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OUTLOOK

2023 Investment Outlook: Private Real Estate

December 20, 2022

Strong Fundamentals Offset Capital Market Weakness for High-Quality Assets

KEY POINTS

1. Strong fundamentals continue to offset capital market weakness for high-quality assets, even as capital flows back into equities and fixed income.
2. On the horizon are more dynamic and highly leveraged markets, ESG retrofit opportunities to optimize asset energy efficiencies, and arbitrage between public and private markets and funds seeking liquidity.
3. We see potential for distressed or forced selling in the weakening environment, as well as increased M&A activity between public and private companies.

What We Are Seeing

Real estate fundamentals generally remain strong and are helping to offset capital market weakness for high-quality assets. New construction on projects that haven't begun has stalled, bolstering fundamentals over the intermediate term. Meanwhile, embedded rental income growth should help to protect values amid a weaker macro backdrop. Industrial and residential fundamentals are leading, buoyed by record-low vacancy and secular tailwinds such as eCommerce and high rentership.

Investors are increasing allocations to niche sectors, such as student and senior housing, healthcare and self-storage, which have counter-cyclical demand drivers. Hotel recovery is accelerating for leisure and lagging for corporate. Hybrid office working models and more discerning occupiers are disrupting office demand. Inflationary headwinds continue to challenge retail real estate.

ESG is growing in importance for investors, occupiers and employees, and is critical to optimize rent and asset value.

Real estate transaction markets have stalled due to lower availability and elevated cost of debt, as well as heightened market uncertainty. Japan remains the exception, where financing costs remain at record low levels. Fund flows into real estate have slowed due to the denominator effect, which is shifting capital back into equities and fixed income as investors rebalance portfolios.

What We Are Doing

Increased volatility and the pullback in market liquidity provide a more favorable environment for investors who have capital to acquire high-quality assets in preferred sectors with robust fundamentals, at a reduced basis.

We are targeting more dynamic and highly leveraged markets where re-pricing is expected to be fastest due to higher debt costs (U.S., UK, Australia, South Korea), and we continue to use existing relationships to acquire assets at an attractive basis in Japan. We're also considering credit opportunities, including gap financing through mezzanine/preferred equity positions.

We are taking advantage of the arbitrage between public and private markets and funds in need of liquidity. We are seeking the highest quality assets that meet post-COVID-19 occupier requirements. We are looking to leverage asset management expertise to drive income growth. Moreover, we are targeting ESG retrofit opportunities to optimize asset energy efficiencies.

What We Are Watching

We are observing how economic, employment, inflation and interest rate signals may inform cyclical market turning points. We are on the lookout for signs of distress or forced selling in the weakening environment.

We are anticipating increased M&A activity between public and private companies.

We see potential for heightened regulatory risks — such as rent control and real estate taxes — from the shifting global political environment. We have our eyes on global dislocation, divergent recovery cycles and different opportunities by region and market. U.S./China geopolitical tensions and the impact on global growth and supply chains continue to add pressure across equities, and we are waiting to see how that impacts private real estate.

Tony Charles
Global Head of Research and Strategy
Morgan Stanley Real Estate Investing

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