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Low interest rates drive high foreign capital interest in Boston real estate market

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Winter may be coming, but the Boston real estate market is as hot as August, fueled by low interest rates, and both institutional and foreign capital flooding the market.

With the Massachusetts economy strengthening and interest rates likely to remain near historic lows at least through next summer, developers are scrambling to take advantage of the economic recovery while rates are low. They are also benefiting from a competitive lending market.

Meanwhile, demand is driving prices to record levels. One reason is that Boston remains one of the top markets in the country for attracting foreign capital, which is funding some large-scale commercial development, but is especially fueling development of luxury condominiums.

About a half dozen luxury condominium projects are in the works, and they are seeing plenty of pre-sales. Foreign investors, in many cases, bought units for their children when they were in college and have enjoyed a bump in value of about 25% over the past few years.

Now they're investing in luxury condominiums, with the expectation of continuing high returns. At least for now, with demand high, they're again profiting. In Millennium Place, for example, condos that were selling for $950 per s/f a year ago are now selling for $1,200 per s/f.

Foreign investors need to understand, though, that there are tax consequences to these purchases. Internal Revenue Code section 897, as enacted by the Foreign Investment in Real Property Tax Act (FIRPTA), subjects the gain on the disposition of an interest in U.S. real property as connected income subject to federal income tax.

To ensure collection from foreign taxpayers, FIRPTA requires buyers of U.S. real property interests to withhold 10% of the sales price. The pain of FIRPTA can be eased with tax guidance from an experienced professional.

The hot Boston market is a boon for developers, but not so much for bankers, who are competing with non-bank leaders, such as life insurance companies and issuers of commercial mortgage-backed securities (CMBS). While banks previously were lending at the Libor interest rate, plus 2% to 3%, now they're forced to lend at around Libor plus 1.5%.

With loan-to-value ratios trending up, bankers are also concerned about a deterioration of lending standards. While lending standards are eroding, real estate prices are rising to the point where capitalization rates are approaching absurd levels.

Looking Ahead

These concerns aside, the large volume of capital flooding into Boston is unlikely to abate anytime soon, according to experts at a recent "Capital Markets" conference held by Bisnow. Boston's growth in recent years and its "solid fundamentals" will continue to be a draw, according to CCRE co-founder Peter Scola, who called debt capital "hyper aggressive."

Demand is especially high for multifamily housing. And while plenty of new projects are being built, there is little worry about an oversupply, given low production of recent years.

One reason is that Boston is growing for the first time in a decade. The city's population growth is coming from new residents ranging from Millennials, who can afford higher rents because they don't own cars and don't yet have children, to empty nesters.

Aside from the fundamentals that work in Boston's favor, at least two other factors could spur development here for years to come.

One is Boston mayor Martin Walsh's recently released, "Housing a Changing City: Boston 2030," an initiative that calls for the creation of 53,000 new units of housing over the next 15 years.

The mayor's plan includes incentives to drive down development costs, including zoning relief, permitting reform, tax incentives, modifications to the Inclusionary Development Policy, and use of land owned by the city.

While creating new housing, primarily for middle-class homeowners, the plan would generate an estimated $21 billion in new development. The middle class is being priced out the current market, so a government program such as that suggested by mayor Walsh may be the only way to accommodate middle-class homebuyers.

The other factor that could drive new development is consideration of Boston as a site for the 2024 Olympics. Whether the city is a wise choice for the Olympics is open to debate, but if it is chosen, the impact on the state would be tremendous, as huge investments would need to be made in the commonwealth's outdated infrastructure.

Regardless of whether Boston hosts the Olympics, the city's development is likely to thrive for many years to come.

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