

Drivers of commercial real estate returns in 2025

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Key takeaways

- The dispersion of REIT sub-sector returns makes a case for active management.
- For REITs, the composition of interest rate changes matters as much as the level.
- Investors should consider building CRE exposure before distress peaks.

A look back. The potential drivers of commercial real estate returns in 2025. And a look forward.

This month we are providing our outlook for the year ahead.

Welcome to the Real Estate Reel from Cohen & Steers.

Let's first start with a quick recap of listed versus private returns in 2024.

1. Listed and private real estate returns in 2024

Listed REITs rose 4.9% percent last year, which follows 11% returns in 2023.

While this may seem modest at first glance, returns were as high as 15% in mid-September.

More importantly, this represents a remarkable, though not entirely unexpected, turnaround from when listed REITs bottomed in late October 2023.

The sector now stands more than 31% percent above that trough. It experienced two significant rallies over that period.

The first was 26% from October 2023 to December 2023 and the second was 28% from April 2024 to September 2024.

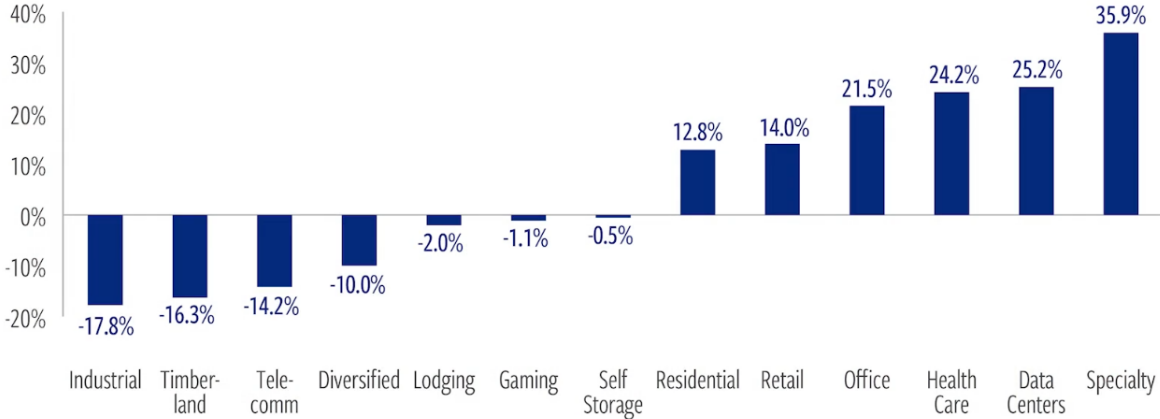
What's also notable about this year's performance is the pronounced dispersion between the best performing subsector, which was specialty at almost 36%, and the worst performing subsector, which was industrial, at almost negative 18%.

While the market often considers listed REITs a singular asset class, it's actually a collection of 18 different subsectors that can behave differently at different times. 2024 was no exception.

In total, ten out of eighteen subsectors were positive with six out of those subsectors generating returns of 20% or greater.

Exhibit 1

2024 REIT subsector performance



At December 31, 2024. Source: NAREIT

By comparison, private real estate, as measured by the NCREIF ODCE index, which tracks 25 open-ended funds that own core commercial real estate, was down negative 3.2% through the first three quarters of 2024.

It's worth noting that listed REITs stood at positive 14% year-to-date as of the end of the third quarter.

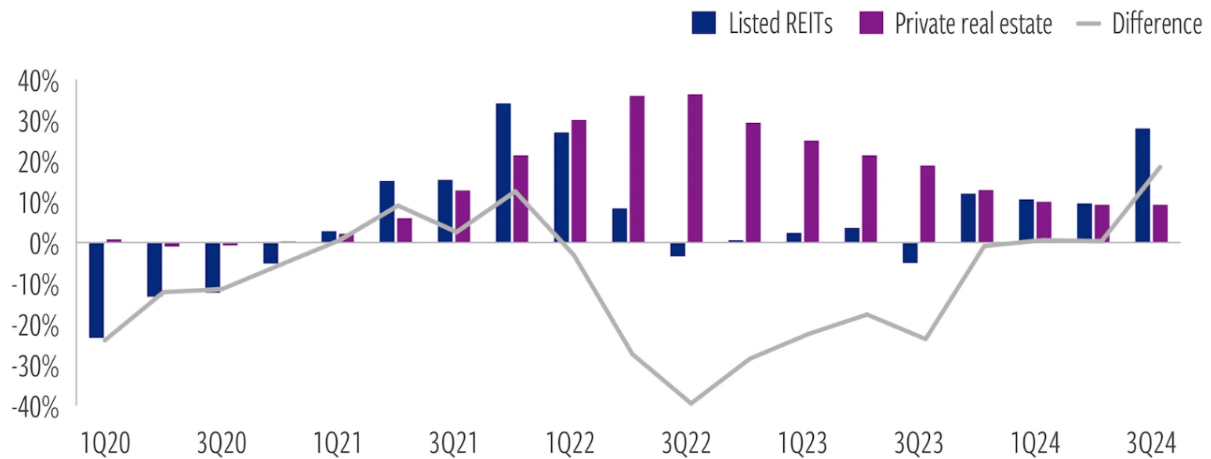
The fact that listed is rising while private is declining shouldn't come as much of a surprise.

We've long argued that listed REITs are leading indicators for private in both downturns and recoveries.

In fact, listed REITs have outperformed private real estate by more than fifty-two percentage points over the prior eight quarters, as shown in this chart.

Exhibit 2

Cumulative performance difference of listed versus private real estate



As of September 30, 2024. Source: NCREIF, NAREIT, Cohen & Steers

What may surprise people about private CRE valuations is what property types performed the best.

Open-air shopping centers led with unlevered property price returns of 3.4% followed by industrial at 1.1%, apartments at 0.5% and office that's down nearly 10%.

We think this is an early signal that last cycle's winners may not be next cycle's winners.

Now that we've reviewed what happened, let's consider the potential drivers of commercial real estate returns in the year ahead.

2. Drivers of returns in 2025

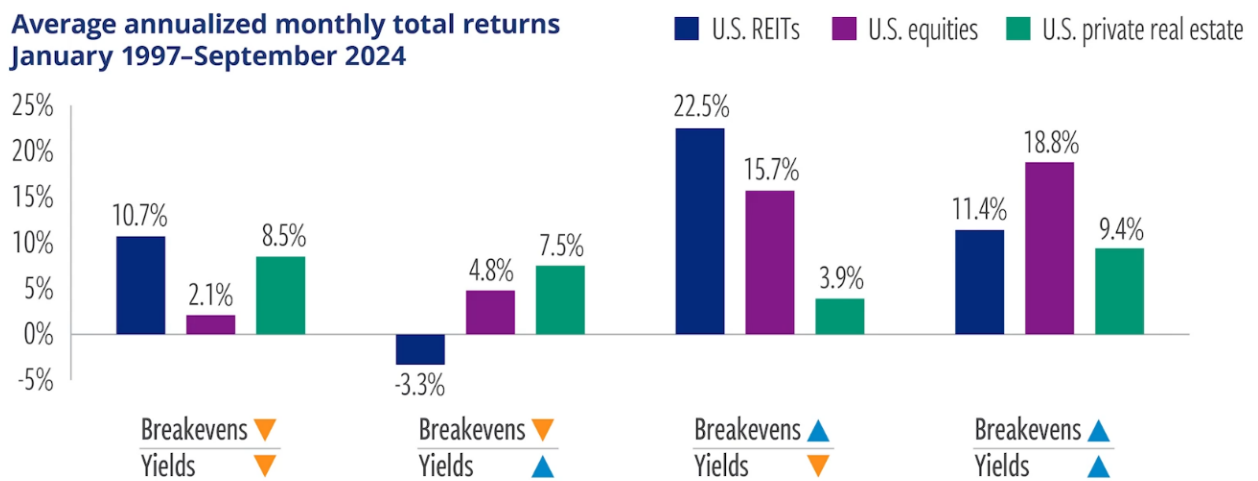
We think investors have become conditioned over the past several years to believe that rising interest rates are uniformly negative for listed REITs.

That's not true. The composition of rate moves matters.

The most challenging regime is when real rates are rising and inflation breakevens are falling. This is also known as stagflation, which is what persisted throughout 2022 and most of 2023 as the Fed increased interest rates to bring down inflation. Listed REITs struggled in that environment. The good news is that stagflation is rare historically.

Exhibit 3

Real estate performance during interest rate and inflation regimes



As of September 30, 2024. Source: Cohen & Steers

However, an environment in which real rates rise and inflation is elevated is a supportive backdrop for listed REITs.

This is because in those conditions net operating income growth typically accelerates, and lending conditions loosen, which can mitigate the impact of rising financing costs.

Bottom line, we think commercial real estate, including listed REITs, can produce positive returns in the year ahead if interest rates rise as long as NOI growth accelerates and lending conditions loosen.

It’s possible that listed REITs are more volatile than private over the near term, but they have much higher correlations over the medium term given similar fundamentals. And, hopefully it goes without saying, REITs have done well in a falling interest rate environment, especially when inflation is falling as well.

This brings me to my last point. What’s our outlook for listed and private returns in the year ahead?

3. The 2025 real estate outlook

We think total returns for private CRE have already troughed. While unlevered prices are still declining, income returns are now offsetting them. However, we do not expect a V-shaped recovery for two primary reasons: First, global central banks aren't coming to the rescue like they did post the great financial crisis.

Second, we expect an uneven recovery across property types.

We think the recovery may mirror what occurred in the early 1990s, albeit for different reasons. This likely means that total returns net of fees for core will be in the low single digits.

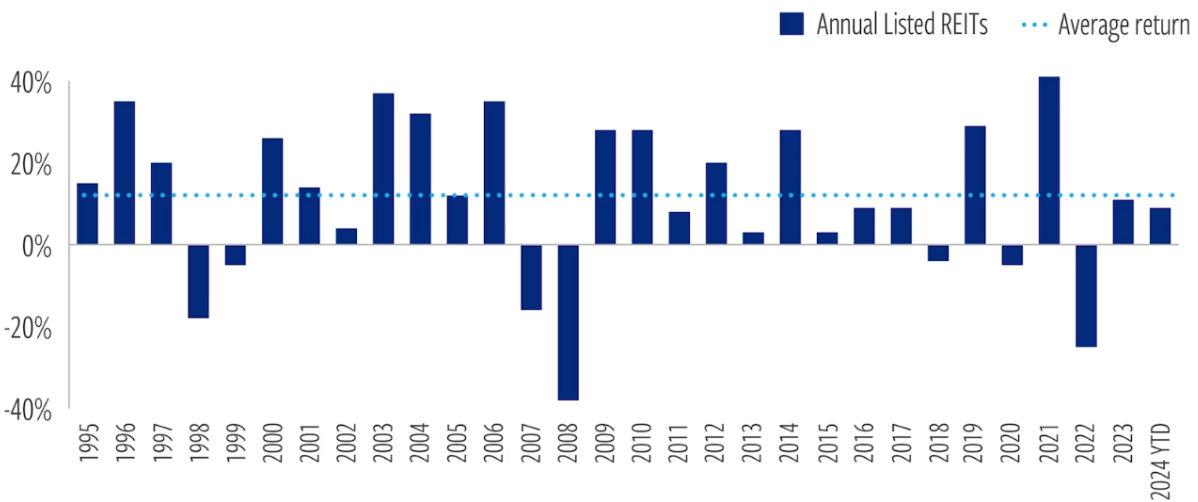
That said, we believe new capital can be selectively deployed at superior returns than headlines suggest via property type and geographic selection.

By comparison, we forecast listed REIT total returns in the high single digits at the index level, driven by earnings and dividend yield.

This would be just below the average annual returns we've seen over the last three decades, which you can see in this chart.

Exhibit 4

Annual and average real estate returns (25 years)



As of December 31, 2024. Source: NAREIT, Cohen & Steers

This is an attractive market for active management, however.

Active managers may be able to increase returns into the low double digits, in our view. We see potential to increase returns even further should investors take advantage of periodic pull backs, such as what we saw in December of last year, to invest given economic and geopolitical uncertainty.

We underscore that institutional investors may be able to build better core portfolios by adding a 10% to 30% allocation of listed REITs to an existing private CRE portfolio.

This can potentially increase returns, reduce volatility, and expand exposure to alternative property types that are underrepresented in most core portfolios.

Finally, one question we're being asked related to our outlook is whether it's too early to build exposure to CRE given distress is rising in the CRE debt markets.

Our answer is no, even as we acknowledge that distress is likely to rise over the next year and the headlines will get worse before they get better.

This is because distress in the debt markets is a lagging indicator.

We describe distress in the debt markets as the final stage of the grieving process. Acceptance.

Lenders don't like liquidating distressed loans into a distressed market because there's limited transparency on prices.

However, they feel far more comfortable liquidating distressed properties into a stabilized market. That's where we think we are headed in 2025.

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