

IQEQ



Real estate in the U.S.

September 2024



This report covers real estate in the U.S.

Introduction

Over the past year, marked by unprecedented developments, we witnessed notable macroeconomic shifts, including record-high inflation rates and aggressive monetary policy tightening across advanced economies.

These headwinds precipitated a global downturn, injecting significant uncertainty into markets. Private markets, in turn, faced substantial pressure, with some notable exceptions across strategies and regions.

As we progress into the second half of 2024 and into 2025, a more optimistic outlook is taking shape. Major economies are experiencing disinflationary trends and have begun entering a period of easing interest rates. Central banks, including the Federal Reserve (the Fed), the Bank of England, the European Central Bank, have already implemented at least one rate cut, marking the start of this easing cycle.

However, in contrast, the Bank of Japan raised its interest rate for the first time since 2007, with two hikes in March and July 2024. Although this move diverges from the global trend, its impact on overall asset prices should not be overstated, as markets often overreact initially to such decisions and are now showing signs of correction.

Optimism surrounding a more accommodative borrowing environment sets the stage for a potential resurgence in private market activity. However, broader uncertainty is expected to linger due to geopolitical tensions, the prospect of significant shifts in the global political order amid numerous elections in 2024, and persistent macroeconomic challenges.

Against this intricate backdrop, we examine how these conditions will influence the outlook for private markets in the latter half of 2024 and into 2025. Our comprehensive series of reports will scrutinize the prospects for three specific asset classes – private debt, private equity, and real estate – across diverse geographical regions. We provide insights into how investors can navigate current market dynamics and leverage opportunities strategically to their advantage.

Macroeconomic overview



Electoral
outcomes



Lingering
inflationary
pressures



Regulatory
compliance

Macroeconomic conditions



Timing and magnitude
of interest rate cuts



Improved prospects
for soft landing



Default risk
and volatile
banking sector



Tech disruption
and AI boom



Geopolitical
realignment



Environmental
challenges

The U.S. economy continued to demonstrate resilience, with GDP growth accelerating to an annualized rate of 3.0% in Q2, up from 1.4% in Q1. However, concerns surfaced recently due to cooling labor market conditions, and the Fed's recent stance on keeping rates in restrictive territory to mitigate upside risks to inflation.

These factors heightened doubts over the chances of a soft landing in the U.S. economy, intensifying market sentiment around a potential slowdown.

Given these concerns, alongside greater confidence on inflation trending sustainably on a disinflationary path, the Fed opted to cut interest rates by 50 basis points at its latest meeting in September. The decision was likely made in lieu of the consideration that rates must be kept restrictive enough to ensure upside risks to inflation are not realized while also preventing any further labour market weakening.

However, even with policy loosening, rates are likely to remain significantly higher than pre-pandemic levels. Consequently, borrowing costs and debt service payments are expected to remain at elevated levels for some time. This raises concerns about increased default rates and poses risks to the banking sector, adding uncertainty to financial markets, which could eventually spill over to the private asset market.

Moreover, 2024, being an election year, introduces an additional layer of uncertainty surrounding the future outlook for policy and regulatory frameworks. Ongoing geopolitical tensions, including the Russia-Ukraine conflict and conflicts in the Middle East, further complicate the U.S. economic outlook, potentially impacting global economic dynamics.



Overview of the global real estate market

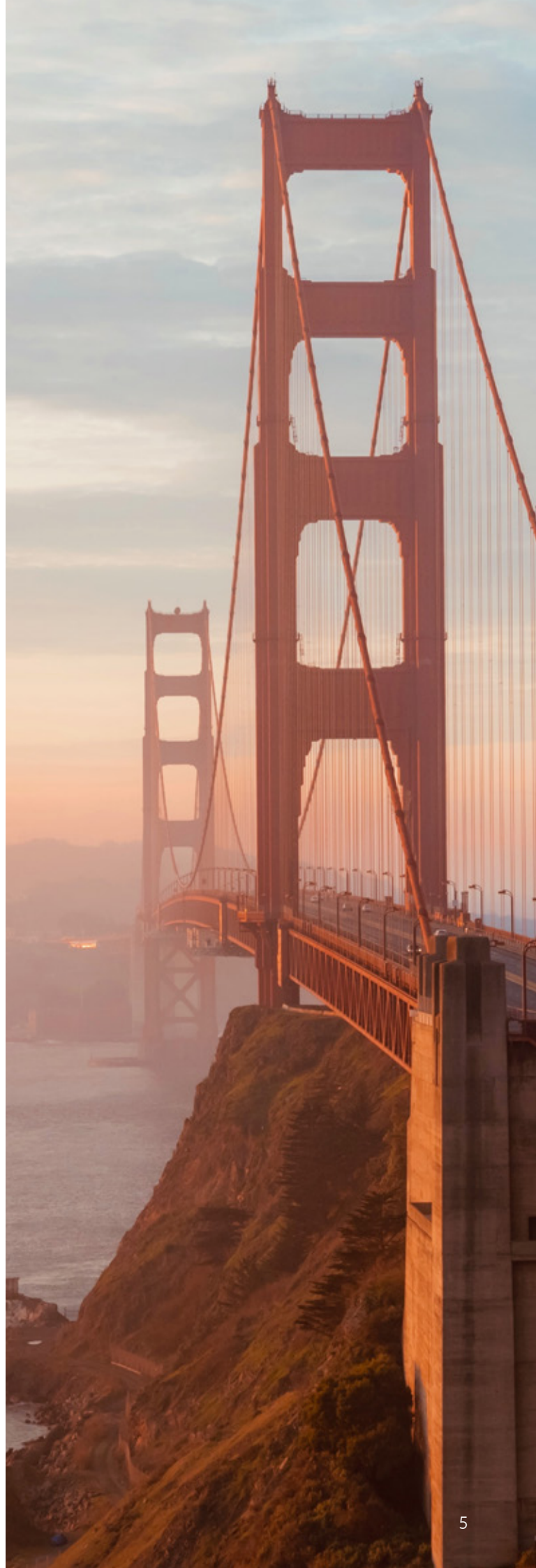
In 2023, subdued fundraising within the real estate sector persisted due to historically elevated interest rates, which raised borrowing costs and limited financing availability.

Coupled with valuation uncertainties, these factors led to a significant decline in global deal activity, hitting a decade-low of \$645 billion across 2023¹. The subdued transaction environment also impacted closed-end fundraising, which dropped by 34% to \$125 billion in 2023 compared to 2022². Overall, global fundraising for real estate declined by 26% in 2023³.

Investor sentiment at the end of 2023 was initially optimistic, with expectations of recovery in the first half of 2024. However, this is now expected to happen more in the latter part of 2024. The subdued fundraising momentum continued to decelerate in the first half of 2024, with only \$59.0 billion raised, representing a 43% drop from the same time period last year.⁴ Further underscoring the subdued activity is the Prequin Real Estate Index,⁵ which recorded a decline of 0.6% in the first quarter of 2024.

Throughout 2023, every strategy within the real estate investment sphere experienced a decline. Specifically, there was a notable shift away from core and core-plus strategies, known for their low-risk but stable returns, with fundraising pertaining to this strategy dropping by 51% in 2023⁶. This shift reflects investors' increasing demand for liquidity amidst constrained exit opportunities due to wider bid-ask spreads. Consequently, capital has been tied up for longer periods with delayed returns. In contrast, opportunistic strategies saw a smaller decline of 18%, benefiting from the shift away from traditional core and core-plus investments⁷.

In the Q1 2024, the trend away from core and core-plus strategies continued, with such strategies accounting for only 3% and 9% of funds raised⁸, respectively. Investor preference for higher returns remains evident, with a strong inclination towards value-added strategies, which accounted for 71% of funds raised in Q1 2024⁹.





In addition, global fundraising for both closed-end and open-end funds fell in 2023. For closed-end funds, this reflected a preference among investors for allocating their capital to larger, well-established funds, a trend similar to that observed in private equity. Indeed, funds exceeding \$1 billion accounted for over 64% of overall fundraising, marking a notable increase from 51% in 2022.¹⁰ Returns on this asset class witnessed weak performance, recording a -3.5% internal rate of return (IRR) through the first three quarters of the year. This represents the first occurrence of negative returns for this class since the Global Financial Crisis (GFC). Open-end fund performance also declined considerably, with NFI-OE funds returning -12.2% on a net basis, experiencing the first annual decline since the GFC.¹¹

The real estate sector is grappling with the dual impact of tighter monetary conditions and pandemic-induced shifts in behaviour, including reduced office occupancy and urban migration trends.

These changes have disproportionately affected certain property types, notably offices and retail spaces. In 2023, the office sector saw the sharpest decline in annual returns among all real estate sectors, plummeting by 17.6%. Fundraising for office spaces continued its downward trend, with no capital raised in Q1 2024, compared with the 8% share of capital raised in 2019.¹² In contrast, the hospitality sector has demonstrated notable improvements, contributing 15% of total fundraising in Q1 2024, highlighting a shift in investor preference.

Despite lower fundraising, the real estate asset class accumulated capital throughout the year in 2023. Dry powder in closed-end real estate funds surged by 19% in the first six months of 2023. Indeed, dry powder in this asset class has grown by 13% per year over the past half-decade, reflecting a pool of funds ready for investment, even amidst a backdrop of diminished fundraising efforts.¹³

Looking ahead to the second half of 2024 and into 2025, indications point towards the market potentially having bottomed out in the first half of the year. This sets the stage for a potential normalization in the real estate sector, aligning with post-pandemic trends and amid tightening monetary policy. However, investors will encounter ongoing challenges and opportunities as they navigate evolving preferences, macroeconomic shifts, and the dynamics reshaped by the pandemic.

Navigating fundraising and exit strategies in the U.S. amidst prevailing macroeconomic conditions

Deal volume in the U.S. commercial real estate sector hit a more than a decade-low of \$348 billion in 2023 amidst tighter monetary conditions.¹⁴ This spilled over to fundraising, with fundraising for closed-end funds in North America, of which the U.S. makes up a substantial share, decreasing to \$84 billion in 2023, recording a 37% drop from 2022 levels.¹⁵ Overall, total fundraising in the U.S. real estate sector decreased from \$117 billion in 2022 to \$101 billion in 2023, representing a 13% decline.¹⁶



However, North America showed some resilience, with \$31.6 billion raised in the first half of 2024, offering a glimmer of optimism for real estate sector activity for the remainder of 2024 and into 2025.¹⁷

Indeed, in 2023, open-end funds in the U.S. saw a net withdrawal of \$13 billion, a reversal from the \$3 billion net inflow of the previous year and a marked shift from the generally positive net inflows witnessed during the 2010s.¹⁸ The downturn in fundraising within this asset category, while partially linked to higher borrowing costs, is also a result of lackluster returns in the private equity space, a key financier for the real estate industry. This highlights the intricate nature of private assets, where shifts in one area can trigger a cascade of impacts on other sectors.

While macroeconomic uncertainty initially hampered fundraising and deal activity in late 2022 and early 2023, high borrowing costs later in the year continued to suppress activity. The downturn in the U.S. commercial real estate market is marked by an 11% decrease in property values since March 2022, coinciding with the commencement of interest rate hikes. This pricing adjustment, alongside increased borrowing costs, has contributed to a broader divergence in bid-ask spreads, dampening transactional momentum within the sector.¹⁹ Despite the start of a policy loosening cycle, borrowing costs are unlikely to return to pre-pandemic lows in the near future. Nonetheless, this scenario is poised to result in a modest narrowing of spreads, enhancing the potential for deals and fundraising activities, albeit not to the extent witnessed during the pre-pandemic period. Overall, this suggests muted optimism for fundraising and deal activity for the remainder of 2024 and into 2025.

This optimism is further enhanced when considering other factors. For one, a significant amount of dry powder is available for deployment. This capital could be crucial as approximately \$1.2 trillion of commercial real estate debt is set to mature in the U.S. over the next two years.²⁰ The presence of substantial unallocated capital might activate deal-making, particularly in strategies that target distressed debt linked to upcoming maturities in the latter half of 2024 and in 2025.

References

1 [McKinsey \(2024\), Private markets: A slower era](#)

2 Ibid

3 Ibid

4 [PERE \(2024\), H1 2024 fundraising](#)

5 Prequin

6 [McKinsey \(2024\), Private markets: A slower era](#)

7 Ibid

8 [PERE \(2024\), Q1 2024 fundraising remains at a 12-year low](#)

9 Ibid

10 [McKinsey \(2024\), Private markets: A slower era](#)

11 Ibid

12 [PERE \(2024\), Q1 2024 fundraising remains at a 12-year low](#)

13 [McKinsey \(2024\), Private markets: A slower era](#)

However, there is a note of caution, given that a significant portion of this maturing debt is tied to the office and retail sectors. While the retail sector shows promise, buoyed by a robust consumer market and solid growth in consumer spending, the outlook for office real estate is less favorable. The widespread adoption of hybrid work models has reduced the demand for office space, leading to a decline in property values and making this sector less attractive for investment. This is underscored by record-high office vacancy rates of 20.1% in Q2 2024²¹ and office delinquency rates climbing to 8.1%, surpassing the 8% mark for the first time since November 2023²², highlighting the ongoing struggles in this sector.

Exit opportunities have become increasingly challenging due to tighter monetary conditions and diminished returns. Notably, cap rates, except for office properties, rose by 150 basis points (bps) from early 2022 to the end of 2023, while office property cap rates surged by 200 bps or more²³. In the first half of 2024, cap rates generally held steady, but trends varied across different property types²⁴. Industrial cap rates declined on average, while office cap rates continued to rise. However, market sentiment suggests that cap rates may have peaked²⁵, with slowing inflation and optimism about further rate cuts in the U.S., improvements in cap rates are expected to materialize in the second half of 2024 and into 2025.

Yet, rates will likely normalize at a level above pre-pandemic levels. Such an environment exacerbates the challenge of finding viable exit opportunities and implies that investors may not achieve their expected returns. As investors adjust to this environment of elevated long-term interest rates beyond 2025, considerable enhancements in exit strategies and returns remain improbable in the near term. This could introduce a degree of apprehension regarding the outlook for the U.S. real estate sector in 2024 and into 2025 as investors navigate a landscape marked by cautious optimism amidst financial uncertainties.

Overall, the outlook for U.S. real estate presents a nuanced picture. Despite ongoing challenges, there is substantial uninvested capital that, along with promising prospects in the retail, industrial, and multifamily sectors, may stimulate the market. Yet, in the face of limited exit opportunities, a measured approach for investors is advisable for the remainder of 2024 and into 2025.

14 [CBRE \(2024\), Investment Volume Continued to Fall in Q4](#)

15 [McKinsey \(2024\), Private markets: A slower era](#)

16 Prequin

17 [PERE \(2024\), H1 2024 fundraising](#)

18 Prequin

19 [IMF Blog \(2024\), US Commercial Real Estate Remains a Risk Despite Investor Hopes for Soft Landing](#)

20 Ibid

21 [Moody's \(2024\), Q2 2024 Preliminary Trend Announcement](#)





22 [Trepp \(2024\), CMBS Delinquency Rate Continues Ticking Up in July 2024 with Office Driving the Increase](#)

23 [CBRE \(2023\), US Real Estate Market Outlook](#)

24 [CBRE \(2024\), US Cap Rates Survey H1 2024](#)

25 Ibid

Degree of opportunity for real estate markets posed by macroeconomic conditions

Development	Degree of opportunity for asset class		
Start of policy loosening cycle			
<p>The U.S. has entered the phase of lowering interest rates, with the Fed reducing rates by 50 basis points at its September meeting. Lower interest rates have significant implications for the real estate asset class. To begin with, it reduces the cost of financing, thereby spurring investment in property markets. Furthermore, more affordable borrowing rates are likely to boost mortgage uptake, fueling a rise in home buying activity and subsequent demand for residential real estate. In addition, the quest for higher returns may drive investors towards alternative assets such as real estate, elevating demand and possibly enhancing property values. In essence, a dip in interest rates tends to create a more conducive landscape for investment in real estate.</p>	 HIGH	MEDIUM	LOW
Strong retail sector			
<p>Within the real estate industry, both the retail and hospitality sectors stood out as they experienced a rise in occupancy over the year. Q2 2024 data revealed that the retail vacancy rate held steady at 10.4% with both asking and effective rents experiencing a marginal increase of 0.2%. As such retailers are gaining confidence from overcoming challenges such as pandemic disruptions and a surge in e-commerce, are now charting expansion strategies for the coming three to five years. In the U.S., strong consumer spending growth has been instrumental in promoting resilience in the U.S. economy, fueling retail demand. This resurgence is fostering a renewed sense of optimism among retail property investors.</p>	 HIGH	MEDIUM	LOW
Investments in industrial and multifamily assets			
<p>Although investments in industrial and multifamily assets were subdued over the past year, they present promising opportunities for investors in the upcoming year. The resilience of the U.S. economy has driven an increase in industrial production, resulting in heightened demand for manufacturing and distribution facilities, particularly near major transportation hubs. This creates an attractive investment opportunity in industrial properties, which offer stable and predictable income streams through long-term leases with creditworthy tenants. Furthermore, the growth of e-commerce and logistics sectors is projected to fuel rental growth in the industrial real estate market.</p> <p>In addition, the demand for rental housing remains robust in the U.S., driven by urbanization, population growth, and the preference for renting among younger generations. This makes multifamily properties an appealing investment option, offering investors steady cash flow through rental income. Moreover, multifamily properties provide diversification benefits, as they are less vulnerable to market fluctuations compared to single-family homes. Overall, both industrial and multifamily assets present compelling investment prospects in the U.S. real estate market.</p>	HIGH	 MEDIUM	LOW
Dwindling investment in the office space			
<p>Hybrid working, which has become increasingly entrenched in working culture since the pandemic, poses a significant challenge to the office real estate segment. Subdued demand resulting from this trend has led to a 24% decline in valuations in North America in the year ending July 2023. Furthermore, offices in particular also generate lower levels of cash flow given rising operating costs, making it harder to meet interest obligations, resulting in increased default rates. Consequently, current owners may face the dilemma of enduring price declines if they opt to sell, potentially deterring them from pursuing such transactions. This, in turn, leads to clogged exit strategies and blocks investor returns, rendering the office segment particularly challenging within the real estate asset class.</p>	HIGH	MEDIUM	 LOW



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