U.S. Real Estate: Recovery Postponed but Not Cancelled

U.S. Real Estate Research Quarterly

MAY 2024

24-3541611

Executive Summary

ECONOMY

- The first quarter of the year marked the seventh consecutive quarter of declining core real estate values, which are down 22.9% from the peak, according to the NFI-ODCE. That is the longest, deepest decline in the index value since the 2008-09 Global Financial Crisis.
- While we make no pretense about getting the timing precisely right, the U.S. commercial real estate market is still approaching stabilization and recovery, supported by consensus that policy rate cuts will happen eventually, followed by lower debt costs.
- Inflation continues to trend lower generally, but certain primary components of core CPI including the services and shelter components either reaccelerated or remained high.
- Much could derail a prescribed path toward inflation and interest rate normalization—including armed conflicts around the world, ongoing geopolitical tensions, and uncertainty around the U.S. election.

PROPERTY MARKET

- As of the first quarter of 2024, the distress build-up is slowing. MSCI RCA estimated that cumulative real estate debt distress across major property types reached $89 billion.
- Transaction activity totaled $79 billion in the first quarter of 2024, a 16% decline year-over-year. All major property types experienced declining sales activity compared to the year prior.
- Composite public REIT share prices are 24% below their prior peak with significant variation by property type. While the NFI-ODCE fund index value has fallen from the peak, the pace of capital value declines slowed over the quarter relative to the prior quarter.

Economic Outlook

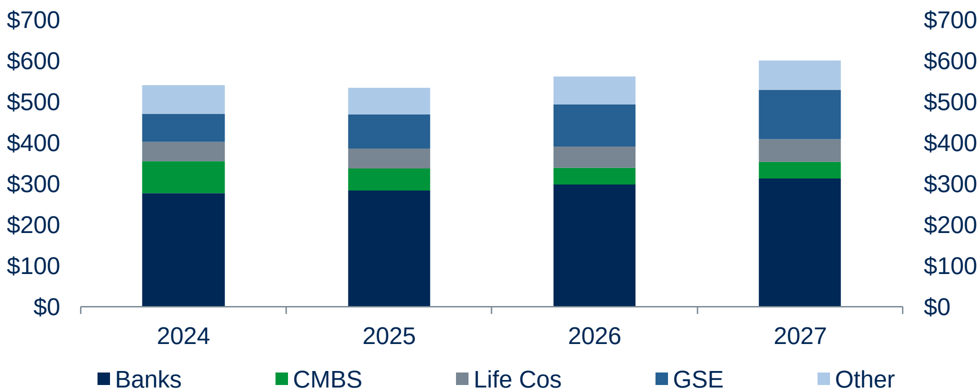
“Reality check” is an apt phrase describing whipsawed investor sentiment during the first quarter of 2024. In mid-December of 2023, the U.S. Federal Reserve (Fed) ignited optimism around a recovery by holding out the prospect of policy rate cuts. Following stronger-than-expected inflation and employment prints, expectations around declining base rates have been reversed.

Still, investors should not despair. Elevated borrowing rates, supply-side improvements, and a pullback in debt capital availability—among other factors—are helping guide inflation lower. Increases in vacancy over the past year have been mainly due to oversupply as opposed to a collapse in absorption trends. While we make no pretense about getting the timing precisely right, the U.S. commercial real estate market is still approaching stabilization and recovery, supported by consensus that policy rate cuts will happen eventually, followed by lower debt costs. The first quarter of this year reminded us that cyclical turns are often bumpy and tenuous.

The first quarter marked the seventh consecutive quarter of declining core real estate values, which are down 22.9% from the peak, according to the NFI-ODCE. That is the longest, deepest decline in the index value since the 2008-09 Global Financial Crisis (GFC), which registered a 44.2% price decline over eight quarters.[1] Distress continues to build, but the deep discounts to peak values prevalent post-GFC are unlikely to materialize outside of conventional office.

The near collapse of New York Community Bank earlier this year highlighted the squeeze regional and community banks face over depository flight and deteriorating commercial mortgage books. Historically, banks represented the greatest share of commercial real estate lending, and their pull back from lending exacerbates the dearth of capital needed to refinance the nearly $600 billion in annual maturities pending 2024 to 2027 (Figure 1). The first quarter saw little improvement in the availability of debt capital outside of commercial mortgage-backed securities, but analysts note this is largely due to improved structures such as lower loan-to-values (LTVs). Non-bank lenders continue to benefit from favorable capital market tailwinds.

FIGURE 1: 2024 TO 2027 REAL ESTATE DEBT MATURITIES AVERAGE $560 BILLION PER ANNUM



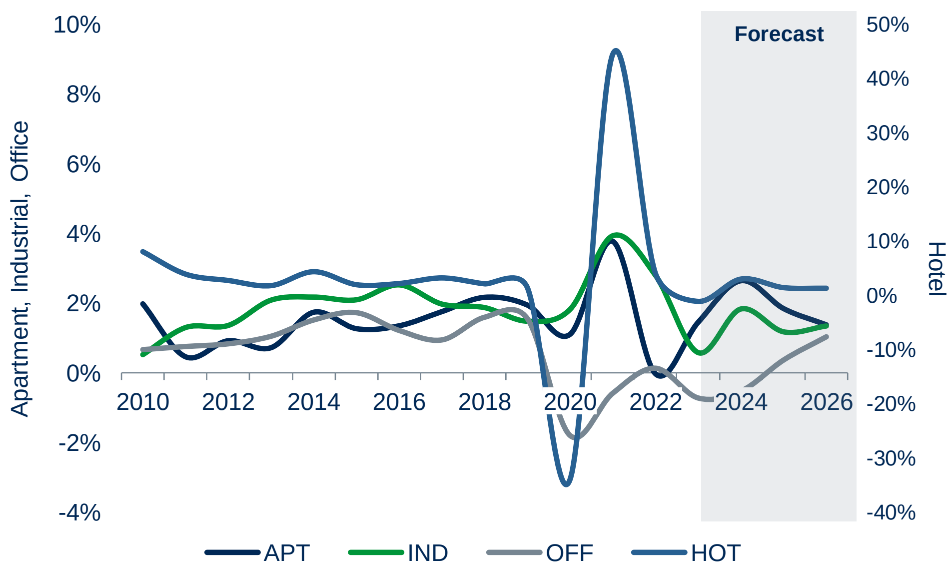
Source: Trepp. As of March 29, 2024.

[1] Source: NCREIF. As of March 31, 2024.

Inflation continues to trend lower generally, but certain primary components of core CPI including the services and shelter components either reaccelerated or remained high.[2] Month-over-month retail sales jumped in February and March, pointing to robust consumer spending. These inflationary trends ride on the back of a resilient economy, although the real GDP growth estimate of 1.6% seasonally-adjusted annual rate in the first quarter was below its 20-year average of 2.0%.[3] Though real GDP growth slowed on account of inventory drag, higher imports, consumer spending and business development buoyed overall economic growth. Unemployment was effectively unchanged at 3.8% over the quarter.[4] Another measure of labor market tightness, the ratio of job openings to unemployed, has declined to 1.4 from a post-pandemic high of 2.0 as labor supply increased due in part to an influx of immigrant workers.[5] This is keeping downward pressure on wage growth, a metric that factors heavily into the Fed's calculus around monetary policy.

Much could derail a prescribed path toward inflation and interest rate normalization. The armed conflicts in Ukraine and Gaza have become tragically protracted. Geopolitical tensions are simmering around the globe. In addition, the U.S. election is now a re-litigation of the fraught 2020 presidential race. Such risks often manifest in higher energy prices. The price of WTI crude rose by 19% over the first quarter of 2024.[6] Yet higher inflation tends to feed into nominal rent growth especially when underlying tenant demand growth remains positive—despite being whipsawed by lockdowns, re-openings, and then rising interest rates. At the same time, slowing demand growth is more a return to a sustainable trend than an indication of structural weakness (with the exception of conventional office).

FIGURE 2: HISTORICAL, FORECAST ANNUAL DEMAND CHANGE AS % OF STOCK

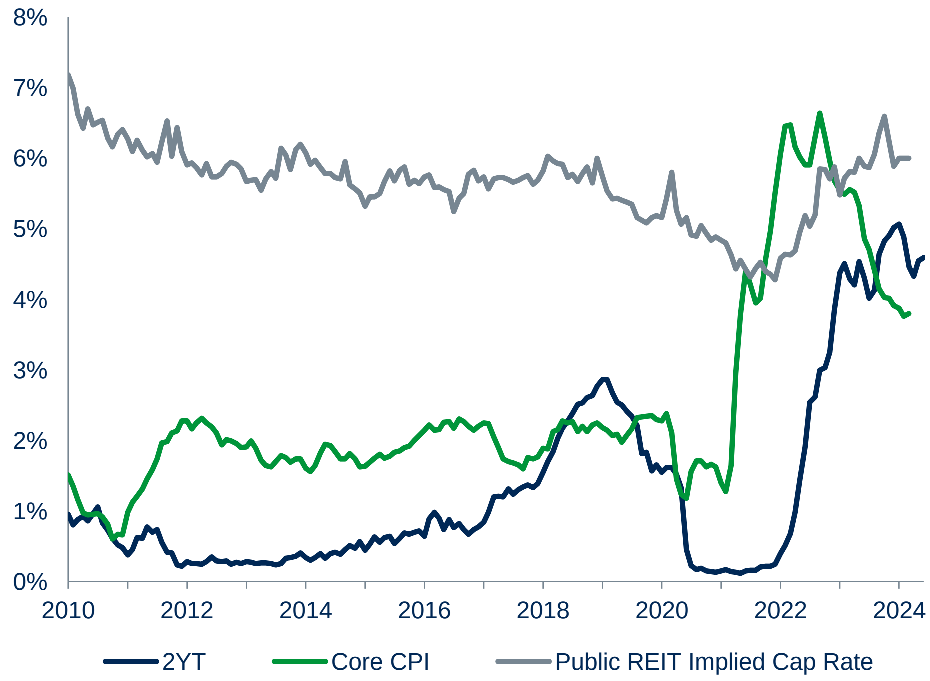


Source: CBRE-EA, Costar. As of March 31, 2024.

[2] Source: BLS. As of April 2024.
[3] Source: BEA. As of March 31, 2024.
[4] Source: BLS. As of April 2024.
[5] Source: Barings Economic and Thematic Research. As of April 2024.
[6] Source: U.S. Federal Reserve. As of March 2024.

Base rate impacts on cap rates continue to play out, but upward pressure has eased. In October 2023, the 10-year Treasury yield reached its highest level in 16 years, almost touching 5.0% before falling to 3.9% by year end.[7] Over the first quarter, the 10-year Treasury yield edged upward by 20 basis points (bps). Composite implied public REIT cap rates peaked at 6.6% in October of last year before falling back to 6.0% where they have been fixed through the first quarter (Figure 3). Cap rates are not retreating to their pre-2022 levels, however, and the risk of a "no landing" scenario sending both base rates and cap rates higher has increased.

FIGURE 3: PUBLIC REIT IMPLIED CAP RATES, 2YT, CORE CPI



Source: BLS, Federal Reserve, Green Street. As of March 29, 2024.

As of the first quarter of 2024, the distress build-up is slowing. MSCI RCA estimated that cumulative real estate debt distress across major property types reached $89 billion. Office comprised the largest share of distressed debt at $38.2 billion. However, distress is building across other property sectors. Potential distress has reached $205 billion down from $234 billion the prior quarter as some troubled loans were cured or modified. Of potential distress, apartment is still the most sizeable portion constituting $56 billion of the total, though this is largely due to capital structure issues—whereas office challenges are both due to debt and long-term fundamentals.

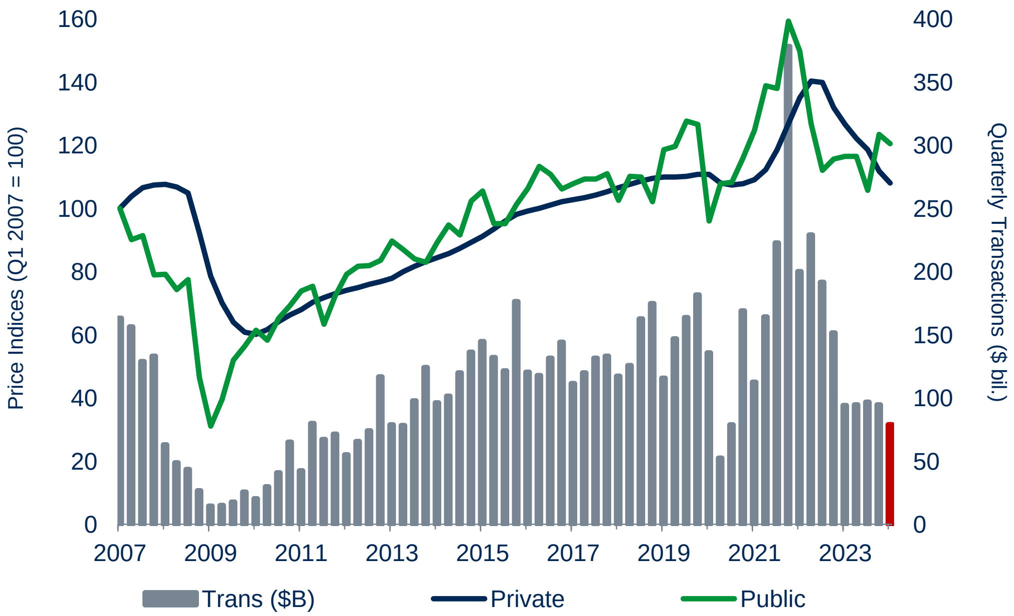
[7] Source: U.S. Federal Reserve. As of March 2024.

Capital Markets

Transaction activity totaled $79 billion in the first quarter of 2024, a 16% decline year-over-year (Figure 4). Optimism around Fed messaging early in the quarter did not ultimately feed into private real estate transactions meaningfully. All major property types experienced declining sales activity compared to the year prior. Apartment transactions were down by 57%, hotels down 39%, office down 27%, industrial down 20%, and retail down 14%. From the fourth quarter of 2021 to the first quarter of 2024, aggregate quarterly transaction activity fell by 80%. This has been a protracted and painful downturn.

Q1 2024 marks the seventh consecutive quarter of falling year-over-year transaction activity eclipsed only by the eight consecutive quarters in the aftermath of the GFC. Composite public REIT share prices are 24% below their prior peak with significant variation by property type (Figure 4). As mentioned earlier, the NFI-ODCE fund index value has fallen by 22.9% from the peak, but the pace of capital value declines slowed over the quarter relative to the prior quarter.

FIGURE 4: QUARTERLY TRANSACTION ACTIVITY, PUBLIC, PRIVATE RE PRICE TRENDS



Source: Bloomberg; MSCI RCA; NFI ODCE. As of March 29, 2024.

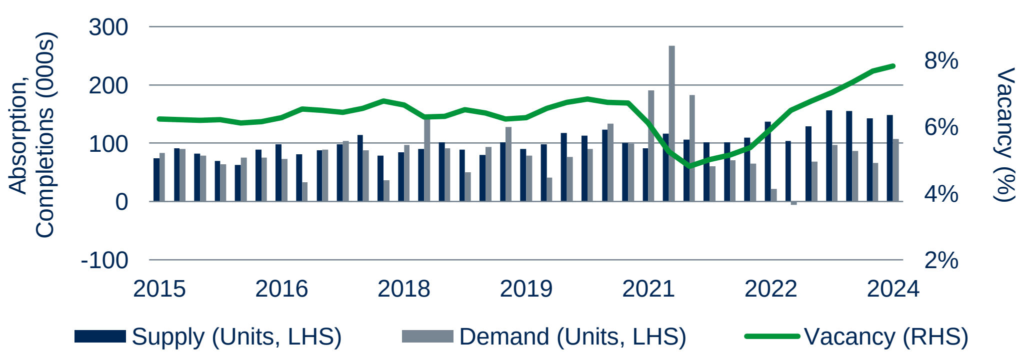
Property Markets

APARTMENT

Apartment vacancy rates rose 20 bps quarter-over-quarter to 7.8% in the first quarter of 2024, though the rate of increases slowed from 30 to 60 bps per quarter in 2022 and 2023 (Figure 5). The market continued to absorb elevated new supply with 149,000 units delivered in the first quarter, which caused rent growth to decelerate to 0.8% year-over-year from 1.0% a quarter ago. However, demand remains strong from a historical perspective with 107,000 units absorbed in the quarter compared to an average of 87,000 units over the past 10 years.[8] The combination of elevated new supply, slower rent growth, and higher interest rates has weighed on credit performance, particularly for higher leverage borrowers. As an example, commercial real estate collateralized loan obligation (CLO) delinquency rates for loans backed by multifamily properties—a proxy for higher risk mortgages—reached 11.1% in March 2024, which was the highest outside of office.[9]

The sector's headwinds—from the impact of higher rates, to increased building costs, to softer real estate fundamentals—are expected to be near-term challenges as net deliveries are forecast to decline by about 40% and 55% by 2025 and 2026, respectively, from 2023 levels. This creates a potentially positive scenario to acquire assets or recapitalize challenged financial structures given the broader residential market's long-term strengths led by overall housing supply shortages and higher mortgage costs. For example, the national median mortgage payment was $2,184 in February compared to $1,320 in April 2021 as mortgage rates hover around 7%.[10] The amount of for-sale inventory is limited as well given the rate-lock effect which has resulted in 1.3 million fewer home sales based on FHFA research. For example, many families have opted to stay in their current home longer than expected given the average rate on existing mortgages is just under 4%.[11] In addition, 56% of households aged 60 and older have no intention to sell their home compared to the 17% that have, or plan to, according to a recent Fannie Mae survey.

FIGURE 5: VACANCY RATES INCREASED AS NEW SUPPLY OUTPACED SOLID DEMAND



Source: CoStar. As of March 31, 2024.

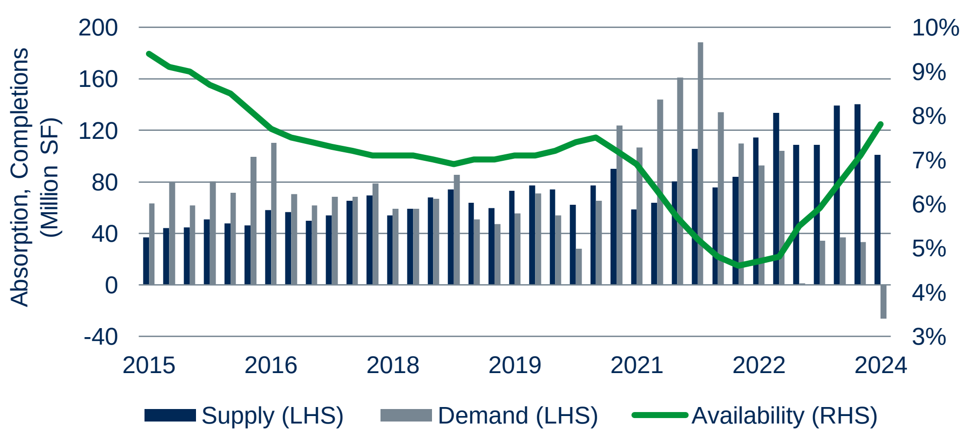
[8] Source: CoStar. As of March 31, 2024.
[9] Source: CRED iQ. As of March 31, 2024. 30+ days delinquent and/or special serviced loans.
[10] Source: MBA, BankRate.com. As of February 29, 2024.
[11] Source: FHFA. As of December 2023.

INDUSTRIAL

The industrial sector's availability rate reached 7.8% in the first quarter of 2024, up 70 bps quarter-over-quarter and to the highest level since 2016 (Figure 6). New supply appears to have peaked but was elevated during the quarter with 101 million SF completed. Deliveries exceeded demand with 26 million SF of negative net absorption, as 87% of new supply was built speculatively and was not pre-leased.[12] The slowdown weighed on rent growth which decelerated to 4.9% year-over-year from 6.5% in the fourth quarter of 2023, though remained above all the other core real estate sectors.[13] New supply is most prevalent for larger properties (400,000 SF and smaller), which had a 9.9% availability rate in the first quarter compared to 7.2% for smaller buildings.[14]

New supply will remain a nearer-term headwind and is viewed as market normalization—particularly given the sector benefits from structurally higher demand post-pandemic. For example, online retailers use 3x more logistics space relative to traditional retailers, and e-commerce is projected to increase from roughly 25% of all retail goods sales in 2023 to roughly 28% by 2026.[15] The industrial market has been supported by higher levels of per capita consumer spending, as well as inflation adjusted annual personal goods consumption. Specifically, this increased from around $11,250 per person in 2014 to around $16,150 in 2023 and is forecast to rise to $16,560 in 2025.[16] In addition, population growth has been stronger than expected. According to the Census Bureau, the U.S. population increased by 3.8 million in 2023 compared to just over 2 million in 2022, which supported increased aggregate demand for goods. These factors, bolstered by increased re-shoring and near-shoring supply chains, support higher structural demand for the sector, along with significant government infrastructure programs.

FIGURE 6: AVAILABILITY REACHED THE HIGHEST LEVEL SINCE 2016



Source: CBRE-EA. As of March 31, 2024.

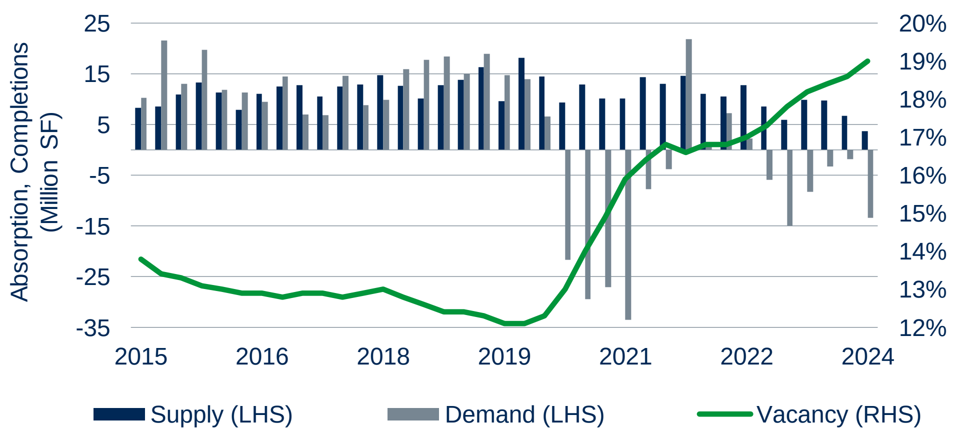
[12] Source: S&W. As of March 31, 2024.
[13] Source: CBRE EA. As of March 31, 2024. Compared to the office, industrial, retail, multifamily and hotel sectors.
[14] Source: CBRE EA. As of March 31, 2024.
[15] Source: Prologis. As of December 2023.
[16] Source: Census Bureau. Oxford Economics. As of December 31, 2023.

OFFICE

Office vacancy rates increased 40 bps quarter-over-quarter to 19.0% in the first quarter of 2024, the highest level since 1992 (Figure 7). Although occupancy will likely fall further, there are signs that demand is recovering as sublease vacancy gradually declined and the number of tenant requirements in the market increased 5.7% quarter-over-quarter and 28.3% year-over-year.[17] The finance and legal services industries have increased their share of total office demand (from 24.0% of total leasing in 2020-2022 to 28.5% in 2023-2024), while technology companies have pulled back (from 15.8% to 11.3% over the same time periods) and all other industries are relatively unchanged. Negative net absorption worsened in the first quarter but occupancy losses were concentrated in lower quality buildings. For example, 30% of office properties in the U.S. account for more than 90% of total vacant office space. However, office conversions and demolitions for lower quality buildings are expected to take an estimated 17% of total post-pandemic occupancy loss off the market's inventory, based on JLL data.

Demand for the highest quality properties remains strong, but Class A+ office inventory is limited. For example, only about 10% of New York City office buildings are considered trophy quality—but these properties recorded 37% of the market's leasing activity.[18] This segment of the market has benefitted from scarcity effects as asking rents for premier office buildings in the 16 largest markets have increased about 9% since the fourth quarter of 2019 compared to roughly 1.5% for the overall market.[19] The supply shortage for next-gen premier office space is expected to persist as ground breakings fell to an all-time low in the first quarter given the impacts of higher rates and decreased investor allocations to the sector. Other segments of the office market that are expected to benefit from the current environment are creative office product, buildings near major transit stations, and offices within vibrant mixed-use submarkets.

FIGURE 7: OFFICE VACANCY RATES REACHED THEIR HIGHEST LEVEL IN 22 YEARS



Source: CBRE-EA. As of March 31, 2024.

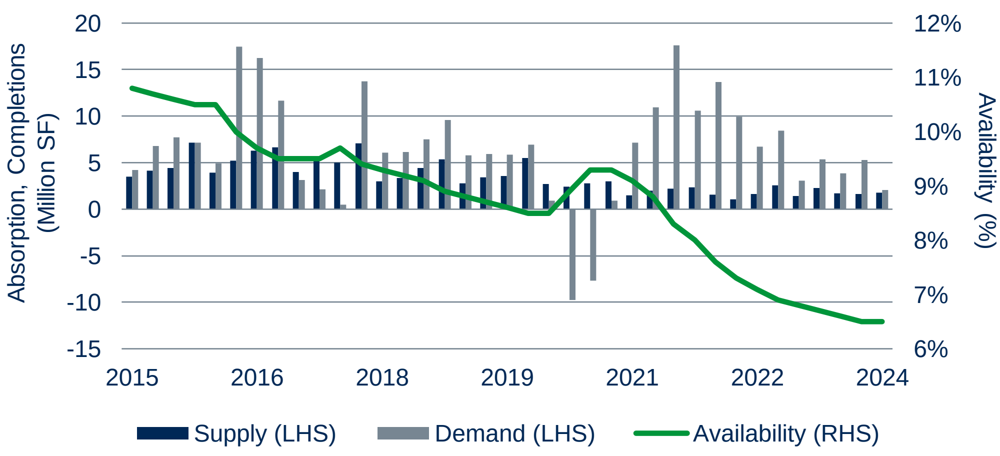
17 Source: JLL. As of March 31, 2024.
18 Source: Avison Young. As of December 31, 2023.
19 Source: CBRE-EA. As of March 31, 2024.

RETAIL

The neighborhood and community shopping center's (N&CS) vacancy rate was unchanged quarter-over-quarter and remained at a record low of 6.5% while rents increased 2.6% year-over-year (Figure 8). Tenant demand slowed during the quarter. This was in part attributed to factors such as higher business operating costs, but mainly due to the lack of available quality space given limited supply.[20] For example, the market's inventory only increased by 24 bps over the past 12-months, which compares to an average of 96 bps since 2005. This has been led by factors such as higher borrowing and building costs. Net absorption was softest in the West and South regions and stronger in the Midwest and Northeast, though these regions are slower long-term growth areas based on factors such as population growth.

Consumer demand remains strong and has supported positive real estate fundamentals. The unemployment rate was 3.8% as of March 2024—well below its long-term average—while wages increased 4.1% year-over-year and exceeded the rate of inflation.[21] In addition, the economy added 303,000 jobs during the month which broadened the number of households earning income.[22] Retail spending has also been supported by increased net worth and savings account balances quarter-over-quarter.[23] For example, retail sales increased 0.7% month-over-month in March which was well above the Dow Jones 0.3% consensus forecast.[24] However, there are signs certain individuals are challenged by higher living costs. For example, Moody's analysis shows the average household pays roughly $1,020 more per month compared to three years ago with substantial increases for items such as rent, food, and car. However, the sector has a favorable outlook due to its core necessities focus and limited supply.

FIGURE 8: N&CS AVAILABILITY RATE REMAINS AT A RECORD LOW, LIMITED SUPPLY



Source: Barings, CBRE-EA. As of March 31, 2024.

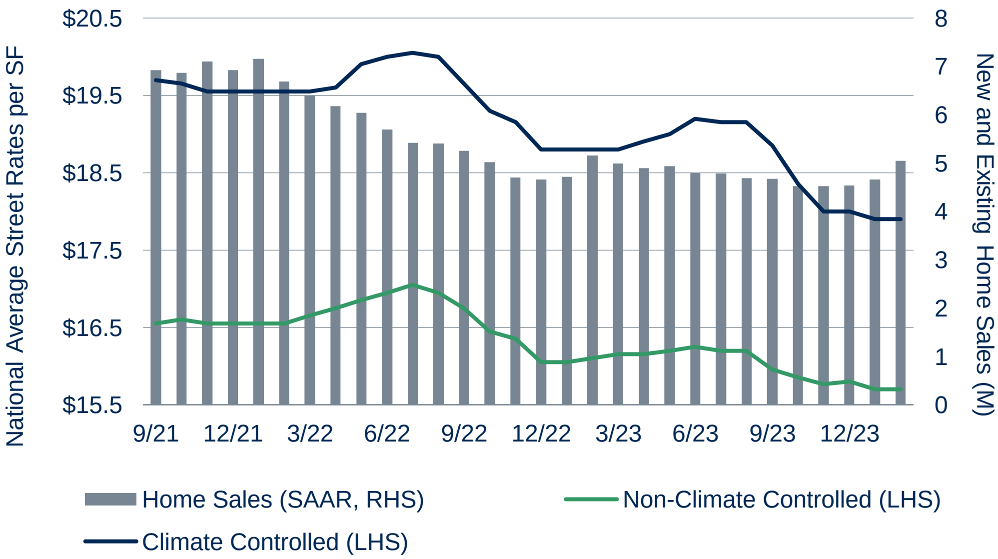
[20] Source: Cushman & Wakefield. As of March 31, 2024.
[21] Source: BLS. As of March 31, 2024. Overall CPI increased 3.5% year-over-year.
[22] Source: BLS. As of March 31, 2024.
[23] Source: Barings Economic & Thematic Research. As of March 31, 2024
[24] Source: Census Bureau data. As of March 31, 2024.

SELF-STORAGE

Self-storage rental rates are down about 8% for non-climate-controlled units and 11% for climate-controlled units relative to their peak reached in July 2022.[25] However, rents were relatively unchanged over the past three months, which is a positive sign for a market that has experienced a significant number of new units. In addition, the pace of availability increases slowed. For example, vacancy rates are expected to rise 30 bps year-over-year to 9.9% in 2024, compared to 210 bps and 90 bps increases in 2022 and 2023, respectively.[26] Nonetheless, supply-side pressures persist as self-storage properties under construction represent 3.8% of existing inventory.

There have been modestly positive developments from a key source of self-storage demand: home sales. For example, new and existing home sales improved to 5.04 million (SAAR) in February 2024, up 12% from 4.52 million in November 2023, which was near the lowest amount since 2011.[27] Increased personal consumption and the prevalence of work-from-home and hybrid work arrangements are other sources of demand for self-storage too. Higher debt and building costs—along with legislation in some markets aimed at curbing self-storage development—are expected to slow the overall rate of development. However, there is nuance by region as markets like Florida continue to have high construction rates.

FIGURE 9: SELF-STORAGE RENTS NORMALIZE FOLLOWING PANDEMIC RECORD HIGHS



Source: NAR; Census Bureau; Yardi Matrix; Federal Reserve. As of February 29, 2024.

[25] Source: Yardi Matrix. As of February 29, 2024.
[26] Source: Marcus & Millichap. As of January 31, 2024.
[27] Source: NAR, Census Bureau, Federal Reserve. As of February 29, 2024.

SUMMARY

The commercial real estate market downturn is approaching two years in duration. Transactional liquidity and property values have dropped by their most since the post-GFC era. This has set the stage for a stabilization in values followed by a recovery, and while that recovery has been postponed as inflation persists, it is still forthcoming. Regardless of how many rate cuts will take place in 2024, properties will transact with a different set of assumptions around NOI growth, terminal cap rates, and financing costs than they did before the Fed embarked on its campaign to rapidly tighten monetary policy. Economic headwinds have given way to near-term softness in property fundamentals, but in most cases, one can reasonably underwrite substantive nominal growth in rents. We recognize that there remains a massive amount of capital "on the sidelines" that has yet to re-engage the market—but at some point, it will set off a new real estate cycle brimming with potential opportunities.

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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Head of U.S. Real Estate Research & Strategy

Lincoln Janes, CFA
Director

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