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## Effect of rising interest rates on real estate industry

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There probably, isn't anyone in the real estate industry that has not wondered what effect rising interest rates will have on the prices/values of real estate.

There are some obvious and complex answers to this question.

Some of the obvious answers are as follows:

\* Mortgage payments will rise. This will decrease the net cash flow and therefore reduce the return on the investment. Depending on the current cash flow from the property, this could result in a negative cash flow.

\* The decrease in cash flow and investment return may result in disgruntled investors. Investors might have alternative, less risky, investment options yielding greater returns than the yield from the property.

\* Negative cash flows can create a need for capital calls. Not all investors may have the required funds. If an investor does not have the needed funds, the dilution clause in the investor agreement may be triggered or it may force a quick sale of the property.

\* The value of the property may decline. Since investors will have alternative investments that will yield them more than they do today, investors would require a greater yield from their real estate investments, translating to a lower price to be paid for your property.

\* The more complex answers relate to how the rise in interest rates will affect tenants. The rise in interest rates will add additional operating costs to tenants. In a time of economic turmoil, this might cause some businesses to close their doors, resulting in higher vacancy rates.

Higher interest rates and higher vacancy rates are a recipe for disaster. The following is an example of a recent property acquisition transaction:

Purchase price: \$24.1 million; Mortgage: \$18.9 million; 10 year mortgage, 30 year amortization, variable rate (currently at 5.75%); Annual debt service (principal and interest): \$1,324,000; Equity: \$5.2 million; Net Operating Income (NOI): \$1.8 million; Current rent roll: \$2.9 million.

At the time of the acquisition, the property had a net cash flow, before capital improvements of \$476,000, yielding the investors a cash on cash return of 9.2%.

If interest rates increased by 2%, the debt service will increase by \$301,000 to \$1,625,000. This reduces the cash flow to \$175,000, reducing the cash on cash return to 3.4%.

The reduced cash flow, not only reduces the return to investors, but also leaves a much lower reserve for capital improvements. Add the increase in vacancies to the increase in interest rates and a property such as this will likely generate a negative cash flow.

If this property were to experience a 6% vacancy rate and a 2% increase in interest rates, the property would have no cash flow, no return to investors and no funds available for capital improvements.

As interest rates rise, investors look for better returns than they can get from investing in "safe," liquid investments. To achieve the better return, a property such as the one in the above example, which originally sold at a 7.5% cap rate, might then sell for a 10% cap rate. Assuming the same NOI and no increase in vacancy rate, this property would be worth \$18 million, instead of the \$24.1 million purchase price.

What is one to do to hedge against the adverse affects of rising interest rates? Consider fixing the rate on any variable rate mortgages. Although this might cost more in the short-term, for the long-term it might save the investment.

Defer making investments until interest or vacancy rates rise. Better opportunities may be available as people are forced to sell their properties at reduced values, which will produce better returns.

No matter what you do, the one thing you ought to be doing is to evaluate your properties to determine which of them might be vulnerable to a significant devaluation.

Then, determine how to protect the investment.

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