AEW RESEARCH & STRATEGY | JANUARY 2025

AEW

2025 INVESTING IN A BRAVE NEW [OLD] WORLD

"Most human beings have an almost infinite capacity for taking things for granted."

~Aldous Huxley, Brave New World

BOSTON
LOS ANGELES
DENVER
LONDON
PARIS
DÜSSELDORF
HONG KONG
SEOUL
SINGAPORE
SYDNEY
TOKYO

AEW.COM

PREPARED BY
AEW RESEARCH
JANUARY 2025

This material is intended for information purposes only and does not constitute investment advice or a recommendation. The information and opinions contained in the material have been compiled or arrived at based upon information obtained from sources believed to be reliable, but we do not guarantee its accuracy, completeness or fairness. Opinions expressed reflect prevailing market conditions and are subject to change. Neither this material, nor any of its contents, may be used for any purpose without the consent and knowledge of AEW. There is no assurance that any prediction, projection or forecast will be realized.

Aldous Huxley's Brave New World offers a chilling view of a society that takes its reality for granted, illustrating the dangers of complacency. In many ways, this resonates with the current state of the commercial real estate market, which has long been fueled by a steady cycle of declining interest rates and property yields. However, as we look ahead to 2025 and beyond, this era may be coming to an end, or at the very least, confidence in underwriting more favorable future yield environments is in question. Instead, success in the evolving market will depend on the time-tested principles of strategic asset selection, active management, and adaptability. In the face of uncertainty, the key to thriving in this brave new [old] world of commercial real estate lies in making informed, deliberate decisions—not just waiting for external factors to shape outcomes.

For property investors 2025 can represent the most attractive U.S. real estate investment entry point in more than ten years, but it is not a riskless entry point. Property yields are at the highest level since 2014 (*Figure 1*) and property values, adjusted for inflation, are at the lowest level since the Global Financial Crisis (GFC) (*Figure 2*). More significantly, the average discount rate incorporated into the valuation of a property held by a diversified core open-ended property fund (ODCE) is above the average pension fund expected return for the first time since 2010 (perhaps for now...) (*Figure 3*).

This strong entry or re-entry point signal is welcome and timely. Property investment performance badly lagged the stock market over the past two years (*Figure 4*) and, as a result, many investors now find they are well below their target real estate allocation (*Figure 5*). What's more, stock market valuations, in sharp contrast to real estate, are at the highest level in 50 years (*Figure 6*).

History teaches that outsized positive returns typically follow cyclical nadirs. Indeed, the five-year period following each of the last three cyclical lows were marked by NFI-ODCE posting average annual total returns of more than 13% (*Figure 7*).

> **"I have great respect for the past.
> If you don't know where you've come from,
> you don't know where you're going."**
>
> ~ Maya Angelou, Arizona Republic (2011)

On any journey, knowing where you are headed is often well informed by understanding where you have been. The past two years is the first time that U.S. property values have declined absent an economic recession (*Figure 8*). During this time, the NCREIF Property Index (NPI) capital value index declined by approximately 20% while aggregate property income was up approximately 10%. The factor that equates declining values with rising income is, of course, an expansion of property cap rates. In this case, cap rates rose by approximately 100 basis points (*Figure 9*), largely in response to the Federal Reserve rapidly increasing borrowing costs, i.e. capital markets overwhelmed fundamentals in most sectors.

Second, the last two property value recovery upcycles—the period following the tech crash (early 2000s) and the period following the GFC—were marked by both cyclical recovery in NOI and, more importantly, by significant cap rate compression.

In both cases, over the five years following the trough in values, the NPI capital value index rose approximately 40%, property NOI increased approximately 20%, and average property cap rates declined more than 200 basis points (*Figures 10 and 11*).

Left unchanged, market expectations for higher inflation (*Figure 12*) and interest rates (*Figures 13 and 14*) make it difficult to expect near-term value lift from cap rate compression. Additionally, as current values were not generally impacted by cyclical decline in net operating income (NOI), near-term cyclical recovery in income across most property sectors will be difficult to underwrite. This is particularly true given the current narrow spread between appraisal cap rates and Treasury yields (*Figure 15*).

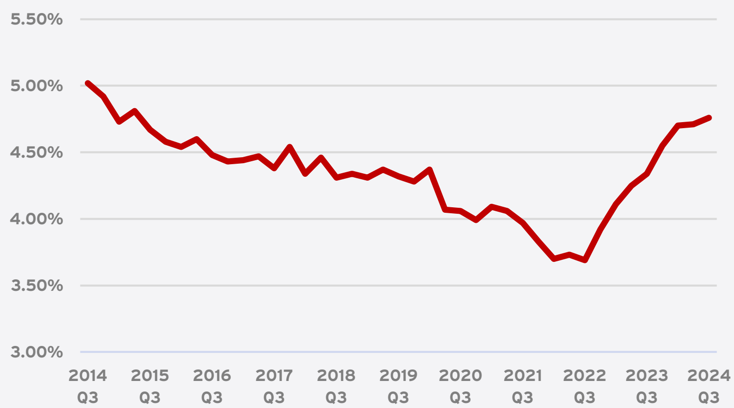
There are specific property sectors that do have expected strong near-term NOI growth (*Figure 16*), most notably Seniors Housing, a property sector that is effectively enjoying a cyclical recovery from the outsized impact of the pandemic. The sector is projected to benefit from far higher same-store NOI growth than other sectors with strong fundamental or loss-to-lease stories such as Cold Storage, Industrial and Data Centers.

Choosing the right sectors and markets will continue to add to overall investment outcomes, but more will be required to truly separate from the index or others. After lagging its public market brethren for many years, private market property investment has steadily become more informationally efficient. We all have access to similar market information and are increasingly utilizing advanced data analytics to extract information advantage.

In a world where capital once again has a true cost, with positive real yields on risk-free assets for the first time since the GFC, we believe we are back in the realm where skill—the ability to select the right assets, manage lease rolls, control expenses, and thoughtfully deploy cap ex—rather than tolerance for risk taking, will likely drive real estate investment outcomes. Divergence in investment outcomes is growing even as the sector becomes more efficient (*Figure 17*). The good news for property investors is that 2025 is an exciting time to deploy capital. The bad news is that you will have to work much harder to find the right managers to execute for you. ■

Best CRE Entry Point Since GFC

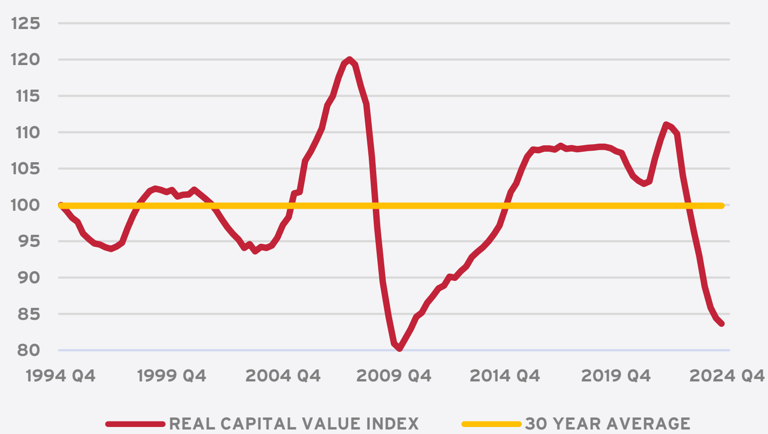
Figure 1: NPI Average Cap Rate



NCREIF Property Index (NPI) weighted average cap rate is now at the highest level in ten years.

Source: NCREIF

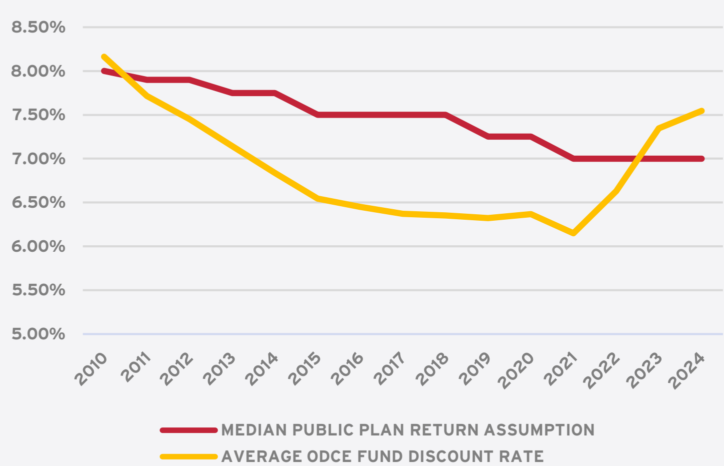
Figure 2: Inflation Adjusted NPI Capital Value Index



The NPI Capital Value Index, adjusted for inflation, is now at the lowest level since the Financial Crisis.

Source: NCREIF, AEW Research

Figure 3: Average ODCE Fund Property Discount Rate and Public Pension Plan Return Assumption

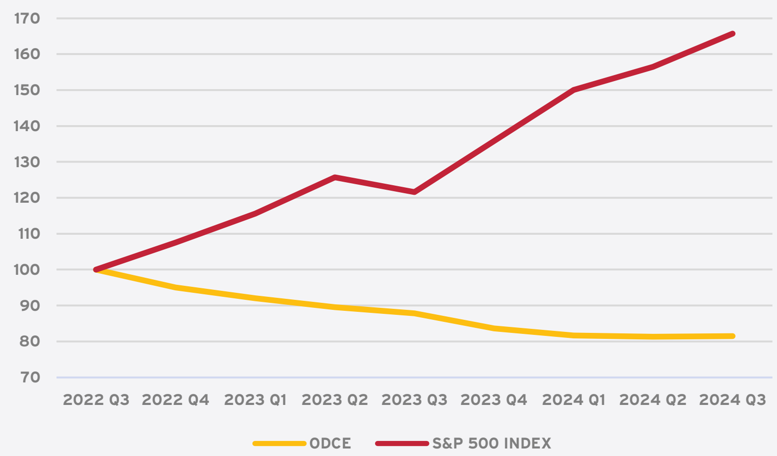


The average discount rate used in the valuation of a property held by a diversified core open-ended fund (ODCE) is now above the average public pension plan return assumption for the first time since 2010.

Source: Altus, NASRA. Annual data 2024.

Many Investors Are Below Target CRE Allocation

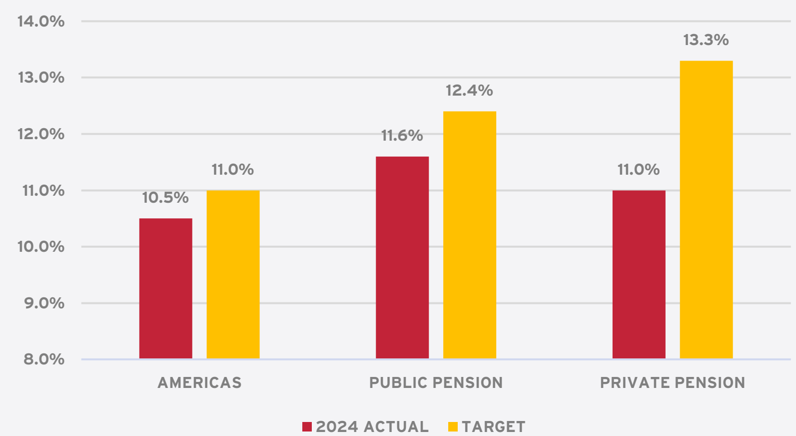
Figure 4: Total Return Index: S&P 500 vs ODCE



Over the past two years, the ODCE total return index is down nearly 20% while the broad equity market is up nearly 70%.

Source: NCREIF

Figure 5: Real Estate Allocation



This difference in investment return performance has led to many actual real estate allocations being below target allocations.

Source: Hodes Weill & Associates

Figure 6: Wilshire 5000 Market Cap Relative to Nominal GDP

In contrast to real estate valuations that are close to post-GFC lows, U.S. equity market valuations are extremely high.

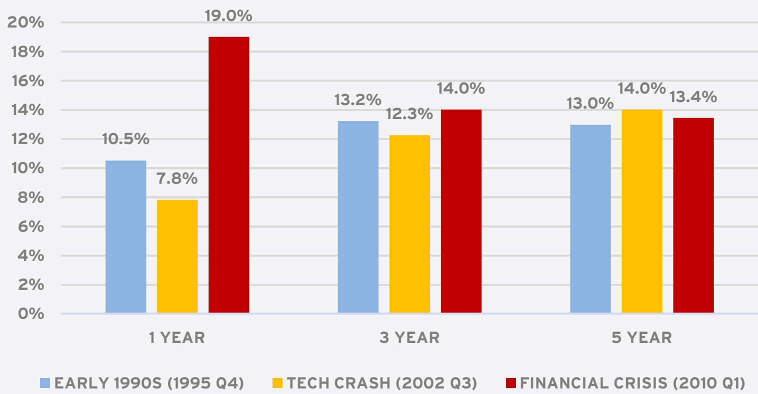
Figure 6 illustrates one simple measure of equity market value showing the ratio of the Wilshire 5000 market capitalization to nominal GDP.

By this measure, the U.S. stock market is at the highest valuation point in the past 50 years.

Source: Wilshire, Bureau of Economic Analysis (BEA). As of 2024 Q4.

This Time Really Does Appear to Be Different

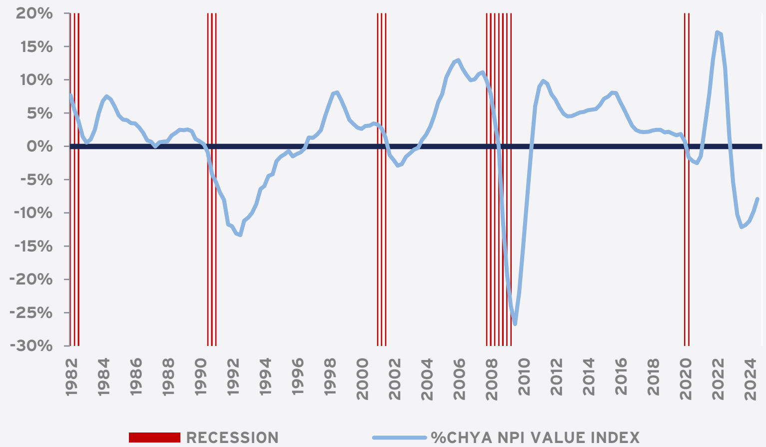
Figure 7: Five-Year ODCE Total Return Following Trough Quarter



Source: NCREIF

The NFI-ODCE Index posted double digit total return in past periods following cyclical troughs.

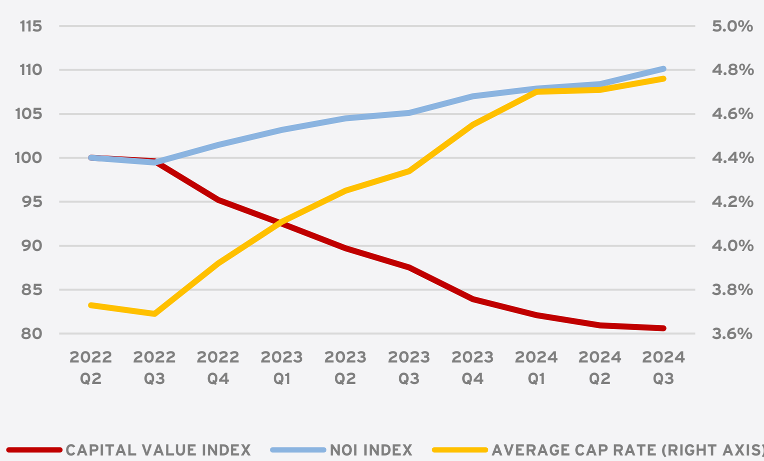
Figure 8: Change in Property Values and Past Recessions



Source: NCREIF. As of 2024 Q3.

The past two years is the first time in the history of NCREIF that saw a sustained downturn in property values without an economic recession.

Figure 9: Composition of NPI Return 2022-2024



Source: NCREIF

In contrast to recessions, aggregate property income increased approximately 10% (blue line) while property values fell approximately 20% (red line).

Average property cap rates (yellow line), increased by more than 100 basis points, by itself enough to account for a 25% decline in value if property income had remained constant.

This Time Really Does Appear to Be Different

Figure 10: Composition of ODCE Return Following Tech Crash

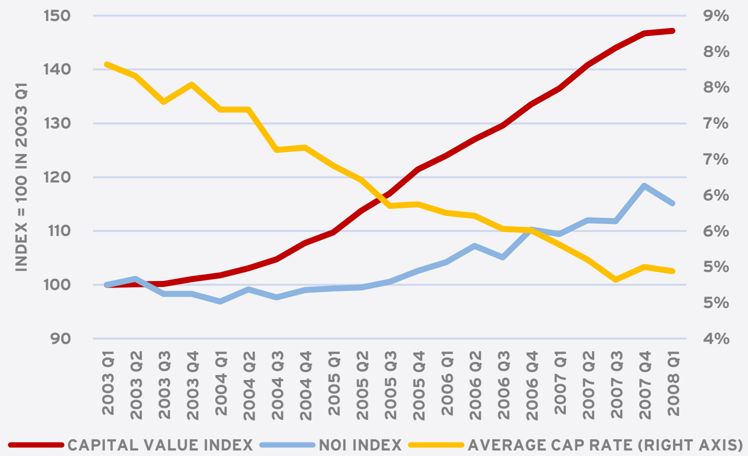
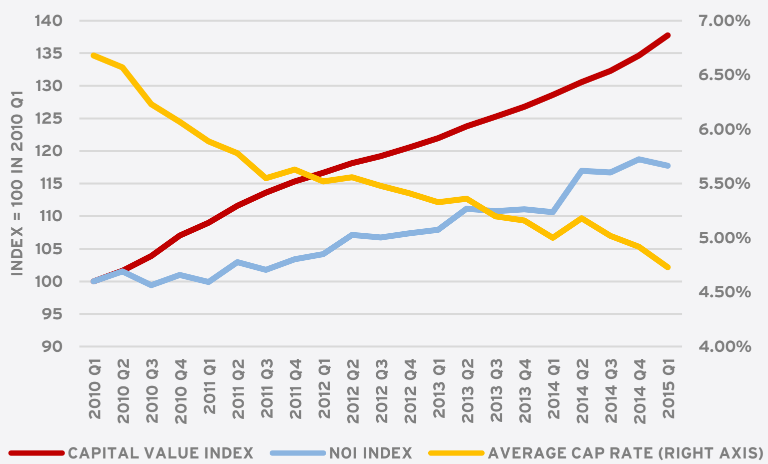


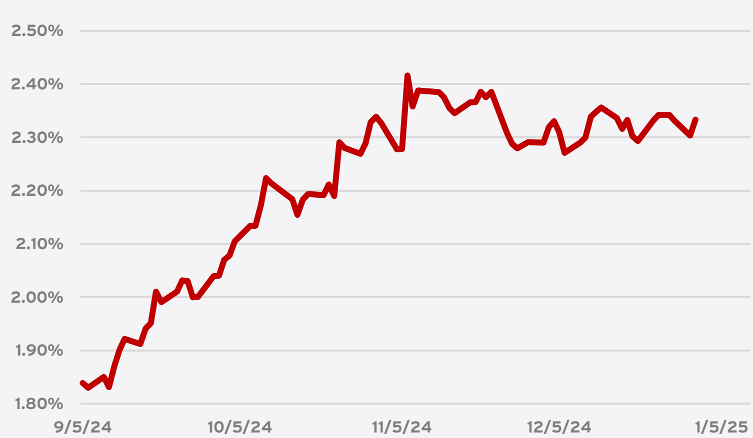
Figure 11: Composition of ODCE Return Following Financial Crisis



Cap rate compression (yellow line) turned NOI growth of less than 20% into value (red line) increase of more than 40% in both recovery periods.

Source: NCREIF

Figure 12: Expected Inflation

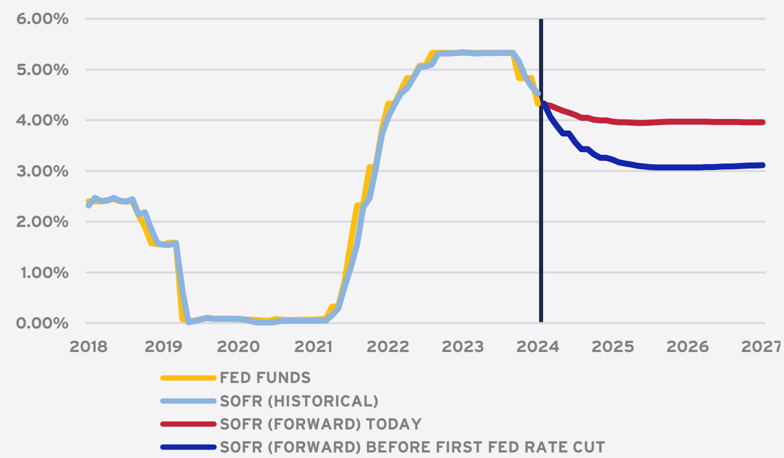


Expected inflation over the next five years has increased by more than 50 basis points since the beginning of September.

Source: Treasury

Hoping for Cap Rate Compression Is Not a Strategy

Figure 13: SOFR Forward Rate

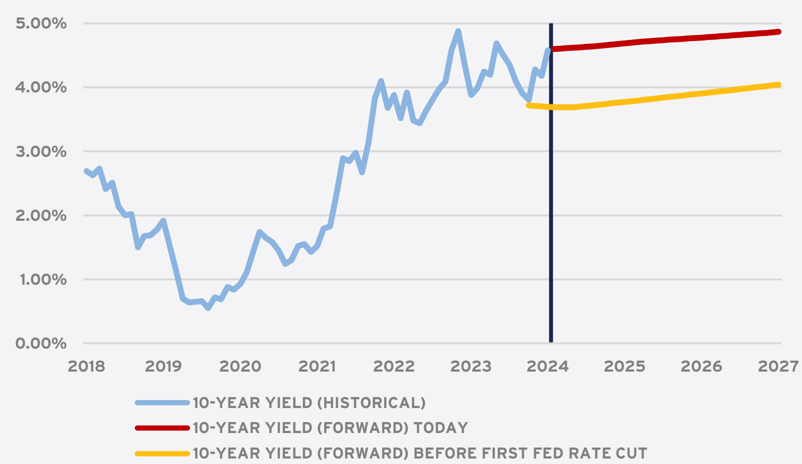


The Fed Funds rate (yellow line) and SFOR (blue line) are essentially the same.

Since the first Fed rate cut in September, the forward curve for short rates has moved upward by approximately 100 basis points.

Source: Chatham Financial. As of January 7, 2025.

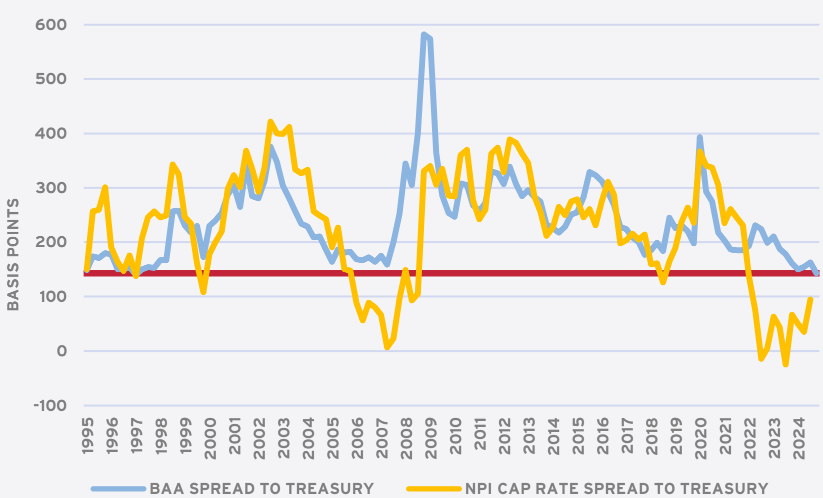
Figure 14: Ten-Year Forward Treasury Yield



The forward curve for the ten-year Treasury yield has also shifted upward by approximately 100 basis points.

Source: Chatham Financial. As of January 7, 2025.

Figure 15: Corporate and Property Spreads to Treasury Yield

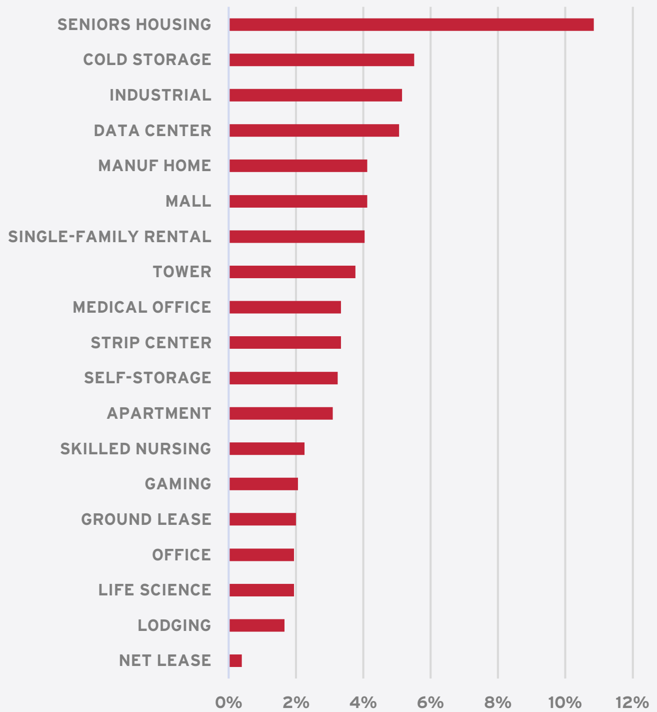


Corporate credit spreads are at the lowest level in 30 years (blue line, red line is lowest level).

Property cap rate spreads (yellow line) are inside of corporates, similar to GFC period but the gap is narrowing.

Source: NCREIF, FRED

Figure 16: Expected Annual NOI Growth 2025-2028



Source: Green Street, Commercial Property Outlook December 2024

Figure 17: Annual Return Difference Between Best and Worst Performing ODCE Fund

Source: NCREIF, ODCE Annual Reports. As of 2024 Q3.