When Will Real Estate Hit Bottom? September 2024

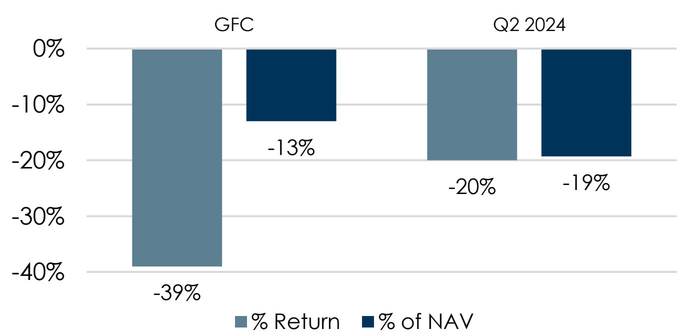
- **Exit queues grew to a record 19% of NAV across the core real estate NFI-ODCE Index as of 2Q 2024.**
- **Recent NFI-ODCE rule changes introduce drivers of secular differentiation and future return dispersion.**
- **Looking ahead, multiple indicators signal an upcoming start to market clearing activity – and investment opportunity.**

The Drawdown

Since 1Q 2022, NFI-ODCE (ODCE) exit queues ballooned from 5% to 19% of index NAV, which on a relative basis is 46% greater than the peak of the real-estate led Great Financial Crisis. As of 2Q 2024, over $38 billion in NAV awaited redemption payout across ODCE constituent core real estate funds.

The precise rationale underpinning investor redemptions varies, but the move reflected broad post-Covid concern about the go-forward prospects for older, CBD office properties and the sudden, sustained jump in prevailing interest rates. The once-brisk transaction market came to a virtual standstill and struggled to restart. Consequently, declining asset values outweighed steady income returns, resulting in a drawdown of almost 20% through 2Q 2024.

ODCE Drawdown (% Return) vs ODCE Exit Queue (% of NAV)



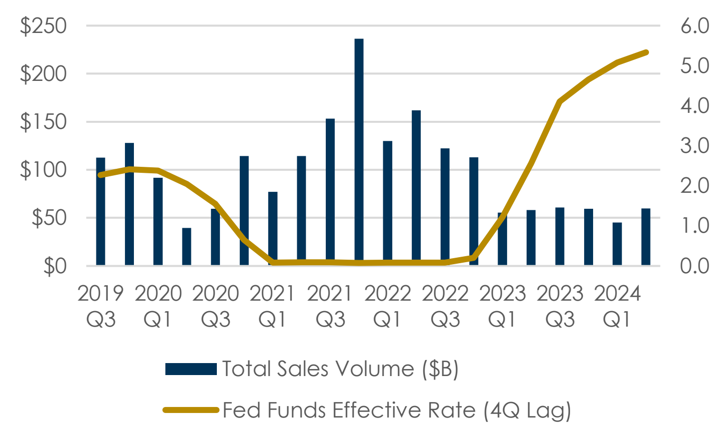
Source: NCREIF, IDR, ACG

Evolution of an Opportunity Set

ODCE has long been the cornerstone of institutional investors' "core" private real estate allocation, known for its high-quality, large-scale, and strategically located assets. Historically, the index maintained diversified exposure across apartments, industrial, office, and retail properties, with minimal inclusion of "alternative" property types like medical office, manufactured housing or student housing. This structure reliably fulfilled its role as a portfolio diversifier, offering low correlation to public equities and fixed income while delivering consistent, attractive long-term returns.

In Q2 2024, ODCE introduced new rule changes, expanding the inclusion criteria for its constituents. Six property sub-types previously categorized as "alternative" now fall under the primary property types, broadening managers' scope for allocation. This shift aligns ODCE more closely with the broader real estate investment community, which increasingly recognized the investability of "alternative" property types highlighted by the NAREIT index's 48% allocation to alternatives in 2023 compared to NFI-ODCE's 9%. As core and core-plus portfolios turn over in the coming years, investors should expect greater portfolio differentiation by property type and increased return dispersion. Both underscore the importance of manager selection and active monitoring in achieving long-term performance.

Fed Funds Rate (4Q Lag) vs CRE Transaction Volumes ($B)



Source: CoStar, Bloomberg, ACG

Green Shoots

But what about that exit queue? As of the end of 2Q 2024, the real estate deep freeze showed early signs of a thaw.

On the property side, Q2 transaction activity held steady year-over-year, permitting some level of ODCE redemption payments and reinvestment. Growth in construction materials costs, which averaged 15% in both 2021 and 2022, fell drastically just as the forward development pipeline narrowed, setting up firm fundamentals into 2026-27. Resilient developers are sharpening their pencils to deliver profitable projects. Disinflation continues, raising the likelihood of key interest rate cuts that in time will help lower the cost of capital and support transaction volumes. Importantly, economic growth persists.

On the technical side, some ODCE managers rolled out fee structures to incentivize investors to reduce their active redemption dollars, at least temporarily. This not only buys time, it can actually grant funds greater room to maneuver long-term – provided managers deliver on the promised redemption payout schedule.

Given investors' strained stance toward core real estate, it is reasonable to expect a sluggish pace of transaction activity to prevail for some time. After all, ODCE returns fell 20% over seven straight quarters. Yet here it is instructive to recall the GFC, when ODCE experienced a peak-to-trough decline of 39% over 6 quarters. Then within two quarters, exit queues equivalent to 13% of NAV flipped into entry queues equivalent to 12% of NAV.

ACG's Position

The current investment environment exemplifies why implementation plans exist. Maintaining discipline and available dry powder can be a powerful tool in a long-term investor's kit. Investors are wise to actively monitor existing exposure while considering rebalancing or adding exposure to high-conviction strategies.

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