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Inflation, rising interest rates, bear market likely to affect commercial real estate deals – but how?

By Ashley Fahey – Editor, The National Observer: Real Estate Edition, Jun 15, 2022

This week, the stock market officially turned bear for the first time since March 2020, raising once again the possibility of a brewing recession.

Because of broader economic turbulence, many in the commercial real estate industry are bracing for a slowdown and are already seeing an adjustment in expectations around property valuations, costs and access to debt. But to what extent the commercial property market will be affected by the downslide in the stock market, not to mention elevated inflation and rising interest rates, won't necessarily play out equally across region, property type or investor.

"The reality is, what’s happening with construction, vacancy and competition for space in your market, that’s going to drive the dynamics of what you experience there," said Rebecca Rockey, global head of economic analysis and forecasting at Cushman & Wakefield PLC (NYSE: CWK).

Richard Barkham, global chief economist and head of Americas research at CBRE Group Inc. (NYSE: CBRE), said despite current pessimism, job growth remains strong, and consumer spending, even with inflation, is holding up. Retail sales rose a seasonally adjusted 0.9% month-over-month in April, the most recent data available, according to Commerce Department data.

CBRE isn't forecasting a recession right now, although Barkham said the rising cost of capital is prompting repricing in parts of the commercial market. And some groups that planned to sell assets in 2023 are actually moving those dispositions into this year, given current economic conditions, Barkham added.

Predicting when inflation will begin easing off is difficult, he said. CBRE continues to forecast that inflation will begin to subside in the second half of 2022, with the Consumer Price Index ending the year up by 6.6% and receding to 2.4% by the end of 2023.

Interest-rate impacts on CRE

The Federal Reserve is meeting this week ahead of what's likely to be a hefty interest-rate hike, an aggressive stance widely believed to increase the chances of a recession. Already, rising interest rates have squeezed deal terms in commercial property.

A developer or owner that did a pro forma on an interest rate of 3.5% is suddenly facing a 5% rate, a significant bump, said Jonathan Kingsley, an executive managing director at Colliers International Inc. (NASDAQ: CIGI), specializing in office and industrial real estate. Meanwhile, higher construction, materials and labor costs continue to be part of the cost calculus.

Owners, therefore, are likely to exercise additional scrutiny in all aspects of a real estate transaction, including the credit worthiness of tenants.

"When returns are compressed, landlords have to be a little more careful that underlying income from tenants is there, to get the value where it needs to be," Kingsley said.

Anecdotally, a growing number of investors are looking to renegotiate terms on sales, with a couple outright walking away from deals they've deemed no longer pencil in a higher-rate environment. The Wall Street Journal recently reported Innovo Property Group LLC backed out of an agreement to buy a midtown Manhattan office tower for $855 million after rising interest rates made it tough to find a mortgage.

Louis Archambault, a real estate attorney for Philadelphia-based Saul Ewing Arnstein & Lehr LLP, said he expects deals already borderline for real estate groups will fall off, as interest rates push them to terms they don't want to move forward on. Still, those are more "fringe" deals, with most transactions continuing to make sense for investors, even with higher costs.

"I still see so much money chasing real estate, especially when you start to see volatility in the stock markets or other markets," he continued.

A year ago, about 5% of institutional capital market sales Kingsley worked on were at risk of becoming a failed sale. That's since grown to about 25% to 30% of deals he's working on today, indicating some groups may decide to wait out the uncertainty and take deals off the market.

Different outcomes

Economic turbulence and a threat of a recession could, potentially, further stymie the U.S. office market's continued recovery from the Covid-19 pandemic and widespread acceptance of remote work. At minimum, higher gas prices may give employees another reason to avoid commuting to their workplace.

Rockey said it's likely too soon to say, even when second-quarter data is released in a few weeks, with certainty whether inflation and the economy have slowed the ongoing office-sector recovery. But the risk profile has changed from the start of 2022.

"Our outlook is shifting down from six months ago," she continued. "Part of that is inflation and expected monetary policy response from that."

She said, to an extent, inflation causes rents to rise, but whether that relationship is causal is more nuanced. The dynamics of a particular market, such as vacancy, are more likely to determine rental-rate movement, she added.

CBRE expects price-sensitive segments of the hospitality, retail, multifamily and industrial sectors will be most impacted by repricing, thanks to inflation and rising interest rates. If an economic slowdown that's disruptive to jobs happens, that will affect the hotel sector, in particular, Barkham said.

If a recession does occur, multifamily will likely continue to perform well, said Nico Romano, real estate team leader and partner at Coral Gables, Florida-based Spiritus Law, but more renters may be pushed into Class B and C multifamily. Rental rates for apartments have been surging, with Zumper Inc.'s National Index hitting an all-time high in May. Median one-bedroom rents nationally were at $1,414, a 12.8% annual increase, and two-bedroom units at $1,758, or 13.9% year-over-year growth.

"At some point, you’ve got to think that can’t go on forever," Romano said, of rent increases. "Then your B and C Class multifamily properties become more attractive."