

Landings, Reunions, and Revivals: Keys to the US Property and REIT Outlooks



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With softening fundamentals, a lingering public-private valuation problem, and muted property transaction activity, the US commercial real estate (CRE) market appears to be stuck in a period of stagnation.

However, all is not lost. The current glide path of the US economy holds the keys to unlocking the property market’s stifled potential. Executing the hat trick of an economic soft landing, a reunion of public and private real estate values, and a revival of property transaction activity can revitalize the CRE market. In this environment, REITs too are expected to benefit, maintaining their investment performance and acquisition advantages over their private market competitors.

The Elusive Soft Landing?

Lacking an official definition, an economic soft landing is typically described as a time when the Federal Reserve’s monetary tightening policy has been successful in reducing inflation as well as avoiding a surge in unemployment and negative economic growth. The process has frequently been likened to the story “Goldilocks and the Three Bears,” in which too little tightening does not resolve the inflation problem and too much tightening results in a

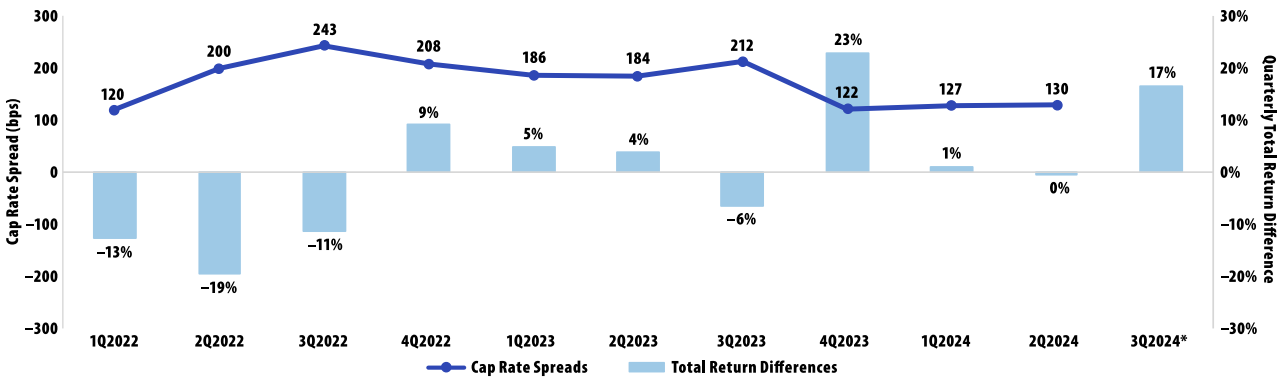
hard landing—i.e., a recession. A soft landing is only possible with just the right amount of tightening. Because of this delicate balance, soft landings have regularly been described as elusive and rare.

While it is often reported that the Fed has successfully engineered only one soft landing, which occurred in the mid-1990s, research by Alan S. Blinder, a Princeton University economist and former vice chairman of the Board of Governors of the Federal Reserve System from 1994 to 1996, indicates otherwise. Presenting thoughtful analyses of past monetary tightening episodes, his paper in the *Journal of Economic Perspectives* “Landings, Soft and Hard: The Federal Reserve, 1965–2022”¹ found that the Fed has capably executed several soft and softish landings. Even though the notion of rarity has been upended, soft landings remain the holy grail of monetary policy.

In today’s economy, the pace of inflation has been moderating toward the Fed’s 2% objective, the employment situation has exhibited more strength than anticipated, economic growth has remained healthy, and the prospects of recession have lessened considerably. The Fed appears to be poised to successfully engineer another soft landing, a sentiment shared by Blinder. This is particularly good

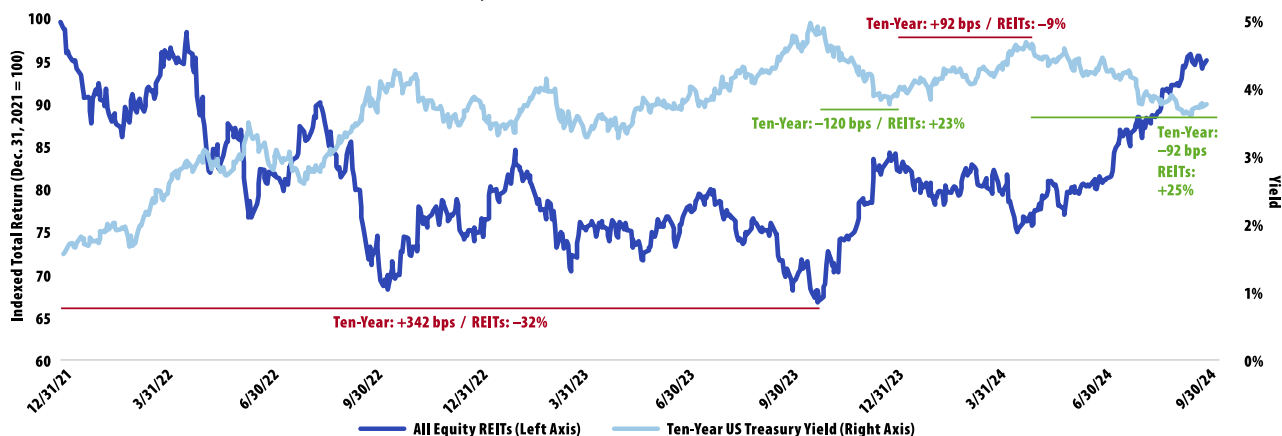
1. Alan S. Blinder, “Landings, Soft and Hard: The Federal Reserve, 1965–2022,” *Journal of Economic Perspectives*, Vol. 37, No. 1, Winter 2023.

Exhibit 1: Public-Private Real Estate Cap Rate Spreads and Total Return Differences



Sources: Nareit T-Tracker, NCREIF, FTSE Russell, FactSet Research Systems, S&P Capital IQ Pro
*Calculation includes preliminary NFI-ODCE total return.

Exhibit 2: REIT Total Returns and US Ten-Year Treasury Yield



Sources: Nareit, FTSE Russell, FactSet Research Systems

news for the broad CRE market, especially as it relates to property fundamentals and operational performance. Market-expected monetary policy easing and declining interest rates also likely hold the keys to solving the lingering public-private real estate valuation problem.

A Public and Private Real Estate Valuation Reunion

During the current real estate valuation divergence, the spread between REIT-implied and private-appraisal cap rates has been stubbornly slow to close. Almost two years after reaching its crest in the third quarter of 2022, the gap has remained wide. Exhibit 1 displays public-private real estate cap rate spreads and total return differences since the first quarter of 2022. REIT metrics are from the Nareit Total REIT Industry Tracker Series, or T-Tracker, and the FTSE Nareit All Equity Index. Private real estate measures focus on properties from the NCREIF Fund Index—Open End Diversified Equity.

A negative relationship is evident between quarterly total return differences and cap rate spreads. With the most significant degree of REIT underperformance (-19.5%) in the second quarter of 2022, the cap rate spread surged by 80 basis points (bps). When REITs enjoyed the greatest degree of outperformance (+22.8%) in the fourth quarter of 2023, the cap rate spread plunged by 90 bps. Given the solid REIT outperformance (+16.5%) in the third quarter of 2024, the cap rate spread will likely drop to less than half its previous quarter's value; a level akin to the average spread across periods since 2000 that did not have a valuation divergence.

Declining interest rates and continued monetary policy easing are expected to play critically important roles in accelerating the slow wheels of progress and allowing public and private property valuations to once again reunite. The closing of the cap rate gap is also anticipated to fuel continued REIT outperformance through year-end and potentially into 2025. Note that REIT performance has generally followed an inverse relationship with ten-year Treasury movements since 2000. Exhibit 2 presents US ten-year Treasury yields and the FTSE Nareit All Equity Total Return Index on a daily basis from Dec. 31, 2021, to Sept. 30, 2024.

With declines (increases) in the ten-year Treasury yield, REIT total returns have tended to increase (decline). As the ten-year Treasury yield dropped over the third quarter of 2024, REITs posted solid total returns, resulting in expected material declines in the REIT implied cap rate and the corresponding public-private cap rate spread. But since the end of the third quarter, the ten-year Treasury yield has ticked upward, and REIT total returns have retreated. If REITs can maintain their gains, and private property investors remain steadfast in their modest and measured quarterly appraisal cap rate increases, CRE may finally close the door on its current public-private valuation dislocation.

Reviving the Stalled Property Transaction Market

As public and private real estate values become more in sync with each other, a revival is anticipated in the



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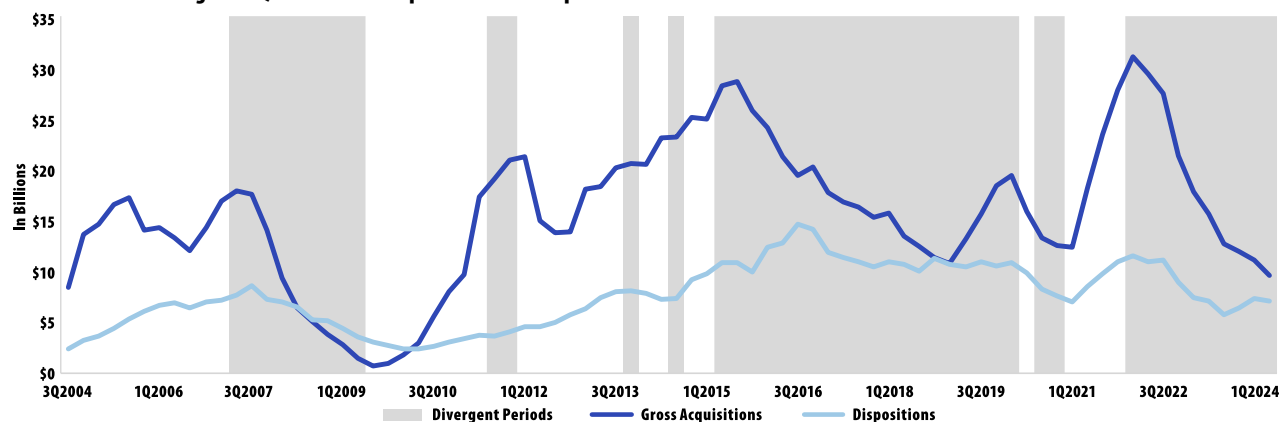
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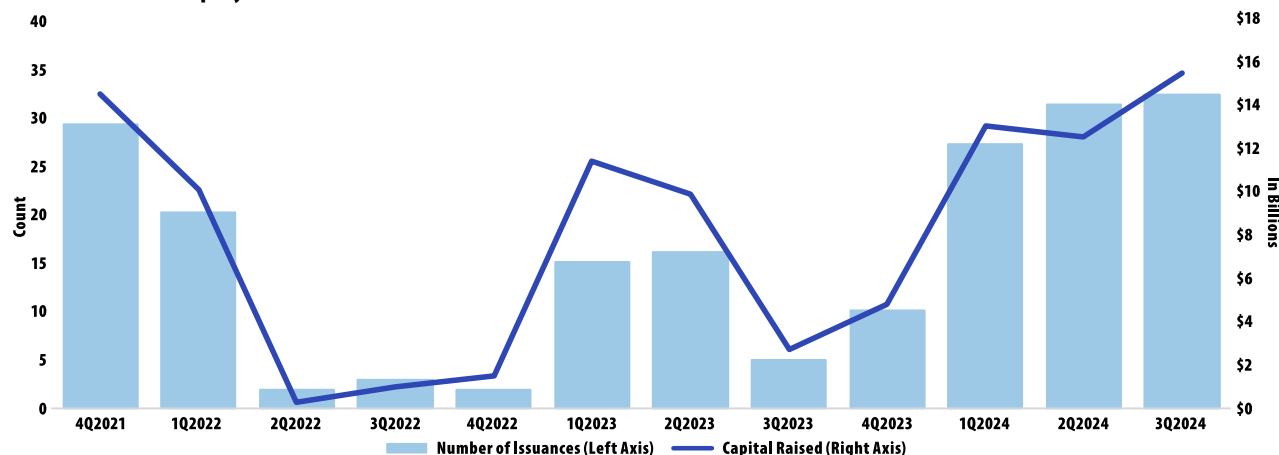
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Exhibit 3: REIT Rolling Four-Quarter Gross Acquisitions and Dispositions



Sources: Nareit T-Tracker, NCREIF, S&P Capital IQ Pro; data are as of 2Q2024

Exhibit 4: US Public Equity REIT Unsecured Debt Issuance



Sources: Nareit, S&P Global Market Intelligence

currently stalled CRE transaction market. Using the REIT experience as a proxy for the broader market, Exhibit 3 shows rolling four-quarter gross acquisitions and dispositions for REITs over the past 20 years; it also highlights quarters that experienced a divergence in public and private real estate values, i.e., periods in which the REIT-implied and private-appraisal cap rate spread was greater than or equal to 100 bps. Divergent and nondivergent valuation periods had average public-private cap rate spreads of 160 and 54 bps, respectively.

Showcasing their focus on growth, REITs have been net buyers of real estate, except for a period during the global financial crisis. Consistent disposition activity highlights REITs’ diligence in pruning their portfolios

throughout the cycle. Although property transaction activity has been muted, current gross acquisitions and dispositions have remained significantly higher than their respective financial crisis levels. REITs have been active buyers and sellers, but they have modified their appetites with changing market conditions. Across consistent periods of divergence, REIT transaction activity declined markedly. It accelerated when valuations were once again aligned with each other.

Acquisition Advantages, REITs

In this newly anticipated environment in which public and private real estate valuations converge and the transaction market regains its footing and accelerates, REITs will likely



maintain several advantages over their private market counterparts. REITs are expected to be in an enviable position when it comes to acquisitions because of their solid operational performance, well-structured balance sheets, and efficient access to cost-advantaged capital.

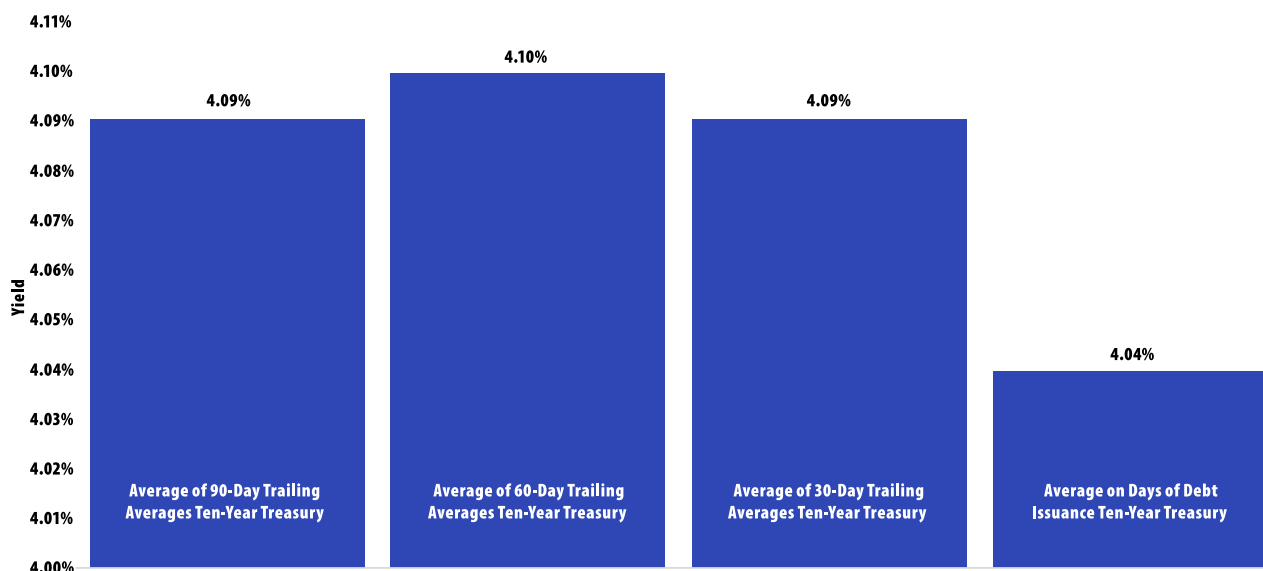
Although US public equity REITs have access to a variety of public and private capital sources, they have a penchant for fixed rate and unsecured debt. Data from Nareit’s T-Tracker show that, on average, fixed rate debt accounted for more than 90% of total debt in the second quarter of 2024 (the most recent data available); unsecured debt composed nearly 80% of total debt. Access to unsecured debt provides REITs with a competitive advantage over their private real estate competitors. Exhibit 4 displays quarterly US public equity REIT unsecured debt issuances by the number of issuances and total capital raised from the fourth quarter of 2021 to the third quarter of 2024.

With the surge in the ten-year Treasury yield in 2022, debt costs swelled. Acting rationally, REIT unsecured debt issuance dropped precipitously that year. Importantly, the limited issuance activity at that time confirmed that despite the rise in interest rates and debt costs, the “kitchen remained open” for REITs. Since then, there have been material increases in REIT unsecured debt issuances, with year-to-date 2024 numbers being particularly strong. In the third quarter of 2024, 32 senior debt deals closed with an aggregate value of \$15.4 billion. The average yield to maturity for these issuances was 5.2%; the ten-year Treasury yield averaged 4.0% over the same time period.

Notable recent transactions highlighting REITs’ specialized access to other forms of capital include:

- Lineage, the world’s largest temperature-controlled warehouse REIT, raised \$5.1 billion in gross proceeds at its initial public offering in July 2024; it was the largest listing of a US REIT.

Exhibit 5: Ten-Year US Treasury on Days of REIT Debt Issuance Versus Trailing Periods (January 2023 through September 2024)



Sources: Nareit, FactSet Research Systems, S&P Global Market Intelligence

■ Equinix, the largest US data center REIT, signed a joint venture with GIC and the Canadian Pension Plan Investment Board in October 2024 to raise more than \$15 billion to expand hyperscale data centers and support AI and cloud innovation.

■ Simon Property Group, L.P., a majority-owned operating partnership of leading mall REIT Simon, closed on a \$3.5 billion unsecured revolving credit facility in September 2024 at an interest cost of SOFR plus 82.5 bps.

While REITs have established a competitive advantage with their efficient access to the public debt markets, they might have also developed another quantifiable advantage in the execution of their financing strategies. Exhibit 5 presents the average yield of the ten-year Treasury on days of REIT unsecured debt issuances, as well as trailing periods, from January 2023 through September 2024. Trailing measures include the averages of 30-, 60-, and 90-day averages of the ten-year US Treasury yield.

The averages for the 30- and 90-day trailing periods were both 4.09%; the average for the 60-day trailing period was 4.10%. On the dates of issuance, the ten-year Treasury yield averaged 4.04%. It appears that, on average, REITs were able to secure a debt cost advantage of 5 bps through timing. With \$70.3 billion of REIT unsecured

debt issued over the examination period, this execution advantage translated to meaningful cost savings.

Change Is in the Air

Avoiding recession, bidding a fond farewell to the public-private real estate valuation divergence, and regaining traction in property transactions are keys to a brighter tomorrow for CRE. Though executing these tasks may seem daunting, the Fed is capable of engineering a soft landing, and property conditions are ripe for change. Success would reenergize the CRE market; it would also benefit REITs. In this environment, REITs will likely continue to outperform private real estate and maintain the upper hand on the acquisition front. With increased enthusiasm for real estate, investors should remain mindful of external shocks that have the potential to disrupt economic outcomes. ■

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