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Where next for Commercial Real Estate?

July 2024

When it really matters.sm

Global real estate markets have been upended: what's next for the sector?

Real estate markets have faced extreme turbulence in recent years, as multifaceted cyclical and structural headwinds have collided to upend traditional real estate models and the investment status quo founded on belief of the permanence of "lower for longer".

The investment logic aligned to well over a decade of ultra-low interest rates since the Great Financial Crisis (GFC) of 2007-08 ended abruptly in mid-2022. The global surge in inflation brought a sudden end to a near 40-year cycle of monetary loosening, replaced by uncompromising quantitative tightening programmes by central banks worldwide.

In the 18 months that followed, global policy rates widened dramatically (500bps in the U.K.), catalysing similar widening of 5-year swap rates – a key reference rate for Commercial Real Estate (CRE) lending, culminating in a substantial increase in the cost of real estate debt and finance.

Investors rapidly adjusted their return requirements, driving a broad-based reset in real estate values. Despite resilient income returns, capital value attrition swung global real estate total returns negative.

The powerful paradigm shift triggered a huge spike in uncertainty that damaged market sentiment and drove investors and lenders to adopt a significantly more risk-averse approach.

Global media and financial press sentiment in the year to date would appear to accord with the data point opposite, from AlixPartners' most recent Turnaround and Transformation Survey. However, despite the collapse in global investment volumes, the rapid broad-based valuation reset, and continuing widespread structural evolution, in reality – and perhaps counterintuitively – there has only been a modest uptick in distress to date.

57%

of AlixPartners' 2024 Turnaround and Transformation Survey respondents globally expect CRE to be one of the sectors most likely to face distress in 2024.

Why is it different now?

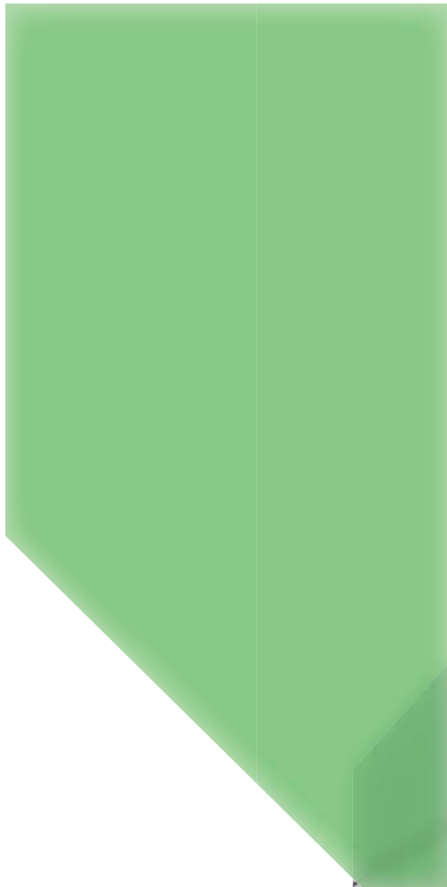
Real estate is inherently cyclical and has endured multiple downturns and crises of confidence. Almost without fail, the industry has brushed itself down and emerged with renewed strength and vigour.

However, we believe the current dislocation facing global real estate markets to be different, presenting relatively uncharted waters.

To explain why, we dive deeper into the key themes facing the market today, from investment market paralysis and potential catalysts for renewed activity, to structural factors potentially compounding cyclical valuation reset and aggravating the potential speed of recovery.

By doing so, we aim to explain why the present combination of cyclical and structural factors facing real estate stakeholders creates an exciting market for developing proactive, granular and forward-thinking strategies.

These strategies will help stakeholders navigate and insulate from current dislocation, while seizing opportunities emerging from this profound structural evolution as cyclical headwinds appear to start to abate.



Global investment market paralysis

Pricing uncertainty and loss aversion led global investment volumes to fall by nearly 50% in 2023 (see figure 1), as investors adopted a “wait and see” approach in the hope that markets would start to stabilise and erode rather than crystallise paper losses.

Global volumes failed to recover in Q1 24, falling a further c.25% YoY according to transaction volume data from MSCI.

Last year, U.S. and European volumes fell by approximately 50% and 46% respectively, with the latter receding to volumes last witnessed in 2012, driven by the retrenchment of core capital from global institutional investors as illustrated in figure 2 (down c.60% in 2023 vs. 2018-22 average run-rate).

Perhaps unsurprisingly, the withdrawal of capital was most readily evidenced within office markets. European transaction volumes fell by around 65% vs. pre-pandemic levels, suffering the worst year on record in 2023.

50%

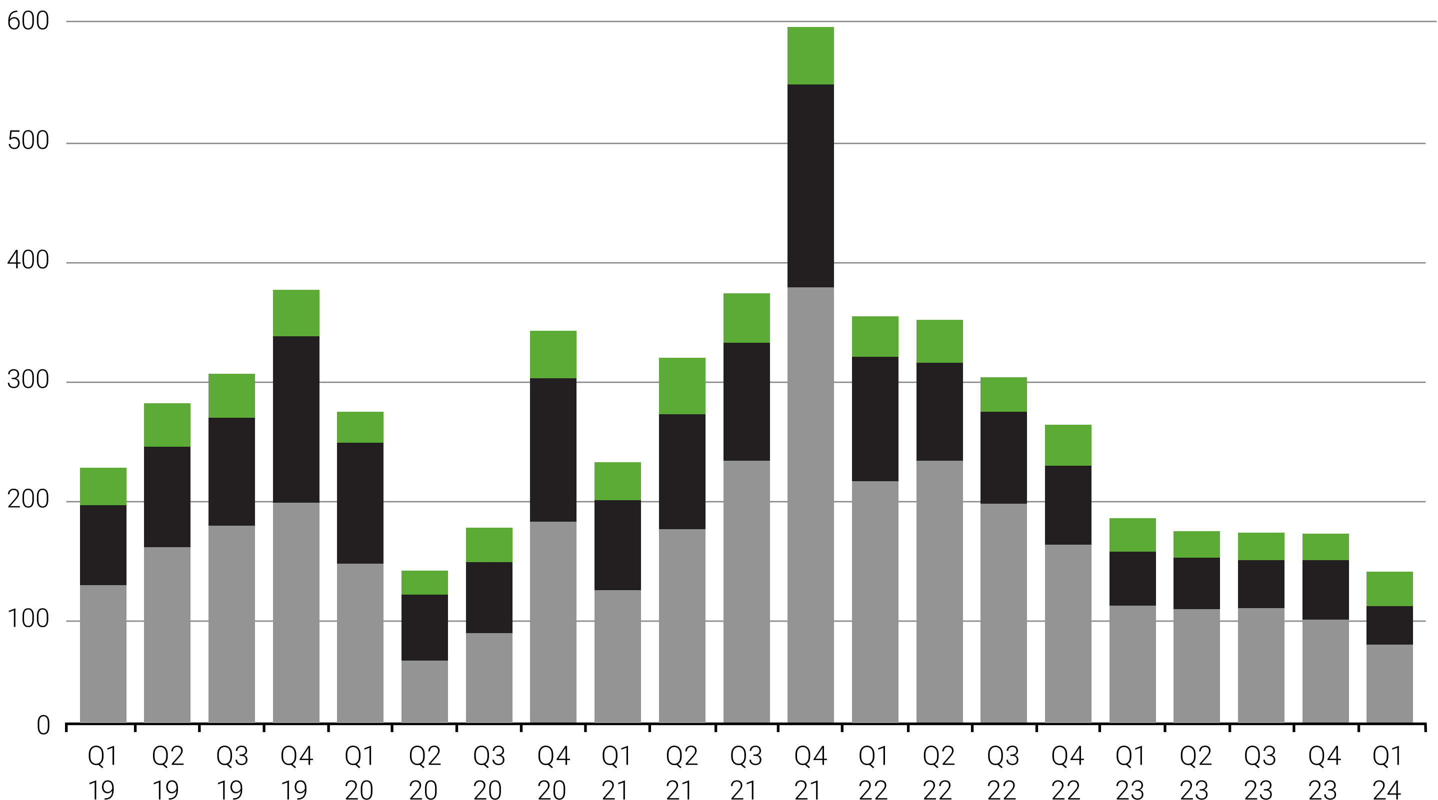
Global real estate investment volumes fell by c.50% in 2023.

Figure 1: Global CRE investment volumes continued to fall in Q1 2024

(USD bn)

Americas Europe Asia Pacific

Source: MSCI Real Assets, CBRE Research, Bloomberg



Global office markets are suffering from a crisis of confidence, largely stemming from the lack of a clear trajectory for the evolution of hybrid working, which was inflamed by COVID, but also due to growing awareness of the size of the investment required to modernise and future-proof estates.

The fragmented unwind of the "WFH" phenomenon is illustrated in figure 3, highlighting how the return to work in the U.S. has materially lagged both Europe and Asia Pacific.

However, while the malaise in the U.S. office market has created significant media noise, analysis by MSCI suggests that liquidity in several European markets is worse than in the U.S. For example, the MSCI Price Expectations Model (Q4 23) estimated that office values in German A cities would need to reduce by a further c.41% to return liquidity to its long-term average, versus 29% in San Francisco.

Figure 2: Retrenching institutional capital – Annual European Real Estate investment 2018-2022 Average vs. 2023 (€ bn)

2018-22 Avg ● 2023

Source: MSCI

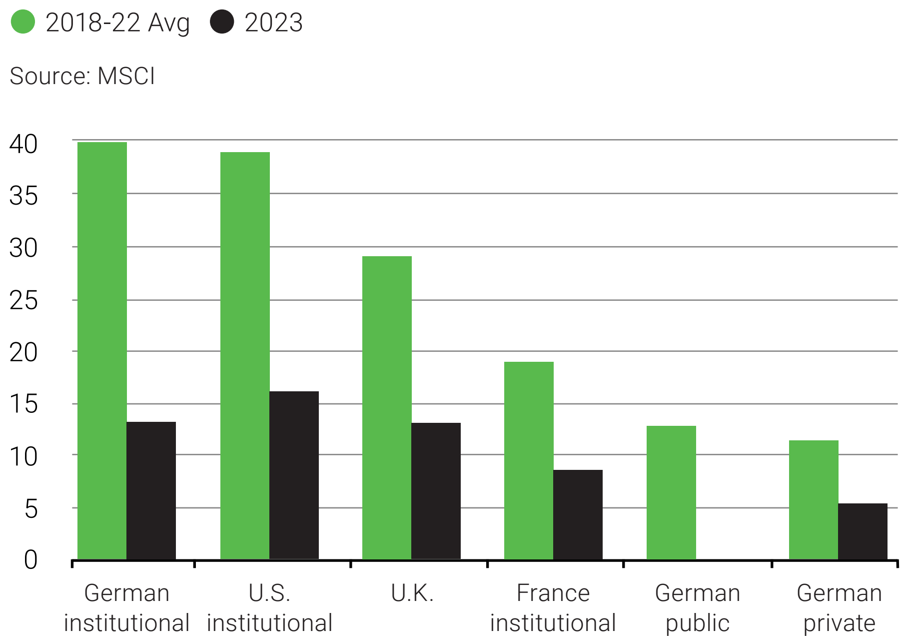
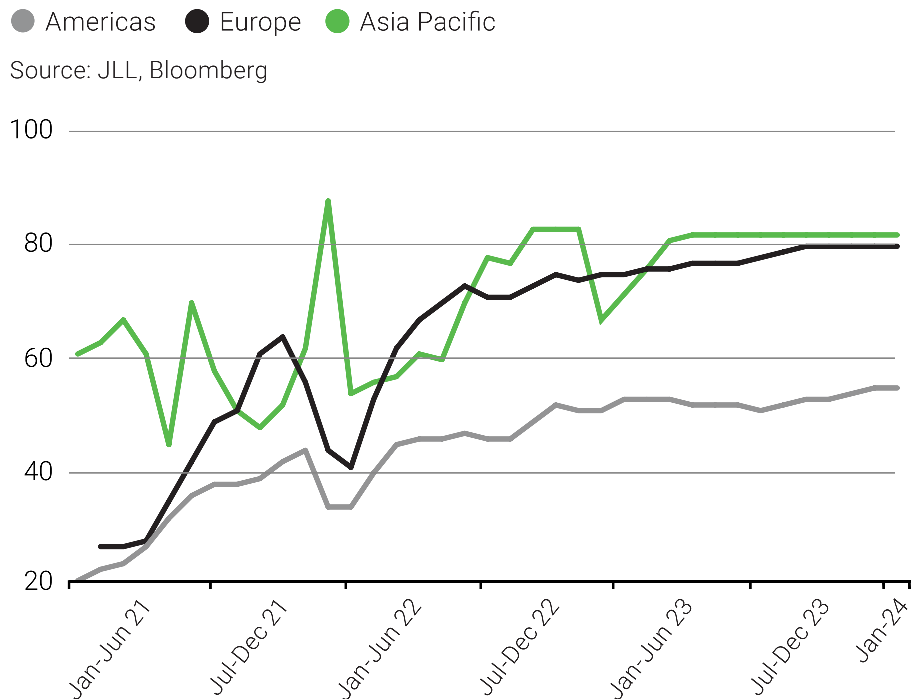


Figure 3: Office occupancy rates as a percentage of pre-COVID levels (%)

Americas ● Europe ● Asia Pacific

Source: JLL, Bloomberg



Unusual correction

Real estate corrections commonly witness adverse repricing and reduced capital availability, but resilient occupier markets and robust structural fundamentals, as largely prevailing in certain markets, are highly unusual (e.g. prime office).

Typically, real estate pricing and underlying fundamentals are closely correlated. When rents fall, values tend to fall. However, the broad-based value erosion endured recently appears weighted towards the impact of monetary policy responses to rampant inflation, while market fundamentals remain buoyant, albeit not universal, across and within sectors.

While monetary policymakers are aware of the "long and variable" lag between implementing monetary actions and their effect, there is much less empirical evidence or consensus on the length of any such delayed transmission.

For real estate, the evolution of fixed versus variable debt weighting or preference has been identified by many commentators as a potential cause of more delayed transmission.

The concern that real estate fundamentals appear unusually robust is the risk that the full impact from the shock of the recent hiking cycle is still feeding through the economy, raising the risk of second order valuation reset, should markets start to soften as the economy adjusts to the higher cost of capital.

Going forward, capital value performance will therefore be much more granular and bifurcated, dependent on individual property fundamentals than on financing. This will require a much more focused approach to asset management to ensure income security, resilience, and growth.

How close are markets to the bottom?

The current valuation reset has spanned more than six quarters but, as illustrated by figure 4, has been materially shallower to date than the contraction in real estate values witnessed during the GFC.

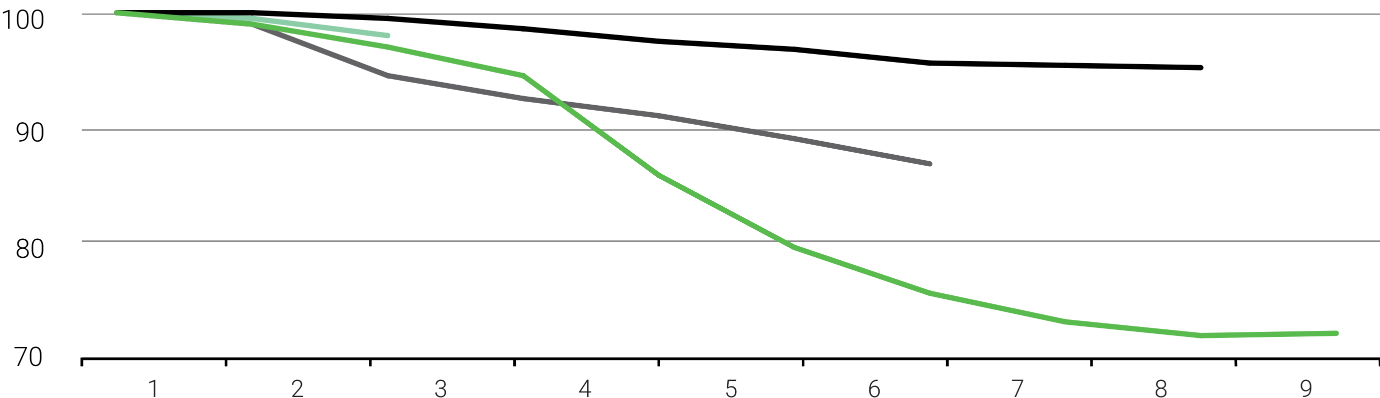
However, as discussed previously, investment market activity remains severely constrained, suggesting that real estate investors (buyers and sellers) have yet to agree on where equilibrium values sit. This raises the spectre that meaningful further valuation reset is required.

Data tracked by MSCI around deal volumes in contract at the end of Q1 24 indicates that transaction activity in Q2 24 will remain muted.

> "The main objective… of investment should be pricing, not timing."
>
> Benjamin Graham, Economist

Figure 4: Capital value decline vs previous downturns (nine quarters displayed from peak of downturn)

Source: MSCI



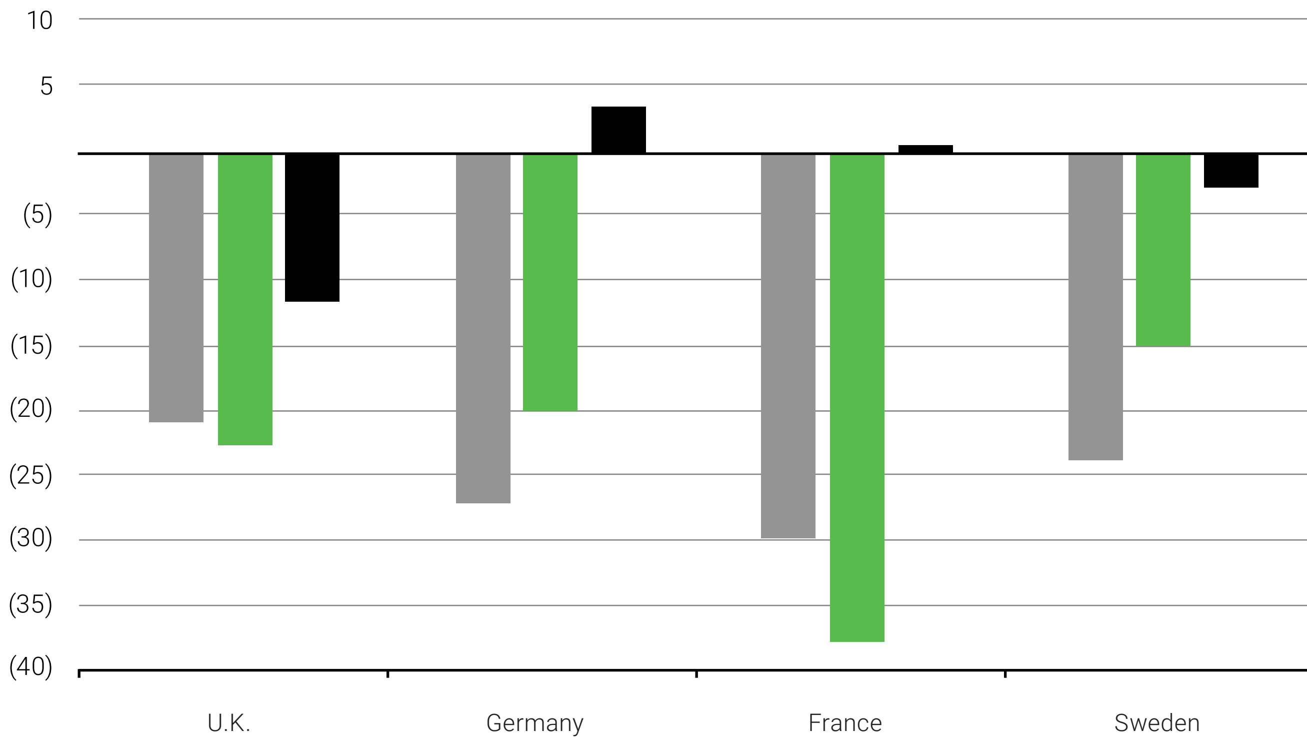
MSCI's Price Expectations Gap model assesses what further price recalibration is required to return investment market liquidity to long run averages.

The output of MSCI's European modelling as at Q1 24 perhaps surprisingly indicates that France overtook Germany as the market facing the greatest further valuation reset required to return long-term liquidity. Of greater note, maybe, is that the Q1 24 model indicates that retail, not office, fares the worst from a sector point of view, at least in France and the U.K.

Figure 5: Price expectations gap, Q1 2024 (%)

Office Retail Industrial

Source: MSCI



What are the potential catalysts to unlock the market?

The prevailing investment logic from the past 15 years has been inverted – upending traditional views of real estate as a passive investment and meaning that investors can no longer acquire and hold assets until disposing of them into a more favourable market[1].

In this market, models like MSCI's Price Expectations Model help to understand and quantify why markets are currently "stuck" (i.e., prices need to fall further to persuade buyers to re-enter the market and transact). They do not, however, offer insight into potential triggers to catalyse activity.

Many of our recent conversations have centred on the market dynamics that need to shift, for bottlenecks to ease and for the war chests of dry powder waiting on the sidelines to be deployed.

> "Landlords grow rich in their sleep without working, risking, or economising."
>
> — John Stuart Mill

We see a number of triggers that could help to catalyse activity in the second half of 2024 and beyond:

1. Improved stability, visibility, and sentiment

Uncertainty is bad for real estate, and has forced real estate investors to sit on the sidelines, waiting until the storm clouds have cleared and visibility of the trajectory for investment markets, occupier markets, and financing has improved.

Macroeconomic data at the back end of 2023 hinted that stability was improving (with interest rates peaking, recessions largely avoided, solid fundamentals, and diminished supply pipelines) lifting sentiment and providing hope for the return of investment market activity, driven by the return of institutional capital.

Yet since the start of 2024, sentiment has arguably deteriorated, as illustrated by the marked uptick in 5-year SWAP rates YTD. Concerns about potential double-dip inflation as witnessed in the 1970s and 80s (see figure 7) and widening geopolitical instability suggest battles are not won yet, strengthening the new 'higher for longer' paradigm.

The first interest rate cuts announced by international central banks in recent months (e.g., Canada and the ECB) do, however, indicate that some policymakers consider modest loosening to be appropriate.

Still, the real estate financing market is expected to remain challenging, with a "selective credit crunch" emerging, limiting availability to structurally supported sectors and adding to the risk of further correction in secondary sectors and locations.

1. Assuming an average institutional hold period of seven years, over the past 40 years investors would have almost certainly sold assets into a market where 10-year government bond yields were lower at disposal than at acquisition.

Continued macroeconomic uncertainty is further complicated by the sheer number of countries facing political elections in 2024, representing 60% of the world's population and 65% of the institutionally investable real estate universe.

Real estate faces multiple long-term structural pressures, which are often not aligned to the short-term nature of political cycles and government changes.

For example, the U.K. has seen 26 Ministers for Housing in position in 27 years, sharply illustrating the mismatch between short-term "politicking" and the need for a long-term strategic view in the sector, given the nature of the asset class. Uncertainty surrounding prospective new regulations such as rent caps, new stimuli such as stamp duty thresholds, and planning reform may all contribute to an extended hiatus in decision making.

Figure 6: Five-year SWAP rates have ticked up YTD 2024 (%)

U.K. 5Yr SWAP · Eur 5Yr SWAP · USD 5Yr SWAP

Source: Investing.com

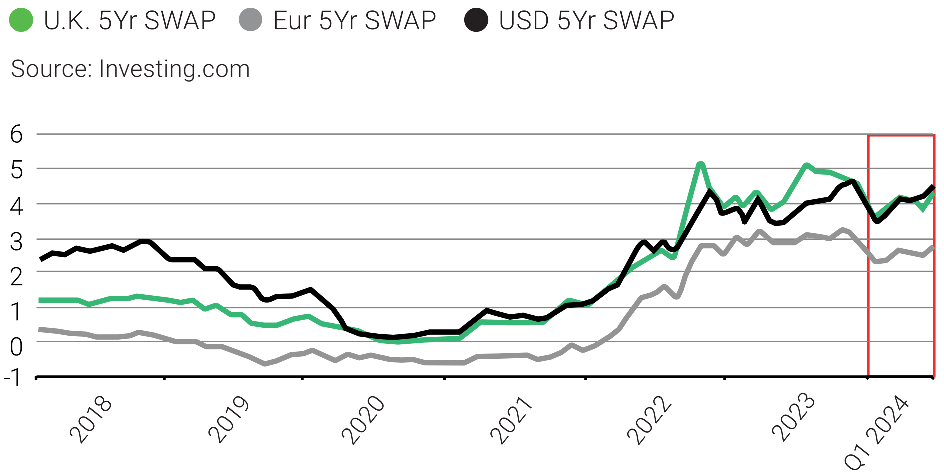
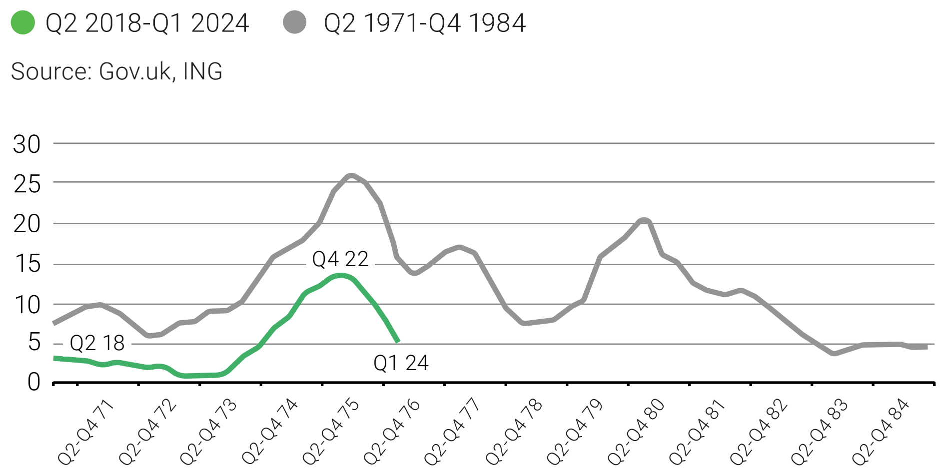


Figure 7: U.K. RPI – the threat of "double-dip"? (%)

Q2 2018-Q1 2024 · Q2 1971-Q4 1984

Source: Gov.uk, ING



2. An unprecedented Commercial Real Estate debt maturity wave...

Figure 8: U.S. CRE debt maturity wave, 2024-28 (USD bn)

Banks · CMBS · Life Insurers · GSE · Other

Source: Trepp, Bloomberg

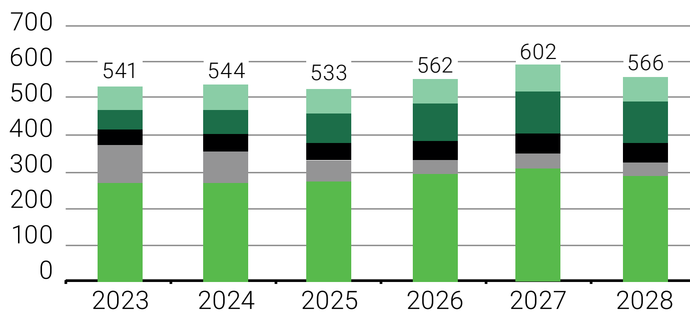
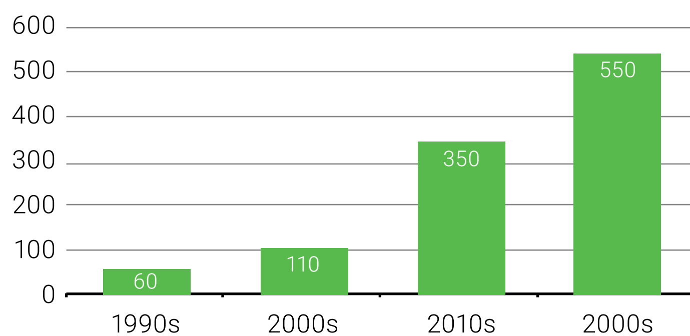


Figure 9: Average U.S. CRE debt maturities by decade, 1990s to 2020s (USD bn)

Source: Trepp, Bloomberg



Over the next five years, global real estate markets need to address an unprecedented volume of real estate debt maturities, at a time when uncertainty remains elevated, and many investors are simply trying to "survive until '25".

As illustrated in figure 8 opposite, real estate analytics provider Trepp estimates that around $2.8tn of U.S. CRE debt will mature before 2028, approximately $550bn per year, which is five times higher than the average maturities between 2000 and 2010 (figure 9).

The maturity wall of the GFC was similar, but a zero-interest-rate policy supported "extend and pretend" strategies. Investors and lenders found support for adopting a "wait and see" approach rather than crystallising losses, but these strategies have simply resulted in pushing maturities to the right and compounding today's headache.

Analysis from Cohen & Steers in March 2024 estimates that 40% of 2023 loan maturities were extended or otherwise modified, deferring the immediate need to address problematic refinancing positions, but likely not resolving the problem.

In the U.K., the latest Real Estate Lending report from Bayes Business School (May 2024) indicates that 42% of the £170bn of outstanding commercial real estate borrowing in the market requires refinancing over the course of the next 12 months.

3. ...Creating material debt funding gaps

The CRE debt maturity wave is crashing at a time when the market is already facing severe cyclical and structural dislocation. Coupled with reduced credit availability in many sectors, elevated debt pricing, and tighter lending and underwriting criteria, the "Achilles heel" of the heavily leveraged prevailing business models within the market is exposed. Sharply higher interest rates have also contributed to equally abrupt and rapid tightening of real estate liquidity. According to the latest survey results compiled by Bayes, only 32% of lenders will consider underwriting secondary offices, versus 86% who are willing to underwrite prime offices.

As lenders lower Loan To Value (LTV) and raise Interest Coverage Ratio (ICR) thresholds, material deltas arise between the quantum of borrowing available – and affordable – at refinance. The "new" prospect of material "cash-in" refinancing will rattle many investors and properties – if they can find finance at all.

CBRE estimates that a debt funding gap (DFG) of around €176bn (figure 10) will emerge between 2024 and 2027, across approximately €640bn of private real estate debt originated in Europe between 2019 and 2022. The gap peaks in 2026, with offices and Germany showing the widest potential shortfalls.

Assumed modest market recovery from stabilisation and lower interest rates helps to mitigate some of the gap (to €114bn), with further possible optimisation from the ability to part-fund the remaining shortfall with subordinated debt (to €72bn).

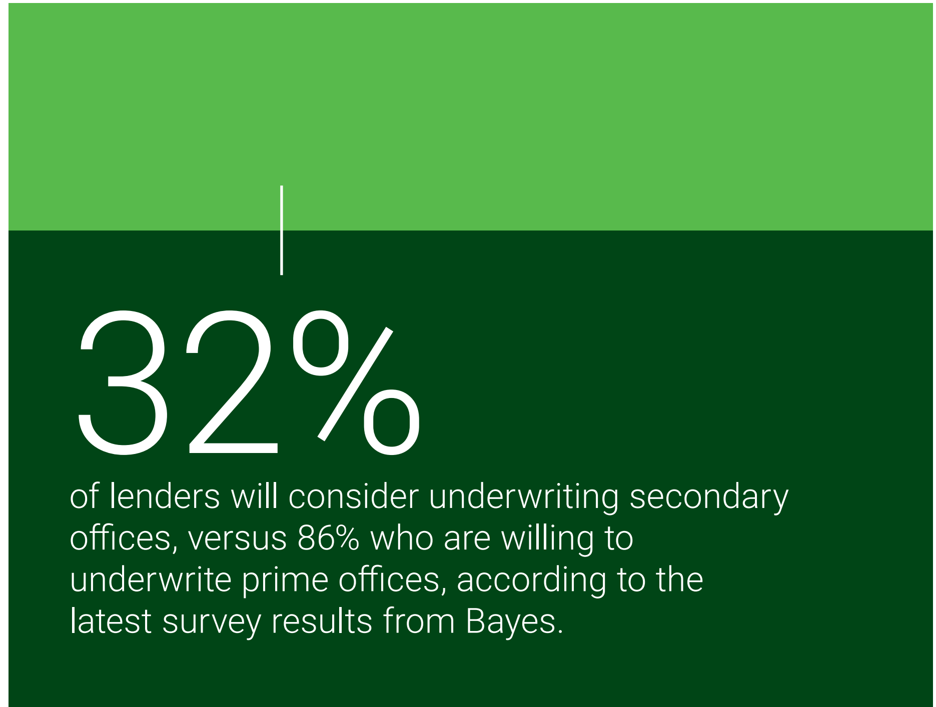
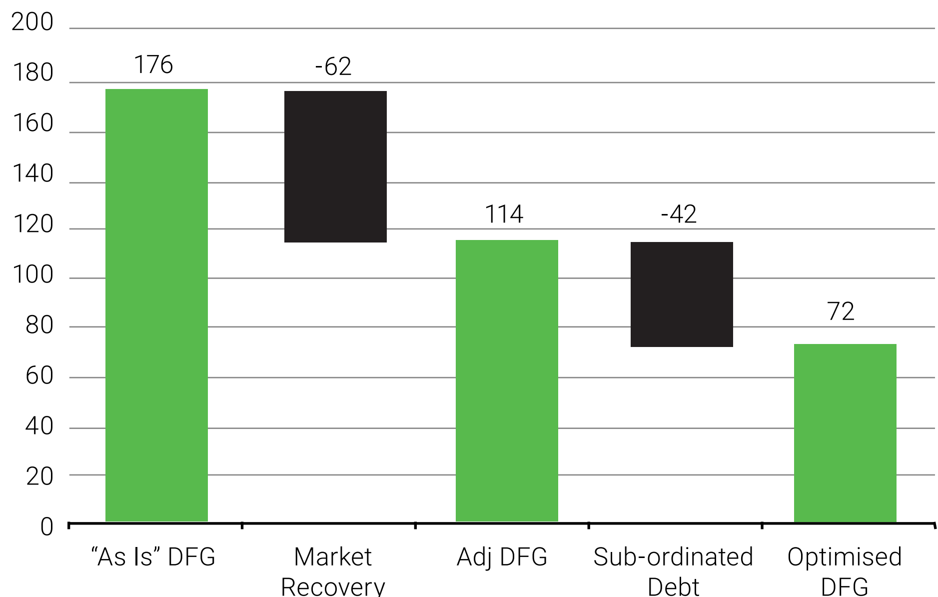


Figure 10: Estimated European debt funding gap, Q4 2023 (USD bn)

Source: CBRE



4. Deepening distress

As referenced earlier, the level of real estate distress emerging from the "perfect storm" in recent years has remained low to date, largely explained by some of the concepts previously discussed, including loss aversion, and playing for time through amend and extend activity.

At the end of Q1 24, the weighted average default rate across U.K. lenders was c.3.9% according to Bayes, increasing just 40bps on 2022, albeit this masks much greater variance between the default rates of smaller (c.7.5%) and larger lenders (1.5%).

As the storm clouds recede from a previously broad-based blanket valuation reset, significant variations will emerge between sectors and markets, demonstrating bifurcation and underscoring less resilient strategies, properties, sectors, and locations.

As illustrated in figure 11, history suggests a lag between the initial shock and peak loan defaults. For example, during the GFC, loan defaults did not peak until 2011, around three to four years after the initial shock.

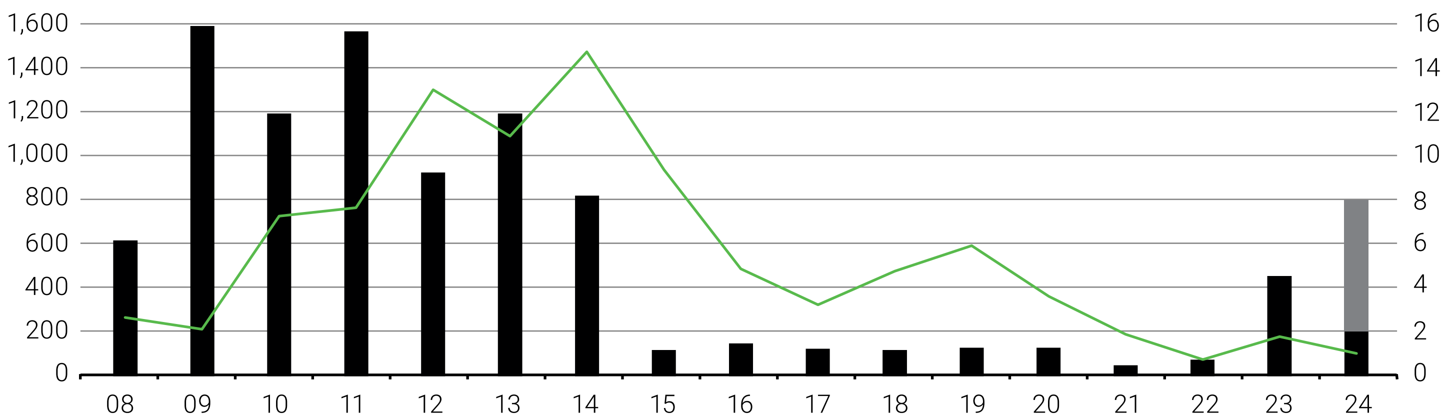
3.9%

was the weighted average default rate across U.K. lenders at the end of Q1 24, increasing just 40bps on 2022.

Figure 11: Properties in distress and distressed Real Estate sales, Europe – 2008-Q1 2024 (€ bn)

Number of distressed properties · Distressed sales (€ bn) · Pro-rata distressed property volumes

Source: MSCI, Public Reported Information



The culmination of the debt maturity wave and the debt funding gap is likely to catalyse increased levels of distress, particularly within loans written between 2017 and 2021, when investor sentiment was frothy and interest rates were at historical lows.

Secondary assets will likely face further correction; they are typically much more exposed to cyclical pressures and the risk of structural obsolescence. Liquidity will therefore be much slower to return, forcing investors and lenders to act.

However, volume growth borne out of distress can create a virtuous circle, by delivering concrete comparables evidence that removes investors' and lenders' ability to use depressed investment volumes and a lack of comparables to support inaction. The resulting potential wave of more mark-to-market losses will compound further distress and force action.

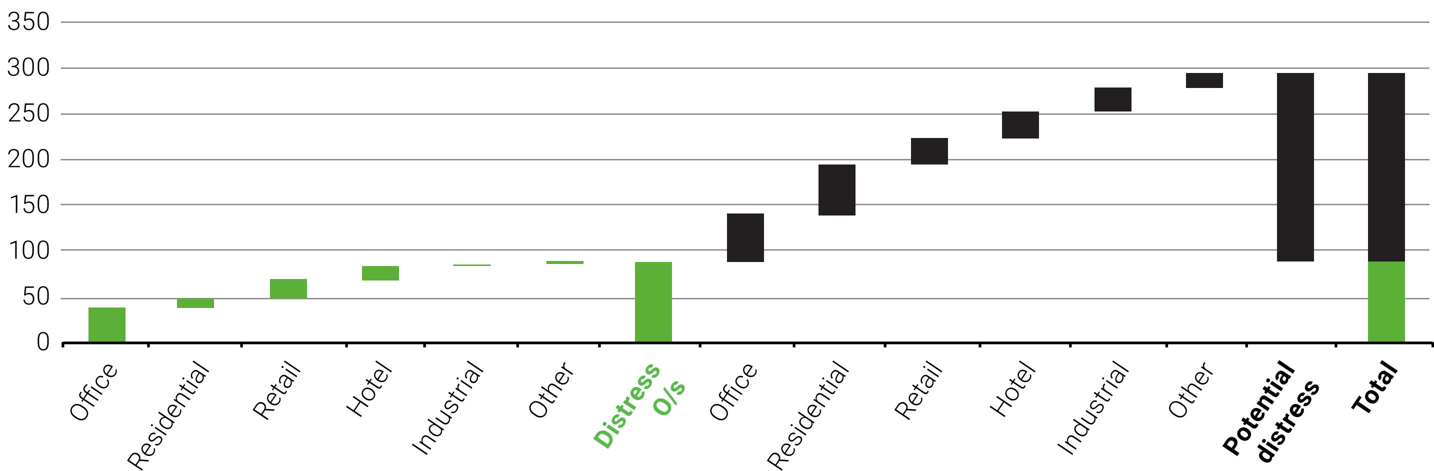
MSCI analysis into the value of distressed real estate assets in the U.S. market at Q1 24 aptly illustrates the split between distress outstanding (i.e., crystallised) at approximately $89bn and potential distress at around $205bn, c.132% higher.

Potential distress is heavily weighted to office (due to factors discussed elsewhere) and residential. The latter reflects the fact that the sector had become overbid and therefore is suffering more pronounced adjustment within the higher for longer environment, coupled with scheduled delivery of new supply that commenced when markets were most frothy.

Figure 12: Outstanding and potential U.S. Real Estate distress, Q1 2024 (USD bn)

Distress O/s   Potential distress

Source: MSCI



5. Widespread structural evolution masked by short-term, cyclical-driven dislocation

Due to the pace of upheaval within global real estate and financial markets since mid-2022, substantial attention has been focused on addressing the dislocation arising from these mostly cyclical headwinds.

The result has been to divert attention and finite resource away from the challenges and vulnerabilities exposed by diverse and profound structural forces. These include the strengthening influences of ESG, the climate crisis, and sustainability requirements, technological disruption encompassing Data and AI, the hotelisation of real estate as an asset class, and changing asset class preferences emerging from demographic and behavioural change.

This structural evolution heightens the downside risks for specific commercial real estate sectors, and the likelihood of increasing disparity both between and within these sectors.

On the following pages, we focus on two of the newest and arguably largest structural forces: ESG and Sustainability, and Data and AI.

ESG and Sustainability – CRE's greatest challenge?

Real estate has a heavy carbon footprint, accounting for 40% of annual energy consumption and 36% of GHG emissions, according to research by the European Commission, who also estimate that around 75% of the bloc's floorspace is energy inefficient.

To meet sustainability and net zero emissions targets, real estate's energy consumption needs to fall by at least 35% by 2030, necessitating a huge acceleration in the rate of transition to address historical underinvestment and avoid potential asset stranding and obsolescence. According to data from the European Commission, annual refurbishment rates need to increase by nearly 300% to deliver this transformation.

PwC's Emerging Trends in Real Estate 2024 survey highlights that 90% of respondents believe ESG will have the biggest impact on real estate by 2050, but also that 50% expect compliance to be a major challenge.

This is likely due to the extremely high costs associated with retrofitting buildings, meaning that real estate faces a significant funding need to reduce its carbon footprint, estimated at c.€225-600bn annually, according to Scope Ratings. Many investors, perhaps understandably, have therefore further delayed or scaled back their capex budgets and upgrade programmes during the recent downturn.

However, while current owners may have deferred investment, potential buyers will undoubtedly embed all relevant costs to bring buildings up to code within their underwriting, representing another major threat to valuations or requiring substantial state support. Some investors may decide to hand over responsibility to new investors, or perhaps pass the keys back to lenders.

90%

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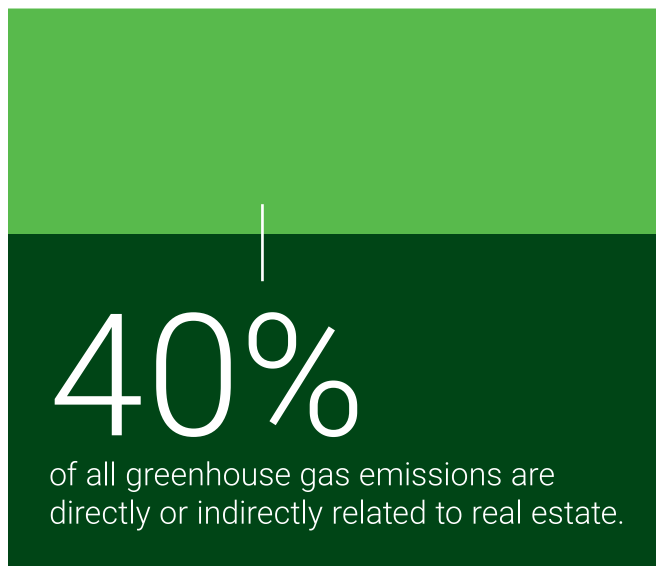
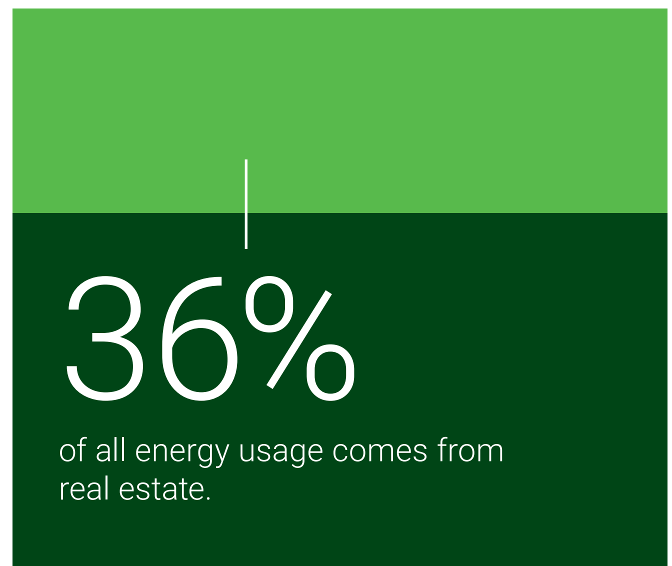




GenAI will fundamentally and permanently alter global real estate

Real estate generates a vast amount of data across the entirety of its life cycle, but the industry is often criticised for failing to fully leverage and capitalise on its embedded value. Criticism focuses on the siloed nature of industry thinking, operation, and ownership and the fact that the sector has been slow to embrace the technology that can aggregate, interpret, and apply this insight-rich resource.

However, proptech investment in recent years demonstrates the growing interest in and awareness of the opportunities that AI, and particularly the recent emergence of generative AI, can create in harnessing the industry's immense datasets and real-time data to improve financial and operational efficiency across the entire property life cycle.

Energy efficiency is an obvious example of where AI can leverage vast quantities of real-time occupancy and space utilisation data to deliver actionable insights, to optimise building operations and facility management, as well as delivering significant and rapid financial benefit. CBRE recently announced that its AI-powered facilities management platform, now implemented across over 1bn sqft of space, has helped reduce maintenance costs and energy consumption by 20% and technician callouts by 25%.

Access to high-quality, robust data is also critical in the prevailing market conditions to aid trend identification, track performance, and guide decision making in the absence of reference points to aid price discovery.

Yet AI outputs are only as good as the data inputs that they have been trained on, and currently sub-optimal structuring of data and legacy infrastructure are delaying adoption of even basic generative AI capabilities.

The deepening evolution of generative AI will also likely have profound implications for the composition of workforces globally, driving transformation in the demand and supply of space (e.g., office demand and space programming, proliferation of the data centre sector and resultant energy requirements).

Real estate is at an inflection point; the potential to drive real, positive change is clear – from dynamic pricing to intelligent asset registers – but there remains a significant gap between the benefits realised to date and the upside potential still to be harnessed.

2024/25 could yet be an excellent vintage for real estate investment

2023 proved to be a record weak year for real estate capital-raising activity. However, the largest funds did still manage to raise substantial amounts of capital, which still awaits deployment as investors continue to sit on the sidelines until greater transparency returns and closer alignment on equilibrium pricing emerges.

Analysis of historical all-property real estate returns from previous downturns in the 1990s and post GFC highlights that entering the market at or near to trough capital values can deliver superior returns, by harnessing the subsequent market upswing as the sector emerges from cyclical downturns.

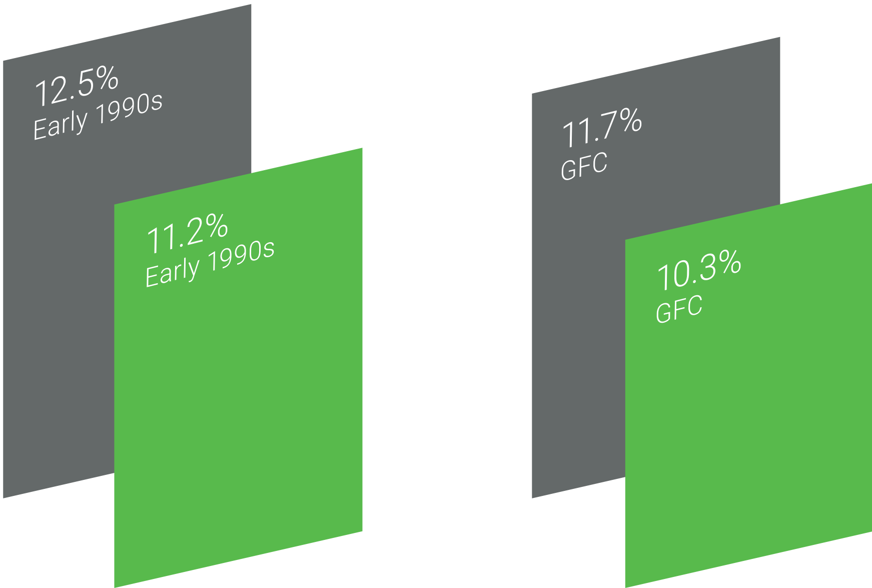
Figure 13 also demonstrates how shorter hold periods have realised superior annualised returns than longer-term hold periods, suggesting accelerated returns in the early stages of a new cycle.

Furthermore, widening market bifurcation could present investors with opportunity within structurally-supported real estate sectors (e.g. sheds, meds and beds) for even greater outperformance, but which will require nuanced data analysis and deep industry expertise to identify the individual properties, locations and portfolios with the strongest potential opportunity.

Figure 13: U.K. all property total returns emerging from downturns (%)

5 Yr 10 Yr

Source: MSCI



Conclusion

Navigating periods of intense dislocation is extremely difficult, requiring depth of industry understanding and granularity of thinking across diverse sectors and geographies.

Where resources and capital are heavily constrained, the days of buying assets, sitting back, and allowing yield compression to do the heavy lifting are over – for now at least.

Instead, investors must think and act differently, focusing more on building income security, resilience, and growth. This requires a significantly more proactive, sophisticated, and meticulous approach to capital and resource allocation and asset management, as well as openness to “lean into” new partnership models and approaches, and application of new technology to drive operational efficiencies to sweat assets fully.

Proactive, collaborative, and timely discussions with lenders are critical when addressing impending maturities, business plans, asset repositioning strategies and funding.

There will be bifurcation, though, and stakeholders will likely be torn between addressing legacy issues within current portfolios and capitalising on new opportunity. Investors should and will focus on structurally-supported income returns from well-located, good quality, amenity-rich, and future-proof/prepared real estate, or the opportunity to create it.

It would be wrong to ignore that cyclical pressures are abating, even though prolonged periods of anaemic growth are arguably more disruptive or damaging than short, sharp recessions and subsequent quick rebounds.

At the same time, many structural headwinds are strengthening, set to catalyse profound changes in the way that global populations interact with the built environment for years to come. Progress on ESG and sustainability in recent years suggests significant investment deficits in addressing these issues that will need to be narrowed.

Real estate financing costs will remain elevated, creating pressure for investors and lenders to work together to develop strategies to address impending maturities. Amend and extend strategies have succeeded in deferring action until a more stable macro environment prevails, but more holistic restructuring is likely to be required going forward. The potential distress that emerges as a result should help to catalyse transaction markets, but will also present challenges by providing valuation comparables that force more assets to be marked to market. But again, we expect significant bifurcation to emerge.

The market must unlock and, when it does, capturing the attractive returns on offer will require different strategies than those used successfully in the past. Today’s investment market is a much more volatile and nuanced environment, coupled with secular growth drivers, which once again will highlight active management as the optimal strategy to maximise the opportunities presented within real estate’s new paradigm.

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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