Can Rising Rents or Property Growth Make Negative Leverage Worthwhile?

Some CRE professionals are making assumptions that are 'very aggressive.'

By Erik Sherman

It's been decades since negative leverage was a regular unwelcome guest in commercial real estate. Now it's a trend again, according to Moody's Analytics, between growing loan interest rates and cap rates.

For those in the industry who are too young to have knowingly felt the impact of negative leverage, the concept is simple. Whereas many will say the three ls of real estate are location, location, and location, it might be truer to say that they are more leverage, leverage, and leverage.

In CRE, typically you use borrowed money to buy properties and ultimately make money. Until recently, 70% or 80% loan to value ratios weren't unheard of, and that was fine. Interest rates were only barely above ground, prices past the global financial crisis were on the rise, and so were rents. The internal rate of return was far better on all that cheap leveraged money than on unleveraged.

With negative leverage, the situation flips. Because of increased financing costs, increasing cap rates, and inflation driving up the cost of operations and putting tenants into worry over the cost of everything, negative leverage has returned.

"Negative leverage will most immediately translate to lower loan-to-value (LTV) ratios, a slowdown in lending and trading volume, and ultimately downward pressure on asset values, which hadn't yet occurred during the COVID-19 downturn," Moody's writes. "Negative leverage clearly marks a transition phase for the CRE market. We'll have to wait for the dust to settle in 2023 as the Fed's plans to curb inflation play out and if the broader economy can continue to grow at or near potential to continue propping up CRE demand and rent growth."

The company noted that CMBS loan interest rates are up between 75 and 175 basis points from the first to the third quarters. But cap rates, while starting to rise in some places, haven't seen a big change in multifamily or industrial.

"Meanwhile in Q3, the interest rates spike and cap rate stickiness has led to a dramatic jump in the share of CMBS loans with negative leverage," said Moody's. "The share of negative leverage loans ticked up in the second quarter, but then shot up to nearly a third of all CMBS loans in Q3." That is, up to 30.3% by count and 27.6% by loan balance. The balances in multifamily and industrial were, respectively, 30.8% and 35.9%.

Why multifamily and industrial owners and investors might accept negative leverage is because they think rising rents or property value growth will make it worthwhile.

But, as Moody's points out, to maintain about the same degree of leveraged IRR, "unprecedented average annual rent growth would have to be achieved," with, depending on the scenario, NOI growth between 6% and 11.5% on average per year.

"Therefore, the often-heard argument that rent growth will curb the impact of negative leverage means that some investors are making very aggressive assumptions, typical of the start of a transition phase of the market," Moody's said.