Industry Top Trends Update

Real Estate

Fundamentals slowing amid higher recession risk

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What's changed?

Slower growth ahead. Following a period of solid recovery with operating metrics across many property types reaching pre-pandemic levels, REITs face the prospect of slowing growth over the next two years as inflation pressures consumer spending.

Rising rates curtail capital spending. Given rising borrowing costs, we expect acquisition activity to slow. Debt issuance has slowed significantly in 2022 amid market volatility, and credit spreads have widened significantly. Stock buybacks could also rise in 2022.

Outlooks split positive and negative. Eighty percent of the rated REITs have stable outlooks, with the remaining split almost evenly between positive and negative. Subsectors that have more of a positive bias include residential, industrial, and net-lease REITs, while a more negative rating bias remains for office and retail.

What to look out for?

Slow return to the office. Office REITs will remain pressured due to greater adoption of remote working and weaker job growth. An increasing flight to quality to class-A offices should mitigate downside risk for rated office REITs. But leasing activity will likely remain subdued.

Inflation pressures consumer spending. Real estate generally provides inflationary protection as rents can be reset higher to pass on inflation. However, high inflation in the context of weaker economic growth could limit pricing power and weaken tenant quality, particularly for retail REITs as consumers are likely to cut back on discretionary spending, tempering occupancy gains and rent growth. Properties exposed to more discretionary retailers could be harder hit by rising inflation.

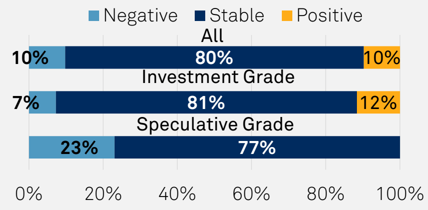
Pressure on asset valuation. Rising rates and slower growth will widen capitalization rates over the next year. This could dampen merger and acquisition (M&A) activities and delay asset disposition plans.

What if there's a recession?

Revenue pressure. A recession will pressure rental growth and occupancy, with retail and office assets hit harder by weaker consumer spending and slower job growth, the primary driver of office space demand. Office real estate saw the steepest decline in rent during the Great Financial Crisis and took longer to recover, although a decline would be more modest if a recession were to occur now, given improved tenant credit quality and well-laddered lease expiration schedules. We expect rental housing and industrial assets to recover more quickly.

Rate hike accelerating. Steep increases in rates could drive a more significant drop in asset values. We expect capitalization rates to widen more for assets with weaker growth prospects, such as discretionary retail and office.

Outlook Distribution

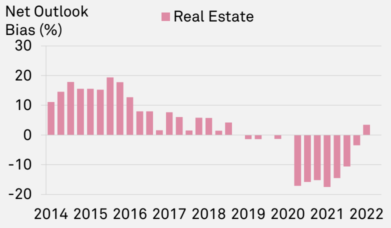


Ratings Statistics (YTD)*

	IG	SG	All
Ratings	69	13	82
Downgrades	3	0	3
Upgrades	6	0	6

Ratings data as of end-June 2022. * Year-to-date

Ratings Outlook Net Bias



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