Mercer

welcome to brighter

Is now the time to re-enter open-end real estate?

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Introduction

Real estate (as it refers to physical properties and assets) is a critical foundation of the global economy for both businesses and consumers. For investors, the inherent scarcity of real estate provides a natural value that is independent of inflation, thus providing an inflation hedge. Further, real estate provides income to equity owners, with the ability to benefit from capital appreciation through improvement of the assets. While the Real Estate Sector ("Real Estate" or the "Sector") has been a challenged asset class in recent years, we are optimistic the next 6 to 12 months will be a pivotal time and could offer potentially significant upside for investors allocating to the space while further diversifying an investment portfolio.

In this paper, we will discuss the recent challenges for real estate, optimism for the asset class and why we believe now may be the time to invest in the Sector, particularly in open-end real estate.

Open-end real estate funds are perpetual-life funds that tend to consist of core or core-plus strategies. These strategies focus on stable, income-producing properties that offer a low level of risk alongside the potential for appreciation. Additionally, open-end funds are semi-liquid, allowing investors to enter and exit the fund throughout the vehicle's life. This paper specifically focuses on the private open-end real estate equity market.

Recent challenges

Recent challenges in the sector have been driven by rising interest rates and declining valuations, as well as prominent headlines against office investments.

Office headlines

The office sector is facing headwinds; falling occupancy rates have put pressure on property cash flows, which has led to refinancing challenges across the sector. While headlines in the Real Estate Sector have been quick to proclaim the downfall of the office, investors should be mindful that not all office is bad, and there is hope for stability and strong fundamentals in certain segments of the sector going forward. Office has particularly taken the brunt of recent write-downs, primarily driven by new hybrid work settings, causing employers to rethink their office space and leasing needs following the COVID lockdowns. However, physical office space still plays a vital role in corporate America, and employers are prioritizing higher-quality office space to entice their employees into returning to the office. As such, a significant bifurcation between older, traditional office assets and newer, more amenitized buildings has emerged (the "flight to quality"). The high-quality office assets are experiencing stronger leasing demand from tenants and display promising fundamentals for future investments. That being said, we believe investors should retain an underweight allocation to office assets, as there are more compelling investment opportunities in the asset class. Our high-conviction investment managers have been actively pruning their office portfolios, selling down their overall exposure, while retaining a small allocation to newer, high-quality office assets.

Rising rates and declining valuations

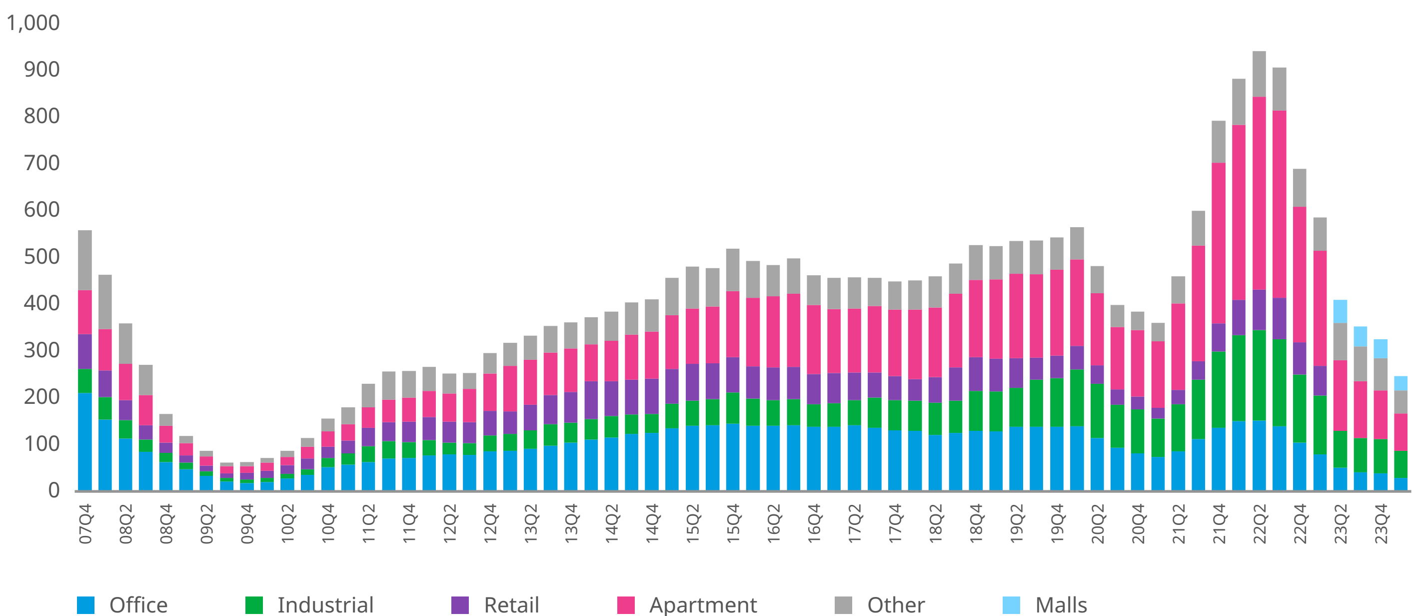
Property valuations declined over the 18 months ending December 2023, after hitting their peak in March 2022. In aggregate, as measured by Green Street's Commercial Property Price Index,[1] prices are down 21% from their March 2022 peak. This decline can be attributed to several factors, including monetary policy, limited transaction data and broader economic factors. While the value declines are widespread across all property types, office assets have seen the sharpest fall, down 37% since March 2022.

The aggressive fiscal tightening that occurred in the previous two years has been the primary driver of price declines. Higher interest rates increased borrowing costs, muting the transaction market. Fourth quarter 2023 transaction volumes were down approximately 60% year-over-year and 35% quarter-over-quarter, with overall 2023 transaction volumes ending well below long-term averages.[2]

The limited number of sales and transactions has made it challenging for appraisers to find accurate comparable properties to determine the true market value of a property. Additionally, economic factors such as slower economic growth, geopolitical uncertainties and changes in market sentiment can also impact property values. These factors can affect investor confidence and lead to a decrease in demand for real estate assets.

The expectation of upcoming interest rate cuts suggests rates have likely peaked after the aggressive monetary tightening of the last two years. As confidence builds around pricing, alongside the Fed's guidance on potential rate cuts by the end of 2024, we believe valuations are close to reaching a bottom and expect to begin moving out of the valuation trough late in 2024 or early 2025. Additionally, with expected downward policy rate movements over the next 6 to 12 months, borrowing costs are expected to fall, encouraging a more active transaction market which will further support overall pricing.

US: Annual investment volumes — USD billions



The case for open-end real estate

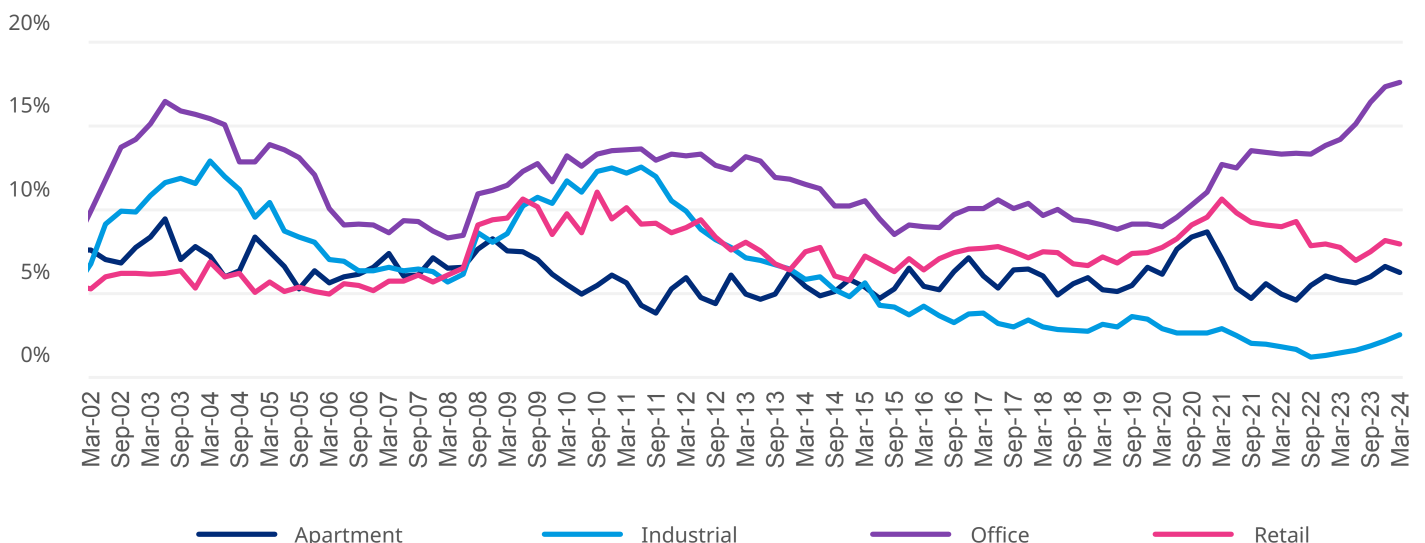
Demand drivers

While there has been recent volatility in returns due to the asset repricing, apart from office, underlying fundamentals for the Sector remain healthy. Vacancies remain in line with long-term averages, indicating continued resiliency and stable demand.

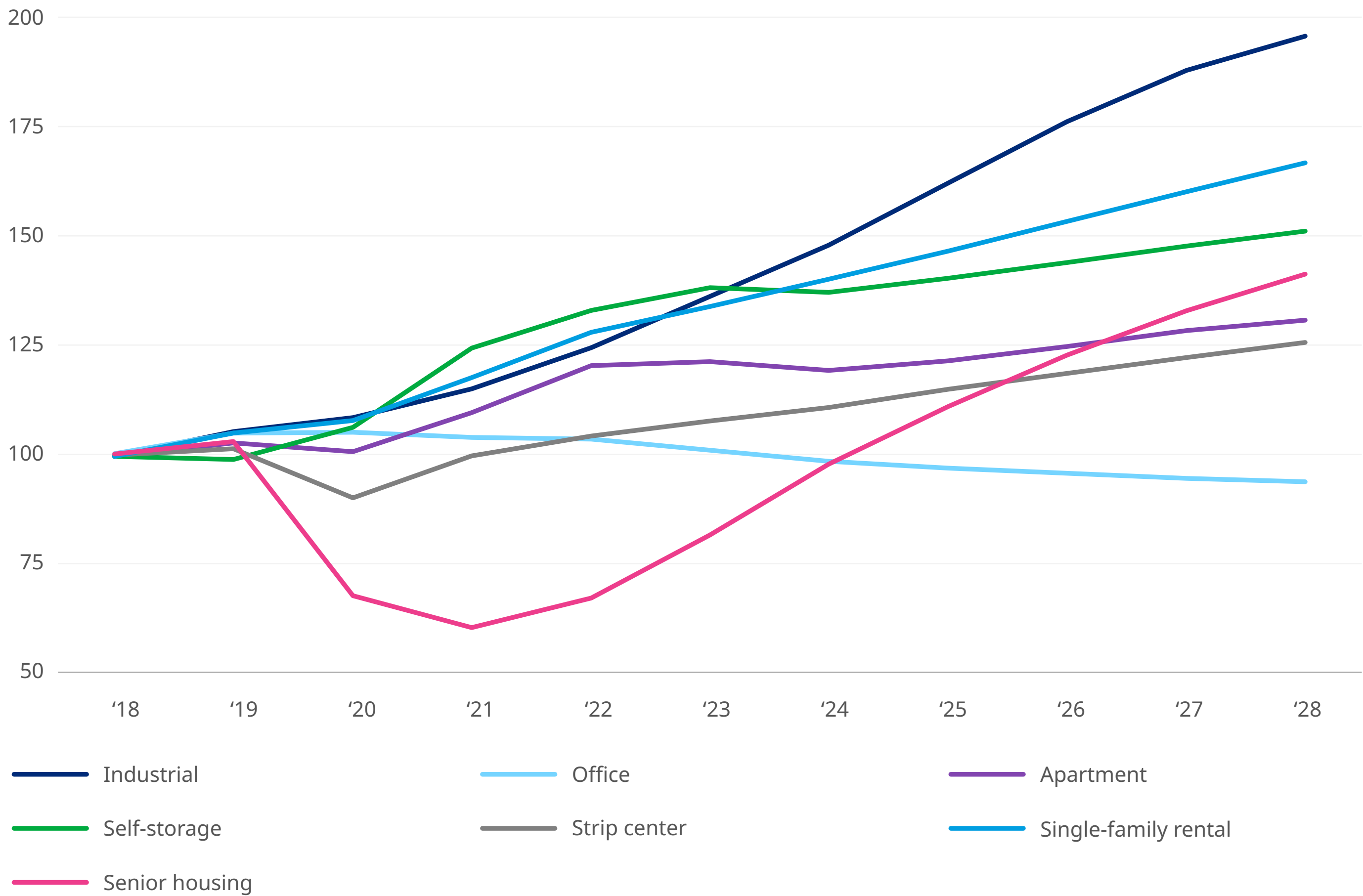
While retail had previously received a lot of negative press due to the demise of regional shopping malls, over the last couple of years the sector (excluding enclosed malls) has seen an investment resurgence — in particular with necessity-based retailing. Grocery-anchored retail remains a strong performer and continues to provide stable income for many portfolios. Although retail is generally a more cyclical sector, centers with essential and value-oriented retail tenants are expected to provide attractive income and overall performance.

In light of the weakened fundamentals for traditional office and mall retail, our high-conviction managers have proactively moved their portfolios toward overweight positions in the industrial and multifamily sectors. Demand for industrial space remains very strong, with vacancy rates reaching all-time lows for the sector. E-commerce growth continues to drive the demand for industrial assets, aiding in the strong fundamentals for the property type. Additionally, as the cost of home-buying continues to rise, alongside a national housing shortage, demand for multifamily remains strong and allows for continued rent increases.

NCREIF NFI-ODCE vacancy by sector



Source: NCREIF NFI-ODCE. Data as of Mar 2024



Source: Green Street, as of 31 Dec 2023

Overall Net Operating Income (NOI) growth has a forecasted upward trajectory across all property types, with the exception of office. This continued NOI growth will further bolster future returns for real estate.[3] This, coupled with an attractive pricing entry point, may offer higher income returns going forward.

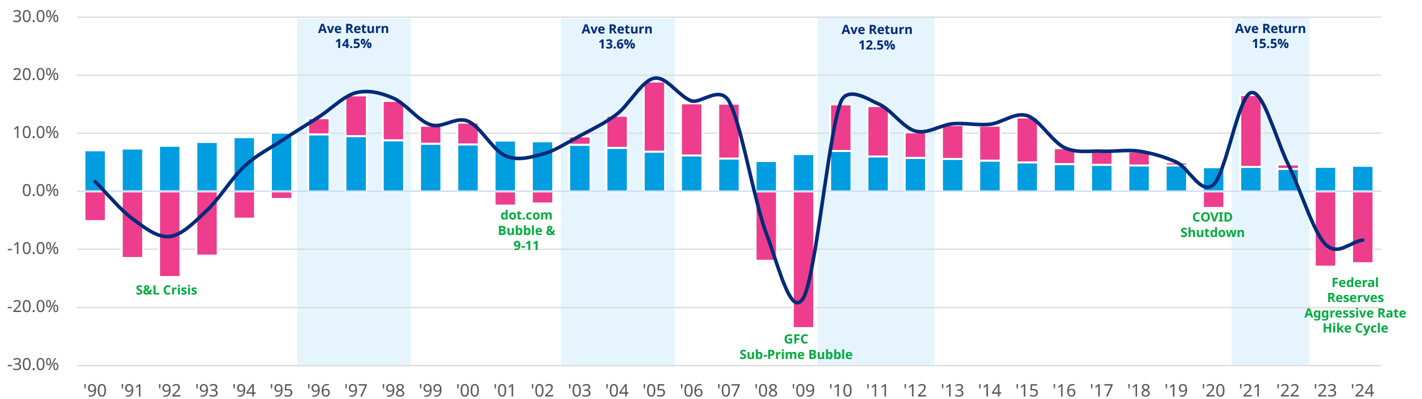
Technological and demographic trends continue to impact the nature of real estate, which has led the industry to reimagine and expand institutional investing. Our high-conviction managers are actively sourcing "extended sector" opportunities to aim to deliver strong returns at reduced risk. Investment focus will remain on next-generation logistics facilities, self-storage, life science labs and alternative housing (such as single-family-rental, manufactured housing) solutions.

Why now?

Property value corrections, historically, have reset the stage for extended periods of positive total return performance. In the open-end core real estate market, periods following economic downturns have produced outsized returns, ranging from 12.5% to 15.5%[4] (unlevered) for the NCREIF ODCE[5] funds. Long-term investors do not need to call the bottom and can be confident they will benefit from the outsized returns, regardless of their entry point around the trough. Regarding the last three downturns (early 1990s downturn, early 2000s tech crash, and the Global Financial Crisis), the NCREIF NFI-ODCE index delivered net returns ranging from 11.3% to 14.0% over the five-year period following investments made within the four quarters surrounding the true trough period.[6] While returns remain negative in the first quarter of 2024, we are beginning to see quarter-over-quarter improvement, possibly indicating the beginning of the upswing for future performance. To further reduce the risk of market timing, investors could also consider dollar cost averaging their commitments over several quarters.

	Early 1990s downturn			Global Financial Crisis			Tech crash	
	Quarter-end	Future 5-year return		Quarter-end	Future 5-year return		Quarter-end	Future 5-year return
	1995 Q2	11.92%		2009 Q3	11.34%		2002 Q1	12.68%
	1995 Q3	12.30%		2009 Q4	12.85%		2002 Q2	13.51%
Trough	1995 Q4	12.99%	Trough	2010 Q1	13.44%	Trough	2002 Q3	14.01%
	1996 Q1	12.97%		2010 Q2	13.33%		2002 Q4	14.01%
	1996 Q2	12.69%		2010 Q3	12.94%		2003 Q1	12.05%

NCREIF ODCE-NPI Annual unlevered returns for ODCE Funds



Source: NCREIF Property Index NPI-ODCE: Data through March 31, 2024. As reported 1Q 2024 ODCE unlevered returns published on April 25, 2024.

Nearly all open-end real estate funds have seen a rise in redemption queues — with many in excess of 15% of NAV as of December 31, 2023. Following the COVID lockdowns, volatility in the equity markets paired with significant property appreciation at the time caused many investors to become over-allocated to Real Estate, forcing them to rebalance by redeeming (the "denominator effect"). While the existing redemption queues were first a result of the denominator effect, they remain elevated due to investors' desire to withdraw capital to protect against further value declines. However, as witnessed during the Global Financial Crisis, once appraisals reflect true market value, lengthy exit queues will quickly shift to entry queues, which may span several quarters or years. Entry queues are already in place for some funds as they receive commitments, suggesting this shift from exit to entry queues is in process. As liquidity permits, we believe now may be the right time to invest in open-end real estate funds, ensuring investors get to the front of entry queues, capitalizing on the impending strong entry point in the Real Estate Sector.

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[1] Green Street, as of May 6, 2024
[2] Source: Green Street
[3] Source: Green Street, as of December 31, 2023
[4] NCREIF Property Index (NPI). Average annualized, unlevered returns for the Open-end Diversified Core Equity (ODCE) funds.
[5] NCREIF ODCE refers to NCREIF's open-end diversified core fund index.
[6] NCREIF NFI-ODCE net returns incorporate the impact of leverage, fund costs, and other ownership / fund vehicle structuring components.

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