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The power of branding for REOCs

by David "Mac" McWhorter

The most common two complaints I hear from our real estate operating company (REOC) members and prospective members are: 1) I have way too many deals and not enough capital, and 2) I have more capital than I need right now and very little time to waste looking for more capital partners.

The irony here? The very best time to start looking for potential new joint venture capital partners is when you're pretty sure you absolutely don't need any more. And the very worst time, conversely, is when it's already too late and you're desperate to find the next capital partner.

Most of you reading this already intuitively "get" this. And that's why it's so surprising that so few of you actually act on it.

When you're desperately in need of capital, it shows. Your potential capital partners can sense the desperation in your voice, in your words and in your face. They literally can smell it.

When you're flush with capital and struggling to find deals, it also shows. Your potential capital partners can sense that you're not needy, and therefore they are a lot more likely to be open to whatever it is you have to say.

The problem is, when you have more capital than you need, it's tempting to focus all your time and attention on looking for the right deals to satisfy your current capital's appetite and to ignore the ongoing imperative to always be on the hunt for new capital partners.

Capital, of course, can be a renewable resource. It can, that is, until it no longer is.

One thing is certain: Your current capital partners are eventually going to become overexposed to your geographic market(s), overexposed to your property type(s) and/or overexposed to your company. At that point in time, what once appeared to be an inexhaustible source of capital is going to dry up. And that can happen in an instant, without much in the way of warning.

What's the lesson to be learned here? Whenever you find yourself feeling that you're flush with capital and your real problem is how to find the right deals, keep your firm and capabilities exposed to alternative potential capital partners. And if you're short of capital and face a surplus of potential deals, try to adopt a mentality of abundance; try not to telegraph your frustrations, your fears and your hunger.

Also be aware that at the extremes your potential capital partners can be in one of two conditions: They can view you as a known quantity, someone they're already aware of and open to entertaining. Or they can be completely unfamiliar with you and your company.

Why is that important? Because we, as human beings, have been conditioned since our earliest days of struggling to survive on the savannas of Africa to shun the unfamiliar. That's why we — despite our egotistical belief that we are immune to the effectiveness of advertising — tend to prefer to purchase well-branded products and services we trust.

Still think you're immune? Can you name the maker of "the ultimate driving machine?" The coffee brand that has a green mermaid as its logo with shops representing a welcome place of comfort and refuge where you can work remotely and connect with your neighbors, while enjoying your favorite coffee or tea drink? The trusted shoe and related athletic gear manufacturer whose logo look somewhat like a "swoosh"? The large-cap computer and mobile device manufacturer with a partly eaten fruit for its logo?

If you're like most people, you instantly knew which brands I was describing above, even though I didn't mention the names of the companies. And even though you know you have to pay a premium to purchase the products or services of these companies, chances are you already are a customer of at least one. That's the power of branding.

What's strange about all of this is that most REOCs simply don't get it. They think branding is for the tenant markets they serve through the properties they own, not for the capital partner/investor markets they serve through their joint venture investment offerings.

Blackstone understands this as a real estate investment manager. I was told by someone who knows, the one thing that can get you fired at Blackstone is doing anything that potentially could damage its brand. Blackstone raises more money than any other real estate investment firm because, before they even pick up the phone, they know they're going to be welcomed on the other end. That's the power of owning a strong brand in the investor marketplace.

Branding is more than developing a logo. Branding is about standing for something, and then, getting your potential customers (and competitors) to associate what you stand for with your name and your company's reputation. Think, for example, of everything that comes to mind when you hear the name "Blackstone." Now, consider everything that's likely to come to mind when others think about your firm. That's the difference between a firm with a well-developed brand and a firm with no brand identity at all.

How do you develop a brand? To find out, read this column in the first quarter 2024 issue of *iREOC Connect*.

David "Mac" McWhorter
Managing Director

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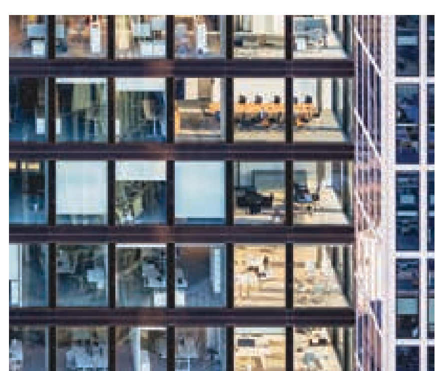
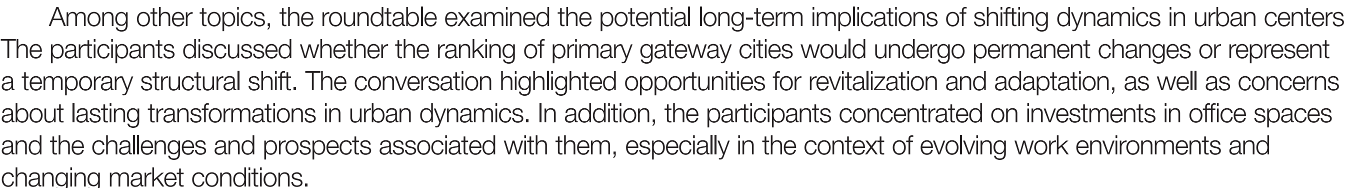
Is the office sector doomed? Insights from a roundtable discussion with investment experts



Institutional investors are generally taking a pessimistic view of the office sector. The office sector continues to grapple with increased vacancies, and the younger generation's reluctance to fully embrace traditional office work and city living. Recent headlines depict cities such as San Francisco and other major metropolitan areas as empty, with businesses and residents departing due to cost and safety concerns.

The question arises: Are American cities stuck in a never-ending downward spiral? Some are quick to respond with a resounding "yes," while others argue some cities are effectively addressing these issues.

This was discussed during a recent virtual roundtable hosted by Institutional Real Estate, Inc. The panel featured institutional investors, consultants and investment managers and was moderated by Chase McWhorter, managing director, Americas, with IREI.



Among other topics, the roundtable examined the potential long-term implications of shifting dynamics in urban centers. The participants discussed whether the ranking of primary gateway cities would undergo permanent changes or represent a temporary structural shift. The conversation highlighted opportunities for revitalization and adaptation, as well as concerns about lasting transformations in urban dynamics. In addition, the participants concentrated on investments in office spaces and the challenges and prospects associated with them, especially in the context of evolving work environments and changing market conditions.

One participant, a New York City resident, challenged the prevailing pessimism by pointing out the bustling restaurants and crowded transit systems, illustrating the ongoing vibrancy of cities, even outside the traditional office landscape. He emphasized the potential for micro-level transformations within cities, such as repurposing offices into residential spaces, to contribute to urban revitalization.

Another participant argued there might be an excess of conformity in predicting the demise of the office, especially when considering residential rents in cities such as New York and San Francisco. This raises questions about whether people still aspire to dwell in these urban hubs.

While certain aspects of city life and the office sector may face challenges, others continue to thrive. The urban landscape is evolving, and there is a likelihood of a more permanent shift toward hybrid working models, aligning with the evolving needs of the workforce.

Student housing performance slips, but sector still well-positioned, Yardi Matrix reports

Preleasing for student housing dropped back from 2022 levels in the final weeks of summer and start of fall, according to the latest *National Student Housing Report* from Yardi Matrix.

The preleasing slowdown also affected rent growth, which has dropped 0.9 percent from its March peak. Still, the sector is strongly positioned going into the fall 2023 semester, with high occupancy and record-high rents for the 2023–2024 school year.

The updated Yardi Matrix data set includes 892,511 beds in 30 markets as of this reporting period; this grouping incorporates more markets with institutionally owned dedicated student housing properties.

As of September 2023, 95.1 percent of beds at Yardi 200 universities were preleased, compared to 96.2 percent in September 2022. Analysts say lower preleasing in recent months can be partly attributed to slow lease-up of new 2023 deliveries, which were only 84.4 percent preleased in September.

"This year's lease-up was still a success, however, as September preleasing was ahead of September 2019, 2020 and 2021, and 56 university markets had preleasing of 99 percent or above," states the report.

Rents are near an all-time high at $846 per bed, relatively unchanged in the past four months. Rent growth dropped to 6.1 percent in September, down from 6.5 percent in August and a peak of 7 percent in March 2023. But it is still well above previous years; it averaged 2.9 percent in September 2019, 2020, 2021 and 2022.

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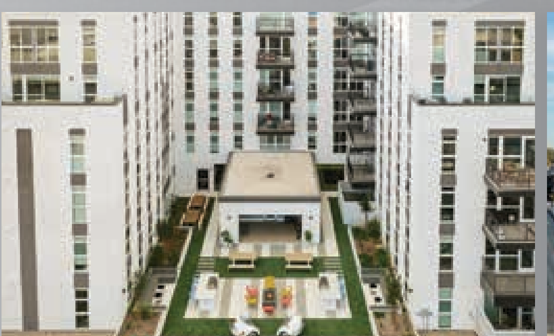

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Aging in place

More seniors than ever are working longer across U.S. metros

by Denise Moose

In the past, most seniors chose to move and retire to places such as Florida, South Carolina and Arizona, but recently, seniors are deciding to work longer and "age in place", making metros the fastest growing senior population with the highest job growth.

According to a recent report by Oxford Economics titled *U.S.: More seniors age in place and work longer across metros,* the senior population continues to migrate to Sun Belt metros, but the trend has abated as more seniors are deciding to age in place than in previous generations.

Over the years, metros that have seen the greatest in-migration of seniors include The Villages, Punta Gorda, Sebastian, and Naples, Fla.; St. George, Utah; and Myrtle Beach, S.C. However, for most of these metros, senior in-migration fell from higher levels in previous generations. Metros with the steepest senior out-migration include many in the Northeast and Midwest, but these have seen less senior out-migration in recent years than 10 or more years ago.

Not surprisingly, Florida metros still saw the highest rate of in-migration of seniors aged 65 to 74; however, most of these metros saw slower rates of in-migration in 2018 to 2022 compared with previous periods. According to the report, this is especially striking given that overall migration soared during the pandemic, and that the large baby boomer generation made up a greater share of those in the 65-to-74 age group in 2018 to 2022.

The report also states that 10-year age cohort changes by state over time show traditional senior in-migrating states are seeing continued but reduced levels of in-migration. Likewise, many out-migrating states are seeing fewer seniors leave, as more are choosing to age in place. Florida, Arizona, New Mexico and Nevada continued to see positive, yet lower, in-migration in 2018–2022 relative to 2008–2012. However, South Dakota, South Carolina, Maine, Idaho and especially Delaware have seen growing in-migration. In Delaware, Maine and South Carolina, seniors are drawn to the coasts, particularly Hilton Head Island and Myrtle Beach in South Carolina. In Idaho and South Dakota, seniors are drawn to the mountains, especially in Boise, Coeur d'Alene and Rapid City.

Most of the Midwest and Northeast states — along with their respective metros — are seeing out-migration of seniors, but less of it than 10 years ago. And although California is showing evidence of greater senior out-migration, Los Angeles, San Francisco and San Jose all show an out-migration of seniors somewhat on par with figures over the past 10 years.

Finally, West Virginia, Alaska, Oklahoma, Arkansas, Wyoming and the other states saw heavier out-migration in 2018 to 2022 than they did in 2008 to 2012.

One reason fewer are migrating after turning 65 is because many continue to work past the age of 65, according to the report. More than one-third of those ages 65 to 69 remained in the labor force in third quarter, up from an average of 20 percent in the late 1980s. Likewise, nearly 20 percent of those in their early 70s are currently in the labor force, almost double the rate of the late 1980s.

With all of this said, the report shows most of the fast-growing metros will see a slowdown in senior population growth over the next five years as the peak of the baby boomer generation (born in 1961) will be 65 in 2026. Births started to drop in 1962 and then precipitously thereafter. Population growth of seniors will continue to outpace overall population growth but then will slow in 2026 and subsequent years as lower birth rates from the mid-1960s through the 1970s will continue to drag down the growth rate in seniors.❖

Denise Moose is the editor of *iREOC Connect* at **Institutional Real Estate, Inc.**

The ever-changing industrial sector

A look at the latest trends in industrial real estate

by Denise Moose

The logistics industry is changing and transforming at a rapid rate, and the pace of change is only expected to accelerate in the coming years. To stay ahead of these changes, investors and managers need to be aware of logistics trends that are shaping logistics in the year ahead.

One of those trends to watch is a possible economic slowdown affecting the sector. A recent report from JLL, *"Industrial Outlook: Industrial and logistics sectors feel the squeeze amid headwinds, Q3 2023,"* states industrial fundamentals showed increasing signs of slowing in the third quarter as the turbulent macroeconomic environment persists. And, although there is still demand from industrial tenants, many users either have pressed pause on executing new deals or are taking much longer to finalize deals as they evaluate all possible outcomes. Furthermore, real estate decisions are being reviewed by more people within the company, going as far up as the C-suite in some cases, adding to the prolonged timeline. Those with upcoming renewals in markets that have seen tremendous rental rate growth are weighing the options of moving locations to a more cost-effective market.

Rapid changes and potential slowdowns are yet more issues for developers facing challenges and growing pains.

"One of the biggest challenges facing industrial developers today is the political and social pushback for building big-box warehouses near residential areas," says Brian Malliet, CEO and founder at BKM Capital Partners. "We've seen this happening in several markets across the country. For instance, when someone buys an office campus and rezones it for warehouse/distribution centers, we see a lot of objections. Many complain about the increased commercial traffic, or the rezoning

would be detrimental to the local economy since it would bring down employment levels."

Malliet continues to add there is already a distinct lack of space in most markets, and the unavailability of debt and high development costs have cut down speculative development by half. While upcoming industrial deliveries will open a brief tenant-favorable window this year and next, the subsequent slowdown in development will once again squeeze supply and demand because ecommerce will only continue to grow. The supply-demand imbalance is going to be exacerbated again in late 2024.

"Additionally, demand has normalized, and ecommerce sales growth has returned to its pre-pandemic norms, but the lasting impact of supply-chain disruptions has increased the desire for more control," says Malliet. "This will translate to a need for more W&D space, yet the type of space won't be one-size-fits-all or concentrated in just a few markets."

Technological advancements

Digitization is another trend transforming the logistics industry, with companies adopting new technologies to streamline their operations and improve customer experiences, according to an article from CriticaLog, *"6 major logistics trends shaping logistics management in 2023."* This includes the use of cloud-based platforms, as well as mobile apps to manage logistics operations more efficiently.

To achieve digital transformation, logistics companies need to invest in advanced technologies and develop digital strategies that align with their business objectives. This can involve partnering with technology vendors, hiring skilled IT professionals and training employees to use new technologies effectively.

As logistics companies continue to embrace digital transformation, they will be able to improve their customer experiences, reduce their costs and gain a competitive edge in the market.

Malliet agrees and explains, in terms of logistics, the pandemic shed light on the need for supply-chain agility, to better track and control the process, costs, time and inventory — companies have embraced technology to improve efficiency and controls.

"The logistics industry generates vast amounts of data, which needs to be managed, utilized and stored," says Malliet. "Robust data analytics and management systems are needed to help companies gain insights, make decisions and improve operations. Yet technology integration — IoT, AI, blockchain, robotics — can be costly and requires modern, updated facilities."

In addition, technologies that increase the productivity of logistics facilities, such as automated storage and retrieval systems, keep attracting investment. The continued evolution of these technologies and the emergence of new ones like drones and autonomous vehicles will probably lead to more efficient and responsive supply chains and greater productivity for industrial assets.

"For industrial developers and their tenants, the challenges of customer proximity and land constraints demand solutions," says Malliet. "For this reason,

among others, it's important for industrial developers to invest in advanced technologies and ensure their facilities can meet the end users' technological needs."

New trends affect fundamentals

Knowing what trends are current or coming up is always an advantage when it comes to investing. The same report by JLL states the nearshoring trend will remain one to watch for the long term, while ecommerce will fuel the need for last-mile facilities.

Although absorption will likely remain positive through the end of 2023, it will largely be attributed to the delivery of preleased assets, according to JLL. Rental rate growth is expected to remain positive, but it is anticipated to be less robust than the unprecedented growth witnessed over the past two years. Though industrial is predicted to remain a landlord-favorable sector through 2024, some geographies might soften as certain indicators moderate. As companies nearshore their operations, some companies have adjusted their distribution strategies by using ports on the Gulf of Mexico and the East Coast — such as New Jersey; Savannah, Ga.; and Charleston, S.C. — which affected West Coast port volumes slightly.

To meet the demands of sustained ecommerce growth and same-day/next-day delivery expectations, there will be an increased need for urban logistics facilities located closer to major population centers.

To meet the demands of sustained ecommerce growth and same-day/next-day delivery expectations, there will be an increased need for urban logistics facilities located closer to major population centers. These last-mile facilities bring inventory closer to consumers, which reduces delivery times and transportation costs. At the same time, occupiers strive to achieve sustainability goals by implementing initiatives such as using a fleet of electric vehicles for deliveries or adding solar panels to unused rooftop space to offset any negative carbon footprint. Technology and automation activities are expected to advance significantly in the coming years, which will provide industrial users with increased opportunities for growth.

Malliet backs these trends up by stating that several trends are converging to shift and reconfigure the logistics landscape in the United States, in terms of the type of space going up, and in which markets.

"The type of space being built will have to change," says Malliet. "The importance of last-mile locations has boosted the need for infill industrial, but those sites are hard to find and expensive to develop, necessitating bigger projects to justify the costs. As such, much of the logistics space that has been developed in past several years has been large footprints of 100,000 square feet or more."

Furthermore, he explains, the increased need for manufacturing facilities is further squeezing the availability of smaller industrial assets. As manufacturing heats up, given that some manufacturers are shifting facilities back to the United States as part of the onshoring and nearshoring trends, it may reduce the demand for the types of large distribution centers that have been dominating development of late. The lack of available land and development costs will also require the reuse of existing, underutilized, older assets, particularly for small-bay logistics.

"We're also seeing a slight shift started in the geographic hubs," explains Malliet. "Combination of supply chain problems and issues at U.S. ports — namely, Los Angeles and Long Beach — led to a shift away from traditional logistics hubs, opening more markets as viable areas for logistics. Nearshoring also will give an advantage to logistics hubs in proximity to both the Mexican border and U.S. customers to enable cross-border transportation. Transportation executives anticipate 20 percent of Asia-originating freight will move to closer-proximity markets by 2025, doubling to 40 percent of freight originations by 2030. In addition, foreign direct investment in Mexico rose 41 percent year-over-year through the first half of 2023, with U.S. accounting for almost half. And as more factories open in the Midwest and U.S. South, they will need logistics services to store and distribute those goods."

Going forward

A recent article from Forbes, *"Six trends for shipping and logistics globally in 2024, and beyond,"* states logistics will be shaped by six key trends in 2024 and beyond. Those trends are digitization, economic headwinds, sustainability, last-mile delivery, supply-chain resilience and cybersecurity.

Malliet explains there is going to be a continuing downward pressure on facility sizes in the logistics side of the equation because of the evolution of advanced manufacturing machines and 3D printing.

"Technology also ties into alternative delivery methods driven by customers' desire for speedy deliveries," says Malliet. "This may drive a rise in the use of autonomous robots and drones to speed delivery and strategically positioned micro-fulfillment centers near urban areas."

He further explains that crowdsourced delivery platforms — aka collaborative logistics — that tap into local resources are also rising as part of the effort to meet customer expectations and improve efficiency and sustainability. ❖

Denise Moose is the editor of *iREOC Connect* at **Institutional Real Estate, Inc.**

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Consistency and growth

An examination of the future of grocery-anchored strip centers

by Mike Makinen, Chris Reed and Jim Sylvia

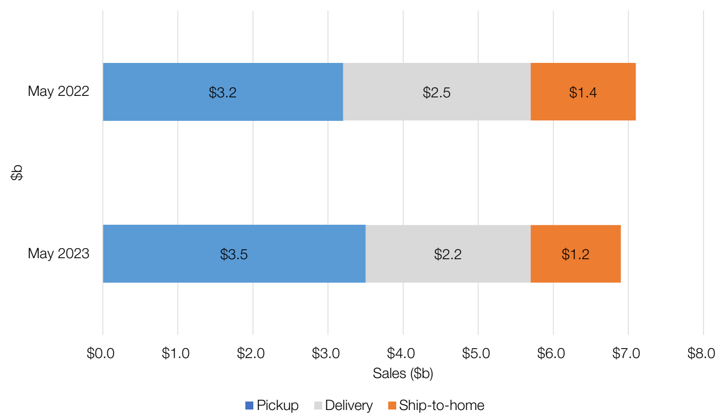
In the realm of commercial real estate, grocery-anchored strip centers have proven to be much less volatile than other retail investment vehicles. Combining the stability and consistent foot traffic generated by a grocery anchor with the diverse tenant mix of smaller, and predominantly service-oriented tenants, these centers have proven to be resilient prior to, during and after the COVID-19 pandemic. The following explores the advantages of investing in grocery-anchored strip centers, their potential for long-term success and key considerations for investors looking to capitalize on this market segment.

The strength of the grocery sector

The presence of a healthy grocery anchor provides a steady stream of customers, ensuring consistent foot traffic throughout the center. Groceries are a necessity, making them highly resistant to economic downturns and changing consumer habits. In addition, the grocery sector is highly concentrated; the top six grocers comprise two-thirds of the grocery sector. Walmart and Kroger alone account for more than 35 percent of sales.

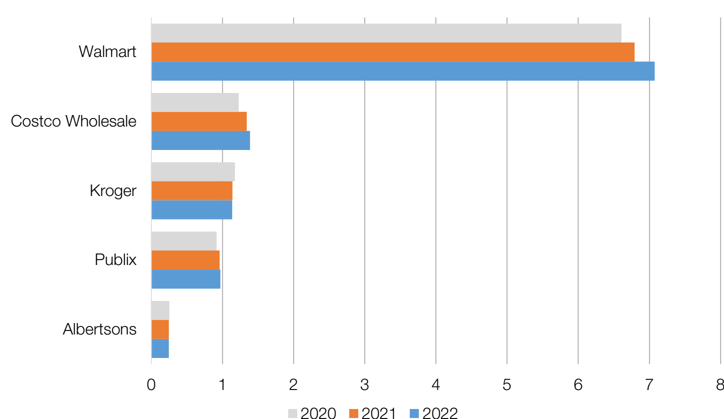
This concentration and the overall financial health of the leading grocers has allowed these companies to invest heavily in omnichannel technological innovation. These include major investments in automation, on-site/in-store pick-up and home delivery. Grocers' omnichannel efforts are designed to meet consumers' needs as they continue to evolve. And despite pandemic-related boosts in home delivery, consumers remain committed to the trip to the grocery store, which is by far the most profitable way for grocers to meet

Total U.S. online grocery sales, as of May 2023



Source: F&D's The Executive Review: Grocery Retail Report; July 18, 2023

Annual visits to grocery stores



Source: Placer Labs

their customer's needs. In fact, in the past year, the proportion of groceries purchased online has remained relatively flat, with half of those purchases including a trip to a physical store.

The outlook for the grocery sector remains attractive. The chart above, "Annual visits," provides a comparison of foot traffic in some of the country's largest supermarket brands from 2020 through 2022. In all cases, foot traffic has remained steady or increased since the pandemic.

The sector also continues to consolidate, including a pending major merger between Kroger and Albertsons as the leading example. If consummated, this merger would strengthen both companies to compete effectively with the likes of Walmart, Costco and Amazon. This consolidation is likely to continue among traditional grocers but at the same time, the food industry continues its evolution with many new formats expanding including deep discount/limited assortment (e.g., Aldi, Lidl), specialty (e.g., Sprouts, The Fresh Market) and ethnic concepts (e.g., multiple Asian and Latino concepts).

The health of the grocery anchor

Despite the overall health of the grocery sector, there is substantial variation in the value of grocery-anchored strip centers, the key differentiator being the quality of the grocery anchor tenant, according to GreenStreet's *Strip Center Sector Update* in June 2023. It is not unheard of to see a 100–200 basis point variance in cap rates when comparing similar centers in the same market, albeit with different grocery anchors. As such, the investment thesis of grocery-anchored strip center revolves around the strength of the anchor tenant and the resulting benefit received by the ancillary tenants in the form of consistent customer foot traffice at the property. The keys to evaluating the grocer's health include: The overall financial health of the chain, the strategic positioning of the store within its network of sister stores, its existing and potential competitive set within its submarket, its sales performance, its physical condition, the attractiveness of the shopping experience to prospective customers and other factors affecting store-level profitability. Store-level profitability drives the grocer's decisions relative to continuing to operate, closing and investing additional capital for remodeling. Of course, the real estate metrics of lease-term commitment, rent, CAM, taxes and other operational lease terms have potential bearing on the long-term health and sustainability of the grocer and its relationship to the other tenants in the shopping center.

Diversified tenant mix

Beyond the grocery anchor, grocery-anchored strip centers are enhanced by the strength of a diverse mix of smaller tenants. With a strong grocery operator, tenants strive to be close to the anchor tenant and will often pay higher rent to gain the benefit of the grocery-anchored foot traffic. In addition, the types of tenants attracted to these centers are focused on capitalizing on the frequency of visitation to the grocer. The tenant mix is decidedly service oriented, ranging from nail salons, hair salons, casual restaurants (both carry-out and sit-down), financial services and fitness uses, and as a result, are ecommerce resistant. This diversity ensures a variety of products and services, attracting a broad range of customers. Grocery-anchored

centers will remain critical points of sale of services. To use a specific example of hair salons, while customers can reserve a place in line using the internet, the internet cannot cut hair, so customer traffic remains high.

By investing in a grocery-anchored strip center, investors gain exposure to multiple revenue streams from different, yet complimentary, tenant types. This diversification minimizes the risk associated with relying solely on a single tenant or sector, enhancing the overall stability and resilience of the investment. Even if one tenant were to vacate, the presence of a healthy grocery anchor makes it easier to attract new tenants due to the consistent foot traffic and established customer base.

Overall, the stability of the grocery anchor has a positive cascading effect on the other tenants within the strip center. It establishes a hub where people come to fulfill their daily needs, generating a constant flow of potential customers for the surrounding retail and service outlets. This is true regardless of whether the shopper shops in-store or only visits to pick up online orders.

Conclusion: Why invest in open-air and grocery-anchored retail?

Grocery-anchored strip centers offers a unique and compelling value-proposition and risk-adjusted return in today's uncertain and volatile macro environment. Retail tenant relationships and a proven track record of operational expertise are vital to the long-term success of an open-air strip center, as the concentration of prospective national retail tenants is more impactful to property-level value-creation than in other asset classes.

The investment highlights of open-air and grocery-anchored retail include:

1. Strength of post-pandemic operating fundamentals
2. Non-discretionary tenant mix and diversified income stream
3. Limited new retail supply with increased landlord pricing power and rental rate growth
4. Attractive relative going-in unlevered yields (cap rate) and current cash flow investment profile

Robust operating results for open-air retail in 2023 continue the recent post-pandemic trend of strong leasing and retailer performance. According to CBRE Econometrics Advisors' Q4/2022 report, public retail sector average re-leasing spreads of 11 percent are on the high-end of recent historical performance, dating back to 2014 and an average public-sector retail leased occupancy of more than 95 percent now exceeds pre-pandemic levels. The report also states that net retail space absorption was positive for the ninth straight quarter and new retail space deliveries in fourth quarter 2022 were at a 15-year low. High occupancy, robust tenant demand, and virtually no meaningful new supply pipeline has given retail landlords pricing power and leverage when negotiating with prospective tenants, driving trailing 12 month 2023 rental rate growth of 3.2 percent nationally, nearly double the historical average, according to CoStar's *Retail National Report* published in late November 2023.

"By investing in a grocery-anchored strip center, investors gain exposure to multiple revenue streams from different tenant types. This diversification minimizes the risk associated with relying solely on a single tenant or sector, enhancing the overall stability and resilience of the investment."

While the industrial and multifamily asset classes realized record-setting investment sales transaction volume since the start of the pandemic, going-in unlevered yields were low relative (4.3 percent–5.1 percent, according to CoStar's *United States Capital Markets Data Sheet* released in late July 2023) to the cost of debt, as much of the underwriting was predicated upon outsized rental growth or speculative development and leasing. Given the retail sector's high occupancy and limited new supply pipeline, attractive current yield and cash-flow drives pricing for grocery-anchored retail, with an average going-in unlevered yield (cap rate) of 6.8 percent (according to MSCI Real Assets' *U.S. Capital Trends Q3 2023* report) for high-quality grocery-anchored neighborhood and community shopping centers containing a market leading grocer.

In addition, open-air and grocery-anchored retail can be acquired at a basis significantly less than new construction replacement costs (the average price of grocery-anchored strip center transactions in third quarter 2023 was less than $200 per square foot), providing rental rate pricing power against potential new construction in the market and optionality to adjust to the ever-evolving needs of retailers and their target customers. ❖

Mike Makinen is chief operating officer and **Chris Reed** is chief investment officer with **ShopOne Centers REIT. Jim Sylvia** is principal with **JSylvia Advisory Services.**

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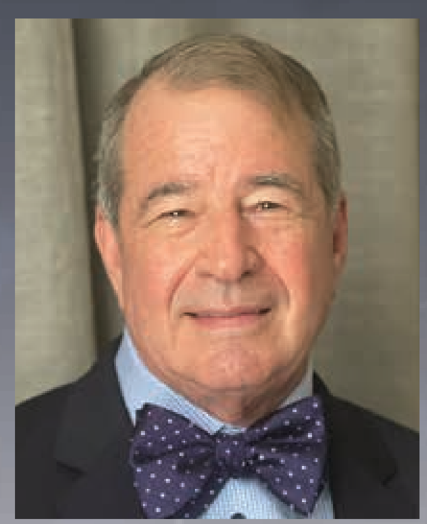

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Taking the long view

Navigating multifamily short-term headwinds with a long-term perspective

by Paul Landerr and Yichen "Ethan" Sun

In today's uncertain U.S. commercial real estate (CRE) market, multifamily stands out as a resilient asset class. While we observe short-term trends such as decelerating rent growth, increasing expenses and lower transaction volumes, it is important to consider them within the context of structural housing-market challenges, including an overall shortage of housing and increasing barriers to ownership. In light of this, we view long-term debt as a compelling option to access the multifamily asset class.

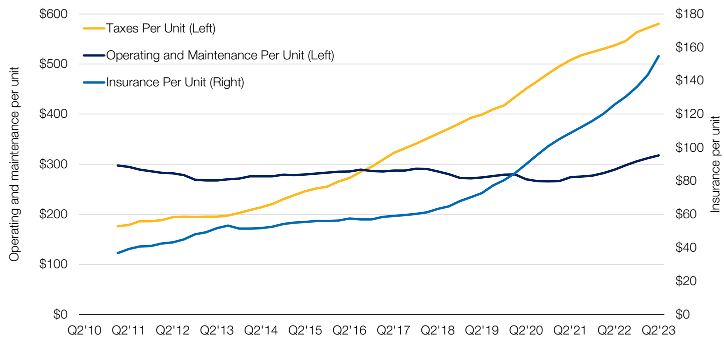
Deceleration in rent growth

Deceleration in rent growth has become a point of concern making headlines in 2023. While factors such as slower job growth, reduced household formation, and weaker in-migration may contribute to the deceleration, our primary focus is on the supply pressures affecting various markets. Generally, we observe that markets with higher new deliveries as a percentage of existing inventory are experiencing slower rent growth. In the near term, we expect that rent growth in these markets will continue to be constrained as projects in construction reach completion.

Expenses continue to increase

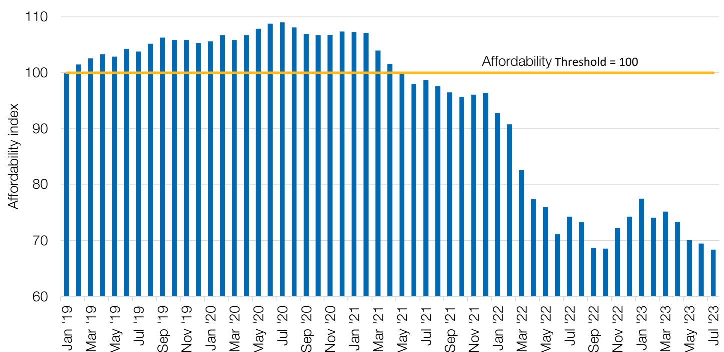
In addition to decelerating rent growth, expenses continue to increase. Reports of insurance cost increases in the southern and western regions continue to permeate throughout U.S. CRE for good reason. Operating expenses across markets typically track inflation, with certain factors beyond borrower control (such as taxes and insurance). Major expense categories have shown quarterly growth since 2019 that significantly outpaces the average quarterly expense growth since 2010. Stagnating rent growth, coupled with continued expense growth, are expected to weigh on expense ratios in the short term.

CRE expenses increase since 2019 , four-quarter rolling average



Source: RealPage; as of second quarter 2023

Home ownership affordability monitor index, (2019–2023)



Source: Federal Reserve Bank of Atlanta; as of Sept. 20, 2023

Valuation gap impeding transactions

Property owners are holding onto property values from 2021 and 2022, while buyers are attempting to earn increased target IRRs to keep up with higher interest rates. This disconnect has led to a significant slowdown in multifamily transaction volume which was down 68 percent in second quarter 2023 compared with the previous, according to MSCI Real Capital Analytics. Green Street's CPPI suggests CRE values have declined 16 percent from the recent peak in 2022, despite a lack of transactions that are skewing actual results higher. This slowdown has created uncertainty related to property values when evaluating new opportunities due to a lack of comparable sales information.

Across the investment landscape, borrowers continue to seek shorter loan terms coupled with some level of interest-only and flexible prepayment options. These preferences reflect borrowers' mindset that rates will decrease once the U.S. Federal Reserve is finished with the rate hikes, allowing for increased cash flow/loan proceeds in the future.

However, despite market expectations, the Fed's projections indicate rates will remain elevated for longer than expected. According to the Federal Open Market Committee projections in September, short-term rates in 2025 are expected to be 3.9 percent, compared to a 3.4 percent estimate in June.

A long-term Investment horizon can help mitigate short-term risks

We believe the risks identified above appear to be short term in nature and can be mitigated by adhering to a disciplined underwriting approach and focusing on longer-duration investments to weather the short-term disruptions in the multifamily market. Longer investment horizons will allow for more time for market fluctuations to stabilize.

Rental income growth, while slowing, typically aligns with long-term demographic trends and local demand dynamics. In our view, expense increases are expected to return to levels closer to the long-term inflation rate, and the uncertainty surrounding valuation rates today can be mitigated through strategic investment decisions.

The relationship between compounded quarterly rent growth since second quarter 2018 and new quarterly construction completions indicates markets experiencing the highest completions relative to overall supply tend to encounter a larger increase in rents over the same period. This relationship suggests developers responded to strong housing demand by building more units, indicating current supply levels will be absorbed, despite the short-term lack of pricing power.

Expense Inflation is being driven by the repricing of insurable risks, municipal budget adjustments in response to growth and inflation, and general inflation that may not have been experienced immediately across all expense categories.

Property values may take more time to stabilize as investors adjust to higher borrowing rates and identify properties for sale within their portfolios. We believe strategic investments that prioritize downside protection, disciplined underwriting of the property and business plan, and careful sponsor selection will help drive performance during the investment period.

The multifamily sector's sustained appeal is rooted in fundamental factors like evolving homeownership patterns, affordability concerns in the housing market and shifting demographics. As seen in the chart to the left, homeownship affordability is at its lowest point since 2018. These factors collectively indicate multifamily real estate remains well positioned for stability and growth in the years ahead.

As we navigate today's uncertainties, we believe it is crucial to maintain a forward-thinking mindset, recognizing the multifamily sector's potential to provide durable value and investment opportunities over the long term. ❖

Paul Landherr is associate director commercial mortgage loans and **Yichen "Ethan" Sun** is senior applied research analyst with **Aegon Asset Management.**

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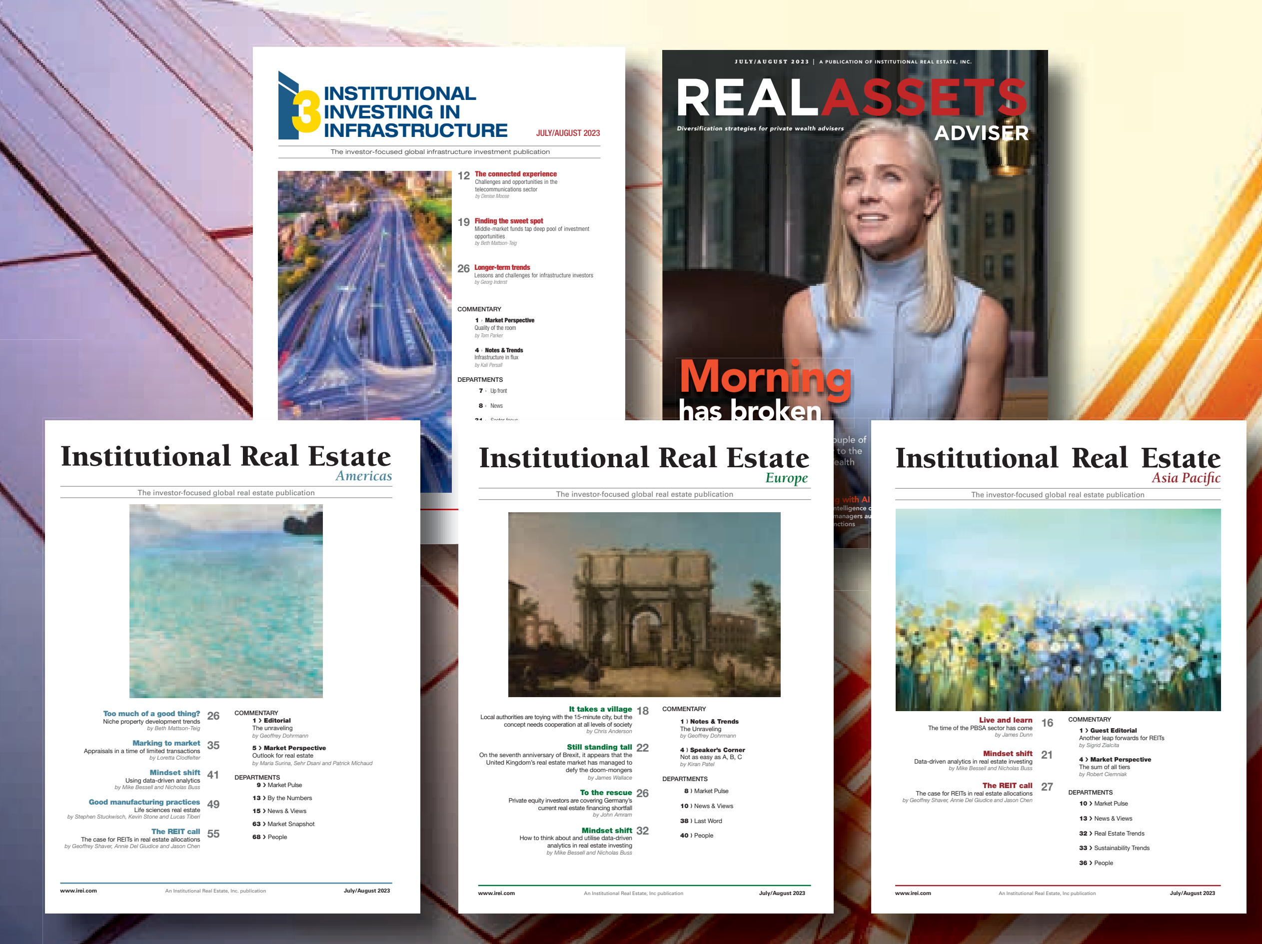

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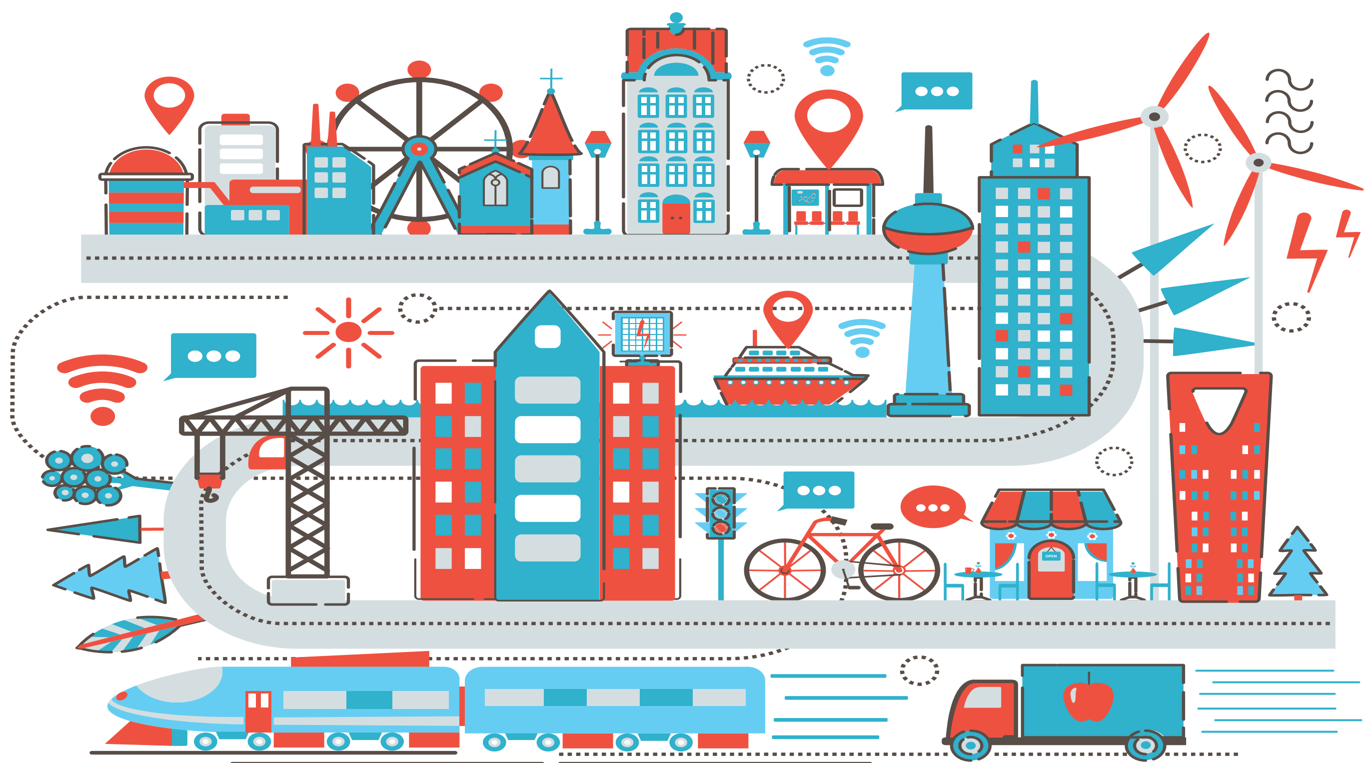


Urban utopia

Livable cities are Europe's next luxury export

by Zsolt Kohalmi

America's capital, Washington, D.C., was designed by a Parisian. Pierre Charles L'Enfant had a grand vision for the new city he planned of magnificent diagonal boulevards, which opened up the possibilities of city living. The result was a rare European-style urban design in the United States, which stood in stark contrast to the rigid grid urban structure seen elsewhere in the country.

Today, there are few in downtown D.C. to appreciate L'Enfant's contribution to his adopted country as the U.S. capital struggles to emerge from its post-lockdown slump.

Office vacancy rates in D.C. have reached a record high of 18.9 percent. In comparison, the rate in L'Enfant's birth city (central Paris) is 2.4 percent. These are not anomalous examples; they are both representative of their continent. Overall, the office vacancy rates in the United States and Europe are 21 percent and 7.6 percent, respectively. Moreover, while offices are underoccupied across America from New York City to San Francisco, in Europe there are numerous areas with robust demand. The office vacancy rate is below 5 percent in Munich, Stockholm, Vienna, Berlin and central Paris.

Of course, a city is much more than a parcel of land for offices. But broaden the lens from office occupancy to "quality of life," and the pattern is the same. In the Economist Intelligence Unit's *2023 Global Liveability Index,* no U.S. city is in the top 20 (the highest ranked is Honolulu at 25), while Europe accounts for four of the top 10. The Economist Intelligence Unit methodology reflects stability, healthcare, culture and environment, education and infrastructure, rather than only economic metrics.

Post-post-pandemic

Given this evidence, European cities appear to be in better shape than their North American counterparts. But why is this the case?

Much of the debate about the outlook for real estate has hinged on whether the trend toward remote work is sustainable — as post-lockdown

behaviors become entrenched or revert. Yet that misses the broader point implied by the divergence in vacancy rates and liveability scores. The question is less where people want to work, and more where people want to live, play and work.

Of course, the U.S. economic urban powerhouses are not going to disappear overnight, but investors should not be surprised to see property values erode slowly as such cities become less and less attractive for residents as well. San Francisco could be a prime example. It benefited for a long time from a booming local economy and a thriving culture that reinforced each other. Now, with well-documented social problems, the Bay Area has the country's fastest-dropping real estate values, and earlier this year its office vacancy rate hit a record high of 29.4 percent.

This is the challenge to the established social fabric in many U.S. cities, affecting not only troubled inner districts, but also the adjacent suburban expanses, whose key attribute is proximity to the downtown. As office occupancy dwindles, restaurants and shops close at ground level, leading to the whole downtown experience becoming less attractive. In turn, if there is no real reason to go central, people paying large premiums for their homes in the suburbs to be near the downtown may look at the equation and come to the conclusion that they should move an hour further out for a fraction of the price per square foot of their current home.

This is unlikely to be an existential threat, given America's immense economic strength and ingenuity. But for the short to medium term, it is undoubtedly a concern for real estate investors.

From a New York minute to a 15-minute city

For the longer term, the United States may draw inspiration from the revitalization of many European cities.

In Europe, one compelling concept has been the "15-minute city." The idea that residents can access all the routine facilities they need for work and leisure within a 15-minute walk, bike ride or trip on public transport, is about making cities richer and denser experiences. The critical ingredients include mixed-use neighborhoods, efficient public transit and integrated planning.

Interestingly, one longstanding complaint among European real estate investors has become an advantage in this regard. Stricter planning regimes in Europe have sometimes been criticized by local developers for preventing construction. Yet, while more accommodative regulation in the United States has led to sprawl in American cities — oversupply, in other words — restrictions in Europe have often fostered innovation.

Washington, D.C., was designed by the Parisian, Pierre Charles L'Enfant. Given the woes faced by many American cities, it may be time for U.S. planners to go back into the history books to rediscover L'Enfant's influence.

For example, Europe has proven more productive ground for office-to-residential conversions than the United States. This in part reflects a structural difference between American and European offices. The former's office buildings are more typically towers that lack natural light in the core, a physical barrier to residential conversion that is extremely expensive to remedy. In Europe, meanwhile, JLL estimated this year that 250 million square feet of vacant office space in the continent's top 35 cities could be transformed into 500,000 new homes — creating more than $107 billion in investment opportunities in the top 10 cities alone, based on current residential capital values.

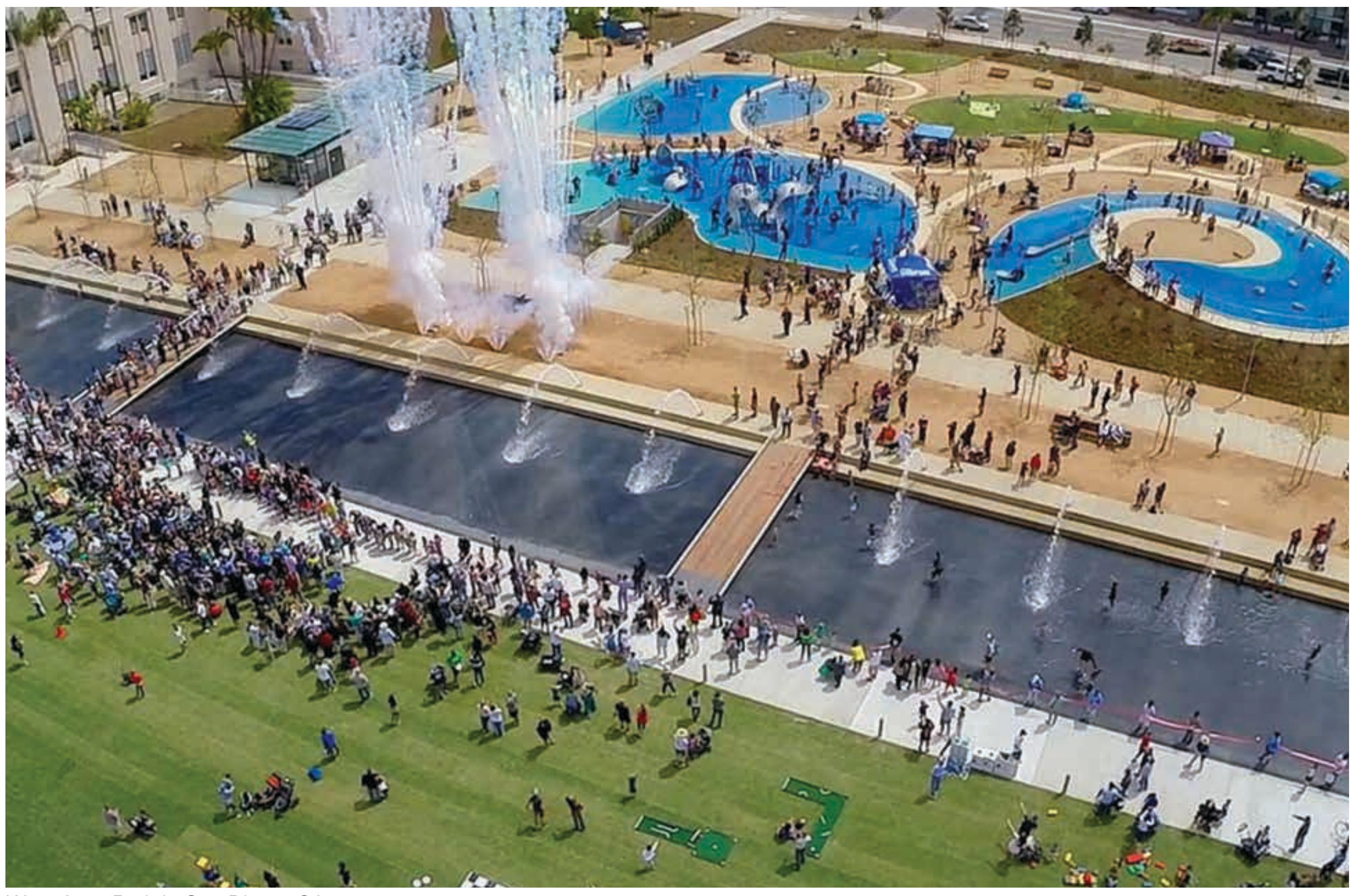
European city landscapes are far from perfect, as anybody who resides there knows. From chronic undersupply in residential and lagging infrastructure projects to waste collection issues, a lot remains to be fixed. This time around, however, there is something that Europe can finally look to export to North America. A related topic that Europe will surely export to North American shores in the coming years is greater care about the "E" in ESG; the focus in the United States today is often on the "S."

This combination of self-help initiatives and a better starting point underpins European real estate's resilience and prospects in the years ahead, despite the region's forecast lower economic growth than the United States.

Beyond that timeframe, much will depend on whether some aspects of European city planning and management can flow across the Atlantic. This would require a reverse of recent history, with Canary Wharf, in London, and La Défense, in Paris, are examples of imported U.S. models that have dominated during the past 30 years.

With both now facing challenges similar to those confronting American cities, it may be opportune to go back even further to rediscover L'Enfant's influence. ❖

Zsolt Kohalmi is global head of real estate at **Pictet Alternative Advisors.**



Waterfront Park in San Diego, CA

The use of creative placemaking

Using creative placemaking can boost real estate values and returns for cities and REOCs alike

by J. Wickham Zimmerman

The sea change taking place in cities across America is greatly impacting commercial properties and public spaces.

We all know the pandemic ushered in hybrid and work-from-home policies that changed the face of cities. No longer tied to urban commutes in expensive markets, many people migrated away from big cities to more affordable areas of the country, according to a Brookings commentary titled *New census data shows a huge spike in movement out of big metro areas during the pandemic*. This left city stakeholders challenged to make up for lost revenue in transportation, retail sales and taxes.

While navigating this new diasporic environment, city officials — along with developers and their investors — sought ways to attract businesses, residents and visitors back to the urban core. Ironically, according to an article by *Insider,* titled "*Welcome to generic town, USA,"* in striving to stand out from the pack, some implemented a "hip," modern vibe that has left many of them looking alike.

Meanwhile, others have been applying creative placemaking strategies to commercial properties and public spaces that are connected to the character of the communities in which they are located. The latter approach is transforming cities into vibrant, unique and sustainable destinations for locals and guests.

As an experienced design-build firm with deep expertise in creating customized water

features, rockwork and themed environments, our company, Outside the Lines, Inc., has worked with numerous stakeholders and developers to help them create unique commercial properties and public spaces that draw people in from miles around. We have observed how the right placemaking strategies can add value to these destinations while boosting revenues and returns for cities and real estate operators.

Offering a unique experience

The most successful destinations offer people an experience unlike any other. This drives them to visit the location and generates a buzz that draws additional visitors.

An example of this is the dynamic Illuvia show fountain (pictured below) our team designed and constructed at EpicCentral, a 172-acre retail and attraction park in Grand Prairie, Texas. Combining air-fired jets and robotic nozzles that shoot water 60 feet high with colorful lighting, engaging music and large-scale projection moving images, Illuvia delivers an unforgettable experience for Grand Prairie residents and visitors.

While the fountain has been labeled "Vegas-style," there is truly no other water feature in the world that has all the elements of Illuvia, which makes Grand Prairie the only place where people can experience its magic. The project's singular quality is attracting people from miles around to EpicCentral and the city of Grand Prairie.

In fact, according to an article by The Dallas Morning News, the experiential displays provided by the show fountain have attracted more than 30,000 guests per week to the park to behold Illuvia's displays.

Projects such as Illuvia can inject new life into cities by providing unparalleled, immersive experiences — an excellent placemaking strategy that incentivizes people to visit. This adds value to the commercial properties and public spaces where they are located and generates revenue for surrounding businesses and communities.

Creating public gathering spaces

Over the past three years, the demand for public gathering spaces has increased dramatically. According to an article by Strong Towns, titled "Infrastructure that does more: Investing in public spaces for a resilient America," investment in these spaces has been shown to improve physical and mental health, foster social connections, reduce crime, and improve safety.

Cities, with their walkability and wealth of dining, shopping and entertainment options, are the ideal location for public gathering spaces. Experts have been making the connection between investment in public spaces and economic recovery, noting that this type of investment can revitalize cities by supporting nearby small businesses, fostering innova-

Illuvia Show Fountain in Grand Prairie, Texas

tion, and connecting businesses and residents to regional markets and networks.

One way to invest in and create public spaces as part of an effective placemaking strategy is to incorporate elements such as water features into a city's landscape. In downtown San Diego, OTL installed an 830-foot-long fountain and children's splash area at Waterfront Park, helping to turn a nondescript municipal building site into a vibrant gathering place. The water features, which delight and entertain locals and tourists, use LED lighting and water that is constantly filtered and recirculated to provide a sustainable attraction for the city of San Diego.

> ***"By employing targeted placemaking strategies that offer unique experiences and enhance public gathering spaces, REOCs, city governments and other stakeholders can establish their cities as one-of-a-kind destinations that attract locals and visitors while boosting property values and returns for years to come."***

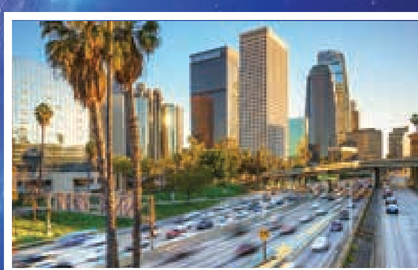
Augmenting public spaces with such innovative amenities allows a city to highlight its own unique character while providing people the opportunity to gather and enjoy what that city has to offer. While spending time at these amenities, residents and guests will have a natural tendency to visit shops, restaurants and other commercial properties in the area, thus increasing their dwell time and dollars spent at these places.

In addition, amenities such as water features in public gathering spaces provide opportunities for additional income from retail sales, special events and signage that can add significant value to the venues in which they are located, allowing the placemaking strategy to pay for itself in a relatively short time frame.

Conclusion

Today's cities are tasked with bringing people back to the urban core after societal trends scattered them to other locales. By employing targeted placemaking strategies that offer unique experiences and enhance public gathering spaces, REOCs, city governments and other stakeholders can establish their cities as one-of-a-kind destinations that attract locals and visitors while boosting property values and returns for years to come. ❖

J. Wickham Zimmerman is the CEO of **Outside the Lines, Inc.**



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