

REO

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Real Estate Outlook – US



Finding liquidity in muddy waters.



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“US private real estate values are now correcting, and capital availability is at a cyclical low. Fundamentals are still expected to remain relatively healthy across the apartment, industrial, and retail sectors but the pricing of these sectors will impact total returns the most.”

Finding the bottom

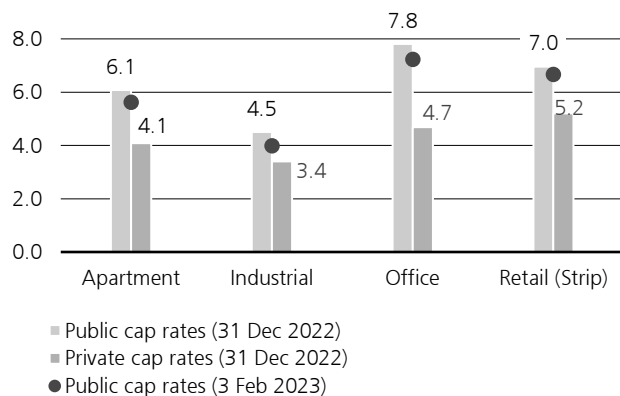
Private real estate values are now correcting, and capital availability is at a cyclical low. Heightened uncertainty around the cost of capital and minimal amounts of financing contribute to the scarcity of capital. 4Q22 transaction volume declined by 62% when compared to 4Q21, creating hardships for appraisers trying to use comparable sales to evidence price changes.

The lag in private real estate price correction has exacerbated the performance differential between public and private markets, creating a need for institutions to rebalance. Redemption pools are now common across most open-end investment vehicles, but without a reasonable ability to create liquidity.

All four of the traditional real estate sectors experienced negative total returns driven by depreciation during 4Q22 according to NCREIF’s ODCE performance attribution data set. Continued weakness in the office sector combined with hardships in refinancing contributed to the sector’s negative quarterly return of 5.7%, followed by apartment and industrial both returning -3.9%.

The higher priced sectors (i.e., lower cap rates) are impacted more severely by exit cap and discount rate increases. Conversely, the retail sector, which exhibited higher cap rates, had a total return of -1.0%. The public markets are a good indicator of directional pricing movements in the private sector but tend to overcorrect. The graph (see Figure 1) shows the gap in pricing between private and public real estate, but recent improvements in the equity markets since October 2022 are bringing public implied cap rates closer to private pricing.

Figure 1: Yield spreads (%)



Source: Green Street Advisors and Altus Databridge, as of 3 February 2023.
Note: Private cap rates are unlevered and appraised rates for ODCE properties. **Past performance is not a guarantee for future results.**

Bracing for headwinds

Figure 2: February US real estate return forecasts

Total return (%)	2020	2021	2022	3-year forecast
Apartment	1.8	19.9	7.1	4.8
Industrial	11.8	43.3	14.6	5.1
Office	1.6	6.1	(3.4)	4.6
Retail	(7.5)	4.2	2.7	5.2

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

Apartment

Apartment fundamentals continued to soften in 4Q22 (see Figure 2). The apartment sector delivered a total unlevered return of 7.1% in 2022 – a moderation from 2021's robust performance of 19.9%. Capital returns fell during the quarter by 4.1%, signaling that price corrections on the private side are catching up to the public markets.

A slower pace of job growth and hesitancy around the outlook of the economy discouraged new leases. Demand fell for the third consecutive quarter, while deliveries picked up and drove the occupancy rate down by 70bps over the quarter and 200bps over the year to 95.4%. Apartment rent declined by 0.8% QoQ, but was still 6.7% higher than a year ago. Transaction volume was reduced in 4Q22, down 36% from a quarter ago, and 70% from a year ago. We expect returns to moderate in 2023 before picking up again, as a cooling labor market and elevated interest rates weigh on returns.

Industrial

Tight market conditions kept industrial fundamentals solid amid a slowing economic backdrop. Availability increased 20bps over the quarter to 4.9% but remained 30bps below 4Q21 levels. Industrial rent rose 13.8% YoY in 4Q22, as low availability rates reinforced landlord's ability to push rents.

Despite solid fundamentals, volatility in the capital markets has weighed on returns. The sector's 2022 total unlevered returns moderated to 14.6%, as value declines during the fourth quarter dragged performance. Capital returns fell by 4.5% during 4Q22, breaking the sector's 13-year streak of appreciation. Transaction volume increased slightly by 5.3% over the quarter, but was 60% below 4Q21 levels. We anticipate a further moderation in returns in 2023, primarily driven by capital markets.

Office

The office sector struggled to maintain demand in 4Q22. Office utilization relative to pre-pandemic levels is at ca. 50%, and the sector faces additional headwinds from a cooling economy and volatile capital markets. Total annual unlevered returns for the sector fell by 3.4% in 2022, driven by further value declines during the fourth quarter.

Net absorption turned negative while the pace of new deliveries slowed in 4Q22. Office occupancy rates reached a 29-year record-setting trough of 82.7% during the quarter. We expect structural vacancy to be higher and demand for high-quality office buildings to persist as companies seek to attract workers back into the office while reducing their footprint. Our outlook supports the long-term average return forecast over the next three years.

Retail

Retail fundamentals ended 2022 on a solid note. Robust leasing activity surpassed new deliveries for the eighth consecutive quarter, boosting occupancy rates up by 20bps QoQ and 110bps YoY to 93.1%. Total unlevered returns moderated to 2.7% in 2022, but capital returns during 4Q22 were resilient relative to other property types. Values fell by just 2.9% during the quarter, partly because the sector already took a big hit in 2020 when capital returns fell by 11.2%. Additionally, the pandemic swept away the weakest retailers, which reduced the number of store closures and tenant bankruptcies in 2022. Transaction volumes remained slow in 4Q22, down 17% from a quarter ago and down 54% from a year ago. We expect retail performance over the next three years to be on par with industrial, because of limited write downs in 2023.

Select niche sectors

Returning back to normal

Self-storage¹

Self-storage fundamentals softened in 4Q22 as seasonal patterns resumed. A slowdown in mobility and a partial return to the office contributed to lower move-in rates. Same-store occupancy for Public Storage (PSA), a self-storage REIT, was 92.4% in 4Q22, down 90bps from a quarter ago and 250bps from a year ago. According to PSA, rapid growth in rents from existing customers offset a decline in move-in rental rates. In-place rents grew by 15.0% YoY, while move-in rents fell by 5% during the quarter. Supply remains a headwind for the sector, but elevated construction costs, supply chain bottlenecks and labor shortages have pushed back the incoming pipeline for another two years.

Cold storage²

Cold storage occupancy rates continued to climb above pre-pandemic levels in 4Q22. Americold, a global cold storage REIT that holds 83% of its inventory in the US, reported a 630bps YoY increase in economic occupancy to 85.0%. The company also reported strong same-property NOI growth but noted that labor shortages remain Americold's greatest operational headwind that continues to weigh on NOI margins. Although NOI margins remain ca. 400bps below 4Q19 levels, they have improved by 156bps over the year as the company hires more permanent workers. Same-property NOI during 4Q22 was 15.4% higher than 4Q21 levels, and over the full year of 2022, grew by 6.7%. We expect occupancy rates to continue to rise as the demand outlook for manufacturing, food production and online grocery consumption positions remain.

Senior housing³

The senior housing sector continued to make positive gains in 4Q22. Occupancy rates in primary markets rose by nearly 100bps to 83.0%, marking the sixth consecutive quarter of an upward shift. While occupancy rates are 520bps above the pandemic-driven trough, they are still 450bps below pre-pandemic levels. Solid recovery during the quarter was driven by strong demand paired with slow inventory growth. Quarterly net absorption was 1.2% of total inventory, outpacing new deliveries at 0.5%. The industry also saw improvements from an operational side, as a slowdown in wage growth helped ease staffing pressures and operating expenses.

Life sciences⁴

The life sciences sector retracted to pre-pandemic levels, but fundamentals remained solid in 4Q22. Venture capital (VC) funding, a major driver of demand, increased by 18.4% QoQ in 4Q22, after falling for three consecutive quarters. Total VC funding for 2022 was 34.4% below 2021's record level, and just 3.7% below 2020 levels. However, public funding from the National Institute of Health (NIH) continues to increase, and funding for 2023 is budgeted to be 45.6% higher than 2022 levels. Despite solid funding, demand slowed as life sciences companies anticipate economic headwinds. Vacancy rose by 60bps over the quarter to 5.7%, matching rates in 4Q21 but still near record lows.

Source: **1** Green Street, as of February 2023; **2** Americold Company Report, as of 4Q22; **3** NIC MAP, as of February 2023; **4** CBRE, as of February 2023.

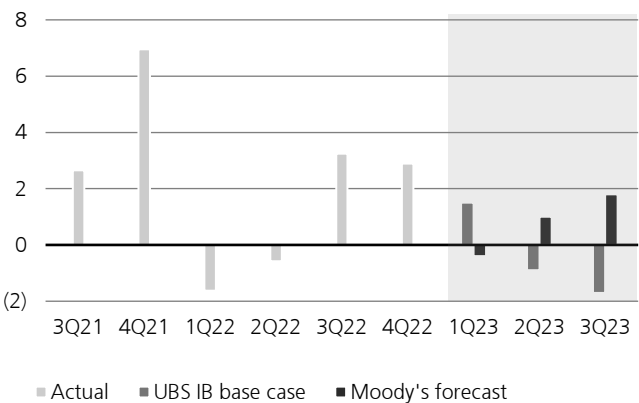


Balancing act

Economic viewpoint

Real GDP came in at a 2.9% annualized growth rate during 4Q22 (see Figure 3). Despite beating consensus estimates, the details from the report show that the surprising increase in GDP came from unexpected contributions from inventories – adding 1.5 percentage points. Consumer spending was also stable, contributing 1.4 percentage points to GDP growth, but came in below expectations after declining in November and December. Unexpectedly high retail sales in January will balance out some of these declines, but we expect further weakening in 2023. GDP gains were partially offset by decreases in residential fixed investment and exports. Imports, a component that is subtracted from the GDP calculation, also decreased. An increase in inventories and a decrease in imports are both signs of weakening demand.

Figure 3: Real GDP quarterly annualized forecast (%)



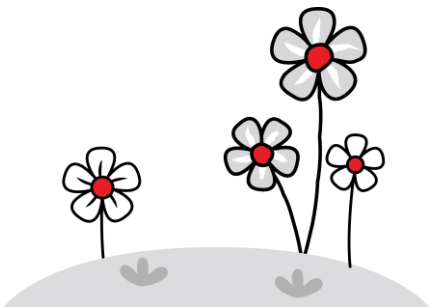
Source: Actual Moody's Analytics as of 15 February 2023; UBS Investment Bank forecast, as of 15 February 2023. Note: Shaded area indicates forecast data.

Nonfarm payrolls came in well above expectations, increasing by 517,000 in January. These robust gains were driven by hiring in the service sector, as consumer spending on leisure and hospitality businesses remain solid. Consumer credit balances have continued to increase while savings rates remain relatively low. Despite this, the Federal Reserve has continued to hold steady on their median terminal goal of 5.1% with no cuts during 2023. The elevated nonfarm numbers in January could also mean further rate hikes in May, as the Federal Open Market Committee (FOMC) attempts to balance controlling inflation with a resilient labor market. Inflationary pressures are already easing, and during 2023, we will likely see more disinflationary pressures coming from a reduction in core goods prices and rent measures that have been slow to respond.

UBS Investment Bank economists expect the terminal rate to peak at 5.25% after increases in March and May 2023 with a risk of further increases in June. GDP is forecast to increase 0.7% in 2023, but with declines starting in 2Q23 through 4Q23. Growth is expected to rebound at the beginning of 2024 and continue into 2025 following a reduction in the restrictiveness of the Federal Reserve policy.

The key measures to watch going into 2023 will certainly shift towards job numbers and domestic demand when attempting to gauge how the FOMC will adjust their policy during 2Q23 and the second half of the year. A continuously strong labor market could mean no rate cuts during the second half of 2023.

In the scenario that UBS Investment Bank lays out, the durability of income in real estate will become key, rather than the more recent focus on shorter lease duration to capture rent bumps. 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 a lower number of value-add activities. Additionally, investors can dollar-average into sectors with general repricing that also exhibit strong demand forecasts over the next three-to-five years.



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