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Fed Interest Rate Cuts Won't Drive New Construction, But Still Good News

Lower rates are more likely to prompt real estate refinancing of existing projects as opposed to new construction, experts say.

By **Lidia Dinkova** | October 28, 2019 at 05:00 AM

L-R Noah Breakstone,CEO and managing partner at investment and development firm BTI Partners LLC in Fort Lauderdale and Peter Mekras president of real estate and investment merchant bank Aztec Group Inc. in Miami.

The Federal Reserve's two interest rate cuts this year generally bode well for the real estate market, although it doesn't necessarily feed more construction.

The Fed lowered the benchmark interest rate in July for the first time since the Great Recession a decade ago and then again in September. Each decrease was 25 basis point, or a quarter percentage point to lower the Fed fund rate at 1.75%-2%.

A third cut is expected as early as this week with the rate-setting Federal Open Market Committee meeting Tuesday and Wednesday.

The Fed fund rate is the bank-borrowing rate and, if banks borrow at lower rates, they can lend at lower rates.

Developers and home buyers generally can take out cheaper loans and borrow more when they're paying less in interest, developer Noah Breakstone noted.

"Typically, when interest rates are lower, there's an incentive to make that investment even for developers, real estate, manufacturing, anything in the business world," said Breakstone, CEO and managing partner at investment and development firm BTI Partners LLC in Fort Lauderdale. "The cost of borrowing is less."

BTI Partners has been in the market to finance a new multifamily project in South Florida and a new condominium community in Central Florida, Breakstone said. He declined to identify the projects with negotiations under way.

"We are seeing a direct relationship in the lowering of the Fed rate to the lowering of the cost of borrowing. We would look to borrow at close to 6.5% maybe six or eight months ago," Breakstone said. "We are seeing the same opportunities that we can borrow for development and construction at probably 5.75%. Maybe we are seeing half a point to three-quarters reduction. Usually there's a direct relationship with that."

The lower borrowing cost likely won't prompt more commercial construction in the busy South Florida market.

Instead, expect more refinancings of existing real estate, said Peter Mekras, president of Aztec Group Inc., a Miami real estate capital markets intermediary and merchant bank.

New construction is driven more by fundamentals such as demand and rents, but current owners of existing property generally want to secure lower interest rates by refinancing projects, he said.

Aztec is working to refinance a new apartment tower in Miami's Central Business District and a Lakeland shopping center, Mekras said, without identifying the developments.

If owners "previously could only borrow say $80 or $90 (million), they may be able to borrow $100. I am just using that as relative term. Meaning they can get more in loan proceeds because at the lower cost of interest, the amount of income coverage they have over the cost of the loan allows them to get a greater loan amount," he said. "This move is surely a positive for the borrowing and buying community at large."

Breakstone noted the new development costs won't be lower in spite of the lower interest rates because of recent increases in construction and labor costs.

"The cost of materials has increased, so it almost offsets the reduction of the added value of lower interest rates and having more affordable products," he said. "There's a number of elements that helps create affordability."

One group that would see more affordability is individual home buyers, who essentially can take out bigger loans because of lower rates.

"I want to buy $300,000 home and put 10% down and am left with a $270,000 mortgage. At 5% interest, the mortgage would be about $1,100 a month," Breakstone said in a hypothetical scenario.

“If interest rates were instead 3.5%, you can afford $340,000 and get the same $1,100 payment.”

This year’s rate cuts were factored in the trade war with China, weakness in U.S. manufacturing and a global economic slowdown. The thinking is that lower rates would encourage consumer borrowing and spending to boost economic growth.

Investors are more likely to take money out of the bank, where they are earning low interest, and put the money into real estate or other opportunities, Breakstone said.

“You may contemplate investing in the stock market or in a real estate opportunity, looking to make more money than the money just sitting there,” he said. “When rates are lowered, investment is encouraged. Whether you buy housing or you invest in equipment or new real estate opportunities, the cost of borrowing is less because interest rates are less.”