ARCAPITA

US Commercial Real Estate: Looking Past the Slowdown to Pinpoint Opportunity

January 2024

Forward

When the topic is US commercial real estate, it's not hard to find negative headlines. One widely reported recent estimate put the value of distressed assets in the sector at US$80 billion, its highest in a decade, as rising interest rates and tepid demand bite.[1]

Yet compelling opportunities exist in the US commercial real estate market, and now may be the optimal time to access them, even as sentiment remains cautious. With higher interest rates pushing debt costs above capitalization (cap) rates, more asset owners are facing liquidity pressures, valuations are contracting and relative bargains are emerging as sellers grow more flexible on pricing. There are already clear signals of the interest rate outlook stabilizing, and the sheer weight of capital earmarked for the sector will inevitably be deployed, even if it is currently confined to the sidelines.

We believe investors who target the right assets and move quickly to take advantage of these interesting dynamics will benefit from being ahead of the curve. This report is part of our ongoing effort to connect our clients and partners to the value being generated even now in US real estate, and to give them the confidence to act.

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An Environment of Caution, with Signs of Strength

In all the dialogue about distress, it can be easy to lose sight of the fact that US commercial real estate (CRE) is closely connected to the real economy, which is proving remarkably resilient.

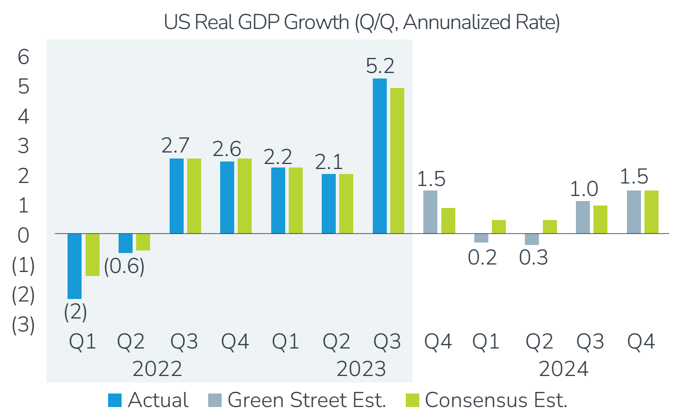
US growth has defied higher interest rates to consistently outpace consensus forecasts, supported by strong consumer spending and a vibrant job market.[2] Even if, as expected, consumers start to feel the pinch going forward, the impact will not be entirely negative for CRE as inflationary pressures are likely to subside, providing more certainty around interest rates.

It is nonetheless true that the picture in some parts of the CRE market is less than rosy. Transaction volumes have plunged[3] amid tighter financing conditions, with demand in the office sector particularly hard hit. Despite the sustained slowdown, bid/ask spreads between buyers and sellers remain though there are indications spreads are poised to tighten. The upcoming maturity of a significant amount of real estate debt is likely to pressure the market further.

However these conditions must be balanced against the strength of the underlying economy, the size and diversity of the US market, and the abundance of capital earmarked for CRE assets – almost US$300 billion by some estimates.[4]

With activity remaining sluggish and financing harder to secure, property values are likely to continue to decline,[5] creating attractive entry points in some sectors and assets with a positive mid to long-term outlook. The key will be identifying and acting on those opportunities before they coax a rush of capital back to the market, changing pricing dynamics in the process.

As rates are set to remain high relative to recent years even as they normalize, the question becomes the right way to invest into such a market. A window is emerging over the next 12 to 24 months where rates are higher than they will be on a sustained basis going forward, which means that pricing will be lower, favoring investors with the capital, expertise and flexibility to structure deals, and the appetite to deploy in this time frame.



Source: Green Street, Bloomberg, BEA

Would-be investors in US CRE are spoiled for choice across five main asset classes – industrial, office, residential, retail and hospitality – which exhibit markedly different characteristics. The investment case and data behind each need to be looked at closely.

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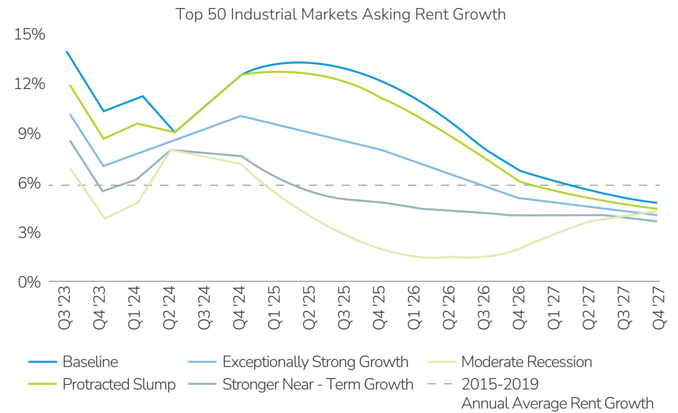
Early Movers: Multi-Tenant Industrial to Lead the List of Opportunities

Based on its analysis Arcapita has zeroed in on industrial real estate as a promising area of value generation against the current market and economic backdrop. One reason is the asset class is firmly supported by ongoing macroeconomic shifts such as the reshoring trend in US manufacturing, which will contribute to its resilience in the event of an economic downturn. Industrial real estate is playing an important role in the US economy and will continue to do so for the next decade, not least because of the increasing expansion and sophistication of the domestic supply chain.

Despite a high level of new supply coming onto the market, vacancies in the industrial space remain relatively low and development is expected to taper off, which should be positive for rental growth. According to real estate intelligence company CoStar, US industrial rents rose almost 8% per year in 2023.



Source: Newmark Research, Green Street July 2023

Industrial real estate is playing an important role in the US economy and will continue to do so for the next decade

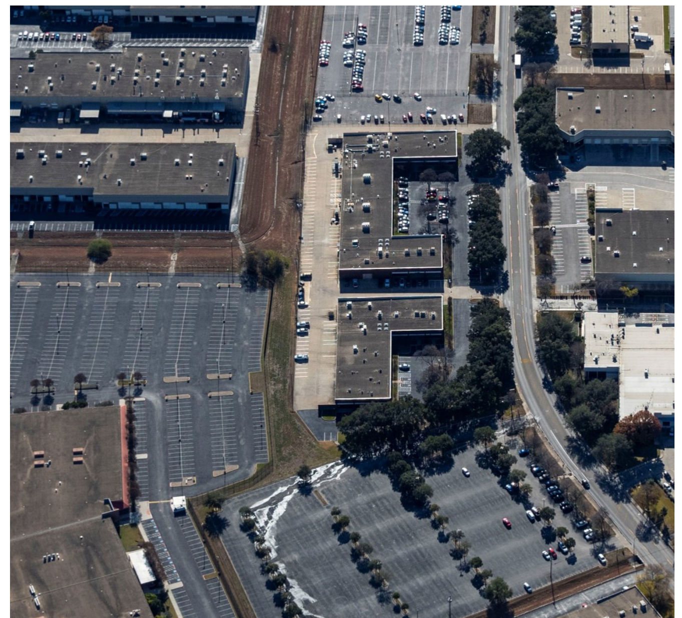
Arcapita believes the investment case is particularly strong for a specific type of industrial real estate – multi-tenant properties. These tend to exhibit shorter weighted average lease terms (WALTs), a measure of the average amount of time left on the leases of a property.

WALTs have a major impact on the amount of income an investor can realistically expect from an industrial asset. A large warehouse or fulfillment facility is more likely to be rented by a single, large tenant – often an e-commerce giant like Amazon – under a long-term lease, meaning it may be seven, 10 or even 15 years before the owners can raise rents to reflect market realities.

Multi-tenant industrial properties, on the other hand, tend to target a regional or even local tenant base. Such tenants are most often signing three to five-year leases, so in any given year, there is 25% of the rent roll with leases expiring, creating the opportunity to mark in-place rents to market.

Given that in the right markets rents can be close to double the levels of previous leases, this churn often generates material income growth. Such properties also carry inherent downside protection in that even if a recession brings rental growth to a grinding halt, the opportunity will remain to realize mark-to-market value simply by catching up to current rents.

The case for multi-tenant industrial is particularly strong given the market's current dynamics. As industrial properties are among the most liquid and in demand, they tend to be offloaded first by owners who have mixed portfolios and are facing stress from undercapitalized investments. This is bringing more appealing assets to market, but at the same time prospective buyers are thin on the ground.



While industrial assets often require capex to retain and enhance their value, for potential investors with dry powder, circumstances have opened a rare window that is likely to endure only for the next one to two years, before rates normalize. Even then, owners are likely to benefit from cap rate compression as rates settle at a higher level than they have been over the last decade, creating in effect a double-sided opportunity.

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Mid-Term: Rental Housing Bears Watching

Looking further ahead, Arcapita views rental housing as another area of potential, though it is likely to face some adjustments.

The sector has long been a major investor focus due to its attractive risk-return characteristics. Rental housing in the US generally exhibits the lowest operational risk of all main property types, simply because the need for it is persistent.

Vacancy also remains tight – but this is on the cusp of changing as more supply comes online and rents push the upper limits of consumer tolerance. Owners will have to accept that the potential for additional rent growth is limited given recent increases have tested the limits of consumer affordability, and that returns will be lower.

Rents are already starting to retreat in some cities, and in general more landlords are likely to be trapped in an anemic growth model of high occupancy and flatlining rents.

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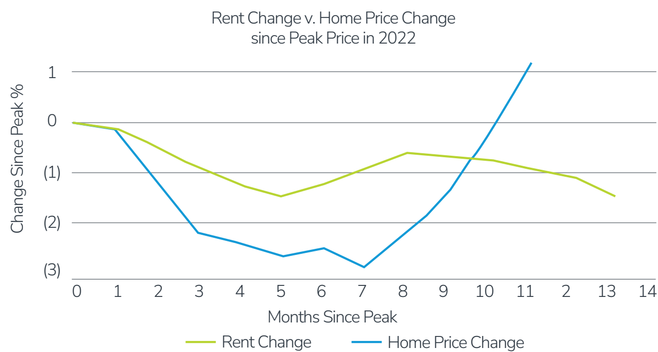
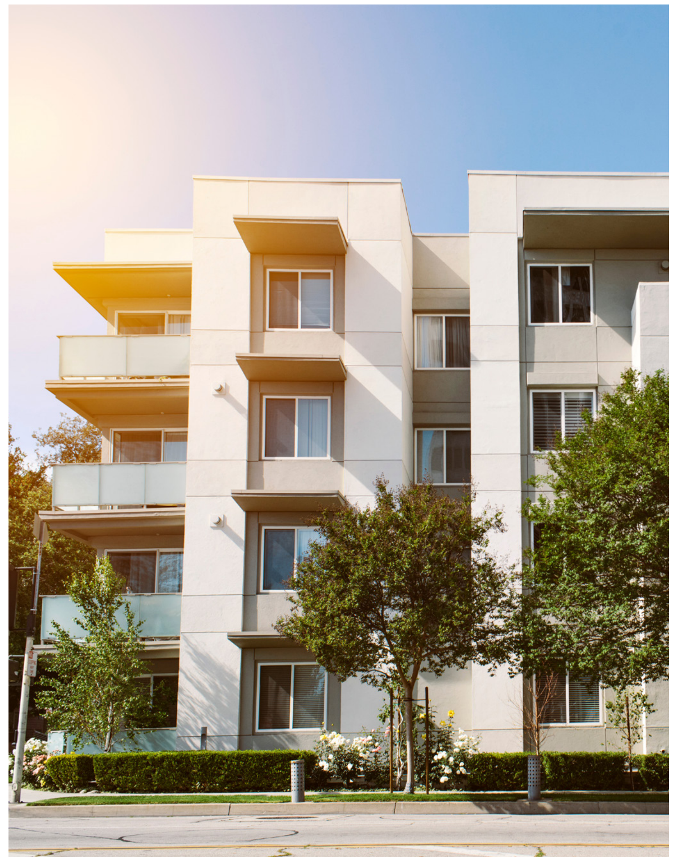


Source: Apartment List National & Metro Area Rent Estimates, Case-Shiller National & Metro Area

This means for those acquiring multifamily properties, current yields might be in the mid-single digits and internal rates of return (IRR) in the high-single digits - a very different scenario than multifamily three years ago, when leverage could turn those metrics into a high single-digit current yield and a double-digit IRR.

Compared to the last decade, the outlook for rental housing may appear negative, but Arcapita believes the sector will continue to offer value over a longer time horizon. The basic supply-demand dynamics continue to be favorable, with sustained population growth and a housing shortage that Fannie Mae estimates at 4.4 million homes, and some other sources see as even more severe.[6] With housing affordability expected to remain a challenge, demand for rental product is unlikely to decline substantially for the foreseeable future.



The current scenario argues for a tactical approach to investment in the sector, which still offers attractive opportunities if investors structure deals in the right way.

One example that can lead to higher returns is investing in development, which means rent growth risk is traded for absorption risk. Projects that are building to a 6.5-7% return on costs offer returns more in line with historical levels.

Another option is to invest in multifamily with rescue capital, to fill gaps in the capital stack. There are many buyers of multifamily in recent years who may or may not satisfy their covenants for extension options on maturing debt, creating interesting opportunities to make preferred equity investments where the investor is paid disproportionately for the risk they are taking.

The fundamental message is that multifamily offers a good risk profile, but in order to get optimal yields, new ways to invest may need to be considered.

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Office, Retail and Hospitality: Monitor with Caution

High-grade, centrally located office assets in top-tier locations continue to benefit from robust demand; the prospects for other office properties are much more mixed

Other segments of the US real estate market will also generate opportunities, but present a less positive picture overall.

In office, supply remains high, with a buildup of negative 231 million square feet in net absorption since the first quarter of 2020. This means that the supply of unoccupied office space increased, taking into consideration vacated and newly constructed office space.[7] With remote and hybrid working keeping offices roughly half-occupied,[8] vacancy rates are hovering at around 18%, though they are expected to peak next year with new supply hitting decade lows.[9]

It is increasingly clear that office is in essence a tale of two markets. High-grade, centrally located assets in top-tier locations continue to benefit from robust demand, and will be fastest to see vacancy rates normalize, positioning owners to drive rental growth. The prospects for other office properties are much more mixed.

Much of the distress is being felt disproportionately in the bottom tiers of the office market. Given that even two buildings sharing an intersection in a major city can exhibit completely different risk and growth profiles, assets need to be evaluated at an individual level. Office investment has to become a highly nuanced analysis, where local knowledge is key and confidence can be derived only from having 'boots on the ground.'

Retail and hospitality, meanwhile, have benefited from a post-pandemic surge in consumer spending,[10] but there are indications the tide may be beginning to turn.

In retail, while availability of supply remains near record lows and rents continue to rise, declining savings and the resumption of student loan payments could threaten the consumer spending boom. In hotels as well, though leisure and business travel has surged back to pre-pandemic levels[11] both occupancy and revenue per available room (RevPar) have declined from recent peaks, pointing to choppier conditions ahead.

Strategy Implications and Recommendations

Overall, we urge investors to look beyond the news flow to see US CRE for what it is: a complex and varied asset class unrivaled globally in its scope, depth and liquidity, with segments that present a broad range of interesting risk/return profiles and potential entry points to buyers.

For investors exploring these opportunities we advise:

1

Adopting Granular Analysis

As is evident in the bifurcated nature of the office sector, the driving factors and value propositions of each asset class, and even of specific properties within asset classes, can be very different. In the office sector for example, occupancy rates remain depressed overall but a ‘flight to prime’ is taking place that is nonetheless pushing up rents in top-tier buildings in important locations.[12] This makes it important to examine any potential investment at the individual asset level as much as possible, and to combine consideration of overarching financial and macroeconomic conditions with knowledge of the local market.

2

Look Beyond Traditional Acquisitions

Investors will have to become more creative and look for alternative ways to contribute or generate value, such as investing in different layers of the capital stack or forging alliances with property developers. Strategies such as preferred equity have the potential to generate attractive returns even in a higher-rate, growth-constrained environment.[13]

3

Be Prepared To Act

As this report notes, investors with capital and the appetite to deploy it are in many ways facing an ideal scenario as tighter financial conditions push more owners to offload assets and buyers remain relatively thin on the ground, putting downward pressure on prices. However this imbalance is unlikely to last long, given stabilizing interest rates and the amount of pent-up investment that is poised to return to the market as confidence grows. We believe the best investment opportunities are likely to emerge over the next 12-24 months.

4

Evaluate The Full Range Of Opportunities

The scale, depth and diversity of the US real estate market is massive and various submarkets exhibit different characteristics. Asset classes are also highly developed with a range of distinct sub-sectors emerging, such as cold storage, last-mile logistics and data centers in industrial. It is important that investors look beyond short-term trends and market cycles to focus on fundamental drivers of value connected to long-term economic and demographic forces - such as reshoring, which will benefit US industrial real estate. Assets supported by these tailwinds offer a degree of downside protection and growth prospects that will stand the test of time.

Working with a team that has expertise in different CRE sectors, that understands the forces driving them and which has an extensive local network can make all the difference to constructing a portfolio that provides downside protection and is positioned for long-term performance.

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[1] https://fortune.com/2023/10/18/commercial-property-distress-real-estate-10-year-high/
[2] See e.g. https://www.whitehouse.gov/cea/written-materials/2023/10/30/as-the-u-s-consumer-goes-so-goes-the-u-s-economy/
[3] https://www.prnewswire.com/news-releases/us-investment-sales-transaction-volume-plummets-70-in-1q-301873242.html
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[13] https://www.entrepreneur.com/money-finance/taking-a-closer-look-at-preferred-equity-and-why-its-so/414283

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Overview

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With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.

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