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2023 Outlook: The Impact of Interest Rate Hikes on the Real Estate Market

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In July 2022, we wrote an alert describing the impact of rising interest rates on the real estate market. There were initial and embryonic signs of a slowdown. Now, we have collected data and surveyed clients and members of our Real Estate group to assess the impact of rising interest rates over the past six months and will share our thoughts about the prospects for the commercial real estate market in 2023. A number of these topics have been addressed in the press.

Our July alert can be found here.

Big picture over the last half of 2022, purchases and lending in all sectors consistently slowed down to a virtual standstill by the end of 2022 due to rising rates. This includes the industrial, office, retail, hospitality, multifamily, and senior living sectors.

The consistent interest rate increases, along with the knowledge that more increases were coming, caused great uncertainty in the marketplace. Sellers and buyers in all sectors either could not agree on a selling price or agreed on an initial price only to find that the buyer insisted on renegotiating or walking from the deal. Many transactions stalled and eventually died. New construction and rehab also slowed to a halt because of high rates combined with recession concerns.

Concurrently, lenders imposed very conservative requirements in the midst of continued uncertainty. High rates coupled with very low leverage requirements (like 50% loan-to-value ratios) made it very difficult for transactions to take place. Either the transactions did not underwrite with the high-interest rates on loans, or the buyers could not raise sufficient equity at acceptable returns given the low leverage requirements of lenders.

In addition, there has been significant turmoil in the derivatives market which has caused issues in the commercial real estate market. About one-third of the commercial real estate market is variable rate, and lenders require rate caps to hedge against interest rate risk. Cap terms are generally 3-5 years with the requirement that a new cap is purchased prior to the existing cap terminating. The price of new caps is extremely high, given rising interest rates. *The Wall Street Journal* reports that cap prices are 10 times from a year ago.

Many borrowers cannot afford such high prices. Consequently, some borrowers have converted their debt to a fixed rate if they can afford it and others have sold their properties at low prices so as not to default on their loans. In some cases, lenders have agreed to increase the strike rate of the cap and/or to shorten the term, both of which steps decrease the price of the cap.

Some lenders, including Fannie Mae and Freddie Mac, require that borrowers escrow monies to purchase future caps. These escrows are marked to the market generally every six months and have increased significantly with rising rates. This requirement has also caused dislocation and added stress for borrowers resulting in negotiations with lenders.

In terms of 2023, parties anticipate continued stagnation until the market has a reasonable level of certainty that rates have stabilized. Most believe this could last through the first six months of the year. During this period, parties will likely sit on the sidelines, waiting until rates stabilize. Once rates stabilize, many believe that transactions will resume at a relatively robust pace in all sectors except to the extent that a recession occurs and dampens activity. A worst-case scenario for 2023 is that there is stagnation during the initial six months due to interest rate uncertainty, and then there is a recession beginning in the third quarter. Given the already stagnant nature of the real estate market, a recession could result in a deeper downturn in the real estate sector overall than many seem to be anticipating. If this occurs, it is also unclear how lenders will respond to defaults. Whether lenders will forbear and provide extensions or exercise remedies is an open question.

Here are observations about specific sectors:

1. **Multifamily**: Given the shortage of multifamily housing in general and affordable housing in particular, it is expected that a recession will have less of an impact on this sector. This view is reinforced by trends impacting the demand for multifamily rental housing. Because single-family housing is still priced relatively high and because of high mortgage rates, growing numbers of people are renting. In addition, demand in the affordable housing sector is supported by various federal, state, and local governmental programs. Therefore it is likely that supply and demand dynamics will mitigate the impact of a recession in this sector.

2. **Industrial**: This sector is supported by federal policies designed to allow our country not to be vulnerable to supply shortages. The goal of national self-sufficiency will drive demand in this sector to help mitigate the impact of a recession. In addition, as long as a good amount of shopping is done online, there will be continuing demand for warehouses and distribution centers. Nonetheless, CBRE projects a 10-15% decline in leasing activity in the industrial and warehouse sector in 2023 and that lending will likely only be available to very strong counterparties, with others struggling to obtain financing.

3. **Senior Living**: While this sector has been impacted meaningfully by inflation, long-term trends in this sector may help mitigate the impact of a recession. Baby boomers are coming of age for the need for senior living facilities, which will expand demand. Lenders in the mid-market seniors space have gotten more active in January of 2023 based on a belief that interest rates have sufficiently stabilized. And lastly, some development deals are taking place with the expectation that construction will be finished after a recession is over.

4. **Hospitality**: With increased business and leisure travel, this sector has improved financially. However, a recession is likely to decrease travel creating some financial distress. Others factors will also exacerbate this distress. There has developed greater competition from Airbnb’s and similar alternatives that will continue to have an impact. Also, some areas are overbuilt with hospitality facilities. A recession is likely to have a negative impact on this

sector.

5. **Retail**: Retail business has generally increased as people have been more willing to shop in person rather than online. However, holiday sales were disappointing, with a 1.1% decline in retail sales in December 2022 from the prior month. We are aware of a few retail properties that were foreclosed upon by lenders. A recession will likely cause more stress in this sector. It will decrease people's spending as more people become unemployed and become concerned about becoming unemployed. Also, a recession will likely have the impact of slowing wage growth. In addition, the pandemic changed many people's habits so that online shopping may continue to undermine business at shopping centers. All of these factors make this sector more vulnerable to a negative impact from a recession.

6. **Office**: The office sector is the most vulnerable sector to a recession, given its already depressed state. The Wall Street Journal reports that office vacancies at the end of the third quarter of 2022 were at 12.3%, which was as high as the peak of the Great Recession. The office vacancy rate in San Francisco is more than 25%, and utilization of office space is at 40% of pre-pandemic levels. The pandemic has transformed work habits in a manner that materially undermines the office sector. If these habits continue for the long term, the office sector and many downtowns will be forever transformed. While there is some conversion of office space to multifamily housing, the long-term solution is uncertain. In addition, on some office properties, lenders have taken deeds in lieu of foreclosure and are now working to figure out how to maximize value for the properties.

7. **Public Sector**: Due to extensive federal support during the pandemic, States and local governments are generally in good financial shape with sufficient reserves to withstand a recession. The longer-term challenge for this sector will be the potential reshaping of downtowns if working from home continues to prevail. The workforce has historically supported small businesses and helped generate sales tax revenue. With office properties devalued and with less downtown business, property tax and sales tax revenue will decline. In addition, there is significant distress in mass transit systems which will not be abated until people go back to work to a greater extent and use mass transit rather than driving cars.

With unemployment at historic lows, many anticipate a mild recession in the latter half of 2023. Economic growth in 2022 was up 2.1%, with growth in the last quarter at 2.9%. Given this growth, it is likely that the FRB will not let up on interest rate increases causing continuing uncertainty. Whether a recession takes place and its severity are unclear. However, the unfolding of certain megatrends could cause any downturn to be more severe than many seem to anticipate. This includes new COVID variants resistant to the existing vaccine, climate change events that are persistently disruptive to economic activity, a slowdown in China's economy, the impact of growing protectionism, new amounts of supply shortages (on account of the above), and destabilizing domestic political events such as a prolonged struggle over raising the debt ceiling which shakes the financial markets.

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