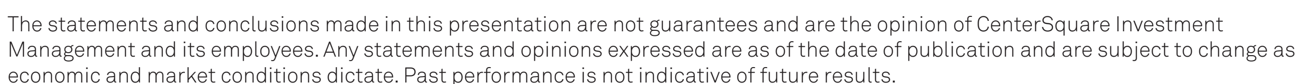
CenterSquare
REAL ASSET INVESTMENT LEADERSHIP

A RESET ENTRY POINT FOR REAL ESTATE

2024 Global Market Outlook



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A Reset Entry Point for Real Estate

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Excessive fiscal spending and protracted expansionary monetary policy created a valuation bubble in financial assets that ended in early 2022. Negative nominal rates, SPACS, Meme Stock mania, and a 45% increase in home values over 28 months were tell-tale signs that the economy was oversupplied with money. We are now firmly in the hangover and clean up phase from this period of "irrational exuberance." Higher rates are shortening the options and life expectancy of the weak while well-capitalized bidders are patiently waiting for valuations to meet rational price levels.

Amid what seems to be a prolonged period of uncertainty, as permanent investors in commercial real estate, CenterSquare would like to share our thoughts on why we believe 2024 will serve as a great entry point for real estate investors across public and private markets. Our thoughts about where values "should be" and how to thoughtfully deploy capital in the year ahead are derived by attempting to answer the following questions:

1. What are our macroeconomic expectations for inflation, growth, and interest rates?
2. What are our fundamental expectations for various property types and markets?
3. How will real estate debt markets accelerate the real estate repricing to create an excellent vintage in 2024?

Macroeconomic Expectations

Where pricing ultimately settles for real estate depends largely on where interest rates (i.e., 10-year yields) ultimately land as a function of inflation and growth.

Inflation

It seems evident that we are past peak inflation globally as aggressively tightening monetary policy has worked to temper demand. However, we don't believe the market, nor the Fed, truly appreciate the following structural issues that will likely result in inflation settling higher than it was in the prior cycle:

1. The emergence of the "multipolar world" – prompting the diversification of supply chains away from China, including on-shoring or near-shoring strategies – is going to come at a cost. While it seems there is little bilateral support these days, addressing the geopolitical threats associated with China is one of the few issues both sides of the aisle agree on, which further underscores this trend.

2. The market is likely underestimating the "greenflation" effect of the global investment required to achieve the energy transition, which is at nearly 2x current levels. The International Monetary Fund (IMF) estimates global inflation could be 0.1% to 0.4% higher as a function.

3. Housing shortages around the world are likely to put a floor on steady-state shelter components of inflation.

4. The global population is aging into retirement, structurally hampering labor force growth and keeping labor markets tight.

If we're correct here, inflation will not settle at 2% as the Fed would like and will probably land somewhere closer to 3%.

Growth

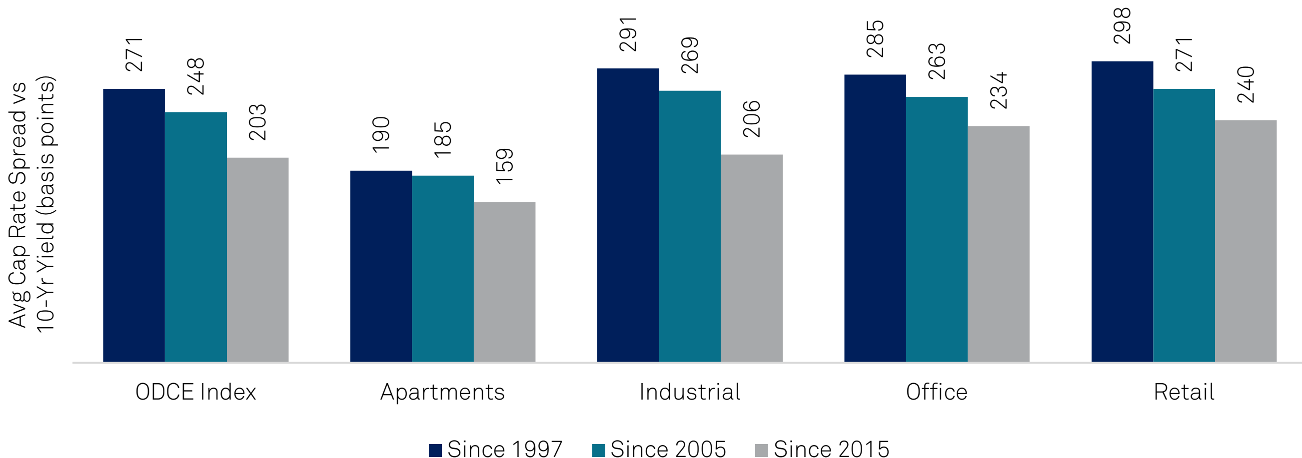
While growth has been surprisingly strong in the face of aggressively tightening monetary policy, we believe the consensus building around a “soft landing” fails to recognize several key factors. This “stronger than expected” economy is a function of excess fiscal spending and heightened pandemic savings exacerbating the long and variable lag with which monetary policy impacts the real economy. However, much of the excess savings have been spent today and we anticipate tight monetary policy will start to impact growth more meaningfully in the coming year. Even past the cyclical slowdown we expect in 2024, longer-term real growth is likely to be restricted by the following issues dampening productivity gains:

1. Stimulative fiscal policy has resulted in a historic level of U.S. federal debt, and the cost associated with servicing that debt is increasing at the fastest rate we have seen in recent history. As a result, the rising interest expense on our federal debt is crowding out productive government spending elsewhere.
2. Despite technological advances, productivity has weakened over the last economic cycle as a function of cheap money. Employers grew accustomed to demanding less from their capital investments as financing rates were low for a long time, and they have demanded less from employees as the labor market has tightened.
3. Public policies are resulting in a heightened level of moral hazard whether it’s in the form of regulatory policy (i.e., lack of prosecuting crimes in certain markets) or fiscal policy (i.e., heightened unemployment insurance benefits).

While the proliferation of Artificial Intelligence (AI) offers a possible solution to boost productivity, we believe this to be a longer-dated boost while also being a shorter-term inflation driver as capital spending increases to build AI capabilities. In the meanwhile, the aforementioned forces are hampering real growth. **We expect real growth will land somewhere in the 0-2% range, near the lower end of what we have experienced through this past economic cycle.**

Taken together, we can see in a world in which the 10-year yield settles close to 4%. This would indicate we are not returning to the free money era we experienced over the last decade, and real estate needs to be repriced in this new reality of debt costs. If real estate pricing reverts to historical pricing in relation to the 10-year treasury yield, **we could anticipate cap rates to settle in the 5.5%-7.0% range depending on the property type** (Figure 1).

Figure 1: Historical real estate cap rate spreads to 10-year treasury yield



Source: NCREIF, cap rates are equal weighted appraisal cap rates for ODCE index, as of September 30, 2023.

Fundamental Expectations

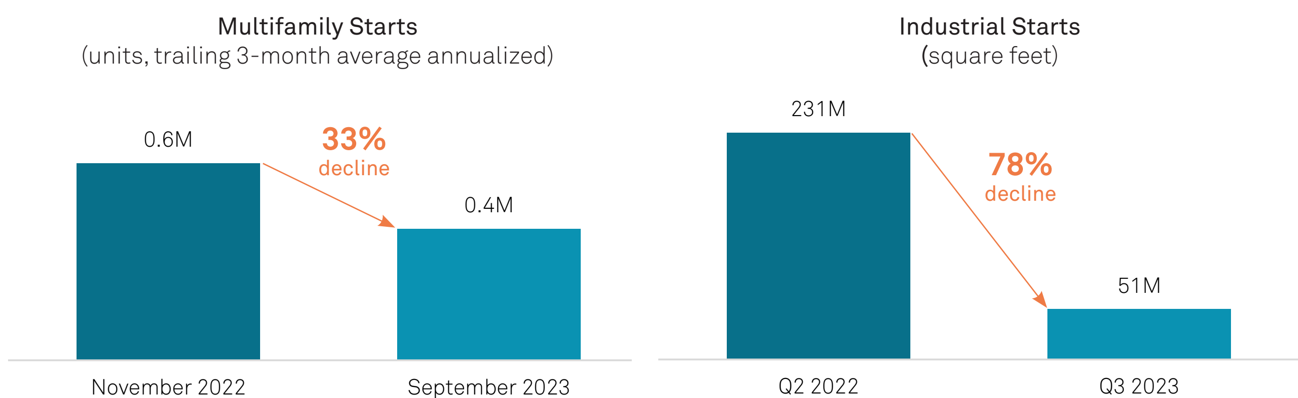
Real estate fundamentals on the ground are mostly strong, though there are some undeniable clouds on the horizon. It is no surprise that the office sector is undergoing a reckoning, and low-quality office is facing true obsolescence risk as demand consolidates into relevant, high-quality office real estate. We also anticipate low-quality malls are likely to experience additional pain as we head into another recession following the negative impacts on this property type from e-commerce and COVID. However, these are the only notable structural concerns within the real estate world. Elsewhere, fundamentals screen incredibly strong for many property types like data centers or senior housing as secular thematics like digitalization and the aging population drive demand in sectors with supply constraints.

There are some passing clouds to note, primarily associated with the recent overbuilding of multifamily, industrial, and life science lab space in certain markets. This especially reigns true in the context of an economic slowdown. However, the structural demand tailwinds for all these sectors remain.

We continue to face undersupply of housing across the country, and home ownership remains extremely unaffordable, creating renters for longer. Industrial real estate is experiencing the structural tailwinds associated with near-shoring and on-shoring strategies along with a need to build resiliency across supply chains to sustain shocks (i.e., trade wars, military conflict, global pandemics) in a multipolar world. Life science lab space is becoming increasingly crucial as we strive to innovate across healthcare, developing treatments and therapies for our aging population globally.

Further, we are currently seeing a standstill in new development activity due to a lack of available financing and elevated construction costs, which should curtail further oversupply concerns as new construction starts have meaningfully decelerated (Figure 2). While pockets of supply in certain submarkets might be creating some clouds on the horizon for these property types, the underlying resiliency associated with their structural demand drivers should prevail in the long term.

Figure 2: U.S. multifamily and industrial construction starts from 2022 Peak to Q3 2023



Source: U.S. Census Bureau, CoStar, as of September 30, 2023.

Debt Induced Repricing

Despite strong fundamentals, pricing remains elusive. While the public market has priced the impact of the new cost of debt, private market valuations have yet to appropriately readjust. As a result, we observed a meaningful delta between cap rates ascribed to valuations in the public versus private markets as of the third quarter (Figure 3).

Figure 3: Real estate valuations across public and private markets

	REIT Implied Cap Rate			CSIM NAV Cap Rate			ODCE 3Q23 Cap Rates	
Sector	**3Q23**	**3 Mo. Change (bps)**	**12 Mo. Change (bps)**	**3Q23**	**4Q21**	**3Q23 REIT GAV Discount**	**Appraisal Cap Rate**	**Transaction Cap Rate**
Apartment	6.38%	73	118	5.22%	3.57%	-18%	3.93%	4.51%
Industrial	4.38%	48	-10	4.21%	3.20%	-4%	3.70%	4.27%
Office	9.01%	50	123	6.63%	5.02%	-26%	5.64%	8.61%
Retail	7.62%	41	-22	7.03%	5.83%	-8%	4.94%	7.44%
All REITs	**6.40%**	**57**	**56**	**5.45%**	**4.47%**	**-15%**		
REIT ODCE Proxy	**7.12%**	**49**	**65**	**5.77%**	**4.37%**	**-19%**	**4.25%**	**5.06%**

287 bps Δ between REITs and ODCE

CenterSquare Cap Rates +140 bps from peak

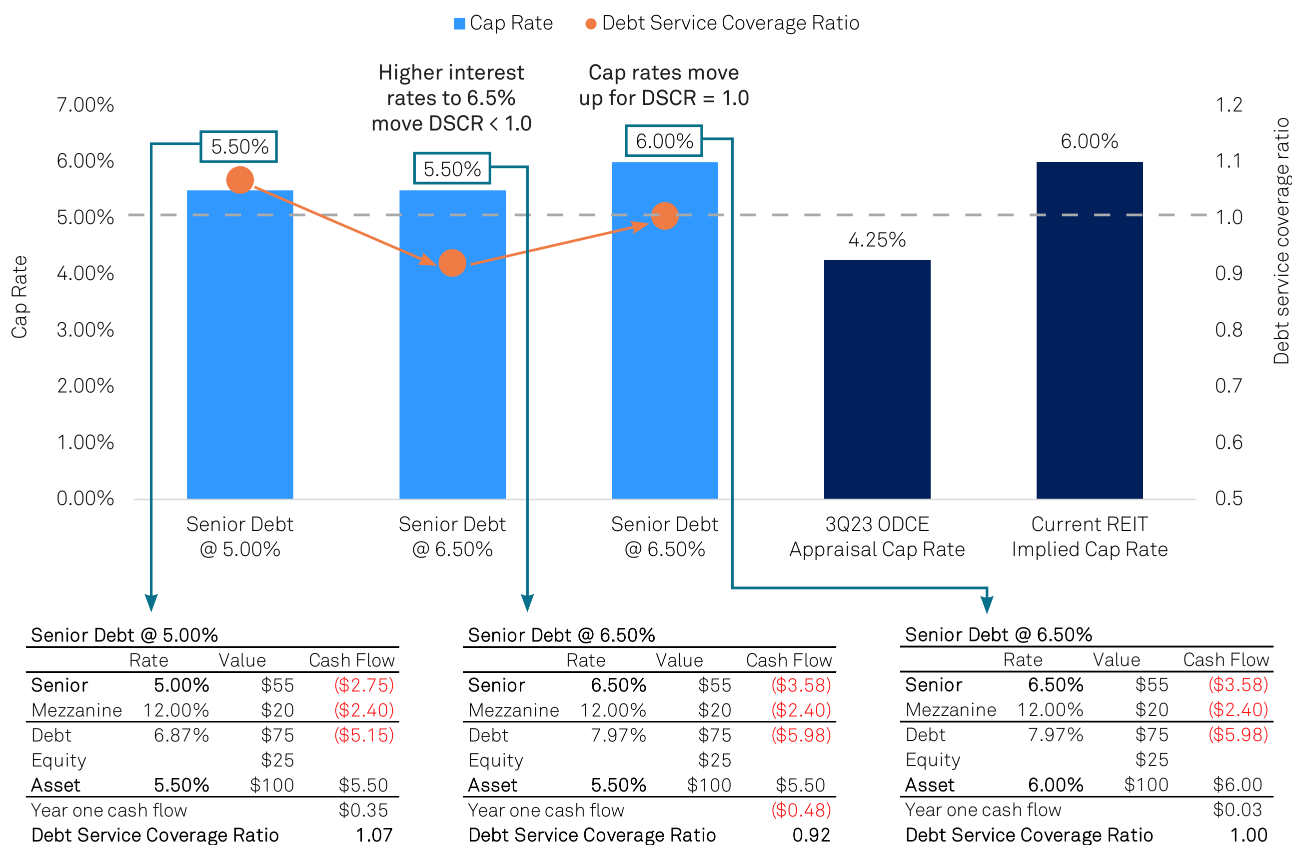
81 bps Δ between transactions and appraisals in ODCE Funds

Source: CenterSquare REIT Cap Rate data, as of September 30, 2023. Please refer to cap rate methodology at the end of this presentation.

However, we do anticipate the credit market is likely to accelerate the private market's needed repricing. Over $700 billion commercial mortgages were set to mature in 2023 (many of which have been extended into 2024 and 2025) and over $600 billion are set to expire in 2024 per the Mortgage Bankers Association. As these mortgages get refinanced, a change in valuation must occur to meet debt service coverage ratio requirements. Take the below illustration (Figure 4) as an example with in-place senior debt priced at a 5% interest rate. In this scenario, the asset which is priced at 5.5%, is generating enough cash flow for the debt service coverage ratio to be above 1.0. As the senior debt gets repriced to 6.5%, the same 5.5% cap rate on the asset results in a debt service coverage ratio below 1.0. For the debt service coverage ratio to be back to at least 1.0x when senior debt is priced at 6.5%, the cap rate must rise to at least 6%. While the public market has priced in this new reality of debt costs and REITs are trading at a 6% cap rate to start the year, pricing across private markets has yet to fully reset.

Though the resetting of private market valuations occurred modestly last year, we anticipate it to continue in earnest through 2024 as debt markets drive this shift and plentiful capital remains on the sidelines waiting for transactions to meet the market.

Figure 4: Cap rate expansion required to meet debt service coverage ratio requirements



Senior Debt @ 5.00%

	Rate	Value	Cash Flow
Senior	5.00%	$55	($2.75)
Mezzanine	12.00%	$20	($2.40)
Debt	6.87%	$75	($5.15)
Equity		$25	
Asset	5.50%	$100	$5.50
Year one cash flow			$0.35
Debt Service Coverage Ratio			1.07

Senior Debt @ 6.50%

	Rate	Value	Cash Flow
Senior	6.50%	$55	($3.58)
Mezzanine	12.00%	$20	($2.40)
Debt	7.97%	$75	($5.98)
Equity		$25	
Asset	5.50%	$100	$5.50
Year one cash flow			($0.48)
Debt Service Coverage Ratio			0.92

Senior Debt @ 6.50%

	Rate	Value	Cash Flow
Senior	6.50%	$55	($3.58)
Mezzanine	12.00%	$20	($2.40)
Debt	7.97%	$75	($5.98)
Equity		$25	
Asset	6.00%	$100	$6.00
Year one cash flow			$0.03
Debt Service Coverage Ratio			1.00

Source: CenterSquare, as of December 31, 2023.

Deploying Capital in the Coming Year

In the context of our base assumptions, where the 10-year yield settles near 4%, economic growth slows, and real estate reprices across the private market (due to cap rate expansion rather than fundamental deterioration), we remain acutely focused on identifying asymmetric payoffs in the form of favorable real estate supply and demand fundamentals as we deploy capital in 2024. We look forward to sharing our thoughts about deploying capital across public and private debt and equity real estate markets in the coming year through the upcoming installations of our market-specific forecasts:

Global REITs:

Global REITs have rapidly repriced in the last two years driven by a new reality of debt costs. However, we anticipate the end of the global rate hiking cycle, combined with a recession on the horizon, to act as a catalyst for performance in 2024. Our global REIT outlook covers 10 themes we anticipate playing out in the coming year.

Private Debt:

Lower proceeds from traditional lenders in the real estate debt market are creating an opportunity for alternative lenders to provide gap capital in the form of mezzanine debt or preferred equity on high-quality assets at favorable terms and positioning in the capital stack, providing some of the most compelling risk-adjusted returns we have seen in over a decade for real estate debt.

Private Equity:

Resetting pricing for real estate through 2024 provides a compelling opportunity to deploy capital at a reset basis, especially in niche property types with strong underlying fundamentals, such as purpose-built rental communities, service industrial, and essential service retail, that can drive asymmetric payoffs.

Strategic Capital:

Dislocation and volatility in the marketplace allow us to make unique real estate platform investments that are supported by major thematic trends.

In navigating the current real estate landscape, 2024 represents a juncture marked by the aftermath of increased fiscal spending and aggressive monetary policy. Looking forward, we remain focused on anticipating and capitalizing on favorable imbalances in the context of changing supply and demand fundamentals and resetting private market valuations. This reset provides a unique opportunity for investors to strategically position themselves across Global REITs, Private Equity, Private Debt, and Strategic Capital, each offering distinct avenues for capital deployment. In essence, 2024 emerges not only as a reset entry point for real estate, but also signifies a pivotal time for investors navigating the complexities of the market, leveraging insights, and positioning themselves for long-term success.

About the Authors

Todd Briddell, CFA

Chief Executive Officer, Chief Investment Officer

As Chief Executive Officer and Chief Investment Officer of CenterSquare Investment Management, Todd Briddell brings three decades of real asset experience and vision to direct the firm's global strategy, with a sharp focus on growth, performance and corporate values.

Upon joining CenterSquare in 1993, Todd founded the firm's listed real estate securities group and served as a driver of both the public and private investment platforms, holding numerous leadership positions across the firm. He became Chief Executive and Chief Investment Officer in 2012, and in 2018 headed the firm's successful management buyout from BNY Mellon. Todd currently maintains oversight responsibility for all of CenterSquare's real asset investment advisory services including listed real estate, private equity real estate and private real estate debt across the United States, Europe and Asia. He also chairs the firm's Management Committee and CenterSquare's Private Real Estate Investment Committee.

Todd holds a B.S. in Economics from the Wharton School of Business at the University of Pennsylvania with concentrations in Finance and Real Estate. He is a member of NAREIT, the CFA Institute/Society of Philadelphia and PREA, where he was Co-Chair of the Green Building Committee. He is a Research Sponsor and sits on the Executive Committee of Zell/Lurie Real Estate Center Advisory Board at the Wharton School.

Uma Moriarity, CFA

Senior Investment Strategist and Global ESG Lead

Uma Moriarity is the Senior Investment Strategist and Global ESG Lead for CenterSquare Investment Management. She focuses on investment strategy and leads thought leadership across the Firm's public and private real estate platforms. She is part of the listed real estate investment team and serves on CenterSquare's Private Real Estate Debt Investment Committee. Uma leads the Firm's Environmental, Social, and Governance (ESG) strategy to incorporate ESG into the decision-making and management of listed and private real estate investments to create long-term value, reduce risk, and generate superior risk-adjusted investment returns. Prior to joining CenterSquare, she spent three years in corporate strategy and planning at ExxonMobil in Houston. Uma graduated from The Pennsylvania State University with Interdisciplinary Honors and High Distinction and holds a B.S. in Finance with a minor in International Business, B.S. in Accounting, and Master of Accountancy. She is a CFA charterholder and member of the CFA Institute, a LEED Green Associate, and a member of the ULI San Francisco Sustainability Committee. She currently serves on the Board of Directors for Green Building United, the Penn State Smeal Sustainability Advisory Board, and the FTSE EPRA Nareit Americas Regional Advisory Committee.

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CenterSquare REIT Cap Rate Perspective Methodology

CenterSquare REIT Implied Cap Rates are based on a proprietary calculation that divides a company's reporting net operating income ("NOI") adjusted for non-recurring items by the value of its equity and debt less the value of non-income producing assets. The figures above are based on Q4 2023 earnings reported in September 2023.

The universe of stocks used to aggregate the data presented is based on CenterSquare's coverage universe of approximately 200 U.S. listed real estate companies. Sector cap rates are market cap weighted. Sectors and market classifications are defined by the following:

Apartment: REITs that own and manage multifamily residential rental properties; Industrial: REITs that own and manage industrial facilities (i.e. warehouses, distribution centers); Office – REITs that own and manage commercial office properties; Retail – REITs that own and manage retail properties (i.e. malls, shopping centers); Hotel – REITs that own and manage lodging properties; Healthcare – REITs that own properties used by healthcare service tenants (i.e. hospitals, medical office buildings); Gateway – REITs with portfolios primarily in the Boston, Chicago, LA, NYC, SF, and DC markets; Non-Gateway – REITs without a presence in the gateway markets.

The REIT ODCE Proxy is a universe of REIT stocks built to resemble the NCREIF Fund Index – Open End Diversified Core Equity (ODCE). The ODCE, short for NCREIF Fund Index - Open End Diversified Core Equity, is the first of the NCREIF Fund Database products and is an index of investment returns reporting on both a historical and current basis the results of 36 open-end commingled funds pursuing a core investment strategy, some of which have performance histories dating back to the 1970s. The REIT ODCE Proxy is proprietary to CenterSquare and uses gateway/infill names in apartments, retail, industrial and office, and then weights them according to the ODCE index to create a proxy.

Private Market Cap Rates represent the cap rate achievable in the private market for the property portfolio owned by each company, and are based on estimates produced by CenterSquare's investment team informed by various market sources including broker estimates.

Definition of Indices

FTSE Nareit All Equity REITs Index "FNER"
The FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

This benchmark is a broad-based index which is used for illustrative purposes only. The investment activities and performance of an actual portfolio may be considerably more volatile than these indices and may have material differences from the performance of any of this index.
A direct investment in an index is not possible.

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