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REO

Real Estate Outlook – US

Playing limbo.

UBS

UBS Asset Management

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"We expect disinflationary pressures to take hold and the focus of the wider investment community to shift towards unemployment. In this scenario, the durability of income in real estate will become key."

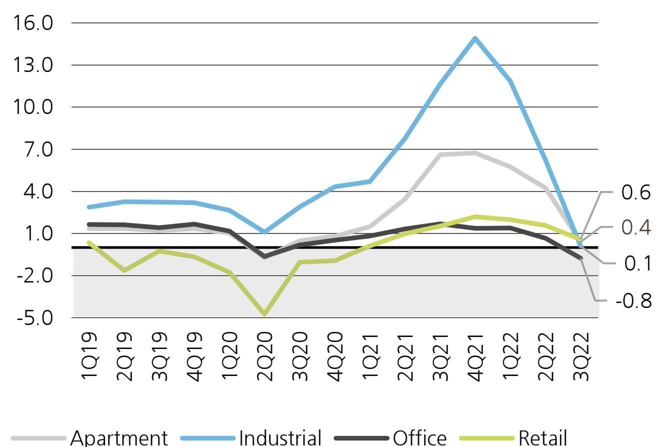
Gravitational pull of higher rates

Private real estate pricing and transaction volume are feeling the impact of higher cost of capital and concerns about weaker economic fundamentals. According to the NCREIF Property Index, appreciation for 3Q22 slowed dramatically from the beginning of the year (see Figure 1). The apartment and industrial sectors depreciated by 0.41% and 0.57%, respectively, compared to the lofty appreciation of 4.88% and 11.09% in 1Q22. Retail and office depreciated by 0.58% and 1.79%, respectively, in 3Q22. Transaction volume decreased by 21% YoY and bid-ask spreads are widening. We expect further pricing corrections to be widespread across the sectors and regions in 2023.

As cited in our last outlook, financing a real estate asset continues to be difficult and more expensive. Rates on conventional secured loans rose 90bps between July and November 2022, to 6.0%. Higher rates have widened the negative leverage situation where the cost of debt is above income yields. Investors in liquid markets have reacted, pushing public REIT share prices lower, which partially implies cap rate expansion at the property level. Private real estate typically trails large movements in implied cap rates by three-to-four quarters, but impact will vary by sector depending on the persistency of demand growth.

For example, supply constrained warehouse markets in port-related metros have 1% or less availability and have lease rollover opportunities where in-place rents are 10% to 20% below market.

Figure 1: Property sector total quarterly returns



Source: NFI-ODCE Performance Attribution, 3Q22 Preliminary Property Detail Report. Note: Past performance is not a guarantee for future results.

Relying on income

Figure 2: October US real restate total return forecasts

Total return (%)	2019	2020	2021	2022 forecast	3-year forecast
Apartment	5.5	1.8	19.9	5.9	5.2
Industrial	13.4	11.8	43.3	8.3	6.5
Office	6.6	1.6	6.1	1.8	4.0
Retail	1.9	(7.5)	4.2	3.9	4.9

Source: Oxford Economics Forecasts, as of October 2022. Total return: NCREIF as of September 2022. Data shows unlevered NCREIF Property Index total returns. Expected / past performance is not a guarantee for future results.

Apartment

Momentum slowed in the apartment sector, but market fundamentals were stable in 3Q22. The apartment sector delivered an annual total unlevered return of 18.2% in the year ending 3Q22 – a slight dip from last quarter's 42-year record (see Figure 2). Capital return slowed during the quarter to 0.3%, indicating that elevated interest rates are weighing on appraisal-based property values. Negative net absorption drove occupancy rates down by 80bps over the quarter and 90bps over the year.

Despite negative absorption, occupancy hovered near record highs and apartment rents continued to rise in 3Q22 (+10.4% YoY). Transaction volume was reduced in 3Q22, down 19.9% from a quarter ago, and 16.4% from a year ago. We expect a moderation in returns from record-setting levels as elevated interest rates weigh on capital returns.

Industrial

Industrial market fundamentals remained solid during the quarter amid a slowing macroeconomic environment. The industrial sector posted strong annual total unlevered returns of 34.6% in 3Q22 a moderation from the past two quarters, but still an impressive performance. Capital returns were flat during the quarter, as high borrowing costs and muted transaction activity dragged values. Supply outpaced demand for the first time since 3Q20, as absorption slowed from the prior quarter while the pace of new deliveries picked up (see Figure 3). Availability ticked up by 10bps over the quarter but remained 110bps below 3Q21. Transaction volumes were down 12.5% from a quarter ago and 21.0% from a year ago. We anticipate continued outperformance of the industrial sector over the next three years, albeit at less robust rates.

Office

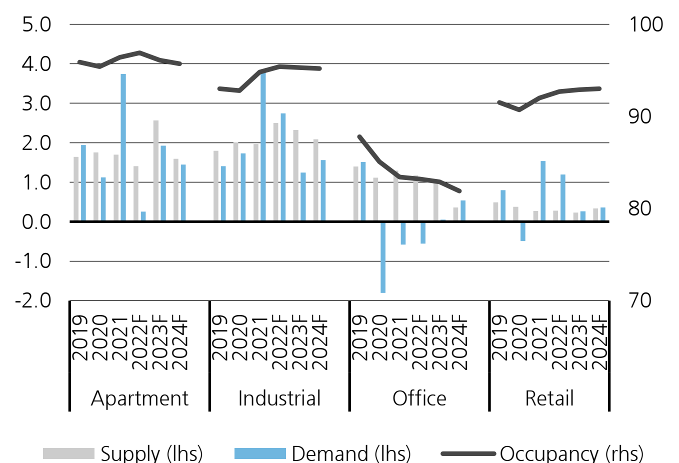
The office sector remains challenged by work-from-home trends, capital markets, and a cooling in the labor market. Total annual unlevered returns for the sector decelerated to 3.3% in 3Q22, as income returns held steady while negative capital returns accelerated. Increasing sublease inventory, coupled with weak demand, drove occupancy rates down 30bps during the quarter to 82.9%. The pace of 3Q22 office transactions was 6.1% below 2Q22 levels and 33.2% below 3Q21 volumes. Although the office sector faces multiple headwinds, we expect demand for high-quality office buildings to persist, given tenants are increasingly seeking to improve their office space while reducing their footprint. Our outlook supports the below long-term average return forecast over the next three years.

Retail

Retail demand held steady during 3Q22 while the pace of supply continued to shrink. Occupancy rose by 10bps over the quarter, and 90bps over the year to 92.9%. Transaction volumes slowed in 3Q22, down 30.1% from a quarter ago, but up 3.2% from last year's pandemic-driven decline. Total unlevered returns moderated to an annual return of 6.4% in 3Q22, as capital returns fell 0.8% during the quarter. We expect solid retail performance over the next three years as the sector continues to rebound from pandemic disruptions.

Figure 3: Sector fundamentals

(% completion rate vs occupancy rate)



Source: CBRE-EA, as of September 2022, Apartment Occupancy is Real Page as of September 2022. Note: Completion and absorption rates shown are the total supply delivered and absorbed within the year as a percentage of inventory. Past performance is not a guarantee for future results.

Normalizing back to pre-pandemic trends

Self-storage

Self-storage fundamentals remain healthy amid a seasonality-driven deceleration. Occupancy rates fell by 188bps YoY to ~ 94%, as move-in rates decelerated while move-out rates accelerated to a pace that is more in line with general seasonality trends. Despite the slowdown, occupancy rates remain above the sector's long-term average of 92%, and same-store NOI growth continues to achieve double-digit growth. Among self-storage REITS, same-store NOI grew at an equal weighted-average of 15.9% in 3Q22, marking the sixth consecutive quarter of double-digit growth for CubeSmart, Extra Space and Public Storage. We expect self-storage to remain resilient during the current economic environment, but for robust NOI growth expectations to soften.

Cold storage

Cold storage occupancy rates exceeded pre-pandemic levels for the first time in 3Q22. Americold, a global cold storage REIT that holds 87% of its inventory in North America, reported a 260bps QoQ and 440bps YoY increase in economic occupancy to 78.7%. The company reported strong operating results amid elevated inflation, supply-chain disruptions, declining food commodity inventory levels and labor shortages. YTD, same-store-NOI grew 4.4%, which is partly attributable to tenants absorbing additional operating costs incurred from inflation. Near-term fundamentals continue to beat expectations and the long-term outlook for the sector remains strong as increasing online grocery consumption drives demand for temperature-controlled spaces.

Senior housing

Senior housing occupancy rates rose for the fifth consecutive quarter in 3Q22. Robust demand, coupled with limited inventory growth, drove occupancy rates in primary markets up by 100bps to 82.2%. While occupancy rates are 430bps above the pandemic-driven trough in 2Q21, they are still 480bps below pre-pandemic levels. Boosted by strong occupancy, rental rates accelerated by 4.4% over the trailing year. Increasing construction costs and a slowdown in loan issuances should favor further recovery in sector fundamentals as supply remains muted over the near term.

Life sciences

Life sciences normalized back to its pre-pandemic pace. Venture capital (VC) funding fell by 29% QoQ in 3Q22 – in line with pre-pandemic levels, as increasing concerns about the near-term economic outlook weighed on investors' appetite. However, public funding from the National Institute of Health (NIH) accelerated, partially offsetting the current slowdown in the private sector. Vacancy rates inched up by 30bps over the quarter to 5.3% in 3Q22, driven by robust new deliveries. Asking rents continued to rise even amid a slight softening in market fundamentals.

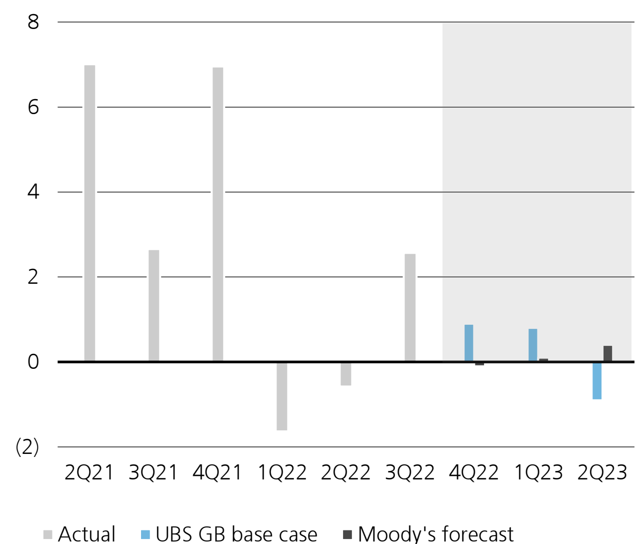
Playing limbo

Real GDP growth came in stronger than expected at a 2.6% annualized rate in 3Q22 (see Figure 4). The solid growth was primarily propelled by trade amid a sharp pullback from residential investment. Trade contributed 2.8% to the headline figure, which implies that the remaining components of the economy shrank slightly. Consumer spending, which accounts for 70% of GDP, has been resilient, but is expected to slow given weakening growth in real incomes.

Households are spending through savings at a faster rate and credit card balances are rising. Consumer sentiment is at a record low and large goods sales, which is a leading indicator of sales in other segments, are declining. October payrolls increased by 261,000, but the unemployment rate, calculated from a different survey, increased by 20bps over the month to 3.7%. The hawkish stance by the Fed has spurred concerns in future business investment and may introduce more downside risks.

UBS Global Bank expects the current economic momentum to wane in the coming months and an economic contraction, marking the beginning of a recession, to start in 1H23. The recession is expected to be milder than the 1991 recession but with the same duration, contracting by ~1% and lasting for 8 months. The unemployment rate is expected to increase to approximately 5% by the end of 2024 with a reverse in the Fed's restrictive policy.

Figure 4: Real GDP quarterly annualized forecast (%)



Source: Actual Moody's Analytics; UBS Global Bank forecast as of 8 November 2022. Note: Shaded area indicates forecast data.

Given UBS Global Bank's forecast, we expect disinflationary pressures to take hold and change the investment community's focus from CPI to unemployment. In this scenario, the durability of income in real estate will become key, rather than the more recent focus on shorter lease duration. Investors should continue to focus strategies on defensive positioning while economic uncertainties persist. This can include marginal movements around strategy targets, i.e. less leverage, and lower amount of value-add activities. Being defensive does not mean that there are limited opportunities in the market. In fact, there may be attractive opportunities to dollar-average into sectors with general repricing that also exhibit strong demand forecasts over the next three-to-five years.

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