BlackRock Alternatives

April 2023

Global real estate viewpoint

Opportunities in an era of higher volatility

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BlackRock Real Estate Research

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Key takeaways

- **The new investment regime of higher volatility** creates capital markets disruption for real estate investors. Financial cracks have started to appear.
- The recent **banking turmoil** that started in March 2023 is an example of financial cracks that impacts the commercial real estate sector as regional banks make up a significant portion of the commercial real estate lending market. Credit is now more constrained than before. Longer-term, we expect **more regulation for U.S. regional banks**, which ultimately will result in lower amounts of debt availability.
- Real estate transaction volumes started declining during the latter half of 2022. Global transaction volumes were down 32% y/y (source: Real Capital Analytics). We expect **transaction volumes to remain subdued** as capital markets continue to be fractured and all players are experiencing higher cost of capital.
- At the same time, **real estate fundamentals are largely steady** thanks to a tight labor market globally, but there is **dispersion** between property types. For example, industrial and residential sectors are supported by long-term structural trends. Necessity based retail offers stability, but office will likely face meaningful correction as uncertain and weak tenant demand prevails.
- Not all office is the same. We expect continued performance dispersion between high and low quality office spaces and between regions with slightly more positive sentiment in European and Asia Pacific markets as utilization rates are higher.
- **Tighter credit conditions** from higher debt costs and constrained availability increases the cost of capital for many market participants and reduces competition for desirable properties. We are entering into a **window of opportunity** for a compelling investment environment for well-capitalized investors as cyclical and structural opportunities present themselves.
- We see this time as an opportunity for real estate investors to **add resiliency** to portfolios by allocating to assets with defensive characteristics with long-term structural trends in place such as industrial, residential, necessity-based retail (grocery and retail warehouses) and being highly selective on high beta sectors such as office. **Asset selection** is key.
- At the same time, real estate investors should consider **changing tenant needs** which will likely drive large dispersions in performance and may accelerate the obsolescence of existing stock.

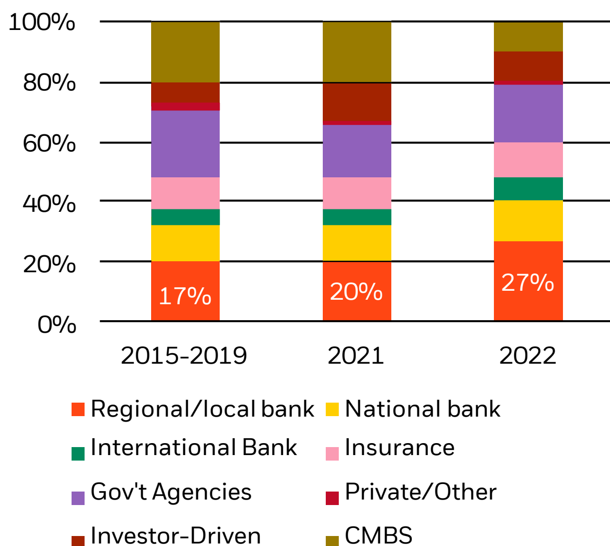
Banking turmoil: impact for real estate investors

Financial cracks started to appear in the form of the banking turmoil in March 2023 which started with the regional U.S. banks. At the same time, central banks are sticking to a clear separation of financial stability and monetary policy objectives. We expect further rate hikes to combat inflation and a key impact to markets is further tightening of credit conditions.

Banks are active lenders in real estate. In the U.S., banks and thrifts comprise of 38% of outstanding commercial real estate (CRE) loans. Small and medium-sized banks hold 67% of CRE bank loans, which means their overall share is 25% of outstanding CRE loans. In 2022, US regional/local banks made up 27% of lender composition (source: Real Capital Analytics).

In the short term, other lenders can step in, such as high yield debt funds and mortgage REITs, but likely at higher costs to the borrower. Even though the transaction market has slowed, capital needs will come from refinancings. Longer term, tighter bank regulations, especially for smaller sized ones, will likely result in lower amounts of debt availability from traditional sources.

At this stage we do not expect widespread contagion to impact the European banking sector. Credit Suisse's financial position was much worse than that of other major European banks. However, the ECB has stated they are ready to deploy all tools at their disposal should the situation worsen.



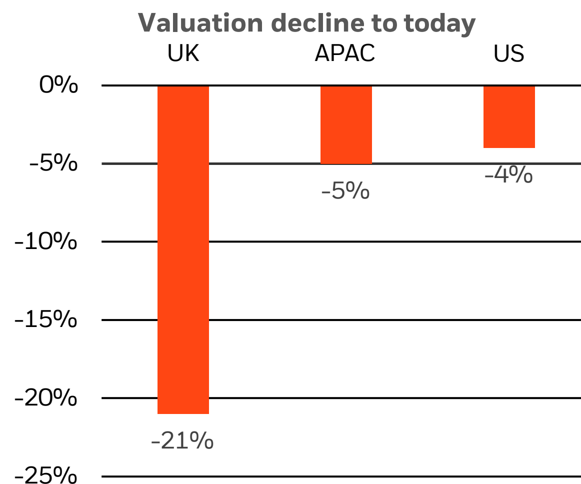
Source: Real Capital Analytics and BlackRock, as of February 2023

For real estate, we see **three main implications** from the recent tightening of credit conditions:

1. **Performance dispersion with quality of cash flows in focus:** Credit availability will ultimately result in a greater performance dispersion between sectors and markets. Equity investors and lenders alike will more carefully underwrite new deals. Quality of cash flow will matter more to investors and therefore dictate return performance.

As debt availability is challenged, buyers reliant on debt capital will be affected more than cash or low-leverage buyers.

2. **Recent events a catalyst for further value declines:** Real estate is generally a debt driven asset class and therefore the lack of credit availability will likely trigger widening bid-ask spreads and ultimately further valuation declines in the short term. Valuations have meaningfully declined over the past year in the UK, but have been slower to unfold in the rest of Europe, the U.S. and Asia Pacific.



Source: MSCI, JLL, REIS, NCREIF and BlackRock, as of Dec. 31, 2022

3. **A window of opportunity:** In our view, as the market corrects, the current situation will create a *once-in-a-cycle opportunity* for real estate investors to enter at a much reduced basis. Buyers and sellers are mostly sitting on the sidelines, but there will be refinancing needs. We should expect even higher quality properties to come to market at attractive pricing which should yield outsized returns with the option of investing at different points of the capital stack.

While the clouds are darkening, real estate markets today are in much better shape compared to pre-GFC due to the following reasons:

- **Underwriting standards** are generally tighter than pre-2008, many lenders and owners demanding lower LTVs and higher coverage ratios when entering into a deal.
- **Tighter bank regulations** have also helped to keep up lending standards.
- **Supply is generally lower** today with less speculative construction, and the silver lining to higher costs of capital is it will likely limit supply in the outer years.
- **Real estate fundamentals** are buoyed by steady labor market conditions, critical as quality of cashflow becomes more important.

If a protracted recession with a substantially weaker jobs market should occur, we will likely see a deterioration in real estate fundamentals. Vacancy rates will likely increase across most property types and rental growth will likely slow or decline. In this downside scenario, investors would benefit from positioning more defensively and reducing exposure to higher beta sectors such as office and discretionary retail.

United States: fractured capital markets...

Volatility has been a prevailing theme for real estate capital markets as participants face higher costs of capital. The regional bank crisis has resulted in a lack of capital availability for real estate sponsors, including those seeking construction financing. Some investors have found it difficult to underwrite deals with higher debt costs. In 2022, the transactions market was dominated by private buyers, according to Real Capital Analytics, with institutional and other buyers remaining on the sidelines. In general, all-cash and lower-leverage investors have continued to be active in the market, but high-leverage buyers have had to underwrite with higher debt costs. This will likely lead to more differentiation in pricing going forward according to the quality of cash flow. There are generally less bidders for deals today compared to earlier in the year, creating opportunity for some investors.

...but steady fundamentals

Real estate fundamentals are still broadly steady with low vacancies for many property types and markets. The job market remains tight, but cracks have started to emerge with higher layoff announcements.

The **office** sector outlook remains negative in the U.S. More office workers have returned in-person and physical occupancy in many markets is increasing. However, downside risk remains as many employers are rethinking space needs, including large tech companies which used to be a bright spot in the leasing market. A few tech companies have relinquished space in the new year, a U-turn from the strong absorption during the pandemic. As the labor market tips back towards employers, more employees will be incentivised to work in-person. Modern state of the art spaces are seeing good tenant demand and investor interest, whereas commodity office space is languishing, a clear demand divergence. Nevertheless, a more prevalent issue is many lenders are stepping out of the market for this property type. We expect to see sizeable correction in this sector.

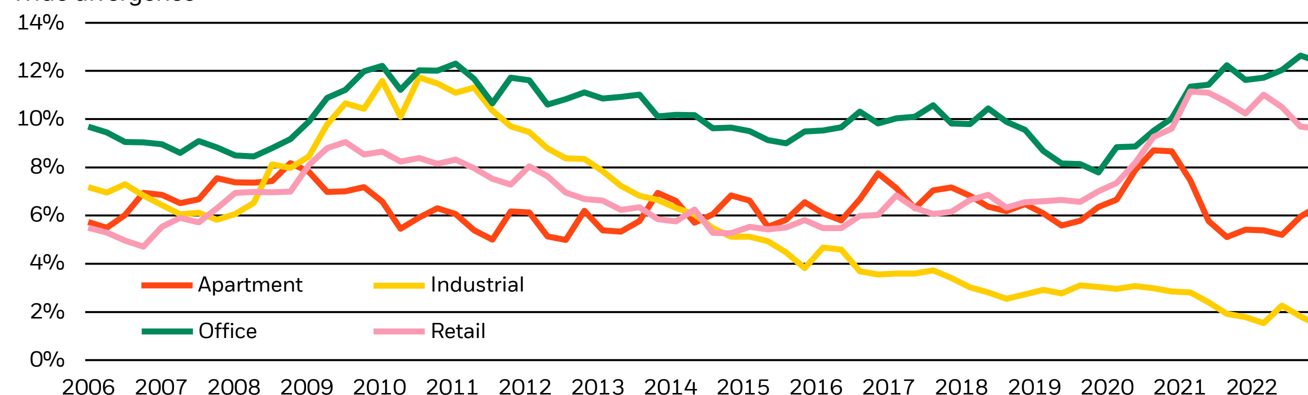
The **industrial** sector greatly outperformed over the past couple of years due to demand from strong e-commerce tenants, and the inventory build-up and on-shoring of production will likely drive additional demand going forward. The NCREIF Property Index (NPI) had U.S. industrial total returns at 14.5% y-o-y to Q4 2022 (-3.6% total returns during the quarter). While e-commerce growth will likely slow, the shift in consumer behavior is structural. Onshoring of manufacturing and production and rewiring of supply chains will likely boost incremental demand for industrial space. Rent growth and occupancy will likely soften in many markets as we head into a weaker economic landscape, but we still anticipate opportunities to significantly mark rents to market, especially in submarkets with tight vacancies.

The **apartment** sector has performed well, which has attracted strong investor interest. We believe the sector will continue to be buoyed by solid income growth, lack of affordable for-sale housing in many markets, higher home prices, and increasing household formation. Occupancy and rent growth has started moderating over the past two quarters from the extraordinarily high levels experienced in 2021 and H1 2022. Many secondary markets in the Southeast continued to outperform the national average, although incoming supply over the next two years will likely mar the outlook. Higher mortgage rates impact homebuying affordability, and many would-be homeowners continue to rent. We expect outperformance in suburban apartments as there is greater growth in renter demand in the family formation-age category.

Retail is eking out a slower but steady recovery compared to many other property types, although there has been significant dispersion across the market and certain assets are still producing strong cash flow streams. Tenant demand has improved across the sector, and supply has been low. Necessity-based retail is a bright spot delivering steady performance with resilient cash flows, diverging from malls and power centers. The use of centers will likely evolve over the medium term as non-traditional tenants look for space, such as medical and fitness tenants.

Vacancy remains low

Wide divergence



Sources: NCREIF and BlackRock, as of December 31, 2022

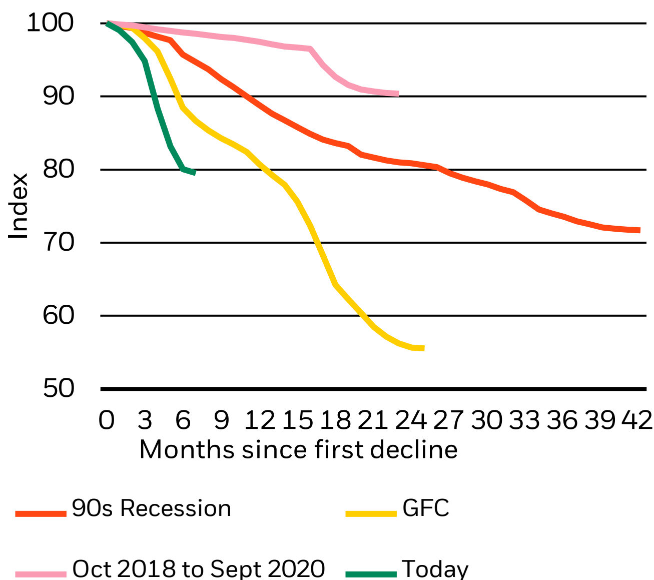
Europe: Faster repricing, resilient occupier demand

Elevated debt costs and an unfavorable spread to bond yields, alongside an uncertain macro environment has continued to take a toll on investment volumes. European all property transaction volumes sat at €49 billion in Q4, a 65% decrease on the same period in 2022 (source: Real Capital Analytics). However, it is worth noting the relative record volumes observed in 2021.

Real estate valuations have come down significantly, especially in the UK, and at a fast pace particularly when compared with previous downturns. This could suggest that values could reach a floor soon especially considering the relatively resilient occupier markets. If central bank policies continue to bring inflation under control and the rate of capital value declines eases, we could see improving sentiment and increased pricing confidence leading to more transaction activity and price discovery.

This gives us greater confidence that we may be nearer to the bottom of the cycle than the top, and whilst cracks appearing in the banking sector might moderate this view, we still believe we could see a window of opportunity open later this year. Despite ongoing uncertainty, we believe now is the time for strategic positioning of portfolios ahead of the inevitable cyclical upturn, positioning to capitalize on the acceleration of structural change in a post pandemic world.

Rapid valuation falls in the UK



Source: MSCI UK Monthly Index, 1/2/2023. Indexes are unmanaged and one cannot invest directly in an index.

While the outlook for **offices** remains uncertain, a lack of Grade A space and a contracting development pipeline will likely facilitate future rental growth for prime office assets. The outlook is for the sector is more positive than in the US. Demand for the best office space remains steady with take-up in 2022 reaching 2% above its pre-pandemic average, despite occupiers re-evaluating their needs to adapt to new models of working.

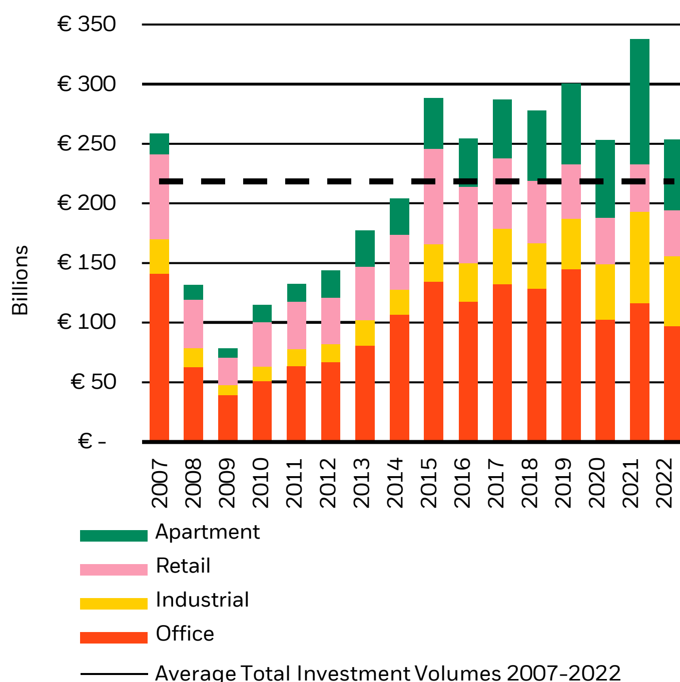
Vacancy rates have increased to 8% in Europe, however, most of this increase is a result of occupiers moving out of secondary space into grade A properties with the highest sustainability credentials, a trend that we expect only to continue and intensify. More stringent EPC regulation for offices is expected in all markets and will continue to drive the dispersion in performance between prime and secondary assets.

Logistics continue to have favorable fundamentals, though transaction volumes have been disproportionately impacted by the rising rates turmoil across Europe. Leasing activity has shown some signs of slowing, however historically low levels of available space are likely to support rental values and growth in the medium term. Long term structural trends, notably the widespread adoption of e-commerce across the Eurozone, and nearshoring for resilience ensure ongoing resilience of the sector.

Residential continues to be viewed as one of the most defensive sectors. Several demographic structural trends will ensure the sector remains attractive. Increased household formation, shrinking household sizes, increased mobility, rising house prices and the increasing cost of debt has made rental accommodation a more attractive option in recent years. This increased occupier demand is expected to continue to push up rents.

There has been a structural shift out of the **retail** sector in recent years, as investors continue to shrink their retail portfolios. Ongoing competition from e-commerce has left many retailers struggling to maintain profitability, and this challenge has only been exacerbated by the cost of living crisis. From an occupier perspective, 2023 has the potential to be a difficult year.

European transaction volumes down, but only to long term average



Sources: RCA Transaction Volumes, 20/3/2023.

Asia Pacific: Nascent repricing on fewer trades

A softer tone to the economic outlook persists for the Asia Pacific region, for now, driven by higher inflation, interest rates and slower global growth. The post-COVID reopening of China's economy will likely provide a boost in the region, but the languishing global economic outlook will continue to dampen activity. The moderation of this region is not as severe as what we have seen in Europe, given a more diverse supply of manufactured goods and energy. Nevertheless, economic growth is slowing and with prices visibly elevated in most APAC markets, valuation moderation is expected.

The real estate cycle will likely to slow down from here. In specific regions, asset values have retrenched a bit as funding costs lifted and there is likely to be greater spot pressures in some regions and segments in 2023. While activity relaxations are supportive of foot traffic and occupancy within city centers, higher mortgage rates and steeper prices are weighing heavily on discretionary household budgets, which impact disproportionately on some retail segments.

Higher construction costs are affecting new supply and lifting replacement costs for existing assets. Meanwhile, there is increasing scope for financial distress from over-levered, under-capitalized owners, specifically those not sufficiently hedged against interest rate and currency movements.

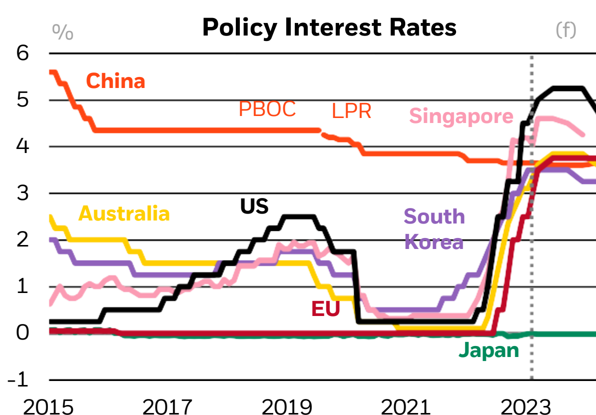
White-collar workers are continually shifting back into the **office** on a staggered basis. More broadly, the recovery of activity across the region are reflected in rising in-office presence. In most Asian markets, the office is again the default workplace for white-collar professionals. The permanent demand drag of working-from-home is becoming more apparent yet remains relatively muted for a broad range of APAC markets.

While improving mobility has put more people back into **shopping centers**, household budgets are being broadly impacted by rising prices and mortgage repayments, which weaken retail spending, particularly for discretionary, big-ticket household items. Consumer confidence is also being adversely affected. Volatile equity prices and downbeat house prices both weigh heavily on household wealth.

Industrial and logistics are still leading the way. The uplifts in e-commerce and logistics tenant demand are likely to be structural and persistent, in part reflecting the relative under-supply of modern, well-located warehousing facilities. Keen investor demand continues to support liquidity and values, at least partially, although higher funding costs are becoming a transitory overhang for markets like Australia and South Korea.

Residential markets show widening correction. With rising mortgage rates, built-for-sale housing markets are seeing deep price corrections in most part of the region. Meanwhile, built-for-rental markets such as Tokyo multifamily are holding up relatively well, on the back of firm investor demand for stable income and a steady recovery in occupancy.

Interest rates are expected to stay elevated in 2023



Source: Bloomberg, BlackRock (28/2/2023). Forecasts may not come to pass.

Higher interest rates have been impacting short-term growth outlook in APAC

Real GDP (% p.a)	2022a	2023f	2024f
China	3.0	4.5	4.7
Hong Kong	-3.5	2.1	4.0
Australia	3.6 (f)	1.9	2.0
Singapore	3.6	0.9	2.8
Japan	1.1	0.7	1.3
South Korea	2.6	0.8	2.7
Asia-Pacific (US$ basis)	3.3	3.4	4.1

Source: Oxford Economics, national statistics agency, BlackRock (22/2/2023). Forecasts may not come to pass. Arrows show revisions of forecasts in the past 3 months.

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