Investment Report: Fall 2024

The real estate market in the United States has experienced significant changes in recent years. From booming housing prices to shifts in buyer preferences, the industry has seen its fair share of ups and downs. We will take a closer look at the current state of the real estate market in the United States, including macroeconomic factors, and explore some key trends and Alternative Investment Strategies that are shaping the industry.

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"Don't wait to buy real estate. Buy real estate and wait." – Will Rogers, actor

Key takeaways for 2024 from JP Morgan 2024 commercial real estate midyear outlook (1)

- Interest rate uncertainty and geopolitical issues could influence commercial real estate in the remainder of 2024.
- Certain asset sectors, including multifamily, retail, and industrial, continue to perform well. Office vacancies continue to rise.
- A focus on liquidity and safeguarding against fraud should be a focus of commercial real estate owners and operators.

Macroeconomic Factors and Concerns for 2024

- Interest Rates: The Federal Reserve has indicated it will maintain higher interest rates to curb inflation, which will impact borrowing costs and investment returns. This approach reflects a cautious stance, as policymakers aim to balance economic growth with the need to maintain price stability.
- Geopolitical Concerns: Ongoing global conflicts, such as those in Ukraine and the Middle East, contribute to market volatility and can affect the global supply chain. Economic growth, both local and global, remains a critical factor.
- Elections: The upcoming presidential election in the U.S., coupled with congressional gridlock, may impact consumer confidence and spending. Globally, over 70 countries holding elections in 2024 add to geopolitical uncertainty.

Asset Class Discussion and Insurance Costs

Residential

One of the defining features of the housing market in recent years has been the imbalance between supply and demand. Despite a slight increase in new housing construction, inventory levels remain relatively low, especially in desirable urban and suburban areas. This limited supply continues to drive buyer competition, often leading to bidding wars and elevated home prices. As we move through the summer, the demand for homes is expected to remain robust, particularly among millennials and first-time homebuyers seeking to capitalize on favorable conditions. According to the National Association of Realtors, pending home sales intensified 4.8% in June of 2024, although year over year, there was a decline (2). "The rise in housing inventory is beginning to lead to more contract signings," said NAR Chief Economist Lawrence Yun. "Multiple offers are less intense, and buyers are in a more favorable position."

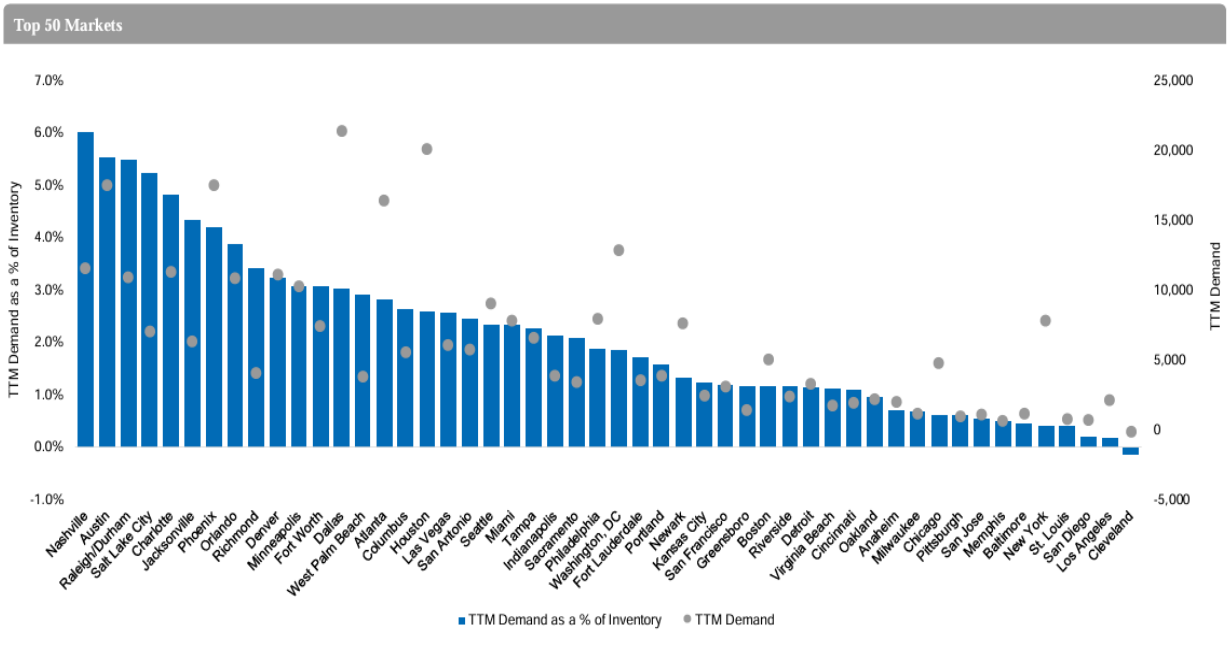
Multifamily

Current Inventory and New Properties**:** The multifamily sector remains a cornerstone of the commercial real estate market, with a significant new inventory entering the market. However, the pace of new construction has been tempered by several factors, including rising construction costs, labor shortages, and regulatory challenges. As a result, while there has been an increase in new multifamily properties, the supply has not kept pace with the burgeoning demand in many urban centers.

Multifamily oversupplied but still successful**:** Overall, multifamily properties remain strong due to demand from a population in need of affordable and workforce housing. Moody's Analytics indicated a 4.6% vacancy rate in 2023 for B and C class properties. With the net absorption of new properties being lower than usual, many property managers are making concessions to attract new tenants. The recent increase in new multifamily supply is putting pressure on the overall market performance. As new construction slows down, the pressure should be relieved.

Several cities are experiencing significant challenges with the absorption of new inventory and maintaining balanced supply and demand dynamics. These cities include:

- Houston, TX**:** The multifamily market in Houston has struggled with high vacancy rates due to an oversupply of new units and economic fluctuations in the energy sector.
- Chicago, IL: Chicago's slower population growth and economic diversification have resulted in absorption difficulties for new multifamily developments.
- Miami, FL: Despite strong demand, Miami faces absorption challenges due to a high volume of new luxury developments that outpace the market's ability to absorb them.



Source: Newmark Research, RealPage

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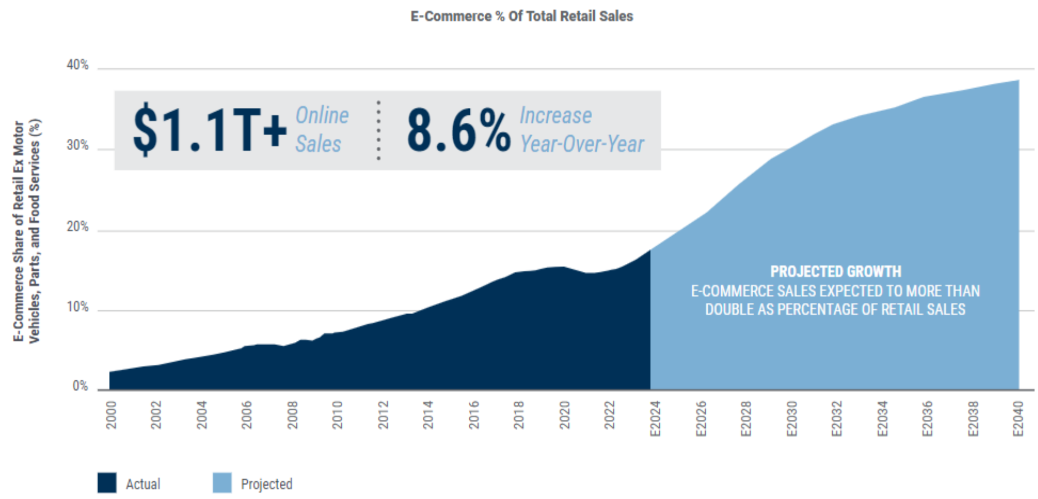
Industrial

According to the US Department of Commerce, retail e-commerce makes up 15.6% of retail sales and demand continues to increase.

The industrial real estate market in the United States continues to demonstrate robust performance, driven primarily by the following factors:

- E-commerce Boom: The ongoing growth of e-commerce has significantly increased demand for logistics and distribution centers. Companies are investing heavily in large warehouse spaces to manage their supply chains efficiently and meet the rising consumer demand for fast delivery services.
- Supply Chain Optimization: Businesses are optimizing their supply chains by strategically locating warehouses and distribution centers closer to key markets. This trend is driving up occupancy rates and rents in major logistics hubs.
- Technological Advancements: The adoption of automation and advanced technologies in warehouses is further enhancing the efficiency of industrial spaces. This technological shift is attracting more tenants to modern facilities equipped with state-of-the-art systems.
- Nearshoring Trends: The growing trend of nearshoring, along with the need to replace older, outdated industrial buildings, is expected to continue driving construction and demand in the second half of 2024 and beyond.



Sources: U.S. Census Bureau, May 2024 | Projections from CBRE EA: Pandemic Accelerates E-Commerce Adoption Implications for Industrial and Retail. The percentages presented for future periods are projections and there is no guarantee that these projections will accurately reflect future performance. E-commerce sales are sales of goods and services where the buyer places an order, or the price and terms of the sale are negotiated over the Internet, mobile device (M-commerce), extranet, Electronic Data Interchange (EDI) network, electronic mail, or other comparable online system. Payment may or may not be made online. Online travel services, financial brokers and dealers, and ticket sales agencies are not classified as retail and are not included in either the total retail or retail e-commerce sales estimates. Projections are for 2030 and 2040 and not annual, each year estimated based on 2030 and 2040 projection.

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Office

According to Moody's Analytics, the national office vacancy hit a record high of 19.6% in the fourth quarter of 2023, breaking the previous record of 19.3%. While new construction is at the lowest levels since 2012, it is unclear how far demand will drop and how high vacancies will rise. New Class A Properties will offer flexible or smaller configurations, which are attractive to tenants who have decided to keep a physical office.

Retail

The retail sector continues to innovate with the trend towards small concept stores, especially with grocery-anchored neighborhood shopping centers. While new retail construction grew by 583,000 sqft in Q4 of 2023 (Moody's Analytics), retail is facing the same finance and economic challenges as other sectors. The concept of omnichannel will be a focus of major retail brands to meet consumer needs by combining the in-person experience with the accessibility of online shopping.

National Commercial Insurance Costs

Over the past three years, national commercial insurance costs have been on an upward trajectory. Several factors have contributed to this rise:

- Natural Disasters: The increased frequency and severity of natural disasters, including hurricanes, wildfires, and floods, have led to higher insurance premiums as insurers adjust to the greater risk and payout costs.
- Construction Costs: Rising construction costs have increased the replacement value of properties, consequently driving up insurance premiums.

- Litigation Trends: The commercial real estate sector has seen a rise in litigation and liability claims, prompting insurers to increase premiums to cover potential legal expenses.
- Impact of Fannie Mae and Freddie Mac Changes: Recent changes in insurance coverage by Fannie Mae and Freddie Mac have added complexity to the market. These government-sponsored enterprises have implemented stricter requirements for insurance policies on properties they finance. This has led to higher insurance costs for property owners and developers, who must secure comprehensive coverage that meets the new standards. The increased costs are often passed on to tenants, contributing to overall rent inflation.

Sailing Through a Real Estate Eddie

The demand for housing has continued to support the success of multifamily investments. Online retail shopping has continued to fuel demand for industrial properties, while certain retail assets have remained resilient while the office sector is still struggling to rebound from the covid era. Considering population and economic trends we look at strategies around real estate investments and how Sequent helps our client's navigate investment decisions.

A real estate investment strategy can be a cornerstone of a well-diversified portfolio, offering opportunities for income, appreciation, and tax benefits. Understanding the various structures within private real estate is crucial to matching the right strategy with the right investment need.

Primary Real Estate Investment Solutions

There are two primary real estate investment solutions to consider to effectively integrate CRE into a portfolio: (5)

1. **Tax-Advantaged Real Estate Strategies.** Tax-efficient investment vehicles like Delaware Statutory Trusts (DST) and Qualified Opportunity Zone (QOZ) funds are designed to minimize tax liabilities and can play a crucial role in wealth preservation and growth. These investment vehicles may optimize returns and defer or eliminate capital gains taxes.

2. **Income and Growth Real Estate Strategies.** These strategies focus on properties with the potential for capital appreciation and durable cash flow. Opportunistic, value-add, and development projects fall into this category, offering higher returns but with increased risk. Both traditional and alternative real estate sectors can be utilized, providing a balanced approach to income generation and growth within a client's portfolio.

Commercial real estate offers a broad range of strategies that can help meet investors' diverse needs. By integrating tax-advantaged and/or income and growth strategies, portfolios may experience enhanced returns, diversification, and resilience during times of economic volatility.

Looking ahead in 2024

Real estate across the board is being affected by a similar macroeconomic story: higher-than-usual interest rates and asset valuations that have slowed transaction activity. The U.S., although it does appear to be headed towards an economic soft landing, is optimistic about interest rate cuts in the upcoming months, which should build traction for more investment opportunities.

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