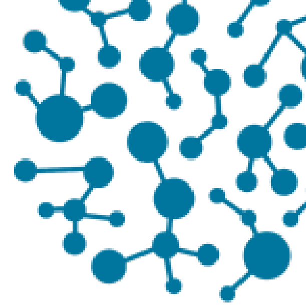

COMMERCIAL REAL ESTATE

HIGHER INTEREST RATES MAY LEAD TO LOWER VALUATIONS IN COMMERCIAL REAL ESTATE

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The U.S. commercial real estate (CRE) industry, already facing challenges with economic uncertainty, the shift to remote work, and recent layoffs by many major office tenants, now confronts an additional headwind: higher interest rates. Property values, which soared 30% in the 24 months prior to July 2022, have fallen -12% since then, with the bulk of the declines occurring during the first half of 2023[1].

The sharp rise in interest rates has not only forced property yields higher to compete with more attractive yields in other asset classes, but also sent financing costs for leveraged investors soaring. Over the next two years, the CRE market will experience a record amount of over $1 trillion in loans coming due[1]. Many of these loans were secured in the past five years when interest rates were lower, and many of these loans are held by banks. As a result, owners now face the challenge of refinancing or extending property-level loans for investments with a decreased value in a higher interest rate environment. Refinancing today will often require additional capital, making it more costly than borrowers originally projected due to the combination of higher interest rates and lower valuations.

Acquisition activity decelerated meaningfully in the first half of 2023. Sale volumes totaling $128 billion were down -61% relative to 2022 and on par with levels from 2013[2]. This can be primarily attributed to the rapid surge in financing costs, which has put mortgage rates on par with cap rates and severely hampered the economics of deal-making[1]. Power has certainly shifted from borrowers to lenders, who are in position to drive attractive returns.

Historically, CRE owners have relied heavily on banks for financing. As recently as year-end 2021, banks and other lenders were more than willing to lend. Now, options to finance an acquisition or refinance a property have narrowed considerably resulting in a drastic change in liquidity making it difficult for borrowers to secure any loans. Banks generally do not want to own real estate assets, which means banks may be willing to work with borrowers when a loan comes due. Modest to large loan paydowns may be necessary, and short loan extensions are a likely near-term solution.

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Sources:

1. MSCI Real Capital Analytics as of May 31, 2023
2. FS Investments Q3 2023 Real Estate Outlook

Given current macro, capital markets, and changing utilization trends in office, investors with fresh capital have an opportunity to take advantage of undercapitalized owners, especially in the middle market, creating a wide pricing gap between buyers and sellers. As loans continue to mature and more distressed sellers enter the market, pressure will push pricing lower, potentially spurring transaction activity. Increased transaction activity will likely restore confidence in pricing and valuations, signaling a positive shift in the commercial real estate market cycle.

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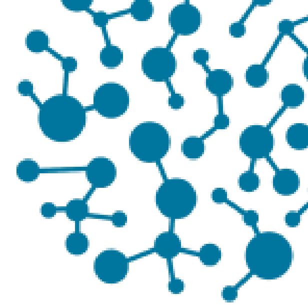

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