Real Estate Americas Outlook

Adapting to the new economy

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In Brief

- A challenging capital market environment has driven the largest repricing of real estate since the global financial crisis (GFC), with spot market values down by roughly 25%.
- However, fading economic headwinds, a more accommodating interest rate outlook and relatively healthy industry fundamentals mean the opportunity to capitalize on the disruption may be shorter and come sooner than many expect.
- Demographic changes and shifting consumer preferences are transforming the demand dynamic of commercial real estate from where it was just a few years ago.
- Long-term success will require investors to adapt existing buildings and expand portfolios to incorporate what were once considered niche subsectors.

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J.P.Morgan ASSET MANAGEMENT

Capital market headwinds create a buying opportunity

Real estate has faced a challenging market over the last 12-18 months. Expectations of the Fed holding rates higher for longer filtered through all aspects of the economy and real estate was no exception, with both lenders and investors resetting their expectations. Borrowing costs increased in lockstep with interest rates, and lenders became less willing to put capital out in the face of growing uncertainty. With debt both more expensive and more difficult to secure, required returns increased sharply, driving pricing down. Although a headwind for existing portfolios, the drop in values does represent an opportunity to acquire assets at attractive valuations. Transaction market pricing is down somewhere in the range of 25%, with fund values not far behind. This reset in values has go-forward IRRs at levels not seen since the GFC, making for an attractive entry point.

Real Estate Unlevered IRRs

Source: J.P. Morgan Asset Management; as of 12/31/2023.

However, the window to take advantage of this opportunity may be narrow. A still healthy but cooling labor market, along with a normalization of supply chains, has inflation drifting slowly but steadily down toward the Fed's target of 2%, and the good news hasn't gone unnoticed. After holding steady for some time, the Fed has shifted to a more dovish tone, indicating they expect to start reducing rates sometime in 2024. This has come as welcome news, and markets have reacted accordingly with interest rates down noticeably since peaking early in the third quarter.

Although we are not out of the woods yet, the prospect of an economic soft landing and the pullback in interest rates is alleviating a significant amount of the downward pressure on values. From a fundamental perspective, outside of office, rent and NOI growth are slowing, but not backtracking. This combination of easing capital market headwinds and mostly favorable fundamentals helps build the case that we may be approaching a floor. This means the window to take advantage of rock bottom pricing may start closing sooner rather than later.

Adapting to the changing use of real estate

Demographic shifts, as well as changing consumer and worker preferences, continue to change the way real estate is used in the post-pandemic economy. Rows of office cubicles are being replaced with more amenity-rich open floor plans, warehouses closer to population centers are growing in popularity, consumer adoption of online shopping continues to grow and millennials are now favoring less dense suburban living options as opposed to the high-rise CBD towers they once coveted. In short, portfolios that anchor to the philosophies of 10 years ago are at a disadvantage, and investors that don't adapt to the new environment run the risk of being left behind. That's not to say all previous uses of real estate are obsolete, but legacy assets do need to adapt, and portfolios must expand to incorporate the newer subsectors that complement the more traditional uses.

Traditional sector evolution

New/creative office: Employees are no longer interested in sitting in a sea of cubicles in a drab building, and office design has evolved to become more worker-centric. By clearing out cubes and opening up floorplates, individual desk space is reduced, but it has been replaced with more amenities such as lounge areas, game rooms, conference centers, roof decks and gyms. These changes provide a more welcoming environment that creates a lifestyle for workers, as opposed to just a place to show up for work. These attributes often work most efficiently in new construction, but an adaptive reuse of older assets can also yield successful outcomes.

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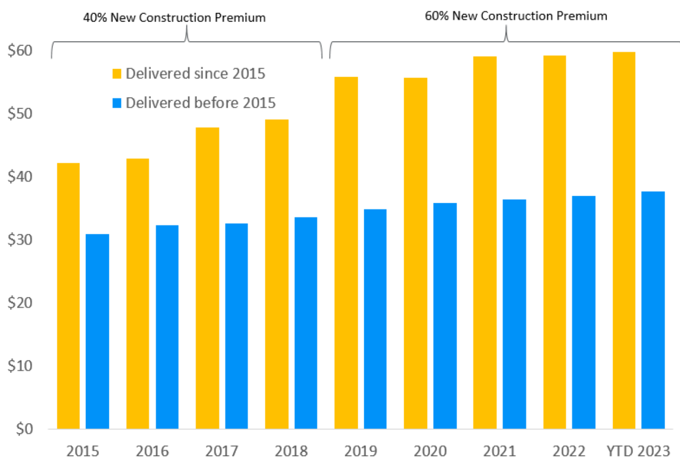
Office Asking Rent by Vintage ($ PSF)



Source: JLL, J.P. Morgan Asset Management; as of 9/30/2023.

Infill warehouse: As e-commerce and direct-to-consumer sales continue to grow, assets that are closer to the population bases they serve are also increasing in popularity. Location, not functionality, is the top priority, as closer-in assets allow retailers to get goods in the hands of end consumers faster and more cheaply. For owners, the lack of developable land serves as a governor to supply, increasing negotiating power in lease discussions.

Experiential retail: As brick-and-mortar retail battles growing online competition, centers that provide services and experiences that can't be replicated online are at an advantage. Gyms, movie theaters, restaurants and now even medical tenants are all uses that drive foot traffic and boost center performance, while also having minimal overlap with internet competition. This also includes the largest and highest quality shopping centers and malls in a metro. Their sheer size and diversity of tenants acts as a draw, as it allows shoppers to have the extended options that internet shopping affords, while also allowing them to see, touch and, in some cases, even smell and taste the products before buying, making for a more enjoyable shopping experience.

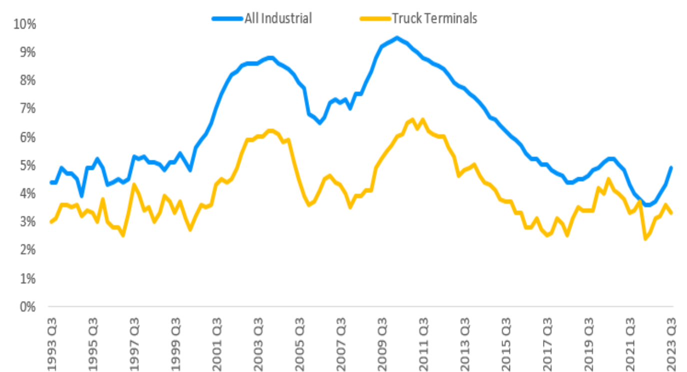
Suburban multi-family: As millennials age into their peak family formation years, they are increasingly leaving cities and "efficient" (otherwise known as small) apartments behind and moving to suburban locations that offer more space, lower rent, better schools and a safer environment than the cities they loved in their mid-20s. As these locations are typically more antidevelopment than downtown cores, supply is less of an issue. This, combined with the growing demand, creates a more landlord-favorable environment, which is showing few, if any, signs of fading.

Extended sector growth

Single-family rentals: These assets benefit from all the same demographic drivers as suburban multi-family, but offer even more space, greater privacy and often come with yards for the kids to play in. What they don't come with is the hefty down payment, elevated mortgage rate and transaction costs of owning a home. These favorable characteristics have kept demand strong and rent growth healthy. A muted for-sale single-family supply pipeline and healthy demand should keep home prices elevated, pushing more would-be owners into rentals, driving future rent growth.

Low coverage industrial: The growth of e-commerce also benefits what were once more niche industrial uses that are now growing in popularity. Among other things, truck terminals and industrial outdoor storage facilities provide the infrastructure that supports the growing shipping and trucking networks needed to get packages from the ports to your porch, in an age where two-day delivery is now considered the norm.

Industrial Vacancy



Source: CoStar, J.P. Morgan Asset Management; as of 9/30/2023.

Age-restricted housing: Baby boomers represent one of the largest and wealthiest age cohorts in the country. These individuals are now in their mid-50s to mid-70s, are increasingly becoming empty nesters and often looking to

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downsize. They are still independent and active, but typically prefer to live in the company of others in a similar stage of life. Age-restricted housing provides the ideal option for many of these individuals and delivers a way for investors to help serve the needs of an aging population without having to contend with the added operating complexity, costs and risks that come with owning higher-care facilities such as assisted living and nursing homes.

Lab: This same aging population is also looking to live longer and healthier lives, and the need for additional therapeutics is growing because of it. Pharmaceuticals are one avenue, but more advanced technologies, including gene therapies and MRNA vaccines, also hold the potential to improve the quality of life for everyone. Demand for the real estate used to facilitate these advancements should continue to grow. Although the industry is facing a temporarily unfavorable supply and demand imbalance, the long-term prospects remain promising. As a result, we view any near-term headwinds as a potentially attractive entry point to a sector that should see outsized growth for some time.

The path forward

The world continues to evolve and so does the use of real estate. Short-term market disruptions have created what may be a generational buying opportunity across the industry, while longer-term structural changes have shifted, but not completely upended, the demand profile of real estate assets. Staying nimble, acting decisively and adapting and expanding portfolios to incorporate the assets and subsectors that cater to future demand is the best path to success. However, the process is a challenging one that will take an experienced team and disciplined investment process to effectively implement.

Next steps

For more information, contact your J.P. Morgan representative.

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