SitusAMC Insights

5 Commercial Real Estate Sectors Ranked By Investors

3Q 2023

INTRODUCTION

Apartments and retail properties topped investor preferences in 3Q 2023, although enthusiasm has waned for both sectors. In a recent survey, SitusAMC Insights asked institutional and regional investors what they believe will be the best-performing property sectors over the next year, and which should be avoided. With investors citing less income risk than other sectors, apartment barely edged out retail for the most favored segment. Still, preference for the asset class dropped 22 percentage points YoY.

Click through to see the latest expectations for office, multifamily, industrial, retail and hotel properties in the year ahead, and trends driving investor interest. (All figures refer to third-quarter 2023 activity, and comparisons are quarter-over-quarter unless otherwise noted.)

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#1 APARTMENT

Apartment was chosen by 37% of respondents as the best property type in which to invest over the next year, roughly the same percentage as last quarter. Though investors were most bullish on apartments, NPI returns were the second lowest among the property types, according to NCREIF. Apartment total returns remained negative for the fourth consecutive quarter, retreating from the previous quarter by 40 bps. Returns were 340 bps below the long-term average (LTA) and have fallen precipitously since their pandemic peak at the end of 2021, down 820 bps. However, income returns increased slightly to the highest level since the onset of the pandemic. Among the apartment subtypes, garden performed the worst, the first time that's occurred since 2014. One-year trailing returns were -7.6%, the lowest since the Global Financial Crisis (GFC).

#1 APARTMENT

FUNDAMENTALS

- Apartment demand remained steady, though relatively weak, with occupancy unchanged QoQ at the lowest rate since mid-2021, according to Reis. Occupancy fell below both pre-pandemic and long-term average (LTA) levels by 40 bps and 20 bps, respectively. Net absorption declined nearly 17% QoQ, but remained positive and near the LTA.

- However, lower supply may offset the decline in demand. Completions fell for the fifth consecutive quarter to the lowest level since 2014. Effective rents ticked up slightly by 0.1% following an increase of 0.9% in the previous quarter. Rent growth has slowed tremendously from its peak in third quarter 2021; however, rents remain over 20% higher than pre-pandemic levels.

- Class A occupancy grew 10 bps QoQ, returning to pre-pandemic levels and near the LTA. However, Class BC occupancy was unchanged, among the lowest in a decade, though still 60 bps above the LTA. Asking rent growth was slightly stronger for Class BC than Class A at 0.3% and 0.1%, respectively. Class BC asking rent growth has outpaced Class A during COVID-19, at 20.2% and 18.4%, respectively. The number of new apartment starts has fallen dramatically this year, a consequence of higher interest rates, declining rents and prior overbuilding in certain markets, according to The Wall Street Journal. Higher materials costs and rising expenses, such as insurance, are making development projects difficult to pencil out.

3Q 2023 STATISTICS

NPI Total Return
-1.4%
Down 40 bps QoQ

Occupancy Change
0 bps

Effective Rent Growth
+0.1%

Sources: NCREIF, Reis, SitusAMC Insights, 3Q 2023

#2 RETAIL

Retail ranked second as the best property type in which to invest over the next year, chosen by 24% of respondents. However, preference for retail fell 12 percentage points QoQ. Retail returns were relatively flat and earned the second-highest returns among the property segments, despite remaining in negative territory. Though total returns were nearly 210 bps lower than the LTA, income returns were among the highest in eight years. Returns have fallen 240 bps since their pandemic peak set in early 2022. Neighborhood centers, community centers and power centers eked out positive returns of between 0.5% to 0.6% each. Single-tenant retail was the worst-performing subtype. One-year trailing returns were -1.4%, the lowest in over two years.

#2 RETAIL

FUNDAMENTALS

- Retail fundamentals remain solid, with the occupancy rate unchanged for the third consecutive quarter, according to Reis. Although that's the highest level since the beginning of the pandemic, cccupancy is still 120 bps below the LTA. Retail completions were the lowest on record. Net absorption slowed substantially, though it remained positive, as it has for the last 11 quarters. Effective rents grew for the tenth consecutive quarter and have surpassed pre-pandemic levels.

- The Wall Street Journal reports that the owner of Westfield Malls is dialing back its plans to sell nearly all of its U.S. properties this year, instead holding on to some top-tier, high-performing malls. Major mall operators are reporting strong tenant sales this year and occupancy in many high-end, Class A malls has reached or surpassed 2019 levels.

3Q 2023 STATISTICS

NPI Total Return	Occupancy Change	Effective Rent Growth
-0.1%	0 bps	+0.3%
Up 4 bps QoQ		

Sources: NCREIF, Reis, SitusAMC Insights, 3Q 2023

#3 INDUSTRIAL

Dipping only two percentage points from last quarter, industrial ranked third as the best property type in which to invest over the next year, chosen by 23% of respondents in our survey. Industrial performance continued to improve from the pandemic trough in 4Q 2022, increasing almost 50 bps QoQ. Still, returns were negative — among the worst since the GFC and 300 bps below the LTA. All of the major industrial subtypes posted negative returns, with flex performing the worst at -0.5%. One-year trailing returns were -5.3%, the lowest since the GFC.

#3 INDUSTRIAL

FUNDAMENTALS

- Warehouse occupancy retreated from near-record highs by 20 bps. Occupancy remained about 550 bps above pre-pandemic levels and the LTA, per Reis. Net absorption remained positive, as it has since the GFC. However, absorption slowed to the lowest level since 2019 and was more than 60% below its LTA.

- Warehouse effective rent growth continued to lose steam from record levels, growing by 0.8%, the slowest pace since early 2021, but on par with the historical average. Still, rents are 42% above pre-pandemic levels following the epic run-up in 2021 and 2022. Ongoing supply shortages should keep rent growth afloat. Completions declined by 40% to the lowest level since early 2019.

- As a result of relatively affordable and limited supply along popular transportation routes, and legislation such as the Inflation Reduction Act, the Piedmont Triad region of North Carolina is becoming a major hub for EV battery manufacturing, according to Commercial Property Executive. Toyota is investing $14 billion in the region to create a 7 million-square-foot campus near Greensboro to produce batteries for plug-in hybrid and battery-operated electric vehicles. The demand surge has led to a spurt in speculative industrial construction.

- Excitement over AI is powering a boom in data centers. Developers are rushing to build hundreds of data centers that can provide the increased power and cooling capabilities required by AI computing. According to The Wall Street Journal, Blackstone has grown its data center development pipeline to more than $15 billion from only $1 billion in two years. Rising interest rates are less of a concern for data center owners because of extremely strong demand and the willingness of tenants to pay higher rates. Data center owners are less deterred by rising rates because their business is booming and their tenants are willing to pay higher rents, according to analysts and data-center companies.

3Q 2023 STATISTICS

NPI Total Return	Warehouse Occupancy Change	Warehouse Effective Rent Growth
-0.3%	-20 bps	+0.8%
Up 50 bps QoQ		

Sources: NCREIF, Reis, SitusAMC Insights, 3Q 2023

#4 HOTEL

Hotel ranked fourth in our institutional investor survey, with 16% of respondents favoring the segment, a substantial jump from last quarter's 3%. Hotel had the strongest returns among the main property types at 1.9% and was the only segment to earn a positive quarterly return. Hotel saw negative appreciation for the first time in over two years; however, this was offset by the second-highest income return seen during the pandemic. Still, hotel has performed well over the last year with one-year trailing returns of 12%, among the highest in nearly eight years.

#4 HOTEL

FUNDAMENTALS

- Seasonally adjusted hotel occupancy surged to the highest level over the past year. According to Reis, the current occupancy rate is almost 500 bps higher than the LTA, but remains about 140 bps below the pre-pandemic rate. Hotel occupancy data has been extremely volatile since the onset of the pandemic, but Reis forecasts the occupancy rate to surpass pre-pandemic levels by year-end.

- Seasonally adjusted room rates declined for the second consecutive quarter by 0.1%, reaching the lowest level since mid-2022. The jump in occupancy more than offset the decline in room rates, however, leading to a considerable increase in RevPAR for the quarter. Room rates and RevPAR were 15% and 13% above pre-pandemic levels, respectively.

- Both upper-tier and lower-tier hotels have yet to return to pre-pandemic occupancy. While lower-tier hotel occupancy was 60 bps shy of the pre-pandemic level, upper-tier occupancy was 220 bps lower. Lower-tier hotels have outperformed upper-tier hotels throughout the pandemic. Lower-tier hotel RevPAR was 16% above pre-pandemic levels, but was up just 7.3% for upper-tier hotels.

- As reported in GlobeSt, the disconnect between solid demand and growth prospects and uncertain financing conditions is creating a sizable gap between the expectations of buyers and sellers in the hotel asset class. Buyers should be patient and very selective in their deals, looking for motivated sellers and taking advantage of minimal institutional competition for listed properties. Sellers who are not getting the price they want will likely need to wait for the cost of capital to decline, which should increase the buyer pool.

3Q 2023 STATISTICS

NPI Total Return
+1.9%
Down 210 bps QoQ

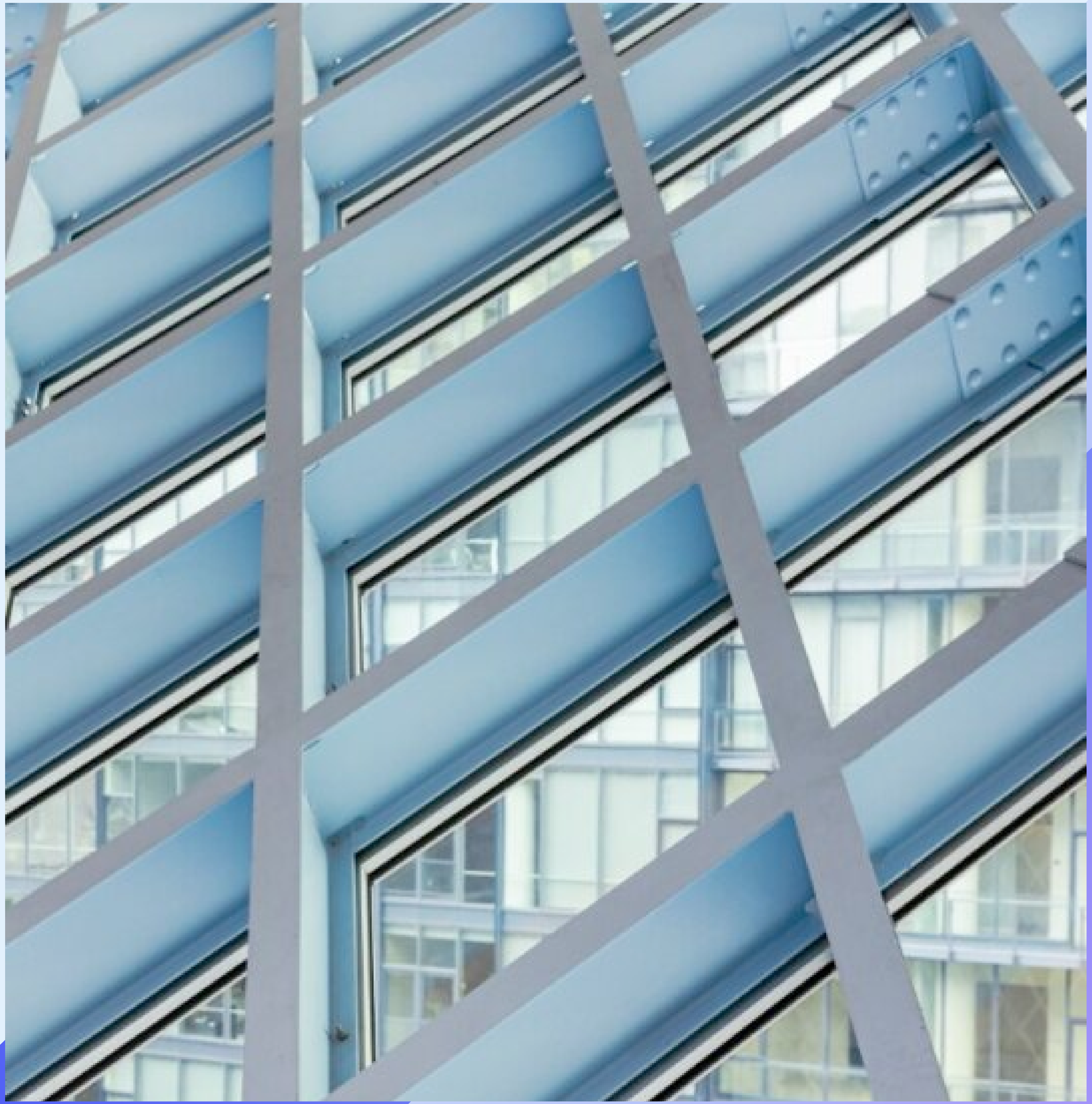
Occupancy Change
+380bps

RevPAR Growth
+6.1%

Sources: NCREIF, Reis, SitusAMC Insights, 3Q 2023

#5 OFFICE

No respondents from our quarterly survey selected office as the best property type, leading to its last-place ranking. Office returns were in the red for the fifth consecutive quarter despite being up more than 200 bps QoQ. The segment was once again the worst-performing in the NPI. Income returns, however, increased slightly to the highest level since 2014. Suburban office outperformed CBD office by 230 bps, but both subtypes were substantially negative. The past year has been unkind to the sector, with one-year trailing returns at -17.1%, the lowest since the GFC.



#5 OFFICE

FUNDAMENTALS

- Office fundamentals continue to deteriorate, with occupancy dropping 30 bps QoQ to a record low, per Reis. Net absorption was substantially negative and among the weakest since the GFC. Effective rents declined slightly, marking the first decrease since mid-2021. Rents are 1.5% above pre-pandemic levels. Completions fell by 78% QoQ to the lowest level on record. With fundamentals so weak and the outlook for office usage still very cloudy, we would not expect development to stage a comeback anytime soon.

- Class A office occupancy was the lowest on record and was an astonishing 430 bps below the LTA. Class BC occupancy was 70 bps higher than the pandemic low set in second quarter 2021, but was 240 bps below the LTA. Class A asking rents were unchanged following eight quarters of minimal increases; Class BC rents increased 0.1%, the seventh consecutive quarterly increase. Rents are up relative to pre-pandemic levels by 3.5% and 1.7% for Class A and Class BC, respectively.

- Recent cell phone tracking data from Placer.ai finds office activity in the top 26 downtowns at about 65% of pre-pandemic levels, according to Bloomberg. Business districts in San Antonio, Nashville, Midtown Manhattan, and San Diego have recovered more than 75%, while the figure is about 50% for Portland, San Francisco and Denver.

- Amid decreased demand and a wall of maturities, the Urban Land Institute reports a coming wave of distressed office, which could present large return opportunities for keen investors. Buyers should be focused on property fundamentals, tenant creditworthiness and lease terms in addition to capital requirements. New York, Washington, D.C. and Chicago top the list of MSAs facing the largest amount of office distress.

3Q 2023 STATISTICS

NPI Total Return
-3.7%
Up 210 bps QoQ

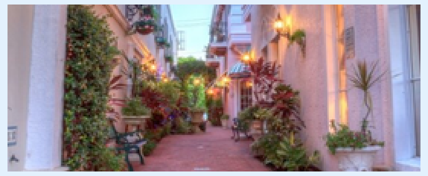
Occupancy Change
-30 bps

Effective Rent Growth
-0.1%

Sources: NCREIF, Reis, SitusAMC Insights, 3Q 2023

RANKING RECAP

3Q 2023 STATISTICS

	NPI Total Return	Occupancy Change	Rent Growth / RevPAR Change
 #1 APARTMENT	-1.4%	0 bps	+0.1%
 #2 RETAIL	-0.1%	0 bps	+0.3%
 #3 INDUSTRIAL	-0.3%	-20 bps Warehouse Occupancy Change	+0.8% Warehouse Effective Rent Growth
 #4 HOTEL	+1.9%	+380 bps	+6.1%
 #5 OFFICE	-3.7%	-30 bps	-0.1%

Sources: NCREIF, Reis, SitusAMC Insights, 3Q 2023

SitusAMC Insights

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