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Investing in a falling rate environment - by Harrison Klein

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Long-term interest rates have fallen by 100 basis points, and the market is normalizing. In December of 2022 I wrote an article about investing in a high interest rate, high inflation market. Since then, inflation has cooled off, and the Fed has begun lowering their funds rate. All indicators point to rates continuing to fall throughout the first half of 2025. So, what does this mean for real estate investors?

Lower interest rates mean that more deals are penciling out again. While the days of 3% interest rates are in the rear-view mirror, we are presently seeing loans at rates below 6%. Many expect mortgage rates to reach as low as 5.0% in 2025, which would make the majority of our deals positively leveraged. The vast majority of our 2023 to 2024 sales closed with negative leverage (cap rate lower than mortgage constant). For the past two years, the only way to be a real estate investor was to bank on massive rent growth. Many investors chose to sit on the sidelines through 2023 and 2024. Now, these investors chasing cash flow are back in the market, making offers on our listings, especially those with cap rates between 7.5% and 8.5%. With more buyers entering the market to take advantage of a much more reasonable cost of debt, I'm projecting cap rates to compress in early 2025 and prices to increase.

Positive leverage is available today for properties offered at a 7.5% cap rate. At that level, the building should generate cash-on-cash returns north of 8%. This opens up many opportunities in the industrial, strip center, Class B medical office and professional office asset classes. Marginal positive leverage, with cap rates 150-300 basis points above borrowing costs, is what I'd call a "normal" market. Investors who have begrudgingly parked their money in CDs for the past two years should be getting ready to buy.

This shift also creates opportunities for sellers to pursue worthwhile 1031 exchange transactions. "I'd sell, but there is nothing to buy" has been a common objection we've had to navigate over the past two years. With existing debt 400 basis points below the cost of new debt, many would-be sellers, chose to hold. In 2025, those cheap loans start coming due, with the remainder mostly maturing by 2027. The delta between rates and shorter terms will create parity in the market. Cash-out refinances will free up capital for new deals, and local banks will start getting paid back on those 2020 loans, freeing up capital for new lending. Brokers are anticipating a significant uptick in transactional activity.

Will prices spike upwards in 2025?

Several factors will be working against that. First, there will almost certainly be more investment opportunities for potential buyers in 2025 compared to the previous two years. Second, falling interest rates have already been priced into many of the deals that have traded recently. The most aggressive buyers, who set the market, have all planned on having the opportunity to refinance in the 5% range in 18-36 months. One could argue that borrowing costs falling into that range have already partially been priced in. Finally, slowing inflation is often a precursor to deteriorating economic conditions, which could negatively affect the leasing market. Overall, I expect increasingly aggressive buyers to push prices higher. This said, I wouldn't expect to see the types of growth

experienced in 2021.

The bigger factor that owners and investors need to be wary of is the possibility that a slowing economy is driving rates down. This slowing is already impacting tenants. In 2021, many industrial tenants were growing and tripling their floor plates. Today, most leases are horizontal moves, business is stable, but it's not surging in the same way it was a few years ago. Without broad inflation, landlords should expect relatively modest rent growth over the next year or two. In the industrial world, the market will need time to absorb the large new spaces delivered over the past year. We expect to see a relatively neutral leasing market, with tenants negotiating concessions while landlords continue to achieve strong rents.

Another opportunity in today's market is refinancing for those who purchased within these last two years. Personally, I sold several buildings with traditional financing at rates over 7.25% in 2023. Those owners can refinance below 6% today, significantly improving cash flow. Lenders are getting busy, and if you have an opportunity for a cash-out refinance, it may make sense now. If you have leases with minimal term, refinancing today could help mitigate the risks associated with lease rollover. Every investor should be considering alternative debt sources, especially insurance companies, which continue to compete with traditional banks.

The time is now. Rates are heading down, and new deals are coming to market. If you've been on the sidelines, take another look at what's available. Lower rates are making buying, selling, developing and refinancing all more attractive than ever. I'm excited for 2025.

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