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The Heat Is Off? Recession-Related Valuation Drops Could Douse Overheated Markets

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With a likely recession on the horizon, property owners across the U.S. are preparing for the drop in property values that tends to accompany economic downturns, but some property types can anticipate a harder hit than others.

Property types responded differently to pandemic-era market shifts, causing some to shoot up in value at a supercharged pace while others languished. But now, faced with a recession, the playing field could be leveled.

Unsplash/Tina Rolf
Real estate values are headed for a cooldown in the event of a recession.

"Broadly speaking, all real estate valuations are likely to come down in the coming months, since there is little doubt that interest rates will continue to rise, perhaps substantially," Reveille Hospitality Chief Investment Officer Marco Roca Jr. said.

But how much values drop, and what it means when they do, is not so easily generalized.

For instance, the two darling property types of recent years, industrial and multifamily, could be in for a correction that will turn down the temperature on overheated markets for those property types.

Industrial will drop from its pre-recession valuation highs by 14.1% and multifamily will be down 12.2% next year, Cushman & Wakefield predicted in its latest economic forecast.

For industrial, a drop in valuation is a strong possibility because the market has been so hot for so long that some kind of correction is in order.

"Industrial has been red-hot now for years, with record cap rates and record values," Partner Valuation Advisors Senior Managing Director Eric Enloe said. "Now I'm seeing a bit of a flight to quality for industrial. There are still big numbers being paid, but buyers are really looking hard at those cap rates, especially since borrowing costs have increased."

How a recession impacts individual space users could also be a factor in driving industrial valuations down, Enloe said.

"For industrial, valuation really depends where and how companies will continue to grow their logistics networks — do they still want to expand?" Enloe said. "A recession would definitely not be a good thing when it comes to expansion."

Meanwhile, retail — the values of which have already taken a beating — will lose only 1.8%, according to Cushman.

Perhaps the least predictable is what awaits office properties. Cushman & Wakefield projects office values will drop 12.1% next year, while other reports note that the slide in valuation is already well under way.

An analysis by the Business Journals found a net total of nearly $6.9B in property value has evaporated across 460 office properties that secure debt in CMBS loan portfolios since August 2021. Reaching back to the pandemic's beginning raises that figure to $8.5B in property value lost among 652 offices in CMBS portfolios.

Until there's clarity on how much space companies need, there will continue to be a spread between what buyers think a large multi-tenant office building is worth and what sellers think they're worth, Enloe said.

Other experts are more sanguine about the strength of office as an asset class.

"In the U.S., the worst really seems to be behind us," CBRE Head of Office Research, Americas Jessica Morin said during a recent CBRE podcast. "Over the past three quarters, we have seen that move-ins have actually exceeded move-outs. Vacancies are starting to stabilize, although they reached that nearly 30-year high, and asking rents are starting to moderately rise."
As for multifamily, Apartment List Senior Research Associate Rob Warnock said there isn't much hard evidence yet to predict what is going to happen to multifamily property values in a recession.

"The multifamily apartment market is still looking strong," Warnock said. "Although rent growth is slowing, rents are continuing to rise, suggesting that near-term revenue streams are solid."

While rising interest rates have tempered construction in the single-family sector, multifamily construction hasn't slumped, signaling longer-term optimism within the industry that apartments are still a good investment, Warnock said.

"Rising interest rates and inflationary price increases will spark a recalibration over the next six to 12 months," Kaplan Residential President Morris Kaplan said, but added that there are still deep pockets in CRE and deals are still being aggressively pursued, so a correction — at least for multifamily — might actually bring a sense of normalcy to the industry.

For multifamily developers, he said, construction prices are beginning to stabilize, which will also be a positive for the industry going forward.

"This cycle restart will put us in better-controlled conditions for the future," Kaplan said.

Unsplash/Alexander Popov
Economists say a recession is increasingly likely, threatening property values.

Cushman's forecast predicts there is a 50% chance the U.S. economy will enter a mild recession during Q4 2022, or perhaps the first quarter of next year. A mild recession, in this context, means no GDP growth in 2023, a loss of 1.4 million jobs during that year, and relatively high inflation (3.9% for the year) cutting into consumer and corporate spending power, according to the firm.

In a mild recession, the company predicts, all U.S. commercial property values will drop an average 11.2%, but will resume modest growth (2.6%) the next year.

A relatively short dip, in other words.

The report also predicts a 30% chance of a "soft landing," which is a slowdown without a recession. Much less likely (5% each), according to Cushman & Wakefield, is no slowdown at all, or a period of 1970s-style stagflation.
Other economists are predicting a recession as well. The Conference Board, for example, forecasts that economic weakness will intensify throughout the U.S. economy in the second half of 2022, while Fannie Mae now expects a modest recession to begin in Q1 2023 as opposed to its previous expectation of the latter half of 2023.

Although valuation changes will vary by property type, the likely drops across the board will create ripple effects for other segments of the CRE market, such as REITs and capital markets.

In the periods leading up to previous recessions (with one exception), REITs have experienced significant losses in returns, according to Cushman.

In 1973, for example, the drop in total returns was 34.5% peak-to-trough, and in 1990, the drop was 23.9%. The big kahuna among lost returns, however, was the Great Financial Crisis of 2008, with a decline of 68.3%, while the dot-com recession was the exception, according to Cushman & Wakefield.

That year, returns rose 17.8%, since that recession was short-lived, and at the time the REIT market was recovering from a contraction that began in 1997.

Cushman & Wakefield also predicts that in a mild recession, cap rates will increase across property types, most acutely this year and during all of 2023. Industrial and multifamily are forecast to see the largest increase in cap rates, something of a mirror to the significant compression they experienced during 2020 and 2021.

Higher interest rates and tighter lending will likely slow transaction volume and depress prices, but Location Ventures CEO Rishi Kapoor posits that any such correction will be healthy for long-term growth of the industry. His company holds a $3.5B residential and commercial portfolio.

"Both factors work toward stabilizing what has been record-breaking and rather unsustainable transaction volume and pricing," Kapoor said. "We enjoyed it, but always knew the tide would recede, meaning a re-evaluation of deals, and whether placing more equity on the table to close a transaction is worthwhile."

Lower prices will also represent a fresh jumping-in point for opportunistic investors ahead of the next phase of growth, Kapoor said.

“While not fully insulated from the recent macro headwinds adding downward pressure to valuations, as an asset class commercial real estate still has sound fundamentals and healthy performance," Altus Group President, Analytics Americas Rick Kalvoda said. "That should provide some valuation support."

Commercial real estate asset values continue to be driven by local market economic activity, property sector trends and property-level performance, Kalvoda added.

"That said, if the current macroeconomic concerns do materialize and negatively affect local markets, then we might see more downward pressure on commercial real estate values," he said.

Among the macroeconomic trends to watch is the rising cost of capital, which will factor into property values. While capital is more expensive than it has been for many years, and probably won't get cheaper any time soon, the impact of rising interest rates on CRE values isn't necessarily straightforward, Enloe said.

"The cost of borrowing has gone up, and so the returns necessary to make the investment work have also gone up," Enloe said. "That means there's pressure on cap rates."

On the other hand, he said, the market is still flush with capital — the same capital funneled into CRE in recent years, driving prices upward.

"That kind of negates some of the interest rate pressure," Enloe said.

Even so, a lot of CRE is sensitive to interest rate hikes, which will be a headwind to the market in the post-pandemic era, DGIM Law founding partner Daniel Gielchinsky said.

Certain areas of the country and sectors will be more insulated than others, so evidence of a sweeping correction is hard to find, said Gielchinsky, whose specialty is real estate.

"I see an uptick in certain classes feeling the heat from lowering investment volume, reduced lending activity, higher interest rates and souring deals," he said.

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