Reset ready: Navigating the great reset in commercial real estate

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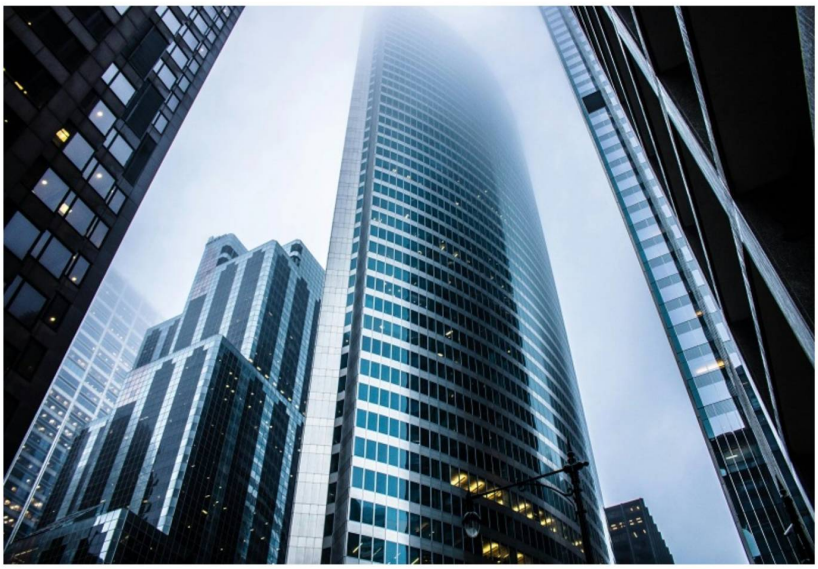


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A short-term interest rate cut may be on the horizon—but that doesn't mean we are returning to yesterday's persistent low rates and high valuations. The year ahead will require new thinking and reformulating the math as we structure financing for the next wave of commercial real estate investment. What CRE needs now is a significant recalibration—a Great Reset.

The first step: shifting how we think about interest rates. Sitting around and waiting for long-term interest rates to return to near-zero is overly optimistic. Even if the Federal Reserve achieves its inflation target of 2%, the federal funds rate will settle in at around 2% and a normal, upwardly sloping yield curve will result in a 5-year Treasury rate of approximately 3% and a 10-year Treasury rate around 4%.

With long-term Treasury rates at those levels, financing for stabilized properties will be in the 5% to 7% range—a far cry from the 3% to 4.5% range we saw just a few years ago. Unless real estate investors can withstand negative leverage for a short time because of increasing net operating income (NOI), most investors can expect to price prime properties using capitalization rates in the 6% to 7% range or higher. Moving from a 4% cap rate to a 6% cap rate is a 33% decline in a property's value, assuming NOI is stable.

That brings us to step two of the Great Reset: changes to NOI. While there has been significant rental rate growth—especially for apartments in certain markets and industrial properties nationwide—in many instances, expenses have increased as fast or faster than rental rates. Major operating expenses like real estate taxes, insurance rates, personnel costs and repair and maintenance costs have all had significant increases. The increase in expenses outpacing the increase in rents also creates a decrease in value to all property types.

Additionally, there is the coming wave of loan maturities to consider. **Twenty percent** of the $4.7 trillion in outstanding commercial mortgages will mature in 2024, according to the Mortgage Bankers Association, with **nearly $2 trillion** coming due by the end of 2026. About one-third of the debt coming due in 2024 is a result of loan extensions from 2023 by borrowers and lenders that were hoping for rates to come down in 2024. Assuming lenders do not extend the loans into the future, this wave of maturities will bring many properties to market at prices lower than the owners paid for them in the past.

Lenders whose underwriting factored in favorable debt service coverage ratios and traditional debt yield tests will likely weather the interest-rate storm without major losses in the CRE sector due to the low leverage that underwriting based on debt yield required. Those disciplined lenders will be able to remain active in the market and stand to gain considerably as the Great Reset occurs. The moment is especially ripe









financing during the low-interest-rate window between 2017 and 2020 now face the need to restructure their debt.

How can investors and lenders alike stay ahead of the curve? Here's a look at the year ahead.

Where we are—and where we are headed

Many "pretend and extend" lenders have long been awaiting a drop in interest rates that will likely not happen. The aftermath of the global financial crisis of 2008 created a misplaced sense of permanence around the low rates that followed. Many developers, investors and debt providers misinterpreted a temporary phase (albeit a temporary phase that lasted a decade) as the new normal. The reality is that interest rates in the 6% to 7% range, or far higher, were the norm in previous decades. To expect extremely low rates indefinitely was simply unrealistic.

Sellers have also been slow to adjust. Now, the disconnect between seller expectations and buyer willingness has propelled billions into funds aimed at acquiring distressed debt or assets. The pressing question remains: What will cause the bid-ask spread to narrow enough for transactions to take place? Borrowers that have locked in low, fixed-rate financing have no reason to sell into this environment. However, as loans mature and a wave of maturities occurs over the next year or so, these borrowers will be faced with the decision to refinance at much higher rates—assuming NOI growth has kept up enough to overcome the increase in interest rates—or they will be forced to sell or infuse significant equity into projects to replace the existing debt with lower leverage.

Different product types and geographies deliver different opportunities

Despite current challenges, the Great Reset will offer opportunities to both investors with dry powder and lenders with the capacity and willingness to lend into the CRE market. Some sectors, like new industrial and multifamily development, have cooled in recent months as the wave of new supply has overwhelmed the positive demographics of many multifamily markets (such as in the Sun Belt), and the satiation of industrial demand in the aftermath of pandemic-era supply chain disruptions.

Long term, both trends will enable unique opportunities for strategic investments amid market excess and the rise of office adaptive reuse. When an apartment community is not performing to pro forma, for example, a buyer can potentially acquire the property with less leverage and more equity, then refinance when lower rates come along.

The next phase of the Great Reset

Advancing the market requires a shift in collective thinking. After all, one investor's bad news may be another investor's golden opportunity. A well-performing building, such as a multifamily property within an in-fill market with high barriers to entry might simply have the wrong debt structure for the times. With a forced sale due to a maturing, low-rate loan, a new ownership group can invest at a reset basis. This creates opportunities for lenders and enables projects to be revived with a reinvented capital stack. Fresh capital and a willingness to invest and lend will be critical in successfully navigating the Great Reset.

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*As Executive Vice President and Head of **Commercial Real Estate and Specialty Finance** for Byline Bank, John M. Barkidjija leads an expert team managing an originated CRE loan portfolio totaling more than $1.8 billion in commitments.*

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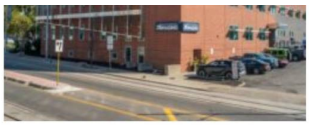
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