Reading the tea leaves - by William Pastuszek

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Looking at the real estate data and the economic data, there are some issues that need to be examined. It may be time to take a look at where markets are heading. The froth of the post-pandemic days seem to be moving behind us, replaced with a less heady, and more sober reality going forward.

Real estate observers and analysts put much stock in “comps,” historical, verifiable transactional data that help those using them frame and define market thinking. Collecting, analyzing, and understanding transactional data is core to making sense of market activity and modeling buyer-seller behaviors. The relationship of those transactions is dynamic as markets change and not necessarily purely as a function of the passage of time.

Markets have inflection points, moments of significant change and transition. Could we be at an important crossroad at the present time?

Comparables are only as good as the analyst’s understanding of how they relate to the current market. Clear thinking will view comparable data as benchmarks with which to understand the current market.

Real estate markets generally have relatively few transactions, and analysts often must go back in time to find suitable transactions for purposes of comparison. Thus, for example, making the connection between a sale transaction a year old and today’s market requires some cogent thinking.

Here are some questions that need to be answered in looking at a year-old transaction. How do general economic conditions compare, then and now. Is the cost of financing similar? Has demand changed, i.e., are buyers buying and sellers selling in the same manner today as a year ago? The example gets picked up again further along. But first, let’s gather some context by looking at some property sectors.

Industrial, which was a bright spot, is showing some signs of peaking. Everyone is always quick to use Amazon as a bellwether, and, rightfully so, as they are huge space users. However, those large spaces have a limited market. But what seems to be a pullback in large user-space demand will surely have a trickle down effect and will likely be viewed by market participants at many levels (and the media) as a sign of weakness in what has been a most robust sector. Continued huge rent and price spike ups in industrial markets are probably a thing of the past.

Another darling of investors, single tenant net lease (STNL) markets are also exhibiting caution signs. A recent CoStar piece notes: “Rising inflation is causing an influx of single-tenant commercial properties to hit the market after the number of sales shrank in the third quarter, a marked change from the first half of the year…The dynamic raises uncertainty whether sellers can get offers that match their pricing expectations, according to brokers and investors specializing in net-lease properties. Buyers, in the meantime, may now be more willing to wait and see which way the economy goes…The average sale price per square foot is now way off its second-quarter 2022 peak, according to CoStar data. In addition, the number of buyers willing to make an offer and the number of sellers willing to accept lower offers are shrinking, according to investors." The "shock" effect of rising interest rates is attributed to this pullback and shifts in market perspectives. And the interest rate shocks keep coming.

Office markets appear to be taking a hit from a variety of tenants, including larger users, who are all finally facing up to the lessons learned from the pandemic's work-from-home movement. This sector may be in for some pain going forward as office users re-evaluate space needs as leases term out. (Side note: not all office space converts easily to lab space or to apartments!)

A consensus is emerging that, pandemic stimulus, combined with a bloated government balance sheet and zero interest rate policies, probably was too much for too long. The expectation that inflation would be a short-term phenomenon appears to have been optimistic. (Recent unanticipated events have not helped either.) Not only the Fed, but central banks globally are now struggling mightily to check inflation by raising interest rates and trying, at the same time, to avoid a recession, an event which is probably nearly inevitable at this point.

Remembering that real estate markets can be slow moving is useful in not jumping to conclusions based on short-term data. But, when markets move, they move dramatically, and that's what may be happening here. (We may only know that six months from now when we look at the data from a slightly longer view.)

Understanding the shifts will prevent misinterpretation of historical data. To build on the prior example, there may be several sales of a property type that took place in 2021 that sold with cap rates of say, +-6%. Looking back at those sales in late 2022, with dramatically higher money costs and a far less rosy economic picture, the good question to answer is, where would those cap rates be if the sales took place now? Using those sales without accounting for the changed conditions may not result in a believable result. If there were no sales in 2022, might that also be an indicator of demand?

While real estate is a long game, big shifts in the outside world must be recognized and accounted for in deconstructing investor behaviors and in making sense of markets, both generally and specifically. Not being cognizant, and not responding to and not understanding these shifts creates missed opportunities for credible analyses and conclusions with the end result being inaccuracies in valuations. It's a great time to be reading those tea leaves.

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