

MARKET MATTERS: 1ST QUARTER 2024

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"Buy land, they aren't making any more of it" – Mark Twain

TAKEAWAYS

- **Real estate has experienced a prolonged reset.**
- **The market is bifurcated- offices face distress, other space is healthy.**
- **Lags in repricing could mean further markdowns this year.**
- **Loan maturities could lead to fire sales and foreclosures.**
- **Capital shortages mean opportunities for investors.**

SPOTLIGHT ON REAL ESTATE

Real estate assets are a unique investment with a lot to offer investors: consistent income from rents, capital appreciation, and inflation protection. In normal circumstances, quality properties can offer all of these features in a vehicle that can often be financed by relatively cheap, secured debt and includes tax advantages in the form of depreciation and interest deductions. Unlike bonds, rent increases and asset appreciation tend to protect real value from inflationary pressures, while still supplying an income stream to investors. Since 2020, we have not seen normal circumstances in the real estate markets, which have been shocked by swings in interest rates and rapidly changing supply and demand conditions.

Real estate markets have a tendency to get disjointed because shifts in demand can happen quickly, while supply is relatively fixed. People, business, and investment can move in weeks or months, while buildings are stationary and take years to build or renovate. The structural changes that accompanied the global pandemic - remote work, online retail, higher interest rates, along with the boom in artificial intelligence, have exacerbated these effects. The force that has had the largest effect is remote capabilities. Many people can work from anywhere and buy anything online. Both earning and spending have increasingly become untethered to physical space. While there has been some reversion to office attendance, the overall remoteness trend is here to stay.

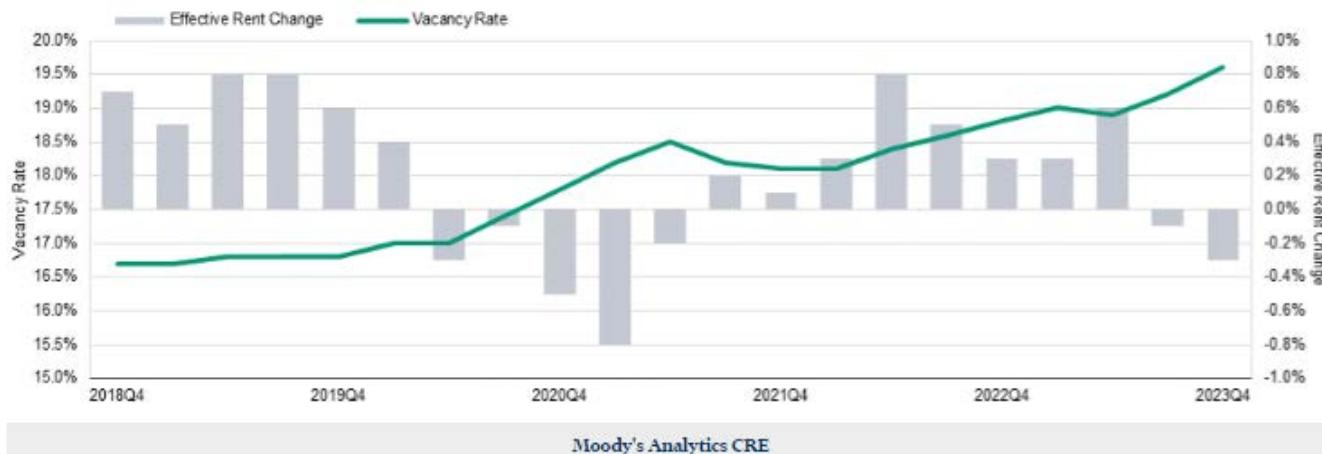
Real estate's risk and reward are measured using "cap rates" (capitalization rates), calculated as the asset's net operating income divided by its market value to derive a type of yield measure. Not dissimilar to bond yields, valuations fall as cap rates rise. Higher interest rates drive cap rates higher and valuations down. Inflation tends to compress cap rates because real estate is seen as an inflation hedge, propping valuations up. Anticipated rent growth and economic growth also play a role. The location and type of real estate asset, lease length, net income volatility from vacancies, uncertainty about lease renewals, and perceived tenant quality have their own effects on valuations. Higher cap rates indicate higher risk, but also higher potential return. Because real estate changes hands very infrequently, market prices (the denominator) are often unobservable. Transactions also take an extended period of time and transaction costs are high, making it difficult to determine an appropriate valuation. It can take multiple quarters or even years for investors to see paper valuations that reflect fair market prices. Higher interest rates get incorporated into cap rates through the 10-year treasury yield, which is more stable than the Fed Funds rate, but higher rates overall have slowed transaction and financing activity, suspending price discovery. This mix of factors has created **a prolonged reset as interest rates, inflation, vacancies, and rents sluggishly get baked into valuations.**

THE CURRENT LANDSCAPE

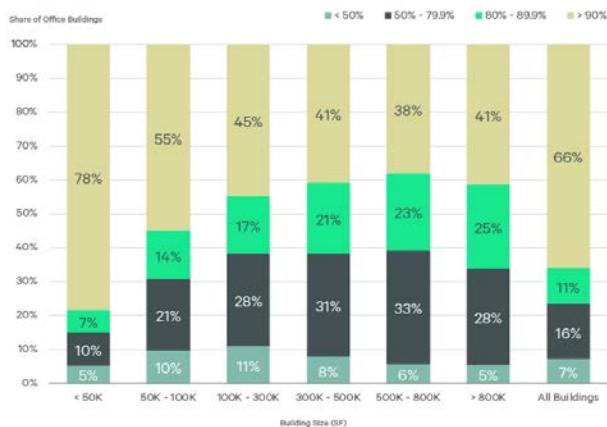
Residential real estate has held up in the face of high mortgage rates due to low supply and high demand. Residential property is for personal use, not investment. Though a homeowner could see some upside in the long run, this is secondary. Residential demand affects the investment landscape tangentially by influencing land development or apartment rents and vacancies. In the commercial sector, single and multifamily rental housing has performed positively due to growing rents and healthy vacancy rates. While projections are for slower rent growth from slower household formation and more apartment supply, demand is projected to persist as renters are priced out of ownership. **However, supply and demand are highly location-specific.** While multifamily may generally be on solid ground, oversupply in some areas could be disruptive.

Industrial properties have generally fared well in the midst of higher rates due to strong economic activity and the move toward online retail, which has increased the need for warehouses and distribution centers. The boom in artificial intelligence has ratcheted up demand for data centers, which require specialized connectivity and power infrastructure. Retail spaces have had mixed results, with some malls suffering in the wake of the trend to online consumerism but smaller shopping centers holding up as consumers continue to spend.

The thorn in the side of the overall real estate sector is office space (see below). Even with some companies reverting to more in-office attendance, businesses are downsizing their office footprints to save money on unnecessary space. Office vacancies overall hit an all-time high of 19.6% at the end of 2023, while effective rents declined by 0.3%.



This will likely make many lower quality buildings obsolete, and inflation has made it cost prohibitive to convert properties to better use. Some office buildings may be repurposed, but for others it will be more economical to demolish them and start from scratch. Even with a reversion to some in-office presence, companies often remain flexible. Allowing remote work can help businesses access otherwise inaccessible talent at lower wages. The flight to quality in real estate could help Class A buildings in good locations with copious amenities, while B and C properties take the brunt of markdowns.



Note that a small percentage of buildings account for a large percentage of occupancy losses – mainly large buildings in larger cities like New York, Washington D.C. and San Francisco. Only 45% of buildings in Manhattan and ~50% of buildings in San Francisco and Washington are 90% leased. Meanwhile, in the smaller cityscape, almost 90% of buildings in Albany and ~80% of buildings in Pittsburgh and Raleigh are 90% leased.

Office markets in many smaller, growing cities are still thriving.

FINDING TERRA FIRMA

Within real estate investing there are two different markets, public and private. Public real estate assets are comprised of mainly equity REITs and debt REITs, shares of which can be bought directly or through mutual funds and ETF's. In the private market, real estate debt and equity funds make up most of the space, including specialties in core (the safest assets), opportunistic, and distressed properties. Other funds access less direct exposure through asset based lending and other avenues. Each type of investment appears to be in a different stage of finding the floor on valuations.

PUBLIC REAL ESTATE (REITS): GET IN ON THE GROUND FLOOR

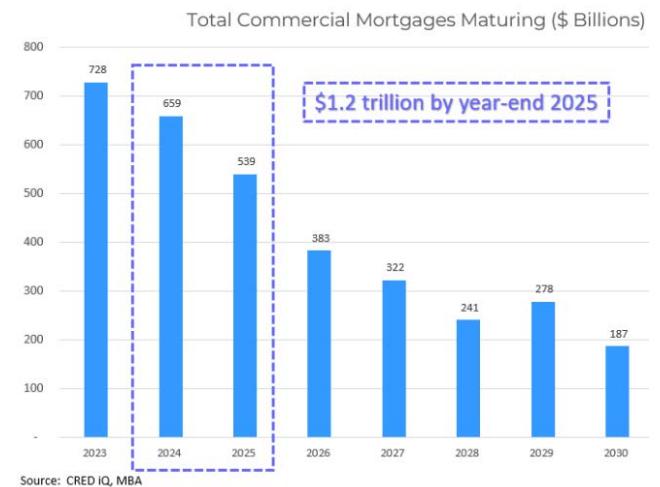
REITS (Real Estate Investment Trusts) are designed to provide income and diversification for investors. **Equity REITs acquire or invest in commercial properties across real estate sectors.** As the owners and operators of buildings, they collect rents and distribute excess operating income in the form of dividends. Many REITs are defined by the sector that they invest in – retail, storage, office, apartments, etc. **Debt or mortgage REITs lend money to real estate buyers in the form of mortgages or other loans.** These generate revenues from interest earned on loans rather than rents. Equity REIT holders benefit from capital appreciation, where debt REIT holders generally do not. REITs are required to distribute 90% of their taxable income in the form of dividends. This income is taxed only once, to the investor, and therefore avoids double taxation (REITs do not pay corporate income taxes). REIT investors may also be able to deduct a portion of their dividends.

The typical description of REIT returns is that they act like stocks in the short run and private real estate in the long run. In times of volatility, their prices will sink faster than private assets are marked down, as these are often only re-priced when there is a capital transaction, financing event, or significant change in net income. REIT valuations also recover more quickly. Because these assets trade frequently, they can price in more information, including market expectations, and can signal where markets may be headed. **At this point in the cycle, REITs may have already bottomed, while private real estate will most likely experience further markdowns over the next quarter or two.**

PRIVATE REAL ESTATE: CALLING THE ELEVATOR

Private real estate investment is hurt by high interest rates, which lead to more expensive financing costs for longer-term investments. Financing availability has also become significantly constrained. Banks and other lenders are safeguarding their balance sheets by increasing underwriting standards, lending less and increasing covenants. However, with valuations discounted, distressed properties offer opportunities. **Banks have pulled back on extending credit to commercial real estate investors, leaving private markets sources to fill some of the funding gap.**

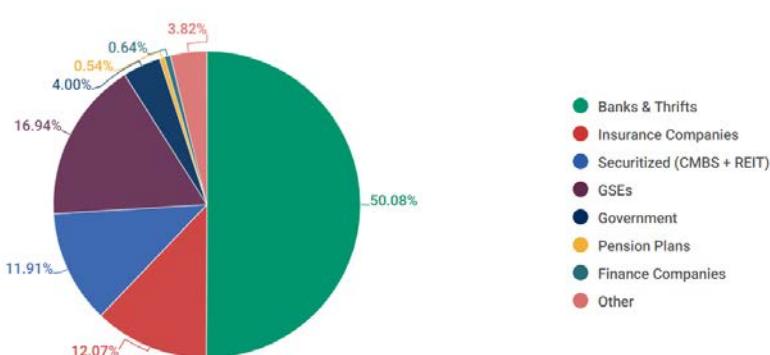
Opportunistic investors who have capital to deploy in distressed properties have recently found a limited number of promising opportunities. These investors have been staying on the sidelines in expectation of more favorable opportunities. A key shift in real estate appetite is also occurring in certain geographical areas, which may become un-investable due to climate change and insurance costs. Deal activity will depend on how interest rates change and how economic growth holds up. Private real estate direct investors and lenders will be buyers and lenders of last resort, after valuations meet appropriate entry points. Though the market has shifted dramatically in terms of where demand lies, opportunities are on the horizon. **Industrial assets, data centers, high quality offices, and single- and multi-family rentals are in demand, even if transaction volumes remain very subdued.** The post-disruption period will be a transition to a new real estate investment scene.



THE REFINANCING CLIFF

Owners and lenders have been playing financing Jenga for the last couple of years - extending, pretending, and generally trying to keep debt propped up while fundamentals erode. Now, \$1.2T in commercial mortgages are set to mature by the end of next year, and more of these are “hard maturities”, where extensions and modifications are off the table. This estimate has increased due to 2023’s maturities being extended and/or modified. About 25% of these loans are on office properties, and half are owned by banks. We could see another two quarters of downward pricing in office valuations from these maturities. Second quarter transactions will give investors a better measure of price discovery.

The Interest Rates and Occupancy double dilemma will undoubtedly cause the terrain to be rocky in 2024. Refinancing is now extremely expensive and lenders will not finance more than 60% of what they think a building is worth. Buildings with high vacancy rates are likely to default on debt. Even fully occupied properties could have significant issues rolling over their debt, making office space the most exposed real estate sector but not the only one. Commercial mortgages typically do not fully amortize, or pay off over time, so a building

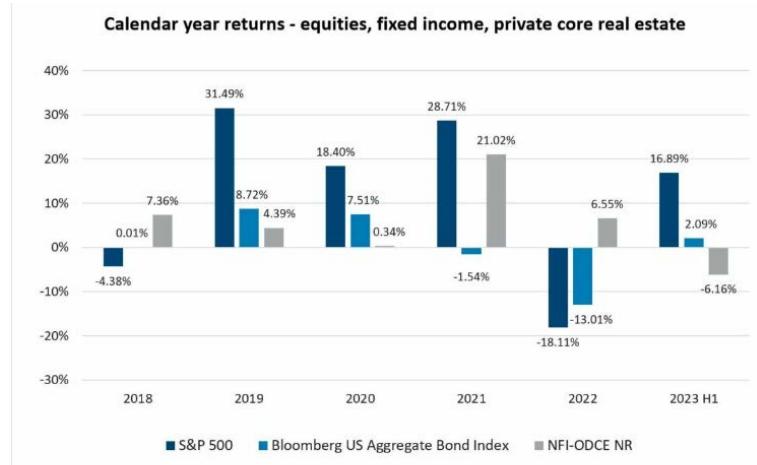


with a balloon payment coming due that is fully occupied with stable tenants may still face markdowns if their debt service cost doubles and they need to access auxiliary forms of capital due to lower caps on loan-to-value ratios. Trying to refinance cheap debt with more expensive debt backed by assets with depleted valuations will be a losing battle for many owners, who may be forced to sell at a discount or foreclosed on by lenders. **With declining property values, higher interest rates, and office space usage down an estimated 30% from 2019 levels, 14% of all loans and 44% of office loans could be in the red, where the property value is below the outstanding loan balance.** The threat of foreclosure is risky for lenders, who aren’t set up to operate and market real estate. Many have preferred to “pretend and extend” or offer owners extensions and modifications in the hopes that properties can be stabilized and/or alternative financing can be secured. In the longer term, however, financing headwinds in office space may lead to real estate debt turning into real estate equity, further depressing valuations if lenders must fire sale properties. Solutions are few and far between.

SHORT ON CAPITAL, LONG ON OPPORTUNITY

Higher cap rates and volatile valuations open the door to possible future higher returns. Current market conditions could make for attractive opportunities to diversify portfolios and add inflation protection. High interest rates have led to low transaction volumes and slower new development. Valuations are considerably cheaper

than traditional assets, and the return outlook is brightening. REITs have most likely seen their lows and still have attractive valuations. They may continue to benefit from increasing clarity in central bank policy and potentially lower interest rates. However, dispersion within REIT industries could remain high as residential prices rise, but office properties realize further declines. Slower inflation and rate cuts could turn headwinds into tailwinds.



Source: NCREIF, Morningstar

Sources: Macquarie, JP Morgan, PwC, CBRE, Nuveen, NCREIF, Morningstar, BlackRock, Moody's, CBRE, NBER, MBA, Fidelity.

“Historically, the real estate asset class tends to perform well after periods of dislocation. And we believe this environment of repricing amid steady

market fundamentals represents a great opportunity. There are, however, strong headwinds. Transaction volume globally is down 57% year-over-year, largely due to the higher cost of capital. In the near term, limited financing availability will likely contribute to an environment that's very different from the low-rate world that followed the global financial crisis" – BlackRock

These opportunities maximize portfolio diversification. Real Estate has historically shown a relatively low correlation to both bonds and equities, and dividends from REITs tend to put a floor under valuation when stocks correct provided that fundamentals hold up. Equity REITs have less than a 0.6 correlation with broad equity markets and less than 0.2 correlation with investment grade bonds. Private real estate has a negative correlation to U.S. bonds and <0.2 correlation to U.S. equities. **The lower correlation combined with current valuations creates the opportunity to earn a diversification premium. The capital return opportunity is further enhanced by inflation protection and income production.** As the rocky terrain of the current period of transition gives way to a more uphill climb to higher valuations, investors can benefit from the multiple facets of these reward opportunities.

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