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Top CRE Trends for 2024

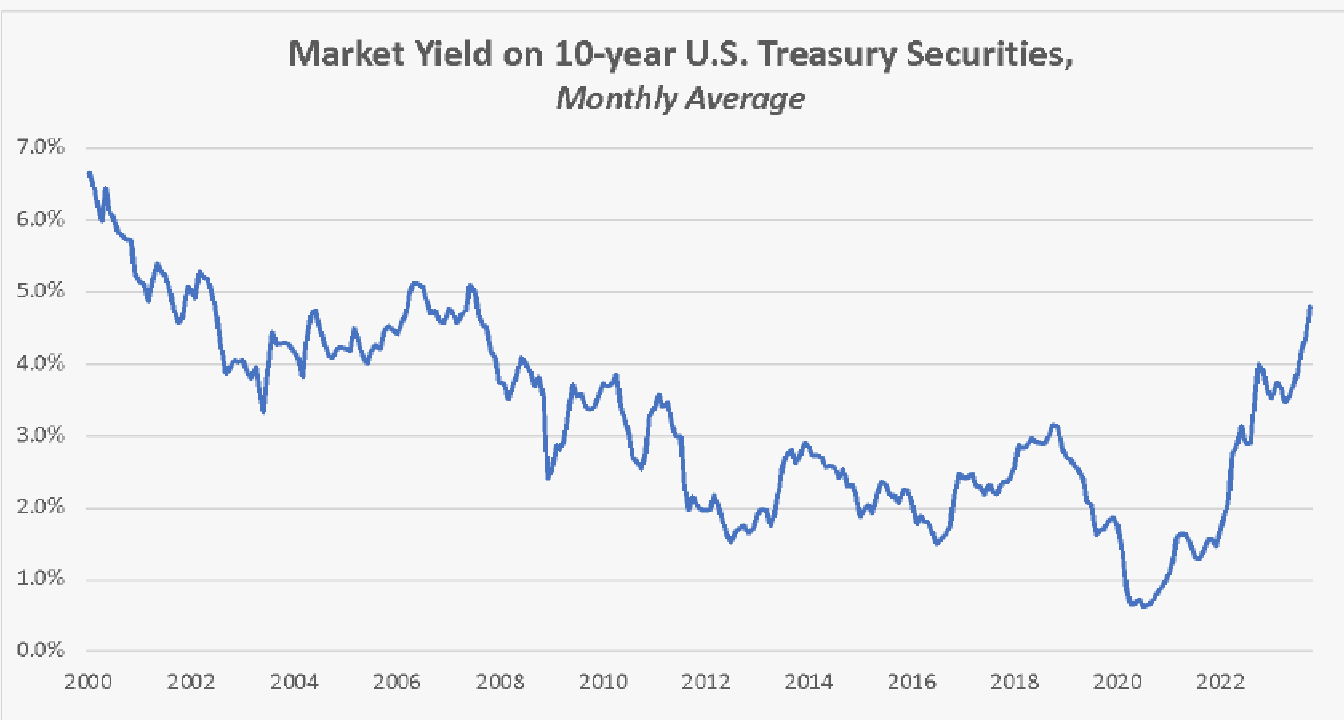
Muted Real Estate Outlook Puts More Focus on Property Operations

Andrew J Nelson

Investors should expect commercial real estate markets to be more challenging – and competitive – going forward than they have been for quite a while. That's the clear message from this year's "Emerging Trends in Real Estate" report, released by the Urban Land Institute (ULI) and PwC. These conditions will put more focus on property operations to generate returns.

This flagship report holds a remarkable record of accurately identifying trends that come to play out in succeeding years and thus is closely watched by industry leaders and others who care about what happens in the nation's CRE property markets. The survey data underlying the report reveals a more downbeat mood this year, with industry participants exhibiting greater caution than at any point since the Global Financial Crisis.

What accounts for the pessimistic outlook? It's more than one factor. The most prominent reason is that interest rates are at the highest level in 15 years, as the Federal Reserve aggressively raised rates in its quest to reduce inflation. Higher interest rates make acquisitions more expensive and depress both property prices and returns. They also make new construction more expensive and more difficult to justify.



Source: Federal Resrve Bank. Compiled by Nelson Economics.

In a survey of over 1,200 industry professionals, "interest rates and cost of capital" was the leading concern expressed, followed by "capital availability," a related but distinct issue. Banks and other lenders are reducing their lending to commercial property owners due to concerns about creditworthiness at the same time many building owners face debt maturities. This credit crunch is depressing sales transactions and further pressuring prices for even high-performing assets.

Beyond these economic and financial concerns, there is growing agreement that 3+ years after the onset of COVID-19, property market dynamics will not be reverting to their pre-pandemic patterns. In particular, few workers will be returning to the traditional company workplace as often as they used to – and many not at all. The impacts are being felt most acutely in the office sector, where vacancies continue to rise, and no recovery is in sight.

But the downstream implications will also be profound, with collateral impacts on other property types that depend on having a vibrant office market nearby. This includes all retailers, hotels, restaurants, and other services whose businesses rely on the foot traffic generated by office workers.

In this environment, being a good property operator will be especially critical as the onus for generating profits will shift more heavily onto effective building management. Owners can no longer rely on falling capitalization rates, fast-rising rents, and ultra-low interest rates to generate returns. Instead, managers will need to highlight their competitive advantages to attract tenants and learn how to keep them satisfied in order to retain them.

A Challenging Environment for Real Estate Investors

As is traditional for "Emerging Trends," now in its 45th year of publication, the report identifies ten trends expected to drive commercial property markets and the built environment in the coming years. Of these ten trends, seven relate either directly or indirectly to how shifting market dynamics will reduce investors' ability to generate returns.

Trend #1: Higher and Slower for Longer

The leadoff trend is called **Higher and Slower for Longer**, which outlines the economic conditions that will present a "challenging environment for real estate investors," according to the report.

Forecasts call for interest rates to remain elevated while economic growth will be slower than in recent decades. The slower growth will reduce rent and price appreciation, while higher interest rates strain the feasibility of both acquisitions and new development.

Trend #2: The Great Reset

These expectations of "higher and slower for longer" mean that investors will be hard-pressed to generate the outsized returns they came to expect during the long era of cheap money. Due to what the report calls **The Great Reset**, market participants must reduce their expectations as rent growth, property values, and returns will all be challenged in the coming years.

The report points out one unfortunate irony: Returns are falling primarily due to financial factors, but aside from the office sector, occupancy and rents are still generally high in most sectors, while financial distress rates are low. That's undeniably good news. However, since there is less overall room for improvement, it will be difficult to reap financial gains simply through better property management alone. What strategies might be most effective? We conclude this ebook with some suggestions.

Barely half of office workers come into the workplace on a typical day. Remote working in the country has almost tripled relative to pre-pandemic trends but has been far higher in the large cities home to the greatest concentration of office space.

Trend #3: A Painful but Needed Capitulation

The report leaves little doubt that the office sector is facing enormous problems stemming primarily from the dramatic decline in tenant demand for office space, as noted in the trend entitled **A Painful but Needed Capitulation**. That capitulation refers to office building owners' belated and reluctant acceptance that tenant space demand will not return to prior levels. By some measures, leasing volumes are only half as much as before the pandemic. In contrast, all other major property sectors are either already performing at historically strong levels (such as industrial and apartments) or are on the path to better performance (hotels and retail).

Trend #4: Not Remotely the Same

Office tenant demand per worker was already declining long before COVID, but the dramatic shift to remote work during the pandemic is the primary reason for the sharp decline in office fundamentals. The **Not Remotely the Same** trend explains that most firms have adopted hybrid work arrangements in which most office workers work at home or elsewhere for at least part of the work week. Barely half of office workers come into the workplace on a typical day. Remote working in the country has almost tripled relative to pre-pandemic trends but has been far higher in the large cities, home to the greatest concentration of office space.

Other Challenges for Owners and Operators

The Great Reset has at least two other major components complicating the investment environment. First, CRE debt has become much more expensive and scarce, contributing to the slowdown in both sales transactions and construction activity. These issues are explored in a trend called **It's All About the Debt**.

Trend #5: It's All About the Debt

Office demand is down **60%** from pre-pandemic levels

Total sales transaction volumes in the first half of 2023 fell about a quarter from their pre-pandemic levels. However, this decline varies widely by property sector, mainly depending on the strength of underlying market conditions in each sector.

Sales of warehouses are up by almost **1/3**

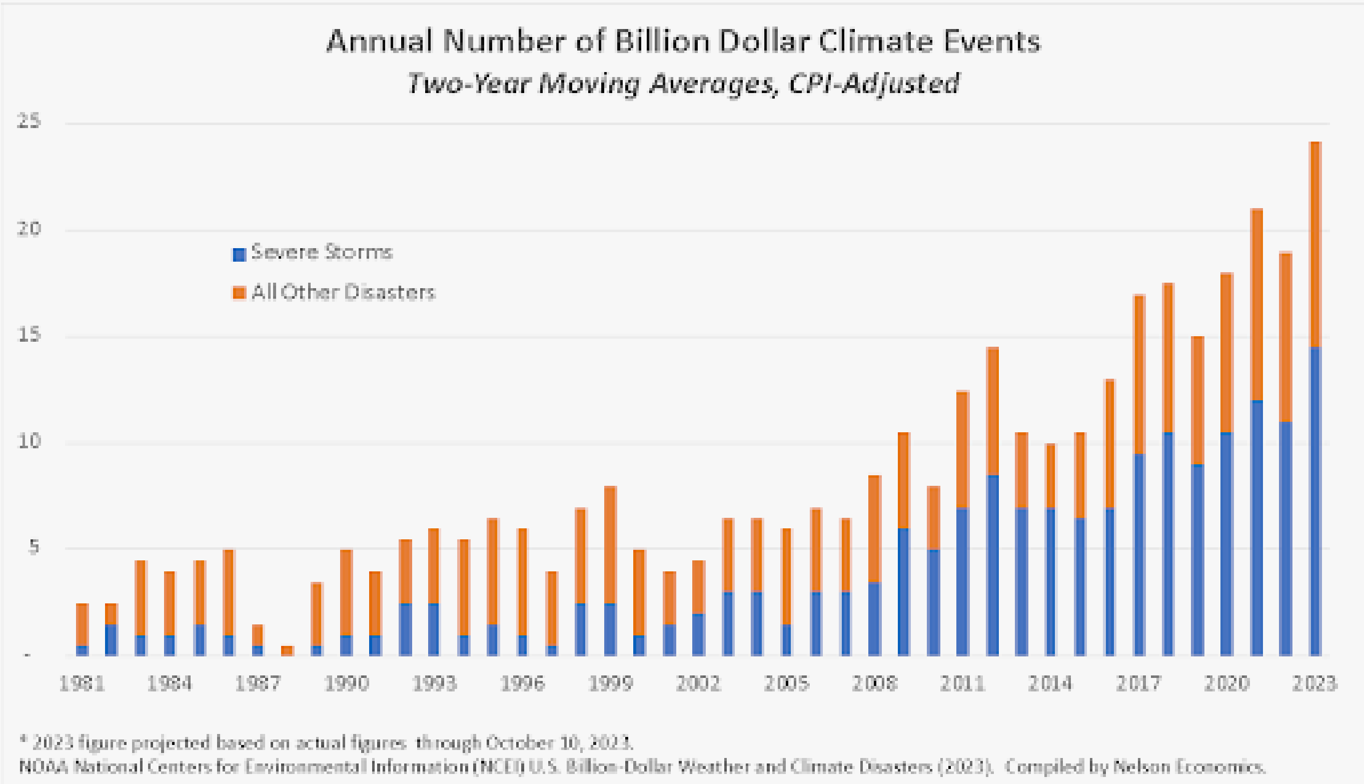
For example, investor demand for office buildings has plummeted along with tenant demand, with sales in the first half of 2023 down over 60 percent from pre-pandemic levels. At the other end of the spectrum, sales of warehouses are up by almost a third.

Most industry observers expect volumes to pick up again when interest rates stabilize, providing greater certainty to investors. Recent statements by the Federal Reserve Bank have suggested that the Fed's aggressive tightening may finally be over, giving hope that rates may soon begin to fall.

Still, the spreads between buyer offers and seller expectations remain wide, and few experts believe that transactions will increase substantially until prices fall enough to make yields more compelling to investors in this new "higher and slower for longer" era.

Trend #6: Eco-Anxiety Comes Home

The growing threat of climate change is also on the minds of owners and property managers, as laid out in **Eco-Anxiety Comes Home**. The number of billion-dollar climate events is rising sharply as heat records continue to fall, raising the risks and costs of property damage.



Eco-anxiety is also elevating insurance as a key issue for property managers. Historically, insurance has been only a minor budget item. Yet now, much like interest rates, insurance costs are rising rapidly, and at the same time, it's getting more difficult to obtain coverage in some markets. These changes are forcing the industry to rethink how real estate assets are insured against growing climate risks and how to improve building resilience.

A Renewed Focus on Careful Asset Selection and Property Management

Trend #7: Portfolio Pivot

All of these market, financial, and environmental issues together are upending long-established norms about how real estate investors should select and manage their properties. As explained in **Portfolio Pivot**, even the definition of "core" assets is changing.

Core properties are supposed to be the low-risk, lower-return assets that form the foundation of a conservative real estate portfolio. But the two traditional pillars of CRE portfolios – downtown offices and regional malls – are now out of favor with investors.

Both have sustained significant declines in tenant demand and property values, forcing fund managers to look elsewhere for replacement investments. Moreover, some of the most popular investment markets are located in coastal and Sunbelt markets that are most vulnerable to climate risk.

Indeed, the "Emerging Trends" industry survey shows that investors are becoming more discerning about both the specific property types they prefer as well as their target geographic markets. Rather than giving blanket endorsements to broad property types (like office or industrial), they focus on more narrow niches (like life science or cold storage). Similarly, they target specific submarkets within a metropolitan area for particular property types, perhaps buying a retail center in a desired neighborhood of one city while looking for apartments in the suburbs of another city.

And, with projected property yields falling due to higher interest rates and slower rent growth, owners will be counting on their property managers even more to operate their assets as efficiently and effectively as possible to achieve the desired returns.

For example, managers should do all they can to increase tenant satisfaction and thereby improve tenant retention. We discussed this strategy in a prior blog, using KingsleySurveys to engage tenants and identify potential tenant concerns before they become problems. This engagement is proven to not only increase re-leasing but also helps attract new tenants through favorable word of mouth.

Moreover, with owners becoming more selective in the types and locations of assets they acquire as old portfolio assumptions become antiquated, managers will need to better understand their new tenants. Again, effective engagement will be essential to demonstrate that management cares about improving the tenant experience and to gauge what tenants are thinking.

These strategies may be simple to articulate but the challenge will be how to execute successfully. The market will reward those managers who can marshall the tools needed most effectively.

Find out how KingsleySurveys can help you engage and retain tenants.