What Factors Drive Market Trends in Commercial Real Estate?

By Rose Morrison, Writer & Managing Editor, Renovated February 27, 2024

The relationship between supply and demand ultimately determines property prices, rents, and yields. However, you must understand how economic conditions, government policies, demographics and other forces influence this universal law to make commercial real estate (CRE) trends work in your favor. Familiarize yourself with these six market drivers.

1. Economic Conditions

The sentiments of local business owners are reliable indicators of how hot or cold real estate markets are. Entrepreneurs are generally level-headed — they study employment, population and other economic data to assess corporate environments and forecast which types of CRE will be profitable.

Note when chambers of commerce are optimistic or pessimistic toward particular local, regional, state, and national economic sectors. Their rosy or bleak outlooks can tell you how rewarding or unprofitable your prospective investments will be.

2. Government Policies

Authorities can create demand for real estate and limit supply through legislation. State and local governments enact zoning laws, defining land use rules within their jurisdictions. Commercial zoning ordinances tend to be stricter than residential ones. Investing in a less accommodating area can be resource-intensive since there are usually more hoops to jump through.

In many cases, a small group of voters overwhelmingly influence local policymaking. For instance, NIMBYism has significantly contributed to California's housing crisis. The anti-growth homeowners tend to be older and wealthier than the state's population. Over the years, they've successfully opposed multi-family developments in their backyards to preserve their neighborhoods' character and their properties' values — even if others have to pay rising rents due to low housing inventory.

Moreover, the federal government can push or subsidize development projects, generating interest in specific property types. The Biden Administration's decision to fund the construction of seven regional clean hydrogen hubs is an excellent example. It states the Department of Energy choice to host these energy facilities will likely create a CRE boom for a long time since clean hydrogen is renewable and may be the answer to the country's energy security.

State rules can also present unique challenges to investors. For example, buying real estate in a non-disclosure jurisdiction involves various surprising risks, including limited access to property sales data, market analysis inconsistency and legal disputes. Relying on local expertise more is necessary to contend with the uncertainties non-disclosure markets bring.

3. Innovations

Technological disruptions regularly alter the real estate landscape. Airbnb has shaken up the hospitality industry. Mobile access control systems have neutralized package theft in multi-family structures, while biometric smart locks have promoted apartment security. Internet of Things devices have boosted property energy efficiency and improved building maintenance. Big data analytics has resulted in more reliable credit risk assessments.

Some innovations are more game-changing than others, but each has the potential to make specific properties more sought-after, valuable and marketable. At the same time, every disruption can render some CRE assets obsolete.

Look at what happened to retail real estate when online shopping became mainstream — once-bustling shopping malls are now on the brink of extinction. Some get sold for about 18 cents on the dollar, representing a massive decline in value in 10 years.

Meanwhile, the U.S. is leading the global storage and warehouse leasing market growth, which may expand at a CAGR of 7.17% from 2022 to 2027 and be worth more than $91 billion. E-commerce giants like Amazon have converted empty malls into distribution centers and warehouses.

4. Demographic Shifts

CRE markets change when the balance of people participating in them shifts. Boomers are less influential than they used to be because many of them have entered retirement. Millennials account for most of today's labor force. However, Gen Zers will eventually gain control over real estate markets since they outnumber their older generational cohort.

Generations uphold distinct values and deal with unique problems. The dominant group naturally dictates trends and establishes norms. For example, yearly existing home sales in the United States have remained below $6.52 million since millennials took over the property market.

Housing has been unaffordable for these adults because of enormous student loan debt, expensive rents and fast-rising home prices. Although they're now owner-majority, they've given landlords business longer than their parents and grandparents did in their day.

Race and ethnicity are just as impactful as age. Locations with the most foreign-born residents become melting pots, generating CRE investment opportunities like international restaurants that may be less commercially viable elsewhere.

5. Borrowing Costs

Taking out loans with low interest means money is cheap, whereas using leverage comes with more risk than reward when the central bank is curbing inflation. CRE is capital-intensive, so less cash usually changes hands when the cost of debt is high. Investors with dry powder are better positioned to acquire new assets, whereas existing borrowers may find refinancing difficult. Such a condition can lead to defaults, foreclosures and financial losses, rendering underperforming properties even less attractive to lenders.

Furthermore, tighter access to credit can drive up borrowing costs. Bank turmoil compels traditional lenders to be more cautious and reduce their exposure to riskier assets. This situation opens the door for other CRE lending market participants to pick up the slack and extend credit to desperate refinancers for less favorable deals. For example, industry observers expect life insurance companies to fill the void regional banks left and address the urgent funding needs of CRE borrowers, especially office building owners plagued by years of distressing vacancy rates.

6. Black Swan Events

High-impact events are often impossible to predict but can have lingering effects. The COVID-19 outbreak fits this description better than anything in recent memory. It paved the way for telecommuting to become more socially acceptable and has normalized hybrid work arrangements. The average office space occupancy rate is just below 50% — a far cry from the nearly 100% pre-pandemic level.

Current tenants have resorted to subleasing, nearly doubling subleased office space availability from Q1 2020 to Q3 2023. Office tenants may renew their contracts for less space and money, hurting building owners' revenues in the long run.

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Keep Your Finger on the Pulse of CRE

CRE is ever-evolving. Prevailing trends can last for decades, although any of the above factors can suddenly upend the industry. Pay attention to all market drivers to navigate the tricky world of CRE as an investor or a tenant.

Rose Morrison is a residential and commerical real estate writer and the managing editor of Renovated. To see more of her work visit: https://renovated.com/

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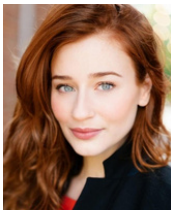

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