Hamilton Lane

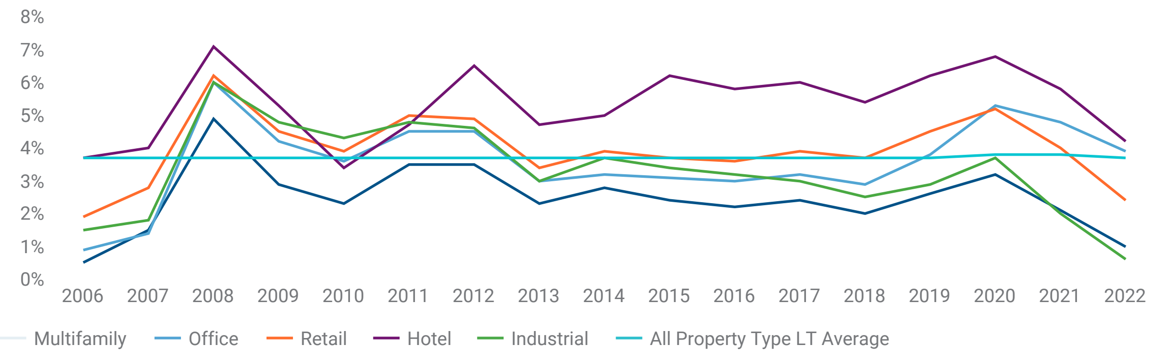
Navigating the Juxtaposition

Challenges and Opportunities in Today’s Real Estate Market

July 2023 | By Elizabeth Bell and Sabeen Jameeli

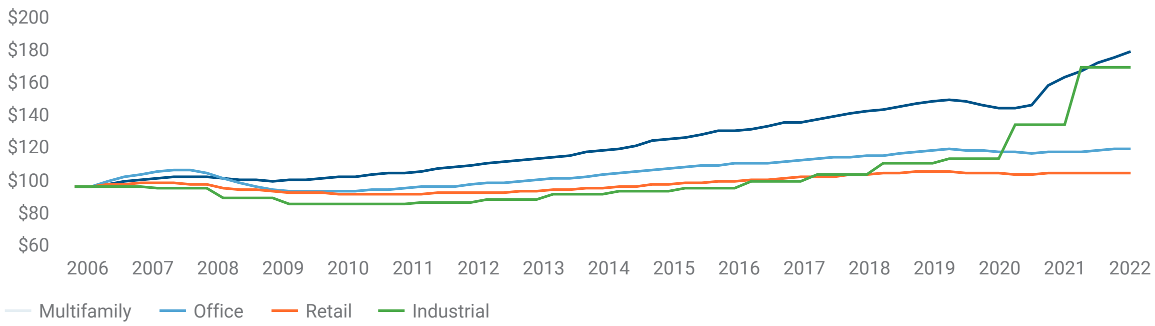
The current market juxtaposition – with low vacancies and double-digit rent growth in certain sectors versus market volatility and reduced liquidity – creates a few challenges when it comes to determining the value of a real estate property in today’s rapidly shifting environment. In terms of property valuations, today’s market is feeling a bit like the gameshow, “The Price is Right.” With price discovery happening in real time, we are all determining our own estimates for what we think is “fair market value.”

Cap Rate Spreads vs. 10-Year Treasury Yield



Source: FRED, Green Street Advisors, Bloomberg. As of December 31, 2022

Effective Rent Growth



Source: Bloomberg as of December 31, 2022 & Green Street Advisors

What Role Have Interest Rates Played?

Due to the pace and quantum of recent U.S. interest rate hikes, real estate yields (i.e., "cap rates") have failed to keep up with this expansion, resulting in narrow spreads over U.S. treasury yields. Will real estate spreads revert to their historical averages in the near term through an increase in cap rates? Or will sellers refuse to transact at higher yields (i.e., lower values), resulting in real estate maintaining narrow, or even negative, debt spreads?

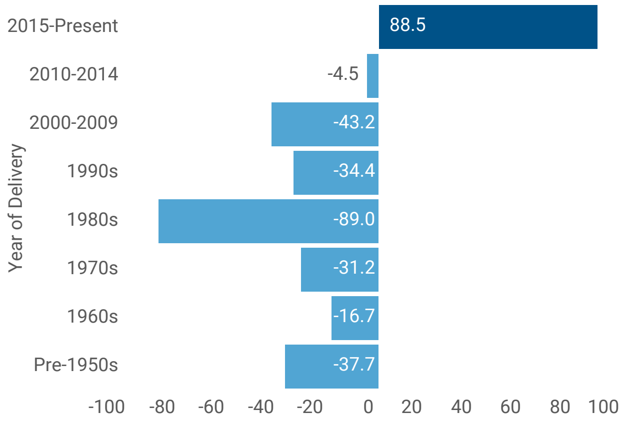
This valuation uncertainty, in combination with a pullback in lending, has reduced liquidity in the U.S. real estate market. Further, overall increased borrowing costs and perceptions of value diminution have created pockets of distress within commercial real estate. While some owners who are facing upcoming debt maturities won't have a choice other than to sell at higher cap rates, the current market uncertainty may lead to attractive buying opportunities.

Across real estate sectors, the highest levels of distress are observed in commodity office and shopping malls, with vacancies rising and rents flattening or even decreasing. Despite these challenges, fundamentals in other sectors such as multifamily, industrial, hotels, Class A office and necessity-based retail have widely remained strong, with continued demand and positive rent growth.

How is the Office Sector Faring?

When looking at the contrast within the commercial real estate sectors, office and industrial are on two different ends of the spectrum in terms of fundamentals and overall investor sentiment. Industrial has been a strong performer, supported by e-commerce tailwinds, while office has been challenged. There is no doubt that the pandemic has forever shifted the way we work, creating less overall demand for office; however, even within that sector, we are seeing a great amount of variance in performance based on the individual property type. Class A office continues to hold up much better than the dislocation we have seen in traditional commodity office. In contrast to older vintage office product, we have actually observed positive demand for Class A office space. The chart below shows that high-quality office product has seen positive net absorption, while older vintage commodity office has faced severe challenges with negative net absorption overall.

Net Absorption Since COVID-19 by Building Vintage

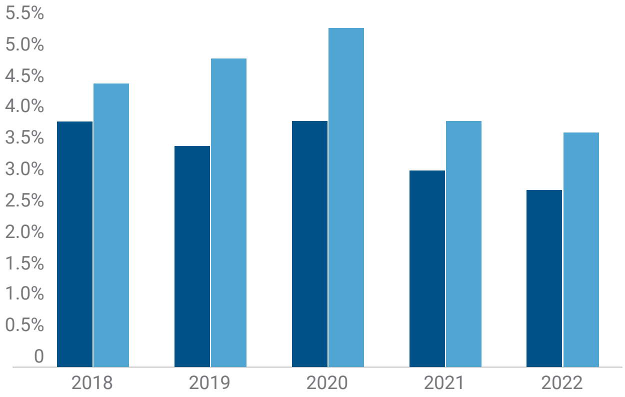


Source: JLL Research. As of September 30, 2022

Industrial Outdoor Storage: The Next Big Thing?

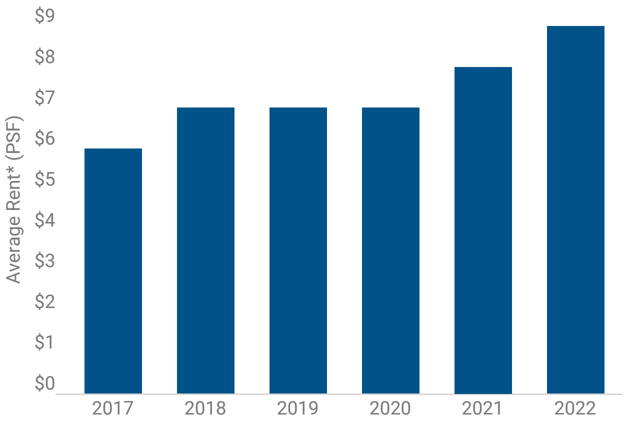
A segment where we have seen an increased interest from private and institutional investors is the industrial outdoor storage ("IOS") space. IOS is an industrial subsector that is a critical component of the supply chain for retailers and logistics operators. The sector benefits from similar structural demand drivers (e-commerce and onshoring) as traditional industrial; however, due to land scarcity and zoning, and entitlement challenges, limited new supply is coming online. This supply and demand imbalance in the U.S. IOS space has led rents to advance by nearly 30% on average since the end of 2019 and vacancy to fall to less than 3% in mid-2022.[1] In addition, given the fragmented nature of current IOS ownership and the nascency of the sector from an institutional perspective, IOS assets can be acquired at capitalization rates (i.e., initial yields) that are typically 100bps to 250bps higher than traditional industrial assets. With the potential for strong income growth over the near-term and higher entry cap rates, will IOS be the next hot real estate subsector to which institutional capital will flock?

IOS vs. Industrial Vacancy



Source: Marcus & Millichap, as of October 2022

IOS Rent Trends



Source: Marcus & Millichap, as of October 2022
*Based on direct, triple-net leases. All values from 2Q of each year

The current real estate market environment is unlike anything we have seen before; a gameshow-esque, true juxtaposition across sectors. We find it hard to paint any one sector with a broad brush, so we continue to monitor each sector closely as we believe dislocations may also bring great investment opportunities.

We cover more on this and other compelling areas within private infrastructure in our 2023 Real Assets Market Overview. Fill out the form below for an instant download of the deck.

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