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A Painful Evaluation of the Current State of CRE

If the Federal Reserve does increase the federal funds rate further, then the default rate will double to 4%.

By Joseph J. Ori | August 22, 2023 at 08:34 AM

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The CRE industry has been dealt a big blow with eleven interest rate hikes since March 2022 and a federal funds rate that jumped from 0.0% to 5.25%. This rapid interest rate increase has caused expected cap rates to rise to the 6.0%-8.0%+ range from the 3.5%-5.0% range only fifteen months ago and a painful revaluation of almost all CRE assets. The average CRE property's value has slid by about 25% due to this higher cost of capital. This is a risky situation for the industry; however, it does not mean that the CRE market in the U.S. will crash, similar to the Great Recession, which lasted from 2007 to 2012 when property values were down 50% on average.

Even though values are down, most properties are still generating enough cash flow to pay the annual debt and other costs like tenant improvements, leasing commissions and capital improvements. Most of the properties that are in distress were purchased at ultra-low cap rates during the last few years or are located in the high-crime Gateway cities with high vacancies and outmigration of businesses. Many of the buyers of these properties used floating rate debt to acquire the property without any interest rate protection by using an interest rate swap or rate collar. The rapid increase in interest rates since March 2022 has made it extremely difficult for these owners to cover the annual debt service on the property. Currently, the majority of distress in the CRE industry is concentrated in office properties located in the Gateway cities and buyers who overpaid and did not prepare for the interest rate risk from the use of floating rate debt.

However, the overall distress in the CRE market is not at dangerous levels as many pundits have been claiming during the last year. There is a total of $4.5 trillion in CRE loans outstanding per the Mortgage Bankers Association of America, of which the commercial banks/thrifts own 38% or $1.7 trillion. The distress level today is only about 2.0% of the total loans outstanding or $90 billion, which is a cause of concern, but not Armageddon as many have claimed. If the Federal Reserve does increase the federal funds rate further from 5.25% to between 5.50% and 6.0%, then I believe the default rate will double to 4.0% or $180 billion, a significant number, but still not a crash or CRE depression. There will be hundreds of properties in default but not enough to create an economic crash. During the Great Recession, the default rate for CRE loans was over 10.0%, which was a secular crash in the industry.

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