REAL ESTATE

The rising interest rate environment has narrowed the spread between real estate capitalization rates and investment grade bonds. Historically, the 10-year average spread has been 2% to 3.5%, depending on the property type, but the current range sits between -0.5% to 2%. Capitalization rates generally lag public markets, and continued rate increases suggest that cap rates will widen, putting further pressure on property valuations. As such, our focus in this environment has been to invest in strategies where growth in net operating income will continue to drive returns and offset any cap rate expansion.

In the property sector, office space continues to feel the most pain as financing costs increase. On several occasions in the first quarter, real estate owners had to give back the keys to the lender. The first to occur was in February, when Brookfield defaulted on two office properties worth a combined $784 million in downtown Los Angeles. After Brookfield, there was a domino effect of other respected and well-capitalized institutions like Blackstone, Columbia Property Trust, and RXR. Within the office sector, landlords have been generating less income to service debt as the work from home trend has led to declining vacancy and lower rents. This in turn has impacted loan-to-value ratios and the ability to refinance. Further, declining vacancies and higher rates have led to extraordinarily high carry costs for owners and have increased the risk of default.

As discussed in our private credit section of this letter, the distress in some property sectors and lack of traditional bank lending has led to opportunities for private lenders to generate equity-like returns against higher quality assets at lower attachment points. Office to residential conversions is another area where we are beginning to see opportunity. Until recently, the purchase price and renovation cost has been too high for the economics to make sense, but as value continues to decline, this area becomes more interesting. Since 2010, over 200 office buildings have been converted to residential, with Chicago, Philadelphia, and Los Angeles being among the most active markets for redevelopment. These conversions are not without physical challenges, but they have the potential to provide affordable housing in dense urban areas in need of solutions. In addition to affordable housing, we continue to remain focused on our high conviction investment themes across real assets, including communications, energy transition, and logistics to improve supply chains.