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Commercial Real Estate Market Analysis Report

Q4 2022

Rising interest rates have been a topic of discussion throughout 2022 for homebuyers and investors alike. The Fed has increased interest rates four times this year with the intent to curb spending,¹ hiring, and investments to reduce demand and bring down inflation.² These rate increases represent the most aggressive pace for interest rate increases since the 1980s.

The home buying industry has already seen the impact these interest rate increases can have on new loan applications. The volume of applications has fallen over the past several months, but inflation still remains high with levels reported at 8.2% for September and 7.7% for October.

¹ [Effective Federal Funds Rate](#) - Federal Reserve Bank of New York

² [Inflation Report Seals Case for 0.75-Point Fed Rate Rise in November](#) - The Wall Street Journal



Interest rate increases affect more than just homebuyer activity and have implications for those investing in commercial real estate (CRE). In this report, we'll cover:

- ▶ The impact interest rates have on underwriting standards and lower loan-to-value (LTV) ratios.
- ▶ How some institutional investors are using a slower pace of residential homebuying to secure discounted investment properties.
- ▶ What impact rising interest rates have on investment returns.
- ▶ What investors should consider when evaluating a commercial real estate investment.



The current state of interest rates

In November, the Fed increased interest rates by 75 basis points for a fourth time this year alone. The current Fed funds rate is 3.75% to 4.00%, representing levels not seen since early 2008.³

HOW INTEREST RATE INCREASES AFFECT CURRENT LENDING STANDARDS

Interest rate increases affect all areas of real estate financing – not just for prospective homeowners. Rate increases have the goal of increasing short-term borrowing costs, which reduces credit supply and makes loans more expensive for both consumers and institutional investors.⁴ Additionally, increasing property values over the last 12 months have forced lenders to tighten their underwriting standards and decrease the loan-to-value (LTV) ratio compared to LTVs seen in previous years.⁵

The market is showing current LTV percentages that are about 10% lower than those seen in the last few years as lenders are becoming more cautious

due to rising interest rates and the changing economic environment.⁵ This shift in LTV means anyone securing funding for commercial investment purchases must bring more upfront cash to the table than seen in previous years. According to David Bitner, head of Americas Capital Markets Research at Cushman & Wakefield, lenders are asking for more compensation because we are in a riskier environment than years past.⁶

Additionally, the pacing associated with the deals is slowing. Lenders are tightening their underwriting because they're focused on covering the debt in the current market and are not sure what the exit will look like when the property is sold. This has caused deal pacing to slow, be put on hold, or be canceled altogether.⁷

³ [Federal Funds Rate History 1990 to 2022](#) - Forbes

⁴ [Understanding The Federal Funds Rate](#) - Forbes

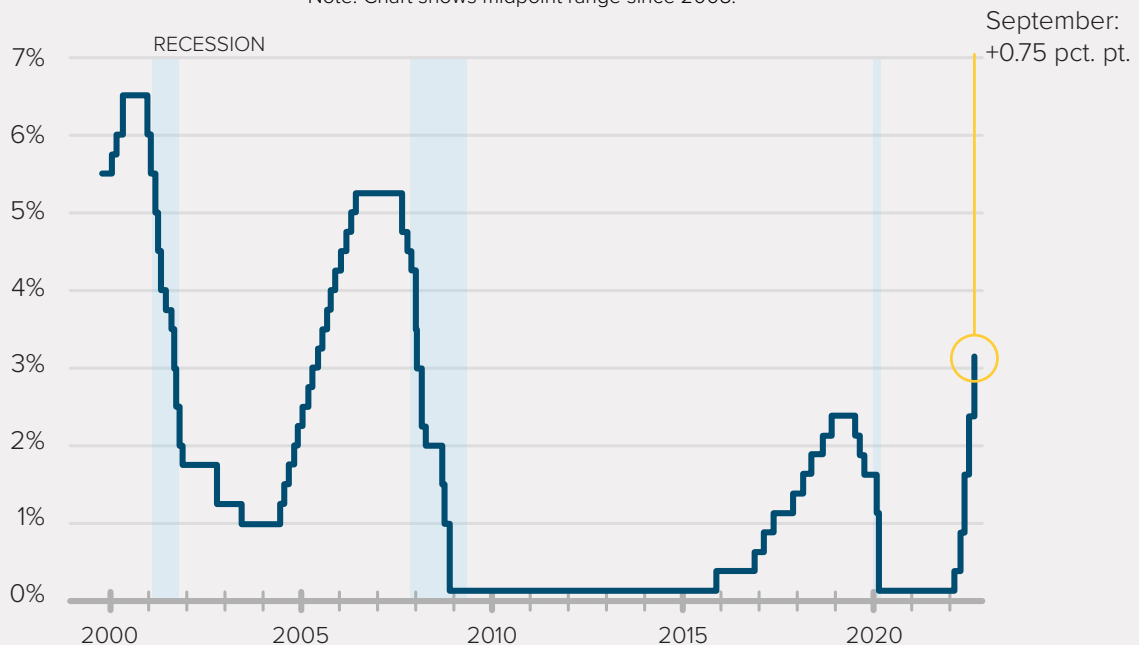
⁵ [Sponsored: What To Know About Interest Rates And Commercial Real Estate](#) - The Business Journal

⁶ [Commercial Real Estate Is Facing a Triple Threat: Interest Rates, Inflation, and Recession](#) - EisnerAmper

⁷ [Higher interest rates putting brakes on commercial real estate](#) - MPA

Federal-Funds Target Rate

Note: Chart shows midpoint range since 2008.



Source: Federal Reserve



How decreased mortgage activity may benefit select investors

The increase in interest rates has caused consumers to slow mortgage application and homebuying activity. Overall loan applications have decreased throughout 2022, with application rates halting to the slowest pace seen in 25 years as of the end of September. The main reason for the decrease in activity? According to Joel Kan, associate vice president at the Mortgage Bankers Association, the recent spike in mortgage rates is the cause. Additionally, he added that applications were down 37% compared to the same time period in 2021.⁸

⁸ [Mortgage applications see double-digit drop across the board](#) - MPA

⁹ [Home Builders Offer to Sell Homes in Bulk at Discount to Investors](#) - Wall Street Journal

However, this decrease in loan activity may prove advantageous for institutional investors who have the means to secure properties directly from developers. Because of the decrease in application activity, many developers are selling single-family homes directly to institutional investors because the developers fear average consumers won't be able to qualify for the financing needed to buy a home. One institutional investor in Florida is buying 20 new homes a month from a local builder as the builder's business has slowed due to higher interest rates. Because of the institutional investor's ability to purchase the homes in bulk, they are estimating a 15% to 20% discount on the purchase price of each home. Additionally, by purchasing the houses in bulk and directly next to each other, the investment is easier to manage.⁹

How interest rates affect potential investment decisions

For anyone considering a commercial real estate investment in the current environment, higher interest rates bring additional scrutiny in several areas. According to Jonathan Kingsley, an executive managing director at Colliers International Inc., a developer who did a pro forma on a deal with a 3.5% interest rate is now facing a 5% rate, which is a considerable jump. Additionally, these projects are facing higher construction, materials, and labor costs, which leads institutional investors to evaluate all areas of the transaction, including credit worthiness in tenants in the completed properties.

High interest rates could have a positive impact on real estate rental growth, however. Increasing interest rates that continue to trend upward will impact what investors can pay, but institutional investors will also be focused on increasing rents in their properties to keep their valuations high.⁵

The changing interest rate equation is causing some institutional investors to either attempt to renegotiate the terms of their deals or potentially walk away. However, real estate attorney Louis Archambault considers those deals more of the exception and said that most transactions continue to make sense for institutional investors even if there is a higher cost associated with the deals, especially taking into consideration the volatility seen in the stock market.¹⁰

THE POTENTIAL IMPACT OF INTEREST RATES ON THE DST MARKET¹¹

Higher interest rates will impact real estate transactions in 2023, but it may not be all bad for investors. There are many potential impacts increased interest rates could have on the Delaware Statutory Trust (DST) market. If investment demand softens, this could create an increase in competition among Sponsors, potentially giving more seasoned Sponsors and large institutions staying power while eliminating weaker, less experienced players in the market.

“When returns are compressed, landlords have to be a little more careful that underlying income from tenants is there to get the value where it needs to be.”

JONATHAN KINGSLEY¹⁰
Colliers International Inc.



However, the DST market is currently experiencing an increase in demand even while interest rates have increased throughout the year. DST Sponsors raised \$7.8 billion in the first nine months of 2022, exceeding the \$7.2 billion raised in 2021 and representing twice as much as the \$3.4 billion raised in 2019. Some Sponsors attribute the growing size of the DST market to the interest from aging boomers to transition into passive property. This increased competition among Sponsors could force them to improve their DST product offerings to make them more investor friendly.

¹⁰ [Inflation, rising interest rates, bear market likely to affect commercial real estate deals — but how?](#) - The Business Journals

¹¹ [Interest in DSTs as a Real Estate Investment Option Continues to Grow](#) - WealthManagement.com

What should investors consider now?

Knowing this, what considerations should investors keep in mind when determining whether to invest in commercial real estate in a high interest rate environment?

NEW TYPE OF INVESTMENT?

Single-family rental (SFR) properties may become more available for investors as they become a new asset type for Delaware Statutory Trusts (DSTs). A DST comprised of SFRs can give the average investor fractional access to these rental homes that are purchased in bulk and professionally managed by the Sponsor. With mortgage applications slowing, many prospective home buyers may decide to prolong their decision to purchase until interest rates decrease, leading to a stronger rental market.

CONSIDER RENT FLEXIBILITY

In the event of a recession, multifamily and rent-flexible investments such as self-storage can prove beneficial as rates can easily be adjusted to affect current market conditions. Strong rental growth potential can help ensure a positive cash flow in situations where upfront costs (interest rates, construction costs, labor) continue to increase.

LOANS AND UNDERWRITING CONDITIONS MAY CONTINUE TO TIGHTEN

With decreasing LTV and increased underwriting scrutiny, institutional investors securing funds for commercial investments may need to bring more cash to the table to secure financing for their deals.

FOCUS ON SPONSOR TRACK RECORD AS PART OF INVESTMENT DUE DILIGENCE

When evaluating a potential DST investment, look at the Sponsor's track record. Those with a longer track record may have the ability to withstand market downturns and wouldn't be forced to sell an asset at an inopportune time. They may have experience operating during an economic downturn and investors can review how their deals performed.



TRY TO FIND INCOME-PRODUCING AND APPRECIATING PROPERTIES

One way to combat inflation is to purchase income producing and appreciating real estate with low-rate fixed debt. "Low rate" will be a relative term for a while as the future of interest rates may be uncertain. Even though interest rates are the highest we have seen in the past decade, there is the possibility that rates will continue to rise even more in the future.

ANTICIPATE REALISTIC RETURNS

Higher interest rates lead to higher debt service payments, which typically means less cashflow to investors. The penciled returns of last year are not the same returns anticipated today. All cash deals may be better options for investors, but this might be difficult if the investor has leverage on their relinquished property, like most 1031 Exchange investors do.

SHOULD YOU CONSIDER A DEBT-FREE INVESTMENT?

Given the challenges in securing debt terms that are accretive to the investment, there has been a substantial increase in DST offerings without debt. While debt-free investments may not be an ideal fit for every investor, for those seeking such opportunities, they now have substantially more DST choices than historically available.

Conclusion

Current and future interest rates will continue to grab prospective homebuyers' and investors' attention for months to come. Interest rates will affect investment activity, the volume of deals that hit the market, and investor returns, but that doesn't mean there aren't opportunities available to investors in the CRE market. By doing the proper due diligence and keeping a realistic view on returns relative to the state of the market, investors can still find investment options that are aligned to their goals and risk tolerance.

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All real estate investments have the potential to lose value during the life of the investment. All financed real estate investments have the potential for foreclosure.

All investments have an inherent level of risk. The value of your investment will fluctuate with the value of the underlying investments. You could receive back less than you initially invested and there is no guarantee that you will receive any income.

No public market currently exists, and one may never exist. DST programs are speculative and suitable only for Accredited Investors who do not anticipate a need for liquidity or can afford to lose their entire investment.