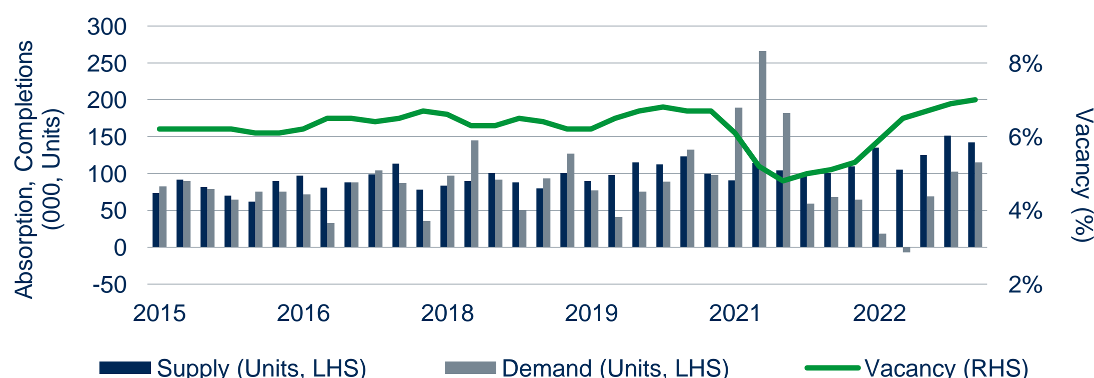
Property Markets

APARTMENT

U.S. apartment vacancy rates increased 10 basis points (bps) quarter-over-quarter to 7.0% in the third quarter of 2023 as new supply outpaced demand for the eighth consecutive quarter—though to a lesser extent than during previous periods (Figure 4). The higher-quality multifamily property segment has experienced elevated new completion rates relative to other product types, particularly in the Southern region. As an example, 4-5 Star properties had nearly twice as many units delivered as 3 Star properties during the quarter and a vacancy rate that was 330 bps higher at 9.6%.[5] Although occupancy levels declined, increased demand kept rent growth positive year-over-year at 0.7% but well below the double digit increases in late 2021 and early 2022. The development pipeline remains robust, but the number of new construction projects is expected to decline given factors such as higher interest rates. Although limited to date, it appears tighter financing conditions are having an impact on some properties. As an example, delinquency rates on Fannie and Freddie multifamily loans 60+ days past due increased approximately 10 bps since the third quarter of 2022 to 0.37% and 0.21%, respectively, but remain favorable compared to other CRE loan types.[6]

The apartment sector benefits from significant structural supports despite elevated nearer-term supply given factors such as barriers to homeownership. As an example, higher home values and borrowing rates have resulted in a nearly 50% cost premium for homeownership relative to rent according to a CBRE index with mortgage rates near 8%.[7] These headwinds have contributed to a lower homeownership rate, which has declined 330 bps since its long-term peak in 2004 to 65.9% in the second quarter of 2023. This decline is estimated to have added 4.2 million renter households—in addition to 5.9 million from general population growth—leading to further supply-demand housing imbalances.[8]

FIGURE 4: VACANCY INCREASED AT A SLOWER RATE AS DEMAND IMPROVED



Source: CoStar. As of September 29, 2023.

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[5] Source: CoStar. As of September 29, 2023.
[6] Source: MBA. As of June 30, 2023.
[7] Source: CBRE, Freddie Mac, Census Bureau, Realtor.com, FHFA, WSJ. As of September 29, 2023.
[9] Source: Census Bureau, Barings Real Estate Estimates. As of June 30, 2023.

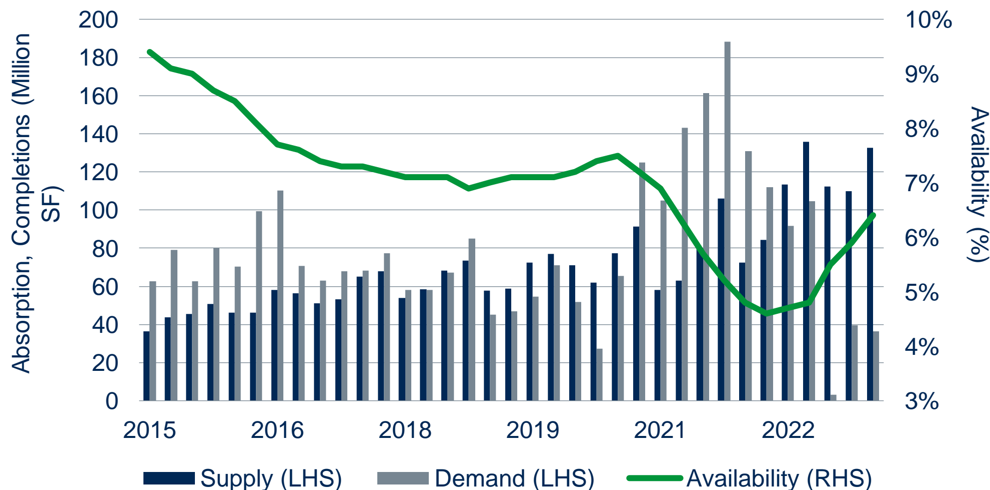
INDUSTRIAL

U.S. industrial availability rates rose 50 bps quarter-over-quarter to 6.4% as of the third quarter of 2023 but remained below the long-term average (Figure 5). The increase was broad-based as 65 out of 75 markets tracked by CBRE EA reported lower occupancy rates, which were attributed to solid, but slowing, demand and elevated new supply. As a measure of magnitude, 132 million square feet were delivered during the quarter, the second highest amount on record. Speculative development projects have dominated new supply, accounting for 82% of the square footage built year-to-date based on Cushman & Wakefield data. However, industrial rent growth remained above all other property types, up 9.6% year-over-year, despite elevated new supply as absorption remained positive (particularly for smaller-sized properties that are generally less than 100,000 square feet).

Demand slowed as a result of many tenants having previously secured their real estate leases or because they are taking a more cautious stance given macroeconomic risks. This has caused some retailers to delay full replacement of their inventories, especially given volatile consumer demand in recent years which led to costly overstock situations for some firms. However, consumer spending remained strong during the third quarter with e-commerce sales (measured by non-store retailers) up 8.4% year-over-year as of September, while the broader retail category increased 3.0% over the same time.[9]

Although moderating real estate demand and elevated supply are nearer-term headwinds for the market, the industrial sector has several significant structural strengths such as continued e-commerce driven consumption as well as supply chain reshoring and near-shoring—these are longer-term and durable trends backed by significant government programs such as the Inflation Reduction Act, the Infrastructure Investment and Jobs Act, and the CHIPS Act.

FIGURE 5: NEW SUPPLY OUTPACED DEMAND, AVAILABILITY RATES INCREASED



Source: Barings, CBRE-EA. As of September 29, 2023.

[9] Source: Census Bureau. As of September 29, 2023.

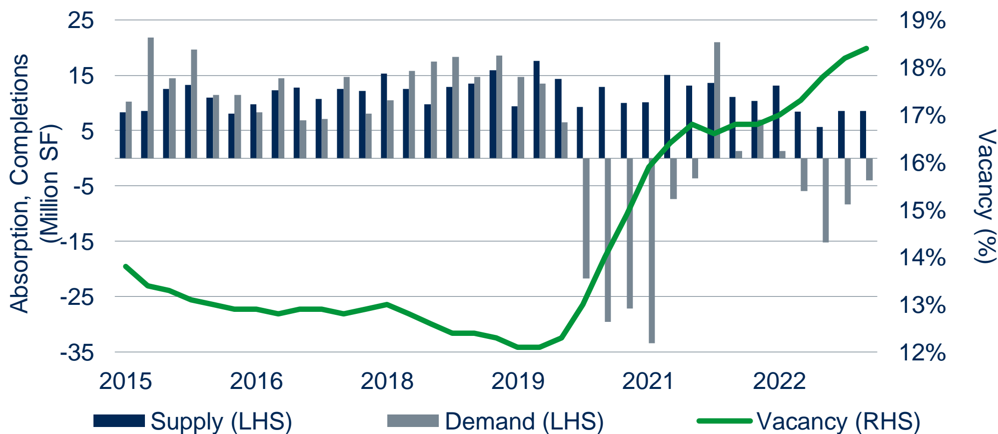
OFFICE

U.S. office vacancy rates increased 20 bps quarter-over-quarter to 18.4% in the third quarter of 2023 (Figure 6). That compares to 12.1% in the fourth quarter of 2019, despite a 6.1% increase in office using jobs since the start of the pandemic. The sector faces continued challenges from lease maturities as JLL estimates 34% of all office leases are set to expire by the fourth quarter of 2025. This environment has led to significant competition for tenants which has resulted in generous concession packages.

According to CoStar, recent leases have had longer free rent periods (commonly one month of free rent for every year of term) and higher tenant improvement allowances. That has resulted in owners sometimes giving up 40–50% of the value of the lease for a 10-year term. However, these challenges are most acute for commodity office space while trophy office effective rents are up approximately 3.8% relative to 2019 rates.[10] In addition, buildings delivered since 2015 have experienced positive net absorption of over 120 million square feet, while properties completed prior to 2015 have reported over 300 million square feet of negative net absorption.

The office market's fundamental challenges are compounded by higher interest rates and limited capital availability, which has led to growing sector distress, particularly as debt comes due. As an example, 30+ day delinquency rates for CMBS loans backed by office collateral increased to 5.58% in September, which compares to 1.58% the same time a year ago.[11] Although the office market faces long-term challenges, there are opportunities for investors with available capital to acquire properties at a significantly lower basis and value to replacement cost given the rate and inflation environment.

FIGURE 6: OFFICE VACANCY CONTINUED TO RISE WITH NEW SUPPLY, SLOWER DEMAND



Source: Trepp, JLL, CBRE-EA. As of September 29, 2023.

[10] Source: JLL. As of September 29, 2023.
[11] Source: Trepp. As of September 29, 2023.

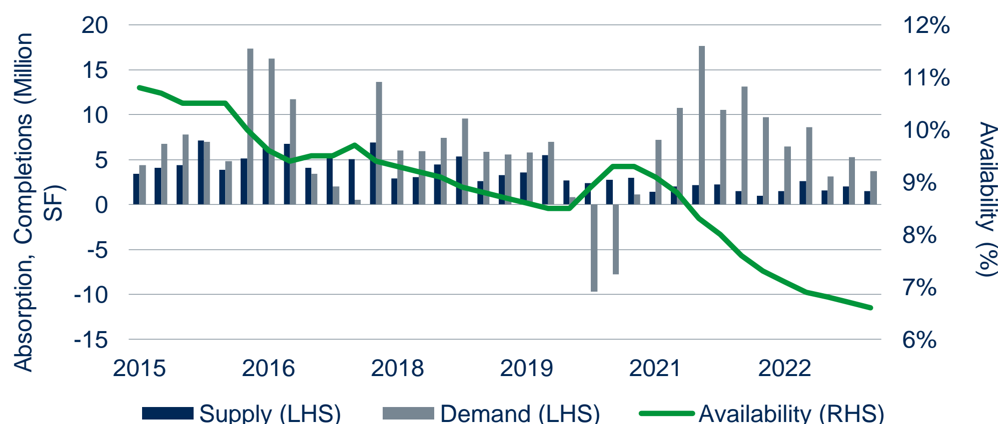
RETAIL

The retail neighborhood and community shopping center (N&CS) sector remained resilient in the third quarter as vacancy rates reached another new record low of 6.6% and rents increased 2.5% year-over-year (Figure 7). Although performance is strong for both segments, suburban market vacancy rates recently fell approximately 30 bps below urban availability rates for the first time since 2006, supported by work-from-home trends as consumers spend more near where they live.[12] Although vacancy continued to fall, leasing activity slowed given a lack of available space as new deliveries averaged only 0.3% of total inventory on a trailing 12-month basis since 2021.[13] New supply is likely to come to the market due to bankruptcies from retailers such as Bed Bath & Beyond and Rite Aid, but this appears manageable for the market to digest as announced retail store openings have exceeded closures year-to-date.

Strong labor markets have supported demand for retail. The unemployment rate was 3.8% as of September while average hourly earnings increased by 4.2% year-over-year, above the CPI's 3.7% rise for the same period.[14] Although certain households are financially stretched, retail has benefitted from pandemic-related excess household savings, particularly among older consumers. According to the Labor Department, individuals aged 65 years and older represent 22% of all consumer spending (the largest of any age cohort) and the cohort is relatively insulated from the impacts of inflation and higher rates. As an example, older households have the highest homeownership rates and are likely to have locked in low cost mortgages in 2020 and 2021.

However, there are signs of challenges for younger consumers. The New York Fed's Q3 2023 "Household Debt and Credit" report showed consumer loan delinquency rates for 18-39 year olds increased at a greater rate than older households (particularly for auto and credit card loans loans). N&CS locations are well positioned for a range of scenarios and headwinds—such as the start of student loan repayments—given their nondiscretionary focus.

FIGURE 7: N&CS VACANCY RATES REACHED A RECORD LOW WITH LOW SUPPLY



Source: Barings, CBRE-EA. As of September 29, 2023.

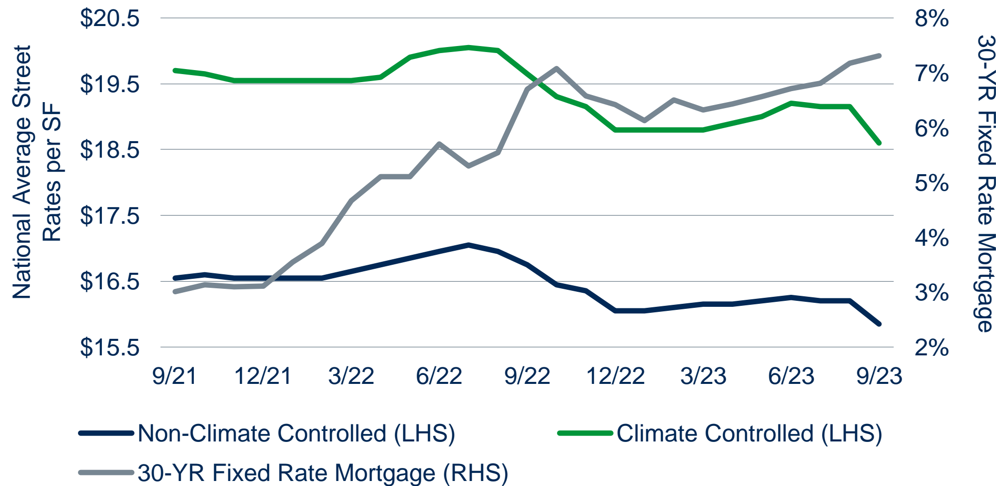
[12] Source: CBRE EA. As of June 30, 2023.
[13] Source: CBRE EA. As of September 29, 2023.
[14] Source: BLS. As of September 29, 2023.

SELF-STORAGE

U.S. self-storage fundamentals weakened in the third quarter given a robust supply pipeline and softening demand largely attributed to lower home sales, which is an important source of new customers for the sector. As an example, existing home sales declined 36% in September 2023 compared to the same time in 2022 given elevated home prices, tight inventory, and surging mortgage rates (Figure 8). Although new renter demand has slowed, operators have increased rents on existing customers to maintain revenues. Nonetheless, U.S. street rates have declined by approximately 5% year-over-year as of September and were negative in 30 of 31 markets tracked by Yardi Matrix.

New deliveries have weighed on rents with inventory under construction accounting for 3.7% of the market.[15] The number of planned projects has increased but those projects have been slow to move to the construction phase, suggesting developers are facing headwinds in starting new projects due to higher rates, building costs, and other factors. Structural changes such as a greater need for at-home workspace and the impact of aging demographics provide longer-term support to the market and the sector has been relatively resilient during past economic cycles.

FIGURE 8: LOWER HOME SALES ACTIVITY WEIGHS ON SELF-STORAGE RENTS



Source: NAR, Yardi Matrix, Federal Reserve FRED, Freddie Mac. As of September 29, 2023.

[15] Source: Yardi Matrix. As of September 29, 2023.

SUMMARY

Tight financial conditions brought about by monetary policy are causing investors to rethink their yield requirements. This is putting continued pressure on property prices. The accumulation of distress is accelerating and engulfing all property types, not just office. However, the resiliency of the economy, especially the labor market, has supported tenant demand and is mitigating what would surely be a much more painful episode were the U.S. to fall into a deep recession. Transactional activity has declined for the past five quarters and is likely to remain subdued as property values reprice. Though the circumstances of the current downturn are different from previous iterations, the deleveraging process underway is a necessary part of the real estate cycle and long overdue.

About the Team

BRE's research team efforts are led by Dags Chen in the U.S. and Paul Stewart in Europe. The research team is structured by sector and geographic expertise. The team's diverse backgrounds include appraisal, legal, technological and academic applications across multiple asset-classes, across buy and sell-side shops in markets around the globe. The real estate research team is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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