A return to cautious optimism amid expectations of interest rate reductions: Q&A on the state of commercial real estate with John Sullivan

After a period of multiple interest rate hikes and dramatically decreased investment activity, John Sullivan, chair of the DLA Piper's US Real Estate Practice and co-chair of the Global Real Estate Sector, sees a market that is showing signs of recovery as he prepares for DLA Piper's Global Real Estate Summit on May 7.

Sullivan leads the firm's US real estate group and co-leads the firm's more than 500-lawyer global real estate sector. With decades of experience in both the legal and business side of the CRE industry, he is keenly focused on the events and trends that impact the sector and ways DLA Piper's world-leading real estate practice can provide value-added advice to its real estate clients globally.

WHILE BEARISHNESS IS STILL THE PREVAILING SENTIMENT AMONG CRE LEADERS THIS YEAR, WHAT'S DRIVING THE INCREASE IN OPTIMISM COMPARED TO LAST YEAR?

First and foremost, an expectation of interest rate reductions later this year. Although recent employment and CPI reports have cast some doubt on the timing of rate reductions, there is still a general consensus that rates have stabilized and will come down over the next 6-12 months. Second, there is substantial interest in investing in asset classes, such as data centers, that investors believe will benefit from long-term secular growth trends. Finally, certain investors, including some of the world's largest funds, believe values are starting to reduce to a level that supports new investments.

IS THE CRE SECTOR CONCERNED ABOUT THE VOLUME OF DEBT COMING DUE THIS YEAR?

What challenges and opportunities does this "wall of maturities" present? Yes, this is a concern. Although estimates differ, there is something close to $1 trillion of debt coming due over the next year or so.

Some of these loans will be extended and some will be repaid (including through short-sales), but in some cases, the properties will go back to lenders. This is a double-edged sword; it's a difficult situation for the borrowers who may be wiped out, and the lenders who may have to book losses, but it will force asset repricing, help the market clear, and ultimately result in buying opportunities.

WHAT TRENDS AROUND SPECIFIC ASSET CLASSES AND MARKETS STAND OUT TO YOU?

In a market where transaction volume was down 50-60 percent, data centers stood out as an exception. With the rise of artificial intelligence, along with cryptocurrencies, streaming services, and other heavy computing power usages, data centers are an example of an asset class viewed as benefiting from favorable secular growth trends. According to CBRE, North American data center deliveries increased 26 percent from 2022 to 2023, and current construction projects were up almost 50 percent from last year. A Cushman & Wakefield study predicts a 2.5x increase in data center capacity in the Americas, 2x in Europe, Middle East, and Africa, and 2.2x in the Asia Pacific region. Research firm Renub predicts that within four years, the Asia Pacific data center market alone will be worth $54 billion. All indications are that we will continue to see significant growth in this asset class in the next few years.

HAVE THERE BEEN ANY DEVELOPMENTS SINCE THE DLA PIPER SURVEY WAS TAKEN THAT YOU THINK WOULD HAVE HAD A MATERIAL IMPACT ON THE SURVEY RESPONSES?

Much of the year-over-year increase in optimism was based on an expectation of interest rate cuts. However, after the survey was taken, the US Bureau of Labor Statistics' March jobs report showed an acceleration in the pace of hiring, a 3.8 percent unemployment rate, and a 0.3 percent month-over-month rise in average hourly earnings. The March Consumer Price Index showed an increase in inflation from March 2023 to March 2024 of 3.5 percent, marking the third consecutive month in which the reading exceeded expectations. Following the release of this data, at its May meeting, the Fed held rates steady and indicated that any rate cuts will be delayed until it is more confident that inflation is under control. It is possible that if this data had been available before the survey was taken, there would have been less optimism expressed, at least by those respondents who were placing significant importance on interest rate cuts this year. That said, long-term investors tend to be more focused on the general direction of interest rates, which most observers still believe is down, rather than the exact timing of those interest rate movements.

DLA PIPER'S 18TH GLOBAL REAL ESTATE SUMMIT ON MAY 7 WILL FEATURE SOME OF THE TOP DEALMAKERS, INVESTORS, AND INNOVATORS IN THE CRE INDUSTRY. WHAT INSIGHTS DO YOU THINK THE AUDIENCE IS MOST LOOKING TO GLEAN FROM THESE IMPORTANT CRE LEADERS?

We've seen tremendous fluctuations in the commercial real estate market recently: a long bull market, fueled by historically low interest rates; an abrupt shutdown caused by the most serious global pandemic in over 100 years; a rapid recovery driven, in part, by unprecedented governmental stimulus (and the continued availability of cheap debt); a spike in inflation (that turned out not to be transitory); a series of 11 interest hikes to combat that inflation; and, with debt suddenly significantly more costly and fears of a recession, a 50-60 percent reduction in investment activity. It's no wonder that many of us in the commercial real estate business feel a sense of whiplash. With this type of volatility, getting leaders in the commercial real estate industry in the same room is more important than ever. I think people will want to hear from these experts about where they think we are in the cycle and where they see the biggest challenges and the greatest opportunities. My hope (and expectation) is our clients will come away from this event having gained knowledge,

For more information

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