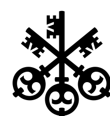
Top 10 questions

Real estate markets in 2024

Is there light at the end of the tunnel?



UBS

Positioning in uncertainty

Last year, we were faced with prolonged high inflation, sharp interest rate hikes and a weak economy, with looming fears of recession. However, most countries proved resilient and avoided recession, with the US particularly strong. There were continued challenges from geopolitical tensions and bank failures. Now, as markets can see disinflation and signs of interest rates at their peak, there may be light at the end of the tunnel and a path to improved market conditions in 2024.

If we revisit *our 2023 predictions*, our outlook was fairly realistic. Our gloomy prediction that global real estate capital values would bottom out in the second half of the year or later has proven prescient. Although we think the bulk of the correction had occurred by the end of 2023, we expect capital values to bottom out in 2024. We also discussed *opportunities for investing in Japan* due to its continuing low interest rates and resulting hedging gains, which continued through 2023.

We look at 10 key questions for real estate investors and begin by highlighting opportunities and how artificial intelligence can be incorporated into real estate investing. We also analyze the bifurcation in bid-ask spreads across the different property types and assess if the investment opportunities in favored sectors can match the available capital. Next, we look at government incentives for improving the sustainability of commercial real estate and the conversion of offices to residential.

We also discuss the ongoing geopolitical shocks and how investors can position themselves defensively against them. We consider a higher-for-longer interest rate scenario. So, a wide-ranging selection of topics for us to consider for 2024. We hope you find our answers insightful.

Where do you see opportunities in 2024?

Continuous interest rate hikes in 2022 to 2023 and tighter credit conditions led to reduced transaction activity in real estate markets and uncertainty over values. We think we may see some more distress, focused on offices, as underperforming buildings face debt deadlines and are unable to refinance, resulting in defaults and distressed asset sales. Currently default rates are low but increasing as major leases expire and mortgages come due. This presents opportunities for nimble investors to access assets at attractive and discounted pricing. However, the question is whether there will be enough buyers for the more troubled properties.

As credit conditions have tightened and capital costs remain high, refinancing existing debt secured against real estate and taking on debt for new real estate investments becomes more difficult, presenting the debt market as another opportunity for investors. With reduced debt availability from banks and as interest payments have become more expensive, private markets investors can step in to provide rescue capital with favorable terms and attractive returns. Furthermore, for debt that is expected to come due in the next few years, investors can benefit from more profitable refinancing of it in the higher interest rate environment. Debt backed against real estate assets for bridging loans or loans to finance real estate development can achieve double-digit returns in some cases.

How can AI be used in real estate investment?

Firms across industries are figuring out how to tap artificial intelligence (AI). Real assets are ripe for AI applications because a single investment can generate almost limitless amounts of data.

Data collection
Programs can 'read' existing documents – like leases – store key variables and flag important terms. AI can help tie disparate data sources together such as underwriting metrics, people flows, amenity usage, revenue, utilities, sustainability, mechanicals health and repair work orders. Firms with large datasets could use AI to create customized benchmarks.

Predictive analytics are possible now
Many national asset management teams use AI in analyzing rental rate data to predict optimal unit pricing using real-time data and inputs. Future possible applications include real-time tenant credit analysis, market data trends, adaptation of floorplates and amenity spaces to tenant demand, prediction of environmental transition risk, adding alternative data to traditional underwriting (examples: mobile data, package flows, market-based amenity demand) and automated valuation models.

Writing reports
AI can help draft comprehensive market reports and quarterly fund reports or to respond to routine data requests faster than a human. No matter the application, for the foreseeable future, firms still need people to review AI output before it is released or relied upon for decision-making.

Will governments use incentives to promote office sustainability upgrades or residential conversions?

Offices which lack sustainable features and suffer from weak demand can avoid obsolescence by being refurbished into modern offices or repurposed to other uses, such as residential. In the US, the Biden-Harris administration is supporting conversion of high vacancy commercial buildings to residential with the aim of creating affordable, energy-efficient housing near transit and good jobs. In 2023 the White House released the "Commercial to Residential Conversions" guidebook on the federal resources available, covering 20 federal programs to support conversions, including low interest loans and tax incentives.

However, retrofitting can be seen as the preferred, less carbon intensive solution. In 2023, the Singapore government launched the SGD63 million Green Mark Incentive Scheme to fund retrofitting projects based on their expected emissions reduction. In the UK, the Minimum Energy Efficiency Standards regulation requires landlords of commercial properties to have a minimum Energy Performance Certificate rating of E (B in 2030), to avoid a penalty of up to GBP150,000. And in the US, the Inflation Reduction Act 2022 provides tax incentives such as the commercial buildings energy efficiency tax deduction which enables building owners to claim a tax deduction for installing qualifying systems.

Overall, we expect more schemes to be launched across countries.

Will the market have sufficient industrial and residential investment opportunities to absorb the dry powder?

A gap between what sellers expect and what buyers are willing to pay today is holding back commercial real estate deals and reducing investment opportunities. Buyers, though actively pursuing deals, expect a considerable discount on pricing due to the current high interest rate environment. Meanwhile, most sellers are unwilling to lock in losses and would rather hold on to their assets until prices begin to pick up again. Only sellers in a handful of markets are adjusting prices to align with buyers' expectations. Other investment opportunities are coming from distressed sales.

According to MSCI, the bid-ask spread differs by property type, with the industrial sector being the most balanced and office being the least. The bid-ask spread for industrial is relatively narrow because current industrial cap rates remain below their average rates from 2015 to 2019, even with the recent upward pressure on rates. In contrast, multifamily, retail and office cap rates are above their pre-pandemic averages, resulting in a broader gap between buyer and seller expectations.

Despite the narrow bid-ask spread for the industrial sector, investment opportunities remain limited. Unless this gap closes, possibly due to more favorable capital market conditions or a widespread acceptance of price adjustments, investment opportunities across sectors look unlikely to be sufficient to absorb all the dry power waiting on the side lines.

How can real estate investors prepare for geopolitical shocks?

The eruption of the conflict in Ukraine in 2022 and Gaza in 2023, as well as increasing tensions between China and Taiwan, have led to a stark increase in geopolitical uncertainty over the past two years. Apart from their effects on consumer and business confidence, the large weight of the players involved and their impact on the world's energy markets mean that these conflicts have the potential to trigger a global recession. The restrictions on gas deliveries from Russia in early 2022 gave a foretaste in Europe of what an escalation in the Middle East could mean for energy supplies and prices and subsequently for the world economy.

For real estate investors, this means that a very close look on local landscapes becomes even more crucial as risks and opportunities can vary tremendously from market to market. Consequently, diversification becomes more important than ever. Crisis-resistant or at least crisis-robust segments become extra attractive. The residential segment generally shows less correlation with economic cycles and as such is often regarded as a safe-haven. The significant housing shortages in many cities throughout the advanced economies allows for substantial rent increases and thus supports the case.

Though more closely linked to business cycles, the industrial segment is likely to profit from increasing geopolitical risks and subsequent lower reliance on global supply chains, resulting in a reshoring boom which presents an investment case for real estate investors in times of high geopolitical tensions. At the same time, logistics properties focused on international trade could be exposed to increasingly insular economies.

What would a higher-for-longer interest rate scenario mean for real estate?

Our best estimate is that post-pandemic, stabilized interest rates will lie somewhere between those prevailing from 1995 through to the Global Financial Crisis (GFC) and the decade following it. In the stabilized post-pandemic world, higher interest rates mean investors are set to receive a higher yield on real estate investments. However, in the near term, higher-for-longer interest rates could result in further capital value adjustment and delay the recovery in real estate values. Real estate typically offers a risk or yield premium compared to government bonds to compensate investors for the increased risk of real estate investment. This includes occupiers defaulting on rental payments.

Compared to the pre-GFC period, global real estate markets are much more mature and with more liquidity and investment options. This would argue for a lower risk premium. By contrast, the post-GFC period saw investors flock to real estate as they looked to generate a positive yield as interest rates on swathes of the government bond market turned negative, focused on Europe and Japan. This resulted in sharp downward pressure on real estate risk premiums. In the post-pandemic era we expect interest rates and bond yields to be higher, but also expect some increase in the risk premium on property as investors are able to generate an income from risk-free government bonds again.

How much distress is there in global real estate markets?

There are many ways to measure "distress" in markets. One is liquidity levels. In the first three quarters of 2023, according to MSCI data, global investment volume in commercial real estate was nearly 40% below the pre-pandemic average level of USD 461 billion (first 3Q of the years 2015-2019).

Another indicator is the value of the collateral, which influences loan-to-value (LTV) ratios and the rate of forced sales. MSCI recently reported that in the US, ca. 7% of commercial real estate mortgages have seen the collateralized asset's value drop by more than 20% over the lifetime of the debt, implying that there are very few assets underwater. Furthermore, among assets with an LTV of 60% or more, only 37% face a debt maturity date in the next three years, limiting the immediate, and systemic, pressure on capital markets.

There is much need for nuance when we speak of distress in global real estate markets. Good assets get buy offers, but bad ones none at all, or only at very depressed prices. Some sectors, offices in particular, are shunned more than others. And the quality of assets, especially when it comes to sustainability criteria, matters more and more.

The short answer to the question is therefore "severe" for the wrong assets, but "limited" for the right assets.

Will the Bank of Japan finally raise interest rates in 2024?

Likely, that is the current market consensus. That said, this outlook is not set in stone. Inflation has so far been cost-driven and largely imported. This could be temporary in nature and a wage-price virtuous cycle is required for a more sustainable price growth. We think that the upcoming wage data in 2024 will likely be key in order for the Bank of Japan (BoJ) to kick-start its normalization journey.

As it stands, wage hike expectations for 2024 are tracking at 2023 levels if not higher. In October 2023, labor union Rengo announced that it would seek total pay hikes of "more than 5%" (including a 3% increase in base salaries), a stronger stance than its 2023 demand of "around 5%", and the highest since 1995.

For timing of policy normalization, most economists expect a rate hike in 1H24. UBS Investment Bank forecasts a first hike of 10bps in April 2024, which would bring policy rates to zero, followed by a 25bps increase in July 2024. Oxford Economics expects an April hike to zero as well, but is less optimistic about the sustainability of inflation over the long term. As a result, its forecast looks for a zero-interest rate policy to remain indefinitely.

In any case, we expect any policy adjustments to be slow and steady. Remember that the BoJ has tried hard for a very long time to manufacture a healthy inflation rate. Delivering a shock tightening and causing another deflationary period is probably the last thing it wants and would also have implications for the government in servicing of its massive debt.

After several challenging years, is now the time for retail?

The retail sector has experienced several challenging years due to the surge of e-commerce and the effects of the COVID-19 pandemic. These disruptions caused the pace of new supply to diminish over the years, as developers scaled back on retail projects. Additionally, during the pandemic, several retailers filed for bankruptcy and property values experienced a significant decline across countries, failing to rebound back to pre-pandemic levels.

Despite these challenges, the retail sector has emerged stronger. Years of limited supply, combined with resilient demand, has boosted occupancy levels to record highs. Tenant credit is stronger, as the pandemic weeded out weaker retailers. Furthermore, property value write-downs provide investors with a rare opportunity to acquire retail at a discount to historical pricing.

Although retail fundamentals and pricing remain attractive, capital market headwinds still pose a risk. High interest rates and limited debt availability have caused transaction volumes for retail, and commercial real estate in general, to remain subdued. While consensus expectations are for interest rates to decline in 2024, and capital returns to turn positive in 2025, investors must still navigate interest rate risk, while seeking opportunities to invest in retail at a discount to historical pricing. We favor grocery and convenience retail.

What next for global office markets?

We expect the bifurcation to continue, especially in terms of quality and location. On the quality spectrum, the top assets capable of meeting tenants' demands for employees' well-being, energy efficiency and low carbon footprint are set to see their rents grow. On the location spectrum, offices located close to transport nodes and those within "live-work-shop" areas are well suited to benefit from the synergies of their neighborhoods. Commodified offices in "monocultured" city zones that are difficult to reach offer fewer attractions and conveniences in the local area. Tenant demand for such buildings is set to suffer.

Prime offices fulfil tenants' requirements and many employers are ready to pay for their quality and location. Consequently, their rental growth is cyclically quite strong. As an example, prime offices in Europe have seen their rents grow by nearly 5% over the last year, well above (ca. 200bps) their long-term annual rental growth value.

The office sector is unlikely to leave the news headlines in 2024 as low-quality, badly-located assets become economically or environmentally stranded. Multiple assets need to be repurposed to better use or refurbished to stay relevant on tenants' radars. This may represent selective opportunities for value-add oriented investors. Prime offices are likely to continue to see their rents rise – and capital values recover as interest rates stabilize. They are also critical for corporates in meeting their net-zero carbon goals.

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