Mid-Year 2023

Commercial Real Estate Outlook & Opportunities

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CROWDSTREET

June 2023

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Introduction

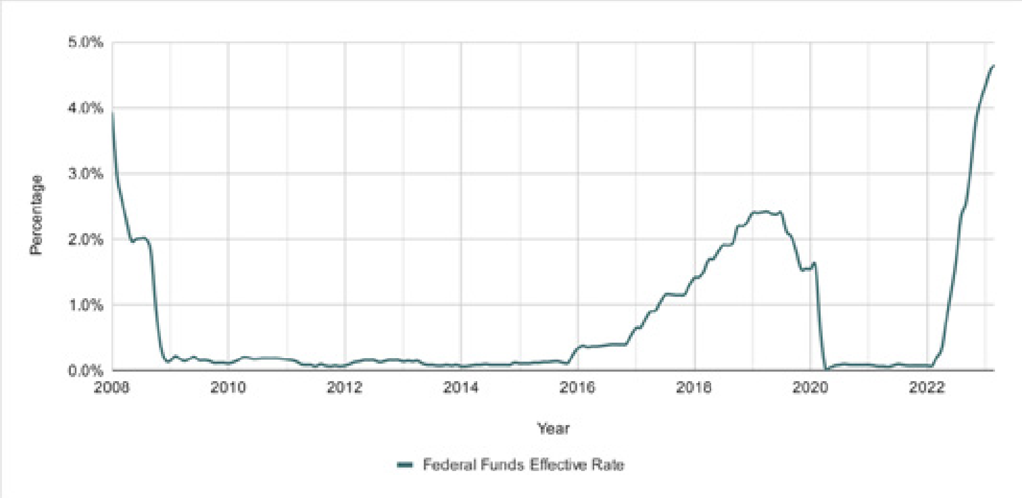
A Period of Mispriced Opportunities

Swings in the market are inevitable, but sometimes things change drastically and require a remarkable shift in strategy to navigate. The events of the past few years have created markedly different environments for investing in commercial real estate (CRE).

In 2023, not only are interest rates at their highest level seen in the last 16 years, the pace at which the Federal Reserve raised interest rates was one of the most aggressive hiking sprees that we have experienced in our U.S. history.[1] The reason, according to the Fed, is quite simple: to battle high inflation and bring it closer to its 2% annual target over the long run.

Figure 1:
U.S. Federal Funds Effective Rate by Year

Source: Federal Funds Effective Rate, Federal Reserve Economic Data, May 2023.

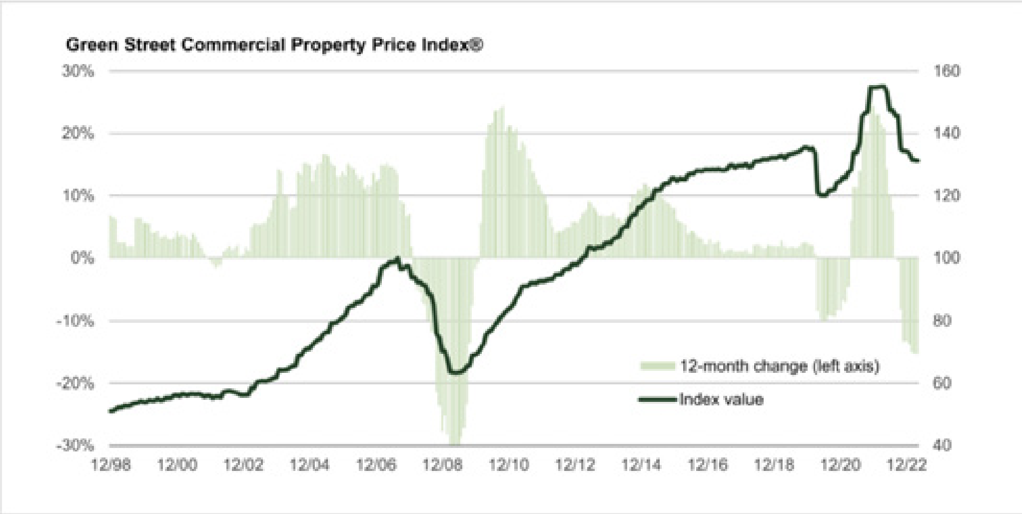


1 Federal Funds Effective Rate, Federal Reserve Economic Data, May 2023.

We have long since exited the age of "free money", where the Fed lowered interest rates to 0% to boost economic activity in 2020, and have entered a period of strict access to lending.[1] After more than a year of tight monetary policy, not only has the cost of borrowing increased precipitously, but liquidity has also markedly decreased. In 2022, we witnessed major banks move to the sidelines starting in the second half of the year due to increased reserve requirements while in 2023 we are witnessing regional banks pull back further in the wake of a regional banking crisis.

Figure 2:
Green Street Commercial Property Price Index® - All Property

Source: Commercial Property Price Index, Green Street, May 2023.



We are observing that today's high interest rate market environment is affecting deal pricing as groups are basing their underwriting assumptions on a significantly higher cost to acquire debt, to build new projects, and to maintain existing ones. Additionally, the current interest rate environment is generally leading to higher cap rate assumptions at exit.

Consistent with dwindling sources of capital, CRE prices declined roughly 13% in 2022 after rising by 24% in 2021.[2] The majority of the price declines occurred in the second half of 2022, coinciding with the effects of deteriorating capital markets.

> Bidders in the market are going back and forth on pricing, which has opened up room to exploit mispriced opportunities.

The rate at which prices are declining has since slowed down (prices down by only 2.2% in Q1 2023) for most asset classes, but we expect further declines to materialize over the course of 2023.[2] As CRE property values are shifting, we have observed widening bid/ask spreads on deals depending on the property type, location, risk profile of the investment, and the motivation of the seller with significant discounts to peak pricing.

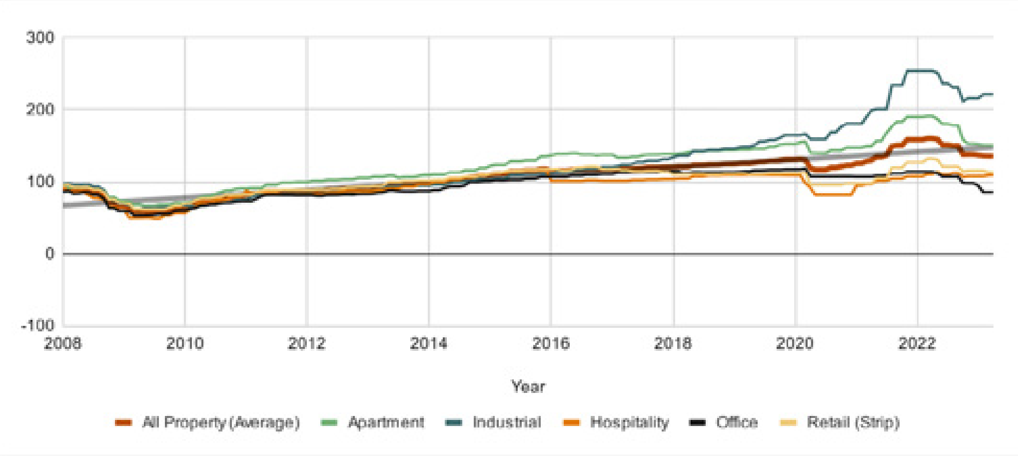
1 Federal Funds Effective Rate, Federal Reserve Economic Data, May 2023.
2 Commercial Property Price Index, Green Street, May 2023.

Unlike the stock market, which is by definition considered to be an efficient market, meaning that market prices reflect all available and relevant information, CRE is inherently an inefficient market, which basically means that assets may transact at prices that are higher or lower than their intrinsic value. This can be possible in the CRE market for reasons which may include a) information is not readily available to market participants or b) participants are interpreting information differently. It appears that high interest rates and the resulting uncertainty may have increased the CRE market's "inefficiency", so to speak.

Bidders in the market are going back and forth on pricing, which has opened up room to exploit mispriced opportunities, especially those where buyers can justify

Figure 3:
Price Dispersion between Major Asset Classes

Source: Commercial Property Price Index, Green Street, May 2023.



significant discounts to recent peak pricing. Uncertainty is the name of the game and no one can accurately predict when or if the economy will go back to a low interest rate environment and therefore are adjusting to the "new normal."

Keeping in mind that many trends in this economic environment are still taking shape, we are keeping a close eye on interest rates, inflation, and other economic indicators to keep you informed. Our latest outlook and opportunities report update combines industry knowledge and in-depth research to build our outlook and assess opportunity across multiple CRE asset classes.

Chapter 01: Major Asset Classes

Section 01: Hospitality

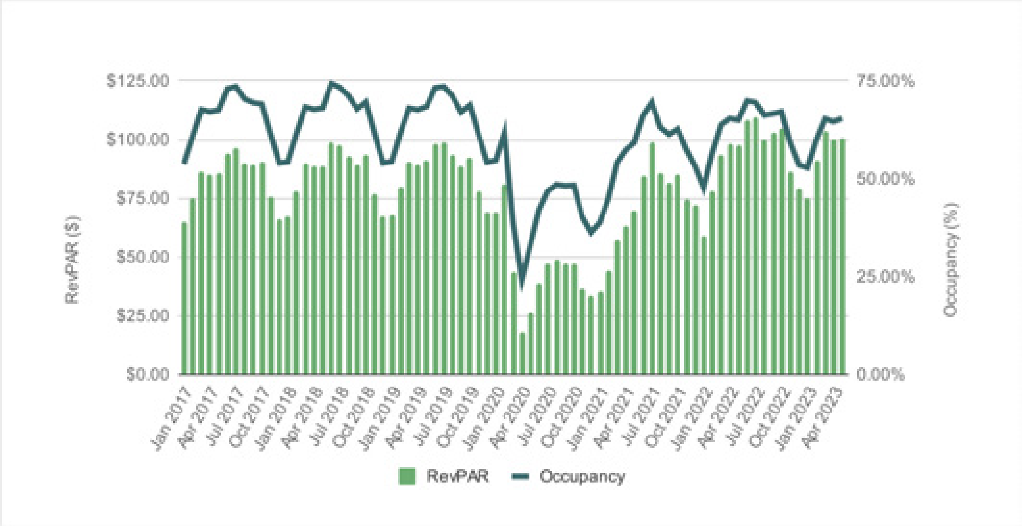
Outlook

The hospitality industry was arguably the hardest hit sector during the pandemic, from an operating perspective, when the industry practically came to a standstill overnight. For context, STR reported that Revenue per Available Room (RevPAR) at the national level dropped from its 2019 peak of $99 in July 2019[3] to historic lows of $17 per room in April of 2020[4].

Despite the absolute devastation that the industry experienced in 2020, the sector recovered in 2022 as RevPAR reached its highest level at $110 per room in June of 2022[5]. Leisure travel helped drive the initial rung in recovery amid what was referred to as the "summer of all summers" by STR, due to pent-up demand during the lockdown and the highest consumer savings rate in recent history[6]. Savings

Figure 4:
Hospitality Market Fundamentals by Year

Source: Hospitality, United States, CoStar Data, as of May 2023.



3 "U.S. hotel performance for July 2019," STR, 2019.
4 "U.S. hotel performance for April 2020," STR, 2020.
5 "Market Recovery Monitor - 11 June 2022," STR, 2022.
6 Personal Savings Rate, Federal Reserve Economic Data, May 2023.

have since toned down and given that the economic environment has become more uncertain, we expect that consumers may hold back on travel plans in the second half of 2023.[6]

STR reported that leisure travel is now exceeding business travel and the latter is "up and down" and inconsistent across markets. Business travel is generally affected by convention and conference activity, which had dwindled to basically nothing during 2020 to 2021 and had resurfaced in 2022. However, with increased layoffs in 2023, companies may pull back further on conference and business travel which may dampen recovery.

> **Given that the economic environment has become more uncertain, we expect that consumers may hold back on travel plans in the second half of 2023.**

Business travel recovery may also depend on the recovery and activity in the respective market's office sector. Office ghost towns such as the Silicon Valley are still behind in their hotel recovery while markets like Dallas, which are seeing more activity are recovering faster due to resurging business transient demand. Overall, along with leisure travel, business travel needs to pull its weight for us to see a stronger recovery in the hospitality sector.

Although revenue is recovering, occupancy is still below pre-pandemic levels.[7] The recovery in revenue is mainly due to higher Average Daily Rates (ADR) as opposed to occupancy levels. We believe that when occupancy starts to catch up and exceed pre-pandemic levels, it will likely add more fuel to the recovery and growth in this sector. Hotels are now performing at pre-pandemic levels on a nominal basis, according to data by STR; however accounting for inflation, the real recovery in revenue is still underway.[8] Concurrent with STR's forecast, we expect real recovery by 2025 and believe that 2024-2025 could likely set a new top line performance bar for the hospitality sector, based on the recovery so far.[8]

While STR reported that revenue hit its all-time high, it's hard to ignore that labor costs are rising significantly as well. Historically, hotels have been relatively more susceptible to inflation given their larger operating budgets. While the pent-up demand for hotels is helping push up occupancy and revenue rates nationwide, we still see labor shortages, high inflation, and a rise in interest rates collectively hampering the pace of recovery.

6 Personal Savings Rate, Federal Reserve Economic Data, May 2023.
7 "U.S. hotel commentary - February 2023", April 2023.
8 "STR, TE make modest upgrade to first U.S. hotel forecast of 2023," STR, 2023.

Opportunity

We are leaning into the next phase of recovery for the hospitality sector, but with caution. In the immediate aftermath of the pandemic, we saw hospitality asset pricing discounted by as much as 20%[9] relative to 2019 trades, but Green Street reported that prices climbed back up in 2021.

As with many asset classes, the illiquidity of capital markets and the resulting high cost of debt is seeping into hotel valuations by putting downward pressure on deal pricing, which is currently at a relative discount to its own historical trendline. However, because pricing was already at depressed levels and is still in mid-recovery after the pandemic, the percentage of decline due to the capital markets is relatively low as compared to the multifamily and industrial sectors.

CBRE stated that although price declines varied by the type of hotel, they were down by roughly 15% year-over-year in 2022. From our lens, prices for hospitality assets are essentially stuck at their pre-pandemic levels—some of these assets would have likely appreciated were it not for the outlier effects of the pandemic that disrupted pricing from its standard growth trend.

> When occupancy starts to catch up and exceed pre-pandemic levels, it will likely add more fuel to the recovery and growth in this sector.

With overall prices now roughly back to pre-pandemic levels, we are focusing on situations where pricing disparities continue to exist for properties that are bouncing back in their occupancy, revenue, and average daily rate, particularly leisure, high-tier/luxury, and extended-stay hotels, especially in drivable, leisure-oriented destinations or vacation markets with travel demand. Our outlook, however, is cautious because we expect a low savings rate, slow recovery of business travel, and high inflation to affect travel demand.

Assuming business travel recovers, the blending of remote work into leisure travel or "**bleisure**" may provide opportunities in upcoming years for urban, leisure, and extended-stay hotels.

9 CrowdStreet, May 2023.

Chapter 01: Major Asset Classes

Section 02: Industrial

Outlook

Often considered the darling of the commercial real estate market, the industrial sector is generally under supplied and in high demand, despite the uncertainty in the overall market. The frenzy for industrial space however is starting to fade as the rate of growth in e-commerce sales is down. However, Morgan Stanley reported that e-commerce sales in the U.S. could reach 31% of total sales by 2026, up from 14.7% in 2022, indicating a change in behavior and a lasting consumer preference toward online shopping.

Green Street stated that the industrial sector has a "solid outlook" over the next few years and that the "defending champion" broke its 2021 record for revenue growth in 2022, posting a strong outlook for the year ahead after coming off of

Figure 5:
Industrial Market Fundamentals by Year with Forecast

Source: Industrial, United States, CoStar Data, as of May 2023.

strong NOI growth—this growth was due in part to a continued expectation of e-commerce sales paired with rent growth in the last two years (with national market rents growing over 40% cumulatively, exceeding that of the previous seven years combined.)[10]

Green Street data also shows that as with some other asset classes, the current market shift is pushing up cap rates, which compressed to record levels for the industrial sector, reaching as low as 3.5% in early 2022. As soon as interest rates began to rise to the level that industrial cap rates would intersect with the yield on the 10-year treasury (which is also known as the "risk free" rate), it became likely that the industrial sector would soon experience cap rate expansion. Since then, industrial cap rates expanded by over 90 basis points in 2022, according to Green Street, and consistently, asset prices declined.[10]

> We also anticipate the "friend-shoring" trend taking hold—moving industrial production to the shores of political allies - maybe bring more manufacturing to Mexico. If it continues, it may create increased demand for new distribution space in markets like Texas.

With demand still strong however, prices for industrial properties have increased by 2.5% in Q1 of 2023 after declining by 15% annually in 2022—the only CRE asset class for which prices increased in 2023.[11] It is important to note that price declines in 2022 were a reversion to the mean from its peak pricing in 2021, when industrial assets had appreciated by record-levels, according to Green Street, following the pandemic. Despite these price declines, we believe industrial values are far from a bargain when put into the context of the sector's long-term historical trendline.

The outlook for rent growth is expected to remain above long-term historical trends, according to Green Street, although some deceleration is expected from its growth within the last two years. Overall, Green Street predicts the outlook for the industrial sector remains positive, and it will likely remain a sought after asset class over the next few years, especially in low vacancy and high barrier markets.

10 "Industrial Sector Update: Still Flexing Rent Growth Muscles," Green Street, 2023.
11 Commercial Property Price Index, Green Street, May 2023.

Opportunity

Considering that long-term trends such as undersupply, low vacancies, and high demand for industrial projects are still in place, we continue to believe in adding new supply for industrial projects located in growth markets. Primary markets with strong industrial demand are highly competitive and, as such, we are seeing increased demand in secondary and tertiary markets with burgeoning institutional presence.

We also anticipate that the "**friend-shoring**" trend that is taking hold, which means moving industrial production to the shores of political allies, may bring more manufacturing to neighboring Mexico, which if it continues may bring increased demand for new distribution space in markets like Texas.

We are also favoring acquisition opportunities as they are making more sense in today's expanding cap rate environment—a strategy that has not been viable, in our estimation, since 2020. Therefore, the yield on cost, which is calculated by dividing a property's annual net operating income (NOI) by its total project cost, has generally been higher today on average than we have observed in the past few years. With that in mind, we are favoring opportunities to acquire assets, especially in tight markets with strong pre-leasing activity, as long as we budget exit values that reflect the current expanding cap rate environment.

> We continue to believe in adding new supply for industrial projects located in growth markets.

As with other property types, lenders are typically requiring an increase in interest reserves on ground up development projects, which is adding to the total project costs. Industrial projects do, however, typically require lower interest reserves due to their usually less complicated build-outs. They generally offer potentially shorter construction and stabilization timelines, compared to multifamily and hospitality properties.

Industrial properties also generally have less operational risk due to the Triple Net (NNN) nature of leases, where tenants are responsible for paying all operating expenses including property taxes and insurance. Because operating costs are passed on to the tenant, NNN lease structures can help insulate industrial properties from operating expense exposure, to a degree, as operational costs go up. However, the flip side is that predetermined contractual rent escalations (typically set at 3% per annum) may not be as attractive as they were pre-pandemic due to inflation, which is also part of the reason behind the current cap rate expansion.

Chapter 01: Major Asset Classes

Section 03: Multifamily

Outlook

The price appreciation for multifamily in certain markets reached double-digits in 2021, according to Green Street, (up 26% year-over-year in 2021) and then prices declined steeply in 2022 (down 20% year-over-year in 2022). The rate of decline has slowed down since with only a 1.8% price decline recorded by Green Street in Q1 2023.

CoStar reported that the pace of rent growth for multifamily is projected to taper in the next few years down to low single-digits after record rent growth of about 11% annually in 2021. The descent in annual rent growth was to be expected and, in our opinion, a necessary step in re-establishing a sustainable cycle for this asset class. To put things into perspective, annual rent growth in the five years from 2015 to 2019 was around 3.0% on average.

Figure 6:
Multifamily Market Fundamentals by Year with Forecast

Source: Multifamily, United States, CoStar Data, as of May 2023.

CoStar stated that rents in Sunbelt markets, which is the region of the United States generally considered stretching across the Southeast to Southwest, had overshot in 2021, reaching as high as 16% annual appreciation. Rents in the Sunbelt markets have since recorded some of the largest pullbacks in growth. Yet, Green Street reported that the overall market rent growth in 2022 was "better-than-expected" in Sunbelt markets while recovery in some West Coast markets was more "sluggish-than-expected."[12]

A spike in new supply is a contributing factor to the deceleration in rent growth for multifamily. Given the overall undersupply relative to projected demand (roughly 462,000 units undersupplied on a cumulative basis since 2002 through January 2023[13]) we are not yet concerned about increasing supply at the macro level, but there is a risk that certain submarkets may overshoot.

Data from CoStar suggests that more than 1.1 million total units are currently under construction and about 627,000 of those units were started in 2022, the highest rate of new starts in the last 36 years.

Although CoStar shows that multifamily construction pipeline on the national level is still loaded, many of these projects will not be delivered until about 2025. Given the significant decrease in liquidity for construction financing, the pace of new construction has slowed down according to CoStar, with new construction starts down by 48% on an annual basis as of Q1 2023. We expect new construction to trend downward over the next year, changing the outlook for new supply.

> We are not yet concerned about increasing supply at the macro level, but there is a risk that certain submarkets may overshoot.

Despite robust job growth and sizable wage gains, Census data shows that household formation is slowing down due to economic uncertainty and low consumer confidence, which may negatively affect the demand for multifamily in the short-term.

CBRE reported that overall multifamily investment volume decreased by roughly 19% year-over-year in 2022 but was still the "second largest annual total on record" after 2021. When all is said and done, the demand for multifamily is largely non-discretionary and therefore we expect some level of stability in this sector going forward. Especially considering that the underlying fundamentals remain strong, with occupancy rates reasonably in line with long-term historical trends and positive rent growth. High interest rates also make it more difficult to afford a home, which may push more would-be homebuyers to remain in the rental market and help bolster demand in the multifamily market.

12 "U.S. Apartment Outlook," Green Street, January 2023.
13 "The Linneman Letter, Winter 2022-23," Linneman Associates, 2023.

Opportunity

While keeping in mind that multifamily prices have shifted to reflect an outlook of slower growth, we see three viable strategies right now:

1. First, opportunities to acquire well-located, high quality properties at prices discounted enough to offer going in cap rates (typically 5 to 6%+) that have been simply unobtainable for the previous two years because they were previously compressed. This strategy can span from "Core," (assets that are often considered one of the more stable types of real estate investment, typically fully leased to high credit tenants, generally have more stabilized returns, and require little to no major renovations) to "Value-add," (assets that have some level of management or operational problems and require some physical improvements, and/or suffer from capital constraints)—but it is predicated first and foremost on asset quality, market outlook and relative discount to the asset's peak pricing.

2. The second strategy is distressed deal flow opportunities. With the rapid rise in interest rates, there have been more off-market opportunities from owners that have un-capped debt on their deals and are seeking relief from their (much higher) reset of debt service requirements. We believe the current market dynamic may produce a handful of distressed trades where sellers are compelled to sell into a highly inefficient market. Such trades will likely fit an opportunistic business plan and have little to no current cash flow, but could be discounted enough to present a favorable entry point.

3. Finally, ground up development may also be a viable strategy. Such developments tend to be located in markets where entitlements are difficult to obtain, which has translated into lower new supply over the past few years relative to some of the hyper growth markets. With tempered expectations of higher cap rates at exit and lower rates of rent growth between now and stabilization, a window of opportunity has opened to reset business plans to more realistic expectations. A strategy may be to differentiate between developers who were merely seeking to ride the hot hand of sizzling markets back in 2021 to cash in on an unsustainable bonanza, and those developers who are committed to delivering quality projects by going into markets that may still welcome new supply in the years ahead.

Chapter 01: Major Asset Classes

Section 04: Office

Outlook

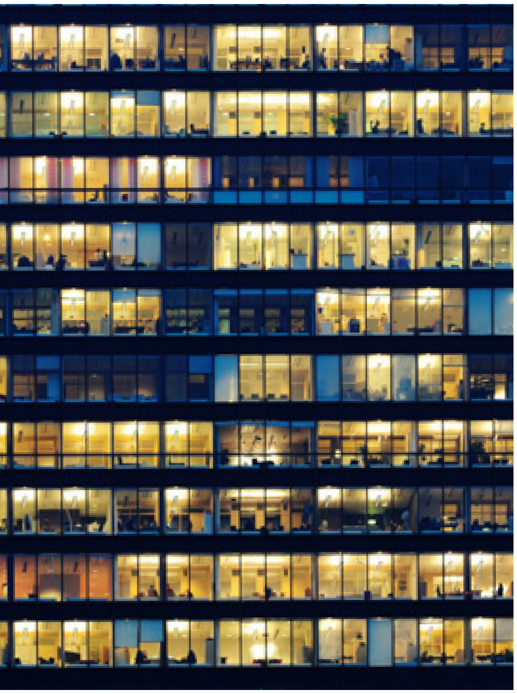
It's a transformational time for the office market. Increased remote work options following the pandemic added downward pressure on employee utilization rates in offices. Data from Green Street shows that office values fell precipitously by 28% (as of May 2023) from their peak in March 2020 and are trending below 2014 levels.[14] This, as reported by CoStar data, has translated into an outlook for stagnated rent growth and absorption within the next two years. The bleak outlook for office suggests that values will continue to decline for the foreseeable future, driven in part by the next wave of office loan maturities, especially for lower class office products.

Figure 7:
Office Market Fundamentals by Year with Forecast

Source: Office, United States, CoStar Data, as of May 2023.

14 Commercial Property Price Index, Green Street, May 2023.

Although loan maturities within the next few years are a looming risk for some of the major asset classes, the risk is typically higher for the office sector because of low probability that refinancing requirements will be adequately met. Roughly **$130 billion** of office loans are scheduled to mature in 2023 and 2024, according to MSCI Real Capital Analytics. Considering that the capital markets are almost completely frozen for office loans, the market dynamic seems to foreshadow more loan defaults. This could lead to more distress and further downward movement in prices.



> Considering that the capital markets are almost completely frozen for office loans, the market dynamic seems to foreshadow more loan defaults.

"Five to 10 office towers each month join the list of properties at risk of defaulting because of low occupancy, expiring leases or maturing debt that would have to be refinanced at a higher rate," according to **Connect CRE**.

With that said, office distress is not equally distributed. The top 15% of office inventory have registered over 100 million square feet of positive absorption since the pandemic and will remain highly desirable until 2030, according to a Cushman & Wakefield report titled "**Obsolescence Equals Opportunity**."

As the post-pandemic office use saga drags on, office obsolescence is becoming a serious issue. With relatively high vacancy rates and a tepid forecast for demand, data suggests that offices will lose at least, if not more than, **39%** of their market value within the next decade as compared to 2019 levels. Roughly **25%** of the total inventory will be rendered functionally obsolete, requiring repositioning or repurposing to achieve high occupancy.

Opportunity

From a strategic standpoint, our perspective is that there are potentially two ways to approach the office sector in 2023. First, tuning into the "flight-to-quality" trend in the office market which is a trend where tenants are increasingly disqualifying older and functionally obsolete projects while opting into newer or repositioned projects that offer modern amenities to uplift the office experience.

We believe that high-quality office assets with strong tenants, long weighted average lease terms (five to 10 years), and priced at a going in yield that fits the current state of the market, could enable investors to ride out the current storm and possibly exit later this decade when greater certainty for the sector may return.

> Despite a negative outlook for the office sector, the level of emerging distress suggests some office projects may be mispriced, which will reset the basis to a lower bar.

Our second strategy centers on creatively restructuring distressed assets that are deeply discounted relative to their 2019 values. Despite a negative outlook for the office sector, the level of emerging distress suggests some office projects may be mispriced, which will reset the basis to a lower bar.

Investors can approach distressed office deals in two ways, either by purchasing the real estate directly from a seller or by acquiring through alternative routes such as bank foreclosures or discounted note purchases. Such transactions by nature could present high risk going in but we believe there is potential that this strategy could translate into upside scenarios later this decade when the office sector exits its recession.

Chapter 01: Major Asset Classes

Section 05: Retail

Outlook

Retail was undeniably one of the hardest hit sectors during the pandemic, but it has made notable strides in its recovery. In fact, CBRE reported that 2022 was one of retail's "best years," with strong performance among neighborhood, community and strip centers, while lifestyle and mall segments performed inconsistently. It's important to note that retail is a mixed bag of subtypes and the outlook is varied as such. Retail activity in neighborhood and community centers is expected to remain generally strong, especially in stores with essential products and services, while power centers may be exposed to a higher level of risk as they are more vulnerable to e-commerce growth with higher capital expenditures.

> Retail activity in neighborhood and community centers is expected to remain generally strong, especially in stores with essential products and services.

CoStar reports that retail rents in the United States grew at their fastest pace in over a decade in 2022 due to tight market fundamentals, low availability rates, and low numbers of projects in the pipeline across the nation. In a year dominated by negative news, the performance of the retail sector didn't fit that narrative and, as a result, it was not a story that garnered attention. Gleaning from CoStar data, retail occupancy is expected to remain relatively high (in the 95%+ range), however, rent growth is expected to temper slightly but remain positive.

Figure 7:
Retail Market Fundamentals

Source: Retail, United States, CoStar Data, as of May 2023.

Despite the solid year the retail sector enjoyed, there are macro headwinds in 2023 that could dampen further recovery. Consumers are "feeling the pinch" of high inflation with increased credit card purchases and erosion of real income, according to a report by Green Street, suggesting that the near future could bring challenges to the retail sector.[15]

Immediately after the pandemic, the consumer savings rate had jumped to an anomalous 30%, which has now dropped all the way back down to about 5.1% (Bureau of Economic Analysis data as of April 28, 2023 release). Retail sales data from the previous few months suggests that with rising interest rates and uncertainty in the market, consumers have pulled back on their spending habits. Some of consumer's conscious spending habits were to avoid discretionary activity while they continued shopping more for essential or "core" retail such as grocery stores, general merchandise, beauty, health, medical, and online sales, etc.

15"U.S. Strip Outlook, 2023," Green Street, 2023.

Opportunity

Despite what the headlines are touting against it, retail may be an overlooked asset class from an investment standpoint. We believe that Retail is in the next phase of its evolution with a narrow window of opportunity, especially in grocery-anchored and neighborhood centers. We published an article in 2022 titled "Retail Real Estate Investments are Back in Style" going into more detail about why we believed that the sector was sitting in an interesting spot with many tailwinds that could potentially benefit its recovery.

First, foot traffic has returned to physical retail stores. For the first time since 2017, sales growth in physical retail stores surpassed online sales growth in 2021, helping to push up the profitability of physical retail which was severely hit during the pandemic.

Second, retail centers that are functioning generally well today may have a chance of functioning well moving forward because they were able to endure the brunt of the pandemic which brought a unique set of challenges.

Third, CoStar data shows that retail has strong fundamentals as compared to its recent history, with low availability and a dearth of supply, with only about 0.5% of its inventory under construction. Therefore, we believe that retail is set up to experience demand that will outstrip supply in upcoming years. Until new supply can be generated to meet demand, which could take years, we believe the current discount to replacement cost for retail will narrow over the next few years, possibly leading to some cap rate compression.

> Despite what the headlines are touting against it, retail may be an overlooked asset class from an investment standpoint.

We will continue to tune into retail, particularly grocery-anchored stores in well-located, neighborhood or community centers, as opposed to traditional shopping malls or second-tier big-box stores. The reason for our focused admiration is based primarily on the performance of grocery-anchored retail. CBRE reported that roughly $14.6 billion of grocery-anchored centers traded in 2022, (which was up 24% year-over-year and the highest number in over a decade) in a year that was considered a down year for CRE transactions, overall.

The non-discretionary nature of grocery shopping keeps the fire burning for this industry sector and is one of the reasons why retail had a pulse during the depths of the pandemic while activity in many other non-essential stores had come to a complete halt.

There is one major financial strategy that we will pay attention to when considering retail investments and that is the potential to enter a deal at **positive leverage** which is difficult to achieve in today's high interest rate climate for many asset classes, especially those with very low cap rates.

Retail cap rates are currently in the 5.0% to 7.5% range, depending on the type of retail and its vintage, according to Green Street.[15] This makes retail a potential candidate for achieving positive leverage at acquisition. Positive leverage occurs when the debt costs less to service than the cash flow received from the leveraged portion of the project (negative leverage is the opposite, when the debt service exceeds the cash flow on the leveraged portion of the project). Another way to tell if leverage is positive is when the operating cap rate from a deal is greater than the interest rate of its debt.

We feel that retail assets today (especially grocery-anchored neighborhood centers) have a unique pairing of strong market fundamentals, surging demand, low supply collectively achieving durable cash flow and a potential for positive leverage at acquisition. And as such, we will continue to seek retail opportunities that fit this criteria.

15"U.S. Strip Outlook, 2023," Green Street, 2023.

Chapter 02: Niche Asset Classes

Section 01: Self-Storage

Outlook

The self-storage sector has boomed over the last decade, but it experienced decelerating market fundamentals over the three years prior to the COVID-19 pandemic. During the pandemic, demand for self-storage space spiked again, bolstered by COVID-19-related migration.

With increased flexibility offered by work from home trends, people moved across states, as well as intrastate, from urban to suburban locations. People also moved in with their parents and/or decided to share housing expenses by adding roommates, leading to a reversal of household formation, which further increased demand for self-storage.

> We've seen market fundamentals for self-storage soften over the last year with modest cap rate expansion, declining prices, moderating rent growth, and a bearish outlook for NOI growth.

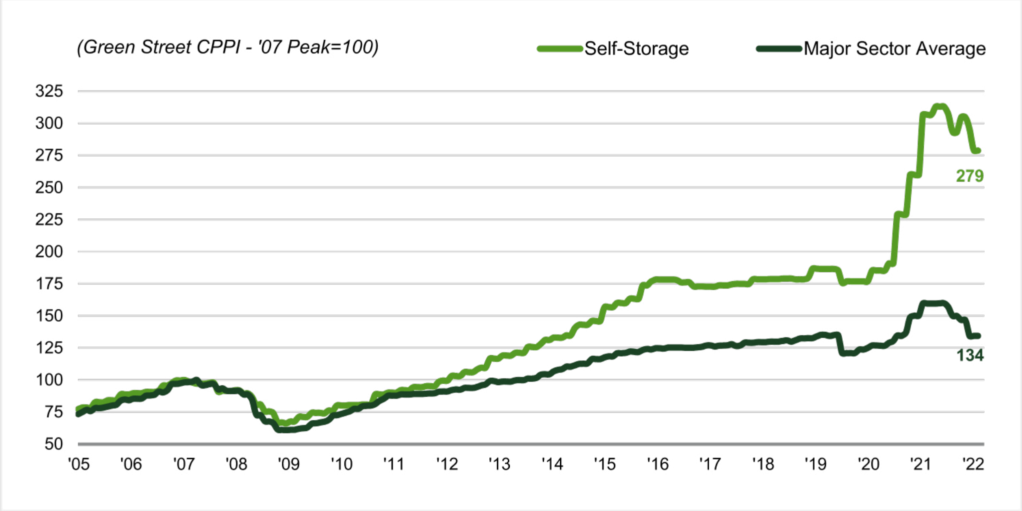
Green Street reported that increased migration and movement improved self-storage operating fundamentals over the last three years. Occupancy in self-storage units achieved levels never seen before, ranging from 94% to 96%, nationwide.[16] Resultantly, prices appreciated by 64% in 2021 compared to 2019 levels. That level of performance would have been challenging for the sector to sustain so, not surprisingly, we've seen market fundamentals for self-storage soften over the last year with modest cap rate expansion, declining prices, moderating rent growth, and a bearish outlook for NOI growth.[16]

16 "U.S. Self-Storage Outlook," Green Street, 2023.

Figure 7:

Self-Storage Asset Values by Year

Source: Green Street - U.S. Self-Storage Outlook, 2023.



It appears that the pandemic-fueled exponential growth the self-storage sector enjoyed over the past few years may now be receding to historical norms with a reversion to seasonal patterns, lower overall mobility and some people returning back to the office. However, according to Inside Self-Storage, "drivers such as displacement, home remodels, migration, divorce, home/office downsizing and retirement" continue to keep self-storage in high demand.

Unrestrained supply has historically been risky for self-storage operating fundamentals because of the downward pressure it imposes on rents. But this risk is expected to remain relatively low, at least for the next few years.

Opportunity

Opportunities to develop new storage facilities continue to present themselves (albeit at a slowing pace,) especially with the increased institutionalization of the sector that has gained traction over the past decade. Older self-storage facilities often lack amenities such as climate control, modern security systems, and self-serve kiosks, creating opportunities to supply in-demand and modern self-storage facilities.

Developing these assets is relatively simple as compared to other real estate asset classes. Thus, in a labor-constrained construction market where hard costs are still increasing, the higher probability of cost certainty and speed to deliver self-storage facilities can make them a viable option. While we are primarily focused on ground up development, we also like adaptive reuse projects as oftentimes they are situated in favorable in-fill locations such as a retail center on a busy thoroughfare.

> Older self-storage facilities often lack amenities such as climate control, modern security systems, and self-serve kiosks, creating opportunities to supply in-demand and modern self-storage facilities.

Once they are stabilized, self-storage projects can also help mitigate the effects of inflation due to the owner's ability to change rents as frequently as a monthly basis which makes it one of the more adaptable asset classes to periods of high inflation. The nature of tenants also tends to be sticky, meaning most keep their belongings in facilities once they have stored them, rather than remove them due to an uptick in monthly rents.

We believe in the long-term prospects of this sector because of its growing and resilient demand but we are approaching the short-term cautiously to address the softening of market fundamentals. However, the continued need for self-storage due to migratory trends and a prevalence of remote work will likely continue over the course of the next cycle.

Chapter 02: Niche Asset Classes

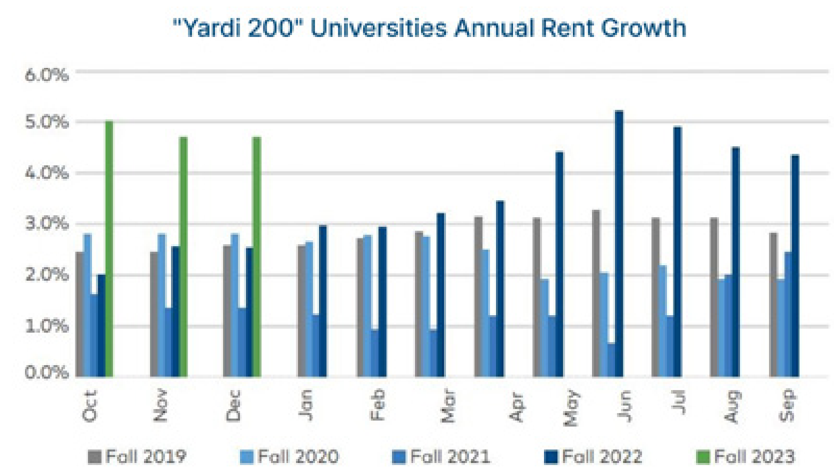
Section 02: Student Housing

Outlook

Despite headwinds in the student housing sector related to declining enrollment in higher education, Yardi reported that pre-leasing reached an all-time high in 2023. As of March 2023, pre-leasing was at 69.7% of beds at “Yardi 200” universities, up by 7.8% year-over-year. Yardi recorded that rents were up 7.0% annually, but transaction volume was down significantly, recording $148 million in Q1 2023 compared to $1.5 billion during the same quarter last year.

Figure 10:
Student Housing Pre Leasing by Year

Source: National Student Housing Report, Yardi Matrix, 2023.



Looking at larger demographic trends, it appears that overall reduced enrollment in colleges and universities, combined with declining birth rates, may pose future challenges to a number of schools. At a national level, college enrollment has been on the decline **since 2012** and potential factors that have contributed to this decline may include the cost associated with obtaining a post secondary education combined with a relatively strong labor market.

> It appears that overall reduced enrollment in colleges and universities, combined with declining birth rates, may pose future challenges to a number of schools.

Observing the overall trend of declining enrollment and how it impacts investment in the student housing sector, one could suspect that this equates to sustained negative headwinds. However, as Yardi reported in their most recent **quarterly update** on student housing, there are, in fact, many universities that are experiencing strong growth in applications and enrollment. In fact, Yardi states that some of the most desirable and best-capitalized flagship universities, with selective admissions, strong athletic conferences, and brand recognition, are showing the ability to attract students as their enrollment is growing.

Opportunity

We see the opportunity in the student housing sector as dichotomous with location playing a key role in choosing the right investment. We believe the more desirable and well capitalized flagship universities will exploit their competitive advantage to attract students. This could propel the student housing markets in areas with large universities at the expense of markets with smaller institutions and community colleges, especially those with declining enrollment.

This leads us to be generally bullish on Tier I universities with large endowments (schools that are expected to bring in **at least $100 million per year in research grants**, plus have selective admissions and high-quality faculty), particularly those with large student populations, strong research programs, and affiliated with major conferences.

> We are seeing several markets that are reporting shortages within the sector which may provide attractive development opportunities in the next few years.

We are focused on deals where the current and projected student enrollment is strong enough to match the current and projected supply of student housing in particular micro markets. Not only do you need adequate demand but you must also factor in "shadow inventory"—means off-market properties in the surrounding community of that market. That's why we are highly attuned to finding the right location and tend to favor those areas that are in close walking proximity to campus. We are seeing several markets that are reporting shortages within the sector which may provide attractive development opportunities in the next few years.

Though we expect more educational institutions to adopt a blended learning approach, with both in-person and online courses, there is little evidence to support that this blended approach will significantly affect the student populations on campuses, considering that in-person college experience is still important to students.

Overall, we see an opportunity in this sector and will focus on areas surrounding some of the top-tier universities with a prudent supply of new housing relative to forecasted demand.

Chapter 02: Niche Asset Classes

Section 03: Life Sciences

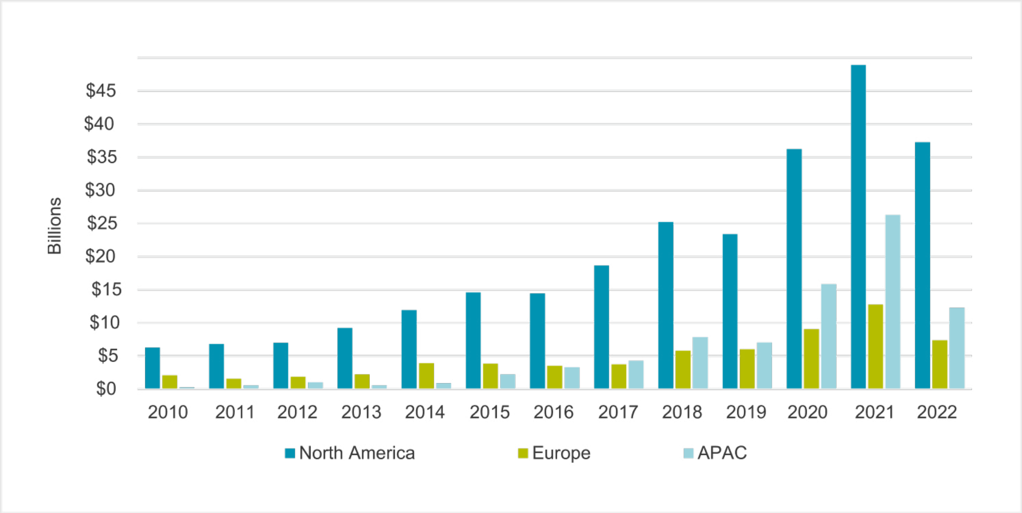
Outlook

As reported by Cushman & Wakefield, life sciences is an emerging commercial real estate sector with double-digit rent growth, single-digit vacancy rates, and strong investment flows within the last 10 years. A record $63.7 billion of private and public capital pouring into life sciences-related companies in the U.S. in 2021.

The growth in the sector, especially following its popularity among investors after the COVID-19 pandemic, was a 103% increase in 2022 from the $31.3 billion received in 2018. Recent growth in funding, however, slowed down in 2022 to normalized levels and totaled $49.2 billion, down 23% from its 2021 peak. Deceleration in funding was more pronounced in public capital but less so for the venture capital private sector.

Figure 11:
Life Sciences Venture Capital by Year

Source: Life Sciences Update, Cushman & Wakefield, March 2023.

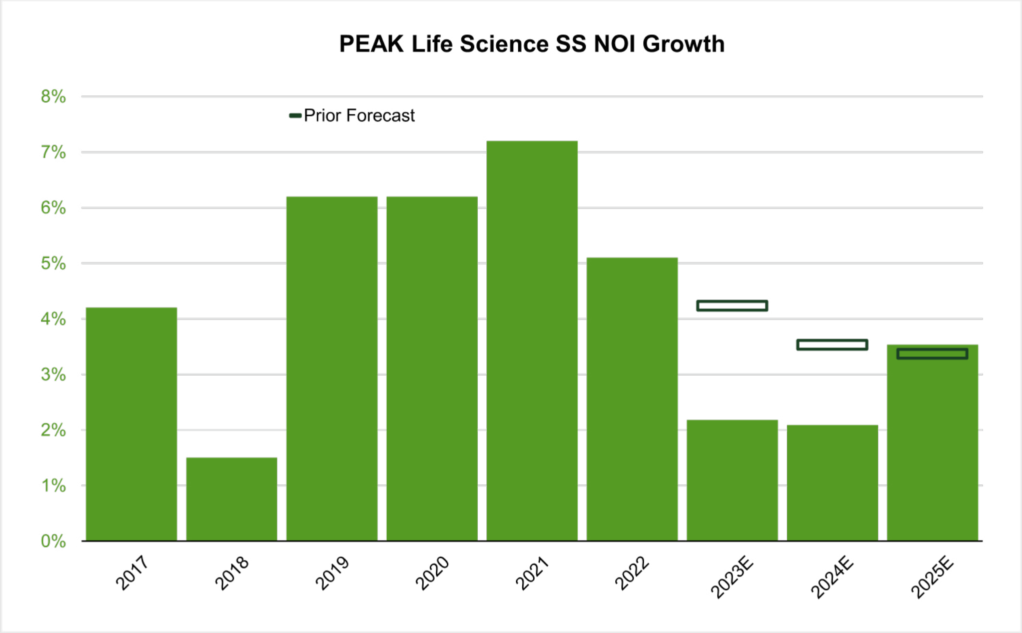


The collapse of Silicon Valley Bank may further slow funding for biotech over the next few years. Investment was already dipping due to waning interest from investors who are shying away and moving toward seemingly safer investments with less risk in the face of rising interest rates.

Green Street states in their “Health Care Sector Update: Never a Dull Moment” report that the life sciences sector will see “leaner days,” with short-term NOI growth forecasts cut down by almost half for 2023 and 2024 in the face of “a higher probability of life science tenant bankruptcies and lower go-forward demand for space.”

Figure 11:
Life Sciences Venture Capital by Year

Source: Life Sciences Update, Cushman & Wakefield, March 2023.



Shockwaves from the headwinds in the banking sector, combined with limited and more expensive capital, may take some demand out, especially for early-stage incubators.

However, the relatively slow anticipated growth in capital funding from its highs does not necessarily mean that the long-term outlook is bleak. The long-term drivers for the life sciences sector remain intact. PWC anticipates the life sciences sector will continue to invest in oncology, gene therapy, neurology, and cardiology for the foreseeable future.

Opportunity

Even with a tapering outlook, identifying an attractive life sciences opportunity is still possible, perhaps not as plentiful an opportunity as the market presented back in 2021. Suitable life sciences projects are still relatively rare. Tenants require highly specialized real estate, which is tough to come by—appropriate ceiling heights, robust power, high floor load capacity, venting, excess plumbing, and freight elevators.

> We continue to see opportunities as greater near bustling urban environments, especially in areas with top talent, high intellectual capital, and the presence of top research universities.

In addition, life sciences tenants need to consider the overall feasibility of the building for their specialized operations. Availability for lab space and R&D facilities is still tight nationwide at 5.7% on average, leading to rising rents.

Upcoming supply, however, is providing some relief in extremely tight markets such as Boston-Cambridge, the San Francisco Bay Area, and San Diego. The Boston-Cambridge life sciences market, for instance, had the tightest vacancy in the nation at one percent in 2021 - that vacancy has now jumped up to about 3% as of March 2023.

A unique aspect of life sciences occupiers is that they tend to cluster around specific markets, making it almost the antithesis of the current decentralization phenomenon witnessed in the traditional office sector. We continue to see opportunities as greater near bustling urban environments, especially in areas with top talent, high intellectual capital, and the presence of top research universities.

In a report by CBRE, the top markets for life sciences real estate include Boston, the San Francisco Bay Area, and San Diego, where demand grew by more than 34% since mid-2020, with significant rent growth, tightening vacancies, and pre-leasing in new projects. Therefore, we prefer ground-up developments in these clusters, especially where demand is outstripping current supply.

Additionally, we prefer creative opportunities to reposition existing properties when they are suitable for conversion. Converting existing office properties to life sciences uses is complex, so we're placing heightened sensitivity on the convertibility of the asset and the experience of the sponsor.

Chapter 03

Outlook by Geography

The tides have turned to some degree on surging market dynamics, especially in 18-hour cities, a trend that immediately followed the COVID-19 pandemic. We are now honing our focus on cities that we view as well positioned to provide opportunities in a market that is actively normalizing. Within these cities, we are zooming in further on micro markets or submarkets where deals make sense in the current high interest rate environment.

Our strategy is to go "back to the basics" when approaching markets to invest. By keeping a close eye on short-term concerns related to high inflation, tempered rent growth, oversupply risk, and high cost of capital, we will prioritize pockets where we see potential for stable rent growth, strong absorption rates, continued job growth, and strong median household income growth.

> The long-term outlook still appears attractive for some of the previously fastest growing markets but the current market dynamic must be priced in.

To counter some of the headwinds in the current environment, first and foremost, we prefer markets that rank higher in relative affordability, which brings our focus to Texas markets – Houston and San Antonio, and coastal markets – San Diego, Fort Lauderdale, and Tampa among others.

While affordability is one major factor, we are also cautious about rent growth prospects in certain markets, especially in many of our perennial secondary markets such as Austin, Atlanta, and Nashville, which had experienced outsized rent growth and asset appreciation after the pandemic and are now showing an outlook of tempered rent growth. Although future growth potential remains relatively attractive for these markets, in the short-term we are approaching selective assets based on strong NOI projections.

We are also seeking appropriate discounts relative to peak pricing when considering these locations. Furthermore, we are sensitive to the increase in supply in many of the previously high-growth markets and are tracking the possibility of some of them overshooting in the short-term which can be a concern from a demand standpoint. The long-term outlook still appears attractive for some of the previously growing markets but the current market dynamic must be priced in.

> All boats rise in a rising tide, but in a correction scenario, secondary and tertiary markets tend to get hit harder.

Lastly, our strategy is to focus back on certain **primary markets**, especially Boston, and New York, which have witnessed tremendous cap rate compression in the last three to five years. Now that some of these markets have repriced, we are discovering a re-emergence of relative value or "better bang for the buck".

Such markets also benefit from stronger in-place infrastructure which can serve them well when other markets pause or slow their growth. All boats rise in a rising tide, but in a correction scenario, secondary and tertiary markets tend to get hit harder while primary markets tend to provide safety due to their inherent economic stability.

Chapter 04

Closing Statement

“ With CRE prices down last year, debt markets still in a state of disarray, and what feels like a near certainty that a recession is in store, it would be logical to have a bearish outlook. Instead, I see an environment where a strategy of patiently scouring the market for mispriced opportunities could lead to upside scenarios later this decade. And most of the ‘why’ is summed up in the maxim, ‘Things are rarely as good or as bad as they seem at the time.’

Ian Formigle
Chief Investment Officer
CrowdStreet Advisors

Continued on next page

The whirlwind of events over the past few years has led us to a market dynamic that has completely transformed the CRE investing space, from both a lending and pricing standpoint. It's been more than a year since the Fed frantically started raising interest rates to extinguish the flames of high inflation. In that effort, the capital markets, which are the bloodline of CRE transactions, have come to a near standstill. First quarter 2023 transaction volume was down 56% year-over-year, according to MSCI Real Capital Analytics, and we have likely not witnessed the bottom from a velocity standpoint.

Figure 13:
Commercial Real Estate Transaction Volume by Quarter

Source: MSCI Real Capital Analytics, Q1 2023.

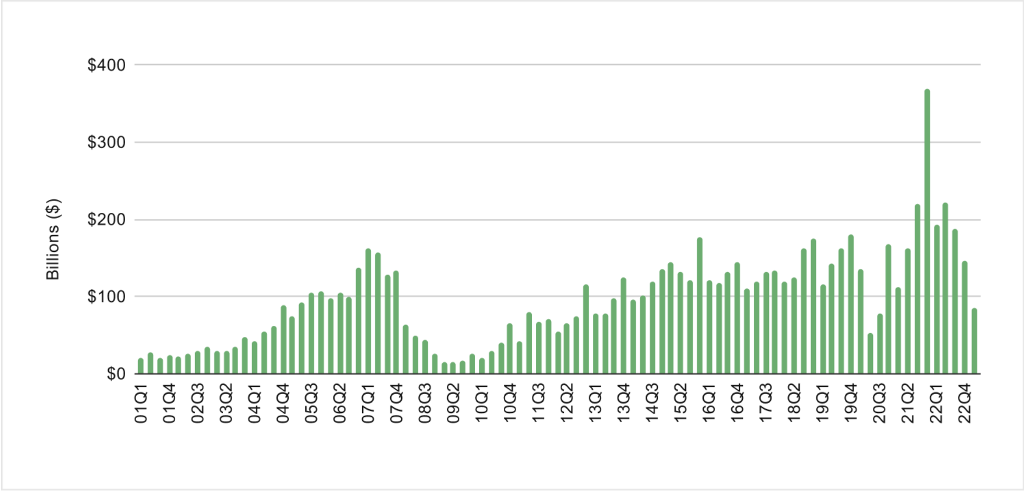
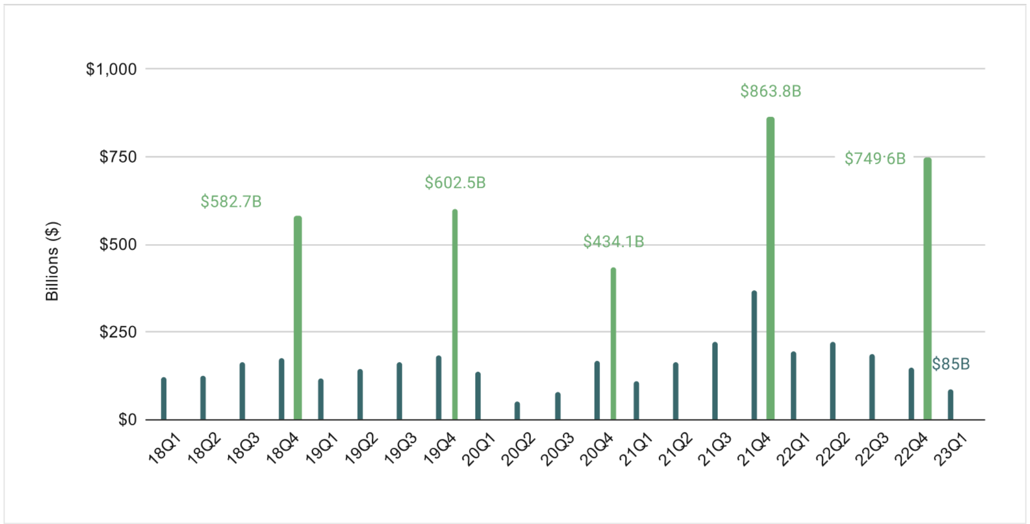


Figure 14:
Commercial Real Estate Transaction Volume by Year

Source: MSCI Real Capital Analytics, Q1 2023.



In today's market environment:

1

Debt financing for CRE will likely remain scarce for the remainder of the year.

Many lenders continue to stay on the sidelines and underwriting standards are arguably as stringent as they were coming out of the Global Financial Crisis (GFC). To the extent that debt financing is available, it is punitively expensive. While high levels of friction in deal making are likely to persist in the immediate future, it does create niche opportunities for creative financing such as private senior debt, middle tranche solutions such as mezzanine debt and/or **preferred equity**, and scenarios to avoid an undesirable transaction market altogether through recapitalizations.

2

It's bargain shopping season.

The CRE market is reverting back to the mean from a pricing standpoint. Prices have declined considerably from their March 2022 peak (Green Street states it as down ~15% from its peak, as of May 2023) since the Fed started raising interest rates. Many projects are at a discount to peak pricing. Absolute troughs are only known in retrospect but pricing for multiple sectors currently stands below its 25-year trend as discussed in my **March memo**.

3

The overall market is in financial distress but remains largely removed from operational distress, except for the office sector.

Underlying fundamentals for most CRE asset classes remain intact but are at moderate levels relative to the strong growth that the market experienced in 2021. Currently, among other major CRE asset classes which include retail, multifamily and industrial, office is the only asset class that, according to national data by CoStar, is expected to experience negative rent growth for the next three years as it is in a uniquely devastating recessionary cycle of its own.

The remaining major CRE asset classes in CoStar's forecast are expected to show positive rent growth during that time. In comparison, from 2008 to 2010 during the GFC, every other major CRE asset class with the exception of multifamily experienced three years of negative rent growth. As for occupancy levels, according to Costar, the industrial and retail sectors may remain above long-term averages while multifamily is expected to experience a one-year spike in vacancy in 2024, then to trend upward by around 2026.

With that said...

We are assuming tempered future rent growth projections with slightly higher vacancy assumptions. But overall, the outlook suggests moderate continued demand for CRE.

While uncertainty remains, depressed levels of transaction volume and institutional investor activity can often benefit private investors. A relative scarcity of equity capital in the broader market is compelling operators and developers to offer private investors the types of deal structure incentives we haven't seen since the depths of the pandemic. Such incentives can include increased percentages designated for preferred returns (before a disproportionate share of profits kicks in for the sponsor), increased splits to limited partners above preferred returns, reduced fees to sponsors and, in certain instances, profits participation with the sponsor.

The dry powder is out there, but it is currently on the sidelines. Once institutions re-enter the market in force, I anticipate that it may lead to a normalization of deal terms and an end to the dynamic of exceptional investor-friendly structures.

Overall, these transition times can provide a window of opportunity for private capital to invest as the large pools of institutional capital sit and wait for continued data to support a market recovery. While fewer in number, the deals that do transact in 2023 may prove to be relative values in the years ahead.

Ian Formigle
Chief Investment Officer
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About the Author

Ian Formigle is the Chief Investment Officer for CrowdStreet Advisors. He has more than 25 years of experience in real estate private equity, startups, and equity and options trading.

Ian is a respected industry thought leader who serves on ULI's Redevelopment and Reuse Council and has served as a contributing author to Forbes.com.

Ian attended the University of California at Berkeley where he obtained a Bachelor of Arts in Economics and a Bachelor of Arts in Political Science.

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