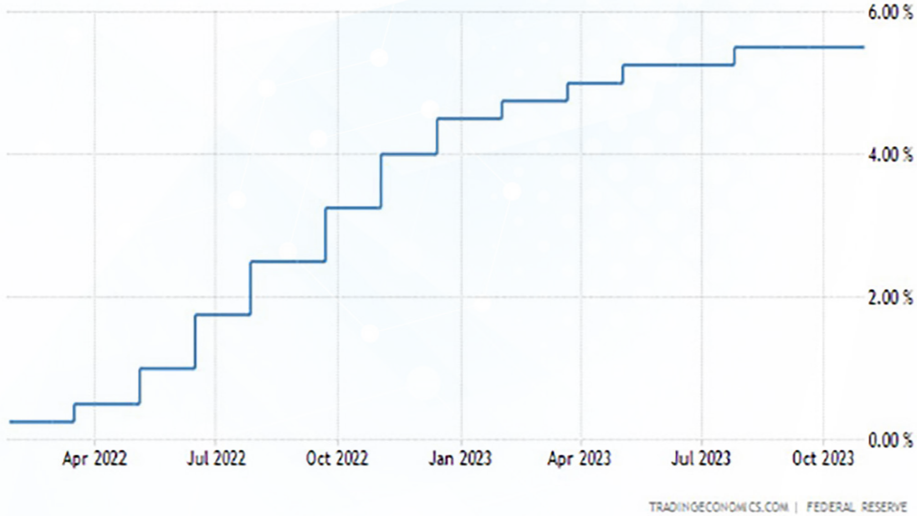
Commercial Real Estate Outlook 2024

By Paul Ayoub and Joseph Jannetty

As we begin 2024, the commercial real estate industry is looking for signs of what lies ahead, following a year of challenges in 2023. Those challenges included a significant decline in commercial real estate transaction and financing volume, unstable interest rates, proposed regulations to raise lender capital requirements, and uncertainty regarding property values. All of this and more make it difficult for lenders to extend credit, while prospective investors and property owners are challenged to obtain financing. In time, the market will begin to move again as outstanding debt matures, interest rates stabilize and the market has a clearer sense of the road ahead.

To better understand where the market is headed, even as we wait for complete Q4 2023 data, it first is helpful to remember how we got here.

Rising Interest Rates – To combat inflation, the Federal Reserve raised interest rates eleven times between March 2022 and July 2023, from 0.25% to 5.5%. Monthly year-over-year inflation rates have fallen from a height of 9.1% in June 2022 to 3.2% in October 2023 and the Federal Reserve has signaled three potential rate cuts of a quarter point each in 2024, but the Federal Reserve is generally expected to keep interest rates "higher for longer" as they pursue a target inflation rate of 2%.[1]



Rising Costs – Elevated operating and construction costs continue to exert pressure on property owners and commercial real estate developers alike. Commercial real estate operating expenses have risen by more than 30% since 2017 according to a recent *Barron's* report, driven by rising insurance costs, while construction costs remain elevated.[2] According to a recent *Marcus & Millichap* report, some commercial real estate sectors experienced year-over-year increases in insurance premiums as high as 33% through Q3 2023.[3] Construction costs have stabilized, but remained 31% higher in Q4 2023 compared to pre-pandemic pricing, according to a recent *Gordian* report.[4]

Declining Revenue – Commercial real estate revenues are under deep stress, becoming particularly acute in the Class B and Class C office sector. Widespread adoption of work from home policies, accelerated by the pandemic, are here to stay in some hybrid capacity. This has reduced office space utilization by 51% compared to pre-pandemic years according to a recent report from *Goldman Sachs*.[5] Other sectors have come under pressure too, including multifamily where new supply has outpaced demand with projected new construction deliveries hitting a 40-year high in 2023 according to a recent *FTI Consulting* report based on CoStar data.[6]

Rising Cap Rates – Before the interest rate hikes, deals in some sectors, including multifamily, were transacting at cap rates as low as 3%. Buyers are now seeking higher cap rates, demanding a 1.5% premium compared to 10-year treasury bond yields which have risen as high as 5% in 2023. In other words, buyers seek to purchase properties at a minimum cap rate of 6% to 6.5%, suggesting an unwillingness to rely on equity appreciation or potential revenue increases to justify the increased investment risk compared to 10-year treasury bond yields.

Pricing Issues – Elevated interest rates and operating costs, combined with declining revenues and higher cap rates sought by buyers, have suppressed property values. This has resulted in a gulf between buyer offers and seller asking prices. To generate a safe return, buyers often require a purchase price where much or all seller equity is eliminated. Accordingly, there has been very little transaction volume, and it is difficult to establish where the value of commercial properties will settle.

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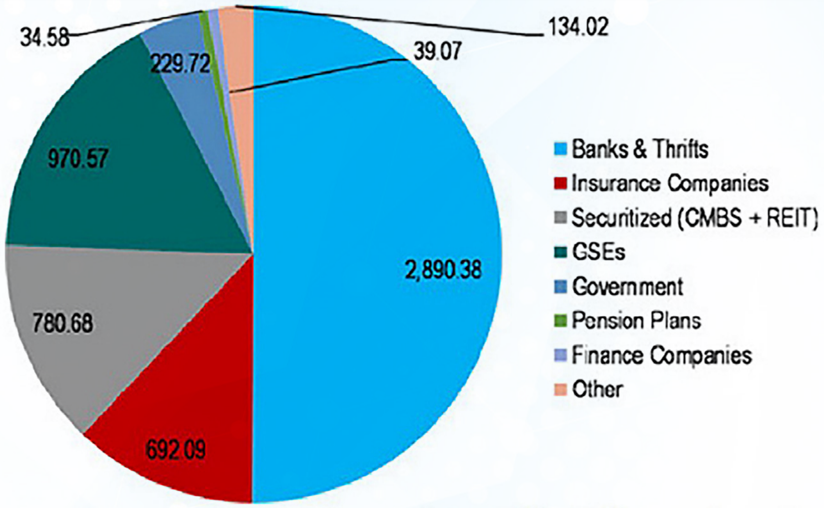
Uncertainty at Banks – Traditional lenders are the primary source of debt for commercial real estate, as the adjacent chart shows. Among these lenders, small to medium sized regional banks play an outsized role.[7] Many of these banks find it challenging to offer new financing for commercial real estate given the current interest rate environment, questions surrounding stability of deposits following the collapse of Signature Bank and Silicon Valley Bank, and stricter capital requirements proposed by the Federal Reserve.[8] Matters are further exacerbated by uncertainty regarding the value of the underlying real estate on outstanding loans. Highlighting this issue, a recent working paper published by the *National Bureau of Economic Research* estimated that 14% of all commercial real estate loans, and 44% of office loans, are already in negative equity due to declining property values.[9] It was further estimated that as many as 10%-20% of all commercial real estate loans could default resulting in up to $160 billion in losses.

Lack of Alternative Financing – Other forms of financing have also been well below prior volumes, with domestic, private-label CMBS issuance down $58 billion, or 64% year-over-year through Q3 2023.[10] Large banks, which traditionally serve as a source of financing for debt funds, have in many cases pulled back their financing due to debt funds having over-indexed investments in the office sector.

Looking Forward – Movement will pick up again in the commercial real estate market as $2.77 trillion of commercial real estate debt, or half of all outstanding commercial real estate debt, matures between 2023 and 2027.[11] The pace of maturities will be steady, with average maturities of $555 billion per year, as demonstrated in the adjacent table. Borrowers who purchased properties at lower cap rates, based on higher revenues and lower costs, and who financed at lower interest rates may find it difficult to refinance. Thus far, banks have been reluctant to take back the keys as the current market for resale is unfavorable. Instead, banks have more often sought to apply a collaborative approach, working with borrowers and offering short term extensions in the hopes of riding things out until market conditions improve. Regulators have been lenient with banks with to respect to how these loans are considered for regulatory compliance purposes. "Survive until 25" and "find a fix until 26" have become the mantra of many a lender and property owner.

CRE Debt Sources - 2Q 2023



Source: Federal Reserve, Trepp Inc.

Domestic, Private-Label CMBS Issuance

	9Mos2023			9Mos2022		
Type	#Deals	Vol $mln	Mkt Shr%	#Deals	Vol $mln	Mkt Shr%
Conduit	18	14,017.79	43.19	20	19,865.88	21.92
Single-borrower	22	12,444.50	38.34	50	42,644.71	47.05
Other				2	766.07	0.85
CLO	9	5,997.56	18.48	27	27,351.56	30.18
TOTALS	**49**	**32,459.85**		**99**	**90,628.22**	

Source: Commercial Real Estate Direct

Commercial Real Estate Maturity Volumes ($bln)

	Total	Banks	CMBS	Life Cos	GSE	Other
2023	536.93	270.43	103.26	42.50	58.37	62.37
2024	540.58	277.15	77.90	46.67	68.86	70.01
2025	534.73	282.97	54.55	49.04	82.31	65.86
2026	562.02	298.05	40.77	52.25	102.28	68.67
2027	601.09	313.05	39.81	55.76	120.30	72.17
2023 to 2027	**2,775.35**	**1,441.64**	**316.28**	**246.23**	**432.12**	**339.08**

**Based on Federal Reserve flow of funds data*
Source: Trepp Inc.

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It is unclear how long these short-term fixes can be drawn out, however, and market clarity will not be achieved until interest rates and the regulatory environment have stabilized. Potential interest rate cuts in 2024 will offer relief, but in the meantime, signs of market distress are amplifying as commercial real estate debt credit quality deteriorates and more loans default.[12] As distressed real estate and paper starts to get sold off, it will create pressure on banks to recalibrate values along their entire portfolios. These eroding values will add further pressure on banks from a regulatory compliance standpoint, potentially reducing lending capacity. This type of activity has escalated recently, as a large portfolio of Signature Bank real estate loans traded at discounts of as much as 40%, while mezzanine lender foreclosures have increased, as reported in the *Wall Street Journal*.[13]

Prevailing market conditions may produce a number of opportunities, as a potential increase in foreclosure activity may lead to favorable purchase opportunities for cash buyers with capital at the ready. There may also be opportunities for other non-traditional lenders, including insurance companies, to step into the financing gap and expand their commercial real estate financing market share. Finally, mezzanine lenders may be able to lend into distressed situations and ultimately take control of properties relatively inexpensively. ■

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[12] Id.

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