THE LONG GOOD BUY:
Successfully Redeploying In Today's Market

The heart of the buy-hold-sell decision is recognizing there are two real estate market cycles that interact with each other.

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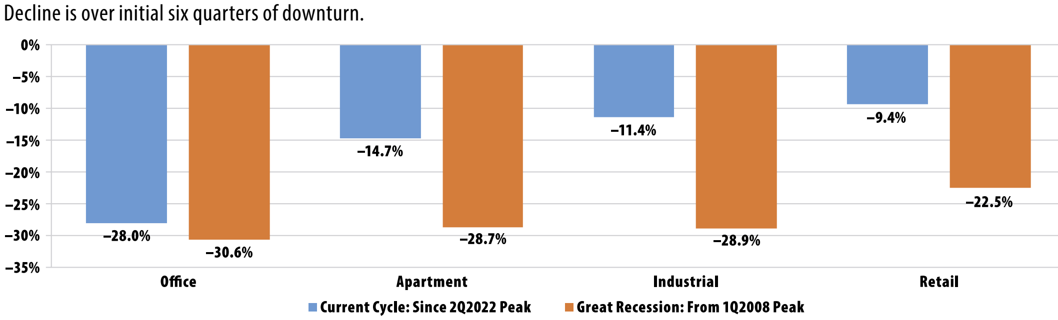
After nearly two years of policy tightening on the part of central banks around the world, the consensus among most analysts, investors, and pundits is success is within reach—inflation is falling and will likely continue to fall. Yet both the US economy and the real estate market continue to demonstrate a split personality. Signals have been conflicting, but a real recession would quickly force the hand of supply and demand, defining what returns would be needed to clear markets. Instead, the current property reset has been disjointed and ongoing, with fundamental performance and price movements differing across sectors and regions. There is also the expectation of billions of dollars in distressed assets piling up this year through 2027. In contrast to previous (more synchronized) property downturns, this ongoing reset may offer investors a richer opportunity for capital rotation.

The Interplay of Fundamentals and Capital Markets

The heart of the buy-hold-sell decision is recognizing there are two real estate market cycles that interact with each other. The first is the fundamentals cycle, including metrics such as supply and demand, occupancy rates, and rent growth. The second is the capital markets cycle—pricing responds to changes in fundamentals, expectations of future conditions, and changes in the cost of capital. Although fundamentals do not always lead pricing, this was the case in the major downturns of the 1990s and 2008–2010. Initial signs from Hines' research indicate that the current cycle may play out that way as well, allowing investors to monitor the trajectory of fundamentals to anticipate pricing trends by sector. Opportunities to harvest and redeploy capital arise not simply when there are two distinct cycles but when these are asynchronous across sectors. For example, occupancy in one sector (or region or submarket, etc.) can change independent of others, or pricing

Exhibit 1: Asynchronous Current Cycle Shows Dispersion of Performance Across Sectors

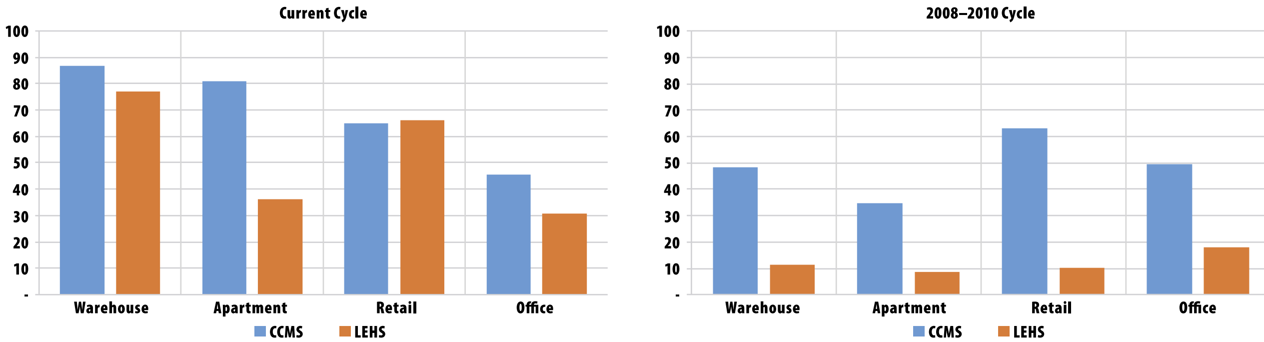
Decline is over initial six quarters of downturn.



Sources: NCREIF, Hines Research
Notes: Data are as of 4Q2023. The cumulative change in capital values for the initial six quarters of the 2008–2010 downturn are shown in order to match the current cycle (six quarters since the peak at the end of 2Q2022).

Exhibit 2: Relative Pricing and Sector Health—Current Downturn Versus the Great Recession

Hines Research Composite Capital Market Score (CCMS) and Leasing Environment Health Score (LEHS)



Sources: NCREIF, CoStar, Hines Research

Notes: Data are as of 3Q2023, due to availability of data, and show the data points for the fifth quarter into each cycle (for the current cycle, which uses 3Q2023 data, the length of the cycle as of 3Q2023 is six quarters). The Composite Capital Market Score (CCMS) is an aggregate score (0–100) derived from the following metrics: price to trend, cap rate spreads, growth-adjusted spreads, trailing price growth, and trailing total returns. The CCMS is calculated as a percentile relative to each market's own history. Higher scores indicate that the market is expensive relative to its history: "very expensive"—85–100th percentile; "expensive"—70th–85th percentile; "fairly valued"—30th–70th percentile; "inexpensive"—15th–30th percentile; and "very inexpensive" or "cheap"—0–15th percentile. This chart averages the CCMS for all markets covered by Hines Research within each property type shown. The Leasing Environment Health Score (LEHS) measures the relative health of a market's current leasing environment. It combines vacancy rates, trailing annual rent growth, and trailing annual demand growth into a composite score. The score is a backward-looking snapshot of where the market is today and can help inform a forward-looking view that is most predictive over the next one to two years. The score measures the environment relative to the prior environment in the market's own history. A score of 100 is a strong leasing environment, stronger than 100% of the market history. A score of 10 is a weak environment, worse than 90% of a market's history.

declines can be more severe in one sector or market than another. Identifying these anomalies can help investors find potentially attractive investments.

Hines believes the dynamics of this cycle (compared to those of the great recession) could be more favorable for investors looking to rotate capital. Exhibit 1 illustrates repricing across the current and the 2008–2010 property resets (using six quarters, the length of the current downturn). The 2008–2010 cycle saw more-severe, front-loaded, and relatively similar declines across the four major sectors. Yet in the current adjustment, office prices have clearly fallen hardest of the four sectors—almost as severely as during the great recession. Apartment, industrial, and retail have adjusted more modestly, but why? In Exhibit 2, proprietary Hines research provides a clue.

US Sectors Telling Different Stories

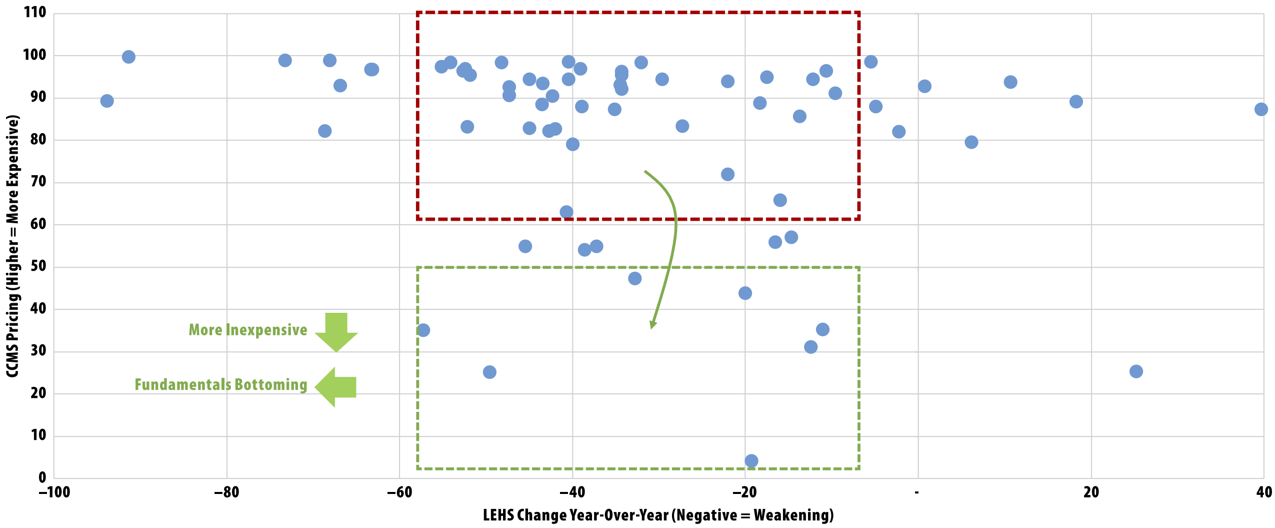
During the property downturn resulting from the great recession, pricing and fundamentals weakened uniformly. Based on the Composite Capital Market Score (CCMS),[1] prices in all four sectors fell to the fair to inexpensive range within five quarters of the onset of the downturn. With the great recession underway, weak employment and consumption clearly undermined real estate demand. Fundamentals were exceedingly weak across all four sectors, contributing to a repricing that continued into 2010. As shown in Exhibit 2 (left graph), as of 3Q2023, office appeared fairly valued. Yet as measured by the Hines Research Leasing Environment Health Score (LEHS),[2] office recorded a score of about 30, meaning that conditions were worse than during 70% of its recorded history. For the current cycle, the four sectors show clear differentiation in pricing and fundamental performance. Office is the only significantly inexpensive market by Hines' measures. Although US property appraisal data may not be fully reflecting opportunity in the market, the current data suggest pricing for the warehouse and apartment sectors

1. The CCMS is a proprietary Hines metric intended to measure the current value of a given market compared to its own history. It is calculated as a percentile, using the long-term averages of these five indicators: price to trend, capitalization-rate spreads, growth-adjusted spreads, trailing annual total return, and trailing annual price return.

2. The LEHS is a proprietary Hines metric intended to measure the current health of a given market compared to its own history. It is calculated as a percentile using the long-term averages of three demand-side indicators: trailing annual demand growth, vacancy rates, and trailing annual rent growth.

Exhibit 3: Relative Pricing and Apartment Sector Health

CCMS and Year-Over-Year Change in LEHS



Sources: NCREIF, CoStar, Hines Research

Notes: Data are as of 3Q2023, due to availability of data, and cover all the apartment markets covered by Hines Research. The Composite Capital Market Score (CCMS) is an aggregate score (0–100) derived from the following metrics: price to trend, cap rate spreads, growth-adjusted spreads, trailing price growth, and trailing total returns. The CCMS is calculated as a percentile relative to each market's own history. Higher scores indicate that the market is expensive relative to its history. "Very expensive"—85–100th percentile; "expensive"—70th–85th percentile; "fairly valued"—30th–70th percentile; "inexpensive"—15th–30th percentile; and "very inexpensive" or "cheap"—0–15th percentile. This chart averages the CCMS for all markets covered by Hines Research within each property type shown. The Leasing Environment Health Score (LEHS) measures the relative health of a market's current leasing environment. It combines vacancy rates, trailing annual rent growth, and trailing annual demand growth into a composite score. The score is a backward-looking snapshot of where the market is today and can help inform a forward-looking view that is most predictive over the next one to two years. The score measures the environment relative to the prior environment in the market's own history. A score of 100 is a strong leasing environment, stronger than 100% of the market history. A score of 10 is a weak environment, worse than 90% of a market's history. Year-over-year change is calculated by subtracting the LEHS for one year prior from the current score.

has been strong, although the leasing environments are very different. Hines' data suggest US warehouse fundamentals (although currently robust) have started to deteriorate, and in the apartment sector, fundamentals have already weakened and the sector has begun to recover. Finally, retail seems to be following its own countercycle, weakening significantly since 2015 (likely because of investor alarm over the threat of e-commerce). However, as a sector it has suffered the smallest decline this cycle, looks to be fairly valued, and is enjoying relatively healthy fundamentals.

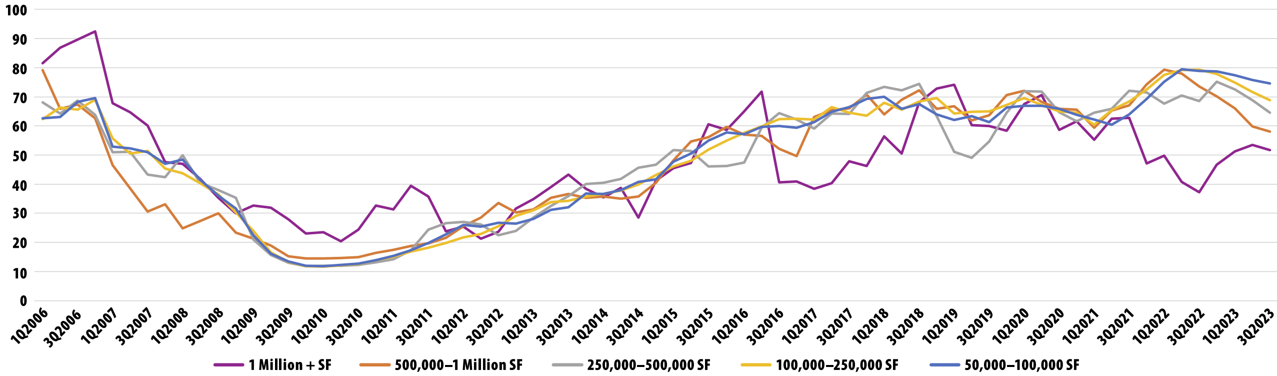
How to Play the Redeployment Opportunity

Two strategies should be considered for capital rotation, but investors will also need to consider a distress overlay to be discussed:

1. There is inter-sector rotation. Hines' view on pricing suggests investors could sell the in-favor warehouse sector and redeploy into the apartment market, invest in the more successful retail subtypes (such as grocery-anchored centers where Hines still sees an upside), or carefully examine the admittedly out-of-favor office market. As in retail, there is increased clarity on what type of office will likely thrive even in a hybrid world. For bold investors, equity investments in only the best office properties at a significant discount may result in attractive returns over time, but there could also be opportunities to use office assets as a covered land play or to invest in the debt portion of the capital stack on high-quality properties where the seller needs an alternative source of capital.

2. There is intra-sector redeployment. As noted earlier, the fundamentals of the US apartment sector have already weakened, suggesting that while overall sector average pricing still looks expensive, select markets may

Exhibit 4: Relative Sector Health History of Warehouses by Size

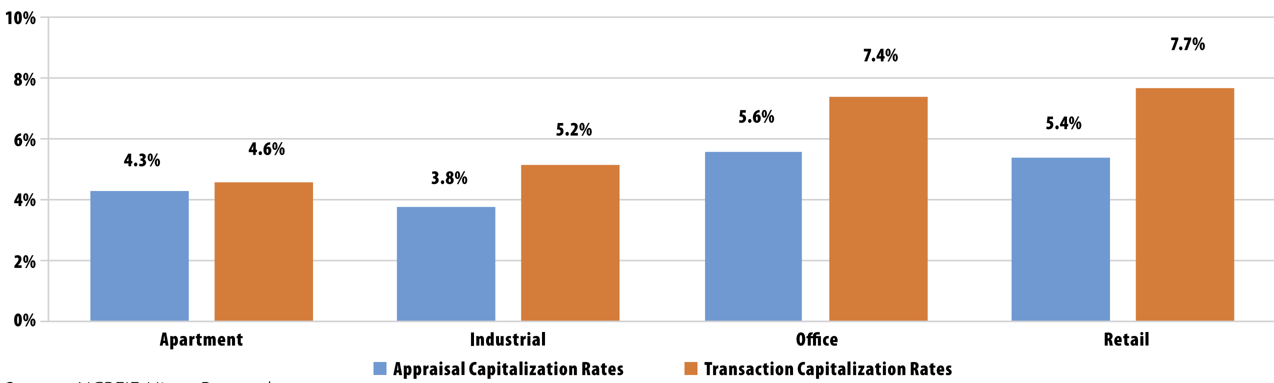


Sources: NCREIF, CoStar, Hines Research

Notes: Data are as of 3Q2023. The LEHS measures the relative health of a market's current leasing environment. It combines vacancy rates, trailing annual rent growth, and trailing annual demand growth into a composite score. The score is a backward-looking snapshot of where the market is today and can help inform a forward-looking view that is most predictive over the next one to two years. The score measures the environment relative to the prior environment in the market's own history. A score of 100 is a strong leasing environment, stronger than 100% of the market history. A score of 10 is a weak environment, worse than 90% of a market's history.

Exhibit 5: Book Values Are Still Catching Up With Market Values

US Property Appraisal and Transaction Capitalization Rates



Sources: NCREIF, Hines Research

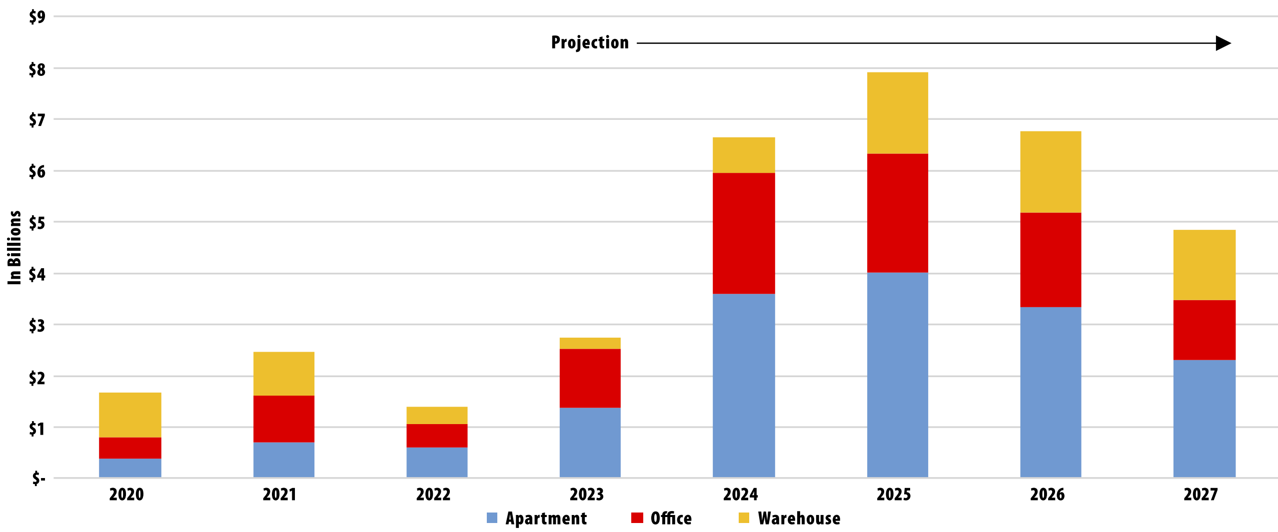
Notes: Data are as of 4Q2023. The value-weighted series for each category of capitalization rate was used.

have experienced more significant repricing. In Hines' opinion, the opportunity to rotate among markets is richer because fundamentals have bottomed and are starting to improve. Exhibit 3 charts the pricing and change in fundamental strength for the US apartment markets covered by Hines Research. There is an opportunity to rotate from markets in the top of the chart, particularly those Hines views as expensive but that have already started to see fundamentals slip, and move into those at the bottom of the chart—inexpensive with fundamental recovery ahead.

2b. There is another intra-sector idea for the in-favor warehouse sector. It may be a bit too early, but as shown in Exhibit 4, there has been a material difference in the LEHS trajectories of the different-sized warehouses, with those of one million square feet or more looking the weakest. If this disparity in fundamental performance drives a similar dispersion in pricing, there may very well be potential investment opportunity to sell smaller, urban logistics for higher-yielding and even higher-returning discounted e-commerce "mega sheds."

Exhibit 6: Projected Distressed Assets Through 2027

Projected Distress by Property Type, Billions in Total Project Value



Sources: CoStar, Hines Research

Notes: Data are as of 3Q2023. Submarket estimates based on submarket transaction volume and risk multiplier. The Hines Risk Multiplier is a proprietary composite metric designed to indicate the probability of a permanent loss of capital over a five-year hold period. The six dimensions of risk included in the multiplier are pricing risk, liquidity risk, construction risk, fundamentals risk, economic risk, and global market risk. Distress sales are defined as transactions that have been flagged by CoStar as distressed sales, REO sales, or short sales. This information represents subjective opinions of Hines Interests Limited Partnership. Other market participants may reasonably have differing opinions.

The Role of Distress: Book Values Versus the Real World

A final and interesting overlay of this cycle is the opportunity to buy property across all four sectors but at distressed valuations compared to appraised values. Exhibit 5 shows capitalization (cap) rates as reported by NCREIF for both appraisals and transactions reported by its members. Even for what is considered "institutional-quality" property, transaction cap rates for office and retail, though likely driven by the mall subsector, differ markedly depending on whether they are calculated using appraisal data. More important, this suggests that higher cap rates are available relative to appraised cap rates across all four sectors. Even for the most liquid markets (warehouse and apartments), these rates were less divergent. As of 3Q2023, appraised values per the NCREIF Property Index were down 16.1% in aggregate, but when using transaction cap rates (to calculate the implied decline by comparing current transaction cap rates to the most recent trough), transactional values are down 26% or more. Investors might very likely expect this is skewed by the office sector, but in fact, 73% of NCREIF sales by value over 2023 were from the (stronger and more liquid) industrial and apartment sectors. Hines believes this not only represents a further avenue to rotate out of these strong sectors into those (such as office) out of favor but also to reinvest within the strong sectors by seeking out higher-quality properties in higher-quality locations but with more distressed valuations.

Of course, sellers are obviously reluctant to adjust prices in some areas and sectors to market-clearing levels. With the higher interest rate environment and billions in commercial loans scheduled to mature in the near future, Hines believes distressed sales will likely dramatically increase.

As shown in Exhibit 6, distressed sales in the apartment, office, and warehouse sectors are projected to more than double this year, increase again in 2025, and remain elevated through 2027. For this chart, the trajectory is more important than the totals—the underlying data represent a subset of all distressed transactions. In any case, the distress overlay will likely gain importance over the next year or two,

further enabling capital redeployment. The challenge for investors will be to have the market knowledge and presence required to find and sift through those opportunities.

The Opportunity in a Nutshell

The current property downturn is different from past cycles in which changes in fundamentals and pricing were synchronized. These two cycles have been playing out in an asynchronous fashion across the major sectors, sector subtypes, and geographies. Investors can watch for changes in metrics such as supply/demand, occupancy, and rent growth to suggest the direction of sector health, and this has implications for the trajectory and timing of any repricing. Proprietary Hines data (such as LEHS and CCMS) may further help determine market trends. The disparity in performance noted offers an unusual opportunity to harvest and redeploy capital during the ongoing pricing reset. Strategies for capital rotation include inter-sector, intra-sector, and a more broad-based play for distressed pricing even for higher-quality assets in higher-quality locations. ■

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