

ARA House View Midyear 2024

July 2024

U.S. Real Estate Investment Outlook

Cautious Optimism Prevails Given Moderation on Growth, Inflation Fronts.



Macroeconomic Context

- Economy has held up better than expected, and most indicators suggest a downshift is in progress.
- Labor market remains broadly supportive, though moderate slowdown is exacerbating households' battle with higher prices.
- Inflation taking the gradual path lower but remains above the Fed target.
- Slower growth is the expected price to pay for weaker inflation; we expect a more hawkish Fed to persist through much of 2024 and do not anticipate more than one rate cut.



Real Estate Impacts

- Stabilizing prices and modest improvements in cost of capital are fueling increased market confidence.
- Liquidity has come off the bottom, signaling a growing appetite to transact.
- Fundamental turning points emerging across sectors as supply cliffs come into view, though timeline hinges on depth of current oversupply and demand outlook.
- Differences in supply-demand at the subsector level are creating a dispersion in returns; selecting the right market and submarket can further enhance outperformance potential.



I. Macro Outlook

Economic growth is slowing:

- First quarter GDP growth slowed to a more sustainable pace.
- We believe slow growth is the best-case scenario for achieving a soft landing; maintaining the balance between growth and moderating inflation will be a delicate act.

Resiliency of consumers may be coming into question:

- The healthy labor market has supported consumer spending, though recent job gains have come from part-time (typically lower paying) positions.
- Fewer new full-time jobs and elevated credit card debt (with corresponding elevated interest rates) could curb this critical driver of the economy.

Higher-for-longer forecast remains intact:

- Inflation continues to moderate but has stalled a bit in recent months; Fed officials are willing to wait on rate cuts.
- Dot plot suggests higher neutral rates should be expected in the coming cycle.

Labor market remains strong, but the types of jobs coming online are facilitating a slowdown.

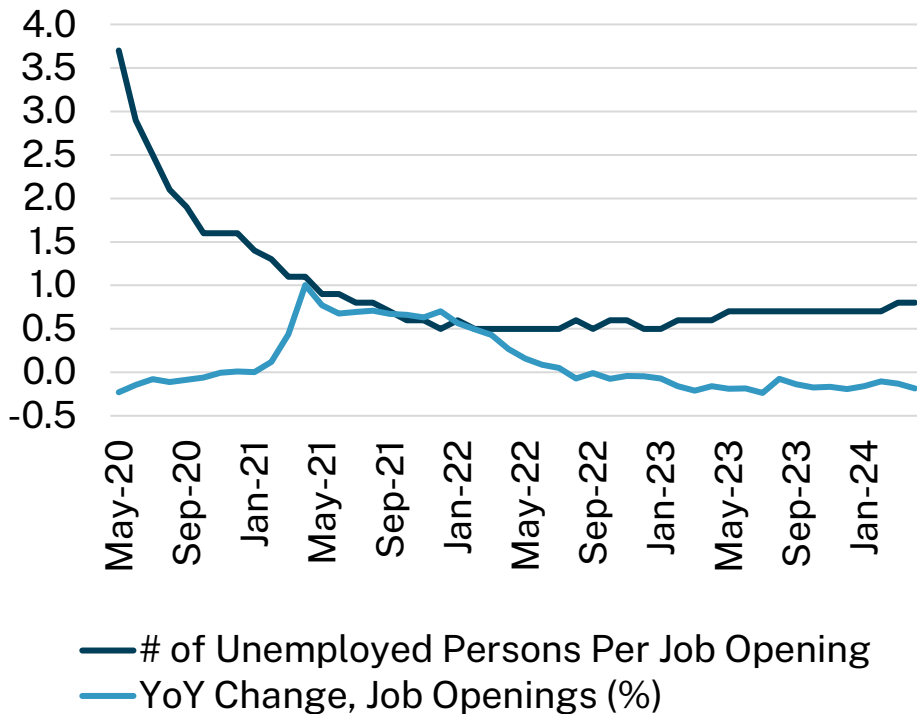


The number of job openings relative to those unemployed **has remained favorable to employees for the last 36 months, however, job openings year-over-year have been contracting.**

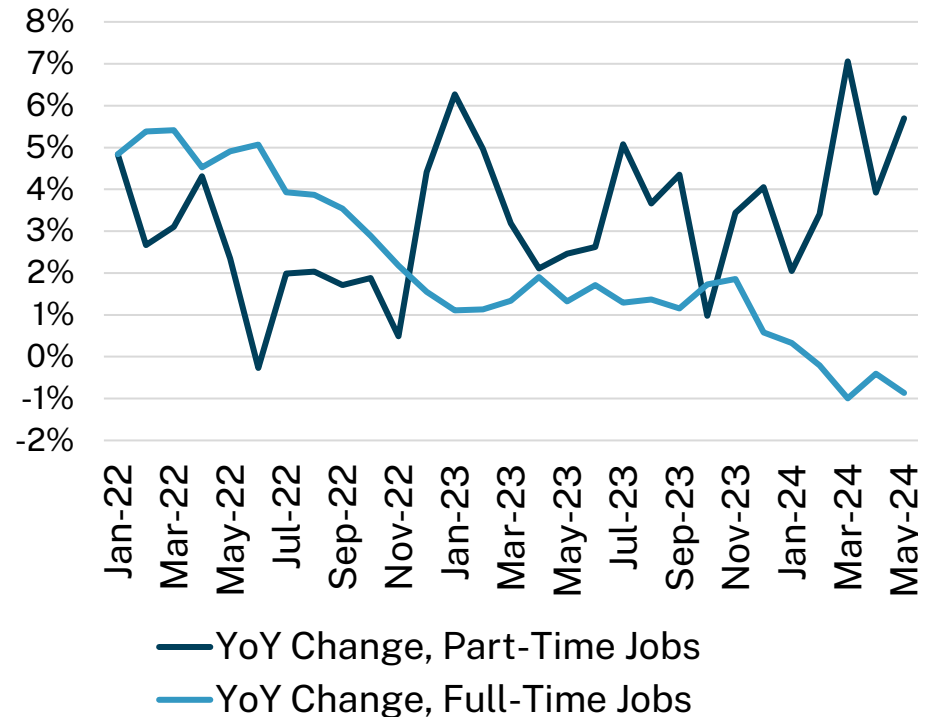


The U.S. economy has lost nearly 1.5 million full-time jobs in the last six months. **Part-time jobs typically pay less, which could put a strain on consumer spending power.**

Number of Unemployed Persons per Job Opening and YoY Change in Job Openings



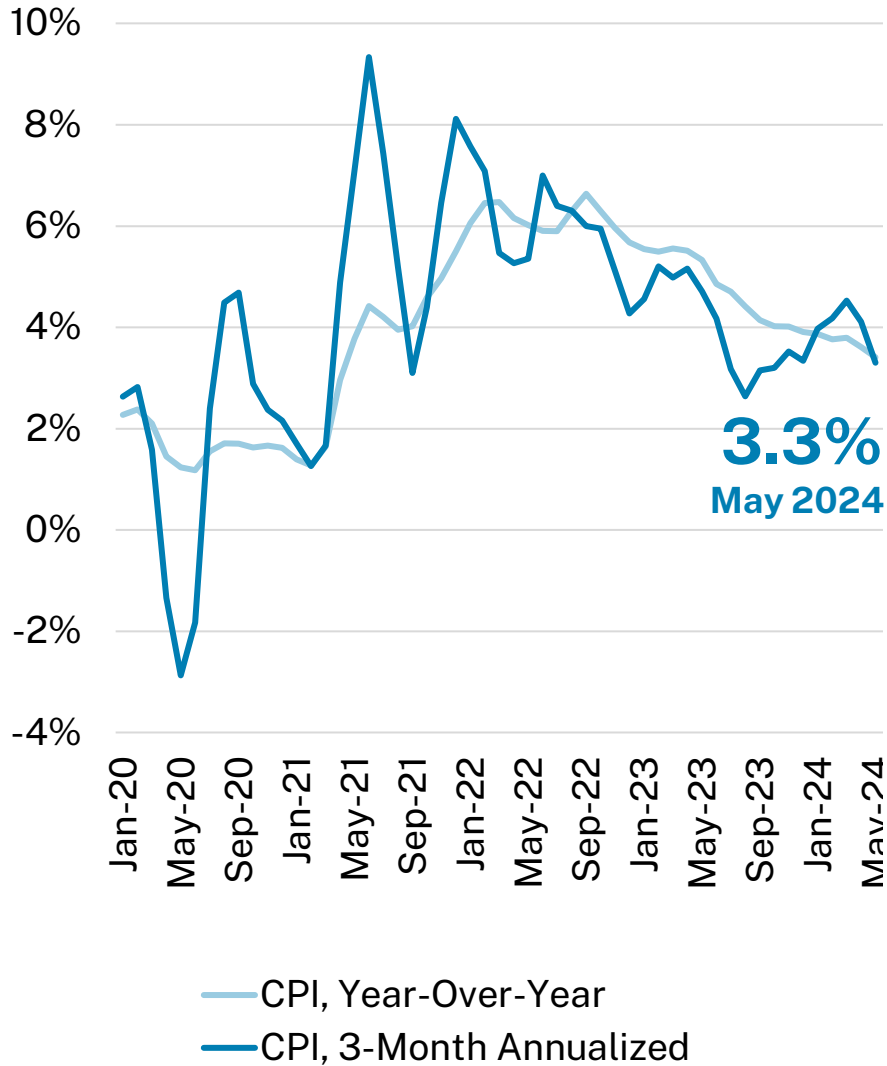
YoY Change, Total Nonfarm Employment, Part- and Full-Time



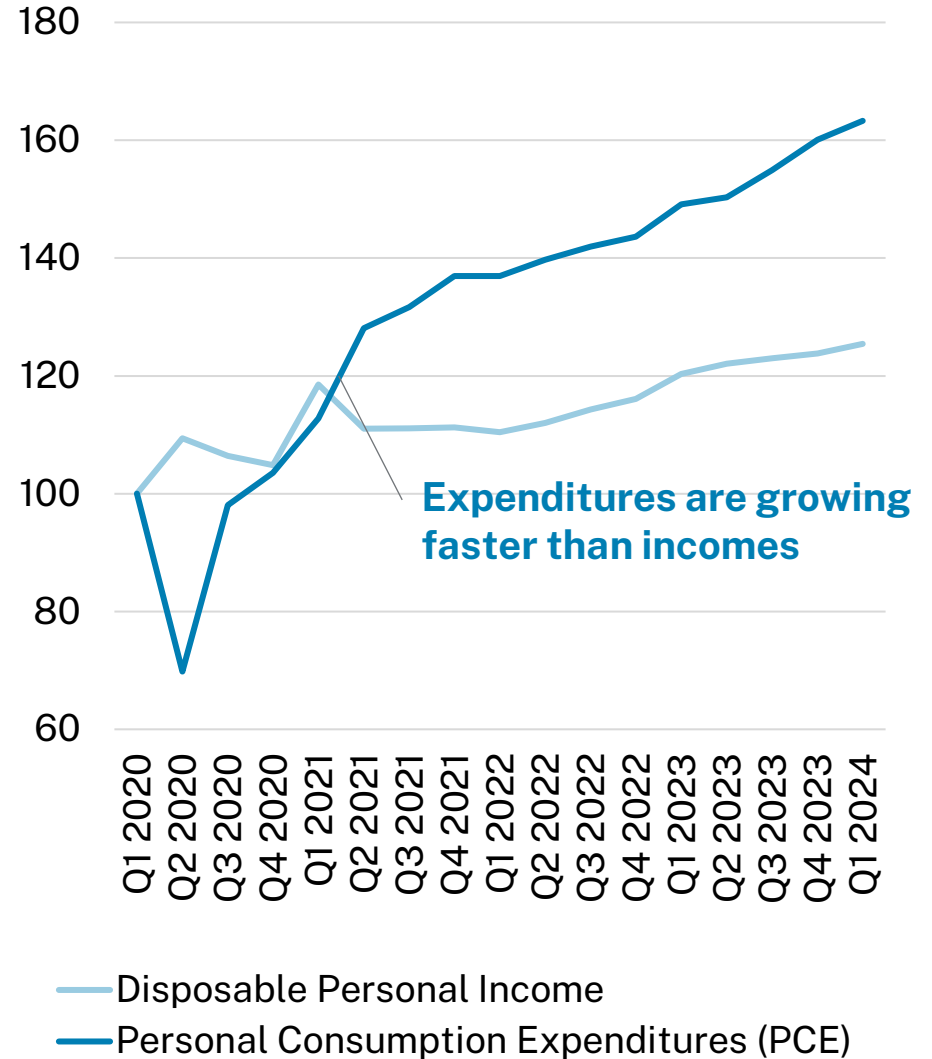
Source: American Realty Advisors based on data from U.S. Bureau of Labor Statistics as of June 2024. Unemployed persons per job opening data reflects seasonal adjustment.

Inflation is improving, but households feel the sting of higher prices.

Consumer Price Index



Personal Income and Expenditures, (Q1 2020 = 100)



Source: American Realty Advisors based on data from the Bureau of Economic Analysis as of June 2024.

Credit card balances continue to hit new highs as consumers turn to debt to offset higher prices.

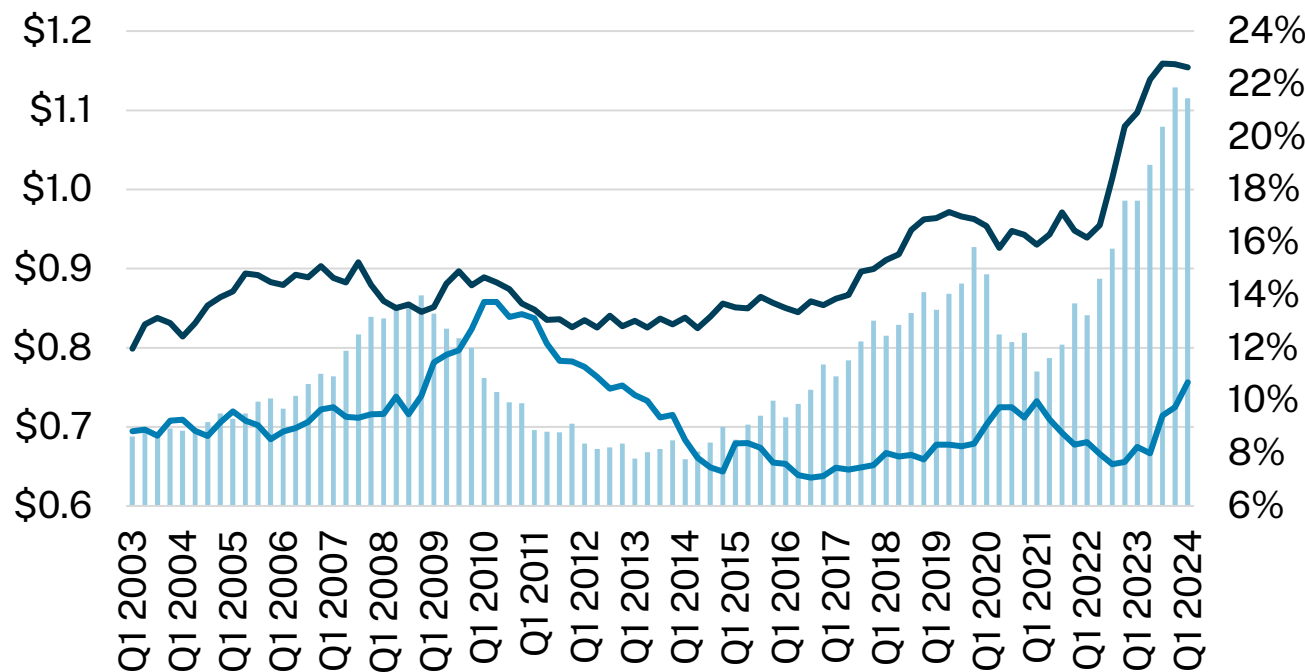


In the past four years, U.S. consumers have added credit card debt **2x faster than in the run-up to the 2008 financial crisis.**



In the same four-year period, **interest rate on this debt has increased 43.8%**, leading to an uptick in delinquencies.

Credit Card Balances, % Severely Delinquent and Average Annual Interest Rates



- Credit Card Balances (\$, tn, LHS)
- % 90+ Days Delinquent (RHS)
- Credit Card Interest Rates (on Cards with Interest, RHS)

Source: American Realty Advisors based on data from the Federal Reserve Bank of New York and Macrobond as of June 2024. Severely delinquent refers to accounts 90+ days delinquent.

Despite a more challenged consumer, economy still able to turn out steady growth in line with a soft-landing scenario.

First quarter GDP growth slowed relative to the prior quarter, but **the economy has held up better than expected.**

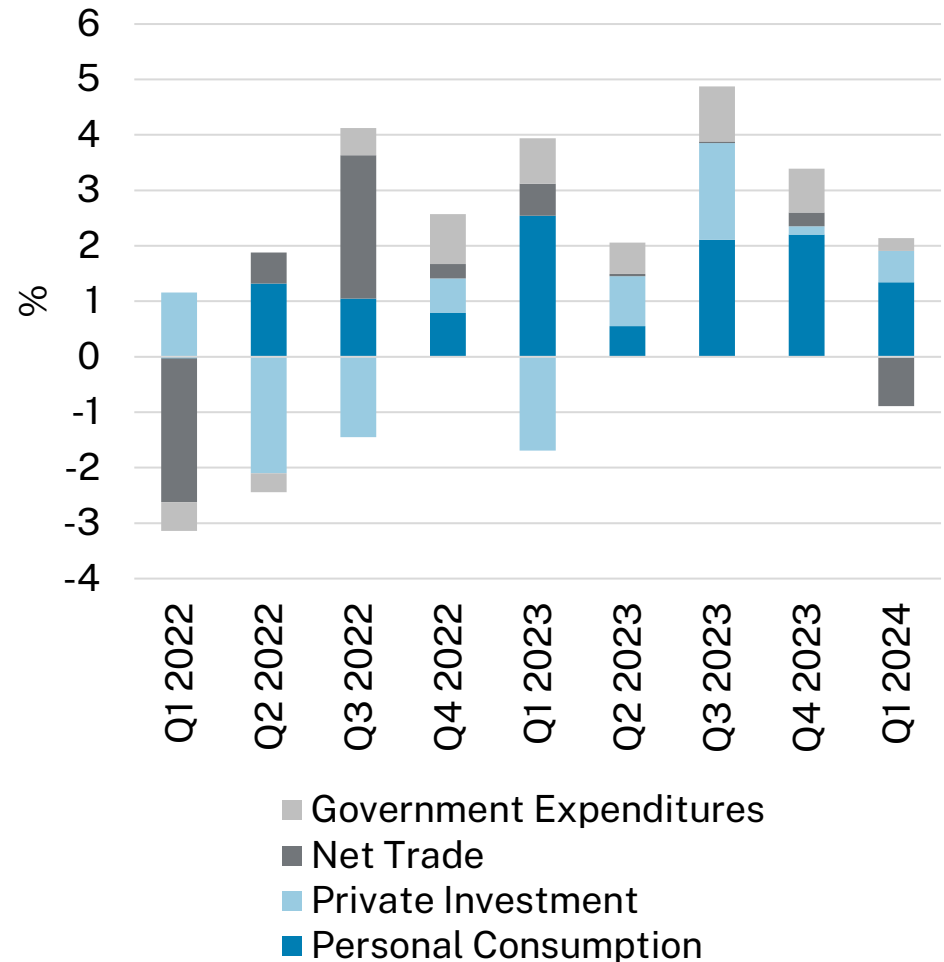


Real GDP growth slowed from an annualized 3.4% growth in Q4 2023 to 1.3% in Q1 2024, **the largest moderation since mid-2022** but a welcome development towards a soft landing.



The slowdown was the result of net trade – U.S. imports were greater than its exports; however, this suggests that **domestic demand remained strong.**

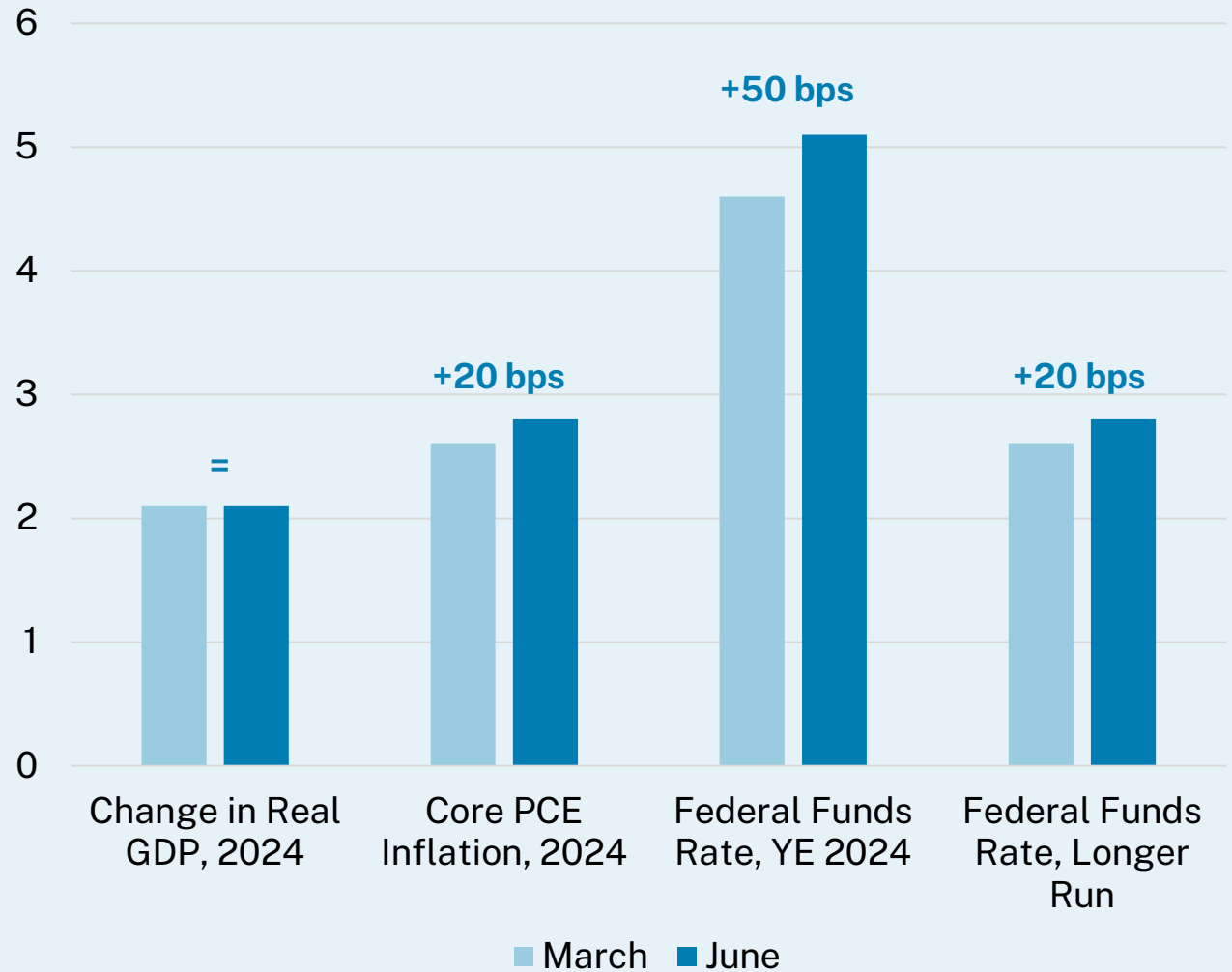
Contributions to Percent Change in Real GDP Growth



Source: American Realty Advisors based on data from the Bureau of Economic Analysis Q1 2024 GDP Second Estimate as of June 2024.

Fed's projections reflect expectations of a higher-for-longer interest rate environment.

Comparison of Fed Quarterly Projections, GDP Growth, PCE Inflation and Interest Rates March vs. June 2024



Source: American Realty Advisors based on data from the Board of Governors of the Federal Reserve System FOMC Summary of Economic Projections dated June 12, 2024 and March 20, 2024.



II. Capital Markets

Capital markets moving through their bottom:

- Distress momentum has moderated as workouts are offsetting a greater share of new distress.
- Pricing declines have slowed and, in some measures, started to reverse.
- Credit spreads have come down from recent peak, offering an improved relative cost of capital.

Real estate liquidity showing signs of improvement:

- CMBS originations reversed course in Q1 and hit the highest volume in nearly two years as non-bank lenders re-engaged.
- A proprietary broader measure of industry liquidity has improved, suggesting we have turned the corner.

Pivot to positive returns expected to follow:

- Core returns have historically trended with pivots in liquidity, which has moved from negative to neutral.
- Greater optimism on the outlook for real estate is driving an uptick in anticipated activity and allocations.

Moderation in net new real estate distress in the system signals market stabilization.

More workouts and fewer newly distressed loans is **moderating net distress**.

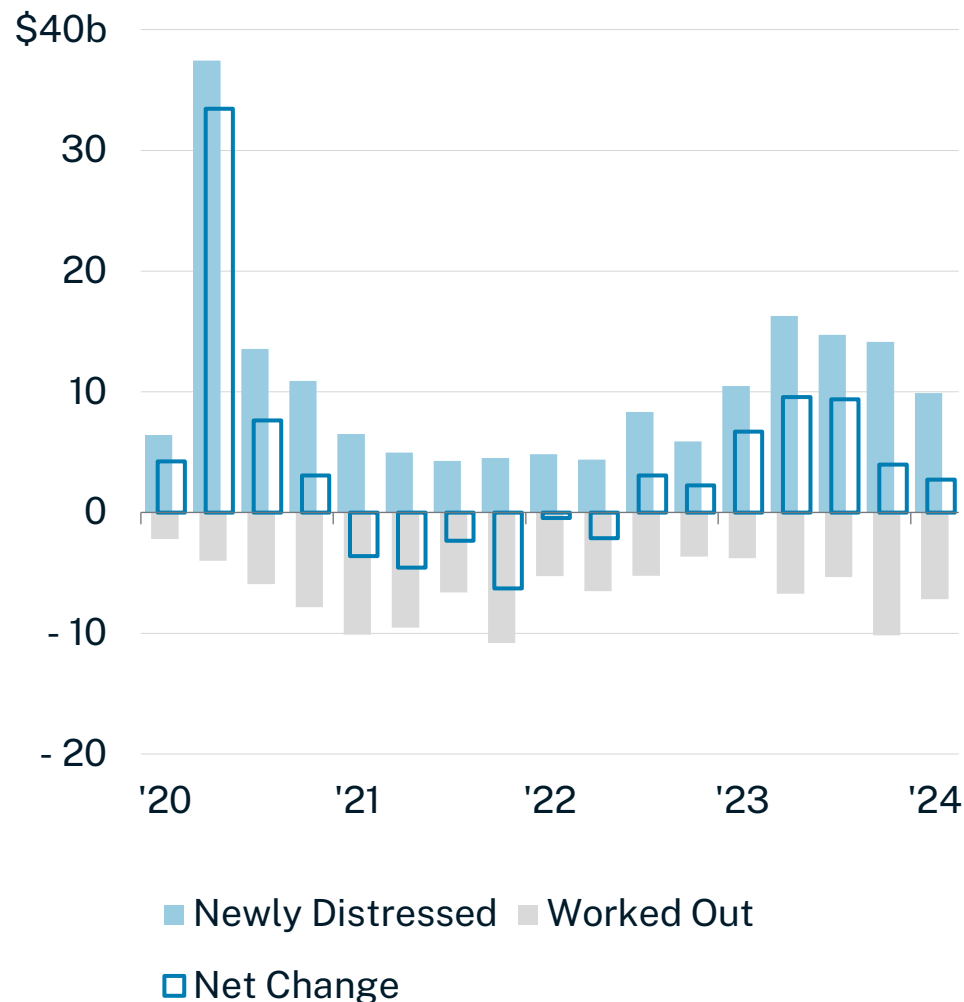


Net new commercial property distress increased \$2.7 billion in Q1 2024, down 59% year over year, marking the **third consecutive quarter of declining net additions**.



Cumulative distress this cycle remains less than half the GFC-era peak; while there is expected to be ongoing pain points in certain segments, a willingness by lenders to work with borrowers **reduces the risk of a widespread systemic sector collapse**.

Additions and Reductions to Real Estate Distress

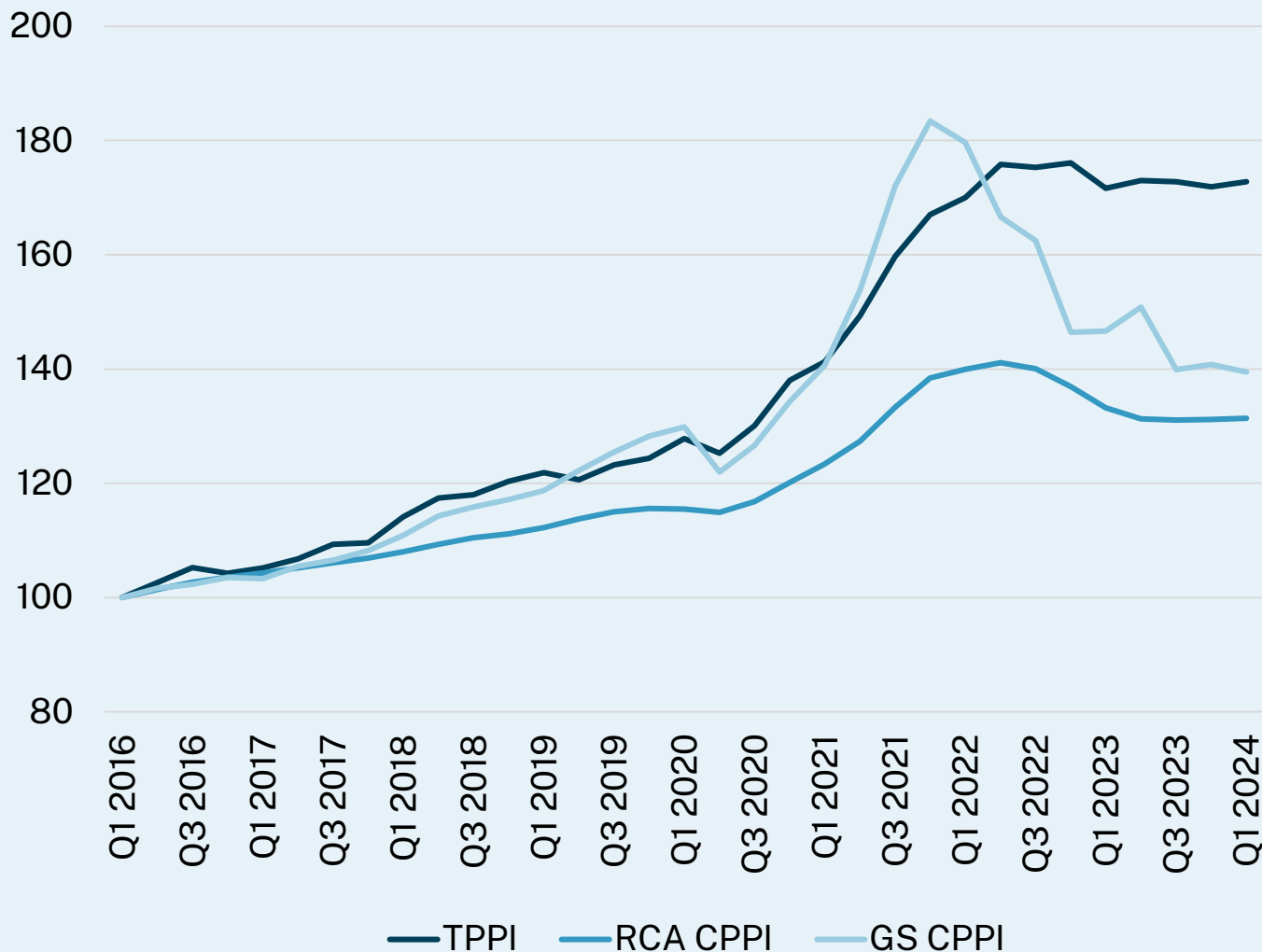


Source: American Realty Advisors based on data from MSCI Real Capital Analytics as of June 2024.

Real estate pricing beginning to find its footing as bid-ask spreads narrow.

Different Measures of Real Estate Pricing (Q1 2016 = 100)

After declining throughout much of 2023, **real estate pricing has stabilized in recent quarters** as market participants have gained greater conviction on rate and fundamental outlooks.



Source: American Realty Advisors based on data from MSCI Real Capital Analytics, Trepp, and Green Street Advisors as of June 2024. Green Street CPPI reflects an equal-weighted index of the industrial and apartment indices.

Lending market becoming slightly more favorable for borrowers.

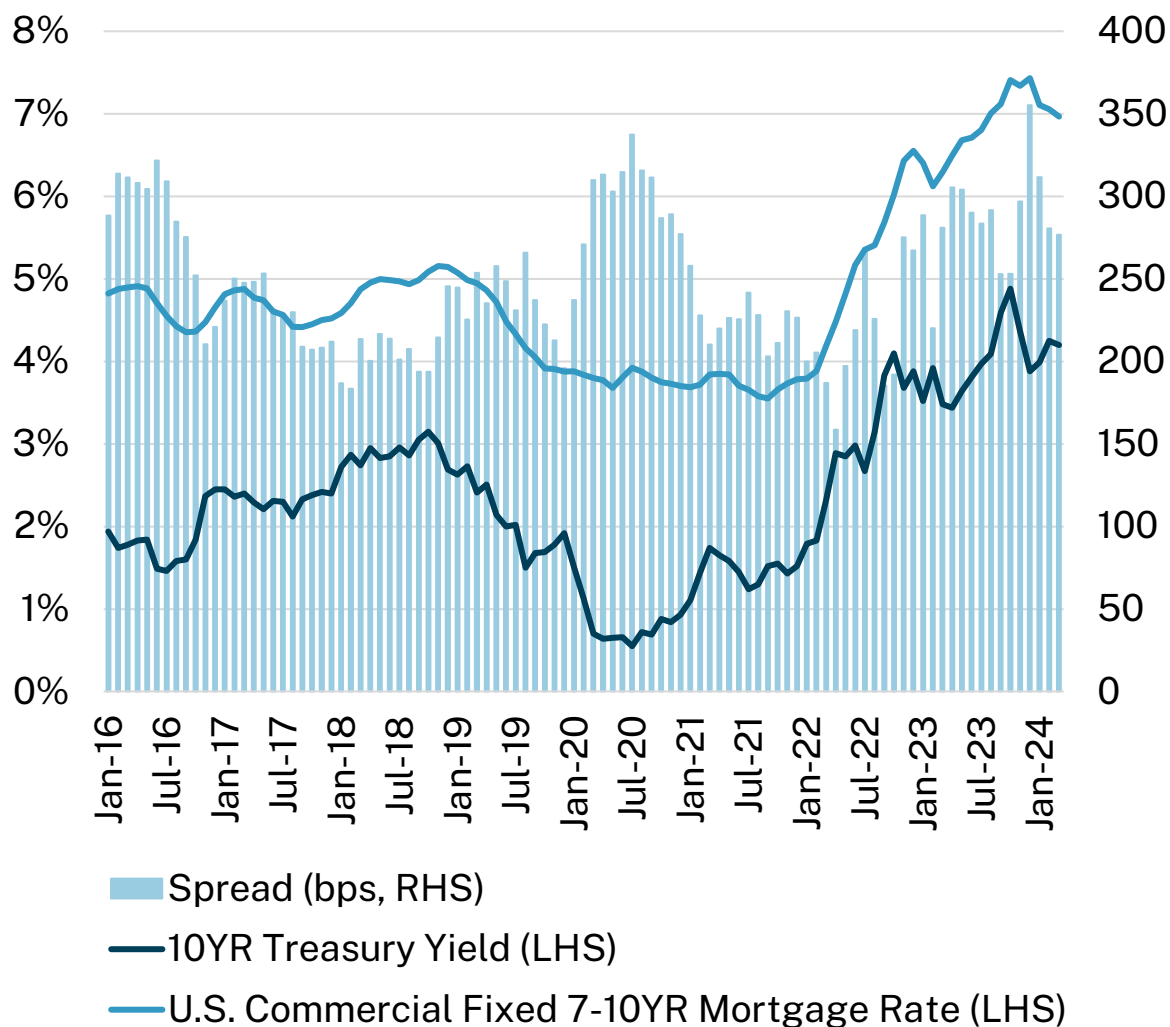


Credit spreads between the 10YR Treasury yield and fixed-rate commercial real estate loans **compressed by 35 basis points over the first quarter** to levels on par with late 2022 as investors have grown more comfortable in today's operating environment.



This may be because more investors have been moving into lower-risk strategies, fueling debt capital dry powder that then intensifies competition from private lenders.

Credit Spread Between 10YR Treasury and 7-10YR Fixed Rate Commercial Loan

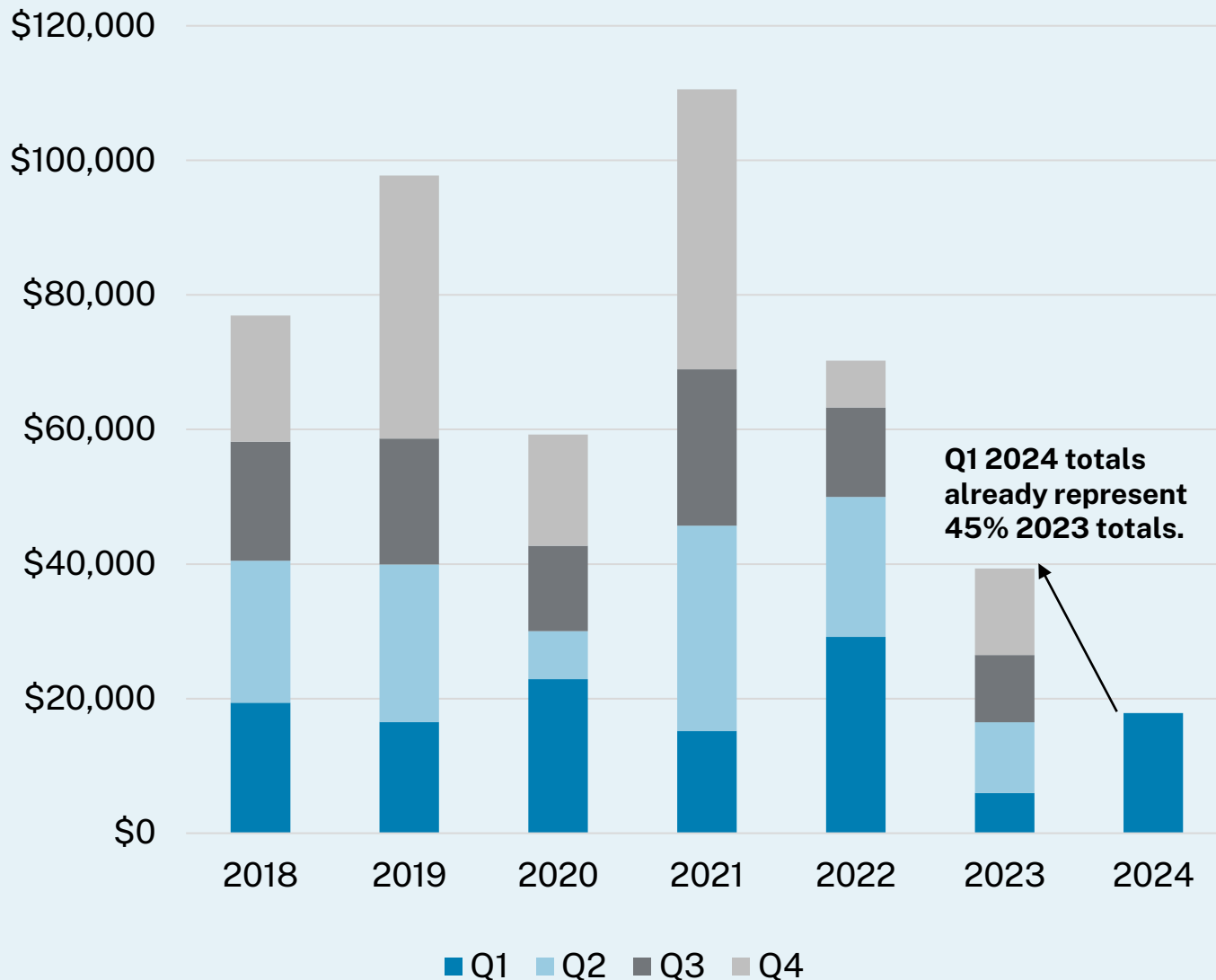


Source: American Realty Advisors based on data from Macrobond and MSCI Real Capital Analytics as of June 2024.

CMBS issuance has reaccelerated after a lukewarm 2023.

U.S. CMBS Volume (\$M)

CMBS has stepped into the liquidity gap left by more subdued bank lending. The strong quarterly surge (the largest since Q2 2022) reflects an improvement in confidence and a belief that **projects can produce positive cash flow at higher interest rates.**



Source: American Realty Advisors based on data from Green Street as of June 2024.

Broad measure of liquidity appears to have turned a corner, which bodes well for core returns.

Improvements in broad measure of liquidity have historically coincided with turning points in real estate returns.

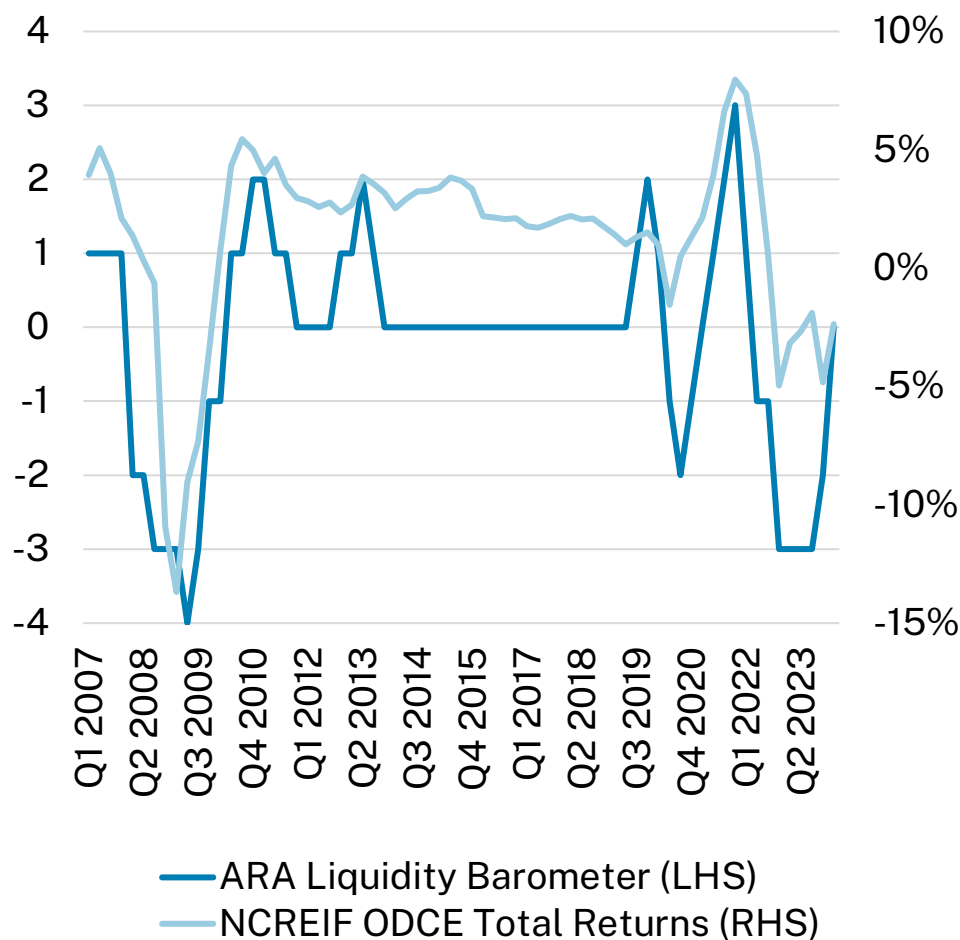


Having spent much of 2023 near maximum low levels, ARA's proprietary measure of **liquidity conditions improved meaningfully in the first quarter.**



The last time the liquidity barometer went from -3 to zero, core performance turned positive; core returns were still modestly negative in Q1 2024, but history suggests **the turning point for returns could be coming soon.**

ARA Research Market Liquidity Barometer and NCREIF ODCE Total Returns



Source: American Realty Advisors based on data from MSCI Real Capital Analytics, Green Street Advisors, FRED St. Louis and NCREIF as of June 2024. The barometer aggregates the sum of four broad measures that influence real estate liquidity – the average interest rate on commercial real estate debt, CMBS issuance, bank lending conditions and transaction volume – measured against their historic long-run normal bounds. ODCE returns reflect the gross total returns of the value-weighted index.

Improved investor sentiment reflects increasing appetite for investment activity.

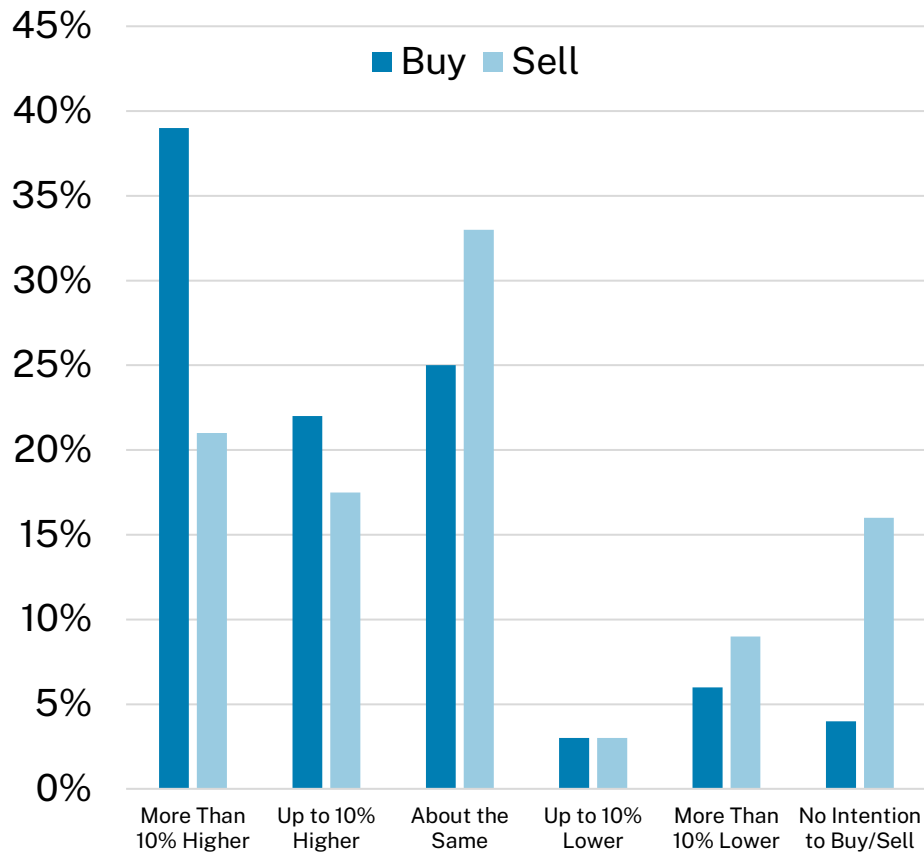


Over **60% of investors anticipate ramping up their real estate activity this year.**

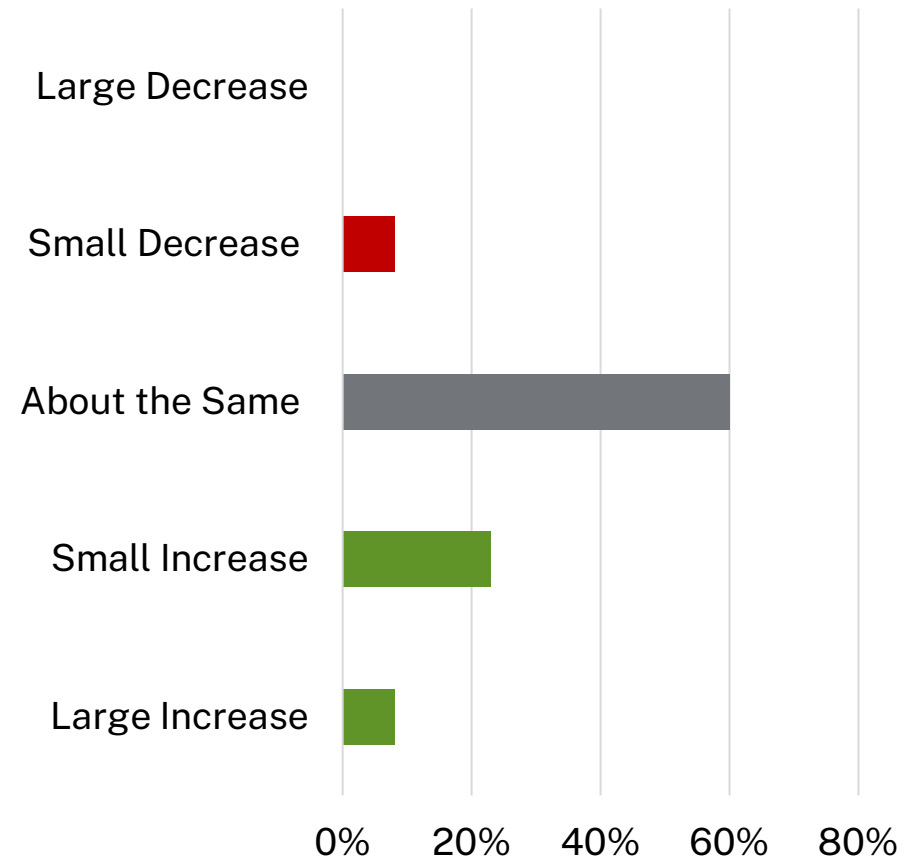


90% of U.S. investors are signaling an expectation to either **maintain or increase their allocations to real estate this year.**

Investment Activity Expectations for 2024 vs. 2023



Real Estate Allocation Expectations for 2024



Source: American Realty Advisors based on data from CBRE's U.S. Investor Intentions Survey 2024.



III. Property Markets

Selection matters more than ever:

- Dispersion in performance across a widened sector opportunity set is providing another mechanism for differentiating returns.
- Wide differences in fundamental outlooks within real estate subsectors suggests market, submarket, and asset selection will be crucial for driving outsized performance.

Supply receding is setting up a potential recovery in 2025:

- Industrial and multifamily are working through all-time-high levels of construction.
- Weaker relative fundamentals from the current supply plus elevated interest rates are spurring a pullback that should result in fewer deliveries starting in 2025.

Office sector still has hurdles to overcome:

- More than 200 million sf of pre-pandemic leases have yet to roll.
- Lower office-using job growth in a slow-growth GDP cycle expected to prolong recovery cycle, though lack of new supply should help.

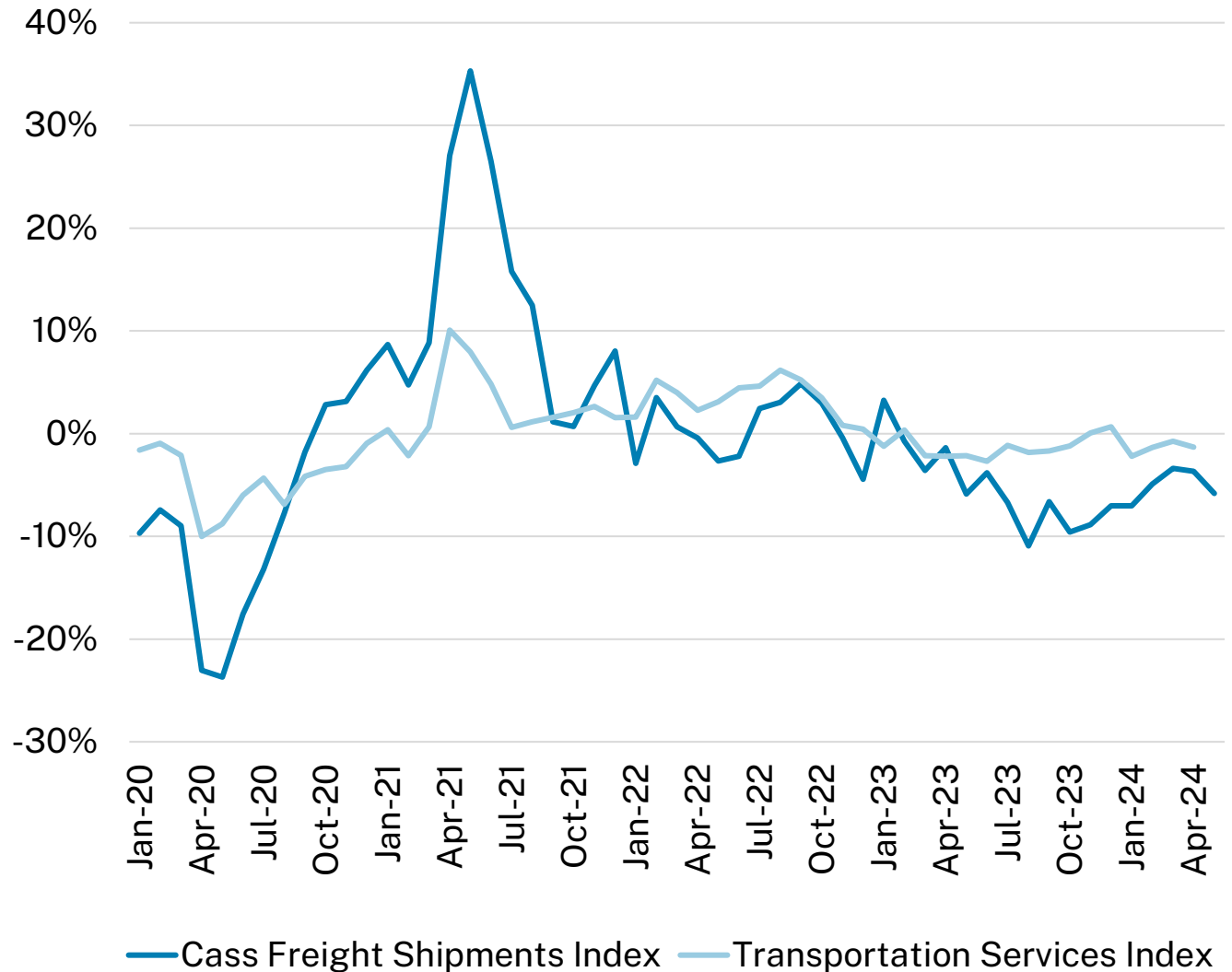
Industrial



Reduced goods demand from pandemic highs is **cooling freight volumes and demand for industrial space.**

As services continue to capture a greater share of consumer spend, **we anticipate flow-through volumes, and thus demand, will remain healthy but modest compared to pandemic highs.**

Year-Over-Year Change, Cass Freight Shipments Index and Transportation Services Index



Source: American Realty Advisors based on data from Macrobond as of June 2024. The Transportation Services Index – Freight measures the volume of services performed by the for-hire transportation sector encompassing activities of for-hire trucking, freight railroad services, inland waterway traffic, pipeline movements and air freight.

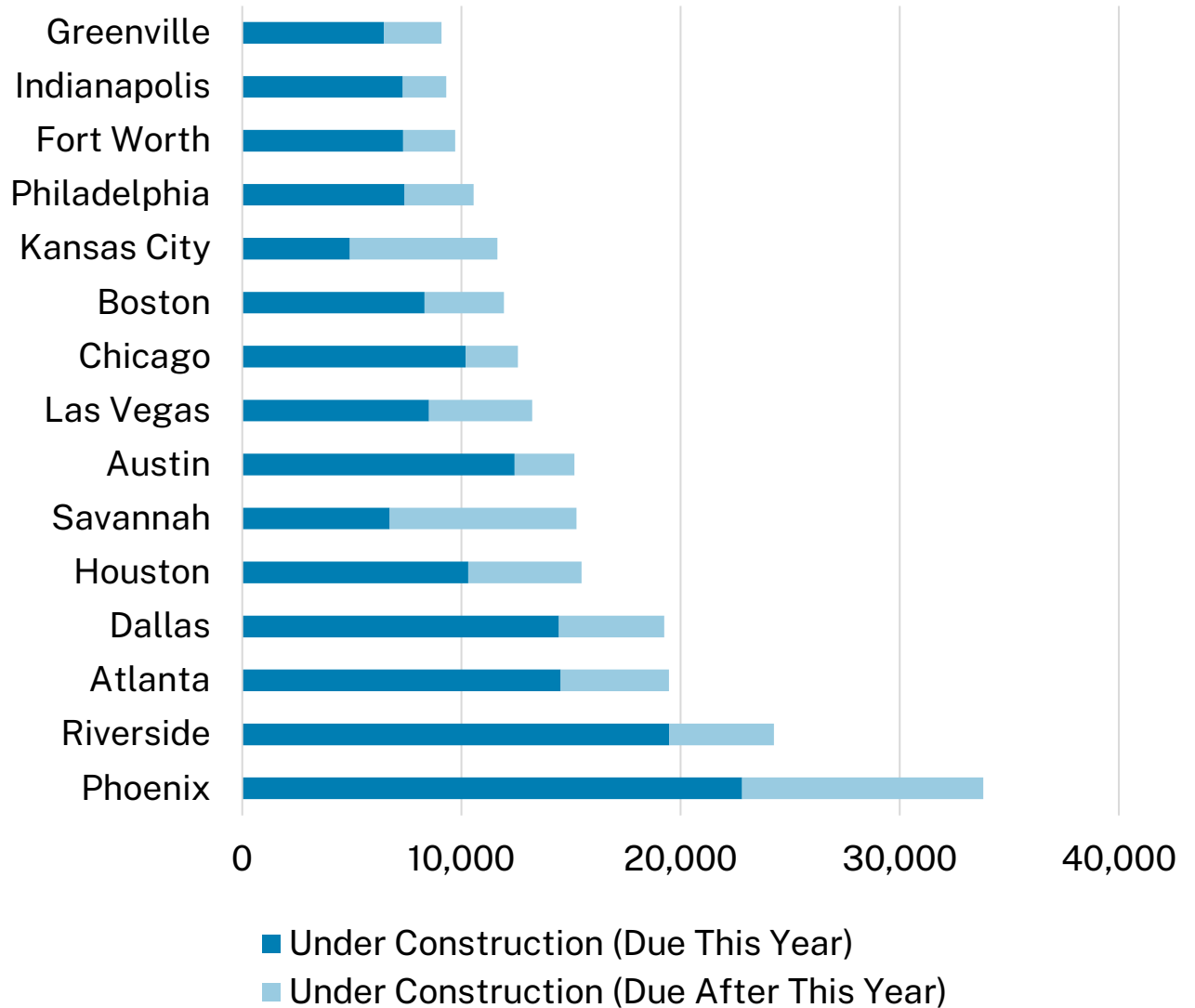
Industrial



Supply has proven challenging to industrial sector fundamentals, but **next year's pipeline looks much lighter.**

While we do expect **rent growth going forward to be more moderate** than the last cycle, a shutting off of the supply spigot beginning next year **should help stabilize vacancies** at levels still well below their long-term average.

Under-Construction Industrial Pipeline by Delivery, Top 15 Markets (million sf)



Source: American Realty Advisors based on data from CBRE-EA as of June 2024. Markets sorted by total square footage currently under construction.

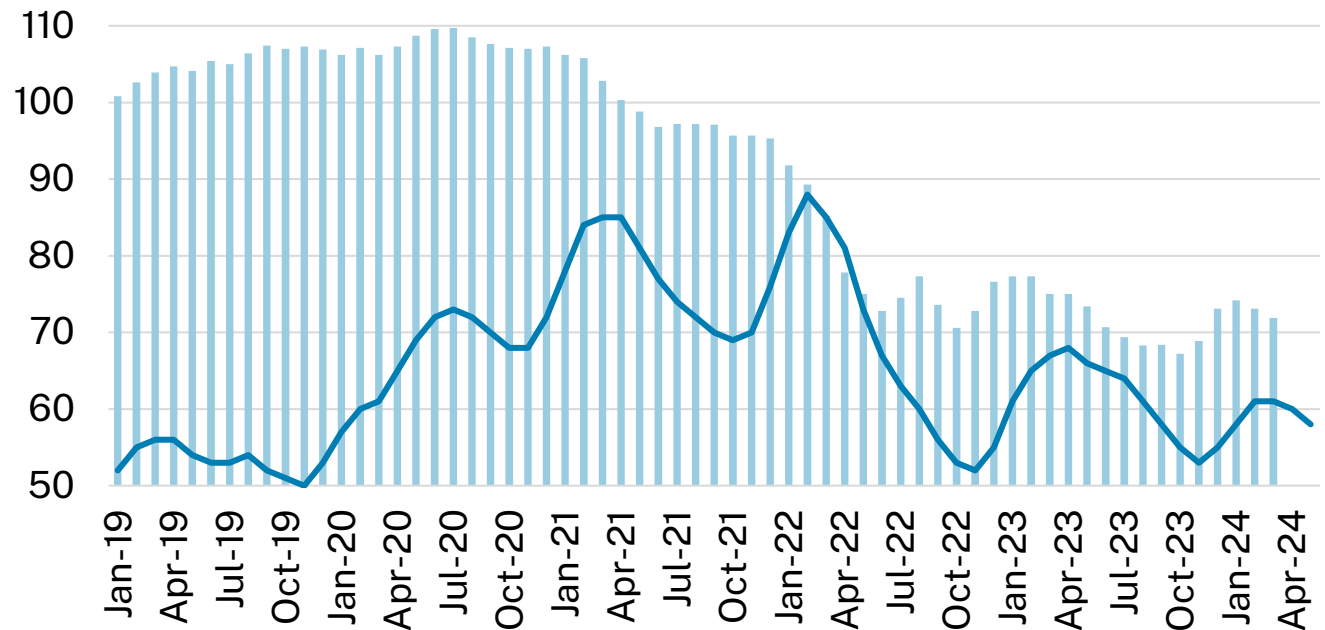
Residential



Competitiveness of the for-sale market has come down off recent highs, but affordability remains near all-time low levels **driving ongoing demand for rentals.**

- Zillow's Market Heat Index (a measure of the balance of supply and demand) reflects slightly cooler conditions today vs. one year ago, however **affordability has not improved to the same degree.**
- Though a reduction in interest rates could help ease affordability to some degree, the chronic under-housing nationwide is expected to keep purchase prices elevated, **forcing households to rent because "there is no alternative."**

Home Ownership Affordability Index and Zillow Market Heat Index



■ Home Ownership Affordability (< 100 = Unaffordable)
— Market Heat Index (>55 = Sellers' Market)

Source: American Realty Advisors based on data from the Federal Reserve Bank of Atlanta Home Ownership Affordability Monitor and Zillow as of June 2024.

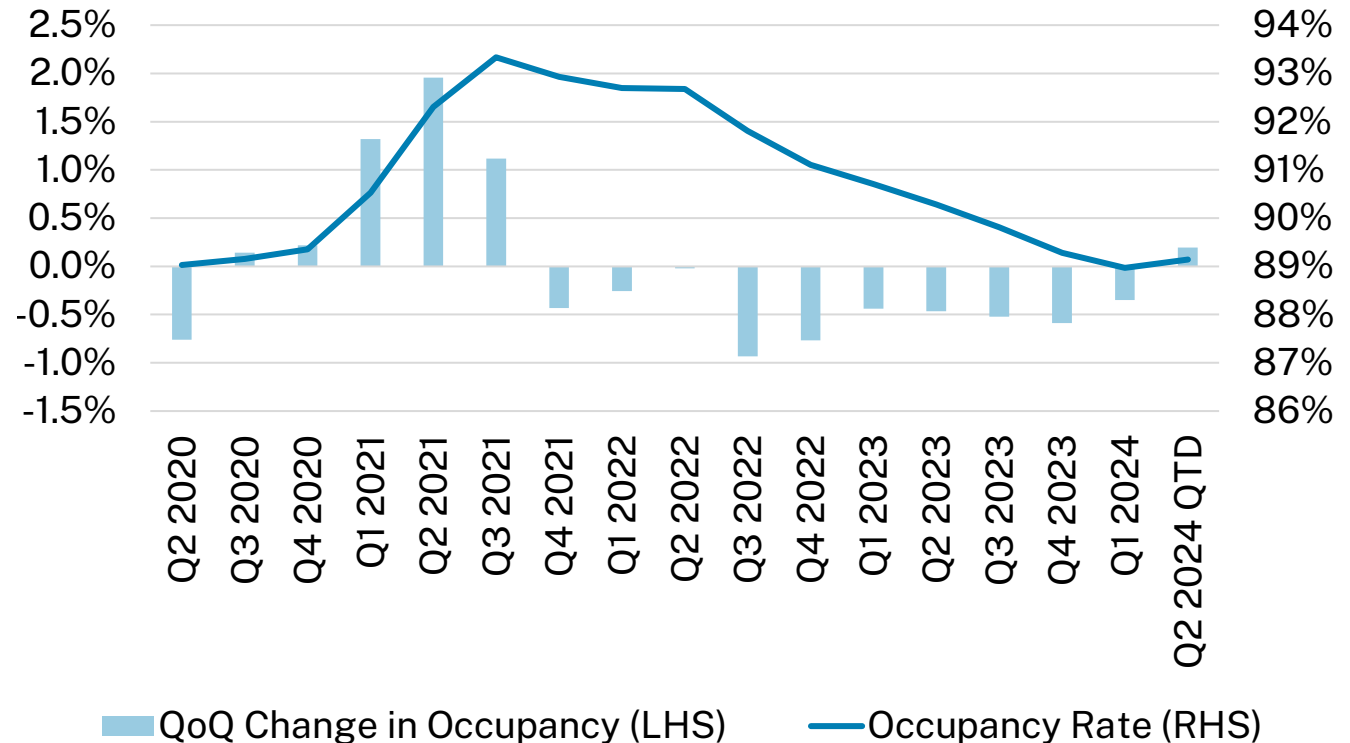
Residential



A gradual moderation in new supply combined with strong ongoing demand is fueling a **nascent recovery in apartment fundamentals.**

- After declining on a quarter-over-quarter basis for the last 10 consecutive quarters, **multifamily occupancy posted positive gains in Q1 2024.**
- Given the ongoing challenges for renters in the for-sale market, **we expect occupancy levels to continue to improve going forward** as demand remains elevated and supply begins to dwindle.

U.S. Multifamily Occupancy and Quarterly Change



Source: American Realty Advisors based on data from CoStar as of June 2024.

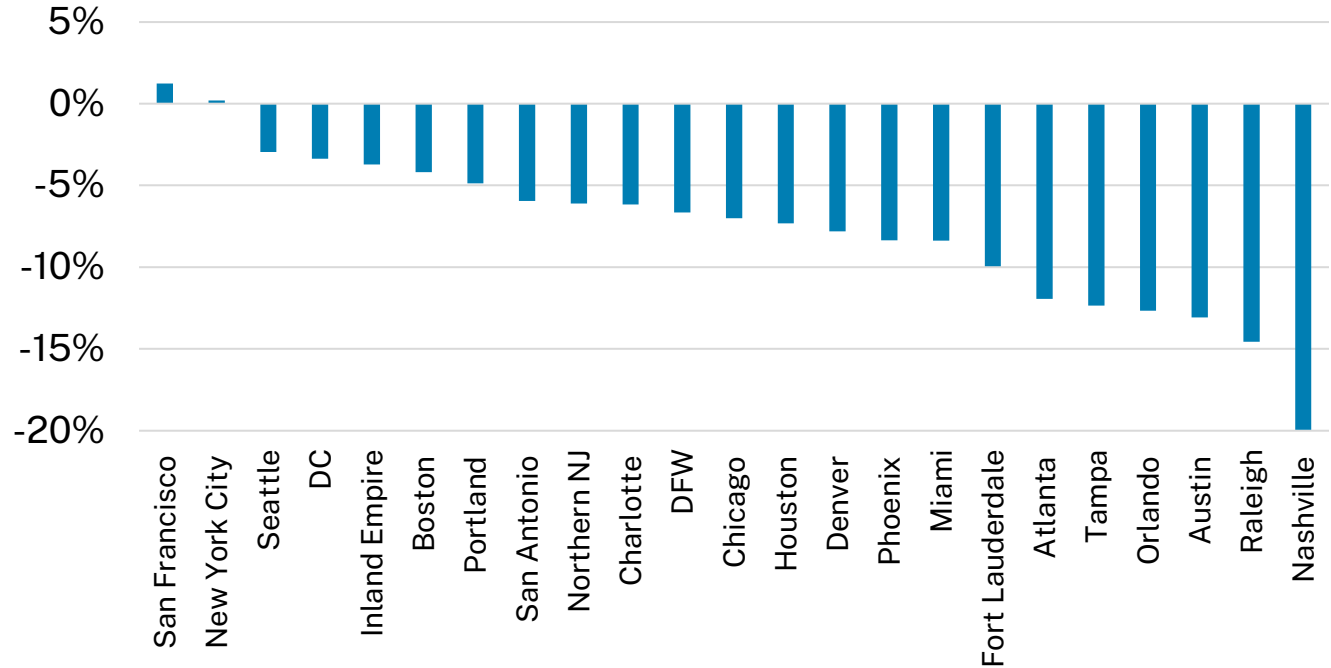
Residential



Oversupply dampened apartment rent growth in 2023, but **the next two years are expected to see considerably fewer units deliver.**

- After all-time-high deliveries in 2023-2024, investors are focused on where the subsequent supply cliff may represent **the strongest potential rebound.**
- Some high-growth markets that saw the most are expected to see the largest drop off in percent of supply added in 2025-2026 relative to what's delivering currently, **suggesting an improved mid-term outlook.**

Percentage Change, Forecasted New Supply 2025-2026 Relative to Deliveries in 2023-2024



Source: American Realty Advisors based on data from CoStar as of June 2024.

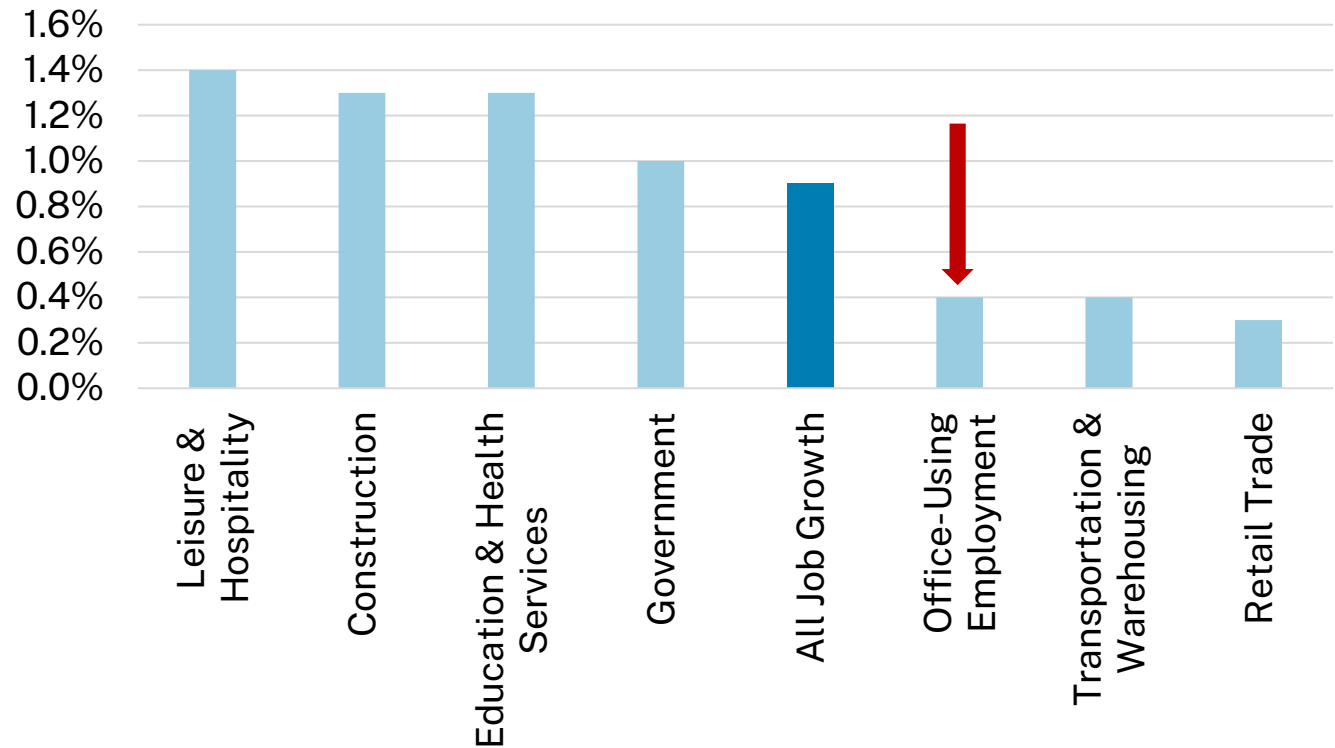
Office



More jobs are needed to produce the same demand relative to history given the altered relationship between jobs and space.

- Office-using employment growth is expected to average just 0.4% over the next five years, **less than half the overall national job growth rate of 0.9%**.
- **Lower growth in office-using jobs is likely to keep space demand tepid** and extend the sector's recovery timeline.

National Job Growth, Select Categories, 2024-2028 Average



Source: American Realty Advisors based on data from Oxford Economics and Macrobond as of May 2024.

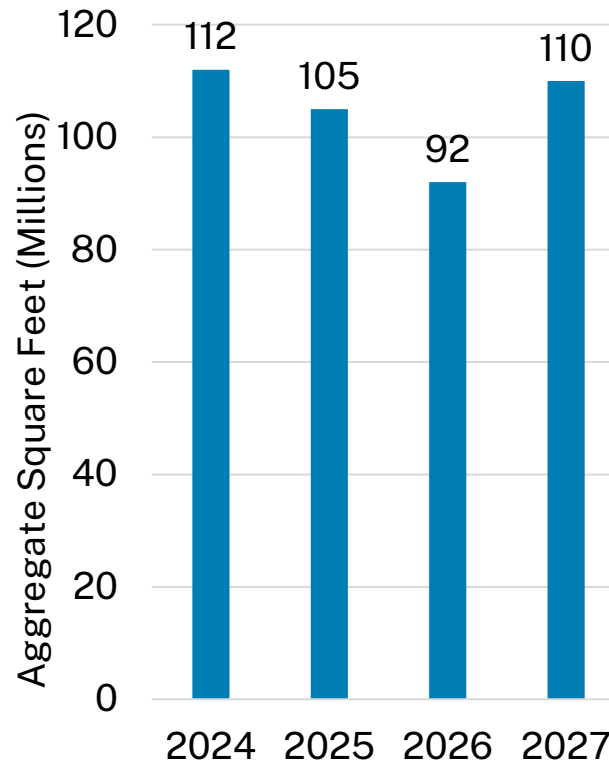
Office



217 million sf of pre-pandemic-era leases are expiring in 2024 and 2025, which may spur another round of downsizing as companies evaluate their needs.

- Several major office markets face further downside given **over half of all leases executed before April 2020 have yet to expire.**
- **Such elevated turnover risk could knock marginally improving office occupancies off track.**

Office Lease Expirations by Year



Share of Leases Executed Before April 2020 That Have Yet to Expire



Source: American Realty Advisors based on data from Credit IQ and CoStar as of May 2024.

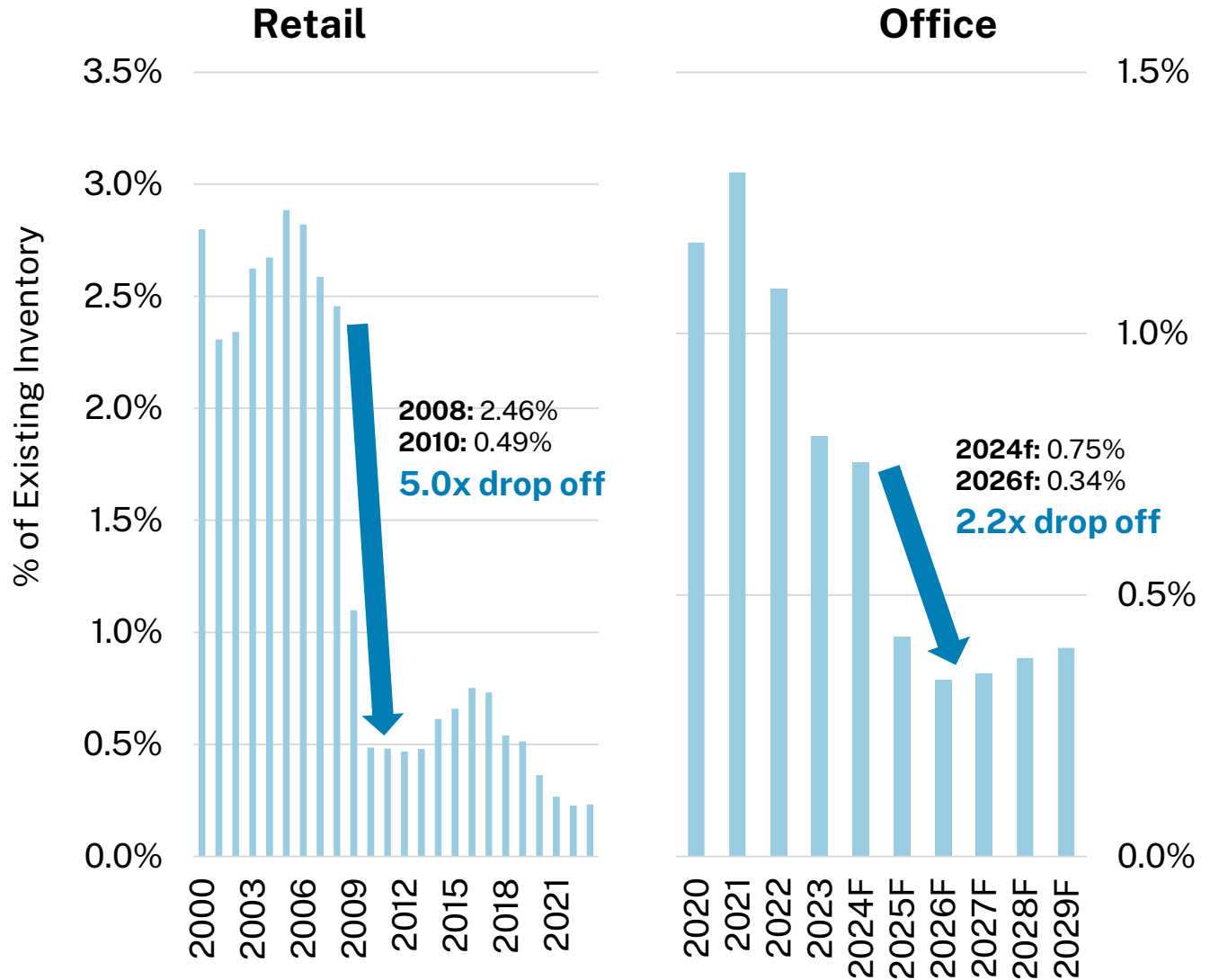
Office



A halt in new office construction should lead the sector into its **eventual rebalancing.**

Retail’s seismic shift post-GFC resulted in a 5x drop-off of new supply between 2008-2010 that supported its subsequent recovery; **office deliveries are expected to drop by 2.2x between 2024-2026.**

Retail Historic and Office Projected Deliveries



Source: American Realty Advisors based on data from CBREEA as of May 2024. f=forecast.

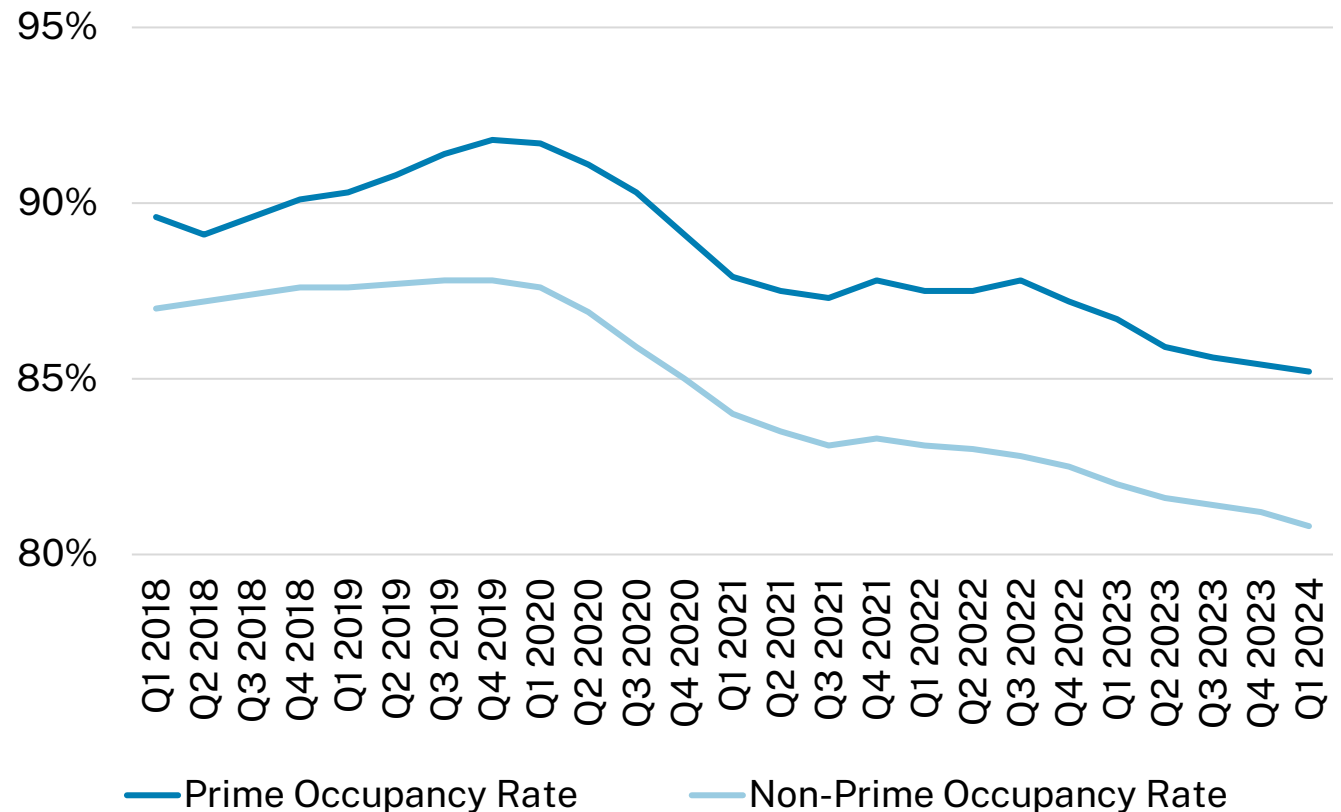
Office



Best-in-class offices are gaining a greater occupancy edge as **flight to quality persists**.

- Prime office buildings have historically had higher occupancy versus non-prime, but today **the gap is nearly 450 basis points**.
- With declining new office supply, existing prime buildings will benefit from less competition, **widening the gap between winners and losers**.

Office Occupancy Rate, Prime vs. Non-Prime Office



Note: Prime office is a CBRE proprietary distinction consisting of buildings classified as Class A++ in the top 16 office markets.

Source: American Realty Advisors based on data from CBRE as of June 2024.

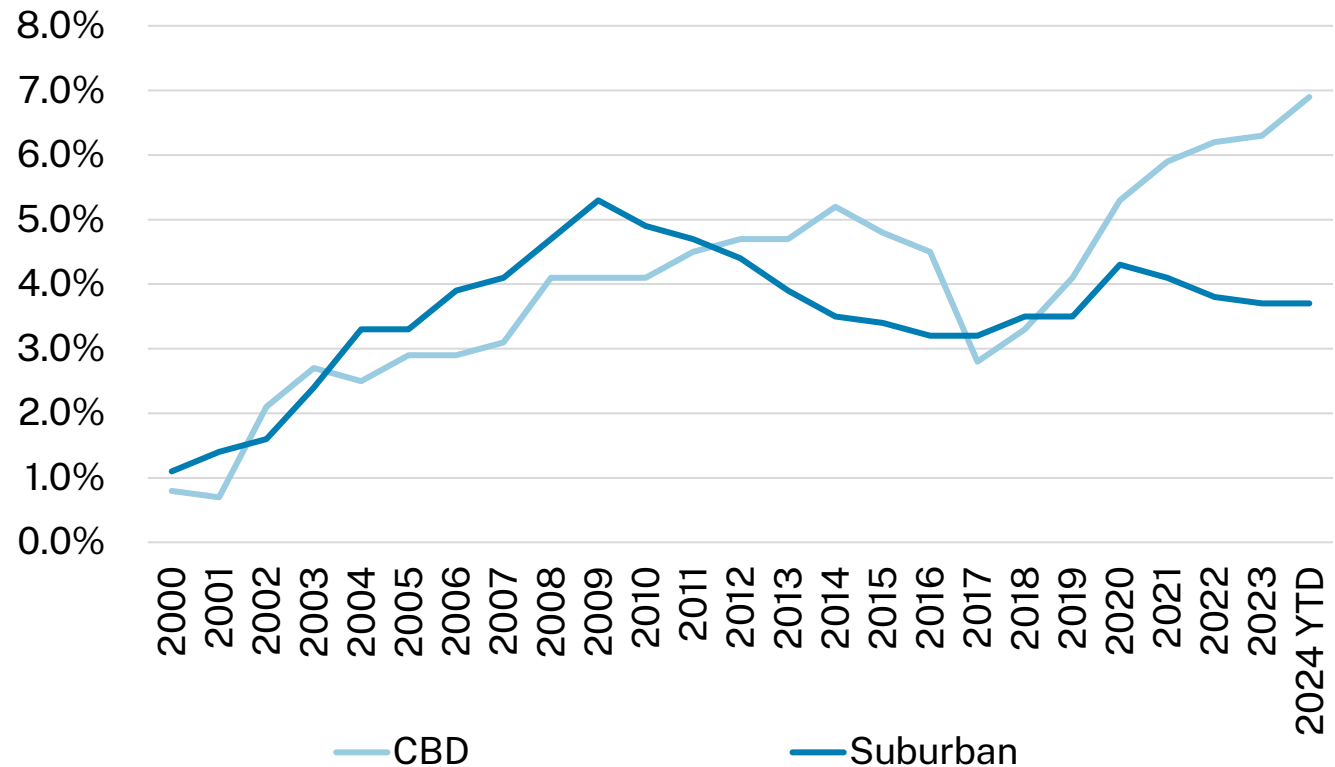
Retail



The gap between suburban, necessity-based and urban retail vacancies has widened in the last four years as **consumers spend more time near their homes.**

- Suburban retail has been the main driver of retail’s resilience as the segment has been **where vacancy has improved post-pandemic.**
- This bifurcation highlights a shift in consumer behaviors as **WFH has consumers shopping in their own neighborhoods more often,** a trend we expect to continue.

Retail Vacancy Rate by Location, 4&5 Star, 2000-2024YTD



Source: American Realty Advisors based on data from CoStar as of May 2024.

Subsector and market selection offering potential for more differentiation.

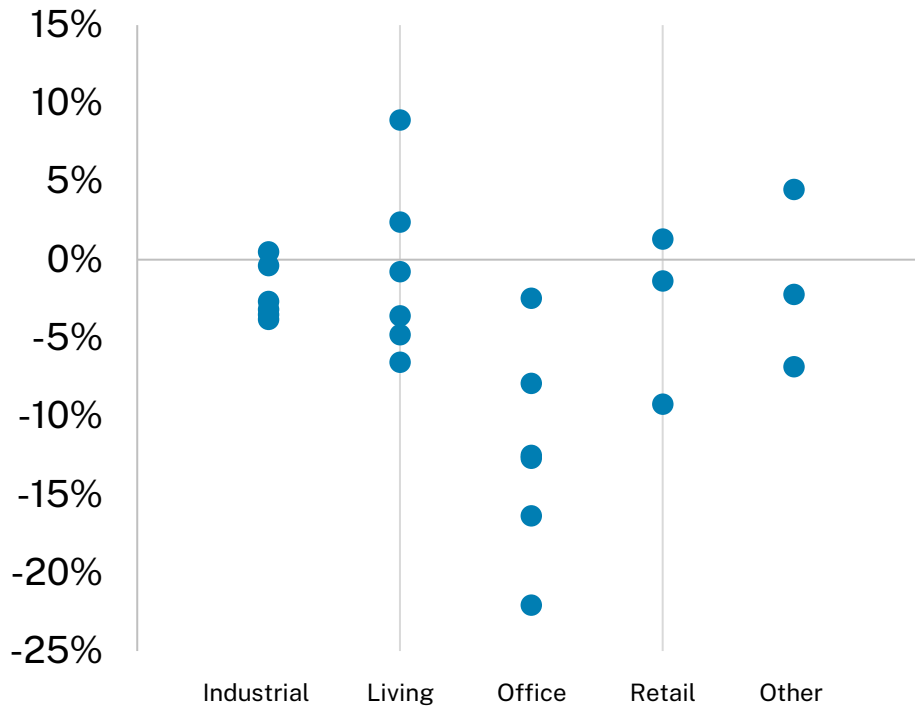


Varied returns among sector subtypes suggests the potential to **boost performance by choosing the right types within broader sectors.**

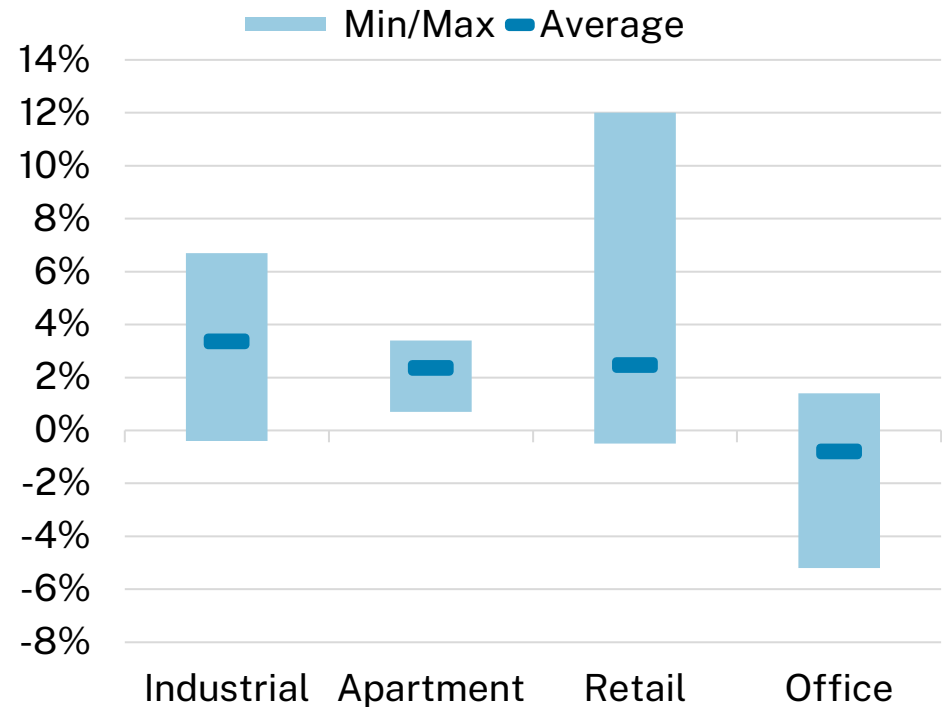


We think further performance enhancement is possible from geographic selection given the dispersion in rental growth outlooks within sectors.

Annualized Total Returns by Subsector Through Q1 2024



Dispersion of Rent Growth Forecasts by Market Sector, Next 2 Years



Source: American Realty Advisors based on data from NCREIF and CBRE-EA as of June 2024. The Living category encompasses all sub-types of residential as defined by NCREIF plus Assisted Living and Independent Living Senior Housing. Other includes Data Centers, Parking, and Self Storage.

Outlook for Property Sectors

Localized supply exposure is expected to drive near-term NOI growth prospects amid more moderate demand.

The current supply wave and softer fundamentals are prompting a pullback in construction starts that is expected to serve as the basis for a mid-cycle improvement in fundamentals.



Industrial

- Current oversupply impacting rent and occupancy rates but expected to rebalance by 2025.
- After a pause in 2023, major occupiers are shifting back into expansion mode.



Residential

- 2024 marks peak deliveries for many markets, with steep declines in 2025 - 2026 offering a much-needed reprieve for the sector.
- Despite supply headwinds, persistent demand stemming from affordability issues in the for-sale market should support sector fundamentals for several years.



Office

- Pre-pandemic lease expirations could trigger further downsizing as companies reassess their space needs amidst slower office-using employment growth.
- Decline in new space should help stabilize headline vacancy and further insulate demand for prime buildings by virtue of lesser competition.



Retail

- Hybrid work has shifted consumer behavior, driving neighborhood retail to outperform urban.
- Consumer spending remains steady despite stubborn inflation, though higher prices may mean a softening in discretionary retailer sales.



Specialty Sectors

- Varietals of primary industrial and residential property types such as cold storage, data centers, and SFR positioned well on the supply-demand spectrum.
- 28 of 30 top self-storage markets show positive monthly growth despite new supply in many markets.

Implications for Core and Value-Add Strategies

We believe that capital values are adjusting to the new reality of higher-for-longer interest rates, putting greater emphasis on operational execution and asset selection.



Asset Management

- Less potential for capital markets driven-cap rate compression reemphasizes importance of generating alpha through operations.
- Invest in technology and operational efficiencies to reduce costs and enhance property performance amidst a slow recovery.
- Prioritize improvements that directly enhance tenant satisfaction and retention.
- Seek to minimize out-of-pocket expenditures on commercial lease renewals to maintain effective rent levels.



Portfolio Construction

- Improved liquidity conditions should increase disposition opportunities.
- Prolonged rate plateau deepens housing undersupply by virtue of fewer starts; shore up residential holdings and take on lease-up plays at the right basis.
- Turning point in capital markets offering an early reentry signal.
- Identify markets where depressed asset values are a function of cyclical conditions and whose pipeline declines suggest the potential for a strong relative rebound once the recovery unfolds.
- Focus on investment opportunities in fundamentally good asset with overleveraged capital structures.

Summary and Strategy Implications

While there is still more navigating to be done to declare victory, we believe a slowdown in growth is the best-case scenario for achieving a soft landing.

- The economy has shown resilience despite a downshift in growth, inflation remains above Fed target, suggesting higher-for-longer environment.
- Consumers have continued to support GDP, but fewer full-time jobs and elevated credit card debt could weaken that growth engine.
- Capital markets approaching stabilization as values and liquidity improve and transaction appetite returns.
- Unlevered property-sector returns getting “less bad” and in some cases moving into positive territory as the fundamental outlook improves.
- Industrial and residential sectors facing back half of their oversupply waves, but new construction anticipated to fall materially over next two years.
- Office recovery timeline extended versus other property types given forthcoming lease expirations and low projected office-using employment growth.
- A widening dispersion of performance outcomes suggests sector subtype, market, and submarket selection will be critical performance differentiators.

Disclosures

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