RESEARCH
REPORT

American Portfolios Research Report: REIT Overview

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THERE ARE FEW, if any, areas of the financial markets more impacted by interest rates than real estate. The cost of debt has obviously risen significantly over the past year, as well as defaults and loan loss provisions throughout the banking industry. This is most notable in the office sector, which has struggled to recover since the pandemic. Higher debt costs and banks' reduced risk appetite have weighed on existing property valuations and pressured new real estate development. It has simply become more costly and more difficult to locate financing for property managers while still maintaining a profitable deal outlook. The Commercial Property Price Index from Greenstreet is down 15% since last year's peak through March. Many office-related properties are down 25%, with the outlook still cloudy as a recession looms and credit availability appears likely to become scarcer.

Given the rise in rates and its likely triggering of a recession, coupled with our concern that the recent banking crisis will spur notable tightening in credit availability, we wanted to take a closer look at the private real estate investment landscape and the factors that investors and advisors need to understand about the deals and companies they're investing in.

With few private transactions to analyze, a look at the public REIT market can help summarize the current environment for commercial real estate properties. Public REIT prices slipped again in March, with dramatic underperformance from the office (-16.9%) and hotel (-10.1%) sectors. Additionally, the average NAV discount widened from 19.6% to 23.5%, indicating growing concerns about the direction of real estate prices. The first quarter also closed out with more U.S. bankruptcies in the space than any first quarter since 2010, with the number of filings accelerating each month. These trends do not bode well for the future direction of private real estate values and NAVs of such investments.

INTEREST RATES, BALANCE SHEET STRENGTH AND MATURITY SCHEDULES

While little can be done about the correlation between higher interest rates and lower real estate valuations, investors can navigate the rate cycle and help mitigate client risk in the near-term by focusing on floating-rate exposure, the quality or health of the balance sheet, the strength of the investment manager as a whole, and the investment's maturity schedule.

All real estate properties and transactions have been impacted by the dramatic rise in interest rates. Further exacerbating this issue is whether and how much the deal has in floating rate exposure, which could continue to erode cash flow and pressure valuations in the coming quarters as rate caps expire.

Investors must also understand the minimum and maximum amounts of leverage that can be used for both individual properties and the broader portfolio, as well as how they relate to loan covenants and interest rates, which could change based on leverage ratios. What's more, not all players are equal. Where does your manager stand in the industry? Blackstone's ability to navigate the credit cycle and withstand the difficult periods could be markedly different than a small, regional player.

Finally, investors should assess the debt maturity schedules of the properties and portfolios. Even average-sized maturities compared to history could be an issue in the current environment, but investors should certainly be on the lookout for any that fall into the balloon category, which could be detrimental to the property and/or portfolio even if the debt is renegotiated, which isn't guaranteed.

CREDIT AVAILABILITY

We touched above on the risk appetite for banks, or lack thereof, but here we'll dive in a little deeper. Reports from the aftermath of the recent bank failures estimate that up to 200 banks have worse balance sheets and with greater mismatches and bond losses than the few that failed.

Given this, coupled with the scare likely given to many other banks—a good portion of which are seeing deposits leave—many banks are likely focused on shoring up their balance sheets and, as such, lending standards are extremely likely to rise throughout 2023, which was already occurring in a significant way prior to the aforementioned failures. This has nothing to do with interest rates. The cost of borrowing is different than the availability of credit. If banks want to reduce risk, they don't lend or their terms become more restrictive, which also reduces demand for the loans. Regional banks have supplied 20% of the credit to the economy over the past decade, so changes on the margin here are likely to have a widespread and negative economic impact.

While the Fed has successfully prevented contagion, it can't control the credit contraction that is under way, which is both deflationary and recessionary. The Fed's Senior Loan Survey is a reliable recession indicator with a rise in lending standards predating the downturns in 1990, 2001, 2008-09 and 2020. The latest survey results for the first quarter signal a similar outcome, and that is even before the response to the bank failures. What's more, the tightening in lending conditions has been broadly based across corporate, consumer and commercial/residential real estate credit markets. We expect tightening financial conditions to accelerate from here, further weakening the outlook for the broader economy with perhaps the greatest impact on real estate, specifically.

KNOW YOUR EXPOSURES

While the cost of capital affects all real estate asset values, there are obviously other fundamentals that impact valuations and the stability of cash flows. Investors need to understand the fundamentals of the underlying sector from both a broad economic and geographical perspective. Below, we'll look at the core real estate sectors and offer a brief overview of the economic sensitivities and outlook for each.

Multi-family—Given the shortage of multi-family housing in general and affordable housing in particular, the outlook here is pretty solid. Local labor market strength and population growth are, important, of course, but we think a recession will have less of an impact on this sector in the coming year than other areas, even with the large supply coming online. Single-family housing prices are still high and many lower-income or first-time buyers are being priced out of the purchase market. Not to mention, federal, state and local governmental programs support affordable multi-family housing.

Senior Living—While this sector has been impacted meaningfully by inflation, long-term demographic trends are supportive of the senior living market segment. The older Baby Boomers are utilizing senior living facilities in significantly larger numbers and have only just reached the prime age for such, as most senior living residents range in age from 75-84. The Baby Boomer generation currently ranges from 59-77, so there should be a steady flow of demand for these facilities for years to come.

Industrial—We see this sector as vulnerable in the short term, as it is significantly economic dependent. Lease activity will likely decline at a double-digit rate in the next 18 months, should a recession hit, which is our base case. Longer-term, the outlook is supported by federal policies that aim for national self-sufficiency, not to mention the growing demand for online shopping.

Health care—Given some of the same trends supporting the senior living segment, namely demographics and less economic sensitivity to the services provided, we see health care real estate as more solid than other areas in the face of growing recession risks, and long-term. That does not mean valuations have held up in the sector recently; interest rates have dogged all sectors, including this one, and any private deals coming to market may still disappoint. But demand is more recession proof here and still outpacing supply, and vacancy rates remain tight, making this a solid area for short-term cash flow and long-term opportunities.

Retail—This is another area with heightened recession risk. A weakening labor market and uncertain economy always leads to a pullback in discretionary purchases. The sector has already been under stress since the pandemic changed many peoples' shopping habits. What is a benefit to the industrial space in online shopping and warehouse expansion is to the detriment of retail establishments. So, both the short- and long-term outlooks are currently shaky. Expect to see managers transition this space to other uses, either partially or completely, which could help mitigate losses or even generate solid returns, but these are on a case-by-case basis.

Hospitality—With increased business and leisure travel, this sector has improved during the past two years. However, a recession is likely to negatively impact the hospitality space as both business and leisure travel are big ticket and among the first to get cut or curtailed as economic risk rises. There has also been a rise in competition from Airbnb's, VRBO and the like that will continue to have an impact. Also, some areas are overbuilt with hospitality facilities. Overall, the short-term carries significant recession risk and the long-term outlook is mixed.

Office—The office sector is certainly the most vulnerable sector, as it has already been underperforming, and the deal sizes and refinances are typically larger. National office vacancy rates are currently 12% with the risk skewed to the upside as economic activity is set to pull back. What's more, the underutilization of office space is much greater, meaning there will be significantly less demand for space once leases expire. The pandemic transformed work habits in a dramatic way, which could be detrimental to the office market in the years to come, if conversions to other sectors are unsuccessful. In fact, our concern for this sector is what spurred this entire report. Both the short-term and long-term outlooks carry significant risk and could spur another banking crisis should the situation deteriorate from here.

Public Sector—States and local governments are generally in good financial shape following significant federal pandemic support. Most carry sufficient reserves and should be able to withstand a recession, but certainly not avoid one. Longer term, there are concerns. With office properties devalued and with less downtown business, property and sales taxes will decline in the coming years. Furthermore, there is significant distress in many mass transit systems from lack of traffic, and higher funding and pension costs, which add to the risk involved in certain locations.

WHO'S VALUING THE PORTFOLIO AND HOW ARE THEY DOING IT?

A handful of private real estate companies have sought liquidity recently, some surprising investors with significant cuts to valuation metrics/NAVs on exit. It is important for investors to understand how private portfolios are evaluated and why such disappointments can occur. A manager's process and valuation method can lead to deviations from public market values, and often do. The deviations usually support NAVs in the short term, but generate pain in the long term as public transactions reflect reality, which can no longer be avoided (unless they really time the cycle right). You never truly know what a property or portfolio is worth until a transaction takes place. During periods of uncertainty or stress, like we see currently, appraisals and non-transaction-based valuations become even more questionable as comps dry up and banks and buyers become more conservative. Private portfolios should be valued with a discount to public values, not the other way around.

While the market price of a publicly-traded REIT is readily accessible, private/non-traded portfolio values can be difficult to determine. It is therefore important to understand the manager's methods for doing so. Investors should know when valuations will occur, who they're being done by, what their affiliations are to the manager, if any, and what valuation methods are being used. Funds that have bought properties from related funds could also highlight valuation issues. Did new investors just cash out old investors at above-market prices? The new investors won't truly know until they receive their exit, so it is worth considering whether or not you want to be involved with managers that operate with such policies. Appraisals can be more art than science; the closer the ties to the manager, the more the appraisals tend to lean toward art and in support of increasing NAVs—which, as previously mentioned, have to snap back to reality on exit.

CONCLUSION

Private real estate investing carries significantly more risk than the traditional financial markets, which is why the firm limits clients' exposure and has dedicated resources for due diligence; that does not absolve advisors from doing their own due diligence. We hope the above can help guide advisors in navigating this difficult time period and the unique challenges private market investing can bring.

QUESTIONS AND COMMENTS

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