Q1 2023

bakertilly

Commercial Real Estate Market Report

INSIDE THIS REPORT

03 Introduction

04 General economic overview

08 Section 1: Multifamily

12 Section 2: Office

16 Section 3: Retail

20 Section 4: Industrial

24 Section 5: Capital markets

29 About the authors

30 About Baker Tilly

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INTRODUCTION

Dear Reader,

Last quarter, we anticipated that the tenuous economic situation would not be resolved quickly. We noted in the quarter that certain trends persisted from the end of the year, with transaction activity decelerating even further and indications of inflation beginning to ease. Energy remains the primary source of deflationary pressure, but the easing of inflation was more broadly based in the first quarter, providing some confidence that the trend is meaningful and sustainable. The biggest economic headlines this quarter were related to bank distress with the publicized failures of Silicon Valley Bank and Signature Bank, sparking concerns of broader issues. For commercial real estate, the last quarter was most remarkable for its lack of activity. The multifamily and industrial sectors, which continued to transact even when other asset classes were subdued, finally slowed significantly. In addition to inactivity, the increase in distress and default in the office sector was notable, if not unexpected. We expect that transaction activity in the second quarter will remain muted with no economic influences serving to narrow the bid-ask spread that has developed between buyers and sellers.

For some time now, pundits and market commentators have been talking about how the United States is heading for or may have already been in a recession, however the first quarter still posted GDP growth of 1.1%. This tepid growth rate represents a decline from prior quarters, perhaps presaging the widely expected recession could finally arrive in 2023. The mix of positive and negative indicators is proof that the economy is disjointed. Coming out of the pandemic, the term “new normal” was thrown around a lot. In reality, society and the economy aren’t finished processing and evolving based on shifts that were likely not created by the pandemic but in many cases accelerated by it. This was coupled with a strong overreaction at the federal level that pumped cash into the economy when all these factors are still being worked through in what is proving to be a messy and unprecedented process. Beyond the U.S., other countries are going through similar processes, and Russia’s war on Ukraine adds a disjunctive element. If there is such a thing as a “new normal,” we think it is safe to say we are not there yet.

We are optimistic that inflation will continue to improve, paving the way for a compression of interest rates, but the environment is highly uncertain. We anticipate the second quarter will be defined by increased distress and how those issues are resolved.

As always, thank you for reading.

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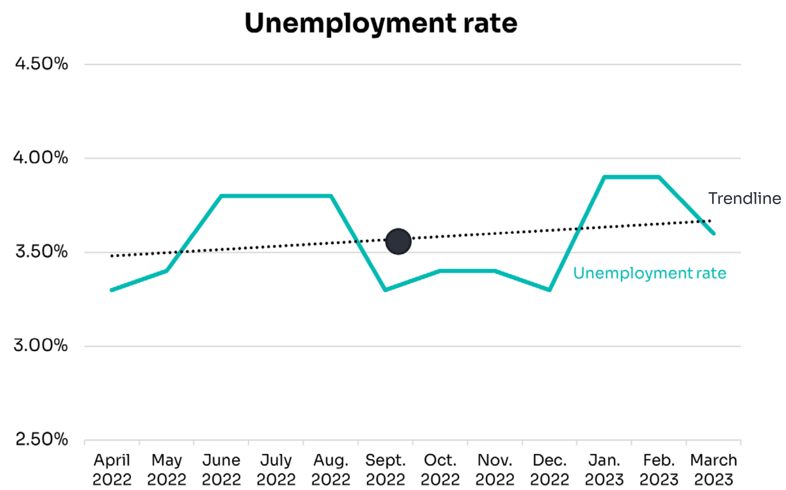
General economic overview

Unemployment near historic lows

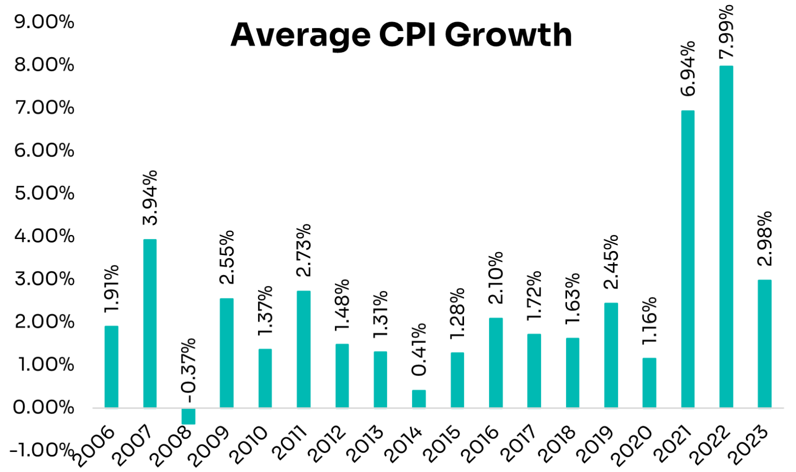


Source: U.S. Bureau of Labor Statistics

Unemployment figures ended the quarter up slightly from 3.3% in the fourth quarter to 3.6% at the end of March.

Unemployment remained below 4% for the entirety of the first quarter, logging a full year of sub 4% unemployment for the first time since 2019. The number of unemployed seeking employment reversed trend and headed up for the quarter overall but declined in March to end the quarter at 4.95 million compared to 4.35 million at the end of 2022. In its April 7 employment situation summary press release, the United States Bureau of Labor Statistics (BLS) noted that employment extended its trend upward in leisure and hospitality, government, professional and business services, and healthcare industries. The fairly static employment environment is in relative juxtaposition to the capital markets environment which is still unfavorable. However, other economic indicators stayed more positive than some prognosticators anticipated with GDP remaining positive and inflation showing improvement.

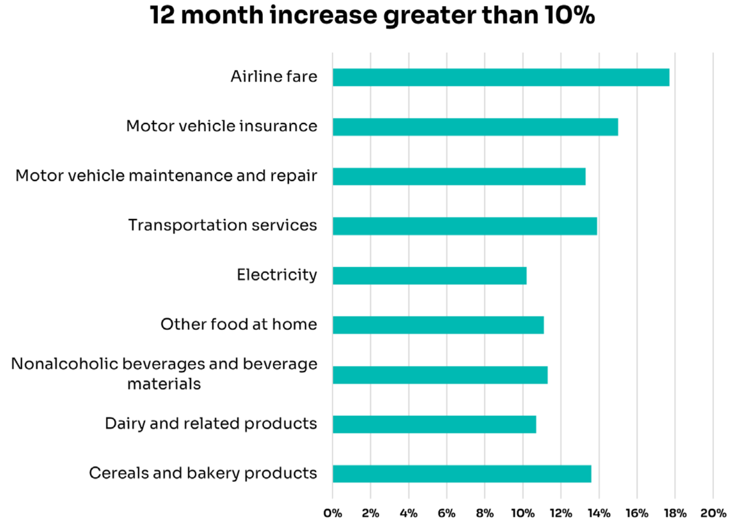
Easing of inflation becomes more widespread



Source: U.S. Bureau of Labor Statistics

Consumer Price Index (CPI) growth in the first quarter would imply an average annual rate of 2.98%, a significant drop from 2021 and 2022, though notably higher than any other year since 2008. Since July 2022, the average monthly CPI inflation rate averaged 0.26% (3.16% annualized), representing a stark decrease from the average 0.8% monthly rate (9.66% annualized) in the first half of 2022.

The number of categories with more than 10% year-over-year growth as of March 31 declined compared to the prior quarter, with food-related items and transportation comprising the majority of the categories that remain elevated. Looking more granularly at some of the leading components of the data, food, which had averaged an increase in CPI of 0.81% per month in 2022, demonstrated a marked deceleration in the first quarter, averaging 0.29% and as low as 0.02% in March. Housing was more stubborn, showing only a modest decrease in the rate of inflation. Transportation previously experienced volatile fluctuations but was relatively flat in the first quarter behind a 0.55% decline in March. If the rate of inflation continues to ease, 2023 should be a year of modest inflation. However, the economy remains precariously balanced between managing inflation without overcorrecting.



Source: U.S. Bureau of Labor Statistics

Item: materials and components in construction
Source: BLS.gov

Real estate cost inflation

Construction cost indexes reversed their downward trend from the fourth quarter of last year and returned to growth in 2023, exhibiting a 0.54% increase as of March 31 from the end of 2022. According to the latest National Association of Home Builders (NAHB) Cost of Construction survey, the average construction cost of a new home exceeded 60% of the average home sales price in 2022. According to the NAHB, this has only occurred four other times since the survey began in 1998 and is reflective of stubbornly inflated construction costs. Cost increases were relatively widespread among construction inputs, but normalization of the supply chain has begun, with improved lead times and delays, according to a March 15 GlobeSt article.

Given the significance of construction and housing to the overall CPI, persistently elevated construction costs and the large rent increases of the past couple years are likely to contribute to persistently high housing cost growth relative to historical averages. While on the rent side, landlords have already seen meaningful decreases in rent growth from the lofty post-COVID highs, elevated construction costs will invariably contribute to rents remaining elevated for renters as well as higher costs of home ownership. Single-family rentals have attempted to address housing affordability, but these projects are not immune to higher costs for both land and construction. Notwithstanding all the headwinds, the NAHB survey expressed a level of optimism about the housing market, largely based upon the enduring lack of housing inventory. In an article published March 16, NAHB Chairman Alicia Huey said, “A significant amount of housing demand exists on the sidelines. Even as builders continue to deal with stubbornly high construction costs and material supply chain disruptions, they report strong pent-up demand as buyers wait for interest rates to drop.”

Fed continues to taper rate hikes

The Federal Reserve reacted to favorable inflation numbers by reducing the scale of rate increases, notching 25 basis points increases in February and March after a total of 125 basis points of increases in the fourth quarter of 2022. While the Fed's actions imply some optimism, it has largely been tempered by cautionary or pessimistic public comments, pleading restraint and noting the likelihood of additional rate hikes while also warning of recession. The Fed predicted a recession for the second half of 2023 in its March 21-22 policy meeting and reiterated these sentiments in April.

Transaction markets

Global M&A fell to the lowest level in more than a decade according to a March 31 Reuters article. The slow pace of activity followed a modest fourth quarter of 2022 and was reflective of the uncertainty and disjunction present in the economy. Deal-making was slowed by inflated borrowing costs, but uncertainty around inflation and the potential for recession also inhibited investors as well as a banking crisis that started in the U.S. and has spread globally. First-quarter activity was down 48% with $575.1 billion in announced deals. Major transactions were limited, with only three deals over $10 billion announced according to S&P Global Intelligence (S&P). In an April 7 report, S&P noted "Private equity firms have plenty of equity dry powder to put to work. However, they often generate better returns when they can add leverage to transactions." With banks less willing to lend and interest rates high, investors have little incentive to jump into deals, particularly if they foresee borrowing rates moderating within the next 12 to 24 months.

Slower M&A activity has been combined with a hefty increase in corporate bankruptcy filings in the U.S. S&P reports that the first quarter saw the most such filings since 2020. Bankruptcies included the highly publicized Silicon Valley Bank collapse but also featured a diverse range of companies such as Serta Simmons Bedding, Party City Holdco and Avaya Holdings.

Real estate activity did not bolster the global transaction environment in the first quarter. Similar to the last quarter, REIT M&A was essentially non-existent, and the overall transaction environment was substantially down. This is not surprising given the significance of debt financing to real estate deals. Even equity powerhouses in the real estate industry faced headwinds with Blackstone's BREIT, KKR and Starwood all experiencing considerable withdrawal requests from investors, straining their liquidity and requiring each to limit withdrawals. A high volume of real estate deals is unlikely to occur until either interest rates subside or sellers adjust pricing to get deals done. We would imagine that absent distress buyers and sellers are willing to wait out the current environment a bit longer to see how things develop, but depressed REIT prices could lead to some opportunistic deal-making in that space.

Equity markets

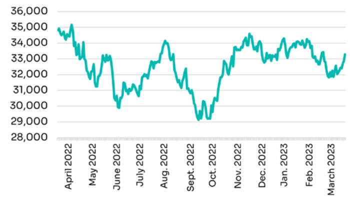
The Nasdaq and S&P 500 recovered some of their losses in the first quarter relative to the prior year, while the Dow Jones traded flat. The markets seemed to reflect the mild optimism and caution inherent to the current economic environment with investors rebalancing and recalibrating in light of the broader capital market environment.

	DOW JONES	S&P 500	NASDAQ
Change from Jan. 1, 2020	15%	26%	34%
Change from March 23, 2020	79%	84%	78%
Change year to-date March 31, 2023	0%	7%	18%

Source: Yahoo Finance, through March 31, 2023

12-MONTH EQUITY MARKET PERFORMANCE

Dow Jones



S&P 500

Nasdaq

Source: Yahoo Finance, through March 31, 2023

Conclusion

While the Fed may be predicting a recession, we think many investors and market participants are taking a wait-and-see approach, considering talks of the looming or current recession have been seemingly endemic for the last year or longer. In reality, the divergence of data points and economic indicators makes for a difficult situation to read. Employment remained strong through a period of significant inflation that has shown signs of abating while policymakers seek to engineer a steady course to stability. The economic and social upheaval spurred by the pandemic and the likely overly strong government reaction to it have disjointed an economy that appears to be slowly processing these changes. The economy is behaving abnormally because it was impacted by abnormal events. While we can’t claim to predict that everything will look the same when a normalized environment is established, we believe the later part of this year will provide additional clarity.

SECTION 1

Multifamily

For the first time since the early pandemic days, the multifamily sector finds itself in a potentially challenging position. The macroeconomic environment has stayed difficult for consumers as well as developers and investors, while affordability in some of the markets that drove a good amount of multifamily expansion has continued to decline. In the first quarter, the sector has seen a trend back toward rental growth rates and vacancy levels more in line with pre-COVID norms, but it's possible these fundamentals could deteriorate if new supply outstrips demand in the near term. The days of massive rent growth paired with low vacancy rates are gone, and owners and operators of multifamily assets will need to focus on operations to drive margin growth. This is definitely the mindset of many players in the space, as evidenced by comments from market participants at the National Multifamily Housing Council's Apartment Strategies Conference in Las Vegas earlier this year. Lili Dunn, CEO of Bell Partners, said her firm was "... in a defensive position with more focus on occupancy, driven by renewals." In a similar vein, BH Companies' President and CEO Joanna Zabriskie dubbed 2023 the "year of expense control." We anticipate the remainder of the year to see opportunistic dealmaking paired with a focus on expense control and operational improvements focusing on personnel and technology.

Rent growth in line with pre-COVID norms

Predictably, the first quarter of 2023 demonstrated a lingering decline in the rate of rent growth. According to Apartment List's April National Rent report, year-over-year growth as of the end of March was 2.6%, the lowest level since April 2021 and below the averages from 2018 to 2019. The report noted a 0.5% national increase for the month of March, an acceleration over February's growth and consistent with seasonal trends observed prior to the pandemic.

The Apartment List report also found that 28 of 100 major cities experienced negative rent growth since the beginning of the year. These cities were largely clustered in California and the Southwest. This is not unexpected considering the huge increases in these markets in recent years and, in the case of the California markets, the exceptionally high rents relative to the rest of the country. San Francisco particularly saw notable decreases with the city's extreme lack of affordability, downturn in the tech industry and the collapse of Silicon Valley Bank.

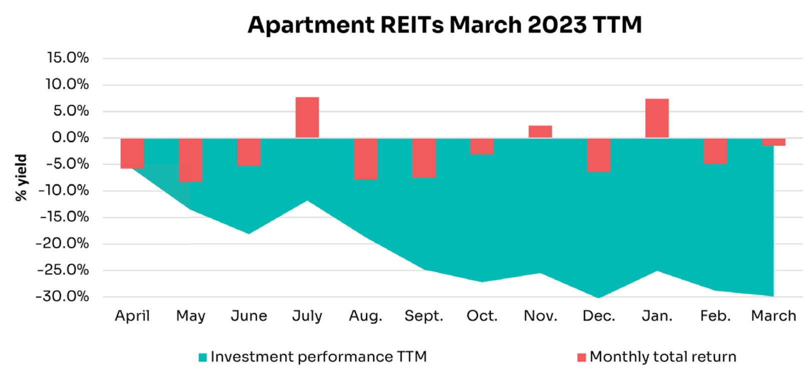
Vacancy continued the upward trend that began in the second half of 2021 reaching 6.6% on a national basis in March, which is in line with the average rates from 2018 to 2019. While new housing and multifamily unit starts are down compared to 2022 per data from the Federal Reserve, the number of multifamily units under construction is the highest since 1970, which is likely to drive higher vacancy as these units come online this year. We anticipate this will lead to further deceleration in rent growth as landlords find themselves competing for tenants.

Underwriting trends reversed

The post-COVID period saw a sizable increase in multifamily asset values driven by plummeting cap rates as investors raced to get into assets ahead of massive rent increases. It's unlikely anyone felt these remarkably low rates would last. It now appears rates have reversed course and are increasing rapidly, according to data from CBRE that was referenced in a Jan. 26 GlobeSt article. The article noted that in the fourth quarter of 2022, the average multifamily cap rate increased by 38 basis points to 4.49%, and further mentioned that represented an increase of 113 basis points over the past nine months. The report also stated that investors are projecting rent growth more in line with the 2014 to 2019 period than the higher rates experienced in 2021 and the first half of 2022. A lot of this change is anticipated since the unprecedented rent growth was not sustainable. As the upside of improved margins was realized, any rational justification for the extremely low cap rates observed in 2021 and 2022 disappeared. Couple this with the current elevated costs of capital, higher underwritten cap rates are to be expected. Nonetheless, buyers who invested in assets more recently at lower rates are not looking to divest of assets so soon at higher rates. Other investors are facing the same cost of capital issues and short-term uncertainty that are hanging over the industry as a whole, which is likely to contribute to a sustained lower level of transaction activity in the short term.

Government eyes remain on the multifamily sector

Last quarter, we noted that the majority of attempts to impose rent controls failed in 2022, but momentum appeared to be growing for various forms of government intervention in the rental housing industry. This trend has only gained steam in 2023, with the White House publishing a "Blueprint for a Renters Bill of Rights" in January which espoused a set of principles including references to affordable housing, eviction prevention and relief, among other items. Although the guidelines are not official policy or binding in any way, they did include action items that could lead to official government measures. More tangibly, in February, Boston Mayor Michelle Wu proposed a rent control that ties rent increases to CPI and caps growth between 6% and 10%. This measure was officially passed in March. Across the country, the Los Angeles City Council passed a package of ordinances that extended the countywide eviction moratorium until March 31, 2023, and provides additional protections from eviction and requirements for relocation assistance in the case of eviction. Owners and investors in residential rental assets will need to keep an eye on the political environment for the foreseeable future as housing affordability and access remain a keen government focus.



Source: Nareit

Multifamily transactions in 2023's first quarter

Multifamily remains one of the better performing asset classes, especially in the Sun Belt region. While the overall number of high-dollar transactions are down from the prior quarter and year, 2023 has already seen some record-setting prices. A highlight of some the most significant transactions are outlined below with further detail on the more notable sales.

BUYER	SELLER	CLOSE DATE	PROPERTIES	PRICE ($M)
Apartment Income REIT	Gumenick Properties	Jan. 2023	2 & garage	$250.50
Avanath Capital Management	The Brodsky Organization	Jan. 2023	1	$101.25
Beitel Group	Davis Development	Jan. 2023	1	$125.10
Spieker Companies	Koret Foundation	Jan. 2023	1	$106.00
Tishman Speyer	Green Cities Company	Jan. 2023	1	$135.00
Blackstone	Goldman Sachs Asset Management	Feb. 2023	1	$133.00
FPA Multifamily	C-III Capital Partners	Feb. 2023	1	$101.92
HHHunt	Wood Partners	Feb. 2023	1	$106.00
Sequoia Equities	Crescent Real Estate	Feb. 2023	1	$123.50
AEW Capital Management	DWS Group	March 2023	1	$123.00
Alliance Residential	Kennedy Wilson Multifamily	March 2023	1	$110.00
Avanath Capital Management	BJB Partners	March 2023	1	$119.00
Creative Media & Community Trust Corporation	CIM Group Management	March 2023	1	$142.70
Knightvest Capital	Eaton Vance Management	March 2023	1	$102.50
Priderock Capital Partners	TruAmerica Multifamily	March 2023	1	$115.00

Source: Press releases, SEC filings and published articles

First-quarter notable transaction activity

In one of the largest multifamily transactions so far this year, Apartment Income REIT (AIR) paid $250.5 million for Southgate Towers in the South Beach neighborhood of Miami Beach. The transaction also included The Shoppes at West Avenue, a 219,270-square-foot parking garage with ground-floor retail. Southgate Towers are two 14-story buildings with 495 luxury units sitting on four acres and overlooking Biscayne Bay and Miami. The property has not been traded in more than 50 years. AIR's presence in South Beach, a submarket with limited supply, now comprises 1,630 apartment homes between Flamingo Towers and Southgate Towers. The five-story garage, located across the street from Southgate, was completed in 2002 and has multiple retail tenants.

Creative Media & Community Trust Corporation (CMCT) completed the previously announced acquisition of Eleven Fifty Clay, a 16-story apartment building with 288 units in downtown Oakland, California, from CIM Group Management for $142.7 million (including an assumption of a mortgage of approximately $78.3 million). The purchase was funded with cash and the drawing under CMCT's revolving credit facility. This acquisition was a part of CMCT's strategy to grow its multifamily portfolio and advance its strategy to focus on premier multifamily and creative office assets in high barrier-to-entry markets. CMCT also closed on acquiring Channel House, a 333-unit, eight-story apartment building at 40 Harrison Steet, for an undisclosed price.

Tishman Speyer acquired The Eddy from Green Cities Company for $135 million. Built in 2016, The Eddy is a 17-story luxury apartment building that sits on the waterfront in East Boston and has unobstructed views of the Boston skyline. The property has 259 studio, one- and two-bedroom residences and a range of amenities It is the first multifamily acquisition in Boston for Tishman Speyer. According to Tishman Speyer's managing director, the purchase is "a testament to the enduring strength of the Boston market and the continued growth of its residential neighborhoods, especially along the waterfront." East Boston evolved in recent years from a marine industrial area into a destination for residents and visitors with multifamily developments, popular restaurants and other attractions.

After a record-setting 2022, the Sun Belt sustained its activity. Collier County property records show that Beitel Group paid $125.1 million for The Pearl Founders Square Apartments in Naples, Florida. The property consists of 400 units, which equates to $312,767 a unit. This is the third-highest per unit price for a single property sale in Naples' history. Investment sales boomed in the area last year, notably in the fourth quarter when the rest of the country had largely anemic sales because of pressure from higher lending costs and slowing rent growth.

Also in the Southeast, Blackstone paid $133 million for the 473-unit Ellington Midtown in Atlanta from Goldman Sachs Asset Management. Ellington Midtown sits in the heart of Atlantic Station, a mixed-use development with offices, high-end retail, entertainment and grocers. It is located in Midtown Atlanta, a retail and entertainment corridor and employment hub surrounding Georgia Tech. Blackstone plans to invest several million dollars in upgrades, including improving common areas, unit interiors, swimming pool areas and the fitness center. Asim Hamid, a senior managing director for Blackstone Real Estate, said that the purchase of Ellington Midtown illustrates the ability to deploy capital in Blackstone's high-conviction investment themes even during volatile times.

Trends and takeaways

Affordability remains an issue

We discussed the growing government interest and involvement in rental real estate; at its core, the issue relates to housing affordability. The government may desire widespread access to affordable housing, but the reality is a confluence of economic factors persists in constraining housing supply. With construction and land costs rising, and development of new single-family and multifamily units made even more expensive in a high-interest-rate environment, it's difficult to reconcile these economic facts with lower rents in the absence of government subsidies. While affordable housing programs have expanded, the majority of residential units are still market rate and market rate developers are starting fewer units in the current economic environment.

Earlier in the quarter, Moody's released a report that labeled the U.S. as "rent-burdened" on a national level. With rent and housing costs outpacing income growth, the national average rent-to-income ratio exceeded 30% for the first time in 20 years according to Moody's. The report further noted rent burdens were highest and the decrease in affordability was the most significant in markets that drew more investor and resident attraction during and after the pandemic, namely the South Atlantic and Southwest. For some of these markets, affordability was one of the key attractions. As this dissipates, a rebalancing is to be expected.

Lower rent growth and increasing vacancy are no cause for panic

The affordability issues we touched on before dampened migration and when combined with economic uncertainty led to decreased household formation, which in turn hurt vacancy rates for multifamily units. According to Trepp, major apartment REITs reported a 0.63% decline in occupancy in the fourth quarter relative to the prior year. This is consistent with the broader vacancy uptick noted in Apartment List's report.

As we mentioned before, it's likely vacancy will increase further as the large number of apartment units under construction come online. Despite the likelihood of deteriorating fundamentals over the course of 2023, the fact is the U.S. is underserved with housing units. Owners and investors will not be able to count on multidigit rent growth to fuel returns, but the positive long-term fundamentals of the segment remain compelling.

SECTION 2

Office

With office transaction volume back down near its pandemic low point in early 2021, the first quarter of 2023 witnessed a national office market seeking remedies to fill vacant office space amid a decreasing national office rent growth rate near 1%. Vacancy rates nationwide are consistently increasing, with a current national office vacancy rate over 12%, higher than at the peak of the Great Recession. Certain markets are substantially higher, such as Manhattan, where office vacancies rose to 16% in the first quarter. San Francisco, which has struggled with occupancies since the onset of the pandemic as tech companies continue to cut costs and downsize brick-and-mortar locations, currently resides at a staggering 30% office vacancy rate. In the future, office vacancies will likely maintain their ascent as a glut of new supply, delayed by supply chain issues and elevated construction costs, is projected to come online this year.

Additional sublease space is also coming to market. The amount of office space listed for sublease is up 25% since the first quarter of 2022, and up more than 110% since the end of 2019. All of this space available for lease combined with new product in the market has resulted in solidly negative net absorption for the office sector, with CoStar reporting total net absorption since the end of 2019 of negative 140 million square feet.

The demand that does exist for office space retains the same characteristics as in previous issues of this report. Tenants are leasing smaller spaces, shifting toward more collaborative amenities and more space per employee, and seeking out new, high-quality offices in accessible locations. This trend reflects many employers' desires to woo employees back to the office by providing more amenities in desirable buildings and, if possible, shorter commutes.

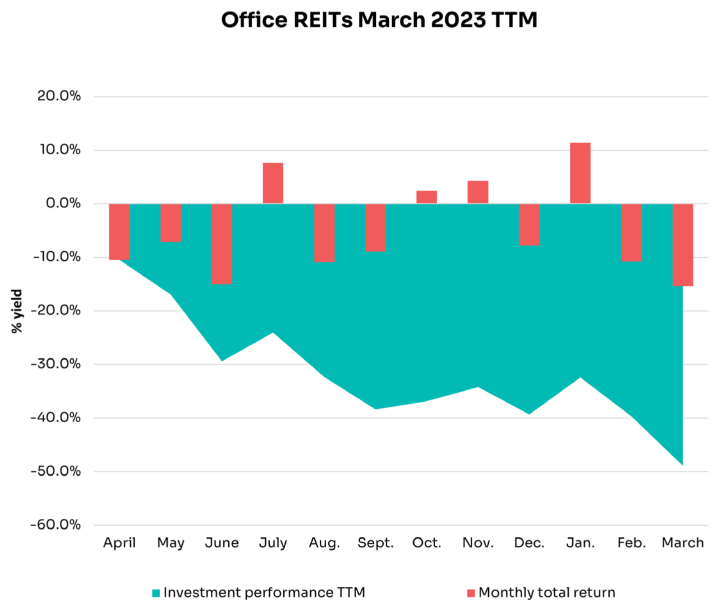
With monthly job growth in office-using sectors down significantly over the past six months, an increase in layoffs in these sectors and the threat of a pending recession on the horizon, these trends are unlikely to reverse in the near term. Additionally, low rent growth, rising vacancies, high inflation and loan maturities in a time of escalating interest rates and relatively stagnant office cap rates have initiated asset impairment discussions for some office owners, with others at risk of missing loan payments due to subdued property cash flows. A recent report from Morgan Stanley noted that approximately $1.5 trillion in commercial real estate debt will come due by the end of 2025. While these borrowers would traditionally refinance in order to extend their hold period, opportunities for new lending are becoming considerably more difficult due to rising interest rates and heightened lender scrutiny.

Office demand

The VTS Office Demand Index (VODI) tracks tenant tours of office properties across the nation and compares them to a pre-pandemic benchmark index of 100. VODI reports that February office tours, which typically receive a bump as office tenants analyze potential spring relocations, increased by 4.3% month over month. However, February 2023 demand was down 12.7% compared to February 2022. This landed at an index of 48, less than half of typical pre-pandemic levels and falling short of the lowest-recorded February index from 2018.

REIT performance

NAREIT reported another tumultuous quarter for office REIT returns. January started off strong posting gains of 11.3% followed by two consecutive months of losses to end the quarter down 16%. This March's negative 15.3% yield represents the worst monthly office REIT performance since March 2020 when the pandemic initially shuttered offices across the country, resulting in a drop of negative 20% in office REIT yields.



Source: Nareit

Office outlook

Office sales and leasing activity remains concentrated in newer, high-quality assets, with many tenants seeking smaller spaces, shorter lease terms and generous rent concessions. However, certain office subsectors have proven to be more resilient than traditional office. Life sciences and laboratory offices are still in demand and data center properties continue to be developed to meet an increasing demand for server space and cloud computing needs.

Blackstone recently closed a global real estate fund, Blackstone Real Estate Partners X, with $30.4 billion in total capital commitments. This is the largest real estate or private equity drawdown fund ever raised and is composed primarily of a mix of logistics, rental housing and hospitality as well as laboratory office and data centers.

Stafford Technology, an affiliate of Peterson Company, also recently announced plans to develop a $1.5 billion data center campus in Stafford County, Virginia, comprising 5.5 million square feet across more than two dozen buildings on a 524-acre site.

Medical offices have also weathered the remote-work environment with more resiliency than their traditional office counterparts. Office Properties Income Trust (OPI) and Diversified Healthcare Trust (DHC) recently announced plans to merge, citing asset diversification and a defensive tenant base as drivers behind the agreement. The move is anticipated to provide OPI with much-needed access to stabilized cash flows from DHC's medical office and life sciences portfolio.

Businesses in the tech sector made headlines in recent months for downsizing their physical footprints in order to cut costs. Salesforce recently announced it is listing its remaining space at 350 Mission Street in San Francisco for sublease. However, this contraction in the sector is not universal. Apple recently announced plans to build a new 282,000-square-foot office building in Cupertino, California, to replace and expand upon an aging 141,000-square-foot counterpart. This announcement follows other expansive moves by the tech giant which also acquired an 817,000-square-foot complex in Rancho Bernardo, California, last summer and inked a lease for a new office campus in Sunnyvale, California, in June.

Office transactions in the first quarter

The Fed's unprecedented number and pace of interest rate hikes have had a severe impact on office transaction activity. Potential buyers and developers are struggling to identify feasible financing options for acquisitions and new developments, resulting in the lowest level of transaction activity for an opening quarter in more than a decade, according to CoStar. The transactions that did occur primarily involved high-quality assets with strong fundamentals, a selection of which are presented below.

BUYER	SELLER	CLOSE DATE	PROPERTIES	PRICE ($M)
Welltower	TF Cornerstone	Jan. 2023	1	~$78.30
Enchanté Accessories	Columbia Property Trust	Feb. 2023	1	$77.00
Hyundai Motor Group	Vanbarton Group	Feb. 2023	1	$275.00
Sovereign Partners	Parkway Partners	Feb. 2023	1	~$83.00
HPS Investment Partners	The Chetrit Group	March 2023	1	$266.00
Vision Properties	Griffin Realty Trust	March 2023	1	$110.00
Waterbridge Capital	KBS	March 2023	1	$110.00

Source: Press releases, SEC filings and published articles

First-quarter notable transaction activity

In one of the higher-dollar transactions so far this year, the 617,000-square-foot, 21-story building at 850 Third Avenue in New York City was sold to the private investment firm HPS for a reported $266 million. The property generated $30.9 million in revenue, according to PincusCo. Tenants at the building include Chase Bank, which occupies ground-floor retail space. The seller, the Chetrit Group, purchased the building in 2019 for $422 million, representing a 37% decrease in sale price over the four-year period.

Vision Properties acquired the 10-story, 270,000-square-foot South Lake at Dulles Corner Business Park in Herndon, Virginia, for $110 million from Griffin Realty Trust. The $60 million loan structure includes five years of interest-only payments. The building, which is fully leased to Amazon Web Services, has a new fitness center, gaming rooms, high-tech conference rooms and a dog park in addition to a 921-space parking garage with charging stations for electric vehicles. Dulles International Airport is nearby as is Amazon's HQ2 in Arlington, Virginia, which is nearing completion of its first phase.

The iconic 40-story, 701,888-square-foot Union Bank Plaza in Downtown Los Angeles also changed hands this past quarter. Joel Schreiber's Waterbridge Capital bought the property from KBS, a little over a day before the city's new transfer taxes went into effect. Waterbridge reportedly paid $110 million, which equates to approximately $158 per square foot. The buyer paid $104 million for the building and assumed about $6 million in capital commitments to existing tenants, according to KBS' Giovanni Cordoves.

After almost 20 years of ownership, Parkway Property Investments sold the 46-story, 960,000-square-foot San Felipe Plaza in Houston. The buyer, an affiliate of the New York investment firm Sovereign Partners, purchased the property for just under $83 million. As this report has noted for other high-profile office transactions, the price tag was well under the prior sale price of $156.5 million in 2005.

Hyundai Motor Group reportedly paid $275 million for a redeveloped, eight-story boutique office building in Lower Manhattan. The automaker joins a recent trend among companies, which is to not only expand into the city but also own their own real estate, according to a report in Bloomberg. Hyundai plans to use the building for offices and a showroom on the ground floor. Hyundai purchased the property from developer Vanbarton in a deal brokered by Newmark.

Trends and takeaways

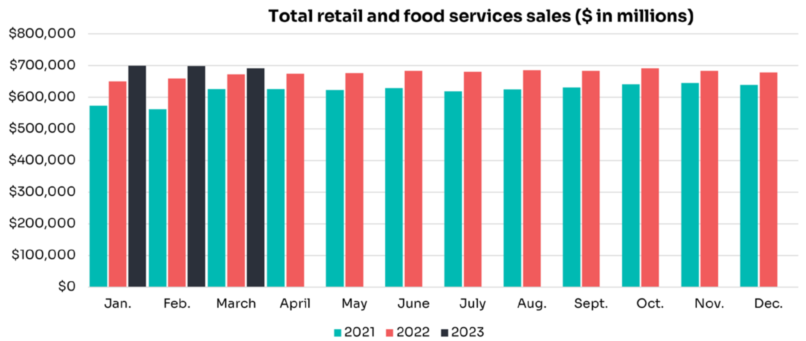
The first quarter illustrated that clarity around office users' hybrid work schedules has not been enough to stabilize the sector. Demand for rentable space, increasing vacancies and lukewarm rent growth continued to trend downward as the sector searches for ways to reposition traditional office properties, while creative investors are shifting capital toward more resilient office subsectors. Interest rate hikes further hampered deal volume with lenders increasingly unwilling to accept soft fundamentals in underlying collateral, and the outlook for the office sector remains tenuous. Office transaction activity may pick up in the near term as a large volume of maturing loans could force some office owners to exit their positions within the next 12 months. However, price discovery during this cycle will likely not be favorable for sellers.

SECTION 3

Retail

Retail sales growth pace slows

January sales figures were strong, showing a 3.13% month-over-month increase and 7.59% year-over-year increase before declining in February and March, though still posting year-over-year increases. An April 14 Reuters article highlighted that the declines were driven by reduced spending on big-ticket items such as motor vehicles. The article noted that households are reducing expenses to compensate for prolonged inflation; however, we would not necessarily agree with that. A significant decline in higher-priced purchases and particularly vehicles would clearly indicate a lack of desire to incur debt to acquire goods, but according to data from the U.S. Census Bureau, total retail trade, excluding autos, actually posted a month-over-month increase in February (March data was not available at this level of detail at the time of writing). We would agree there is sentiment among manufacturers and economists that a downturn is coming, but with strong employment and solid wage growth, it is also quite possible the U.S. consumer may prove more resilient and willing to spend more than expected, even if they wisely avoid financing vehicles and big-ticket items at interest rates that have not been seen in many years.



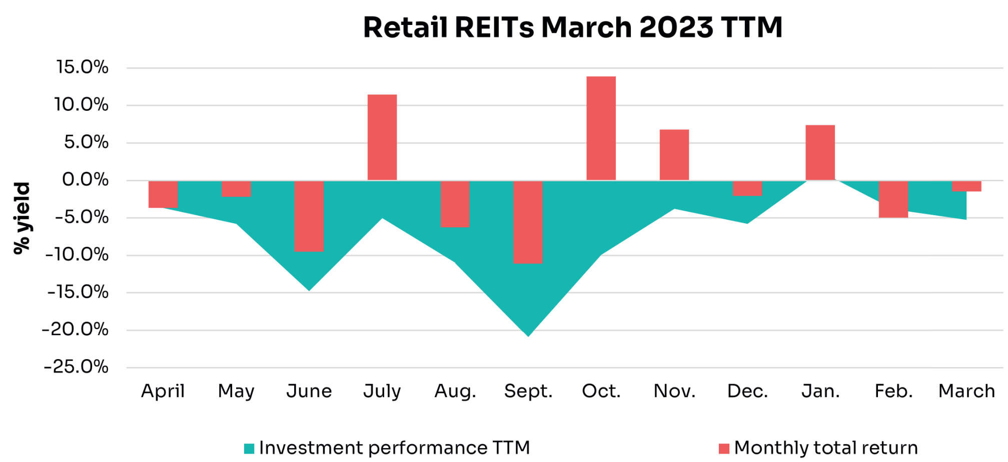
Source: U.S. Census Bureau, seasonally adjusted monthly sales

Grocery-anchored assets remain a highlight

We have discussed the durability and strong investor interest in grocery- anchored retail assets many times in our quarterly updates, but it's worth noting in a time when overall activity and interest is down, that these assets continue to perform. According to a Jan. 26 GlobeSt article that cites JLL's 2023 Retail Grocery Outlook, 2022 was a record year for grocery-anchored retail with $14.7 billion in transaction volume. We've also observed a trend among owners of these assets to begin bifurcating centers between the anchor space and the inline space. There are practical accounting reasons for such an approach, but this also provides more liquidity with these assets and the ability to more easily divest one or both components of an asset. Retail investors would pay a lower cap rate for just a grocery anchor tenant than for an entire strip center with the higher rates associated with the leasing risk and turnover of the line space. This flexibility could be essential to getting deals done in 2023 when the security of grocery-anchored space may look even more desirable in an uncertain economic environment.

Tremors of office issues impacting downtown retail

The pandemic undoubtedly influenced commercial real estate, but the longest-term impact, which is still playing out, is a shift in office demand and utilization. Of course, offices do not exist in a vacuum, and wherever there is a large office population, retailers and restaurateurs will follow. The lack of utilization in many downtown office buildings has seriously affected this basic supply and demand element. JPMorgan Chase issued a report in early March that discusses what it calls the "Downtown Downturn." The report noted that multiple large urban markets have fewer retail establishments now than at the end of 2021. It also stated that brands which had historically defined mall and urban center retail corridors are moving to the suburbs and surrounding areas where their customers are. This is not surprising and the trend of decentralizing and localizing real estate user experience is not limited to just retail. Consumers have shown a desire for the brick-and-mortar experience, but there is a balance with the convenience of online retail. Moving shopping experiences closer to where consumers live and providing a pleasurable experience are more important than ever, as consumers have demonstrated a clear preference for local shops versus driving into a downtown or heading to a large regional mall. As office utilization remains lower and it becomes more apparent that it will never fully reach pre-pandemic levels, this retail shift will undoubtedly stick around.



Source: Nareit

NNN market stagnated by bid-ask spread

We touched last quarter on how the NNN lease market was experiencing rising cap rates. This trend lingered into the second quarter as rates continued to trend upward and deal activity slowed appreciably, notwithstanding the announcement of a $1.5 billion sale leaseback transaction by Realty Income in March. Considering that NNN assets typically have long terms and limited rent escalations, buyers who may have purchased assets at lower capitalization rates were loath to sell when asset valuations were recently higher. In addition, buyers of these assets have little incentive to buy if they think rates still have more room to go up, which will effectively decrease the value of their investment. The Boulder Group cited a 10-basis-point increase to an average of 6.05% for single-tenant retail cap rates in its Q1 2023 Net Lease Market report.

However, in the current capital market environment, we would not anticipate activity to pick up significantly. For those with the ability to transact, opportunities will present themselves, particularly as the interest rate environment begins to shift.

2023's first-quarter transactions

Based on our research, notable transaction activity was down substantially in the quarter with only a handful of significant sales with prices over $50 million. The quarter did, however, feature the aforementioned announcement of a $1.5 billion convenience store sale leaseback transaction by Realty Income, which is expected to close in the second quarter.

BUYER	SELLER	CLOSE DATE	PROPERTIES	PRICE ($M)
Home Depot	Ares Real Estate	Feb. 2023	1	$55.50
Cannon Commercial	Laurus Corp. and Torchlight Investors	March 2023	1	$80.00
Hines U.S. Property Partners	UBS Realty Investors	March 2023	1	$112.00
Kohan Retail Investment Group	Deutsche Bank	March 2023	1	$71.00
Watumull Properties Corporation	Blue Vista Capital Management	March 2023	1	$66.00
Weybourne	Thor Equities	March 2023	1	$60.00

Source: Press releases, SEC filings and published articles

First-quarter 2023 notable transaction activity

TTM Real Estate Capital, a subsidiary of Cannon Commercial, acquired a 248,841-square-foot retail center in Los Angeles for a reported $80 million. The price was a discount of about 28% from the previous sale when Laurus Corp. and Torchlight Investors acquired the property for $111 million in 2015. TTM and Cannon own more than 22.2 million square feet of real estate in the U.S.

In a major transaction in the Aloha State, Watumull Properties Corporation purchased Niumalu Marketplace for a reported $66 million. The 20-acre, 205,000-square-foot retail center is located in Kailua-Kona and is anchored by one of the highest-grossing Safeway stores in the country. According to Pacific Business News, Niumalu Marketplace was developed in 2019-2020 but experienced challenges early on due to the pandemic and government restrictions on tourism.

Hines U.S. Property Partners (HUSPP) bought The Source, a Whole Foods-anchored 262,000-square-foot-retail center in White Plains, New York, for a reported $112 million. Serving as HUSPP's first acquisition in the New York metro area and first grocery-anchored retail property, this firm said the deal represents its confidence in the recovery of the retail sector.

According to CBRE, The Source is currently 99% occupied with five retail tenants and two office occupiers. Retail tenants include the Cheesecake Factory, Dick's Sporting Goods and the NY State Department of Motor Vehicles. Recently, Whole Foods and Dick's renewed their leases for 10 years. The location also serves as the U.S. headquarters of Danone, a French multinational food corporation. In addition to its close proximity to New York City, White Plains has been growing as a residential destination, with more than 7,000 units of housing recently built or under construction.

In late January, Kohan Retail Investment Group paid $71 million to acquire the majority of Town Center at Cobb in Kennesaw, Georgia, according to property records. Kohan specializes in acquisition and turnaround of distressed retail assets. Town Center adds to New York-based Kohan's portfolio of more than 50 shopping malls. Although regional malls are struggling nationally, several malls in the Atlanta area are being reworked to incorporate apartments and mixed-use spaces such as office space and entertainment attractions. Town Center's 1.3 million square feet of space is spread across 92 acres. Deutsche Bank has owned the mall since 2021 when it was returned to the lender after Simon Property Group defaulted on its loan payments.

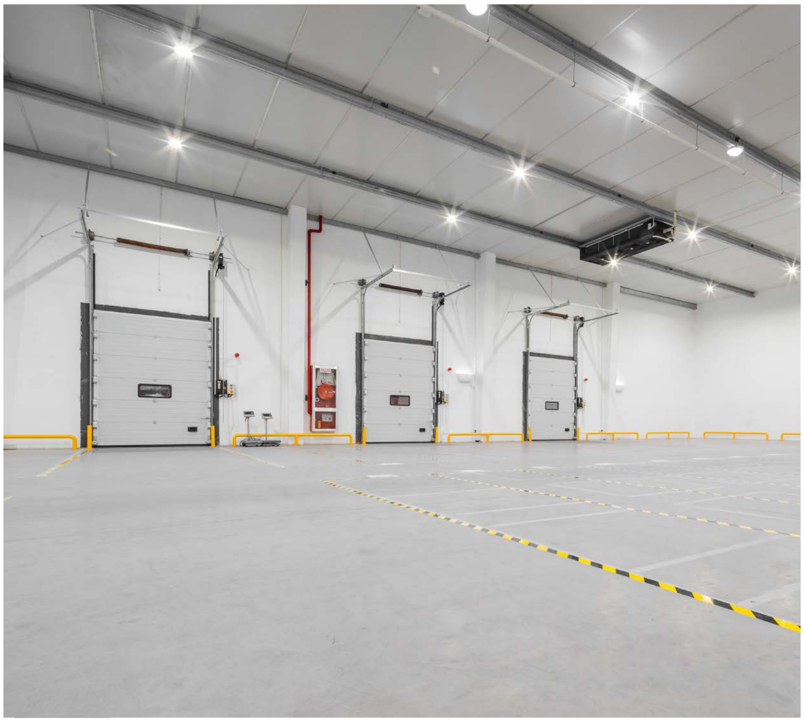
Trends and takeaways

Retail remains less regarded by institutional money than multifamily and industrial, which is unlikely to change for some time. Whereas the multifamily and industrial sectors have deep fundamental tailwinds to provide some sense of certainty, retail has been defined recently by uncertainty and evolution. It is not surprising that the most active retail segments have been grocery-anchored assets and single-tenant NNN, which are on the "safe" side of retail investing.

While the dynamic retail environment may not be enticing the scope and scale of investment these other sectors have received, the retail segment has proven to be incredibly resilient and adaptive. Malls have sought creative redevelopment or adaptive reuse to rejuvenate and make themselves relevant. Traditional department stores and other brick-and-mortar retailers have launched concepts that mix online and brick-and-mortar elements in a way that is proving to be highly appealing to consumers. The dynamism and creativity of retail operators and owners will likely continue to aid the sector as it navigates the uncertain economic environment. However, it's clear there is compelling demand for retail real estate now and into the future, even if the size, shape and tenancy is a little different than it was even a few years ago.

SECTION 4

Industrial



The industrial real estate sector continues to glide on low vacancies and an overall positive outlook while remaining a solid investment position for many real estate owners. Regardless, certain headwinds have begun to emerge over the past six months as vacancies nationwide have crept slowly upward and cap rate compression in the sector has generally ceased, with most markets essentially flat through the first quarter of 2023. Rent growth began to decelerate around the third quarter of last year and hasn't stopped declining, while still boasting elevated levels nationwide at an average of around 10%. These trends are likely driven by a number of factors, including record-high deliveries coupled with steadily decreasing absorption in the sector as overall market sentiment remains tepid amid a looming recession.

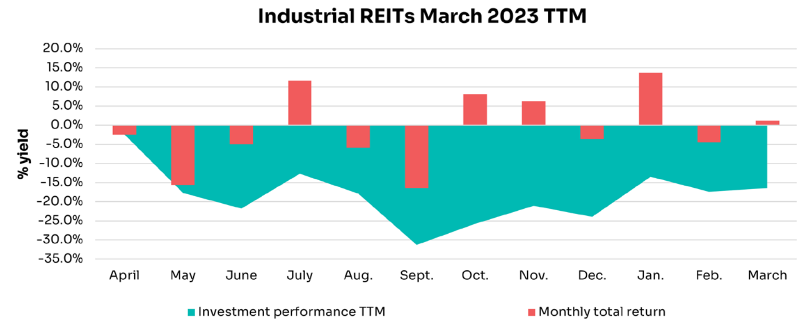
We also note these trends are not limited to tertiary or secondary markets, as even the red-hot Inland Empire witnessed a relatively steep increase in vacancy rates in the first quarter and a recent turnaround in market rent growth trends. This news should be taken with a grain of salt, as vacancy in Inland Empire still sits below 3% and market rent growth has only tempered by a few percentage points from the high rent growth watermark of nearly 20% in mid-2022. This trend may be, in part, a byproduct of prolonged negotiations in 2022 between the Pacific Maritime Association and the International Longshore and Warehouse Union, which elicited worries of a port shutdown along the West Coast and resulted in a drop of almost 25% in transpacific cargo entering the U.S. through West Coast ports.

While nationwide industrial cap rates are fairly flat over the previous year, it is likely more accurate to note a bifurcation between two types of industrial assets with diverging cap rate trends. Historically, a new industrial property with a 10-year lease term to a credit tenant would typically sell at a lower cap rate than the same property with a remaining lease term of one or two years given the lease-up risk perceived by potential investors. However, in the post-pandemic world of high rental growth rates and increased demand for industrial properties, those with shorter weighted average lease terms, or “WALTs,” tend to be viewed by investors as having more upside/less risk than properties with longer WALTs.

This phenomenon is logical given that the owner of a property with a shorter WALT can capitalize on elevated market rents in the near term as tenant leases expire, with leasing spreads – the difference between the rate for a new lease and the prior rate for the same space – often reaching 10% to 20%. Furthermore, properties with long WALTs tend to be locked into contractual growth rates which are typically less than market rent growth. Therefore, the nationwide static industrial cap rate trend is more likely the result of offsetting cap rate compression for high-quality, short-WALT properties and expansion for lower-quality, long-WALT properties.

REIT Performance

After gaining more than 13% in January, industrial REIT returns cooled in February and March, posting negative 4.5% and 1.2% yields in the latter portion of the first quarter, ending the quarter up approximately 10% and down annually about 14% since April 2022. Regardless, industrial posted one of the highest overall REIT returns by sector in the first quarter, second only to self-storage.



Sources: Nareit

The industrial upside

Despite macroeconomic headwinds and a softening of fundamentals, the industrial sector retains an overall positive outlook and appears to be shifting toward stabilization rather than signaling reasons for concern. In March, Ermengarde Jabir, senior economist at Moody's Analytics, said, "Industrial properties remain healthy from a capital-markets perspective, as Moody's Analytics data found that the share of all industrial property loans that are at least 60 days delinquent is at a 14-year low of 0.51% as of November 2022." This confidence persists in spurring investment in the sector as a relatively lower-risk option compared to other traditional investment sectors such as office and retail.

While logistics facilities and mega-warehouses tend to make headlines as major industrial players such as Amazon and Prologis carry on shuffling their portfolios, some shrewd investors are shifting attention to manufacturing facilities for their high cap rates and reliable tenant base. According to Rob Gemerchak, vice president of investment sales at Northmarq, manufacturers tend to be "stickier" tenants given the higher hurdles to relocation associated with the time, expense and production challenges involved in a relocation. "The regional workforce that supplies the tenant's operation is an important variable that investors consider," Gemerchak said. "As onshoring and reshoring of the manufacturing base continue, industrial properties located in strong regional labor markets will continue to be considered very attractive as a long-term investment."

Of note in the manufacturing sector are electric vehicle and electric vehicle battery manufacturers, which require both a local, skilled workforce as well as large, accessible locations for their production facilities. They further need accessibility to supplemental manufacturers and suppliers such as semiconductors which is a key component in electric vehicles. Government assistance has also spurred investment into these facilities with manufacturers taking advantage of the more than $400 billion in clean energy incentives being rolled out by the Biden administration. These facilities will keep driving industrial demand, as business intelligence firm GlobalData forecasts that the 66 electric vehicle plants in existence in 2020 will expand to 155 plants by 2030.

Industrial transaction in 2023's first quarter

Industrial transaction volume in the first quarter slightly dipped over the previous quarter. While the year started out with several high-dollar transactions, these high-profile sales began to level out as the quarter progressed. Below is an array of notable industrial transactions this quarter.

BUYER	SELLER	CLOSE DATE	PROPERTIES	PRICE ($M)
BentallGreenOak (US)	Loctek	Jan. 2023	1	$120.00
Brookfield Asset Management	Shopoff Realty Investments and Artemis Real Estate Partners	Jan. 2023	1	$329.00
LaSalle Investment Management	Ares Management Real Estate	Jan. 2023	1	$109.00
National Resilience	AstraZeneca	Jan. 2023	1	$212.00
Rexford Industrial Realty	Tireco Inc.	Jan. 2023	1	$365.00
Lincoln Property Company	Salkovitz Family Trust	Feb. 2023	1	$105.00
Pell Development	Scannell Properties	Feb. 2023	1	$115.20
Amazon	Owens Corning	March 2023	1	$237.80
Reyes Holdings	Ares Management	March 2023	1	$140.00

Source: Press releases, SEC filings and published articles

Notable transaction activity

In the first of several high-profile transactions in Inland Empire, Rexford Industrial Realty announced the purchase of a 1.1 million-square-foot industrial site in Fontana, California, from its current occupant, Tireco. According to the announcement, the firm paid $365 million, or about $331 per square foot. The property is located south of Interstate 10 and is surrounded by various industrial buildings, with occupants such as Amazon and CJ Logistics. The deal is in step with Rexford's 2022 track record. In its earnings report, it noted acquisitions of 61 properties totaling more than $2.4 billion.

Shopoff Realty Investments and Artemis Real Estate Partners sold their I-10 Logistics Center project to a Brookfield Asset Management real estate fund for a reported $330 million. The 1.8 million-square-foot logistics center is located in the Inland Empire East and was completed in December 2022. The I-10 Logistics Center (also known as "Cherry Valley Logistics Center") includes two high cube, LEED Silver certified logistics/warehouse buildings.

Loctek, a Chinese-based office furniture manufacturer, recently sold its Inland Empire warehouse for a 170% premium over the $44.4 million it paid in September 2020. An entity managed by BentallGreenOak and its Institutional Logistics Partners spent $120 million to acquire the 361,346-square-foot facility in Riverside, California. The deal adds to BentallGreenOak's portfolio which included $83 billion in assets under management as of December 2022 and more than 64 million square feet of assets under administration.

The former Owens Corning insulation factory in Santa Clara was sold to Amazon in the first quarter for $237.8 million, which would equate to about $5.7 million per acre for the 41.4-acre site. There is speculation, according to the Silicon Valley Business Journal, that there may be plans to redevelop the site into a data center/warehouse development.

Inland Empire made news this past quarter again with the sale of a property type not typically seen on this list. The Auto Club Speedway (ACS) in Southern California held its final NASCAR race recently after the 364-acre racetrack was purchased by Ross Perot Jr.'s Hillwood Development and CBRE Investment Management. The firms paid a reported $559 million to purchase the site from NASCAR, which was represented by Corion Properties. Corion founder and CEO Fred Cordova said in a statement, "The ACS logistics 'unicorn' site and perhaps the best site of its size in the entire United States." CBRE's Mary Lang, portfolio manager, added, "The availability rate for Class A buildings larger than 500,000 square feet in the entire Inland Empire is 0 percent," and that the acquisition will allow the new owners "to provide brand new product in the most undersupplied size segment within this high-growth infill market."

Moving away from Southern California and into the Midwest, AstraZeneca sold its 580,000-square-foot West Chester Township site to National Resilience Inc. for $212 million. National Resilience is a technology-focused biomanufacturing company. The sale is reported to be part of a new long-term partnership between AstraZeneca and Resilience, in which the property will be used to manufacture select AstraZeneca medications, with operations including pre-filled syringe filling, device assembly and packaging operations.

Trends and takeaways

The industrial sector continues to generate enthusiasm among commercial real estate investors for its low vacancies, high rent growth and perceived safety in the midst of macroeconomic headwinds as a national recession looms. The insatiable demand for warehouse and logistics space has begun to show signs of softening toward normalized levels as the industrial construction boom, driven by e-commerce growth and elevated demand for consumer goods, should bring more square footage to market over the coming 12 months as supply chain bottlenecks ease and construction costs moderate. Savvy industrial investors are more heavily considering tenant quality and asset WALTs to capitalize on market rent growth, while manufacturing and other niche sectors such as outdoor storage for last-mile delivery vehicles will continue to drive investment in the sector.

SECTION 5

Capital Markets

REIT performance and activity

REIT equity performance varied across sectors in the first quarter with industrial functioning substantially better than other sectors. Unsurprisingly, the office sector performed the worst behind headlines of owners handing over the keys of office properties to their lenders and enduring low office utilization. All sectors other than industrial were down in March with large declines in office, retail and mortgage pushing those sectors negative for the year.

REIT SECTOR	NUMBER OF REITS	MARCH 2023 RETURN	YTD TOTAL RETURN	2022 TOTAL RETURN	2021 TOTAL RETURN
Office	19	-15.32%	-15.86%	-37.62%	22.00%
Industrial	12	1.19%	9.92%	-28.58%	62.03%
Retail	32	-3.46%	-1.47%	-13.29%	51.91%
Multifamily	19	-3.31%	2.04%	-31.34%	58.29%
Hospitality	14	-4.24%	2.99%	-15.31%	18.22%
Mortgage	33	-8.52%	-2.81%	-26.61%	15.64%

Source: FTSE™, Nareit, as of March 31, 2023

Blackstone followed up its $4 billion capital raise with the University of California in early January with another large infusion of dry powder of $30.4 billion, representing the largest real estate drawdown fund raised in U.S. history. This demonstrates a solid foundation behind the sentiments conveyed by Nadeem Meghji, Blackstone's head of Americas real estate, who said in a late January shareholder meeting that Blackstone would have the liquidity to both meet the influx of investor withdrawals as well as pursue new acquisitions. With elevated borrowing rates, an influx of equity capital gives Blackstone an advantage over many investors. At the same time, Blackstone has been limiting investor withdrawals, a practice that other major nontraded REITs such as Starwood and KKR's KREST fund have also adopted.

The first quarter was yet another quarter of no significant REIT merger activity consistent with the negative capital markets environment and languid transaction markets. There were still a handful of notable transactions announced in or shortly after the end of the quarter:

- On March 6, Realty Income announced a 415-property, $1.5-billion sale leaseback transaction; 80% of the properties were Cumberland Farms convenience stores. The acquisition is expected to represent a 6.9% capitalization rate.
- Lessen, a property services platform provider, acquired SMS Assist, a provider of cloud-based facilities maintenance software, for $950 million. As labor challenges persist, property technology and real estate software firms continue to perform well and draw investor interest.
- In March, Blackstone announced it would pay $4.6 billion for Cvent, the meetings, events and hospitality platform. The Cvent platform provides a network for event spaces, hotels and other venues, and the acquisition represents a vote of confidence in live events. According to a March 16 GlobeSt article, hotel demand is anticipated to surpass pre-pandemic levels in 2023.

- Brookfield sold the Diplomat Beach Resort in Hollywood, Florida, to a joint venture managed by affiliates of Trinity Real Estate Investments for $835 million. The Diplomat is a 1,000-room resort hotel operated under Hilton. According to JLL, this represents the third-largest single-asset hotel sale in U.S. history. The sale highlights the strong continued investor interest in South Florida spanning multiple asset classes.
- Just after the first quarter ended on April 3, Extra Space announced a deal to buy Life Storage for $12.7 billion in a massive self-storage merger. This comes on the tail of Life Storage turning down Public Storage's $11 billion offer in February. The merger will create the largest self-storage operator by store count in the U.S., according to Reuters.

The protracted challenging debt environment has seriously hampered transaction activity, which is evident in the major transactions noted above which are primarily equity deals and a sale leaseback. Cash is definitely king in the current environment.

Debt and equity markets

Newly announced funds remained relatively subdued similar to the last quarter. However, dry powder continues to accumulate including some record-setting dedicated funds expressing confidence in multifamily and self-storage.

PARTIES	AMOUNT RAISED ($M)	TARGETS
Bridge Investment Group	$2,260.00	Multifamily
Burton Katzman – DRA Advisors	$240.00	Industrial
Covenant Capital Group	$2,000.00	Multifamily
Greenpoint Partners	$500.00	Industrial outdoor storage
Harbor Group International	$1,600.00	Multifamily debt
Haven Capital	$20.00	Manufactured housing
Mesa West Capital	$1,370.00	Value-add
Mill Creek – 3 platforms	$1,200.00	Single-family, multifamily and value-add
Prime Group Holdings	$2,500.00	Self-storage

Source: Press releases, SEC filings and published articles

Despite slower fund raising, the amount of equity capital available for deals is high. The challenging environment has led to a prolonged decline in institutional transaction markets despite the quantity of available equity. A widened bid-ask spread is part of this, but with inflation showing signs of moderating, absent distress, there are not a lot of compelling reasons to transact. From a buyer's perspective, if sellers are not willing to make price concessions, waiting for improved borrowing rates will increase returns on potential deals. Sellers, on the other hand, likely do not feel compelled to concede on price when properties are fundamentally strong. Distress could lead to more deals as properties approach refinancing if rates stay elevated. But unless a liquidity event is imminent, holding on to assets is still more desirable than selling at a discount. Office is the one sector that is beginning to realize more fundamental distress; nonetheless, buyer pools for these assets appear to be limited as more owners are seeking to "turn over the keys" of assets to their lenders.

Bank failures and debt distress

The failures of Silicon Valley Bank and Signature Bank were somewhat alarming, but ultimately did not seem to rattle markets too much. They highlighted the risk a rapid change in interest rates represents to those with undiversified positions. Silicon Valley had considerable exposure to long-term bonds while Signature had a large concentration of loans in New York City real estate assets. The emergency takeover of Credit Suisse by UBS Group affected commercial real estate with parties such as PIMCO and BlackRock holding significant amounts of the $17 billion in bonds written off in the transaction, according to GlobeSt. In March, 11 banks collaborated on a deal to save First Republic Bank from insolvency with a $30 billion rescue deposit.

Signature's failure will likely take some time to unwind in relation to the impact on commercial real estate. Despite these clear signs of distress in the banking sector, debt capital markets issues for real estate are likely to play out over a longer term. Expect to see increasing distress with looming refinancings approaching, interest rate hedges expiring and interest rates remaining elevated relative to recent historical levels and above cap rates for many assets.

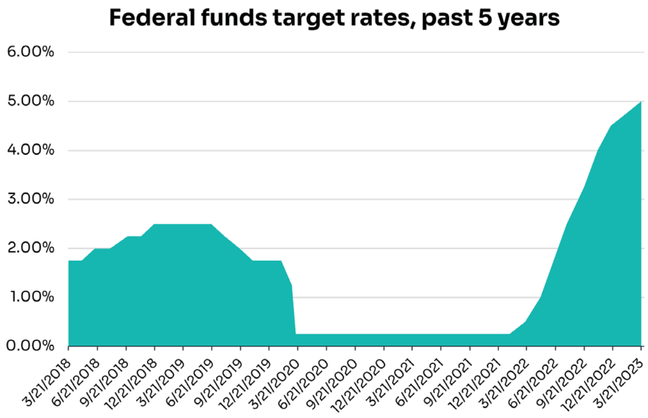
According to a CRED iQ report, 34 out of 50 major U.S. MSAs exhibited higher levels of distress in commercial real estate debt on a month-over-month basis. The report mentioned office as a driving factor of distress, which is not surprising, but evidence of distress was not limited to office and large players were not immune. Vornado Realty Trust disclosed a $600 million write-down to its portfolio with a $480 million impairment related to the company's stake in a portfolio of mixed-use assets in Manhattan. Blackstone stopped making payments on a $325 million loan related to its Hughes Center office complex in Las Vegas. According to GlobeSt, the asset was placed under special servicing with KeyBank National Association on March 2. Brookfield defaulted on loans for two Los Angeles office properties which were coming up for refinancing. A Financial Post article reported that the two properties represented $465 million in debt.

While we noted that distress is not limited to office, it's certainly the primary driver as the sector faces broad fundamental challenges in the wake of the pandemic. A Commercial Edge report found that in the next three years, 9,500 buildings representing approximately 17% of national office stock will be up for refinancing. In addition to the defaults mentioned previously, the report disclosed that Columbia Property Trust defaulted on $1.7 billion in loans related to seven buildings, and RXR was contemplating handing over the keys on at least two assets in New York. If these trends linger, which is likely, barring an unexpected and remarkable improvement in office leasing activity, the level of defaults on office-related debt will be substantial.

Federal Reserve and treasurys

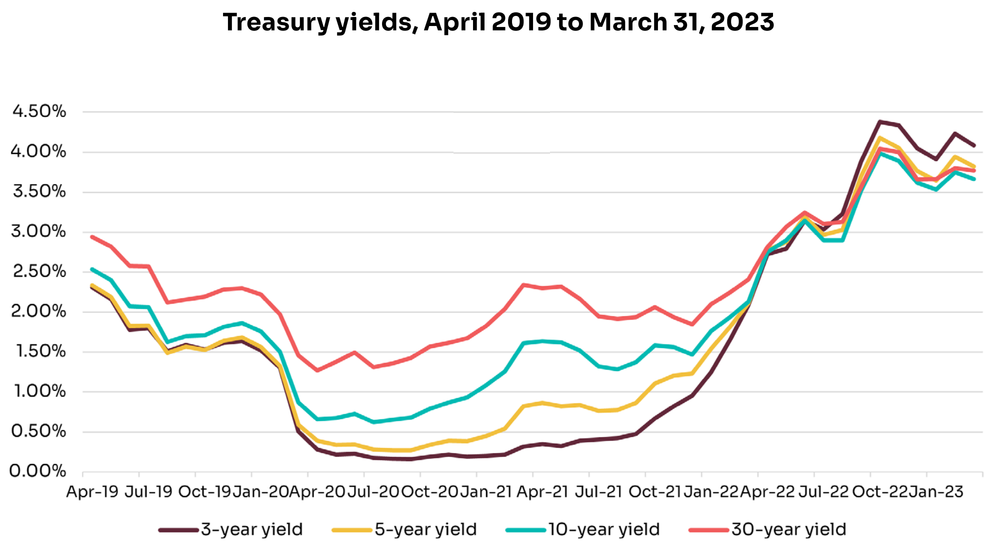
The Fed stayed its course to decelerate rate hikes, with two increases of 25 basis points each in the quarter.

In both its February and March Federal Open Market Committee statements, the Fed provided little context beyond its fairly muted rate increases. However, the shift was consistent with the Fed's stated goal of reducing inflation back to the long-term target of 2%. With inflation showing signs of moderation and some distress in the banking sector, a more moderate approach was expected. Beyond rate moves, the Fed has also been actively involved in managing the various banking issues and measures to ensure liquidity in the U.S. financial system.



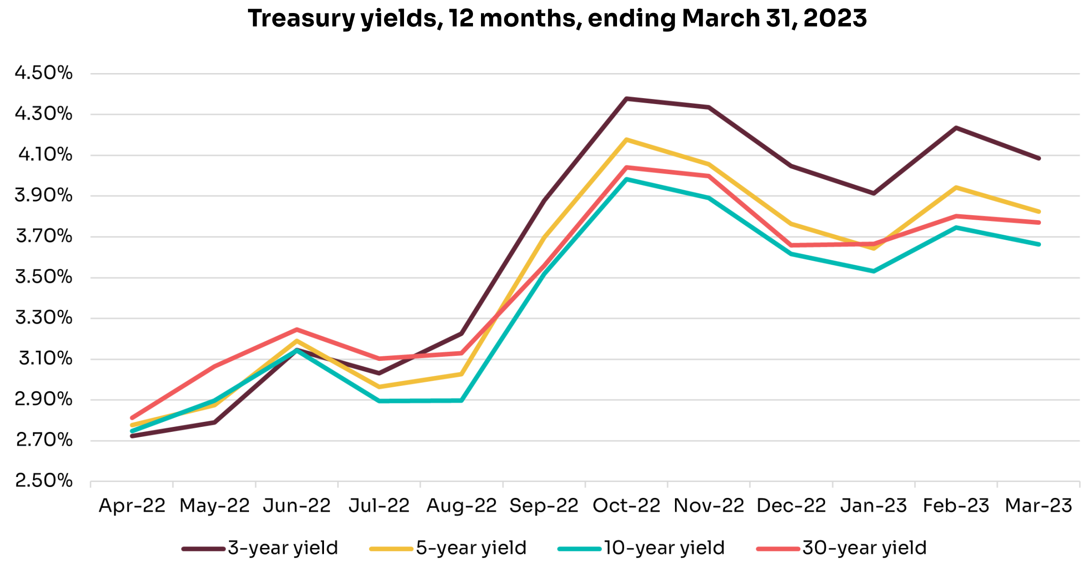
Source: FXStreet

DATE	ACTION	FED FUNDS TARGET RATE
Mar. 17, 2022	+25 bps	0.25% to 0.50%
May 5, 2022	+50 bps	0.75% to 1.00%
June 16, 2022	+75 bps	1.50% to 1.75%
July 27, 2022	+75 bps	2.25% to 2.50%
Sept. 21, 2022	+75 bps	3.00% to 3.25%
Nov. 2, 2022	+75 bps	3.75% to 4.00%
Dec. 14, 2022	+50 bps	4.25% to 4.50%
Feb. 2, 2023	+25 bps	4.50% to 4.75%
March 23, 2023	+25 bps	4.75% to 5.00%



Source: treasury.gov, through March 31, 2023

The yield curve remains inverted with yields starting to trend down in March.



Source: treasury.gov

Conclusion

The anticipated slowdown in transaction activity was realized in the first quarter with both global M&A and real estate activity significantly subdued. As we noted last quarter, there is not likely to be a meaningful increase in activity until market participants gain more confidence. The Fed slowing rate hikes and lowering inflation were good signs, but bank failures and U.S. government funding issues are not confidence-inspiring events. We anticipate the second quarter will continue to be a period of "wait and see" for most investors, punctuated with an uptick in distressed transactions. Long term, the outlook for commercial real estate remains positive and conditions are ripe for a healthy transaction environment on the other side of the current market adjustment.

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ABOUT BAKER TILLY

Baker Tilly US, LLP (Baker Tilly) is a leading advisory CPA firm, providing clients with a genuine coast-to-coast and global advantage in major regions of the U.S. and in many of the world's leading financial centers – New York, London, San Francisco, Los Angeles and Chicago. Baker Tilly is an independent member of Baker Tilly International, a worldwide network of independent accounting and business advisory firms in 145 territories, with 41,000 professionals and a combined worldwide revenue of $4.7 billion.

Real estate valuation and advisory services

Real estate valuation is a complex and disciplined process that requires deep understanding of properties and broader market trends. Our real estate valuation and advisory services professionals work closely in the context of transactions on a regular basis, which allow them to apply holistic, strategic insight encompassing the entire transaction life cycle.

PRE-TRANSACTION SUPPORT

Due diligence

- Financial due diligence
- Tax due diligence and structuring
- CAM reconciliations
- Lease review and abstraction
- Argus and roll diligence

Decision support and analysis

- Fairness opinions
- Solvency opinions
- Rent studies
- Transaction structuring

POST-TRANSACTION SUPPORT

Integration

- Interim management assistance
- Project-based accounting and financial services
- Project management
- Systems implementation

Purchase agreement

- Working capital/closing date balance sheet
- Earn-out calculation support
- Dispute or claims support

Valuation

- Purchase price allocation, impairment analysis
- (ASC 805 and ASC 350)
- Periodic fair value reporting
- Tax matters

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