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Commercial Real Estate: Macro Risk or Investment Opportunity?

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The most common scavenger bird in the western United States is the turkey vulture, more commonly called the turkey buzzard. It is a marvel of evolution, with keen eyesight and an extraordinary sense of smell, allowing it to locate the recently deceased from miles away. Ungainly as it takes off with furious flapping, once in the air it is a majestic creature, soaring thousands of feet upwards on air thermals, with an out-spread V-shaped wing span of up to six feet. As it circles from a height, it surveys the landscape below and then plunges to feast on the remains of less

fortunate creatures.

I don’t believe in reincarnation but, if I did, I would have to say the best real estate investors were probably turkey buzzards in a previous life. And never more so than today, when the real estate landscape is littered with the victims of the seismic changes wrought by the pandemic and a sudden return to normal interest rates, following 15 years of super-easy money.

There are plenty of opportunities in commercial real estate today. However, to appreciate them, it’s important to consider why some areas are in extreme distress and others are thriving, how these trends could impact the macro economy, and which investors are best positioned to take advantage of growth areas going forward.

The Real Estate Landscape: The Impact of Two Earthquakes

Following a long and slow recovery from the Great Financial Crisis, the environment for commercial real estate appeared relatively benign at the end of the last decade. Vacancy rates had fallen to low levels across the office, retail, industrial and multi-family sectors, as we show on page 19 of our *Guide to Alternatives,* and cap rates were generally attractive relative to low-yielding Treasuries. Often good times in commercial real estate end in an orgy of over-building. However, this wasn’t the case at the end of the last decade – real non-residential construction grew at just a 1.5% annualized pace from 2014 to 2019.

The pandemic led to a temporary emptying out of offices, hotels, restaurants and retail space. However, even after health concerns waned, two lasting effects endured. First, many businesses, having adopted work-from-home measures in an emergency, found that they were actually cost effective, with home computers and Zoom calls allowing workers to avoid long commutes and promising potential savings to businesses in a reduction in required office space. There are, of course, downsides to work-from-home, and many businesses have returned to a traditional five days in the office. However, for others, a new equilibrium may be work-from-home or else a hybrid model, permanently reducing the demand for office space

while putting a premium on high-quality space that is best able to compete with home offices in attracting and retaining employees. As a result, the U.S. office sector has seen negative net absorption, that is to say, a declining quantity of occupied space, in 15 of the last 16 quarters, with older buildings being particularly badly hit[1].

Retail also saw significant changes. Online retailing has, of course, been increasing its market share since its inception in the 1990s. However, the pandemic significantly accelerated this trend. In the fourth quarter of 2019, before the pandemic, non-store retailers accounted for 14.2% of U.S. retail sales – by the first quarter of this year, that had surged to 19.8%.

This, along with a continued growth in income inequality, has put further pressure on some traditional store types, such as clothing, furniture and electronics and older retail space in general. However, relatively cautious construction activity has prevented a sharp increase in vacancy rates overall. Meanwhile, real consumer spending has been remarkably strong, rebounding far above pre-pandemic levels in 2021, growing by more than 2% over each of the last two years and on track to climb by 2.5% this year. *How* consumers are spending continues to evolve, with greater demand for services and online purchases presenting opportunities for those who can adapt to the new consumer landscape.

Demand for multi-family housing is also rising strongly. While the rental vacancy rate has risen above its post-pandemic low of 5.6%, it has remained flat at 6.6% over the past three quarters. This is the result of a surge in demand meeting a surge in supply. In the year that ended in the first quarter of 2024, the number of housing units occupied by owners climbed by 546,000 while the number of units occupied by renters rose by 907,000. The overall growth in households provides further evidence of the impact of a migrant surge over the past three years. The increasing renter share (and note that renters account for just 34% of the stock of occupied units but 62% of the growth in occupied units over the past year), reflects the impact of soaring home prices followed by higher mortgage rates - a one-two punch that has made homeownership unattainable for many families.

Even if the migrant surge at the southern border abates, the U.S. may well have strong immigration in the years ahead, as employers lobby to allow foreign workers fill vacant positions. Meanwhile, mortgage rates are unlikely to fall to pre-pandemic levels in the absence of a recession. Consequently, the demand for rental housing should remain strong, absorbing what has been a very strong supply of new units.

This should continue to present investment opportunities in the multi-family as well as single-family rental spaces, although in this area, as in all areas of commercial real estate, understanding locations and market segments is crucial.

Understanding sellers is also particularly important in real estate. Many, particularly in the office space, are in distress, having purchased at too high a price with cheap financing. As leases expire and loans come due, there are many who the real estate industry euphemistically calls "motivated sellers". While cheap financing is unlikely to return anytime soon, buyers with the ability to close deals quickly have a particular advantage in dislocated and, in places, distressed markets.

Macro Impacts and Investment Implications

It should also be recognized that the current struggles of some parts of commercial real estate have limited macroeconomic repercussions. Construction spending, including both residential and commercial, accounts for just 7.1% of GDP, compared to 9.5% at the peak of the mid-2000's housing bubble. Importantly, despite higher interest rates, there are plenty of areas of strong growth, such as multi-family housing, manufacturing facilities, warehouses, data centers and anything linked to AI.

Moreover, while the real estate casualties of the pandemic and higher interest rates will impact the market for years to come, from a macro-economic perspective, it is more of a leak than a flood. The Federal Reserve and other Washington authorities have, so far, proven very adept at quickly mopping up problems as they emerge among regional banks. In addition, in the office space, negative absorption is being accompanied by the removal of substantial space from the market, through renovations, conversions and demolition. Furthermore, rather like the scavengers in an ecosystem, the actions of real estate investors, in both where they allocate capital and where they withhold it, should gradually restore equilibrium across commercial real estate.

Even after some difficult years, commercial real estate has broad characteristics that should be attractive to both institutional and individual investors. Cap rates, on average, still exceed Treasury yields, although spreads are tight by historical standards.

Real estate can, on average, provide protection against inflation in ways that core fixed income cannot and diversify portfolios in general. There is, on average, value in some of the assets being sold by distressed sellers and growth potential in areas linked to the evolution of consumer and worker behavior.

However, investors should not settle for average real estate managers. In every asset class, there is the potential to boost or diminish returns through manager selection. However, this is much more the case in alternative assets than in public markets. This is particularly the case in commercial real estate today, where managers, burdened by the wrong properties bought at the wrong price and at the wrong time, could well continue to underperform. However, managers who have better insights into what to buy, where and from whom and who can put fresh money to work today, have a very distinct advantage in the aftermath of some very turbulent years for commercial real estate.

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