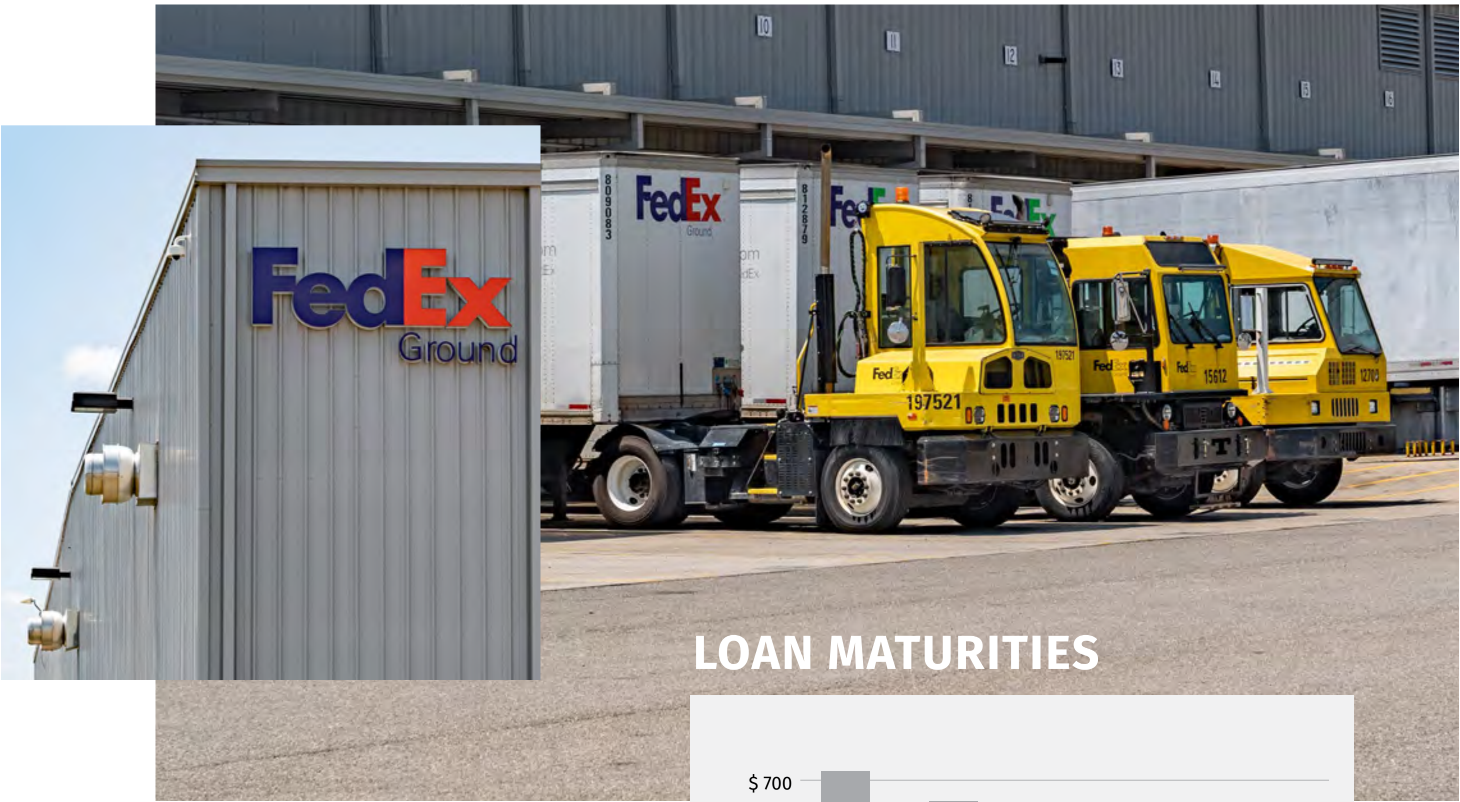
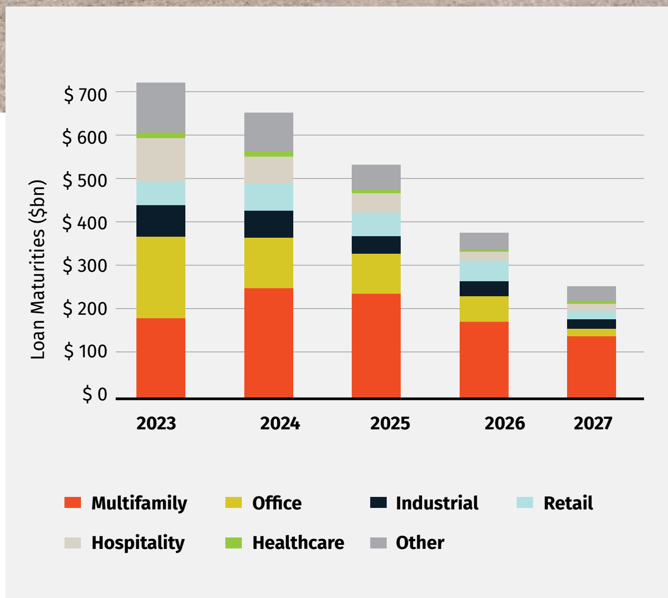
CRE INCOME FUND

MID-YEAR OUTLOOK 2023

OVERVIEW



LOAN MATURITIES



First quarter volume of U.S. Commercial Real Estate investments was **$77.5 billion**, 58% lower than last year. Volume will likely be restrained in the near term as inflation, while cooling, is still above the Fed's target. Fed officials have broadcast "higher for longer" as a theme, though recent statements offer rate flexibility. The forward curve suggests rates will fall in the upcoming quarters, which would support additional investment sales activity. Signs of thawing are emerging, specifically around industrial.

Investors are building ample capital to deploy. A near-record amount of money remains on the sidelines, and Blackstone recently announced the closing of its latest fund, with **$30.4 billion** raised. The market is signaling distress, with headlines reporting property defaults. Some of these defaults result from owners handing the keys back to lenders, and others are procedural to rework debt terms. Lenders are willing to extend loans for performing properties; those not meeting DSCR or LTV covenants will need equity infusions.

Loan maturities are a focus. More than **$700 billion** in maturities are due this year across all lender types, per estimates from the Mortgage Bankers Association. A total of **$2.6 trillion** is set to mature by 2027, creating buying, recapitalization, and rescue capital opportunities in the months and years ahead. Unlike the period after the Global Financial Crisis, the Fed cannot be as accommodative with monetary policy. Owners and lenders are looking to buy time, but kicking the can in a higher interest rate environment is more challenging.

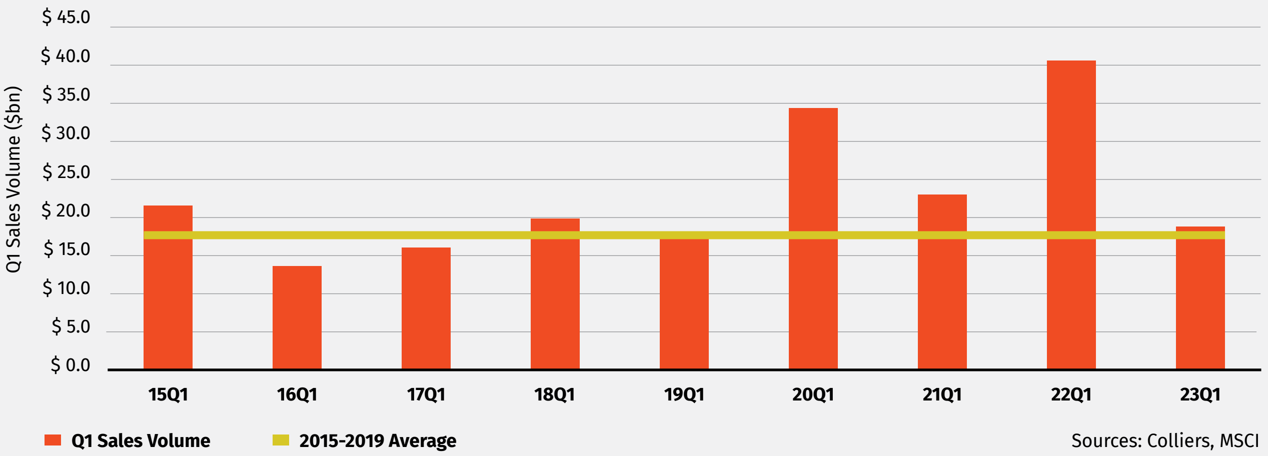
INDUSTRIAL

Industrial offers relatively stronger liquidity than other property types. While volume is down, it exceeds the 2015-19 Q1 sales average, signaling this asset class may be returning to a sense of normalcy after a surge in sales activity in recent years. Industrial buyers can still underwrite mark-to-market rent upside, keeping some cap rates at or below **5%**. At the same time, assets are trading at wide cap rate spreads to one another within the same market, suggesting there may be a mismatch between pricing and credit quality, providing strategic buying opportunities.

Buyers and sellers are narrowing their bid-ask spread, helping to keep transactions moving. Relative to other asset classes, the sense is that more deals are coming to market. A number of owners have re-calibrated their previous pricing expectations given the rise in interest rates.

Sale-leasebacks, or outright corporate sales, are continuing to gain popularity. With a difficult public market on the debt side (issuing bonds) and limited interest in diluting shares via additional stock offerings, real asset sales are providing an attractive alternative. Depending on the asset(s), campus, or land, the short term security of credit tenancy with the upside of additional development in the future is appealing.

Q1 INDUSTRIAL SALES VOLUME



Sources: Colliers, MSCI

MULTIFAMILY, INDUSTRIAL AND NEIGHBORHOOD RETAIL ARE STILL GOING STRONG.

KEY TAKEAWAYS

- Market disruptions and a rising interest rate environment have furthered economic uncertainty.
- Multifamily, industrial and neighborhood retail continue to perform well. But B- and C-class office buildings may have an uphill battle.

INTEREST RATES

Between March 2022 and May 2023, the Fed raised interest rates 10 consecutive times. Rates have risen at the fastest pace in decades, and it's taking investors time to adjust. Many commercial real estate owners still pay rates lower than current levels, so refinancing activity has slowed. It's unclear if rates will continue to rise or if the Fed will change course in the second half of the year. This leaves investors with a familiar feeling: uncertainty.

COMMERCIAL REAL ESTATE TRENDS ACROSS ASSET CLASSES

While the future of the office is unclear, commercial real estate has remained resilient in the first half of 2023.

Multifamily rental costs rising more slowly:

Multifamily properties are still going strong. The national vacancy rate for multifamily was at **4.5%** at the end of 2022, according to Moody's Analytics, even as the rate of rent increases fell. Vacancy rates vary widely across metro areas, but the median vacancy rate nationwide is **3.9%** as of April.

Increasing affordable housing:

The country's affordable housing supply continues to lag far behind demand. A multipronged method to growing the housing supply is critical moving forward. Efforts may include finding creative ways to preserve, build and finance affordable housing—and working with public entities to create zoning variances that allow greater density in residential areas.

The strength of retail:

E-commerce accounts for roughly **15%** of retail, but that doesn't mean consumers can get everything online. There are still services that favor or even require in-person visits. For example, trips to the nail salon, barbershop and sports bar are still standard.

Industrial may be stabilizing:

Fueled by e-commerce and an everything-on-demand economy, industrial has been booming for years. The vacancy rate for distribution and warehouse space was **4.1%** throughout the second half of 2022—a record low, as the rate has steadily declined each quarter since the end of 2020. The rate rose 10 basis points in the first quarter of 2023 to **4.2%**.

Office space still up in the air:

Remote and hybrid work have largely reduced demand for office space. Still, A-class properties are performing well. Office properties with leases of 10 years or more may be able to ride out the market correction. But B- and C-class office buildings—especially those located with shorter leases outside prime locations—face challenges as the workplace evolves.

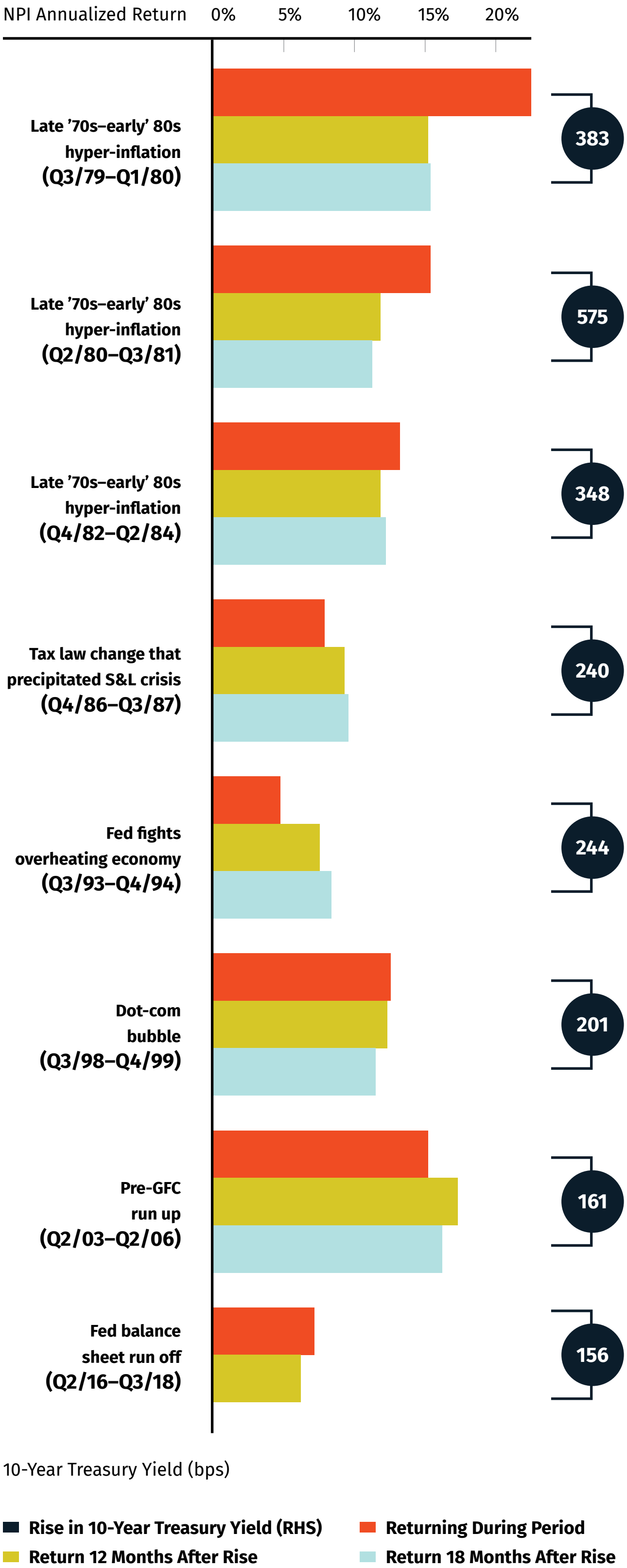
MOVING FORWARD REQUIRES REMODELING FOR HIGHER INTEREST RATES

HIGHER RATES WILL TEST MARKETS

The combination of higher inflation and rising interest rates will likely have a material yet varied impact on the US commercial real estate market in 2023. There have been some disruptions across real estate debt and equity capital markets.
In 2022, ten-year financing costs ranged between **3.3%** and **6.3%**, up 300 basis points at their peak.8 Higher financing costs along with tighter lending standards have added some upward pressure on capitalization (cap) rates and downward pressure on property values. There are, however, still significant positive tailwinds. National consumer spending, labor markets, business activity, and corporate balance sheets have all continued to be relatively healthy. For these reasons, we do not believe the coming downturn will be as severe. Baseline forecasts for US economic growth are generally positive, including the expected creation of more than **2.5 million** new jobs between 2023 to 2025. While every real estate downturn has its own unique dynamics, historically, US private real estate investment performance has been positive during periods of rising yields, as well as during the 12 to 18 months thereafter. In fact, looking across periods where rates rose at least 150 basis points, real estate typically rebounded with nearly double-digit returns in the subsequent periods.

REAL ESTATE PERFORMED WELL DURING PERIODS OF RISING INTEREST RATES

NCREIF Property Index (NPI) Returns During Periods of Rising 10-Year Treasury Yield Greater than 150 Basis Points.



Sources: Bloomberg, NCREIF, Clarion Partners Investment Research, Q2 2022.

Past performance is no guarantee of future results.

LOCATION, LOCATION, LOCATION… AND SECTOR ROTATION

If the first rule of real estate is location, the second rule in the new environment is knowing which sectors are in need of rotation. Post-pandemic trends like remote work, e-commerce growth, and the migration of people to non-traditional urban business centers are reshuffling real estate markets. Because of strong job growth and overall demand for commercial space, property cash flows have remained relatively healthy. While some property sectors, such as office and mall, have not fully recovered from the pandemic impacts, other property sectors have reported sizable ongoing rent growth, including industrial, apartment, life sciences, and self-storage. In addition, new supply is at manageable levels, especially since elevated construction costs and supply chain disruptions present additional headwinds for new development projects. Geographically, high-growth markets with thriving industries, business-friendly policies, and strong demographics have also seen robust investment performance given the strength of underlying demand fundamentals. Steady migration and corporate relocations have led to outperformance in many Sun Belt metros and premier suburban areas.

TRENDS LIKE REMOTE WORK AND E-COMMERCE ARE RESHUFFLING SECTOR LEADERSHIP

US Real Estate Fundamentals and Pricing Power by Property Sector

Weakening	Improving	Strong	Robust	
Office	Hotel	Data center	Industrial	Self-storage
High-street retail	Senior housing	Student housing	Multi-family housing	Manufactured housing
Regional mall	Infill necessity retail	Medical office	Life sciences	Single family housing

Source: Clarion Partners Investment Research.

OPPORTUNITIES IN A SHIFTING CYCLE

Looking into 2023, investors should take a long-term view during this period of uncertainty. The current macroeconomic risks and market dislocations may create attractive buying opportunities over the next 12 to 18 months. In the long run, we believe an adequate allocation to commercial real estate makes sense for many investors, as it has proven to be an effective inflation hedge historically and can offer portfolio diversification benefits. As commercial real estate transitions into the next market cycle, we also think positioning portfolios for better risk-adjusted performance is important, with an overweight to property sectors and markets that have strong pricing power and the ability to grow cash flow over time.

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