Brookfield

Tidal Shift: The Impact of Lower Interest Rates on Real Estate Markets

For investors who have been waiting for the tide to turn in real estate, the Federal Reserve's ("Fed") recent interest rate cuts may have signaled a highly anticipated inflection point.

The Fed's September interest rate cut of 50 basis points ("bps") and subsequent 25 bps cut in November has calmed the headwinds created by high interest rates that slowed real estate transaction volumes over the past two years. Investors who had been standing on the sidelines are beginning to reengage with markets, as they seek to unlock increased returns on commercial real estate investments enabled by the drop in the cost of capital.

While a 75 bps drop in the overnight Fed Funds rate may not seem like much, the corresponding decrease in commercial real estate lending rates has had a material impact on real estate investment. For example, an investor could have purchased a multifamily property in Houston, Texas in Q3 2023 for $15 million using a floating-rate loan with a financing rate of ~7.2% and a loan-to-value ("LTV") ratio of 60% **(Figure 1)**. The property's cap rate was 6.2% at time of purchase last year. After accounting for interest expense, the investment would have generated an annualized 4.8% cash on cash return.

A year later, in Q3 2024, the investor's floating financing rate dropped to ~6.3% on the same loan balance. Net operating income also increased during the period by 3.4% due to rental growth in the Houston market over the year, and the investor's equity in the property grew by 6% due to price appreciation. Importantly, the most material impact on the investment is due to the lower financing cost, which helped increase the investor's annual cash on cash return to 5.7%.

Figure 1: Lower Interest Rates Can Have a Significant Impact on Returns

Multifamily Investment Scenario in Houston, Texas

	Q3 2023	Q3 2024
Price	$15,000,000	$15,900,000
NOI	$933,232	$964,847
Cap Rate	6.22%	5.44%
Mortgage	$9,000,000	$9,000,000
Interest Rate	7.15%	6.34%
Annual Payment	$643,500	$570,600
Equity Investment	$6,000,000	$6,900,000
Net Cash Flow	$289,732	$394,247
Cash on Cash	4.8%	5.7%

Source: Bloomberg, Cushman & Wakefield, Green Street, as of November 2024. This hypothetical investment scenario is not a representation of an actual investment.

Shifting Market Tides Offer Potentially Favorable Outcomes

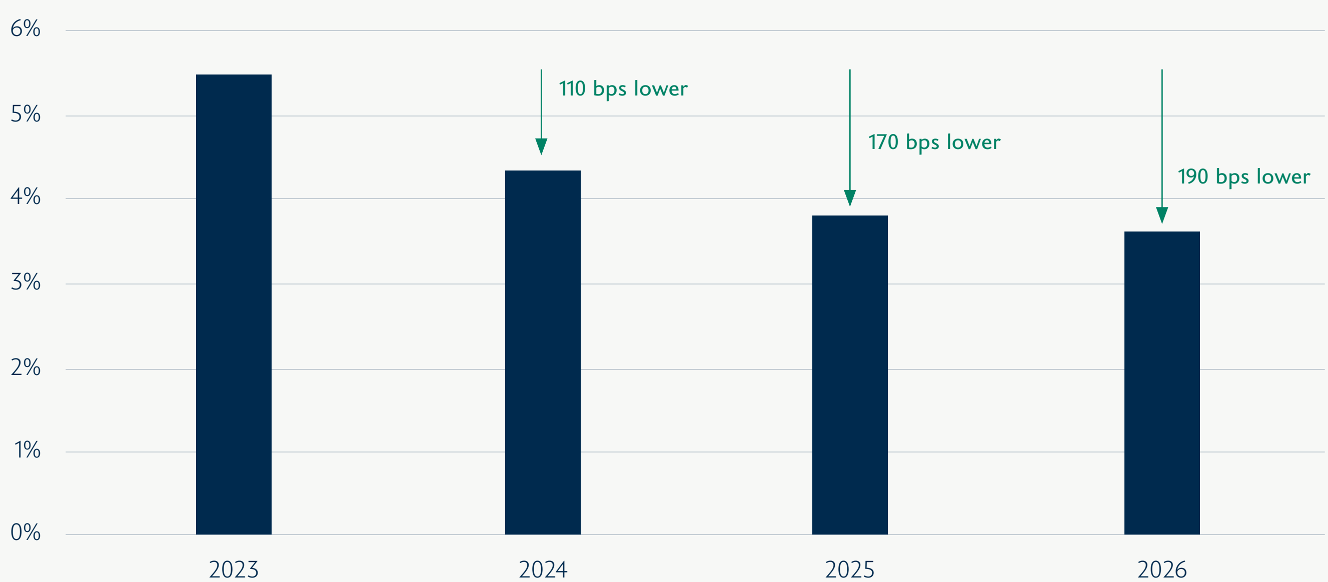
We are already in the next phase of the market cycle as real estate debt markets have reopened, evidenced by a three-fold increase in new-issue volume of commercial mortgage-backed securities for the first half of the year as compared to last year. According to CBRE, CMBS issuance reached $29 billion in Q3 2024, tripling the amount of the same time last year. Transaction volumes have begun to increase in the commercial real estate market, with $60 billion in transaction volume in Q2, a 31% bump over the previous quarter, according to CoStar real estate data.

Increased transaction volumes could lead to an uptick in real estate valuations, as increased bidding activity drives prices higher. Additionally, a drop in costs of debt usually results in lower cap rates (the ratio of a property's net operating income (NOI) to its purchase price), due to rising prices. Cap rates are used by appraisal firms to evaluate long term growth expectations and create valuations. Lower cap rates generally indicate lower levels of risk in a property investment.

Commercial real estate seeks to provide stable, long-term income through leases. When the Fed holds an accommodative policy stance and looks to further reduce rates, steady and predictable cash flows become even more critical to investors. Amid fluctuating economic conditions, investors seeking reliable income streams can capitalize on the current rate cuts to secure favorable investment terms. Markets are currently expecting additional cuts next year, which could further support real estate markets (**Figure 2**).

Figure 2: Markets are Predicting Additional Fed Cuts Next Year

FOMC Median Projections at Year-End

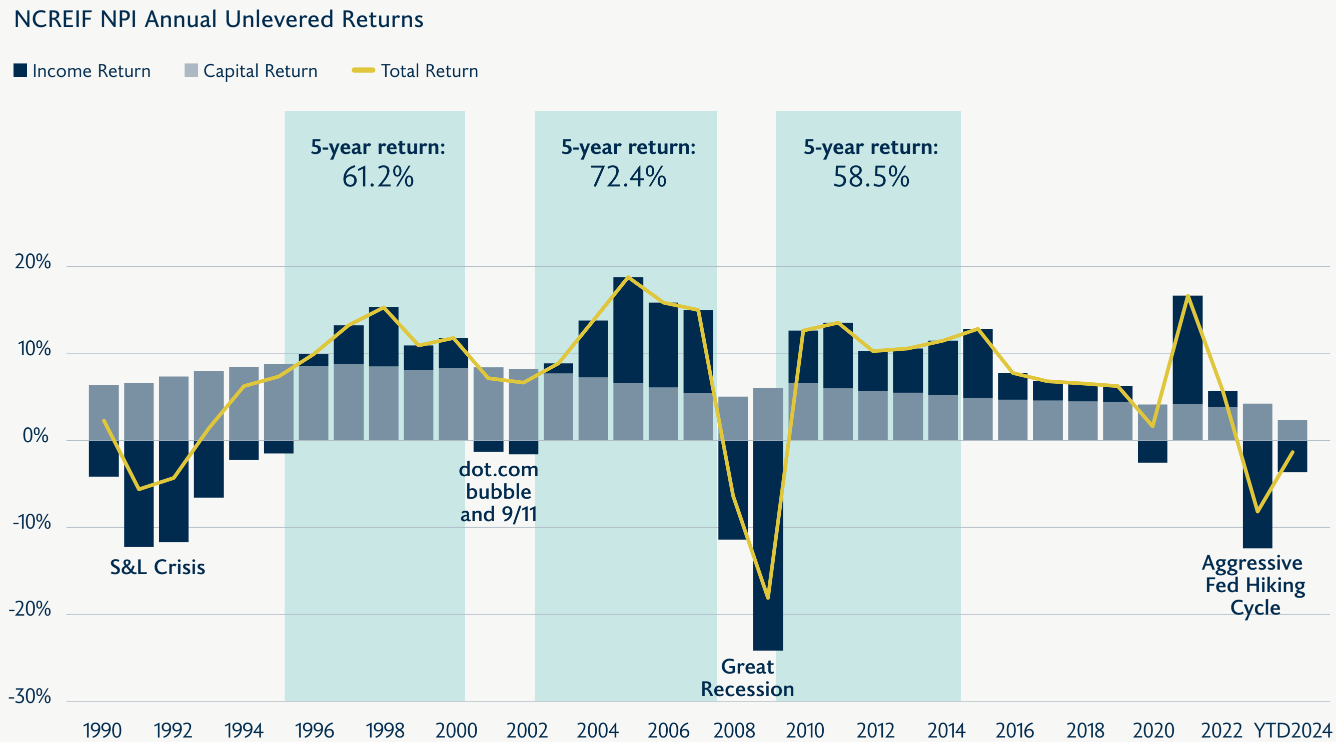


Source: Bloomberg, as of November 2024.

Historical Patterns of Extended Performance

Historically, property value corrections have reset the stage for extended periods of positive total return performance. As shown in Figure 3 below, periods following economic slowdowns in commercial real estate markets have been followed by large rebounds in subsequent years. Using the NCREIF NPI Index as a proxy for commercial real estate values, over the five-year periods following downturns, outsized cumulative returns followed, ranging from 58.5% to 72.4%.

Figure 3: Historically, Periods Following Economic Slowdowns Have Been Followed by Large Rebounds



Source: NCREIF NPI Index, as of September 2024. Income and Capital breakouts are included within the NPI Index and are provided by NCREIF. **Past performance does not guarantee future results.** Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. There may be material factors relevant to any such comparison, such as differences in volatility and also regulatory and legal restrictions between the indices shown and the strategy. The indexes are unmanaged and cannot be purchased directly by investors.

Capturing a Rising Tide in Valuations

Real estate markets are already showing quarter-over-quarter improvement, indicating the beginning of the upswing for future performance. Investing with a long-term objective means investors do not need to call the bottom, as they can be confident that they could benefit from outsized returns over an extended period, regardless of their entry point. We believe investing now, as rates have come down and have the potential to go even lower, positions investors well to capture a rising tide in real estate valuations.

DISCLOSURES

All real estate investments, ranging from equity investments to debt investments, are subject to some degree of risk.

FORWARD-LOOKING STATEMENTS

Information herein contains, includes or is based upon forward-looking statements within the meaning of the federal securities laws, specifically Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements include all statements, other than statements of historical fact, that address future activities, events or developments, including, without limitation, business or investment strategy or measures to implement strategy, competitive strengths, goals, expansion and growth of our business, plans, prospects and references to our future success. You can identify these statements by the fact that they do not relate strictly to historical or current facts. Words such as “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan,” “believe” and other similar words are intended to identify these forward-looking statements. Forward-looking statements can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Many such factors will be important in determining our actual future results or outcomes. Consequently, no forward-looking statement can be guaranteed. Our actual results or outcomes may vary materially.

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