

SEPTEMBER 2025

# Real Estate Reset: Capitalizing on Record Dispersion

## KEY TAKEAWAYS

- The sharp repricing of commercial real estate (CRE) across sectors and regions—triggered by steep interest rate hikes that began in 2022—marks a structural reset. This is leading to more differentiated outcomes for real estate investors.
- Our analysis of commercial property valuations over the past 40+ years shows the U.S. CRE market is hitting record dispersion among the best and worst performing sectors and geographies due to divergence in rent growth and cap rates.<sup>1</sup>
- We believe we are in a period of sustained higher long-term interest rates. Higher rates tend to coincide with higher cap rates and increased cost of capital. This typically leads to decreased new construction, which in turn drives above-average rent growth for extended periods.
- Over the last 60 years, rents have increased at significantly faster rates during higher cap rate periods. This pattern appears likely to repeat—and could be significant in certain sectors and markets.
- In addition to higher rates, significant secular and structural changes triggered by technology and government policy have also contributed to performance dispersion.
- Even though cap rate spreads to risk-free rates are below their historical average, we believe that average statistics obscure distinct pockets of opportunity and the potential for outsized returns.
- Europe stands out as broadly attractive from a valuation standpoint, with less competition. In the U.S., as regional banks rebalance their CRE exposure, there are opportunities to participate in the recapitalization of CRE—e.g., buying debt or providing capital to undercapitalized and overlooked segments—which can lead to idiosyncratic returns.
- With the prospect of structurally higher cap rates, we believe the key to outperformance will be identifying supply/demand differentials that drive rent growth and maximizing free cash flow via asset selection, entry price optimization and operational execution.
- A more volatile valuation environment with differentiated outcomes creates an ideal setting, in our view, for alpha generation.
- To capitalize on the CRE structural reset, we believe investors will need to seek out market dislocations with nimble capital and structuring expertise, a global strategy with local sourcing capabilities, and a special situations orientation to capture the "complexity premium."

## Hitting the Reset Button

The rate hiking cycle that began in 2022 has reshaped the global CRE landscape dramatically given the industry's high leverage. Asset values have declined approximately 18% in the U.S. and 22% in Europe from their 2021 peaks<sup>2</sup>—a drop fueled almost entirely by higher risk-free rates.

In the U.S., despite price declines across the industry, net operating income (NOI) has grown and cap rate spreads (i.e., incremental yield above the 10-year Treasury) have compressed. Absent income growth and tightening cap rate spreads, values would have declined even more.

*"The CRE market is hitting record dispersion among the best and worst performing sectors and geographies due to divergence in rent growth and cap rates."*

These dynamics are the result of an inflationary environment and differ from what happened during the Global Financial Crisis (GFC), when price decreases were driven by declining net operating income and widening cap rate spreads. Also, the reduction in rates during the GFC helped to offset overall price declines.

In contrast to the GFC, fundamentals in 2025 are generally solid for existing CRE stock. Replacement costs are elevated because of the higher cost of capital as well as rising construction costs due to inflation, tariffs and immigration restrictions. New development activity, therefore, is expected to remain low in aggregate, which should support continued rent and NOI growth.

The period of low interest rates made it relatively easy to deliver new supply and muted the rent growth that is normally driven by supply/demand differentials. Higher rates, on the other hand, have the impact of making it more challenging to deliver new supply and therefore magnify supply/demand differentials, resulting in excess rent growth. As a result, we're currently observing—from 2020 to present—the highest levels of performance dispersion across sectors and geographic markets for any period since 1980. This record dispersion underscores the importance of sector and market selection to drive CRE outperformance.

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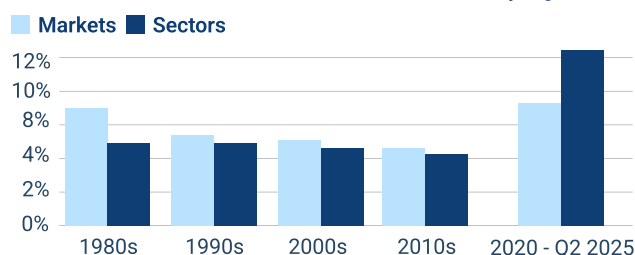
Our analysis shows that the total annualized return differential between the top and bottom 50<sup>th</sup> percentile performers across sectors and markets are at record levels. For example, industrial (+12%) is the best performing sector since 2020, while office is the worst (-4%). Even within industrial, performance can vary dramatically across different markets: for example, California's Inland Empire<sup>3</sup> (+15%) vs. Chicago (+9%).

While market selection had a bigger impact than sector pick from 1980 to 2020, sector pick has become the more powerful differentiator since 2020. The average annualized performance differential from sector selection since 2020 has been approximately 12% between the top and bottom 50<sup>th</sup> percentiles—more than twice the historical average by decade going back over the last 45 years (See Exhibit 1).

In addition to higher rates, labor inflation, supply chain disruptions, deglobalization trends and significant changes to tariff and immigration policies have made it more challenging to deliver new supply—amplifying the impact of market and sector selection on performance.

### Exhibit 1: Performance Differential Between Best-Worst Performing Markets/Sectors (1980-Q2 2025, Annualized)

Since 2020 Sector Selection Has Become Historically Significant



Source: NCREIF, CBRE Econometric Advisors, DKCM Research

In such an environment, we believe a nimble CRE investing mandate supported by deep research is crucial to capture alpha opportunities. Given the cost of capital is expected to remain elevated in the higher rate environment, we believe the most compelling CRE returns will come from (1) asset selection, (2) entry price optimization and (3) the operational know-how to drive excess income growth and maximize free cash flow.

## Sector Selection is a Moving Target

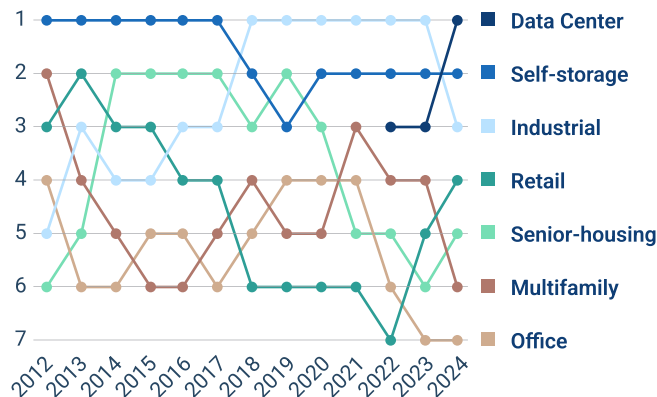
Even before the rate increases, the right sector bets would have significantly outperformed the broader U.S. CRE market. In a low rate environment, it was challenging for a sector to remain the top performer since success begets competition (new supply), driving down expected returns. While we expect that higher rates will prolong these cycles, we believe that nimble capital is still essential to capitalize on mispricing and supply/demand differentials.

Since 2012, the best performing sector has shifted from self-storage to industrial to data center; annualized total returns for the best performing sector ranged from 6% to 22%, with an average of 17%. The second-best performing sector varied from multifamily, retail, senior housing and self-storage; annualized total returns for those sectors ranged from 5% to 18%, with an average of 13% (See Exhibit 2).<sup>4</sup>

Deploying capital, during this period, to the top two performing sectors—with average annualized returns of 17% and 13%—would have outperformed the 9% return on an investment in the U.S. CRE market overall (with smaller weights to the alternative sectors that have outperformed).<sup>5</sup>

**Exhibit 2: Sector Performance Ranking 2012-2024 (Trailing 3-Yr Returns)**

Shifting Sector Leadership Highlights Value of Flexible Approach

Source: NCREIF, DKCM Research<sup>6</sup>

Over the next few years, we believe the differences in sector performance along with the duration of a sector's outperformance could become even more pronounced given elevated rates, soaring construction costs, public policy shifts and rapid technological changes.

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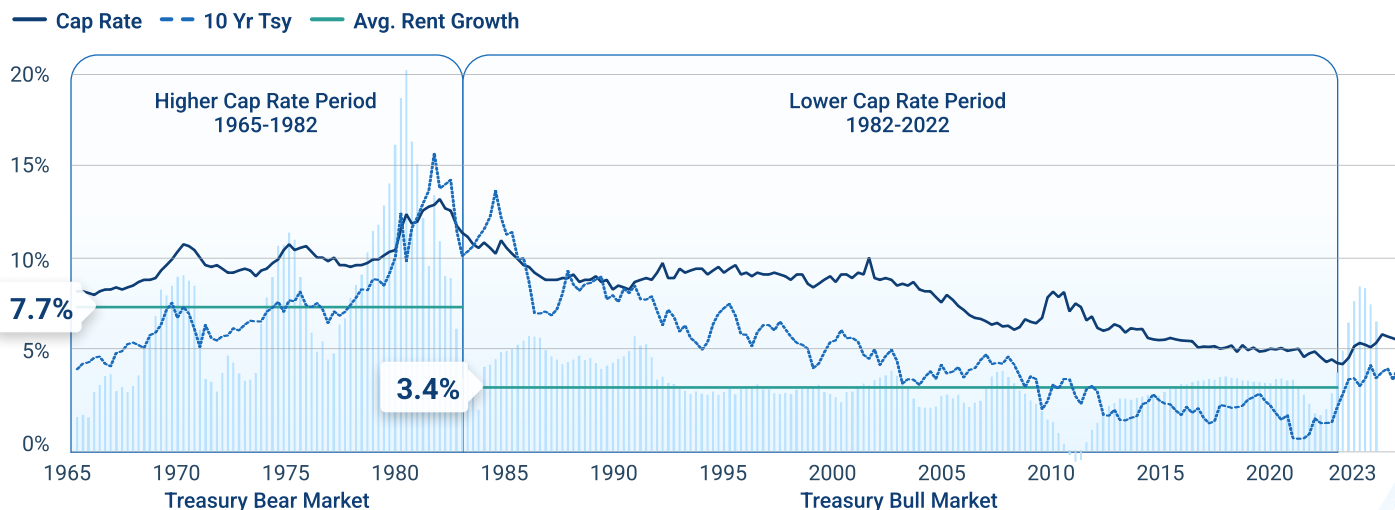
## Higher Rates, Higher Rent

Our theory is that, with higher rates, sectors with excess demand should be able to capitalize on the supply/demand differential for longer because of the challenges with delivering new supply. In such an environment, we believe that sectors with high occupancy and supply/demand imbalances are best positioned to drive excess rent growth.

*"There is a differential in rent growth by more than a factor of two during periods with higher cost of capital."*

Our analysis of cap rate<sup>7</sup> and rent growth data since 1965<sup>8</sup> shows that there is a differential in rent growth by more than a factor of two during periods with higher cost of capital (high vs. low cap rates) (See Exhibit 3).

During the higher cap rate period from 1965 to 1982, which coincided with an increase in 10-year Treasury yields (a "Treasury bear market"), the average rent growth was almost 8%. In contrast, during the lower cap rate period from 1982 to 2022, which coincided with a decline in 10-year Treasury yields (a "Treasury bull market"), the average rent growth was just under 4%. This differential is perhaps unsurprising when inflation is taken into account, but it does reinforce CRE's ability to serve as an inflation hedge in addition to being a potential return driver.<sup>9</sup>

**Exhibit 3: Higher Average Rent Growth During Higher Cap Rate Period (1965-2023)**

Source: American Council of Life Insurers (ACLI) Commercial Mortgage Commitments, ECD Rent Index, DKCM Research



Given our view that we are in a period of higher rates for longer, the ability to pick the best sectors and markets, and drive income growth, will be an essential component of CRE returns. Moreover, rising construction costs should further support rent growth, particularly in sectors with high occupancy levels.

*"In sectors with supply/demand imbalances, high interest rates, soaring construction costs, supply chain issues and labor shortages are stalling ground-up development and should result in excess rental growth."*

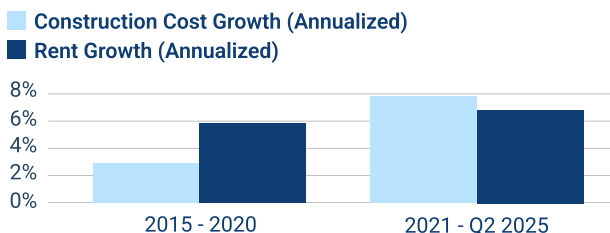
## Under Construction?

The era of higher rates is likely to create significant challenges for delivering new supply. For sectors with strong occupancy and demand, above-trend cash flow growth is expected.

Elevated construction costs are also likely to support strong rental growth. The industrial sector is a prime example of how construction costs can impact supply. From 2015 to 2020, industrial experienced 6% annualized rent growth and 3% annualized construction cost growth. As a result, new supply averaged 1.5% of existing stock. Since 2021, rent growth has remained around 6% per annum and supply growth has started to moderate (25% below pre-Covid levels) because construction costs have increased by 8% per year (See Exhibit 4).

### Exhibit 4: Industrial Sector (2015-Q2 2025)

Construction Costs Outpacing Rent Growth: Hampers Development but Supports Longer-Term Rent Growth



Source: CoStar, BLS

In sectors with supply/demand imbalances, high interest rates, soaring construction costs, supply chain issues and labor shortages are stalling ground-up development and should result in excess rental growth.

For example, the U.S. is in the midst of a senior housing shortage: over 560,000 new units are expected to be needed by 2030 but only 191,000 will be built at the current development rate.<sup>10</sup> As a result, REITs/managers are pivoting toward acquisitions of existing assets (and capital improvements to maximize NOI).

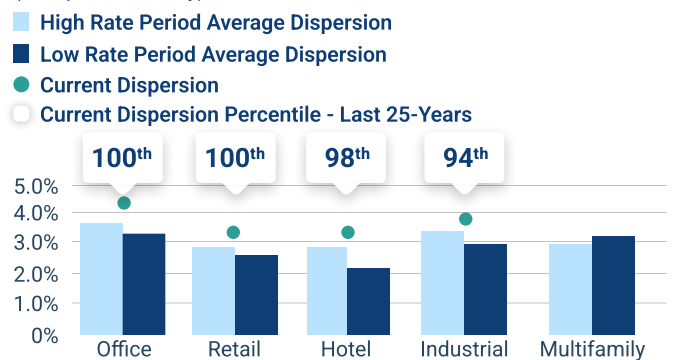
## But It's Not Just Rates: E-commerce, Covid-19, AI and More

In higher rate environments, sectors with strong supply/demand differentials not only benefit from increased rent growth but also from investor capital flows. As investors chase performance, capital flows tend to follow. This can be observed in greater cap rate dispersion during periods with high rates.

According to our review of 25 years of cap rate data, the dispersion of cap rates within a sector is meaningfully higher during higher interest rate periods than lower interest rate periods. We calculated the cap rate dispersion within a sector as the difference between the 90<sup>th</sup> and 10<sup>th</sup> percentile markets.<sup>11</sup> We looked at average dispersion in the lower and higher interest rate periods using 3.5% on the 3-month Treasury bill as the point of divide.<sup>12</sup> For every sector other than multifamily, the current cap rate dispersion is near or at the 25-year high, with industrial at the 94<sup>th</sup>, hospitality at the 98<sup>th</sup>, and office and retail at the 100<sup>th</sup> percentile (See Exhibit 5). We believe multifamily is an outlier due to its relative stability as an asset class, government-supported financing markets and long-term structural factors, such as supply that has underperformed demand since the GFC.<sup>13</sup>

### Exhibit 5: Cap Rate Dispersion by Sector (2000-Q2 2025)

Dispersion at or Near 25-Year Peak for Every Sector (Except Multifamily)



Source: CoStar, STR, Inc., DKCM Research



We think the current wide cap rate dispersion is driven by the increased sector and market-performance dispersion, which in turn has resulted not only from elevated interest rates, but also from rapidly evolving structural and secular trends. The ubiquity of e-commerce has increased demand for distribution centers. The Covid-19 pandemic accelerated hybrid work trends, reshaped office space use, altered migration patterns<sup>14</sup> and increased the need for more robust logistics supply chains. The recent surge in AI computing has fueled the growth in data centers.

Dramatic changes in U.S. government policy on tariffs, immigration and spending are also contributing to the disruption.

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## TAKEAWAY FOR INVESTORS: MARKETS MATTER

### Spotlight on Laredo vs. L.A.

When demand shifts rapidly, it can be challenging for supply to keep pace, which can lead to excess rent growth. This is exemplified by the impact of "nearshoring" and "reshoring" on industrial markets. With rising geopolitical and trade tensions, and still-fresh memories of supply chain vulnerabilities from Covid-19 shortages, many U.S. businesses are investing to relocate manufacturing processes closer to the U.S. (nearshoring) or back to the U.S. (reshoring).

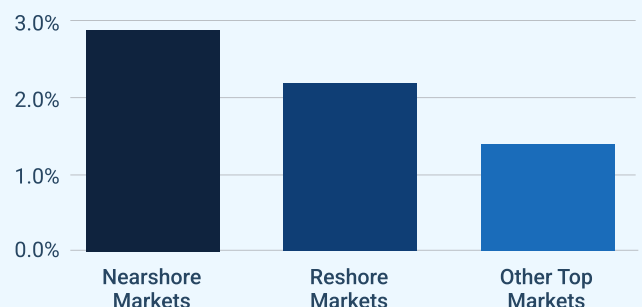
*"Markets with nearshore tailwinds in aggregate have shown the strongest demand growth relative to other top industrial CRE markets—nearly double the rate of square footage demand growth by comparison..."*

In the U.S., nearshoring has resulted in increased trade with Mexico, a long-term trend we expect to continue despite higher tariffs. U.S. markets exposed to nearshoring are concentrated in Texas, including Laredo, San Antonio, Houston and Dallas. As evidence, the Port of Laredo has surpassed the Port of Los Angeles in total trade values since 2023. Imports in Laredo have grown at a 7% CAGR compared to a 2% CAGR in the Port of Los Angeles, while exports have increased by 4% in Laredo compared to 2% in Los Angeles since 2015. Markets with nearshore tailwinds in aggregate have shown the strongest demand growth relative to other top industrial CRE markets—nearly double the rate of square footage demand growth by comparison, at a roughly 3% annualized growth rate (See *Exhibit 6*).

Reshoring trends in the U.S. are most evident for semiconductor and pharmaceutical manufacturing. Those reshore markets include Phoenix, Atlanta, Charlotte and Chicago. Markets exposed to reshoring demonstrated the second highest level of demand growth—approximately 50% higher than that of other top industrial CRE markets (See *Exhibit 6*).

#### Exhibit 6: Industrial Demand Growth by Market (2015-Q2 2025)

Higher Demand Growth in Nearshore and Reshore Markets



Source: CoStar, DKCM Research

Similar to the broader theme of dispersion across traditional CRE sectors, performance varies among the reshore exposed markets due to varying degrees of progress in reshoring and relative ease of delivering new supply. For example, Phoenix is the most in demand among the reshore cities since major semiconductor fab construction is already underway. That onshoring project has the potential to address up to 7% of the semiconductors that the U.S. needs, according to U.S. Treasury Secretary Scott Bessent.<sup>15</sup> In contrast, the benefits to Raleigh and Charlotte are more muted since the reshoring of biomanufacturing is just starting.

## TAKEAWAY FOR INVESTORS: MARKETS MATTER

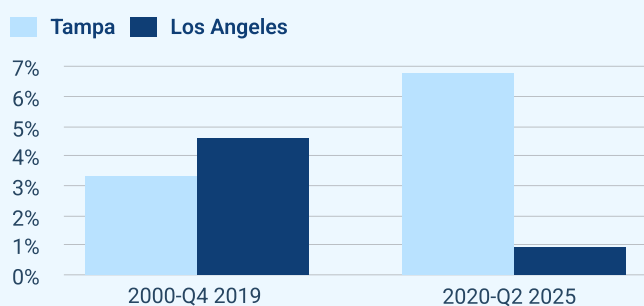
## Plenty of Room at the Hotel California

Different government policies can also lead to substantial performance dispersion within a sector. One example of the stark difference is illustrated by the hospitality sectors in Los Angeles and Tampa. Among the top 25 hotel markets in the U.S., Los Angeles has had one of the slowest recoveries from the pandemic.<sup>16</sup> Revenue per available room (RevPAR), a key metric for the hotel industry, is effectively unchanged in nominal terms since the end of 2019; adjusted for inflation, RevPAR is down 15%. Flat RevPAR over a 6-year period in an environment with escalating costs means that cash flows are likely down dramatically. Demand (as measured by room nights) has declined by approximately 5% since the end of 2019. International arrivals (measured on a trailing 12-month basis) are at 93% of 2019 levels. More recently, the potential for a minimum wage increase of nearly 70% to \$30 per hour has many hotel owners concerned given the already weak pricing environment.<sup>17</sup>

Conversely, in Tampa, where the minimum wage is \$13 per hour and policy has largely been more accommodative for businesses, hospitality performance has been strong. RevPAR is up approximately 40% in nominal terms since 2020 (See *Exhibit 7*).

**Exhibit 7: Tampa vs. L.A. Annualized RevPar Growth (2000-Q2 2025)**

Since 2020, Tampa's RevPar Growth is 6x L.A.'s Growth Rates More Comparable Prior to 2020



Source: CoStar, STR, Inc., DKCM Research

From 2000 through 2019, Tampa RevPar growth averaged approximately 75% compared to Los Angeles. Since 2020, Tampa's RevPar growth has averaged about six times higher.

## Mind the Valuation Gaps in Europe

The size of the CRE markets in the U.S. and Europe are fairly similar in nominal and GDP terms, with the U.S. CRE market totaling \$21.7 trillion<sup>18</sup> and Europe equal to about 90% of that.<sup>19</sup> On the surface, banks hold CRE loans equivalent to roughly 10% of GDP in both the U.S. and Europe—a ratio that has remained relatively constant over time. However, in both markets there have been significant shifts in the lending mix. Moreover, the U.S. and Europe have followed differing rate, policy and inflation paths since 2022, which has created different opportunity sets.

Europe stands out as broadly attractive from a valuation standpoint. REITs in continental Europe and the UK trade at discounts of 7% and 22%, respectively, to their intrinsic net asset values (NAV) vs. U.S. REITs trading in-line with their NAVs, according to Green Street's estimates.<sup>20</sup> The UK discount to NAVs is at the 94<sup>th</sup> percentile since 2009.

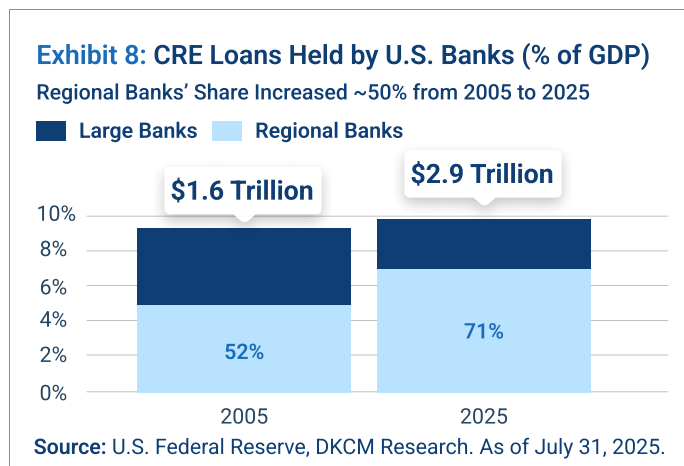
*“Europe stands out as broadly attractive from a valuation standpoint.”*

Moreover, private real estate investor capital in Europe is half that of the U.S.—just 3% of GDP versus 6% in the U.S.—which means there is less competition in Europe compared to the U.S.<sup>21</sup> This dynamic is even more pronounced in parts of Southern Europe that are underbanked and less developed.

## Follow the Money: Bank Retrenchment, Investor Opportunity

Differences in bank and investor capital availability across regions shape the opportunity set. In the U.S., regional banks have become a larger portion of overall CRE lending, jumping from 52% of the total bank CRE lending market in 2005 to 71% in 2025 (See *Exhibit 8*). Regional banks have continued to modestly increase their CRE loan exposure, while large banks have been reducing their exposure since 2023.<sup>22</sup> We see opportunities arising from U.S. regional banks as they focus on balance sheet optimization. To minimize capital charges and continue to be active in the CRE lending market, regional banks occasionally sell CRE loan portfolios to free up regulatory capital. In some cases, it is most capital efficient for these banks to provide the buyer with attractive seller financing on these portfolios, creating a win/win dynamic for both the seller (via better regulatory treatment) and the buyer (via enhanced levered returns).

As these banks rebalance their CRE exposure, there are opportunities to participate in the recapitalization of CRE—including buying debt, acting as a capital solutions provider, and providing capital to undercapitalized and underappreciated geographies and segments—which we believe can lead to idiosyncratic returns.



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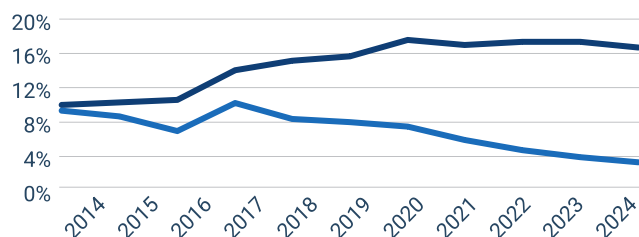
In Europe, the share of CRE loans going to southern European countries has declined over the last 10 years while overall CRE lending across Europe has remained steady. In our white paper [Europe: Opportunity in Fragmentation](#), we discussed how regulatory changes after the Eurozone crisis resulted in less lending by banks to non-financial companies (NFCs) in what were then termed "periphery" countries, while lending to NFCs in "core" countries remained stable.

We observe a similar divergence in bank CRE lending, which increased approximately 45% (from roughly 11% to 16%) for "core" countries in GDP terms vs. a decline of 45% (from 11% to 6%) to "periphery" countries (See [Exhibit 9](#)). This occurred over a period when the "periphery" countries grew at roughly twice the rate as the "core" countries (around 2% annualized real GDP growth in the "periphery" versus just over 1% for the "core"); that outperformance increased to three times the rate over the last 5 years.<sup>23</sup> In our view, the current gap of bank CRE loans to countries in Southern Europe, such as Spain, Portugal, Italy and Greece, creates attractive white space for capital providers, especially since these economies are expected to grow faster than the Eurozone average.

### Exhibit 9: European Bank CRE Lending (by Country as % of GDP)

From 2014 to 2024 CRE Lending Declined in "Periphery" and Expanded in "Core" Countries

— "Core" Countries: Austria, Belgium, France, Germany and the Netherlands  
— "Periphery" Countries: Cyprus, Greece, Ireland, Italy, Portugal, Spain



Source: U.S. Federal Reserve, DKCM Research. As of July 31, 2025.

## TAKEAWAY FOR INVESTORS: SECTOR SIGNIFICANCE

### Italian Logistics

Within Europe, we view the logistics sector in Italy as particularly attractive given less CRE supply and development activity. We see Italy as one of the healthiest markets for logistics development given its low vacancy rate, relative lack of competition in markets outside of Milan or Rome, and the potential for upside on rent and capital values relative to other western European countries.

Logistics vacancy rates in Italy are at 3% – among the lowest in Western Europe – and are expected to remain in this vicinity in the medium term due to low levels of development.<sup>24</sup> Rents per square meter in Italy are significantly lower than in other countries in Western Europe (36% lower than in Germany, 34% lower than in the UK and 18% lower than in France),<sup>25</sup> allowing for expansion over time given the low starting point. In addition, e-commerce penetration is smaller in Italy (11% vs. 15% in Germany and 29% in the UK); logistics supply per capita is also low (0.5 square meters per capita vs. 1.2 square meters per capita in Germany).<sup>26</sup> When taking supply and online spending per capita into account, Italy appears to have significant upside potential.

The ability to source off-market opportunities in less competitive processes, thereby lowering entry price points, makes the logistics opportunity set in Southern Europe even more compelling.



## TAKEAWAY FOR INVESTORS: SECTOR SIGNIFICANCE

## Data Centers: Watt Matters

Data centers have increasingly become a focal point for many investors given their role in supporting cloud computing, artificial intelligence and the broader digital economy. Limited power availability remains the main inhibitor of global data center growth in certain core hub markets. Consider Northern Virginia, the largest U.S. data center market with 10 GW of installed base—there are about 200 projects in the pipeline that have applied for approximately 45 GW of power.

The relentless demand for computing power from generative AI models has turbocharged the situation, making the ability to source and develop sites for data centers in a timely fashion imperative. Moreover, supply is capped by the sheer amount of capital required. Building out data centers is so costly that it can make it very challenging to pursue projects on a speculative basis, therefore reducing the potential for oversupply. As such, there is tremendous need for capital and many opportunities for flexible capital providers.

We believe there are many interesting ways to address the opportunity set. Examples include: (i) investing in prime locations with multiple use cases and near-term power; (ii) enabling undercapitalized developers to scale with capital solutions for horizontal capital expenditures; and (iii) funding vertical development with experienced operators. Power availability and supply/demand dynamics are likely to be significant issues over the next few years; we believe time to market will be critical and there will be considerable value to unlock by anticipating demand needs and navigating approval processes.

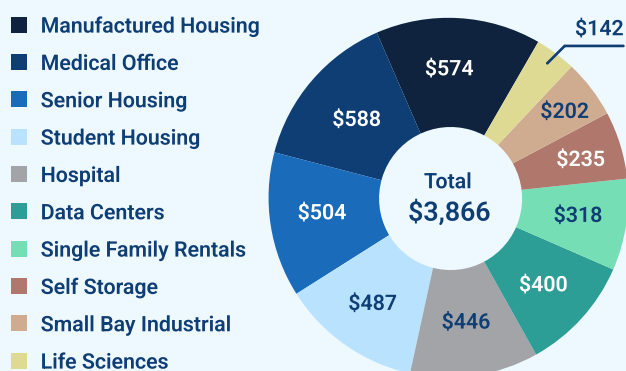
## Alternatives Ascend

Over the last cycle, as low interest rates reduced the expected rate of return expectations for CRE, investor interest increased in alternative sectors. Despite the interest rate reset, many traditional sectors either face oversupply (e.g., office) or cap rates that are at a tight spread to risk-free rates. As a result, investors remain focused on capturing potentially higher returns via alternative sectors. In addition to data centers, other alternative sectors such as single-family rental, manufactured housing, senior housing, student housing, self-storage, small bay industrial, medical office and life sciences collectively comprise a meaningful share of the CRE market.

The institutional investor addressable market for these alternative sectors in the U.S., based on our bottom-up analysis, is approximately \$3.9 trillion. At this size, alternative sectors represent 18% of the total \$21.7 trillion U.S. CRE market (See *Exhibit 10*). As previously illustrated in Exhibit 2, some of the alternative CRE sectors were top performers from 2012 to 2024.

**Exhibit 10: Alternative Sectors and Their Addressable Market Sizes**

Approximately 18% of Total U.S. CRE Market



Source: DKCM research, Green Street, CoStar, John Burns Research and Consulting, NIC MAP and datacenterHawk, LLC

*“The institutional investor addressable market for these alternative sectors in the U.S., based on our bottom-up analysis, is approximately \$3.9 trillion. At this size, alternative sectors represent 18% of the total \$21.7 trillion U.S. CRE market.”*

An example is small bay industrial, an emerging alternative subsector, which we estimate to have a market value of \$202 billion and has garnered increased investor interest due to its favorable supply/demand dynamics. The subsector is made up of warehouses that are 25,000-50,000 square feet and are typically rented by small and medium size enterprises (SMEs) vs. the traditional 100,000+ square feet industrial assets that are rented by big box retailers like Amazon. These assets have demonstrated strong rental growth as demand from SMEs has consistently outpaced supply, which has resulted in significantly lower vacancies for small bay properties compared to big box assets.

## CRE Comeback

While CRE transaction activity has been subdued, we see green shoots as investors come to terms with the prospect of higher interest rates and cap rates for longer. In the first half of 2025, Private Label<sup>27</sup> CMBS volume hit the highest level in 15 years, with volumes up 35% year over year. In addition, banks are focused on balance sheet optimization and rotating capital from non-core assets to strategic origination; this trend has the dual effect of creating opportunities from banks as sellers of loan portfolios while also improving the ability of banks to continue to be constructive lending partners. With transaction volumes and debt financing markets returning, we believe the most compelling opportunities across the risk/reward continuum will come from providing liquidity, ranging from complex structured equity and debt transactions to loan portfolio purchases from banks. To capitalize on this will require, in our view, a global strategy with local sourcing capabilities and “boots on the ground” to widen the funnel and allow for capital deployment in less competitive markets.

Long-term interest rates are poised to stay elevated, driven by structural fiscal deficits and persistently sticky inflation, which in turn should keep overall cap rates above the levels seen during the zero-interest rate era. Despite cap rates being below their historical average

spread to risk-free rates, we remain enthusiastic about the current environment for opportunistic CRE investing because the elevated performance dispersion by market and sector will, in our view, drive differentiated outcomes for investors. With replacement costs elevated and development activity more muted, fundamentals are generally positive, and income growth is an increasingly important component of overall returns.

Against this backdrop, we believe the biggest driver of excess return can be achieved through a combination of dynamic sector and market selection, entry price discount to intrinsic value via a “complexity premium” and enhancements in free cash flow via “operational alpha.” To illustrate this, consider a hypothetical example: an attractive industrial asset with the potential for 3% annual rent growth<sup>28</sup> purchased through a more complicated process can go from a 6% to a 6.6% cap rate. With just 5% improvement in day-one NOI less capital expenditures (CapEx), levered returns can go from a sector/market “beta” of 13.5% to 21.1% (see *Exhibit 11*). In other words, a 10% discount to intrinsic value and a 5% improvement in cash flow via business plan execution can improve levered returns<sup>29</sup> by over 50%. In summary, we believe that discerning asset selection, entry price optimization, thoughtful structuring and rigorous management to ensure business success can lead to improved risk-adjusted returns amid the CRE reset.

### Exhibit 11: Complexity Premium + Operational Alpha Can Amplify Returns

Illustrative Example Based on a Hypothetical Industrial Asset (\$\$ in millions)

		+ Complexity Premium <sup>a</sup>	+ Operational Alpha <sup>b</sup>
NOI less Recurring CapEx	\$4.00	\$4.00	\$4.00
Purchase Price	\$66.70	\$60.60	\$60.60
Optimized NOI less Recurring CapEx	\$4.00	\$4.00	\$4.20
Entry Yld	6.0%	6.6%	6.6%
Exit Yld	6.0%	6.0%	6.0%
Plus: Rent Growth	3.0%	3.0%	3.0%
<b>Implied Est. Unlevered Return</b>	<b>9.2%</b>	<b>11.5%</b>	<b>12.8%</b>
LTV %	65%	65%	65%
<b>Implied Gross Debt Proceeds</b>	<b>\$43.30</b>	<b>\$39.40</b>	<b>\$39.40</b>
<b>Equity Basis</b>	<b>\$23.30</b>	<b>\$21.20</b>	<b>\$21.20</b>
Spread over SOFR	250	300	300
SOFR	4.0%	4.0%	4.0%
<b>All-In Cost of Debt</b>	<b>6.5%</b>	<b>7.0%</b>	<b>7.0%</b>
Interest Expense	(\$2.80)	(\$2.80)	(\$2.80)
<b>FCF</b>	<b>\$1.20</b>	<b>\$1.20</b>	<b>\$1.40</b>
Yld	5.1%	5.9%	6.8%
<b>Illustrative Levered Return</b>	<b>13.5%</b>	<b>18.3%</b>	<b>21.1%</b>
<b>Cumulative IRR Improvement</b>			<b>56.7%</b>

**Note:** Assumes stable interest rates

<sup>a</sup> Hypothetical complexity premium equates to a 10% discount on cap rate.

<sup>b</sup> Hypothetical operational alpha in form of 5% improvement in FCF via CapEx optimization and cost efficiencies.

## Disclosure

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## Endnotes

1. While we examined U.S.-specific data, we believe this trend is present outside the U.S.
2. Green Street - Commercial Property Price Index (June, 2025). Note that CoStar, MCSI, and Real Capital Analytics indicate different declines in the U.S. of -21% and -13%, respectively. In addition, the European Central Bank shows the decline as -13%. We believe this divergence based on different indices is another example of the current high level of dispersion in CRE.
3. The region in California including Riverside, San Bernardino and Ontario.
4. Calculated based on 3-year trailing total returns.
5. NCREIF Total Return Index 2012-2024.
6. We excluded hotels from this analysis due to Covid-related closures which created noise in the data.
7. We used the American Council of Life Insurers (ACLI) Commercial Mortgage Commitments data, which is comprised on average of 500 loans per quarter across a range of CRE sectors going back to 1965 and associated cap rates. While not perfect data, it provides a good proxy for cap rate trends over time and is the longest available data set we have come across.
8. We used residential rent growth based on the Organisation for Economic Co-operation and Development (OECD) rent index as commercial rent data is only available from STR, Inc. since 2002. We found the OECD rent index was highly correlated with commercial rent growth from 2002-2023, with an R-squared of 0.75.
9. Unfortunately, there is no robust total return data going back before 1985 so we cannot analyze the longer-term total return trends with confidence, but the (intuitive) relationship between higher cap rates and higher rent growth is helpful to confirm with data.
10. Wall Street Journal, "Aging Boomers Are About to Rekindle the Senior-Housing Market," February 11, 2025.
11. We analyzed cap rates across the largest U.S. markets (80 markets for Office, Industrial, Retail and Multifamily; 172 for Hotel). For each period starting in 2000, we ranked cap rates within each sector across markets and calculated dispersion as the difference between the 90th and 10th percentiles.
12. See our ["Absolute Return: The Party is Just Getting Started"](#) white paper for more information on why we chose 3.5% as the point of divide.
13. Multifamily in the U.S. is effectively government-backed due to the involvement of government-sponsored enterprises like Fannie Mae and Freddie Mac.
14. According to the Census ACS Survey, Florida, Texas, North Carolina, Arizona and Georgia experienced the largest net gains from 2021 to 2023, averaging 238,000 in net migration, which was 20% above 2017-2019 levels. New York, Illinois and California had the largest net losses; notably, California changed from a net gain in 2017-2019 to a net loss in 2021-2023.
15. All-In Podcast, "Winning the AI Race: Part 5," July 23, 2025.
16. CoStar.
17. New York Times, "Minimum Wage in L.A. Could Rise to \$30 an Hour. Just Enough or Too Much?," August 4, 2025. The current level is \$17.87.
18. U.S. Federal Reserve, Financial Stability Report, April 2025.
19. La Salle Investment Management.
20. Green Street, August 15, 2025.
21. Preqin Ltd.; International Monetary Fund (IMF).
22. U.S. Federal Reserve, "Financial Stability Report," April 2025.
23. European Central Bank.
24. CBRE Econometric Advisors, Q4 2024; Green Street estimates for 2028.
25. CBRE Econometric Advisors; Green Street.
26. CBRE Econometric Advisors, Q4 2024.
27. Bank-issued, non-Agency U.S. volumes.
28. Green Street rent growth projections for the top 30% industrial markets in the U.S. from 2026-2030 are between 3.0-3.5%.
29. Assuming market debt financing terms for a fully leased industrial asset.



## About Davidson Kempner

Davidson Kempner is a global investment management firm with more than \$35 billion of assets under management. Backed by over 40 years of experience, our global teams invest across the capital structure, applying our research-driven investment process to evaluate and execute a diverse range of transactions across asset classes, geographies and market cycles. We combine our opportunistic, event-driven approach with a disciplined focus on downside protection, serving as an established sponsor with a strong track record of value creation. Our Firm has over 500 employees across seven offices: New York, Philadelphia, London, Dublin, Hong Kong, Shenzhen and Mumbai. Additional information is available at [www.davidsonkempner.com](http://www.davidsonkempner.com).



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