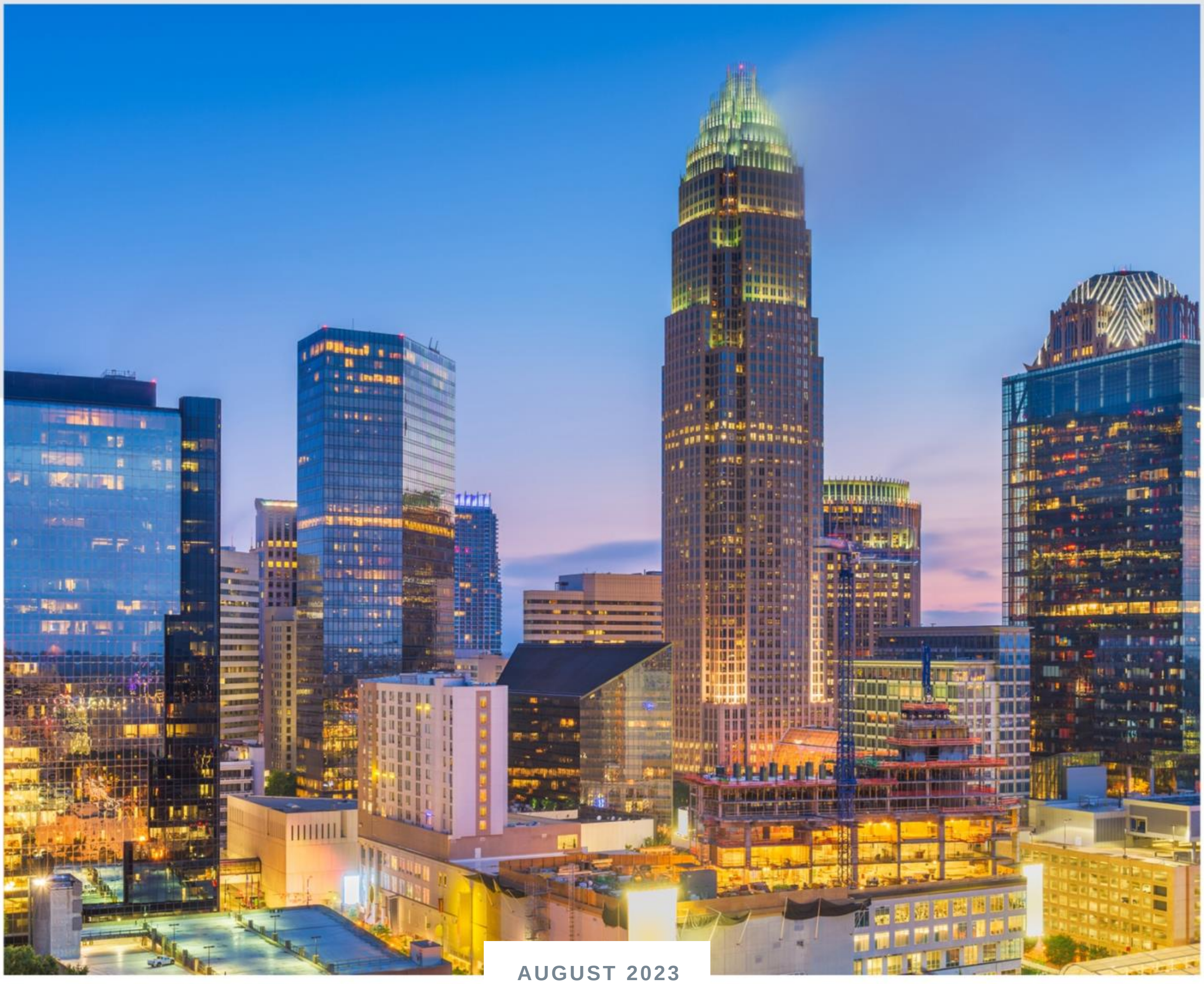
U.S. Real Estate: Fundamentals Under Pressure as Values Correct

U.S. Real Estate Research Quarterly



AUGUST 2023

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Executive Summary

ECONOMY

- While lower interest rates may be coming, the U.S. Federal Reserve maintains its inflation-fighting efforts by continuing to tighten credit.
- Despite a strong labor market, the effects of tighter credit may reveal themselves in a recession—a mild and shallow one—later this year or in the first half of 2024.
- Exposure to maturing loans on commercial real estate (especially office properties) remains a driver of real estate distress, which could take time to work through the system.

PROPERTY MARKET

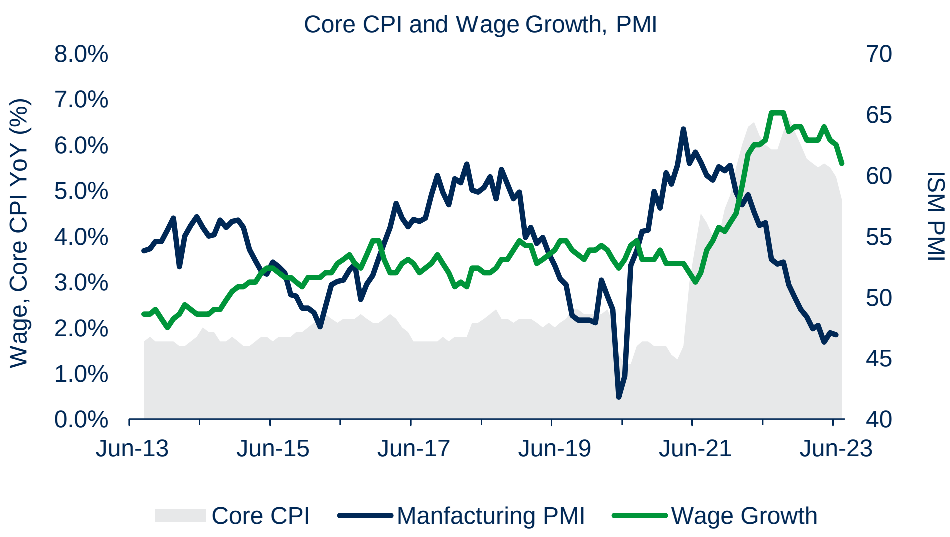
- The challenged office property sector continues to deteriorate. Two bright spots: newer buildings have seen positive rates of absorption and the number of employees fully working from home seems to have bottomed out.
- Transaction activity, at $84 billion in the second quarter, is 63% below year-ago levels and the weakest since the second quarter of 2020.
- Following macroeconomic fundamentals, real estate demand has also flagged. Q2 2023 net absorption as a percentage of stock was below the quarterly post-pandemic average for all major property types.
- Elevated supply in the South helped push U.S. apartment vacancy rates higher to 6.9%, while asking rents increased by only 1.2%, less approximately 30 bps in concessions.

Economic Outlook

Real estate fundamentals reflect slowing economic activity brought about by tight financial conditions. Public equity indices, which have climbed since the start of 2023, have been buoyed by expectations that the U.S. Federal Reserve (Fed) will eventually lower the funds rate. However, the threat of resurgent inflation and the stress facing the regional banking sector combined with the lag in appraisal valuations mean that property prices and risk premiums should continue to adjust amid dislocated capital markets. Real estate debt distress, primarily involving mortgages on office properties, is rising with lenders attempting damage control on their loan portfolios. Working through this distress, which is expected to eclipse the level reached during pandemic, will take time, but also presents opportunity.

Second quarter data provided more evidence of a broad-based deceleration in demand fundamentals, but both core CPI and wage inflation have been more resilient than other metrics. Q2 2023 real GDP growth came in at a seasonally adjusted annual rate of 2.4%, which is above its long-term average.[1] Manufacturing PMI, which has been contractionary since Q4 2022, inched downward from 46.3 to 46.0 over the second quarter. June non-farm payrolls rose by 209,000 versus a monthly pace of 466,000 since January 2021. Topline CPI inflation slowed to 3.0% by the end of the second quarter from 5.0% the prior quarter. Core CPI inflation, however, only declined to 4.8% at the end of the second quarter from 5.6% the prior quarter given the index is heavily impacted by the cost of services, which continued to expand based on the sector's PMI (Figure 1).

FIGURE 1: ECONOMIC ACTIVITY, WAGE AND GOODS INFLATION DECELERATE FURTHER



Source: Atlanta Fed; BLS; ISM. As of June 30, 2023.

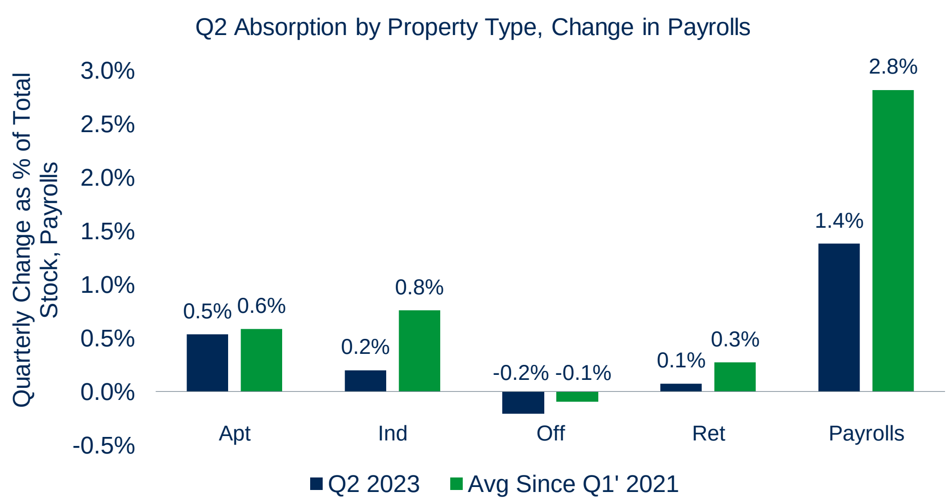
The probability of a U.S. recession over the next four quarters has been above 50%, but it is expected to decline. If a recession does materialize it is not expected to be deep. The prospect of a mild recession or of a "soft landing," however, is unlikely to mitigate the ongoing and substantial correction to property values especially for the office property sector. The past five quarters have dispelled the notion that interest rates can remain indefinitely low without

1. Source: BEA. As of June 30, 2023.

distorting asset values. Even after inflation returns to target, there is a growing consensus that it would be imprudent to return to the post-GFC “zero policy rate” era.

Following macroeconomic fundamentals, real estate demand has also flagged. Q2 2023 net absorption as a percentage of stock was below the quarterly post-pandemic average for all major property types (Figure 2). Cumulative office net absorption since the COVID-19 pandemic is by far the worst on record, but other property types are under pressure though not collapsing. In fact, apartment absorption rebounded through the first half of 2023 following Q4 2022’s negative net absorption figure, which was the first in 20 years according to CoStar. Despite the softness in real estate fundamentals, 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 lockdowns, we see conclusive evidence of how population flows have been accelerated by COVID-19 and the adoption of hybrid work, and we will explore this in greater depth in upcoming quarterly updates.

FIGURE 2: LABOR MARKET, TENANT DEMAND SOFTENING



Source: BLS; Costar; CBRE-EA. As of June 30, 2023.

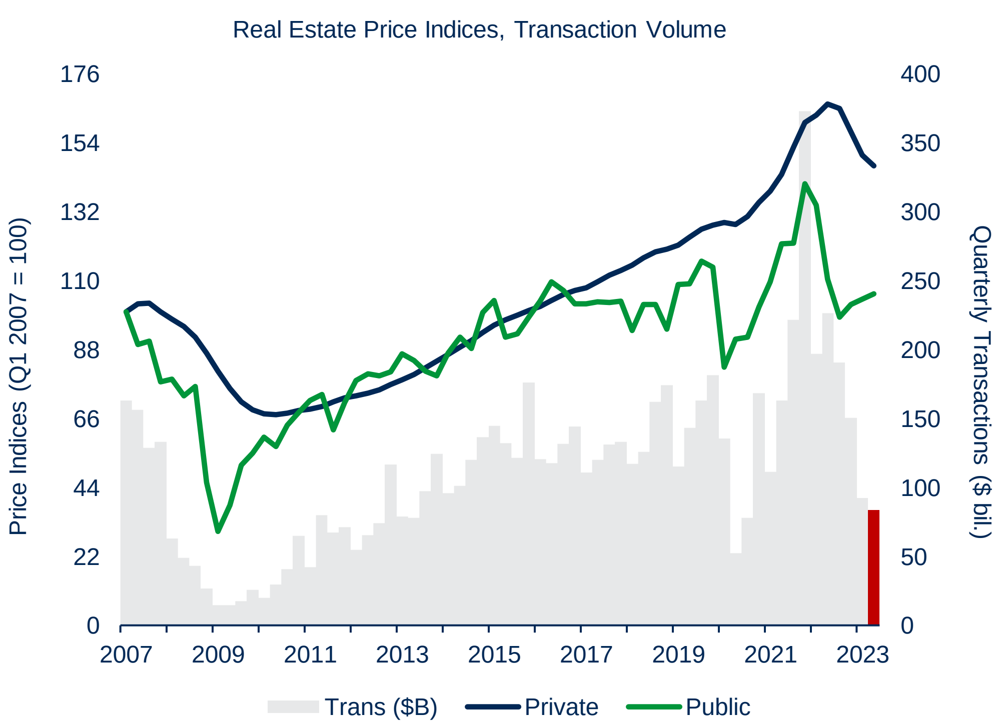
Cumulative real estate debt distress has climbed back to its 2021 peak as of the second quarter. MSCI Real Capital Analytics (RCA) reports nearly $72 billion of outstanding distress across lender types, a figure that has climbed for the fourth consecutive quarter; 80% of the distress added since the first quarter has been office. The Mortgage Bankers Association estimates that $1.3 trillion in commercial mortgages across all lender types will mature in the following six quarters starting in the second quarter of this year, and nearly half of maturing real estate debt is held by banks. RCA estimates that there is currently more than $160 billion of potential distress, a number that is likely to rise even as the Fed tightening cycle draws to a close. Real estate investors are adjusting their expectations around higher base rates and real estate risk premiums, particularly as debt matures. It is unlikely that debt capital providers would quickly roll back loan costs even once the Fed policy rate stabilizes.

Capital Markets

Transaction activity totaled $84 billion over the second quarter, 63% below the same quarter last year and the weakest since the second quarter of 2020 (Figure 3). All major property types saw meaningfully lower sales activity compared to the year prior. Apartment transactions were down by 72%, retail by 66%, office and hotel by 58%, and industrial by 47%.

Lower transactional liquidity and higher interest rates have impacted property prices. Since the beginning of 2022, composite public REIT share prices have fallen by 25% to 30% with significant variation (Figure 3). Unlevered privately-owned property prices have declined by only 12% from their recent peak according to the RCA Commercial Property Price Index (CPPI). While we think that property values will decline further before stabilizing, anecdotes suggest the standoff between buyers and sellers is easing 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 June 30, 2023.

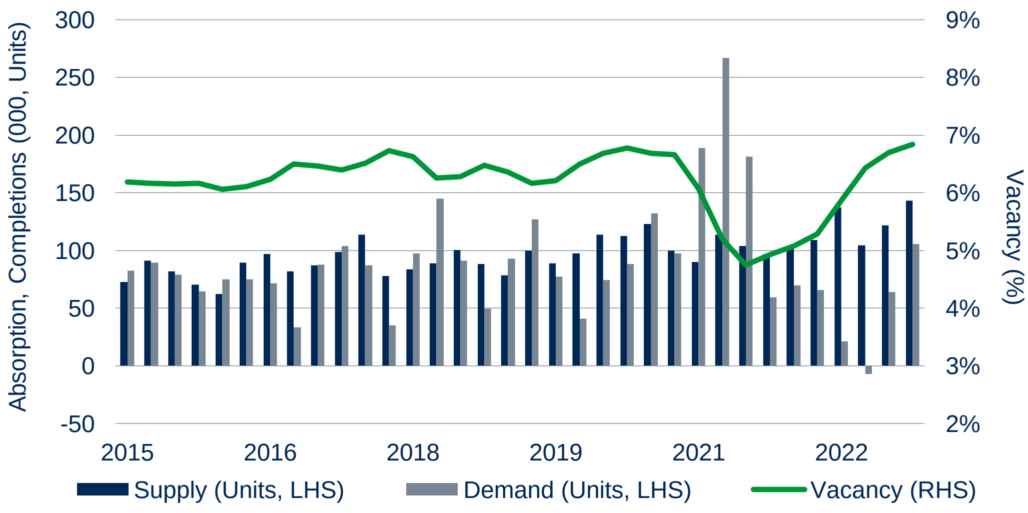
Property Markets

APARTMENT

U.S. apartment vacancy rates increased 20 basis points (bps) quarter-over-quarter to 6.9% in the second quarter as new supply outpaced demand given elevated new deliveries and affordability challenges (Figure 4). The South region is a beneficiary of domestic migration changes but has experienced elevated new supply and in-turn higher vacancy rates, whereas the Northeast, Midwest, and West regions generally reported lower availability rates. Although absorption increased quarter-over-quarter, demand was not strong enough to offset slowing asking rent growth which decelerated from an unsustainably high rate of 10.9% in Q1 2022 to 1.2% in Q2 2023.[2] In addition, property owners used incentives to attract residents, which eroded approximately 30 bps of rent growth during the quarter. New supply will continue to be a nearer-term headwind as 530,000 units are expected to be delivered in 2023, the most since the mid-1980s.

Although apartment fundamentals softened in the second quarter, the sector benefits from long-term structural supports such as demographic advantages, the core necessity status of housing, and homeownership affordability issues which are exacerbated by higher borrowing costs. As an example, the principal and interest payment on a $350,000 home purchase with a 20% down-payment increased from $1,197 in Q4 2021 to $1,808 in Q2 2023 as mortgage rates rose from 3.11% to 6.71%. In addition, the number of households increased 15% since 2010, well above a 10% rise for housing inventory, leading to supply-demand imbalances.[1]

FIGURE 4: VACANCY INCREASED AS NEW SUPPLY ADDS NEARER-TERM HEADWINDS



Source: CoStar. As of June 30, 2023.

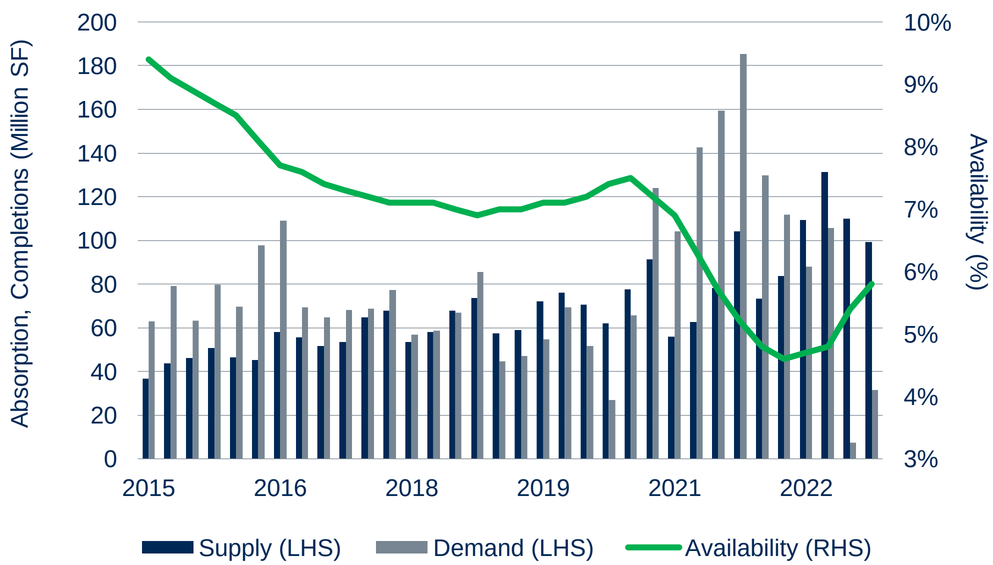
2. Source: CoStar. As of June 30, 2023.
3. Source: BankRate.com; Freddie Mac; Federal Reserve Bank of St. Louis (FRED). As of June 30, 2023.
4. Source: Census Bureau. As of June 30, 2023.

INDUSTRIAL

U.S. industrial sector availability rates remained low from a historical perspective at 5.8% as of the second quarter, but increased 40 bps quarter-over-quarter and 120 bps from the Q2 2022 all-time low (Figure 5). Similar to the apartment sector, supply has outpaced demand with 497 million square feet delivered over the past 12-months. Although leasing cooled from record levels in 2021 and 2022, net absorption remained positive in the second quarter. However, tenants have taken a more cautious approach given slowing economic activity, though consumer spending for industrial property-related industries (such as e-commerce) has been resilient to-date. Softer demand caused rent growth to decelerate in the second quarter but remain strong and well above other property types at 10.5% year-over-year.[5] According to Cushman & Wakefield, rent growth was broad-based across the U.S. but highest in the Northeast.

The sector faces supply-related headwinds as the development pipeline is expected to remain elevated through the first half of next year while only 19% of construction projects are pre-leased. However, this nearer-term risk appears manageable given the sector's secular strengths such as e-commerce growth (which is estimated to require three times more logistics space than brick-and-mortar retail) and near-shoring and re-shoring manufacturing and supply chains (which is supported by the government through the CHIPS Act and the Inflation Reduction Act).

FIGURE 5: AVAILABILITY RATES EDGED HIGHER AS DEMAND SLOWED, NEW SUPPLY REMAINED ELEVATED



Source: CBRE-EA. As of June 30, 2023.

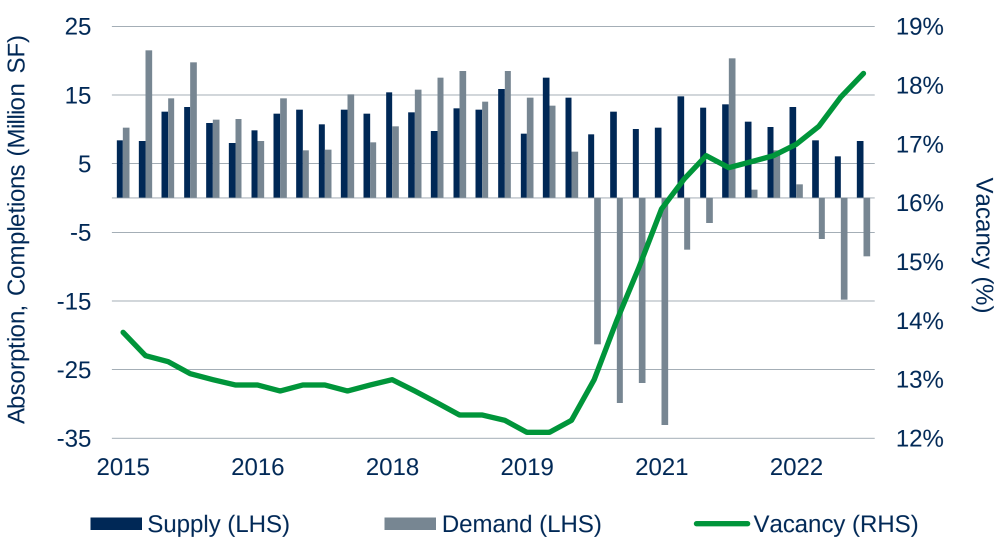
5. Source: Cushman & Wakefield. As of June 30, 2023.

OFFICE

U.S. office fundamentals continued to weaken in what is expected to be a long and protracted downturn for the sector due to structural changes in the market. The sector's vacancy rates increased 610 bps since the start of the pandemic to 18.2% in the second quarter (the highest level in 30 years), and CoStar estimates 65% of leases are set to expire over the next five years (Figure 6). However, the challenges are largely concentrated in older commodity office buildings whereas recent vintage properties have experienced positive net absorption. As an example, buildings completed since 2015 have averaged approximately 14 million square feet of positive net absorption per quarter since the start of the pandemic.[6] Weak overall demand for office space has kept asking rents relatively unchanged year-over-year while concessions, such as tenant improvement (TI) allowances and free months' rent, are elevated and have weakened effective rents, based on CBRE EA and JLL data.

The sector remains challenged, but it appears fully remote work has peaked while survey data suggests companies have modestly increased work-from-office requirements. As an example, businesses planned for workers to come into the office approximately 2.75 days per week in July 2023 compared to 2.62 days per week the same time a year ago based on a recent survey.[7] Placer.ai foot traffic data suggest office building visits improved to 65% of 2019 levels in June 2023 compared to 56% in June 2022. In addition, large employers across industries (including Amazon, Dell, BlackRock, JP Morgan, and AT&T) announced, or put into effect, increased return-to-office plans.

FIGURE 6: OFFICE VACANCY RATES REACHED THE HIGHEST LEVEL SINCE 1993



Source: CBRE-EA. As of June 30, 2023.

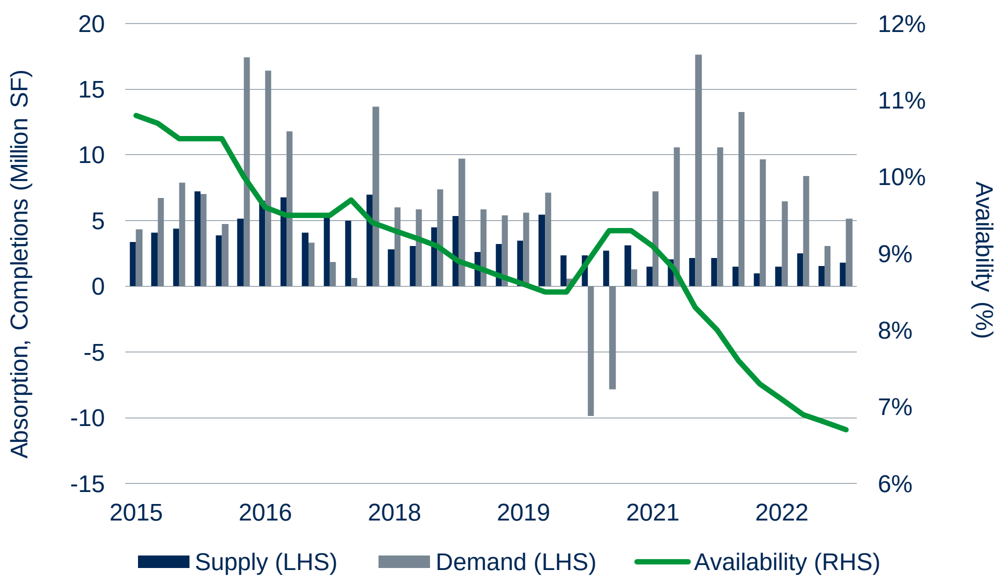
6. Source: CoStar. As of June 30, 2023.
7. Source: WFH Research. As of July 2023.

RETAIL

Neighborhood and community shopping center (N&CS) vacancy rates declined to a new record low of 6.7% in the second quarter while rents increased 2.7% year-over-year (Figure 7). Leasing activity was strong during the quarter, particularly in lower-cost-of-living Sunbelt markets, while inventory remained tight. As an example, N&CS inventory increased by only 7.3 million square feet year-over-year in the second quarter, which compares to approximately 18.8 million square feet per year for the five years ended Q4 2019.[8] The supply-demand imbalance provides a favorable environment for the sector to absorb space from several retail companies that recently filed for bankruptcy, particularly prime locations.

The retail industry has benefitted from solid consumer spending, supported by a resilient labor market and excess personal savings. However, consumers will be further stretched and savings drawn down given student loan repayments resume later this year. As an example, subprime auto loan delinquency rates in May set a record while prime auto loan late payments were the highest in 12 years, according to ABS data from S&P Global Ratings. In addition, consumer credit card balances reached a record high in May, suggesting households are borrowing more to maintain spending levels. This environment is expected to benefit N&CS locations as consumers prioritize non-discretionary goods and services such as groceries, along with other less cyclical retail industries such as health and personal care stores and limited-service restaurants.

FIGURE 7: NEIGHBORHOOD AND SHOPPING CENTER VACANCY RATES REACHED A RECORD LOW



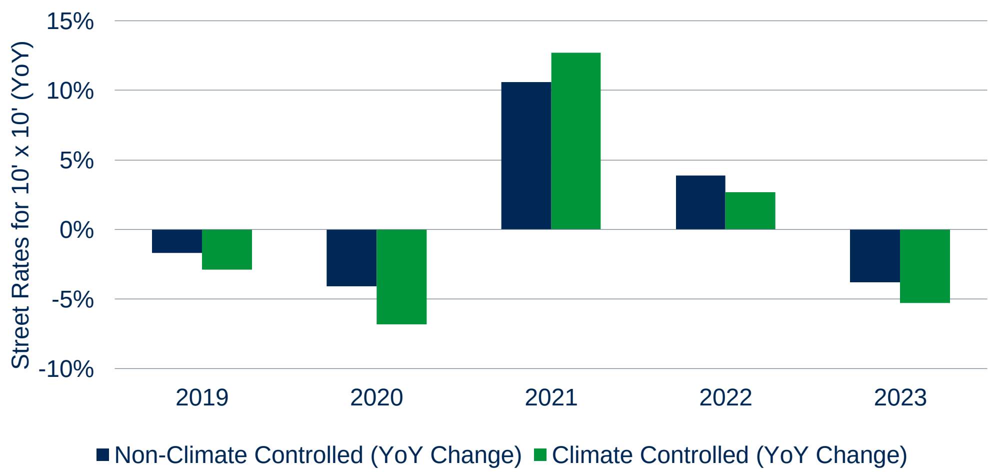
Source: CBRE-EA. As of June 30, 2023.

8. Source: CBRE-EA. As of June 30, 2023.

SELF-STORAGE

U.S. self-storage fundamentals moderated in the second quarter following elevated new supply as capital flowed into the sector given robust performance during the pandemic. As an example, rents increased approximately 11% year-over-year in the second quarter of 2021 while the number of properties under construction or in the planning stages represented 10% of existing inventory in the second quarter of 2022.[9] The new supply contributed to a nearly 4% year-over-year decline in rents in the second quarter while rates also normalized from record levels.[10] Market participants note existing customer demand remained stable during the quarter, but move-ins cooled due to factors such as relatively low home sales activity, which is a key driver for space. Although demand and economic activity have slowed, self-storage has been less sensitive to changes in the economy in recent cycles, as well as more efficient due to technology advances. In addition, the sector benefits from long-term secular trends such as aging demographics and an increased need for work-from-home office space, which leads many consumers to store belongings outside the house.

FIGURE 8: SELF-STORAGE RENTS DECLINED AS HOME SALES DECLINED, RENTAL RATES NORMALIZE



Source: Yardi Matrix. As of June 30, 2023.

9. Source: Yardi Matrix. As of June 30, 2023.
10. Source: Yardi Matrix. As of June 30, 2023.

SUMMARY

The commercial real estate market downturn persists, but unlike prior downturns, this one has not been accompanied by an economic recession. Distress continues to build, but thus far has proved manageable outside of the office sector. Transactional liquidity remains subdued for a second consecutive quarter. Underlying fundamentals remain relatively resilient even as property prices decline. The regional banking system has been steady following the shock failure of a handful of large banks in the first quarter, but concerns around systemic risk are still elevated.

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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Director

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