Real Estate Market Update

SUMMER 2023

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Houlihan Lokey

Houlihan Lokey's real estate advisory and banking professionals are pleased to share our take on trends impacting commercial real estate investors today.

Value, Drivers, and Discrepancies

01

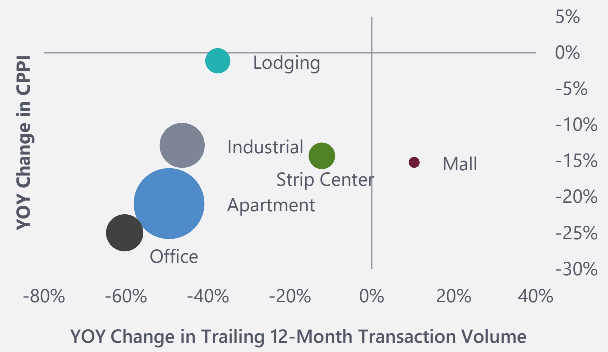
57% High interest rates and capital markets slowdown have created a **large bid-ask spread**, plummeting sales volume; U.S. commercial real estate investment volume fell by 57% year over year ($78 billion invested in Q1).

Over the past year, transaction markets essentially halted as a result of increased divergence in buyer vs. seller sentiment on pricing and turmoil in the debt markets. As a result, price discovery is extremely limited and there remains a strong **disconnect on forecasted fundamentals** for certain sectors/markets as well as disagreement on **how to underwrite** yields in this environment.

YOY Change in CPPI vs. Transaction Volume

As of July 1, 2023

Bubble Size is Representative of TTM Transaction Volume



Reversion to Mean/Cap Rate Drivers

The previous era of cap-rate-compression-driven appreciation has come to an end, and **property-specific characteristics** have once again become key value drivers.

Fears of a recession challenge the ability to grow rental rates while inflationary impact on **operating expenses**, including insurance costs, puts pressure on the bottom line.

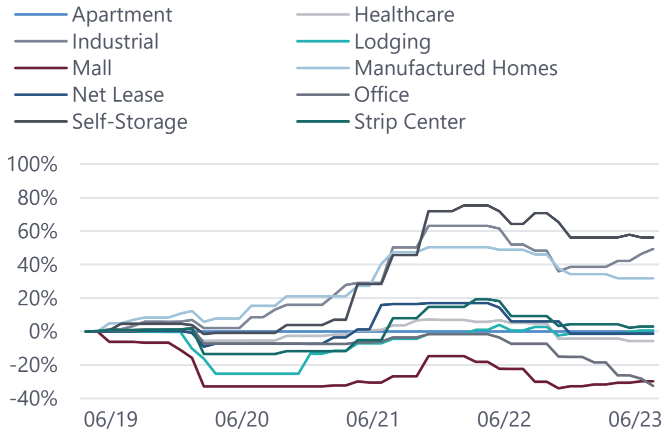
Consequently, **savvy operators** who can control cost through expense bundling across portfolios are likely to perform better.

Divergence Continues Among Sectors

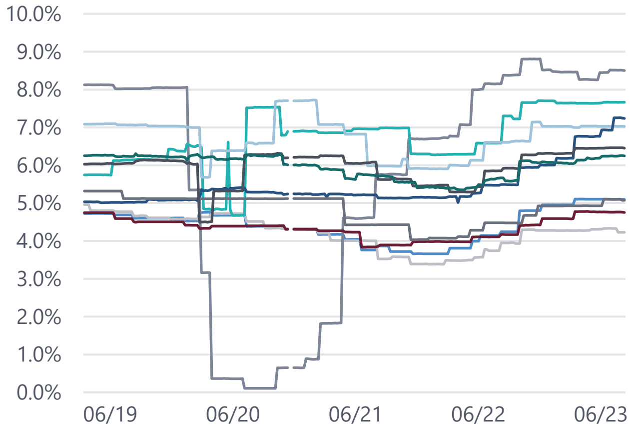
02

Cumulative Change in Commercial Property Price Index

As of July 1, 2023



Nominal Cap Rate Trends



As illustrated by Green Street's CPPI index (left), value changes have varied wildly across the sectors over the past few years, with industrial, manufactured homes, and storage clearly runaway leaders. Other sectors, like office and certain retail, have been more severely impacted, with a long recovery period expected. As expected, cap rates are expanding, as shown above.

Sources: Bloomberg, Cushman & Wakefield, Green Street, Wall Street Journal, PERE, Real Capital Analytics, CoStar, and proprietary sources.

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Headwinds and Tailwinds Across Asset Classes

Although all asset classes are negatively impacted by cap rate changes, each sector demonstrates varying levels of underlying strength in their fundamentals.

Tailwind — Headwind

Multi-Family

- ▲ Nationally undersupplied (5+ million households).
- ▲ SFR and BTR remain attractive investment classes.
- ▼ Rent growth slowing.
- ▼ Wage growth lagging inflation, potentially leading to rent-coverage issues.

Industrial

- ▲ Continued growth in rents, particularly infill locations and transportation hubs.
- ▲ Continued growth in manufacturing and consumer good production.
- ▲ Increased focus on just-in-case models over older just-in-time models.
- ▼ Continued robust supply pipeline.

Hospitality

- ▲ RevPAR at or above pre-COVID-19 levels.
- ▲ Resurgence of leisure and emergence of leisure travel.
- ▲ Sustained surge in demand for luxury.
- ▲ Rising interest in alternatives: glamping, vacation rentals, etc.
- ▼ Rising expense growth and tight labor market.

Retail

- ▲ Neighborhood centers and grocery-anchored retail in demand.
- ▲ Absorption continues to exceed new deliveries.
- ▼ Bankruptcies impacting absorption.
- ▼ Potential of recession limiting consumer spending.

Office

- ▲ Trophy assets outperforming.
- ▼ Remote work, layoffs, and downsizing footprint.
- ▼ Expensive releasing costs required for high-quality tenants; sometimes, but not always, offset by higher rents.

Turmoil to Result in Opportunities

03

Near-term maturities, secular headwinds, and regional banking turmoil will pressure both lenders and borrowers to restructure problematic capital structures and turn to alternative lenders and gap equity providers for bespoke capital solutions.

$1.5T

of CMBS loans are coming due before year-end 2025, creating a **refinancing risk** against the backdrop of falling capital values and rising debt costs. CMBS loans are only a portion of the overall CRE loan market.

Average cost of debt has gone up substantially, as underlying SOFR for floating-rate loans exceeded 5% in 2023 compared to 0.1% in 2021. Assuming a constant spread of 150 bps over 1 million SOFR, **cost of debt went up from 160 bps to 675 bps in less than two years**.

→ As low-cost debt begins to mature, valuations remain muddied, and interest rates remain high, landlords may be forced to:

Pay Down Lenders	Amend and Extend
Sell at a Discount	Try to Execute an Expensive Refinancing/Recapitalization

→ As risk ratings and capital reserve requirements increase, banks are increasingly turning to discounted loan sales and bespoke solutions such as take-back paper, off-balance sheet JVs, and preferred equity to reduce exposure and contingent funding liabilities.

→ Sale activity has picked up. Kennedy Wilson acquired a $5.7 billion portfolio of loans from Pacific Western Bank. The first tranche of this portfolio, totaling $3.25 billion in commitments and $1.8 billion of principal, was acquired for $1.6 billion.

→ As nonrecourse borrowers strategically default on debt service due to declining cash flows, flipping the keys back to lenders that want/can own the assets is harder than anticipated.

Sources: Bloomberg, Cushman & Wakefield, Green Street, Wall Street Journal, PERE, Real Capital Analytics, CoStar, and proprietary sources.

The Way Forward

Key market indicators suggest that the real estate industry will be faced with a variety of restructuring situations and create significant buying/consolidation opportunities for sponsors with dry powder.

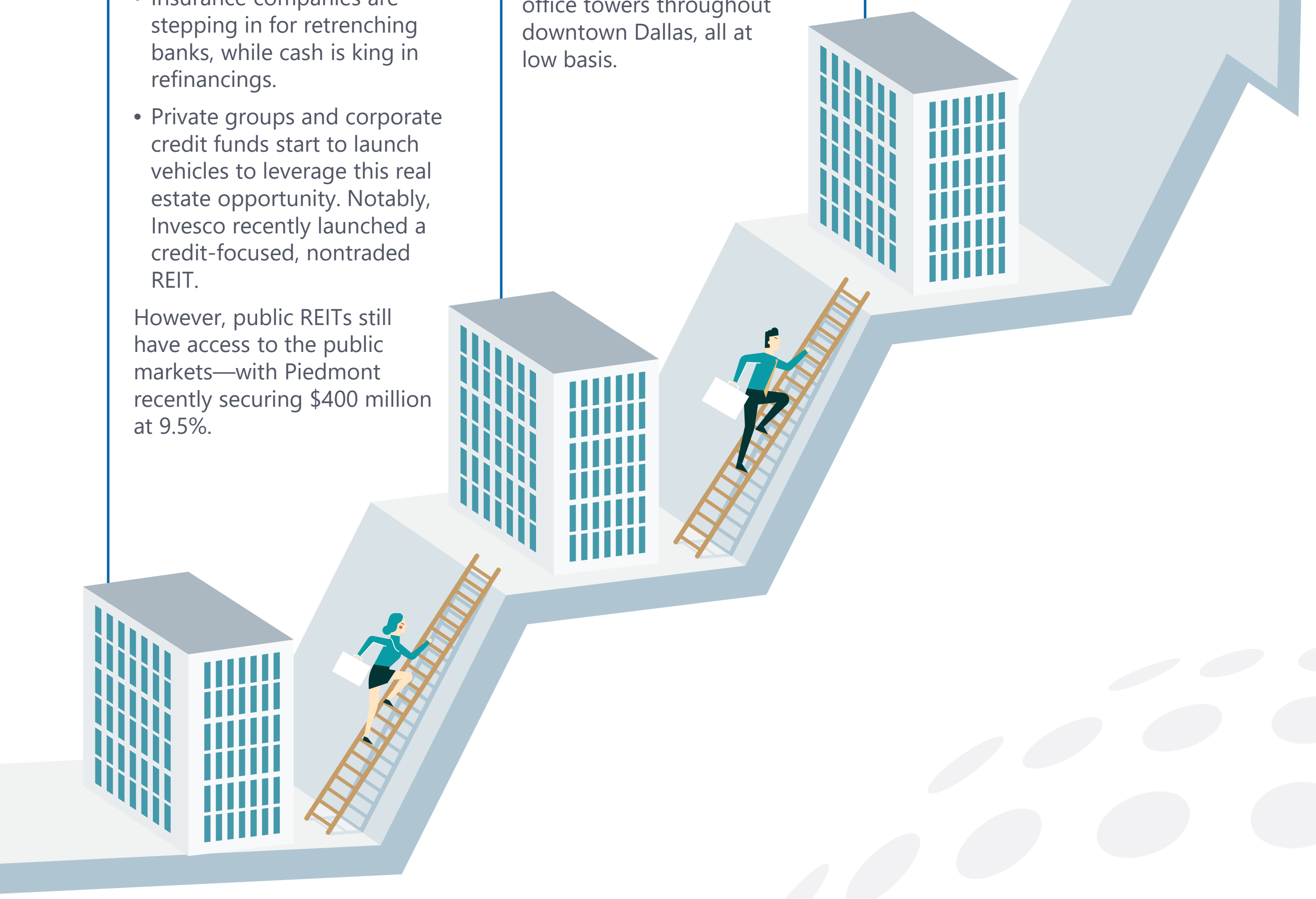
Traditional lenders have started pulling back from the market, making room for alternative lenders and structured capital to fill the void at escalating costs:

- RE debt funds are becoming particularly active across the capital stack, filling a hole left by traditional lenders.
- Insurance companies are stepping in for retrenching banks, while cash is king in refinancings.
- Private groups and corporate credit funds start to launch vehicles to leverage this real estate opportunity. Notably, Invesco recently launched a credit-focused, nontraded REIT.

However, public REITs still have access to the public markets—with Piedmont recently securing $400 million at 9.5%.

While the pain in the office sector is going to take some time to resolve, there are contrarian investors who will make a play. For example, Carlyle Group sees CRE debt in downtown offices as a "prime investment," while Woods Capital has opportunistically acquired office towers throughout downtown Dallas, all at low basis.

Institutional investment capital is being reallocated to niche asset classes, creating an opportunity for sponsors to achieve opportunistic returns.



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Houlihan Lokey has a successful track record of assisting its clients—comprising real estate investors, owners, and other stakeholders—with various valuation, transaction, and special situation needs.

Houlihan Lokey's Real Estate Expertise

Valuation and Advisory Services

We have deep valuation expertise in investment, financial reporting, and tax matters.

We advise boards of directors and special committees as they navigate a range of strategic situations and challenges.

We value large portfolios of real estate equity and debt positions and offer bespoke valuation services (e.g., positive assurance) to help clients mitigate valuation risk.

Leveraging our accounting and real estate expertise, we help clients with transaction advisory services related to real estate equity and debt investments.

Our bench of experts includes dispute resolution counselors to advise on valuation matters involving disputes, mediation, arbitration, and litigation.

We provide fairness opinions, solvency opinions, and valuation opinions to clients across a variety of property- and entity-level transactions.

Investment Banking

We have a track record of structuring and executing value-optimizing transactions for our clients.

We run efficient, momentum-driven processes that drive results in M&A and capital raising for both healthy corporate finance and restructuring transactions.

We advise clients on strategic alternatives that enable them to accomplish next-level strategic goals—whether the aim is accelerated growth or divestiture—for PropCo and/or OpCo structures.

Our team of experienced investment bankers has extensive and expansive reach of traditional and nontraditional real estate debt and equity investors around the world.

We are well versed in crafting tailored solutions to achieve client objectives, with deep experience across sectors, company types, and market cycles.

We are uniquely positioned to help address special situations, ranging from liquidity management to recapitalizations.

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