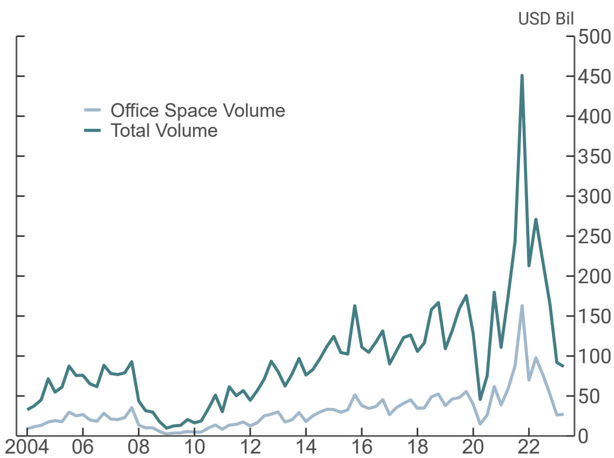
REAL ESTATE

During the second quarter, the commercial real estate sector was portrayed in the media as facing a broad crash on all fronts. Rather than a downturn across all property types, it is the lower quality office properties that face the greatest threats. These assets have experienced declining occupancy rates from work-from-home impacts in select cities and increased carrying costs due to higher interest rates that have further impacted values. Through the first half of 2023, there have been numerous examples where owners have decided to hand the keys back to lenders in the face of maturities, rather than reinvest capital to revive stranded assets, as seen with Park Hotels in San Francisco and office landlords across major markets.

Figure 12. Transaction volumes fall as commercial real esate feels pressure



Source: REAL Capital Analytics via Bloomberg Finance LP.

Overall, we expect commercial real estate pressure to continue for the rest of the decade, as longer term leases come to an end. Lenders who are not structured to operate properties received out of bankruptcy will be forced to sell the properties at a discount, at which point a new buyer may have a low enough basis to reinvest capital into the property and compete on rents. To avoid distressed sales, lenders may “blend and extend” the maturities, similar to what occurred during the Global Financial Crisis.

We are also closely monitoring appraisal values and transaction volumes, as these are indicative of the health of the entire sector. Certain landlords will use dated appraisal values, which may be artificially high in the current environment, so they do not breach their debt service covenants or look to manage redemption queues. With each quarter, appraisals should better reflect values that will lead to more transaction volume.

The second quarter performance of the ODCE, a widely tracked index of core real estate properties, came in at -2.7%. While painful for investors, this negative mark more accurately reflects values and has the potential to jumpstart transactions for the second half of the year. Once the bid-ask spread narrows enough, liquidity, and the health of the real estate market, should return. At the end of the quarter, green shoots appeared in the transaction market as transactions closed for properties such as Prologis' purchase of industrial properties from Blackstone for $3.1 billion or Japan's Mori Trust purchasing a stake in a prominent midtown office tower from SL Green at a $2 billion valuation.

In this environment, we have been cautious when underwriting new opportunities and are focused on ensuring that the business plan still works with higher financing costs in the medium term. Additionally, this environment will provide clarity on investors that are able to generate alpha through NOI growth, rather than strategies that have benefitted from essentially free debt and cap rate compression. Investments that can generate durable cash flow in this environment are a focus area for deployment in our portfolios, with strategies such as affordable housing, investment grade net lease, industrial, telecommunications, and sustainable infrastructure providing attractive risk adjusted return profiles. In contrast, commodity office and high capital expenditure strategies reliant on cap rate compression or aggressive assumptions are not our current areas of focus.