# U.S. real estate capital markets update

## JLL Capital Markets Research

September 2023

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JLL SEE A BRIGHTER WAY

# Overview & Trends

# Current state of the capital markets

**01**

Government debt rating downgrade and U.S. Treasury's heightened quarterly borrowing estimate **causing noise in bond markets**; 10-yr UST again elevated

**02**

**Debt markets generally liquid** albeit at elevated cost of capital; SIFI bank liquidity improving but local/regional bank concerns continue

**03**

**More investors banking on 'higher for longer'**; expectations are that Fed will keep rates elevated for longer to keep inflation in check

**04**

**Distress:** Delinquencies accelerating; give-backs to lenders increasing in office sector; and selectively, in hotel sector

**05**

**CRE debt is not deemed to be a systemic risk for U.S. banks:** CRE loans represent 23% of banks' overall loan portfolios, in other words, not an outsized share

**06**

**Dry powder at record levels** but denominator effect still limiting inflows into CRE; fundraising continues to be challenged

 

# Focus on the trendlines, not current headlines

## Trendlines

### "Work-from-home rendering office investment non-institutional"

- **Leverage Between Employer and Employee Reset:** "Work-from-work" mantra in 2023
- **Hybrid Work:** Minimal space contraction
- **Labor Productivity:** Declining across industries and stifling innovation
- **Key Metrics:** Pre-pandemic vacancy was 14.3%, now 20.3%; peak day card swipes at 58.3% of pre-pandemic levels, Q2 2023 leasing activity increased 10.8% q-o-q
- **Haves and Have-Nots:** Top 10-15% of inventory will out-perform, next 30-35% will devalue between 30-50%, pricing for bottom 50% of stock still unknown for some time

### "Retail is losing institutional investment class status"

- **2022 Retail Net Absorption:** 5-year high
- **Retail Spending** holding its own; up 1.5% in June
- **Fundamentals still strong:**
  - Vast amounts of consumer debt locked in at low interest rates
  - Inflation easing but still above target
  - More trading down to value
- **Grocery-Anchored Centers:** Continued strong investor demand; strip centers increasingly in favor
- **Mixed-Use Assets:** High conviction for differentiated product
- **Logistics and Last Mile:** Last mile locations critical; retailers changing business models and reconfiguring floor plans

### "Suburban flight will end dominance of urban markets/gateways"

- **Gateways:** Continue to be leaders in innovation ecosystem and talent base
- **Reversal of Trend:** Multi-housing performance in gateways outperforming Sun Belt markets on relative basis in 2023
- **Structural Issues Persist:** Taxation, regulation, cost of doing business, commute times and affordability increasingly driving location preference
- **New Growth Drivers:** AI jobs a new tailwind for Bay Area
- Urban hotel market performance accelerates in 2023

### "Distressed transactions will be robust"

- Distress of any scale will likely be limited to commodity **office product**, and selectively, hotels
- There will be **tactical distress opportunities** in every property sector given mezz or other 'over-leveraged' situations
- Loan sale, short sales, delinquencies and defaults **accelerating**
- **Buying bank debt** becoming more prevalent

 

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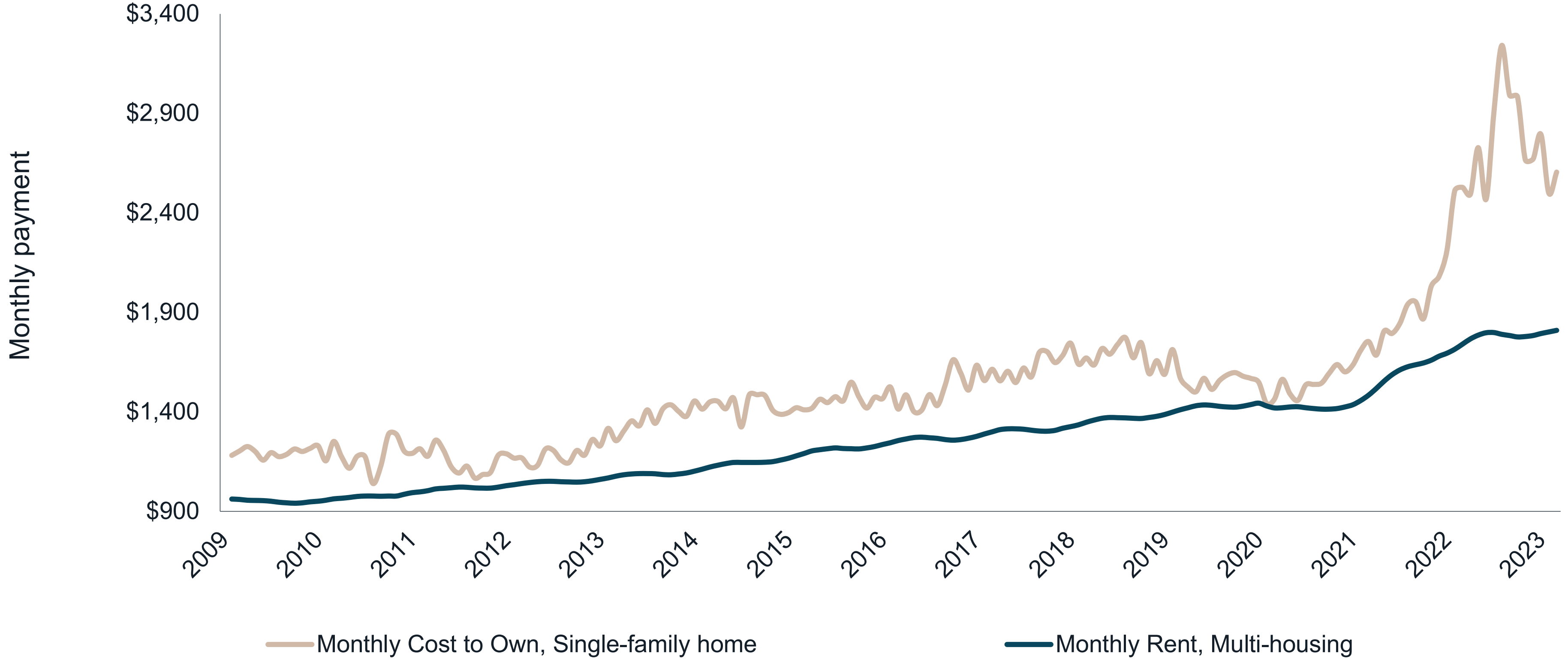
# Property Level Fundamentals

# Multi-housing

# The spread above renting remains near all-time highs despite a slow summer home sales market, extending rentership

## Cost to own vs. cost to rent, US average (monthly)

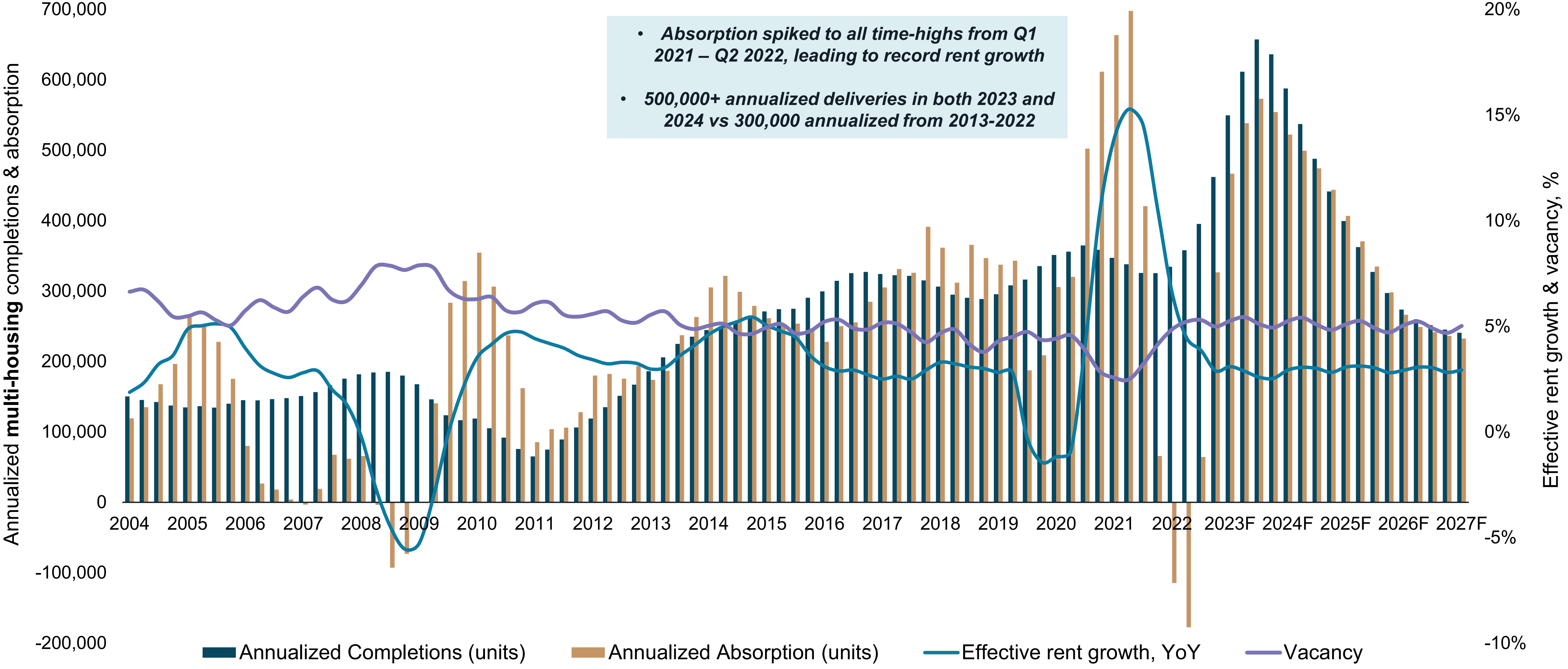



| Period | Avg. 30yr Mortgage rate |
|---|---|
| August 2, 2023 | 6.90% |
| Q2 2023 | 6.71% |
| Q1 2023 | 6.32% |
| Q4 2022 | 6.42% |
| Q3 2022 | 6.70% |
| Q2 2022 | 5.32% |
| Q1 2022 | 3.86% |
| Q4 2021 | 3.13% |
| Q3 2021 | 2.92% |

**Source**: JLL Research, U.S. Census Bureau, Freddie Mac, WalletHub, Axiometrics, Green Street
**Note**: Monthly cost to own includes principal, interest, and property taxes on a 30-year fixed rate mortgage assuming standard mortgage underwriting criteria on a median-priced new home, based on national data.

# The multi-housing sector is facing headwinds of tempered rent growth and elevated supply in 2023/24 before normalization

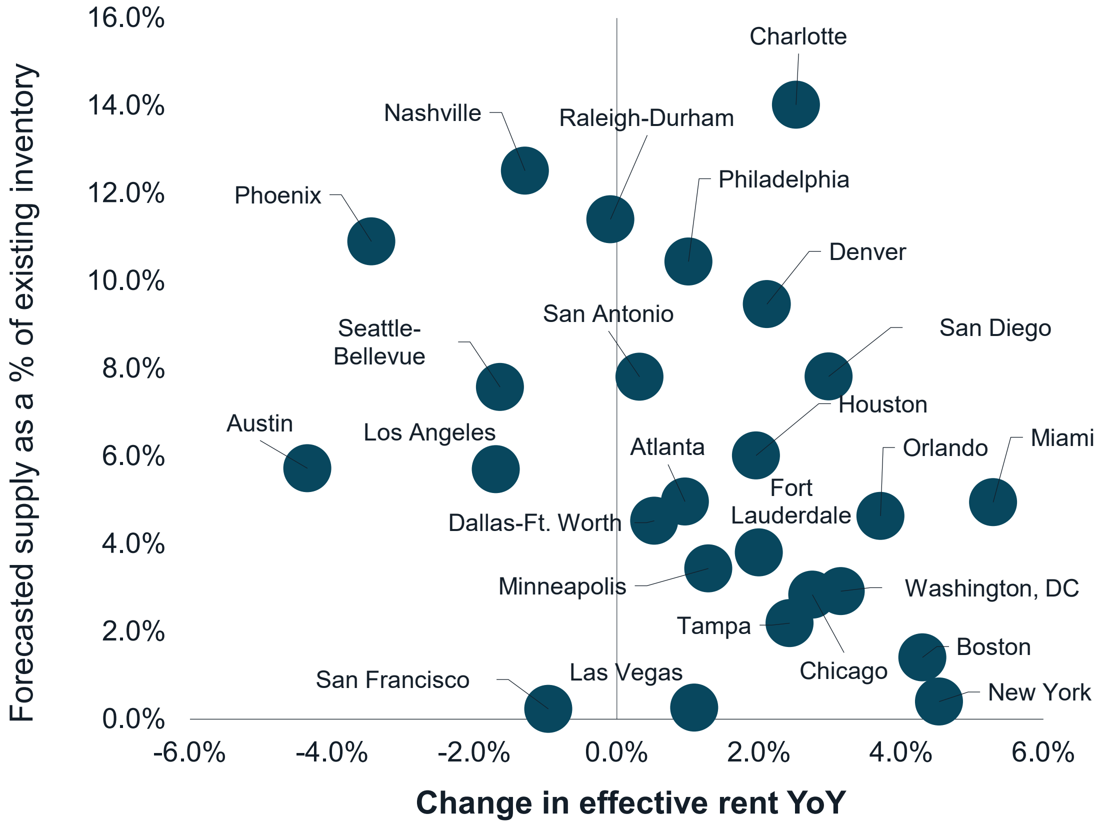



**Source**: JLL Research, Axiometrics; completions and absorption are annualized via a four-quarter rolling summation.

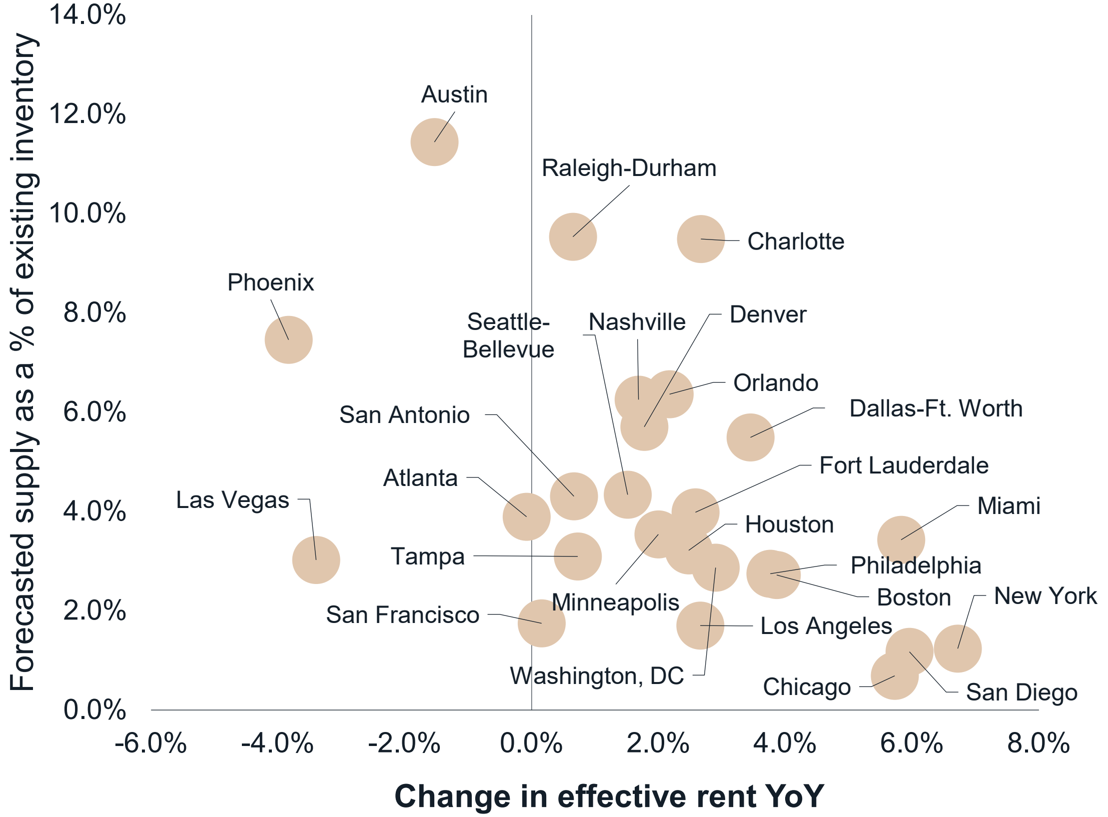
 

# Gateways show strength in Q2 as rent growth in both urban and suburban markets normalizes to 0-5% nationally; select Sunbelt markets delivering elevated supply

## Urban submarkets




## Suburban submarkets

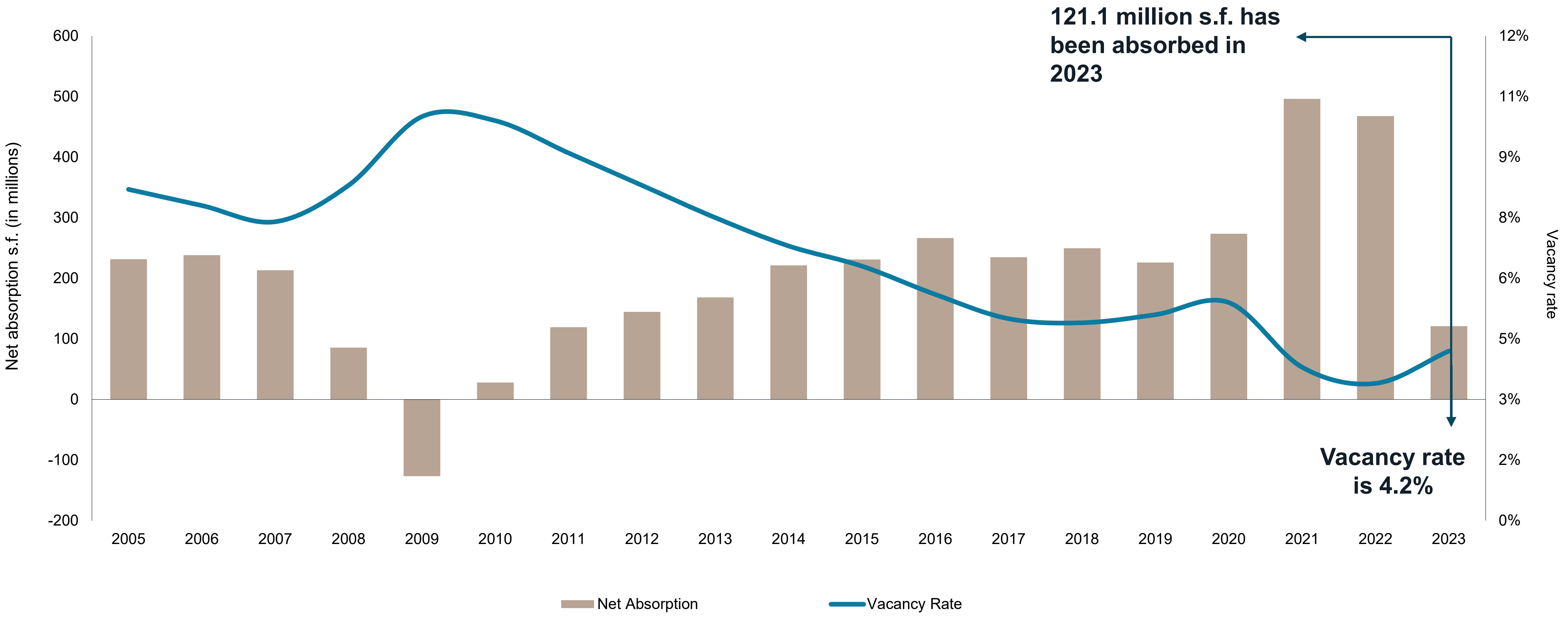



**Source**: JLL Research, Axiometrics; forecasted supply represents the next 12 months of projected completions.

# Industrial

# Absorption reverts to pre-pandemic levels through H1 ‘23




Source: JLL Research

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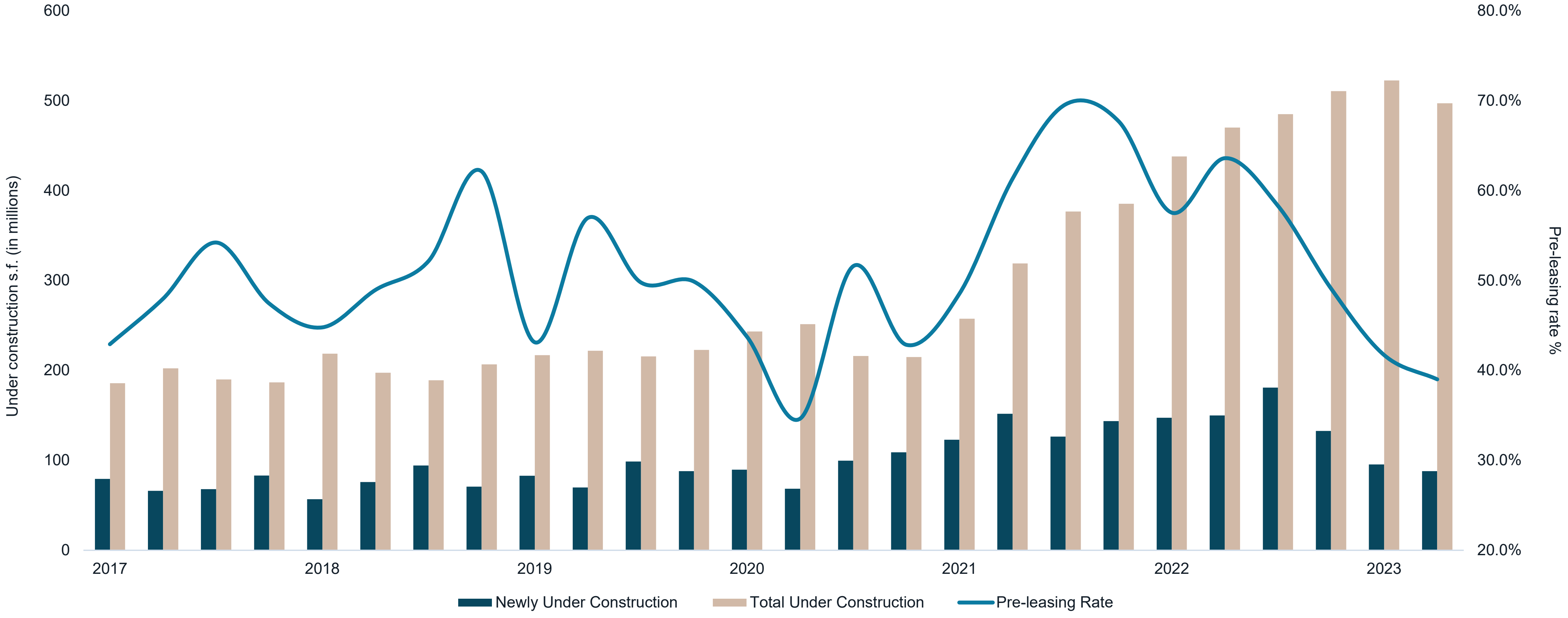
# New ground-breakings have slowed 41.3% year-over-year as pre-leasing on new deliveries slides



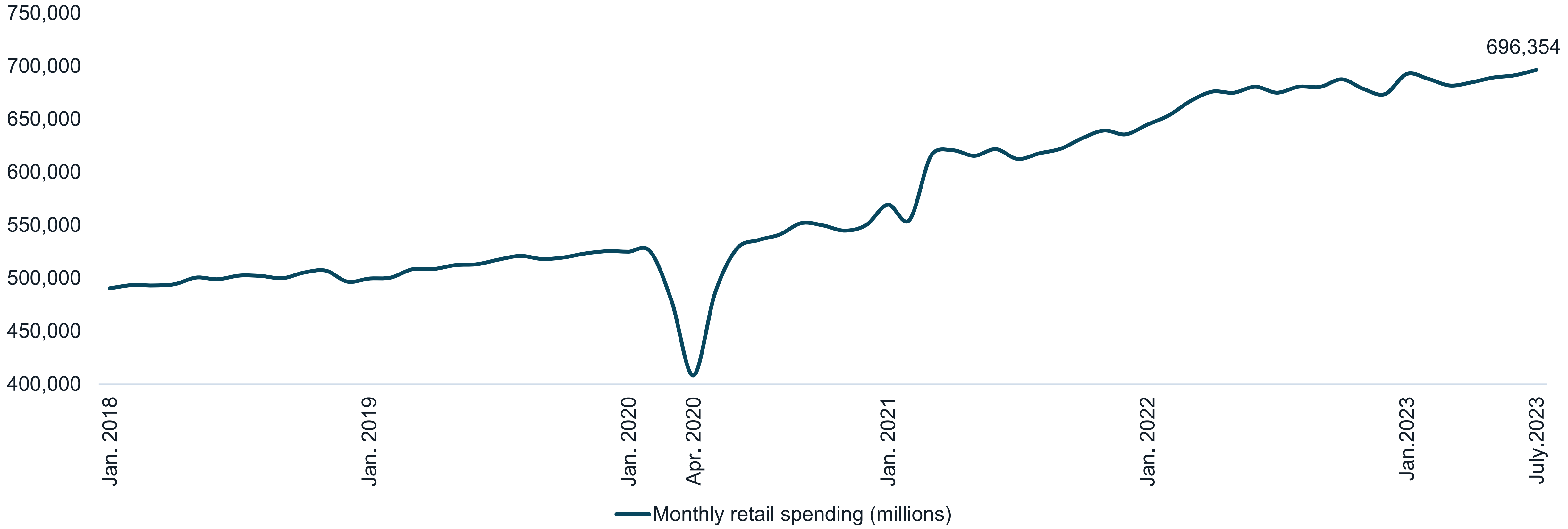

 

# Retail

# Sales rise as consumers remain resilient despite inflation

## Retail sales rise 0.7% month-over-month from June and are up 3.2% year-over-year in July

### Retail spending rises



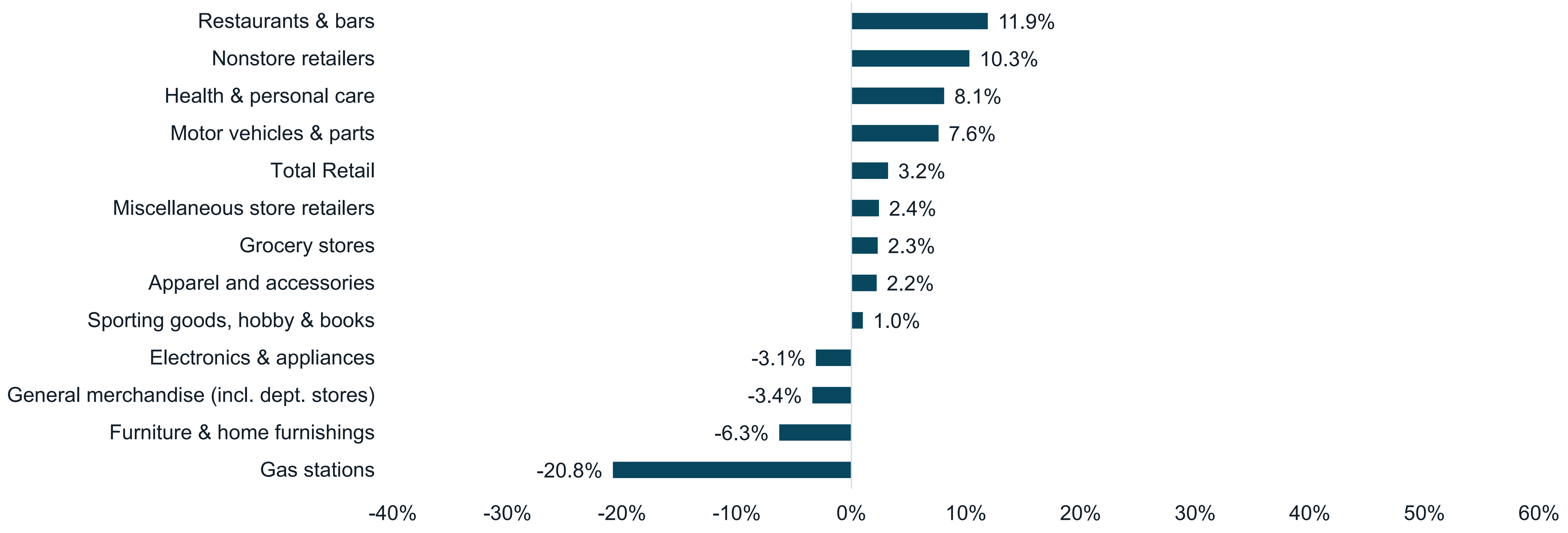

Source: US Census, adjusted sales

# Consumers dine out amidst easing inflation

## Spending on restaurants and bars rises with a 1.4% increase month-over-month and a 11.9% increase year-over-year

**Year-over-year change in spending as of July 2023**

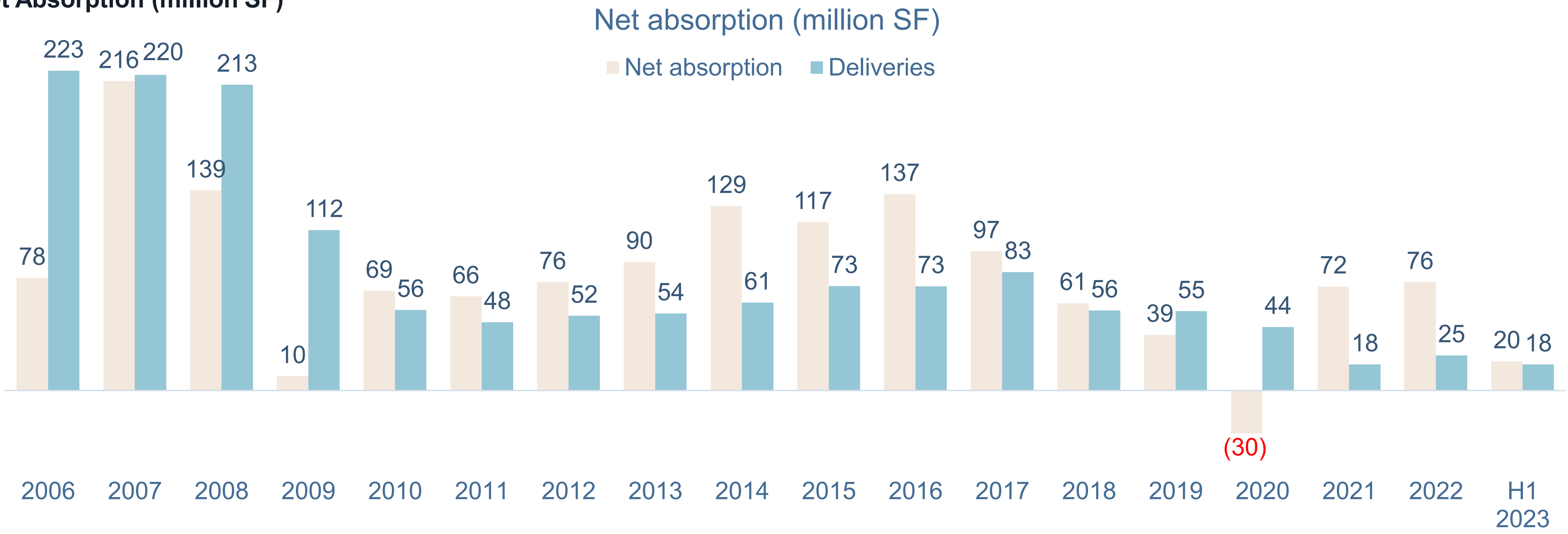



Source: US Census, JLL

# Retail net absorption totalled 20.3 million in the first half of 2023

**Net Absorption (million SF)**

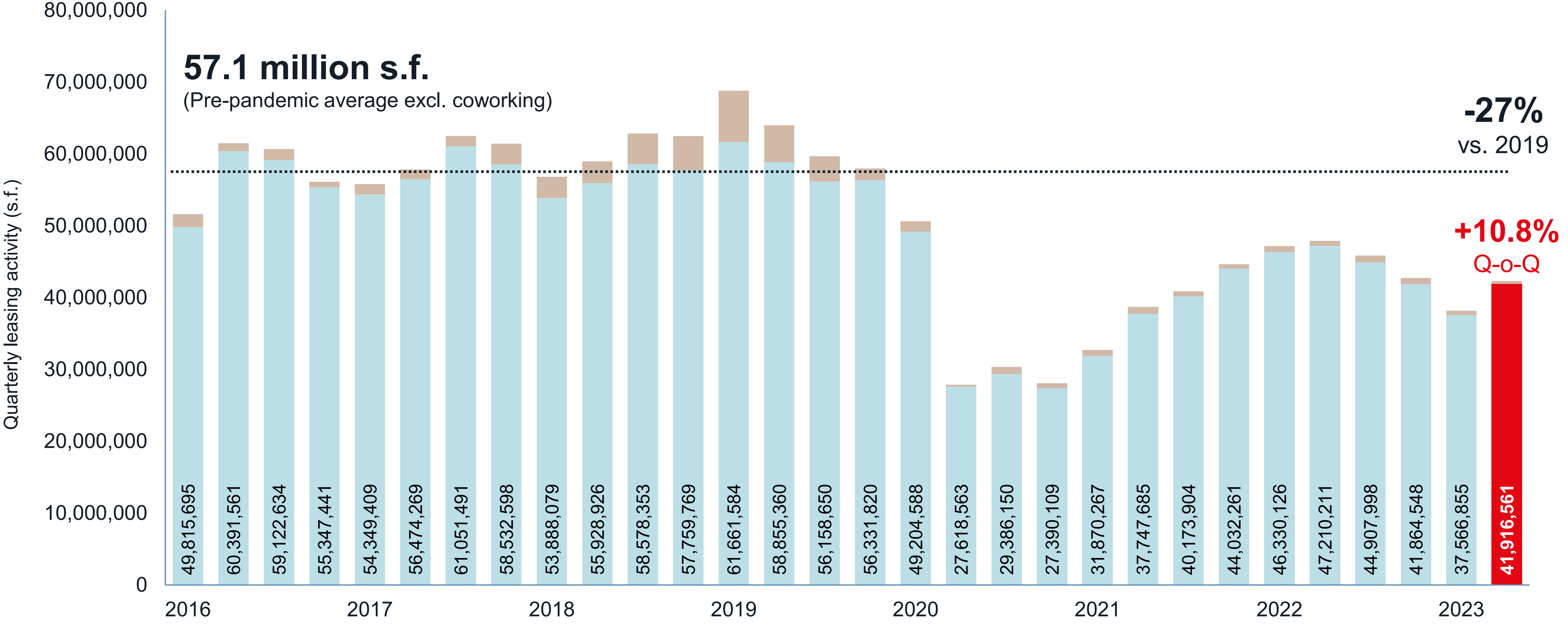



Source: JLL, CoStar

# Office

# Office: Moderate uptick in leasing volume in second quarter as market conditions gradually stabilize

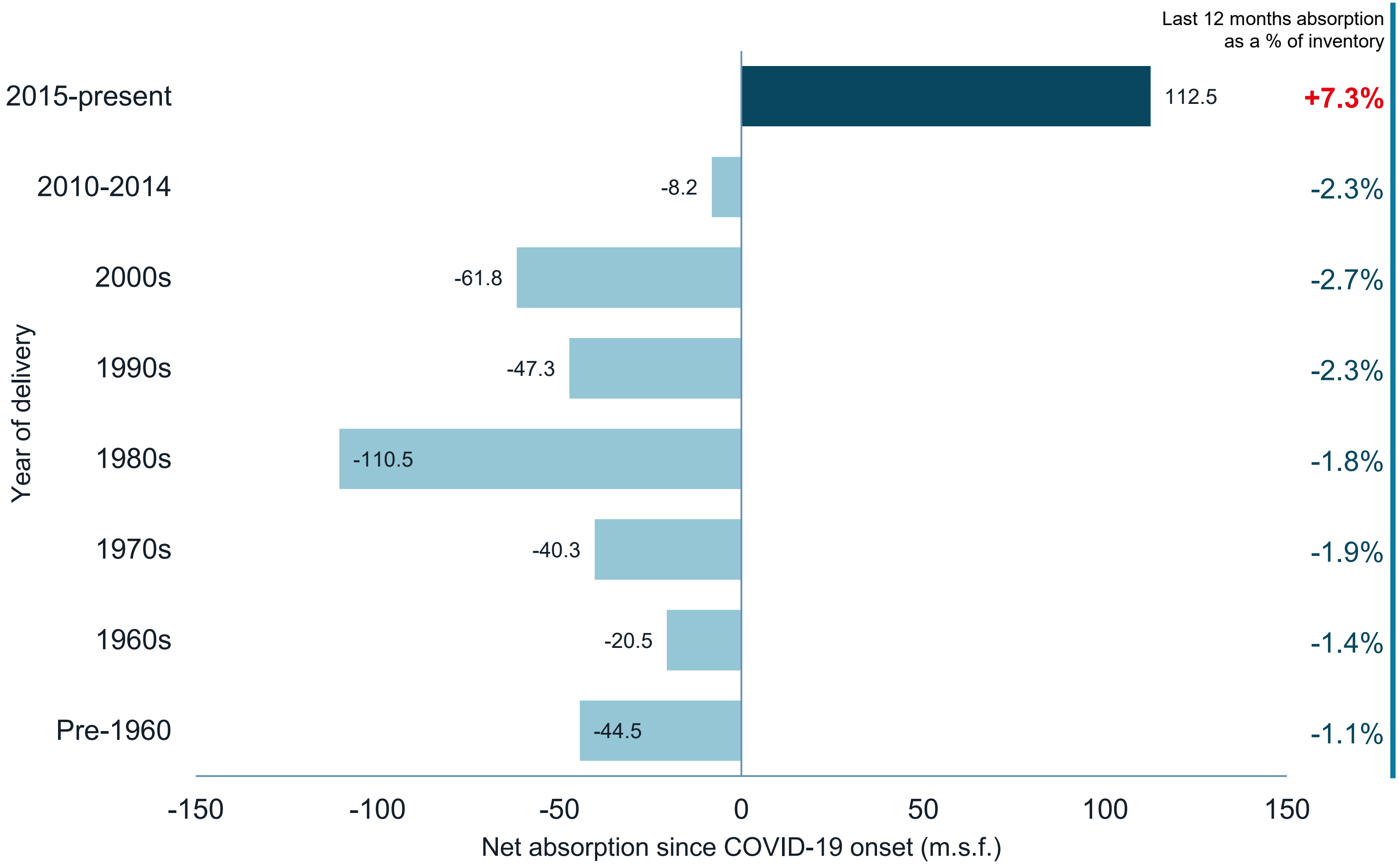



Source: JLL Research

Note: Tan bars represent leasing volume by coworking providers and are excluded from pre-pandemic average, but not quarter-over-quarter growth.

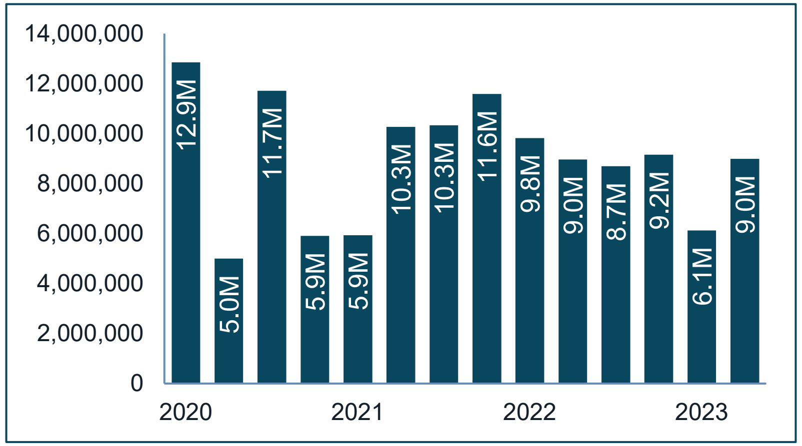
# Office: Tenants who aren't renewing are often opting to relocate into higher-quality offices, driving flight to quality




**360 N Green**
Chicago
Greenberg Traurig
90,000 s.f.

**1050 17th**
Washington, DC
Davis Polk & Wardwell
82,000 s.f.

*Quarterly net absorption in offices built since 2015*



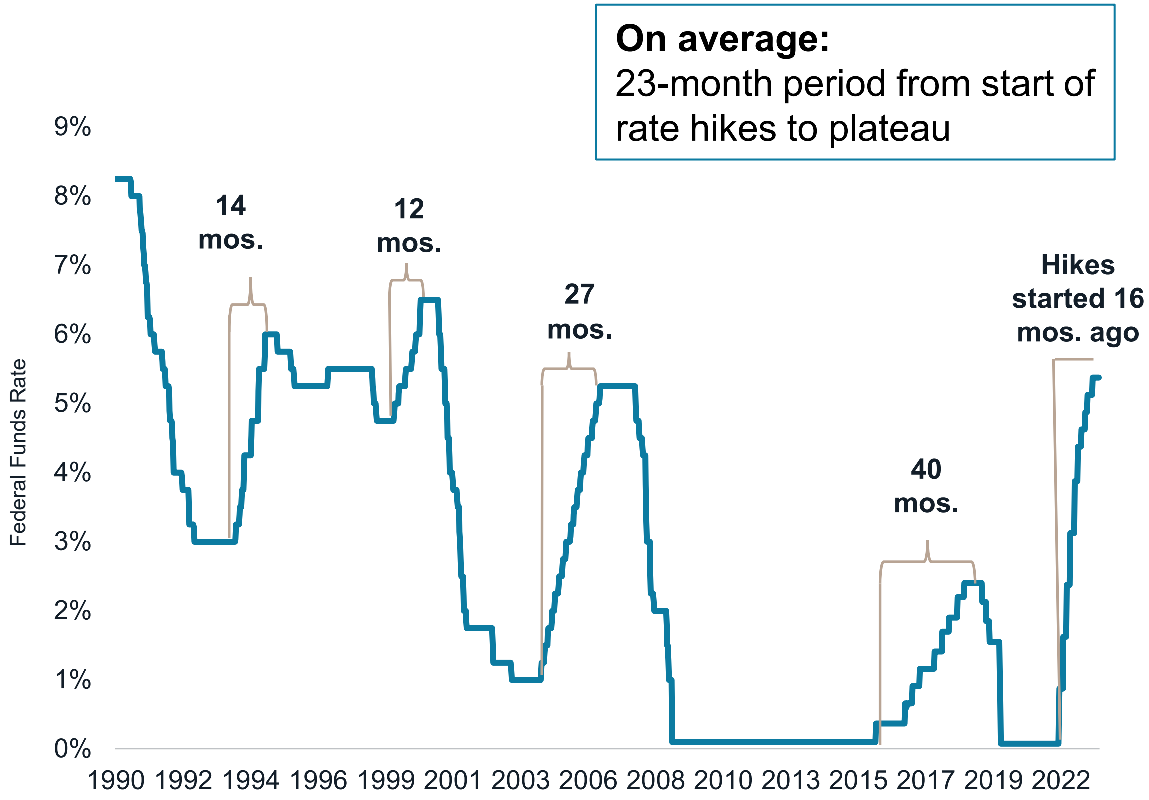

Source: JLL Research

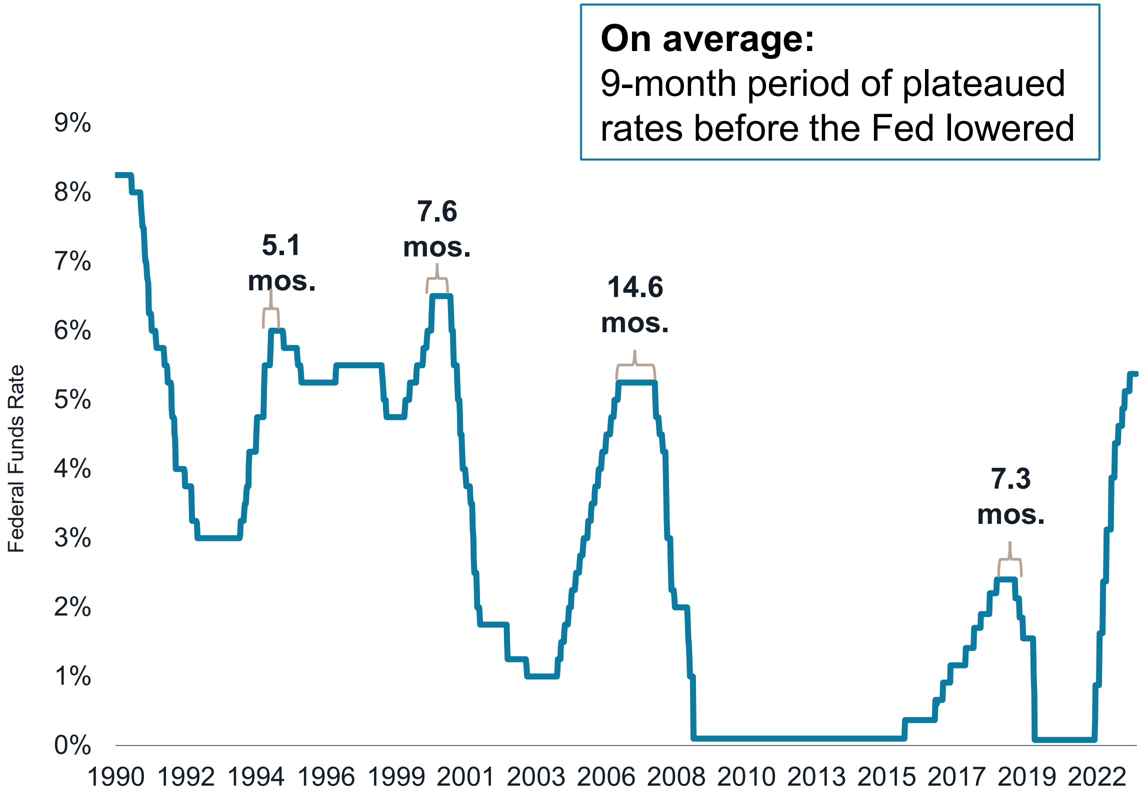
# Liquidity and pricing in the current market

# Speed and scale of rate hikes this cycle unprecedented, portending to shorter overall duration and plateau before future cuts

**Duration of rate hike cycles**




**Length of plateau in rates before subsequent easing**




Source: JLL Research, Federal Reserve

# Higher interest rate environment challenging buy/sell decisions

| | Index | | | + | Spreads | | = | Borrowing rates | |
|---|---|---|---|---|---|---|---|---|---|
| | Term SOFR (1M) | 5-Year treasury | 10-Year treasury | | A / BBB corp average | Real estate (10-Year)* | | 10-Year | |
| Current | 5.32% | 4.45% | 4.29% | | 142 bps | 150-200 bps | | 5.79%-6.29% | ⟵ Elevated over mid-May levels |
| 3/15 – 5/15 2023 | 4.88% | 3.53% | 3.45% | | 145 bps | 150-200 bps | | 4.95%-5.45% | ⟵ Steady state? |
| Nov 2021 | 0.04% | 1.14% | 1.53% | | 94 bps | 100-140 bps | | 2.53%-2.93% | ⟵ Anomaly |
| 2018 average | 2.06% *(30D LIBOR)* | 2.75% | 2.91% | | 123 bps | 120-150 bps | | 4.11%-4.41% | ⟵ Benchmark? |

*Assumes core/core plus assets with low to moderate leverage.
Source: Bloomberg Finance L.P. (Current is as of August 23, 2023)

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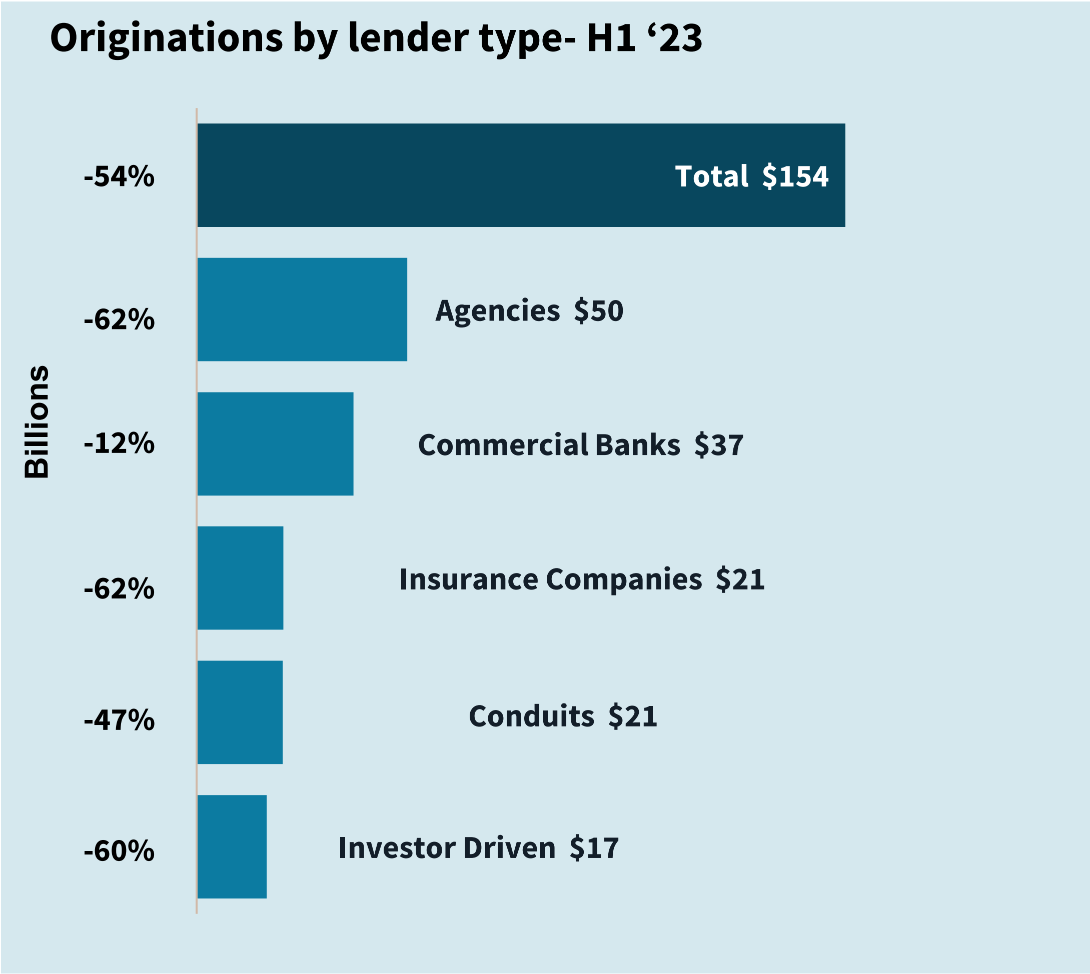
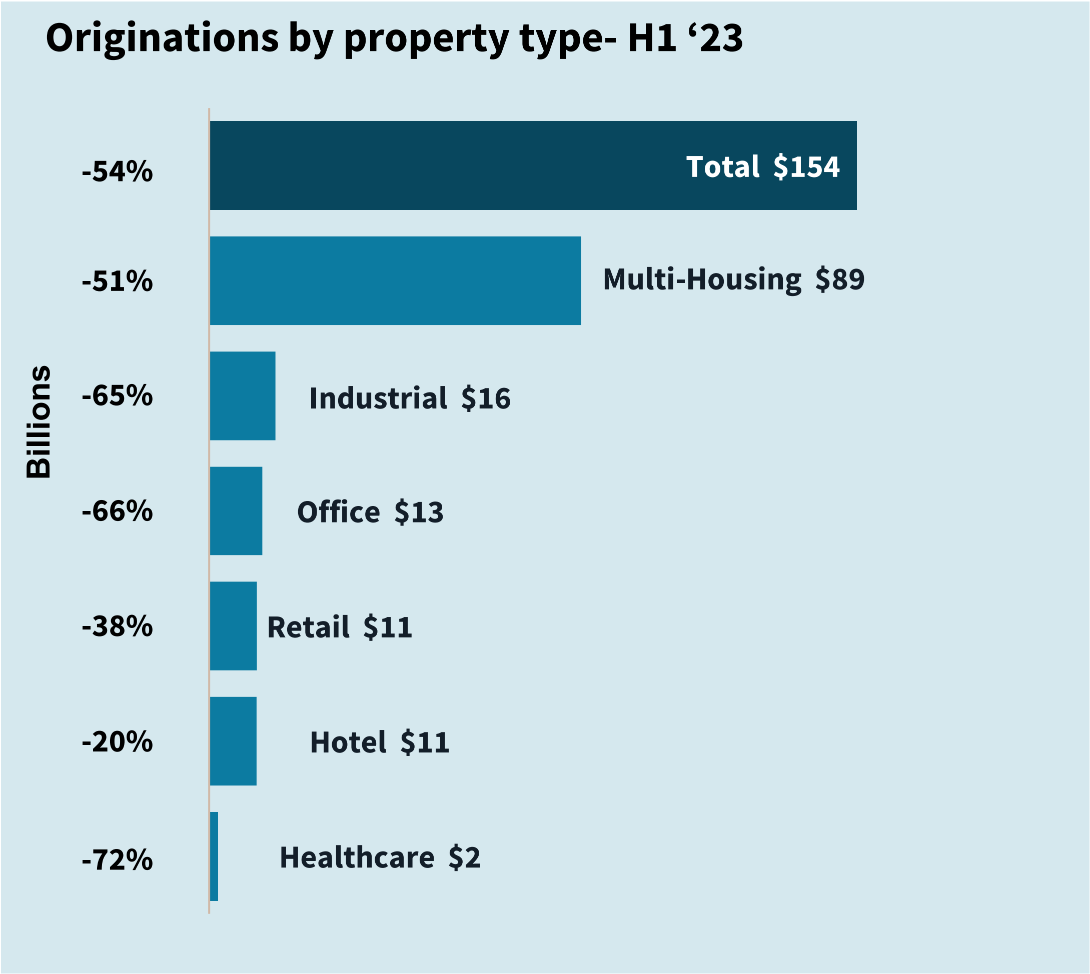
# All debt capital sources active, YoY Change




Source: JLL Research, Mortgage Bankers Association, ACLI, Green Street

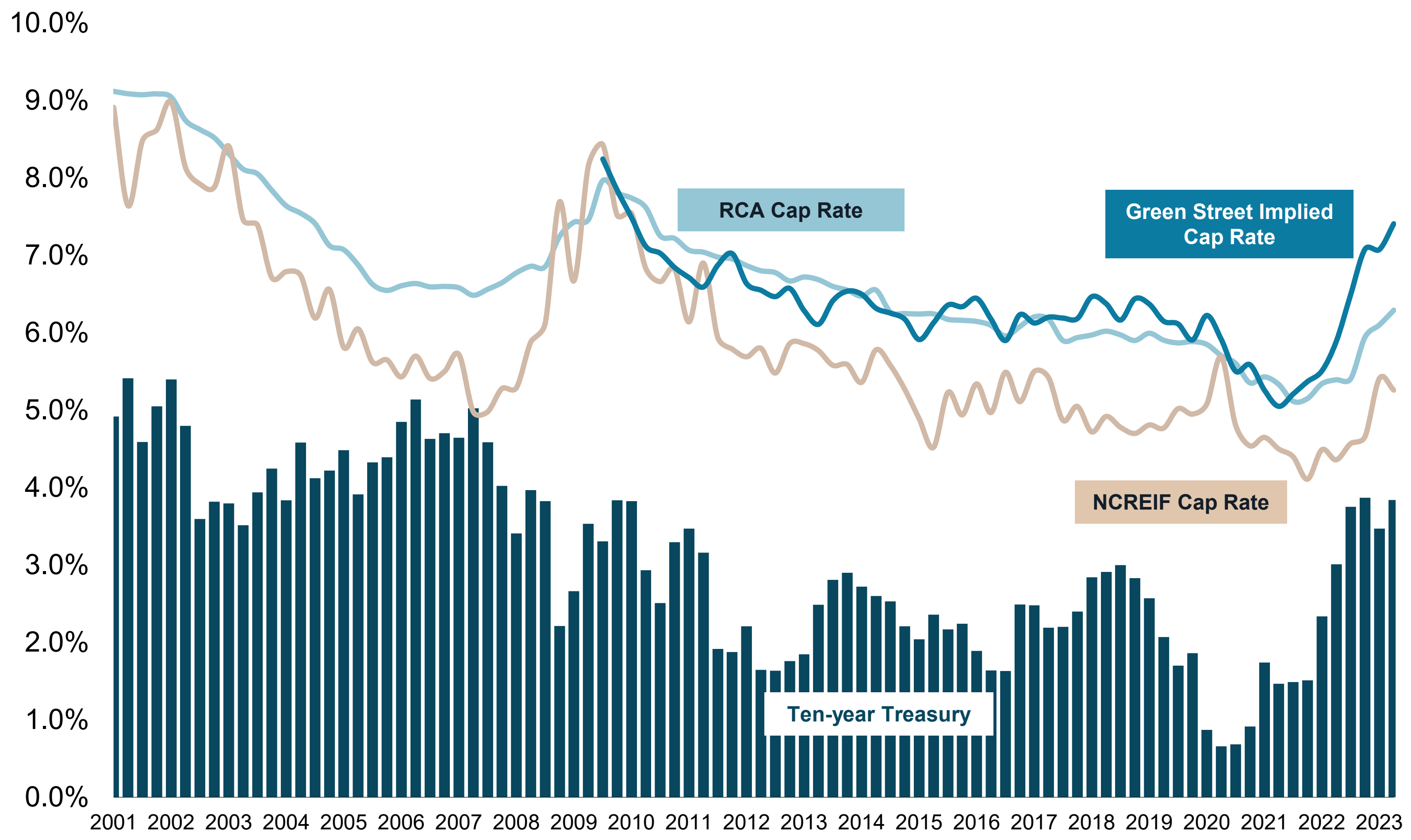
# Comparison of “now” vs. “peak” valuation and underwriting metrics

| | Office | Multi-housing | Industrial | Retail |
|---|---|---|---|---|
| **Going-in yields (core assets)** | **YE 2019:** 4.25% - 4.75%<br>**Peak:** 3.75% - 4.25%<br>**Now:** 6.0% - 7.0% | **YE 2019:** 3.75% - 4.50%<br>**Peak:** 2.75% - 3.25%<br>**Now:** 4.50% - 5.50% | **YE 2019:** 4.50% - 5.30%<br>**Peak:** 2.75% - 3.25%<br>**Now:** 4.50% - 5.75% | **YE 2019:** 5.25% - 6.25%<br>**Peak:** 4.50% - 5.75%<br>**Now:** 5.25% - 6.25% |
| **Exit cap rate (bps above going-in cap rate)** | **Peak:** +25 bps<br>**Now:** +50 - 100 bps | **Peak:** +25 - 50 bps<br>**Now:** +0 - 25 bps | **Peak:** +25 bps<br>**Now:** +25 - 35 bps | **Peak:** +25 bps<br>**Now:** +0 - 50 bps |
| **Rent growth then and now** | **Peak:**<br>3% Years 1-3<br>**Now:**<br>0% Year 1, 3% Years 2-3 | **Peak:**<br>15-30% Year 1<br>**Now:**<br>Up to 5% Year 1, 3% Years 2-3 | **Peak:**<br>10%+ Year 1, 5%+ Years 2-3<br>**Now:**<br>6-8% Year 1, 4-5% Years 2-3 | **Peak:**<br>3% Years 1-3<br>**Now:**<br>3% Years 1-3 |

Source: JLL Research

# Capitalization rate spreads




**In 2018:**

- Four interest rate increases during the year
- Treasury averages 2.9%
- Total return driven by income

**In 2019:**

- Three interest rate cuts during the year
- Treasury averages 2.1%
- Total return driven by income (but slows overall)

**Spreads (bps)**

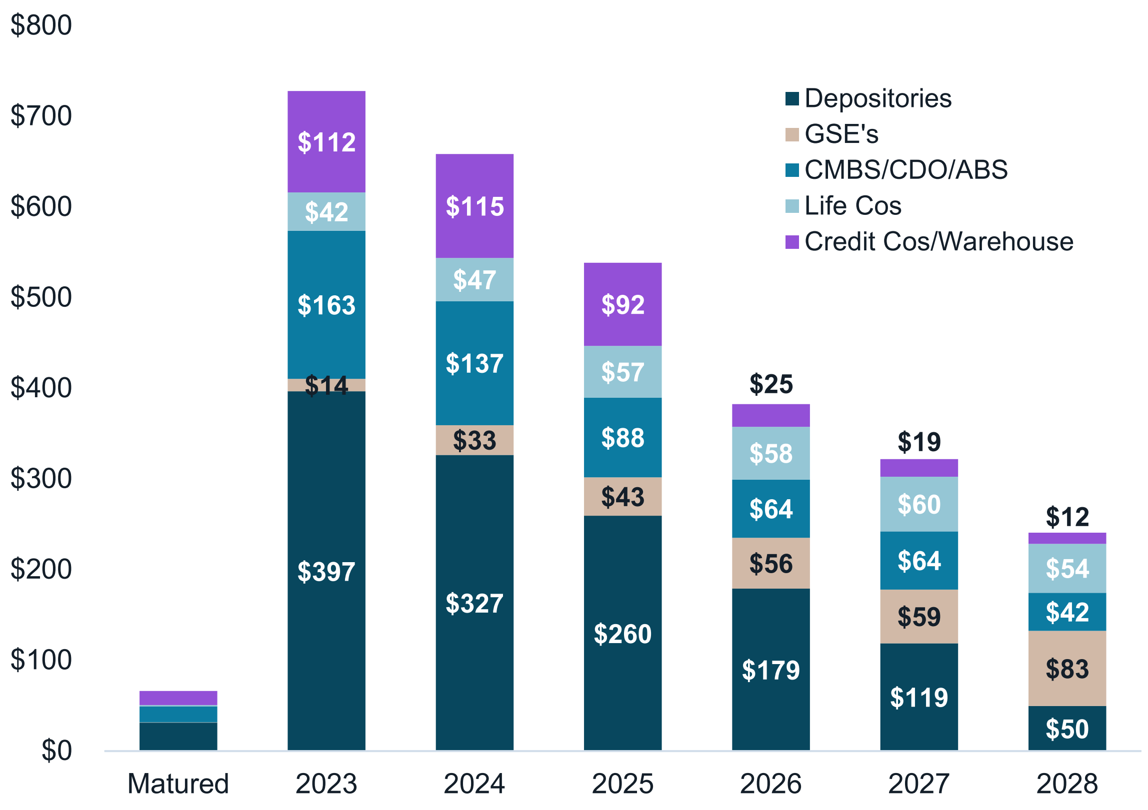
| | 2023 Q2 | 2019 | 2018 | LT avg. |
|---|---|---|---|---|
| RCA | 245 | 393 | 311 | 364 |
| GS | 357 | 408 | 346 | 399 |
| NCREIF | 142 | 284 | 189 | 276 |

Note: NCREIF figures represent transactional cap rate data; the slight compression observed in Q2 was largely driven industrial sales, which represented 47% of the dataset.
Source: JLL Research, Real Capital Analytics, Green Street, National Council of Real Estate Fiduciaries, Federal Reserve (Ten-year Treasury values pertain to quarter-end figures)

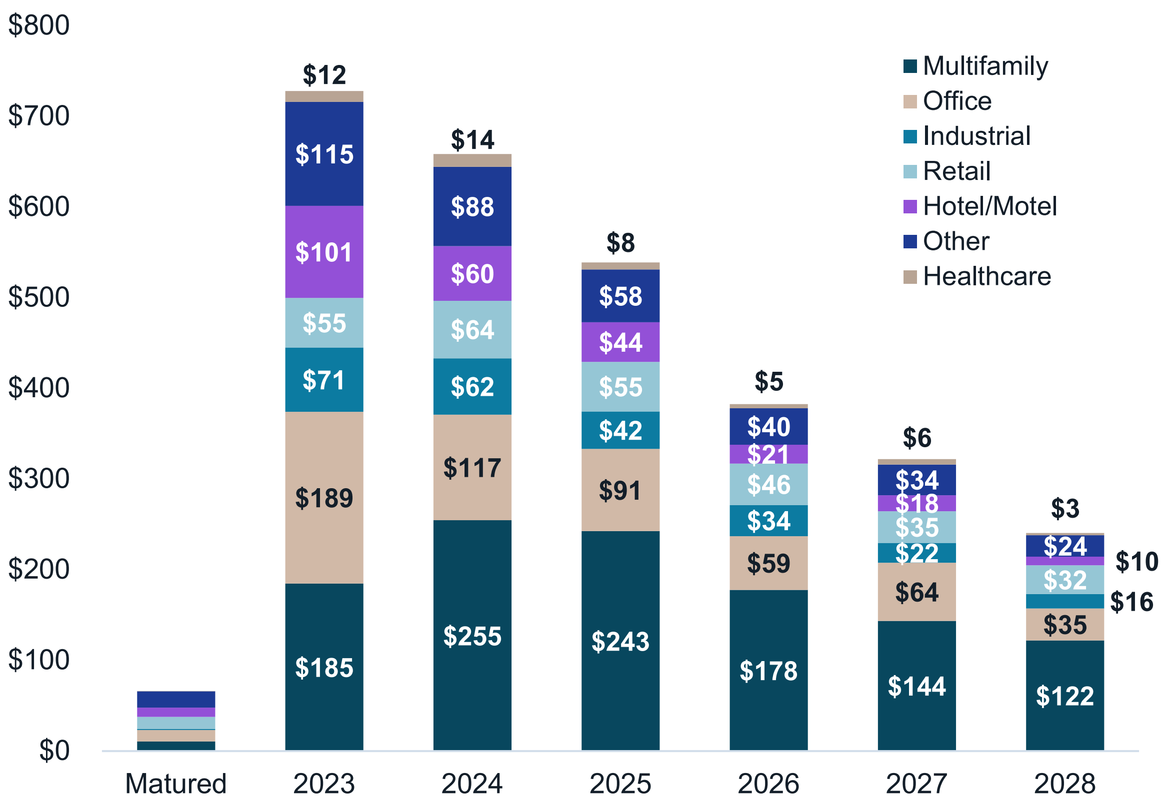
 

# Upcoming loan maturities will catalyze transactions activity

## Loan maturities by lender type ($ billions)




## Loan maturities by property type ($ billions)




Data pertains to all lender types
Source: JLL Research, Mortgage Bankers Association

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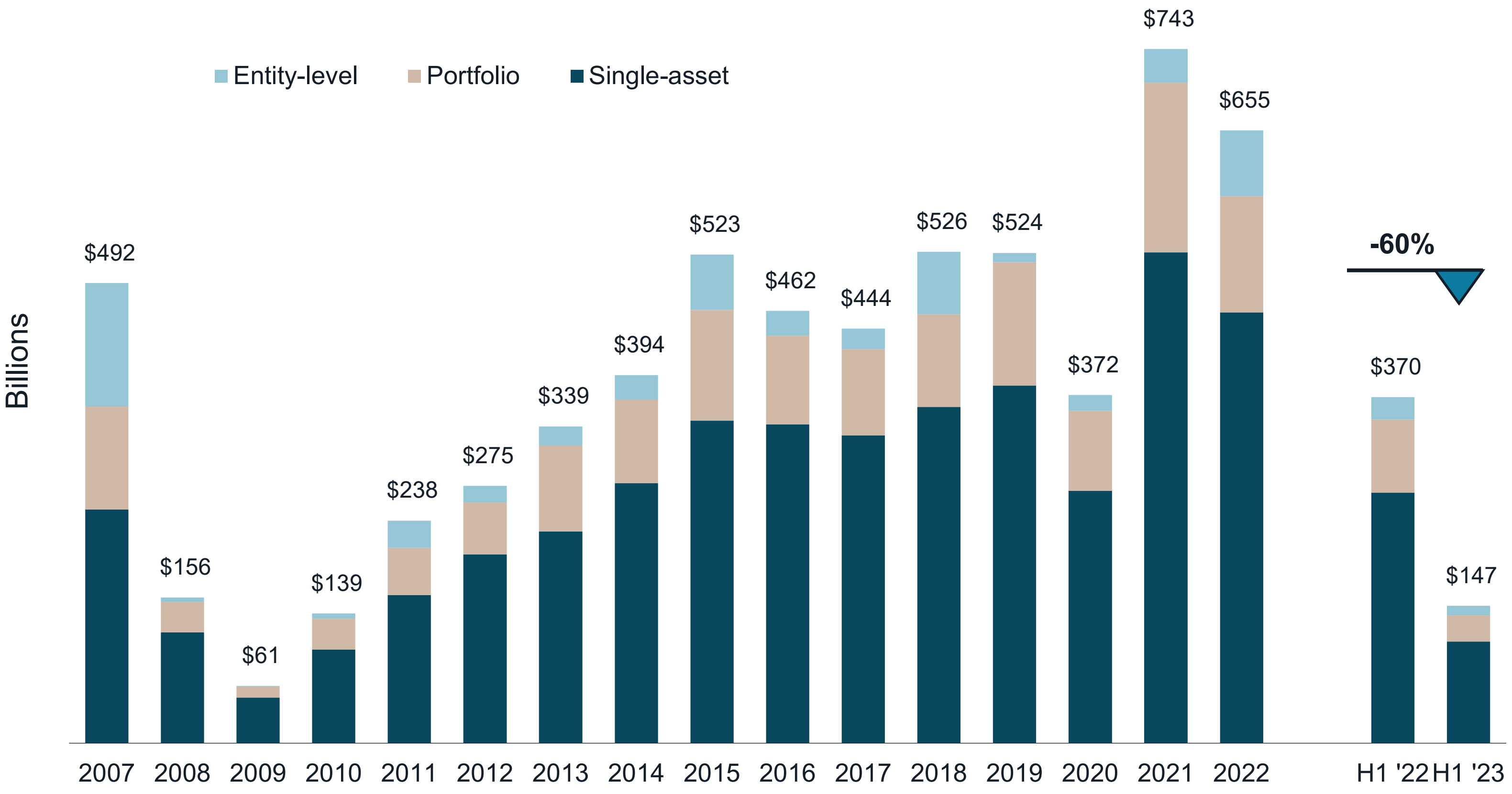
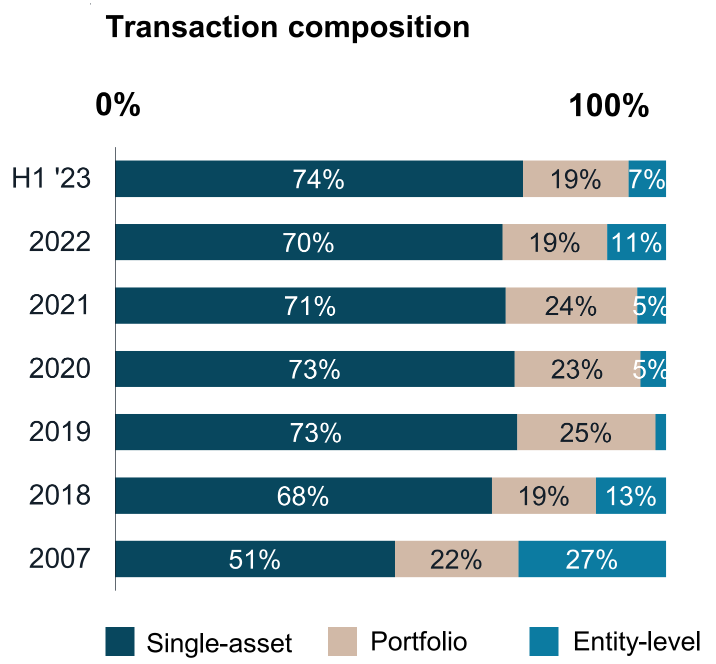
# Transactions volume is down precipitously but y-o-y comps will start looking more favorable in third quarter



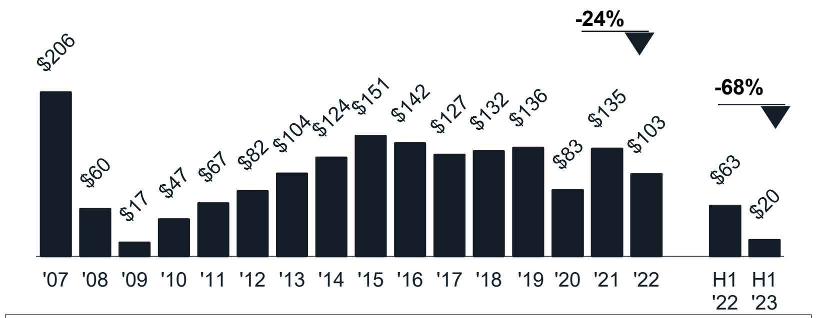




Source: JLL Research, Real Capital Analytics (transactions over $5 million, includes entity-level transactions), includes: office, industrial, multi-housing, retail, hotels and seniors housing. Includes recaps; excludes refinances

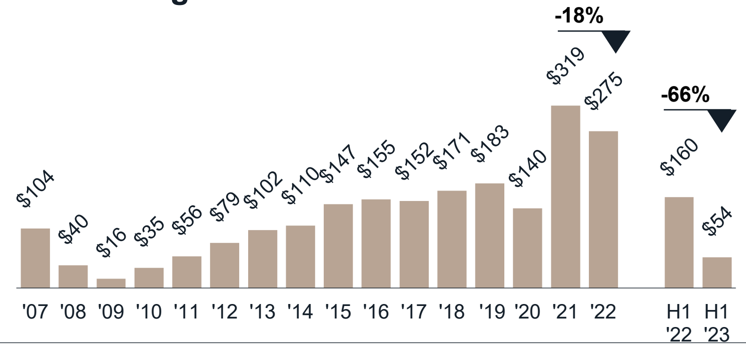
# Transaction velocity by property type

## Office



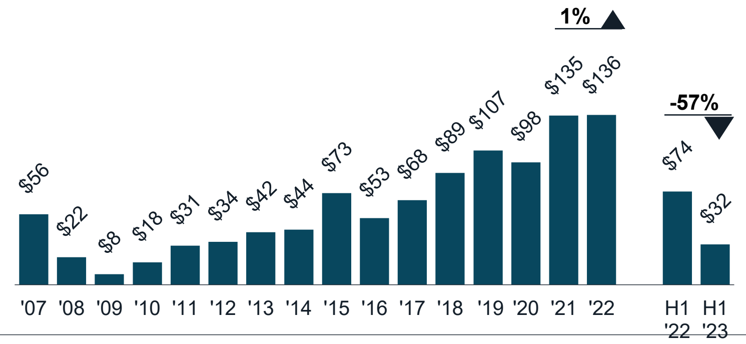

Blackstone | Q3 '22 | $7.6B

## Multi-housing




Blackstone | PAC Preferred Apartment Communities | Q1 '22 | $5.8B

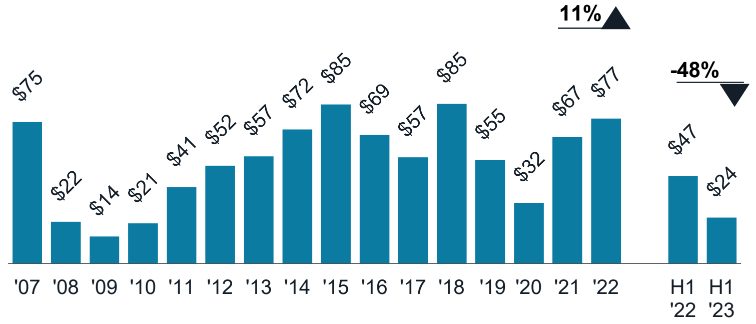
## Industrial




PROLOGIS | Blackstone | Q2 '23* | $3.1B

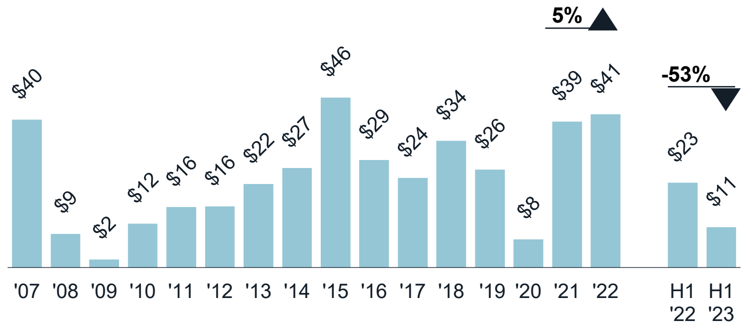
*announced in June 2023

## Retail



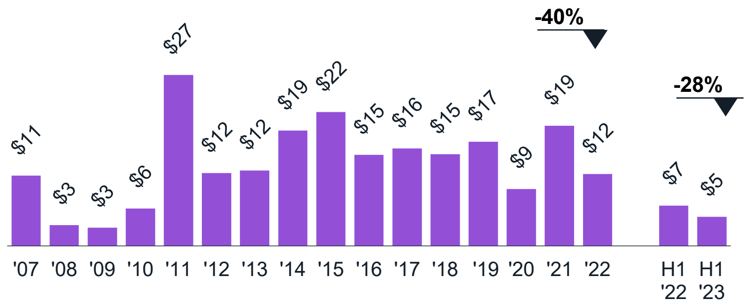

GIC | STORE capital | Q1 '23 | $15B

## Hotels




Brookfield | WLT Watermark Lodging Trust | Q2 '22 | $3.8B

## Seniors housing




VENTAS | New Senior Investment Group | Q4 '21 | $2.3B

Note: Logos beneath each bar chart pertain to a recent notable transaction (buyer | seller | close date | transaction value)
Source: JLL Research, Real Capital Analytics (transactions over $5 million, includes entity-level transactions); industrial includes Flex-R&D; includes recaps, excludes refinances

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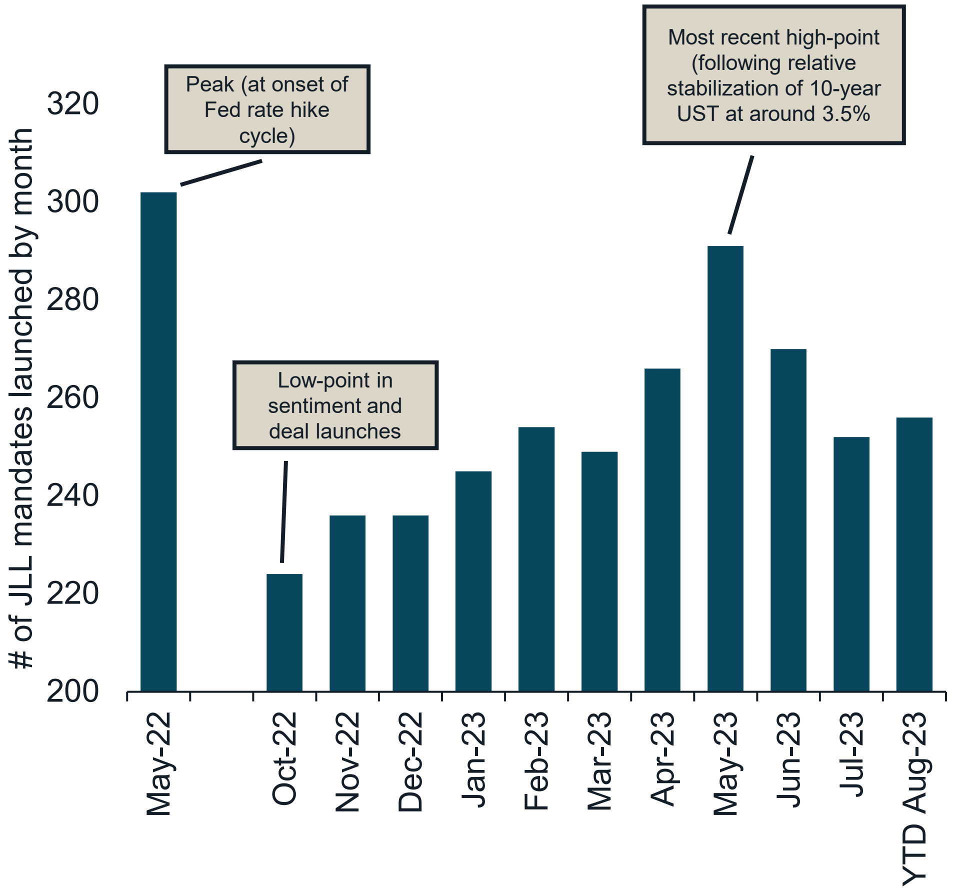
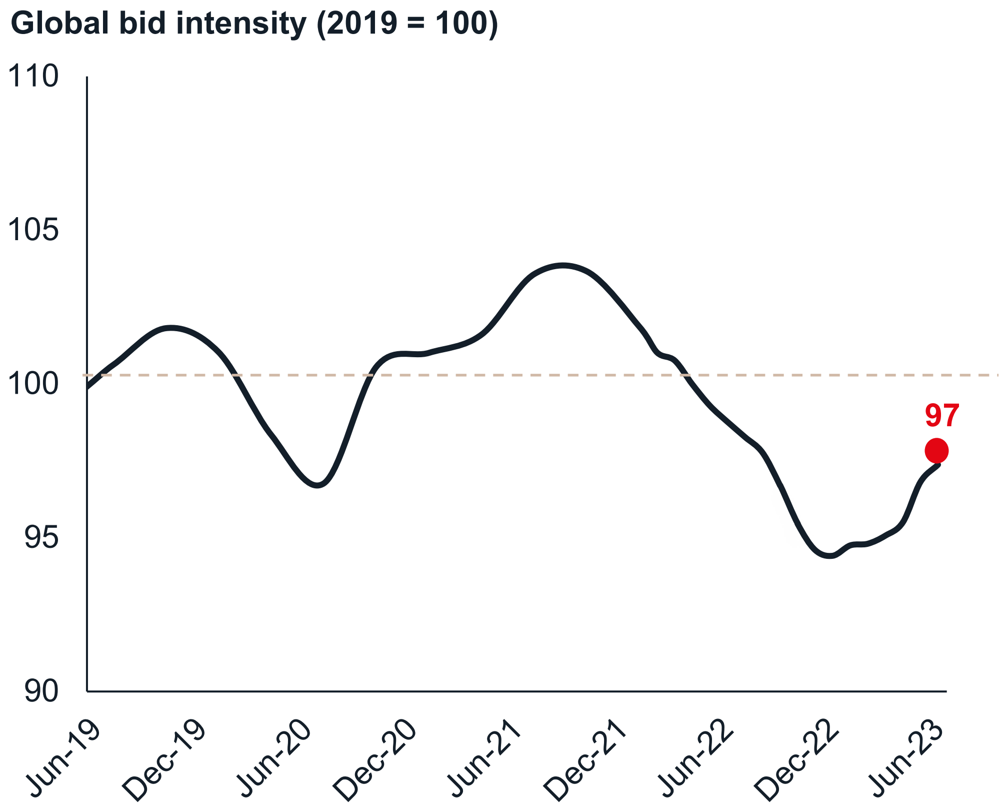
# Real-time indications around transactions momentum

**Timing of transactions launches continues to be impacted by sentiment around 10-year UST; May marked recent monthly peak in launches**




**Evaluation of bidder activity suggests that we've moved past market bottom; recovery path will depend on Fed's posturing and economic health**




Source: JLL Research

# What is needed for a meaningful CRE capital markets recovery to set in?

**Fed has to signal that interest rate increases are stopping**

**Bond markets and debt spreads have to stabilize**

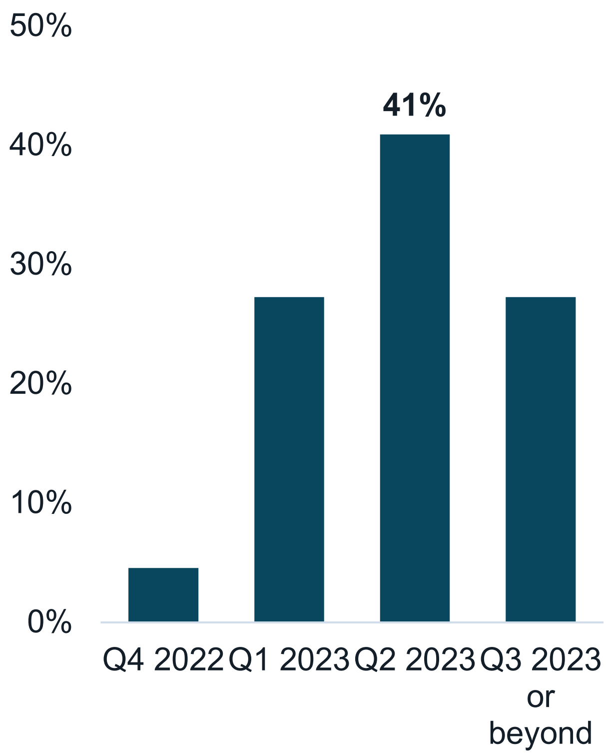
**Investors' risk premium around recession risk must not worsen**


**Large money center banks have to meaningfully return to the market**

**More clarity has to emerge around office demand**


**Core funds' appraised valuation marks need to reflect current 'spot' values**

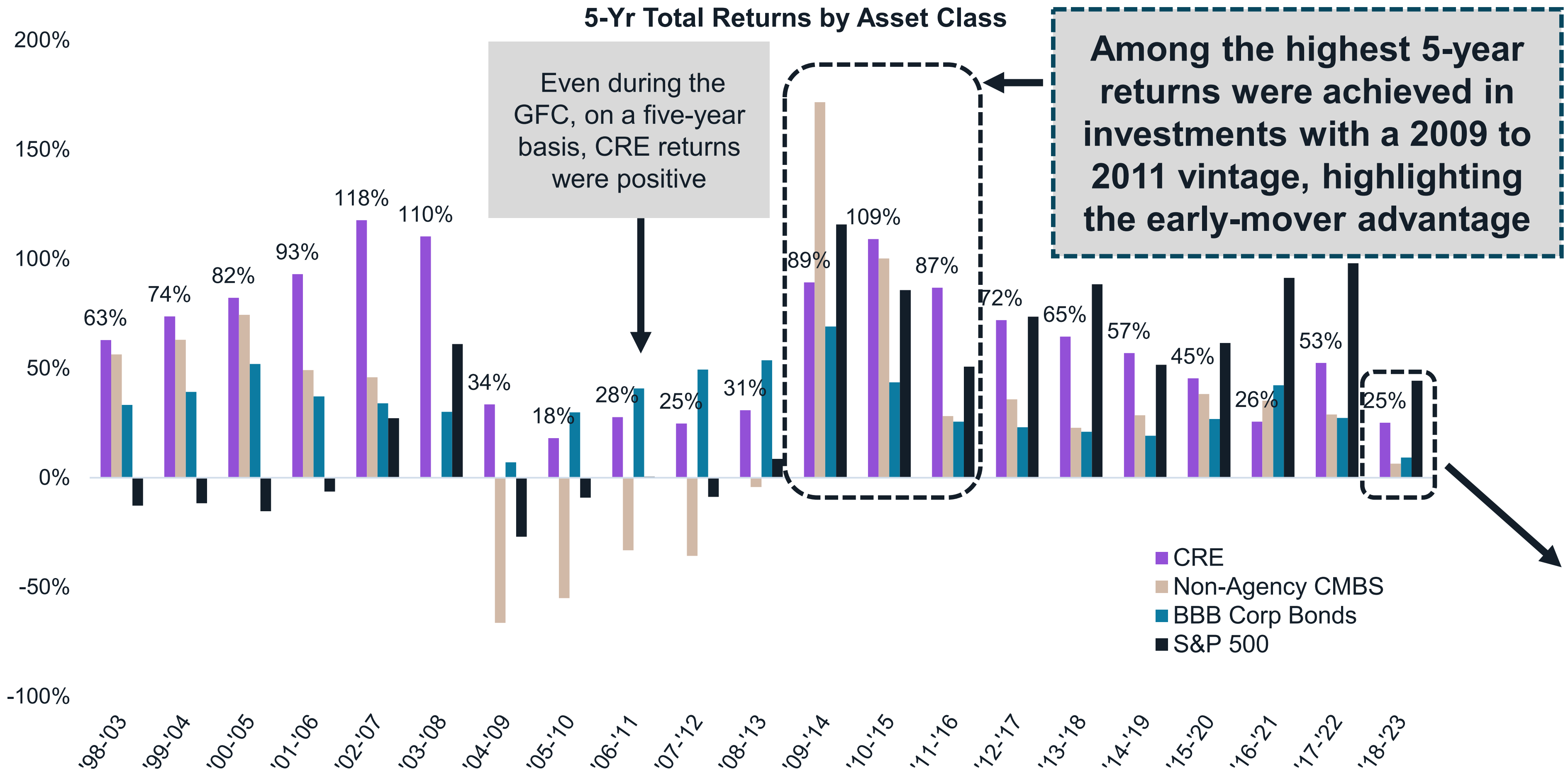
**Which quarter will represent the market bottom in terms of closed transaction volumes / investor sentiment?**




Source: JLL survey of 25 top LPs and institutional investors – February 2023

# CRE has outperformance track record and adds stability/diversification to investment portfolios; focus now turning to early-mover advantage




**Overall outperformance analysis:**

- Notwithstanding the current dislocation, CRE has long track record of outperforming and adding stability and diversification to investment portfolios
- CRE outperformed corporate bonds and non-agency CMBS in 71% of 5-year hold periods during the past 25 years (and outperformed S&P 500 in half of the periods)
- CRE has not posted negative total returns during any 5-year hold during the past 25 years, proving cyclical durability

- CRE's advantage eroded during the past 12-month period (CRE return of -13%), but further losses have been stemmed in YTD 2023 (CRE return of -1%)

**Notes:**
- X-axis labels in main chart pertain to investment horizon (with first year being the acquisitions year)
- CRE returns are based on Green Street's Commercial Property Return Index (CPRI) which reflects total return (capital appreciation + income)
- JLL also conducted the analysis for three-year and seven-year investment horizons, and the proportion of years where CRE outperforms largely holds consistent

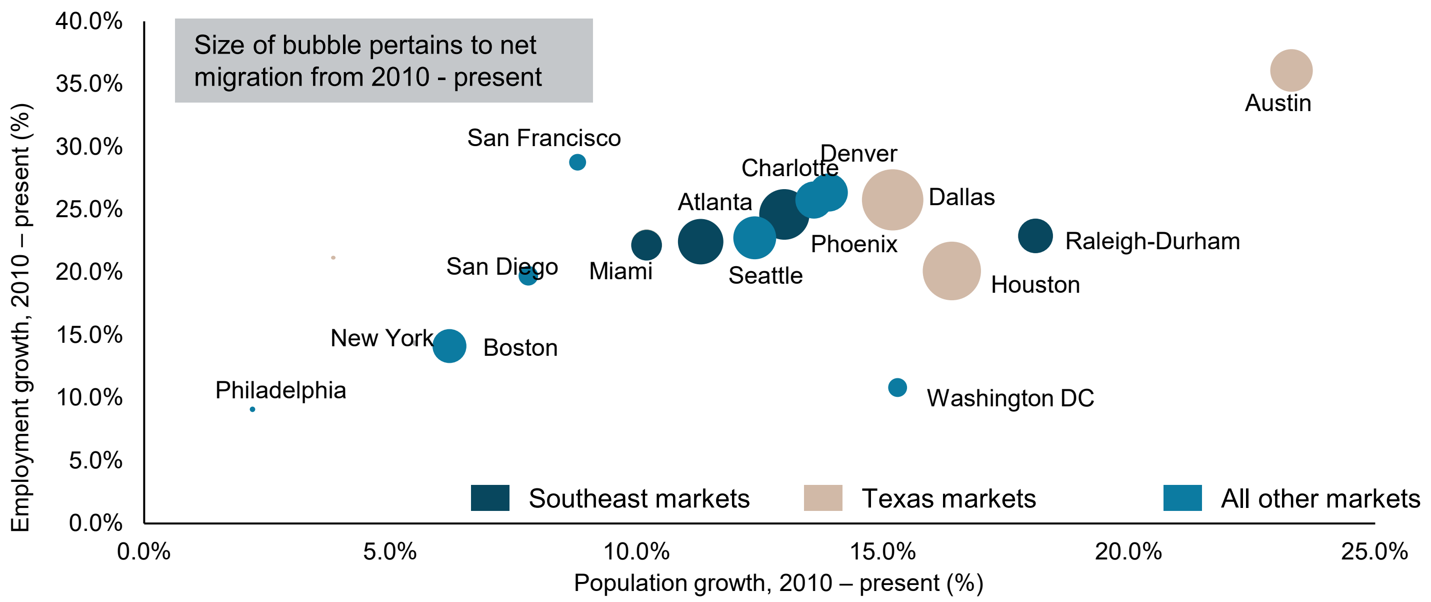
Source: JLL Research, Green Street, Bloomberg Finance, LP

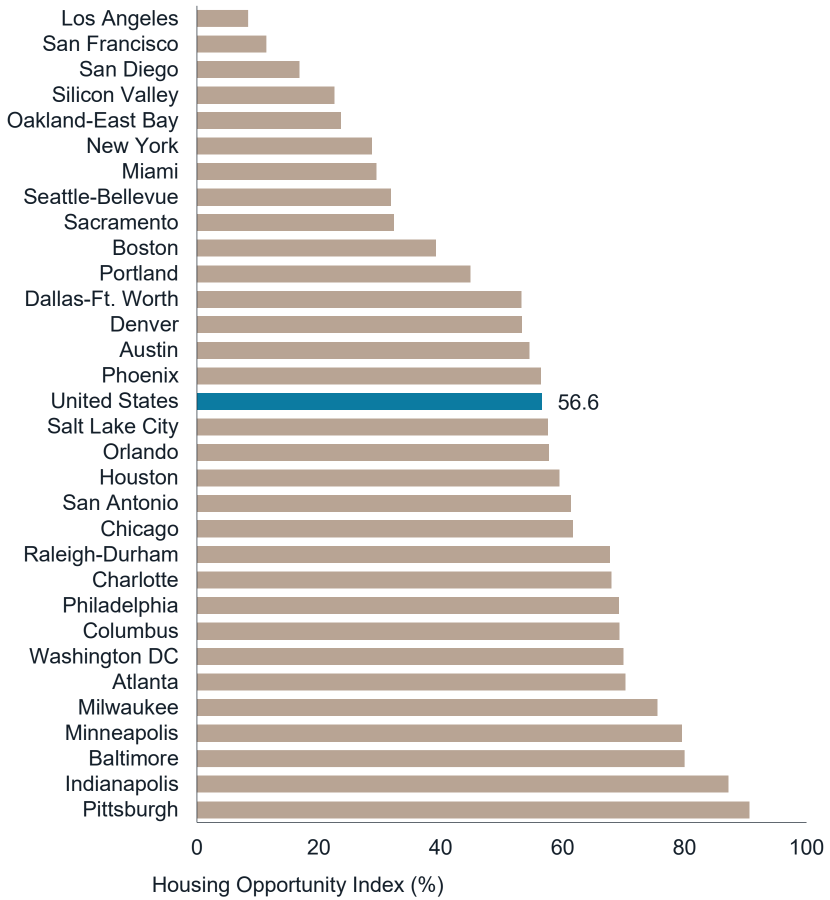
# Pandemic has accelerated pre-existing migration trends

### Drivers of migration:

Affordability | Taxes & governance | Business environment | Talent base | Entertainment & amenities




### Housing affordability is at a new low nationally




Source: JLL Research, Bureau of Economic Analysis, National Association of Home Builders

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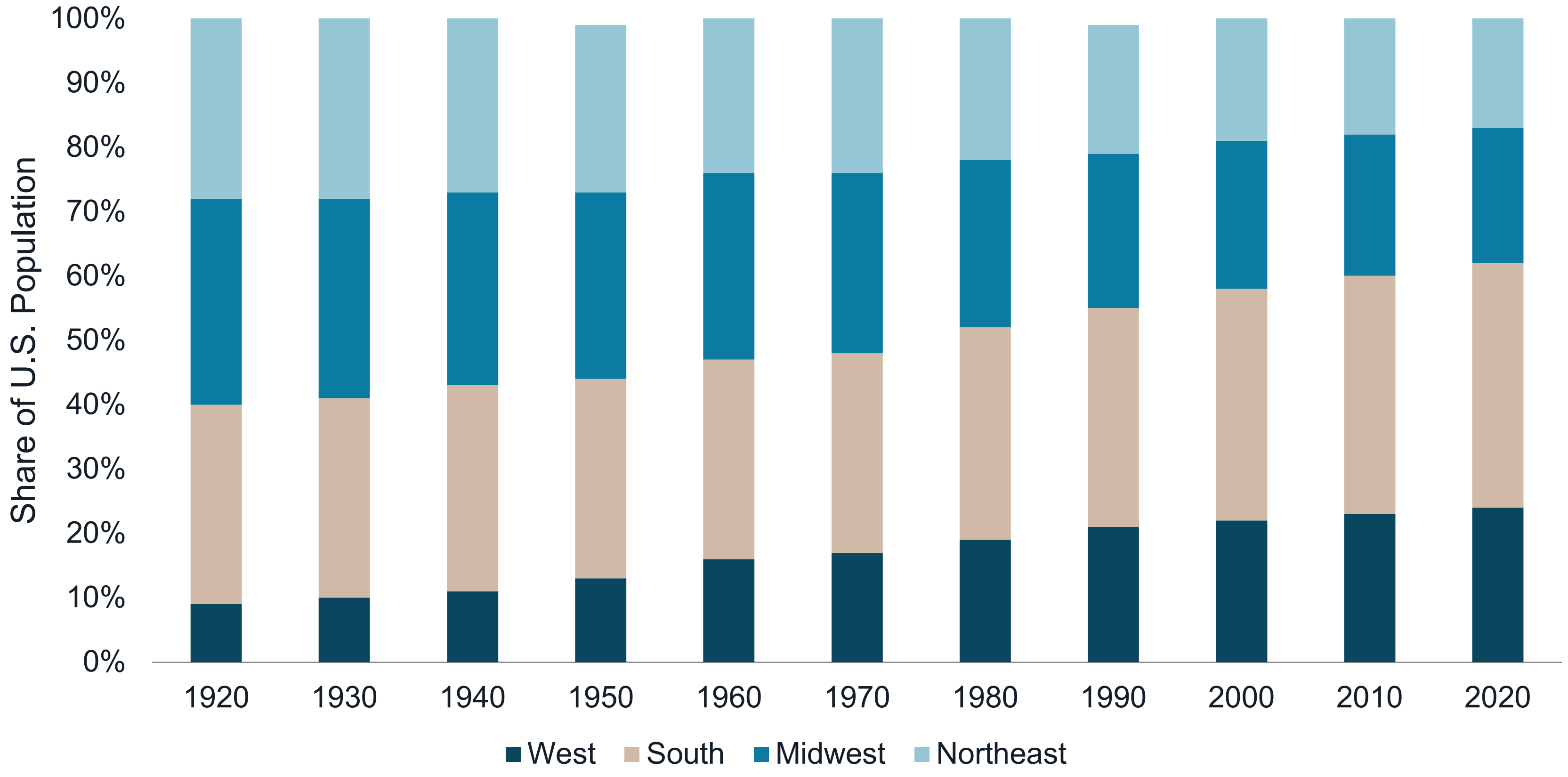
# The U.S. population has been shifting for the past century




- In 1920, 60% of the population was in the Northeast and Midwest.
- In 2020, over 60% was in the South and West.
- Demand and growth opportunities across property types have followed.

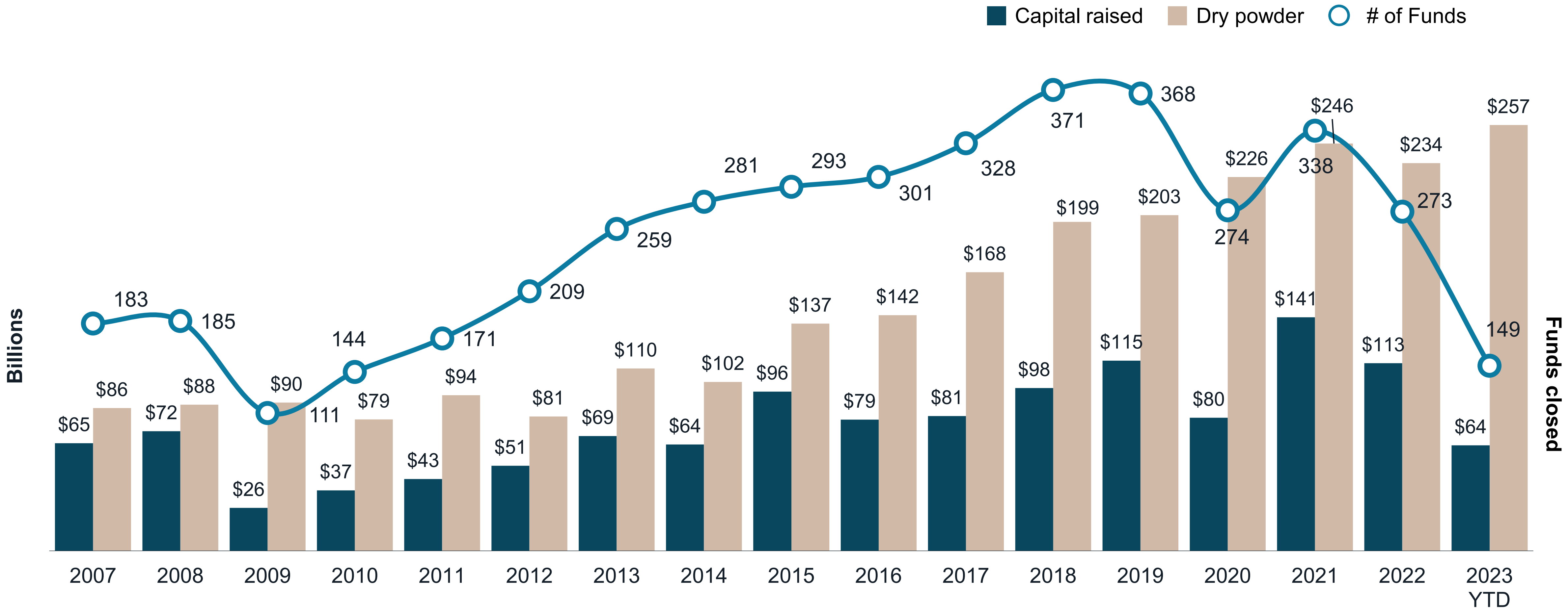
Source: Census Bureau, William H. Frey, Brookings Institution

# Long-term drivers of capital formation

02

# Dry powder at record levels but fundraising facing increased headwinds

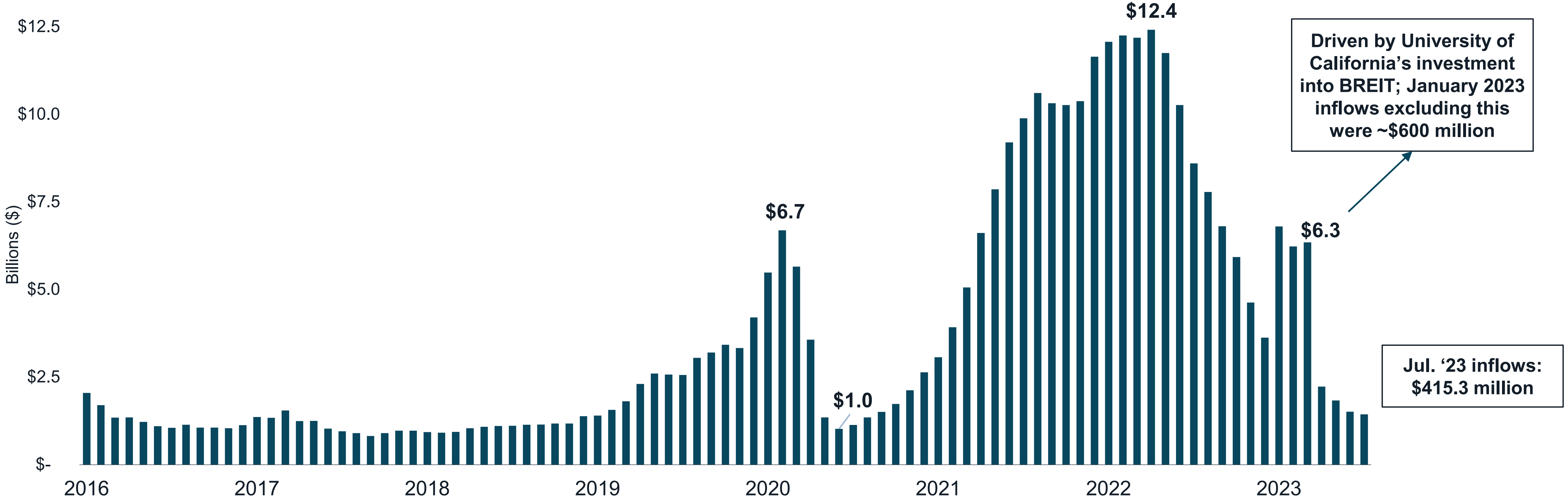



Note: Pertains to closed-end funds
Source: JLL Research, Preqin

# Non-traded REIT fundraising continues to be well below recent levels

**Non-listed REIT fundraising**
(Rolling three-month total)



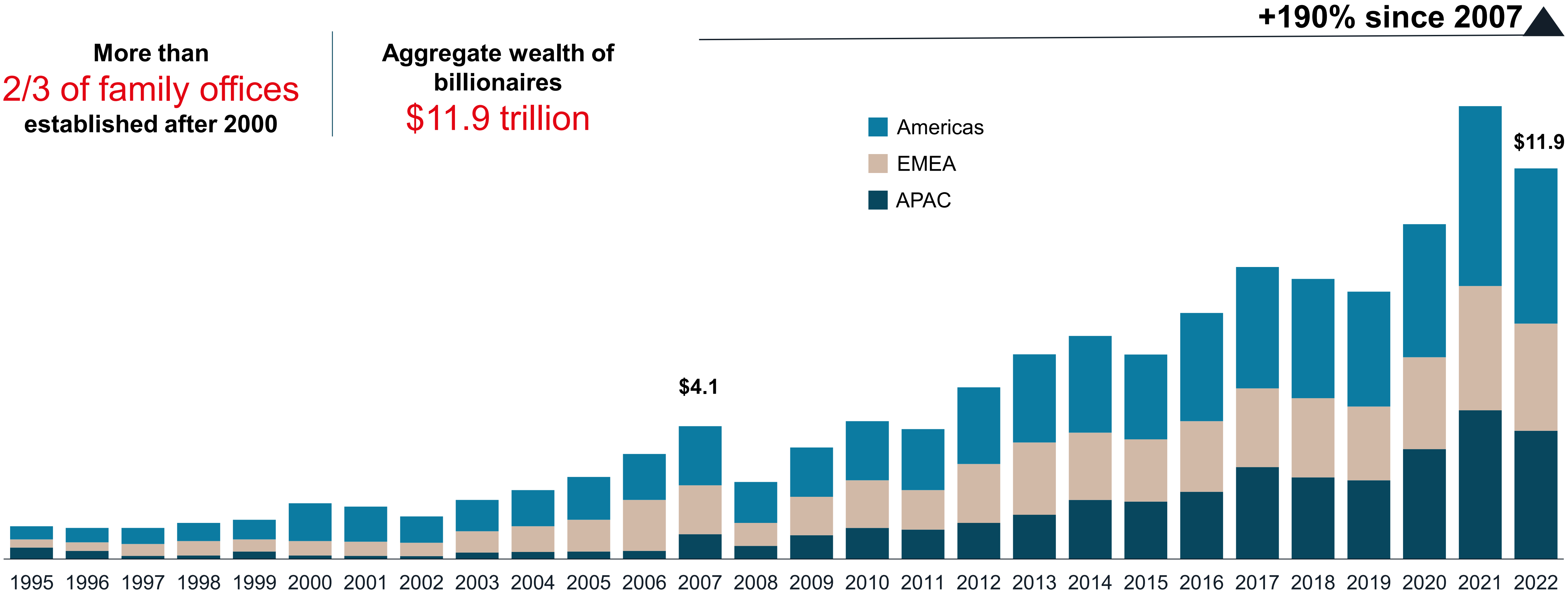

Source: JLL Research, Robert A Stanger & Co, Inc.

# Surge in private wealth globally provides untapped capital for future investment

**More than**
2/3 of family offices
**established after 2000**

**Aggregate wealth of billionaires**
$11.9 trillion




Source: JLL Research, UBS, PwC, Forbes

# Appendix

03

# Thank you

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