

US commercial real estate finds life in niche sectors

Eric Smith, CEO and Managing Partner at Locust Point Capital, details the outlook on commercial real estate in the US and the opportunities in senior housing

What are the current acquisition opportunities in US commercial real estate?

Sectors in commercial real estate are starting to show appealing valuations, but it's key that investors consider how upcoming shifts in technology, society, and the environment might shape the commercial real estate sector in the coming decade.

Take senior housing, for instance. US senior housing is predicted to more than double over the next 35 years. The population of people aged 85 and over is expected to nearly triple, jumping from 6.7 million in 2020 to 19.0 million by 2060.¹ Roughly 70% of this group will likely need long-term care, opening a wide range of investment opportunities.

The US senior housing market cap sits around \$500bn, and many predict that this sector will more than double over the next 35 years.² This growth could introduce numerous investment opportunities, particularly in new development. A deceleration in core inflation and a transition toward a rate-cutting cycle would also pave the way for a burst in senior housing development.

How have current market conditions shaped the outlook on real estate debt and equity returns?

As the gap between debt and equity returns tightens, investors will likely shift strategies. Right now, real estate debt investments are hitting some of the highest yields and the lowest leverage in more than a decade.³ However, real estate debt funds, especially those with vintages from 2018 to 2020, might be hitting challenges in their portfolios. Borrowers who previously chose not to lock in an interest rate may find the ongoing higher interest rate environment tricky to navigate. On the flip side, real estate credit funds with 2023 and 2024 vintages have the potential to outperform their peers, and even pull in returns comparable to equity funds. This trend is expected to hold for both real estate debt funds, SMAs, and investors originating direct loans.



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Switching gears to real estate equity, it's wise for institutional investors to start to adjust their return expectations. The Federal Funds rate had been under 2% for the last 15 years, pushing up real estate asset values significantly. If the 10-year Treasury stays around 5%, expectations for long-term real estate equity returns will need to come down.⁴ While value-added opportunities may still offer tempting real estate equity returns, core real estate returns might lose some of their shine.

How important is it to have sector and operational expertise?

Investment size really shapes a fund's strategy, especially in real estate. Big funds, which typically invest between \$100mn and \$500mn at a time, tend to use a broad, generalist approach. These large funds and their typically reliable returns are crucial for investor portfolios. However, institutional investors aiming for Alpha might think about adding more sector-specific funds to the mix even though they're often smaller. These funds can lean into specialized strategies, plus debt and equity real estate markets are not commoditized. Critics argue these funds lack diversification, but portfolio diversification in the asset class and the deep-dive expertise of their managers usually mitigate this risk. Additionally, investors should look at real estate sectors that do not move in lockstep with the overall economy to generate Alpha, especially the ones that benefit from a specialist's touch.

¹ <https://www.census.gov/content/dam/Census/library/publications/2020/demo/p25-1144.pdf>

² <https://store.nic.org/products/nic-investment-guide-investing-in-seniors-housing-care-properties-sixth-edition>

³ <https://fred.stlouisfed.org/series/DRTSCILM>

⁴ <https://www.cbre.com/insights/viewpoints/spiking-10-year-treasury-rate-signals-caution-for-commercial-real-estate#:~:text=Econometric%20evidence%20suggests,the%20banking%20sector.>

Take the US senior housing sector, for example. According to the National Council of Real Estate Investment Fiduciaries (NCREIF), it has one of the highest Alpha and lowest Beta among core real estate sectors.⁵ Senior housing goes beyond a real estate investment; it's a complex business that provides healthcare to seniors. Success in this asset class means partnering with an owner-operator known for high-quality care in their markets. Senior housing is a niche asset class where institutional investors typically benefit from investing with a sector-focused fund manager as opposed to a generalist.

⁵ <https://ncreif.org/>

Eric Smith serves as the Chief Executive Officer and Co-Founder of **Locust Point Capital**, a credit-focused alternative asset manager established in 2016, exclusively specializing in the US senior housing sector. Eric is responsible for shaping the firm's core investment philosophy. With over two decades of experience in structured finance, he has dedicated the past 25 years to originating, underwriting, and overseeing investments in the long-term care, senior housing, and healthcare services sectors. He has participated in more than 500 transactions, with a combined value of about \$7bn in senior debt, mezzanine, and equity investments.