Top Ten CRE Predictions for 2023

Cap rates will increase and in the case of multifamily and industrial they will increase significantly.

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2022 has been a tumultuous year for the CRE industry and more volatility is expected in 2023. Below are my Top Ten CRE Predictions for 2023.

Short-term interest rates will increase by at least 1.0%

The Federal Reserve will continue to increase the federal funds rate even after the latest .50% increase at the Fed meeting on 12/14/22, from its current 4.25% to 4.5%-5.0% by the summer of 2023. This will create more havoc in the CRE industry as funding costs and cap rates will increase substantially.

Capitalization rates will increase by 1.0% to 2.0%

As the Fed increases short-term interest rates, cap rates for CRE deals will continue to rise with the increase in short-term interest rates and the average cap rate for all properties will rise to 7.0%+ from 5.5%. Many investors are buying and developing new projects with negative leverage which is very risky and if future rent increases are lower than projected, will result in lost equity.

Cap rates for apartment and industrial properties will increase significantly

Cap rates for the two hottest CRE sectors during the last five years will increase substantially from 3.0%-4.0% to 5.5% to 6.5%+. The projected growth in rents for these two sectors will decline substantially, which will force higher cap rates on sellers.

The bid-ask spread for CRE property sales will begin to narrow

The bid-ask spread for CRE acquisitions is currently wider than the Grand Canyon, with sellers seeking cap rates of 4.0% to 6.0% and buyers offering cap rates of 6.0% to 7.0%+. However, the bid-ask spread will narrow significantly as sellers become more realistic regarding property values. This will lead to more transaction activity in 2023.

Hotels will be the most favored investment

The hotel industry which was decimated in 2020 and 2021 by the Covid pandemic is beginning to turn around with very positive fundamentals and will be the favorite CRE investment next year. Many hotels were sold in 2021 at 60% on the pre-pandemic dollar and there are still discounts in the sector. There is a huge pent-up demand for both business and leisure travel and since hotels have one-night leases, they are the best protection against higher inflation.

There will be a sizable increase in CRE defaults and foreclosures

Higher interest rates and a slowing economy or recession will cause a sizeable increase in CRE defaults and foreclosures. This will depend on how aggressive the Federal Reserve is in increasing short-term interest rates. There are many properties that are overleveraged and with a slowing economy, will see substantial vacancy increases that will lead to higher foreclosures and defaults. Investors should begin raising capital for distressed and workout funds.

The sunbelt states will continue to attract the majority of CRE capital

The high-growth, low-tax, Sunbelt states like Florida, Tennessee, Texas, Nevada, North Carolina, Arizona, Georgia, and others will see much higher CRE investment than the high-cost and high-tax states. Investors and lenders see less risk and are more comfortable investing and lending in these locales.

Office investments and valuations in the gateway cities will continue to decline

Office building investment and development in the gateway cities of New York, Chicago, Los Angeles, San Francisco, Seattle, Oakland, Portland, and Atlanta will continue to see a dearth of new investment and capital due to their high crime rates and low quality of life. Office utilization in these markets will also continue to be soft at less than 50%.

Industrial rents will decline more than 10%

The booming industrial market where cap rates compressed to below 4.0% and average asking rents increased about 50% over the last seven years will see rent levels declining over 10%. Higher interest rates and inflation has curtailed the purchase of goods by consumers and the development of over 700 million square feet of new space will soften rents nationally. Some of the hottest markets in the last few years like the Inland Empire, Orange County, San Francisco, and Miami will lead to falling asking rents.

The single-family rental market will see reduced rents and higher lease defaults

The single-family rental market, which has boomed in the last few years with double-digit annual rent increases and 95%+ occupancies, will see lower or flat rent increases and vacancies and lease defaults will rise. A sizable portion of the tenancy have low credit ratings and when the economy tips into recession, these tenants will be more prone to lose their jobs and default on their lease contracts.