Sagard Real Estate
US Real Estate Market Outlook

October 2024

A stable, growing market ahead
as inflation-led asset repricing
is fully reflected in valuations

Written by: ***Jay Alexander**,*
Chief Investment Officer

Recent Market Conditions compared to Other Real Estate Down Cycles

While economic market cycles tend to have some typical markers that are observed each time, each cycle has its own unique set as well.

The US real estate market is no exception. The last few real estate downturns since the 1980's have generally been characterized by the following attributes:

- Ten quarters of declining or negative returns (typically two quarters of positive but declining towards negative returns followed by eight quarters of negative returns.)
- After valuations hit bottom, the real estate market tends to be more stable (and slightly improving) for approximately two years before real estate fundamentals improve sufficiently to drive occupancies, rents, and values higher.

The major factors behind a typical real estate down cycle have been consistent over the last few cycles. These include a retrenchment in economic growth (i.e., a recession), a pullback in tenant demand, and too much new construction (3% or more of stock added to existing inventory annually). This current real estate downturn, which started in 2022, does not possess any of these attributes however as the US economy has remained positive and robust at times (i.e., no recession). Furthermore, US real estate demand did not decline in 2022-2024 and, in fact, remained positive throughout the cycle (the office sector being the exception here given the sector's negative secular trends due to WFH-related factors), and real estate construction levels have not, for the most part, overshot demand in most markets.

For these reasons, the current downturn should not be characterized as a 'real estate recession'. Rather, it can be described more accurately, as an 'inflation-led repricing' occurrence. This repricing, which began two years ago as the Fed raised interest rates, has led to an increase in capitalization rates as well as overall required returns -- and real estate value declines ranging from 20% to over 30% depending on the sector and geography. This downdraft was further exacerbated by real estate operating costs, and property taxes, which in many instances grew faster than market rents thanks to elevated inflation. Combined with decreased investor-confidence levels and dislocations in the real estate capital markets, transaction levels declined to a fraction of pre-COVID levels, further depressing the entire real estate asset class.

Current Market Conditions

In the second half of 2024, real estate fundamentals are stabilizing, following a period of softness where vacancies increased and overall effective rents flattened.

Reproduction costs have also been stable, with only modest evidence of construction costs declines (of 10%) in some property sectors. And with transaction volumes starting to revert towards normal historical levels (as seen in 3Q 2024), combined with price increases in some property sectors, US real estate should be fully stabilized approaching year end 2024. In addition, the real estate capital markets and transaction volumes should continue to improve, aided by lower interest rates (with the 10 yr US treasury down 125bp from its recent peak). Due to these factors, market pricing is hitting a cyclical bottom at around 20-35% below reproduction costs depending on the property sector, with investors willing to accept a lower cap rate (well below 6%) in exchange for a great cost basis.

> "US real estate should be fully stabilized approaching year end 2024."

The Market Going Forward

In many recent real estate downturns, after values hit bottom property asset values have been stable with only modest value increases for a few years.

This is typically due to oversupply, which keeps a lid on rents and value gains for a few years until the overhang is absorbed. Regarding the US real estate market today, our base case is that the market remains stable for the next few years, with attractive and steady rent and value growth going forward for the following reasons:

- The US economy is slowing but remains positive. In addition, consumer consumption is expected to remain stable, without any sizable pent-up demand which would materially move real estate occupancies/rents/values.
- Interest rates, which have declined towards more normalized levels, are not expected to decline much further. This will preclude any meaningful debt-fueled real estate asset price increases.
- New supply to the real estate market in 2025/26 will be lower (compared to 2023/24), prompting higher occupancy levels and tighter market conditions.
- A significant amount of 'dry powder' (money raised, not placed) and a significant number of lower leveraged buyers lie in-wait ready to invest, especially compared to prior real estate market down cycles. This sizable amount of available capital could produce at least a modest asset price increase (of 5%+) off the bottom over the next year.

Opportunity Window

In real estate, strong historical out-performance has come through the deployment of capital in the 'best vintage years', which are logically the years immediately following a market trough (and even investing a quarter or two before the bottom is a strong alpha strategy).

As for 2025/26, this again is very likely to be the case, even after taking into account all the competing market factors noted above. The next two years present a strong investment opportunity window, giving early-mover investors ample time to acquire assets at a low-cost basis, execute new value-creation strategies and achieve out-performance.

Disclosures

The views expressed above are those of Sagard Real Estate as of October 2024 and are subject to change.

The document may include certain statements, estimates and projections provided by Sagard Real Estate with respect to anticipated or possible future performance of the prospective investments. Such statements, estimates and projections are based on various assumptions, which assumptions may or may not prove to be correct. Sagard Real Estate makes no express or implied representations or warranties as to the accuracy or completeness of the information contained herein. Sagard Real Estate expressly disclaims any and all liability which may be based on such information, errors therein or omissions therefrom. Only such representations and warranties as may be set forth in a definitive agreement between the final issuer and the investor shall have any legal effect.

This document is private, confidential, and is intended exclusively for the use of the person or organization to which it has been delivered. This document and none of the materials provided herein may be used, reproduced, distributed, or transmitted, in any form or by any means whatsoever, without the prior written permission of Sagard Real Estate. In addition, Sagard Real Estate expressly reserves the right, at its sole discretion, to reject any or all offers to commit to the investment outlined herein and/or terminate discussions with any interested party at any time with or without notice. Sagard Real Estate expressly reserves the right to select an interested party on any basis or using any criteria. Sagard Real Estate expressly reserves the right, at its sole discretion, to withdraw, supplement, change, amend, bifurcate or reduce the scope of this document and/or the subject thereof.