Yardi Matrix

National Office Report

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Rate Increases Another Challenge for Office

- In an effort to combat inflation levels not seen in nearly 40 years, the Federal Reserve has raised interest rates 375 basis points since March. For an office market already facing the headwinds of remote work and corporate downsizing, rate increases have added another challenge that will hinder the new-supply pipeline and transaction deal flow.

- On top of volatility in material costs and labor shortages, increasing debt costs make deals for new office supply increasingly difficult to pencil out. Build-to-suit or pre-leased properties will still get financing, but not much else. We expect some office projects to be paused or canceled in 2023 as the market adjusts to the new conditions. Some developers may even look at alternative uses for plots of land they are developing. Last month, CIM Group submitted paperwork to build a 46-story apartment property in downtown Oakland where it had previously planned to construct an office tower.

- Lenders are becoming more selective given market conditions, and when they do originate loans for commercial real estate, the multifamily and industrial sectors are preferred over office. Buyers are now looking for discounted prices, but so far sellers are hesitant to reduce them. The bid-ask spread on office properties will likely grow in coming months and deal flow could slow to a trickle. For investors that have recently reached the end of their hold period, it is an especially tricky time. While some may be tempted to hold and reassess until rates decrease, that may take a few years, and owners may be holding onto properties with worse lease situations than they have today.

- Some of these challenges may ease when inflation cools and rate hikes taper off. Right now, investors, developers and debt markets are unsure how far the Fed will go with rate increases and when a recession may hit. Once rates stabilize, deal flow and loans for new construction may increase as investors and developers have more certainty about debt costs. However, by that point the federal funds rate may be higher than it has been in two decades. Combined with the other challenges impacting the office sector since the onset of the pandemic, we expect that deals may only get done for well-positioned, high-quality assets. Additionally, we expect an increase in office space in mixed-use properties as a means to diversify income streams and reduce risk.