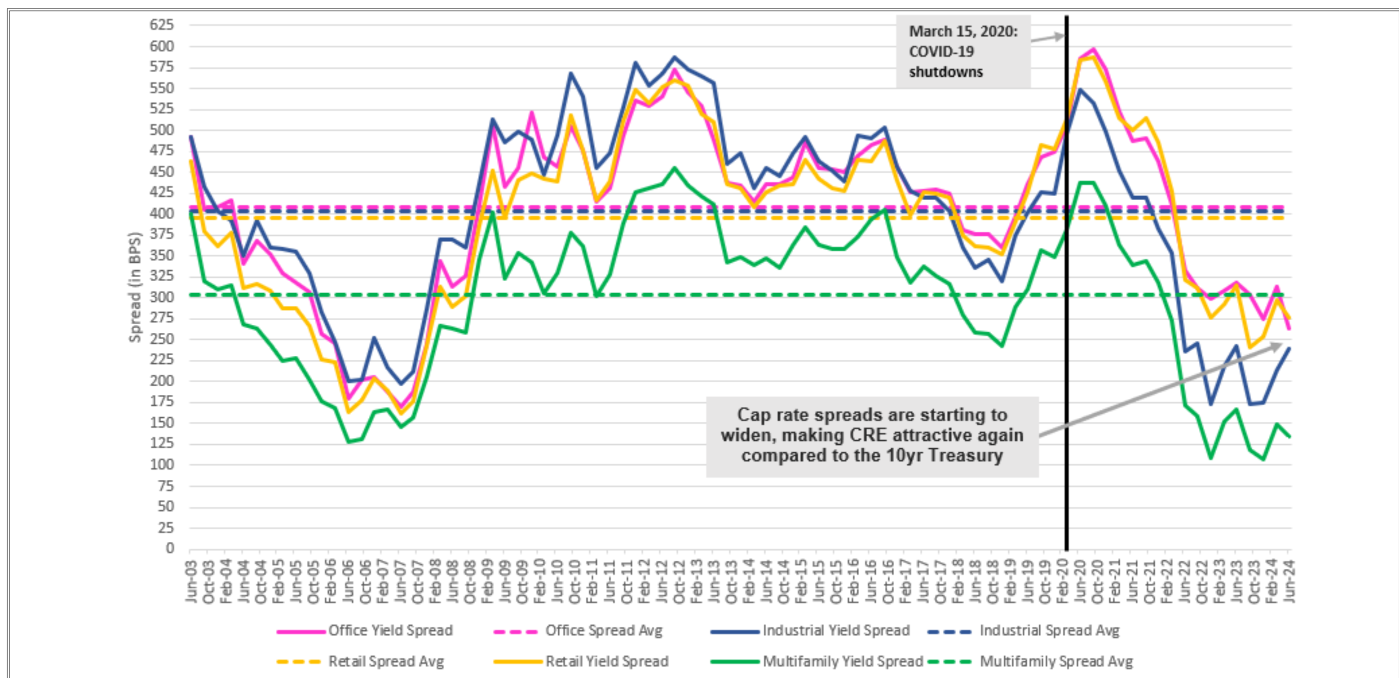
2024 MIDYEAR OUTLOOK

CRE ACTIVITY IS COMING BACK: AS THE FED DELAYS RATE CUTS, BUYERS AND SELLERS ARE FINALLY ADJUSTING THEIR EXPECTATIONS

EXECUTIVE SUMMARY

After four years on a rollercoaster that began with the 2020 COVID-19 pandemic and continued through its aftermath into recovery, the commercial real estate industry is gradually coming to accept a new reality, boosted by what is overall a strong economy. A slow transactions market could pick up toward the end of the year as investors realize that practically free money is gone but is still historically cheap, strong employment boosts the economy, a presidential election is decided, and demographic trends force action.

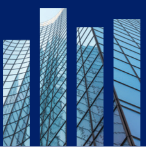
EXHIBIT 1: CAP RATE SPREADS OVER 10YR TREASURIES ARE STARTING TO WIDEN



Source: CBC Research, MSCI Real Capital Analytics, Federal Reserve.

The standstill in transactions is largely due to interest rates as the Federal Reserve cut the fed funds rate to near zero at the height of the COVID-19 pandemic, then rapidly raised them from 2022 on to tame post-pandemic inflation. This resulted in a dramatic rise in the cost of capital over the last two years which stalled transactions as buyers and sellers waited on the sidelines. Total U.S. commercial real estate volume fell a staggering 51% year-over-year to $374.1 billion in 2023, according to MSCI Real Assets.

Slowly, that is beginning to change. Investors are recognizing that they may never return to the nearly free money of yesteryear. With inflation down to 3% (from 3.4% last year), according to U.S. Labor Department data published on July 11, 2024, many analysts expect the Fed to begin cutting rates from the 5.25% to 5.50% range at year end, which should trigger more transactions in the commercial space. This is especially true as the overall U.S. economy has rebounded well from the pandemic. Unemployment, which peaked at 13.0% in the second quarter of 2020, now sits at 4.1% (source: BLS).



The results of the presidential election in November should also remove some uncertainty, and many expect a flurry of deals to close in December. The process has already begun, as both buyers and sellers become more realistic.

BUYER/SELLER SENTIMENT

Sales transactions are picking up slowly. Tired of waiting for a number that may never come, sellers are finally accepting that the sky-high pricing frenzy is over and lowering prices in order to complete deals. Other than triple-net investors and growing businesses that need space, buyers believe cap rates are still too low, and are not budging on price.

Coldwell Banker Commercial professionals around the country are seeing owners who held out for a long time now looking to sell due to changing personal circumstances or an acceptance that deal terms will not vary substantially in the near future. Long-term property holders, such as those exiting the family business, want to sell so they can realize valuation gains. Owners with maturing loans and pressure from banks are starting to come down on price if they cannot modify loan terms. And in markets with very little inventory, cash buyers are willing to pay premiums and may get into bidding wars.

BANK FINANCING IS STILL A CHALLANGE

Big banks in most markets are lending at historically high interest rates and requiring 30% to 40% equity. Private investors and mom & pop businesses are having the most difficulty getting approval. Lending for new construction has also tightened significantly, with many developers pausing large projects. Only a handful of growing markets are seeing qualified buyers get traditional bank financing without a problem. As such, an increasing number of people are turning to seller financing and leasing.

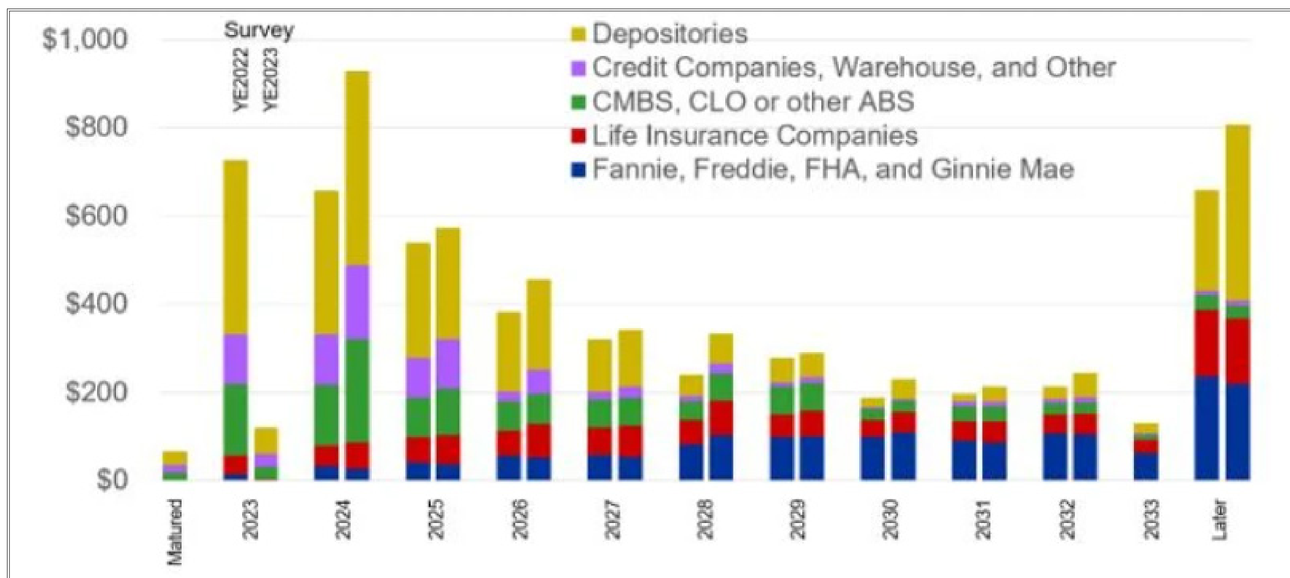
SALES TRENDS

Despite the lack of bank financing, sales activity has picked up because sellers are tired of waiting for rates to drop. While cap rates have gone up 150-300 basis points year-over-year on average, property prices haven't declined as much as they should have due to the severe shortage of inventory in most of our markets. Properties trading at 7% cap rates should really be 9.5%.

The successful buyers are mostly all cash, 1031 exchanges, private and institutional investor groups who will pay premiums for strong market rent growth potential and growing neighborhoods. Outside of cash, seller financing has become key to getting deals done. More and more owners with no debt on the property are choosing seller financing to get top dollar from the sale (making 6% interest compared to a 7-8% bank rate).

There has been very few distressed asset sales activity in our markets to date. However, with $929 billion (of the $4.7 trillion) in commercial real estate loans coming due in 2024 (according to the Mortgage Bankers Association), we expect sales volume to pick up over the next six months. There are a lot of experienced investors sitting on the sidelines waiting for the wave of refi's to begin, and this will likely be the catalyst that brings cap rates back to equilibrium.

EXHIBIT 2: CRE MORTGAGE MATURITIES PUSHED UP BY 2023 EXTENSIONS ($billions)



Source: Mortgage Bankers Association.

LEASING TRENDS

Leasing remains bifurcated and activity depends on location and the property type. Some landlords recognize that the market has peaked and that they need to compromise; they're still asking for high prices, but not as high as they once were. Other landlords have become more aggressive, raising rents significantly and forcing out tenants that can't pay. There are still many companies across CBC markets looking to downsize or get better amenities to lure employees back to the office a few days per week. All sides must accept that this higher-cost environment will be the reality for quite some time to come.

RETAIL SECTOR

Strong consumer demand for fast casual, fine dining, services and value retail is pushing rents and property values higher across all CBC markets. Prices have risen substantially because there is not nearly enough product to meet demand – everyone from national brands and franchisees to mom & pop restaurants, dollar stores and professional services are expanding. Because of the lack of new construction in recent years, finding space has been very difficult. Vacancies are rare, with most shopping center projects fully leased before coming to completion, and rents in high-growth markets are becoming unaffordable. Lack of inventory is driving potential tenants to the suburbs and outer regions. Despite these challenges, businesses are moving forward with expansion plans — and potential sellers are hanging on to their investments to cash in.

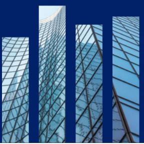
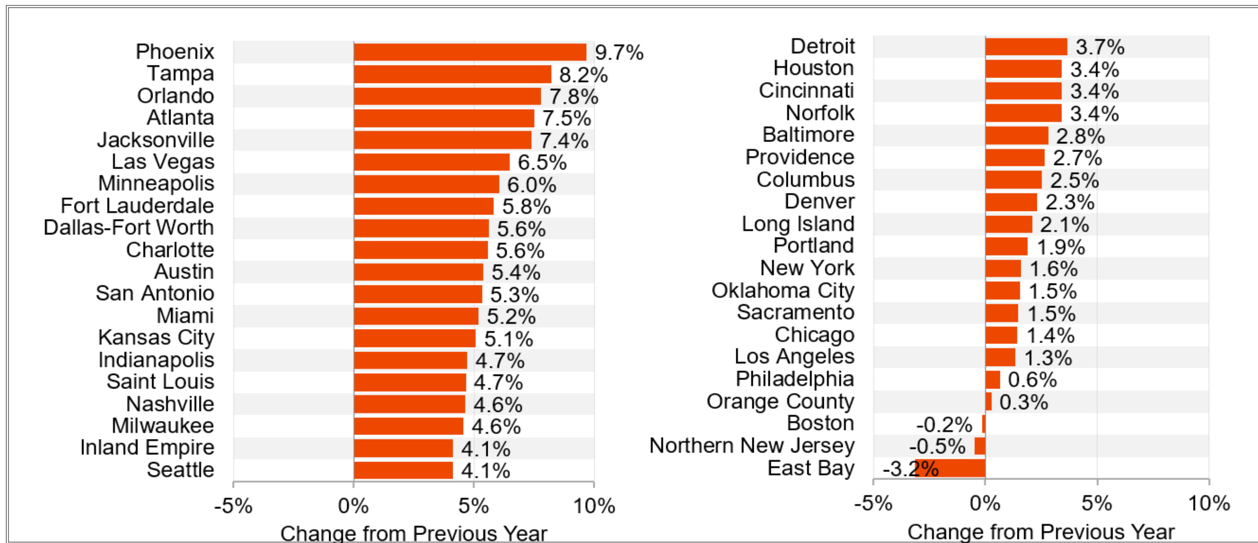


EXHIBIT 3: RETAIL RENT GROWTH, BY MARKET



Note: Includes markets with 100 Million+ Square Feet of Inventory. Source: Costar

INDUSTRIAL SECTOR

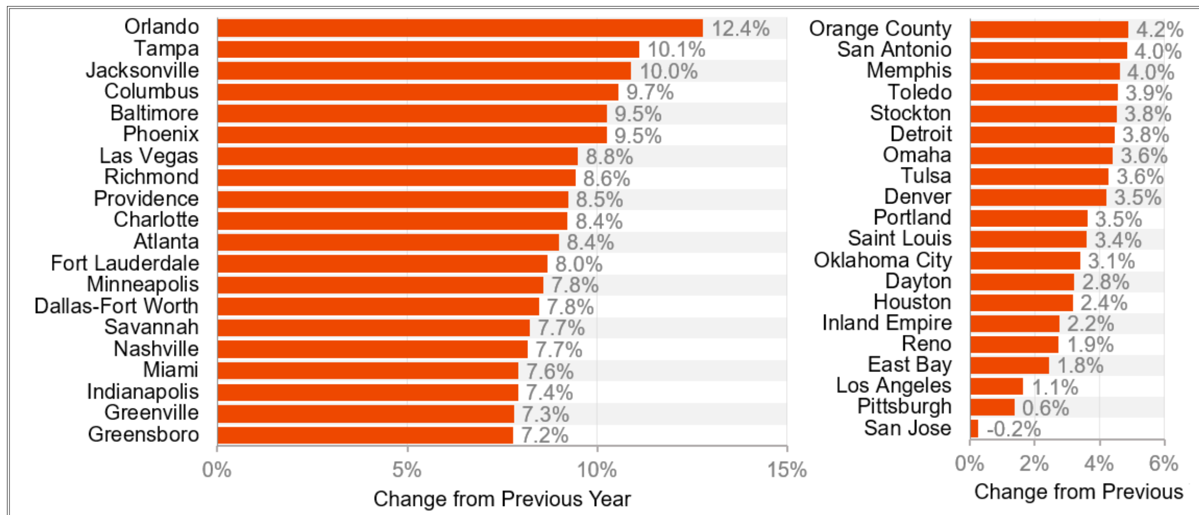
Industrial demand is mixed – small footprints are highly coveted (particularly incubator spaces, which stand at 0% vacancy) while the desire for large buildings has slowed down as the market tries to absorb massive new product, such as in Southern California where industrial parks have 1% to 3% vacancy rates and larger properties are at 5% vacancy. Rents and property prices for space under 30,000 SF are up year-over-year while an influx of inventory for 100,000+ SF is leading to landlord concessions.

Absorption by large multinational corporations are moving the needle in some markets – including Boeing and Volvo in Charleston, SC; Mazda and Toyota plants in Huntsville, AL; and Taiwanese chip maker TSMC in Phoenix, AZ. Markets with an influx of big manufacturers moving into the state are seeing strong demand for both small and large spaces; these areas are building spec warehouses and fully leasing buildings before construction is complete.

The real challenge is that not enough developers are building spaces to accommodate the suppliers to these big companies. Most buyers want 1,000 to 3,000 SF of industrial space, which can be very hard to find. Opportunity exists for owners should they either subdivide large buildings into multiple spaces to increase rent or build 5,000 to 30,000 SF warehouses despite high construction costs – because they will get top dollar for it.

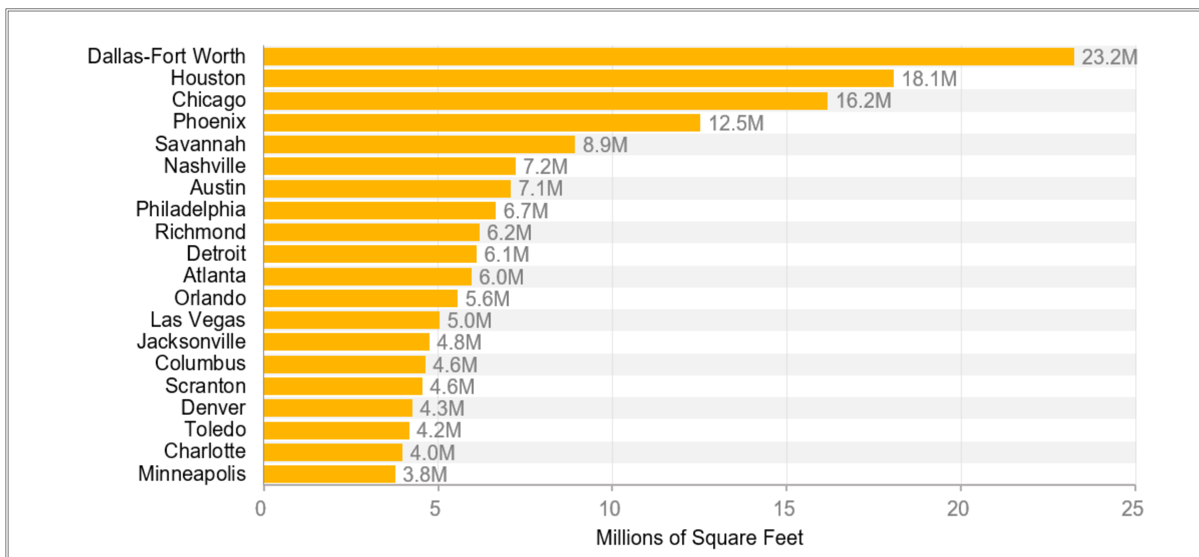
Depending on the market, spec warehouses are doing well or struggling. Those doing well, such as in Texas and Montana, tend to have a diverse ecosystem of users: car and boat manufacturers, aerospace, tech companies, food distributors, engineers, plumbers, electricians and pickleball companies. Other markets, such as Wisconsin and Southern California, continue to work through overbuilding as tenants vacate older buildings to occupy the oversupply of new, modern space.

EXHIBIT 4: INDUSTRIAL RENT GROWTH, BY MARKET



Note: Includes markets with 100 Million+ Square Feet of Inventory. Source: CoStar.

EXHIBIT 5: MOST INDUSTRIAL SPACE ABSORBED (Net Absorption: last 4 quarters)

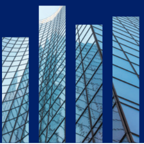


Source: CoStar.

OFFICE SECTOR

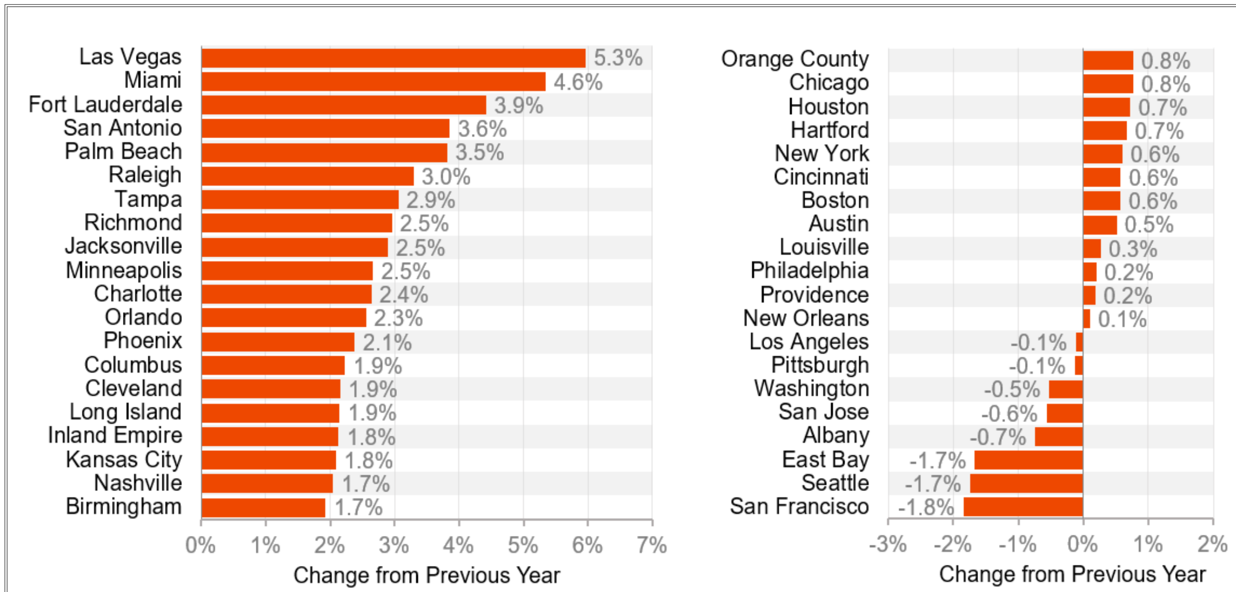
Similar to industrial, small is big right now. Most of the tenant demand is for smaller offices (30,000 SF and less), particularly among medical providers and other professional services (financial advisors, insurance companies, lawyers and credit unions). Tenants are looking for flexibility in lease terms including early termination rights and sizable tenant improvement allowances.

Demand for large office space (100,000+ SF) is weak as many companies have downsized due to work-from-home policies. These landlords are giving away concessions as tenants are renewing leases at 30-50% of their original footprint while competition to attract tenants is fierce. Higher quality, class A properties are able to attract tenants at competitive rates with building amenities that may help with in-office employee attendance.



Quality, too, is critical. In suburban Los Angeles, Class A buildings are 100% occupied while other buildings are 60% vacant. Notably, landlords are including more parking concessions and better amenities rather than giving rent reductions.

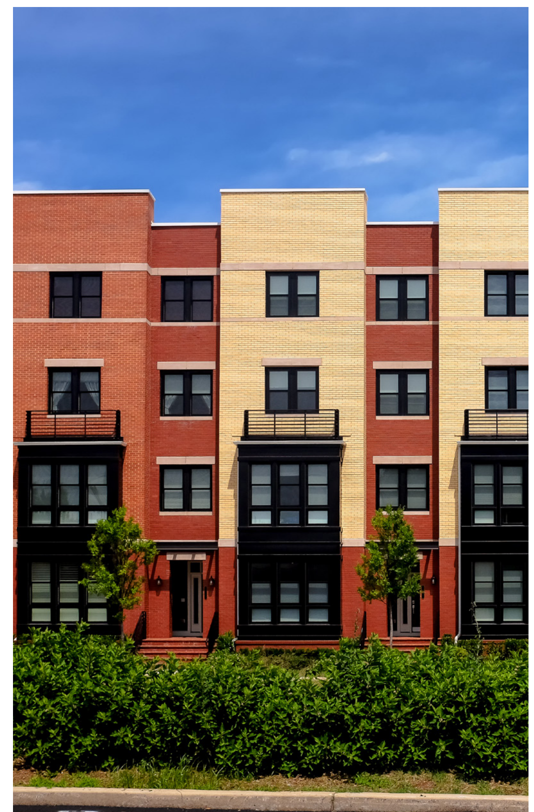
EXHIBIT 6: OFFICE RENT GROWTH, BY MARKET



Note: Includes markets with 50 Million+ Square Feet of Inventory.
Source: Costar

MULTIFAMILY SECTOR

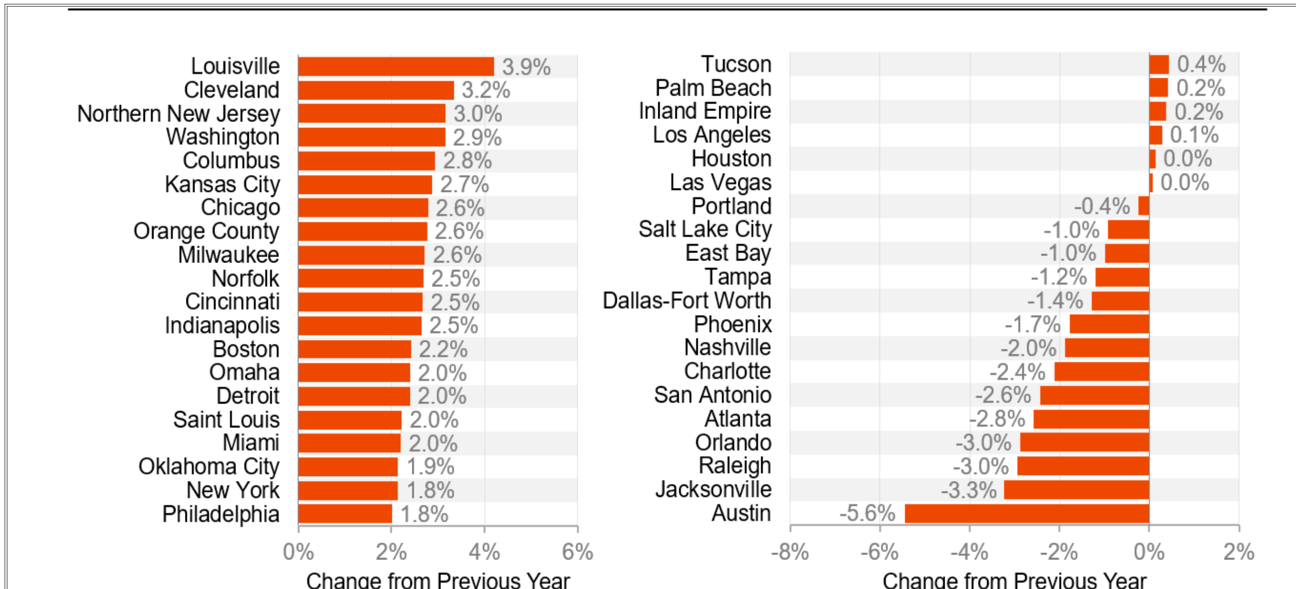
Multifamily investors are dealing with a mixed market. Opportunity for accelerating rent growth has waned as demand for rental housing has slowed while new supply is plentiful in a number of markets, particularly in the southeast. Larger, institutionally owned multifamily properties may be challenged with borrowers unable to secure refinancing terms that support the original underwriting model. In contrast, private investors are focused on smaller or value-add properties where there is still potential for rent appreciation.



With lower demand and higher construction costs, compared to pre-pandemic years, new multifamily development is expected to slow. Hence over time, with less supply coming online, rent rate appreciation should return. The increased political pressure for rent rate caps may also limit new supply in markets where rent control ordinances are enacted, further increasing supply constraints. Market conditions vary substantially around the country. While the pandemic-driven population shifts have slowed, markets with continuing migration into the state will have rental demand.

This includes areas of the country that are desirable for baby boomer aged retirees who opt for master-planned communities with amenities or age-restricted single family home developments.

EXHIBIT 7: MULTIFAMILY RENT GROWTH, BY MARKET



Note: Includes markets with 75,000+ units of inventory. Source: Costar

PREDICTING THE UNPREDICTABLE

Earlier in the year, the market was expecting multiple interest rates cuts in 2024. Sentiment has now shifted to accept that current rates will be in place for a longer period of time with only a modest decrease in 10-year treasury rates. This will result in some property owners unable to refinance their properties as short-term loans come due, which in turn creates an opportunity for buyers.

At the same time, long-term property owners who do not have mortgage pressure are acknowledging that the lower prices of the current market aren't going to change substantially in the near future so it is time to sell. Our network of professionals have also observed that buyers may be realizing that prices will not fall further, and it is time to act – particularly for cash buyers.

The keys to unleashing transactions are to identify expanding businesses, think outside the big bank box for financing (including private investor groups, credit unions and insurance companies) and talk frankly and realistically with clients about current market conditions. While transaction activity may show only modest improvement in 2024, compared with 2023, because of interest rates – this, too, shall pass.

CONCLUSION

It's taken time, and some sectors (especially office) continue to cope with societal shifts, but the bounce back after years of turmoil is taking shape. Stable or growing economic activity will likely encourage the Fed to hold rates steady for longer.

The real key is interest rates. Even a minor cut toward year-end could trigger long-delayed transactions. Growing markets, especially in the South and West, will continue to grow. Patience is the key.

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