



INSIGHTS FROM
CFA SOCIETY SINGAPORE

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Commercial real estate today: A four-sector outlook

Asset repricing, shifting attitudes, bloodletting in capital markets will open up new opportunities for operators

NOW that individual investors can access direct real estate investments, what should they keep in mind regarding the main US commercial real estate (CRE) sectors and their respective outlooks? We analyse the prevailing perspectives on the US CRE market and four of its key segments, specifically residential (multi-family), industrial, retail and office.

Residential – multi-family

The US faces a significant housing unit shortfall. Pre-Covid, Fannie Mae data estimated a shortage of 3.8 million homes. New estimates range from two million to three million. While construction starts rose through most of 2021, according to Green Street analysis, the estimated influx of 1.3 million net units after subtracting obsolete properties will not be enough to accommodate the projected 4.7 million household formations.

Real wages have increased across the wealth spectrum, but suitable, affordable housing that costs less than 30 per cent of household income is still out of reach for much of the US population, particularly in leading primary markets. At 63.1 per cent, the US homeownership rate is at a record 53-year low as millennials, who are of prime age to start families and purchase homes, face far steeper costs than prior generations.

Given the recent surge in housing prices as well as the high (mortgage) interest rate environment and ongoing economic uncertainty, the shortage of affordable housing should further fuel near-term demand for rental properties. This could benefit sub-asset classes, such as single-family rental as an alternative to ownership and, at the most affordable end of the spectrum, manufactured (or prefabricated) housing.

The US population today is also more mobile than previous generations. Remote and hybrid work, and changing family and community structures have prompted greater geographic movement. Knowledge workers may relocate to secondary metros, suburbs and exurbs at increasing rates, in search of lower rent and lower cost of living as well as more space and more favourable tax regimes.

Tech hubs have emerged outside of San Francisco, Seattle, Boston and other knowledge capital strongholds. With their robust educational institutions, affordability and business-friendly climates, Salt Lake City, Utah; Phoenix, Arizona; Memphis, Tennessee; Raleigh, North Carolina; and other ascendant cities are attracting knowledge workers and tech businesses. These trends



New York City has the equivalent of 26.6 Empire State buildings' worth of office vacancies. PHOTO: AFP

will provide fertile ground for multi-family investors.

Demand for affordable rental housing will grow, given the underlying scarcity and elevated inflation. This dynamic accounts for recent growth in real rents – 14 per cent nationally and 20 per cent to 30 per cent in some markets. Since residential leases are usually of shorter duration – often one year – relative to other asset classes, they better capture a portion of inflation, and rents recalibrate more quickly.

Despite an estimated 20 per cent decline in apartment values compared with 2022 according to Green Street's Commercial Property Pricing Index (May 2023), as rent growth normalises in the near term, residential units in robust markets may still see additional rent growth.

Industrial

Industrial today has diverse and persistent demand drivers. The Covid-19 consumption boom spurred e-commerce sales growth of almost 40 per cent in 2020, generated nearly 250 million square feet in warehouse demand and led to global supply chain disruptions. As a result, US industrial is coming off the best two years in its history.

Thanks to Covid-19 quarantines, e-commerce experienced perhaps decades of evolution in two

or three years. In the new normal, e-commerce has greater penetration than traditional bricks-and-mortar retail and requires three times the warehouse square footage, according to Green Street estimates. As such, national market rents grew by more than 40 per cent in the last two years, more than in the previous seven years combined.

Industrial has had historically low vacancy rates – below 5 per cent since 2016 – and sustained elevated demand: Retail sales are up 17 per cent over pre-Covid levels despite inflation, according to Green Street. These strong fundamentals augur well for future performance.

Geographically, coastal markets, particularly on the East Coast and Gulf Coast, should have the most valuable investments. Thanks to port expansions and supplier diversification, they have gained 8 per cent in market share over the last five years, according to the American Association of Port Authorities, and US imports are almost evenly divided between both coasts.

Many importers shifted volume from West Coast to Gulf Coast and East Coast ports during the pandemic, to the benefit of the latter. But population growth in secondary West Coast markets, California's large population base and continued market capture of e-commerce mean there is still significant opportunity for industri-

al operators in certain West Coast markets.

Orange County and the Inland Empire were both in the top five markets for revenue per available square foot growth in 2022. This was driven by per capita industrial square footages for Amazon fulfilment centres that still lag other key markets throughout the United States. Southern California markets, in particular, also benefit from more stringent barriers to entry for new supply.

Fundamentally, the current capital-constrained market has reduced new construction, with 15 per cent fewer deliveries in 2024 and 2025, according to Green Street estimates. That adds up to some 100 million sq ft.

The sector should be on pace to produce enough new supply to roughly match new demand, with occupancy remaining stable, and otherwise support continued rent growth. Real e-commerce sales remain 50 per cent higher over year-end 2019, and firms are building out traditional and last-mile warehouse facilities to meet increased online sales. This should further help demand keep pace with supply.

While industrial values declined by an estimated 15 per cent compared with 2022, according to Green Street's Commercial Property Pricing Index (May 2023) (CPPI), industrial investors should look for appealing assets in robust coastal markets with strong rent growth potential. Among the in-demand sub-categories are third-party logistics and last-mile industrial facilities that cater to e-commerce.

Lease structures that index to CPI/inflation could become more common – again, following a prolonged period of low inflation resulting in fixed rent steps – and offer investors a means to offset inflation.

The cold storage sub-sector is worth paying attention to as consumers trend towards fresher, healthier, and better-quality foods delivered in shorter timeframes and as food producers continue to ramp up their production volumes. In line with its overall growth, e-commerce took up a larger share of total US grocery sales, and it is set to rise from 13 per cent of sales in 2021 to 21.5 per cent by 2025, showing particular strength within grocery distribution and delivery.

Retail

Years of softening brick-and-mortar retail demand and an oversupplied US retail landscape gave way to mall closures even before Covid-19. With the initial lockdowns, curb-side deliveries, and partial store re-openings, many malls and strip retail centres became obsolete. But those that survived are now more secure. Some benefited from pre-pandemic repositioning efforts, such as replacing dated anchor tenants with grocery stores, fitness/health/wellness offerings, and other strong foot-traffic generators. Fewer than 50 per cent of the anchor tenants in today's US malls are traditional department store chains.

While not immune from capital market volatility, strip retail centres generally have a stickier



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demand base given their focus on local and essential products. Overall, with greater consumer appreciation for traditional retail post-pandemic and a robust US job market, retail sales have kept pace with inflation at 6 per cent growth year-over-year as of Q1 2023, with e-commerce, restaurants, and personal care leading the way, according to Green Street's May 2023 "Mall Sector Update". Retail occupancy has stabilised at around 94.5 per cent, or about where it was pre-Covid.

But temporary tenants account for a portion of this occupancy, and foot traffic at even the top-tier Class A malls has yet to return to pre-pandemic levels on a consistent basis, according to Green Street. Additionally, consumer spending may slow if price-sensitive shoppers pull back. Although mall valuations recovered somewhat in Q1 2023, they are still 18 per cent down from the March 2022 peak valuation as measured by Green Street's Commercial Property Price Index.

While the outlook for retail investment is comparatively bearish, some retail assets may have a compelling investment basis, including positioning as a leading regional mall, having the potential for a turnaround into a viable regional centre, and/or benefiting from recent consistent foot-traffic drivers and less discretionary offerings, such as food, health, and wellness.

Office

The office sector is under well-documented secular pressure and has suffered greatly since the onset of the pandemic. With the surge in hybrid and remote work, US office utilisation plateaued at around 50 per cent in 2022, according to Green Street. There are significant vacancies across several key US markets: New York City has the equivalent of 26.6 Empire State buildings' worth. Recession fears, layoffs in various industries, and a hawkish US Federal Reserve constitute further headwinds for the sector. This is driving a rethink of the office asset class and a potential evolution towards such all-encompassing lifestyle offerings as Related's Hudson Yards development in New York City.

Developers in other market segments will make partial conversion plays. Aspen Hospitality's and Tishman Speyer's plan to repurpose 10 floors of New York City's Rockefeller Centre

office tower into a hotel, for example. Other efforts include zoning legislation reform and public/private partnerships.

Aside from high-quality, fully stabilised properties with long-term credit tenant leases – and rent increases based on inflation – office sector transaction activity has stalled. As a result, Class A office and Class B/B+ asset valuations are down about 30 per cent and as much as 45 per cent, respectively, since Q1 2020, according to Green Street's CPPI.

So, where should investors look? We will be exploring value-add opportunities to enhance/(re-)lease viable office properties in strong markets, such as those with a more affordable cost of living, and for (partial) conversions that may offer compelling risk-adjusted returns.

What's next?

"If it bleeds, it leads." Or so goes the old journalism saw. Indeed, for the better part of the last year, doom and gloom had been the theme for much of the finance and investing news cycle. But in direct real estate investing, change is both good and inevitable. The US economy's bull run lasted long enough for a generation to forget the lessons of the global financial crisis (GFC). Ultimately, asset repricing, shifting attitudes and bloodletting in the capital markets will open up new opportunities for real estate operators.

In the shadow of the GFC, Starwood and BlackRock, among other major asset managers, capitalised on distressed real estate and realised sizeable profits. The world has flattened since then. Thanks to technology and regulatory changes, individual investors can tap into various private-market real estate investments.

When interest rates and inflation stabilise or moderate, the real estate capital markets will rebound. Investors should look to the private/direct CRE market for pricing dislocations, appealing acquisitions and other opportunities.

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