Commercial real estate decline: Not over yet. - by Daniel Calano

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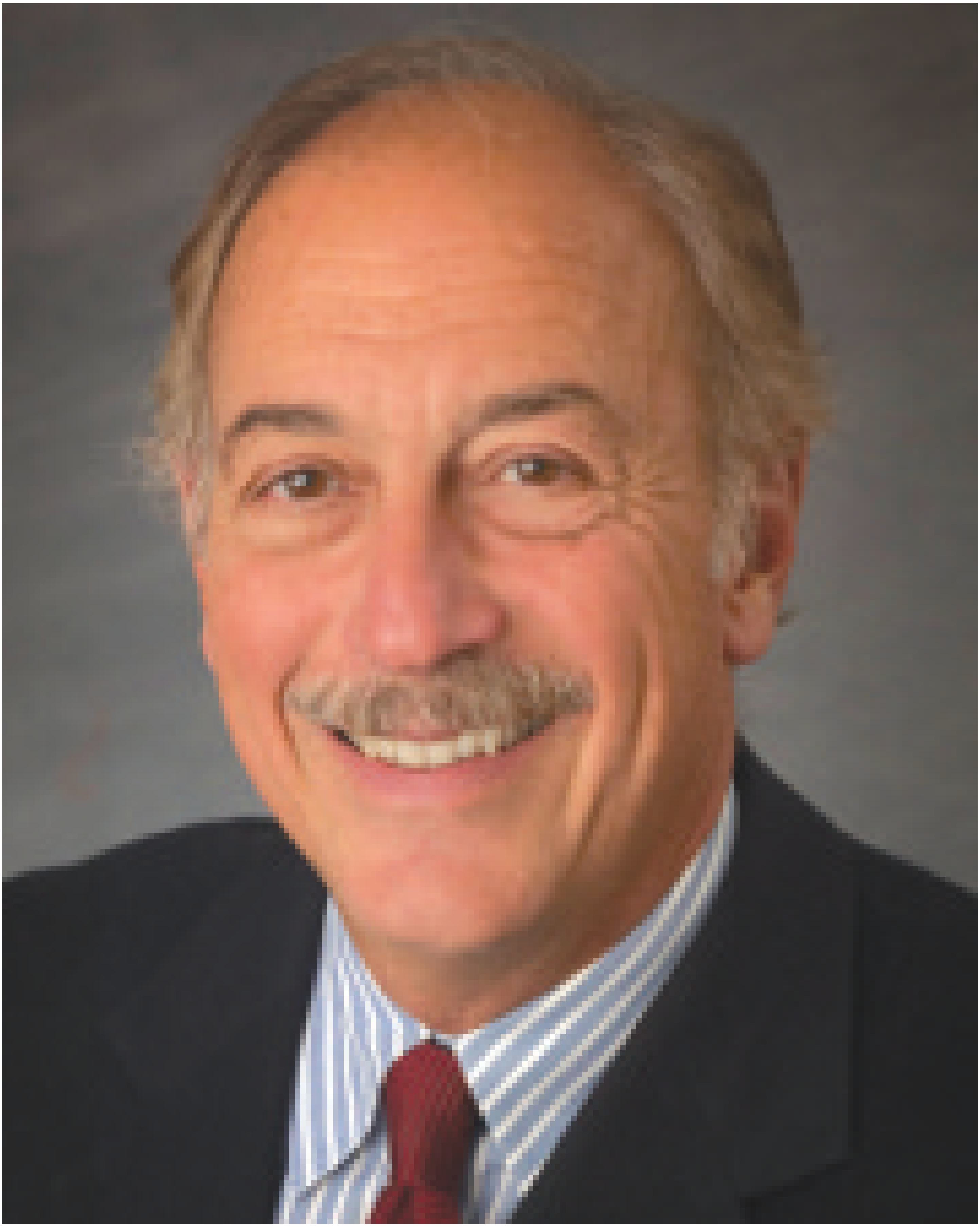

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Recently, I and others have written about office vacancies, leading to loss of income, and thus potential credit problems. As noted, not all sectors of commercial real estate are in the same boat as office, which has many more problems than other sectors such as retail and industrial. Office problems are exacerbated by culture shifts, business and work changes, and population movements, mostly all started in the pandemic.

Most recently, financial credit is becoming an issue, due to the fact that many commercial loans were made 10 years ago, at variable rates, and are coming due to be re-financed, clearly at higher rates. Developers and investors have been aware of this issue, but it is clearly becoming more significant and onerous. Refinancing has ramifications to reevaluate net operating income, as well as investment profit after debt, and thus cap rates, and thus overall property valuation. All of this is continually moving towards credit problems, and thus troubled business buildings are impacting otherwise better buildings. In other words, overall credit issues may impact financial strength of real estate investors, thus extending this problem further.

As one example, in a recent Wall Street Journal article, a writer opined on unanticipated and further reaching consequences of the recent de-valuing in commercial real estate. The article suggested ramifications much deeper than simple office vacancy. The article is about government pension funds, unloading real estate assets, at significant losses. Without going into detail, Canada National Pension Fund, California Teacher Pension Fund, and others are selling because their income from real estate is decreasing, thus putting pension payments at risk: To quote, “these moves offer a new glimpse into the widespread and slow moving commercial real estate slump.”

You can see now how one thing has led to another, creating a rolling wave, crossing related currents. Not a tsunami by a long shot, but certainly impactful. This process suggests that credit issues are beginning to impact businesses, lower wage growth,thus less consumer spending, which is approximately 70% of our economy. See the pieces of the puzzle falling into place?

It is not so much that we were unaware of these issues. What we have not considered or reconciled is how long the issues may impact real estate. Didn’t we all hope that things would be better this summer, or at least by end of the year. It is now becoming more clear that this resolution of issues will take longer, probably well into 2025. No one can tell for sure at this point, but it would be naïve to think short-term context. On the other hand, and on a positive note, those who are well prepared may find opportunities among the problems. Stay aware, realistic and be prepared!

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