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TYPES NOT MAPPED YET November 08, 2024 | TTR not mapped yet | Gayle L. Mercier

Federal Interest Rate Cut and Potential Impacts on Commercial Real Estate

The Federal Reserve opted in September and November to cut interest rates for the first time since 2020, by a total of 75 basis points between the two moves. The latest drop on November 7, 2024, brought the federal funds rate to 4.50%-4.75%, citing inflation and an uptick in unemployment as the rationale.

The Federal Reserve may make a further cut in December, for a potential drop of 100 basis points by 2025. The rate cuts may lead to more noticeable movement in terms of higher sales and refinancing activity and a leveling off of commercial real estate distress.

The cuts in interest rates come after more than a year of uncertainty. In 2022, the Federal Reserve increased the interest rate from 0% to 5%, creating a stressful environment for banks and investors alike. Commercial real estate ("CRE") loans are often refinanced after 5, 7 or 10 years. This means that CRE loans taken out in 2019 would face refinancing at considerably higher rates in 2024 after the rate hike in 2022. The rate jump led to an increase in the costs of lending and a decrease in profitability. Banks consequently tightened lending standards and charged higher interest rates, which disincentivized investors, borrowers and developers and ultimately led to a decline in transaction volume.

While the recent rate cuts are a welcome surprise and certainly provide a psychological boost to some of the players, do not get too excited yet, because the implications of the rate cuts will likely be felt in the long term rather than short term. Lower interest rates will reduce the cost of loans and provide investors with access to cheaper capital, reduced interest payments and improved cash flow.

Additionally, the rate cuts may also open doors for refinancing opportunities. A significant amount of commercial real estate debt matures in 2025. Lower rates may provide borrowers more favorable opportunities to refinance existing fixed rates or floating debt at a lower cost. And with the reassurance from the Federal Reserve that further cuts are coming, banks might be reassured that they can grant extensions on struggling properties in the hope that performance will improve.

Notwithstanding the foregoing, it is important to note that the rate cuts will likely not have the same impact on all CRE sectors. For instance, in the multifamily sector, those who financed multifamily projects with floating rate debt or fixed rates may be able to refinance more efficiently following the Federal Reserve's rate cuts, leading to significant savings in interest and opening up cashflow for renovations or new projects. However, banks will likely continue to keep tight lending standards given the volume of upcoming debt maturities, so future transactions in the multifamily sector may tend toward refinances rather than originations.

In the office sector, the rate cuts do not excite much optimism. Since the Federal Reserve began raising rates, the U.S. office market has lost nearly a quarter of its value as a result of ongoing challenges following the pandemic, such as elevated vacancies and tenant delinquencies. Moreover, as of September 5, 2024, approximately 10% of CRE mortgages maturing in 2024 were office properties, according to S&P Global,[1] but landlords may find it difficult to refinance despite the rate cuts as the office sector continues to face high scrutiny and low valuations.

In summary, while we do not expect the Federal Reserve's rate cuts alone to open up the flood gates in CRE lending, we expect the cuts to lead to positive changes with CRE financing, including boosting the general CRE outlook and increasing transaction activity in the multifamily sector. However, Federal Reserve rate cuts alone will not solve sector specific issues such as those facing the office sector due to the overall current state of the economic and financial markets. While CRE is influenced by the economy and financial markets, CRE does not strictly follow the broader economy and capital markets, which are more directly impacted by the drop in interest rates.

[1] Thomas Mason, *Commercial Real Estate Maturity Wall $950b in 2024, Peaks in 2027*, S&P Global: Market Intelligence (September 5, 2024), S&P Global

About The Ground Floor

Whether you're traveling the 405, the 101, or the I-80, California is all about commercial real estate. In fact, other than water, many believe the most important legal issues concerning the Golden State are those with respect to the acquisition, management, and disposition of real property.

On The Ground Floor, we take a look at the complex issues involving commercial real property in California, including:

- Purchase and sale issues, such as those concerning due diligence, reps and warranties, indemnities, and remedies;
- Environmental and land use issues before and after buying the property;
- Leasing issues, both during the lease-up process and after a dispute arises between landlord and tenant;
- Property and transfer tax issues;
- Litigation issues;
- and more.

For any questions regarding commercial real estate or the blog content, please contact Jeff Brown.

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