CAPITAL ECONOMICS

INDEPENDENT ANALYSIS, FORECASTS AND CONSULTANCY

What does the new normal mean for real estate?

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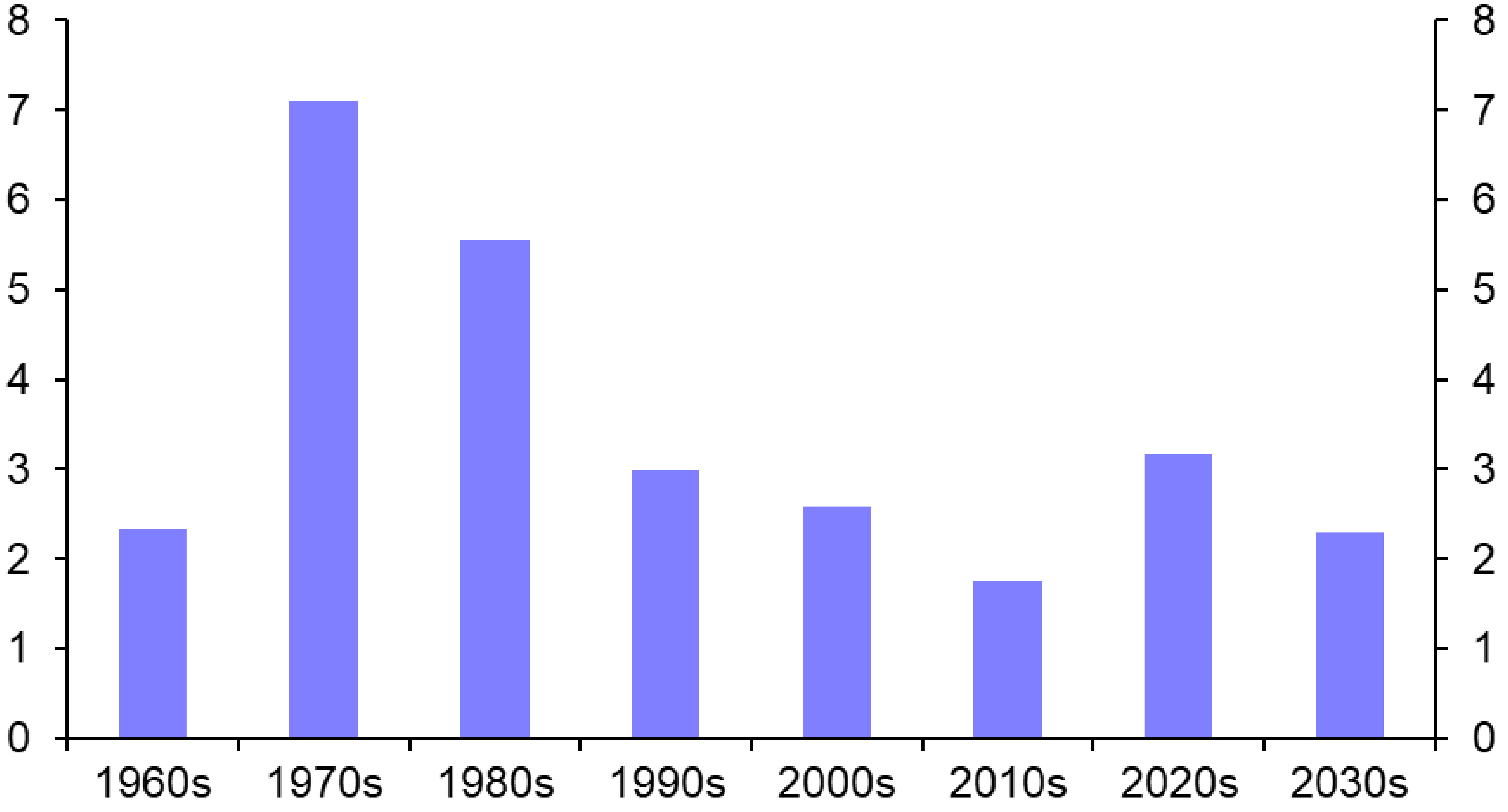
Navigating the "New Normal"

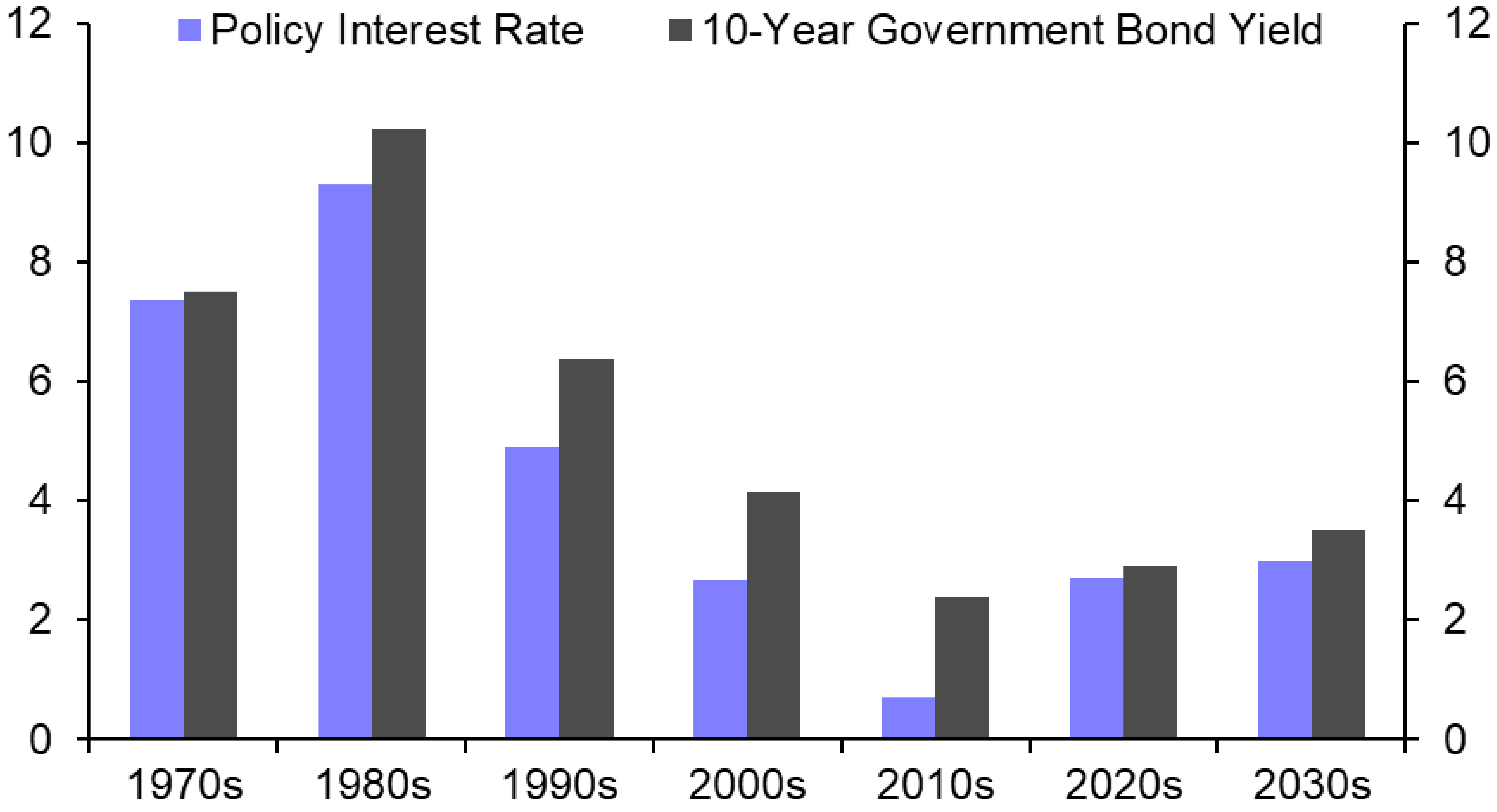
- We expect global growth to be slower this decade than in past decades, weighing on US growth.
- Meanwhile, higher inflation will keep interest rates above the lows seen in the 2010s.
- This means after a strong run, real estate cap rates have to rise, causing prices to fall.
- The new normal of how we work (and live) will drive further weakness / offset the weakness in specific sectors.

US Headline Inflation (% y/y)



Sources: Refinitiv, Capital Economics

US Interest Rates (%)



Sources: Refinitiv, Capital Economics

Office Sector Headlines

Unhedged

CRE's strains are contained Premium

...For Class C offices, the worst kind, refurbishing is too expensive and rent cuts alone won't stimulate demand, notes Kiran Raichura, property economist at Capital Economics....

JUNE 28, 2023

Commercial property

Fund managers cut commercial property exposure to lowest since 2008

...“The outlook for the US office sector looks ...icularly bleak,” said Kiran Raichura, deputy chief property economist

MAY 16, 2023

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Wealth
Real Estate

US Office Owners Get Dire Warning: Rebound Unlikely Before 2040

- Property values seen plunging 35% from pre-pandemic peak
- Major investors have already begun defaulting on buildings

BUSINESS INSIDER | Business Insider

Office building prices will crash 35% in the next 2 years and won't recover for decades, economist says

The office real estate crash will be so sharp and deep that Capital Economics thinks office values are unlikely to recover by 2040

Now, the research firm suggests that the “35% plunge in office values we're forecasting by end-2025 is unlikely to be recovered even by 2040,” in a ...

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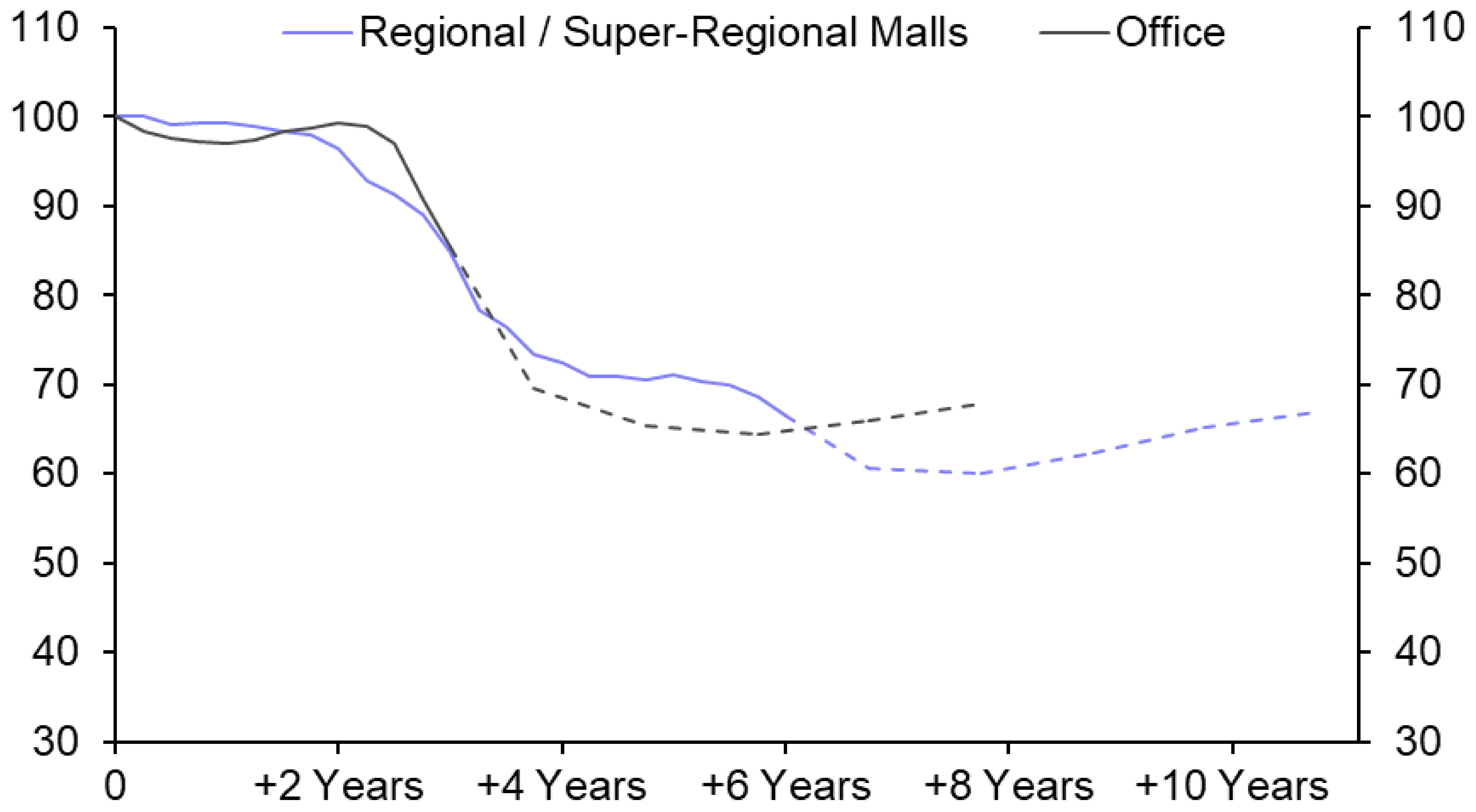
Commercial real estate rebound may not happen until 2040, economist explains

Indexed Capital Values (Peak = 100)

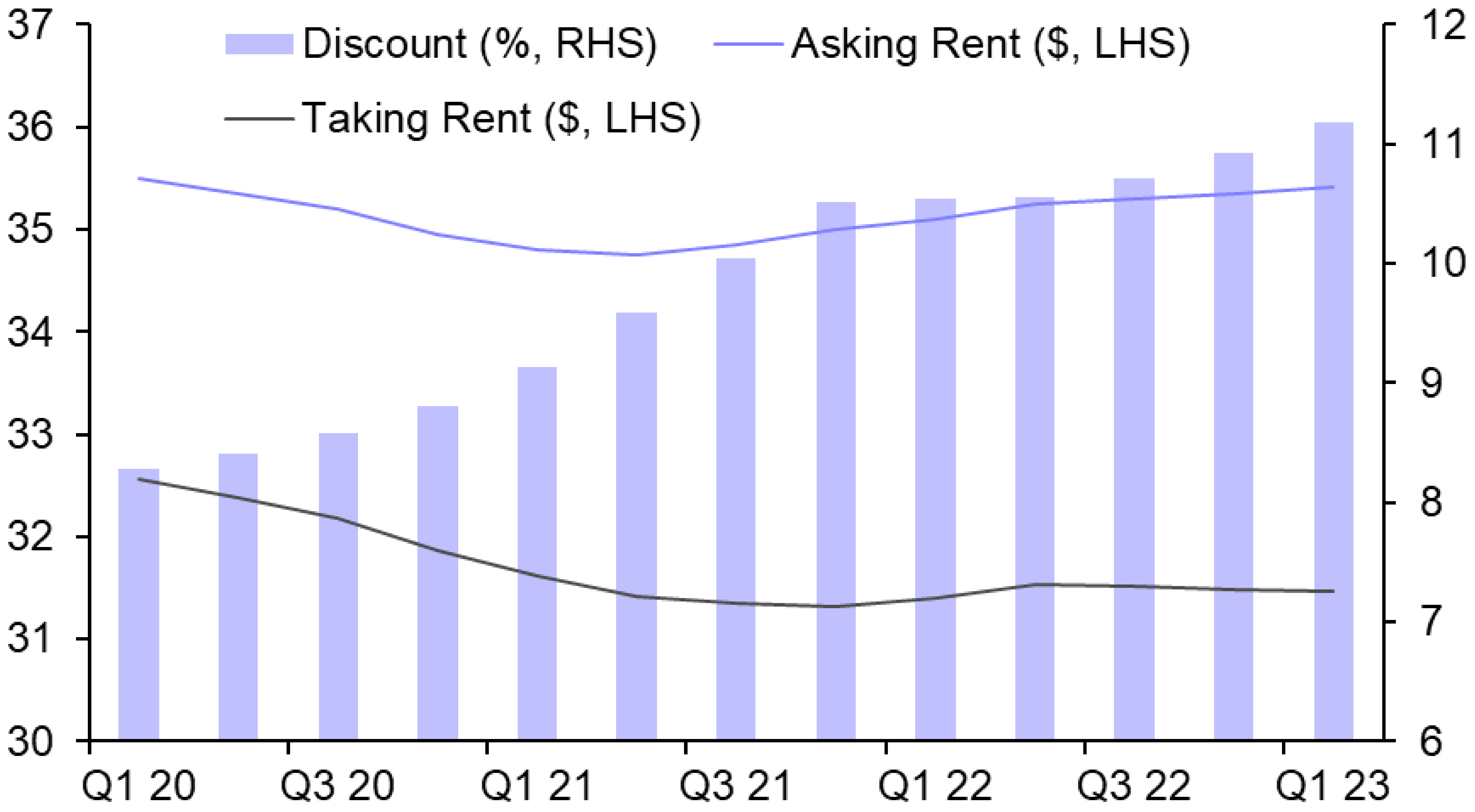


Sources: MSCI, Capital Economics

Office Occupier Markets Struggling

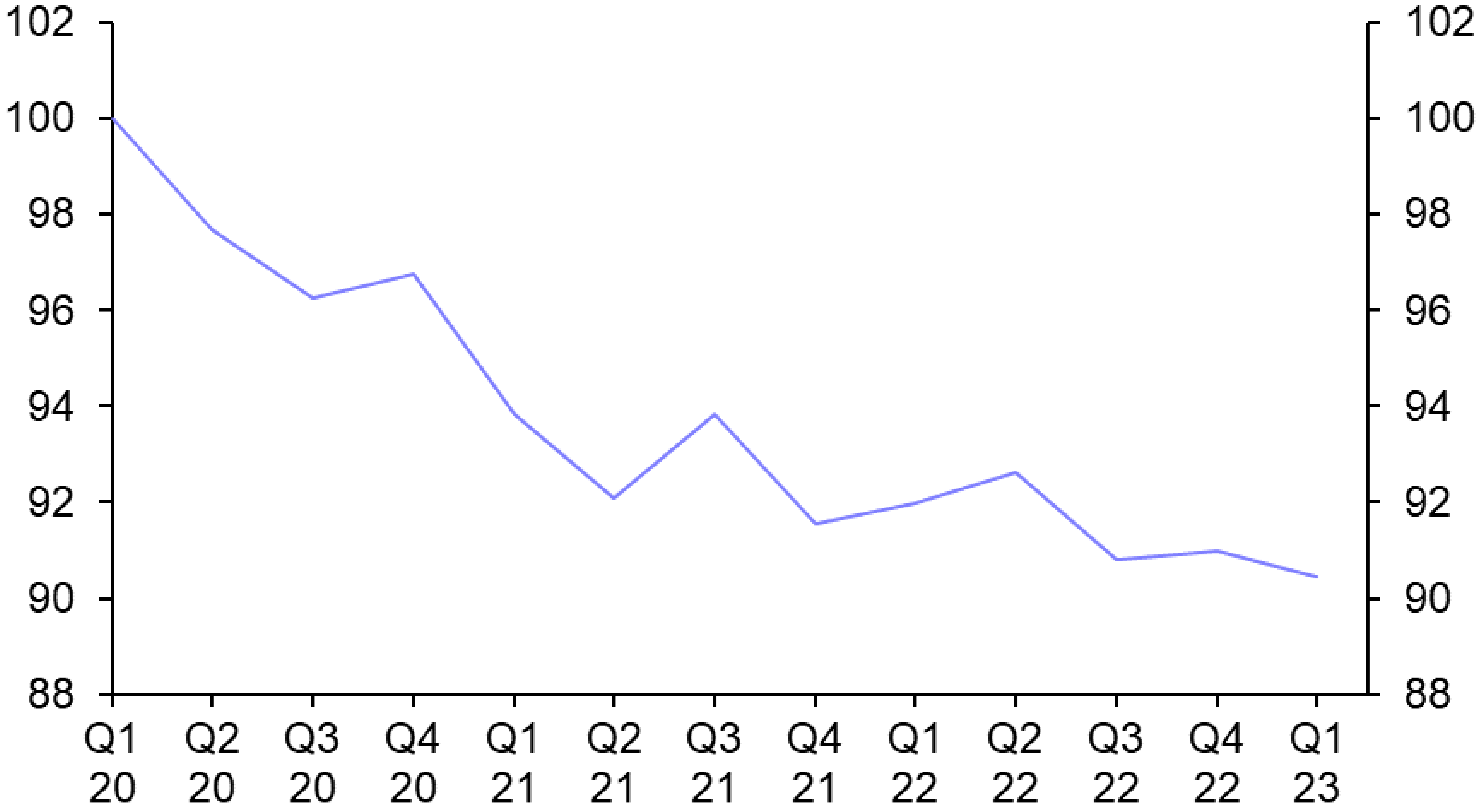
- Office utilization is still only around 50% of pre-pandemic levels.
- Negative absorption has pushed the vacancy rate around 5%-pts higher. Sublease availability points to this growing.
- But asking rents holding up; trophy buildings hitting new highs.
- Incentives have ballooned, meaning net effectives are much lower and bigger discounts to come.

Average Office Rents



Sources: CBRE, Capital Economics

Net Effective Taking Rents (Index, Q1 2020 = 100)

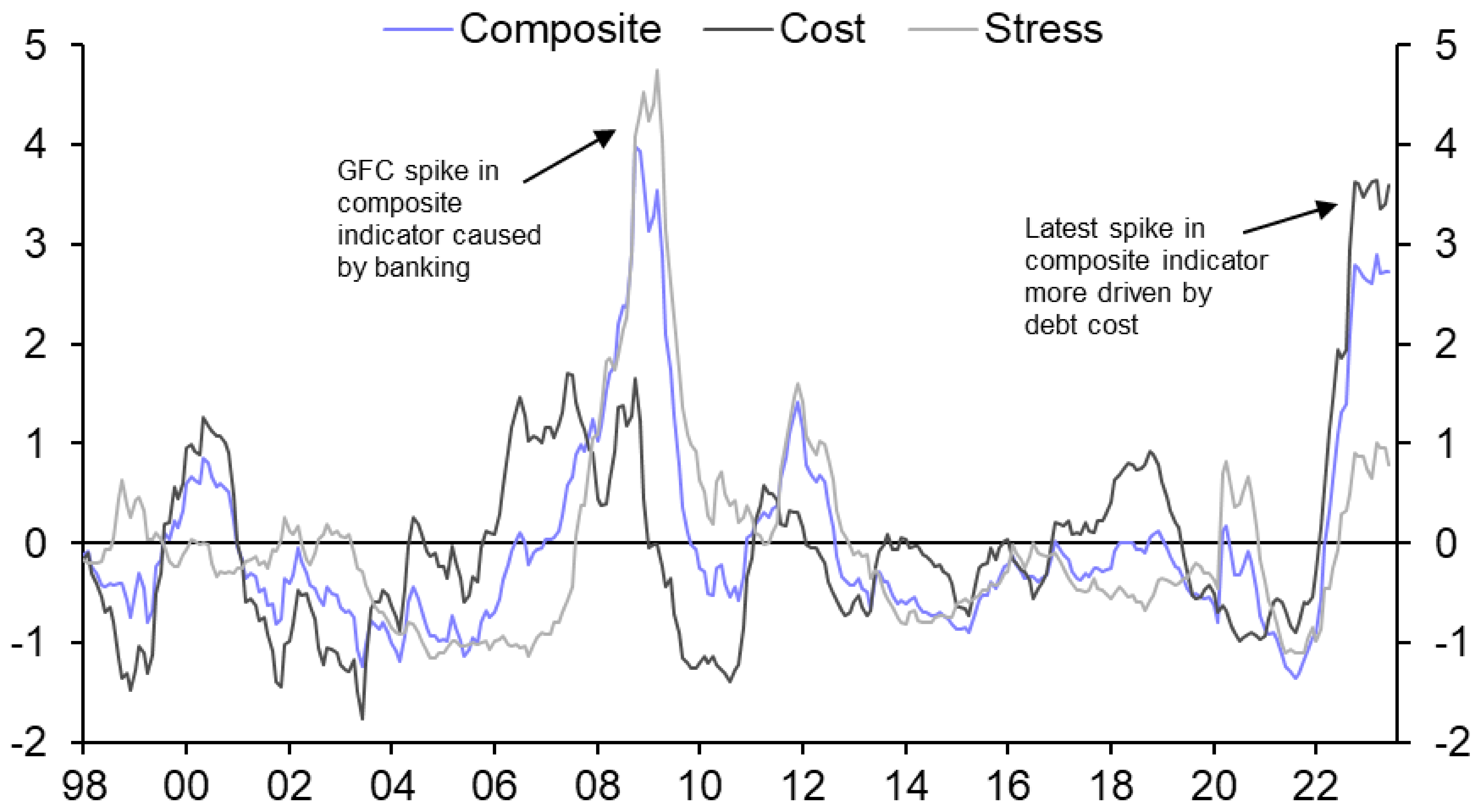


Source: Capital Economics

Office Capital Markets Drying Up

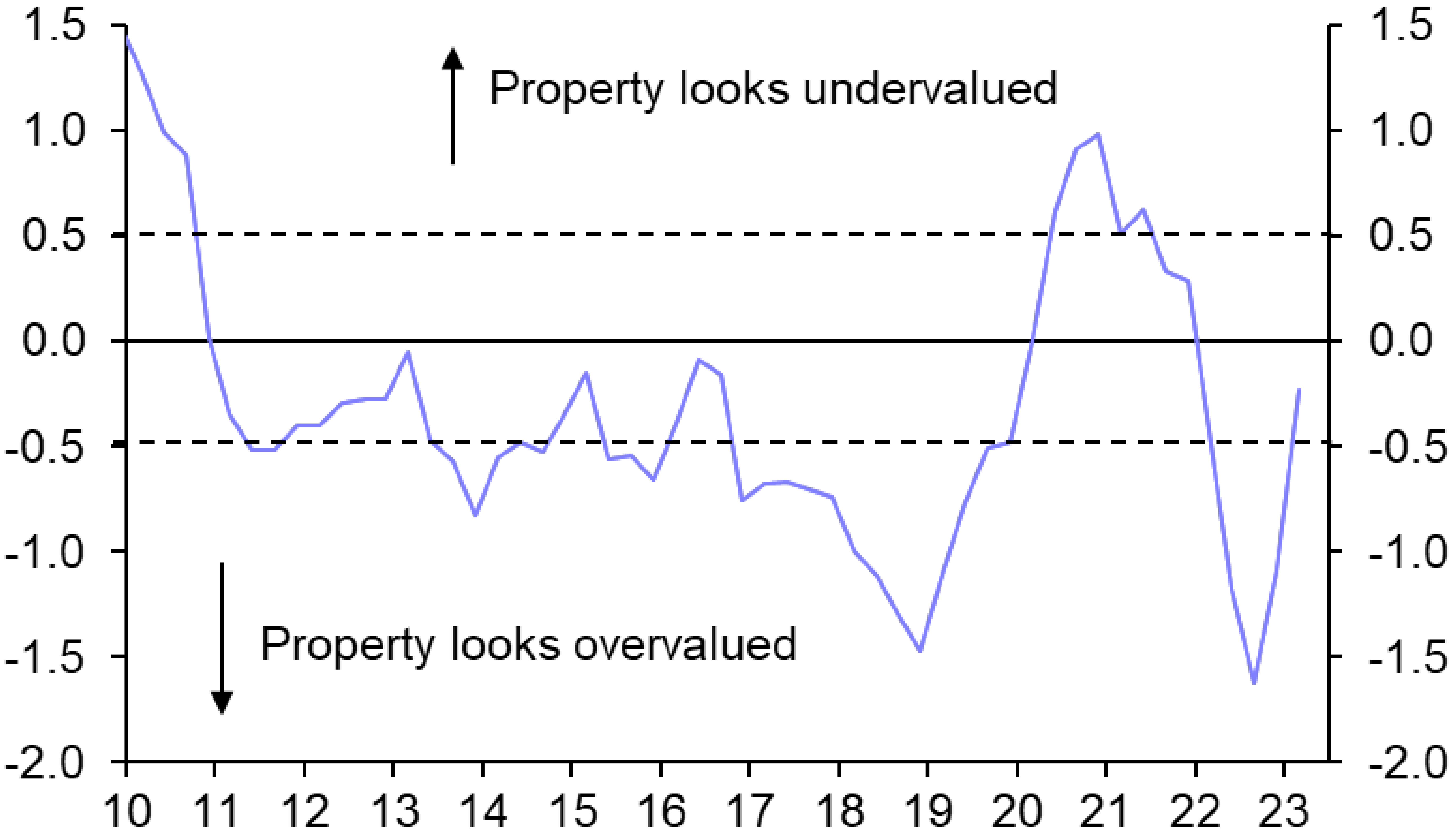
- Financial conditions have tightened considerably, especially for offices – investors talk of an office sector “credit crunch”.
- Valuations against other asset classes look fair. But they are not telling the full story.
- Office investment volumes have fallen off a cliff, with little prospect of a recovery this year.

CE Financial Conditions Indices



Source: Capital Economics

CE Office Valuation Scores (%)

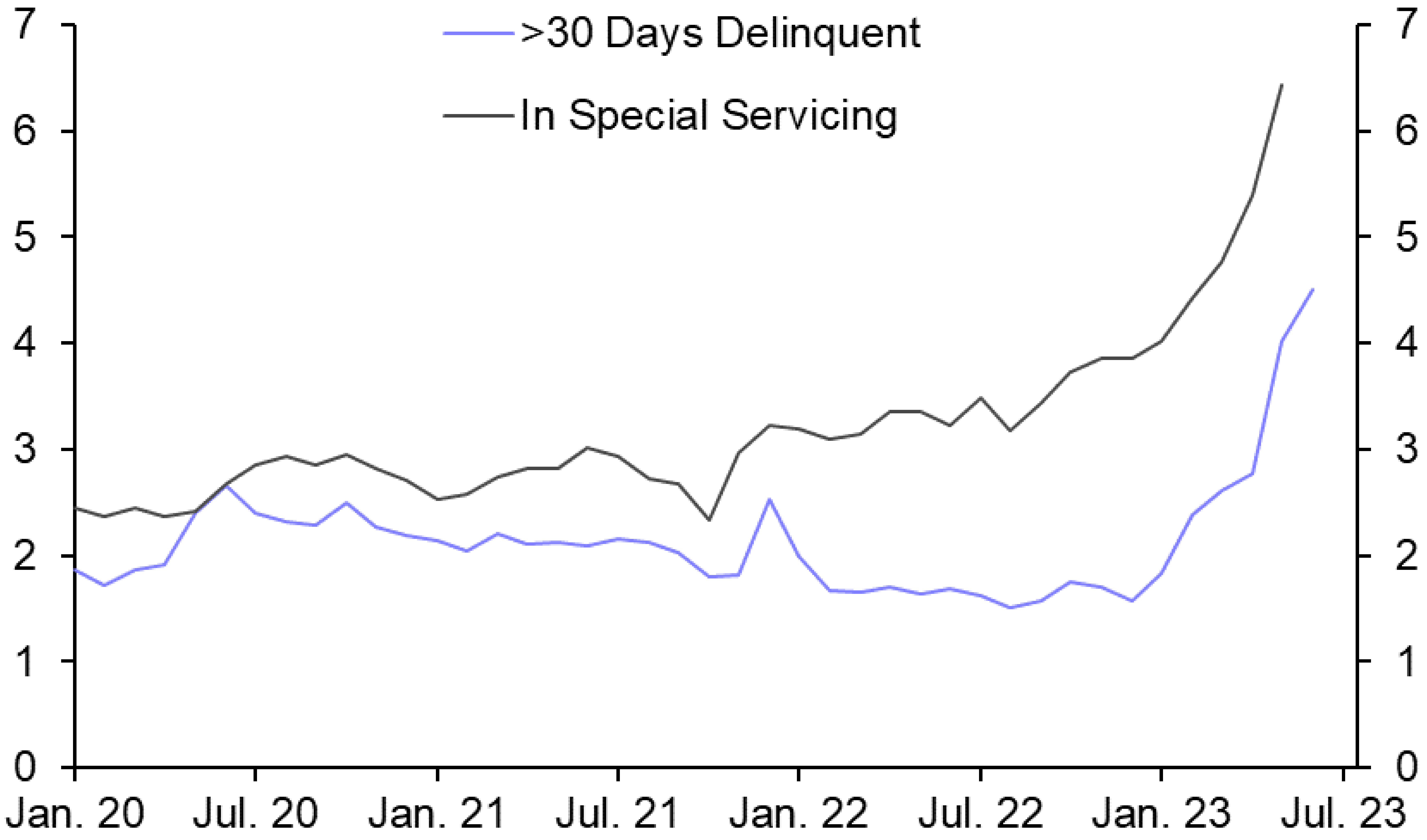


Source: Capital Economics

How Bad Could It Get?

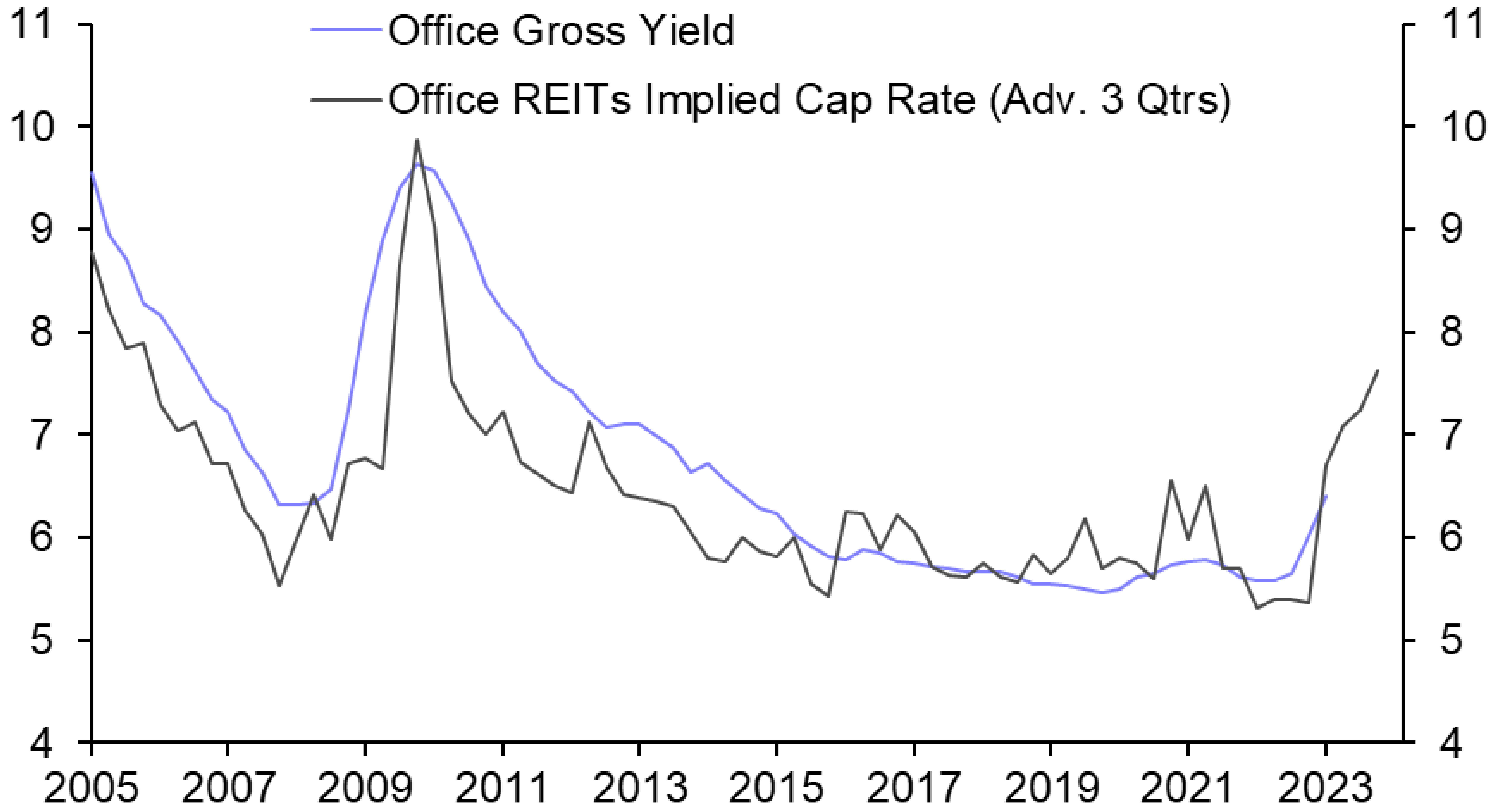
- CMBS distress is growing. The office delinquency rate could hit 10% this year.
- Investors returning unviable assets to lenders.
- Cap rates have increased, but REITs point to another 100 bps. We also expect to see another 100 bps rise in NOI yields.
- Valuation indices down 15% so far, but examples of struggling assets in worst-hit markets trading at 60%-75% markdowns.

Office CMBS Delinquency and Special Servicing Rates (%)



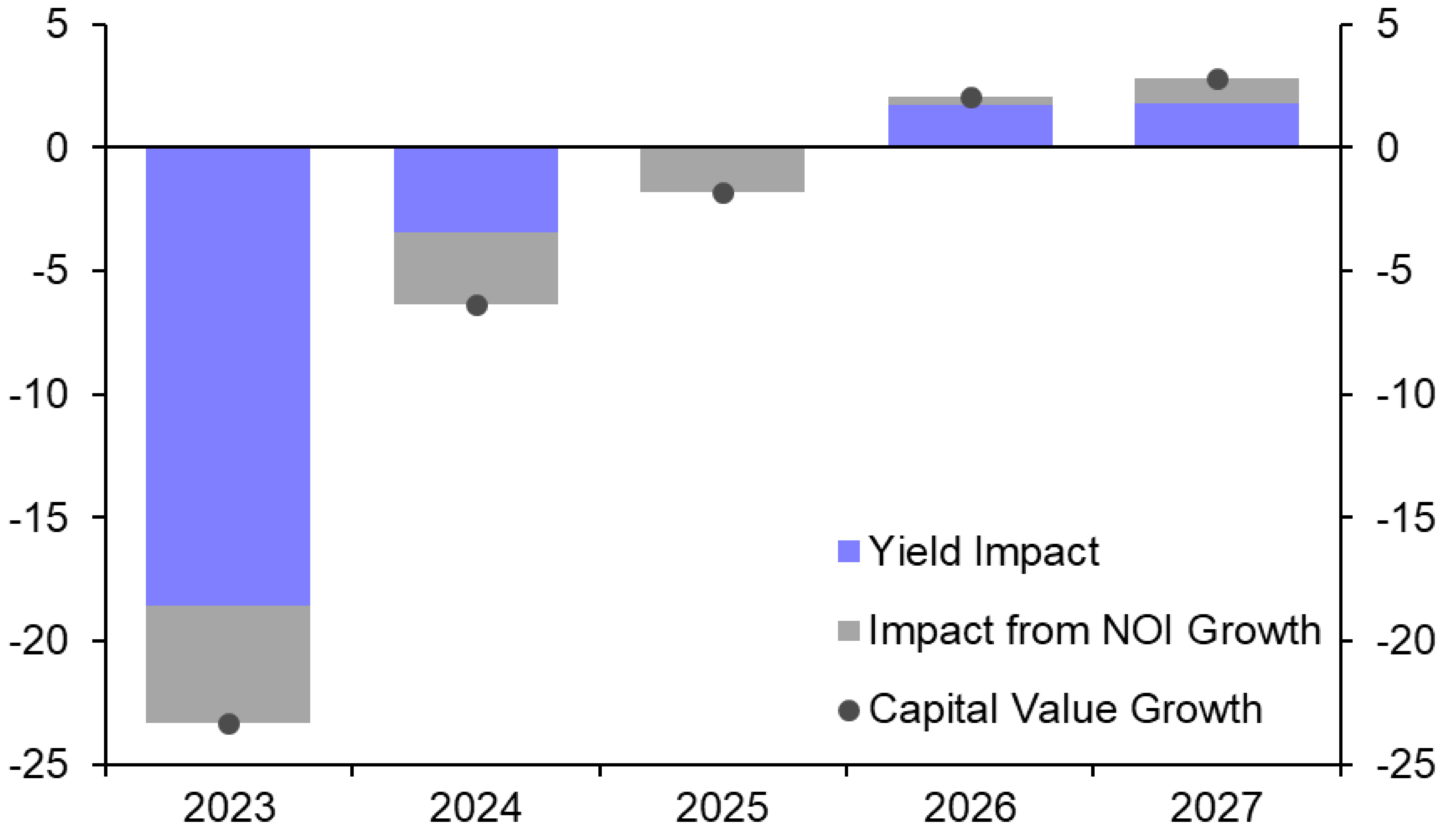
Source: Trepp

Office Cap Rates (%)



Sources: MSCI, NAREIT, Capital Economics

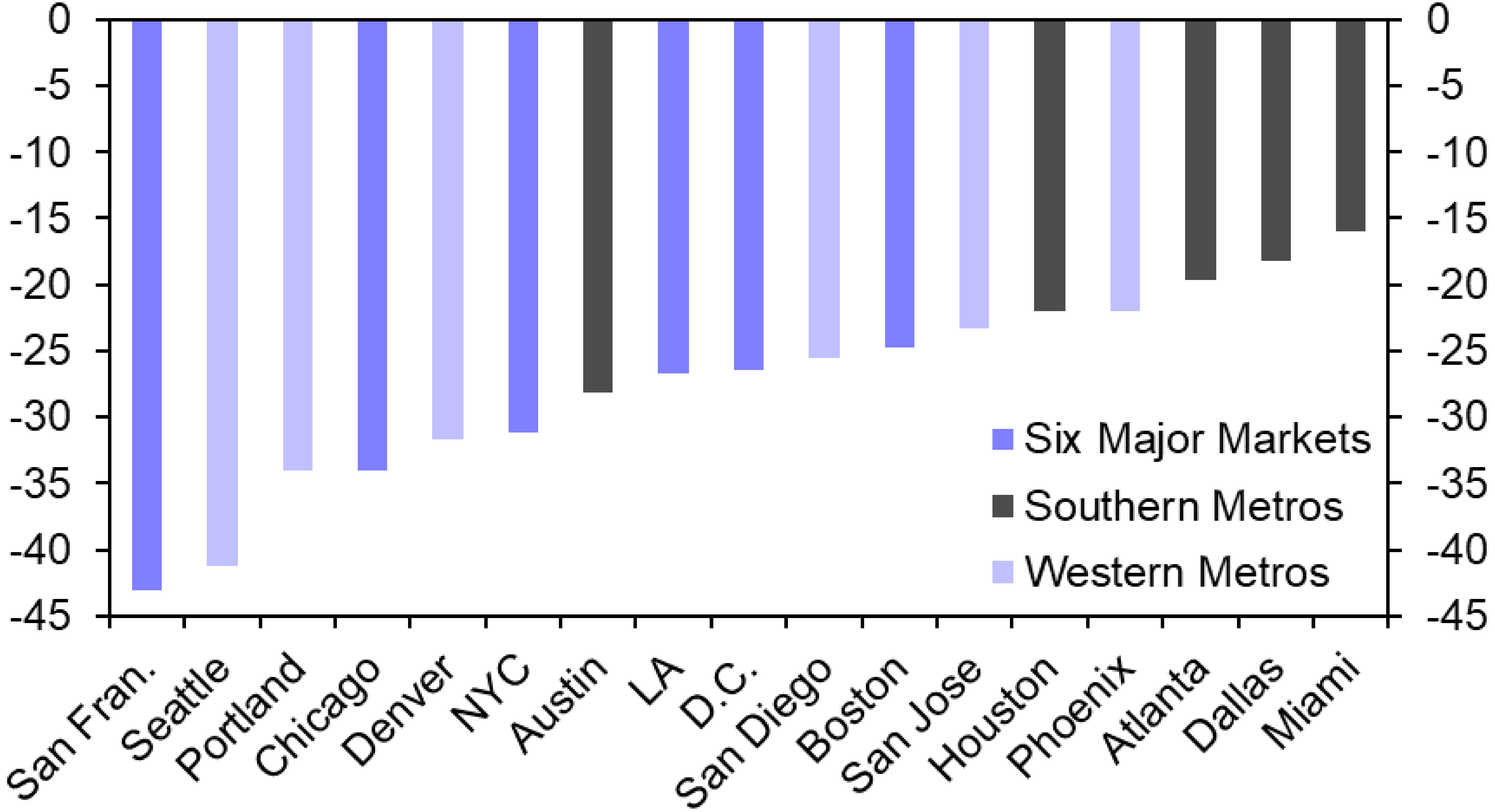
Capital Economics Office Capital Value Forecasts (% y/y)



Putting the National Office Outlook in Context

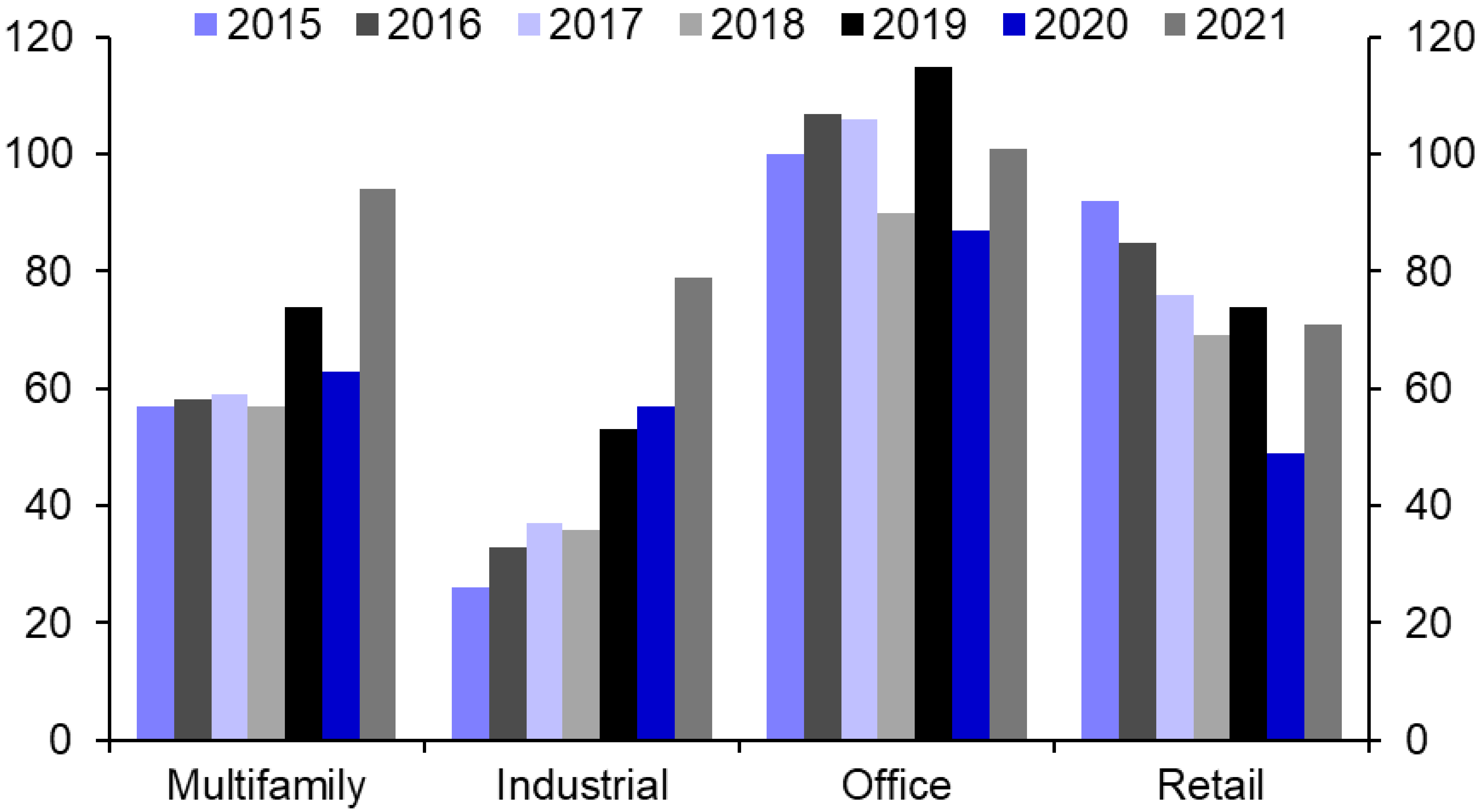
- The metro-level outlook varies due to a range of factors, including commute times, industry sector shares and rent levels.
- The outlook for offices is much worse than the other sectors, with distress much more likely. But other sectors are not without risk.
- We expect retail to outperform on both a 3-and-5-year basis. The longer-term prospects for multifamily and industrial also look good.
- The hit to office values will be much larger in the US than in Europe, with differing office utilization rates driving this divergence.

Office Capital Value Forecasts, 2023-25 (%, Cumulative)



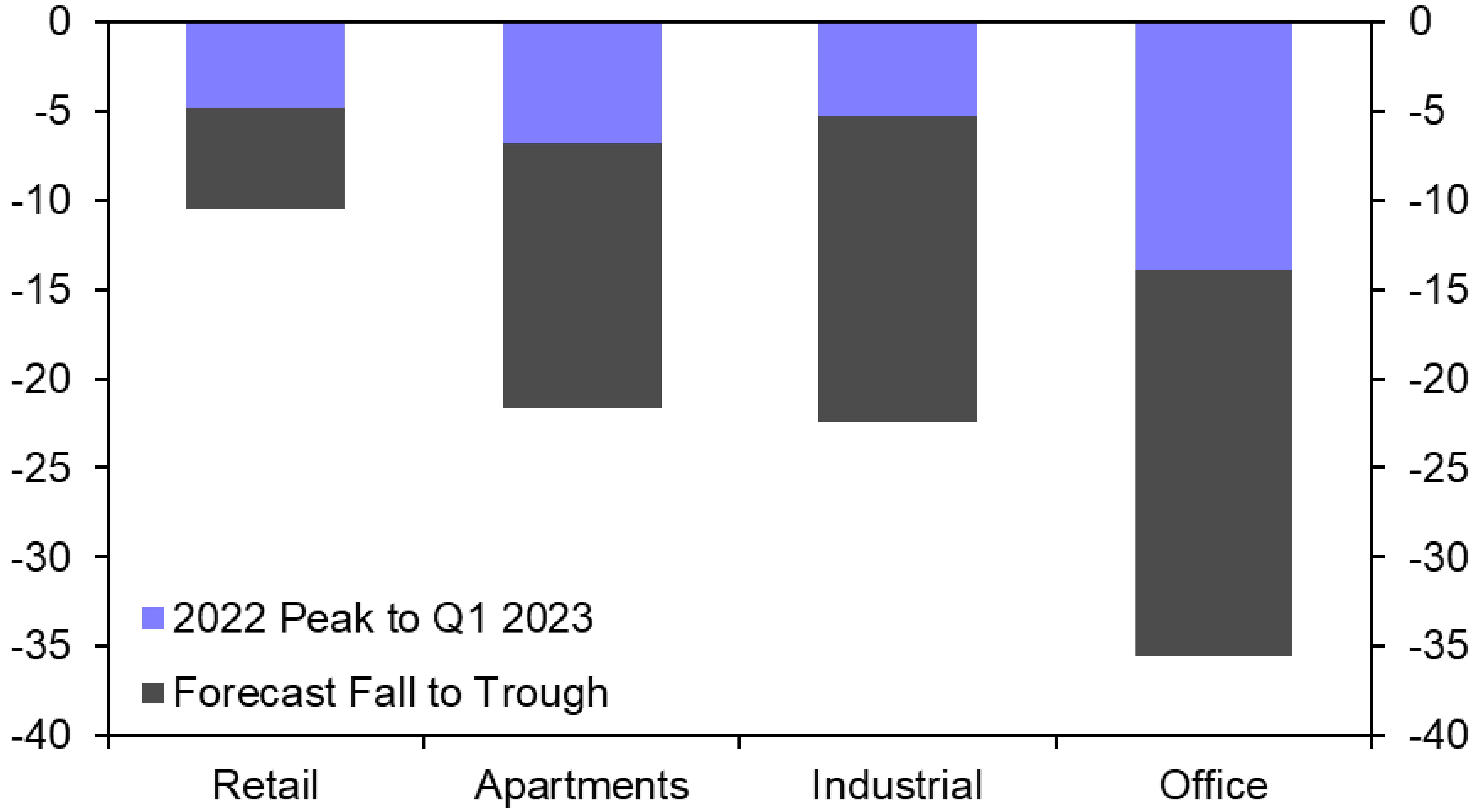
Source: Capital Economics

Implied LTVs by Origination Year (%)



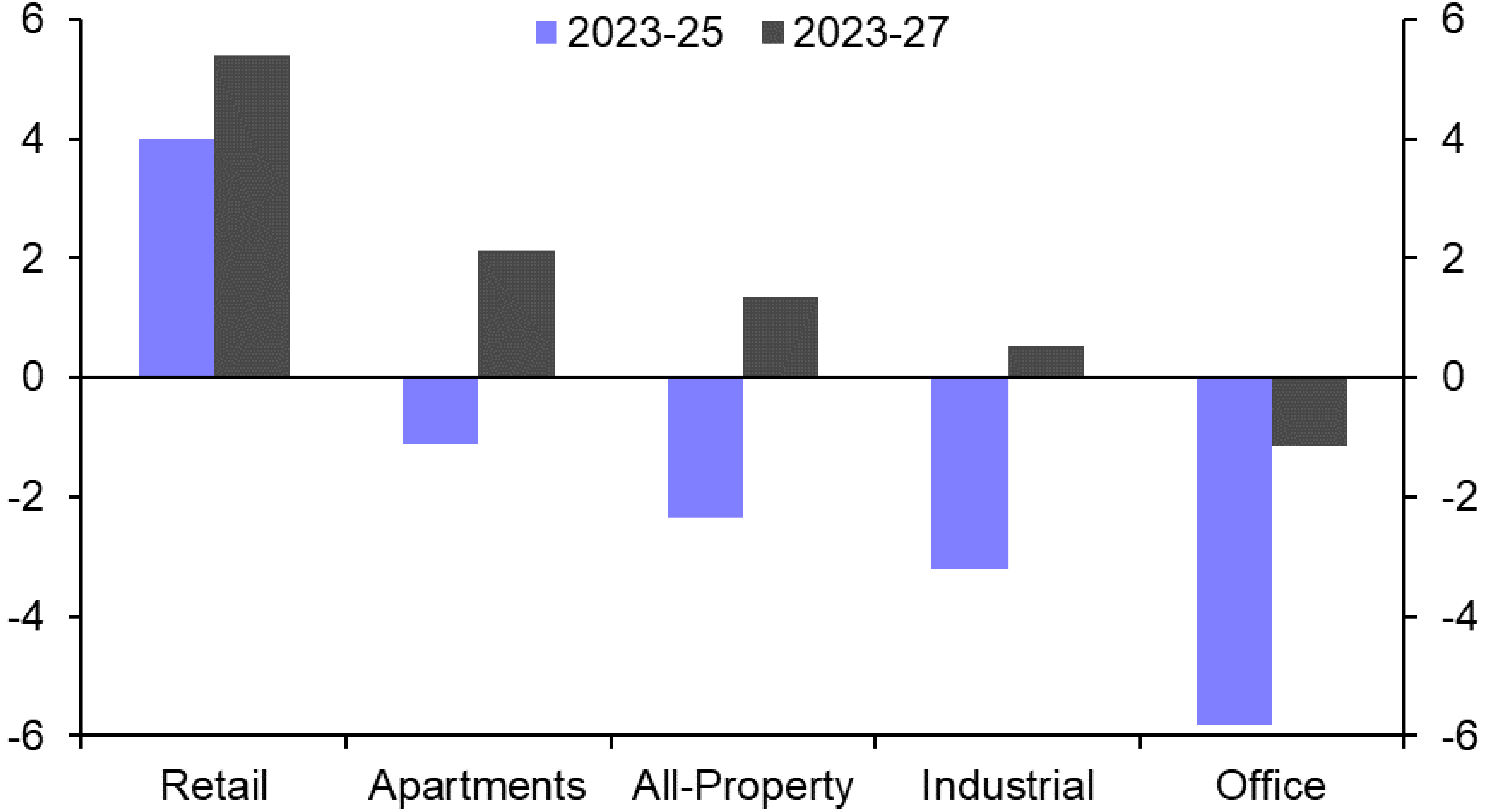
Source: Newmark Research

2022 Peak to Trough Capital Values (% Cumulative)



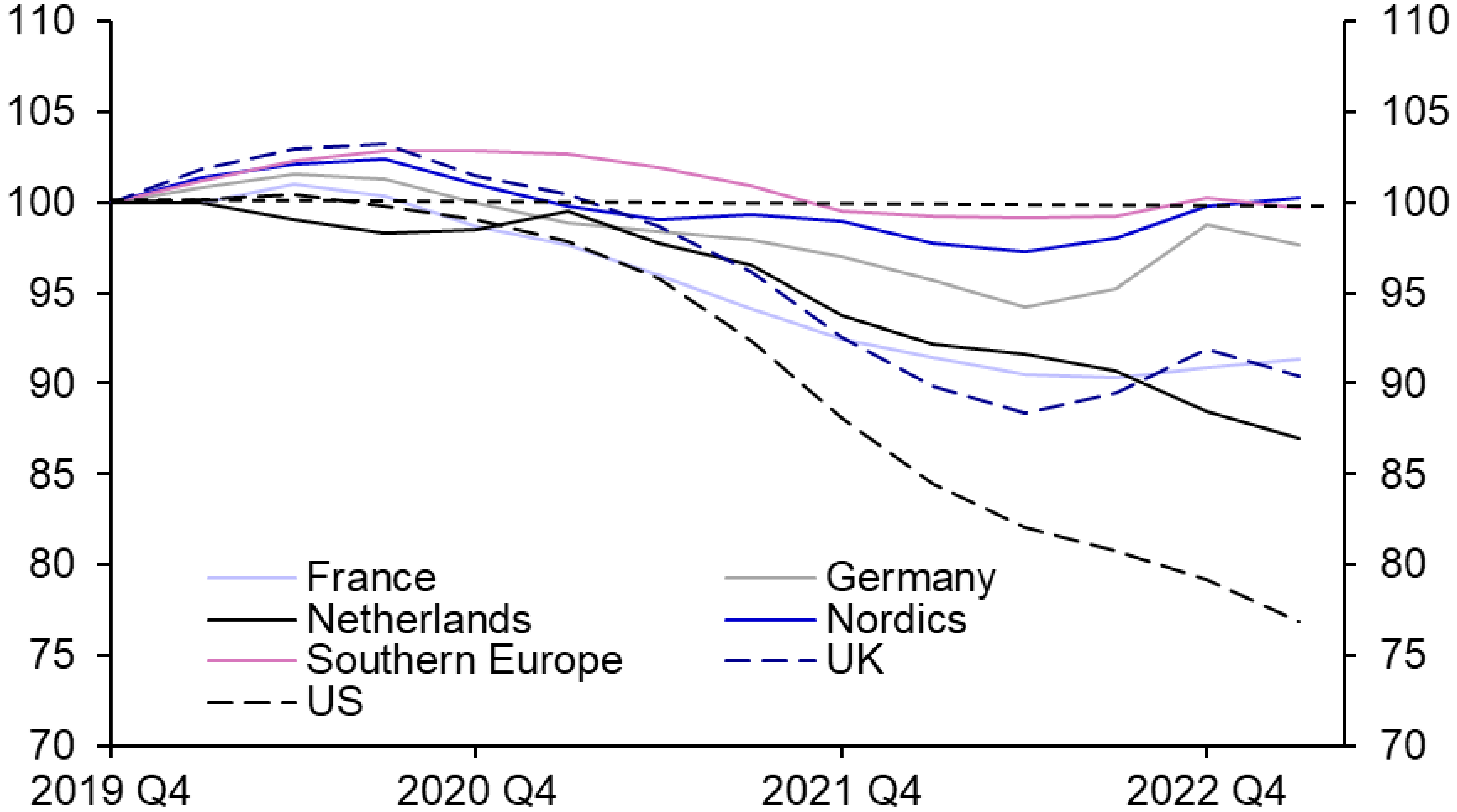
Sources: MSCI, Capital Economics

Forecast Total Returns (% p.a.)



Source: Capital Economics

Office Capital Values Relative to All-Property (Q4 2019 = 100)



Sources: MSCI, Capital Economics

Key Takeaways

- The “new normal” will be negative for real estate values in the short-term but will support decent income returns further ahead.

- Offices will be the clear loser, especially in metros with a high share of tech, long and expensive commutes and expensive housing.

- Southern metros will continue to benefit from migration patterns, although the rate of growth of recent years will not continue.

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