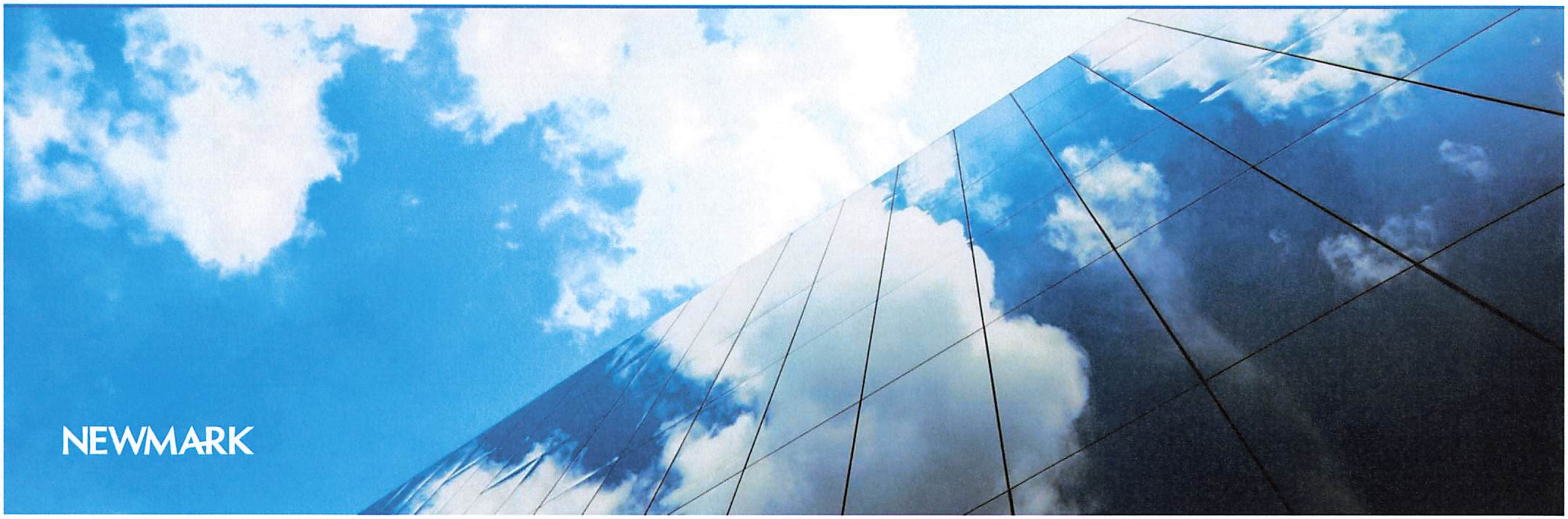
3Q24

State of the U.S. Capital Markets



Market Observations

- **Economy.** Strong economic data was the hallmark of the third quarter of 2024, despite the continuing effects of 2-decade high interest rates. GDP growth in the third quarter of 2024 came in at a strong but slightly below expectations 2.8%, with solid growth from both consumers and business investment. Unemployment remains low, and finished the quarter at 4.1%, the same as June. The U.S. economy has made some headway on inflation, however YoY core PCE has remained stubbornly 60 basis points above the Feds long term target since May. Rate market expectations have been volatile, seeming to live from economic data print to economic data print. The market recently has been pricing 50 basis points of cuts in 2024, with another 100 to 15 basis points of cuts in 2025, though the election results are moving these expectations significantly. The more important message is that the market has been consistently pointing to an equilibrium federal funds rate of 3.0% or greater, which would anchor long-term Treasury yields in the mid-3% range even after the Fed has normalized its policy stance.

- **Debt Markets.** CRE debt origination activity began to show signs of growth in the third quarter, though volumes remain well below pre-pandemic averages. Overall, origination volume was up 7.1% in the first 3 quarters of 2024. The number of active lenders continued to decline, now down 30% from peak. Industrial, Multifamily, and Hotel originations rose in 2024 offsetting declines in other sectors. Overall, securitized, insurance and debt fund lending all rose as well, more than offsetting a decline in originations from banks whose lending fell sharply. Regional banks face a protracted deleveraging from CRE. All this is occurring while the market is set to absorb $2.0 trillion in debt maturities in the 2024-to-2026 period. 46% of this maturing debt was originated while the fed funds rate was less than 25 basis points, vs. 513 basis points at the end of 3Q24. Additionally, many loans are underwater or nearly so, especially recent loan vintages of most property sectors and broad swaths of office debt. <u>We estimate that $529 billion in debt maturing between 2024 and 2026 is potentially troubled</u>.

- **Equity Markets.** <u>Investment sales declined 4.7% year-over-year in the first 3 quarters of 2024 and negative 33% compared with the 2017-to-2019 average</u>. Office sales were flat compared to the second quarter, while multifamily took a step back after an M&A heavy second quarter. Liquidity has been strongest for smaller transactions. Deals under $100M made up 67% of volume traded in the last four quarters. Institutional investment continues to outpace 2023, with a 38% increase in Office acquisitions, though institutional remains net sellers of Office.

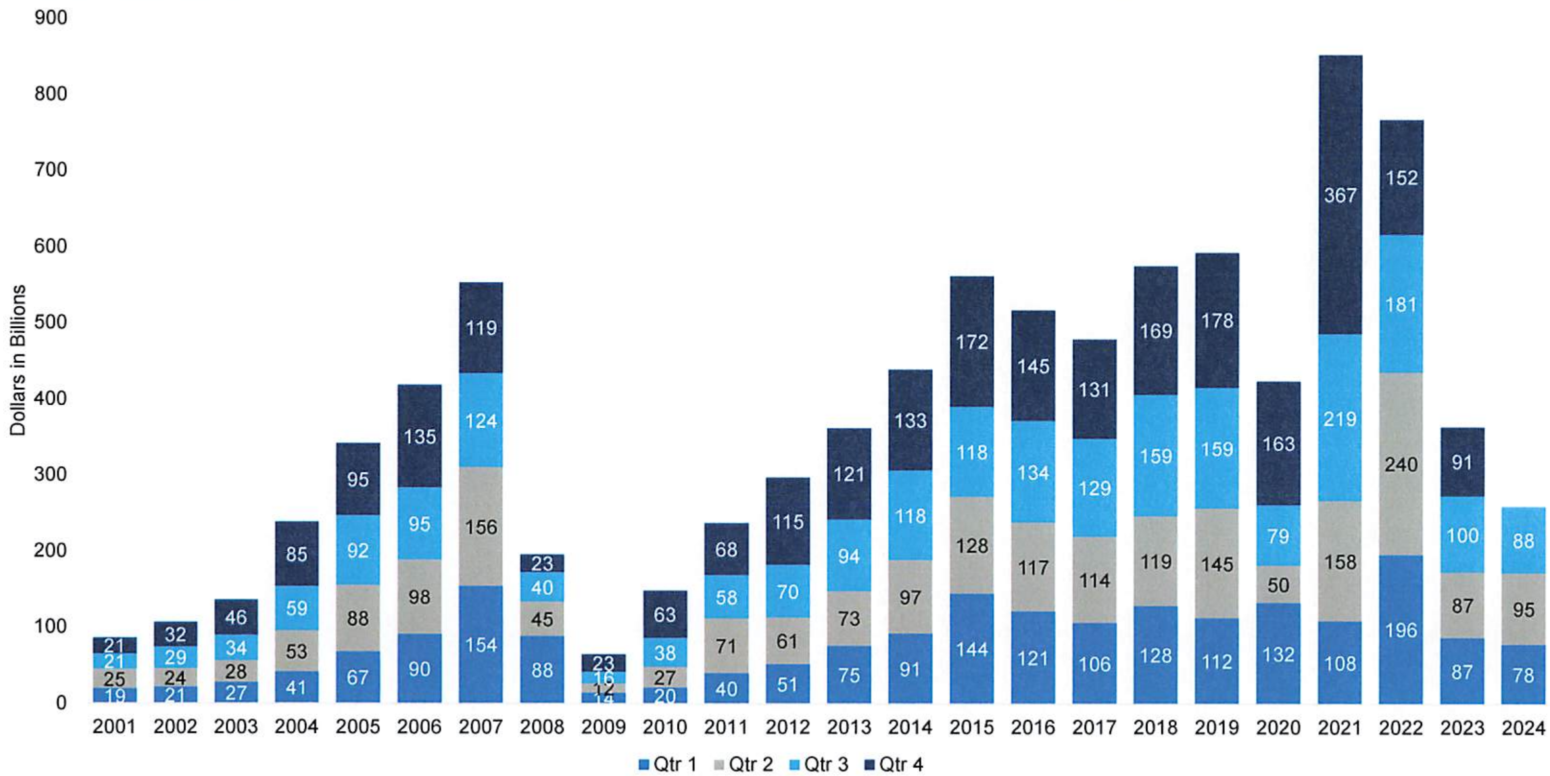
- **Supply of Capital.** Dry powder at closed-end funds currently sits at $326 billion, down 11.7% since December 2022. Dry powder at value-added, opportunistic and debt funds are now well-off their peak levels. We estimate that 78% of this capital is targeting residential and industrial assets. Much of this dry powder was raised from prior vintages. ODCE fund flows decelerated showed net outflows for an 8th straight quarter. Redemption queues remain an issue for many funds, driven by persistent if narrowing gaps between NAV and market values.

- **Pricing and Returns.** Transaction markets now show clear increases in transaction cap rates, following the public markets. Lower corporate bond yields have driven improvement in mortgage bond spreads. Nonetheless, <u>both in the private and public markets, cap rates appear distinctly unattractive relative to the cost of debt capital, possibly excepting office REITs</u>. This is not surprising in the private markets, where transaction volumes are muted and reflect selection bias and appraisal-based valuations lag market conditions. Extremely narrow cap rate spreads in the REIT markets are harder to justify and seem to require a rapid decline in debt costs, historically abnormal NOI growth or a combination of the two. Notwithstanding the structural deficiencies in NCREIF valuations during periods of rapid change like today, NCREIF NPI broadly improved in 3Q24 and was positive for first time since 3Q23. All sectors recorded positive total returns except for office. 77% of markets recorded positive total returns in 3Q24 up from 41% in 3Q23.

Sales Activity Remains Anemic, With A Possible Light At The End Of The Tunnel

Sales declined 4.7% year-over-year in the first three quarters of 2024 and negative 33% compared with the 2017-to-2019 average. This represents little improvement compared to 1Q24 which was down 33% relative to the 2017-to-2019 average. The Feds September 50 basis point rate cut did help thaw the market, even if it really has not turned up in the data yet, but strong economic data has pushed up terminal rate expectations, complicating the picture for CRE investors.

Investment Sales Volume



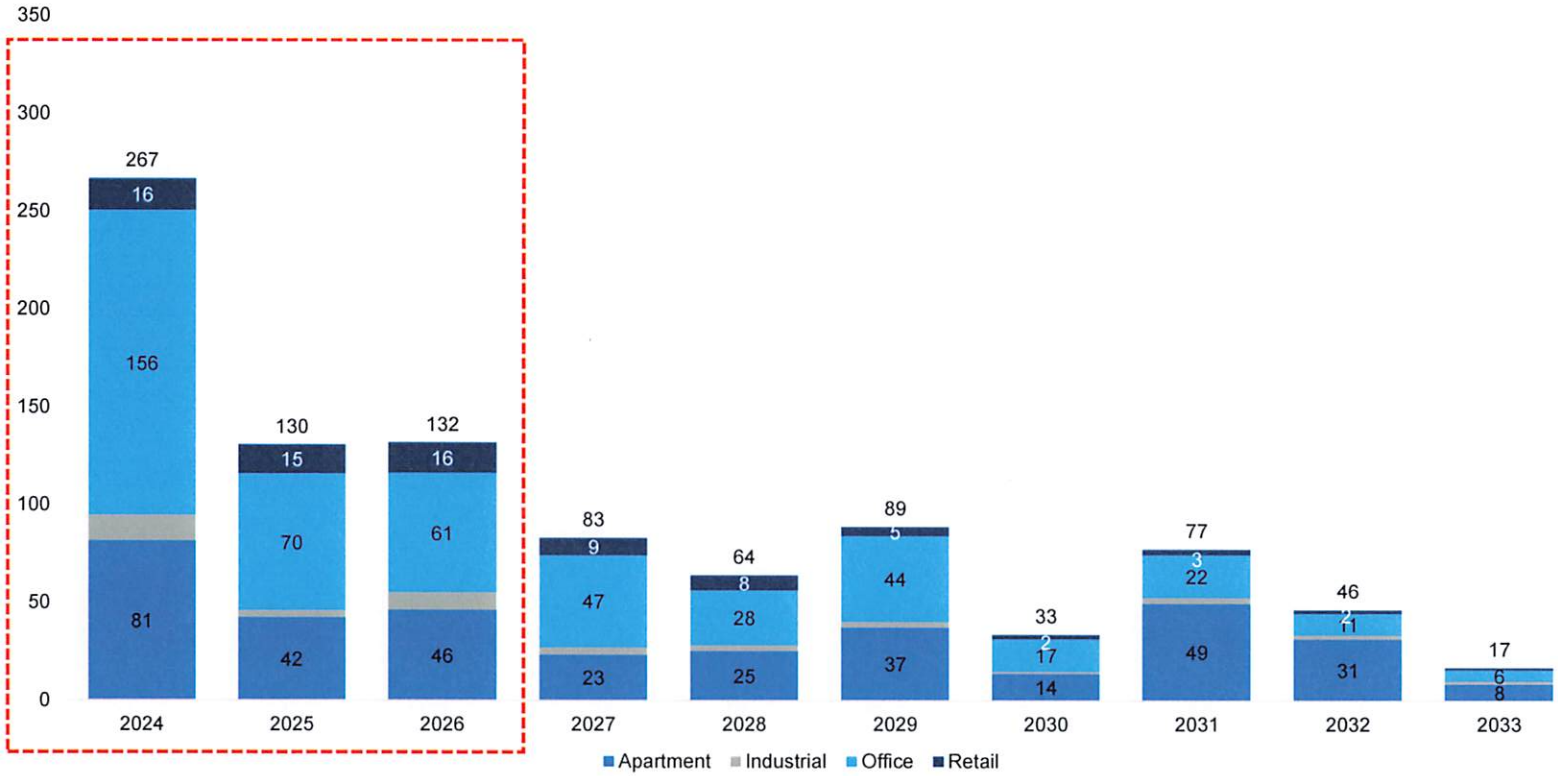
Source: RCA, Newmark Research as of 10/23/2024

We estimate $529 billion in loans maturing between 2024 and 2026 are potentially troubled. Office, Multifamily, and floating rate loans are of particular concern.

Nearly $1T of Outstanding CRE Debt is Potentially Troubled, $529B Maturing in '24-'26

Combining our analysis of mark-to-market LTVs with the structure of debt maturities, we estimate the volume of debt that currently is potentially troubled.* Office and multifamily loans constitute most potentially troubled loans, particularly in the 2024-to-2026 period. The high office volume results from most loans being underwater. The distribution of LTV ratios for multifamily are more favorable overall, but the greater size of the multifamily market and the concentration of lending during the recent liquidity bubble drive high nominal exposure.

Potentially Troubled Loans by Maturity Year*



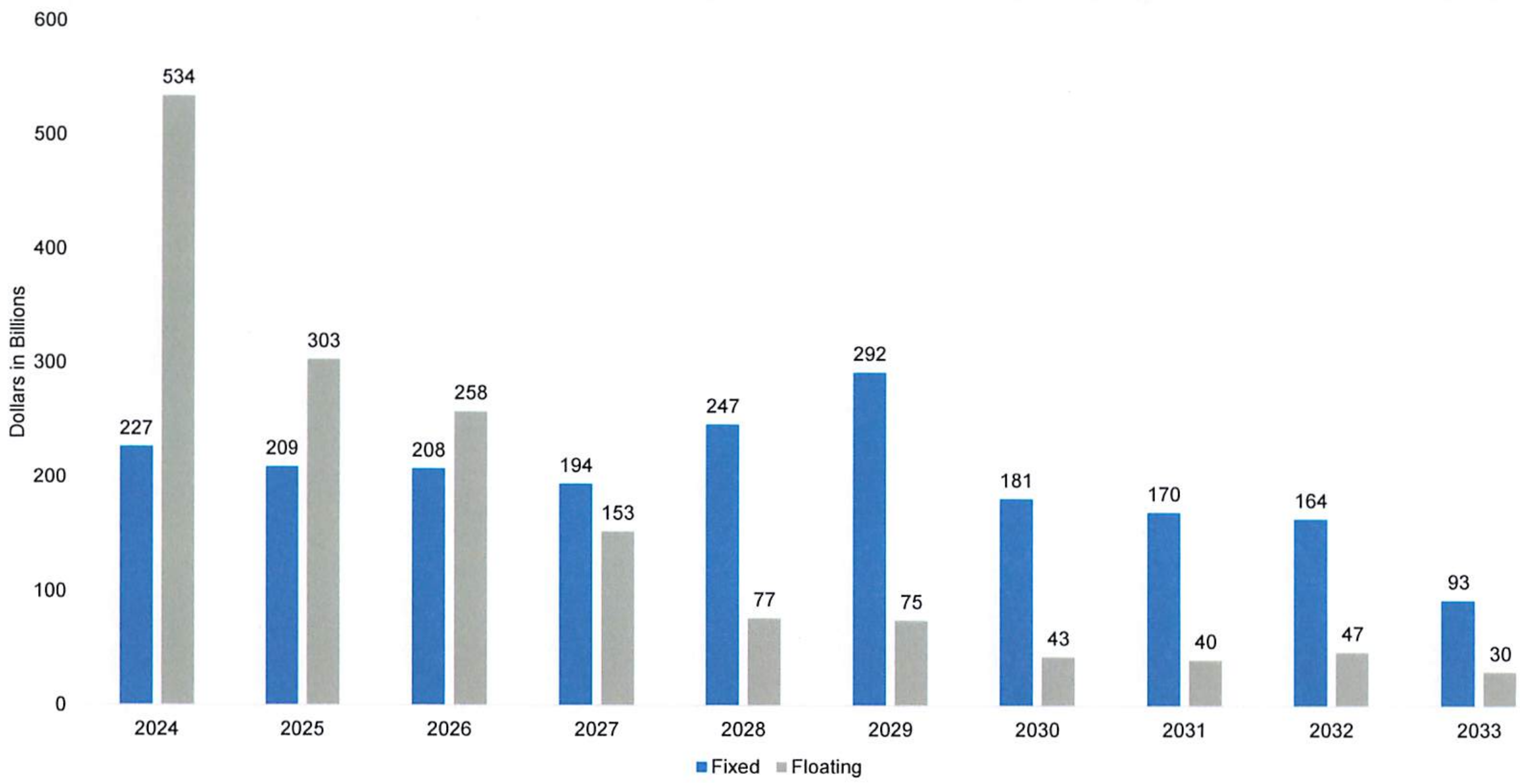
Source: Moodys, Green Street, RCA, Trepp, MBA, Newmark Research as of 10/23/2024

*Loans with an estimated senior debt LTV of 80% or greater are potentially troubled. The loans are marked-to-market using an average of cumulative changes in the Dow Jones REIT sector price indices, REIT sector enterprise value indices and Green Street sector CPPI.

Estimated $534 Billion in Floating Rate Loans Mature in 2024, $1.1 Trillion in '24-'26

Floating rate loans are the most likely to be facing cash flow problems. Extensions of existing loans at in-place rates offer little comfort to these borrowers in contrast to the fixed rate market. As such, floating rate loans are most likely to exhibit distress.

Commercial Mortgage Maturities: Fixed Rate vs. Floating Rate*



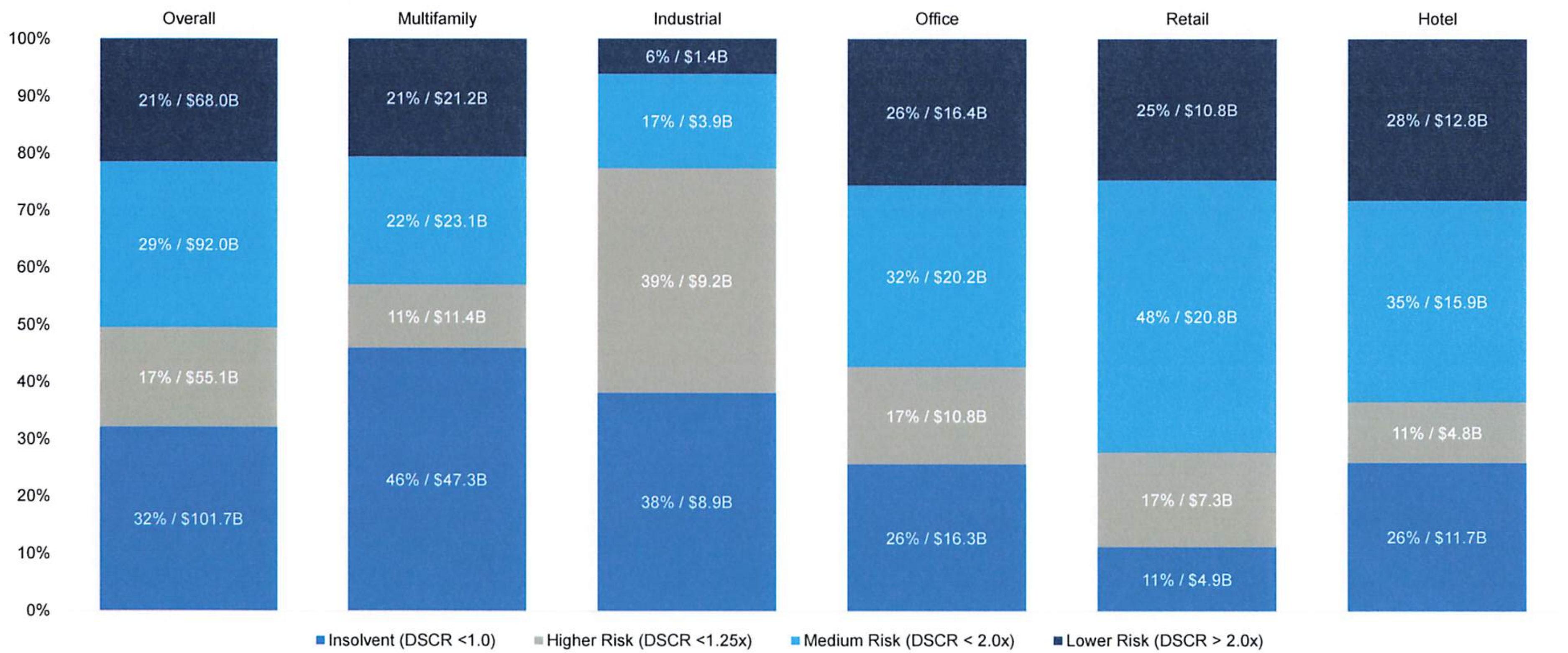
Source: RCA, MBA, Newmark Research as of 10/23/2024

*Includes office, multifamily, industrial, retail, hotel and healthcare property sectors. These figures are estimates and may differ both from MBA's published figures and from Newmark's model projections for property and lender sector totals. Analysis does not incorporate the effects of rate caps.

Some Loans Will Be Able to Absorb Higher Interest Costs – Many Will Not

Even property types with strong operating fundamentals could face challenges covering new, higher interest costs. Floating rate loans on transitional product – a significant portion originated by debt funds and securitized in CRE CLO – are particularly fraught. This is largely responsible for the high portion of at-risk loans in the multifamily and industrial sectors. The securitized markets are not an isolated problem; banks engaged in a great deal of this newly risky lending. New bank regs give them a "pass" on underwater loans but not DSCRs.

DSCR Profile of Outstanding Securitized CRE Debt Maturing Before 2026

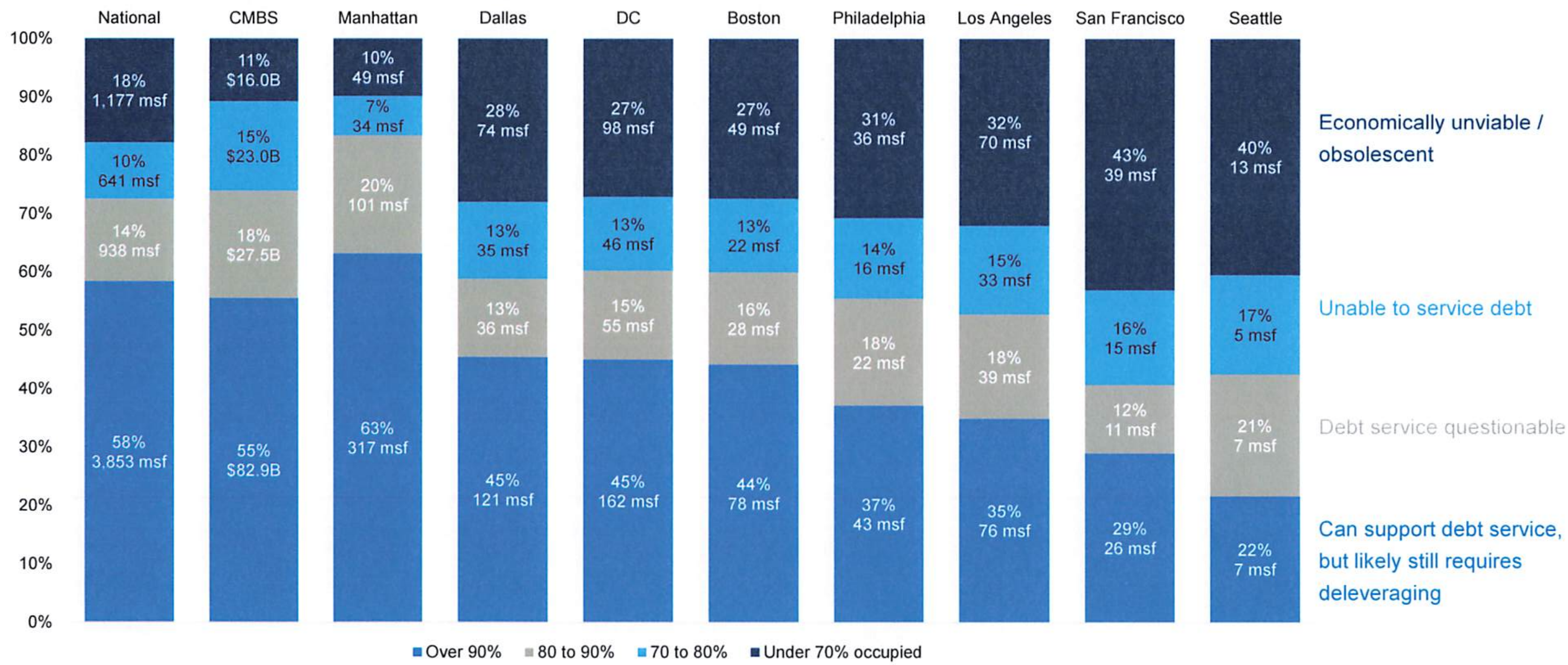


Source: Trepp, Newmark Research as of 10/29/2024

Vacancy Is Not Evenly Distributed within Markets, nor Will Be Impairments

Significant portions of the office market are structurally impaired purely from an occupancy perspective. Debt issues will accelerate their demise. On the other hand, many offices have healthy occupancy profiles. While they may still be over-levered, there is a clear fundamental path to solvency.

Distribution of Office Vacancy



Source: Costar, Newmark Research as of 10/25/2024