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Leverage - The future risk no one is talking about

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Over the past several years, commercial real estate has attracted investors not only for its potential capital appreciation but also for its income relative to other investment options in the current low-yield environment. As investors deploy capital they are accumulating portfolios of institutional real estate at historically low cap rates. While the current spread between real estate cap rates and 10 year Treasuries is favorable compared to historical levels, current low cap rates (and underwriting) reflect the expectation that the low interest rate environment will continue over the long term.

Investors have accepted current cap rates and leverage terms in underwriting investments acquired or developed with debt, which still accompanies a majority of real estate acquisitions. Given current interest rates it is understandable that real estate investors will utilize leverage in building their portfolios. What is more uncertain, however, is the impact of a significant rise in interest rates to levered real estate. Investors review refinancing sensitivities for leveraged real estate but the scenarios rarely reflect a return to mean reverted debt levels.

The likely reason such significant downside modeling is not performed is that investment professionals expect that interest rates will remain low for an extended period of time. Certainly the continuation of the global trend of deleveraging has put downward pressure on the markets and continued sluggish business activity and receding inflation (and the prospect of deflation) suggest low rates will remain for a period of time. But for how long?

Why do I raise this as a concern? Certainly the multiple impacts to a mean reverting debt environment will have broad implications not only to real estate but also to all asset classes. Bonds in particular will react quickly to rising interest rates since today's historically low interest rates have resulted in record high duration in the fixed income market. (Duration is a bond's price sensitivity to interest rate increases. For example, if you own a 10-year bond with a five-year duration and interest rates increase 1%, you should expect it to lose 5% of its value.)

The reason I raise this concern is that although rates are expected to remain low for an extended period, interest rates have more room to rise than fall and, as the economy recovers, are likely to move higher. Therefore, it is important that real estate investors understand the impact of maturing debt to their properties through sensitivity analysis and extrapolate that (potentially very negative) result to how they might mitigate the risk through structure of the debt or possible alternative strategic property initiatives to offset potential increased debt service and reduced equity returns.

In addition to examining leverage sensitivity and strategic alternatives, a focus on (a) income, (b) specific deals and relative value with greater opportunity to outperform and (c) a long term outlook with themes expected to favorably impact real estate and evolve over a five+ year time frame can strengthen the prospect for real estate performance and particularly levered real estate in a period of rising interest rates.

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