Principal Asset Management[SM]

U.S. Real Estate sector report

Four quadrant perspectives

FALL 2023

Sector conditions and outlook

KEY:

● Improving ● Neutral ● Deteriorating

↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

		Current condition	Outlook
APARTMENT	The apartment sector is starting to feel the effects of both capital market and economic headwinds. Demand has wavered but remains largely positive without offsetting record levels of new apartment deliveries. Capital and liquidity constraints are also negatively affecting both pricing and transaction activity within the sector.	● Neutral	↗ Moderately positive
HOTEL	The hotel sector remains in good shape following its recovery from the pandemic. Occupancy rates are within equilibrium ranges and RevPAR growth on a 12-month trailing basis has continued to show solid improvement. There are emerging signs, however, that the sector is beginning to show signs of slowing.	● Neutral	→ Neutral
INDUSTRIAL	The industrial sector remains in good condition, but headwinds to both market fundamentals and investment performance continue to mount. Demand has slowed in 2023, reverting to its pre-pandemic norms, while high levels of new supply have already begun to push vacancy rates upward. Longer-term, higher interest rates, and more restrictive debt capital will slow the pace of new supply helping steady the sector.	● Improving	↗ Moderately positive
OFFICE	The office sector remains vexed by subpar workplace attendance and still weakening market fundamentals. Net absorption continues to decline, and the national vacancy rate is as high as it has been since the early 1990s when the sector faced a supply overhang due to excess new development. Capital markets have ground to a halt and lending within the sector is scant due to uncertainty in the sector and exposure risk on the part of banks and life companies.	● Deteriorating	↓ Negative
RETAIL	The retail sector, by most accounts, continues to outperform. Consumers have been resolute and market fundamentals are improving, unlike most other sectors at this stage in the real estate cycle. A strong job market and continued income growth have provided momentum, but there are signs that consumers may be starting to waver, which is concern for larger shopping centers. Grocery Anchored neighborhood and community centers will continue to outperform in the current environment but may come under some pressure with the specter of recession in the next 12 months.	● Improving	↘ Moderately negative

Sector conditions and outlook continued

KEY:

● Improving ● Neutral ● Deteriorating

↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

Sector		Current condition	Outlook
SINGLE-FAMILY RENTAL	The single-family rental sector is one of a few that are experiencing an improvement in fundamentals as demand remains healthy and rent growth is in the mid-single digits. Pressures from the supply side of the market remain a concern, but the lack of financing available for new development will curb new supply over the next 12 months.	● Improving	↗ Moderately positive
DATA CENTERS	The data center sector remains tight, with demand continuing to increase through the first half of 2023. Occupancy remains in the high 90% range and rental growth trends remain healthy as space is in short supply, which continues to be a potential headwind for the sector. Although capital markets remain a persistent headwind, this is one of the few sectors that is contnuing to see an increase in demand for space despite economic uncertainty.	● Improving	↗ Moderately positive
STUDENT HOUSING	Tenant demand is robust and leasing for the 2023-2024 school year outperformed expectations for both occupancy and rental rates. Tenant demand and rent increases may now be positioned to outperform traditional apartments over the near-term horizon.	● Neutral	↗ Moderately positive
LIFE SCIENCES	Life sciences has seen both capital market and space market fundamentals pull back in 2023. Venture capital funding, a key source of growth for life science companies, has become much scarcer during the year. As a result, tenant demand has moderated considerably for lab space.	● Neutral	↘ Moderately negative

Source: Principal Real Estate, September 2023

APARTMENT

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↘	→	→	↘	↓	→

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium

Sector overview

The apartment sector is starting to feel the effects of both capital market and economic headwinds. Demand has wavered but remains largely positive. However, it has not been strong enough to offset record levels of new apartment deliveries. Capital and liquidity constraints are also negatively affecting both pricing and transaction activity within the sector.

Private equity

Although the apartment sector remains among the favored asset classes for commercial real estate investors, it has not been immune to capital market disruptions and a deceleration in space market fundamentals. Year-over-year, sales volumes have declined by 67% through August. Although the sector continues to benefit from liquidity through government sponsored enterprises (GSEs), potential apartment buyers are still deterred by the rising cost of leverage, particularly at a time when private valuations are challenged.

Elevated levels of supply brought to the market over the past two years are beginning to put pressure on rent growth, as demand struggles to keep up with the wave of construction deliveries. Traditionally high-growth markets that have seen over-supply, most notably in the Sunbelt, have seen a significant slow-down in rental rate growth, with some markets turning negative year-over-year. More mature markets in the Midwest and Northeast are leading the country, with growth down only slightly over 2022.

Upward pressure in cap rates, IRRs, and exit caps has continued to filter through apartment valuations in the back half of 2023. Data through the middle of 2023 shows that the sector has seen values written down by 8.9% relative to their peak in Q2 of 2022, according to the NCREIF National Property Index (NPI). Slower economic growth projections through the end of 2023 and into 2024 could challenge valuation further, particularly in a higher interest rate environment.

The positive news for the sector is that higher required yields, higher cost of debt capital, and reduced availability of construction debt have begun to put downward pressure on supply pipelines. Permits for multifamily units—a good indicator of future supply—have declined by 18% through August on a year-over-year basis. Once the current supply is absorbed over the coming years, landlords should have a period with significantly reduced deliveries and increased pricing power.

Private debt

Apartment loans remain mostly attractive to lenders today, given overall still healthy property market fundamentals, but pressure from increasing interest rates has strained valuations, debt service coverage ratios, and other underwriting metrics in recent months. Reduced investment sales activity resulting from capital markets challenges, a reduction in refinancing requests, and tighter underwriting jointly led to a -51% reduction in multifamily lending volume during the first two quarters of 2023 compared to the prior year according to data from the Mortgage Bankers Association.

Nonetheless, broad-based lender interest in apartments paired with competitive pricing and enhanced liquidity GSEs continue to make multifamily lending rates the lowest of all property sectors. Insurance companies, Fannie Mae and Freddie Mac, are routinely offering rates near 6% for 55% to 65% loan-to-value (LTV) senior apartment loans secured by average to above-average quality apartments.

REITs

Apartment REITs have slightly outperformed the REIT index year-to-date in 2023, with coastal focused REITs leading the way. Increasing numbers of new deliveries and slowing cross-state migration have pressured Sunbelt-focused companies, with negative market rent growth reported in some recent updates.

On the other hand, limited new supply, continued return to office recovery, and the lack of recession impacts (following higher profile layoffs in the technology sector) have supported the positive, albeit decelerated, fundamentals reported by the coastal REITs. These trends are expected to continue into 2024 and potentially beyond until elevated supply in the Sunbelt is better absorbed. Following modest year-to-date returns, apartment REITs continue to trade near a 15% discount to NAV, which is slightly larger than the average for other sectors.

CMBS

The GSEs continue to be a dominant lender in the multifamily space with $150 billion of approved lending capacity. Combined agency issuance has been constrained by low transaction volumes. While much smaller in scale, multifamily exposure in conduit and single-asset single-borrower (SASB) CMBS is significant at roughly $55 billion outstanding. Loan performance has remained very strong in fixed rate, as the conduit multifamily delinquency rate is at 1.0%, its lowest level in 15 years. Similarly, the agency delinquency rate is only 0.2%.

Some weakness is emerging in floating rate SASB loans underwritten at tight debt yields when interest rates were extremely low. Rising rates have resulted in large increases in debt service burdens, cooling prospects for net operating income (NOI) growth, and valuation challenges that have resulted in the SASB multifamily delinquency rate rising to 3.0%. Overall, multifamily remains an in-favor sector within CMBS given historical NOI growth, slowing construction starts, poor single-family affordability, and consumer-oriented credit exposure.

HOTEL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	→	↑	↑	↗	↓	↗

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Sector overview

The hotel sector remains in good shape following its recovery from the pandemic. Occupancy rates are within equilibrium ranges and RevPAR growth on a 12-month trailing basis has continued to show solid improvement. There are emerging signs, however, that the sector is beginning to show signs of slowing. The pace of demand and RevPAR improvements on a 3-month trailing basis have both begun to slow. Declines in both business travel and consumer sentiment will likely dim the outlook for income growth as economic uncertainty and a slower-than-anticipated return to office will continue to provide headwinds for the sector.

On a positive note, supply-side pressure remains in check and is expected to remain muted. High borrowing costs and a lack of ample funding will conspire to keep development pipelines in check. This should help the sector remain on an even keel despite the growing concern of a recession in the next 12 months.

Private debt:

Although RevPAR has grown in 2023, its rate of growth has decelerated while hotels face increasing prices for labor, insurance, and other expenses. Consequently, lender appetite for hotel loans has also waned in 2023, with the volume of hotel loans originating during the first half of 2023 down by 20% compared to the first half of 2022 based on data from the Mortgage Bankers Association. Debt funds remain a primary source of capital for hotel financings.

REITs:

Lodging REITs underperformed other property sectors year-to-date due to weaker demand from leisure travelers, partially offset by an acceleration in business and urban hotel demand. Throughout the summer, luxury resorts and leisure destinations saw weaker demand as many travelers chose to vacation abroad, particularly in Europe. This led to lower nightly rates in markets that previously benefited from pent-up demand throughout the pandemic. The recovery in corporate travel accelerated with urban hotels narrowing their underperformance relative to leisure properties, driven by increases in group demand. Corporate transient travel remains weaker than expected at this time due to still sluggish return-to-office trends.

Throughout earnings season, lodging REITs delivered underwhelming results as revenue per available room (RevPAR) was negatively impacted by decelerating leisure demand while higher operating expenses—particularly wages—resulted in weaker-than-expected profitability. RevPAR in recent months has grown in the 1% to 3% range compared with 2022, which is a meaningful slowdown in growth since the start of the year, reflecting tougher RevPAR comparisons. Lodging REITs are trading at 15% to 20% discounts to NAV estimates, a larger magnitude than what is seen across most other REIT sectors, reflecting the uncertainty that a potential recession may have on both consumer and business travel demand.

CMBS:

Despite a slowdown in demand from post-COVID highs, hotel operations have continued to show solid performance with loan performance following suit. The conduit hotel delinquency rate peaked near 20% in July of 2020 and now stands at 4.8%, just 1% higher than the overall conduit delinquency rate. Leisure travel initially spurred a strong recovery in vacation destination markets with business travel recovering in turn. Smith Travel Research reports that RevPAR for the 28 days ending September 15, 2023, is up 10% relative to the same pre-COVID period in 2019. Hotel operators have grown RevPAR by raising average daily rates, while occupancies are lower than four years ago which is especially prevalent in higher-end categories. RevPAR growth appears to be leveling out year-over-year as consumers have mostly burned through excess savings.

CMBS issuances in 2020-2021 included very little hotel exposure due to underwriting challenges and investor skepticism. As fundamentals have improved, hotel loan contributions have grown and now stand at 10% of total conduit and over 26% of SASB collateral issued year-to-date, showing that capital is available for better-positioned properties. While the recent macro trends have been supportive, hotel performance is highly correlated to economic growth and would be negatively impacted by recession, warranting a conservative approach to underwriting and a forward-looking credit assessment.

INDUSTRIAL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	↘	↗	↗	↘	↘	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Sector overview

The industrial sector remains in good condition, but headwinds to both market fundamentals and investment performance continue to mount. Demand has slowed in 2023, reverting to its pre-pandemic norms, while high levels of new supply have already begun to push vacancy rates upward. Longer term, higher interest rates and more restrictive debt capital will slow the pace of new supply helping steady the sector.

Private equity

Industrial market fundamentals are beginning to moderate, with positive but slowing net absorption, which is more in line with pre-pandemic norms. Year-over-year rent growth is still healthy at 7.7% as of mid-year 2023 but has normalized from a peak of 11.5% a year ago. The national vacancy rate has risen for the fourth consecutive quarter, which will cause rent growth to moderate further into 2024.

Industrial occupiers are exercising caution as fears that the current high-interest rate environment will trigger a recession. Weaker retail sales figures and reports of consumers trading down have also forced third-party logistics as well as e-commerce and brick and mortar retailers to rethink their near-term strategies. Consequently, they have pulled back on growing inventories that they had accumulated during 2021 and into 2022.

Despite solid fundamentals and income growth, the industrial sector has not been immune to capital market headwinds. High interest rates and restrictive debt capital are putting further downward pressure on valuations, largely due to the still low nominal cap rates, discount rates, and exit cap rates prevalent within the sector. As a result, transaction volume has continued to decline, posting a total of $46.9 billion through the first eight months of 2023, down 53% from last year's pace.

Private debt

Lenders continue to view industrial—along with multifamily—as a preferred property sector, although the volume of available industrial loans has also suffered because of changing capital market conditions and lower investment sales activity. The volume of industrial loans made during the first half of 2023 declined by 65% versus the same period in 2022 according to data from the Mortgage Bankers Association.

Many lenders' relative under-exposure to the property sector, concerns regarding some other property types (particularly office), and reasonably robust industrial demand forecasts have fueled lender appetite for debt secured by core industrial properties. Lenders today frequently offer industrial loan interest rates very near the levels offered for prime multifamily properties, with LTVs commonly up to 60%. Lenders also require less structure (e.g., escrows and letters of credit) for potential future re-tenanting costs at industrial properties than for loans secured by most other property types.

REITs

Industrial REITs have outperformed the broader REIT index year-to-date. Fundamentals for the sector remain generally healthy but conditions have normalized relative to recent years. Rent growth has moderated with REITs generally expecting 5% to 10% growth for the year in most markets. Southern California has been the most topical market in recent months, as conditions are decelerating faster than elsewhere, causing several REITs to slightly dial back overall rent growth expectations for the year. Key drivers include West Coast port issues and rent fatigue which have dampened demand, especially for larger format warehouses.

Despite modestly lower rent growth, REITs have beaten earnings expectations and raised guidance for the full year, driven by stronger leasing spreads, lower credit loss, and acquisitions. The outlook for next year is also positive as the supply and demand picture improves thanks to the sharp drop-off in development starts since late 2022. Supported by sizeable, embedded mark-to-market opportunities, the industrial sector is well-positioned to deliver above-average earnings growth in the intermediate term. The industrial sector is trading at a mid-to-high single-digit discount to consensus NAV, which is in line with other REITs.

CMBS

Industrial loans currently carry the lowest delinquency rate within the CMBS universe and continue to be viewed positively, especially relative to office, retail, and hotel exposures. This view is supported by the current economic outlook, space market fundamentals, and availability of capital. The CMBS SASB market provided over $35 billion of floating rate debt to industrial owners from 2020-2022, offering an efficient source of financing for very large portfolio deals.

More recently, the significant increase in floating rates has made these financings relatively unattractive to borrowers, and the pace of SASB industrial issuance has fallen dramatically. One dynamic to watch is the potential for borrowers to refinance existing floating rate loans into new fixed rate loans, given the inverted yield curve and recent tightening in SASB credit spreads.

In the conduit space, year-to-date industrial allocations within issuances have grown to three times the historical average, a positive for diversification. Conduit CMBS industrial loans are generally smaller than the large SASB deals and in some instances, exhibit exposure to tertiary locations, less functional layouts, and non-investment grade tenancy (often via sale and lease backs). Because of this, underwriting metrics for conduit industrial loans have typically been more conservative than SASB industrial loans. Overall, historically strong NOI growth, relatively durable cash flows, and positive investor sentiment should benefit the space.

OFFICE

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↓	↗	↓	↓	↓	↓	↓

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Sector overview

The office sector remains vexed by subpar workplace attendance and still weakening market fundamentals. Net absorption continues to decline, and the national vacancy rate is as high as it has been since the early 1990s, when the sector faced a supply overhang due to excess new development. Capital markets have ground to a halt, and lending is scant due to uncertainty in the sector and exposure risk on the part of banks and life companies.

Private equity

Office remains the most challenged property sector today. Headwinds are stemming from both capital and space markets. Fundamentals have eroded further throughout 2023, with nearly every market across the country experiencing negative net absorption and rising vacancy rates. The sector could face additional challenges from slower economic growth that would undermine office-using job growth, which up to this point has been unflagging.

Despite stricter return to work policies, office attendance has been stubbornly flat. Physical office occupancy across the top 10 U.S. cities remains well below pre-COVID levels and has not increased materially since reaching a post-pandemic peak in January of approximately 50%, where it still stands as of mid-September. In-office attendance remains highest in sunbelt metros such as Austin and Houston, which are seeing attendance in the 60% range, while San Jose and San Francisco are in the low 40% range.

Progress within capital markets remains negligible. Investors are continuing to require higher yields while debt capital remains difficult to find in the best of situations. In many cases, traditional bank and life company lenders are focused on addressing upcoming maturities within their current portfolios, severely limiting the availability of new office financing and forcing some sellers to provide financing to clear office trades. Consequently, transaction volume is down 68% in 2023 on a year-to-date basis through August.

Private debt

Few lenders are willing to finance office properties today, even on the most conservative basis, due to weak property market fundamentals and existing portfolio exposures. Some CMBS conduits will finance office properties that feature a combination of favorable tenancy, longer remaining weighted average lease terms, strong physical utilization of space, healthy rent collection experience, and conformance with emerging design preferences. However, even then capital is quite limited. Certain debt funds have expressed a willingness to provide loans for office properties, although their required yields are typically greater than the properties' existing economics will support.

Most office financing today involves existing lenders refinancing their own debt or sellers (sometimes banks) providing seller financing in connection with a disposition. The volume of office loans made during the first half of 2023 was down 69% compared with the same period in the prior year, based on data from the Mortgage Bankers Association, with very few truly new office loans made.

REITs

Office REITs have had a rollercoaster year but continue to underperform other REIT sectors. The group started the year strong on hopes of peaking interest rates, sold off sharply after the banking turmoil in March, and then rallied following a high-profile office sale in New York City (that featured attractive assumable financing) combined with growing market optimism for a soft landing. Stock market gyrations have been largely detached from fundamentals, which have remained weak throughout the year.

Leasing continues to be well below historical levels and REITs have seen occupancy deteriorate steadily. While tenant demand remains muted, the biggest issue for the sector continues to be the availability and cost of debt funding. REITs have been able to refinance maturing debt, but rates are materially higher which has put significant pressure on earnings and has resulted in several dividend cuts. Office REITs trade at a 20% to 30% discount to consensus NAV, reflecting the challenging outlook.

CMBS

Office exposure is facing intense scrutiny as the sector continues to face secular headwinds. Conduit CMBS has historically averaged approximately 30% office exposure, however issuers have responded by limiting office exposure to approximately 20% in recently issued securitizations. Delinquency rates remained remarkably stable throughout the pandemic but have trended up this year from 1.9% to 3.4% for fixed rate conduit transactions. Long term leases, diversified rent rolls, and high underwritten debt service coverage ratios (DSCRs) help to significantly mitigate term default risk. However, refinance risk is elevated given NOI pressure, constrained capital markets, and higher interest rates.

Floating rate SASB loans are much more exposed to near-term default risk given the significant increase in short rates and corresponding drop in DSCRs, which has led to several high-profile defaults and pushed the SASB office delinquency rate to 5.8%. Given the difficult refinance environment, CMBS servicers are working with borrowers by providing loan extensions in exchange for fresh equity contributions, cash flow sweeps, and other lender friendly requirements. This approach seeks to improve bondholder outcomes, although it does create timing uncertainty, which is adding to pricing concessions. Recently constructed class A office is performing quite well, exhibiting positive net absorption and significantly higher market rents. Importantly, nearly 50% of conduit CMBS office exposure is considered class A, a fact that is not reflected in highly elevated market risk premiums. Investors that can approach office exposure with a more discerning viewpoint are positioned to benefit from current pricing levels over the longer term.

RETAIL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↑	↗	→	↘	↘	↘

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Sector overview

The retail sector, by most accounts, continues to outperform. Consumers have been resolute and market fundamentals are improving, unlike most other sectors at this stage in the real estate cycle. A strong job market and continued income growth have provided momentum, but there are signs that consumers may be starting to waver, which is a concern for larger shopping centers. Grocery anchored neighborhood and community centers will continue to outperform in the current environment but may come under some pressure with the specter of recession in the next 12 months.

Private equity

Retail market fundamentals have remained resilient thus far in 2023, with steady demand, limited store closures, and minimal new supply. The national vacancy rate has fallen to 4.2% and rent growth on a trailing 12-month basis is 3.2% year-to-date, according to CoStar. Fundamentals to date have been supported by strong hiring and wage growth, and a concomitant drawdown in pandemic stimulus-fueled spending.

While retail has not been immune to capital market headwinds over the past 12 months, it has outperformed other property sectors on a relative basis according to the NFI-ODCE index. The strong relative outperformance reflects not only solid fundamentals but also the higher nominal valuation metrics coming into this period of repricing. Retail sales volume through August declined by 53% relative to the same period last year, which reflects decreased investor appetite for commercial real estate driven by higher interest rates, as well as a potential slowdown in consumer spending.

Investor demand continues to favor well-located, grocery anchored neighborhood and community centers, reflecting strength of the operating fundamentals for that retail format and the perceived resilience of non-discretionary consumer spending in a weakening macroeconomic environment.

The outlook for private equity retail remains murky. Despite strong operating fundamentals today, consumer resolve appears to be weakening. High inflation and retailer reports of consumers trading down suggest that spending trends are starting to moderate. This is a key area of concern, particularly across discretionary retail formats such as malls, power centers, and high street properties.

Private debt

Some traditional lenders have shown growing interest in neighborhood and community shopping centers with strong tenancy. Major grocers, creditworthy discounters, and creditworthy home improvement stores with significant remaining lease terms may find receptive lenders, although interest rates for even the highest quality retail properties remain perhaps 10 basis points greater than debt for similarly leveraged multifamily and industrial properties.

Debt for high street properties, power centers, and lifestyle centers remains difficult to procure even at more modest leverage levels, and significant loan structure (e.g., escrows and amortization) is often required. Debt for regional malls remains unavailable for all but the very best assets with top operators. Lenders continue to focus heavily on tenant creditworthiness, tenant sales history, remaining weighted-average lease terms, and sponsor quality, with widely disparate loan terms offered.

REITs

Shopping center REITs have underperformed the broader REIT sector year-to-date, while the performance of mall REITs has been roughly in line. Fundamentals for the retail sector remain healthy, with open-air shopping center REIT portfolios at record occupancy rates and improved pricing power. A modest pick-up in bankruptcy activity, particularly in the shopping center sector, has been worked through successfully. REITs have already made good progress backfilling vacancies, often at 10% to 30% higher rents, which compensates for the downtime and capex associated with re-leasing.

The near-term outlook for the sector remains positive as retailer demand for space continues to be strong while there is limited supply on the horizon. However, the impact of a potential deterioration of retail sales due to a weaker economy, softer job market, depleted excess savings, and the resumption of student loan payments remains to be seen. This uncertainty is reflected in valuations with retail REITs trading at discounts of roughly 15% compared with consensus NAVs, a modestly wider discount than is available in other property types.

CMBS

Retail's image has recovered significantly from the pandemic era, fueled by a resilient consumer base, the spending drawdown in excess savings, and a robust jobs market. Store closures have slowed dramatically over the past two years, and the entertainment-oriented transformation of malls has gotten back on track post-COVID. In conjunction with conduit transaction office exposures falling in 2023, retail exposure has increased back towards historical averages at approximately 27%. Interestingly, once out-of-favor malls have grown to 13% of conduit issuance year-to-date relative to 3% in 2022, supported by generally positive sales trends along with conservative underwriting metrics of >2.0x DSCR and sub-50% LTV on average.

Maturity stress from loans originated in 2012 and 2013 is still weighing on the conduit retail delinquency rate, which stands at 6.6%. CMBS servicers continue working with retail operators as loans approach maturity by providing loan extensions on performing properties, typically in exchange for fresh equity contributions. This approach seeks to maximize bondholder outcomes by keeping strong operators in place, while avoiding near-term foreclosure at a time when valuations are depressed. That said, note sales have recently been utilized by servicers as a more expeditious resolution strategy. Similar to the hotel sector, retail has benefited from the recent upside in economic activity. However, the health of the consumer and a potential pullback in spending need to be closely monitored for turning points.

SINGLE-FAMILY RENTALS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	→	↑	↑	↘	→	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Private equity

Homeownership is out of reach for an increasing number of Americans as mortgage rates reached 23-year highs in September and a lack of for-sale inventory persists. The combination of a strong labor market and tight for-sale inventories have bolstered home prices and will likely continue to do so in the coming quarters. Without significant relief in mortgage interest rates, the for-sale inventory is likely to stay low as locked-in owners are discouraged from listing. These factors should support future rent growth for single-family rentals as the gap between rent and ownership costs nears record levels.

Consequently, tenant demand for scattered-site single-family rentals and build-for-rent remains strong, with fundamentals supported by demographics, limited supply, and challenged affordability, particularly in the for-purchase market. Capital markets have to-date been supported by growing institutional interest in the space, though upward pressure on cap rates remains evident in the single-family rental sector as well.

Private debt

The decline in bank lending activity has had a large impact on the single-family rental debt market. Developers and institutional investors who own non-stabilized properties now often must seek debt fund capital for their financing needs, which greatly increases their cost of funds. For stabilized single-family rental properties, Fannie Mae and Freddie Mac remain the dominant lenders in the market.

REITs

The single-family rental sector meaningfully outperformed the REIT index thus far in 2023 as it continues to benefit from favorable affordability relative to the single-family-for-purchase market. Higher mortgage rates/rising cost of homeownership, tight supply, and accelerating demographic growth are supporting single-family rental landlords' high occupancy, strong pricing power, and low turnover.

Recent operational updates from the REITs have been positive and highlighted continued strength in fundamentals, particularly relative to multifamily. Additionally, prior concerns regarding property taxes and other expense items are viewed as manageable and are now better understood. Single-family rental REITs are trading at high-single-digit discounts to consensus NAV estimates, in line with the index.

DATA CENTERS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	→	↑	↑	↘	↗	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

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Private equity

Demand within the sector remains white hot with the North American market experiencing a 32.9% increase in commissioned megawatt hours (MWH) on a year-over-year basis, according to datacenterHawk. Demand in Northern Virginia and Phoenix alone accounted for over half of all data center net absorption over the past 12 months, with the Dallas-Fort Worth, Chicago, Atlanta, and Salt Lake City markets also seeing year-over-year growth in excess of 25%. The largest demand drivers include the continuing growth of the cloud and the recent fervor around artificial intelligence (AI), as users begin to deploy space for the training and use of the latest AI models.

On the supply side of the market, concerns and uncertainty continue to cloud the outlook. The vacancy rate is now 3.34% and much of that space continues to be in small blocks under 5 MW, leaving little space for larger deployments, which tenants are looking for in the market today. Pricing and rental growth continue to remain strong, driven by the supply and demand fundamentals. Capital markets continue to be challenged by interest rate volatility.

Private debt

Private debt capital remains available for data center properties with long-term leases to investment grade tenants. The very large loan sizes associated with the property sector means that borrowers typically need to work with investment banks to arrange that financing. Funding terms and pricing are quite lender-friendly today.

REITs

Data center REITs have outperformed the broader index year-to-date, driven by an optimism that AI will provide significant tailwinds for the sector. Fundamentally, demand and supply in many key markets continue to look more favorable, which has provided an uplift to both rents and pricing. This is evidenced in REIT financial results for in-place portfolios as well as new leasing.

Thematically, the stocks have particularly benefited from the positive market narrative around AI brought to the spotlight by impressive financial updates since May, and are further reinforced by positive channel checks indicating incremental data center capacity requirements. From a valuation perspective, data center REITs valuation multiples have been expanding year-to-date with the property type trading at premiums to NAVs and relative to other property types.

STUDENT HOUSING

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	↘	↑	↗	↘	NA	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Tenant demand is robust and leasing for the 2023-2024 school year outperformed expectations for both occupancy and rate. Tenant demand and rent increases may now be positioned to outperform traditional apartments over the near-term horizon.

Despite strong fundamental performance, the student housing sector has not been immune to capital market headwinds. Higher interest rates and borrowing costs have forced many investors to the sidelines. Transaction volume through August totaled just $2.5 billion, representing a decline of 86% over the same period in 2022. We anticipate the same headwinds affecting other sectors to continue to affect capital flows toward the sector until investors have more clarity on the direction of interest rates.

LIFE SCIENCES

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↘	↘	→	↗	↘	↓	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Private equity

Life sciences has seen both capital market and space market fundamentals pull back in 2023. Venture capital funding, a key source of growth for life sciences companies, has become much scarcer during the year. As a result, tenant demand has moderated considerably for lab space, even in top life sciences markets like Boston and San Francisco.

The lack of available debt capital has also impacted the sector's performance. Lender appetite for life science construction has especially slowed in 2023, putting many planned projects on hold due to economics that no longer pencil.

Long term, fundamentals are likely to be most resilient in the education-centric key life sciences clusters of Boston-Cambridge, the Bay Area, the Raleigh-Durham Research Triangle, the Baltimore-D.C. corridor, and San Diego. We continue to believe that life sciences will remain a favorable sector with investors.

Private debt

Increased supply of life sciences space paired with slowing demand has reduced lender appetite for the sector over the past year. Certain insurance companies and CMBS lenders continue to pursue life sciences property financing on a conservative basis but are focusing heavily on weighted average remaining lease terms and business plans for the properties. Mortgage capital has clearly become scarcer for the property sector.

REITs

Life sciences focused REITs underperformed broader index year-to-date, primarily due to supply concerns in many key markets. The amount of space under construction, in planning, or available in the sublease market has caused consternation, particularly as leasing activity and NOI growth have softened relative to last year.

A slower demand environment appears at least partially impacted by incremental concerns surrounding the underlying tenant funding backdrop, as venture capital funds have been more sluggish in capital deployment and tenant IPO activity has also remained light. Additionally, as it relates to valuations, REITs with high life sciences exposure have seen meaningful contraction in valuation multiples and the respective stocks are trading at meaningful discounts to NAV.

CMBS

Life sciences properties represent a bright spot in the CMBS office landscape and have risen in prevalence, especially in the SASB market. Investors are currently requiring elevated risk premiums to compensate for anticipated office stress. While downside scenarios are concerning, risk-adjusted returns look attractive in select situations where market credit assumptions seem overly conservative.

Risk considerations

Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate.

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