



# Are We Heading Toward a Recession—and Is Commercial Real Estate Ready?

What commercial property professionals should know as they finalize their 2023 budgets.

*By John Salustri*

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## **THE OVERVIEW**

These are tricky times for market clarity. We are still shaking the remnants of COVID-19 from our collective boots, even if it no longer dominates the news cycle. We are simultaneously dealing with a looming recessionary threat fueled in large part by such issues as a hobbled supply chain and geopolitical conflicts, all of which are contributing to the rising costs of goods and services.

But two “ifs” arise. If the U.S. does, indeed, slip into a recession, and if that recession follows patterns of past downturns, building owners may divert capital previously earmarked for acquisitions into enhancing the value of their existing buildings. That diversion of capital would bode well for property managers and industry service providers, especially while the race is on to attract workers back into the office.




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Those are two big “ifs,” but assuming they do not materialize, the news is still positive. At this point, the consensus from economists, building owners and commercial real estate analysts points to a mild recession and a soft landing, bringing its promise of price correction. Plus, there is still an impressive amount of capital chasing real estate deals, according to the experts. In addition, overall industry fundamentals remain strong for investors, even if some sectors, such as retail, are weaker than others.

Meanwhile, property managers must keep moving forward, meeting the needs of their owner constituents through exemplary service to their tenants. In pursuit of those goals, they are currently finalizing their 2023 budgets, a tricky proposition, given the new pricing changes and the lack of workable base years since the start of the pandemic.

Of course, short and shallow as a recession might be, forces beyond the control of commercial real estate practitioners are not making the path forward any clearer. In the past few months, residential brokerages Redfin and Compass both reported major layoffs. Citing its most recent earnings call, there are reports that CBRE is following suit, with head-count reductions as the major component of a \$400 million cost-cutback plan. Murmurs of similar cutbacks at JLL, Cushman & Wakefield and Newmark are being discussed with these firms slated to report their earnings later this year.

Yes, deteriorating economic conditions, despite depth or duration, are being taken more seriously right now. It is ironic that, no sooner does COVID-19 begin to fade in urgency that another challenge emerges. So, what can commercial real estate do to prepare itself for a multitude of potential economic outcomes in the months to come?



**“Tenants are always looking for landlords and managers to keep costs down. But at the same time, they need to incentivize their employees to come back into the office.”**

— Coleen Spratt, Spratt Asset Advisory Services



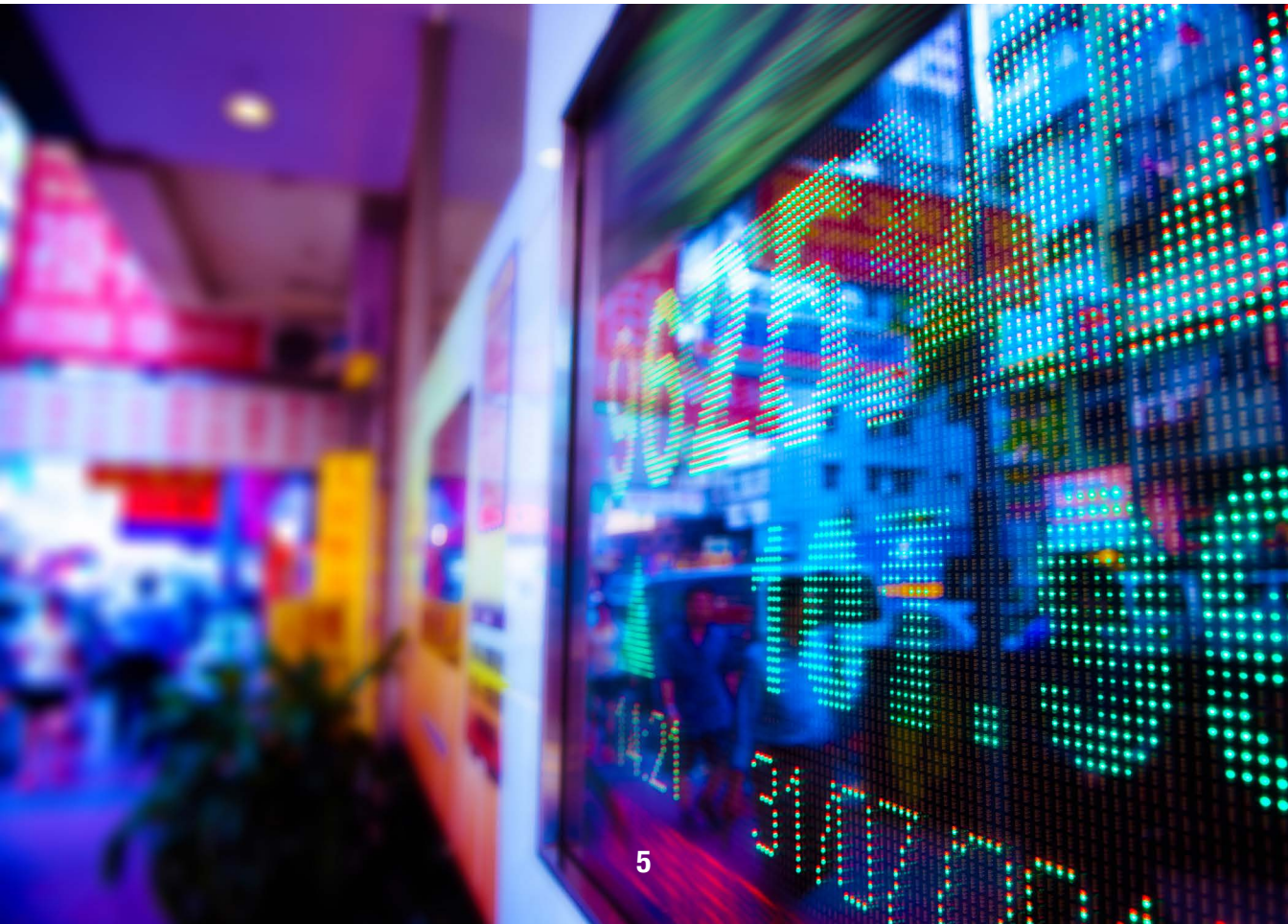
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## ECONOMY BY THE NUMBERS

One measure that the pandemic is no longer the major headline comes from the recent 2022 *BOMA International COVID-19 Commercial Real Estate Impact Study*. This final study in the three-part series, done in conjunction with Brightline Strategies and Yardi, surveyed more than 1,200 office space decisionmakers and influencers and found that economic conditions now overshadow pandemic concerns. While COVID-19 issues are still with us (and dominate for 73% of the corporate tenants polled), inflation and the cost of doing business were top of mind for 83%, and the supply chain was more worrisome for 80%.

No wonder. “We’ve seen GDP growth come in slightly negative for two quarters,” says Cushman & Wakefield Senior Economist James Bohnaker. And while that is not the technical definition of a recession, it certainly is “a lot weaker than we would have expected at the beginning of the year.”

Add to this the highest inflation rate in roughly 40 years, ongoing supply chain problems, rapidly rising interest rates and Russia’s invasion of Ukraine, and you have what Bohnaker describes as “a definitely choppier environment.” All of these factors stand to differentiate this expected recession from past downturns. (See “*A Recession Like No Other?*” Page 17.)



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“Something is coming for sure,” says one property manager we spoke with. He cites the interest rates, which after a 0.75% hike by the Federal Reserve Board in mid-September—it’s fifth this year—is now at 3.25%, the highest rate since 2008. This, of course, is the Fed’s ongoing effort to tamp down inflation, which at the end of August rose to 8.3% year over year. And while it has moderated somewhat recently, raising some speculation that it may have peaked, inflation remains at a four-decade high.

Not surprisingly, these statistics are common knowledge throughout the commercial real estate industry. “Fluctuations in rates are complicating the financing process for both balance sheet and non-balance sheet lenders,” says Marcus & Millichap, “prompting greater caution on underwriting.” The firm goes on to predict more hurdles for investors closing transactions, “although trading velocity was still historically elevated across most property types at midyear.”

Just as the pandemic was a global phenomenon, so too is the current economic uncertainty. “There’s capital that needs to be put to work, but there’s this countervailing force of recessionary fears,” says Gunnar Branson, CEO of the Association of Foreign Investors in Real Estate (AFIRE). The group’s annual survey reveals that its members expect some sort of downturn over the next 18 months.

“But that’s a shifting target,” Branson says. “Europe will be in worse shape as we get into winter due to a lot of forces, including the Russia-Ukraine war. Of course, real estate as we know it is an asset people use to hedge against inflation. But there is also a general aversion to risk, and we’re all trying to figure out what that risk is.”

Property managers are also feeling the pinch. “It’s been tough trying to manage operating expenses as goods and services become more expensive and harder to get,” says one source. “On one hand, we’re certainly not in the same position we were two years ago when we were wondering where all the toilet paper for our buildings would come from.” But the current extended time and cost remain troublesome. “And everybody’s feeling it.”

But this would be a recession like no other also because of all the good news, at least from a macroeconomic standpoint. Bohnaker lists “arguably the best labor market we’ve seen in 50 years” with both near-record-low unemployment—3.7% currently—and record job openings. Plus, wages are rising. He adds to that the strong fundamentals of most real estate asset classes.

Cushman & Wakefield suggests four possible recessionary outcomes: (1) a soft landing, (2) an upside scenario, with no further deepening of recessionary fears (3) a mild recession and (4) stagflation. For the record, the firm’s formal stance is for scenario 3—a mild downturn.

Assuming that stance is correct, values for office, which dipped this year, will dip again in 2023 by 12.1% and rise slowly until 2026, says the firm, when they will grow by 1.3%. By comparison, while both industrial and multifamily sectors are expected to dip next year—due to their rapid COVID-19 runup—by 2026, they will rise 9.3% and 4.3%, respectively. Retail will suffer a small hit next year and gain 3.6% by 2026.

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What does the rental rate picture look like as we shift from the COVID-19 pandemic to inflationary concerns? “After a full year of growth,” reports JLL, “effective rents for CBD Class A space fell by 1.9% in Q2.” This remains below 6% of pre-pandemic levels. “Substantial improvements in activity will need to take place for this dynamic to shift.”

That 78% of the corporate decisionmakers who took the BOMA International survey feel comfortable about returning to the office bodes well for that improved activity, as does the 76% of their employees who feel the same. And there has also been a 36% year-over-year spike in the recognition of the office as vital to running a business—up to 86% of all tenant decision-makers.

On the other hand, while 36% of respondents would expand or hold when their leases come up for renewal, 61% would reduce space, underscoring the uncertainty that pervades the market.

And that uncertainty will put pressure on property managers—and their 2023 budgets.



**“Cost control is always on the shoulders of property managers, whether we’re in a stabilized environment or a rising-cost environment.”**

— Cary M. Fronstin, Foundry Commercial



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## THE BATTLE OF THE BUDGET

Budget season brings its own set of challenges to property managers attempting to align tenant and building needs with shifting cost issues. Those challenges are complicated by two years of wildly different expense and revenue scenarios, leaving little more than a toehold on which to build budget projections.

“This cycle is definitely different, with so many factors playing into it and exacerbating the issue,” says one property manager, “from COVID to the war in Ukraine, which disrupted the supply chain and drove prices up.”

How much? Construction costs have jumped 20% from January 2021 to the same time this year, according to the Associated General Contractors of America. But it is not construction materials alone.

One property manager reports being hit with a 12% rate hike from the local utility company, while another says custodial costs will rise 30%. “They used to give us a heads up for a 2% increase. Now it’s 30%, and there’s no heads up.” It should be noted, however, that such experiences are market-specific.

Given the anomaly of building performance over the past two years, finding a base year on which to build a 2023 budget is a puzzle. “We’ve been struggling with this on several different levels,” says one contributor, who points to 2019 as the last “normal year” for budgetary purposes. “But conditions are different now. And given hybrid work strategies, we’re not sure of occupancies.”

Care has to be taken as well with the costs that will be passed through to tenants since, as the BOMA International survey revealed, they too are dealing with their own economic pressures and are in serious reevaluation mode.

More than one property manager tracks the rise in turnkey space demands and the expectation that owners will absorb tenant improvement (TI) costs in their entirety. “They’re pushing back on TI allowances, which are higher than previous years by a wide margin. We’re seeing more turnkey buildouts than I’ve ever seen in my career.”

What is a landlord’s typical response? “They foot the bill 100%,” he says, “because there’s not a lot of transaction volume out there now.”

In fairness, not all tenants are so demanding. For instance, some will actually opt for a painted wall rather than a “fancy wood treatment in order to keep their expenses down,” says one contributor.

Then we have the issue of expense caps. Leases written a few years ago might carry a cap on expenses of, say, 5%. But operating expenses today are not where they were in 2020—especially now that more people are in the office. Maybe, she suggests, it is time to rethink our leasing language.

“Occupancy has always been based on square footage,” she says. “It’s not like that anymore. We might have to change lease language to focus instead on employee occupancy.”

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“We have owners who look at operating costs and tell us not to do anything,” says one property manager. “Or they start taking away some of the things we need to do to keep a healthy, functioning building. I get it from a money standpoint, but those are tenant costs, and they’ll hurt us in the long run when tenants compare this building to the one across the street.”

He is not alone. “It’s all about curb appeal,” agrees a colleague. “The tenant experience is definitely a priority with our clients. Everyone’s competing for deals, and the flight to quality remains.”


We should note that such uncertainty is also forcing certain investors to shift their plans, often focusing more on diversification to reap the benefits of safe-haven plays. This is true on the national and international stage.

CBRE reports that, in Q2 2022—its most recent report—investment volume rose by 10% year over year to \$167 billion. Multifamily topped the list of preferred investments at \$78 billion, with industrial hitting \$32 billion and office dipping 9% from last year to \$24 billion. Retail came in last at \$21 billion.

For international players, the current economic question mark “is worse than expected,” Branson says. AFIRE’s largely institutional members have historically been office investors. “But their portfolios have been gradually shifting over the past 10 years to a more residential emphasis, both multifamily and single-family rentals,” he says. Branson is quick to point out that they are not divesting their office holdings, just ramping up on the asset classes that can guarantee more solid long-term value, again, keeping that risk aversion first and foremost.

“Debt is more expensive than it was before, and interest rates impact hedging costs when you’re crossing borders,” Branson says. The AFIRE survey reveals that, in terms of acquisitions in the U.S., 56% of its members believe they are behind in their allocations. But given that the U.S. is still a safer investment bet than Europe or Asia, “there remains a lot of excitement about the long-term opportunities.”

That is a good thing, since investment capital always needs to find a home. For property managers, however, the mandate is to make their budgets work.



**“We’ve seen some of the categories of construction increase up to 300% over a short amount of time.”**

— Chris Horsley, Hokanson Cos. Inc.



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## HOW PROPERTY MANAGERS ARE PREPARING

Savvy, borne of experience, instinct and communication. Property managers hold these three traits as key to navigating paths through uncharted budgeting waters. One property manager tells of an older building in his portfolio with aging air conditioning units.

“We’ll take the hit on pricing and timing because we know we’re going to need them at some point,” he says. “If one goes down and our provider tells us it will take six to eight weeks, what else can we do?” If the choice is between tenant comfort and waiting, he clearly opts for the former. “This was never an issue before.”

As one property manager commented when asked about material costs and delay: “Who even thought about the supply chain three years ago?”

Interestingly, despite the budgetary anomaly of the past two years, he still finds using base years helpful. “We’re not throwing them out. We know our costs and occupancies for 2022. If a building is 70% occupied now, maybe we can get it up to 80% or 85% next year. So, we project how that assumption will impact our expenses.”

Which brings up the discussion of leases, discussions that can no longer take place six months ahead of expiration. “You’ve got to be talking to them nine to 12 months before,” he says, “because we’ll need to negotiate a deal and build that space out.”

And this, in turn, points to the importance of communication. “We know what 2022 looks like as far as lease occupancy and physical occupancy are concerned and what costs we had,” he continues. “So, what are we projecting for next year, at least in terms of physical occupancy?”

That’s where the tenant enters the conversation, which would go something like this: “‘You used to have 100 employees here 40 hours a week. What are you doing now?’ Then we have to calculate the cost of the services they expect.”

Not surprisingly, conversations must take place with building owners as well. In fact, says one property manager, this is “one of the biggest pieces of the budget process. You’ve got to educate the person you’re submitting the budget to. They don’t do it day in and day out. So there has to be some sort of conversation.”

As we have seen, while some behind-the-scenes repairs and upgrades might be taken off the table, even if they would yield a return on investment, “they’ll spend money on updating the cantina or the fitness center—the things the tenants can see and touch.”

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That rationale makes sense, especially given the post-pandemic allure managers and owners are trying to achieve. The BOMA International survey reveals that fully 83% of tenant decisionmakers would work, or already have worked, with property managers and building owners to brainstorm ways to make buildings, common rooms and other amenities more welcoming for, and better utilized by, tenant employees.

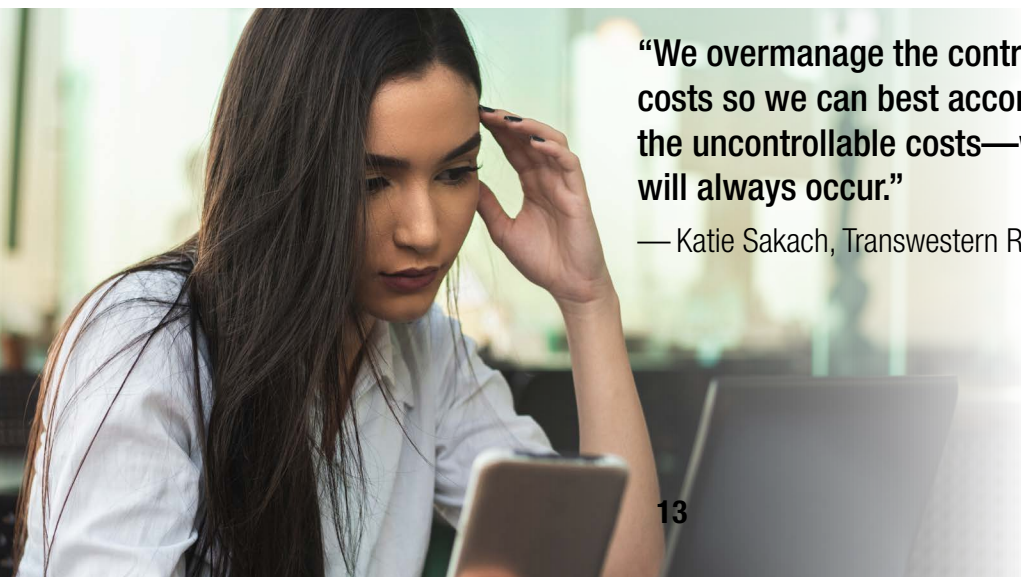
“We are laser-focused on expenses and prioritizing things like capital planning,” says one contributor, and those that produce a great ROI rise to the top of the pack. More than ever, she explains, for the 2023 budget season, “and for the long term, we’re prioritizing those capital projects that add value, that add to the tenant experience and also align with the client’s environmental, social and governance [ESG] goals.”

Of course, any enhancement to the physical plant is a smart move, no matter the economic climate. “Downturns are a great time to reinvest in your property and set yourself up for better income streams,” says Bohner. It is a strategy that can justify higher rents, which in turn “improves the long-term value of the property.”

And there is one more level of conversation that our speakers swear by. One property manager explains that “as BOMA members, we can leverage the experience and expertise of our colleagues. We can bounce all this stuff off of each other, not just locally but around the country, and the world.” It is a reminder, he says, “that we’re not doing this in a silo. We’re not alone.”

As we move farther away from the upheaval of the past two-plus years, there is actually some hint of normalcy, at least in the budgeting process. “We anticipate 2023 to be more traditional from a budgeting standpoint,” says one contributor. “We have a pretty good idea now which tenants are coming back, and which ones aren’t. So, we’re able to pinpoint the major line items, like janitorial and trash pickup.”

If we are approaching a “new” normalcy, it would bode well for the mid- and long-term outlook.



**“We overmanage the controllable costs so we can best accommodate the uncontrollable costs—which will always occur.”**

— Katie Sakach, Transwestern Real Estate Services



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## THE OUTLOOK

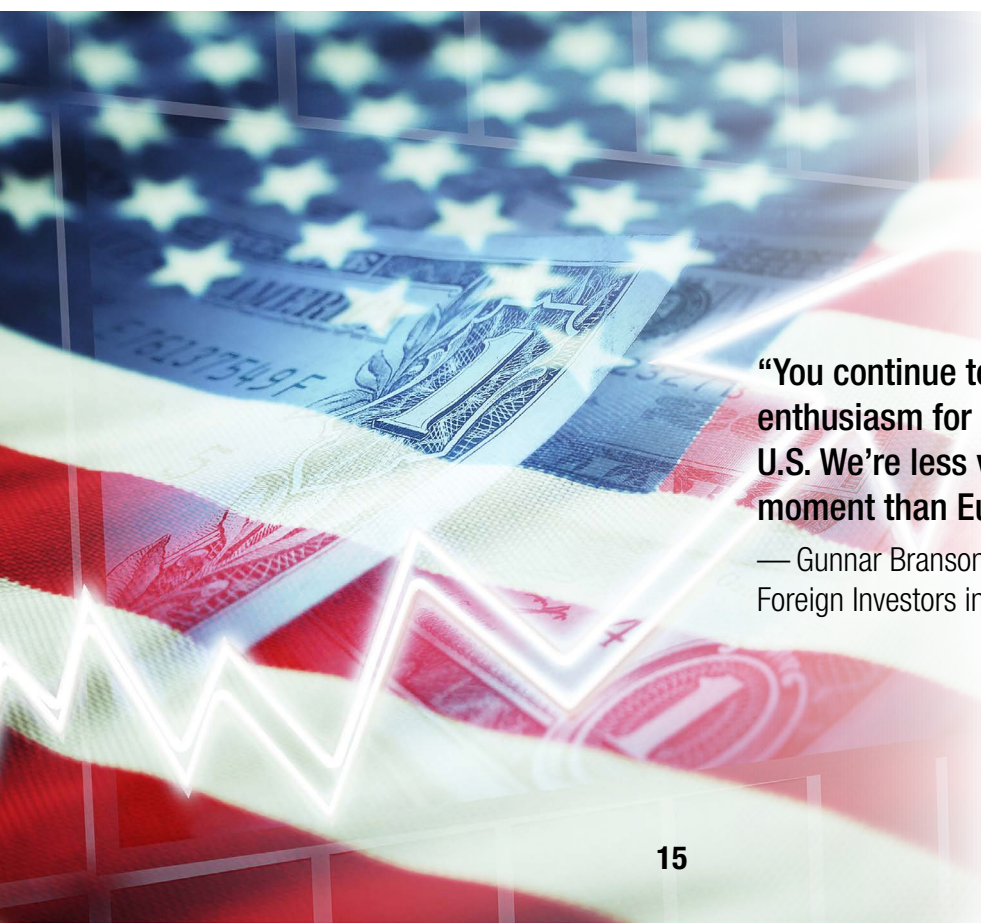
Clearly, property managers are preparing to the best of their ability, despite the recessionary headwinds. Of course, they can only do so much.

“Economists aren’t in agreement on the likelihood of a recession,” says one contributor, “but they do agree that reining in stubborn inflation is a priority. To accomplish this, the Fed must slow growth, and their primary tool is raising interest rates.”

The old saw about pain and gain comes into play here. While the word “recession” is unnerving, it might carry with it some upside—if your job is not cut, that is. One contributor notes that, while pundits in roundtable discussions do not want to be quoted on this, “I’ve never heard so many people whisper that we really need a recession right now.”

The rationale is that a recession corrects pricing. It also shrinks expansion plans, and thus adds more people to the job market. “It will actually help you find people a little easier than it is right now,” he says.

“A shallow recession is not necessarily a bad thing if it helps stabilize the economy for another long period of expansion,” agrees a colleague. One can only hope, she adds, that supply chain disruption and geopolitical unrest subside in coming years.



**“You continue to see a real enthusiasm for investing in the U.S. We’re less volatile at the moment than Europe or Asia.”**

— Gunnar Branson, Association of Foreign Investors in Real Estate

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Meanwhile, she adds, “the prudent approach for businesses and investors is to plan for a slowdown, while at the same time focusing attention on the optimal ways to use commercial real estate going forward.”

All indicators point to a transitional period for the industry. This transition was not borne of COVID-19 because many of those forces (think work-from-home trends) were already in play. But a possible recession is sure to add new wrinkles to the redefinition of what the office is and how it functions.

“The smartest investors, developers, property owners and managers are acknowledging where we are,” Branson says, “and they’re not pining for some Golden Age.”

It is good advice. Looking ahead rather than back will help align property managers with the new realities of business, help them navigate current challenges and position them for growth.

Despite some potential hurdles ahead, the current economic glass is half full. As one property manager said, “I’m forever an optimist.”

**“Everyone’s come to realize that the office isn’t going away. Yes, it will look different. But we need to continue to adapt for what tenants will need.”**

— Murray S. Greene, Greene Commercial Real Estate Group



# A Recession Like No Other?

It is safe to assume that there has never been a recession on the heels of a global pandemic that was then worsened by a war and rapid shifts in technology. But what is the classic definition of a recession? Essentially, it is a judgment call, albeit an informed one, based in large part on the sentiments of the National Bureau of Economic Research (NBER), which Cushman & Wakefield Senior Economist James Bohnaker calls the official scorekeeper of U.S. business cycles.

“The NBER’s traditional definition of a recession is a significant decline in economic activity spread across the economy and lasting more than a few months,” he explains. “The committee’s view is that, while each of the three criteria—depth, diffusion and duration—need to be met individually to some degree, extreme conditions revealed by one criterion may partially offset weaker indications from another.”

Not surprisingly, there is a wide range of economic indicators that go into that judgment call, including personal income and spending, nonfarm payroll employment, retail sales and industrial production.

“There is no reason to think the NBER will change the criteria used during this potential upcoming recession,” Bohnaker says.

There are also degrees of recession, and this is totally subjective, although extremes are pretty easy to spot. “The Great Financial Crisis (December 2007 through June 2009) saw nearly 9 million job losses,” says Bohnaker, “and it took seven years for the economy to recover all those jobs, easily the worst downturn since the Great Depression.”

By comparison, while the COVID-19-induced recession in 2020 lasted only from February to April, the U.S. lost 22 million jobs, “incredibly severe but very short-lived since it was tied to the pandemic.”

And now?

“We expect that the next recession will be both relatively mild and short in duration, lasting maybe around six months and resulting in 1 to 2 million net jobs lost,” Bohnaker predicts.

**“We expect that the next recession will be both relatively mild and short in duration, lasting maybe around six months and resulting in 1 to 2 million net jobs lost.”**

— James Bohnaker, Cushman & Wakefield





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