

U.S. Real Estate sector report

Four quadrant perspectives

FALL 2024

Sector conditions and outlook

KEY:

● Improving ● Neutral ● Deteriorating

↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

		Current condition	Outlook
APARTMENT 	<p>The apartment sector is beginning to see stabilization in market fundamentals. Strong demand is starting to offset supply-side issues that have troubled several Sunbelt markets. While rental trends remain flat, there are signs that the pricing pendulum may be shifting in favor of landlords. The sector continues to be a favorite among investors, with debt capital remaining available from all sources.</p>	●	↗
HOTEL 	<p>Sector performance is generally healthy, with occupancy rates stabilizing above historical trends. However, demand across leisure segments has underperformed, as weaker labor dynamics have affected consumer discretionary spending. Debt capital remains available to the sector, but a weaker business environment could pose challenges going forward.</p>	●	→
INDUSTRIAL 	<p>The industrial sector continues to face dual headwinds of slower demand and strong new supply. However, net absorption has rebounded from its early-year decline, as both e-commerce retailers and 3PLs have increased leasing activity in the second half of the year. The sector remains well-capitalized, and investment activity appears to be picking up. Higher interest rates and weaker market performance have reduced under-construction activity by more than 50% from its peak, which should help markets adjust in the near term.</p>	●	↗
OFFICE 	<p>The most recent data suggest signs of life for office demand, though much remains to be done for a sustained recovery. Individual asset valuations are still in a corrective phase, which will take more time to resolve. Some opportunistic investors have begun entering the market to capitalize on pricing dislocations. While in-office attendance has improved, it remains well below pre-pandemic levels, and hiring in office-using industries—a key demand driver—has been modest in the second half of 2024.</p>	●	↓
RETAIL 	<p>The retail sector has outperformed on several measures and remains among the top performers in commercial real estate. Valuations appear to have stabilized, and the lack of new supply has helped maintain healthy occupancy levels. Consumer spending at brick-and-mortar stores has grown moderately, but there are concerns that household balance sheets may lead to a reduction in discretionary spending. Slower economic growth remains a risk, but neighborhoods and communities with value-oriented stores are expected to remain healthy.</p>	●	↗

Sector conditions and outlook continued

KEY:

● Improving ● Neutral ● Deteriorating

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		Current condition	Outlook
<p>SINGLE-FAMILY RENTAL</p> 	<p>The single-family and built-to-rent sectors remain healthy and well-positioned. Fundamentals are strong, driven by solid demand and favorable affordability metrics compared to both the single-family for-purchase market and equivalent multifamily units. While rental growth has slowed compared to the previous year, this trend has been exacerbated in a few metros due to increased build-to-rent activity. Although lower interest rates could improve affordability in the for-purchase market, elevated home prices will likely limit a broader shift in the near term.</p>	●	↗
<p>DATA CENTERS</p> 	<p>The data center sector remains extremely tight, with vacancy rates across major markets averaging under 2%. Rental growth in core markets is approaching 30% on a year-over-year basis, as new supply cannot keep pace with increasing demand. Debt capital remains available for existing assets, but high development costs have limited lending primarily to larger investment banks.</p>	●	↑
<p>STUDENT HOUSING</p> 	<p>The student housing sector continues to perform well, with preleasing close to 90% through mid-year. Rent growth remains stable, and overall demand supports rental increases in the mid-single digits. While demographics continue to favor healthy performance, tailwinds may fade as key cohorts decline and enrollment rates in four-year institutions have flattened in recent years.</p>	●	↗
<p>LIFE SCIENCES</p> 	<p>The sector continues to face significant headwinds following its stellar performance during the pandemic. The lack of capital for start-ups has challenged occupancy amid a rapid pace of development in several metros. While well-capitalized biotech and life science companies continue to perform well and attract interest as tenants, the sector overall is struggling. Exacerbating these issues is the lack of hiring within life science occupations, partly due to insufficient venture capital funding. Although funding has improved from its lowest point, it remains well below its highs.</p>	●	↓

Source: Principal Real Estate, Fall 2024.

APARTMENT

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	↘	↑	→	↘	↗	↗

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Sector overview

The apartment sector is beginning to see stabilization in market fundamentals. Strong demand is offsetting supply-side issues that have troubled several Sunbelt markets. While rental trends remain flat, there are signs that the pricing pendulum may be shifting in favor of landlords. The sector continues to be a favorite among investors, with debt capital remaining available from all sources.

Private equity

Apartment market fundamentals are slowly improving as demand has accelerated throughout 2024. While we have seen deliveries at record levels this year—up 9% from 2023 and 30% from 2022, there are clear signs that the wave of construction is beginning to slow. Long-term investors are also looking past this wave as a reason to be positive over the medium term.

Rental inflation remains flat, but most markets continue to see positive trade-outs on new leases and renewals. In the East and Midwest regions, rent growth in most markets has outpaced the national average in recent quarters, aided by limited new supply compared with the metros in the South and West. In addition, age-restricted and affordable to moderately priced residential subsects have outperformed the class A category.

Most markets continue to see modest positive trade-outs on new and renewal leases. The East and Midwest regions have led rent growth in recent quarters largely due to continued demand with limited new supply.

In addition, age-restricted and affordable housing subtypes have outperformed class A given the recent wave of new construction in the class A category.

The decline in treasury rates since April (85 bps) has provided an immediate boost to apartment underwriting. While the corrective phase in capital values has continued through the first half of 2024, we are at or near the bottom of the cycle. Going forward a more accommodative interest rate environment and a lack of home price affordability align well with stronger performance as tenants will increasingly make the economic choice to rent.

Private debt

Despite oversupply in some markets, modestly increasing market vacancy rates, and increased cap rates, apartment loans continue to appeal to many lenders who favor the property type based on housing shortages nationally, challenging economics for first-time home buyers, and generally favorable long-term trends. Reduced investment sales activity resulting from capital markets challenges, a reduction in refinancing requests, and tighter underwriting standards continue to hinder multifamily lending volumes, with multifamily financing activity over the first six months of 2024 down approximately 10.6% from one year earlier.

Broad-based lender interest in apartments paired with competitive pricing and enhanced liquidity provided by government-sponsored entities (GSEs) continue to make multifamily lending rates the lowest of all

APARTMENT (continued)

property types. Fixed-rate 10-year loans for high-quality, well-located apartment properties with 55% to 65% LTV tend to receive interest rates near 5.05-5.15% from insurance companies today, with slightly higher rates from many banks and occasionally tighter rates from the GSEs. Fannie Mae and Freddie Mac sometimes offer 75% LTV financing with rates in the high 5% range for select multifamily properties, and in some instances offer more aggressive rates for properties with a strong affordability component for lower-income households.

REITs

Apartment REITs have meaningfully outperformed the broader index year-to-date in 2024. A wide affordability gap between renting and owning and stronger than expected labor markets have supported demand. To date, robust demand has helped absorb elevated deliveries in certain markets. Additionally, there is better visibility on private market valuation for apartments compared with other property sectors.

Most apartment REITs raised 2024 net operating income (NOI) outlooks for the year thanks to quicker moderation of both controllable and non-controllable expense items. Top line growth remains superior on the coasts but sunbelt portfolios competing against elevated deliveries have delivered better than feared results. Investors have also been encouraged by comparatively better sequential pricing power trends from sunbelt operators, despite running at lower absolute levels. Given year-to-date outperformance, apartments are trading at slight premiums vs. NAV, but remain at mid-single-digit discounts compared to the REIT index.

CMBS

The GSEs continue to be a dominant lender in the multifamily space with \$140 billion of approved lending capacity. Combined agency issuance has been constrained by low transaction volumes. While much smaller in scale, multifamily exposure in conduit and single-asset single-borrower (SASB) CMBS is significant at roughly \$61 billion outstanding. Conduit multifamily lending has been strong in 2024 as exposure to multifamily loans in conduits issued year to date was 19%. Over the past five years, multifamily exposure in conduit deals has ranged from 22.6% in 2021 to 9.1% in 2023. Loan performance remains very strong in fixed rate, as the conduit multifamily delinquency rate is at 1.3% which is the second lowest by the property sector behind industrial.

Some weakness is emerging in floating rate SASB loans underwritten at tight debt yields when interest rates were extremely low. Rising rates have resulted in large increases in debt service burdens, cooling prospects for NOI growth, and valuation challenges that have resulted in floating rate loans having difficult refinancing. The SASB multifamily delinquency rate is 4.7%, which is being driven by maturity defaults.

Overall, multifamily remains an in-favor sector within fixed-rate conduit CMBS given longer loan terms, fixed-rate coupons, historical NOI growth, poor single-family affordability in the for-purchase market, and low exposure to rent-regulated properties.

HOTEL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	→	↘	→	↘	↓	↗

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Sector overview

Sector performance is generally healthy, with occupancy rates stabilizing above historical trends. However, demand across leisure segments has underperformed, as weaker labor dynamics have affected consumer discretionary spending. Debt capital remains available to the sector, but a weaker business environment could pose challenges going forward.

Private debt

Hotel debt markets have seen an increase in activity year-to-date. This has been driven largely by CMBS lenders (particularly for SASB executions that sometimes exceeded \$200 million in size). Hotel lending by insurance companies and large banks remains limited, but debt funds and CMBS have been attracted to the relatively higher credit spreads associated with hotels.

Hotel loans today may be structured with either variable or fixed interest rates. As of September 2024, stabilized hotel loans were being financed by CMBS lenders (both SASB and conduit) with spreads in the upper-200s basis points over SOFR or swaps, assuming the collateral features a debt yield over 10% and an LTV under 65%. Debt funds often allow slightly higher loan-to-value ratios with spreads in the mid-300 to 425 basis point range over SOFR or swaps.

REITs

Lodging REITs underperformed other property sectors year-to-date due to disappointing leisure demand, partially offset by continued improvements in group and business hotel demand. During spring

and summer, leisure travel continued to moderate, with underperformance in resort hotels plus weakness in the economy and midscale travel segments. Group travel is the best-performing travel segment with continued strong demand from corporates. Corporate transient also continues to show improvements and drive mid-week occupancy improvements, however, ADR continues to lag earlier expectations.

Recent earnings updates were mixed with several REITs outperforming driven by out-of-room spend and other company-specific issues while the underlying RevPAR trends generally disappointed. RevPAR guidance for 2024 was cut by 150 to 200bps on average and is now mostly in the 1% to 3% growth range. Margins are still expected to contract year-over-year in 2024 as expense growth is expected to outpace RevPAR. Lodging REITs are trading at a 20-30% discount to NAV estimates, a larger magnitude than what is seen across most other REIT sectors, reflecting economic uncertainty, concerns about leisure travel weakness, and general margin erosion.

CMBS

Despite a slowdown in demand from post-COVID highs, hotel operations have continued to show solid performance with loan performance following suit. The conduit hotel delinquency rate peaked near 20% in July of 2020 and now stands at 4.5%, which is 0.5% less than the overall conduit delinquency rate. Leisure travel initially spurred a strong recovery in vacation destination markets with business travel recovering in turn. Hotel operators have grown RevPAR by raising average daily rates, while occupancies are lower than 4 years ago which is especially prevalent in higher-end

HOTEL (continued)

categories. RevPAR growth appears to be leveling out year-over-year as consumers have mostly burned through excess savings.

CMBS issuances in 2020 and 2021 included very little hotel exposure due to underwriting challenges and investor skepticism. As fundamentals have improved, hotel loan contributions have grown to 12% of 2023 conduit issuance, 10% of 2024, and over 28% of SASB collateral issued year-to-date, showing that capital is available for better-positioned properties. While the recent macro trends have been supportive, hotel performance is highly correlated to economic growth and could be negatively impacted by a slower growth scenario where discretionary spending trends become challenged warranting a more conservative approach to both underwriting and forward-looking credit assessments.

INDUSTRIAL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
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Sector overview

The industrial sector continues to face dual headwinds of slower demand and strong new supply. However, net absorption has rebounded from its early-year decline, as both e-commerce retailers and 3PLs have increased leasing activity in the second half of the year. The sector remains well-capitalized, and investment activity appears to be picking up. Higher interest rates and weaker market performance have reduced under-construction activity by more than 50% from its peak, which should help markets adjust in the near term.

Private equity

Following a soft patch in demand early in 2024, the second half of the year is shaping up to show a material improvement in warehouse demand. Major e-commerce operators and third-party logistics providers have reversed course on space reductions and are now looking to expand operations. This is evidenced by key leases signed in Southern California and Phoenix over the past several months.

Supply-side pressures continue to affect the market and occupancy levels have compressed during the first half of the year as a result. While debt capital remains available to private equity investors, development as evidenced by square footage under construction has fallen 55% below this cycle's peak in 2022. Labor and materials are also in short supply, which will continue to help buffer the market against more robust supply-side pressures.

Rents continue to post new highs in most markets. Inland Empire is the notable exception where supply in the short term has resulted in a material weakness

in fundamentals. Investors continue to benefit from favorable trade-outs on market-to-market leases given the robust rental growth that occurred between 2020 and 2023.

Investors continue to view the industrial sector as attractive, with a favorable risk-return profile due to its strong secular demand tailwinds. Most investors are looking to either maintain or expand their allocations toward the sector.

Private debt

The industrial sector—along with apartments—remains a favorite among lenders. Recent weaker demand paired with continued new supply has rattled very few lenders, with most perceiving the property type's long-term supply and demand fundamentals as still favorable. Well-located, high-quality logistics properties in major markets today often garner 10-year, fixed-rate financing with 55-60% LTV ratios and interest rates near 5.10 to 5.20%. Pricing tends to be somewhat less competitive than that offered by lenders for multifamily properties, perhaps due to multifamily competition from the government-sponsored enterprises that do not exist for industrial properties; that said, the sector is a very close second to multifamily in terms of lender preference and aggressive pricing.

REITs

Industrial REITs have materially underperformed the broader index so far this year. Demand has been weaker than expected as tenants remain reluctant to commit to new space due to macroeconomic uncertainty, a higher cost of capital, and overcapacity.

INDUSTRIAL (continued)

Slower leasing combined with elevated supply has resulted in disappointing rent growth. This forced Prologis to revise its 2024-2026 market rent growth forecast meaningfully lower from 4 to 6% per annum to flattish, a seismic shift considering the prior forecast was issued just two of quarters earlier. Southern California continues to be the poster child of the slowdown and is expected to remain soft through mid-2025. In other markets, easing supply pressures and a moderate improvement in demand are expected to create a more favorable backdrop in 2025 and beyond.

Despite softer fundamentals, industrial REITs are still delivering solid high-single-digit earnings growth thanks to sizeable, embedded growth from below-market rent leases. Recent REIT earnings were ahead of expectations and several companies raised 2024 guidance. This brought some relief after Prologis cut guidance earlier in the year, something that shocked investors that had been accustomed to “beat and raises” from industrial REITs in recent years. The longer-term outlook continues to be positive as secular trends supporting the industrial sector are still intact. However, near-term growth projections have moderated as the market inflection point has been pushed out, the mark-to-market opportunity is shrinking as rent growth has stalled, and REITs have pared back development activities due to tepid demand for new space. Industrial REITs trade broadly in line with consensus NAV as the sector has lost some of its premium valuation.

CMBS

Industrial loans currently carry the lowest delinquency rate within the CMBS universe at 1.0% and continue to be viewed positively, especially relative to other traditional sectors. This view is supported by the current economic outlook, market fundamentals, and availability of capital. The CMBS SASB market provided over \$43 billion of floating-rate debt to industrial owners since 2020, offering an efficient source of financing for very large portfolio deals. Blackstone drove most industrial loan demand to start the year but since the first quarter, multiple borrowers have been in the market financing portfolios of industrial properties.

In the conduit space, industrial allocations since the pandemic have increased to 9% compared to 6% to 7% before 2020. Conduit CMBS industrial loans are generally smaller than the large SASB deals and in some instances, exhibit exposure to tertiary locations, less functional layouts, and non-investment grade tenancy (often via sale and leasebacks). Because of this, underwriting metrics for conduit industrial loans have typically been more conservative than SASB industrial loans. Overall, historically strong NOI growth, relatively durable cash flows, and positive investor sentiment should benefit the space.

OFFICE

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↓	↑	↘	↓	↓	↓	↓

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Sector overview

The most recent data suggest signs of life for office demand, though much remains to be done for a sustained recovery. Individual asset valuations are still in a corrective phase, which will take more time to resolve. Some opportunistic investors have begun entering the market to capitalize on pricing dislocations. While in-office attendance has improved, it remains well below pre-pandemic levels, and hiring in office-using industries—a key demand driver—has been modest in the second half of 2024.

Private equity

The office sector is beginning to show signs that is nearing its cyclical bottom but remains in weak condition. The vacancy rate in nearly all markets remains high and demand is muted due to work-from-home and hybrid arrangements that have kept in-office attendance and physical occupancy well off their pre-COVID levels. Through the first half of 2024, we have seen signs of stabilization in occupancy as employers have continued to call workers back to the office, but occupiers continue to right-size their leasing footprints. At present, less than a quarter of pre-pandemic leases have rolled and it will be a lengthy process to align space needs to new in-office standards.

The good news for the sector is that net absorption was positive in Q2 2024 a significant shift from the give-back in space that occurred since the pandemic began. The sublease market is also stabilized and the amount of space available has begun to decline following its peak at the end of 2023. Supply has also been muted with a significant contraction in new construction.

There has also been an increase in office sales volume since bottoming in late 2023, driven by a spate of entity-level deals that occurred during the first quarter of this year. More owners and lenders have been willing to meet the market on office disposition as we move through 2024. We expect to see several sale comps posted in the coming quarter that highlight significant discounts to peak pricing.

Problematic for the sector going forward is the economic viability of some office buildings as landlords continue to offer significant concessions to attract tenants. Leases have become both shorter in term (-6% vs. pre-pandemic) and smaller (-13%). Investors will continue to deal with distress in the market with \$349B in “troubled” (LTV >80%) office loans maturing between now and 2026, which will continue to produce headlines and capital markets activity in the sector.

Private debt

CMBS lenders have shown an increased interest in office loans over recent months, but that interest is reserved solely for better-quality properties with strong in-place leasing. Even on a moderate leverage basis interest rates rarely pierce below 6.0% and more often are closer to 7.0% for those high-quality office properties. Certain debt funds are willing to provide loans for office properties, but their required yields are typically greater than the property-level economics will support.

Office buildings deemed class B or C in quality; those with occupancy below 85-90%; and those with weighted average remaining lease terms shorter than

OFFICE (continued)

5 to 7 years generally find no lender interest from any class of lender today. Most insurance companies and banks continue to avoid new office loans (regardless of property and tenancy quality) as they seek to manage existing portfolio exposures.

Most office loans today involve existing lenders refinancing their own debt or sellers providing seller financing in connection with a disposition. Seller financing transactions typically provide buyers with low-to-moderate leverage at interest rates unavailable in the market while allowing sellers to reduce their exposure to the property type.

REITs

Office REITs have outperformed the broader index year-to-date thanks to strong performance since late spring. This coincides with the decline in interest rates which supports the highly levered office sector. In addition to lower rates, sentiment has improved driven by a pick-up in tenant demand and less fear of work-from-home posing an existential threat to high-quality buildings. New York and the Sunbelt continue to outperform the tech- and media-heavy West Coast markets although AI-demand offers a glimmer of hope for the hard-hit San Francisco market.

Recent REIT earnings beat expectations and most raised guidance for 2024 driven by better operations and one-time items. Companies benefit from the flight-to-quality and flight-to-capital trends as REITs tend to own above-average quality portfolios and are well-capitalized relative to many private owners. Management teams are increasingly optimistic that occupancy is approaching a bottom. They also expect pricing power to improve in select submarkets where the availability of premium office space is falling. REITs' cost of capital is still elevated but has improved thanks to the rebound in share prices, lower base rates, and a tightening of unsecured borrowing spreads. Several management teams would like to go on the offensive to take advantage of distress in capital markets. However, transaction activity remains muted as the bid-ask spread continues to be wide for trophy or

premier buildings targeted by REITs. From a valuation perspective, office REITs are now trading at roughly 10% below consensus NAV, a much narrower discount than in recent years but still wider than REIT average.

CMBS

Office exposure continues to face challenges due to ongoing secular headwinds. Conduit CMBS has historically averaged roughly 30% office exposure; however, issuers have responded by limiting office exposure, which declined to 20% in 2023 and to just 15% year-to-date in 2024. Delinquency rates remained remarkably stable throughout the pandemic but have trended up since 2022 from 1.9% to 8% for fixed-rate conduit transactions. Long-term leases, diversified rent rolls, and high underwritten debt service coverage ratios (DSCRs) help to significantly mitigate term default risk. However, refinance risk continues to be elevated given NOI pressure, constrained capital markets, and higher interest rates.

Floating rate SASB loans are much more exposed to near-term default risk given the significant increase in short rates and a corresponding drop in DSCRs, which has led to several high-profile defaults and pushed the SASB office delinquency rate to 6.3% with almost 70% of the defaults occurring at maturity. Given the difficult refinance environment, CMBS servicers are working with borrowers by providing loan extensions in exchange for fresh equity contributions, cash flow sweeps, and other lender-friendly requirements. This approach seeks to improve bondholder outcomes, although it does create timing uncertainty which is adding to pricing concessions. Recently constructed class A office assets are performing quite well, exhibiting positive net absorption and significantly higher market rents. Importantly, nearly 50% of conduit CMBS office exposure is considered Class A, a fact that is not reflected in highly elevated market risk premiums. Investors who can approach office exposure with a more discerning viewpoint are positioned to benefit from current pricing levels over the longer term.

RETAIL

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↗	↑	↗	→	→	↗	→

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Sector overview

The retail sector has outperformed on several measures and remains among the top performers in commercial real estate. Valuations appear to have stabilized, and the lack of new supply has helped maintain healthy occupancy levels. Consumer spending at brick-and-mortar stores has grown moderately, but there are concerns that household balance sheets may lead to a reduction in discretionary spending. Slower economic growth remains a risk, but neighborhoods and communities with value-oriented stores are expected to remain healthy.

Private equity

The retail sector continues to outperform most others in commercial real estate. The sector is the only one that posted weak, but positive capital value growth through the first half of 2024 driven by strong performances in both the neighborhood and community center subtype categories of the NCREIF NPI. Strip centers, particularly those with a strong grocery anchor tenant and value-oriented retailers remain favored by investors and continue to perform well. Investor demand has also increased for well-positioned retail assets with cap rates stabilizing and even compressing in some cases.

The sector continues to benefit from low construction starts that have allowed occupancy rates to improve at a time when most sectors are facing challenges. Tight market conditions have also shifted negotiating leverage from tenants to landlords, particularly for high-quality retail assets. We feel that this dynamic will continue in the near term as market rents are well below those required to justify new construction.

On the operational side of the market, the openings and closing ratio has remained positive following the pandemic following six years of net store closings between 2015 and 2020. During the pandemic, several commodity-based retailers and weaker operators were forced to close, leaving a stronger field to pick up as retailers returned to in-person shopping. A stronger field bodes well for healthy fundamentals going forward.

Private debt

Lenders continue to pursue new investments in neighborhood and community shopping centers with healthy tenants achieving healthy sales. Properties featuring major grocers, creditworthy discounters, and creditworthy home improvement stores often find receptive lenders willing to compete for financing assignments somewhat aggressively. Nonetheless, interest rates for the highest quality retail properties remain perhaps 10 to 15 bps higher than debt for similarly leveraged apartment and industrial properties.

Debt for high street properties, power centers, and lifestyle centers remains difficult to procure, particularly from insurance companies and banks, and significant loan structure (e.g., escrows and amortization) is often required. Debt for regional malls remains unavailable for all but the very best assets with top operators. Lenders focus heavily on tenant creditworthiness, tenant sales history, remaining weighted-average lease terms (WALTs), and sponsor quality, with widely disparate loan terms offered.

RETAIL (continued)

REITs

Retail REITs have modestly outperformed the broader index year-to-date. Concerns about the consumer persist but retail sales are holding up and the economy has outperformed expectations through the first half of 2024. Fundamentals remain strong as supply and demand fundamentals continue to favor landlords. Store closures and bankruptcy activity have ticked up but are offset by robust, broad-based demand from retailers amid dwindling availability and minimal new supply. Pricing power has improved reflected in stronger lease spreads and higher contractual rent escalators. Market conditions are expected to remain favorable into 2025 barring a major setback for the economy or retail sales.

Recent operating results from REITs were ahead of consensus driven by earlier-than-expected store openings and lower bad debt. Guidance for 2024 was raised by most but earnings growth of around 3% remains uninspiring as 2023 bankruptcies and higher interest expenses continue to weigh on this year's results. However, REIT management's outlook is bullish and growth is projected to accelerate in 2025 driven by the delivery of outsized pipelines of signed-not-open leases. Valuations largely reflect solid operations and healthy fundamentals with mall REITs trading at a 5 to 10% premium to NAV and shopping center REITs at a 0 to 5% discount.

CMBS

Retail's image has recovered significantly, fueled by a resilient consumer base, the spending drawdown in excess savings, and a robust labor market. Store closures have slowed dramatically over the past 2 years, and the entertainment-oriented transformation of malls has gotten back on track post-COVID. In conjunction with conduit transaction office exposures falling in 2023, retail exposure has increased back toward historical averages with 2023 and 2024 exposure at 29% and 28% respectively. Interestingly, once out-of-favor malls grew to 13% of conduit issuance in 2023 relative to 3% in 2022, supported by generally positive sales trends along with conservative underwriting metrics of >2.0x DSCR and sub-50% LTV on average.

Maturity stress from loans originated in 2012 and 2013 is still weighing on the conduit retail delinquency rate, which stands at 5.2%. CMBS servicers continue working with retail operators as loans approach maturity by providing loan extensions on performing properties, typically in exchange for fresh equity contributions. This approach seeks to maximize bondholder outcomes by keeping strong operators in place while avoiding near-term foreclosure at a time when valuations are depressed. Several regional malls currently facing refinancing challenges from these vintages have debt yields higher than 10%. Like the hotel sector, retail has benefited from the recent upside in economic activity. However, the health of the consumer and a potential pullback in spending need to be closely monitored for turning points.

SINGLE-FAMILY RENTALS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
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Private equity

The single-family and built-to-rent sectors remain healthy and well-positioned. Fundamentals are strong, driven by solid demand and favorable affordability metrics compared to both the single-family for-purchase market and equivalent multifamily units. While rental growth has slowed compared to the previous year, this trend has been exacerbated in a few metros due to increased build-to-rent activity. Although lower interest rates could improve affordability in the for-purchase market, elevated home prices will likely limit a broader shift in the near term.

Private debt

The decline in bank lending activity has had a large impact on the single-family rental debt market. Developers and institutional investors who own non-stabilized properties now often must seek debt fund capital for their financing needs, which increases their cost of funds. For stabilized single-family rental properties, Fannie Mae and Freddie Mac remain the dominant lenders in the market.

REITs

The single-family rental sector has lagged YTD with underperformance primarily occurring in recent months. While the sector continues to benefit from highly favorable affordability dynamics, the prospect of lower mortgage rates has weighed on sentiment for single-family-rental owners in recent months as it will make buying a home incrementally more attractive. Additionally, impacts from build-for-rent supply are being felt in select markets (Phoenix and central Florida) and have caused pockets of weaker pricing power.

Recent operating results have been mixed relative to expectations but remain superior to traditional apartment owners in terms of higher blended rental spreads and faster income growth. Single-family-rental REITs have also benefited from reduced expense growth expectations, although outsized property tax pressure in recent years has likely made management teams cautious on this line item. Single-family rental REITs are trading at mid-single digit discount to consensus NAV estimates, at a mid-teen discount to the REITs index.

DATA CENTERS

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↑	↑	↑	↑	↗	↑	↗

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Private equity

The data center sector remains red hot, with demand outpacing supply and projected to remain strong with the potential for additional AI-driven demand yet to hit the market. Vacancy rates among the top 10 North American markets are below 2%. Rental growth in core markets is approaching 30% on a year-over-year basis, as new supply cannot keep pace with increasing demand.

The first half of 2024 saw a record number of new deals signed (>3,000 MW), 75% of which were in the U.S., according to data from Green Street Advisors. The sector is also among the few posting a positive capital value in the NCRIF NPI as institutional investors are actively pursuing the sectors within both core and opportunistic strategies.

The primary headwind to the sector remains high development costs and extended construction timelines. The availability of power is the primary source of development bottlenecks today and it has forced some hyper-scalers to take on significant leases or develop new capacity themselves.

Private debt

Private debt capital remains available for data center properties with long-term leases to investment-grade tenants. The very large loan sizes associated with the property sector means that borrowers typically need to work with investment banks to arrange that financing. Funding terms and pricing are lender-friendly today.

REITs

Data center REITs have had split stock performance relative to the broader real estate index year-to-date. Nonetheless, updates from large technology companies continue to support optimism that artificial intelligence (AI) will provide significant tailwinds for the sector. Data center REITs are seeing AI-related deployments in their portfolios. From a broader fundamental perspective, REITs are benefiting from favorable supply and demand dynamics in many key markets, which continue to support market rental rates and pricing conditions.

Despite record levels of leasing seen in recent quarters, data center REIT management teams are not seeing signs of slowing demand momentum and have accessed accommodative capital markets to help fund growth. From a valuation perspective, data center REITs trade at premium valuation multiples and higher premiums to NAVs relative to other property types.

STUDENT HOUSING

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
→	→	↗	↗	↘	N/A	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

The student housing sector continues to perform well, with preleasing reported at 89.2% through mid-year. Rent growth remains healthy at 4.7% according to Yardi Matrix. The supply of new inventory to deliver in 2024 is 41,432 beds, down 5% from 2023, which will allow the sector to remain in equilibrium in the near term. The primary challenge to the sector will be a shift in demographics that has provided a tailwind for college enrollment over the past three decades. The population of individuals aged 10 to 14 years old is 5% below those aged 15 to 19 and will continue to shrink, based on Census population projections, over the next 10 years. As this trend develops the student housing sector will become more difficult to paint with a broad brush and will require more detailed tracking at a regional and university level that tracks more detailed enrollment trends.

☐ LIFE SCIENCES

Sector rating	New supply	Demand	Rent growth	Capital values	REIT pricing relative to NAV*	Debt availability
↓	↓	↘	↘	↓	↓	↘

Key: ↑ Positive ↗ Moderately positive → Neutral ↘ Moderately negative ↓ Negative

*REIT pricing relative to NAV: Red/downward yellow signifies prices are trading at a discount, upward if trading at a premium.

Private equity

The life science sector continues to face significant headwinds following a stellar performance during the pandemic. The national vacancy increased to 23.8% in Q2 2024 a 14.4% increase from Q1 2020. New supply deliveries remain elevated as U.S. lab space totaled 171.6 million square feet at mid-year 2024 a 14% increase over the same period in 2023. Adding to supply-side challenges, demand for space remains as a sharp decline in venture capital funding, an uncertain economy, and higher interest rates combined to slow the growth projections of life-science tenants.

There are nascent signs that venture capital funding for health sciences and bio-technology companies is increasing in key markets. Given the supply and demand imbalance, the sector will remain challenged in the near term. We continue to see pockets of potential strength in key educational corridors such as Cambridge (Boston), San Francisco, and San Diego the synergy between top research universities and life science companies will generate growth for the sector.

Private debt

Lender appetite for life science property investments has waned recently as the market deals with softer conditions. For those life science properties that do find lender interest, lenders focus heavily on tenant creditworthiness due to the sector's reliance on venture capital financing. Life science properties in major research hubs may find receptive lenders, but those located in secondary markets are likely to have trouble procuring financing without offering recourse or other substantial credit enhancements.

REITs

Life science-focused REITs have had split stock performance relative to the broader REIT index year-to-date. Notably, the REITs have reported signs of improved leasing activity but not enough to change the narrative around the broader supply-demand imbalance. Elevated and still increasing availability rates in key markets remain a concern. Additionally, with new supply pipelines under construction, lab real estate operating fundamentals are likely to remain under pressure beyond 2024.

The two primary life science-focused REITs appear relatively advantaged relative to the competition given their real estate market positioning, strong tenant relationships, and healthy balance sheets. Even so, their portfolio mark-to-market rent cushions have been narrowing—but are still positive—while in-place operating portfolio occupancy levels have been at least marginally pressured on a year-over-year basis. As it relates to valuations, Life Science REITs are trading at discounts to NAV, although above trough levels seen in 2023.

CMBS

Life science properties continue to represent a bright spot in the CMBS office landscape from a performance perspective, and the sector continues to play a role in the SASB market. Investors are still requiring elevated risk premiums to compensate for the fact it is categorized as office and growing supply pressure on rent growth, but we have seen deals with investment grade tenants on long leases in strong markets well received in the market. Location, tenancy, and sponsorship are becoming increasingly important as more square footage continues to be added to the life science sector.

Risk considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. Fixed-income investment options that invest in mortgage securities, such as commercial mortgage-backed securities, are subject to increased risk due to real estate exposure. Floating rate debt instruments are subject to credit risk, interest rate risk, and impaired collateral risk, which means that the value of the collateral used to secure a loan held by the fund could decline over the course of the loan. Credit risk refers to an issuer's ability to make interest and principal payments when due.

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