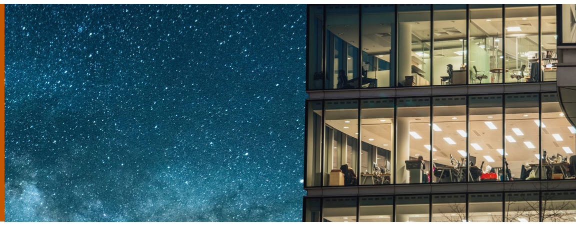
JO Knows Lending Issues Impacting Real Estate



DECEMBER 15, 2022 | BY: THE REAL ESTATE TEAM

You cannot turn on the news and not be bombarded with concerns about the economy and inflation, concerns which are particularly relevant to the real estate community. While some suggest that we are in a recession, there are economic indicators such as job growth and unemployment that argue against a recession. No matter what you call it, real estate is affected by what is happening, especially as interest rates are increased to try to battle inflation.

Interest Rates

The feds just increased rates another 50 points bringing the WSJ Prime rate from 7.00% to 7.50%. This is another increase in rates which started back in early 2022. The increase in rates is starting to affect decisions regarding possible deals as well as cash flow decisions. Deals that were originally papered with a much lower rate are now seeing a larger hit to projected cash flow for stabilized deals, and those in development are seeing increased carry costs. Depending on the size of the deal and the sponsors behind the scenes, these increases could cause activity to change. The effects of the interest rate hikes will probably be felt more outside the major hubs across the US.

Another issue we are seeing is with stabilized deals with loans that have rate adjustments coming up. These properties have enjoyed low interest rates for years, but the spike in interest rates is going to create a major cash flow problem as well as potential covenant issues. As rate changes happen on existing variable rate loans, companies need to be aware of and prepare for how those changes not only affect their cash flow but how debt covenants are affected. This could lead to a potential bump in refinancing in order to work out a deal that makes sense for the property and the bank.

Lending Environment

Lenders have voiced their concerns with the market and are getting more conservative in their lending. We are seeing more recourse debt than we have in the past, causing developers to rethink projects and/or structures for their deals. In addition to guarantees, financial reporting to the banks may increase. Those lenders that typically required internal financial statements may be requiring financials to be reviewed or audited by an independent CPA firm. While that may help to give the banks some comfort in the numbers being presented, it is another cost added to the deal.

Other Issues

The real estate industry has been battling increased pricing on materials and labor since COVID arrived. However, the value of the real estate being developed increased as well, so while the cost of the project increased, so did the exit values that allowed the deals to continue. These interest rate hikes will start to have an effect on exit value and the increased construction costs as a result of the larger carry costs from the interest and general cost of construction, it could cause a deal to pause. Subcontractors are also dealing with these increased rates, which will likely further cause the cost of developments to increase.

The rental markets for the various property types have been wildly different over the past few years. Multi-family rates are still high, and there are still projects being developed. Industrial rents remain historically high as well, with the shift to online shopping and consumers' expectation of immediate delivery, thanks to the Amazon two-day delivery we have all become accustomed to. Office rentals have seen the biggest adjustment, with higher vacancy rates due to the shift to remote work and tenants doing more with less space. As negotiations begin for leases coming due, it's important to factor in these interest rate increases to avoid problems with debt service commitments.

As mentioned in a previous blast related to changes to **Code Section 163J**, interest expense may be limited due to the changes in the limitation calculation. With interest rates increasing on top of an increase in the interest limitation, businesses will need to consider the impacts of 163j and whether the real property trade or business election should be done to preserve the interest deduction.

These issues affect all aspects of your business, including cash flow and the eventual tax consequences. We are here to help analyze various options with you to make sure you get the most given your situation.

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