Real Assets
June 2024

AEGON **INSIGHTS**

US Commercial Real Estate Insights

Key takeaways

- *The optimism seen earlier this year on interest rates has not translated into a rebound in transaction volume. We believe buyers and sellers need to come to a better agreement on pricing before we see meaningful improvement.*
- *The sharp rise in interest rates since early 2022 is raising the risk of refinancing for maturing commercial real estate loans. Given where we are in the current cycle, Aegon Asset Management expects that distress will certainly rise as more loans mature and face difficulty refinancing. However, the magnitude of distress may not be as severe as the market fears.*
- *The office sector continues to find minimal demand for space, with vacancies rising another 20 basis points (bps) to a new record high of 13.7%.[1] Newer vintage offices continue to see positive absorptions, and we believe bifurcations in performance will widen further as leases renew.*

Aegon Asset Management's Real Assets Research Team utilizes primary and secondary research to monitor commercial real estate property fundamentals, capital markets, and macroeconomic conditions. The team applies both qualitative and quantitative techniques in its contribution to our investment outlook.

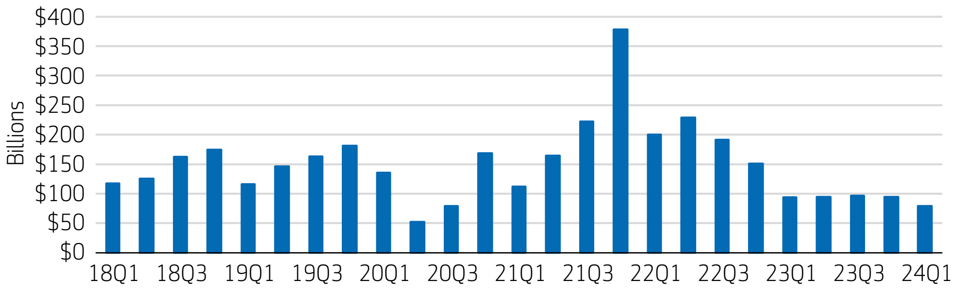
Transaction volume remains muted

The market started the year with strong optimism that the US Federal Reserve (Fed) would cut interest rates as much as six times through 2024. However, inflation data remained too high for the Fed to be confident to cut interest rates through the first half of the year. Following the June Federal Open Market Committee (FOMC) meeting, that optimism seen earlier in the year has come down significantly with Fed Chair Jerome Powell only expecting one interest rate cut through the remainder of the year.[2] Given the anticipated interest rate cuts have not materialized as initially expected, transaction volume has yet to rebound as shown in Exhibit 1. Transaction volume during the first quarter of 2024 totaled $79 billion, down 16% from a year earlier. The pace of decline continues to moderate despite marking the seventh consecutive quarter of double-digit year-over-year decline as of March 31, 2024.[3]

We believe buyers and sellers need to come to a better agreement on pricing before we can see meaningful improvement in transactions. Buyers are hoarding cash with a near-record amount of dry powder sitting on the sidelines in anticipation of distressed opportunities. Despite this, the impact of higher interest rates on borrowers has yet to materialize into a wave of distressed opportunities, as we will discuss in greater detail below. On the contrary, sellers that do not face immediate debt maturity and have enough capital are unwilling to forfeit perceived value and are waiting for prices to normalize. We have observed property owners putting their assets out to test the market, but not transacting. The bid-ask spread remains too wide for transactions to close.

We have observed property owners putting their assets out to test the market, but not transacting.

Exhibit 1: Commercial real estate transaction volume declined in 4Q 2023 by 16% compared to the previous year



Source: MSCI Real Capital Analytics, as of March 31, 2024.

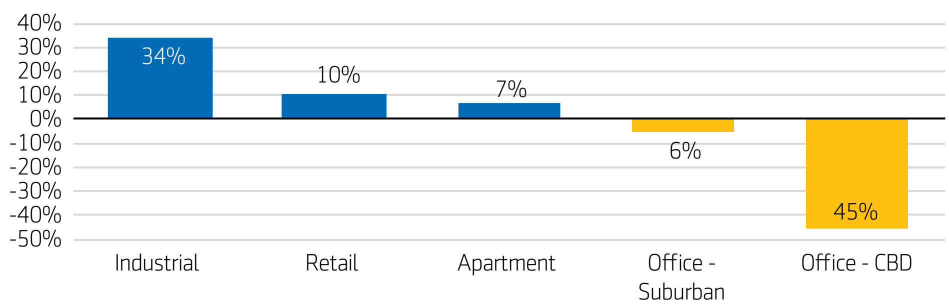
Fear of potential distress resulting from the maturity wall may not be as severe as anticipated

The sharp rise in interest rates since early 2022 is raising the risk in refinancing for maturing commercial real estate loans. According to the Mortgage Bankers Association (MBA), over $900 billion or 20% of total outstanding commercial mortgages are set to mature in 2024. Offices make up more than 20% of the loans expected to mature in 2024.[4] Borrowers will face not only significantly higher debt costs at maturity but also less availability of capital as lenders, especially banks, continue to pull back from leverage and adopt a more stringent lending standard.

However, numerous mitigating factors can limit the potential downside risk:

- **Valuations.** Loans backed by industrial, apartment, and retail properties have likely experienced a rise in valuations since they were originated. According to MSCI Real Capital Analytics (RCA), loans originated in 2021 make up the largest vintage year in loans set to mature in 2024. Property prices are above where they were in 2021 as of the first quarter of 2024 for all property types, except office (Exhibit 2).[3,]

Exhibit 2: Percentage change in property pricing since the beginning of 2021



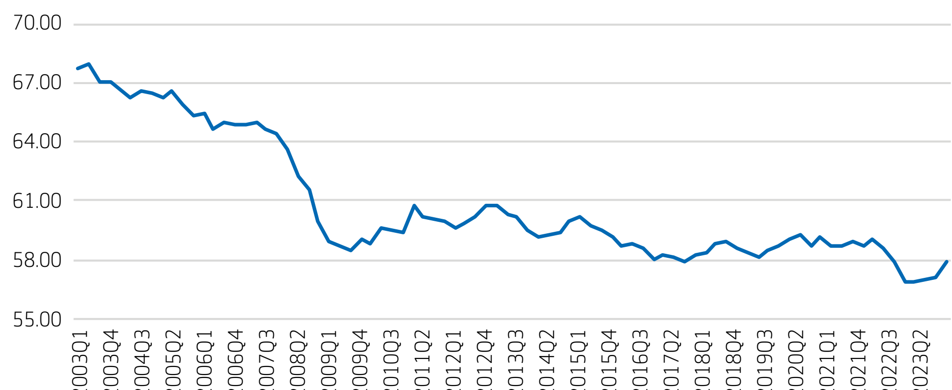
Source: MSCI Real Capital Analytics, as of April 30, 2024.

- **Modifications.** We observed that for loans that make economic sense, lenders with capacity are willing to work with borrowers on modifying and extending the loans until capital market conditions improve. This relief may afford borrowers time to stabilize an underperforming asset or source other loan payoff options.
- **Underwriting.** The aftermath of the global financial crisis (GFC) in 2008 introduced a tougher regulatory environment, with lenders underwriting to a lower loan to value (LTV) ratio compared to pre-GFC. For example, life companies' underwriting LTV ratios decreased from the mid-60s range before the GFC to a high 50s range, thereby providing lenders with a larger equity cushion than in the previous cycle to absorb any potential value deterioration (Exhibit 3).[5] Furthermore, the pro forma cash flow underwriting seen pre-crisis has been largely absent. Additionally, some lenders took the opportunity to recalibrate their portfolios away from riskier property types such as office properties. MSCI RCA estimates that cumulative outstanding distress[6] for commercial real estate mortgages reached $89 billion during the first quarter of 2024. Office properties comprise the biggest proportion of outstanding distress, at $38 billion.[3,4]

Given where we are in the current cycle, Aegon Asset Management expects that distress will certainly rise as more loans mature and face difficulty refinancing. Risk will likely be most acute in loans backed by office properties, floating rate loans, and short-term loans originated during early 2022's pricing peak. However, the magnitude of distress may not be as severe as the market feared.

Life companies' underwriting LTV ratios decreased from the mid-60s range before the GFC to a high 50s range, thereby providing lenders with a larger equity cushion than in the previous cycle to absorb any potential value deterioration.

Exhibit 3: Life companies average LTV for committed commercial mortgages (rolling 4 quarters)



Source: Moody's Analytics, American Council of Life Insurers, December 31, 2023.

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Property sector outlook

Apartment: Apartment sector fundamentals are likely to improve as supply and demand come to a better balance in 2024. During the first quarter of 2024, apartment supply continued to outpace demand. However, demand continued to grow, registering the highest level since late 2021. By the end of 2024, current supply projections show an almost 32% pullback from the record high posted in 2023. With apartment demand on the rise, this could be an opportunity for the sector to stabilize and recover in the latter half of this year.[1]

Industrial: The industrial sector is still digesting the massive wave of unleased properties delivered over the past year, with the current vacancy rate rising by 50 bps over the past quarter. Despite near-term supply pressure, the vacancy rate remains near the historical norm. In addition, new supply for industrial properties has plummeted since last fall. The current construction pipeline suggests new deliveries are expected to reach a 10-year low in mid-2025.[1]

Office: The office sector continues to find minimal demand for space, with vacancies rising another 20 bps to a new record high of 13.7%. Newer vintage offices continue to see positive absorptions, and we believe bifurcations in performance will widen further as leases renew.[1]

Retail: The first quarter of 2024 saw a slight softening of the retail sector, but it remained close to the tightest level ever. With minimal supply-side pressure, demand remained robust, and many retailers struggled to find quality spaces for expansion.[1]

	1Q 2024 Total return	Under Construction as % of Inventory	1Q 24 Vacancy Rate	1Q 23 Vacancy Rate	1Q 24 YoY Rent Growth	1Q 23 YoY Rent Growth	Aegon Real Assets Sector Outlook
Apartment	-6.5%	4.6%	7.8%	6.8%	0.9%	2.9%	Neutral
Industrial	-3.1%	2.1%	6.2%	4.3%	5.6%	9.9%	Neutral
Office	-16.7%	1.2%	13.7%	12.7%	0.7%	0.9%	Most Cautious
Retail	-0.7%	0.4%	4.1%	4.2%	3.1%	4.1%	Neutral

Sources: National Council of Real Estate Investment Fiduciaries, CoStar Realty Information Inc., and Aegon Real Assets US. As of March 31, 2024.

Property prices are above where they were in 2021 for all property types, except office.

[1]CoStar Realty Information, Inc. March 31, 2024.
[2]CME Group, Fed Watch Tool. June 13, 2024.
[3]MSCI Real Capital Analytics. March 31, 2024.
[4]Mortgage Bankers Association. February 2024.
[5]Moody's Analytics, December 31, 2023.
[6]Distress (also Troubled/Special Servicing) indicates direct knowledge of property-level distress. Known through announcements of bankruptcy, default and court administration as well as significant publicly reported issues – such as significant tenant distress or liquidation – that would exemplify property-level distress. This also includes CMBS loans transferred to a special servicer. Source: MSCI Real Capital Analytics.

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