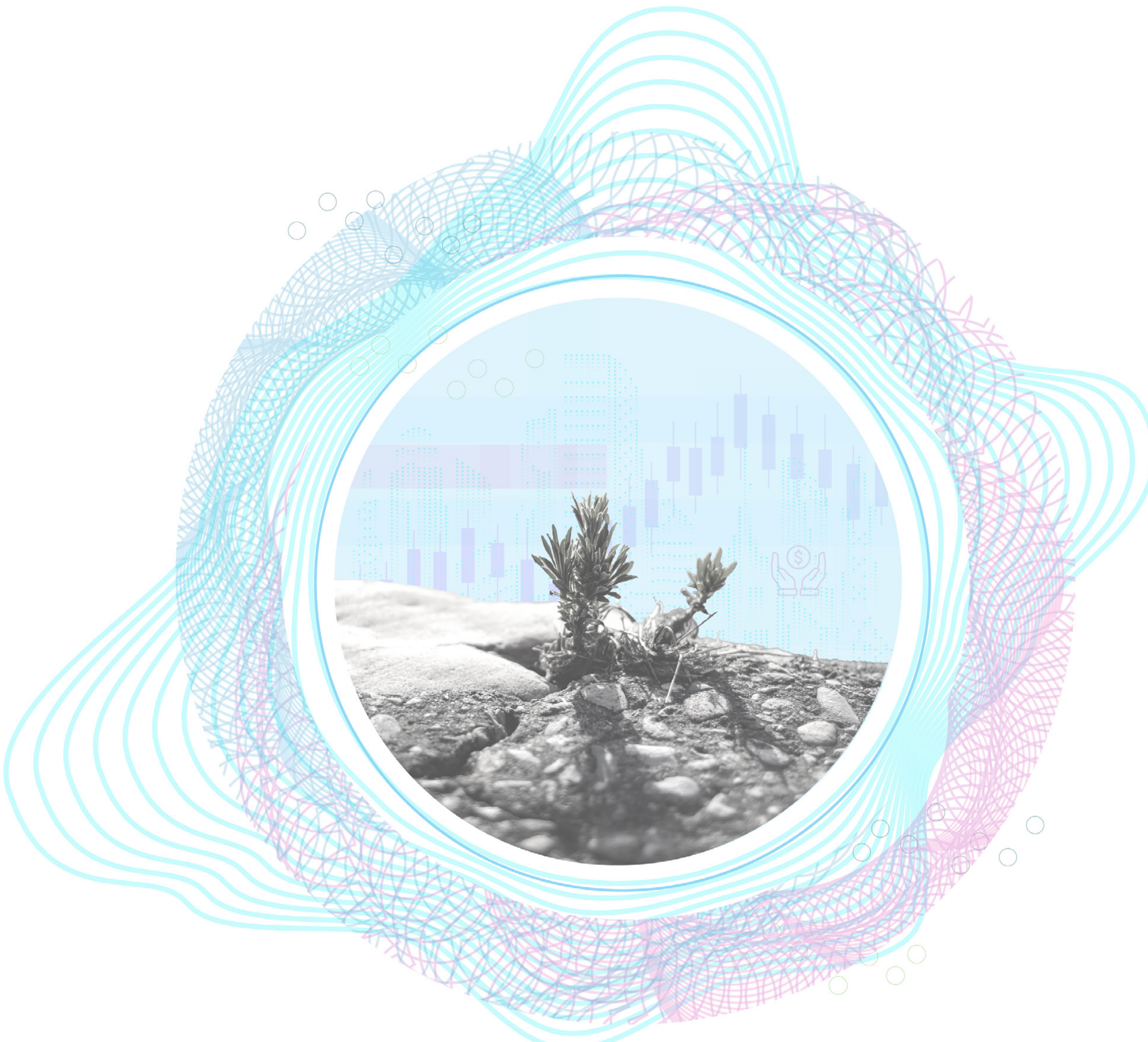


2024 commercial real estate M&A outlook

Extreme resilience

Contents

A time for cautious optimism

History may remember 2023 as the year when commercial real estate mergers and acquisitions (M&A) hit the pause button. Many sellers were reluctant to reduce their prices, perhaps hoping for a return to the record levels of 2021. Meanwhile, rising interest rates meant prospective investors had alternative uses for their money. As a result, many dealmakers struggled to agree on what a fair price ought to be.

This dislocation took place against a backdrop of overall economic uncertainty. Inflation remained higher than normal. Geopolitical tensions flared. Then there were the bank failures of spring 2023.

Following the bank failures, lending for commercial real estate projects tightened significantly,[1] exacerbating an already difficult environment for those seeking financing. By the third quarter of 2023, the share of non-owner-occupied commercial properties that were behind on their loans had risen to nearly 3%, close to three times what it had been for the same quarter in 2022.[2]

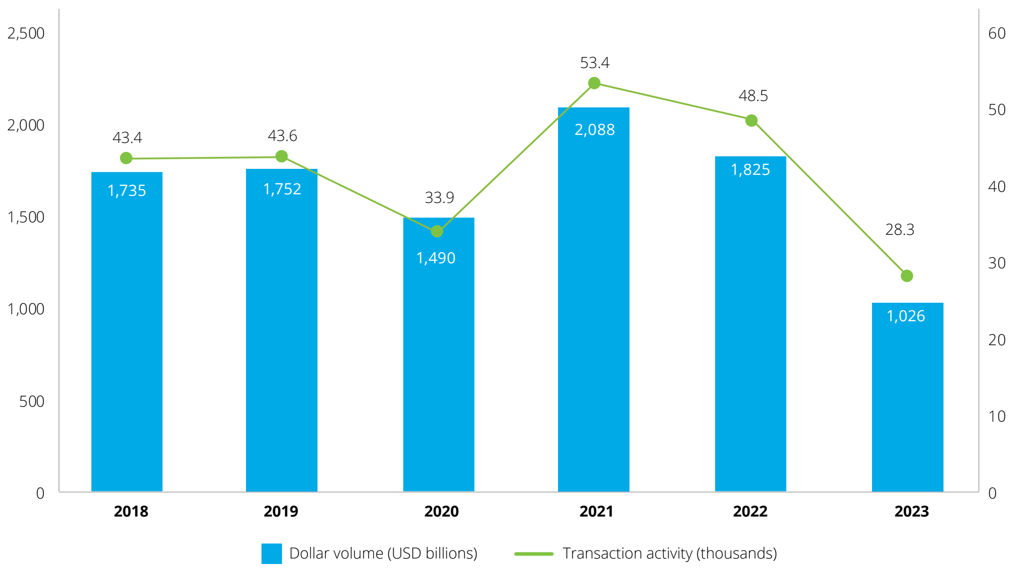
Toward the end of 2023, however, the storm clouds began to part. Inflation fell steadily.[3] Interest rate hikes slowed.[4] Corporate profits improved.[5] And private equity firms remained flush with dry powder.[6] Are the conditions in place for an upswing in M&A? To find out, let's take a closer look at where the industry has been and what the implications are for the year ahead.

Global and US M&A

2023 in review

Property sales experienced a pullback in 2023. Worldwide, year-over-year property transactions fell 42%, ending up at roughly half their 2021 peak and representing a six-year low. Dollar volume followed suit (figure 1).

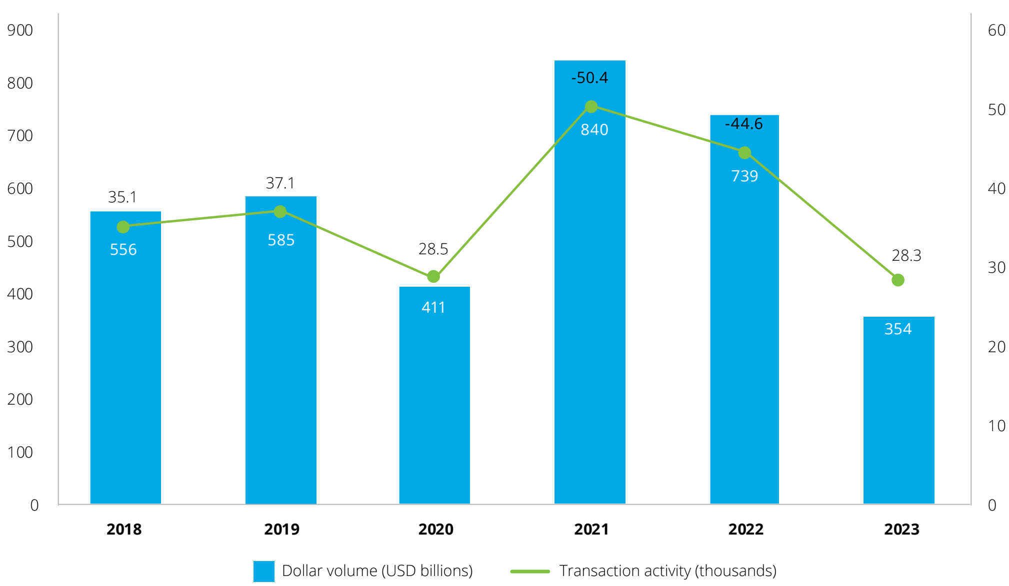
Figure 1. Global (including US) property sales, 2018–2023



Source: MSCI Real Capital Analytics, accessed January 30, 2024.

The picture was a little brighter in the United States. Year-over-year property sales fell 37% in 2023, which was about 44% off their peak from two years earlier. The final tally was about the same as in 2020. Dollar volume fell 52% year over year and 58% from its 2021 peak (figure 2).

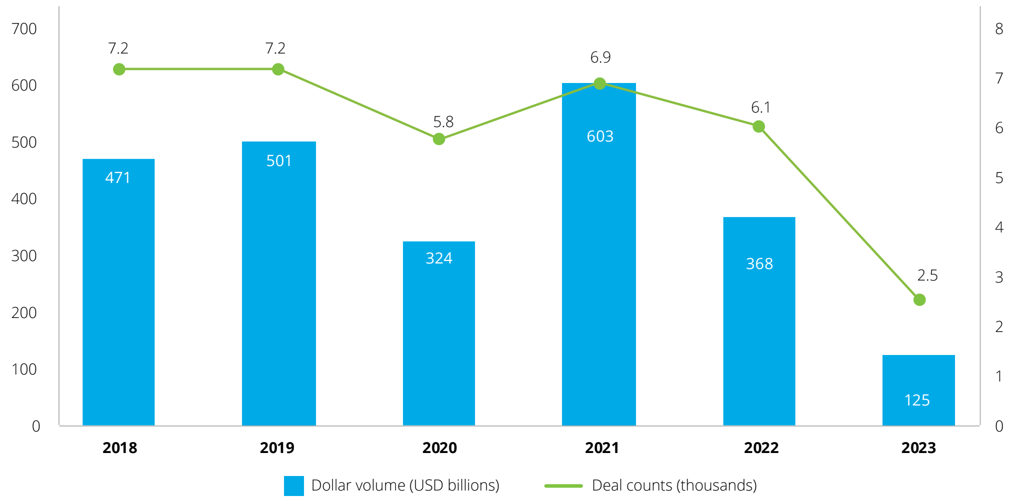
Figure 2. US property sales, 2018–2023



Source: MSCI Real Capital Analytics, accessed January 30, 2024.

The drop-off was even more dramatic for M&A. In 2023, only about 2,500 commercial real estate deals took place globally. That's down 59% from the year before, and 64% off the 2021 peak. Dollar volume fell 66% from the previous year, and 79% off its peak in 2021 (figure 3).

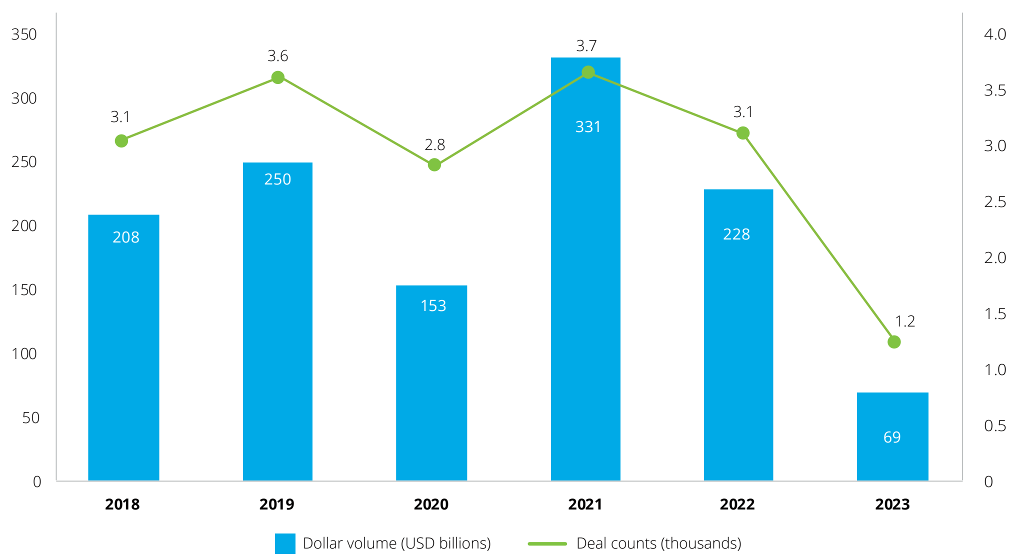
Figure 3. Global (including US) M&A transaction activity, 2018–2023



Note: Includes closed deals only.
Source: S&P Capital IQ, accessed January 24, 2024.

Activity in the United States was slightly worse. The 1,200 transactions that took place in 2023 represented a 61% drop from the year before and 64% off the 2021 peak. Dollar volume was down 70% year over year and 79% from 2021 (figure 4).

Figure 4. US M&A transaction activity, 2018–2023



Note: Includes closed deals only.
Source: S&P Capital IQ, accessed January 24, 2024.

Expectations for 2024

A pickup in transactions. If interest rates continue to moderate, real estate may begin to look more valuable to investors, boosting valuations and narrowing the bid-ask spread so that more transactions can take place. If M&A activity does pick up, expect the healthiest markets—such as industrial, data centers, student housing, and open-air retail—to take the lead.

A swath of debt maturities. Roughly $929 billion in commercial mortgages will come due in 2024.[7] Lenders and borrowers will need to work together to address any shortfalls that may occur. The actions they take may include one or more of the following:

- Extension of maturity dates
- Turning the keys over to the lender
- Finding alternative lenders or investors from traditional financial institutions
- Finding other solutions to fill the gap created by decreased collateral values and required loan-to-value thresholds (e.g., mezzanine debt or additional equity)

Federal policies to make debt restructuring easier will likely stave off any impact on financial markets amid the "wall of maturities" coming due.[8]

More assets going private. Private equity firms are sitting atop more than $2 trillion in dry powder with increasing pressure to deploy their uncommitted capital.[9] Between this on-hand capital and the ability to raise large funds, private equity firms are likely well positioned to take more assets private this year. Look for more deals similar to KSL Capital Partners' 2023 acquisition of Hersha Hospitality Trust.[10]

Private equity getting creative. Until markets open up in earnest, private equity firms may continue to explore deal targets or structures that haven't traditionally been on their radar, such as those in the infrastructure space.

Proptechs seeking acquisition. Like other up-and-coming technology companies, proptechs saw their pipeline of venture capital funding dry up amid a faltering market for initial public offerings.[11] Smaller proptechs looking to exit in 2024 may pivot to acquisition by private equity, a real estate investment trust (REIT), or a larger proptech company—a strategy that may be challenging for companies not yet generating cash from operations.

Regulators gear up on the tax front

Tax laws remain an important factor in commercial real estate M&A activity, with three considerations in particular contributing to the state of play in 2024.

Friction from tax laws. State and local regulations involving transfer taxes and property tax revaluations remain an underwriting concern, especially in deals where margins are small. Expect these considerations to play an important role in how real estate companies invest, how they structure transactions, and where they buy assets.

Pillar Two global minimum tax rules. Pillar Two rules generally require multinational enterprises with €750 million or more in annual revenue to pay a global minimum tax of 15% on income received in each country where they operate.[12] (Learn more about Pillar Two global minimum tax rules here.) Although many real estate companies may not be subject to the global minimum tax themselves, a country's response to Pillar Two rules may influence where companies decide to acquire assets.

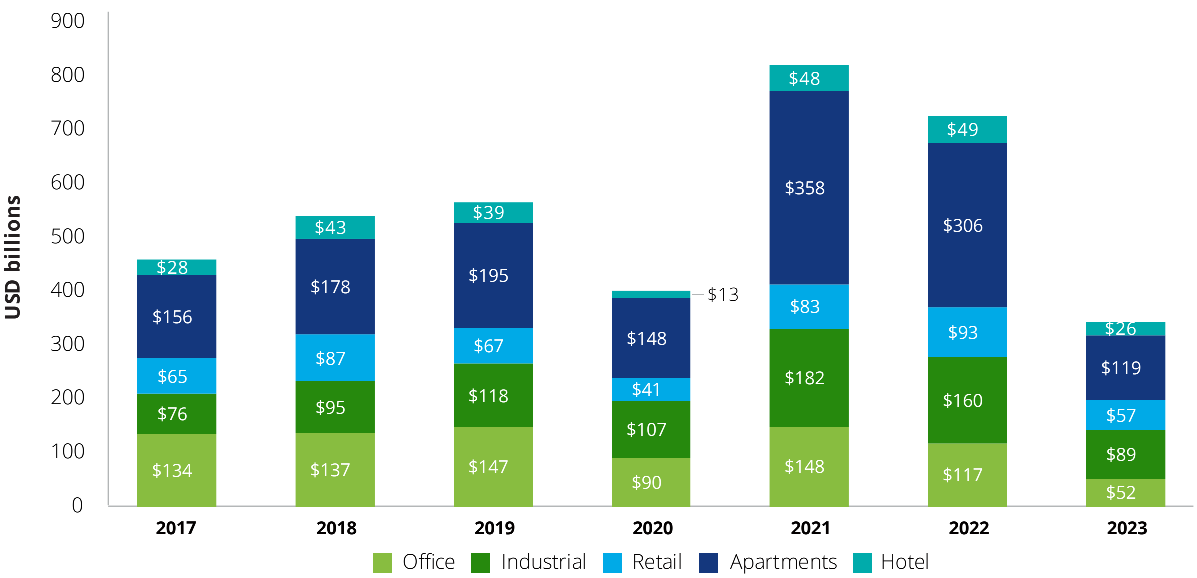
More enforcement actions. Resources provided under the Inflation Reduction Act have expanded the Internal Revenue Service's capabilities, leading to more audits among real estate partnerships.[13] This increase in audit activity has the potential to slow down M&A by adding to the amount of due diligence required to close a deal.

M&A by sector

2023 in review

Although US property sales reached a seven-year low in 2023, a sector-by-sector breakdown reveals a more nuanced perspective. Sales for industrial properties were about half what they were in 2021 but still more than they were in 2017, for example. And hotels and retail fared better than they did in 2020, reflecting the ongoing recovery from the COVID-19 pandemic (figure 5).

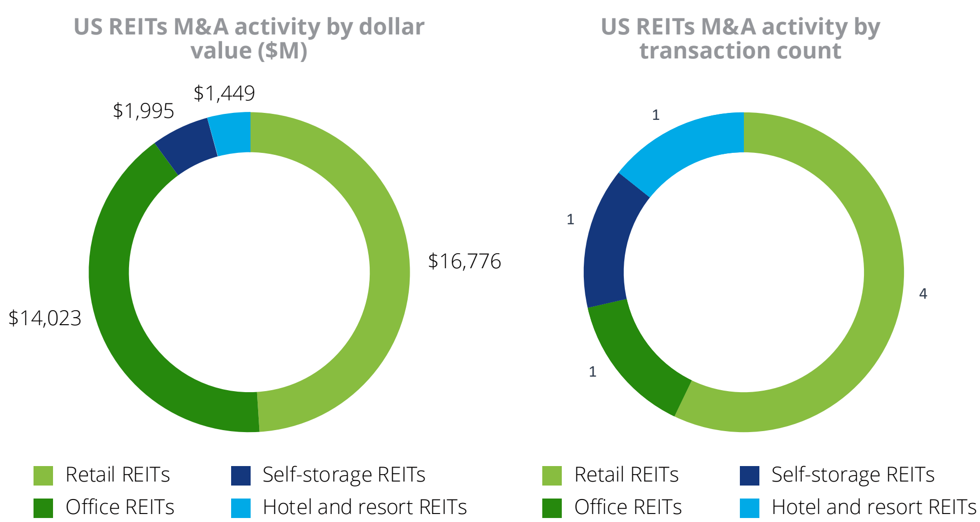
Figure 5. US property sales by sector, 2017–2023



Source: MSCI Real Capital Analytics, accessed January 30, 2024.

The retail sector dominated M&A activity for REITs last year. However, the total value of all four retail REIT deals was nearly matched by the value of just one industrial deal, Extra Space Storage's $14 billion acquisition of Life Storage (figure 6).

Figure 6. US REITs M&A activity, 2023



Note: Includes closed deals only where target is based in the US and was a REIT.
Source: S&P Capital IQ, accessed January 24, 2024; MSCI Real Capital Analytics, accessed January 24, 2024.

Expectations for 2024

A bounce-back in retail. With shoppers once again filling stores and restaurants, landlords are dialing back the concessions they were making post-COVID-19.[14] By the final quarter of 2023, vacancies at US shopping centers had fallen to 5.3%, a record low.[15] Rising occupancy and consumer optimism may help to stabilize prices and draw interest from investors looking for rental yields that are higher than those of residential properties.

Less activity for multifamily properties. Higher borrowing costs and a cooler labor market may make it harder for multifamily property developers to refinance existing loans, especially in pockets with too much supply. Keep an eye on signs of distress, which may create acquisition opportunities as more public and private debt holders seek to shed assets.

Moderating deal values in hospitality. Travel came back strong in the wake of COVID-19.[16] However, many developers have run into difficulty securing loans for new hotels.[17] A slowdown in supply may allow existing hotels to keep their rates high enough that revenue lines can absorb a drop in occupancy, moderating the effect on deal value.

No day of reckoning for the office sector. Amid rising vacancies and falling rents, even higher-end office buildings have started to falter.[18] A record 20% of the office space in large US cities stood empty by the end of 2023.[19] That doesn't necessarily mean a surge in distressed assets will hit the market anytime soon. The possibility exists for mezzanine equity to enter the scene or lenders to engage in workarounds as market participants wait to see what transpires in the near term.

Optimism about industrial and nontraditional sectors. As incentives from the federal CHIPS Act begin to flow,[20] demand for new construction in the industrial sector may stay strong after approaching record highs in 2023.[21] As for alternative sectors, Deloitte research indicates that data centers and cell towers have become one of the most attractive risk-adjusted properties to real estate owners and investors. Meanwhile, opportunities like self-storage properties and senior care appear to be gaining ground.[22]

Sustainability arrives for real estate due diligence

Many investors have begun to incorporate environmental, social, and governance (ESG) data requests into their due diligence procedures. In part, they're looking to gauge resiliency to climate risks. But they also want to know whether target companies are on top of any regulatory compliance to which they may be subject.

In addition, certain regulators have been dialing up the scrutiny. New York City's Local Law 97, which sets building emissions limits for most buildings over 25,000 square feet, went into effect this year.[23] Other local and state jurisdictions, along with the federal government, have enacted or are preparing to enact similar legislation. Meanwhile, the European Union is set to adopt the Energy Performance of Buildings Directive in 2024.[24]

Real estate investors should consider potential fines or penalties from not meeting requirements like these. The New York law, for instance, aims to reduce emissions limits progressively over time. Buildings that exceed those limits will face financial penalties.

In response to these concerns, a number of third-party organizations have developed standards and frameworks that can provide a common language between negotiating parties. Here are two that may be useful in diligence.

Task Force on Climate-related Financial Disclosures (TCFD) framework. The TCFD framework provides recommended language to describe, among other matters, physical and transition risks from climate change. Disclosures prepared in accordance with this framework could, for example, help a real estate investor assess a target's resiliency to physical risks such as extreme weather events or transition risks such as compliance with building performance standards.

Greenhouse Gas Protocol. The Greenhouse Gas Protocol is the most widely respected standard for measuring and managing carbon emissions.[25] It's especially important to real estate because more jurisdictions are mandating reduction requirements on carbon emissions. In some jurisdictions, failure to meet these reductions may result in significant fines and penalties for real estate owners, potentially creating uncertainty over the future cash flow of their investments.

Newer, more sustainable assets will likely remain in demand as the flight to quality accelerates among tenants and investors alike. For real estate companies seeking to raise capital, being able to furnish information on ESG factors in alignment with standards and frameworks may allow them to convey that the information provided in diligence meets the boundaries, assumptions, and judgments expected from an investor.

Powering ahead

So far, 2024 appears to be a transition year. From an uneven global economy to a balancing act of competing pressures in the United States, the stage is set for a range of possibilities in commercial real estate M&A.

Do they point to an end of the dealmaking slump? Possibly; but either way, we know this much: If you wait until the M&A market fully heats up to prepare for deal opportunities, you may find yourself at a disadvantage. With that in mind, consider taking the following steps:

- **Refresh your strategy.** Reviewing and adjusting your strategy on a regular basis can position you to flex quickly when an unexpected opportunity or roadblock comes up.
- **Button down your due diligence.** Understand potential tax legislation, controversies, data capabilities, and ESG matters as well as how they could affect the underwriting of the deals you're considering.
- **Decide who will do the work.** Given how significant the volume of deal analytics can be, there's little downside to determining the capacity and capabilities you'll need for the number of deals that interest you.
- **Make your assets as profitable as possible.** That includes reducing expenses, keeping the tenants you have, and enhancing the efficiency of your back-office processes.
- **Embrace technology.** Explore ways for emerging technologies to boost your bottom line and enable you to scale up more efficiently (like Generative AI for lease management, to name one example).

After two straight years of declining fundamentals, real estate capital markets may have reached a market bottom. How industry leaders choose to respond could determine the trajectory for 2024. By establishing a sturdy base of operations, organizations can be better positioned to improve their resilience to uncertainty and make bolder, more effective deals.

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