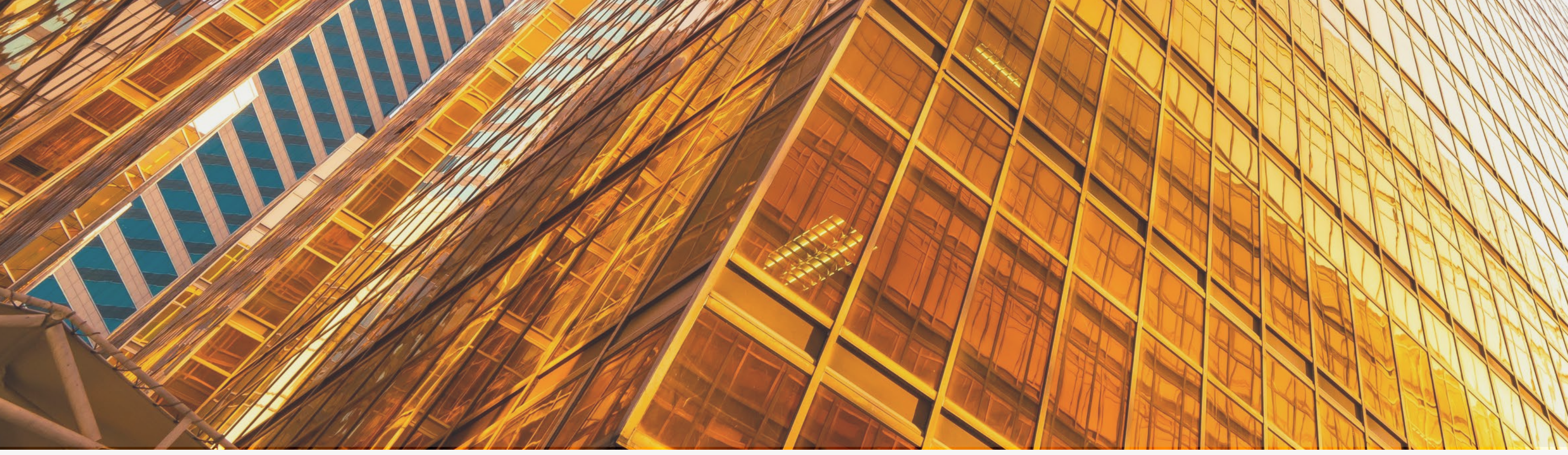
Real Estate in 2025

Market Insights

February 2025

Wealth Investment Office



Real Estate in 2025

"Make Real Estate Great Again" may not be a 2025 story

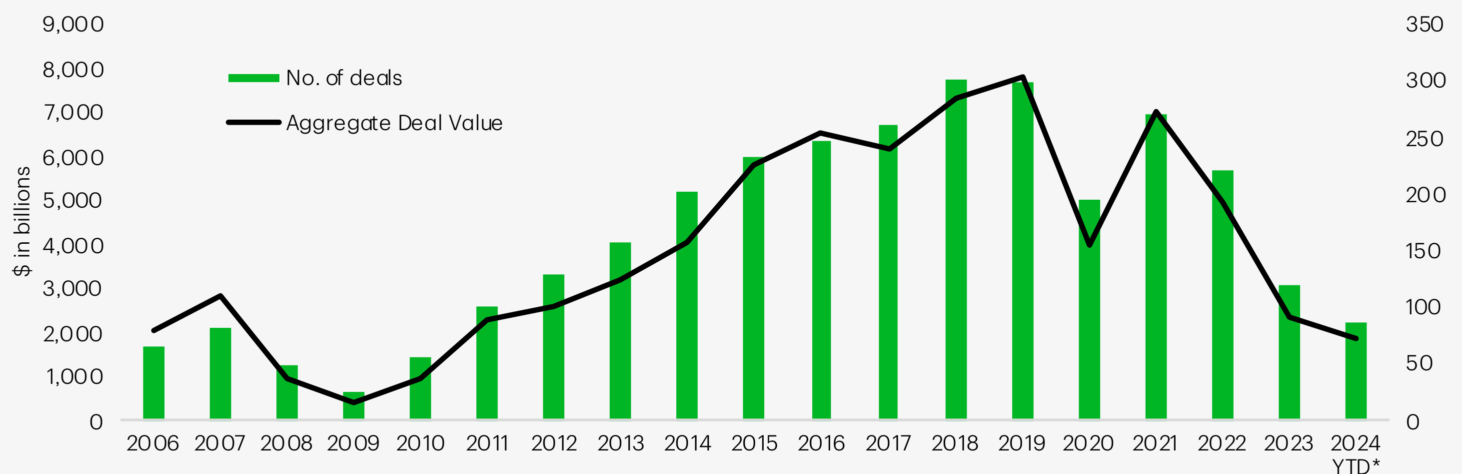
Neelarjo Rakshit, Senior Equity Analyst | TD Wealth

We believe that U.S. commercial real estate closed-end fundraising and transaction activity — which has fallen off a cliff since 2022 — will remain muted through 2025. Capitalization (cap) rates and stabilized yields in commercial real estate (CRE) are not attractive relative to other asset classes. In many instances, quasi-governmental lending entities engaged in single-family and multi-family property types (such as Fannie Mae and Freddie Mac) are getting better risk-adjusted returns than equity investors in CRE due to the amount of capital chasing common equity deals in the space.

Better alternatives exist

Consider yields for investment-grade (IG) corporate bonds. AAA bonds yield in the range of 5.10% to 5.20% all-in, while BBB bonds yield anywhere from 5.30% to 5.60% all in. As a result, we believe it remains unlikely CRE investors will chase real estate deals in common equity with cap rates between 5% and 6% when IG bonds offer similar or better yields with lower risk. Most CRE lenders are getting far better deals than common-equity investors from a risk-adjusted perspective.

Figure 1: North American Fundraising Activity



Source: Preqin as of December 31, 2024

To rebalance this equation and make common equity attractive again, cap rates need to go to 7% or higher, which is one of the reasons public REITs have been trending towards higher implied cap rates in recent months (i.e., REIT stock prices have been going down). For real estate common equity to be attractive again, cap rates must be at least 7%.

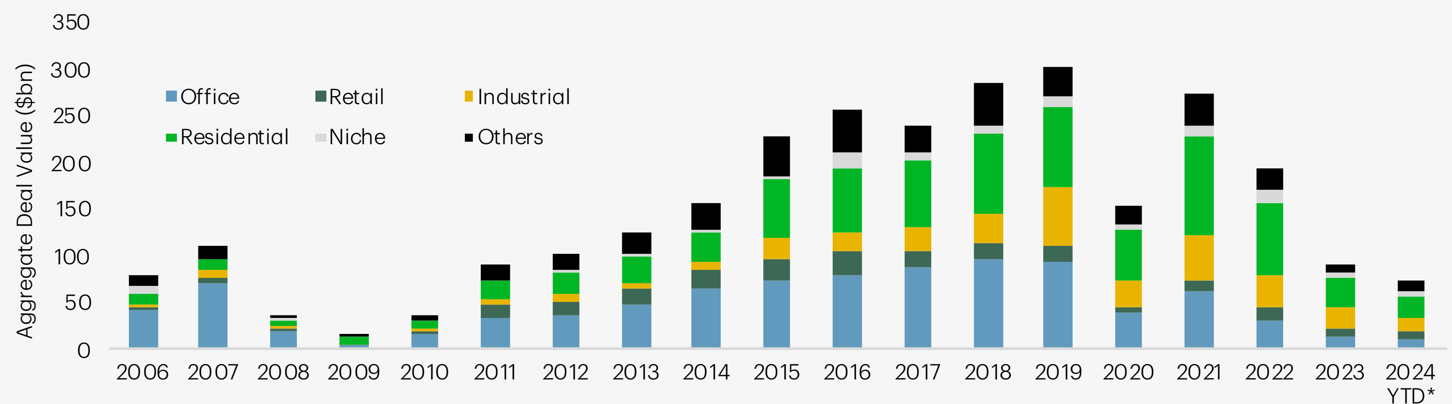
CRE buyers and sellers remain at an impasse

The challenge today is that all CRE investors want to buy at 7% cap rates, but sellers are reluctant to exit at that level, especially when they expected to sell at a 5% cap rate. There remains a significant gap between what a CRE buyer can pay and what sellers will accept — this has been a common theme across most real estate property types for more than two years now.

Financing rates are higher than cap rates in most markets, meaning negative leverage. It means that, if you are buying at, say, a 5% cap rate and have debt/interest costs at 6.5%, your cash flow yield in the first year is *lower* than the cap rate of 5%. If you are a rational economic party, the only reason you might accept this return is if the prospect of a future return was more than this — via rising net operating income (rent growth) or falling financing costs, or both.

The problem today is that rates have been sticky — rents have been generally flat (for the most part), vacancies are rising (albeit slightly), and expenses are increasing. This implies that there's too much risk in buying a stabilized deal and not enough return for that risk. Owners still holding long-term debt below market rates (via low-cost financing in 2021/2022) have no reason to sell now only to buy into negative leverage. Provided we don't see massive, forced asset sales on a large scale, this pattern will likely continue to hold.

Figure 2: North American Real Estate Deal Value By Sector



Source: Preqin as of December 31, 2024

Looking Ahead

If rates stay where they are, the market could stabilize within a cap-rate band of 6.5% to 7%. On a positive note, for opportunistic returns, the play is creative, structured financing lower down the capital structure (e.g., preferred equity or mezzanine). Common-equity returns are simply not there yet, since forced sales haven't yet materialized.

Finally, we can safely suggest that we have no idea if or when forced asset sales will happen, or whether the dynamic between interest rates and cap rates will return to the "norms" of the past 30 years. What we do know is that there is no "normal" dynamic between interest rates and cap rates through the cycle — that relationship is constantly evolving.

Wealth Investment Office, TD Wealth

Head of Wealth Investment Office

Brad Simpson | Chief Wealth Strategist

North American Equities:

Christopher Blake | Senior Portfolio Manager
Chadi Richa | Senior Equity Analyst
David Beasley | Senior Quantitative Portfolio Manager, Equities
Andrej Krneta | Senior Equity Analyst
Neelarjo Rakshit | Senior Equity Analyst
Nana Yang | Senior Equity Analyst

Managed Investments:

Christopher Lo | Senior Portfolio Manager, Head of Investment Team
Fred Wang | Senior Portfolio Manager
Aurav Ghai | Senior Fixed Income Analyst
Mansi Desai | Senior Equity Analyst
Kevin Yulianto | Portfolio Manager, Equities
Shezhan Shariff | Senior Alternative Investments Analyst
Daniel Carabajal | Senior Fixed Income Analyst
Jack Zhang | Investment Management Analyst

Investment Consulting:

Brian Galley | Head of Portfolio Management Consulting
Shanu Kapoor | Portfolio Management Consultant
Richard Nguyen | Portfolio Management Consultant
Shaun Arnold | Portfolio Management Consultant
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Jesse Kaufman | Portfolio Management Consultant
Ivy Leung | Portfolio Management Consultant
Anita Linyu Li | Portfolio Management Consultant
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Omar Aldin | Portfolio Management Consultant

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