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Boston’s commercial real estate market remains resilient, underpinned by its strong economic fundamentals - by Jeffrey Muñoz

July 28, 2023 - Spotlights

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Boston’s commercial real estate market has long been a bastion of economic stability, attracting investors and businesses alike with its vibrant landscape and thriving industries. However, the city’s real estate landscape is facing a unique set of challenges. In a time characterized by soaring interest rates and high vacancies among traditional office space, navigating the commercial real estate sector in Boston requires a strategic approach and a keen understanding of the capital market dynamics.

Local and regional banks have pulled back on funding construction projects. Historically, these banks have been the overwhelming source of construction financing in Boston. While some banks are originating construction loans, overall, the level of dollars allocated to these projects have decreased significantly. There are many reasons for this decrease, but much has to do with where current rates stand and if the property's cash flows upon completion can support the higher payments. Since rates have nearly doubled in the last year, construction loans with upcoming maturities may find significantly lower refinance loan amounts due to debt-service coverage constraints. This may cause investors to come out of pocket to pay down their loan balances or risk forcing a sale of the asset. Another reason for limited construction funds available is high residential mortgage rates are lowering demand for condominiums and newly built homes. For these reasons, alternative capital sources have been seeing more lending opportunities for projects in the Greater Boston market.

While some may be inclined to paint a gloomy picture for the Boston office market, it is essential to delve deeper into the capital flow and the reasons behind it. Class A offices, lab space and medical offices have experienced the strongest leasing activity, hence these assets are where lenders are still active. Often at the expense of older office buildings, newly built offices are seeing the most demand. One Congress at Bulfinch Crossing, consisting of over one million s/f, achieved 100% pre-leasing prior to opening. While One Congress is just one example, this trend extends to many new class A office deliveries as employers opt for high-quality space and amenities. The lab sector has shown strength as tech and pharmaceutical demand for space continues to surge. By nature of their businesses, these employers require employees to be on-site rather than allowing remote work. Much of the new office supply coming on-line is lab space, especially in the Seaport, Longwood/Fenway and Somerville neighborhoods. Medical office space is still seeing rent growth with occupancy rates in line with their 10-year averages.

We have seen a surge in short-term financing requests as investors expect more favorable rates in the next 24 to 48 months. So much so that institutions typically lending on 10-year terms or longer have started adjusting their programs to accommodate shorter terms. Although we cannot predict how rates will move in the future, we always explore loan structures that allow flexibility to refinance in case rates become more favorable. While this strategy may be the best play today, it's worth exploring how short-term rates have risen compared to longer term rates. The one-year U.S. treasury yield has risen 490 basis points since January 2022, while the 10-year U.S. treasury yield has risen 213 basis points in the same period. Additionally, the shorter end of the yield curve rose nearly double than the longer end of the yield curve. So, if rates do fall, how low is the long end of the U.S. treasury index likely to go? And how significant would a recession have to be for the Federal Reserve to cut rates even close to their 2020 - 2022 levels?

Despite these challenges, Boston's commercial real estate market remains resilient, underpinned by its strong economic fundamentals, diverse industries and robust demand for multifamily, retail and industrial spaces. The city's reputation as a center for innovation, education and healthcare continues to attract businesses seeking to establish a presence in a thriving ecosystem.

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