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Lenders Need Stability Before CRE Markets Will Recover

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Historically, the commercial real estate market has increased or at least maintained its value and overall performance during periods of high inflation. According to a study done by Principal Asset Management, which accounted for notable periods of high inflation throughout history (including the late 1970s and early 1980s), commercial real estate has outperformed inflation 87.7% of the time. Investors in commercial real estate have widely considered the sector to be a long-term hedge against inflation, due to the fact that owners of commercial properties are often able to offset any increases in operating expenses by increasing rents by comparable amounts. The commercial real estate lending market, however,

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is particularly susceptible to inflation, since, during periods of high inflation, central banks tend to raise interest rates to increase the cost of debt, which, in turn, discourages borrowing and decreases consumer demand. Conversely, when the central banks lower interest rates, the cost of debt becomes cheaper, which results in increased borrowing and higher demand for debt. In the last two years, inflation in the United States has risen to levels not seen since the 1980s. Macroeconomic factors such as supply shortages, geopolitical uncertainty, and low borrowing costs have led to higher commodity costs and inflation. In turn, high inflation has

led central banks to continue to increase interest rates, ultimately resulting in high borrowing costs and curbing economic growth.

From 2019 until 2021, particularly in light of the COVID-19 pandemic, the Federal Reserve cut the federal funds rate to generate borrowing and spur economic growth. The federal funds rate sets the range that banks will lend or borrow to each other overnight and directly influences the federal prime rate. The federal prime rate is the rate that banks will customarily charge their most creditworthy customers, and is generally 3% higher than the federal funds rate. During the pandemic, the federal funds rate was near zero. Like other industries, low interest rates stimulated the commercial real estate market significantly, and commercial real estate lending was at an all-time high, with a record $891 billion in loan originations generated in 2021.

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However, in an effort to combat high inflation, beginning in March of 2022, the Federal Reserve began rapidly increasing the federal funds rate. Today, the federal funds rate is just over 5%—a massive increase from the near zero rate seen just 18 months ago, and the highest federal funds rate in 16 years. The Federal Reserve rate increases have ranged from 25 basis points to 75 basis points. In March 2023, Federal Reserve Chair Jerome Powell stated that the goal in raising the rates is to bring inflation down to the annual 2% target, implying that the Federal Reserve may continue to increase the federal funds rate until that annual 2% target is met. Over the past year, the total cost of debt is up nearly 300 basis points or 3%. This higher cost of debt has made it increasingly difficult for commercial real estate developers to secure financing within a budget for a particular project, dampening commercial real estate lending and the construction of new developments.

One of the more significant expenses for commercial real estate borrowers is the purchase of an interest rate cap, which many commercial real estate lenders require borrowers to obtain (and to continue to maintain for the term of the loan) when originating or refinancing a floating-rate loan. Essentially, interest rate caps serve as insurance against the floating rate portion of the loan's aggregate interest rate. Prior to 2023, this floating rate was often the soon-to-be-phased-out LIBOR (and is now often Term SOFR). In exchange for an up-front fee or premium, a third-party provider will agree to make payments to the borrower (or lender) if the floating rate goes beyond a certain upper limit (i.e., the strike price). If the floating rate exceeds the strike price, then the third-party provider is responsible for the interest payment in excess of the strike price. Both borrowers and lenders benefit as a hedge from

having an interest rate cap in place. Lenders receive some additional comfort that a significant rise in the floating rate will not result in the borrower and property being unable to service its debt service, and borrowers are protected from high floating rates diminishing the property's net operating income.

Interest rates play a significant role in determining the cost of an interest rate cap. If a borrower purchases a cap when interest rates are low (and are expected to remain low for the term of the cap), the cost of the cap premium is usually reasonable. On the other hand, when interest rates are high, or if there is uncertainty with respect to how high interest rates will reach during the term of the cap, the cap premium could be one of the most significant closing expenses for a borrower. For instance, according to data from Chatham Financial, a two-year cap on a $25 million loan at a 4% strike rate has risen to $569,000 today compared with $97,000 just a year ago.

Federal Reserve officials have signaled that they are increasingly likely to hold the federal funds rate steady at their upcoming June meeting. This reprieve will give Federal Reserve officials more time to analyze the effects of the many prior rate increases on the economy and inflation (which was down to 4.9% in April (which was down over 4% from the previous high of 9.1% in June, 2022)). If the Federal Reserve is not satisfied that the prior rate hikes were sufficient to bring down inflation to a manageable percentage, many investors believe, and some Federal Reserve officials have indicated, that there will be additional interest rate hikes before the end of the summer.

Before deal activity in the commercial real estate lending sector can approach anywhere close to returning to its 2021 highs, many commercial real estate borrowers, investors and lenders will look for stable interest rates—either a cessation of rate hikes, or, at the very least, a clear ceiling. A certainty of stability in interest rates would allow borrowers and lenders to more accurately gauge borrowing costs, and therefore more reliably underwrite and predict their respective investments. Many market participants are hopeful that this stability will arrive as early as the fall of 2023. The real estate finance industry trade group predicts a 15% annual drop in commercial real estate lending in 2023, but assuming market participants gain more clarity on stable interest rates and valuations projects, an optimistic 32% bounce back in 2024. Although currently in a slow-growth period, if rates stabilize later this year as predicted, the commercial real estate sector will hopefully see a significant increase in deal activity in 2024, as previously sidelined borrowers and lenders return to the negotiating table.

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