Commercial Market Insights Report

January 2023

National Association of REALTORS®
Research Group

NATIONAL ASSOCIATION OF REALTORS®

Summary

2023 Commercial Real Estate Outlook

Despite the uncertainty surrounding the market, commercial real estate performed well overall in 2022. With healthy balance sheets, consumer demand was boosted significantly in retail and industrial asset classes. In both of these sectors of the real estate market, vacancy rates fell even further than the previous year, illustrating strong demand for retail and industrial spaces in the post-pandemic period. Specifically, the retail sector experienced the largest drop in vacancy rates to 4.2% at the end of 2022. Due to a lack of new supply, net absorption and rent price gains were substantial in the retail sector.

However, **this year will be challenging for most commercial real estate market sectors,** with higher vacancy rates in the office and multifamily sectors.

After its recent record-breaking year in 2021, the multifamily sector has started to slow down in the second quarter of 2022. Demand remains solid, but net absorption dropped by 75 percentage points in 2022 compared to 2021. As a result, rent growth decelerated, and the vacancy rate increased in 2022. Due to rising borrowing costs, people may need to rent for a longer period keeping strong demand for apartment buildings. While the U.S. may skirt recession, the multifamily sector will likely regain momentum later this year and perform better than pre-pandemic.

The future of **office space is ambiguous**. COVID-19 has already disrupted the idea of the "traditional office" work environment. Hybrid work is now a reality for many people, and this trend only goes one way, just like e-commerce changed the "traditional retail" sector. Thus, **2023 will be another challenging year for the office sector** as this sector will continue to change to improve the occupant experience and attract more employees to return to the office. But, this may be even more difficult with older office spaces lacking modern amenities. Vacancy rates may drop even further for these office spaces.

Thanks to the rise of e-commerce during the pandemic, industrial real estate outperformed in the last couple of years. Big online retailers needed warehouses to store their products, boosting the demand for industrial spaces. Even though demand for industrial space cooled off in 2022, **the industrial sector will continue to be one of the bright spots of commercial real estate in 2023**. Despite the slowdown, vacancy rates will remain low, and rent growth will increase by a double-digit number due to low supply in the industrial sector.

The retail sector is expected to remain strong and perform better than pre-pandemic levels. With inflation moving down and interest rates to stabilize later this year, consumer spending power will be back this year. Specifically, growth in the brick-and-mortar stores will be driven mainly by smaller shops such as neighborhood centers. The trend is clear. Due to remote-work policies, neighborhood stores are on the rise, and this trend will continue this year. Consumers like to shop locally as these neighborhood stores offer convenience and personal interaction.

Hotel revenue dipped in 2020 due to the COVID-19 travel restrictions and self-quarantine orders, but it fully recovered in 2022. In fact, the revenue per available room (RevPAR) is 10 percent higher than the pre-pandemic level. After two years of social distancing and working from home, Americans travel again. With business and leisure time increasing, the **demand for hospitality spaces will continue to grow in 2023**.

The year is still young. Inflation, interest rates, supply chain, and geopolitical events are the main factors determining how commercial real estate will perform in the following months. The National Association of REALTORS® will keep you informed monthly about the developments in commercial real estate.

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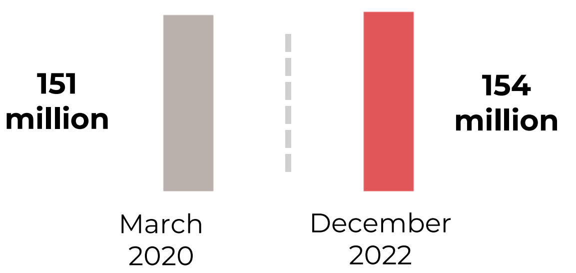
Economy

Job growth (compared to March 2020): 1.8%
Inflation: 7.1%
Interest rates: 4.5%

Robust job growth in 2022

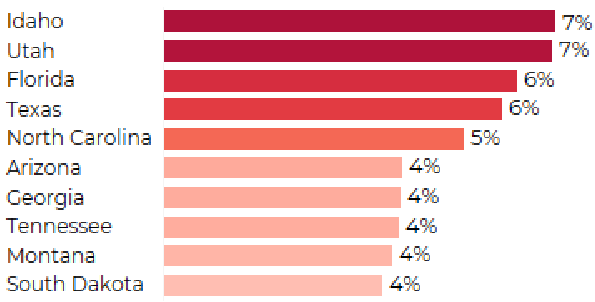
The U.S. labor market ended 2022 with a record-high number of jobs and historically low unemployment. The economy was able to recover all the jobs that were lost at the beginning of the pandemic. There are more jobs now than ever. Within a year, the economy added about 4.5 million jobs.
Meanwhile, the unemployment rate is at record lows – 3.5 percent - which indicates how strong the labor market is since it shows how many people who want a job and are available for work can find a job. In fact, there are two jobs for every unemployed person. Thus, the job market recovery after the pandemic has been remarkably rapid compared to other notable recoveries in recent history.

Number of Jobs



At the local level, Utah and Idaho continue to be the states with the fastest employment growth across the country.

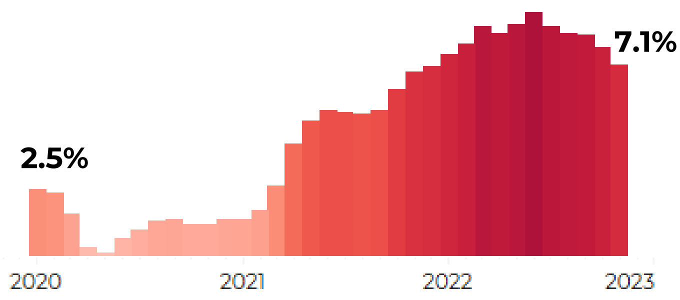
Top 10 states with strongest job growth since March 2020



Inflation is finally slowing down.

2022's higher federal funds rates have started to tame inflation. After peaking in June, inflation is cooling off. However, consumers are still feeling the burden of higher prices. Consumer prices continue to rise, but at a slower pace than in the summer months. Rising rents continue to put upward pressure on inflation. As of November 2022, inflation continues to be higher (7.1%) than the previous year (6.8%).

Inflation



Interest rates rose by 4.25 percentage points in 2022

The Federal Reserve has recently switched to smaller interest rate hikes as inflation is finally slowing down. However, the current Fed's fund rate is 4.5 percent compared to 0.25 percent a year ago. While this is not the rate that consumers pay, a higher rate for banks makes borrowing more expensive for consumers, eventually also affecting long-term interest rates such as the 10-year Treasury yield. While inflation remains elevated, well above the Fed's 2 percent target, the Federal Reserve will need to take additional rate hikes in 2023, increasing borrowing costs even further.

Source: NAR analysis of U.S Bureau of Labor Statistics data

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Economy

2023 Economic Outlook

After the strong rebound of the U.S. economy in 2021, with the fastest average growth in nearly 40 years (6%), U.S. economic growth is set to slow with a 2% growth at the end of 2022. Looking into 2023, although economic growth is expected to decelerate further due to the restrictive monetary policy, the **U.S. economy may skirt recession in 2023**. Generally, during inflationary periods, people hold less money and thus spend less. However, that's not currently the case. Amid elevated inflation and higher interest rates, both real income and real spending continue to advance. Meanwhile, job growth remains resilient, with a record-high number of jobs and a record-low unemployment rate. Thus, the U.S. economy will likely remain in positive territory throughout this year. GDP is expected to increase by about 1.3% in 2023.

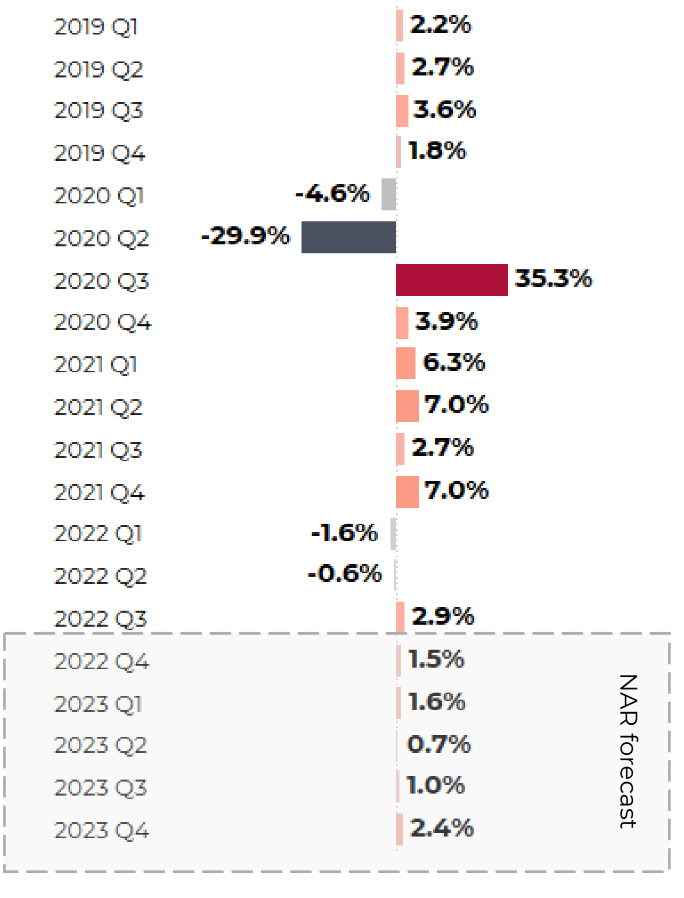
Nevertheless, while inflation remains well above the Fed's 2% target, the Federal Reserve will continue to use a restrictive monetary policy this year. The National Association of REALTORS® expects the **Fed funds rate to reach 5% in early 2023** and remain near that level through the second quarter of 2023. However, the Fed will likely cut interest rates back in the last quarter of 2023 as **inflation will slow down even further**, increasing by less than 4 percentage points.

The labor market has continued to be resilient albeit Fed's tight monetary policy. Typically, when interest rates go up, it becomes more expensive to borrow, so households are less willing to buy goods and services, and businesses are in a more difficult position to purchase items to expand their businesses, such as property and equipment. Thus, under the restrictive monetary policy, businesses freeze hiring or let people go, influencing employment. However, data shows that the job market remains solid. There has been a slight decrease in hiring and a small increase in layoffs, but overall there hasn't been any substantial softening of the labor market.

However, **the job market may not be as strong as in the previous year**. With slower economic growth, there will likely be less hiring and more unemployment in 2023. The National Association of REALTORS® expects the number of payroll jobs to grow modestly by 1.4% and the unemployment rate to average 4.0% in 2023.

Thus, 2023 will be another year of below-potential growth with higher interest rates, higher unemployment rates, and slower job growth but lower inflation.

Gross Domestic Product (GDP) 2019-2023



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Multifamily

Absorption of units in the last 12 months: 174,442
Rent growth in the last 12 months: 3.7%
Cap rate: 4.9%

Rent prices are still higher than they were a year ago, but the gains have returned to more normal levels. Rent growth dropped to the lowest level since the first quarter of 2021. Rents rose 3.7% year-over-year in the last quarter of the year compared to 5.6% and 9.2% in the previous two quarters.

As elevated prices continue to hurt consumers, fewer people can afford to cover their rent expenses, decreasing the demand for apartments. After reaching all-time lows in 2021, the vacancy rate rose significantly in Q4 2022 to 6.1%.

While rents have increased in nearly all the metro areas across the county, Sun Belt areas have experienced an even faster rent growth, including Kingsport and Knoxville in Tennessee, Fayetteville, NC, Charleston, SC, and Naples, FL.

Respectively, demand for apartment buildings remains strong in big city centers such as New York and Washington, DC. In these two areas, more than 9,000 multifamily units have been absorbed in the last 12 months ending in December.

2023 Outlook:

Rent price growth won't likely hit the 2022's highs. Although multifamily housing construction has slowed down, the number of apartment buildings under construction is at record highs. Thus, the completion of these homes may ease rent growth.

Nevertheless, demand for apartment buildings will remain strong, considering many buyers have already been priced out of the market. Due to rapidly rising mortgage rates, buyers need to earn more than $100,000 to afford to buy the median-priced home. However, only 15% of the renters earn that income.

Top 10 areas with fastest rent growth

	Q4 2022	Q4 2021
Kingsport, TN	10.9%	7.2%
Fayetteville, NC	9.7%	13.6%
Knoxville, TN	9.6%	13.8%
Charleston, SC	8.9%	15.2%
Naples, FL	7.9%	39.3%
Savannah, GA	7.8%	20.1%
Anchorage, AK	7.8%	9.7%
Asheville, NC	7.8%	16.9%
Gulfport-Biloxi-Pascagoula, MS	7.6%	10.6%
Lynchburg, VA	7.6%	7.3%

Top 10 areas with the strongest 12-month absorption

	Q4 2022	Q4 2021
New York, NY	26,282	36,806
Washington, DC	9,644	23,342
Los Angeles, CA	7,669	32,262
Austin, TX	7,423	20,347
Minneapolis, MN	7,070	12,108
Chicago, IL	6,534	20,216
Seattle, WA	6,468	17,003
Denver, CO	5,653	11,884
Dallas-Fort Worth, TX	4,934	47,658
Kansas City, MO	4,787	7,583

Source: NAR analysis of CoStar data

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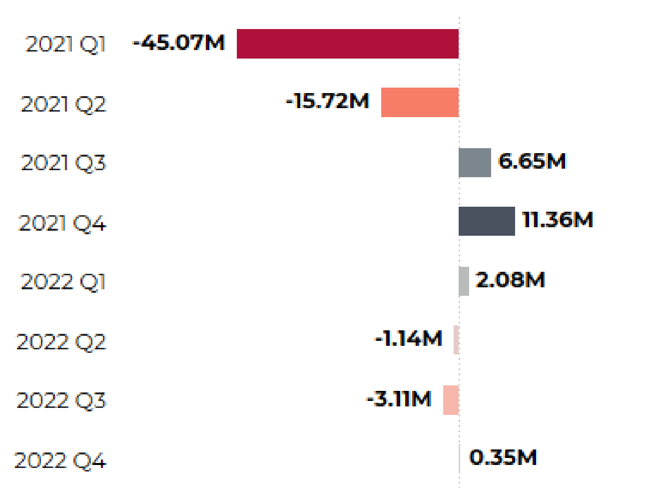
Office

Net absorption in the last 12 months: -1.8 million sq.ft.
Rent growth in the last 12 months: 1.1%
Cap rate: 6.9%

With more employers demanding a return to the office, demand for office space increased in the last quarter of 2022. After two quarters of negative net absorption, demand for office space increased in Q4 2022 as net absorption turned positive again. That was mostly due to stronger demand for "Class A" office space. This means more office space was leased up than was made available on the market, indicating a relative decrease in the supply of office space available to the market.
Nevertheless, the amount of office space leased in the U.S. in the three months ending in December was nearly half of the activity in Q4 2019. As a result, the vacancy rate continues to be significantly higher than pre-pandemic at 12.5%.

Net Absorption by quarter in sq. ft



2023 Outlook:

The widespread adoption of hybrid work will continue to put downward pressure on office space demand. Thus, 2023 will be another challenging year for the office sector. Flexible workplaces are expected to disrupt the office sector in the same way that e-commerce changed the traditional retail sector. As a result, office vacancy rates will be even higher in 2023.

Top 10 areas with the largest vacancy rates

	Q4 2022	Q4 2021
Houston, TX	18.8%	18.8%
Dallas-Fort Worth, TX	17.2%	17.5%
San Francisco, CA	16.4%	13.5%
Washington, DC	15.4%	14.8%
Chicago, IL	15.0%	14.6%
Phoenix, AZ	15.0%	13.9%
Denver, CO	14.6%	14.3%
Los Angeles, CA	14.4%	13.6%
Atlanta, GA	14.1%	14.1%
Austin, TX	14.1%	12.7%

Top 10 areas with the lowest vacancy rates

	Q4 2022	Q4 2021
Myrtle Beach, SC	2.1%	2.1%
Youngstown, OH	2.7%	2.9%
Lancaster, PA	3.1%	3.2%
Sarasota, FL	3.5%	4.7%
Chattanooga, TN	3.7%	4.7%
Springfield, MO	4.2%	3.3%
Knoxville, TN	4.2%	4.4%
Albany, NY	4.3%	5.6%
Lakeland, FL	4.5%	4.7%
Fort Myers, FL	4.5%	4.5%

Source: NAR analysis of CoStar data

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Industrial

Net absorption in the last 12 months: 401 million sq. ft.
Rent growth in the last 12 months: 11.1%
Cap rate: 6.2%

The industrial sector continued to outperform compared to pre-pandemic. Demand is strong as net absorption was above 400 million SF in the last 12 months ending in Q4 2022. Although demand may have tapered, the volume of industrial space absorbed continues to be double that of pre-pandemic levels. As a result, this sector had the lowest vacancy rate at 4% than any other sector in the commercial real estate market.

Rent prices for industrial spaces grow faster than any other sector of commercial real estate at 11.1% year-over-year. Meanwhile, rents increase even faster for logistics space with 12.7% year-over-year gains compared to 7.7% for flex space and 8.9% for specialized space.

Chicago, IL, had the largest absorption of industrial space in the past 12 months. Dallas-Fort Worth, TX, Houston, TX, Phoenix, AZ, and Kansas City, MO absorbed more than 18 million square feet over the past 12 months ending in Q4 2022.

In addition, Miami and Fort Lauderdale in Florida, Phoenix, AZ, Columbus, OH, and Las Vegas, NV, experienced the largest rent gains.

2023 Outlook:

The expansion of e-commerce during the pandemic helped the industrial sector to outperform. The strong demand for e-commerce created the need for warehouses and industrial spaces. However, the industrial boom is expected to slow down, with vacancy rates turning higher in 2023.

Top 10 areas with the strongest 12-month absorption

	Q4 2022	Q4 2021
Chicago , IL	35.2M	36.3M
Dallas-Fort Worth, TX	34.7M	48.3M
Houston , TX	29.3M	34.0M
Phoenix , AZ	25.7M	22.8M
Kansas City, MO	18.2M	8.4M
Indianapolis , IN	15.7M	17.6M
Atlanta, GA	15.6M	39.0M
Columbus , OH	12.6M	16.8M
Austin, TX	12.3M	10.0M
San Antonio , TX	11.3M	5.0M
Charlotte, NC	10.4M	4.8M

Top 10 areas with the slowest 12-month absorption

	Q4 2022	Q4 2021
Los Angeles, CA	-2.3M	13.4M
New York, NY	-0.9M	15.5M
Syracuse, NY	-0.8M	5.8M
Chattanooga, TN	-0.7M	1.6M
Santa Rosa , CA	-0.6M	0.6M
Columbus , GA	-0.6M	0.1M
Lexington, KY	-0.5M	1.3M
Augusta, GA	-0.5M	3.4M
Springfield, MA	-0.4M	-0.3M
Lansing, MI	-0.4M	1.1M

Source: NAR analysis of CoStar data

Retail

Net absorption in the last 12 months: 75.8M sq. ft.
Rent growth in the last 12 months: 4.0%
Cap rate: 6.7%

Demand for retail space was stronger in 2022 than the previous year. **U.S. retail net absorption** remained positive for the eighth straight quarter, increasing in the last quarter of 2022 to 21 million square feet – a 52 percent increase from the third quarter. This means that more retail space was occupied than available for lease. In fact, not only did retail net absorption advance in 2022, but also the demand for retail space continues to remain double that of pre-pandemic levels. By type of retail stores, general retail and neighborhood centers have driven the demand, accounting for nearly 80% of the net absorption in 2022.

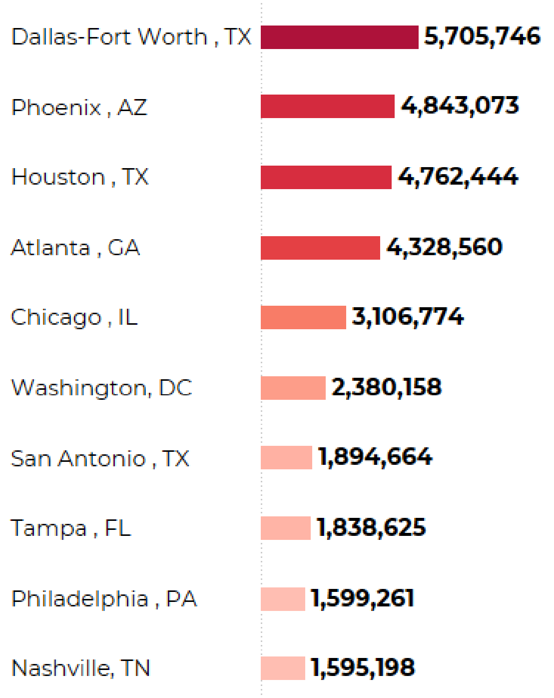
Net Absorption by type (2016, 2019 and 2022)

	2016	2019	2022
General Retail	72.61M	23.92M	33.72M
Mall	7.00M	-3.73M	-0.32M
Neighbor hood Center	38.60M	11.23M	27.66M
Other	1.43M	0.20M	0.67M
Power Center	1.90M	2.08M	8.17M
Strip Center	13.25M	4.00M	4.94M
All	**135.19M**	**37.97M**	**75.41M**

Rents for retail spaces continued to be higher than the previous year, but the pace of the increase has slowed down as consumers are still feeling the burden of higher prices. Across the country, **retail asking rents** increased by 4.0%, slower than the previous quarter but faster than the previous year and pre-pandemic. While rents rose across all types of retail stores,. neighborhood (4.9%) and strip centers (4.7%) experienced the highest rent gains.

At the **local level,** demand for retail space was very strong in Dallas, TX, Phoenix, AZ, Houston, TX, Atlanta, GA, and Chicago, IL, as these areas experienced the largest net absorption in 2022 with more than 3 million square feet more occupied than available for lease retail space.

Top 10 areas with the strongest net absorption in the last 12 months



Source: NAR analysis of CoStar data

2023 Outlook:

Despite elevated inflation and higher interest rates, after nearly two years of unprecedented retail sales – from mid-2020 to mid-2022 – the momentum of retail sales has slowed down since the middle of 2022. As a result, although the retail sector continues to be resilient, there are signs that it is facing headwinds. However, it will remain better than pre-pandemic levels.

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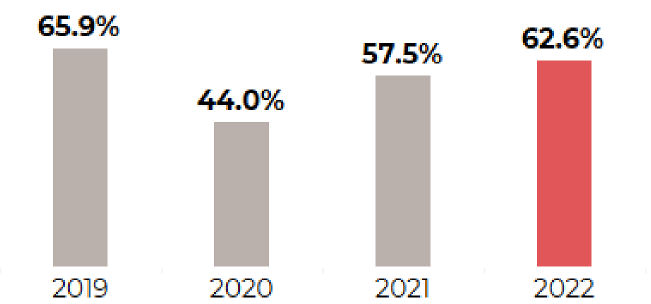
Hotel

Occupancy rate in the last 12 months: 62.6%
Average daily rate in the last 12 months: $149/room
Revenue per available room in the last 12 months: $93/room

The hospitality sector continued to advance in 2022. Although hotel occupancy hasn't fully recovered yet to pre-pandemic levels, both the most prevailing measures of hotel performance - Average Daily Rate and Revenue Per Available Room – have fully rebounded.

12-month occupancy rate in December



Specifically, in 2022, the average daily rate (ADR) per room rose to $149/room, up 14% from 2019. The revenue per available room (RevPAR) also increased to $93/room, up 8% compared to 2019.

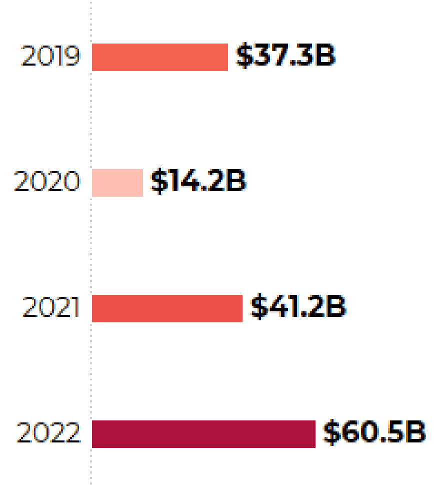
12-month ADR and RevPAR in December

	Average daily rate	Revenue per available room
2019	$131	$86
2020	$103	$45
2021	$125	$72
2022	$149	$93

ADR is the total revenue/number of rooms.
RevPAR is ADR x occupancy rate.

Sales acquisitions have been rising since 2021. In 2022, the 12-month sales volume rose to $60.5 billion from $37.3 billion in 2019.

12-month sales volume as of August



Source: NAR analysis of CoStar data

At the local level, harder-hit markets such as San Francisco and New York still have an occupancy rate significantly lower than pre-pandemic. For example, in San Francisco, the occupancy rate was 82% in 2019 compared to 65% in 2022. As a result, the revenue per available room is still 33% below the pre-pandemic level. In contrast, in Sarasota, FL, Portland, ME, and Knoxville, Tennessee, the occupancy rate is more than 5% higher than in 2019.

2023 Outlook:

Demand for hospitality spaces will continue to grow in 2023. Both occupancy and average daily rates will advance as business and leisure travel will increase this year even further. This could further boost the revenue per available room (RevPAR), especially in the harder-hit areas where activity is still slower than the pre-pandemic level.

COMMERCIAL REAL ESTATE REPORT
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