January 2024

Global real estate viewpoint

Opportunity in 2024: A vintage advantage

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BlackRock Real Estate Research

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Key takeaways

- A window of opportunity has opened; real estate investors can take advantage of historically low pricing for high quality assets.
- Granularity is key: investors should position portfolios to align with key structural trends such as aging demographics, rewiring of supply chains, and the energy transition.
- Fundamentals are generally steady with low vacancy in living and logistics.
- Higher cost of capital means less projects are getting started, which sets up the sector well for post-2025.
- Dispersion will persist between and within both sectors and markets. A driver of such dispersion will be the recovery that will play out at a differing pace by region. The transition will be a key driver of dispersion as the impact of regulation, occupier and investor demand drive rental and yield premia.

Capitalizing on the vintage advantage

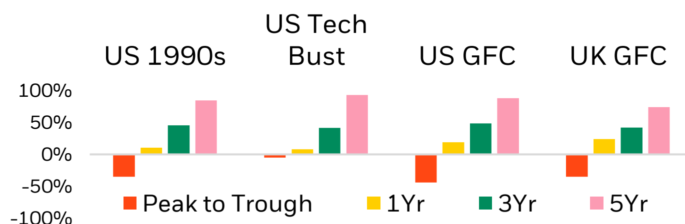
Entering at the right time. Investments made after periods of crisis or downturns tend to perform well in subsequent years. The current year may provide such an entry point. Credit market disruptions created by rapidly raising interest rates since 2022 contributed to a wider bid-ask spread, lower transaction volume and declining values.

Unlike previous downturns, fundamentals remain stable. Vacancy rates have remained solid, particularly in the living and logistics sectors. Higher construction costs and interest rates as well as tighter lending conditions will likely keep the number of development projects low, exacerbating the undersupply of prime property. This will only lessen any downside risk for future real estate performance.

This year is likely to be transitionary for real estate values and sales volumes. Tighter credit conditions have placed pressure on debt financing, the feasibility of utilizing leverage, and has driven significant reprice adjustment. This resulted in limited liquidity throughout 2023. Even though, we are in a 'higher for longer' environment, real estate is in a stronger position today than it have been for the previous 18 months. Inflation is on a downward trajectory and today we have more macro clarity, which should culminate in improved sentiment and price transparency.

Capital markets remain dislocated. The lending environment is still constrained, and lenders are increasingly selective on what they will lend against. Going forward, the financing environment will likely change with more participation from non-bank lenders. Following three recent downturns, real estate has generated strong returns fuelled by improving fundamentals and capital appreciation. Investors today have an advantage to acquire assets at below replacement cost and can potentially take advantage of growing distress in the market.

Figure 1: Cumulative Returns Post Downturns



Source: NCREIF; 1990s: peak to trough: 3Q1989-4Q1995, 4Q1995 starting for cumulative returns; Tech Bust: 1Q2001-3Q2002, 3Q2002 starting for cumulative returns; GFC: 1Q2008-1Q2010, 1Q2010 starting for cumulative returns UK Msci Index. **Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.**

Investors today can potentially benefit from the cyclical opportunity of lower valuations while positioning themselves alongside key structural trends that can drive returns. Some of these key structural trends include aging demographics, the rewiring of supply chains, and transitioning assets for higher energy efficiency or modernization.

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Building a portfolio for a new demographic

The real estate market has faced sharp dispersion in outcomes over the past few years. Office used to be a bellwether sector for the asset class but is now facing a reckoning driven by the prevalence of remote working. Industrial has grown sharply, from less than 19% of the NCREIF ODCE Index in 2019 to 32% as of September 30, 2023, and from 18% in 2015 to 32% as of September 2023, in the UK MSCI Index. Residential is becoming a more meaningful sector globally but was considered an alternative sector in Europe only 5-10 years ago.

The BlackRock Investment Institute has identified aging demographics as a mega force. As a result of improved healthcare and longer life expectancy, the over-65 cohort is projected to increase by up to 28% in both the US and Europe by 2040.[1] The so called "silver wave" will mean how we use real estate will shift; demand will likely increase for health and social services, age-restricted and care housing. Medical office will likely be desirable, especially when underpinned by long-term leases. Doctors' offices can also be set up at retail centers and some office buildings, leading to a rethink of how we use these spaces. Age-restricted housing such as active adult communities may become more in vogue. While senior housing or care homes may spring to mind, we caution nuances such as high operational overheads and policy risk. Market selection is also key here as retirees will tend to leave high-tax jurisdictions in favour of lower cost of living areas with favourable climates.

Everyone is aging, including Millennials. The world's 1.8 billion Millennials are aging and forming families. Globally, this will drive demand for the residential sector. In the U.S. we see garden style apartments in desirable suburbs and build-for-rent communities as attractive opportunities over the next few years. High-migration markets in the southeast and west of the U.S. screen well, though investors should monitor supply pipelines. In Europe, a lack of housing for sale and higher mortgage rates has made renting a lot more attractive. According to the European Commission, the number of people renting in the EU is expected to increase by four million by 2025,[2] while total European housing stock is increasing by only 1.5% a year, with only a small proportion of this being rented accommodation. This sets up the sector for good rent growth going forward, although we would caution that some markets may be at risk for various forms of rent control which will ultimately affect performance. This means market selection and intelligence remains crucial.

Millennials are entering into peak consumption and earnings phase of their lives. This will likely point to higher goods spending, thus driving demand for industrial through e-commerce, and necessity-based retail. We see opportunities in key logistics hubs such as Sweden and Germany in Europe and Northern New Jersey, Riverside and Southern Florida in the U.S. As for retail, we see good income growth from necessity-based retail centers in suburban areas with relatively high median household income and population density.

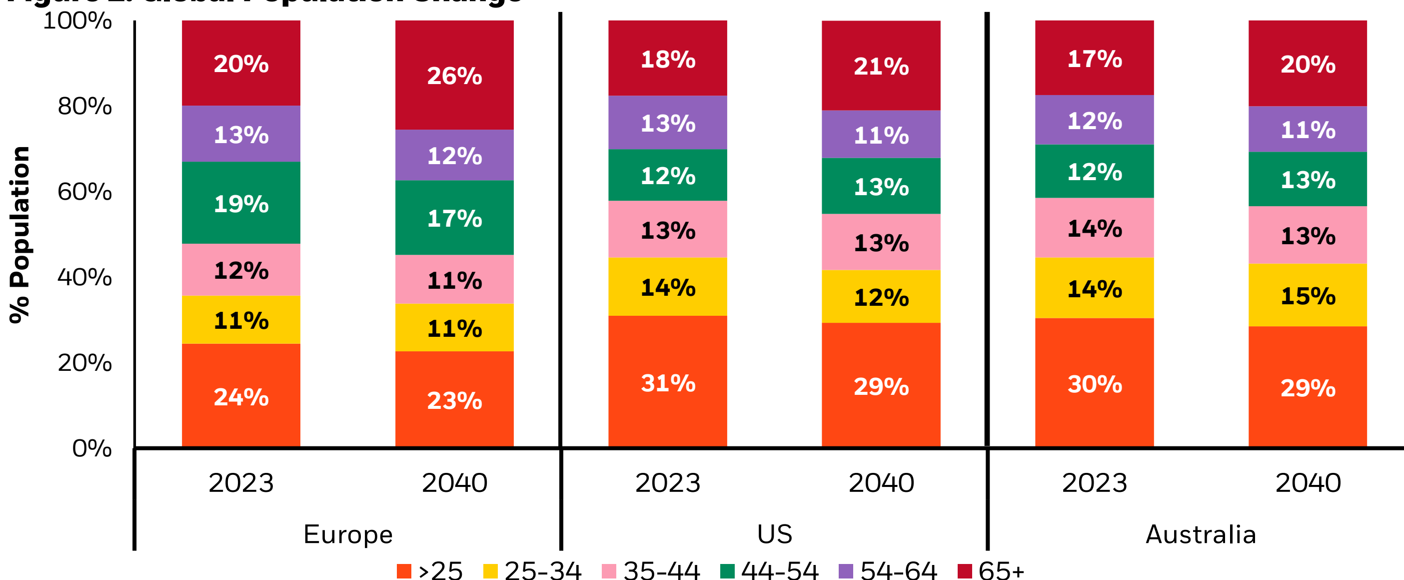
We see opportunity emerge in some **niche sectors** such as childcare centers. In developed markets where a greater proportion of women are returning to work, demand for childcare is growing. In Australia, the cohort of under 15 is forecast to grow by circa 14% by 2040,[3] thus indicating strong demand for childcare centers. In addition, the government is increasing childcare subsidies, instilling the sector's stability. We also see continued demand for self-storage in many U.S. markets as the need for space will likely increase with higher family formation, and supply-demand dynamics will likely improve for this property type in the longer term.

[1] Oxford Economics Forecasting, Dec 2023.

[2] European Commission, Dec 2023.

[3] Oxford Economics Forecasting, Dec 2023.

Figure 2: Global Population Change



Source: Oxford Economics Forecasting, **Forecasts may not come to pass.** 12 Dec 2023.

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United States: Navigating to the long-term

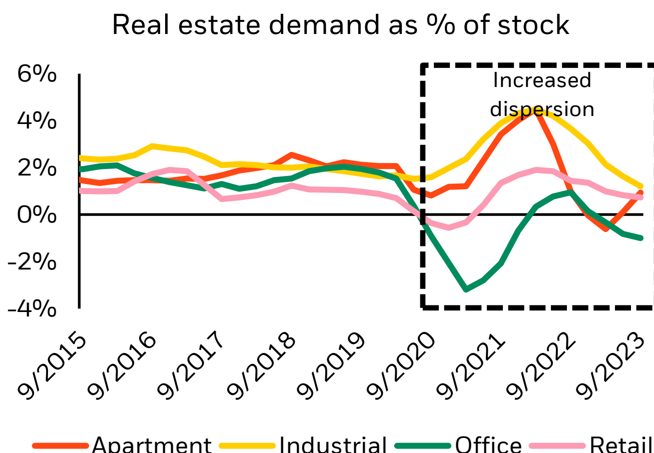
The current environment, characterized by stable, albeit, slowing growth in property fundamentals and disruption in the capital market, is creating attractive opportunities for investors to capitalize on strong underlying trends. Real estate investors are having to contend with a higher-for-longer rate environment which is reflected in the transactions market. Bond yields surged from mid-September with the 10-year Treasury yield ranging between 4.5% and 5% early in the fourth quarter (source: Federal Reserve), which weighed on real estate sales activity. At the same time, economic growth is holding up in the United States. As such, trends in real estate fundamentals are still relatively stable. The interplay of tighter and more volatile capital market conditions and consistency of market fundamentals is leading to dispersion in performance across the real estate market. In this environment, investors would benefit from taking a more granular view and sticking to strong underlying structural trends. Asset selection will matter even more than the macro performance of a property type, which calls for a different playbook compared to the period following the Great Financial Crisis.

Real estate fundamentals should remain steady over the medium term on average. Demand growth for real estate is decelerating, but still positive. Supply forecasts are largely concentrated in the in-demand industrial and multifamily sectors. While higher supply could contribute to slowing rent growth for both sectors in the near term, this is partially mitigated by the fact that any development not currently underway will be harder to finance going forward. We expect supply growth to meaningfully decline in 2025. Long lease terms and contractual inflationary bumps will additionally support the industrial, retail and even office somewhat. Further, Net Initial Income (NOI) growth for industrial properties specifically can still achieve meaningful mark-to-markets upon re-leasing as the market is approximately 30% underlet, according to data from Altus Group (as of September 30, 2023).

Align with long-term trends

The dislocation in today's commercial real estate market presents unique opportunities for investors, especially those who can execute with low or no leverage. We believe investors are in a window of opportunity to acquire solid cash-flowing assets at a discounted basis. At the same time, investors can look to reposition portfolios to align with three key long-term trends:

Figure 3: Property type dispersion to persist



Source CBRE-EA and BlackRock, as of 30 September 2023

1) **Aging demographics**: The average age of the U.S. population is expected to shift older over the next decade as life expectancy improves and families have fewer children. While senior housing and other healthcare real estate comes to mind due to the expected "silver tsunami," Millennials are entering their prime consumption age (35-64 years old) and Gen Z is advancing in the workforce making up the young professionals group. Both generations will be key drivers of real estate use.

2) **Modernization**: Existing assets will likely need to be retrofitted to be more energy efficient and resilient against adverse climate events and changing weather patterns. Probabilities of natural disasters or adverse conditions will also drive geographical selection. At the same time, the prevalence of some degree of work-from-home will change how we live and work.

3) **Geopolitical fragmentation**: Supply chain resiliency will likely be more important for many governments and corporations. In addition, manufacturing activity is returning to the US, as can be seen by record construction spending in manufacturing facilities, totaling $199BUSD in September 2023 (source: U.S. Census Bureau). We believe this will likely create more demand for warehouses and logistics facilities. Investors would also likely benefit from future-proofing investments to account for the possibility of more automation in the future, which would likely point to features such as higher clear heights and larger electrical loads.

Europe: A softer landing becoming more of a possibility

Recession imminent, but not as significant as previously forecast. We expect continued softening into next year, with European GDP growth forecast to grow at circa 0.8% in 2024.[4] Several headwinds to growth, namely elevated energy prices, have now come under control. Higher interest rates have had the desired effect of reducing inflation. The peak interest rate is likely to have been reached, sitting at 5.25% by the BoE and 4.5% by the ECB. Divergence in inflation is significant but is likely to normalise this year, reaching the 2% central bank target by the end of 2024. However, we expect rates to remain higher for longer, particularly in the UK whereby wage growth remains strong.

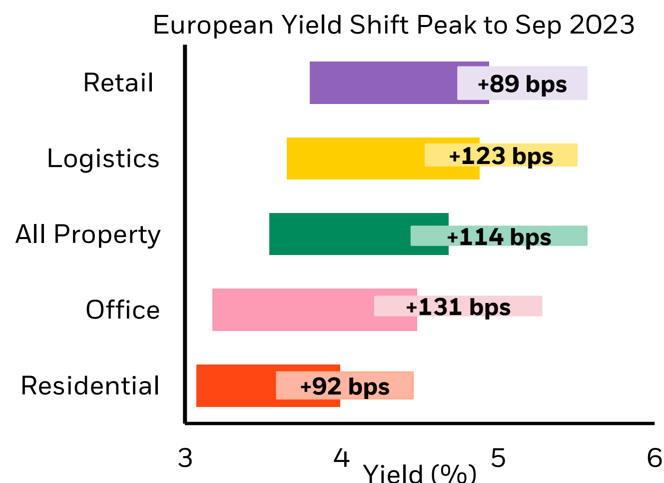
We see now as the time for investors to position themselves ahead of any potential cyclical upswing. Today there is not only scope for investors to enter the European real estate market at attractive entry levels but also to capitalise on opportunities arising from forced sellers. But investors must also align themselves with the mega forces that will shape the real estate landscape and provide a reliable stream of income going forward.

As a result of persistently higher interest rates, and limited financing options, we have observed a sharp drop in liquidity. The adjustment to a high-rate environment has caused deal flow to fall away. Throughout 2023 we observed rapid yield expansion, once we see stabilisation of the cost of debt and a greater degree of price transparency, transaction volumes should pick up. Unlike other business cycles, the real estate market should show some resilience due to the strength of underlying cashflows, income growth and the low level of supply coming through in the medium term.

The office sector continues to grapple with both cyclical and structural headwinds. The bifurcation in demand persists as an uptake in remote working has become more mainstream across Europe. Average occupancy currently sits at 57%, below the pre-pandemic average of circa 70%.[5] Another challenge for landlords is increasingly tighter ESG regulations which are causing a growing differential in demand, rental growth, and valuations between prime and secondary space. The capex requirements to bring secondary space up to necessary requirements is becoming potentially untenable due to uncertainty surrounding sustained occupier demand This year, granularity will be key. Stronger tenant demand partnered with limited availability of prime space due to a sparse development pipeline, is expected to push up rents in core markets.

[4] Oxford Economics Forecasting, Dec 2023.
[5] Savills European Office Outlook, Dec 2023.
[6] Savills European Logistics Outlook, Dec 2023.
[7] PMA European Multifamily Forecast, Autumn 2023. **Forecasts may not come to pass.**

Figure 4: Repricing has created attractive window for entry



Source: CBRE Yield Sheet Peak June 2022 to September 2023, 6 Dec 2023.

Despite significant correction this year, the logistics sector remains poised for growth. Vacancy rates moved out marginally in 2023 from record low levels recorded during the pandemic and are expected to stabilise. A shrinking speculative development pipeline in the medium term suggests the market is not at risk of oversupply, and leasing activity should pick up as macroeconomic conditions improve. We have observed how digitalization and subsequent e-commerce penetration has driven demand. The impact of geopolitical fragmentation is now materializing, as nearshoring becomes increasingly prevalent in Europe. The amount of industrial space taken up by manufacturers in key European cities has increased by 28%[6] since last year, as companies focus on increasing their supply chain resilience. The continued impact of such mega forces will continue to drive value in the sector.

Demographic convictions add to attractiveness of the residential sector. Increased household formation, shrinking household sizes, rising house prices and the increasing cost of debt has made rental accommodation a more attractive option in recent years. This year is expected to be another strong year for multifamily rental growth, with 2024 growth predicted to reach circa 3%[7]. Growing student numbers in key cities such as Barcelona, Paris, and London will bolster demand for PBSA.

Selectivity key in retail sector. 2023 was a challenging year for the sector as the occupier markets came under pressure from shrinking disposable incomes. Over the long term, growing e-commerce penetration continues to pose a structural headwind. However, repricing partnered with distressed sellers may result in opportunities at attractive entry levels. We continue to favor grocery anchored retail parks and see value-add opportunity in prime shopping centers.

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Asia Pacific: Divergence persists as the "higher for longer" regime sets in

APAC is expected to ride out the economic headwinds better than other regions globally, given that inflation has come under control relatively quickly. One of the main tailwinds for APAC's growth was expected to be China's re-opening. However, such recovery has been a lot weaker than previously anticipated. This has had knock on effects for the entire region in terms of domestic demand, causing growth forecasts to be downgraded marginally to 3.5% in 2024.[8]

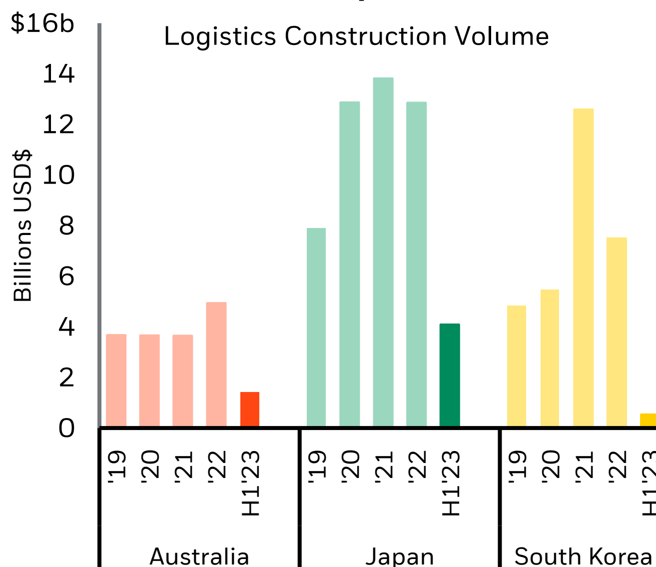
Monetary policy diverges across the region. A combination of sticky inflation, currency depreciation and the Fed setting a hawkish tone has driven hikes, namely in New Zealand and Australia. It is forecast that the peak in hikes has been reached. Japan has maintained its ultra-loose monetary position. Despite the BoJ loosening its yield curve control enabling rates to move in line with inflation last year, the bank has made it clear they will only revise the negative interest rates once Japan is sustainably hitting the 2% inflation target. In China, we have seen rate cuts, signalling to the market ongoing attempts to stimulate the economy whilst managing the banking sector.

A higher cost of capital has resulted in weakening transaction volumes. As the narrative of rates remaining elevated for longer comes to fruition, pricing has shifted, and we have seen further yield adjustments. A pocket of optimism can be found in Japan in terms of investor appetite where the weakness of the Yen partnered with ultra-low interest rates, continues to drive deployment of capital by offshore investors. Even though we have seen depressed growth in the short term, but long-term growth drivers remain strong, and we see dislocation driving the window of opportunity.

To successfully invest into the living sectors, investors must continue to understand nuances in demographic trends. The Australian childcare sector is poised for continued growth due to robust immigration partnered with strong governmental support. We also see significant opportunity in the hotel space. Led by Japan and Hong Kong, there has been a steady growth of international arrivals, currently reaching 84% of 2019 levels.[9] Moreover, the average daily rate and revenue per room are higher than pre-pandemic levels. Given strong population growth partnered with a structural undersupply, we continue to favour the living sectors, with a particular focus on the prospects in the services apartments sector in mature markets such as Australia, Singapore and Hong Kong.

Logistics continues to defy headwinds. This is primarily due to resilient occupier demand that continues to be buoyed by growing e-commerce penetration, significant 3PL players and global manufacturing hubs. The long-term outlook for logistics, in terms of fundamentals, remains attractive. In some precincts on the East coast of Australia, vacancy has been reported to be as low as 0.6% this year. This has supported rental growth levels of close to 30%[10] year-on-year in markets such as Sydney. The rising cost of construction, debt and wages has caused a shrinking of new stock entering key markets. This should solidify fundamentals (Figure 5).

Figure 5: Shrinking construction to exacerbate demand for space



Source: RCA Q3 2023, Construction dates based on ground-breaking or commencement, 4 Dec 2023. Past Performance is not to guide current or future performance.

The structural shift out of the retail sector persists. Competition from e-commerce has created challenges for occupiers, and a loss of confidence amongst investors. The weak economic outlook has created a difficult backdrop, as the real economy comes under pressure, and disposable incomes are squeezed.

The outlook for the office sector remains uncertain. As a result of macroeconomic headwinds, alongside a shift in pricing expectations, we have observed more buyers pulling out office deals. With the exclusion of Australia, we have seen a faster return office work post-pandemic compared to other countries. The flight to quality remains apparent and is leading to a bifurcation in performance. This has the potential to push up vacancy levels, particularly in submarkets where there is a high level of new stock being delivered causing secondary stock to become unattractive.

[8] Oxford Economics Forecasting, Dec 2023.

[9] CBRE, Dec 2023.

[10] JLL Q3 Figures, Dec 2023.

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