CELEBRATING 55 YEARS

New Hampshire CRE provides ‘the best total returns’ - by David De Lise

April 07, 2023 - Northern New England

David De Lise

The Federal Reserve's decision to raise interest rates again last month by .25%, (25 basis-points) represents the ninth rate hike in 12 months (a ± 425 basis point increase since the start of 2022). While further interest rate increases seem inevitable, they will likely extend the muted theme and velocity of real estate financing for the next quarter, or longer. The pace and pursuit of new development projects, acquisitions of existing properties and the cost/availability of debt financing will continue to lag for longer.

We are advising clients of the probability that cap rates may experience upward pressure in the coming months. This will be particularly evident across markets and property types forecasting minimal rent growth, in addition to increased operating costs and declining occupancies. Capital market experts have cautioned rent growth projections should be conservatively underwritten across all property types for the next 18-24 months, with an assumption of operating costs increasing annually by approximately 5-8%.

While the interest rates are at their highest in over a decade, capital markets experts believe that short and long-term rate increases have mostly been priced into new development projects and financing requests. A commercial property or ground-up development will be more closely scrutinized by lenders, and we should utilize conservative assumptions for rent growth and increased operating costs over the coming months.

Tighter underwriting standards and increased borrower scrutiny illustrate a significant deviation from what we've seen over the course of the past decade. These challenges will present short-term headwinds within the market, and may stall or further delay construction, rehab projects and new acquisitions. Moving forward, the availability and cost of financing will be analyzed based largely on leverage. Investors with low leveraged assets will find a number of attractive solutions.

The decline in the 5- and 10 year treasury rates by approximately 70 basis points over the last five months has helped reduce the cost of capital in some instances. However, the significant increase in the cost of materials, labor, etc. will require a borrower to come to the closing table with more equity and expanded personal guarantees, which in the absence of increased value may make it difficult to obtain favorable financing.

Assets with shorter duration leases such as apartments and hotels and those with 'sticky' tenancy characteristics like self-storage facilities and manufactured housing communities have historically performed well during periods of high inflation and recessionary pressure. Investors recognize the short-term nature of these leases provides an opportunity to quickly adjust rental rates to meet market conditions and demand.

We anticipate there to be moderation to the pace of rental rate increases across all apartment unit sizes over the coming 24 months. There are several New Hampshire counties which experienced annual residential rental rate increases of more than 12%, 14%, even 20% during the past 36 months. Nationally, residential rental rates are projected to grow by an estimated 3.9% in 2023. The national vacancy rate should settle around 5.1% for the remainder of 2023. In our most recent market survey, we found that the overall vacancy rate for all unit types in New Hampshire remains under 1%.

The increase in the percentage of renters in New Hampshire who exceed 30%- 40% of their household income as it relates to rental costs is not sustainable or healthy. The increase in the number of cost-burdened households in New Hampshire has been somewhat overshadowed by the fact that New Hampshire already had very little existing inventory available prior to the pandemic. Many people are now looking to rent versus own, as higher interest rates, borrowing costs and tighter scrutiny have made it increasingly difficult to purchase a home.

A preferred investment strategy is the implementation of a value-add program, when a developer or investor will explore opportunities to increase rental rates and potential appreciation by creating a turnaround/upgrade/capex strategy. The goal is to accomplish the turnaround within a short period of time in order to increase rental rates, preferably coinciding with the expiration of the variable rate financing the developer utilized. The investor typically uses short-term variable rate financing to finance the initial acquisition as well as the cost of the improvements. Because of higher interest rates and increased borrowing costs associated, investors utilizing short-term variable rate debt will likely find it difficult refinancing when the loan matures.

If repositioning of the asset and rent increase is going to take longer than originally agreed upon, the lender might consider extending the loan maturity date which could result in more costs and contingencies on the borrower. The more likely scenario is that borrowers may have to realize a mark down in valuation until the property transitions from value-add to stabilized. In this situation, additional investor equity will be required, and expect personal guarantee provisions or completion guarantees to be expanded and extended.

The primary lending benchmark (the SOFR rate - formerly known as LIBOR) has increased by +400 basis points since the start of 2022. This rate is utilized when financing for value-add deals. These increases have caused lenders to curtail/reduce their exposure to value-add deals. We expect this challenge to persist across markets and property types over the shorter term, gradually improving late 2023 or early 2024.

Attractive investment and development opportunities can still be found throughout New Hampshire and select northeast markets. Over the years New Hampshire has been quite successful attracting investment dollars from a wide array of investors, and they have typically seen a slightly enhanced return on their dollars in New Hampshire. While this enhanced rate of return has narrowed slightly since the start of the pandemic, we have started to see a return to solid asset level performance across most property types, with multifamily and industrial properties leading the way.

A large global real estate services firm recently commented that investing in New Hampshire commercial real estate provides ‘the best total returns’ in comparison to commercial real estate investments in all other New England states.

We maintain great relationships with apartment community investors, owners/operators, developers and asset management firms throughout the country, with particular emphasis on expanding and dynamic communities along the eastern seaboard. We have an active pipeline of investors who are always looking to purchase additional 2-20 unit properties, however, over the course of the past 18-24 months, we have seen a significant increase in inquiries from investors and developers looking for 50+unit (or larger) communities.

Whether you’re considering a sale, looking to expand your real estate portfolio or seeking professional guidance and advice to analyze market conditions and trends, the commercial team of experts at Berkshire Hathaway are dedicated, caring and experienced professionals ready to assist you.

David De Lise is the director of commercial services at Berkshire Hathaway HomeServices Verani Realty, Londonderry N.H.