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Is it getting better? Commercial real estate tends to move slowly - by Bill Pastuszek

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In reviewing the year so far, what are some of the factors that are influencing markets? For commercial real estate (CRE), what are some signposts that may help to understand what is in the offing? How is New England doing compared to other markets?

First, the Fed. The “benchmark” federal funds rate sank to the 4.75-5% range, a 50 basis point drop. The Fed’s rate-setting committee noted the reduction was made “in light of the progress on inflation and the balance of risks.” The rate had been in the range of 5.25 to 5.5 percent for well over a year. The St. Louis Fed reports the September Fed Funds rate at 4.83% after having reached a high of 5.33% earlier this year.

Not too long ago, an analyst was quoted as saying “things will get worse before they get better.” Is it now time for things to get better?

Property Sectors. Let’s take a look at a couple of property sectors.

Real Estate Lending. Commercial real estate lending is closely tied to the 10-year treasury. That rate, currently, according to FRED, is in the upper 3% range. The rate peak came earlier in 2024 at 4.7%. Participants in the CMBS space report that conditions have “eased.” Overall, then, with lower financing rates, does the CRE logjam ease? Rates may be lower, which eases the cash flow crunch on existing loans, but will slightly lower rates stimulate refinancing and, more importantly, purchases.

Office. There is greater optimism out there, but some observers might say, things can only go up from where they are. It’s reported that office pricing is still in the phase of “discovery,” (have we reached bottom yet?). Markets adapt by figuring out ways to repurpose buildings and work with tenants to achieve higher occupancies. Rents are not in free fall but awareness of generous landlord concessions may make those deals look more tenant friendly than they on their face value. Clearly, this asset class is still trying to overcome the dislocations due to COVID and the work-from-home era and larger forces out there that are reducing the need for office space.

Drugstores. Over the past 15 years, most investors and analysts would have identified a drugstore leased to one of the majors as one of the safest real estate plays. Recently, Walgreens announced the closing of more than 1,000 stores. Rite Aid has consolidated. CVS is in the process of trimming its portfolio. That seemingly safe environment has shifted dramatically of late. The net lease market overall has seen some shifts.

Market Sentiment. On the other hand, for investors who have been on the sidelines and who have been waiting for a turnaround, this cut may represent an inflection point. High quality assets may have greater attractiveness and possibly less of a bid-ask spread. Bid-ask between buyers looking at current realities and sellers with higher expectations.

What about New England? While not immune from the prolonged doldrums, the fundamentals are sounder and there is less overbuilding here than in more growth-oriented markets. Sure, downtown office markets are struggling (with signs of adaptation) and retail is considered “constrained.” Slow growth New England has never been a leader in retail development as the sector is sensitive to population and housing growth.

Industrial reached a peak but remains a source of CRE strength in the region. Much development took place to catch up with historically lackluster development. Similarly with multi-family: much new stock has been created in the Boston Metro and there are some ups and downs at the top of the market but the class as a whole remains stable. (That’s not the case nationwide.)

Lodging has rebounded well over the past few years. While always privy to the vagaries of the economy, with lower debt costs, greater transactional activity is envisioned.

The CoStar index has listed Boston as a prime market in several of its property categories.

Summary. Don’t get too excited about slightly lower rates. Commercial real estate tends to move slowly. While more optimism is created by a relief in rates, buyers and sellers are still looking for agreement, a lot of leases will turn over and reset, and bankers and investors will be careful about jumping in too soon. After a challenging three quarters in 2024, the news is likely to get better going forward, barring any unanticipated mishaps, but all signs point to caution until a clearer path is illuminated.

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