



Industry Less Optimistic About Cap Rates, Interest

Rate Cuts

Two rate cuts or less anticipated by 92% of survey respondents.

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Optimism levels about the impact of mortgage and cap rates on commercial real estate are mixed, according to a new survey from CRE Finance Council, with 31% expecting a positive impact and 37% foreseeing a negative one.

This marks a shift from the previous quarter's more optimistic 48% reading, according to the 1Q 2024 Board of Governors Sentiment Index survey.

The poll was taken April 4-15, while the 10-Year Treasury rose from roughly 4.3% to top 4.6%.

Recent signals that the US Federal Reserve might not ease any time soon may be viewed negatively, according to the report.

The Fed's latest projections showed officials still anticipate three rate cuts of 25 bps each in 2024. "However, the economy's strength and signs that inflation is proving stickier than expected have resulted in the market adjusting expectations downward from 3 rate cuts to as few as 1 and potentially none in 2024," CREFC writes.

In the survey, 45% of respondents said two rate cuts are expected and 47% combined said there would be one or none. No one suggested there would be more than three.

Regarding debt refinancing, 56% said loan extensions with added credit-positive provisions (lockbox/cash management, equity infusion, added reserves, etc.) would be used.

Remarked one respondent, "It is worse than most people think it is, but we will get by with a lot of capital from alternative lenders and a kick-the-can approach by existing lenders. It will catch up to us with higher rates than other recoveries in 2025-26."

Another commented, "The impact of high interest rates, both negative and positive, is not just a function of how high rates are but for how long they are high. Continued elevated rates are not only bringing more loans to resolution via sale or liquidation but also resulting in more borrowers with refinanceable loans looking for financing at realistic rates and proceeds."

Aaron Jodka, US Capital Market Research Director at Colliers, tells GlobeSt.com that the rising sentiment around real estate fundamentals is a standout point.

“There is more conviction that conditions will improve over the next year, as the wave of multifamily and industrial development has peaked,” Jodka said. “This is a good sign for investment activity.

“Overall, the survey speaks to a stabilization of market conditions, which is a positive indicator for increased lending and borrowing volume in the quarters ahead.”

CRE Needs Stability

More than anything else, the commercial real estate market desperately needs interest rate stability, Michael J. Romer, Esq., Co-Managing Partner, tells GlobeSt.com.

“For well over a year, we all keep hearing about expected rate cuts which are coming but never actually come,” Romer said. “For financial and psychological reasons, such communication will stagnate any real estate market.

“Investors, both private and institutional, and lenders alike, need a better sense as to what market norms are or will be. With inflation still a serious problem and failed efforts such as the poorly named Inflation Reduction Act in the rearview mirror, serious market players are remaining cautious.”

Romer said on a positive, Blackstone’s recent \$10 billion investment in multifamily should result in a much-needed boost in market confidence.

Entering a Stagflation Environment

Chad Littell, national director of capital markets analytics at CoStar Group, tells GlobeSt.com he believes CRE is grappling with the implications of a stagflationary environment.

The 10-year treasury yield has climbed to 4.7%, a peak not observed since October 2007, barring a transient uptick in Q3 2023. For perspective, during the peak for multifamily and office prices in late 2021, this critical benchmark hovered around 1.5%.

"Global government bond yields are ascending as major world economies regain momentum after decelerating in 2023," Littell said.

Inflationary pressures are evident across various commodities, with oil prices increasing by \$10 per barrel recently, and copper surging 25% since October 2023. Since last year, even daily staples like butter and coffee have seen significant price hikes, up 33% and 40%, respectively.

"With high and rising prices at full employment, the narrative of persistently high interest rates is becoming more entrenched," Littell said.

From a growth perspective within the stagflationary framework, marked by net absorption, the trajectory has notably declined since the onset of 2022 amidst unprecedented levels of new supply.

"Nationally, net office absorption is anticipated to retract by 70 million square feet (MSF) in 2024," Littell said. "While the industrial sector is on pace to take in 64 MSF and retail at 9 MSF for the same period, these figures are significantly below pre-pandemic averages, particularly in industrial where large-tenant leasing has all but gone dark.

He said the outlook for the remainder of 2024 presents considerable challenges.

"Elevated interest rates, which are high relative to the past 15 years, add to the pain of falling rent growth and rising vacancies, which, in combination, should push capitalization rates higher. Although many in

the industry believe that the most severe declines in asset prices may have passed, it is premature to conclude that the market correction has fully run its course.”

Capital ‘Stable Enough’ to Price Deals

Victor Gutierrez, Vice President at Ten-X, tells GlobeSt.com that the market is cautiously optimistic that the cost of capital is stable enough to price deals.

“We have seen several buyers jump off the sidelines and actively participate in our auctions since the Fed announced the pausing of rate hikes in December,” Gutierrez said. “Ten-X believes CRE transaction activity will continue at elevated levels in 2024 compared to last year.”

From a lending mortgage banking perspective, Ivan Kustic, Vice President, MetroGroup Realty Finance, tells GlobeSt.com that he sees plenty of capital available.

“However, with the recent uptick in rates and the Fed’s hesitancy to begin lowering rates, we see cap rates remaining at their elevated levels for the rest of the year.

“With available debt currently in the mid-6’s, cap rates will remain less of a sizing factor until they rise to the mid-7 percent range.”

David Frosh, CEO of Fidelity Bancorp Funding, tells GlobeSt.com that he believes the \$1 trillion in maturing loans this year will be refinanced or sold at cap rates 100bps to 200bps above interest rates.

“New loans or sales will not pencil unless cap rates are higher,” Frosh said.
An Uptick in Transactions Anticipated

Jeff Brown, Founder and CEO of T2 Capital Management, noted that with an abundance of capital having been sidelined over the past couple of years with a 'wait-and-see' approach, coupled with sellers increasingly accepting prevailing pricing that comes with "higher for longer," 2024 is poised to see an uptick in transaction volume.

"However, regarding financing, demand will be increased, but the supply of financing will remain consistent with 2023, thus the conventional lending market seems relatively stuck," he said.

Ryan Severino, Chief Economist and Head of US Research, BGO, tells GlobeSt.com that although some people have been disappointed with the Fed's pace of rate hikes, so far, they are on course with BGO's expectations.

"Rates and sentiment aren't likely to shift meaningfully (at least not in a positive fashion) until the market is convinced that the monetary policy environment is becoming more supportive," Severino said.

"The empirical evidence is strong here – once the Fed stops raising and ultimately starts cutting volume increases, prices increase, and cap rates decrease. We see no reason why that shouldn't play out again this cycle, even if the exact timing remains unclear. Cap rates will certainly become a more positive factor in the market. We just aren't there yet."

This high interest rate scenario isn't historically unprecedented, Ben Kadish, President, Maverick Commercial Mortgage, tells GlobeSt.com.

Decades ago, many properties traded at 10% cap rates with interest rates at 8%. The lower rates the industry has enjoyed since the global financial

crisis are likely not coming back anytime soon: Gone are the 3% and 4% cap rates across the board.”

Alternatively, Mike Green, CEO of multifamily investment firm Virtú Investments, tells GlobeSt.com that the transaction market will slow down.

“While that’s not good for the industry, it does make for better buys for those willing to make the trade, because the competition is so reduced that you’re getting a better price for the intrinsic value of the real estate,” Green said.