Market Outlook 2024

MaxCap Group Research – January 2024

New year, old challenges

Staying alive. After a tumultuous 2023, global real estate investors are bracing for more difficult conditions in 2024, perhaps this is best summed up by the industry catch cry of "stay alive 'til '25" to illustrate the challenges of high interest rates, lower values and rising distress.

Survive and thrive. In this context, investors are looking more broadly for demand growth and resilient returns, leading many to the relatively stable and less correlated markets of Australia and New Zealand, where firm population gains are driving an unfolding surge in demand.

The big pivots. With interest rates holding higher for longer, passive and levered real estate strategies reliant on cheap debt no longer work. Indeed, investors are keenly reallocating from passive to active, from office / retail to living / logistics and from equity to credit.

Seeking shelter. Changing demand and falling prices are locking in underperformance for specific sectors for years ahead. Passive rent collection is challenging. Levered beta is strained by elevated rates. Instead, look to firmer sectors, alpha generation and resilient credit.

Life in the fast lane. Undoubtedly, residential is shaping up as the standout sector for the year ahead, given rapid population growth, alongside diminished supply, driving marked undersupply. Already, housing markets are responding with broad gains in rents and values.

Tips for navigating 2024. Given this market outlook, our three pieces of advice for the year ahead are… seek shelter (from underperforming sectors), take more credit (to improve portfolio returns) and live a little (and track the robust drivers for residential and other living sectors).

Finding growth and opportunity

Looking back, **2023** was a difficult year, with economic uncertainty being the new norm. High inflation has led to aggressive rate increases. For investors, uneven earnings growth, negative real bond yields and struggling real estate occupancy have all adversely hit portfolio returns.

Looking ahead, **2024** carries many similar themes, with some added risks.

- **Economic growth** is set to weaken further. High borrowing costs are impacting harshly on consumer spending, while a softer global environment puts a heavy dampener on commodity exports to Asia.
- **Inflation** is past its cyclical peak, but the return to normal is not expected until 2025. A volatile oil price is the main risk to the moderation in construction costs and recovery in builder profit margins.
- Many **uncertainties** persist. Wars in Ukraine and Gaza rage on, with no obvious resolutions in sight. The US Presidential election may drive abrupt policy shifts by year-end. Meanwhile, meteorologists are calling for warmer temperatures and higher rainfalls in early 2024.

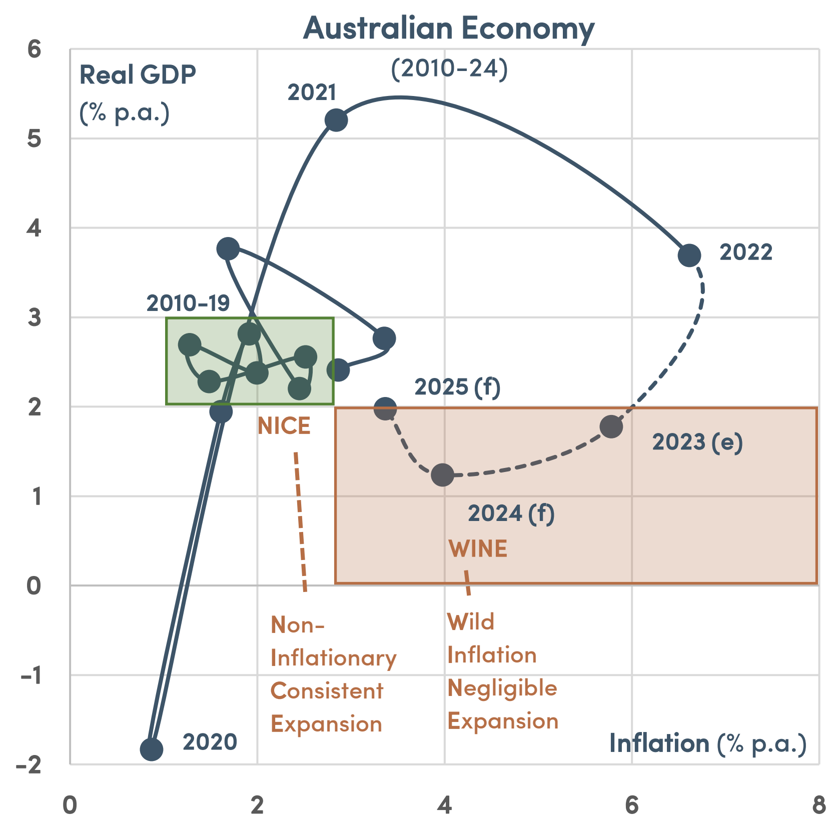
Amid these challenges, we do see **islands of growth and opportunity**.

- Australia and New Zealand are still well-regarded **safe havens** for people and capital looking for economic and market stability. Big population booms are unfolding right now, given the surge in inbound migrants. Capital inflows are set to follow as investors keenly seek out markets with relatively firmer demand growth and returns resilience.

"We are very excited by the year ahead. There are clear opportunities to deliver resilient investor returns in what is still a challenging market landscape. MaxCap is extremely well positioned to help investors take advantage."

Wayne Lasky Executive Chairman

The world of slow growth and high inflation is likely to persist into 2024 and beyond, driving investors to look for sustained demand growth and resilient returns.



Source: International Monetary Fund, MaxCap Group (January 2024)

Capitalising on change

For many investors, the year ahead presents some urgent choices.

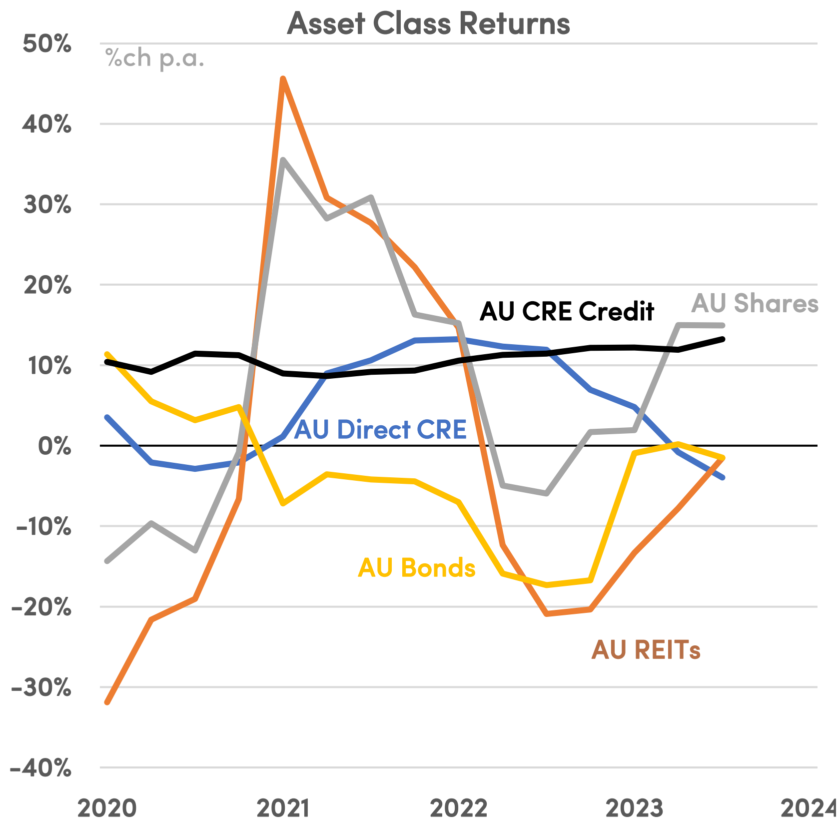
- **It is harder to find diversified returns.** While it is somewhat troubling to see subdued returns across many asset classes like equity, bonds, real estate and infrastructure, what is more concerning is the reduced diversification in this stagflationary market environment. Portfolio returns are softening because of this synchronised slowdown.
- **Real estate strained by high rates.** At the same time, real estate is likely to see a rising tide of global distress in 2024, given sluggish demand, falling values and depressed returns expectations. Indeed, passive rent collection models no longer work with higher borrowing costs. Hence the rather bearish industry catch cry of "stay alive 'til '25".
- **Making the big switch.** This new market landscape requires different strategies for capital allocation. Specifically, investors need to explicitly address several factors like patchy growth, elevated inflation and high rates. Beta returns are weaker in this environment, while there is more scope for alpha returns from active market / sector selection.
- **Avoiding entrenched underperformance.** Looking ahead, we expect this wide gap in performance to persist for several years ahead, prompting investors to make urgent pivots from passive to active, from office & retail to living & logistics, and from a traditional focus skewed to private equity to more one skewed towards private credit.

In our view, 2024 presents a prime window to reset these allocations.

"Investors have many compelling reasons to remix their portfolios in 2024, to increase investment returns, to hedge against high rates, to improve portfolio resilience and to avoid areas of sustained underperformance."

Robert Hattersley Group Head of Capital

There are clear investment trends return unfolding right now, with sluggish returns across many segments and more concerning signs of diminished diversification.



Source: APRA, Bloomberg, MSCI, MaxCap Group (January 2024). AU CRE credit based on unweighted mix of MaxCap's CRE debt strategies. Past performance is not a guarantee of future performance.

Taking more credit

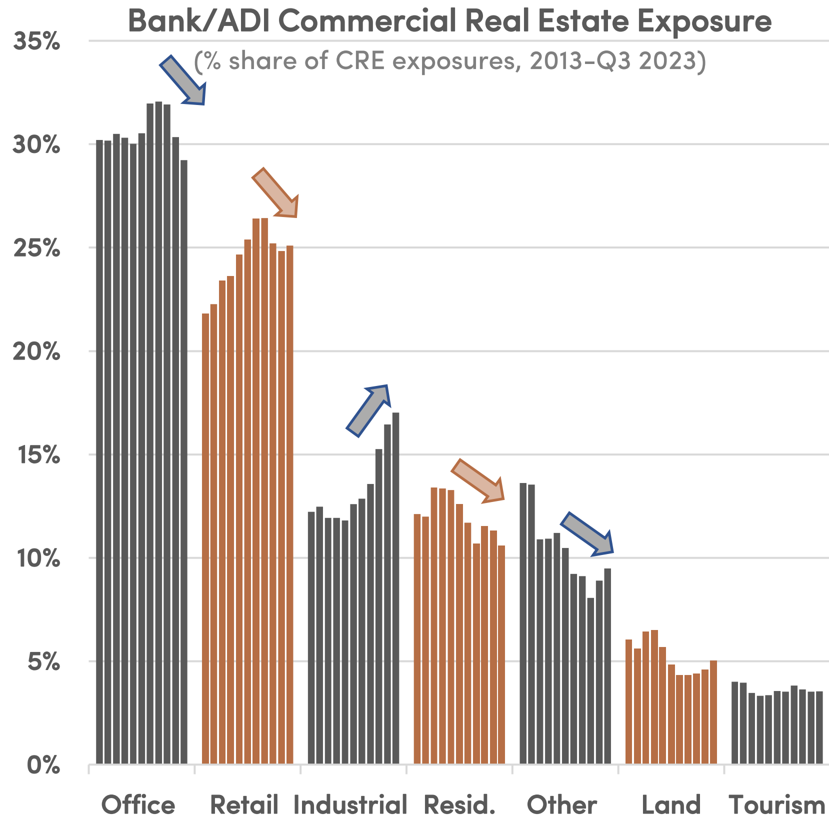
In this market environment, there are still exceptionally strong tailwinds supporting **real estate credit** in 2024 and beyond.

- **The ultimate rate hedge.** With a convincing end of zero interest rate policy, the outlook for rates is set to remain higher for longer. Many investors have been slow to back out of levered beta strategies and into floating rate credit, to the clear detriment of portfolio returns.
- **Sustained credit resilience.** Amid a moderate real estate market correction, the credit position continues to hold up strongly. While real estate equity returns have faded with softening occupancy and prices, real estate credit returns continue to deliver steady, robust returns.
- **A focus on living.** There is a clear shortfall of credit for residential construction ahead, as banks shift out of lending segments with high capital charges, at a time of robust migration and persistent undersupply. Rising prices and rents are restoring project feasibility.
- **Keeping loan books healthy.** Cost inflation has moderated since the peak in 2022, which allowed construction companies to rebuild profit margins. Active loan book management is vital right now, to ensure good visibility on borrower cash flows and timely loan repayments.
- **Upgrading your sponsors.** Indeed, this is a great time to be focusing on sponsor quality. The stronger developers continued to deliver and repay even through the most challenging period in 2022, and now stand to benefit from the recoveries in selling prices and profit margins.

"We are seeing deep opportunity sets for real estate credit from our origination teams. For us, the main focus for the year ahead is to support high-quality low-risk sponsors, who have good track records and strong balance sheets."

Bill McWilliams Chief Investment Officer

The bank lending landscape is continuing to change, in line with regulator-mandated capital charges for writing loans across different commercial real estate sectors.



Source: APRA, MaxCap Group (January 2024)

Selecting for success

For real estate equity, we see widening gaps in performance ahead, driving the need for astute **market and sector selection**.

- **More roofs over more heads.** Strong migration is driving demand for all types of housing, from inner-city apartments to urban-fringe land subdivisions. With a lagging supply response, there is still more upside to rents and values ahead, despite high mortgage interest rates.
- **Living in all its forms.** Robust housing demand is also spilling out to associated living sectors, including student accommodation, hotels, co-living, senior housing and build-to-rent / multifamily. In our view, some segments are more capital-ready than others, with student accommodation likely to be a leading segment over the next few years.
- **Logistics running a little less hot.** The structural rise of logistics is still intact, on the backs of online shopping and inventory hoarding. That said, the rise in funding costs is weighing on pricing in the near term, while rental growth eases back to a more sustainable pace.
- **Office & retail face further adjustments.** Investor demand and asset pricing are slowing for both. The turning points ahead are likely to be different. Office needs a deeper pricing correction to entice the return of buyers, while retail needs lower mortgage rates to support shoppers.

In our view, **sector selection** is still a big source of alpha in 2024. Moreover, there is considerable scope to add value by buying mispriced assets, working with strong partners and fixing poor financial structures.

"We have strong conviction in living and logistics, especially in more fragmented sub-markets, where we can find value, strong fundamentals, severe undersupply and downside protection via hybrid capital structures."

Simon Hulett Head of Direct Investment

There is a large and persistent gap in historical returns between the top- and bottom-performing real estate categories. Simply put, sector selection creates alpha.

Returns	Bottom	Average	Top
2015	**12** Regional Malls	**14** Average	**21** Warehouses
2016	**9** Regional Malls	**12** Average	**16** Alternatives
2017	**8** Industrial	**12** Average	**17** Alternatives
2018	**3** Neighbourhood Ret.	**10** Average	**16** Industrial Estates
2019	**-2** Regional Malls	**7** Average	**13** Other Industrial
2020	**-9** Other Malls	**1** Average	**16** Industrial Estates
2021	**5** Other Malls	**12** Average	**33** Other Industrial
2022	**3** Suburban Office	**7** Average	**14** Warehouses
2023 YTD annual	**-5** CBD Office	**-1** Average	**6** Warehouses

Source: MSCI IPD, MaxCap Group (January 2024).
Past performance is not a guarantee of future performance.

Tips for navigating 2024

...beyond just surviving until 2025

Seek shelter

- In a world of weak growth and high inflation, many traditional asset classes are struggling for returns.
- Traditional modes of diversification are becoming less effective, given the synchronised dip in returns.
- This is a time to remix portfolios, to lift sluggish aggregate returns and to rebuild portfolio diversification.

Take more credit

- Indeed, high interest rates have upended a lot of strategies and many investors are late to respond.
- Investors need explicit hedges against higher rates, with real estate credit being a prime candidate.
- With the end of zero interest rates, there is set to be a long-running structural shift from equity to credit.

Live a little

- In a world with sluggish demand, robust population gains present a sustained source of growth ahead.
- Living sectors – in their many forms – stand out in the year ahead for their demand and returns outlook.
- It is quite a simple thing to follow the people, as migrants and students settle into specific market segments.

Source: MaxCap Group (January 2024)

Additional information

#1
in Australia

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#2
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