PIMCO

REAL ESTATE OUTLOOK

JULY 2024

Facing the Music:

Challenges and Opportunities in Today's Commercial Real Estate Market

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SUMMARY

- The headwinds buffeting the commercial real estate market will likely result in a materially slower recovery than that seen after the global financial crisis.
- Nonetheless, the market is entering a phase with numerous opportunities for those with capital, patience, agility, and expertise to provide financing solutions to both lenders and borrowers.
- From a sector perspective, we believe investors should focus on high conviction themes, including digitalization, decarbonization, and demographic shifts, targeting sectors such as data centers and logistics.

For commercial real estate (CRE) borrowers and lenders, central banks have been a persistent source of frustration in recent years. Aiming to rein in stubborn inflation, the Federal Reserve and most of its peers have maintained elevated interest rates longer than anticipated. That's their mandate, of course. But the consequences have been immediate pain for CRE borrowers facing higher debt costs, along with a duller discomfort from falling valuations due to reduced liquidity and higher capitalization rates.

Today, short-term interest rates appear to have peaked, and long-term interest rates are slowly trending lower. One might – but should not – see these trends as leading to a dramatic recovery of the sort induced by quantitative easing in the aftermath of the global financial crisis. Prevailing market assumptions, with a forward curve indicating real rates 200–300 basis points (bps) above 2021 levels, suggest that cap rates will remain elevated, keeping property values 20%–40% below their 2021 highs.

As a $1.5 trillion wall of loan maturities hits over the next two years,[1] the implications are profound. In an elevated interest rate environment, borrowing costs and cap rates will remain challenging. Lenders and borrowers will be forced to "face the music": In the near term, we expect further declines in appraised valuations and price indices, making loan extensions even more difficult to rationalize.

There's also geopolitical risk. Conflicts in Ukraine and the Middle East, tensions between the U.S. and China, and major elections this year give rise to additional uncertainty. This is compounded by growing concerns over climate change that directly affect real estate investment and development.

While these uncertainties will prolong liquidity pressures, they also create opportunities across the financing spectrum. For those with capital and proficiency in customized solutions, private opportunities range from senior debt to mezzanine debt and preferred equity. Continued volatility may also create relative value opportunities across the four quadrants of real estate investment: public and private equity, and public and private debt. Additionally, some sectors and geographies remain attractive based on long-term fundamentals, implying an attractive entry point today given the liquidity pressures facing CRE broadly (see Figure 1).

Figure 1: Global real estate heat map – 2024 vs. 2023 outlook by sector and region

Sector	U.S. Outlook	Europe Outlook	Asia-Pacific (ex China) Outlook
Data centers	May 2024: + AI and cloud demand; − Power, ESG, and overbuilding concerns May 2023	May 2024: + AI and cloud demand; − Limited power supply May 2023	May 2024: + AI and cloud demand; − Policy and operational risks May 2023
Logistics	May 2024: + Strong lease mark-to-market supports cash flow; − Moderate oversupply May 2023	May 2024: + Yields stabilizing; − Rental growth normalizing May 2023	May 2024: + Persistent demand; − Yield expansion, oversupply May 2023
Living (student housing)	May 2024: + Modest rental growth; − Niche sector May 2023	May 2024: + Strong fundamentals; − Niche sector May 2023	May 2024: + Strong leasing, undersupply; − Competition, scalability May 2023
Living (multifamily)	May 2024: + Affordability advantage vs. home ownership; − Sun Belt oversupply May 2023	May 2024: + Stable rental growth; − Price discovery May 2023	May 2024: + Strong leasing, yield spread; − Potential yield expansion May 2023
Lodging	May 2024: + Trends in leisure and corporate group travel improving; + Limited supply; − Business travel sluggish May 2023	May 2024: + Tourism rebound, undersupply May 2023	May 2024: + Tourism rebounding; − Capacity constraints May 2023
Retail	May 2024: + Resilient leasing demand; − History of tenant restructurings May 2023	May 2024: + Leasing stabilizing; − Limited investor appetite May 2023	May 2024: + Pent-up leasing demand; − E-commerce, weak sentiment May 2023
Office	May 2024: + Deeply discounted; − Uncertain demand; − Challenged capital markets May 2023	May 2024: + Bifurcation continues; − Price discovery ongoing May 2023	May 2024: + Improving office reentry; − Yield expansion, oversupply, weak sentiment May 2023

Note: Nuances of cyclical opportunities and key risks vary by region.
Source: PIMCO Global Real Estate Forums 2023 and 2024

These takeaways were gathered from PIMCO's second annual Global Real Estate Investment Forum, held in May. Similar to PIMCO's Cyclical and Secular Forums, this event convened global investment professionals to discuss the near- and long-term outlook for commercial real estate. PIMCO has one of the world's largest CRE platforms, with over 300 investment professionals managing close to $190 billion in assets across a broad spectrum of risk profiles in public and private global real estate debt and equity markets.[2]

Key sectors

DATA CENTERS: A RACE FOR POWER IN THE AGE OF AI

The AI boom has set off a global dash for data centers and green energy to power them, and it also has introduced broad risks to CRE. Over the long term, AI could reduce the need for office space, decrease demand for student housing, lower urban population density, and make long-term leases and secondary locations less attractive. However, the pace and scale of repercussions remain unclear. (See our June 2024 article, "Powering the Future: The Strategic Role of Data Centres in the AI Evolution in Europe".)

What is clear is that demand for AI and cloud services has ignited a global scramble for data center capacity. In the first quarter of 2024, global leasing volumes surpassed 1,800 megawatts, a sevenfold increase from just three years ago.[3] Growth shows no signs of slowing, with tenants contracting for entire campuses rather than individual buildings. This is amplified by governments' quest for digital sovereignty – the ability to control critical data, software, and hardware. Conversely, limited supplies of power are becoming a growing constraint on data center development across the globe.

Data centers will play a pivotal role in investor portfolios in the coming years. They are critical infrastructure, offering investors a way to capitalize on AI growth as suppliers to AI platforms without having to bet on the ultimate winners in AI technology.

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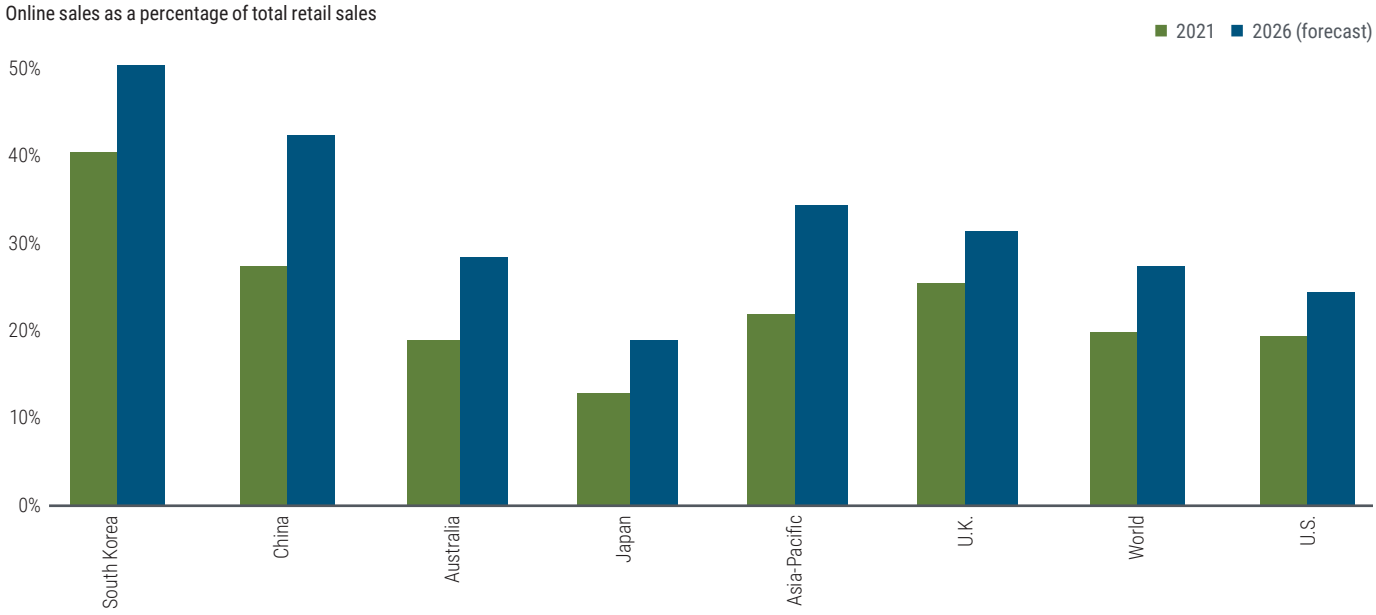
LOGISTICS AND WAREHOUSES: SECULAR DEMAND SUSTAINS LONG-TERM GROWTH

We anticipate that deglobalization and e-commerce will continue to drive sustained long-term growth in warehouses and logistics. Though geopolitics will influence demand, logistics facilities linked to digitalization trends, such as e-commerce, appear to have a more reliable demand trajectory (see Figure 2).

Figure 2: Online commerce continues to grow

Online sales as a percentage of total retail sales



Source: Green Street and CBRE as of April 2024

Deglobalization and e-commerce will continue to drive sustained long-term growth in warehouses and logistics.

In Europe, demand is slowing but rents continue to increase. Logistics, once again, tops many investors' shopping lists, and may provide a floor to today's widened capitalization rates.

In the Asia-Pacific region, online sales are projected to grow from about 20% of total sales in 2021 to nearly 40% by 2026.[4] Further, deglobalization continues to drive nearshoring and "friendshoring" trends. Vietnam and India will gain as companies shift production from China, while reshoring could benefit Japan and South Korea.

In the U.S., industrial demand remains positive, although net absorption has slowed over the last six months, with the first quarter of 2024 being the weakest first quarter since 2012.[5] New deliveries have peaked, although some lower-barrier Sun Belt markets are digesting a supply wave that could lead to a prolonged period of higher availability, particularly among larger industrial properties; in recent years, developers have focused on projects over 100,000 square feet.

MULTIFAMILY HOUSING: STRONG DEMAND, BUT RECOVERY DELAYED IN THE U.S.

The global outlook for apartment buildings is generally positive amid strong structural demand.

In Europe, rents are rising steadily with no signs of abating. Limited supply, exacerbated by high development costs and stricter environmental regulations, is meeting firming demand as household formation accelerates and migration to major metropolitan regions continues.

In the Asia-Pacific region, prices and rents are firming amid moderate undersupply. Soaring home prices and urban migration by younger individuals are driving demand. Demographic shifts, such as delayed family formation and the rise of single-person households, are reinforcing the trend of renting for longer periods. In addition, the evolving emphasis on community living and access to amenities has boosted the growth of thematic residential and co-living spaces across the region.

In the U.S., the near-term outlook is slightly less positive. The multifamily sector overall is experiencing record new supply, with apartment completions reaching a 40-year high of 583,000 units last year.[6] This surge has led to rising vacancies and, coupled with widening cap rates, has resulted in market values dropping by more than 25%–30%. While long-term tenant demand fundamentals remain strong for multifamily – particularly as higher rates exacerbate already challenged affordability metrics – these short-term pressures suggest more distress in the near term for the U.S. multifamily sector.

Overall, the U.S. market is likely to stabilize by 2026. Construction starts have fallen due to higher costs and tighter financing. The Sun Belt, spanning the southern tier of U.S. states, shines as a key area of growth. The region is home to half of the country's population, and its incoming domestic and international migration is projected to drive the vast majority of the increase in the U.S. population from 335 million today to 373 million by 2054.[7]

The global outlook for apartment buildings is generally positive amid strong structural demand.

OFFICES: FACING HEADWINDS, BUT NOT EVERYWHERE

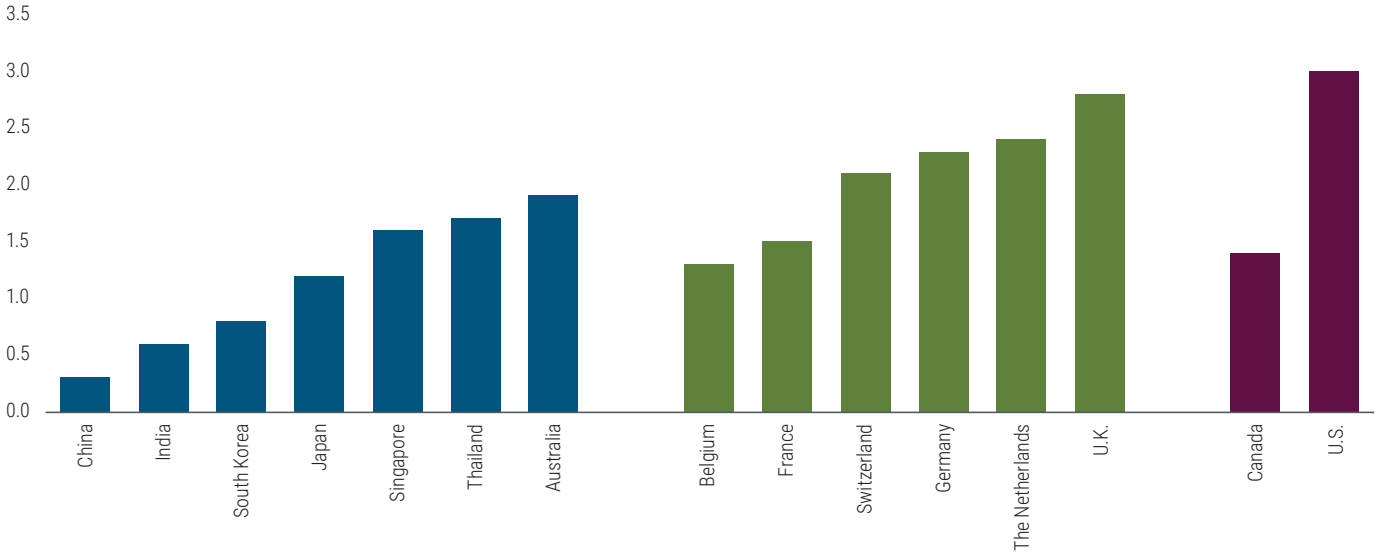
The global outlook for offices remains challenging. Demand and price discovery are limited worldwide, with valuations still under pressure as global CRE owners and lenders look to reduce office allocations. The share of offices in global institutional CRE portfolios has fallen from 35% in 2022 to 29% today,[8] with further declines likely.

However, regional outlooks vary. In Europe, there is relatively healthy demand for green, high quality buildings in prime central business districts. The work-from-home trend is less entrenched in many parts of Europe, partly because workers tend to live in smaller homes in city centers and have better public transportation. Tenants tend to be stickier because of the Continent's linguistic, currency, and regulatory diversity, which complicates corporate relocations. Importantly, energy regulations will likely dramatically reduce existing supply, as many office buildings will struggle to meet increasingly stringent rating requirements in Europe.

In the Asia-Pacific region, demand for offices in central business districts remains broadly near 2021 levels. This is due to generally smaller apartments, shorter commutes, and a more persistent "work-at-the-office" culture than in the West. As in Europe, demand is strongest in central business districts, especially for buildings with "live, work, play" amenities (see Figure 3). In the U.S., corporate cost-cutting and a stronger work-from-home trend have led to office demand lagging behind job creation. Here, we expect prices and rents outside of class A+ buildings to continue falling as private capital remains cautious and headline cap rates continue to expand.

Figure 3: The U.S. leads in working from home

Number of days working from home per week



Source: Green Street and JLL as of 3Q 2023

TAKEAWAYS: SEIZING OPPORTUNITIES AMID CHALLENGES

The commercial real estate market stands at a crossroads, beset by formidable challenges yet brimming with opportunities. Elevated interest rates, geopolitical tensions, and climate change concerns have created a complex and often dismaying landscape for CRE borrowers and lenders.

Yet these very pressures also set the stage for innovative financing solutions and strategic investments. For those equipped with capital and expertise, today's environment offers fertile ground for opportunities across the financing spectrum, from senior debt to mezzanine debt and preferred equity. Sectors such as data centers and logistics, buoyed by enduring trends in digitalization and e-commerce, present particularly enticing prospects.

Navigating this turbulent terrain will require resilience and adaptability. The ability to discern and exploit hidden opportunities amid market volatility will be essential. By homing in on high conviction themes such as digitalization, decarbonization, and demographic shifts, and leveraging PIMCO's extensive expertise and global platform, investors have the potential to not only weather the current storm but also thrive in the evolving commercial real estate landscape. The road ahead is fraught with uncertainties, but it is also rich with potential for those ready to face the music and seize the moment.

1 Source: CBRE as of May 2024
2 Source: PIMCO as of 31 March 2024. Includes assets managed by Prime Real Estate (formerly Allianz Real Estate), an affiliate and wholly owned subsidiary of PIMCO and PIMCO Europe GmbH, that includes PIMCO Prime Real Estate GmbH, PIMCO Prime Real Estate LLC and their subsidiaries and affiliates. PIMCO Prime Real Estate LLC investment professionals provide investment management and other services as dual personnel through Pacific Investment Management Company LLC. PIMCO Prime Real Estate GmbH operates separately from PIMCO.
3 Source: datacenterHawk as of 31 March 2024
4 Source: Green Street and CBRE as of April 2024
5 Source: Green Street as of April 2024
6 Source: CoStar as of 17 March 2024
7 Source: U.S. Congressional Budget Office
8 Source: Pension Real Estate Association Investment Intentions Survey, 2022 and 2024

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