Real Estate in a Time of Uncertainty

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Anu Rajakumar: Private real estate is an asset class with the potential to provide investors with numerous portfolio benefits, including income generation, capital appreciation, and inflation hedging. But amidst a backdrop of higher interest rates, the recent banking crisis, and recession concerns, questions loom about how real estate will be impacted and whether the opportunities outweigh the risks. My name is Anu Rajakumar, and today I'm pleased to be joined by Josh Overbay, member of Neuberger Berman's Almanac Investment Committee, to discuss how the current market dynamics are impacting the real estate market. Josh, thanks for joining me today.

Josh Overbay: Great to be here, Anu. Thanks for having me.

Anu: So Josh, just to get us started, why don't you share some overall key themes that are impacting the private real estate market today?

Josh: Sure. So the first thing I would say is we are clearly at a point of inflection and that's due to a multitude of factors that are driving that, which I'm sure we'll go into. The second thing I would say is, and this is a Mark Twain quote, all generalizations are false, including this one. So it's very difficult to generalize the real estate market even within the US, which is where I'll direct most of my comments because that is where we're primarily focused, but it's a massive market.

It's a $20 trillion sector in the US alone. So an immense asset class, highly fragmented and diversified across all different sectors, all different markets, all different ways to make money. To provide a little bit more context around that, the public REIT market in the US is about 1.3 trillion. So, of that 20 trillion, that's obviously a relatively small percentage. And institutional investment managers control about a similar amount, about a trillion dollars.

So the vast majority of the US real estate market is still highly fragmented and local, regional, national owner-operators control the vast majority of that market. Obviously today there are a lot of headlines around the impending doom of "commercial real estate", and a lot of that is conflating the office sector with the commercial real estate market more broadly. Clearly, the office sector is deeply challenged, but many sectors outside of the office sector continue to have strong fundamentals, strong occupancy, leasing momentum, good demographics.

However, the other layer to this, which is a little bit beyond office versus other sectors, is that the common pain point for real estate right now across sectors is borrowing costs. Debt financing costs have increased dramatically across the board, , which is having an impact on valuations and the ability for asset owners to either finance new acquisitions or development, or for existing asset owners to get refinancing on the debt that they currently have in place on those assets. So what that has resulted in is a wide spread between the buyer's bid and the seller's ask on portfolios, which is resulting in a seizure of the overall transaction market. And I think I saw a data point that transaction volumes are down 50% to 60% year over year. And you know, what is getting done is well-located, well-occupied assets in more favored sectors outside of office, such as residential, industrial, data centers, storage, and so on.

Anu: Perfect. Thank you very much. That's a great backdrop. And today, we'll touch on a lot of the things that you just mentioned in your opening comments. Let's start off with the impending doom because everyone wants to talk a little bit about office, so we'll get that out of the way up front here. You mentioned office sector. It's obviously been significantly affected over the last three-plus years, given the shift to remote and hybrid work, et cetera. Just give us a few more comments about how you're assessing the opportunity in office.

Josh: Sure. So just to frame it a little bit, and all of these numbers are a little fuzzy just because the size of the market is so immense, but directionally office comprises 3 trillion of that 20 trillion in the US that I mentioned. And clearly in certain markets, New York and San Francisco come top of mind, based on the changing nature of flexible work, the way that tenants and workers are utilizing space, most large tenants are rethinking their space needs in a post-COVID flexible work environment. The general conclusion is we have too much office supply in the market and that will need to be rectified at some point.

And we're really seeing, particularly in these primary markets, a big bifurcation in these markets between new highly amenitized buildings and excellent locations. They're still seeing positive leasing activity and those assets are still attracting interest, both from tenants and from investors. On the flip side of that, inferior locations, older obsolete assets are seeing negative leasing absorption, loss of tenants, lack of interested buyers, and a general unwillingness on the part of lenders to provide financing for those types of assets.

COVID and work from home certainly have accelerated the pain that's being felt in the office sector, but our view was this sector was undergoing disruption even before, you know, the last three years or so. The advent of coworking certainly upended the traditional, sort of, 7, 10, 15-year lease term. Tenants were looking for more flexible, shorter lease terms.

And I would say, overall, it is a sector that has been a little bit less interesting from a fundamental standpoint, even pre-2020, and all the things that we're seeing right now. And look, there will always be outliers. Again, these are generalizations. I think smaller footprint, smaller floor plate, amenitized office in growth cities with a stronger in-office work culture are fine. But given the overall uncertainty, most office opportunities are just in the too difficult pile for us at the moment.

Anu: All right. So given those comments, Josh, is it fair to say that we've entered a new market cycle for real estate given all that you've just mentioned?

Josh: I think we're certainly at a point of transition and we are clearly no longer in the long upward trajectory of asset values or in an environment where capital is free or very cheap. Anecdotally, a lot of investors use the Odyssey Index as a real estate benchmark. This is the open-end diversified core equity index that's administered by NCREIF. It's an index of 26 open-end diversified core funds. They are generally thought to own "safe-safe assets" that are lowly, levered and-and income oriented. This year, of course, is not in the books we're just over halfway through, but I think this year is on track to be the first negative returning year for the Odyssey Index since 2009 coming out of the global financial crisis.

So 14 years of positive returns since the GFC is a long time. I think if not due, we're overdue for a correction there. I think the sheer number of debt maturities and higher financing costs across the board will result in a reset of values in most sectors. Similar to the years after the GFC, the new paradigm will create winners and losers and some firms will die a slow death and others will see their businesses accelerate greatly. I would also say it seems that we are safely into a new era where traditional sectors like office and retail are less favorable.

So 20 years ago, people considered office and retail as two prime sectors of the real estate market from an institutional ownership standpoint. Fast forward to today, and those two sectors are probably at the bottom of most investors' priority lists. So I do think we've seen a fundamental shift in terms of perspectives from either investment managers or institutional investors in terms of what are the most attractive sectors of the real estate market.

Anu: So Josh, why don't you continue on that thought, tell us about some of the sectors that you are finding quite attractive at this time.

Josh: Sure, so new sectors increasingly attracting capital and demonstrating strong fundamentals. Data centers, obviously we're seeing increasing utilization of AI and everything that we do, self-storage, cold storage, other specialized industrial assets, health care, as well as other variations of residential. You know, traditionally, people didn't even think of multi-family as an institutional sector for a long time, and then they did, and now we've got different variations of residential. We have single-family rentals, student housing, senior housing. We continue to have a shortage of housing in this country as a general statement, particularly affordable housing or attainable housing in a lot of markets, so I would expect that those sectors will continue to draw a lot of investor interest.

I think it's interesting, you know, if you think about historically institutional ownership of real estate, particularly as manifest through the Odyssey funds, which again is most groups' benchmark. Ownership, really being concentrated in office, retail, industrial, and multi-family and you correlate that with the different exposures that you see in the public REIT market, the difference is vast. If you look at the sector breakdown of the public REIT market, which again just as a reminder is about 1.3 trillion in aggregate market cap.

Residential is the largest sector at $190 billion, and that includes manufactured housing, which is a $30 billion sector in and of itself. Single-family rental is now a $35 billion sector which, it really didn't exist as an institutional sector 10, 15 years ago. Retail is 180 billion. Industrial is 160 billion. So, you know, those are a little bit more traditional with some of the new variations

of residential but then you get into cell towers and infrastructure assets are a $160 billion sector within the public REIT Market. Data centers I think $110-$112 billion sector. Health care is over $100 billion sector. Self-storage is a $90 billion sector.

So, you know, just to put it in perspective, the aggregate market cap of the office sector as it relates to public REITs is 60 billion, just by way of comparison. So, a lot of these "alternative" sectors are still nascent parts of most institutional portfolios from a private market standpoint, it's not reflected that way in the ownership from a public market standpoint. And I think over time you'll see that continue to change and more and more of these alternative sectors or niche sectors, which aren't alternative or niche anymore, continuing to represent larger and larger portions of institutional portfolios.

Just an anecdote, we recently made an investment in a self-storage company where we were both a preferred equity and a common equity position in the company with a great irreplaceable portfolio of self-storage assets in and around New York City. Very excited about our partnership with that company and I think we're excited about that sector, the self-storage sector as one of these new emerging sectors that offer really strong fundamentals and-and good prospects for growth.

Anu: Can I just ask a follow-up question to that, why is self-storage now becoming more attractive? What has changed? Is there an underlying demographic shift that means people wanna-- are they going back into urban centers, and that's why they need the self-storage? And I say that as someone who is for the first time in her life just used a self-storage unit, so I'm very curious.

Josh: Well, I hope you're utilizing that company..

[laughter]

for all your storage needs.

Anu: Is there a Neuberger discount for that?

Josh: Uh, and if you're not and you're looking to switch, you know, we-we can follow up after this.

Anu: You know a guy.

Josh: Yeah, I know a guy, I know a company. Um, so I think self-storage is not just utilized in urban markets. It is prevalent everywhere. I think we do have a lot of supply in some markets relative to the demand that is there. What's particularly attractive about this company and the portfolio that they own, which is in and around New York, is these are irreplaceable assets. Today, you would not build a new self-storage asset on the land on which these assets sit and there's an incredible amount of demand for them.

Particularly over the last few years, and I think we see a newer generation being more mobile and less focused on buying a home in the suburbs as soon as they can and a little bit more open to moving around and finding that right place for them. And every time somebody moves, it's great for the self-storage business. And I think particularly as it relates to being an infill markets where there's just not a lot of supply and there's a constraint to the supply that's in that market, we think that's a good resilient business with a good strong mode around it.

Anu: Great. Thank you very much. You've talked about some of the attractive areas that you are increasingly looking into. They were privacy alternative and now they're a little bit more mainstream. But on the other hand, there are, of course, a lot of headwinds with real estate. We've spoken about borrowing costs. What are some of the other big issues that investors are grappling with or disruptions that you are focused on that investors may not know about?

Josh: Sure. I'm not sure I'm gonna be pointing out anything that other investors aren't aware of, but I think liquidity is really the big issue in the market today. Being a provider of liquidity to those who need it will be handsomely rewarded, and those opportunities are starting to present themselves in many ways. First, I would say from our core business standpoint, lots of owners and operators are in need of liquidity, either to right-size the existing debt that's maturing in their portfolio or buying out equity partners in assets or portfolios where those other equity partners need liquidity. Those opportunities are starting to present themselves and we always get excited when there is someone who needs liquidity because that might be a good opportunity for us to invest with a good margin of safety or at a discount.

Also I think many institutional investors are grappling still with the denominator effect and being at or over their target allocations to real estate within their broader portfolios and aren't seeing the write-downs in the real estate book or in the

private markets book generally that they hoped would get them back to equilibrium relatively quickly that that's been slow going, which is not really a surprise, but still a dynamic that-that we're dealing with.

And that introduces disruption in terms of liquidity needs for those investors. And we're seeing more opportunities where investors in funds are thinking about tapping the secondary market to find liquidity for those portfolios. I know our colleagues here at Neuberger Berman who are focused on secondary investments have been quite busy and I would expect that those opportunities will continue.

And somewhat related to that, I think the best managers and operators within real estate are gearing up for what they expect to be an attractive upcoming vintage for new go-forward investment opportunities. As this period of dislocation plays out. Perversely, lots of investors, whether they're traditional LPs or other capital partners, tend to retrench in times like this, and there can be a tendency to just, sort of, wait and see and oftentimes the best opportunities will pass by. So a Warren Buffett quote that we take to heart is, we like to lean in during times like this, we like to be greedy when others are fearful. We like to be fearful when others are greedy.

Anu: Yeah. I love that. That's a great quote and certainly a theme that we've been speaking to a lot of allocators about. If you have the ability to be a liquidity provider, the likelihood is that you'll be richly rewarded to that in this current environment.

Josh, just to wrap up here, I would love if you could share a few comments on your outlook for real estate and just any other final comments that you'd like to leave our listeners with today.

Josh: Sure. So obviously a period of great dislocation, obviously a period of great uncertainty. What I would say first is there are always opportunities, and it's times like this where we get excited. Again, maybe a little bit perverse, but we get excited in times like this where there is a lot of uncertainty, and we can seek to expand our business in a lot of different ways.

I think patience, discipline, and dry powder are not strategies per se, but they are attributes. Our business is focused on finding very high-quality management teams with which to partner, that we'll be able to outperform the broader market. We invest really in two main ways. One is we provide growth capital to real estate owners and operators, often in a structured security, where we can get seniority in the capital structure.

The other main way that we invest is buying stakes in successful real estate investment management firms that have contractual fee streams underpinning those businesses. So I think we'll look to do more in those two primary categories for us. And over the past 30 years, we've typically made two investments per year.

Those investments tend to be large and they tend to be concentrated. So we always spend an incredible amount of time on due diligence and analysis, but also the more qualitative assessment of people and teams as good potential partners. As always, patience and discipline combined with capital availability will allow us to continue to invest intelligently.

Anu: Excellent. Thank you so much for that. I like that patience and discipline when you have the capital to deploy, really is a recipe hopefully for success for your team. Before I let you go, Josh, I have to ask you one bonus question that I know you're unprepared for. As I was thinking about our conversation today and office, I was wondering if you could share perhaps a story from one of your early days, like a first job that you had, whether that was in an office or elsewhere. What was one of the first jobs and what was that experience like for you?

Josh: One of my first jobs before I got into real estate was working for the US Chamber of Commerce in Washington DC which is located in perhaps one of the coolest office buildings outside of the White House in the Executive Office Building, but just across the lawn on the north side in a building that's been there for over 100 years, all granite, beautiful marble and those were some of the biggest offices I have ever seen in my life, and it's really a vestige of the past. And I had the pleasure of working there for a little over three years. And the building that we get to work here at Neuberger Berman is a beautiful building, but I'm not sure I'll ever be able to replicate the beauty or the grandeur of that building. So it was a lot of fun.

Anu: It's a good incentive to show up for work every day. I imagine. [crosstalk].

Josh: That's right. That's right. [crosstalk]

Anu: Josh, thank you for joining me today. From what it sounds like, real estate has been going through quite a transformation as it adapts to changing consumer behaviors and technological advancements. You know, we talked a lot about office, which

has, of course, attracted so much scrutiny in recent years. But importantly, you noted it's only about $3 trillion of a $20 trillion market. And as you said, you can't generalize the real estate market. It's not a monolith. And while there are a number of headwinds, with patience, discipline, and capital, there are also a number of opportunities ahead. Thanks again for coming on the show.

Josh: Thanks for having me. It's been a pleasure.

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