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LGIM America

Real Estate Pulse

Excess Supply Delaying CRE Upturn

Q2 2024

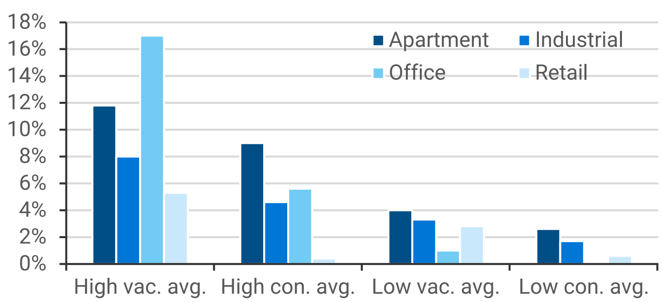
Executive summary

The lagging investment performance of property is clearly apparent in the first quarter report for the unlevered NCREIF index. Despite solid economic growth and stronger than expected employment, first-quarter NCREIF data shows continuing deterioration in unlevered property total return, but, at a significantly more subdued rate versus Q4 2023. For the four quarters ending in March, NCREIF total return clocked -7.2%, with the appreciation component at -11.2% and the income component at 4.4%. The appreciation component contributed half the rate of decline in the first quarter compared to the fourth quarter. Three of the four major sectors showed such improvement with only office failing to at least halve its rate of decline.

While the macro-economy continues to provide solid growth to support commercial property performance, CRE sectors are in varying stages of supply-demand balance. Figure 1 divides the top 50 US metros into the ten highest vacancy rate metros and the 10 lowest vacancy rate metros by sector. For each vacancy slice, the chart shows the construction pipeline for delivery in 2024-2025 as a percent of current inventory.

Retail is the most balanced sector with the ten highest metro vacancy rates averaging 5.3% and less than 1.0% of new supply in the pipeline in those metros. The ten lowest retail vacancy rates average 2.8% also with less than 1.0% of new supply on the way. Office occupies the other extreme. The highest ten metro vacancy rates average 17.0% with 5.6% of new supply in the pipeline. This imbalance reflects

Figure 1 – Top 50 metros - Vacancy rates and construction pipelines



Source: CoStar. Data as of May 2024. Please note that "vac" represents vacancy rate and "con" represents construction as a percentage of stock.

the very long lags associated with office construction which is prolonging recovery in those oversupplied metros. The lowest ten vacancy rates for office average 1.0% with essentially empty new supply pipelines on average. This difference between the hi-and-lo office vacancy metros is very important to note. It shows that office distress is concentrated in a relatively small segment of the sector. Of the 30 metros not covered in the chart, ten have single-digit office vacancy rates.

In between the retail-office extremes, the industrial segment is the more balanced with the ten highest vacancy metros averaging 8.0% vacancy and 4.6% supply pipelines. The lowest ten report a 3.3% average vacancy rate and 1.7% average pipelines. Finally, the apartment sector reports the most robust pipelines with the ten highest vacancy metros at

11.8% vacancy with 9.0% new supply on the way. On the low end, vacancy averages 4.0% with pipelines averaging 2.6%.

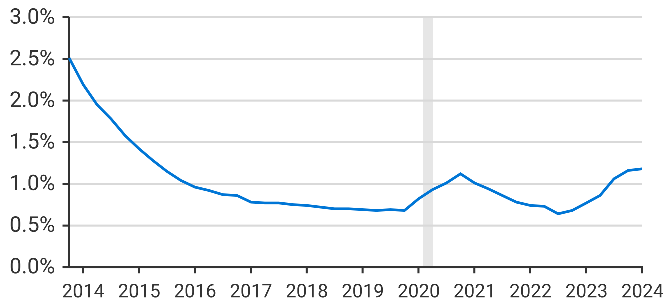
These readings illustrate the COVID-era response of developers to the combination of historically low interest rates and strong demand in hot metro markets. Both forces were transitory and both forces concentrated the widest supply-demand imbalances in a relatively small segment of metros. As supply pipelines empty, better balance will be restored.

Reflecting this, CRE distress has been much less severe compared with the GFC. This is illustrated in Figure 2 showing delinquency rates on bank loan to commercial real estate.

It is also illustrated by the willingness of lenders to modify and extend CRE debt to avoid foreclosures. CRED IQ reports that modifications of securitized mortgages maturing in 2023 were 150% above the level of modifications in 2022.

At the same time, US non-agency CMBS issuance in the first was nearly triple the issuance rate in last year's first quarter. Improved market sentiment was reflected also in CMBS spread decline over the second half of 2023. Altogether, the US CRE recovery is underway, but it will take time to restore supply-demand balance enough to lift property performance.

Figure 2 – Loan delinquency rates



Source: Board of Governors of the Federal Reserve System (US).

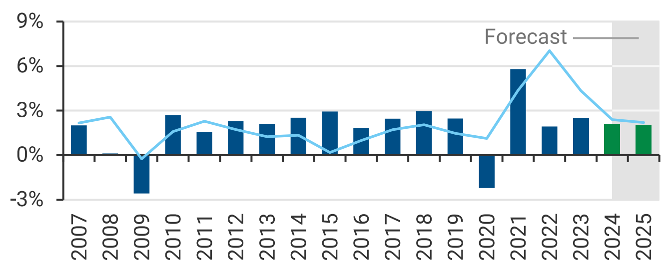
Macro economy

The US economy posted a solid 1.6% real GDP growth rate in Q1 2024 after the surprisingly strong 3.4% beginning and 4.9% postings for the prior two quarters, respectively. The moderation was largely due to a slowing in consumer spending partly offset by a pickup in investment spending, especially in the residential sector. The first quarter's performance reinforces confidence in the durability of growth in the face of elevated interest rates.

Looking ahead, forecasters are boosting expectations for 2024 growth. Federal Reserve projection materials released in late March show a 2024 expectation for 2.1% real GDP growth, up substantially from the 1.4% expectation reported in December. At the same time, projections for inflation were not changed with the personal consumption expenditures (PCE) inflation expectation for 2024 holding at 2.4%. The Fed's projections for 2025 show only minor changes; GDP growth at 2.0% is up from the 1.8% forecast reported in December while the PCE inflation forecast is now 2.2% up from 2.1% earlier. These projections seem to support pervasive hopes for some interest rate cuts later this year.

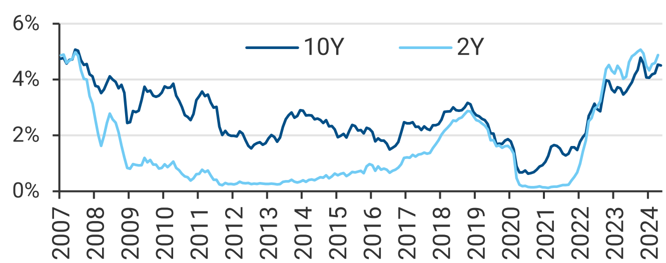
Such hopes are holding following the official statement that accompanied the Fed's May decision to maintain the current rate stance. The statement noted the "lack of progress" toward bringing inflation closer to the Fed's 2.0% target and that any rate reduction will require "greater confidence that inflation is moving substantially toward 2 percent." The projections themselves show an expected decline in the federal funds rate to a 4.6% average for 2024 and further to 3.9% for 2025. Financial markets shared that confidence by pushing down the 10-year Treasury yield slightly in the first weeks of May.

Figure 3 – Annual US real GDP and core CPI



Source: St. Louis FRED. Data as of May 2024. Federal Reserve Projection Materials. Data as of March 20, 2024.

Figure 4 – US 10-year and 2-year Treasuries (monthly yield)



Source: University of Michigan, Survey of Consumers. Data as of April 2024.

The moderation in job creation is likely contributing to prospects for further easing in the inflation rate. For April, nonagricultural employment posted an increase of 175,000, down from the 269,000 per month average for the first quarter of 2024. More than half of April's job gains were in health care and social assistance, neither of which is likely to produce inflationary pressure on wages. More importantly, job creation in these categories may be the ongoing recovery from covid disruption.

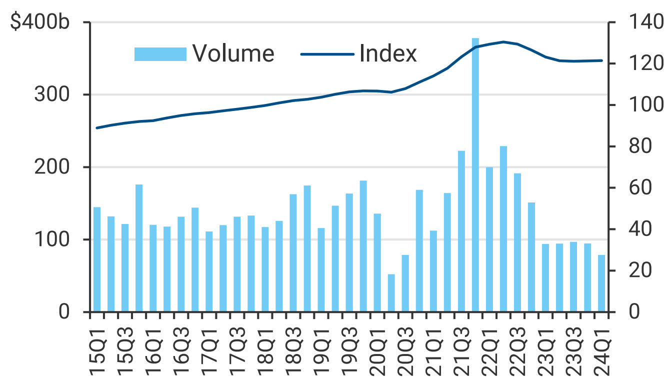
At the same time, ongoing employment growth without significant wage inflation may be benefiting from the pickup in processing immigrants reported by the Congressional Budget Office (CBO) from data produced by Homeland Security. CBO's January 2024 analysis suggests that the regular Census data updates later this year will reflect this information.

Transactions and pricing still muted

The volume of US property transactions continued to contract on a year-over-year basis in Q1 2024, down 16% from Q1 2023. As shown in Figure 5, 2022 suffered the most severe collapse in transactions followed by moderate ongoing declines in the subsequent quarters. Surprisingly, the office sector enjoyed an uptick in transactions due to an entity sale of medical offices rather than any improvement in the liquidity of traditional offices. Apartment, industrial and retail sectors posted shrinking year-over-sales but at a moderating rate of shrinkage. Distressed sales are increasing, however, accounting for almost 4% of first quarter transactions. Distressed apartment sales totaled roughly $1 billion of the total indicating that investors are shopping for bargains in the sector.

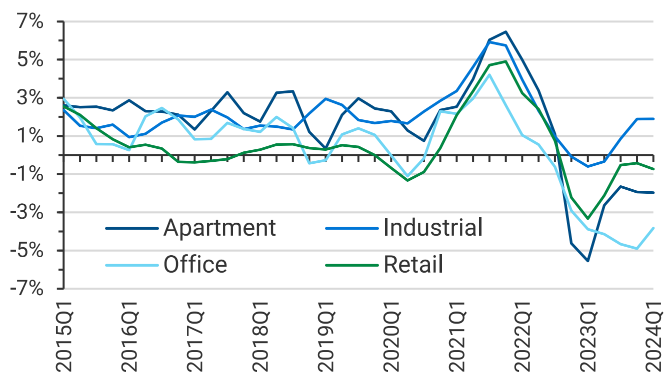
Transactions prices reported in the Real Capital Analytics CPPI offered some better first quarter news. Industrial property prices rose 2.2% and retail property inched up slightly. In contrast, apartment and office property suffered further price declines but at a less serious pace than in prior quarters. Overall, property prices outside of the six major metros (NY, LA, SF, DC, Chicago, Boston) were flat. Separately, Green Street's more forward-looking price calculations were unchanged in May which is a particularly favorable indicator for the troubled office sector. Altogether, the calmer pricing environment that is emerging could enhance price discovery activity among investors that will eventually propel an upswing in transactions and define the turning point in this cycle.

Figure 5 – Transaction volume (quarterly, $b)



Source: Real Capital Analytics. Data as of May 2024.

Figure 6 – RCA CPPI (% change quarter-over-quarter)



Source: Real Capital Analytics. Data as of May 2024.

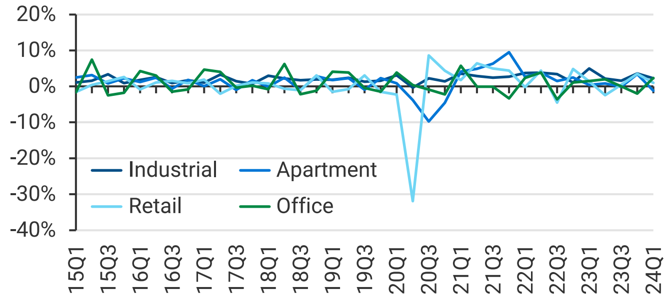
Property investment returns lag soft landing in macro economy

While the capital appreciation component of the NCREIF total return benchmark continued to deteriorate, property net operating incomes did enjoy the benefits of the economic soft landing. As shown in Figure 7, NOI growth for industrial has been roaring at 9.5% for the four quarters ending in March. Apartment, office and retail have been tagging behind but still managing more than 2% NOI growth rates over the year. When viewed in the context of office sector work-from-home challenges and excess supply in select apartment markets, the solid sectoral NOI growth rates are comforting. They reaffirm that the source of property pressures are the cap rate adjustments to interest rate changes. Fundamentally, property is producing NOI growth somewhat above the long-term 2% inflation target.

The ongoing negative capital appreciation component of the NCREIF is shown in the second chart. Office depreciation is most prominent showing a 5+% decline in the first quarter and a 22% cumulative decline over the four quarters ending in March. Four quarter decline in apartment amounted to a much less severe 10% followed by industrial at 7% and retail at 6%.

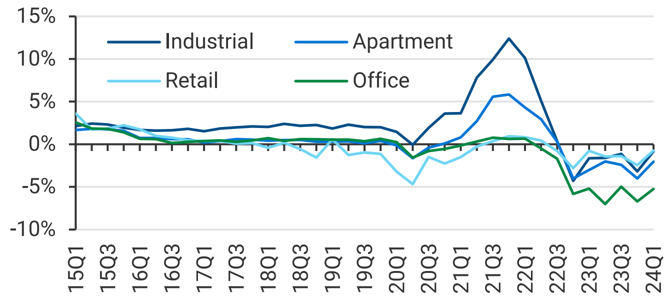
NCREIF's first quarter report offers an enhancement to the usual performance results for the four major property types plus hotel. In response to investor interest, NCREIF is reporting an expanded variety of subsector breakdowns. These include medical and life science office along with office located in secondary business districts and urban non-CBD. Apartments now contain breakdowns for student housing, manufactured homes and single-family rentals. Self-storage and seniors are now included as well as separate sectors. Altogether, the additions have enlarged the NCREIF index by roughly $64.5 billion or 8% bringing it to almost $900 billion in the first quarter. The expanded index showed slightly stronger performance over the four quarters ending March, a -10.9% total return versus -11.2% for the "traditional" index portfolio.

Figure 7 – NCREIF-NPI NOI growth



Source: NCREIF. Data as of May 2024.

Figure 8 – NCREIF-NPI capital return



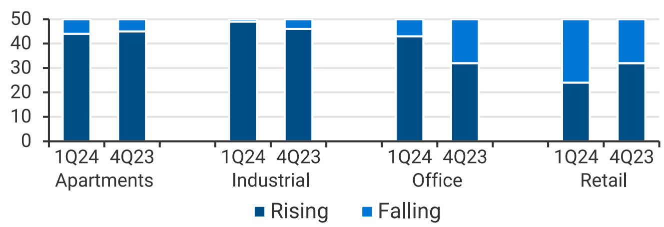
Source: NCREIF. Data as of May 2024.

Market fundamentals

Figure 9 and Figure 10 are designed to portray momentum in metro area markets as defined by changes in vacancy rates and rents by property sector. First quarter data shows almost no signs of shifting momentum that would indicate a bottom to the current cycle. Vacancy rates rose year-over-year in most of the top 50 metros for apartment, industrial and office properties while retail properties showed improvements across roughly half of the top 50. Similarly, rents fell on a year-over-year basis in the majority of industrial, office and retail markets but in roughly half of apartment markets.

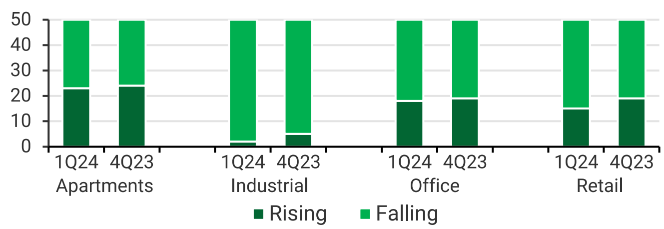
These readings indicate that property markets are still digesting supply inflows with rent changes serving as an equilibrating mechanism. With property pricing changes calming down, these continuing fundamental market adjustments in vacancy rates and rents can be defined as modest. Ongoing employment growth will help to establish a new equilibrium and set the stage for a turnaround in momentum.

Figure 9 – Vacancy rate changes (top 50 metros)



Source: CoStar, Q1 2024 vs Q4 2023.

Figure 10 – YoY rent growth changes (top 50 metros)



Source: CoStar, Q1 2024 vs Q4 2023.

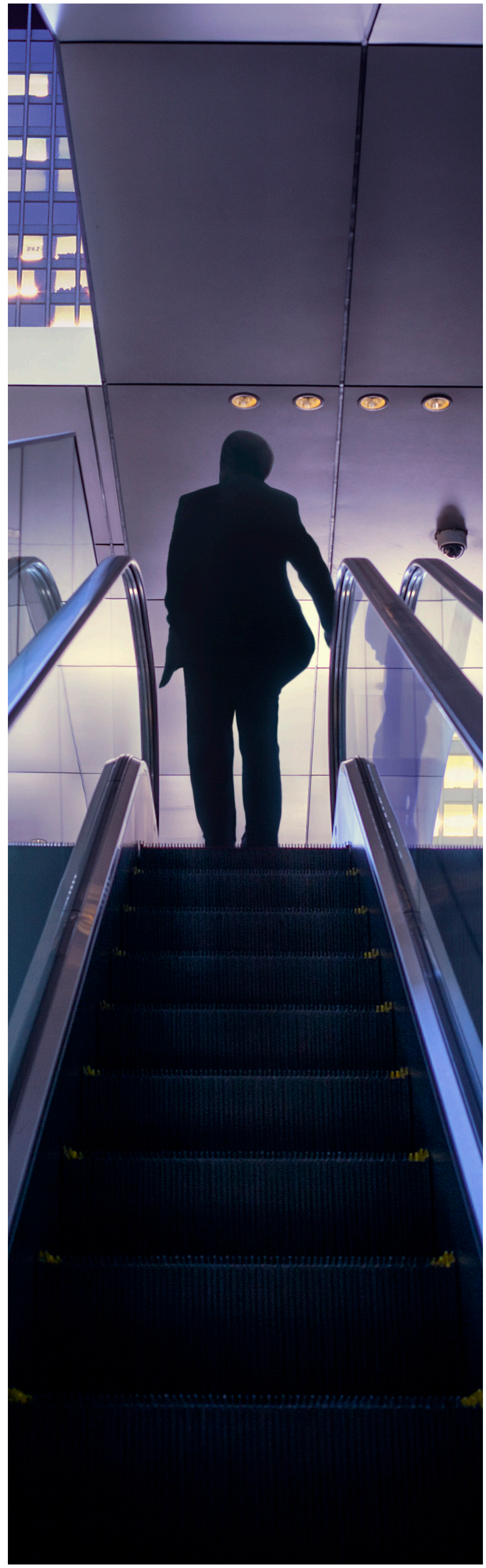
Our assesment process

Analysis of real estate investment prospects commonly starts with a review of recent and expected macroeconomic performance. That starting point reflects the importance of the macroeconomy as a driver of the supply and demand forces that determine property investment performance. The macroeconomic environment influences those drivers and propels a national real estate cycle. That cycle is the dominant influence on performance with property sector and local geographic influences following in importance. At the same time, the idiosyncratic characteristics of specific properties and their specific locations combine with the national cycle feeding each property's bottom line. These diverse influences encourage investors to evaluate both the "top-down" macro environment and the "bottom-up" characteristics of each individual investment under consideration.

Economic growth affects property sectors through varying channels. For apartments, demand drivers include employment and income growth that enable maturing young people to form households along with the absolute number of that population cohort. Interest rates are also important as they influence the cost of buying a home versus renting. Stronger economic growth fuels both employment and income growth. Employment and income growth along with population growth also influence prospects for the retail sector. But growth that is too strong can promote inflation leading to rising interest rates which put a lid on growth.

The industrial sector depends on the widest definition of GDP including the international trade sector. Industrial space demand reflects the flow of goods through the domestic economy. Industrial space demand is very responsive to the macroeconomy in part because the sector can build new space quickly when compared with other types of structures. This responsiveness contrasts sharply with office space where construction lags dampen responsiveness to the macroeconomy.

But, at the same time, there are structural forces of various strengths affecting each sector. For apartments, the strongest is the ongoing shortfall in the supply of housing due to weak construction following the 2008 recession. For industrial, the adjustment to more online shopping and demand for faster delivery is an ongoing tailwind. For office, work-from-home appetite is still uncertain and space obsolescence is a mounting concern. Finally, the retail sector is enjoying a tailwind from disparate population growth contributing demand for space in growing localities while the headwind of excess space in declining areas and shrinking venues is ongoing.



Martha Peyton

Research Consultant to LGIM America

Martha Peyton is a Research Consultant to LGIM America's Real Estate Equity team. In this role, she is responsible for US economic and property market research, which is a foundation for the team's investment strategy.

Between 2018 and mid-2023, she was Managing Director of Applied Research for Aegon Real Assets US, primarily responsible for the development and application of research to real asset strategies. Between 1993 and 2016, Martha was Managing Director, Head of Real Estate and Global Real Assets Research for TIAA-Nuveen. While at TIAA, she built and oversaw the research function for the commercial mortgage loan and real estate businesses. This included managing research staff, setting the research agenda, conducting ongoing monitoring and analysis of the investment environment and asset class performance and authoring white papers and research publications.

Martha earned her BA, MA and PhD in Economics from Fordham University. She is a Counselor of Real Estate (CRE) and is President of the Real Estate Research Institute.

1. Source: St. Louis FRED.
2. Source: University of Michigan, Survey of Consumers. Data as of February 2024.
3. Source: NCREIF. Data as of December 2023.

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