



CIO favors biasing investments toward high-quality assets with strong fundamentals in growing markets that can withstand an expected, gradual deceleration in the US economy as 2024 progresses. (UBS)

What's next for private commercial real estate?

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The commercial real estate (CRE) sector in the US continues to face headwinds. These include muted transaction activity that is limiting price discovery, liquidity constraints for a number of property owners seeking to refinance debt, and a gradual return to the office. All have contributed to a challenging CRE landscape.

Headlines have also drawn attention to some perpetual capital vehicles that invest in private real estate, as they seek to limit redemptions and sell assets in order to maintain their liquidity levels as a share of net asset value.

While “gating” is primarily used to protect existing investors from forced sales of fund assets and impairments to the value of their investments, some reports have painted this risk management tool as a sign of stress, leading to further redemption requests and creating a vicious cycle.

But CIO would argue that the fundamentals of the US commercial real estate sector—and global direct real estate markets at large—is gradually improving, does not pose a systemic risk to the US banking system, and is even creating selective, promising areas for patient investors to consider.

What is the state of the US CRE market today?

The total commercial real estate debt in the US amounts to approximately USD 5.8 trillion, with USD 2.1 trillion in multifamily loans and USD 3.7 trillion in other CRE debt. Banks hold about half of this total exposure. Notably, smaller banks (those with less than USD 20 billion in assets) hold the majority of CRE debt, accounting for 28.5% of total CRE exposure. In contrast, large banks (those with over USD 250 billion in assets) have only 11.1% exposure to CRE loans.

Banks have increased their reserves for credit losses, particularly for office properties, which now stand at around 8–10% of loans outstanding. The exposure of US banks to office properties is relatively small, representing about 2% of total loans at large banks and 4% at small- and mid-sized banks.

What is CIO's outlook?

We believe negative headlines mask improvements in the fundamentals for many parts of the private real estate market. For example, in direct real estate we expect transaction volumes to rise from USD 600bn in 2023 to USD 900bn in 2024, indicating a revival in market activity. Cash-rich investors are beginning to deploy capital. Leasing activity, particularly in high-quality offices, retail, and hotels, remains robust, with rising rental incomes. The industry and logistics sector is rebounding. And as inflation peaks and the global interest-rate-cutting cycle begins in earnest, we expect a tightening to today's wide yield spreads to support total returns through capital gains. CIO anticipates rental income growth to offset any final value corrections, after already sharp repricing following the steepest US rate hiking cycle in recent memory. We foresee over 3% capital gains and an income return above 4% for global direct real estate in 2024.

Another factor to consider is the substantial dry powder that is earmarked for CRE investments that is currently on the sidelines. We estimate that private equity alone is sitting on more than USD 425bn of unlevered dry powder with much of that capital oriented toward distressed, opportunistic, and real estate debt strategies. When this capital finally begins to be invested in earnest, we believe a bottoming trend in CRE values will begin as a more robust transaction market develops.

We expect banks exposed to the US CRE sector to face manageable earnings risks over 2024-26. However, we do not foresee any significant deterioration in bank capital or a systemic crisis. The Federal Reserve's annual stress tests, which include a severely adverse scenario with a 40% impairment of CRE values, indicate that banks can withstand potentially substantial losses and continue their operations.

The CRE sector is expected to experience a multi-year business cycle, with losses spread out over several years. Bank regulators are encouraging banks to pursue workouts of relationship-based CRE loans to minimize the macroeconomic impact of sudden write-downs in real estate values.

The Federal Reserve has also been closely monitoring the CRE office market and the linkages to the US financial industry. We should note that all banks passed the 2023 Comprehensive Capital Analysis and Review, a sign of their resilience amid continued headwinds for parts of the US real estate market.

How should investors position going forward?

CIO continues to think that investors should approach the CRE market with caution, but we recognize the opportunities that exist within this challenging environment. We would highlight a few potential strategies to help investors navigate the current landscape:

Focus on well-capitalized banks. Large US banks with better capital reserves are more likely to withstand potential losses from CRE debt, in our view. These banks have a lower exposure to office properties and construction & development loans, making them less susceptible to shifts in investor sentiment and valuation.

Diversify across segments. While the US office segment faces significant challenges, other segments like multifamily housing and industrial properties may offer investors more stable returns and help to spread idiosyncratic risks from uneven office recovery.

Look for quality assets across every segment. Headlines about beleaguered sectors such as US offices overlook the fact that high-quality assets can deliver appealing prospective returns. For example, modern offices in appealing locations and with robust sustainability credentials are arguably a different market to the "brown" office assets in less salubrious areas. We note that on a weighted basis, vacancy rates in the first category of US offices are far lower and may even experience supply shortages given low levels of construction starts and continued cost pressures.

Take the long-term view. Given the multiyear investment horizon of the US CRE markets, we suggest investors adopt a long-term perspective and be prepared for a potential continuation of short-term volatility in select pockets of the market. We favor biasing investments toward high-quality assets with strong fundamentals in growing markets that can withstand an expected, gradual deceleration in the US economy in 2024.

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