

Fast Rise In Rates Hobbles Property Rebound

Commercial buyers seek new terms as market distress begins to take hold

BY PETER GRANT

A growing number of commercial real-estate buyers are threatening to walk away from recent transactions unless the seller offers better terms.

Rapidly rising interest rates are to blame.

Investors who agreed to a purchase price this year when financing was cheaper are now demanding price cuts or other concessions before closing.

That insistence on retrading deals began when bond yields started to rise in late summer. It intensified last month after the Federal Reserve raised its benchmark rate by a quarter point and signaled more to come. "Rates went up, what, just a few days ago and I'm already getting calls where they're talking retrade," Jeff Powers, a Cushman & Wakefield managing director, said last month.

The typical six to 12 months between when a buyer signs a contract and when the sale is completed can make a substantial difference in financing costs when borrowing rates are rising as rapidly as they are now.

Eastham Capital agreed to pay about \$20 million for a roughly 200-unit apartment property in the Midwest. Before it put down a deposit, borrowing costs jumped by more than six-tenths of a percentage point, said Matt Rosenthal, the Boca Raton, Fla.-based firm's founder and managing director.

Rosenthal was able to convince the seller to cut the price

by \$600,000, after threatening to walk away. "It's certainly a different deal now," he said.

These retrades are an early sign of broader market distress weighing on property values, slowing development and making maturing loans harder to refinance.

"We are working harder to close deals now than we ever have before," said Bobby Werhane, a managing director of Marcus & Millichap's IPA Capital Markets division.

Commercial real estate— from offices in certain cities to shopping malls and hotels—had been enjoying a budding recovery. Reduced new supply, a pickup in workers returning to the office and a leveling off in interest rates in recent years helped boost property values.

Now, the sudden surge in interest rates is derailing that period of progress.

The fallout extends beyond property owners. Falling real estate values and fewer sales squeeze property- and transfer- tax collections. Higher rates also make it harder for developers to earn their targeted returns. That cuts demand for construction workers, architects and building materials. "The hurdle is simply higher," said Alfonso Munk, co-head of investment management at Houston-based developer Hines.

Few industries are as sensitive to interest rates as commercial real estate. Buyers typically put up a fraction of a property's purchase price and borrow the rest, boosting the return on their invested money. More than \$5 trillion of commercial and multifamily real-estate mortgages are outstanding. That's far more than Americans owe on credit cards or auto loans combined.

Commercial real-estate investors were expecting the Fed to cut rates earlier this year. Property values were rising because debt was costing less and yields on competing investments such as bonds were dropping, making commercial real estate more attractive.

Now the mood has soured. From late August, when rates began rising more sharply, through Friday, the FTSE Na-reit All Equity REITs Index fell more than 8%, according to real-estate analytics firm Green Street.

Higher rates are also adding to landlord distress because mortgages made when borrowing costs were lower come due. Owners that can't refinance or repay the loans at maturity are falling behind or being pushed into special servicing.

Data firm Trepp reported that in August, 11.4% of mortgages packaged into commercial mortgage-backed securities were being handled by special servicers, a sign that those loans were facing problems. That's the highest special serving rate since February 2013.

One bright spot is that lenders and investment funds still have ample capital to put to work. Debt and equity investors have raised money faster than the market has produced deals, intensifying competition among lenders for the strongest projects.

Northwind Group, a New York-based lender, recently provided a \$208 million first mortgage to convert much of a 355,000-square-foot office tower in Brooklyn into apartments. Ran Eliasaf, Northwind's founder and managing partner, said banks and private lenders competed heavily to make the loan.

Eliasaf agreed higher rates have increased loan pricing and prompted more conservative property valuations. But the increase "hasn't changed the ability for borrowers to obtain loans," he said.

Still, on the front lines, fights over price and retrade attempts are more common.

In June, real-estate firm Medalist Diversified agreed to sell a 65,000-square-foot retail property in Greenville, S.C., for about \$10.2 million. As rates rose during the summer, the buyer sought a price cut.

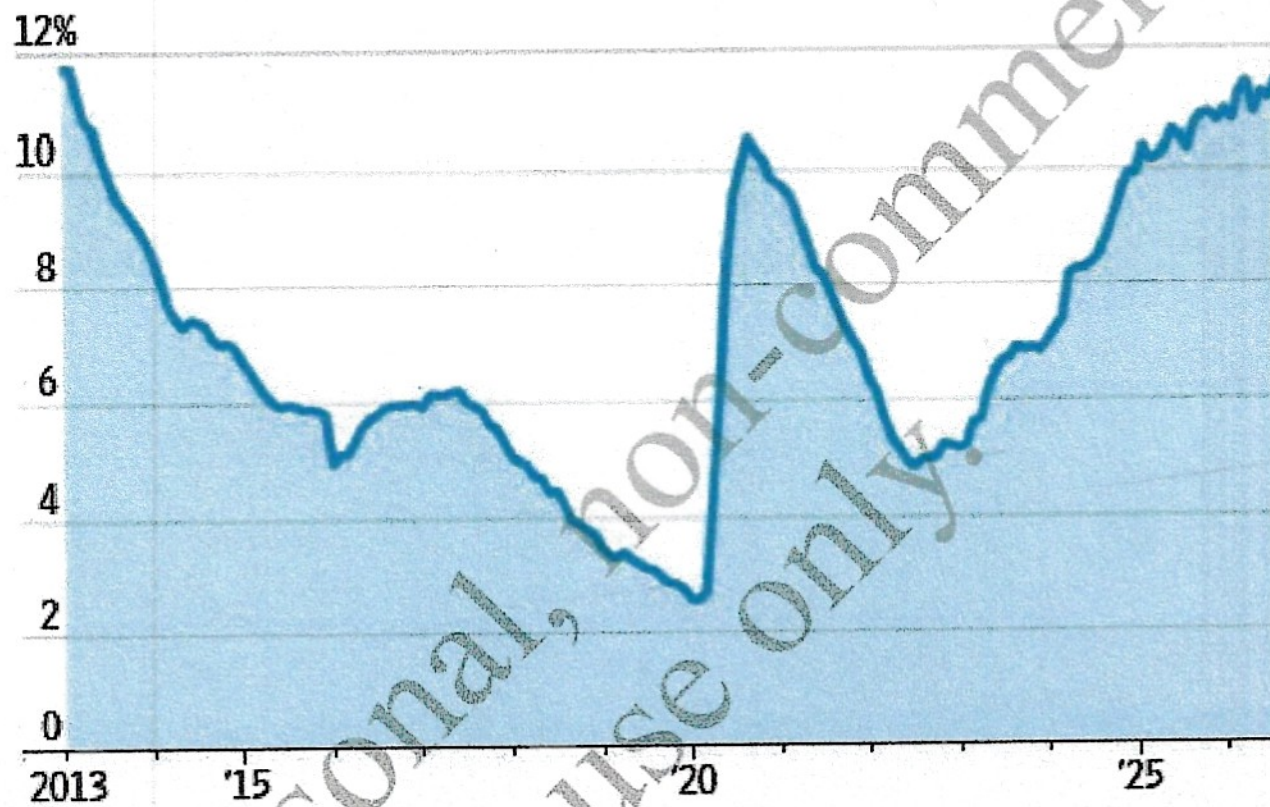
After some wrangling, Medalist agreed to reduce the price by \$100,000, and the deal closed in September "due to the potential impact of the interest rate environment," said Chief Financial Officer C. Brent Winn Jr.

And some lenders are backing out. A bank participating in a \$45 million construction loan for a more than 90% leased retail center in North Carolina pulled out because of market conditions. Marcus & Millichap was able to find a replacement lender.

"There's just much more friction in the market," said Werhane, of Marcus & Millichap.

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Percentage of commercial real-estate mortgages packaged into securities being handled by special servicers



Source: Trepp

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