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Top CRE Trends for 2025

Property Management Still Paramount Even as the Real Estate Outlook Brightens

Commercial real estate investors are more optimistic going into 2025 than they have been in recent years. This welcome news is the biggest takeaway from the 46th annual edition of the **"Emerging Trends in Real Estate"** report, recently released by the Urban Land Institute (ULI) and PwC.

This outlook report is closely watched by industry leaders for insights into future commercial real estate (CRE) market conditions due to its exceptional track record of accurately anticipating trends before they unfold. The forecasts are developed from a survey of over 1,600 industry participants and more in-depth interviews with some 450 CRE leaders.

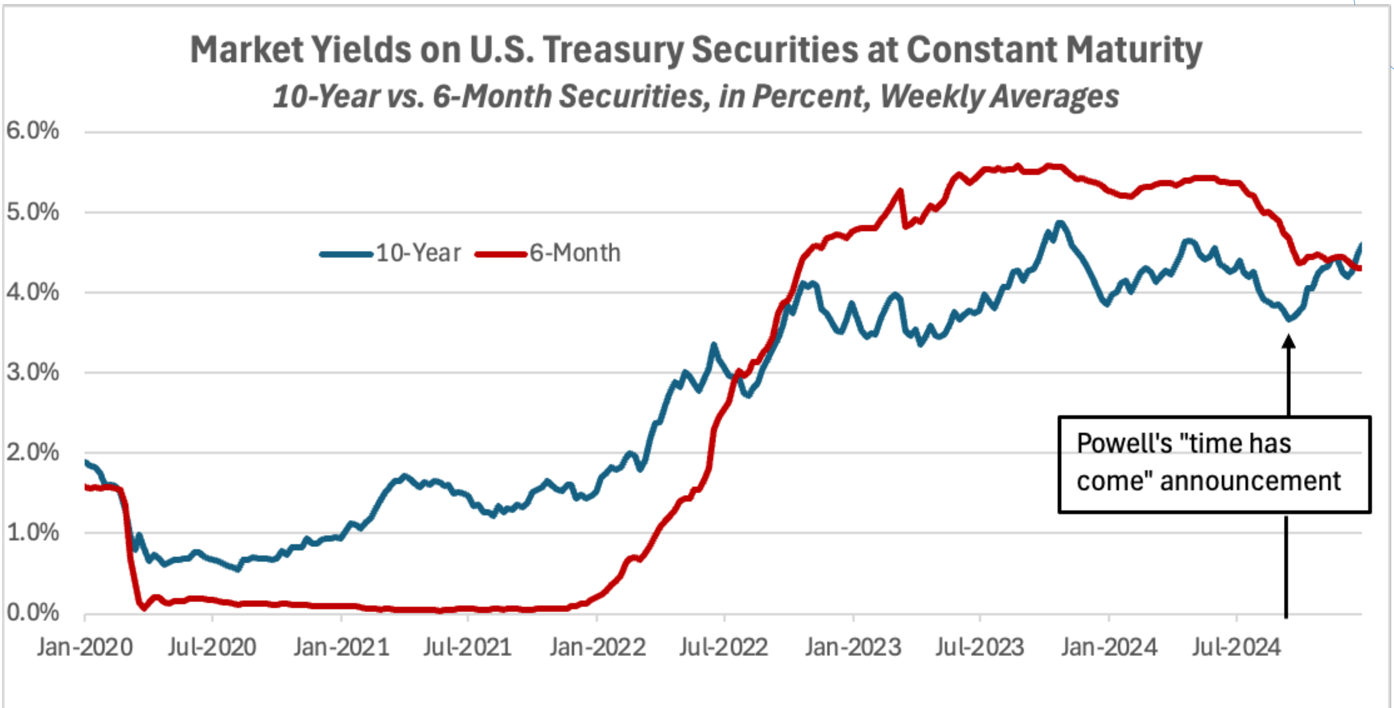
Despite the greater optimism reflected in this year's report, few professionals expect a return to the golden era that preceded the COVID-19 pandemic, when record-low interest rates, combined with strong national economic growth, helped fuel double-digit returns. Despite strong tenant demand overall, vacancies are rising in several major property sectors due to historic levels of construction, as the market is adding more space than tenants can absorb. The weakening market conditions place renewed emphasis on the need for property managers to position their assets for success.

A More Positive Outlook

The reason for the more buoyant mood is clear: the prospect of lower interest rates, which are the lifeblood of CRE investing. This pivot in outlook came last summer when the Federal Reserve Bank Chair Jay Powell finally announced what real estate professionals had long hoped for and expected: "The time has come for policy to adjust."

That declaration signaled that the Fed believed inflation was finally returning to acceptable levels. Thus, after 30 months of tightening monetary policy, the Fed would start reducing the Federal Funds Rate. Indeed, the Fed has been good on its word, cutting its reference rate three times for a total of 100 basis points in the second half of 2024.

Unfortunately, the broader investment market does not seem to share the optimism of the CRE community. Market interest rates — the actual interest rates that matter for CRE transactions — did decline modestly immediately following Powell's announcement. But financial market conditions have not improved further since then — despite two additional Fed rate cuts — and have even worsened for some debt.



Source: Board of Governors of the Federal Reserve System (US) via FRED®; compiled by Nelson Economics.

Interest rates on longer-term debt (used to set mortgage rates) bottomed out in late September and have generally risen since then. Rates on short-term debt (used to set interest rates on construction) also bottomed out in late September but have plateaued. With financing for CRE acquisitions still generally no more affordable for most borrowers, sales transaction levels continue to languish.

Most investors are not yet ready to make aggressive moves back into real estate capital markets. In the "Emerging Trends" survey, "interest rates and the cost of capital" remain by far the greatest concern among industry participants, followed by capital availability. Still, the industry expects conditions to improve, with almost 80% of survey participants saying that mortgage interest rates will decline in 2025 and growing shares of investors believing that more capital will become available for mortgages and refinancings.

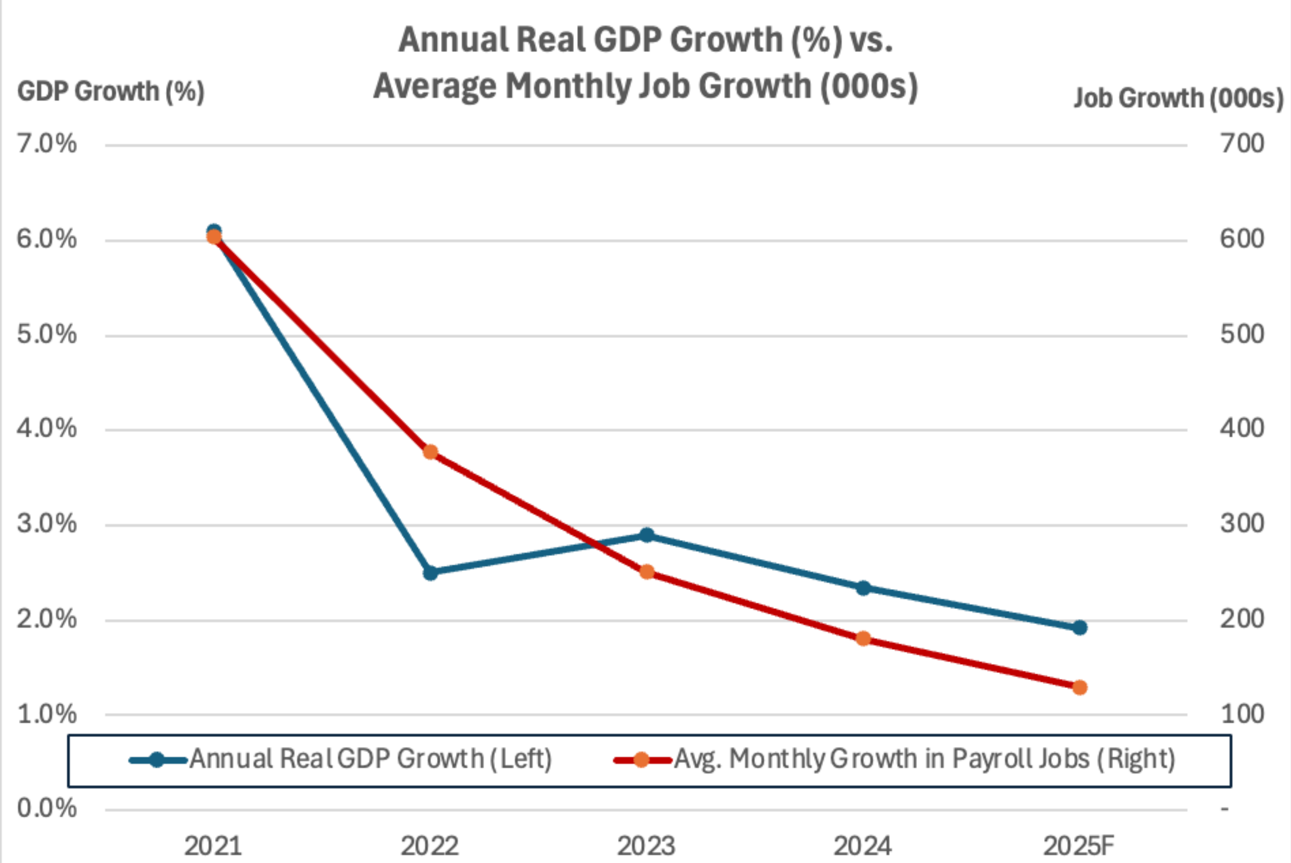
Still a Challenging Environment for Real Estate Operators

Even if capital market trends turn more favorable for investors this year, property operating conditions will likely remain difficult for property managers and owners. The "Emerging Trends" report identifies five key trends that will impact CRE markets in coming years, and most point to issues that will challenge property occupancy and rents.

Trend #1 – Be Careful What You Wish For

If interest rates do come down — as CRE investors hope and expect — it might come at a painful cost. Interest rates tend to decline as inflation subsides, but lower interest rates are also often associated with slower economic growth. That is, interest rates typically fall when the economic outlook worsens, signaling deteriorating operating conditions for CRE properties.

The good news is that the Fed seems to have achieved its goal of a "soft landing" — cooling the economy enough to tame inflation without crashing it. Both Gross National Product (GDP) and employment continue to expand at a moderate pace. However, this growth has been slowing, and the outlook is for even slower growth, even if we manage to avoid a recession.



Sources: Bureau of Economic Analysis (GDP) and Bureau of Labor Statistics (jobs); forecasts from Wall Street Journal survey 10/24; compiled by Nelson Economics.

That's problematic for property markets because tenant demand tends to drop when economic growth cools: Households demand fewer new apartments, consumers spend less in stores, and firms lease less office space and fewer warehouses.

Of course, this more moderate economic outlook is by no means certain. Some economists expect growth to accelerate under the incoming Trump administration, which promises to reduce regulation and lower taxes. On the other hand, some fear the economic consequences of Trump's promises to increase tariffs and reduce, or even reverse, immigration.

But on balance, most economic growth forecasts have come down over the past year, as reflected in the Wall Street Journal survey of economists shown in the chart above. The result would be more competitive leasing conditions as property managers compete in a dwindling pool of potential tenants.

Trend #2 – A New Cycle Begins

More positive conditions are expected in the capital markets. Based on the industry survey and interviews, investors should expect a modest uptick in CRE sales transactions in 2025 and a greater rise in debt transactions as more owners refinance and banks re-enter the market.

Also positive is that prices seem to have stopped falling and might finally be turning positive again, though those gains are driven partly by higher-quality assets accounting for a larger share of the transactions.

Finally, delinquencies on mortgages and structured debt remain well below levels seen after the Great Financial Crisis (GFC), though they still may rise. However, with liquidity returning to CRE capital markets, concerns about distressed debt are fading, with rising confidence that many underwater mortgages will get worked out.

Trend #3 – Building Boom, Tenant Boon

The surge in new supply may present the most challenging issue for property owners. Occupied space now exceeds pre-pandemic levels as demand remains robust across most property types, yet vacancy rates are rising in many markets as new construction outpaces absorption.

Tenants are exploiting softer market conditions in different ways in different property sectors. In some sectors, tenants are negotiating lower rents as the amount of available space rises. In other sectors, occupiers are upgrading to a new class of higher-quality space and leaving behind their older, less functional space — bifurcating performance between newer and older buildings.

In either case, property managers will be challenged to retain their tenants. One proven tenant-retention method is for managers to regularly survey their tenants and residents. As part of a comprehensive communication strategy, these surveys help gather feedback on what's working in the building and what's not. Managers can leverage these insights to refine amenities and services and improve overall satisfaction.

Trend #4 – Now Where?

The fourth trend identified in this year's "Emerging Trends" report concerns changing domestic migration patterns. While many households continue to move from the Frost Belt to the Sun Belt, the surge in Sun Belt and suburban migration following the pandemic appears to be moderating and transforming. Many metros that had attracted strong in-migration earlier in the decade are now seeing moderate gains.

One factor is declining housing affordability, as demand has been increasing faster than builders can supply new homes in many high-growth markets (see Trend #5 below). However, climate change may already be playing a role, poised to trigger more shifts in the years ahead. Almost half of homes nationwide are at risk from at least one type of severe or extreme climate risk, and many homeowners cannot obtain affordable insurance in the private market.

Property managers are paying attention, particularly in high-risk markets where insurance costs are skyrocketing and securing policies is becoming more challenging.

Trend #5 – Many Solutions, No Answers

Housing affordability continues to decline and remains the most concerning social and political issue facing the real estate sector. Even as mortgage rates edged down in the summer and fall of 2024, housing affordability remained stubbornly near all-time lows as home prices continued to set new record highs. According to the report, the most direct solution to address affordability is to build more housing, but developers face a variety of daunting obstacles that slow or limit housing production.

No Rest for Property Managers in 2025

Despite a more optimistic outlook overall for commercial real estate in 2025, property managers will still face a tough operating environment. Interest rates may be coming down, which should reduce debt costs and improve return prospects for new acquisitions. But, many markets will experience heightened competition for tenants as historically high new supply comes to market. Plus, tenants may be harder to find as the expected slower economic and job growth reduces space demand.

These factors point to a "tenants' market," in which tenants will be in a stronger position to negotiate favorable terms due to rising space availability. Under these conditions, property managers will be especially motivated to do all they can to ensure they understand what their tenants need and want and assess how they can improve overall tenant satisfaction to drive retention.

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