Bankers Seek Interest Rate Clarity as Real Estate Deal-Making Slumps

Higher Rates, Inflation, Recession Concerns Force Some Property Investors to the Sidelines

Goldman Sachs' headquarters in New York is reflected in the One World Trade building. (Getty Images)

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Deal-making for commercial real estate properties has fallen into a slump, and some executives and analysts say it may take a while for the industry to snap out of it while bankers seek more clarity on interest rates to do their jobs and underwrite loans.

Sales volumes for U.S. office, retail, industrial and multifamily properties all declined over the past 12 months that ended Sept. 30, both in terms of total value and number of deals, according to CoStar data. And the pace of sales so far in the fourth quarter through Monday indicates the decline is ongoing. Volume may not rebound until the end of this year or early 2023, executives say.

Bankers at Goldman Sachs, JPMorgan Chase and Citigroup, in comments made within the past week, all cited the combination of concerns about rising interest rates, inflation and recession risk as culprits. Loans are more expensive or harder to obtain, forcing many property investors to the sidelines.

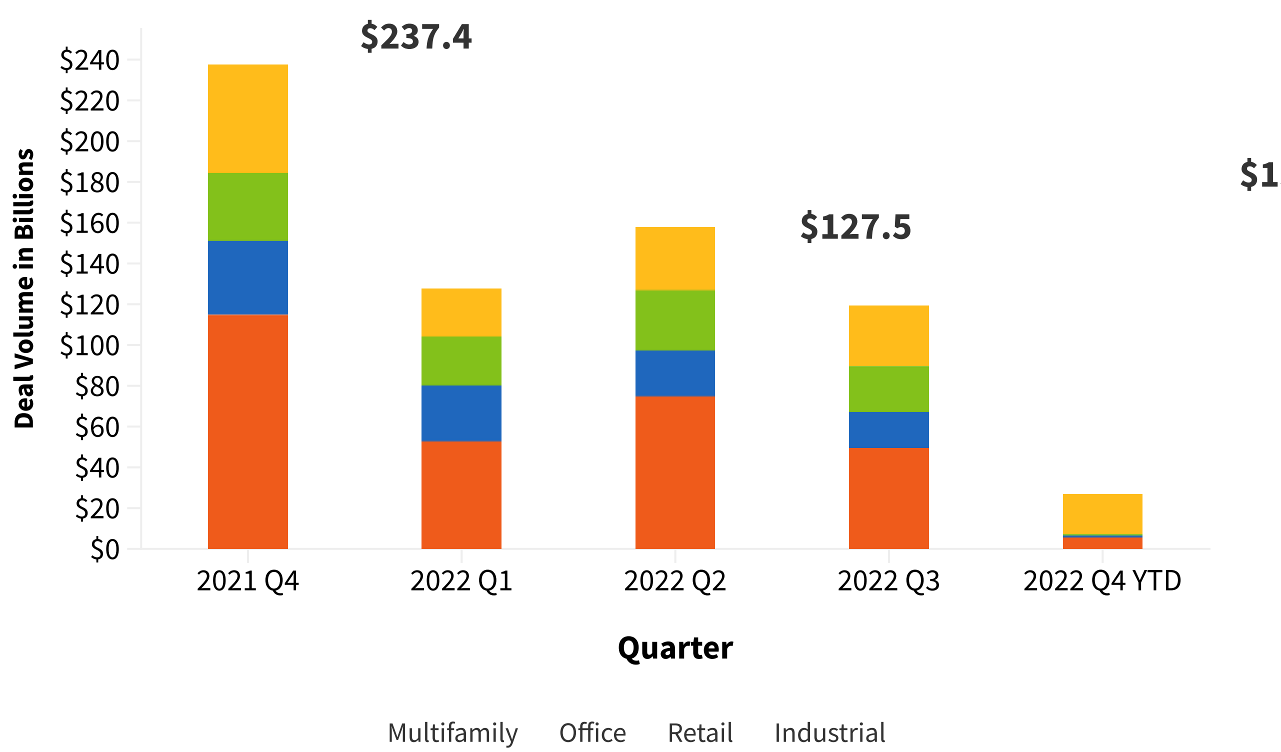
“Clients are focused on stability and financial conditions, pushing out the timing of certain deal and financing-related activity,” said Denis Coleman, chief financial officer at Goldman Sachs, during a Tuesday conference call for the investment bank's third-quarter earnings.

The slump took hold recently, as deal-making remained active during the first half of 2022 in areas such as real estate investment trust acquisitions. The activity was reflected in big real estate deals that closed earlier in the year, such as Blackstone Group’s $7.6 billion purchase of PS Business Parks, the owner of 27 million square feet of commercial properties. Investors also made bets on single buildings this year, including Boston Properties’ $730 million acquisition in May of the Madison Centre office tower in Seattle.

But the market has cooled considerably with the multifamily sector seeing the steepest drop.

US Deal Volume Slumps

All Property Types



Source: CoStar, October 2022
Chart: Nicole Shih

Multifamily sales during the third quarter fell 56.5% to $49.8 billion compared to the same time a year earlier, according to CoStar. The number of multifamily sales in the third quarter dropped 46% to 4,382 units.

Total volume for office sales declined about 51% to $17.6 billion in the same 12 months, industrial sales fell almost 45% to $29.2 billion and retail sales dropped almost 33% to $22.5 billion, according to CoStar data.

Some banks have dropped out of the market of making loans for commercial real estate deals as they watch interest rates rise, said Lauren Gerdes, a real estate analyst at accounting and consulting firm RSM.

"Traditional financing is almost nonexistent for office and retail assets, especially for smaller deals and for Class B and Class C assets," Gerdes told CoStar News.

Fewer Deals

Big investment banks have had fewer deals available to generate fees from advising the buyer or seller. At JPMorgan Chase, third-quarter investment banking revenue fell 43% to $1.7 billion versus the year-earlier period. But rising rates allow banks to offset lower fee income with better margins on loans because they can charge borrowers higher rates.

Bankers need some degree of certainty for where interest rates are heading to successfully underwrite commercial real estate loans, said John Sullivan, chairman of the real estate group at law firm DLA Piper. It's not just that the Federal Reserve has repeatedly raised rates, but the overall market has been volatile.

"It's very hard to predict where various rates are going to go," Sullivan told CoStar News. "That makes it hard for lenders to price loans because of the risk involved right now with interest rate movements."

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At Citigroup, third-quarter revenue from underwriting new debt issuances fell 82% to $139 million compared to the year-earlier period. The drop "is really more of a function of low deal volume pretty much across the board and there really isn't a whole lot more to it than that," said Mark Mason, Citigroup's chief financial officer, during an Oct. 14 conference call.

Securities offerings by real estate investment trusts have also fallen, according to the National Association of Real Estate Investment Trusts. U.S. REITS have closed a total of 95 securities transactions through Sept. 30, off the pace of the 260 deals that closed in 2021, according to NAREIT. No initial public offerings have been held for REITs this year, compared to four each in 2021 and 2020.

Citigroup, which operates this Citibank branch in Washington, D.C., has seen a slowdown in deal-making. (Pia Mianulli/CoStar)

Still, Gerdes with RSM said that deal volume could rebound quicker than some expect because many investment funds have plenty of capital to deploy. The real estate group at RSM believes transaction volume will pick up by the end of this year or early 2023.

“The amount of dry powder focused on [commercial real estate] is up to $200 billion,” she said. “It’s 20% higher than the level available in 2019. And fundraising by investors has remained active.”

But in the meantime, bankers and investors wait for more clarity on whether the Fed's rate hikes put the brakes on inflation, Goldman Sachs CEO David Solomon said during a Tuesday conference call.

“We have to get to a point where we better understand the trajectory of inflation,” Solomon said.