Private Markets

June 2024

U.S. Real Estate Outlook: Reaching clarity

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EPMH0624U/M-3616506-1/12

U.S. Real Estate Market Insights

BlackRock Real Estate Research & Strategy

June 2024

Market insights contributors

Alex Symes
Director
Head of U.S. Real Estate Research & Strategy

Yasmine Kamaruddin
Director
U.S. Real Estate Research & Strategy

Key highlights

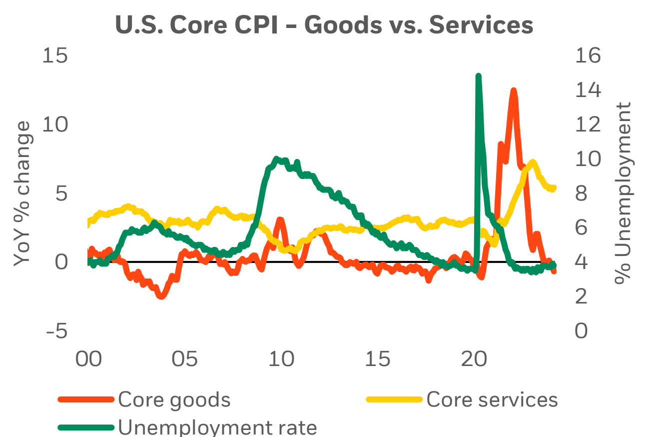
- The real estate capital market is gaining clarity and stability, thanks to more predictable interest rates and solid market fundamentals.
- Inflation is still above 2%, but the Fed is indicating that hikes are over and they are monitoring the economy for weakness. (Source: U.S. Bureau of Labor Statistics and Federal Reserve, March 31, 2024)
- Real estate fundamentals are steady, although will see some near-term softness due to construction deliveries in the multifamily and industrial spaces; supply is expected to drop off sharply by the second half of 2025.
- Transaction volumes will likely recover starting in the second half of 2024. Investors currently have the advantage of acquiring at prices below replacement cost as well as at meaningful discounts to peak pricing.

Reaching clarity

The US real estate market is finding stabilization after roughly eight quarters of declines. Policy rates have likely peaked, which is providing some clarity to the capital market and reducing the bid-ask spread. At the same time, real estate NOI growth remains positive and fundamentals, outside of the office sector, are generally stable. Volatility will likely remain a part of the capital market milieu as investors look for a bottom, but the current environment is creating some attractive entry points for real estate acquisitions.

While the policy rate has been stable, hopes for rate cuts at the beginning of the year have been tempered by stubbornly elevated inflation. Inflation is moving in the right direction, with CPI declining from a peak of 8.9% in June 2022 to 3.5% in March 2024 (source: U.S. Bureau of Labor Statistics). Tremendous progress has been made in goods prices, but services inflation remains high (+5.4% y/y), including shelter costs (+5.6% y/y). The Fed has indicated that the policy rate will not move higher but given current the inflation situation they

U.S. Core CPI – Goods vs. Services



Source: Bureau of Labor Statistics, LSEG DataStream, BlackRock Investment Institute, as of March 31, 2024

have less of a need to cut. This is partially because economic growth remains resilient. The job market is steady, and unemployment is low despite some layoff activity, indicating a tight and dynamic labor market. Wage growth declined slightly to 4.2% three-month annualized rate. Job openings remain historically high at 8.5 million in March 2024,

albeit 30% lower than the peak of 12.2 million two years ago in March 2022 (source: U.S. Bureau of Labor Statistics).

Real estate fundamentals are largely stable thanks to the strength of the U.S. economy. NOI growth was 4.5% year-over-year as of March 31, 2024 (source: NCREIF), driven by industrial at 9.8%. The industrial property type is still benefiting from meaningful mark-to-market in rental rates thanks to strong rent growth achieved over the past few years. Leases are still 30% below market on average according to Altus Group as of March 31, 2024. Supply is a risk for both industrial and multifamily sectors although construction deliveries are projected to drop off sharply starting mid-2025. Office sector fundamentals are an exception to the broad sector trend, but NOI growth is not quite as weak as many have feared due to long in-place leases. Office tenant demand is weakening as companies rethink their workplace.

The real estate capital market is gaining clarity and stability, thanks to more predictable interest rates and solid market fundamentals. Deal activity first started to slow in 2022 due to interest rate volatility and pull back in debt markets. Stability in the wider capital market is now filtering into the real estate sector, and we can see this in recent sales data. Initial data during 2024 show transaction volume declining 16% year-over-year during Q1 2024, after having declined 51% year-over-year in 2023 (source: MSCI, as of April 2024). We believe transaction volumes will likely recover meaningfully during the second half of 2024, allowing for more price discovery.

Property fundamentals

Real estate fundamentals are generally steady, although rent growth has softened even in the most desirable sectors, industrial and apartments. While we are constructive on the long-term prospects of these sectors, near-term record supply has dampened very-near term rent growth prospects. High cost of capital and rising construction costs should dampen new starts for both sectors. Demand remains resilient for both property types, driven by strong demographic trends and the rewiring of supply chains.

Shopping center demand drivers have improved over the past few years, especially for necessity retail. The office sector is still facing many headwinds and investors would need to factor in large amounts of incremental capital expenditures in the face of declining demand.

Survive 'til 2025

Supply as a percent of inventory

Source: RealPage, CBRE-EA and BlackRock, as of March 31, 2024.

Apartment rent growth and occupancy have been resilient, thanks to the tight labor market and good economic growth. As of Q1 2024, apartment occupancy rate was 94.1%, down 70 bps year-over-year and 130 bps below the 10-year average, and effective rent growth was flat at 0.2% year-over-year. The strongest rent growth markets over the past quarter were Milwaukee, Chicago, Cincinnati and Washington, D.C., thanks to more stable fundamentals and more muted supply. Indeed, high supply caused many major markets to cut rents, such as Austin at –6.7% (source: RealPage). We should expect supply challenges to persist over the near-term, which will likely negatively impact rent growth. Supply is then expected to fall off sharply from mid-2025, thus setting up the sector well then, and rent growth should return to a long-term growth rate. We are most constructive on high net migration markets such as Dallas, Phoenix, and Miami, as well as established metros with good barriers to entry such as Boston and San Diego.

Industrial fundamentals have softened from the incredible highs in 2020-2022. Rent growth was 6.5% in 2023, approximately half of the peak market growth rate of 13.9% in 2022 (source: CBRE-EA). Occupancy declined 250 bps from the peak in mid-2022 at 95.4% to 92.9% at YE 2023. Supply deliveries have likely peaked in 2023 at

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3.1% of inventory and will likely decline to an average of 2-2.5% of inventory annually for the next few years. Many industrial assets still have leases significantly below market rates given the immense rent growth over the past few years. Releasing and thus, marking to market these rent rates, will likely drive NOI growth going forward.

Retail is appealing for stable income growth and wider entry cap rates; 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. Fundamentals are solid, yields are attractive, cash flows are stable, and supply is muted, all of which point 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 high risk with a lack of liquidity, 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. 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.

Hotel fundamentals were soft toward the end of 2023 and into Q1 2024. While a full recovery post-pandemic was achieved in 2022, it has slowed since then. Occupancy declined 2.0 percentage points year-over-year in Q1 2024, and average daily rates (ADR) declined by 0.1%. RevPAR declined 2.1% year-over-year. We see the drivers of hotel demand to be stronger inbound international travel, group travel demand, and improvements in independent business travel. However, this will be offset by competition from outbound international travel, cruise lines and other lodging sources such as short-term rentals. Hotel fundamentals benefit from low unemployment and good wage growth, but recent headwinds from stalling economic growth is partially responsible for holding back discretionary spending. CBRE-EA expects continued improvements in group business and inbound international travel which was at only 88% of 2019 levels in Q1 2024. CBRE-EA also forecasts RevPAR to be 3.0% in 2024 and 3.5% in 2025.

Capital markets

After a period of instability, the real estate capital market appears to be finding its footing. The NCREIF Property Index shows a 17.3% decrease in appraisal valuations peak-to-current in Q1 2024, and the transaction market has seen even greater adjustments. The latter half of 2023 experienced stringent credit conditions, with lenders being particularly choosy. Nonetheless, early indicators of improved financing availability are emerging, as evidenced by the Senior Officer Loan Survey for commercial real estate. Despite this, the increased cost of capital persists, compelling many in the market to seek higher returns.

Transaction volumes have started on a slow pace in 2024, with volumes at $78.9B during the first quarter, down 16% year-over-year. Apartments continued to be the most favored by investors, with $20B transacted during the quarter, but still down 25%. Industrial won second place with $17B transacted, but still down 20% year-over-year. Interestingly, office and retail volumes were similar at $15.5B. Office deal volumes has been very low,

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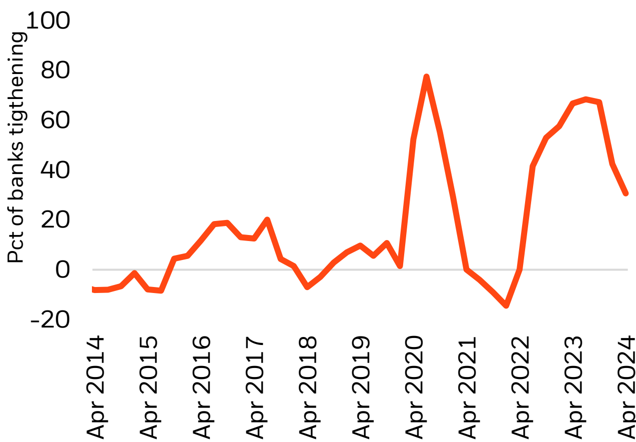
and this quarter's volume was up 27% year-over-year. Active groups continue to be private buyers or family offices who can transact with limited or low leverage and typically target smaller transaction sizes of less than $100M. However, we have seen institutional investors start coming back to the market based on anecdotal observations of our investment pipeline. We expect transaction volumes to meaningfully recover during the second half of 2024.

Senior Officer Loan Survey

Net Pct of Dom. Banks Tightening Standards*

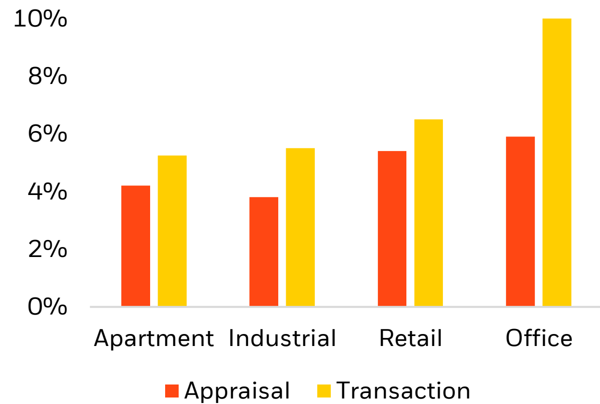


* For Commercial Real Estate Loans Secured by Nonfarm Nonresidential Structures

Source: Federal Reserve, as of April 30, 2024

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 has likely reached a bottom.

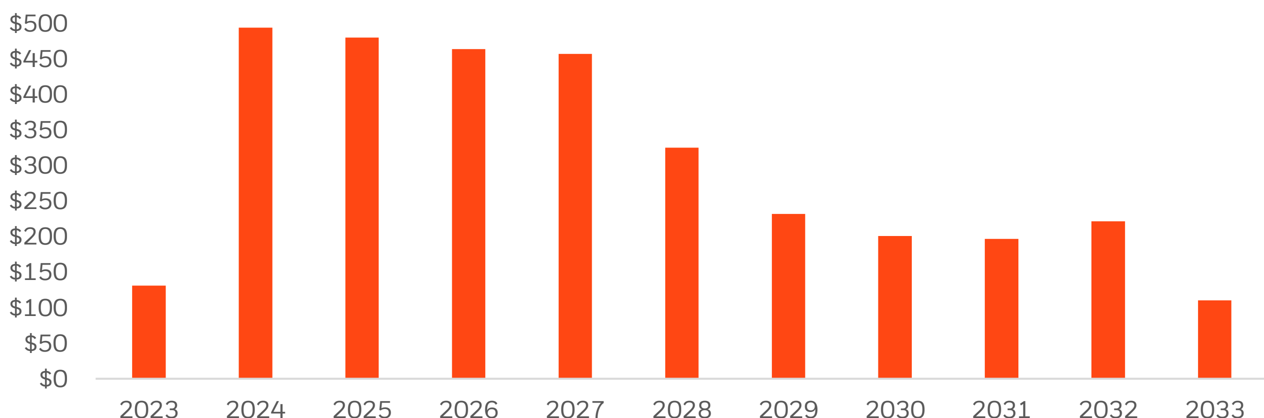
Appraisal and transaction cap rates



Source: BlackRock and NCREIF, as of March31, 2024. Appraisal cap rates from the NCREIF Property Index (NPI)

Distress in the market is quite low, although should increase modestly, especially as landlords with maturing high-leverage loans fail to find refinancing. The value of distressed properties increased by $9.9B during the first quarter to $88.6B as of Q1 2024, according to MSCI. Office continues to be the leading distressed property type at 43% of outstanding distress. We expect distress to remain low this cycle, but the market will see an increase in the near term as debt maturities come due and refinancing needs arise. We do not expect a repeat of the Great Financial Crisis as underwriting standards generally improved post-GFC with lower LTVs and higher DSCRs. 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 (~$400B according to Preqin), especially those with good fundamentals. Borrowers unable to complete either of these options will face foreclosure, and we will likely see more of that from office landlords especially.

U.S. commercial real estate loan maturities ($bn)

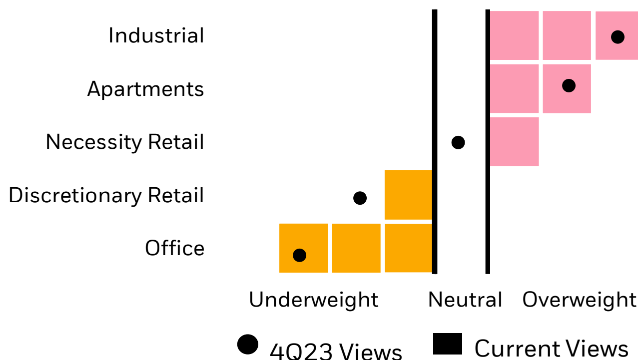


Source: MSCI, as of December 5, 2023.

Portfolio Strategy

In a context of more volatility, inflation, and relatively stable property fundamentals, investors should prioritize quality for the medium term, holding properties that can benefit from both short-term and long-term trends. Based on that, we recommend an overweight to industrial and apartments because of the high demand for both sectors. Investors should also overweight necessity retail because of the wider initial cap rates, low supply, and stable demand characteristics. Although growth is not expected to be as strong, the transformation of the necessity retail sector that is happening should provide stable returns with the possibility of upside. Lower-quality shopping centers have been declining in the investment universe over the past five years, enhancing the performance of the sector overall. The outlook for discretionary retail and office is not as appealing although it did start adjusting almost a decade ago and therefore is facing less revaluation risk.

Strategic allocation views
3Yr asset allocation views



Source: BlackRock as of May 2024. Notes: The chart shows our asset views for the next three years.

Office faces the most uncertainty given weak demand due to more remote/hybrid work norms leading to a structural change in how we use office space. The office sector has faced valuation corrections of 30.9% peak-to-current so far according to the NCREIF Property Index, much more than the 17% of the overall index. Upcoming debt maturities over the next two years will likely be the catalyst for larger market movements across the sector on a whole as transactions occur. At the same time, investors may still consider selective exposure to high-quality office and discretionary retail properties at attractive prices that are well-positioned to capture longer-term trends.

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 demographics, net migration favoring the South and secondary metros in the West and the rewiring of supply chains.

Global Research Team

Simon Durkin
Global Head of Real Estate Research
simon.durkin@blackrock.com

Alex Symes
Head of U.S. Real Estate Research
alex.symes@blackrock.com

Chloe Soar
EMEA Real Estate Research
chloe.soar@blackrock.com

Yasmine Kamaruddin
U.S. Real Estate Research
yasmine.kamaruddin@blackrock.com

Rukeyah Syeda
Real Estate Portfolio Analytics
rukeyah.syeda@blackrock.com

Tobias Gotfredsen
Real Estate Portfolio Analytics
tobias.gotfredsten@blackrock.com

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