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A summer of some discontent - by Bill Pastuszek

July 28, 2023 - Spotlights

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As observers of real estate activity, we can get very caught up in the short-term gyrations of markets, all the while knowing that smart investors generally play the long games. The media and related pundits pounce on short-term variations and produce conclusions that may or may not be grounded in solid theory and depth of research.

So go real estate markets. They are good, not so good, uncertain, drifting, lacking definition. A lot of investors are a) waiting for a recession or believing that it is almost here, b) thinking the soft landing may yet occur, or is occurring. There are many out there who think that if only interest rates went down, all would be well again.

Looking back at the first two quarters of 2023, ask the question: Is it that bad out there? First, let’s take a quick look at housing as an example.

Early this year, data by the Realtors and Warren Group showed the beginnings of a downward price trend in Massachusetts. The data, a couple of months later, showed an upward swing. Surely sales activity was way off but inventories were not ballooning. The Case Schiller index shows a very elegant waveform for the performance of the Boston market in 2023. Ask any residential Realtor, appraiser, or lender and they will tell you business is way off.

On the commercial side, volumes are also off and some instability in pricing is evident. I recently listened to a webinar of commercial real estate (CRE) experts. A gloomy, unexciting picture was painted of most property and capital markets. One panelist was waiting for the recession to hit, as if that would solve the markets’ problems: at the very least, it would provide some resolution and something else to talk about.

Another worried about the office building crisis; it was mentioned that as leases rollover and renew, tenants might not stay, and, if they did, they would “give back” space no longer needed, and renegotiate leases aggressively. That creates problems for both equity and debt positions. Further, in terms of office space going forward, it was noted how difficult it would be in many downtowns to repurpose older office buildings and, even if those renovations made economic sense - which to this observer, they don’t seem to in theory, anyway - how would the kinds of amenities that apartment dwellers expect be able to be provided?

Another panelist spoke to the issue of the “unfinished” banking crisis. Community and sub-regional banks made a huge percentage of CRE lending over the recent past. Many are undoubtedly in panicky states about the interest rate mismatches that were created when loans were made during the not so long ago “free money” era and which are subject to be heavily discounted in today’s “high money” environment. Additionally, many loans coming due have properties that aren’t going to cash flow as originally underwritten. Some bank consolidation is and will be taking place, maybe some outright failures.

Capital market issues were discussed. Panelists agreed that “rational” investors have adjusted their models. High loan-to-value ratios are gone, and non-recourse terms are “challenging” to find. The leverage that borrowers have come to expect is not there. Underwriting is tight and, in many cases, lenders are not looking for new business.

The issue of cap rates came up and a question was asked: if markets are so challenged, why haven’t cap rates moved? One sensible answer was that the good deals got to closing and show stable cap rates; the bad deals didn’t get to the finish. Look to see cap rates moving more in sync with interest rates going forward. Appraisers, underwriters, and investors: check your cap rates, please!

In a low transaction climate, where everybody is looking over their shoulders, not much will happen until the headwinds subside and some tailwinds occur.

This is that part of summer that if you are not at the beach, mountains, or islands, you either should be or should want to be. Then I guess there are those who would just as soon sit on the back deck at home. Then there are those that don’t necessarily have those kinds of choices.

In an unendingly hot, rainy, and smokey summer, where everything is disturbed and uncertain, there is worry for all of us, whatever our beliefs might be, about the permanence of this state of change. Maybe this is the future: permanent uncertainty and discomfort, to varying degrees, but always there.

Be cognizant of short-term changes but realize also that a couple of quarters of activity and change does not make for a broad trend. In a market right now that lacks direction, has no passion, and seems to be waiting for “the world to change,” careful parsing of the data – sometimes limited and equivocal in markets with low transaction volume – is more important than ever. Patience is required to not overreact to short-term shifts. And, if you are sitting on the deck staring out on the backyard, take care that you don’t miss something coming in the front!

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