PIMCO

Turning the Corner? Commercial Real Estate Themes for 2025

How to unlock value in a complex market landscape

As major central banks lower interest rates, is the prolonged and painful downturn in commercial real estate (CRE) finally coming to an end? Yes, at least in some sectors, according to senior investors from PIMCO's commercial real estate platform. In a recent roundtable discussion, they emphasized that recovery will likely be slow and uneven, requiring a strategic focus on specific geographies and sectors, along with a considered choice between debt and equity investments.

Q: THE COMMERCIAL REAL ESTATE MARKET HAS BEEN AT AN IMPASSE THROUGHOUT MUCH OF 2024. LOOKING AHEAD, DO YOU BELIEVE THE MARKET WILL FINALLY TURN THE CORNER IN 2025?

John Murray *(managing director, global private commercial real estate)*: Yes, there appears to be more willingness to bring transactions to market following the September rate cut by the Federal Reserve. We are seeing some green shoots, particularly in core transactions in the multifamily sector, and redemptions in core open-end funds seem to be slowing.

That said, I don't expect a sharp rebound in 2025 similar to what occurred after the global financial crisis (GFC). During that period, the industry was aided by a plethora of Federal Reserve programs, including quantitative easing, which led to a dramatic decline in capitalization rates.

Although the Fed has finally begun to cut rates, we don't expect long rates to fall anywhere close to 2021 levels. Thus, cap rates should remain elevated relative to 2021, and this, along with the growing wall of maturing CRE loans, suggests the thawing process will be prolonged.

Russell Gannaway *(managing director, alternative credit)*: I agree that we should see increased activity and a trend toward recovery next year. Public markets already indicate that we are farther along the route to recovery than private markets suggest. For instance, valuations for equity real estate investment trusts (REITs) and collateralized mortgage-backed securities (CMBS) are approaching 2021 levels. While public markets could be wrong, I believe we will start to see private markets catch up next year.

François Trausch *(managing director, PIMCO Prime Real Estate)*: Investors should keep in mind that in Europe, unlike in the U.S., interest rates were negative or close to zero from 2009 to 2022, and most market players got used to this. So while rates are coming down, they are not likely to reach levels anywhere close to what we saw after the GFC. This requires a significant change in mindset: In our view, investors should not rely on low rates or decreasing cap rates, but focus instead on pockets of growth where rent and net operating income (NOI) will increase. This transition will take time.

That said, while we don't expect substantial growth across Europe, we can reasonably expect growth in Asia, excluding China, which could help markets recover more quickly.

Q: HAVE VALUATIONS BOTTOMED OUT?

Gannaway: Valuations are in the process of bottoming out, if they have not already done so. I would say this is the case in certain areas.

Seray Incoglu *(executive vice president, global private commercial real estate)*: Class A buildings have likely bottomed out, with some selling below replacement cost. However, Class B and Class C properties[1] particularly in sectors such as office and life sciences, still have room to decline. Delinquency rates and maturity defaults are marginally elevated, but this may not fully reflect the extent of the distress. For example, delinquency rates for CRE collateralized loan obligations (CLOs) have increased to 7% from less than 1% before the pandemic. CRE issuers are taking back defaulted loans at par, likely masking some underlying issues still facing the market.

Murray: To quantify, we believe liquidation values have hit bottom, having fallen 20%–40% from their peak. Recent core-focused transactions traded at 20% to 25% discounts to 2021 levels. Interestingly, the NCREIF Open End Diversified Core Equity Index suggests U.S. CRE values have only fallen 16%, so we probably have a bit more to go, at least as it relates to formal indices such as this one.

Trausch: To the extent investors hold on to assets and forced sales are limited, we are at the bottom, at least according to the valuation companies. However, if we see a pickup in forced sales – and there is good reason to believe that could happen – valuations could face further pressure. Remember, the pretend-and-extend practices that followed the GFC could be justified at the time because rates came down quite quickly. But now, if rates fall more slowly, it becomes less justifiable for lenders, especially banks, which are growing more impatient with defaults and their impact on capital charges.

Q: WHAT FACTORS DO YOU THINK THE MARKET IS CURRENTLY UNDERAPPRECIATING OR OVERESTIMATING?

Trausch: Rates are declining in Europe, but for the wrong reasons – specifically, low economic growth prospects, particularly in Germany and France, although growth remains stronger in Spain and Italy. In addition, the market's newfound excitement about office properties may be overdone. While institutional investors will hang on to their best properties, it's important to remember that well-located offices and those with alternative uses represent only a small segment of the market. Tenants are becoming more discerning, favoring higher-quality, more sustainable assets. This trend presents an opportunity for both owners and lenders to upgrade properties to core-plus status. But it also highlights a risk for weaker properties, which are likely to continue facing declining occupancy over time.

Gannaway: I agree. There is no benefit to being early to this party. Remember that Class B and C malls took 10 years to transition to alternative uses. Furthermore, I don't think the market fully appreciates how slowly and carefully the Fed will reduce rates.

Murray: Likewise, I think the market is overestimating the significance of the recent rate cuts on valuations. Lower short-term rates are like a bandage: They reduce the bleeding but don't necessarily cure the wound, which is higher cap rates.

Incoglu: The market may also be overlooking how regulatory pressures on capital are driving a secular downshift in bank lending. Despite recent signs of improvement in bank lending conditions, the focus of banks has been and will remain on core assets, maintaining lower leverage, generating income from products such as deposits and investment banking fees, and creating opportunities for alternative lenders.

Q: IN OUR *REAL ESTATE OUTLOOK* IN JULY 2024, WE INDICATED A PREFERENCE FOR DEBT OVER EQUITY INVESTMENTS IN REAL ESTATE. DOES THAT INCLINATION STILL HOLD?

Murray: Yes, it's still an attractive time to be a lender across the risk spectrum. Interest rates remain elevated, and property valuations and business plans have been disrupted given the weak economic backdrop. In particular, we are seeing a lot more opportunities on the higher end of the risk spectrum for rescue capital and gap financing.

Trausch: We previously said, "Go broad in debt and stay narrow in equity." While this remains true overall, we believe the market now presents a more attractive entry point for long-term equity investors than it did even six months ago, as liquidation values bottom out and supply pressures subside. That said, investors should remain disciplined and highly selective.

Q: WHAT ARE YOUR HIGHEST-CONVICTION VIEWS REGARDING WHERE AND HOW TO INVEST?

Gannaway: I continue to gravitate to the residential sector, which is underpinned by strong long-term supply/demand dynamics. In the U.S., we anticipate a housing shortage over the next five years, which will have clear implications for sustained or growing demand for build-to-rent strategies, as well as for existing single-family and multifamily properties. While there are still some near-term supply challenges, over the long run we believe it's the right place to invest, with the Sun Belt being a great example of this.

Trausch: We should pay attention to the residential sector, but as Russ said, it's essential to be discerning and identify the right pockets of opportunity. Another one of these is multifamily housing in Japan, where household formation is still increasing in big cities such as Tokyo and Osaka, tenant delinquency is rare, and financing conditions are attractive.

More generally, student housing has shown strong rental growth – not only in the traditional markets of the U.S., the U.K., and Australia, but also in continental Europe and parts of Asia.

Murray: Data centers remain at the top of my list, particularly in Europe. Demand continues to grow globally, but we believe in the convergence story in Europe, which is five to seven years behind the U.S. in data center capacity relative to its population. The gap is underpinned in part by digital sovereignty regulations, which require countries to retain critical data, software, and hardware within their borders.

Incoglu: I would be remiss not to flag sectors where we are exercising greater caution. During and immediately following COVID-19, the life sciences sector became highly sought after for both investment and development. However, net absorption has shown signs of deceleration in recent quarters due to new supply and reduced tenant demand in several markets. That said, select operators in specific markets are well-positioned to navigate and overcome current market challenges.

Q: ANY PARTING THOUGHTS?

Incoglu: This cycle will not unfold like any previous one. This alone will create volatility and tactical trade opportunities, particularly in public markets. As such, investors should consider how they might allocate across all four quadrants – public and private equity, and public and private debt.

Gannaway: There remains a clear gap between public and private markets that must close in one direction or another. The ability to accurately assess relative value – whether in public or private markets, or in determining where to invest across the capital stack – will likely be the skill set that separates the winners from the losers in 2025.

1 Class A buildings are premium properties with modern amenities and prime locations, typically occupied by prestigious companies. Class B buildings are good-quality, older properties in less desirable areas, while Class C buildings are lower-quality buildings that may require significant renovations and are often located in less favorable locations, attracting budget-conscious tenants.

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