https://www.theadvocate.com/baton_rouge/news/business/baton-rouge-commercial-property-hurt-by-high-interest-rates/article_11b7300e-ce72-11ed-8f60-6f717fb4172b.html

'Chilling effect': Baton Rouge real estate investors wary of rapid rise in interest rates

BY ROBERT STEWART | Staff writer

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Crews work to secure plastic siding at a new construction project along Bluebonnet Boulevard near Burbank Drive.

STAFF PHOTO BY HILARY SCHEINUK

Ask seasoned commercial real estate agents and bankers in Baton Rouge, and they'll tell you they've seen interest rates this high before, even if it's been a while.

The rapid rise in rates, however, is a different story.

"There has not been, in my 20-plus years in the business, a time when we've seen rates rise as rapidly as they have," said Branon Pesnell, who leads Corporate Realty's Baton Rouge office.

As the Federal Reserve has accelerated interest rate increases over the past year to cool inflation, Baton Rouge commercial real estate brokers and bankers say they've seen a slowdown in activity.

The market here is healthy enough to weather the storm, thanks in part to built-in demand from industrial, governmental and educational sectors, brokers and bankers said.

But those higher rates — along with rising construction costs and Louisiana's deteriorating insurance market — are causing some buyers and sellers to rethink their strategies, particularly on investment properties that may need refinancing in the next year or two.

"Investors, the new reality is whatever your expectations are, they shouldn't be the same as they were two years ago or three years ago or 10 years ago," said Steve Legendre, regional vice president and Baton Rouge market director for Stirling Properties.

Making the numbers work

Tracking interest rates for commercial mortgages is tricky because they are often variable, unlike for standard residential mortgages, said Mathew Laborde, president and CEO of Elifin Realty.

However, Gary Littlefield, Baton Rouge market president for Gulf Coast Bank and Trust, said the Wall Street Journal Prime Rate — a standard index for commercial banks — went from 3.25% in March 2022 to 8% earlier this month. That's led to a "chilling effect" in the market, particularly for office space.
As a result of low interest rates and stimulus infusions amid the COVID-19 pandemic, commercial real estate prices had shot up the past few years, Laborde said.

"I think we're kind of getting to that point where maybe we just reached a peak and we're kind of coming on the other side of it," he said.

Amid stubborn inflation in 2022, the Federal Reserve began raising its benchmark rates in March and has frequently implemented severe increases, which have since slowed. That's led to a mild shock in commercial real estate, including in Baton Rouge.

In East Baton Rouge Parish, commercial real estate sales hit about $1.2 billion in 2022, up from $993 million in 2021 and well ahead of nearly $500 million in 2020, according to Elifin Realty's latest market report. However, sales through February 2023 were only $70 million, compared with $131 million in the same time frame in 2022 and $119 million in 2021.

Sales in Baton Rouge's office sector have dropped only marginally from 2021 to 2022, according to the latest data from the National Association of Realtors. The retail and industrial sectors suffered. Sales for retail properties plummeted from $69.8 million in the third quarter of 2021 to $27.4 million in the third quarter of 2022. Industrial sales fell from $17 million to $5.5 million.

Owner-occupant properties — where the owner is also the tenant — aren't quite as sensitive to interest rate fluctuations, Laborde said. For investment properties, though, investors have to maintain tenant rental rates that offset their debt payments.

Some investors may have bought properties a decade ago at a 3% or 4% rate, Legendre said. Those loans are likely about to mature, so those investors will have to refinance at a higher rate.
"Even in a market where you have 6.5%, 7% interest rates, it's not going to completely kill investment, but the criteria is going to be a little different," Legendre said.

With rising interest rates, it's cheaper for some businesses to rent property instead of own it, Pesnell said. However, property owners will likely have to raise their rental rates to offset higher costs for borrowing and construction.

"It's going to have to equate into a rise of rental rates in order for it to be sustainable," he said.

The market moving forward

There's still plenty of reason for optimism in the market, brokers and bankers said.

In 2020 and 2021, amid COVID uncertainty, most commercial tenants downsized their space and extended their leases by only a year, Pesnell said. But at the end of 2022, that trend began to fade.

"Back in 2020, 2021, people were thinking, 'Do we even need office space at all? Or do we need half of we had?'" Pesnell said.

Legendre said investors will have to adjust, but sectors like petrochemical and industrial should continue to see solid activity.

"As quickly as they lowered (rates), they're coming back and raising them, and it's just a knee-jerk reaction," Legendre said. "I'm not smarter than the Fed for sure, but common sense will tell you that there's going to be fallout from this."

Scott Singletary, senior vice president of Concordia Bank and Trust, said he hasn't seen any major price corrections yet in the market, though he has had customers choose to "sit on the sidelines" until the dust settles.

"Supply and demand is still driving the prices that are out there," he said. "Some areas have slowed some, but there haven't been any big price corrections. There will probably some price corrections in the future."

Higher interest rates can present an opportunity for well-positioned investors as smaller players bow out of the market, said Mike Nizzo, southwest regional president for b1Bank. Investors who can weather higher rates can buy properties now, then “right size” expiring leases to create a better cash flow.
“For the stronger investors, this is where they make their best buys,” he said.

Baton Rouge also does well in downturns, Nizzo said. It’s a steadier market than big plays like California.

“Once things become more constant, I do believe our real estate market, our entire economy is going to adjust to it and still continue to do very well,” he said.

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