Cambridge International Advisory Group

Small Businesses

Trends in the Real Estate Industry

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Introduction

This briefing sheet offers an overview of current trends in the real estate industry. It covers key factors in the real estate market as well as emerging and continuing trends.

Office Space

The pandemic-induced shift towards remote work has left a lasting impact on the market for office space. It has become clear that workers in most industries will never work in-person as much as they did pre-pandemic. Due to the proliferation of hybrid and remote work schedules, historically high office vacancy rates will persist for the foreseeable future. In response, there is a growing trend of converting obsolete office spaces into more viable uses such as residential units or data centers.

It should be noted that not all office space is affected equally by the shift to remote work. Higher quality "Class A" office spaces are increasingly valued by employers seeking to incentivize employees to return to the office. This quality over quantity approach is reshaping the stock of office space as employers have adopted desk-sharing for hybrid workers and workers demand more workplace amenities. Older office spaces are facing increasingly difficulty finding and retaining tenants, driving the trend of conversion to other uses.

Retail

The retail sector is often associated with struggling malls, but this narrative overlooks the resilience of neighborhood and community shopping centers. These retail hubs, situated in densely populated urban and suburban areas, continue to perform well, even as e-commerce expands its share of the market. The shift towards experiential retail and the integration of entertainment offerings into shopping centers are strategies that are paying off, attracting foot traffic and enhancing the appeal of these properties. Retail real estate is expected to remain stable in 2024, with steady vacancy rates and moderate rent growth.

Industrial

Industrial real estate, particularly warehouse and logistics properties have been strong performers in recent years due to supply chain adjustments and a boom in e-commerce. However, surges in demand for these types of properties may be abating as we begin to exit the post-pandemic recovery and adjustment period. The need for large inventory stockpiles has decreased due to fewer supply chain disruptions. Despite this, the outlook for industrial properties is positive, with moderate rent growth likely in the near future and a downturn unlikely.

One area of particular strength in industrial real estate in cold storage, driven by increased demand for temperature-controlled logistics solutions. Additionally, nearshoring and reshoring, the trend of moving industry and supply chains closer to the final destination in an effort to reduce supply chain vulnerabilities, is likely to continue. This will further support the US industrial real estate market.

Multifamily

Multifamily properties have shown remarkable resilience, continuing to perform well despite broader economic challenges. High interest rates have kept mortgage rates elevated, pricing out many potential homebuyers and sustaining strong demand for rental properties. Although rent growth has slowed from the rapid pace seen in previous years, vacancy rates have remained low, around 5%, indicating a healthy market. One area of concern within the multifamily sector is the luxury apartment market. While these properties are relatively easy to build, they are not always easy to lease, leading to rent reductions and concessions in some cases. The demand for affordable and mid-market rental units remains robust.

Affordable housing

The lack of affordable housing remains a critical issue in many parts of the country. The real estate industry is exploring innovative solutions, including modular construction and adaptive reuse of existing buildings, to increase the supply of affordable housing. Property conversions, particularly of underutilized office spaces, present a significant opportunity to address this shortage. However, these conversions often require significant investment and government support, such as streamlined approval processes and updated zoning regulations. Legislation aimed at increasing the production of affordable housing is likely to gain traction in the coming years, providing further incentives for developers to pursue these projects. The federal low-income housing tax credit (LIHTC) remains a key tool in this effort, but additional measures will be necessary to meet the growing demand for affordable rental units.

Increasing Costs

High inflation has also contributed to rising costs in the real estate sector, particularly in construction and insurance. The cost of materials and labor has increased, and more frequent natural disasters have led to higher insurance premiums. Property owners are facing the dual challenges of managing these increased costs while maintaining profitability. To address these challenges, many in the industry are focusing on efficiency gains. Streamlining payables and receivables processes, optimizing cash flow, and investing in energy-efficient upgrades are strategies that can help mitigate the impact of rising costs. Additionally, there is a growing emphasis on the use of technology, or "proptech," to improve operational efficiency and enhance decision-making.

Interest rates

Over the past 18 months, rising interest rates have posed a significant challenge for the commercial real estate industry. The increase in rates has led to a decline in real estate construction projects and transactions, driven by higher borrowing costs. The 30-year fixed mortgage rate has risen sharply, reducing home buyers' purchasing power and slowing home sales. Projects already underway have faced substantial deficits due to these rising rates, and owners of existing properties have struggled to refinance their loans. Looking ahead, most experts anticipate that interest rates will stabilize or slightly decline. If this occurs, lower rates could spur more new construction projects as financing becomes cheaper and more accessible.

Mortgage and Lending Terms

US household and corporate debt remains manageable, which is a positive sign for commercial real estate. However, rapidly rising federal debt could be more problematic, potentially crowding out private investment in the industry, leading to slower economic growth as well as higher interest rates. Since the Federal Reserve began raising rates in March 2022, credit has become less accessible, more expensive, and subject to stricter underwriting, resulting in fewer loan originations and a decline in sales transactions. As a result, borrowers are holding onto existing debt, leading to a rise in outstanding commercial real estate debt while banks issue fewer new loans.

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