

Perspective from



CREdge: Understanding Negative Leverage in Commercial Real Estate: Challenges and Risks

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The concept of negative leverage

If you tune in to our quarterly earnings calls, a recurring theme you've heard me talk about for over two years is negative leverage. Negative leverage is an incredibly unhealthy dynamic and has been shockingly prevalent in the Commercial Real Estate market for over two years, longer than any period in my 30-year career.

Negative leverage¹ is very easy to understand. It exists when a loan constant² (coupon + amortization³, or only coupon for interest-only loans) is higher than a property's capitalization rate (cap rate)⁴ - which is the unleveraged return⁵ on equity.

For example, if someone acquires an asset for a 5% cap rate, that means they are receiving a 5% return on their equity investment because they are not utilizing any debt. The return on that equity can increase or decrease in the future based on performance of the asset cashflows.

Impact on equity returns

Historically, in “normal” markets, investors will borrow debt at a loan constant or coupon that is lower than their cap rate – which results in positive leverage – meaning their return is higher than their 5% unleveraged return. We have been living in a market for over two years where the cost of debt is higher than the cap rate, resulting in the equity return declining by the borrower utilizing debt.

What does this mean? While Real Estate has exhibited strong fundamentals in several areas, ex-office, technical factors such as negative leverage have forced equity allocators to be very selective.

On the other hand, supply demand dynamics appear to favor lenders, and we always enjoy an environment where we get to swim downstream.

Resolving negative leverage

Negative leverage is solved in one of two ways, either interest rates decline or cap rates increase, or both. Until the commercial real estate market returns to positive leverage environment; real estate equity allocators must beware of their leverage utilization and allocate with a long-time horizon mindset.

Endnotes

1. **Negative Leverage:** A financial situation where the cost of debt (loan constant) is higher than the unleveraged return generated by an asset (cap rate), thereby reducing the overall return on equity.
2. **Loan Constant:** The total annual cost of a loan, expressed as a percentage of the original loan amount, encompassing both interest and principal payments (or just interest for interest-only loans).
3. **Amortization:** The process of gradually writing off the cost of an intangible asset over its useful life or paying off a debt through regular principal and interest payments.
4. **Capitalization Rate (Cap Rate):** A measure of a property's unleveraged rate of return, calculated by dividing its net operating income by its current market value.
5. **Unleveraged Debt:** refers to a financial metric or investment analyzed without considering any debt financing, focusing solely on its intrinsic performance before the impact of borrowing costs.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

The risks associated with a **real estate strategy** include, but are not limited to various risks inherent in the ownership of real estate property, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars).

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