

RPM Ep. 50 | Spring 2025 Real Estate House Views with Jeff Giller and Margaret McKnight

MY: Welcome to RPM. In today's episode, we'll be diving into StepStone Real Estate Spring 2025 House views. Our house views are shaped by a unique combination of top down macroeconomic, demographic, and geopolitical analysis from our market research team, alongside bottom-up insights from our global investment professionals. These perspectives are grounded in real time market intelligence. StepStone Real Estate has committed approximately 17 billion annually across real estate funds, secondaries, Recapitalizations and Co-investments. In 2024 alone, our team met with more than 1000 real estate GPS around the world. With that context, I'm pleased to turn things over to today's guests, Jeff Giller, partner and head of StepStone Real Estate, and Margaret McKnight, partner and head of portfolio solutions for SRE. Both Jeff and Margaret are based in San Francisco and will be joining me to lead today's conversation. Now let's get started.

JG: What a difference six months makes, right, Margaret. The story is really shifting from what we've been talking about in the past few house views. We've been discussing a market that by the beginning of this year was turning up off the bottom in terms of pricing and volume, with lenders back in the game. Rates were expected to ease some after fed policy tamed inflation. Real estate fundamentals were softer in a moderating but resilient economy. There was some overbuilding in strong markets, but a clear path to absorption, plus lots of opportunity on the distressed and recap side, because so many balance sheets hadn't been adjusted to reflect the value declines driven by higher interest rates. Now things are different. We have a new US presidential administration with lots of new policies and in many ways, a new economic order globally. What happened to normal economic and real estate market cycles since the post-gfc protracted market run up? Non-systemic events seem to have become systemic.

We've had Covid. The interest rate hike, shock and now tariffs impacting our markets. So let's talk about where we are now and how to approach this new cycle.

MM: Yeah there's a lot going on and it's stacking up on real estate. So just running through those same points for the US right now, US trading volume is holding at the same level as last spring, but word is that large transactions and industrial property trading, especially in the West, are off. We've seen over the last few years that higher rates and uncertainty, which we have now, are not good for trading volume, mainly because they widen the bid ask

spread. On the plus side, lenders are still active. The Green Street Commercial Property Price Index is bouncing around up and down slightly month to month. And then with respect to fundamentals, real estate houses the economy and uncertainty is the word. Now we work hard to be data oriented. Unfortunately, there's not a lot of hard data yet available. With such big changes happening so fast and there may not be useful data for a while because there isn't enough clarity yet on the policy changes to know how they're going to affect the economy and decision making in enough detail to understand how that's going to impact space use. So this is also a time to really lean on best practices, which I'll talk about more in a bit. We do have survey data which confirms high uncertainty, among other things, US consumer inflation expectations are 6 to 8%. Wow. And confidence is around Covid lows, which does not bode well for economic growth drivers ranging from business investment to consumer spending. And as I say this, so much of this just keeps taking me back to economics class. And I did indulge in a supply and demand chart on the main House views report. Remember $GDP = C + I + G$ consumption plus investment plus government spending. If you think about what's happening to those variables, you'll understand why US economic forecasts keep dropping. The most important thing for investors with money to put out. Now this is good. Remember that uncertainty and turmoil create opportunity. So to your last point Jeff. Many balance sheets are starting this new cycle in need of restructuring, and they don't have a lot of resilience left. And they're running into challenges and time constraints, so motivated sales should continue to rise. The opportunity that we highlighted in the last edition. So saying that conditions are ripe for the most interesting non-core vintages in 15 years is now even more true with these added stressors. So it is a good time to deploy to non-core. Also, debt is still interesting and can be a more conservative way to play real estate with current income. In that vein, Core plus strategies focused on new buys can tap into motivated selling opportunities with more income in a lower risk way. The open-ended Core and Core Plus funds are still expensive and somewhat sidelined on the buy side, which can boost the Core Plus buying opportunity with uncertainty and volatility prevailing.

We're working to get investors, including open ended fund investors, to their target allocations, which are there for a reason, and we put a lot of resources in doing it with best execution available. Given that the average fund, the average fund, not all of them, are still expensive. Now, as I said, best practices bolster us setting and maintaining thoughtfully diversified target exposures from the top down at the whole portfolio level and to some extent within the real estate allocation as part of a best practices portfolio management process that most institutional investors use. That has been developed specifically to

negotiate portfolios successfully through times just like this. This is really helpful to remember when volatility, worrying news, and maybe emotions are running high so you can calmly look through the turmoil, find the opportunity, and make good decisions.

JG: Margaret, how do we apply that model to real estate?

MM: There are three ways. So first focus on income. Income reduces risk. And it's a big factor that draws investors to real estate in the first place and relates to its nature as a hard asset. The government policy changes amount to a supply shock, whether it's tariffs on steel and lumber, higher carrying costs or reduced workforce from immigration, policy changes that can cause delays and higher costs. Immigrants comprise up to half of construction crews in some places, so you end up with less supply for longer. This means incomes are more resilient if markets are full. Even low demand growth can mean some rental growth, and you get more rental growth before supply turns back on in a recovery. This is all part of one of the parts of the mechanisms that makes real estate source of inflation protection. Second, as I said, position to take advantage of opportunity. And while you're doing that, emphasize durable income. So skip the strategies that need a lot of lease up or require significant rent growth. And also flip from valuing short in-place lease terms, which were desirable to access higher rents faster in a rising market. To valuing long lease terms with in-place leases there to weather the storm. Residential properties, of which there's pretty much a global shortage and essential services are most resilient in downturns. And of course, position to capitalize as stresses expand the buying opportunity by amplifying the balance sheet challenges. If you pull back on real estate now, you miss these. Thirdly, diversify thoughtfully. This is why we haven't had much of an overweight to industrial for some time. It's been over a third of the index, which starts to get pretty concentrated. Even when it's doing well, diversification is part of why investors have been shifting into and institutionalizing many smaller niche property types. It's because industrial plus apartments comprised over 70% of the US Odyssey. Also, policy risk to property types is going to be different, which is another reason to diversify. Deglobalization further supports greater geographic diversification. We increased our overweight to Europe.

There are balance sheet issues there to resolving faster than the US. So the opportunity is more active with lower interest rates, which implies better positive spread investing and the downward GDP revisions that were regularly seeing have a steeper drop in the US. So the projected US GDP advantage is waning. We'd have a bigger overweight to Europe, but many

funds there haven't delivered great results. So it's harder for fund investors to really access it well.

JG: Well we are definitely seeing interesting things in Europe. It will get impacted by US policy changes, but less so. And shifting trade and travel patterns make it even more complicated to predict. They don't have the governmental pullback. It's the opposite. They're starting to spend more on defense, which we are already hearing is translating to more industrial leasing in Germany. Over the past few years, we've seen dislocation which has been driving investment opportunities in Europe. But let's go back to the US. Can we talk more about the policy risks. And these can be opportunities. Margaret.

MM: Oh, yeah. I definitely recall in the depths of the GFC managers getting great pricing on assets that they couldn't touch on price in normal times because they were quality assets that were durable. And this is key managers who know what to buy and are well connected enough to source it. These delivered some terrific returns. And I know you have these stories too. So first let's talk about policy impact by location. In the House views deck, we laid out different risks for major US cities with an interesting baseline note that 19% of the US workforce is foreign born. So cities like Los Angeles and Houston that are dominated by ports with above average immigrant communities are going to be hardest hit. Also, Los Angeles, because it's the main port for China trade, and Houston because oil prices are low. Of course, the DC metro is going to be hard hit with so many federal jobs lost. And every federal job correlates to two contractor jobs on average lost. Plus all three have a multiplier effect on the economy. More diversified cities like New York, Chicago, and Atlanta score in the middle. A big tech presence reduces risk in San Francisco and actually pushes Seattle to lower risk, because tech seems to be protected in all of this. Boston may be weaker depending on outcomes about universities and NIH spending, and this is all evolving in real time. So turning to property types. Once again there is a matrix you can refer to in the report. Of course the slowing economy hurts leasing generally and inflation rises expenses but may have other benefits. So most at risk is industrial which is directly impacted by the tariffs and the trade war. Dropping volume over time. The idea is that onshoring boosts demand, particularly around manufacturing hubs. But this is going to take some time to manifest and there will be both winners and losers.

Retail is vulnerable, with retailers caught between the higher cost of imported goods due to tariffs unless consumer spending so small businesses with less resilience are more at risk. The drop in international tourism, plus the pullback in corporate and business travel will further challenge hotels, which were already facing a normalisation of the post-Covid travel surge. Immigration policies are leading to margin squeeze and staffing challenges. On the plus side, residential is likely to be a lot more resilient, but it's not immune. Uncertainty and higher interest rates are going to keep more people in the rental pool, but household formation declines in bad economies. Also, 70% of folks who have immigrated to the US since 2010 are renters, and this compares to the national average of 33%. So less new immigrants will slow multifamily demand growth. We also like senior and select student at schools with population growth and low foreign student population. Foreign students are only 5% of the total. They're concentrated in certain places, so it can seem like more. There's a lot more on niches that we encourage you to find in the report if you're interested. So as we look across all these many risks, one of the most important things to bear in mind is that they're all stroke of the pen risk. They're deliberate policies created them and then deliberate policies can likewise change them. So volatility is likely to continue with this going on. And it's again why it's so important to thoughtfully diversify. Definitely positioned to capture the pricing opportunities which are often found with proven high-quality managers who can source and underwrite well.

JG: So stay tuned for more updates. Before we finish, let's hit capital raising. We just put out a paper on liquidity that concluded that fundraising would likely stay challenged until asset sales and distributions normalized. It does not sound like it's getting better. If transaction volume may be slowing.

MM: A lot of these funds had transitional assets with a lot of cheap leverage, so have been the ones kicking the can down the road. Time will run out and it will get resolved. Though not. It won't necessarily translate to the kind of distributions investors are going to like. We did some work that showed on average funds of 2017, vintage and later are still holding assets at cost. There certainly was rental rate growth and there should have been accreted value added work since then. But market prices are down over 20% since 22. So if you're 55% leveraged. Simple math says you lost 45% of your equity, which seems like on average the carrying values are inflated. This makes it hard to sell the asset, even if your balance sheets okay. And even if there's volume, because you have to record a loss and people don't want to do that. So values are part of the problem, the valuations, not the trading values.



The end result of all this is that capital calls are 7% above normal, which likely includes buying new assets but also feeding the existing assets. And distributions are down 65%.

So investors are still not getting their money back, which makes it hard. They don't have it to reinvest. Also on the plus side, after a lot of gyrations, the stock market is slightly up for the year and it's up a lot over the last three years while real estate is down. So investors are likely on average under allocated to real estate. So they should have space to capitalize on this opportunity.

JG: Thanks for that update, Margaret. There are so many changes going on in the market right now, and we've only had time for a few of the topics. Please check out our house views or come talk to us for more of our market insights.

MM: Yes, we are always happy to talk about real estate. So thank you, Jeff for this conversation. And thank you everyone for listening.

MY: Thanks to everyone for tuning in. To access the full spring 2025 House views report, visit us at [StepStone group.com](https://StepStone.group.com). And as Jeff mentioned, if you'd like a replay of the House views webinar or have questions, feel free to contact a member of the real estate team. And again, don't forget you can find RPM on Apple Podcasts, Spotify, and all other major podcast platforms.