Investors should diversify CRE investments across resilient asset classes and focus on properties with stable cash flows with potential for long-term growth (UBS).

Negative leverage in CRE: Risks and opportunities for savvy investors

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The commercial real estate (CRE) market currently struggles with high interest rates, a wall of debt maturities, and negative leverage in many cases, which increases risks for investors. Amid this environment, opportunities remain for well-researched, well-located investments to outperform in the long term, particularly in light of the significant unlevered dry powder on the sidelines. As CRE is a long-duration asset, investors must consider, among other things, an investment's future cash flow generation potential.

The CRE transaction market remains mired in a slump and continues to seek stabilized and/or lower interest rates and the USD 425 billion-plus in unlevered dry powder sitting in the hands of private equity to come off the sidelines. We believe a number of factors have contributed to the dearth of CRE transaction volume, including, but not limited to elevated interest rates, reduced access to capital, economic uncertainties, rising CRE debt defaults, negative leverage in many acquisitions, and interest rate volatility. The substantial increase in nominal 10-year Treasury yields in recent years has created a conundrum for CRE investors.

The relative stickiness in property cap rates in the face of rapidly rising bond yields has led to substantial spread compression between bond yields and cap rates, increasing risks for CRE investors, particularly in light of a potentially decelerating economy coupled with rising real estate taxes, and labor and insurance costs. The narrow spread, especially relative to long-term averages, is particularly noticeable for two of the stronger asset classes in CRE—multifamily and industrial.

In a vacuum, we believe rising bond yields could be manageable for CRE investors if there was a concomitant increase in property cap rates. However, property cap rate increases have largely lagged rising debt costs, resulting in a phenomenon known as negative leverage. Negative leverage develops when the cost of debt exceeds the operating yield produced by the property. In a negative leverage environment, the property's cash return is lower than the debt service (and vice versa for positive leverage).

Negative leverage develops when the cost of debt exceeds the operating yield produced by the property. In a negative leverage environment, the property's cash return is lower than the debt service (and vice versa for positive leverage). With negative leverage, the addition of debt to a CRE transaction results in levered returns being less than un-levered returns as increased debt service costs reduce a property's cash flow.

We believe it is possible for investors to make money in a negative leverage environment. A properly underwritten and financed levered investment can generate a higher IRR than a comparable un-levered investment. That said, it is crucial to stress test one's underwriting assumptions and run a variety of scenario analyses to understand the points at which negative leverage begins to erode value and potentially result in poor risk-adjusted or even negative returns.

There is much more to consider than just initial cash-on-cash returns with negative leverage. As CRE is a long duration asset, investors must consider an investment's future cash flow generation potential. This requires careful consideration of a number of variables, including, but not limited to, the type of debt financing (fixed versus floating, amortizing versus interest only), occupancy levels, and rent and operating cost assumptions. If the property's cash flow cannot keep pace with the debt service, then the potential for significantly lower or even negative returns is elevated.

Capital access from traditional CRE lending sources such as banks, insurance companies and CMBS is more restrictive. However, amid all the negative headlines about the current CRE cycle mirroring that of the global financial crisis (GFC) we believe the capital environment is substantially better than that of the GFC when for all intents and purposes, capital access was effectively nonexistent.

We observe notable trends in CRE capital raised across the bank, CMBS and unsecured debt markets. Although bank lending has declined substantially from its 2022 peak, the first quarter of 2024 has witnessed a significant rebound from recent quarters, particularly for multifamily and traditional CRE. In the CMBS market, YTD through June 2024 has seen more than the total CMBS issuance for 2023. This comes despite a meaningful increase in CMBS default rates for select CRE sectors. Through YTD June 2024 US REITs have raised more than 50% of the total capital raised by the sector in 2023. We would note that a majority of this capital is unsecured debt where spreads have continued to tighten since mid-2023.

When it comes to the multifamily sector, we continue to expect a bumpy ride in 2024. However, 2025–2030 will likely be rewarding to those investors that do detailed market, submarket, and asset-specific research to identify those markets that are benefiting from strong demographics, migratory patterns, and job creation.

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