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Emerging Trends: Recalibrating Expectations For The Era Ahead In Commercial Real Estate

By Beth Mattson-Teig
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Real estate market participants are in the midst of a "Great Reset" when it comes to adjusting views related to pricing, risk, and return expectations in an environment marked by higher interest rates and slower economic growth. The need to align thinking and strategies to fit current market dynamics is one of the key themes in the 2024 *Emerging Trends in Real Estate* forecast for the United States and Canada.

"The good news is that we have more clarity, more certainty, but the bad news is we don't like what we see, because the rates are higher for longer," says one leading investment banker interviewed. The report, now in its 45th edition, features proprietary survey data and insights from more than 1,250 leading real estate industry experts.

Respondents to this year's *Emerging Trends* survey believe that the worst of inflation is behind us, with more than half expecting inflation to decline in 2024, and another third believing that inflation will at least stabilize. However, only three in 10 survey respondents expect commercial mortgage rates to drop in the coming year. Interest rates and cost of capital constitute the top concern in the survey, followed closely by

A clear theme highlighted in *Emerging Trends* is that commercial real estate investors are becoming increasingly cautious in their outlook and more careful in choosing their assets. Such a mindset reflects the expectation that, in an era of "higher and slower for longer," earning an acceptable return will be harder. Investors are reconsidering not just which property types they should buy but also the qualities of specific assets within each property sector.

With commercial real estate capital markets so disrupted by the recent increases in interest rates, property owners and investors have turned their attention to property market fundamentals as the best way to generate returns. Yet a surprising result from the survey is that investors are still eager to acquire new assets. The *Emerging Trends* Barometer for 2024 registered its highest "buy" rating since 2010, which probably reflects anticipated buying opportunities stemming from recent and expected price declines.

Research also clearly shows more mixed sentiment and diversity of outlooks among industry participants. As one advisor to pension funds says, "There's different people in different places for different idiosyncratic reasons. There's some investors that are full speed ahead, some are starting to pick up their pencils, some that are still pencils down." Performance is very nuanced, with some markets and property sectors that are outperforming, even as others are struggling and significant bifurcation is occurring within sectors such as office and retail.

Top markets

Respondents still see the best opportunities in the Sun Belt, or so-called smile markets, spread across the southern third of the country. Of the top 20 markets for "overall prospects," 15 are located within the Sun Belt. For the third year in a row, Nashville is

One industry consultant interviewed says, “There has been a 50-year pattern of migration from the Northeast and the Midwest to the Sun Belt. There’s no evidence in the last year that that trend is abating.” The consultant added that, when you consider the relative cost of living, the quality of life, and the extent to which these states are business-friendly ones, “There’s a reason … some of that’s happening, and I think that that will continue.”

Also notable is that expectations are more downbeat nearly everywhere. Survey respondents gave lower ratings to 74 of the 80 markets in the Emerging Trends coverage universe this year, whereas only five improved. That decline could be attributed to various factors, including a more difficult investment environment generally, and a recognition that some fast-growing markets are experiencing growing pains or pockets of oversupply. In addition, people are taking note of escalating risks from climate change and higher insurance costs, which could be viewed as a deterrent for some Sun Belt markets.

Key trends

The key trends identified by industry professionals are the following:

- **Higher and slower for longer.** Economists have dialed back predictions of a looming recession, and the emerging consensus is that the economy is headed for a soft landing or a “growth recession.” The near-term outlook is for slow economic growth and at least moderate job growth, but with risks weighted firmly toward the downside. Looking further ahead, the U.S. economy appears to be stuck on a course of slower economic growth and higher interest rates, which will present a challenging environment for real estate investors.

reflect diminished drivers in the coming years to the detriment of rent growth, property values, and returns. In the new environment, investors will need to focus on basic fundamentals, operations, and cash-on-cash returns.

- **Painful bifurcation for office.** After three years of remote and hybrid work, no reasonable expectation of a full office market recovery to pre-pandemic levels endures. What appears to be a permanent shift toward more flexible work is contributing to a bifurcated office market and challenges for downtowns and central business districts. A significant share of the existing office inventory is functionally obsolete and will need to be repurposed or demolished to make way for new uses.

- **It's all about the debt.** Commercial real estate capital has become scarce and expensive, making it more difficult to pencil out acquisitions and development projects. Distress levels remain low, but a looming wall of loan maturities may create a tipping point for some assets and owners. The Mortgage Bankers Association estimates that more than $725 billion of commercial and multifamily mortgages mature in 2023, with another $1.2 trillion maturing over the following two years, representing more than 40 percent of outstanding commercial real estate mortgages.

- **Eco-anxiety comes home.** Climate risk issues that have been percolating in the background for years have become increasingly urgent amid extreme weather-related events. During the past five years, the U.S. average of billion-dollar climate events that occur annually has risen to 18. That increase is resulting in higher insurance premiums alongside greater risk of loss and operating challenges for owners and operators.

homeownership further out of reach and slowing home sales. According to the National Association of Realtors, the share of U.S. households that can afford a median-priced home is at its lowest point in almost 40 years.

- **Portfolio pivot.** Recent shifts in both property and financial markets are upending long-established norms about how commercial real estate portfolios should be constructed. Fund managers are rethinking traditional "core" strategies. They're reducing exposure to office and to top-tier malls, and they're increasing their focus on alternative sectors—such as storage, student housing, and life sciences—that offer more compelling returns.

- **Not remotely the same.** The percentage of people who report working remotely in the U.S. has almost tripled, relative to pre-pandemic trends. The stickiness of remote and hybrid work has far-reaching effects across property sectors, changing demand for the amount and type of office space, altering migration patterns, and influencing the kinds of housing people want. This factor also affects household formation rates, and where people shop and eat. In many parts of the country, it is also sapping the vitality of downtowns.

- **Downtowns need to reinvent themselves … again.** Downtowns are home to a disproportionate share of empty office buildings. Opinions are mixed on the future of America's cities, in part because not all cities or regions of the country are experiencing the same trends. Some central business districts (CBDs) are struggling, even as their urban neighborhoods are thriving. What's clear is that cities will need to take action to address key issues, including obsolete office buildings, crime and safety, and cities' ability to fund key infrastructure.

potential includes probabilistic models to help predict property climate risks, identify investment opportunities, and construct higher-performing portfolios. Yet uncertainty exists around how AI could directly affect demand for space.

Prospects by sector

- **Housing.** Housing is now the preferred property type, with both multifamily and single-family housing in the two top positions. Apartment occupancy rates nationwide are down from record highs but still solid relative to historical averages. Rent growth decelerated in 2023 and is likely to remain muted in 2024. Although the capital crunch is painful, the multifamily sector retains more liquid than other property types.

- **Industrial.** Tenant demand is normalizing after a period of unprecedented growth, with absorption during the first half of 2023 that dropped 48 percent year-over-year. Construction starts are declining, and rent growth is expected to drop from previous double-digit levels. Regionalization of supply chains is expected to be a long-term driver of demand.

- **Office.** Sentiment for office is largely negative due to declining space demand, pressure on owners to increase capital expenditures, and the impact of rising interest rates. Although most office buildings are performing well, office property values are expected to drop 30 to 40 percent on average. More attention is being focused on redeveloping obsolete office buildings.

- **Retail.** Overall retail performance has surprised to the upside. The U.S. consumer has remained resilient, with steady spending that continues to fuel retailer struggle.

- **Hotels.** Key rate and occupancy metrics have recovered to pre-pandemic levels. Inbound international travel continues to improve. Leisure demand is starting to plateau, however, and future occupancy from business travel remains more uncertain. Investors are favoring limited-service hotels in the current environment.

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