Insight

Market pulse **September's rate cut is positive, but distress still looms**

The Federal Reserve cut interest rates by 50 basis points at its September meeting. But the decrease will not be enough to significantly move the needle for commercial real estate lenders and borrowers in the near term, ***writes Samantha Rowan.***

The cut was the first since the Federal Reserve initiated what would become a 500-basis point increase in interest rates from March 2022 to July 2023. While comments from Fed chair Jerome Powell indicate the potential for additional near-term cuts, the commercial real estate market continues to grapple with the understanding that rates will not revert to pre-2022 levels.

"Our house view is that interest rates will be higher for longer," says Greg Friedman, chief executive of Atlanta-based manager Peachtree Group.

"This means we will continue to be in a sluggish real estate market and a situation in which valuations remain under pressure because cashflows have not yet caught up to the rate environment."

Higher rates have also meant a significant slowdown on capital formation and deployment, kept transaction activity muted and made it more difficult for managers to raise capital for new debt and equity vehicles, according to Matt Posthuma, a partner at New York-based law firm Ropes & Gray.

> "We will continue to be in a sluggish real estate market"
>
> Greg Friedman
> Peachtree Group

"Higher rates are pushing everything back, and the delay in the disposition of deals affects the return of capital and the ability of investors to put money into new funds," Posthuma says.

Additionally, funds that have raised capital and have dry powder to deploy are often not doing so because the higher cost of debt means that often deals will not pencil at a level that will allow managers to achieve their returns, Posthuma adds.

Digging into the data

The thesis articulated by Posthuma and Friedman is illustrated by several metrics. Mid-year analysis from affiliate title *PERE* indicates fundraising for all private real estate funds lost momentum in the first half of 2024, with just $59 billion raised during that period – a level that is the lowest since the first half of 2024.

Meanwhile, New York-based data and analytics provider MSCI tracked about $92.8 billion of new transactions in the second quarter of 2024, a 2 percent drop from the same period last year. "Transaction volumes have remained muted as we haven't seen a lot of assets trading hands, although this could change somewhat going into the end of next year and into 2024," Friedman adds.

There are two potential catalysts which could force a market reboot: more predictability around key benchmarks, including the 10-year US Treasury, and the looming wall of maturing loans which MSCI pegs at $1 trillion through the end of 2025.

"Where the 10-year Treasury settles will impact the cap rate applied to assets, and the valuation and give buyers more conviction and sellers more confidence," Friedman adds.

"We also see the debt maturity wall is getting pushed and extended, and eventually, that will come to an end."

John Wilson, a partner at New York-based law firm King & Spalding, is starting to see some green shoots as the prospect of future rate cuts rises. The firm is seeing more sponsors seeking to raise capital – and more engagement from institutional investors.

"Even if rates don't decline significantly, we have reached the point where they will not be going up. That will lead to stability – and the reckoning everyone has been talking about because buyers will think, 'This is the bottom, and it is time to move,'" Wilson says.

Ryan Severino, chief economist at Miami-based investment management company BGO, anticipates activity to progress quickly once it starts.

"Fund managers are sitting on the largest amount of dry powder we have ever seen. Once the Federal Reserve cuts interest rates, you will see a repricing of assets and an increase in transaction and lending activity," Severino says. ■

Ups & downs

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"We are beginning to see signs of a market recovery, including stable to slightly improving overall values"

***Jarrod Phillips**, chief financial officer at Los Angeles-based Ares Management, on why the firm sees a potential upswing for commercial real estate, to affiliate PERE in August*

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"Calling the bottom of the market is a fool's game because you don't ever know the bottom until you look in the rear-view mirror"

***Todd Henderson**, co-global head of real estate at New York-based manager DWS Group, speaking to PERE Credit in August about the market's recovery*

The big numbers

Higher rates' impact on fundraising, deployment and valuations, and the Fed's first rate cut in more than two years were top issues in the market

50bps

Size of the Federal Reserve's long-anticipated interest rate cut; a move made at the central bank's September 18 meeting

20.9

Average months it took for real estate private equity managers to reach a final close for funds in the first half of 2024, a rise from the 11.2 months seen in 2019, per data from affiliate *PERE*

$120bn

Amount of capital real estate private equity managers could raise for new funds through the end of 2024 if current fundraising levels continue, also from mid-year *PERE* data – the lowest level since 2012

20-30%

Average valuation decline for commercial real estate properties, as estimated by lenders looking at refinancing opportunities or originating new loans

$92.8bn

Volume of transactions completed in the second quarter of 2024, according to data from New York-based data provider MSCI

$1trn

Value of commercial real estate loans slated to come due through the end of 2025, per data from Washington, DC-based trade group the Mortgage Bankers Association