Private Markets

March 2024

U.S. Real Estate Outlook: Seize the moment

BlackRock.

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U.S. Real Estate Market Insights

BlackRock Real Estate Research & Strategy

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Key highlights

- Dislocation in the commercial real estate market presents unique opportunities for investors to acquire solid cash-flowing assets at a discounted basis.
- Interest rates appeared to have peaked but may only come down moderately over time. Inflation decelerated substantially over the past year and a half, but the Federal Reserve is monitoring the economy cautiously. Though the 10-year Treasury yield has come down from its recent peak, investors should be prepared for elevated rate volatility.
- Real estate fundamentals will see some near-term softness but improve over the medium term. 2024 will likely be a peak supply year for multifamily especially, but supply is expected to drop off sharply by the second half of 2025.
- There will be greater opportunity for investors to benefit from asset selection as dispersion is expected to persist.

Seize the moment

A window of opportunity has emerged for real estate investors due to dislocation in the capital market. Historically, investments made after market disruptions often yield strong results in subsequent years. We are likely at such entry point and thus, investors can capitalize on the vintage advantage. The cost of capital remains high, though the 10-year Treasury yield has come down from the recent peak reached in the Fall 2023; the 10-year Treasury was 4.25% in early March, 75 bps lower than the recent peak reached on October 19, 2023, of 5.0%. Nevertheless, investors should be prepared for elevated rate volatility, consistent with the new investment regime of higher macro and market volatility.

A reduction in inflation is helping provide clarity on the direction of rates. Inflation decelerated substantially over the past year and a half, from a peak of 8.9% year-over-year in June 2022 to 3.3% in December 2023 (source: U.S. Bureau of Labor Statistics). Nevertheless, the Federal Reserve is monitoring the economy cautiously, and would like to see evidence of persistence in the current direction inflation. The BlackRock Investment Institute expects the Fed to start cutting rates around mid-2024 for a total of three cuts during the year.

At the same time, the economic growth is on a reasonably

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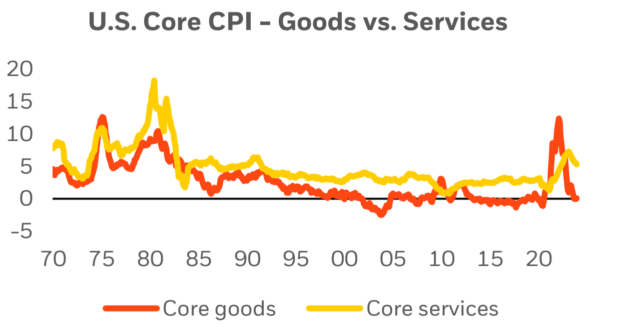
strong footing. The job market remains resilient despite layoff activity in the headlines since the start of 2024. The unemployment rate was 3.7% in January 2024, only up 20 bps from a year ago. The number of job openings were 9.0 million as of December 2023, a historically elevated level, albeit down 25% since the March 2022 (source: U.S. Bureau of Labor Statistics).

This stability in the economy has been evident in the property market. Real estate fundamentals remain solid with NOI growth at 5.5% year-over-year as of December 31, 2023 (source: NCREIF). NOI growth was 12.8% for industrial and 4.5% for multifamily over the past year as of December 31, 2023, and both are forecast to have positive income growth going



Source: Bureau of Labor Statistics, LSEG Datastream, BlackRock Investment Institute, as of February 2, 2024

forward, albeit at a slower rate. Supply is a risk for both sectors in the near term, but mitigated by continued demand and the fact that any development not currently underway will likely be delayed due to the current financing environment. We expect supply to meaningfully drop off starting in mid-2025.The balance of supply and demand vary by market. Further, NOI growth for industrial properties specifically can still achieve meaningful mark-to-markets upon re-leasing as the market is approximately 30% underlet, according to data from Altus Group, as of December 2023.

While fundamentals are reasonably stable, the real estate capital market is still challenged. Higher rates have contributed to repricing and the rate volatility has reduced the amount of capital available for investment. Both equity and debt participants pulled back from the market late in 2023. As it takes upwards of 90-days to close a deal, this information is just starting to show up in the data. Only $22bn closed in January, the slowest monthly total since the pandemic (source: Real Capital Analytics). Activity on the ground has improved markedly since then, suggesting that closed volumes will improve over the next few months.

There is data showing green shoots in the capital market as well heading into 2024. According to the latest Senior Officer Loan Survey in Q4 2023 (source: Federal Reserve), there was a significant reduction in net percent of bank tightening commercial real estate lending standards. This suggests that lenders will slowly open up over the coming quarters to greater lending although with bias towards higher-quality properties.

Dislocation in today's commercial real estate market presents a compelling opportunity for investors, which will exist over the next 24 months. Maturing debt over the next 24 months and the need to refinance construction loans for completing projects may act as catalysts for further price discovery. At the same time, investors can look to reposition portfolios to align with key long-term trends:

1**) Aging demographics**: The average age of the U.S. population is expected to shift older over the next decade as life expectancy improves and families have fewer children. While senior housing and other healthcare real estate comes to mind due to the expected "silver tsunami," Millennials are entering their prime consumption age (35-64 years old) with a desire for family formation and Gen Z is advancing in the workforce making up the young professionals group. Both generations will be key drivers of real estate use.

2) **Modernization**: Existing assets will likely need to be retrofitted to be more energy efficient and resilient against adverse climate events and changing weather patterns. Probabilities of natural disasters or adverse conditions will also drive geographical exposure selection. At the same time, the prevalence of remote work will change how we live and work.

3) **Geopolitical fragmentation**: Supply chain resiliency will likely be more important for many governments and corporations. In addition, manufacturing activity is returning to the US, as can be seen by record construction spending in manufacturing facilities, totaling $213.9B in September 2023 (source: U.S. Census Bureau). We believe this will likely create more demand for warehouses and logistics facilities. Investors would also likely benefit from future-proofing investments to account for the possibility of more automation in the future, which would likely point to features such as higher clear heights and larger electrical loads.

Property Fundamentals

The tight labor market is supporting real estate fundamentals. The unemployment rate at 3.7% in December 2023 is close to record lows and, with nonfarm payrolls, employment grew 353k per month during the third quarter, well above the 2013-2019 monthly level of 199k. There is more room for growth here; the labor participation rate has improved to 62.5%, but it remains below pre-pandemic levels. Wage growth remains good at 3.7%.

While demand drivers are still solid, rent growth has softened even in the highly desirable industrial and multifamily markets due to the recent wave of development. Demand is steady for these two sectors, but supply is expected to be elevated through 2024 and likely the first half of 2025. The markets with higher levels of supply tend to be in the Sunbelt, which also tend to be higher net-migration markets. At the same time, many developers have chosen to delay starting new projects due to high construction and financing costs. Therefore, we expect a drop off in supply starting in 2025, which bodes well for real estate fundamentals over the medium term.

By sector, we favor industrial, necessity retail and

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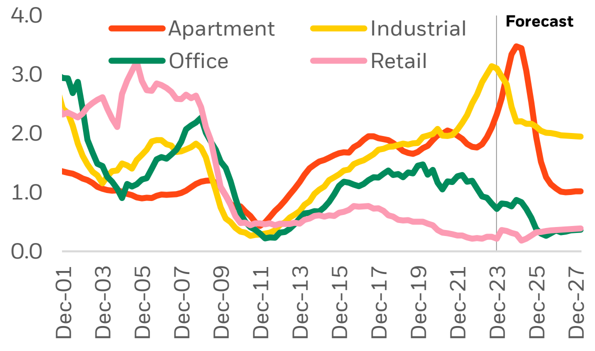
apartments for any incremental investment today. The office sector is still facing many headwinds and many assets have faced steep valuation declines; most investors would benefit from paring down allocations to this sector.

Survive 'til 2025

Supply as a percent of inventory



Source: RealPage, CBRE-EA and BlackRock, as of December 31, 2023.

We believe the **industrial** sector should outperform during the next few years due to multiple demand drivers. Strong e-commerce demand post-GFC drove performance. This should continue to be a driver of demand going forward, but the rewiring of supply chains and more onshoring of manufacturing should provide an added boost. Industrial real estate should perform well over the long term but rent growth and occupancy has softened in many markets off the incredible highs of 2021 and 2022. U.S. occupancy declined 250 bps from the peak in Q2'2022 to 96.9% in Q4'2023 according to CBRE-EA. Still, rent growth was 6.5% year over year in Q4'2023 (source: CBRE-EA). We anticipate significant mark-to-market rents in many metros and tight vacancies to drive NOI growth over the next year or two. We are most positive on markets with strong demand and measured supply, such as in Southern Florida, Southern California, Boston, and Northern New Jersey.

Apartment demand should remain steady over the next year thanks to a tight job market but rent growth will likely decelerate and turn negative in some areas due to near-term supply. Occupancy retraced from the record highs achieved during 2021 and the first half of 2022, declining 320 bps to 94.2% in Q4'2023 from a recent high in the first quarter of 2022 according to RealPage. Effective rent growth also moderated to just 0.2% year over year in Q4'2023 from a high of 15.3% in Q1'2022. Supply growth has accelerated but has been generally concentrated in high-demand markets, most of which are high-growth markets in the Southeast and West. We expect apartment supply to meaningfully decline starting in 2025 due to the high cost of capital, which sets up the sector well ~18 months from now. Aforementioned job growth trends coupled with higher mortgage rates, which reduce home affordability, should keep tenants looking for units. Still, we favor apartments in suburban locations in metros that benefit from high in-migration and garden style multifamily over urban centric product. The metros we are most positive on include Boston, Dallas, Miami, and Southern California cities.

Retail appealing for stable income growth and we see the best supply and demand dynamics in necessity retail centers. In contrast to other property types, the retail property type started experiencing a correction almost a decade ago, so the sector is positioned for growth for the first time in a long period. Fundamentals are solid, yields are attractive, cash flows are stable, and supply is muted, which all points to good risk- adjusted returns for the property type. Necessity retail centers in attractive catchment areas with good median household incomes and population density can act as a portfolio diversifier. Strong necessity retail centers can likely attract a variety of complementary tenants with varying usage such as medical and fitness brands and specialty stores. However, more tenant improvements and capital expenditures may be needed, which creates an opportunity for investors with the right risk profile and expertise. Discretionary retail (malls and power centers) should still be viewed as being higher on the risk spectrum, though note that valuations have adjusted to a new level.

Office continues to be out of favor and subject to intense debate and speculation. Utilization has recovered well but remains below pre-pandemic levels; even as more companies have called for a return to office, hybrid work is here to stay. Office fundamentals will likely be challenged going forward with tepid demand, rising vacancy and weak rent growth. Trends will somewhat mirror those of retail from a decade ago. Tenants will likely trade up where possible to better locations and higher-quality properties. This will contribute to a vast bifurcation between the best properties and the rest. Contributing to this trend will be owners of lower-quality properties conserving cash by delaying capital projects. This will contribute to even worse performance of these properties. The outcome will likely be reduced stock in the office market, with some properties redeveloped into a new use.

Lack of capital markets support have pointed to sharp valuation corrections. Indeed, anecdotal transaction activity and the Q4'2023 CBRE Cap Rate Survey show that some office buildings are expected to be valued at double digit cap rates and at valuations below $200 per square foot. We expect the office sector to continue to shrink and its share as a percent of the overall institutional real estate universe will likely continue to decline.

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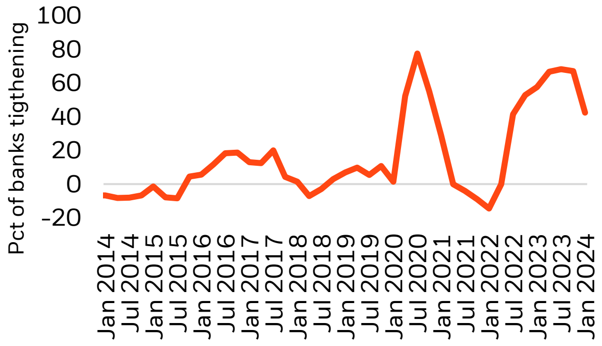
Capital markets

There are signs that liquidity is returning to the market, after slowing significantly during the spike in interest rates last October. Anecdotally, there are an increasing number of deals coming to market and this activity will contribute to greater transparency.

Additional support should come from debt capital, as lenders step into the fray to take advantage of higher prevailing interest rates. While hard data is scarce, there are a few indicators suggesting this trend is starting to take hold. For example, the Senior Officer Loan Survey for commercial real estate is showing that fewer banks were tightening lending standards in the 4th quarter than earlier in the year. Additionally, CMBS as of February 2024, is ahead of where it was a year earlier and spreads have compressed since last fall. At the same time, we expect lenders to be selective for the near term, leading to a concentration of lending activity in the most favored sectors such as industrial, residential, data centers, necessity retail and self-storage. The debt market may improve further as Federal Reserve is expected to incorporate easing measures from the second half of this year, which should help lower the rate on shorter term debt. Ultimately, a real estate investor's cost of capital will likely decline through the year, which will help transaction volumes rebound.

Senior Officer Loan Survey

Net Percentage of Domestic Banks Tightening Standards for Commercial Real Estate Loans Secured by Nonfarm Nonresidential Structures

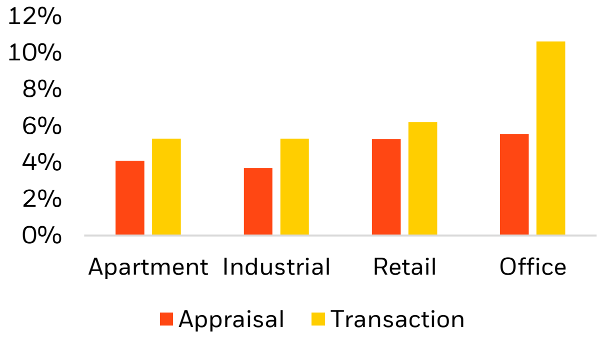


Source: Federal Reserve, as of February 5, 2024

The increase, however, will be coming off a low base. Sales volumes were down 51% year-over-year in 2023 to $374.1B according to data from MSCI. Apartments continued to be the most favored by investors, with $119B transacted during 2023, but down 61% year-over-year. Industrial won second place with $89.2B transacted, a year-over-year decline of 44%. Office, which once was the favorite among institutional investors, is less desired today and deal volume was less than half of the apartment total, at $52B during 2023. Active groups continue to be private buyers or family offices who can transact with limited or low leverage and typically target smaller transaction sizes of less than $100M. 2024 will likely be a transitional year when we anticipate institutional investors to return in a bigger way.

Good quality assets with solid cash flows are still sought after, but prices have adjusted by 15-20% or more relative to peak values based on cap rate movements. In many instances, properties can be acquired at below replacement cost. Appraisal values have been correcting and will likely continue to decline further, but the transactions market is likely already reflecting adjusted pricing.

Gap between appraisal and transaction cap rates



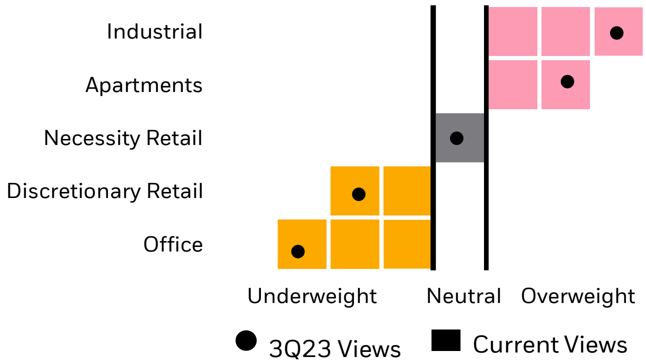
Source: BlackRock and NCREIF, as of December 31, 2023. Appraisal cap rates from the NCREIF Property Index (NPI)

Distress is creeping into the market, but the market will see an increase in the near term as debt maturities come due and refinancing needs arise. The value of distressed properties increased by $28.9B over the past year to $85.8B as of YE 2023, according to MSCI. Distress activity continues to be low and office still makes up a significant share at 41% of the value of troubled and bank-owned (REO) properties. There are several options for borrowers facing maturities. Some lenders will offer extensions and in other situations investors will contribute additional equity, either directly or through a recapitalization. Owners can also sell their properties as there is dry powder waiting on the sidelines. Borrowers unable to complete either of these options will face foreclosure, and we will likely see more of that from office landlords especially.

Portfolio Strategy

Given the environment of higher volatility, higher cost of capital, and relatively stable property fundamentals, we recommend investors to move down the risk curve and focus on quality for the medium term. At the same time, investors will likely benefit from aligning allocations to long term trends and to properties with higher pricing power. With that in mind, we suggest an overweight to industrial due to the strength of demand and NOI growth over the next 2-3 years to be driven by substantial mark to market of rents. We still favor apartments despite the near-term supply headwinds as due to the long-term demand potential for this sector. Investors should consider a slight overweight to necessity retail given very low supply and attractive entry yields. While growth is not forecasted to be as strong, the transformation of the necessity retail sector that has been underway for a decade or so should provide stable returns with the potential for upside. Lower-quality shopping centers have started to disappear from the investment universe over the past few years, improving the performance of the overall property type.

Strategic allocation views
3Yr asset allocation views



Source: BlackRock as of December 2023. Notes: The chart shows our asset views for the next three years.

The outlook for discretionary retail and office is not quite as attractive. Both sectors are experiencing headwinds, although office is likely at greater risk. Discretionary retail started repricing almost a decade ago, and therefore is facing less revaluation risk going forward compared to office. According to the NCREIF Property Index, the office property type has seen capital value declines of -17% since mid-2022, and we think there is more to go. Upcoming debt maturities over the next two years will likely be the catalyst for larger market movements across the sector on a whole.

Lastly, tight credit conditions should create an attractive entry point across most sectors and markets. Highly levered owners may look to sell ahead of loan maturities, potentially at discounted values. Investors can seek to marry this tactical strategy with long-term underlying trends such as aging demographics, net migration favoring the South and secondary metros in the West and the rewiring of supply chains.

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