2024 OUTLOOK

COMING INTO FOCUS

REAL ESTATE

CONVERSATIONS

Against a hazy backdrop, our real estate debt and equity experts bring today's biggest challenges into focus—while also weighing in on where opportunities are emerging across the U.S., Europe, and Australia.

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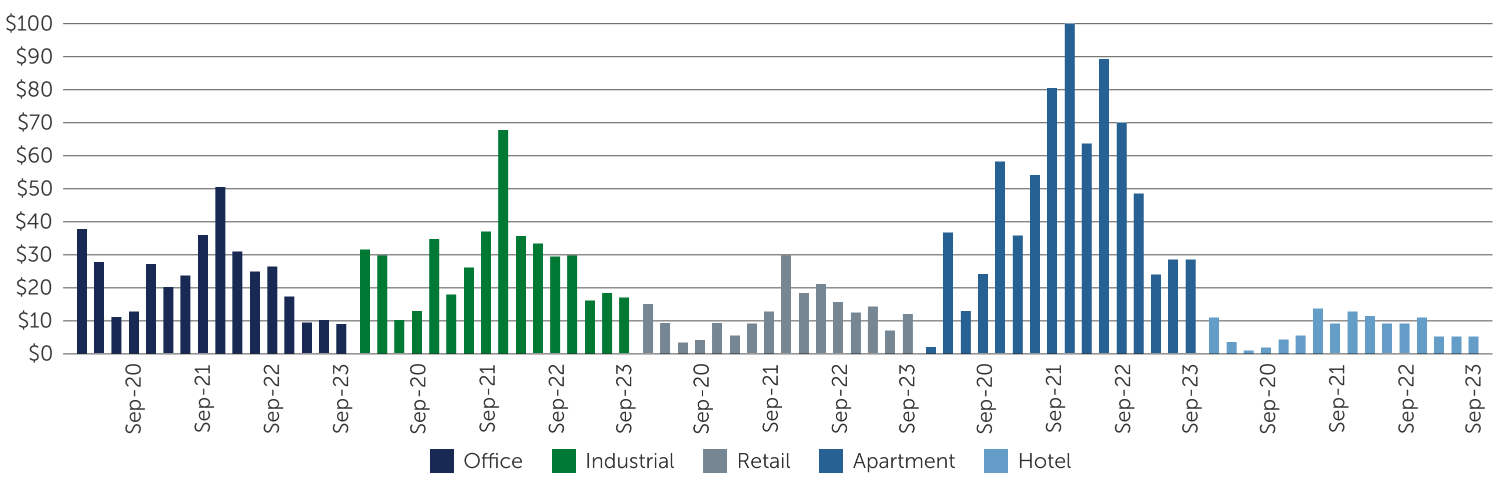
MAUREEN JOYCE (MODERATOR): How has the increase in rates impacted real estate, and how are you thinking about a potentially 'higher-for-longer' rate environment?

JOHN OCKERBLOOM: Against the backdrop of a significant rise in rates, transaction volumes across U.S. real estate markets have meaningfully declined this year. The shock to the system of a doubling of the risk-free rate has created a gap in prices between buyers and sellers, resulting in a transaction pipeline that's around 60% below the average level of recent years (Figure 1). In addition, we are seeing underlying valuations continue to adjust in the private and public real estate markets in the U.S.

Going forward, rates could remain higher for longer—but this isn't necessarily all bad for real estate. For example, while prices remain elevated today, there has been some cooling in the cost of materials and, to some extent, labor—which has been beneficial for development and redevelopment activity in real estate. Also, the shift in rates means that U.S. Treasuries are now hovering around 4%, which we believe is indicative of stability and much more consistent with the long-term average.

Figure 1: U.S. Quarterly Transaction Activity by Property Type (B)



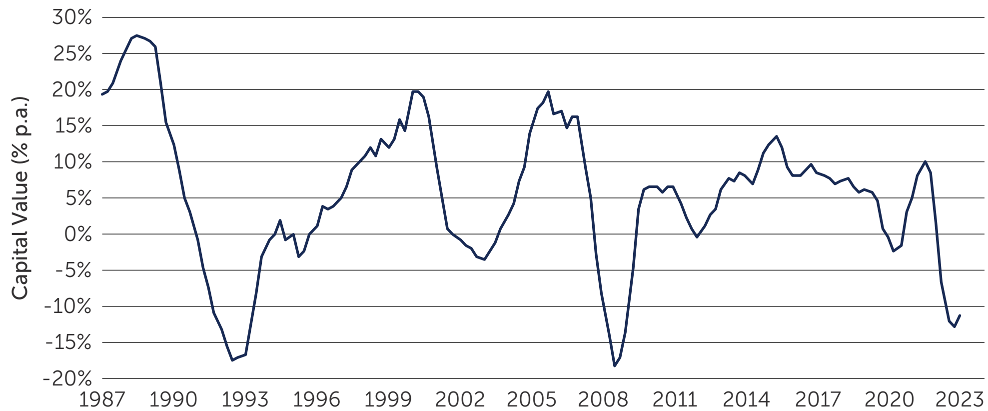
Source: Barings Real Estate Research, Bloomberg, FTSE/NAREIT, NCREIF, MSCI Real Capital Analytics. As of September 30, 2023. Includes transactions of $10 million and over.

NICK PINK: While the significant rise in rates has indeed been a shock to the market, inflation has dropped back toward target in many European countries. In the year ahead, the prospects of rates returning to 2021 levels is remote, however, rate anxiety has eased in recent months. Against this backdrop, European property transaction volumes, having slumped in 2023, should begin to revive in 2024.

MAUREEN JOYCE: What do real estate valuations look like in your markets? Do you expect more clarity going forward?

NICK PINK: We think we're probably passing the inflection point in the property cycle in terms of market pricing and the rate of return, which means we may be closer in Europe to valuations bottoming out. European real estate valuations have been relatively quick to adjust, perhaps due to the impact from the proximity of the Russia-Ukraine war, with valuations down nearly -15% (Figure 2). Encouragingly, there has been some upward movement in public market pricing more recently as central banks have signaled rate hikes may be done for now. So, while more falls in valuations are expected, the worst has hopefully passed.

Figure 2: European CRE Cycle (Capital Values)



Source: Cushman & Wakefield. As of October 31, 2023.

ALASTAIR WRIGHT: In Australia, valuations tend to be slower to adjust and come through over a longer period of time, as they are mainly driven by transactional data points on other asset valuations, rather than sentiment. The market currently appears to be in the middle of a shift downward, with valuations likely to continue declining in the next six months or so. Investors in this market do not want to sell their assets at below book value, and so the quicker that valuations fall and create pressure on debt covenants—especially if rates do remain higher for longer—the more likely investors will be to start selling their assets. The end result is more transaction activity, more liquidity, and a narrowing of the gap between buyers and sellers.

JOHN OCKERBLOOM: The U.S. is probably more similar to Australia than Europe, in that valuations likely have further room to correct. **But one additional point I would make is that the forthcoming adjustments to valuations are going to lead to greater differentiation of outcome—and that will essentially create what we think of as a stock picker's market in real estate.** It's going to be a market in which the experience and quality of your team, and your ability to pick assets, will lead to greater differentiation in performance than we've seen over the last 10 years (in raging bull markets, lots of boats rise with the tide).

MAUREEN JOYCE: Following on from that, how confident are you in private market valuations relative to what's being reported in public real estate markets?

NICK PINK: It's quite a mixed picture in Europe, where we're operating across multiple jurisdictions. But generally speaking, valuations in more liquid markets such as logistics appear in line with pricing and seem to be closer to their floor. However, the picture on office sector valuations remains hazy given the lack of transactions in the sector—and there are particular concerns that office values in the private real estate market are not accurately reflective of clearing levels. As a result, we believe the office sector will likely continue to see more pain going forward.

“Many of the deals we’re seeing today exhibit attributes like enhanced credit quality, lower advance rates, well-capitalized sponsors, substantial completion guarantees, and improved cash equity requirements, to name a few.”

ALASTAIR WRIGHT: There is a general expectation that valuations in Australia will continue to fall in the coming months, and as a result we’re seeing assets selling for 5-10% below book value.[1] Similar to the rest of the world, activity in Australia’s office sector has been limited, with assets selling around 10-20% below book value. This suggests that there isn’t a huge amount of confidence in current valuations.

JOHN OCKERBLOOM: In the U.S. market, there are indeed significant concerns that valuations in the private market are not reflective of clearing levels. Appraisals generally consider transactions with willing buyers and willing sellers, but when you don’t have many of these, appraisals tend to rely on historical information, and that can be stale or dated. And like in Europe and Australia, concerns around current valuations are most notable for the office sector.

MAUREEN JOYCE: Real estate debt, generally, seems to be more in favor than real estate equity. Can you talk about the opportunity that exists in this space?

JOHN OCKERBLOOM: Current market conditions for real estate debt in the U.S. are very favorable for lenders, for a couple of reasons. For one, traditional lenders like banks—which typically account for a substantial portion of lending, particularly in areas like construction—have significantly pared back their activity. While partly due to a more uncertain backdrop, this retrenchment also stems from the fact that many borrowers locked in favorable terms on their loans and have opted to hold onto them longer, rather than repay their lenders early. The resulting dearth of capital has paved the way for non-traditional lenders such as asset managers to step in and fill the gap.

In addition to the lack of capital, the significant increase in base rates, combined with wider spreads in the market, has resulted in a more attractive risk-return profile for real estate debt. Areas like construction lending look particularly compelling, as spreads on construction loans have widened materially, by as much as 150 to 300 basis points (bps) in some instances.[2] And this is despite the fact that almost every element of the loan process appears to be tilted in favor of the lender. Indeed, many of the deals we’re seeing today exhibit attributes like enhanced credit quality, lower advance rates, well-capitalized sponsors, substantial completion guarantees, and improved cash equity requirements, to name a few.

NICK PINK: Broadly speaking, the dynamics are similar in Europe, but the market structure is slightly different. Many European countries’ real estate markets remain dominated by banks today. However, given the tighter regulations in the European banking sector, banks tend to be more restricted in terms of the

1. Source: Barings’ observations. As of October 31, 2023.
2. Source: Barings’ observations. As of October 31, 2023.

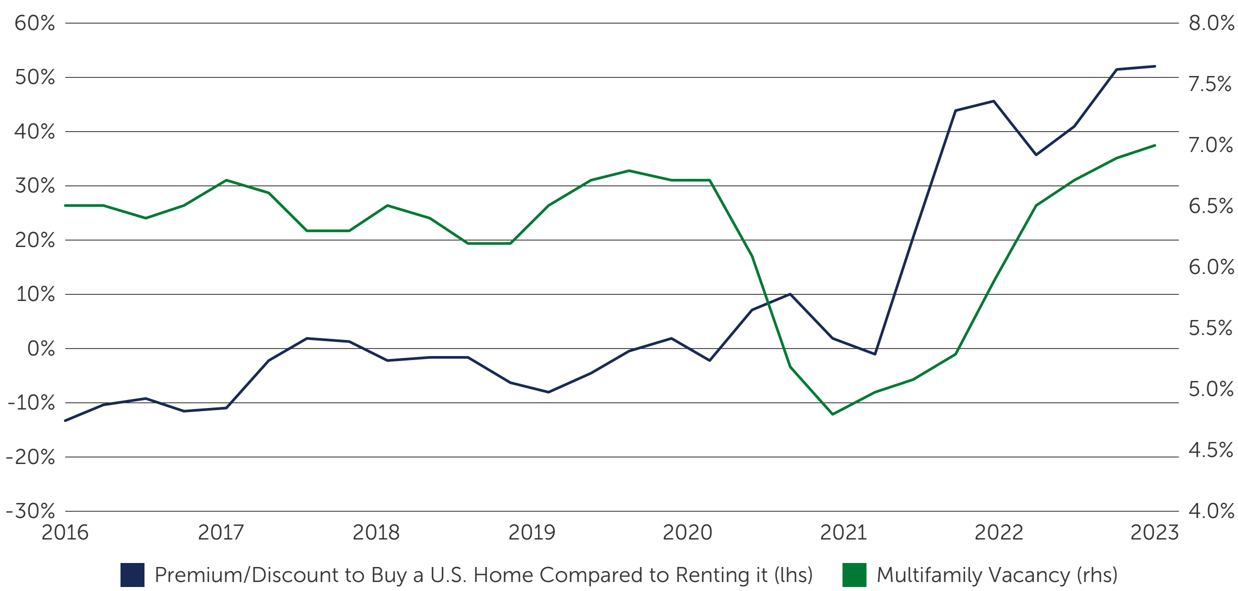
covenants and loan-to-values that they are willing to offer, resulting in a less liquid market. This is reflected in lower leverage in European real estate than the U.S. These conditions have made it quite favorable to be an alternative lender today—especially if you have dry powder and can structure around the current risks.

MAUREEN JOYCE: Real estate equity has, of course, been more challenged recently amid the higher-rate environment. But opportunities do still exist. Are there areas of the equity market that look particularly attractive?

ALASTAIR WRIGHT: In Australia, we focus on areas of the real estate equity market that are supported by structural themes. For example, fundamentals appear strong in the residential sector. In particular, immigration remains high and foreign students are returning to the country following Covid, while supply remains constrained following the increase in construction costs. We believe that this supply/demand imbalance is likely to persist over the next five to 10 years, which should positively impact both rents and values. For this reason, as we look to deploy capital, we believe residential assets that offer an opportunity for development over the medium term look particularly compelling.

JOHN OCKERBLOOM: One of the biggest themes we're focusing on in the U.S. market is housing affordability. Given that owning a home has become increasingly difficult, the population of renters has risen quite substantially over the last 10 years. While supply has increased at the same time, it hasn't been enough to match rental growth. Going forward, we expect this theme to continue—albeit not at the same pace—which is shaping compelling opportunities in residential assets from apartments, to build-to-rent single family housing, to senior and student accommodation, across both the equity and debt spaces.

Figure 3: Multifamily Vacancy Rates And Homeownership Premium/Discount To Renting



Source: Barings Research, CoStar, CBRE, Freddie Mac, U.S. Census Bureau, Realtor.com, FHFA. As of September 30, 2023.

Beyond this, we are seeing value in the hotel sector, given that it benefits from being able to increase rates in the inflationary environment. The sector also benefits from increasing discretionary spending among leisure travelers. Elsewhere, fundamentals in the industrial sector remain healthy, and retail assets have also been performing well over the last couple of years.

NICK PINK: We also see opportunities in areas of the market that are supported by structural themes. In Europe, we see value in the logistics and residential sectors, where ongoing supportive supply and demand conditions should help underpin positive rental growth performance. Elsewhere, depending on how the global macroeconomic picture develops, we expect to see opportunities emerge in distressed loans.

MAUREEN JOYCE: What are the biggest risks facing your markets today?

ALASTAIR WRIGHT: One of the biggest challenges we're facing is the significant 30% increase in costs, especially given our current substantial development activity. This has been impacting project feasibilities—particularly residential projects, where a significant amount of the total cost relates to the build. And we have seen a number of builders file for administration, and continue to do so, making this environment quite tricky to navigate. **The key for us, therefore, is to not only rigorously assess the builders that we partner with, but also ensure we have the right capital partners in place for these strategies.** This helps us to be patient and ride through periods of volatility, with the aim that attractive potential returns will follow.

NICK PINK: With rates likely to stay elevated in the near term, refinancing risks are a potentially destabilizing factor for the market, especially given that a lot of near-term refinancing focuses on the more challenged sectors. At the same time, it could also turn into a potential opportunity—but this requires lenders in Europe to meet investors halfway with some flexibility and a degree of accommodation. Geopolitics is also another risk to be managed in the year ahead, as it could have a significant impact on the recovery that the market is waiting for.

Looking ahead, legislation in Europe is becoming a growing concern as the political cycle matures. For example, in the residential sector, we are starting to see societal pressure on governments to introduce rent controls in countries like the U.K. and Spain. And in many of these sectors, the strong fundamentals have been supporting rent value growth—but this is potentially now under threat.

Nonetheless, the landscape is also presenting attractive opportunities across the market—many of which we have discussed here today. **In particular, past periods of economic slowdown have resulted in some of the most attractive vintages for real estate investing—and we expect this cycle to be similar, with compelling opportunities likely to emerge in the next couple of years across the U.S., Europe, and Australia.**

This piece has been adapted from our 2024 Global Real Estate Outlook Roundtable. Watch the full webinar here.

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