DIAMOND HILL

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2023 Real Estate Outlook

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A rising interest rate environment and a possible recession cloud the prospects for more leveraged and yield-focused sectors such as real estate. But the outlook isn't as gloomy across all sub-sectors within real estate, given its broad and diverse makeup. Even in 2022, there were certain sub-sectors that performed well — namely net lease and hotels — given some of their defensive characteristics. Several factors, beyond interest rates and inflation, impact the outlook for various markets within real estate, including economies of scale, supply/demand, location, and cost base, to name a few. As we look out into 2023 and beyond, we find ourselves constructive on certain sectors and believe other sectors will continue to face challenges in the coming months and quarters.

Residential

Housing

If you look back to 2008, we saw a very slow recovery in the housing market pretty much through early 2020. Rates were incredibly low, but consumers who had gone throughout the financial crisis were far more hesitant to buy a home, especially within the Millennial generation. We simply didn't see the move from for-rent housing into the classic for-sale residential housing. The pandemic was somewhat of a catalyst to jumpstart that market again, however there was so much demand, and it grew so quickly, that builders in the latter part of 2020 and throughout 2021 and early 2022 could not keep up. Add in supply chain disruptions and prices in the housing market went sky high.

We think there is probably a large cohort among Millennials and even some Gen Zers who would want to purchase a home, but prices remain high and now mortgage rates are far higher than they have been in the past decade or so. We do think one of those things will see a correction. It's more likely to correct on the new home sales side than within existing home sales. On the new home sales side, builders will be motivated to sell out communities even if it requires providing rate buy downs, lower prices, upgrades, or other incentives. Existing home sales will be more challenging, especially among homeowners who have sub-3% mortgage rates in place right now. It will take a lot for them to want to sell in an uncertain market and buy another house. So, I think we'll continue to see very low existing home inventories.

The good news right now in the housing market is that mortgage distress is low and the long-term backdrop for demand remains positive. Of course, a recession could impact the market but the big picture for homes sales demographically looks positive going forward.

Apartments

Despite the rising interest rate environment over the past year, the outlook on rent growth has remained strong. Apartments, in general, have continued to deliver excellent same store revenue and same store net operating income growth. And as we start out 2023, the market has decent size loss leases, meaning that in-place rents remain significantly below market even though rent growth has moderated. Additionally, in an inflationary environment, apartments have the ability to reprice leases each year, helping them maintain pricing power and the ability to catch up with inflation. Our outlook for apartments remains positive: A continued slowdown in new and existing homes sales should benefit the for-rent market. Additionally, though rent growth may slow further, diminishing supply should benefit the apartment market, especially those with good balance sheets, solid debt availability and excellent operating platforms.

Commercial

Office

The office market has been challenged since the start of the COVID pandemic as the work-from-home (WFH) movement took hold. Many thought that the WFH trend would be temporary and that businesses would return to the office way of life as we have done for the past 75 to 100 years. In 2021, as the pandemic started to show signs of moderating, that seemed plausible. However, as we moved through 2022, it seemed more likely that WFH or at least a hybrid model would become a more permanent fixture for many businesses. We certainly saw a return to office as concerns about the pandemic dissipated, but the rise of flex work arrangements continues to grow, which has been a huge challenge for the office market. Add into that a potential economic recession as we enter 2023, and the outlook seems more challenging in our opinion.

In the two decades prior to the pandemic, you saw a steady drop in square footage per employee. Offices got smaller, workers moved to cubicles and the open office concept started to take hold. And now with the WFH movement seemingly here to stay, we believe companies will continue to evaluate their space needs, but the outlook points towards a continued reduction in square footage.

Hotels

In the wake of the pandemic, hotels suffered greatly from paltry demand from both leisure and business travelers. As lockdowns were lifted and travel restrictions eased, leisure travelers were the first to hop back on a plane for a vacation. But business travel continued to lag as trepidation about in-person meetings remained and businesses were reluctant to send workers back out on the road. Even now as the US has largely returned to a more normal work environment, business travel remains below pre-pandemic levels and isn't expected to reach those levels until 2024 or even 2026. On the leisure side, however, hotel demand has been tremendous because the WFH model has given people more flexibility to work from anywhere, opening a lot of different avenues for leisure travelers.

Most of the hotel REITs tend to have a mix of pure leisure, business/leisure, urban, drive-to, and fly-to business, so the environment has had an uneven impact. Going forward, it's likely we'll see similar unevenness for some time to come — that is, growth on the leisure side but offset by the business side.

Industrial

Warehouse

Looking back to 2007/2008, the industrial sector faced a huge oversupply of warehouses for several years. Then around 2015/2016, we started seeing increased tightening of that market. Heading into 2022, warehouse assets were priced extremely aggressively given the tailwind from the post-pandemic environment when e-commerce expanded, and demand was tremendously outpacing supply. Today, we're probably seeing some slack because many companies took on excess supply — they couldn't secure space in 2020/2021 without making big multi-year commitments. What we saw in 2022 has been reflective of the fact that some of those companies, perhaps most notably Amazon, are having a bit of buyer's regret. In the end, we believe the market will take some time to work out, but overall, we believe it still favors the landlords over the next decade as we expect e-commerce to remain robust.

Data Centers

Data centers have been beneficiaries of the explosion of big data, e-commerce and cloud computing. At the same time, this area of the market has experienced tremendous consolidation as a lot of public-to-private take outs over the last few years have resulted in only 3 large data center companies remaining — compared to 7 companies just 18 months ago. Some projections imply that we will run out of data center storage as soon as 2025. Power is becoming increasingly expensive and finding locations for data centers is a challenge, so supply constraints in this market are growing. We believe overall demand should trend positively in this sub-sector over the next 5 to 10 years.

Self-Storage

Self-storage has been a beneficiary of the shift to WFH that was a result of the pandemic. As people shifted to the WFH model, home office space needs grew and in turn drove home expansion projects or home remodeling projects, fueling the need for self-storage either on a short-term or long-term basis. National self-storage brands with resources to advertise digitally, such as on Google, have benefited from this trend. Self-storage tends to be a sub-sector that does well in good and bad economic environments, and we believe it will continue to see attractive growth in the coming years.

As of 31 December 2022, Diamond Hill owned equity shares of Amazon.com, Inc. and Alphabet, Inc.