Commercial Real Estate Market Insights

December 2023

National Association of REALTORS®
Research Group

Reflecting and predicting the year ahead

A recap of commercial real estate in 2023

In 2023, inflation and interest rates emerged as the twin pillars steering the economic landscape and, consequently, the dynamics of the commercial real estate sector. In pursuit of lower inflation, the Federal Reserve implemented multiple interest rate hikes throughout the year. One of the most direct effects of these higher interest rates was the increased cost of borrowing, affecting the profitability of new developments, the feasibility of certain projects, and the overall volume of real estate investments. As a result, for most of the year, nearly every commercial real estate market segment encountered a continuous rise in vacancy rates and a deceleration in rent growth.

The **office** sector remained the most significantly affected segment within commercial real estate, enduring the biggest losses in 2023. Even with the reduction in remote work opportunities, the office sector witnessed an unprecedented surge in vacancy rates, almost reaching a pinnacle of 14%. Amid shrinking leasing velocity, net absorption has remained negative throughout 2023, with a substantial surplus of available office spaces.

With mortgage rates surpassing 7.5%, the **multifamily** segment witnessed a revival in apartment demand in the second half of the year following a nearly year-long slowdown. However, due to the construction boom, vacancy rates continued their upward trajectory, reaching 7.4% and consequently reducing rent growth to 0.6% at the end of the year. Nevertheless, even though slower, rent prices kept rising from the previous year.

Slower rent growth has also been observed in the **retail** sector. However, notwithstanding the challenges posed by elevated consumer prices, this sector performed in 2023 better than pre-pandemic: rent prices rose faster, absorption of retail spaces increased, and vacancy rates remained at a 10-year low of 4.1%.

In 2023, the **industrial** sector maintained its status as the standout segment with the most robust growth among all categories within the commercial real estate market in 2023. Even though rent prices did not escalate as rapidly as they did in 2022, the cost of renting industrial spaces saw a notable increase of 6.6% compared to the previous year. But, with a 31% increase in square footage delivered over the past year, both vacancy rates and net absorption moderated even further.

Predicting the year ahead

While 2023 impacted all facets of commercial real estate, marked by an increase in vacancy rates and a deceleration in rent growth, a better year is on the horizon for commercial real estate. Although market headwinds will persist, the anticipation for 2024 is that lower interest rates will mitigate these challenges. The Federal Reserve has already paused its interest rate hikes since last July, while rate cuts will likely follow as soon as the first quarter of 2024. This could reduce cost for borrowing capital and, consequently, stimulate investments in the commercial real estate market. Thus, market activity is poised to pick up next year.

It's important to remember that the activity level will differ across sectors.

Reflecting and predicting the year ahead

Starting with the most significantly affected sector, the **office** sector, it's unfortunate that 2024 is projected to be another challenging year for this commercial real estate segment. Activity is unlikely to pick up anytime soon. Despite a reduction in the number of full-time remote employees, hybrid workplace policies are becoming a lasting feature. Consequently, office demand is expected to stay subdued, probably not reverting to pre-pandemic levels. Occupancy in 2024 is likely to decline further from the current historic lows, signaling a continued transformation of this sector and splitting office spaces into three categories: top-tier properties with modern amenities, properties requiring upgrades or conversions, and old properties that will become obsolete. But the office sector was already bifurcated even before the pandemic. The pandemic simply intensified this transformation in this segment of commercial real estate.

With a record-high number of apartment buildings under construction in 2023, rent growth will decelerate further in the **multifamily** sector as many of these units will be added to the market in 2024, thereby expanding available inventory. This is expected to bring some relief to many renters grappling with both increasing rental prices and rising borrowing costs for those looking to transition to homeownership. Currently, one in two renters is already cost-burdened, spending more than 30% of his income on rent. Nevertheless, demand in the multifamily sector will remain solid as many buyers will remain out of the market even though mortgage rates are expected to drop below 6.5% in 2024.

The **retail** sector is poised to maintain its strength in the commercial real estate market throughout 2024. Despite a projected decrease in net absorption for the year, the vacancy rate is anticipated to hold steady at around 4% due to limited supply, maintaining the sector's status with the lowest rate compared to other commercial real estate market segments. Nevertheless, performance will vary across different types of retail space. Malls will continue to underperform, undergoing additional transformations. However, neighborhood and strip centers are expected to experience steady performance, with the strongest rent growth among all types of retail spaces in 2024.

Industrial will continue to perform well in 2024. Undoubtedly, net absorption will moderate further from the pandemic highs and stabilize at pre-pandemic levels. Nevertheless, rent growth will remain strong, likely above 5%. Rent increases for warehouse and distribution spaces will be even higher, driven by the continued growth of e-commerce. While retailers must add more warehouse and distribution spaces, significantly fewer spaces are under construction.

Despite the pent-up demand for traveling and pent-up savings in the post-pandemic period, **hotel** occupancy hasn't fully rebounded to the pre-pandemic levels, and it is not expected to reach those levels in 2024 either. The outlook for 2024 remains positive, driven by stable leisure travel and stronger business, group, and international travel. But, this sector will continue to face challenges due to economic uncertainty and the shift in consumer behavior. Both the average daily rate (ADR) and revenue per room (RevPAR) growth will moderate further in 2024, while the occupancy rate will likely remain below 65%.

Economy

Job growth (compared to March 2020): 4.1%
Inflation (November 2023): 3.1%
Gross Domestic Product (GDP) Q3 2023: 5.1%

The labor market remains strong

The resilience of the job market, characterized by low unemployment and solid job growth, is considered the key factor driving the unexpectedly growing economy in 2023. Sustained job growth is essential for a vibrant economy, as it enhances consumer spending and stimulates demand for goods and services. This, in turn, fosters the expansion of businesses and generates increased demand for commercial real estate.

Despite the moderation in the labor market, it continues to exhibit remarkable strength, reaching new record highs in available jobs. Specifically, the number of available jobs rose beyond 157 million. As of November, the economy added approximately 2.8 million additional jobs to the market in 2023. Meanwhile, since March 2020, when the pandemic hit our country, the U.S. has created more than 6.1 million jobs. As a result, the unemployment rate remains below 4%, standing at 3.7%.

Number of Jobs

March 2020	**150.9 million**
November 2022	**154.3 million**
November 2023	**157.1 million**

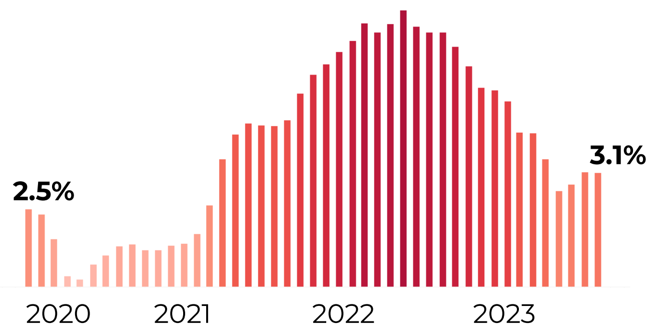
Source: NAR analysis of U.S Bureau of Labor Statistics data

Inflation continues to ease

Inflation may not have yet reached the Federal Reserve's goal of 2%, but it's considerably lower than the previous year. As of November 2023, consumer prices were 3.1% higher than the previous year. A year ago, the inflation rate stood at 7.1%.

But, the inflation rate will further ease in the following months, driven by a continued slowdown in rent growth. The National Association of REALTORS® forecasts inflation to drop to 2.7% in 2024.

Inflation



Source: NAR analysis of U.S Bureau of Labor Statistics data

The Federal Reserve will cut interest rates in 2024

The Federal Reserve's interest rate ended the year at 5.5%, marking a one percentage increase compared to the previous year. However, with rate hikes likely done, the Federal Reserve has announced its intention to initiate rate cuts next year. While interest rates set the foundation for borrowing costs, these lower interest rates are expected to stimulate investment activity in commercial real estate. The National Association of REALTORS® forecasts interest rates to fall below 4.5% by the end of next year.

The economy is growing faster than expected

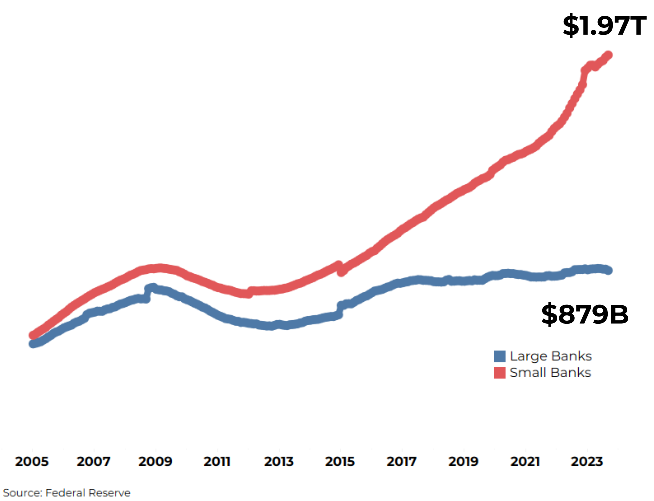
The U.S. economy was not anticipated to expand to this extent in 2023, especially following the multiple rate hikes by the Fed. Against all expectations, the economy grew more than 5% in the third quarter. Despite grappling with high interest rates and inflation, Americans maintained a persistent spending spree, contributing to the advancement of economic growth throughout 2023. The prospect of lower interest rates signals optimism for continued economic expansion in 2024.

Commercial Real Estate Lending

CRE debt is increasing

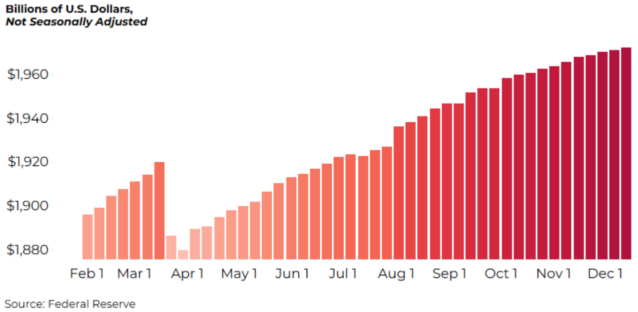
Despite reports of more stringent lending standards, commercial real estate debt continues to grow. In fact, the CRE debt is currently larger than the levels observed before the collapse of the two regional banks. In April, the CRE debt of small domestically chartered commercial banks fell to $1.88 trillion, while it's currently at $1.97 trillion. However, for large domestically chartered banks, it seems that the volume of CRE loans is slightly lower - nearly $880 billion – than before the two regional banks collapsed.

Commercial Real Estate Debt by Bank Size



Source Federal Reserve

Commercial Real Estate Debt Small Domestically Chartered Commercial Banks-weekly data

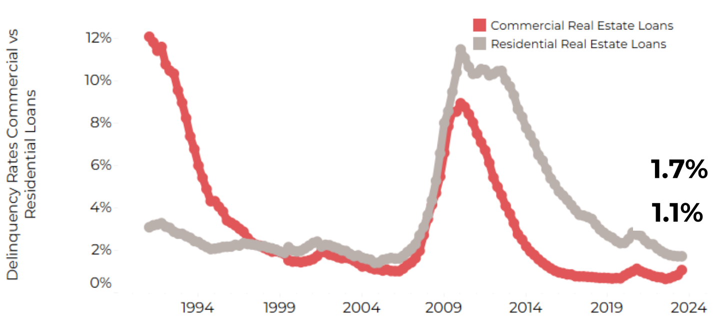


Source Federal Reserve

Increasing CRE delinquency rates but still historically low

The Federal Reserve also provides data on delinquency rates for both commercial real estate (CRE) and residential loans. According to the latest data, commercial loans consistently maintain lower delinquency rates compared to residential loans. However, while the delinquency rate for residential loans is decreasing, there has been an upward trend in delinquent commercial real estate loans since the last quarter of the previous year. Specifically, the CRE delinquency rate was 0.64% in Q3 2022, which currently stands at 1.07%. This marks the first time since 2015 (excluding the end of 2020) that the delinquency rate of CRE loans has exceeded 1%. Nonetheless, when delving into historical records, the delinquency rate for CRE loans consistently stays historically low, below 3.5%.

Delinquency rates Commercial vs Residential loans



Source Federal Reserve

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Multifamily

Absorption of units in the last 12 months: 313,416 units
Rent growth in the last 12 months: 0.6%
Cap rate: 5.8%

As 2023 draws to a close, the multifamily sector witnesses a demand surge, with a 114% year-over-year increase in 12-month absorption of units, reaching 313 thousand units and exceeding the 10-year median. However, vacancy rates have escalated to a new 10-year high at 7.4%, a 0.9% increase from last year, influenced by a 22% hike in 12-month new unit deliveries. Simultaneously, rent growth has bottomed to a 10-year low, with only a 0.6% uptick compared to 3.9% the preceding year. The simultaneous occurrence of robust absorption and increasing vacancies indicates a market in transition, adapting to the influx of new units into the market.

In major urban hubs like New York, NY, Washington, DC, Houston, and Dallas-Fort Worth, TX, there continues to be a robust demand for apartments. Over the past 12 months, ending in November, these areas have absorbed over 10,000 multifamily units. While higher mortgage rates have curtailed the purchasing power of many potential buyers, the rental market in numerous high-cost areas throughout the country is anticipated to maintain its strength.

While rent growth deceleration is evident in many parts of the country, the Northeast is bucking the trend, with cities like Providence, RI, Rochester, NY, and Syracuse, NY, all experiencing rent growth above 5%. Rockford, IL, and Anchorage, AK, stand out nationally with some of the highest rent increases. Despite these growth areas, certain markets are witnessing a downturn. Austin, TX, alongside Fort Myers and Ocala, FL, continue to see significant rent reductions, with declines of over 5% year-over-year.

Top 10 areas with fastest rent growth

	2023 Q4	2022 Q4
Rockford, IL	6.67%	6.14%
Providence, RI	5.52%	5.38%
Anchorage, AK	5.42%	7.71%
Rochester, NY	5.23%	5.69%
Kingsport, TN	5.12%	12.52%
Syracuse, NY	5.03%	6.41%
Huntington, WV	4.65%	2.32%
Lexington, KY	4.63%	7.32%
Worcester, MA	4.61%	5.03%
Springfield, MA	4.54%	5.89%

Top 10 areas with the strongest 12-month absorption

	2023 Q4	2022 Q4
New York, NY	18,992	27,254
Houston, TX	12,880	970
Dallas-Fort Worth, TX	11,925	2,949
Washington, DC	11,543	8,571
Austin, TX	9,684	6,650
Phoenix, AZ	9,487	2,924
Minneapolis, MN	8,943	7,038
Denver, CO	7,618	7,701
Charlotte, NC	7,460	3,626
Chicago, IL	7,402	7,565

Source: NAR analysis of CoStar data

Office

Net absorption in the last 12 months: -62.8 million sq.ft.
Rent growth in the last 12 months: 0.7%
Cap rate: 8.2%

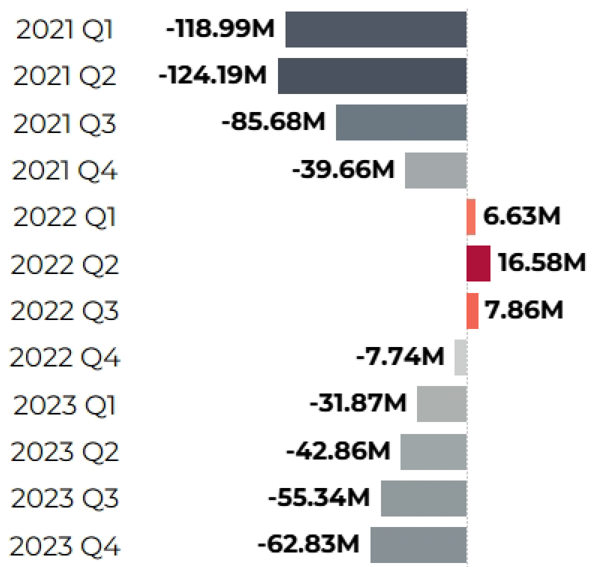
With the shift towards hybrid work arrangements becoming more prevalent, the demand for office spaces continues to fall. For the last year, the amount of unused office space is larger than that of newly occupied spaces.

Over the past 12 months, ending in November, net absorption rate fell by 13.5% compared to the preceding quarter, leading to a slight increase in vacancy rates of 0.2%, which culminated in a record peak vacancy rate of 13.5%.

On a local scale, the major rise in vacancy rates occurred in prominent technology centers such as San Francisco, Houston, Dallas-Fort Worth, Austin, and Washington, DC. This shift was driven by relocating numerous companies and individuals to more cost-effective regions.

In contrast, metropolitan areas exhibit favorable vacancy rates in the Southern region. Savannah, GA, and Wilmington, NC, are leading the pack, having vacancy rates under 2%.

12-month Net Absorption in sq. ft



Top 10 areas with the largest vacancy rates

	2023 Q4	2022 Q4
San Francisco, CA	21.46%	16.42%
Houston, TX	18.74%	18.37%
Dallas-Fort Wort..	17.98%	17.16%
Austin, TX	16.70%	13.90%
Washington, DC	16.51%	15.69%
Denver, CO	16.49%	14.62%
Chicago, IL	16.22%	15.20%
Phoenix, AZ	16.07%	14.71%
Los Angeles, CA	15.44%	14.33%
Atlanta, GA	15.24%	13.88%

Top 10 areas with the lowest vacancy rates

	2023 Q4	2022 Q4
Savannah, GA	1.59%	2.18%
Wilmington, NC	1.76%	1.98%
Hickory, NC	2.08%	2.98%
Huntington, WV	2.09%	1.92%
Olympia, WA	2.25%	2.21%
Pensacola, FL	2.27%	2.33%
Myrtle Beach, SC	2.28%	2.05%
Davenport, IA	2.30%	3.19%
Asheville, NC	2.44%	2.58%
Gulfport-Biloxi, MS	2.47%	3.17%

Source: NAR analysis of CoStar data

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Industrial

Net absorption in the last 12 months: 178.3 million sq. ft.
Rent growth in the last 12 months: 6.6%
Cap rate: 7.0%

The Industrial sector is witnessing a shift, with year-over-year net absorption down 57% to 178.3 million square feet, coupled with a record-high net delivery increase of 28% from the previous year. These two factors have contributed to a rise in the vacancy rate to 5.5%, up from 3.9% a year ago, and a tempering of rent growth to 6.6% year-over-year, a decrease from the previous 10.8% a year ago. Despite this deceleration, the industrial sector still boasts the strongest rent growth compared to all other commercial real estate sectors and exceeds pre-pandemic performance.

Within the industrial branch, logistics spaces lead with a 7.8% rent increase. Meanwhile, flex spaces have seen a rise of 3.9%, and specialized spaces are growing at a rate of 5.2%.

Dallas-Fort Worth, TX, had the largest absorption of industrial space in the past 12 months. Chicago, IL, Houston, TX, and Phoenix, AZ, absorbed more than 14 million square feet over the past 12 months, ending in November 2023.

In contrast, Los Angeles, CA, is experiencing negative net absorption as more industrial spaces are available for lease than occupied. After seeing strong demand in early 2022, market momentum has moderated as vacancy levels have slightly increased. However, Los Angeles continues to have a vacancy rate of 4.2%, which is below the national average of 5.5%.

Furthermore, cities like Orlando and Fort Lauderdale, FL; Charlotte, NC; and Phoenix, AZ, saw the most significant increases in rent. In these locations, industrial space rents have surged more than 11 percent from the previous year, driven by the unwavering demand for warehouse areas.

Top 10 areas with the strongest 12-month absorption

	2023 Q4	2022 Q4
Dallas-Fort Worth, TX	32.67M	34.50M
Chicago, IL	19.74M	33.94M
Houston, TX	19.67M	31.66M
Phoenix, AZ	14.40M	24.96M
Indianapolis, IN	9.05M	19.67M
Kansas City, MO	7.07M	15.82M
Columbus, OH	10.52M	13.72M
Savannah, GA	12.60M	10.10M
Charlotte, NC	7.22M	9.28M
Philadelphia, PA	7.55M	9.21M

Top 10 areas with the slowest 12-month absorption

	2023 Q4	2022 Q4
Los Angeles, CA	-15.15M	-2.51M
New York, NY	-4.18M	-1.87M
San Diego, CA	-2.01M	1.98M
Shreveport, LA	-1.96M	0.31M
Inland Empire, CA	-1.92M	13.49M
Seattle, WA	-1.84M	8.93M
San Francisco, CA	-1.82M	0.53M
Birmingham, AL	-1.36M	1.17M
South Bend, IN	-0.96M	1.46M
Manchester, NH	-0.96M	0.85M

Source: NAR analysis of CoStar data

Retail

Net absorption in the last 12 months: 54.7 million sq. ft.
Rent growth in the last 12 months: 3.3%
Cap rate: 6.8%

Interest in retail real estate remains strong. Even though absorption has seen a 28% decrease from the previous year, the sector is experiencing the lowest vacancy rates in a decade. Currently, at 4.1%, the retail sector holds the record for the smallest vacancy rate across all commercial real estate categories.

Focusing on retail categories, General Retail spaces and Neighborhood Centers have been instrumental, accounting for approximately 83% of the net absorption as of November 2023.

Net Absorption by type (November 2019, 2021, and 2023)

	2015 Q4	2019 Q4	2023 Q4
General Retail	56.08M	25.36M	30.84M
Mall	12.30M	-3.76M	-0.49M
Neighborhood Center	28.84M	11.43M	14.92M
Other	3.50M	0.37M	0.85M
Power Center	10.13M	2.22M	3.48M
Strip Center	8.42M	3.95M	2.90M
All	**119.28M**	**39.58M**	**52.51M**

Retail space rents continue to be high relative to the previous year, but the rate of increase has slowed, possibly due to consumer caution in the face of rising costs. The national increase in retail asking rents stands at 3.3%, a step down from the 4.4% high of the prior year, yet it remains above pre-pandemic levels.

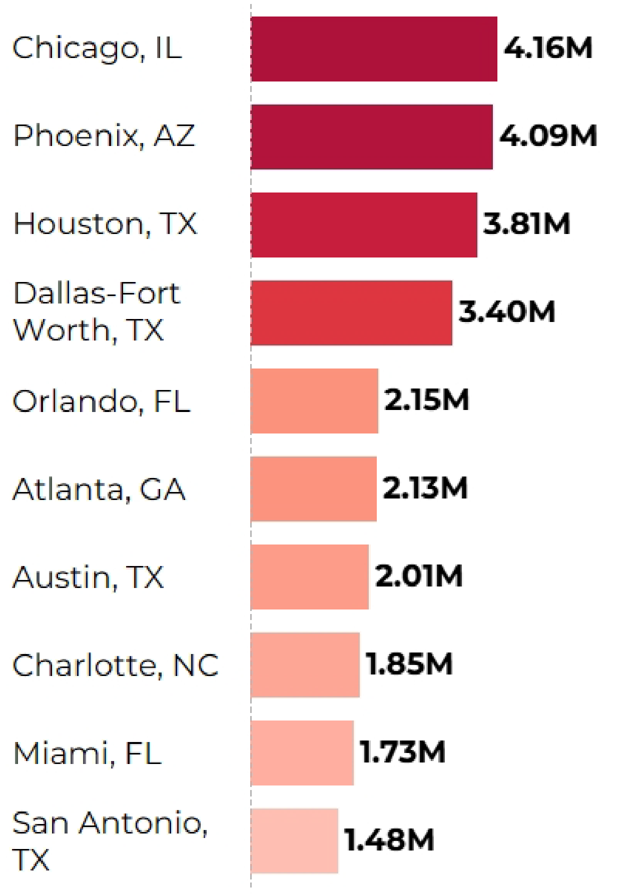
Regarding specific retail categories, Neighborhood Centers (4.2%) and Power Centers (3.9%) registered the most significant rent hikes.

In contrast, General Retail marked a modest rent growth of 2.8%, yet it retains the lowest vacancy rate of 2.5% among all retail subsectors.

Locally, Sun Belt cities, including Phoenix, AZ, Orlando, FL, and Salt Lake City, UT, are experiencing a surge in demand, with rent growth surpassing 8%.

Furthermore, the retail sector thrives in areas such as Chicago, IL; Phoenix, AZ; Houston; and Dallas-Fort Worth, TX. These locales have seen considerable net absorption, with an occupation of over 3 million square feet in the year leading up to November 2023.

Top 10 areas with the strongest net absorption in the last 12 months



Source: NAR analysis of CoStar data

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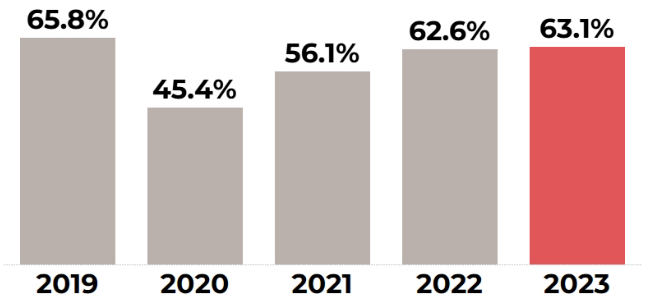
Hotel

Occupancy rate in the last 12 months: 63.1%
Average daily rate in the last 12 months: $155/room
Revenue per available room in the last 12 months: $98/room

The hospitality sector continued to advance at the end of 2023. Yet, despite gains in average daily rates and revenue per available room, hotel occupancy hasn't fully recovered back to the figures seen before the pandemic. The 12-month occupancy rate lags 2.7 percent behind the pre-pandemic benchmark.

12-month Occupancy Rate in November



Specifically, in November 2023, the average daily rate (ADR) per room rose to $155/room, up 18% from November 2019. The revenue per available room (RevPAR) also increased to $98/room, up 13% compared to the same period in 2019.

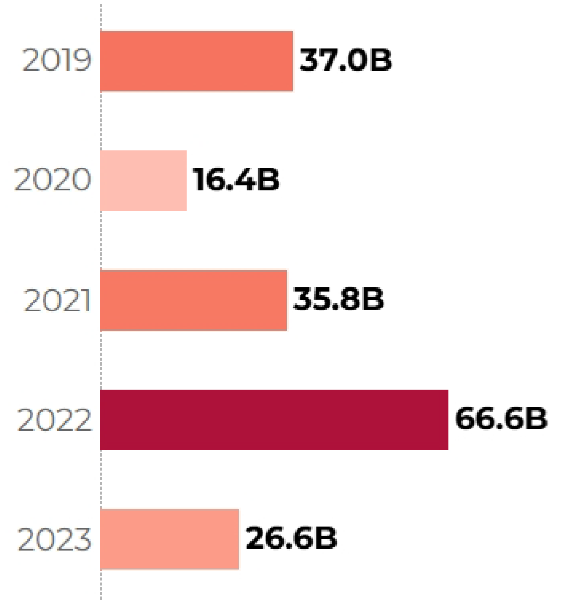
12-month ADR and RevPAR in November

	Average daily rate	Revenue per available room
2019	$131	$86
2020	$106	$48
2021	$122	$68
2022	$148	$93
2023	$155	$98

ADR is the total revenue/number of rooms.
RevPAR is ADR x occupancy rate.

Sales acquisitions have declined since the last year. In November 2023, the 12-month sales volume dropped to $26.6 billion from $66.6 billion in the previous year.

12-month Sales Volume as of November



Source: NAR analysis of CoStar data

Locally, Maui Island in Hawaii is a standout in the hospitality industry, boasting a significant ADR hike of 54% from before the pandemic. It also claims the nation's highest ADR and RevPAR, at $604 and $395, respectively. Meanwhile, New York City tops the charts as the busiest hotel hub with an occupancy rate of 81%, and Sarasota, FL, has seen an impressive 50% jump in hotel RevPAR.

On the flip side, the San Jose/Santa Cruz and San Francisco/San Mateo areas in California have not yet overcome the pandemic's impact, with their RevPAR dipping by 28% and 27%, respectively, compared to November 2019.

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