Deloitte.

CFO Insights

February 22, 2024

As office vacancies mount, commercial real estate CFOs dig in

The past few years have not been the best of times for commercial real estate (CRE) companies.[1] To get a clearer sense of what that means, consider that in last year's fourth quarter, the office vacancy rate in the United States hit 18.6%.[2] That figure represents a 30-year high.[3]

It's hard to make money off of empty space. Even as a post-pandemic economy comes into view, a significant portion of employees aren't interested in flocking back to their workspaces full-time.[4] In Deloitte's 4Q 2023 *CFO Signals*™ survey, 41% of respondents say they "somewhat" or "strongly" agree that their organizations will have a smaller real estate footprint this year.[5] While such decisions will likely help companies reduce costs, the drop in tenants is expected to affect the P&Ls of CRE businesses.

There may be some good news, however. Although a number of factors play into the financial state of the industry, borrowing costs are typically near the top of the list. And the situation on that front may be gradually improving. In the United States, Federal Reserve officials have indicated they may reduce the overnight rate by the end of the year.[6] Similarly, the European Central Bank appears to have finally put a halt to a series of increases to its key rate.[7]

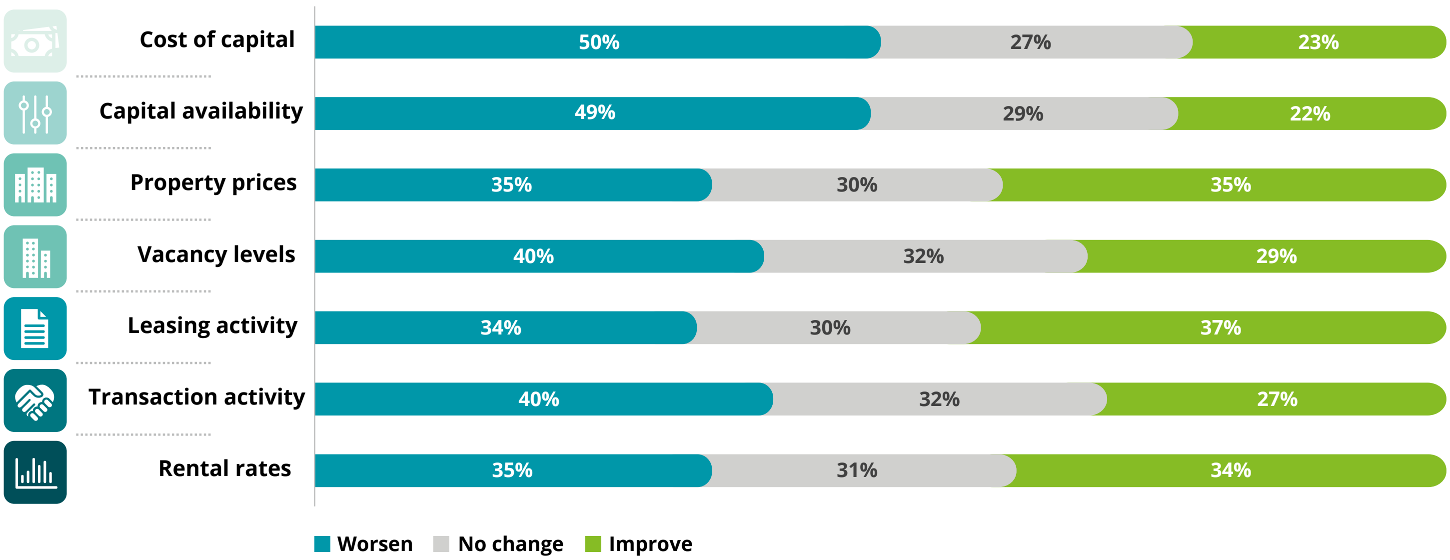
Many CFOs have a stake in how effectively the industry confronts its current challenges, given that costs related to office space typically rank as a top expense category on company balance sheets. Depending on the severity of the sector's woes—and the pace of its recovery—the ripple effects may spread to banks and other financial institutions whose portfolios hold a significant proportion of real estate loans. Such a scenario could make it more difficult for companies to access capital or refinance existing loans. By one estimate, commercial loan production will rise almost 30% this year compared to 2023, which was likely the slowest year for CRE borrowing and lending in about a decade.

In this edition of *CFO Insights,* we deconstruct the challenges currently facing finance executives of CRE companies. How can they reduce costs and streamline back-office operations in a down market—while also laying the groundwork for a potential industry rebound down the road? Longer term, how can they better insulate their organizations from future boom-bust cycles?

Coming up empty

Empty spaces are plaguing commercial office owners across the globe. Office vacancies in Asia-Pacific during the third quarter of 2023 stood at 15%; In Europe, 8% of office space was unoccupied.[8] In the Deloitte 2024 Commercial real estate outlook survey of 750 CFOs and their direct reports at major real estate owners and investment companies, 40% of respondents from the Asia-Pacific region, Europe, and North America say they expect occupancy rates in the property sector to decrease over the next 12 to 18 months.[9] Across all regions, most respondents anticipate property-sector fundamentals will continue to worsen throughout this year (see Figure 1).

Figure 1. More respondents than in prior real estate surveys expect fundamentals to worsen



Note: Percentages may not add up to 100% due to rounding; the Real Estate Outlook survey was introduced in 2018.
Source: Deloitte 2024 Commercial Real Estate Outlook survey.

The advent of hybrid work models has left corporate clients with extra cubicles. In the 4Q23 *CFO Signals™* survey, 65% of CFOs say they expect their companies to offer a hybrid work arrangement this year.

Shrinking office demand has, unsurprisingly, driven down rent prices. In the United States, asking office rents are forecast to drop 3.4% from their 3Q23 average.[10] In Deloitte's 2024 Commercial real estate outlook survey, published in June, 33% of respondents say they expect rents to drop through this year. This ongoing decline in rent revenue, along with inflated interest rates and difficulties obtaining financing, has dimmed not only the enthusiasm of investors for office properties, but other sectors of the industry as well. Globally, year-over-year investment volume across property types (office, industrial, retail, multifamily, hotel) in the fourth quarter of 2023 dropped 37%. Specifically, investment volume dropped 53% in the Americas and 49% in Europe. In the Asia-Pacific region, volume fell 20%.[11]

Given the decrease of money coming in, CFOs at property companies may have little choice but to address spending. Two years ago, only 6% of surveyed CFOs and their direct reports indicate their firms would be cutting costs. In this year's report, 40% say they plan to make additional reductions.[12]

Toward that end, CFOs at some CREs may consider outsourcing such functions as:[13]

- **Property operations and management**. Many real estate companies boast a long list of competencies. Soon, onsite administration of assets like residential towers may not be among them.
- **FP&A**. CRE firms could find it difficult to either attract or retain talent with much-needed technical skills. Employees with expertise in scenario planning and modeling—and now, artificial intelligence—are in high demand, hence hard to find.[14]

Depending on the severity of the sector's woes—and the pace of its recovery—the ripple effects may spread, making it more difficult for companies to access capital or refinance existing loans.

"Modernizing back-office systems and processes right now could be a competitive advantage once the current slump ends."

- **Internal audit**. Workers with experience in internal audit can also be hard to find and retain.
- **Technology**. Technology systems at some CRE operations are past their prime. In fact, 61% of global real estate owners and investors in the Deloitte 2024 Commercial real estate outlook survey say their organizations operate on legacy systems. However, updating or replacing networks could disrupt operations and eat up investment capital, making outsourcing more appealing.

Rebuilding blocks

CFOs at some real estate businesses may have another reason for outsourcing: Modernizing back-office systems and processes right now could be a competitive advantage once the current slump ends.

The Deloitte Commercial real estate outlook survey reflects that thinking: 61% of respondents indicated they are considering outsourcing certain operational capabilities. When asked to cite the primary reason for this, 42% of respondents cite boosting their technology capabilities and streamlining processes. Another 39% say they are looking to add agility and resilience to operations.

Certainly, resilience is vital in an industry that routinely endures boom-bust cycles. But the nature of resilience in the property business may be shifting. Indeed, CFOs and other executives at CRE firms face challenges that haven't existed in past years. An example: As part of Deloitte's Commercial real estate outlook survey, participants were asked to name the risk that poses the biggest threat to their organization's financial performance in the next six to 12 months. In the United States and Europe, cybersecurity tops the list.

Meanwhile, ESG has cropped up as a concern for finance chiefs at CREs. In the Deloitte Commercial real estate outlook survey, respondents in the US rank climate-related regulations as the second biggest risk to their organization's financial performance. In Europe and Asia, ESG compliance came in third on the list.

Structured finance

While finance chiefs at CRE businesses wrangle with relatively new challenges, familiar ones linger. Lining up funding from investors and lenders may be complicated. Some banks have already tightened lending standards and covenants for property loans. Regional financial institutions have pulled back on lending to some sectors of commercial real estate. In the second quarter of 2023, CRE originations of regional and smaller banks plummeted, down 53% year over year.[15] That's an issue, considering regional or smaller banks hold around 70% of all CRE loans in the United States.

Some CRE firms can turn to mezzanine and preferred debt—possibly even bridge loans to solve short-term liquidity problems. But refinancing debt that's coming due remains difficult. And there's no shortage of existing debt that's coming due. In Britain, nearly 40% of outstanding CRE loans will mature in 2024 and 2025.[16] In the United States, about $1.5 trillion in CRE debt is maturing by the end of 2025.[17]

A drop in interest rates could help the situation. In the meantime, CRE CFOs will want to prepare their firms to take full advantage of the inevitable recovery. They might also want to develop risk strategies to insulate their firms from the inevitable downturn that follows. Analyzing tenant mixes in their portfolio—a real estate version of diversification—could help hedge risks. So, too, could identifying markets and industry segments that are less likely to experience high vacancy rates during economic slumps.

After all, it's hard to make money off of empty space.

End notes

1. "The Commercial Real Estate Outlook for 2024," *US News & Business Report,* November 30, 2023.
2. "Negative Office Demand Continues to Ease," US Office, Q4 2023, CBRE, January 26, 2024.
3. Ibid.
4. "Remote Work Stable at Higher Rate Post-Pandemic," Gallup, September 15, 2023.
5. 4Q23 North American CFO Signals™ survey, US CFO Program, Deloitte LLP, January 2024.
6. "Fed officials indicated lower rates would be 'appropriate' by the end of 2024: Meeting minutes," Yahoo Finance, December 2023.
7. "European Central Bank holds interest rates steady after 10 consecutive hikes," CNBC, October 26, 2023.
8. "Commercial Lending Rebound to Continue Into 2025, MBA Reports," *Credit Union Times*, January 26, 2024.
9. "Out of Office: Global Office Space Vacancies at Record High," Statista, November 6, 2023.
10. "2024 commercial real estate outlook: Finding terra firma," Deloitte Center for Financial Services, June 2023.
11. "U.S. Real Estate Market Outlook 2024," CBRE, December 12, 2023.
12. Real Capital Analytics, Q4, MSCI, standardized download, February 8, 2024.
13. "2024 commercial real estate outlook," Deloitte Center for Financial Services.
14. "Preparing for the future of commercial real estate," *Deloitte Insights*, September 2020.
15. "Other Capital Sources Have Stepped in Amid the Small Bank Retreat on Real Estate Lending," WealthManagement.com, October 30, 2023.
16. "Forced sales ahead for indebted global real estate markets -M&G," Reuters, November 28, 2023.
17. "A $1.5 Trillion Wall of Debt is Looming for US Commercial Properties," Bloomberg, April 8, 2023.

Contacts

Tim Coy
Research Manager
Commercial Real Estate
Deloitte Services LP
ticoy@deloitte.com

John D'Angelo
Real Estate Solutions Leader
Deloitte Services LP
johndangelo@deloitte.com

Jeffrey J. Smith
National Real Estate Leader
Deloitte & Touche LLP
jefsmith@deloitte.com

About Deloitte's CFO Program

The CFO Program brings together a multidisciplinary team of Deloitte leaders and subject-matter specialists to help CFOs stay ahead in the face of growing challenges and demands. The program harnesses our organization's broad capabilities to deliver forward thinking and fresh insights for every stage of a CFO's career—helping CFOs manage the complexities of their roles, tackle their company's most compelling challenges, and adapt to strategic shifts in the market.

LEARN MORE

Deloitte CFO Insights are developed by Patricia Brown, Managing Director and Global Research Director, CFO Program; Josh Hyatt, Editor, CFO Insights, CFO Program; and John Goff, Senior Manager, CFO Program, all Deloitte LLP.