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US roundtable: 2022

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US investors pause amid economic turmoil

*Despite reduced liquidity and jittery real estate markets in North America, roundtable participants say opportunities remain in sectors with clear structural tailwinds. By **Stuart Watson***

Sentiment in the US real estate market has undergone a radical transformation over the past six months. At the outset of 2022, investors were expecting another bumper year like 2021, when total investment volume for the US commercial real estate market reached a record \$746 billion, according to CBRE. However, persistent inflation and rising interest rates have dampened formerly high spirits, and with GDP growth turning negative in the first two quarters of this year, concerns that the economy may enter a recession are intensifying.

Interest rate hikes have led to increases in bond rates. In September, the benchmark 10-year US treasury note yielded 3.9 percent, its highest point since 2010. Consequently, spreads between bonds and real estate yields have narrowed. Meanwhile, the weakness of

public equity markets is increasing the relative weighting of real estate in portfolios, and this “denominator effect” is starting to constrain the ability of some investors to allocate to the asset class.

These factors threaten to open a fissure in the wall of equity that has sought to access real estate assets over recent years. Participants in PERE’s US roundtable discussion are acutely aware of the altered investment climate. “The world has changed,” admits Bert van den Hoek, head of the New York office for Dutch pension fund manager Bouwinvest. “The denominator effect is definitely a concern. We will be taking stock and assessing the market, as it is changing very fast.”

“The denominator effect is material. There is less capital out there,” agrees Justin Rimel, senior director at Invesco Real Estate. “You can see that in the dry powder available. And for a

lot of assets there is much less liquidity than there was before.”

Reduced availability of debt will further impact investment activity. “There is very limited capacity for new lending,” says Jason Hernandez, head of real estate debt for the Americas at Nuveen Real Estate. “Risk premiums have widened because of the geopolitical situation, and there are also structural issues in the debt markets. The CLO market, which was formerly incredibly liquid, has shut down.”

The combination of reduced liquidity, tighter bond spreads and increased cost of capital, is expected to impact real estate asset pricing. “We anticipate that valuations in the third quarter are going to be flat to negative, and the transactions market likely will stay suppressed until the Fed stops raising interest rates,” predicts Larissa Belova, portfolio manager at CBRE Investment Management. “Cap rate compression



Larissa Belova

Portfolio manager
CBRE Investment Management

Belova joined CBRE Investment Management in 2019 and serves as a portfolio manager at the independently operated real assets investment management arm of CBRE Group. CBRE Investment Management has around \$147 billion of AUM globally. In the US, its real assets strategies encompass direct and indirect real estate, listed securities, real estate credit and infrastructure.



Bert van den Hoek

Head of New York office
Bouwinvest

Van den Hoek has been head of Bouwinvest's New York office since the beginning of 2020, leading the origination efforts of real estate investments in North America as the Netherlands-headquartered firm seeks to build its international business. Bouwinvest manages a \$16.5 billion real estate portfolio on behalf of 32 institutional clients, including \$13.75 billion of assets for the Dutch construction workers' pension fund bpfBOUW.



Jason Hernandez

Head of real estate debt, Americas
Nuveen Real Estate

Hernandez leads the real estate debt business for Nuveen Real Estate, which has assets under management of \$156 billion globally, including over \$40 billion of credit investments. In the US, the firm invests across a range of risk profiles from core rate-fixed debt to bridge debt, and from core equity to opportunistic equity.



Stephen Rabinowitz

Real estate practice co-chair
Greenberg Traurig

Rabinowitz advises a variety of institutional and entrepreneurial investors, private equity funds, developers, asset managers and operators in the acquisition, financing, development and leasing of hospitality, multifamily, office and industrial properties. His practice is focused on venture formation and engineering sophisticated capital structures.



Justin Rimel

Senior director, North America
Invesco Real Estate

Rimel runs the US closed-ended fund business at Invesco Real Estate, which is owned by parent company, publicly traded asset manager Invesco. The firm's real estate business manages around \$90 billion of US assets, approximately half of which is managed in separate accounts, with some 80 percent of the total in direct real estate.

“The denominator effect is material. There is less capital out there”

JUSTIN RIMEL
Invesco Real Estate

is over, and we will see more focus on income.”

There is little concrete evidence so far of falling values, however, says van den Hoek. “Spot market rates are definitely moving in everybody’s minds, and behind the scenes, so to speak. But in appraisals, we don’t see it coming through yet. We had a very quiet summer in terms of transactions, so we expect third-quarter valuations not to be too detrimental relative to the second quarter. A fall is definitely expected, but a bit deferred into the future.”

Hernandez believes that the question is not whether values will fall, but how far. Two factors will be relevant in determining the extent of the decline, he argues: the increase in bond rates, which will suppress values, and the risk premiums demanded by lenders. Bond rates, while elevated, are not at historically high yields, while risk premiums

“There is lots of strategizing around upcoming debt maturities. Unlike more recent cycles, we don’t believe there will be as much kicking the can down the road”

STEPHEN RABINOWITZ
Greenberg Traurig

US real estate playing catch-up on ESG

While the sustainability agenda is taking hold in the US, participants agree that Europe remains ahead.

Bert van den Hoek: European sustainability regulations are definitely more stringent than we see so far in the US, although some cities are enacting carbon emissions limitation laws. In Europe, we are already seeing some examples of assets stranded by transition and climate risk, so we are more keenly aware, perhaps, than some US players that ESG should be part of the investment thesis.

Justin Rimel: In every acquisition we have an ESG plan for the asset. In particular, European capital providers are demanding that, and we are catching up in the US. There is reason to be concerned over the resiliency of assets within floodplain zones in areas like South Florida. But by and large we do not see much appreciation of that risk within the market yet.

Larissa Belova: ESG is critical to future-proofing your portfolio. In logistics, we are seeing demand from tenants for on-site electricity generation – we are partnering

with Altus Power to put solar panels on a lot of our assets – and charging facilities for electric vehicle fleets. It is an evolving way to make assets more competitive.

Jason Hernandez: The US is way behind Europe, although on the environmental side we are probably doing better than we give ourselves credit for. We can still do a lot to improve the social and governance aspects, though. We have an impact business that mostly invests in affordable housing. We are now offering services to the people who live there, helping to maintain and build those communities.

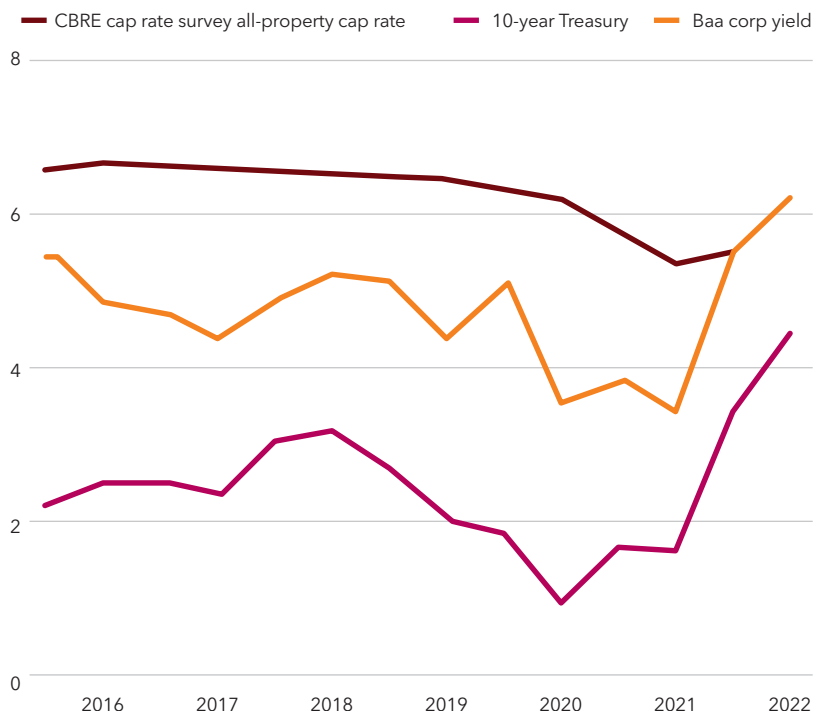
Stephen Rabinowitz: I still hear from some in our industry a sense that ESG will be de-emphasized as soon as the real estate sector faces strong headwinds. But there most likely is no going back. In New York, for example, recent local laws setting tight standards for energy efficiency and emissions require investors to make ESG a crucial consideration for projects and investments.

may gradually reduce as a result of greater geopolitical stability and the resolution of structural issues in the lending market, he reasons. “There is considerable room for risk premiums to come in. And it is the combination of those two components that will determine valuation, not just the fact that bond rates are up,” he says.

He has seen evidence that yields are already softening, however. “From mid-2021 until January this year every value-add multifamily housing deal was done at plus or minus a 3 percent cap rate, anywhere in the country. A couple of data points isn’t a trend, but everything we are looking at today is a 4 to 4.5 percent cap rate on today’s value.”

There has not yet been much active distress, observes Stephen Rabinowitz, real estate practice co-chair at law firm Greenberg Traurig. “But there is lots of strategizing around upcoming debt

Bond yields have risen and real estate cap rates have tracked upward in 2022 (%)



Source: Federal Reserve, Macrobond, CBRE Research (May 2022)

maturities. Unlike more recent cycles, we don't believe there will be as much kicking the can down the road."

Growth sectors

Investors can no longer rely on consistent cap rate compression to drive returns, says Belova, so asset selection is increasingly important. "You need a much more nuanced approach than just buying sectors or markets. The detail and the data surrounding the asset matters. You have to really dig into the demand drivers."

Core real estate, where income is generating most of a manager's return, is the appropriate place to invest in a time of uncertainty, she argues. The definition of core is evolving, however. "Demographics, consumer behavior, and the way we use real estate are all changing. Structural drivers will create tailwinds for some sectors, and that is where capital will flow. Even though the market is sideways, where

is the enduring demand? There is still demand for modern logistics and for quality housing. We are also focusing very much on what we call growth sectors: life sciences, self-storage, student housing and single-family residential, for example. Office and retail are no longer the backbone of core. Growth sectors are key to a core portfolio of the future."

Bouwinvest is targeting a similar menu of opportunities in the US: "Housing and industrial, alternatives as well," says van den Hoek. "We have invested in things like life science, data center and single-family rental over the last two years, and we are certainly not alone. We see those sectors as a way to invest in macro-economic tilts and structural demand. We believe that sustainable investing, particularly in those sectors, yields stable, long-term investment returns."

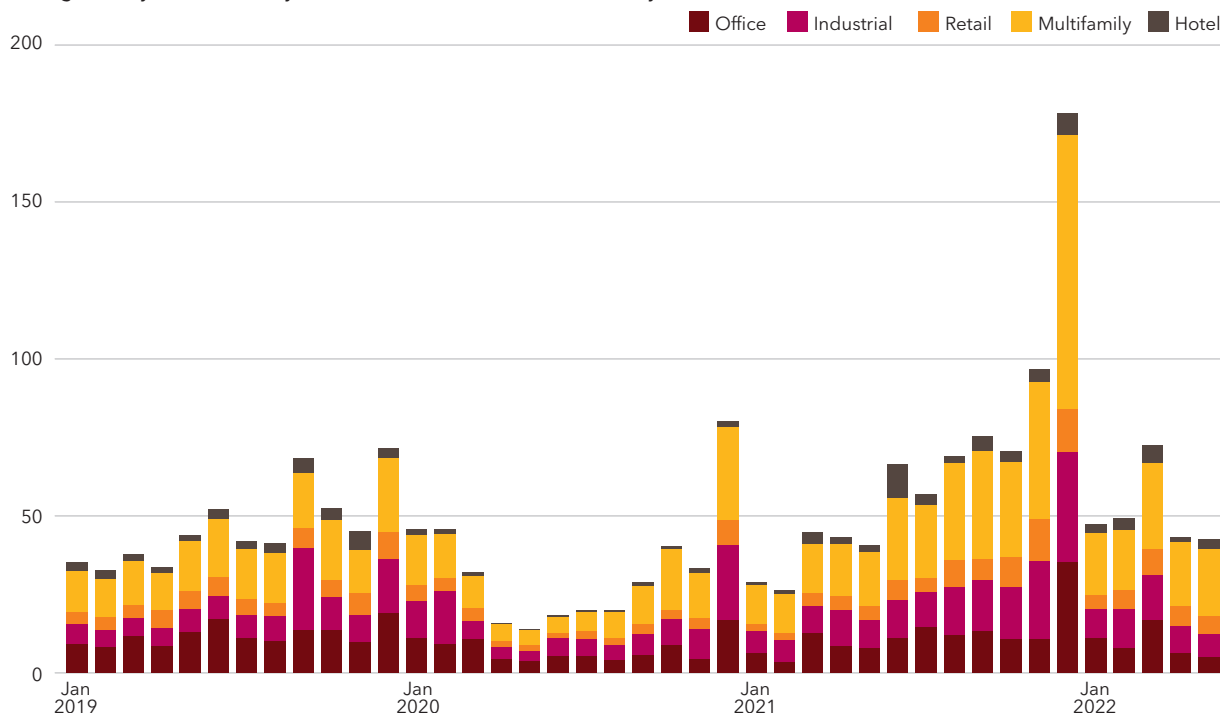
The size of the box within which investors are prepared to play is getting

smaller as they try to reduce the range of risks to which they are exposed, observes Hernandez.

He argues that of the two asset classes with the greatest current popularity, residential shows more appealing characteristics than industrial. "They're both attractive, but one is a little better looking than the other for different reasons. Shorter leases, with people moving every year, make multifamily a better hedge against inflation, and there is less tenant risk because you have more per building. And the structural issues in the credit markets make it harder to finance industrial because it is generally acquired and financed in bulk."

The picture is more complex than simply considering housing versus industrial because selected products within the industrial space will outperform others, argues Belova. "Three-quarters of all logistics product was built before 2000 and does not serve the needs of

Following a steady first half of the year, real estate investment volume is likely to face future headwinds (\$bn)



Source: CBRE Research, Real Capital Analytics (May 2022)

customers using logistics space today, so you can adopt build-to-core strategies that create the right kind of modern product.”

Compelling in uncertainty

“Setting sector aside, one of the most compelling themes is debt,” adds Invesco’s Rimel. “In today’s market you can potentially achieve a total return 200 or 300 basis points higher than you could before, while lending to better borrowers, against better collateral, at a better basis and on lower leverage than you could before. It’s not only a very attractive relative return, but also a very good absolute return for the risk you are taking as well.”

Hernandez seconds the sentiment: “Right now is an incredibly attractive time to play in real estate credit. We are very focused on that space.”

Segments such as multifamily, manufactured housing and self-storage display characteristics that are particularly attractive to investors in the current climate, says Rimel. “They are low capex, with a shorter weighted average lease term, so they are more defensive against the inflationary cycle while meeting a clear need.”

Higher interest rates will increase mortgage costs and make owner-occupation less accessible, leading to an increase in the number of renters, he adds. Meanwhile, higher construction costs will constrain the quantity of new homes coming to market, supporting rents, he predicts. “Starts are relatively elevated, but we are going to see the pipeline shrink until the cost of building comes down significantly. The hurdle for building multifamily or anything else right now has gotten much higher, and margins have compressed.”

Belova cautions that there are likely to be limits on the rents that landlords can expect, however. “We are starting to hear more and more about the Southeast markets that were affordable

are now becoming unaffordable. Yes, rented housing is an inflation hedge, and you can mark rents to market, but we have already seen incredible rent increases over the last year. That is a concern.”

Rimel asks van den Hoek whether the prospect of increased regulation such as rent control will deter European investors like Bouwinvest. “European capital has historically shied away from residential because of the regulatory element,” he suggests.

Van den Hoek responds: “Anywhere in the US is light on regulation, compared to what we are used to domestically in Holland or elsewhere in Europe. We are used to dealing with regulation, and it helps to increase the

number of affordable homes, so we will not shy away from it. Given the political system here, where regulation is state-driven, I don’t think it will ever get to that to a European level. You cannot really compare the US and Europe in that respect.”

Liquidity dries up for offices

The participants offer little comfort to owners of office space impacted by the rise in remote working. Rimel reckons that markets like New York, where commuting is difficult and time-consuming, will see “much lower long-term sustained demand, with the winners vastly outperforming the losers.” Capital flows into the sector will be severely reduced, he predicts. “Try to get a bid on a

“Cap rate compression is over, and we will see more focus on income”

LARISSA BELOVA
CBRE Investment Management

value-add office deal right now, and you literally won't find one."

"We have more retail deals in our pipeline today than traditional office deals," notes Hernandez. He says the market has shifted markedly over the past six to 12 months, during which period liquidity for traditional office assets has largely dried up.

The sector will suffer most from

falling values, says Belova. "Office will probably be the hardest hit on the spectrum of what's to come, particularly because there will be a lot of refinancing activity that can't take place. There's virtually no financing available for office unless it's super-prime, or the best kind of high-amenity product.

"The sector will be very bifurcated, with the best buildings doing well, and

some space letting to the firms that need low rents to operate. But everything in the middle will suffer from uncertainty. For those buildings, landlords literally have to buy occupancy today. They try to maintain rents, but TIs, rent-free periods and other expenses are eating away at the prospects of value in the sector."

Greenberg Traurig's Rabinowitz says that with more firms in the financial services sector now requiring office attendance, there is still demand for modern, amenity-rich buildings in New York locations with multiple commuting options, such as the Park Avenue corridor. "We also are seeing healthcare users breaking out of their traditional neighborhoods and making investments in central business districts. Some are doing it to bring services closer to users, but we also are seeing institutions freeing up their core assets by moving non-clinical functions to traditional office buildings," he adds.

Drawing to a close, the participants assess the prospects for the future, a task they admit is currently near-impossible with any confidence. At the least, the US situation looks less gloomy, says van den Hoek. "In Europe, we see more geopolitical risk and have enormous energy and cost-of-living crises on our hands. There is a less optimistic or positive view of the prospects for the economy than I sense here in the US."

Rabinowitz adds: "In talking to European-based investors, many cite the US's greater food and energy independence as key reasons the US is expected to fare better in this cycle. This is one of the only times in my career that I have heard so many in the real estate investment community concerned that food and energy scarcity could profoundly affect the real estate industry in developed economies."

The unsettled picture is affecting investors' mindset, says Hernandez. "In an uncertain time, you want to

"In Europe, there is a less optimistic or positive view of the prospects for the economy than I sense here in the US"

BERT VAN DEN HOEK
Bouwinvest

Tackling the affordability crisis

The Biden administration pledged in September to help create 100,000 new affordable homes over the next three years. The participants agree that will create opportunities for investors to participate in the market.

Bert van den Hoek: The housing shortage is structural, and very acute, especially in workforce or affordable housing. We need all the help that we can get, but that probably still won't make a balanced market. That gives a very fundamentally strong picture for investing into those segments of the residential market.

Larissa Belova: Affordable housing is still very misunderstood, but it is gaining momentum in terms of institutional capital flows. Anything the administration can do to assist, through cheaper land programs, and partnerships with the private sector will help, so hopefully investors will not be operating in a vacuum.

Justin Rimel: We have seen the crisis in rent affordability spread from high-cost markets like New York to places like Texas. That will create popular

support for programs where there are tax incentives for dedicating housing toward affordability. We are going to start to see that in more locales.

Jason Hernandez: Manufactured housing is an attractive space, partly because it is so illiquid and fragmented at the moment. Government can support increased use of chattel loans, which will make the sector more institutional, bring in more capital, and help to alleviate the affordable housing crisis.

Stephen Rabinowitz: A pledge of 100,000 units is well-intentioned, but in the context of a shortage of over 340,000 units in New York alone, there is still a need for state and local governments to create additional incentives for the development and long-term sustenance of quality affordable housing.

take less risk and for a shorter duration. It is really hard to take a 10-year bet when you don't know whether there is going to be continued inflation or stagflation, or whether the world will return to normal. People will invest more in shorter duration situations."

That will influence the choice of investment structures, says Rimel. "In a market with illiquidity, closed-end fund vehicles with discretion likely do best, because of the denominator effect and because of the uncertainty. It is very much more difficult to be decisive with non-discretionary capital."

"I don't think any of us has been in this kind of market ever, where all of these different levers are acting in different ways," says Belova. "We believe the Fed will be successful in tempering inflation. Hopefully, we'll come out of this with a soft landing and not something much worse. But we didn't know at the start of the year that there would be a war in Europe, and the situation remains unpredictable." ■

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JASON HERNANDEZ
Nuveen Real Estate