Sagard Real Estate

2024 Real Estate Outlook

A Year of Transitioning

When working on this SRE 2024 Outlook, we were surprised at the level of projected transitions we anticipate for the US economy and real estate market. While every year has its natural evolutions, 2024 presents the prospect for more inflection points compared to normal.

Some of the transitions that we believe will occur in 2024 may linger into 2025. In fact, several economic situations may entail the following stages: moderate economic decline, deceleration, stabilization, moderate economic pickup (i.e., green off-shoots), and then recovery.

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US Macroeconomics

The first pivots we believe we will see in 2024 are macro in nature: the US economy, inflation effects, and interest rates.

Regarding the **US economy** we foresee a transition from a strong economy to a weaker one in 2024. For the last three years the US has experienced solid GDP growth. However, in 2024 we may see a weaker economy (for such reasons as a 'stretched US consumer') and we may even come close to a recession. In this regard, we are not making a distinction whether it is anemic growth or a shallow recession and regardless, we anticipate lower net absorption of real estate space compared to the last three years.

Inflation has already pivoted going into 2024, and it is well past its post-pandemic peak. Expectations are that inflation will continue to move towards the Federal Reserve's goal of 2% towards the end of the year. Especially in the first half of 2024 however, we expect inflation to remain elevated.

Interest rates have also pivoted and are past their post-pandemic peak, and we believe rates will continue to decline in the second half of the year as inflation moderates, GDP growth slows, and the Federal Reserve cuts the Fed Funds rate throughout 2024. Due to these factors, we anticipate that the 10 year US treasury rate -- the risk-free rate used as a basis for many real estate investment proformas -- may continue to decline in 2024, decreasing to below 4% towards 3.4% to 3.7%.

US Real Estate Capital Markets and Investment Activity

The second area of transitioning we see in 2024 is within **the real estate capital markets**. In the real estate transaction market, we have already observed pricing declines of -20% to -25% and a massive decrease in transactions. That said, this pricing correction so far seems reasonable to SRE, as the 10 year US treasury rate remains above 3.5%. When combined with the historical risk premium for real estate capitalization rates of 200 bp, we arrive at an implied 5.5% cap rate for overall US real estate in 2024. Applying this math, real estate value declines of 20% to 25% from prior peak pricing are reasonable and cap rates of 5.5% for real estate make sense as a general matter.

However, private real estate is an illiquid asset class with typical valuation/pricing lag (e.g. appraisal lag) of 2-4 quarters or more behind spot market pricing. This phenomenon is observed in the two main private equity real estate benchmarks the NCREIF Property Index and NFI-ODCE. While the aforementioned 20% to 25% valuation declines have been observed in the spot market, only 16% to 20% valuation declines have been incorporated into NCREIF and ODCE (which were offset by 5%-6% positive income returns). Therefore in 2024, SRE expects appraised values to be closer to -5% or so which leads to more "flattish" overall benchmark returns when income is factored in. On balance, these valuation dynamics will keep institutional demand for new investment in real estate in check.

Another capital market dynamic which will continue to constrain a more rapid real estate recovery in the near term is **the real estate credit markets**. Generally speaking, at the beginning of 2024, most large banks remain mostly sidelined with respect to real estate lending. Additionally, we believe tighter underwriting standards and higher borrowing costs will persist across the entire commercial real estate mortgage market throughout 2024. There are of course many exceptions, but overall, we believe only the better assets and most favored borrowers with strong lender relationships will have access to attractive, accretive financing. In this environment in 2024, all cash buyers should be able to take advantage of ample opportunities, both in the core and value add spaces.

Because we believe the spot market is already hitting or nearing a bottom, SRE believes that real estate investment activity will begin to reverse course and increase by year end. In 2023, real estate investment activity was down 50%-60% as most investors were out of the market due to declining real estate values and portfolio denominator effects as well as dislocation in the real estate credit markets. Against that backdrop, at the beginning of 2024, while many of these same capital market issues are still lingering, SRE expects 2024 and 2025 to be great vintage years for new investments. SRE therefore also expects other investors to come off the sidelines and to begin deploying capital into the real estate asset class this year. For these reasons, SRE is already seeking new investments in 2024 for investment mandates that were idle in 2022- 2023. In SRE’s case, we project that our new investment volume will approximate 60% of our typical annual acquisition volume.

Real Estate Market Fundamentals

Another major transition SRE sees in 2024 relates to **real estate fundamentals**. Because of a slowing economy, we are projecting slowing demand across all real estate sectors with less net absorption compared to 2023.

Added to the effects of slowing demand is the forecast of substantial levels of construction in the industrial and multifamily sectors (i.e., upwards of 500M sf of industrial; and 300K units of apartments). These new deliveries in 2024/25 will moderate landlords' pricing power, particularly when combined with slowing demand. While there are some promising green shoots within the retail sector (and many observers believe this sector has hit bottom), there is simply too much vacancy to support a broad-based retail sector valuation recovery. And the office sector will continue to struggle throughout 2024 and beyond.

Due to this overhang of space throughout all sectors, we see another challenging year ahead for real estate fundamentals with NOIs under pressure due to increasing vacancy levels, slower tenant velocity, and increased property operating expenses (taxes, insurance, etc.)

Sagard Real Estate 2024 Investment Strategies

In spite of weakening fundamentals and new supply concerns, these issues are projected to be less of a concern for our SRE managed portfolios as they are located in markets and submarkets where over-supply is not as prevalent.

At SRE, our portfolio and investment strategies remain straight forward. While it takes discipline and strong market knowledge to execute them, our strategies are easy to understand and follow a few simple premises:

- **Real estate returns are serial correlated**, meaning that outperforming strategies tend to remain relatively strong over long periods of time (typically due to secular vs cyclical trends).
  Example: Nashville has outperformed Indianapolis consistently.
- **Real estate investors don't have to take on excessive risks or material benchmark tracking error to achieve strong outperformance**. In fact, relatively small over-weights and under-weights of just 3-5% to markets and sectors have consistently produced significant alpha for thoughtful investors over time.
- **Investing in sectors and markets with higher rent-growth** leads to higher appreciation over time (simple enough)

With these premises in mind, SRE's strategies for 2024are as follows:

- **Remain over-weighted to industrial and multifamily** (serial correlation and higher medium term rent growth)
- **Moderate to high under-weight to the office secto**r (declining NOIs next few years)
- **Selectively add retail**, taking exposure more towards a neutral weight
- In lieu of office exposure, add higher rent growth alternative real estate sectors such as Industrial - Outdoor Storage (I-OS), manufactured housing communities (MHC), and select formats of Student Housing (SH)
- From a sub-sector/market standpoint, **SRE plans to over-weight** the following:
  - Seaport and infill/last mile small box industrial
  - Class B-ish, more affordable/attainable apartments
  - Discount or Box retail
  - Southeast, South, and Southwest Regional Growth markets

Disclosures

The views expressed above are those of Sagard Real Estate as of year-end 2023 and are subject to change.

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