Commentary

A High-Level Look at What's Good, Bad and Ugly in CRE

There has been a lot of pain but good developments as well.

By **Joseph Ori** | June 14, 2024 at 05:58 AM

It has been a grueling and tumultuous twenty-six months for the CRE industry since the Fed began raising the Federal Funds rate in March of 2022. There has been a lot of pain, fallen incomes, job losses and little exuberance during this period and I thought it would be instructive to examine the Good, the Bad and Ugly of the CRE industry during this turbulent period.

The Good

- The CRE market has not crashed and thrown the economy into the Great Recession II as many pundits have predicted
- There has not been a wave of defaulted CRE loans that would take the commercial banking sector under as many have predicted
- The retail sector has done very well with little new construction and increased consumer demand
- The data center sector is booming with huge demand, tight supplies, and rents up 10%-20%
- The apartment and industrial sectors are doing fine even though rents in some of the "hot" markets are down 5%-10%
- New construction in all sectors except data centers, has slowed which will improve demand in late 2024 and 2025
- Total defaults and foreclosures of CRE have been less than 2% of total loans which is manageable and not a threat to the $17 trillion CRE industry
- Job growth has been stable which is the key demographic for the CRE industry
- Prices have fallen and cap rates expanded for many properties, which will increase deal activity in the next few years
- There is over $150 billion of private real estate capital ready to be deployed in the next few years
- New development of all property types except data centers has been curtailed which will be positive for future demand and rent increases

- The Sunbelt markets especially Arizona, Nevada, Texas, Florida, and Tennessee are seeing high demand for CRE and record in-migration of residents and businesses

- Distressed investing will lead to outsized returns for investors in the next few years

- The CRE software and data analytics sectors are still seeing solid demand for their products and services

The Bad

- Interest rates are still elevated with the Federal Funds rate at 5.25%, but it is expected that the Fed will begin lowering rates in the second half of 2024

- Office valuations in the high-crime urban cities have dropped like a "lead balloon" by 50% or more

- Transaction activity including sales, financings and leases has been down by 70% since the Fed began raising interest rates

- The cost of a collar (buy a cap and sell a floor) and interest rate swaps to reduce interest rate risk from floating rate debt have skyrocketed to 2%-5%+ of the loan amount

- Many small syndicators and leveraged CRE investors will go out of business due to the CRE "bear market"

- Most CRE deals today have "negative leverage," wherein the cap rate is less than the debt constant and the "cash-on-cash" return is less than the cap rate

- Institutional demand from pensions funds and sovereign wealth funds for allocations to private CRE have dropped precipitously

- REIT returns, although up 11.36% in 2023 per the FTSE All Equity REITs Index are negative 1.3% through March of 2024

- The data center market is having difficulty finding new development sites with fiber connectivity and most important, access to power

- The excessive cost of debt and tight credit conditions has made CRE investment very challenging

The Ugly

- Interest rate increases by the Federal Reserve have caused considerable pain, loan defaults and foreclosures and steep values declines in CRE assets

- The office markets in the high-crime urban cities of New York, Washington D.C., Chicago, San Francisco, Los Angeles (downtown), Seattle, Oakland and Portland are still in chaos and won't recover until "law and order" is reestablished

- Out-migration in the high crime urban cities of residents and businesses has been at record levels

- Transaction fees for the brokerage industry have dropped 70%, which will cause many participants to leave the industry
- Job demand in CRE has been at the lowest level since the Great Recession especially for new graduates

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