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Student Op-Ed

CAPITAL MARKET RECAP Q4 2022 QUARTERLY

By Antonio Lulli

Investment Sales

The narrative is essentially unchanged from the prior quarter. Inflation has remained at historically elevated levels and the Federal Reserve continued to tighten monetary conditions in an effort to combat it. This has caused a readjustment in the capital markets that has filtered to the reality on the ground in the commercial real estate space. As the cost of capital has gone up, so have effective capitalization rates and valuations have necessarily had to adjust downward. Further, the continued uncertainty around a terminal Federal Funds rate has caused the market to feel a degree of hesitation when deploying capital, debt or equity alike, which has caused risk premia and required returns to rise commensurately. Sellers still have not adjusted to this new dynamic, which has caused a dislocation in the investment sales market.

Retail and hospitality continue along the road to recovery, while multifamily and industrial continue to perform strongly despite a slight deceleration after their unprecedented run-up earlier in the year.

Distress is starting to become apparent in the office market, however. We have recently seen a number of prominent properties across the country having leasing issues, deeply discounted sales or defaulted loans. Many experts predict we are only seeing the beginning of this trend.

Participants are expecting improving conditions in the next few quarters, with the Fed slowing rate increases and market liquidity increasing slightly. A note of caution, however, is that Fed chair Jerome Powell has consistently insisted that the tightening cycle will remain in effect until inflation is properly tamed. With that in mind, investors should not expect an immediate return to the historically loose policy we saw until last year. Further, there remains a relatively high likelihood of economic contraction in the coming quarters, which could have an adverse effect on real estate fundamentals.

This dynamic will create a degree of distress in the market. Deals that were purchased at bloated, top-of-the-market bases and using historically cheap debt will need to face a new reality of higher rates and more conservative underwriting, and as such may need to be recapitalized, sold, or handed back to lenders. Something similar will happen with deals carrying floating rate debt and expiring rate caps, whose prices have skyrocketed beyond the reach of many. We are already beginning to see this play out, with major players such as Blackstone, RXR and Brookfield recently relinquishing trophy assets. 2023 will be a crucial year to determine the severity of the situation described above, as an unusually high volume of CMBS loans will come due in the next 12 months.

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Debt Capital Markets

As benchmark rates rose in Q4 and more broadly throughout the year, we saw a number of emerging dynamics play out.

Cost of capital has spiked and that has squeezed a portion of borrowers while dampening discretionary demand for debt capital. Transaction volumes are muted as a wide disconnect currently exists between buyers and sellers, further dampened by the increased cost of interest rate caps which is making floating rate transactions less attractive.

In most cases, borrowers only enter the market out of necessity and so extensions and restructurings are becoming more predominant. Further, as underwriting standards have become more restrictive in this uncertain environment, higher quality assets in premier markets backed by more reliable sponsors will drive the bulk of deals.

CRE CLO issuance, CMBS issuance and money center bank lending is down significantly YoY which has opened the window for higher-yield transitional capital such as mezzanine, bridge and preferred equity, or for smaller, more nimble local banks or private debt which are better able to offer customized solutions. Shorter term paper is gaining traction in the market because it offers more upside flexibility for borrowers and reduced credit risk for lenders.

Debt transaction volumes are expected to recover once interest rate uncertainty, particularly clarity around the terminal Federal Funds rate, abates and transaction velocity picks back up. In the meantime, there aren't signs of widespread distress in the market, but this could easily change if restrictive monetary policy stays in place for an extended period.

2022 Annual Recap - Investment Sales

2022 can only be described as a year of two halves. The first two quarters had very high transaction volumes as commercial real estate and the broader capital markets experienced an extended period of strong appreciation and optimism following the end of the Covid-19 pandemic. A raft of Manhattan employers stepped up their efforts to bring staff back to in-person work, causing a rush in the apartment market and historic YoY rental rate increases, further boosted by the end of pandemic-era concessions. The industrial market also saw unprecedented demand, driven by e-commerce adoption, which caused rents and valuations to rise dramatically.

Office, hotel, and retail all experienced more difficult conditions due to structural challenges which may take some time to resolve.

The second half of the year was a different story, however. As described in the quarterly analysis, persistent inflation and historically aggressive monetary tightening proved to be a strong headwind for the market, causing transaction volume to suffer as a result of valuation and funding uncertainty.