

# PRIVATE REAL ESTATE Market Commentary

Q2 2024

accordant

*“The market is a pendulum that forever swings between unsustainable optimism and unjustified pessimism. The intelligent investor is a realist who sells to optimists and buys from pessimists.”*

- Benjamin Graham

Dear Valued Clients,

When Benjamin Graham, the renowned investor often referred to as the “father of value investing,” penned the quote about the market being a pendulum, he was primarily discussing the stock market. However, the analogy is equally applicable to other asset classes, including today’s real estate market. The prevailing narrative in the media often defaults to emphasizing pessimism, and while there are certainly valid concerns, focusing solely on these challenges can obscure the positive signs that are beginning to surface. In fact, we believe that the pendulum is starting to swing in the opposite direction of “unjustified pessimism” with respect to the real estate market.

**One of the key drivers of the real estate market is rental income growth, which reflects the balance between supply and demand of different property types and locations.** Over the last few years, we have witnessed a divergence in rent growth trends across various markets, especially in the multifamily sector. On one hand, the Sunbelt region, which includes states such as Texas, Florida, Arizona, and Georgia, has experienced a surge in population and job growth, leading to higher demand for apartments. Conversely, major city high-rise markets such as New York, San Francisco, Chicago, and Boston have faced challenges from the pandemic, social unrest, and remote work, resulting in lower occupancy and rent levels. However, as pandemic-driven trends continue to fade across the U.S. economy, we are seeing a reversion back to the mean. In particular, we anticipate that the Sunbelt markets will face more supply pressure as new construction catches up with demand, while the major city high-rise markets will benefit from renewed urban appeal and limited new deliveries. Therefore, we believe that apartment rent growth will moderate in the Sunbelt and accelerate in major cities, creating more opportunities for value recovery in the latter.

**An interest rate cut may be on the horizon.** While we are not in the business of predicting interest rates, we certainly monitor all the major forecasts and survey data to understand as best we can how borrowing costs will ultimately impact the broader private real estate market. As discussed, low-levered core real estate has the staying power to last through a cycle, but many higher-leveraged buyers need relief, which may be at least partially in sight. Based on current forward rate curves, the market is anticipating one or potentially two rate cuts in 2024. Likewise, the Federal Reserve’s dot plot (a chart showing where each Fed member thinks short-term rates will be at the end of each year) suggests a median expectation of one rate cut as well. This dynamic is notable because, many times over the last few years, there has been a disconnect between the Fed’s forecast and market participants’ expectations. But at least for now, they appear to be aligned. A large part of the optimism around rate cuts is due to the persistent progress on the inflation front as price increases continue to show signs of slowing down. As of May 2024, the annual inflation rate measured at 3.3%, down slightly from the previous rate of 3.4%, as measured by the Consumer Price Index (CPI).



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Admittedly, inflation has proved to be stickier than Fed officials anticipated, but it's worth remembering that we are down significantly from the peak of 9.0% in June 2022. While there remains a debate over when a rate cut will occur, what has become widely accepted amongst market participants is that additional rate hikes no longer appear imminent, a definite sign of progress.

**Green shoots are emerging.** This statement is certainly counterintuitive to the mainstream narrative; however, in order to find these signs of a recovery, you have to know where to look. Admittedly, some of these green shoots are hard to quantify. For example, we've seen a significant number of Requests for Proposal (RFPs) from institutional investors looking to buy core real estate after having hardly any RFPs in the prior 18 months. The significance of large institutional investors beginning to focus their attention on private real estate cannot be understated, as this group has historically been early movers looking to capitalize on what they perceive as an impending recovery in the private real estate space. In our view, a natural rebalancing of portfolios is occurring due to record-high equity markets. We will talk more about asset allocation later, but for now, it's worth noting that early data suggests an uptick in transaction activity over the past three months and into Third Quarter 2024, suggesting the bid/ask gap between buyers and sellers has begun to narrow. Lastly, we are starting to see a decline in the NFI-ODCE Index's redemption queues, a reassuring sign of improving liquidity. The reason for this progress is primarily twofold: managers are transacting more, which creates liquidity, and some investors have rescinded redemption requests, in part because they recognize that selling at current values denies them their upside when a recovery eventually takes hold.

**The forward-looking return of private real estate may be attractive, especially compared to other sectors.** Just as we are reticent to forecast interest rates, we're also cautious about predicting market direction. However, we always look for indicators suggesting that market dynamics are shifting, and we've recently noticed a few interesting observations. But first, putting the current environment in its proper historical context might be helpful. For the last six consecutive quarters, core real estate values have declined, the first such period of negative returns since the Global Financial Crisis of 2008-09, where returns were also negative for six quarters. Thus, down periods for the NFI-ODCE Index are exceedingly rare, occurring on average every 14 years. These periods also tend to be pretty limited in scope. So, if history is any guide, we're already through the worst of the decline. Fast forward to today; as many of you know, we have unique insight into the daily price of the underlying managers in the NFI-ODCE Index. Recently, we've seen consistent positive daily values across several funds for the first time since the rate hike cycle began in 2022. To be clear, this doesn't mean that there isn't any downside risk remaining. However, we believe it indicates that market dynamics are shifting, and we would not be surprised if the market bottomed out over the next couple of quarters.

**High-growth sectors remain attractive.** While the apartment sector is clearly slowing, consistent with inflation, one of the most compelling investment opportunities in the current real estate market is data centers. Data centers are essential for the functioning of many industries and applications, such as e-commerce, cloud computing, streaming media, gaming, social media, and artificial intelligence.

The demand for data centers has been growing at an unprecedented rate, driven by the increasing consumption of digital content, the proliferation of connected devices, the adoption of cloud-based services, and the emergence of new technologies. According to a report by CBRE, the global demand for data center capacity increased by 28% in 2023, reaching a record high of 1,156 megawatts. The report also projects that demand will grow by another 17% in 2024, surpassing 1,350 megawatts.

However, the supply of data center space has not kept pace with surging demand, creating a significant imbalance in the market. The development of data centers is constrained by several factors, such as the availability of land, power, fiber, and water; regulatory and environmental approvals; construction costs and timelines; and the technical expertise required. As a result, many data center markets are facing a shortage of inventory, especially for hyperscale users who need massive amounts of space and power. This supply-demand gap has led us to target "development ready" sites to prelease to hyperscalers with the highest credit and lowest execution risk. We don't believe in the "build it and they will come" model, especially when it comes to development projects having budgets that can approach \$1 billion.

As a real estate investor, this presents a unique opportunity to capitalize on the strong fundamentals and attractive returns of the data center sector with low execution risk. Data centers also correlate positively with inflation, as rents are typically indexed to power costs, which tend to increase with inflation. Therefore, we believe that data center investing is a smart and strategic move for our clients who are looking to diversify their real estate portfolio, enhance their return profile, and benefit from the long-term secular trends that are driving the demand for data centers.

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**As we have consistently discussed, those of you who are already fully allocated to real estate can rest well knowing the sector is performing as expected and has exceptionally strong operating fundamentals.** For others who may have seen a recovery in public equities and are now under-allocated to private real estate, we would encourage you to seize the moment based on your targeted risk/return outcome because market conditions can change quickly.

On behalf of the team at Accordant, we would like to thank you for your trust, especially in today's challenging environment. We are committed to providing high-quality real estate solutions that deliver a range of outcomes, from income to growth, while prioritizing transparency.



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