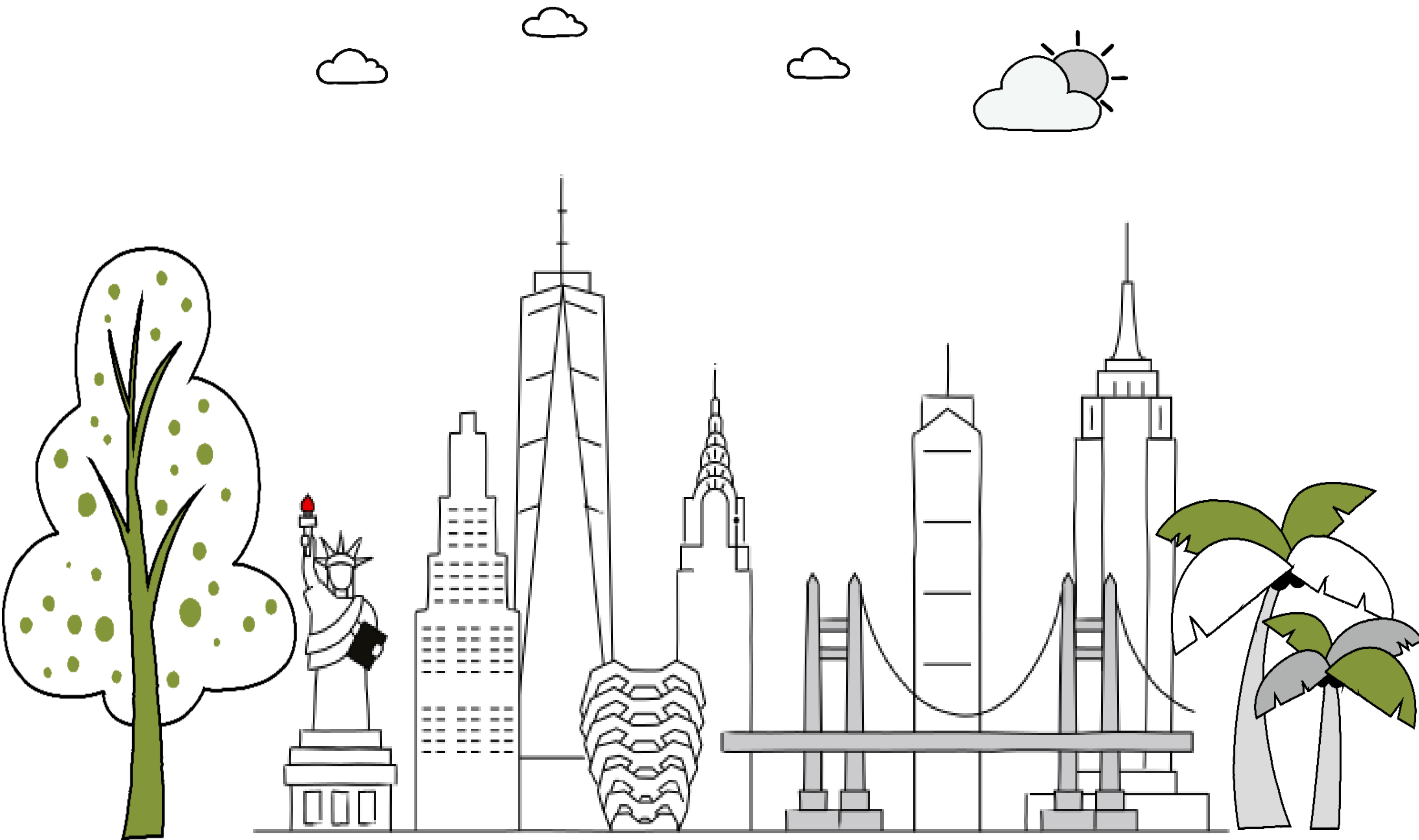
REO

Real Estate Outlook – US

Edition May 2023



UBS

US real estate

Growing liquidity concerns

The pace of interest rate increases by the Fed has created cracks in the regional banking system. Bank deposits are dropping and creating additional liquidity concerns over the banking system's capacity for new loans. As approximately USD 1.5 trillion commercial real estate loans will mature between 2023 and 2025 (according to MSCI RCA), tighter and more expensive lending requirements will increase refinancing risk across the commercial real estate industry. However, this risk is expected to be more severe for office owners, as fundamentals deteriorate.

The current refinancing cost for commercial loans made 10 years ago is approximately 200bps higher. Lenders also have stricter loan standards today than they did just a year ago (eg, lending at average LTVs of 10% or lower). These stricter requirements have reduced activity from predominant commercial real estate lenders, like CMBS, and provided more room for regional and local banks. CMBS, which accounts for roughly a quarter of all commercial originations, only accounted for 9% of commercial lending activity in 2022. On the other hand, commercial lending from regional and local banks grew from an average of 17% between 2015 and 2019 to 27% as of 2022.

With private real estate values declining, and capital availability becoming more scarce, regional and local banks will likely be more sensitive to current market conditions. An uptick in deposit withdrawals will force regional and local banks to fully realize their losses through sales to fund requests. With office values down significantly, office owners will feel the impact more severely. According to Green Street Advisor's Commercial Property Price Index, a transaction-based index of high-quality properties that are owned by REITs, office values are down 25% from their recent peak. However, we expect even steeper declines across the broader market.

As capital dries up and the "wall of maturities" approaches, lenders with loans maturing for properties in other sectors may be more likely to provide flexibility via loan extensions and workouts. Distressed sales are likely to increase over the next year or two, but according to MSCI RCA, they only accounted for 1.2% of total sales in 4Q22. In the midst of uncertainty, investors should position themselves defensively, i.e. less leverage and a lower number of value-added activities. Investors can also look out for distressed opportunities at attractive and discounted pricing.

"The pace of interest rate increases by the Fed has created cracks in the regional banking system. Bank deposits are dropping and creating additional liquidity concerns over the banking system's capacity for new loans."

Tiffany B. Gherlone
Acting Head of Real Estate
Research & Strategy – US

Bracing for headwinds

Figure 1: April US real estate return forecasts

Total return (%)	2020	2021	2022	2023 forecast	3-year forecast
Apartment	1.8	19.9	7.1	(6.9)	1.5
Industrial	11.8	43.3	14.6	(5.8)	0.6
Office	1.6	6.1	(3.3)	(9.1)	(1.7)
Retail	(7.5)	4.2	2.5	(3.9)	1.3

***** Office forecasts were taken from PREA. PREA office forecasts are more consistent with UBS Asset Management, Real Estate & Private Markets Research &Strategy's outlook for a slow and steady recovery in the office sector. Oxford Economics forecasts a strong rebound in office returns in 2025, and a 3-year average annual forecast of 0.6%.

Source: Oxford Economics Forecasts for apartment, industrial and retail sectors, as of April 2023. PREA forecasts for office, as of February 2023. Total return: NCREIF, as of March 2023. Data shows unlevered NCREIF Property Index total returns. **Expected / past performance is not a guarantee for future results**.

Apartment

Apartment demand inched closer to positive territory in 1Q23, as a resilient labor market and high mortgage rates gave the renter base a boost. New deliveries slowed during the quarter, but the sector is still challenged with an elevated supply pipeline through 2024. Occupancy rates fell by 30bps over the quarter and 250bps over the year to 95.1%; however, rates remain below the sector's 10-year historical average. Apartment asking rents declined moderately by 0.1% QoQ, but was still 4.5% higher than a year ago. Transaction volume was reduced in 1Q23, down 48.2% from a quarter ago, and 61.0% from a year ago. The apartment sector delivered an annual total unlevered return of -0.4% in the year ending 1Q23, as capital values fell further during the quarter. We expect capital market headwinds to drive further value declines this year before rebounding in 2024.

Industrial

Industrial demand remained resilient during 1Q23 despite economic headwinds. Net absorption came in positive during the quarter, albeit at the lowest quarterly level in 13 years. New deliveries held up at historically high levels and drove the availability rate up by 70bps over the quarter and year to 5.5%. Despite an uptick in availability, landlords were still able to push rents up by a solid 3.4% QoQ and 12.5% YoY. High borrowing costs discouraged transaction activities, as transaction volume declined 52.5% QoQ and 59.1% YoY. The sector's annual total unlevered return moderated to 2.4%, as value declines for the second consecutive quarter dragged performance. We anticipate further declines in returns in 2023, primarily driven by capital markets.

Office

Office fundamentals continued to weaken during 1Q23. Net absorption fell steeply as subleasing activity rose nearly 10% over the quarter. The pace of new deliveries slowed, and the construction pipeline stayed muted amid high construction costs and market volatility. Office occupancy rates fell by 50bps over the quarter to 82.2%, marking the lowest rate since 3Q93. Increasing borrowing costs and sector headwinds continued to weigh on transaction activities. Transaction volumes were down 51.9% from a quarter ago and 72.1% from a year ago. Total annual unlevered returns for the sector fell by 8.7% in 1Q23, driven by a steep annual capital return of -12.7%. We expect office values to continue to fall over the next two years before stabilizing.

Retail

Retail fundamentals remain stable despite a recent pullback in consumer spending. Retail sales, which are not adjusted for inflation, declined for the second consecutive month in March. This decline reflects both slower economic activity and moderating inflation. Even with a decline in retail sales, demand was solid, outpacing new deliveries for the ninth consecutive quarter and boosting occupancy rates by 10bps QoQ and 80bps YoY to 93.2%. Transaction volumes remained slow in 1Q23, down 2.7% from a quarter ago and down 32.1% from a year ago. Total annual unlevered returns moderated to 1.0% as of 1Q23, however, retail is poised to remain relatively resilient over the next three years.

Selected niche sectors – Crossroads

Self-storage[1]
Self-storage fundamentals softened in 1Q23 as seasonal patterns resumed. A slowdown in mobility and a partial return to the office contributed to lower move-in rates. Same-store occupancy for Public Storage (PSA), a self-storage REIT, was 93.2% in 1Q23, down 240bps from a year ago. First quarter results for CubeSmart and Extra Space show a similar seasonal slowdown and return to pre-pandemic levels. However, most self-storage REIT occupancy levels remain elevated. First quarter earnings from PSA showed continued growth in rents. In-place rents grew by 12.5% YoY despite a slowdown in demand. Supply remains the greatest headwind for the sector, but elevated construction costs, supply chain bottlenecks and labor shortages continue to push back the incoming pipeline.

Cold storage[2]
Cold storage operating results beat expectations during 1Q23. Americold, a global cold storage REIT that holds 86% of its inventory in the US, reported a 750bps YoY increase in economic occupancy to 84.6%. A ramp up in food production volume during the quarter boosted demand for cold storage space and propelled occupancy rates upwards. Higher occupancy also assisted same-property (SP) revenue, which grew by 12.3% YoY. At the same time, SP operating expenses moderated to a 7.0% YoY growth rate and drove SP NOI growth up by a robust 26.1%. We expect these strong fundamentals to persist, as moderating inflation eases pressure on expense growth. Strong tailwinds from food production and online grocery consumption will also continue to drive demand for cold storage.

Senior housing[3]
The senior housing sector continued its positive streak in 1Q23. Occupancy rates in primary markets rose for the seventh consecutive quarter by 30bps to 83.2%. Occupancy rates are 540bps above its pandemic low but are still 400bps below pre-pandemic levels. The continued improvement in occupancy rates was driven by solid demand over the quarter, coupled with limited supply. Quarterly net absorption was 0.6% of total inventory, outpacing new deliveries at 0.3%. The supply pipeline has slowed, and during the quarter, the number of senior housing units under construction as a share of total stock reached its lowest rate since 2014. We expect a muted supply pipeline to support further improvements in sector fundamentals.

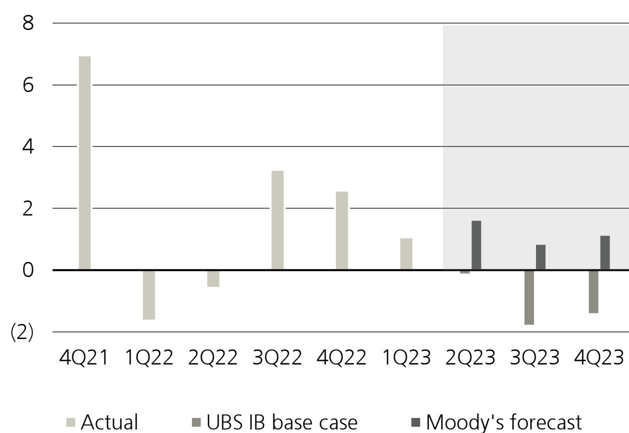
Life sciences[4]
The life sciences sector continues to retract to pre-pandemic levels, but fundamentals remain strong. Venture capital (VC) funding, a major driver of demand, declined to 2019 quarterly levels at USD 3.6 billion. Public funding from the National Institute of Health (NIH) continues to increase, and funding for 2023 is expected to be a record USD 47.5 billion. Vacancy rose by 1.3% over the quarter to 6.7%, but are still below-average falling between 7% and 8% before 2021. The supply pipeline remains elevated with 21.9% of stock currently under construction. Although construction has stalled due to high costs, moderating demand and an elevated pipeline will likely cause a slowdown over the near term, even as long-term tailwinds persist.

Source: **1** GreenStreet, as of May 2023; **2** Americold Company Report, as of 1Q23; **3** NIC Map, as of May 2023; **4** CBRE, as of April 2023.

Cresting wave

Economic viewpoint
Real GDP grew below consensus forecasts at a 1.1% annualized rate during 1Q23 (see Figure 1). The slower-than-expected growth was driven by a decline in private inventory investment and a moderation in non-residential fixed investment, which includes investments in non-residential structures, equipment and intellectual property products. These declines were partially offset by consumer spending, which remained strong and contributed 2.5 percentage points to headline GDP. However, the strength of consumer spending during the quarter was largely due to robust spending in January. Consumer spending in February and March declined, and we expect further weakening in 2023.

Figure 2: Real GDP quarterly annualized forecast (%)



Source: Actual Moody's Analytics, as of 9 May 2023; UBS Investment Bank forecast, as of 5 May 2023. Note: Shaded area indicates forecast data.

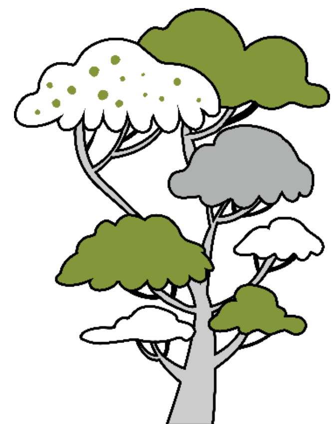
Nonfarm payroll employment posted a 236,000 increase in March, down from its trailing six-month average of 334,000 jobs but in line with consensus expectations. The unemployment rate dipped slightly to 3.5% and the labor force participation rate hit a record high of 62.2%. Although the labor market continued to add jobs, these gains were concentrated in the service sectors, including leisure, hospitality, education and health.

Other industries more sensitive to interest rates, such as construction, manufacturing, retail trade and real estate finance, experienced losses over the month. March's employment report is in line with the Fed's target to slow hiring to combat inflation, which although eased to 4.6% (Core-PCE Inflation) in March, remains elevated.

The Federal Reserve raised interest rates by another 25bps in May, to the highest level in 16 years. Above-target inflation still leaves room for additional hikes, but the stress from the banking crisis will likely lead to a pause as they observe the full impact of the rate hikes over the second half of 2023. The headwinds and strain of higher interest rates, including tightening credit, should be sufficient to push the US into contraction this year.

UBS Investment Bank economists expect the terminal rate to peak at 5.25%. Cumulative GDP is forecast to increase by 0.8% in 2023, but with declines starting in 2Q23 through 4Q23. Job losses are expected to materialize by the end of 3Q23 through 2Q24. Growth is expected to rebound at the beginning of 2024 and continue into 2025, following a reduction in the restrictiveness of the Federal Reserve policy.

In the scenario that UBS Investment Bank lays out, the durability of income in real estate will become key, rather than the more recent focus on shorter lease duration to capture rent bumps. Investors should continue to focus strategies on defensive positioning while economic uncertainties persist. This can include marginal movements around strategy targets, ie, less leverage and a lower number of value-added activities. Investors can also carefully seek out opportunities to expand in strong markets and sectors with long-term tailwinds, at prices that are below what they have been over the past year.



For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Tiffany B. Gherlone
+1-860-616 9059
tiffany.gherlone@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/realestate

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investments in real estate / infrastructure / food and agriculture / private equity / private credit (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of May 2023 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at May 2023 unless stated otherwise. Published May 2023. **UBS Group AG has agreed to acquire Credit Suisse Group AG. Approved for global use.**

© UBS 2023. The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.