North America Living Outlook 2024-2026

Bouwinvest Real Estate Investors

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Introduction

The share of living investments is set to grow significantly in institutional real estate portfolios. Not only traditional multifamily housing, but also upcoming subsectors like Single-Family Rental, Student Housing and Senior Housing are becoming highly sought after living investments.

Although the US and Canada have different housing market structures and regional differences within the two countries can be large, the overall trend is that significantly more rental housing is needed, especially in the heavily undersupplied affordable housing segment.

While looking at the macro-economic environment and occupier- and investment market, we discuss key topics like migration, climate change and climate adaptation, regulatory change and social impact. We believe that institutional investors with strong ESG ambitions and a long-term investment horizon are in the position to tackle these challenges and support future housing demand.

Bouwinvest is a domestic and international specialist in direct and indirect living investments. Through this paper, we share our views on the various sub-sectors and markets in the North American context. If you would like more information or want to discuss investment opportunities, please contact us at Bouwinvest.

Executive summary

Mature living sector

- The US is the most transparent and liquid residential market in the world, and we expect the share of residential real estate to grow significantly in institutional portfolios.
- Throughout the time series that we tracked, Canada has proven less volatile than the US, boosting diversification goals.
- Alternative living sectors are highly institutional in the US and receive high investor interest, broadening the investment opportunity set.
- Rent control measures vary across jurisdictions. In general, rent regulation in most US states is less strict than in Europe, apart from certain states such as New York and California.

Strong market fundamentals

- Strong population growth for both Canada (strongest in G7) and US, mainly driven by immigration.
- We believe the outlook for single-family rental in the Sun Belt states is favourable, Eastern coastal cities are better placed for multifamily rentals.
- Home ownership is financially unfeasible for many North American households, leading to additional pressure on rental markets.
- Investors, developers and occupiers are increasingly recognising the economic benefits of sustainable buildings to help reduce financial risks and increase long-term value.

Tailwinds become stronger

- US economic growth is expected to remain robust and real wage growth may alleviate the affordability squeeze being felt by many US and Canadian households.
- The rate of inflation has peaked, and markets now expect the Fed to start policy rate cuts towards the end of 2024, making residential property risk premiums more attractive.
- Geopolitical developments receive increased attention. The living sector, as a needs-based and safe-haven investment opportunity, stands to benefit (particularly in secondary markets).

Attractive entry moment

- Over the past two years US residential capital value declines have been between 12% and 18%. We believe the trough has nearly been reached.
- US wide apartment property yields have moved out from around 3.8% (Q1 2022) to around 5.25% (Q2 2024). In other words, an increase of approx. 145 bps. We believe most outward movement is behind us.
- Investor interest and investment volumes are picking up, providing attractive residential opportunities in 2024/2025.

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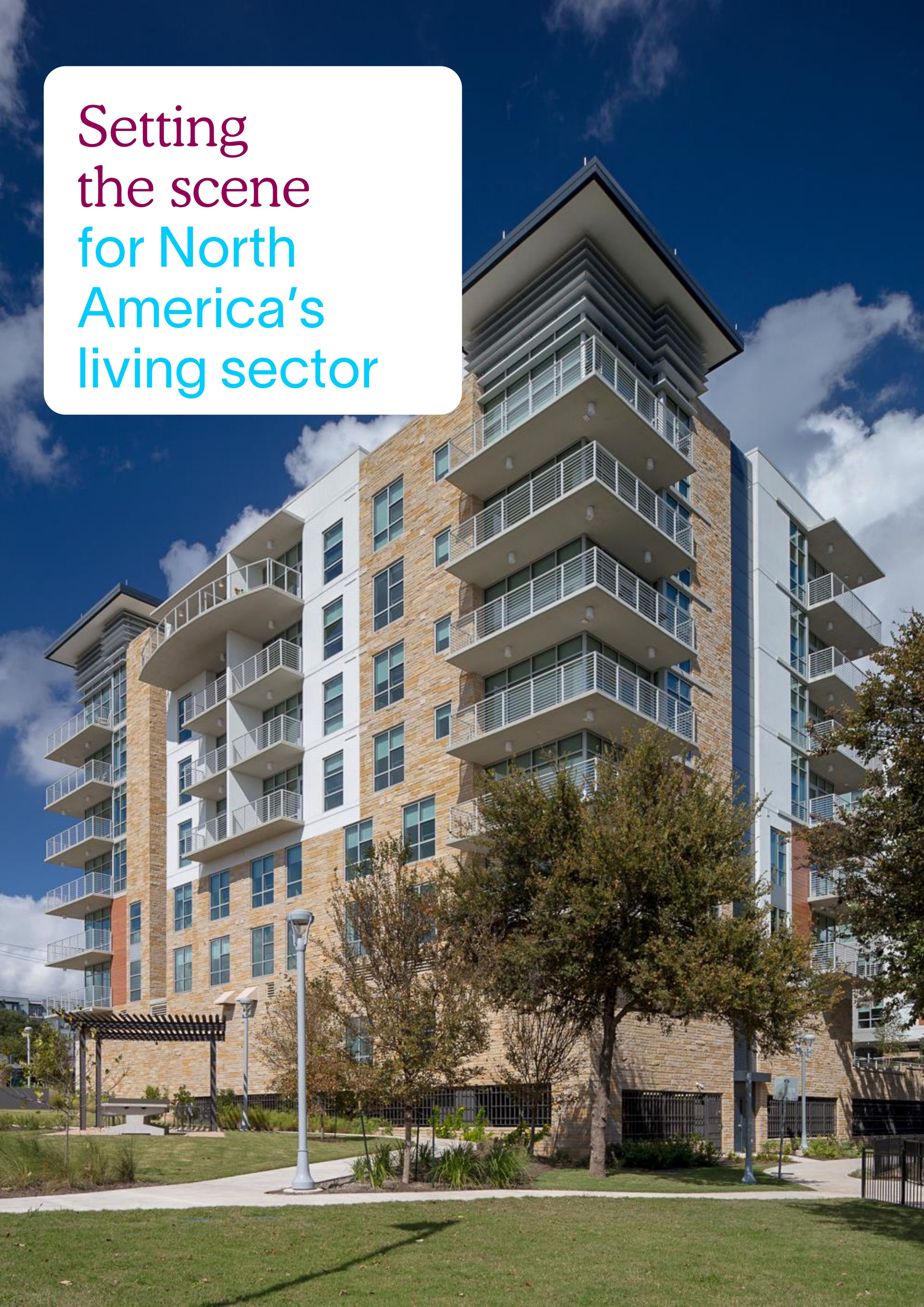
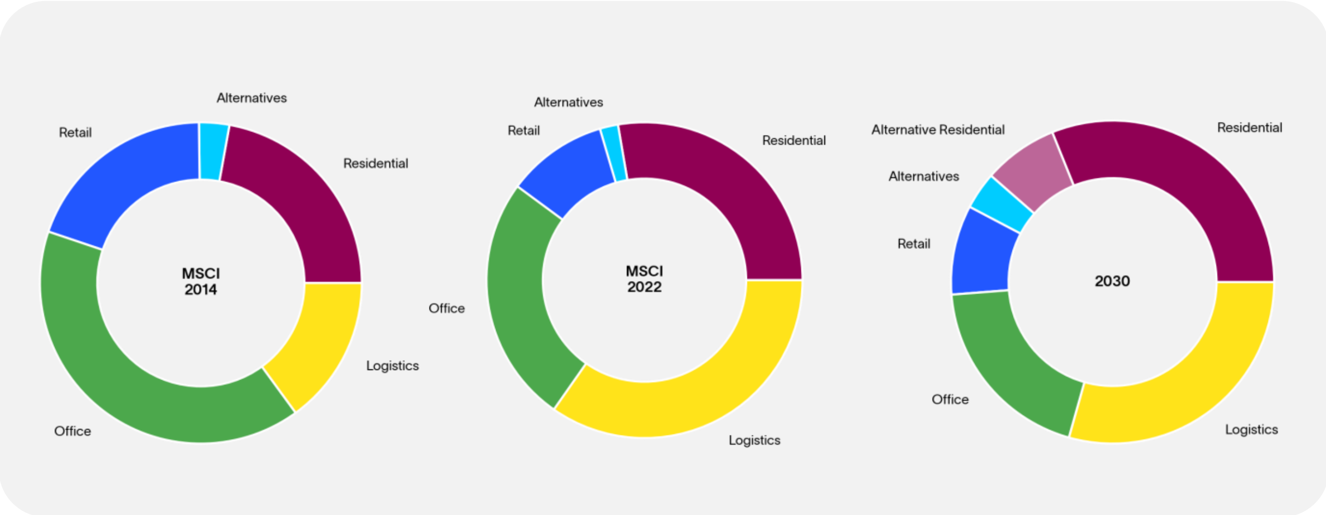
Setting the scene for North America's living sector



The North American living sector is a mature, transparent and highly institutionalized asset class

The US is the most transparent and liquid residential market in the world and home to the largest REIT market globally, aided by broad availability of data and capital sources, the rule of law and a robust banking system. Based on the MSCI investable universe, North American residential real estate made up approximately one-fifth of the total investable universe pre-Covid. Post-Covid, residential real estate has assumed greater significance in investor portfolios and now accounts for more than a quarter of investor portfolios. In our view, this could potentially be more than a third by the end of this decade (see graph below). As many institutional investors are still under-allocated to the sector, we expect the share of residential (and alternative living segments) to grow significantly in institutional portfolios over the next few years.

Figure 1: Share of residential in US institutional portfolios



Source: MSCI, Bouwinvest Research (2024) ; Residential = regular apartment buildings, Alternative Residential = single-family rental, student housing, senior living, manufactured housing, Alternatives = Datacentres, Hotels etc.

However, the residential sector has not been immune to challenging macro-economic circumstances that also affected many other commercial real estate sectors over the past two years. Higher policy interest rates resulted in the highest 30-year fixed US mortgage rates for over 20 years. This led to a worsening of home ownership affordability, forcing many would-be buyers to rent instead. Even though we expect mortgage rates to drop back (as we have seen in the first half of 2024), home-ownership affordability remains a concern. Even rental affordability is an issue in certain US and Canadian cities, but real wage growth may alleviate this affordability squeeze going forward.

‘As many institutional investors are still under allocated to the sector, we expect the share of residential and alternative living segments to grow significantly in institutional portfolios over the next few years.’

Living sector more than just multifamily housing

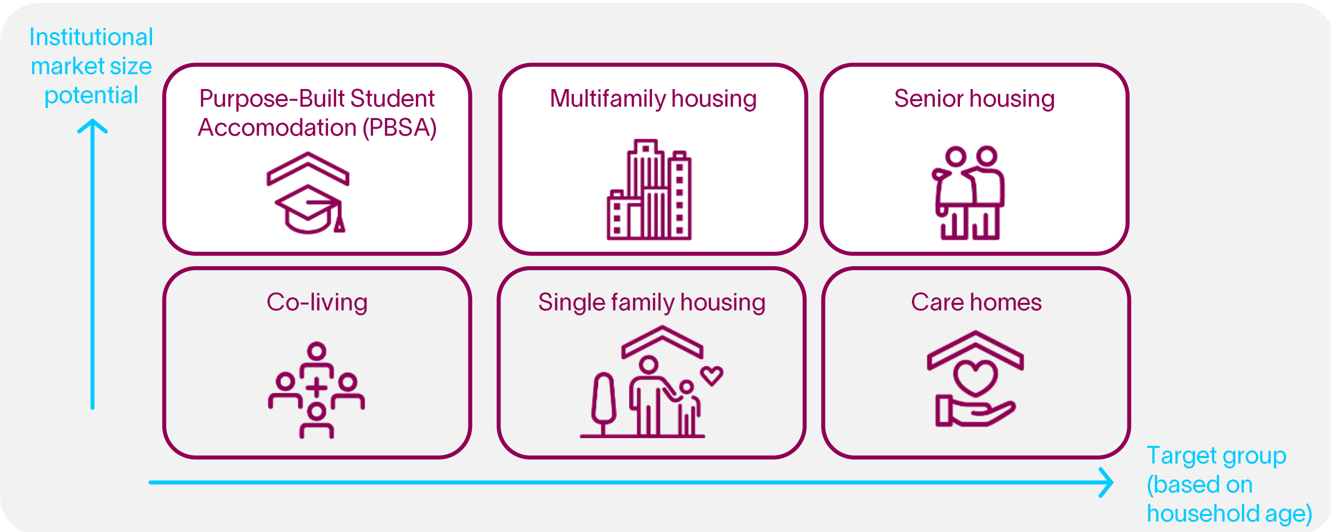
Driven by demographic shifts, ongoing urbanisation and evolving lifestyle preferences, demand for living properties continues to outpace supply.

Overall household growth in Canada is around 2% p.a. between 2024 and 2026, aided by an increase in the number of one-person households. Household growth for the US is around 0.75% during the same period. Also, the prime rental age cohort of 25-39 years old is expected to show sustained growth in Canada and selected markets in North America, which will boost demand for multifamily housing as well as single-family rental. Given high price-to-income ratios in the home-ownership markets, the overall trend is that significantly more rental housing is needed, especially in the heavily undersupplied affordable housing segment.

The number of Americans aged 65 and older is projected to increase from 58 million in 2022 to 82 million by 2050 (a 47% increase), and the 65-and-older age group's share of the total population is projected to rise from 17% to 23%. The number of 80+ inhabitants in North America is currently 13.5 million and expected to increase by 3% to 4% p.a. during the outlook period, boosting demand for care homes.

Moreover, provision rates for student housing show a demand-supply gap as, for example, the number of student beds available compared to the total number of students is between 5% and 10% in Canada (with Vancouver slightly higher at 14.5%). This demand-supply gap is expected to be structural, making the case for student housing investment very attractive.

Figure 2: Living landscape*



Source: Bouwinvest Research (2024)

- *This overview is simplified, as we recognise that more living subsectors are available, including more shared living, manufactured housing, serviced residency, childcare and healthcare concepts.*

This North America Living Outlook delves into the investment potential of the North American living sector, we describe the living sector in the broadest terms, i.e., in addition to regular for-rent apartments, we also include 'alternatives', such as single-family-for-rent, student housing and senior living.

Demographic trends supportive of strong market fundamentals

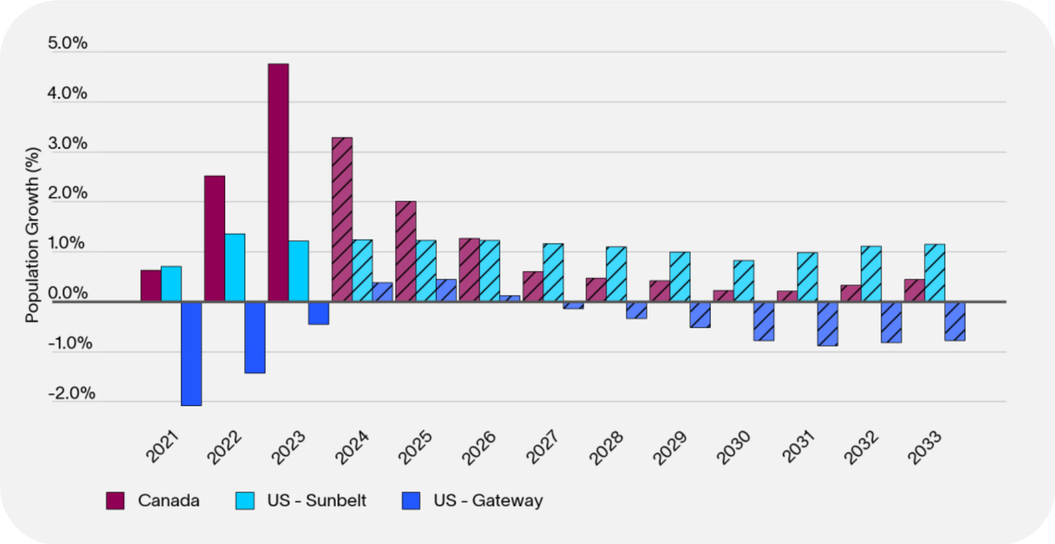
US and Canada set to continue population growth momentum

Canada experienced a substantial upswing in its total population over 2023, marking a historic annual population surge of 1.1 million new inhabitants, culminating in a population close to 40 million. This expansion was almost exclusively driven by (mainly skilled) migration, roughly 60% of which consists of non-permanent residents (e.g., study or work permit holders and asylum claimants). This migration trend is expected to be similar in 2024, after which the population growth rate is expected to gradually taper off but remain robust for the coming years.

In 2023, the United States experienced an influx of approximately 1.5 million new residents, resulting in a growth rate hovering around 0.5%. Forecasts indicate this rate will be sustained in the coming years. However, demographic trends vary across the country, with southern Sun Belt states seeing the most pronounced expansion last year. The growth in the south can be ascribed to a net increase of 700,000 individuals due to domestic migration, as well as an additional 500,000 through net international migration. The sheer volume of this projected growth can be seen in the figure below, driven by several factors, including lower cost of living, job opportunities and a more attractive tax climate.

> ‘Strong demographic outlook for prime rental age cohort in Sun Belt states.’

Figure 3: Population of 25-39-year-olds (% change)



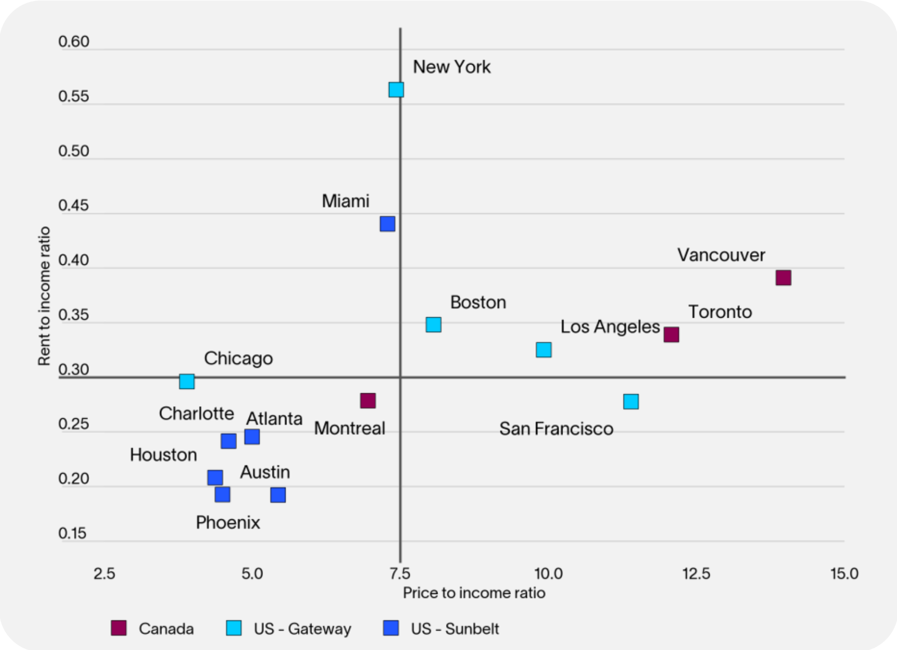
Source: Oxford Economics (2024) ; the graph shows the annual growth of the prime rental age group of 25–39-year-olds. Canada = Montreal, Toronto & Vancouver. Sunbelt = Atlanta, Austin, Charlotte, Houston, Miami & Phoenix. Gateway = Boston, Chicago, Los Angeles, New York & San Francisco.

Supply-demand mismatch strengthens case for Canadian for-rent market

Canada's strategic vision for bolstering population growth is commendable, although given the supply-demand mismatch in its housing market this may lead to more acute shortages. Despite a correction in property prices that has been ongoing since 2022, the housing markets in cities such as Toronto and Vancouver persistently exhibit poor affordability, posing challenges for the growing number of buyers and renters in these cities. The rise in borrowing expenses has led to an increase in the number of households competing on the rental market. Simultaneously, it has curbed the inclination of households to leave their current rental units, further intensifying the demand for rental properties.

In 2022, the growth in market rents accelerated at an unprecedented pace, with units released to new tenants seeing a 24% jump in rental prices in Vancouver, while rents jumped 29% in Toronto. In 2023, the rental prices of units released to new tenants jumped by an average of 27% in Vancouver and 31% in Toronto, while overall vacancy stood at around 1% at the end of the year. Despite relatively strong construction numbers, we expect the current shortfall in for-rent housing to persist over the outlook period due to the high cost of home ownership and the large share of non-permanent residents entering the market. We expect market rents in both Toronto and Vancouver's apartment markets to continue their upwards trajectory, averaging over 4% per annum between 2024 and 2026.

Figure 4: Affordability of select North American Markets



Combining the rent-to-income ratio with the price-to-income multiple, gives us a comprehensive view of the affordability landscape in North American cities – and subsequently reveals whether the current market favours buying or renting a property. We have defined affordable as house prices being 7.5 times the nominal household income, or monthly rental cost being 30% of nominal household income. The Sunbelt cities (dark blue) are significantly more affordable (apart from Miami) than their gateway counterparts (light blue). Sources: Canadian Real Estate Association, Redfin, Zumper, Oxford Economics.

Canada Student Housing

The Canadian student housing market can be characterised as relatively immature with only 850 PBSA assets country-wide, providing early-mover advantages. The relative lack of on-campus accommodation, combined with unfriendly planning regulations aimed at combatting perceived 'NIMBY-isms' related to PBSA (like in Ontario), leaves the growing number of students, especially those paying international tuition fees, with little if any place to go. Therefore, a clear supply-demand mismatch exists of total 40-50 thousand off campus and 100 thousand on campus beds for a total of 2 million students.

Current estimates indicate 10,300 beds will be added in Canada's largest student housing markets between 2024 and 2026, with another 8,000 beds in various planning stages. Relative to its size, Vancouver has a larger development pipeline, while provision rates (beds per student) in Toronto and Montreal are likely to remain below 10% over the forecast period, putting upward pressure on PBSA rents. We forecast that PBSA rents in all three cities will show elevated rental growth (approx. 5%) in the short term (1-2 years), stabilising at 3-4% in the mid-to-longer term. Toronto is expected to outperform given that it has the biggest shortage of student beds.

Moreover, the shorter lease duration and higher turnover leads to more inflation-linked growth, which is higher than many multifamily markets. Therefore the gap between multifamily cap rates and student housing narrowed to 50-75bps and in some markets tightened even further. Canada's recent announcement of a two-year cap on international student arrivals will provide only modest relief on the substantial demand for student accommodation, and we expect the larger and more renowned universities to be impacted the least.

'Provision rates (beds per student) are too low, leading to strong expected rental growth.'

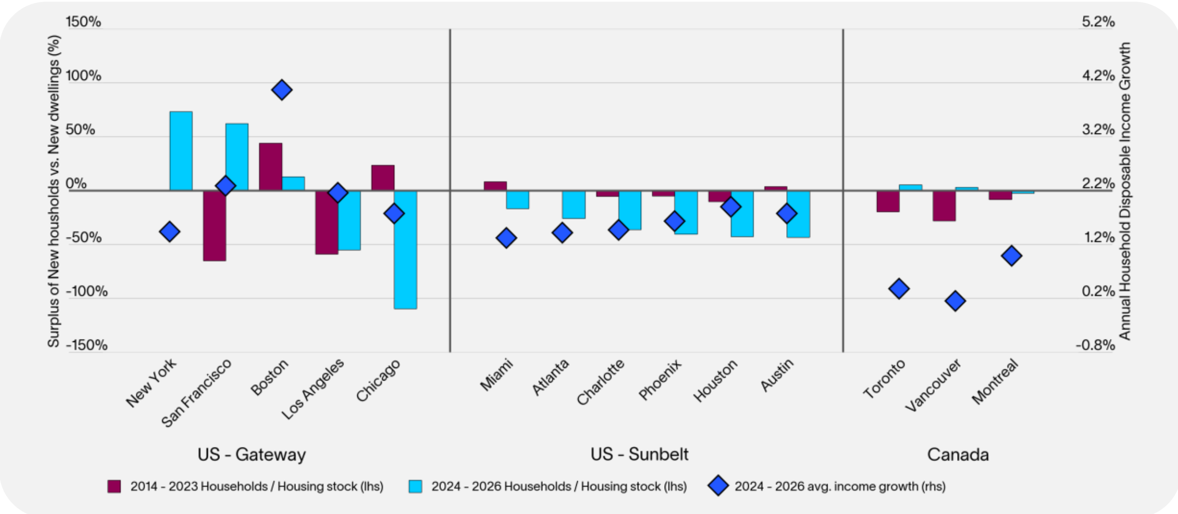
Migration to the Sunbelt in the US met with significant short-term apartment delivery

Despite the 30-year mortgage rate dropping by close to 100 bps in the final months of 2023, we see home ownership growth in most cities remaining below average over the forecast period, with more people entering the rental market compared with the last 10 years.

Domestic migration to the Sun Belt, originating frequently from coastal gateway cities and driven by items like tax policy, job opportunity and housing affordability, has increased rental demand in states like Arizona, Florida and Texas.

Strong commencements in apartment construction in these states have effectively absorbed the impact of this internal migration. Anticipated to reach its peak in 2024, growth of new supply is poised to exert short-term downward pressure on apartment rents in key Sun Belt cities such as Atlanta, Austin, Miami, Phoenix, and Nashville. New supply is forecast to be much lower in 2025 and beyond. The Sun Belt is expected to remain a popular destination for (internal) migrants going forward, which should drive modest rental growth between 2024 and 2026.

Figure 5: Household and supply growth in the US and Canada



A ratio above 0.0% signals that household growth is projected to surpass housing starts in the designated market. Despite the anticipation of continued demographic expansion in sunbelt cities, these areas are also expected to see a significant boost in the supply of residential spaces. New York and Boston emerge as appealing occupier markets, as the historical and anticipated demand/supply dynamic in both cities favours rental growth. Canadian cities have experienced significant supply increases versus household demand over the past 10 years and are expected to continue to do so – pointing towards a mismatch between the nature of supply (e.g., for-sale housing, higher segment or suburban) versus other types of demand. Source: Oxford Economics (2024)

‘Coastal cities continue to be the main beneficiaries of international migration and real income growth is likely to exert pressure on existing stock of rental apartments.’

The delivery of new apartments is less pronounced in the East and West Coasts of the country. Despite the South being a primary recipient of internal migration, coastal cities continue to be the major beneficiaries of international migration. These markets generally exhibit higher barriers to supply compared to their southern counterparts. Coupled with elevated construction costs, rents are expected to increase. We expect rents to rise the fastest in east coast gateway cities New York and Boston, as the expected household or real income growth is likely to exert pressure on the existing stock of rental apartments during the forecast period. While household growth is less impressive in cities such as Chicago and Los Angeles, the lack of historical supply combined with the expectation of stronger real income growth is expected to exert upward pressure on rents in these cities, too.

Structural growth in 'alternative' single-family rental segment

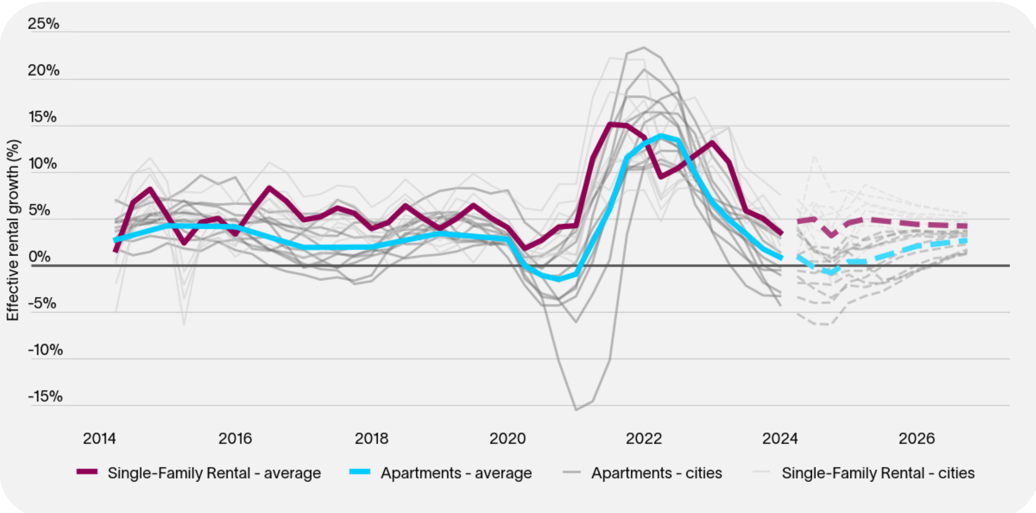
Current estimates are that institutional single-family rental ('SFR') comprises 3-4% of the total single-family rental residential market in the US with the vast majority owned by individual owners. This leaves substantial space for further institutional growth of the sector.

Also, it is important to make a distinction between built-to-rent (BTR) single-family rental and existing SFR stock. Due to the challenges of managing scattered-site real estate (i.e. existing SFR), scale and expertise are important in controlling costs and optimizing revenue in the BTR business. Institutional BTR operators see the benefit of economies of scale and further consolidation is expected. Another benefit for institutionally owned purpose-built single-family rental homes is that existing SFR is often competing with local individual home buyers whereas BTR properties which are sold as one community, increase total housing stock, and do not compete with individual buyers.

Furthermore, while total housing starts are likely to be relatively robust in most markets across the US, the share of single-family rental housing is projected to remain insufficient to meet growing demand in the sector. We see more households renting a home versus buying one relative to the recent 10-year history. Sticky house prices for existing single-family stock and inadequate savings (especially when factoring in student debt) for a down payment leaves the growing 'millennial' cohort (early 30s to mid-40s) renting for longer. Here, single-family rentals present a compelling value proposition versus apartments and for-sale housing, as the segment stands out as the most cost-effective choice for young families that require more than one bedroom. Tenants appreciate the community-feel and amenity-rich environment that characterize single-family rental neighbourhoods.

Because of this, we expect the occupier market for single-family rentals in the Sun Belt states to be in a more favourable position than rental apartments during the outlook period, with rental growth exceeding 4% annually in most markets in the period 2024-2026. The outlook for other alternative (affordable) housing solutions, such as manufactured housing, is also positive as this sub-market caters to the lowest income groups, offering strong demand and stable cash flow income.

Figure 6: Rental growth for US apartments and single-family rentals



Source: Green Street, adapted by Research Bouwinvest

'single-family rentals present a compelling value proposition versus apartments and for-sale housing, as the segment stands out as the most cost-effective choice for young families.'

North America & ESG

Environmental | Social | Governance

The North American real estate market is showing a bifurcated image when it comes to ESG. On the one hand, we are seeing a growing recognition of the importance of ESG factors in the U.S. and Canadian markets. Overall, many institutional investors and managers are adopting GRESB and the implementation of environmental factors, such as energy efficiency, carbon emissions, sustainable building materials and the use of renewable energy sources. Also, more traditional market participants understand the need to integrate ESG considerations, as they (i) reduce energy usage, (ii) reduce insurance costs, (iii) reduce vacancy and (iv) increase exit opportunities.

On the other hand, environmental issues have been politicised in American society. This limits the availability of data and state-level incentives. Other states such as California, New York, and Washington, have traditionally been at the forefront of sustainability initiatives and ESG integration in the real estate sector. These states have implemented stricter regulations and incentivised green building practices. As a result, there is generally a higher level of awareness and commitment to ESG principles in these states.

At the same time, the Inflation Reduction Act (IRA) of 2022 marks the single largest investment in climate change mitigation and renewable energy in American history, aimed at tackling inflation and the climate crisis. Together with the Bipartisan Infrastructure Law, this transformative act will help the United States achieve its the goal of reducing greenhouse gas emissions by 50% in 2030 relative to 2005 levels. The IRA is driving investment in clean energy with a broad range of tax incentives. A total of 280 clean energy projects were announced across 44 US states in the IRA's first year, representing $282 billions of investment.

'The North American real estate market is showing a bifurcated image when it comes to ESG.'

In Canada, the real estate sector is more focused on sustainability and social responsibility. Generally, over 80% of the energy supply stems from sources without any significant carbon emissions (i.e. nuclear & renewables). In provinces like Ontario (Toronto) and British Columbia (Vancouver), this is even higher at >90%. Overall, most US states show 30% or less of the grid attributable to renewable sources.

Efforts to make buildings more sustainable are relatively feasible for new developments. The design can include state-of-the art insulation, sustainable materials and on-site renewable energy generation. Options to modernise existing inner-city multi-family properties are limited. These usually have a smaller plot and roof size, which limits options for geothermal and/or solar energy. Furthermore, renovation costs tend to outweigh replacement costs in dense urban areas like New York.

Of course, North America is not exempt from the impacts of climate change. Over the past few years, we have seen increased risk of extreme weather events such as hurricanes, storms, floods and wildfires. Even though strong federal programmes are in place for communities and companies to help them withstand current climate hazards and anticipate future hazards, properties in high-risk areas are exposed to higher insurance costs. The investor community is increasingly aware of climate change risk, especially as it results in increased insurance costs. The current influx of residents and companies continues to support new investments in affected areas. However, market participants do need to (i) consider the potential impacts of climate change in their investment decisions, (ii) continuously assess exposure and (iii) adjust portfolios where necessary.

North America faces challenges related to the availability of affordable housing. A growing group of people are now dependent on government programmes to obtain safe and reasonably priced housing. In certain states, government programmes, such as rent control, tax abatements and tax-exempt bond financing, provide incentives for the development of projects and stimulate private investment in affordable housing projects. In addition to addressing social issues, this provides real estate investors with stable and high cash flow investments.

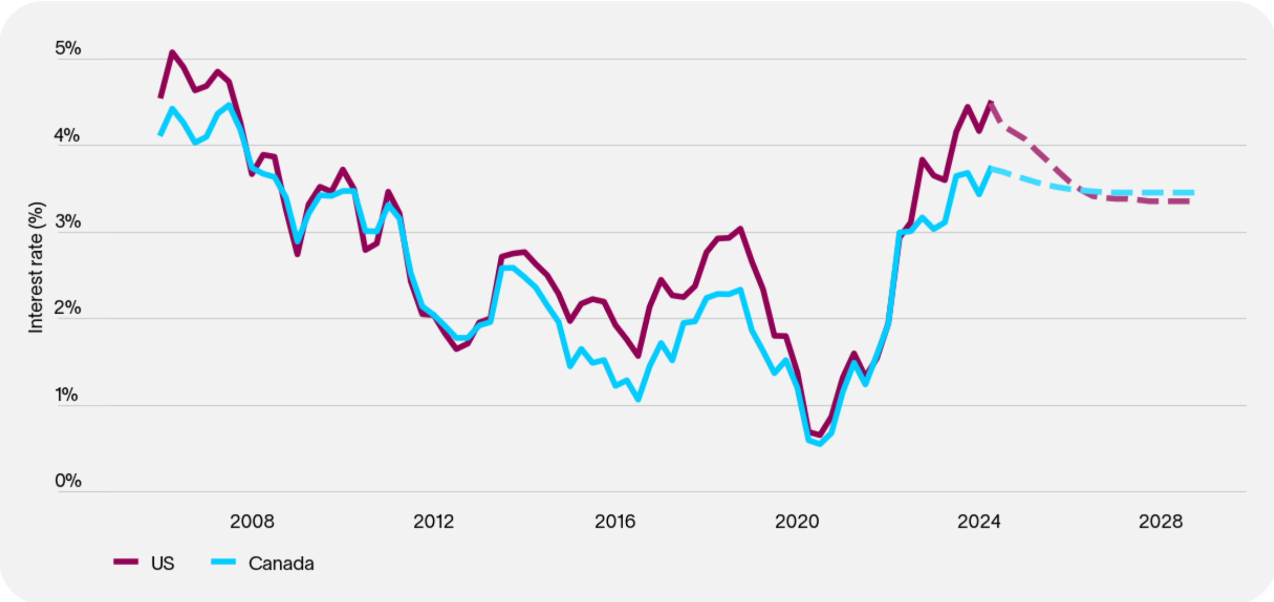
North-American macro-economic environment

Room for cautious optimism

Despite many economists expecting a recession in 2023, the US economy remained surprisingly resilient and expanded by an estimated 2.5%. The unemployment rate is near record lows and, given the Fed's dual mandate of maximum employment and stable prices, the direction of the Federal Reserve's monetary policy is now almost entirely dependent on inflation. The rate of inflation peaked in Q2 2022 at 9.1%, stood at 3.4% in December 2023, and is expected to continue to fall in the course of 2024. While no recession is forecast, the economy is expected to soften in 2024 and markets now expect the Fed to lower the policy rate (at least once) in 2024.

Several factors may interfere with this consensus view. To mitigate the rising cost of living, combined with current low unemployment rates, US employees are in better bargaining position with respect to wage negotiations. A wage-price inflationary spiral could entrench higher inflation. Also, core inflation (which strips out volatile food and energy prices) remains elevated. Recent geo-political turmoil in the Middle East is making international trade in goods more expensive, which is a supply side push factor in higher inflation. Furthermore, less political support for immigration and an ageing society may result in structural labour shortages, leading to additional inflationary pressure. Finally, and over the longer-term, imbalances in the structural change in energy sources from fossil to sustainable may put upward pressure on (energy) prices. This is why many market participants have dialled back their expectations, both in terms of magnitude and in terms of the speed of anticipated rate cuts. However, we believe there is room for cautious optimism, as the combined effect of higher property cap rates and anticipated lower risk-free government bond rates are making risk premiums more attractive. However, we do remain conservative on the speed of recovery.

Figure 7: 10-year government bond interest rates in North America



Source: Oxford Economics (2024)

Geopolitical landscape offering opportunities in secondary markets

The next US Presidential elections are due to be held in November 2024. Although the outcome and subsequent economic consequences are uncertain, the US remains a highly polarised society. Key topics that are prevalent in many states are (domestic) migration patterns, poverty reduction and housing affordability.

Domestic migration patterns have become prevalent in the past years. Many Americans have migrated to larger Sun Belt metro areas, as these offer better economic opportunities and an affordable quality of life. These opportunities and greater affordability are largely due to favourable tax systems. States like Texas and Florida, for instance, do not impose any state income tax.

In addition to tax considerations, the elevated cost of living in coastal states is also pushing people to more affordable areas. The political sentiment in central and southern parts of the country currently does not sway towards any government interference on this front. Opportunities for investors have arisen as secondary markets like Raleigh, Charlotte and Nashville have become institutional markets.

Much attention has been focused on migrant crossings at the United States-Mexico border and battles in Congress over immigration policy. Simultaneously, housing migrants still coming into the country remains a major challenge. The recent measures to limit inflows are faltering, and southern States have been transporting incoming migrants to more liberal states like New York, Illinois and Colorado.

Navigating the North American regulatory landscape

In the United States, investment structures are subject to regulation by various federal and state laws. At the federal level, the Securities and Exchange Commission (SEC) regulates investment funds under the Investment Company Act of 1940, which sets forth rules for the organisation, operation, and disclosure requirements for investment companies, including real estate funds. State securities laws, often referred to as 'Blue Sky Laws', also apply to the offer and sale of securities, including interests in real estate funds.

Since the start of 2023, the Canadian investment market is regulated by the Canadian Investment Regulatory Organization (CIRO), which is a self-regulating organisation that serves as the Canadian counterparty to the SEC. Overall, the legal aspects of the Canadian real estate investment market are like those in the US but may vary slightly per province.

In both the United States and Canada, the legal and regulatory landscape governing residential real estate is multifaceted. Zoning laws, subject to continuous updates and amendments, play a significant role in the feasibility of development projects. Building codes, both at the national and local levels, establish standards ensuring the structural integrity of residential properties. In addition, states and local jurisdictions prone to earthquakes have included specific provisions in their building codes intended to ensure that newly built or renovated structures can adequately resist seismic forces during earthquakes.

Tenant-landlord relations are safeguarded by various laws, although specifics such as eviction processes and rent controls vary across states. Tenant-landlord laws, outlined at the state and provincial level, delineate tenant rights and eviction processes, while rent control measures vary across jurisdictions. Strong anti-discrimination laws underpin fair housing practices, shaped by legal precedents that contribute to ongoing legislative developments.

'Fiscal support to boost the new construction of homes.'

The US can be considered as an attractive market from a tax perspective, as foreign investors may be able to apply for a full tax exemption on capital gains or rental income. However, property taxes are payable in most cases and an increase in charges has been noticed recently. This has had negative impact on the valuations of Chicago and Atlanta properties for example.

On the other hand, the federal Low-Income Housing Tax Credit (LIHTC) provides a tax incentive to build or renovate affordable rental housing for low-income households. These strategies may also be eligible for various state property tax incentives depending on where the property is located.

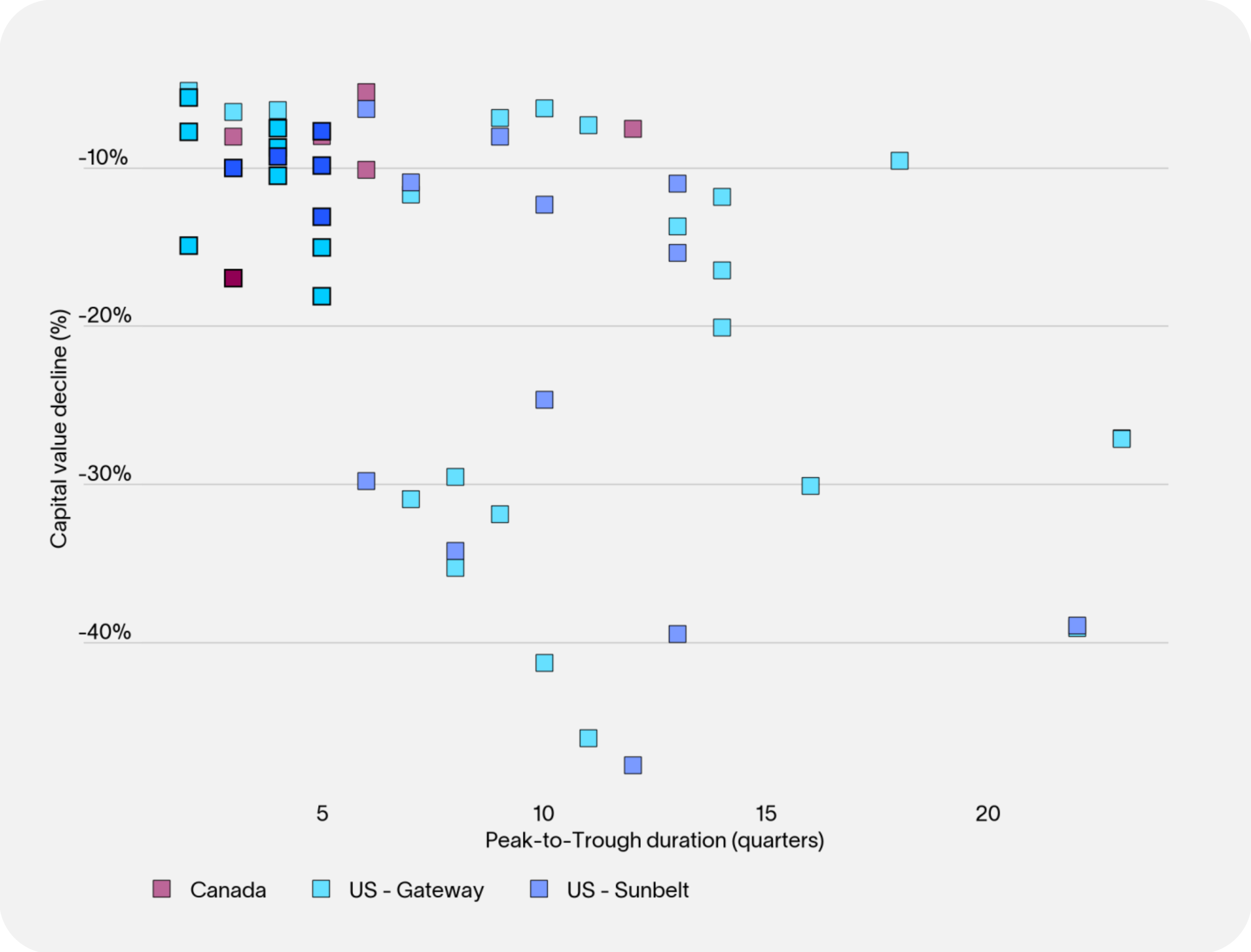
Unlike in the US, foreign investors in Canada are generally subject to corporate income tax and possibly dividend withholding tax. However, from 14 September 2023 an enhanced 100% Goods and Services Tax (GST) rebate applies to new purpose-built rental housing, to incentivise the construction of much-needed rental homes for Canadians. For a two-bedroom rental unit valued at $500,000, the enhanced GST Rental Rebate would deliver $25,000 in tax relief, or total development budget savings of 4-5%. This can be considered as a welcome development.

Investment market
Bottoming out

North American diversification opportunities

Based on the MSCI valuation-based index, US residential prices peaked in Q2 2022. Since then, capital values have dropped a cumulative -12% through Q4 2023. Capital value declines for transaction-driven and theoretical mark-to-mark values, as measured by Green Street and PMA, were even more pronounced, registering a cumulative decline of -15% and -18% respectively. Comparatively speaking, Canadian housing markets have seen lower declines. In the longer run, Canadian housing markets are less volatile than their US counterparts mainly due to a stable and more conservative banking sector with less risk capital available minimizing boom-and-bust cycles. During cyclical upswings, for-rent house prices tend to have lower peaks and the troughs are less deep in downturns. This could prove useful for diversification purposes (as can be seen in the chart below).

Figure 8: Overview of historical capital value decline of North American residential markets



Source: MSCI, Case-Shiller, BIS, Bouwinvest Research (2024) ; the more pronounced squares represent current cycle duration and declines in value for selected US cities. The hazier squares represent capital value declines in previous cycles (such as GFC, DotCom, 1990s).

Also, earlier peak-to-trough periods show that the longest duration of capital value declines happened during the GFC (Global Financial Crisis). Many residential markets in North America registered declines in capital value for 10 to 20 consecutive quarters. It looks like the current duration of value declines is shorter than during the GFC and cumulative value declines are less pronounced.

The time it took for the Fed to hike interest rates between March 2022 and July 2023 (by 525 basis points) was the fastest in its history and is the main reason for the relatively quick correction in current residential markets. Compared to other asset classes, capital value declines are still modest (for instance, compared to offices, which have seen cumulative capital value declines of close to 40% to 60% over the same period).

'The current duration of value declines is shorter than during the GFC and cumulative value declines are less pronounced.'

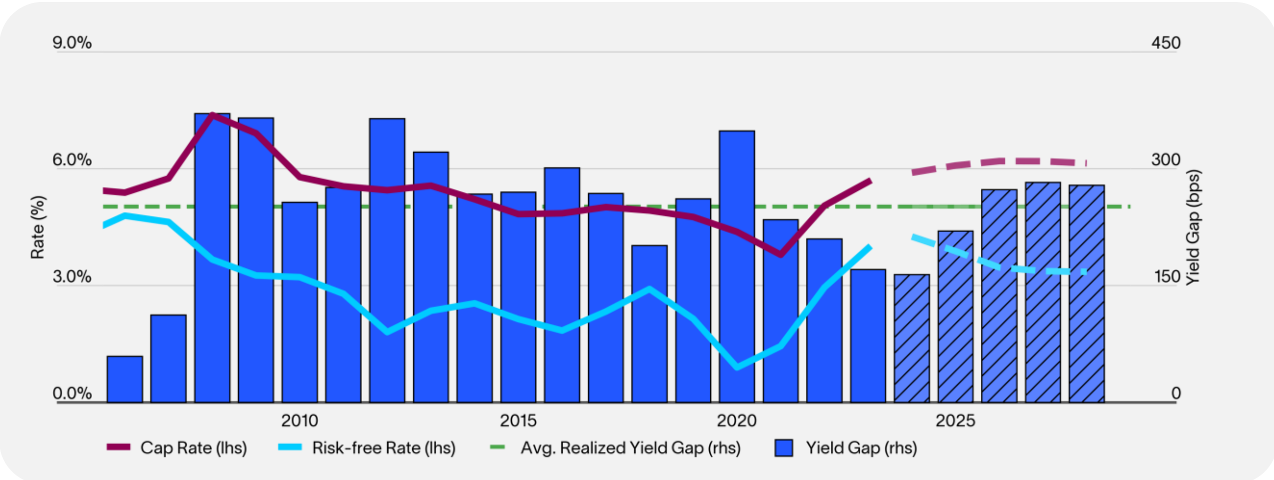
Property yield spreads moving towards long-term average

Various academic studies demonstrate a strong (lagging) correlation between the risk-free 10-year government bond rate and property cap rates. In other words, an increasing risk-free rate generally leads to lower property values. Also, declining transaction volumes have been a leading indicator of declining capital values, as we have seen over the past two years.

Between the start of Q4 2023 and end of June 2024, the yield on 10-year bonds dropped by more than 40 bps. Further declines are possible, and are expected, if the Fed does decide to cut policy interest rates in 2024 and beyond.

We believe that residential property cap rates are close to peak levels. Since Q2 2022, US residential cap rates have risen by approx. 125 to 150bps. Once pricing visibility has improved, bid-ask spreads will decline, and investment volumes can pick up. Investors are looking for strong, stable and predictable cash flows that are less cyclical in nature (for example alternative living segments, such as student housing, single-family rental and manufactured housing). In this respect, spread levels, the difference between 10-year risk-free government bond rates and property cap rates, are important. Naturally, other aspects are important to take into consideration, such as expected rental growth. Sectors with a strong rental growth outlook are likely to witness less outward movement (in a rising interest rate environment) compared to lagging sectors. In the graph below, we have plotted spread levels between US apartments and the risk-free rate. As the graph shows, spread levels are moving closer to the long-term average.

Figure 9: Yield spread between Net Initial Yields and risk-free rates



Source: Green Street (2024), Oxford Economics (2024), adapted by Bouwinvest Research

However, some caution on pricing recovery is warranted. In aggregate, nearly USD 500 billion in multifamily loans are expected to mature in the next two years with an estimated funding gap of USD 75 billion. Eventually, borrowers will need to refinance their loans against significantly higher interest rates (or sell their property holdings to pay down the debt). This may dampen capital value growth in the near future, but also provides opportunities for investors with dry powder and non-bank subordinate debt providers. We expect some modest price declines in 2024, after which 2025 will see a more pronounced turn of the market. Troughs in the market are notoriously difficult to predict, but we expect 2024 and 2025 to prove to be very good vintage years in the longer run.

Canadian investment market

In Canada, the environment is similar to the US, but less pronounced. Residential transaction volumes declined by approximately 40.0% in 2023 (versus -60.0% for the US) and cap rates have increased by approximately 60-80 bps (versus around 100 to 150 bps for the US). The positive investor sentiment towards the for-rent residential sector is mainly due to solid occupier market demand fundamentals. Furthermore, expectations regarding future risk-free levels have improved. Between November 2023 and February 2024, 10-year government bond rates have dropped by approximately 60 bps, improving spread levels significantly. Also, Canadian REIT pricing saw a positive Q4 2023, posting year-on-year total returns of 6.3% (listed real estate companies with a focus on residential).

Even though some of those gains have diminished in the months thereafter, academic research supports the view that listed real estate markets have predictive power for the private property markets and are leading the private markets for about nine to 18 months. If listed prices stabilise at this price-point, private markets may be close to bottoming out and may recover during the second half of 2024 and beyond.

Reach out for more detailed insights

Please contact us for more information

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