Aegon Asset Management

Real Assets Research
Fall 2023

AEGON **INSIGHTS**

US CRE Market Insights

Executive summary

The US Federal Open Market Committee (FOMC) continues to take a cautious approach with interest rate decisions in hopes that inflation will remain on a downward trend towards their 2% goal. The sharp rise in interest rates over the last year, coupled with tighter lending conditions and economic uncertainty continue to take their toll on transaction volume. However, Aegon AM and most others agree that if a recession were to occur, it would be mild.[1]

The commercial real estate (CRE) debt market remains relatively subdued. Life insurance companies and other non-bank lenders remain interested in commercial mortgage loans (CMLs) but remain cautious with their allocations. Borrowers continue to favor shorter-term loans with interest-only options and flexible prepayment terms. Life insurance companies and other non-bank lenders looking to deploy capital should be well positioned as borrowers seek alternative sources resulting from any pullback in bank lending activities.

We believe it is unlikely we have seen the full impact of repricing on the appraisal-based NCREIF Property Index. The impact of tightening monetary policy continues to affect property performance in most sectors.

Content

Property sector outlook

	2Q 2023 total return	Under construction as % of inventory	2Q 2023 vacancy rate	2Q.2022 vacancy rate	2Q 2023 YoY rent growth	2Q 2022 YoY rent growth	Aegon AM Real Assets sector outlook
Apartment	-5.1%	5.6%	6.9%	5.3%	1.2%	8.9%	Neutral
Industrial	-4.0%	3.3%	4.6%	3.8%	9.0%	11.6%	Neutral
Office	-14.5%	1.4%	13.1%	12.1%	0.8%	1.4%	Most cautious
Retail	-0.9%	0.5%	4.2%	4.4%	3.8%	4.3%	Cautious

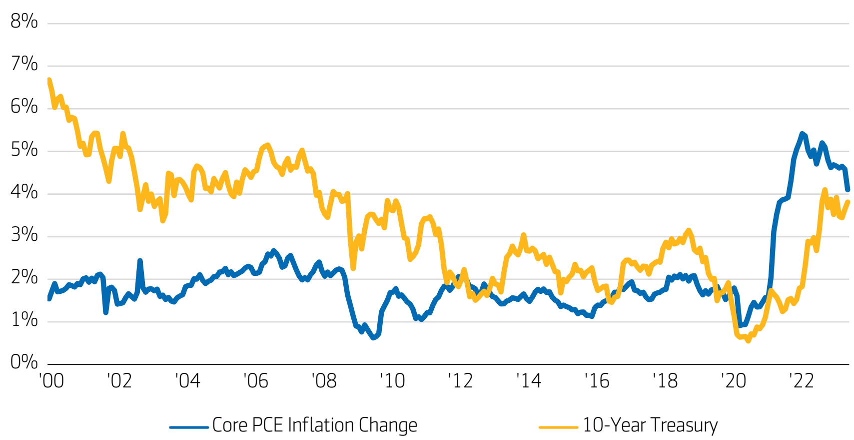
Sources: National Council of Real Estate Investment Fiduciaries, CoStar Realty Information Inc., and Aegon AM Real Assets US. As of June 30, 2023.

Economic outlook

The FOMC agreed to hold interest rates steady in September at a target range of 5.25%-5.50% after a 25 bps hike in July. Inflation as measured by Core Personal Consumption Expenditures continued to moderate, but Fed officials stressed that more evidence of progress is needed to be confident that inflation will remain on a downward trend to the 2% range.[1] A slowdown in monetary tightening allows the FOMC to evaluate the cumulative impact of their policy decisions thus far, and more than half of US Federal Reserve (Fed) officials expect one additional quarter point increases by year end.[2]

We believe a more stable outlook of interest rates will help CRE investors get a better handle on their cost of capital and bring some relief to the tight credit market.

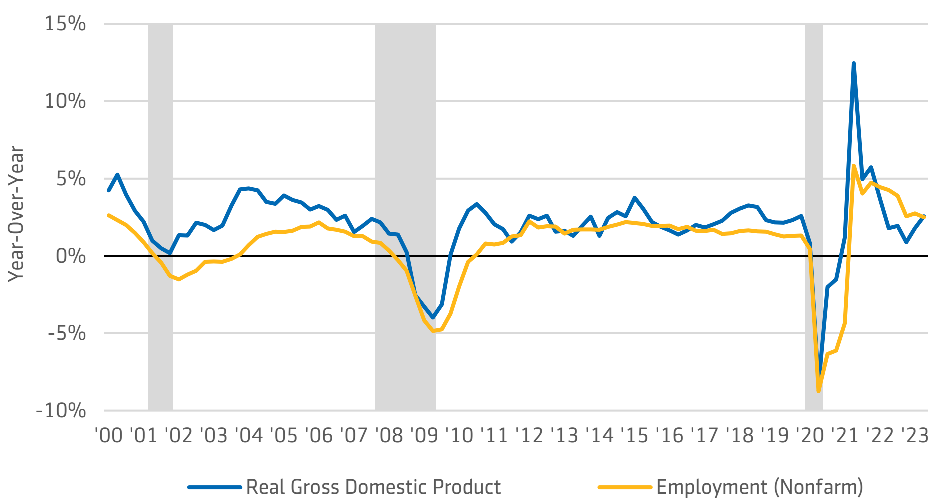
Core personal consumption expenditures (PCE) eases but remains above Fed's 2% target



Sources: US Bureau of Economic Analysis, as of May 31, 2023, and US Department of Treasury as of June 30, 2023.

Despite tightening monetary policy, the labor market remained strong in 2Q 2023 although signs of softening are starting to emerge. Nonfarm payrolls increased a less than expected 187,000 jobs in April, and the unemployment rate remained near a historic low at 3.5%.[3] Job openings continue to cool but are still well above long-term trends. The quit rate and rate of hiring have normalized to pre-pandemic levels.

The US economy grew at a faster-than-expected pace though the labor market is easing



Sources: US Bureau of Labor Statistics as of May 31, 2023. Bureau of Economic Analysis as of April 1, 2023. Employment figures reflect private and government non-farm jobs. Shaded areas indicate US recessions.

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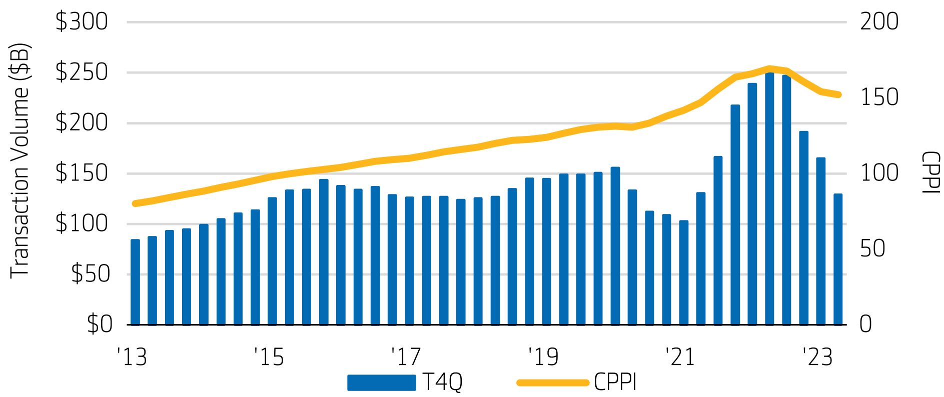
The sharp rise in interest rates over the last year, coupled with tighter lending conditions and economic uncertainty continue to take their toll on transaction volume. Transaction volume for the second quarter ended at $84 billion, a 63% decline from a year ago, and the lowest level since 4Q 2022.

Economic uncertainty continues to take its toll on transaction volume



Sources: Aegon Real Assets US and. Real Capital Analytics. As of June 30, 2023

The decline in transaction volume was observed through all property sectors with apartment seeing the most significant decline at 72%.[4]

Transaction volume by property type

	2Q 23	2Q 22	YoY changes
All Office	**$12.5 B**	**$30 B**	**-58.4%**
CBD	$4.4 B	$7.5 B	-41.0%
Suburban	$8.1 B	$22.6 B	-64.2%
All Industrial	**$22.3 B**	**$42.5 B**	**-47.4%**
Flex	$3.4 B	$7.8 B	-55.8%
Warehouse	$18.9 B	$34.7 B	-45.6%
All Apartment	**$28.2 B**	**$100.2 B**	**-71.8%**
Garden	$16.7 B	$67.7 B	-75.3%
Mid/Highrise	$11.5 B	$32.4 B	-64.5%
All Retail	**$9.5 B**	**$28.2 B**	**-66.2%**
Strip Center	$5.8 B	$19.9 B	-71.0%
Mall & Other	$3.7 B	$8.3 B	-54.9%

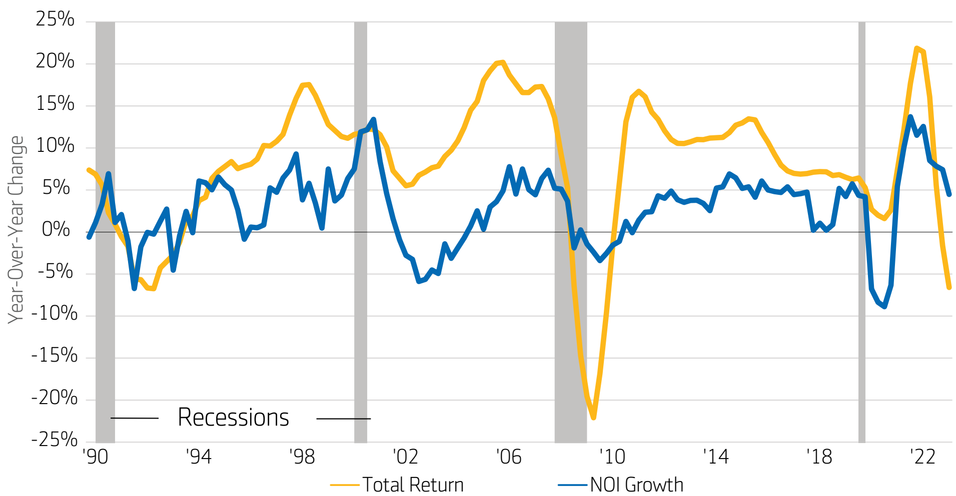
Source: MSCI Real Capital Analytics. As of June 30, 2023.

Real estate equity

The trailing one-year return for the NCREIF National Property Index (NPI), a measure of unleveraged returns, was -6.6% in the second quarter of 2023 compared to 21.5% a year ago. Capital appreciation was reported as -10.3%, with income return at 4.0%.[5]

ODCE's diversified core properties typically reflect lower-risk CRE with relatively low leverage.[5]

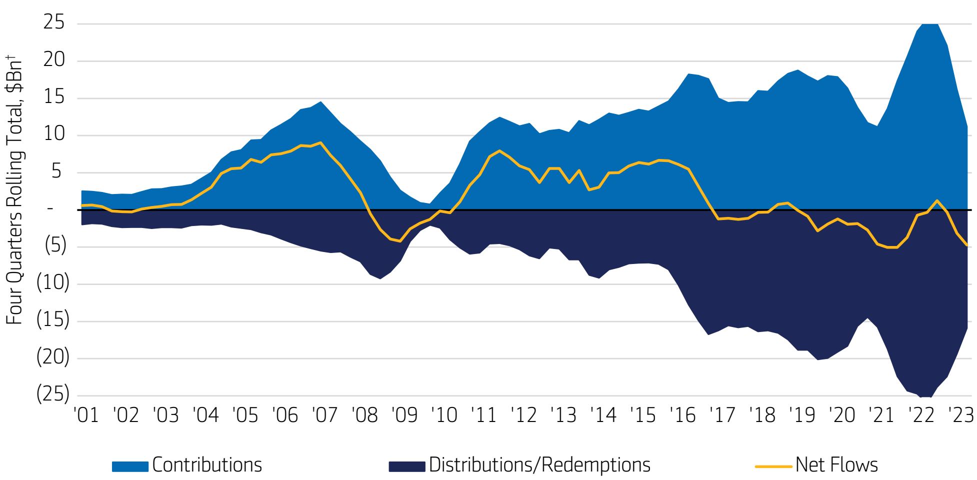
NCREIF property index shows unlevered core real estate total return continues to decline



Source: NCREIF Property Index Detail Report as of June 30, 2023. **Shaded areas indicate US recessions.**

During the second quarter of 2023, NFI-ODCE investor's distributions and redemptions exceeded contribution by 201%. Net flows for 2Q 2023 dropped even further to -$2.45 billion.[5]

NFI-ODCE investor cash flow trends



† The Open End Diversified Core Equity (NFI-ODCE) fund index is a capitalization-weighted index based on each fund's Net Invested Capital, which is defined as Beginning Market Value Net Assets (BMV), adjusted for Weighted Cash Flows (WCF) during the period. Source: NCREIF. As of June 30, 2023.

The NCREIF Fund Index for Open-ended Diversified Core Equity (NFI-ODCE) returned 10.0% gross of fees (-11% net) and inclusive of leverage over the past four quarters spanning from 2Q 2022 to 2Q 2023 with a -2.7% gross (-2.9% net) return in the second quarter separately. Over the last 10 years, the NFI-ODCE averaged a 7.5% gross (6.5% net) annual return.

Retail property performance outpaced other sectors with a -0.9% total return for the second quarter of 2023. At the other end of the spectrum, office property returns remained the lowest, totaling -14.5% for the second quarter.[5]

Within property sectors, subtypes continue to show broad dispersion in performance. The range is particularly wide in the office sectors where there is a 6.8% difference in the second quarter's returns between central business district (CBD) and suburban office properties.[5]

Property sector subtypes continued to show broad dispersion in performance

Trailing four quarter return by sub property type (%)			
	2Q 23	2Q 22	YoY changes
NPI	**-6.6%**	**21.5%**	**-28.0%**
All Apartment	**-5.1%**	**24.4%**	**-29.5%**
Garden	-3.6%	32.8%	-36.3%
Highrise	-6.2%	20.2%	-26.4%
Lowrise	-3.9%	25.2%	-29.1%
All Office	**-14.5%**	**5.8%**	**-20.4%**
CBD	-17.6%	3.0%	-20.6%
Suburban	-10.8%	9.6%	-20.4%
All Industrial	**-4.0%**	**47.7%**	**-51.7%**
R&D	-0.1%	28.2%	-28.3%
Flex	-2.5%	43.8%	-46.3%
Warehouse	-3.6%	47.9%	-51.5%
Other	0.2%	49.3%	-49.2%
All Retail	**-0.9%**	**7.9%**	**-8.8%**
Community	1.0%	12.1%	-11.1%
Neighborhood	0.0%	10.5%	-10.5%
Power Center	1.2%	11.0%	-9.7%
Regional	-3.6%	3.0%	-6.6%
Super Regional	-1.7%	6.8%	-8.5%

Source: NCREIF Property Index Detail Report. As of June 30, 2023. Trend is the year-over-year change of sub property type trailing four quarter return. **Past performance is not indicative of future results.**

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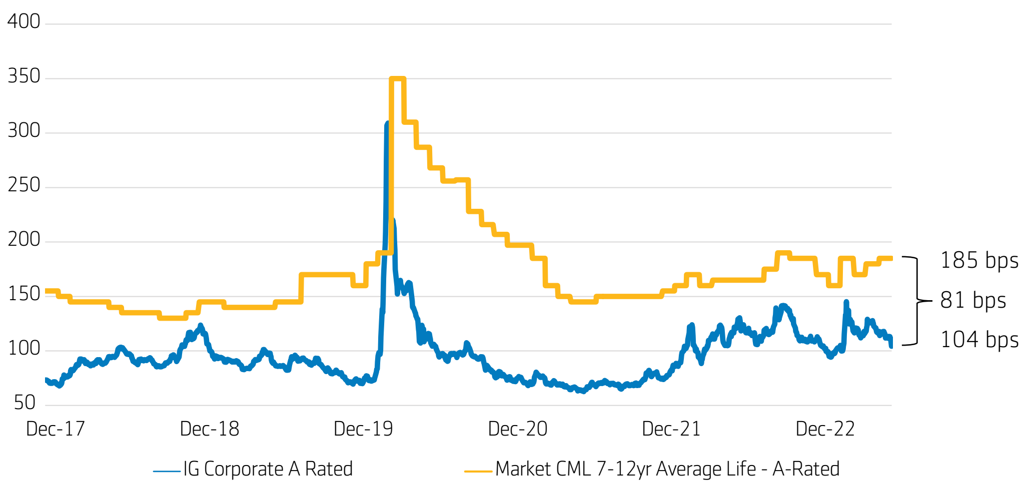
Real estate debt

Banks continue to tighten their lending standards under increasing regulatory and risk control pressures. Life company lending standards are holding for the time being as borrowers continue to seek shorter loan terms, interest-only options, and flexible prepayment during the last 12-24 months of the loan term. Nevertheless, higher interest rates have had a significant impact on debt service, causing lenders to offer lower loan proceeds to maintain a healthy debt coverage ratio.

Domestic banks continue to tighten lending standards for CRE loans

Source: Board of Governors of the Federal Reserve System (US) as of June 30, 2023.

CMLs continue to offer a spread advantage over investment grade corporate bonds January 2018-July 2023

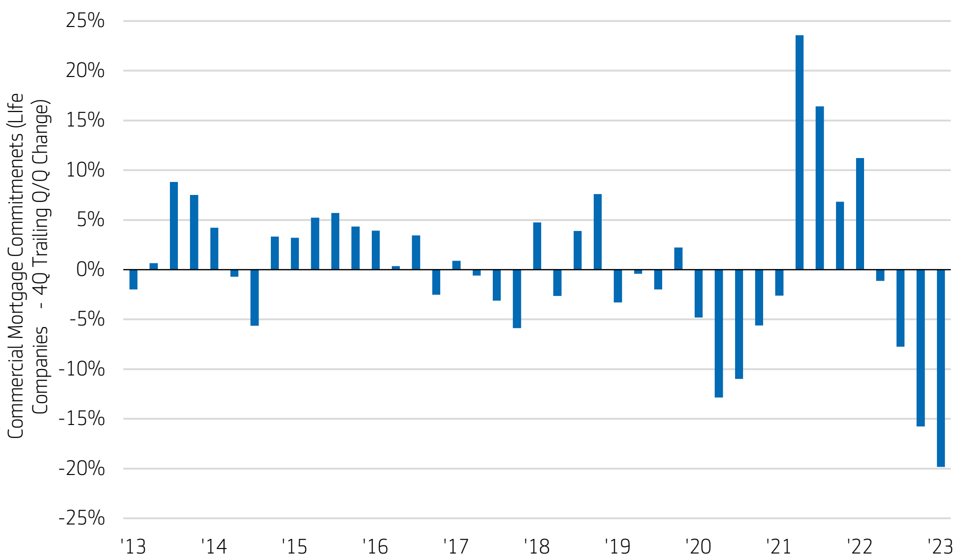


Sources: Corporate Bonds – Bloomberg Barclays. Aegon Real Assets US Commercial Mortgage Mark-to-Market Matrix - A Internal rating using Proprietary CML pricing matrix, developed, and maintained by Aegon Real Assets US as of July 31, 2023. **Past performance is not indicative of future results.**

The CRE debt market remains relatively subdued. Although life insurance companies still exhibit a strong interest in CMLs, some are focused on relative value and only lend when CML opportunities meet certain hurdles compared to corporate bonds. Others are bracing for potential refinance difficulties with existing office loans within their portfolios. Additionally, some have lent extensively in the floating-rate market over the past few years and are now managing their exposure in that sector.

We believe current market conditions create an opportunity for a successful allocation to mortgages with a flexible-duration profile in the three-to-eight-year range.

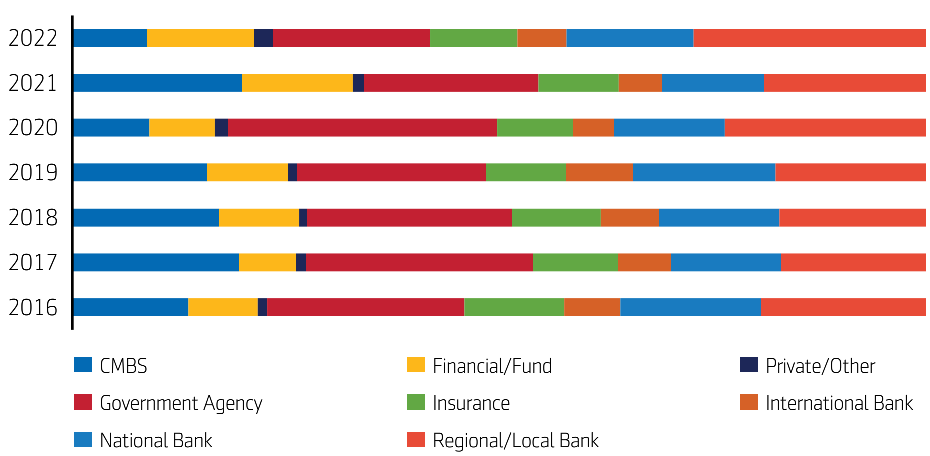
Commercial mortgage commitments (life companies)



Source: American Council of Life Insurers (ACLI) as of March 31, 2023.

Life insurance companies and other non-bank lenders looking to deploy capital should be well positioned as borrowers seek alternative sources resulting from any pullback in bank lending activities.

Lender composition



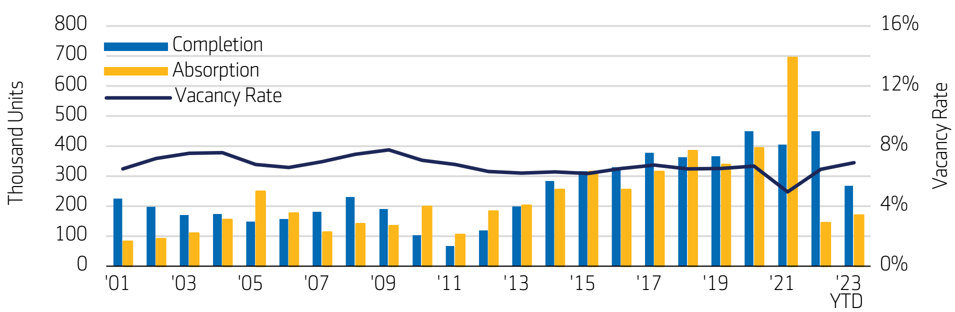
Sources: Real Capital Analytics – US Capital Trends Report, December 31, 2022.

Sector overview

Apartment

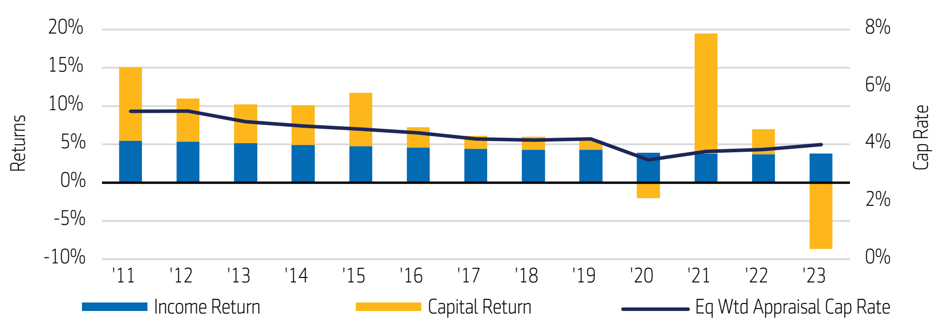
- The apartment sector continues to be challenged by near-term supply headwinds, but long-term fundamentals remain solid. Absorption in 2Q 2023 improved to the highest level since 3Q 2021. However, these absorption rates still fell short of the number of units delivered, a pattern consistent over the last six quarters. As a result, the vacancy rate increased slightly to 6.9% while rent growth moderated to 1.2% compared to last year.[6]
- Construction delays could provide some relief to the record amount of supply with 90% of apartment constructions reporting delays, but new deliveries are not expected to slow until mid-year 2024.[6]
- Longer-term apartment fundamentals continue to be supported by demographic advantages, necessity of housing, and low homeownership affordability. In addition, despite a record amount of new supply in apartments, the United States continues to face a housing shortage especially in affordable housing. As a result, we believe medium-quality apartments remain an investment sweet spot underpinned by relatively modest supply and renter-by-necessity demand.

Apartment sector vacancy rate continues to rise with near-term supply headwinds outpacing demand



Source: CoStar Realty Information Inc., annual data as of June 30, 2023. Current year returns reflect trailing 4-quarter average.

Apartment performance (2Q 2023)



Source: NCREIF Property Index (unlevered) - Equal weighted appraisal cap rate as of year-end or most recent in current year, current year returns reflect trailing 4-quarter average, as of June 30, 2023. Past performance is not indicative of future results.

Vacancy Rate[6]

▲ 6.9%

Rent Growth[6]

▼ 1.2%

Total Return[5]

▼ -5.1%

Outlook

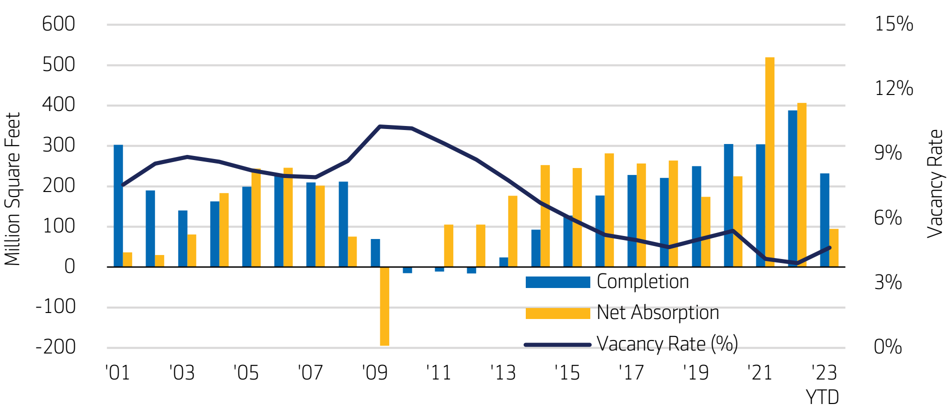
Neutral

Arrows indicate change from previous quarter.

Industrial

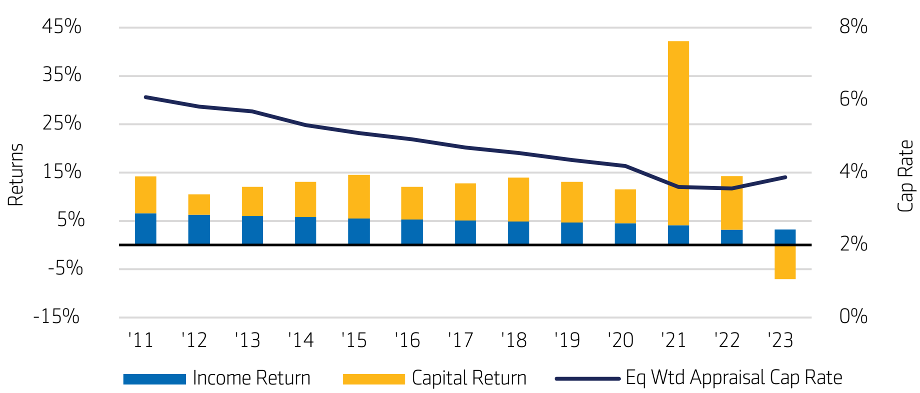
- Record low level of space availability during the pandemic has allowed the industrial market to remain relatively tight as of June 30, 2023. The vacancy rate ended the second quarter at 4.6%, below the 10-year average of 5.1%. Rent growth continued to normalize with a year-over-year change of 9.0%.[6]
- Although, the supply pipeline for industrial properties is expected to remain elevated through the first half of 2024, and net absorption so far this year has remained positive. Oncoming new supply is expected to drop substantially towards the end of 2024, as higher interest rates have caused developers to pull back on starting new projects. However, tenants are adopting a more cautious approach as economic activity slows, though e-commerce activities have been resilient to date.
- We expect the industrial market performance to continue normalize towards pre-pandemic levels.

Industrial sector vacancy remains relatively tight despite supply outpacing demand



Source: CoStar Realty Information Inc., annual data as of June 30, 2023. Current year returns reflect trailing 4-quarter average.

Industrial performance (2Q 2023)



Source: NCREIF Property Index (unlevered) - Equal weighted appraisal cap rate as of year-end or most recent in current year, current year returns reflect trailing 4-quarter, as of June 30, 2023. **Past performance is not indicative of future results.**

Vacancy Rate[6]

▲ 4.6%

Rent Growth[6]

▼ 9.0%

Total Return[5]

▼ -4.0%

Outlook

Neutral

Arrows indicate change from previous quarter.

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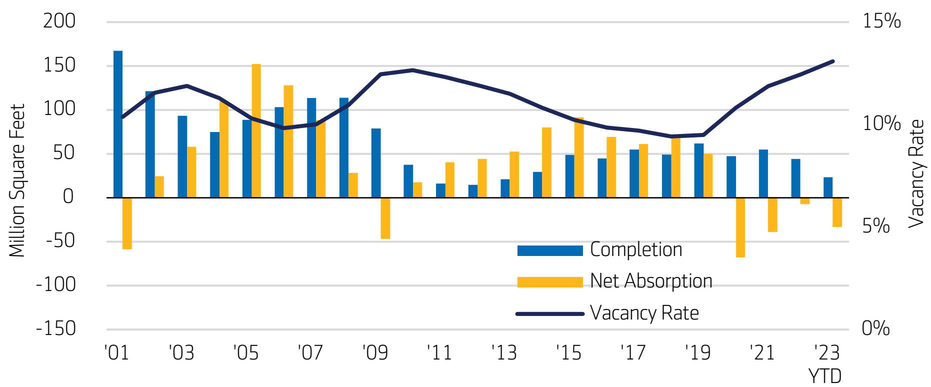
Office

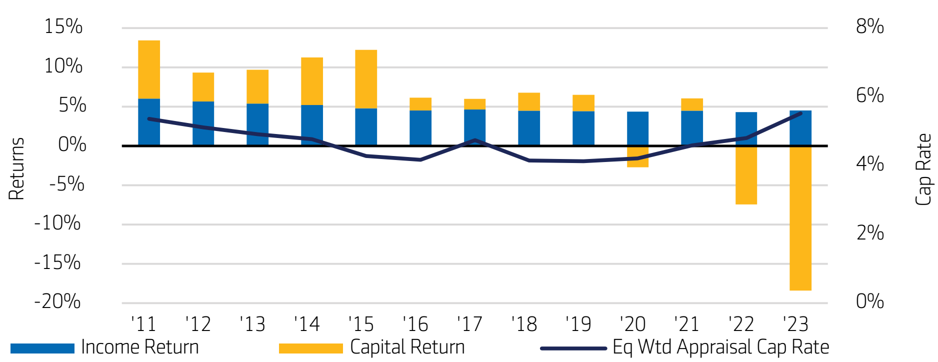
- The office sector will likely remain in a stagnant state through the end of 2023 amid an uncertain economic landscape and evolving post-pandemic work arrangements. With the sharp rise in interest rates, many tenants in the office sector are deferring leasing decisions until office space needs are clear and certainties in the current economy are set in place. Soft demand in the office sector continues to gradually increase vacancy rates throughout most of the largest metro areas, resulting in a historically high national vacancy rate of 13.1%.[6]
- The sector is additionally burdened by maturing debt, compelling property owners and lenders to assess the viability of less competitive properties, given the allure of newer and higher-quality options for tenants.
- Recovery in the office sector hinges on corporations' need for office space with an expanding remote/hybrid workforce, in conjunction with a stabilized economic environment. Until such conditions materialize, the sector's challenges are expected to endure.

Office sector vacancy rate continues to rise with no signs of easing



Source: CoStar Realty Information Inc., annual data as of June 30, 2023. Current year returns reflect trailing 4-quarter average.

Office performance (2Q 2023)



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Vacancy Rate[6]

▲ 13.1%

Rent Growth[6]

▼ 0.8%

Total Return[5]

▼ -14.5%

Outlook

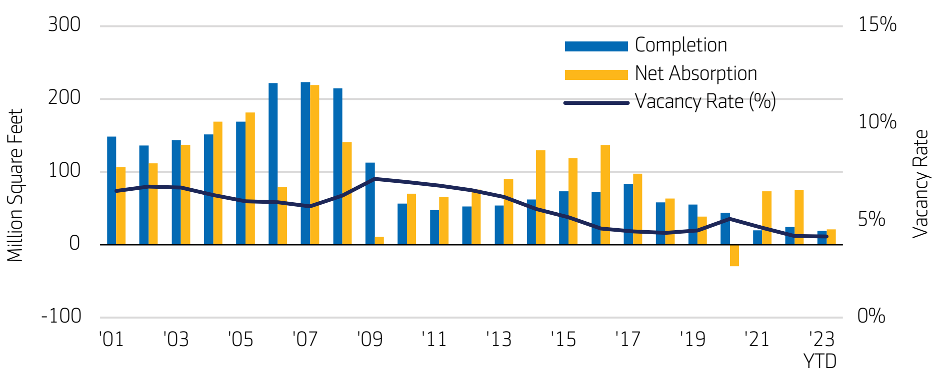
Most Cautious

Arrows indicate change from previous quarter.

Retail

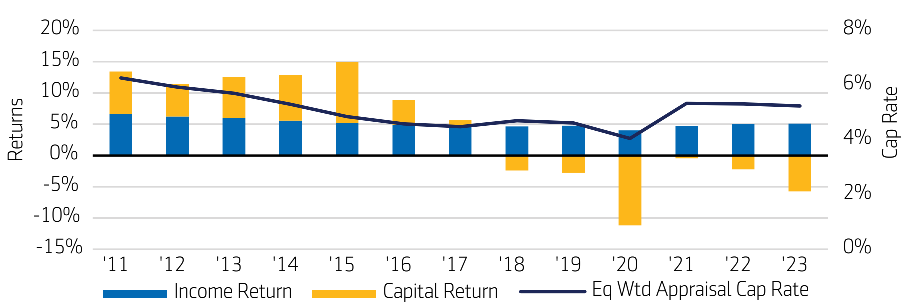
- We believe the retail sector remains well positioned to weather a potential recession. In 2Q 2023, the vacancy rate declined to the tightest level ever recorded at 4.2% while rent growth registered a solid 3.3% for the past year.[6]
- Strong consumer spending, supported by excess personal savings and a resilient labor market continues to benefit the sector. As a result, demand for retail space rose through the first half of 2023, with many tenants reporting having difficulty finding available spaces in desirable locations. While demand for space continues to rise, new retail development remains minimal.
- The rise in construction financing costs coupled with record-high material and labor costs continues to challenge the viability of new construction in most markets. In addition, developers have been shying away from retail projects since the Great Financial Crisis as the sector was overbuilt together with the secular shift towards online shopping.
- Grocery-anchored and necessity-based retail remains the most preferred retail subsector.
- We expect the retail market to remain balanced despite an increasing challenging economy.

Retail fundamentals remain solid with minimal supply pressure



Source: CoStar Reality Information Inc., annual data as of June 30, 2023. Current year returns reflect trailing 4-quarter average.

Retail performance (2Q 2023)



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Vacancy Rate[6]

▲ 4.2%

Rent Growth[6]

▼ 3.8%

Total Return[5]

▼ -0.9%

Outlook

Cautious

Arrows indicate change from previous quarter.

Asset Management

1 Wolters Kluwer. Blue Chip Economic Indicators. July 10, 2023
2 Board of Governors of the Federal Reserve System. September 20, 2023
3 US Bureau of Labor Statistics. Consumer Price Index. May 31, 2023
4 MSCI Real Capital Analytics. August 23, 2023
5 National Council of Real Estate Investment Fiduciaries. June 30, 2023
6 CoStar Realty Information, Inc. June 30, 2023

Disclosures

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