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# Commercial Real Estate Market Analysis Report

Q1 2023

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When the overall market is declining, commercial real estate (CRE) is often a good place to park investments. Knowing where to invest is the key, however. It's often a good idea to look at where the big players are putting their money. While private investors can have a substantial impact on the S&P 500, for example, it's institutional-level investors who drive the real estate market. And right now, those institutional investors, like U.S. public pension funds, are increasing their allocations to real estate in an effort to hedge against volatile market conditions. Of all alternative assets, real estate is the one investors most commonly use as a hedge against inflation.

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According to a recent analysis by S&P Global Market Intelligence, 40 of the largest U.S. public pension funds noted increased real estate investment as a key change to their investment strategies in 2022. That's because as inflation rises so may real estate asset prices, not to mention the fact that CRE investment allows for greater portfolio diversification. In fact, 76% of institutional investor respondents cite diversification as their key motive for investing in CRE.

The California Public Employees' Retirement System and California State Teachers' Retirement System increased real estate allocations from 13 to 15% when comparing 2021 to 2022. Meanwhile the Alaska Retirement Management Board increased its target allocation to real estate from 13 to 14% between 2021 and 2022. Percentage point shifts like these represent a substantial amount of money, considering many of these institutional investors are starting with multi-billion dollar annual allocations to CRE. Even small shifts in asset allocations can significantly influence how the CRE market performs.

<sup>1</sup> [US pension funds up real estate exposure to offset rising risks.](#) S&P Global Market Intelligence.





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As the first quarter of 2023 closes, interest rates continue to rise, but opportunities are growing in many sectors. In this report we'll cover the following:

- ▶ The strength of sales in CRE in 2022.
- ▶ Key CRE markets for investment in 2023.
- ▶ Rent deflation and oversupply in multifamily.
- ▶ Expected CRE transaction volume in the months ahead.





# State of the market

From stocks to CRE, everyone has been riding out the economic waves of the COVID-19 pandemic. And in the same way stock market investors ride out market dips, so must commercial real estate investors — focusing on the long-term, the bigger picture. Even though the Green Street Commercial Property Price Index decreased by 0.6% from December to January and by 14% since its March 2022 peak, these declines will eventually rebound.<sup>2</sup>

Compared to the same quarter in 2021, Q4 2022 commercial property sales in the Americas fell 63%, and annual price growth experienced the slowest rate gain since 2011.<sup>3</sup> Additionally, Green Street index-tracking properties in core sectors dropped 17% since this time last year. So while annual property appraisals will likely continue to decline in 2023, the bittersweet bottom line is if the market hasn't bottomed out yet, it's very close to it, according to Peter Rothmund, Co-Head of Strategic Research at Green Street.<sup>2</sup>

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2022 is still the second strongest commercial property sales year on record after 2021.<sup>4</sup>

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# A good year to be an investor

While these statistics may paint a gloomy picture, 2022 is still the second strongest commercial property sales year on record after 2021.<sup>4</sup>

Despite swelling interest rates, 2022 marked the second-best year for multifamily transaction volume, according to Suzanne Mulvee, senior vice-president and chief strategy officer at GID. Q4 experienced a promising uptick in transactional value, bringing in \$40 billion in deals, despite rate hikes by the Fed. While investors are cautious now, those who take the plunge could reap rewards.<sup>5</sup>

Short-term market disruptions happen. But if investors own profitable properties with ample capital reserves and possess a healthy loan-to-value ratio on the properties they own, they can typically ride out the storm. Having a diversified portfolio is another way to play defense against recessions and market dips. Investing in multiple property types, such as student housing, multifamily, or retail, ensures that should one sector suffer, interests in another sector could off-set a loss.

Here's an overview of how different sectors can expect to perform.

<sup>2</sup> [Property Prices Fall Another 1% in February](#). Green Street: Commercial Property Price Index.

<sup>3</sup> [Global Investment Declines Sharply in Q4 2022](#). CBRE.

<sup>4</sup> [US Property Deals Slumped, Price Growth Withered in Q4](#). Jim Costello. MSCI.

<sup>5</sup> [After Years of High Performance, Multifamily Steps Back in 2023](#). Paul Bergeron. Globest.com.



# Industrial sector posts strong growth

Among the strongest CRE sectors now is industrial. In fact, The Brainy Insights predicts the industrial distribution market will grow from \$7.45 trillion in 2022 to \$11.87 trillion by 2032.<sup>6</sup> Given the continuous growth in e-commerce, companies see expanding their industrial distribution as critical to strengthening their supply chains and remaining competitive.

In the last decade, e-commerce has had the fastest growth of any sales channel. Some surveys predict digital sales could account for as much as 50% of the retail sector's absolute value growth globally between 2020 and 2025. China and the United States could represent some 55% of that growth, and \$1.4 trillion of it could come from the U.S. alone.<sup>6</sup>

Another sign of industrial's continued growth: Industrial REITs posted strong fourth-quarter earnings, and leasing brokers are filling hundreds of millions of square feet almost as soon as

construction on new facilities completes. Real Capital Analytics recently reported the following stats on this quickly growing sector:

Industrial sales topped \$125.7B in 2021.

Those sales grew exponentially by another \$88B in 2022.

Average price per square foot for industrial properties increased by 57% between 2019 and 2022.<sup>7</sup>

<sup>6</sup> [Industrial Distribution Market Size by Product](#). *The Brainy Insights*. 2023.

<sup>7</sup> [Is Commercial Real Estate Really In A Recession? Kind Of, Economists Say](#). Ciara Long. *Bisnow*.

# More volatile CRE sectors

A number of CRE markets remain in decline; however, much of that decrease in value is due to pandemic-related woes. Office and retail experienced some of the toughest effects of lockdown measures and work-from-home initiatives, and neither space has hit bottom yet, according to Green Street.



## OFFICE

Office rents and occupancy continued to drop in 2022. In fact, Green Street expects work from home to reduce office demand by about 15% over the long haul. Owners remain uncertain about the sector's future, and many lenders are selling off their office space loans. Even tech companies like Facebook, Microsoft, and Amazon have scaled back on growing office space now that the days of cheap financing are gone. As of the close of the fourth quarter, office prices were down 17% from their March 2022 peak.<sup>8</sup>



## RETAIL

Retail has been a volatile sector since the onset of the pandemic, which accelerated the trend of more purchasing occurring online. However, from a grocery-anchored standpoint, retail should continue to grow in the year ahead, according to Marcus Duley, chief investment officer at Walker & Dunlop Investment Partners.<sup>9</sup> The sector has shown itself to be particularly resilient, even in the face of COVID, routinely adjusting how it reaches customers, whether that be through online shopping options, curbside pickup, or grocery delivery services.

<sup>8</sup> [Green Street's U.S. Sector Outlooks Examine Commercial Real Estate During Capital Markets Upheaval](#). *Green Street*.

<sup>9</sup> [2023 Unlikely to Bring a Large Wave of CRE Distress, Predicts Walker & Dunlop Exec](#). Buck Wargo. [WealthManagement.com](#).

# Rent deflation and the impact on multifamily performance

Multifamily has had a strong run for more than a decade now. Housing is responsible for nearly one-third of the Consumer Price Index (CPI). So when the pandemic ushered in low-interest loans coupled with a remote-working environment, it contributed to more than half of December's 5.7% core CPI inflation. And even though economists say inflation could continue to climb through spring 2023, it will recede later in the year. Here are some insights from Jake Oubina, senior economist at Piper Sandler:

Shelter inflation should relax from 8.1% in March to 5.3% in December.

Housing interest rates and demand will likely drive up inflation more, peaking in June and shrinking 0.7 of a percentage point by December.<sup>10</sup>

Headwinds for multifamily are already showing in the market, and this backslide boils down to how pandemic-driven deviations affect inflation methodology. To better understand what homeowners and tenants pay for housing, the CPI examines existing leases as well as new leases. The latter are losing momentum and exhibiting delayed renewals and extensions:

Asking rents slipped 0.3% from November to December 2022.

On a national level, rents still stand 7.4% higher than January 2022.<sup>11</sup>

The rental market is showing signs of hitting a plateau. Rents are no longer increasing, and, in some localities, they are dropping — a phenomenon the market hasn't witnessed in a decade. From August through January, apartment rents fell in every major U.S. metropolitan area, while new lessees paid a median rent 3.5% lower in January than they would have paid in August.<sup>2</sup>

One of the leading causes of rent deflation is the fact that so many new multifamily projects initiated 18 to 24 months ago are now coming online. According to the latest apartment market research report from Berkadia, 500,000 new apartment units will hit the U.S. market in 2023. This is the biggest supply of new multifamily inventory in nearly 40 years.<sup>13</sup> While it represents a lot of new options and incentives for renters (more than 50% of tenants didn't renew leases in January, suggesting they found better deals elsewhere), it means some decreased value for investors.<sup>12</sup>

However, multifamily remains a resilient market, as people will always need a place to live. And since home ownership remains out of reach for many, even would-be homebuyers are often forced to rent. The multifamily sector has had an amazing run the past 10 years. While owners of multifamily properties should not be expecting much rent growth in 2023, the sector remains a potentially safe bet for long-term investors.

<sup>10</sup> [Inflation Is Falling, and Where It Lands Depends on These Three Things](#). Gwynn Guilford. *The Wall Street Journal*. February 14, 2023.

<sup>11</sup> [Rents slide for third month in a row to close out 2022 \(December 2022 Rental Report\)](#). Zillow.

<sup>12</sup> [Apartment Rents Fall as Crush of New Supply Hits Market](#). Will Parker. *The Wall Street Journal*. February 27, 2023.

<sup>13</sup> [2023 Forecast: National Apartment Research Report](#). Berkadia.





# “You make your money when you buy”

Howard Lutnick, chairman and CEO of Cantor Fitzgerald, recently remarked that choosing the right moment to invest is the key to making money. He also believes that moment is on the horizon for commercial real estate. According to Lutnick, real estate will reprice later in the summer, and the market will experience an influx of CRE investment.

While some think peaking mortgage and interest rates could bring price readjustment sooner, Lutnik says rates will remain high during a light recession throughout Q1 and Q2. Once rates stabilize later this year and confidence builds in that stability, Lutnik believes real estate will begin to rally, opening the doors for prime investment opportunities, such as REITs and DSTs.

And while some companies continue working from home, others are considering a move to recently completed modern units once the upcoming recession subsides. This will also establish opportunities for CRE investors to convert distressed office space into residential properties through high-quality, purpose-lending loans through Fannie Mae and Freddie Mac.<sup>14</sup>

However, DST investors aren't always influenced by real estate market conditions. Sometimes lifestyle changes, such as pending retirement, may shift investor demand for CRE investment.<sup>15</sup> And even though the pandemic provided its own unique pressures, the CRE market has already experienced signs of rebound:

In 2021, with dramatically low interest rates, investors turned to assets like CREs for higher returns.

That same year, commercial property experienced a record \$809 billion in sales.

The average multifamily-property price per unit rose 21.6% in 2021, outperforming that year's record 14% rent growth.

Industrial sales totaled \$125.7 billion in 2021, with an additional \$88 billion the following year.

The average price per square foot for industrial properties gleaned a 57% increase between 2019 and 2022.<sup>7</sup>

It's no surprise a market correction followed this level of growth. Post-pandemic, CRE has experienced a downturn due to rising interest and capitalization rates. According to Green Street's Commercial Property Pricing Index, values peaked in March 2022, and have dropped 14% since.<sup>7</sup> But considering the pandemic's over-inflated market, investors should view current events as a reset instead of a decline. This transitional period is simply the market leveling the playing field between what sellers believe their property is worth compared to what buyers will actually pay. Either way, things are potentially looking up for CRE later this year.



<sup>14</sup> [Howard W. Lutnick Joined Sara Eisen on CNBC's "Closing Bell"](#). Cantor Fitzgerald. *Youtube*. January 25, 2023.

<sup>15</sup> [DST Sector Battles Excess Inventory as Investor Demand Slows](#). Beth Mattson-Tieg. *WealthManagement.com*.





## Expected transaction volume in the months ahead

That being said, CRE transaction volumes will likely be flat or slightly down the first half of the year when compared to 2022. But investors have capital they want to use, and there are a lot of motivated sellers who are looking to shed real estate investments for multiple reasons:

- Maturing loans
- Hardship due to financed properties with highly leveraged floating rate debt
- Achievement of targeted returns
- Investments at the end of their fund life<sup>9</sup>

However, it's important to keep in mind that would-be investors won't buy if they don't feel they can hit their target returns, and investor expectations on returns have not come down. So given the current higher costs of capital plus return expectations, property values will have to decrease to draw investor interest. While CRE can experience short-term hiccups, it's a resilient investment with historically solid long-term outlooks. An investor who purchases high-quality property in a stable or growing market should expect reliable returns.

The best investment opportunities for the coming year will likely be for transactions below \$100 million because investors may be able to purchase at an attractive basis and build value to potentially outperform market expectations.<sup>9</sup> That means a lot of potential opportunities for Delaware Statutory Trust investors since most DST options are in the \$100 million or under category.

There are currently some 70,000 1031 exchange investors acquiring \$400 billion in CRE a year.<sup>16</sup> In 2022, when the CRE market was hot, many investors could sell and make a profit, but it was hard to reinvest and be assured of profitability since prices were high. In a declining market, there are more opportunities for investments with long-term profitability since investors can potentially reinvest at a lower basis with their replacement properties.

<sup>16</sup> [New CRE Tech Platform Aims to be a 'Dating Service' for 1031 Exchange Deals](#). Buck Wargo. WealthManagement.com.

# Conclusion

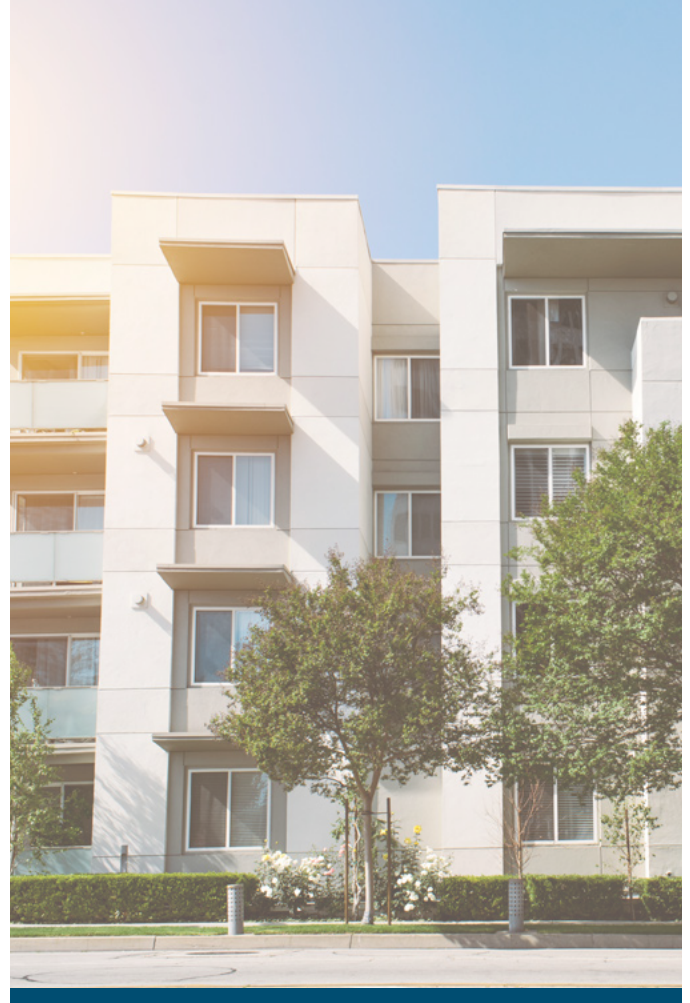
While the first and second quarters of 2023 will likely continue to experience headwinds when it comes to returns in commercial real estate, market corrections resulting from rising interest rates and inflation may start to level off by mid-year. That means the CRE market could offer ever-increasing opportunities for lower investment prices and higher returns in both historically stable and growing real estate markets, particularly for mid-market transactions.

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No public market currently exists, and one may never exist. DST programs are speculative and suitable only for Accredited Investors who do not anticipate a need for liquidity or can afford to lose their entire investment.