

WHAT HIGHER FOR LONGER REALLY MEANS FOR CRE INVESTMENT IN 2025

The Federal Reserve no longer needs to remind us that interest rates will remain higher for longer. The markets have accepted it, and commercial real estate is living it. In its latest move, the Fed delivered a modest quarter-point rate cut at its September meeting, lowering its benchmark range to 4.00% - 4.25%. The decision, widely anticipated as a risk management move to address labor market softening, signals a strategic shift, though the broader policy path remains uncertain amid internal divisions. Some Fed officials project a return to long-term neutral rates near 2.5%, while others see a future floor closer to 4%, underscoring the lack of consensus on how much easing is appropriate—or sustainable. What began as cautious language in 2022 has evolved into a structural reality that's reshaping CRE investment strategy. This isn't just about cost of capital. It's about repricing risk, restructuring portfolios, and redefining value in a market where asset performance, not momentum, drives decisions.

Borrowers, owners, and investors are navigating an environment where elevated rates are not a temporary headwind but a defining condition. Refinancing is no longer theoretical. Deal volume isn't just delayed; it's fundamentally repriced. Across every property sector, capital, leasing, and development decisions are being made through a more conservative, selective, and regionally nuanced lens.

STRUCTURAL PRESSURE FROM PERSISTENT RATES

Despite moderating inflation in energy and goods, core categories like housing and services remain sticky. Shelter inflation alone—roughly a third of the CPI basket—continues to exceed target. Chair Jerome Powell recently acknowledged persistent core inflation at 3.1% and headline inflation at 2.9%, both above the Fed's 2% goal.

Investors remain anchored to a higher-for-longer environment. Ten-year Treasury yields hover near 4%, and real borrowing costs often exceed 6%. The recent Fed cut offers marginal near-term relief, particularly on short-term debt, but has little immediate impact on longer-duration capital.

Capital markets have adjusted accordingly. Lenders are demanding stronger sponsorship, conservative leverage, and clear NOI stability. For borrowers, the new normal means tighter spreads, stricter covenants, and shorter loan terms. Even income-producing, well-located properties are feeling the pinch. While the recent rate cut may ease short-term borrowing costs, it's unlikely to shift lender behavior or valuation discipline without further reductions.

ONCE-LOOMING, REFI RISK REACHING CRISIS LEVEL

Refinancing risk is no longer theoretical—it's here. Roughly \$1.5 trillion in CRE loans are set to mature by the end of 2025. Lee & Associates professionals report a growing wave of short-term extensions as lenders and borrowers try to reconcile current values with peak-era underwriting.

Properties acquired at aggressive pricing are confronting major loan proceed shortfalls, especially where NOI has flatlined. Office and transitional multifamily are most vulnerable, particularly in overbuilt or rent-controlled markets.

Even strong assets in fast-growing metros like Dallas, Atlanta, and Phoenix are under pressure as loan maturities collide with recalibrated rent assumptions, higher taxes, and compressed cap rates. Debt-service coverage ratios are stretched thin. Some borrowers face hard decisions, such as strategic sales, discounted payoffs, or default.

HOW HIGHER-FOR-LONGER IS PLAYING OUT ON THE GROUND

While interest rate dynamics broadly affect CRE investment, sector-specific impacts are sharply divergent.

Office's Slow-Burn Restructuring: The office sector is undergoing an accelerated Darwinian reset. In markets like

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Denver, Chicago, and San Francisco, vacancy rates remain elevated well above 20%, particularly in Class B/C properties. Flight-to-quality continues, but even top-tier assets are scrutinized for tenant rollover risk and capital requirements. Infill conversions to lab, residential, or creative flex space are accelerating, but many outdated assets remain stranded. Lenders are triaging portfolios, and where trades occur, discounts of 30% to 70% from peak values are common.

Multifamily's Divergent Story: Multifamily remains favored, but fundamentals vary significantly. Urban cores like New York, Boston, and Los Angeles are stabilizing with tight vacancies. Meanwhile, Sun Belt markets that experienced explosive supply growth from 2021-2023, like Austin, Fort Myers, and Raleigh, see rising concessions and double-digit vacancies. High construction costs, extended lease-up periods, and local rent caps (such as Washington State's 7% plus CPI cap, equating to approximately 9.683% in 2026) add complexity to underwriting. Private buyers leveraging low-leverage or all-cash strategies are capitalizing on opportunities to purchase well below replacement value.

Industrial Still Means Business: The industrial sector remains fundamentally sound but no longer overheated. National vacancy ticked up to 7.4% in by midyear, with big-box distribution centers in markets like Phoenix and Chicago facing slower absorption. However, urban infill, last-mile, and specialized industrial space, including cold storage, small-bay, and flex, continue to perform well. Investor focus is shifting toward smaller format assets in supply-constrained infill markets, where tenant stickiness, limited new supply, and manageable capital budgets provide insulation against debt volatility.

Experiential and Essential Driving Retail: Retail has surprised many with its durability. Despite macroeconomic pressures, neighborhood centers, grocery-anchored assets, and experiential retail continue to outperform. National vacancy stands at a historically tight 4.3%, with markets like Miami, Charlotte, and San Diego commanding premium rents. That said, bifurcation persists. Outdated power centers and non-credit-anchored properties in tertiary markets face softening demand. Investors remain active, particularly private capital and family offices focused on cash-flowing assets insulated from e-commerce displacement.

A DELICATE BALANCE IN CAP RATES

Cap rates have held relatively stable at the national level, but the surface calm hides a deeper divide. Sellers continue to underwrite peak pricing, while buyers account for today's rates and tomorrow's risks. The result: a valuation standoff unlikely to resolve until more trades re-establish pricing benchmarks.

This tension is expected to persist through late 2025, particularly in multifamily and industrial, where income fundamentals are still strong. Cap rate expansion, when it occurs, often takes the form of silent repricing rather than headline yield shifts. Our next article will explore this in depth.

AN INVESTMENT PLAYBOOK FOR THE NEW NORMAL

In the wake of the Fed's rate cut, some investors are hoping for a looser monetary path, but the current reality still demands disciplined strategy. The CRE investment thesis in 2025 is no longer about anticipating a Fed pivot; it's about operating with discipline, maintaining capital agility, and managing downside risk in a structurally elevated rate environment. Timing matters less than control.

In this environment, successful investors are adjusting their playbooks in several key ways:

Prioritizing In-Place Cash Flow: Stabilized income streams offer the most reliable hedge against elevated borrowing costs and prolonged capital market dislocation.

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Unlocking Value Through Operational Execution: With capital expenditures harder to justify, value creation is coming from leasing optimization, expense control, and targeted asset repositioning—not major renovations.

Underwriting the Exit Before Entry: With liquidity uncertain, deals must pencil on their own merits. Investors are preparing to own and operate through the full cycle, not just to hold for short-term appreciation.

Working the Capital Stack More Creatively: As conventional senior debt becomes harder to secure, financing structures increasingly include seller carrybacks, preferred equity, and bridge-to-perm hybrids to close gaps.

Targeting Efficient Value-Add Plays: Focus has shifted to assets with clear operational or functional upside—such as leasing friction, layout inefficiencies, or obsolescence that can be corrected without overcapitalizing.

In a higher-for-longer regime, returns are no longer driven by leverage or timing—they're earned through execution. This market rewards pragmatism, flexibility, and deep local insight.

THE LEE LENS: NAVIGATING FRAGMENTATION AND SELECTIVITY

This higher-for-longer cycle is forcing CRE to grow up. For many investors, it's the first truly rate-sensitive environment of their careers—and the old playbooks no longer apply. Momentum isn't a strategy. Core doesn't guarantee safety. And capital isn't cheap enough to mask underwriting flaws.

The Fed's recent rate cut provides modest relief and a psychological lift, improving short-term borrowing conditions and boosting investor confidence. But with internal divisions on the path ahead and policy guidance still unclear, any optimism is necessarily cautious.

Elevated rates may be here to stay, but so are the fundamentals of commercial real estate. It's not about waiting for a Fed pivot—it's about identifying opportunity within the new baseline.

This article is part of Lee & Associates' ongoing thought leadership series, offering market intelligence and expert perspectives from across the platform. The insights shared here reflect contributions from the following Lee professionals:

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