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Finding opportunities in a bifurcated market

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Chris Lee,** partner and head of real estate, Americas, and **Justin Pattner,** partner and head of real estate equity, Americas, both of KKR. Following is an excerpt of that conversation.

How would you characterize the U.S. commercial real estate market right now?

Chris Lee: We think real estate is at the beginning of a pretty intense deleveraging cycle. The combination of suppressed rates, limited supply and minimal risk premiums led to elevated values back in 2021. Since then, the cost of capital has increased dramatically, valuations have moderated and debt service has ballooned, putting a number of capital structures that were set in 2021 under some stress at a time when capital is less available. Banks experienced tremendous asset growth between 2020 and 2022, but their capital ratios have been impacted, so they are under pressure to reduce their exposure to commercial real estate. On the equity side, nontraded REITs, public REITs and core funds are on the sidelines for similar reasons.

Where do you think we are in the evolution of this current dislocation?

Justin Pattner: Trying to time the bottom of a market cycle is extremely difficult, if not impossible, but we think we are well off the top. Since the markets peaked in late 2021 or early 2022, short-term rates are up 500 basis points, inflation spiked to 9 percent and is now closer to 4 percent, the 10-year U.S. Treasury bond is up 300 basis points, credit is far less available, and the cost of financing has more than doubled. So, markets went from being highly liquid to illiquid. We think the magnitude of the correction and repricing is potentially larger than many realize. Transaction activity was down about 60 percent year-over-year, as of the end of the first quarter, and visibility into true private market values is not clear. Those assets that are trading are higher quality, in favored sectors, and located in good markets. These trades are pricing 100 basis points to 150 basis points wide, on a cap rate basis, relative to peak. If you extrapolate the cap rate moves in higher-quality assets to what they might be in lower-quality assets, which generally are not trading, they would likely be more than 250 basis points. These are pretty significant moves.

To that point, do you agree with a sentiment we hear a lot – that this market is highly bifurcated between winners and losers?

Pattner: Absolutely agree. There is bifurcation across quality, sectors and markets. Higher-quality assets are outperforming from both a fundamentals and capital markets perspective. The most pronounced bifurcation is across asset classes. Office and retail went through massive revaluations during the past decade; meanwhile, performance has been strong in most housing sectors and industrial. We expect this to continue over the long term, with some potential cyclical disruption in the very near term.

Lee: When there is a sea change in terms of the way people utilize real estate, where people live or where jobs are being created, you always see massive shifts in both valuations and operating fundamentals. COVID-19 changed the fundamental ways people thought about using space, and the effect ecommerce had on retail was similar in the prior decade. The key is to try to get ahead of those tectonic shifts.

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> *– Justin Pattner*

Are there signs we are near a turning point, or is the dislocation getting worse?

Pattner: We are nearing a point where there should be more capital markets activity, primarily driven by an increasing number of motivated sellers. Many borrowers will not be able to cover debt service as their interest rate caps expire, which will lead to either forced sales or loan restructures. In addition, some $1.5 trillion of the $4.5 trillion in outstanding commercial real estate debt comes due over the next two years. Given the meaningful move in values and the drop in availability of credit, many borrowers with maturing debt will have a hard time refinancing.

Could it get worse from here? In the near term, yes, particularly if fundamentals deteriorate. So far, they have been quite strong across most property sectors, but if we hit a big recession, there could be a near-term value reset.

Where are you seeing opportunities open up in the market, and what's driving that?

Pattner: We believe that when capital flows out of the system, it is usually a good time to be a buyer, albeit exercising an appropriate amount of discipline. Lack of liquidity is driving the opportunity set, and we are focused on finding opportunities in three areas.

The first is high-quality, core assets that are being sold by landlords motivated by a need for capital. These could be core funds with large redemption queues, private individuals looking to free up capital to address liquidity needs, or developers in need of capital to fund development in progress or their broader pipelines. Because of the market dynamic, if these groups need money, they are going to have to sell their best assets. We are seeing the absence of a core bid in the market creating opportunities to generate opportunistic returns on these types of assets.

The second category is good, stable assets with stressed capital structures. These could be opportunities to buy loans from special servicers, notes from alternative lenders or portfolios of loans from regional banks.

Third is corporate opportunities – private and public companies looking for liquidity, either to shore up their capital structures or to position themselves to go on offense. Certain management teams running public companies are frustrated and exhausted. They lived through COVID-19 and this rapid rate rise, which forced them to be highly defensive. Now, with depressed real estate values, they'd like to go on the offensive, but they can't issue stock given where they trade and, therefore, are struggling to find ways to grow. So, they are looking for private capital solutions.

It is important to note, however, that we went from being in a market that was efficient to one that requires real effort to identify and create opportunities. If you're going to take risk in a dislocated market, you have to be very disciplined about the amount and type. The tools a manager has for accessing opportunities are more critical than they have been for 15 years.

Lee: Of the three categories Justin mentioned, we are buying core assets today, but we think we are still in the early innings of seeing anything out of banks or public companies. We expect to see pressure building from lenders to deal with problems through loan sales, foreclosures, or other means that bring capital into an asset or capital structure. Right now, transaction volume is still muted. It is still the early part of the cycle, when high-quality assets are being spit out, but it will evolve into more stressed transactions during the next 12 to 24 months.

What thematic ideas are you most bullish and bearish about in U.S. real estate?

Pattner: We have been thematic investors since inception, and we think that is critical. Look at the massive revaluation that has occurred in the two largest sectors, office and retail. People who were not on top of consumer preferences or corporate behavior are in the process of losing a lot of money. To make outsized returns in the last seven to eight years you had to get the growth bet right, which meant selecting the right themes. Today, while theme selection is key, we are in an environment where you can create a lot of value on the buy. We do expect to see some interesting opportunistic deals in our pipeline, where we can purchase properties at an attractive level. We haven't seen this type of opportunity in 15 years.

Medium term, we are still quite bullish on housing. There are some supply disruptions in certain markets that could create an opportune entry point. We were one of the early institutional entrants in student housing, where fundamentals tend to be quite resilient. In the industrial sector, ecommerce remains solid, but we think nearshoring, onshoring and supply-chain security will drive demand growth. Data centers continue to be key to our digital infrastructure, and we have been investing in storage, as well. We are less bullish on office and retail. To do anything in office, values would have to get very cheap, even cheaper than today. Even then, it would be a small exposure for us.

Do you think we will see systemic issues in the banking sector or a ripple effect through real estate as a result of vacancies and underutilization of office?

Lee: We do not think the issues will be systemic. If 20 percent of banks' balance sheets are exposed to real estate, for instance, and 20 percent of that is office, give or take, that amounts to 4 percent of bank assets. Of that, if 50 percent default, 2 percent of assets would be lost over a two- to four-year period. That would lead to a slight drag on earnings for some of the banks, but not a banking crisis. That is not to say it won't have an impact. The office sector is a multitrillion dollar sector. The bifurcation in fundamentals, values and tenant preferences we discussed earlier, however, is already resulting in a big divergence of outcomes for new, high-quality office versus legacy office space.

What about the U.S. housing sector?

Lee: The housing market is still tight. Single-family prices have come off the peaks from 2021. Mortgage rates in the 6 percent to almost 7 percent range put pressure on affordability, but there are also a lot of sellers locked into mortgages with rates of 4 percent and lower who are unwilling to sell. Home builders are not building many homes, and rental demand is high. Some class A rents are starting to fall off in some of the markets we invest in – either moderating or some have rolled over slightly – and we expect more supply for that class A housing in the next 18 months. That may put a bit more pressure on operating income and values, resulting in some stressed owners. The lack of construction demand today implies that a lot less supply is coming online in 2025 and 2026. If you can buy below replacement cost, we think that is a pretty good medium-term backdrop for buying housing assets across several multifamily or single-family rental sectors.

Pattner: That's a really important point. Supply pipelines are usually robust going into an economic downturn, which tends to lead to a more protracted period of fundamental and overall value degradation. This time around, that is not the case. Development pipelines were disrupted in the pandemic and didn't have enough time to build back up in a meaningful way prior to capital pulling back. It's very challenging to capitalize a development deal today and might continue to be for a prolonged period, given that the lifeblood of development across the country has been regional banks, which we know are going to be constrained for quite some time. After this wave of very near-term deliveries, supply will be very muted, which should be very good for real estate fundamentals in the medium to long term.

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COMPANY OVERVIEW

KKR Real Estate is a global provider of equity and debt capital across real estate investment strategies. Real estate has been a part of the firm's strategy since 1981 when we first began pursuing real estate opportunities through our private equity strategy. In 2011, we made a decision to form a dedicated real estate platform, believing that a dedicated real estate team with access to KKR's global investment platform could create differentiated deal flow and generate compelling risk-adjusted returns for our investors. As of March 31, 2023, our team consists of more than 155 dedicated investment and asset management professionals across 11 countries, with more than $65 billion of assets under management.