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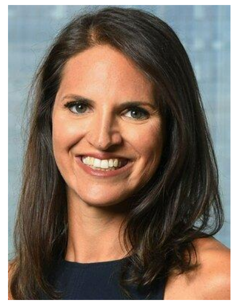
A Tumultuous 2022 For CRE And What Comes Next

By **Bonnie Neuman** (January 3, 2023, 6:02 PM EST)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As 2021 wound down, the long, extended sprint that most participants in the commercial real estate industry had been running all year continued, and the outlook was extremely positive that the pace would continue in 2022. Omicron was a concern but hadn't fully returned the pandemic back into the daily conversation, and so office tenants were returning to work and life seemed to be getting back to normal.

But instead, 2022 turned out to be the year of the unexpected. Seemingly every day, week and month was met with a different, unanticipated challenge: war in Ukraine, inflation, rising rates, continued pandemic variants and the prospect of a recession.

Looking back, the first half of the past year continued to see record levels of activity in many sectors. The return of the public-to-private real estate mergers and acquisition transaction brought new life to the hospitality market, particularly in the extended stay segment, with large deals such as Blackstone Inc. and Starwood Capital Group Management LLC's acquisition of extended stay hotels and the Highgate and Cerberus Capital Management LP acquisition of CorePoint Lodging Inc.

It wasn't all about hotels, though, as the summer brought the acquisition financing of the largest developer, owner and manager of high-quality student housing communities in the U.S., American Campus Communities Inc.

As the year rolled on, however, interest rates continued to rise and access to the capital markets that is often needed for these types of transactions slowed considerably. The third and fourth quarters of 2022 were notably quiet in the hospitality sector, with just one hotel public-to-private transaction of note.

Industrial and multifamily properties continued to perform throughout the course of the year. Multifamily, in particular, has become a highly popular investment, especially given the potential in many cases to combine multifamily and retail into mixed-use properties.

One challenge facing industrial properties in and adjacent to urban areas is the lack of available land zoned for industrial uses. Because of the increased demand resulting from a spike in e-commerce, there is significantly less available space, which, in turn, has caused the costs associated with industrial purchases and leases to rise rapidly. The impact this has on financing costs will be something to watch in the tighter market conditions ahead.

Perhaps the most volatile part of the roller coaster ride that has been 2022 is the office market.

The earlier part of the year started out strong, with deals like SL Green Realty Corp.'s purchase of 450 Park Avenue and the sale of 1330 Avenue of the Americas in New York and 601 Massachusetts Avenue NW in Washington, D.C., but the inflationary environment and a slower than anticipated return to office for many landlords has many watching this area closely.

Office leasing in certain urban centers like New York and San Francisco has also been affected significantly by technology space tenants who have started to give back large amounts of space. The hybrid work model has morphed from being a pandemic question to more of a possible systemic change.

The "Is remote work here to stay?" question is now a regular topic of conversation, and both a concern and a challenge for office landlords everywhere. Seemingly in response to this question, office tenants started reimagining their space to make it more efficient and a more desirable place to draw employees back to the office for work.

In office leasing, particularly in New York City, there has also been a real flight to quality and experience. Tenants are seeking new space amenities and more open space to allow for greater collaboration.

In this challenging environment, higher-quality assets are able to find both tenants and financing sources in a way that less desirable spaces are not. As a result, in 2022 the conversation accelerated — especially among office building owners — about use in general and in particular whether converting space to alternative uses in light of changed working patterns is the most cost-effective option for older properties.

Older office properties designed and constructed for traditional work spaces, and now without choice amenities, struggled to find tenants and, as a result, struggled to find financing. 2022 saw deals like Innovo Property Group's planned purchase of 452 Fifth Avenue collapse after HSBC Holdings PLC announced it would be relocating to a newly constructed building at Hudson Yards.

Construction financing faced meaningful challenges throughout the year in 2022.

Most people, in and out of the commercial real estate industry, would be happy to never hear about the supply chain disruption again, but this is especially true for developers.

The elevated costs of construction materials, along with limited availability, compounded the issues generally facing borrowers in obtaining debt in the current capital markets. The costs to complete the construction, coupled with the delays in getting materials and the cost of obtaining take-out financing, make the overall economics difficult for investors.

In the fourth quarter of 2022, there was a noticeable shift in focus to preparing for distressed scenarios. Borrowers and lenders alike were looking at loans with impending maturity dates and extension tests and finding ways to address likely or potential issues. Lenders also began to focus on ways to clear space on their balance sheets where possible. There is likely more of this to come as the industry stares down a large wall of maturing loans in 2023.

But the news isn't all bad.

As we enter 2023, the latest reports on inflation suggest that the worst may be behind us, and the prevailing thought is that the Federal Reserve Board will start to slow the pace of interest rate hikes, as evidenced by the small increase last month.

While financing sources are likely to remain tight, and commercial mortgage-backed security issuance is at a near-standstill, the new year brings new allocations to balance sheets. And, barring any challenging or disrupting world events or other larger-scale wrenches in the system, the general expectation is that the second half of 2023 will see increased activity in the capital markets.

Inflation data tends to lag, which in turn will impact rates, but a recent report from Marcus & Millichap's institutional property advisers division concluded that, with respect to inflation, "raw data suggests inflation is already greatly reduced, more than it is showing in current [consumer price index] figures. As the results are released, the Fed should eventually start to indicate a slowing or stopping of rate hikes, after which lending will pour back into the market in force."

So, hold on to your hats. It seems the wild ride isn't quite over yet.

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