VIRTUS
REAL ESTATE CAPITAL

U.S. Real Estate

Outlook 2024 & 2023 Year in Review

January 3, 2024

U.S. REAL ESTATE 2024 OUTLOOK AND 2023 YEAR IN REVIEW

As much as we would like to come up with a more creative adjective or euphemism for the present market environment, there is no better word to describe it than "Divergent." You are probably sick of hearing that word from us by now, and we know we are sick of saying it, but 2023 has again continued its divergent trajectory across most asset classes, especially in commercial real estate. The disparity in performance between the winners and losers remains wide, even in the context of having just gone through a Global Pandemic in recent years, with whipsaw performance and widening divergence in the markets near all-time highs. While this downturn parallels in some ways with prior downturns, it is wholly different in many other ways.

There are many reasons for this, not the least of which is this most unusual economic backdrop. Even the Federal Reserve ("Fed") Chairman Jerome Powell was quoted in May this year saying, "It is possible that this time really is different." Further, the pre-pandemic economic playbook has (so far) been wholly irrelevant in a post-pandemic economic backdrop. As a long-time student of economics since my early days at university, I've had to rely on deep breaths and other coping skills to keep me mentally stable in these aberrant surroundings. **However, these conditions have simultaneously created a most exciting framework for investment.** That is because some property sectors and some markets continue to offer compelling property level fundamentals from a supply and demand perspective. Yet, the extreme interest rate increases from 2022 and most of 2023 have amplified credit market volatility to levels not seen in a generation, leaving most Commercial Real Estate ("CRE") assets, including those that are still performing well, with some form of capital structure stress or distress. **This mismatch in positive fundamentals with challenging credit, and hence capital market conditions, has led to a broad reset in values across all of CRE while simultaneously creating far more interesting investment terms for those with the capital and courage to do something about it.**

From our view, and for several of the Virtus targeted property sectors, the present and likely coming market environment has presented and will likely continue to offer some of the most compelling risk-adjusted returns we have seen in years. **Unfortunately, this is not a beta investment opportunity broadly across commercial real estate where one can simply go long and win,** like we saw coming out of the Global Financial Crisis ("GFC") and through most of the 2010s, including the longest bull market ever experienced in the history of the U.S. This is a market where if one chooses wisely, one can take on less risk to achieve the same returns, or the same risk to achieve higher returns (in select spots) since the great investing opportunity period following the GFC. **But, like most great investment periods of the past, fundraising is typically the hardest when the conditions are less obvious.** Just when you thought you could loosen your seatbelt after the wild ride we have had the last few years, we recommend you make sure it is particularly tight and strap in for 2024.

EXECUTIVE SUMMARY

2023 Highlights and Current Market Conditions

- Despite the Leading Economic Indicator ("LEI") index calling for a recession a record 25 months in a row, concerns about an impending recession, especially a deep recession, were abated; **(Page 4)**

- Tenancy demand at the property level was highly bifurcated, with some sectors experiencing substantial declines (office) and others experiencing very stable (medical office, a.k.a. outpatient facilities) or outsized demand (student housing at "high ROI" universities); **(Page 5)**
- Obtaining debt of any kind for non-stabilized properties or in impaired property sectors became extremely difficult, and even stabilized properties and performing sectors saw maximum available leverage fall from 75% - 80% LTV in early 2022 to 50% - 55% LTV in 2023; **(Page 10)**
- 2023 began a wave of maturing CRE debt coming due that will continue for the coming years, most of which cannot be refinanced at present leverage levels without paying the loans down; **(Page 11)**
- CRE transaction volume across virtually all categories was down ~70% year-over-year; **(Page 13)**
- The Fed Funds rate and, ultimately, the 10-Year Treasury continued their 2022 increases through October 2023, leading to the highest valley to peak since the 1976 -1981 period; **(Page 16)**
- Private Equity Real Estate ("PERE") valuations (as measured by real property transactions and not just funds marks based on NAV) declined the most in a single period seen since the GFC, with "basic food group" sectors experiencing a 200 - 400+ basis point expansion in cap rates (30% - 50%+ decline in values), while more defensive sectors still experienced 100 - 150 basis points of cap rate expansion (20% - 25% decline in values); and **(Page 17)**
- "The Great Tightening" ended in December when the Fed paused their rate hikes and signaled an impending cut in 2024, while the 10-Year Treasury has already fallen ~120 basis points since its peak in October; this seismic shift has set the stage for a big opportunity in 2024. **(Page 23)**

2024 Outlook Highlights

- For the time being, it appears the Fed has engineered a soft landing; while the probability of a recession has fallen below 50%, few are calling for a deep recession, and if one were to come, it might actually be positive for some property sectors; **(Page 18)**
- The Fed Funds rate will begin falling around mid-year, with the Secured Overnight Financing Rate ("SOFR") falling earlier, and the 10-Year Treasury has already found its new stabilized normal in the 3.5% - 4.0% range; **(Page 19)**
- New CRE debt issuance will increase, but remain below its long-term average; **(Page 21)**
- Transaction volume will increase from 2023 levels, especially driven by deals with capital structure stress/distress, but it will be below the hyper-transaction activity of prior years; **(Page 23)**
- "Real" property values and cap rates have found their new stabilized levels heading into 2024; **(Page 23)**
- Fundraising will increase from 2023 but remain below its ten-year average; **(Page 25)**
- 2024 will offer the most compelling real estate market opportunity seen in years, but it will not be a ubiquitous beta opportunity; and **(Page 26)**
- If spots are chosen wisely in this opportune environment, investors can generate asymmetric performance with higher returns at given risk levels. **See our Outlook by property type plus Red/Yellow/Green Chart. (Page 40)**

SO WHAT HAPPENED?
2023 U.S. CRE YEAR IN REVIEW AND CURRENT MARKET CONDITIONS (DECEMBER 2023)

Just when we thought we could not top the wild Pandemic ride of 2020 - 2022 (see Market Outlooks from those years here: 2020, 2021, & 2022), **2023 became a record-setting year for U.S. commercial real estate with the most significant single-year drop in transaction volume, the largest decline in property values, the lowest fundraising levels since the GFC, and arguably one of the most expansive disparities in performance at the property level seen in a generation across the CRE spectrum.** Before we talk about CRE, we have to have an appreciation for the economic backdrop of 2023.

"Incongruent" is the best word to describe the U.S. economy in 2023. Since the Global Pandemic hit and the unprecedented monetary easing that followed, historic economic relationships seem to be wholly irrelevant. Admittedly, every time someone throughout my career has told me, "It's different this time," I either let out a hearty laugh, or I ran, not walked away from the madman espousing such delusion. No doubt, the unprecedented 12-year capital markets bull experienced from 2010 - 2022, much of which was fueled by easy money, certainly caused me to reconsider my deep-seated beliefs about: (1) economic relationships being gospel; (2) capital market cycles having to reverse after their typical five to seven year runs; and (3) reversion to the mean thinking.

Regardless of where you shake out on whether or not Monetarist or Neo-Keynesian laws return, let us give credit where credit is due. Chairman Powell (so far) has architected a soft landing, which most other economists, including yours truly, believed was almost the unattainable white elephant with no real historical context. In fact, if you look at the LEI, we have now broken a record for the longest period that the LEI has been negative, and hence calling, actually screaming, for a recession. Historically, the LEI has been pretty spot-on for predicting a recession, but the recession still has not materialized. As you will see in Figure 1, the longest period the LEI was negative without a recession was the 24 months prior to the GFC. We are now 25 months and counting that the LEI has indicated a recession was impending.

FIGURE 1: U.S. LEADING INDICATORS

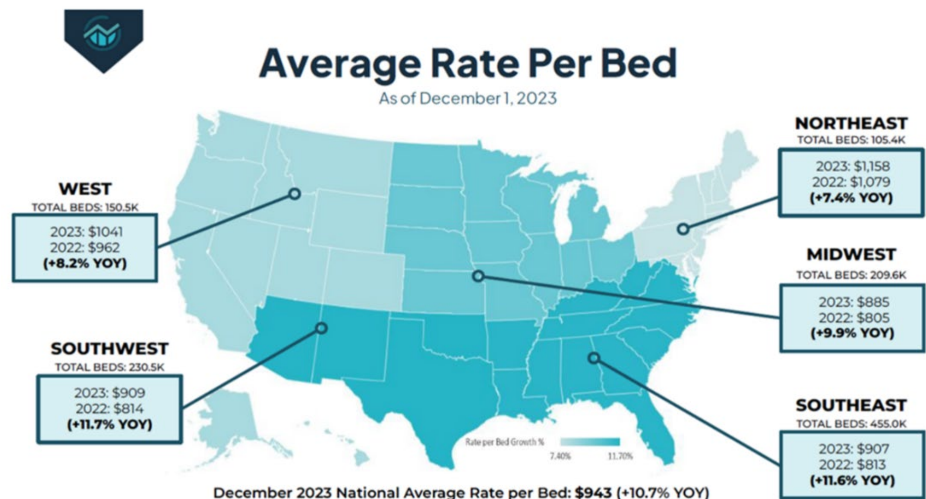
Source: The Conference Board

Despite seven of the 10 indicators in the LEI being very negative, not the least of which being the inverted yield curve, there does not seem to be a recession coming in the near-term. Unemployment in the U.S. (3.7%) is well below the Natural Rate of Unemployment (4.5% - 5%, historically), wages are generally still up, and although the consumer has retreated a bit from the post-COVID-19 spending boom, consumption has remained stronger than expected. Even credit card defaults, typically an indicator of the health of middle and lower-income consumers, have increased since the Biden administration wrote everyone a check, but they are still well below historical averages. Amazingly, the banking crisis that occurred in March 2023, when the second (First Republic), third (Silicon Valley Bank) and fourth (Signature Bank) largest bank failures in nominal dollars in U.S. history occurred, the regulators were able to contain the contagion and prevent it from running through the banking system. At this point, other than another significant Black Swan event upsetting the economic apple cart, a recession is unlikely in the near term. Even for those calling for a recession in 2024, very few believe that it will be a deep recession.

Dispersion in Performance by Property Type and Market

Property level performance as measured by any relevant indicator such as net operating income ("NOI") growth, revenue per available room ("RevPAR"), occupancy, rental rate growth, etc., varied wildly across property sectors. On one hand, sectors like student housing had banner years, benefitting from outsized enrollment growth at select university categories, especially the largest universities in the U.S. At the same time, new construction has been muted since COVID-19 hit in 2020. This author started his CRE career in the student housing sector in 1992. Since I have started my career there has not been a more robust performance year in reviewing occupancy, rental rates, and pre-leasing velocity during those 30+ years (see more detail in the student housing section on page 30). Notice in Figure 2 the increase in the average rate per bed across the U.S.

FIGURE 2: STUDENT HOUSING: AVERAGE RATE PER BED

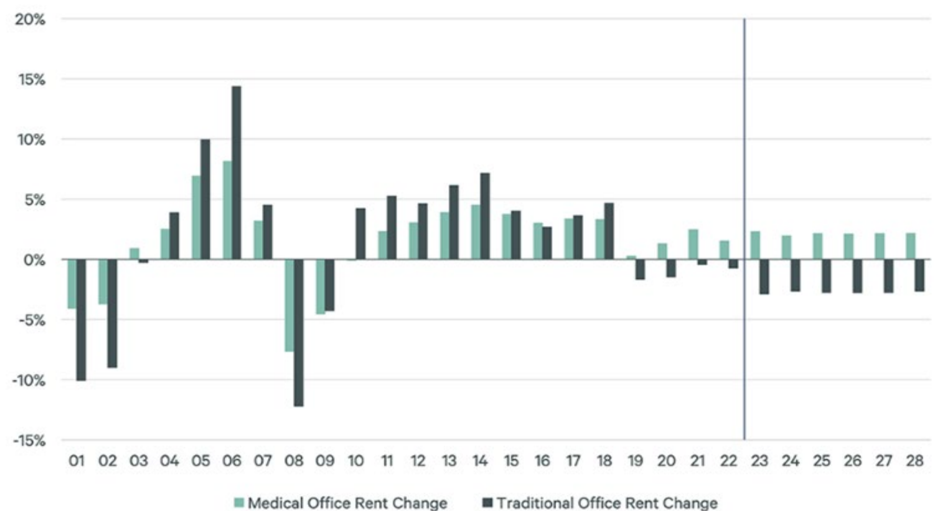


Source: College House Partners, LLC.

On the other end of the spectrum, the office sector experienced its worst downturn, perhaps even compared to the GFC or the Real Estate and Savings and Loan Crisis of the late 1980s and early 1990s. Although most industry professionals knew that office was generally a "dead man walking" well before 2023, reality did not start hitting fund marks or the few property level transaction values until (1) leases started to mature; (2) space began going back to landlords; (3) available subleases in the market exploded; (4) interest rates increased; (5) credit became virtually non-existent, and with it; (6) investor demand evaporated. Graphs and charts will not yet reflect the complete picture of just how decimated the sector is, likely for years to come.

Contrast that to medical office ("MOB"), now often referred to as "outpatient facilities" by the industry, in order to remove the word "office" from the name. In fact, one of our healthcare team's managing directors calls this sector "medical outpatient buildings," still using the MOB moniker without the dreaded "office" word in the phrase. Although less well-known by CRE investors, MOBs have generally been a stalwart of stability within commercial real estate. Although MOB has always been more highly occupied than traditional office, in cycles past, there was some correlation between office and medical office, with office rental rate growth outperforming during extreme bull markets, and MOB outperforming during all other market environments. That historical correlation "has now left the building," pun intended. MOB in 2023 did what it does pretty much all the time and exhibited slow and steady positive performance. Notice the stark contrast in Figure 3 in rental rate change between MOBs and traditional office.

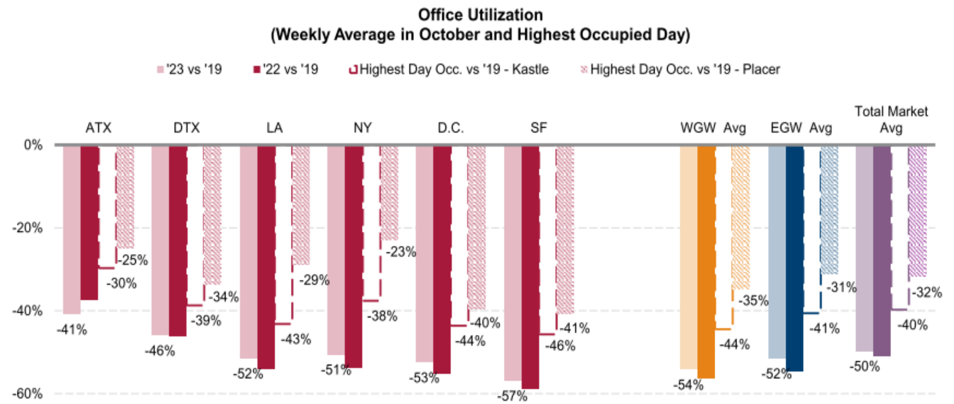
FIGURE 3: THE FUTURE OF MEDICAL OFFICE



This chart does not even begin to tell the full story of how divergent office and MOB performance has become. This does not become clear until one examines effective rental rates, as well as physical and economic occupancies across the two sectors. In terms of effective rental rates, concessions are now playing a huge role in what little leasing is being done in traditional office.

Landlords are doing everything they can to defend "market rental rates" by offering tenants significant free rent, massive tenant improvement ("TI") allowances, buy-outs of existing lease contracts, and other incentives. Because of these factors, it is difficult to truly measure how far effective rental rates have fallen in the office sector, let alone where real occupancies stand. But Figure 4 below provides a sense of where things are going given office utilization:

FIGURE 4: OFFICE UTILIZATION BY MARKET



Source: Kastle, Placer, Green Street

While MOB has historically experienced much higher renewal rates (80%+) because of the more resilient nature of MOB tenants and the high switching costs for changing buildings when compared to traditional office renewal rates (60% - 65%), MOB and office renewal rates have gapped out even further. A stabilized class-A MOB with a synergistic tenancy mix of healthcare providers has an 85%+ renewal rate, while a traditional class-A office building today has likely fallen closer to a 50% renewal rate, especially when tenants who might renew while simultaneously giving back space and reducing their footprint are considered. This has all led to unprecedent increases in office cap rates as measured by Green Street:

FIGURE 5: OFFICE SECTOR CAP RATES

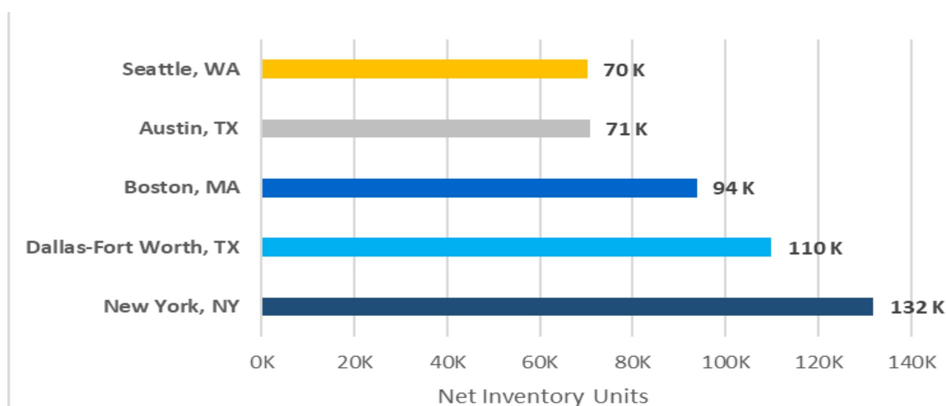
	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22	'23E	'24E	'25E
Office	7.1%	6.6%	6.5%	6.2%	5.6%	5.5%	5.7%	5.8%	5.8%	5.9%	6.4%	6.5%	8.0%	10.6%	11.4%	11.2%

Source: Green Street

Real estate performance by market varied materially in 2023, although with reduced dispersion compared to 2020 - 2022. Sure, some of this variability is still tied to COVID-19 induced migrations, but this went well beyond that or even the Red vs. Blue states (generally, business friendly versus not business friendly), or flight from high-cost areas to more affordable ones.

While multifamily cooled off from its tear over the last several years, performing closer to historical norms in 2023, dispersion in performance by market continued. The highest performing markets of that period cooled, not because of decreasing tenancy demand, but because of hyper amounts of new supply being delivered.

FIGURE 6: FIVE-YEAR TOP FIVE CUMULATIVE INVENTORY GROWTH - MULTIFAMILY



Source: CoStar

Most of the new supply concerns, at least in multifamily, are in the high-growth cities like Nashville, Austin, or Dallas-Fort Worth ("DFW"). But one cannot talk about new supply without also talking about population growth:

FIGURE 7: ANNUAL POPULATION CHANGES AND PREDICTIONS

Year	As of	New York - NY	Boston - MA	Chicago - IL	San Francisco - CA	Los Angeles - CA	Austin - TX	Dallas-Fort Worth - TX	Raleigh - NC	Nashville - TN	Atlanta - GA
2028	2028 Q4	15,229,100	5,097,005	9,328,191	1,613,673	9,787,251	2,702,824	8,667,560	1,590,364	2,209,618	6,675,423
2027	2027 Q4	15,172,510	5,071,414	9,350,074	1,611,694	9,786,531	2,651,952	8,542,869	1,572,002	2,188,460	6,603,295
2026	2026 Q4	15,114,840	5,046,366	9,372,343	1,609,435	9,787,105	2,601,942	8,421,484	1,553,990	2,167,587	6,533,023
2025	2025 Q4	15,041,180	5,020,437	9,392,219	1,602,590	9,788,819	2,553,433	8,307,574	1,536,438	2,147,266	6,465,120
2024	2024 Q4	14,898,110	4,987,622	9,406,640	1,583,295	9,780,248	2,508,660	8,210,436	1,519,906	2,126,095	6,395,296
2023	**2023 Q4**	**14,653,510**	**4,944,955**	**9,416,137**	**1,560,014**	**9,743,460**	**2,470,956**	**8,135,049**	**1,504,506**	**2,102,692**	**6,318,148**
2022	2022 Q4	14,423,910	4,906,236	9,433,047	1,538,188	9,716,550	2,432,902	8,049,619	1,489,243	2,079,477	6,242,197
2021	2021 Q4	14,502,670	4,902,398	9,499,136	1,546,975	9,788,128	2,373,625	7,889,385	1,459,531	2,045,071	6,162,227
2020	2020 Q4	14,750,960	4,923,859	9,580,515	1,612,259	9,947,152	2,314,531	7,764,617	1,426,059	2,025,313	6,113,239
2019	2019 Q4	14,849,020	4,923,573	9,632,926	1,647,443	10,046,150	2,249,557	7,649,444	1,399,999	1,998,500	6,058,860
2018	2018 Q4	14,751,620	4,886,986	9,650,611	1,655,011	10,098,010	2,186,731	7,535,426	1,371,163	1,967,932	5,986,444
2017	2017 Q4	14,651,950	4,849,738	9,663,530	1,654,420	10,132,360	2,133,601	7,420,290	1,343,495	1,935,255	5,912,030
2016	2016 Q4	14,550,990	4,811,999	9,668,343	1,648,405	10,139,830	2,081,137	7,287,348	1,313,957	1,899,184	5,829,766

Source: CoStar

	New York - NY	Boston - MA	Chicago - IL	San Francisco - CA	Los Angeles - CA	Austin - TX	Dallas-Fort Worth - TX	Raleigh - NC	Nashville - TN	Atlanta - GA
Forward 5-YR Population CAGR	0.77%	0.61%	-0.19%	0.68%	0.09%	1.81%	1.28%	1.12%	1.00%	1.11%
Trailing 5-YR Population CAGR	-0.13%	0.24%	-0.49%	-1.18%	-0.71%	2.47%	1.54%	1.87%	1.33%	1.08%

Source: CoStar

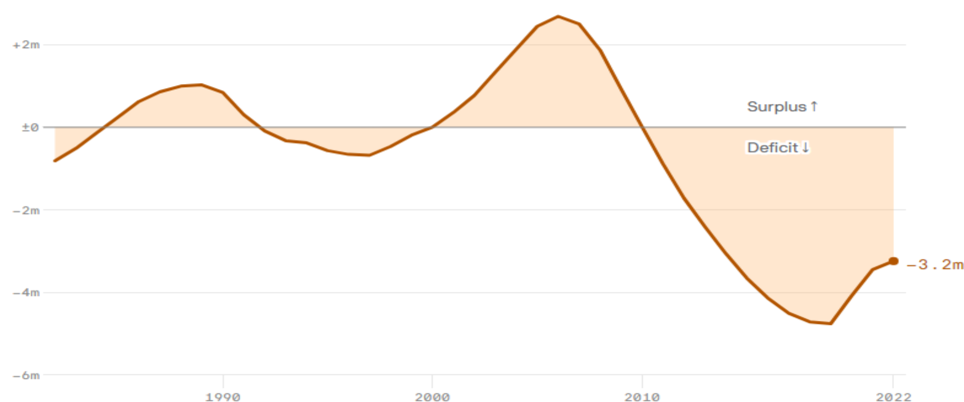
Notice the five-year trailing population compound annual growth rate ("CAGR") and five-year forward population CAGR between the five gateway markets on the left and the high-growth markets on the right. The differential is astounding.

Take a look at DFW's population growth. This is not just transitory or a function of short-term COVID-19 migration. The number of jobs being created in DFW daily is more than most of the gateway markets combined. For example, in just the last few months, Goldman Sachs, Bank of America, and Wells Fargo broke ground on major campuses in the Metro. DFW has now surpassed Chicago and Los Angeles as the second largest financial sector employer with 380,000 workers, only now behind New York. This is just one example of the seismic shift in major employment centers expanding beyond the gateways, and with it a permanent migration of population.

Having owned various cycle-resilient properties in all 10 of the markets listed in Figure 7 through the years, including middle-income workforce housing in four of the high-growth markets, I can tell you that the "overwhelming" multifamily supply in the high-growth markets is differentiated submarket by submarket. In other words, each of those markets have submarkets that are oversupplied, submarkets that are undersupplied, and submarkets that are at neutral supply.

It is also important to recognize that hyper supply is affecting luxury multifamily far more than it is affecting more affordable products like middle-income workforce housing or lower-income subsidized multifamily. As you will see in Figure 8, we are still sorely undersupplied for housing in this country, especially for affordable or attainable housing.

FIGURE 8:



No doubt some of the gateway markets are experiencing a dead cat bounce right now, but the population growth in this country is no longer there, and in most cases, we do not see many changes on the horizon that will reverse that vector. **I'm definitely not saying gateway markets are dead—that would be a fool's errand. All I'm saying is their primacy as a market category was overblown in the first place, and with today's mobile workforce, other market leaders have emerged and will continue to emerge** (see our paper, New Gateways for a New World from December of 2022).

Markets like Austin, DFW, and Nashville will experience temporary pain as they absorb supply over the next 24 months (some more than others), and hopefully Virtus will be there to take advantage of the short-term pain. As you will see in the middle-income workforce housing section on page 27, those markets continue to grow and need more housing, yet deliveries will fall precipitously in 2026 and beyond.

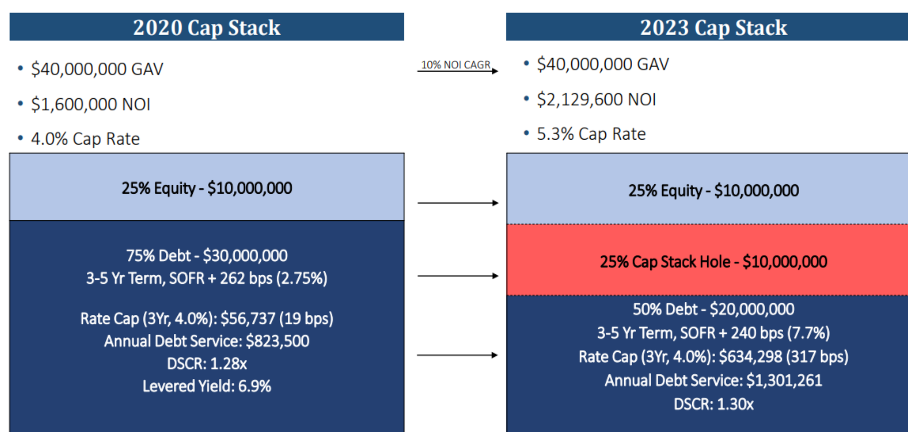
Where Did All the Debt Go?

Credit all but dried up for impaired sectors like office, and even for performing sectors like student housing, MOB, self-storage, and much of industrial and multifamily. In the case of office, of the few deals that went to market, there were often no bidders, and owners were forced to offer up seller notes at below-market terms to entice offers.

Even for performing assets, leverage on new loans for acquisitions or refinancing of existing loans was generally capped at 50% - 55%.

This was entirely due to the rapid increase in interest rates, which at the cap rates most assets were bought in the last several years, caused borrowers to fail to meet required debt service coverage ratio requirements unless leverage was lowered. Here is a live example we shared at our annual investor meeting in September 2023 comparing the same deal with a capital stack in 4Q20 to a capital stack in 3Q23.

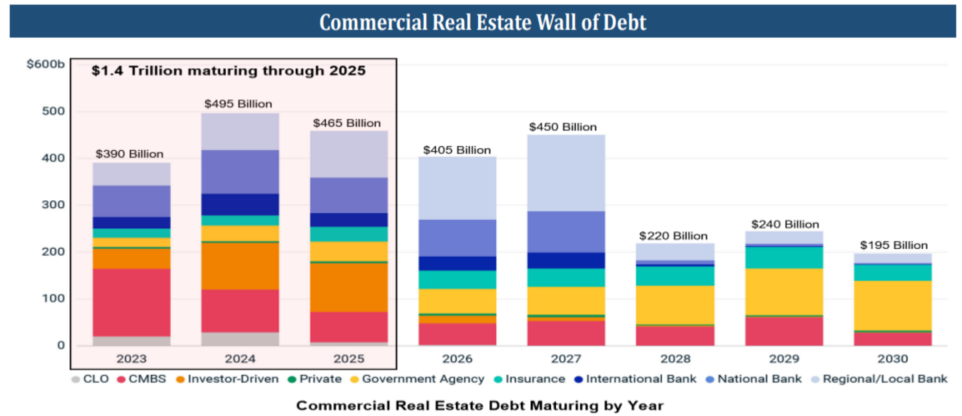
FIGURE 9:



Because cap rates were so low in 4Q20, many borrowers would take on high-leverage floating rate debt on shorter term loans to maximize proceeds and have lower interest rate cap costs, such as a 3 + 1 + 1 term, which means three years of firm term and two one-year extension options if the property meets the lender's debt service coverage ratio requirements, typically 1.25x or greater. The problem is that very few borrowers ever imagined interest rates increasing at the velocity that occurred during the Great Tightening. As such, when the initial three-year term expired, the all-in interest rate was so high that borrowers could not obtain an extension because the annual debt service had increased by over 50%. If borrowers tried to refinance the loan, a new lender would cap the borrower at ~50% leverage based on their debt yield requirements. After increasing NOI by over $500,000, the property value has remained the same because cap rates expanded ~130 basis points in this example (cap rate expansion has arguably been higher), but the biggest problem is the borrower has a $10,000,000 hole in their capital stack.

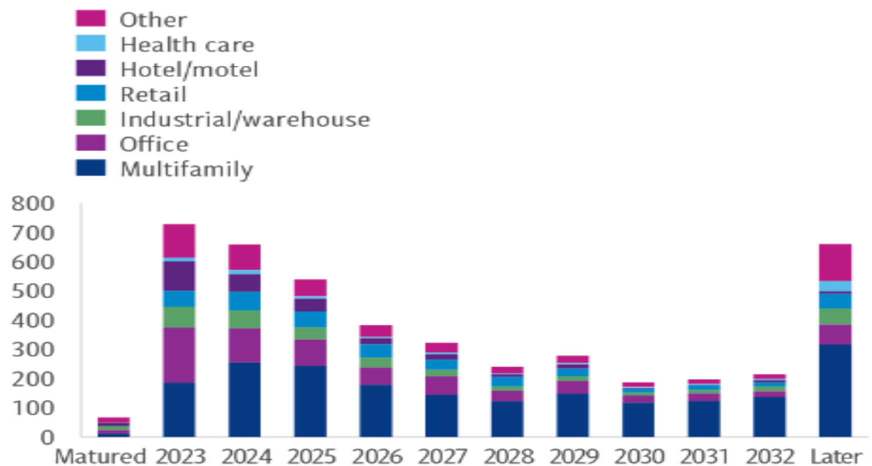
Some borrowers have the cash to fill that hole, but most do not. Bear in mind this is a performing property that was stabilized and had strong NOI growth of 10% CAGR for three years. Imagine what this situation would look like on a property that was not stabilized and performing well. What is concerning is this is not an isolated incident. This is market-wide and is only going to get worse. Notice the "wall of maturities" 2023 - 2027 depicted in Figure 10.

FIGURE 10: "WALL OF DEBT MATURITIES"



The most highly leveraged debt is typically commercial mortgage-backed securities ("CMBS"), debt funds, and Government Agency ("GSE") debt. The shortest-term debt is typically issued by the banks and debt funds. Below is a breakdown by property type from the Mortgage Bankers Association.

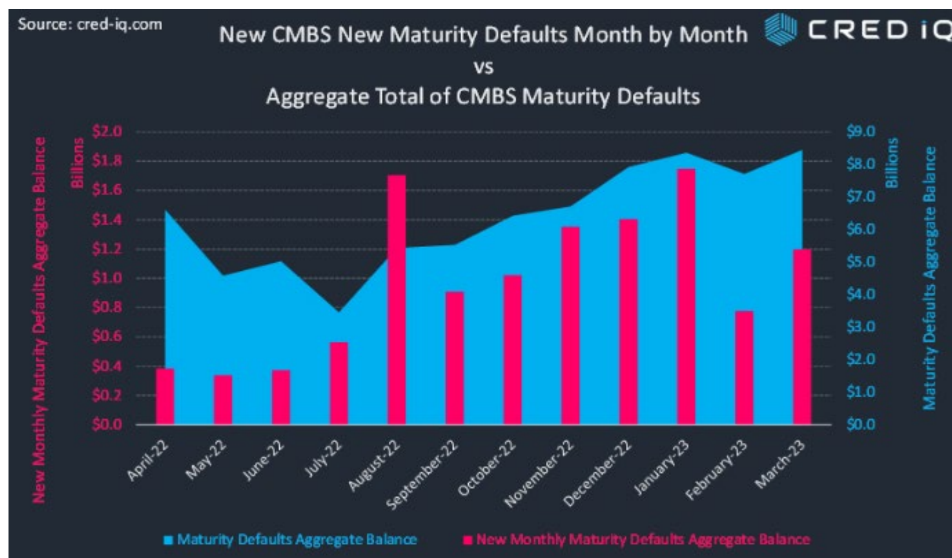
FIGURE 11: DEBT MATURITIES BY PROPERTY TYPE AND LENDER TYPE



Source: Mortgage Bankers Association

Lastly, Figure 12 depicts the scale of the problem within CMBS just from 2Q22 - 1Q23, much of which is collateralized by office properties, which typically make up 30%+ of all CMBS issuance:

FIGURE 12:



These issues are the main reasons why so many lenders went to the sidelines or severely scaled back their new loan issuance in 2023. The reasons are different by lender type:

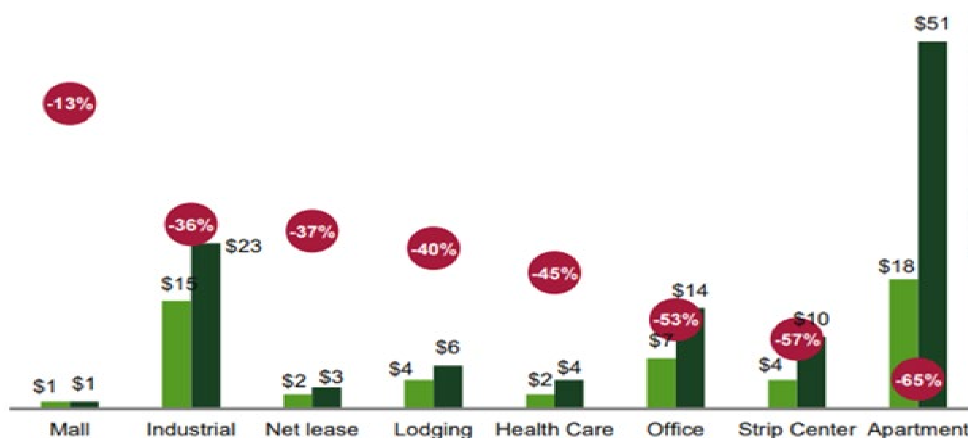
- **Life Insurance Companies:** life insurance companies have always toggled their CRE debt allocations with other fixed income instruments based on where they can achieve the highest yield. As Treasury yields and corporate bonds began increasing, CRE debt became less attractive, on a relative basis.
- **CMBS:** the main factor for CMBS originators is their ability to bundle up and sell their loans at attractive pricing in the syndication market, which became untenable.
- **Banks:** banks are greatly influenced by reserve requirements, which have only become more stringent through the years, especially for construction debt. Banks would historically commit to taking down 100% of a construction note, and then bring in participating banks to lay off some of the risk on larger loans. Given the scale and construction costs of most ground-up projects today, especially residential, most loans have some form of participation by more than one bank. However, after several banks committed to construction loans in 2022 and 2023 for which they could not find participation partners, many pushed back from the table altogether. The few banks who were still willing to lend on the few development deals that penciled made it very clear to borrowers that they would not take participation risk, and if they wanted a loan, the borrower had to setup the participation syndicate, all while bank lending limits were quickly decreasing. As you would imagine, this halted virtually all new construction debt issuance.

For these reasons and others, 2023 saw the sharpest drop in new debt issuance percentage since the year-over-year mark from 1Q08 to 1Q09.

Transaction Volumes Plummeted

It is no surprise then that property transactions fell sharply from their peaks in 2021 and early 2022. Even looking at 3Q23 versus 3Q22, it is a stark contrast, likewise reminding us of the volume declines from 2008 to 2009.

FIGURE 13:



We did our part here at Virtus to buck that trend. Not only were we actively selling properties in 2022 and most of 2023, the vast majority of which were great outcomes, **we put more capital to work in 2023 than we did in all of 2021 or 2022 when the market was pricing everything to perfection. The reason is simple: the entrance pricing and risk-adjusted returns in the performing sectors we have been overweighting were as good as we have seen in years.**

What is fascinating is that, although transaction volume was down across the board, it was the "basic food group" sectors that were down the most. **Several of the more defensive sectors, which many still refer to as "niche" property types, ironically had more relative liquidity than their basic food group counterparts.** For example, selling a MOB in 2023 was far easier than a traditional office building. We know it looks like healthcare was down 45% in Figure 13, but that is because healthcare includes senior living, which made up the majority of that reduction. Historically, that was one of the knocks against niche sectors because they were less liquid due to them being smaller categories with more fragmented ownership. That has changed with more investors wanting to access these defensive sectors, especially on a relative basis during periods of greater volatility.

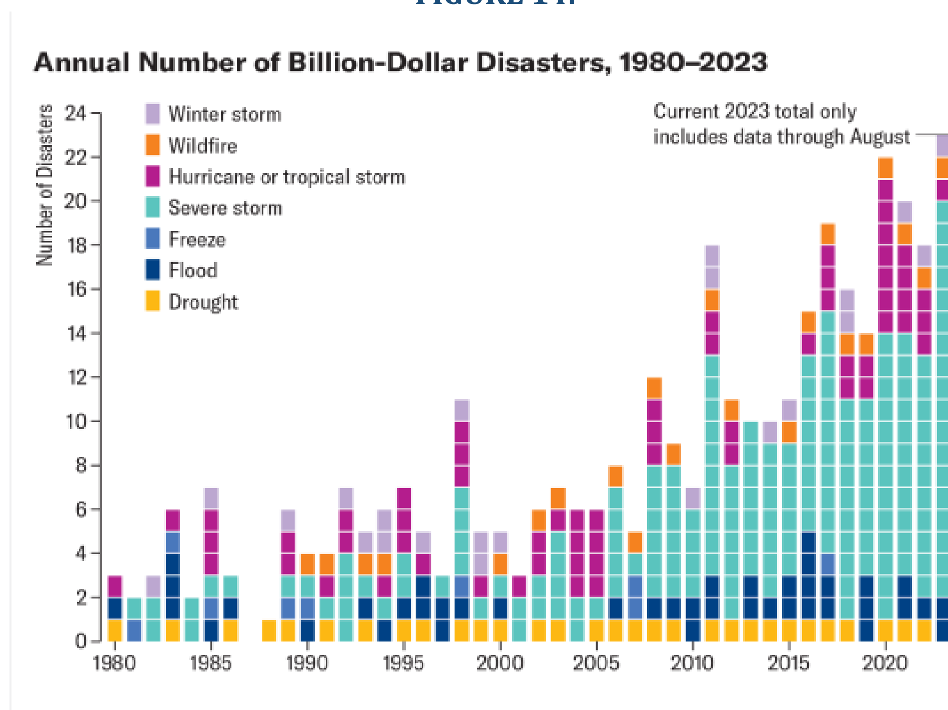
What definitely reversed course in 2023 were portfolio premiums. Large transaction activity was down even more than individual property transactions, ~80% compared to ~70% year-over-year. Historically, the market would often be willing to pay a higher premium for acquiring a portfolio compared to individual properties.

This is because large buyers needed scale, and they appreciated the immediate diversification and risk reduction that came with having a larger diversified portfolio. We have been benefactors of such where we would buy one-off assets at more attractive relative pricing, add-value, grow NOI, and then sell in a portfolio garnering a lower exit cap rate than had we sold individually. This is particularly prevalent in the self-storage industry, where deal sizes are small, or in MOB, where individual properties tend to have more heterogenous characteristics, thus making it harder to scale on a deal-by-deal basis. Historically, you could achieve a 50 basis point cap rate premium, and at really heightened capital market periods, up to 100 basis points of cap rate premium on portfolio exits. For example, in 2022 Blackstone's BREIT purchased the last remaining student housing REIT, American Campus Communities (NYSE: ACC), making a tender offer at 30% above the public share price. At the time this was estimated to be an implied ~4% cap rate or lower, certainly inside of where individual properties would have traded. Admittedly, they were valuing the platform, and it was a good time to go long on the student housing space, but the portfolio premium paid was wide. Those types of transactions were non-existent in 2023. In fact, we saw an opportunity to take one of our early education portfolios, a 21-asset portfolio, and break it up and sell properties individually, because we could get a 50+ basis point lower cap rate selling to smaller buyers. We sold several of those in 2023, with more to come in 2024.

Other Relevant 2023 Forces

While the Consumer Price Index ("CPI") and Personal Consumption Expenditures Price Index ("PCE") both fell dramatically, there was substantial inflation elsewhere. In our previous pieces, we have referenced "experiential inflation," which is the inflation you experience at the grocery store, the gas pump, the restaurant, leisure activities, etc. "Experiential inflation" is not fully captured in the headline inflation rates, whose calculations have been manipulated multiple times since 2000. There are two big areas where there have been hyper-inflation post-COVID-19, especially in the last year. First are luxury goods, where high and ultra-high net worth individuals are willing to pay seemingly double the price for only 10% more experience. **Second, and far more important to CRE more broadly, is the extreme increases in property and casualty insurance ("P&C") premiums.** Historically, P&C was an afterthought in most CRE underwriting. It was a small percentage of operating expenses ,and it was easy to underwrite, especially for those with larger portfolios and scale when negotiating with the insurers. Today, it has become a massive problem. The abundance of extreme weather events and elevated construction and repair costs combined with multiple insurers, and especially re-insurers, pulling back out of the space altogether after massive losses, have left a dearth of availability. This has led to skyrocketing insurance costs, if insurance can be obtained at all in certain higher risk locales. In 2023, there were five extreme weather events in the U.S., each of which caused over $100 B in damage. There is no historical context for anything close to this level. The bar chart in Figure 14 is only through August of 2023, and the record had already been set:

FIGURE 14:



Source: Scientific American

Although there are some improvements to the industry heading into 2024, P&C will be top of mind for all property owners. For more context on this and related factors, see our 2022 paper on the Effects of Climate Change on Real Estate Investments.

Another relevant trend in 2023 was the change in how Environmental, Social, and Governance ("ESG") factors were prioritized by the investor community. For years now, ESG factors have been top of mind for a number of investors, especially institutional investors, with Europe leading the charge. In 2023, we saw a number of investors deprioritize these factors, and in some cases completely reverse their views, especially for certain states, Florida and Texas at the forefront, who created legislation stating that ESG factors could not be considered in an economic relationship with their state. Unfortunately, this has become a divisive topic across jurisdictions. We believe there should be an appropriate balance here. As we and others have proven, considering ESG factors can very much be aligned with prudent financial decisions, and in some cases are highly correlated. We have written about this subject several times, including our paper on Social Impact and ESG Considerations in CRE from almost five years ago.

We are clearly seeing a direct financial impact to P&C costs as referenced above, but it goes way beyond that. **To be clear, financial impact is the priority for how we make decisions at Virtus, and in many cases, we have found that utilizing ESG best practices allows us to be more effective in driving superior financial outcomes.** Aligned with that, in 2023 we became a UNPRI signatory, and we took the necessary steps for one of our primary investment vehicles to meet the requirements of SFDR Article VIII. While we always look to align best practices that optimize financial outcomes, it will be interesting to see where the rest of the industry shakes out on this controversial topic.

At the risk of being obvious or redundant, I would be remiss in not referencing Artificial Intelligence. Since the release of OpenAI's Dall-E 2 and their next-generation chatbot, ChatGPT, at the end of 2022, it has already permeated so much of our lives, including the annoying AI assistant editor that kept trying to automatically edit this paper (I won't admit how long it took me to figure out how to turn that off). In the next generation of ChatGPT and other competitive bots, apparently their ability to deal with numbers is improving, which will have more implications for investments and real estate specifically. I know our data scientists and data analytics team are especially excited about the future of this technology. As these tools expand in capability and scope, their efficacy and use in investments and real estate specifically will increase substantially. **Contrary to what many believe about this replacing humans, just like we once thought Excel would replace armies of analysts decades ago, AI should make us more effective as an industry while requiring the labor force to adapt by adding new skills.**

Where Do We Stand Today?

At this point in time, numerous unique conditions exist as we head into 2024.

- The start of the "big pivot" has occurred in terms of interest rates. After the Great Tightening we experienced from the Fed over the last ~20 months, Chairman Powell and the other governors turned very dovish, and not only paused their rate hikes (steady as she goes at 5.5% for now) before reaching their 2% PCE target, but they also signaled a cut is highly probable in 2024.
- As in past interest rate cycles, the 10-Year Treasury has led the direction Fed Funds will eventually go. After peaking at 5% in late October, the 10-Year yield presently sits at 3.79%. This is very important for CRE heading into 2024. Recall that historically Fed Funds sit at about 140 basis points below the 10-Year Treasury on a long-term basis, but we have obviously been in an inverted yield curve far longer than anyone expected.
- There is much more dry powder on the sidelines than in past downturns; however, much of that dry powder is in the hands of investors who have significant challenges in their portfolios, and they are distracted dealing with those and/or may need to use their capital to defend assets.
- Property fundamentals continue to vary widely.
- Individual market performance likewise varies widely, although that has narrowed in recent months.
- There is a massive wall of debt maturing now through 2024 and beyond.
- Valuations from peak to valley are down 22%, according to Green Street. We think that understates present reality. As we assimilate data from a host of sources, like Green Street, CoStar, RCA, NIC, and others, but more importantly, take note of our own comps database and real transactions happening in the market, we believe real property valuations in basic food groups are down more than that, and ~20% is about right for the more defensive sectors (other than needs-based senior living, which has fallen far more due to the impacts of COVID-19). There are exceptions to these ranges based on a host of factors like market, assumable debt, embedded rate growth, etc., see Figure 15 for comparison for institutional quality stabilized class-A cap rates 4Q21 - 4Q23 (for further notes see full chart):

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FIGURE 15:

Needs-Based Property Sectors Class-A Core Stabilized Cap Rate Comparison		
Property Type	4Q21	4Q23
Medical Office	4.0 - 4.5%	5.25 - 5.75%
Senior Living	N/A	7.0 - 8.0%
Life Sciences	4.75 - 5.25%	5.75 - 6.25%
Self-Storage	4.5 - 5.00%	5.75 - 6.0%
Early Education	5.25 - 5.75%	6.25 - 7.0%
Student Housing	4.0 - 4.75%	5.25 - 5.75%
Middle-Income Workforce Housing	3.75 - 4.25%	5.0 - 5.75%

Source: CoStar

FIGURE 16:

"Basic Food Group" Property Sectors Class-A Core Stabilized Cap Rate Comparison		
Property Type	4Q21	4Q23
Office	4.75 - 5.5%	10.0 - 12.0%
Retail	6.5 - 7.0%	7.0 - 8.0%
Industrial	2.75 - 4.0%	5.5% - 6.0%
Multifamily	3.75 - 4.25%	5.25 - 6.0%

Source: CoStar

- Bid-ask spreads remain wide in some areas, but they have come way in from January to December 2023. There was not the typical rush of year-end property closings those of us in the industry are used to experiencing. It seems most investors and property owners (other than Virtus, who closed two transactions in December 2023) punted until 2024.
- Most of the multifamily sector remains stable in terms of property level performance; however, capital structures of many properties are impaired, as indicated previously. That is simply because borrowers can access higher leverage debt due to the subsidized nature of Fannie May and Freddie Mac, as well as the broader market's view that multifamily is the safest of the basic food group sectors, which is true.
- But of the ~$55 B of debt held by the debt funds that is maturing over the next two years, which is typically shorter term floating rate debt, we estimate that about 25% is completely upside down, 25% is at a 1.0x debt service coverage ratio ("DSCR"), 15% is in technical default below the loan's DSCR requirements but above 1.0x, and 35% is performing. Further, Fannie Mae and Freddie Mac are typically higher leverage lenders (as high as 75% - 80% loan to value), so those maturities occurring now and during 1Q24 will need to be recapitalized, yet leverage availability is still generally only at 50% - 55% loan to value.
- Capital commitments by institutional investors, especially U.S. institutions, were even more anemic in 4Q23 than the rest of the year. Most investors are either asset managing the problem assets in their portfolios, or they took off the month of December and will see you in 2024...maybe. So, of the 1,400+ funds in the market currently, there will be a knife fight for the 40% of capital commitments made in 2024 that do not go to the 10 largest managers if 2020 - 2023 is prescriptive for 2024 in terms of ~60% of limited partner commitments going to the 10 largest fund managers.

2024 U.S. CRE MARKET OUTLOOK

The coming year will likely be one of the most exciting years in U.S. CRE which will be talked about for years to come, and there will probably be a Harvard Business School case study on capital market cycles, Black Swan events, and economic volatility describing the unprecedented 2020 - 2024 period. **The year 2024 will likely start a new bull run in CRE, but it will not be uniform.** Although performance will start aligning more in 2024 than the whipsaw environment of the last several years, the market will remain highly divergent in performance across property sectors, markets, and even submarkets. But before we get to that, we need a baseline view on the economic backdrop.

The Economy in 2024

For now, it appears the Fed has engineered a soft landing without a recession. The LEI and plenty of the pundits are calling for a recession (finally) in 2024. However, only a small percentage of economists are suggesting that a deep recession is likely, short of another massive Black Swan event. Even though the probability of a recession has fallen below 50%, if one were to come in 2024, it would likely be positive for borrowing costs and eventually property valuations as measured by cap rates. Historically, interest rate declines typically lead cap rate declines by three quarters, all things being equal. Obviously, a recession would not be helpful for more cyclical sectors like the basic food groups and hospitality, as tenant demand would be further eroded. If a recession came, it would ironically be a positive for property sectors with resilient tenancy demand, as the Fed (and the market) would likely push interest rates lower, and eventually cap rates with them, while NOI is more likely to hold up in needs-based sectors, such as healthcare, education, and affordable housing. That hypothetical recession would lead to the yield curve finally inverting back to a more normalized curve with shorter term rates, like Fed Funds and SOFR falling quickly potentially below 2%, and other longer-dated interest rates, such as the 10-Year Treasury, remaining in the upper 3% range with pressure to fall lower. As long as the U.S. dollar is the reserve currency, and as long as the global marketplace still views Treasuries as the risk-free instrument (this works when you are the tallest ant in the ant pile), this relationship is inevitable because there will be continued demand for the full faith and credit of the U.S.

Even though Fitch downgraded the U.S.'s Issuer Default Rating ("IDR") in August, and even though there was a failed 30-Year Treasury auction in December, there was barely a blip in the Treasury market, as there remains plenty of buyers for Treasuries at scale.

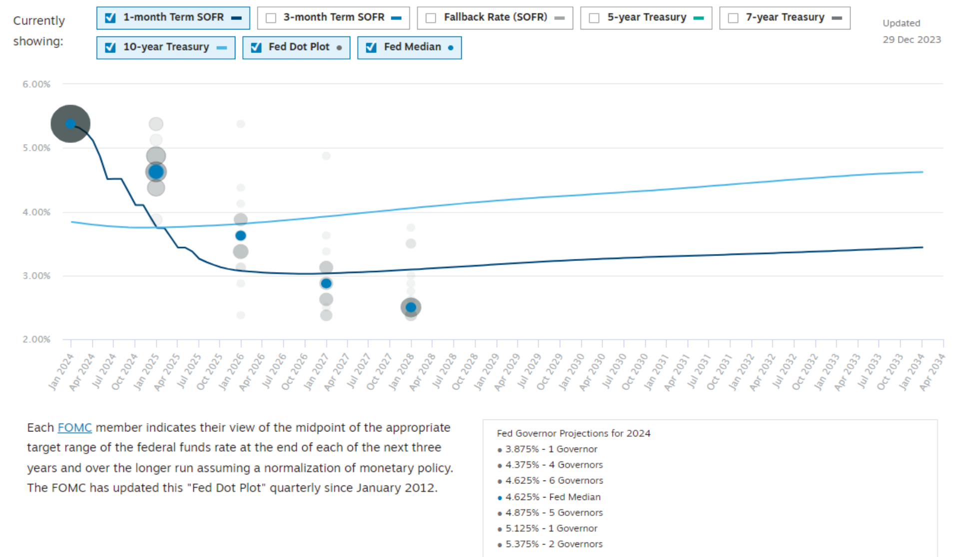
If our baseline is a soft landing without recession in 2024, then our baseline view of interest rates is that the Fed will begin cutting midyear, and SOFR will lead downward ahead of that (as we have already started to see with SOFR sitting ~15 basis points below the Fed Funds rate as of this writing), but the 10-Year Treasury will remain within the current range of 3.5% - 4.0%. Note in the Figure 17 the 1-Month SOFR and 10-Year Treasury curves overlaid with the Fed Dot Plot where the Fed officials are predicting Fed Funds to be at different time frames in the future.

FIGURE 17: TERM SOFR, FALLBACK RATE (SOFR), AND TREASURY FORWARD CURVES, SEPTEMBER

Source: Reuters

For those of you who attended our annual investor meeting in September 2023, we shared our view that we thought the forward curves were wrong (not a big call, since they always are). In particular, we felt both SOFR and the 10-Year curves were sitting higher than where they will shake out, and certainly higher than where Fed officials see interest rates going. In just the three months since that meeting, you'll note above after the FOMC December meeting, both the SOFR and 10-Year curves have moved 50 - 75 basis points lower than they were shortly after the September 2023 meeting , as seen in Figure 18:

FIGURE 18: TERM SOFR, FALLBACK RATE (SOFR), AND TREASURY FORWARD CURVES, DECEMBER



Source: Reuters

Notice how much quicker SOFR is now set to fall in December's curve than just three months ago in September. Ironically, the SOFR curve still does not land in the 2.5% territory at which most Fed officials are saying the Fed Funds rate will stabilize.

Again, we think the forward curve is wrong, and SOFR will eventually align with Fed Funds in the 2.5% - 3.0% range. This will be helpful in 2025 and beyond for borrowers that are still using floating rate debt**. It also means that prices for interest rate caps will continue falling, as they already started to do immediately after the Fed's comments earlier this month. Despite this downward movement, the yield curve will still remain inverted throughout 2024 and not revert to a "normal" curve until 2025.** It is important to note that "higher for longer" in the Fed's view applies to real rates, not nominal rates. So where the PCE is sitting is an important part of the equation for the Fed as they continue their moves.

Inflation as measured by PCE will move lower but likely not all the way to the Fed's 2% target. "Experiential inflation," as referenced on page 14, will remain elevated, but plateau (finally) after the hyper increases we have experienced the last several years. One area of near hyperinflation in years past that has finally reversed course is construction costs. Although construction costs have not expressed much reduction even during past downturns, materials costs and finished goods pricing has finally retreated from the elevated levels of 2021 and 2022. Labor wages have remained stubbornly high, but there has been a light at the end of the tunnel the last couple of quarters as construction pipelines shrink. It seems likely that there will finally be a material reduction in construction labor costs in 2024 due to increasing unemployment along with falling construction activity.

Unemployment will increase in 2024 from 3.7% at the start of the year to landing somewhere around the natural unemployment rate of between 4.5% - 5.0%.

If you have read any of our prior pieces, you know that we are as suspect of the U.S. headline employment numbers as we are of the fallacy that is PCE since it is divorced from inflation reality. We still believe there are throngs of underemployed workers and plenty of people still working at half-time while miraculously getting paid full-time. Much of that also begins reversing course in 2024, and employment will become a hot topic this coming year, especially being an election year. Wage pressure will generally abate but still remain elevated in certain high-demand fields where there is a dearth of qualified workers, such as parts of healthcare, engineering, and technology.

Commercial Real Estate Debt in 2024

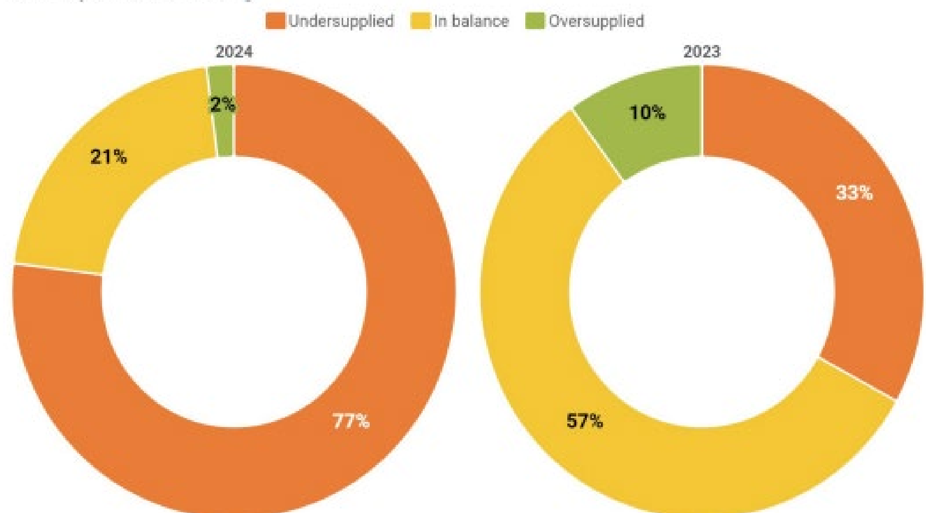
We cannot talk about transaction activity, cap rates, fundraising, or broader market CRE activity without first discussing credit in 2024. Without a doubt, foreclosures by lenders will increase. This is a function of the massive amount of debt maturities that have already come due in 2022 and 2023 and are coming due in 2024 that are out of the money with borrowers unwilling or unable to defend assets. **Lenders have been remarkably patient with borrowers thus far, but as time marches on without a solution, and as reality hits that lower cap rates or lower borrowing costs (interest rates are not falling fast enough) to save most of the upside-down cap stacks, lenders will be forced to foreclose or do workouts.**

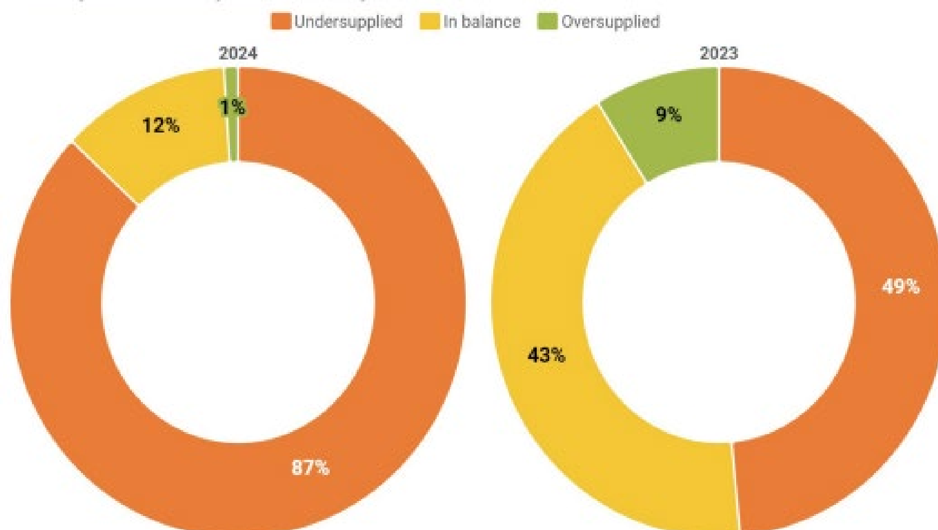
These foreclosures will come primarily from debt funds, the GSEs, CMBS, and banks, with the latter owning most of the construction debt. We are not saying there will be blood in the street on every corner like perhaps the 2009 - 2011 period, because there is far more liquidity today and there have been more lending controls in place for the last decade than there was during the runup prior to the GFC. Also, many lenders do not have the stomach or ability to foreclose at scale. We have not yet found an index that shows the number of asset management personnel at lenders, but it seems clear that lender's asset management and workout teams are probably smaller than they have ever been, certainly relative to the size of their debt books. After a 12-year bull market in CRE, even lenders started "reassessing" their borrower default rate assumptions, and they began deprioritizing resources for dealing with troubled loans. **Many lenders today simply do not have the human resources to deal with the troubled loans in their books at scale.** Technology improvements and automated processing will aid that on the fringes, but human beings are still needed to decide, let alone process, a workout or foreclosure.

What we still cannot answer is what will happen to all the office debt out there. It is such a massive problem with the vast majority of office loans in default, even lower leverage loans, that we do not know whether lenders will push hard to foreclose. It is the old adage that if you have a $10 million debt problem, that is YOUR problem. If you have a $100 million dollar debt problem, let alone a several hundred billion dollar debt problem, that is OUR problem.

Credit availability will begin increasing in 2024 for CRE, but remain below historic lending levels in the aggregate, and loan to value per property. When you consider this in the context of so much maturing debt and such anemic transaction volume in 2023 that leaves significant pent-up demand from borrowers in 2024, **available credit will be even more undersupplied in 2024 than in 2023.**

FIGURE 19:





This means that the majority of available debt will go to sectors that are performing, like infill industrial, workforce housing, student housing, MOB, and possibly other niches, like data centers. Although the GSE's 2024 budgets will be slightly lower, all of it will likely be put to use in 2024, unlike 2023.

It also means that the highest quality borrowers will be rewarded with greater availability of credit. Once again, the old "five Cs of credit" will be prioritized in this environment, with lenders more focused on a borrower's capacity, capital, conditions, collateral, and character. This means subpar borrowers, such as the plethora of small syndicators, real estate sponsors raising high net worth capital from crowdfunding sites or at the local country club, that exploded in the 2017 - 2021 era, and the Johnny-come-lately-players entering new property sectors will be left out in the cold.

Lenders will be cautious with their 2024 allocations. CMBS will remain anemic for new issuance. Banks will struggle in dealing with their existing books. Life insurance companies will increase allocations, as yields in other fixed income instruments fall, but issuance will remain below historical norms. On a relative basis, private credit, primarily from debt funds, will fill part of the void. As mentioned above, private credit reached its highest level of origination in 2023 in terms of percentage, even though nominally it was light in 2023 in the aggregate at 13% of all new debt originated. **We imagine private credit will set another record in 2024 in terms of relative percent of origination** for several reasons: (1) it is one of the few successful CRE strategies in raising capital in 2023, and coffers are relatively full; (2) the opportunistic environment that 2024 presents is ripe for the greater flexibility debt funds can provide; (3) many borrowers will be hungry for the higher leverage debt funds typically provide, even at the higher cost; and (4) the competition from traditional lenders will remain muted, especially for lower quality borrowers or properties.

Property Values and Transaction Volume in 2024

We are sorry to say for many of the readers hoping for cap rates to come down in 2024, that it is unlikely to happen. **Despite falling interest rates, cap rates on real transaction values have now hit a new normal, but the good news is that we believe we have found the bottom of valuations.** Let us not forget that while SOFR increased ~500 basis points and the 10-Year Treasury increased ~450 basis points before recently settling down at 330 basis points above its low point in 2020, cap rates across CRE have only increased on average 225 - 275 basis points. As noted in Figure 15, there are several defensive sectors below this range (MOB, student housing, workforce housing, etc.), and several highly impaired sectors above this range (office, senior living, industrial). There are only two tailwinds supporting lower cap rates: lower interest rates with the Fed's great pivot, and lots of dry powder on the sidelines. Of the myriad of headwinds, here are some to note: (1) massive amount of maturing debt requiring capital infusion leading to capital structure distress; (2) increased operational distress; (3) reduced debt availability; and (4) slowing economy and anticipation of a possible recession on the horizon by some.

While real property transaction values have now stabilized, funds marks, especially those of Open End Diversified Core Equity ("ODCE") funds, will continue falling as NAVs decline toward the reality of property transaction values. Most of the REITs have already rebalanced in terms of pricing, and, as we pointed out previously, their implied cap rates are still generally sitting above that of the ODCE funds. But that gap is narrowing with the recent REIT rally and ODCE continuing to let air out of their elevated marks.

The two major appraisers for ODCE have recently made it quite clear that funds marks must decline, although our CFO recently informed us that those of us who have assumable fixed rate debt on our assets will receive "credit" from the appraisers supporting a higher property value. That is because assumable fixed rate debt not only hedges interest rate risk, but it also hedges cap rate expansion risk, because the buyer places value on assumable fixed rate debt, at lower interest rates than available in the open market today. In our own portfolio, favoring fixed rate debt has been a great asset (finally) throughout the Great Tightening, and a number of the assets we sold over the last 18 months were properties with fixed rate debt assumed by the buyer at below market rates. The cap rates paid were lower than what would have been paid had the new borrower needed to originate new debt at current market terms.

Transaction volumes will increase significantly from the anemic levels of 2023, especially as greater transparency around market pricing becomes obvious and a more stable view on interest rates is assumed by the market. This will be driven first by the myriad of property owners with impaired capital structures, especially those with debt that has matured, who are forced to either sell their property, refinance and bring cash to the closing table, or recapitalize their deal with fresh preferred equity or mezzanine debt.

While it seems evident that the ODCE funds and non-traded REITs ("NTRs") targeting retail investors (BREIT, SREIT, NREIT, etc.) will have to sell assets in 2024 to meet redemption requests, they have been very slow to sell properties so far. It has been surprising as redemption queues continued increasing throughout 2023, yet few of these funds' managers seemed to be in any hurry to sell. The ODCE redemption queues have recently begun coming down, not so much because the funds have been selling properties and providing redemptions to investors, but it seems that some investors may have pulled back their redemption requests realizing that there will not be liquidity for a while. Perhaps they have been listening to the Eagles too much on their final tour this year: "You can check-out any time you like, but you can never leave!" **Either way, there will have to be some sales from these massive funds to either meet redemptions and/or reposition their portfolios away from out-of-favor sectors like office and toward the more desired "beds and sheds" or defensive sectors if they ever hope to fundraise in the future.** Further, institutional limited partners who own many of their assets directly or through separately managed accounts ("SMAs") will likewise be reallocating their capital, thus causing some sales.

Next will be the developers. No doubt available construction debt will remain muted, but there are too many developers with outstanding predevelopment ("predev") costs that need to be recouped. They will be more likely to capitalize a thinner deal at less favorable terms just to recoup their costs and keep their teams employed. We are not referring to the myriad of ground-up deals that make no economic sense due to the combination of elevated construction costs (which are coming down, though not fast enough), higher cap rates, higher borrowing costs, and lower leverage.

Most development deals do not pencil today because the spread between untrended yields on construction costs ("UYOC") using real rental rate assumptions and real stabilized spot cap rates in today's environment is far too low to attract equity capital. Many of these developers are going to struggle, where they let go of land contracts and have to flush a lot of predev capital and effort. We have already seen several established development shops lay off personnel, and in some cases, shut their doors. **However, there are some ground-up deals with good real estate, and even though the UYOC to spot cap spread is thin, the developer may be willing to accept investment terms, such as preferred equity, reduced or deferred development fees, or more favorable waterfalls to the equity to get the deal done.**

This will especially be the case for developers who took down land. At this point, most developers are running out of time, and they will need to do something with their development deals, or risk losing them.

In summary, transaction volumes will increase but remain below the 10-year average, and cap rates have now stabilized around present levels. We believe we have reached the peak in cap rates and the bottom of values on real transaction values, but not fund marks yet.

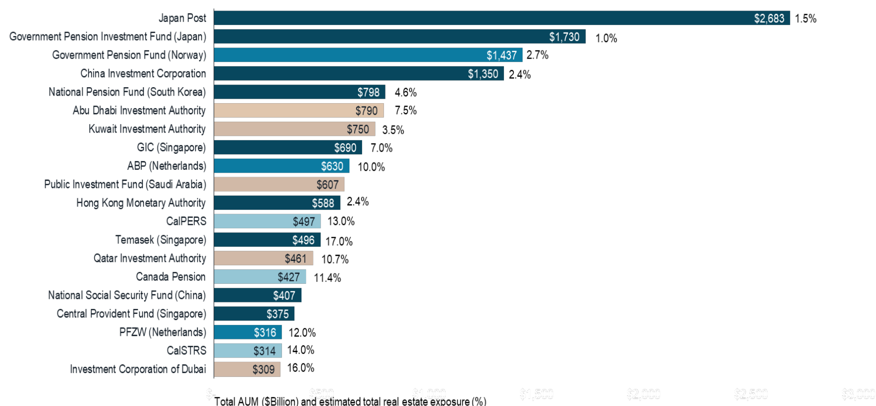
CRE Fundraising in 2024

Similar to transaction volumes, **fundraising will rebound from the basement levels of 2023 but will still be below the 10-year average.** This will especially be the case for U.S. institutions. While the denominator effect is improving after the recent market rally combined with falling PERE funds marks, 2024 pacing plans will likely still be at reduced levels. Having said that, many of the real estate professionals with whom we engage at institutional investment shops (pensions, endowments, foundations, sovereign wealth funds, insurance companies, etc.) want to put more capital to work. **They want to put capital in the hands of the PERE funds managers who can take advantage of the present and coming distressed environment as previously described.** However, their hands are often tied at precisely the wrong time.

The multifamily offices, family office groups, and wealth managers will reengage on real estate in 2024 but will still be slow to deploy capital. Behavioral finance, a.k.a. emotion, still influences much of the decision making of their underlying clients. Even though volatile markets typically provide the best investing opportunities, especially in private markets, because the market environment does not "feel good," these investors have a tendency to pause. That is why high net worth investors often pile in during euphoric times, but go to the sidelines during volatile markets, which of course often leads to the perennial sin of buying high and selling low. We are fortunate that a number of our family office and wealth management relationships tend toward the sophisticated side and have experienced investment teams who know better.

Fundraising from offshore investors in U.S. CRE will increase in 2024. There are tactical reasons for many of these investors increasing their commitments to the U.S., such as wanting to play the U.S. market rebound, getting money out of home country for greater currency stability, and desiring the stability and liquidity of U.S. property markets, particularly with the backdrop of declining demographics and heightened geopolitical risks in other parts of the globe. From a strategic perspective, the reason is quite simple: the world's largest institutional investors primarily sit outside the U.S., and most of them are under allocated to CRE, as indicated in the following chart:

FIGURE 20: LARGEST GLOBAL SOVEREIGN WEALTH FUNDS AND PENSION FUNDS



Source: JLL Research, SWF Institute, Willis Towers Watson, PERE, IPE, Preqin

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For these reasons and others, real estate investors like Virtus have increased their business development efforts outside the U.S.

The primary CRE investment strategies that will be in demand in 2024 will be value-add and especially opportunistic, as investors chase higher octane returns in the present environment. Although core and core-plus fundraising will increase from the non-existent levels of 2023, fundraising will still be light until the open-end marks match today's valuation reality. If a core investor is committing to the few open-end funds with real marks and no concerns for impaired sectors or properties, or they're making new direct investments through a new separately managed account, there will likewise be a compelling investment opportunity within core and core-plus.

The Investment Opportunity for CRE in 2024

The coming year will present the best investment opportunity seen in U.S. CRE since the brief period immediately following the COVID-19 crisis in the second half of 2020. Prior to that, the post-GFC period was the longest bull market in U.S. history. We are not saying the U.S. is in the beginning stages of another 12-year bull market. What we are saying is that **risk-adjusted return opportunities in 2024 will be very favorable for fresh capital.** We know you are rolling your eyes right now, because when have you ever heard a real estate investment firm tell you it is not a good time to invest?

No doubt, for years we have espoused the relative benefits of our cycle-resilient strategy compared to more traditional PERE strategies. Because we exclusively invest in sectors with more perennial tenant demand, it is true we do not have to be as concerned about economic cycles, capital markets, or even global pandemics influencing our outcomes as other funds managers with more cyclical strategies must be. But we do have to be mindful of lofty valuations, liquidity, increased competition, and new supply coming to the market, let alone the multitude of operating factors and nuances at the property level. For that reason, the investments we were making in the go-go times of 2018 - 2019 and 2021 to early 2022 were "diamond in the rough" deals.

We primarily originated opportunities on the fringes, or in the "cracks and the crevices," as we call it. This was because we believed broader market valuations were frothy, and it was hard to have conviction in market-priced deals. One definitely had to bet on growth, and often price that into the value to ultimately succeed. The market has finally pivoted.

For the first time in a while, a value-oriented investor can make investments at scale, not just on the fringes. **We have been in a growth market for years, and it is exciting to transition into a value market in 2024 and perhaps beyond. Unfortunately, it is unlikely this opportunity will last long.** No doubt, there are plenty of headwinds for many property owners, and there will be plenty more bloodletting to come, as previously described. It will take a while for these headwinds to work themselves out, but we have noticed that windows of opportunity in all investable asset classes generally, and in CRE specifically, seem to open and close far faster these days. There are two simple reasons for this. First, information is disseminated far more freely than ever before. Second, there is generally more liquidity available, so when a window of opportunity opens, capital fills in more quickly and thus extinguishes the advantage that existed. **The edge will go to investors who have the ability to recognize patterns, detect windows of opportunity earlier, have available capital, and have in-market knowledge and manpower to move quickly and seize upon opportunities.**

We are also not saying this opportunity in 2024 will be broad-based across sectors or markets. To be consistently successful, an investor must pick their spots, in light of how divergent the market will continue to be in 2024 and beyond. We generally think of sectors or individual properties in three categories:

- Sectors or properties that are secularly impaired.
- Sectors or properties that are temporarily impaired.
- Sectors or properties that are performing with good fundamentals.

More on sector views below, but the immediate opportunity will be on the latter two categories, especially those with positive current fundamentals, with three types of transactions:

1. Purchasing quality assets at more attractive cost bases than seen in recent years;
2. Taking advantage of capital structure distress and providing structured finance options, such as preferred equity, participating preferred, or mezzanine debt to recapitalize current capital stacks; and
3. Distressed purchases, typically from a lender at a deep discount to replacement cost, of high-quality, non-stabilized real estate which also experienced a capital event that caused the deal to go back to the lender or into bankruptcy.

In summary, sage investors who pick their spots wisely and have dry powder will thrive in 2024. Returns will be asymmetric, with higher returns for given levels of risk. **That is to say, one can take on core or core-plus risk to reap value-add returns, or one can take on value-add risk to experience opportunistic returns.**

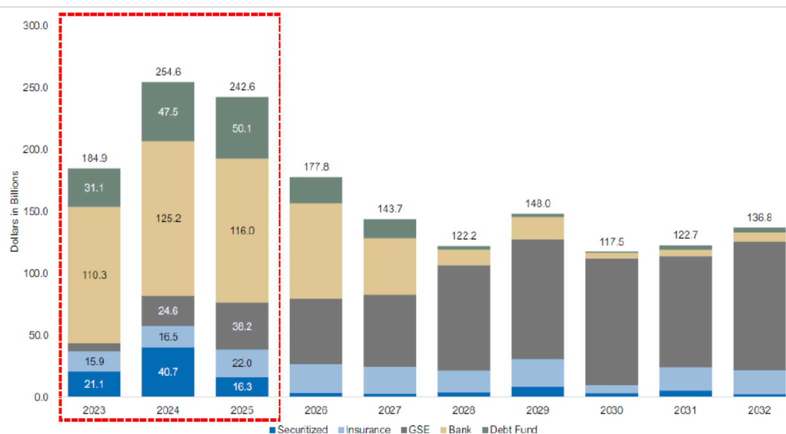
2024 U.S. CRE OUTLOOK BY PROPERTY SECTOR

2024 Middle-Income Workforce Housing Outlook

As we all have either witnessed or experienced firsthand, this past year has seen a dramatic reversion to the mean on all fronts, namely transaction volume, rent growth, and occupancy. Residential mortgage applications hit multi-decade lows, with 30-year mortgage rates increasing beyond 8%. On the flipside, the lack of inventory has kept the median cost of a home in the U.S. near record highs, making it the most unaffordable time to own a home in nearly 50 years. This will continue to drive more middle- and high-income households to the rental market while broadening the cohort of renters to include more renters by choice. Multifamily has lead U.S. CRE sales volume for nine straight years, and it looks to remain as a favored asset class from a transactional standpoint. With adjusted pricing expectations beginning to set in and $284 B of dry powder awaiting deployment, 2024 should be the year this capital goes to work. As indicated above, add to that the Fed signaling their first dovish pivot by holding rates constant in December and a bond market pricing in 200 basis points of rate cuts over the next 12-18 months, confidence will recover quickly and eventually restore market strength, similar to the mid-2010's.

In the meantime, we will continue to face a bid-ask spread in the market with sellers who face little distress if they levered correctly, and new buyers who are faced with borrowing expensive debt to buy deals in this environment, expecting higher cap rates than at which sellers are willing to relinquish their assets. Additionally, year-over-year we have seen non-controllable expenses, like insurance, increase nearly 8%, further pressuring existing owners to sell or recapitalize. Conversely, opportunities have already appeared with newer market entrants who bought at the top of the market and are now faced with needing rescue capital to refinance or purchase rate caps, as a concentration of loan maturities are coming due in 2024 and 2025 (see Figure 21), creating more buying opportunities for Virtus. See Figure 21 below, which shows the familiar Wall of Maturities referenced above (Figure 10), but specific to multifamily this time.

FIGURE 21: MULTIFAMILY LOAN MATURITIES BY LENDER GROUP



Source: MBA, Trepp, RCA, Newmark Research as of 10/24/2023

Of the maturing multifamily debt, approximately one-third is relevant to Virtus' middle-income workforce housing strategy. As a reminder, we look to provide high-quality but affordable housing to middle-income renters, especially grey collar workers, like teachers, first responders and healthcare workers. For multifamily, we generally define this as multifamily affordable to renters making 60% - 80% of the Area Median Household Income ("AMI") as measured by United States Department of Housing and Urban Development ("HUD") without spending more than one-third of their income on rent. Not only is this segment the most resilient renter cohort of multifamily, because these tend to be essential workers with stable employment who also really care about their credit, but this segment is both the largest and fastest growing cohort of the 44 million renters in the U.S. It is also the most undersupplied segment relative to demand because it is often referred to as the "missing middle." Most multifamily development has historically targeted high-end luxury projects with higher rental rates to justify elevated construction costs, or low-income subsidized projects, such as Section 8, Low-Income Housing Tax Credit ("LIHTC"), HUD, etc. This has left a dearth of supply for the large, middle-income cohort, although with rising wages, much of the new supply being delivered in some of the growth markets referenced above is accessible by middle-income tenants.

We also see certain segments of build-to-rent ("BTR" or "BFR") product as a natural complement to our multifamily assets for middle-income renters with larger families or desirous of lower density settings than multifamily. This emerging class (it has actually existed for a long time but has not really been an institutional asset class until recently) has exploded with investor interest, but many of the planned projects have failed to deliver, even well before the recent challenges brought on by the Great Tightening. No doubt, this will be a desired sector for tenants and investors alike in the coming years.

Aside from capital markets volatility, supply will be another near-term challenge as we figure out creative ways to pick our spots within our target markets, given that new supply often concentrates in certain submarkets and not others.

Though, due to a higher cap rate and interest rate environment combined with steep construction costs, future supply deliveries are expected to taper significantly in 2025, and especially 2026. Furthermore, population growth will help drive long-term absorption of new supply. This short-term volatility of added supply in areas continuing to grow creates opportunities for Virtus to capitalize on distress.

Virtus expects workforce housing to continue its resilient trajectory relative to other sectors due to several tailwinds including:

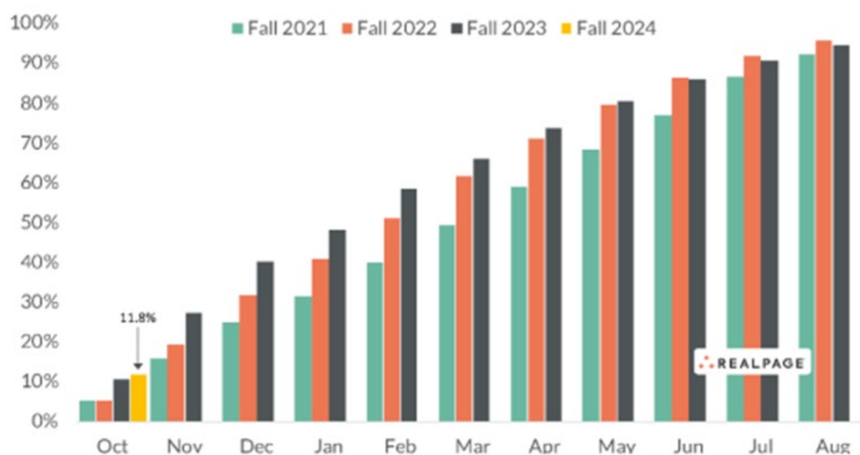
- Increases in home prices and elevated interest rates have widened the spread between homeownership and rental costs, increasing 15.4% from the second to third quarter of 2023.
- The Millennial generation, the largest generation in the U.S. today, is aging into major life events, but due to the unattainability of homeownership in today's market, is strengthening the renter pool with their strong demographics.
- With debt maturities looming, distressed opportunities have already begun to surface with more coming.
- Despite supply concerns in certain sub-markets, in general, there continues to be a housing shortage nationwide, so finding and investing in the best-located, attainable workforce housing assets or development opportunities will be an essential part of Virtus' ongoing investment thesis.
- Elevated cap rates and interest rates provide for lower basis plays at material discounts to replacement costs.

In conclusion, we believe the positive tailwinds outweigh the negatives, and workforce housing will continue to deliver compelling risk-adjusted returns. But the investment plays today will be different from the past. As market participants who have been on the sidelines return to transacting within multifamily, we will see the bid-ask dynamics normalize again, as well as bring back more confidence as investors begin to see the proverbial light at the end of the Fed's tunnel. The pain certainly is not over for those buyers that were less than prudent over the past few years, but capital market distress and supply/demand dislocations will yield many more investment opportunities in which Virtus will participate. We are excited for what the new year may bring as we continue to patiently wait for the right deals to unfold.

2024 Student Housing Outlook

The student housing asset class has continued to demonstrate its resiliency in a post-COVID-19 environment, as sound fundamentals and sustainable growth have been the storyline for each of the past three years. While 2022 was a historic year in terms of the industry's performance, 2023 outpaced the prior year by achieving 9.8% rent growth and 93.2% occupancy nationally. Early pre-leasing for the 2024 school year indicates another historically high year, as pre-leasing velocity is ahead of the 2023 school year by 1.1% and rent growth is tracking to 10.7%.

FIGURE 22: PRELEASE OCCUPANCY TRENDS

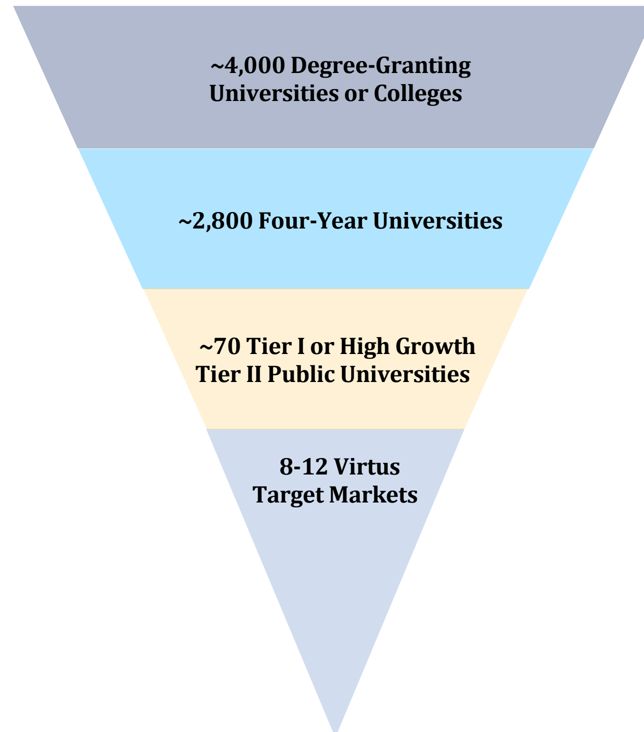


Source: RealPage

Sustained growth in the asset class is based on two obvious variables: supply and demand. While not all markets are created equal, four-year public universities continue to show positive demand, with overall enrollments growing by 24% since 2008, while smaller secondary universities have declined by 2.8% during that same period. Tier I public flagship schools in states with high population growth or positive inward migration patterns are outperforming the pack. Not only do they benefit from the growth of the in-state high school age population; the return on investment ("ROI") of the college education remains compelling to students and their parents, which allows these universities to strategically grow out-of-state enrollment. With an increase in applications, these universities control the levers on growth while not sacrificing the quality of the student body. In the face of declining college-aged students coming through the system nationally, **these high ROI universities have taken the lion's share of enrollment growth while smaller lower ROI schools have been more negatively impacted.** For that reason and others, Virtus primarily targets Tier I Public Flagship Research universities, especially in Power 5 sports conferences. Virtus' existing portfolio represents a great sample set of these market dynamics, with an average enrollment of 38,000 students per university, average annual enrollment growth of 1.5% over the last five years, and locations in markets that are forecasted to have a 1.7% annual increase in the high school age population over the next five years.

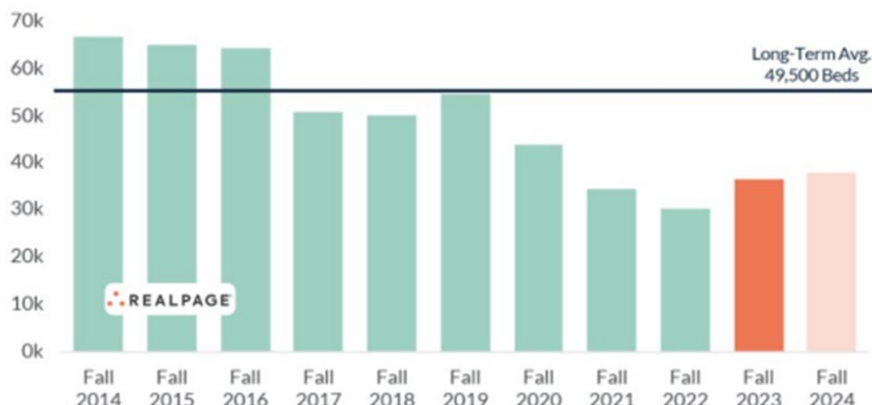
In total, there are approximately 19 million university students in the U.S., which is expected to steadily grow at a modest 0.5% annual growth rate over the next 10 years, according to Statista. While there are 6,000 colleges or universities in the U.S., Figure 23 provides a breakdown of the market opportunity:

FIGURE 23: STUDENT HOUSING MARKET OPPORTUNITY



From a supply perspective, new construction pipelines have declined to well below the 10-year average. While construction cost increases and the rising cost of debt have been a major short-term factor, the lack of quality buildable sites is a longer-term factor. We have seen new supply pipelines steadily decrease since 2013 as the easy development sites have been picked over. Developers are left having to parcel multiple sites together from individual sellers and need additional density to make construction yields work. This causes the land acquisition and entitlement process to take longer and necessitates larger deal size and higher bed counts.

FIGURE 24: STUDENT HOUSING BEDS DELIVERED OVER TIME



Source: RealPage

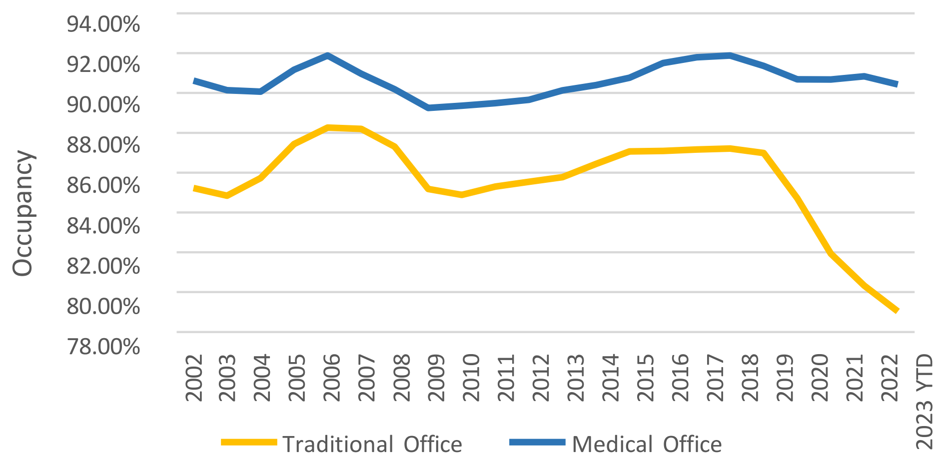
These factors have created positive, prolonged fundamentals for the asset class, but with that said, market and asset selection in student housing is more critical than ever. Student housing is susceptible to short-term headwinds when a concentration of new supply hits a market. While pent-up demand for housing has created a period of historic rent growth, it will also lead to new supply in future years. This is why Virtus is hyper-focused on understanding a university's enrollment growth trajectory, market barriers to entry, and an asset's positioning (location, product differentiation, relative value) compared to its competitors. Virtus remains bullish on student housing going into 2024, and while we do not expect double-digit annual rent growth to be the new norm forever, we will take advantage of current dynamics in the right markets. **With the embedded growth that exists at our target university markets, one can buy a class-A stabilized core property and achieve value-add returns or acquire a core-plus to light value-add risk profile deal and achieve closer to opportunistic returns.**

2024 Healthcare Outlook by Segment

2024 Medical Outpatient Outlook

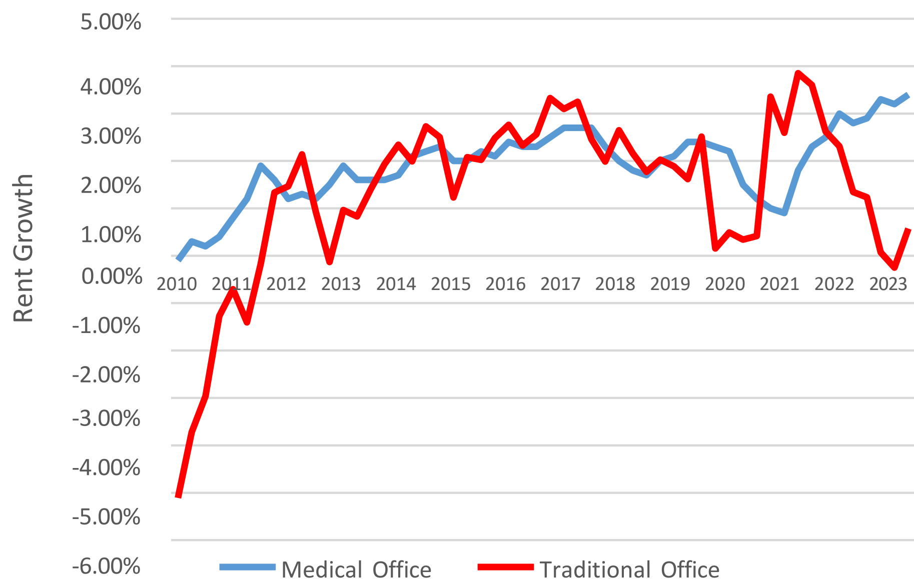
As mentioned above, 2024 may be the year the MOB industry is rebranded as "medical outpatient buildings" or similar. "Office" has become a four-letter word, and the two sectors vary significantly in terms of use, durability of cash flows, and investment performance. Terminology aside, national MOB occupancy has remained resilient over the last 20 years and rent growth's upward trend since 2010 has recently accelerated. This resiliency has resulted in a stark divergence between MOB and traditional office fundamentals.

FIGURE 25: MEDICAL OFFICE VS TRADITIONAL OFFICE OCCUPANCY



Source: CoStar

FIGURE 26: MEDICAL OFFICE VS TRADITIONAL OFFICE RENT GROWTH



Source: CoStar

Despite this, the risk of traditional office being repositioned to MOB remains low, as the two sectors are distinct, both spatially and operationally, and very few traditional office buildings possess the infrastructure, layout, and healthcare-oriented setting desired by medical tenants.

While other industries grapple with expense increases driven by inflation and labor pressures, MOB NOI growth remains healthy and consistent. One reason for this is a hallmark of the MOB sector: triple net leases ("NNN"). The industry continues to gravitate to this lease type whereby tenants pay all property operating expenses, especially for new construction, giving the sector a "back door" inflation hedge. Another trait of the asset class has been muted speculative construction, given high tenant retention and lead times associated with hospital systems and practices committing to new space. This dynamic has become even more pronounced in 2023, as the rise in interest rates and construction costs have suppressed completions to ~1.0% of existing inventory, which is the lowest seen in nine years. Another trend that continues unabated is the migration of healthcare delivery into the neighborhoods and communities, where costs are lower and patient experiences are superior.

Despite strong property fundamentals and long-term demographic tailwinds, the sector is not immune to interest rate increases, thus valuations and transaction volumes have been impacted by the recent monetary tightening. **We continue to believe that the sector will be a relative outperformer, as fundamentals remain resilient, healthcare demand grows with the aging population, and more investors seek exposure to real estate's arguably most resilient asset class.**

Life Sciences 2024 Outlook

A post-pandemic darling of alternative property types, life sciences experienced a pendulum swing in 2022 and especially 2023 amidst an erosion of demand combined with swelling supply. After three years of record fundraising and M&A activity for life sciences companies, 2023 returned to levels commensurate with 2018 and 2019. As a result, tenants have become more cost-conscious and hesitant to pursue growth initiatives, leading to dampened leasing activity, especially for larger requirements. Meanwhile, significant new supply came online in the primary markets, notably Boston and San Francisco. Since 1Q22, vacancy across the top three markets (Boston, San Francisco, and San Diego) has increased

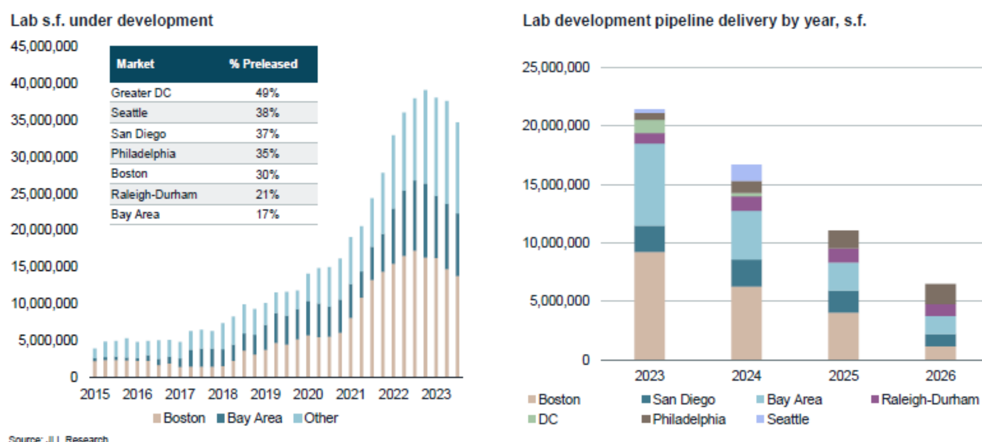
FIGURE 27: NATIONAL ABSORPTION, COMPLETIONS, AND VACANCY RATE

Source: JLL

VIRTUS REAL ESTATE CAPITAL

Despite increased vacancy, asking rental rates have held firm, albeit landlord investment and concessions have increased to win leases. With several projects slated for delivery in 2024, supply challenges are expected to persist. However, new speculative projects that have not broken ground are largely on hold or have been canceled.

FIGURE 28: LIFE SCIENCES DEVELOPMENT PIPELINE



On a positive note, there were some green shoots in venture capital funding in 2H23, which could translate to an uptick in leasing activity in 2024 based on the historical correlation and lead time between venture capital funding and leasing activity.

The sector still enjoys long-term tailwinds driven by demographics and scientific advances and remains at the forefront of innovation, producing life-changing therapies, pharmaceuticals, and medical devices. Nonetheless, **near term real estate fundamentals are not favorable.** San Diego appears the best positioned with the least-onerous supply pipeline of the three major markets. Investment opportunities in 2024 will be intermittent and unique.

Virtus will tactically seek distressed deals, cGMP opportunities (certified Good Manufacturing Process facilities regulated by the FDA and typically leased to larger, stable tenants) projects with a "tenant in tow," and opportunities to invest conservatively in the capital stack such as preferred equity.

<u>2024 Senior Living Outlook</u>

Few property types have struggled as much as senior living over the past few years. First, wage pressure has been escalating at untenable levels since 2016. Next, the COVID-19 pandemic caused massive declines in occupancy (10% - 20%), depending on facility type and who is reporting the numbers. Then wage pressure worsened, and double-digit expense inflation decimated operating margins even more. Finally, interest rate hikes and withering financing markets slashed valuations, impairing capital stacks of most assets.

Without a doubt, senior living has been the most challenging needs-based sector in which Virtus has invested through the years. **Although historically a very resilient asset class throughout economic downturns, the previously mentioned headwinds, any one of which could derail senior living's trajectory, were not normal market cycle headwinds of just oversupply or inflated pricing.** Our senior living team is good at predicting those challenges, but the industry was hit by one "left field" event after another. Prior to COVID- 19, senior living had been a strong performer in our portfolio. We had begun underweighting the sector beginning in 2017 and 2018 when our team detected wage pressures affecting many staffing positions at our properties. We also detected pockets of additional supply, even in the normally high barrier gateway markets. In fact, it has been almost six years since we have made a new senior living investment. Good call, but unfortunately, we were not fast enough in selling the existing senior living portfolio, as most of those properties were just reaching stabilization. Many of those properties were being brought to market for sale in the first part of 2020, but we were too late when COVID-19 hit and shut everything down. The Senior Living industry went backward for two plus years, which has really impacted our returns since inception. Thankfully, we have outperformed our expectations in every one of our other targeted sectors, which has been another good lesson on the benefits of diversification.

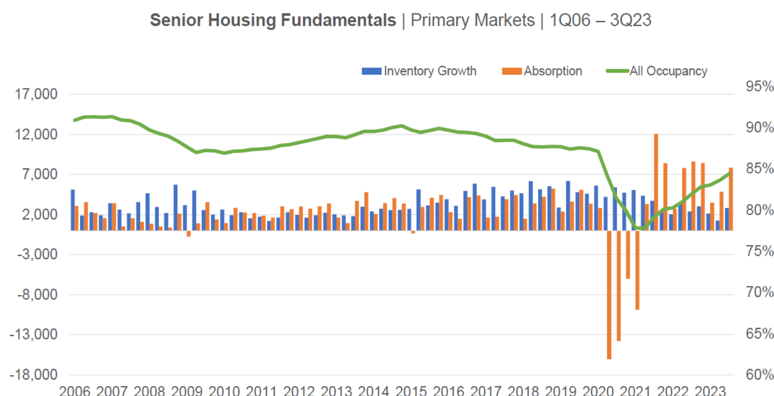
Despite capital markets woes, senior living remains a needs-based product driven by demographics. **Property-level fundamentals continue to improve as the sector recovers from the pandemic.** Occupancy across the sector has now improved for nine straight quarters, reaching 84.4%. Asking rents are up 5.4% from a year earlier, with most operators expecting 4% - 6% rent growth in 2024, suggesting owners are laser focused on clawing back operating margin. The industry has a long way to go, given that operating margins on even core-quality stabilized assets had decreased by ~10 points from previous long-term levels (35% - 40% operating margins historically versus 25% - 30% operating margins today). Most of this decline was driven by labor pressure, with many operators forced to use hyper-expensive third-party agency labor, because there was such a shortage of qualified workers in the market during COVID-19.

Inventory growth was only 1.3% in 2023 and is forecasted to fall further with construction starts now below GFC levels.

Agency financing is currently the only somewhat reasonably priced financing option, yet most properties do not yet produce enough cash flow to qualify for this debt.

FIGURE 29:

Market Fundamentals on Track for Occupancy Recovery



Source: NIC MAP® Data, powered by NIC MAP Vision

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The supply/demand picture for senior living has not looked this favorable since the GFC, which led to several years of very strong senior living performance. Expense growth, particularly labor, food, and insurance, remains a very large headwind and is the biggest risk for new investment. The risk is further compounded by lower stabilized operating margins. However, expense growth has shown signs of stabilizing, with revenue increases fully offsetting expense growth in the past few quarters. Senior living may present a compelling investment opportunity in 2024 or 2025 if expense growth abates, new supply remains low, and additional distressed owners are forced to sell. But we have made it very clear to our senior living team for a number of years that if they are to consider bringing a deal to the Virtus Investment Committee ("VIC"), it must exhibit defenses to all of these factors and all the investment stars must align.

2024 Active Adult Outlook

Active adult, a bourgeoning asset class only a decade ago, has matured immensely and continues to demonstrate that it is here to stay. While active adult also caters to the aging population (typical resident age 65 - 80), the juxtaposition to traditional senior living (resident age 80 - 90+) is stark in terms of property characteristics, operations, and investment performance. An active adult property only requires five to seven employees, does not provide operationally intensive care services, and typically does not provide dining or transportation services.

This enables the property to produce significantly higher NOI margins: 50% - 65% versus 25% - 30% for a similarly sized senior living property. While traditional senior living has struggled during the aftermath of COVID-19, active adult has proven more resilient, even though it tends to be more economically sensitive than needs-based senior living. **Recent performance has mirrored conventional multifamily, though active adult benefits from higher resident retention rate, longer length of stay, and lower turnover capex.**

FIGURE 30: ACTIVE ADULT TRANSACTION TRENDS

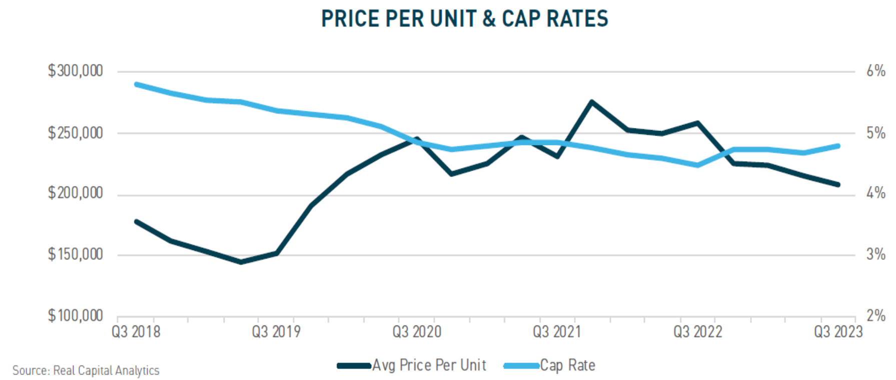
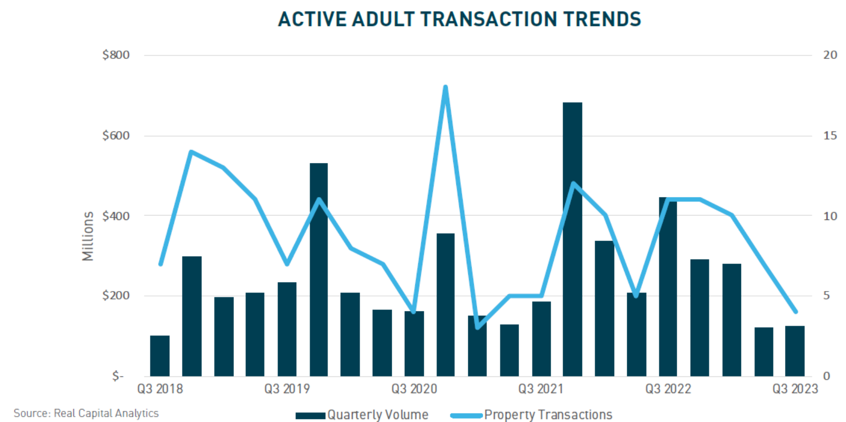


FIGURE 31:



Occupancy for active adult remains healthy at 94.2% nationally. Rent growth has cooled off recently, similar to multifamily, but is still positive at 1.4% year-over-year.

Active adult still enjoys an immense demand tailwind since it caters directly to the fastest growing cohort in the U.S., the massive Baby Boomer demographic, which has 10,000 Boomers turning 65 every day and an age range of 59 to 77 as of 4Q 2023. That is ideal when the average age of an active adult tenant is 74 and average age of entrance is 72. But a slowdown in single family home sales, along with normalizing migratory trends, have brought leasing performance back to earth after record setting years in 2021 and 2022.

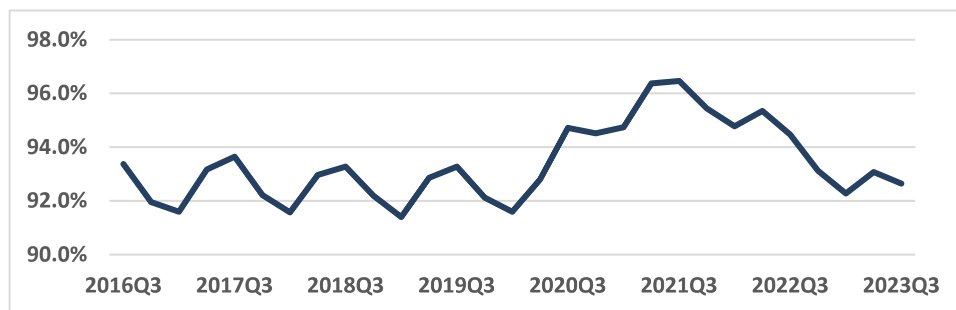
The biggest challenge of the active adult space is that it is often difficult to make development returns pencil because lease-up timeframes are much longer than that of traditional multifamily.

Looking to 2024, active adult remains an area of opportunity. As a smaller asset class, transaction volume remains thin. **The ability to acquire existing communities below replacement cost should keep new supply in check, although certain markets remain at risk in the near-term.** In the long-term, significant demand tailwinds should propel the sector to return to growth, providing attractive opportunities for new development, especially as lease-up velocity continues increasing along its present vector.

2024 Self-Storage Outlook

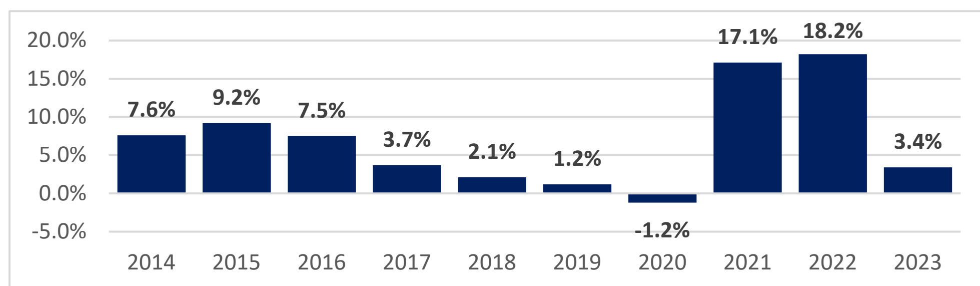
The year 2023 is best summed up as a return to normalcy, i.e. a spring lease-up season, autumn's fall in occupancy, single-digit revenue and NOI growth, and low 90% occupancy. **Following a nearly three-year bull run of the strongest performance the industry has ever seen, self-storage fundamentals retreated in 2023.** When comparing today's market to the COVID-19 highs of 2021 - 2022, it may seem like the sky is falling - declining street rates and occupancy - but it is our view that while it may take a little while longer for the air to leave this bubble, normalcy is not a bad thing for the patient investor.

FIGURE 32: SELF-STORAGE REIT SAME-STORE OCCUPANCY



Source: Yardi Matrix

FIGURE 33: SELF-STORAGE SAME-STORE NOI GROWTH



Source: Yardi Matrix

When we look back to compare some key metrics to 2019 (pre-COVID-19), we like seeing elevated average rates and higher cap rates today. The primary driver of the recent decline in move-in rental rates has been the decline in national "dislocation" - meaning domestic migration - as one of the industry's four "D's" that drive demand (the other three being divorce, death, and downsizing). This is due to the steep decline in home sales due to higher mortgage rates and elevated pricing. Declining street rates coupled with the rise in construction costs and volatility in the credit markets (rising rates, lower credit availability, and more stringent requirements) has led to a decline in new storage facility deliveries. It is estimated that 70% - 80% of new projects have been abandoned or put on hold, which bodes well for eventual bottoming in existing stores' street rates. **Paradoxically, the most durable aspect of the asset class continues to climb: existing customer rent increases ("ECRIs"), which are currently ~40% above street rates due to the "hassle factor" of tenants moving out and the customary auto-payment method property managers facilitate**.

In terms of valuation, 2023 was a year of price discovery, with transaction volume down to levels not seen in over a decade. However, we expect 2024 volume to increase as more sellers accept the return to normalcy for key fundamentals. We expect to see some opportunities due to capital structure stress stemming from newer entrants with elevated levels of debt and nearing debt maturities. **Overall, self-storage will likely not be a large part of our deployment in 2024, as we remain very targeted in the sector. We are, particularly focused on providing quality sponsors with preferred equity and perhaps senior debt, which we believe provide a compelling risk-adjusted return in this environment.**

2024 Market Outlook by Property Sector Chart

For years, we have provided our Red/Yellow/Green chart in our annual Market Outlooks. We changed the format after COVID-19 to provide both short- and long-term views on each sector, since COVID -19 had such acute short-term impacts on many property sectors. **We're now reverting to the prior format where we share our one-year view on each sector, broken down by Tenant Demand, New Supply and Entrance Pricing.** Our property sector teams assimilate dozens of variables from macro research, Big Data, and property level activity in each category to assemble their directional views. This year we have also added a section on the primary investment plays or opportunities that exist in each of the Virtus targeted sectors.

FIGURE 28: 2024 ONE-YEAR MARKET OUTLOOK BY PROPERTY SECTOR

Property Type	Demand	Supply	Entrance Pricing	Investment Opportunities
Hospitality	Tepid demand with business travel down and Covid revenge travel over	Minimal new supply delivered, although plenty of underutilized existing stock	High pricing for the few in-demand trophy assets, but the rest of the market offers high yields	N/A
Retail	Consumer remains stronger than expected, but will fall with softening economy/employment, while e-commerce continues dominating	Negligible construction of new assets, but plenty of existing inventory with high vacancies will keep rental rates down	Grocer-anchored remains bell of the ball with higher pricing, but most of the retail market offers high going-in yields	N/A
Industrial	Demand remains elevated from onshoring trend and for new industrial niches pushing rents higher, but downward pressure as economy softens	Infill and higher barrier submarkets remain tight, but significant oversupply in outfill and lower density locations	While cap rates have increased, still large bid-ask spread, and yields remain very low	N/A
Office	Demand continues its downward trend, and hard to discern where new normal is with work from home backdrop	No supply being delivered other than large blocks already under construction, but vacancy continues growing, especially in functionally obsolete assets	Large bid-ask spread, but for sellers willing to trade, real cap rates are arguably as high as the GFC if not higher	N/A
Multifamily	Demand cools from peak, but remains solid	Pockets of oversupply will struggle to absorb, but still general shortage of U.S. housing units	Cap rates have expanded providing a more attractive entrance point, but still relatively expensive compared to 10-Year Treasury	N/A
Workforce Housing	Demand for affordable product remains strong, especially with home ownership more out of reach	Some of the pockets of oversupply within multifamily will have a knock-on effect in workforce housing, but number of affordable units in U.S. is sorely undersupplied	Cap rates have expanded providing a more attractive entrance point, but still relatively expensive compared to 10-Year Treasury	Rescue capital for performing deals with capital structure distress, distressed purchases of broken cap stack deals, and participating preferred equity for select ground-up deals
Student Housing	Demand at "High ROI" universities remains elevated with strong rental growth for the '24/'25 school year	Select markets with significant new supply, but new deliveries remain well below ten-year average and new construction starts are muted with high delivery costs, but increased rental rates will allow more projects to pencil	Not only have cap rates expanded, but embedded rental rate growth at most High ROI universities allows for outsized returns at today's cost basis	Acquire core deals with embedded rent growth, along with select value-add deals and participating preferred in ground-up opportunities
Self-Storage	Demand to remain stable in 2024, yet "street rate" flat to down, while ECRIs remain elevated	Most of the hyper-supply of the past cycle has been absorbed, and construction fell in 2023 and will remain lower in 2024	While cap rates have increased, they remain below the long-term average, making it harder to justify equity investments with tepid rental rate growth in 2024	Rescue capital for performing deals with capital structure distress
Medical Outpatient	Demand remains stable in this perennial asset class, while aging demos drive the need for more space for years to come	New deliveries remain at ~1% of inventory, while functionally obsolete space needs replacing	Cap rates have expanded providing a more attractive entrance point, but relative rate growth potential is a headwind	Acquire core and value-add deals at more attractive basis
Life Sciences	Demand will continue retreating with the substantial decline in venture and related funding driving vacancy higher	Although there were few new starts in 2023 and scheduled for 2024, hyper supply in certain markets combined with struggling office properties trying to convert will keep supply headwinds high	While cap rates have expanded, the few properties being brough to market likely do not offer pricing reflective of current headwinds	Look for high-quality real estate that can be purchased at deep distressed prices and participate in the eventual reflation of the space in the years to come
Senior Living	Demand is strong and growing, but operational challenges will continue providing headwinds	Negligible supply forecasted for the immediate or long-term	Entrance pricing has become materially more attractive, but necessary given the low operating margins and higher breakeven occupancy	Very selective opportunities for core stabilized deals with value-add returns due to attractive pricing, and high-quality non-stabilized deals bought at deep distressed pricing
Active Adult	Boomer demographics provide strong tailwind, while penetration rates continue inching higher	New supply is in-check with the exception of a handful of select submarkets	Pricing is similar to multifamily, but with a stickier tenant base; construction yields are less attractive on a relative basis	Limited opportunities for select stabilized and value-add acquisitions with possible participating preferred ground-up opportunities

Legend: Positive | Stable | Challenging

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ABOUT VIRTUS

Virtus Real Estate Capital, founded in 2003, is a hands-on, data-driven, curious investor that delivers compelling outcomes from cycle-resilient investments for all stakeholders. Through thoughtful evolution and resilience in challenging times, Virtus has purposefully worked to foster thriving communities that empower people to live better lives. Over the last 20 years, the Firm acquired 289 properties for a combined acquisition value of $6.6 billion and has fully realized 202 property investments. With a strong and established track record, Virtus has proven to be successful in all phases of the market cycle. For more information, please visit virtusre.com.

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