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It's not just interest rates - by Bill Pastuszek

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August is a time when those on school calendars are getting ready and those who aren't are on vacation, or wished they were. If at work, the idea is to be there, looking busy, perhaps, but not necessarily present. It's the shadow weeks of the end of summer.

Weird weather summer. In New England, a bucket of rain couldn't be had last summer. This year, there has been more water than we know what to do with. Other parts of the world are enduring cataclysmic, destabilizing weather events.

Looking at CRE markets for the rest of 2023 and into 2024, there are trends worth considering. Let's examine some of them.

Is it more than interest rates that are crushing parts of the investment real estate markets? Probably. Since March 2022, interest rates were increased by the Federal Reserve at least ten times with an average increase of 50 basis points. The impact of doubling interest rates in a year and a half is something markets have not experienced in nearly 20 years. Are additional rate hikes likely? Quite possibly.

Higher interest rates affect economic activity at all levels. We know that. We also know that income-producing real estate is fundamentally affected by the cost of money.

U.S. residential mortgage rates keep going up, severely eroding home affordability. The 30-year fixed mortgage rate is nearly 7.5%, comparable to the high-rate environment of 2001.

Yields on the U.S. 10-year Treasury bond, a typical benchmark for borrowing rates, are at nearly 15 year highs. Commercial loan rates are strongly influenced by these indicators. Note that Baa and Aaa bond yields have risen over 70% since early 2022.

Strangely enough, indicators suggest a resilient economy.

A recent survey notes: "Distress in CRE transactions is still approaching." It might be here. The survey goes on to say, "Price is a gamble today. Nothing makes sense and land sellers are unrealistic given return-on-cost or yield-on-cost expectations." Transactional activity may restart once sellers realize that their properties are no longer worth what they were worth even six months ago.

Anecdotal research, gained from interactions with appraisers, lenders, brokers, and investors, shows almost universal expectations of greater distress in CRE transactions over the short term. Distress will be particularly acute in the office sector. It's been noted that much "not smart" money paid "unsustainable" prices for CRE during the height of the "free money" era. Those transactions became so comparable that it essentially set the market for further unsustainable purchases, creating a self-fulfilling loop. In that bygone era, plenty of lenders were willing to make loans. In a rising market, these over-priced assets looked just fine. Now with the squeezes from higher debt

service costs, higher operating costs due to inflation, lower occupancy, and subdued investor appetites, these assets are now set to move to the special assets section of balance sheets.

Locally, Boston market fundamentals are marginally more favorable than elsewhere, but there is plenty of pain to be experienced. Bank failures earlier this year spooked lenders. After the fact, many of these lenders have adopted more stringent standards but they won't help the distressed loans already booked. Lending data suggests reduced loan-to-value and coverage ratios with non-recourse loans harder to obtain. The lack of transactions will move appraisers' derivation of cap rates based on interest rate sensitive models.

The troubled loans suffer from several maladies. First, loans made in a different, much lower interest rate environment represent potential losses compared to current interest rates. Secondly, loan renewals will be at higher debt service costs. There will be cases with less NOI to service debt, due to higher expenses and vacancy and lower renewal rates.

The media has abundant examples of properties being returned to lenders and others teetering at the edge of default. And there will be more.

For office, U.S. vacancy is 13.2%, reportedly at near record levels. The average cap rate of +/- 8% is up. Per s/f prices are trending down. While leasing transactions are ongoing, tenants are taking less space; there is +/- 40 million s/f of space that has been "given back" to landlords due to tenant downsizing. Boston vacancy is nearly 11%; the average cap rate is 6.8%. Absorption is negative and there is growing sublease space inventory. Prices are trending down. New product provides competition at the market's upper end.

Commercial real estate sentiment in the spring was that markets were uncertain, drifting, lacking definition, the outlook going forward is more certain, more negative. While recession fears have receded for now, many think that if only interest rates went down or stopped increasing, all would be well again. Probably not.

Volumes are off and downward movement in pricing is evident. Commercial real estate markets peaked not too long ago and the cycle is now on the backside. Many ask, fairly, how low will prices go, how high will cap rates get? Some things to think about in these waning days of summer vacation.

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