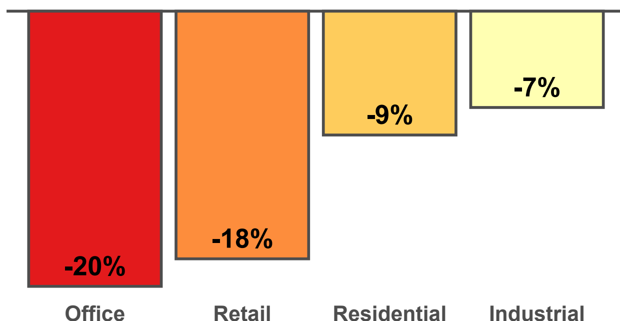
REAL ESTATE

The commercial real estate sector is currently in a state of transformation, with the era of low interest rates driving soaring transaction activity and widespread cap-rate compression seemingly behind us. In its place, the environment is characterized by higher income yields with normalized transaction activity and tenant demand. Despite these changes, real estate remains allocation, offering diversification, durable cash flows, and inflation protection. However, with increasing dispersion in property types, investors must prioritize growth in net operating income. Recent real estate headlines often sensationalize events, potentially causing the enduring strength of real estate fundamentals to be overlooked or underestimated.

Fundamentals have shown signs of strength: net operating income (NOI) has grown 5% since September 2022 and consistently outpaced inflation, but values have been the focus, having depreciated by 10%. This is primarily due to higher interest rates on capitalization rates and discount rates. While the office sector has faced the brunt of negative attention due to both cyclical and structural challenges related to job shifts and hybrid work models, the broader commercial real estate market has also felt the effects of this association bias. Over this period, capitalization rates have experienced significant increases, resulting in a spread between expected unleveraged returns and comparable bond yields that is 30 bps wider than the long-term average (Figure 13).

Additionally, the impact of rising interest rates on cap rates, along with a substantial $1 trillion in maturing debt over the next three years has contributed to challenges in an environment with tighter debt financing (Figure 14).

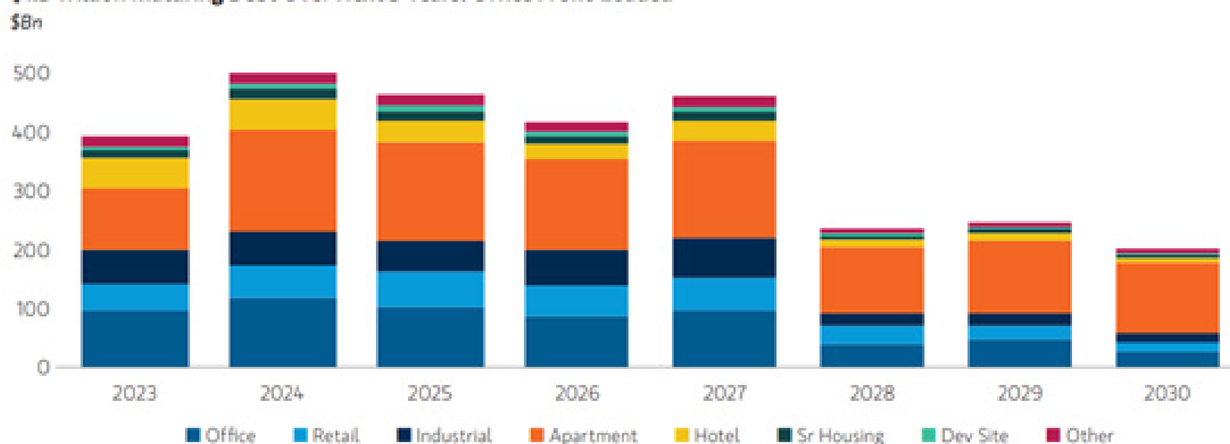
Figure 13. The bifurcation of value across real estate segments



Note: Percent change from unlevered peak to current value.
Source: RockCreek; NCREIF Property Index (NPI),
National Council of Real Estate Investment Fiduciaries.

The industrial sector has experienced a prolonged period of strong performance, marked by an average rent growth of 11% over the past five years, primarily driven by the rapid expansion of e-commerce and the reconfiguration of supply chains. This remarkable growth has been evident across various markets, asset sizes, and product types. However, as the pace of retail sales growth decelerates and tenants become more discerning, rent growth has moderated to a still healthy 5%. The forces driving demand are shifting towards onshoring and increased manufacturing investment, favoring specific segments and markets within the industrial sector. Furthermore, isolated pockets of oversupply, particularly in larger asset sizes, have led to divergent performance trends, necessitating a more nuanced approach to investment in this sector.

Figure 14. A maturing wall of debt on the horizon



Source: Real CApital Analytics, MSREI Strategy. As of August 2023.

Like the industrial sector, multifamily has seen rent growth exceeding the norm over the past five years, buoyed by inflation, robust household formation, and limited affordable housing options for sale. Although rent growth has now stabilized, due to increased supply and more normalized demand, the overall fundamentals remain relatively solid. Unlike the office sector, the multifamily sector faces substantial debt maturities totaling $600 billion over the next five years. However, apartment values have appreciated considerably during the same period, resulting in lower effective loan-to-value ratios. Furthermore, multifamily assets have better access to financing due to government agencies such as Freddie Mac and Fannie Mae needing to meet their annual allocations.

At RockCreek, we have been focused on allocations to affordable multifamily and specific industrial sectors where fundamentals are strongest and have monitored other sectors for potential signs of distress that may warrant an interesting entry point for new investment. Additionally, we have placed an emphasis on digital infrastructure strategies as data demand has continued to grow in excess of other sectors as we emphasize NOI growth and durable cash flow in this market environment.