Park Madison Perspectives

Outlook 2024

PARKMADISONPARTNERS

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About Park Madison Partners

Park Madison Partners is a boutique New York-based capital solutions and advisory firm for global real estate alternative investments. Since its formation in 2006, Park Madison has advised on over $27 billion in private capital placements for a wide range of real estate vehicles including closed-end funds, open-end funds, separate accounts, programmatic joint ventures, and recapitalizations.

Park Madison Partners was founded to offer clients capital raising and strategic consulting services with a high degree of customization, integrity and accountability. The firm provides a relationship-driven approach to structuring and marketing assignments and offers its clients access to global institutional investors. Our team comprises professionals with backgrounds across the buy-side and sell-side, and we leverage this experience to provide a thoughtful approach to global real estate markets.


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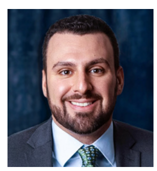
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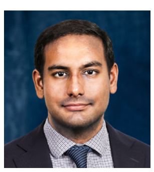
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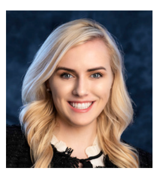
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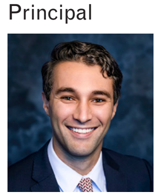
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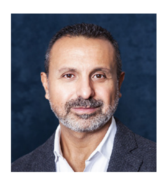
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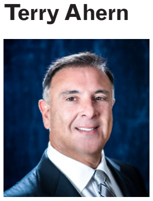
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> **“ There can’t be a crisis next week. My schedule is already full. ”**
>
> **– Henry Kissinger**

The New Year is traditionally accompanied by a sense of hope and optimism as we turn the page and look forward. Real estate investors are no doubt eager to put 2023 in the rearview mirror. But in recent years the sheer volume of crises – economic, financial, public health, geopolitical, constitutional, or otherwise – has almost conditioned us to approach the New Year warily, wondering what strange new surprises and challenges lie in wait. Indeed, the recently popularized real estate slogan “Stay alive till ’25!” does not exude confidence for 2024. While we certainly expect challenges, we don’t think the sky is falling and are optimistic that 2024 could be an exceptional vintage for the right property types and investment strategies.

Each year we make predictions on 10 major themes affecting the commercial real estate industry, attempting to identify the trends and data points that we believe are most relevant to real estate investors today. Last year we did pretty well, and you can see a full analysis of how we fared in our “2023 Scorecard” at the end of this piece. But first, here are our top 10 predictions for 2024:

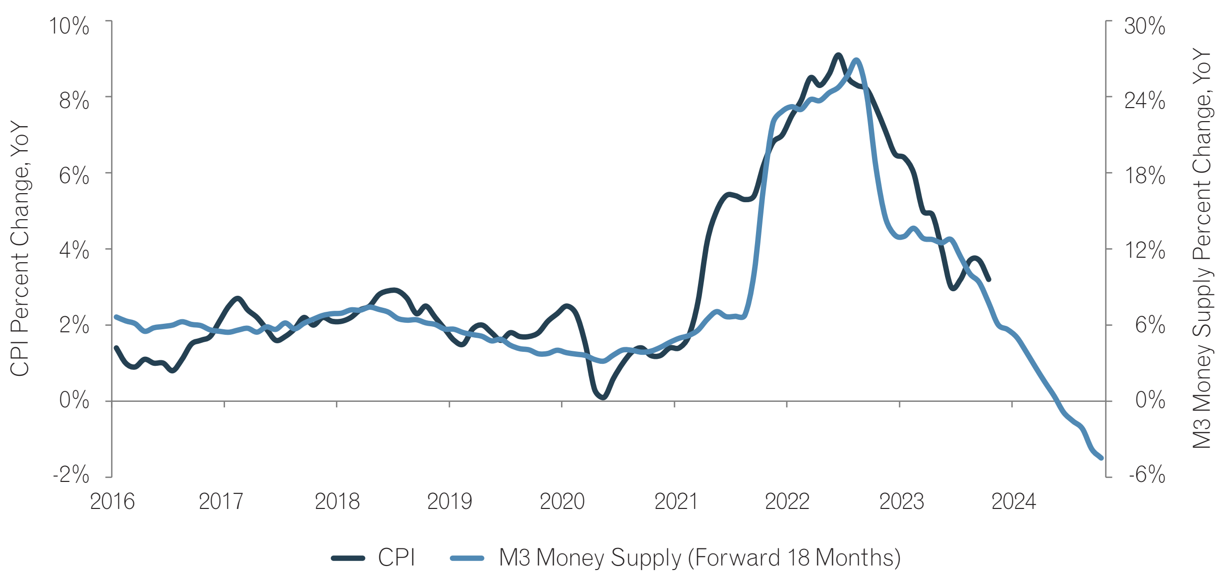
1 The Fed will cut interest rates modestly as inflation cools, but U.S. fiscal policy will become a focus

The U.S. economy's performance in 2023 was nothing short of miraculous, defying nearly every mainstream prediction. Despite numerous recession warning signs, GDP is estimated to have grown by 2.4 percent for the year and unemployment remains near record lows. The March regional banking crisis briefly undermined faith in the banking system, but the damage was contained thanks to decisive action by policymakers. The Federal Reserve was able to continue hiking interest rates to fight inflation, with headline CPI subsequently falling to 3 percent. Markets now expect more than 100 basis points of rate cuts in 2024, and even the mythical economic "soft landing" seems possible.

The direction of Fed monetary policy is almost entirely dependent on inflation, and several indicators suggest inflation will keep falling throughout 2024. Economic growth is expected to slow as the effects of record economic stimulus burn off. Energy prices have cooled, and manufacturers are cutting prices. The Fed's program of quantitative tightening to reduce its balance sheet holdings is also shrinking the money supply, which tends to be a leading indicator of inflation. As inflation pressures ease, the Fed will presumably have more flexibility to cut interest rates.

A Monetary Phenomenon

Consumer Price Index vs M3 Money Supply (Forward 18 Months), 2016-Present

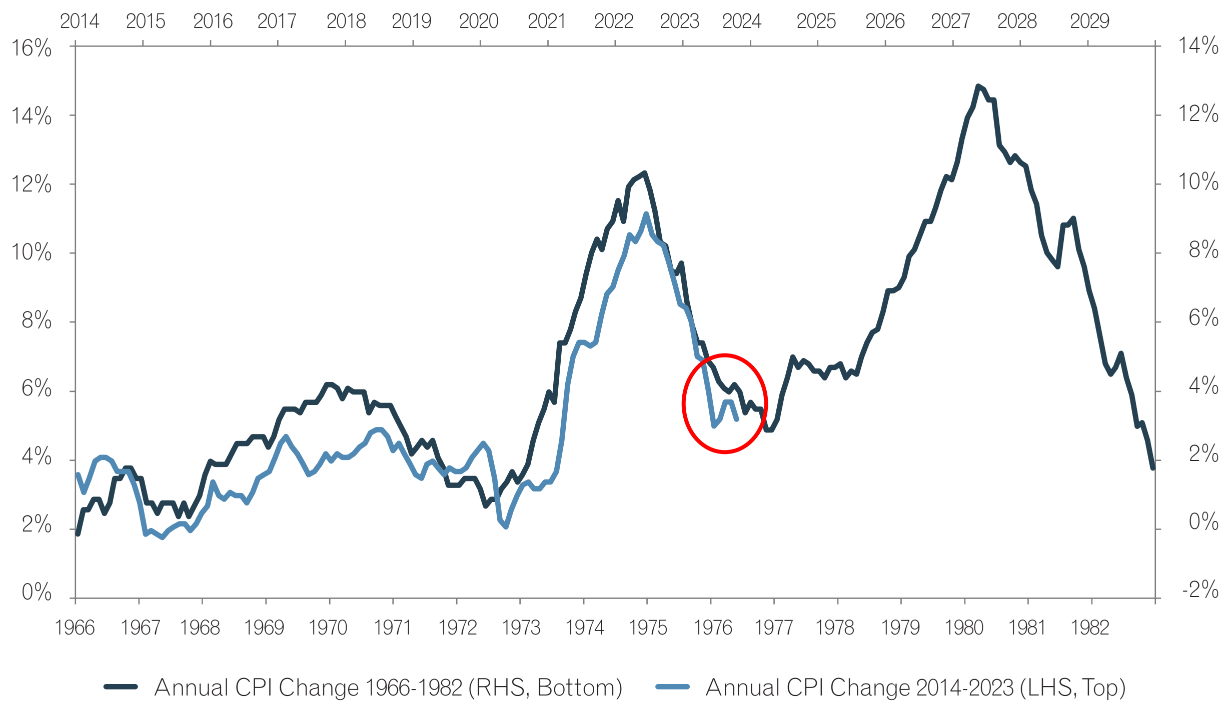


Source: Federal Reserve Economic Data

While we believe rate cuts are likely in 2024, we expect the Fed's vigilance on inflation will keep monetary policy restrictive in the near term. Core inflation, which strips out volatile food and energy components, remains elevated and is declining more slowly than headline CPI. The labor market is still historically tight, placing upward pressure on wages. A wage-price inflationary spiral could cause higher inflation to become entrenched and more difficult to quell, as occurred in the 1970s. Jerome Powell will be wary of repeating the mistakes of that period, when the Fed cut interest rates prematurely only to see inflation come roaring back. As such, we expect the Fed to perform a delicate balancing act of cutting rates while keeping policy mildly restrictive.

When the Fed Pivoted Too Early...

U.S. Inflation, 1966-1983 vs 2014-2023



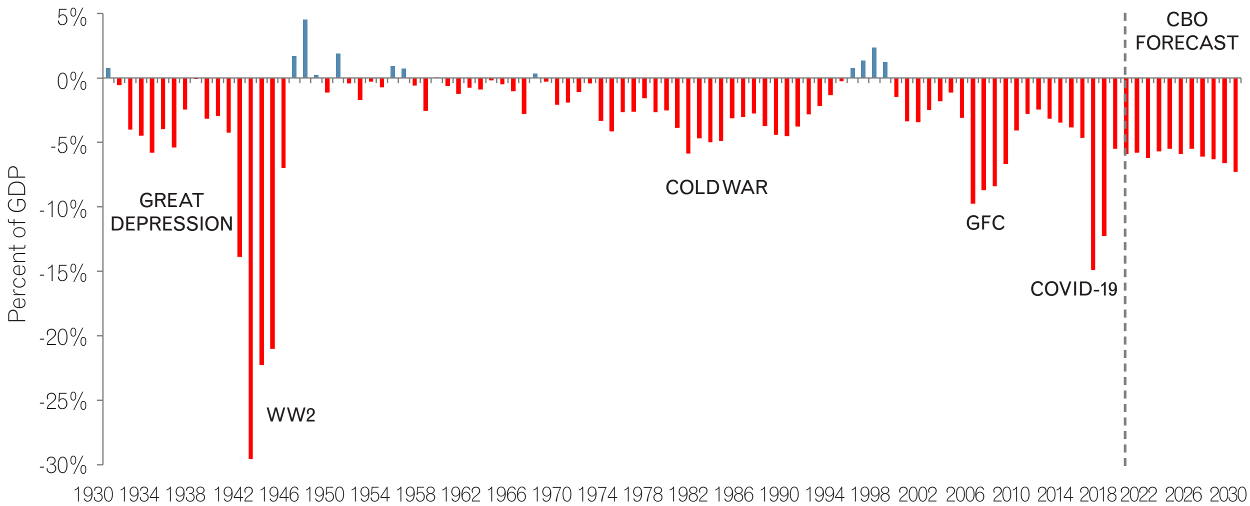
Source: Federal Reserve Economic Data

If inflation keeps falling and the Fed can gradually cut interest rates, we expect the U.S. economy to continue expanding and avoid recession. New technological innovations since the pandemic have made the economy more dynamic and adaptable than ever before. The job market is expected to remain strong as businesses are less willing to lay off workers given the difficulties of finding and retaining good talent, and rising real wages should drive further consumer spending growth. The Fed's resolve to tame inflation without "breaking something" – as nearly occurred with the banking system – has also instilled confidence. Growth will likely slow in H1, but few economists see an outright recession in 2024.

In the long run, investors would be wise to monitor not only the Fed, but also the U.S. fiscal outlook for clues on future interest rates. The federal budget deficit in 2023 was $1.7 trillion, or 6.3 percent of GDP, and is forecasted to remain elevated through the 2030s. Deficits of this magnitude have historically corresponded with recessions or war, but soaring entitlement spending threatens to make them permanent. With the Fed no longer buying bonds through quantitative easing, the general investing public is left to absorb all the new bond issuance from the U.S. Treasury. More demand for capital should in theory increase the cost of capital in the form of higher market interest rates. Investors should therefore be mindful that while Fed policy will continue to dictate short term interest rates, fiscal policy could start having more of an impact further out on the yield curve.

The Elephant in the Room

U.S. Federal Fiscal Deficit, 1930-Present



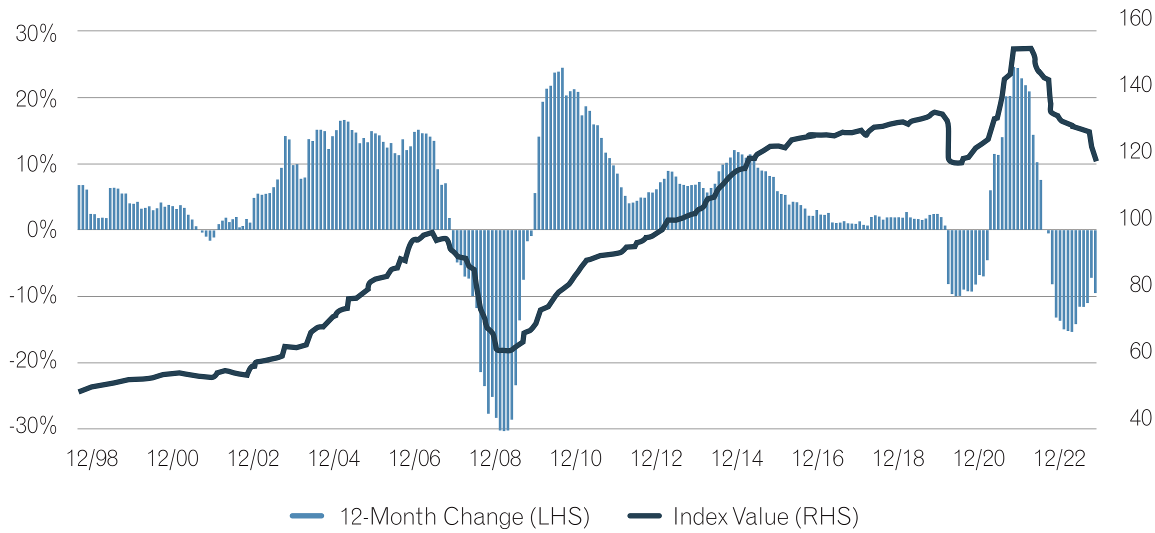
Source: Congressional Budget Office

2 Real estate transaction volumes will bounce back as interest rates and cap rates stabilize

Commercial real estate markets enter 2024 in the midst of a significant price correction. The Green Street Commercial Property Price Index ("CPPI®") is down 22 percent from its March 2022 peak, erasing nearly all the stimulus-fueled gains seen following the pandemic and marking the worst decline since the Global Financial Crisis ("GFC"). Cap rates have tracked interest rates higher across all major property types as buyers show little appetite for negative leverage. Capital availability is scarce as traditional lenders pull back, with loan origination volume down approximately two-thirds since 2022 according to CBRE. Investment transaction volumes are at decade lows amid wide bid-ask spreads. Market sentiment is understandably gloomy, but we believe 2024 will mark the bottom for commercial real estate this cycle as interest rates stabilize and capital markets thaw.

Don't Fight the Fed, Part 1

Green Street Commercial Property Price Index®, 1998-Present

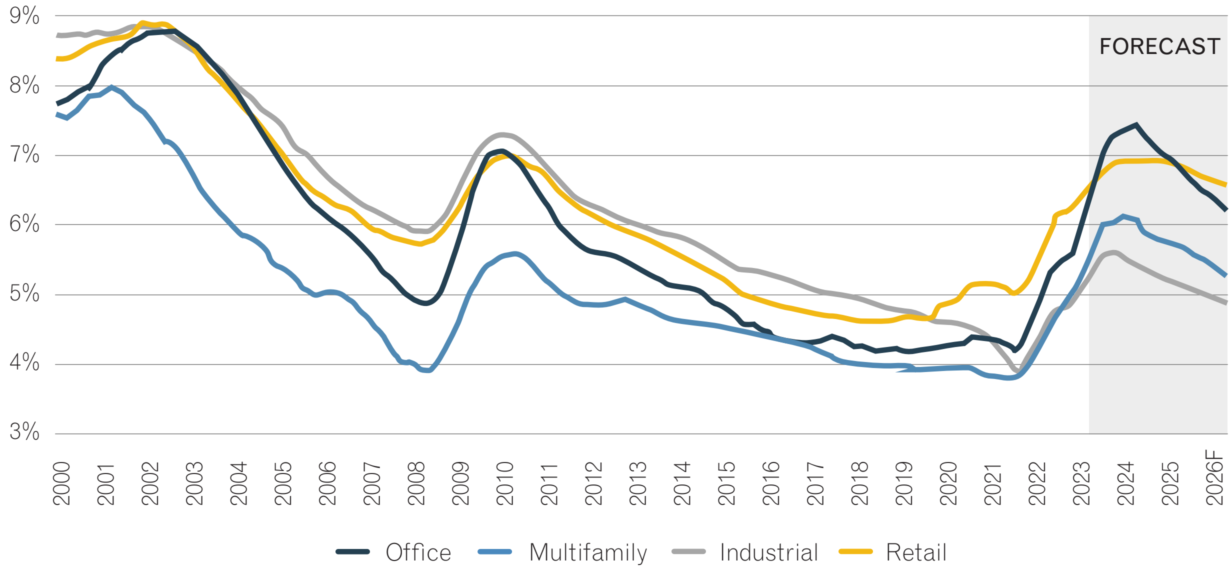


Source: Green Street. Reprinted with permission.

Historical data suggests the sharp move higher in cap rates is nearing an end. CBRE estimates that every 100 basis point increase in long-term interest rates results in a 60 basis point rise in cap rates. Assuming the 10-year Treasury rate settles in the 4 to 5 percent range versus the approximately 1.5 percent level observed throughout 2021, we should expect a roughly 150 to 210 basis points rise in cap rates from 2022 lows. Most property types have already registered such moves, suggesting a peak in cap rates could be near.

Don't Fight the Fed, Part 2

Commercial Real Estate Cap Rates, 2000-2026F



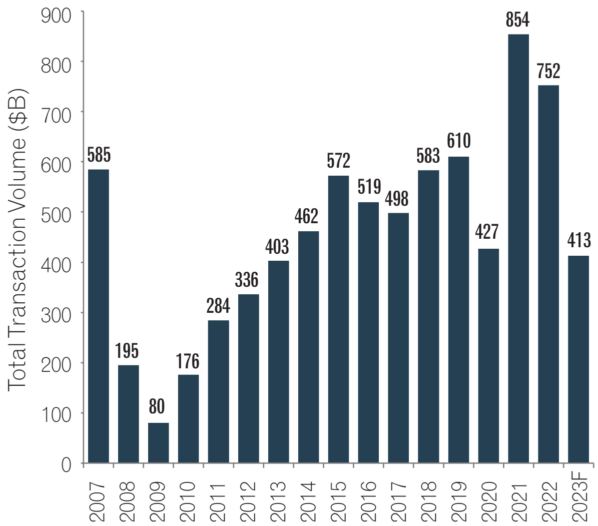
Source: CBRE Econometric Advisors, Q3 2023. Reprinted with permission.

As cap rates and interest rates settle, we expect debt financing to become more widely available in 2024. Despite 2023's regional banking turmoil and a sharp reduction in new loan originations, capital markets have proven much more sophisticated and resilient than during the GFC. As banks and CMBS markets have retreated, life companies have nearly doubled their loan origination volume and private lenders also remain quite active. Counterintuitively, overall commercial real estate loan balances have steadily increased throughout the current capital markets winter. We believe that speaks to both the depth and maturity of today's commercial real estate capital markets and increases the likelihood that debt financing will become more widely available as cap rates and valuations stabilize.

We also expect an uptick in investment volumes in 2024 as less capital market uncertainty causes bid-ask spreads to narrow. Most investors who could avoid selling within the last 18 months have done so, but looming debt maturities will likely increase the number of forced sales in the years ahead. Many investors purchased properties in 2021 and 2022 and eye-wateringly low cap rates, justified through assumptions of aggressive rent growth and continued low interest rates and cap rates. With interest rates and cap rates rising faster than some of these properties' yield on cost, many will encounter financial distress and be sold at a loss – even in situations where NOI has grown meaningfully since acquisition. A recent study from the National Bureau of Economic Research ("NBER") suggests that 14 percent of the $2.7 trillion commercial real estate loan market is at risk of immediate default. While distressed sales will be painful for investors, we believe the increased transaction volume will help the market clear and lead to a wider consensus on values.

Buyers' Strike

Commercial Real Estate Investment Volume, 2007-2023F



Source: CBRE Research, MSCI Real Assets, Q3 2023

Regardless of what happens in 2024, commercial real estate markets are clearly on the cusp of a new era. The alchemy of steadily falling cap rates is a thing of the past as interest rates bounce off the zero bound. However, the absence of this tailwind does not mean that real estate investments are no longer attractive. Cap rate compression was nice icing on the cake, but real estate investors have typically underwritten cap rate expansion, with returns driven by rising rents, NOI growth, and steady cash flow. We believe real estate will always offer such opportunities across market cycles, and investment managers with strong operating capabilities and ability to grow NOI will continue to thrive and profit.

Breaking the Urban "Doom Loop"

The pandemic's effects on urban downtowns and mixed-use environments represents one of the greatest real estate paradigm shifts we may see in our lifetimes, on par with the 1960s urban flight. Large cities historically depend on industry "clustering" for economic vitality, but remote work has caused individuals and companies to more critically assess the benefits of these locations. Other considerations such as cost of living and ease of doing business now factor more heavily and are driving people to relocate. Some cities will need to make big changes to remain competitive, provided they have the political will to do so.

The demise of office complicates the task of arresting urban decay. Office typically forms the core of a mixed-use ecosystem, with complementary property types such as retail, multifamily, and hotels combining to create a self-reinforcing dynamism of entertainment and culture – key benefits of urban living. With office vacancy spreading, the cancer of urban blight threatens to metastasize throughout business districts and downtowns.

As urban cores hollow out and amenities disappear, the higher cost of living associated with city life becomes more difficult to justify. Shrinking property markets diminish tax revenues, which could induce local politicians to either raise taxes or cut services to counter the shortfall. These responses risk making the problem worse: city life becomes less appealing, more people leave, the tax base erodes further, and so on. This fiscal trap has been dubbed the urban "doom loop," and as the term entails, arresting a doom loop is difficult.

Real estate investors will therefore need to carefully weigh local politics in their market selection. Smaller cities with a lower cost of living could become a bigger draw to businesses and high-earning residents. Meanwhile, large cities may need to up their game by better maintaining existing infrastructure, improving public safety, encouraging more housing development, and reducing regulatory burdens. While such prescriptions seem obvious, too often the news of departing businesses is met with sentiments of "good riddance" from local politicians, rather than a discussion on how to improve policy. In places where such political attitudes persist, we expect people and businesses will continue voting with their feet.

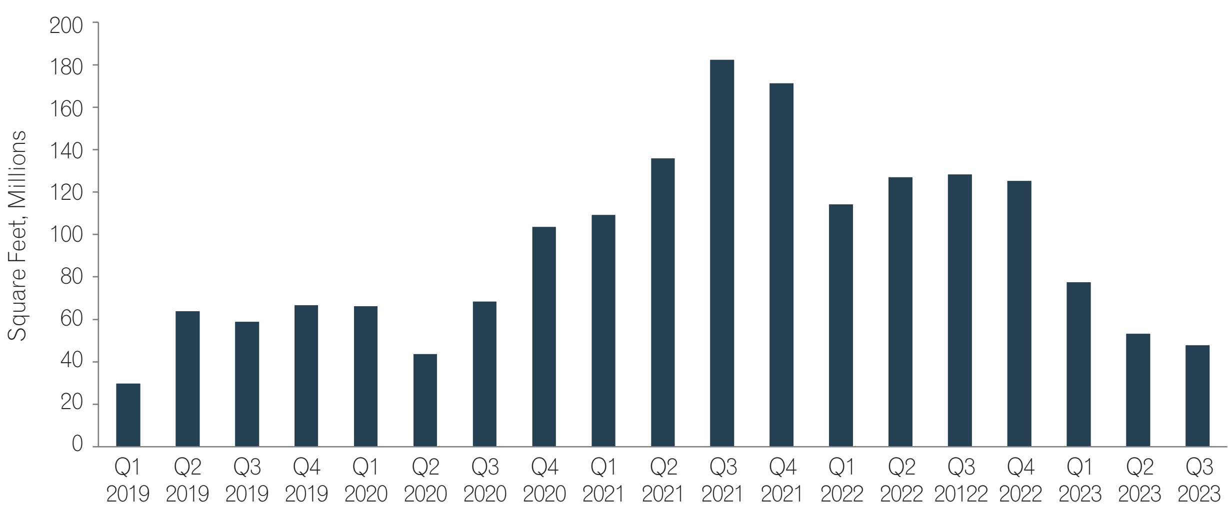
3 Industrial's price correction will prove short-lived as the development pipeline clears

After experiencing breakneck growth throughout the pandemic, industrial demand finally appears to be normalizing. Net absorption dropped to 47.8 million square feet in Q3 2023 according to Colliers, representing a 63 percent decline year-over-year and a 74 percent drop from the peak 182 million square feet absorbed in Q3 2021. With record new supply coming online, the slowdown in leasing activity has caused an uptick in vacancies. Cushman & Wakefield estimates over 500 million square feet developed in 2023, 80 percent of which was speculative. As record new supply outpaces demand, U.S. industrial vacancy has risen to 5 percent and is expected to rise further throughout 2024.

While these headline numbers appear dramatic, we believe U.S. industrial fundamentals are simply reverting to their (quite healthy) pre-pandemic averages. National net absorption rates are expected to stabilize near 2018-2019 levels, with vacancy peaking around 6 percent. Meanwhile, new supply is expected to moderate in the coming quarters, with new construction starts down more than 60 percent since 2022. Higher interest rates and less capital availability – particularly for speculative development – should further curtail new construction starts. As the current development pipeline clears, space shortages will likely become more common. Knowing this, industrial landlords have confidently pushed rents higher throughout 2023, and we expect rent growth to remain resilient in the years ahead.

Less Sizzle, But Plenty of Steak

U.S. Industrial Net Absorption, Q1 2019 – Q3 2023

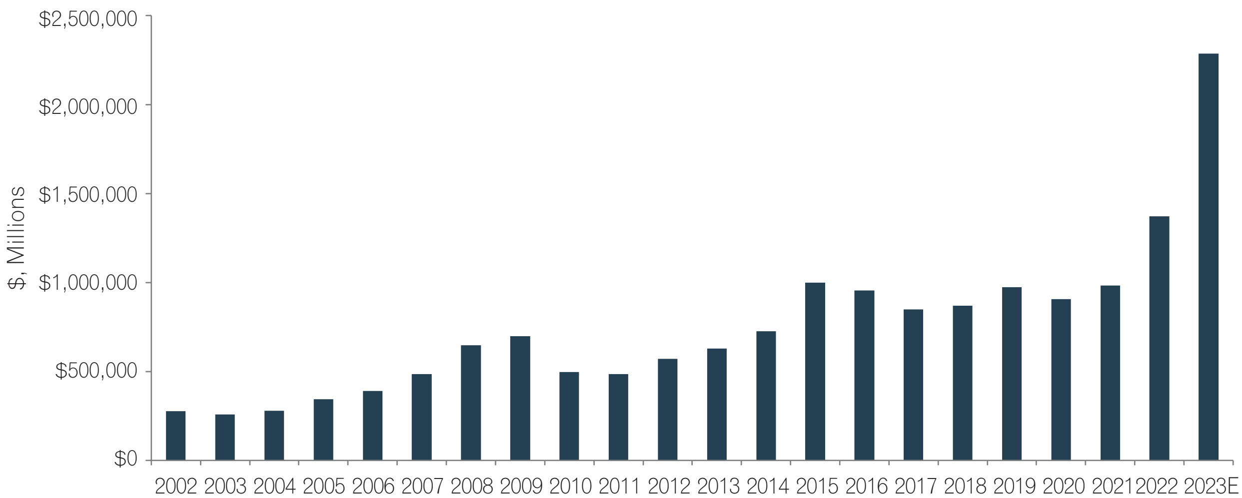


Source: Colliers. Reprinted with permission.

As cyclical pressures ease, the industrial sector's long-term secular growth story remains intact. E-commerce sales are steadily growing at 7.5 percent annually, outpacing overall consumer spending growth. CBRE projects e-commerce sales to grow by $400 billion in the next five years, resulting in approximately 500 million square feet of incremental demand. Manufacturing onshoring and nearshoring also continue to be major demand catalysts, particularly in the Sunbelt and Midwest.

Make It In America

Construction Spending on Manufacturing Facilities, 2002-2023E



Source: Federal Reserve Economic Data

With long-term fundamentals looking sound, we expect industrial property types to continue providing some of the most attractive investment opportunities in real estate. Strategically located infill properties are in high demand as businesses seek closer proximity to the end customer. Surging market rents have embedded significant future NOI growth as existing leases roll. From a development perspective, industrial still benefits from predictable demand growth and relatively short delivery times, allowing developers to quickly capitalize as space shortages emerge. Less institutional segments such as last-mile, small bay, and industrial outdoor storage should also provide portfolio aggregation opportunities as more investors seek exposure to these property types.

Of course, industrial has not escaped the impact of rising cap rates, which have expanded approximately 150 to 200 basis points since 2022. As a result, Green Street estimates that industrial property values have declined 16 percent from their 2022 peak. But we expect industrial's current price correction to be short-lived. Industrial's strong secular tailwinds persist, which should support fundamentals, drive NOI growth, and offset much of the impact from higher cap rates. Oversupply may keep the industrial market on edge in the near term, but for investors who can see 12 to 24 months ahead we believe 2024 will prove to be a bumper vintage.

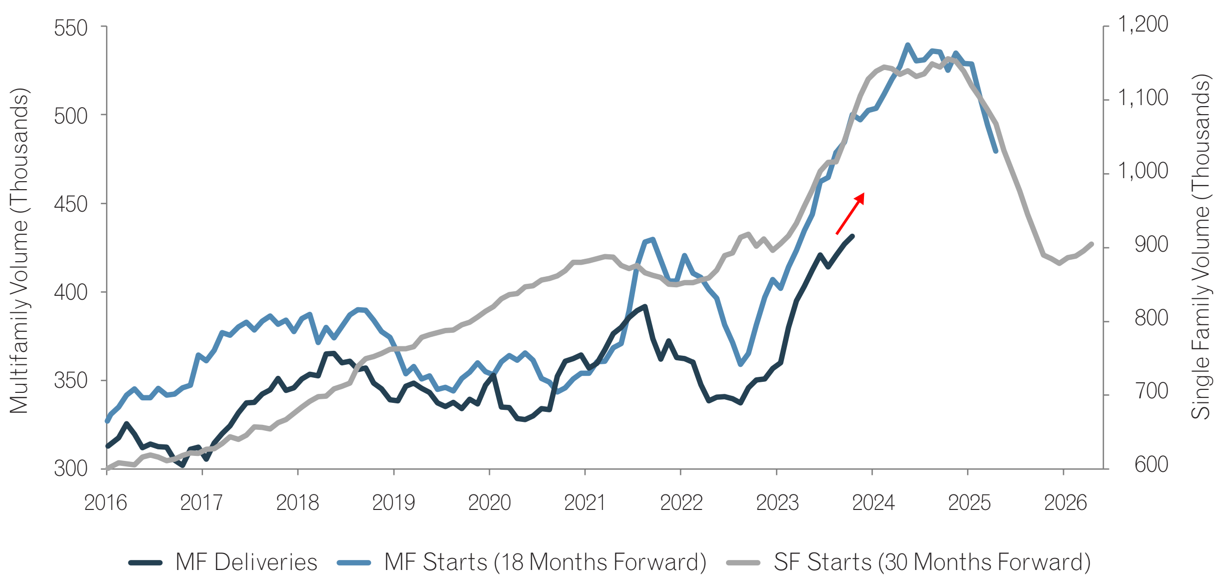
4 Rental housing valuations will bottom, and NOI margins will face pressure as expenses increase and rents remain flat

After an incredible bull market run, rental housing segments enter 2024 in the midst of a price correction. Green Street estimates apartment valuations are down 30 percent from their 2022 peak. This is largely due to rising cap rates, which have expanded by 150 to 250 basis points since the sub-4 percent lows of 2022. Property fundamentals are also under pressure from new supply and slowing demand. While fundamentals will likely soften further in 2024, we believe valuations are bottoming and may offer an attractive long-term entry point for investors.

Rental housing fundamentals were probably due for a soft patch. Several pandemic-era demand catalysts that boosted rent growth are normalizing: household formation has reverted to its pre-pandemic average, the stimulus-fueled jobs boom is cooling off, and home price growth has moderated. Developers have also responded to higher rents with the biggest wave of new supply since the 1970s. Approximately 1 million apartment units are currently under construction, with deliveries expected to crest in 2024. Nationwide occupancy levels have already reverted to near pre-pandemic averages – around 94.5 percent – which means landlords will have less pricing power in the near term as more units become available.

The Impending Wave

Multifamily Starts and Deliveries vs Single Family Starts, 2016-2026F



Source: Federal Reserve Economic Data

By 2025, however, we expect to see a resumption in steady rent growth. The current multifamily construction pipeline as well as single-family starts (which tend to be closely correlated) suggest that deliveries will fall approximately 20 percent by 2026, and elevated interest rates and low capital availability for new development could bring construction activity down further. Barriers to homeownership have also grown more acute. While price gains have slowed, median U.S. home prices in the for-sale market are still 34 percent higher than Q2 2020, which combined with higher mortgage rates means the monthly cost of owning a new home is now roughly 50 percent more expensive than renting. If these conditions persist, we believe renting will remain necessary or even preferred by many would-be homebuyers. This bodes well for apartments, manufactured housing, single-family build-to-rent ("BTR"), and other rental housing segments beyond 2024.

It's Terrible Time to Buy

Cost Premium/Discount to Buy a Home vs Renting One, 1997-Present

Source: CBRE, CBRE Econometric Advisors, Freddie Mac, U.S. Census Bureau, Realtor.com®, FHFA
Assumes purchasing a $430,000 home (U.S. median price) with a 30-year mortgage and a 10% down payment.

Ultimately, we believe the current price correction in residential assets provides an attractive entry point for investors across the risk spectrum. Value-add apartment strategies should continue to offer reliably healthy unlevered returns, with the opportunity for return enhancement when positive leverage is available. As more Millennials enter homebuying age and cannot afford to buy, BTR provides a natural alternative solution and is perhaps one of the most compelling development opportunities in real estate today. Manufactured housing also stands to benefit from increasing demand and barriers to new supply.

While rental housing's long-term secular growth catalysts remain strong, there's a growing consensus that 2024 could deliver further cyclical pain. Properties purchased in 2021 and 2022 at low cap rates with aggressive rent growth assumptions could experience declining NOI as operating expenses grow faster than rents. For those purchased with floating rate leverage, these challenges would be magnified and increase the risk of distress or foreclosure. But we expect the bottom for this cycle is near, with transaction activity picking up as cap rates stabilize. For real estate investors who appreciate rental housing's low volatility, stable cash flows, and secular growth story, we expect 2024 will be a busy year for capital deployment.

5

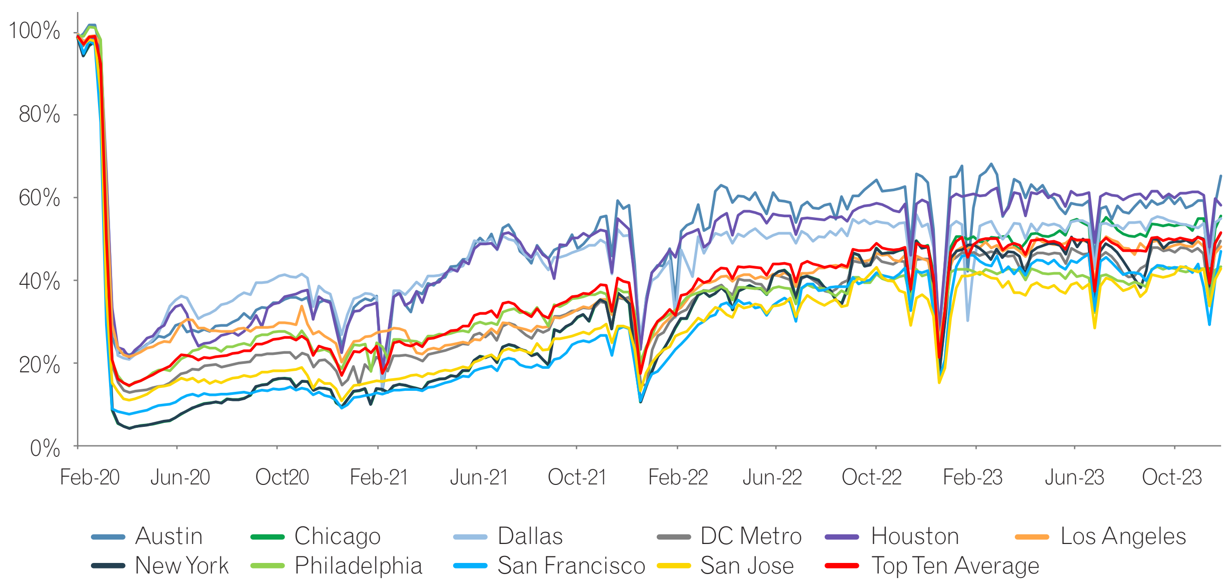
Office valuations will fall further as financial distress spreads

The post-pandemic outlook for office continues to be challenging due to a killer trifecta of stagnant demand, rising operating expenses, and higher interest rates. The office market has registered over 230 million square feet of negative net absorption since Q2 2020 according to JLL, leaving a glut of empty space. Nationwide vacancies continue to rise toward 17 percent, surpassing GFC levels. According to Green Street, valuations are down 31 percent since early 2020 and look set to fall further. Financial distress has been building, and a recent NBER study suggests that 44 percent of office loans have outstanding balances higher than the underlying property values, indicating a wave of foreclosures looming. While newer Class A properties continue to experience healthy demand, widespread weakness across the rest of the office sector will likely undermine office fundamentals and investment for several years.

Office demand continues to be negatively impacted by work from home ("WFH"), which is now entrenched via the hybrid work week. Two to four days per week in the office is the new normal and seems likely to persist, even as more employers enforce return to office mandates. Kastle data shows that office occupancy has stagnated around the 50 percent level. Gross leasing volume has stabilized at around two thirds of pre-pandemic levels, and we expect companies will continue reducing their office footprints as existing leases roll.

L-Shaped Recovery

U.S. Office Occupancy, February 2020-Present



Source: Kastle

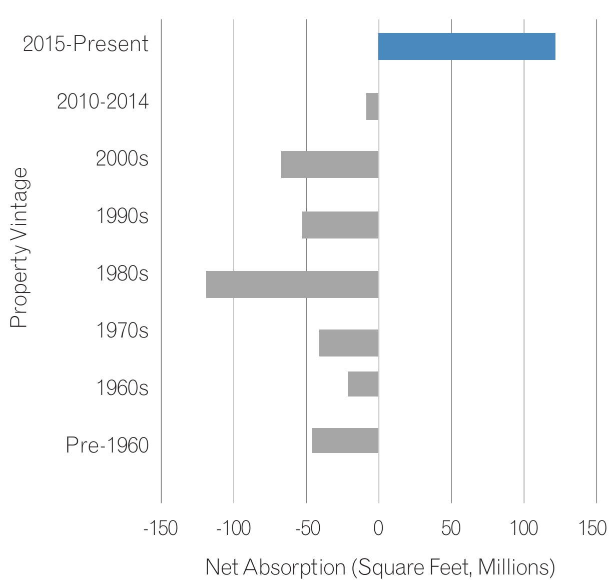
The office sector's problems are further compounded by a severe capital shortage. Office is now the most out of favor property type according to Urban Land Institute's annual survey, officially wresting the dubious distinction from regional malls. Many institutions have moratoriums on new office investments. Properties with 5-year debt coming due in the next 12 to 24 months will have a tough time refinancing at prior LTVs, if at all. Absent a successful "cash-in refinancing," many owners will be forced to surrender properties to lenders. While bad debt sales could help the market clear and reset valuations, such a repricing will have knock-on effects on fundamentals, as properties acquired at a lower cost basis can undercut competitors on rents. As such, we believe office valuations have further to fall before finding a cyclical bottom.

Still, investors should keep a watchful eye on office for signs of an emerging new supply-demand equilibrium. Steady job growth in office-using industries should eventually offset the pandemic's demand destruction. Newer Class A properties are seeing significant positive net absorption, and the pipeline of new supply is reaching lows last seen in 2010. Antiquated supply is also being removed at a faster rate, with conversion and demolition volumes looking set to triple pre-pandemic averages in 2024. Taken together, these market dynamics could eventually lead to space shortages, particularly in Class A. Once such an inflection point is finally reached, demand could spill out to less-favored properties and drive a recovery in values.

We also expect to see sentiment sour further on WFH after nearly four years of it. Prior to the pandemic, companies were highly focused on creative office designs that fostered "chance encounters" among colleagues, which was thought to encourage innovation. Not surprisingly, CEOs today can't seem to say enough bad things about WFH, citing negative consequences to team efficiency, collaboration, and culture as reasons to enforce return to office plans.

Haves and Have Nots

Office Net Absorption by Vintage since Q2 2020



Source: JLL. Reprinted with permission.

Until demand improves, we expect the few actionable office investment opportunities to largely focus on adaptive re-use or redevelopment of antiquated properties. Many older vintage, lower quality buildings are not leasable at any price and a change of use is the most practical option. Conversion to residential is challenging but could make sense in buildings with the right cores and floor plates. Demolition and redevelopment could also be attractive at the right basis, particularly for well-located suburban office campuses with high transportation connectivity. An old real estate adage instructs investors to "always buy the dirt," and we expect there will be increasing investor interest in the land beneath underperforming office buildings in the years ahead.

6

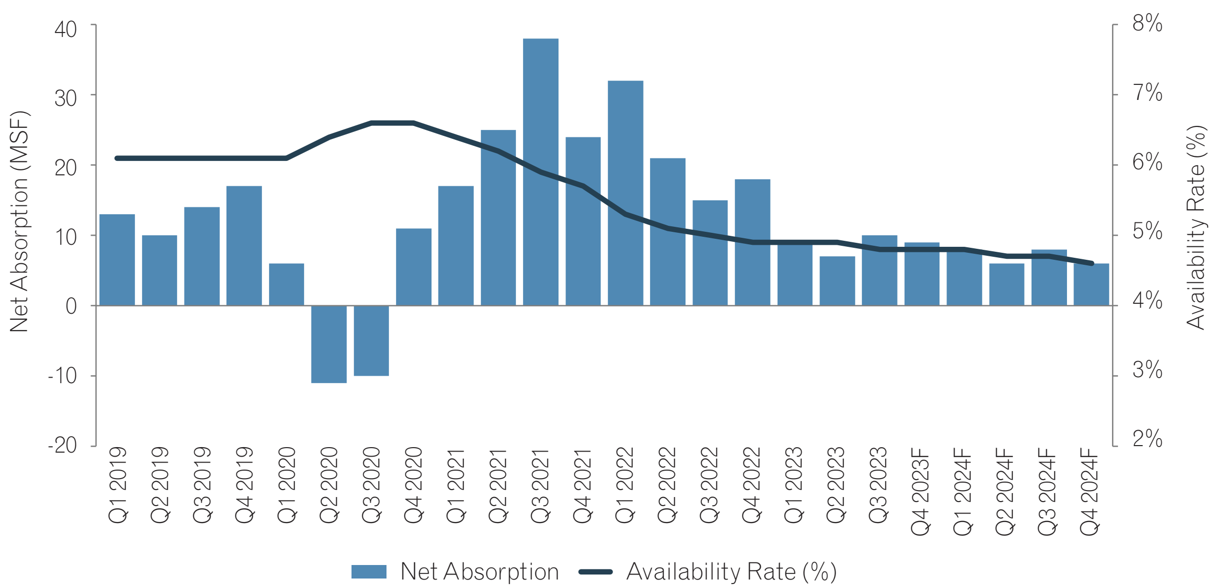
Retail's steady consolidation will continue, but investor sentiment will remain cautious

After a decades-long readjustment, retail fundamentals continue to show promising signs of stabilization. More stores are opening than closing. National vacancy rates have reached new multi-year lows, ending 2023 at 4.8 percent according to CBRE. Malls continue to be challenged, but neighborhood and other "convenience" retail are seeing healthy foot traffic. With retail cap rates already higher than most other property types heading into 2023, valuations have remained relatively flat according to Green Street. While there are few near-term catalysts for increased investment volumes, we expect certain institutional investors will be attracted to the retail sector's high cash flows, positive leverage, and relative margin of safety.

The retail landscape is always evolving and has historically been forced to adapt to change faster than most property types, but the worst years of the "retail apocalypse" appear to be over. There were still some noteworthy store closures in 2023, such as Bed Bath and Beyond and Rite Aid each closing hundreds of locations. But 2023 store openings still outpaced store closings 5,200 to 3,200 according to estimates by Coresight, and that number excludes certain experiential categories like restaurants, salons, and gyms. This volume of turnover should be expected and represents a healthy level of "creative destruction" in a constantly evolving property type.

Apocalypse, Past

Retail Availability and Absorption, Q1 2019-Q3 2023



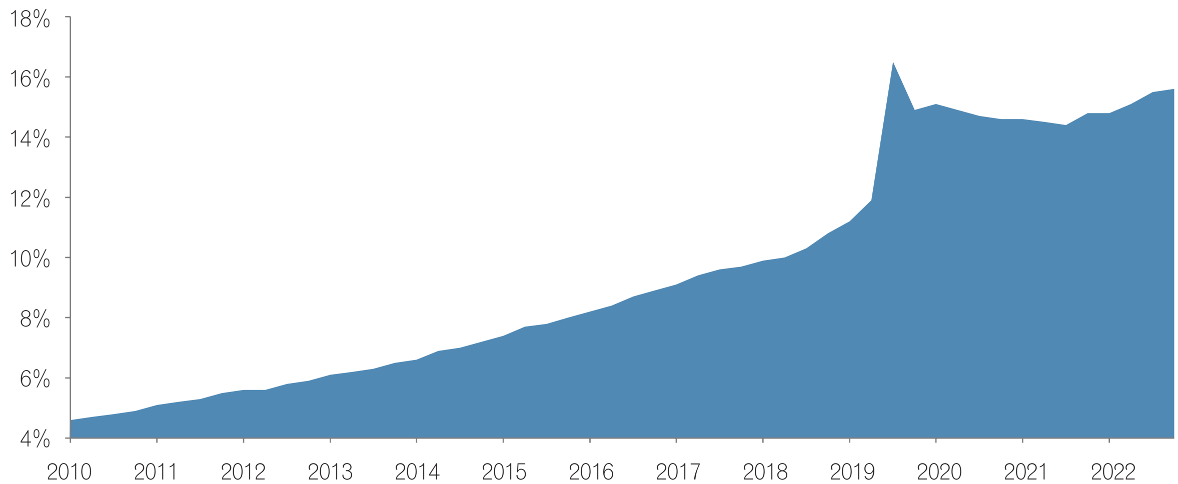
Source: CBRE Econometric Advisors, Q3 2023

Lack of new construction has been central to retail's stabilization. Retail was a victim of decades of overbuilding, averaging approximately 150 million square feet of new deliveries annually prior to the GFC. Current levels are roughly 75 percent lower, with an untold number of underperforming retail properties also being demolished or repurposed. Little to no rent growth makes it difficult to justify new construction in all but a few select markets. As a result, more markets are experiencing space shortages amid low vacancy rates.

While national vacancy remains low, retail's performance remains highly dependent on format and location. Malls will likely continue to struggle as more stores close and vacancies increase; CMBS delinquencies in regional malls are approaching 25 percent according to Moody's. High street or "amenity retail" in the base of office buildings also faces challenges due to the hybrid work week. But grocery-anchored, neighborhood, community, open-air, and strip centers should continue to see healthy demand, including from traditional mall tenants looking for new avenues for expansion. Such segments tend to be more insulated from e-commerce, which continues to steadily gain market share.

Still Gaining

E-Commerce Share of Total U.S. Retail Sales, 2010-Present



Source: Federal Reserve Economic Data

As retail continues to find its new footing in the age of e-commerce, we expect investor interest in the sector to remain tepid and highly selective. While retail fundamentals have stabilized, sustained rent growth remains elusive. However, retail also offers high cash yields and a built-in margin of safety following years of bloodletting. Most retail properties already trade at cap rates of 7 percent or higher, providing steady cash flow and opportunities for positive leverage. The pandemic was also the ultimate Darwinian stress test, with the surviving stores presumably the strongest and most resilient. As such, we expect investor interest to increase marginally in 2024, with more substantial growth possible in the years ahead.

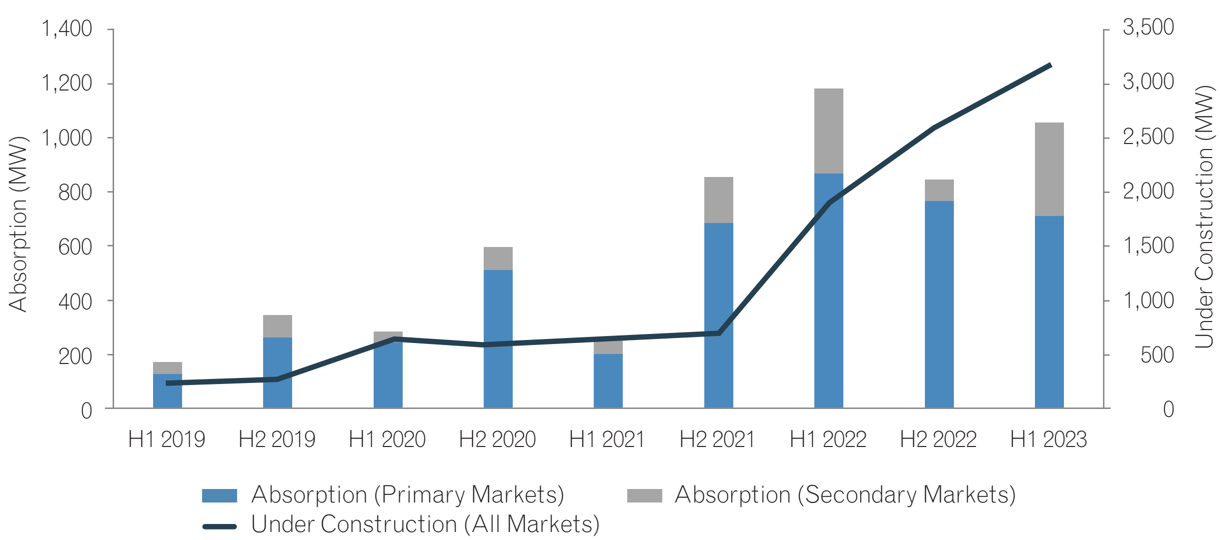
7 Data centers will attract more institutional investment as tenant demand surges

Data centers form the critical backbone of today's digital economy, and we believe investor allocations to data centers will grow significantly in the years ahead. The pace of data creation and consumption continues to accelerate at an unprecedented level with the growth of artificial intelligence, cloud computing, telemedicine, video/live streaming, 5G, and Internet of Things ("IoT") applications. As more investment is needed to meet rising demand, many investors remain under-allocated to this important property type: 37 percent of institutional investors have less than 5 percent of their real estate portfolio allocated to data centers according to a recent CBRE survey. We expect allocations to increase in the years ahead as more investors are attracted to the sector's resilient cash flows, high-quality tenant base, and secular growth drivers.

Despite record levels of new construction, data center demand continues to outrun supply. Vacancies are at a decade low, and JLL estimates that absorption levels hit a new record in 2023 and would have been higher if not for lack of availability. This supply-demand imbalance has led to robust rent growth of 10 to 20 percent annually since 2020. The advent of artificial intelligence creates additional demand drivers. Meanwhile, supply is constrained by lack of available land for development, power supply limitations, fiber connectivity, and access to water for cooling. As a result of these imbalances, data center owners are enjoying a period of considerable pricing power.

Netflix and Build

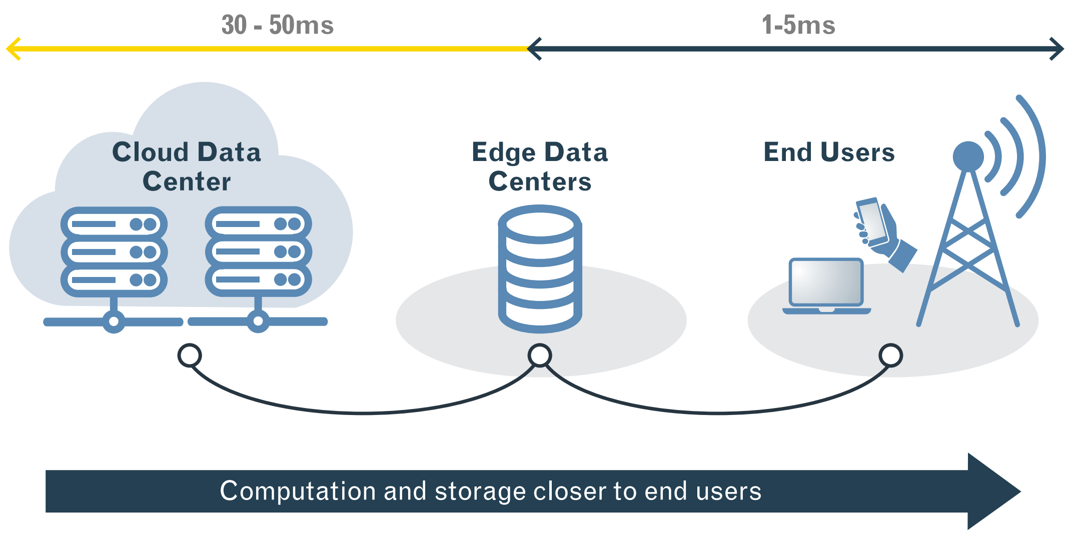
Data Center Absorption vs Construction Pipeline, H1 2019 – H1 2023



Source: JLL. Reprinted with permission.

Institutional investors' data center exposure has historically been concentrated in hyperscale facilities, which are typically constructed on a build-to-suit basis for large technology companies such as Microsoft, Amazon, and Google. "Hyperscalers" require significant amounts of space and power to support operations for cloud computing, data analytics, and storage tasks. The facilities are typically in established data center markets and the leases tend to be long-term (10-20 years), providing investors with durable, infrastructure-like cash flows. We expect demand for hyperscale facilities to continue growing as internet and mobile network traffic increases.

While hyperscale facilities form the core of the data center ecosystem, edge market data centers are growing in importance and could offer new opportunities for investors in the years ahead. Edge market data centers are small, decentralized facilities that offer computing and storage services closer to where data is generated and consumed. This proximity to the end user is necessary for applications that require lower latency, improved network bandwidth, or enhanced security. For example, applications on mobile devices such as media streaming and ridesharing require lower latency in order to function properly. Additionally, by distributing data processing across various edge locations, enterprises can reduce the risk of downtime or network disruption. We believe this is a data center segment that could experience explosive growth in the years ahead.



Data centers are still in their infancy as an institutional property type, with nearly 90 percent of institutional investors surveyed indicating they intended to increase exposure to the sector. Indeed, data centers are critical to the modern economy, allowing businesses and individuals to share and access increasingly large volumes of data instantly. According to McKinsey, demand is forecast to grow by approximately 10 percent annually through 2030. Such outsized growth potential suggests data centers could become a new major property type in real estate portfolios, particularly as investors seek substitutes for office and retail.

8 Real estate capital formation will remain challenging, with more managers exploring alternatives to traditional fund structures

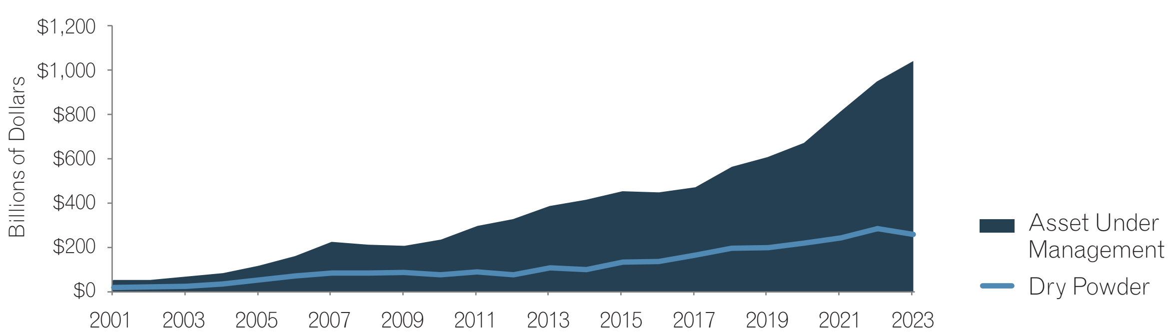
2023 was a difficult year for real estate capital formation. Institutional investors were largely sidelined by the denominator effect, market uncertainty, rising interest rates, and liquidity pressures. According to PERE estimates, 2023 fundraising volumes will be the lowest since 2012. The average time to reach a final close on a closed-end fund is 23 months according to Preqin, the longest timespan on record going back to 2000. We would expect these headwinds to ease somewhat as transaction volumes recover and the denominator effect becomes less potent, but fresh investor commitments will likely remain subdued in the near term due to high levels of uncalled capital. As these barriers persist, we expect more managers to consider alternative private capital solutions to traditional closed-end funds.

The slowdown in real estate capital formation is not a reflection of investor attitudes towards the asset class. Institutions continue to favor real estate despite the recent decline in values, with many optimistic that 2024 and 2025 will be favorable vintages for deploying capital due to anticipated distress and dislocation. Most investors plan to increase capital deployment after being on the sidelines since early 2022. Target allocations have also held steady, averaging over 10 percent.

The private real estate industry has reached a new level of maturity and scale. Current dry powder of $254 billion – most of it allocated to value-add and opportunistic strategies – eclipses the total value of North American AUM in 2008. While this creates something of a safety net for the real estate market overall, it also speaks to another capital formation headwind likely to remain prevalent throughout 2024. Investors have little incentive to make new commitments while so much of their existing commitments remain uncalled, preferring to wait until they have better visibility on exposure to different vintage years, property types, geographies, and risk profiles. The denominator effect has also caused many investors to be overallocated to real estate versus target, which further reduces the urgency to make new commitments.

Healthy and Wealthy

North American Real Estate AUM vs Dry Powder, 2001-Present

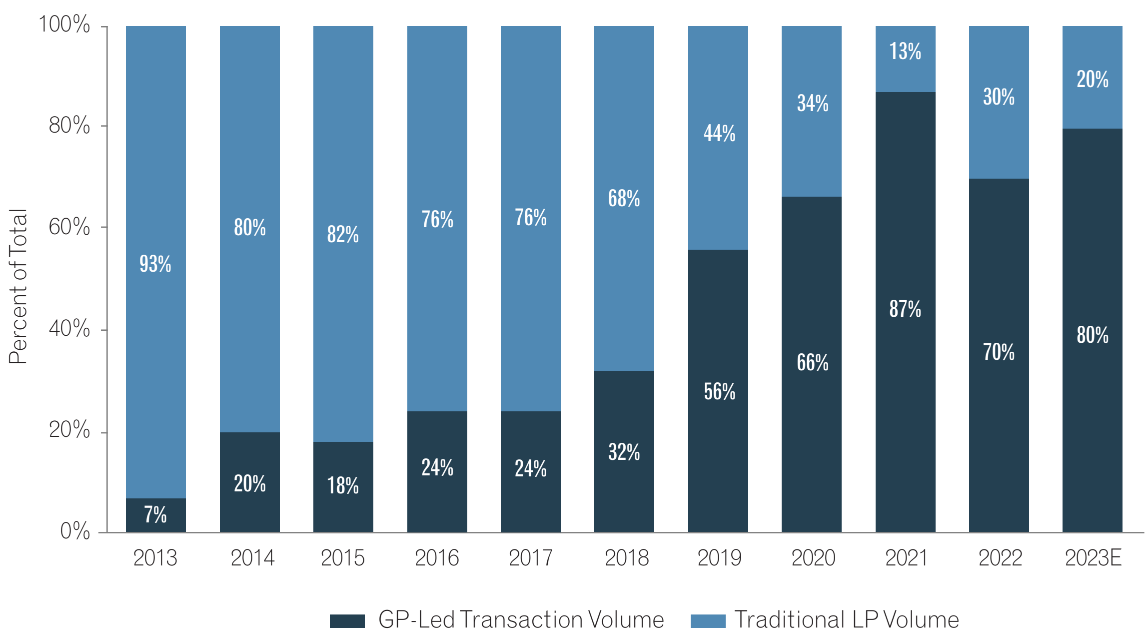


Source: Preqin

As barriers to capital formation remain high, fundraising success increasingly depends on providing investors with differentiated investment exposure. Institutional portfolios have grown more mature, with most investors favoring re-ups with incumbent managers and setting a high bar for adding new managers or funds. Offering investors unique access to niche or specialty property types is one potential path to success. Legacy portfolios tend to be concentrated in office, multifamily, industrial, and retail, and investors increasingly seek new forms of diversification and returns. For instance, the pandemic highlighted the attraction of more infrastructure-like property types that are more closely linked to economic activity rather than physical human occupancy, such as industrial, data centers, cold storage, and cell phone towers. We expect managers focused on these and other hard-to-access specialty asset classes will be more effective at attracting new capital sources.

As the closed-end fundraising route becomes more difficult, real estate managers are increasingly pursuing alternative private capital solutions. In particular, portfolio secondaries and continuation vehicles have become more effective avenues for managers to secure new institutional capital partners, refresh business plans, restructure ownership, and reset GP economics. These types of GP-led recapitalizations now account for most real estate secondaries trades, and dedicated capital pools for such transactions are growing rapidly: secondaries fundraising volume is estimated to hit a record high in 2023. As fund lives and disposition timelines get extended, GP-led recapitalizations could be a way to provide existing investors with liquidity while avoiding a forced sale. We expect to see more managers exploring these types of transactions in 2024.

Share of Real Estate Secondaries Volume, 2013-2023E



Source: Park Madison Partners

9

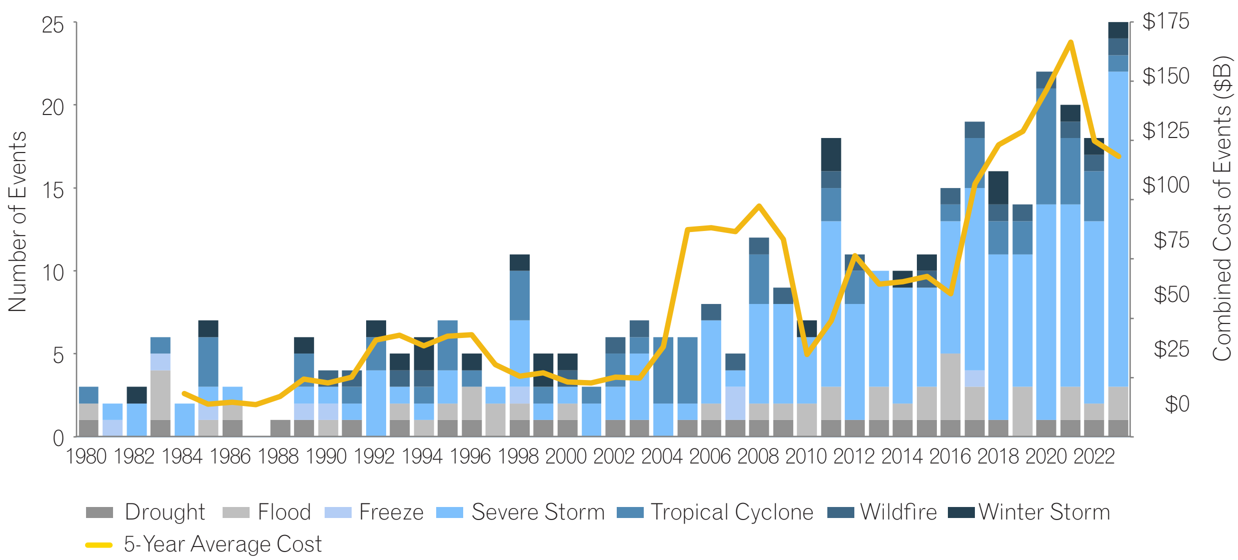
Rising insurance costs will focus investor attention on climate risks

Real estate investors have long been aware of the risks posed by climate change, but 2023 marked an important first step towards quantifying the financial impact for property owners. Soaring insurance costs finally gave real estate markets a climate-related price signal that previously had been lacking. For properties in high-risk locations, higher insurance costs could be a harbinger of other negative economic consequences, both gradual and sudden. These risks are likely to compound over time as the Earth warms, with direct implications for real estate performance.

The main culprit behind rising insurance costs is of course the increased frequency of extreme weather events. Despite the 2015 Paris Agreement, atmospheric CO_2 levels continue to climb, which makes limiting warming to 1.5 degrees Celsius increasingly unlikely. Five of the hottest years on record globally occurred since 2015, with 2023 being the hottest. As temperatures rise, climate models suggest extreme weather events will increase in frequency, and most Americans are now witnessing these effects firsthand. In the Nashville area, for instance, tornadoes now strike five times more frequently than in the early 1990s. The scale and intensity of weather disasters is also increasing, leading to a significant rise in the associated costs.

Actuarial Headache

U.S. Billion-Dollar Disaster Events (Inflation Adjusted), 1980-Present



Source: National Centers for Environmental Information, National Oceanic and Atmospheric Administration

As insurers absorb such losses, a subsequent spike in premiums should come as no surprise. For instance, according to actuarial firm Milliman, California's 2017 and 2018 wildfires wiped out 25 years' worth of insurance company profits in that state. Insurers have responded by raising premiums 10 to 30 percent nationwide, and several insurers are abandoning higher-risk geographies like Florida and California altogether. In Florida, for example, several insurers including Farmers announced in 2023 that they are pulling out of the state, sending insurance costs higher by at least 40 percent on average, and in certain areas increases of 400 percent or higher have been reported. As a result, insurance is increasingly becoming a deal-killer for real estate transactions. Some property owners in higher-risk areas could have trouble getting any insurance quotes at all, which is bound to have a negative effect on property values.

As insurers start to price in climate risks, we expect lenders are not far behind. Most commercial real estate loans have 5 to 10 year terms, during which time a rise in extreme weather events could affect a property's insurability. Lenders could start charging higher interest rates to account for these risks, and investors will need to consider the possibility that take-out financing is no longer available when loans mature.

ESG's Polarizing New Chapter

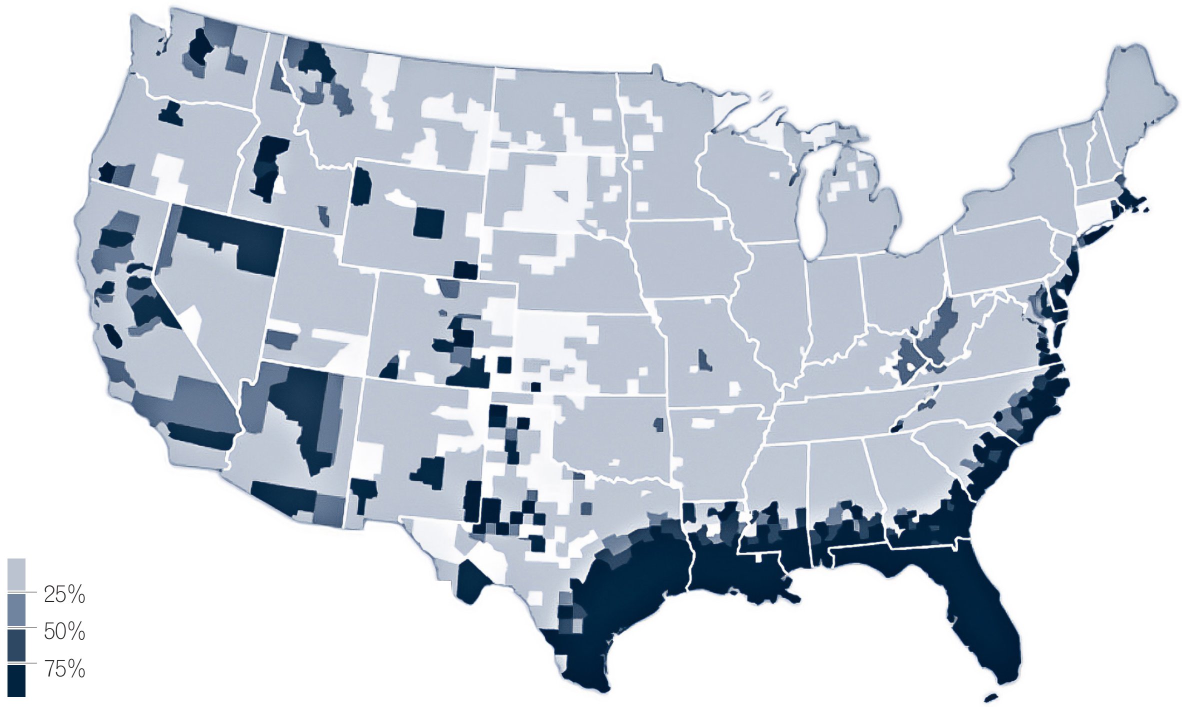
Since the term was first coined in 2004, ESG has been steadily embraced by investment managers and institutions. Over half of global institutions now have a formal ESG policy, and ESG-focused investors are increasingly pushing managers to adopt explicit investment guidelines, benchmarks, and reporting requirements. Many investment managers now see a strong ESG commitment as necessary for fundraising success.

But the growing political backlash could upend that calculus. Right-leaning voters and politicians increasingly view ESG as a smokescreen for left-leaning policy objectives. In March 2023, Republican attorneys general from 21 states sent letters to 53 U.S. investment managers alleging that pursuit of ESG goals constitutes a breach of fiduciary duty. DEI policies are also in the crosshairs, with several companies facing lawsuits over perceived "reverse discrimination." The Supreme Court's June 2023 decision striking down affirmative action has further emboldened DEI's critics.

All of this creates headaches for investment managers, or anyone seeking to run a business without becoming embroiled in America's culture wars. We expect many investment managers will simply pick a lane on ESG, with the understanding that their choice may alienate certain investors. Others could try a middle approach, perhaps by highlighting their organization's ESG statistics while keeping formal policies intentionally vague. Ultimately, we do not expect political currents to alter a firm's core values, but the expression of those values could become more subtle going forward.

Danger Zones

Share of Properties at Risk of Insurance Rate Increase or Non-Renewal, By County

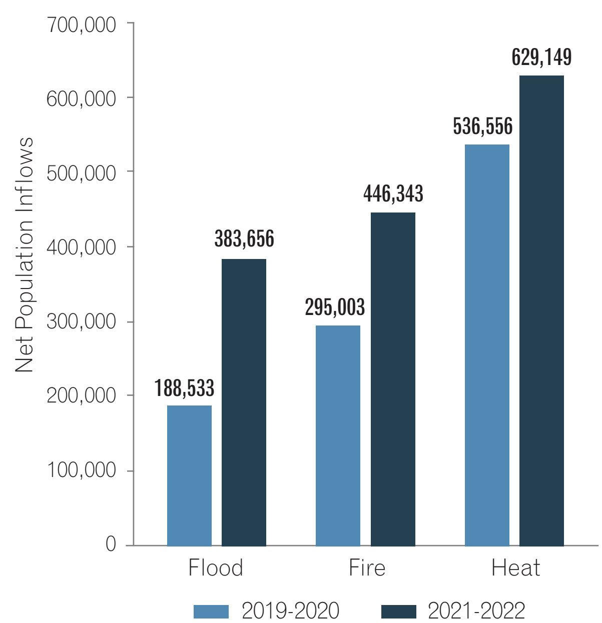


Source: First Street Foundation, Kavya Beheraj/Axios

Paradoxically for investors, migration patterns continue to support new investments in some of America's least resilient geographies. According to a recent Redfin analysis, U.S. counties with the highest wildfire, flood, and extreme heat risk have seen net migration inflows accelerate in recent years. Not by coincidence, Sun Belt cities accounted for 18 of the 20 most favored markets for investment in the Urban Land Institute's 2023 annual survey. In the absence of any immediate climate-related dangers, investment in these areas may be warranted and even highly profitable. But investors might look to insurance company behavior as a potential "canary in the coal mine," and adjust exposure as needed if insurance costs begin to signal more asymmetric risks in certain markets.

Follow the Herd?

Net Migration to U.S. Counties with Highest Property Risk from Flood, Fire, and Heat



Source: First Street Foundation, U.S. Census Bureau, Redfin

10 The 2024 election will test the strength of America's democratic institutions

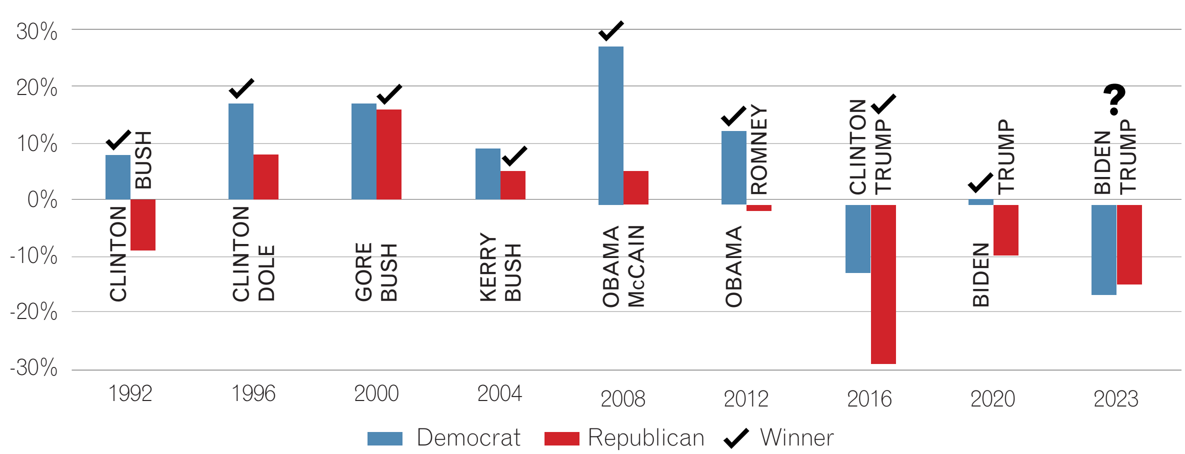
The 2024 U.S. presidential election is shaping up to be one of the strangest in history, and predicting the winner is virtually impossible. At 82 years old, President Joe Biden would become the oldest person ever inaugurated if he wins a second term. Former President Donald Trump is facing multiple criminal indictments and could be a convicted felon by Election Day. Meanwhile, several third-party challengers could be spoilers in key swing states, potentially scrambling Electoral College calculus for the two major parties. America's democratic institutions will face a difficult test.

Despite the Democrats' strong performance in the 2022 Midterms, President Biden looks highly vulnerable heading into 2024. He suffers from low popularity and high disapproval ratings on several key policy issues. Three quarters of registered voters are concerned that Biden's age will negatively affect his mental and physical fitness in a second term. The Democratic coalition is split over the Israel-Hamas War, with only half of Democrats polled approving of Biden's handling of the conflict. In a normal electoral environment, President Biden would appear eminently beatable.

Biden's likely Republican opponent, Donald Trump, also has his own challenges. The Supreme Court's decision to overturn Roe v. Wade has turbocharged Democratic voter turnout. In state legislative special elections over the past year, Democratic candidates have outperformed Biden's 2020 margins by an average 7 percent. Trump himself is facing 91 felony charges, many of which could be decided before Election Day. While Trump is deeply unpopular, he still has a conceivable path to victory due to his Democratic opponent's unpopularity, as was the case in 2016.

Unpopularity Contest

Candidate Net Favorability on Election Day, 1992-2023



Source: Gallup, Park Madison Partners

With two unpopular major party candidates, an historically high number of voters are considering third parties. Robert F. Kennedy, Jr is polling around 15 percent nationally, Cornell West and Jill Stein each poll around 2 percent, and centrist Democratic Senator Joe Manchin has also teased a run. Both the 2016 and 2020 Elections were decided by less than 80,000 votes in key swing states, so any votes redirected to third party candidates could be decisive. The fracturing of existing voter coalitions could also put more states in play, potentially leading to very odd Electoral College outcomes.

However the 2024 Election is decided, its legitimacy will almost certainly be questioned. In theory, if third parties capture 20 to 25 percent of the popular vote then the ultimate winner could carry the Electoral College with 40 percent or less, leaving a majority of voters feeling disenfranchised. Recounts and court challenges could also delay the final results for several weeks, further straining public confidence in the election's fairness. We remain hopeful that America's institutional guardrails will withstand the pressure, as they did in the aftermath of the 2020 Election.

Looking beyond the 2024 Election, while pessimism is cheap and abundant in the short term, we remain optimistic for the American Experiment's long-term prospects. America's multi-ethnic, multi-cultural democracy is over 400 years in the making, and the process has never been linear. After all, humans have lived in tribal societies since first learning to walk upright, and overcoming those tribal tendencies is a generations-long process. But much like the U.S. economy, the U.S. political system is incredibly dynamic and has historically provided the engine for its own renewal. We are confident that today's polarized political fever will eventually break, and American democracy will emerge all the stronger for having overcome yet another difficult chapter.

Who Wins if No One Wins?

In perhaps the wildest potential 2024 scenario, a third-party candidate could win enough Electoral College votes to deprive any candidate of a 270-vote majority. If that happens, the will of the voters would be irrelevant. The President and Vice President would be chosen through a contingent election, an arcane and Constitutionally-murky process that was last used in 1825. Specifically, the outgoing House of Representatives picks the President, and the outgoing Senate picks the Vice President. Presumably everyone votes down party lines.

In the Senate, a simple majority vote decides the Vice President, so the current Democratic majority suggests that Kamala Harris would win. In the House, each state has only one vote, and each state's vote is decided by a voting majority of its Representatives. States with Republican majorities would presumably vote for Trump, and states with Democratic majorities would vote for Biden. Republicans currently hold congressional majorities in 26 states versus 24 for Democrats, meaning Donald Trump would likely win. So a contingent election could result in the oddest of all possible 2024 outcomes: a Trump-Harris Administration.

2023 Scorecard

In the spirit of staying honest with our readers, we continue our tradition of providing a short "scorecard" on the previous year's Outlook. Each of our market calls is scored on a scale of 1 to 10, with 10 meaning "nailed it" and 1 meaning "not even close." We also include some brief (and highly subjective) commentary to explain why we scored ourselves the way we did.

1 Inflation will normalize following a Fed-induced recession

SCORE: 6/10

Like so many others, we believed a 2023 recession was a foregone conclusion given the Fed's aggressive policy tightening. Clearly that was a miss, and the U.S. economy continues to expand at a healthy clip. But we also predicted that inflation would cool, and indeed headline CPI has fallen from 6.4 percent to 3.1 percent. We also suggested that tight labor markets would keep upward pressure on inflation, causing the Fed to err on the side of "higher for longer" until there was a meaningful rise in unemployment. The jury is still out on that one, but there is growing optimism that the Fed could bring inflation down without triggering a recession. It's good to be wrong occasionally.

2 Real estate capital markets will stabilize, but valuations will weaken amid higher interest rates and cap rates

SCORE: 9/10

Using public REITs as a leading indicator, we predicted that private market cap rates would continue to rise, triggering a price correction. We also predicted that by the end of the year the Fed would conclude its rate hikes, cap rates would start to level off, and commercial real estate transaction volumes would pick up again as bid-ask spreads narrowed. Underpinning this belief was also the fact that investment managers were sitting on over $250 billion of dry powder, suggesting that investment activity could recover quickly once a new market equilibrium was established. While the capital markets winter has lasted longer than we anticipated, going into 2024 we are seeing more anecdotal evidence of transactions coming back. We'll happily claim our 9/10 on this one.

2023 Scorecard

3 Residential segments will see a price correction, but fundamentals will remain solid

SCORE: **8/10**

We predicted that rental housing cap rates would rise and that valuations would soften. We acknowledged the threat of new supply, but believed that barriers to homeownership and continued high occupancy rates would continue to provide landlords with considerable pricing power. The "pricing power" prediction was a miss, as rent growth has been relatively flat and landlord concessions have increased as vacancies rise. But our call that the 30 percent drop in single family housing starts presaged a similar cooling of the multifamily construction pipeline looks to have been spot on (we make the same call this year). Finally, we stated our belief that any price correction would provide an attractive entry point for investors across the risk spectrum, and we stand by that call.

4 Industrial will continue to experience moderate rent growth amid low availability

SCORE: **10/10**

Industrial had another good year driven by e-commerce growth, investment in supply chains, and onshoring/nearshoring, which is what we expected. We acknowledged the likelihood of a price correction as cap rates rise, but suggested that industrial was well-positioned to weather the impact of rising cap rates due to embedded rent growth as leases roll. We also acknowledged that vacancies looked set to rise from record lows, but predicted that absorption would remain strong and landlords would continue to enjoy considerable pricing power. Bullish industrial predictions may lack audacity, but they continue to work.

5 Office will see further bifurcation as tenant "flight to quality" is exacerbated by recession and a more permanent WFH culture

SCORE: **10/10**

Spring 2022 was a make-or-break moment for the office sector: the Omicron variant had just redefined the whole nature of the pandemic, and subsequently removed the justification for most social distancing measures. If a rapid return to office movement was going to materialize, that was the time. It didn't happen, and so we predicted a steady erosion in office values and fundamentals as this new reality sunk in. Amid the overall negative sentiment, we also predicted that newer office buildings would continue to see strong tenant demand, and this trend has become more pronounced in 2023. Finally, we suggested there was a potential contrarian case for office investments, particularly as conversion plays, and we have seen more such transactions over the past year. We take no pleasure in grave dancing, but after two straight years of predicting an office recovery that never happened, it admittedly feels good to finally get it right.

2023 Scorecard

6 Retail's post-pandemic recovery will continue despite a slowing economy

SCORE: **7/10**

We predicted that a dearth of new supply would keep retail vacancies low, and indeed vacancies fell further to multi-year lows in 2023. We also stated that e-commerce was no longer the existential threat it had once been as more brands adopt an omni-channel approach. We lose points for suggesting that e-commerce's share of retail sales was topping out, with the steady rise in market share once again becoming clear in 2023. We also suggested that as retail demonstrated its post-pandemic resilience, institutional investor interest would follow. That still hasn't happened, but we could still be proven right in the long term. We'll settle for a 7/10 on this one.

7 Niche property types will continue to gain favor as investors seek new sources of diversification and alpha

SCORE: **10/10**

Given the challenges in office and retail, we predicted that institutional investors would allocate more capital to niche property types that do not fit neatly within the definitions of office, multifamily, industrial, and retail. These niche sectors include self-storage, student housing, senior housing, manufactured housing, data centers, cold storage, industrial outdoor storage, medical office, lab/life-sciences, parking, single-family built-to-rent, media/studios, and cell towers, among others. We also predicted good fundraising outcomes for managers who establish (or partner with other groups that have established) specialized operating capabilities within niche sectors. Given that many such managers are Park Madison clients, we can confirm that all these predictions held true.

8 Real estate capital formation will remain challenging amid low transaction volumes and the "denominator effect"

SCORE: **10/10**

We would have much rather been wrong on this one, but at least we were mentally and emotionally prepared for the year ahead... We predicted that fundraising volumes would fall as investors dialed back their capital commitments amid the denominator effect, market uncertainty, and liquidity pressures. While the data is still preliminary, PERE estimates that fundraising volumes were the lowest since 2012, and they would be even lower without the $30.4 billion final close for Blackstone's BREP X. We also said that emerging managers will face additional difficulty competing with more established incumbents, causing more to explore alternative capital solutions to traditional closed-end funds. Indeed, 2023 saw another busy year for GP-led secondaries, with many being executed as seeded programmatic joint ventures. We'll keep our day jobs for now.

2023 Scorecard

9 ESG's political battle lines will harden and create divisions among the institutional real estate community

SCORE: **10/10**

We predicted that the political battles over ESG would escalate in 2023, creating divisions within the investment community. While ESG fights had mostly been confined to public market investments, we expected that private market commitments – and the outsized influence they command over managers – would be too tempting of a target for right-leaning politicians to ignore. Indeed, the March 2023 nastygram sent by 21 Republican state attorneys general targeted several firms that invest primarily in private markets, including former Park Madison clients. As the U.S. becomes increasingly polarized amid the "politicization of everything," this is one of those predictions that – sadly – seems obvious in hindsight.

10 Climate migration risk will cause investors to reassess their exposure to less resilient geographies

SCORE: **TBD**

This was by far our most "out there" prediction of 2023, and given its long-term nature we are scoring it with an intentionally ominous "TBD." We said that when it comes to climate change, the real estate industry focuses mostly on physical and transition risk when in fact the biggest long-term threat (in our view) is migration risk. We acknowledged the elephant in the room that no one in real estate wants to talk about: many of the most popular investment destinations today are also the most exposed to the extreme heat predicted by climate models. We predicted that as extreme heat becomes more common, people will start migrating to cooler northern climates rather than stay and endure 100°F+ summers (migration risk). This would represent a major paradigm shift for real estate investment, and many investors could discover that their portfolios are not well-positioned for it. We predicted that more investors would start to realize this dynamic and adjust their investment postures accordingly, with long-term implications for capital flows and investment performance. We haven't seen a major shift in migration patterns or investment behavior yet, but if insurance markets are any indicator, investors may want to keep a watchful eye on the thermostat.

About Park Madison Partners

Park Madison Partners is a boutique New York-based capital solutions and advisory firm for global real estate alternative investments. Since its formation in 2006, Park Madison has advised on over $27 billion in private capital placements for a wide range of real estate vehicles including closed-end funds, open-end funds, separate accounts, programmatic joint ventures, and recapitalizations.

Park Madison Partners was founded to offer clients capital raising and strategic consulting services with a high degree of customization, integrity and accountability. The firm provides a relationship-driven approach to structuring and marketing assignments and offers its clients access to global institutional investors. Our team comprises professionals with backgrounds across the buy-side and sell-side, and we leverage this experience to provide a thoughtful approach to global real estate markets.

Park Madison Partners is a member of SIPC-FINRA and is certified with the Women's Business Enterprise National Council. For further information, please visit parkmadisonpartners.com.

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