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Will Rising Interest Rates Squeeze Corporate Space Occupiers?

Interest rates have been historically low dating back to 2009 and remain very attractive today for space occupiers that are in the market to buy or sell property. However, the Federal Reserve has increased the borrowing rate three times in 2018 and noted that additional increases in the benchmark rate are likely to continue in 2019, citing a strong economy and low inflation.

As of September 26, 2018, the benchmark borrowing rate was increased 2% to 2.25%. The increases in the federal funds borrowing rates can result in increases to the interest rates on commercial real estate loans and also consumer interest rates. So, how do rising interest rates affect an occupier's buying power to purchase a commercial property? Or, what is the impact on sale prices?

Generally, higher interest rates are not good for either buyers or sellers. For buyers, their capacity to make purchases is reduced. For sellers, their sales price might ultimately be less. In the following paragraphs, we outline how an increase of an additional 1% in the interest rate will impact both buyers and sellers.

For our example, consider an office building priced at $5,000,000. The buyer will use conventional financing with 20% down to purchase the property. The loan will have a 20-year amortization period and a 10-year term. The loan amount will be $4,000,000.

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Info@compass-commercial.com

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The interest rate on a commercial loan today is roughly 5.3%, so the annual debt service would be $324,787. However, if the interest rate increases to 6.3% by late 2019, the annual debt service increases to $352,246. So, the 1% increase in the interest rate results in the buyer's annual debt service cost increasing by $27,459 each year. Well, that doesn't sound too bad so far, but let's take a closer look at this difference.

A higher interest rate increases the total debt service, but not proportionally. The debt service is a combination of paying interest and also principal on the loan. The largest portion of the increase is the interest payments, so the buyer pays more in total debt service, but builds less equity than they would have built up at a lower interest rate.

In addition to the annual debt service being higher, the remaining loan balance at the end of the 10-year loan term for the 6.3% interest rate loan is $92,000 higher than the 5.3% interest rate loan. In total, the 1% difference in the interest rate results in a total cost difference of $458,000 to the buyer, which is a combination of $366,000 of additional interest expense plus the $92,000 higher principal balance owed at the end of the loan term.

For buyers, clearly there is value to making your purchase now before the interest rate rises because the loan is less expensive and more weighted toward the build-up of your equity in the property over the loan term. For sellers, it is much better to sell now to maximize the sale price of the property. In the example above, for the annual debt service to remain a constant amount despite having an interest rate that is 1% higher, the sale price of the property would need to decrease from $5,000,000 to roughly $4,610,000, which would be a pretty steep price reduction for a seller to approve.

For businesses that would use SBA financing to complete a property purchase with 10% down, the higher interest rate would have an even greater overall effect on the total loan cost because 90% of the property purchase price is debt.

If your company is considering selling a building or completing a sale-leaseback, the time to move forward on those types of initiatives is now, in order to maximize your sale price. For organizations acquiring property to occupy, your dollars will stretch farther today than they will a year from now in a higher interest rate environment. If you need to wait, just keep in mind that the transactions 12 to 24 months in the future are probably going to be a little tighter if the federal funds borrowing rate continues to rise.

Article submitted by Wayne Teig / ITRA Global Minneapolis-St. Paul, Minnesota USA