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# US roundtable

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# US investors still hesitant amid 'shell shock'

*Interest rates may be close to peaking, and wider economic indicators are healthy, but real estate market activity remains muted, say participants in PERE's US roundtable. By Stuart Watson*

Hopes are growing that the US economy could yet manage a soft landing. The US Federal Reserve decided to keep its key interest rate at 5.25-5.5 percent in September, with officials seeking to curb inflation without tipping the economy into a painful downturn, and there are signs the central bank's strategy is working. Inflation fell to 3.7 percent in August, while unemployment is close to a 50-year low. The latest projections show the economy growing 2.1 percent this year and 1.5 percent in 2024 – more than previously estimated.

But the medicine of 18 months of interest rate rises has tasted bitter for real estate investors. Broker CBRE calculates that US commercial real estate investment volume fell by 64 percent year-on-year in Q2 to just $75 billion. Participants in *PERE*'s US roundtable,

PHOTOGRAPHY: **KEITH BARRACLOUGH**

**Shawn Lese**

Chief investment officer and head of funds management, Americas, Nuveen Real Estate

Lese leads a team of portfolio managers and oversees the end-to-end investment process across Nuveen Real Estate's $100 billion-plus Americas portfolio. Under the leadership of retirement services provider TIAA, Nuveen also invests in real estate across Europe and Asia-Pacific, with overall assets under management of around $150 billion and exposure across a wide range of asset classes and risk profiles.

**Jason Schreiber**

Principal, investments, CIM Group

As principal in CIM's investments group, Schreiber is actively involved in the investment management process across the firm's platforms and serves on its investment committee. Real estate and infrastructure owner, operator, lender and developer CIM owns and operates around $30 billion of assets in the Americas and Western Europe, investing through a broad range of debt and equity strategies, and across the risk-return spectrum.

**Stephen Rabinowitz**

Co-chair, global real estate practice, Greenberg Traurig

Rabinowitz co-chairs Greenberg Traurig's real estate practice. He serves as an adviser to a wide variety of institutional and entrepreneurial investors, private equity funds, developers, asset managers and operators in the acquisition, financing, development and leasing of all classes of commercial properties. The global law firm employs more than 2,650 attorneys, including around 700 focused on real estate, in 47 locations on three continents.

**Adam Berns**

Chief investment officer, US, GLP Capital Partners (GCP)

Berns oversees all US investment activity at GCP as chief investment officer, US. The global alternative asset management firm has around $125 billion of AUM, principally in real assets, across 55 funds in Asia, Europe, the US and Brazil. It is one of the largest global players in the logistics sector and also invests in data centers and renewable energy in Asia, Europe and North America, and self-storage in the US.

held in New York in September, agree the slowdown has been dramatic.

"Uncertainty around where the rate hikes will stop and level out appears to be keeping volume down, and also creating wider bid-ask spreads than we've historically seen," says Jason Schreiber, investments principal at manager CIM Group.

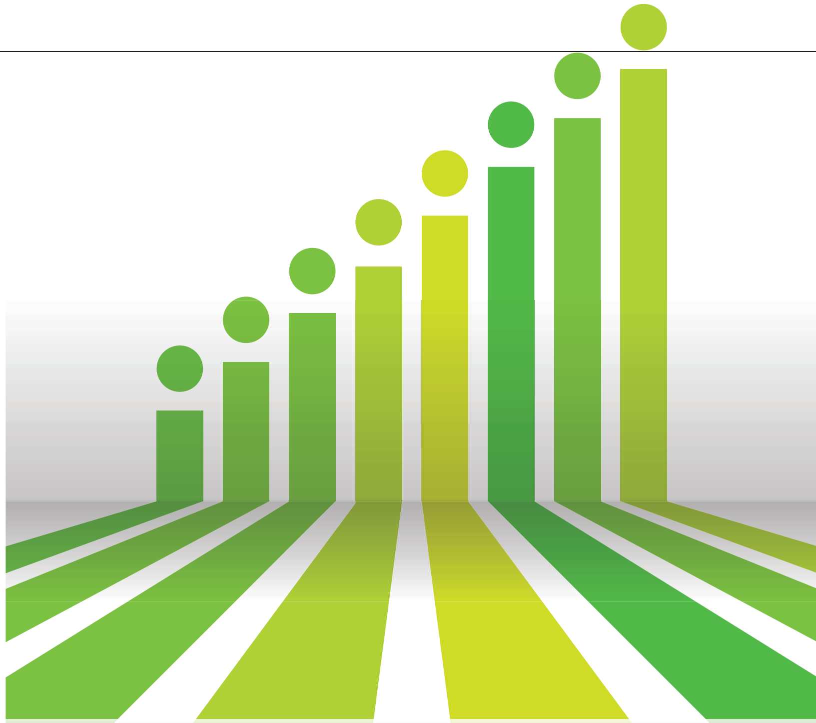
Few deals are closing on the basis set out in the term sheet at the outset of the process, observes Stephen Rabinowitz, co-chair of the global real estate practice at law firm Greenberg Traurig. "I can't remember a time when there was this much uncertainty. There's so much changing, on every transaction."

"The cost of debt has doubled in 18 months and availability is significantly lower. Originations are close to a 10-year low," says Adam Berns, US chief investment officer at alternative asset management firm GLP Capital Partners (GCP). "There is still capital that has been raised for private debt strategies seeking a home. But even when there is debt available, there is often disagreement between buyer and seller on the transactable value, or, if they can seemingly agree on a valuation, a seller may not want to transact at that level yet."

Not only does the high cost and scarcity of financing render many deals on standing investments unviable, but development has been impacted too, says Shawn Lese, chief investment officer for the Americas at manager Nuveen Real Estate. "A lot of transactions just don't pencil out, particularly as you go higher up the risk spectrum. We are seeing new development activity almost cease at this point."

### Tight credit, reduced liquidity

Back in March, the US banking crisis dominated the business pages. Fears were rife that the collapse of both Silicon Valley Bank and Signature Bank might lead to contagion spreading



## Green agenda gathering momentum

**Investors and occupiers drive higher ESG standards despite delayed regulation**

The US Securities and Exchange Commission's climate risk disclosure rules, which were scheduled to be published in April 2023, had the US real estate industry "very worried," says Rabinowitz. "Their impact will probably be positive for the environment and the future of the planet, but in the short to medium term they will make owning and operating real estate more expensive."

The regulation met with opposition from companies arguing it is too expensive and complicated, and the final draft publication ruling has been delayed. Rabinowitz notes that cities and states are pushing ahead with their own rules anyway, including New York's Local Law 97, which requires buildings over 25,000 square feet to meet energy efficiency and greenhouse gas emissions standards. Meanwhile, California has limited the use of natural gas in new developments.

Regulation is not the only driver of higher ESG standards, says CIM Group's Schreiber. "The big LPs come to the table with their own requirements, and so do commercial tenants. We are evolving and growing our own ESG strategies to meet their demands."

International investors are often the most vocal in pushing for better performance, adds Lese. "There are European and Australian investors that require top GRESB scores, for example. They will reject funds that fail to achieve those scores, even if they have great track records." But occupiers' ESG policies are the principal driver: "Many big users need to report on their carbon footprint, or choose to do so voluntarily, and they want that number to be low."

*"Even though we are seeing more activity in the past couple of months, people are generally still more hesitant than they should be"*

**STEPHEN RABINOWITZ**
**Greenberg Traurig**

*"Getting buyers and sellers to line up their cap rate expectations is still a point of contention"*

**JASON SCHREIBER**
**CIM Group**

through domestic and international financial markets. Only six months later, however, the roundtable participants note the topic is rarely raised anymore.

"It seems to have worked itself out," says Rabinowitz. "You still hear grumblings that small regional banks with lots of medium-sized office loans have yet to feel the full effect of what is happening in that market. But in terms of our clients' day-to-day worries, it isn't high on their list. Most have switched to bigger, more secure, money center banks."

The crisis has squeezed the availability of debt finance, however. "Regional banks are no longer growing their loan books, while larger banks are tightening credit standards," says Berns. "But because it accelerated the tightening of credit and reduced liquidity, the regional banking crisis may have had a positive effect in shortening the Fed's campaign of interest rate rises overall."

Meanwhile, the money center banks that are still lending are able and willing to serve only a shrinking group of borrowers, says Lese. "They are active, but don't expect a huge amount of new credit. Out of their existing borrowers they are selecting a limited group to which they will continue to lend. At this point, there are haves and have-nots in terms of who can borrow."

The tightening of banking regulation has created an opportunity for private debt funds to step in and fill the gap, says Schreiber, but they are unlikely to make up the shortfall entirely. "There is approximately $2 trillion of commercial real estate loan maturities in the next two and a half years. I don't see the private debt market stepping in to backfill the whole share of regional banks and those who have turned off lending or had to tighten their standards."

Besides, some private debt providers are facing their own constraints, he adds. "Some credit vehicles are financed through the short-term repo market, as a bridge to a [collateralized loan obligation] exit, and those facilities are essentially frozen when interest rates are high."

### Psychological scars

Interest rates may be at, or nearing, their peak, however. "Most players in the market think that we are hitting the top, that there is maybe one more 25 basis-point hike to come, and that rates are then going to stabilize and remain higher for longer," says Lese. "There are signs that market activity is beginning to come back as sellers and buyers get closer to finding they can finally agree on a price that makes sense for them both."

But Rabinowitz suggests the psychological scars inflicted by recent events still need to heal for the market to return to full health. "I get the sense from talking to people that there has

*"Next year should see a bounce back in terms of activity, and stabilized valuations in most sectors"*

**SHAWN LESE**
**Nuveen Real Estate**

*"With interest rates close to peaking, we hear more optimism about capital commitments in 2024"*

**ADAM BERNS**
**GLP Capital Partners (GCP)**

been so much going on – covid, the office market, interest rates, a major war in Europe, strikes, the climate – that even though we are seeing more activity in the past couple of months, people are generally still more hesitant than they should be in saying now is the time to dive in. There is a sort of shell shock."

With rates seemingly close to their high point, the cost of debt is easier to underwrite, says Berns, but other obstacles remain. "A year ago, the uncertainty in underwriting was both cost of debt and its impact on growth and cap rates. Today, the cost of debt is easier to underwrite, but there is still uncertainty around whether cap rates have stabilized. It's less uncertainty, but it is still leading to disparity between the prices at which sellers will transact, and which buyers will pay."

Market participants sense valuations are still lagging their true levels, says Schreiber. "We believe the spreads between real estate cap rates and 10-year Treasuries, or BBB corporate bonds, are still very thin, and so there is a belief that there is going to be more cap rate expansion in the future, even if there are no more rate hikes. Getting buyers and sellers to line up their cap rate expectations is still a point of contention."

## Fundraising pinch

With differing price expectations making it difficult to deploy capital, it is no surprise that capital raising has been affected. "The first half of this year was down 50 percent versus last year," says Berns. "A lot of capital was raised 12-18 months ago, but LPs aren't seeing that deployed. They're also seeing denominator effects and lower realizations, so they have less ability to make future commitments. Those are all contributing to less new capital being raised."

The fundraising pinch is not affecting all managers equally, notes Schreiber. "Particularly for real estate equity funds, we notice that LPs want to put their money with experienced managers who they believe have the judgment, the foresight and the proven track record to navigate rocky cycles like this."

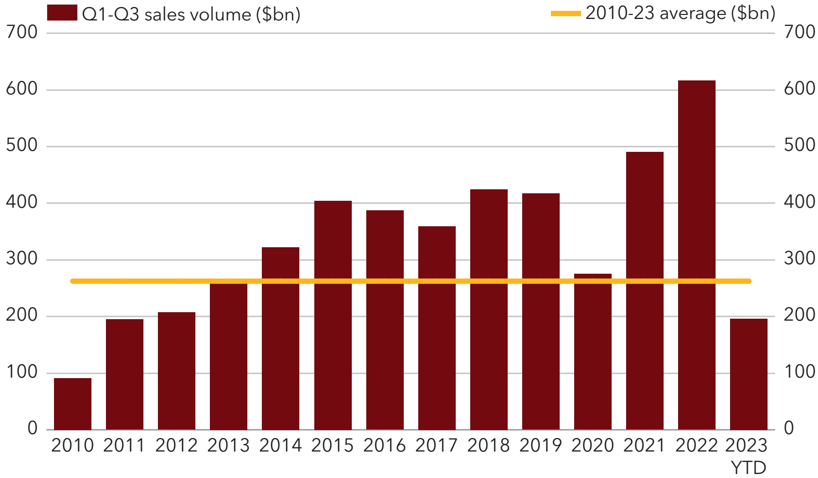
The participants believe the environment for capital formation is likely to improve, however. Lese argues the denominator effect is reversing, and predicts that when more capital begins to flow into the core space, some of the investors currently queuing to redeem their interests in open-ended funds will change their minds and leave their capital where it is.

"With interest rates close to peaking, we hear more optimism about capital commitments in 2024," says Berns. "At some point the transaction market will pick up and current funds will probably be a pretty attractive vintage." In the meantime, most investor demand is for opportunistic and value-add strategies.

"That is reflective of how challenging it is for income-oriented strategies to generate historical target returns in the current interest rate environment."

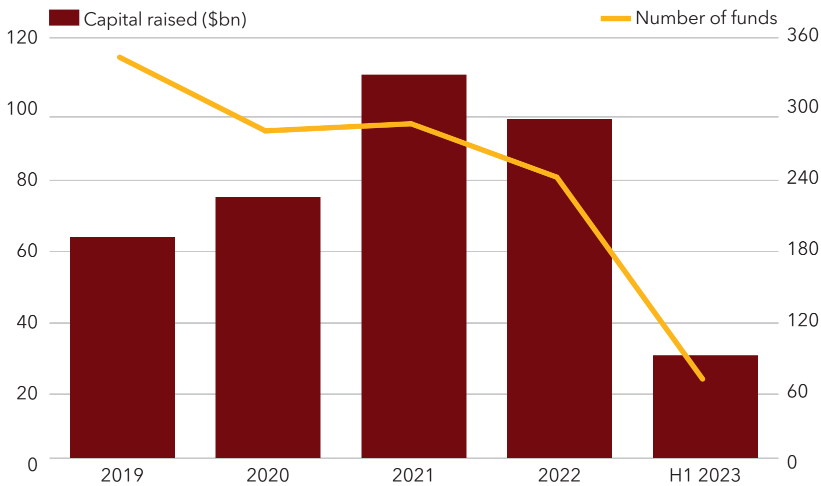
Rabinowitz observes fund formation is one of the "bright spots" for his practice at present. "We are seeing a trend where clients who would have done individual deals are doing specialty funds instead to secure a more permanent source of capital. They might identify a narrow thesis like building hotels in secondary markets, for example, and only plan to do a few deals, and then raise a fund around it."

**Investment in the first three quarters of 2023 is down by 68% compared with the same period last year**




Source: MSCI Real Capital Analytics, Cushman & Wakefield Research

**Sixy-seven North America-focused private real estate funds closed in H1 2023, raising just $28.8bn**




Source: PERE

### Office meltdown

The meltdown in the US office market has been well documented, with values falling by a third to a half and leasing activity weakening. "We don't have any clients actively looking into office right now, other than best-in-class assets," says Rabinowitz.

He identifies a clear "flight to quality" as occupiers and investors focus on a small minority of modern, well-located buildings. One Vanderbilt in New York, the venue for the roundtable discussion, is identified as one such asset. Developer SL Green's Midtown skyscraper 245 Park Avenue, in which Japanese investor Mori Trust bought a 49.9 percent stake in June, is cited by the participants as another example of the type of office asset in which investors will continue to show faith.

"If you can deliver office buildings like that, you will be able to fill them," says Lese. "Demand for space remains strongly positive for offices built or renovated after 2015. Older vintage properties have a much higher vacancy rate."

The extent of the slump in office property values can be explained by the scale of the capital expenditure required to bring dated assets up to the standard expected by contemporary occupiers, he argues.

Reuse for residential apartments has been proposed as a potential strategy for swaths of obsolete office buildings, but the practicality and viability of such projects is often questionable, suggests Schreiber.

"We have done about a dozen conversions over the years, and you really need a perfect trifecta to do it," he says. "It needs a floor plate that is conducive to residential because of building laws about fenestration, light and air, access and emergency exits. The building needs to either be empty, or able to be emptied out. And on top of that, you need to have a seller, whether it is the bank or the owner, who is going to sell at a low enough price for it to pencil. It doesn't just happen overnight. And it happens to very few buildings."

### Cracks in the ice

With two of the largest real estate asset classes, office and retail, out of favor, investors in US real estate have increasingly broadened their investment portfolios to encompass smaller, less established sectors.

"Niche strategies are probably the most interesting place to be looking to acquire assets right now. Some of them have already become mainstream, so you no longer need to go through an

## Climate change drives up insurance costs

**Extreme weather sees premiums spike for residential and commercial properties**

"Every time you think you're getting to the point where things are more stable and certain, another card turns," observes Greenberg Traurig's Rabinowitz. "What is happening in the residential insurance market is having a huge impact, and that is a card that people didn't have in the deck a year and a half ago."

The increasing frequency of hurricanes, floods and wildfires across the US has left many homeowners at risk of spiking insurance premiums. Around 35.6 million properties, more than a quarter of all US real estate, face increasing prices and reduced coverage, according to analysis by the First Street Foundation, a non-profit that studies climate risks.

Rising premiums are consuming an increasing proportion of homeowners' income in some parts of the country, notes Nuveen Real Estate's Lese, and in particularly hard-hit areas it can be difficult to get coverage at all.

Nor is the issue limited to residential properties. "Rising insurance costs are a significant investment risk everywhere. You absolutely need to understand the environmental risks associated with property because a lack of, or very expensive, insurance will hit returns and reduce the asset's potential future liquidity, he adds. "Increased insurance costs seem to be ubiquitous across the industry."

A report from Moody's Analytics published in August bears out the view that insurance will be an increasing headache for commercial real estate owners. It found that year-on-year insurance cost growth has increased to over 17 percent in some markets in recent years. Texas, Sunbelt, California and Northeastern metros showed the highest increases, while commercial properties nationally have seen an average annual growth rate of 7.6 percent since 2017.

educational process where you explain the fundamentals of that industry to investors," says Lese. "The question is, how niche do you want to go? Which are the best ones to select? For me that comes down to how scalable they are, as well as what their growth prospects look like."

The growth of data centers as an asset class has been one of the "shining lights" of the real estate industry in recent years, says Schreiber. CIM Group began investing in the sector eight years ago. "We have seen tenant demand being driven by AI, as well as the growth of cloud services. The supply of developable land with low-cost power is constrained, and the buyer market is increasingly deep as more institutions raise money for that space. Niche asset classes that tell a good story and have a good outlook can have higher growth than more established sectors."

GCP also identifies the sector as offering attractive opportunities to managers with the necessary skills: "There are lots of barriers on the investor side, because it is very technical, very capital intensive and mission-critical for the customers, so counterparty expertise matters. It is one of the few areas where you can say there are still real secular tailwinds to growth, and real supply constraints," says Berns.

Other appealing niche sectors picked by the participants include life science, medical office, new-generation senior living, recreational vehicle parks and self-storage. Lese suggests adding affordable housing to the list: "We have been doing it for about 30 years. It is complicated because the regulations are different in each municipality, and it is operationally intensive. The benefit though is that as well as doing societal good, investors achieve a return profile that is more bond-like in nature, with a high degree of durability, and also an inflationary uplift."

As the discussion draws to a close, the participants consider when the market will succeed in shaking off its sluggishness. "We are seeing some cracks in the ice and some thawing already," says Lese. "Next year should see a bounce back in terms of activity, and stabilized valuations in most sectors."

Banks may be the catalyst for activity as regulatory requirements bite and force them to stop extending loans, predicts Schreiber. "There are lots of maturities coming up. When the banks foreclose or sell non-performing loans, we believe that should provide a reset basis for the market and spur activity, as long as there is debt available to finance purchasers."

Berns adds: "It's hard to imagine that volume isn't going to be higher next year, whether that's because there is more distress, or because there is more liquidity available, and it is just a more functioning market."

Similar predictions have been made in the recent past without the hoped-for recovery ensuing, however, cautions Rabinowitz. "While I am optimistic that next year will be better, it seems that a lot of people have been looking for the next excuse not to do something, and we have a big election coming up in November next year." ■