Commentary

Eight CRE Predictions for 2025

From data center growth to shadow lending to booming transactions.

By **Joseph J. Ori** | December 16, 2024 at 06:52 AM

The best-performing sector will be data centers

The best-performing sector in 2025 will be the data center market. The data center market has been "on fire" and has seen tremendous demand to meet the needs of enterprise providers moving from on-site applications to cloud-based information technology and artificial intelligence solutions. The global data center market is valued at $242 billion in 2024 and will increase to over $584 billion in 2032. Data center investments also have a low correlation with other CRE asset types. The vacancy rate is 3% and the net absorption of space in Q1-24 was 2,755MW (megawatts), a record. There is over 5.3MW of space currently under construction with average rents at $127-$321/kw/month and up 13%-22%, from Q1-23. The primary concern is power access as current and future data center demand has placed exorbitant strains on electricity, gas, and even nuclear power generation.

The Federal Reserve will continue lowering interest rates

The Federal Reserve, which has reduced the federal funds rate to 4.50% from 5.25% with another .25% decrease most likely at its meeting from December 17th-18th and further cuts of at least 1.0%-2.0% in 2025 will be a godsend for the CRE industry. Lower rates will be warranted because of lower inflation and choppy economic growth. A lower cost of debt capital will be a much-needed shot in the arm for the CRE industry and there will be a big boom in sale, financing, and lease transactions in 2025 and the next few years. Transaction volume may reach a total of $700B in 2026 (see prediction four below).

The shadow lending sector will become more important than ever to the CRE industry

The shadow or unregulated lending sector has become a more vital and critical component of debt and equity financing to the CRE industry. The shadow lending sector includes REIT mortgage funds, private equity debt funds, CMBS conduits and hard-money funds. These lenders currently fund about 15% of all CRE loans, which are up from about 5%, ten years ago. These lenders have been critical during this tight credit market that began in March 2022, when the Fed began raising interest rates and will continue to see market share and deal gains even with a lower interest rate regime.

The CRE industry will see a big boom in transaction volume in 2025

Transaction volume, the amount of CRE sales transactions, will increase substantially in 2025. The record for transaction volume was about $900B in deals in 2021. However, there was a steep decline in

2023 and 2024 with volume at [obscured] urtesy of the Federal Reserve and higher interest rates. Estim[obscured] 400B-$450B and a welcome sigh of relief for the thousands [obscured] ave been sidelined for over two years and are essential pla[obscured]

It's time to acquire distressed office assets in the gateway cities

There is over $150 billion in CRE dry powder in private equity funds and these funds should be targeting distressed office assets in the gateway urban markets like New York, Washington D.C., San Francisco, downtown Los Angeles, and Seattle. These urban cores have been decimated by high crime, rampant homelessness and an outmigration of residents and companies. The office markets in these cities are characterized by high double-digit vacancies, declining rents and values that have decreased 30%-50%. Many of the office properties in these markets can be purchased at 50% discounts from pre-covid values and should now be purchased. Even though the risk is high for these markets to turn around, due to the fact that there has to be a change in governance to increase the quality of life for tenants and residents, the deep discounts in value are too good to pass up.

CRE investment in high growth low tax states will outperform high-tax states

The U.S. CRE market has become bifurcated with the high growth low tax states substantially outperforming the low growth high tax states Today, the high-growth, low-tax states are experiencing tremendous influxes of new residents, and their economies are booming. The high-tax, high-crime states are experiencing just the opposite, large outmigration, poor economies, declining CRE fundamentals and very slow growth. A diversified portfolio of CRE assets in high-growth, low-tax states will substantially outperform a similar portfolio in high-tax, high-crime states.

The large bid-ask spread in CRE will narrow substantially

Since mid-2022, the bid-ask spread has become wider than the Grand Canyon as sellers and buyers cannot agree on a sales price due to higher interest rates and higher cap rates. As the Fed has been reducing interest rates, the bid-ask spread has narrowed somewhat but will shrink significantly in 2015 as the Fed continues lowering interest rates and debt capital is priced lower and becomes more readily available. Cap rates will decline to the 5.0%-8.0% area depending on the property and location. A lower bid-ask spread will be the key driver of higher transaction volumes in 2025 and 2026.

REIT returns will outpace private CRE returns

The public REIT market is poised to deliver solid double-digit total returns (dividends plus capital gains) in 2025 and beyond. REIT returns have seen tremendous volatility over the last few years due to higher interest rates. The FTSE-NAREIT All Equity REIT returns were 43.34% in 2021, -24.37 in 2022, 13.73% in 2023 and 10.73% in 2024 (through August 2024). I expect returns to be up by 25%-30%+ in 2025 due to lower interest rates, positive economic and growth policies of the new administration and increased institutional allocations to the CRE sector.

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Joseph J. Ori is founder and CE
