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2023 CRE Vision: Uncertainty With Heavy Unrealistic Expectations

Markets are trying to figure out where they'll land and that may be nothing like the last 15 years.

By Erik Sherman | December 27, 2022

THE PANDEMIC HAS BEEN AN EXERCISE IN people wondering when the world would return to normal. Now, the question is what normal even means. As someone, who wanted anonymity for this comment, said, “It’s like a Magic 8-Ball with the only answer as ‘Outlook hazy, ask me later.’”

Many hope that soon inflation will be over, interest rates return to low levels, and business again will flourish. Or that property valuations and prices will return to what they were not long ago. Or that they’ll get a great deal anyway. As Barry Saywitz, president of national brokerage The Saywitz Company, says: “You have a seller who wants yesterday’s number, and you have a buyer who slings low-ball offers and sees who’s desperate.”

Will CRE make its way back to pre-pandemic patterns? Eventually. The question is which version of normal and how far back?

FOUNDATIONS OF FRUSTRATION

The ground floor of 2023 commercial real estate is based on five factors: long-term Federal Reserve actions and easy money, a lack of better alternative investment choices, pandemic disruption, supply chain collapse, and inflation.

First, a Great Recession hangover as the Fed, trying to stimulate a weakened economy, drastically lowered interest rates and undertook quantitative easing to inject liquidity into trading and credit. The result was nearly 15 years of easy money.

Next, fixed income has been hampered for years by dovish monetary policy. Investors, fueled by ample cheap capital, wanted strong returns, and turned to real estate as one choice. The flood of money drove up prices as groups bid up valuations to clinch deals.

The pandemic was a match falling on gas-soaked rags. The Fed’s benchmark rate went to zero while Congress opened the cash taps. Longer-term demographic changes, with businesses and people moving to the south and west, exploded. Multifamily and industrial became as hot as solar plasma. Building prices soared as did rents in all property types; cap rates sank. “We were in an environment with a continuing decrease of cap environment, from 6 to 5 to 4,” says Jeff Budish, a managing director at Northmarq, and that was in what he notes as the moderate market of Minneapolis-St. Paul. In more volatile places, caps regularly dropped to the 3s.

The pandemic also brought a crippling blow to supply chains as they had been known. Too much dependence on just-in-time delivery to reduce inventory and improve balance sheets, too little supply diversity, and labor shortages accompanying shutdowns around the globe triggered the type of logistics disaster experts had warned against for decades. Construction prices ballooned and completion times dragged on and on.

Finally, inflation, heavily driven by supply chain antics and not a pure result of monetary policy, which had been in effect for many years. The Fed judged that it had to take steps and did by sharply and quickly driving up the baseline interest rate. Suddenly, everything got really expensive.

No one knows when inflation will abate or how high up interest rates will go and there's no relief in sight. The Fed has been clear: it will drive up interest rates and slow the economy, despite the pain. "I can assure you that my colleagues and I are strongly committed to this project, and we will keep at it until the job is done," Chair Jerome Powell said in answer to a question at a Cato Institute function this September.

HOW CRE IS ENTERING 2023

All that transformed 2022 from an expected back-to-normal year to the opening salvo of trying to understand what normal might mean. That will vary by property type and market, but there are some overarching factors and themes coming into focus.

"When you have an abrupt withdrawal in liquidity, like caffeine, you get a headache and 2023 is going to be a headache," Midwood Investment & Development CEO John Usdan says. "When you come out of an environment of unusually low interest rates into an environment like we have now, most of the investment is predicated on the cost of money. There were excesses in all of these markets."

In other words, cheap money compounded by high leverage. Buy and build: It was tempting for many, especially investors seeking big returns who had never ventured far into CRE.

"We're moving from a 15-year artificially inflated environment of low interest rates and value inflation that the Fed created to keep the economy going and that real estate in particular benefited from," says Eisner Advisory Group consultant Joseph Rubin. "Now we're probably going to revert to the historical mean here."

"In 1983, interest rates were at 18%," Michael Fay, principal and managing director, Miami, with Avison Young as well as chairman of the firm's U.S. capital markets group executive committee, remembers. "I was in commercial real estate in 1988 and 89, we saw 10% interest rates and we thought that was incredible. If you look at the average interest rates before the great recession, they were about 5% or 6%."

However, the adjustment is still painful, like someone once athletic taking to an exercise regime after an extended practice as a couch potato. Many in the industry aren't close to ready. "You have a whole generation of people managing money and real estate who have not experienced inflation, a rise in interest rates, shrinking money supply," says Scott Metzner, founder and president of Janus Property Company. They based their business and project planning on low interest rates and the ability for high leverage—because that was normal for years. Now the math no longer works. Especially as lenders get wary.

"Most construction lenders will underwrite the projected cash flow and apply a stress interest rate," Cydney Gurgens, executive vice president and director of commercial real estate at UMB Bank, tells GlobeSt.com. "We are seeing some deals size at 50% to 55% [LTV] today where they might have qualified for 65% previously. Developers, investors may pause, may put projects on hold, because they are not able to see their returns." At UMB, these rates still require full recourse loans.

All uncomfortable news for many in CRE. “I think the fundamentals remain strong, but so much of what we’re transacting on is financial engineering,” says David Perez, president and COO of CARROLL. “Until you have a good understanding of how you can engineer these things, you don’t understand how you’ll get to the expectations of investors.”

Those expectations being one of the places where expectations are overly lofty. Investor expectations throw a large wrench into the mix because they have continued to expect outsized returns. “You can’t pencil out 18% IRRs, [ongoing] rent growth, and expect that to last forever,” says Aaron Strauss, managing partner of AY Strauss. “Investor expectations have to come down, for sure.”

Don’t forget supply chain. Yes, some pressure has come off, but according to Oxford Economics, “we expect rising costs and weakening demand to weigh on global supply chains for the second half of this year and into 2023.” That becomes an additional economic weight beyond financing.

And then, there are taxes. “Tax in real estate is one of the hottest topics out there,” explains Jeff Smith, U.S. real estate leader for Deloitte. “CFOs are mostly worried about changing tax rates.”

WHAT WILL HAPPEN IN 2023

While there is uncertainty—even a bet on a recession depends on where you stand at the moment—everyone has a sense of wariness.

Beth Azor, a commercial retail developer and owner in Florida and national retail real estate consultant, says in her world, the big problem is a lack of staff, which will continue into 2023. “As I speak to prospective businesses in south Florida and even on a project I’m working on in Cleveland—the main message is, ‘Yes, I’d love to expand but I can’t find help,’” she says.

“The medical sector is probably the least impacted from COVID because people still need to go see their doctors,” Saywitz says. “The demand is still there; supply is still limited. Most of the space that’s getting built, particularly in southern California, is by hospitals and it’s usually preleased.”

Cap rates in theory should rise with higher interest rates but no one yet knows what they will be, especially with diverging property types like multifamily, resting on strong demand, on one end and office, where occupancy into September was still hovering between 47% and 48%, according to data from Kastle Systems. But even that is not necessarily representative.

“There are a lot of loud voices in the room, but the predominance is keeping less space,” thinks Michael Silver, chairman and chief broker of Vestian. Especially as many CEOs and CFOs are worried about the possibility of a recession, which would likely hurt earnings. “[Companies] need to gather and get together and that’s their office space, but the notion of office space is changing. CEOs tend to be in their late 50 or early 60s and say, ‘You have to go to work or we’re going to do something.’” Silver breaks out in laughter. “What are they going to do? Nothing.” The labor market remains tight, undercutting employer leverage in policy dictation.

If a recession does hit, cutting real estate obligations from a balance sheet, especially when much can be transferred onto the living arrangements of employees without further payment, will start to look tasty.

“I think people understand [a correction] is coming,” Petra Durnin, the head of market analytics for Raise Commercial Real Estate, a tenant/occupier CRE brokerage, tells GlobeSt.com. “All companies should be looking at their bottom line, their real estate, their function … and how they can utilize it better.”

Suddenly, a lot of buildings aren’t worth as much as they once were.

"The value is lost, so when they get an appraisal to redo the loan, they're not going to come with the number [they need]," notes Joseph Forte, a real estate attorney with McCarter & English. Those that can't source more capital could default and see banks or debt funds that were involved in mezzanine loans taking over properties.

"For guys who bought over the last year, it may be tough for them," whatever property type, Zachary Streit, founder and managing partner at WAY Capital, tells GlobeSt.com. "But they have two, two and a half years to figure it out. If they bought real estate that just needed to be turned around, they should be okay. Was it already turned around, a fully-loaded market-rate deal riding the wave or am I adding value? There's going to be the haves and have-nots."

Plenty of people are betting that multifamily will maintain its advantages. But there's only so much money people facing higher costs of living can ultimately devote to rent.

"There are lots of factors that are going to affect multifamily in the next year or two," says Eric Maribojoc, executive director at Center for Real Estate at George Mason School of Business. "You're seeing a little of it now with rent growth slowing. There's a large amount of supply coming, and I think demand will be affected with the Fed being as aggressive as they said they're going to be. The combination of those will make multifamily underperform in the coming year."

Someone else seeing a squeeze is Ted Bickel, another managing director at Northmarq. "Now that pricing is being adjusted to income rate increases, new construction is harder to justify," he says. "The ability to deliver new housing is that much more difficult. You can argue that the sale pricing has gone down while the costs have gone up."

Jeff Klotz, CEO of The Klotz Group of Companies, which operates in the Sun Belt, said the ongoing growth is still acting like a partial shield from challenges. "But we're still feeling them," he says. "We've seen assets drop 20%, 25% in value in the last four months."

There are even those saying that the industrial build-up may have been overdone. Government figures show e-commerce having receded from the pandemic highs and, while still a bigger portion of overall retail than in 2019, is on that pre-existing trend line.

"That's one of the reasons now that we're mainly doing pre-leased in industrial," says Al Brooks, head of commercial real estate at JPMorgan Chase. "Clients across the spectrum, both large and small, don't want a highly speculative structure. They're trying to project out one and a half, two years. No one—Amazon, Walmart, and Target and the big users—knows for certain if they need to shrink space or need more for expansion."

And yet, "there's still an incredible amount of capital yet to be deployed," Strauss says. "These guys are sitting on the purse strings of billions. They're not giving it back to institutional partners. They need to deploy it."

Everything will come down to the specifics of market location and product type, first because that is the way CRE works and second, at a time of uncertainty, local conditions are easier to observe and offer more tangible and specific impact than broad generalizations.

But in all categories of CRE will be waiting on price discovery as the real first piece of business. Investors on one side demand returns that in the current circumstances are unrealistic. Lenders are cautious, financing harder to get. Sellers want the top prices from scant months ago. Buyers just want it all to work out so they can make a profit.

Until there's more certainty, it's difficult to do anything. How much do you bid or ask in sales? How hard can you negotiate in a lease?

The answer is, “It depends.”

“One of the most important things when you have an uncertain market is to look at your debt and eliminate as much as you can, so you’re stabilized,” suggests Louis Granteed, senior vice president of real estate at Tobin. “Some people will pay the lower cap rate because they want the stability. Depending on where you are in your life depends on how much risk you want to take.”

Remember, too, that even in more challenging times, people look to buy and sell because they still want to create a profit. “Rising interest rates really do not seem to be slowing things down much,” says Scott Johnson, chair of the real estate practice group at Eastman & Smith. “I am actually seeing an uptick in loan transactions from my lender clients. My guess is that over the last year or two, deals were simple refinances or straightforward, so the lenders handled a lot of the transactions internally. New deals are getting a little more complicated meriting engagement of outside counsel.” Sometimes that’s just the way life and business are.

“I’ve been doing this now for 40 years, and I can’t remember a time when there was not some combination of uncertain events or crisis moments,” Metzner says, and then adds, “but they seem to come more often and severely.”

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