Vintage 2024

The Case for Next Cycle Opportunistic Property Investment

Sophisticated property investors have long employed various forms of diversification and allocation discipline to manage risk and ensure portfolio exposure to opportunities for potential outsized return. Among these, the discipline to diversify across investment vintages, is important to successful long-term investment in closed-end (finite life) opportunistic investment vehicles. Inherently, real estate has strong cyclical dynamics; however, how prescient we believe ourselves to be, no crystal ball is perfect, and no forecasting model is infallible. Thankfully, history has been a consistent, though occasionally unkind teacher. We believe most investors understand that the greatest investment opportunities often present themselves when sentiment, and current valuations, have found their cyclical nadir. In the current real estate valuation cycle, we believe that moment is now.

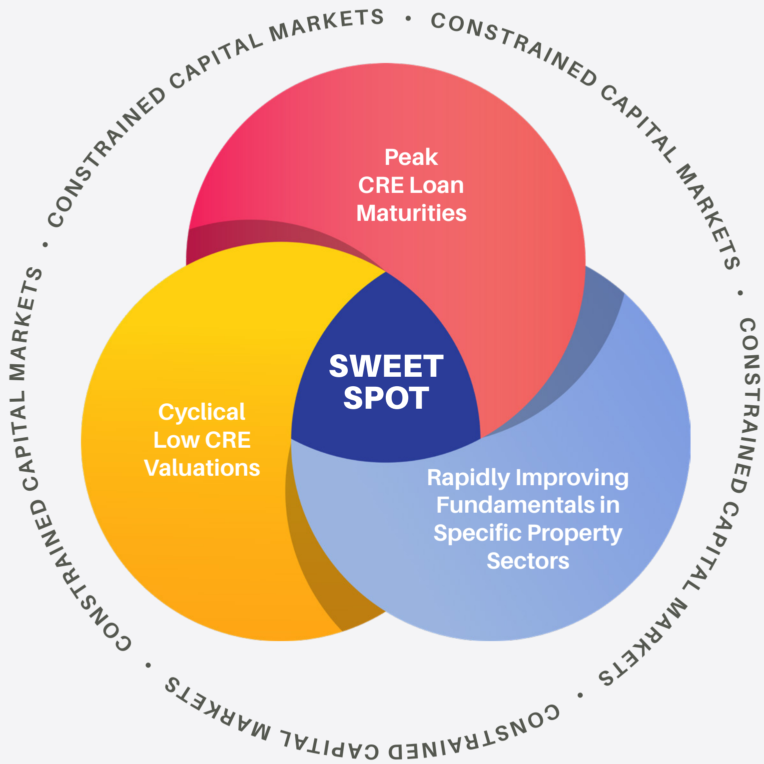
Specifically, we believe several distinct, but related forces are combining to form attractive opportunistic investment vintage since the post financial crisis (GFC) period.

1 **U.S. commercial property valuations are now at or quickly approaching the low point for this cycle. This cyclical low is occurring at the exact same time as the peak volume of existing commercial property loan maturities.**

2 **The resulting capital structure stresses have been increasing, particularly on properties that traded (and were financed as recently as 2021 and 2022) on extreme valuation metrics. This exposure reveals a significant need for debt and equity rescue capital.**

3 **Tight credit conditions and elevated financing costs remain a significant constraint on debt and equity liquidity creating a return premium for providers of capital on high quality asset with misaligned capital structures.**

Figure 1: Identifying Potentially Compelling Opportunities



We believe the most appealing opportunities vary by property segments and location when overlaying the supply and demand dynamics that drive property market fundamentals (e.g. rental rate and occupancy) with the capital market dynamics. While traditional office properties show the most extreme capital structure stress today, the path to recovery is less certain and evolving. Based on our research, we believe the most compelling recapitalization opportunities are primarily in residential markets and certain industrial property segments and locations. Both sectors are benefiting from what we see as ongoing positive secular shifts in the underlying drivers of demand in the wake of elevated construction activity. In select property segments such as seniors housing, the post-pandemic recovery in property markets fundamentals (e.g., rental rate and occupancy) supported by robust demand has been equally pronounced while lacking the supply response.

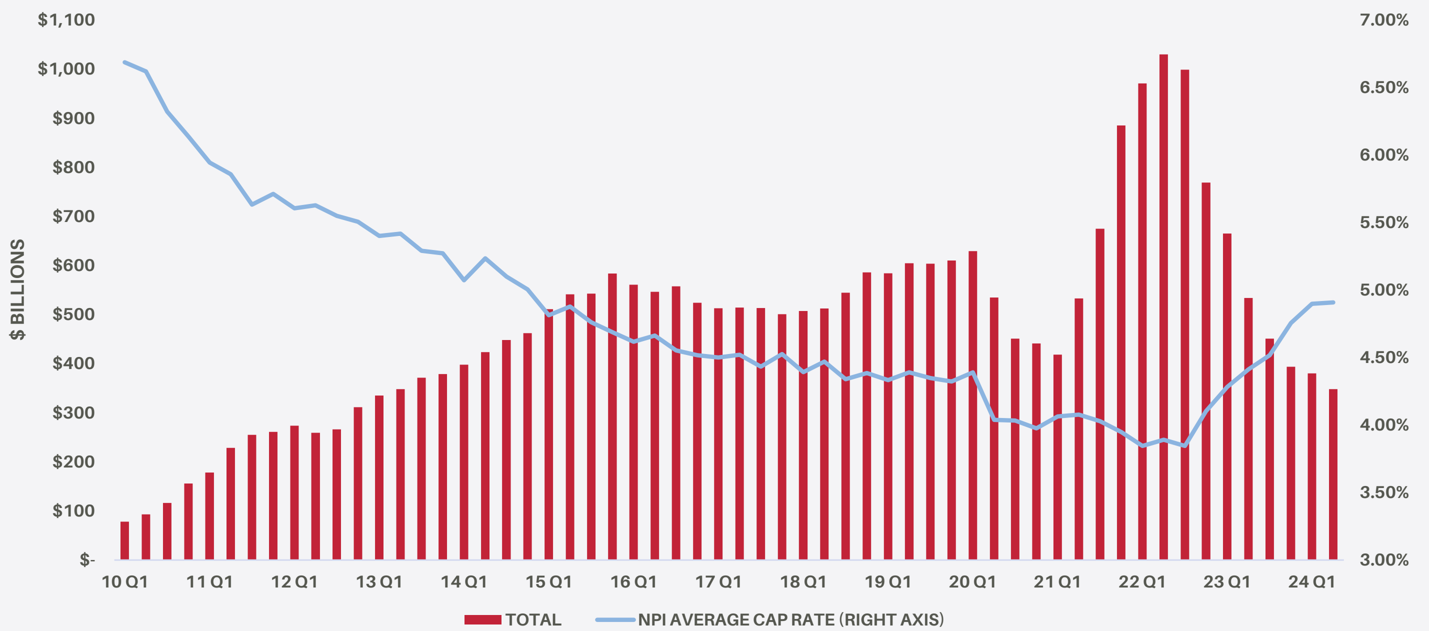
Setting the Stage

The COVID-19 pandemic, and the various policy responses to it, triggered myriad economic and capital market dislocations. For commercial property markets, transaction volumes and pricing are clear examples. Prior to the pandemic, U.S. total commercial property transaction volumes were quite stable, averaging approximately $600 billion per year through 2018 and 2019. In 2020 and into the beginning of 2021, transaction volume unsurprisingly plummeted, declining more than 30% as travel and other restrictions hampered trading. In aggregate, CRE transaction volume bottomed at an annual pace of slightly more than $400 billion at the beginning of 2021 before surging above the trillion-dollar mark by mid-2022. Not surprisingly, this surge coincided with highly stimulative fiscal and monetary policy as the Federal government flooded the economy with direct cash infusion and the Federal Reserve pushed interest rates back towards the zero bound. This record level of liquidity and transaction volume also saw average yields fall to the lowest level ever recorded.[1] In other words, this period saw the greatest amount of property ever traded (by a wide margin) at the lowest yields (i.e., highest values) ever (also by a wide margin).

Fast forward to today and the dynamics are reversed with transaction velocity/liquidity below levels ten years ago coming out of the GFC and with cap rates approaching similar levels. After an aggressive push by the Federal Reserve to harness inflation by raising short-term rates above 5%, the Fed is reversing course. The shift in Fed policy to an easing stance will likely help mitigate a further deterioration in these metrics but the valuation divide remains in place as the yield curve and corresponding growth assumptions are adjusted to reflect current market expectations. While showing some volatility since mid-2022, the 10-year Treasury rate has settled into a range that is 100-150 basis points above pre-pandemic norms and well above pandemic levels[2]. Assets forced to recognize the new capital markets climate through debt maturities or covenant breaches as well as lease turnover present some of the most attractive recapitalization (via sale) or financing opportunities as the cycle progresses.

1 Property yield in Figure 2 is the average appraisal (carrying value) cap rate of the four major property types reported by NCREIF.
2 Pre-pandemic defined as 2012 – 2019 and pandemic defined as 2020-2021

Figure 2: Total CRE Transaction Volume Over Prior Four Quarters and Average Property Cap Rate



Source: RCA/MSCI, NCREIF

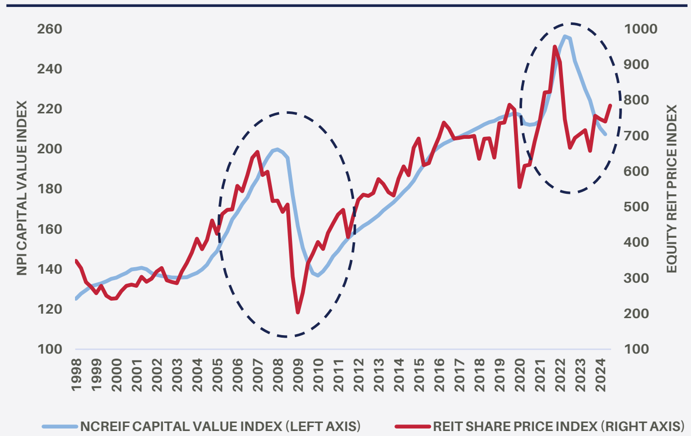
Cyclical Low Valuations – Beginning of Next Valuation Up Cycle

While cyclical valuation peaks and troughs are notoriously difficult to call before they occur, we point to several observations:

Private Market Values Follow Public Market Values by About One Year

- In the last cycle, U.S. equity REIT share prices bottomed in 2009 Q1 and the capital value component of the NCREIF Property Index (NPI) bottomed in 2010 Q1. In the current cycle, REIT share prices bottomed in 2023 Q3 and the capital value component of the NPI looks to bottom in 2024 Q3 or by the end of 2024.
- Previously, the observed cap rate on properties trading in the NPI increased to the same level as REIT implied cap rates just as private market holding value (appraisal) cap rates peaked (i.e., values bottomed). The same has just happened in the current cycle.

Figure 3: U.S. Equity REIT Share Price Index and NPI Capital Value Index

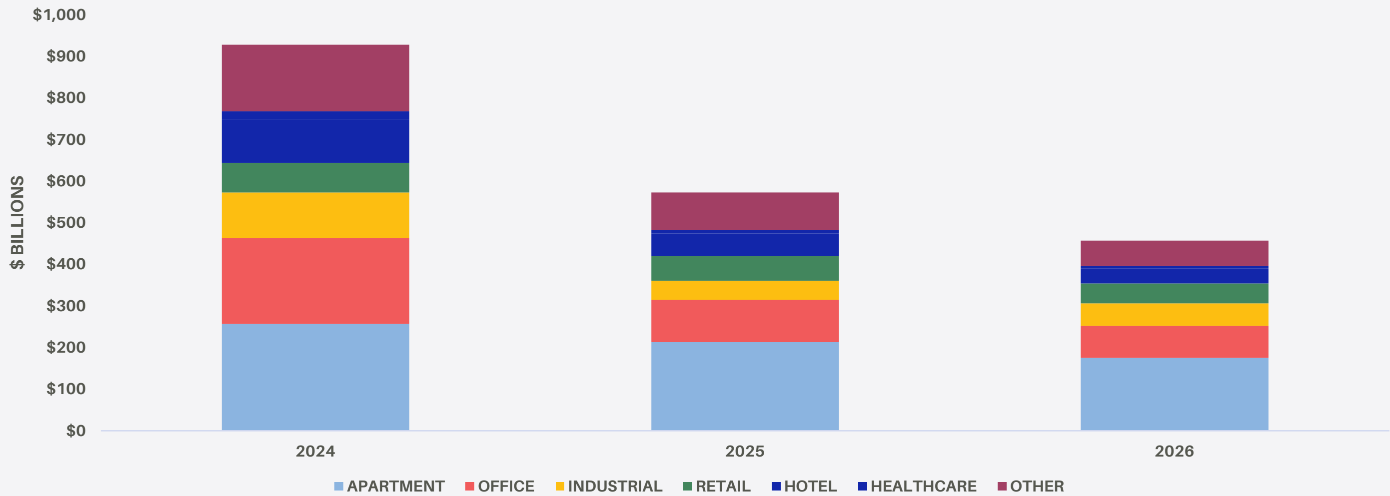


Source: FTSE, NCREIF

Emerging Capital Structure Stress

In aggregate, there is approximately $6 trillion of outstanding commercial and multifamily property loans in the U.S. and one-third of these will mature over the next three years[3]. Invariably, some portion of the loans scheduled to mature during 2024 have (or will be) extended into 2025 and beyond, thereby delaying the resolution of these loans on the hope that improving property values may reduce the degree of loan impairment.

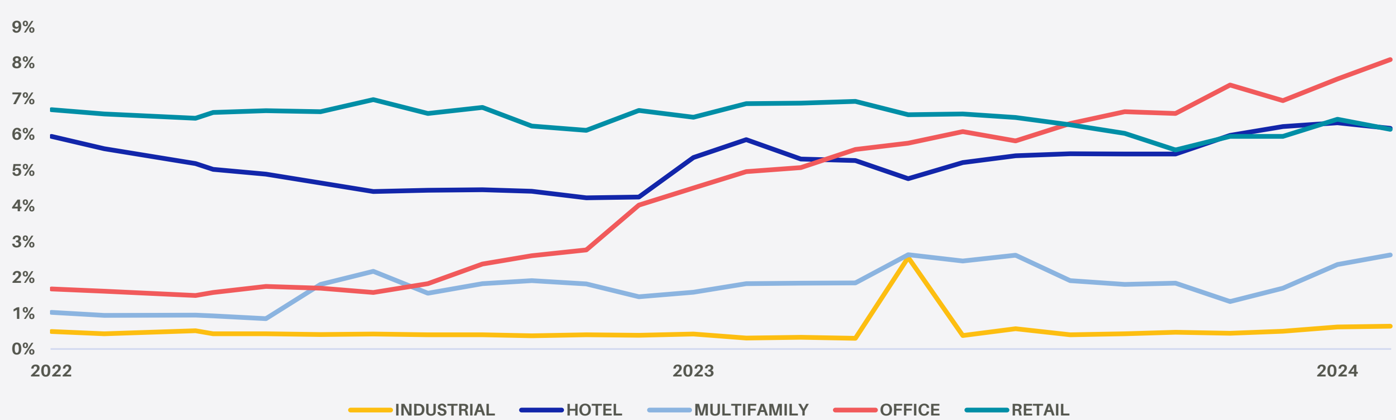
Figure 4: Expected Commercial and Multifamily Loan Maturities



Source: Mortgage Bankers Association (MBA), as of December 31, 2023
There is no assurance that any prediction, projection or forecast will be realized

The most obvious sign of current and likely still emerging capital structure stress is clearly in office properties where easily observed measures such as the CMBS delinquency rate is climbing quickly back towards levels not seen since the post-financial crisis period. Elevated delinquency rates also exist in hospitality and retail loans, albeit at lower levels than observed during the period of pandemic related business disruptions. Other signals have emerged in the banking sector, although not to the degree seen in the GFC, with an elevated number of impairments being reported related to their CRE book of business. Banks have tightened their lending standards considerably over the past two years and held steady most recently[4] constraining access to leverage, especially for new relationships.

Figure 5: CMBS Delinquency Rates by Property Type



Source: Trepp, as of August 2024

3 Mortgage Bankers Association
4 Based on the Federal Reserve Bank's Loan Officers Survey

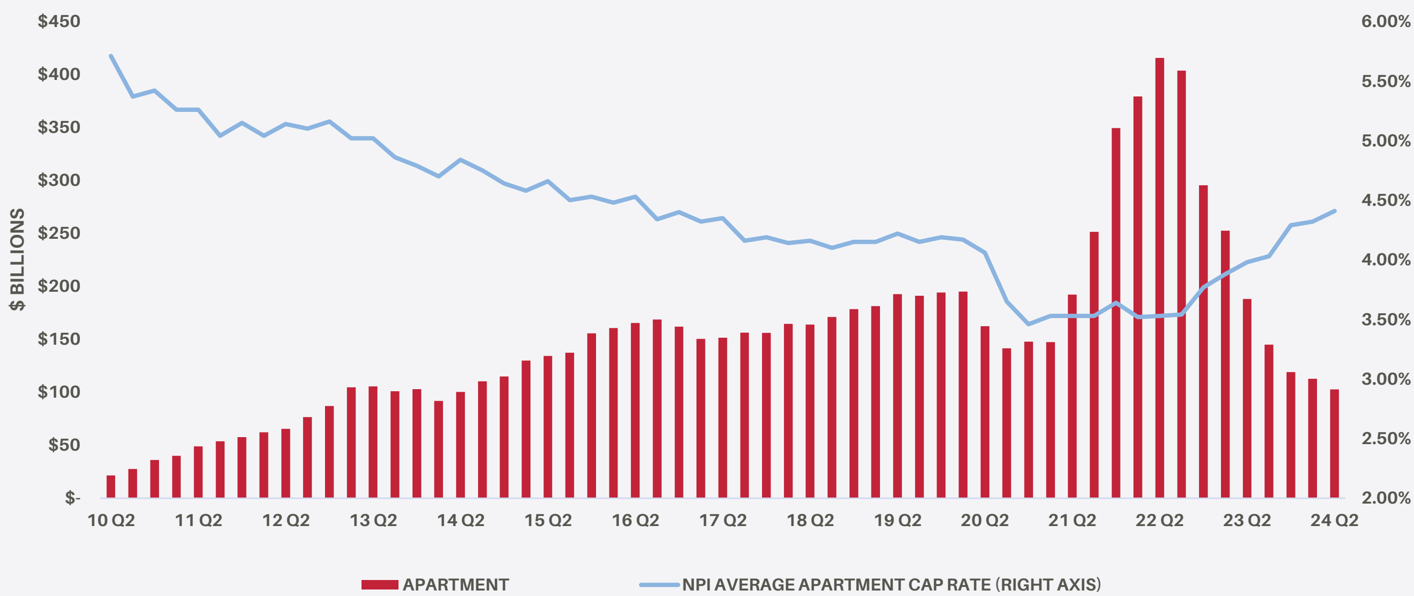
Property Type Focus

The property sectors that we believe can provide some of the most attractive near-term opportunities for outsized returns include components of the industrial (warehouse) and residential (apartments and seniors housing) markets. As the cycle progresses, other select sectors such as hospitality, healthcare/medical office, office and retail can present potential opportunities.

Apartments

Capital market dislocations are proving to be more pronounced in the apartment sector compounded by a supply response to robust increases during the height of the pandemic. While the surge in pricing and volume occurred across all parts of the U.S. commercial property market, it was concentrated in apartment properties and, to a lesser degree, industrial properties. Indeed, apartment transactions alone represented more than 40% of the total peak trading volume over this period[5].

Figure 6: Apartment Transaction Volume Over Prior Four Quarters and Average Apartment Cap Rate



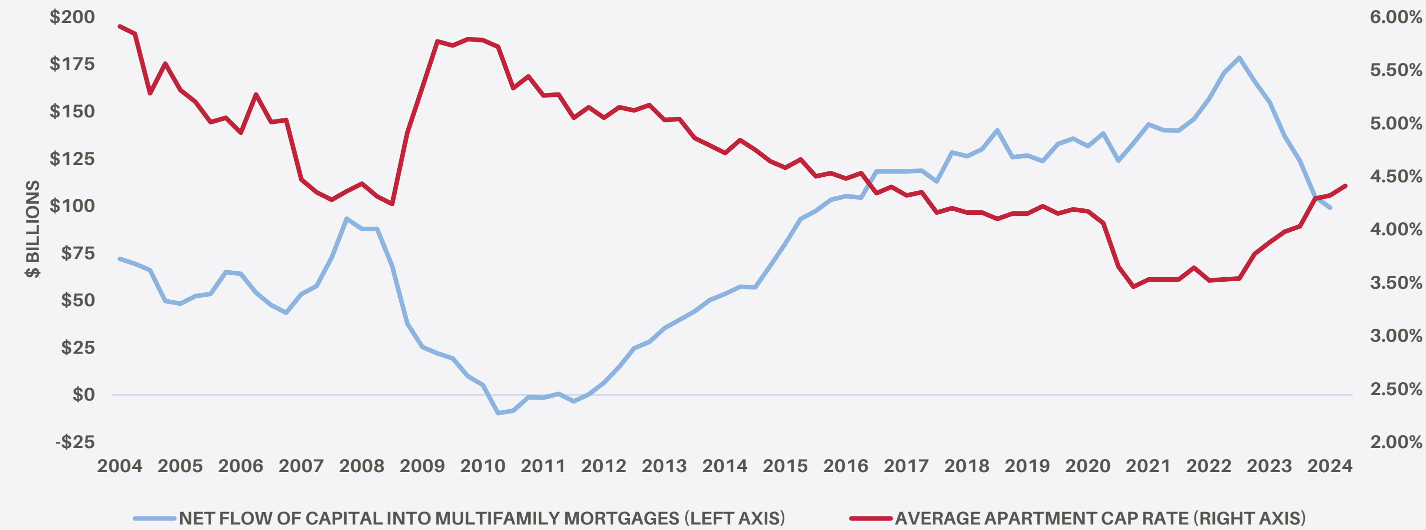
Source: RCA/MSCI, NCREIF

Asset Photo Source: AEW Capital Management. Assets pictured in this material are for illustrative purposes only.

5 Based on MSCI/RCA transaction data.

Similarly, the net flow of capital to multifamily mortgages also reached an all-time high of more than $175 billion (annualized) in mid-2022, again with all time low property capitalization rates for multifamily properties.

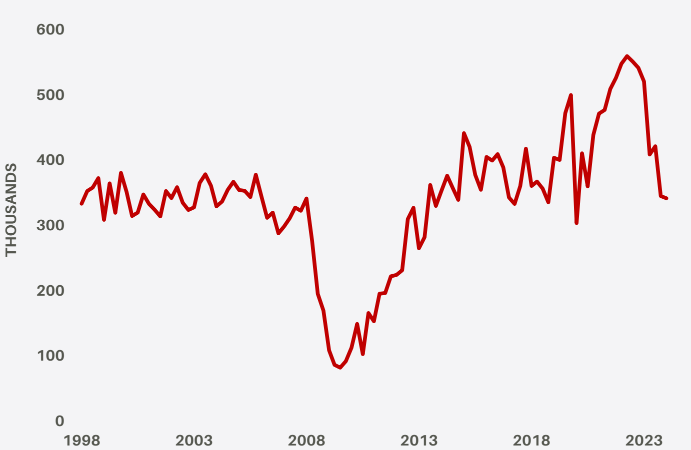
Figure 7: Net Flow of Capital Over Prior Four Quarters into Multifamily Mortgages and Average Apartment Cap Rate



Source: RCA/MSCI, NCREIF, as of June 2024

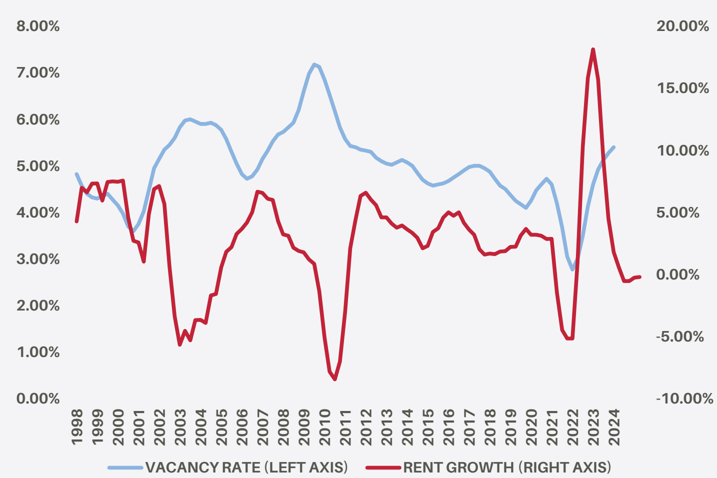
Deteriorating apartment loan performance today is a direct outgrowth of this period of extreme liquidity – transactions and financing. Simply, record high apartment valuations triggered the highest levels of multifamily housing starts in more than 30 years and this record level of new construction has caused vacancy rates to rise and rent growth to slow. Neither of these developments are particularly extreme overall, with the average apartment vacancy rate rising to 5.5% and average apartment rent growth slowing near zero on a year-over-year basis. In specific markets and, more significantly, for specific properties, typically across the southeast and southwest, the impacts are greater. In many cases, the underlying loan problem is the result of aggressive financing applied to peak valuations. The inevitable decline in multifamily starts is already happening. We expect apartment rents to firm over the next 12-24 months and eventually begin to rise again, particularly in places where the current over supply reverts to under supply. The issue, however, will be the outsized debt sized to assumptions of continued near-term strength.

Figure 8: U.S. Multifamily Housing Starts



Source: Census Bureau, as of Q2 2024

Figure 9: U.S. Apartment Vacancy Rate and Rent Growth

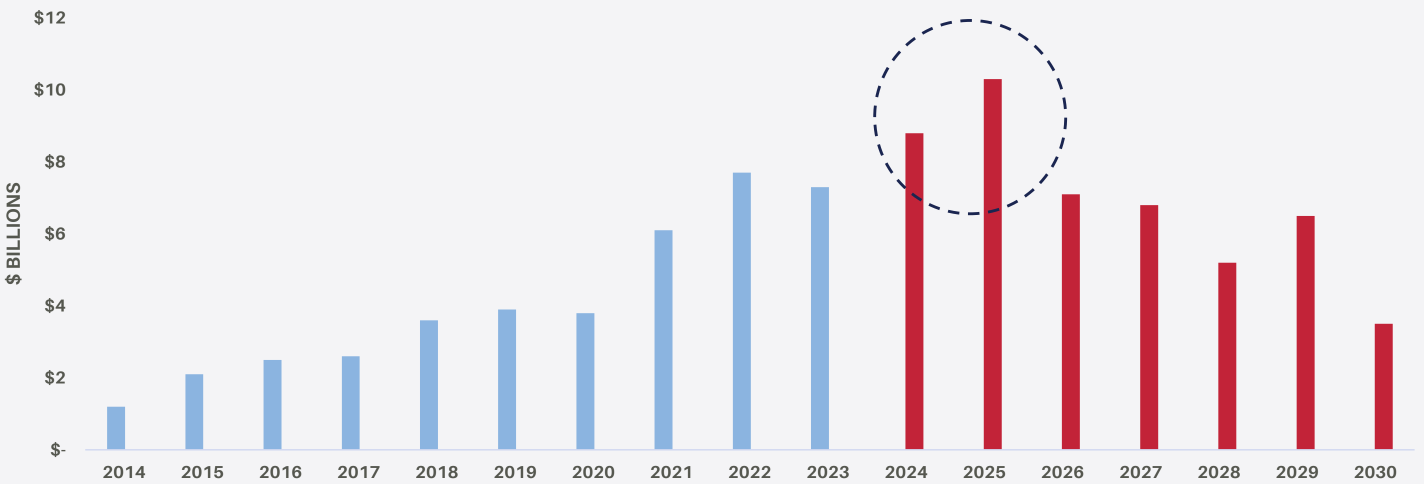


Source: CBRE-EA, as of Q2 2024

Seniors Housing

While we believe there are significant capital structure stress opportunities across numerous apartment markets today (and possibly various industrial property markets over the next several years), we find our single greatest conviction opportunity to be in the property sector where we see both capital structure stress and a powerful cyclical recovery in property operating fundamentals – seniors housing. With respect to capital structure, there is no doubt that many seniors housing properties, particularly newer properties that delivered prior to or during the pandemic, are facing near-term debt maturities. Many of these assets are contending with extended lease-ups and expenses loads materially above pre-pandemic underwriting which is weighing on a recovery in NOI and valuations. Indeed, Figure 10 shows peak near-term seniors housing loan maturities during 2024 and 2025.

Figure 10: Seniors Housing Expected Loan Maturities

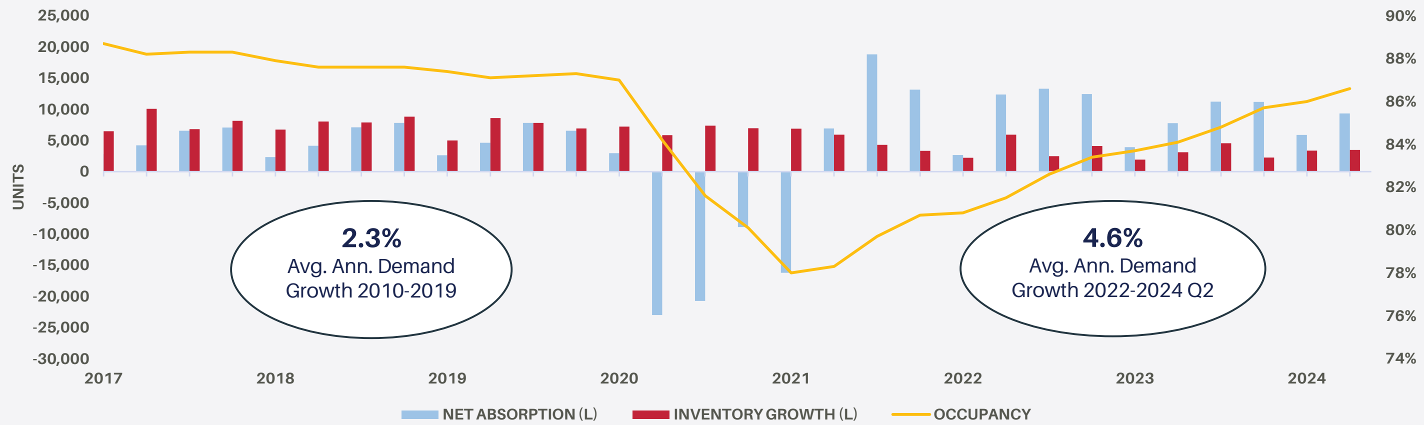


Source: Cushman & Wakefield, RCA, as of October 2024
There is no assurance that any prediction, projection or forecast will be realized.

That said, seniors housing is well into a strong cyclical recovery in fundamentals having gone through a severe adjustment during the health crisis that impacted the prime demand demographic underpinning the sector. The initial shock to new resident demand (move-ins) was severe but proved to be temporary in nature after four quarters of negative absorption followed by a doubling in the pace of demand achieved prior to the pandemic. The higher acuity segments (assisted living and memory care) lead the more discretionary independent living segment, highlighting the durability of demand and 'needs-based' dynamics.

Asset Photo Source: AEW Capital Management. Assets pictured in this material are for illustrative purposes only.

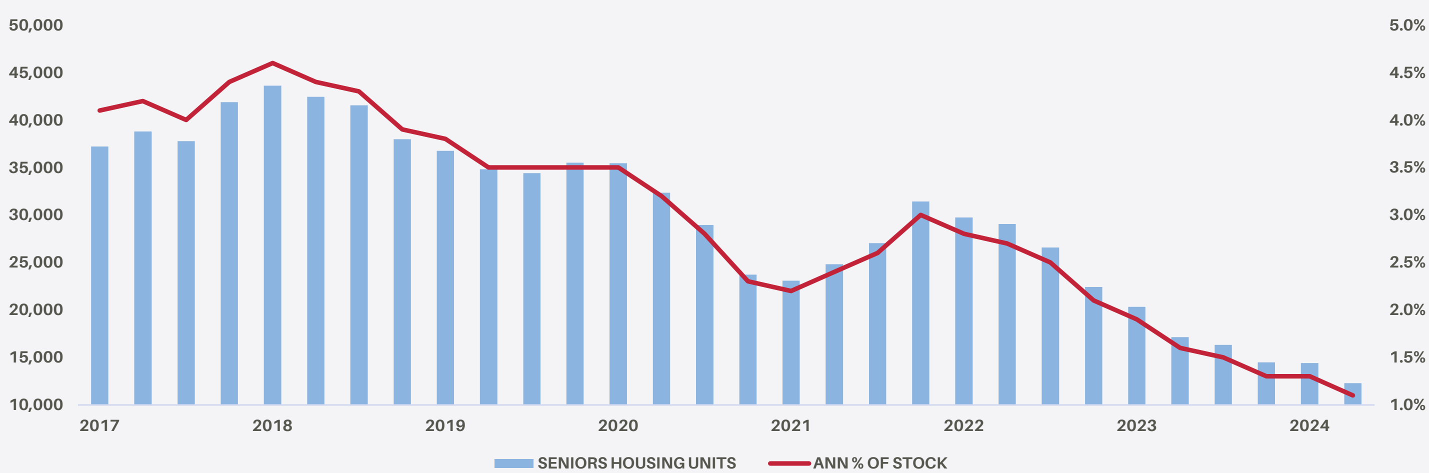
Figure 11: Seniors Housing Occupancy Fundamentals



Source: NIC Map Data Services, as of Q2 2024

On the supply side, many years of strong operating and investment performance led to a significant increase in new construction during the years leading up to the pandemic, particularly in 2017 and 2018, at levels that outpaced demand. The supply cycle had begun to adjust as the pandemic unfolded but the combination of new supply and lower absorption (move ins) led directly to significant declines in occupancy rates which bottomed at 78% in 2021 down just over 1000 basis points at the end of 2019. The reversal in demand dynamics have not been met with a corresponding supply response with new projects breaking ground dropping to the lowest level since the financial crisis. Occupancies have been improving steadily and are now within 70 bps of pre-pandemic levels.

Figure 12: Seniors Housing Starts (Rolling Four-Quarters)



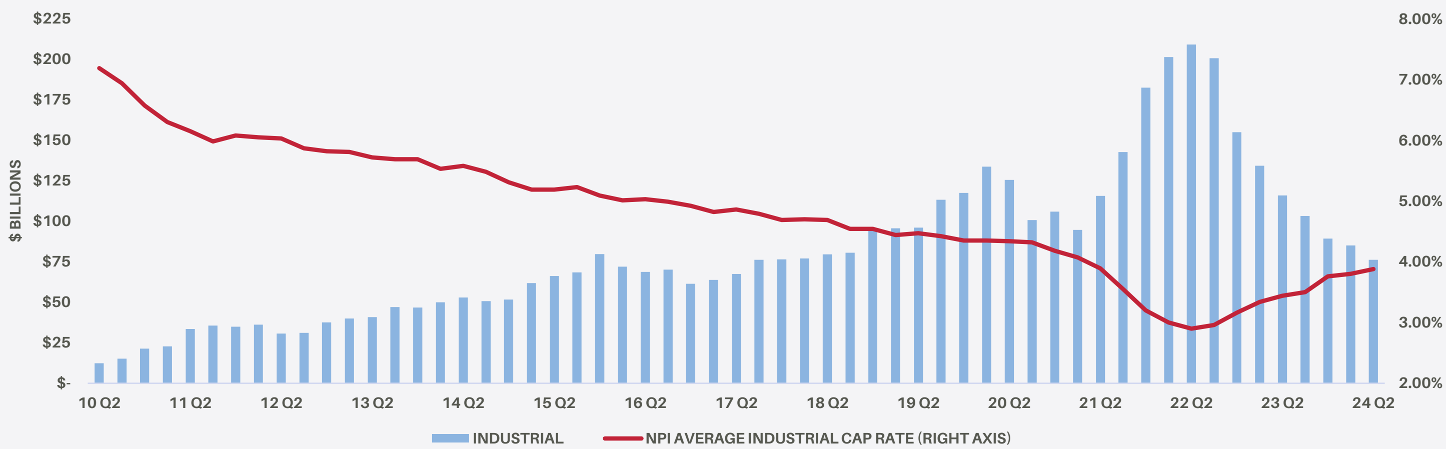
Source: NIC Map Data Services, as of Q2 2024

Despite the sharp occupancy decline during this period, average rent growth for both assisted and independent living remained positive, albeit at reduced rates. In large part, this speaks to both the necessity nature of the property sector as well as the inherent reluctance by individuals or families to relocate established older residents. Not surprisingly, the combination of stronger rent growth and improved occupancy is driving the overall recovery in seniors housing property net operating income. NOI growth has been particularly strong in recent quarters as occupancy returns to levels where the structural operating leverage in seniors housing is additive.

Industrial

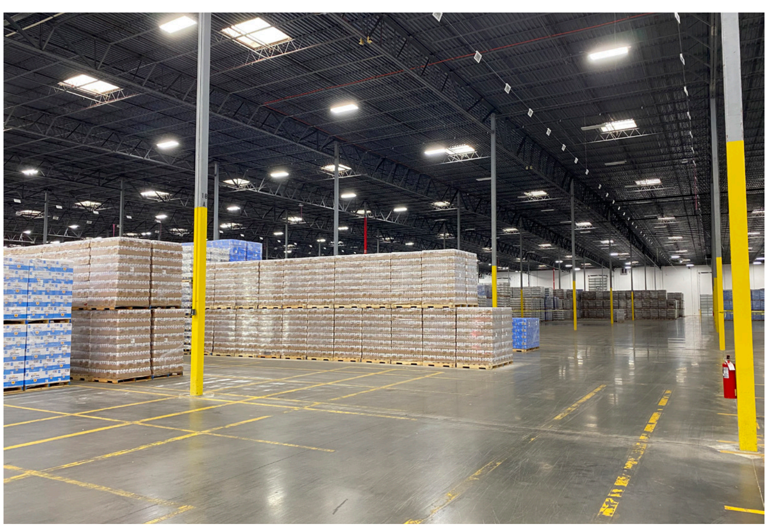
Not unlike apartments, capital market dislocations are proving to be more pronounced in the industrial sector compounded by a robust supply response during the height of the pandemic. Much of this was spurred by an overweighting to spending on goods versus services compounded by an acceleration in the trend of direct-to-consumer delivery. The net result was strong demand for space and robust rent growth as vacancies dipped to historic lows. Similarly, annual transaction volume reached an all-time high of more than $200 billion in mid-2022, again with an all time low property capitalization rates for industrial properties. All told, industrial transactions represented more than 20% of the total peak trading volume over this period.

Figure 13: Industrial Transaction Volume Over Prior Four Quarters and Average Industrial Cap Rate



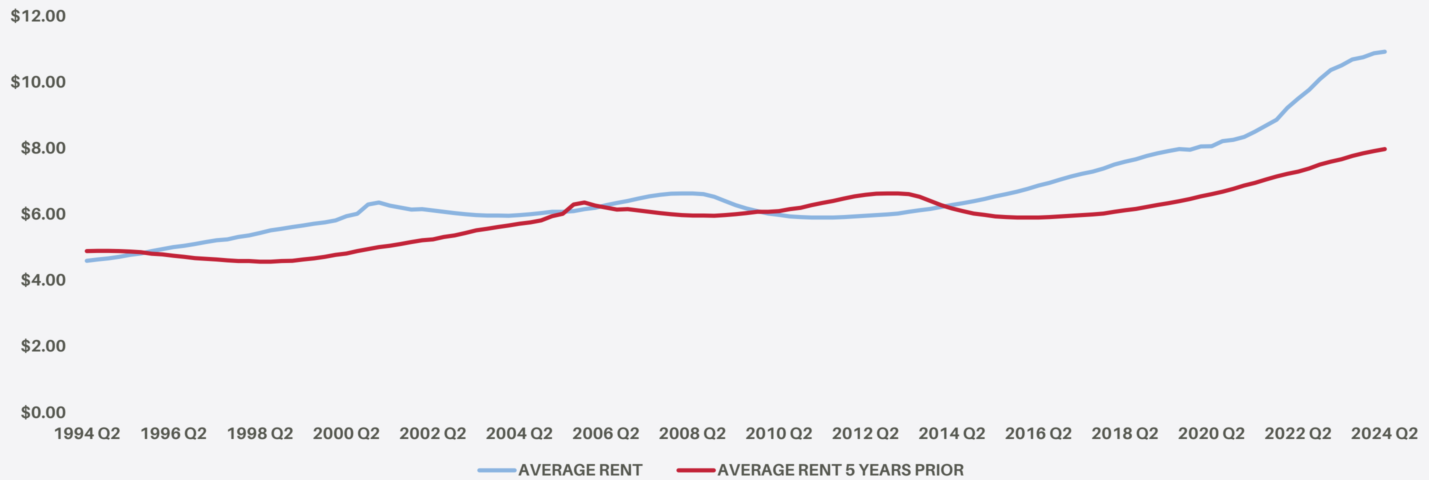
Source: RCA/MSCI, NCREIF

Deteriorating loan performance today is a direct reflection of this period of extreme liquidity – transactions and financing – with record high valuations that triggered a significant supply response, especially for large distribution facilities proximate to key transportation nodes where the pull-forward of future demand has been more pronounced. As a result, fundamentals have softened causing availability rates to rise and rent growth to slow. The pullback has been more a reflection of an easing from extremes with availabilities rising to just above 8% overall and rent growth moderating from double digit increase to the 3-4% range as the demand for space continues to expand (positive net absorption). Large speculative assets that sit vacant in a slower leasing environment as firms contemplate future needs are most exposed to the capital market pressures.



Asset Photo Source: AEW Capital Management. Assets pictured in this material are for illustrative purposes only.

Figure 14: Industrial Rent and Mark-To-Market[6]



Source: CBRE-EA

The pullback in supply has begun and secular growth in demand remains in place despite a cyclical slowing in the current environment. While rent growth has slowed, rent levels in the market today are nearly 40% above where they were when a lease was signed five years ago creating some downside protection to NOI on future rent movements. The issue will be the outsized debt linked to assumptions of continued near-term strength used in underwriting.

Additional Sectors

Other sectors where we believe potential opportunities for attractive returns include:

- Traditional Office (high capital structure stress)
- Hospitality (capital intensive, early cycle play)
- Medical Outpatient Care (durable income, rent reset to market, shifting care/convenience model)
- Structured Financing (bridge funding, preferred capital)

The traditional office market is experiencing the most extreme capital market stress with a correction in values that, for many assets, exceeds debt levels creating impairment deep into the capital stack. Leasing and demand-side fundamentals related to the evolving remote-work dynamics appear to be stabilizing but conviction surrounding a path to recovery remains somewhat elusive. The hospitality sector has experienced similar financial market stress, especially for business-oriented hotels where the cycle has not fully normalized (versus leisure). Brands are becoming stricter on holding owners accountable for scheduled property improvement plans (PIPs) creating more pressure on owners for capital investment dollars. Demand for healthcare services is expanding with an aging population compounded by a shift toward conveniently located outpatient care. Venues we expect to outperform will be geared toward the higher acuity setting outside of the traditional hospital including medical outpatient (medical office); surgical (ambulatory surgical centers); and rehabilitation along with select other segments. Additionally, a widening gap between in place and market rents given low rent escalations clauses presents an attractive market-to-market opportunity in this high tenant retention sector. In aggregate, we see these opportunities emerging as the cycle progresses.

6 Mark-to-Market or Loss to Lease in this context reflects the difference the rent in the current quarter market rent relative to the market rent 5 years prior. This does not reflect any rent escalations built into a lease. For this example, we are assuming a typical 5-year lease. The 2Q 2024 rent reflects a 37% premium over market rents 5 years prior.

Conclusion

The current environment suggests a favorable opportunistic landscape since the financial crisis, as three specific developments intersect now and may continue to do so over the next few years. First, the broader real estate valuation cycle is bottoming, and the transition to stable and rising values will be supported by a well telegraphed change in Federal Reserve interest rate policy. This bottoming in values, however, is occurring in step with a period of historically large commercial property loan maturities. Indeed, one-third of the total amount of commercial and multifamily property loans outstanding will mature over the next three years.

Second, an outsized amount of property traded during 2021 and 2022, in some cases, such as apartment properties, at transaction volumes as much as 50% higher than pre-pandemic norms. More significantly, these properties were collectively valued at the lowest yields (i.e., highest values) ever recorded. Many of these properties, particularly apartments, are unlikely to be able to support their current level of debt as these loans mature, creating the need for various forms of debt and equity rescue capital. Finally, one specific property sector presents both capital structure stress as well as a significant cyclical recovery in property operating fundamentals (i.e., rent and occupancy) – seniors housing.

PREPARED BY
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