Baron Insights

BARON CAPITAL

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Commercial Real Estate: An Optimistic Perspective

Summary

- The likelihood of a commercial real estate crisis is low
- Most real estate distress will be limited to a manageable portion of office buildings
- Long term, we see many secular growth trends in commercial real estate
- The current situation has little in common with the Great Financial Crisis
- The rapidly evolving landscape favors an active investment approach with the flexibility to lean into the most promising areas while avoiding other, more challenged areas

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Since the March 2023 collapse of Silicon Valley Bank (SVB), headlines predicting an impending commercial real estate (CRE) crisis have been rampant. CRE was already under a klieg light in the post-pandemic economy, where work from home arrangements have become commonplace and consumers shop increasingly online, raising doubts around the future of office and retail properties. To add to these challenges, the U.S. Federal Reserve's most aggressive tightening campaign in several decades has pressured credit markets and pushed mortgage rates to their highest levels in more than 20 years.

The failure of SVB and a few other banks in its wake underscored the vulnerability of CRE, at least in the eyes of the financial press. The media variously warned that CRE was headed for a "real estate doom loop," a "financial storm," or even a crash "harder than during the Great Financial Crisis."[1]

As long-time investors in real estate equities, we have a decidedly different view. To paraphrase Mark Twain, we believe the reports of the death of commercial real estate are greatly exaggerated. CRE is a $20 trillion industry in the U.S., and, while select segments are unquestionably facing headwinds, many, if not most, areas of CRE remain healthy.

A Commercial Real Estate Crisis Is Unlikely

Near term, we expect a more restrictive lending environment and moderating growth in real estate. However, for a number of reasons, we do not believe these headwinds will lead to a commercial real estate crisis.

Near-term headwinds

For the next year or so, we expect the real estate market to experience:

- Tighter credit conditions
- A contained rise in delinquency rates
- More moderate growth

Tighter credit conditions We expect a reduction in lending – in part due to the possibility of some banks hoarding deposits, a higher bar for incremental capital outlays, increased scrutiny of existing loan books, tighter bank regulations, and lower CRE values – but we believe the likelihood of a widespread credit crunch is low. We anticipate any credit tightening will focus on Class B and Class C office buildings, which are lower quality commodity office buildings that comprise just 3% to 5% of the total market.

A rise in delinquency rates, although largely contained Higher debt service and refinancing costs and moderating growth are likely to lead to an uptick in delinquency rates. However, we expect bank losses will be less than feared because lending standards have become more conservative – higher debt service coverage ratios and lower loan-to-values – and property prices have mostly increased in the last 5 to 10 years. Additionally, delinquencies remain well below historical levels. As of mid-2023, delinquency rates on CRE loans were

[1] "Real Estate Doom Loop Threatens America's Banks," The Wall Street Journal, September 6, 2023. "Financial storm bears down on US commercial real estate," Financial Times," June 25, 2023. "Morgan Stanley says commercial real estate will crash harder than during the Great Financial Crisis," Fortune, June 26, 2023.

0.84%, versus 8.94% at the peak of the Great Financial Crisis (GFC).[2] We expect challenges to be largely isolated to Class B/C office buildings and, to a lesser extent, retail real estate. We also think lenders will try to work with borrowers to modify loan terms and stave off a default.

More moderate growth We expect CRE growth to decelerate due to tighter credit conditions, increased unemployment, moderating economic growth, and a slowdown in real estate leasing activity, development, and acquisitions.

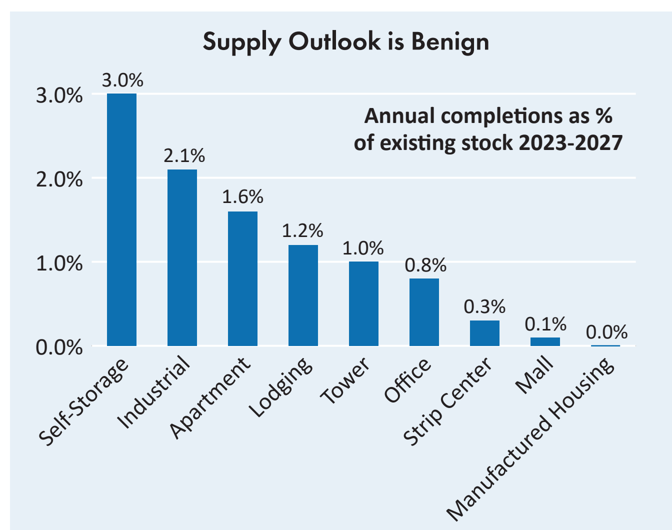
Positives for real estate

While the real estate market is grappling with its share of challenges, a number of factors suggest the likelihood of a crisis is low, including:

- Strong operating fundamentals
- Lack of overbuilding and new construction
- Relatively strong demand
- Solid balance sheets
- Well-capitalized banking system
- A possible Fed “put”

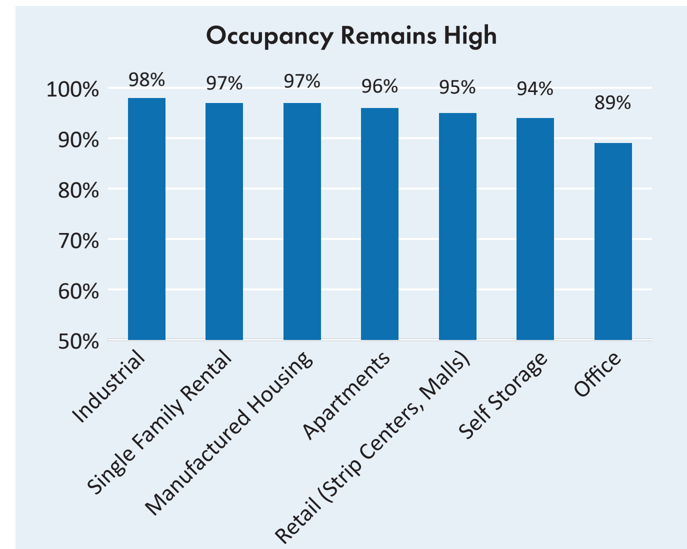
Strong operating fundamentals According to industry experts and our own research, CRE occupancy, rent, and cash-flow growth, though slowing, is still expected to be positive in most cases.

Lack of overbuilding and new construction We are coming off three challenging years. The pandemic and resulting supply chain delays and materials and labor shortages significantly curtailed new development, as seen in the chart below. Looking ahead, we think it will be more costly to build and harder to get loans. As a result, we expect a roughly seven-year period of below-historical levels of new construction activity. This is unlike prior cycles when overbuilding contributed to a deterioration in business prospects.



Source: Green Street Advisors

Relatively strong demand As seen in the chart below, percentage occupancy is in the mid to high nineties across most categories, with an average of more than 95%. In an economic slowdown, occupancy is usually materially lower – high eighties to low nineties.



Source: Green Street Advisors

Regarding the category with the lowest occupancy — office buildings — high vacancies are limited almost entirely to the 10% of U.S. office buildings that are most troubled.[3] Many Class A office buildings, especially new high-quality office buildings in great locations, are fully occupied and command high rents. That said, we are more cautious on office real estate because, over time, we think 10% to 15% less office space will be needed due to remote and hybrid work arrangements. Supply is also elevated in certain markets, although much of this glut consists of old, obsolete buildings in less desirable neighborhoods and lacking the amenities tenants want.

On a side note, the idea of office to apartment conversions has been getting a lot of headlines. The reality is most office buildings lack the proper layouts, ceiling heights, elevator banks, etc. needed to easily convert them. More often than not, it would be cheaper to knock down the building and put up an apartment building in its place, assuming permitting approval. This process would take many years.

Solid balance sheets Real estate debt profiles – debt relative to cash flow, fixed vs. floating rate debt, and annual debt maturity schedules – are, in most cases, manageable. Most debt coming due in the next few years originated with sound lending standards and no major oversupply of real estate.

Well-capitalized banking system with ample liquidity Six months after the collapse of SVB, we are seeing no signs of an impending banking crisis.

[2] Source: FRED
[3] Source: CBRE Econometric Advisors

A possible Fed "put" The Fed raised interest rates to tamp down growth and inflation. Should economic, bank, or real estate distress emerge, we suspect the Fed will reverse course and lower rates to mitigate near-term headwinds.

Long-term Trends Provide Opportunities for Growth

There's a perception that most CRE is highly cyclical, and there certainly is a cyclical component. But we also see long-term secular tailwinds in certain categories with businesses that have enduring cash flow growth in different economic environments, including:

- Industrial real estate
- Apartments/single family rentals
- Manufactured housing
- Data centers
- Wireless towers
- Health care-related real estate
- Self-storage
- Hotels

Industrial real estate Traditionally viewed simply as commodity warehouse space, industrial real estate has been transformed with e-commerce, supply chain reconfigurations, and the desire by businesses to have extra inventory on hand given the widespread shortages during the pandemic. Onshoring driven by deglobalization has also been a tailwind. Examples of industrial REITs include **Prologis, Inc.** and **Rexford Industrial Realty, Inc.**

Apartments/single family rentals Currently, it is much more affordable to rent than to own. In October 2023, the average 30-year fixed mortgage rate spiked to over 8%, the highest in 23 years. The median rent in the U.S. is $1,850 per month, about 30% cheaper than the median cost to buy of $2,700. While the difference between renting and owning was less than $200 in 2022, just a year later, the gap surpassed $800, the largest in 50 years.[4]

There is also a shortage of houses for sale as the existing home market is essentially frozen. Four out of five homeowners have locked in rates below 5%, and they are understandably reluctant to give up these mortgages.[5] As a result, the inventory of existing homes has declined by 36% from 1.7 million in 2019 to 1.1 million in mid-2023. Finally, millennials, the U.S.'s largest demographic, are more inclined than prior generations to rent, given high student debt levels and a desire for flexibility. **American Homes 4 Rent, Inc.** and **AvalonBay Communities, Inc.** are two examples of apartment/single family rental REITs.

Manufactured housing Affordable housing such as manufactured homes has never been in higher demand. Supply chain issues have made it harder to get new homes delivered, and, in many regions, zoning restrictions limit the availability of land.[6] As seen in the chart on the previous page, there is little to no supply on the pipeline.

Data centers The data center market stood at $263 billion in 2022 and consensus forecasts are that it will advance at a CAGR of 10.9% to reach $603 billion by 2030. Demand is burgeoning due to the rising need for data services around social, mobile, analytics, cloud computing, IT outsourcing and advances in AI.[7] Data centers REITs we like include **Equinix, Inc.** and **Digital Realty Trust, Inc.**

Wireless towers Long term, robust mobile data growth and 4G and 5G adoption should provide strong demand tailwinds to tower companies such as **American Tower Corp.** These are great businesses with 90% incremental margins and strong moats due to strict zoning regulations.

Health care-related real estate The 80-plus age bracket is the fastest growing segment of the U.S. population, and senior housing stands to profit. Life science real estate is benefiting from more dollars being committed to pharmaceutical R&D and drug development.

Self-storage Self storage is forecasted to expand at a CAGR of 7.5% through 2023, as people working from home want more space and seek to declutter. Supply barriers should keep oversupply risks at bay.[8] Examples include **Public Storage** and **Extra Space Storage, Inc.**

Hotels Millennials are entering prime earning years, and, according to a Harris report, 72% prefer to spend money on experiences rather than material items. Hotels, timeshares, resorts, and other travel-related companies such as **Hilton Worldwide Holdings Inc.** and **Hyatt Hotels Corporation** should benefit.

Today is Nothing Like the Great Financial Crisis

We have seen a lot of press suggesting we are on the brink of another real estate crisis akin to the 2007-2008 subprime mortgage crisis that contributed to the GFC. We strongly disagree.

Back then, predatory lenders used subprime loans as a way to sell homes to people with sub-optimal credit who took on mortgages they could not afford. When interest rates rose in the mid-2000s, millions of homeowners defaulted. By August 2008, over 9% of all U.S. mortgages were delinquent or in foreclosure. Property values plummeted across both housing and CRE. The loans had been packaged into mortgage-backed securities, so when the housing market collapsed, financial institutions holding these securities became vulnerable.

[4] Source: Reventure Consulting
[5] Source: Redfin
[6] Source: Urban Institute, Multi-Housing News
[7] Source: Prescient Strategic Intelligence
[8] Source: Proficient Market Insights

Lehman Brothers declared bankruptcy in the fall of 2008, sparking the GFC.

Today's situation is different. During the GFC, not only was there a credit crisis, but REITs were levered more than 8.5x cash flow, and debt/gross asset value was 60%. The current backdrop is much better. Net debt/cash flow for REITs is 5.5x, or 35% lower than during the GFC, and debt/gross asset value is 30%, or 50% lower.

The Dodd-Frank Act of 2010 imposed strict regulations that banned banks from engaging in the type of risky high-yield derivatives that helped fuel the crisis. Consequently, while some regional banks may still be vulnerable, large financial institutions are well insulated from any potential contagion, in our view.

We do anticipate some owners will face a debt-funding gap when refinancing. In the last few years, a large portion of CRE was financed with historically low interest rates, contributing to a rise in property values. In the wake of the Fed's rate hike campaign, some owners looking to refinance are facing higher borrowing costs and reduced loan availability due to lower building values. As a result, new loan proceeds may not be enough to repay the debt coming due.

Some landlords may choose to add more equity and/or other financing sources (mezzanine debt) to pay off the existing loan. They may also negotiate a discounted payoff or an extension and modification of loan terms if they expect income conditions to improve. A few may end up delinquent or default and hand back the keys to the bank.

That said, we think the debt-funding gap will disproportionally impact class B and C office buildings (which are generally privately held), with more limited impacts to other sectors. In contrast, during the GFC, large funding gaps were prevalent across all major CRE sectors (office, retail, multi-family, and industrial).

Conclusion

Of all the sectors, Real Estate has been the most transformed by the pandemic and the most impacted by the Fed's aggressive tightening campaign. Commercial real estate, in particular, has been the subject of alarmist headlines suggesting an imminent crisis.

Behind the headlines, it is a very different story. As long-time investors in real estate, we see few, if any, signs of an impending crisis. While there are pockets of weakness, the overall health of CRE remains strong. We do believe the dynamic post-pandemic landscape warrants an active investment approach with the flexibility to lean into the categories, regions, and companies poised to benefit in the "new normal" while steering clear of more challenged categories and regions that may experience secular or cyclical headwinds in the years ahead.

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Disclosures

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Risks: In addition to general market conditions, the value of the Funds will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. **Baron Real Estate Income Fund** invests in debt securities which are affected by changes in prevailing interest rates and the perceived credit quality of the issuer. The Funds invest in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

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Portfolio holdings as a percentage of net assets as of 9/30/2023 for securities mentioned are as follows: Prologis, Inc. – Baron Real Estate Fund (5.5%), Baron Real Estate Income Fund (9.6%); **Rexford Industrial Realty, Inc.** – Baron Real Estate Fund (2.3%), Baron Real Estate Income Fund (2.9%); **American Homes 4 Rent** – ~~Baron Real Estate Fund (1.7%),~~ Baron Real Estate Income Fund (5.0%); **AvalonBay Communities, Inc.** – Baron Real Estate Income Fund (4.6%); **Equinix, Inc.** – Baron Real Estate Fund (5.7%), Baron Real Estate Income Fund (9.7%); **Digital Realty Trust, Inc.** – Baron Real Estate Fund (3.4%), Baron Real Estate Income Fund (9.5%); **American Tower Corporation** – Baron Real Estate Fund (0.5%); **Public Storage Incorporated** – Baron Real Estate Fund (1.0%), Baron Real Estate Income Fund (1.6%); **Extra Space Storage, Inc.** – Baron Real Estate Fund (0.9%), Baron Real Estate Income Fund (2.6%); **Hilton Worldwide Holdings Inc.** – Baron Real Estate Fund (1.4%); **Hyatt Hotels Corporation** – Baron Real Estate Fund (1.2%).

Baron Real Estate Fund

Top 10 Holdings as of September 30, 2023

Holding	% of Net Assets
Toll Brothers, Inc.	8.3
Equinix, Inc.	5.7
Prologis, Inc.	5.5
Lennar Corporation	4.6
Blackstone Inc.	4.5
D.R. Horton, Inc.	4.5
CoStar Group, Inc.	4.4
Brookfield Corporation	3.8
Wynn Resorts, Limited	3.5
Digital Realty Trust, Inc.	3.4
Total	**48.3**

Baron Real Estate Income Fund

Top 10 Holdings as of September 30, 2023

Holding	% of Net Assets
Equinix, Inc.	9.7
Prologis, Inc.	9.6
Digital Realty Trust, Inc.	9.5
Welltower Inc.	7.6
Invitation Homes, Inc.	5.6
American Homes 4 Rent	5.0
AvalonBay Communities, Inc.	4.6
Equity Residential	3.3
Toll Brothers, Inc.	3.3
Wynn Resorts, Limited	3.1
Total	**61.3**

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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