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Capital, loans, transaction volume: North Texas real estate executives discuss the impact of climbing interest rates since March

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To state the obvious: In a quest to curb inflation, interest rates have surged. While no sector is safe from the ripple effect, it's real estate that tends to experience the first wave. Since March, the Federal Reserve Bank has raised rates by 1.75% and with that has come a more cautious deal environment.

Yet, as I often say: We have an asterisk due to the things that are going right in Dallas-Fort Worth andTexas, bucking trends and broader market forces that inhibit progress in other pockets of the United States.

We checked in with a handful of North Texas executives back in April after the first hike, and we're back to do it again after last week's jump. Rather than a crystal ball, we asked for a retrospective of what's changed in their worlds over the past several months. (Though it is tough to separate those experiences from projected activity through the end of the year.)

Here's the question we posed to a handful of executives sitting in the market that cover an array of roles in the commercial real estate sector: How has your world changed since the first interest rate hike in March?

Mike Bryant, CBRE: The increase in Fed short-term rates has created challenges with placing loans and with overall borrowing costs, both of which have been exacerbated by new banking regulations like Basel III, which was implemented in January 2022. We are spending more time advising our clients to provide color on the disconnect happening in capital markets that seems to be changing daily. We are still very active closing transactions, but the loan process is taking sustainably longer than it did 120 days ago as lenders raise their scrutiny of each loan request.

Philip McKnight, Eastdil Secured: Given the unprecedented Fed reaction to our current inflationary environment, the real estate market is quickly adjusting to rising SOFR and US Treasury curves, increased cost of borrowing, and increased discount rates, all of which have put pressure on valuations. The transaction volume has slowed this summer in response, however, given the ample liquidity that sits on the sideline we look for a quick recovery upon signs of economic stabilization.

Chris Peck, JE Dunn: Certain private sector commercial construction markets are experiencing a pause as the impacts of inflation, supply chain disruption and interest rate hikes are causing developers to re-examine project pro-formas. Interest rate increases alone are not a major disruptor, however, combined with the significant increases in construction material and labor costs, the overall project cost increases result in projects needing to realize higher rent rates. Developers and their debt and equity partners are having to evaluate whether their projects remain viable at higher rent levels.

Jordan Menashe, Menashe Properties: The office market remains robust from a leasing standpoint. We continue to see significant positive absorption within our portfolio while always focusing on offering the best product and value to our tenants and prospective tenants in every market or submarket. The investment and capital

markets appear to be starting to see significant 'cracks' due to interest rate hikes as well as a continued and growing bifurcation of asset valuations between buyers and sellers. It is definitely setting up for a fascinating next 12 or so months!

Alan Shor, The Retail Connection: In our world, the first quarter of 2022 continued the positive trends coming out of the last half of 2021. Retail sales were increasing month after month and consumer confidence was strong coming out of the challenges of the pandemic. Unfortunately, inflation was on an unprecedented increase and the Fed had to get aggressive by dramatically increasing interest rates. This slowed retail sales and has begun to cool off the real estate market on both the leasing and investment sides of the business. That said, I believe this is a short-term situation that will be a positive for our business in the long run and we are fortunate to be based in Texas, where the business environment is the best in the country.

Conrad Madsen, Paladin Partners: The capital markets have completely changed over the last 90 days. Capital is still available, but we are in a period of flux right now. Interest rates have rapidly risen, which in turn is pushing up cap rates. The movement in rates escalated so quickly that you now have a disconnect between buyers and sellers of commercial real estate. On the bright side, most capital had already priced the July hike into their pro-formas and are still moving forward with deals as long as the returns still work for their investors. Hopefully, we will start to see inflation come down this fall, rates will then stabilize and capital will start flowing back into the market at a more normal pace. We all know that all that dry powder cannot sit on the sidelines for too long, as they have pressure to put that capital to work. The best news is we are situated in the greatest economic region on earth and DFW is poised to rebound faster than anywhere else due to the continued net migration of corporate relocations, manufacturing operations, logistics and the continued exodus of citizens from the East and West Coasts that are looking for a better quality of life. I'm extremely long on DFW and especially industrial real estate.

Daniel Taylor, Colliers International: I like to say that business likes "certainty" because you can forecast, budget for the future, etc. In commercial real estate, we generally work three or four deals

during times like this to get one or two across the goal line. For instances like this, we see brokers make more of an effort to differentiate themselves from the pack, focus on being extra informative to clients and sometimes dip their toes into additional service lines. It's essential to listen to clients' concerns and give them good advice and information so they can adapt to the market.

Andy Goldston, market principal, Citadel Partners: Since the first interest rate hike in March, the industrial capital markets have certainly been impacted. The anticipation of ongoing interest rate hikes throughout 2022 has resulted in industrial developers adjusting their underwriting to account for higher anticipated exit cap rates. As a result, price adjustments in land negotiations are being made, causing a difference in pricing expectations between purchasers and sellers. Sellers, whose land held a certain value in February, are having to face the reality that large industrial developers can't make the same land acquisition prices work that they could previously. Developers that already have land secured are moving forward with their speculative developments, but a pause in new land acquisition is likely until the gap in pricing expectations narrows into a new pricing reality. The tenant market, particularly users under 300,000 square feet, remains active and we have not seen a slowdown. Many industrial manufacturers and distributors still maintain healthy businesses which are reflected in the low unemployment numbers that have been published. Overall, the industrial market remains healthy, but investors and developers are conservatively managing their risk-taking.

Cannon Camp, JLL: In the Fort Worth market, most developers have been anticipating additional increases in interest rates, so the trend remains the same: speculative development has slowed unless there are strong credit tenants to kick off new projects.

Al Silva, Marcus & Millichap: In the DFW multifamily market, we became used to a long period of predictable and very accommodative capital markets. Most of the deals over the past 18 months were done with bridge loans from debt funds and banks rather than Fannie Mae and Freddie Mac as was the norm for most of the past decade. That dynamic changed on a dime when the inflation data and the resulting rate increases came into play. This

caused loan proceeds to decrease for acquisitions combined with higher interest rates on those bridge loans, which has resulted in a bid-ask spread and a slowing overall transaction market. We and our clients are confident in the strong fundamentals for multifamily, and I predict that as sellers gradually adjust their pricing expectations, the Fannie and Freddie loans will become more attractive and restore balance to the market. Transaction velocity will then recover accordingly.

Howard Altshuler, partner-in-charge – Real Estate and Construction Services, Weaver: The biggest thing our clients and other colleagues see are deals falling through. With the increase in borrowing costs and the expected increases in cap rates, several deals that penciled out at the pre-hike rates are no longer attractive. Purchasers are taking stock of the numbers and are coming back with re-priced proposals to account for current and future interest rates. We expect this trend to continue at least until the Fed indicates that it has reached its interest rate target, if not somewhat longer as cap rates catch up.

Mark Cantrell, Cantrell McCulloch Inc.: Interest rates have yet to impact our industry due to 2022 assessment values being determined and based on valuations as of January 1, 2022, before the last two ¾ point increases. We are seeing and hearing that transactions, and buyer interest, have slowed and values have adjusted downward 10% or so since the vast majority of all commercial property sales are financed with debt that is now currently much more expensive. So 2023 assessments should likely see the effects of these increases as those values are determined based on January 1, 2023, and rates are expected to be even higher then.