The State of CRE — Challenges and Opportunities

lending industry update CRE

Summary: The commercial real estate sector experienced significant headwinds during 2023. Fortunately, early signs suggest a more stable, and in some cases positive, market in 2024. We review the outlook for the industry and suggest ways in which CFIs can manage risk and continue to support their CRE customers.

One of the most expensive commercial real estate (CRE) deals of 2023 involved Italian fashion house Prada. The luxury brand bought the building hosting its flagship boutique store on New York's Fifth Avenue for $425MM, along with the building next door for $410MM.

Deals like this one tended to be outliers in 2023, a year that witnessed a slowdown in CRE transaction activity. Will the same hold true for CRE in 2024? We summarize the outlook for certain CRE sectors and discuss ways in which community financial institutions (CFIs) can manage the associated risks and make the most of the opportunities available.

The State of the CRE Sector

Rising interest rates and high inflation added to the pandemic-related challenges already facing the CRE sector in 2023, as evidenced by lower valuations, tightening credit standards, and lower levels of CRE lending. Although transaction activity is still muted, early indications for 2024 suggest some stabilization — and even a possible renewal, particularly as borrowing costs appear to have peaked.

Here are a few factors that have a large impact on the CRE sector right now:

- **Offices still vacant.** Office vacancy rates reached a 40Y record high of 19.6% in Q4 2023. With average property values continuing to drop, this trend is expected to persist, particularly for older buildings and less desirable locations. Given the popularity of the hybrid working model, it's unsurprising that businesses are favoring smaller office spaces. Class A properties offering flexible or smaller configurations are likely to draw the most interest going forward.
- **Retail on the rebound.** Supported by resilient consumer spending, the retail sector is expected to experience steady performance and consolidation during 2024, with unchanging vacancy rates and moderately positive rent growth. The luxury retail segment, in particular, is showing signs of recovery with increased interest in prime locations.
- **Multifamily continues to perform.** High demand, low vacancy rates, and steady rental growth have been good for multifamily properties. High interest rates will continue to drive demand as potential homebuyers remain priced out of the market.
- **Industrial.** This market boomed in 2023 as ecommerce and nearshoring of supply chains boosted competition and demand for space. However, it's expected to soften in 2024 as demand levels off.

Risk and Uncertainty Remain, Despite Reasons for Optimism

Strong economic growth, cooling inflationary pressures, and expectations that the Fed will make several interest rate cuts during 2024 are all contributing to an improved sentiment across businesses, consumers, and capital markets. Falling interest rates would lower the cost of refinancing and could also trigger increased deal-making. That said, uncertainty regarding the timing and magnitude of the Fed's cuts, ongoing geopolitical tensions, high costs, an unstable energy market, and growing urgency regarding climate risks are adding to market instability.

In addition, the amount of delinquent or deteriorating loans is trending up, so credit risks remain. Indeed, the recent significant drop in value of a large NY-based regional lender — due in part to higher-than-expected losses from its real estate loans as well as its obligations to meet tougher regulatory requirements — has resulted in considerable concerns about potential defaults in the CRE market and what this might mean for CFIs.

Finally, with high numbers of loans due to mature in the coming years, refinancing concerns could impact a CFI's net income considerably.

Three Ways CFIs Can Make the Most of CRE Opportunities

1. Don't underestimate the value of niche sectors. Certain niche CRE sectors are experiencing considerable growth, potentially offering CFIs significant opportunities. For example:

- **Senior living** — an aging population and advances in technology are fueling increased demand.
- **Student housing** — an increasing student population is generating demand for affordable, mixed-use accommodations.
- **Life sciences** — this segment is receiving increased investment from the biopharma and biotechnology sectors, improving its growth potential and expansion requirements.
- **Data centers** — given the exponential demand for data, demand for data centers is unlikely to level off any time soon.

2. Proactively manage risk. As CFIs tend to know their customers and local markets well, they're in a good position to extend credit facilities to existing customers and carefully select new borrowers. In the current environment, institutions may want to ask for more borrower equity to offset higher interest rates — or they could consider including deposits as part of the deal. The latter option would provide a CFI with oversight of a borrower's cash inflows and outflows, allowing the institution to spot potential problems early. Regular re-evaluations of their loan portfolios and ensuring they have appropriate risk-based reserves set aside are also key to a CFI's ongoing success.

3. Collaborate with others. Some institutions may want to consider working together to back CRE deals, particularly the bigger and more complex ones.

The outlook for CRE is cautiously optimistic, particularly given the possibility of rate reductions. That said, the lending market remains uncertain and CFIs will need to proactively manage risk while making the most of the available opportunities.

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ECONOMY & RATES

Rates As Of: 04/08/2024 05:41AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg

3M	5.43	-0.03	0.03
6M	5.34	-0.04	0.08
1Y	5.06	0.04	0.29
2Y	4.78	0.16	0.53
5Y	4.45	0.24	0.60
10Y	4.46	0.25	0.57
30Y	4.59	0.25	0.56

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.32	8.50	5.32