Inflation, Interest Rates & the Disruption to Commercial Real Estate

As of May 2022, the U.S. Inflation Calculator reported the annual inflation rate at 8.6%, the largest annual increase since December of 1981. Pair inflation with an uptick in interest rates, and you have one of the top disruptions to the commercial real estate industry.

Deal flow in commercial real estate is based on a refined screening process built on networking, investment standards and data analysis. With an increase in inflation due to persistent unemployment and growing demand, the commercial real estate market is impacted in several ways — development costs, labor costs, supply chain, etc.

Assessing the Commercial Real Estate Sectors

Post-pandemic had brought a promising increase in the volume of commercial real estate sales. As e-commerce continued to boom, so did the demand for industrial property. But on June 7, The Wall Street Journal published an article noting property sales at $39.4 billion in April 2022, a decrease of 16% from April 2021, and the first decline following 13 consecutive months of increases. Though we may mostly chalk that up to rising interest rates, demand is still overriding supply, and the popularity of e-commerce isn't going anywhere.

Another increasingly popular investment sector is multi-family housing. As stated by GlobeSt.com, with net demand for apartment space hitting 712,899 units over the 12-month period ending in March 2022, we saw an 8% increase from the previous high set one quarter earlier. This is 76% higher than the pre-pandemic peak in 2000. Let's consider the risk this puts on our investment criteria. When looking at the intangible value of a lease, a depreciated replacement cost today is 50 to 60% of the value an investor is paying for the property. This is forcing investors to buy on a negative expected equity in attempt to keep up with demand. However, the rise in interest rates has made it harder for families to buy homes, providing some stability to the sector.

Regardless of the downturn of sales, most commercial real estate sectors have stayed relatively steady. Businesses prepared to accept a new norm after COVID-19, but then the Great Resignation brought new expectations to light and new challenges for the office sector. And, due to the labor shortage that ensued, employers have been seeking fresh ways to attract and retain talent. With flexible and remote work now key to employee satisfaction, there's been an inevitable decline in the need for office space. Magnus Meyer, Managing Director of WSP Nordics & Continental Europe, stated, "The typical tenant will start thinking that maybe they don't need space for 100% of their employees, maybe only 75% or 60%."

Office space investment sales are forecasted to hold steady despite occupancies below the pre-pandemic average of 30%, but location plays an important role in sound commercial investing. As we continue to see a rise in retail, grocery store space and multi-family housing, populated city centers near these growing sectors will present an attractive offer to employees and employers. As for commercial developments that are yet to be built, some might wonder if we even need the additional space. This all depends on supply and demand in a specific market.

Analyzing Future Investments

With periods of high inflation being relatively rare in the industry, commercial real estate has a variety of protections against inflation across its asset classes and sectors. So, when deciding if it's a good time to buy, consider your purchase as a long-term investment. With many unknowns to come, investors may have to adjust their return expectations. However, with deal flow at an all-time high, you can lock in attractive opportunities, decrease market disruptions and seek out the best investments.

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